Yardeni Research

MORNING BRIEFING
November 5, 2020

Back to the Future

Check out the accompanying chart collection.

(1) Refreshed by selloff, tech shares bounce. (2) Semiconductor sales shine in September. (3) China steps on Ant's IPO dreams. (4) CCP calls for tech independence and a bulked-up military. (5) Pompeo taunts China while traveling through Asia. (6) New competition in green transportation: hydrogen-powered cars and trucks.

Technology: Leading a Post-Election Meltup. Investors' appetite for tech shares revived in the wake of the election, after a month-long selloff took some of the froth out of the sector's valuation. The election brought good news from voters in California who exempted the rideshare and food-delivery companies—including Uber Technologies, Lyft, and DoorDash—from having to reclassify their drivers as employees. And more good news arrived in the form of September data that showed semiconductor sales remained strong.

Let's take a look at the market's largest sector as it enters the year's home stretch.

(1) *The selloff that refreshes?* The S&P 500 Technology sector enjoyed an amazing run from March 23 through September 2, gaining 38.6% and leading all other S&P 500 sectors. Since the market's peak on September 2 through the market's low last week on October 30, the sector fell 12.7%. From last week's low, it's up 2.2% through Tuesday's close (*Fig. 1*).

Here's the S&P 500 sectors' performance derby from the September 2 peak through Tuesday's close: Utilities (7.7%), Industrials (0.7), Materials (0.2), Financials (-2.4), Consumer Staples (-3.5), Real Estate (-3.9), Health Care (-4.0), S&P 500 (-5.9), Consumer Discretionary (-6.5), Communication Services (-7.6), Information Technology (-10.9), and Energy (-15.2) (*Table 1*).

The S&P 500 Tech sector has had a banner 2020 so far. Here's the performance derby for the S&P 500 ytd through Tuesday's close: Information Technology (23.5%), Consumer Discretionary (21.6), Communication Services (9.8), Materials (8.0), S&P 500 (4.3), Health

Care (3.0), Consumer Staples (2.1), Utilities (0.1), Industrials (-1.4), Real Estate (-8.3), Financials (-19.3), and Energy (-51.1) (*Fig. 2*). It continued its recent winning ways yesterday, rising 3.8%, trailing only the gains of Health Care (4.5%), and Communication Services (4.3).

(2) *Semis sending good signals.* The strength in semiconductor sales continued through September, according to the Semiconductor Industry Association. The three-month moving average of global semiconductor sales rose 4.5% m/m and 5.8% y/y in September (*Fig. 3*).

Sales were strong across most geographies m/m, rising by 7.9% in China, 3.3% in both Europe and Asia Pacific/Other, 2.2% in the Americas, and 1.5% in Japan. Year-over-year comparisons were only a touch softer: Americas (20.1%), China (6.5), Asia Pacific/Other (2.9), Japan (-1.8), and Europe (-9.8).

The strength in the US semiconductor market was confirmed by data on US industrial production of semiconductors & other electronic components. It rose by 19.3% in September, based on a three-month average (*Fig. 4*).

The S&P 500 Semiconductors stock price index didn't escape this fall's market selloff. It declined by 6.5% from the market's September 2 peak through Tuesday's close (*Fig. 5*).

That leaves the industry's ytd gain at a still-impressive 23.2%. Analysts remain optimistic about the industry's growth next year, with forecasts for 2021 revenue growth of 7.3% and earnings growth of 11.5% (*Fig. 6* and *Fig. 7*). The only thing to keep an eye on is the industry's forward P/E, which even after the recent selloff remains elevated relative to the past decade at 19.4 (*Fig. 8*).

Geopolitics: China Takes Off the Gloves. China's leadership showed over the past week just how controlling and aggressive it can be. On Monday, the leadership called Jack Ma—perhaps the county's greatest entrepreneur—onto the carpet and squashed his company's IPO plans, presumably in retaliation for Ma's criticism of China's banking regulators. That followed the unveiling of the Chinese Communist Party's (CCP) latest five-year plan, which made clear that the country intends to focus on its technological independence and military strength.

These actions follow other aggressive moves, including recent arrests of Hong Kong opposition leaders and the imposition of sanctions on US defense companies because they supply Taiwan with weapons. US officials did little to bring down the temperature between the

two countries. US Secretary of State Mike Pompeo toured Asia, encouraging countries to stand up to China. The cold war got just a bit chillier. Let's take a deeper look.

