



MORNING BRIEFING

May 5, 2020

American Magic

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

(1) Entrepreneurial vs crony capitalists. (2) Big Business and Big Government are natural born allies. (3) The lobbying industry is their love child. (4) Coolidge, Reagan, Emanuel, and Machiavelli. (5) Airlines weighed down by bailouts and on flight plan to be nationalized. (6) Buffett isn't taking any more flyers on airlines. (7) Buffett's search for value halted by Fed's QE4ever. (8) The Sage of Fort Knox. (9) Globalization under attack by viruses, tariffs, and border controls. (10) Stay Home vs Go Global update.

Strategy I: Fed Eats Buffett's Lunch. In the April 27 [Morning Briefing](#), I wrote that in my conference calls with our accounts, I've been making the case for investing in crony capitalism. This system differs from entrepreneurial capitalism where the business of companies is to compete with one another fairly and squarely for their customers' business. Entrepreneurial capitalists who fail to do so go out of business. Those who succeed prosper.

The problem is that successful entrepreneurial capitalists tend to become crony capitalists when they pay off politicians to impose legal and regulatory barriers to market entry by new competitors. It doesn't seem to matter to them that they succeeded because no such barriers blocked their access. Rather than cherish and protect the system that allowed them to succeed, they cherish and protect the businesses they have built.

A related problem is that politicians view successful entrepreneurial capitalists and their companies as ideal candidates for so-called "rent extraction," otherwise known as "extortion." Politicians threaten to use their powers to regulate business to the disadvantage of companies that don't cooperate with their agenda, which is mostly about getting reelected and more power. Crony capitalism is the result of Big Business colluding with Big Government for their mutual benefit.

President Calvin Coolidge, in a January 1925 speech to newspaper editors, famously said, "The business of America is business!" That's no longer true for many big enterprises. Doing business with the government has become increasingly essential for companies, as the

government has become a bigger customer for many of them and also more powerful in regulating all of their businesses. Despite recurring promises by presidential candidates to banish “special interests” from running Washington, the lobbying industry continues to flourish and grow in our nation’s capital, reflecting the symbiotic growth of Big Business and Big Government, i.e., the triumph of crony capitalism.

President Ronald Reagan famously said, “The nine most terrifying words in the English language are “I’m from the government, and I’m here to help.” On November 18, 2008, Rahm Emanuel, the chief of staff for President-elect Barack Obama, famously stated, “You never want a serious crisis to go to waste. ... This crisis provides the opportunity for us to do things that you could not before.” Lots of politicians and policymakers follow “Rahm’s Rule for Politicians,” as I call it. If Rahm’s advice seems Machiavellian, well, it is. Sixteenth-century Italian political theorist Niccolò Machiavelli advised in his famous treatise *The Prince*: “Never waste the opportunity offered by a good crisis.” However, it was Winston Churchill who reputedly popularized the sentiment.

Which brings us to the Great Virus Crisis (GVC). The government is here to help, and to get bigger trying. The CARES Act signed by President Donald Trump on March 27 gave the US Treasury Secretary Steve Mnuchin the power to provide up to \$2 trillion in assistance to rescue the economy.

The Act provided for \$32 billion in grants for the airline industry for payroll support and \$25 billion in direct loans or loan guarantees from the Treasury to support passenger air carriers. The CARES Act “requires the Secretary to receive warrants, equity interest, or senior debt instruments issued by the loan recipients as compensation for providing the loans,” [according](#) to the Congressional Budget Office.

In the above cited *Morning Briefing*, I wrote: “I wouldn’t be surprised if the airline industry ... becomes nationalized on a de facto basis.” I also advocated investing in companies that are likely to benefit from the triumph of crony capitalism. They are big businesses with strong balance sheets that are positioned to survive and even to prosper during the post-GVC era ahead. They don’t need rescuing by the government. Businesses that need bailouts, such as the airline industry, will be beholden to the whims of politicians to manage their affairs.

