MORNING BRIEFING
August 11, 2020

Another Roaring Twenties May Still Be Ahead

Check out the accompanying chart collection.

(1) A precedent for our times. (2) Still lots of years left for the 2020s to roar like the 1920s. (3) Malthusians never see technological innovation coming. (4) Technology solves the problem of scarce resources. It also boosts productivity and prosperity. (5) Lots of amazing innovations during the 1920s, and since then. More ahead in the 2020s. (6) Vaccines, treatments, and cures for those pesky viruses. (7) High-tech spending on IT equipment software, and R&D now accounts for a record 50% of capital spending. (8) Silent Cal vs Loud Don. (9) Government has gotten bigger since 1920s, and will get even bigger in the 2020s. (10) Crony capitalism isn't capitalism, but it doesn't have to be bearish for stocks either. (11) S&P 500 has been tracking 2% Dividend Yield Model since 2010.

Strategy I: Good Times Follow Bad Times. We seem to be living in unprecedented times. We always seem to be living in unprecedented times, according to conventional wisdom, mostly because we don't spend enough time studying history. There's certainly a precedent for our current times in the past, one that was truly unprecedented back then.

World War I was followed by the Spanish Flu pandemic of 1918, which infected an estimated 500 million people and killed as many as 50 million. Given that the world population was 1.8 billion back then, that implied a 28% infection rate and nearly a 3% death rate. Both stats are currently significantly lower for the COVID-19 pandemic. Today, the global population is 7.5 billion. There have been 20 million cases and 735,000 deaths worldwide as of yesterday.

The good news is that the bad news during the previous precedent was followed by the Roaring Twenties. So far, the 2020s has started with the pandemic, but there are plenty of years left for the prosperous 1920s to become a precedent for the current decade. If so, the driver of the coming boom will be technology-enhanced productivity, as it was during the 1920s.

Before we go there, let's go back to the late 1700s and recall the grim forecasts of Thomas Malthus. He was the first economist, and he was a pessimist. In other words, he was the first Malthusian. During the late 1700s, he predicted that populations would grow faster than food

production; the result would be a regular cycle of starvation and death. He was dead wrong. Agriculture was among the industries that benefitted the most from the Industrial Revolution of the 1800s. Technological progress always confounds the pessimists by solving scarce-resource problems. It also fuels productivity and prosperity, as it did in the 1920s and could do again in the 2020s. Consider the following:

(1) *Technology during the 1920s*. In 1920, 51% of the US population lived in cities, up from 23% in 1870. This remarkable urbanization was enabled by innovations in electricity and plumbing. Electric grids provided clean, bright light without emitting smoke. Urban water networks supplied clean water, and sewer systems removed waste without the pungent odors of chamber pots and outhouses. Telephones allowed people to converse with distant friends.

Henry Ford's Model T, built between 1908 and 1927, was the first car invented and helped people to live an easier life by making transportation easier and faster. In 1900, just 8,000 motorcars were registered in the US, but there were 9 million in 1920 and 23 million in 1929. Streetcars and subways, unheard of in 1870, were in all the major cities by 1920. Intercity trains were becoming steadily faster and more reliable. Detroit Police Officer William Potts came up with the idea of traffic lights, taking inspiration from railroad traffic signals. General Electric bought the idea for $40,000, and traffic lights soon were everywhere.

Ford's assembly line innovation boosted productivity in many manufacturing industries, including the processed food industry. National food brands—including Heinz, Campbell's, Quaker Oats, Jell-O, and Coca-Cola—began to fill cupboards. Refrigerated railroad cars and in-home iceboxes meant that vegetables were available in winter. Restaurants began to proliferate early in the 20th century. When people out and about in their Model Ts got hungry, their options were few, but the first fast-food chain opened its doors in 1919, an A&W (better known today for its root beer). White Castle hamburger stands opened in 1921, and the first Howard Johnson's restaurant in 1925.

Increasingly, anything not available in a local store could be obtained by a mail-order catalog. The Montgomery Ward catalog was first issued in 1872, the Sears catalog in 1894. By 1900, Sears was fulfilling 100,000 orders a day, and its catalog featured fur coats, furnaces, furniture, and much more—including homes. Sears sold more than 70,000 mail-order homes between 1908 and 1940. The catalog business was helped along by Parcel Post, which arrived in 1913.

