MORNING BRIEFING
September 4, 2012

Back to School
(1) September is just another month. (2) Let's not ask Clint Eastwood. (3) More upside for P/E than E. (4) Nonfinancial corporate domestic profits still strong. (5) Financial profits have stalled. (6) Weak global growth and strong dollar weighing on profits from abroad. (7) Ben and Mario are two wild and crazy guys. (8) Ben proudly injects steroids into the bull. (9) Mario wants to fix blockages. (10) "The Bourne Legacy" (-).

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Strategy. It's the first trading day of September. So it's time for the annual ritual of badmouthing the month as the worst one for stocks. The *WSJ* did a thorough job of taking a hatchet to September this past weekend in an article titled "Playing the September Effect." Since 1926, September is the only month with a negative average return, i.e., minus 0.8%. The article also notes, "Stocks have risen in only 50% of Septembers since 1926, the worst of any month and far below the 61.8% average success rate." So obviously, the month isn't consistently bad since it has been up half the time.

I asked Sailesh Radha, our consultant on such matters, to double-check the numbers. He was able to get daily data back to 1928. His results are similar, but not identical, to the ones quoted in the *WSJ*. He found that September was down 55% of the time, with an average decline of 4.9%, and up 45% of the time, with an average gain of 3.3%. That's weaker overall than the other months, but not significantly so. We conclude that September is another month like all the rest of them, with ups and downs (*Fig. 1*).

The question we need to focus on is whether this September is likely to be the good, the bad, or the ugly version of this month. (We could ask Clint Eastwood, but he is having strange conversations with empty chairs.) So far, the only down month this year has been May. It made sense to "go away" in May as long as you had the trading sense to come back on June 1. The S&P 500 rose 10.1% during the summer rally from the beginning of June to the end of August. Will it segue into a yearend rally? Or will there be an unpleasant intermezzo this month?

Joe and I doubt that earnings expectations can lead the market higher during September and over the rest of the year. That's because Debbie and I are fairly certain that global economic indicators, on balance, will remain on the disappointing side, as discussed below. However, we don't see much downside to earnings expectations either.

On the other hand, there may still be some upside potential for valuation multiples if the ECB and the Fed inject more liquidity into the global financial system. I'm not advocating more unconventional monetary easing by these two central banks. However, I expect that they won't listen to me or any of the other monetary "hawks," who all agree that there are likely to be lots of adverse unintended consequences from such policies. Nevertheless, financial markets desperately want to believe that central banks will do whatever it takes to avert another Lehman Moment, and the central bankers desperately want to satisfy them. Let's have a closer look at these issues in the following sections.

Profits. I've been bullish on the earnings-led bull market in stocks since March 2009 because I believed that it would continue to be led by earnings. So far, so good. However, as I've been noting lately, the bull is running out of earnings power. Consider the following:

(1) *S&P 500 Earnings Per Share.* Joe and I focus on weekly S&P 500 forward consensus expected operating earnings, which has stalled around $111 per share since May (*Fig. 2*). The quarterly data for S&P 500 operating earnings per share also has lost its upward momentum recently (*Fig. 3*).

(2) *After-Tax Net Income.* Also running out of steam is the aggregate net income of the S&P 500 (*Fig. 4*). It is highly correlated with the after-tax corporate profits measures reported along with GDP in the National Income & Product Accounts (NIPA).

(3) *Pre-Tax Profits by Source.* The Bureau of Economic Analysis disaggregates the components of NIPA profits on a pre-tax basis. The data show that the domestic profits of nonfinancial corporations rose to a record high of $1.1 trillion (saar) during Q2, up 7.0% y/y. However, profits of financial corporations have stalled in a zigzag fashion over the past three years, while profits from the rest of the world have fallen from a recent peak of $451 billion during Q4-2011 to $422 billion during Q2-2012 (*Fig. 5*).

(4) *Financial Corporate Profits.* The S&P, NIPA, and FDIC measures of financial corporate profits are looking especially toppy (*Fig. 6*). The FDIC data show that commercial banks have been reducing their provisions for loan losses from a peak of $71 billion during Q4-2008 to $14 billion during Q2-2012. That has boosted earnings. However, charge-offs for bad loans have exceeded provisions since Q1-2010, which is a drag on earnings (*Fig. 7*).