Warren Buffett seems to agree, at least about the prospects for the airline industry. He is widely revered as one of America’s great capitalists. While there is some debate on where he

is on the spectrum between entrepreneurial and crony capitalism, his annual meeting of Berkshire Hathaway shareholders is dubbed “Woodstock for Capitalists.” Consider the following:

(1) *Dumping airlines.* On Saturday, at Berkshire Hathaway’s first virtual [annual meeting](#), Buffett revealed that he sold his sizeable stakes in all his airline stocks. He said: “The world has changed for the airlines. And I don’t know how it’s changed, and I hope it corrects itself in a reasonably prompt way. ... I don’t know if Americans have now changed their habits or will change their habits because of the extended period.” But, he added, “I think there are certain industries, and unfortunately, I think that the airline industry, among others, that are really hurt by a forced shutdown by events that are far beyond our control.”

(2) *Praising the Fed.* Buffett was impressed by the Fed’s QE4ever announcement on March 23. In addition to unlimited and open-ended QE purchases, the Fed moved for the first time into corporate bonds, purchasing the investment-grade securities in primary and secondary markets and through exchange-traded funds. On April 9, the Fed provided term sheets explaining that Special Purpose Vehicles (SPVs) to do so would be funded by capital provided by the Treasury through the CARES Act. (Melissa and I discussed the SPVs in the April 22 [Morning Briefing](#).)

Buffett said, “They reacted in a huge way.” The bond market “had essentially frozen” just prior to the Fed’s action. Yet April turned out to be “the largest month for corporate debt issuance ... in history,” he said. He added, “Every one of those people that issued bonds in late March and April ought to send a thank you letter to the Fed because it wouldn’t have happened if they hadn’t operated with really unprecedented speed and determination.” On Thursday, April 30, Boeing was able to raise a stunning \$25 billion in funding, allowing it to avoid government help even after it said last month that it would seek \$60 billion in federal bailout money.

(3) *Getting outbid by the Fed.* Buffett isn’t a sore loser. But he should be, given that the Fed acted before he had time to do what he does best—i.e., to take advantage of a financial crisis to buy cheap assets with the record \$137 billion on Berkshire Hathaway’s balance sheet. He hasn’t made a major acquisition in several years, not having found anything “that attractive.”

Actually, there were lots of attractive distressed assets resulting from the 33-day bear market in stocks from February 19 through March 23. But Buffett couldn’t act fast enough since the

Fed and the Treasury came to the rescue so quickly with so much cash. They are here from the government, and here to help.

(4) *Fort Knox*. Then again, Buffett seems to be spooked by the GVC, and is worrying about a second wave of infection. Rather than using his cash for acquisitions, he prefers to use it to fortify his company against “worst-case possibilities.” He said, “Our position will be to stay a Fort Knox.”

An October 16, 2008 *NYT* [op-ed](#) by Buffett was titled “Buy American. I Am.” Now, as then, Buffett believes in America. At the recent meeting he also said, “The American miracle, the American magic has always prevailed, and it will do so again.”

Strategy II: Kiss Globalization Goodbye? The GVC has certainly infected globalization. Whether it will kill globalization is too early to tell, but it certainly will incapacitate global trade for a while. The latest period of globalization started with the end of the Cold War in the late 1980s. It was boosted by the entrance of China into the World Trade Organization (WTO) on December 11, 2001. The US emerged as the one and only superpower when Iron Curtains and Bamboo Curtains gave way to more open economies around the world, resulting in more global trade.

More global trade led to a significant increase in standards of living around the world, particularly in low-wage countries as production shifted from high-wage to low-wage economies. On balance, that increased income equality, as more workers benefitted in the low-wage countries than were harmed in the high-wage countries. Nevertheless, the latter group of workers undoubtedly was very discontented with the adverse consequences of globalization hitting them. For many of them, the pain of losing a job or accepting a pay cut outweighs the gain of lower prices at the mall.

