Yardeni Research

MORNING BRIEFING
October 3, 2019

No Recession in Analysts' Forecasts

See the collection of the individual charts linked below.

(1) Taking no prisoners: Manufacturing gloom hits both safety and growth stocks. (2) Analysts' 2020 earnings estimates hold firm-so far. (3) Boeing boosts Industrials' 2020 earnings, if it can get the 737 Max in the air. (4) IPO market shows some sense by rejecting WeWork. (5) Shared office space providers will abound, with or without WeWork. (6) Landlords: Beware of SPEs. (7) Plastic Energy has one solution for the world's plastic problem.

Strategy: No 2020 Earnings Dip Yet. US manufacturing activity may be slowing and investors may be selling, but analysts have yet to throw in the towel on next year's earnings estimates. The Institute for Supply Management's (ISM) manufacturing index fell to 47.8 in September, the second consecutive reading below the all-important 50.0 that's widely considered to be the line between economic growth and contraction (*Fig. 1*). (As we observed yesterday, the make-or-break level is actually 42.9 according to the ISM.)

The reading spooked investors so much on Tuesday that S&P 500 safety sectors sold off along with their growth counterparts, though admittedly to a lesser extent. Here's the performance derby for the S&P 500 sectors' price performance on Tuesday: Consumer Staples (-0.3%), Utilities (-0.3), Consumer Discretionary (-0.8), Information Technology (-0.9), Health Care (-1.0), Communications Services (-1.0), Real Estate (-1.0), S&P 500 (-1.2), Financials (-2.1), Materials (-2.3), Energy (-2.3), and Industrials (-2.4). The rout continued on Wednesday.

Despite the doom and gloom, analysts continue to expect the S&P 500 Industrials and Materials sectors to have the second- and third-best earnings growth in 2020. Here are the S&P 500 sectors' 2020 earnings-growth estimates: Energy (29.7%), Industrials (17.4), Materials (15.4), Communications Services (12.4), Consumer Discretionary (12.0), S&P 500 (10.1), Health Care (9.7), Information Technology (8.0), Consumer Staples (7.1), Financials (5.2), Utilities (5.1), and Real Estate (-10.2) (*Table 1*).

Let's take a look at how some of the S&P 500 industries are expected to perform next year:

(1) *The last shall be first.* Many of the industries with the fastest expected earnings growth in 2020 are forecast to have some of the worst results this year. Copper's earnings are expected to rebound 350.2% next year after declining 90.6% this year (*Fig. 2*). Oil & Gas Refining & Marketing's earnings are forecast to jump 60.1% next year after tumbling an expected 33.2% this year (*Fig. 3*). Rounding out the top three industries with the best earnings growth in 2020 is Casinos & Gaming, with 58.1% growth, a marked improvement from the 10.4% decline

forecast for this year (*Fig. 4*).

(2) *Boeing needs to fly.* The primary reason Industrials earnings are forecast to rebound in 2020 is that analysts have high hopes for Boeing and its ability to put the 737 Max back in the air. The S&P 500 Aerospace & Defense industry is forecast to grow earnings 47.1% next year, up from the 15.1% decline forecast for this year. Boeing is the primary reason behind the drop (*Fig. 5*). The plane manufacturer earned $17.85 a share in 2018; its results are forecast to fall to $3.64 this year and are expected to surge to $22.50 in 2020.

(3) *Autos in neutral.* So far, the GM auto strike isn't dragging down the S&P 500 Consumer Discretionary sector, primarily because not much has been expected from the Automobile Manufacturers industry for quite a while. The industry's earnings fell 14.5% in 2018 and is expected only to inch higher this year (1.5%) and next year (1.0%) (*Fig. 6*). Analysts have trimmed their GM EPS estimates for 2019 by eight cents over the past month to $6.63, but 2020 EPS consensus hasn't budged from $6.61, where it stood a month ago.

There's a bit more optimism about earnings in the Auto Parts & Equipment industry, which may need estimate-trimming. Analysts forecast the industry's earnings will rise 10.7% next year after falling 7.2% this year (*Fig. 7*).

(4) *Looking at the unloved.* Perusing the list of industries with the lowest earnings-growth forecasts can be fruitful if those industries manage to beat low expectations. Many of the industries are facing structural issues. For example, competition from Amazon and the Internet has decimated business in the Department Stores industry (-20.1% in 2019 and -1.9% in 2020) and encroached on the Drug Retail industry (-0.7% in 2019 and 0.4% in 2020) (*Fig. 8* and *Fig. 9*).