(1) *Ma gets schooled.* China's leadership telegraphed this week that no one, not even China's richest man, is allowed to talk ill about Chinese institutions. "Today's financial system is the legacy of the Industrial Age," Ma said according to a November 3 CNBC article. "We must set up a new one for the next generation and young people. We must reform the current system." He also referred to the big state-owned banks' "pawnshop mentality."

Ma, Ant Group's controlling shareholder, its executive chairman Eric Jing, and CEO Simon Hu were summoned before Chinese regulators on Monday. The same day, the Chinese banking regulator issued new draft rules on microlending, which if implemented could slow Ant's growth and reduce its profitability. Shortly thereafter, the Shanghai and Hong Kong stock exchanges pulled the IPO.

Ant Group issued a *mea culpa*: "We will overcome the challenges and live up to the trust on the principles of: stable innovation; embrace of regulation; service to the real economy; and win-win cooperation."

It was amazing—shocking even—that regulators were willing to squash such a high-profile deal. The Ant IPO was considered evidence of China's growing financial maturity and heft. It allowed China and Ant to snub the US stock exchanges. The IPO's squashing not only gives China one less thing to crow about but also serves as a reminder that, while China might have a stock exchange, it certainly does not believe in capitalism or freedom of expression.

(2) *Following the Chinese roadmap.* The CCP announced its economic and political goals for the next five years. Atop the list: achieving "technological self-reliance." Perhaps this shouldn't come as a surprise given the Trump administration's recent sanctions against Huawei Technologies and efforts to ban Bytedance's TikTok and Tencent Holding's WeChat. And most likely, technological self-reliance has been the party's longstanding intention. It's just jarring to read of the news in black and white.

Hong Kong is intertwined in this plan, as the party intends to build the city into an "innovation and technology center." And in general, the CCP intends to build its own domestic market, creating domestic demand for the products it produces.

The CCP five-year plan also noted that China will "comprehensively strengthen military training and preparation for war," a November 1 Reuters article reported. The goal is to "turn the People's Liberation Army into a modern military force by 2027, by which time, analysts say, China aims to build an army on par with that of the US," an October 29 article the *South China Morning Post* reported. An analyst told the paper that the country's aim was to build an army that could "deter interference by the US army around the Taiwan Strait." Again, China's aggressive stance isn't a surprise given recent US defense companies' sales of weapons of Taiwan.

Notably, the five-year plan lacked a GDP growth target, though one could be added later. Over the past five years, the target was 6.5% annual growth. The plan did target boosting per-capita GDP to about $30,000 a year by 2035, up from $10,262 last year. The goal was accelerated from the previous time target of 2050.

(3) *Pompeo pokes the tiger.* Meanwhile, during a tour of Asia, Secretary of State Pompeo encouraged Indonesia's Muslims to criticize China's treatment of the Muslim Uighurs in Xinjiang.

"The atheist Chinese Communist Party has tried to convince the world that its brutalization of Uighur Muslims in Xinjiang is necessary as a part of its counterterrorism efforts or poverty alleviation," he said, according to an October 29 *WSJ* article. "We know that there is no counterterrorism justification for forcing Uighur Muslims to eat pork during Ramadan or destroying a Muslim cemetery."

When meeting with reporters in Sri Lanka, Pompeo called the Chinese Communist Party a "predator" and warned the country against tightening its ties with China. And while in India, Pompeo and Defense Secretary Mark Esper signed a defense pact on satellite-data cooperation, the October 30 *WSJ* article reported. None of that could have made Chinese officials happy.

Disruptive Technologies: Are Hydrogen Cars in the Future? This week, Toyota introduced the 2021 Mirai, a hydrogen-powered sedan for the US market. The latest version of the car (yes, there was an older version) will be available only in California and Hawaii, where there are hydrogen refueling stations. Hyundai and Honda also have US offerings, but the market remains small, with only about 7,900 hydrogen-powered vehicles sold or leased in the US at the start of this year, according to a February 23 CNBC article.

There are serious pros and cons involved with hydrogen vehicles, including their cost (a con) and refueling convenience (a pro). Here's a look:

(1) *Pricier… for now.* Hydrogen-powered cars and the fuel they run on are more expensive than gas- and electric-powered vehicles and their fuels. The new Mirai is expected to cost more than its predecessor, which starts at $59,545, according to a November 2 *Car and Driver* article. Scientists are working to bring down the cost of hydrogen tanks and fuel cells. The price is also expected to drop as sales volumes increase, just as happened for Tesla's electric vehicles.

