MORNING BRIEFING
June 13, 2019

Material World

See the collection of the individual charts linked below.

(1) The metal with the PhD in Economics has been a doomsayer for the past year, depressed by trade issues. (2) Copper price has lost 19% y/y, and the S&P 500 Copper stock price index more than twice that. (3) Only this past week has some luster returned. (4) But all that glitters isn't copper; other S&P 500 Materials-sector industries have been sparkling ytd. (5) Prospects for Construction Materials—also an economic barometer—look particularly bright. (6) New, new thing in retail—stores without addresses or inventory—are giving traditional retailers, Amazon included, a run for their money.

Materials: Looking Beyond Copper. Investors have been doing lots of fretting over "Doctor Copper's" prognosis for the economy. Since peaking in June 2018, the copper price has fallen 19% to $2.68 per ounce as of Wednesday (*Fig. 1*). In the stock market, copper's plight is reflected in the S&P 500 Copper industry, of which Freeport McMoRan is the sole constituent. The S&P 500 Copper stock price index is down 41.6% y/y as of Tuesday's close, making it the third-worst-performing industry y/y that we cover (*Fig. 2*).

The S&P 500 Copper industry's dismal price performance is among the reasons why the Materials sector is the second-worst performer among the S&P 500 sectors y/y as of Tuesday's close: Utilities (22.3%), Real Estate (17.0), Consumer Staples (14.8), Information Technology (7.2), Health Care (6.9), Consumer Discretionary (5.7), Communication Services (5.4), S&P 500 (3.7), Industrials (-1.7), Financials (-2.4), Materials (-5.4), and Energy (-20.3) *Table 1*.

Amid this doom and gloom, we offer two rays of sunshine. First, copper rallied this week. By no means is one week's performance a trend, but it helped make the Materials the best-performing sector in the S&P 500 so far this month. Here's the performance derby for the S&P 500 mtd through Tuesday's close: Materials (9.2%), Information Technology (7.0), Consumer Staples (5.6), Consumer Discretionary (5.4), Financials (5.1), S&P 500 (4.9), Energy (4.5), Health Care (4.4), Industrials (4.3), Real Estate (2.5), Utilities (1.6), and Communication Services (1.1) (*Fig. 3*).

The second ray of sunshine we offer is the strong ytd returns turned in by a number of other industries in the Materials sector. The S&P 500 Metals & Glass Containers stock price index has climbed 44.5% ytd, Industrial Gases 31.1%, and Construction Materials 30.8% (*Fig. 4*).

I asked Jackie to take a look at what developments might be driving the performances of copper and its Materials-sector mates. Here's what she found:

(1) *It's all about China.* China accounts for roughly half of the global demand for copper. So when the tariff tiffs between the US and China and between the US and Mexico broke out, the price of copper fell on fears that tariffs would hurt the global economy and demand for the metal. Some of those fears receded this week when the US and Mexico resolved their differences about immigration and tariffs.

Recent indications that the Federal Reserve will lower interest rates if tariffs harm the economy also

helped the red metal because lower interest rates would bolster the economy. The potential for lower interest rates likewise benefitted copper and other commodities because it has already put downward pressure on the dollar, which fell 1.1% over the past seven sessions (*Fig. 5*).

More good news arrived Tuesday when the Chinese government announced it would "accelerate the financing of major infrastructure projects through 'special-purpose bonds' issued by local governments," in an effort to bolster growth, a 6/11 CNBC article reported. China is the largest consumer of copper.

Beyond the macro influences, the S&P 500 Copper industry is influenced by the corporate operations of Freeport McMoRan. The company is in the midst of a costly expansion of an Indonesian copper and gold mine. The project's costs have come in above expectations. During the two-year duration of the project, the company will not raise its dividend or make large acquisitions. Freeport CEO Richard Adkerson hopes the expansion will "mark a pivot to massive growth for the company just as copper demand surges for use in electric cars and other electronics. But the growth comes at a high cost and is testing the patience of Wall Street, where investors often look for quicker paybacks on investment projects," a 4/25 Reuters article reported.

