MORNING BRIEFING
September 29, 2020

Still on V-Shaped Recovery Track

Check out the accompanying chart collection.

(1) September data still on V-shaped recovery track. (2) Is there enough stimulus left? (3) Doubling down on the increase in real GDP. (4) Regional business indicators up again in September. (5) Not enough new homes to meet booming demand. (6) Solving part of the puzzle on why federal tax receipts are so strong. (7) Stalling high-frequency indicators could be seasonal issue. (8) The pandemic's impact on corporate finance. (9) Pandemic making corporations dash: from dash-to-cash credit lines to dash-to-issue bonds and stocks. (10) Why is M&A boom MIA? (11) Buybacks bust. (12) Zombies are dead and alive.

US Economy: Not Stalling So Far. The onset of the pandemic at the beginning of the year led to an unprecedented two-month lockdown recession during March and April. That short but severe downturn has been followed by a V-shaped recovery from May through August.

Now some of the economic indicators for September are showing that the V-shaped recovery continued during the month, though a few suggest it may be starting to stall. There's lots of chatter that it might actually do so if Washington fails to provide another fiscal stimulus package. Debbie and I aren't convinced that's necessarily so. As we've previously discussed, we believe that there is enough fiscal stimulus left from the March 27 CARES Act to keep the recovery going.

More importantly, while Fed officials have been clamoring for more fiscal stimulus, they continue to provide plenty of monetary stimulus. Near-zero interest rates across the maturity spectrum of the yield curve are keeping mortgage rates at record lows at the same time that de-urbanization is boosting demand for homes in suburban and rural areas. We believe that the resulting housing boom should more than offset the weak recoveries—and possible stalling—of many pandemic-challenged industries. Consider the following:

(1) *GDP model showing impressive snapback.* The Citigroup Economic Surprise Index (CESI) continues to surprise to the upside (*Fig. 1*). That might seem like an odd observation since it was down to 170.4 on Friday, September 25 from a record high of 270.8 on July 16. True, but

anything north of roughly 100.0 means that the CESI remains in record-high territory this year compared to all previous years since the start of the data during 2003!

The surprising strength in the economic indicators that are reflected in the CESI is also reflected in the Atlanta Fed's GDPNow tracking model. The latest reading on Friday showed that real GDP is up 32.0% (saar) during Q3, unchanged from the model's September 17 reading. Remarkably, capital spending in real GDP is now tracking at a 38.1% annual rate, up from 32.6% on September 17. Keep in mind that real GDP fell 31.7% during Q2, led by a 34.1% drop in consumer spending and a 26.0% drop in capital spending (*Fig. 2*).

The FRBNY Weekly Economic Index (WEI) is up from a record low of -11. 5 during the April 25 week to -4.5 during the September 19 week (*Fig. 3*). It is available since 2008 and scaled to align with the y/y growth rate in the four-quarter moving average of real GDP. It includes high-frequency series covering consumer behavior, the labor market, and production. So, for example, the increase in the WEI for the week of September 19 was due to increases in fuel sales, rail traffic, and tax withholding, which more than offset an increase in initial unemployment insurance claims and a decrease in electricity output. Debbie estimates that the rebound in the WEI is consistent with real GDP rising 27% (saar) during Q3.

We've been bullish on the economic recovery, but not bullish enough. We've had to raise our Q3 estimate from 15% to 20% to 25% in recent months. Here we go again: We are increasing it to 30% (*Fig. 4*). We are doubling our real GDP growth estimate for Q4 from 5% to 10% because we expect significant restocking of depleted inventories. The recovery is likely to continue at a much slower pace next year. But we now expect real GDP to be back at the Q4-2019 record high during the second half of 2021 rather than the second half of 2022, as long as it doesn't stall along the way.

(2) *Regional business surveys buoyant.* Confirming the ongoing V shape of the recovery are the five business surveys available through September, conducted by the Federal Reserve Banks of Kansas City, New York, Philadelphia, Dallas, and Richmond (*Fig. 5*). The September averages of their indexes for overall business activity (15.5), new orders (19.5), and employment (12.6) remained solidly above zero after falling into record negative territory earlier this year during the lockdown recession.

(3) *Durable goods orders rebound.* The regional surveys augur well for September's durable goods orders and shipments, which bottomed during April and have rebounded smartly

through August (*Fig. 6*). Nondefense capital goods orders excluding aircraft is up 10.5% over the past four months through August, exceeding the January pace by 1.3%.

