Weighing the Week Ahead: Will Corporate Earnings Results Change the Message of the Markets?

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by Jeff Miller

of NewArc Investments, Inc.

It is a light economic calendar without any of the most important reports. The government shutdown will command increasing attention as long as it continues. Finally, there is some real competition in financial news – the start of earnings season. For weeks it has been a battle between economic data and stock prices, between economists and traders, between those investing on fundamentals and those trying to time the market. Expect the punditry to be asking:

Will corporate earnings results change the message of the markets?

I hope we can analyze stocks instead of political controversies in the week ahead.

Last Week Recap

In my last edition of WTWA I took a deeper look at indicators that were "rolling over." While that did not slow down the exaggerated use of the term, perhaps a few people were inoculated.

I also mentioned my annual preview for Seeking Alpha. This highlights the factors I see as most important in the year ahead. Currently it is only published on Seeking Alpha, so other readers should look for it there.

The Story in One Chart

I always start my personal review of the week by looking at a great chart. This week I am featuring Jill Mislinski. She includes a lot of relevant information in a single picture – worth more than a thousand words. Read the full post for more great charts and background analysis.

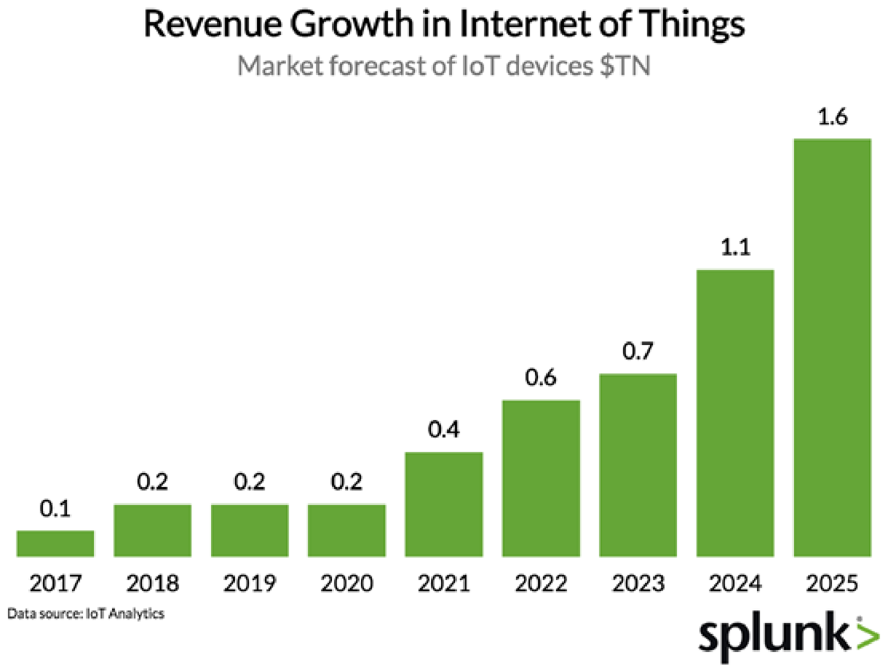
Stocks gained 2.5% with lower volatility. The trading range of 2.8% was only slightly higher. You can see the results compared to some past data in our indicator snapshot (below).

Personal Note

I'm off next weekend. Mrs. OldProf and I are visiting with friends. I'll try to post an update on indicators and perhaps raise some questions for discussion, but no promises. She recommends some chilling time and is probably right.

Noteworthy

Everyone is aware of the Internet of Things, and probably the growing importance. But what about the rate of that growth? Long-term investors should have something in the portfolio to take advantage of the expected revenue. Priceonomics has a good discussion and this chart.



