MORNING BRIEFING
October 27, 2020

Who Owns Stocks in America?

Check out the accompanying chart collection.

(1) From V to swoosh? (2) Setbacks on the health front of the world war against the virus. (3) October's flash PMIs remained strong in US, but weakened in Eurozone. (4) Progress on the vaccine front. (5) We are rooting for the stock market to consolidate, not for another panic attack. (6) A simple question with a complicated answer: Who owns equities? (7) Equities come in assorted varieties: publicly traded, closely held, directly held, and indirectly held. (8) Households have been holding about 60% of all equities in US since early-1980s. (9) Proprietors' income is comparable to corporate profits. (10) S corporations generate as much pre-tax profits as S&P 500 corporations after taxes. (11) S corporate profits taxed as dividends in personal income. (12) So who owns equities? It's complicated.

Global Economy: Winter Is Coming. The V-shaped recovery in the US may start to swoosh in coming months if the latest wave of the pandemic leads to renewed lockdown restrictions. Housing-related businesses should continue to boom even during the winter months, but another round of voluntary and enforced social distancing would likely weigh hard on many services businesses that were especially hard hit during the initial wave of the pandemic. Consider the following:

(1) *Another wave*. The 10-day moving averages of new positive tests compiled by the Covid Tracking Project has moved up sharply in recent weeks through October 23 (*Fig. 1*). That's mostly because new tests continue to increase, reaching a record high of over a million. The positivity rate remains relatively low at 6%, but it has been edging higher recently. Current hospitalizations are also moving higher again in recent weeks, and could lead to rising new deaths before long (*Fig. 2*).

(2) *Weighing on Europe's economy again*. So far, the latest flash PMIs for the US show that the V-shaped recovery continued during October, led by the NM-PMI, which rose to 56.0 this month, the best reading since February 2019 (*Fig. 3*). The bad news is that the latest wave of the pandemic in the US could follow the lead of the one in Europe, where another wave of lockdown restrictions is causing the Eurozone's V-shaped recovery to stall. That's the implication of October's flash PMIs for the region, where the NM-PMI dropped to 46.2 from 48.0 last month (*Fig. 4*).

(3) *Fauci weighs in*. On Sunday, Dr. Anthony Fauci, the director of the US National Institute of Allergy and Infectious Diseases, said, "We will know whether a vaccine is safe and effective by the end of November, beginning of December. The number of doses that will be available in December will not certainly be enough to vaccinate everybody—you'll have to wait several months into 2021." On Friday evening, he said, if "people are not wearing masks, then maybe

we should be mandating it." That's been my position since early on. Requiring everyone to wear masks makes more sense than lockdowns, in my opinion.

(4) *A shot in the arm*. Yesterday, the *WSJ* reported that "a Covid-19 vaccine being developed by the University of Oxford and AstraZeneca showed a promising immune response and low levels of adverse reactions in the elderly and older adults, according to an interim analysis that the drugmaker said was encouraging.

"The vaccine, now in late-stage human trials aimed at showing its efficacy and safety, is a front-runner in the global sprint for a shot to protect lives and jump-start economies hobbled by the pandemic. Trials in the U.K. could produce results before year-end, fueling hopes among scientists and government leaders that a vaccine might be available for high-risk groups here by early 2021."

(5) *Weighing on stocks*. Joe and I have been rooting for the S&P 500 to consolidate its 60.0% meltup gain from March 23 through September 2, when it hit a closing record high of 3580.84. Yesterday, it closed 5.0% below that peak. We would like to see the market give earnings a chance to catch up. It's been doing that since September 2. The market also needs to see that we are winning the world war against the virus on all three fronts. We've made tremendous progress on the financial and economic fronts. But we are on the defensive again on the health front. And, of course, the market needs to see who wins the White House, the House, and the Senate on November 3. Joe and I remain bullish with our target of 3800 for the S&P 500 by the middle of next year.

