MORNING BRIEFING
June 15, 2021

Move Along, Nothing To See

Check out the accompanying chart collection.

(1) Old saying in the pits. (2) Commodity prices providing clearer signal than bond yields. (3) Broken lumber. (4) Dust bowl of 2021? Drought out West getting worse. (5) Chinese fattening up their pigs with US grains. (6) US oil production remains depressed. (7) China tapping on the brakes? (8) Rising commodity prices boosting S&P 500 revenues, earnings, and margins. (9) Strong profits + labor shortages = capital spending boom. (10) Technology production at record high led by computer & peripheral equipment.

Commodity Prices I: Up, Up & Away. There's an old adage in the commodity pits: "The best cure for high commodity prices is high commodity prices." The cure seems to be working in the lumber pit, but not yet in other commodity pits, where prices continue to soar. Fed Chair Jerome Powell is still telegraphing the message "Move along, nothing to see here." Put another way, this too shall pass—as the adage predicts.

The bond market seems to agree, though its pricing mechanism is broken given the tsunami of liquidity provided by the Fed. We discussed this development yesterday in our *Morning Briefing* titled "The Greatest Punchbowl on Earth." We concluded that not only is the Fed keeping markets contented with spiked punch but also supporting them with a tsunami of liquidity. The commodity markets seem to agree. Consider the following:

(1) *Lumber.* The June 11 Bloomberg *reported*: "Lumber futures posted their biggest-ever weekly loss, extending a tumble from all-time highs reached last month as sawmills ramp up output and buyers hold off on purchases." Prices in Chicago fell 18% last week, the biggest decline for most-active futures on record going back to 1986. Lumber has now dropped almost 40% from the record high reached on May 10 (*Fig. 1*). The supply coming out of sawmills is catching up with demand, which has weakened as builders have balked at paying high prices. Building permits, housing starts, and new home sales all have ticked down since peaking earlier this year (*Fig. 2*). Industrial production of wood products now exceeds its pace at the start of last year, just before the pandemic (*Fig. 3*).

(2) *CRB indexes.* The CRB All Commodities spot price index is on the verge of matching its previous record high during 2011, when soaring food prices triggered food riots in the Middle East. It already well exceeds the 2008 peak, when the price of oil spiked close to

$150 a barrel after tripling since early 2007 (*Fig. 4*). The same can be said about the CRB Raw Industrials spot price index, which does not include food or petroleum commodities (*Fig. 5*). However, its metals component is now making record highs, led by its steel component (*Fig. 6*). The prices of copper, tin, and zinc have also been soaring. Among the nonmetal components, burlap and tallow prices are up sharply over the past year. (See our *CRB Raw Industrials Price Index* chart book.)

(3) *Food.* Drought conditions out West are likely to boost food inflation this summer. California is a major producer of fruits and vegetables. Eighty-eight percent of the West was in a state of drought last week, including the entire states of California, Oregon, Utah, and Nevada, according to official data, and one-third of California is experiencing the worst level, "exceptional drought." The drought is affecting more than 143 million Americans. The waters of Lake Mead, the country's largest reservoir, are at their lowest point since the lake was made in the 1930s—representing just 36% of its capacity.

Meanwhile, Chinese demand has fueled a rally in grain markets over the past year and sparked a jump in US grain prices (*Fig. 7*). China imported a record 100 million tons of soybeans last year. Chinese imports of corn also increased, reflecting the rebuilding of capacity to feed the country's pig herds after a disease epidemic. On June 3, the UN's Food and Agriculture Organization announced that its food price index rose in May at its fastest monthly rate in more than a decade, posting a 12th consecutive monthly increase to hit its highest level since September 2011 (*Fig. 8*).

(4) *Oil and gasoline.* Despite the increase in the price of oil over the past year, US oil field production remains around 11mbd, down from 13mbd just before the pandemic (*Fig. 9*). Climate-change activists may be weighing on US oil production, especially after they gained a couple of seats on Exxon's board of directors. Summer oil demand is strong, as Americans have been driving more (*Fig. 10*). Oil prices are likely to move higher.

