Yardeni Research

MORNING BRIEFING
September 9, 2020

Panic Attack #67?

Check out the accompanying chart collection.

(1) S&P 500's next record high likely in 2021. (2) Vivaldi, Templeton, and Birinyi. (3) From pessimism to skepticism, optimism, and euphoria. (4) Oct. 2017: Back to the future. (5) Less exuberance would be bullish long term (6) Time to party like its 2020, not 1999. (7) Tech's fundamentals are much more solid coming out of latest recession than previous two. (8) SoftBank unlikely to be this year's LTCM. (9) Nasdaq includes the FAANGMs, while S&P 500 Tech sector includes only Apple and Microsoft. (10) Fiscal and monetary authorities talking about doing something about income inequality.

Strategy I: The Four Seasons. Looks like the stock market made another record-high top on September 2, when the S&P 500 closed at 3580.84 and the Nasdaq closed at 12056.44. That might be it for record-high tops this year for both, which previously topped out at 3386.15 and 9817.18, respectively, on February 19 (*Fig. 1*). Joe and I expect the next record-high top will be next year on the way to our 2021 year-end target of 3800 for the S&P 500.

I view the latest three-day selloff as Panic Attack #67 in the bull market that started March 9, 2009 (*Fig. 2*). "Hold on," you might be thinking. "What about the bear market earlier this year?" That would make it Panic Attack #1 in the new bull market that started on March 24. (See our *Table of S&P 500 Panic Attacks Since 2009*.)

Technically speaking, the 33.9% plunge in the S&P 500 from February 19 through March 23 was a bear market. It meets the sole requirement to be labeled as such: a 20% or more drop in the S&P 500 on a closing basis. However, as I previously discussed on August 31, the latest bear market lasted only 33 calendar days and 23 trading days from its peak to trough, with the market down more than 20% from its peak during just 18 of those days. That's not much of a bear market. It's the shortest one on record. It's more like a correction, in my opinion. Nevertheless, Joe is a by-the-book quant and insists that we add it to our table of *S&P 500 Bear Markets and Corrections Since 1928* as a bear market.

Why quibble over the definition of a bear market? Let's instead debate whether the action since March 23 has been more in tune with Phase 4 than Phase 1 of bull markets. In 1725, Antonio Vivaldi composed *The Four Seasons*, a set of four violin concertos. The sounds of each concerto resemble its respective season. So for example, "Winter" is punctuated with pizzicato notes from the high strings, suggesting icy rain. "Summer" sounds like a thunderstorm in its final movement, which is often called "Storm."

One of the great virtuosos of the investment business was Sir John Templeton. He observed that bull markets experience four phases: pessimism, skepticism, optimism, and euphoria. Similarly, my friend Laszlo Birinyi has identified four phases: reluctance, digestion, acceptance, and exuberance. Where are we now in the current bull market?

Consider the following points excerpted from our October 9, 2017 *Morning Briefing* titled "FOMO & MAMU":

"(1) *First and second*. The first phase [of the current bull market] started on March 9, 2009 and ended after the second and worst correction of the bull market, on October 3, 2011 (*Fig. 3*). The second phase included three minor corrections, with the last one ending on November 15, 2012.

"(2) *Third and fourth*. On July 8, 2014, I wrote that the S&P 500 was moving from the third to the fourth phase. Now I'm thinking that the third phase was extended by the energy-led earnings recession. Instead, the third phase might have ended on February 11, 2016, when the S&P 500 fell to the lowest reading since April 11, 2014, taking out some of the optimism that had been building during the third phase. During the fourth phase since then, there have been no significant corrections, which certainly must be contributing to the mounting euphoria/exuberance about stocks.

"(3) *P/E phase profile*. The S&P 500's forward P/E also can be used to identify these four phases (*Fig. 4*). It mostly fell during the first phase, when earnings caught up with the initial bull market euphoria. During the second phase, it rose slightly but remained relatively low as investors continued to fret about another financial crisis and a renewed recession. During the third phase, the forward P/E trended higher, rising to a cyclical peak of 17.2 on February 24, 2015. It was back down to 14.7 on January 20, 2016. It has been above 17.0 ever since January 24, 2017, and was at 18.0 at the end of last week."

By the way, I concluded: “This is all still Nirvana territory but bordering on meltup terrain, in my opinion. If the P/E rises over 20.0, that would suggest to me that the exuberance phase of the bull market is well underway.”