The News

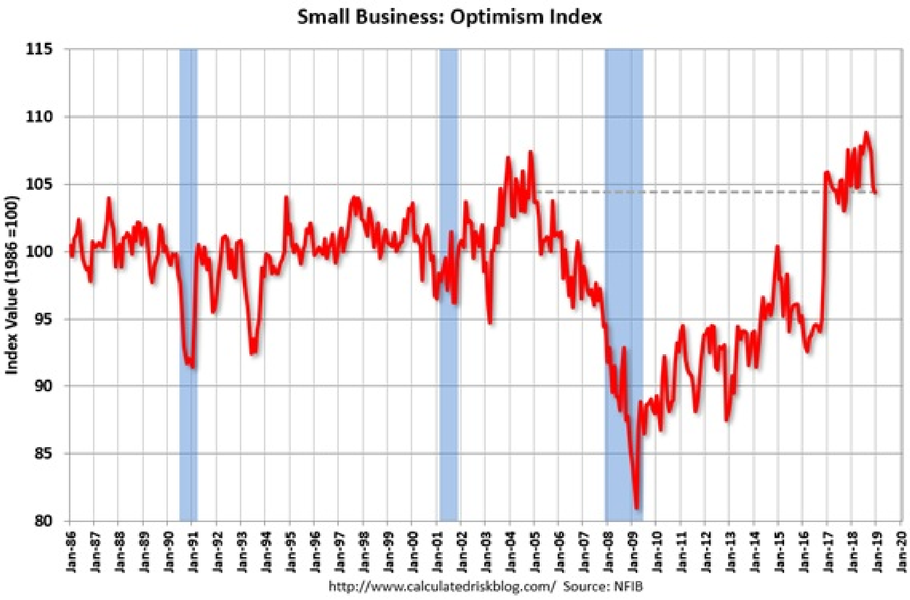
Each week I break down events into good and bad. For our purposes, "good" has two components. The news must be market friendly and better than expectations. I avoid using my personal preferences in evaluating news – *and you should, too!*

New Deal Democrat's high frequency indicators are an important part of our regular research. This week's update shows that the short-leaning indicators have declined further and are now negative. The long-leading forecast is now slightly positive "for the first time in months.

When relevant, I include expectations (E) and the prior reading (P).

The Good

- ***CPI*** remained benign with a decrease of 0.1% (in line with forecasts and lower than last month's flat reading. The core CPI was also as expected, showing an increase of 0.2%. Eddy Elfenbein explains the market significance.
- ***FOMC Minutes*** confirmed the "more patient Fed" interpretation. Business Cycle expert James Picerno notes that Fed Funds futures are pricing in a pause in 2019.
- ***Rail traffic is very strong*** reports Steven Hansen (GEI). He shows accelerating growth in rolling averages compared to one year ago.
- ***NFIB Small Business Optimism*** registered 104. (P 104.8). Calculated Risk notes the strong result in a noisy series. Unlike during the recession where businesses cited "poor sales" as their biggest problem, it is now a question of finding qualified workers. Yes, there is a bit of "rolling over" as ratings remain near the all-time record.

