Weekly Market Review

***e*Research Corporation** is pleased to provide a commentary courtesy of Urban Carmel of **The Fat Pitch.**

Detailed information on **The Fat Pitch** is provided at the end of the article. However, a brief overview is provided immediately below, with the article beginning on the next page.

WHAT IS THE FAT PITCH?

Specifically, the Fat Pitch on this site refers to two situations.

First: A Fat Pitch comes at a market turning point.
Second: The Fat Pitch is a favorable investing environment.

Objectives

The objective of The Fat Pitch is to provide a structured, quantitative, and empirical methodology for evaluating the state of the market. At any point in time, there are a variety of factors pulling on the market. We want to determine the relative importance of each factor in order to answer two questions:

(1) In which direction should we be investing in the market?
(2) Are tailwinds behind this direction or are headwinds picking up?

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Bob Weir, CFA
Director of Research

February 23, 2018

Weekly Market Summary

Summary: S&P sales grew 9% over the past year, the best growth in 6 years. Earnings rose 23%, the best growth in 7 years. Profit margins expanded to a new all-time high of 10.8%. Overall, corporate results in the fourth quarter were very good. Earnings during 2017, in fact, rose as much as the SPX index itself.

The outlook for 2018 appears to also be strong. "Baseline" economic growth is about 4%-5%. The dollar is depreciating, which could add another 3 percentage points to growth. The new tax reform law, passed in late 2017, is expected to add another 7 percentage points. Finally, rising oil prices are a tailwind for the energy sector. As a consequence, the consensus expects earnings to grow 18% this year.

Where critics have a valid point is valuation: even excluding energy, the S&P is now more highly valued than anytime outside of the late 1990s. With profit margins already at new highs, it will likely take excessive bullishness among investors to propel equity price appreciation faster than earnings over the next few years.

Bearish pundits continue to repeat several misconceptions. In truth, 90% of the growth in earnings in the S&P over the past 8 years has come from better profits, not share "buybacks." The S&P's price appreciation has been primarily driven by better earnings (60%) not higher valuations (the remaining 40%). The trend in "operating earnings" is the same as those based on GAAP.

* * *

86% of the companies in the S&P 500 have released their fourth quarter (4Q17) financial reports. The headline numbers are very good. Here are the details:

Sales

Overall quarterly sales are 9% higher than a year ago. This is the best sales growth in 6 years (since 2011). On a trailing 12-month basis (TTM), sales are 7% higher yoy (all financial data in this post is from S&P).

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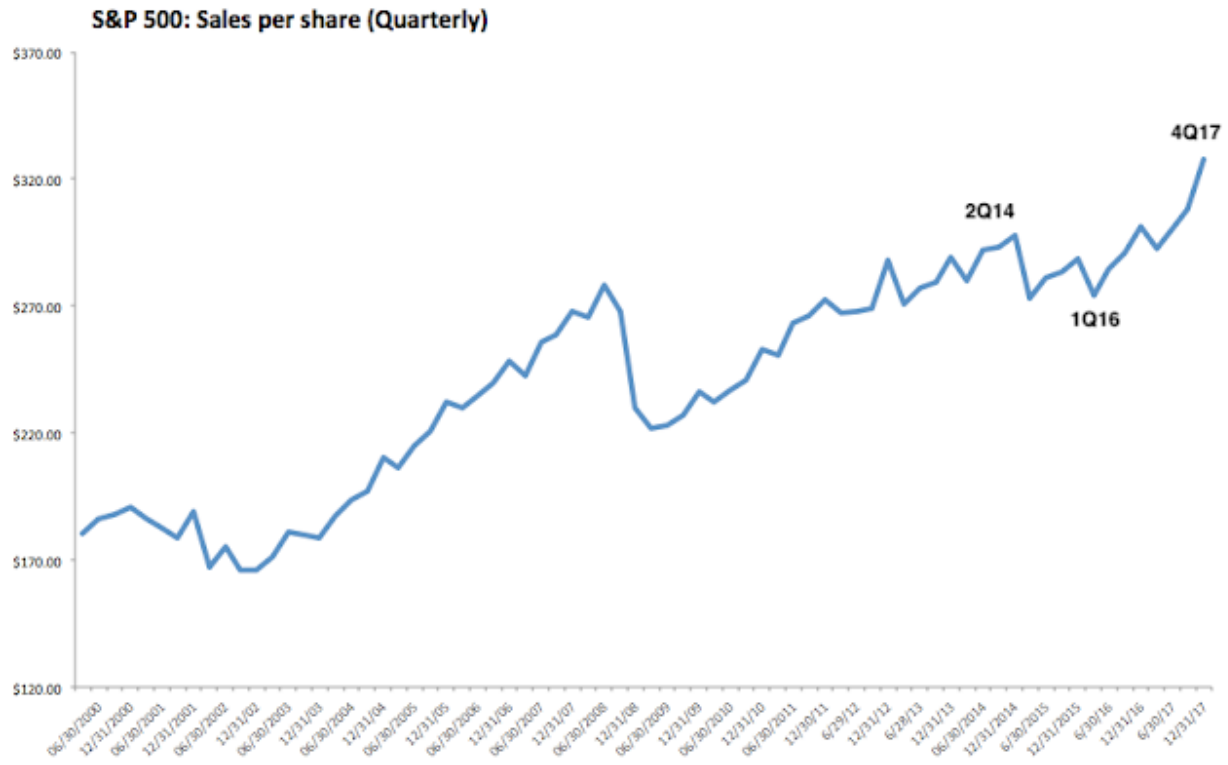
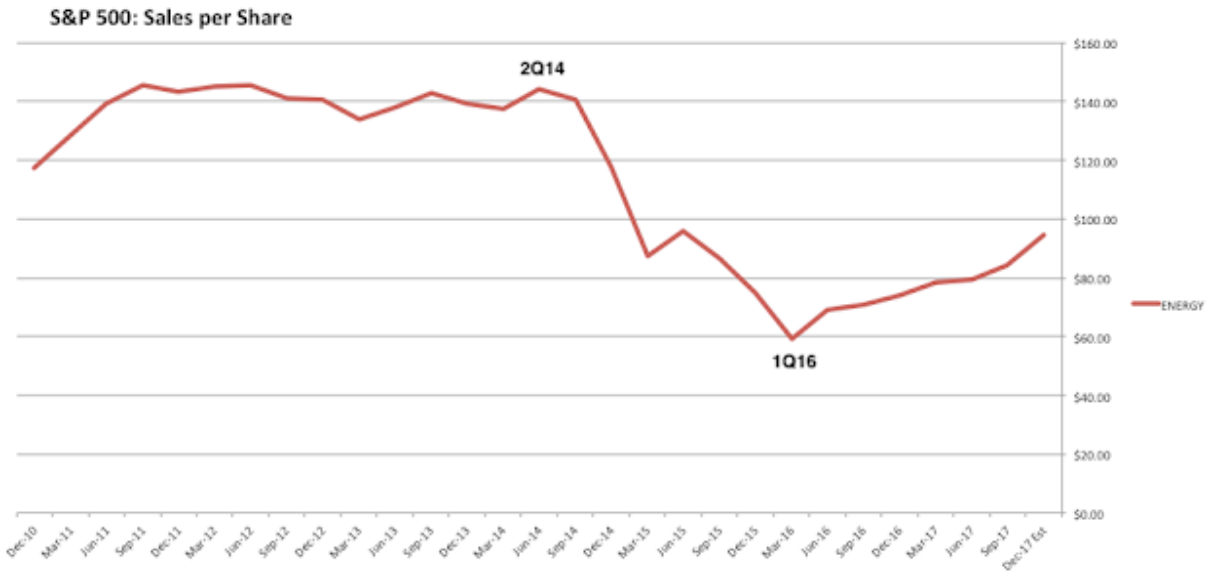


