MORNING BRIEFING
August 13, 2020

Material Information

Check out the accompanying chart collection.

(1) S&P 500 Materials sector's big bounce signaling better days ahead. (2) Gold loses some luster as bond yields edge higher. (3) Dr. Copper confirms the patient is on the mend. (4) Companies that cut costs in downturn should see profitability pop as volumes improve. (5) Electric vehicle demand should boost lithium demand. (6) Eastman Chemical says demand "likely" bottomed in May. (7) Developers looking for the Holy Grail: a battery that lasts forever and doesn't use cobalt.

S&P 500 Materials I: Betting on Economic Revival. The S&P 500 Materials sector contributes only 2.6% to the S&P 500's market capitalization, but its health is often used to divine the broader economy's direction.

After tumbling 37.4% from the start of the year through the S&P 500's bottom on March 23, the Materials sector subsequently became the second-best-performing sector, up 61.9% and trailing only the Amazon-driven Consumer Discretionary sector. The sector is in positive territory ytd, up 1.4% through Tuesday's close and follows only Consumer Discretionary (18.4%), Communications Services (6.8), and Health Care (3.3) (*Fig. 1*). The Materials sector's major rebound appears to be signaling that the worst of the Great Virus Crisis (GVC) has passed and confirms that the S&P 500 deserves to be just shy of its all-time high. Let's take a deeper look at the sector's performance this year in the context of how its peers performed:

(1) *On the way down.* During the market's downdraft from the start of the year through March 23, the Materials sector underperformed the broader S&P 500 index and seven other sectors, beating only three. Here's the S&P 500 sector performance derby: Consumer Staples (-22.6%), Information Technology (-23.1), Communication Services (-24.2), Health Care (-26.7), Consumer Discretionary (-27.6), Utilities (-30.6), S&P 500 (-30.7), Real Estate (-34.0), Materials (-37.4), Industrials (-40.1), Financials (-42.6), and Energy (-60.3) (*Table 1*).

(2) *On the way up.* Since the market's March bottom, however, Materials along with Consumer Discretionary have led the way up. Here's the performance derby for the S&P 500's sectors

from the March 23 low through Tuesday's close: Consumer Discretionary (63.6%), Materials (61.9), Energy (59.4), Industrials (58.6), Information Technology (57.9), S&P 500 (49.0), Financials (43.1), Health Care (40.9), Communication Services (40.8), Real Estate (39.8), and Utilities (34.0) (*Table 2*).

(3) *Industries leading the way.* While the Gold industry helped cushion the Materials sector's performance during the early-year downdraft, other industries have fueled the sector's outperformance since the March low. In particular, the S&P 500 Copper industry has risen 159.0% since March 23; Diversified Chemicals (95.8%), Commodity Chemicals (70.2), and Specialty Chemicals (67.3) also have helped catapult Materials' performance since March. Companies that cut costs sharply this spring to survive the market downdraft are now being rewarded as economies reopen and volumes start to improve.

S&P 500 Materials II: Digging Deeper. Let's look now at some of the underlying factors that have driven the S&P 500 Materials sector's market-beating rebound:

(1) *Gold losing its shine?* The price of gold—and silver for that matter—have gone straight up for most of this year, helped first by the onset of COVID-19 and the related economic uncertainty and then by the ballooning deficit (*Fig. 2* and *Fig. 3*). The dollar, which has fallen in value by 6% since March 23, further buttressed the metals (*Fig. 4*). Only this week did the metals lose some of their luster as optimism grew about a vaccine and the economy. That optimism combined with ever-larger Treasury auctions to fund the deficit sent the 10-year yield up to 0.69% yesterday from its low of 0.52% on August 4 , which also weighed on precious metals (*Fig. 5*).

