



MORNING BRIEFING

January 29, 2020

Climate for a Change

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

(1) LargeCap's forward revenues & earnings beat the SMidCaps. (2) Profit margins lower for stocks of all sizes. (3) No new high for SmallCap index price. (4) Valuation for SMidCaps worsened compared to LargeCap. (5) Coronavirus fears spread through markets. (6) FAANGMs causing P/E divergence between LargeCap and SMidCaps. (7) Global elite and youth activists debate climate change in Davos. (8) Global prosperity linked to carbon emissions? (9) IPCC says eight years left before planet gets too hot. (10) Corporate CEOs focused on sustainability for good. (11) Capital reallocated to sustainable investments.

Strategy I: Will Large Caps Continue To Lead SMidCaps? Yesterday, Joe and I reviewed the S&P 500 LargeCap's impressive rebound since the Christmas Eve bottom in 2018. The index price rallied to record highs and valuation soared to multi-year highs. Forward revenues and earnings edged up to record highs too, but earnings rose slower, causing the forward profit margin to edge down. But how have smaller-capitalization indexes fared since Christmas Eve 2018?

Today, let's look at the performances of the SMidCap indexes since 12/24/18 and compare them to LargeCap's:

(1) *Forward revenues & earnings.* Looking at their forward revenues and earnings, the LargeCaps rose to record highs and easily beat the SMidCaps. Forward revenues are up 4.4% since 12/24/18 to a record high on 1/16 for LargeCap, ahead of the 2.5% gains for MidCap and SmallCap. However, they are down from their record highs in July and November ([Fig. 1](#)). LargeCap's forward earnings is up 2.4%, also to a record high. That's easily ahead of the 2.6% and 1.2% declines for MidCap and SmallCap ([Fig. 2](#)). The SMidCaps' forward earnings haven't hit a record high since October 2018.

(2) *Profit margins.* However, all three indexes have seen better improvements in forward revenues than forward earnings. So their forward profit margins have moved lower.

LargeCap's is down to 12.0% from 12.2%; MidCap's has dropped to 7.1% from 7.6%; and SmallCap's has slipped to 5.2% from 5.4% ([Fig. 3](#)).

(3) *Performance derby*. The price indexes for LargeCap and MidCap rose to new record highs during 2019. LargeCap was the first to break into new record-high territory, on 4/23/19, just five months after the 12/24/18 bottom. MidCap took nearly 12 months to reach a new high, on 12/20/19. SmallCap hasn't yet made a new high after the market's Christmas Eve 2018 bottom. It took the longest among these indexes to exit its correction, and even today still remains well below its 8/31/18 high ([Fig. 4](#)).

(4) *Valuation*. All three of the indexes had impressive and similar P/E recoveries during 2019, but the SMidCaps' valuation relative to LargeCap's has worsened. LargeCap's 39% gain in the P/E to 18.7 on 1/17 from 13.5 was ahead of both MidCap's (38% to 17.4 on 1/16 from 12.6) and SmallCap's (35% to 18.1 on 12/24/19 from 13.4) ([Fig. 5](#)).

(5) *Year-to-date*. Monday's market selloff was inspired by fears that China's coronavirus epidemic will go global. LargeCap's price index is now down 2.6% from its 1/17 record close, and MidCap's is down 3.1% from its 1/16 record. SmallCap's price index has fared slightly worse, falling 3.6% from its high on 1/16; it is nearly back in a correction again, at 8.6% below its 8/31/18 record.

Forward P/Es fell on Monday to 18.2 for LargeCap, 16.8 for MidCap, and 17.1 for SmallCap. MidCap's is now 7% below LargeCap's, a reading last seen several times during 2019—and characteristic of levels at the depths of the financial crisis in 2008-09. SmallCap's is now 6% below LargeCap's, a reading not seen since July 2003, when LargeCap was still deflating from the tech bubble ([Fig. 6](#)). Before Monday, SmallCap had been at a slight discount to LargeCap since October 2018; MidCap has been at a solid discount since August 2018.

