Basis Points

Weekly Market Commentary

Basis Points August 7, 2018

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Above the Fold

- The Apple quarter recently reported showed great sales growth and earnings numbers in its Services businesses, such as iCloud, AppStore, Apple Music, etc., a business segment that grew revenue 31 percent over last year. However, it was the much higher average iPhone price that really drove the numbers. Due to the addition of the much higher priced iPhone X, the average price paid for new iPhones grew from $604 last year to $724 this year, a 20 percent increase. This higher average selling price drove iPhone revenue up 20 percent in the quarter to $30 billion vs. unit shipment growth of less than 1 percent. The mix of growth in phones shipped vs. the growth in the price of those phones is not a bad thing, as it indicates that there is still tremendous consumer appetite for improved products with value-added features such as the iPhone X.
- U.S. corporate capex in overall GDP rose 8 percent year over year in the second quarter of 2018, while S&P 500 company capex is on track to rise more than 20 percent. And capex spending is strong at both big and small companies. Large cap companies' 2Q capex is on track to rise over 20 percent, and small cap companies show a rise in capex of over 24 percent. The causes of all this spending are 1) Rising corporate profits from lower tax rates, 2) Full immediate deductions for capex spending, 3) A very old age of U.S. corporate hard assets like equipment and buildings makes capex spending an immediate need for many companies, and 4) Access to credit, the availability of financing for capex spending is very plentiful.

Three Things

- Some good news in the recent unemployment report: the unemployment rate for workers with less than a high school diploma is at a record low. The willingness of companies to hire less educated workers may help explain why wage pressures remain subdued. U.S. GDP is also off to a strong start in July, as railcar loadings and the trucker's survey rose last month to a new strong level. These strong shipping numbers should lead to S&P 500 earnings in the third quarter of 2018 to post another big increase, with perhaps 25 percent growth over last year, after showing 25 percent growth in 2Q 2018. And during past expansions, the metric of Average Hourly Earnings (AHEs) rose to a 4 percent rate right before a recession began. AHEs in the current expansion have been slowly trending higher for over five years but were up just 2.7 percent in July. At this rate of growth, AHEs will not hit 4 percent for another nine years.

- The indexing of capital gains to inflation is an issue that may get a lot of news traction in the coming months, as the White House is considering bypassing Congress to grant a $100 billion tax cut in a new tax reform 2.0 bill. It is dubious if the Treasury department has the power to unilaterally make this change, and since most of the gains from the change will flow to the wealthiest tax filers, the optics may cause much political angst. In simple terms, if you bought a stock for $10 in 1980 and sold it for $50 in 2018, you would owe capital gains taxes on the profit of $40. With the change, if the inflation rate over this holding period caused half of the gain in the stock, then $20 of the $40 capital gain would not be taxable. Apart from the optics of giving even more tax breaks to wealthy people, the change would be a nightmare to calculate, as one would need to determine the holding period inflation rate of each share purchase lot since the purchase of that particular lot. If a taxable investor used dollar-cost-averaging to buy shares over a long period of time, he or she will have a lot of work ahead of him or her come tax filing time.
- Cornerstone Macro Research feels that the strength in the Dollar this year may reduce the risk of a late-cycle inflation breakout. Despite the economic expansion entering its 10th year, the CPI inflation rate is likely peaking now and will slow into year-end, in part due to strength in the Dollar. The Dollar's strength is helping to slow energy and food inflation and will hold down core inflation. Inflation will probably slow from 3.0 percent in July to 2.2 percent by December. Prospects of lower inflation will help keep interest rates lower than they otherwise would be, which could help prolong the business cycle.

Did You Know

An interesting investor question posed to us last week: Why does the p/e multiple that investors are willing to pay for corporate earnings rise and fall with changes in the inflation rate?

Answer: Suppose I told you that I would sell you a dollar now, payable to you in five years. How much would you pay for the future claim to that dollar right now? To assess that dollar's future value, you will need to ask one very important question: What will the inflation rate be over the next five years? The amount of buying power that dollar will lose over the five-year period matters greatly. If there will be a 2 percent inflation rate, then you may pay $.92 for that dollar now in order to break even in purchasing power then you may pay $.92 for that dollar now in order to break even in purchasing power after five years. However, if the inflation rate will be 8 percent, then you would want to pay no more than $.72 now. And likewise, if the inflation rate will be 15 percent a year, you would not want to pay more than $.52 now in order to break even on a purchasing power basis over five years.

This discounting principle applies to future corporate earnings as well. If company X will generate $1.00 in earnings in five years, a low inflation rate over that time would cause an investor to pay a higher multiple on those future earnings now, and a high inflation rate would justify paying a much lower multiple on those future earnings, as the purchasing power of those earnings will be eroded by a high inflation rate over time. In a low inflation environment such as the one we are in now with inflation over the past 10 years running at 2 percent or lower, a 16-18x multiple on S&P 500 earnings is certainly justified. However, in the period of 1978-82, when inflation raged in the double-digits every year, the S&P 500 traded in a 7-9x earnings multiple range. With such a high inflation rate, the purchasing power of future earnings were so much lower that investors would not pay a high price to receive these lower quality future earnings.