The price of gold has fallen 6% from its peak on August 6 through Tuesday; but even after those losses, it remains up 27% ytd. The price of silver dropped even more dramatically from its peak (Monday), by 11% on Tuesday. Still, it is up 46% ytd. The market's uneasiness about the metals is reflected in the CBOE Gold ETF Volatility index, which has risen 65% over the past month, though "well below" its recent peak in March, an August 12 *WSJ* article reported.

(2) *Dr. Copper says all's well.* Freeport McMoRan, the sole constituent in the S&P 500 Copper industry, mines, copper, gold, and molybdenum, an alloy used in steel and other materials. The price of copper fell sharply, by 26%, from January 14 through March 23. It has since rebounded 37%, leaving it up 3% ytd (*Fig. 6*).

Freeport responded to the tumbling price of copper by slashing costs and eliminating its dividend in March. It has not increased spending as the price of copper has rebounded. As a result, adjusted Q2 earnings per share was three cents compared to a loss of four cents in the same quarter last year.

CEO Richard Adkerson said during the Q2 conference call on July 23 that he doesn't see the company returning to its old ways of doing business. "As a company, we'll never work in the same way that we did before. ... There's going to be less office space, less meetings, less travel. … We did not go back to work in Phoenix when the Governor opened the state up. The halls are and offices are empty in our headquarters. And yet, you can see the results from this core about how effectively we can operate in this kind of environment."

The prices of commodities have been boosted by the strong and steady recovery of China's economy from the Q1 low, led by its industrial sector, infrastructure spending, and government stimulus, observed Adkerson. He also mentioned "positive signs" in Western economies, helped by the restart of auto production.

Lastly, Adkerson noted that in traditional commodity downturns, inventories rise and then need to be worked off when a recovery arrives. This year was different, as inventories remained low throughout the downturn. "Currently low inventories are a good omen for copper," he said, "as it positions the metal for material gains as economic activity rebounds."

Going forward, demand for copper will grow because it's used in many of the electronic items that are growing in popularity, including electric vehicles (EVs) and charging stations, windmills, solar energy, and 5G technologies. He also predicted that copper's use in healthcare equipment, facilities, and public places would grow because COVID-19 and other viruses die much more quickly when they land on copper compared to other materials, like glass and stainless steel. Its killing powers are laid out in this April 14 *Smithsonian* article. In all, the company forecasted that its copper-mining volume would jump by 21% next year and mining volume for gold would increase 75%.

The S&P 500 Copper stock price index is up 6.4% ytd (*Fig. 7*). After falling 9.3% this year, the industry's revenue is expected to jump 29.2% in 2021 (*Fig. 8*). Earnings are expected to improve this year from near-breakeven results last year and increase 470.1% next year (*Fig. 9*). After suffering through negative net earnings revisions for much of the past two years, the industry enjoyed positive net revisions of 33.2 in July (*Fig. 10*). And while investors may have missed the low of this cycle, the forward P/E remains elevated and could fall further if the industry's earnings continue to improve, which historically has been good news for the industry's price performance (*Fig. 11*).

(3) *EVs drive specialty chemicals.* The S&P 500 Specialty Chemicals industry has been among the top performers in the Materials sector since the market bottomed in March. The industry's stock price index has risen 67.3% since March (*Fig. 12*). Driving much of that improvement is Albemarle, up 73% from the March low.

Albemarle makes lithium used in batteries for EVs. With COVID-19 stopping vehicle production cold, demand for lithium dropped sharply, and its price sank. The lithium division's Q3 EBITDA will still be down by 10% to 20% q/q, after falling by 33% in Q2 y/y. CEO Kent Masters believes that COVID-19 did not destroy demand for lithium, but it did result in elevated inventories and pushed out demand by a year.

The company also has a bromine business, which it sells to make flame retardants and to the oil industry. That division's Q2 EBIDA fell 10% and is expected to be flat in Q3 q/q as strength in construction offsets continued weakness in flame retardants and drilling fluids used in oil fields. Albemarle actually raised its dividend in Q2, by 5% y/y.