Tariffs from the US/China trade war are hurting the Construction Machinery & Heavy Trucks industry (8.6% in 2019 and -2.4% in 2020) and Steel (-40.3% in 2019 and -7.7% in 2020) (*Fig. 10* and *Fig. 11*). The trade war has also brought us low interest rates and a flat yield curve, which have taken a toll on Financials. Consider that the Regional Banks industry's earnings are expected to inch up 4.8% in 2019 and 4.3% in 2020; these rates compare with Diversified Banks' 12.0% and 3.4%, Reinsurance's 446.9% and -5.0%, and Multi-Line Insurance's 136.7% and 1.8%.

Real Estate: Postmortem on WeWork's IPO. Much handwringing has occurred since WeWork pulled the plug on its IPO and sent its CEO packing. Some are worried it's a sign that the IPO market has shut down forever. Others fear the company will drag down US real estate markets.

The demise of the shared office space provider's IPO doesn't make us shudder. We think the market, by rejecting a company with poor governance that's hemorrhaging money, behaved rationally and has yet to enter the always dangerous bubble stage. WeWork's fail doesn't mean the IPO market is closed to profitable companies or those with a plan for reaching profitability in the near term.

Likewise, we're less concerned about WeWork's impact on the real estate market than we would be if its clients were going out of business. Yes, the company is NYC's biggest landlord, with about 7 million square feet of office space. But the Big Apple is a big place. WeWork represents less than 2% of the city's 450 million square feet of commercial space, and its customers will keep renting from WeWork or from another lessor. Let's take a deeper look:

(1) *Tapping into the zeitgeist*. WeWork's arguably kooky—and greedy—CEO notwithstanding, the company did tap into a niche that other landlords had largely ignored, the office-less self-employed. The romance of starting a business sitting alone at a kitchen table grows old fast. WeWork offers a cool place to be social while working. If the company stopped its frivolous spending and improved its governance, it might make for an interesting investment.

"Flexible workplace now accounts for 1.2% of all U.S. office inventory, and is expected to grow to 30% in the next 10 years," according to a Cushman & Wakefield 8/16 report. "Driving this shift is technology advancement and companies needing to provide work settings that include access to technology culture, community, hospitality and wellness capabilities to help them stay competitive in the war for talent."

(2) *Alternatives abound.* We'd be a lot more concerned about the commercial real estate market if WeWork's customers couldn't access capital and were going bust. Then demand from self-employed renters would disappear, as it did when the tech bubble burst. We'd also be concerned if the tech market took a dive. Roughly a quarter of the top leases in US markets as of mid-2019 are to companies in the tech sector, according to Cushman & Wakefield.

However, the environment for small businesses remains healthy, and the self-employed no doubt will continue to seek out social workplaces, whether provided by WeWork or not.

Long before WeWork's IPO was DOA, we noted in the 5/9 *Morning Briefing* that traditional competitors were upping their game to compete with WeWork and entering the short-term leasing market. CBRE Group launched Hana, a business to help landlords create their own flexible offices. Tishman Speyer started Studio, a coworking business. Blackstone and Brookfield Property Partners have partnered with coworking companies Industrious and Convene to manage flexible space in their buildings, according to a 12/19/18 Finance & Commerce article.

(3) *Not so mismatched.* We noted two major problems with WeWork. First it was losing tons of money, and on that front nothing has changed. Last week Standard & Poor's downgraded WeWork's debt one notch to B- and after the IPO was pulled this week, Fitch Ratings downgraded WeWork's credit rating two notches to CCC+.

Fitch warned that the company doesn't "have sufficient funding to meet its growth plan" now that it won't be raising $3 billion from the IPO and $6 billion from a bank loan that was contingent on the IPO, a 10/1 Reuters article reported. The company is discussing alternative funding sources with its banks and SoftBank, its largest investor. Fitch warned that customers, particularly big companies, might "hesitate" before becoming WeWork members given the company's turmoil.

Our second concern was the funding mismatch between the company's long-term leases with landlords and short-term memberships with customers. When a recession comes along, members can drop their memberships, but WeWork will still have to make lease payments. WeWork has $47.2 billion of future undiscounted fixed minimum-lease-cost payment obligations.

However, this concern may have been misplaced. WeWork, in its IPO filing, noted that a majority of its leases are held by individual special-purpose entities (SPEs). Presumably, this means that if WeWork has a problem making lease payments at a specific building, it can stop making payments and walk away. The landlord's only recourse might be to get what is owed to it from the SPE—not WeWork.

Boston Fed President Eric Rosengren noted this structure in his 9/20 speech at a conference on credit markets, which Melissa dissected in the 9/24 *Morning Briefing*. Rosengren worried not about WeWork but about the banks lending to the building owners that lease space to WeWork and others like it.

(4) *Risks still exist.* Despite our general optimism about the IPO and real estate markets, we're well aware of the potential risks. For example, it's unclear just how much of WeWork's real estate is leased. If the company has gobs of unleased real estate to return to the market, the real estate market may take a bigger hit than we're anticipating.

