MORNING BRIEFING
June 23, 2016

Musk's Oil

See the collection of the individual charts linked below.

(1) Either a visionary or a snake oil salesman. (2) Market gives Bronx cheer to converting Tesla into a solar company. (3) Utility valuations may be flying too close to the sun. (4) Utilities want to charge more, while paying less for their customers' surplus solar electricity. (5) Musk's idea of combining solar energy with electric cars would be great if his companies ever stop losing money. (6) Chanos is short Tesla and SolarCity and ranting about the deal. (7) Building homes is a profitable business, but finding workers and land is challenging. (8) Winnebago indicator is bright green.

Sector Focus I: Utilities in MuskCity. Whether you think Elon Musk is a visionary or a snake oil salesman, you have to admit the man thinks big. His latest maneuver, Tesla's bid for SolarCity, caught the market by surprise yesterday and drew a barrage of negative commentary. Pundits were quick to say the deal "defied common sense" and warned of a "storm ahead."

Why would a money-losing electric car company attempt to buy a money-losing solar company saddled with debt? It could certainly be a sign of desperation as the losses at SolarCity, in particular, mount. James Chanos, who is short both companies' stocks, told CNBC that "SolarCity, whose bonds were yielding 20 percent yesterday, is a company headed toward financial distress. It is burning hundreds of millions in cash every quarter, a burden that now Tesla shareholders will have to bear, at a total cost of over $8 billion." He also described the deal as a "shameful example of corporate governance at its worst," as Musk is a large shareholder in both companies, is the chairman and CEO of Tesla, and is the chairman of SolarCity, where his cousins run the show.

So what could the man, who has said he plans to retire on Mars, be thinking? Obvious positives for the deal don't leap to mind. However, we do see two possible justifications for it. Just by coincidence, Jackie was looking at the Utilities sector when news of the deal broke, and it's possible that Tesla's acquisition of SolarCity will allow the solar panel company to bypass utilities, which are fighting to protect their turf from retail solar power producers. In addition, using solar panels to provide electricity for both a home and a car would likely reduce the amount of time it would take for the solar system to pay for itself and reduce the cost of running an electric car over its lifetime.

Below is her best attempt to explain why the deal might be a bold attempt by Musk to outfox his electric utility competitors. Is he as smart as a fox or as slimy as a snake oil salesman? In any event, are Utilities still a buy after their most recent rally? Consider the following:

(1) *Charged up utilities.* Investors have flocked to utilities in search of safety and yield, but time may show that today's buyers are getting little of either. The S&P 500 Utilities sector is up 16.5% ytd through Tuesday's close, behind only the 17.2% jump in the Telecom sector and besting the S&P 500 by 14.3ppts (*Fig. 1*).

Thanks to the Utilities sector's sharp rally, it no longer offers much more yield than other sectors. The Utilities sector yields 3.4%, which isn't bad relative to a 1.70% 10-year Treasury note yield. However, the sector is yielding only 1ppt more than most of the other sectors in the S&P 500.

Here is the current yield on the 10 sectors in the S&P 500 as of June 16: Telecom (4.7%), Utilities (3.4), Energy (3.0), Consumer Staples (2.6), Financials (2.6), S&P 500 (2.6), Industrials (2.4), Tech (2.4), Health Care (2.3), Materials (2.3), and Consumer Discretionary (2.2).

A 1ppt yield advantage wouldn't seem enough to compensate for sluggish earnings growth. Yet investors continue to buy the S&P 500 Utilities sector--which is expected to grow both sales and earnings by only 3.4% over the next 12 months--when other areas of the market are expected to grow earnings much more quickly (*Fig. 2* and *Fig. 3*).

Here are the forward earnings growth estimates for the 10 S&P 500 sectors as of June 16: Consumer Discretionary (12.6%), Health Care (9.5), Tech (9.4), Materials (8.9), S&P 500 (8.0), Consumer Staples (7.9), Financials (6.4), Industrials (6.0), Utilities (3.4), Telecom (3.0), and Energy (2.2).

