MORNING BRIEFING
October 1, 2020

Lots of Issues To Debate

Check out the accompanying chart collection.

(1) A presidential debate for the history books. (2) Mnuchin's stimulus hint trumps debate shouting match. (3) More V-shaped indicators. (4) Hotel REITs need travelers to continue their rebound. (5) Shuttered stores hurting Retail REITs. (6) Cell towers and data centers help Specialized REITs outperform. (7) Chinese media fans the US/China cold war flames. (8) Diplomats stop talking. (9) Sinicization continues. (10) Will more Chinese professors in the US return home? (11) The Boring Company keeps on digging.

US Politics: Debate Debacle. The presidential debate on Tuesday evening was historic—historically horrible. The only good that came of it is that it saved us from wasting our time watching the next two presidential debates.

Former Vice President Joe Biden mostly kept his cool, unrattled by President Donald Trump's barrage of attacks and interruptions. Biden often looked straight into the television camera, directly addressing the viewers. Trump tended to growl in Biden's direction most of the time.

Biden had a few memorable choice lines—including his advice early on for the President to shut his mouth, which seemed disrespectful at first but before long proved to be a very good suggestion. Biden's declaration that "I *am* the Democratic Party right now" was also memorable. However, he equivocated on some questions, such as whether he would pack the Supreme Court and his stance on maintaining law and order.

Trump came out swinging from the start of the debate. His punches often had been previously telegraphed, so they mostly missed their mark. He took a direct blow from the moderator after refusing to denounce white supremacists. Trump pushed hard on Biden's recent swerving to the left.

The widespread view seems to be that Biden won the debate, but he did so basically by staying ambiguous about several key issues. Does yesterday's stock rally suggest that Biden would be bullish for stocks? That's not the conventional view given that Biden was definitive about one issue: He said he will raise the corporate tax rate from 21% to 28%.

More likely is that the stock market was lifted yesterday by Treasury Secretary Steven Mnuchin's saying that there is a chance of a "reasonable compromise" in Washington on another fiscal stimulus bill. In addition, there's no debating that yesterday's economic news was very good. ADP reported a 749,000 increase in private payrolls for September, and pending sales of existing homes jumped 8.8% in August.

US Economy: V-Shaped Recovery Winning the Debate. Here's more on the latest data confirming that the hotly debated slope of the recovery is still V-shaped:

(1) *ADP payroll.* According to ADP, private payrolls fell 19.7 million from February through April, and have increased 9.3 million since then through September (*Fig. 1*). Here are the comparable numbers for service-producing companies (-17.3, 7.8) and goods-producing ones (-2.4, 1.5).

Interestingly, the biggest job losses during the lockdown recession were among large companies, down -9.3 million from February through April, followed by a 3.9 million gain through August (*Fig. 2*). By comparison, here are the comparable stats for medium-sized companies (-5.0, 2.1) and small-sized ones (-5.4, 3.3).

(2) *Pending home sales.* The housing boom that we've been writing about was confirmed yesterday by the jump in the Pending Home Sales Index to a record 132.8 during August, up from a record low of 69.0 during April (*Fig. 3*). It is an excellent leading indicator of actual existing home sales, since it is based on contracts actually signed. The boom is evident in all four regional sub-indexes (*Fig. 4*). There's no debating that this is great news for housing-related retail sales.

Real Estate: Covid Creates Winners & Losers. "All happy families are alike; each unhappy family is unhappy in its own way" is the famous first sentence of Leo Tolstoy's classic novel *Anna Karenina*. Like unhappy families, no two recessions are ever quite the same.

In the Great Financial Crisis, homeowners with outsized mortgages and home equity loans meant residential real estate took it on the chin during the downturn, while commercial real estate escaped relatively unscathed. In the ensuing years, the amount of commercial real estate debt increased. Now during the Great Virus Crisis, with retailers and hoteliers facing sharp drop-offs in business, commercial real estate is having a much tougher time than residential real estate, a market that's booming.

