Yardeni Research

MORNING BRIEFING
June 18, 2020

Don't Sell US Consumers Short

Check out the accompanying pdf and chart collection.

(1) American shoppers once again live up to their reputation. (2) A pile of personal saving helps fuel a V-shaped spending recovery. (3) Trump wants US manufacturing to come home. (4) Complex supply chains may make reshoring difficult. (5) Manufacturing in the US may increase costs and turn former Chinese suppliers into competitors. (6) Down on the farm: Robots killing weeds and picking fruit. (7) Autonomous tractors can work day and night.

US Economy I: E Pluribus Unum Shopper. Out of many, one humongous shopper. In our May 21 *Morning Briefing*, Jackie and I responded to the 16.4% m/m drop in April retail sales with the following advice: "Don't sell the consumer short." We observed 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."

After almost three months of cabin fever, we all need a dopamine rush. Now that we are allowed to leave our cabins, we are rushing to buy goods that couldn't be ordered online and delivered to our front door. So Jackie and I weren't surprised to see retail sales jump 17.7% during May (*Fig. 1*). April's decline was revised to a 14.7% drop. Now consider the following related developments:

(1) *A pile of unintended saving*. In the June 1 *Morning Briefing*, we wrote: "Because the stores were closed, both employed and unemployed workers couldn't spend their incomes as they normally do. The result was a huge increase in personal saving during April that is likely to revive economic growth as stores reopen. The mad dash for cash during March led to a big stash of cash during April, which could fuel a consumer-led V-shaped recovery in the economy in coming weeks if the economy continues to reopen without major setbacks. The stock market may simply be discounting that the GVC [Great Virus Crisis] is more akin to natural disasters, which more often are followed by a solid recovery than another great depression."

Personal saving soared from $1.4 trillion (saar) during February to $2.1 trillion during March to a whopping $6.1 trillion during April (*Fig. 2*). All that cash certainly contributed to the V-shaped rebound in retail sales last month.

(2) *Downs & ups.* Here is a roundup of the ups and downs during April and May among the major retail sales categories: motor vehicles & parts dealers (-12.3%, 44.1%), furniture & home furnishings (-48.4, 89.7), electronic & appliance stores (-43.2, 50.5), building materials & garden equipment & supplies (-2.4, 10.9), health & personal care (-14.8, 0.4), gasoline stations (-24,4, 12.8), clothing & accessories (-75.2, 188.0), sporting goods, hobbies, musical instruments, & book stores (-33.7, 88.2), general merchandise stores (-13.6, 6.0), food services & drinking places (-34.6, 29.1), and food & beverage stores (-12.8, 2.0). (See our *Retail Sales* chart book.)

(3) *Double rush.* Online retail sales data are available through April. They rose to a record $883.0 billion (saar) during the month (Fig. 3). They accounted for a record 50.7% of GAFO (general merchandise, apparel and accessories, furniture, and other sales), which includes retailers that specialize in department-store types of merchandise such as furniture & home furnishings, electronics & appliances, clothing & accessories, sporting goods, hobby, book, and music, general merchandise, office supply, stationery, and gift stores (Fig. 4).

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. In any event, May's retail sales data confirm that the best cure for cabin fever is to leave the cabin and go shopping.

(4) *Q2 still a big downer.* Notwithstanding the big rebound in May's retail sales, the Atlanta Fed's GDPNow tracked real GDP at -45.5% on June 17, only a bit better than the June 9 estimate of -48.5%. Debbie and I are still predicting -40.0% for the quarter, but we are raising our Q3 estimate from up 20.0% to up 25.0%.

US Economy II: Reshoring Is Easier Said Than Done. President Donald Trump and White House trade advisor Peter Navarro would like to see US companies' manufacturing operations come back home. Navarro noted last weekend that the administration is working on a phase four stimulus package of at least $2 trillion that would focus on strengthening American manufacturing and include incentives for American companies to reshore operations. The goal is to push legislation through Congress before its August recess, a June 13 CNN article reported.

