MORNING BRIEFING
April 29, 2021

Hubris Goeth Before a Fall

Check out the accompanying chart collection.

(1) Off-base inflation assumptions. (2) Fiscal and monetary policies sending demand well above supply. (3) Not-so-transient inflation may force Fed action. (4) Beware taper tantrums. (5) China's latest misdeeds. (6) Tesla bows to Chinese government's pressure. (7) Companies opting out of China. (8) Chinese censors cancel director's Oscar win. (9) China's Orwellian campaign goes global. (10) World leaders waking up. (11) From jeans to genes. (12) A look at the picks and shovels in genomics.

What's New? This week, we converted our system to HubSpot, an integrated production and distribution software platform. So far, so good. It seems that our research has been delivered by email without any disruption. We have had some positive reviews on the look of our emails, especially on smartphones. They should be easier to read.

On a related subject, we've also had lots of positive feedback on our "Zoomcasts," in which I cover the main points of our Monday *Morning Briefings* with illustrative charts. You can find an *archive* of them on our website. Finally, please have a look at our updated *Getting the Most from Yardeni Research*.

Inflation: A Price Will Be Paid. The divergence between the plethora of indicators showing rising inflationary cost pressures and still subdued consumer prices may result from a lag between the former and the latter. If so, then CPI inflation may soon accelerate sharply. Fed officials do expect inflation to move higher during March, April, and May. But they attribute that to a "base effect," as Fed Chair Jerome Powell reiterated in his press conference yesterday. Year-over-year comparisons in the CPI are likely to rise simply because prices were depressed by the lockdown recession a year ago. So Fed officials expect that any pickup in inflation will be transitory.

The problem with this notion is that it is increasingly off base. Inflationary pressures are mounting because excessively stimulative fiscal and monetary policies are boosting demand well above supply in many industries in the here and now! Powell attributed this development to temporary supply bottlenecks. Nevertheless, consider the following:

(1) *Prices paid & received.* The regional business surveys conducted by five of the 12 Federal

Reserve Banks are showing that the averages of their prices-paid and prices-received indexes soared to new record highs of 71.9 and 39.6, respectively, during April (*Fig. 1*). These are diffusion indexes based on m/m comparisons, not y/y comparisons.

(2) *Prices paid.* In any event, the average of the five regional prices-paid indexes suggests that the PPI for final demand continues to move higher on a y/y basis (*Fig. 2*). It was up 4.2% during March, the highest since September 2011.

(3) *Prices received.* The average of the five regional prices-received indexes is highly correlated with the y/y inflation rate in the PPI for personal consumption (including goods and services), which was 3.8% during March (*Fig. 3*). It's likely to move higher. If so, then so should the PCED headline and core inflation rates (*Fig. 4*, *Fig. 5*, and *Fig. 6*).

Higher inflation in coming months won't be just a base effect, and it may not be as transient as Fed officials insist. When they realize this, they may need to reconsider their current policy stance. Beware of a tapering tantrum in the financial markets.

China: Still Behaving Very Badly. The Chinese communist government is providing the US and other nations with lots of wake-up calls. On almost a daily basis, we are reminded that China's President Xi Jinping, who also heads the Chinese Communist Party (CCP), is an ambitious, arrogant, and dangerous dictator intent on controlling China's citizens and corporations while imposing the country's influence on the rest of the world. China has rapidly emerged as the number one threat to global political and economic stability. The CCP's mounting arrogance is heating up the cold war between the US and China. It increases the risk of a geopolitical crisis that could end the global bull market in stocks. The most obvious calamity would be an invasion of Taiwan by mainland China.

Outside of China, there isn't much doubt that Covid-19 started inside China. However, the Chinese government has stymied the World Health Organization's efforts to investigate whether the source of the virus was a meat market or a top virology lab in Wuhan, China; the former obviously would have been unintentional, the latter less certainly so. An intentional leak from the lab is unlikely but can't be ruled out.

