As The World Turns

Strategy: Transports Rolling Along. The world is still turning. The sharp drop in stock prices around the world during the first half of October was partly attributable to fears of a global economic slowdown. Those fears seemed to be confirmed by falling commodity prices. The plunge in the price of a barrel of Brent crude oil was a particular concern, as evidenced by the 9.2% drop in the S&P 500 Transportation stock price index from its then-record high on September 18 to the recent low on October 13 (Fig. 1).

Since then, this index rebounded 14.7% to yet another record high last Friday as investors suddenly realized that if the world continued to turn after all, then transportation companies would be the most obvious immediate beneficiaries of lower fuel prices. Industry analysts jumped on board the train, and raised their 2014 and 2015 earnings estimates (Fig. 2). They now expect earnings to rise 15.6% this year and 16.7% next year.

The forward earnings of the S&P 500 Transportation composite rose to a record high during the 10/23 week, as it has been doing since August 2010. The forward P/E rose from a recent low of 15.0 to 16.7 yesterday (Fig. 3). The stocks aren’t cheap, but their earnings outlook is very good given the ongoing improvement in the US economy and lower fuel costs. We continue to recommend overweighting the S&P 500 Air Freight & Logistics, Airlines, Railroads, and Trucking Industries. (Click to add S&P 500 Transportation to MyPage.) Let’s briefly review the latest bullish fundamentals:

(1) Railcar loadings. According to Atlantic Systems, railcar loadings rose in late October to the highest pace since December 2007, based on the 26-week average Debbie and I use to smooth out the volatile data (Fig. 4). The total is at a record high excluding coal loadings, which have been depressed by tougher regulations on coal usage by power plants and cheaper natural gas. The weakness in coal loadings that started in 2009 has been partially offset by strength in petroleum loadings that started in 2009 has been partially offset by strength in petroleum loadings.

The big story for the railroad industry has been the rise to record highs since late August 2013 in intermodal loadings. This series tends to be highly correlated with real business inventories (Fig. 5). The latest record highs in both suggest that the US economy is strong and that retailers are getting set for a very good holiday shopping season.

(2) Trucking index. Also at a record high during September was the ATA Trucking Index, which measures trucking tonnage (Fig. 6). It is also highly correlated with both real business inventories and intermodal railcar loadings. (Click to add Railcar Loadings & Truck Tonnage to MyPage.)
US Economy: On the Right Track. There are plenty of other economic indicators showing that the US economy remains on the right track. However, a few recently have been suggesting that it isn’t barreling along. That’s alright, in our opinion, since it reduces the odds of derailing the economy. Let’s review:

(1) GDP. Real GDP rose solidly during Q3 by 3.5% (saar). It has risen by 3.5% or better for the past four out of five quarters. However, it was up 2.7% excluding government spending, which was led by an odd 16.0% jump in defense spending. Nevertheless, on a y/y basis, real GDP continues to grow around 2%, as it has been since 2010 (Fig. 7). Excluding government spending, it continues to grow solidly around 3%.

Debbie and I are most impressed by the strength of capital spending on both industrial and transportation equipment in real GDP (Fig. 8). The former is up 16.5% y/y, while the latter is up 16.6% y/y. This confirms that manufacturing is enjoying a renaissance that it is driven not only by cheaper energy costs but also by more domestic demand.

(2) Personal income & spending. Real personal consumption expenditures contracted 0.2% during September, the weakest since January’s 0.3% decline. That’s likely to be reversed given that real wages and salaries continue to climb to new record highs. It was up 0.1% m/m, but 3.6% y/y. The recent plunge in gasoline prices will boost consumers’ purchasing power and should boost their spending.

Auto sales averaged 16.8 million units (saar) during Q3. October sales totaled 16.5 million units and are likely to move higher over the last two months of the year in response to lower gasoline prices. Retail sales of gasoline exceeded $500 billion (saar) in recent months. A decline of 20%-30% in the price of gasoline would save consumers $100 billion to $150 billion per year.

(3) Wages. There is finally a sign that wage inflation may be picking up a bit. Wages and salaries in the Employment Cost Index for private industry workers rose 2.2% y/y during Q3, the highest since Q4-2008 (Fig. 9). This is one of the key indicators on Fed Chair Janet Yellen’s “dashboard.” However, she would like to see it rising by 3%-4%. At least it is heading in the right direction, though it has yet to be confirmed by average hourly earnings, which remained stuck around 2.0% y/y during September.