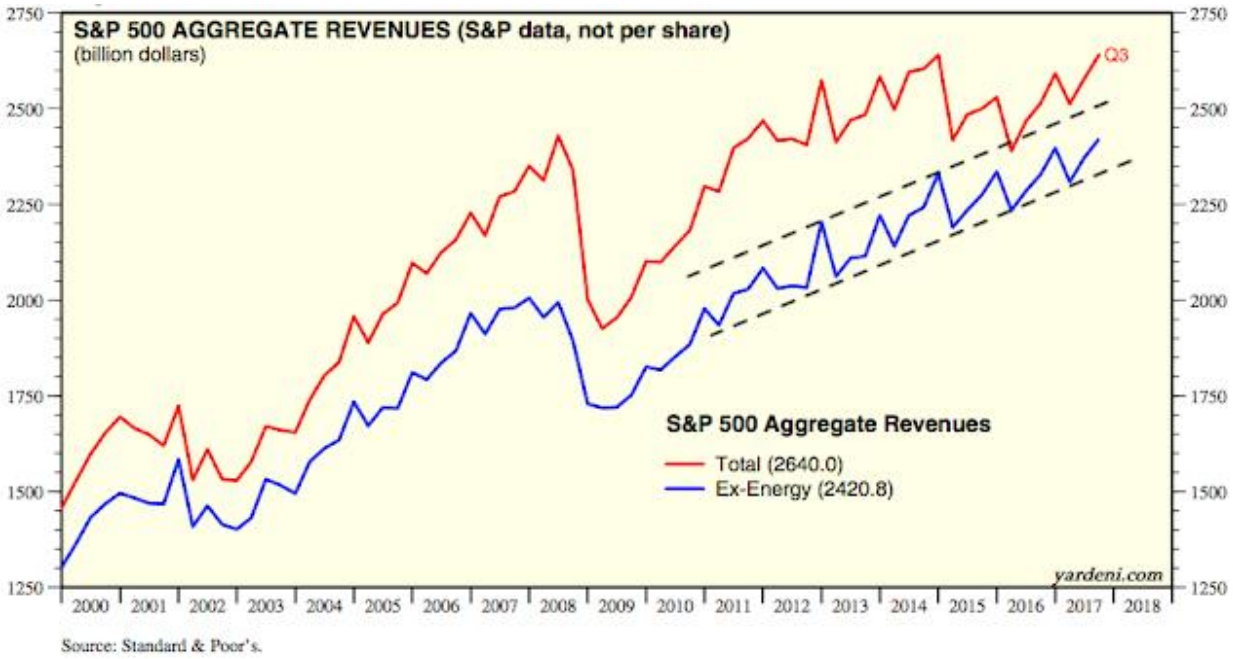
Two dates are called out on the chart above and those that follow. Recall that oil prices peaked at the end of 2Q14 and then fell 70% before bottoming at the end of 2015 and early 2016. The negative affect on overall S&P sales (above) and the energy sector alone (below) is apparent.



Since the oil peak in 2Q14, energy sector sales have declined 32%*; despite this, overall S&P sales are now 12% higher* (far right column). Importantly, most of the other sectors have continued to grow. In the past year, the sectors with the highest weighting in the S&P have grown an average of 9% (box in middle column) and since 2Q14, their sales have grown an average of 26%.

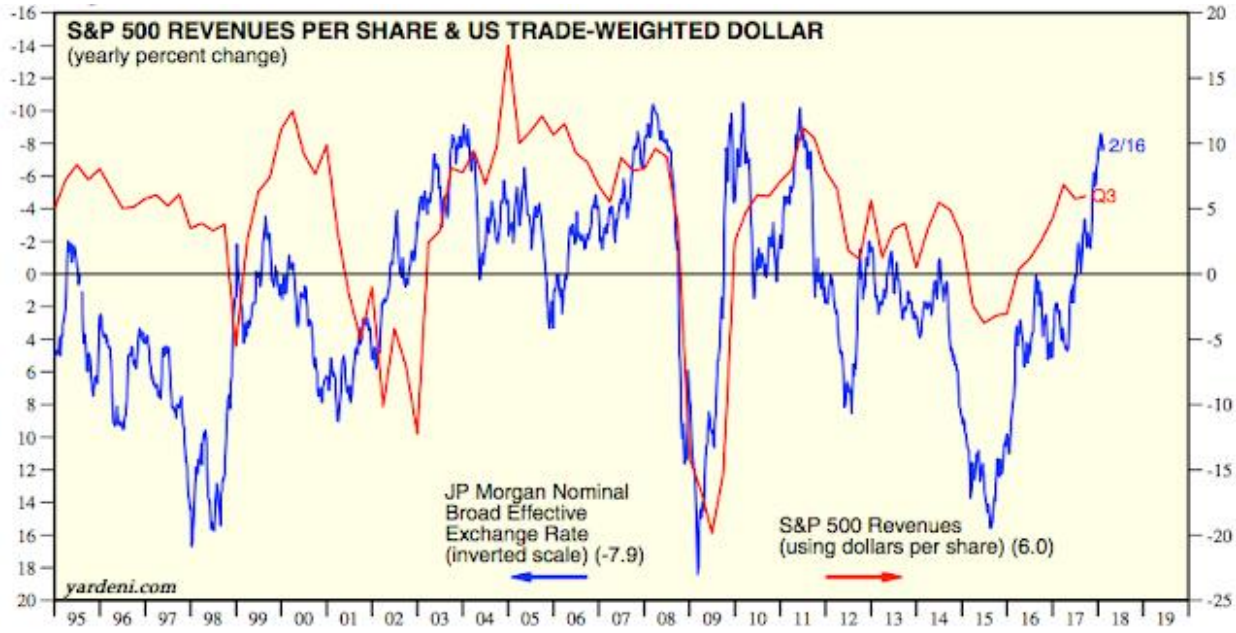
QUARTERLY SALES PER SHARE	Change Last 1 yr	Change Since 2Q14
ENERGY	28%	-33%
MATERIALS	10%	-6%
INDUSTRIALS	8%	18%
CONSUMER DISCRETIONARY	5%	30%
CONSUMER STAPLES	10%	15%
HEALTH CARE	6%	28%
FINANCIALS	9%	32%
INFORMATION TECHNOLOGY	15%	35%
TELECOMMUNICATION SERVICES	-2%	3%
UTILITIES	5%	-10%
REAL ESTATE	-5%	13%
S&P 500	**9%**	12%

Excluding the volatile energy sector, sales for the remainder of the S&P have continued to trend higher at about the same rate over the past 7 years (blue line; from Yardeni).



Some of the volatility in sales outside of energy is due to significant changes in the value of the US dollar over the past 4 years. Companies in the S&P derive about half of their sales from outside of the US. When the dollar rises in value, the value of sales earned abroad (in foreign currency) falls. If foreign sales grow 5% but the dollar gains 5% against other currencies, then sales growth will be zero in dollar terms.

The trade-weighted dollar appreciated by a massive 25% between 3Q14 and 2Q15. The dollar's appreciation alone cut S&P sales by more than 10 percentage points. As an example, the chart below compares changes in the dollar (blue line; inverted) with growth in S&P sales (red line). A higher dollar corresponds with lower sales, and vice versa (from Yardeni).



* Argentina, Australia, Brazil, Bulgaria, Canada, Chile, China, Colombia, Croatia, Czech Republic, Denmark, Ecuador, Egypt, France, Germany, Hong Kong, Hungary, Japan, India, Indonesia, Israel, Italy, Korea, Kuwait, Malaysia, Mexico, Morocco, New Zealand, Nigeria, Norway, Pakistan, Panama, Peru, Philippines, Poland, Romania, Russia Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Taiwan, Thailand, Turkey, United Kingdom, Ukraine, Uruguay, Venezuela, Vietnam, and United States.
Source: JP Morgan and Standard & Poor's.

Importantly, the dollar has since become a tailwind of sales. In the past year (thru 4Q17), *the dollar depreciated by 4%; this accounts for about 2 percentage points of the growth in corporate sales.* For the current quarter (1Q18), the dollar is on track for another 6% depreciation.

Earnings and Margins

Overall quarterly EPS (operating-basis) is now at a new high. It is 23% higher than a year ago on a quarterly-basis and 18% higher on a trailing 12-month basis (TTM). Earnings growth is the strongest in 7 years.

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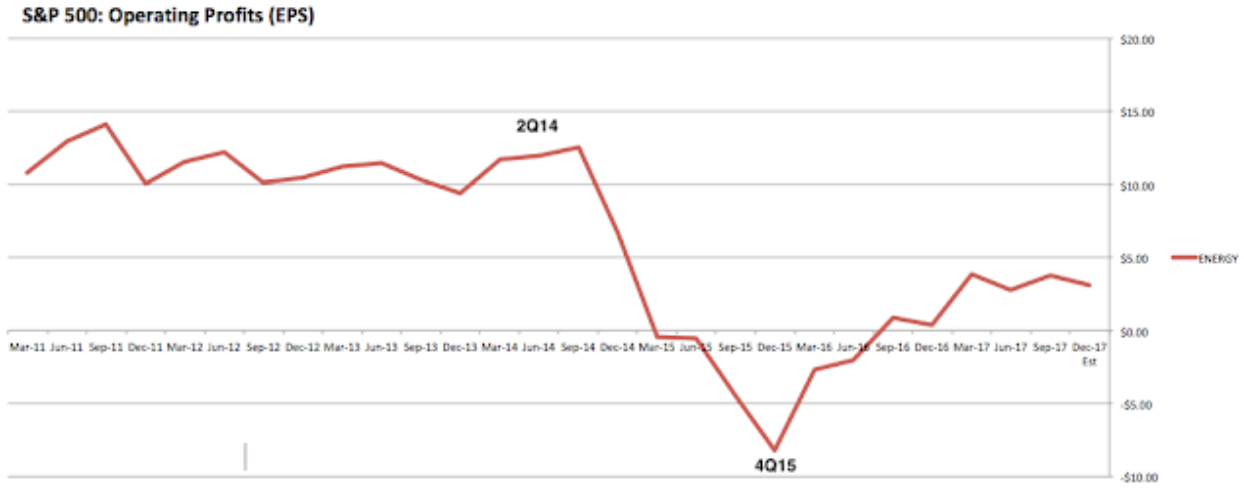
Again, note the impact of oil price on earnings: EPS peaked with high oil prices in 2Q14 and then bottomed near the low in oil prices at the end of 2015. The *new high in total EPS comes with energy sector EPS at a quarter of its level in 2014.*



