



MORNING BRIEFING

August 27, 2020

Homes & Drones

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

(1) Low rates and fleeing urbanites send new home orders surging. (2) Millennials forming families create long-term housing demand. (3) Wedding dreams dashed by COVID-19 free up funds for home down payments. (4) Homebuilders have pricing power, but face increasing lumber costs. (5) Keeping an eye on increasing mortgage delinquencies and falling rents. (6) Chipotle drives S&P 500 Restaurants index's return to positivity. (7) Green technology: Tree-planting drones help revive barren lands.

Consumer Discretionary I: Homebuilders Cashing In. As we discussed in yesterday's [Morning Briefing](#), recent economic data have indicated that the housing market is on fire. Sales are up, prices are up, and inventories are down in both the new and existing home markets. The recent earnings reported by some of the largest homebuilders confirm that the industry not only has recovered from the COVID-19 pandemic's impacts but indeed is benefiting from some of them—including dependably low interest rates, thanks to the Fed's pandemic response, and the desire of urbanites to escape city living as they crave more space given the need to social distance and work from home. All these factors have helped the housing industry fare much better than anyone might ever have expected earlier this year.

The S&P 500 Homebuilding stock price index has enjoyed a major V-shaped recovery. The index fell 46.5% from December 31 through March 23. It then rallied 144.5% through Tuesday's close, leaving it up 30.9% ytd through Tuesday's close ([Fig. 1](#)). The index closed at its first new high on August 10 in 15 years.

Investors certainly should keep an eye on surging lumber prices, rising mortgage delinquency rates, and falling apartment rental rates; respectively, these could add costs, boost housing supply, and offer buyers alternatives. But for now, homebuilders' CEOs sound awfully optimistic. Here's a sampling of what they've been saying:

(1) *Buyers are buying.* Homebuilders have been reporting amazing rebounds in their orders in June, July, and August. The latest data point came from Toll Brothers, which [reported](#) on Tuesday that \$2.21 billion of contracts for 2,830 homes were signed in its fiscal Q3, ending July 31, compared to \$1.81 billion of signed contracts for 2,201 homes in Q3 2019. “Our third quarter net signed contracts were our highest third quarter ever in both units and dollars, and our contracts per community, at 8.5, were the highest third quarter in fifteen years. This strength has continued into August,” said CEO Douglas Yearley in the company’s press release.

PulteGroup reported that net new orders fell 53% in April y/y, only to increase 50% in June. Demand remained strong through the first few weeks of July, CEO Ryan Marshall reported in Pulte’s July 23 earnings [conference call](#).

D.R. Horton’s results followed a similar pattern. In April, net sales orders fell 1% y/y as COVID-19-related stay-at-home orders were in place in most of their markets. But as they lifted, business surged: Both May and June saw net sales orders increase by more than 50% y/y, CEO David Auld reported on the company’s July 28 earnings [conference call](#). Activity remained strong in July, with orders “consistent” with May and June’s results.

“We believe the increase in demand after April has been fueled by increased buyer urgency due to lower interest rates, the limited supply of homes at affordable price points, and to some extent, pent-up demand,” said Horton’s CFO Bill Wheat. Sales were also boosted by folks relocating to more affordable and tax-friendly environments, Auld noted.

Pulte has noticed that daily online searches using new-home-related phrases have been growing since mid-March and have been hitting multi-year highs routinely. In addition, ZIP code “analysis of buying patterns points to a movement of renters and homeowners from urban centers into the surrounding suburbs. Based on an internal survey, roughly half of our division presidents report that their business has experienced a modest increase in demand from urban buyers, while several of our divisions referenced a material increase in such demand,” said Pulte’s Marshall.

The difference between the urban condo market and suburban housing market was evident in Toll’s earnings. The company has a City Living division that develops condominiums in what were some of the hottest urban markets, including New York, Hoboken, Seattle, and Los

Angeles. The division's new contracts signed in Q3 fell to three from 40 in the year-ago quarter.

(2) *Long-term picture looks good too.* As we discussed yesterday, the Millennials are finally moving to the 'burbs and settling down. The generation has formed households later and had children later, noted Horton's Auld. And that means there are "just a whole lot of people out there that I think are going to be looking for housing over the next five-plus-years," he added.

