



MORNING BRIEFING

July 27, 2021

Hot Metals

Check out the accompanying [chart collection](#).

(1) Commodity price indexes at or near record highs. (2) Metals prices are mostly still red hot. (3) Easy money can explain high commodity prices and low bond yields. (4) Rising commodity prices tend to boost S&P 500 revenues and earnings. (5) Earnings Confidence Index is making a comeback. (6) Regional business surveys still finding strong growth and plenty of inflationary pressures. (7) More upside in leading indicators. (8) LEI/CEI ratio tracks S&P 500 profit margin.

Commodities: Still Flying. Sir Richard Branson and Jeff Bezos aren't the only ones going vertical into outer space lately. The CRB raw industrials spot price index has been doing so since it bottomed on April 21 last year ([Fig. 1](#)). Unlike the two billionaires who have returned safely back to the Planet Earth, the index is still heading higher. On Friday, it was only 3.2% below its record high during April 11, 2011. The metals subindex has been rising in record-high territory since May 4 ([Fig. 2](#)).

You might be wondering how this is possible given that the price of copper has been looking toppy in recent days ([Fig. 3](#)). Copper's price action makes sense given that global auto production has been held down by a shortage of semiconductors ([Fig. 4](#) and [Fig. 5](#)). The prices of tin and steel remain stratospheric. The prices of lead and zinc remain on solidly upward trajectories ([Fig. 6](#)).

The strength in commodity prices certainly is at odds with the weakness in bond yields. The former suggests that the global economy is booming, while the latter suggests it is slowing significantly. The divergence makes more sense in light of the extraordinarily easy monetary policies of the major central banks ([Fig. 7](#)). Easy money is boosting commodity prices while keeping a lid on bond yields. This certainly explains the divergence since the start of the pandemic between the 10-year US Treasury bond yield and the ratio of the prices of copper to gold ([Fig. 8](#)).

Meanwhile, notwithstanding the bottlenecks depressing production of autos, Markit's July M-PMIs remained elevated for the US (63.1), the Eurozone (62.6), and Japan (52.2), according to flash estimates ([Fig. 9](#)).

The CRB raw industrials spot price index does not include petroleum products, lumber, and food commodities. Their prices have been weak recently. However, even the S&P GSCI commodity index—which was originally constructed by Goldman Sachs and is the broadest measure of commodity prices—remains near its recent post-pandemic highs ([Fig. 10](#)).

Needless to say, if the Biden administration succeeds in getting a multi-trillion-dollar infrastructure spending plan through Congress, that would be bullish for many industrial commodities.

Strategy: Earnings Confidence Is Back. 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. 11](#)). That makes lots of sense since the revenues of commodity producers are boosted by rising commodity prices.

(2) *Earnings*. The growth rate of S&P 500 forward earnings, on a y/y basis, is highly correlated with the y/y percent change in the CRB raw industrials spot price index ([Fig. 12](#)). The former is up 38.9% through the July 22 week, while the latter was up 43.3% through the July 20 week. Both series are probably peaking, but they should continue to increase for the foreseeable future at slower rates.

(3) *Earnings Confidence Index*. This outlook is confirmed by the S&P 500 Earnings Confidence Index (ECI) that Joe constructs ([Fig. 13](#)). Our ECI is 100 minus the percent spread of 12-month forward earnings forecasts within one standard deviation of the mean. It had peaked at a record-high 96.2 just before the pandemic during the week of February 13, 2020. It plunged to an 11-year low of 86.5 during the week of April 9, 2020. Since then, it has rebounded to 93.8 during the July 15 week, the same level as its historical average since 1985.