That discontent was demonstrated by the rise of populist politicians in democracies in recent years. In totalitarian regimes, dictators continue to do what they always do, i.e., resort to nationalist propaganda to solidify their authoritarian power and control. President Donald Trump won his first term in office largely by bashing the unfair trade practices of the Chinese government during his campaign. Meanwhile, China’s President Xi Jinping has turned increasingly Maoist. Consider the following:

(1) *New Cold War*. Now as a result of the GVC, the tensions between the US and China seem to be rapidly evolving into Cold War II. On May 1, Trump signed an executive order aimed at limiting the use of foreign-supplied parts and equipment in the nation's electric grid, declaring that the practice poses an "extraordinary threat to national security." Senior intelligence officials are convinced that foreign adversaries including Russia and China have secured hidden footholds in the electric system and could use that access to cause blackouts at some future date. National security concerns are bound to lead to more such bans, particularly against imports and exports of information and medical technologies.

(2) *New supply chains*. Globalization is expected to be the big loser as supply chains are brought home from overseas. Technology and healthcare companies are particularly likely to do so. That could squeeze profit margins by driving up supply-chain costs. It could also lead to higher prices as companies attempt to protect their profit margins. However, economic demand could be weak as a result of the GVC aftershocks. On the other hand, companies that can help other companies bring their supply chains home—by implementing technological innovations such as 3D printing, robotics, artificial intelligence, and fully automated production facilities—could benefit themselves and their customers greatly.

(3) *New border controls*. Globalization will also likely be hit with tighter border controls around the world. More and more countries are likely to require foreign visitors to get visas and health documents before they can enter. Jumping on a plane for a weekend in Paris or a business trip on short notice in London may not be so easy anymore.

Strategy III: Staying Home Still. Like everyone else going through lockdowns, Joe and I are definitely getting cabin fever, but we are in no rush to Go Global. Stay Home still seems to be the right investment strategy to us, especially during the GVC and its coming aftershocks. Stay Home has significantly outperformed Go Global during the bull market from March 9, 2009 through February 19 of this year. It continued to do so during the 33-day bear market from February 19 through March 23. Consider the following:

(1) *Performance*. Joe and I track the ratio of the US MSCI stock price index to the All Country World MSCI ex-US (ACW) stock price index (in both local currencies and in US dollars) on a daily basis ([Fig. 1](#) and [Fig. 2](#)). It rose sharply during the second half of the 1990s, when investors around the world viewed the US as having the strongest economy, led by the world's #1 technology industry. European economies were still suffering from Eurosclerosis, and emerging markets remained submerged. The dollar was strong during this period.

That all changed after China joined the WTO. The US/ACW ratio fell from late 2001 through early 2008, signaling the outperformance of global economies and stock markets. Emerging markets stocks and commodity prices soared, while the dollar sank.

Since the Great Financial Crisis (GFC), the ratio has been trending solidly higher and rose to an all-time high on April 24, in the thick of the latest bear market. Here is the ytd performance derby of the major MSCI stock price indexes in dollars and local currencies through the May 1 week: US (-12.2%, -12.2%), Japan (-15.2, -16.6), Emerging Markets (-17.8, -12.8), EMU (-22.2, -20.7), and UK (-28.1, -24.1) ([Fig. 3](#) and [Fig. 4](#)). The trade-weighted dollar is up 7.1% ytd, while the Goldman Sachs Commodity Index is down 41.2% ([Fig. 5](#)).

(2) *Forward revenues, earnings, and margins.* Forward revenues are falling around the world ([Fig. 6](#)). However, the US is holding onto its gains since the start of the bull market in March 2009 better than the other major economies: US (51.1%), Emerging Markets (48.6), EMU (-1.4), and UK (-3.5). The same can be said for forward earnings: US (120.4), Emerging Markets (33.1), UK (-2.0), and EMU (-3.6) ([Fig. 7](#)). Forward profit margins are tumbling everywhere. During the April 23 week, they were down to 10.3% in the US and 6.3% in both the EMU and Emerging Markets ([Fig. 8](#)).