(4) *New home sales on fire.* Confirming our housing-led boom scenario are August new homes sales, which have jumped 77.4% over the past four months through August to 1.01 million units (saar), the best pace since September 2006 (*Fig. 7*). They probably would have been higher but for the shortage of inventories of new homes as the months' supply fell to 3.3 during August, the lowest on record (*Fig. 8*).

The National Association of Home Builders compiles a Housing Market Index, which jumped from a recent low of 30 during July to a record-high 83 during September (*Fig. 9*). Leading the way was a remarkable rebound in the traffic-of-prospective-home-buyers sub-index from 13 during April to a record high of 73 during September!

(5) *Federal tax receipts are remarkably strong.* You might be surprised to hear that the 12-month sum of federal government receipts from individual income taxes rebounded by $229 billion during the past two months through August (*Fig. 10*). Well, that's easily explained: Unemployment benefits are included in taxable income. So the big boost to weekly benefits provided by the federal government from April through July also boosted individual income tax revenues.

More puzzling is why the 12-month sum of payroll taxes has been rising to new record highs every single month this year notwithstanding the lockdown recession. We can't explain it. Could it be that most of the job losers had been paid off the books? We don't get it. Also surprising is that the 12-month sum of corporate income tax receipts has rebounded during the past two months through August. We sort of get that: The enormous package of fiscal and monetary stimulus trickled down to profits, perhaps creating more winners from the pandemic than losers as measured by business profits. Maybe.

(6) *Stalling indicators.* Of course, the pandemic is far from over. There probably won't be widespread distribution of a vaccine until the second half of next year. Before then, it will be winter in the Northern Hemisphere, raising the prospect of another wave of Covid-19 combined with the seasonal flu. Restaurants that have survived by offering outdoor dining may not survive the winter. So everyone is watching such high-frequency indicators as restaurant reservations and various mobility metrics. Some of them have been stalling in recent weeks.

Among our favorite high-frequency indicators is credit-card spending (*Fig. 11*). After a V-shaped recovery from mid-April through late June, the uptrend has slowed through mid-September. However, the data—which are not seasonally adjusted—are still trending higher. Weekly gasoline usage has recovered smartly since it bottomed on April 24 (*Fig. 12*). It has stalled during September, but that's consistent with the typical back-to-school slowdown after the summer driving season.

Corporate Finance: Impact of the Pandemic. The lockdown recession and the subsequent recovery have been unique experiences for all of us, including consumers, workers, companies, business managers, and investors. There have been winners and losers in almost every aspect of our economy.

The corporate business sector certainly has had its share of winners and losers. That's been reflected in the stock market. Among the notable ytd winners are lots of technology companies, housing-related industries, and transportation companies (with the exception of airlines). Among the big losers are regional and diversified banks, energy-related companies, REITS, and hotels, resorts, and cruise lines. (See our *S&P 500 Sectors & Industries Year-To-Date Change*.)

I asked Melissa to review and update the big-picture impact of the pandemic on corporate finance. Here is her report:

(1) *Mad dash for cashing in credit lines*. The initial reaction of nonfinancial corporations (NFCs) to the pandemic was to raise lots of cash by cashing in their lines of credit at the banks. Commercial and industrial loans jumped $730 billion from the beginning of the year to a record high of $3.1 trillion during the May 6 week before dipping back down a bit to $2.7 trillion during the September 16 week (*Fig. 13*). The Fed's quarterly data show that the increase in loan demand occurred mostly during Q1 at depository institutions (*Fig. 14*). The mad dash for cash abated after the Fed implemented QE4ever on March 23 and pledged to backstop the corporate bond market.

(2) *Mad dash for issuing stocks and bonds*. Corporate bond issuance soared after the Fed's actions opened up the bond market after it seized up when the pandemic panic hit during February and early March. Over the past 12 months through August, corporate bond issuance totaled $2.4 trillion, led by a $1.4 trillion increase in NFC bond issuance (*Fig. 15*).

The rally in stock prices following the Fed's moves led to a surge in corporate stock issuance too. The new supply of such corporate securities totaled a record $267 billion over the 12 months through August.

(3) *M&A boom is MIA*. Along with the increased activity in the equity and credit markets, we expected that the pandemic would trigger a flurry of M&A activity as so many deeply discounted buying opportunities popped up. But so far that hasn't happened.

A June *Harvard Business Review* survey confirmed that forecast deal volume for the remainder of the year was substantially reduced during the first half of this year. Late-stage deals were done as the pandemic lockdowns began, but many early-stage deals were put on hold. Some opportunistic activity occurred, but it was not reported by most survey respondents.

