MORNING BRIEFING
January 11, 2016

Revenant

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(1) Bull mauled by a grizzly bear. (2) Grizzly technical picture. (3) During current bull market, average stock has done much better than shown by S&P 500. (4) Nifty Nine less nifty last week. (5) Lots of technical wounds. (6) Sentiment is very bearish again, which is bullish. (7) Bloodied, but not buried. (8) Chaos doesn’t have to end badly. (9) Rerating valuation? (10) The bursting of the commodity bubble shouldn’t be as bad as those of other recent bubbles. (11) China’s devaluation worse for other EMs than for US. (12) Europe is wide open for trouble. (13) US is an oasis of tranquility. (14) “The Revenant” (+ +) & “Joy” (+).

Strategy I: Vicious Bear Attack. This is the first time I am starting my Morning Briefing with a movie review. I always have saved them for the end of my commentary on Mondays. However, on Saturday, my wife and I saw “The Revenant” (+ +) with an Oscar-worthy performance by Leo DiCaprio as Hugh Glass, a scout for a group of fur trappers during the 1820s. The film is grizzly and a bit tedious, as the protagonist hunts down one of the other trappers who abandoned him for dead while he was still breathing in a shallow grave after he was mauled by a grizzly bear. His nearly fatal encounter with the mother bear was intensely graphic. It brought back painful memories for me of this past week in the stock market, when the bear took big bites out of the bull. Let’s assess the technical carnage before discussing why Joe and I aren’t convinced that it is justified by the fundamentals:

(1) Correction with bear claws. Needless to say, for investors the technical picture of the market has turned as grizzly as the film. The S&P 500 is down 9.8% since its record high on May 21, 2015 (Fig. 1). That’s a garden-variety correction still (Fig. 2). More disconcerting is that 39 of the 129 S&P 500 industries we track are down 20% or more since last May. (See Table.) Most of them are in the Materials and Energy sectors, which are down 21.3% and 28.7%, respectively, since last year’s market peak (Fig. 3). Of course, they are both down much more from their 2014 peaks, by 22.8% and 43.3% respectively.

(2) Bull with bear breadth. Technicians have been warning about the narrowing breadth of the bull market since the second half of last year. While the market-cap-weighted S&P 500 index is down 9.8% since May 21, 2015, the equal-weighted S&P 500 is down 13.0% since then (Fig. 4). Keep in mind that the former is up 184% since the start of the bull market on March 9, 2009, while the latter is up 255%. So the average stock has enjoyed a much more exuberant bull market than the biggest ones until last year.

(3) Fangs get fanged. The 11/27 FT reported last year that the big-cap Fang stocks (Facebook, Amazon, Netflix, and Google) and the Nifty Nine (which adds Priceline, Ebay, Starbucks, Microsoft, and Salesforce) significantly boosted last year’s market performance. (Apple appeared on neither list.) “If made into indices, research by the FT statistics group shows that either of these groupings would have gained about 60 per cent for this year, while the S&P 500 is up about 1 per cent.” Last week’s 6.0% rout in the S&P 500 included big declines in the Nifty Nine: Priceline (-10.8%), Amazon (-10.2), Facebook (-7.0), Salesforce (-6.6), Ebay (-6.3), Google (-6.1), Starbucks (-5.7), Microsoft (-5.7), and Netflix (-2.6).
(4) Other technical wounds. The percentage of S&P 500 stocks trading below their 200-day moving averages has been mostly below 50% since late summer (Fig. 5). Dow Theory is also bearish, with the DJIA down 24.6% from its record high on December 29, 2014, dropping on Friday to the lowest since November 7, 2013 (Fig. 6).

The NYSE composite is down 15.2% from its record high last year to the lowest since October 9, 2013 (Fig. 7). It comprises all common stocks listed on the NYSE, including ADRs, REITs, and tracking stocks. The NYSE issues’ advance/decline line peaked last year on April 24 and is down 8.1% since then through January 1. (Click ★ to add Breadth to MyPage.)

The Investment Company Institute compiles weekly estimates of equity mutual funds’ net new cash flows. It isn’t a pretty picture either, with funds hemorrhaging $245 billion during the last 13 weeks of 2015 at an annual rate (Fig. 8).