(5) *Profits from Abroad.* I've been arguing that despite the global slowdown, US corporations would find enough business opportunities overseas to offset slower growth in the US. The latest data show I got that exactly backwards so far. Domestic profits rose to a record high, as noted above. Profit receipts from abroad, which account for 33.4% of pre-tax corporate profits, declined 3.2% y/y, the weakest growth rate since Q3-2009 (*Fig. 8*). The problem is that the y/y growth in profit receipts from abroad tends to be inversely correlated with the trade-weighted dollar on a 2-for-1 basis. The dollar is up 8.8% y/y through July, implying a decline twice as much for overseas profits. (See third panel in *Fig. 8*.) (You can receive our regularly updated *Corporate Profits* by clicking ★.)

Global Economy. Another problem for profits around the world is that the weakness in global economic activity seems to be spreading. While there are only a few signs that the worst is over, there are growing expectations that central banks will respond by easing their monetary policies. In other words, stock investors are treating bad economic news as good news because they are counting on more monetary easing. There may not be any upside for earnings over the rest of the year, but valuation multiples may continue to lead relief rallies around the world if central banks deliver what is expected of them. Let's review:

(1) *China.* China's manufacturing PMI dropped from 50.1 in July to 49.2 in August. The new orders and employment components of the index also edged down to below 50 (*Fig. 9*). The problem is that profits are hurting as revenues slump while labor costs are rising. As a result, the Chinese stock market is among the worst-performing around the world with a ytd decline of 5.0% (*Fig. 10*). Yesterday's *WSJ* story about the weak PMI data was headlined, "Slowing Growth Pressures China To Take Action." The expectation is that the PBoC will cut interest rates and reserve requirements again soon.

(2) *India.* India's Q2 real GDP rose 5.5%, languishing near its slowest pace in three years. However, it was slightly better than expected, signaling that the worst may be over for Asia's third-largest economy and dashing investor hopes of another rate cut this year. While the GDP figure is strong by global standards, it is considered almost recessionary in India, which targets 9% expansion to provide jobs for a bulging young population. Persistent economic sluggishness was reflected in data on Friday that showed infrastructure output grew only 1.8% y/y in July.

(3) *Brazil.* On Friday, Bloomberg reported: "Brazil's economy in the second quarter showed signs that it's turning the corner after a year of stagnation as government stimulus measures help offset the impact of the global crisis. Gross domestic product expanded 0.4 percent from the previous three months, the fastest pace in a year…" Last Wednesday, Brazil's central bank slashed its interest rate for the ninth time since August of last year, to a record low of 7.5%, in a bid to revive sluggish economic growth.

(4) *Euro Zone.* Yesterday, we learned that the Purchasing Managers' Index for the 17 nations that use the euro rose to 45.1 in August from 44.0 in July. The latest reading remains well below the 50 break-even level. Last Friday, we learned that the number of unemployed rose to a record 18 million in the euro zone during July. German retail sales fell in July. The ECB is expected to take additional monetary measures on Thursday to support the economy.

Central Banks. Fed Chairman Ben Bernanke spoke on Friday, August 31 at the Kansas City Fed's annual meeting in Jackson Hole, Wyoming. ECB President Mario Draghi did not attend the meeting, which is an annual gathering for central bankers and monetary economists. He was too busy at home working on a plan that would allow the ECB to lower the borrowing costs of debt-challenged members of the euro zone. The plan is controversial in Germany, and Draghi felt compelled to publicly defend it in the 8/29 issue of Germany's *Die Zeit.* Draghi is committed to doing whatever it takes to defend the euro. Bernanke is committed to doing whatever it takes to boost employment. Both are big fans of unconventional monetary policy tools. Let's briefly review what they had to say in their latest comments:

(1) *Bernanke.*The Fed Chairman took a victory lap at Jackson Hole, arguing that the Fed's models confirmed that his unconventional policies have boosted GDP growth and created jobs. This begs the question of why he believes that more of these policies are necessary if the previous ones simply made things less worse rather than much better.

