



MORNING BRIEFING

March 4, 2020

The BS Virus

Check out the accompanying [chart collection](#) and [podcast](#).

(1) Investors prefer Biden over Sanders. (2) Centrists uniting against Sanders in Democratic party. (3) Socialism is a virus that won't go away. (4) From Rousseau and Robespierre to Castro and Sanders. (5) Fed's medicine cabinet doesn't include any vaccines for viruses. (6) Analysts chopping Q1 and Q2 earnings estimates. (7) Lots more earnings warnings coming soon. (8) No sign of a pickup in inflation.

Strategy I: Getting Bernied. I've been asked several times since last week's stock market correction whether the selloff might not be just about the COVID-19 virus outbreak. Might the emergence of Bernie Sanders as the Democratic party's frontrunner—and the possibility that it will be a “democratic socialist” running against Donald Trump in the general election—in part explain the stock market rout? The S&P 500 peaked at a record high of 3386.15 on Wednesday, February 19. It plunged 12.8% to 2954.22 on Friday, February 28. There were lots of headlines about the spreading virus that coincided with the plunge in stock prices. However, also coincidentally, Bernie won the New Hampshire primary on Tuesday, February 11.

Sanders took New Hampshire with the support of a majority of the voters aged 18 to 29, winning 51% of their votes. Former South Bend, Indiana, Mayor Pete Buttigieg trailed him with 20% of the youth vote, followed by Massachusetts Senator Elizabeth Warren at 6%. On Saturday, February 22, Sanders had another big win in the Nevada primary. Last week, Sanders had the momentum, and the market plunged.

But then on Sunday, March 1, Joe Biden handily beat Sanders and the other contenders in the South Carolina primary, with lots of support from black voters. CNN enthusiastically [reported](#): “Former Vice President Joe Biden's blowout South Carolina win reshaped the Democratic presidential campaign and positions him as the surging moderate alternative to Vermont Sen. Bernie Sanders in a 48-hour sprint to Super Tuesday.”

On Monday, March 2, Joe Biden welcomed former rivals Pete Buttigieg, Amy Klobuchar, and Beto O'Rourke into his camp in a show of force by the Democratic party's establishment

against frontrunner Bernie Sanders the night before Super Tuesday. Buttigieg and Klobuchar dropped out of the race and threw their support behind Biden, whose decisive win in South Carolina on Saturday appears to have cemented his status as the moderate alternative to Sanders's democratic socialism.

On Monday, March 2, the S&P 500 jumped 4.6%. The DJIA soared 5.1%, the biggest such gain since March 23, 2009. The Dow's 1,293.96-point gain was its largest one-day gain ever.

Is it possible that stock market investors may fear Bernie Sanders almost as much as they fear the coronavirus?! Yes, it's possible. After all, the widespread view is that the virus pandemic will probably abate in coming months. Monday's stock market rally might also have been fueled by news reports—such as Reuters' March 1 [report](#)—that China's efforts to halt the spread of the virus are paying off.

Socialism, on the other hand, is a virus that won't go away even though extreme versions of it have immiserated and killed millions of people since it started to spread after infecting the French during the French Revolution. The philosophical founding father of socialism was Jean-Jacques Rousseau. He inspired Maximilien Robespierre, literally the first politician to execute socialist principles. He headed the Jacobin terrorist group that led the French Revolution during the eighteenth century. He was a big fan of the guillotine. Rousseau said lots of crazy things, but here is my personal favorite:

“There is therefore a purely civil profession of faith of which the Sovereign should fix the articles, not exactly as religious dogmas, but as social sentiments without which a man cannot be a good citizen or a faithful subject. While it can compel no one to believe them, it can banish from the State whoever does not believe them—it can banish him, not for impiety, but as an anti-social being, incapable of truly loving the laws and justice, and of sacrificing, at need, his life to his duty. If anyone, after publicly recognizing these dogmas, behaves as if he does not believe them, let him be punished by death: he has committed the worst of all crimes, that of lying before the law.”