Despite earnings that are growing slowly and a yield that isn't far superior to other sectors', the Utilities sector valuation multiple has increased sharply over the last year. The forward earnings multiple, at 17.8, is up from 15.6 a year ago, while the S&P 500 forward P/E is unchanged, at 16.8, over the past year (*Fig. 4*). Here's how Utilities' current forward P/E stacks up against those of the other S&P 500 sectors: Energy (44.3), Consumer Staples (20.4), Utilities (17.8), Consumer Discretionary (17.0), Materials (16.6), S&P 500 (16.5), Industrials (15.8), Tech (15.8), Health Care (15.0), Telecom (13.8), and Financials (13.2).

(2) *Seeking to charge more.* Given the pervasiveness of all things digital--cell phones, computers, iPad--it would seem logical to assume that electricity usage has risen sharply in recent years. But actually, consumption has been flat. There was less electricity used last year than there was in 2007, according to EIA data. Some of the decline can be attributed to the recession, but some of it can be credited to increased energy efficiency and the move overseas of energy-intensive manufacturing.

Declining demand is not good for an industry with a very high fixed-cost base like Utilities. Nor is the small but growing competition from retail and industrial customers, who are generating their own electricity through solar power. Utilities are responding by trying to change the way they charge consumers. "Now, many utility companies are seeking to increase their monthly fees by double-digit percentages, raising them to $25 or more a month regardless of the amount of power consumers use. The utilities argue that the fees should cover a bigger proportion of the fixed costs of the electric grid, including maintenance and repairs," the 10/20/15 *WSJ* explained.

Additionally, some utilities are trying to reduce the amount they pay customers for the excess electricity generated by rooftop solar panels. SolarCity, the nation's largest solar company, wanted Arizona Public Service (APS), Arizona's biggest utility, to pay homeowners the full retail price for solar power produced on homes and sent back to the grid. APS asked lawmakers to enact separate rates for solar and non-solar power because, it argued, paying full price for solar shifts the maintenance costs for the grid to non-solar customers. "APS has 40,000 rooftop solar customers, and the number is growing. The company said it expects $1 billion in costs to be shifted over 20 years from solar to non-solar customers," the 6/9 AP reported. Discussions between the two parties were suspended earlier this month.

(3) *Alternating currents.* Two big future developments could dramatically change the demand and supply of electricity. The most obvious is the electric car. While lots of ink has been spilt on electric cars and Tesla, there are only 450,000 electric vehicles on the road in the US, according to a 5/9 article on HybridCars.com. That compares to the more than 200 million passenger vehicles on the road as of

2014, according to US Department of Transportation statistics. If electric cars become widely accepted, the use of electricity could certainly soar.

On the supply side of the electricity equation, the cost to produce solar power continues to decline, as does the cost to store that power. Tesla is involved here as well. As we discussed in our 12/17/15 *Morning Briefing,* the company is in the midst of building a $5 billion Gigafactory that's expected to bring down the cost of batteries by 30% or more.

By purchasing SolarCity, Musk creates an environment where Tesla's electric cars are charged from electricity produced using SolarCity's solar panels on a home's rooftop. "We would be the world's only vertically integrated energy company offering end-to-end clean energy products to our customers," Tesla's blog explained. A consumer who pays $200 a month for gasoline would essentially pay off a $25,000 roof solar system in just over 10 years. That same homeowner could use any additional energy generated to reduce the home's electricity bills, further reducing the payback time for the solar system.

Left unsaid is the fact that by buying SolarCity, Musk may be doing an end run around utilities. We're guessing that after charging a car and providing electricity to a home, it's unlikely that there would be any additional energy from the solar panels to sell back to the utility. As a result, the entire debate over utility compensation levels for consumer-generated solar energy becomes moot. Likewise, payments from utilities no longer are necessary to justify the economics of solar panels for consumers who own a Tesla automobile.

The merged companies would provide one-stop shopping and a vision of the future that no one else offers. The only question is whether Musk can convince investors to continue funding the losses at Tesla and SolarCity. So far the answer is no; the market panned the deal in no uncertain terms on Wednesday, with Tesla shares down 10.5%. Stay tuned.

