MORNING BRIEFING
May 21, 2020

From Cabin Fever To Dopamine Rush

Check out the accompanying chart collection.

(1) Betting on dopamine to recharge retail sales. (2) Household debt levels pushed to new records by auto and student loans. (3) Low interest rates keep a lid on debt service. (4) Unemployment rising, incomes falling. (5) Have consumers been scared into saving more? (6) US and Chinese officials trade more barbs as manufacturers exit China. (7) Chinese companies may need to clear higher hurdles before listing shares in the US. (8) Tesla hopes to have a battery with a million-mile life expectancy. (9) Are peak sales of gas-fueled cars in the rearview mirror?

Strategy I: Don't Sell Consumers Short. As the US slowly reawakens from this COVID-19 nightmare, we're about to see just how quickly businesses will put employees back to work and just how much US consumers will spend when stores reopen. While April's retail sales data were awful, down a record 16.4% m/m, we're hopeful that US consumers will open their wallets and spend once some semblance of normalcy returns.

Jackie and I have often said that when American consumers are happy, we spend money and that when we are depressed, we spend even more money, because shopping releases dopamine in our brains, which makes us feel good. Obviously, the Great Virus Crisis (GVC) is writing a new chapter in the history of consumer behavior. We aren't virologists, but one widespread side-effect of the virus is evident: Most of us are suffering from cabin fever, which can be depressing. But this time, we haven't been able to seek relief through shopping much because the stores have been closed.

There is a theory that online shopping is more exciting than shopping in person. You get a double dopamine rush from ordering an item and then opening it upon arrival. During March, online shopping jumped to a record $783.5 billion (saar), accounting for a record 40.0% of GAFO sales (*Fig. 1* and *Fig. 2*).

A recent optimistic sign for sales came from Home Depot on Tuesday, when it reported that online sales soared 80% y/y and total sales jumped 7.1% y/y during its fiscal Q1 ending May 3.

Certainly, some of that spending was inflated by purchases of cleaning supplies and masks, but not all of it was on necessities. Jackie was at a Home Depot last week taking advantage of the company's curbside pickup for an order placed over the Internet and shipped to the store. The parking lot was full, and the garden center was hopping—and this was in the heart of Nassau County, Long Island, which remains locked down.

The S&P 500 Consumer Discretionary sector does have a handful of industries with ytd gains in their stock price indexes. Internet Retail & Direct Marketing, which benefits from having Amazon as a constituent, is up 25.6% ytd through Tuesday's close; other ytd gainers include: Home Improvement Retail (5.8%), Hypermarkets & Super Centers (4.5), and General Merchandise Stores (0.5).

Granted, those gains are offset on the sector level by gigantic drops in other Consumer Discretionary industries, including: Department Stores (-63.4%), Hotels, Resorts & Cruise Lines (-52.0), Apparel Accessories & Luxury Goods (-50.0), Casinos & Gaming (-40.5), Automobile Manufacturing (-37.2), and Restaurants (-10.1) (*Fig. 3*, *Fig. 4*, and *Fig. 5*). All told, the S&P Consumer Discretionary sector is down only 1.5% ytd, behind only the Information Technology sector, up 4.0% ytd (*Fig. 6*).

Let's take a look at how the consumer was positioned at the end of April:

(1) *Loaded with debt, but at low rates.* There's no sugarcoating it. After bottoming in 2013, household debt has been on the rise and hit a new record of $14.3 trillion in Q1 (*Fig. 7*). While home mortgage debt, including home equity loans, has remained relatively flat in recent years, student loans and auto loans have jumped sharply (*Fig. 8* and *Fig. 9*).

Fortunately, interest rates have remained low in recent years; so prior to the pandemic, the ratio of household debt-service payments to disposable personal income during Q4 remained at its lowest reading in the 40-year history of the series (*Fig. 10*). With unemployment surging to 14.7% last month, that ratio is bound to deteriorate in Q1 (*Fig. 11*). The YRI Earned Income Proxy, which multiplies the aggregate weekly hours worked times the average hourly earnings of total private industries times 52 weeks, plunged 10.9% in April back to levels last seen in June 2017 (*Fig. 12*).

(2) *Scared into saving.* Despite the surge in unemployment, personal saving also has soared. In March, personal savings rose to $2.2 trillion (saar), up 61.2% m/m and 59.3% y/y (*Fig. 13*). The 13.1% saving rate in March is higher than the 12.0% peak in December 2012 and reminiscent of the saving rates of the early 1980s (*Fig. 14*).

