MORNING BRIEFING
June 22, 2021

Looking Under the Hood

Check out the accompanying chart collection.

(1) Will services boom follow goods boom? (2) Fixing up our house. (3) National parks crammed with too many humans seeking communion with nature. (4) Hint of rotation from goods to services in retail sales. (5) US manufacturing has been flatlining since China entered WTO. (6) Lean inventories should continue to boost domestic production and imports too. (7) Light, medium, and heavy trucks are all in high demand. (8) No sign of tech slowdown. (9) Construction industry hitting an affordability wall? (10) Climate-change activists capping oil wells? (11) Defense & space still flying high.

US Economy I: From Goods to Services. While our team at YRI continues to focus on analyzing the latest developments on the inflation front, we don't want to neglect other important issues that are relevant to investors. We sense that investors are becoming increasingly concerned about an abrupt slowing in economic growth.

That may happen soon for goods consumption, assuming that the remarkable strength in this important source of economic growth has been driven by hoarding during the pandemic followed by post-lockdown pent-up demand. Once pent-up demand has been satisfied, there could be a significant drop in demand for durable goods in particular. However, such a decline might simply reflect the fact that people are spending more on services, purchases of which have been more challenged by social-distancing restrictions during the pandemic than purchases of goods.

The Yardeni household repainted the interior of our house during the pandemic. Then we had to order a couple of new couches and chairs for the den and living room to go with the new color of the walls. We refinished the cabinets in our kitchen and purchased a new patio dining set. I think we are done for a while on housing-related purchases of goods. Now that we've spent some bucks on our home, we want to get away from it to go on some vacations.

We would like to go see the national parks, but they are too crowded. America's national parks face a popularity crisis. From 2010 to 2019, the number of national park visitors spiked from 281 million to 327 million, largely driven by social media, advertising, and increasing foreign tourism. More Americans are heading to the parks this year because traveling abroad is still challenging. For the second consecutive year, reservations are required to visit Yosemite, Rocky Mountain, and Glacier national parks. Other popular sites, including Maine's Acadia National Park, encourage visitors to buy entrance passes in advance.

May's retail sales report suggested that the switch from goods to services has started. Retail sales of food services and drinking places rose $14.2 billion (saar) during May, while retail sales excluding this category and gasoline service station sales fell $119.8 billion (*Fig. 1* and *Fig. 2*).

US Economy II: Manufacturing's Fall & Rise. For now, let's take a tour of the national economy, focusing on the latest industrial production data released by the Fed, for May. Before we take a deep dive into the data, let's look at the big picture:

(1) *Capacity.* The Fed's data show that manufacturing capacity in the US rose from 1948 through December 2001 on a trendline with an annual growth rate of 3.9% (*Fig. 3*). China joined the World Trade Organization on December 11, 2001. Since then, manufacturing capacity in the US stopped growing. In fact, in May it was 1.5% below its level during December 2001.

Manufacturing production is much more cyclical than manufacturing capacity, but it follows the same trends. So it too has been essentially flat since December 2001 after rising along with capacity prior to that month (*Fig. 4*). Here are the percent changes in the capacity of selected industries from December 2001 through May of this year: semiconductors (953%), computer & peripheral equipment (182), communications equipment (139), petroleum & coal products (29), motor vehicles & parts (28), aerospace (27), iron & steel (-3), fabricated metal products (-11), chemicals (-11), and textile & mill products (-50). (See our *Manufacturing Production & Capacity by Major Industries*.)

(2) *Inventories.* Even if sales of goods slow, inventories are so low that production should get a boost from inventory restocking. The inflation-adjusted business inventory-to-sales ratio is available through March (*Fig. 5*). It was 1.30 that month, the lowest since February 1973. The ratio for manufacturing is actually up to 1.71 from a recent low of 1.65 at the start of this year (*Fig. 6*). It's back to its pre-pandemic level. However, the latest ratios for wholesalers (1.22) and retailers (1.05) are the lowest since December 2013 and the lowest in the history of the series going back to 1997, respectively.

However, keep in mind that some of that restocking of inventories is likely to be met by imports. Merchandise imports rose $743 billion y/y during April to $2.8 trillion (saar) in current dollars (*Fig. 7*). Over that same period, manufacturing shipments rose $1,286 billion to $5.8 trillion (saar) (*Fig. 8*).

US Economy III: Autos in the Fast Lane. Inventories of motor vehicles are especially low because sales have been booming. They rose to 18.5 million units (saar) during April but declined to 17.1 million during May, probably because of the shortage of inventory (*Fig. 9*). Shortages of parts, especially semiconductors, are weighing on auto production (*Fig. 10*).

Interestingly, inflation-adjusted personal consumption expenditures on new motor vehicles soared 106% y/y during April to a record high and 44% above January 2020 (*Fig. 11*). That strength is attributable to the fact that the rebound in sales over the past year has been led by booming demand for light trucks. Meanwhile, used car prices have been soaring because of a shortage in that segment of the car market as well.

US Economy IV: Buying More Trucks Despite Driver Shortage. There's a shortage of truck drivers, which is forcing trucking companies to boost pay to keep the drivers they have on their payrolls. Truckload carriers—which move trailer-size shipments long distances—are experiencing the industry's most severe driver shortages. The average annual turnover rate for truckload carrier drivers is about 95%.

The pay hikes are prompting many drivers to bounce from company to company and/or to use the larger paychecks to cut down on their driving. Others are opting to work in the construction industry instead, allowing them to go home every day after work.

Yet despite the shortage of drivers, May's medium-weight and heavy-weight truck sales jumped 16.9% m/m and 84.9% y/y to 553,000 units (saar) (*Fig. 12*). That's almost back to the pre-pandemic pace. The ATA truck tonnage index was up 6.7% y/y during April, still below its pre-pandemic record high during August 2019 (*Fig. 13*).

