Yardeni Research

MORNING BRIEFING
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Back to Business

Check out the accompanying chart collection and podcast.

(1) Viral lyrics: Getting to know you, getting to know all about you. (2) May or may not be highly contagious, lethal, and seasonal. (3) Mild symptoms might be undercounted, exaggerating the death rate. (4) Time to consider extreme measures to stop auto accidents? (5) Tech to the rescue? (6) Shaving GDP outlook. (7) Virus bad for capital spending and exports, good for residential investment. (8) M-PMI around 50 corresponds to 2.1% real GDP growth, but also to low-single-digits S&P 500 revenues growth. (9) Truck tonnage index in record-high territory, but truck sales taking a dive recently. (10) Growth in railcar loadings of containers is still weak, reflecting Trump's deescalated trade wars. (11) Now global health crisis is infecting global trade. (12) Swedes leading the way in e-currency.

Virology I: Knowns About the Unknown. We don't intend to write much about COVID-19 today. We intend to spend most of our time with you on updating the latest developments in the US economy. That doesn't mean that we have a handle on the impact of the latest virus outbreak on the economy and financial markets. But here's a recap of what we have and haven't learned so far:

(1) *COVID-19 is contagious.* It spreads quickly unless the government contains it by imposing extreme measures including quarantines, suspensions of international flights, border closings, school closings, and warnings to prepare for the worst. These measures are very disruptive to our everyday business and personal lives. They are depressing global economic activity and sent stock prices plunging last week.

(2) *COVID-19 may or may not be more lethal than the seasonal flu.* On a percentage basis it seems to be killing more people who get infected with it than those who get the seasonal flu. However, for most people, the symptoms are relatively mild, and recovery is fairly quick.

(3) *Most alarming seems to be that people with COVID-19 infections could be asymptomatic for several days.* So, they can inadvertently spread it. Then again, it may be so mild in many people that their infections aren't included in the daily case counts. If so, then the percentage of deaths of those infected might be a lot lower than reported.

(4) *COVID-19 may or may not go away once the weather warms up.* However, it has infected areas that are warm now, such as Singapore. If it does go away in a month or two, it may or may not come back like the seasonal flu. In other words, we may just have to learn to live with it, taking reasonable health precautions and without the extreme measures that are disrupting the global economy and our lives.

Virology II: Putting COVID-19 in Perspective. As noted above, governments are responding to the COVID-19 epidemic with extreme measures that are depressing the global economy. Maybe motor vehicles should be banned as well to stop all the injuries and deaths they cause. The Association for Safe International Road Travel reports:

(1) Around the world, nearly 1.25 million people die in road crashes each year, representing 3,287 deaths a day on average.

(2) An additional 20 million to 50 million people are injured or disabled.

(3) Road traffic crashes account for 2.2% of all deaths globally.

(4) Over 90% of all road fatalities occur in low- and middle-income countries.

(5) Road crashes cost $518 billion globally, costing individual countries from 1% to 2% of their annual GDP.

I'm guessing that in a worst-case scenario, the damage from COVID-19 may be in the same ballpark.

The good news is that technological innovation is making driving much safer as motor vehicles become autonomous, requiring no steering wheel, accelerator, or brake pedals. Perhaps technological innovation will help to protect us better from those pesky viruses. I asked Jackie to investigate that for a story in this Thursday's *Morning Briefing*; stay tuned.

US Economy: Shaving Our GDP Forecast. Yesterday, Joe and I lowered our estimates for S&P 500 revenues and earnings per share. Today, Debbie and I are doing the same for our outlook for real GDP in the US. However, we think most of the weakness in S&P 500 revenues will be attributable to US companies' overseas sales. Consider the following:

(1) *YRI GDP.* We are cutting our forecast for real GDP growth this year from 2.3% to 2.0%. Capital spending is likely to be weighed down by uncertainties about how long and how badly the current global health crisis will depress the global economy. In addition, US exports are likely to be weighed down by the weakness in overseas economies. (See *YRI Economic Forecasts*.)