Sector Focus II: Housing's Shortcomings. There's more good news on the home front. Early earnings from the homebuilders indicate the slow but steady improvement in the housing market continued in the second quarter. The only obstacles to further improvement appear to be the increasing costs of labor and materials. However, an optimist might consider those good problems to have, as they indicate strength in both the housing industry and the job market. Here's a quick look at some of the results:

(1) Lennar's profits rose to $218.5 million in the quarter ending May 31, up from $183 million in the year-ago period. Its Q2 earnings per share of 95 cents soundly beat Street estimates of 87 cents, noted a 6/21 *FT* article. The number of Lennar's new home orders jumped 10%, and their dollar value jumped 11%.

CEO Stuart Miller described the company's expectations for future growth and experience with land and labor expenses in the Q2 conference call: "We expect that demand will continue to build and come to the market over the next years and that will drive increased production as the deficit and housing stock ultimately needs to be replenished. Nevertheless, land and labor shortages will continue to be limiting factors and will constrain supply and restrict the ability to quickly respond to growing demand, while the mortgage market and higher rents will continue to constrain that demand. We expect that these conditions will continue to result in a slow and steady positive homebuilding market and will enable slow, steady though sometimes erratic growth throughout the industry."

(2) The story at KB Homes is similar. Revenue jumped 30% y/y in Q2, and profit came in at $15.6 million, up from $9.6 million in the year-ago quarter. Earnings per share came in at 17 cents, above the

Street consensus estimate of 14 cents, noted a 6/21 *WSJ* article. In addition, new orders rose 8%. KB's CEO Jeff Mezger credited the strong results to the strengthening of the first-time homebuyer, as Millennials are getting jobs and forming their own households.

KB Homes had less trouble with labor in the most recent quarter. The labor shortage became "pretty intense" during the second half of last year and delayed construction, the 6/21 *WSJ* reported, "but in the latest period KB Home managed to lower build times by 10 days in part because of efforts to secure labor in advance with trade partners."

(3) Winnebago may not build homes, but its RVs are large, discretionary purchases that often tumble at the first sign of economic trouble. So its strong fiscal Q3 earnings are a welcome sign. Revenue in the quarter increased only 2% because the company exited a business line, but the company enjoyed a 12.4% increase in shipments of motorized units and a 62.4% jump in towables, according to its press release. Adjusted net income jumped 25.2% to $14.4 million, or 53 cents a share, well above the 45 cents analysts expected.

Together, these three earnings reports confirm that low interest rates and a much-improved job market have given consumers the confidence to make large purchases despite the uncertainties in the global economy. Domestic economic strength was also reflected in yesterday's report on existing home sales, which increased 1.8% m/m in May. Debbie elaborates on the report's details below. While slow but steady improvement in the housing market may not make for sensational headlines, it may be just what the economy needs to keep this recovery going.

CALENDARS

US. **Thurs:** Jobless Claims 270k, Leading Indicators 0.2%, New Home Sales 565k, M-PMI Flash Estimate 51.0, Chicago Fed National Activity Index, Weekly Consumer Comfort Index. **Fri:** Durable Goods Orders Total and Ex Transportation -0.7%/0.0%, Consumer Sentiment Index 94.0. (Bloomberg estimates)

Global. **Thurs:** Eurozone, Germany, and France Composite PMI Flash Estimates 53.0/54.3/51.0, Eurozone, Germany, and France M-PMI Flash Estimates 51.4/52.0/48.7, Eurozone, Germany, and France NM-PMI Flash Estimates 53.2/55.0/51.6. **Fri:** Germany Ifo Business Climate, Current Assessment, and Expectations Indexes 107.4/114.0/101.2. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Investors Intelligence Bull/Bear Ratio (BBR) moved back above 2.00 this week after seven weeks below. The BBR climbed for the third time in four weeks from 1.48 to 2.05 over the period. Bullish sentiment jumped 12.1ppts over the four-week span from 35.4% to 47.5%--a new high for the year--as the correction count sank 11.3ppts (from 40.6% to 29.3%). Barely budging for the fifth week was bearish sentiment at 23.2%. The AAII Bull Ratio dropped for the second week last week from 50.9% to 40.3% over the period. Bullish sentiment fell from 30.2% to 25.4% over the two-week span, while bearish sentiment rose from 29.1% to 37.5%.

