MORNING BRIEFING
April 30, 2020

What Is the Market Thinking?

Check out the accompanying chart collection.

(1) Obsessing over the P/E. (2) Pricing stocks for normal earnings and abnormally low interest rates. (3) Don't fight the Fed, especially when it teams up with the Treasury. (4) A trillion here, a trillion there adding up to serious money. (5) Twilight Zone: Falling S&P 500 forward earnings boosting P/E. (6) Three US companies talk about China's recovery. (7) PPG reporting paint sales improving in China. (8) Starbucks brewing more coffee again in China, and soon in US. (9) CAT is open for business in China. (10) Fortnite hosting crossover events.

Strategy I: Our P/E Obsession. Joe and I aren't the only ones currently obsessed with the valuation question. In my Zoom conference calls with our accounts in recent days, the question was frequently raised in more or less the following way: "How can we make any sense of the rebound in the S&P 500's forward P/E since March 23 given that earnings are taking a dive along with the economy?" More simply: "What is the market thinking?"

Good questions. The obvious answer is that investors are looking past the current abyss in earnings to a recovery later this year into next year. They are pricing the S&P 500 off of "normalized" earnings. In addition, they must be assuming that the US Treasury yield curve is going to stay close to zero for the foreseeable future, justifying above-average valuation multiples.

Alternatively, none of this matters. All that matters is that fiscal and monetary policies have teamed up to provide the fastest and greatest economic stimulus and injection of liquidity in world history. A trillion here, a trillion there adds up to massive policy stimulus.

At the beginning of this year, tight credit-quality spreads confirmed that investors were still reaching for yield. By March, the pandemic of fear triggered a mad dash for cash, causing the bond market to seize up. On March 23, the Fed implemented QE4ever, opening up the bond market and resulting in a mad dash to rebalance out of cash and bonds into stocks. On March 27, President Trump signed the CARES Act. On April 9, the Fed implemented its NALB (no asset left behind) program. On April 27, the Fed expanded the eligibility criteria for a $500 billion lending facility set up to backstop municipal bond markets, in a move that will allow smaller US cities and counties to access liquidity from the central bank.

The bottom line is that asset prices are being driven by the unprecedented ultra-stimulative policies of the US Treasury and the Fed. There's no point in trying to answer the question: "What is the market thinking?" The market has been cornered by policymakers. For now, that's bullish for asset prices. Now consider the following:

(1) *Higher P/Es ahead even if market goes sideways.* As of yesterday's close, the S&P 500 forward P/E rose to 20.1, well exceeding the year's peak of 19.0 on February 19 (*Fig. 1*). It's the highest since April 19, 2002 (*Fig. 2*).

S&P 500 forward earnings is a time-weighted average of analysts' consensus estimates of operating earnings per share during the current and coming year (*Fig. 3*). During the April 23 week, the estimates for 2020 and 2021 fell to $134.92 and $170.04, so weighted forward earnings were $146.40.

During the previous recession and bear market, S&P 500 forward earnings plunged 39% from its record high in October 2007 to its bottom in May 2009. A similar drop from the record high of $179 during the January 31 week would put forward earnings down to about $110 in the next few weeks given that it is already down 18.2% from the recent peak. If the S&P 500 were to remain at yesterday's close, then the forward P/E would jump to 27.

(2) *Much higher P/Es if stock prices continue to move higher*. Just for fun, if the S&P 500 stock price index retested the February 19 record high of 3386.15, which is only 15% above yesterday's close, the P/E would jump to 31 in the event that forward earnings dropped to $110 at the same time!

Strategy II: Will US Follow China's Footsteps? Companies delivered a bifurcated view of the world in some of this week's earnings calls. First, the bad news: If you thought Q1 results were bad, you ain't seen nothing yet. Q2 is expected to be much worse, with businesses shuttered in the US and in many other nations as the quarter begins.

But there's also good news. Business is picking up in China. The country that was first to close due to COVID-19 appears to be the first to recover, with manufacturing plants and restaurants back in business. US companies' comments reinforce recent economic data out of China. Its official manufacturing purchasing managers index (PMI) jumped to 52.0 in March, rebounding from its low of 35.7 in February (*Fig. 4*). Likewise, China's comparable non-manufacturing PMI jumped to 52.3, up from 29.6 at its low in February (*Fig. 5*).