Strategy I: The Fed's Quarterly Data. The Fed's quarterly *Financial Accounts of the United States* is a treasure trove of information on the balance sheets and income statements of the major sectors of the US economy. Today, I would like to focus on answering a simple question with the Fed's data: "Who owns stocks in America?" The answer isn't as simple. Nor are the Fed's data detailed enough to assess the extent of wealth inequality based on equity holdings. Nevertheless, here are some interesting insights:

(1) *Market capitalization.* The total market value of all corporate equities held by US residents was $52.0 trillion at the end of Q2-2020 (*Fig. 5*). That was down just 5.5% from the record high at the end of Q4-2019. The Fed slices and dices the total into a domestic sector, which includes nonfinancial and financial corporations, and the rest of the world. Data are also available showing publicly traded and closely held equities of corporations in the domestic sector.

The total market cap comprised $33.5 trillion in equities issued by nonfinancial corporations, $10.0 trillion issued by financial corporations, and $8.5 trillion issued by the rest of the world and held by US residents. The $43.5 trillion issued by the domestic sector's corporations included $37.2 trillion of publicly traded equities and $6.3 trillion of closely held equity (*Fig. 6*).

Of the $6.3 trillion closely held equities, $4.7 trillion was in S corporations and $1.6 trillion was in C corporations (*Fig. 7*).

(2) *Equities directly held by sectors.* The Fed's data can be used to calculate the percent of the total market cap of all equity issues directly held by the major sectors as follows: household (37.6%), mutual funds & ETFs (27.8), institutional investors (13.4), the rest of world (15.8), and all others (5.4%) (*Fig. 8*). Institutional investors include property-casualty insurance companies, life insurance companies, private pension funds, federal government retirement funds, and state and local government retirement funds.

(3) *Equities directly and indirectly held by households.* The Fed's data show equities held by households both directly and indirectly through life insurance companies, mutual funds, private pension funds, federal government retirement funds, and state and local government retirement funds. (Equities held by defined contribution plans are included in the three retirement funds. Assets held by defined benefit pension funds are not considered assets of the household sector. However, defined benefit pension entitlements are included in the "other" category of household assets.)

The percent of the total market value of US equities held directly and indirectly by households was 61.4% during Q2 (*Fig. 9*). It's been hovering between 60% and 65% since the early 1980s. It had been as high as 90% in 1960.

(4) *Another piece of equity puzzle.* Both S and C corporations are included in the Fed's accounts and their earnings are included in the profits measure of the National Income & Products Account (NIPA). In NIPA, proprietors' income is included in personal income (and taxed as such), not in corporate profits. Proprietors' income is significant, tending to be roughly 80% as much as pre-tax corporate profits since the mid-1960s (*Fig. 10* and *Fig. 11*). In the Fed's account, there is a table for "proprietors' equity in noncorporate business." It rose to a record high of $12.4 trillion at the end of Q2.

The *NIPA Handbook* explains: "Nonfarm proprietors' income measures the income, before deducting income taxes, of sole proprietorships, partnerships, and other private nonfarm businesses that are organized for profit but that are not classified as corporations. Sole proprietorships are businesses owned by a single individual. Partnerships include most associations of two or more of: individuals, corporations, noncorporate organizations that are organized for profit, or of other private businesses. Other private businesses are made up of tax-exempt cooperatives, including credit unions, mutual insurance companies, and rural utilities providing utility services and farm marketing and purchasing services."

(5) *Are S corporations undervalued?* We are researching whether closely held S corporations are being appropriately valued in the Fed's accounts. NIPA corporate profits includes the profits of both C and S corporations. C corporations pay corporate taxes on their earnings. Their shareholders report any dividends they receive on their personal tax returns.

S corporations are legal entities that pay no federal corporate profits taxes; instead, all their earnings are treated as taxable income of shareholders, regardless of whether the income is distributed as dividends or retained by the corporation. As a result, most income is paid out as dividends.

In the early 1980s, C corporations produced almost all business income. In 2013, only 44% of the income of business owners was earned through C corporations. Owners of S corporations and partnerships now earn about half of all income from businesses. The shift occurred because of tax and legal changes that benefited pass-through business owners and made the pass-through form more attractive to file. For instance, in 1986, the top individual income tax rate fell below the corporate tax rate. This created significant incentives for a business to un-incorporate and for new businesses to organize as pass-throughs.

