



MORNING BRIEFING

July 25, 2019

Targeting Big Tech

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

(1) Internet War Game: DOJ vs FANGs. (2) Investors trust that anti-trust is tough to prove. (3) Harm to customers may be a lower bar for Barr. (4) S&P 500 Industrials is rocking it, outperforming the broad index and in third place among sectors ytd. (5) Boosting the sector ytd are ten industries, including Aerospace & Defense. (6) A scary world and a free-spending Congress mean defense won't be attacked. (7) The industry's P/E has fallen to a very grounded 16.6. (8) Crouching credit crunch in China? (9) Rising defaults are ominous in a slowing economy with mammoth amounts of debt outstanding: \$25 trillion of corporate bonds and bank loans.

Technology: Harming Consumers? When Google went public in 2004, its corporate motto was "Don't be evil." That's a bit creepy, and quite ironic since the US government has decided to investigate whether Google and fellow FANGs (Facebook, Amazon, and Netflix) are evil after all.

The Department of Justice (DOJ) announced on Tuesday that it's taking a crack at investigating the Internet Giants. Specifically, the DOJ said it's "reviewing whether and how market-leading online platforms have achieved market power and are engaging in practices that have reduced competition, stifled innovation, or otherwise harmed consumers." Much attention has been paid to the "reduced competition" element of the above statement. But making an antitrust case seems awfully difficult. Facebook can argue that there are myriad ways to communicate. Google can swear it just built a better mousetrap than Microsoft. And there are tons of places to shop online and off; no one forces consumers to buy from Amazon.

The government might focus instead on the last item, "otherwise harmed consumers." It's a much broader, catch-all category. Proving harm could be a much easier case to make. Facebook allowed Russia to manipulate our elections and misused consumers' data. Amazon generated \$232.9 billion of revenue last year and paid only \$1.2 billion of taxes. And Google's YouTube allowed the New Zealand mass murder video to air over the Internet site for more than an hour. None of these actions are anticompetitive, but they arguably did harm, so they could lead to more fines and perhaps behavioral remedies, which could impact the businesses of the giants.

Investors haven't seemed overly concerned about antitrust cases. News that the DOJ and the Federal Trade Commission (FTC) were looking into anticompetitive behavior broke on 6/3, and the shares of these companies fell. But from 6/4 through Monday's close, each of the companies' stocks shook off their antitrust fears and outperformed the S&P 500 as follows: Facebook (up 23.3%), Apple (19.6), Amazon (17.3), Google (9.8), and S&P 500 (8.8).

If the DOJ arrives at settlements like the one the FTC reached with Facebook, then the shares shouldn't have a problem. Facebook will pay a fine of roughly \$5 billion to the FTC, and CEO Mark Zuckerberg personally will certify that the company is taking steps to protect consumer privacy, a 7/23 *WSJ* [article](#) reported. Despite the regulatory distractions, Facebook reported on Wednesday Q2 revenue and earnings growth that beat analysts' forecasts, with \$48.6 billion of cash and short-term investments, making a \$5 billion bill no sweat.

But if the DOJ gets a bit more creative—and “otherwise harmed consumers” implies that it might—the shares might face a tougher road. What would happen if the DOJ forced Facebook to know and disclose its advertisers, as television companies are required to do with political ads? Or worse: What if Facebook had to ensure the items it publishes are true, as a newspaper does? Could the DOJ require a five-minute delay before video is streamed over the Internet to millions? Could the government change the tax laws so companies such as Amazon pay more? And could the DOJ force Apple to let consumers buy apps for the iPhone outside of the Apple app store? Those actions might make investors sweat a little more.

Industrials: Defying Trade Slowdown. It may not have the dazzling returns of the S&P 500 Tech sector, but the S&P 500 Industrials sector has turned in an above-average performance this year despite the drag from US and Chinese tariffs and the escalating trade war between the two nations.

Here's the performance derby ytd through Tuesday's close: Technology (32.4%), Consumer Discretionary (25.0), Industrials (21.9), S&P 500 (19.9), Communication Services (19.8), Real Estate (19.5), Financials (18.7), Consumer Staples (18.4), Materials (17.8), Utilities (13.1), Energy (10.2), and Health Care (6.5) ([Fig. 1](#)).

