Yardeni Research

MORNING BRIEFING
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Wall of Worry

Check out the accompanying chart collection.

(1) Market meltup meets Wall of Worry. (2) COVID spike lengthens list of investor concerns. (3) NY roads get crowded as COVID restrictions lift. (4) Price of crude drops on COVID spike, but still up sharply from March low. (5) A look at how COVID has affected oil supply and demand. (6) Surge in oil inventory should peak this quarter. (7) Honeywell joins the ranks of companies offering quantum computers. (8) A quantum Internet is being developed to link quantum computers.

Strategy I: A Ton of Bricks. The stock market has been climbing the proverbial Wall of Worry since it recently bottomed on March 23, when the S&P 500 closed at 2237.40 (*Fig. 1*). The index recently peaked at 3232.39 on June 8, which matched the closing price for 2019. It certainly climbed a wall of woes remarkably fast, with that 44.5% sprint achieved in just 53 trading days. Indeed, it has been the most impressive meltup since bigger gains were recorded during August-September 1932 (up as much as 109.2%) and May-June 1933 (up as much as 73.2%).

Joe and I have been fretting lately about a continuation of the meltup, since it could set the stage for a meltdown. We've been rooting for the S&P 500 to consolidate its gains through the end of this year to give earnings a chance to recover and support stock prices. We are still using 2900 as our year-end target for the S&P 500 and 3500 for the end of next year.

That consolidation looks increasingly likely as the Fed's waves of liquidity are offset by waves of bad news on the health front and elsewhere:

(1) *Viral woes.* On Tuesday, CNBC reported that their analysis of Johns Hopkins University data found that the seven-day average of coronavirus cases in the US surged more than 30% over the week-ago level. California, Florida, and Texas are all seeing spikes in their COVID-19 hospitalization rates.

(2) *Profit-taking.* On Tuesday, CNBC reported: "Wall Street is already speculating that there's the potential some asset allocators, like pension funds, could take the big gains from the stock market and move them into bonds." Joe and I don't share this concern since bond yields are at historical lows. There's still plenty of cash on the sidelines and even in bonds that weren't sold to buy stocks in the portfolio rebalancing wave since March 23; those sources of funds are likely to be used for rebalancing into stocks on any sharp stock market selloff.

(3) *Cut in jobless benefits.* Also on Tuesday, CNBC reported: "Tens of millions of Americans who lost their jobs because of the coronavirus pandemic have been able to collect an extra $600 in weekly federal unemployment benefits over the past few months on top of the standard amount given by their state. … But on July 31, that enhanced benefit will end—and that could have dire consequences for millions of households." True, but the reopening of the economy should significantly reduce the number of people who were rendered unemployed by the mandated state lockdowns.

(4) *Trump is slipping.* This past Saturday, President Donald Trump was shocked by all the empty seats at his campaign rally in Tulsa. Political pundits immediately concluded that his chances of getting reelected are close to zero. There's lots of chatter now about the Democrats winning not only the White House but also both the House and the Senate. The fear among investors is that a Democratic sweep could lead to higher income and business taxes as well as a wealth tax.

(5) *Stress tests.* Today, the Fed will announce the results of its annual bank stress tests. These will include a "sensitivity analysis" to gauge the impact of the global pandemic on the banks. The findings could force the biggest banks to suspend or cut dividend payments after they temporarily quit share buybacks for this quarter. Sheila Bair, who led the Federal Deposit Insurance Corp. during the last financial crisis, said the Fed shouldn't need stress tests to put a stop to dividends, according to a June 24 Bloomberg article.

There's no shortage of worries. There's also no shortage of liquidity.

Strategy II: Back in the Driver's Seat. When we look back on the COVID-19 pandemic, we'll certainly remember the pleasant but unsettling lack of traffic. During the height of the quarantine, bike rides on normally busy streets were a joy and the Long Island Expressway was empty enough that Jackie let her newly minted 17-year-old driver take the wheel.

Things certainly have changed in the last few weeks. Local traffic has picked up, and we've started driving in the HOV (high-occupancy vehicle) lane again. The four-week average of US gasoline demand bottomed in May at roughly 5.4 million barrels per day (mpd) and since has jumped to about 7.6 mbd, the US Energy Information Administration reports. Demand is still about 2 mbd lower than it was last year, but it's improving along with the price of oil (*Fig. 2*).