(6) *Year ahead*. So where do we go from here? Previously, we've observed that SMidCap companies may be having a harder time offsetting labor costs as new workers are becoming harder to find. That won't change over the rest of this year. Furthermore, as we discuss in the next section, LargeCap technology companies have been driving the outperformance of the S&P 500. That probably won't change either this year.

Strategy II: De-FAANGM-ing Cheapens the S&P 500. So, what's causing the P/E

divergence between LargeCap and the SMidCaps? Our analysis of the FANG (Facebook, Amazon, Netflix, and parent of Google, Alphabet) stock portfolio shows that it has added from 0.8 to 1.2 points to the S&P 500's forward P/E since mid-2017 ([Fig. 7](#)). Indeed, the portfolio's 1/16 reading had the FANG stocks boosting the S&P 500's forward P/E 1.1 points from 17.4 to 18.6. Almost, but not enough to account for the divergence fully.

The FAANGM stocks portfolio, which also includes Apple and Microsoft, is the bigger outperformer. Its contribution has risen from 1.0 points during mid-2017 to a record high 1.9 points on 1/16 ([Fig. 8](#)). Take away the FAANGMs, and the S&P 500's P/E falls to 16.7, below the SMidCaps.

We've often said that valuation is as subjective as a beauty contest. Currently, the FAANGMs remain the fairest of them all. Earnings will have to support the market's P/E gains for LargeCaps and the SMidCaps, as well as the FAANGMs, or those gains will fade as beauty does.

Climate Change I: The Main Event. An acts-of-God clause protects parties to a contractual agreement from breach of contract due to an event outside of human control like epidemics and weather-related calamities. Unfortunately, investors don't get any such protection; analysts can't model potential market outcomes of "acts of God." Let's take a break from all the news on the new coronavirus to focus on something else outside of our control, climate change.

Last week, the world's leading bankers, economists, and academics gathered in Davos, Switzerland for the World Economic Forum to discuss the biggest challenges facing the world today. Two of the conference's [key themes](#) were cohesion and sustainability. The former was in short supply, as views on climate change were all over the map, but the latter was a hot topic. Here is a brief overview of the debate:

(1) *Mnuchin vs Lagarde*. In a panel discussion, US Treasury Secretary Steven Mnuchin and European Central Bank President Christine Lagarde sparred over climate change. Lagarde said it's critical to understand the risks that climate change could pose to the global economy and markets so they can be "anticipated, measured" and "hopefully mitigated."

Mnuchin countered that long-term planning for climate change is futile, CNN [reported](#). "I just don't want to kid ourselves," said Mnuchin. "I think there's no way we can possibly model what

these risks are over the next 30 years with a level of certainty.” Earlier in the week, the Treasury Secretary had questioned the qualifications of Greta Thunberg, a 17-year-old Swedish climate activist who headlined the conference.

(2) *Trump vs Thunberg*. During a speech at the conference, President Donald Trump called climate activists like Thunberg “perennial prophets of doom.” The President said: “This is not a time for pessimism; this is a time for optimism. Fear and doubt [are] not a good thought process because this is a time for tremendous hope and joy and optimism and action.”

Thunberg argued that there is too much talk and not enough action on climate change. She called for investments and subsidies for fossil fuels to end immediately, [reported](#) CNN. Trump had [said](#) in a December tweet that Greta has an “anger management” problem and should “chill.” Much of Thunberg’s discontent is aimed directly at the President, who has reversed US environmental regulations and [withdrawn](#) the US from the Paris Agreement, an international initiative to lower global carbon emissions.

(3) *Optimists vs pessimists*. Trump’s strong language notwithstanding, the administration is not in the denier camp, i.e., those who say that climate change from carbon emissions is fake news. The deniers believe that Earth naturally has gone through phases of warming and cooling and may continue to do so despite any human influence. Mnuchin told CNBC in a 1/23 “Squawk Box” [interview](#) that the administration’s intentions are “misunderstood.” He said that the President “supports a clean environment.” The real environmental issues are in China and India, he added. “If you look at what the US has been doing on its own, without government intervention, industry has gotten a lot more efficient on carbon emissions.”

