Yardeni Research

MORNING BRIEFING
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Small World

Check out the accompanying audio excerpts and chart collection.

(1) China's quarantine disrupts global supply chains. (2) Chinese factory workers are staying home. (3) Coronavirus hits Apple's demand for phones and supplies of parts. (4) Some auto companies facing parts shortages too. (5) Flying parts on jets. (6) At new highs, stocks still taking it all in stride. (7) Global MSCI forward earnings and revenue estimates holding up. (8) However, industry analysts are starting to cut their S&P 500 earnings estimates for Q1-Q3. (9) Musk's hyperloop getting bored toward reality in Vegas.

Strategy I: Broken Supply Chains. "It's a Small World After All" is played every hour of the day at Disney theme parks spanning the world. Some speculate that it's the world's most played song. Composed by Disney staff writers Richard and Robert Sherman in the wake of the Cuban Missile Crisis, the tune accompanied a ride designed for the 1964-65 New York World's Fair before becoming a staple at Disney's parks.

The coronavirus reminds us just how small the world is. Even as the infection has been largely contained to China, the business ramifications have rippled across the world. China is both a major consumer of goods and services as well as a key manufacturer of finished goods and parts exported across the globe. China represents 35% of global manufacturing output, and it's the world's largest exporter of goods.

In 2017, China exported $2.2 trillion of goods, accounting for 11.4% of global goods exported and imported, a June 2019 McKinsey Global Institute report states. China accounts for 40% of global exports in textiles and apparel and 26% in furniture. The country makes 80% of the world's smartphones and tablets, and it exports 55% of the world's handsets and computers, according to UBS research cited in a 2/17 *LA Times* article.

To stop the coronavirus outbreak, nearly 60 million people in Wuhan and surrounding Hubei province are under quarantine. Workers who visited family there over the Lunar New Year holiday can't return home to work. And travelers returning home from elsewhere in China are being asked to stay isolated at home for 14 days before going back to work.

The upshot is a massive labor shortage. In a trade group survey of 109 companies with manufacturing operations in Shanghai and nearby areas that was released Monday, 78% said they don't have sufficient staff to run a full production line, a 2/17 *WSJ* article reported. Companies are required to track workers' movements, provide masks, and record temperatures, a 2/17 *NYT* article reported.

With Chinese manufacturing and transportation of goods severely limited, it should come as no surprise that US companies are starting to acknowledge that the supplies of materials and goods sourced from China could start to run short in the days and weeks ahead. Here's Jackie's rundown of some of the supply-chain announcements made over the past week:

(1) *Apple's dubious first.* Apple was the first company to warn that Q1 revenue would miss expectations because of coronavirus ramifications. The company suffered from production bottlenecks inside China and a drop in Chinese demand for Apple products. Many retailers of Apple products in China, including Apple stores, are closed for the time being or have limited operating hours.

Apple's contract manufacturers in China have been increasing production "more slowly" than Apple anticipated, resulting in iPhone shortages that are hurting worldwide sales temporarily. The company didn't come out with a new Q1 sales estimate but said it would give additional information during its April earnings call.

"As the coronavirus spread, travel restrictions made it difficult for its largest manufacturing partner, Foxconn Technology Co., to secure workers for its factories, according to people familiar with its supply chain. Some plants have resumed limited production but are uncertain when they will return to full capacity, one of these people said. Foxconn is aiming to resume 50% of mainland China production by the end of February, and 80% in mid-March, another person familiar with the matter said," a 2/17 *WSJ* article reported.

(2) *Facebook's Oculus on backorder.* The coronavirus's impact on manufacturing led Facebook to stop accepting new orders for its Oculus Quest. The device had been on backorder into March, when in early February the company announced that the device was completely unavailable in some countries, according to a 2/6 article in UPLOAD.

According to a Facebook spokesperson: “Oculus Quest has been selling out in some regions due to high demand. That said, like other companies we’re expecting some additional impact to our hardware production due to the Coronavirus. … We are working to restore availability as soon as possible.”

(3) *Autos looking for parts.* Numerous auto manufacturers have found themselves vulnerable to manufacturing closures in China. Fiat Chrysler Automobiles said last week that it moved up a previously planned shutdown of its Serbian plant because it needed parts from China. Hyundai Motor and Renault SA temporarily idled some assembly lines in South Korea.