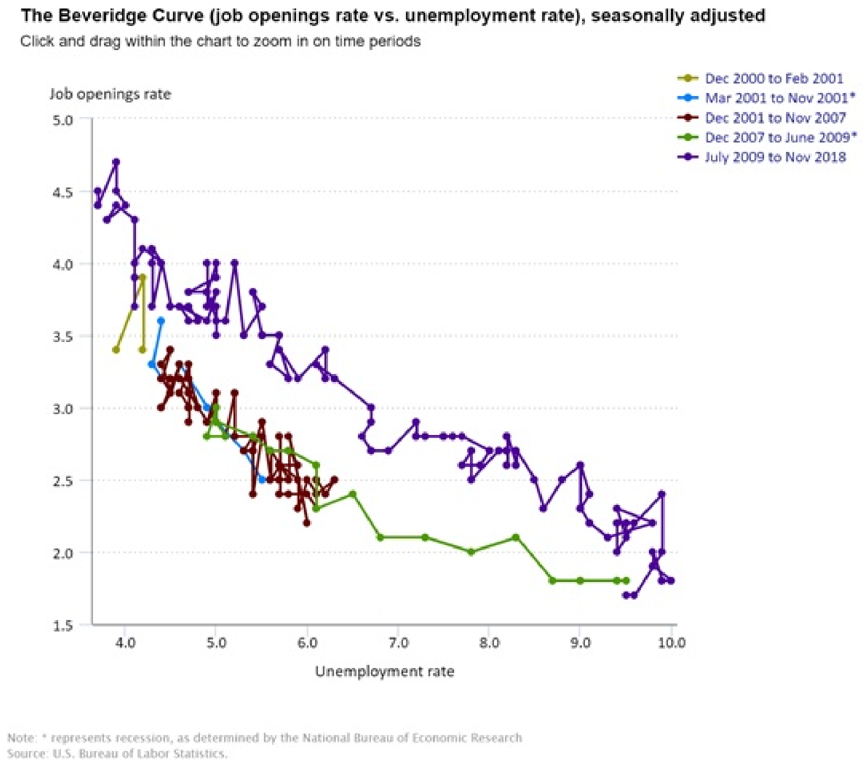


- ***Initial jobless claims*** declined to 216K, beating expectations by 12K and the prior week by 17K. The data do not yet include any effects from the government shutdown.

The Bad

- ***ISM Non-Manufacturing*** recorded 57.6. Last month was 60.7 and the forecast was 58.0 so I am scoring it as “bad.” One of my “reliably bearish” Twitter follows quoted ZH in describing this as “plummeting.” I note that new orders increased to 62.7. The ISM’s research states that the index, if annualized, implies real GDP growth of 3.2%. This is the danger of “rolling over” in the hands of those on a mission to sell you something. Read the entire report for the component results and some comments from those surveyed.
- ***JOLTS*** showed a decline in job openings to 6.888 million (P 7.131 M). This was treated as bad news by the market, which does a poor job on this report. JOLTS is not the best measure of job growth or economic strength. The monthly payroll report is better for that. JOLTS explains the structure of the labor market, especially whether it is tightening. The needed interpretation defies the capsule summary required by financial media.

And this update on the widely-misunderstood Beveridge Curve, among several other good ones in the chart pack.



The Ugly

The implications of CEO denials of valid, on the record talks with reporters. Chris Roush (Talking Biz News) explains the implications for financial journalism of the Moonves denial.

The government shutdown "doomsday scenario." Here are all the developing effects, gathered in one place. May cooler heads prevail before this happens.

The Week Ahead

We would all like to know the direction of the market in advance. Good luck with that! Second best is planning what to look for and how to react.

The Calendar

The calendar is a bit light, featuring PPI (inflation not expected) homebuilder sentiment, industrial production, and the early read on Michigan consumer sentiment.

Much more exciting for markets will be the first important earnings reports for Q418.

Briefing.com has a good U.S. economic calendar for the week. Here are the main U.S. releases.

