Yardeni Research

MORNING BRIEFING
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Staying Defensive in a World of Danger

See the collection of the individual charts linked below.

(1) Dangerous world means more defense spending. (2) Boeing shares grounded, but most other aerospace & defense stocks flying high. (3) Mergers, spending on aircraft, missile defense, and space all help. (4) If Dems win Oval Office, there may be trouble for defense stocks ahead. (5) Venture capital funding a bit soft in Q4 but strong for 2019 as a whole. (6) Internet companies are receiving the most funding, especially Software as a Service.

Industrials: Defense Plays Offense. It was a heck of a way to start 2020. The US killed Iran's military commander General Qasem Soleimani in an air strike on 1/3, causing tensions between the US and Iran to spike. When Iran's retaliatory bombing of an Iraqi/US military base didn't kill anyone, a worldwide sigh of relief followed.

The drama is the latest reminder of the dangerous world in which we live and the most recent reason to believe that the defense budget is not about to be reduced anytime soon.

When the US ended the wars in Iraq and Afghanistan, defense spending did begin to drift lower even though a US presence in those countries remained. Defense spending set a recent low of $591 billion in fiscal year 2015 and has been increasing each year since, hitting $701 billion in fiscal year 2019 (*Fig. 1*). This year, the Department of Defense budget is set at $738 billion.

Separately, private companies like SpaceX, Blue Origin, and Virgin Orbit are actively competing to launch satellites and dominate space. Since the end of 2017, US industrial production of defense and space equipment has climbed nearly 20% (*Fig. 2*).

Let's take a look at what that has meant for defense stocks:

(1) *Defense has been good offense.* The S&P 500 Aerospace and Defense stock price index is

among the top-performing ytd. It has climbed 4.0% through Tuesday's close even though its largest member, Boeing, has fallen 3.8% ytd (*Fig.3*). Aerospace & Defense is the best-performing industry within the S&P 500 Industrials sector and has outpaced all but three of the other 11 sectors in the S&P 500 (*Fig. 4* and *Fig. 5*). Propelling the Aerospace & Defense industry's strong start to the year are top-performing stocks TransDigm Group (up 15.0% ytd), Huntington Ingalls Industries (11.0), Northrop Grumman (9.9), and Lockheed Martin (9.4).

(2) *Rebounding results.* The industry's earnings and revenue are expected to rebound this year as Boeing's 737 Max planes are expected to receive approval to return to the air around midyear. The S&P 500 Aerospace & Defense industry is expected to see revenues grow by 12.9% in 2020 after they stagnated last year, growing only 1.2% (*Fig. 6*). Likewise, earnings are expected to jump 41.2% this year, reversing last year's 19.8% decline (*Fig. 7*). The industry's forward P/E has fallen to 17.6 from a peak of 22.7 in January 2018 (*Fig. 8*).

In addition to a dangerous world and a growing defense budget, investors may be hoping that the rash of mergers in the industry in recent years will lead to better economics for the surviving companies. "The number of bids on U.S. government contracts has trended down, and more of them have been awarded on a 'cost-plus' rather than 'fixed-price' basis, which is thought to be better for firms because it guarantees a fee regardless of cost overruns," according to an 11/9/19 *WSJ* article that cast doubt on the endurance of the defense stock rally.

(3) *What's propelling top stocks*. TransDigm has become a market darling because it has been surprising investors with large, one-time dividends. TransDigm makes new and aftermarket parts for the aerospace and defense industry. Last March, it acquired Esterline Technologies, which makes advanced materials, avionics and controls, and sensors for the aerospace and defense industry, for about $4 billion.

Subsequently, TransDigm sold some of the pieces of Esterline it didn't want. It sold Souriau-Sunbank for $920 million in Q4, and it sold Esterline Interface Technologies for about $190 million in September. The company rewarded shareholders with two special dividends: a $32.50-per-share dividend paid on 1/17 and a $30.00-a-share dividend paid on 8/23/19. Ironically, the company does not pay a regular dividend. Investors, with their shares up 87.4% over the past year, seem okay with that.

Huntington Ingalls Industries is another defense player whose shares have far outpaced the broader market. It both builds new ships—including aircraft carriers and submarines—and maintains existing ships. In December, Huntington Ingalls and General Dynamics were awarded a $22 billion contract to build nine submarines for the Navy. The same month, the company was awarded a submarine-planning-yard contract potentially worth $454.1 million.