Climate Change II: Carbon Basics. Melissa and I don’t pretend to know how much of a problem climate change will become or when. But we think it’s necessary to understand the implications for the global economy given that companies are reallocating capital based on this potential problem. We must all become climatologists now.

To get us started, here are some basics on climate change and its possible outcomes:

(1) *Carbon problem?* The world’s climate is changing, Microsoft President Brad Smith contends in a 1/16 [Official Microsoft Blog](#), because carbon emissions have created a blanket of gas that traps heat in our atmosphere. The planet’s temperature has risen by 1 degree

centigrade. There is a “high risk that average temperatures will increase between another one and four degrees Celsius by the end of this century. And the impact of such a temperature increase would be catastrophic,” wrote Smith, who uses this [chart](#) to bolster his case.

(2) *Investment risk*. But how would that impact the global economy? Blackrock’s chairman and CEO Larry Fink released a 1/14 [letter](#) to CEOs, titled “A Fundamental Reshaping of Finance,” that explains the importance of sustainability for his firm’s investment portfolio going forward. Investors are “recognizing that climate risk is investment risk,” he states. Investors are looking to understand “both the physical risks associated with climate change as well as the ways that climate policy will impact prices, costs, and demand across the entire economy.”

Financial markets need to be prepared to withstand the planet’s heating up, as the ramifications will be varied and great, according to Fink, citing examples on municipal bond markets, mortgages, insurance markets, inflation, interest rates, productivity, and economic growth.

(3) *Net zero*. Excess carbon in the atmosphere can take “thousands of years to dissipate,” Smith claimed. Climate experts agree that “we must reach ‘net zero’ emissions, meaning that humanity must remove as much carbon as it emits each year,” Smith added. The root of the problem is easy to understand: Global prosperity as measured by GDP is directly tied to energy usage (see Fink’s [chart](#)). Especially since the 1950s, economic development has required more carbon emissions. To untangle this long-standing relationship, business leaders and climate change experts aim to fix the problem with technology.

(4) *Scoping carbon*. Containing carbon emissions is a challenge because businesses and individuals rarely know their carbon footprints. Scientists classify carbon emissions into three scopes: scope 1 are direct emissions activities such as driving a car, scope 2 are indirect emissions such as produced from lighting homes and businesses, scope 3 are even more indirect and usually related to production by a third-party such as the emissions consumers promote when purchasing products. Scope 3 emissions can be particularly expansive for businesses along the supply chain.

(5) *Carbon terminology*. Companies are “carbon neutral” if they effectively offset their emissions “with payments either to avoid a reduction in emissions or remove carbon from the atmosphere,” noted Smith. Companies are “net zero” emissions if they directly offset their

emissions. Companies are “carbon negative” if they more than offset their emissions by removing more carbon than they produce.

(6) *Greta’s plea*. Thunberg explained the basis for her platform in a speech at Davos. She cited a 2018 [report](#) by The Intergovernmental Panel on Climate Change that said, in Thunberg’s words, “if we are to have a 67 percent chance of limiting the global average temperature rise to below 1.5 degrees Celsius, we had on January 1st, 2018, about 420 gigatons of CO2 left to emit in that budget.” That remaining budget “is gone within less than eight years” at today’s emissions levels.”

Climate Change III: Sustainable Capital Commitments. Believe that the planet will heat up or not, climate change issues already have started impacting business decisions and are changing the investment landscape. Major multinational companies recently have announced sustainability initiatives. Business leaders are moving both to appease investor appetites for sustainability and to meet what they see as a social responsibility.

The World Economic Forum founder Klaus Schwab wrote in a book about the forum distributed to Davos attendees: “It is my deep personal conviction that we must move towards a society which is no longer based on production and consumption,” [observed](#) the *Washington Post*. Schwab asked companies attending the conference to commit to net zero greenhouse gas emissions by 2050.

Separately, the Business Roundtable [released](#) last year a new “Statement on the Purpose of a Corporation,” signed by 181 CEOs representing the largest US companies. One of the five purposes included in the statement is a commitment to “protect the environment by embracing sustainable practices across our businesses.”

