Yardeni Research

**MORNING BRIEFING**
**December 10, 2020**

# The Margin Imperative

*Check out the accompanying chart collection.*

(1) Sowing the seeds of future profits. (2) Tech margins forecast to keep getting better. (3) Industrials and Financials margins expected to rebound in 2021. (4) Real estate margins shrinking this year and next. (5) State and local government payrolls and budgets under pressure. (6) Watching municipal bonds sold by transit systems, airports, toll roads, universities, and nursing homes for signs of trouble. (7) Consider China the US's top national security risk. (8) Chinese scientists say their quantum computer has achieved quantum supremacy. (9) Introducing quantum cryptography.

**Strategy: Cut Costs Today, Boost Margins Tomorrow.** Cost-cutting was a unifying theme throughout many Q3 conference calls, as companies did what was necessary to survive until a Covid-19 vaccine can be widely distributed. While cuts of some expenses—like advertising or 401(k) contributions—are temporary, others will remain to boost margins after the pandemic.

Marriott CEO Arne Sorenson noted in the company's Q3 earnings conference call that costs relating to food and beverages have fallen with the drop in hotel guests and will likely increase again as hotel occupancy improves. But other changes made in response to the pandemic, including staffing model changes and keyless entry, should reduce costs permanently. "We've probably reduced breakeven occupancy by three to five points, something like that depending on the brand," he said. "Net-net, we'd expect that what we've done should deliver some long-lasting margin improvement. It's a little too soon to be able to tell you what that number will be."

Emerson Electric CEO David Farr called the company's cost reductions "self help" in the company's FQ4 earnings conference call on November 3. "We're on track to deliver the peak margin plan we laid out in February of 2020 despite sales being approximately $2 billion lower than we said back then before the pandemic, before, obviously, the recession we've had to go through. But the hard work on cost actions, the hard work in restructuring, the hard work in new product investments and the things we had to do to make this company stronger for our shareholders and for our customers, we have done. We have confidence in 2021."

Analysts have begun to factor in a rebound in margins. Joe calculates analysts' consensus forecasts for S&P 500's profit margins by dividing their consensus earnings forecasts by their consensus revenues estimates. At the start of this year, analysts forecast the S&P 500's 2020 profit margin would be 11.9%. By July 9, that estimate had fallen to its nadir of 9.3%, only to rebound to 10.7% currently. The real optimism lies in forecasts for the S&P 500 operating margin for 2021, which stands at 11.4%, and for 2022, which is 12.5% (*Fig. 1*). If the 2022 S&P 500 margin estimate is correct—and that is a big "if" given how far in the future 2022 is—margins would be better than their peak of 11.8% in 2018.

Let's take a closer look at where margins stand in different sectors:

(1) *2020 margin massacre.* The pandemic impacted sectors very differently. The S&P 500 Information Technology and Utilities sectors are expected to see improvement in their operating profit margins this year compared to 2019, and the Consumer Staples sector isn't far behind, with unchanged margins forecasted for 2020. Margin strength in these sectors makes sense given that we were all stuck at home this year using more cleaning products and buying keyboards and monitors for home offices.

On the opposite side of that equation are the S&P 500 Real Estate, Energy, and Industrials sectors, which are expected to see the largest deterioration in their operating margins in 2020. Again, that's not surprising since they're also among the sectors with the sharpest expected drops in revenues and profits this year.

Here's the performance derby for the S&P 500 sectors' operating profit margins in 2019 and 2020, from largest y/y gain to largest y/y drop: Utilities (13.8%, 14.3%), Information Technology (20.8, 21.0), Consumer Staples (7.3, 7.3), Health Care (10.4, 10.4), Materials (9.3, 8.9), Communication Services (14.6, 13.7), S&P 500 (11.5, 10.1), Consumer Discretionary (7.1, 4.9), Financials (16.7, 13.1), Industrials (9.8, 5.4), Energy (5.2, -0.6), and Real Estate (20.6, 12.7) (*Table 1*).