Other companies in the Specialty Chemicals industry have also performed well since the S&P 500's March bottom: Sherwin-Williams (58.1%), PPG (51.6), Ecolab (38.3), and International Flavors and Fragrances (22.3). After an expected revenue drop of 9.2% this year, the Specialty Chemicals industry's revenue is forecast to increase by 6.4% in 2021 (*Fig. 13*). Earnings are forecast to improve even more dramatically, from an 18.6% drop this year to a 19.8% jump in 2021 (*Fig. 14*). With earnings still depressed, the industry's forward P/E is a lofty 22.2 (*Fig. 15*).

(4) *Cost cutting aids Eastman Chemical too.* Like others in the chemicals industries, Eastman Chemical's Q2 results were hurt by the drop in volumes as economies closed in response to COVID-19. Eastman's Q2 revenue dropped 19% y/y, and adjusted earnings fell by more than half to 85 cents per share. The company responded by working toward removing more than $150 million of costs this year.

While visibility remains limited, Eastman Chemical said in its Q2 earnings presentation that demand "likely" bottomed in May. As volumes recover, Eastman is expecting to see a “substantial increase” in earnings in Q3, helped in part by the leverage resulting from cost cuts. The company, which is the only member of the S&P 500 Diversified Chemicals industry, did not give more specific earnings guidance.

Investors aren’t waiting for more detailed guidance. The S&P 500 Diversified Chemicals industry’s stock price index has jumped 95.8% since the March low (*Fig. 16*). And while analysts continue to expect revenue will fall 10.5% this year, it’s expected to grow 6.5% in 2021 (*Fig. 17*). Earnings are forecast to follow a similar path, falling 21.4% in 2020 and jumping 23.8% next year (*Fig. 18*).

Disruptive Technologies: The Battery Battleground. New EV company Lucid Motors has made an audacious announcement: Its Lucid Air sedan can run for 517 miles on a single charge, roughly 200 miles more than most Tesla cars on the road today. The catch is that the car will be priced north of $100,000. More details will be revealed on September 9. But the point is that battery life will be one of the main items on which EVs compete. So let’s take a look at some of the new technology being developed to help EVs drive farther before needing to plug in and power up.

(1) *Imagine: 1,000 miles on a charge.* Phinergy, an Israeli company, and Alcoa Canada have developed a souped-up battery that uses an aluminium-air battery to move an EV for 1,000 miles on one charge. Indian Oil bought a minority stake in Phinergy in March and is talking with EV makers about starting to test the battery, a March 2 article in *The Economic Times* reported.

The article explained: “Aluminium-based metal-air battery uses oxygen from the air and combines it with the metal to create an aluminum hydroxide, which activates the electrolysis process and creates an electric current. These batteries are lighter and compact with high energy density.” The aluminium hydroxide can be recycled to make new batteries every few months.

(2) *Graphene batteries.* Grabat has developed graphene batteries that could allow EVs to drive up to 500 miles on a charge and can be fully charged in a few minutes, a July 21 article in Pocket-Lint reported. Graphene is a material that tightly binds carbon atoms in a honeycomb-like structure, and it’s only one atomic layer thick. The company, which is working with several car and airplane companies, says the price point is similar to that of a lithium ion battery, but the graphene battery lasts four times larger, a February 4 press release stated.

(3) *Could silicon be the answer?* Sila Nanotechnologies has developed an anode made of silicon that replaces the graphite now used in lithium ion batteries. The company says that by using silicon anodes, a battery's energy density is improved by 20%, and there's the potential to improve it by 40%. Silicon is also cheaper to use than graphite.

The company's employees include CEO and co-founder Gene Berdichevsky, an early Tesla employee who led the development of Tesla's Roadster battery system, and Alex Jacobs, Sila's co-founder and VP of Engineering, who previously developed battery packs at Tesla. Last year, Kurt Kelty, former Tesla director of Battery Technology, joined as Sila's VP of Automotive. Bill Mulligan, former SunPower executive VP of Global Operations, became Sila's first COO.