It's tough to calculate how much of the company's real estate is occupied. According to WeWork's 8/14 IPO filing: "As of June 1, 2019, our occupancy stabilized at an average of approximately 89% after 18 months and generally remained at that level after 24 months." Because the company is growing so fast, only 30% of its locations have been open for 24 months or more. The company had 528 locations in 111 cities in Q2-19, up from 425 locations in 100 cities in 2018 and 111 locations in 34 cities in 2016.

The bigger problem the real estate market has faced over the past few years is the disappearance of Chinese buyers. They've gone from big buyers to net sellers of US real estate. Chinese investment in US property fell to $336 million in 2018 from $8.8 billion in 2016. The Chinese government imposed capital controls to end "splashy overseas property deals," and a crackdown on shadow banking led to tighter credit conditions, a 6/24 *FT* article reported. But as 2020 quickly approaches, that problem should be fully priced into the market.

Disruptive Technologies: Chemically Recycling Plastic. Once created, plastic can stick around forever. So more than a century after it was invented, we're realizing that something needs to be done with all the plastic that's in our landfills and oceans. About 35% of plastics can be mechanically recycled, i.e., picked out of trash and recycled by cutting the bottles into small pieces, melting them, and forming new plastic items. But 65% can't be. It typically ends up in landfills—in the best-case scenario. Plastic Energy, a private company founded in 2011, believes it has come up with the answer:

(1) *A chemical solution.* According to its website, Plastic Energy heats used plastic without

using oxygen until it melts and the molecules break down to form a saturated hydrocarbon vapor. The condensable gasses are converted to hydrocarbon products, like raw diesel, light oil, and synthetic gas components. These can be sold back to the petrochemical industry to make new plastic, fuel oil, or transportation fuels. For every ton of used plastic it gathers, the company generates about 700 liters of oil. The non-condensable gases are collected and can be burned to generate energy and run the plant.

(2) *Two plants running, two on the way.* The company has two plants in Spain and sells what it produces to SABIC's petrochemical plant in the Netherlands, which makes packaging for consumer products. While still in the pilot stage, the materials produced are being supplied to Unilever, Tupperware, and Vinventions to develop high-quality packaging for foodstuff, personal care, and homecare products, according to an 8/28 article in *New Food*. Plastic Energy and SABIC have also agreed to build a recycling plant in the Netherlands that could begin commercial production in 2021.

Plastic Energy also has an agreement with the Indonesian province of West Java to build five recycling plants. In addition, Petronas Chemicals Group is working with Plastic Energy to evaluate building a commercial plant in Malaysia.

(3) *Better alternatives?* Not everyone is convinced that chemical recycling of plastic is the answer. Jan Dell is a chemical engineer whose organization, the Last Beach Cleanup, works with investors and environmental groups on projects to reduce plastic pollution. "The economic realities of cheap new plastic production and low-cost oil and gas production make chemical recycling processes economically uncompetitive and impractical at commercial scale," she said in a 4/11 article in *Chemical & Engineering News*. "Labor, transport, and processing costs for collecting, sorting, and recycling plastic make it more costly than new plastic or new oil." Her preference: reducing the consumption of single-use plastics.

CALENDARS

US. Thurs: ISM & IHS/Markit NM-PMIs 55.0/50.9, Factory Orders -0.5%, Jobless Claims 215k, Challenger Job-Cuts Report, EIA Natural Gas Report, Clarida, Evans, Quarles, Kaplan. **Fri:** Payroll Employment Total, Private, and Manufacturing 145k/125k/4k, Unemployment Rate 3.7%, Average Hourly Earnings 0.3%m/m/3.2%y/y, Average Workweek 34.4hrs, Merchandise Trade Balance -$54.5b, Baker-Hughes Rig Count, Powell, Rosengren. (DailyFX estimates)

Global. Thurs: Eurozone Retail Sales 0.3%m/m/2.0%y/y, Eurozone, Germany, France, and Italy C-PMIs 50.4/49.1/51.3/50.0, Eurozone, Germany, France, and Italy 52.0/52.5/51.6/50.4, UK C-PMI & NM-PMI 50.0/50.3, Guindos, Tenreyro, Ellis. **Fri:** Guindos. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) edged slightly lower this week, even as bullish sentiment moved further above 50.0%, as bearish sentiment rose for the first time in five weeks. The BBR was little changed at 3.23 this week, after climbing the prior four weeks from 2.35 to 3.28. There have been wide swings between the bullish and correction