Some consumers may be saving because they're scared that they'll lose their jobs. Those lucky enough to have jobs may be saving because there are few ways to spend money when stores are closed as a result of the lockdowns. Either way, we'd expect that as normalcy returns, spenders will resume spending and the saving rate will normalize—though the uptrend since 2006 is likely to continue as a result of the aftershocks from the GVC.

(See Dr. Ed's recent *video podcast* on April's retail sales.)

Strategy II: US/China Battle Continues. The tug of war between the US and China continues to escalate. The latest slight by President Donald Trump came in a tweet yesterday: "Some wacko in China just released a statement blaming everybody other than China for the Virus which has now killed hundreds of thousands of people. Please explain to this dope that it was the 'incompetence of China', and nothing else, that did this mass Worldwide killing!"

Perhaps more conflict-creating was Secretary of State Mike Pompeo's congratulations to Taiwan's President Tsai Ing-wen, who was sworn in for a second term. In an official press statement, he said: "Her re-election by a huge margin shows that she has earned the respect, admiration, and trust of the people on Taiwan. Her courage and vision in leading Taiwan's vibrant democracy is an inspiration to the region and the world. The United States has long considered Taiwan a force for good in the world and a reliable partner."

According to a *South China Morning Post* article yesterday, China's foreign ministry objected to Pompeo's statement, saying: "We have expressed our strong indignation and condemnation over this." The article continued: "[T]he ministry said the US actions had betrayed their commitment that Beijing was the sole and legitimate government of all of China and sent a wrong signal to independence forces in Taiwan—something that would seriously endanger stability in the Taiwan Strait and damage US-China relations."

Let's take a look at some of the other recent words and actions that are widening the growing divide between China and the West, possibly setting the stage for Cold War II:

(1) *Producers diversifying*. More and more manufacturers are moving to make their goods outside of China. Apple was among the latest to make such an announcement. Two of the company's suppliers will make Apple's Studio range of headphones, a new product, in Vietnam. There have also been unconfirmed reports that Apple plans to move almost a fifth of its production capacity from China to India.

Apple's news came on the heels of reports that Taiwan Semiconductor Manufacturing will spend $12 billion to build a chip factory in Arizona. Construction will begin next year with production starting in 2024. The plant will manufacture 5-nanometer transistors, which are today being produced in Taiwan.

(2) *Homemade drugs.* And while most drugs or drug ingredients are produced in China, the US Department of Health and Human Services awarded a contract to make COVID-19 drugs in the US to a new US company, Phlow Corp. The contract could be worth more than $800 million, a May 19 Reuters article reported. Phlow is run by Eric Edwards, who previously founded Kaleo Pharmaceuticals, which was criticized for its high prices. The company claims that Edwards was not in control of pricing during his Kaleo tenure.

(3) *Senators send a signal.* Yesterday, the US Senate passed legislation that requires companies to certify that they are not owned or controlled by a foreign government. In addition, companies are required to submit an audit that can be reviewed by the Public Company Accounting Oversight Board, a nonprofit that oversees US company audits. Chinese companies are currently not required to do so.

The legislation is not currently scheduled for a vote in the House of Representatives, but if it becomes law, 165 Chinese companies listed on US stock exchanges—including Alibaba Group Holding, Baidu, and JD.com—could be at risk of delisting, a May 20 MarketWatch article stated.

The move came after Chinese company Luckin Coffee announced that senior executives fabricated $310 million of sales from Q2-2019 to Q4-2019. Its IPO priced shares at $17 each and raised $645 million last year. The shares, which traded above $40 in January, now fetch less than $3 each and are at risk of being delisted. The firm's filings were audited by Ernst & Young Hua Ming, with the following caveat: "The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting."

The Senate's move also followed the Trump administration's request that the Federal Retirement Thrift Investment Board end its plans to invest later this year in an international stock index that contains Chinese companies. The thrift invests retirement savings for federal employees and members of the military. The request was made over concerns about national security and investor risk, a May 12 CNBC article reported.

Disruptive Technologies: Electrifying News. We've long believed that bigger, better batteries are the key to getting consumers to replace their gas-powered cars with electric vehicles (EVs). Bring down the cost and increase the power of the battery, and consumers will have a reason to switch. With gas prices hovering around $2 a gallon, making an economic case for electric cars is tough. But Tesla is continuing to innovate, reducing the cost and increasing the power of its batteries. Here are some of its latest breakthroughs:

(1) *Million-mile battery.* Tesla's Battery Day was postponed due to COVID-19, but news of the company's million-mile battery leaked out. Telsa reportedly plans to introduce in China a new battery for its Model 3 with a life expectancy of a million miles, a May 14 Reuters article reported. Current batteries in electric cars last for 100,000-200,000 miles. Tesla's longer-lasting battery would finally bring the cost of EVs down to the cost of gas-powered cars.