(5) *Shortages.* Backlogs of manufacturing orders rose to a record high in May (*Fig. 11*). Labor is scarce and getting more expensive. Both job openings and quits are at record highs (*Fig. 12*). Shortages of semiconductors are certainly weighing on global auto production, including in the US (*Fig. 13*). In turn, that might cause the price of copper to peak until auto production picks up.

(6) *China.* The surge in commodity prices has been reflected in China's PPI, which was up 9.0% y/y during May, led by an 18.8% increase in raw materials (*Fig. 14*). The May 23 Bloomberg *reported*: "With global commodities rising to record highs, Chinese government

officials are trying to temper prices and reduce some of the speculative froth that's driven markets. Wary of inflating asset bubbles, the People's Bank of China has also been restricting the flow of money to the economy since last year, albeit gradually to avoid derailing growth. At the same time, funding for infrastructure projects has shown signs of slowing." Maybe so, but Chinese bank loans rose 12.2% y/y to a record high in May (*Fig. 15*).

(7) *Boom-Bust Barometer.* By the way, our Boom-Bust Barometer continues to rebound along with the CRB Raw Industrials spot price index (*Fig. 16*). It's been held back from a full recovery to its pre-pandemic record highs by the slow pace of improvement in initial unemployment claims.

Commodity Prices II: Earnings Bonus. It's widely believed that rising commodity prices are bad for corporate earnings. Rising commodity prices increase costs, which should squeeze profit margins. That makes sense, but that's not what typically happens. Companies can offset the costs of their raw materials by increasing their selling prices or their productivity or both. In the context of the S&P 500, there are plenty of commodity producers that enjoy significant increases in their profit margins when their selling prices soar, as they are doing now. Consider the following:

(1) *Revenues.* The CRB Raw Industrials spot price index is a relatively good leading indicator of S&P 500 aggregate revenues (*Fig. 17*). That makes lots of sense since the revenues of commodity producers are boosted by rising commodity prices.

(2) *Earnings.* The question is whether rising (falling) commodity prices decrease (increase) the profits of commodity users more than they increase (decrease) the profits of commodity producers. The answer for the S&P 500 is that commodity prices—based on the y/y percent change in the CRB Raw Industrials spot price index and the prices-paid index of the M-PMI—are highly correlated with the y/y growth rate of the forward earnings of the S&P 500 (*Fig. 18* and *Fig. 19*).

(3) *Profit margins.* Commodity prices are pro-cyclical, and so is the profit margin for the S&P 500. Among the S&P 500 sectors, Energy and Materials have the most pro-cyclical margins (*Fig. 20* and *Fig. 21*). The forward profit margin of the former rebounded from last year's low of 0.2% to 6.4% during the June 3 week. The profit margin of the latter rebounded from last year's low of 8.8% to 12.6% during the June 3 week.

Here's the performance derby of the forward profit margins of the S&P 500 and its 11 sectors, from their 2020 lows to their latest (June 3) readings: S&P 500 (10.3%, 12.8%), Communication Services (13.2, 15.9), Consumer Discretionary (4.7, 7.6), Consumer Staples (7.2, 7.7), Energy (0.2, 6.4), Financials (13.0, 19.2), Health Care (10.0, 10.9), Industrials (7.3, 9.6), Information Technology (21.6, 24.3), Materials (8.8, 12.6), Real Estate (12.4, 15.0), and Utilities (13.3, 14.6).

Capital Spending: Boosted by Profits Boom & Labor Shortages. The business cycle is driven by the profits cycle. Profitable companies consistently respond to their success by hiring more workers, building more plants, and buying more equipment. Unprofitable companies batten down the hatches. They freeze hiring and fire whomever they can without jeopardizing the business. They restructure their operations to reduce their costs, including divesting or shuttering divisions that are particularly unprofitable. They freeze or slash capital budgets.

Based on real GDP, the economy has fully recovered from last year's pandemic recession. It is now in the expansion phase when many companies expand their payrolls and capacity. However, this time, they are already facing significant shortages of labor. As a result, capital spending is booming as companies strive to boost the productivity of their available labor force. Consider the following:

(1) *Profits boom.* There is a high correlation between the y/y growth rate of capital spending in real GDP and the y/y growth rate of S&P 500 forward earnings. The former was up to 2.9% during Q1 and going higher given that the latter was up to 41.9% through May (*Fig. 22*). The forward earnings growth rate is also highly correlated with the comparable growth rate in nondefense capital goods orders excluding aircraft, which rose 25.2% in April, the highest pace on record (*Fig. 23*).