Joe also constructed similar “squiggles” indexes for each year since 2008 ([Fig. 14](#)). During normal times, the ECI for each year tends to start the year around 95 or so and rise above 98 by the end of the year. The current year's ECI is still around 95, while next year's is at

93. Meanwhile, forward earnings rose to yet another new record high during the July 22 week.

US Economy: Surveys Still Seeing Inflationary Economic Boom. Investors continue mostly to ignore the strength in the commodity pits, while fretting about whether the recent decline in the bond yield signals an imminent economic slowdown. Another massive fiscal stimulus package in connection with Biden's Build-Back-Better infrastructure plan could quickly bring back inflation-higher-longer concerns. Meanwhile, the latest batch of economic indicators suggests that the economy is still booming and that inflationary pressures remain hot:

(1) *Regional business surveys.* Four of the five regional business surveys conducted by the Federal Reserve Banks are available through July ([Fig. 15](#)). The average of the composite business indicators, the new orders indexes, and the employment indexes all rose back toward recent record highs.

(2) *Regional price surveys.* Among the four available business surveys, the prices-paid indexes all down ticked from last month but remained near their respective recent record highs ([Fig. 16](#)). The prices-received indexes were mixed but all clustered around their recent record highs.

(3) *Leading indicators.* As Debbie discussed in yesterday's [Morning Briefing](#), the Index of Leading Economic Indicators (LEI) continues to point north ([Fig. 17](#)). It rose 0.7% m/m and 12.0% y/y during June to a record high ([Fig. 18](#)). The Index of Coincident Economic Indicators (CEI) rose 0.4% m/m during June but is still 1.8% below its record high during February 2020.

We've found that the ratio of the LEI to the CEI is highly correlated with the resource utilization rate, which is the average of the capacity utilization rate and the employment rate ([Fig. 19](#)). So it isn't surprising that it is also highly correlated with the S&P 500 operating profit margin ([Fig. 20](#)).

The S&P 500 quarterly operating profit margin rose to a record high of 13.5% during Q1. It is available since 1993. The LEI/CEI ratio, which is available since 1959, suggests that the profit margin tends to bottom during recessions and peak during economic booms. The latest data suggest that we are already in an inflationary boom. If so, then the upside in the profit margin may be limited from here.

Calendars

US: Tues: Consumer Confidence 124.1, Durable Goods Orders 2.1%, Nondefense Capital Goods Orders Ex Aircraft 0.5%, Richmond Fed Manufacturing Index, S&P/CS HPI 20 City Composite Index 1.5%*m/m*/16.3%*y/y*, Weekly Crude Oil Inventories, Kuroda. **Wed:** Goods Trade Balance Advance, Retail & Wholesale Inventories, MBA Mortgage Applications, Crude Oil Inventories, FOMC Interest Rate Decision 0.25%, FOMC Press Conference. (Bloomberg estimates)

Global: Tues: Australia CPI 3.8% *y/y*. **Wed:** Germany Consumer Climate 1.0, France Consumer Confidence 102.0, 11UK HPI 0.6%*m/m*/12.1%*y/y*, Canada Headline & Core CPI 3.2%/2.4% *y/y*. (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 20th week and the first time since October 2018. LargeCap's was at a record high for a 21st straight week; MidCap's was at a record for a 24th week; and SmallCap's posted its 24th gain in 26 weeks. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 61 of the past 62 weeks, with the one down week in late December due to Tesla's addition to the index. MidCap's is up in 58 of the past 60 weeks, and SmallCap's posted 58 gains in the past 61 weeks. LargeCap's forward earnings is now up 45.9% from its lowest level since August 2017; MidCap's has risen 86.9% from its lowest level since May 2015; and SmallCap's is up 133.3% 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 dropped to 38.9% *y/y* from 39.6% 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 fell 2.3ppt *w/w* to 69.4% *y/y*. 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 dropped 1.3ppts to 117.1%; it's down from a record high of 124.2% in late June and 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 (39.2%, 10.5%), MidCap (63.8, 9.1), and SmallCap (94.4, 16.4).

