MORNING BRIEFING
August 5, 2020

Survival of the Fittest?

Check out the accompanying chart collection.

(1) Less civil civilization. (2) It's all relative. (3) More like Darwin's natural selection than survival of the fittest. (4) The virus picks winners and losers. (5) With interest rates near zero and a scarcity of Growth stocks, valuation multiples soar. (6) The US has the FAANGMs, and the rest of the world does not. (7) Service-providing companies remain among the biggest losers from the pandemic. (8) A brief update on the plunges and weak recoveries so far in various service industries. (9) Millennials finally have a good reason to buy homes. (10) Baby Boomers may stay put. (11) Not enough homes for sale. (12) Many tenants and their landlords are in a world of pain.

Strategy I: Natural Selection. Have you noticed that human civilization has gotten less civil since the Great Virus Crisis (GVC) was declared a pandemic by the World Health Organization on March 11? Actually, it's been getting less civil for a while, all around the world. And it wasn't all that civil in the past.

On the other hand, it's not like the virus has presented humankind with a Darwinian survival-of-the-fittest existential challenge. Despite all our troubles, we still aren't living through anything like the miseries of World War I, the Spanish Flu, and World War II. Since the end of the Cold War, life has been much better for lots of people who had been behind the Iron Curtain and the Bamboo Curtain. In the US, our extreme partisanship isn't really that extreme in the context of American history. If we can just develop an effective vaccine soon, maybe we can go back to our old normal, which wasn't so bad, all things considered.

For now, the virus continues to plague our society, increasing tensions, which might account for some of the lack of civility. In every nation, no matter the economic system, there are always haves and have-nots as reflected in measures of income and wealth inequality. The virus has sliced the collective pie in whole new ways, with widening divides between people who remain employed and those who have lost their jobs as well as between businesses benefitting from increased demand thanks to the pandemic and those hit so hard by it that they may not survive.

The virus has caused a very odd kind of Darwinian struggle, because there is no real struggle. The virus has naturally selected certain businesses and their workers to prosper while others have been naturally selected to struggle to survive. Consider the following winners and losers selected by the virus:

(1) *Internet-related businesses.* In the economy and the stock market, the selected winners are the FAANGM companies (i.e., Facebook, Amazon, Apple, Netflix, Google, and Microsoft). They benefit as more of us use the Internet to work and study from home and to be entertained by movie- and game-streaming services. Cloud providers and technology companies that provide the hardware and software to maintain and expand the cloud are booming.

(2) *Home, sweet home.* Online retailers and delivery services are also flourishing as more people prefer to stay home and out of stores. Homebuilders and realtors are profiting from the booming demand for new and existing homes in the suburbs and rural areas as a result of de-urbanization. Lumber yards are scrambling to meet demand. Home furnishings and appliance makers and retailers are also making lots of money.

In the transportation sector, commuter rail and air transportation companies have lost lots of passengers as more Americans work from home, prefer to drive to work, and replace business trips and meetings with Zoom calls. Most trucking services remain in high gear, delivering all the goods ordered online to warehouses and customers' front doors.

(3) *Investors gaining and losing.* In the financial sector, stock investors have recovered almost all their February 19-March 23 losses since then. They are actually up for the year if they've invested in the Nasdaq. The losers are investors who relied on fixed-income securities and can no longer do so with interest rates so close to zero.

(4) *Healthy and not so.* In the health care sector, drug companies and biotech companies are being showered with billions of dollars from private and public investors hoping to expedite the development of vaccines, treatments, cures, and tests for the virus. Meanwhile, the bread-and-butter business of elective surgery for physicians and hospitals has suffered.

The stress on our nation's mental health remains severe. While the press is monitoring the cases, hospitalizations, and deaths related to the virus, drug abuse, depression, and suicides are mounting and taking a long-term toll on our society.