There are many benefits of reshoring to the US economy. As Navarro noted: "Manufacturing jobs not only provide good wages but also create more jobs, both up- and downstream through multiplier effects." They also increase our national security by ensuring access to necessary drugs or items related to national security

That said, those writing the legislation should take into account the many reasons why reshoring is difficult. It's expensive, it requires access to capital, and it may result in former Chinese partners becoming competitors. Most importantly, it may force US companies to raise prices, something that consumers are likely to resist. Let's take a look at the obstacles that need to be overcome before we see manufacturers lining up to return to the US.

(1) *Reshoring ain't easy.* Manufacturing has grown increasingly complex as suppliers have specialized in specific products to remain on the cutting edge of technology and to produce at volume at the lowest cost possible. It means that companies may have suppliers, who rely on suppliers, who rely on suppliers, who rely on suppliers. This multi-tiered chain is hard to fully understand, let alone replicate, states an April 15 article in the *Harvard Business Review* by Willy C. Shih, the Robert and Jane Cizik Professor of Management Practice in Business Administration.

Medtronic CEO Geoff Martha explains the complexity in a May 21 *Irish Times* article: "Take our ventilators which we make in Galway, for example. The ventilator has around 1,600 parts that come from suppliers in 14 different countries. The minute the U.S. does that [reshores], the question is what does the EU do, what does Ireland do, and it can create a lot of challenges for the global economy." Medtronic, which moved to Ireland after acquiring Covidien in a tax-driven deal in 2015, will make contingency plans in case its forced to manufacture more in the US market.

(2) *Reshoring may increase costs.* Outsourcing allows companies to run their factories very efficiently. They can build plants that will run constantly and contract out manufacturing of any surge capacity. The companies who provide surge capacity can pool numerous clients to "smooth out their own workload

and try to maximize capacity utilization" to keep their own operating costs low, *HBR's* Shih writes. Take away this model and companies will have to build larger, more costly, and less efficient factories to handle surge capacity manufacturing.

The US government and US manufacturers may also need to spend more on research and development related to manufacturing. Chinese total R&D spending "which at the turn of the millennium was only about $10 billion, had by 2018 hit nearly $300 billion (2.2% of GDP), second only to the U.S. itself," a June 2 *WSJ* article reported. "If "decoupling" proceeds, then much more federal funding for basic research—and for U.S. science and math education—may be needed to plug the gap." China also subsidizes the construction and equipping of new production facilities.

Who will pay for these increased costs? Consider four options. The US government could provide subsidies to US manufacturers. US companies could assume the costs and watch their margins get squeezed. Or companies could try to pass on the costs to consumers, risking the loss of customers who typically prefer the least expensive product regardless of where it's produced. There also is an optimistic fourth option: US manufacturers could deploy new technologies to lower their manufacturing costs and remain competitive with importers.

(3) *Looking beyond the US and China*. Companies looking to diversify away from China, may not opt to move their manufacturing operations to the US. There are certainly other alternatives. A survey by Site Selectors Guild, an association of professional site selection consultants, predicted an uptick in onshoring to the US, Canada, and Mexico, particularly in the pharma and life sciences industries, a May 20 article in Pharmaceutical Technology reported. Countries in Central and Eastern Europe and in Asia outside of China were also seen as offering low-cost production.

"Canada is set to attract several projects as it enjoys a low-profile versus the US, because of the exchange rate, and because of the nationalized healthcare system, which lowers the corporate burden to provide healthcare for employees," John Boyd, founder of location consultancy Boyd Company told Pharmaceutical Technology. "Our clients in the US typically pay upwards of 40% of their payroll for fringe benefits, whereas the rate in Canada is half that, largely due to its single payer healthcare system."

The article concludes that to minimize the impact of a disruptive event, companies should consider "spreading facilities across a number of regions."

(4) *Chinese roadblocks.* China might make leaving the country difficult and expensive for foreign manufacturers. Most employees have one- to two-year employment contracts that must be fully paid if a company leaves, said Rosemary Coates, executive director of the Reshoring Institute, in a April 30 article in the Global Supply Chain Law blog.

In addition, China may not allow a company to take any of the machinery, tools, and molds in its manufacturing plants to another country even if the company has contractual ownership rights of the equipment, Coates explained.

And, perhaps most importantly, companies exiting China are leaving behind potential competitors. "You have taught your Chinese suppliers how to make your products, and they are not likely to stop just because you are no longer doing business there," Coates said. It's why she encourages companies not to produce their latest products in China.

