Yardeni Research

MORNING BRIEFING
February 6, 2020

Social Insurance Is Inflating

See the pdf and the collection of the individual charts linked below.

(1) Comparing and contrasting. (2) Ford vs Tesla. (3) Insurance brokers vs insurance companies. (4) Rising premiums help the top line. (5) Low interest rates are a drag. (6) Social inflation translation: juries on the war path and attorneys on the hunt. (7) Anti-solar panels generate electricity while the moon shines.

Autos: Tesla vs the Rest. Tesla and Ford Motor have two shockingly different stocks that are just begging for comparison. Before a bout of profit-taking hit Wednesday, Tesla's shares had risen an astounding 112.1% ytd through Tuesday's close, while Ford's shares had fallen 1.3%. Tesla's Q4 earnings report surprised and delighted investors, while Ford's disappointed. Likewise, the forward P/E on Tesla's stock was 105.5, while Ford's was 7.2.

Ford's and GM's shares are part of the S&P 500 Automobile Manufacturers stock price index, which has fallen 4.0% ytd and has gone nowhere for much of the past five years (*Fig. 1*). In fact, the industry has the lowest P/E of all the S&P 500 industries we track.

Insurance: Brokers vs the Rest. While not as dramatic, another interesting comparison can be made between the S&P 500 Insurance Brokers industry and the industries filled with insurance companies. The folks selling insurance have had a great few years, while some of the companies underwriting the risk are having a tougher time. Let's take a look at what's driving the diverging fortunes of these insurance-related industries:

(1) *Brokers' stocks benefitting.* The S&P 500 Insurance Brokers industry's stock price index has risen 114.2% over the past five years, and it stands at an all-time high (*Fig. 2*). The industry also sports a 21.0 forward P/E, up from 16.9 a year ago (*Fig. 3*). That's far better than the S&P 500's five-year return of 61.5%.

Meanwhile, the stock price indexes of the other major insurance industries have lagged significantly behind. Consider the stock price performance of the following insurance industries

over the past five years: Property & Casualty Insurance (72.4%), Life & Health Insurance (23.6), and Multi-Line Insurance (17.3) (*Fig. 4*, *Fig. 5*, and *Fig. 6*).

These industries all have much lower forward earnings multiples than the Insurance Brokers industry and the S&P 500 in general: S&P 500 (18.5), Life & Health Insurance (8.4), Multi-Line Insurance (10.4), and Property & Casualty Insurance (14.3) (*Fig. 7*, *Fig. 8*, and *Fig. 9*).

(2) *Rising prices don't lift all boats.* In general, the price of insurance is rising and that's great news for the brokers, who work on commission. Higher prices have helped insurance companies, just not enough in some cases, to offset lower interest rates on investment portfolios and higher costs. We took a look at Hartford Financial Services Group's Q4 earnings, which were reported on Monday, to gain some insight into these issues.

Hartford reported core Q4 EPS of $1.43, beating the analysts' average estimate by 11 cents. The result was almost twice the 78 cents EPS reported in Q4 2018, which was hurt by losses from California's wildfires. Harford also boosted its dividend by 8%, bringing its quarterly payout to $0.325 per common share.

Despite the strong quarter, the shares slid 4.0% after the report, presumably because of the company's 2020 forecast. Hartford doesn't offer an EPS outlook, but it does give its expectation for combined ratios, which are the company's expected losses plus expected expenses divided by its expected earned premiums. Combined ratios below 100 imply the company is making money on its insurance business, and those above 100 indicate the company is losing money on its insurance policies.

Hartford's personal lines division's combined ratio is forecast to jump from 95.0 last year to 98.5-100.5 in 2020, while its commercial lines combined ratio is expected to fall slightly from 97.9 last year to 95.5-97.5 in 2020, a 2/3 company press release stated. The net income margin in its group benefits unit is also expected to narrow from 9.8% last year to 6.25%-7.25% in 2020.

Analysts are expecting Hartford to earn $5.46 a share in 2020, down from $5.65 a share in 2019. This year's estimate was trimmed by a nickel over the past seven days.

(3) *Offsetting falling yields*. In the quarterly conference call, CEO Christopher Swift told investors that he expected Hartford to continue to increase prices for the next 18-24 months.

The company and industry need to raise prices to get to an “adequate return for the risk” it takes.