One of the industries boosting the sector's performance is Aerospace & Defense, up 24.9% ytd. Here are the others: Diversified Support Services (59.5%), Research & Consulting Services (34.5), Building Products (33.6), Environmental & Facilities Services (26.2), Construction & Engineering (25.5), Industrial Machinery (24.5), Railroads (23.6), and Industrial Conglomerates (21.7) ([Table](#)).

US defense spending has been bolstered by a world of seemingly rising danger and a Congress that's willing to open the federal wallet despite already huge deficits. The two-year budget agreement reached by White House and congressional leaders this week will lift defense spending by 3% to \$738 billion in 2020 and leave it basically flat in 2021 at \$741 billion. With Iran raising the ante in the Strait of Hormuz and North Korea showing off a nuclear submarine, we'd bet the 2021 budget will be revised north before that fiscal year begins.

Lockheed Martin, a beneficiary of the Department of Defense's largess, reported [earnings](#) on Tuesday that exceeded expectations, and the company raised its forecast for this year. Lockheed reported Q2 revenue jumped 7.7% to \$14.4 billion, operating profit increased by 6.0% to \$1.6 billion, and adjusted EPS gained 16.0% to \$5.00. EPS beat analysts' \$4.77 consensus and the company raised its full-year guidance to \$20.85-\$21.15, up from a prior forecast of \$20.05-\$20.35.

The S&P 500 Aerospace & Defense sector stock price index has plateaued at a very high level over the past two years ([Fig. 2](#)). However, its forward operating EPS has continued to climb over that period, which has brought down the index's valuation ([Fig. 3](#) and [Fig. 4](#)). The industry is expected to grow earnings by 5.5% this year and 11.2% in 2020 ([Fig. 5](#)). Meanwhile, its forward P/E has fallen to 16.6, down from 22.7 in January 2018 ([Fig. 6](#)).

Investors should note that Boeing has weighed heavily on the S&P 500 Aerospace & Defense sector. Since Boeing's stock price peaked on 3/1, it has fallen 15.6% through Tuesday's close. Excluding Boeing, the industry's stock price index would be up 9.3% instead of 0.9%, Joe calculates.

China: The Art of Credit Analysis. Lots of debt and a slowing economy aren't a good combination. But that's exactly what China is facing. They may be big enough problems that US Trade Representative Robert Lighthizer and Treasury Secretary Steven Mnuchin can use them as leverage during their face-to-face trade meetings next week with China's Vice Premier Liu He. The number of bankruptcies and defaults in China has jumped over the past year, a trend that bears watching because the country has a \$4 trillion corporate bond market and \$21 trillion of bank loans outstanding, which has doubled since January 2013 ([Fig. 7](#)).

China's debt may get more difficult to service if the Chinese economy continues to slow. China's real GDP fell to 6.2% y/y in Q2, down from 6.7% a year ago ([Fig. 8](#)). Likewise, its Manufacturing Purchasing Managers Index fell to 49.4 in June, with new orders falling below the 50 marker as well ([Fig. 9](#) and [Fig. 10](#)).

"This year, 35 Chinese onshore corporate issuers have defaulted on interest or principal payments on 58 bonds with a total principal value of 54.31 billion yuan (\$7.90 billion)," a 7/19 Reuters [article](#) stated. "That is 60% more than the value of defaulted bonds in the first seven months of 2018, and more than half of the total for all of 2018, the highest on record." S&P Global expects the number of Chinese corporate defaults will rise in the back half of the year as the slowing Chinese economy and the Chinese/US trade war weigh on credit.

"Last year, 165 bonds worth 157.2 billion yuan (\$23.3 billion) defaulted, according to data provider Wind. That was just 0.6% of the entire corporate bond market—but it was more in both volume and value than all such debt in the four years starting 2014, when China saw its first onshore default by a private company," a 1/11 *WSJ* [article](#) reported.

The latest defaults were reported in a Caixin [article](#) on Tuesday. Shanghai-listed retailer and electronics manufacturer Jiangsu Hongtu High Technology didn't make interest and principal payments due Monday on 700 million yuan (\$101.8 million) of medium-term notes issued in 2016. Likewise, Nanjing Construction Industrial Group Co. Ltd. didn't pay interest and principal due Friday on 2 billion yuan of privately placed green bonds issued in 2017.