We expect that consumer spending and residential investment both will continue to grow solidly. We are cutting our forecast for the average 10-year US Treasury bond yield during each of this year's four quarters to 1.25% from 1.75% (*Fig. 1*). The resulting drop in mortgage rates should continue to boost home sales and construction (*Fig. 2*). Housing-related retail sales should provide lots of support to consumer spending (*Fig. 3*).

We expect that employment gains will remain solid. We also predict that inflation-adjusted wages will continue to rise to record highs this year, with nominal wage gains exceeding the PCED (personal consumption expenditures deflator) inflation rate—as they have been doing since the mid-1990s, by the way (*Fig. 4*).

(2) *GDPNow.* We continue to track the Atlanta Fed's GDPNow projections for the current quarter's real GDP growth rate based on the latest weekly and monthly economic indicators. Yesterday's estimate for Q1 was raised from 2.6% to 2.7%. The latest "nowcast" is showing real personal consumption expenditures up 2.2%, real capital spending up 5.2%, and real government spending up 1.7%.

(3) *M-PMI.* All of the available high-frequency indicators used by the GDPNow model are pre-virus. However, February's M-PMI, which is incorporated into the model and was released yesterday, may just be starting to weaken as a result of supply-chain and demand disruptions caused by the global health crisis. But not by much: The index edged down from 50.9 during January to 50.1 last month, as Debbie discusses below (*Fig. 5*). That corresponds to a 2.1% increase in real GDP, according to the report of the Institute for Supply Management.

Of the 18 manufacturing industries included in the monthly survey,14 reported growth in February. Ten quotes from respondents about business conditions were included in the report. Six mentioned the virus as a looming problem for supply chains and demand.

The M-PMI is highly correlated with the y/y growth rate in S&P 500 revenues, which rose 4% during Q3 and, we estimate, around 5% during Q4 (*Fig. 6*). Comparisons are likely to be weak

during the first half of this year but should improve during the second half of this year along with the improvement in the global economy we expect.

(4) *Truck & railcar traffic.* The major transportation indicators we monitor are continuing to lose momentum. The 12-month moving average of the ATA truck tonnage index edged up to a record high during January, but the actual index was up just 0.8% y/y (*Fig. 7* and *Fig. 8*). More disturbing is that sales of medium-weight and heavy trucks has dropped 23.8% during the past four months through January (*Fig. 9*).

The M-PMI tends to be a leading indicator for the growth rate of railcar loadings (*Fig. 10*). The former is mildly bullish for the latter, which has been one of the economy's more bearish indicators. We can attribute much of the weakness in railcar loadings since early last year to railcar loadings of intermodal containers, which can be explained by the weakness in the growth of the sum of inflation-adjusted exports plus imports (*Fig. 11* and *Fig. 12*). So Trump's escalating trade war weighed on US trade and intermodal railcar traffic. Now the global health crisis could have the same depressant effects on US trade.

(5) *West Coast ports traffic.* We track the relationship between US real exports and outbound West Coast ports container traffic (*Fig. 13*). We do the same for real imports using the comparable inbound series. The ports data are more current than the government's data by about a month. However, they are available only through January, i.e., before the virus started to hit the global economy hard. Both the outbound and inbound series have been weakening in recent months. It's easy to predict that they both got worse during February.

Disruptive Technologies: Swedish Currency. The Swedes were early adopters of electronic transactions, using Swish, an app that lets them receive or make digital payments directly to their bank accounts. So, it's logical that the country is one of the furthest along in developing a digital currency, which they dub the e-krona. We described Swish in the July 20, 2017 *Morning Briefing*, so we thought it only fitting to bring you details about the e-krona's pilot announced earlier this month. Read on:

(1) *Cash on the decline.* The Swedish move away from cash has continued. Only 13% of Swedish purchases were made in cash in 2018, with consumers opting instead to use electronic payments like Swish, or credit and debit cards. The use of cash has fallen so dramatically that some Swedish bank branches don't even provide hard currency and the number of ATMs in the country has fallen by 25% since 2011.