Volkswagen, which operates 33 plants in China, said on Monday that production would not start up at some of its Chinese plants for another week. The company blamed “national supply chain and logistics challenges as well as limited travel options for production employees,” a 2/17 *WSJ* article reported.

General Motors said it began on Saturday to gradually reopen plants in China. However, union officials at two of the company’s major US plants warned that certain parts were running low and could result in production outages, a 2/14 *WSJ* article reported. The company doesn’t anticipate any impact on production for now.

Toyota’s Chinese plants are also slowly coming back online. “Toyota said that its four assembly plants had operated on two work shifts a day before the virus spread. But it planned to reopen three of them on Monday and Tuesday with just one shift and leave closed for now the fourth and smallest,” the 2/17 *NYT* article reported.

(4) *Parts flying first class.* Some companies are flying needed parts to their factories, because even if plants are up and running, shipping goods via normal channels is a challenge. Companies are running short of packing material, and fewer flights and ships are going to and from China. The 2/17 *LA Times* article noted that the number of cargo containers received at the ports of Los Angeles and Long Beach could drop by one-fifth as a result of coronavirus effects.

GM has arranged for parts to be flown by chartered jet from China when parts are available, the 2/14 *WSJ* article reported. Likewise, “Jaguar Land Rover is flying components out of China in suitcases as it races to prevent its UK plants from closing by the end of this month,” a 2/18

FT article noted. In the interest of continued production, cars temporarily are being produced with just one key fob instead of two.

Samsung also has been using airplanes to transport electronic components from China to its plants in Vietnam, because the Vietnamese government is restricting the daily transport volume from China to Vietnam over land routes, a 2/17 *FT* article reported. “Hanoi has imposed a quarantine on truck drivers returning from China, making some reluctant to drive there for fear of losing wages,” the article added.

(5) *Soft goods industries vulnerable too.* Toy company Hasbro has said China is responsible for about two-thirds of its global sourcing, while PVH—owner of the Calvin Klein and Tommy Hilfiger brands—said 20% of its global sourcing comes from China, a 2/19 MarketWatch article noted. It cited Hasbro CFO Deborah Thomas as saying on the company’s conference call: “The biggest unknown right now is how quickly the manufacturing factories can get their production ramp back up.”

US stores’ shelves are stocked right now, as retailers ordered ahead of the Chinese Lunar New Year and ahead of potential tariff issues. Spring and summer merchandise has already shipped. “That being said, our sources indicate that out-of-stocks at retail for replenishment product could start within 60-to-90 days if disruptions continue beyond the next few weeks, with more significant inventory issues in seasonal product possibly by midsummer if disruptions stretch longer,” wrote Wells Fargo analysts, according to a 2/12 MarketWatch article.

The report noted that big-box retailers, such as Target and Walmart, often have shorter lead times for replenishing their inventories. However, Walmart executives last week said the impact on its supply chain, though uncertain, would likely be more muted than for other companies, a 2/18 *NYT* article reported. Two-thirds of the products Walmart sells, primarily food, is sourced from the US.

(6) *Market resilient … so far.* Despite the growing knots in manufacturing supply lines, the S&P 500 remains up ytd through Tuesday’s close. Here’s the performance derby for the S&P 500 sectors: Information Technology (10.6%), Utilities (9.4), Real Estate (7.9), Consumer Discretionary (5.8), Communication Services (5.8), S&P 500 (4.3), Industrials (3.1), Consumer Staples (2.4), Health Care (1.4), Financials (0.0), Materials (-1.7), and Energy (-11.0) (*Fig. 1*).

Here's the performance derby since 1/23, the day before the virus hit the headlines: Real Estate (4.2%), Consumer Discretionary (3.9), Utilities (3.8), Information Technology (3.7), S&P 500 (1.3), Communication Services (0.9), Consumer Staples (0.7), Materials (0.3), Industrials (0.1), Financials (0.1), Health Care (-0.7), and Energy (-6.5) (*Fig. 2* and *Table*).