(3) *Valuation.* Since the March 19 week, the US MSCI forward P/E has rebounded from 14.1 to 19.6 during the April 23 week ([Fig. 9](#)). Over this same period, the forward P/E of the ACW ex-US rebounded from 10.8 to 13.5. The US isn't cheap relative to the rest of the world, but that's been the story for many years now. Then again, the spread between the two forward P/Es has never been wider. The rest of the world may be relatively cheap for many good reasons, especially if the US comes out of the GVC better than the rest of the world does, as seems likely.

(4) *Macroeconomic data.* As Debbie reviews below, the collapse in global manufacturing PMIs (M-PMIs) during April is unprecedented ([Fig. 10](#)). April's soon-to-be-released nonmanufacturing PMIs are expected to be even uglier. This is really the first global recession that has significantly depressed services-providing economies around the world because they tend to have their workers in close contact with each other and with their customers. Social distancing during the GVC has been an unmitigated disaster for these companies.

For now, here is a brief damage assessment of April's major M-PMIs around the world from worst to best: India (27.4), Indonesia (27.5), Greece (29.5), Spain (30.8), Italy (31.1), Poland (31.9), Malaysia (31.3), Russia (31.3), France (31.5), UK (32.6), Vietnam (32.7), Turkey (33.4), Eurozone (33.4), Germany (34.5), Mexico (35.0), Ireland (36.0), Brazil (36.0), Netherlands (41.3), US (41.5), South Korea (41.6), Japan (41.9), Australia (44.1), and China (50.8).

CALENDARS

US: **Tues:** IHS Markit C-PMI & NM-PMI 27.4/27.0, Balance of Trade -\$44.2b. **Wed:** ADP Employment Change -20k, MBA Mortgage Applications, EIA Crude Oil Stocks. (DailyFX estimates)

Global: **Tues:** IHS Markit UK C-PMI & NM-PMI, Guindos, Weidmann, Wuermeling, Mersch. **Wed:** Eurozone Retail Sales -9.0%, Eurozone, Germany, France, and Italy C-PMIs 13.5/17.1/11.2, Eurozone, Germany, and France NM-PMIs 11.7/15.9/10.4, Italy & Spain NM-PMIs 9.0/10.0, Germany Factory Orders -10.0%. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings fell for all three indexes yet again last week, but the rates of decline are decelerating. LargeCap's forward earnings dropped 2.6% to its lowest level since November 2017; MidCap's fell 3.6% to its lowest level since February 2017; and SmallCap's dropped 1.5% to the lowest point since April 2016. These indexes had begun a forward-earnings uptrend during March 2019 but stumbled from July to November before rising until mid-February. LargeCap's is now 19.7% below its record high at the end of January; that's the most since April 2010. MidCap's and SmallCap's are 27.5% and 37.1% below their October 2018 highs; that's the most since October 2009 and July 2009, respectively. 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 dropped to -17.4% y/y from -15.8% the week before. That's the lowest since October 2009 and down from 23.2% in September 2018, which was the highest since January 2011. MidCap's fell w/w to -26.8% y/y from -23.6%. That was the lowest since October 2009 and compares to a TCJA-boosted 24.1% in September 2018 (the highest since April 2011). SmallCap's dropped w/w to -32.7% y/y from -29.9%; that's the lowest since September 2009 and compares to the TCJA-boosted eight-year high of 35.3% in October

2018. Analysts' y/y earnings growth forecasts for 2020 are down substantially in the past eight weeks, and further declines are still ahead. Here are the latest consensus earnings growth rates for 2020 and 2021: LargeCap (-19.7%, 28.4%), MidCap (-24.9, 32.0), and SmallCap (-34.9, 42.3).

