Trend Macro™

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MACROCOSM

A Year of Upgrades in 16 Days

Tuesday, January 16, 2018
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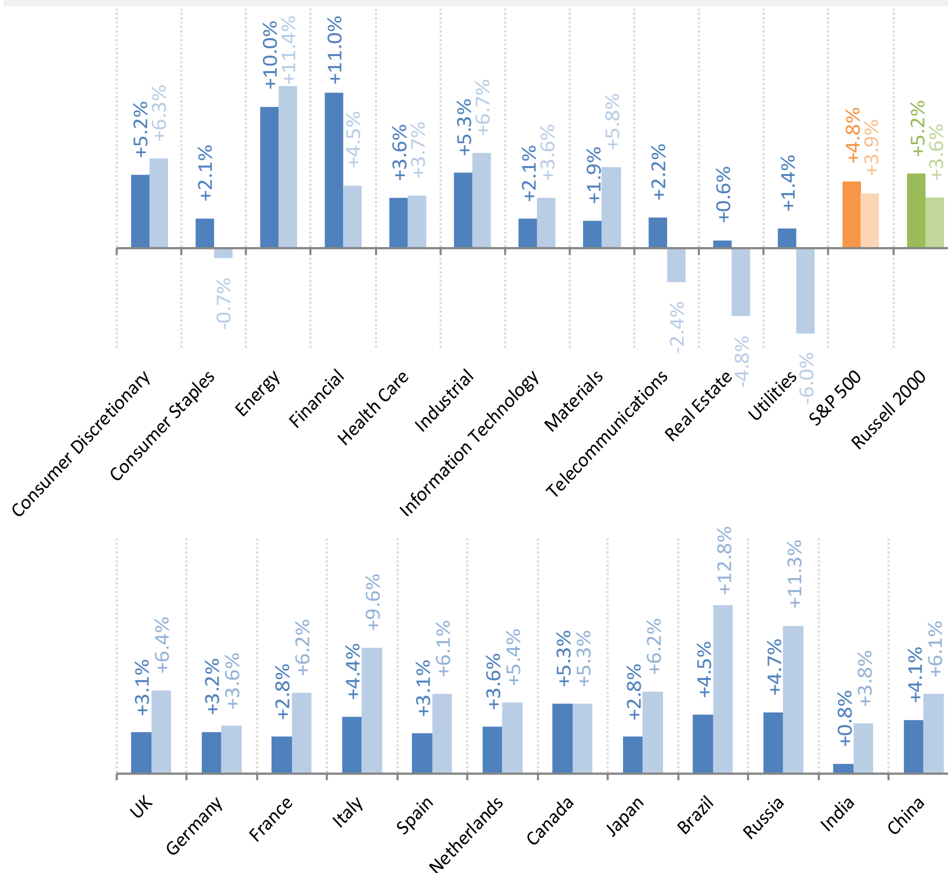
We rest our case that the tax cuts weren't fully discounted. And they still aren't.

For earnings estimate upgrades, there's almost never been 16 market days as amazing as the last 16 market days. S&P 500 year-ahead consensus estimates have been upgraded 4.8%, and for the Russell 2000, 5.2% (please see the top chart below). Historically, more than one-third of *entire years* have seen less upgrading than that (please see the chart on the next page). *And there's more to come. As we've been saying, the explanation is simple: the Tax Cuts and Jobs Act effectively raises after-tax US earnings by 22%* (see, "Tax Cuts: Smells Like Victory (For Some more than Others)" December 18, 2017).

Change over 16 market days ■ **Forward earnings** ■ **Stock prices**
From Dec 19, 2017 enactment of TCJA — Non-US markets in USD



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US STOCKS, FX, US MACRO: S&P 500 forward earnings are up 4.8% since tax cuts were enacted 16 market days ago. Stocks have moved to new highs in tandem, proving that the tax cuts were not fully discounted. Sector performance is highly correlated to magnitude of estimate upgrades, with defensive sectors systematically underperforming. Weak USD has surprised the consensus, due to dis-preference for defensive assets. We expect more upgrades, and higher equity prices. The equity risk premium has not narrowed much, because higher prices have been supported by higher earnings. We will go on alert for the inevitable correction when the ERP moves to a new post-crisis tight. It's not that far away.