Here are some other headlines that caught Jackie's eye:

(1) *Fraud comes to the fore.* Some companies are defaulting because the cash that they say is in the bank isn't. Beijing's Kangde Xin Composite Material Group (KDX) is a high-tech

materials firm that supplies optical film products to Apple and carbon fiber materials to Mercedes-Benz. It reported 12.2 billion yuan of cash on its balance sheet last fall but defaulted on 1.5 billion yuan of short-term debt in January. That triggered defaults on another 6.3 billion of other debt the company has outstanding.

In May, the company's bank told its auditor that it had no funds in its deposit account, a 5/8 Reuters [article](#) reported. Founder Zhong Yu reportedly misappropriated around 10 billion yuan in company funds, supposedly for a carbon-fiber project being done by Kangde Investment Group, which owns a 24.04% stake in KDX. He resigned as chairman in March. KDX shares were used to back more than 8 billion yuan in loans for Kangde Investment.

(2) *Cross defaults a concern.* China Minsheng Investment Group won't repay the principal or interest on \$500 million of bonds due in August. The unrated bonds carried a coupon of only 3.8% and were issued by an offshore subsidiary called "Boom Up Investments," a 7/19 *WSJ* [article](#) reported. China Minsheng is a conglomerate that "has focused on investments related to China's economic development as well as the country's Belt and Road infrastructure initiative."

The conglomerate also defaulted on 2.35 billion yuan in onshore debt earlier this year. A definitive reason for the defaults wasn't given, but the *WSJ* article noted an anonymous employee who blamed the company's use of short-term debt to fund some of its long-term assets.

The default triggered another \$800 million in "cross defaults," which has raised concerns. "Chinese companies in recent years have included cross default clauses in debt agreements for their subsidiaries and affiliates as a means to secure easier funding," a 4/25 [article](#) in the *South China Morning Post* reported. "Essentially, the clauses allow less creditworthy companies to borrow on the strength of their parent company. The practice is especially common in industries with overcapacity issues, such as coal and steel, among lower quality private companies, as well as local government-linked companies."

Total bond issuance containing cross default covenants due in 2018 was \$80.2 billion, up from \$446 million in 2016, the article stated, citing Wind Financial. The number of cross defaults actually triggered rose to \$3 billion last year from \$187 million in 2017.

(3) *Chinese government gets involved.* China's central bank and the banking regulatory commission took over Baoshang Bank, a small bank in Inner Mongolia. The government takeover was unusual because it was done so publicly. It raised concerns about the financial health of small banks in China's rural areas and small cities.

Baoshang Bank was under an umbrella company, Tomorrow Holding Ltd., which was owned by Xiao Jianhua, who left Hong Kong, entered mainland China, and disappeared in 2017. Later that year, the bank reported a capital shortage. A 5/24 *WSJ* [article](#) reported on the trend of the missing corrupt tycoon: "The seizing of Baoshang is another coda on an era in which a clutch of tycoons disappeared, some resurfacing later, as Chinese authorities pressed a crackdown on corruption and a cleanup of the financial sector following a stock-market meltdown. Some

were formally detained and investigated while others saw their businesses come under pressure.” Another example: the state’s seizure last year of Anbang Insurance Group. Its chairman was convicted of fraud and abuse of power and sentenced to 18 years in prison.

(4) *Foreign bonds not immune.* Qinghai Provincial Investment Group, which is two-thirds owned by the provincial government, defaulted in February on a \$300 million Hong Kong note and a 20 million yuan (\$3 million) onshore note. Five days later, the company—whose main businesses are aluminium, coal, and hydroelectric power—paid what it owed.

The brief defaults came as a surprise because the local municipality allowed them to occur. Investors typically believe that companies like Qinghai Provincial Investment Group will receive financial support from the municipality. The price of the dollar-denominated bonds dropped from 93 cents on the dollar to about 70 after the defaults. The bond price rebounded to 88 after the defaults were cleared, a 3/12 Bloomberg [article](#) reported.

