MORNING BRIEFING
June 17, 2021

Powell, Earnings, FAANGs & Robots

Check out the accompanying chart collection.

(1) Fed's dots paint a new picture. (2) Powell's talking about talking about tapering. (3) Might tapering begin in September? (4) Expecting blockbuster Q2 earnings and record GDP. (5) Post-Covid ad-spending surge helps Facebook and Google. (6) Netflix hurt by competition from Disney and the outdoors. (7) Tech regulatory threats grow. (8) Tech shares no longer leading the market. (9) Welcome to the Fourth Industrial Revolution. (10) Faster and cheaper computers and sensors creating better robots. (11) Robots improve companies' efficiency and productivity.

The Fed: Connecting the Dots. The Federal Open Market Committee (FOMC) released its latest *Summary of Economic Projections* (SEP) yesterday. The most significant change was in the Dot Plot. It now shows seven FOMC participants anticipating at least one rate hike next year—five expecting one hike to 0.25% and two expecting two hikes to 0.50%. The previous Dot Plot, in the March 17 *SEP*, showed three expecting one rate hike next year and one expecting two. The latest Dot Plot still has a majority of 11 participants expecting no change next year.

Another significant change is that the median projections for headline and core PCED inflation for this year were raised from 2.4% to 3.4% and from 2.2% to 3.0%. However, both are expected to cool off to 2.1% in 2022, reiterating the Fed's party line that inflationary pressures should be temporary. The FOMC's *statement* noted: "Inflation has risen, largely reflecting transitory factors."

The statement continued to mention the pandemic as a risk even though vaccines have been widely distributed and seem to be working very well. Meanwhile, the Fed will continue to purchase $120 billion per month in securities "until substantial further progress has been made toward the Committee's maximum employment and price stability goals." This boilerplate language has been in each statement since December 16, 2020 even though real GDP rose during Q1 to a new record high and inflation is clearly running above the Fed's 2.0% target. On the other hand, unemployment remains high, though mostly for reasons that are likely to dissipate in coming months.

During his press conference yesterday, Fed Chair Jerome Powell acknowledged that participants "talked about talking about tapering," and suggested it's time to retire that expression since tapering will likely be talked about at coming meetings. This opens the possibility that the subject will be discussed at the July 27-28 meeting and that tapering of the Fed's asset purchases may possibly start following the September 21-22 meeting.

Earnings: Thinking About Q2. This is mindboggling: Business sales rose 40.0% y/y during April (*Fig. 1*). This suggests that Q1's 11.7% y/y increase in S&P 500 revenues was followed by a much greater increase during Q2. No wonder the stock market is at a record high. The Atlanta Fed's *GDPNow* tracking model estimates that real GDP will be up 10.5% during Q2, placing it above the previous record high during Q4-2019 just before the pandemic. All this suggests that another strong "earnings hook" is likely during the upcoming Q2 earnings reporting season. Consider the following:

(1) *S&P 500 earnings for Q1 and Q2.* There was a huge earnings hook during Q1's earnings reporting season for the S&P 500 companies. The final results exceeded expectations at the start of the season by 23.7%. The growth rate turned out to be 48.4% y/y, well above the pre-season forecast of 20.0%—creating a hook-like pattern in the chart (*Fig. 2*).

As a result of this unforeseen degree of strength in Q1 earnings, industry analysts have been raising their Q2 earnings estimates. They currently expect a 59.7% y/y increase in Q2 earnings. That's up from their estimate of 49.7% just before the start of the Q1 season—making for another pronounced hook.

(2) *S&P 500 sectors' earnings for Q1.* Here are the earnings hooks for the S&P 500 and its 11 sectors during Q1, expressed as percent changes in the expected results at the end of March to the realized results: S&P 500 (23.7%), Communication Services (39.6), Consumer Discretionary (66.0), Consumer Staples (9.0), Energy (29.2), Financials (59.0), Health Care (-7.4), Industrials (19.5), Information Technology (5.0), Materials (3.5), Real Estate (38.0), and Utilities (6.0) (*Fig. 3*).

(3) *S&P 500 sectors' earnings for Q2.* Here are the analysts' consensus Q2 y/y earnings growth expectations for the sectors currently: S&P 500 (59.7%), Communication Services (39.9), Consumer Discretionary (223.1), Consumer Staples (8.6), Energy (returning to a profit), Financials (99.4), Health Care (11.2), Industrials (547.0), Information Technology (30.1), Materials (111.1), Real Estate (23.8), and Utilities (0.8).

