



MORNING BRIEFING

May 16, 2019

Yin and Yang

See the [collection](#) of the individual charts linked below.

(1) A smaller earnings hook. (2) Not a good year for pigs. (3) The Chinese don't want to be bullied. (4) China's Orwellian state and Gulag. (5) Real retail sales growth falling as China turns into world's biggest nursing home. (6) Xi needs a trade deal with US and Trump needs a deal with China. (7) Digital payments system disrupting financial system. (8) Lots of competition to deliver caffeine.

Correction: A Smaller Hook. Yesterday, Joe and I reported that Q1 S&P 500 earnings rose 4.8% y/y. It's actually 2.2% so far, with 90% of S&P 500 companies having reported their results. During the 4/11 week, analysts had estimated a 2.5% y/y decline in S&P 500 earnings. That's still a big upside hook.

China: Homegrown Problems. In the Chinese Zodiac, this is the Year of the Pig. With a swine flu epidemic in China, at least a few superstitious Chinese must be concluding that the forces of Yin and Yang aren't in harmony for their country. They clearly don't like to be bullied by President Donald Trump, who is delivering on his threat to impose a 25% tariff on all their exports to the US unless they change their ways on trade.

That's all very ironic, of course, since the Chinese government has been bullying foreign companies that want to do business in China to agree to joint-venture deals that often entail "sharing" their intellectual property. The government and its proxies have been implicated in stealing such property as an alternative to sharing. The trade tensions with the US have also shone a light on the authoritarian nature of the government led by President Xi Jinping, who is a Maoist in a business suit.

The government is installing an Orwellian "[Social Credit System](#)" that uses artificial intelligence and facial recognition software to keep track of everyone in the country, and assigning them a 350-950 score for how responsible and trustworthy they are. Low scorers are punished in various ways, including getting denied a passport, booking flights, and good jobs. This is converting the entire country into one big Gulag.

In fact, the government is interning hundreds of thousands of Chinese Muslim ethnic minorities in concentration camps. The 5/3 NPR website [reported](#): "China has detained an estimated hundreds of thousands of Muslims inside what it calls vocational training centers in its northwest region of Xinjiang. Those who've been released describe them as concentration camps and tell NPR they're places where authorities brainwash detainees with communist doctrine and where some claim they were tortured."

Meanwhile, the government's disastrous one-child policy (1979-2015) is rapidly turning China into the world's largest nursing home. Melissa and I have observed the consequences in the rapidly falling growth rate of inflation-adjusted retail sales. Consider the following:

(1) *Nominal retail sales* rose 7.2% y/y during April ([Fig. 1](#)). That's the slowest pace since May 2003.

(2) *The CPI inflation rate* rose to 2.5% y/y during April, led by a 6.1% increase in food prices including a 14.4% increase in pork prices ([Fig. 2](#)). Pork has a big weight in the consumption basket of most Chinese.

(3) *Inflation-adjusted retail sales* rose just 4.7% y/y during April, the slowest since May 2003. The 12-month average of this series dropped to 6.3% during April, the lowest since July 1995 ([Fig. 3](#)). It is down from a record high of 17.0% during June/July 2009.

(4) *The growth rate of industrial production* has also been slowing, with the 12-month average down to 6.0% y/y during April ([Fig. 4](#)).

(5) *Bank lending* soared at a record pace during the first three months of this year ([Fig. 5](#)). However, the economy is getting less and less bang per yuan from all this profligate credit. The ratio of industrial production to bank loans has dropped by 50% from April 2008 through April 2019 ([Fig. 6](#)).

(6) *The bottom line* is that the Chinese need a trade deal with the US.

US: Problems at Home. The Trump administration also needs a deal. The latest batch of economic indicators suggests that the US economy is starting Q2 on a weak note. As Debbie discusses below, retail sales fell 0.2% m/m during April, while industrial production declined 0.5% during the month. The weakness in retail sales was widespread, with large declines at building supply stores, electronics and appliance stores, and vehicle dealers. Other declines included nonstore retailers, drug stores, and apparel stores. April's drop in production was the third decrease in the last four months.

Financials: New Ways to Pay. Despite all the turmoil surrounding privacy and politics, Facebook made it clear during its Q2 [conference call](#) that it has two new priorities: shopping and payments. Executives spent valuable airtime discussing the ability to shop on Facebook's Instagram or in its Marketplace division. We noted in the 5/2 [Morning Briefing](#) CEO Mark Zuckerberg's brief mention of the company's intention to enter the payments business. Facebook hopes users will use its payments options when making purchases on the company's websites or when using the private social platform it's developing, he said.