AC World ex-US MSCI (*link*): This index is down 0.7% ytd in dollar terms after falling 8.0% in 2015. In local currency terms, the index has fallen 5.3% ytd after slipping just 0.7% in 2015. Dollar-based forward revenues has risen 2.9% from its seven-year low in February, but is still down 22.8% from its record high in August 2011. Local currency forward revenues is at a fresh five-year low, but has been more stable longer term and is down just 9.2% from its October 2014 record high. Dollar-based forward earnings has risen 1.9% from its low in March 2016, but is still near a seven-year low and down 36.0%

from its record high in July 2008 and 29.9% from its cyclical high in August 2011. Local currency forward earnings is up 1.3% from its six-year low in early April, but is down just 21.4% from its September 2008 record. Revenues are expected to rise 0.3% in 2016 and 6.1% in 2017 following a 2.9% decline in 2015, and earnings are expected to rise 2.5% (2016) and 12.8% (2017) after falling 6.3% (2015). Analysts are forecasting STEG of 8.6%, up from their 6.3% forecast in January, the lowest in seven years. The implied profit margin is expected to edge up to 6.8% in 2016 from 6.7% last year before improving to 7.3% in 2017. NERI has been negative for 63 straight months, but improved to an 11-month high of -5.3% in June from -7.2% in May, and is up from a 51-month low of -11.3% in March. The P/E was down to 13.3 in June from 13.7 in May, which compare to a 16-month low of 12.4 in February and a six-year high of 15.3 in April 2015. The index's 11% discount to the World P/E has deepened from a 6% discount last April and is nearing historical lows.

EMU MSCI (*link*): The EMU's MSCI price index has dropped 4.6% ytd in dollar terms after falling 3.3% in 2015. In euro terms, the price index is down 8.1% ytd and is the worst regional performer following a gain of 7.7% in 2015, when it was the best performer. Euro-based forward revenues is up 1.2% from its six-year low in May, but has weakened 3.0% from its cyclical high (August) and 9.5% from its record high (September 2008). Euro-based forward earnings is stalled too—at 5.7% below its cyclical high (September) and 32.0% below its record high (January 2008). Analysts expect earnings to rise 2.2% in 2016 and 13.5% in 2017 after 6.4% in 2015, and revenues to rise 0.3%, 4.3%, and 3.3% in those respective years. STEG improved to 8.1% in June from 7.3% in May and 5.6% in April--a seven-year low and well below April 2015's 15.6%. STEG is now below LTEG (8.5%) after topping it since late 2013. However, the forward profit margin has improved 0.5ppt to 6.7% from a cyclical bottom of 6.2% in May 2013. The implied profit margin is expected to edge up to 6.4% in 2016 from 6.3% in 2015 before jumping to 6.9% in 2017. NERI was negative for an 11th straight month in June and was the lowest globally even as it improved to -5.3% from -9.2% and from a 24-month low of -13.2% in April. It's down from a 56-month high of 4.0% in May 2015. The P/E of 12.8 is down from a 13-year high of 16.4 in April 2015, but up from a 30-month low of 12.2 in early February. It's trading at a 15% discount to the World MSCI's P/E now, up from a record-low 25% discount during 2011. But the current reading is still well below the 1% premium during April 2015--the post-euro-inception record high.