Again, it was October 2017 when I wrote that. Much has happened since then. There was a significant meltup through September 20, 2018. The S&P 500 then experienced a 19.8% correction through December 24 (which we labeled “Panic Attack #62”). The next big event was the “banana” at the start of the year. Exuberance came back very rapidly after the Fed announced QE4ever on March 23, as the S&P 500 forward P/E soared from 12.9 to peak at a 19-year high of 23.3 on September 2. It still seems like the fourth phase of the bull market.

If the three-day selloff (so far) turns out to be just another panic attack, then it should tamp down the market’s exuberance just enough that the bull market can resume. Joe and I expect that the S&P 500 will stall around current levels, consolidating its gains since March 23 at least through the November 3 elections. That would give earnings some time to catch up with the stock market’s rally. Before the market resumes its climb, investors might want to see more progress on the vaccine front, how the elections play out, and which letter of the alphabet best describes the shape of the economic recovery.

Strategy II: 1999 Interrupted? So far, the Tech Wreck of 2020 is a minor fender bender compared to the multi-stock crash during 2000. The tech-heavy Nasdaq seemed to be on course for a meltup similar to the one that occurred during 1999, setting the stage for the subsequent meltdown. It’s too early to tell, but the three-day tech-led selloff might have derailed a repeat of the 1999 scenario. Besides, the underlying fundamentals for many technology companies are better now than they were back then. Consider the following:

(1) *Tech in US GDP.* High-tech spending on IT equipment, software, and R&D rose to a record $1.33 trillion (saar) during Q2-2020 (*Fig. 5*). It jumped to a record 50.1% of total capital spending in nominal GDP during the quarter (*Fig. 6*). Equipment and software accounted for 31.1% and R&D 19.1% of capital spending in nominal GDP.

Furthermore, US industrial production of high-tech equipment, which has been on an uptrend in record-high territory since mid-2010, rebounded 3.7% from May through July to a new record high, after falling 2.8% from January through May (*Fig. 7*). Output of communications equipment rose to a record high during July. Output of computers is likely to rise to record highs in coming months given the boost to demand for PCs and laptops attributable to the work-from-home trend that was accelerated by the pandemic.

(2) *Semiconductors.* US industrial production of semiconductors has been on a solid uptrend since early 2009. During July, it was only 1.3% below its record high. The forward earnings of the S&P 500 Semiconductors industry is highly correlated with the three-month average of worldwide semiconductor sales (*Fig. 8*). Both have bottomed recently from their minor dips earlier this year, and both remain on solid uptrends.

The peak-to-trough declines in worldwide semiconductor sales and in forward earnings were: 46.3% and 85.7% during the 2000 recession, 38.6% and 87.1% during the 2008 recession, and 0.3% and 7.8% during the latest two-month recession. The S&P 500 Semiconductor industry's forward earnings is only 5.0% below its record high during the week of November 1, 2018.

(3) *Forward revenues & earnings.* Now let's have a look at forward revenues and earnings for the entire S&P 500 Information Technology sector. During the August 27 week, the sector's forward revenues matched its record high at the end of last year (*Fig. 9*). So it already has recovered from the 4.6% peak-to-trough decline earlier this year. By comparison, the sector's forward revenues fell 18.1% from peak to trough during the previous recession and didn't fully recover to a record high until the September 2 week of 2010.

The S&P 500 Information Technology sector's forward earnings also has fully recovered its 6.7% dip earlier this year (*Fig. 10*). That's impressive compared to the 28.4% drop during the previous recession, with the full recovery taking 49 weeks. It's even more impressive compared to the 61.4% drop during 2000-01. The full recovery back then didn't happen until the week of June 7, 2007!

(4) *Market capitalization & valuation.* All of the above certainly helps to explain why the S&P 500 Tech sector (and the tech-heavy Nasdaq) have been leading the way in the meltup since March 23. They are also leading the way in the three-day mini-meltdown, which Joe and I view as a healthy correction.

During the last week of August, the S&P 500 Information Technology sector accounted for 28.5% of the S&P 500's market capitalization, the highest share since September 2000 (*Fig. 11*). That's still well below the sector's record-high share of 33.7% during March 2000.

Furthermore, back then, the sector's earnings share peaked at 18.2% during September 2000, well below the latest reading of 23.7% during the August 27 week.

