MORNING BRIEFING
August 18, 2020

More Comparisons of GVC and GFC

Check out the accompanying chart collection.

(1) Natural and man-made disasters. (2) GVC recession is shorter but deeper than GFC downturn. (3) An unprecedented lockdown recession. (4) GVC recovery should take less time than GFC did. (5) Big Q3 recovery ahead for real GDP. (6) US business sales of goods almost back to normal. (7) Big boost from inventories ahead. (8) Amazingly fast roundtrip for US auto assemblies. (9) No recession in tech output. (10) China's NM-PMI was different this time. (11) Too many old people in China? (12) Eurozone showing partial recovery in production, but complete recovery in retail sales. (13) More oomph in Germany. (14) Submerging economies emerging again. (15) FAANGM update.

US Economy: Inventory Wipeout. We received lots of positive comments about yesterday's *Morning Briefing*, in which we compared the economic and financial consequences of the Great Virus Crisis (GVC) to those of the Great Financial Crisis (GFC). So today, we'll continue the exercise.

As we noted yesterday, "[t]he GFC was to a large extent a typical business-cycle downturn. It was preceded by an economic boom that was led by speculative excesses, particularly in the housing industry. When that bubble burst, a credit crunch worsened the resulting recession. … The GVC is unique. In many ways, it's like a major natural disaster that hit the entire world economy. Initially, it did trigger a credit crunch, but the world's major central banks stopped that from happening by pouring liquidity into global financial markets." It could turn out to be a two-month recession, we noted and observed: "A recession that short is unprecedented, but that's because there is no precedent for a recession caused by government-mandated lockdowns around the world to slow the spread of the virus."

Debbie and I believe that the V-shaped recovery in the US will continue through September, but then slow along the lines of the Nike swoosh logo. Real GDP fell 5.0% (saar) during Q1, with all of the weakness occurring during March, when state governors issued stay-in-place executive orders (*Fig. 1*). The resulting lockdown recession saw real GDP plunge 32.9% during Q2. While the brunt of the recession occurred during only two months, i.e., during

March and April, real GDP fell 10.6% from Q4-2019 through Q2-2020, more than twice as much as during the GFC recession's 4.0% decline.

We are projecting a 15% rebound during Q3 and a 5% increase during Q4. The pace of growth slows during 2021 and 2022 in our forecast, with real GDP recovering to its Q4-2019 record high during Q4-2022.

Using the monthly series for the Index of Coincident Economic Indicators as a proxy for real GDP, we expect that the full recovery from the GVC recession will take 32 months, which is the average recovery period following the past six recessions (*Fig. 2*). By comparison, the GFC recovery took 68 months.

High-frequency indicators are starting to show a slowing, and even a possible stalling, in the recovery. For example, gasoline usage has stalled around 8.7mbd for the past four weeks through the August 7 week (*Fig. 3*). Also stalling during July was consumer credit- and debit-card spending (*Fig. 4*).

On the other hand, the Weekly Economic Indicator compiled by the Federal Reserve Bank of New York bottomed at -11.5% during the week of April 25 and rebounded to -5.5% during the August 8 week (*Fig. 5*). It is a good proxy for the y/y growth in real GDP and jibes with the Atlanta Fed's GDPNow tracking model shows Q3's real GDP increasing 26.2% as of August 14 (up from 20.5% on August 7) following the release on Friday of July's retail sales, June's manufacturing and trade sales and inventories, and July's industrial production. Let's compare these latest stats to their performances during the GFC:

(1) *Manufacturing & trade sales.* As we've previously observed, retail sales rebounded dramatically by 29.9% from April through July to a new record high (*Fig. 6*). Retail sales took 29 months to fully recover from the GFC. The huge difference during this crisis was the huge increase in government social benefits that more than offset the drop in wages and salaries in personal income.

Along with July data for retail sales, June sales data were released for manufacturers, wholesalers, and retailers. The aggregate of these business sales of goods rebounded 17.6% over the past two months through June (*Fig. 7*). They are still 5.1% below the record peak during January. However, excluding petroleum products, they are up 16.7% and just 1.3% below the record high during February! The business sales series is highly correlated with aggregate S&P 500 revenues, which is on track to fall not much more than it did during the GFC (*Fig. 8*).

(2) *Business inventories.* The 14.7% plunge in business inventories from peak to trough during the GFC lasted 13 months. So far, the fall during the GVC has been 7.4% over the past six months through June (*Fig. 9*). The recent round of inventory liquidation has been led by retailers (*Fig. 10*).

The unprecedented rebound in retail sales suggests that inventory investment, which accounted for 3.98 percentage points of the 32.9% drop in real GDP during Q2 should be a big contributor to the rebound in real GDP during Q3 and Q4.

(3) *Industrial production.* Manufacturing production plunged 20.1% from February through April (*Fig. 11*). It rebounded 15.2% since then through July but remains 8.0% below the pre-pandemic level. The V-shaped pattern now contrasts sharply with the more typical U-shaped pattern during the GFC.