Could a second wave of COVID-19 stop China's progress? Absolutely. But so far, so good. And if we're lucky, the US and other nations coming out of lockdowns will follow in China's path, reopening in the next month or two and seeing their economies recover shortly thereafter. Here's a bit of what the managements of PPG Industries, Caterpillar, and Starbucks had to say about their Chinese operations on their conference calls this week:

(1) *Painting a rosier picture.* PPG Industries sells paint and coatings to folks fixing up their homes as well as companies building or repairing cars and airplanes, among other things. Q1 sales volumes worldwide fell 8%, and "about 6% of that decline [is] estimated to be associated with the pandemic," PPG's CEO Michael McGarry said in the Q1 conference call. Total sales fell 6.8% y/y to $3.4 billion, and adjusted earnings per share of $1.19 is 13.8% below the year-earlier Q1 result. The impact of COVID-19 was an estimated 35 cents a share.

Things are only expected to get worse in the current quarter. "[W]e are currently experiencing and continue to expect global economic activity to significantly contract in the second quarter. We then anticipate moderate demand improvement from this lower base level of demand as the year progresses and as economies begin the process of getting restarted," said McGarry.

The company has already started to see improvement in China, where PPG's factories were shut for two weeks in February and slowly began to open in March. McGarry said: "Since early March, in China, we've seen a measured recovery in demand patterns. Our factories in China have been running at 70% to 80% of capacity utilization for several weeks, moving closer to our 2019 levels, and mirroring the needs of our customers demand."

PPG's sales in China fell by 36% y/y in January and February, dropped 19% y/y in March, and are expected to decline 11% y/y in April, according to a company presentation. While still negative, results are moving the right direction and should continue do so if the favorable trends in China's auto and airline industry persist.

There were almost no retail auto sales in China in late January, but sales have gradually improved so that in the first half of April, sales were down only 8% y/y, PPG reported. In addition, China's traffic congestion is nearing 2019 levels, which implies there will be more traffic accidents requiring repairs that could use PPG paint. PPG also produces the paint and coatings used by airlines, so the company noted that Chinese airlines are offering more intra-China flights and occupancy rates have improved.

PPG is a member of the S&P 500 Specialty Chemicals industry, which has fallen 15.9% ytd though Tuesday's close, but has rallied 11.1% over the past week (*Fig. 6*). Net earnings revisions for the industry has been decidedly negative: -54.9% in April, -38.4% in March, and -29.3% in February (*Fig. 7*). As a result, revenues are forecast to drop 4.9% this year and rise 4.8% in 2021, while earnings are forecast to drop 10.0% this year and rise 15.3% in 2021 (*Fig. 8* and *Fig. 9*). The Specialty Chemicals industry's forward P/E is 17.5 (*Fig. 10*).

(2) *Coffee percolates again.* Starbucks' results were awful in fiscal Q2, and the company warned that results will be even worse in the current quarter. But thereafter, things should improve. Starbucks has reopened 98% of its stores in China, and it plans to start reopening closed US stores next week, with the goal of having about 90% of its company-operated US stores open in early June. Today, about 50% of company-operated stores and 46% of licensed stores in the US are temporarily closed.

"Unsurprisingly, business disruption attributable to the COVID-19 pandemic has materially impacted our financial results. Our belief is that these impacts are temporary as evidenced by our continued recovery in China," said CFO Pat Grismer.

Many of Starbucks' stores in China have limited seating, reduced hours, and other safety protocols. Those remaining closed are in cinemas, enclosed entertainment venues, and international travel hubs as well as certain tourist zones where restrictions haven't been lifted.

Starbucks' comparable-store sales in China were down 35% in April, an improvement from the 90% drop suffered in February. For the fiscal Q2, ended March 29, comparable-store sales fell 50%, and they're forecasted to drop 25% in Q3 and trend toward "roughly flat" by the end of Q4, Grismer said.

"We believe, barring any new disruptions, that our business in China is on a path to substantial recovery by the end of this fiscal year," CEO Kevin Johnson said in the fiscal Q2 conference call. Starbucks' total fiscal Q2 revenue fell 5% y/y, and its adjusted earnings per share fell 47% y/y to 32 cents.

