# Yardeni Research

**MORNING BRIEFING**
**November 26, 2019**

## Some More Thanks Giving

**The next *Morning Briefing* will be sent on Monday, December 2.**

*See the collection of the individual charts linked below.*

(1) Wearing a cardigan sweater at TD dinner. (2) Raining on the parade. (3) Ready for Santa. (4) Wild ride for S&P 500 P/E since early 2018. (5) The case for a meltup. (6) More panic attacks or the big bear? (7) Trump and Xi need a face-saving phase-one deal. (8) Does Pelosi really want to impeach Trump, or just embarrass him? (9) Another government shutdown? Probably not. (10) Scientists making progress on CO2 scrubbers.

**Strategy I: The Bull Is No Turkey.** While we are on the subject of Thanksgiving, my team and I would like to thank you for your interest in, and support of, our research service. Yesterday, I compared the holiday to Mr. Rogers, who always had kind words to say to everyone he knew or met for the first time, especially if they were children. I intend to take my lead from Mr. Rogers during our family gathering. I'll wear a cardigan sweater and say only nice things to all my relatives.

According to the weather forecasters, most of us won't be thankful for the weather on Thursday, when we gather for Thanksgiving. It's going to be stormy around the country. Depending on the winds, the organizers of the Macy's Thanksgiving Day Parade might have to ground their balloons.

For those of us in the stock market, the questions are whether there will be a Santa Claus rally this year, and whether it will inflate stock prices with too much hot air. Joe and I are predicting that the S&P 500 will reach 3500 by the end of next year. That's an increase of 12.5% over Friday's close, which itself represents a year-to-date gain of 24.1%.

Our main worry currently is that the S&P 500 will get to 3500 well ahead of schedule in a meltup scenario. Our 3100 target for this year was surpassed on 11/15. However, that was actually well behind schedule, since 3100 had been our target for the end of last year. Everything was working out fine for our forecast through 9/20/18, when the S&P 500 peaked at 2930.75. But then recession fears emerged as investors fretted that the Fed was set on an overly restrictive monetary policy course and that the trade war with China was escalating. The S&P 500 proceeded to plunge by 19.8% through the day before Christmas (*Fig. 1*).

The day after Christmas, investors came to their senses, betting that Fed officials would do the same and that the US and China would eventually work out a trade deal. As a result, there has been a meltup of sorts in the S&P 500 and its 11 sectors since the day before last Christmas through Friday's close, as follows: Information Technology (50.0%), Industrials (35.3), Communication Services (35.2), Financials (33.7), S&P 500 (32.3), Consumer Discretionary (30.5), Real Estate (26.9), Consumer Staples (25.4), Materials (25.4), Utilities (21.7), Health Care (21.6), and Energy (10.0) (*Fig. 2*).

However, it doesn't look like a meltup when we compare the market's performance since last year's

9/20 peak: Utilities (18.8%), Information Technology (15.3), Real Estate (14.4), Communication Services (12.5), Consumer Staples (11.0), S&P 500 (6.1), Health Care (4.2), Financials (3.4), Industrials (2.7), Consumer Discretionary (1.0), Materials (-2.4), and Energy (-20.7) (*Fig. 3*).

When we look at fluctuations in the S&P 500's valuation multiple, however, the picture does look like a meltdown during 2018 followed by a meltup this year (*Fig. 4*). The forward P/E of the S&P 500 peaked at 18.6 on 1/23/2018, the highest reading during the current bull market. It crashed 28% to 13.5 on 12/24/2018. It soared back up to 17.5 last week.

**Strategy II: Yearend Meltup or Another Panic Attack?** Let's consider some of the possible events during the holiday season that might fuel the meltup or trigger panic attack #66. (See our table of the 65 panic attacks since the start of the current bull market.)