Remaining down-and-out despite their recent rebounds are the industrial production indexes for aerospace, construction supplies, and energy and non-energy industrial materials. Making a huge comeback is motor vehicle assemblies, which plunged from 11.4 million units (saar) during February to just 0.1 million units during April, and rebounded since then to 11.9 million units during July (*Fig. 12*). The output index for high-tech industries held up very well during the first half of this year, with communications equipment rising to a new record high during July. (*Fig. 13*).

Global Economy: V-Shaped Indicators. Yesterday, we observed that both global PMIs and leading indicators for the 36 members of the OECD and the four BRIC emerging economies have staged V-shaped recoveries in recent months. Today, let's focus on China, the Eurozone, and emerging economies:

(1) *China.* China's official M-PMI dropped from 59.2 during April 2008 to a low of 38.8 during November 2008 (*Fig. 14*). It rebounded to a 2009 high of 56.6 during December. This time, it dropped from 50.2 during December of last year to a record low of 35.7 during February. So far, it has rebounded to 51.1 during July. China's official NM-PMI fell from 60.2 during January 2008 to a low of 50.8 during December 2008, remaining above 50.0. This time, the lockdowns

over there caused the NM-PMI to plunge from 54.1 during January to a record low of 29.6 during February. It has rebounded to 54.2 as of July.

On a y/y basis, China's industrial production rebounded from a low of -13.6% during January to 4.9% during July (*Fig. 15*). Somewhat less impressive is the comparable rebound in inflation-adjusted retail sales from -20.1% during March to -3.8% during July.

Over the past couple of years, Debbie and I have observed that China's rapidly aging population—a result of the fall in the fertility rate below replacement as a result of urbanization and the one-child policy—would weigh on consumer spending in China. The government, run by the Chinese Communist Party, is scrambling to stimulate domestic demand, as the country's export-led growth is vulnerable to rising trade tensions, especially with the US. However, this effort is likely to be stymied by the nation's increasingly geriatric demographic profile, which will be more of a challenge to China's recovery coming out of the GVC than it was coming out of the GFC.

(2) *Eurozone.* Industrial production in the Eurozone plunged 27.8% from January through April of this year and regained about 22.5% of that loss through June (*Fig. 16*). However, it's only back to around the low recorded during the GFC!

Remarkably, the Eurozone has had a similar V-shaped recovery in retail sales as the US has. The index for the volume of retail sales (excluding motor vehicles) plunged 21.2% in the region from February through April (*Fig. 17*). Over the past two months through June, the index is up 27.1%, just above its previous record high during February! Following the GFC, the index was on a downtrend that lasted until 2012. The indexes are in new record-high territory in Germany and France and have recovered most of the ground lost earlier this year in Italy and Spain. (See our *Eurozone Retail Sales* chart publication.)

German industrial indicators are following the V-shaped recovery in the Eurozone's retail sales volume index. The IFO business confidence index jumped from a record low of 74.3 during April to 90.5 during July (*Fig. 18*). This series is highly correlated with German manufacturing orders, which are up 41.2% over the past two months through June. Both are still below their levels at the beginning of the year, but they've regained more than half their losses since then.

(3) *Emerging economies.* Data available through May show that industrial production in the advanced economies fell slightly below the trough of this series during the GFC (*Fig. 19*).

Interestingly, industrial production in emerging economies has remained well above its low back then. That's mostly because the recent low in China's value-added output index during January remained 113.3% above where it was at the end of 2008 (*Fig. 20*). Also remaining well above their 2008 lows have been output indexes in Indonesia, Singapore, South Korea, and Taiwan (*Fig. 21*). Bungee-like roundtrips in output indexes can be found for India, Malaysia, Brazil, and Mexico (*Fig. 22*).

Strategy: FAANGM Update. Joe and I continue to respond to lots of questions about the FAANGM stocks (Facebook, Amazon, Apple, Netflix, Google's parent Alphabet, and Microsoft). More often than not, the answers can be found in our *FAANGM* chart book, which is automatically updated. Here are a few recent developments:

(1) *Market cap.* As of August 14, the Magnificent Six had a record market cap of $7.1 trillion, accounting for a near-record 25.5% of the S&P 500's market cap.

(2) *Performance.* On a ytd basis, the FAANGM stocks collectively are up 40.0% (*Fig. 23*). Over the same period, the S&P 500 is up 4.2% with them but down 4.1% without them. Since March 23 through Friday's close, here are the comparable performance stats: 66.4%, 50.4%, and 45.6%.

(3) *Valuation.* During the week of August 7, the collective forward P/E of the FAANGM stocks was 40.9. The S&P 500 forward P/E with and without them was 22.0 and 18.9. The Buffett Ratio, using the weekly forward price-to-sales ratio, was 6.0 for the FAANGM stocks. It was 2.37 and 1.96 for the S&P 500 with and without them. These are all historically high readings.