More details arrived quickly. Facebook is "recruiting dozens of financial firms and online merchants to help launch a cryptocurrency-based payments system on the back of its gigantic social network," the *WSJ* reported in a 5/2 [article](#). The company aims to create a digital coin that can be used to make purchases on the Facebook platform or elsewhere on the Internet. Facebook could use the coin like a loyalty program, paying users when they view ads or shop on Facebook.

Facebook now joins Apple Pay, Google Pay, Amazon Pay, and PayPal, among other competitors aiming to push aside the traditional banks and credit card companies to conquer the payments industry. The timing is perfect, as people have shifted more of their spending online and as mobile phones have become as important as a traditional wallet.

The payments industry is also attractive because it's growing, as the shift from cash to plastic continues around the world. Global payments revenue is expected to grow 9% annually through 2022, which equates to roughly \$1 trillion of net new revenue, according to a 10/18 McKinsey [report](#). Nearly two-thirds of the new revenue will be generated in Asia, but there's still plenty of growth in the US.

The report states that "In the United States, in-person use of digital wallets will increase at a 45 percent compound annual growth rate to reach nearly \$400 billion in annual flows by 2022. Although most of this growth is expected to be on 'pass through' wallets like Apple Pay, private-label wallets such as

Starbucks and Walmart Pay—both of which have enjoyed impressive early adoption—will also continue to increase in popularity.” Even after growing that quickly, digital wallets will represent less than 10% of US consumer in-person point-of-sale payments in 2022.

I asked Jackie to consider which players have the best shot of winning the industry’s game of Survivor. Here is her report:

(1) *He who has the most players wins.* Successful payments companies need a large installed base of users. Here the Android phone wins hands down with 2.5 billion active devices as of the company’s 5/7 update. The Google Pay app, which runs on Android phones, has been downloaded more than 100 million times. And the Samsung Pay app, which also runs on Android phones, has had 50 million downloads.

Not far behind, Facebook has 1.6 billion daily active users and 2.4 billion monthly users. In comparison, Apple’s installed base of iPhones seems paltry, at just over 900 million. Its installed base of all Apple devices is beefier at 1.4 billion at year-end 2018, according to a 1/30 [zdnet.com article](#). Amazon’s estimated 410 million active customers and PayPal’s 277 million active accounts worldwide also appear small next to the Android/Facebook user base.

(2) *Attracting bricks and clicks.* The payments system that gets adopted both online and at physical stores would be best positioned. Right now, Apple seems to be winning in the “real” world, as Apple Pay is accepted at 50% of all retail stores, the company said in January 2018. These include established retailers such as Target, Costco, Stop & Shop, and McDonald’s, according to Apple’s [website](#).

Google Pay has also made inroads with traditional retailers, including Walgreens and American Eagle Outfitters, according to its [website](#). Some of Apple Pay’s and Google Pay’s success may be due to the fact that they aren’t Amazon. Retailers might be reluctant to accept Amazon Pay for fear of giving business insight to the competition.

Amazon is fast becoming the second payment button offered after PayPal on many web retailers’ sites, though. Some of the retailers accepting Amazon Pay are established, including Vineyard Vines and Avis, according to Amazon’s [website](#). But most of the retailers listed are smaller and less recognizable, such as Simple Wishes and Moda Operandi.

PayPal may have a small user base, but it’s the Switzerland of payments. It can be used as the payments option on mobile phones using either Apple Pay or on Google Pay. The websites we looked at offered either Apple Pay or Amazon Pay and typically PayPal as the second option.

But credit cards are still the leading form of payment online (62%), followed by PayPal (22), Amazon Pay (5), Google Pay (2), and Apple Pay (2), according to a spring 2018 survey quoted in a 3/24 [article](#) on Patentlyapple.com.

(3) *Keeping it simple.* Most of the new payment systems simply tap into a user’s existing credit card for actual payments. Apple’s impending introduction of a credit card with Goldman Sachs pushes the company a bit further into the world of banking than its competition. Facebook’s development of a cryptocurrency to make payments seems awfully complex when a credit card does the job nicely. However, the company is reportedly trying to reduce or eliminate the 2%-3% swipe fees charged on credit card transactions. The savings may go a long way toward enticing merchants to adopt the Facebook system.