The S&P 500 companies tend to account for about 50% of total after-tax corporate profits (*Fig. 12* and *Fig. 13*). The difference between total profits in the NIPA and S&P 500 aggregate earnings is attributable mostly to the profits of S corporations, accounting for roughly the other half of corporate profits (*Fig. 14*).

Strategy II: The Fed's Triennial Survey. The Fed recently released its Survey of Consumer Finances tracking changes in US family finances from 2016 to 2019. It's been conducting these surveys every three years since 1983. They include information about family income, net worth, balance sheet components, credit use, and other financial outcomes. Here are some of the key findings related to stock ownership of families:

(1) *Directly and indirectly held stocks.* "Families may hold stocks in publicly traded companies directly or indirectly, and information about each of these forms of stock holding is collected separately in the Survey of Consumer Finances. Indirect holdings are those in pooled investment funds, retirement accounts, and other managed assets. Indirect holdings, particularly through tax-deferred retirement accounts, are much more common than direct holdings.

"When direct and indirect forms of stock holdings are combined, the 2019 data show a slight uptick in stock ownership since 2016. In 2019, about 53 percent of families owned stocks, compared with nearly 52 percent in 2016. …. In 2019, about 31 percent of families in the bottom half of the income distribution held stocks, whereas about 70 percent of families in the upper-middle-income group held stock, and more than 90 percent of families in the top decile held stock."

(2) *Median values of stock holdings.* "In addition to these differences across income groups in stock market participation rates, there are significant differences in the value of stock market holdings, conditional on holding stock. In 2019, the conditional median value of stock holdings for the bottom half of the income distribution was about $10,000, compared with $40,000 for the upper-middle-income group and nearly $439,000 for the top income decile. Conditional mean values are substantially larger than the conditional median values and exhibit wider differences across groups."

(3) *Retirement assets.* "Among families that have these assets, the average combined IRA and DC pension account balance increased to $269,600 in 2019, and the gains occurred throughout the usual income distribution. For families in the bottom half of the distribution, although participation in IRA or DC plans fell in 2019, the average balance for participating families increased slightly from 2016, reaching $57,400. The average balance for participating

families in the upper-middle part of the distribution increased about $3,700 between 2016 and 2019, to $170,600. The average balance for participating families in the top 10 percent of the distribution increased the most, reaching $692,800."

(4) *Ownership of business equity*. 'Ownership of business equity was about 13 percent in 2019. The conditional median value was more than $89,000, and the conditional mean value was more than $1.2 million. The wide difference between the median and mean values reflects the small fraction of privately held businesses with very high valuations. Ownership of equity in nonresidential property was 6.7 percent in 2019, and conditional median and mean values of equity in nonresidential property were about $70,000 and $375,000, respectively."

(5) *Bottom line.* Wealth inequality, like income inequality, is a controversial subject. Contributing to the controversy is that both sides in the debate tend to make assertions without providing much, if any, data to support their vociferously held views. Melissa and I are working on compiling and analyzing the available data. Consider today's commentary as part of an ongoing study.

CALENDARS

US: Tues: Consumer Confidence Index 102,5, Durable Goods Orders Total & Ex Transportation 0.5%/0.4%, Richmond Fed Manufacturing Index, S&P Case-Shiller Home Price Index 4.2% y/y, API Crude Oil Inventories. **Wed:** Advanced Goods Trade Balance, MBA Mortgage Applications, EIA Crude Oil Inventories. (DailyFX estimates)