(4) M-PMI. Manufacturing activity in the US accelerated last month according to the ISM survey, but slowed according to Markit. ISM’S M-PMI reversed September’s decline, climbing from 56.6 to 59.0, back up at August’s cyclical high, which was the highest since March 2011. The gauge for new orders rebounded from 60.0 to 65.8, its second-highest level since August 2009 and its fourth straight month at 60 or higher.

Markit’s M-PMI fell for the second month, from August’s 57.9 (the highest since April 2010) to a three-month low of 55.9 in October, still solid growth. The average composite index of the regional business surveys conducted by several Fed district banks sided with Markit. It fell from 17.5 during September to 12.9 during October. (Click ⭐ to add Business Surveys to MyPage.)

Global Economy: Muddling Along. The ongoing decline in oil prices since the summer reflects a glut of supply rather than a sudden slowing in the global economy, in our opinion. We note that the CRB raw industrials spot price index remains range-bound since 2012, though it is near the bottom of that range (Fig. 10). If it dives below it, we will have to reconsider our assessment of the global economy. Here’s a brief rundown on some other recent economic indicators:
(1) **Europe.** As Debbie reported yesterday, manufacturing activity in the UK improved in October, while it remained subdued in the Eurozone. The UK’s M-PMI increased for the first time in four months from a 17-month low of 51.5 in September to a three-month high of 53.2 last month, boosted by domestic demand. The Eurozone’s M-PMI ticked up from a 14-month low of 50.3 to 50.6, the third reading just above 50 (*Fig. 11*).

(2) **China.** China’s official M-PMI fell from 51.1 to a five-month low of 50.8 last month (*Fig. 12*). Growth slowed for production (from 53.6 to 53.1) and new orders (52.2 to 51.6), while new export orders (50.2 to 49.9) contracted for the first time in May, albeit slightly. The supplier deliveries measure was unchanged at 50.1. The employment measure ticked up from 48.2 to 48.4, its 29th consecutive reading below 50.

**CALENDARS**

**US.** **Wed:** ADP Employment 230k, Markit NM-PMI 57.1, ISM NM-PMI 58.0, MBA Purchase Applications, Kocherlakota. **Thurs:** Jobless Claims 283k, Productivity & Unit Labor Costs 1.5%/0.8%, Challenger Job-Cut Report, Weekly Consumer Comfort Index, Powell, Mester. (Bloomberg estimates)

**Global.** **Wed:** Eurozone Retail Sales -0.8%m/m/1.5%y/y, Eurozone, Germany, France, and Italy NM-PMIs 52.4/54.8/48.1/49.4, UK M-PMI 58.5, BOJ October Meeting Minutes. **Thurs:** Germany Factory Orders 2.0%m/m/-1.1%y/y, UK Headline Industrial Production 0.4%/1.6%, UK Manufacturing Production 0.3%m/m/2.8%y/y, Japan Leading & Coincident Indicators 105.5/109.8, Australia Employment Change & Unemployment Rate 10k/6.1%, ECB Bank Rate Decision, Deposit Facility Rate, and Marginal Lending Facility 0.05%/-0.20%/0.30%, BOE Rate Decision and Asset Purchase Target 0.50%/375b. (DailyFX estimates)

**STRATEGY INDICATORS**

**Fundamental Stock Market Indicator** (*link*): Our FSMI—a good coincident indicator that can confirm or raise doubts about stock market swings—fell 0.5% during the final week of October after rising five of the prior six weeks by a total of 2.9% to a new record high. Our FSMI is the average of our Boom-Bust Barometer (BBB) and Bloomberg’s Weekly Consumer Comfort Index (WCCI). The BBB also slipped 0.5% after a six-week climb of 4.5% to a new record high. The recent run up in the BBB was led by a sharp cut in jobless claims to a new cyclical low, which more than offset a drop in the CRB raw industrial spot price index—another BBB component. Jobless claims continued to improve during the latest week, falling to 281,000 (4-wa), but not enough to offset the decline in the CRB. The WCCI sank 1.3% after rising two of the prior three weeks by a total of 8.3%.

