MORNING BRIEFING
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Peak Earnings Growth & Biden's Competition Plan

Check out the accompanying chart collection.

(1) Q2 marks peak earnings growth for current cycle. (2) M-PMI dips in June, but still signals earnings growth ahead. (3) As earnings growth slows, so may stock gains. (4) Federal agencies get Biden's marching orders on boosting business competition. (5) Tech, healthcare, agriculture, and transportation industries are among those targeted. (6) Stocks shrug off threat of increased regulations. (7) Meet the progressive lawyers with their fingerprints on Biden's plans. (8) Small electric airplanes taking flight.

Strategy: Peak Earnings Growth. Industry analysts are currently estimating that S&P 500 operating earnings per share rose 61.6% y/y during Q2, up from 48.3% during Q1 (*Fig. 1* and *Fig. 2*). That undoubtedly will be the peak growth rate for earnings for a while. The analysts are currently estimating that earnings growth will fall to 23.2% during Q3 and 17.1% during Q4. I asked Joe to run a few charts showing the relationship of the earnings growth cycle (on a y/y basis) to various stock-market-related variables. Consider the following:

(1) *Forward earnings.* Joe and I often have observed that S&P 500 forward earnings—i.e., the time-weighted average of consensus estimates for this year and next year—tends to be an excellent 12-month-ahead leading indicator of actual earnings (*Fig. 3*). So we aren't surprised to see that the cycles in both tend to coincide (*Fig. 4*). During June, forward earnings rose 41.3% y/y, slightly exceeding the peak growth rate following the Great Recession. Odds are that this growth rate will decline over the rest of this year through next year, as it has during previous cycles.

(2) *Net Earnings Revisions Index (NERI).* During the current and past five earnings growth cycles, the S&P 500's NERI tended to turn increasingly negative in the months before the earnings cycle's trough, and then bottom a few months after the trough (*Fig. 5*). NERI would then turn less negative and increasingly positive until it peaked at about the same time as the earnings growth cycle peaked. Admittedly, this is a stylized interpretation of the data, which show some variability around this narrative. NERI probably peaked at 22.5 during June.

(3) *M-PMI.* Interestingly, the growth cycle in the S&P 500 operating earnings per share is

very highly correlated with the M-PMI (*Fig. 6*). The M-PMI peaked at a 64.7 during March and fell to 60.6 during June. This confirms that earnings growth peaked during Q2.

(4) *Stock prices.* Not surprising is that the earnings growth cycle affects the S&P 500 stock price index (*Fig. 7*). This is especially easy to see when we focus on the yearly percent change in the S&P 500 stock price index (*Fig. 8*). The obvious conclusion is that stock market gains should continue for the time being but at a slower pace as earnings growth slows.

(5) *Investment styles.* The data since the late 1990s show that the S&P 500 Growth stock price index tends to outperform S&P 500 Value stock price index during periods of accelerating earnings growth (*Fig. 9*). The results are mixed during periods of decelerating earnings growth.

(6) *The peak*. As of yesterday, Joe reports the following consensus expected earnings growth rates for the S&P 500 and its 11 sectors during Q2: S&P 500 (61.6%), Communication Services (40.0), Consumer Discretionary (273.3), Consumer Staples (10.2), Energy (223.5), Financials (102.9), Health Care (10.6), Industrials (570.7), Information Technology (31.7), Materials (116.0), Real Estate (25.1), and Utilities (-1.2).

Politics I: Biden Orders Up Competition. Last Friday, President Joe Biden rolled out an *Executive Order* directing government agencies to write new rules to increase business competition throughout the American economy. The rules would target noncompetitive areas within technology, telecommunications, health care, transportation, finance, and agriculture. The Biden administration believes that these changes will result in falling prices for families and rising wages for workers, while fostering innovation and economic growth.

Stocks shrugged.

The next few trading days saw only one sector lose any ground. Despite the tough talk coming from the Oval Office, the stock market has rallied since President Biden's election, helped by massive fiscal and monetary stimulus and the reopening of the US economy.

Investors may have taken the news in stride because it could take years for the impact of the Executive Order to be felt. Its influence will depend on how hard government agencies push to implement the order and the legal challenges brought by affected companies. Also, the rule changes could be reversed by the next President.