(2) *Things look brighter in 2021.* Some of the margins hurt the worst by Covid-19's effect on the economy are poised to improve the most next year as the pandemic ends—we hope! The S&P 500 Energy, Industrials, and Financials sectors are forecast to see their margins improve the most in the upcoming calendar year (*Fig. 2*, *Fig. 3*, and *Fig. 4*). Meanwhile, the Real Estate

sector’s margins are forecasted to shrink for a second year, and there’s little improvement forecast for the Consumer Staples and Utilities sectors.

Here’s the derby for the S&P 500 sectors’ projected operating margins for 2021 and the percentage-point changes from 2020: Energy (2.8%, 3.4ppts), Industrials (8.7, 3.3), Financials (15.5, 2.4), Consumer Discretionary (6.7, 1.8), Materials (10.6, 1.7), S&P 500 (11.4, 1.3), Information Technology (22.2, 1.2), Health Care (10.8, 0.4), Communication Services (14.0, 0.3), Consumer Staples (7.5, 0.2), Utilities (14.4, 0.1), and Real Estate (12.7, -0.9).

It’s somewhat surprising that analysts continue to see the operating margin for the S&P 500 Information Technology sector continuing its upward trajectory in 2021, returning it to levels that are close to its peak of 23.1% in November 2018 (*Fig. 5*). It’s also impressive to see how well profit margins for the Materials sector have held up throughout 2020. That cyclical sector saw its margins drop roughly five percentage points during the Great Financial Crisis (GFC), but they dropped only 0.4ppt in 2020 (*Fig. 6*). And there may be opportunities in the Industrial sector, which saw the second largest drop in its operating margin in 2020 but is forecast to enjoy the second-largest rebound in 2021.

**Economy: The State of the States.** Political jockeying around a second Covid-19 relief bill is heating up as Congress attempts to get something passed before they recess for the holidays. Senate Majority Leader Mitch McConnell (R-KY) suggested moving forward with aid to individuals and dropping the items that are sticking points until next year. His proposed bill would not include Republicans’ request for businesses to get Covid-related liability protection, nor would it grant Democrats’ request to give financial aid to states and local governments.

While that may be the most expedient way to get relief to households that need it most, it’s bad news for the governors and local officials trying to plug swelling budget deficits. No doubt President-elect Joe Biden will try to provide fiscal relief to municipalities, but a prospective Republican-controlled Senate come January could hinder his efforts. Meanwhile, municipalities may need to take more aggressive action. As evidenced during the GFC, layoffs and cost-cutting by municipalities can slow the broader economy’s growth.

Here’s a look at some recent headlines and related economic data:

(1) *Municipal misery.* State and local municipal budgets are suffering from the double whammy of lower revenue and higher spending due to Covid-19. A December 4 report from the Center

on Budget and Policy Priorities estimates that states could incur aggregate revenue shortfalls of $185 billion in fiscal 2020, $370 billion in fiscal 2021, and $210 billion in 2022. States are required by their constitutions to balance their budgets every year. So they understandably are hoping for relief from the federal government and will still need to raise taxes and cut spending. Without federal aid, those tax increases and spending cuts will be even more draconian.

In reaction to the fiscal stress, Moody's Investors Service has lowered its outlook to negative on all municipal bond sectors except for housing finance agencies and water, sewer and public power, a September 4 *WSJ* article reported. Municipal bonds are sold by more than just state governments. Concerns are rising about municipal bonds sold by mass transit systems, airports, toll roads, universities, and nursing homes. And while still low at 55 episodes so far this year, municipal bond defaults have climbed sharply from the 35 defaults last year and are the highest since 2011, when there were 88 defaults.

Ridership and revenue on mass transit systems are down sharply given so that many people have been working from home and avoiding closed-in spaces this year. A December 6 *NYT* article reported that New York City's transit authority forecasts a $6.1 billion deficit next year; Boston's is looking at a $600 million budget hole, and Chicago's shortfall is pegged at $500 million.

States may also have to cut Medicaid services and healthcare benefits because their costs have risen as enrollment for the fiscal year ending September 2021 is expected to jump 8.2%, a November 27 *WSJ* article reported. Medicaid represented about 30% of states' fiscal 2018 budgets.