Blackrock and other like-minded companies foresee a greater push toward sustainability from governments. Fink wrote: “a company cannot achieve long-term profits without embracing purpose and considering the needs of a broad range of stakeholders.” They also expect heightened attention on sustainability from the investment community, so have put it at the forefront of their investment strategy. Corporations that exemplify sustainability best practices and those that supply the technologies to do so (e.g., renewable energy providers) are likely to earn a premium valuation, they seem to believe.

Microsoft and Blackrock are examples of how climate change is shifting the allocation of capital for direct business investments and in the financial markets:

(1) *Microsoft going negative*. Microsoft plans to go “carbon negative” by 2030 and to invest \$1 billion into a climate innovation fund, Smith announced in his blog. By 2050, “Microsoft will remove from the environment all the carbon the company has emitted either directly or by electrical consumption since it was founded in 1975.” That includes its scope 1, 2, and 3 emissions all along the supply chain.

(2) *Blackrock’s sustainable strategy*. Blackrock, with a massive \$7 trillion in assets under management, has committed to clients to put sustainability at the center of its investment approach, including exiting investments that pose a high sustainability risk (like thermal coal producers) and launching new investment products that screen for fossil fuels. Blackrock is also requiring that companies in its portfolio disclose its risks and plans for dealing with climate change.

We are all climatologists now.

CALENDARS

US: **Wed:** Advance Merchandise Trade Balance -\$65.5b, Pending Home Sales, MBA Mortgage Applications, DOE Crude Oil Inventories, FOMC Rate Decision 1.63% (1.50%-1.75%), Rate on Excess Reserves 1.55%, Powell. **Thurs:** Real GDP & PCE 2.2%/2.2%, GDP Price Index & Core PCED 1.8%/1.6%, Jobless Claims 214k, EIA Natural Gas Storage. (DailyFX estimates)

Global: **Wed:** Germany Gfk Consumer Confidence 9.6, Japan Consumer Confidence 39.5. **Thurs:** Eurozone Economic Confidence 101.8, Eurozone Unemployment Rate 7.5%, Germany Unemployment Change & Unemployment Claims Rate 5k./5.0%, Germany CPI -0.6%/m/m/1.7%/y/y, Germany Sovereign Debt to be Rated by Moody’s, UK Gfk Consumer Confidence -9, Japan Industrial Production 0.7%/m/m/-3.6%/y/, Japan Retail Trade 1.2%/m/m/-1.7%/y/y, Japan Jobless Rate 2.3%, China M-PMI & NM-PMI 50.0/53.0, BOE Bank Rate 0.75%, BOE Asset Purchase Target £435b, Carney, Beaudry, Amamiya. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Q4 Earnings Season Monitor ([link](#)): With over 20% of S&P 500 companies finished reporting revenues and earnings for Q4-2019, revenues and earnings are beating the consensus forecasts by 1.1% and 4.6%, respectively. Those are in line with their respective 1.1% and 4.3% beats at the same point in Q3, but the percentages of companies showing a positive earnings surprise is lower. On a positive note, y/y earnings growth is exceeding revenue growth for the first time since Q4-2018. Of the 104 companies in the S&P 500 that have reported through mid-day Tuesday, 69% exceeded industry analysts' earnings estimates. Collectively, the small sample of reporters has a y/y earnings gain of 4.8%. On the revenue side, 65% of companies beat their Q4 sales estimates so far, with results 1.7% higher than a year earlier. Overall Q4 earnings growth results are positive y/y for 61% of companies, and revenues have risen y/y for 70%. 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

Consumer Confidence ([link](#)): Confidence improved in January for the third straight month, climbing from 126.1 in October to a five-month high of 131.6 this month—driven by a more positive assessment of both current and future job prospects. Both the present situation (to 175.3 from 170.5) and expectations (102.5 from 100.0) components rose to five-month highs this month. Lynn Franco, senior director of economic indicators at The Conference Board, noted: “Optimism about the labor market should continue to support confidence in the short-term and, as a result, consumers will continue driving growth and prevent the economy from slowing in early 2020.” The consumers' assessment of the current job market was upbeat this month, with the percentage saying jobs are plentiful (to 49.0% from 46.5%) near its cyclical high and those saying jobs are hard to get (11.6 from 13.0) bouncing around cyclical lows. As for the job outlook six months from now, the percentage of respondents expecting more jobs (17.2 from 15.5) once again outpaced those expecting fewer jobs (13.4 from 13.9), with the spread widening; a wide majority (69.4%) expects labor conditions to remain the same. Meanwhile, consumers' appraisal of business conditions improved again this month, with the percentage of respondents saying business conditions are good (40.8% from 39.0%) moving higher, while the percentage claiming times are bad (10.4 from 11.0) moving lower. The percentage of those expecting conditions to be better (18.8 from 18.7) six months from now

