



## MORNING BRIEFING

November 7, 2018

### Energy Getting Re-Energized?

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

(1) S&P 500 Energy: Been down so long that it may be time to look up. (2) A trade deal would energize crude prices. So would another war in the Middle East. (3) It's all about supply and demand. (4) An alarming article by a credible source on the potential for a war between Israel and Iran. (5) A new molecule may reduce your heating bill. (6) US government is watching Chinese companies watching us. (7) TikTok recognizes you..

**Energy I: From Worst to First.** There are few times in life when problems can be boiled down to something simple. For the market in crude oil, the current problem is simply too much supply and not enough demand. US crude production has soared, and a sluggish world economy has led to punk consumption.

If the US and China can strike a trade deal, there's a chance that the worst has passed for the energy markets for a while. A deal should cause consumers and businesses to use more oil, at the same time as US fracking production growth may be slowing down. With those feathers of hope in the air for long-only investors, the S&P 500 Energy sector became the best-performing of the 11 S&P 500 sectors over the past week. It's a nice change of pace given that the Energy sector is also the worst-performing sector ytd and over the past year.

Over the past week through Tuesday's close, the Energy sector has risen 3.5%, besting the S&P 500's 1.2% gain, and the price of Brent crude oil futures has risen 2.2% ([Fig. 1](#) and [Fig. 2](#)). For the energy industry, this move is a step in the right direction after many weeks of subpar performance. The S&P 500 Energy sector is up by only 6.9% ytd, while the S&P 500 has gained 22.6% over the same period ([Fig. 3](#)). The sector gave back some of its recent gains on Wednesday, when the meeting between Presidents Trump and Xi was reportedly postponed until December.

The consensus of industry analysts is optimistic that the Energy business has solid fundamentals ahead. The Energy sector's earnings, which are expected to drop 25.7% this year, are also expected to have a solid rebound next year, 24.7% ([Fig. 4](#)). Likewise, revenues flip from a drop of 3.1% this year to an increase of 4.0% in 2020 ([Fig. 5](#)). That said, analysts' forecasts are notoriously slippery in the Energy sector and can change quickly along with the price of crude.

The sector has been struggling ever since peaking in 2014, and at long last it may be washed out. Its forward P/E has declined to 16.1, and it represents only 4.3% of the S&P 500's market

capitalization, down from a peak of 16.1% in July 2008 ([Fig. 6](#) and [Fig. 7](#)).

Let's take a look at the supply and demand fundamentals that are giving investors hope for the first time in a long while:

(1) *US production forces OPEC and Russia to cut output.* US oil and gas production has continued to surge this year even as the rig count has fallen. US oil rigs have fallen by 22% to 691 since mid-November 2018; yet over that time, crude production has jumped 8% ([Fig. 8](#)). Crude production has surged to 12.9 mbd this year from 8.7 mbd in 2016 ([Fig. 9](#)).

The US oil production miracle means the country no longer depends on imported oil to meet its needs ([Fig. 10](#)). OPEC and Russia have responded by cutting production to deal with the global oil glut and falling prices ([Fig. 11](#) and [Fig. 12](#)). Their production cuts helped keep world oil production flat this year, but supply is set to rise again next year, according to the Energy Information Administration's (EIA's) 10/8 [Short-Term Energy Outlook](#).

(2) *Dwindling demand.* OPEC's and Russia's efforts to support the market have been thwarted by the global economic slowdown in the wake of the trade war between the US and China. The world produced more oil in 2018 (100.81 mbd) than it consumed (99.98 mbd). This year, the market was more balanced, with production (100.80 mbd) roughly equal to consumption (100.82 mbd). Next year, the EIA forecasts production (102.44 mbd) will again be more than world consumption (102.12).

The agency assumes world real GDP (weighted by oil consumption) picks up to 2.4% growth in 2020 compared to 2.0% this year. However, it continues to see the price of Brent crude oil per barrel declining to \$59.93 from \$63.37 this year.

(3) *What could go wrong?* If the US and China manage to repair their trade relationship—something that's in both parties' interests—it's possible that global economic growth will rebound more than the EIA expects. Global growth was 3.0% in 2018 down from 3.2% in 2017. It should be at least as good as 2017 if a deal is struck, in which case energy demand might surpass the forecast.

There's also some concern that US oil production growth could slow more than expected as fracking wells age and as the price of oil remains subdued. US oil production increased by less than 1% during the first six months of 2019, down from the 7% growth in the same period of 2018, a 9/29 *WSJ* [article](#) reported.