The cost of hydrogen is also more expensive than that of alternative fuels. The CNBC article estimates that the cost of hydrogen fuel in California is the equivalent of about $5-$6 per gallon of gasoline. So the car companies offer customers hydrogen-fuel rebates. Toyota offers $15,000 or three years of free hydrogen to purchasers of its current car, and it's expected to make that offer again with the new model.

Another problem is the lack of hydrogen refueling infrastructure. There are only about 45 hydrogen fuel pumps in the US, and they're primarily in California. Electric charging stations have multiplied rapidly in the US, and every house has electricity that electric cars can use for charging.

One advantage that hydrogen-powered cars have over electric cars is their ability to be refilled in minutes at a pump, just like gasoline-powered cars. It still takes too long for electric cars to be refilled at stations to make them convenient for long road trips.

(2) *Greener than gasoline.* Like electric cars, hydrogen-powered cars are considered better for the environment IF the hydrogen is made using renewable sources of energy, like solar or wind power. When hydrogen is burned, it produces only water. When gasoline is burned in a car's engine, carbon dioxide is produced.

(3) *Elon's not a fan, but the Pope is.* Tesla's Elon Musk has been vocal in his belief that hydrogen-fueled vehicles cannot be successful. Not one to hold back, Musk has said that hydrogen fuel cells are "mind-bogglingly stupid," "fool cells," and a "load of rubbish." Part of his argument hinges on the fact that electricity can be produced, transmitted, and used in cars more efficiently than hydrogen.

Nonetheless, Pope Francis has given hydrogen his blessing. The Pope will use Toyota's Mirai as his official "popemobile," according to an October 20 article in The News Wheel. The article states that Francis rode a Mirai during a visit to Japan and ordered one on the spot.

Many Japanese citizens live in apartment buildings that lack plugs to charge electric vehicles. So Japan sees hydrogen-powered cars as an interesting alternative to electric- and gasoline-powered vehicles. The country and three private companies unveiled earlier this year one of the world's largest hydrogen plants. The plant, which runs on solar power, produces enough hydrogen to fill 560 fuel cell vehicles a day, a March 8 article in Nikkei Asia reported. However, Japan is likely to import most of its hydrogen from countries like Australia, where it can be produced less expensively.

(4) *Trucks coming too.* While batteries are considered a good option for smaller trucks that recharge at the same place every night, hydrogen is being developed for large, long-haul trucks that are at a different stop every night.

Newcomers Nikola and Hyliion Holdings have made headlines recently as they develop hydrogen-fueled trucks. But traditional players are also getting involved. General Motors is supplying Nikola with the hydrogen fuel cells for its trucks. Daimler and Volvo Group are jointly developing fuel cells for trucks. And Toyota and Hyundai have hydrogen-powered trucks under development.

The impediment to making hydrogen-fueled trucks commonplace is the added cost and the need for refueling infrastructure. We'll be watching the progress.

CALENDARS

US: Thurs: Initial & Continuous Jobless Claims 732k/7.20m, Nonfarm Productivity & Unit Labor Costs 5.6%/-11.5%, EIA Natural Gas Inventories, FOMC Rate Decision 0.25%.
Fri: Payroll Employment Total, Private, and Manufacturing 600k/700k/50k, Unemployment & Participation Rates 7.7%65.0%, Average Hourly Earnings 0.2%m/m/4.6%y/y, Average Workweek 34.7 hours, Consumer Credit $9.0b, Wholesale Inventories -0.1%, Baker-Hughes Rig Count. (DailyFX estimates)

Global: Thurs: Eurozone Retail Sales -1.0%m/m/2.8%y/y, Germany Factory Orders 2.0%,

Japan Household Sprnding -10.7%, BOE Interest Rate Decision & Quantitative Easing 0.10%/£845b, BOE Inflation Report, RBA Statement on Monetary Policy, Weidmann, Schnabel, Guindos. Bailey. **Fri:** Germany Industrial Production 2.7%, Canada Employment Change & Unemployment Rate 100k/8.8%. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) this week declined for the first time in four weeks, falling back below 3.00, on a sharp pullback in bullish sentiment. The BBR sank to 2.60 this week after climbing from 2.35 to 3.00 the prior three weeks. Bullish sentiment fell 7.00ppts this week to 53.6%—after increasing 9.1ppts (to 60.6% from 51.5%) the prior five weeks—as bulls stampeded to the correction camp. The correction count jumped 6.6ppts this week alone, to 25.8%, after falling the prior two weeks from 22.2% to 19.2%—the lowest since September 2018. Bearish sentiment rose to 20.6% after falling 3.0ppts the prior three weeks from 23.2% to 20.2%. The AAII Ratio slipped to 50.0% last week, after climbing the prior four weeks from 35.1% to 52.0%, as bullish sentiment fell from 35.8% to 35.3% and bearish sentiment rose from 33.0% 35.3%.