(2) *CEO confidence.* The CEO Outlook Index compiled by the Business Roundtable rebounded during Q1-2021 to the highest reading since Q3-2018 (*Fig. 24*). It is also highly correlated with the growth rate in real capital spending.

(3) *High on high tech.* We've previously observed that technology now accounts for a record 51% of total nominal capital spending (*Fig. 25*). Industrial production of high-tech equipment soared 12.8% y/y to a record high during April, led by a 32.5% jump in computer & peripheral equipment (*Fig. 26*).

Calendars

US: Tues: Retail Sales Total, Ex Autos & Gas, and Control Group -0.8%/0.3%, Headline & Core PPI 6.3%/4.8% y/y, Empire State Manufacturing Index 22.0, Headline & Manufacturing Industrial Production 0.6%/0.5%, Capacity Utilization 75.0%, Business Inventories -0.1%, NAHB Housing Market Index 83, API Oil Inventories. **Wed:** Housing Starts & Building Permits 1.630mu/1.730mu, Import & Export Price Index 0.8%/0.8%, MBA Mortgage Applications, Crude Oil Inventories, Fed Interest Rate Decision, FOMC Meeting Minutes. (Bloomberg estimates)

Global: Tues: Eurozone Trade Balance Germany CPI 0.5%m/m/2.5%y/y, France CPI 0.1%m/m/1.4%y/y, Italy CPI 0.0%m/m/1.3%y/y, UK Employment Change & Unemployment Rate 150k3m/3m/4.7%, Japan Headline & Core Machinery Orders 8.0%/2.7%China FDI, Bailey. **Wed:** Eurozone Headline & Core CPI 2.0%/0.9% y/y, UK Headline & Core CPI 1.8%/1.5% y/y, UK PPI Input & Output 10.6%/4.5% y/y, Canada Headline & Core CPI 3.5%/2.4% y/y, China Retail Sales 13.6% y/y, China Industrial Production 9.0% y/y, China Fixed Asset Investment 16.9% y/y, Australia Employment Change 30k, Australia Unemployment & Participation Rate 5.5%/66.1%, Lowe. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose for all three of these indexes last week and were at record highs simultaneously for a 14th week and the first time since October 2018. LargeCap's was at a record high for a 15th straight week; MidCap's was at a record for an 18th week; and SmallCap's posted its 18th gain in 19 weeks. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 55 of the past 56 weeks, with the one down week in late December due to Tesla's addition to the index. MidCap's is up in 52 of the past 54 weeks, and SmallCap's posted 52 gains in the past 55 weeks. LargeCap's forward earnings is now up 42.1% from its lowest level since August 2017; MidCap's has risen 80.1% from its lowest level since May 2015; and SmallCap's is up 124.6% from its lowest point since August 2013. These indexes had been on a forward-earnings uptrend from November 2019 until mid-February, before tumbling due to the Covid-19 economic shutdown. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act (TCJA) but began to tumble in October 2018 as y/y comparisons became more difficult. In the latest week, the yearly rate of change in LargeCap's forward earnings ticked down 0.1ppt to 39.8% y/y and is down from a record high of 40.4% at the end of May. That's up from -19.3% in May 2020, which was the lowest since October 2009. The yearly rate of change in MidCap's forward earnings also dropped w/w, but to 75.8% y/y from 78.4%. That's down from a record high of 78.8% at the end of May and up from record low of -32.7% in May 2020. SmallCap's rate fell to 122.0% y/y from a record high of 123.4% a week earlier; it is up from a record low of -41.5% in June 2020. Companies have been easily beating consensus estimates since the Q2-2020 earnings season, causing analysts' y/y earnings growth forecasts for 2021 to improve instead of decline as is typical. Here are the latest consensus earnings growth rates for 2021 and 2022: LargeCap (36.4%, 11.8%), MidCap (58.8, 9.9), and SmallCap (89.8, 17.2).