(2) *Payroll cuts underway.* While payrolls in the private sector increased by 344,000 in November, government payrolls fell by 99,000 (*Fig. 7*). Since bottoming in April, private payrolls have rebounded 12.7 million. Government payrolls have suffered a double dip this year. They dropped 1.4 million from the start of the year through May. Then government payrolls increased 752,000 through August, only to continue falling by 585,000 through November. Year to date, private and government payrolls are down 8.1 million and 1.2 million, respectively.

For those on the government payrolls, cuts were larger at the state and local level. Federal government payrolls fell 86,000 in November and 264,000 during the three months through

November. That compares to state and local payrolls' decline of 13,000 and 321,000 over the comparable periods (*Fig. 8*). That has brought payrolls back down to levels last seen in June.

Prior to the GFC, state and local employment peaked at 19.8 million in August 2008, and it declined for the next 59 months before bottoming at 19.0 million. Only late last year did the number of state and local employees return to pre-GFC levels. If Covid-19-related cost-cutting ensues, expect states and local governments to be a continued drag on total employment and spending. Spending by state and local governments accounts for about 15% of US economic activity.

**Disruptive Technologies: Quantum Chaos.** The race to develop quantum computers heated up last week when Chinese scientists claimed to have built a computer that has achieved quantum supremacy, which means it can operate faster than the fastest traditional supercomputer. Their triumph comes almost a year after Google claimed to have achieved quantum supremacy.

China's news is disturbing on several levels. The Chinese government has been acting increasingly aggressively against the US and US allies in a number of areas. It certainly wouldn't help the US position if China gained the technological upper hand. Quantum computers are expected to have the ability to unlock the computer security now commonly used by the Internet and traditional computers. Fortunately, scientists are working on a solution: quantum cryptography.

Let's take a closer look at China and its latest move to dominate computing's next era:

(1) *A blunt warning.* Over the last two years, we've related various stories about how the Chinese government under the leadership of President Xi Jinping was growing increasingly authoritarian and aggressive in its efforts to dominate both its own citizens and to grow more powerful than the US. Evidence came from the Department of Justice, which began prosecuting people delivering US government and industrial secrets to the Chinese government. The Chinese government has also behaved aggressively militarily toward neighbors Taiwan and India. And under Xi's leadership, the government also punishes citizens, including those in Hong Kong, who advocate for democracy or criticize the government.

The latest warning about the Chinese government's mal intent comes from John Ratcliffe, director of National Intelligence, in a contribution to the *WSJ*'s editorial pages last week. Ratcliffe's article is shockingly blunt and eschews political correctness as it warns about the national security risk that the Chinese government poses to the US. Ratcliffe states: "The intelligence is clear: Beijing intends to dominate the U.S. and the rest of the planet economically, militarily and technologically. … I call its approach of economic espionage 'rob, replicate and replace.' China robs U.S. companies of their intellectual property, replicates the technology, and then replaces the U.S. firms in the global marketplace."

While Russia and terrorism once were the main areas of focus for intelligence agencies, "China should be America's primary national security focus going forward." After laying out numerous examples of Chinese misdeeds, Ratcliffe concludes: "This generation will be judged by its response to China's effort to reshape the world in its own image and replace America as the dominant superpower. The intelligence is clear. Our response must be as well." The article is a worthy read.

(2) *The battle for quantum supremacy.* Chinese scientists have built a photonic quantum computer that they say has achieved quantum supremacy. Their achievement follows Google's claim to quantum supremacy in October 2019.

China's and Google's quantum computers have different designs. The Chinese developed a photon-based quantum computer, called "Jiuzhang," which carries out boson sampling, a specific type of calculation, a December 4 article in Phys.org reports. Google's computer uses superconducting materials.