Well productivity may be falling off more quickly than expected. Again from the *WSJ* article: "In December, drilling rigs helped extract 25% more oil than they had a year prior. In August, they were producing about 14% more than last year, according to the [EIA]. Meanwhile, production in the first 90 days of an average shale well, its most productive period, declined by 10% in the first half of the year compared to the 2018 average, according to research by Raymond James."

A better supply/demand balance could support the energy market over the next 12 months,

and the price of crude oil could rise modestly. A longer recovery or major spike in the price of oil is unlikely, however. There's just too much oil available at the right price. If oil prices spiked to \$70 or \$80 a barrel, OPEC and Russia would probably reverse their production cuts and US companies would find a way to pump more oil out of existing wells or find more wells to drill. Oil prices then would fall back down. Likewise, technological developments in renewable energy and batteries are coming along rapidly and may dampen crude oil consumption within the next few years.

But over the next 12 months or so, oil production and consumption appear to be more in balance than they have for a while, and that could help the downtrodden sector. Drill, Baby, drill.

**Energy II: Another Middle East War Soon?** If you want to get really bullish on oil, and more depressed about geopolitical developments in the Middle East, then read the 5/4 [article](#) in *The Atlantic* titled, "The Coming Middle East Conflagration." It is written by Michael Oren who is very well informed about the region given that he served as Israel's ambassador to the US from 2009-2013. He was a member of Knesset and deputy minister in the Prime Minister's Office from 2015-2019.

The article starts off ominously enough, and doesn't provide much relief to its bitter end:

"The senior ministers of the Israeli government met twice last week to discuss the possibility of open war with Iran. They were mindful of the Iranian plan for a drone attack from Syria in August, aborted at the last minute by an Israeli air strike, as well as Iran's need to deflect attention from the mass protests against Hezbollah's rule in Lebanon. The ministers also reviewed the recent attack by Iranian drones and cruise missiles on two Saudi oil installations, reportedly concluding that a similar assault could be mounted against Israel from Iraq.

"The Israel Defense Forces, meanwhile, announced the adoption of an emergency plan, code-named Momentum, to significantly expand Israel's missile defense capacity, its ability to gather intelligence on embedded enemy targets, and its soldiers' preparation for urban warfare. Israeli troops, especially in the north, have been placed on war footing. Israel is girding for the worst and acting on the assumption that fighting could break out at any time."

Here is how Oren concludes his dire warning:

"But I also remember that, back in 1973, Egypt and Syria saw a president preoccupied with an impeachment procedure, and concluded that Israel was vulnerable. In the subsequent war, Israel prevailed—but at an excruciating price. The next war could prove even costlier."

**Energy III: Disruptive Technology.** We've been a bit obsessed with the technological advances in batteries because they may be the key to making solar power, wind power, and electric cars widely economical. If the cost of energy storage drops enough, then all of the above becomes economical for the masses.

China too has been focused on batteries. An 11/3 *WSJ* [article](#) laid out the lengths to which the

country nurtured and protected CATL so it could grow from an also-ran to the world's biggest maker of electric vehicle batteries. But there are others who believe the key to energy storage lies beyond the battery.

Researchers at Sweden's Chalmers University of Technology have harnessed a molecule made of carbon, hydrogen, and nitrogen to absorb sunlight. It can then hold the energy for days or decades "until a catalyst triggers its release as heat," an 11/4 Bloomberg [article](#) reports. It's called "MOST," or "molecular solar thermal storage."

Using this molecule, the scientists developed a storage unit that they claim can outlast the 10-year span of a lithium-ion battery. They've also created a transparent coating that uses the energy-trapping molecules. It can be applied to home windows, vehicles, and clothing. It absorbs the daytime sun's heat, keeping rooms cool during daylight hours, and when the sun sets, it releases heat and keeps rooms warm.

The coating doesn't require the silicon used in solar panels or the rare metals used in lithium-ion batteries. Up next: determining whether the molecules can produce electricity.

**Technology: Uncle Sam on Alert.** The US government is objecting to how Chinese technology companies are conducting business in the US. TikTok, the social media website, and DJI, a Chinese drone maker, are the latest to come under scrutiny. Here's a look at some of the concerns:

(1) *Singing off-key?* TikTok is a popular social media site where people make 15-second videos to trendy music. Jackie is sad to say her daughter spends far too much time on the app.

The Committee on Foreign Investment in the United States (CFIUS) has reportedly inquired about TikTok's Chinese parent ByteDance's purchase of US social media app Musical.ly. CFIUS fears that the November 2017 acquisition poses a national security risk because it gives the Chinese company access to millions of Americans' personal data, according to an 11/4 CNBC [article](#).