(5) Sentiment & valuation. The Bull/Bear Ratio compiled by Investors Intelligence fell back down to 1.10 during the first week of this year (Fig. 9). That can’t be good for valuation multiples. On the other hand, the S&P 500 forward P/E actually has a better correlation with the weekly Bloomberg Consumer Comfort Index, which remains near last year’s cyclical highs (Fig. 10). Furthermore, bearish readings around 1.00 have tended to be bullish for the stock market. (Click ★ to add Bull/Bear Ratios to MyPage.)

(6) Happy ending. Keep in mind that Hugh Glass survived that bear attack by stabbing the beast multiple times in the head. Our hero was bloodied and near death, but managed to track back to civilization and take his revenge. We aren’t giving up on the secular bull market.

Strategy II: Chaos & Joy. I also rarely include two movie reviews in the same Morning Briefing. However, another recent movie that seems to have some relevance to the stock market is “Joy” (+) starring Jennifer Lawrence as the title character. She established a very profitable business by inventing better household products (like the self-wringing mop). She did so despite a very chaotic situation in her own household. It is all based on an inspirational true story showing that entrepreneurs can overcome lots of both personal and professional challenges to become wildly successful.

My bet is that all the chaos we are now seeing around the world that suddenly seems to be depressing stock investors won’t end as badly as circumstances in 2008 but rather will sort itself out, allowing the secular bull market to resume. Let’s review why:

(1) Rerating valuation. Our Blue Angels analysis of the S&P 500/400/600 shows that last week’s plunges of 6.0%, 6.4%, and 7.2% in the three market-cap indexes reflected big declines in their forward P/Es, while their forward earnings remained stalled at record highs during the second half of 2015, mostly weighed down by falling earnings in their Energy sectors (Fig. 11). The forward P/Es of the three have plunged from last year’s highs to Friday’s lows: the S&P 500 from 17.2 to 15.1, S&P 400 from 18.7 to 15.5, and S&P 600 from 19.6 to 16.1 (Fig. 12).

We aren’t expecting a recession in 2016, so we are expecting that forward earnings will resume their climbs to new record highs this year. Energy should weigh much less on overall earnings this year even if oil prices continue to fall, since the Energy sector now has much smaller shares of total earnings in each of the S&P 500 (3.7% now, down from 21.3% at 2008 peak), S&P 400 (0.5%, 13.7% in 2006), and S&P 600 (-1.5%, 14.4% in 2008).

After their recent declines, Joe and I can see upside in the valuation multiples over the rest of this year since we doubt that the Fed will be hiking the federal funds rate four times this year, as predicted in the
Fed’s “dot plot.” Another year of one-and-done seems much more likely to us. The soaring dollar is continuing to soar, which is bound to limit the Fed’s rate-hiking enthusiasm (Fig. 13). By the way, since 1995 a strong (weak) dollar has tended to be associated with a rising (falling) P/E.

(2) **Downside & upside of commodities.** The stock market has been spooked by the ongoing weakness in commodity prices, particularly oil prices. Falling commodity prices directly weigh on the Energy and Materials sectors, but they also raise concerns that the global economy is falling into a recession. With the benefit of hindsight, it’s obvious that the commodity super-cycle was a bubble. Debbie and I came to that conclusion back in late 2013. That bubble has burst and is depressing exports, revenues, earnings, capital spending, and the employment of commodity producers. It is also causing a credit crunch in that sector.

While the CRB raw industrials spot price index is showing some tentative signs of bottoming, the price of oil still seems to be falling in a bottomless pit (Fig. 14). Unlike previous bubbles, this one has been financed in the credit markets much more so than in the banking system. So we don’t expect that it will have the same contagion effects that the previous financial crisis did.

We also see lots of geopolitical benefits of cheap oil. It may cause more chaos initially in the Middle East, but it also greatly reduces the revenues available to our natural-born enemies in the region along with those in Russia. There may be more chaos for them, but less mischief inflicted on us. Of course, the biggest upside of cheap oil and other commodities is that they provide a big windfall for commodity users. On balance, we think the net effect should boost, rather than depress, global economic activity.