S&P 500/400/600 Valuation ([link](#)): Valuations moved higher for all three of these indexes last week, and were up slightly from 15-month lows for the SMidCaps. LargeCap's forward P/E gained 0.2pt to 21.4 and remains above its eight-month low of 20.7 during mid-June. That compares to 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 0.3pt w/w to 17.3 from a 15-month low of 17.0. That's down from a seven-month high of 20.5 in early March and is 5.7pts below its record high of 22.9 in June 2020. SmallCap's edged up 0.2pt w/w to 16.8 from a 15-month low of 16.6. It's now down 9.9pts from its record high of 26.7 in early June 2020. During March 2020, MidCap's 10.7 and SmallCap's 11.1 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 43rd week. That's the longest stretch at a discount since last May and during 2002-03. SmallCap's P/E had been mostly below LargeCap from May 2019 to May 2020 after being solidly above since 2003. SmallCap's P/E was at a discount to MidCap's for a fifth straight week. It had been at an atypical discount to MidCap around the start of the year 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 earnings warnings season, when forecasts typically decline. In the latest week, the S&P 500's Q2-2021 blended estimate rose \$0.99 to \$47.43 due to positive earnings surprises. That \$47.43 estimate for Q2-2021 represents a gain of 69.5% y/y on a frozen actual basis and a 78.1% 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. All 11 sectors are expected to post positive y/y earnings growth during Q2-2021, up from 10 during Q1-2021.

Here are the S&P 500 sectors' latest expected earnings growth rates for Q2-2021 versus their final Q1-2021 growth rates: Industrials (603.9% in Q2-2021 versus 3.0% in Q1-2021), Consumer Discretionary (292.6, 226.1), Energy (224.7, 28.0), Financials (147.6, 138.0), Materials (126.0, 62.4), S&P 500 (78.1, 52.8), Communication Services (44.6, 53.1), Information Technology (33.9, 44.9), Real Estate (26.2, 5.8), Health Care (18.8, 26.7), Consumer Staples (13.6, 11.1), and Utilities (0.3, -0.9).

S&P 500 Q2 Earnings Season Monitor ([link](#)): With 25% of S&P 500 companies finished reporting revenues and earnings for Q2-2021, revenues are beating the consensus forecast by a well-above-trend 4.0%, and earnings have exceeded estimates by 17.5%. At the same point during the Q1 season, revenues were 2.9% above forecast and earnings beat by 23.3% in large part due to reversals of loan loss reserves at the banks. At first glance, the S&P 500's earnings surprise appears to have weakened q/q, but is actually about the same excluding the Financials. The S&P 500's Q2 earnings surprise excluding Financials is 12.1% compared to 12.2% during Q1. For the 124 companies that have reported Q2 earnings through mid-day Monday, the aggregate y/y revenue and earnings growth rates and the percentage of companies reporting a positive revenue and earnings surprise have improved significantly from their Q1 measures due to the low base a year earlier when the US economy was shut down due to Covid-19. The small sample of Q2 reporters so far has a y/y revenue gain of 18.0% and an earnings gain of 128.8%. A whopping 89% of the Q2 reporters so far has reported a positive earnings surprise, but only 85% has beaten revenues forecasts. More companies have reported positive y/y earnings growth in Q2 (90%) than positive y/y revenue growth (87%). These figures will change markedly as more Q2-2021 results are reported in the coming weeks. The y/y growth rates will more than likely mark the peak of the recovery from the Covid-19 shutdown.

US Economic Indicators

New Home Sales ([link](#)): New home sales (counted at the signing of a contract) fell sharply for the third month in June by 6.6% m/m and 22.6% over the period to a 16-month low of 676,000 units (saar), as affordability remains an issue. It had rebounded 6.1% in March from February's 17.1% weather-related drop. The Midwest was the only region to record a monthly and yearly increase in June. Here's a regional snapshot of how new home sales fared on both a monthly and yearly percent-change basis in June: Midwest (+5.7% m/m & +7.0% y/y), West (-5.1 & -12.7), South (-7.8 & -24.8), and Northeast (-27.9 & -40.4). Inventory is climbing in recent months, rising from a recent low of 284,000 units in October

to 353,000 units in June—the highest since the end of 2008—which should lead to a slower increase in home prices. The median new single-family home price rose 6.1% y/y in June, less than a third of April's 22.0% pace, which was highest since the late 1980s.