Riksbank, Sweden's central bank, fears that a growing number of retailers will stop accepting cash in the future. In addition, the institution doesn't want all digital payment options to be controlled by private companies. "If the state, via the central bank, does not have any payment services to offer as an alternative to the strongly concentrated private payment market, it may lead to a decline in competitiveness and a less stable payment system, as well as make it difficult for certain groups to make payments," the Riksbank explained in an October 2018 press release. Among those who prefer cash are the elderly, the blind, and disabled.

In addition, the central banker notes that a digital currency issued by a private company is a claim on that private company, whereas a digital currency issued by the central bank is a claim on the state. It's a subtle difference that's often not appreciated until a crisis occurs. Other reasons for the central bank to offer a digital currency include reducing the risk of a weaker krona relative to private currency alternatives and providing a system with highly safeguarded data that would provide a backup to the current private payment system and receive the support of the state in the case of a serious crisis.

(2) *The project begins.* The Riksbank picked Accenture to build the e-krona's "consumer facing features." The firm will determine what a consumer will see and do when paying at a store with e-krona whether using a mobile phone, a card or a watch, according to the December 13, 2019 press release. The e-krona is built on a blockchain, or distributed ledger, technology.

This month, the central bank and Accenture began a pilot project "to show in a test environment how an e-krona could be used by the general public," according to a February 2020 Riksbank report. The e-krona will be held in a digital wallet, and an app will let consumers make deposits and transfers as well as make and receive payments. The e-krona will be available all the time, and payments will be instantaneous. The pilot also examines how the e-krona could be used offline. The pilot is to run through February 2021.

In this system, only the Riksbank will be able to issue and redeem e-krona, just as it does with physical cash today. The central bank will approve and add new participants to the e-krona network, and those participants will be able to obtain or redeem e-krona against the debiting or crediting of reserves held by the participants in the Riksbank's settlement system. The system, which uses technology from R3's Corda DLT platform, is expandable, so that in the future it might also include automatic deposits or transfers.

(3) *Concerns raised.* While the technology is cool, there have been concerns raised about a future without cash. For example, what would happen if the payment system failed? What happens in time of war? What happens if there's a blackout?

As many as 40 countries reportedly are evaluating e-currency options. Nine others listed in a February 23 *WSJ* article are: Bahamas, Barbados, China, France, Marshall Islands, Saudi Arabia, United Arab Emirates, Thailand, Turkey, and Uruguay. We'll be watching to see who's the first to cross the finish line.

CALENDARS

US: Tues: Mester, Evans. **Wed:** ADP Employment Change 170k, ISM & IHS/Markit NM-PMIs 54.9/49.5, MBA Mortgage Applications, DOE Oil Inventories, Beige Book. (DailyFX estimates)

Global: Tues: Eurozone Headline & Core CPI Flash Estimate 1.2%/1.2% y/y, Eurozone Unemployment Rate 7.4%, Japan Consumer Confidence 38.3, China Caixin NM-PMI 48.0, Australia GDP 0.4%q/q//2.0%y/y. **Wed:** Eurozone Retail Sales 0.6%m/m/1.1%y/y, Eurozone, Germany, France, and Italy C-PMIs 51.6/51.1/51.9/50.1, Eurozone, Germany, France, and Italy NM-PMIs 52.8/53.3/52.6/51.2, Germany Retail Sales 1.0%m/m/1.5%y/y, Italy GDP -0.3%q/q/0.0%y/y, UK C-PMI & NM-PMI 53.3/53.2, BOC Rate Decision 1.75%, Broadbent. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose for two of these three indexes last week. LargeCap's was up for a third straight week and the 12th time in 15 weeks. MidCap's was down for a third week, but SmallCap's was higher for the first time in four weeks. These indexes began a forward-earnings uptrend during March 2019 but stumbled from July to November. LargeCap's forward earnings has risen during 40 of the past 54 weeks, MidCap's 30 of the past 50 weeks, and SmallCap's 29 of the past 48 weeks. While LargeCap's is just 0.1% below its record high, MidCap's and SmallCap's are 3.5% and 5.0% below their October 2018 highs. Index changes for the SMidCaps at the end of 2019 helped MidCap's forward earnings improve from November's 18-month low, while SmallCap's is up from September's 17-month low. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act (TCJA) but began to tumble in October 2018 as y/y comparisons became more difficult. In the latest week, the rate of change in LargeCap's forward earnings was steady at 4.3% y/y, which compares to an eight-month