One thing is clear: Banks should be on high alert. The digital titans have payments in their sights, and that's probably not where they'll stop. The McKinsey report provides some advice: "Banks can safeguard their client relationships, expand advisory services, and strengthen margins only if they take the lead in developing new strategies to address digital disruption in GTB. There is significant risk that banks will cede important aspects of the business to emerging digital challengers if they do not take advantage of recent advances in technology, regulatory changes, and new partnership models." In other words, banks must disrupt themselves or risk being disrupted.

Consumer Discretionary: Caffeinated. Bostonians must really need caffeine, because the city hosts a gaggle of independent coffee shops, including Boston Common Coffee, Flat Black, George Howell, and—our favorite name—The Wired Puppy. All are competing with Starbucks and the coffee kingdom that JAB Holding is cobbling together.

Jackie recently ducked into Tatte Bakery and Café, a white-tiled space serving up coffee and pastries in real cups and plates. Panera's former CEO Ron Shaich is a major investor and mentor of the privately held company with 13 Boston locations. One Tatte location was within a block or two of a Starbucks and Caffe Nero, another European-inspired coffee chain that arrived in Boston in 2014 and has more than 24 area locations.

In addition to small coffee operators, Starbucks faces growing competition from JAB Holding, which has been on an acquisition spree in recent years. The European conglomerate has purchased directly and through its investments: Peet's Coffee & Tea (acquired in 2012), Caribou Coffee (2013), a large stake in Jacobs Douwe Egberts (2013), Einstein Noah Restaurant Group (2014), Mighty Leaf Tea (2014), Intelligentsia Coffee & Tea (2015), Stumptown Coffee Roasters (2015), Krispy Kreme Doughnuts (2016), Keurig Green Mountain (2016), Panera (2017), Bruegger's Bagels (2017), Pret a Manger (2018), and Dr. Pepper Snapple Group (2018).

Meanwhile, Chinese competitor Luckin Coffee is expected to price an initial public offering Thursday night that could raise as much as \$585.5 million, giving the company a market capitalization of roughly \$4 billion, according to a 5/15 [article](#) in *Investor's Business Daily*. Luckin has 2,370 stores in China, compared to Starbucks 3,789 stores.

Starbucks's results last quarter didn't show any sign that the market is saturated. In FQ2, Starbucks reported 3% same-store-sales, with sales up 4% in the Americas and up 3% in China, according to a 4/25 *WSJ* [article](#). The company also increased its earnings-per-share target for this year.

Starbucks is one of the five fast-food members of the S&P 500 Restaurants stock price index. The index is up 18.0% ytd and 26.4% y/y, both through Tuesday's close ([Fig. 7](#)). Despite the US-China wrangling over tariffs, the Restaurants index is just 1.1% below its all-time high last week.

The industry's revenue is expected to improve by 3.7% this year and 5.3% in 2020 ([Fig. 8](#)). Earnings growth is expected to come in at 8.5% this year and 9.9% next—impressive after 2018 earnings grew 17.6%, helped by the reduction in corporate taxes ([Fig. 9](#)).

Two things to watch: margins and the earnings multiple. The industry's profit margin may remain pressured if wages continue to tick higher ([Fig. 10](#)). And the industry can ill afford any hiccups, because it's priced to perfection with a forward P/E of 25.0, near the highest level of the past two decades. As for Starbucks, we'd be keeping an eye on the competitors in Bean Town.

CALENDARS

US. Thurs: Jobless Claims 221k, Housing Starts & Building Permits 1.209mu/1.287mu, Philadelphia Fed Manufacturing Index 9.0, EIA Natural Gas Report, Kashkari. **Fri:** Leading Indicators 0.2%, Consumer Sentiment Index 97.5, Baker-Hughes Rig Count, Williams, Clarida. (DailyFX estimates)

Global. Thurs: Eurozone Trade Balance €19.0b, Australia Employment Change & Unemployment Rate 15k/5.0%, BOC Financial System Review, Coeure, Praet, Guindos. **Fri:** European Car Sales, Eurozone Headline & Core CPI 1.7%/1.2% y/y. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): The Bull/Bear Ratio (BBR) sank back below 3.00 this week (after moving above 3.00 two weeks ago for the first time since October) as bulls fled to the correction camp. The BBR declined for the second week to 2.94 after climbing from 2.52 to 3.17 the prior five weeks. Bullish sentiment dropped 5.0ppts the past two weeks, from 56.4% to 51.4%, with all moving to the correction camp, which climbed 5.3ppts (to 31.1% from 25.8%) over the period. Bearish sentiment ticked down from 17.8% to 17.5% (the fewest bears since late March 2018) over the same two-week span; it bounced in a range between 20.4% to 21.5% from late January through late March. The AAll Ratio increased for the second week last week from 62.4% to 65.0% over the period. Both bullish (to 43.1% from 33.5%) and bearish (23.2 from 20.2) sentiment increased over the two-week span.