camps since early June. Over the past five weeks, bullish sentiment climbed 11.4ppts, to 55.3% from 43.9%, as the correction count dropped 9.8ppts, to 27.6% from 37.4%. Bearish sentiment rose to 17.1% this week, after falling from 18.7% to 16.8% the prior four weeks—fluctuating in a narrow band most of this year. The AAII Ratio fell to 46.9% last week, after advancing the previous three weeks from 38.2% to 56.0%, as bullish sentiment fell from 35.3% to 29.4% last week while bearish sentiment rose from 27.8% to 33.3%.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): Consensus S&P 500 forward revenues rose w/w to another record high, but forward earnings dropped 0.4% from its record. Analysts expect forward revenues growth of 5.4% and forward earnings growth of 8.5%, with both measures steady w/w. 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 8.4ppts from a six-year high of 16.9% last February but has improved 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 8.5% in 2018 to 4.3% in 2019 and 5.5% in 2020. They're calling for earnings growth to slow sharply from 24.0% in 2018 to 1.9% in 2019 before improving to 10.1% in 2020. The forward profit margin edged down 0.1ppt w/w to a five-month low of 12.0% and is down 0.4ppt from a record high of 12.4% in September 2018. 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 drop 0.3ppt y/y from 11.9% in 2018 to 11.6% in 2019 before improving to 12.1% in 2020. The S&P 500's forward P/E edged down less than 0.1pt w/w to remain near a two-month high of 17.1, which compares to an 18-month high of 17.4 in late July. 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 dropped 0.2pt w/w to 2.05 from an eight-week high of 2.07 and compares to an 11-month high of 2.10 in late July. 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 7/11 S&P 500 sectors, but forward earnings was down for all 11 sectors. Forward revenues and earnings are at or around record highs for 4/11 sectors: Consumer Discretionary, Health Care, Industrials, and Tech. Forward P/S and P/E ratios have declined from recent multi-year or record highs for four sectors: Communication Services, Real Estate, Tech, and Utilities. However, all sectors remain well above their multi-year lows during December 2018. 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 one sector now: Financials. 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. During the latest week, it was lower for 6/11 sectors, and at a record high for Utilities. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (21.4%, down from 23.0%), Financials (18.3, down from 19.2), Real Estate (16.2, down from 17.0), Communication Services (15.0, down from 15.4), Utilities (13.1, record high), S&P 500 (12.0, down from 12.4), Health Care

(10.6, down from 11.2), Industrials (10.3, record high), Materials (10.1, down from 11.6), Consumer Discretionary (7.5, down from 8.3), Consumer Staples (7.4, down from 7.7), and Energy (6.7, down from 8.0).

US ECONOMIC INDICATORS

ADP Employment (*link*): "Businesses have turned more cautious in their hiring. Small businesses have become especially hesitant. If businesses pull back any further, unemployment will begin to rise," according to September's report. Private industries added 135,000 to payrolls in September. This result followed a downwardly revised gain in August (to 157,000 from 195,000) and virtually no revision to July (143,000 from 142,000), for a net two-month loss of 37,000. The average monthly gain in payrolls over the past five months slowed to 117,600, from 224,250 the first four months of the year. Services-providing industries added only 127,000 to payrolls last month, the third lowest this year, while goods-producing industries added 18,000 jobs during the two months through September, after losing 30,000 during the three months through July. The biggest gains in the service-providing sector were recorded by health care & social assistance (35,000), trade, transportation & utilities (28,000), professional & business services (20,000), and leisure & hospitality (18,000). Within goods producing, construction companies have hired 33,000 the past three months after cutting 26,000 jobs over the prior two-month period, while factories added 5,000 jobs during the two months through September after reducing payrolls by 7,000 in July. In the meantime, natural resource & mining companies cut payrolls for the sixth straight month by 3,000 in September and 22,000 over the period. Large companies (to 67,000 from 39,000 in August) moved to the top of the leader board in September, as hirings accelerated, while medium companies (to 39,000 from 62,000) fell to the number-two slot, as growth slowed; small companies (30,000 from 55,000) remained in the cellar.

Construction Spending (*link*): Construction spending lacks momentum. Overall spending edged up 0.1% in August, following downward revisions to July (to 0.0% from 0.1%) and June (-0.9 from -0.7) spending; investment had increased 3.4% the first four months of the year. Still, despite the recent weakness, spending remains at a relatively high level, within 3.6% of February 2018's record high. Spending on private construction was unchanged in August, after falling the prior four months by 2.2%, while public construction investment rebounded 1.9% during the two months through August after falling 3.9% during the two months through June. Private residential spending is showing signs of life, rising 0.9% in August following a 0.6% advance in July—the first gains since last November—driven by a two-month gain of 2.9% in single-family homes. Multi-family investment fell for the third month, by a total of 2.6%, while home-improvement spending continued its up-and-down pattern, up 0.8% in August but down 1.2% ytd. Private nonresidential construction fell for the fourth time in five months, by 4.8%, sinking to a nine-month low.

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