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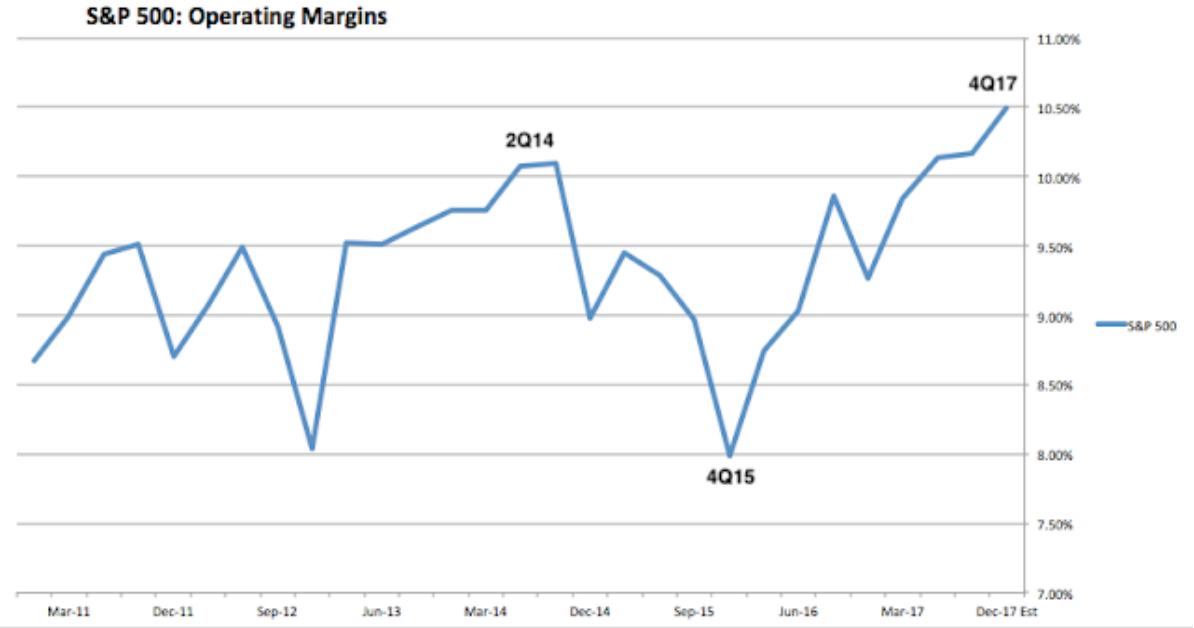
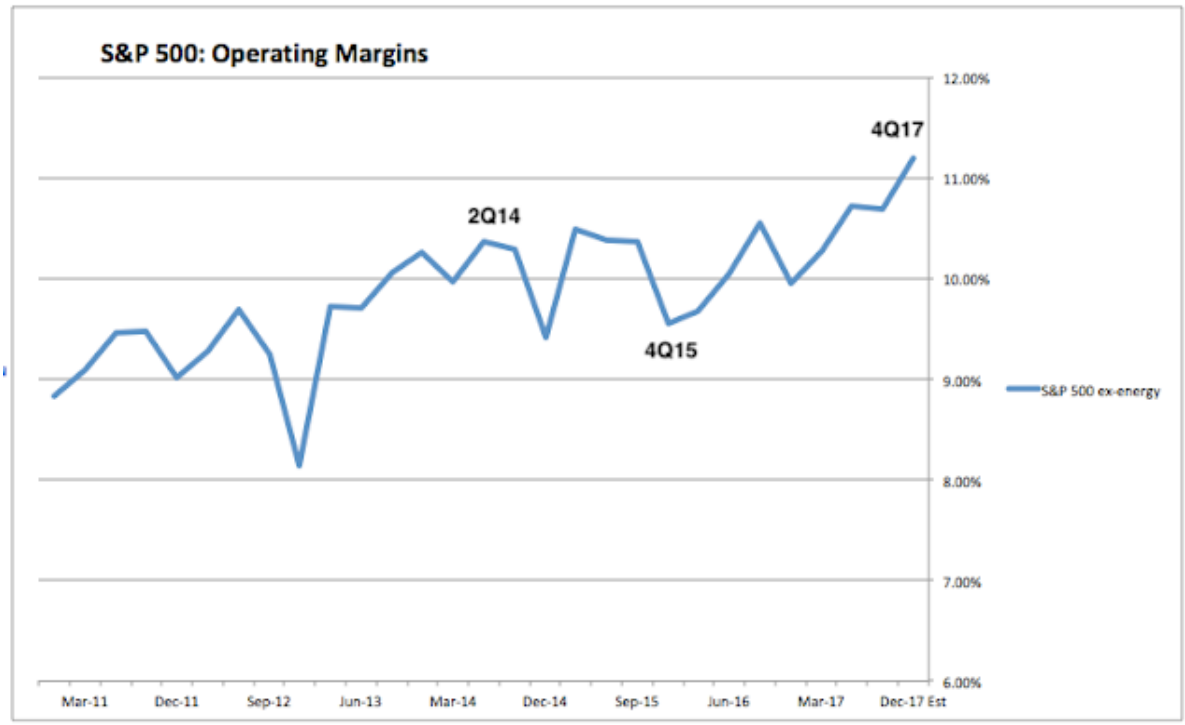
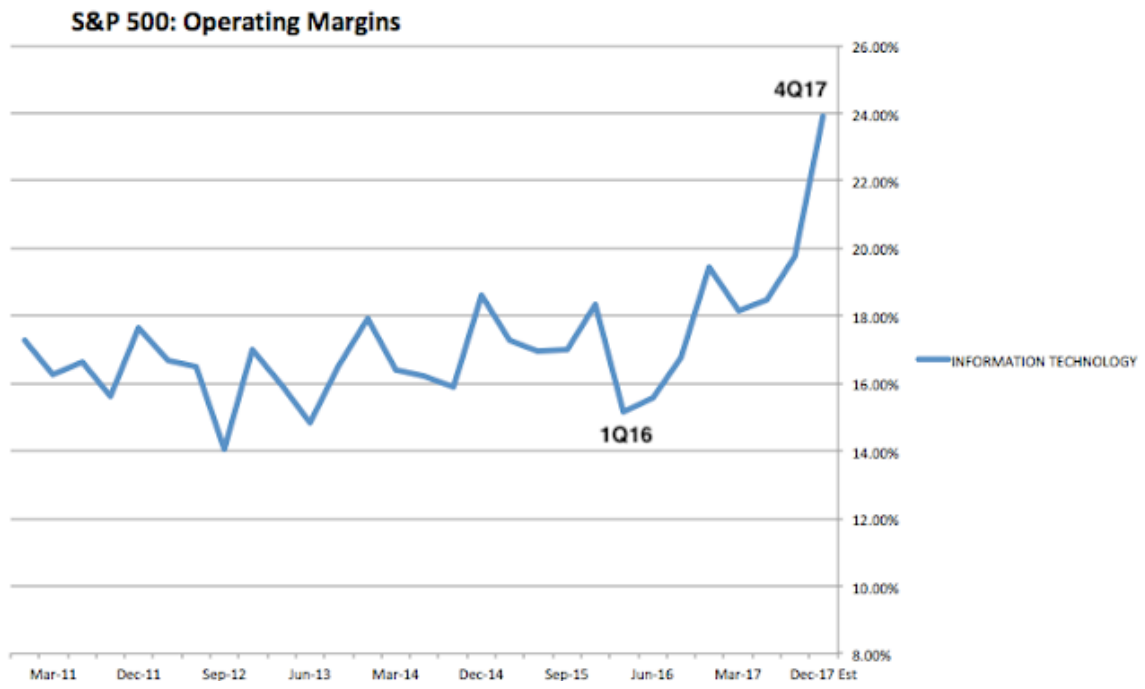
Likewise, overall profit margins peaked at 10.1% in 2Q14, fell to 8% at the end of 2015 and have since rebounded to *new highs of 10.5%* in 4Q17.



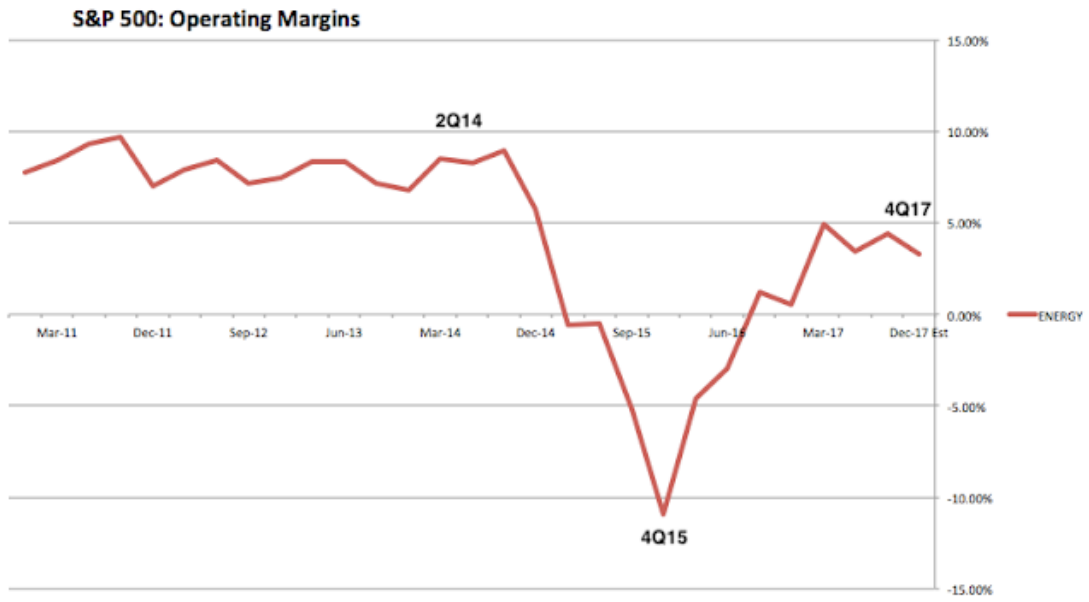
For most sectors, margins remained relatively stable between 2Q14 and 1Q17 (blue line). In the past 3 quarters, *non-energy margins have expanded to 11.2%, a significant new high*.