(2) *Copper by the numbers.* Analysts see better times arriving for the S&P 500 Copper industry in 2020, forecasting a 19.3% decline in 2019 revenues and a 6.3% increase in 2020 (*Fig. 6*). Likewise, earnings are expected to drop by 73.8% this year, only to rebound by 136.0% in 2020 (*Fig. 7*). While 2019 revenue estimates have plateaued, this year's earnings estimates have continued to be revised downward (*Fig. 8*). Because Freeport is so leveraged to copper prices, investors may find they've lost their buying opportunity if they wait for copper prices to rise before buying the mining company's stock.

(3) *Looking up at home.* At recent levels, the copper price is almost as low as it was in 2008, when the housing bubble was bursting. We'd be worried were it not for the S&P 500 Construction Materials industry's 30.8% ytd return. The industry—which includes Martin Marietta Materials and Vulcan Materials, two building materials companies—is arguably a better reflection of the domestic economy than is copper.

Martin Marietta is primarily involved in producing concrete for use in buildings and homes. There is hope that the company and others in the industry will benefit if President Trump's border wall is funded. Likewise, anticipation of an infrastructure spending bill had buoyed Martin Marietta Materials shares earlier this year. But that also seems to be on the back burner, as President Trump said at the end of last month that he won't strike an infrastructure deal while the Democrats are investigating him.

Even without a wall or an infrastructure deal, Martin Marietta executives struck an upbeat tone in the company's Q1 conference call on 4/30, according to the transcript: "Consistent with our expectations, public and private sector construction growth in our leading markets is outpacing the nation as a whole and supports our view of continued pricing momentum. These trends bode well for increased construction activity and position Martin Marietta for improved shipments, pricing and profitability for the remainder of 2019," said CEO Ward Nye. Many of the company's markets are in the South, where populations are growing faster than other areas of the US.

Martin Marietta anticipates strong demand from the construction of highways and streets, thanks to federal funding from the Fixing America's surface and Transportation Act and other state-funded programs. Commercial construction continues to be strong thanks to profuse construction of distribution centers, warehouses, data centers, and wind turbine projects. Large energy sector projects along the Texas Gulf Coast should increase demand for heavy building materials, as should the need to make repairs in the wake of flooding in the Midwest. And finally, the residential outlook is positive, "driven by favorable demographics, job growth, land availability, steady interest rates, and deficient permitting."

(4) *Building buildings*. The value of US construction put in place through April confirms Martin Marietta's positive experience. Last year, the value of construction climbed to a record high and then pulled back slightly until bottoming in November because of a drop in residential construction. Since then, the value of construction put in place has enjoyed a modest bounce, leaving it near all-time highs (*Fig. 9* and *Fig. 10*).

The residential market was hurt by a sharp drop in home improvement construction spending over the past year or so: Home-improvement spending has plunged 22% since its April 2018 peak, while new single-family home construction spending is off 8% from its peak last May. Meanwhile, new multi-family home construction spending has continued to hit new highs, jumping 13% during the eight months through April (*Fig. 11*). Activity in all three areas should be helped by the recent drop in the 10-year Treasury yield and 30-year mortgage rate (*Fig. 12* and *Fig. 13*).

Martin Marietta's optimism about construction spending on transportation is also reflected in the data. Public spending on highways and streets and on transportation hit new highs in April (*Fig. 14*). There have also been sharp jumps in the amount spent on education-related construction and sewage and waste disposal construction.

(5) *By the numbers*. Analysts are forecasting strong revenue growth for the S&P 500 Construction Materials industry: 9.8% this year and 6.9% in 2020 (*Fig. 15*). The industry's bottom-line prospects are robust as well, with forecasts of 22.1% earnings growth in 2019 and 17.8% next year (*Fig. 16*). The industry's forward P/E of 23.9 isn't much higher than the earnings growth expected this year (*Fig. 17*). With this stock, vigilance is warranted because when a recession does come along, earnings tend to drop sharply. Even after recovering for the past seven years, earnings are below their 2007 peak.

Disruption: A Shrinking Retail World. Teenagers are great for ferreting out the latest and greatest new trends, particularly in retailing. Jackie's daughter has been asking to buy clothes from online retailers that Jackie had never heard of before. These retailers are getting their message out by advertising on Instagram and Snapchat, by being cited by Internet "influencers." or by good, old-fashioned word of mouth. They certainly aren't advertising on TV!