The price of Brent crude oil futures has been very sensitive to COVID-19 headlines. The price of Brent surged past $40 on Monday on optimism about the global economic reopening and fell to $40.20 on Wednesday on reports of spikes in COVID cases in some states (*Fig. 3*). If the OPEC+ consortium can stick together, the price of a barrel of oil should continue to head higher, perhaps to between $50 and $60. But it's tough to see the price of oil heading much higher because there's so much excess capacity waiting on the sidelines to be brought back to the market. Here's a look at some of the inputs that will determine where the price of oil goes next:

(1) *Oil prices recovering along with demand.* Petroleum use has picked up as China's economy restarts and restrictions attempting to stop the spread of COVID-19 are lifted in the US and Europe. The Global Purchasing Managers Composite Index, for both manufacturing and non-manufacturing businesses, bounced to 36.3 in May from a low of 26.2 in April, and all indications are the improvement continued in June (*Fig. 4*).

The US Energy Information Administration (EIA) recently upped its Brent crude oil price estimate to $37 per barrel in the second half of 2020, up $5 from its forecast in May, because demand increased more than expected and production fell more than expected. Global petroleum and other liquid fuels consumption averaged 82.9mpd last month, up 3.7 mbd from April, the EIA estimates in its June 17 report. The agency estimates that global demand will bottom in Q2 at 82.8 mbd, down from 100.5 mbd in Q2-2019, before it gradually recovers over the course of the next year.

That progress could undoubtedly reverse if the rise in COVID-19 cases pushes governments to shut down economies again. However, we're inclined to believe that isolated shutdowns are a most likely a reaction to COVID-19 hot spots and that widespread shutdowns won't repeat.

(2) *Global supply falling fast.* OPEC's oil production cuts and the dramatic drop in US production have combined to shrink oil production sharply. OPEC +, which includes Russia, agreed in April to cut 9.7 mbd from its production and recently extended that agreement

through July. The organization estimated that 87% of members conformed to the agreement and that those that hadn't met their commitments would do so in the upcoming months.

Meanwhile, US production has fallen sharply, as the low price of oil has made it uneconomical to pump out of the ground. The US rig count has fallen to 266 as of the June 19 week, the lowest in the history of the series dating back to mid-1987 (*Fig. 5*). Meanwhile, US crude oil production has tumbled to 11.0 mbd in mid-June, down from the peak of 13.0 mbd in October 2019 (*Fig. 6*).

The drop in production from OPEC+ and the US combined is expected to reduce worldwide oil production to a low of 92.0 mbd in Q3, down from 100.1 mbd in Q3-2019, before production slowly starts to climb again, according to EIA's June forecast.

(3) *Inventories surge.* With supply running far higher than demand, inventories have surged at home and abroad. US stocks of crude oil and petroleum products jumped to 1.45 billion barrels during the June 19 week, well above the more normal levels of 1.34 billion barrels last year at this time (*Fig. 7*).

The EIA estimates that the oversupply for the entire OECD (Organisation for Economic Co-operation and Development) will peak in Q2 at 8.75 mbd of excess supply, and OECD commercial inventories will peak in the same quarter at 3.35 million barrels, up from 2.92 million barrels a year ago. EIA forecasts demand then will outpace supply starting in Q3, and inventories will gradually be drawn down over the course of the next year.

(4) *US energy sector decimated.* US energy companies have scrambled to adjust to COVID-19 energy-demand destruction. Those with flexibility slashed capital expenditures and raised cash, while overleveraged players filed for bankruptcy protection.

Eighteen exploration and production companies and 14 oilfield service providers have filed for bankruptcy this year, including some companies with massive debt loads. McDermott International had $9.9 billion of debt when it filed for bankruptcy protection. Diamond Offshore Drilling had $2.6 billion of debt, and there was roughly $3.5 billion of debt at each Whiting Petroleum and Ultra Petroleum, according to May 31 reports from Haynes and Boone law firm.

Energy stock investors had started to look past the bankruptcies and instead look forward to the reopening of global economies. The sector rallied 95% from its March 18 low through June

8. Since then, the S&P 500 Energy sector has lost some ground and is now up only 65% from its March low (*Fig. 8*). The Energy sector remains down 34.6% ytd through Tuesday's close and is the worst-performing sector in the S&P 500 ytd (*Fig. 9*).

Analysts forecast the S&P 500 Energy sector's revenue will plummet 28.8% this year, and then rebound by 13.9% in 2021 (*Fig. 10*). Earnings are expected to decline even more sharply, by 109.4% in 2020, only to surge next year (*Fig. 11*). The industry's forward P/E has soared as earnings tumbled (*Fig. 12*). If a COVID vaccine is in our future, the Energy sector should be among the S&P 500 sectors that benefit the most.