The Real Estate sector is among the worst performing of the 11 S&P 500 sectors. Here's the performance derby for the S&P 500 sectors' stock price indexes ytd through Tuesday's close: Information Technology (26.4%), Consumer Discretionary (21.6), Communication Services (7.5), S&P 500 (3.2), Materials (2.7), Health Care (1.9), Consumer Staples (0.7), Industrials (-5.1), Utilities (-8.9), Real Estate (-9.4), Financials (-22.7), and Energy (-50.0) (*Fig. 5*).

Most, but not all, real estate industries are performing poorly this year. In positive territory are Industrial REITs (real estate investment trusts), up 11.0% ytd through Tuesday's close, and Specialized REITs, up 12.2%.The rest of the Real Estate industries' stock price indexes have fallen sharply: Real Estate Services (-23.7%), Health Care REITs (-28.5), Office REITs (-30.1), Hotel & Resort REITs (-42.2), and Retail REITs (-43.1) (*Fig. 6*).

Here's Jackie's look at what's driving this underperformance and some ramifications for related industries:

(1) *Earnings forecasts keep tumbling.* While the S&P 500's forward earnings (i.e., the time-weighted average of analysts' consensus earnings estimates for this year and next year) have improved since the end of May, Joe points out that analysts have continued to slash earnings forecasts in the S&P 500 Real Estate sector, bringing down its forward earnings calculation. Over the past 13 weeks, forward earnings for the broader index climbed 9.2% while forward earnings for its Real Estate sector tumbled 4.3%.

The dour outlook is spread across many real estate industries, with only the S&P 500 Specialized REITs industry bucking the trend; its forward earnings has risen 9.4% over the past 13 weeks. Here's how the other S&P 500 Real Estate industries have fared in terms of forward earnings over the past 13 weeks: Hotel & Resort REITs (to a deeper loss), Industrial REITs (-23.7%), Health Care REITs (-18.6), Office REITs (-15.6), Real Estate Services (-10.8), Residential REITs (-9.2), and Retail REITs (-4.5).

In all, earnings for the S&P 500 Real Estate sector are forecast to fall by 31.6% this year and 3.6% in 2021 (*Fig. 7*). That gives the sector the weakest 2021 earnings growth of all the S&P 500 sectors except Energy.

(2) *Hotel REITs clobbered.* The downward revisions to Hotel & Resort REITs' earnings were the most dramatic, perhaps because Covid-19 and its ramifications were so unexpected. Prior to Covid, the hotel industry was booming, and new hotel construction was at record levels.

"There were 214,704 hotel rooms under construction in the U.S. at the end of March, according to STR. It is the highest end-of-month construction total ever recorded by the hotel data firm. The previous record high was one month earlier in February, when STR reported 211,859 rooms under construction," according to an April 21 article in Skift. Because of the long lead times, trends in construction often lag what's occurring in the broader economy.

While many hotel metrics have improved from the dark days of March, they remain severely depressed on a y/y basis. For the week of September 13, US hotel occupancy was 48.6%; that's down 31.9% from the same week last year, but it's a vast improvement over the 22.0% registered in March, according to a Hotel News Now September 24 press release. Improvement in occupancy has plateaued in August, and for it to get another leg up may require a vaccine or a sharp drop in Covid cases.

(3) *Retailers closing shop.* As we noted in the September 10 *Morning Briefing*, what's different about the current retail shakeout is that an increasing number of retailers are closing shop forever. They're liquidating instead of restructuring under bankruptcy protection—and that means there's a lot of unoccupied retail real estate on Main Street and in the mall.

From January through mid-August, retailers announced they'd closed more than 10,000 stores in the US, topping last year's record 9,500 store closures, according to a September 29 *WSJ* article. Of the ytd total, 6,000 closures were due to retailers' bankruptcy filings, and the total figure could rise north of 25,000 before 2020 is over.