US defense of the seas has gained importance now that China appears to be building an aggressive seafaring force. The country's first home-built aircraft carrier entered active duty in December and has been sailing through contested waters. Per a 12/17/19 *WSJ* article: "The carrier sailed through the strategically sensitive Taiwan Strait last month, with U.S. and Japanese navy vessels on its tail, before proceeding to the South China Sea for what the Chinese Navy said then were 'scientific tests and routine drills.'" With big fish like that prowling the seas, the US may need to bulk up its Navy. Huntington Ingalls' shares are up 41.8% over the past year.

Lockheed Martin and Northrop Grumman have also led defense shares. Lockheed manufactures aircraft, missiles and missile defense systems, submarines, satellites, and space transport and defense systems. One of its most important products is the F-35 Fighter, and this year's budget earmarks $1.87 billion for 98 new F-35 jets, a 12/19 DefenseNews article reports. The recent Iranian attack and the attack on Saudi oil infrastructure drove home the importance of missile defense systems. Northrop's missile defense system knocked out two cruise missiles simultaneously, and the company stands to benefit from the defense budget's $40 million allocation to the Space Force. Northrop's shares are up 42.8% over the past year.

(4) *Beware the Dems.* While President Trump has been vocal about his willingness to increase spending on US defense, the Democrat presidential candidates don't seem nearly so inclined. The stock market seems to be assuming that President Trump will win in 2020. But if that changes, the fate of defense stocks could too.

In the 1/14 Democratic debate, Senator Elizabeth Warren (MA) stated that she wanted US troops out of the Middle East and wanted the defense budget cut, Byron Callan noted in a Capital Alpha Partners 1/15 research note. Senator Bernie Sanders (VT) didn't explicitly call for cuts, but he noted that there were bigger domestic issues meriting financial resources than the Middle East. All the rest on the debate stage that night—former Vice President Joe Biden, Senator Amy Klobuchar (MN), and Mayor Pete Buttigieg—seemed to favor keeping some US troops in the region. Those stances are a far cry from Trump's enthusiastic support for additional military spending.

Disruptive Technologies: Following the Money. Many of the disruptive technologies we write about start out as small enterprises funded by venture capitalists (VCs). While off its record levels, the VC industry was quite healthy last year. US venture capital deals totaled $108 billion in 2019, the third-largest year ever, according to a Q4 MoneyTree report by PwC and CBInsights. Funding was down slightly from 2018's $118 billion and from the record year of 2000, when $119 billion was invested.

Let's take a deeper dive into the report and the VC industry that keeps disruptive technologies coming to market:

(1) *Touch of Q4 softness.* Twenty-nineteen ended on a soft note, with companies raising only $23.0 billion of VC funding during Q4. That compares to $40.0 billion raised in the year-earlier quarter. The drop-off was due to far fewer mega-rounds of VC funding, defined as $100 million or larger. Last quarter saw only $7.3 billion of mega-round funding raised by companies, compared to $25.3 billion in Q4-2018.

Investors may have held back a bit in the wake of high-profile disappointments among the likes of Uber, WeWork, and Lyft. But there's money on the sidelines waiting to get invested, so we'd bet that deal volumes will bounce back if the broader market holds up. VC funds raised $983 billion last year, almost double the $544 billion raised in 2018. The largest funds were raised by Sequoia Capital, Andreessen Horowitz, General Atlantic, Summit Partners, and Adams Street Partners.

(2) *Internet, health care, and SaaS deals are hot.* Internet companies received the lion's share of Q4 venture funding: 575 deals valued at $10.0 billion. That's followed by deals in health care (203 deals, $5.1 billion), non-Internet/mobile software (135 deals, $1.7 billion), mobile and telecommunications (123 deals, $2.7 billion), and consumer products and services (64 deals, $500 million).

Confirming that software is indeed eating the world, companies selling software as a service (SaaS) dominated fundraising within the Internet category. SaaS focused on accounting and finance, analytics and performance management, advertising, sales & marketing, monitoring and security, human resources and workforce management, health care, and education and training.

(3) *Five largest deals*. The five largest deals of the quarter each had raised multiple rounds of capital previously. Bright Health raised the largest Q4 funding round, $635 million. The health insurance company is expanding its insurance lines, including its Medicare Advantage health insurance, which will enter seven new markets in six states. The company, which has raised more than $1 billion since 2016, also plans on expanding all of its insurance business lines. That includes individual coverage under the Affordable Care Act, according to a 12/17/19 article on Forbes.com.