(3) **China stir-fried.** Of course, last week’s plunge in the stock market was very reminiscent of the drop in August that also was triggered by turmoil in China’s stock market and weakness in the yuan. Once again, the situation has raised concerns about weaker Chinese economic activity, though December’s official and unofficial M-PMLs and NM-PMLs were somewhat contradictory. However, deflationary pressures continued for the 46th consecutive month in manufacturing, with the PPI down 5.9% y/y through December (Fig. 15). (Click ★ to add China Inflation & Deflation to MyPage.)

In addition to last week’s plunge in the Shanghai Shenzhen 300 by 9.9% and the inept official response to stop the rout, investors were unsettled by the 1.4% depreciation of the yuan, which now is down 8.3% from its January 14, 2014 peak. We also learned last week on Thursday that China’s non-gold international reserves dropped a record $108 billion during December and $665 billion since peaking at a record high of $4.01 trillion during June 2014. Keep in mind that some of that reflects the devaluation of some of the other key currencies held by the Chinese, such as the euro and the yen. However, China clearly has a problem with capital outflows as Chinese investors seek to protect some of their wealth by buying real estate and other assets overseas.

The weakness in China’s currency is bad news for other emerging economies. So is the weakness in commodity prices. No wonder that the MSCI Emerging Markets stock price index (in dollars) fell 6.8% last week to the lowest since July 2009 (Fig. 16). For the US, it isn’t bad news. Imports from China and other EMs will be cheaper, which will keep a lid on inflation and provide more purchasing power for American consumers. It is bad news for those Fed officials who are trigger-happy to raise rates again, albeit at a “gradual” pace.

(4) **Europe with and without borders.** While we are on the subject of chaos, Europe’s refugee crisis certainly seems to be out of control. There have already been a few criminal activities associated with the refugees. They certainly increase the risk of terrorist activities. Odds are that European authorities will have no choice but to regulate their borders more strictly.
In any event, as Debbie reports below, economic sentiment indexes rose to new cyclical highs in the Eurozone and the broader EU at the end of last year (Fig. 17). German factory orders rose for the second month in a row during November. On the other hand, the volume of retail sales (excluding motor vehicles) fell during November for the third month in a row.

(5) US oasis. With the exception of the US presidential campaign, the US seems like an oasis of tranquility compared to the rest of the world. We soon will see how the first round of Republican primaries unfolds, but there certainly is a chance that the final race will be between Hillary Clinton (with Bill as her VP) and Donald Trump (with Gary Busey as his VP). If I had to pick between the two pairs, I might go for the least corrupt.

Meanwhile, despite fears of a manufacturing recession and stalling GDP growth, employment remains strong while wage gains remain moderate. Our Earned Income Proxy rose 0.2% m/m during December to yet another record high (Fig. 18). That’s an auspicious sign for wages and salaries in current dollars. In real dollars, they are also getting a lift from falling gasoline prices. Average hourly earnings rose 2.5% y/y during December for all workers and 1.9% in real terms through November (Fig. 19).

On balance, we think that the increased purchasing power of US consumers will fuel more consumer spending and boost economic activity, more than offsetting the slowdowns in merchandise exports and energy-related capital goods. While labor costs may be rising, they don’t seem to be doing so fast enough to weaken profit margins. In other words, profits should continue to grow this year.

CALENDARS

US. Mon: Lockhart. Tues: NFIB Small Business Optimism Index 95.0, JOLTS, Lacker. (Bloomberg estimates)

Global. Mon: Eurozone Sentix Investor Confidence, Canada Housing Starts. Tues: UK Industrial Production, Japan Consumer Confidence, Japan Money Supply. (DailyFX estimates)

PERFORMANCE & ASSET ALLOCATION

Global Stock Markets Performance (link): The US MSCI index tumbled 6.0% last week, ranking 28th of the 49 markets as only one market rose in US dollar terms--compared to 80th a week earlier, when it dropped 0.8% as 16 markets rose. The AC World ex-US index underperformed slightly, falling 6.3% versus a 0.6% decline a week earlier. The best-performing regions last week, albeit with declines: EM Eastern Europe (-4.8%), EMEA (-5.3), and EAFE (-6.1). The week’s worst: EM Latin America (-8.5), EMU (-6.5), and EM Asia (-6.4). Hungary and Egypt were last week’s best performers among countries, with a gain of 0.4% and a 0.5% decline, respectively. Last week’s biggest decliners: Greece (-10.7) and South Africa (-10.1).