Part of the problem is that the Fed's March 23 announcement was followed by an extraordinary meltup in valuation multiples. So the pandemic-triggered buying opportunities didn't last long enough to stimulate an M&A boom. Even Warren Buffett couldn't fire his "elephant gun" fast enough.

(4) *Buybacks are busted for now*. It's not unusual for firms to cut back on share buybacks during recessions. Standard & Poor's data on S&P 500 buybacks shows a substantial decline in the pace of buybacks to $88.7 billion during Q2, the lowest since Q1-2012 (*Fig. 16*).

As Joe and I discuss in our *Topical Study #84*, companies often use share buybacks to offset the dilution attributable to employee stock plans, which get cut along with bonuses in general during recessions. The S&P 500 sectors with the industries hardest hit by the pandemic saw the largest quarterly declines in buybacks during Q2. For example, buybacks in Health Care and Information Technology have held up relatively well while Consumer Discretionary, Consumer Staples, Energy, and Real Estate share repurchases have dropped more significantly to record lows. Communications Services was the only sector to see an increase in quarterly buyback activity during Q2, which is not surprising since most of its industries are flourishing.

(5) *Dying and thriving zombies.* Will NFCs experience a major debt hangover from all the debt accumulated on their balance sheets since the pandemic hit? Maybe some, but likely not most. Given that interest rates are at record lows and that lots of companies have locked in these low

rates by refinancing existing debt at extended maturities, all that debt may be serviceable, especially as the US economy recovers from the current crisis.

As a September 23 Bloomberg article discussed, the Fed's zero-rate policy and the search for yield have created a borrower's market in the credit space, even for high-yield junk. It noted that "all-in yields for U.S. junk bonds have dropped to 5.81%, near pre-pandemic levels, according to Bloomberg Barclays index data." It mentioned Ball Corp.'s record-setting lowest coupon ever for a junk bond with a maturity of five years or longer during August at 2.875%. That's as US high-yield bond sales totaled $329.8 billion through last Wednesday, eclipsing the prior annual sales record set in 2012.

An August 21 Capital Group Insights report by Fixed Income Portfolio Manager Shannon Ward noted that corporate defaults are indeed up (as we discussed in our August 12 *Morning Briefing*). The default rate has tripled from last year to around 6.0%. Nevertheless, it remains low in the single digits. Ward observed that the market for low-rated companies is ripe with opportunities for selective investors.

She also noted (as we did in our earlier note) that companies with problems that pre-dated the pandemic—such as brick-and-mortar retailers and energy companies—may be ones to avoid. Not surprisingly, these industries account for a large share of the rise in ytd defaults and bankruptcies. Lots of investment-grade companies dropped in their ratings as the lockdowns occurred, but many already have recovered. It helped that the Fed has been and remains at the ready to support these "fallen angels." Ward notes that the BB-rated market is about 55% of the high-yield market as of July 31, 2020.

Investors with elephant guns may find more to hunt for in the debt markets than in the equity markets.

CALENDARS

US: Tues: Consumer Confidence Index 89.2, Goods Trade Balance, Wholesale Inventories, S&P Case-Shiller Home Price Index 3.8% y/y, API Crude Oil Inventories, Williams, Harker, Presidential Debate. **Wed:** ADP Employment Change 610k, GDP (Q2, final) -31.7%, Pending Home Sales 3.8%, MBA Mortgage Applications, Chicago PMI 52, EIA Crude Oil Inventories, Kashkari, Kaplan. (DailyFX estimates)

Global: Tues: Eurozone Economic Sentiment 93, Germany CPI -0.1%/-0.1% y/y, France Consumer Confidence 93, Japan Retail Sales -3.5% y/y, Japan Industrial Production 1.5%, China Caixin & IHS Markit M-PMIs 53.1/51.2, Mauderer. **Wed:** Germany Unemployment Change & Unemployment Rate -8k/6.4%, Germany Retail Sales 4.2%, Italy CPI -0.4% y/y, Japan Tankan Survey, BOE FPC Meeting, Lagarde, Lane, Haldane, Wuermeling. (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 19 straight weeks, MidCap's is up in 16 of the past 17 weeks, and SmallCap's posted its 16th gain of the past 19 weeks. LargeCap's forward earnings is now up 11.6% from its lowest level since August 2017; MidCap's has risen 23.6% from its lowest level since May 2015; and SmallCap's is up 31.9% 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 12.1% below its record high at the end of January. MidCap's and SmallCap's are 17.9% and 27.8% 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 -11.3% y/y from -11.7%. 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 -15.1% y/y from -18.6% 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 edged down w/w to -20.3% y/y from -20.2% y/y, but 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%, 27.9%), MidCap (-30.7, 48.6), and SmallCap (-53.0, 110.2).