From 1/23 through 2/18, here are the 10 best-performing S&P 500 industries: Internet & Direct Marketing Retail (12.6%), Systems Software (11.4), Metal & Glass Containers (8.6), Specialized REITS (7.1), Insurance Brokers (7.1), Industrial Gases (7.0), Property & Casualty Insurance (6.5), Health Care Distributors (6.2), Oil & Gas Drilling (5.6), and Application Software (5.0).

From 1/23 through 2/18, here are the 10 worst-performing S&P 500 industries: Home Furnishings (-10.2%), Alternative Carriers (-10.2), Oil & Gas Exploration & Production (-8.6), Steel (-8.4), Electronic Manufacturing Services (-8.2), Food Distributors (-8.1), Leisure Products (-7.6), Auto Parts & Equipment (-7.5), Oil & Gas Refining & Marketing (-7.2), and Oil & Gas Equipment & Services (7.0).

Strategy II: Looking for—and Hiding from—Trouble. So far, the coronavirus hasn't infected analysts' forward revenues, earnings, and profit margins for the major MSCI stock price indexes—at least through the 2/13 week, i.e., roughly four weeks since the virus made headlines. Consider the following:

(1) *World revenues, earnings & margins.* Forward revenues for the US MSCI, Developed World ex-US MSCI, and Emerging Markets MSCI have been relatively flat in recent weeks (in local currencies) (*Fig. 3*). The same can be said, more or less, about these three broad indexes' forward earnings and forward profit margins (*Fig. 4* and *Fig. 5*).

(2) *World revenues and earnings growth rates.* During the 2/13 week, analysts' consensus expectations for the All-Country World MSCI's 2020 revenues and earnings growth rates remained relatively strong (and unfazed by the virus), at 4.3% and 8.9%, respectively (*Fig. 6* and *Fig. 7*).

(3) *US earnings.* For the US MSCI, however, the 2020 earnings growth rate consensus did fall sharply recently, from just over 10% during the 10/24/19 week to 7.8% (*Fig. 8*). The virus may be starting to weigh on consensus Q1-Q4 earnings estimates for the S&P 500 (*Fig. 9* and *Fig. 10*).

(4) *China's revenues and earnings.* Data available through the 2/13 week show that the 2020 consensus expected growth rates for the China MSCI revenues and earnings held up solidly at 9.1% and 11.8%, respectively (*Fig. 11* and *Fig. 12*).

(5) *Stay Home.* When the virus outbreak made the headlines in late January, Joe and I decided to Stay Home like the millions of people quarantined in China. We terminated our Go Global excursion, which started in early October of last year as we searched for cheaper valuations in overseas stock markets. Lots of other investors did the same, sending the ratio of the US MSCI stock price index to the All Country World ex-US stock price index soaring to new record highs (*Fig. 13* and *Fig. 14*).

Disruptive Technology: Digging Hyperloops. Elon Musk's idea of a hyperloop is creeping slowly into reality. A tunnel in Las Vegas has been drilled. Missouri legislators have cleared the way toward making funding available. And regulators in Europe are working to make sure hyperloops in different countries can work together. Let's take a look:

(1) *Digging in Las Vegas.* Musk's Boring Company has completed drilling on one of two vehicular tunnels that will connect the two ends of the Las Vegas Convention Center. The $52.5 million project will use new Tesla vehicles to carry up to 16 passengers up to 155 miles per hour. Expected to be completed by January 2021, the tunnels will turn the 15-minute walk between two convention center buildings into a one-minute ride for up to 4,400 people per hour.

After the Convention Center tunnels, The Boring Company hopes to dig more Sin City tunnels to connect downtown Las Vegas, the Vegas Strip, and Las Vegas with Los Angeles, a 2/17 article in Interesting Engineering reported.

(2) *Missouri study gives thumbs up.* A panel tasked with studying the feasibility of a 250-mile hyperloop between three Missouri cities—St. Louis, Columbia, and Kansas City—has given the project its blessing. "The study found that the Hyperloop could save the state up to $500 million annually in increased productivity thanks to reduced travel times, reduced fuel use, and fewer road accidents on I-70," a 2/14 article in Jalopnik reported.