(4) *IBM is in the running too.* IBM has developed a battery that uses materials extracted from sea water in its cathode instead of cobalt and nickel, which are difficult to mine and considered more environmentally harmful. It also uses a safe liquid electrolyte with a high flash point, a December 18 IBM blog post stated.

The new IBM battery costs less than lithium-ion batteries, charges faster, and has a higher power and energy density. It can be 80% charged in under five minutes, the blog boasts. IBM Research is working with Mercedes-Benz Research and Development North America, Central Glass, and battery manufacturer Sidus on creating a new battery ecosystem

(5) *Don't count Telsa out.* Tesla's CEO Elon Musk undoubtedly knows that battery power will make or break the company's future, and investors are hoping to get more information on Tesla's plans during its self-named Battery Day on September 15 at the company's California factory. The company is expected to use the day to disclose more efficient EVs.

There's been speculation that Tesla will use batteries from Contemporary Amperex Technology (CATL), which has said it has a battery for EVs that will last up to 1.2 million miles. Current EV batteries last about 150,000 miles and have an eight-year warranty. While it is 10% more expensive than batteries currently on the market, CATL's battery theoretically could be used in multiple cars over its lifespan.

CALENDARS

US: **Thurs:** Initial & Continuous Jobless Claims 1.120m/15.898m, Import & Export Prices 0.6%/0.4%, EIA Natural Gas Inventories. **Fri:** Retail Sales Total & Excluding Autos 1.9%/1.3%, Consumer Sentiment Index Total, Present Situation, and Expectations 72.0/81.8/66.7, Headline & Manufacturing Industrial Production 3.0%/3.0%, Capacity Utilization 70.3%, Business Inventories -1.2%, Productivity & Unit Labor Costs 1.5%/6.2%, Baker-Hughes Rig Count. (DailyFX estimates)