The second-largest funding amount was $500 million raised by Chime, a digital bank, which was valued at $5.8 billion after the latest funding round. The company plans to hire more employees, build out new financial products, open a Chicago office, and potentially make acquisitions, a 12/5/19 Forbes.com article reported. It noted that Chime had 6.5 million accounts and was expected to hit almost $200 million in revenue by the end of 2019.

Databricks, a SaaS company focused on data analytics, and Convoy, a digital freight network that connects truckers with shippers, each raised $400 million. And $319 million was raised by Vacasa, which manages vacation-home rentals and aims to expand into new markets beyond the 31 US states and 17 countries in which it currently operates.

(4) *Unicorns multiply.* The number of new "unicorns"—startups valued at $1 billion or more—continued to grow, reaching 199 by the end of last year. The five largest unicorns are Juul Labs (valued at $50.0 billion), Stripe ($35.3 billion), Airbnb ($35.0 billion), SpaceX ($433.3 billion), and Palantir Technologies ($20.0 billion). These and other privately funded companies undoubtedly will keep the M&A and IPO markets busy.

CALENDARS

US: Thurs: Leading Indicators -0.2%, Jobless Claims 215k, Kansas City Fed's Manufacturing Index -6, DOE Crude Oil Inventories, EIA Natural Gas Storage. **Fri:** M-PMI & NM-PMI Flash Estimates 52.5/52.5, Baker-Hughes Rig Count. (DailyFX estimates)

Global: Thurs: Eurozone Consumer Confidence -7.8, Japan CPI Headline, Core, and Core-

Core 0.7%/0.7%/0.9% y/y, ECB Rate Decision 0.00%, ECB Marginal Lending & Deposit Facility Rates 0.25%/-0.50%, BOJ December Meeting Minutes, Lagarde. **Fri:** Eurozone, Germany, and France C-PMI Flash Estimates 51.2/50.5/52.0, Eurozone, Germany, and France M-PMI Flash Estimates 46.8/44.5/50.6, Eurozone, Germany, and France NM-PMI Flash Estimates 52.8/53.0/52.2, UK C-PMI, M-PMI & NM-PMI Flash Estimates 50.7/48.7/51.0, Canada Retail Sales Headline & Ex Autos 0.9%/0.8%, Lagarde, Zhu, Mnuchin, Scholz, Georgieva, Kuroda, Javid, Villeroy, Knot, Haskel. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) rose for the second week this week, to 3.32, after falling from 3.34 to 3.10 the prior two weeks—its13th straight reading above 3.00. Once again, there were wide swings in bullish sentiment and the correction count. Bullish sentiment rose 4.3ppts (to 59.4% from 55.1%) over the two-week period, to its highest percentage since September 2018, while the correction count sank 4.4ppts (22.7 from 27.1), to its lowest percentage since September 2018. Bearish sentiment ticked up to 17.9% from 17.8% the prior three weeks, continuing to fluctuate in a very narrow band. The AAII Ratio climbed to 60.3% last week, after sliding the prior three weeks from 68.3% to 52.5%. Bullish sentiment rose to 41.8% after falling from 44.1% to 33.1% the prior three weeks, while bearish sentiment fell to 27.5% after rising from 20.5% to 29.9% the previous three weeks.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): Consensus S&P 500 forward revenues and earnings both edged up last week. Forward revenues was at a record high, but forward earnings remains a tad below its record high in early January, which had been its first since early October. Analysts expect forward revenues growth of 4.9% and forward earnings growth of 9.4%, with each measure remaining steady w/w. Forward revenues growth is at a 40-month low and 1.4ppt from a seven-year high of 6.3% in February 2018. Forward earnings growth is down 7.5ppts 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 4.1% in 2019 and 4.8% in 2020. They're calling for earnings growth to slow sharply from 24.0% in 2018 to 1.1% in 2019 before improving to 8.8% in 2020. The forward profit margin remained steady w/w at 12.0%, which is up 0.1ppt from a 22-month low of 11.9% in late December and is down only 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 0.4ppt y/y from 11.8% in 2018 to 11.4% in 2019 before improving to 11.9% in 2020. The S&P 500's forward P/E rose 0.2pt to an 18-year high of 18.6. That's up from 14.3 during December 2018, which was the lowest reading since October 2013 and down 23% then 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 0.02pt w/w to a record high of 2.23. That's up from 1.75 during December 2018, when it was the lowest since November 2016, and down 19% from its then-record high of 2.16 in January 2018.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): Consensus forward revenues rose w/w for nine of the 11 S&P 500 sectors last week, and forward earnings was higher for five. Industrials and Materials had both measures fall 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's valuation has only recently improved from its multi-year low during December 2018. Due to the TCJA, the profit margin for 2018 was higher y/y for all sectors but Real Estate. All sectors except Real Estate are expected to record higher margins y/y in 2020, up from just two sectors improving y/y in 2019: Financials and Utilities. The forward profit margin rose to record highs during 2018 for 8/11 sectors, all but Energy, Health Care, and Real Estate. Since then, it has moved lower for nearly all the sectors. Industrials and Utilities are the only sectors with their forward profit margins still near a record high. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (21.7%, down from 23.0%), Financials (18.1, down from 19.2), Real Estate (15.8, down from 17.0), Communication Services (14.8, down from 15.4), Utilities (13.2, down from its record high of 13.3% a week earlier), S&P 500 (12.0, down from 12.4), Health Care (10.5, down from 11.2), Industrials (10.4, down from its record high of 10.5% in mid-December), 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 (6.2, down from 8.0).