(4) *S&P 500 earnings for 2021.* Here are the percent changes in analysts' consensus

expectations for 2021 earnings since the end of last year through the June 10 week: S&P 500 (37.1%), Communication Services (23.6), Consumer Discretionary (69.3), Consumer Staples (7.7), Energy (returning to a profit), Financials (45.6), Health Care (15.6), Industrials (83.0), Information Technology (30.0), Materials (62.5), Real Estate (5.4), and Utilities (1.6) (*Fig. 4*).

Technology: FAANGs Feeling the Heat. Today, let's revisit the original FAANG club, before it turned into the FAAMG club. Facebook (up 23.3% ytd through Tuesday's close) and Google (up 43.9% ytd) have outperformed the S&P 500's 13.1% gain ytd. However, Amazon (up 3.9% ytd), Apple (down 2.4% ytd), and Netflix (down 9.0% ytd) are underperforming the broader market in dramatic fashion. These high-tech shares are being bolstered and dragged down by the mundane: advertising spending, industry competition, and regulatory pressures. (The FAAMG club excludes Netflix and includes Microsoft.)

Here's a look at what's driving the FAANGs:

(1) *It's all about the ads.* Facebook and Google shares are being helped by the expected bounce in ad spending during this post-Covid economic boom. US advertising revenue excluding political advertising is forecast to grow 22% this year, according to a GroupM report cited in a June 14 *WSJ* *article*. The spending is bolstered by US digital advertising, which is forecast to grow 26% this year, up from just 15% estimated in December.

Over just the past decade, the tech giants have risen to dominance in the advertising market. "Last year, the top five ad sellers—Google, Facebook, Amazon, Alibaba and ByteDance—generated $296 billion in ad revenue, or 46% of global ad spending, according to the report. Ten years earlier, the top five ad sellers—Google; Viacom and CBS; News Corp. and Fox; Comcast, and Disney—collected only 17% of global ad spending, GroupM said," the *WSJ* reported.

(2) *Netflix is facing slower growth.* Increased competition, among other factors, has slowed the growth of Netflix. The company faces competition from Disney, Hulu, and HBO. Netflix added 4.0 million subscribers in Q1, missing its own 6 million forecast. Those disappointing results followed an extremely strong 2020, when demand was likely pulled forward by consumers looking for in-home entertainment during the Covid-19 shutdowns. But now with even the New York and California economies back in business, streamers also face competition for consumers' time from the plethora of away-from-home activities that are once again available.

Finally, the streamers are facing internal supply-chain problems. New programming is in short supply because projects were postponed during Covid. But original content should again be available later this year, which could boost sign-ups for streaming services, *The Hollywood Reporter* explained in a June 16 *article*.

(3) *Threat of regulations looms.* Republicans and Democrats have found something on which they can agree: Tech platforms have too much power. In that vein, a bi-partisan group of House lawmakers has put forward bills that could dramatically affect how business gets done by Amazon, Apple, Facebook, and Google.

A June 9 *WSJ article* reported that the bills "would make it unlawful for operators of large platforms to control a business that creates an irreconcilable conflict of interest, to advantage their own products or services over a competitor, and to acquire companies that pose current or potential competitive threats. Another bill targets the budgets of antitrust enforcement agencies, while a fifth requires platforms to make their services interoperable with those of other companies."

If enacted, these bills could affect Amazon's relationship with the sellers on its platform, how Google's ad platform works with YouTube, Facebook users' ability to communicate with people on other platforms, and how Apple operates its app store.

More bad news for the tech titans arrived Tuesday when President Joe Biden appointed Columbia University law professor and outspoken critic of powerful tech companies Lina Khan head of the Federal Trade Commission (FTC) after the Senate's confirmation. Khan believes that too little has been done to "restrain corporate dominance and stop mergers that have eroded competition," a June 15 *WSJ article* reported. "Ms. Khan has reserved her deepest criticisms for dominant tech companies, especially Amazon.com Inc., the subject of a widely read law-review article she wrote while at Yale Law School that argued that antitrust law has failed to restrain the online retailer."

Khan may have to recuse herself from FTC cases against the tech giants, however, because of her past work on the House antitrust investigation of large online platforms, which recommended new laws to restrain these businesses.