Disruptive Technologies: Quantum Leaps. Just as technological advancements in traditional computing have slowed down, advancements in quantum computing have sped up. Companies are rolling out faster quantum computers, and scientists are dreaming up ways to connect these computers with a quantum Internet that requires the development of new equipment.

The industry is evolving quickly. Gartner estimates that by 2023, one-fifth of businesses and governments will have budgets for quantum-computing projects, up from less than 1% in 2018. Here's Jackie's look at some of the latest quantum developments:

(1) *Honeywell jumps in.* Honeywell, an industrial company founded in 1906 in Wabash, Indiana, has entered the fray with a quantum computer that it claims is faster and more accurate than the competition's offerings.

IBM's and Google's quantum computers use superconducting qubits in circuits supercooled to just above absolute zero. Honeywell's computer uses ion traps, which hold the computer's qubits in place with electromagnetic fields. "Superconducting quantum chips are faster, but ion traps are more accurate and hold their quantum state for longer," a March 3 *MIT Technology Review* article reported.

Honeywell's computer has six qubits, but because they have fewer errors, the quantum computer has a quantum volume of 64. Quantum volume uses a quantum computer's qubits, their error rates, and connectivity to give users a measure of the computer's power. IBM's quantum computer has a quantum volume of 32.

Google hasn't divulged its quantum computer's quantum volume measurement. But last year, Google boasted that its quantum computer, with 53 qubits, had achieved "quantum supremacy" by performing a task that couldn't be done by a traditional computer. IBM disputed Google's claim.

Nonetheless, as Honeywell adds more qubits to its system, it believes its quantum volume will increase from today's 64 to 640,000, or by a factor of 10 each year, a June 18 CNET article reported. IBM believes its computer will double its quantum volume each year.

(2) *Looking to the clouds.* These super-advanced quantum machines are too expensive for companies to own at this point. So they are being set up in the cloud, and companies can pay to "rent" them. Microsoft's Azure Quantum lets customers remotely use quantum computers by Honeywell, IonQ, and QCI. Amazon Web Services lets customers use quantum computers from D-Wave, IonQ, and Rigetti. IBM's computer is available through its own IBM Cloud. A June 19 *Forbes* article reported that Honeywell is charging customers about $10,000 an hour to use its quantum computer.

(3) *Connecting to the cloud.* To access quantum computers in the cloud most efficiently and safely, scientists are building a quantum Internet. Unlike the existing Internet, the quantum Internet will be unhackable.

Four cities in the Netherlands have been connected by a quantum Internet developed by scientists at Delft University of Technology. The system communicates by sending entangled photons. It is considered unhackable because "entangled photons can't be covertly read without disrupting their content," an April 2 article in *MIT Technology Review* explains.

Right now, the particles can travel a bit less than a mile. To increase the travel distance, scientists are working to create quantum repeaters. Researchers at MIT and Harvard University have developed a prototype "that can catch, store, and entangle bits of quantum information," ensuring that the information is unhackable, a March 24 Interesting Engineering article explained.

Because quantum computers are being housed in the cloud, it's important that the means of accessing them is unhackable. For example, a company may want to use a quantum computer in the cloud to test its proprietary material design. But if it sends the design to the cloud via the traditional Internet, the information could be exposed. If it can send the design via the quantum Internet, the design can remain secret.

CALENDARS

US: Thurs: Initial & Continuous Jobless Claims 1.300m/19.968m, Real GDP -5.0%, GDP, PCE, and Core CPI Price Indexes 1.4%/1.2%/1.6%, Durable Goods Orders Total & Ex Transportation 11.2%/2.5%, Advance Goods Trade Balance, Kansas City Fed Manufacturing Fed Manufacturing Index, EIA Natural Gas Storage, Fed Stress Test Results For Big Banks, Kaplan, Mester, Bostic. **Fri:** Personal Income & Spending -6.0%/9.0%, Core PCED 0.9% y/y, Consumer Sentiment Index Total, Current Conditions, and Expectations 79.0/87.8/73.1, Baker-Hughes Rig Count. (DailyFX estimates)