Higher rates will help the company offset two elements that are pushing down returns: low interest rates and social inflation. With the 10-year Treasury below 1.7%, all insurance companies—and investors in general—are having difficulty finding investments that offer high yields without requiring them to take on too much credit risk (*Fig. 10* and *Fig. 11*).

Hartford’s Q4 annualized investment yield before taxes is 4.0%, and the yield shrinks to 3.8% if limited partnership returns—from investments in hedge funds and private equity—are excluded. Insurance companies have long used the returns on their investment portfolios to supplement the returns on their insurance business.

Swift addressed the interest-rate environment in the earnings conference call: “Currently, our portfolio continues to perform well, but it is clear that the interest rate environment is becoming more challenging. This will impact the investment returns on new cash flows, reinvestment rates and our overall portfolio yield. The implication is that net investment income will likely become a headwind to core earnings growth, requiring higher levels of underwriting income to support earnings and ROE. This, coupled with loss cost trends, leads me to believe the firming cycle we are experiencing will likely continue for the next 18 to 24 months.”

(4) *Social inflation.* The insurance industry is full of jargon including the term “social inflation.” It refers to the “rising costs of insurance claims resulting from things like increasing litigation, broader definitions of liability, more plaintiff-friendly legal decisions, and larger compensatory jury awards,” a 1/3 article in Insurance Business explained.

The increase in social inflation can be attributed to the anti-corporate sentiment that has its roots in the financial crisis, according to Mike Hudzik, head of casualty underwriting in the US and Canada at Swiss Re, who’s quoted in the article. The greater division of wealth within society since the crisis has led to the feeling that someone needs to pay when there has been damage or injury.

Increasing litigation—driven by rising advertising by plaintiffs’ attorneys and litigation funding—has also caused social inflation, he said. Social inflation has been felt the most in “commercial auto (insurance), medical malpractice, in certain professional lines like directors’ & officers’,

and in the umbrella and excess liability arena—especially when those policies are for large corporate risks because that's where the largest limits tend to be offered," the article explained.

Hartford, like other insurance companies, has experienced social inflation—it was mentioned eight times during the company's conference call—and has adjusted its pricing and reserves accordingly. In the excess area, the company has seen "a little bit more severity, a little bit more social inflation than maybe we expected a year ago. And that's also driving our price increases in the marketplace," said Hartford President Douglas Elliot. In fact, when CEO Swift was discussing why the firm will need to raise pricing over the next two years he said: "[G]iven where we're starting from and given some of the pressure on social inflation and liability cost, commercial auto in general, it's going to take two years to get back to target margins."

As with most businesses, the key will be whether or not insurance companies can successfully pass through high enough prices to offset their rising costs. The market reacted much more favorably to Wednesday's Q4 earnings releases from Chubb and Allstate, as their stocks rose 7.2% and 3.9%, respectively. Chubb's CEO Evan Greenberg, while not giving a 2020 earnings forecast, did say during the company's Q4 earnings conference call that he thought the ability to raise prices would continue "for some time." The momentum toward higher prices had "picked up" and was "spreading," he added.

(5) *Multi-line membership.* Hartford is a member of the S&P Multi-line Insurance industry, along with American International Group, Assurant, and Loews. The industry is expected to have minimal revenue growth of 0.4% this year and moderate earnings growth of 6.0% (*Fig. 12* and *Fig. 13*). The industry's forward P/E since the recovery from the financial recession has bounced around 10 and is currently 10.4 (*Fig. 14*). Prior to the recession, the industry's earnings multiple ranged anywhere from a floor of 10 to a ceiling of 25.

Disruptive Technologies: Making Electricity Day *and* Night. Fans of electric cars have had a few good weeks. The UK moved up its target to ban the sale of gas, diesel, and hybrid cars by five years to 2035. The move is part of the country's plan to reduce UK emissions to net zero by 2050, a 2/4 *FT* article reported. As we noted above, Tesla stock continued to rally in the wake of last week's strong Q4 earnings report. The stock's price climbed briefly, to nearly $969, on Tuesday before profit-taking brought the stock back down to $735 by Wednesday's close.

A world filled with electric cars will mean greater demand for electricity. One way to meet that demand will be by building out more solar panels to capture the sun's energy. The problem with solar energy has always been its inability to generate electricity at night or when the sun's not shining. To address this problem, scientists at the University of California, Davis have created the "anti-solar panel," which generates electricity at night.