[Strategy dashboard]

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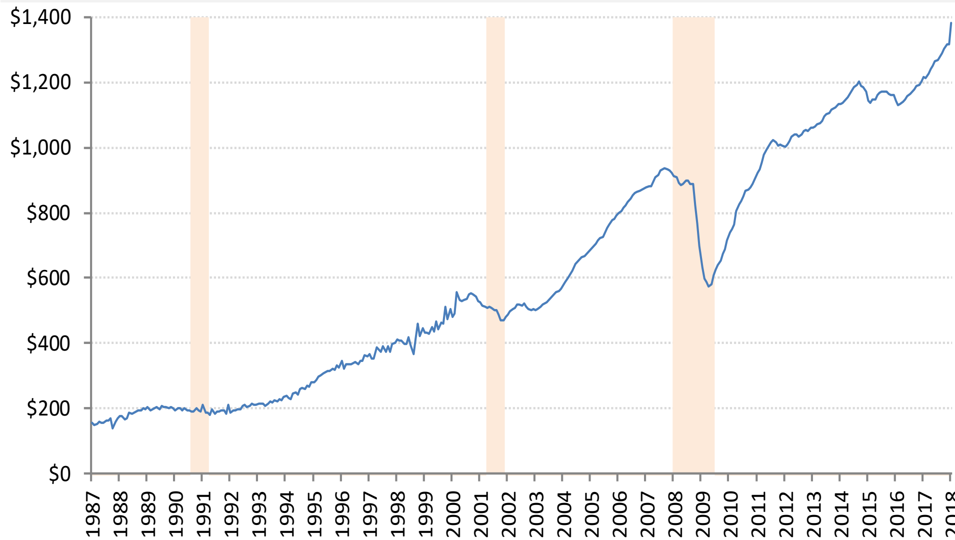
S&P 500 year-ahead consensus forward earnings USD bil **Recessions**

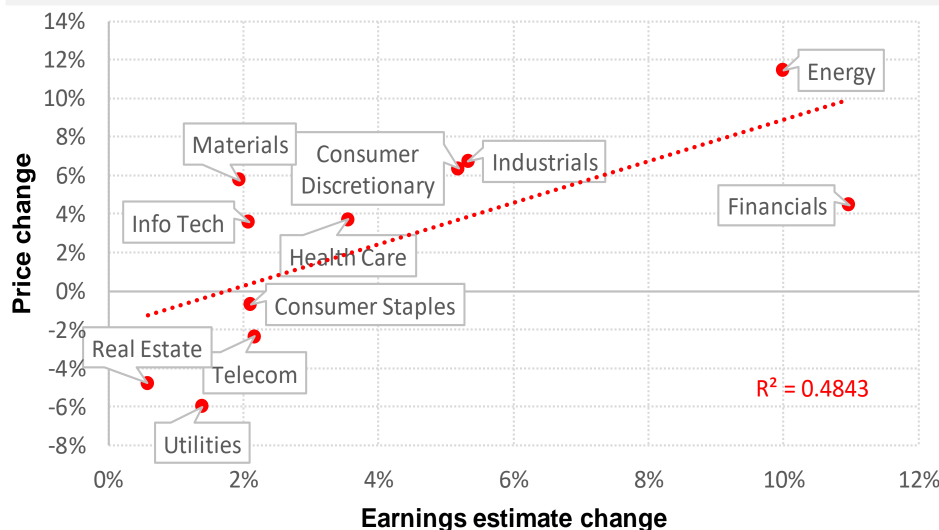


Source: Various, TrendMacro calculations

The 4.2% gain for the S&P 500 *year-to-date* has been consensus-beating, and proves our thesis that *the tax cuts were not fully discounted*. But because there was, as we expected, a brief sell-on-the-news reaction right after the tax cuts were enacted, and because surely *some* upgrades *were* discounted (again, see "Tax Cuts: Smells Like Victory (For Some more than Others)") – so far the S&P 500's 3.9% gain *since enactment* hasn't entirely kept up with the 4.7% gain in consensus earnings estimates.