And while it's just anecdotal, the wedding industry's loss may be the housing market's gain. Sad brides and grooms across the country have had to postpone or cancel weddings, as COVID-19 makes large gatherings impossible. Some who have canceled festivities are using the money they (or their parents) originally saved to pay for weddings as down payments for a home purchase instead.

While we haven't found concrete data on just how many couples have opted for this practical route, the potential pot of money up for grabs is huge. Americans spent \$54 billion on more than 2 million weddings in 2019, a March 20 NPR [article](#) reported. Theknot.com's [survey](#) found that couples paid \$33,900 on average for a wedding, which includes the engagement ring but not the honeymoon. For those living in New York or New Jersey, the figure is closer to \$50,000. A perfect down payment.

(3) *Gross margins improve.* Homebuilders raced to cut costs when COVID-19 shut down the economy this spring. And when demand resurfaced this summer, homebuilders were able to sharply reduce sales incentives, and, in some instances, raise prices. As a result, gross margins have improved. D.R. Horton's gross profit in the June quarter was 21.6%, up 0.30ppt q/q and 1.3ppt y/y.

Pulte reported that more than half of its divisions have raised prices by 1%-3% in 50% or more of their communities, either by changing the base price and/or reducing incentives. Its gross margin was 23.9%, up 0.80ppt y/y and a 0.20ppt increase from Q1. For next quarter, the company is forecasting a gross margin of 23.9%-24.2%.

(4) *Lumber and land costs bear watching.* The S&P 500 Homebuilding industry's forward profit margin (which is a time-weighted calculation of the component companies' collective profit margin based on analysts' earnings and revenue forecasts for this year and next) has improved, but not quite as dramatically as forward revenues have ([Fig. 2](#)). Analysts may be

concerned about the recent surge in lumber prices. The random-length lumber futures price soared to a record high of \$830.90 per 1,000 board feet last Friday, and was little changed at \$829.30 by Tuesday, up 105% ytd and well above the previous record high of \$651.00 hit on May 14, 2018 ([Fig. 3](#)).

We expect wood prices to remain elevated as mills try to catch up with demand from home construction and renovation projects. Tariffs only add to the cost of Canadian lumber imports. Horton's COO Mike Murry said lumber prices could be a "headwind" later this year and early next year. In addition, the rise in land prices could accelerate as homebuilders replenish their inventory as home sales have accelerated.

(5) *Watch inventory levels too.* The number of homes up for sale is extremely low. The situation may be artificially exacerbated by the hesitancy of folks who want to sell their homes but fear exposure to COVID-19 from potential buyers looking through their homes. If that reverses, a pent-up supply of homes may hit the market.

The number of homes for sale might also increase if foreclosures start to rise. Currently, the percentage of loans that actually are in foreclosure remains extremely low, at 0.68%, down 0.05ppt from the Q1 level. However, the percentage of residential mortgages that are at least one payment past due rose nearly 4ppts q/q to 8.2% in Q2, according to the Mortgage Bankers Association's [National Delinquency Survey](#). The figures include the 4.2 million homeowners in the forbearance program, which allows those facing financial struggles due to the pandemic to put off mortgage payments for up to one year.

(6) *Watch rents.* When asked about his firm's pricing power, Pulte's Marshall suggested that analysts pay attention to rents, implying that the ability to raise home prices could be limited by falling apartment rents. Among many considerations, first-time home buyers weigh the cost of renting an apartment versus buying a new home. And in many of the nation's cities, rental prices are falling. Rents for one-bedroom apartments in the 10 priciest US markets fell by an average of 5% y/y in August, according to [zumper.com](#). The biggest y/y rental price drops in August occurred in San Francisco (-11%), New York (-6.9), Boston (-6.0), San Jose, CA (-9.4), and Oakland, CA (-3.5). However, on average across the nation, one-bedroom rents increased by 0.3% y/y.