Global: Thurs: Germany Gfk Consumer Confidence -12, ECB Council Meeting, Mersch, Schnabel. **Fri:** None. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) rose yet again this week, moving back above 3.00 for the first time since the January 21 week. The BBR climbed for the 13th straight week, to a 22-week high of 3.11, after falling from 2.89 to 0.72 (the lowest since February 2016) the prior five weeks. Bullish sentiment jumped to 57.3% (also the highest since the January 21 week) after a swift pullback last week to 54.9%. It has increased 11 of the past 13 weeks by 27.2ppts, following a five-week plunge of 24.6ppts (to 30.1% from 54.7%)—to its lowest percentage since late December 2018. Bearish sentiment has slumped 23.3ppts the past 13 weeks to 18.4% (the lowest since January 21 week), after shooting up 22.8ppts (41.7 from 18.9) the previous five weeks. Meanwhile, the correction count fell to 24.3% this week from 26.5% last week, reversing roughly half of last week's 4.0-point gain; it's been in a volatile flat trend in recent weeks. The AAII Ratio fell to 33.8% last week after increasing the prior five weeks from 31.0% to 47.4%. Bullish sentiment fell for the second week to 24.4% last week after rising the prior three weeks from 23.3% to 34.6%, while bearish sentiment rebounded to 47.8% after dropping from 52.7% to 38.1% the prior five weeks.

S&P 500 Growth vs Value (*link*): The S&P 500 Growth price index leads ytd through Tuesday's close with a gain of 8.2% versus a 15.8% decline for Value. Since their low for the year on 3/23, Growth's 45.3% gain is well ahead of the 32.8% rise for Value. Growth is now just 0.3% below its 2/19 record high, and Value is back in a correction again at 16.8% below its

1/17 record high. Looking at the fundamentals, Growth is expected to deliver higher revenue growth (STRG) and earnings growth (STEG) than Value over the next 12 months. Specifically, 5.6% STRG and 7.3% STEG are projected for Growth, respectively, versus -0.1% and -4.7% for Value. Through Tuesday's close, Growth's P/E of 27.4 was the highest since June 2001 and up from its 15-month low of 16.8 on 3/23. Growth's valuation previously peaked at 24.2 on 2/19, which was then its highest level since April 2002 when the tech bubble was deflating. Value's forward P/E of 17.1 is down from 18.6 on June 8, which was then the highest since July 1999 and up from 10.0 on 3/23, which was its lowest reading since November 2011. Regarding NERI, Growth's was negative in June for an 11th straight month, but improved to -27.9% from an 11-year low of -35.0% in May. That compares to a record high of 22.3% in March 2018. Value's NERI was negative in June for a 20th month, and up to -32.5% from an 11-year low of -39.0% in May; that compares to a record high of 21.2% in March 2018. The Tax Cuts and Jobs Act (TCJA) sharply boosted the consensus forward earnings estimates and the forward profit margin for both Growth and Value in 2018. Growth's forward profit margin improved from a low of 14.9% during May to 15.0% on 6/18. It remains above the 14.4% prior to the TCJA's passage but is down from its record high of 16.7% during September 2018. Value's forward profit margin of 8.1% is up from a low of 8.0% during May, but is well below the 9.1% prior to the TCJA and down from a record high of 10.5% in December 2018.

US ECONOMIC INDICATORS

New Home Sales (*link*): New single-family home sales rose in May for the first time since January, soaring an unexpected 16.6% to 676,000 units (saar) after plunging 25.1% during the three months through April. Of the four regions, Northeast sales were the strongest in both May and compared to a year ago—with both coincidentally up 45.5%. Here's a tally of sales performances for the remaining three regions: West (29.0% m/m & 31.0% y/y), South (15.2 & 6.4), and Midwest (-6.4 & 2.8). The outlook remains promising as homebuilders become more optimistic. 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.

GLOBAL ECONOMIC INDICATORS

Germany Ifo Business Climate Index (*link*): "German business sees light at the end of the tunnel," Ifo Chief Clemens Fuest said in a statement, as expectations soared. Germany's Ifo Business Climate Index posted back-to-back record monthly gains in May (+5.4 points) and June (+6.5), climbing to 86.2 this month, after plunging a record 21.6 points during the two months through April to a record-low 74.3. The recent two-month rebound was driven by a record 21.9-point surge in the expectations component to 91.4, following a two-month record plunge of 23.6 points to a low for the series of 69.5. The present situation component increased for the first time in five months to 81.3, after falling from 99.1 in January to 78.9 in May—which was the lowest since July 2009. The improvement in morale was enjoyed by almost all the economic sectors—driven by soaring expectations; most firms' assessments of their current situation remained poor. Expectations within the manufacturing sector advanced at its strongest rate on record—jumping 55.8 points during the two months through June to 0.0, while other sectors also enjoyed a surge in expectations over the two-month period: service sector (+45.7 points to -7.4), trade (+40.0 to -24.1), and construction (+19.6 to -30.7).

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