high of 4.4% at the end of January and a 38-month low of 1.0% in early December. That's down from 23.2% in September 2018, which was the highest since January 2011. MidCap's weakened w/w to -0.8% y/y from -0.4%. That compares to a five-month high of -0.2% in mid-February and -5.5% in November, which was the lowest since December 2009. That also compares to a TCJA-boosted 24.1% in September 2018 (the highest since April 2011). SmallCap's improved w/w to a nine-month high of 2.0% y/y from 1.1%; that's up markedly from -9.6% in mid-September, which was the lowest since December 2009 and compares to the TCJA-boosted eight-year high of 35.3% in October 2018. Analysts had been expecting double-digit percentage earnings growth for 2019 during late 2018, but those forecasts are down substantially since then. Here are the latest consensus earnings growth rates for 2019, 2020, and 2021: LargeCap (0.7%, 7.6%, 11.5%), MidCap (-6.0, 10.0, 10.8), and SmallCap (-0.8, 11.0, 13.9).

S&P 500/400/600 Valuation (*link*): Valuations moved substantially lower last week for these three indexes. LargeCap's forward P/E fell w/w to 16.5 from 18.7. It had been at 18.9 the week before that, which was the highest level since June 2002 and compares to a five-year low of 13.9 during December 2018. Of course, that's still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E dropped w/w to 15.1 from 17.2. That's up from 13.0 during December 2018, which was the lowest reading since November 2011. MidCap's P/E is down from a 22-month high of 17.4 in mid-December and the record high of 20.6 in January 2002. However, MidCap's P/E has been at or below LargeCap's P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap's P/E decreased w/w to 15.2 from 17.3, and is down from mid-December's 16-month high of 18.1. That's well above its seven-year low of 13.6 during December 2018 and compares to its 15-year high of 20.5 in December 2016, when Energy's earnings were depressed. SmallCap's P/E is also below LargeCap's. It had been below for four months through the end of August—the first time that has happened since 2003.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): With the bulk of December quarter-end companies having already reported Q4 earnings, earnings revisions activity should begin to slow. The blended Q4 EPS forecast fell a penny w/w to $41.99. That represents a gain of 2.0% on a frozen actual basis and an increase of 3.1% y/y on a pro forma basis. That compares to a 0.3% decline in Q3 and y/y gains of 3.2% in Q2, 1.6% in Q1, 16.9% in Q4-2018, and 28.4% in Q3-2018 (which marked the peak of the current earnings cycle). If the y/y earnings gain comes to pass in Q4-2019, it would mark a return to growth following Q3's drop, which was its first

since earnings fell y/y for four straight quarters through Q2-2016. Eight of the 11 sectors are expected to record positive y/y earnings growth in Q4, with two rising at a double-digit percentage rate. That compares to seven positive during Q3, when none rose at a double-digit percentage rate. Six sectors are expected to beat the S&P 500's 3.1% gain in Q4; down from seven in Q4 but up sharply from just three beating the S&P 500 during Q2. Seven sectors are expected to post improved growth on a q/q basis during Q4: Communication Services, Consumer Discretionary, Financials, Health Care, Real Estate, Tech, and Utilities. On an ex-Energy basis, the consensus expects earnings to rise 6.0% y/y in Q4. That compares to ex-Energy gains of 2.2% in Q3, 3.9% in Q2, and 3.0% in Q1 but is well below ex-Energy's 25.0% and 14.2% y/y gains in Q3-2018 and Q4-2018, respectively. Here are the latest Q4-2019 earnings growth rates versus their final Q3-2019 growth rates: Utilities (17.6% in Q4-2019 versus 6.7% in Q3-2019), Financials (10.1, 2.6), Health Care (9.9, 8.8), Information Technology (9.3, -1.7), Communication Services (8.3, -1.4), Real Estate (7.1, 5.9), Consumer Staples (2.5, 3.7), Consumer Discretionary (1.9, 1.8), Industrials (-9.5, 3.4), Materials (-12.5, -10.9), and Energy (-41.2, -37.8).