Starbucks is a member of the S&P 500 Restaurants stock price index, which has enjoyed quite a resurgence of late. The index is down only 8.4% ytd (*Fig. 11*). The industry's revenues are forecast to drop 7.7% this year, only to rise 15.1% in 2021 (*Fig. 12*). And after dropping by 25.3% this year, earnings are expected to rebound and rise 43.9% in 2021 (*Fig. 13*). The industry's forward P/E has also recovered and now stands at 30.1 (*Fig. 14*).

(3) *CAT's Chinese factories reopen.* Caterpillar's sales fell 21% to $10.6 billion in Q1, and its adjusted earnings per share fell 45.6% to $1.60, missing analysts' forecast by nine cents. The good news doesn't end there.

"We expect the impacts of the pandemic on our results to be more significant in the second quarter and to linger until global economic conditions improve," CEO Jim Umpleby on the Q1 earnings conference call. As a result, Caterpillar declined to give a financial outlook for 2020. The company is exposed to the oil and gas industry as well as the construction and mining industries, all of which are under pressure with major economies closed.

Despite the gloomy news, the shares rose ever so slightly on Tuesday, by 0.23%, on a day when the DJIA fell ever so slightly, -0.13%. There were three positive aspects of the company's report. First, Caterpillar noted that all its China facilities once again were operating, and its suppliers are doing much better. Second, the company dramatically improved its financial flexibility. It raised $2 billion through bond offerings, increased its short-term credit facility by $3.9 billion, and added a $4.1 billion commercial paper support program. Finally, the company suspended its stock-buyback program, but intends to continue paying its dividend.

Caterpillar is a member of the S&P 500 Construction Machinery & Heavy Trucks stock price index, which is down 18.5% ytd, but up 7.3% over the past week (*Fig. 15*). The industry's revenues are expected to fall sharply, by 24.5% this year and then bounce by 10.1% next year (*Fig. 16*). Following the same pattern, earnings are forecast to drop 49.0% and then recover, rising 36.5%, in 2021 (*Fig. 17*). At 17.5, the industry's forward P/E hasn't climbed as high as it normally does during a cyclical downturn in the industry that sends earnings tumbling (*Fig. 18*).

Disruptive Technologies: Online Gaming's Power Grows. Wondering what your teen was doing online last week? There's a good chance he or she watched Travis Scott, one of the rap world's most popular entertainers, "perform" in Fortnite, an online game from Epic Games.

Scott's image was a character in the game, singing some of his hits and a newly released song.

Epic showed the 10-minute event, dubbed "Astronomical," five times from April 23 through April 25. The first "showing" set a record, with more than 12.3 million players logging into Fortnite to attend; add in those who watched the event using live-streaming services like Twitch, and more than 15 million people viewed the first showing, reported ARK Investment Management's April 27 newsletter. That's more than the average number of nightly viewers who watched the 2019 World Series.

By the time all five shows concluded, 27.7 million people had logged in as players to participate in the event 45.8 million times. And even those extremely large numbers don't capture the event's impact, because it was also seen subsequently on YouTube, Instagram, and other social media sites.

Jackie's son, for example, didn't participate in the original "showing" but saw the video on his Instagram feed. The concert's video on YouTube from Travis Scott has been watched 9.8 million times. A video of gamers reacting to the concert has 383,295 views. These are numbers a TV network dreams about.

Fortnight has held promotional events before. DJ Marshmello held a concert in Fortnite in February 2019, which attracted 10.7 players. In December 2019, Fortnite ran a clip from "Star Wars: The Rise of Skywalker," and in April a clip from Quibi was shown in the game. ARK rightly concluded: "By hosting crossover events, Fortnite is becoming more than a game." It's becoming traditional media's worst nightmare.

CALENDARS

US: Thurs: Personal Income & Spending -1.5%/-5.0%, Core PCED 1.6% y/y, Jobless claims 3.5m, Employment Cost Index 0.6%, EIA Natural Gas Storage. **Fri:** ISM & IHS /Markit M-PMIs 36.9/36.9, Construction Spending -3.5%, Baker-Hughes Rig Count. (DailyFX estimates)

Global: Thurs: Eurozone GDP -3.5%, Eurozone Headline & Core CPI Flash Estimate 0.1%/0.7% y/y, Eurozone Unemployment Rate 7.7%, ECB Interest Rate Decision 0.0%, ECB Deposit Facility Rate -0.5%, Germany Retail Sales -7.3%, Germany Unemployment Change & Unemployment Rate 76k/5.2%, France GDP -3.5%, Italy GDP -5.0%, Italy Unemployment