Let's start with the meltup scenario:

(1) *Growth*. On the meltup side, investors are starting to anticipate better global economic growth next year, while inflation is expected to remain subdued. This year's earnings growth slowdown to near zero was mostly attributable to tough y/y comparisons because last year's growth rate was boosted by Trump's tax cut and higher Energy earnings. Earnings comps should be easier next year, with industry analysts currently projecting gains for S&P 500 operating earnings of 9.1% in 2020 and 10.8% in 2021 (*Fig. 5*). Joe and I think the analysts are too optimistic, as they often have been in the past. Earnings should grow in line with revenues growth, which is currently expected to be 5.2% in 2020 and 4.7% in 2021 (*Fig. 6*). Analysts tend to be more realistic about revenues growth than earnings growth.

(2) *Monetary policy.* The major central banks are likely to persist with their ultra-easy monetary policies. The Fed probably will keep the federal funds rate unchanged through next year's election. However, the Fed started buying $60 billion per month in Treasury bills during mid-October and will continue doing so through mid-2020 (*Fig. 7*). On the other hand, the Fed's holdings of mortgage-backed securities continue to decline (*Fig. 8*).

Now let's consider some of the possible triggers of yet another panic attack and why the next one should be followed by yet another relief rally rather than a bear market:

(3) *Trade war*. Both China and the US have a clear interest in getting a phase-one trade deal completed relatively soon to calm financial markets and reduce the drag on their economies from the uncertainty attributable to the trade war. However, it won't be a done deal until the deal is done.

Trump wants to secure a big phase-one announcement. He is expecting that the Chinese will commit to purchases of US agricultural goods that he can tout as an important win during his re-election campaign. The signing of a phase-one deal could slide into next year as the two countries tussle over Beijing's demand for more extensive tariff rollbacks.

In any event, Beijing trade officials aren't likely to sit down to discuss a phase-two deal before the US election, in part because they want to wait to see if Trump wins a second term.

If there is no deal, stock prices could crater. However, Trump views the DJIA as his most important poll. So he would likely respond to a market selloff with some encouraging words. More importantly, Fed officials would most likely signal a willingness to ease some more if trade headwinds threaten to depress the US economy.

(4) *Impeachment.* The impeachment hearings seem to be over at the House, where the Democrats

have majority control of that body. Now it's up to Nancy Pelosi, the speaker of the House, to decide whether to proceed with a vote to impeach the President, so that the actual trial can start in the Senate. She knows that there is no way that there will be enough votes in the Senate to impeach Trump. If she hands the process over to the Senate, where the Republicans have the majority, the Republicans will have the opportunity to stick it to the Democrats the way that the House Democrats stuck it to their Republican colleagues. That means calling witnesses who could discredit the House investigation and open up cans of worms for the Democrats.

Pelosi is under pressure from the far-left wing of her party to proceed with the impeachment vote in the House, where she probably will have the votes to impeach the President. However, there is some chatter that she might opt out of an impeachment vote in favor of a vote to censure the President instead—and magnanimously claim that for the good of the country, the Democrats are willing to let the voters decide in the next election. The problem for Pelosi is that anything short of a vote to impeach would be seen as an embarrassing failure.

Stocks could melt up if Pelosi caves, because investors probably perceive more uncertainty if a Democrat wins the White House than if Trump gets a second term. In my meetings two weeks ago in London, I was asked whether Trump could be even more disruptive to world trade if he gets a second term. It's possible. It's also possible that he'll get faster and better deals once the other sides realize that he won't go away.

(5) *Budget deficit.* Congress passed a massive budget deal earlier this year, but lawmakers still need to pass individual spending bills to divvy up the money. An 11/25 Politico article reported: "In one sign of progress over the weekend, negotiators announced they had agreed on overall spending levels for each of the dozen bills that fund the government—which means the measures can now be written and then start coming to the floor."

"But lawmakers also acknowledge there's a very real possibility Congress falls flat on its face despite securing a breakthrough agreement in August that increased federal spending by $320 billion over two years and raised the debt ceiling."

Trump signed a short-term spending bill into law last Thursday averting a government shutdown. The measure funds the government at current levels through 12/20, setting up another potential showdown over spending next month.