Here's how the article explains the Chinese computer: "Boson sampling is a means for calculating the output of a straight-line optical circuit that has multiple inputs and outputs. It is carried out by constructing a machine in which photons are sent into a circuit in parallel, and once inside, are split by beam splitters. The split photons continue through the circuit, encountering mirrors and other beam splitters. Notably, if two photons happen to encounter the same splitter simultaneously, both unsplit photons will follow one of the paths away from the splitter. The process is repeated, resulting in a distribution of numbers that represent the network output. Conventional computers become bogged down very quickly when trying to calculate distributions of such a system. Jiuzhang was built to handle 100 inputs and 100 outputs using 300 beam splitters and 75 mirrors." The researchers found that it took Jiuzhang approximately 200 seconds to provide an answer, far faster than the 2.5 billion years it would have taken the world's fastest supercomputer.

(3) *Not just a matter of ego.* The fact that China has developed a quantum computer is problematic because it could mean the country is getting closer to cracking the encryption that protects all of our data. That's bad news for public and private records as well as Internet communication. There's also the potential threat that an adversary could be collecting encrypted data today with the intent of using a quantum computer in the future to access the data.

Fortunately, US scientists and national security types are working on a solution. They're developing quantum-safe cryptography that they expect both government and private institutions will adopt. IBM recently announced that it's offering "quantum-safe cryptography support for key management and application transactions in IBM Cloud." The company aims to reduce the risk that hackers will retain encrypted data today and decrypt it later as quantum computing advances.

## CALENDARS

**US:** **Thurs:** Headline & Core CPI 1.1%/1.6% y/y, Initial & Continuous Jobless Claims 725k/5.3m, Monthly Budget Statement, EIA Natural Gas Storage. **Fri:** Consumer Sentiment Index Total, Current Conditions, and Expectations 76.5/87.0/71.0, Headline & Core PPI 0.8%/1.5% y/y, Baker-Hughes Rig Count, Quarles. (DailyFX estimates)

**Global:** **Thurs:** UK GDP 0.4%m/m//10.1%(3m average)/-8.3%y/y, Headline & Manufacturing Industrial Production -6.5%/-8.4% y/y, France Industrial Production 0.4%, ECB Interest Rate Decision & Deposit Facility Rates 0.0%/ -0.5%, European Council Meeting. **Fri:** Germany CPI -0.8%m/m/-0.3%y/y, Italy Industrial Production 1.0%m/m/-4.3%y/y, Bundesbank Semi-Annual Forecasts, Euro Summit, European Council Meeting. (DailyFX estimates)

## STRATEGY INDICATORS

**Stock Market Sentiment Indicators** (*link*): The Bull/Bear Ratio (BBR) took a small step back this week, its first decline in five weeks. The BBR ticked down to 3.83—on a small downtick in bullish sentiment and a small uptick in bearish sentiment—after climbing steadily from 2.60 to 3.87 (highest since January 2018) the prior four weeks. Bullish sentiment edged down to 64.4% (its third consecutive reading above 60.0%) after jumping 11.1ppts (to 64.7% from

53.6%) the prior four weeks; last week's percentage was the highest since January 2018. Bearish sentiment ticked up to 16.8% after falling 3.9ppts (to 16.7% to 20.6%) the previous four weeks; percentages the past two weeks are near the 2.5-year low of 16.2% posted during the first week of September—which was also shown twice during August. The correction count edged higher for the second week to 18.8%, after sliding 7.6ppts the prior three weeks from 25.8% to 18.2%—which was the lowest since December 2006. The AAII Ratio rose for the second week last week to 68.4% following a decline from 69.1% to 62.7% the prior week. Bullish sentiment climbed for the second week last week to 49.1% after falling from 55.8% to 44.4% during the November 18 week, while bearish sentiment fell to 22.7% last week after increasing from 26.4% to 27.5% the prior week.