Week of January 14 - January 18

Date	ET	Release	For	Actual	Briefing.com Forecast	Briefing.com Consensus	Prior	Revised From
Jan 15	08:30	PPI	Dec		-0.1%	-0.1%	0.1%	
Jan 15	08:30	Core PPI	Dec		0.2%	0.2%	0.3%	
Jan 15	08:30	Empire State Manufacturing Survey	Jan		10.0	12.2	10.9	
Jan 16	07:00	MBA Mortgage Applications Index	01/12		NA	NA	23.5%	
Jan 16	08:30	Import Prices ex-oil	Dec		NA	NA	-0.3%	
Jan 16	08:30	Export Prices ex-ag.	Dec		NA	NA	-1.0%	
Jan 16	10:00	NAHB Housing Market Index	Jan		55	56	56	
Jan 16	10:30	EIA Crude Oil Inventories	01/12		NA	NA	-1.7M	
Jan 16	14:00	Fed's Beige Book	Jan		NA	NA	NA	
Jan 16	16:00	Net Long-Term TIC Flows	Nov		NA	NA	$31.3B	
Jan 17	08:30	Initial Claims	01/12		225K	221K	216K	
Jan 17	08:30	Continuing Claims	01/05		NA	NA	1722K	
Jan 17	08:30	Philadelphia Fed Index	Jan		10.0	10.5	9.4	
Jan 17	10:30	EIA Natural Gas Inventories	01/12		NA	NA	-91 bcf	
Jan 18	09:15	Capacity Utilization	Dec		78.4%	78.5%	78.5%	
Jan 18	09:15	Industrial Production	Dec		0.1%	0.2%	0.6%	
Jan 18	10:00	Univ. of Michigan Consumer Sentiment - Prelim	Jan		97.0	96.0	98.3	

Next Week's Theme

The continuing government shutdown will attract plenty of media attention; it is starting to filter into stories about market and economic effects. Financial matters are usually among the easiest for compromise, since splitting the difference is easy. The problem is the symbolism of the President's signature campaign promise. We can begin to see some movement and changes in terminology, but who knows how long it will take?

I expect (and hope) that financial news will pay more attention to the start of earnings season. Because of the backdrop of economic data versus action in financial markets, we'll all be asking:

Will corporate earnings results change the message of the markets?

I will first provide some background on 2018, then consider theories about the upcoming season, and finally describe what to watch for.

> ***Background***

> For much of 2018 stocks were under pressure despite a strong economy and growing earnings. The financial punditry emphasized the "message" from stock weakness. The Pundit-in-Chief took the lead (with a reprise of his famous rant) insisting that he had special information about the problems faced by many companies. The decline in stocks became "evidence" that the economic and earnings data did not tell the entire story. In the Q3 earnings season, stocks missing expectations declined significantly. Those beating expectations had only modest gains.

The result? Year-over-year earnings growth over 20% could not generate a rally in stocks. Instead, P/E multiples contracted. This is a clear signal of skepticism about earnings growth.

> ***Theories***

Speculation might be a better term than "theories." Each of the following, stating with the most bearish, has its disciples:

- Weak earnings growth will reveal the error in reported economic data. This quarter may lead to an "earnings recession," a term used by some to designate two consecutive quarterly declines.
- Earnings expectations are always too high, so expect disappointment.
- The "beat rate" will be normal, but only because expectations have declined so much.
- Earnings might be OK, but revenues will not.
- Earnings and revenues might be OK, but companies will be very cautious about guidance and outlook.
- Early 2019 stock gains have already anticipated any positive earnings effect.
- Earnings growth will be in mid-single digits for this quarter, with stronger growth to come. (See Brian Gilmartin's excellent post).
- Companies will describe business conditions as strong, while expressing some possible trade concerns.

> ***Indicators***

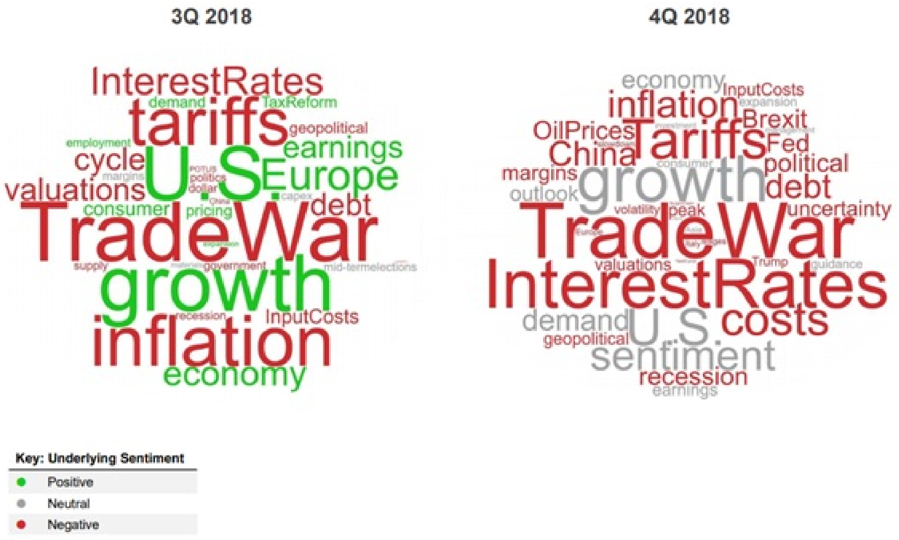
Astute observers will see some early indications this week.