Nonetheless, the writing on the wall is clear: The current environment in Washington, DC could prevent the tech giants from making large acquisitions in the upcoming years.

(4) *A tough year for tech.* The threats of higher interest rates, more regulation, and

company-specific items have toppled the S&P 500 Information Technology sector from its frequent perch at the top of the leaderboard. Here's the performance derby for the S&P 500 and its sectors ytd through Tuesday's close: Energy (46.9%), Financials (25.9), Real Estate (23.7), Communication Services (17.9), Materials (16.6), Industrials (16.4), S&P 500 (13.1), Health Care (9.4), Information Technology (9.1), Consumer Discretionary (6.2), Utilities (5.2), and Consumer Staples (4.0) (*Fig. 5*).

Within the Tech sector, the industry leadership has changed, with Communications Equipment up 20.5% ytd, helped by 5G excitement, and Semiconductor Equipment up 33.4%, driven by the need for new semiconductor factories to resolve the shortage of semiconductors. Meanwhile, Applications Software (6.1%), Home Entertainment Software (0.3), and Hardware Software & Peripherals (-0.9) have dragged down the sector's performance.

Apple's 2.3% decline ytd deserves some blame for the negative ytd performance of the Hardware Software & Peripherals industry. It's also the reason why FANG (i.e., Facebook, Amazon, Netflix, and Google without Apple) is up 18.2% ytd while FAANG is up only 3.2% (*Fig. 6*).

Disruptive Technologies: Robots Getting Smarter. Bert, Ernie, Kermit, and Scooter are all being considered for jobs at Amazon's warehouses. We're not talking about Sesame Street Muppets but rather autonomous mobile robots that the tech giant is testing to reduce the strain on its workers, and allow them to focus on activities that require critical thinking.

Ever faster and cheaper computers and sensors have meant that industrial robots are enjoying a renaissance of sorts in what's been dubbed "the Fourth Industrial Revolution." Robots are being created to do advanced work that once was thought only possible to be done by humans. Add software to the mix, and these robots allow companies to both reduce their HR expenses and increase their output, thereby boosting their productivity and bottom lines. And over the past year, as manufacturers have expanded and reshored their operations amid a tight labor market, the importance of robots has only grown.

Let's take a look at some of the companies working to make work easier and more productive in the US and in China:

(1) *Robots that weld.* Path Robotics says that its mission is to enable robots to build so that humans can create. Right now, that means the company has developed robots that can weld.

Most robots are programmed to perform one task repetitively. They're custom made for each client based on what that client is producing. Privately held Path says that its robots are different because they use artificial intelligence and computer vision systems to self-adjust for unique parts, analyze where a weld is needed, and execute a weld. That means the same robot can be used to weld various items for many different clients, which dramatically changes the economics of the business, enabling it to be scaled.

"We started this company looking for the biggest pain point in manufacturing," Path Robotics' CEO Andy Lonsberry said in a May 4 *podcast* with WOSU. They discovered it was welding because there's a shortage of skilled welders that's supposed to reach a 300,000 shortfall by 2024. But there's a shortage of workers in many trades. Just as they learned to weld, Path robots could learn to grind, paint, and assemble—manufacturing operations that occur before and after welding. The company expects to introduce a new product at year-end.

(2) *Robots that manufacture smartly.* Bright Machines has developed a modular system of manufacturing using robots to create what it calls "microfactories." Using software, an operator can tell the machines what to do, and machines can be linked together to do numerous tasks, including assembling, fastening, welding, dispensing, pressing, and labeling. The system can be quickly deployed, and the instructions can be altered by using the software to change what the microfactory does.

Bright Machines, which is in the process of merging with a special-purpose acquisition company, began operations in 2018 and had sales of $34 million last year. On its *website*, the company lists numerous case studies showcasing how much money or labor its product has saved customers. In one example involving an automotive manufacturer, the microfactory reportedly increased unit production by 33% per hour, required only 25% of the human touches that the previous manual process needed, improved defect rates by 88%, and reduced assembly-line staff by 50%.

(3) *Robots that pluck.* Sanderson Farms plans to test robots at a Texas plant that processes chickens weighing nine pounds or more. The company already uses robots at three plants tasked with removing bones from small and medium-sized birds for white meat. It now aims to do the same with the larger birds.

