More Grand Plans, Again

(1) A list for the bulls. (2) Grand Plans buy time. (3) Getting ready for a Grexit. (4) Strong dollar weakens commodity prices. (5) Why are oil prices falling? (6) US growing. (7) Sentiment is bearish, which is bullish. (8) April and May data confirm housing recovery. (9) Lots of weak indicators in Europe and China.

For your convenience, a collection of the individual charts linked below and a PDF version of this text are also available.

Strategy. That was a nice rebound yesterday. The S&P 500 closed up 0.2%, after falling by as much as 1.5% earlier in the day. It did that mostly after European stock markets closed for the day and after 27 European leaders ended their one-day meeting in Brussels. Once again, they met in an emergency session to discuss what to do about their financial crisis. It was the 18th summit in more than two years of crisis fighting.

Just imagine what our stock market could do on the upside if Europe wasn't such a pain in the backside. We all know all the reasons to be bearish. Let's review a few of the reasons to remain bullish, or at least to expect that any more downside is a correction rather than the end of the bull market:

(1) Europe's Grand Plans may not be so grand, but they do tend to buy more time. Rumor has it that the stock market rallied late yesterday on a rumor that Germany might agree to a plan to provide an EMU-wide guarantee of bank deposits at an informal dinner of the European leaders last night. On Monday, Ambrose Evans-Pritchard of The Telegraph reported that the euro zone's “Latin Bloc” (France, Italy, and Spain) would push for this measure at Wednesday's meeting.

If any progress was made on this issue yesterday in Brussels, it remains a well-kept secret. The headline stories covered by Reuters, FT, and WSJ all focused on the lack of agreement and lots of discussions on preparing for the Grexit. Senior finance ministry officials from the 17 euro zone governments decided on Monday to develop national "contingency" plans should Greece abandon the euro.

In any case, there will be plenty more emergency meetings, and opportunities for relief rallies like the one yesterday. At their dinner, the European leaders agreed to meet again in June. This morning’s FT reports that there was a discussion late last night about a plan proposed by Italy’s Mario Monti, and supported by France’s François Hollande, for deposit guarantees backed by the 17 members of the euro zone. They also talked about commonly backed Eurobonds, which the Germans continue to strongly oppose.

Herman Van Rompuy, president of the European Council, cautioned that even the June plan would be limited to “building blocks” and “working methods” towards economic integration. In other words, don’t expect any specific proposals towards a banking union or mutualizing euro zone debt.
(2) The euro may be starting to trade more like the drachma than the D-mark. It fell below $1.26 yesterday, down from $1.40 a year ago, and the lowest since July 1, 2010 (Fig. 1). That could provide a boost to European exporters and offset some of the weakness in domestic demand in the euro zone. On the other hand, contrarians should be on the lookout for a bounce since large speculators had a record net short position in the euro during the week of May 15 (Fig. 2). Contrarians will be on the lookout for a bounce.

(3) The flip side of a weak euro is a strong dollar, which is putting downward pressure on commodity prices, including oil. I tend to worry about the outlook for global economic growth when the CRB raw industrials spot price index is falling. The same goes for copper, which is included in this index. However, some of the recent weakness in commodity prices is attributable to the strength in the dollar (Fig. 3 and Fig. 4). On the positive side, lower commodity prices can provide a boost to profit margins, as long as final demand grows and doesn’t fall into a recession.

(4) Falling oil prices should help revive global growth. The recent drop in the price of oil would also concern me if it was unambiguously related to weakening global economic activity. But again, the stronger dollar can explain some of the recent weakness in oil (Fig. 5). Another important factor in the oil market is that the Saudis are doing their best to flood it in order to increase the effectiveness of sanctions imposed against Iran.

The sanctions seem to be working, and yesterday’s news that the Iranians may be starting to budge on the nuclear issue helped to send the spot price of a barrel of Brent crude oil down by $3.00 to $106.21, the lowest since December 19, 2011. The nearby futures price of gasoline has dropped by 54 cents since March 26 (Fig. 6). This morning’s WSJ reports that during yesterday’s negotiations, the Iranians balked at making any concessions unless the sanctions are lifted. However, the price of oil is up only slightly this morning.

