Wrong Side of the Bed

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Strategy: Wrong Footed. There is an ancient superstition that it’s bad luck to put one’s left foot down first when stepping out of bed in the morning. On Monday, the stock market started the new year wrong footed by several developments:

(1) China’s cold noodles. China’s weak December official M-PMI (compiled by the China Federation of Logistics & Purchasing) and the Caixan/Markit unofficial M-PMI renewed fears of decelerating Chinese economic growth (Fig. 1). The former wasn’t as weak as the latter, and the output component of the official measure remained solidly above 50.0 at 52.2, as it has since February 2009 (Fig. 2).

Nevertheless, Monday’s 7% plunge in the Shanghai and the weakness in the yuan also raised alarm bells about China among investors (Fig. 3 and Fig. 4). These market reactions seemed to confirm that China’s economy is in serious trouble. However, the plunge in stocks was exacerbated by fears that a ban on selling shares would expire on Friday. Yesterday’s FT reported: “China is to extend a ban on stock sales by large shareholders until permanent rules to restrict such sales take effect, as authorities seek to calm market fears over the lock-up that was due to expire on Friday.”

Yesterday, there was more bad news out of China. The Caixan/Markit NM-PMI fell to 50.2 during December, the weakest reading since July 2014 (Fig. 5). That suggests that the transition from manufacturing to services isn’t proceeding well. However, that’s totally at odds with the official NM-PMI, which rose to 54.4 in December, the highest since August 2014. No wonder China’s stock market has tripped up, with China’s left foot and right foot headed in completely different directions!

(2) US losing energy. The US economic outlook was wrong footed by December’s disappointing M-PMI on Monday and slower December auto sales reported on Tuesday. On Wednesday, there was more bad news about the NM-PMI. The good news was that US auto sales totaled 17.4 million units last year, the best year since 2000 (Fig. 6). The bad news is that December’s annual rate dipped to 17.3 million from 18.2 million units the month before.

It is hard to imagine that auto sales can get much better, which means that the booming auto industry may not do enough to offset the bust in energy-related manufacturing. That would explain the drop in December’s M-PMI, compiled by ISM, to 48.2, the lowest since June 2009 (Fig. 7). The Markit measure of the US M-PMI remained above 50.0 at 51.2 during December, but that was a big drop from November’s 52.8 and the lowest since October 2012.
There wasn’t any good news in the ISM and Markit measures of the NM-PMIs. Both fell in December, though they remained solidly above 50.0 at 55.3 and 54.3, respectively (Fig. 8). (Click ★ to add US Business Surveys to MyPage.)

(3) GDP cuts. The Atlanta Fed’s GDPNow model aims to forecast GDP by monitoring the same economic statistics that the Bureau of Economic Analysis uses in its initial estimates of GDP. GDPNow is updated frequently by the Atlanta Fed as new data become available.

Yesterday, the model projected that GDP grew by 1.0% (saar) during Q4-2015, up from Monday’s estimate of 0.7%, reflecting a swing in net exports’ contribution to Q4 GDP from a preliminary estimate of negative 0.2ppt to a positive 0.2ppt following yesterday’s trade report. It still remains below the model’s previous prediction of 1.3% on December 23, reflecting lackluster construction spending and ISM manufacturing numbers at the start of the week.

Yesterday’s November merchandise trade report showed 1.1% m/m and 4.0% y/y drops in real exports (Fig. 9). In current dollars, total construction spending dipped 0.4% m/m during November, the first decline since June 2014 (Fig. 10). While residential construction remains on an uptrend, nonresidential and public construction have stalled in recent months. (Click ★ to add US Construction Spending to MyPage.)

Also yesterday, the World Bank cut its global growth projection for 2016. “Deeper contractions than expected in Brazil and Russia and meeker output in most of the world’s biggest economies, including the U.S. and China, led the international development institution to downgrade its forecast for global growth in 2016 by 0.4 percentage point to 2.9%. That is up slightly from last year’s downward-revised growth rate of 2.6%,” observed a 1/6 WSJ article.

(4) Delusional Fed heads. In response to this deluge of new year’s bad news, a couple of Fed officials offered some delusional discussions of several rate hikes in 2016. FRB-SF President John Williams on Monday told reporters “I could easily see it be three or five or more or less depending” on what happens with the economy. But he noted that the median view of FOMC officials is four rate increases, saying that would leave the central bank overnight target rate at around 1.35%, which he said is “a reasonable guess” for what’s likely to happen. Yesterday, in a CNBC interview, Fed Vice Chair Stanley Fischer echoed that four rate hikes would be “in the ballpark.”