A 2/2 article in *Inverse* explains their work. Solar panels collect the sun's light and turns it into energy. These new thermal panels collect the earth's heat at night as it is released and heads toward space, which is colder than the earth. They turn the heat into electricity. The panels can reportedly generate about a quarter of the electricity at night that a solar panel generates during the day.

The scientists at UC-Davis are exploring the use of mercury alloys to capture the heat in the thermoradiative cells. The brains at Stanford University are also exploring anti-solar panels, according to an IEEE 9/22/19 blog post. In their current form, they could be used in areas that are off the electrical grid. But years from now, as the science improves, who knows?

CALENDARS

US: Thurs: Nonfarm Productivity & Unit Labor Costs 1.5%/1.0%, Jobless Claims 215k, EIA Natural Gas Storage, Kaplan, Quarles. **Fri:** Payroll Employment Total, Private, and Manufacturing 160k/150l/-4k, Average Hourly Earnings 0.3%m/m/3.0%y/y, Unemployment Rate 3.5%, Consumer Credit $15.0b, Baker-Hughes Rig Count, Fed Releases Semi-Annual Monetary Policy Report to Congress. (DailyFX estimates)

Global: Thurs: Germany Manufacturing Orders 0.7%m/m/-6.6%y/y, Japan Household Spending -1.6% y/y, China Trade Balance $36.8b, Italy Sovereign Debt to be rated by Fitch, ECB Publishes Economic Bulletin, RBA Statement on Monetary Policy, Lagarde, Lowe. **Fri:** Germany Industrial Production -0.2%m/m/-3.7%y/y, Germany Trade Balance €15.0b, Canada Employment Report, Japan Leading & Coincident Indicators 91.3/94.7Mexico CPI 3.28% y/y. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) dropped further below 3.00 this week, after falling below last week for the first time since 10/22/19. The BBR declined

for the second week, to 2.49, after climbing from 3.10 to 3.32 the prior two weeks. There continues to be wide swings between bullish sentiment and the correction count, though bearish sentiment has moved out of its very narrow range in recent weeks. Bullish sentiment sank 11.8ppts the past two weeks, to 47.6%, after rising 4.3ppts (to 59.4% from 55.1%) the prior two weeks, while the correction count rose 10.6ppts the past two weeks, to 33.3%, after falling 4.4ppts (22.7%, 27.1%) the previous two weeks. Bearish sentiment climbed 1.3ppts to 19.1% the past three weeks—its highest percentage since 4/16/19. The AAII Ratio dropped to 46.5% last week after increasing from 52.5% to 64.8% the prior two weeks. Bullish sentiment fell to 32.0% after rising from 33.1% to 45.6% the prior two weeks, while bearish sentiment rose to 36.9% after falling from 29.9% to 24.8% the previous two weeks.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): Consensus S&P 500 forward earnings rose w/w to another record high, but forward revenues was down for a second week to 0.2% below its record in mid-January. Analysts expect forward revenues growth of 4.9% and forward earnings growth of 9.0%. The revenues measure is up 0.1ppt w/w, but earnings dropped 0.2ppt. Forward revenues growth is 0.1ppt above its 41-month low a week earlier and 1.4ppt below its seven-year high of 6.3% in February 2018. Forward earnings growth is down 7.9ppts 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 4.9% in 2020. They're calling for earnings growth to slow sharply from 24.0% in 2018 to 1.4% in 2019 before improving to 8.6% 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 0.3ppt y/y from 11.8% in 2018 to 11.5% in 2019 before improving to 11.9% in 2020. The S&P 500's forward P/E fell 0.3pt w/w to 18.5 from an 18-year high of 18.8. 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 declined 0.03pt w/w to 2.23 from a record high of 2.26. 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 six of the 11 S&P 500 sectors last week, and forward earnings was higher for four. Three sectors had both measures rise w/w: Consumer Staples, Real Estate, and Tech. Forward revenues and earnings are at or around record highs for 3/11 sectors: Consumer Discretionary, Health Care, 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 (22.0%, down from 23.0%), Financials (18.1, down from 19.2), Real Estate (15.7, down from 17.0), Communication Services (14.8, down from 15.4), Utilities (13.3, record high), S&P 500 (12.0, down from 12.4), Health Care (10.6, down from 11.2), Industrials (10.2, down from its record high of 10.5% in mid-December), Materials (10.0, down from 11.6), Consumer Staples (7.5, down from 7.7), Consumer Discretionary (7.4, down from 8.3), and Energy (6.1, down from 8.0).