[Look it up](#); it's in his seminal book *The Social Contract* (1762), which is appropriately posted on the [Marxist Internet Archive](#). (Hat tip to Mark Melcher and Steve Soukup, my friends at The Political Forum. Read their excellent and provocative book, [Know Thine Enemy: A History of the Left](#), Volume 1, 2018.)

Investors fear Bernie because he wants to cut off the head of capitalism by raising taxes significantly on the rich and using the funds to provide free everything to everybody else. He also wants to regulate everyone. On his [website](#), he promises college for all. He will cancel all student debt and medical debt. He'll expand Social Security. Medicare will be for all. His program includes housing for all and universal childcare and pre-K. He will embrace the Green New Deal: "Reaching 100 percent renewable energy for electricity and transportation by no later than 2030 and complete decarbonization of the economy by 2050 at latest." In effect, he will either privatize or destroy the health care and fossil-fuel energy sectors. He will break up any company he deems to be a monopoly.

All we need to know is that Sanders is a fan of Fidel Castro. He said so in a town hall [meeting](#) on Monday, February 24:

"[W]hen Fidel Castro first came into power ... you know what he did? He initiated a major literacy program. It was a lot of folks in Cuba at that point who were illiterate. And he formed a literacy brigade ... [they] went out and they helped people learn to read and write. You know what? I think teaching people to read and write is a good thing.

"I have been extremely consistent and critical of all authoritarian regimes all over the world including Cuba, including Nicaragua, including Saudi Arabia, including China, including Russia. I happen to believe in democracy, not authoritarianism. ... China is an authoritarian country ... But can anyone deny—I mean the facts are clear—that they have taken more people out of extreme poverty than any country in history? Do I get criticized because I say that? That's the truth. So that is the fact. End of discussion."

Getting everything for free trumps freedom, according to Bernie. No wonder investors are reacting to him as though he is going to infect us all with the virus of socialism.

Strategy II: Getting Jeromed. Fed Chair Jerome Powell is a central monetary planner. Along with his two predecessors, he has drugged us with easy money to protect us from life's economic stresses and pains ever since the Great Financial Crisis. The effectiveness of the Fed's painkillers have worn off from over-use. The Fed certainly doesn't have a vaccine to stop the current global health crisis.

This past Friday at 2:30 pm, Fed Chair Powell issued a short, reassuring [statement](#) promising that the Fed “will act as appropriate to support the economy” in response to risks posed to the global economy by COVID-19. On Monday, we wrote:

“Another round of Fed rate-cutting is widely expected even though it’s hard to imagine how that will stop the pandemic of fear. It could backfire if it leads people to fear that the Fed has concluded that the situation is so bad that they have to do something. It would also increase fears of negative interest rates. Nevertheless, the markets are expecting that the federal funds rate will be lowered by 100 basis points over the next 12 months. The surprise is that it could all happen as a one-shot rate cut.”

We were half right: Yesterday, on Tuesday, March 3, 2020, the FOMC cut the federal funds rate by 50 basis points to a range of 1.00% to 1.25%. The Fed has not made an emergency move like this since late 2008. The move came after President Trump, in a tweet, called for a “big” interest rate cut by the Federal Reserve “to make up for China’s coronavirus situation and slowdown.”

Also on Tuesday morning, Group of Seven finance ministers and central bankers held a call to discuss how to respond. But a statement released after the call contained no specific actions.

The S&P 500 fell 2.8% yesterday despite the Fed’s elixir.

Strategy III: Analysts Cutting Earnings Forecasts. Last week’s selloff in the markets was the worst since the financial crisis in October 2008. On Monday, the S&P 500/400/600 rebounded strongly with gains of 4.6%, 3.4%, and 2.6% ([Fig. 1](#)). Those were the best daily gains for the indexes since December 26, 2018.