(5) *Timing is everything.* Before pushing hard for companies to leave China, the US should consider how long the transition will take. Building new US facilities could take five to eight years, said John

Murphy, senior vice president for international policy at the Chamber of Commerce, in a May 4 Reuters article. What did Mom say about cutting off your nose?

Disruptive Technologies: Old MacDonald Gets a Robot. Technology is changing the way farmers do their jobs, with robots, digitization, and sensors reducing the manpower need. Adopting new technology is nothing new for farmers, who throughout history have proved naysayers wrong by continually improving their operations to meet the food demands of the world's growing population.

In my 2018 book, *Predicting the Markets: A Professional Autobiography* I explained: "One of the greatest success stories in the history of technological innovation has been in agriculture. … Grain production soared during the 1800s thanks to new technologies, more acreage, and rising yields. During the first half of the century, chemical fertilizers revived the fertility of European soil, and the milling process was automated using steam engines.

During the second half of the century, vast new farmlands were opened in the United States under the Homestead Act of 1862, and agriculture's productivity soared with the proliferation of mechanical sowers, reapers, and threshers. Tremendous progress in agriculture continued during the 20th century, particularly during the Green Revolution of the 1950s and 1960s."

Farm yields and efficiencies are still improving thanks to technology. Here's Jackie's report on how technology is making farmers look awfully hip even if they're not based in Silicon Valley.

(1) *Smart weed killers.* Farmers have long sprayed their crops with insecticides to keep weeds at bay. But over the years, weeds have grown resistant to certain insecticides. So, Blue River Technology built the See & Spray machine to identify a weed and spray it with an insecticide, fungicide or fertilizer. The company, which was purchased for $305 million by John Deere in 2017, claims that its "See & Spray" technology allows farmers to use 90% less herbicide in a field, which is good both for the farmer's bottom line and the earth.

This machine uses cameras and software similar to that used in facial recognition programs to differentiate between weeds and crops. See & Spray constantly gathers data on the tens of thousands of plants in each field, so that its software continues improving, the company reports. And because pesticide is only sprayed on specific weeds and not entire fields, it increases the number of chemical alternatives the farmer can use. Blue River says its machine can do the work of eight to 10 people.

(2) *Gentle robot pickers.* For years wheat and corn have been harvested by machine. Fruits and vegetables have typically been considered too delicate for anything but human pickers. But a machine by Traptic is changing that.

Traptic has developed a machine with "3D cameras and neural networks to spot strawberries and distinguish ripe from unripe," an October 2 TechCrunch article states. The picker has claws with "rubberized bands that have enough give to conform to the fruits' irregular shapes while holding them snuggly enough to remove them from the plant." In the future, Traptic aims to use its technology in machines that will pick other crops including oranges, melons, and peppers.

Traptic plans to charge farmers not for the equipment but for the service. The company will provide the human driver, a tractor, and picking machine and farmers will pay Traptic 23 cents per pound of strawberries picked. One machine equals the work of 20 people and will pay for itself in seven months, Traptic CEO Lewis Anderson said at TechCrunch Disrupt SF 2019. The company isn't alone. Harvest CROO Robotics also plans to offer a berry-picking service to farmers using its own new strawberry-picking machine.

(3) *Autonomous & electric tractors*. Just as car manufacturers are developing autonomous cars, Bear Flag robotics is developing self-driving tractors that will allow farmers to work on their fields around the clock, in good weather and bad, an August 31, 2018 CNBC article reported. It's competing against larger companies like Deere and CNS Global

Deere has an autonomous tractor that looks like a traditional tractor and allows a human to remain behind the wheel, according to this January 14, 2019 Engadget video. Deere also has a much smaller autonomous and electric tractor in development that doesn't have a cab for a human. The problem it faces is battery life. An electric tractor would ideally be able to run all day and it can't do that with the batteries currently available, explains a January 30 article in Progressive Farmer.

Deere's electric solution for today: an autonomous tractor with a huge cable to tap into electricity source on the border of the field, instead of batteries. A spool on the back of the tractor unwinds the cable as the tractor makes its way down a row of farmland and the cord is rewound as the tractor turns and makes its way up the next row of farmland, this February 7, 2019 article in Industrial Vehicle Technology reports.