Retailers plan to close more than 130 million square feet of US store space, the article states. More than half of the closures are from Bed Bath & Beyond, Macy's, JCPenney—which is in bankruptcy and being sold to mall operators Simon Property Group and Brookfield Property Partners—and Stein Mart and Pier 1 Imports, which are liquidating after filing for bankruptcy protection.

Joe reports that the industry's fortunes have shrunk so much that the S&P 500 Department Store's price index will be no longer. Trading was suspended on September 18 for the first time since 1946. None of the few survivors are big enough any longer to qualify as LargeCaps (*Fig. 8* and *Fig. 9*).

We wouldn't be surprised to see more retail closures after the holiday selling season, the time of year when bankruptcies are more typically seen. Indeed, Retail REIT industry analysts may be anticipating more closures early next year as well, as their consensus earnings forecast implies a decline of 8.6% in 2021 after this year's projected 13.6% decline.

(4) *Why are Specialized REITs outperforming?* The S&P 500 Specialized REITs includes a hodgepodge of companies that own everything from cell towers to timber. The industry's stock price leaders ytd through Tuesday's close are SBA Communications (up 32.1%), Equinix (30.4), Digital Realty Trust (22.7), and Crown Castle (17.2).

SBA and Crown Castle own cell towers and other items that allow for cellular communications and are sure to be in demand as 5G rolls out. Meanwhile, Equinix and Digital Realty Trust own data centers, which are in increasing demand as many of us work from home and tap into our office documents housed in the cloud. The S&P 500 Specialized REIT industry is expected to produce solid earnings growth of 19.9% in 2021, an improvement from this year's 1.0% growth forecast (*Fig. 10*).

Geopolitics: The Xi/Trump Faceoff Continues. US and Chinese leaders continue the tit-for-tat that is exacerbating the cold war brewing between the two nations. The chill has even started to infect the business sector, according to WPP's founder Sir Martin Sorrell. "It's making it extremely difficult to run a global business when you have the two biggest economies in the world fighting one another," he told CNBC in a September 29 article. Let's take a quick look at the latest volleys between the two nations:

(1) *Chinese media banging the drum.* Chinese state media has been harping on the forced sale of TikTok to US companies, but last week the *Global Times* threw gasoline on the fire. Hu Xijin is editor-in-chief of the *Global Times*, a newspaper controlled by the Chinese state. On September 28, he tweeted: "Based on information I learned, Trump govt could take the risk to attack China's islands in the South China Sea with MQ-9 Reaper drones to aid his reelection

campaign. If that happens, the PLA will definitely fight back fiercely and let those who start the war pay a heavy price."

(2) *Not very diplomatic.* Chinese and US diplomats are no longer allowed to talk. US Secretary of State Mike Pompeo announced that Chinese diplomats in the US must receive permission to meet with US local government officials or visit university campuses. China responded this week by telling Hong Kong officials to abstain from meeting American diplomats and talking with them on the phone, a *South China Morning Post* (SCMP) September 28 article reported. It stated: "City officials have to report to their department heads if they receive invitations for meetings from the US consulate general in Hong Kong under the updated policy. All requests will be handled on a case by case basis."

(3) *War on religion.* China's government continues its push to rid the Xinjiang region of the Uighur Muslims and their culture. The Chinese government has razed or damaged two thirds of the region's mosques, roughly 16,000, according to a report by the Australian Strategic Policy Institute cited in a September 25 *WSJ* article. Shrines, cemeteries, and pilgrimage routes were also demolished, damaged, or altered, the article states.

Another report out of the same Australian organization identified more than 380 suspected detention facilities in Xinjiang that were newly built or had been expanded "significantly" since 2017. China's Foreign Ministry denied the report's claims and told the *WSJ* that it "fully protects the human and religious rights of all ethnic minorities."

