MORNING BRIEFING
January 21, 2021

Covid's First & Last Anniversary

Check out the accompanying chart collection.

(1) Approaching Covid-19 anniversary. (2) Can businesses that grew because of Covid-19 maintain the momentum? (3) A look at Logitech, Peloton, and Netflix earnings and conference calls. (4) BofA works to keep the fintechs at bay. (5) Liquidity piling up at commercial banks, with deposits up 21.6% y/y. (6) Banks stashing cash in Treasuries. (7) Electricity generation getting a little bit greener every year. (8) Natural gas consumption expected to fall. (9) Welcome Tesla to the Magnificent Five.

Strategy: Viral Bull Market. It's hard to believe, but we're quickly approaching the one-year anniversary of the upheaval of our lives that Covid-19 has caused. Like everyone else, we hope it will be its first and last anniversary. On February 3, 2020, the Trump administration declared a public health emergency due to the virus; on March 11, the World Health Organization proclaimed it a pandemic; and by March 20, California, New York, and Illinois had announced state-wide stay-at-home orders. Our lives haven't been the same since.

While the business of some companies—like airlines, restaurants, and cruise lines—fell sharply because of Covid-19, other businesses benefitted. Logitech International, which makes computer peripherals, saw its revenue jump 85% y/y and net income soar 192% in its fiscal Q3, ending December 31. Shares of Peloton Interactive, which were down by double-digit percentages y/y in Q1, have skyrocketed 373.6% y/y as many gyms closed their doors and consumers opted to exercise at home on a Peloton bike. And Netflix reported Tuesday night that Q1 subscription growth would come in far above expectations, as we have all become couch potatoes.

But as the burst of Covid-related business approaches its first anniversary, and as more consumers receive the Covid-19 vaccine, investors have to decide how much of the Covid-induced business spike over the past year is sustainable. Let's take a look at what some Covid beneficiaries have been reporting:

(1) *Do you need another webcam?* Many workers have been working out of their homes since March. Some likely raced to outfit their home offices right away. Others may have waited until it became clear that their offices would not be reopening for a while to go buy some new tech

equipment. Logitech has benefitted from the move to home offices. It sells computer peripherals, like headsets, webcams, and keyboards. The company's sales rose 25.9% in fiscal Q3-2019 but surged 84.7% in fiscal Q3-2020. Logitech's gross margins swelled 760 basis points to 45.2% in fiscal Q3-2020, which ended December 31, helped by strong sales, reduced sales promotions, favorable product mix, and some currency tailwinds.

While Logitech CEO Bracken Darrell didn't give fiscal 2022 guidance, he did say on Tuesday's conference call that sales in the current quarter ending March 31 should grow 40%-50% y/y and that gross margins will probably decline from current elevated levels. In fiscal Q3-2019, the gross margin was 37.5%, and for the full fiscal 2019, the gross margin was 37.8%. "I think we're going to need to move back to more reasonable levels of promotion as supply and demand normalize," he said.

Even so, he remained convinced that the move to communicate via video would continue, whether it was being used by workers at home or in offices or by teens creating TikToks and Instagram messages. It all benefits the company's webcam sales. Likewise, the sales of gaming peripherals, like headsets and controllers, remain strong. Darrell noted that more than one billion people watched some part of the League of Legends final last quarter, and around 100 million people watched the live final, the same size as the audience for the Super Bowl last year. Looking forward, he was optimistic about what virtual reality will mean for the company. The shares fell 3.2% Tuesday to $97.73, but they remain up 109.9% y/y.

(2) *Are you sick of the basement gym yet?* Peloton's sales in fiscal Q1, ending September 30, surged 232%, and the company is racing to keep up with demand for its stationary bikes. The company raised its revenue outlook for fiscal 2021 to $3.9 billion-plus, up from the prior range of $3.50 billion to $3.65 billion. But you do have to wonder what will happen to demand when gyms reopen. Peloton shares are up 373.6% y/y. But they fell 4.9% Tuesday to $150.14 after a UBS analyst downgraded his recommendation to sell from neutral but upped his price target. While he warned about the risk to investors after the stock's runup, he remained optimistic about the company's "long term opportunity to disrupt traditional fitness business models," a January 18 CNBC article reported.

(3) *We may never live without Netflix again.* After Internet access, Netflix may be the most important subscription we have at home. The company enjoyed a huge bump in subscriptions in the wake of the Covid-19 lockdowns as the masses stuck at home searched for entertainment. Netflix's subscribers grew in Q1-2020 by 15.8 million. This year, the company

expects 6.0 million new subscriptions in Q1, the company's January 19 quarterly letter to investors reported.