At first glance, it's hard to see how TikTok is a national security risk. For every entertaining clip, at least 20 seem little more than a waste of time and a few offensive. The fact that this website is draining the brainpower of America's youth seems, on the surface, to be its most egregious offense.

But how much is TikTok content being censored? The Chinese parent company easily could prevent any videos from showing on TikTok that criticize the Chinese government or support the Hong Kong protestors or Taiwan; that flies in the face of American freedom-of-speech values but is common practice in China.

And what sort of data collection and data retention is going on? The site could allow the Chinese government to collect US citizens' faces, emails, phone numbers, and locations to some privacy-invasive end or even rights-abusing end if today's US users travel to China in the future. These are questions the CFIUS will likely delve into. Separately, one could argue that

the US should not allow China to own a social media offering in the US when Facebook is blocked from entering China's market.

(2) *Not CFIUS's first rodeo.* Earlier this year, CFIUS told Chinese gaming company Beijing Kunlun Tech that its ownership of Grindr, a popular gay dating app, posed a national security risk, a 3/27 Reuters [article](#) noted. CFIUS never explained why it arrived at that conclusion. The US agency also blocked Alibaba's Ant Financial from purchasing MoneyGram International in 2018 for \$1.2 billion.

(3) *Grounding drones.* The most popular drone being used by US government agencies is made by a Chinese company, DJI. There's concern that these drones could send back to China whatever they "see." There's also concern that DJI has captured so much of the drone market—more than 70%—that the US government and companies have few good alternatives, an 11/5 *FT* [article](#) reports.

"There are people within the administration who want to hit DJI with a hammer right now," said one senior government official quoted in the *FT* article. "But there are plenty of others who are warning that if you do, there are not many alternatives."

Last week, the US Department of the Interior grounded its fleet of 810 drones, because 121 of them are made by DJI and the remainder contain parts made in China. The agency aims to determine whether the drones can send data they've collected back to China, posing a threat to national security.

This wouldn't be the first time that the US government got involved in commerce. National security concerns were also invoked when the Trump administration and the US Department of Commerce effectively banned Huawei from selling telecom equipment into the US market.

## CALENDARS

**US. Thurs:** Consumer Credit \$15.0b, Jobless Claims 215k, EIA Natural Gas Storage, Kaplan. **Fri:** Consumer Sentiment Index 95.5, Baker-Hughes Rig Count, Daly, Brainard. (DailyFX estimates)

**Global. Thurs:** Germany Industrial Production -0.3%*m/m*/-4.3%*y/y*, Japan Household Spending 7.1% *y/y*, China Trade Balance \$40.6b, EU Commission Economic Forecasts, ECB Published Economic Bulletin, UK Sovereign Debt to be Rated by Moody's, UK Office for Budget Responsibility Publishes Updated Forecasts, RBA Monetary Policy Minutes, Carney. **Fri:** Germany Trade Balance €18.8b, China New Yuan Loans ¥800.0b, China Aggregate Financing ¥887.5b, China CPI & PPI 3.2%/-1.5% *y/y*, Canada Employment Change & Unemployment Rate 10k/5.5%, Japan Leading & Coincident Indicators 92.2/101.0, Paul. (DailyFX estimates)

## STRATEGY INDICATORS

**S&P 500 Q3 Earnings Season Monitor** ([link](#)): With the Q3-2019 earnings reporting season now over 80% complete, S&P 500 revenues and earnings are beating the consensus forecasts by 0.9% and 4.8%, respectively. At the same point during the previous earnings season for Q2, revenues and earnings had beaten forecasts by a higher 1.5% and 6.3%, respectively.

However, a higher percentage of companies has recorded a positive earnings surprise in Q3 than in Q2—75% versus 74%. A slightly lower percentage of companies showed a positive revenue surprise—58% versus 59%. The 401 companies in the S&P 500 that have reported through mid-day Wednesday collectively have recorded flat earnings growth y/y, dragged down by Micron Technology's earnings deceleration. On the revenue side, results are 3.4% higher than a year earlier. Ex-Micron, y/y earnings growth for the S&P 500 jumps 1.1ppts to 1.1% and revenue growth improves 0.2ppt to 3.6%. Adjusting for the dismal y/y growth declines for the Energy sector, Q3's S&P 500 ex-Energy revenue growth improves 1.5ppt to 4.9% and earnings growth rises 2.6ppts to 2.6%. Overall, Q3 earnings growth results are positive y/y for 63% of companies versus a higher 66% at the same point in Q2, and revenues have risen y/y for 70% compared to a lower 68% in Q2. These figures will continue to change as more Q3-2019 results are reported in the coming weeks. However, y/y earnings growth is likely to trail revenue growth for a third straight quarter, something that hasn't happened since the last Energy "recession" in H1-2016. Regardless, what companies say about their expectations for Q4-2019 and their early peek at 2020 prospects will be investors' main focus.