- The sector-distribution of estimate upgrades and price gains has been quite diverse. But the relationship between the two has been logical – *the magnitudes of upgrades and price gains have been reasonably highly correlated* (please see the chart below).

Earnings upgrades and stock prices From Dec 19, 2017 enactment of TCJA



Source: Bloomberg, TrendMacro calculations

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[About us]

- Obviously the tax cuts haven't been the only thing going on, so they aren't the only influence on either earnings or prices.
- For example, the energy sector is the best-performing year-to-date not only because the tax cuts are very flattering to its US-focused income statements, but also because there's been an almost 12% gain for the WTI crude price since the tax cuts were enacted. By the way, that brings it to within pennies of our $65 price target (see, most recently, "Oil: From Priced to Perfection, to Perfect Storm" November 27, 2017) – but we're still not quite there!
- On the negative side of the ledger, for the utilities sector, consensus estimate upgrades are puny in the wake of the tax cuts, apparently assuming that regulators will direct the gain in free cash-flow into the hands of customers in the form of lower rates, not shareholders in the form of higher dividends. Was someone expecting otherwise? Apparently – year-to-date, the sector is down almost as much as the S&P 500 is up.
- *In part, it's due to a systematic dis-preference for defensive sectors – utilities, consumer staples, telecom and real estate, in what is shaping up to be an aggressive pro-growth environment.*
- We think the same logic applies to the weak dollar year-to-date. The consensus was that the combination of lower taxes, higher after-tax earnings, and a tighter Fed would strengthen USD. The only slight surprise has been in the last of those expectations.
- As it has turned out, curve-implied ECB tightening expectations (for hikes in the bank rate three years out) have grown by 20 bp since the tax cuts were enacted, while Fed tightening expectations (for hikes in the funds rate three years out) have grown by only 13 bp. At the same time, the 10-year bund yield has backed up 20 bp, while the US 10-year has backed up only 8 bp.
- We hardly think those 7 bp and 12 bp differences, respectively, can explain the 2.6% weakening in the trade-weighted dollar over the same period. All the less when differential central bank tightening expectations and long-term bond yields in Japan have gone the other direction, relative to the US.
- We note that this dollar weakness means that, no matter how spectacular US stock returns have been since the tax cuts, most non-US markets look even better, at least in USD terms (please see the bottom chart on the first page). As we expected, emerging markets are strongly out in front – even without the USD boost (see "2018 Outlook: From Denial to Acceptance" December 29, 2017).
- While many credible-sounding theories are adduced to explain FX movements (differential interest rates, inflation rates, debts and deficits, capital flows, and so on) the only one that consistently holds water in our view is that USD is a safe-haven asset. So it's entirely consistent, and consistent with our expectations (again, see "2018 Outlook: From Denial to Acceptance"), that USD would weaken just as defensive equity sectors have.
- The dis-preference for defensive sectors is consistent with our expectation that growth would broaden out from last year to more sectors (again, see "2018 Outlook: From Denial to Acceptance"), and indeed it has. Who thought energy would start the year in the lead? To be sure "growth" has outperformed "value" in all

Recommended Reading

Everyone Is Getting Hilariously Rich and You're Not
Nellie Bowles
New York Times
January 13, 2018

Inside One of America's Last Pencil Factories
Christopher Payne and Sam Anderson
New York Times Magazine
January 12, 2018

James Damore et al. versus Google
Dhillon Law Group
Superior Court of California
January 8, 2018

How high-tax states may try to get around the new SALT deduction cap
Jeanne Sahadi
CNN Money
January 3, 2017

'We All Knew' street art welcomes Hollywood elites to Golden Globes
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American Mirror
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Band of the Insulted: The Nicknames of Trump's Adversaries
Matt Flegenheimer
New York Times
January 6, 2018