Investors looked past the expected slowdown in Q1 subscriber growth because last quarter Netflix subscriber additions were 8.5 million, well above the 6.5 million expected and only slightly below the 8.8 million additions in Q4-2019. The company also reported that its cash-flow losses are in the past. Its free cash flow should be around breakeven this year and positive in future years, eliminating the company's need to raise money to fund future operations. After this news, Netflix shares rallied in Tuesday's aftermarket trading by $61.43 to $563.20, a 12.2% gain.

Netflix shares are in the S&P 500 Movies & Entertainment stock price index, which has risen 28.9% y/y through Tuesday's close. The index, which also includes Disney and Live Nation, has traded sideways for much of the past three years but broke out of the range in the fall of 2020 (*Fig. 1*). The shares of the indexes' three constituents have performed much differently y/y, with Netflix shares up 47.7%, Disney shares up 19.4%, and Live Nation shares up 1.3% through Tuesday's close. The industry is expected to grow revenues by 13.8% and earnings by 28.8% this year, compared to a revenue decline of 6.0% and earnings drop of 57.1% last year (*Fig. 2* and *Fig. 3*).

Financials: Drowning in Deposits. The bank earnings that have rolled in this week have, in general, been better than expected. Loan losses haven't surged, and some banks are confident enough about the future to have released some portion of their loan-loss reserves. Capital markets activity has been robust.

After reading Bank of America's earnings transcript, one opportunity and one problem jumped out. Bank executives highlighted just how rapidly customers were moving their transactions online and the cost benefits that accrued to the bank as a result. BofA executives also noted the huge surge of deposits it has seen over the past year, raising questions about how those funds will be deployed during a time of sluggish loan growth and low interest rates. Here's a look at what was said:

(1) *Customers go digital.* Bank of America customers continued to embrace digital banking tools, good news as all banks have myriad fintech companies nipping at their heels. "Full-year 2020 cash and check transaction volume fell to the lowest on record, down 21% as Covid accelerated the migration to digital card-based payments," said CEO Brian Moynihan on

Tuesday's conference call. Meanwhile, both person-to-business and person-to-person electronic transactions were up 22% y/y in 2020.

Consumers throughout the bank's many businesses used digital tools. Sixty nine percent of wealth management households are "digitally active." Forty two percent of consumer sales last year were online sales, including sales of checking accounts, auto loans, and mortgage loans. The number of customers using Erica, the bank's digital assistant, grew to 17 million in Q4, up 67%. y/y. Zelle's person-to-person volume jumped to $43 billion in Q4, up almost 80% y/y. Almost half of the checks deposited by Merrill clients were done digitally last quarter, and 70% of the checks deposited by private bank clients were done digitally.

(2) *Lots of liquidity.* Bank of America's year-end deposits were up 25.1% y/y in Q4, or $360.7 billion, to $1.8 trillion—a Bank of America record. But the bank's loans and leases fell 4.2% y/y in Q4, or by $39.7 billion, to $906.6 billion. Loans fell as companies used their loan revolvers less and as credit-card borrowing declined. "With deposits up [and] loans down, excess liquidity is piling up in our cash and securities portfolios," Moynihan said.

Here's the truly amazing number: The bank's interest cost on $1.7 trillion of deposits in Q4 was only $159 million. Unfortunately, the interest rate on the company's loan portfolio is shrinking almost as dramatically. The bank's net interest yield on its loans fell to 1.71%, down one basis point q/q and down from 2.35% in Q4-2019. As a result, the bank's net interest income fell by almost $2 billion, or by 15.6% y/y.

And as lending declines, the bank's holdings of debt securities and global liquidity sources have increased sharply. Debt securities jumped 45.0% y/y to $684.9 billion in Q4. Global liquidity sources soared 63.7% y/y to $943 billion. Global liquidity sources are defined by the bank as cash and high-quality, liquid, unencumbered securities—including US government securities, US agency securities, US agency mortgage-backed securities, select non-US government and supranational securities, and other investment-grade securities that are readily available to meet funding requirements as they arise (but not the bank's borrowing capacity from the Federal Reserve discount window or Federal Home Loan Bank).

The need to stash cash somewhere appears to be driving many banks to invest in securities. Commercial banks total deposits surged this spring and has continued to grow. Deposits are up $2.9 trillion and 21.6% y/y (*Fig. 4* and *Fig. 5*). Commercial and industrial loans have grown as well, but not as quickly. They're up $234 billion y/y and 9.9% (*Fig. 6* and *Fig. 7*).