The government's Sinicization efforts may be expanding to other regions including Sanya, a small island south of China where the Muslim Utsuls have been banned from wearing traditional dress in schools and in government offices. Mosques must now have a Communist Party member sitting on their management committees for monitoring purposes and "Arabic script must also be removed from shopfronts, along with Chinese characters such as 'halal' and 'Islamic,'" a September 28 *SCMP* article reported.

The US has imposed sanctions on companies and individuals accused of human rights violations in the region and blacklisted several Xinjiang-based suppliers to major Western brands.

(4) *Brain drain goes into reverse.* As might be expected, a number of Chinese professors working in the US opted to return to China after facing US government inquiries into their

undisclosed ties to Chinese institutions. Less clear is why Professor Zhu Songchun, an award-winning expert in artificial intelligence and computer vision at the University of California at Los Angeles, left the US to join Peking University to lead its Institute for Artificial Intelligence.

Zhu obtained a PhD at Harvard University in 1996 and joined UCLA after brief periods at Stanford and Ohio State. His departure follows that of Harry Shum, Microsoft's former head of AI and research who now chairs the academic committee of the Institute of Artificial Intelligence. The two men are long-time acquaintances.

It could be problematic if leading Chinese researchers start finding their Chinese career opportunities more attractive than those available in the US. "China is the largest global source of top-tier AI talent. However, 88 per cent of those who completed graduate studies in the US have chosen to stay and work there, helping America lead the way in the field," according to study by MarcoPolo, a US think tank quoted in a *SCMP* September 29 article.

Disruptive Technologies: Boring Away. Speculation is swirling about whether Elon Musk's Boring Company is working on plans to build a tunnel from Las Vegas to Los Angeles. Industry website Teslarati noted in a September 21 article that the Boring Company's website posts three open positions in Adelanto, California, which is strategically located between Sin City and the City of Angels. The company is searching for a human resources associate, mechanic, and Boring machine operator.

The Boring Company's Adelanto location had already raised speculation due to pictures taken in August of large machinery and tents. Industry watchers were already on high alert after noticing that a map of the Boring Company's Las Vegas Loop includes a dotted line representing "conceptual future expansion" with an arrow labeled "To Los Angeles."

As we've discussed before, the Boring Company is in the midst of constructing a tunnel that spans the Las Vegas Convention center. "The Loop," as it's known, is expected to be completed in January, and then it's expected to be expanded to connect the casinos on the Strip and the Las Vegas Airport.

Up next: a Boring tunnel linking Rancho Cucamonga, California with the Ontario International Airport, a June 14 article in Lynxotic reported. The 2.8-mile Boring tunnel is expected to cost $60 million-$75 million—compared to the $1 billion-$1.5 billion estimated cost of an alternative, above-ground light rail system. The Boring tunnel should take four years to build compared to the 10 years estimated for the light rail system.

CALENDARS

US: **Thurs:** Personal Income & Spending -2.2%/0.8%, Core PCED 0.3%m/m/1.4%y/y, Initial & Continuous Jobless Claims 850k/12.225m, Auto Sales, Construction Spending 0.8%, ISM M-PMI 56.3, EIA Natural Gas Inventories, Williams. **Fri:** Total, Private, and Manufacturing Payroll Employment 850k/850k/33k, Unemployment Rate 8.2%, Average Hourly Earnings 0.2%m/m/4.8%y/y, Average Weekly Hours 34.6, Consumer Sentiment Index 79, Factory Orders 1.0%, Baker-Hughes Rig Count, Harker. (DailyFX estimates)