(7) *Homebuilding stock market metrics.* The sharp rebound in the housing market caught analysts by surprise. The S&P 500 Homebuilding industry is currently expected to grow

revenue by 2.4% this year and 9.6% in 2021. That's an improvement from April 30, when the estimates stood at -5.1% and 3.8% ([Fig. 4](#)). Likewise, the industry's earnings are forecast to rise 17.8% this year and 10.2% in 2021. But back on April 30, earnings were expected to fall 10.6% this year and rise 4.5% next year ([Fig. 5](#)).

The S&P 500 Homebuilding stock price index is trading at a forward P/E of 12.1, in line with its historical readings ([Fig. 6](#)). Since 2014, the industry's P/E bounced between 5.7 in March 2020 and 15.3 in February 2014. If homebuilders can pass on rising lumber costs and Millennials keep moving to the 'burbs, 2020 will be a comeback year to remember for the homebuilding industry.

Consumer Discretionary II: Restaurants' Deceptive Rally. The S&P 500 Restaurants industry stock price index finally has recouped its losses from earlier this year and turned positive. The index is now up 3.5% ytd through Tuesday's close (versus 6.6% for the broader S&P 500), an impressive 61.0% comeback since March 18, when it was down by 37.5% ytd ([Fig. 7](#)).

Unfortunately, things aren't quite as rosy as they first appear. Almost all the gains enjoyed by the index come from one stock: Chipotle Mexican Grill. Here's how the S&P 500 Restaurants industry's stocks have performed ytd through Tuesday's close: Chipotle (51.7%), McDonald's (7.6), Yum! Brands (-4.2), Starbucks (-5.9), and Darden Restaurants (-24.2).

Chipotle has benefited from its online sales and ability to offer drive-through service, takeout, and delivery to customers. Online sales accounted for 60.7% of revenue in Q2, up from 26% in Q1. That has given it an edge over competitors without those services while COVID-19 continues to circulate.

Chipotle may also be benefitting from speculation that it will announce a stock split given that its shares trade hands at \$1,277 each. When Tesla and Apple announced stock splits, their shares rallied even though stock splits have no effect on the underlying company's finances.

Analysts are optimistic that S&P 500 Restaurants industry's losses this year will reverse in 2021. They're forecasting forward revenues will drop 6.6% in 2020 and jump 15.1% in 2021, while earnings will drop 33.3% this year only to surge 60.0% in 2021 ([Fig. 8](#) and [Fig. 9](#)). That's good news for all involved.

Disruptive Technologies: Drones Lend Mother Nature a Hand. Whether or not you believe in climate change, it's hard to argue against trees. They look good, provide a habitat for our furry friends, and clean the air. They have inspired and even humbled great poets like the late Alfred Joyce Kilmer (1886-1918), who penned the famous poem [Trees](#). "Poems are made by fools like me," he wrote, "But only God can make a tree." Maybe so, but drones now are making it possible to plant trees more quickly and cheaper than ever before.

A number of startups have created biodegradable pods that contain a seed and nutrients to increase the odds that the seed grows into a tree. These companies have also built drones that shoot seeds into the ground in areas to be reforested, which the drones have mapped out as well. Potential areas for reforestation include lands that have been scorched by fire or stripped of vegetation after being used for mining or oil and gas operations.

[Dendra Services](#), which operates in the UK and Australia, worked with Glencore in 2019 to plant seeds over land that was previously used to mine coal. The company also has software to provide monitoring and reporting services and estimates there are 2 billion hectares of degraded land across the globe ripe for restoration.

[Flash Forest](#) is a similar company located in Canada, which aims to plant 1 billion trees by 2028. It claims that by using its drones, one supervisor can oversee the planting of 100,000 seed pods per day. That's a vast improvement over the 1,500 trees a day that humans can plant.

This spring, the company planted 40,000 seeds on land north of Toronto that had burned in a wildfire, a May 15 *Fast Company* [article](#) reported. Here's the process: First, drones survey the area and identify the best places to plant seeds. Then, drones drop the seed pods. In the ensuing months or years, they return to monitor the trees' progress. "The company aims to bring the cost down to 50 cents per tree, or around a fourth of the cost of some other tree restoration efforts," the article stated.