(5) *Reading the tea leaves.* Earlier this month, China’s central bank released draft rules on trading defaulted bonds in the interbank market, according to a 7/1 Caixin [article](#). A sign, perhaps, that the Chinese bond market is maturing and more defaults should be expected?

CALENDARS

US. Thurs: Durable Goods Orders Total and Ex Transportation 0.7%/0.2%, Advance Merchandise Trade Balance -\$72.2b, Kansas City Fed Manufacturing Index 2, Jobless Claims 217k, Wholesale Inventories 0.4%. **Fri:** Real GDP & PCE 1.8%/4.0\$, GDP Price Index & PCE Core Index 1.9/2.0, Baker-Hughes Rig Count, National Income & Accounts Revisions (GDP). (DailyFX estimates)

Global. Thurs: Germany Ifo Business Climate, Current Assessment, and Expectations Indexes 97.0/100.4/94.0, Japan CPI Headline, Core, and Core-Core 1.0%/0.8%/0.7% y/y, ECB Rate Decision 0.00%, ECB Marginal Lending Facility and Deposit Facility Rates 0.25%/-0.40%, Draghi, Lowe. **Fri:** ECB Survey of Professional Forecasters. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): The Bull/Bear Ratio (BBR) fell this week for the first time in seven weeks, as did bullish sentiment, though the ratio remained above 3.00 for the fourth straight week. The BBR slipped to 3.23 after climbing the previous six weeks from 2.31 (the lowest since mid-February) to 3.45—which was the highest since mid-March 2018. Bullish sentiment retreated to 54.2% this week after soaring 15.3ppts the prior six weeks—from 42.7% (which was the fewest bulls since mid-January) to a high for this year of 58.0%. The 3.8ppts drop in bullish sentiment this week went to the correction (to 29.0% from 25.2%) camp, while the recent six-week move up in bullish sentiment came almost entirely from the correction camp—which fell from 38.8% to 25.2% over the period. Bearish sentiment was unchanged at 16.8% this week after fluctuating in a small band from 18.0% to 18.5% over the prior six-week period. The AAI Ratio rose for the sixth week last week to 55.6% after a four-week decline from 65.0% to 34.6%. Bullish sentiment increased from 22.5% to 35.9% over the

six-week period, while bearish sentiment ticked up to 28.6% last week after falling from 42.6% to 27.5% the prior five weeks.

S&P 500 Q2 Earnings Season Monitor ([link](#)): With the Q2 earnings season 28% complete for the S&P 500, the early indications compared to the same point during Q1 show that a higher percentage of companies are reporting positive revenue surprises and y/y revenue growth. The actual revenue and earnings percentage surprise and their y/y growth rates are weaker than during Q1, but much of the shortfall can be attributed to Boeing's dismal Q2 results. Of the 139 S&P 500 companies that have reported through midday Wednesday, 77% exceeded industry analysts' earnings estimates. Collectively, these reporters have averaged a y/y earnings gain of 2.3%, and exceeded forecasts by an average of 2.9%. Ex-Boeing, earnings growth improves 4ppts to 6.3%, and the earnings surprise rises 1.9ppts to 4.8%. On the revenue side, 64% of companies beat their Q2 sales estimates so far, with results coming in 0.5% above forecast and 2.9% higher than a year earlier. Ex-Boeing, the revenue surprise improves 0.3ppt to 0.8% and y/y revenue growth rises 1.4ppts to 4.3%. Q2 earnings growth results are positive y/y for 70% of companies, versus a slightly higher 72% at the same point in Q1, and Q2 revenues have risen y/y for 73% versus a slightly lower 72% during Q1. Looking at earnings during the same point in the Q1-2018 reporting period, a higher percentage of companies (79%) in the S&P 500 had beaten consensus earnings estimates by a higher 5.4%, and earnings were up 4.8% y/y. With respect to revenues at this point in the Q1 season, a sharply lower 53% had exceeded revenue forecasts by 0.6%, but sales rose a higher 4.9% y/y. These early readings for Q2 indicate a continuation of a marked slowdown in revenue and earnings growth and a slight deterioration in profit margins compared to 2018's stellar results. But that should come as no surprise to investors. Q1-2019 had marked the 11th straight quarter of positive y/y earnings growth and the 12th of positive revenue growth. However, earnings growth trailed revenue growth during Q1-2019 for the first time since Q2-2016. That has happened just five times in the 42 quarters since the bull market started in Q1-2009. As more companies report, it's looking less possible that Q2-2019 will make the sixth.