**S&P 500 Earnings, Revenues, Valuation & Margins** (*link*): Consensus S&P 500 forward revenues and earnings dropped for a fourth straight week from their record highs. Analysts expect forward revenues growth of 5.1% and forward earnings growth of 8.5%, with the earnings measure down from 8.7% a week earlier. Forward revenues growth is down 1.2ppt from a seven-year high of 6.3% in February 2018 and is closing in on its 31-month low of 5.0% in mid-February. Forward earnings growth is down 8.4ppts from a six-year high of 16.9% in February 2018 but is still comfortably above its 34-month low of 5.9% in February 2019. 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 4.0% in 2019 and 5.1% in 2020. They're calling for earnings growth to slow sharply from 23.9% in 2018 to 1.2% in 2019 before improving to 9.5% in 2020. The forward profit margin was steady w/w at 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 12.0% in 2020. The S&P 500's forward P/E rose 0.3pt w/w to a 21-month high of 17.5. 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 gained a miniscule 0.04pt w/w to a 14-month high of 2.10. 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 four of the 11 S&P 500 sectors, and forward earnings was higher for 3/11 sectors. Health Care and Information Technology saw both measures rise w/w. 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 remain near record or cyclical highs for Communication Services, Consumer Discretionary, Information Technology, Real Estate, and Utilities. Health Care is near a cyclical low, while the remaining sectors are 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 the sectors. Industrials and Utilities are the only sectors still at record highs. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (21.6%, down from 23.0%), Financials (18.2, down from 19.2), Real Estate (15.9, down from 17.0), Communication Services (14.9, 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, down from a record high of 10.4 a week earlier), Materials (10.2, down from 11.6), Consumer Discretionary (7.4, down from 8.3), Consumer Staples (7.4, down from 7.7), and Energy (6.4, down from 8.0).

**Stock Market Sentiment Indicators** (*link*): The Bull/Bear Ratio (BBR) ratio climbed for the fourth week this week to 3.15; it fell from 3.28 to 2.77 the previous two weeks. The wide swings between the bullish and correction camps since early June continue. Bullish sentiment is up 9.5ppts the past four weeks to 57.1%, after plunging 7.7ppts the prior week from 55.3% to 47.6%. Meanwhile, the correction count is down 10.4ppts the past four weeks to 24.8%, after jumping 7.6ppts the prior week to 35.2%. Bearish sentiment ticked up from 17.8% to 18.1% this week—fluctuating in a narrow band most of this year. The AAll Ratio slipped to 54.4% last week after increasing the prior two weeks from 31.6% to 55.7%. Bullish sentiment fell to 34.0% after a two-week climb from 20.3% to 35.6%, while bearish sentiment rose to 28.4% after falling from 44.0% to 28.3% over those weeks.

## US ECONOMIC INDICATORS

**Merchandise Trade** (*link*): The real merchandise trade deficit in September narrowed for the third time in four months, suggesting trade was likely not a drag on Q3 real GDP growth as reported in the initial GDP report last month. The real deficit narrowed from -\$86.3 billion in July to -\$82.6 billion in September, with Q4's average monthly deficit at -\$84.6 billion, virtually matching Q3's -\$84.8 billion. Both real exports (-1.0%) and real imports (-2.0) contracted during September, imports at double the pace of exports. During the three months through September, real exports rose 0.6%, while real imports fell -1.2%. Over the three-month period, real exports of consumer goods ex autos (7.2%) posted a big gain, while real exports of food (-8.8) posted a big loss; real exports of industrial supplies & materials (0.7), capital goods ex autos (0.4), and autos (0.3) posted little change over the three-month period. Meanwhile, real imports were a sea of red during the three months through September—except for food, which expanded 4.5% over the time span; real imports of autos (-5.2), capital goods ex autos (-1.2), industrial supplies & materials (-0.7), and consumer goods ex autos (-0.5) all moved lower during the quarter.