**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 and Q3 earnings seasons. 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 mid-March and is now just 1.8% below its record high in mid-February. Forward earnings is at its highest level since late March and is now 6.2% below its record high in early March. Forward revenues growth of 7.8% rose 0.9ppts w/w to its highest level since May 2011 and is up from 0.2% in April, which was the lowest reading since June 2009. Forward earnings growth of 21.6% was up 3.1ppts w/w to its highest level since July 2010 and has risen 27.2ppts from its record low of -5.6% at the end of April. Analysts expect revenues to decline 3.1% y/y in 2020 and rise 7.8% in 2021 compared to the 4.3% reported in 2019. Analysts expect an earnings decline of 15.2% y/y in 2020 and a 21.9% gain in 2021 compared to a 1.5% rise in 2019. The forward profit margin rose 0.1ppt to 11.4%; that's the highest reading since early April. That's up 1.1ppt from 10.3% during April and May, which was the lowest level since August 2013. It's still down 1.0ppt from a record high of 12.4% in September 2018. Analysts expect the profit margin to fall 1.4ppt y/y in 2020 to 10.1%—from 11.5% in 2019—and to improve 1.3ppt y/y to 11.4% 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 edged down 0.1pt w/w to 22.1 from a 12-week high of 22.2 and is up from a six-month low of 20.6 at the end of October. 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 gained 0.01pt w/w to 2.52. That's below its 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 ten of the 11 S&P 500 sectors. Dropping this week were Consumer Staples' forward revenues and Real Estate's forward earnings. 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 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. The forward profit margin rose for 8/11 sectors in the latest week. Real Estate's forward profit margin dropped to its lowest level since February 2012. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (22.4%, down from 23.0%), Financials (15.5, down from 19.2), Utilities (14.3, record high), Communication Services (14.0, down from 15.4), Real Estate (12.7, down from 17.0), S&P 500 (11.4, down from 12.4), Health Care (10.8, down from 11.2), Materials (10.6, down from 11.6), Industrials (8.7, down from its record high of 10.5% in mid-December), Consumer Staples (7.5, down from 7.7), Consumer Discretionary (6.6, down from 8.3), and Energy (2.8, 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 6.8%, forward earnings has gained 19.1%, and the forward profit margin has risen 1.1pt to 11.4%. Among the 11 sectors, all but Real Estate posted new post-Covid-19 highs last week in either their forward revenues, earnings, or profit margin. The major laggards since then: Energy's revenues, and Real Estate's earnings and profit margin. Energy's forward revenues rose 1.7% w/w, and forward earnings surged 10.2%, but forward revenues remains near a 15-year low. Real Estate's forward earnings and profit margin both fell w/w to their lowest levels in more than eight years. Here's how the 11 sectors rank by their changes in forward revenues and forward earnings since May 28: Consumer Discretionary (forward revenues up 11.1%, forward earnings up 57.3%), Communication Services, (9.1, 14.7), Information Technology (9.0, 12.5), Industrials (7.9, 28.4), Materials (7.8, 29.6), Financials (7.3, 22.9), S&P 500 (6.8, 19.1), Health Care (5.6, 13.5), Consumer Staples (2.4, 8.0), Energy (1.1, 387.3), Real Estate (0.5, -10.3), and Utilities (-1.5, 1.8).

## US ECONOMIC INDICATORS

**JOLTS** (*link*): Job openings unexpectedly rose in October, increasing for the fifth time in six months, since hitting bottom in April, up 1.6 million over the period to 6.652 million—within 360,000 of its pre-Covid level. There were 11.1 million unemployed in October, leaving less than two unemployed workers competing for every job opening during that month. The number of hires (which includes rehired employees) fell 74,000 in October to 5.812 million and is down 1.4 million since its record high of 7.199 million in May. Total separations—which includes quits, layoffs & discharges—increased for the fourth time in five months, by 263,000 in October and 871,000 over the period to 5.107 million. The number of total quits increased 18,000 in October and 1.2 million since bottoming in April to 3.092 million—a sign that employees likely feel more confident about the employment situation. Meanwhile, layoffs & discharges was little changed at 1.680 million, down nearly 10 million since peaking at 11.489 million during March. The quit rate remained at 2.2% in October—just shy of the 2.3% reading before the pandemic hit, while the layoff & discharges rate was at 1.2%—holding around September's record low of 1.0%; the rate was at 7.6% in March.

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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