MORNING BRIEFING
June 3, 2021

Biden, Oil, and Solar

Check out the accompanying chart collection.

(1) Biden's $6 trillion budget proposed. (2) Administration banks on low growth, low inflation, and low interest rates. (3) Higher taxes don't prevent deeper deficits. (4) Debating the definition of infrastructure. (5) Shell gets shellacked by court ruling. (6) Climate change court cases on the rise. (7) Will CO2 emissions fall or just shift to new players? (8) Massachusetts may be next to require new homes have solar. (9) Finding new surfaces for solar panels.

US Fiscal Policy: Biden's Budget Blueprint. President Joe Biden has said that his father told him, "Don't tell me what you value; show me your budget, and I'll tell you what you value." If budget items correlate with moral values, then Biden has a very long list of values.

On Friday, Biden released his first official budget *proposal*, entailing $6 trillion of proposed spending next fiscal year (beginning October 1). Biden's budget is best characterized as a gigantic redistribution package because it contains a lot of spending partially offset by lots of tax increases, producing not a lot of growth. Consider the following:

(1) *Low growth expected.* Astonishingly, the historically huge spending side of the budget ledger is not expected to result in much growth for the US economy. The administration predicts that real GDP would grow by 4.3% y/y in 2022, falling to 2.2% in the following year and remaining near 2.0% through 2031. Interestingly, the administration also does not expect the rate of inflation to heat up any higher than 2.3% over the next 10 years as a result of its major spending. Unemployment is anticipated to improve by the end of the year, dropping to 4.1% in 2022, and to remain at 3.8% for 2023 through 2031. Meanwhile, interest costs are expected to remain historically low.

(2) *Flawed projection.* There may be at least one flawed economic assumption in Biden's budget. Jared Bernstein, a member of the president's Council of Economic Advisers, acknowledged on Friday in an *interview* on CNBC's Closing Bell that the economic predictions had been compiled back in February of this year when inflation rates were still low, for example.

(3) *Trillion-dollar deficits forever.* As we see it, the low growth is expected because the Democrats have committed to raising taxes on large corporations and wealthy households. In the words of the current administration, Biden's plans would "extend the benefits of economic growth to all Americans." (By the way, the budget shows that the corporate tax rate rises from 21% to 28%. Biden has said he could go as low as 25%.) Nevertheless, the budget still projects that the 2022 fiscal deficit will be about $1.8 trillion, falling to around $1.4 trillion for 2023 and staying about there through 2031.

(4) *Spending not finalized.* The spending side of the plan will not be the last iteration of Biden's budget, however. It includes the cost of both his American Families Plan and American Jobs Plan proposals. Already, the American Jobs Plan was reduced from the Democrats' initial $2.3 trillion proposal to $1.7 trillion to appease both moderate Democrats and Senate Republicans.

Last week, we explained why we expected some pared-down version of the American Jobs Plan, which contains Biden's proposals for domestic infrastructure enhancements, to pass. But the American Families Plan may be harder to push through Capitol Hill. Republicans have produced their second counteroffer of slightly less than $1 trillion in spending for the American Jobs Plan—closer to Biden's latest proposal but not quite there. It would require unused Covid-19 relief funds to pay for it. Democrats said they would continue to negotiate the legislation in June.

(5) *Hot ticket debates.* Among the items on Biden's massive priority list that the budget plan addresses are child and elder care, climate change, and clean energy. Surely, the final plan won't include all of Biden's asks; we'll see which survive. Neither the proposed volume of spending nor the entirety of the Democrats' expansive definition of infrastructure is likely to make it into the final version of the legislation. Republicans tend to define infrastructure mainly as hardscapes such as roads and bridges, while Democrats' "modern" definition includes childcare and elder care. How to pay for Biden's spending plans is also one of the most hotly debated components of the legislation, as we discussed last week.

(6) *Budget reconciliation tool.* It's interesting that the budget was released just ahead of the three-day holiday weekend, when the public likely wasn't paying much attention, as *US News* *observed*. Most of what is in the package is old news anyway. Nevertheless, the fiscal-year budget is a way for the Democrats to use the budget reconciliation process to bypass Republican approval on the infrastructure bill and pass whatever elements of it the moderate members of their party will accept.

Energy: Climate Activists Land a Blow. These should be the best of times for oil and gas companies. With Covid-19 rapidly receding, we're all jumping in trains, planes, and automobiles to visit friends and families we haven't seen in more than a year. The number of people passing through TSA checkpoints almost tripled to 1.9 million on Memorial Day compared to January (*Fig. 1*).

