



MORNING BRIEFING

August 25, 2020

Forward Looking

Check out the accompanying [chart collection](#).

(1) GDPNow model tracking at 25.6% for Q2. (2) Citi's economic surprise index remains surprisingly strong. (3) US flash PMIs flashier than the ones for the Eurozone. (4) NY and Philly business surveys were solid in August. (5) Leading indicators leading higher. (6) Transportation indicators in low gear. (7) S&P 500 revenues and earnings data were down sharply during Q2. (8) Weekly forward revenues and earnings show both recovering from their recent bottoms. (9) Unlike in the movie, gold and bond prices are good friends.

US Economy: Stalling? If the economic recovery is stalling, someone forgot to tell that to the folks who manage the Atlanta Fed's [GDPNow](#) model, which tracks real GDP based on the latest available economic indicators. As of August 18, it indicated that real GDP was rising at a 25.6% seasonally adjusted annual rate during Q3, a significant recovery from the record quarterly freefall of 32.9% during Q2. Debbie and I are predicting a 20.0% increase during Q3 ([Fig. 1](#)). We are still expecting that real GDP will fully recover all that was lost during the Great Virus Crisis (GVC) by the second half of 2022. Consider the following:

(1) *Economic surprise index*. The Citigroup Economic Surprise Index remained in record-high territory through the August 21 week ([Fig. 2](#)). Two weeks ago, retail sales and industrial production were surprisingly strong. Last week, numerous housing indicators were surprisingly strong, as they should have been given record-low mortgage rates and the rush by urban dwellers to move to the suburbs in reaction to the pandemic. Soaring lumber prices are another indicator of the strong demand for new homes and for fixing up existing homes. No wonder that home improvement retailers are reporting gangbuster sales.

(2) *Flash PMIs*. August's flash estimates for the US M-PMI and NM-PMI rose to solid readings of 53.6 and 54.8, respectively ([Fig. 3](#)). That contrasts with August's downticks in the Eurozone to 51.7 and 50.1 ([Fig. 4](#)).

(3) *Regional business surveys.* There were slight downticks in August's regional business surveys conducted by the Federal Reserve banks of New York and Philadelphia ([Fig. 5](#)). The labor market remains challenging, as evidenced by the rise in initial unemployment claims back above 1.0 million during the August 15 week. On the other hand, the average of the employment indexes in the NY and Philly Fed districts was 5.7 during August, well above the record low of -51.0 during April.

(4) *Leading indicators.* Also signaling that the recovery should continue in coming months is the Index of Leading Economic Indicators. It plunged 13.2% from February through April ([Fig. 6](#)). Since then through July, it is up 7.6%. The Index of Coincident Indicators also bottomed during April. Both indexes are confirming that real GDP is recovering ([Fig. 7](#) and [Fig. 8](#)).

(5) *Transportation indicators.* Then again, as we noted last week, gasoline usage has been flat around 8.7 million barrels per day during the past four weeks through the August 14 week ([Fig. 9](#)). The ATA truck tonnage index dipped 5.1% m/m during July, remaining 8.3% below its record high during March ([Fig. 10](#)). Railcar loadings remain weak, though the intermodal series may be starting to bottom ([Fig. 11](#)).

Strategy: Wagons Ho! The popular television series *Wagon Train* aired from 1957 to 1965. It was noted for the catchphrase: "Wagons ho!" This was said whenever the members of the wagon train set out on their respective journeys.

The Adventures of Rin Tin Tin was a television show that aired from 1954 to 1959 and starred a German Shepherd and his owner Rusty, a boy orphaned by an Indian raid. Together, they were raised by soldiers at a US Cavalry post known as "Fort Apache." A similar catchphrase, "Forward ho!," was often heard on the show. John Wayne said the same in a few of his classic cowboy westerns.

The same type of let's-move-forward outcry is currently emanating from both S&P 500 forward revenues and earnings. Both have been showing signs of recovering in recent weeks. That's encouraging, since Joe reports that we now have data confirming how bad actual revenues and earnings were during the GVC through Q2. Consider the following:

(1) *Revenues.* S&P 500 revenues per share fell to an annualized \$1,236.32 during Q2 ([Fig. 12](#)). It's down 16.3% from its record high during Q4-2019. That GVC-related fall compares to the 20.4% drop from peak to trough during the Great Financial Crisis (GFC). While S&P 500

weekly forward revenues misleadingly signaled a much less severe drop, it should still be a good coincident indicator of actual revenues. If so, then it suggests that Q2 was the bottom for actual business sales, which should recover during the second half of 2020 along with GDP.

(2) *Earnings*. S&P 500 operating earnings per share (using I/B/E/S data by Refinitiv) fell to an annualized \$110.80, down 34.0% from Q4-2019. That compares to a peak-to-trough drop of 77.0% during the GFC. Again, forward earnings has signaled a much less severe drop, but it too has been recovering since bottoming during the May 15 week. That also suggests that earnings should recover over the rest of the year. Joe and I are still estimating earnings per share of \$120 this year, \$150 next year, and \$175 in 2022.

(3) *Profit margin*. The S&P 500 profit margin fell to 9.0% during Q2, down from 11.4% during Q4-2019. Again, the forward profit margin didn't drop as much, but clearly is pointing to a rebound.