Given all of the above, the Tech sector's forward P/E of 27.5 during the week of August 27 might have been exuberant, but not irrationally so (*Fig. 12*). Granted, that's the highest reading since January 2004, but the 10-year US Treasury bond yield was 4.15% back then. It is under 1.00% now.

Here are the forward P/Es of the Tech sector's industries during the final week of August: Application Software (51.5), Data Processing & Outsourcing (34.0), Systems Software (31.6), Technology Hardware, Storage & Peripherals (30.1), Semiconductors (20.1), IT Consulting & Other Services (16.8), Semiconductor Equipment (15.7), and Communications Equipment (14.3) (*Fig. 13* and *Fig. 14*).

(5) *Magnificent Six.* As we've previously observed, the S&P 500 Tech sector includes only two of the FAANGM stocks, namely Apple and Microsoft. Of the four others, Amazon is in the S&P 500 Consumer Discretionary sector, while Facebook, Google's parent Alphabet, and Netflix reside in the S&P 500 Communication Services sector. As of the week of September 4, the FAANGM stocks collectively accounted for 26.3% of the S&P 500's market-cap share and sported a forward P/E of 42.4. They are down 12.2% over the last three trading days, while the S&P 500 excluding them is down 5.0%.

There has been lots of chatter since Friday about SoftBank's aggressive purchases of stocks and call options in these names. Unless SoftBank is about to go the way of Long-Term Capital Management (LTCM), which we doubt, it's possible that some of the recent selling pressure in the Magnificent Six and other techie stocks might be attributable to profit taking rather than forced selling by SoftBank and other investors who recognize that valuation multiples may be too high, even though interest rates are so low. If so, then Panic Attack #67 should turn out to be a buying opportunity, as have all the other panic attacks since March 9, 2009.

(6) *1999 revisited.* A repeat of 1999 is still possible. Let's focus on the tech-heavy Nasdaq because it includes all the FAANGM stocks as well as other high-flyers like NVIDIA and Tesla. The index is up 75.7% from its March 23 low through its recent record high on September 2.

Recall that the Nasdaq fell 29.5% from July 20, 1998 through October 8 of that year. That period included the Russian debt default crisis and LTCM's collapse. It was back at a record high by November 27, then proceeded to soar 255.8% through March 10, 2000. It then fell 77.8% during the subsequent bear market.

US Economy: The Income Inequality Issue. Since the start of the Great Virus Crisis (GVC), economic inequality has increased in significance as an issue for monetary and fiscal policymakers. Democratic presidential nominee and former Vice President Joe Biden crafted his campaign platform on the issue. US Treasury Secretary Steven Mnuchin recently suggested that there is work to be done on economic disparities. On June 19, Federal Reserve Chairman Jerome Powell said that the economic shock caused by the coronavirus pandemic has exposed "troubling inequalities" that predated the crisis. "A particular cruelty of the pandemic has been its disproportionate effects on many areas that were already suffering," Powell said, according to the *WSJ*.

Reducing economic inequalities may soon be a congressionally mandated responsibility of the Fed, as Melissa and I discussed in our August 19 *Morning Briefing*. Some see the Fed's policies as having buoyed the value of stocks and bonds, which are disproportionately held by the wealthy, while doing little to benefit lower-income earners who have lost their jobs. The word "inequality" appeared 34 times in the US central bank's recent *FedListens* report, which summarized findings from a series of Fed-sponsored events focused on evaluating the Fed's approach to policy setting. Here are some reasons that inequality suddenly has policymakers' attention:

(1) *Fewer service jobs*. "The Service Economy Meltdown" was the title of a September 4 *New York Times* article. "As companies reconsider their long-term need to have employees on site, low-wage workers depending on office-based businesses stand to lose the most," the article anecdotally observed. Indeed, the recent "lockdown recession" has caused far more people to lose their jobs than ever before, especially in services-producing industries. Payroll employment plunged 22.2 million from February through April. Although payroll employment rebounded 10.6 million from April through August, it remains 11.6 million below the February 2020 level.

A disproportionate number of leisure and hospitality workers lost their jobs during the lockdowns, reported a May 8 CNBC article, and many remain unemployed. The leisure and hospitality industry lost 8.3 million jobs, or 37% of total positions from February to April. The industry gained just over half those jobs back from April through August, or 4.2 million jobs, but the level remains 4.1 million below February.