Emerging Markets MSCI (*link*): The EM MSCI price index is up 3.9% ytd in US dollar terms after tumbling 17.0% in 2015. In local currency terms, EM has gained 1.6% ytd compared to an 8.0% decline in 2015. Dollar-based forward revenues is steadying now near the lowest level since September 2010 and 27.0% below its record high in August 2014, but local currency forward revenues is only near a three-year low and down just 14.7% from its November 2014 record. Dollar-based forward earnings is steady too, near the lowest point since September 2009 and down 37.3% from its August 2011 record, but local-currency earnings has improved 2.3% from April's six-year low and is down just 16.3% from its January 2014 record. Revenues are expected to rise 2.9% in 2016 and 9.6% in 2017 following a 2.5% decline in 2015--with the recovery leading to an earnings gain of 6.3% (2016) and 13.7% (2017) following a 7.2% decline in 2015. STEG of 10.5% is up from a seven-year low of 6.0% in February, but remains below LTEG (13.3%). STEG had been in a downtrend since mid-2013, when it peaked at 14.3%. The implied profit margin is expected to improve to 6.1% in 2016 from 5.9% last year before moving even higher to 6.3% in 2017. The forward profit margin is down more than four full percentage points from a record high of 10.3% in December 2007 to a near-record low of 6.2% now. NERI--negative for 64 months--improved to a 21-month high of -4.3% in June from -5.8% in May and is up from an 83-month low of -10.2% in March. Emerging Markets' valuation has been more stable recently than that of the rest of the world. The P/E of 11.6 is up from a 17-month low of 10.2 last August, but down from a four-year high of 12.6 in April 2015. The index is trading at a 23% discount to the World MSCI P/E, up from a 10-year-low 30% discount in August.

MSCI World & Region MSCI Net Earnings Revisions (*link*): Analysts' recent earnings revisions suggest less pessimism about profits across some of the world's regions outside the US. NERI improved m/m again in June for all regions for the first time since May 2015. EM Eastern Europe was positive for a second straight month and at a 63-month high, while the US MSCI was positive for the first time since September 2014. The AC World MSCI's NERI was negative for a 60th straight month, but improved 1.8ppt to a 21-month high of -3.4% from -5.2% in May and compares to an 83-month low of -12.4% in March. The World Ex-US improved to -5.3% from -7.1%, paced by gains in all regions. June's score among the regional MSCIs: EM Eastern Europe (up to 1.2% from 4.2%), United States (1.0, -0.7), EM Latin America (-1.7, -4.2), AC World (-3.4, -5.2), Emerging Markets (-4.3, -5.8), Europe (-4.9, -6.8), EM Asia (-5.1, -6.7), World ex-US (-5.3, -7.2), EMU (-5.9, -9.2), EAFE (-6.3, -8.4), and Europe ex-UK (6.4, -9.2).

MSCI Countries Net Earnings Revisions (*link*): NERI was positive for 11/44 MSCI countries in June, unchanged from May but up from 4/44 in April and 2/44 in March--which had marked the fewest positive since just one in August 2012. NERI improved m/m in June for 36/44 countries, the highest since August 2009 and up from 35 improving in April. Russia was at a 76-month high, followed by Mexico (74), Peru (65), Korea (59), Singapore (30), Hong Kong (25), Brazil (24), and Greece (22). Countries at multi-month lows: Indonesia (5) and New Zealand (4). The three-month positive NERI streaks are the best for Argentina, Egypt, and Hungary. NERI turned positive in June for Austria and Korea and dropped backed into negative territory for New Zealand and Turkey. Hungary is the strongest recently, with positive readings in 13 of the past 14 months, followed by Ireland in 19 of the past 22 months. Italy's NERI has been negative for 79 straight months, followed by the negative streaks of Brazil (72), Singapore (63), UK (61), Chile (59), Malaysia (48), Thailand (36), and China (29).

US ECONOMIC INDICATORS

Existing Home Sales (*link*): Existing home sales--tabulated when a purchase contract closes--reached their highest level in nearly a decade in May. Sales rose 1.8% m/m and 9.1% the past three months to 5.53mu (saar), the highest since February 2007. Single-family sales advanced for the fifth time in six months, up 1.9% in May and 15.0% over the period to 4.90mu (saar); multi-family sales climbed for the third month by a total of 12.5% to 630,000 units. Regionally, sales posted solid gains everywhere but the Midwest. The number of existing single-family homes on the market climbed for the fourth month to 1.90mu after dropping to 1.55mu in December. Unsold inventory remained at 4.7 months' supply at the current sales pace, up from December's 3.9 months, which was the lowest since January 2005. Still, that's below the 6.0 months that's considered a marker of a balanced market. Tight inventory has pushed the median single-family home price to a new record high. The NAR's chief economist notes that housing market's mantra has been replaced from "location, location, location" to "affordability, affordability, affordability." Currently, affordability is being helped by ultra-low mortgage rates.

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