Flash Forest has projects planned in Hawaii, Australia, Columbia, and Malaysia. "In some cases, funding comes from forestry companies, government contracts, or mining companies that are required to replant trees; in other cases, the startup plants trees for companies that offer tree-planting as a donation with the sale of products, or for landowners who can get a tax break, in some areas, for planting trees," the *Fast Company* article reported.

A third company, [DroneSeed](#), was set to work with The Nature Conservancy in Oregon to reforest an area where trees had been killed by an invasive species. The company also helped plant seeds in Medford, Oregon after a fire burned more than 7,000 acres. “Rather than plant seedlings—which would require a two-year wait while they grew in greenhouses—the timber company overseeing the reforestation effort decided to have DroneSeed plant immediately,” a March 1, 2019 [article](#) on the UAV Coach website stated.

Alfred Joyce Kilmer would be pleased.

CALENDARS

US: Thurs: Real GDP -32.5%, GDP & PCE Core Price Indexes -2.0%/-1.1%, Corporate Profits, Initial & Continuous Jobless Claims 1.000m/14.450m, Kansas Fed Manufacturing Index, Pending Home Sales, EIA Natural Gas Storage, Jackson Hole Economic Policy Symposium. **Fri:** Personal Income & Spending -0.2%/1.5%, Core PCED 0.5%^m/m/1.5%^y/y, Consumer Sentiment Index 72.8, Advance Goods Trade Deficit, Chicago PMI 52.0, Baker-Hughes Rig Count. (DailyFX estimates)

Global: Thurs: Lane, Macklem. **Fri:** Eurozone Economic Sentiment 85.0, Germany Gfk Consumer Confidence 1.2, France GDP -13.8%, Canada GDP -39.6%, Baily. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): The Bull/Bear Ratio (BBR) climbed to its highest reading since January 2018, as bullish sentiment climbed to its highest percentage since September 2018. The BBR increased for the 19th time in 22 weeks to 3.70 from 0.72 during the March 24 week—which was the lowest since March 2018. Bullish sentiment has increased 29.9ppts (to 60.0% from 30.1%) the past 22 weeks, while bearish sentiment has dropped 25.5ppts (16.2 from 41.7) over the same period—though has fluctuated in a narrow band just above 16.0% the past few weeks. The correction count has been in a volatile flat trend for a while, fluctuating between 22.5% and 26.5%. It moved down for the third week to 23.8% this week from 26.0% three weeks ago. The AAll Ratio increased for the third week last week to 41.8%, after sliding the prior two weeks from 40.5% to 29.4%. Bullish sentiment rose for the third week to 30.4% after falling the prior two weeks from 30.8% from 20.2%, while bearish sentiment advanced to 42.4% last week after falling the prior two weeks from 48.5% to 42.1%.

S&P 500 Earnings, Revenues, Valuation & Margins ([link](#)): The rapid pace of COVID-19 estimate cuts has morphed into gains as analysts play catch-up from their lowball estimates prior to the better-than-expected Q2 earnings season. Consensus S&P 500 forecasts previously had been falling at rates paralleling the declines during the 2008-09 financial crisis. Forward revenues ticked up 0.1% w/w and is now 5.0% below its record high in mid-February. Forward earnings rose 0.2% w/w to its highest level since early April and is now 14.5% below its record high in early March. Forward revenues growth remained steady w/w at 4.2%, and forward earnings growth of 9.6% was up 0.1ppt w/w. Forward revenues growth is 2.2ppts 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 0.1ppt w/w and down 9.8ppts since the start of the year. Analysts expect an earnings decline of 19.7% y/y in 2020 compared to a 1.4% rise in 2019. Their 2020 growth rate was up 0.2ppt w/w and is down 28.7ppts since the beginning of the year. The forward profit margin remained steady w/w at 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 1.7ppt y/y to 11.3% in 2021. The S&P 500's weekly forward P/E edged down 0.1pt to 22.2 and is down from 22.4 at the end of July, 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 dropped 0.01pt w/w to 2.40 from a record high of 2.41. 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 rise w/w for seven of the 11 S&P 500 sectors and forward earnings was higher for nine sectors. Financials was the only sector to post declines in both measures. 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. Tech and Utilities are the only sectors expected to have their profit margin improve in 2020. 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 rose for four sectors: Consumer Discretionary, Energy, Health Care, and Utilities. 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 (14.2, record high), Real Estate (13.5, down from 17.0), Communication Services (13.6, down from 15.4), S&P 500 (10.8, down from 12.4), Health Care (10.5, down from 11.2), Materials (9.5, 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 (2.0, 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, bottomed at cyclical lows on May 28 after 14 weeks of COVID-19 declines. Since then, S&P 500 forward revenues has risen 3.3%, forward earnings has gained 8.6%, and the forward profit margin has risen 0.5pts to 10.8%. On a sector basis, all but Real Estate and Utilities have been rising from the lows in their forward revenues, earnings, and profit margins. In the latest week, Utilities made a new low in its forward revenues, but its profit margin rose to a record high. Here's how the sectors rank by their forward revenues changes and forward earnings changes since May 28: Consumer Discretionary (forward revenues up 6.0%, forward earnings up 28.5%), Information Technology (3.9, 5.5), Financials (3.8, 9.4), Communication Services (3.7, 5.3), Industrials (3.7, 10.2), Materials (3.4, 11.0), S&P 500 (3.3, 8.6), Health Care (2.7, 7.2), Consumer Staples (1.8, 3.5), Energy (1.0, 248.6), Real Estate (0.3, -4.6), and Utilities (-2.2, -0.2).