S&P 500 Earnings, Revenues, Valuation & Margins ([link](#)): Consensus S&P 500 forward revenues rose to a record high for a second week, and forward earnings rose for a fourth week to 0.6% below its record high in early December. Analysts expect forward revenues growth of 5.5% and forward earnings growth of 7.2%. Forward revenues growth is down 0.8ppt from a seven-year high of 6.3% in February 2018, but is up from a 31-month low of 5.0% in mid-February. Forward earnings growth is down 9.7ppts from a six-year high of 16.9% last February, but that's up from a 34-month low of 5.9% in late February. Prior to the passage of the Tax Cuts and Jobs Act (TCJA), forward revenues growth was 5.5% and forward earnings growth was 11.1%. Turning to the annual growth expectations, analysts expect revenues growth to slow from 8.3% in 2018 to 5.0% in 2019 and 5.3% in 2020. They're calling for earnings growth to slow sharply from 24.1% in 2018 to 3.4% in 2019 before improving to 11.1% in 2020. The forward profit margin edged up 0.1ppt w/w to 12.1%, but is down 0.3ppt from a record high of 12.4% in mid-September. Still, that's up from 11.1% prior to the passage of the TCJA in December and compares to a 24-month low of 10.4% in March 2016. The S&P 500's forward P/E has moved higher in 15 of the past 19 weeks and peaked at eight-month high of 17.0 in late April. It fell 0.3 points in the latest week to a six-week low of 16.6. That's up from 14.3 during December, which was the lowest reading since October 2013 and down 23% from the 16-year high of 18.6 at the market's valuation peak in January 2018. The S&P 500 price-to-sales ratio of 2.01 is up from 1.75 during December, when it was the lowest since November 2016, and down 19% from its then-record high of 2.16 in January 2018.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins ([link](#)): Consensus forward revenues rose w/w for four of the 11 S&P 500 sectors and forward earnings for 5/11 sectors. Forward revenues and earnings are at or around record highs for 4/11 sectors: Consumer Discretionary, Health Care, Industrials, and Tech. Energy's forward earnings is beginning to move higher now after tumbling about 25% from November to February. Forward P/S and P/E ratios are now well above their multi-year lows during December 2018 for all sectors, and are near or above their 2018 highs for four sectors: Communication Services, Real Estate, Tech, and Utilities. Due to the TCJA, the profit margin for 2018 was higher y/y for all sectors but Real Estate. The outlook for 2019 shows higher margins are expected y/y for just 3/11 sectors: Consumer Discretionary, Financials, and Industrials. The forward profit margin was at record highs during 2018 for 8/11 sectors, all but Energy, Health Care, and Real Estate. Since then, it has moved lower for nearly all of the sectors, but early signs of a bottom are appearing. During

the latest week, the forward profit margin rose 0.1ppt for Consumer Staples and the S&P 500. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (22.2%, down from 23.0%), Financials (18.6, down from 19.2), Real Estate (15.3, down from 17.0), Communication Services (14.8, down from 15.4), Utilities (12.9, down from 13.0), S&P 500 (12.1, down from 12.4), Health Care (10.5, down from 11.2), Materials (10.4, down from 11.6), Industrials (10.2, down from a record high of 10.4 in mid-March), Consumer Discretionary (7.6, down from 8.3), Consumer Staples (7.4, down from 7.7), and Energy (7.2, down from 8.0).