The world has almost finished working through the glut of oil that built up during the past year, and the US Energy Information Administration expects world production and consumption to be balanced in the second half of this year, according to a May 11 *forecast*. OPEC+ has begun to unwind production cuts made during the Covid-19 epidemic and plans to increase output by 450,000 barrels a day starting in July.

Brent crude oil futures held onto recent gains and closed Tuesday at $70.25, up 263% from the April 21, 2020 low of $19.33 (*Fig. 2*). The sharp rebound in crude prices has propelled energy stocks to the top of the leaderboard this year. Here's the performance derby for the S&P 500 sectors ytd through Tuesday's close: Energy (41.6%), Financials (29.3), Materials (21.8), Real Estate (20.5), Industrials (18.8), Communication Service (16.2), S&P 500 (11.9), Health Care (6.8), Consumer Discretionary (5.8), Information Technology (5.5), Consumer Staples (3.9), and Utilities (2.7) (*Fig. 3*).

However, there is a dark cloud in the distance. The oil and gas industry may be facing its version of tobacco litigation. Last week, the District Court in the Hague, Netherlands ruled that Royal Dutch Shell must dramatically reduce its carbon dioxide (CO_2) emissions. The court didn't specify how the company should reduce its emissions—or how the ruling would be enforced—but the decision could radically change the way Western oil and gas companies operate. The tougher question is whether the ruling will achieve environmentalists' goal of reducing the amount of CO_2 produced by burning oil and gas.

Let's take a look at the case that environmentalists made against Shell and try to discern what impact it will have on the environment and the energy sector's future:

(1) *Environmentalists' successful argument.* The case that seven environmentalist organizations brought against Shell looked a lot like cases brought against tobacco and asbestos companies in years past. Shell knew as early as 1986 that climate change was occurring and was exacerbated by fossil fuels, the environmentalists argued.

Shell "foresaw that increasing climate change as a result of the continued use of fossil fuels would have major consequences in the long term for the living environment of man, our future standard of living and for food reserves around the world," according to an English translation of the *case*.

“Shell also foresaw that this could potentially have major social, economic and political consequences. And at that time, Shell also realised that the environment could be affected by global warming to such an extent that parts of the world could, in time, become uninhabitable.”

Despite this knowledge, Shell has kept producing oil and gas and lobbying against changes to improve the environment. As a result, the company endangers human rights and lives, the environmentalists argue.

Shell positions itself as promoting environmentally friendly methods and plans to halve its energy products’ net carbon footprint by 2050. However, the environmentalists argue that the company could do so simply by purchasing renewable energy assets while never even cutting its CO2 emissions, so they asked the courts to force the company to cut its absolute CO2 emissions in line with the levels specified in the Paris accord—i.e., by 45% in 2030, 72% in 2040, and 100% by 2050 compared with 2010 levels.

The court ruled that the company was responsible not only for its own CO2 emissions from producing oil and gas but also for the emissions generated by those using Shell’s oil and gas products. The court required Shell to cut its “aggregate annual volume of all COT emissions” by 45% at the end of 2030 relative to 2019 levels. The decision applies to the company’s operations both inside and outside of the Netherlands.

(2) *What it all means.* The court’s ruling definitely gives Shell’s attorneys job security, as they plan to appeal—a process that can take a year or two and can be followed by yet another appeal to the Dutch supreme court. Normally, a company could hold off taking any action until the appeals were completed. However, in this case because the reduction goals must be met by 2030, the company may need to start selling or spinning off CO2-producing assets before the appeals process concludes.

Even if Shell wins on appeal, climate-change court cases against the oil industry are building and are likely to accelerate after the Shell ruling. The number of cases rose more than 10% to 1,824 over the past six months, with most of the cases in the US, according to data from the Sabin Center for Climate Change Law and law firm Arnold & Porter cited in a May 27 *WSJ* article.

Climate-change activists undoubtedly hope that the court’s decision will force Shell to shutter its carbon-producing assets, a move dramatic enough that other companies in the industry will also begin to reduce their oil and gas production. While that might lead to higher oil and gas prices, it would push companies and consumers to develop and buy renewable energy, which would benefit the world’s atmosphere, in the activists’ dream scenario.