Did you notice that nobody in Washington is holding hearings to investigate why the price of gasoline is plunging? Our fearless political leaders only do so when it is going up. That’s because everyone likes lower gasoline prices, which should lift consumer confidence and spending this summer in the US. The Europeans may not be quite as lucky since a weaker euro to some extent offsets the drop in oil prices. However, fuel prices are a major component of budgets and inflation rates in emerging economies. They get a direct economic boost from lower oil prices, and can provide more monetary stimulus when inflation is ebbing.

(5) The US economy isn’t booming, but it is growing relatively well. The drop in the price of gasoline seems to be lifting consumer spirits already. The Gallup Economic Confidence Index rose to a new high last week for the first time in the four-plus years of this poll. Rising confidence may also reflect improving labor market conditions. If so, then auto sales of autos should continue to rebound, and home sales should finally start to recover, as discussed below.

Debbie tracks the regional business surveys as they are released each month and averages their key components. For May, we have survey data collected by the Federal Reserve Banks of New York, Philadelphia, and Richmond for their districts (Fig. 7). The May averages for overall business conditions, new orders, and employment all declined from their April readings, but remained solidly in positive territory. Indeed, May’s average employment index for the three districts was the second best reading in the past 11 months.

(6) Sentiment is very bearish, which is bullish. The Investors Intelligence Bull/Bear Ratio dropped to 1.44 this week. It was at an 11-month high of 2.45 seven weeks ago (Fig. 8). Bullish sentiment fell from
39.4% a week ago to a seven-month low of 38.3%. Bearish sentiment jumped to 26.6% from 20.4% two weeks ago, which was the lowest since last May. Those calling for a correction sank to 35.1% from a multi-decade high of 40.9% two weeks ago (Fig. 9).

**US Economy.** Is that a recovery in the housing market? It seemed so earlier this year. However, there was some debate about whether the mild winter weather might have provided a temporary lift. We now have data for new and existing home sales during April. They didn’t retreat as they might have if spring sales had been brought forward by the balmy weather during the first three months of the year. (You can see all the latest charts of these and other housing-related indicators in our Analyst’s Handbook: Real Estate. To receive updates of this and our other publications by email, click on the Home Delivery link at the top.) Here are some of the highlights:

(1) May data are available for the monthly survey conducted by the National Association of Homebuilders. Their Housing Market Index rose to a new cyclical high of 29, the best reading since May 2007 (Fig. 10). It tends to be highly correlated with new single-family home sales and housing starts.

(2) On a seasonally adjusted basis, the inventory of new homes for sale edged up to 146,000 in April after falling in March to 144,000 (Fig. 11). Those are the lowest readings on the record, which started in 1963!

(3) Single-family existing home sales during April were up 9.9% y/y (Fig. 12). The most startling development is that the median single-family existing home price was up 10.4% y/y during the month, the best pace and first double-digit increase since January 2006 (Fig. 13).

**Global Economy.** While the US economy continues to grow, the economies of Europe continue to contract. In China, the government is scrambling to provide some more stimulus to boost growth. Let’s review this morning’s data:

(1) Markit’s preliminary composite purchasing managers’ index (PMI) for the 17 nations of the euro zone fell to 45.9 in May from 46.7 in April. That was the fourth straight decline and the lowest reading since June 2009, when the euro zone was last in recession. This index covers manufacturing and non-manufacturing firms.

(2) France’s composite PMI was very weak, falling to a three-year low of 44.7 in May from 45.9 in April. The index for Germany performed better, contracting slightly with a reading of 49.6 from 50.5 in April.

(3) Germany’s Ifo business confidence index fell to 106.9 in May from 109.9 in April (Fig. 14). The drop was led by the current component of the index, though the expectations component also dipped (Fig. 15). The May 6 election results in France and Germany undoubtedly contributed to this fall.

(4) The second estimate for Q1-2012 GDP in the UK shows that it shrank 0.3% q/q. That compares with a preliminary estimate released on April 25 of a 0.2% contraction. On the other hand, Germany’s GDP grew by 0.5% in Q1 on a bounceback in exports, which rose 1.7%.

(5) China’s preliminary manufacturing purchasing managers’ index, produced by HSBC, fell to 48.7 in May from a final reading of 49.3 in April, a seventh-straight reading below 50. The more comprehensive official index has been stronger, and its May reading will be out at the end of next week.