The battery, developed by Tesla and China's Contemporary Amperex Technology (CATL), uses little to no cobalt, an expensive and rare material. The cost of CATL's cobalt-free lithium iron phosphate battery packs has fallen below $80 per kilowatt-hour (kWh), with the cost of the battery cells dropping below $60/kWh, Reuters' sources said. CATL's low-cobalt NMC battery packs are close to $100/kWh. Auto industry executives have said $100/kWh for battery packs is the level at which EVs reach rough price parity with internal combustion competitors.

With this long-lasting battery, Tesla sees its global fleet of cars connecting to and sharing power with the electric grid. It will allow the company to compete with national energy providers such as Pacific Gas & Electric and Tokyo Electric Power, the Reuters article reported.

(2) *GM racing to boost performance too.* General Motors is also trying to develop a million-mile battery with LG Chem, but it isn't expected to hit its goal until the mid-2020s. GM and LG are looking at various ways to bring the cost of producing batteries down, including investing in mines, hedging metals prices, and partnering with metals refiners, a May 19 Reuters article reported. Teams are working on developing zero-cobalt electrodes, solid state electrolytes, and ultra-fast charging.

(3) *Peak combustion engine in the past?* Global passenger vehicle sales are expected to drop 23% this year due to COVID-19. As the market rebounds, EVs should gain market share, and the number of new gas-powered automobiles sold in one year may never again return to 2017 levels, Bloomberg NEF projects.

Global EV sales are expected to fall 18% this year to 1.7 million cars. But next year, EV sales should rebound, Bloomberg NEF forecasts, and their market share grow to 7% (5.4 million cars) by 2023. The following years should bring continued growth in EVs' market share, to 28% of new global car sales in 2030 and 58% in 2040. Two factors should help EVs snare market share long term: their pricing dropping to levels that are more competitive with gas-powered cars' and continued government support in China and Europe—which should mean faster market-share growth in those two regions than in the US.

Global auto sales of combustion automobiles will also start to recover in 2021, but not as quickly as EV sales, Bloomberg NEF expects. Gas guzzlers will represent only 40% of new vehicle sales by 2040.

CALENDARS

US: Thurs: Leading Indicators -5.9%, Jobless Claims 2.4m, Existing Home Sales -18.9%, M-PMI & NM-PMI Flash Estimates 38.0/30.0, Philadelphia Fed Manufacturing Index -41.5, EIA Natural Gas Storage, Powell, Brainard, Clarida. **Fri:** Baker-Hughes Rig Count. (DailyFX estimates)

Global: Thurs: Eurozone, Germany, and France C-PMI Flash Estimates 25.0/34.1/32.0, Eurozone, Germany, and France M-PMI Flash Estimates 38.0/39.2/36.1, Eurozone, Germany, and France NM-PMI Flash Estimates 25.0/26.6/27.8, UK C-PMI, M-PMI, and NM-PMI Flash Estimates 25.0/36.0/25.0, BOJ Rate Decision. **Fri:** UK Retail Sales Including & Excluding Fuel