(6) *Hong Kong.* An 11/25 NBC News article reported: "Pro-democracy forces swept Hong Kong district council elections over the weekend, boosting pressure on the city's Beijing-backed government to listen to protesters' demands for greater freedoms.

"China responded sternly to the landslide in the vote widely seen as a referendum on public support for the anti-government movement. Foreign Minister Wang Yi said that no matter how the situation in Hong Kong changes, the semiautonomous region is part of China."

Beijing has avoided directly intervening so far, preferring to let Hong Kong's embattled leader Carrie Lam handle the situation. In this age of smartphones, Beijing has been deterred from cracking heads and having the carnage live-streamed around the world.

(7) *Middle East.* Yesterday, Brig.-Gen. Zvika Haimovich, former commander of the Israel Defense Forces' Aerial Defense Division, warned that Iran is planning a "multi-directional" attack against the state of Israel together with its proxies, and that the Jewish state needed to prepare for it now.

Iran has been gripped by an economic crisis since the US restored painful sanctions on 5/8/18 after withdrawing from the 2015 nuclear deal. Last week, there were widespread riots in Iran following a fuel price hike by the government. During the violence, dozens of banks, gas pumps, and police stations were torched across the Islamic republic.

Iranian officials accused the US, Britain, Israel, and Saudi Arabia of stoking the unrest. Yesterday, the head of Iran's Islamic Revolutionary Guard Force threatened to destroy Israel, the US, and other countries as he addressed a pro-government demonstration.

**Disruptive Technologies: Recycling CO2.** Let's not forget Thursday to be thankful for all the scientists toiling to improve our lives, including those working to reduce the amount of carbon dioxide (CO2) in our air. The concentration of CO2 in the atmosphere reached another record high in 2018, according to a report released Monday by the World Meteorological Organization. Scientists envision building synthetic forests that suction CO2 out of the air to be sold to companies that use it as a raw material. In a perfect world, costs will fall, and revenues will rise enough to make carbon-capture companies self-sustaining and profitable. Let's take a look at some recent developments in this quickly evolving field:

(1) *MIT scientists at the fore.* The brains at MIT claim to have developed the holy grail: a device that can take carbon out of the air inexpensively.

"The device is essentially a large, specialized battery that absorbs CO2 from the air (or other gas stream) passing over its electrodes as it is being charged up, and then releases the gas as it is being discharged," a 10/24 MIT press release states. The MIT method eliminates an intermediate step that requires significant heat or pressure required by competitors' methods. It can take the carbon out of the CO2-rich air spewed by power plants or "regular" air, which contains far fewer CO2 particles.

In a power-plant setting, the MIT scientists envision two separate stacks of electrochemical cells operating next to a plant's flue. The plant's emissions would be directed at the first stack, which would capture CO2 until it's full. Then the flue's emission would be directed at the second stack, which would start capturing the CO2 while the first stack discharges concentrated CO2. The researchers have set up a company, Verdox, to commercialize the process.

(2) *Oil giants jumping in too.* This summer, ExxonMobil announced a joint development agreement to advance Global Thermostat's technology to capture CO2 from the air. It follows news earlier this year that the venture arms of Occidental Petroleum and Chevron jointly invested in Carbon Engineering, a Global Thermostat competitor.

"Global Thermostat already has built two pilot facilities, each with the capacity to remove 3,000 to 4,000 metric tons of CO2 per year. ExxonMobil aims to help the company build bigger facilities in more places, until they're removing a gigaton (1 billion tons) of CO2 every year," an 8/29 article in GreenBiz reported. Exxon has reportedly provided Global Thermostat with millions of dollars and a team of 10 ExxonMobil employees. The companies will also try to find markets for the captured CO2.

Global Thermostat was started by Graciela Chichilnisky and Peter Eisenberger. Chichilnisky is a development economist and a member of the Intergovernmental Panel on Climate Change, which shared the 2007 Nobel Prize with Al Gore. She wrote the section of the Kyoto Protocol dealing with carbon markets. Eisenberger, a materials scientist, was the founding director of Columbia's Earth Institute, an interdisciplinary environmental research center, who early in his career worked in R&D at ExxonMobil.