was roughly double those expecting conditions to worsen (8.4 from 8.8)—though the wide majority (72.8%) expects conditions to stay the same.

Durable Goods Orders & Shipments ([link](#)): Core capital goods orders remain volatile around its record high, while core capital goods shipments posted only one gain during the final seven months of last year, though remains at a relatively high level. Nondefense capital goods orders ex aircraft (a proxy for future business investment) sank 0.9% in December, following a two-month gain of 1.1% and a two-month loss of 1.3%. Meanwhile, core capital goods shipments (used in calculating GDP) has contracted 1.6% since reaching a new record high in May, suggesting business investment will be drag on real GDP growth for the third consecutive quarter, when Q4 data are released tomorrow. The yearly growth rates for both core capital goods orders and shipments are hovering around zero, down from recent peaks of 13.2% and 10.2% y/y, respectively, during September 2017 and November 2017. Total durable goods orders rebounded 2.4% in December from November's 3.1% drop, led by a 7.6% surge in transportations orders following November's 8.3% drop. Orders for defense aircraft and parts soared 168.3% last month, offsetting a 74.7% plunge in demand for civilian aircraft. (Boeing's website reported it received only three commercial aircraft orders last month—usually a strong month for orders—down from 63 in November.) Excluding transportation, durable goods orders contracted three of the final months of 2019, by a total of 0.9%.

Regional M-PMIs ([link](#)): Five Fed districts now have reported on manufacturing activity for January—Philadelphia, New York, Dallas, Kansas City, and Richmond—and show growth picked up this month. Thanks to a sharp acceleration in the Richmond and Philly Fed regions, the composite (to 8.1 from -1.5) index posted its best performance since last March. By region: Richmond (20.0 from -5.0) recorded its strongest growth in 16 months, Philadelphia (17.0 from 2.4) the best in eight months. Meanwhile, growth in the Kansas City (-1.0 from -5.0) area continued to contract, though at a slower pace, while Dallas' (-0.2 from -3.2) looked poised to expand after contracting for four months. New York's (4.8 from 3.3) growth remained stalled at a sluggish rate. The new orders index (10.7 from -2.3) shows billings this month expanded at the best pace since November 2018, led by strong growth in the Philly (18.2 from 11.1), Dallas (17.6 from 1.6), and Richmond (13.0 from -13.0) regions; New York (6.6 from 1.7) orders accelerated at a faster rate, while Kansas City's (-2.0 from -13.0) contracted at a slower pace. Employment (10.8 from 6.7) data show manufacturers hired at a slightly faster pace this month, with Richmond (20.0 from 7.0) and Philadelphia (19.3 from 16.8) factories hiring at double the pace of New York's (9.0 from 10.4). Meanwhile, Kansas City (4.0 from -7.0) manufacturers added to payrolls for the first time since last June, while Dallas' (1.9 from 6.2)

showed little growth.

Regional Manufacturing Price Indexes ([link](#)): In January, the average of the New York, Philadelphia, Richmond, Kansas City, and Dallas regions prices-paid (to 20.6 from 15.2) measures appears to have found a bottom, climbing to a six-month high this month—though only the Kansas City region is showing a clear acceleration in input prices. The New York and Philadelphia prices-paid measures appear to have bottomed, while price pressures in both the Dallas and Richmond regions are still easing. The average of the prices-received measures is holding around recent lows, with no signs of an acceleration in prices in any of the five regions. (Note: Richmond prices are not diffusion indexes but rather average annualized inflation rates.)

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