S&P 500 Sectors Net Earnings Revisions [\(link\)](#): The S&P 500's NERI improved in August for a third straight month and was positive for the first time in 14 months. All 11 sectors rose markedly, and most were positive and at their highest levels since the spring of 2018. The S&P 500's NERI rose to a 27-month high of 9.5% from -12.1% and is up from an 11-year low of -37.4% in May. That compares to a tax-cut-induced record high of 22.1% in March 2018. NERI improved m/m in August for all 11 sectors for a third month; that compares to all 11 worsening on a m/m basis from March to May. During August, NERI turned positive for nine sectors, the most since September 2018, which compares to negative NERI readings for all 11 sectors from April to July. Utilities now has the worst track record, with 19 months of negative NERI, followed by Real Estate (9). Here are the sectors' August NERIs compared with their July readings: Consumer Staples (29-month high of 14.4% in August, up from -6.7% in July), Industrials (14.4 [28-month high], -18.1), Energy (14.0 [25-month high], -6.5), Health Care (13.5 [28-month high], -8.5), Communication Services (10.9 [22-month high], -10.2), S&P 500

(9.5 [27-month high], -12.1), Information Technology (9.4 [23-month high], -8.5), Materials (8.3 [25-month high], -19.4), Consumer Discretionary (6.8 [26-month high], -16.6), Financials (6.5 [24-month high], -10.5), Utilities (-0.4 [19-month high], -12.4), and Real Estate (-10.9 [five-month high], -18.1).

US ECONOMIC INDICATORS

Durable Goods Orders & Shipments ([link](#)): Durable goods orders remain in a strong V-shaped recovery, while concerns about the path of COVID-19 have slowed momentum in the recovery of core capital goods orders and shipments. Orders for total durable goods blew past forecasts once again, soaring 11.2% in July and 37.7% during the three months through July—to within 6.3% of its pre-pandemic high. Billings had plunged 32.0% during the two months ending April. The rebound in durable goods orders is being driven by unprecedented demand for motor vehicles: Vehicle orders have soared 191.2% during the three months ending July to a new record high! These orders had tanked 62.9% during the two months through April. Excluding transportation, orders advanced 2.4% in July, and 10.0% the past three months, to within 1.3% of its level at the start of this year. In the meantime, both core capital goods orders and shipments increased for the third month, though the pace slowed a bit last month. Nondefense capital goods orders ex aircraft (a proxy for future business investment) climbed 1.9% in July, less than half of June's upwardly revised 4.3% (vs 3.3%) increase, while core capital goods shipments (used in calculating GDP) advanced 2.4% in July, slowing from June's upwardly revised 3.8% (vs 3.4%). Over the past three months, core capital goods orders and shipments jumped 7.8% and 7.9%, respectively, to within a percentage point of their pre-pandemic levels.

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