(3) *CO2 for sale*. The hope is that these CO2-removing plants become profitable by selling the CO2 they capture to companies that use the gas in their businesses. One potential customer: soft-drink-bottling plants that currently burn fossil fuels to generate the CO2 that gives sodas their bubbles. Farmers who burn natural gas to produce CO2 to feed their plants in greenhouses are also potential clients.

Scrubbed CO2 is also used by the fracking industry. NRG's electric plant outside of Houston runs on coal, and it uses equipment to capture more than 1.4 million tons of CO2 gas each year. The CO2 is piped 80 miles to an oil field, West Ranch, where it's injected into the spaces between underground rocks where oil used to be. The CO2 forces any remaining oil up to the surface, making older oil wells profitable again.

"Before using carbon capture technology, West Ranch produced about 300 barrels of oil daily. Now, NRG is recovering 4,000 barrels per day," reported a 6/28 article on Now, a website "powered" by Northrop Grumman.

Carbon Engineering aims to combine the CO2 its plants capture with hydrogen to create a new "clean" fuel it calls "Air to Fuels" (A2F), a 2/4/18 article in *The Guardian* reported. The company was founded by Harvard physicist David Keith and initially funded by Bill Gates and oil sands executive Norman Murray Edwards. They hope the cost of direct air capture and producing A2F will fall to "little more than" the price of fossil fuels today.

(4) *A future solution?* Scientists at RMIT University in Australia are turning CO2 back into coal, in a laboratory anyway. When electricity and pure CO2 gas are pushed into a glass tube holding liquid composed of an alloy of gallium, indium, cerium, water and tin, flakes of solid carbon form on the surface, according to a 2/26 article in *Science* magazine, quoting the scientists' report in *Nature Communications*.

After the reaction, the carbon flakes can be separated off, allowing the reaction to continue with additional CO2. The carbon produced by the reaction could be used in battery electrodes, tennis rackets, golf clubs, and airplane wings, observed a scientist from Utrecht University in The Netherlands. The trick will be scaling the experiment up from something done in a laboratory to something that can work beside a power plant.

## CALENDARS

**US. Tues:** Consumer Confidence 127.0, Advance Merchandise Trade Balance -$71.0b, Wholesale Inventories 0.1%, Richmond Fed Manufacturing Index 5.0, New Home Sales 708k, S&P Case-Shiller Home Price Index 3.3% y/y, Brainard. **Wed:** Real GDP & Real PCE 1.9%/2.8%, GDP Price Deflator 1.7%, Personal Income & Spending 0.3%/0.3%, Real Consumer Spending 0.0%, Headline & Core PCED 1.4%/1.7% y/y, Durable Goods Orders Headline & Ex Transportation -0.7%/0.1%, Core Capital Goods Orders & Shipments 0.0%/0.0%, Chicago Purchasing Managers Index 47.0, Pending Home Sales 5.5%, MBA Mortgage Applications, DOE Crude Oil Inventories, EIA Natural Gas Storage, Baker-Hughes Rig Count, Beige Book. **Thurs:** None. **Fri:** None. (DailyFX estimates)

**Global. Tues:** Germany Gfk Consumer Confidence 9.6, China Industrial Profits, Lowe, Coeure. Wed: Japan Retail Sales -3.8% y/y. **Wed:** Japan Retail Sales -3.8% y/y. **Thurs:** Eurozone Economic Confidence 101.0, Germany CPI -0.6%m/m/1.2%y/y, UK Gfk Consumer Confidence -14, Japan Retail Sales 2.4% y/y, Japan Industrial Production -2.0%m/m/-5.3%y/y, Coeure. **Fri:** Eurozone Headline & Core CPI Flash Estimate 0.9%/1.2% y/y, Eurozone Unemployment Rate 7.5%, Germany Unemployment Change & Unemployment Claims Rate 5k/5.0%, Germany Retail Sales