In any event, China's autocratic government has controlled the pandemic better than any other country in the world, even though its vaccines are much less effective than those available in the West. That has increased the government's arrogant self-confidence, as China's leaders claim that their success in dealing with Covid-19 proves the superiority of China's totalitarian political system. Meanwhile, the pandemic continues to weigh on the rest of the world. In other words, whether by design or not, the pandemic has worked to the benefit of the CCP.

Xi's swelling hubris shows growing signs of uniting other nations against China and pushing corporations to expand anywhere but inside China. Let's review the latest batch of disturbing developments, updating our previous review in the April 15 *Morning Briefing*:

(1) *Tesla, Apple & Ford.* Tesla is the latest company to come under attack by the Chinese government and social media. The company's car was involved in a crash that the driver alleges was caused by faulty brakes. Tesla denied the claim and refused to pay the driver because she was unwilling to let a third party look at the car to investigate. Protesters, including the car owner, demonstrated at the Shanghai Auto Show, and Tesla found itself in the glare of China's state-run media.

The company ultimately caved, stating the following: "We apologize deeply for having not resolved the problem with the car owner in a timely manner," Tesla wrote on Weibo, according to an April 21 *FT* *article*. Tesla said a team was sent to handle the protester's case and would "work with any government investigation." This dustup follows news that some military compounds in Beijing banned Teslas for fear that the cars' cameras posed a security threat. The company denied that such a threat existed. The American company appears quickly to have lost its darling status in China.

Separately, Apple and Ford Motor both have announced large investments to expand in the US. Ford is spending $185 million to build a battery lab that will research new lithium ion batteries as well as solid-state batteries, an April 27 CNBC *article* reported. The auto company, which is hiring 150 people for the effort, hopes to develop in-house battery expertise, with an eye toward potentially manufacturing batteries in-house in the future. The company currently buys batteries from South Korea's SK Innovation among other suppliers. Last year, it spent another $100 million to build a battery benchmarking and testing lab in Allen Park, Michigan.

Apple has begun delivering on its promise to add 20,000 jobs in the US by 2026. The company is building a new campus and engineering hub in North Carolina that will create 3,000 jobs in machine learning, artificial intelligence, software engineering, and other fields, an April 26 *WSJ* *article* reported.

Apple, which historically has outsourced its manufacturing to Taiwanese companies with operations primarily in China, appears to be changing tactics. The company plans to move 7%-10% of its Chinese production of iPhones by Foxconn to India, a March 11 Nikkei *article* reported. Foxconn, a Taiwanese company, was looking to cut its exposure to rising labor costs and to mounting US-Chinese tensions, the article states. Pegatron, another Taiwanese iPhone manufacturer, decided last year to expand in India instead of in China, and Winstron, a third Taiwanese producer, has "similar plans," Nikkei reported.

Delta Electronics, a Taiwanese producer of power components for Apple and Tesla, has cut its headcount in China by almost 40% and ultimately aims to reduce headcount by 90%, a March 18 *FT* *article* reported. The company is exiting the country to reduce manufacturing costs—like higher wages—and to sidestep the US-China trade war.

In 2019, Delta moved its production of telecom power equipment from China to Thailand and Taiwan, and now it's building four large factories in India to make photovoltaic inverters and industrial automation equipment for the local market and information technology and communications gear for export. Factories remaining in China will be highly automated to reduce headcount.

(2) *More censorship makes headlines.* News of Chinese-born director Chloe Zhao's Oscar win is hard to find on Chinese media, with references on Weibo and WeChat deleted. Her sin was giving a 2013 interview to *Filmmaker* magazine in which she reportedly described China as "a place where there are lies everywhere." The comments were deemed offensive and insulting to China, an April 26 *South China Morning Post* *article* reported.

A more scholarly crowd also has found itself censored. Beijing has blocked the Centre for Strategic and International Studies' (CSIS) website. The Washington DC group's offense: It criticized China's sanctions on a European think tank. China sanctioned the European think tank, Germany's Mercator Institute for China Studies, after the European Union sanctioned four Chinese officials and the Xinjiang public security bureau over human rights abuses.

"The biggest change lately is that China now believes it has the right to police debate about China wherever it occurs in the world, whoever does the work, on whatever platform it appears," CSIS fellow Scott Kennedy said in an April 17 *South China Morning Post* *article*.