**S&P 500 Q3 Earnings Season Monitor** (*link*): With 74% of S&P 500 companies finished reporting their Q3-2014 results, the earnings surprise metrics are the strongest since 2010-2011, but revenue surprise metrics have lagged. Of the 370 companies in the S&P 500 that have officially reported Q3-2014 results, 75% have exceeded industry analysts’ earnings estimates by an average of 5.4%; they’ve averaged y/y earnings growth of 11.2%. That’s better than the same time period in Q2-2014, when fewer companies (68%) in the S&P 500 beat consensus earnings estimates by a smaller surprise of 3.0% and lower growth (-0.3). However, only 59% have beat Q3 sales estimates so far, coming in 0.2% above forecast and 4.1% higher than a year earlier. That’s weaker than Q2’s comparable results of 64% above forecast by an average of 1.3% and up 5.2% y/y. Energy is the only sector recording a y/y decline in revenues. Consumer Discretionary is the only sector with a y/y decline in earnings, and it’s still negative without the Homebuilders. Financials’ results, particularly Bank of America, are giving a slight boost to the S&P 500’s aggregate earnings surprise, but are lowering earnings growth. Ex-Bank
of America, the S&P 500 earnings surprise weakens to 4.9% from 5.4%, and earnings growth improves to 12.5% from 11.2%.

GLOBAL TRADE INDICATORS

Global Trade (link): The volume and value of world trade both moved lower in August. Trade volume slipped 0.8% after rising three of the prior four months by 3.7% to a new record high. The value of trade sank 7.8% after a 3.8% increase and a 1.2% decrease the prior two months, remaining in record territory. These data tend to be very volatile from month to month; the 12-month sum remained at its record high in August.

G7 Exports (link): Export growth in most G7 economies remains in record territory, though some are faltering. German exports plunged 7.3% in August (the steepest monthly drop since January 2009) after reaching a new record high in July. French exports retreated 4.7% in the two months ending August; Italy’s were down 4.8% during the three months through August. UK exports continue to hold in a volatile flat trend around recent highs, though are down at the bottom of the range; Japan’s appear to have found a bottom. Exporters in both the US and Canada are feeling the impact of a weakening European economy, though their exports remain on uptrends in record territory.

US Merchandise Trade (link): The real trade deficit widened at the end of Q3, suggesting that trade may be less of a positive to GDP than first estimated. (Preliminary estimate showed trade added 1.32ppt to Q3 GDP.) The real merchandise trade deficit (used to calculate real GDP) widened for the second month to -$50.8 billion in September (steepest since April’s six-year high of -$54.0 billion) after narrowing to a low for the year of -$47.7 billion in July. Despite September’s widening, Q3’s average monthly gap of -$48.9 billion remained considerably below Q2’s average of -$51.7 billion. Real exports of goods fell for the first time in seven months, down 1.8%, after a six-month jump of 6.9% to a new record high. Real imports increased for the third month by a total of 1.4% after a two-month slide of 1.9%. September’s drop in real exports was widespread, led by industrial supplies (-4.1%), consumer goods (-3.7) and capital goods (-2.6), with food exports (13.2) the only positive. Real imports saw mixed results, with gains in consumer goods (4.2) and food (0.8) more than offsetting declines in capital goods (-1.8), auto (-1.7), and industrial (-1.0) imports. The nominal merchandise trade gap widened to -$62.7 billion from -$60.2 billion in August and -$59.8 billion in July. It was at a two-year high of -$65.7 billion in April.

Emerging Markets Exports (link): Exports in Eastern Europe, which was the strongest market recently, have stopped climbing. The Czech Republic, Hungary, and Poland have seen their exports drop from recent highs; Russian and Romanian exports remain volatile around their highs. Ukraine’s continue to trend lower. In Asia, the exports of most countries we track are moving sideways around record highs, except in China where exports reached a new record high in September. Indian exports are also showing signs of life recently. In Latin America, Mexico’s exports remain on uptrend, holding at its record high in September. Exports in Venezuela have plunged after an impressive upswing from their cyclical low; Colombian exports have stalled after rebounding off three-year lows. Exports from Argentina, Brazil, and Chile remain very volatile.

FOCUS ON S&P 500 TRANSPORTATION

S&P 500 Transportation Railcar Loadings & Truck Tonnage (link): Truck tonnage was unchanged at August’s record high in September. It’s up 6.8% since hitting a recent low in January. ATA’s Chief Economist noted, “September data was a mixed bag, with retail sales falling while factory output increased nicely. As a result, I’m not too surprised that truck tonnage split both of those readings and remained unchanged.” Railcar loadings are following the seasonal pattern of recent years—a weak first
half followed by a strong second half--with loadings on an upswing after their first-half slump to a new cyclical high.