S&P 500 Sectors Net Earnings Revisions (*link*): The S&P 500's NERI improved m/m in January for a second straight month to a six-month high, but was negative for the 13th time in 15 months despite several sectors turning positive. NERI improved to -4.1% in January from -7.4% in December, which compares to a 43-month low of -8.9% in November and a record high of 22.1% in March 2018. NERI improved m/m for eight of the 11 sectors; that's the most since all 11 improved m/m in May 2019 and compares to five improving in December. NERI was positive in January for four sectors, the most since June 2019 and up from two during December. Materials has the worst track record, with 16 months of negative NERI, followed by Industrials (15), Consumer Discretionary (14), and Utilities (12). Financials' NERI turned positive m/m for the first time since November 2018, and Consumer Staples' positive reading was its first since July. Here are the sectors' January NERIs compared with their December readings: Tech (4.7% in January [15-month high], up from 2.2% in December), Health Care (3.8, 1.5), Financials (1.4 [14-month high], -7.0), Consumer Staples (0.1, -4.2), Real Estate (-1.0, -1.4), Utilities (-4.9, -4.4), Communication Services (-6.7, -7.3), Consumer Discretionary (-8.0, -7.4), Energy (-12.1, -21.7), Industrials (-13.9, -18.6 [47-month low]), and Materials (-17.5, -17.3).

S&P 500 Q4 Earnings Season Monitor (*link*): With over 11% of S&P 500 companies finished reporting revenues and earnings for Q4-2019, revenues and earnings are beating the consensus forecasts by 1.2% and 4.1%, respectively. Those are in line with their respective 1.3% and 4.7% beats at the same point in Q3, but the percentages of companies showing a positive earnings surprise and positive y/y earnings growth are much lower. Of the 57 companies in the S&P 500 that have reported through mid-day Wednesday, 68% exceeded industry analysts' earnings estimates. Collectively, the small sample of reporters has a y/y earnings gain of 4.1%. On the revenue side, 68% of companies beat their Q4 sales estimates so far, with results 3.7% higher than a year earlier. Overall Q4 earnings growth results are positive y/y for 67% of companies, and revenues have risen y/y for 79%. These figures will change markedly as more Q4-2019 results are reported in the coming weeks, but what companies say about their growth and margin prospects for 2020 will be investors' main focus.

US ECONOMIC INDICATORS

Existing Home Sales (*link*): Existing home sales—tabulated when a purchase closes—tracked a volatile uptrend during 2019, finishing the year on an up note, with December sales climbing 3.6% to 5.54mu (saar), its highest reading since February 2018. Single-family sales rebounded 2.7% to a 22-month high of 4.92mu (saar) during December, following a 1.2% loss in November, with December sales up 10.6% y/y—the best yearly growth since November 2016. Multi-family sales jumped 10.7% m/m and 12.7% y/y in December, to an 18-month high of 620,000 units (saar). Regionally, total sales rose in three of the four regions in December, with all finishing 2019 well above year-ago levels: South (5.4% m/m & 12.4% y/y), West (4.6 & 10.7), Midwest (-1.5 & 9.2), and the Northeast (5.7 & 8.8). Meanwhile, the total of single-family homes available for sale at the end of December dropped dramatically, to a record low of

122,000 units, while the unsold supply sank to a record low of only 3.0 months. Lawrence Yun, NAR's chief economist, cautioned: "I view 2019 as a neutral year for housing in terms of sales. Home sellers are positioned well, but prospective buyers aren't as fortunate. Low inventory remains a problem, with first-time buyers affected the most."

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