We should respect the conclusion of Brian Gilmartin, who is looking to early reports in financials as a useful "tell."

> If 2019 SP 500 estimates have made a low in terms of expected growth for the coming year, with the Street expecting just 6.1% as of this week, then readers should know it shortly, and certainly by the end of the coming week, with Financial's still being 13% of the market cap weight of the SP 500.

John Butters and FactSet's Earnings Insight provides detailed, up-to-date reports on both estimates and results. He has noted the 3.8% decline in bottom-up estimates during the quarter.

Corbin Advisors interviews analysts to determine sentiment and expectations. Two-thirds of those interviewed are buy-side, so it is a different and interesting perspective. This word cloud is a nice way to see the negative changes as well as the most frequently mentioned concerns.



Read the full report for more interesting charts and plenty of data.

> I'll add my own speculation in today's Final Thought.

Quant Corner

We follow some regular featured sources and the best other quant news from the week.

Risk Analysis

I have a rule for my investment clients. ***Think first about your risk. Only then should you consider possible rewards***. I monitor many quantitative reports and highlight the best methods in this weekly update.

The Indicator Snapshot

Risk Indicator	Current	Last Week	Last Month	Last Quarter	Interpretation
Valuation					
Ten-year note yield	2.70%	2.67%	2.90%	3.16%	
S&P 500	2596	2532	2600	2767	
S&P Forward Earnings	174	169	171	174	
S&P Earnings yield	6.68%	6.67%	6.58%	6.27%	
Equity Risk Premium	3.99%	4.00%	3.68%	3.11%	Very High
Economy					
C-Score	384	387	387	323	9 MoRecession Prob about 24%
*Leading SuperIndex**	3.42%	3.11%	1.63%	0.88%	3-4 MoRecession Prob
BCIp	51.6	47.4	78.0	99.3	No recession indicated
SLFSI	-0.667	-0.508	-0.815	-1.263	Very Low Risk
Anticipated Inflation	1.81%	1.68%	1.83%	2.16%	
VIX	19.50%	25.45%	20.65%	24.98%	
Historical S&P Volatility					
Last Five Days	19.80%	33.52%	15.30%	29.68%	
Last Twenty Days	30.36%	30.77%	21.80%	15.87%	
Technical Health					
Short-term	4	5	4	2	Bearish
Long-term	5	5	4	1	Extremely Bearish
Overall Outlook	Neutral	Neutral	Neutral	Str. Bull	
Sources: Stlouisfed.org, RecessionAlert.com, iMarket Signals, fundamentalis.com, and NewArc Investments, Inc. ©2018					
	*SuperIndex is the public value, delayed one month				

Short-term trading conditions have improved a notch, but not yet enough to signal an “all clear” for our trading methods. Finding the right trading environment is important. Patience is an essential part of trading success.

Long-term trading remains solidly at the highest risk level. Those who emphasize technical analysis have emphasized the “damage” done to charts by the sustained correction. Our methods show that a clean bill of technical health will require some time.