A 1/4 Bloomberg article titled “Fed Vice Chairman Fischer’s hawkish tone may have added to market angst” noted: “On Sunday, Fed Vice Chairman Stanley Fischer said the U.S. central bank should be open, in the future, to raising interest rates to ward off potential asset bubbles. How much financial stability concerns should play in monetary policy remains an unsettled policy at the U.S. central bank. Prior to the crisis, the Fed’s leadership did not support hiking rates to ward off asset bubbles."

(5) Geopolitical disturbances to the peace. Yesterday, North Korea claimed to have detonated an H-bomb. That’s after Shiites around the world, led by Iran’s Supreme Leader, angrily denounced the execution of a Shiite cleric in Saudi Arabia—with many calling for the overthrow of the House of Saud.

Usually, geopolitical disturbances tend to be mostly ignored by the stock market or to be viewed as buying opportunities by investors. As Melissa and I observed on Tuesday, this year is widely expected to be fraught with more dangerous geopolitical disturbances than usual. So far, we’ve certainly gotten off on the wrong foot in the new year.
**Sector Spotting: Valuing Earnings.** As the stock market sank miserably during the first few trading days of 2016, pessimists had already prepared long worry lists for the year and added the plunge in Chinese stocks and heightened Middle East tensions this week. Another item on everyone’s worry list is the market’s P/E, which is widely viewed as historically high. Jackie, Joe, and I had a closer look at this issue. We agree that the P/E is high, of course, but there are some nuances (in addition to devils) in the details. Consider the following:

1. **Sector P/Es mixed.** The forward P/Es on six out of 10 sectors are lower today than they were at the end of 2014. The only sectors that saw a notable increase in their earnings multiples were Energy and Consumer Staples. Here’s a list of sectors’ forward P/Es today and where they stood at the end of 2014: Energy (28.3, 16.9), Consumer Staples (20.1, 19.0), Consumer Discretionary (18.3, 18.2), S&P 500 (16.5, 16.3), Tech (16.3, 15.7), Health Care (16.1, 17.0), Utilities (15.6, 17.3), Industrials (15.6, 16.1), Materials (15.5, 15.8), Financials (13.6, 14.2), and Telecom (12.5, 13.4).

Two of the sectors with the highest multiples—Energy and Consumer Staples—don’t include any go-go stocks like FANG (Facebook, Amazon, Netflix, and Google) indicative of overheated valuations. In fact, in our opinion, it’s pessimism—not the optimism of an overheated bull market—that’s driving their multiples higher.

2. **Energy is expensive.** With a forward P/E of 28.3, Energy has the highest multiple among the 10 sectors in the S&P 500. The sector’s multiple has soared as its earnings have fallen sharply while the stock prices of energy stocks haven’t fallen as much. So the high multiple reflects depressed earnings expectations, not speculative fervor. However, as we’ve noted before, the most expensive oil in the world may be in the US stock market given the Energy sector’s elevated P/E.

3. **Defensive stocks highly valued.** The Consumer Staples sector sports the second-highest forward earnings multiple, at 20.1, even though it’s expected to grow earnings by only 5.4% this year. Some industries within the sector, notably Brewers and Distillers & Vinters, became frothy as a result of the M&A boom. But other areas have lofty P/Es mostly because they are in defensive areas with decent yields. Household Products, for example, has a 20.9 forward P/E on earnings that are expected to decline by 2.1% this year. Likewise, earnings in the Soft Drinks industry are predicted to rise only 5.7% yet the forward P/E is 21.5.

Without these high-multiple sectors, the S&P 500’s valuation looks a bit more reasonable. Excluding the depressed Energy sector and the defensive Consumer Staples sector, the S&P 500’s forward P/E shrinks to 15.6 from 16.5, Joe calculates.

4. **A couple of FANGs.** Another sector with an outsized P/E is Consumer Discretionary, at 18.3, which might not be so bad given the expected earnings growth of 14.5% over the next year. This is one sector that is affected by the FANG stocks, since it includes the Internet Retail industry, which counts Amazon and Netflix as members. The Internet Retail industry, with a 60.6 forward P/E, has one of the highest multiples among the S&P 500’s industries. And it has increased since the end of 2014, when it was “only” 45.3. However, earnings growth is expected to be 52.1% this year.