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 continue to play catch-up from their lowball estimates prior to the better-than-expected Q2 earnings season. Consensus S&P 500 forecasts previously had been falling at rates paralleling the declines during the 2008-09 financial crisis. Forward revenues is at its highest level since early April and is now just 3.4% below its record high in mid-February. Forward earnings is also at its highest level since early April and is now 10.3% below its record high in early March. Forward revenues growth remained steady at a 21-month high of 6.2%. That's just 0.1ppt 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 of 16.4% was down 0.3ppts w/w, which is 1.3ppts below its 10-year high of 17.7% in early October. Forward earnings growth is up 22.0ppts from its record low of -5.6% at the end of April. Analysts expect revenues to decline 3.7% y/y in 2020 and rise 8.0% in 2021 compared to the 4.3% reported in 2019. Analysts expect an earnings decline of 17.4% y/y in 2020 and a 23.9% gain in 2021 compared to a 1.5% rise in 2019. The forward profit margin was unchanged at a six-month high of 11.1%. That's up 0.8ppt from 10.3% during April and May, which was the lowest level since August 2013. It's still down 1.3ppt from a record high of 12.4% in September 2018. Analysts expect the profit margin to fall 1.6ppt y/y in 2020 to 9.9%—from 11.5% in 2019—and to improve 1.4ppt y/y to 11.3% in 2021. Valuations

dropped for a second straight week from six-week highs in mid-October. The S&P 500's weekly forward P/E fell 1.1pts w/w to a 24-week low of 20.6. 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 lost 0.12pt w/w to a five-week low of 2.29. 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 rise w/w for ten of the 11 S&P 500 sectors and forward earnings rise for nine sectors. Energy's forward earnings fell w/w, and Real Estate had both measures decline. 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. Utilities is now the only sector expected to have an improved profit margin 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 three sectors (Financials, Materials, and Tech) and fell for Energy and Real Estate. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (22.2%, down from 23.0%), Financials (15.0, down from 19.2), Utilities (14.3, record high), Communication Services (13.8, down from 15.4), Real Estate (13.0, down from 17.0), S&P 500 (11.1, down from 12.4), Health Care (10.6, down from 11.2), Materials (10.3, down from 11.6), Industrials (8.2, down from its record high of 10.5% in mid-December), Consumer Staples (7.4, down from 7.7), Consumer Discretionary (6.2, 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 5.0%, forward earnings has gained 13.9%, and the forward profit margin has risen 0.8pt to 11.1%. Eight of the 11 sectors posted new highs last week in either their forward revenues, earnings, or profit margin. The laggards: Energy, Industrials, and Real Estate. Energy's forward revenues remains near a 15-year low. Energy and Industrials' forward earnings and profit margins are falling now from their post-Covid-19 highs in early October. Real Estate's forward earnings have worsened to a six-year low, and its profit margin is at an eight-year low. Here's how the 11 sectors rank by their changes in

forward revenues and forward earnings since May 28: Consumer Discretionary (forward revenues up 7.2%, forward earnings up 43.0%), Information Technology (6.7, 8.7), Financials (6.0, 17.7), Materials (6.1, 23.6), Industrials (6.0, 18.4), Communication Services (5.8, 9.1), S&P 500 (5.0, 13.9), Health Care (4.1, 10.5), Consumer Staples (2.5, 6.1), Energy (2.1, 295.4), Real Estate (-0.2, -9.1), and Utilities (-1.7, 1.0).

S&P 500 Q3 Earnings Season Monitor (*link*): With over two-thirds of S&P 500 companies finished reporting revenues and earnings for Q3-2020, revenues are beating the consensus forecast by a whopping 2.7%, and earnings have crushed estimates by 19.8%. 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 3.0% above forecast and earnings beat by 23.6%. For the 359 companies that have reported through mid-day Wednesday, 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 Q3 reporters so far collectively have a y/y revenue decline of 3.0%, and their earnings are down 8.3%; those results mark a huge recovery from Q2, the worst quarter since Q1-2009 during the financial crisis. More than 86% of companies are reporting a positive earnings surprise, and nearly 82% have beaten their revenues forecast. Slightly fewer companies are reporting positive y/y earnings growth in Q3 (52%) than are reporting positive y/y revenue growth (54%), but those readings are up sharply from their respective Q2 readings of 37% and 33%. Taking a look at the Q3 shares outstanding tallied so far, companies outside of Tech have put the brakes on share buybacks and are letting their share counts edge higher. Basic shares outstanding are up 0.1% q/q and down just 0.4% y/y. At the same point during the Q2 season, the share count was down 0.1% q/q and 0.5% y/y. The Q3-2020 figures will continue to change 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