(3) *World leaders waking up.* Taiwan's leaders have always had a front-row seat to the happenings in China. Today, the country worries that China will try to poach its semiconductor industry's people and trade secrets. Taiwan Economy Minister Wang Mei-hua said the US-China trade war had "obstructed" China's efforts to build its own semiconductor industry, but that China's efforts were far from over. "In order to achieve self-sufficiency in the supply chain, poaching and infiltration are the quickest way for mainland China to do this," she said, according to a March 31 *article* in the *South China Morning Post*.

The most recent example of China stealing trade secrets in the US occurred this week. Qin Shuren, a Chinese national living in the Boston suburbs, "pled guilty in federal court to felony charges that he illegally procured more than $100,000 in US marine technology for a Chinese military research institute," an April 27 *WSJ* *article* reported. He's described as helping China reach its goal of building an undersea drone armada that could track US submarines, eroding America's naval strength.

Australia also has been taking a tougher line with China in recent years. Just last week, the country's federal government canceled a Belt and Road infrastructure deal between China and one of Australia's largest states, Victoria. Leaders in Victoria had hoped the deal—which offered help with infrastructure projects, biotechnology, advanced manufacturing, and technological innovation—would increase investment and create jobs in Victoria, an April 22 *WSJ* *article* reported.

However, Australia's leaders feared that China was using the deal to build influence in the country. While Australia and China are major trading partners, Australia recently provoked China's ire by banning China's Huawei Technologies from rolling out 5G equipment in Australia due to security concerns raised by the US. Australia also has provoked China by criticizing China's handling of the Covid-19 outbreak.

Australia's Department of Home Affairs Secretary Mike Pezzullo's message to department staff on Australia's veterans' day was chilling. "In a world of perpetual tension and dread, the drums of war beat—sometimes faintly and distantly, and at other times more loudly and ever closer," Pezzullo said according to a April 26 CNBC *article*. "Today, as free nations again hear the beating drums and watch worryingly the militarisation of issues that we had, until recent years, thought unlikely to be catalysts for war, let us continue to search unceasingly for the chance for peace while bracing again, yet again, for the curse of war." While some critics in Australia have urged politicians to tone down the rhetoric, the statement certainly let China know that the country is on guard.

Disruptive Technologies: Picks and Shovels in Genomics. Levi Strauss, at only 18 years old, came to New York after traveling across the ocean in the section of the ship given to passengers with the cheapest tickets. Strauss, his mother, and sisters brought sewing goods to the New World, and he worked as an itinerant peddler, according to a PBS *website*. Strauss moved to San Francisco in 1853 as part of the Gold Rush, opening a dry-goods store supplied with goods from his brother back in New York. One of his customers actually invented Levi's jeans, hammering rivets into the pocket corners to make them more durable. But the Levi's name is all that most of us remember.

The race to understand genes has set off a similar gold rush. And like Levi Strauss, there are many companies selling picks and shovels to these modern explorers. They are tapping into ever cheaper, faster, and smaller technologies that allow even small labs to do the research that previously has been the purview of large institutions. One news account compared what's happening today in genomics to what occurred when computers shrank from room sized to lap sized. The advancement meant that researchers didn't have to work for an institution that could afford expensive, large computing equipment. Researchers and entrepreneurs could work in their garages.

There are many companies supplying genomics researchers, but two that have caught our eye are 10K Genomics, a public company, and privately held Inscripta. Even though analysts aren't expecting 10K to turn a profit until 2023, the company's shares have climbed from their initial public offering price of $39.00 in 2019 to $198.70 as of Tuesday's close. Its equipment allows scientists to study thousands of individual cells, capturing data on each cell's DNA, RNA, and proteins. Using that information, 10K's software helps scientists interpret the information.

Inscripta's desktop sized equipment allows scientists to edit a cell's genes and understand the results. For example, E. coli strains have been bred to produce lysine, which they don't naturally produce. Inscripta showed how its platform could make edits, resulting in an E. coli that "had a 10,000-fold increase in production versus the wild type. To get there the company tested 200,000 edits," a March 16 *Fast Company* article reported.