The machines cost $5 million a plant, and they could replace 75 workers per facility. "All of our plants are very tight with labor," CEO Joe Sanderson said in a May 27 Bloomberg *article*. Tightness in US labor markets is keeping a lid on American meat output, he said, tying much of the problem to enhanced unemployment benefits that are keeping some people out of the workforce. “We could hire a bunch of people if we could get them to come to work,” he said.

(4) *Robots that work in China too.* An excess of cheap labor helped China become the manufacturing floor for the world. But the country has seen wages rise, young workers become less interested in factory work, and its working-age population begin a decline that’s expected to continue for many years. As a result, many manufacturers are turning to robots to fill both repetitive jobs and those requiring more skill. And the Chinese government is supporting these efforts. Its Made in China 2025 industrial policy plan provides robotics manufacturers with subsidies, low-interest-rate loans, tax relief, and land rental incentives, a May 27 *South China Morning Post* (*SCMP*) *article* reported.

Like their American counterparts, Chinese companies deploying robots benefit from future cost savings and efficiencies. Midea, a home appliance manufacturer, invested the equivalent of $622 million in machinery for its factory in a city in southern China. The investment raised the factory’s efficiency by 62% and reduced its workforce by 50,000, the *SCMP* article reported. Midea acquired German industrial robot maker Kuka in 2017 for the equivalent of $5.1 billion.

Foxconn, a Taiwanese company, operates a “lights-out” factory in Shenzhen, China, where it produces Apple devices and iPhone components. The fully automated plant is staffed by 5G-powered robots that can operate in the dark because no humans are involved. The factory is on the World Economic Forum’s list of “lighthouse” factories—i.e., those featuring the world’s most advanced technologies.

Calendars

US: **Thurs:** Leading Indicators 1.3%, Initial & Continuous Jobless Claims 359k/3.43m, Philadelphia Fed Manufacturing Index 31.0, Natural Gas Storage. **Fri:** Baker-Hughes Rig Count. (Bloomberg estimates)

Global: **Thurs:** EU Car Registrations, Eurozone Headline & Core CPI 2.0%/0.9% y/y, Japan Core CPI 0.1% y/y, BOJ Rate Decision -0.10%. **Fri:** UK Headline & Core Retail Sales 29.0%/27.3% y/y, BOJ Press Conference. (Bloomberg estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) ticked down to 3.32 this week after climbing the prior two weeks from 3.07 to 3.36. Bullish sentiment dipped to 54.1% after advancing the prior two weeks from 51.5% to 54.5%, while the correction count rose to 29.6% after falling the previous two weeks from 31.7% to 29.3%. Recently, most of the movement has occurred between the bullish and correction camps. Bearish sentiment edged up to 16.3% from 16.2%, fluctuating in a very narrow band the past couple of months. The AAII Ratio continued its up-and-down pattern (prevalent since early March), falling to 66.0% last week after rising from 58.0% to 69.0% the prior week. Bullish sentiment fell to 40.2% after rising from 36.4% to 44.1% the prior week, while bearish sentiment climbed to 20.7% after retreating from 26.4% to 19.8% the previous week.