At their recent bottoms on Friday, February 28, forward P/Es for the S&P 500/400/600 were down more than two points from their February 19 peaks to 16.5, 15.1, and 15.2 ([Fig. 2](#)). Forward P/Es recovered on Monday to 17.3, 15.6, and 15.6 for the three indexes.

While forward P/Es are bouncing up and down on headline news about the virus, the presidential race, and monetary policy, 2020 earnings forecasts are going in one direction: down. Consider the following:

(1) *Faster pace of cuts for Q1 & Q2.* Since COVID-19 hit the headlines in late January, there have been faster-than-usual declines in forecasts for current-year earnings, especially for Q1 and Q2 ([Fig. 3](#) and [Fig. 4](#)). Consensus Q1 earnings-per-share estimates for the S&P 500/400/600 are down 3.2%, 4.9%, and 7.9% ytd through February 27.

As of the February 27 week, analysts lowered their year-over-year Q1 earnings growth rates to 0.0%, -0.5%, 2.6%. Their Q2 estimates were lowered to 4.6%, 4.8%, and 8.7%.

We think they may still be too optimistic. On Monday, we revised our S&P 500 forecasts to zero growth for 2020, with an earnings decline of 5.5% in Q1 and a bigger 8.8% drop in Q2 as more companies see lower sales and breaks in their supply chains.

(2) *Surge in earnings warnings likely ahead.* We expect earnings warnings to surge in the next few weeks to levels not seen since the Great Financial Crisis. LargeCap companies with a better feel for the pulse of their businesses will dominate the news. Firms with exposure to Asian demand and supply lines should be able to quantify their impacts somewhat since the virus has been there longer. With quarantines only recently being implemented in Italy and Europe, demand will take a hit there too.

Energy companies will see a more quantifiable hit. Their earnings forecasts have been falling all year as a result of the 30% drop in oil prices since their peak in early January. Financial firms will be hit by the trading volatility and could see an uptick in loan losses from smaller companies and the mom & pop businesses.

(3) *Less visibility for SmidCaps than for LargeCaps?* Smaller companies may not be as in tune with their suppliers in Asia as the LargeCaps. Instead of pre-releasing a number or a range, they'll withdraw guidance instead. As a result, the upcoming earnings season for Q1 will probably see the SMidCaps deliver substantially more earnings misses than the LargeCaps, and we'll see Q2 forecasts drop substantially on top of that.

(4) *Second-half recovery.* For now, analysts are holding the line on their growth forecasts for the second half of the year, with S&P 500 earnings expected to rise 9.2% year over year in Q3 and 11.4% in Q4. S&P 400 earnings is expected to return to double-digit growth of 13.4% and 13.0% growth in Q3 and Q4. The comparable growth rates for the S&P 600 are very strong for Q3 (22.2%) and Q4 (23.0%).

We are forecasting that S&P 500 earnings will rise 2.0% during Q3 and 7.1% during Q4.

US Inflation: Still Subdued. While I've been busy studying virology on a daily basis since late January, I want us to stay informed about more normal and mundane issues that are relevant to investors, such as the latest inflation reports. After all, the reason the Fed has been free to lower the federal funds rate so aggressively since last summer is that inflation remains below the Fed's 2.0% target. Here is an update from Melissa:

(1) *Headlines higher.* During January, the headline Consumer Price Index (CPI) recorded a seemingly healthy 2.5% year-over-year increase, above the Fed's 2.0% target rate. But the Fed prefers the personal consumption expenditures deflator (PCED) measure of inflation, and that remained below target at 1.7% ([Fig. 5](#)). The core measures for the CPI and PCED—i.e., excluding food and energy—rose less swiftly than the headline measures at 2.3% and 1.6%, respectively ([Fig. 6](#)).

(2) *Services pricier.* Consumer services inflation in January was 2.9% in the CPI and 2.4% in the PCED, with the former matching its highest rate since July 2018, and the latter the highest since April 2019 ([Fig. 7](#)). Consumer goods inflation rates was just 1.7% for the CPI and 0.1% for the PCED ([Fig. 8](#)).