The project also got a boost from the Missouri House of Representatives, which passed a bill that would allow state transportation grants to fund the construction of hyperloops. The state aims to partially fund the $300 million-$500 million project with private equity if it's approved. The hyperloop would reduce travel time between St. Louis and Kansas City to 30 minutes, from four hours by car.

(3) *Europeans working together.* Europeans are looking to create standards so that hyperloops built in different countries can work together. The European Committee for Standardisation and the European Committee for Electrotechnical Standardisation have formed a committee dedicated to the standardization of hyperloops, a 2/18 article in Construction Europe reported. Standards could be created for the components, infrastructure, and communications used by any hyperloops built in Europe.

CALENDARS

US: Thurs: Leading Indicators 0.4%, Jobless Claims 210k, Philadelphia Fed Manufacturing Index 11, DOE Crude Oil Inventories, EIA Natural Gas Storage. **Fri:** Existing Home Sales 5.45mu, M-PMI & NM-PMI Flash Estimates 51.5/53.5, Baker-Hughes Rig Count, Brainard, Clarida, Mester, Bostic. (DailyFX estimates)

Global: Thurs: Eurozone Consumer Confidence -8.2, Germany Gfk Consumer Confidence 9.8, UK Retail Sales Including & Excluding Fuel 0.6%/0.5% y/y, Japan Headline, Core, and Core-Core CPI 0.7%/0.8%/0,.8% y/y, Account of ECB's Monetary Policy Meeting (January), Guindos. **Fri:** Eurozone Headline & Core CPI Flash Estimates 1.4%/1.1% y/y, Eurozone, Germany, and France C-PMI Flash Estimates 51.0/50.8/51.0, Eurozone, Germany, and France M-PMI Flash Estimates 47.5/44.8/50.8, Eurozone, Germany, and France NM-PMIs 52.3/53.9/51.3, UK C-PMI, M-PMI, and NM-PMI Flash Estimates 52.8/49./7/53.4, Canada Retail Sales 0.1%, Lane, Tenreyro. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) rose again this week, though remained below 3.00 for the fourth straight week. The BBR climbed for the second week this week, to 2.89, after falling from 3.32 to 2.49 the prior two weeks. The seesaw-movement between the bullish and correction camps continued: Over the past two weeks, bullish sentiment has rebounded 7.1ppts to 54.7%, after falling 11.8ppts (to 47.6% from 59.4%) the prior two weeks and rising 4.3ppts (to 59.4% from 55.1%) the two weeks before that. Meanwhile, the correction count sank 6.9ppts the past two weeks, to 26.4%, following a two-week surge of 10.6ppts (33.3 from 22.7) and a two-week loss of 4.4ppts (22.7 from 27.1).

Bearish sentiment slipped to 18.9% this week after climbing 1.4ppts to 19.2% the prior four weeks—which was the highest percentage since 4/16/19. The AAII Ratio advanced for the second week to 61.0% last week after dropping from 64.8% to 46.5% the previous week. Bullish sentiment increased from 32.0% to 41.3% over the two-week period, while bearish sentiment fell from 36.9% to 26.4%.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): Consensus S&P 500 forward revenues rose w/w to a record high, but forward earnings edged down 0.1% from its record. Analysts expect forward revenues growth of 4.9% and forward earnings growth of 8.4%. The revenues measure was steady 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 8.5ppts 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 improve to 4.9% in 2020 from 4.2% in 2019, but that's down from 8.5% in 2018. They're calling for earnings growth to improve to 7.5% in 2020 from 1.7% in 2019, but that's down sharply from the TCJA-fueled 24.0% rise in 2018. 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 improve 0.3ppt y/y to 11.8% in 2020 from 11.5% in 2019, which would match the 11.8% recorded for 2018. The S&P 500's forward P/E rose 0.3pt w/w to 19.1, which is the highest since May 2002. 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 rose 0.03pt w/w to a new record high of 2.29. 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 three of the 11 S&P 500 sectors last week and forward earnings was higher for 5/11 sectors. Health Care posted notable gains in both measures w/w, but these three sectors had both measures fall: Consumer Discretionary, Energy, and Materials. 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 Health Care and 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. Utilities is the only sector with its forward profit margin at a record high. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (22.1%, 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 (13.5, new record high this week), S&P 500 (12.0, down from 12.4), Health Care (10.5, down from 11.2), Industrials (10.0, down from its record high of 10.5% in mid-December), Materials (9.9, down from 11.6), Consumer Staples (7.4, down from 7.7), Consumer Discretionary (7.4, down from 8.3), and Energy (6.0, down from 8.0).