**CALENDARS**
US. Thurs: Durable Goods Headline & Ex Transportation Orders 0.5%/0.7%, Jobless Claims 371k, Kansas City Fed Manufacturing Index, Dudley. Fri: Consumer Sentiment 77.8. (Bloomberg estimates)

Global. Thurs: China Flash Manufacturing PMI, Germany GDP 0.5% q/q/1.7% y/y, Germany Manufacturing and Services PMIs 47/52, Germany Ifo Business Climate, Current, and Expectations 109.4/117.1/102.2, Euro Zone Composite, Manufacturing, and Services PMIs 46.6/46.0/46.7, UK GDP -0.2% q/q/0.0% y/y, UK Retail Sales Headline & Core 0.7%/1.0%, Japan CPI Headline and Ex Food & Energy 0.4%/-0.4% y/y, Bank of Japan Monthly Economic Report. Fri: Germany GfK Consumer Confidence 5.6. (DailyFX estimates)

STRATEGY INDICATORS

Earnings Season Monitor (link): How are the companies in the S&P 500 Retail Composite reporting relative to the S&P 500? Their surprise is smaller, but more of them are beating forecasts. With 88%, or 37, of the Retail Composite companies having reported Q1-2012 results (versus 96%, or 481, of the S&P 500), it clearly was a better-than-expected quarter: 75.7% of the retailers exceeded industry analysts’ earnings estimates (versus 66.3% for the S&P 500), and 69.4% beat sales estimates (64.9% for the S&P 500). Retail Composite earnings came in 4.5% above forecast, slightly below the S&P 500’s 4.8%, but the Retail revenue surprise of 1.1% matched the S&P 500’s. Retail Composite earnings growth also beat the S&P 500’s (11.9% versus 7.8%), and so did revenue growth (7.6% versus 5.4%).

S&P 500 Earnings, Revenues, & Valuation (link): Industry analysts were mostly less optimistic last week on prospects for revenues and earnings, but unchanged on profit margin expectations, near their lows. Revenue and earnings forecasts for S&P 500 companies fell last week for 2012 and 2013, but were mixed for the next 12 months. Forward earnings are at a record high again, but the forward revenue forecast edged down 0.1% from its highest level since September 2008. The projected revenue growth rates were steady to slightly higher last week for 2012 (4.0%) and 2013 (up to 4.8%), but earnings growth rate changes were mixed (down to 8.9% from 9.1% for this year, up to 12.5% from 12.4% for next year). Projected profit margins held steady for both years (9.5% and 10.2%).

S&P 500 Sectors Earnings, Revenues, & Valuation (link): Forward revenue and EPS estimates rose last week for less than half of S&P 500 sectors (four and three, respectively). Forward revenues are at a record high for Health Care and Industrials, but down from recent record highs for Consumer Staples and Tech. Forward earnings rose to new record highs for Consumer Discretionary and Industrials, but fell from recent record highs for Consumer Staples, Health Care, and Tech. The y/y change in forward earnings is down from cyclical peaks for all sectors except Tech. Tech is the y/y forward earnings momentum winner (up 18.6%), followed by Consumer Discretionary (11.2) and Industrials (11.1). The S&P 500’s P/E fell to 11.9 last week from 12.2, and is off from its 11-month high of 13.0 in late March.

US ECONOMIC INDICATORS

New Home Sales (link): The market for new homes remains depressed, though recent signs are encouraging. Sales increased a larger-than-expected 3.3% in April to 343,000 units (saar), posting only one decline in the past eight months (for a total gain of 17.5%). The number of new homes on the market (146,000 units) was little changed from March’s record low of 144,000. Stronger sales dropped the months’ supply to 5.1, near February’s six-year low of 4.9 months. The median new home price was up 4.9% y/y last month, though this data tend to be volatile; based on a three-month average, prices were up 6.3%. Builders’ low inventory could help support prices and spur home building if a better jobs environment boosts demand later this year.
Mortgage Applications (link): Falling mortgage rates are boosting the MBA refinancing index. The refinancing index rose for the third straight week (through May 18), by a total of 20.8%, to its highest reading since early February. The index had been trending lower before the recent rebound. The applications for new purchase index has lost steam in recent weeks, falling 3.0% adding to the prior week’s 2.4% decline. That followed a three-week spurt of 9.2%. Fundamentals suggest that this index has more upside than downside.