Most of the largest sectors have done well, but none so much as technology, where margins have shot up from 18% to 24% in the past year. This sector disproportionately benefits from a weaker dollar.



The energy sector remains the big outlier, where margins have fallen from a high of 9% to just 3% in the most recent quarter (red line).



Growth Outlook for 2018

Looking ahead, the consensus expects earnings growth of 18% and sales growth of 7% in 2018 (from FactSet). There are four considerations with a strong bearing on forward sales and earnings.

First, as a baseline, it is reasonable to assume that corporate (non-energy) sales growth will be largely similar to the *nominal economic growth rate of 4-5%*, excluding currency effects (numbers below are real; from the OECD).

Real GDP growth

Year-on-year, %

	2016	2017		2018		2019
		November Projections	Difference from September interim	November Projections	Difference from September interim	November Projections
World	3.1	3.6	0.1	3.7	0.0	3.6
United States	1.5	2.2	0.1	2.5	0.1	2.1
Euro area[1]	1.8	2.4	0.3	2.1	0.2	1.9
Germany	1.9	2.5	0.3	2.3	0.2	1.9
France	1.1	1.8	0.1	1.8	0.2	1.7
Italy	1.1	1.6	0.2	1.5	0.3	1.3
Japan	1.0	1.5	-0.1	1.2	0.0	1.0
Canada	1.5	3.0	-0.2	2.1	-0.2	1.9
United Kingdom	1.8	1.5	-0.1	1.2	0.2	1.1
China	6.7	6.8	0.0	6.6	0.0	6.4
India[2]	7.1	6.7	0.0	7.0	-0.2	7.4
Brazil	-3.6	0.7	0.1	1.9	0.3	2.3
Russia	-0.2	1.9	-0.1	1.9	-0.2	1.5

Note: Difference in percentage points based on rounded figures.

1. With growth in Ireland in 2015 computed using gross value added at constant prices excluding foreign-owned multinational enterprise dominated sectors.
2. Fiscal years starting in April.

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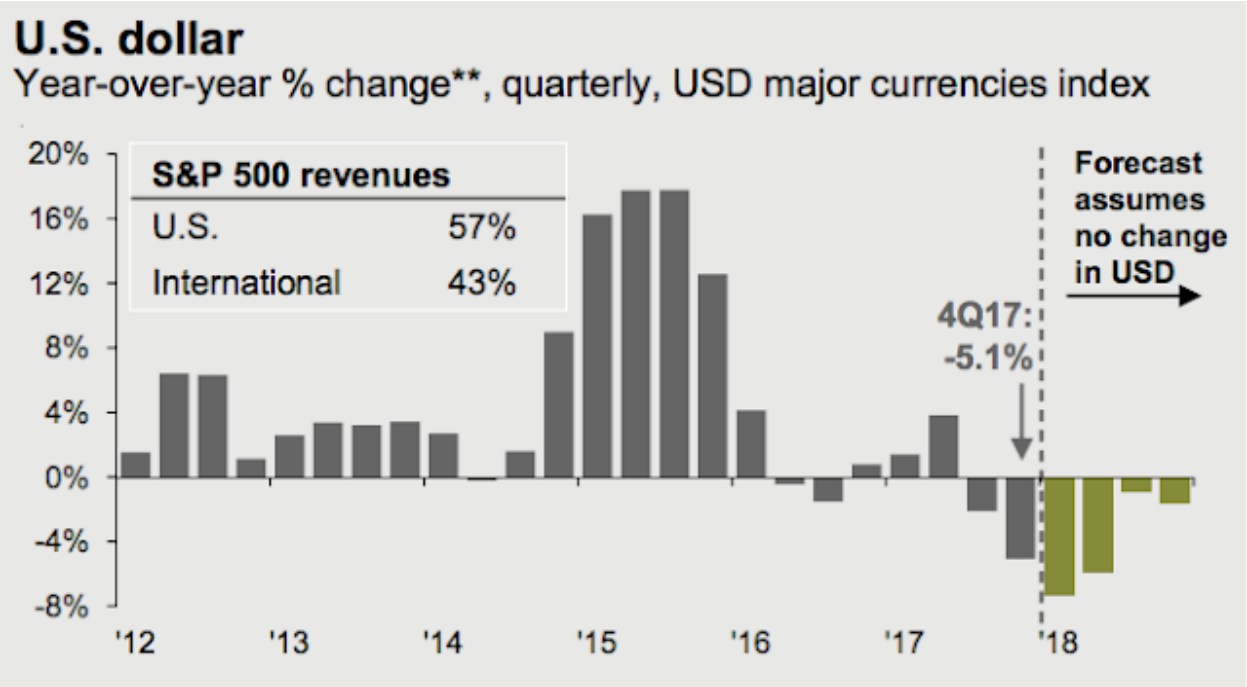
Second, the dollar has weakened over the past two years, tracking a depreciation of 6% yoy for 1Q18. That means that currency effects are a tailwind to growth; with half of corporate sales coming from abroad, *the weaker dollar could add another 3 percentage points to growth*. In other words, 4-5% baseline growth could become 7-8% if the dollar weakens 6% for the year (second chart from JPM).



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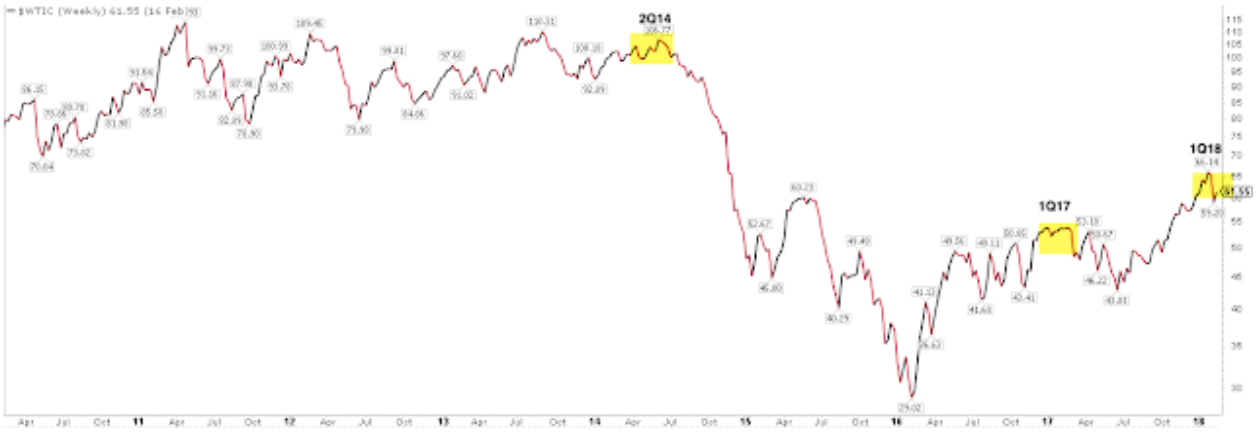
Third, the price of *oil is tracking a healthy 15% yoy gain,* meaning the energy sector should continue to be a tailwind to overall corporate sales and EPS growth.