The impact of the FANGs shouldn’t be ignored. The S&P’s forward P/E would fall to 15.7 without the impact of just those four stocks. When Joe subtracted the FANG stocks, the depressed Energy sector, and the defensive Staples sector from the S&P 500 P/E calculation, the index’s multiple fell to 14.7. Thus the vast majority of stocks look much more reasonably priced than the broader index’s multiple would imply.
Sector Focus: AutoTech. The Tech sector has captured headlines this week as CES 2016, the consumer electronics industry’s preeminent trade show, kicked off Tuesday night. Making headlines were electronic cars, autonomous cars, and car sharing. There’s a trend there. Here are a few of the highlights:

(1) Batteries not included. Faraday displayed a new electric sports car that it hopes to produce by 2017. The 1/4 WSJ reported that it boasts “a new battery-pack design that uses ‘strings’ of batteries that can be added or subtracted, like a brick from a candy bar. That will allow for many sizes and electric range offerings from the company.” In addition, the car “will be designed to offer autonomous driving capabilities from the start, and Faraday also is exploring shared ownership of pay-per-use ownership models.”

(2) No license required. Which brings us to driverless cars. Nvidia, the graphics chip maker, introduced a new computer to power autonomous cars. Volvo will use the system in 100 SUVs in Sweden next year, a WSJ article reported. Along those lines, GM invested $500 million in Lyft, a ride-hailing service that competes against Uber. “GM said it would work with San Francisco-based Lyft to develop a service that could let customers order a car on their smartphones and have the vehicle appear at their doors with no driver required,” the WSJ explained. Separately, GM plans to have a fleet of self-driving Chevrolet Volt plug-in hybrid sedans operational in its Detroit technical center this year.

(3) Fewer cars needed. This came on top of news that 2015 auto sales broke a 15-year record. Yet Ford and GM shares each have fallen 10.3% y/y. Some headlines attribute the weakness in these stocks to fears that the auto cycle could be at a peak, as it could be tough to push sales above last year’s record. That certainly may be true. But perhaps the market is also getting a whiff of uncertainty about who will profit from auto manufacturing in the future, car companies or tech titans? And if car sharing becomes the norm, will we need as many cars as we have today?

Earnings Season: Seeing Red. I asked Joe to compile the Q4-2015 earnings outlook for the current earnings season based on the few actual reports available and the consensus estimates for all the rest of the S&P 500. Currently, 6 of the 10 sectors are expected to show negative y/y comparisons as follows: Energy (-68.0%), Materials (-24.2), Utilities (-6.7), IT (-3.8), Industrials (-2.2), Consumer Staples (-1.7), Health Care (4.2), Financials (8.0), Consumer Discretionary (8.6), and Telecom Services (18.1).

No wonder that investors aren’t looking forward to the season given all the earnings declines expected by industry analysts. However, y/y comparisons are likely to get easier in 2016, which should limit the earnings-led downside for the stock market. The S&P 500’s earnings are expected to be down 4.6% y/y. Excluding Energy, they would be up 1.5%.

CALENDARS

US. Thurs: Jobless Claims, Challenger Job-Cut Report, Weekly Consumer Comfort Index, Lacker, Evans. Fri: Headline & Private Payroll Employment 200k/193k, Unemployment 5.0%, Average Hourly Earnings 0.2%, Average Workweek 34.5hrs, Consumer Credit $18.8b, Wholesale Inventories 0.0%, Williams, Lacker. (Bloomberg estimates)

Global. Thurs: Eurozone Retail Sales 0.2%m/m/2.0%y/y, Eurozone Unemployment Rate 10.7%, Germany Factory Orders 0.1%m/m/1.1%y/y, Germany Retail Sales 0.5%m/m/3.7%y/y, Australia Retail Sales 0.4%. Fri: Germany Industrial Production 0.5%m/m/0.5%y/y, Germany Trade Balance (euros) 20.2b, UK Trade Balance (pounds) -2700, Canada Net Change in Employment & Unemployment Rate 10k/7.1%, China CPI & PPI 1.7%/-5.8% y/y, Japan Leading & Coincident Indexes. (DailyFX estimates)
STRATEGY INDICATORS