US Economy V: Technology Still Going Strong. The Fed's latest industrial production report shows that May's output of high-tech equipment rose 18.1% y/y, led by a jump of 41.8% in computer and peripheral equipment (*Fig. 14*). Both are at record highs, along with production of semiconductors (15.9%) and communication equipment (12.3). Just as impressive is the 33.6% y/y ascent in consumer-related production of computers, video, and audio equipment (*Fig. 15*).

The pandemic certainly boosted the demand for high-tech products by both businesses and consumers during the pandemic. Yet now that the pandemic is ebbing, there are no signs that this demand is slowing.

US Economy VI: Construction Getting Hammered by Affordability. Labor shortages and rapidly rising costs seem to be weighing on the supply of houses available to meet the demand boom that started last spring as lockdown restrictions were lifted. Everyone got cabin fever during the lockdowns. While some of us found relief by redecorating our cabins, others decided it was time to either buy their first one (rather than continue to rent) or to buy a bigger cabin.

May's industrial production of construction supplies rose 10.2% y/y but edged down 0.2% m/m, remaining just below its pre-pandemic pace (*Fig. 16*). The shortage of inventory of both new and existing homes caused the prices of the latter to jump about 20% y/y, reducing the affordability of home purchases. Not surprisingly, the construction supplies index is highly correlated with the four-week moving average of mortgage applications for new purchases, which was down 22% from the week of January 29 through the June 11 week.

US Economy VII: Energy Getting Turned Off by Climate Activists? The Fed's monthly production index for energy is highly correlated with the weekly US crude oil field production series (*Fig. 17*). The latter remains depressed at 11.1mbd during the June 11 week, well below the pre-pandemic record high of 13.0mbd during the week of January 24. That's even though the price of crude oil has increased 280% from last year's low. The reason may be that climate-change activists are starting to have a significant impact on companies that supply fossil fuels.

US Economy VIII: Defense & Space to Infinity & Beyond. It's too soon to tell what impact the Biden administration will have on the industrial production of defense and space equipment. The Fed's index for this industry rose to a record high during May (*Fig. 18*). The private sector has rapidly become a very big component of the space industry. May the force be with them.

Calendars

US: Tues: Existing Home Sales 5.72mu, Richmond Fed Manufacturing Index, API Weekly Crude Oil Inventories, Powell, Daly. **Wed:** M-PMI & NM-PMI Flash Estimates 61.5/70.0, New Home Sales 875k, Current Account -$206.2b, MBA Mortgage Applications, Crude Oil Inventories, Bowman, Bostic. (Bloomberg estimates)

Global: **Tues:** Eurozone Consumer Confidence -3.0, Japan CPI, BOJ Monetary Policy Meeting Minutes, Ellis. **Wed:** Eurozone, Germany, and France C-PMI Flash Estimates 58.8/57.5/59.0, Eurozone, Germany, and France M-PMI Flash Estimates 62.1/63.0/59.0, Eurozone, Germany, and France NM-PMI Flash Estimates 57.8/55.5/59.4, UK C-PMI, M-PMI, and NM-PMI Flash Estimates, Canada Retail Sales -5.0%, Japan Leading & Coincident Indicators. (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 15th week and the first time since October 2018. LargeCap's was at a record high for a 16th straight week; MidCap's was at a record for a 19th week; and SmallCap's posted its 19th gain in 21 weeks. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 56 of the past 57 weeks, with the one down week in late December due to Tesla's addition to the index. MidCap's is up in 53 of the past 55 weeks, and SmallCap's posted 53 gains in the past 56 weeks. LargeCap's forward earnings is now up 42.5% from its lowest level since August 2017; MidCap's has risen 82.2% from its lowest level since May 2015; and SmallCap's is up 127.1% 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 0.2ppt to 39.6% 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 rose w/w to 76.5% y/y from 75.8%. 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 ticked down 0.1ppt to 121.9% y/y and is down from a record high of 123.4% at the start of June; 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 (36.5%, 11.8%), MidCap (61.0, 9.0), and SmallCap (91.9, 16.5).

S&P 500/400/600 Valuation (*link*): Valuations dropped across the board last week to multi-month lows for these three indexes. LargeCap's forward P/E dropped to an eight-month low of 20.7 from 21.2. 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 tumbled 1.1pt to a 14-month low of 17.3, and is down from a seven-month high of 20.5 in early March. Its current level is 5.6pts below its record high of 22.9 in June 2020. SmallCap's also dropped 1.1pt to a 14-month low, but to 17.4. It's now down 9.3pts 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 40th 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 third 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. Those gains have endured even through the current earnings warnings season, when forecasts typically decline. In the latest week, the S&P 500's Q2-2021 estimate rose 5 cents to $44.74. That $44.74 estimate for Q2-2021 represents a gain of 59.9% y/y on a frozen actual basis and a 64.0% y/y gain on a pro forma basis. That would mark the second straight quarter of double-digit percentage growth and compares to a pro forma 52.8% gain in Q1-2021. Ten of the 11 sectors are expected to post positive y/y earnings growth during Q2-2021, the same as 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 (548.2% in Q2-2021 versus 3.1% in Q1-2021), Consumer Discretionary (244.3, 225.1), Energy (223.1, 27.9), Materials (113.3, 62.3), Financials (99.5, 137.9), S&P 500 (64.0, 52.8), Communication Services (39.8, 53.4), Information Technology (31.0, 44.9), Real Estate (24.3, 5.8), Health Care (11.3, 26.7), Consumer

Staples (8.8, 11.1), and Utilities (-0.1, -0.9).

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