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 edged down w/w for just the second time this year, but earnings rose yet again. They've both 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 remained steady w/w at 9.2%, down from a record high of 9.6% at the end of May, and should continue to move lower due to base effects. Still, that's up from 0.2% during April 2020, which was the lowest reading since June 2009. Forward earnings growth was steady w/w at 21.2%, and should also move lower due to base effects. That's down from 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. On a positive note, analysts have been raising their 2021 forecasts for revenues and earnings growth and the profit margin. They now expect revenues to rise 12.3% in 2021 and 6.7% in 2022 compared to the 2.2% decline reported in 2020. They expect earnings gains of 37.1% in 2021 and 11.7% 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. The S&P 500's forward P/E was steady for a third week at 21.2, up slightly 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 was steady w/w at 2.72. 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 and earnings rise w/w for eight of the 11 S&P 500 sectors. Six sectors have both their forward revenues and earnings at or near record highs: Communication Services, Consumer Discretionary, Consumer Staples, Health Care, Information Technology, and Materials. Energy, Industrials, and Real Estate have both measures well below record highs. Financials and Utilities have record-high forward earnings, but their forward revenues are lagging. Only three sectors posted a higher profit margin y/y in 2020: Consumer Staples, Tech, and Utilities. For 2021, a y/y improvement is expected for all but two sectors: Real Estate and Utilities. The forward profit margin was at record highs during 2018 for 8/11 sectors, all but Energy, Health Care, and Real Estate. Currently, four sectors are at record highs, down from five in early May. Here's how they rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (24.3%, record high), Financials (19.3, record high), Communication Services (15.9, record high), Utilities (14.6, down from its 14.8 record high in early May), Real Estate (15.2, down from 17.0), S&P 500 (12.8, record high), Materials (12.7, a new record high), Health Care (10.9, down from 11.2), Industrials (9.6, down from its record high of 10.5% in mid-December), Consumer Staples (7.7, matches its prior cyclical high in May 2018), Consumer Discretionary (7.6, down from 8.3), and Energy (6.6, 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 13.8% and 42.4%, 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. Here's how the 11 sectors rank by their changes in forward revenues and forward earnings since May 28, 2020: Materials (forward revenues up 21.4%, forward earnings up 74.8%), Communication Services (19.8, 42.7), Information Technology (19.7, 34.0), Energy (17.8, 1250.2), Industrials (16.7, 52.2), S&P 500 (13.8, 42.4), Financials (13.7, 62.4), Health Care (11.9, 21.6), Consumer Discretionary (9.1, 76.9), Consumer Staples (7.5, 15.4), Real Estate (5.8, 12.9), and Utilities (-2.0, 2.8).

US Economic Indicators

Housing Starts & Building Permits (*link*): Housing starts rebounded in May, while building permits fell; builders' confidence sank to a 10-month low last month as higher costs for lumber and other building materials slowed the pace of homebuilding. May housing starts jumped a smaller-than expected 3.6% to 1.572mu (saar), while April's loss (to -12.1% from -9.5%) was much steeper than previously reported. Starts were at 1.725 mu in March, which was the highest level since mid-2006. Single-family starts advanced 4.2% to 1.098mu (saar), after sliding three of the first four months of the year by 19.9% from December's cyclical peak of 1.315mu (saar). Meanwhile, multi-family starts remain in a volatile flat trend, near the top of the range, climbing 2.4% in May to 474,000 units (saar). Building permits—a good leading indicator of housing starts—have dropped 10.7% during the four months through May, to 1.681mu (saar), since reaching a cyclical high of 1.883mu at the beginning of this year. Single-family permits sank 10.9% over the comparable period to 1.130mu (saar); it was at a cyclical high of 1.268mu in January. Multi-family permits is down 10.4%, to 551,000 units (saar), from January's peak of 615,000 units. NAHB's June's Housing Market Index (HMI) shows builders' confidence slipped to 81, from 83 the prior two months. It's 9 points below November's record high of 90. All the components have been drifting lower, though remain at elevated levels near their November record highs: traffic of prospective homebuyers (to 71 from 77 in November), current sales (86 from 96), and future sales (79 from 89).

Import Prices (*link*): Import prices have heated up over the past six months, climbing 1.1% in May, and 7.4% over the period, with the yearly inflation rate accelerating 11.3%—the fastest pace since 2011. Before turning positive this January (+1.0% y/y), the yearly rate had declined for 11 successive months. Petroleum prices were a big contributor to both the May and six-month gain in overall import prices—climbing 3.8% and 52.4% over the respective periods—as were nonpetroleum prices, which were up 0.9% and 4.4% over the comparable time periods. The rate for industrial supplies & materials imports (54.3% y/y) reached a new record high in May, after turning positive for the first time in a year in January, while the rate for capital goods (1.1% y/y) continues to hold around 1.0%, up from November 2019's bottom of -2.0%. Rates for consumer goods ex autos (0.9% y/y) is moving further into positive territory, while the rate for autos (1.1) remains in a flat trend around 1.0%. Food prices (5.6% y/y) have accelerated sharply recently, though eased a bit from April's 7.9%—which was its highest rate since November 2011; the rate had bounced around zero the past few years. Import prices are accelerating among our trading partners, with May import prices for goods from the EU (6.5% y/y) increasing at the highest rate since October 2011 and China (2.7% y/y) posting its highest yearly gain since February 2012.

The May rate for the NICs (6.7% y/y) was the steepest on record, while the rate for Japan (2.4) recorded its highest rate since November 2011, after hovering around zero early 2019 through the end of last year.

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, 570-228-9102

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