CALENDARS

US: Thurs: Leading Indicators 2.5%, Initial & Continuous Jobless Claims 1.3m/19.8m, Philadelphia Fed Manufacturing Index -23, EIA Natural Gas Stocks, Mester. **Fri:** Current Account Deficit -$103b, Baker-Hughes Rig Count, Powell, Mester, Quarles. (DailyFX estimates)

Global: Thurs: Japan Headline & Core CPI 0.1%/-0.2% y/y, BOE Interest Decision & Quantitative Easing 0.1%/ £745b, European Council Meeting, ECB Economic Bulletin, BOJ Monetary Policy Meeting Minutes. **Fri:** UK Retail Sales Total & Ex Fuel -17.1%/-14.4% y/y, European Council Video Meeting. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) rose yet gain this week and is just shy of 3.00. The BBR climbed for the 12th straight week, to a 21-week high of 2.95, after falling from 2.89 to 0.72 (the lowest since February 2016) the prior five weeks. Bullish sentiment slipped to 54.9% this week after rising 10 of the prior 11 weeks, by 26.8ppts to 56.9% (the most since last January), following a five-week plunge of 24.6ppts (to 30.1% from 54.7%)—to its lowest percentage since late December 2018. Bearish sentiment sank 23.1ppts the past 12 weeks to 18.6% (the lowest since January), after shooting up 22.8ppts (41.7 from 18.9) the previous five weeks. Meanwhile, the correction count climbed 4.0ppts this week, to 26.5%, after falling 4.4ppts the prior three weeks—from 26.9% to 22.5%. The AAII Ratio last week increased for the fifth week from 31.0% to 47.4% over the period. Bullish sentiment ticked down to 34.3% last week after rising the prior three weeks from 23.3% to 34.6%, while bearish sentiment dropped from 52.7% to 38.1% the past five weeks.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): Analysts continued to slow 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 rose 0.1% w/w and is now 7.4% below its record high in mid-February. Forward earnings was steady w/w and is now 19.6% below its record high in early March. The forward revenue growth forecast remained steady w/w at 1.7%, and forward earnings growth improved 0.1pts to 0.7%. Forward revenues growth is up from the lowest reading since June 2009 and 4.6ppts 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 16.2ppts 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 are stabilizing now. Analysts expect revenues to decline 5.2% y/y in 2020 compared to the 4.2% reported in 2019. That's up 0.1ppt w/w and down 10.2ppts since the start of the year. They're calling for earnings to decline 22.9% y/y in 2020 compared to a 1.4% rise in 2019. The 2020 growth rate rose 0.1ppt w/w and is down 31.9ppt since the beginning of the year. The forward profit margin remained steady w/w at 10.4%. It's up from 10.3% during the previous five weeks, which was the lowest level since August 2013. It's still down 2.0ppt 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 2.2ppt y/y in 2020 to 9.4%—from 11.6% in 2019—and to improve 1.8ppt y/y to 11.2% in 2021. Valuations have been extremely volatile this year on both a daily and weekly basis. The weekly snapshot of the S&P 500's forward P/E was up 0.5pts to 22.4, which is the highest level since early 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 rose to a record high of 2.33 from 2.28. That's up from the 49-month low of 1.65 in mid-March and compares to the previous record high of 2.29 in mid-February.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): Consensus forward revenues and earnings rose w/w for six of the 11 sectors. Energy, Financials, and Utilities were the only sectors to have both measures rise w/w. Due to the sharp decrease in forward earnings this year, forward P/E ratios are now back above the recent record or cyclical highs prior to the bear market for nearly all sectors. However, forward P/S ratios remain below their highs for most sectors. 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. Materials and Real Estate had their forward profit margin tick lower in the latest week. 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 (14.1, down from 17.0), Communication Services (13.4, down from 15.4), Utilities (13.9, steady at a record high), Financials (13.8, down from 19.2), S&P 500 (10.4, down from 12.4), Health Care (10.1, down from 11.2), Materials (8.9, down from 11.6), Industrials (7.6, down from its record high of 10.5% in mid-December), Consumer Staples (7.2, down from 7.7), Consumer Discretionary (4.9, down from 8.3), and Energy (0.9, down from 8.0).