S&P 1500/500/400/600 Performance (link): All three market-cap indexes tumbled last week for their worst performances since September 2011 as all 30 sectors fell. LargeCap (-6.0%) fell less than MidCap (-6.4) and SmallCap (-7.2). The poor start to the year leaves LargeCap 9.8% below its May 21 record high, MidCap 15.6% below its June 23 record, and SmallCap 16.0% below its June 23 record high. LargeCap is still 2.9% above its August 25 low, but MidCap and SmallCap are both 3.2% below their lows then. Seventeen of the 30 sectors are below their lows then too. The best performers since August 25: SmallCap Utilities (12.5), SmallCap Telecom (10.0), LargeCap Consumer Staples (7.6), and LargeCap Tech (7.1). The worst performers since August 25: SmallCap Energy (-17.9), MidCap Energy (-15.0), and SmallCap Materials (-12.8). Utilities is the top SuperComposite sector performer ytd (-0.5),
ahead of Consumer Staples (-3.0) and Telecommunication Services (-3.0). These SuperComposite sectors are down the most ytd: Materials (-7.7), Financials (-7.2), and Information Technology (-7.2).

**S&P 500 Sectors and Industries Performance** (link): All 10 S&P 500 sectors fell last week as the index tumbled 6.0% for its worst decline since September 2011. That compares to all 10 sectors also falling a week earlier, when the index edged down 0.8%. The index is now 9.8% below its record high, but that’s still up 2.9% from its 2015 low of 1867 on August 25. Last week’s best sector performers: Utilities (-0.4%), Consumer Staples (-2.9), and Telecommunication Services (-3.0). Last week’s biggest underperformers: Materials (-7.8), Financials (-7.5) and Information Technology (-7.0). Seven sectors still trade above the market’s August 25 low. The exceptions: Energy (-3.4), Materials (-1.0), and Financials (-0.5).

**Commodities Performance** (link): Seven of the 24 commodities we follow rose last week, down from 12 rising a week earlier. Last week’s best performers: Natural Gas (5.8%), Gold (3.6), and Lean Hogs (1.9); the biggest laggards: Unleaded Gasoline (-10.8), Lead (-9.9), and Crude Oil (-9.8). Seven commodities were positive in 2014, but just three were positive in 2015: Cocoa (10.3), Cotton (5.0), and Sugar (5.0). 2015’s worst performers: Nickel (-41.8), Heating Oil (-38.7), and GasOil (-35.9).

**Assets Sorted by Spread w/ 200-dmas** (link): Commodities were the only asset class to see gains last week in spreads between prices and 200-day moving averages (200-dmas): Spreads rose for 4/24 commodities, 0/9 global stock indexes, and 0/30 US stock indexes compared to 13/24 commodities, 4/9 global stock indexes, and 0/30 rising a week earlier. Sugar is the only commodity trading above its 200-dma (by 13.9%), down from three commodities above a week earlier. Gold improved the most w/w as it rose 4.4ppts to -2.7%. Cocoa weakened the most, falling 8.1ppts w/w to -6.3% below its 200-dma. Commodities’ average spread fell w/w to -13.5% from -11.0%. All nine global indexes continue to trade below their 200-dmas. Indonesia now leads the global indexes at 4.6% below and fell the least w/w--just 0.8ppt. China is now the lowest at 18.0% below its 200-dma, followed closely by Brazil (-17.9%). The global indexes' average spread tumbled to -10.0% from -5.3%. Two of the 30 US stock indexes trade above their 200-dmas, down from 11 a week earlier, as their average spread weakened to -4.6% from -3.3%. SmallCap Utilities leads all US stock indexes at 7.0% above its 200-dma, but LargeCap Utilities was the best performer last week, falling just 0.3ppt to -0.3%. At the other end of the spectrum, SmallCap Energy continues to lag all the indexes and was the weakest US stock index last week, tumbling 7.3ppts to 37.9% below its 200-dma.