Global: **Thurs:** Germany CPI -0.5%m/m/-0.1%y/y, France Unemployment Rate 8.3%, China Retail Sales 0.1% y/y, China Industrial Production 5.1% y/y, NBS Press Conference, Lowe. **Fri:** Eurozone GDP -12.1%q/q/-15.0%y/y, Eurozone Balance of Trade €12.6b, France CPI 0.4%m/m/0.8%y/y. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) climbed this week to its highest level since February 2018, as bullish sentiment was back near its high for this year while bearish sentiment dropped to its lowest reading since March 2018. The BBR rose for the18th time in the past 20 weeks, climbing to 3.58 this week; it had dropped from 2.89 to 0.72 (the lowest since February 2016) over the prior five weeks. Bullish sentiment increased to 58.1% this week after a small dip to 56.7% last week; the latest reading matches its high from four weeks ago and is near its mid-January peak of 59.4%. Meanwhile, bearish sentiment sank to 16.2%, down 25.5ppts from its 41.7% peak during the March 24 week. The correction count has been in a volatile flat trend for a while, fluctuating between 22.5% and 26.5%. It moved down to 25.7% this week from 26.0% last week. The AAII Ratio increased to 32.9% last week after sliding the prior two weeks from 40.5% to 29.4%. Bullish sentiment rose to 23.3% last week after falling the prior two weeks from 30.8% from 20.2%, while bearish sentiment fell to 47.6% after climbing from 42.7% to 48.5% the previous three weeks.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The rapid pace of COVID-19 estimate cuts has abated, and forecasts are showing increasing signs of recovery now. Consensus S&P 500 forecasts previously had been falling at rates paralleling the declines during the 2008-09 financial crisis. Forward revenues surged 1.0% w/w to its highest level since early April and is now 5.0% below its record high in mid-February. Forward earnings soared 3.2% w/w, also to its highest level since early April, and is now 10.3% below its record high in early March. Forward revenues growth jumped 1.2ppts to 4.2%, and forward earnings growth of 9.6% was up 4.2ppts w/w. Forward revenues growth is 2.1ppts below its seven-year high of 6.3% in February 2018, but is up from 0.2% in April, which is the lowest reading since June 2009. Forward earnings growth remains 7.3ppts below its six-year high of 16.9% in February 2018 but is up 15.2ppts from its record low of -5.6% at the end of April. Analysts expect revenues to decline 4.6% y/y in 2020 compared to the 4.3% reported in 2019. That's up 0.3ppt w/w and down 9.8ppts since the start of the year. Analysts expect an earnings decline of 20.0% y/y in 2020 compared to a 1.4% rise in 2019. Their 2020 growth rate was up 1.5ppt w/w and is down 29.0ppts since the beginning of the year. The forward profit margin rose 0.3ppt w/w to 10.8%. That's up 0.5ppt from 10.3% during April and May, which was the lowest level since August 2013. It's still down 1.6ppt from a record high of 12.4% in September 2018. Analysts expect the profit margin to fall 1.9ppt y/y in 2020 to 9.6%—from 11.5% in 2019—and to improve 1.6ppt y/y to 11.2% in 2021. The S&P 500's weekly forward P/E fell 0.2pt to 22.0 from 22.2 and is down from 22.4 the week before that, which was the highest level since early 2002 and up from a 77-month low of 14.0 in mid-March. The S&P 500 price-to-sales ratio rose 0.03pt w/w to a record high of 2.37. 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*): Last week saw consensus forward revenues and earnings rise w/w for ten of the 11 S&P 500 sectors. Energy was the only sector to post a drop in forward revenues, and Real Estate posted the sole drop in forward earnings. Due to the sharp decrease in forward earnings this year, forward P/E ratios for nearly all sectors now are back above their recent record or cyclical highs prior to the bear market. Utilities is the only sector expected to have its profit margin improve in 2020, and Tech is expected to remain steady. That's down from eight sectors expected to improve on a y/y basis 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. In the latest week, the forward profit margin fell for Real Estate and rose for all of the remaining ten sectors. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (22.1%, down from 23.0%), Financials (14.2, down from 19.2), Utilities (14.1, matching its record high from early July), Real Estate (13.6, down from 17.0), Communication Services (13.6, down from 15.4), S&P 500 (10.8, down from 12.4), Health Care (10.4, down from 11.2), Materials (9.4, down from 11.6), Industrials (7.8, down from its record high of 10.5% in mid-December), Consumer Staples (7.3, down from 7.7), Consumer Discretionary (5.7, down from 8.3), and Energy (1.9, 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, appear to have bottomed on May 28 after 14 weeks of COVID-19 declines. Since then, S&P 500 forward revenues has risen 3.3%, and forward earnings has gained 8.4%. The profit margin rose 0.3pts w/w to 10.5%, which is the highest since early April and compares to a cyclical low of 10.3% during May and June. On a sector basis, all but Real Estate has been rising from the lows in their forward revenues, earnings, and profit margins. In the latest week, Real Estate made new lows in its forward earnings and profit margin. Here's how the sectors rank by their forward revenues changes and forward earnings changes since May 28: Consumer Discretionary (forward revenues up 5.2%, forward earnings up 27.1%), Financials (4.1, 9.8), Information Technology (3.9, 5.5), Communication Services (3.7, 5.4), Industrials (3.6, 9.8), Materials (3.3, 10.1), S&P 500 (3.3, 8.4), Health Care (2.6, 7.0), Energy (2.6, 232.1), Consumer Staples (1.7, 3.5), Real Estate (0.2, -3.9), and Utilities (-1.7, -0.3).