CALENDARS

US: **Tues:** Housing Starts & Building Permits 1.237mu/1.313mu, API Crude Oil Inventories, Brainard. **Wed:** MBA Mortgage Applications, EIA Crude Oil Inventories, FOMC Meeging. (DailyFX estimates)

Global: **Tues:** Japan Machinery Orders -17.6% y/y, Guindos. **Wed:** Eurozone Headline & Core CPI 0.4%/1.2% y/y, UK Headline & Core CPI 0.6%/1.3% y/y, Canada CPI 0.4%m/m/0.5%y/y. (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 13 straight weeks, MidCap's is up in ten of the past 11 weeks, and SmallCap's posted its tenth gain of the past 12 weeks. LargeCap's forward earnings is now up 8.2% from its lowest level since August 2017; MidCap's has risen 11.3% from its lowest level since May 2015; and SmallCap's is up 12.2% 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 14.8% below its record high at the end of January. MidCap's and SmallCap's are 26.0% and 38.6% 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 -13.6% y/y from -13.8%. That's up from mid-May's -19.3%, 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 -25.1% y/y from -25.4% 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 -34.4% y/y from -34.9% 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 (-20.3%, 27.6%), MidCap (-35.2, 49.6), and SmallCap (-52.1, 82.3).

S&P 500/400/600 Valuation (*link*): Valuations were slightly mixed last week, and remain below their cyclical and record highs in early June when forward earnings was bottoming. LargeCap's forward P/E rose 0.1pt w/w to 22.1, which compares to a 19-year high of 22.4 in early June. That's up from 13.3 in mid-March, which was the lowest since March 2013. MidCap was down 0.1pt w/w to 21.1, which is down 1.8pts from its record high of 22.9 in early June. SmallCap's 24.3 fell a similar 0.1pt w/w and is down 2.4pts 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 dropped 61 cents w/w to $26.47. That $26.47 estimate represents a decline of 35.9% y/y on a frozen actual basis and -33.6% y/y on a pro forma basis. For Q3, the estimate fell 16 cents w/w to $32.31, which represents an earnings decline of 23.3%, or 22.9% 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 (-2.3% in Q3-2020 versus 2.9% in Q2-2020), Health Care (-2.9, 5.5), Utilities (-3.8, 6.4), Consumer Staples (-6.7, -7.8), Real Estate (-14.7, -15.1), Materials (-20.4, -28.6), Communication Services (-20.9, -16.7), Financials (-24.3, -54.0), Consumer Discretionary (-41.2, -76.2), Industrials (-65.4, -84.1), and Energy (-105.9, -168.5).

S&P 500 Q2 Earnings Season Monitor (*link*): With over 91% of S&P 500 companies finished reporting revenues and earnings for Q2-2020, revenues are beating the consensus forecast by a whopping 2.9%, and earnings have crushed estimates by 23.4%. 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 (GFC). At the same point during the Q1 season, revenues were 1.1% below forecast, and earnings beat by 4.0%. For the 456 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 10.1%, and earnings are down 35.1% in the worst quarter since the GFC of 2009. The percentage of companies reporting a positive revenue surprise (63) 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, but the upcoming reports from the retailers are more important now than ever. What they say about the state of their business and their plans to ride out the COVID-19 crisis will be investors' main focus. Many companies still are not providing guidance about their future financial periods.

US ECONOMIC INDICATORS

Regional M-PMIs (*link*): The New York Fed has provided our first glimpse of manufacturing activity in August (being the first of the Fed regions to report), and it's a sobering one: Growth slowed considerably after increasing significantly in July. Still, firms remained relatively optimistic about the six-month outlook. August's composite index fell 13.5 points to 3.7 this month, after rebounding 95.4 points the prior three months—from a record low of -78.2 in April to 17.2 in July—which was the first positive reading since February. The new orders (to -1.7 from 13.9) component contracted slightly, while growth in shipments (6.7 from 18.5) was roughly one-third July's pace; both had posted big positive swings into expansionary territory in July. Factories stopped cutting payrolls in July, and the August employment (to 2.4 from 0.4) measure showed another slight improvement, while the average workweek (-6.8 from -2.6) contracted at a faster pace. Both these measures are a dramatic improvement from April's record lows of -55.3 and -61.6, respectively. Meanwhile, delivery times (to 1.3 from 2.6) were fairly steady this month, while unfilled orders (-14.0 from -0.6) and inventories (-10.7 from -9.7) contracted. The future business conditions index eased for the second month, though was at a respectable level of 34.3 this month; it had jumped significantly from 1.2 in March to 56.5 by June. The report notes that future new orders (37.2) and shipments (30.8) posted similar readings, while the employment (15.5) measure signals continued gains in payrolls. The capital expenditures index came in at 6.0, a sign that firms, on net, planned small increases in capital spending.

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