**S&P 500 Technical Indicators** (link): The S&P 500 suffered serious technical damage last week as the index tumbled 6.0%. With its 50-dma now lower than its 200-dma, the S&P 500 fell into a Death Cross. However, four sectors remain in a Golden Cross: Consumer Discretionary, Consumer Staples, Industrials, and Tech. The S&P 500 has been below its 50-day moving average (dma) for five straight weeks and falling for the past two weeks; it’s also been below its 200-dma for two weeks, and it’s falling now after struggling to move higher since August. The S&P 500 weakened to a four-month low of 6.6% below its falling 50-dma from 1.2% below a week earlier, and dropped to a three-month low of 6.6% below its falling 200-dma from 0.8% below a week earlier. Its 50-dma relative to its 200-dma slipped to less than -0.1% from a four-month high of 0.4% a week earlier. Utilities is the only sector trading above its 50-dma, down from four a week earlier as Consumer Staples, Health Care, and Telecom turned negative in the past week. Consumer Staples is the only sector trading above its 200-dma (by just a hair), as three sectors turned negative in the past week: Consumer Discretionary, Tech, and Utilities. All 10 sectors have falling 50-dmas now compared to seven a week ago, as Health Care, Tech, and Telecom since have turned down. All 10 sectors also have a falling 200-dma now as Financials reversed lower.

**US ECONOMIC INDICATORS**
Employment (link): Payroll employment beat expectations again in December, and once again there were upward revisions to the prior two months. Payroll employment increased 292,000 last month, nearly 100,000 above expectations of a 200,000 advance. Gains in both November (from 211,000 to 252,000) and October (from 298,000 to 307,000) were revised higher, by a net 50,000. Private payrolls advanced 275,000 after upwardly revised gains of 240,000 (vs. 197,000) and 312,000 (304,000) the prior two months, for a net revision of 51,000. The breadth of job creation (percent of private industries increasing payrolls) continued to rebound from a five-year low of 54.2 in September to a high for 2015 of 64.4% in December. Our Earned Income Proxy (EIP)--which includes the index of aggregate weekly hours and average hourly earnings--reached yet another record high, advancing 0.2% (the 22nd increase in the last 24 months), with aggregate weekly hours accounting for December’s gain. Our proxy is up 4.4% the past year and 9.8% the past two years, with average hourly earning increasing 2.5% and 4.4%, respectively, and aggregate hours climbing 1.9% and 5.4%.

Employment by Industry (link): In December, most of the jobs gains occurred in professional & business services, construction, health care, and restaurants. Details by industry: Professional & business services employment continued to trend higher, adding 73,000 jobs in December--well above 2015’s average monthly gain of 50,400. This industry added 605,000 to payrolls last year, below 2014’s 704,000 pace. The construction industry recorded strong jobs growth for the third straight month, climbing 45,000 in December and 128,000 for Q4--the best three-month performance in nearly 10 years. Health care added 39,400 jobs last month, basically matching 2015’s monthly average, which was above 2014’s 26,000 per month. Health care added 474,700 to payrolls last year, the best year in the history of the series, going back to 1990. Within leisure & hospitality (up 29,000), employment at restaurants continued to expand, climbing 36,900 m/m and 357,300 y/y. Natural resources companies reduced payrolls every month of 2015, down 8,000 in December and 131,000 for the year. Employment in other major industries--including manufacturing, wholesale trade, retail trade, financial activities, and government--showed little or no change, though within manufacturing nondurable goods industries added 14,000 jobs.

Unemployment (link): December’s unemployment rate once again held at 5.0% (the lowest since April 2008). The participation rate (62.6%) edged up for the second time in three months, but is still little changed from September’s cyclical low of 62.4%--the lowest since October 1977. (The civilian labor force rose 466,000 last month, while those not in the labor force fell 277,000.) December’s teenage jobless rate increased to 16.1% after falling from 16.8% to 15.6% (lowest since October 2007) the prior three months. The adult unemployment was at a cyclical low of 4.6% for the fourth straight month; the college grad rate (2.5%) held at its cyclical low--recorded eight of the 12 months of last year. Those working part-time for economic reasons (a.k.a. “involuntary part-time workers”) ticked down to 6.0 million (3.8% of the civilian labor force) after rising from a cyclical low of 5.8 million in October to 6.1 million in November. Both the U6 rate (which includes marginally attached workers) and the sum of the underemployment and jobless rates were a tick above their respective October cyclical lows at 9.9% and 8.8%, respectively.