S&P 500/400/600 Valuation (*link*): Valuations dropped across the board last week and slipped further below their recent cyclical and record highs. LargeCap's forward P/E fell to a 13-week low of 21.0 from 21.2 a week earlier and a 19-year high of 22.7 at the end of August. That's up from 13.3 in mid-March, which was the lowest since March 2013. MidCap's dropped to a 21-week low of 17.8 from 18.8, which is down 5.1pts from its record high of 22.9 in early June. SmallCap's was also down sharply, to a 21-week low of 18.8 from 19.9, and is down 7.9pts 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 fifth 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 adjusted their estimates slightly higher for Q3 for a sixth straight week, which is not the typical pattern before an earnings season begins. Since the Q2 earnings season, which came in substantially better than greatly reduced forecasts, they have been adjusting nearly all of their future quarterly forecasts higher instead of lower as is the norm. In the latest week, the S&P 500's Q3 blended EPS estimate/actual rose 9 cents w/w to $32.78. That $32.78 estimate represents a decline of 22.2% y/y on a frozen actual basis and -21.6% y/y on a pro forma basis. That compares to a pro forma 30.6% decline in Q2-2020, 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 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, a y/y earnings decline is expected for all 11 sectors, but six 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 (-0.7% in Q3-2020 versus 5.6% in Q2-2020), Health Care (-2.2, 6.8), Utilities (-3.8, 6.4), Consumer Staples (-5.3, -4.2), Real Estate (-14.5, -15.2), Materials (-17.6, -28.6), Communication Services (-20.6, -16.8), Financials (-22.4, -46.7), Consumer Discretionary (-34.3, -64.7), Industrials (-65.4, -85.3), and Energy (-108.8, -168.1).

US ECONOMIC INDICATORS

Regional M-PMIs (*link*): Five Fed districts have now reported on manufacturing activity for September (New York, Philadelphia, Richmond, Kansas City, and Dallas) and show the manufacturing sector expanded at its fastest pace since October 2018. The composite index climbed to 15.5 this month from 12.2 last month; it was at a record low of -58.6 in April. Activity in the Richmond (to 21.0 from 18.0) and Dallas (13.6 from 8.0) regions were the best since September 2018 and November 2018, respectively, while New York's (to 17.0 from 3.7) was back near July's 17.2—which was the first positive reading since February, Meanwhile, growth in the Philadelphia (15.0 from 17.2) region slowed for the fourth month, though remained at an elevated rate, while Kansas City's (11.0 from 14.0) was little changed from August's 21-month high. (The Richmond, Dallas, New York, Philadelphia, and Kansas City activity measures were at record lows of -54.0, -74.0, -78.2, -56.6, and -30.0, respectively, in April.) Meanwhile, September's new orders (to 19.5 from 13.6) measure expanded at the best pace since July 2018, as billings in the Richmond (27.0 from 15.0) region accelerated at its fastest rate since fall 2018, while Philadelphia's (25.5 from 19.0) and Dallas' (14.7 from 9.8) expanded at their fastest paces since just before the pandemic. The growth in Kansas City's (23.0 from 26.0) billings barely budged from August's 27-month high, while New York's (7.1 from -1.7) swung from contraction to expansion. (The Richmond, Dallas, Philadelphia, Kansas City, and New York billing measures were at record lows of -62.0, -68.7, -70.9, -64.0, and -66.3, respectively, in April.) In the meantime, employment at factories continues to improve, turning positive in July (4.7) for the first time since hitting bottom in April (-36.0)—expanding to an 18-month high of 12.6 this month. Richmond (to 23.0 from 17.0), Philadelphia (15.7 from 9.0), and Dallas (14.5 from 10.6) all saw manufacturers hiring at a faster pace this month, while Kansas City's (7.0 from 9.0) hired at a slightly slower pace and New York's (2.6 from 2.4) remained just north of the breakeven point between contraction and expansion. (The Richmond, Philadelphia, Dallas, Kansas City and New York employment measures were at record lows of -22.0, -46.7, -22.0, -34.0, and -55.3, respectively, in April.)

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