S&P 500 Q4 Earnings Season Monitor (*link*): With nearly 55% of S&P 500 companies finished reporting revenues and earnings for Q4-2019, revenues and earnings are beating the consensus forecasts by 0.5% and 5.1%, respectively. That compares to their respective 1.1% and 4.8% beats at the same point in Q3. The percentage of companies showing a positive revenue surprise in Q4 is higher than during Q3, but the percentage of positive earnings surprises is lower. On a positive note, y/y earnings growth, at 3.3%, is exceeding y/y revenue growth, at just 1.2%, for the first time since Q4-2018. Of the 273 companies in the S&P 500 that have reported through mid-day Wednesday, 71% exceeded industry analysts' earnings estimates. Collectively, the small sample of reporters has a y/y earnings gain of 3.3%. On the revenue side, 64% of companies beat their Q4 sales estimates so far, with results 1.2% higher than a year earlier. Overall Q4 earnings growth results are positive y/y for 66% of companies, and revenues have risen y/y for 69%. These figures will continue to change 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

ADP Employment (*link*): Private industries blew past forecasts, adding 291,000 to payrolls at the start of 2020—the biggest monthly gain since May 2015—with unseasonably warm weather likely overstating growth last month. Mark Zandi, chief economist of Moody's Analytics, noted: "Abstracting from the vagaries of the data underlying job growth is close to 125,000 per month, which is consistent with low and stable unemployment." There were negligible downward revisions to both December (to 199,000 from 202,000) and November (121,000 from 124,000) payrolls, for a net loss of only 6,000. Job creation in January was across companies of all sizes, with medium-sized companies once again keeping the top spot. Service-providing industries posted their largest gain since February 2016, adding 237,000 to payrolls, with leisure & hospitality (96,000) posting the biggest gain, followed by professional & business services (49,000), health care & social services (47,000), and education (24,000). Goods-producing payrolls were up big the past two months, adding 54,000 jobs last month, building on December's 21,000 gain; it had lost a total of 5,000 jobs the prior three months. Construction companies added 82,000 jobs over the two months through January, while factories hired 10,000 in January—reversing December's decline. Natural resources & mining companies shrank payrolls for the 10th straight month, by a total of 37,000. Medium-sized (128,000) companies once again added the most jobs—recording its best pace since last April, while small (94,000) companies hired at their best pace since July 2018. In the meantime, large (69,000) companies remained in the bottom spot, though also posted a solid gain.

Merchandise Trade (*link*): The real merchandise trade deficit in December widened to -$80.5 billion, after narrowing five of the prior six months, from -$86.8 billion in April to -$76.2 billion in November. The real deficit averaged -$78.7 billion per month during Q4, considerably below Q3's -$85.3 billion, with trade contributing to real GDP growth for the first time since Q1-2019. In December, real exports (1.0%) expanded at a slower pace than real imports (2.6), with the latter rising for the first time since August. Real exports were boosted by a 4.0% increase in industrial supplies & materials, while gains in exports of food, feeds & beverages (0.7) and capital goods ex autos (0.3) were negligible. Offsetting these gains was a sharp 7.5% drop in auto exports, with consumer goods ex autos losing 3.5%. Industrial materials & supplies (7.5) also gave the biggest boost to real imports in December, with consumer goods ex autos (1.3) and capital goods ex autos (1.1) likewise in the plus column. Taking a look at our trade deficit with China (in nominal terms), it has narrowed steadily from -$419.5 billion at the end of 2018 to -$345.6 billion by the end of 2019. Over this comparable period, US exports to China fell by

$13.5 billion—from $120.1 billion to 106.6 billion—while US imports from China fell at more than six times that pace, from $539.7 billion to $452.2 billion.