Apparently, the Fed Chairman isn't satisfied with the progress that he claims has been made: "The stagnation of the labor market in particular is a grave concern not only because of the enormous suffering and waste of human talent it entails, but also because persistently high levels of unemployment will wreak structural damage on our economy that could last for many years." Yet he claimed that the unemployment problem isn't structural, but rather cyclical. He strongly suggested that QE3 is coming.

By the way, Bernanke once again raved about the success of Large Scale Asset Purchases (LSAPs) in boosting stock prices: "LSAPs also appear to have boosted stock prices, presumably both by lowering discount rates and by improving the economic outlook; it is probably not a coincidence that the sustained recovery in U.S. equity prices began in March 2009, shortly after the FOMC's decision to greatly expand securities purchases. This effect is potentially important because stock values affect both consumption and investment decisions." The message for bears: Don't fight the Fed.

(2) *Draghi.* In his article, the ECB President also strongly suggested that more quantitative easing is coming for the euro zone: "Yet it should be understood that fulfilling our mandate sometimes requires

us to go beyond standard monetary policy tools. When markets are fragmented or influenced by irrational fears, our monetary policy signals do not reach citizens evenly across the euro area. We have to fix such blockages to ensure a single monetary policy and therefore price stability for all euro area citizens. This may at times require exceptional measures. But this is our responsibility as the central bank of the euro area as a whole."

Movie. "The Bourne Legacy" (*link*) (-) is the legacy that just won't quit. It's a retread of the previous three Bourne movies starring Matt Damon, who must have lost interest in making yet another sequel. This fourth film in the legacy stars Jeremy Renner, who is a good actor lost in a pointless rehash of a tired and boring genre.

CALENDARS

US. Tues: Motor Vehicle Sales 14.3/11.2mu, M-PMI 50.0, Construction Spending 0.4%. **Wed:** Nonfarm Productivity & Unit Labor Costs 1.9%/1.4%, MBA Purchase Applications. (Bloomberg estimates)
Global. Tues: Euro Zone PPI 1.6% y/y, Reserve Bank of Australia rate decision. **Wed:** Australia GDP 0.8% q/q/3.7% y/y, Euro Zone NM-PMI 46.5, Germany NM-PMI 48.3, Bank of Canada rate decision. (DailyFX estimates)

PERFORMANCE & ASSET ALLOCATION

Historical Performance of S&P 500 in August and September (*link*): The S&P 500 rose 2.0% in August for its third straight monthly gain and an above-average August performance. This August ranked 21st among the 67 Augusts since 1946, which averaged a decline of 0.2%. The average September performance over the past 66 years, a decline of 0.7%, makes September the worst-performance month of the year. Positive Septembers have been up an average of 3.4%, and negative ones down by an average 3.9%--the third worst negative performance month of the year.

Global Stock Markets Performance (*link*): The S&P 500 fell 0.3% last week, its second straight decline following six gains in a row--but ranked close to the top third of the 41 stock markets we monitor in a week when 13 markets rose. The S&P 500's performance last week beat that of all the major MSCI indexes--MSCI Europe (-0.6%), MSCI World (-0.7), MSCI EAFE (-1.2), MSCI Emerging Asia (-1.7), MSCI Emerging Latin America (-2.0). Year to date also, the S&P 500 (11.8) is ahead of even the leader of the major MSCI indexes, MSCI World (8.2). In August, the S&P 500 (2.0) tied MSCI Europe (2.0) and led all other MSCI indexes. With 35/41 markets up ytd, the S&P 500 ranks a better-than-average 11th. Pulling up the rear: Spain (-12.6).

S&P 1500/500/400/600 Performance (*link*): How did the S&P cap group performances compare last week? LargeCap fell 0.3%, and trailed both SmallCap (0.4) and MidCap (0.1). For the month of August, SmallCap (3.7) and MidCap (3.3) both outperformed LargeCap (2.0). The sector leaders in August: MidCap Tech (6.4), SmallCap Consumer Discretionary (5.8), and MidCap Health Care (5.7). On a ytd basis, LargeCap (11.8) is leading MidCap (10.5) and SmallCap (10.3). The sector winners ytd: MidCap Health Care (22.1), LargeCap Tech (19.2), and SmallCap Consumer Discretionary (18.0). Just four of the 30 sectors are down ytd, but Energy continues to predominate the worst performers: MidCap Energy (-7.5), SmallCap Energy (-4.3), and SmallCap Utilities (-0.8).