Penicillin is considered one of the most important inventions to come out of the 1920s. It was created by Sir Alexander Fleming, Professor of Bacteriology at St. Mary's Hospital in London, after studying bacteria in 1928. The antibiotic kills or prevents the growth of bacteria.

The bulldozer—used today in all kinds of construction the world over—was invented in 1923 by James Cummings and J. Earl McLeod, originally to dig canals.

Another popular invention found in almost every home by the mid-1900s was the radio. Listening to the radio became a national pastime, and many families gathered in their living rooms to listen to sports news, concerts, sermons, and "Red Menace" news. The phonograph—invented in 1877 and widely used by the 1920s—offered another entertainment option: listening to professional-quality music at home, unheard-of in earlier generations. Outside the home, going to motion picture shows—which were silent until 1927—was a very affordable and popular pastime.

(2) *Technology during the 2020s*. Today's doomsters could be confounded by biotechnological innovations that deliver not only a vaccine for COVID-19 but for all coronaviruses. In the March 5 *Morning Briefing*, we discussed technology using messenger RNA (mRNA) to instruct our cells to make antibody-producing proteins that provide immunity to viruses.

Last Thursday, Jackie and I observed: "Scientists are investigating a dizzying array of approaches to fight COVID-19. Hopefully, beyond finding a cure or a vaccine, one of beneficial outcomes of all this research will be that scientists learn many more ways to combat illnesses in general and viruses in particular." Typically, it takes roughly a decade for a new vaccine to go through the various stages of development and testing. However, the urgency of the pandemic has mobilized global medical resources as rarely seen in human history. Billions of dollars, provided by both the public and the private sectors, are funding the global campaign to develop tests, vaccines, and cures for the virus.

Jackie and I have been writing about disruptive technologies for some time, usually in our Thursday commentaries. (See our archive of Disruptive Technologies Briefings.) The awesome range of futuristic "BRAIN" technological innovations includes biotechnology, robotics and automation, artificial intelligence, and nanotechnology. There are also significant innovations underway in 3-D manufacturing, electric vehicles, battery storage, blockchain, and quantum computing. As I wrote in my 2018 book *Predicting the Markets*:

“Economics is about using technology to increase everyone’s standard of living. Technological innovations are driven by the profits that can be earned by solving the problems posed by scarce resources. Free markets provide the profit incentives to motivate innovators to solve this problem. As they do so, consumer prices tend to fall, driven by their innovations. The market distributes the resulting benefits to all consumers. From my perspective, economics is about creating and spreading abundance, not about distributing scarcity.”

Now consider the follow stats on technology capital spending in the US: High-tech spending on IT equipment, software, and R&D rose to a record $1.32 trillion (saar) during Q2-2020 (*Fig. 1*). It jumped to a record 50.1% of total capital spending in nominal GDP during the quarter (*Fig. 2*). Equipment and software accounted for 31.1%, while R&D accounted for 19.1% of capital spending in nominal GDP (*Fig. 3*).

Strategy II: More Socialism, and Crony Capitalism Too. The 2020s differ from the 1920s in several important ways. As noted above, urbanization increased significantly during the 1920s. It’s too soon to be sure, but one of the initial reactions to the COVID-19 pandemic could be de-urbanization, which has already sparked a boom in demand for existing and new homes in the suburbs and rural areas of the country. If that trend continues, it might contribute to the Roaring 2020s. De-urbanization could also boost auto sales, especially of hybrids and electric vehicles.

Perhaps the biggest difference between the 1920s and the 2020s are the structure of the US economy and the size of our government. During the 1920s, the White House was occupied by two laissez-faire Republican presidents. Warren Harding (1921-23) took the advice of his Treasury Secretary Andrew Mellon and cut marginal tax rates and deregulated business. By late 1922, the economy started to rebound from the recession at the start of the decade. Calvin Coolidge (1923-29) was Harding’s vice president and replaced him when Harding died suddenly. “Silent Cal” didn’t say much, but he clearly believed in small government. One thing he famously said: “The business of America is business!” While the President remained relatively silent, the economy roared. (By the way, what he actually said was: “After all, the chief business of the American people is business. They are profoundly concerned with producing, buying, selling, investing and prospering in the world.”)