Regional M-PMIs ([link](#)): Four Fed districts have now reported on manufacturing activity for July (New York, Philadelphia, Kansas City, and Dallas) and show the manufacturing sector expanded at a faster pace—with the New York region accelerating at a record high. The composite index accelerated to 30.6 this month after easing the prior two months to 26.6, lifting the measure back toward April's record high of 36.2. The New York (to 43.0 from 17.4) manufacturing sector grew at more than double June's pace, while Kansas City's (30.0 to 27.0) moved back to within a hair of April's record high of 31.0; measures for both Philadelphia (21.9 from 30.7) and Dallas (27.3 from 31.1) slowed—though remained robust. The new orders (to 25.8 from 21.8) measure saw an acceleration in billings, driven by a near-record rate in orders growth in the New York (33.2 from 16.3) region and an acceleration in billings in the Kansas City (26.0 from 22.0) region. Orders in the Dallas (to 26.8 from 26.7) region matched June's pace, while Philadelphia's (17.0 to 22.2) rate slowed, though was still strong. Meanwhile, factories added to payrolls at a near record rate (to 25.1 from 23.0) this month, with both the Philadelphia (29.2 from 30.7) and Kansas City (27.0 from 26.0) measures just below their record highs of 30.8 and 29.0 posted during April of this year. New York (20.6 from 12.3) manufacturers hired at the fastest pace since June 2018, while Dallas' (23.7 from 22.9) moved back toward their record high of 31.3 posted in April.

Regional Prices Paid & Received Measures ([link](#)): So far, we have prices-paid and -received data for July from the Philadelphia, New York, Kansas City, and Dallas regions. New York's prices-paid gauge eased for the second month to 76.8 from May's record high of 83.5, while the prices-received (to 39.4 from 33.3) gauge accelerated to a new record high. Kansas City's price data followed a similar script—with its prices-paid (to 78.0 from 79.0) gauge easing for the second month since reaching a record high 86.0 in April, while the prices-received measure reached a new record high of 52.0. Meanwhile, both the Dallas prices-paid (to 73.5 from 80.8) and -received (40.9 from 42.8) gauges held near their June record highs, while Philadelphia's prices-paid (to 69.7 from 80.7) and prices-received (46.8 from 49.7) measures eased this month from their June readings, which were the highest since June 1979 and October 1980, respectively.

Global Economic Indicators

Germany Ifo Business Climate Index ([link](#)): German business confidence in July fell for the first time since January as an upturn in coronavirus infections, along with continued raw materials' supply concerns, pushed expectations lower. Ifo's business climate index slipped to 100.8 in June after climbing steadily from 90.6 in January to 101.7 in May—which was the best reading since November 2018. While the present situation component climbed for the sixth successive month, from 89.4 in January to a 25-month high of 100.4 in June, the expectations component turned lower last month. Expectations sank to 101.2 (still a very high level of confidence), after climbing from 91.9 at the start of this year to 103.7 by June—the highest level since December 2010. July's manufacturing index is stalled around recent highs, ticking down to 27.4 this month from 28.5 last month—which was the highest level since May 2018—as the expectations measure fell for the fifth month, from a recent peak of 25.0 in March to 14.6 in July. (Ifo reports that almost two thirds of all manufacturing companies are telling them they're experiencing supply concerns.) Manufacturing's present situation component continued to ascend, rising every month since bottoming at -44.4 last June to 41.0 this month, though the pace has slowed. There are fears that the service sector could be hit by another wave of Covid as variants spread. The service sector, which was hardest hit by the pandemic, is experiencing a big recovery, though there was a warning flag this month as the expectations component took a step back. The overall index dipped to 19.8 after rising 26.3 points (to 22.5 from -3.8) during the five months through June to its highest level since May 2019, as the expectations component fell to 17.3 after climbing 34.1 points (24.2 from -9.9) over the comparable five-month period to its highest level on record. Meanwhile, the present situation component climbed from 2.6 at the start of this year to a 17-month high of 22.4 this month.

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