S&P 500 Sectors and Industries Performance (*link*): The S&P 500 fell 0.3% last week as eight of the 10 sectors and 71 of the 129 industries moved lower. The week's best performers were Consumer Discretionary (0.2%) and Health Care (0.1). Seven of the 10 sectors rose in August; the leaders were: Tech (4.8), Consumer Discretionary (4.2), and Financials (3.0). The laggards in August: Utilities (-4.8), Telecom (-2.5), and Consumer Staples (-0.6). The S&P 500 is up 11.8% ytd, and all 10 sectors are up so far. The ytd sector leaders: Tech (19.2), Telecom (16.5), Consumer Discretionary (16.4), and Financials (16.1). The ytd sector laggards: Utilities (0.2), Energy (2.4), Materials (6.2), Industrials (7.6), Consumer Staples (9.1), and Health Care (11.5).

Commodities Performance (*link*): Ten of the 16 commodities that we follow rose last week, down from the 12 that moved higher the prior week. The best-performing commodities last week: Natural Gas (up 3.6%), Cotton (2.7), Silver (2.5), and Heating Oil (1.9). Twelve of the 16 commodities moved higher in August. Leading the way were Silver (12.5), Heating Oil (11.5), and WTI Crude Oil (9.6). Natural Gas (-12.8) was the worst performer in August. Prices are up ytd for 10 commodities; in 2011, only six rose for the year as a whole. Soybean (47.2), Wheat (33.3), and Corn (24.2) are leading in 2012, while Stainless Steel (-23.8), Cotton (-16.7), and Zinc (-7.7) have been the worst performers so far this year.

Assets Sorted by Spread w/ 200-dmas (*link*): How are stock indexes and commodities trading relative to their 200-day moving averages (200-dmas)? Spreads between the prices and 200-dmas fell w/w for all nine global stock indexes and 33/44 US stock indexes, but rose for 11 of the 19 commodities indexes. Ten of the commodity indexes are now trading above their 200-dmas; commodities' average spread rose to 2.6% last week from 2.2%. Three of the nine global indexes trade above their 200-dmas, down from six above their 200-dmas a week earlier. The average global index spread dropped to -1.4% from 0.2%. Forty-one US stock indexes now trade north of their 200-dmas, up from 33 four weeks ago; their average spread slipped to 3.8% from 4.2% in the prior week.

Commitments of Traders (*link*): What were Large Speculators doing in the futures pits on August 28? They were neutral on the S&P 500 and slightly bullish on the 10-year Treasury Note. They had a big bullish position in the US Dollar and a significant bearish position in the Euro. They were very bullish on the Canadian Dollar and on the Aussie Dollar after a brief bearish spike. They were slightly bullish on the Pound. They were bullish on the Yen. They were also still bullish on Gold. They are rebuilding their already still sizable net long position Gasoline. They had a near-record bullish position in Crude Oil and Soybeans.

US ECONOMIC INDICATORS

YRI Forecast Table (*link*): We're keeping our real GDP growth forecast for the second half of the year at 2.2%. Under this scenario, the unemployment rate is likely to remain above 8%. Productivity growth should be weak as employment begins to pick up again. Inflation should remain relatively tame, with the core rate between 2.0%-2.5%. The 10-year bond yield will likely stay below 2% until late this year, when it moves back above the 2% mark as the economy begins to strengthen again.

GDP (*link*): Real GDP grew an upwardly revised 1.7% (saar) last quarter (from initial 1.5%), slowing from gains of 2.0% and 4.1% the prior two quarters. (Q2 revision reflected a big downward revision to imports and upward revisions to consumer spending, exports, and S&L government spending. Inventory investment was slower.) Trade was a positive in Q2 for the first time in nine months. Consumer spending advanced 1.7% (slowest in nearly a year), as spending on durable goods swung from an 11.5% (saar) increase during Q1 to zero growth during Q2. Business investment posted its weakest growth (4.3%) in over two years on slower spending on structures. Real final sales (GDP less the change in inventories) outpaced Q2 GDP growth--increasing 2.0% (saar), above the 1.2% preliminary estimate.