President Donald Trump certainly isn’t the silent type. But he has cut taxes and deregulated business, carrying on the tradition of his predecessors of the 1920s. However, he is hardly a believer in laissez-faire economics, as evident from his trade policies and his various economic

interventions. In addition, unlike Harding and Coolidge, he isn't troubled by Big Government and huge federal deficits (*Fig. 4*).

Trump actually may have set the stage for bigger deficits, a Universal Basic Income (UBI), and the fiscal and monetary excesses championed by advocates of Modern Monetary Theory (MMT). Indeed, under Trump, government social benefits soared this year to offset the damage to earned incomes wrought by the pandemic (*Fig. 5*). If Trump loses the November 3 presidential election, a radical regime change could lead to higher taxes, more regulation, a Green New Deal, a UBI, more MMT policies, and lots more socialism.

It all adds up to Big Government getting bigger. When that happens, crony capitalism proliferates as Big Business and Big Government pursue their mutual interests. The business of American businesses, to adapt Coolidge's famous one-liner, becomes to do more business with the government. 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.

This isn't a new development, but it is getting a boost from the Great Virus Crisis (GVC). This must be very depressing for proponents of entrepreneurial capitalism and free markets. However, it isn't necessarily bearish for the stock market. As we've discussed in our recent commentaries (most recently in the August 5 *Morning Briefing* titled "Survival of the Fittest?"), the GVC has naturally selected certain industries as winners and others as losers from the pandemic's fallout. The winners literally have carried the most weight in the S&P 500 and led the 50.2% rally in the index since it bottomed on March 23 through Monday's close of 3360.47. That's a hair below the February record high of 3386.15. That's truly remarkable.

Stock investors can rejoice that Big Government is their friend—for now. The risk is that the stock market's exuberance turns increasingly irrational, resulting in the Mother of All Meltups (MAMU). That could be followed by the Mother of All Meltdowns (MAMD). It's not too hard to imagine what could possibly go wrong to convert MAMU into MAMD: i) vaccines don't work to stop the pandemic; ii) violent civil unrest worsens; iii) extreme political partisanship gets more extreme; iv) the Cold War between the US and China rapidly heats up; v) a game of chicken between the US and Iran in the Strait of Hormuz leads to a military confrontation; vi) out-of-

control MMT fiscal and monetary policies get even more out-of-control; vii) a radical left-wing regime change occurs on November 3; and viii) inflation makes a surprising comeback.

The 1920s ended with a stock market meltup followed by a meltdown. The 2020s may already be seeing a meltup, begun on March 23. We live in interesting, though not unprecedented, times. The Roaring 1920s could be a precedent for the Roaring 2020s. As Mark Twain observed: "History doesn't repeat itself, but it often rhymes."

Strategy III: Valuation One More Time. Yesterday, we pondered the valuation question, asking what the fair-value forward P/E of the S&P 500 is in a zero-bond-yield world. We concluded the obvious: It should be higher than the historical mean of this valuation metric, when inflation and interest rates were well above zero (*Fig. 6*). Today, let's examine the valuation issue based on the dividend yield of the S&P 500, again in a zero-bond-yield world:

(1) The dividend yield has hovered around 2.00% since the start of the current bull market in 2009 (*Fig. 7* and *Fig. 8*). The 10-year Treasury bond yield consistently exceeded the dividend yield from Q3-1958 through Q3-2008. Since then, the bond yield has mostly fluctuated around the dividend yield. This year, the bond yield fell to a record low of 0.52% last week. That's decisively below the Q2-2020 dividend yield of 1.92% based on the four-quarter moving sum of dividends and 1.85% using the actual annualized result for the latest quarter.

(2) During Q2-2020, the S&P 500 quarterly dividend fell 6.6% from the record high during the previous quarter (*Fig. 9*). During the Great Financial Crisis (GFC), the four-quarter sum of dividends fell 22.7% from the peak during Q3-2008 to the trough during Q1-2010. A similar decline is likely during the GVC.