S&P 500/400/600 Valuation ([link](#)): Valuations moved higher last week, but the gains were primarily due to lower forward earnings. LargeCap's forward P/E rose 0.3pts w/w to 19.7 from 19.4. That's the highest level since May 2002 and is up from 13.3 in mid-March, which was the lowest since March 2013. MidCap's 17.6 and SmallCap's 19.2 were up a markedly higher 1.1pts and 1.4pts w/w. That compares to MidCap's 10.7 and SmallCap's 11.1 in mid-March, which were their lowest readings since March 2009. LargeCap's forward P/E based on pre-COVID earnings had been at 18.9 during mid-February, which was the highest level since June 2002. Of course, that high was 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 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 is down from mid-December's 16-month high of 18.1 and a 15-year high of 20.5 in December 2016, when Energy's earnings were depressed. However, SmallCap's P/E is still below LargeCap's. It has been mostly below since last May—the first time that has happened since 2003. During mid-March, SmallCap's P/E was briefly below MidCap's for the first time since July 2008.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): The March quarterly earnings books have been closed for five weeks now, but analysts continue to slash their estimates amid a “withdrawn guidance” environment in what's shaping up to be the worst season in many years. The Q1 EPS forecast dropped 19 cents w/w to \$32.70. That represents a decline of 16.5% y/y on a frozen actual basis and -12.7% y/y on a pro forma basis. That compares to a 3.1% gain in Q4-2019, a 0.3% decline in Q3-2019, and y/y gains of 3.2% in Q2-2019, 1.6% in Q1-2019, 16.9% in Q4-2018, and 28.4% in Q3-2018 (which marked the peak of the current earnings cycle). Besides the small y/y decline in Q3-2019, the last time earnings fell markedly y/y was during the four quarters through Q2-2016. Six of the 11 sectors are still expected to record positive y/y earnings growth in Q1, but none are forecasted to rise at a double-digit percentage rate. That compares to eight positive during Q4, when two rose at a double-digit percentage rate. Five sectors are expected to beat the S&P 500's pro-forma 12.7% decline in Q1. That compares to six in Q4 and seven in Q3, and is still up sharply from just three beating the S&P

500 during Q2-2019. Looking ahead to Q2, all sectors except Utilities are expected to post worse growth on a q/q basis during Q2. Here are the latest Q2-2020 earnings growth rates versus their blended Q1-2020 growth rates: Utilities (1.9% in Q2-2020 versus 1.5% in Q1-2020), Information Technology (-6.9, 6.3), Real Estate (-8.5, 0.6), Consumer Staples (-12.3, 6.2), Health Care (-13.7, 5.9), Materials (-29.6, -14.5), Financials (-43.6, -37.1), Industrials (-81.3, -32.6), Consumer Discretionary (-88.3, -47.6), and Energy (-153.2, -34.5).

S&P 500 Q1 Earnings Season Monitor ([link](#)): With over half of the S&P 500 companies finished reporting revenues and earnings for Q1-2020, revenues are beating the consensus forecast by 1.3% and earnings are 3.0% ahead of forecast. 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 lower at 0.5% and the earnings beat was sharply higher at 5.1%. For the 283 companies that have reported through mid-day Monday, aggregate y/y revenue and earnings growth and the percentage of companies reporting a positive revenue and earnings surprise has weakened relative to the same point during Q4. The Q1 reporters so far have a y/y revenue decline of 0.5% and earnings are down 13.4% 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 (62%) than a positive earnings surprise (66%). However, more companies are reporting positive y/y revenue growth in Q1 (59%) than are reporting positive y/y earnings growth (48%). 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 improve, to 1.7% and 8.6%, respectively, from 1.3% and 3.0%. The y/y revenue decline improves without Financials & Real Estate to -0.1% from -0.5%, but the earnings decline is markedly better, improving to -4.7% from -13.4%. 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

Manufacturing Orders & Shipments ([link](#)): Factory orders in March tumbled a record 10.3%—led by a 41.3% plunge in transportation-related orders. Excluding transportation, billings fell 3.7%—the steepest loss since January 2009. Meanwhile, both core capital goods orders and shipments data continued to fluctuate around their record highs in March.