US ECONOMIC INDICATORS

Construction Spending (*link*): Construction expenditures in January continued to reach new record highs, not posting a decline since last June. Total spending climbed 1.8% in January and 6.5% over the seven-month period—with the rebound centered in private residential and public construction spending. Private construction spending accelerated 1.5% and 6.6% over the respective periods, while public construction spending rose by 2.6% and 6.2%. Within private construction spending, residential investment is on a tear, climbing 2.1% in January and 11.0% over the seven-month period, led by single-family construction (2.8% & 12.7%) and home-improvement (1.5 & 15.8) spending. Meanwhile, private multi-family construction is down 10.1% from last May's record high, and private nonresidential construction lacks momentum—bouncing around its record high for over a year.

GLOBAL ECONOMIC INDICATORS

Global Manufacturing PMIs (*link*): "Global manufacturing suffers steepest contraction in over a decade as COVID-19 outbreak hits supply chains and demand," was the headline of February's IHS Markit report. The JP Morgan Global M-PMI tumbled from 50.4 to 47.2 this month—the weakest reading since March 2009, as a record contraction in China's M-PMI (to 40.3 from 51.1) led the plunge in the emerging economies' M-PMI (44.6 from 51.0).

Meanwhile, the advanced countries' M-PMI (49.5 from 49.8) continued to hover just below 50.0. Of the 31 nations for which February data were available, 15 registered a contraction of output, with China at the bottom, followed by the Czech Republic (46.5), Japan (47.8), Germany (48.0), Poland (48.2), Russia (48.2), Malaysia (48.5), Italy (48.7), South Korea (48.7), Vietnam (49.0), Kazakhstan (49.2), Thailand (49.5), France (49,5), and Taiwan (49.0)—with Mexico (50.0) at the breakdown point. Greece (56.2) recorded the strongest expansion in manufacturing activity this month, followed by India (54.5), the Netherlands (52.9), Colombia (52.5), Turkey (52.4), Philippines (52.3), Brazil (52.3), Indonesia (51.9), Canada (51.8), UK (51.7), Ireland (51.2), US (50.7), Spain (50.4), Austria (50.2), and Australia (50.2).

US Manufacturing PMIs (*link*): Manufacturing activity in February was at a virtual standstill, according to the ISM survey, and didn't fare much better according to IHS Markit's—as supply bottlenecks emerged due to the coronavirus. ISM's M-PMI (to 50.1 from 50.9) moved back down toward the breakeven point of 50.0 this month, after rebounding back into positive territory in January for the first time since last July. (Still, February's M-PMI is consistent with roughly a 2.1% annualized increase in real GDP, based on the past relationship of the two measures.) The new orders measure sank back below 50.0, to 49.8, after rebounding to 52.0 in January from 47.6 in December, though the new export orders' (to 51.2 from 53.3) sub-index continued to expand, remaining on a volatile uptrend. The production (50.3) gauge slipped back toward the breakeven point, after jumping from 44.8 to 54.3 in January. Meanwhile, the supplier deliveries' (57.3 from 52.9) index jumped 4.4 percentage points, as "suppliers continue to struggle to deliver, at a stronger rate compared to January." The report continued: "The index reached its highest level since November 2018, when it registered 61 percent. Lead times are generally stable. Concerns about current and ongoing reliable Asian supply dominated the comments from panelists." The remaining two components of the index show employment (46.9 from 46.6) fell at a slightly slower pace, while inventories (46.5 from 48.8) contracted at a faster pace. On the inflation front, ISM's price (45.9 from 53.3) index fell back below 50.0 after two months above. IHS Markit's M-PMI eased for the third month in February, to 50.7, after climbing steadily from 50.3 in August to a seven-month high of 52.6 in November. The pace of new orders and production was the weakest since June 2019 and July 2019, respectively. Meanwhile, positive sentiment reached a ten-month high, though remained below the long-run series average, restrained by "supply chain issues, weaker demand in the lead up to the presidential election and a general slowing of the economy," according to the report.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-775-6823

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