0.2%m/m/3.0%y/y, France GDP 0.3%q/q/1.3%y/y, Italy GDP 0.1%q/q/0.3%y/y, Canada GDP 1.4% y/y, China M-PMI & NM-PMI 49.5/53.1. (DailyFX estimates)

## STRATEGY INDICATORS

**S&P 500/400/600 Forward Earnings** (*link*): Forward earnings rose for all three of these indexes for the first time in seven weeks. These indexes began a forward-earnings uptrend during March, but only LargeCap is near a record high. LargeCap's forward earnings has risen during 29 of the past 41 weeks, MidCap's 20 of the past 37 weeks, and SmallCap's 18 of the past 35 weeks. LargeCap's is just 0.3% below its record high 10 weeks ago, while MidCap's and SmallCap's are 5.6% and 9.6% below their October 2018 highs. MidCap's forward earnings is near an 18-month low now, while SmallCap's forward earnings is near September's 17-month low because analysts are now including a large goodwill writeoff in their 2019 annual forecast for Frontier Communications. At their bottoms earlier in 2019, LargeCap's forward EPS had been the most below its record high since June 2016 and MidCap's was the lowest since May 2015. During mid-September, SmallCap's had not been this far below since October 2010. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act but began to tumble in October as y/y comparisons became more difficult. In the latest week, the rate of change in LargeCap's forward earnings rose to 1.3% y/y from a 38-month low of 1.0%. That's down from 23.2% in September 2018, which was the highest since January 2011. MidCap's improved to -5.1% y/y from -5.5%, which was the lowest since December 2009. That compares to 24.1% in September 2018 (the highest since April 2011). SmallCap's -7.5% y/y change is up from -9.6% in mid-September, which was the lowest since December 2009 and compares to an eight-year high of 35.3% in October 2018. Analysts had been expecting double-digit percentage earnings growth for 2019 last October, but those forecasts are down substantially since then. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, 0.5%, 9.8%), MidCap (22.7, -7.3, 12.4), and SmallCap (22.4, -19.2, 36.3).

**S&P 500/400/600 Valuation** (*link*): Valuations fell for all three of these S&P market-cap indexes for the first time in seven weeks, but remain well above their three-month lows during the late summer. LargeCap's forward P/E edged down 0.1pt w/w to 17.5 from a 22-month high of 17.6. That compares to a five-year low of 13.9 during December and a 16-year high of 18.6 during January 2018—and of course is well below the tech-bubble record high of 25.7 in July 1999. Last week's level remains above the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E was down 0.2pt w/w, to 16.9 from a 20-month high of 17.0, but is up from 13.0 during December, which was the lowest reading since November 2011. MidCap's P/E is down from a 15-year high of 19.2 in February 2017 and the record high of 20.6 in January 2002. However, MidCap's P/E has been at or below LargeCap's P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap's P/E dropped 0.2pt to 17.5 from 17.7, and remains below the 12-month high of 17.8 in mid-September. That's still well above its seven-year low of 13.6 during December and compares to its 15-year high of 20.5 in December 2016, when Energy's earnings were depressed. SmallCap's P/E was a tad below LargeCap's for the first time in six weeks. It had been below for four months through the end of August—the first time that has happened since 2003.

**S&P 500 Sectors Quarterly Earnings Outlook** (*link*): With the Q3 earnings season approaching the finish line, the Q3 blended estimate/actual improved for a sixth straight week. The S&P 500's Q3-2019 EPS forecast rose 7 cents w/w to $42.35. That represents an earnings decline of 0.7% y/y compared to the prior week's forecasted earnings drop of 0.9%. On a pro forma basis, blended Q3 earnings are down 0.4% y/y, which is the first drop in 13 quarters and compares to y/y gains of 3.2% in Q2, 1.6% in Q1, 16.9% in Q4-2018, and 28.4% in Q3-2018 (which marked the peak of the current earnings cycle). Looking ahead to Q4, the forecast dropped 5 cents w/w to $41.03. That represents an earnings decline of 0.4% on a frozen actual basis, and flat earnings y/y on a proforma basis. Seven of the 11 sectors are