Global: **Thurs:** Eurozone, Germany, France, and Italy M-PMIs 53.7/56.6/50.9/53.5, Eurozone Unemployment Rate 8.1%, Italy Unemployment Rate 10.1%, UK M-PMI 54.3, Japan Unemployment Rate 3.0%, European Council Special Meeting, Lane. **Fri:** Eurozone Headline & Core CPI Flash Estimates -0.2%/0.5% y/y, European Council Special Meeting, Guindos, Wuermeling. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators(*link*): The Bull/Bear Ratio (BBR) this week was below 3.00 for the third week after 11 weeks above. The BBB posted its fourth decline in as many weeks, slipping to 2.41 this week after climbing 20 of the previous 23 week from 0.72 (lowest since March 2018) during the March 24 week to 3.75 (highest since January 2018) four weeks ago. Bullish sentiment (to 52.5% from 51.5%) moved up slightly this week, but was 9.0ppts below its percentage four weeks ago; it had increased 31.4ppts (to 61.5% from 30.1%) from the March 24 week through week of September 1. Bearish sentiment has climbed 5.6ppts (to 21.8% from 16.2%) the past three weeks—the highest since the week of June 2—after fluctuating in a flat trend between 16.2% and 16.5% the prior five weeks; it was at 41.7% during the March 24 week. The correction count slipped to 25.7% this week after climbing 7.0ppts (to 29.1% from 22.1%) the prior three weeks. The AAII Ratio slipped to 35.1% last week after rebounding from 32.9% to 44.2% the prior week. Bullish sentiment fell from 32.0% to 24.9% last week, while bearish sentiment rose from 40.4% to 46.0%.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The rapid pace of Covid-19 estimate cuts has turned into a v-shaped recovery 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. They mostly edged lower during the latest week though. Forward revenues dropped 0.3% w/w from its highest level since early April and is now 4.3% below its record high in mid-February. Forward earnings was down 0.1% w/w from its highest level since early April and is now 12.6% below its record high in early March. Forward revenues growth fell 0.1ppt w/w to 5.2% as forward earnings growth improved 0.2ppt to 13.9%. Forward revenues growth is 1.1ppts below its seven-year high of 6.3% in February 2018, but is up from 0.2% in April, which was the lowest reading since June 2009. Forward earnings growth remains 3.0ppts below its six-year high of 16.9% in February 2018, but is up 19.5ppts from its record low of -5.6% at the end of April. Analysts expect revenues to decline 4.1% y/y in 2020 compared to the 4.3% reported in 2019. That's up 0.2ppt w/w and down 9.3ppts since the start of the year. Analysts expect an earnings decline of 19.3% y/y in 2020 compared to a 1.4% rise in 2019. Their 2020 growth rate was up 0.1ppt w/w and is down 28.3ppts since the beginning of the year. The forward profit margin remained steady w/w at 10.9%. That's up 0.6ppt from 10.3% during April and May, which was the lowest level since August 2013. It's still down 1.5ppt from a record high of 12.4% in September 2018. Analysts expect the profit margin to fall 1.8ppt y/y in 2020 to 9.7%—from 11.5% in 2019—and to improve 1.6ppt y/y to 11.3% in 2021. Valuations were down for a third straight week. The S&P 500's weekly forward P/E dropped 0.9pt to a 19-week low of 20.9. That compares to 23.1 in early September, which was the highest level since July 2000 and up from a 77-month low of 14.0 in mid-March. The S&P 500 price-to-sales ratio slipped 0.09pt w/w to an 11-week low of 2.40. That's down from a record high of 2.53 at the beginning of September and up from the 49-month low of 1.65 in mid-March.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): Last week saw consensus forward revenues and earnings rise w/w for just four of the 11 S&P 500 sectors in what seems to be the typical breather ahead of the earnings season. Communication Services had both measures rise w/w, while Consumer Discretionary, Energy, Health Care, and Real Estate had both measures fall. 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 now expected to have improved profit margins in 2020, whereas back in early March eight sectors were expected to see margins improve y/y. During 2019, just two sectors' margins 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 moved higher for Consumer Discretionary and Materials, and dropped for Financials, Industrials, and Tech. 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 (13.4, down from 17.0), Communication Services (13.6, down from 15.4), S&P 500 (10.9, down from 12.4), Health Care (10.5, down from 11.2), Materials (9.8, down from 11.6), Industrials (8.1, down from its record high of 10.5% in mid-December), Consumer Staples (7.3, down from 7.7), Consumer Discretionary (6.0, down from 8.3), and Energy (2.2, 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 4.0%, forward earnings has gained 11.0%, and the forward profit margin has risen 0.6pt to 10.9%. The S&P 500 and nine of its 11 sectors have posted new highs during the last four weeks in either their forward revenues, earnings, or profit margin. The exceptions: Energy's revenues; Utilities' revenues and earnings; and Real Estate's revenues, earnings, and profit margin. Real Estate's earnings and margin made a new low again in the latest week. Here's how the sectors rank by their changes in forward revenues and forward earnings since May 28: Information Technology (forward revenues up 5.5%, forward earnings up 7.3%), Consumer Discretionary (5.5, 34.8), Financials (5.4, 11.1), Industrials (5.3, 16.2), Communication Services (4.6, 6.9), Materials (4.3, 16.1), S&P 500 (4.0, 11.0), Health Care (3.1, 8.6), Energy (1.3, 297.1), Consumer Staples (1.7, 4.4), Real Estate (-0.1, -5.6), and Utilities (-2.1, 0.4).