Stock Market Sentiment Indicators (link): The Investors Intelligence Bull/Bear Ratio sank from 1.63 during the week of December 8 to a three-month low of 1.10 this week. Bullish sentiment dropped from 44.9% to 34.7% over the period—the weakest since the first week of October. Bearish sentiment rose to 31.6% after 10 weeks below 30%. The percentage of respondents in the correction camp was unchanged at 33.7% again this week, up from 27.5% a month ago. The AAII Bull Ratio increased from 37.7% to 51.5% during the two weeks ending December 30. Bullish sentiment fell to 25.1% during the latest week after climbing from 23.9% to 26.4% the prior week; bearish sentiment dropped from 39.4% to 23.6% over the two-week period.

S&P 500 Earnings, Revenues, & Valuation (link): S&P 500 forward revenues rose 0.3% last week to its highest level in 11 weeks, but forward earnings edged down. Despite this year’s collapse in Energy sector forecasts, both remain close to their record highs from October 2014: Forward revenues is down 2.2%, and forward earnings is down 1.8%. From their 2015 lows in April and February, forward revenues has gained 2.5% and forward earnings is up 3.6%, respectively. The forward profit margin forecast was down w/w to 10.6% from 10.7%. Forward revenue growth is down to 4.0% from a 14-month high of 4.3% in early December, and forward earnings growth is down to 7.3% from a nine-week high of 7.9% then. Ex-Energy, forward revenue growth and earnings growth forecasts were steady, with revenues at 4.6% and earnings at 8.1%. Consumer Discretionary and Materials are expected to have the best y/y margin gains in 2016: to 7.7% from 7.1% and to 9.2% from 8.6%, respectively. Financials has the best expected two-year margin gain, to 16.5% in 2016 from 14.3% in 2014. Energy and Telecom margins are expected to deteriorate in 2016 versus 2015: to 4.3% from 4.7% and to 10.6% from 11.1%.

S&P 500 Sectors Earnings, Revenues, & Valuation (link): Consensus forward revenue forecasts rose w/w for 9/10 sectors (all but Telecom), but forward earnings rose for just 1/10 (Industrials). Forward revenues and earnings are at or around record highs for Consumer Discretionary, Consumer Staples, Health Care, Industrials, and Tech. They are at new cyclical lows for Energy and Materials. P/E ratios rose w/w for 9/10 sectors. The P/E of 28.3 for Energy is back near a record high due to falling earnings. They remain close to cyclical highs for Consumer Discretionary, Consumer Staples, and Tech, and are down from six- to 10-year highs several months ago for the remaining sectors. Looking at the forward P/Sales ratios, just three sectors remain close to their recent highs: Consumer Discretionary, Consumer Staples, and Tech. P/Sales ratios remain near their 2015 lows for Health Care, Telecom, and Utilities.

US ECONOMIC INDICATORS

ADP Employment (link): Private industries added 257,000 people to December payrolls, the largest monthly gain of 2015. However, there were downward revisions to both November (from 217,000 to 211,000) and October (196,000 to 173,000) job gains. December’s advance once again was driven primarily by service-providing jobs, which rose by a 13-month high of 234,000; goods-producing companies added 23,000 to payrolls—the second-best reading of 2015. Large companies (97,000) replaced small companies (95,000) at the top of the leader board, though by a very small margin. Within large companies, services-providing payrolls advanced 81,000, while goods-producing rose at a high for the year of 16,000. Small businesses added 84,000 service-providing jobs and 11,000 goods-producing ones. Medium-sized companies provided 65,000 jobs, once again entirely driven by service-providing jobs (69,000); goods-producing jobs fell for the third month by 4,000 during December and 17,000 during the final quarter of last year.
US Trade (link): Trade was likely a drag on growth again last quarter. The real merchandise trade gap narrowed to $59.6 billion in November from $61.0 billion in October, but the October/November average monthly deficit of $60.3 billion is wider than Q3’s $58.8 billion average. Real exports fell 3.7% in the two months through November, while imports dropped for the second time in three months by a total of 2.5%. November’s loss in exports was led by declines in consumer goods ex autos and industrial goods of 4.0% and 1.1%, respectively, which was only partially offset by gains in exports of autos (0.8%) and capital goods ex autos (0.2). The decline in imports was driven by consumer goods ex autos (-5.6) and capital goods ex autos (-0.8); food imports were up 1.1%, while auto and industrial goods imports were both flat.