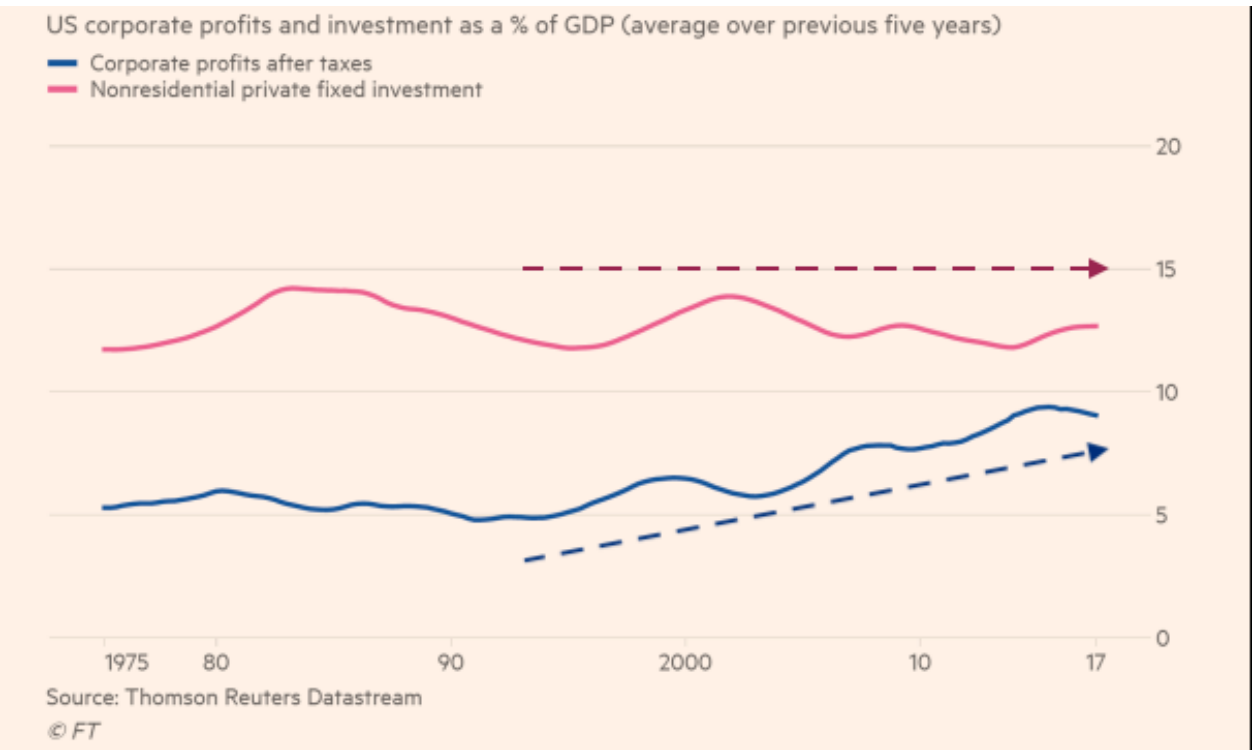


Importantly, the overall dollar level of energy EPS is now less than a third of its prior level, meaning the energy sector has greatly reduced impact on overall EPS relative to 2014 (from JPM).

As we have seen, the direct impact of oil prices on the energy sector is far more significant than any ancillary effects on other sectors. As an example, consider this: the price of oil fell from over $100 to under $50 between mid-2013 and mid-2016 but non-energy sector operating margins were 10% in both instances.

Finally, perhaps the biggest wild card for 2018 is corporate tax cuts. Analysts estimate that these could add 7 percentage points to growth, meaning baseline growth of 4-5% could jump to 11-12%.

The tax cut is a one-off adjustment probably applicable only to 2018. Why? US corporations are not capital constrained; they have abundant cash and access to low cost debt and equity. Moreover, corporations have been making fixed capital investments and have ample slack capacity (utilization is only 77%). Over the past 3 decades, rising corporate profitability (blue line) has had no positive affect on new investments (red line; from the FT). Net, there is not much reason to expect the tax cut to permanently raise growth rates.

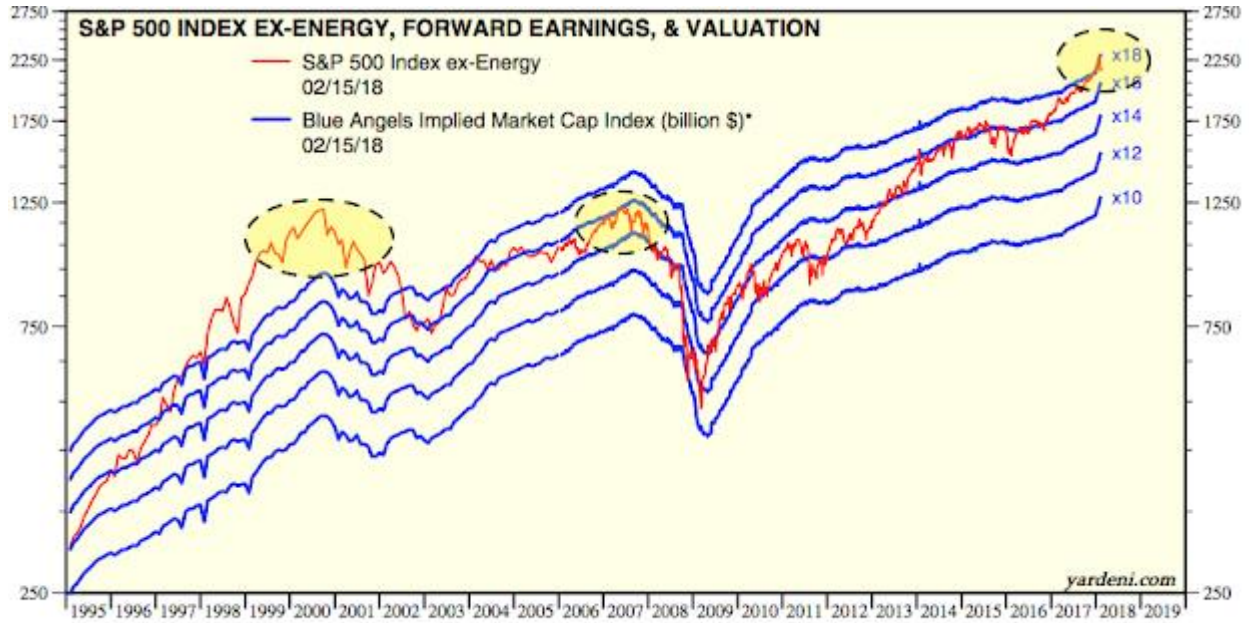


Valuation

Corporate growth appears to be attractive in 2018. This should be a tailwind for equities in 2018.

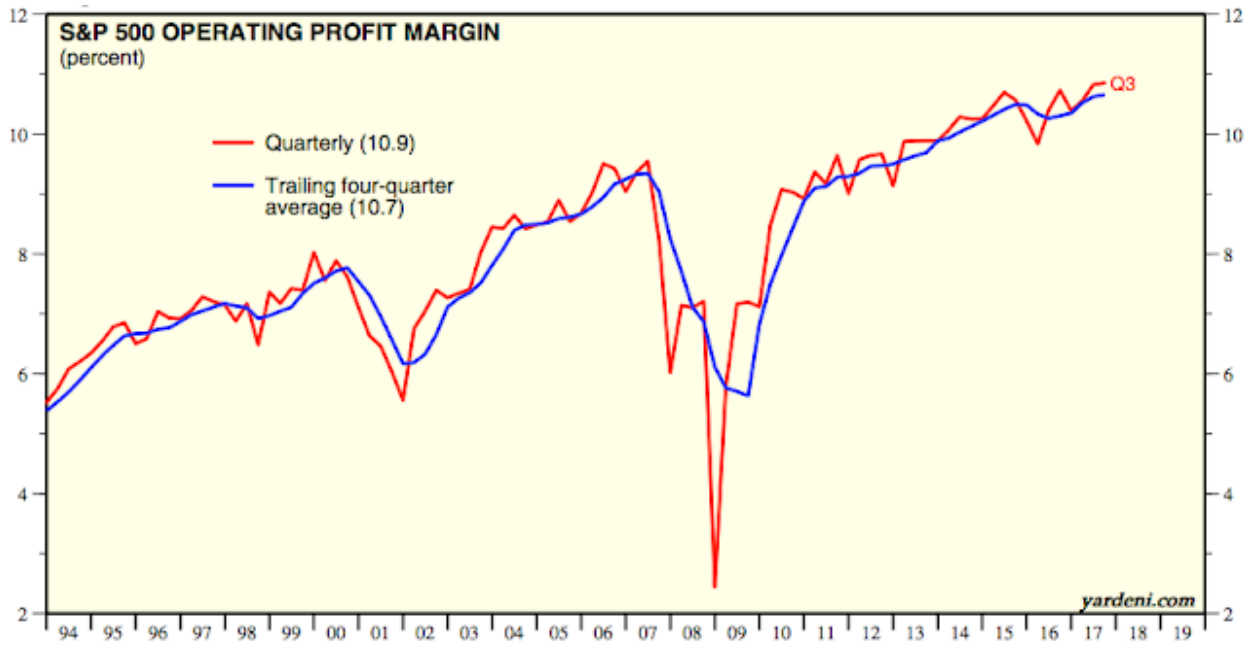
However, where bearish pundits have a valid point is valuation. Even excluding the energy sector, valuations were rich at the end of 2014 and are even more so today.

These *valuations are higher than in mid-2007*, when the prior bull market ended, and the highest since 1997-2002 (from Yardeni).



* Implied price index calculated using forward earnings times forward P/Es.
Source: Standard & Poor's Corporation and Thomson Reuters I/B/E/S.