US ECONOMIC INDICATORS

ADP Employment (*link*): "The labor market continues to recover gradually," said Ahu Yildirmaz, vice president and co-head of the ADP Research Institute. "In September, the majority of sectors and company sizes experienced gains with trade, transportation and utilities; and manufacturing leading the way. However, small businesses continued to demonstrate slower growth." September's employment increase blew past forecasts, rising 749,000 (vs 649,000 estimate) and there were upward revisions to August (to 481,000 from 428,000) and July (216,000 from 212,000) for a net gain of 57,000. While employment is up 9.3 million from its April low through September, it is still a sizeable 10.4 million below February's pre-pandemic level. Service-providing industries are up 7.8 million since April, but are 9.6 million below February levels, while goods-producing are up 1.5 million and down 880,000 over the comparable periods. Here's a tally of industry performances from strongest to weakest during the five months through September, and where they stand relative to February's pre-pandemic levels: leisure & hospitality (+3.51 million & -4.18 million), trade transportation & utilities (+1.52 million & -1.59 million), health care & social assistance (+1.11 million & -978,000), construction (793,000 & -205,000), manufacturing (+736,000 & -595,000), other services (+734,000 & -546,000), administrative & support services (+563,000 & -1.00 million), professional & technical services (+155,000 & -384,000), education (+131,000 & -329,000), financial activities (+ 100,000 & -161,000), management of companies & enterprises (-20,000 & -103,000), natural resources & mining (-26,000 & -80,000), information services (-30,000 & -291,000). Here's the same exercise by company size: Large (+3.85 million & -5.47 million), small (+3.30 million & -2.10 million), and medium (+2.12 million & -2.86 million) businesses.

Pending Home Sales (*link*): "While I did very much expect the housing sector to be stable during the pandemic-induced economic shutdowns, I am pleasantly surprised to see the industry bounce back so strongly and so quickly," said Lawrence Yun, NAR's chief economist. The Pending Home Sales Index has been on a steep upward trajectory since bottoming in April at 69.0, climbing by 92.5% during the four months through August to a record-high 132.8. Sales were up 24.2% y/y in August, the best year-over-year performance since April 2010. All regions have posted massive gains the past four months, with all regions more than 20% above year-ago levels. Here's a look: Northeast (+174.9% four months ending August & 26.0% y/y), West (110.7 & 23.6), South (76.0 & 23.6), and Midwest (72.9 & 25.0). Yun warns that while pending home sales are outperforming many pre-pandemic averages, without matching levels of supply, the recovery will not be sustainable.

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