A *fact sheet* on the Executive Order released by the White House recaps the massive changes President Biden hopes to make to American industry. Let's take a look:

(1) *Technology.* "The American information technology sector has long been an engine of innovation and growth, but today a small number of dominant Internet platforms use their power to exclude market entrants, to extract monopoly profits, and to gather intimate personal information that they can exploit for their own advantage. Too many small businesses across the economy depend on those platforms and a few online marketplaces for their survival. And too many local newspapers have shuttered or downsized, in part due to the Internet platforms' dominance in advertising markets," the Executive Order states.

The administration would like to see greater scrutiny of acquisitions made by the Internet platform companies. The Federal Trade Commission (FTC) is directed to regulate the surveillance and accumulation of data, bar unfair methods of competition on Internet marketplaces, and allow people to repair technology devices they own. Targeted companies could include Amazon's marketplace, Apple's app store, and data collection by Facebook and Google.

The technology companies are also under attack by Congress, the states, the FTC, the Department of Justice (DOJ), and the European Union. The US House of Representatives has passed the Ending Platform Monopolies Act, which would require the structural separation of big tech companies. It would prohibit the platform companies from owning businesses that create conflicts of interest and allow them to give their own products advantages over competitors'. The act would also force online platforms to make their services interoperable with competitors'. Mergers of rivals or potential rivals would be illegal, and the bill would raise merger filing fees for deals valued at more than $1 billion and lower them for transactions under $500,000.

Lawsuits abound. Google is being sued by 10 states. It's accused of running an illegal digital advertising monopoly and enlisting Facebook in a deal to rig ad actions. The DOJ has sued Google, accusing the company of anticompetitive tactics to preserve a monopoly for its search engine business. The FTC has sued Facebook, accusing it of buying or freezing out small startups to stop competition. Facebook also has been sued by 46 states, the District of Columbia, and Guam, which claim that a lack of competition has hurt consumers.

(2) *Telecommunications.* "In the telecommunications sector, Americans likewise pay too much for broadband, cable television, and other communications services, in part because

of a lack of adequate competition," the Executive Order states.

So the Biden administration has asked the Federal Communications Commission to regulate pricing disclosures, ban excessive early contract termination fees, and ban the exclusivity deals between Internet providers and landlords that give tenants only one Internet option. The order also calls for the reinstatement of the net neutrality rules first enacted under the Obama administration. Those rules require Internet providers to give all Internet companies equal access to the Internet.

(3) *Banking.* "In the financial-services sector, consumers pay steep and often hidden fees because of industry consolidation," the Executive Order states.

Consumer Financial Protection Bureau is encouraged to issue new rules allowing customers to download their banking data to make it easier and cheaper to switch banks. The Biden administration also asks the DOJ and banking regulators to update guidelines on bank mergers and scrutinize them more robustly.

(4) *Healthcare.* "Americans are paying too much for prescription drugs and healthcare services—far more than the prices paid in other countries. Hospital consolidation has left many areas … with inadequate or more expensive healthcare options. And too often, patent and other laws have been misused to inhibit or delay …competition from generic drugs and biosimilars, denying Americans access to lower-cost drugs," the Executive Order states.

To rectify this, the Biden administration directs the Department of Health and Human Services (HHS) to fight high prescription drug prices and support lower-cost generic drugs. It directs the Food and Drug Administration to support state and tribal programs that will import safe and cheaper drugs from Canada. And it encourages the FTC to ban "pay for delay" arrangements whereby brand-name drug manufacturers pay generic manufacturers to stay out of the market. Such arrangements raise drug prices by $3.5 billion a year.

The order allows the over-the-counter sale of hearing aids. It also asks the DOJ and FTC to review and revise hospital merger guidelines. It asks the HHS to support hospital price transparency rules and standardize health insurance plan options in the National Health Insurance Marketplace to facilitate comparison shopping.

(5) *Agriculture.* "Consolidation in the agricultural industry is making it too hard for small family farms to survive. Farmers are squeezed between concentrated market power in the agricultural input industries—seed, fertilizer, feed, and equipment suppliers—and

concentrated market power in the channels for selling agricultural products. As a result, farmers' share of the value of their agricultural products has decreased, and poultry farmers, hog farmers, cattle ranchers, and other agricultural workers struggle to retain autonomy and to make sustainable returns," the Executive Order states.