Fundamental analysis remains strongly bullish. Earnings are great, prices are lower, and there is even less competition from bonds. We reduce fundamental positions (as we did in 2011) when we get a warning from the recession or financial stress indicators, not merely as a reaction to technical signals. At this point there are no significant fundamental warnings. We remain fully invested in fundamental programs, illustrating that a diversity of methods leads naturally to differing levels of market exposure.

The Featured Sources:

Bob Dieli: Business cycle analysis via the “C Score.

Brian Gilmartin: All things earnings, for the overall market as well as many individual companies.

RecessionAlert: Strong quantitative indicators for both economic and market analysis.

Georg Vrba: Business cycle indicator and market timing tools. None of Georg’s indicators signal recession. Here is the latest update on his BCI indicator.

Doug Short and Jill Mislinski: Regular updating of an array of indicators. Great charts and analysis.

Insight for Traders

Check out our weekly “Stock Exchange”. We combine links to important posts about trading, themes of current interest, and ideas from our trading models. This week we asked fellow traders to evaluate the possibility that this is a “bear trap rally.” We provided advice from expert traders, and a recommendation from our Holmes model, the only one that has not gone to cash. We also provided sector ratings from Oscar and Felix, featuring the DJIA stocks. Our ringleader and editor, Blue Harbinger, provided fundamental counterpoint for the models, all of which are technically-based.

Insight for Investors

Investors should embrace volatility. They should join my delight in a well-documented list of worries. These are the best opportunities.

Best of the Week

If I had to recommend a single, must-read article for this week, it would be Brian Gilmartin's report on *The Best Lecture of 2018*. The lecture was by Joel Greenblatt, hedge fund manager, author, and Adjunct Professor at Columbia's Graduate School of Business. Read Brian's entire post to get more color on the lecture and read Greenblatt's books to get more about his system. This quotation from Brian struck me as especially good advice.

> Of the top-decile portfolio managers for any measurable 10-year time period, at least 41% of those managers (and with my chicken scratch handwriting, I couldn't read in the handwritten notes if that number was 41 or 47) spent at least three years in the bottom decile of performance rankings. The point being top flight portfolio managers can go long periods with poor relative performance and not looking so smart.

The top group of managers (unlike Mr. Madoff) does not get there with consistently strong performance. Mr. Market is too emotional for that. Investors who want great results have to believe in a system (or manager) and not fret when things do not seem to be working. Focus on finding a strong and proven investment process, not on short-term returns. And "short" is shorter than most think!

Stock Ideas

Chuck Carnevale looks at defense stocks as a possible method to play offense. As always, readers will get a valuable lesson in investment selection techniques as well as some interesting ideas. Here are some of the key metrics for five candidates.

Ticker	www.fastgraphs.com Name	CR	Sub-Sector	P/E	P/CF(FFO)	EPS Yld	CF(FFO) Yld	Div Yld	Market Cap	LT D/C
LMT	LOCKHEED MARTIN CORP	BBB+	Aerospace & Defense	15.3	22.2	6.5%	4.5%	3.3%	76.758 Bil.	99.5
GD	GENERAL DYNAMICS CORP	A+	Aerospace & Defense	14.2	13.5	7.0%	7.4%	2.3%	46.987 Bil.	25.8
RTN	RAYTHEON CO	A+	Aerospace & Defense	15.5	15.6	6.5%	6.4%	2.2%	44.738 Bil.	31.6
NOC	NORTHROP GRUMMAN CORP	BBB	Aerospace & Defense	13.2	11.7	7.6%	8.6%	1.9%	43.572 Bil.	64.5
LLL	L3 TECHNOLOGIES INC	BBB-	Aerospace & Defense	16.5	12.0	6.0%	8.3%	1.9%	13.443 Bil.	39.6

The RoseNose updated dividend portfolio is here. This is a detailed, transparent and analytical account. Take special note of the discussion of income versus portfolio value. Putting dividends to work when prices are low is an attractive portfolio feature.

Dividend Sensei suggests three "undervalued dividend kings." [Jeff – I own one, with short calls written against it].