Global: Tues: Australia CPI 0.7% y/y Balz. **Wed:** BOC Rate Decision 0.25%, BOJ Rate Decision -0.10%, China Communist Party Annual Meeting. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose for all three of these indexes last week. In a typically V-shaped recovery, LargeCap's forward earnings has risen for 23 straight weeks, MidCap's is up in 20 of the past 21 weeks, and SmallCap's posted its 20th gain of the past 23 weeks. LargeCap's forward earnings is now up 13.9% from its lowest level since August 2017; MidCap's has risen 28.1% from its lowest level since May 2015; and SmallCap's is up 43.4% from its lowest point since August 2013. These indexes had been on a forward-earnings uptrend from November 2019 until mid-February, before tumbling due to the Covid-19 economic shutdown. LargeCap's forward earnings is now 10.3% below its record high at the end of January. MidCap's and SmallCap's are 14.9% and 21.5% 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 -9.5% y/y from -10.4%. 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 -11.6% y/y from -12.3% 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 improved to -14.5% y/y from -15.7% 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 (-18.9%, 26.1%), MidCap (-30.0, 48.2), and SmallCap (-50.4, 106.4).

S&P 500/400/600 Valuation (*link*): Valuations were mostly steady last week, and remain below their recent cyclical and record highs. LargeCap's forward P/E dropped to 21.6 from 21.9. That compares to a 19-year high of 22.7 at the end of August and is up from 13.3 in mid-March, which was the lowest since March 2013. MidCap's was unchanged at 19.0, which is down 3.9pts from its record high of 22.9 in early June. SmallCap's was steady at 19.4, which is down 7.3pts 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 tenth 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*): Since the Q2 earnings season—which came in substantially better than greatly reduced forecasts—analysts have been raising all of their future quarterly forecasts instead of lowering them as is the norm. In the latest week, the S&P 500's Q3 blended EPS estimate/actual rose 74 cents w/w to $34.76. That $34.76 estimate represents a decline of 17.5% y/y on a frozen actual basis and -16.7% 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. All 11 sectors had been expected to record negative y/y earnings growth for Q2 when that earnings season began, but three recorded positive y/y earnings growth: Health Care, Tech, and Utilities. That was a big improvement from Q1 when all 11 sectors posted a y/y decline in earnings. For Q3, a y/y earnings decline is expected for eight of the 11 sectors, but seven 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: Health Care (2.3% in Q3-2020 versus 6.8% in Q2-2020), Consumer Staples (0.9, -4.2), Information Technology (0.3, 5.6), Utilities (-3.3, 6.4), Financials (-3.7, -46.7), Materials (-9.0, -28.6), Real Estate (-13.7, -15.2), Communication Services (-19.9, -16.8), Consumer Discretionary (-30.3, -64.6), Industrials (-63.3, -85.3), and Energy (-122.2, -168.1).

S&P 500 Q3 Earnings Season Monitor (*link*): With nearly 28% of S&P 500 companies finished reporting revenues and earnings for Q3-2020, revenues are beating the consensus forecast by a whopping 3.0%, and earnings have crushed estimates by 17.5%. The large surprises are primarily due to a lack of financial guidance from the companies that analysts follow. At the same point during the Q2 season, revenues were 2.6% above forecast and earnings beat by 12.6%. For the 138 companies that have reported through mid-day Monday, aggregate y/y revenue and earnings growth and the percentage of companies reporting a positive revenue and earnings surprise have improved from their Q2 measures. The small sample of Q3 reporters so far has a y/y revenue decline of 4.4%, and earnings are down 13.5%; those results mark a huge recovery from Q2, the worst quarter since Q1-2009 during the financial crisis. Over 83% of companies are reporting a positive earnings surprise, and 81% have beaten their revenues forecast. Slightly more companies are reporting positive y/y earnings growth in Q3 (53%) than are reporting positive y/y revenue growth (49%). Taking a look at the shares outstanding tallied so far, companies have put the brakes on share buybacks. Basic shares outstanding are up 0.2% q/q and down just 1.2% y/y. At the same point during the Q2 season, the share count was down 0.4% q/q and 2.5% y/y. The Q3-2020 figures are subject to change markedly as more results are reported in the coming weeks, but we expect y/y revenue and earnings growth results to remain negative. Now more than ever, what companies say about the state of their business and their plans to ride out the Covid-19 crisis will be investors' main focus. With more companies providing guidance about their future financial periods, the revenue and earnings surprises should become smaller in future reporting periods.