(2) *Wider income gap.* Evidence suggests that the GVC has exacerbated income inequality, as it has disproportionately affected lower-paid service workers. Whether they can regain full employment as the economy recovers is a question mark. Unlike higher-paid professionals, who generally are able to work from home and have earned their usual income during the lockdowns (if not more owing to the pandemic-related fiscal stimulus), lower-paid service workers who can't work remotely, such as hairdressers and restaurant servers, have lost jobs and income during the lockdowns.

New research shows that the effects on income inequality from the COVID-19 recession have been driven mainly by job losses rather than slowed wage increases, as an Illinois News Bureau report discussed. Using data from the Current Population Survey, the researchers showed that the COVID-19 pandemic led to a loss of aggregate real labor earnings of more than $250 billion from March to July 2020 compared with such earnings a year ago, almost entirely driven by declines in employment, particularly among the lowest-paid.

However, those declines were offset by the federal stimulus provided under the Coronavirus Aid, Relief, and Economic Security (a.k.a. CARES) Act. Individuals from the bottom third of the wage-distribution scale received almost half of all federal dollars from unemployment insurance payments, reversing the increase in wage inequality, according to the paper.

The paper observed, as we discussed in our June 29 *Morning Briefing*, that many low-wage workers who lost their jobs perversely received an income boost on unemployment insurance, as the federal aid offered an extra $600 per week in addition to state benefits. But that provision expired at the end of July, and now instead of receiving a median replacement to their income of 156%, unemployed workers are receiving 30%-40% of their previous earnings. The people receiving aid are those "who are likely to spend every dollar, so giving them that extra money very likely rescued the economy from a more severe recession," the Illinois report said.

(3) *Personal savings divided*. The personal saving rate has increased dramatically over the course of the pandemic, but it seems likely that the distribution of savers between income deciles may have skewed toward higher-income workers able to work from home. That's supported by many reports of lower-income folks struggling to pay rent, as we recently covered, and evidence that food insecurity is on the rise.

Further, a September 3 article in *The Atlantic* observed that reduced spending among the top 25% of earners accounted for over 50% of the estimated reduction in consumer spending reflected in the latest GDP numbers, according to economic researchers at Harvard. The damage done by that lost spending "reflects what happens in a pandemic when high-income people can work at home … but it also reflects the huge growth of inequality of recent decades," Harvard economist Lawrence Katz said. "Such a large part of our economy, and of employment, has been embedded in servicing high-income people."

CALENDARS

US: Wed: Job Openings 6.0m, MBA Mortgage Applications. **Thurs:** Initial & Continuous Jobless Claims 846k/12,9m, Headline PPI 0.2%m/m/-0.3%y/y, Core PPI 0.2%m/m/0.3%y/y, Wholesales Inventories -0.1%, EIA Natural Gas Storage. (DailyFX estimates)

Global: Wed: Japan Machine Orders 1.9%m/m/-18.3%y/y, BOC Rate Decision 0.25%. **Thurs:** France Industrial Production 5.0%, Italy Industrial Production 3.5%m/m/-9.7%y/y, ECB Interest Rate Decision & Deposit Facility Rate 0.0%/-0.5%, Lagarde, Machlem. (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 16 straight weeks, MidCap's is up in 13 of the past 14 weeks, and SmallCap's posted its 13th gain of the past 16 weeks. LargeCap's forward earnings is now up 10.1% from its lowest level since August 2017; MidCap's has risen 17.9% from its lowest level since May 2015; and SmallCap's is up 26.3% 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 forward earnings is now 13.3% below its record high at the end of January. MidCap's and SmallCap's are 21.6% and 30.8% 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 -12.4% y/y from -12.8%. 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 -20.2% y/y from -21.1% 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 -22.7% y/y from -26.8% 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 (-20.1%, 27.8%), MidCap (-32.8, 49.6), and SmallCap (-53.1, 108.7).