Morningstar has 29 "undervalued stocks" broken down by sector. It is a starting point for your own research.

Valuentum likes Dollar General (DG), consistent growth and "poised to break out."

AT&T? D.M. Martins Research is ready to "give it another shot."

Personal Finance

Seeking Alpha Senior Editor Gil Weinreich's Asset Allocation Daily is consistently both interesting and informative. Each week he highlights stories of interest for both advisors and investors. This week he discussed his interview (podcast here) with Berkeley behavioral economist Shachar Kariv. He explicitly addressed the inclination of investors – even smart and savvy ones – to exit markets at the wrong time. He notes that a single mistake of staying on the sidelines can wipe out a lifetime of advisor fees. Prof. Kariv seemed to assume the importance of using financial advisors.

This sort of discussion is at the heart of Gil's work, taking a common question head-on. [Jeff — I might add that having a good risk-control method is also important].

Abnormal Returns is an important daily source for all of us following investment news. I read it religiously.

His Wednesday Personal Finance Post emphasizes financial independence. Among the many good links I especially liked Blair duQuesnay's timely reminder about the increase in limits for retirement account contributions. I also enjoyed Ross Menke's *Never Retire*.

Watch out for…

Bonds. Another respected voice joins the discussion of stocks versus bonds. Bill Miller's annual letter includes this comment:

> For investors, the sharp selloff from the September high of 2940 to the current 2530 level coupled with the rise in bond prices over the same period has stocks now priced at under 15x 2019's estimated earnings compared to about 37x the annualized, hold-to-maturity return on 10-year treasuries. At 15x, the market is at the lowest point it's been since late 2013. Corporate earnings and dividends should grow about 5% or so long-term, while today's 10-year coupons will not. Back in 2008 near the lows, *Warren Buffett wrote an op-ed* saying he was buying US stocks and urged others to do so. When someone asked him later how he knew it was time to buy, he said he didn't know the time to buy, but he knew when prices were attractive. I also have no idea when it's time to buy, but I do believe US stock prices are the most attractive they have been since the 2016 lows and there are plenty of bargains to be had.

ETF trading traps. Do you know the best time of day for trades? Morningstar offers *5 Tips for Trading ETFs*.

Final Thought

This week was a pleasant surprise for long-term investors. I had expected that the market would need a trade deal or some great earnings results as a rally catalyst. Instead, we found that algorithms react to positive terms, sparking rallies as well. There was not specific progress on the China/US trade talks, but a few encouraging words have had an effect in an oversold market.

Regular readers, and those who have acted my 2019 preview, should have had a great start to the year. I expect to see a reversal of last year's sector winners and losers. The big rally catalysts are yet to come.

What am I watching this earnings season?

I expect the beat rate to be normal. I am perpetually amazed that the same people claim that forward earnings estimates are too high and simultaneously assert that earnings beats reflect a low bar.

Earnings data is easier to spin than economic data. Financial media emphasizes the big stock moves. There is little overall sense of the big story. Those with cherry-picking skills can find specific stocks to prove any point. This is why we must track overall results via a range of great sources.

I am particularly interested in comments about tariff policy and trade. We know this will be a negative effect, but how big and how soon?

Most importantly, I don't think the 2019 gains have much to do with earnings expectations. In 2018 we had a year's worth of great earnings with a negative reaction.

There is plenty of room for stock gains if earnings cooperate.

The next few weeks can provide some clarity for a confused and volatile market.

I'm more worried about:

- Delays in planned business investments. We are a long way from "talking ourselves into recession," but it is an economic drag. (WSJ)
- A shortage of data. Many people do not seem to care, but these results are important for many doing business and investment analysis.

I'm less worried about:

- Trade issues. Negotiation is showing some of the early signs of progress I suggested a month ago.
- Consumer sentiment and spending. So far, the shutdown and tariffs do not seem to have created a drag on consumption.