The Biden administration asks the US Department of Agriculture (USDA) to issue new rules to make it easier for farmers to bring and win claims that would preserve fair competition and trade. It also strengthens the USDA's ability to stop the abusive practices of some meat processors, like the underpayment of and retaliation against chicken farmers. The Executive Order directs the USDA to allow the "Product of USA" label on meat only if the product is grown in the US, not simply processed here. And finally, the order encourages the FTC to require that equipment manufacturers allow farm equipment to be repaired by independent repair shops or by the farmers.

(6) *Transportation.* "[T]he global container shipping industry has consolidated into a small number of dominant foreign-owned lines and alliances, which can disadvantage American exporters," the Executive Order states. In 2000, the 10 largest shipping companies controlled 12% of the market, and today their market share is 80%. Likewise, the top four commercial airlines control nearly two-thirds of the domestic market, and the number of railroads has shrunk to seven compared to 33 back in 1980.

So the administration asks the Department of Transportation to issue rules requiring better disclosure of airline fees and easier ability to get refunds and comparison shop by requiring clear upfront disclosure of add-on fees. The Surface Transportation Board is tasked with requiring railroad track owners to provide rights of way to passenger rail and to treat other freight companies fairly. Finally, the order asks the Federal Maritime Commission to "ensure vigorous enforcement against shippers charging American exporters exorbitant charges."

(7) *Labor.* The Executive Order would ban or limit non-compete agreements and unnecessary occupational licensing requirements. It would prevent employers from collaborating to suppress wages or reduce benefits by sharing wage and benefit information. Separately, Biden has asked Congress to pass the Protecting the Right to Organize Act, which gives workers the choice to join a union and collectively bargain.

Politics II: The Enforcers. President Biden has chosen two progressive law professors from Columbia University to lead his efforts to increase competition throughout American business. In March, President Biden appointed Tim Wu, Columbia's Julius Silver Professor of Law, Science and Technology, as special assistant to the President for technology and

competition policy in the White House National Economic Council. Wu is believed to be a key architect of the Executive Order. The President also appointed Lina Khan, an associate professor of law at Columbia, to chair the FTC.

Both lawyers believe that antitrust actions should focus on the size of a company and an industry's level of concentration rather than the previous focus on harm to consumers. It's a philosophical change that will need to gain acceptance for antitrust actions to succeed in the Internet age, when most services are free to consumers. The two also crossed paths when Khan was a campaign staffer on Wu's unsuccessful run for the Democratic nomination as lieutenant governor of New York in 2014. Let's take a quick look at these key players:

(1) *Wu and net neutrality.* Wu is known for "coining the term net neutrality in 2002 and championing equal access to the Internet," Columbia's *website* states. Wu worked in the Obama administration where he and others "called for a new office at the White House that would pressure federal agencies to promote competition," a July 9 *WSJ* *profile* of him stated. And in his 2018 book, *The Curse of Bigness*, "he argued that unrestricted economic concentration was increasing income inequality and threating democracy itself," the *WSJ* article stated.

(2) *Khan and online platforms.* Khan is well known for her article "Amazon's Antitrust Paradox," which argued that antitrust law has not restrained the online retailer. She also served as counsel to the US House Judiciary Committee's Subcommittee on Antitrust, Commercial, and Administrative Law. "She was a House staffer on a congressional antitrust panel that conducted a 16-month investigation of large online platforms and last year recommended that lawmakers take steps to rein them in. She served as legal director of the Open Markets Institute, a group that favors aggressive trustbusting," a May 23 *WSJ* *profile* of her stated.

Both Amazon and Facebook have asked for Khan's recusal from the FTC's considerations concerning the companies. "When a new commissioner has already drawn factual and legal conclusions and deemed the target a lawbreaker, due process requires that individual to recuse herself," Facebook said in a petition cited in a July 14 *WSJ* *article*. During her confirmation hearing, Khan said she would defer to FTC ethics officials if a recusal request arose.