S&P 500/400/600 Valuation (*link*): Valuations dropped across the board last week, but remain near their recent cyclical and record highs. LargeCap's forward P/E fell to 22.1 from a 19-year high of 22.7. That's up from 13.3 in mid-March, which was the lowest since March 2013. MidCap's was down 0.7pts w/w to 19.4, which is down 3.5pts from its record high of 22.9 in early June. SmallCap's fell 0.7pts w/w to 21.0 and is down 5.7pts 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 was below LargeCap's for a third week and for the first time since May. 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 on their Q3 estimates for now as the quarter begins to wind down. During the Q2 earnings season, which came in substantially better than expected, they adjusted their future forecasts higher instead of lower as is the norm. In the latest week, the S&P 500's Q2 blended EPS estimate/actual rose 7 cents w/w to $28.09. That $28.09 estimate represents a decline of 32.0% y/y on a frozen actual basis and -29.7% y/y on a pro forma basis. For Q3, the estimate rose 3 cents w/w to $32.45, which represents an earnings decline of 23.0%, or 22.4% 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 Q2-2020 growth rates: Information Technology (-1.7% in Q3-2020 versus 5.4% in Q2-2020), Health Care (-2.6, 6.8), Utilities (-3.4, 6.4), Consumer Staples (-7.0, -5.9), Real Estate (-14.1, -15.1), Materials (-19.8, -28.6), Communication Services (-20.8, -16.7), Financials (-23.4, -42.8), Consumer Discretionary (-39.5, -64.9), Industrials (-65.3, -82.5), and Energy (-106.8, -168.5).

US ECONOMIC INDICATORS

NFIB Small Business Optimism Index (*link*): "Small businesses are working hard to recover from the state shutdowns and effects of COVID-19," said NFIB Chief Economist Bill Dunkelberg. "We are seeing areas of improvement in the small business economy, as job openings and plans to hire are increasing, but many small businesses are still struggling and are uncertain about what the future will hold." The Small Business Optimism Index (SBOI) rose for the third time in four months to 100.2 (slightly above its 46-year average), after sliding from 104.5 in February to 90.9 in April—which was the lowest since March 2013. Seven of the 10 SBOI components improved in August, led by a 7ppts increase in earnings trends (to -25% from -32%), while the remaining six components improved from 1ppt to 3ppts: job creation (to 21% from 18%), current job openings (33 from 30), plans to increase inventories (6 from 4), current inventory (3 from 1), now good time to expand (12 from 11), and expected credit conditions (-4 from -5)—with job creation plans experiencing an unprecedented recovery from its 1% reading in April. In the meantime, percentages for sales expectations (to 3% from 5%) and expect the economy to improve (24 from 25) dipped slightly, while the percentage for capital outlay plans was unchanged at 26%. Of the owners surveyed, quality of labor (21%) was the top business problem, followed by taxes (17) and poor sales (15). The uncertainty index rose to 90%—the second-highest reading since March 2017—with the main reasons for the uncertainty being sales volumes, regulations, COVID-19, and the elections.

GLOBAL ECONOMIC INDICATORS

Germany Manufacturing Orders (*link*): Factory orders continued to ascend in July, though at a considerably slower pace than June and May. Orders rose 2.8% in July, following surges of 28.8% and 10.4% the prior two months, though even with this three-month jump of 46.2%, billings were still 9.2% below pre-pandemic levels. Foreign orders jumped 14.4% in July and 53.7% during the three months ending July, with orders from within the Eurozone up 7.3% and 60.3% over the comparable periods and from outside the Eurozone up 19.2% and 49.7%, respectively. Foreign orders are still 11.0% below pre-pandemic highs, with orders from inside and outside the Eurozone down 12.8% and 10.0%, respectively. In the meantime, domestic orders fell 10.2% in July after a two-month surge of 52.1% to a 16-month high in June. Here's a look at the three-month performance by market group for total, domestic, and foreign orders, respectively—with capital goods the clear winner and consumer nondurable goods the loser: capital goods (76.5%, 57.3%, 89.2%), consumer durable goods (34.4, 56.0, 22.9), intermediate goods (21.8, 23.0, 20.7), and consumer nondurable goods (-3.2, -2.6, -3.8).

Germany Industrial Production (*link*): August data show industrial output continued to rebound, though as with orders, paled in comparison to prior months. Germany's headline production (which includes construction) climbed a more subdued 1.2% in August, following record gains of 9.3% in June and 7.4% in May, for a total tally of 18.8%; manufacturing output was up 2.8% in July and 25.6% over the three-month period. Excluding construction, July's gain was double the headline increase, climbing 2.4% after advances of 10.9% and 9.2% the prior two months, for a three-month total of 24.1%. Of the top four Eurozone economies, Germany's lockdown was the least severe since it never mandated factories close—though companies did stop production in some areas. Here's a snapshot of movements in the main industrial groupings over the past three months: capital goods (53.7%), consumer durable goods (32.1), intermediate goods (8.7), and consumer nondurable goods (7.8).

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