Zaful says it's a business owned by a Hong Kong-based company. Red Bubble is an Australian-based company that connects t-shirt artists with buyers. Cupshe says it's a "California-inspired" swim and beachwear brand, but no where does it give a headquarters address or information on its owners. SHEIN says it was founded in 2008 and ships to over 220 countries and regions worldwide. But again, nowhere does it give a corporate address or information about its ownership. None of this is very comforting when handing over a credit card.

Many web retailers appear to be little more than websites with pictures of products. They may not even need to carry inventory if they are doing business with wholesalers, often in China, that will ship the product directly to customers (a practice called "drop shipping"). One website estimates that roughly 22% of Internet retailers use drop shipping as their primary method of order fulfillment, according to an article on AmeriCommerce.

Shipping small products from China to the US is unexpectedly inexpensive due to the Universal Postal Union treaty. It can be less expensive to ship from China to the US than it is to ship within the US.

Here's an example given on the website mywifequitherjob.com. An anti-snoring mouthguard on AliExpress costs $1.73 per piece. A US retailer can have a picture of the mouthguard on its website and not carry any mouthgard inventory. If an order comes in, AliExpress will send the item to the

customer. Shipping a small package from Shanghai to Virginia costs only $1.12 even though sending the package in the other direction could cost north of $20. So buying the mouthguard from China—including shipping—could cost under $3. A similar mouthguard is listed on Amazon for $26.

The ability to run a business in this way allows retailers with almost no overhead to compete with traditional companies like Macy's, Target, and Amazon. Teens don't seem to differentiate between established companies and no-name retailers, especially if the price is right. There are downsides to this retailing model. Shipping from China often takes longer, there's greater risk that the item will be defective or counterfeit, and often returns aren't accepted.

Additionally, it's unclear for how long cheap shipping from China will be available. President Trump has threatened to withdraw the US from the Universal Postal Union. Until he pulls the plug, competition in the world of retailing will continue to be insanely difficult, and you can't blame it all on Amazon.

CALENDARS

US. Thurs: Jobless Claims 215k, Import Prices Headline & Ex Petroleum -0.3%/-0.1%, EIA Natural Gas Report. **Fri:** Retail Sales Total, Ex Autos, Ex Autos & Gas, and Control Group 0.7%/0.4%/0.4%/0.4%, Consumer Sentiment Index Total, Current Situation, and Expectations 98.0/109.0.92.0, Headline & Manufacturing Industrial Production 0.2%/0.2%, Capacity Utilization 78.0%, Business Inventories 0.4%, Baker-Hughes Rig Count. (DailyFX estimates)

Global. Thurs: Eurozone Industrial Production -0.5%m/m/-0.5%y/y, Germany CPI 0.2%m/m/1.4%y/y, Australia Employment Change & Unemployment Rate 16k/5.1%. **Fri:** Japan Industrial Production, China Retail Sales 8.0% y/y, China Industrial Production 5.4% y/y, China Fixed Assets Ex Rural (ytd) 6.1% y/y, Carney. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) rose for the first time in six weeks this week as bullish sentiment headed back up toward 50.0%. The BBR climbed to 2.63 this week after declining the prior five weeks from 3.16—which was the first reading above 3.00 since October—to 2.31 (lowest since mid-February). Bullish sentiment advanced 5.4ppts this week, to 48.1%, after a five-week plunge of 13.7ppts, from 56.4% to 42.7%—which was the fewest bulls since the first week of this year. The move to the bullish camp this week came entirely from the correction camp, which fell 5.2ppts to 33.6%. The correction count had soared 13.0ppts the previous five weeks—from 25.8% to 38.8%—which was the highest percentage since just before Christmas. Bearish sentiment ticked down from 18.5% to 18.3% this week, after fluctuating in a narrow range from 17.2% to 17.8% the prior four weeks. The AAII Ratio declined for the fourth week last week from 65.0% to 34.6% over the period. Bullish sentiment decreased for the third time in four weeks last week from 43.1% to 22.5%, while bearish sentiment increased for the fifth time in six weeks from 20.2% to 42.6%.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): Consensus S&P 500 forward revenues remain stalled near a record high for a ninth week, and forward earnings rose for an eighth week to its first record high since early December. Analysts expect forward revenues growth of 5.4% and forward earnings growth of 7.2%. Forward revenues growth is down 0.9ppt 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 4.7% in 2019 and 5.3% in 2020. They're calling