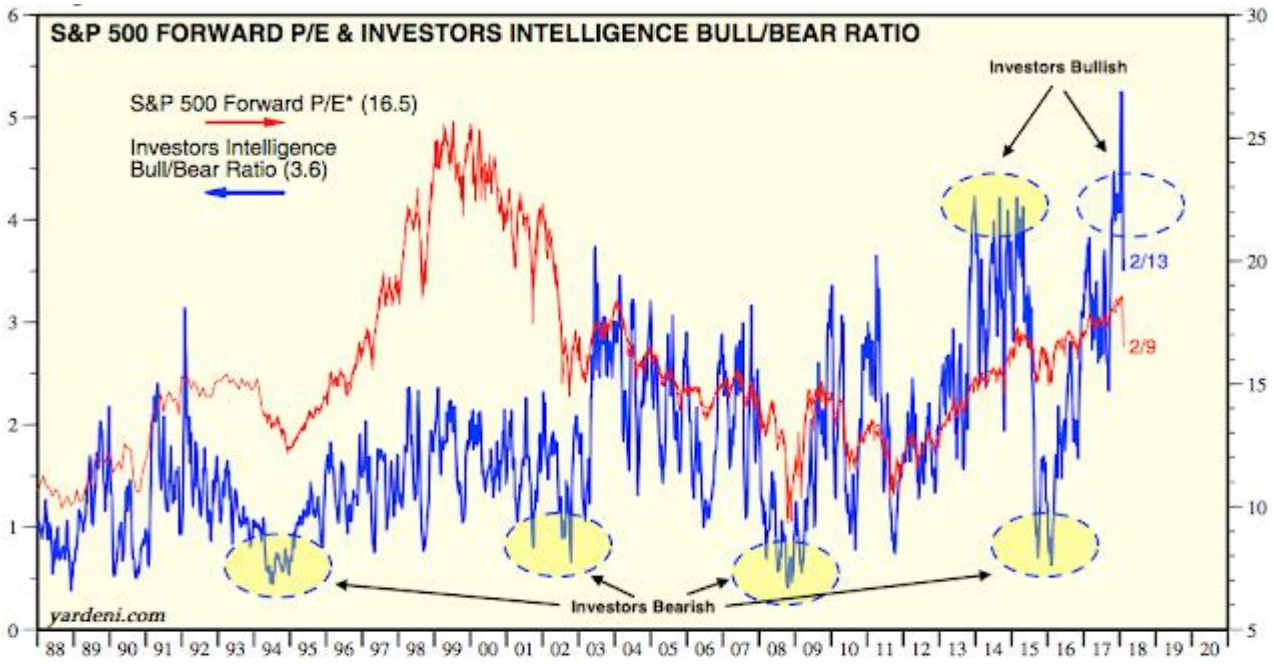
Part of the reason for the increase in valuations is corporate profitability. *Margins have reached successive new highs with each economic cycle over the past 23 years*: they are now more 100bp higher than in 2007, and that peak was more than 100bp higher than in 2000. It is objectively impossible to know when or at what level margins will peak for this cycle. It's a reasonable guess that further upside is probably limited (from Yardeni).



Source: Standard & Poor's Corporation.

With profit margins already at new highs, it will likely take excessive bullishness among investors to propel S&P price appreciation at a faster annual clip than corporate growth. Why?

When investors become bullish (blue line), valuations rise (red line). Investors had been pessimistic in early 2016; they are now very optimistic once again. If oil prices and the dollar flatten, earnings growth may be 10% yoy (including 6% from the tax cuts), so it will take higher valuations to push equity market appreciation higher. At this point, *valuations are a headwind to longer term equity returns* (from Yardeni).



* Average weekly price divided by 52-week forward consensus expected operating earnings per share. Monthly through April 1994, then weekly.
Source: Standard & Poor's Corporation, Thomson Reuters I/B/E/S, and Investors Intelligence.

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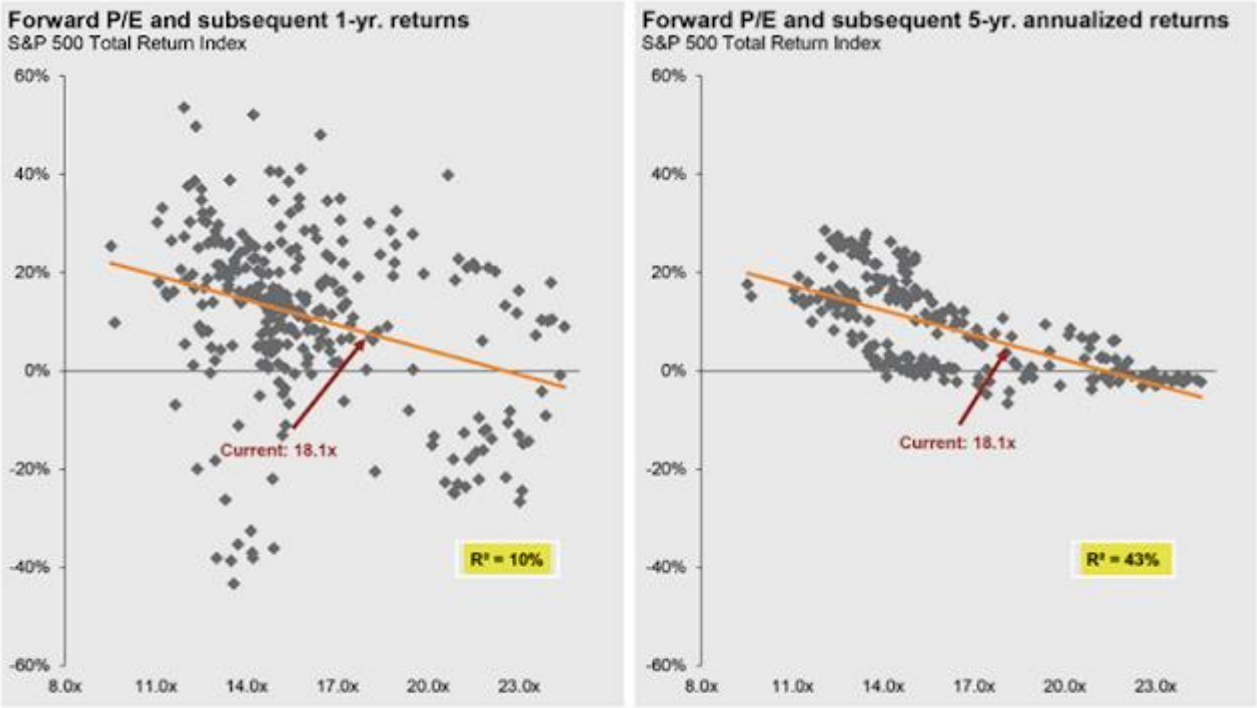
Importantly, valuations have almost no bearing on the market's 1-year forward return (left side). But over the *longer term, current valuations suggest that low single digit annual returns are odds-on* (right side; from JP Morgan).

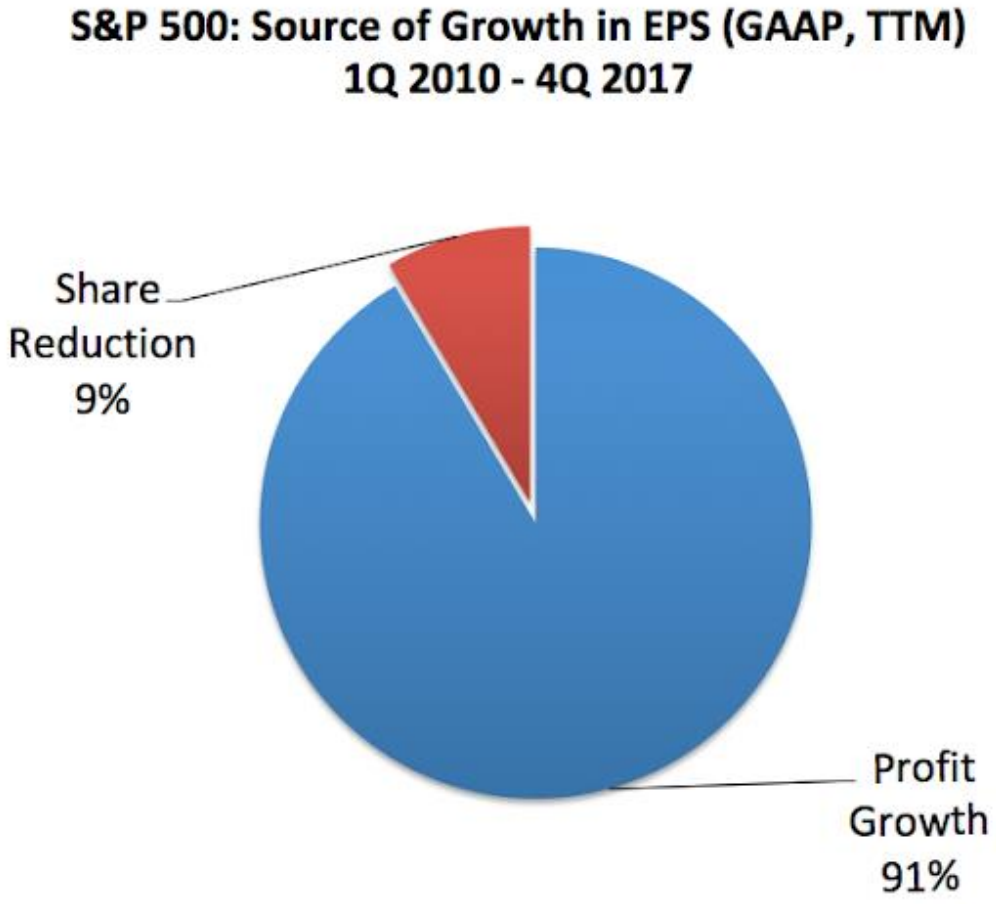


Source: FactSet, Thomson Reuters, Standard & Poor's, J.P. Morgan Asset Management.
Returns are 12-month and 60-month annualized total returns, measured monthly, beginning January 31, 1993. R^2 represents the percent of total variation in total returns that can be explained by forward P/E ratios.
Guide to the Markets – U.S. Data are as of January 31, 2018.