Rate 10.5%, Spain GDP -4.4%, Japan Consumer Confidence, BOJ Monetary Policy Minutes. **Fri:** UK M-PMI 32.8. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) rose again this week, and was above 1.00 for the third week after three weeks below. The BBR climbed for the fifth straight week, to 1.60, after falling from 2.89 to 0.72 (the lowest since February 2016) the prior five weeks. Bullish sentiment advanced for the fifth week, by 16.5ppts to 46.6%, following a five-week plunge of 24.6ppts (to 30.1% from 54.7%)—to its lowest percentage since late December 2018. Meanwhile, bearish sentiment sank 12.6ppts the past five weeks to 29.1%, after shooting up 22.8ppts (41.7 from 18.9) the previous five weeks. The correction count has dropped 8.0ppts the past four weeks to 24.3% following a 4.1ppts increase four weeks ago to 32.3%; it had plunged 12.7ppts (to 28.2% from 40.9%) the prior two weeks. The AAII Ratio dropped for the second week to 33.2% last week, after advancing from 38.7% to 45.0% the previous two weeks. Bullish sentiment fell from 36.6% to 24.9 over the two-week period, while bearish sentiment rose to 50.0% last week after sliding the prior three weeks from 52.1% to 42.8%.

S&P 500 Q1 Earnings Season Monitor (*link*): With over 38% of the S&P 500 companies finished reporting revenues and earnings for Q1-2020, revenues are beating the consensus forecast by 1.1%, but earnings have missed by 1.5%. Both measures are improving now and diluting the results from the early reporting Financials, which had boosted their credit and loan loss reserves. At the same point during the Q4 season, the revenue surprise was slightly lower at 0.7% and the earnings beat was sharply higher at 4.1%. For the 192 companies that have reported through mid-day Wednesday, aggregate y/y revenue growth and the percentage of companies reporting a positive revenue surprise actually improved relative to the same point during Q4. However, all of the earnings measures were markedly weaker. The Q1 reporters so far have a y/y revenue gain of 0.7%, but earnings are down 18.9% in what's sure to be the worst quarter since Q1-2009 during the financial crisis. At the present time, fewer companies are reporting a positive revenue surprise (64%) than a positive earnings surprise (65%). However, more companies are reporting positive y/y revenue growth in Q1 (61%) than are reporting positive y/y earnings growth (47%). That's the lowest rate for earnings since Q3-2009. S&P 500 results excluding the Financials & Real Estate sectors are markedly better. The revenue and earnings surprises both improved, to 1.4% and 5.9%, respectively, from 1.1% and -1.5%. The y/y earnings decline is markedly better too, improving to -6.1% from -18.9%. While these figures will change markedly as more Q1-2020 results are reported in the coming weeks, the earnings results are expected to remain dismal, and earnings growth could trail revenue growth for the fourth time in the past five quarters. Now more than ever, what companies say about the state of their business and their plans to ride out the COVID-19 crisis will be investors' main focus.

US ECONOMIC INDICATORS

GDP (*link*): COVID-19 killed the longest expansion on record. Real GDP growth contracted for the first time in six years last quarter, plunging 4.8% (saar)—the steepest decline since the Great Recession—as the coronavirus triggered plant shutdowns and a surge in unemployment. Data for Q2, so far, suggest another sizable decline this quarter, with consumer confidence collapsing in April—as initial unemployment claims totaled 16.3 million the first three weeks of April, following a 10.2 million spike the last two weeks of March. Real consumer spending was the biggest drag on growth during Q1, plunging 7.6% (saar), as services consumption (led by health care) tanked a record 10.2% (saar), while spending on goods declined 1.3%. Within goods, durable goods consumption plunged 16.1% (saar) last quarter—driven by a big drop in motor vehicles—while spending on nondurable goods expanded 6.9%, the most since Q3-2002. Real nonresidential investment recorded its largest decline since Q2-2009 during Q1, tumbling 8.6% (saar), with investment in both equipment (-15.2%, saar) and structures (-9.7) posting notable losses; spending on intellectual property products (0.4) avoided what would have been its first decline in 20 quarters. Inventory investment was also a drag on growth, dropping to -$16.3 billion—its first contraction since mid-2018—after slowing steadily from $116.0 billion at the start of 2019 to $13.1 billion by the final quarter. Real exports (-8.7%, saar) also subtracted from GDP growth last quarter, though overall trade was positive as real imports (-15.3) fell at roughly double the pace of exports. Meanwhile, real residential investment soared a whopping 21.0% (saar) last quarter—its strongest performance since Q4-2012. Real government spending expanded 0.7% (saar), with federal spending up 1.7%, while state & local government spending was flat.