Contributions to GDP (*link*): Consumer spending was the largest positive contributor to Q2 GDP growth, inventories the biggest negative. Here's a tally (in order of contribution): (1) Real PCE added

1.20pps, led by services (1.11). Nondurable goods spending contributed only 0.09pps, durable goods zero. (2) Real nonresidential fixed investment added 0.43pps to GDP, led by equipment & software (0.34); structures (0.08) had little impact. (3) Revisions show trade added 0.32pps to growth (rather than subtracting 0.31pps), as exports' positive contribution (0.82pps) more than offset imports' negative one (-0.51). (4) Real residential investment added 0.20pps. (5) Inventory investment now shows a subtraction (-0.23pps) to Q2 growth rather than an addition. (6) Real government spending remains a drag on growth (-0.18pps), with state & local spending (-0.17) primarily responsible.

Corporate Profits (*link*): Corporate cash flow is stalled around record highs. It edged up 0.3% during Q2 after dropping 6.8% during Q1, following a three-quarter gain of 15.1% to a new record high. (The latest level is 70% above the recession-depressed low at year-end 2008.) "Cash" profits from current production increased 1.1% after dipping 8.6% during Q1. It had more than doubled from year-end 2008 through year-end 2011. S&P 500 operating and reported earnings are at cyclical highs, up sharply from their respective 2009 lows. Profit margins remain impressive: During Q2, pre-tax profits from current production represented 13.9% of National Income, remaining near its cyclical high. The after-tax corporate profit margin for nonfinancial companies was 10.4%, not far from Q4-2011's 11.0% (highest since the 1960s).

Personal Income & Spending (*link*): Both consumer income and spending began Q3 on an up note. Personal consumption expenditures (PCE) accelerated 0.4% in July (in nominal and real terms), the first increase for both since April. Real spending grew 1.1% in the three months ending July (based on three-month average), the weakest since last summer. Personal income rose for the eighth straight month, climbing 0.3% in July and 3.5% over the period. Wages and salaries rose 0.2%, following a 0.4% gain in June (after little growth the prior two months). The saving rate had a "four handle" for the third straight month, edging down to 4.2% from 4.3% in June (highest in more than a year).

Consumer Sentiment (*link*): The University of Michigan's Consumer Sentiment Index (CSI) has treaded water the past couple of months--73.2 in June, 72.3 in July, 74.3 in August (up from 73.6 preliminary). It climbed the prior seven months from 60.8 in October to 79.3 in May (highest since October 2007). Recent months have seen consumers become cheerier about the present and gloomier about the future. The present situation component gained 7.2 points the past two months to 88.7. The expectations component index has dropped 9.2 points the past three months--from nearly a five-year high of 74.3 in May to 65.1 last month. (Both components exceeded their mid-month readings, though, and are way above year-earlier lows of 68.5 and 47.6.)

Kansas City Manufacturing (*link*): Midwest manufacturing activity grew at a slightly slower pace in August than July, but still considerably slower than during H1-12. The Chicago Purchasing Managers Business Barometer fell for the first time in three months, edging down from 53.7 to 53.0 last month (it averaged 58.0 during H1). Here's a look at some components. The employment index climbed from 53.3 to 57.1 last month, reversing nearly half of July's 7.1 point drop. Both the production (from 54.5 to 57.4) and orders (52.9 to 54.8) indexes moved higher (orders for the second straight month). The backlog orders index, however, tumbled 11.1 points to 41.7 after jumping 10.6 points in July. Inflationary pressures increased slightly; the prices-paid index rose from 54.0 to 57.0 the past two months.

Chicago PMI (*link*): Manufacturing activity in the Tenth District picked up in August along with expectations. The composite index increased for the second straight month from 3 in June to 8 in August. The components were mostly higher: The new orders index increased significantly from -4 to 11; new orders index for exports improved from -13 to -6. The production index climbed to 7 after falling from 17 to 2 the prior two months. Manufacturers hired workers at a slower pace, with the employment index falling from 6 to 2 (lowest this year). The future composite index was solidly in positive territory, advancing from 8 to 16 the past two months.

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