Common Misconceptions

Finally, let's address some common misconceptions that are regularly cited with respect to stock prices and corporate fundamentals.

First, companies have been accused of inflating their financial reports through corporate buybacks. In reality, however, *90% of the growth in earnings in the S&P over the past 8 years has come from better profits, not a reduction in shares*. Better profits drive growth, not "financial engineering."


S&P 500: Source of Growth in EPS (GAAP, TTM)
1Q 2010 - 4Q 2017
Share Reduction 9%
Profit Growth 91%

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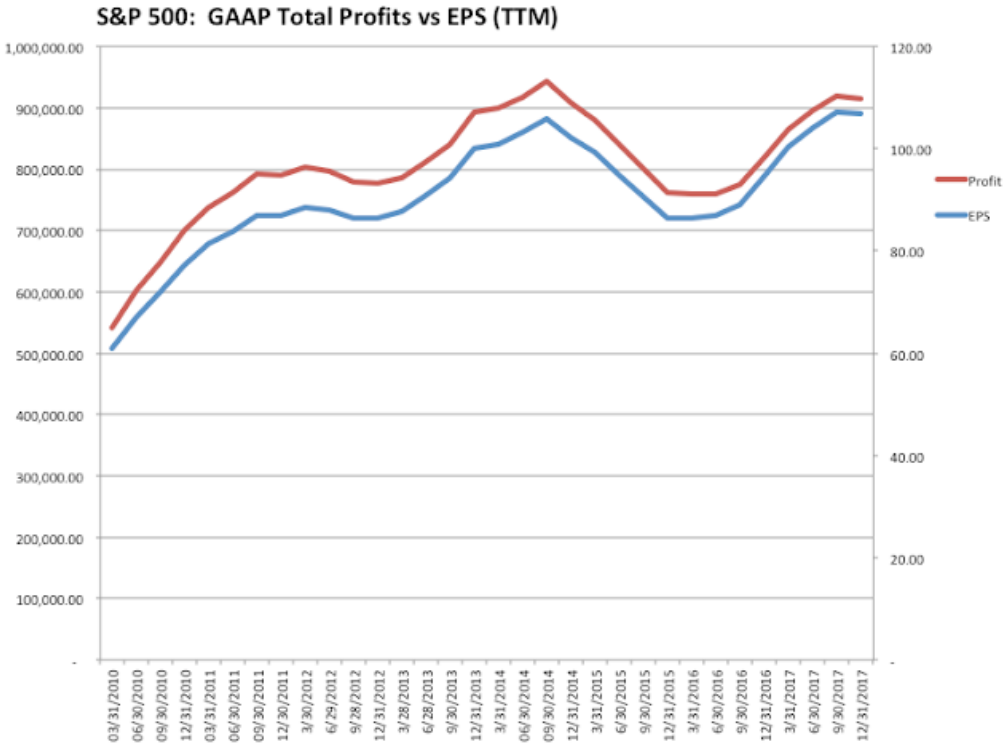
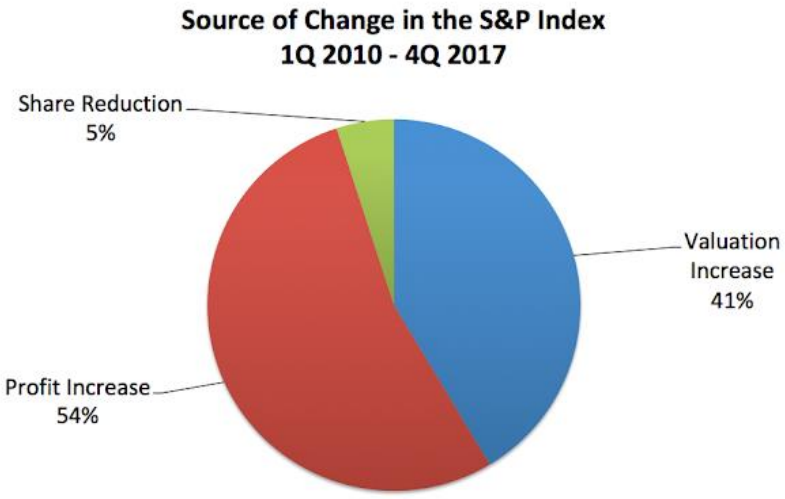
In fact, the impact of share reduction has declined over the past two years as the difference between EPS and profits has narrowed.

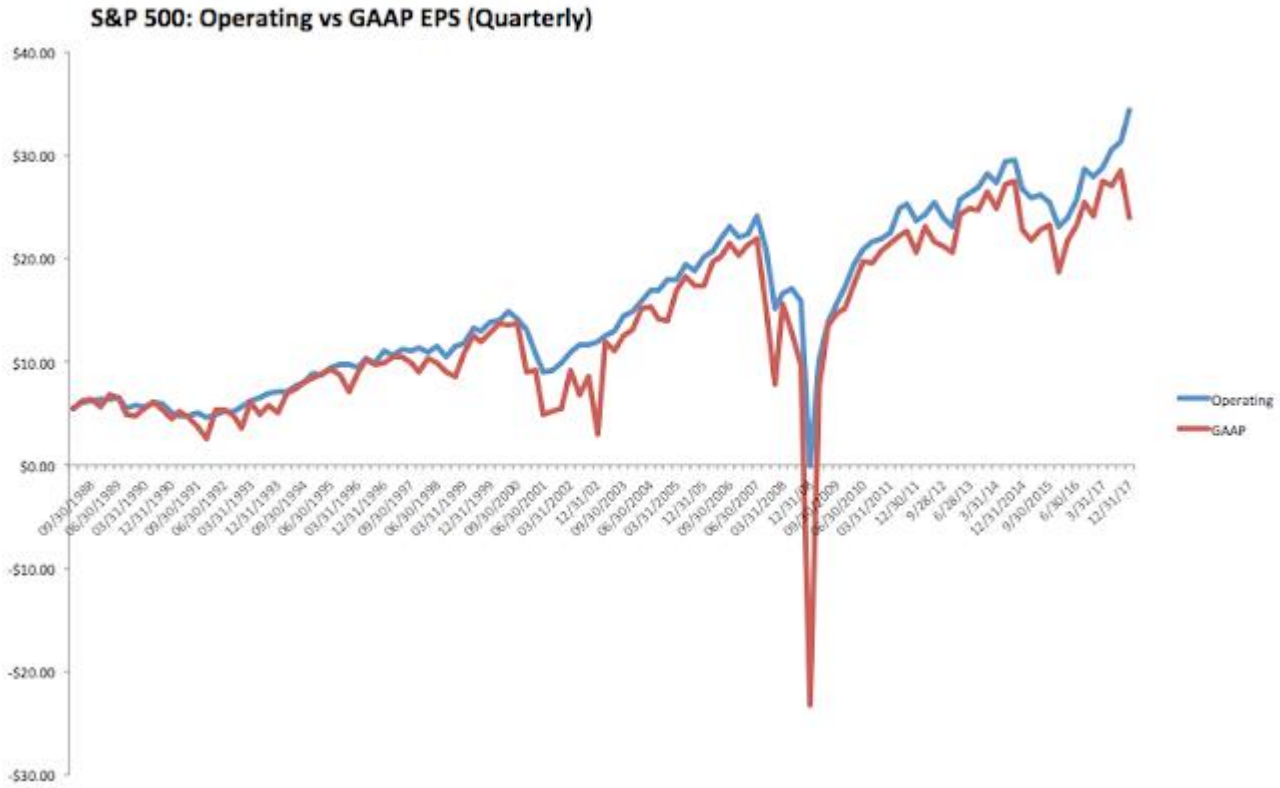


Second, equity prices are said to have far outpaced earnings during this bull market. In fact, *better profits accounts for about 54% of the appreciation in the S&P over the past 8 years*. Of course valuations have also risen - that is a feature of every bull market, as investors transition from pessimism to optimism - but this has been a smaller contributor. In comparison, 75% of the gain in the S&P between 1982-2000 was derived from a valuation increase (that data from Barry Ritholtz).



Even over the past 2 years (since 4Q15), during which time the S&P has risen about 31%, better earnings have accounted for 65% of price appreciation. Higher valuations contributed 24% of the index's return and share reduction the remaining 11%.

Third, financial reports are said to be fake. This complaint has been a feature of every bull market since at least the 1990s. In truth, the *trend in GAAP earnings (red line) is the same as "operating earnings"* (blue line).