Contributions to GDP Growth (*link*): Real consumer spending, by far, was the biggest negative contributor to Q1 real GDP growth, though it wasn't the only one. The details: 1) Real consumer spending subtracted a whopping 5.26ppts from Q1 GDP, with services (-4.99) accounting for most of the drag. Goods consumption recorded a much smaller detraction—as a positive contribution from nondurable goods (0.94) consumption partially offset the negative contribution from durable goods (-1.21) spending. 2) Real nonresidential fixed investment (-

1.17ppt) subtracted from GDP growth for the fourth consecutive quarter, led by continued declines in both structures (-0.28) and equipment (-0.91); spending on intellectual property products (0.02) was relatively neutral, eking out a small gain. 3) Inventory investment (-0.53) detracted from real GDP growth for the fourth straight quarter; once again, it was all nonfarm (-0.63). 4) Meanwhile, trade was the biggest positive contributor to Q1 GDP growth—as real net exports added 1.30ppt to growth and imports (2.32) contracted at a much faster pace than exports (-1.02). 5) Real residential investment (0.74ppt) added to GDP growth for the third straight quarter, posting its strongest showing in seven years, after subtracting from real GDP from Q1-2018 through Q2-2019. 6) Real government spending (0.13ppt) contributed to GDP growth every quarter of 2019, and continued to do so at the start of 2020, though federal (0.12) spending accounted for last quarter's gain.

Pending Home Sales (*link*): "The housing market is temporarily grappling with the coronavirus-induced shutdown, which pulled down new listings and new contracts," said Lawrence Yun, NAR's chief economist. "As consumers become more accustomed to social distancing protocols, and with the economy slowly and safely reopening, listings and buying activity will resume, especially given the record low mortgage rates." The Pending Home Sales Index tumbled 20.8% in March to 88.2, and was 16.3% below year-ago levels. Regionally, it was a sea of red, with sales falling at a double-digit pace on both a monthly and yearly basis across the board: Northeast (14.5% m/m & -11.0% y/y), Midwest (-22.0 & -12.4), South (-19.5 & -17.8), and West (-26.8 & -21.5). "The usual Spring buying season will be missed, however, so a bounce-back later in the year will be insufficient to make up for the loss of sales in the second quarter," Yun said. "Overall, home sales are projected to have declined 14% for the year." However, due to the continued housing shortage, Yun expects home prices to "squeeze out a gain in 2020 to a new record high."

GLOBAL ECONOMIC INDICATORS

Eurozone Economic Sentiment Indicators (*link*): The Economic Sentiment Indexes (ESI) for both the Eurozone (-27.2 points to 67.0) and the EU (-28.8 to 65.8) posted record declines in April—triple their previous record losses posted just a month ago. Over the past two months, the ESIs for the Eurozone and the EU sank 36.4 points and 37.2 points, respectively, to their lowest levels since March 2009. Among the largest Eurozone economies, ESIs collapsed in the Netherlands (-32.6 points to 65.6), Spain (-26.0 to 73.3), Germany (-19.9 to 72.1), and France (-16.3 to 82.7)—while strict confinement measures in Italy blocked data from being collected during the month. The report warns that "in many countries the response rate was lower this month than usual. The data published in this release may be less accurate and comparable across countries than usual." At the sector level, within the Eurozone there were record monthly declines recorded for services (-32.7 points to -35.0), retail (-19.7 to -28.3), industrial (-19.2 to -30.4), construction (-15.1 to -12.8), and consumer (-11.1 to -22.7) confidence, though only the service sector saw confidence tumble to its lowest level on record; retail confidence, however, was within a fraction of a new low. Meanwhile, both industrial and consumer confidence were the lowest since 2009, while the confidence in the construction sector was near a four-year low.

Contact us by email or call 480-664-1333.

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