US ECONOMIC INDICATORS

Retail Sales ([link](#)): Both headline and core retail sales—which excludes autos, gasoline, building materials, and food services—were weaker than expected in April, though remained at record-high levels; real sales took a step back. Core sales was unchanged at its record high last month after rebounding 2.5% the first three months of this year. (The BEA uses this core retail sales measure to estimate personal consumption expenditures each month.) Meanwhile, total sales edged down 0.2% after jumping 2.2% during the three months through March to a new record high. We estimate real core retail sales contracted 0.4% in April after a 0.5% gain and a 0.6% loss the prior two months; sales had jumped 2.1% at the start of the year. Total sales followed the same pattern. After rebounding 1.1% at the start of the year, sales declined in February (-0.5%), rose in March (1.0), and fell again in April (-0.6). Over the three months through April, we calculate core retail sales expanded 1.5% (saar), based on the three-month average, slowing from 4.4% in March; real headline sales grew 1.4% (saar) over the comparable period, not far from March's 2.0%. In April, seven of the 13 major nominal sales categories fell—with declines in excess of 1.0% recorded by building materials (-1.9%), electronics & appliance (-1.3), and motor vehicle (-1.1) retailers, while health & personal care, clothing, and nonstore retailers all saw only a 0.2% decline. Meanwhile, gasoline services stations (1.8) posted the biggest sales gain, while advances of 0.2% were recorded for food & beverage, restaurants, sporting goods, and general merchandise establishments; sales for furniture and miscellaneous store retailers were both flat in April.

Business Sales & Inventories ([link](#)): Nominal business sales in March rose for the third month to a new record high, while real business sales dipped slightly in February from January's record high. Nominal manufacturing & trade sales (MTS) expanded 2.1% during the three months through March after contracting 1.3% the final two months of 2018, while inflation-adjusted MTS slipped 0.3% in February after increasing 11 of the prior 12 months by 3.3%. Real sales of both wholesalers and retailers were stalled at record highs, while manufacturers' was stalled at its cyclical high. March's nominal inventories-to-sales ratio fell to 1.37 from a recent high of 1.39 the prior three months. Meanwhile, the real inventories-to-sales ratio is moving higher, climbing from a recent low of 1.42 last year to 1.44 in February.

Industrial Production ([link](#)): Industrial production in April contracted for the third time this year as manufacturers faced headwinds from trade tensions and a global slowdown, as well as weak auto sales. Headline production sank 0.5% in April and 1.2% ytd, to its lowest level since last July. Factory output slumped 0.5% and 1.6%, respectively, over the comparable periods, to its lowest reading since last May. By market group, consumer goods production has declined 2.0% ytd, driven by a 4.6% drop in durable goods output led primarily by autos (-6.8% ytd) and furniture & appliances (-4.0%); consumer nondurable goods production slumped 1.1% over the period. Business equipment output contracted 2.7% during the four months through April, as transit and industrial equipment contracted 5.3% and 2.6%, respectively, while output of information processing equipment was flat ytd. Meanwhile, mining output rose 1.6% in April after a three-month loss of 1.7%, while utilities usage fell 3.5% last month after three-month gain of 3.7%.

Capacity Utilization ([link](#)): The headline capacity utilization rate fell in April to a 14-month low of 77.9% after reaching a cyclical high of 79.6% in November. It was 1.9ppt below its long-run (1972-2018) average of 77.9%. Manufacturing's rate fell from 76.9% in November to a 15-month low of 75.7% over the same period; it was 2.6ppts below its long-run average. Meanwhile, the utilization rate for mining rose for the first time this year, to 91.4%, remaining well above its long-run average of 87.1%; the rate for utilities sank to a 14-month low of 76.2%—more than 9.0ppts below its long-run average.

Regional M-PMI ([link](#)): The New York Fed—the first district to report on manufacturing for May—showed business activity picked up for the second month, posting its best growth in six months, while firms were significantly more optimistic about future conditions than they were in April. The composite index climbed to 17.8 this month from 10.1 in April and 3.7 in March—which was the weakest reading since May 2017. Both the new orders (to 9.7 from 3.0) and shipments (16.3 from 7.7) gauges improved over the two-month period, though were still weaker than the pace recorded during the final quarter of last year. Meanwhile, employment growth slowed again this month, with its measure falling to 4.7 from March's high for this year of 13.8; the hours worked gauge held steady at 4.4, after turning negative in March. Meanwhile, the delivery times (0.7 from 7.0) measure fell back toward zero this month, while the index for inventories (-4.1 from 8.4) show they're contracting again. Both the prices-paid (26.2 from 27.3) and -received (12.4 from 14.0) indexes show prices increased at about the same pace as last month. Meanwhile, manufacturing firms were significantly more optimistic about the six-month outlook than they were in April, with the future business conditions index jumping from 12.4 to 30.6 and measures for future new orders and shipments climbing to similar levels. Firms are expecting solid increases in employment, but no change in the average workweek, in the months ahead.

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