for earnings growth to slow sharply from 24.1% in 2018 to 2.1% in 2019 before improving to 11.1% in 2020. The forward profit margin edged up 0.1ppt w/w to 12.2%, and is down just 0.2ppt from a record high of 12.4% in mid-September. That compares to 11.1% prior to the passage of the TCJA in December 2017 and a 24-month low of 10.4% in March 2016. Analysts are expecting the profit margin to fall from 12.2% in 2018 to 11.9% in 2019 before rising to 12.5% in 2020. The S&P 500's forward P/E has moved higher in just two of the past five weeks after peaking at an eight-month high of 17.0 in late April. It rose 0.1 point w/w to 16.2 from a 16-week low of 16.1. 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 improved to 1.98 from a 16-week low of 1.95. Still, that's 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 nine of the 11 S&P 500 sectors and forward earnings for 10/11 sectors. Materials was the only sector to have both measures fall w/w, primarily due to constituent changes within the index. 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 4/11 sectors: Consumer Discretionary, Financials, Industrials, and Utilities. The forward profit margin rose to 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 for four sectors: Materials gained 1.8ppts due to constituent changes; Industrials increased 0.2ppt; Energy and Utilities each rose 0.1ppt. 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 (18.7, down from 19.2), Real Estate (15.7, down from 17.0), Communication Services (14.8, down from 15.4), Utilities (13.0, matching its record high in mid-May), S&P 500 (12.2, down from 12.4), Materials (record high of 12.1), Health Care (10.5, down from 11.2), Industrials (10.4, matching its record high in mid-March), Consumer Discretionary (7.6, down from 8.3), Consumer Staples (7.4, down from 7.7), and Energy (7.3, down from 8.0).

US ECONOMIC INDICATORS

CPI (*link*): May's core CPI rate returned to the Fed's target rate of 2.0%, where it was in March (after 12 months above); it peaked at 2.4% last July, which was the fastest pace since September 2008. Here's a ranking of the core goods rates in May, lowest to highest: Apparel (-3.1% y/y), medical care commodities (-0.7), used cars & trucks (0.3), new vehicles (0.9), alcoholic beverages (1.6), tobacco & smoking products (4.6); only the last one surpassed the total core rate of 2.0%, while apparel prices posted the biggest decline since May 2003. Here's the same drill for the core services rates: Airfares (0.9), physicians' services (0.3), motor vehicle insurance (0.7), hospital services (1.3), owners' equivalent rent (3.3), motor vehicle maintenance & repair (3.4), and rent of primary residence (3.7). Only the rate for auto maintenance & repair is on an accelerating trend (though looks toppy), while those for hospital services and motor vehicle insurance are on sharp decelerating trends. Core prices in May rose 0.1% for the fourth month, after gains of 0.2% in each of the prior five months. The three-month rate held at April's 21-month low of 1.6% (saar), slowing from January's 2.6%—which was the highest since March 2018. The headline CPI rate dropped back below 2.0%, to 1.8% y/y, after accelerating from 1.5% in February (which was the lowest since September 2016) to 2.0% in April; it peaked at 2.9% during June and July 2018.

PPI (*link*): The Producer Price Index for final demand slowed for the second month in May, after a spike in goods prices during March generated the biggest monthly gain in the headline measure in five months. Total prices advanced only 0.1% last month, slowing steadily from March's 0.7% advance, with the yearly rate easing to a 28-month low of 1.8% y/y. Prices for final demand goods fell for the first time in four months in May, by 0.2%, after a 0.3% gain in April and a 1.0% jump in March—which was the biggest since May 2015. Nearly 40% of May's decrease in the index is attributable to gasoline prices, which fell 1.7%, while food prices slipped 0.3%. Total demand goods' prices rose only 0.6% y/y—matching recent lows, and down from a recent peak of 4.4% last summer. Prices for final demand services moved up 0.3% in May, the fourth consecutive increase, with nearly 80% of May's advance due to a 10.1% jump in guestroom rentals. Its yearly rate was unchanged at 2.4% y/y, down from a record high of 3.0% at the end of last year. Meanwhile, there's no inflation in the pipeline: Intermediate goods prices fell 0.6% y/y in May, turning negative for the first time since 2016, while crude goods prices dropped 8.8%, near a three-year low.

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