The FTC is currently deciding whether to file a new antitrust case against Facebook, conducting an antitrust investigation into Amazon, and reviewing Amazon's proposed acquisition of MGM.

Disruptive Technologies: Electric Planes Take Flight. Battery-powered flight received a strong endorsement from United Airlines Ventures on Tuesday. The investment arm of United Airlines, Breakthrough Ventures and Mesa Airlines announced they had invested in Heart Aerospace, which is designing an electric battery-powered airplane. Heart raised a total of $35 million in this funding round, a July 13 *WSJ* *article* reported.

The Swedish company has developed a 19-seat plane that "has the potential" to fly up to 250 miles on electric batteries. United and Mesa have also agreed to each buy 100 of these aircraft, subject to it meeting safety requirements. The planes are expected to hit the market "as early as" 2026 and could be used on more than 100 of United's regional routes, a July 13 *press release* stated. Like electric cars, the electric plane is expected to be less expensive to operate than traditional aircraft.

There has been a lot of activity in electric aviation. Rolls Royce is testing the Spirit of Innovation, which it *says* will be the world's fastest electric plane, able to fly 292 miles on a charge. American Airlines, Virgin Atlantic, and Avolon have made preliminary commitments to buy from Vertical Aerospace up to 1,000 electric air taxis able to fly for more than 100 miles at 200 miles per hour and carry five people. And Israel-based Eviation plans the first test flight later this year of its nine-passenger aircraft that's expected to fly roughly 500 miles.

Calendars

US: **Thurs:** Headline & Manufacturing Industrial Production 0.6%/0.2%, Capacity Utilization 75.6%, Initial & Continuous Jobless Claims 360k/3.31m, Empire State Manufacturing Index 18.0, Philadelphia Fed Manufacturing Index 28.0, Import & Export Prices 1.2%/1.2%, Natural Gas Storage, OPEC Monthly Report, Powell, Evans. **Fri:** Retail Sales Total, and Core -0.4%/0.4%, Consumer Sentiment Headline, Current Situation, and Expectations 86.5/90.2/85.0, Business Inventories 0.5%, Baker/Hughes Rig Count. (Bloomberg estimates)

Global: **Thurs:** Italy CPI 0.1%m/m/1.3%y/y, UK Employment Change & Unemployment Rate 90k3m/3m/4.7%, BOE Credit Conditions Survey, BOJ Monetary Policy Statement. **Fri:** EU Car Registrations, Eurozone Headline & Core CPI 1.9%/0.9% y/y, BOJ Rate Decision -0.10%. (Bloomberg estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) advanced this week for the sixth time in seven weeks, from 3.07 to 4.00 over the period—the highest since late January 2018. Bullish sentiment climbed 9.7ppts (to 61.2% from 51.5%) over the period, while the correction count fell 8.2ppts (to 23.5% from 31.7%). Meanwhile, bearish sentiment slipped for the second week to 15.3% this week—the fewest bears since early 2018—after climbing from 15.8% to 16.2% the previous week. Before the recent up-and-down movements, bearish sentiment had fluctuated in a narrow band (from 16.2% to 17.5%) the prior couple of months. The AAII Ratio slipped to 62.1% last week after climbing the prior two weeks from 61.1% to 68.7%, as bearish sentiment rose from 22.2% to 24.5% and bullish sentiment fell from 48.7% to 40.2%.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin dropped 0.1ppt last week to 12.9% from a record high of 13.0%. Since the end of April, it has exceeded its prior record high of 12.4% in September 2018. It's now up 2.6ppts from 10.3% during April 2020, which was the lowest level since August 2013. Forward revenues and earnings both rose w/w. 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 was steady w/w at 8.9%. That's 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 unchanged w/w at 19.6%, and should also continue to 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 continue to raise their 2021 forecasts for revenues and earnings growth and the profit margin. They now expect revenues to rise 12.6% in 2021 and 6.7% in 2022 compared to the 2.1% decline reported in 2020. They expect earnings gains of 38.0% in 2021 and 11.6% in 2022 compared to a 13.2% decline in 2020. Analysts expect the profit margin to rise 2.2ppts y/y in 2021 to 12.5%—from 10.3% in 2020—and to improve 0.6ppt y/y to 13.1% in 2022. The S&P 500's weekly reading of its forward P/E rose 0.3pt to a 10-week high of 21.6. 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