**S&P 500 Transportation Composite** ([link]): The S&P 500 Transportation Composite rose 40.9% in 2013, and its 22.2% gain ytd to a record high is well above the S&P 500’s 9.2% rise. Forward revenues and earnings have been rising to record highs since September 2013. Valuation of 15.8 is up from a 12-month low of 15.0 in mid-October, and the relative valuation is up to a 5% premium to the market from a near-11-year-low discount of 15% in mid-2012. NERI was positive in October for a sixth straight month, but edged down to 23.7% from a 44-month high of 23.9% in September. Analysts expect earnings to rise 15.6% in 2014 on revenue growth of 6.4%, before rising a faster 16.7% in 2015 on slower revenue growth of 4.8%.

**S&P 500 Air Freight & Logistics** ([link]): Air Freight & Logistics’ stock price index rose 38.7% in 2013 for the lowest gain among the four Transport industries, and its 6.2% gain ytd is the worst too, but up to a record high. Analysts’ forward revenues and forward earnings are at record highs too. They expect revenue growth of 5.2% in 2014 to result in earnings growth of 16.4%, and to pick up to 5.6% and 16.9% in 2015. The biggest risks to earnings is slower global growth and price competition, but lower fuel prices are a positive. The P/E of 17.6 is down from a four-year high of 18.7 last December, and its 16% premium to the market is down from a two-year high of 24% in November 2013. NERI was positive in October for a fourth straight month, and improved to 4.7% from 4.5% in September. The forward profit margin of 6.5% has held steady near a three-year low; it’s down from a record-high 7.9% in 2006.

**S&P 500 Airlines** ([link]): Airlines’ stock price index continues to fly high, rising 62.0% ytd to a record high for the second-best performance among the 130 S&P 500 industries, up from seventh-best in 2013 with a 71.2% full-year gain. This industry has tremendous earnings leverage and high sensitivity to fuel prices. Forward revenues and earnings have been making new cyclical highs, with earnings at the highest level since early 2001. During 2013, Airline industry revenues rose 3.2%, and earnings soared 18.1%, up from a forecasted earnings decline of 10.3% back in January. They expect revenue growth to slow to 4.6% in 2015, but expect earnings growth to pick up to 22.6%. The P/E of 11.5 is up from a five-year low of 8.8 in September 2013, and its 24% discount to the market is up from a 12-year low of -38% back then. NERI edged down to a still-impressive 50.2% in October from 51.0% in September and a record high of 59.4% in July. That’s the highest among the Transports and positive for 13 straight months. The forward profit margin of 7.9% is at a record high for the first time since late 2009.

**S&P 500 Railroads** ([link]): The Railroads index was up 39.3% in 2013, and has risen another 27.1% ytd to just 1.0% below its recent record. Forward revenues and forward earnings had stalled during 2012-2013, but are back at record highs now as consensus forecasts move higher for 2015. The implied forward profit margin of 19.7% is at a record high and is more than double the next best Transport industry, Airlines at 7.9%. Analysts expect revenue growth of 10.0% in 2014 to result in earnings growth of 14.0%, above 2013’s 3.6% and 10.7%, respectively. Analysts expect revenue growth to slow to 3.1% in 2015, but expect the earnings growth rate to edge up to 14.1%. Railroad’s P/E of 16.6 is close to mid-September’s record high of 17.2, and its premium to the market is up to 10% now after stalling at around 1% since early 2013. NERI has oscillated between negative and positive territory ten times in the past three years, but improved to a four-year high of 33.2% in October from 32.5% in September.

**S&P 500 Trucking** ([link]): The Trucking index increased 47.8% in 2013 and is up another 20.3% ytd, but has pulled back 5.1% from its record high in mid-September. Forward revenues has been edging slowly higher to new record highs recently, but forward earnings has risen at a faster pace to new records. Analysts expect revenue growth of 4.0% in 2014 to result in earnings growth of 14.7%, before
picking up in 2015 to 5.0% and 15.9%, respectively. The implied forward profit margin of 4.8% is at a record high, but is lowest among the transport-related industries. Trucking’s P/E of 12.8 is down from a three-year high of 14.8 in mid-September, and its discount to the market of 15% is up from a cycle-low 32% discount in mid-2012. NERI dropped to 26.3% in October from 33.7% in September, but was positive for a sixth straight month.