S&P 500 Sectors Forward Revenues and Earnings Recovery From COVID-19 Trough (*link*): The S&P 500's forward revenues and earnings as well as its implied forward profit margin appears to have bottomed on May 28 after 14 weeks of COVID-19 declines. Since then, S&P 500 forward revenues has risen 0.7%, forward earnings has gained 2.0%, and the profit margin has risen 0.1pt to 10.4%. With the exception of Real Estate, all sectors appear to have bottomed and are beginning their recovery. Here's how the sectors rank by their forward revenues change since May 28, along with their forward earnings change: Energy (revenues up 1.9%, forward earnings up 56.4%), Consumer Discretionary (1.1, 5.2), Industrials (0.8, 4.5), Communication Services (0.8, 1.2), S&P 500 (0.7, 2.0), Financials (0.7, 2.8), Materials (0.6, 2.0), Information Technology (0.6, 1.1), Health Care (0.3, 1.2), Utilities (0.3, 0.5), Consumer Staples (0.2, 0.8), and Real Estate (0.0, -1.2).

US ECONOMIC INDICATORS

Housing Starts & Building Permits (*link*): Housing starts in May rose for the first time in four months and the recent upswing in builder confidence bodes well for the trajectory. Housing starts climbed 4.3% to 974,000 units (saar) last month after record declines in April and March of 26.4% and 19.0%, respectively, as the effects from the coronavirus spread throughout the economy. Starts were at a cyclical high of 1.617mu (saar) at the start of this year. May's advance in starts reflected a 15.0% rebound in multi-family starts to 299,000 units (saar);

single-family starts were flat at 675,000 units (saar). May building permits rebounded 14.5% to 1.220mu (saar) with both multi- (18.8%) and single- (11.9) family permits posting double-digit gains during the month—to 475,000 units (saar) and 745,000 units, respectively. In the meantime, NAHB's Housing Market Index (HMI) climbed 28 points during the two months through June to 58, after plunging a record 42 points in April to 30—the lowest builder confidence since mid-2012, and the first reading in negative territory (below 50) since mid-2014. All three measures of the HMI moved sharply off their lows: current sales (to 63 from 36 in April), future sales (68 from 36), and traffic of prospective buyers (43 from 13). Also encouraging is the V-shaped recovery in mortgage applications for new purchases of new and existing homes in recent weeks.

GLOBAL ECONOMIC INDICATORS

European Car Sales (*link*): May EU passenger car registrations (a proxy for sales) suffered another big drop in registrations, falling 52.3% y/y after collapsing 76.3% y/y in April. May's report notes that while COVID-19 measures were eased in several countries last month, the number of cars sold across the European Union sank to 581,161 units this May from 1,217,259 units last May. Double-digit declines in sales were experienced across the 27 EU markets, though the declines were not as large as April. Spain (-72.7% y/y) recorded the largest decline among the four major EU markets, followed by France (-50.3), Italy (-49.6), and Germany (-49.5). Meanwhile, sales plunged 41.5% during the first five months of this year, compared to the comparable period a year ago—as the coronavirus pushed sales sharply lower during both March and April. Looking at the four key EU markets, year-to-date sales fell sharply in all: Spain (-54.2% y/y), Italy (-50.4), France (-48.5), and Germany (-35.0).

Eurozone CPI (*link*): May's CPI headline rate slowed for the fourth month to 0.1% (the lowest rate since June 2016), after accelerating the prior three months from 0.7% in October to 1.4% in January. It was the 19th consecutive month the headline rate was below 2.0%. Meanwhile, the core rate held at April's eighth-month low of 0.9% y/y after edging down from 1.2% in February. Looking at the main components, food, alcohol & tobacco (to 3.4% from 3.6% y/y) recorded the highest rate in May, though easing from April's recent high, while energy prices posted the lowest rate (-11.9 from -9.7)—falling at the fastest pace since July 2009. Meanwhile, the rate for services (1.3 from 1.2) accelerated slightly while the non-energy industrial goods (0.2 from 0.3) rate continued to hover just above zero. Of the top four

Eurozone economies, rates in Germany (0.5% y/y) and France (0.4%) were above the Eurozone's headline rate of 0.1%, while Italy's (-0.3) and Spain's (-0.9) were below—with Estonia (-1.8) and Luxembourg (-1.6) recording the lowest rates among all the Eurozone members.

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