Strategy II: 800-Pound Gorillas. As Joe and I have been discussing in recent months, the clear winners are the FAANGM companies, as evidenced by the outperformance of their stock prices during the GVC. They've had a significant impact on the three major investment styles: LargeCaps versus SMidCaps, Growth versus Value, and Stay Home versus Go Global. Here are a few updates of points we've made in the past along with a couple of new insights:

(1) *Market-cap & earnings shares, and valuation.* The FAANGMs' collective current market capitalization is a record $6.9 trillion, accounting for a record 25.6% of the S&P 500's market cap (*Fig. 1* and *Fig. 2*). Their share of S&P 500 forward earnings rose to 13.5% during the week of July 31 (*Fig. 3*).

The FAANGMs aren't cheap by historical standards of valuation. Their forward P/E rose to 40.7 during the July 31 week (*Fig. 4*).They've led the rebound in the forward P/Es of the S&P 500 and the S&P 500 Growth indexes to 22.3 and 28.2 currently. Meanwhile, the forward P/E of the S&P 500 Value index is currently relatively cheap at 17.1.

Then again, the growth rates of the forward revenues and forward earnings of the FAANGMs continue to outpace that of the S&P 500 excluding them (*Fig. 5* and *Fig. 6*). With interest rates near zero all across the yield curve, investors have been willing to pay much higher forward P/Es for Growth stocks than in the past.

(2) *Big impact on Stay Home vs Go Global.* Joe and I monitor the relative performance of Stay Home versus Go Global by tracking the ratios of the market caps of the US MSCI to the All Country World ex-US MSCI in dollars and in local currencies (*Fig. 7*). While the former has underperformed the latter in recent week, the trends of both ratios remain solidly to the upside.

Then again, when we calculate the ratios excluding the FAANGMs plus NVIDIA and Tesla, we see that they have been relatively flat since late 2018 (*Fig. 8*).

US Economy I: From Big To Small. While the Magnificent Six are gobbling up more of the economy, market cap, and earnings, everyone else is losing their relative shares. Certain service-providing companies have been especially hard hit by lockdowns, the slow lifting of lockdown restrictions, and ongoing social-distancing requirements. Consumer spending on services plunged by 20% from a record high of $10.3 trillion (saar) during February to $8.2 trillion during April and bounced back up by 11% to $9.1 trillion during June (*Fig. 9*). Let's review how the GVC has impacted current-dollar spending by consumers on the various categories of services:

(1) *Health care services.* While hospital ICUs in some parts of the country have been overwhelmed by COVID-19 patients, spending on health care services in general and on hospitals in particular plunged 44% during March and April as hospitals prepared for the expected onslaught of such patients by cancelling all elective procedures (*Fig. 10*). Health care services has rebounded 42% since then through June.

(2) *Restaurants.* Consumer spending on food consumed in restaurants and bars plunged 48% from a record high of $863.8 billion during January to $452.8 billion during April (*Fig. 11*). Meanwhile, food consumed at home jumped 23% from $1,033 billion during January to $1,273 billion by March. Since the recent low, spending on food in dining establishments rebounded 50% to $680.7 billion during June.

(3) *Travel.* Among the hardest-hit services industries have been hotels and air transportation. People are traveling less for business, tourism, and entertainment. Consumer spending on hotels and motels plunged 83% from a record high of $123.5 billion (saar) during December to $20.5 billion during April (*Fig. 12*). Over the same period, consumer outlays on air transportation dropped 96% from $120.8 billion to $5.1 billion. Since then through June, both have barely rebounded.

(4) *Recreation.* Consumer spending on recreation services plunged 62% from a record high of $598.7 billion (saar) during January to $229.2 billion during April. It has recovered just 49% since then through June. Looking at some of the components of the total: amusement parks, campgrounds & related recreation and admissions to specified spectator amusements fell 79% and 100%, respectively, from their December peaks through April, with the latter barely budging from its record low. Gambling was down 82% from its January peak through April, though appears to be on an upswing (*Fig. 13*).

(5) *Rent.* Last, but not least, tenant-occupied rent rose to a record $647.3 billion (saar) during June (*Fig. 14*). That figure is bound to be revised sharply down once the government's statisticians can assess the magnitude of the eviction problem caused by the inability of millions of unemployed workers to pay their rent, as discussed below.