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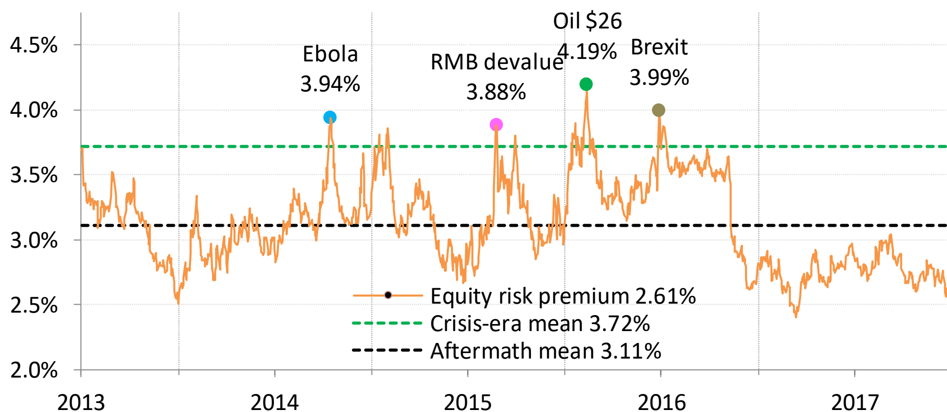
capitalization classes, as it did last year. The "FANG" stocks have slightly outperformed the market. But the overall technology sector has not led the way by any means, either year-to-date or since the tax cuts were enacted, in terms of either earnings upgrades or price gains.

- We think there are more upgrades to come – immediately, based on analysts continuing to recognize the first-order free cash flow effects of the tax cuts, and over time as the higher-order effects materialize (see "Delayed Gratification for Corporate Tax Cuts" November 20, 2017). *We think stocks will generally push higher, as the upgrades come in.*
- There has been a lot of chatter about supposedly high equity valuations (see "Tax Reform Has Released the Bulls" January 12, 2018). Perversely, we are encouraged by the excess of caution about it displayed on Wall Street and in the financial media. We were particularly encouraged, and amused, by the Bloomberg headline proclaiming "Pimco, Citigroup Sound Complacency Alarm for Global Economy." Surely "complacency alarm" is a contradiction in terms.
- *As to timing the inevitable correction, we're living headline-by-headline. But our touchstone is the equity risk premium* (please see the chart below, and see "Data Insights: Global Equity Risk Premia" December 12, 2017).

S&P 500 equity risk premium Fwd earnings yield minus 30-yr Treasury



Source: Bloomberg, TrendMacro calculations

- So far, though US stocks have aggressively pushed to new highs, the S&P 500 ERP has *not yet* narrowed beyond its post-crisis tight last March (which triggered our correct call for 2017's only stock market correction – see "A Trump Correction at Last?" March 3, 2017).
- *The ERP has stayed as wide as it has because, again, earnings upgrades have actually outpaced stock price gains – and at the same time, the back-up in long-term Treasury yields has been quite modest.*
- *We fully expect that sometime this year the ERP will punch through to new post-crisis tights, as part of the global generational "turning"*

to greater risk-tolerance that we have often written about (see, among many, "From Executive Orders to Spontaneous Order" February 17, 2017). *But if experience is any guide, there is usually a stock market correction when it first tries to do so. It's not far away.*

Bottom line

S&P 500 forward earnings are up almost 4.8% since tax cuts were enacted 16 market days ago. Stocks have moved to new highs in tandem, proving that the tax cuts were not fully discounted. Sector performance is highly correlated to magnitude of estimate upgrades, with defensive sectors systematically underperforming. Weak USD has surprised the consensus, due to dis-preference for defensive assets. We expect more upgrades, and higher equity prices. The equity risk premium has not narrowed much, because higher prices have been supported by higher earnings. We will go on alert for the inevitable correction when the ERP moves to a new post-crisis tight. It's not that far away.