weekly price-to-sales ratio ticked up 0.02pt w/w to a new record high of 2.78. That compares to 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 for all 11 S&P 500 sectors and forward earnings rise for seven 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 still have both measures well below record highs. Financials and Utilities have forward earnings at or near record highs, 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, five sectors are at record highs. 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 (19.2, down from a record 19.3 in early June), Communication Services (15.9, record high), Utilities (14.5, down from its 14.8 record high in early May), Real Estate (15.3, down from 17.0), the S&P 500 (12.9, down from a record high 13.0 a week earlier), Materials (12.9, a new record high), Health Care (10.9, down from 11.2), Industrials (9.7, 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 (7.8, down from 8.3), and Energy (7.1, 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 15.0% and 44.7%, respectively, since then to new record highs. The forward profit margin has risen 2.8ppt to 12.9%, down from a record high 13.0% a week earlier but still exceeding its prior record high of 12.4% in late 2018. During the latest week, all 11 sectors 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 22.7%, forward earnings up 79.9%), Information Technology (21.1, 35.5), Communication Services (21.0, 44.2), Energy (19.4, 1372.1), Industrials (18.3, 56.9), S&P 500 (15.0, 44.7), Financials (14.6, 62.8), Health Care (12.5, 22.6), Consumer Discretionary (10.9, 83.7), Consumer Staples (8.3, 16.1), Real Estate (6.4, 14.8), and Utilities (-0.9, 3.3).

US Economic Indicators

Producer Price Index (*link*): The producer price index for final demand increased 1.0% in June after gains of 0.8% and 0.6% the prior two months; it began 2021 with a record 1.2% monthly gain. Final demand goods posted its fifth monthly gain above 1.0% this year, climbing 1.2% in June following May's 1.5% advance. Nearly 60% of June's gain was attributed to final demand goods ex food & energy, which climbed 1.0%. Meanwhile, prices for final demand services increased 0.8% in June after climbing 0.6% in each of the prior two months. The yearly rate for final demand accelerated for the fifth month, jumping a record 7.3% y/y; the rate was at only 0.8% at the end of last year. There was deflation in the yearly rate from April through August of last year. Boosting the overall rate was a record 11.7% y/y jump in final demand goods; it was negative from March through November of 2020. The yearly rate for final demand services also rose at a record pace, up 5.2% y/y; it has averaged monthly gains of 0.6% during the first half of this year. In the meantime, yearly rates for pipeline prices continued to soar further into positive territory after negative readings most of last year. Intermediate prices jumped 22.5% y/y—the highest since the mid-1970s, after posting its first positive reading in December since spring 2019, accelerating steadily since hitting bottom at -7.7% last April. The price of crude rose 53.5% y/y, easing slightly from April's 57.8%—which was the highest since the mid-1970s—turning positive in November (0.5%) for the first time since December 2018; it hit bottom at -28.6% last April.

Global Economic Indicators

Eurozone Industrial Production (*link*): Headline production in the Eurozone, which excludes construction, fell 1.0% in May after climbing 1.1% during the two months through April to within 0.4% of its pre-pandemic level. Only consumer durable goods production (+1.6%) was in the plus column in May, while consumer nondurable goods (-2.3), energy (-1.9), capital goods (-1.6), and intermediate goods (-0.2) output were all in the red—after sizeable gains in April. Manufacturing production contracted 0.8% in May after a two-month gain of 1.2%; it's within 1.4% of its pre-Covid level. Here's a look at how the main industrial groups fared since bottoming last April and where they stand now relative to their pre-pandemic levels: consumer durable goods (+119.6% & +4.3%), capital goods (+61.4 & -1.7), intermediate goods (+38.2 & +0.8), consumer nondurable goods (+14.8 & -2.2), and energy (+11.2 & -0.2). Here's the same exercise for total production among the top four Eurozone economies: Italy (+75.0% & -0.8%), Spain (+47.8 & -1.5), France (+44.7 & -5.7),

and Germany (+33.2 & -6.3). For the month of May, all four were in the red: Italy (-1.5%), Spain (-0.8), Germany (-0.6%), and France (-0.3).

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