(3) Our Blue Angels analysis of the actual versus the implied price of the S&P 500 (based on the four-quarter sum of dividends divided by hypothetical dividend yields) shows that the S&P 500 has been closely hugging the trajectory based on a 2.00% dividend yield since 2010 (*Fig. 10*). The S&P 500 dividend yield is likely to be closer to 1.00% in coming quarters assuming that the S&P 500 either holds its price gains or moves still higher while dividends decline during the GVC, as they did during the GFC. That still beats a bond yield that is getting very close to zero.

CALENDARS

US: Tues: NFIB Small Business Optimism, Headline & Core PPI 0.3%/0.1%, API Crude Oil Inventories, Daly. **Wed:** Consumer Price Index Headline & Core 0.8%/1.2% y/y, MBA Mortgage Applications, EIA Crude Oil Inventories, Monthly Budget Statement, Kaplan, Daly. (DailyFX estimates)

Global: Tues: Eurozone ZEW Economic Sentiment Index, Germany ZEW Economic Sentiment Index 59, UK Employment Change & Unemployment Rate -298k.4.2%, Average Hourly Earnings Including & Excluding Bonuses -1.2%/-0.1%. **Wed:** Eurozone Industrial Production 10.0%m/m/-11.6%y/y, UK GDP 8.0%m/m/-21.2%q/q/-18.5%y/y, UK Industrial Production 9.4%m/m/-13.1%y/y, Manufacturing Production 10.0%m/m/-15.0%y/y, UK Goods Trade Balance -£4.75b, Italy CPI -0.3% y/y, China New Yuan Loans & Social Financing ¥1200b/¥1850b, Australia Employment Change & Unemployment Rate 40k/7.8%. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose for all three of these indexes last week. LargeCap's forward earnings has risen for 12 straight weeks, MidCap's is up in nine of the past ten weeks, and SmallCap's posted its ninth gain of the past 11 weeks. LargeCap's forward earnings is now up 5.3% from its lowest level since August 2017; MidCap's has risen 10.5% from its lowest level since May 2015; and SmallCap's is up 11.3% from its lowest point since August 2013. These indexes had been on a forward-earnings uptrend from November until mid-February, before tumbling due to the COVID-19 economic shutdown. LargeCap's is now 17.0% below its record high at the end of January. MidCap's and SmallCap's are 26.6% and 39.1% below their October 2018 highs. 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 yearly rate of change in LargeCap's forward earnings improved to -15.9% y/y from -16.3%. That's up from mid-May's -21.2%, which was the lowest since October 2009, and down from 23.2% in September 2018, which was the highest since January 2011. The yearly rate of change in MidCap's forward earnings rose w/w to -25.4% y/y from -25.8% y/y, and is up from a record low of -32.7% at the end of May; that compares to a TCJA-boosted 24.1% in September 2018 (the highest since April 2011). SmallCap's rate rose w/w to -34.9% y/y from -36.4% y/y and is up from a record low of -41.5% in early June. SmallCap's

prior record low in its y/y percent change occurred during July 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 since early March but have been relatively stable since late May. Here are the latest consensus earnings growth rates for 2020 and 2021: LargeCap (-23.4%, 30.9%), MidCap (-35.2, 49.6), and SmallCap (-51.9, 82.0).