It might be more realistic to assume that Shell will sell oil and gas assets on the cheap, which might be purchased by non-western corporations that aren't subject to the Hague's court. The purchasers would likely use Shell's assets to fill the world's thirst for oil and gas. In this scenario, the producers of oil and gas might change while the amount of CO_2 produced continues to rise.

Disruptive Technologies: The Solar Solution. Outside of the environmental debate, selling oil and electricity are great businesses. Customers need the product, they're willing to pay up for it, and they need to replace it on a daily or weekly basis.

While solar power seems like a no brainer for society, it's easy to see why corporations entrenched in the oil, gas, and electric industries won't flourish if their product is replaced by solar alternatives. Solar puts the power—literally—in the hands of the customer. Even if entrenched companies get into the business of selling solar panels and battery equipment, they'll have entered a business where they have to constantly go out and find new customers. Consumers don't need to buy sunshine, and their need to buy electricity is sharply reduced. The repeat-purchase business model is gone.

That said, old energy companies and new upstarts are diving into solar, sometimes pushed by the government. Let's take a look at some recent developments:

(1) *A little push from The Man.* California's regulations requiring all new residential buildings to have solar panels went into effect in 2020, and now the idea is being proposed in Massachusetts.

In California, new homes must install enough solar to meet the home's annual electricity needs. The California Energy Commission estimates the solar requirements add $8,400 to the cost of a single-family home, but the reduction in energy bills exceeds the increase in mortgage payments by about $35 a month, a February 13, 2020 *article* in *PV Magazine* reported.

The Massachusetts bill introduced this spring offers exemptions to houses with roofs that are shaded, to homes with solar hot water systems or other renewable technology, and to affordable housing developments, a March 16 *Building, Design & Construction Network* *article* reported. "Single-family homes would need to produce enough electricity via solar each year to meet 80% of the average demand for similar houses," the article said.

Environment America is pushing for similar mandates in nine states in addition to Massachusetts: Nevada, Colorado, New Mexico, Texas, Minnesota, Michigan, North Carolina, Maryland, and Pennsylvania. In those 10 states, about a quarter million homes are built each year, and solar would be suitable in about 83% of them, a June 23 *PV Magazine* *article* reported.

(2) *Gathering rays in new places.* To keep solar farms from blanketing valuable real estate, there's an effort to find new places to put solar panels. One option is creating floating solar farms by making solar panels that float on reservoirs, dams, and other bodies of water. Installation costs less, and the panels are more efficient because they are cooled by the water. The panels also reduce the loss of water due to evaporation, a January 29 *blogpost* on SolarReviews reported.

Another option under consideration is placing solar panels on highway noise barriers. A water management agency in the Netherlands installed solar panels on a highway that runs north/south so that panels on both sides of the road can generate electricity as the sunlight changes during the day. The project started with panels placed along 400 meters of the barrier, but the hope is to extend it for hundreds of kilometers, a February 20, 2019 *PV Magazine* *article* reported.

Spain's Port of Valencia has installed solar panels that can be walked as part of its effort to reduce its emissions to zero by 2030. Twenty-four walkable solar tiles were installed over six square meters of area, and they generate enough energy to run a three-person household for half a year, a May 27 Valenciaport *press release* stated. The project is testing both how much electricity the panels can produce and where they can be installed. The "solar floor" was developed by Solum, a startup, which claims that the panels are anti-slip and resistant to loads, impacts, and scratches.

Calendars

US: Thurs: ADP Employment Change 650k, Initial & Continuous Jobless Claims 390k/3.62k, Nonfarm Productivity & Unit Labor Costs 5.5%/-0.4%, ISM NM-PMI 63.0, IHS Markit C-PMI & NM-PMI 68.1/70.1, EIA Natural Gas Inventories, Bostic, Quarles. **Fri:** Payroll Employment Total, Private, and Manufacturing 650k/600k/24k, Unemployment Rate 5.9%, Average Hourly Earnings 0.2%m/m/1.6%y/y, Average Weekly Hours 35.0, Factory Orders -0.2%, Baker-Hughes Rig Count, Powell. (DailyFX estimates)