Wages (link): Wage inflation--as measured by the average hourly earnings rate for all workers on private nonfarm payrolls (AHE)--remains below Yellen’s comfort zone of 3%-4%. Wages were slightly lower in December, with wage gains for the three months ending December slowing for the second month to 1.9% (saar) after accelerating steadily from 1.6% in June to 3.2% in October. The yearly rate, however, was back up at October’s cyclical high of 2.5%. The wage rate for service-producing industries accelerated to 2.5% y/y after slowing from 2.6% to 2.3% in November; the rate for goods-producing industries climbed to a 21-month high of 2.6%. Within goods-producing, the wage rate in manufacturing (2.6% y/y) jumped to its highest reading since June 2014, while construction’s (2.9) was the highest since October 2009. Meanwhile, the natural resources’ rate slowed to 1.9% from
November’s 14-month high of 2.9%. Within service-providing, rates for information services (3.8) and retail trade (3.4) were at highs for 2015, while transportation & warehousing (0.4) remained near its high after posting negative readings from April through September. Wage rates for utilities (4.6), financial activities (2.9), professional & business services (2.6), wholesale trade (2.2), and education & health services (2.1) remained around recent highs, while leisure & hospitality’s (2.8) moved up from recent lows.

Consumer Credit (link): Consumer credit eased for the second month from $28.7 billion in September to $14.0 billion in November—the lowest since January—as consumers took out fewer loans for big-ticket items like cars and education. Nonrevolving credit rose only $8.3 billion in November, down from a recent high of $22.0 billion in September, and the weakest since February 2012. Meanwhile, revolving credit accelerated by $5.7 billion after no growth in October.

GLOBAL ECONOMIC INDICATORS

Eurozone Economic Sentiment Indicators (link): Economic sentiment in the Eurozone (up 0.7 points to 106.8), and more markedly in the overall EU (1.4 points to 108.9), climbed to new cyclical highs at the end of 2015. Of the top five Eurozone economies, Spain’s (+3.4 points to 112.2) Economic Sentiment Index (ESI) soared, while the Netherlands’ (-2.4 to 104.4) dropped sharply. Italy’s ESI (+0.4 to 109.8) was slightly higher in December, France’s (-0.1 to 102.5) slightly lower. Germany’s was unchanged at 106.0. At the sector level, only retail confidence (-2.8 to 3.0) fell in December, while industry confidence (1.2 to -2.0) recorded the biggest improvement. Services (+0.3 to 13.1), consumer (+0.2 to -5.7), and construction (+0.2 to -17.6) confidence all posted modest gains.

Eurozone Retail Sales (link): Eurozone retail sales fell for the third month in November after reaching a new cyclical high in August. November sales slumped 0.3% in November after slipping 0.1% in each of the prior two months. Monthly data show the weakness was widespread. Spending on food, drinks & tobacco dropped 0.4% in November after no change the prior two months, while nonfood products (excluding fuel) declined for the third month, down 0.1% m/m and 1.2% over the period. Fuel prices also dropped for a third month, by 0.7% m/m and 1.5% the past three months. Among member states for which data are available, gains in retail sales were recorded in Finland (0.9%), Slovenia (0.7), Malta (0.3), and Germany (0.2). More than offsetting these gains were sales declines in Portugal (-1.6), Estonia (-1.5), France (-1.2), Austria (-0.8), Belgium (-0.4), Luxembourg (-0.4), and Spain (-0.2), with Slovakia showing flat sales.

Germany Factory Orders (link): German factory orders rose in November for the second month, by a total of 3.2%, after a three-month slide of 4.9%. Domestic orders recovered 4.0% over the two-month period; foreign orders were 2.5% higher. Within foreign orders, billings from outside the Eurozone advanced for the third straight month, up 1.4% m/m and 4.3% over the time span, with capital goods orders recovering 4.8% over the period. Orders from within the Eurozone fell 0.5% in November, following a 2.6% gain and a 4.7% loss the prior two months. Consumer goods orders plunged 11.8% after a 13.7% spike in October. The rebound in domestic orders over the past two months was widespread, with intermediate (5.1%), consumer (4.4), and capital (2.9) goods orders all posting gains.