Of course, if these products make it cheaper and easier for scientists to develop new cells for good causes, they will also make it easier for rogue operators to develop cells—viruses—for evil purposes. That's something we're sure to hear about in the future.

Calendars

US: Thurs: GDP 6.1%, GDP & Core PCE Price Deflators 2.5%/2.4%, Initial & Continuous Jobless Claims 549k/3.61m, Pending Home Sales 4.7%, EIA Natural Gas Inventories, Williams, Quarles. **Fri:** Personal Income & Spending 20.3%/4.1%, Core PCED 1.8% y/y, Employment Cost Index 0.7%, Consumer Sentiment 87.4, Chicago PMI 65.3, Baker-Hughes Rig Count. (DailyFX estimates)

Global: Thurs: Eurozone Economic Sentiment 102.2, Eurozone Consumer & Industrial Sentiment

-8.1/4.0, Germany CPI 0.5%m/m/1.9%y/y, Germany Unemployment Change & Unemployment Rate -10k/6.0%, Spain Unemployment Rate 16.6%, Japan Unemployment Rate 2.9%, Japan Industrial Production -2.0%, China NBS M-PMI 51.7. **Fri:** Eurozone GDP Flash -0.8%q/q/-2.0%y/y, Eurozone CPI Headline & Core Flash Estimates 1.6%/0.8% y/y, Eurozone Unemployment Rate 8.3%, Germany GDP Flash -1.5%q/q/-3.2%y/y, France GDP Flash 0.1%, France CPI 1.3% y/y, Italy Unemployment Rate 10.3%, Italy GDP Flash -0.5%q/q/-1.6%y/y, Spain GDP Flash -0.5%q/q/-4.2%y/y, UK Nationwide Housing Prices 0.5%m/m/5,0%, Japan Consumer Confidence, Japan Housing Starts -7.4%. (DailyFX estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) fell this week for the first time in seven weeks—as bullish sentiment dropped below 60.0% for the first time in four weeks. The BBR sank to 3.59 this week after climbing the prior six weeks from 2.48 (lowest since early October 2020) to 3.81. Bullish sentiment dropped to 59.2% this week after advancing during five of the prior six weeks by 12.7ppts (to 63.7% from 51.0%), with most of the recent moves occurring between the bullish and correction camps. The correction count rebounded this week to 24.3% after falling during five of the prior six weeks by 8.8ppts (to 19.6% from 28.4%). Meanwhile, bearish sentiment declined this week for the sixth time in seven weeks by 4.1ppts (to 16.5% from 20.6%). The AAII Ratio rebounded to 72.0% last week after sinking from 73.6% (the highest since January 2018) to 68.6% the prior week, as bullish sentiment rose to 52.7% after falling from 56.9% (the highest since January 2018) to 53.8% the prior week; bearish sentiment slipped to 20.5% last week after climbing from 20.4% to 24.6% the week before.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin rose 0.1ppt to 12.4% this week. That matches its record high of September 2018 and is up 2.1ppts from 10.3% during April 2020, which was the lowest level since August 2013. Forward revenues and earnings have been making new record highs since the beginning of March and for the first time since February 2020. Analysts have been playing catch-up with their lowball estimates from the Covid-19 shutdown ever since the Q2-2020 earnings season came in way better than expected. Consensus S&P 500 forecasts had been falling at rates paralleling the declines during the 2008-09 financial crisis. Forward revenues growth rose 0.2ppt w/w to 8.9%, just below its 9.0% record high in mid-February. Forward revenues growth has come a long way from the 0.2% to which it had dropped in April 2020, which was the lowest reading since June 2009. Forward earnings growth gained 0.6ppts w/w to 22.9%. That's its highest level since July 2010 and up substantially from its record low of -5.6% at the end of April. Analysts continue to boost their 2021 growth forecasts. They now expect revenues to rise 10.3% in 2021 and 6.6% in 2022 compared to the 2.2% decline reported in 2020. They expect an earnings gain of 30.2% in 2021 and 13.5% in 2022 compared to a 13.3% decline in 2020. Analysts expect the profit margin to rise 1.9ppts y/y in 2021 to 12.1%—from 10.2% in 2020—and to improve 0.8ppt y/y to 12.8% in 2022. Valuations ticked higher last week. The S&P 500's weekly forward P/E was up 0.1pt w/w to 22.4 and compares to a 17-week low of 21.3 at the beginning of March. That also 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 0.03pt w/w to a new record high of 2.78, which compares to its 49-month low of 1.65 in March 2020.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): Last week saw consensus forward revenues rise w/w for all 11 S&P 500 sectors. Forward earnings increased for all but the Industrials and Utilities sectors. Forward P/E ratios for nearly all sectors now are back above their record or cyclical highs prior to the Covid-19 bear market. During 2019, just two sectors' margins improved y/y: Financials and Utilities. Consumer Staples, Tech, and Utilities were the only sectors with an improved profit margin in 2020. For 2021, all but Real Estate and Utilities are expected to improve y/y. Back in 2018, the forward profit margin was at record highs for 8/11 sectors, all but Energy, Health Care, and Real Estate. Now, only three sectors are at record highs—Materials, Tech, and Utilities—but Consumer Staples and Financials are close. The forward profit margin rose for three of the 11 sectors last week and edged down for two. Financials' surged 0.6ppts last week; Real Estate's has been improving since December's lowest level since January 2012; and Energy's is up from its record low in April 2020. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (23.6%, record high), Financials (19.0, down from 19.2), Communication Services (14.8, down from 15.4), Utilities (14.8, record high), Real Estate (14.0, down from 17.0), S&P 500 (12.4, now matches its prior record high), Materials (11.9, a new record high), Health Care (10.9, down from 11.2), Industrials (8.9, down from its record high of 10.5% in mid-December), Consumer Staples (7.6, down from 7.7), Consumer Discretionary (7.0, down from 8.3), and Energy (5.7, 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-related declines. Forward revenues and earnings have risen 10.6% and 33.5%, respectively, since then to new record highs. The forward profit margin has risen 2.3ppt to match its prior record high of 12.4% in late 2018. During the latest week, all but Consumer Staples and Utilities posted gains in either their forward revenues, earnings, or profit margin. Energy, Financials, and Materials have been particularly strong in recent weeks and have moved up in the forward revenues performance leaderboard. Here's how the 11 sectors rank by their changes in forward revenues and forward earnings since