Global: Thurs: Eurozone, Germany, and France, C-PMIs 56.9/56.2/57.0, Eurozone, Germany, and France NM-PMIs 55.1/52.8/56.6, UK C-PMI & NM-PMI 62.0/61.8, Japan Household Spending -2.2%m/m & 9.3%y/y, Bailey. **Fri:** Eurozone Retail Sales -1.2%m/m/25.5%y/y, Canada Employment Change & Unemployment Rate -20k/8.2%, Lagarde. (DailyFX estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) climbed to 3.25 this week, after falling four of the prior five weeks from 3.81 to 3.07. Bullish sentiment rebounded modestly to 53.6% this week after falling 12.2ppts (to 51.5% from 63.7%) the prior five weeks—with nearly all of the movement occurring between the bullish and correction camps in recent weeks. The correction count slipped to 29.9% this week after jumping 12.1ppts (to 31.7% from 19.6%) the prior five weeks. Meanwhile, bearish sentiment slipped to 16.5% this week from 16.8% last week; it's been fluctuating in a narrow band between 16.5% and 17.2% the past nine weeks. The AAII Ratio continued its up-and-down pattern (prevalent since early March), falling to 58.0% last week after rising from 57.5% to 58.5% the prior week. Bullish sentiment slipped from 37.0% to 36.4% last week, while bearish sentiment ticked up from 26.3% to 26.4%.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin was steady last week at a record high of 12.8%. Since the end of April, it has exceeded its prior record high of 12.4% in September 2018. It's now up 2.5ppts from 10.3% during April 2020, which was the lowest level since August 2013. Forward revenues and earnings also rose again. They've been making new record highs since the beginning of March and for the first time since February 2020. Since the Q2-2020 earnings season came in way better than expected, analysts have been playing catch-up with their lowball estimates from the Covid-19 shutdown. Consensus S&P 500 forecasts had been falling at rates paralleling the declines during the 2008-09 financial crisis. Forward revenues growth rose 0.2pts w/w to a new record high of 9.6%. That's up from 0.2% during April 2020, which was the lowest reading since June 2009. Forward earnings growth gained 0.1ppt w/w to 23.2%. That's just below its 23.9% reading at the end of April, which had been its highest since June 2010 and up substantially from its record low of -5.6% at the end of April 2020. Analysts continue to boost their 2021 forecasts for revenues and earnings growth and the profit margin. They now expect revenues to rise 12.1% in 2021 and 6.6% in 2022 compared to the 2.2% decline reported in 2020. They expect earnings gains of 36.8% in 2021 and 11.8% in 2022 compared to a 13.3% decline in 2020. Analysts expect the profit margin to rise 2.3ppts y/y in 2021 to 12.5%—from 10.2% in 2020—and to improve 0.6ppt y/y to 13.1% in 2022. Valuations ticked up this week for a second week after falling for three weeks. The S&P 500's weekly forward P/E was up 0.3pt to 21.2 and is up from a 28-week low of 20.8 in mid-May. 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 March 2020. The S&P 500 price-to-sales ratio gained 0.05pt to 2.73. That compares to a record high of 2.77 in late April and a 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 nine of the 11 S&P 500 sectors and forward earnings rise for seven sectors. 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. Four sectors are currently at record highs. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (24.3%, a new record high), Financials (19.2, down from a record high 19.3 a week earlier), Communication Services (15.9, matches its prior record high four weeks earlier), Utilities (14.4, down from its 14.8 record high three weeks ago), Real Estate (15.0, down from 17.0), S&P 500 (12.8, a record high), Materials (12.6, a record high), Health Care (11.0, down from 11.2), Industrials (9.4, down from its record high of 10.5% in mid-December), Consumer Staples (7.7, matches its prior high in May 2018), Consumer Discretionary (7.5, down from 8.3), and Energy (6.2, 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, 2020 after 14 weeks of Covid-19-related declines. Forward revenues and earnings have risen 13.1% and 40.8%, respectively, since then to new record highs. The forward profit margin has risen 2.7ppt to 12.8%, which now exceeds its prior record high of 12.4% in late 2018. During the latest week, all but the Utilities sector posted gains to new highs in either their forward revenues, earnings, or profit margin. In the latest week, Tech moved ahead of Communication Services 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 20.4%, forward earnings up 71.7%), Information Technology (18.7, 32.4), Communication Services (18.6, 41.0), Energy (18.3, 1186.7), Industrials (15.5, 47.9), Financials (13.5, 61.9), S&P 500 (13.1, 40.8), Health Care (11.1, 21.9), Consumer Discretionary (7.8, 71.8), Consumer Staples (6.8, 14.5), Real Estate (5.2, 10.8), and Utilities (-1.9, 2.1).

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