expected to record positive y/y earnings growth in Q4-2019, with two rising at a double-digit percentage rate. That compares to seven positive during Q3, when none rose at a double-digit percentage rate. The same seven sectors are expected to beat the S&P 500's flat y/y growth in Q4, the same count as in Q3 and up sharply from just three beating the S&P 500 during Q2. Six sectors are expected to post better (or less worse) growth on a q/q basis during Q4: Communication Services, Energy, Financials, Materials, Tech, and Utilities. On an ex-Energy basis, the consensus expects earnings to rise 2.2% y/y in Q4. That compares to ex-Energy gains of 2.1% in Q3, 3.9% in Q2, and 3.0% in Q1. However, that's well below the 25.0% and 14.2% y/y gains in Q3- and Q4-2018, respectively. Here are the latest Q4-2019 earnings growth rates versus their blended Q3-2019 growth rates: Utilities (14.7% in Q4-2019 versus 6.7% in Q3-2019), Financials (12.5, 2.3), Health Care (6.1, 8.8), Real Estate (3.8, 5.6), Communication Services (1.9, -1.5), Consumer Staples (0.7, 3.6), Information Technology (0.5, -2.0), Industrials (-4.4, 3.5), Materials (-7.9, -11.0), Consumer Discretionary (-11.7, 1.7), and Energy (-33.5, -37.8).

**S&P 500 Q3 Earnings Season Monitor** (*link*): With the Q3-2019 earnings reporting season now over 95% complete, S&P 500 revenues and earnings are beating the consensus forecasts by 0.8% and 4.8%, respectively. At the same point during the previous earnings season for Q2, revenues and earnings had beaten forecasts by a higher 1.2% and 6.1%, respectively. However, a higher percentage of companies has recorded a positive earnings surprise in Q3 than in Q2—76% versus 74%. A slightly higher percentage of companies showed a positive revenue surprise—58% versus 57%. The 477 companies in the S&P 500 that have reported through mid-day Monday collectively have recorded flat earnings growth y/y, dragged down by Micron Technology's earnings deceleration. On the revenue side, results are 3.6% higher than a year earlier. On a sour note, y/y earnings growth trailed revenue growth for a third straight quarter, something that hasn't happened since the last Energy "recession" in H1-2016. Ex-Micron, y/y earnings growth for the S&P 500 jumps 1.0ppt to 1.0%. Adjusting for the dismal y/y growth declines for the Energy sector, Q3's S&P 500 ex-Energy revenue growth improves 1.1ppts to 4.7% and earnings growth rises 2.5ppts to 2.5%. Overall, Q3 earnings growth results are positive y/y for 62% of companies versus a higher 65% at the same point in Q2, but revenues have risen y/y for a higher 68% in Q3 compared to 66% in Q2. We don't expect these figures to change materially as the remaining Q3-2019 results are reported in the coming weeks.

## GLOBAL ECONOMIC INDICATORS

**Germany Ifo Business Climate Index** (*link*): German business confidence is on the rise after falling fairly steadily for almost two years. "The German economy is showing resilience. The Ifo institute is expecting GDP growth of 0.2 percent in the fourth quarter," according to Clemens Fuest, president of Ifo. The Ifo Business Climate index in November edged higher for the third month, to 95.0, after falling from a recent peak of 105.2 in January 2018 to 94.3 this August—driven by expectations. The expectations component climbed to a 92.1 this month from 91.6 and 90.9 the prior two months, while the present situation component advanced to 97.9, remaining in a flat trend just above August's low of 97.4. "The signs are that business will be very good this Christmas," according to Fuest, as the trade industries were more satisfied with the current situation this month and expectations rose markedly. Sentiment in the service sector (17.3 from 13.2 in August) continued to improve, with the expectations component (0.2 from -3.5) departing negative territory. Meanwhile, the manufacturing sector remains stuck in a recession, though looks to have found a bottom—with expectations (to -13.0 from -16.9 in August) climbing to a five-month high. Construction is still in a rut, as sentiment fell to a nine-month low of 20.4 in November—with both components continuing to deteriorate.

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