ADP Employment (*link*): "The labor market continues to add jobs, yet at a slower pace," said Ahu Yildirmaz, vice president and co-head of the ADP Research Institute. "Although the pace is slower, we've seen employment gains across all industries and sizes." October employment climbed 365,000 following gains of 753,000 and 482,000 during September and August,

respectively. While employment is up 9.7 million from its April low through October, it's still a sizeable 10.0 million below February's record high. Service-providing industries are up 8.1 million since April, but are 9.2 million below February levels, while goods-producing are up 1.5 million and down 860,000 over the comparable periods. Here's a tally of industry performances from strongest to weakest during the six months through October, and where they stand relative to February's levels: leisure & hospitality (+3.64 million & -4.05 million), trade transportation & utilities (+1.57 million & -1.54 million), health care & social assistance (+1.18 million & -910,000), construction (801,000 & -197,000), other services (+757,000 & -523,000), manufacturing (+746,000 & -585,000), administrative & support services (+606,000 & -960,000), professional & technical services (+173,000 & -366,000), education (+143,000 & -318,000), financial activities (+ 107,000 & -154,000), management of companies & enterprises (-18,000 & -101,000), natural resources & mining (-24,000 & -78,000), information services (-29,000 & -290,000). Here's the same exercise by company size: Large (+3.94 million & -5.38 million), small (+3.44 million & -1.96 million), and medium (+2.26 million & -2.73 million) businesses.

GLOBAL ECONOMIC INDICATORS

Global Composite PMIs (*link*): "Global economic growth fastest in over two years in October," is the headline of the IHS Markit report. The JP Morgan Global Composite Output Index (C-PMI) climbed for the sixth month since hitting bottom in April, advancing from 26.2 to 53.3 over the period—to its highest reading since August 2018. The Global M-PMI has rebounded steadily from April's record low of 39.6 to a 32-month high of 53.0, while the NM-PMI is up from 23.7 to a 19-month high of 52.9 over the same period. C-PMIs for both the emerging (to 54.5 from 34.6 in April) and advanced (52.7 from 22.2) economies moved further into expansionary territory. The report notes that five out of the six sub-sectors covered by the survey showed output expanded at the start of the final quarter of this year. Leading the way were solid performances in the business services, financial services, intermediate goods and investment goods categories; consumer-facing industries were a drag on growth. From a country perspective, C-PMIs show rates of expansion accelerated in India (58.0 from 54.6), the US (to 56.3 from 54.3), China (55.7 from 54.5), and Australia (53.5 from 51.1) last month, while growth slowed in the UK (52.1 from 56.5). Meanwhile, growth in the Eurozone (to 50.0 from 50.4) was stagnant, though Germany was the one bright spot, with its C-PMI (to 55.0 from 54.7) moving further above the breakeven point of 50.0. Meanwhile, C-PMIs show Italy (to 49.2 from 50.4) contracting again, while France (47.5 from 48.5) and Spain (44.1 from 44.3) moved

further into contractionary territory. Japan (to 46.7 from 46.6) contracted for the ninth consecutive month.

US Non-Manufacturing PMIs (*link*): The US service sector accelerated at its best pace since April 2015, according to the IHS Markit measure, and remained stalled at a high level according to ISM—with both measures giving similar readings in October. ISM's NM-PMI slipped slightly to 56.6 in October after climbing from 56.9 to 57.8 in September; it has averaged 57.3 the past five months. The business activity (to 61.2 from 63.0) component showed growth slowed a bit—though the reading was above 60.0 for the fifth straight month—while the new orders (58.8 from 61.5) measure saw a slight dip below 60.0 after four months above. October's employment measure (to 50.1 from 51.8) showed businesses held payrolls steady last month. Meanwhile, the supplier deliveries (to 56.2 from 54.9) gauge moved higher after slowing in September. The IHS Markit NM-PMI climbed from 54.6 in September to 56.9 last month, on a steep upturn in new business at service providers, as looser coronavirus restrictions boosted sales for the second month. According to the report, "Encouragingly, future business optimism showed a record surge, pulling prospects for the year ahead up to the highest for more than two years. Hopes of a brighter outlook were pinned on a vaccine ending the COVID-19 pandemic over the coming year and additional stimulus supporting the economy in the meantime."

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