US Economy II: Staying-Home Economy. The pandemic has accelerated previously developing demographic and lifestyle trends, which have boosted the housing market despite the virus-ridden climate. Millennials (born 1981-96) are notorious for delaying the natural middle-class American progression of adulthood from getting married to having kids to moving to the suburbs. But virus-related lockdowns may have caused many 30-somethings to value home life more than before the pandemic. And with work-at-home arrangements and historically low mortgage rates facilitating moves from cramped city apartments into the 'burbs, Millennials' leap into the traditional trappings of adulthood is accelerating.

At the same time, many Baby Boomers are opting to stay put in their existing homes for now, tightening the supply of available homes for Millennials. Let's anecdotally consider some of the likely demographic drivers of the housing market expansion:

(1) *Betting on the farm*. Redfin's CEO, discussing the effects of the pandemic on housing markets recently, said that homebuyers have undergone a "profound, psychological change" that has flipped demand toward rural areas and away from cities. Folks were forced to spend nearly all their time at home during the pandemic-related lockdowns. Many continue to socially distance, staying home as much as possible, as the virus spread accelerates in many communities after the lifting of lockdowns.

Many folks want to leave densely populated areas hit hard by the pandemic and head for the hills. They've been cooped up and are dreaming of large interiors, with designated spaces for work and school, as well as nice backyards and pools. Many workers who were able to work from home during lockdowns suffered no income loss and indeed received an income boost from the first round of pandemic-aid stimulus checks. With many of their employers still operating remotely and some planning to do so permanently, these workers are enjoying freedom from a commute-free lifestyle.

Some parents of school-aged children may have become disenchanted with previously sought-after school districts. Many school buildings remain closed for the foreseeable future. Lots of children are either set to learn remotely or to be homeschooled at least through the fall until who-knows-when. Homeschooling, previously considered atypical education, may become more commonplace. Our very own Melissa, an older Millennial, half-jokingly has considered moving her young family out of a suburban area north of Atlanta to a rural town in Tennessee, zoned for chickens and ideal for homeschooling on the homestead. Just like *Little House on the Prairie*.

(2) *Millennials buying homes*. Melissa is far from alone among Millennials in reevaluating where to put down roots. The trickle of urban exodus that the generation has been noted for may be accelerating. The Millennials overtook the Baby Boomers as the largest generation during 2019, and now they are at the prime age range for homebuying (24-39 years old in 2020). The median age of first-time homebuyers is 31, a July 31 *Forbes* article noted. First-time buyers were responsible for 35% of sales in June as compared to an annual share of 33% during 2019, according to the National Association of Realtors.

(3) *Boomers staying put.* Even before the pandemic, an "aging-in-place" trend was evident among the Baby Boomers. Since the pandemic hit, Baby Boomers mostly have continued to stay put in their current homes given the increased risks COVID-19 poses to them, particularly older Boomers living in communal arrangements. Data from the National Association of Home Builders showed that homebuilder confidence for 55+ communities or assisted living dove during Q1 but has rebounded during Q2. That may indicate that existing housing inventory could open up for Millennials if more Boomers retire and trade their homes for community living down the line. Many Boomers may be retiring earlier, said a recent AARP blog, which pointed to evidence that those aged 65 are leaving the labor force at an expedited pace.

By the way, the homeownership rate skyrocketed in Q2 from Q1 to a record 67.9% from 65.3%. Some of the increase may be explained away by changes to the data collection due to the pandemic, but likely not all of it. Nevertheless, the monthly average response rates to the survey for Q2-2020 were about 15ppts below those of Q2-2019. The US Census Bureau's release noted that data users should "exercise caution when comparing the second quarter estimates to previous quarters."

US Economy III: Eviction Cliff Looming. While the picture may be rosy for those with the freedom and ability to afford a white-picket fence, that's not the case for all. A dichotomy is growing in the housing market. Many low-income workers living in rental units are on the brink of eviction. Not only are renters increasingly cost burdened by rising rents and other costs of living, but the moratorium on evictions for federally assisted housing put into place by the Coronavirus Aid, Relief, and Economic Security (CARES) Act recently has expired (see here for more).