S&P 500 Q4 Earnings Season Monitor (*link*): With nearly 81% of S&P 500 companies finished reporting revenues and earnings for Q4-2019, revenues and earnings are beating the consensus forecasts by 1.0% and 5.5%, respectively. That compares to their respective 0.9% and 4.9% 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 is exceeding y/y revenue growth for the first time since Q4-2018. Of the 404 companies in the S&P 500 that have reported through mid-day Wednesday, 72% exceeded industry analysts' earnings estimates. Collectively, the small sample of reporters has a y/y earnings gain of 4.6%. On the revenue side, 65% of companies beat their Q4 sales estimates so far, with results 3.5% 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 71%. The FAANGM aggregate has recorded a 14.3% earnings surprise and 21.6% y/y earnings growth. That compares to a sharply lower S&P 500 ex-FAANGM surprise of 3.9% and 1.8% earnings growth. On the revenue side, the FAANGMs exceeded forecasts by 1.9% and recorded whopping y/y revenue growth of 15.7%. Those were well above the S&P 500 ex-FAANGM figures of a 0.9% revenue surprise and 2.3% revenue growth. The S&P 500's figures will continue to change as more Q4-2019 results are reported in the coming weeks, but less markedly so. The main focus will be on what companies say about their growth and margin prospects for 2020 and the effects of the coronavirus on their businesses.

US ECONOMIC INDICATORS

Housing Starts & Building Permits (*link*): The US housing market remains hot, despite January's decline in housing starts. Starts dropped at a smaller-than-expected 3.6% in January, to 1.567mu (saar), following a three-month surge of 28.4%, to a 13-year high of 1.626mu in December (which was 1.1% above the initial estimate of 1.608mu). Single-family starts slumped 5.9% to 1.010mu (saar) in January, after catapulting 19.0% the prior three months to its first reading above 1.0mu since July 2007. Meanwhile, multi-family starts climbed for the fourth month, by 0.7% in January and 53.0% over the four-month period, to 557,000 units (saar)—its highest level since 1986! Building permits are very upbeat, jumping 9.2% in January to 1.551mu (saar)—the highest level since March 2007, with both single- and multi-family permits rising—the former to 987,000 units (saar)—its highest reading since June 2007. However, NAHB Chief Economist Robert Dietz cautioned: "At a time when demand is on the rise, regulatory constraints along with a shortage of construction workers and a dearth of lots are hindering the production of affordable housing in local communities across the nation." NAHB's Housing Market Index (HMI) was at 74 in February—barely budging from December's reading of 76—which was the highest since June 1999; it was 56 at the end of 2018. All three HMI measures are hovering just below their recent highs and are up big from December 2018 readings: current sales (to 80 from 61), expected sales (79 from 61), and buyer traffic (57 from 43).

Producer Price Index (*link*): The Producer Price Index for final demand jumped 0.5% in January—its biggest monthly gain since October 2018—pushing the yearly rate up to an eight-month high of 2.1% y/y (from a recent low of 1.1%). Prices for services rebounded at a 15-month high of 0.7% last month, following no gain in December and a 0.3% decrease in November. The yearly rate rose to 2.0% y/y after falling from 2.7% in August to nearly a three-year low of 1.3% at the end of last year. Meanwhile, goods prices ticked up 0.1% after averaging monthly gains of 0.4% the prior three months. The yearly rate accelerated for the third month— to a 14-month high of 1.8%—after hovering just below zero from August through October of last year. In the meantime, there's still deflation in the pipeline, though declines are narrowing. Intermediate goods prices fell 1.0% y/y in January, easing steadily from October's 40-month low of -3.7%, while crude prices fell 3.1% y/y last month—its 13th consecutive negative reading—though continued to narrow from October's double-digit decline of 12.1%.

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