S&P 500/400/600 Valuation (*link*): Valuations mostly edged up for these three indexes last week from near multi-month lows. LargeCap's forward P/E was steady at 21.2 for a third week, up from a 29-week low of 21.0 three weeks ago. That's down from a 19-year high of 22.7 in early January and is up from 13.3 in March 2020, which was the lowest since March 2013. MidCap's rose 0.1pt to 18.4 from a 30-week low of 18.3, and is down from a seven-month high of 20.5 in early March. Its current level is 4.5pts below its record high of 22.9 in June 2020. SmallCap's ticked up 0.1pt to 18.5, up slightly from a 28-week low of 18.1 four weeks ago. It's now down 8.2pts from its record high of 26.7 in early June 2020. That compares to MidCap's 10.7 and SmallCap's 11.1 in March 2020, which were their lowest readings since March 2009. LargeCap's forward P/E in February 2020—before Covid-19 decimated forward earnings—was 18.9, the highest level since June 2002. Of course, that high was still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's P/E was below LargeCap's P/E yet again last week, as it has been for most of the time since August 2018. In contrast, it was last solidly above LargeCap's from April 2009 to August 2017. SmallCap's P/E was below LargeCap's for a 39th week. That's the longest stretch at a discount since last May and during 2002-03. SmallCap's P/E had been mostly below from May 2019 to May 2020 after being solidly above since 2003. SmallCap's P/E was at a slim 0.1pt premium to MidCap's for a second week. It had been at a discount for two weeks prior for the first time since early January, when it had been at a discount for 10 straight weeks.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Since the Q2-2020 earnings season—which came in substantially better than greatly reduced forecasts—analysts as a whole have been raising their consensus forecasts for all future quarters instead of lowering them as is the norm. In the latest week, the S&P 500's Q1-2021 estimate extended its upside hook another 10 cents to $49.18. That $49.18 estimate for Q1-2021 represents a gain of 48.4% y/y on a frozen actual basis and a 52.7% y/y gain on a pro forma basis. That marks the first quarter of double-digit percentage growth since Q4-2018 and compares to a pro forma 3.8% gain in Q4-2020. Looking ahead to Q2-2021, all 11 sectors are expected to post positive y/y earnings growth, up from 10 during Q1-2021. Here are the S&P 500 sectors' latest expected earnings growth rates for Q2-2021 versus their nearly final Q1-2021 growth rates: Industrials (547.0% in Q2-2021 versus 3.1% in Q1-2021), Consumer Discretionary (240.5, 225.0), Energy (223.1, 27.9), Materials (111.1, 62.3), Financials (99.4, 137.4), S&P 500 (63.6, 52.7), Communication Services (39.9, 53.4), Information Technology (30.1, 44.9), Real Estate (23.8, 5.8), Health Care (11.2, 26.7), Consumer Staples (8.6, 10.4), and Utilities (0.8, -0.9).

Global Economic Indicators

Eurozone Industrial Production (*link*): Output in the Eurozone was within 0.3% of its pre-pandemic level in April, rising for the 11th month since bottoming last April—with production in all but one of the main industrial industries above pre-pandemic levels. Headline production, which excludes construction, climbed 1.2% during the two months through April, reversing February's decline; it is up 39.3% since bottoming last April. Manufacturing output rose 0.9% and 42.3% over the comparable periods to within 1.0% of its pre-pandemic level. All the main industrial groupings—with the exception of consumer nondurable goods (-0.3%)—recorded production gains in April, led by consumer durable goods (3.4%), followed by energy (3.2), capital goods (1.4), and intermediate goods (0.8). Here's a look at how the main industrial groups fared during the 12 months through April and where they stand relative to their pre-pandemic levels: consumer durable goods (+117.3% & +2.8%), capital goods (+65.4 & +0.3), intermediate goods (+38.7 & +0.9), consumer nondurable goods (+15.4 & -2.3), and energy (+14.4 & +2.7). Here's the same exercise for total production among the top four Eurozone economies: Italy (+79.5% & +1.2%), Spain (+50.5 & -0.4), France (+45.0 & -5.5), and Germany (+33.0 & -6.2). April's production numbers were a mixed bag, with Italy (+1.8%) and Spain (+1.1) posting gains, Germany posting a decline (-0.3), and France's measure flat.

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