US ECONOMIC INDICATORS

New Home Sales (*link*): New single-family home sales (counted at the signing of a contract) unexpectedly fell in September, though the market remains strong, and builder confidence is through the roof. Sales slumped 3.5% last month to 959,000 units (saar), but that followed a four-month surge of 74.4%; sales are 32.1% above a year ago. Regionally, three of the four regions are considerably above September 2019 sales, with only the Northeast on the short end: West (49.7% y/y), Midwest (34.8), South (27.4), and Northeast (-5.9). The number of new home sales on the market was at 284,000 units last month, little changed from August's 35-month low of 282,000 units, with the months' supply (3.6), holding near August's 3.4months—which was the shortest period going back to 1963. NAHB's Housing Market Index (HMI) climbed 55 points during the six months through October to a new record high of 85, after plunging a record 42 points in April alone to 30—the lowest builder confidence since mid-2012 and the first reading in negative territory (below 50) since mid-2014. All three measures of the HMI are their highest levels in the 35-year history of the survey—moving sharply off their April lows: current sales (to 90 from 36 in April), future sales (88 from 36), and traffic of prospective buyers (74 from 13).

Regional M-PMIs (*link*): Four Fed districts have now reported on manufacturing activity for October (New York, Philadelphia, Kansas City, and Dallas) and show the manufacturing sector expanded at its fastest pace since October 2018, led by a sharp acceleration in the Philadelphia region. The composite index climbed to 18.9 this month—improving every month since April's record low of -59.7. Activity in the Philadelphia (to 32.3 from 15.0) region accelerated at its fastest pace in eight months, with Dallas' (to19.8 from 13.6) the fastest since October 2018. Meanwhile, growth in the Kansas City (13.0 from 11.0) region was slightly faster than September's, while New York's (10.5 from 17.0) slowed—though remained at a respectable rate. New orders (to 25.2 from 17.5) accelerated at the fastest pace since May 2018, with last month's rate nearly double August's pace. Once again, Philadelphia (to 42.6 from 25.2) led the gain, with billings posting the fastest growth since the 1970s, while Kansas City's (26.0 from 23.0) was back up at August's pace which was the best since May 2018. Growth in billings in the Dallas (19.9 from 14.7) and New York (12.3 from 7.1) regions was also faster, though not as robust as Philadelphia and Kansas City. In the meantime, factories added to payrolls at roughly the same pace as last month, ticking down to 9.4 from 9.9 in September. Philadelphia (to 12.7 from 15.7) and Dallas (8.7 from 14.5) manufacturers hired at a slower pace than last month, while Kansas City's (9.0 from 7.0) and New York's (7.2 from 2.6) hired at a slightly faster pace—though were south of Philadelphia's pace.

GLOBAL ECONOMIC INDICATORS

Germany Ifo Business Climate Index (*link*): "In the view of rising infection numbers, German business is becoming increasingly worried," said Clemens Fuest, president of the Ifo Institute, as business confidence fell for the first time in six months. Germany's Ifo Business Climate Index fell to 92.7 this month, after climbing 18.0 points (to 93.2 from 75.2) from April through September. Dragging the overall index lower this month was a drop in the expectations component to 95.0, following a five-month spurt of 26.1 points (to 97.4 from 71.3). Meanwhile, the present situation component increased for the sixth successive month from 79.4 in April to 90.3 this month. (The total, expectations, and present situation components were at 95.5, 92.8, and 98.8 before the pandemic hit.) By sector, sentiment among manufacturing companies continued to improve, rising steadily from -42.5 in April to +1.6 in October—its first positive reading since June 2019. Flash estimates for October's M-PMI (to 58.0 from 56.4) show manufacturing activity is expanding at its best pace in 30 months. In the meantime, sentiment in the service sector deteriorated for the second month, to 3.9, after climbing from -32.6 in April to +7.6 by August; the flash estimate for the NM-PMI shows Germany's service sector is contracting for the first time in four months, dropping from 55.6 in July to 48.9 this month. Sentiment among construction companies also took a step back in October, slipping to 0.80, after climbing steadily from -17.1 in April to +3.3 by September.

Contact us by email or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-775-6823