## GLOBAL ECONOMIC INDICATORS

**Global Composite PMIs** (*link*): The global economy began the final quarter of 2019 on a weak note, as the rate of output growth slowed to its joint second-weakest during the current seven-year sequence of expansion. Last month, new order inflows expanded at a weaker pace, while job losses were recorded for the first time in nearly a decade. The JP Morgan Global Composite Output Index (C-PMI) slipped for the third month, from 51.7 in July to 50.8 in October—its lowest reading since February 2016—consistent with only a mild increase in

economic output. It peaked at 54.8 in February 2018. The Global PMI for the service sector (to 51.0 from 51.4) continues to outperform the manufacturing sector's (49.8 from 49.7)—which contracted for the sixth consecutive month. However, the former is heading down toward 50.0 the past three months, while latter is moving up toward 50.0. The C-PMI for the emerging economies was at 51.8 for the third month, up from a recent low of 50.9 in June, while the C-PMI for the developed ones is heading toward negative territory—falling from 51.7 in July to 50.3 in October. Among the nations for which October C-PMI data are available there were continued expansions in Russia (53.3 from 51.4), China (52.0 from 51.9), Brazil (51.8 from 52.5), the US (50.9 from 51.0) and the Eurozone (50.6 from 50.1)—with growth in Russia, China, and the overall Eurozone accelerating. Meanwhile, disparities remained between the main Eurozone economies, with the two largest economies showing solid growth in France (52.6 from 50.8) and an ongoing contraction in Germany (48.9 from 48.5). C-PMIs for Spain (51.2 from 51.7) and Ireland (50.6 from 51.0) recorded their poorest performance in 71 months, and 89 months, respectively; Italy's (50.8 from 50.6) was at a three-month high. C-PMIs for both the UK and Australia were at the breakeven-point of 50.0, while Japan's C-PMI (49.8 from 51.5) sank below 50.0 for the first time in three years, and India's (49.6 from 49.8) was below for the second consecutive month.

**US Non-Manufacturing PMIs** (*link*): ISM's October survey shows non-manufacturing activity accelerated from September's three-year low, while IHS Markit's measure reveals only marginal growth last month, recording its slowest pace since the current expansion began in February 2016. ISM's NM-PMI (to 54.7 from 52.6) remains on a volatile downtrend, though October's reading is consistent with a 2.1% increase in real GDP growth on an annualized basis. All four of the components of the NM-PMI moved higher last month, with both business activity (57.0 from 55.2) and new orders (55.6 from 53.7) comfortably above 50.0. Meanwhile, the employment (53.7 from 50.4) gauge rebounded after dropping to its lowest level since February 2014, which came dangerously close to the 50.0 breakeven point. The supplier deliveries (52.5 from 51.0) measure has been trending higher since dropping below 50.0 in May (49.5) for the first time since December 2015. IHS Markit's NM-PMI (to 50.6 from 50.9) is nearing contractionary territory, down sharply from its recent peak of 56.0 just eight months ago, as new work failed to grow for the first time since 2009. According to the report, with inflows of new work drying up, firms are relying on previously placed orders to sustain current output growth, meaning the rate of expansion could weaken further in coming months, if demand doesn't revive. Meanwhile, jobs are being cut at a rate not seen since 2009. "The news was by no means all negative," noted IHS Markit's chief economist, "with firms becoming more optimistic about the year ahead, buoyed by hopes of an easing of trade tensions and stimulus from lower interest rates."

**Eurozone Retail Sales** (*link*): Retail sales advanced for the seventh time this year in September, to a new record high. Sales rose 0.1% in September and 2.8% ytd. Of the three major sales categories, spending on automotive fuel (0.4%) drove September's gain, while nonfood products excluding fuel rose 0.1% in September and 0.8% the past two months to a new record high. Meanwhile, sales of food, alcohol & tobacco contracted 0.4% after expanding 0.5% in August, bouncing around its cyclical high. Sales of nonfood products (4.6% ytd) also drove ytd sales, while spending on automotive fuel (0.8) and food, alcohol & tobacco (0.7) was little changed so far this year. Regionally, sales in September were mixed for the three of the



top four Eurozone economies for which data are available—though all were solid ytd. Here's a tally: Germany (0.1% m/m & 4.5% ytd), France's (-0.5 & 3.3), and Spain (0.0 & 2.8). Among the Eurozone economies for which data are available, Ireland (2.4%) posted the strongest growth in September, Portugal (-2.4) the weakest.

---

Contact us by [email](#) or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683  
Debbie Johnson, Chief Economist, 480-664-1333  
Joe Abbott, Chief Quantitative Strategist, 732-497-5306  
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967  
Mali Quintana, Senior Economist, 480-664-1333  
Jackie Doherty, Contributing Editor, 917-328-6848  
Valerie de la Rue, Director of Institutional Sales, 516-277-2432  
Mary Fanslau, Manager of Client Services, 480-664-1333  
Sandy Cohan, Senior Editor, 570-775-6823

Copyright (c) Yardeni Research, Inc. Please read complete [copyright and hedge clause](#).