US ECONOMIC INDICATORS

Consumer Price Index (*link*): The core CPI rose again in July after COVID-19 caused record declines in apparel and transportation services prices during the three months ending May. Core prices jumped 0.6% in July—the biggest monthly gain since the start of 1991—following a 0.2% advance in June, pushing the yearly rate up to 1.6% from a nine-year low of 1.2% the prior two months. The yearly rate was at 2.4% before the pandemic hit. Here's a ranking of the 12-month core rates on a July-over-July basis, from lowest to highest for goods: apparel (-6.5% y/y), used cars & trucks (-0.9), new vehicles (0.5), medical care commodities (1.1), alcoholic beverages (1.5), and tobacco & smoking products (5.2). Here's the same drill for the core services rates: airfares (-23.7% y/y), motor vehicle insurance (-1.9), physicians' services (2.6), owners' equivalent rent (2.8), rent of primary residence (3.1), motor vehicle maintenance & repair (3.5), and hospital services (5.0). Only the hospital and physicians' services rates are on accelerating trends, though the former is looking toppy and the shelter components are on steep decelerating trends. The headline CPI rate accelerated for the second month, to 1.0% y/y, after easing steadily from 2.5% at the start of the year to 0.1% y/y in May—the lowest since mid-2015.

GLOBAL ECONOMIC INDICATORS

Eurozone Industrial Production (*link*): The bounce back in output from the lockdown continued in June following May's record-breaking advance. Production jumped 9.1%, building on May's 12.3% record gain, after the coronavirus shutdown generated the biggest output declines in the history of the series (going back to 1991) during both April (-18.0%) and March (-11.8). The improvement still leaves output 11.4% below its pre-crisis level. Here's a look at how the main industrial groups fared during the two months through June and where they stand in relation to February levels: consumer durable goods (+84.8% & -9.4%), capital goods (+43.9 & -13.0), intermediate goods (+17.0 & -14.1), consumer nondurable goods (+8.2 & -7.8), and energy (+5.7 & -3.8). Here's the same exercise for the top four Eurozone economies: Italy (+53.2% & -12.8%), France (+35.7 & -11.2), Spain (+31.3 & -12.3), and Germany (+21.0 & -13.8). Looking ahead, according to July's IHS Markit M-PMI, the Eurozone's manufacturing sector posted its first expansion since January 2018 during July, as output and demand continued to recover in line with the further easing of restrictions on activity related to COVID-19. The Eurozone's M-PMI climbed to 51.8, up from 47.4 in June and a low of 33.4 in April.

UK GDP (*link*): The UK economy contracted during Q2 at its steepest rate since records began in 1955, as its GDP shrank by more than any other major nation's; however, the monthly data for the quarter indicated that growth strengthened in June—as lockdown measures were gradually relaxed. Quarterly data show real GDP plummeted 20.4% (not annualized) last quarter after a 2.2% decline during Q1. Both consumer and business spending dove as lockdown measures kept consumers at home and shutdowns sent the economy into a tailspin. Meanwhile, recent data offer hope. Real GDP expanded 8.7% in June, its largest monthly gain in the history of the data going back to 1997, following an upwardly revised 2.4% advance in May. Still, it remains 17.2% below its pre-pandemic level in February. By sector, construction (33.0%) and manufacturing (20.2) posted double-digit gains during the two months through June, while growth in services (9.2) was in the high single digits; these sectors' June levels were 24.8%, 14.2%, and 17.6%, respectively, below where they stood in February.

UK Industrial Production (*link*): Output rose for the second month in June, though still has a long way to go to recoup COVID-19 losses. Production expanded 9.4% in June and 16.1% during the two months ending June, after contracting an historic 20.4% in April, following March's 4.3% loss. Factory production advanced 20.2% during the two months ending June after plunging 28.6% during the two months through April. Looking at the main industrial groupings, capital (31.4%), intermediate (27.3), and consumer durable (20.2) goods production are on sharp upswings, while consumer nondurable (4.1) goods output posted only a modest two-month gain, as its losses paled in comparison to the other sectors.

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