Nondefense capital goods orders ex aircraft (a proxy for future business investment) slipped 0.7% during the two months through March, after a 1.0% jump in January, while core capital goods shipments (used in calculating GDP) edged down 0.2% in March after a 0.9% loss and a 1.0% gain the previous two months. Looking ahead, April data for the M-PMI signal that core capital goods orders is headed sharply lower, with shipments likely following suit. ISM's M-PMI orders component plunged to 27.1 from 42.2 in March and 52.0 at the start of the year.

GLOBAL ECONOMIC INDICATORS

Global Manufacturing PMIs ([link](#)): Global manufacturing activity contracted at its fastest clip in more than a decade. The JP Morgan Global-PMI (to 39.8 from 47.3) slid to its lowest reading since March 2009, though the downturn would have been more severe if it “wasn’t softened by the recent relative resilience of the Mainland China PMI.” Excluding China, the global MPI fell to 35.8 from 46.2 in March. The emerging economies M-PMI (42.7 from 49.0) continued to deteriorate, after a brief China-related blip up in March, while the M-PMI (36.8 from 45.9) for advance economies continued to tumble, with its manufacturing measure contracting at a much faster pace than that for emerging economies. None of the manufacturing sectors expanded last month, though China’s (49.4) came close, while M-PMIs for Australia (44.1), Taiwan (42.2), Japan (41.9), South Korea (41.6), and the Netherlands (41.3) contracted at a slower pace than the overall global measure. Here are the rankings of the remaining countries: Kazakhstan (39.3), US (36.1), Ireland (36.0) Brazil (36.0), Czech Republic (35.1), Mexico (35.0), Germany (34.5), overall Eurozone (33.4), Turkey (33.4), Canada (33.0), Vietnam (32.7), UK (32.6), Poland (31.9), Austria (31.6), Philippines (31.6), France (31.5), Russia (31.3), Malaysia (31.3), Italy (31.1), Spain (30.8), Greece (29.5), Myanmar (29.0), Colombia (27.6), Indonesia (27.5), and India (27.4).

US Manufacturing PMIs ([link](#)): Manufacturing activity contracted again in April, with the ISM measure showing the biggest decline in 11 years, while IHS Markit’s recorded the steepest drop on record. Both measures would have been even weaker if not for a slowing in deliveries—once again—contributing positively to the headline numbers. (Usually, slower deliveries are a sign of strengthening demand, though this time it reflects widespread supply shortages due to the coronavirus.) ISM’s M-PMI fell for the third month, from 50.9 in January to an 11-year low of 41.5 last month. Its supplier deliveries (to 76.0 from 65.0) component jumped sharply for the second month—to its highest reading since 1974. Meanwhile, the production (27.5 from 47.7) component sank to a new record low, while the new orders (27.1 from 42.2) component recorded its weakest performance since the Great Recession—with the new export

orders (35.3 from 46.6) sub-index plunging to its lowest reading since the end of 2008. The employment (27.5 from 43.8) component showed factories slashed payrolls at the fastest pace since the 1940s last month. Inventories (49.7 from 46.9) continued to contract, though at a slower pace, just below the breakeven point of 50.0. Meanwhile, IHS Markit's M-PMI tumbled to an all-time low of 36.1 from 48.5 in March and 52.4 at the end of last year. Driving this headline figure lower was a record drop in output—linked to factory and other business closures due to the implementation of COVID-19 related emergency measures. Meanwhile, orders collapsed at a rate not recorded since the Great Recession—due to a big disruption in supply chains.

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

Copyright (c) Yardeni Research, Inc. Please read complete [copyright and hedge clause](#).