-22.2%/-18.2%, y/y, Canada Retail Sales Total & Ex Autos -10%/-5%, ECB Monetary Policy Meeting Account, Lane. (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 sixth week, after three weeks below. The BBR climbed for the eighth straight week, to an 11-week high of 2.02, after falling from 2.89 to 0.72 (the lowest since February 2016) the prior five weeks. Bullish sentiment is climbing again, after taking a small step back last week, rising for the seventh time in eight weeks, by 18.9ppts to 49.0%, 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 17.6ppts the past eight weeks to 24.1%, after shooting up 22.8ppts (41.7 from 18.9) the previous five weeks. The correction count remained at 26.9% this week, after climbing the prior two weeks from 24.3%; it had dropped 8.0ppts the prior four weeks (to 24.3% from 32.3%). The AAII Ratio ticked up to 31.5% last week after sliding from 41.0% to 31.0% the previous week. Bullish sentiment fell for the second week from 30.6% to 23.3%, while bearish sentiment fell to 50.6% last week after climbing from 44.0% to 52.7% the prior week.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): Analysts slowed their pace of COVID-19 estimate cuts during the latest week. The consensus S&P 500 forecasts previously had been falling at rates that paralleled the declines during the financial crisis of 2008-09. Forward revenues dropped 0.3% w/w to its lowest level since June 2018 and is now 7.6% below its record high in mid-February. Forward earnings fell 0.9% w/w to its lowest level since September 2017 and is now 20.7% below its record high in early March. Forward growth forecasts fell w/w too. Analysts expect forward revenues growth of 0.7% and a forward earnings decline of 3.1%. The revenues growth measure was down 0.1ppt w/w, and earnings growth dropped 0.3ppts. Forward revenues growth is up from the lowest reading since June 2009 and 5.7ppts below its seven-year high of 6.3% in February 2018. Forward earnings growth is up from its record low of -5.6% at the end of April, but remains 20.0ppts below its six-year high of 16.9% in February 2018. Prior to the passage of the Tax Cuts and Jobs Act (TCJA), forward revenues growth was 5.5% and forward earnings growth was 11.1%. Annual growth expectations for 2020 continue to deteriorate. Analysts expect revenues to decline 5.2% y/y in 2020 compared to the 4.2% reported in 2019. That's down 0.4ppts w/w and 10.1ppts since the start of the year. They're calling for earnings to decline 22.2% y/y in 2020 compared to a 1.5% rise in 2019. The 2020 growth rate fell 0.7ppt w/w and is down 31.2ppt since the beginning of the year. The forward profit margin of 10.3% was steady for a third straight week at the lowest level since August 2013, but is down 2.1ppt from a record high of 12.4% in September 2018. That compares to 11.1% prior to the passage of the TCJA in December 2017 and the prior cyclical low of 10.4% in March 2016. Analysts now expect the profit margin to fall 2.1ppt y/y in 2020 to 9.5%—from 11.6% in 2019—and to improve 1.7ppt y/y to 11.3% in 2021. Valuations have been extremely volatile this year on both a daily and weekly basis. They edged down ever so slightly last week for a second weekly decline after rising for six weeks. The weekly snapshot of the S&P 500's forward P/E was down less than 0.1pt to 20.1 from 20.8 two weeks ago, which had been the highest since March 2002 and up from a 77-month low of 14.0 in mid-March. It's still well above the 14.3 bottom during the December 2018 selloff (that 14.3 bottom was the lowest reading since October 2013 and down 23% from the 16-year high of 18.6 at the market's valuation peak in January 2018). The S&P 500 price-to-sales ratio dropped to 2.06 from 2.08 and is down from a 10-week high of 2.14 at the end of April. That's still up from the 49-month low of 1.65 in mid-March, which compares to mid-February's record high of 2.29. It's now back above the 1.75 trough during the December 2018 selloff, when it was the lowest since November 2016 and down 19% from its then-record high of 2.16 in January 2018.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): Consensus forward revenues fell w/w for nine of the 11 sectors, and forward earnings was lower for all 11 sectors. Energy and Health Care were the only sectors to post a w/w gain in forward revenues. Due to sharply lower forward earnings, forward P/E ratios for most sectors are now back above the recent record or cyclical highs prior to the bear market, but forward P/S ratios remain below their highs. Utilities is the only sector expected to record higher margins y/y in 2020, down from eight expected to do so in early March. During 2019, just two sectors improved y/y: Financials and Utilities. The forward profit margin rose to record highs during 2018 for 8/11 sectors, all but Energy, Health Care, and Real Estate. Since 2018, it has moved lower for nearly all the sectors. Six sectors had their profit margin drop in the latest week, but Financials and Tech both rose. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (21.8%, down from 23.0%), Real Estate (14.2, down from 17.0), Communication Services (13.4, down from 15.4), Utilities (13.8, down from a record high 13.9 a week earlier), Financials (13.5, down from 19.2), S&P 500 (10.3, down from 12.4), Health Care (10.0, down from 11.2), Materials (8.8, down from 11.6), Industrials (7.3, down from its record high of 10.5% in mid-December), Consumer Staples (7.2, down from 7.7), Consumer Discretionary (5.0, down from 8.3), and Energy (0.6, down from

8.0).

GLOBAL ECONOMIC INDICATORS

Eurozone CPI (*link*): April's CPI headline rate slowed for the third month to 0.3% (the lowest rate since August 2016), after accelerating the prior three months from 0.7% in October to 1.4% in January. That's the 18th consecutive month the headline rate was below 2.0%. Meanwhile, the core rate edged down for the second month to an eight-month low of 0.9% y/y in April from 1.2% in February. Looking at the main components, food, alcohol & tobacco (to 3.6% from 2.4% y/y) recorded its highest rate since November 2008, while rates for both services (1.2 from 1.3) and non-energy industrial goods (0.3 from 0.5) eased slightly. Meanwhile, energy prices fell again in April, by 9.7% y/y—the steepest decline since September 2009—down from January's 1.9%. Of the top four Eurozone economies, rates in Germany (0.8% y/y) and France (0.4) were above the Eurozone's headline rate of 0.3%, while Italy's (0.1) and Spain's (-0.7) were below—with Slovenia (-1.3) and Cyprus (-1.2) recording the lowest among all Eurozone members.

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