Factory Orders (link): Factory orders contracted for the third time in four months, down 0.2% in November and 1.9% over the period. Business investment plans took a step back. Nondefense capital goods orders ex aircraft (a proxy for future business investment) fell 0.3% after a two-month gain of 1.0%. They expanded 1.6% (saar) during the three months ending November (based on the three-month average), the weakest growth rate since turning positive in July for the first time in nine months. These core shipments (used in calculating GDP) fell for the third time in four months, with its comparable three-month growth rate (-1.9%, saar) turning negative for the first time in six months.

GLOBAL ECONOMIC INDICATORS

J.P. Morgan Global Composite PMI (link): Global growth lost momentum during the final month of 2015. The J.P. Morgan Global Composite Output Index fell from 53.6 to 52.9 in December, reversing gains made the prior two months, as the rate of increase in new orders fell to an 11-month low. Emerging markets remained the principal drag on global growth as all-industry output dropped for the fourth time in five months, with declines for both manufacturers and service providers. Downturns occurred in China, Brazil, and Russia, while India continued to grow. Brazil’s contraction remained especially steep. Among developed countries, all-industry output continued to grow in the US, UK, Eurozone, and Japan, though the Eurozone was the only one to post faster growth, led by strong gains in Germany and Italy. All-industry employment advanced again last month, extending job growth to 70 consecutive months. Similar to output, employment rose in the US, UK, Eurozone, and Japan, and fell in China, Russia, and Brazil. Hirings in India were broadly unchanged.

US Nonmanufacturing PMIs (link): Activity in the US service sector grew at its slowest pace in 11 months according to Markit’s survey, and the slowest in 20 months according to ISMs. The ISM N-PMI slumped for the second month from 59.1 in October to 55.3 in December (the weakest since April 2014, though still solid), as the supplier deliveries sank from 53.0 to 48.5 last month, the first reading below 50 since October 2014. The remaining three index components--business activity (from 58.2 to 58.7), new orders (57.5 to 58.2), and employment (55.0 to 55.7)--all were slightly higher last month. Markit’s NM-PMI dropped to 54.3 after rising for the first time in three months in November from 54.8 to 56.1. Output and new business growth were the lowest since January. Employment continued to expand at a solid rate, but the latest survey indicated a greater degree of caution about the business outlook.

European Nonmanufacturing PMIs (link): Service-sector growth in both the Eurozone and UK stabilized at a robust pace at the end of last year, though the latter’s was noticeably slower than the pace during the first half of the year. The Eurozone’s NM-PMI remained at 54.2 last month, just below its cyclical high of 54.4 posted in June and August--after falling to a seven-month low of 53.7 in September. According to the report, rates of growth accelerated in Germany (56.0, 17-month high) and Italy (55.3, 69-month high), but eased a bit in Ireland (61.8, 2-month low) and Spain (55.1, 3-month low), though at high levels. France (49.8) was the only country contracting during the month. The UK’s NM-PMI eased slightly to 55.5 after climbing the prior two months from a 29-month low of 53.3 in
September to 55.9 in November. (It averaged 57.6 during the first half of the year.) Growth was supported by a further strong increase in new business last month. The rate of job creation slowed to a five-month low, though was strong relative to its long-run average.

China Nonmanufacturing PMIs (link): China’s service sector once again accelerated in December according to the official series but slowed according to Caixin/Markit. The official measure rose for the second month from 53.1 in October (the slowest pace since December 2008) to 54.4 in December (the fastest pace since August 2014). Caixin’s NM-PMI fell for the second month from 52.0 in October to 50.2 last month—the weakest since July 2014. Total new work placed at Chinese service providers increased only marginally again in December after a solid expansion in October. Employment continued to increase last month, though modestly.

Japan Nonmanufacturing PMI (link): Japan’s service sector continued to expand at a modest pace in December. Nikkei/Markit’s NM-PMI slipped to 51.5 from 51.6 in November and 52.2 in October, which was the second-highest reading since September 2014. New business growth at Japanese services companies accelerated at a four-month high, while output matched November’s 20-month high. Employment rose for the first time in three months at its best pace since November 2014.

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