GLOBAL ECONOMIC INDICATORS

Global Composite PMIs (*link*): Global economic growth accelerated at the start of 2020 at its best pace in 10 months, improving for the third consecutive month. The JP Morgan Global Composite Output Index (C-PMI) climbed to 52.2 at the start of 2020 after falling fairly steadily from a peak of 54.8 in February 2018 to a 44-month low of 50.9 during October 2019. The Global PMI for the service sector (to 52.7 from 52.0) continued to outperform that for the manufacturing sector (50.4 from 50.1)—with both posting their best performances since April 2019. (The manufacturing sector had contracted from May through October of last year.) Although the trend in international trade flows remained a drag on growth, new export business moved closer to stabilization. The C-PMI for the emerging economies edged up to 52.3 in January after easing from an eight-month high of 52.7 in November to 52.2 in December. Meanwhile, the C-PMI for the developed ones accelerated to a 10-month high of 52.1 in January after falling to a recent low of 50.3 in October. C-PMIs for January show the upturn in economic activity was fairly broad-based: The C-PMIs for India (to 56.3 from 53.7), Ireland (54.7 from 53.0), the US (53.3 from 52.7), the UK (53.3 from 49.3), Russia (52.6 from 51.8), Brazil (52.2 from 50.9), China (51.9 from 52.6), Spain (51.5 from 52.7), and the overall Eurozone (51.3 from 50.9)—including Germany (51.2 from 50.2) and France (51.1 from 52.0)—are showing solid growth. Meanwhile, Italy (50.4 from 49.3), along with Japan (50.1 from 48.6) and Australia (50.2 from 49.6), saw modest growth following contractions before the turn of the year—though the UK saw the most impressive turnaround.

Global Non-Manufacturing PMIs (*link*): January saw the rate of growth in the global service economy expand at a nine-month high, while business optimism rose to its highest level in seven months—with confidence improving across the business, consumer, and financial services sub-industries. JP Morgan's Global NM-PMI increased for the third month to 52.7 in January from 51.0 in October—which was the weakest reading since February 2016—as the NM-PMI for developed economies advanced from 50.7 to a 10-month high of 52.8 over the three-month period. In the meantime, the NM-PMI for emerging (to 52.6 from 52.3) economies edged higher after edging lower in December. NM-PMIs show service-sector business growth expanded in 13 out of the 14 nations covered last month, with Kazakhstan (45.0) the one outlier. Here's a look at growth in the remaining 13 economies, from highest to lowest: Ireland (56.9), India (55.5), Germany (54.2), Russia (54.1), the US (53.4), Brazil (52.7), Sweden

(52.5), Spain (52.3), China (51.8), Italy (51.4), France (51.0), Japan (51.0), and Australia (50.6).

US Non-Manufacturing PMIs (*link*): Both the ISM and IHS Markit surveys show non-manufacturing activity continued to accelerate heading into 2020, with the former expanding at its fastest pace in five months in January and the latter in 10 months. ISM's NM-PMI is on an upswing, climbing for the third time in four months, to 55.5 in January, from 53.5 in September—which was the lowest reading since August 2016. (January's reading is consistent with a 2.4% increase in real GDP growth on an annualized basis.) The four components of the NM-PMI were mixed, with business activity once gain the standout, jumping to 60.9 in January from 57.0 in November and 52.3 in October; the new orders (to 56.2 from 55.3) measure improved slightly, fluctuating in a flat trend around 55.7 the past five months. The remaining two components of the NM-PMI, employment (53.1 from 54.8) and supplier deliveries (51.7 from 52.5) both moved lower, with the former dropping to a four-month low. IHS Markit's NM-PMI improved for the third month, climbing from 50.6 in October to 53.4 in January, with growth below Q1-2019's pace of 55.2, though headed in the right direction. According to the report, January's reading shows a solid expansion in output at the start of 2020, supported by greater marketing activity and a sustained increase in new business. However, foreign demand remains challenging and is weighing on overall orders.

Eurozone Retail Sales (*link*): Retail sales plunged in December after rebounding to a new record high in November. Sales sank 1.6% at the end of last year, following a 0.8% gain in November, which had more than reversed declines the prior couple of months. All of the three major sales categories contracted in December—with nonfood products ex fuel (-1.6%), automotive fuel (-1.4), and food, drinks & tobacco (-1.4) all falling at a comparable pace. Meanwhile, only spending on nonfood products ex fuel (3.6% y/y) was in the plus column compared to a year ago, with spending on automotive fuels, and food, drinks & tobacco, down 3.5% and 0.7% y/y, respectively. Data are available for three of the top four Eurozone economies—Germany (-3.3), France (-1.4), and Spain (-1.3)—and all were in the red in December, with Germany posting the largest decline among the Eurozone members. The yearly growth rate in sales for the overall Eurozone (1.3) slowed to a 12-month low, with Germany's (0.8) nearing negative territory and Spain's (1.1) slowing from its recent peak of 3.6% to its weakest pace since the end of 2018; sales in France (2.5) continue to grow at a fairly steady pace.

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