(4) *Odds & ends*. On a y/y basis, S&P 500 revenues and earnings dropped 12.2% and 32.9%, respectively ([Fig. 13](#)). S&P calculates that write-offs per share rose to an annualized \$36.00 during Q2 ([Fig. 14](#)). On the other hand, the I/B/E/S measure of write-offs fell to \$40.28 during Q2 after spiking to \$85.00 during Q1.

Gold & Bonds: Arch Friends. Auric Goldfinger and James Bond were arch enemies. In the 1964 film *Goldfinger*, Bond is flat on his back, strapped to a table, and [appears](#) to be on the verge of getting sliced in half by a giant laser. The villain tells 007: "This is gold, Mr. Bond. All my life, I have been in love with its color, its brilliance, its divine heaviness. I welcome any enterprise that will increase my stock." Bond responds, "I think you've made your point, Goldfinger. Thank you for the demonstration." As the laser beam approaches Bond's lower torso and Goldfinger says "Good night," our hero asks Goldfinger, "You expect me to talk?" The villain casually responds, "No, Mr. Bond, I expect you to die."

In the real world, the price of gold and the price of bonds have been in sync for several years. The price of gold has been very highly correlated with the inverse of the yield on 10-year US Treasury Inflation-Protected Security (TIPS) ([Fig. 15](#)). That relationship has been a tight one since 2006, when TIPS data became available.

Not surprisingly, the TIPS yield does closely track the nominal yield on 10-year Treasury bonds less the core PCED (personal consumption expenditures deflator) inflation rate. However,

using this real bond yield as a proxy for the TIPS yield prior to 2006 doesn't work as well to explain the price of gold ([Fig. 16](#)).

The close relationship between the two since 2006 has been explained by noting that the TIPS yield reflects both the cost of storing gold and also the alternative return available in the fixed-income markets. Gold doesn't pay a dividend or interest. Lower TIPS yields, especially this year's negative ones, make it cheaper to store gold and pose less competition for the beloved metal.

That still raises the question of why the inverse relationship between the price of gold and the TIPS yield was weaker prior to 2006 than it is now. For now, that relationship seems to remain a strong one since the price of gold stopped soaring in recent days at the same time as the TIPS yield has drifted sideways.

CALENDARS

US: Tues: Consumer Confidence 93.0, New Home Sales 786k, S&P Case-Shiller Home Price Index 3.6% y/y, Richmond Fed Manufacturing Index, API Crude Oil Inventories, Daly.

Wed: Durable Goods Orders Headline & Ex Transportation 4.3%/2.0%, MBA Mortgage Applications, EIA Crude Oil Inventories, Jackson Hole Economic Policy Symposium. (DailyFX estimates)

Global: Tues: Germany Ifo Business Climate, Current Conditions, and Expectations 92/87/98, Germany GDP -10.1%q/q/-11.7%y/y. **Wed:** France Consumer Confidence 94, Japan Leading & Coincident Indicators 85.0/76.4, Schnabel, Haldane. (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 14 straight weeks, MidCap's is up in 11 of the past 12 weeks, and SmallCap's posted its 11th gain of the past 14 weeks. LargeCap's forward earnings is now up 8.8% from its lowest level since August 2017; MidCap's has risen 15.7% from its lowest level since May 2015; and SmallCap's is up 23.0% 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 14.3% below its record high at the end of January. MidCap's and SmallCap's are 23.1% and 32.6% 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 -13.3% y/y from -13.6%. 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 -22.1% y/y from -25.1% 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 -28.3% y/y from -34.4% 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 (-20.4%, 28.0%), MidCap (-33.5, 50.7), and SmallCap (-52.9, 106.8).

S&P 500/400/600 Valuation ([link](#)): Valuations were mostly lower last week and remain below their cyclical and record highs in early June when forward earnings was bottoming. LargeCap's forward P/E remained steady w/w at 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's was down 1.2pts w/w to 19.9, which is down 3.0pts from its record high of 22.9 in early June. SmallCap's fell 2.7pts w/w to 21.6 and is down 5.1pts 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 yet 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 dropped below LargeCap's last week for the first time since May, though much of the drop was due to a big rise in SmallCap's forward earnings. SmallCap's P/E 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 sitting back now as the Q2 earnings season draws to a close. They had been adjusting their future forecasts higher as Q2 earnings results came in substantially higher than forecasted. The S&P 500's Q2 blended EPS

estimate/actual rose 123 cents w/w to \$27.70. That \$27.70 estimate represents a decline of 32.9% y/y on a frozen actual basis and -30.5% y/y on a pro forma basis. For Q3, the estimate rose 4 cents w/w to \$32.35, which represents an earnings decline of 23.2%, or 22.5% 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, six 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 (-1.8% in Q3-2020 versus 3.3% in Q2-2020), Health Care (-2.8, 5.7), Utilities (-3.5, 6.4), Consumer Staples (-6.9, -6.2), Real Estate (-14.5, -15.1), Materials (-20.0, -28.6), Communication Services (-20.8, -16.7), Financials (-23.8, -42.8), Consumer Discretionary (-39.7, -67.6), Industrials (-65.4, -82.7), and Energy (-106.2, -168.5).

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