The extra cash seems to be flowing into Treasuries and similar securities. Bank holdings of securities has jumped to $4.8 trillion as of January 6 week (*Fig. 8*). That's up $941 billion and 24.7% y/y (*Fig. 9*). And 85% of those securities appear to be invested in Treasury and agency debt (*Fig. 10*). Treasuries and agency securities now make up 25% of bank credit, a record going back to 1973 (*Fig. 11*). The irony, of course, is that banks purchasing Treasuries helps to keep interest rates low, which in turn hurts banks' loan portfolios.

Disruptive Technologies: Slowly Getting Greener. Change may happen slowly, but it does happen. And while our electricity generation is still dominated by natural gas, the new capacity coming onstream over the next year is dominated by green sources.

A US Energy Information Agency (EIA) report dated January 11 estimates that this year 39% (15.4 gigawatts) of the new electricity generating capacity will come from solar, 31% (12.2 GW) from wind, 16% (6.6 GW) from natural gas, 11% (4.3 GW) from batteries, and 3% (1.1 GW) from nuclear. This is the first year that growth in solar capacity is expected to exceed growth in wind capacity.

The new capacity fueled by natural gas, at 16% this year, has shrunk dramatically from two years ago, when 34% of new capacity was fueled by natural gas, and from three years ago, when more than 60% of new capacity was fueled by natural gas, a January 15 ARS Technica article reported. The surge in wind and solar additions is even more impressive given that tax credits for renewable energy were supposed to phase out in 2020, which often means the pipeline of new projects decreases in anticipation, ARS explained. This time around, companies decided to move forward with the projects either because they disregarded the tax implications or because they bet the tax credits would be extended, which they were.

The more that new electricity production capacity comes from wind and solar, the more that the total electric power generation changes on the margin. The EIA forecasts that the percent of total US electric power generated from natural gas will drop from 39% in 2020 to 36% this year and 34% in 2022 as natural gas prices rise. Coal's share of electricity generation is expected to rise from 20% last year to 22% this year and 24% in 2022. Meanwhile, the percentage of electricity generated from renewable sources should climb from 20% in 2020 to 23% next year. Nuclear is projected to fall from 21% of generation last year to 19% in 2022, as six nuclear reactors are scheduled to retire this year or next and two are scheduled to come online.

This shift in the fuels used by utilities will reduce overall natural gas consumption. The EIA forecasts that US natural gas consumption, which fell 2.5% in 2020, will continue to drop this year, by 2.8%, and in 2022, by 2.1%. “Most of the decline in natural gas consumption is the result of less natural gas use in the power sector, which EIA forecasts to decline because of rising natural gas prices. These declines are partly offset by rising natural gas use in other sectors,” the agency’s January 12 report states. The change is slow, but it’s happening.

Meet the New Magnificent Five. The Magnificent Five (Mag 5) are the five biggest-market-capitalization firms in the S&P 500. At the end of August, the Mag 5 included Facebook, Amazon, Apple, Microsoft, and Google (Alphabet). They accounted for a record-high 25.9% of the S&P 500 then, easily surpassing their prior cyclical peak of 17.5% at the end of August 2018 and the prior record high of 18.5% at the height of the tech bubble during March 2000 (*Fig. 12*).

On January 7, the Mag 5 became TAAMG as Tesla displaced Facebook as the fifth largest company in the S&P 500. Facebook’s forward P/E of 25.0 then was easily eclipsed by Tesla’s 217.4. That caused the Mag 5’s forward P/E to rise overnight from 40.0 to 45.6. That surpassed its prior record high of 44.3 during the August 28 week. While the aggregate market cap of the Mag 5 has risen to new record highs, its share of the S&P 500’s market cap has dropped (*Fig. 13*).

Facebook’s market cap was $744 billion at Tuesday’s close. That’s just 7% below Tesla’s $801 billion. As their individual fortunes and valuations rise and fall, Facebook could easily move back into the Mag 5 index. Stay tuned.

CALENDARS

US: Thurs: Housing Starts & Building Permits 1.56mu/1.60mu, Jobless & Continuous Claims 900k/5.5m, Philadelphia Fed Manufacturing Index 12. **Fri:** M-PMI & NM-PMI Flash Estimates 56.5/53.6, Existing Home Sales 6.55mu, EIA Natural Gas Storage, Baker-Hughes Rig Count. (DailyFX estimates)

Global: Thurs: Eurozone Consumer Confidence Flash Estimate -15, UK Gfk Consumer Confidence -29, France Business Confidence 94, ECB Interest Rate Decision & Deposit Facility Rate 0.0%/-0.5%, European Council Meeting, UK BOE Credit Conditions Survey.