May 28: Materials (forward revenues up 16.7%, forward earnings up 57.5%), Information Technology (15.1, 24.7), Communication Services (15.0, 27.6), Energy (13.9, 1043.6), Industrials (12.4, 37.1), Financials (12.3, 58.0), S&P 500 (10.6, 33.5), Health Care (10.2, 20.1), Consumer Staples (5.4, 12.3), Consumer Discretionary (4.2, 55.3), Real Estate (3.5, 1.8), and Utilities (-2.2, 4.0).

S&P 500 Q1 Earnings Season Monitor (*link*): With nearly 31% of S&P 500 companies finished reporting revenues and earnings for Q1-2021, revenues are beating the consensus forecast by a well-above-trend 3.0%, and earnings have crushed estimates by 22.4% in large part due to loan loss reversals at the banks. At the same point during the Q4 season, revenues were 2.5% above forecast and earnings beat by 17.9%. The S&P 500's Q1 earnings surprise excluding Financials drops to 12.4% from 22.4%. For the 153 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 Q4 measures. The small sample of Q1 reporters so far has a y/y revenue gain of 6.2% and an earnings gain of 50.3%, which drops to 4.9% and 10.2%, respectively, when Financials are excluded. A whopping 86% of the Q1 reporters so far has reported a positive earnings surprise, and 77% has beaten revenues forecasts. Slightly more companies have reported positive y/y earnings growth in Q1 (76%) than positive y/y revenue growth (73%). These figures will change markedly as more Q1-2021 results are reported in the coming weeks, particularly the y/y earnings growth rate.

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