The share of income lost from the pandemic has been disproportionately huge for low-income workers. Displaced hospitality and food services workers have limited earning prospects in the near future. Also lapsed is the generous weekly federal $600 boost to state unemployment insurance afforded by the CARES Act. Some level of aid is likely to be reinstated, but it's currently unclear how much. On Monday, as leaders on both sides of the aisle met to continue to negotiate the next virus-relief plan, President Trump said that he might act to stop evictions, reported Bloomberg. While Trump offered no details, the eviction crisis clearly has become a national concern.

The problem preceded the pandemic, but the pandemic has made it worse. "Of America's nearly 43 million renters, about 20.8 million—almost half—were 'cost-burdened,' meaning more than 30 percent of their income went to housing costs, according to the Joint Center for Housing Studies of Harvard University. Of those, about 10.9 million renter households were 'severely burdened,' spending more than 50 percent of their income on rent," reported Vox. The article added: "The Covid-19 Eviction Defense Project, a Colorado-based legal project, estimates that between 19 million and 23 million renters are at risk of eviction by the end of September."

CALENDARS

US: **Wed:** ADP Employment Change 1.5m, ISM NM-PMI 55.0, IHS Markit C-PMI & NM-PMI 50.0/49.6, Balance of Trade -$50.3b, MBA Mortgage Applications, EIA Crude Oil Inventories. **Thurs:** Initial & Continuous Jobless Claims 1.408m/16.839m, Challenger Job Cuts Report, EIA Natural Gas Inventories. (DailyFX estimates)

Global: **Wed:** Eurozone Retail Sales 5.5%m/m/-0.5%y/y, Eurozone, Germany, and France C-PMIs 54.8/55.5/57.6, Eurozone, Germany, and France NM-PMIs 55.1/56.7/57.8, UK C-PM & NM-PMI 57.1/56.6, Mester, Kuroda. **Thurs:** Germany Factory Orders 10.1%, Italy Industrial Production 5.1%m/m/-16.9%y/y, Japan Household Spending -7.5% y/y, China Trade Balance $42.5b, BOE Rate Decision 0.1%, BOE Quantitative Easing £745b, BOE Inflation Report, RBA Statement on Monetary Policy, Beermann, Ellis. (DailyFX estimates)

US ECONOMIC INDICATORS

Manufacturing Orders & Shipments(*link*): Factory orders rose again in June, after tumbling to its lowest level since 2009 in April. Billings jumped 14.4% during the two months ending June, following a two-month plunge of 23.0%—as transportation equipment orders soared 114.9% after a two-month plunge of 71.0%. Excluding transportation, orders accelerated 7.1% during the two months through June following a 12.6% freefall the prior two months. In the meantime, both core capital goods orders and shipments recovered a bit in May and June following steep declines. Nondefense capital goods orders ex aircraft (a proxy for future business investment) accelerated 3.4% in June; this followed a downwardly revised 1.5% (vs 2.3%) in May, 6.6% in April, and 8.3% during the three months through April. Meanwhile, core capital goods shipments (used in calculating GDP) jumped 3.3% in June, double May's 1.5% gain, which followed declines of 6.4% and 8.2%, respectively, over the comparable April periods.

Auto Sales (*link*): Motor vehicle sales in July remained on its upward trajectory since hitting bottom in April, driven by domestic light truck sales. Total sales rebounded 5.7mu during the three months ending July, to 14.5mu (saar), after plummeting 8.3mu during the two months ending April to a record-low 8.8mu. Domestic light truck sales jumped to 8.6mu (saar) last month, up from April's cyclical low of 5.4mu and within 1.4mu of its peak rate of 10.0mu at the start of the year. Meanwhile, domestic car sales remain in a rut, climbing to 2.5mu in July—only 1.0mu above April's record low of 1.5mu. Sales of imports in July recovered to 3.4mu (saar) after tumbling from a recent peak of 3.9mu in February to 2.0mu in April—its weakest performance since September 1998.

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