S&P 500/400/600 Valuation (*link*): Valuations rose across the board last week, but only the SMidCaps remain below their cyclical and record highs in early June. LargeCap's forward P/E rose 0.5pt w/w to a 19-year high of 22.6. That's up from 13.3 in mid-March, which was the lowest since March 2013. MidCap was up 0.8pt w/w to 21.2, which is down 1.7pts from its record high of 22.9 in 1999 when the SMidCap series began. SmallCap rose a similar 0.8pt w/w to 24.4 and is down 2.3pts from its record high of 26.7 in early June. 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 in mid-February—before COVID-19 decimated forward earnings—was 18.9, 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 was below LargeCap's P/E again last week, where it mostly has been since August 2018. It was last solidly above LargeCap's from April 2009 to August 2017. SmallCap's P/E is still above LargeCap's, though. It had been mostly below from May 2019 to May 2020 after being solidly above 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*): Analysts are coming off the sidelines and adjusting their future forecasts higher as Q2 earnings results come in substantially higher than their forecasts. Indeed, the S&P 500's Q2 blended EPS estimate/actual surged an unprecedented $2.39 w/w to $27.08. That $27.08 estimate represents a decline of 34.4% y/y on a frozen actual basis and -33.9% y/y on a pro forma basis. For Q3, the estimate rose 41 cents w/w to $32.47, which represents an earnings decline of 22.9%, or 22.6% on a pro forma basis. That compares to a 12.8% decline in Q1-2020, 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). The last time earnings fell markedly y/y was during the four quarters through Q2-2016. Just three of the sectors have recorded positive y/y earnings growth during Q2: Health Care, Tech, and Utilities. That's a big improvement from Q1 when all 11 sectors posted a y/y decline in earnings. Looking ahead to Q3, seven of the 11 sectors are expected to post less worse growth on a q/q

basis, reflecting the reopening of the US economy. Energy is expected to report a second straight quarterly loss during Q3. Here are the S&P 500 sectors' latest Q3-2020 earnings growth rates versus their blended Q2-2020 growth rates: Information Technology (-1.9% in Q3-2020 versus 2.2% in Q2-2020), Health Care (-2.7, 5.5), Utilities (-3.3, 6.4), Consumer Staples (-6.7, -7.8), Real Estate (-14.6, -14.9), Communication Services (-20.9, -16.7), Materials (-20.9, -28.6), Financials (-23.7, -54.1), Consumer Discretionary (-40.9, -78.3), Industrials (-65.2, -84.1), and Energy (-106.3, -168.0).

S&P 500 Q2 Earnings Season Monitor (*link*): With nearly 90% of S&P 500 companies finished reporting revenues and earnings for Q2-2020, revenues are beating the consensus forecast by a whopping 3.0%, and earnings have crushed estimates by 23.6%. The large upside surprises are primarily due to a lack of financial guidance from the companies that analysts follow, which mirrors the experience of the Q2-2009 earnings season on the heels of the Great Financial Crisis. At the same point during the Q1 season, revenues were 1.1% below forecast, and earnings beat by 4.0%. For the 449 companies that have reported through mid-day Monday, aggregate y/y revenue and earnings growth are well below the similar Q1 measures, but the percentages of companies reporting positive revenue and earnings surprises actually improved. The Q2 reporters so far have a y/y revenue decline of 9.9%, and earnings are down 34.7% in the worst quarter since the great financial crisis of 2009. The percentage of companies reporting a positive revenue surprise (64) is well below those reporting a positive earnings surprise (82). Furthermore, fewer companies are reporting positive y/y revenue growth in Q2 (33) than are reporting positive y/y earnings growth (37). We don't expect these figures to change markedly as more Q2-2020 results are reported in the coming weeks. The y/y revenue and earnings growth results are expected to remain dismal. 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. However, many companies still are not providing guidance about their future financial periods.

US ECONOMIC INDICATORS

JOLTS (*link*): Job openings unexpectedly rose for the second month in June following a two-month freefall. Openings rose 518,000 in June and 893,000 during the two months ending June, to 5.889 million, after plunging 2.01 million during the two months through April. Openings were at 7.012 million at the start of the year, falling as low as 4.996 million by April. Accounting for most of the gains the past two months were openings in leisure & hospitality (541,000)—primarily accommodations & food services (446,000)—and retail trade (153,000).

Meanwhile, June hirings fell 503,000 to 6.696 million (its second-highest reading on record)—after soaring 3.15 million in May to a record-high 7.199 million. June's decline was centered in other services (-326,000), health care & social assistance (-282,000), and construction (-181,000); gains were recorded in professional & business services (255,000), accommodations & food services (78,000), and state & local governments, excluding education (30,000). Total separations rose 522,000 to 4.758 million in June, after plummeting 10.4 million the prior two months, from a record-high 14.643 million in March to 4.236 million in May. Within separations—which includes quits, layoffs, and discharges—quits (which are generally voluntary separations initiated by employees) accounted for the entire gain, climbing 531,000 in June, to 2.598 million, after a 190,000 advance in May.

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