Fri: Eurozone, Germany, and France C-PMI Flash Estimates 47.6/50.3/49.0, Eurozone, Germany, and France M-PMI Flash Estimates 54.5/57.5/50.5, Eurozone, Germany, and France NM-PMI Flash Estimates 44.5/45.3/48.5, UK C-PMI, M-PMI, and NM-PMI Flash Estimates 45.5/54.0/45.0, UK Retail Sales Total and EX Fuel 4%/5% y/y. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) this week fell to 3.59 after rising last week (to 3.81 from 3.44) for the first time since the week of December 22; it's been above 3.00 since the week of November 11. Bullish sentiment sank to 60.4% after rising from 60.2% to 63.7% last week—which ended a streak of declines from the 2020 high of 64.7% at the end of November. Meanwhile, bearish sentiment was little changed at 16.8%, after falling from 17.5% to 16.7% last week; it's only 0.6ppt above the 2.5-year low of 16.2% posted during the September 8 week. The correction count jumped to a 10-week high of 22.8% this week after falling from 22.3% to 19.6% last week; in late November, the percentage was at 18.2%—which was the lowest since December 2006.

S&P 500 Sectors Net Earnings Revisions (*link*): The S&P 500's NERI improved in January for an eighth straight month and was positive for a sixth month following 13 straight negative readings. NERI rose to a 34-month high of 16.3% from 15.4% in December and is up from an 11-year low of -37.4% in May. That compares to a tax-cut-induced record high of 22.1% in March 2018. NERI was positive for 10 sectors for a fifth month in January, the most since an 18-month streak through October 2018. That compares to negative NERI readings for all 11 sectors from April to July. Just six of the 11 sectors improved m/m in January, down from seven in November and December, eight in October, and all 11 from June to September. All 11 had been worsening on a m/m basis from March to May. Real Estate has the worst track record among the sectors, with 14 months of negative NERI. Here are the sectors' January NERIs compared with their December readings: Financials (34-month high of 29.4% in January, up from 24.1% in December), Consumer Staples (21.3, 22.3), Materials (21.0 [34-month high], 20.8), Energy (17.1 [20-month high], 10.2), Consumer Discretionary (16.7, 18.5), S&P 500 (16.3 [34-month high], 15.4), Industrials (16.7, 19.6), Information Technology (15.3 [31-month high], 11.7), Communication Services (11.9, 13.8), Health Care (9.2, 8.6), Utilities (6.3 [78-month high], 6.1), and Real Estate (-1.5, -0.8 [13-month high]).

S&P 500 Q3 Earnings Season Monitor (*link*): With nearly 9% of S&P 500 companies finished reporting revenues and earnings for Q4-2020, revenues are beating the consensus forecast by

a well-above trend 2.8%, and earnings have crushed estimates by 22.8%. The large surprises result from a lack of financial guidance from the companies that analysts follow during an economic rebound. At the same point during the Q3 season, revenues were 3.3% above forecast and earnings beat by 26.7%. For the 43 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 Q3 measures. The small sample of Q4 reporters so far has a y/y revenue gain of 3.5% and earnings gain of 6.5%. Those results mark a big recovery from Q3-2020, which was the worst quarter since Q1-2009 during the financial crisis. A whopping 93% of the Q4 reporters so far has reported a positive earnings surprise, and 84% has beaten revenues forecasts. Slightly more companies have reported positive y/y earnings growth in Q3 (65%) than positive y/y revenue growth (63%). These figures will change markedly as more Q4-2020 results are reported in the coming weeks, and we expect the y/y revenue and earnings growth results to turn negative.

GLOBAL ECONOMIC INDICATORS

Eurozone CPI (*link*): December's CPI headline rate was negative for the fifth month, after moving into negative territory in August for the first time since May 2016. December's was unchanged at -0.3% for the third month, after rising from 0.1% in May (which at the time was the lowest rate since June 2016) to 0.4% in July; the rate was at 1.4% in January. The core rate held at its record low of 0.2% y/y again in December; it had dropped from 1.2% in July to 0.2% y/y in September, where it has levelled out. Looking at the main components, food, alcohol & tobacco once again posted the highest rate, at 1.3% y/y, slowing for the second month since climbing from 1.7% in August to 2.0% by October; it was as high as 3.6% in April—which was the highest since November 2008. Meanwhile, once again energy had the lowest rate at -6.9% y/y (the 11th consecutive negative reading); the decline had narrowed from -11.9% in May—which was the steepest since July 2009—to -7.8% by August. The rate for non-energy industrial goods was at -0.5% y/y in December; the rate had bounced between -0.1% and -0.3% from August through November. Of the top four Eurozone economies, only France (0.0% y/y) is above the Eurozone's headline rate of -0.3%, while the rates for Spain (-0.6) and Germany (-0.7) are below; Italy's matches its headline rate.

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