US ECONOMIC INDICATORS

New Home Sales ([link](#)): New home sales rebounded in June, though there were downward revisions to prior months; still, sales are in the plus column ytd. Sales jumped 7.0% last month to 646,000 units (saar) after sliding a revised 12.8% during the two months through May (steeper than the -11.2% previous estimate), which followed a three-month surge of 22.9%. Year to date, sales are up 14.5%, led by the two largest markets, the West and South, which were up 52.9% and 8.8%, respectively, over the period; sales in the Northeast and Midwest were down 14.8% and 13.8%. The supply of new homes on the market last rose for the second month to 338,000 units, after falling from 347,000 to 332,000 units the prior three months; the months' supply declined from 6.7 to 6.3 months' supply last month. Roughly two-thirds of the homes sold in June were either under construction or yet to be built. The National Association of Home Builders Housing Market Index (HMI) for July shows homebuilders' confidence rose for the fifth time this year, with all three components trending higher through the first seven months of this year: current sales conditions (to 72 from 61 in December), expected sales (71 from 61), and buyer traffic (48 from 43).

GLOBAL ECONOMIC INDICATORS

US PMI Flash Estimates ([link](#)): Business activity growth accelerated this month, according to flash estimates, as stronger service-sector growth more than offset the continued slowing in the manufacturing sector—to the breakeven point of 50.0. July's C-PMI improved for the second month to 51.6 after falling from 55.5 in February to a 36-month low of 50.9 in May. Also bottoming at 50.9 in May was the NM-PMI, which improved to 52.2 this month, while the M-PMI sank to a 118-month low of 50.0, according to July estimates. While the service sector is showing signs of life, the rate of expansion remained modest and much softer than growth seen during Q1. Meanwhile, the manufacturing sector shows factory production at its lowest since August 2009, led by a contraction in exports, leading to the first decline in employment in six years.

Eurozone PMI Flash Estimates ([link](#)): Eurozone economic growth slowed further in July, according to flash estimates, as a deepening in the manufacturing downturn was accompanied by a slight moderation in service-sector growth. The C-PMI was back down at 51.5 this month after climbing from 51.5 in April to 52.2 in June; over the past six years, only four months have seen lower C-PMI readings. The M-PMI (to 46.4 from 47.6) continued to deteriorate this month, sinking to a 79-month low, while the NM-PMI (53.2 from 53.6) eased a bit from June's eight-month high. Looking at the top two Eurozone economies, C-PMIs for both Germany (51.4 from 52.6) and France (51.7 from 52.8) showed similar modest rates of growth this month (as well as the rest of the Eurozone region as a whole), dragged lower in all cases by manufacturing activity—led by Germany, which was especially hard hit by the auto-sector downturn. Germany's M-PMI dropped to an 84-month low of 43.1 this month, while France's M-PMI was back down at the breakeven point of 50.0, after climbing from 49.7 in March to a nine-month high of 51.9 in June. Meanwhile, Germany's NM-PMI (55.4 from 55.8) shows the service sector continued to expand at a robust pace, while France's NM-PMI (52.2 from 52.9) remained around recent highs after contracting in two of the first three months of this year.

Japan M-PMI Flash Estimate ([link](#)): Yesterday saw the first public release of the Jibun Bank's flash C-PMI (in conjunction with IHS Markit) and shows growth accelerated for the third time in four months, from 50.4 in March to a high for this year of 51.2 in July, led by stronger service-sector growth. The NM-PMI improved for the second month from 51.7 in May to 52.3 this month—back up at its high for this year. Meanwhile, the M-PMI showed Japan's manufacturing sector was in contractionary territory for the fifth time this year, though moved close to the breakeven-point of 50.0, edging up from 49.3 to 49.6 this month. Factory output was cut for the seventh straight month, with weak demand from China a key factor, while “heightened friction between Japan and South Korea added some downside risk to the manufacturing supply chain” in Japan, according to the report.

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