(3) *Medical care prices rising.* Leading the services sector higher were prices for medical care services, which rose 5.1% and 2.0% for the CPI and PCED during January ([Fig. 9](#)). Medical care services rates have risen sharply for the CPI since October 2018 and steadily increased since July 2015 for the PCED.

The CPI for medical care overall (including commodities such as prescription drugs) rose 4.5% while the PCED continued a slower, but sustained upward trend to a rate of 2.0% during January ([Fig. 10](#)). Health insurance, a sub-component of medical care services, rose 20.5% year over year ([Fig. 11](#))!

(4) *Rents elevated.* The rent-of-primary-residences components of the CPI and PCED remained elevated at 3.8% and 3.7%, respectively ([Fig. 12](#)). Owner's equivalent rent rose at a sustained pace of 3.4% for both the CPI and PCED during January ([Fig. 13](#)).

Shelter, which includes both types of rent, is weighted heavily in the CPI. Excluding shelter, food, and energy, the core CPI rose just 1.5% during January compared to the 2.3% core rate

excluding just food and energy. There's been a large gap between these figures since mid-2012 ([Fig. 14](#)).

(5) *Education costly*. Consumers paid more for tuition and childcare on a three-month basis through January. It rose 2.8%, the highest in eight months.

(6) *Other stuff falling*. Some categories that declined or rose significantly slower than the headlines during January on a year-over-year basis included prices for used cars (-2.0% CPI, -3.6% PCED) and furniture and bedding (1.0% CPI, 0.9% PCED).

CALENDARS

US: **Wed:** ADP Employment Change 170k, ISM & IHS/Markit NM-PMIs 54.9/49.5, MBA Mortgage Applications, DOE Oil Inventories, Beige Book. **Thurs:** Productivity & Unit Labor Costs 1.3/1.4, Jobless Claims 217k, Factory Orders -0.1%, Challenger Job Cuts, EIA Natural Gas Storage, Williams, Kaplan, Kashkari. (DailyFX estimates)

Global: **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. **Thurs:** Japan Real Earnings & Household Spending -0.5%/-3,9% y/y, Carney, Poloz, Haldane. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Q4 Earnings Season Monitor ([link](#)): With over 96% of S&P 500 companies finished reporting revenues and earnings for Q4-2019, revenues and earnings are beating the consensus forecasts by 0.8% and 5.4%, respectively. That compares to their respective 0.8% 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 is exceeding y/y revenue growth for the first time since Q4-2018. Of the 481 companies in the S&P 500 that have reported through mid-day Tuesday, 71% exceeded industry analysts' earnings estimates. Collectively, these reporters have a y/y earnings gain of 4.0%. On the revenue side, 64% 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 69%.

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 1.3% 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 0.7% revenue surprise and 2.3% revenue growth. We don't expect the S&P 500's figures to change as the remaining companies report, so this will be our last update for Q4.

GLOBAL ECONOMIC INDICATORS

Eurozone CPI Flash Estimate ([link](#)): February's CPI headline rate is expected to slow to 1.2% y/y after accelerating the prior three months from 0.7% in October (which was the lowest since November 2016) to 1.4% in January. It would be the 15th consecutive month the headline rate was below 2.0%. Meanwhile, the core rate is expected edge up to 1.2% y/y after easing from 1.3% in November and December to 1.1% in January. Looking at the main components, food, alcohol & tobacco (to 2.2% from 2.1% y/y) is expected to record the highest rate, followed by services (1.6 from 1.5) and non-energy industrial goods (0.5 from 0.3)—all slightly higher than their January rates. Meanwhile, the rate for energy (-0.3 from 1.9) dipped back into negative territory after two months above. Looking at the main Eurozone economies, rates in both Germany (to 1.7% from 1.6% y/y) and France (1.6 from 1.7) are expected to be above the Eurozone's headline rate of 1.2%—with the former accelerating and the latter decelerating—while rates in Spain (0.9 from 1.1) and Italy (0.3 from 0.4) are expected to be below.

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