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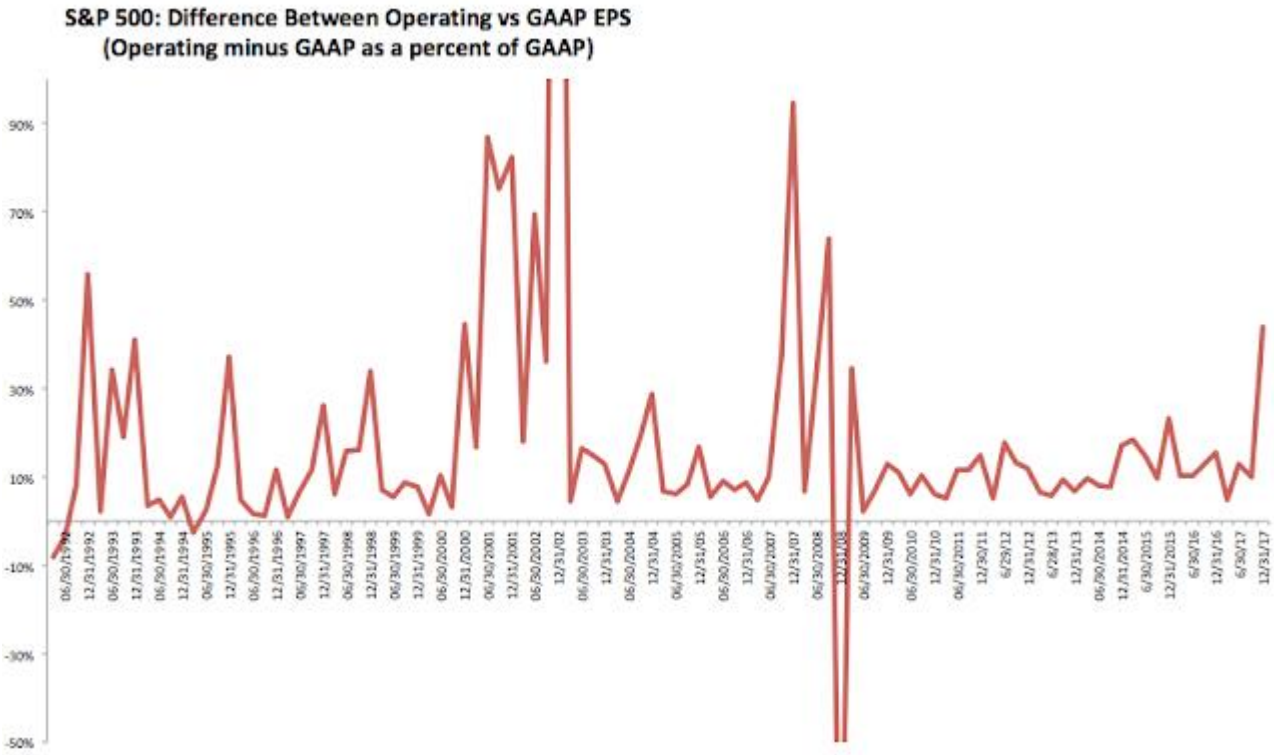
It is accurate to say that operating earnings somewhat overstate and smooth profits compared earnings based on GAAP, but that is not new. In fact, the difference between operating and GAAP earnings in the past 25 years has been a median of 10% and the recent history has been no different. Operating earnings overstated profits by much more in the 1990s and earlier in the current bull market. The biggest differences have always been during bear markets.



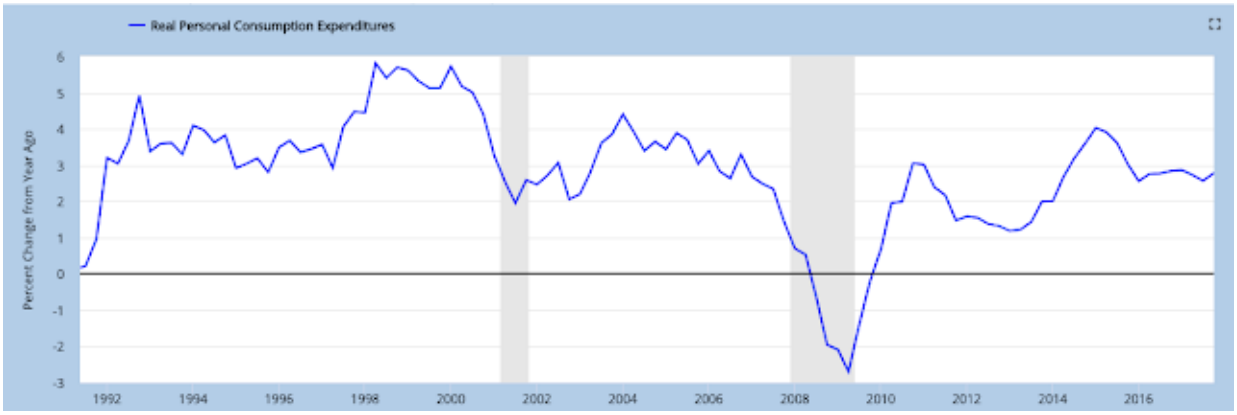
The last two charts show a larger than normal discrepancy between "operating earnings" and those based on GAAP in 4Q17. This is entirely due to the new tax reform law passed by Congress in late 2017. This impacted GAAP earnings in two adverse ways:

A reduction in the corporate tax rate reduces the value of prior year losses used to offset future year profits (termed "deferred tax assets"). To take one example, Citigroup, which incurred great losses during the financial crisis, had to take a one-time *non-cash* charge of $22 billion in 4Q17. This is a rare case where non-GAAP numbers are more meaningful. Read more here.

The new "territorial" tax law requires a one-time "toll tax" on foreign income previously earned abroad. This tax has to be paid over the next 8 years. This only adversely impacts companies that had planned to keep their profits offshore forever (like American Express); companies that had already accounted for repatriating the money will end up doing so at a lower rate and thus generate an accounting profit (like Apple). Read more here.

A basic sanity check on financial reports is to ask whether they are largely congruent with recent economic data. The answer at this point is that they are.

Jobless claims, for example, are at a 45-year low, and the trend down has not abated as it normally does ahead of a recession (first chart below). More people working drives consumption higher. US demand growth, measured any number of different ways, has been about 4-5% nominal yoy during the past three years (second chart below). There has been no marked deterioration in domestic consumption. In fact, new home sales reached a 10-year high in November. Under these conditions, continued growth in corporate sales should be expected.



In summary, corporate results in the fourth quarter were very good. S&P sales grew 9% over the past year, the best growth in 6 years. Earnings rose 23%, the best growth in 7 years. Profit margins expanded to a new all-time high of 10.8%.

The outlook for 2018 appears to be strong. "Baseline" economic growth is about 4%-5%. The dollar is depreciating, which could add another 3% to growth. The new tax reform law, passed in late 2017, is expected to add another 7%. Finally, rising oil prices are a tailwind for the energy sector. As a consequence, the consensus expects earnings to grow 18% this year.

Where critics have a valid point is valuation: even excluding energy, the S&P is now more highly valued than anytime outside of the late 1990s. It will likely take excessive bullishness among investors to propel equity price appreciation faster than earnings over the next few years. **BW: Information on Mr. Urban Carmel and his blog, The Fat Pitch, follows on the ensuing page.**

The Fat Pitch

WHAT IS THE FAT PITCH?

In baseball, a fat pitch is a hittable ball. The odds are in your favor. You might miss, but it is a situation where you should take a swing of the bat. If you swing at good pitches and avoid the crappy ones, you improve your OBP. Once on base, it becomes a running game.

The stock market serves a lot of curve balls. Now and then there comes a Fat Pitch, your odds-on opportunity to swing the bat. So, get on base and then manage your base-runners.

Specifically, the Fat Pitch on this site refers to two situations.

First: A Fat Pitch comes at a market turning point. It is an identifiable and quantifiable capitulation point where sellers or buyers have become exhausted and panic or euphoria is at an extreme. The Fat Pitch here is measured by a combination of (in no particular order): put-call, Trin, NYMO, sentiment, fund cash balances, major accumulation or distribution, volume, price relative to Bollinger bands, volatility, and consecutive days in a row in one direction. Swinging the bat without popping up is the hardest part.

Second: The Fat Pitch is a favorable investing environment. Old hands talk about there being only a few good times each year to be involved in the market. The remainder are unprofitable. I think this is correct. The Weekly Market Summary is intended to help discern when it is favorable to be long (or short) and when it is best to work on improving your French.

Every day, week, and year is a learning experience. The purpose of this site is to help refine what constitutes a Fat Pitch. Like baseball, you have to continue to work on your swing.

Our Objectives

The objective of the Fat Pitch is to provide a structured, quantitative, and empirical methodology for evaluating the state of the market. At any point in time, there are a variety of factors pulling on the market. We want to determine the relative importance of each factor in order to answer two questions:

1. In which direction should we be investing in the market?
2. Are tailwinds behind this direction or are headwinds picking up?

Every Friday we publish a Weekly Market Summary with green, yellow, and red lights on it. Green is good and red is bad. Everything on this site is in support of this market summary.

The little tabs across the top of the site (trend, breadth, etc.) mirror the different factors we follow to monitor the market. There is nothing here that does not fit with the methodology.

Anytime you want to understand why a factor is red or green, click on the tab and read the accompanying analyses. To the fullest extent possible, we quantify and use empirics to determine the state of every factor.

The Fat Pitch is authored by Urban Carmel, see below.

Urban Carmel

Strategy Consultant and Finance Commentator

Current	The Lewis Carmel Group
Previous	UBS Securities Indonesia, East Asia Hamon Asset Management, McKinsey & Company
Education	Wharton School, University of Pennsylvania

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