Yardeni Research

MORNING BRIEFING
August 23, 2021

Red Flag

Check out the accompanying *chart collection*.

(1) Hurricane season is here. (2) Stormy season ahead for stock market too. (3) Rooting for consolidation of 100% gain in S&P 500. (4) Three peaks—in economic growth, earnings growth, and policy stimulus. (5) Geopolitical risks rising. (6) Signs of a top in commodity prices and a bottom in the dollar. (7) Real retail sales are unreal in China. (8) President-for-life Xi needs more babies. (9) The world's largest nursing home. (10) China uses America's Afghanistan disaster to warn Taiwan. (11) Movie review: "Stillwater" (-).

YRI Podcast. In our latest video *podcast*, Dr. Ed discusses the main points of today's *Morning Briefing.*

Strategy: Storm Is Coming. I am writing our commentary before Hurricane Henri hits us on Long Island on Sunday. The lights will probably go out, though we did get a generator after we were pounded by Hurricane Sandy in 2012. However, we could lose our Internet connection through the cable company.

Officially, the Atlantic hurricane season started on June 1 and runs until November 30. In the stock market, September and October tend to be among the stormiest months. Joe and I aren't expecting a significant correction, but we wouldn't be surprised to see lots of sideways action. After all, the S&P 500 rose 100% from March 23, 2020 through August 16, 2021. A prolonged period of consolidation would be a healthy development. We are still targeting the S&P 500 to hit 5000 by the end of next year or sooner. That would be a 12.6% gain from Friday's close.

For now, the bull market has some challenges to deal with. These include the three peaks—in economic growth, earnings growth, and policy stimulus. On a y/y basis, nominal GDP growth undoubtedly peaked at 12.2% during Q2, while S&P 500 earnings growth most likely peaked around 85% during the quarter on a comparable basis. There may be more fiscal stimulus coming, but it won't have the immediate punch that was delivered by the three rounds of pandemic-relief checks. The Fed is likely to start tapering its bond purchases in coming months. Geopolitical risks are increasing as a result of the Biden administration's disastrous troop withdrawal from Afghanistan.

The policy-fueled V-shaped recovery in the US stimulated the global economy greatly, especially Chinese exports to the US. However, a demographic storm has been brewing in China for many years, as discussed below. The result is that inflation-adjusted retail sales has stopped growing in China. A slowdown in the US economy could turn out to be a bigger problem for China than for the US.

In any event, Debbie and I will be monitoring commodity prices closely for signs of weakness, and the dollar for signs of strength. The signs are already there. The nearby futures price of a barrel of Brent crude oil is down from this year's peak of $77.16 on July 5 to $65.18 on Friday. The nearby futures price of copper is down 13.6% from $4.78 on May 11 to $4.13 on Friday. The DXY dollar index bottomed this year on May 25. It is up 4.3% through Friday's close.

China I: Economic Consequences of One-Child Policy. Jackie and I have been waving the red flag about Red China for some time. We've focused on both the political and the economic risks for investors. In our August 15, 2018 *Morning Briefing*, we observed that President Xi Jinping consolidated his hold on power on March 11, 2018 by becoming leader for life and outlining a grandiose vision for China's global ambitions. That move followed Xi's elevation during October 2017 to a status on a par with the founder of the People's Republic of China, Mao Zedong, and the inclusion of Xi's "new era" political ideas and philosophy in the party constitution.

In December 1978, two years after Mao Zedong died, China's communist leadership decided that it was time to modernize the country's economy. Deng Xiaoping, China's new leader, announced an Open-Door Policy that aimed to attract foreign businesses to set up manufacturing operations in Special Economic Zones. This was the first step along the path that eventually led China to join the World Trade Organization (WTO) in 2001. Along the way, market reforms were implemented, and foreign trade expanded.

China's economy flourished. However, in recent years, China's economic achievements were partly attributable to the theft of intellectual property from other countries as well as other abusive practices that were inconsistent with the free-and-fair trade rules of the WTO. Under Xi, the Chinese Communist Party (CCP) has been moving rapidly, especially this year, to undo Deng's market reforms—establishing the supremacy of the party, led by its Supreme Leader, in all economic and political matters.

Before we delve into the latest developments on the political side, let's do so on the economic front:

(1) *Retail sales flagging.* The October 1, 2018 *Morning Briefing* was titled "China Syndrome." We wrote that "inflation-adjusted retail sales in China may be the most important variable for tracking the impact of China's increasingly dismal demographic profile on its economy." Every month, the Chinese report nominal retail sales and the CPI, which we use to calculate real retail sales. We've been monitoring the yearly percent change in this series for the past few years (*Fig. 1*). To smooth out the impact of the pandemic on this series, Mali and I calculate the 24-month growth rate in the 24-month average of the series (*Fig. 2*). The result must be downright alarming for Xi and the CCP. At an annual rate, this growth rate peaked at a record high of 18.7% during May 2011. It has been trending down since then, falling to almost zero during July of this year!

(2) *Demography is destiny.* We've been monitoring this series for some time as an indicator of how China's rapidly aging population might weigh on the country's economic growth. The destiny of Xi's would-be dynasty is challenged by the legacy of the CCP's disastrous one-child policy, which was imposed from 1979 through 2015. This has frustrated the CCP's efforts to transform the Chinese economy from export-led growth to consumer-led growth. The ongoing strength in China's exports explains why industrial production growth, calculated on the same basis as real retail sales, remains relatively strong around 5%—though that too is down significantly from a peak of 15.0% during March 2012 (*Fig. 3*).

(3) *Make babies*. China's fertility rate has been falling since the mid-1950s in part because of urbanization (*Fig. 4*). The one-child policy pushed the fertility rate below the replacement rate of 2.1 children per woman during 1994 (*Fig. 5*). The UN projects that it will remain below the replacement rate through the end of the current century.

One of the consequences of this development is that the percentage of the population that is 65 years old and older started to exceed the percentage that is under five years old, and the gap between the two is widening (*Fig. 6*). Another one of the terrible consequences of the one-child policy is that there aren't enough women to have babies because it caused far more boys than girls to be raised, resulting in a gender-imbalanced society. The number of women between the ages of 20 and 39 is expected to drop by more than 39 million over the current decade, to 163 million from 202 million, according to an August 11, 2018 *NYT* article titled "Burying 'One Child' Limits, China Pushes Women to Have More Babies."

When China introduced the one-child policy back in 1979, it was to slow the country's surging population growth. The government limited most urban couples to one child and rural couples to two if their firstborn was a girl. China officially ended its one-child policy on January 1, 2016, when the country, trying to cope with an aging population and shrinking workforce, passed a law allowing all married couples to have a second child. On May 31, 2021, the limit was raised to three children.

The latest policy change comes with “supportive measures” including lower educational costs for families, stepped-up tax and housing support, strengthened legal protections for working women, a clamp-down on “sky-high” dowries, and “marriage and love” education for young people.

Thanks to the government’s one-child policy, most young adults have no siblings and two old parents to support. If they get married, the couple will be burdened with four old parents. In China, children are still expected to take care of their elderly parents, since public support programs are very limited. Under these circumstances, the government’s campaign to boost births is unlikely to succeed.

(4) *Nursing home*. The legacy of the CCP’s one-child policy is that China is rapidly turning into the world’s largest nursing home as the population ages without enough young adults to support the elderly.

China II: Progressive Authoritarianism. President-for-life Xi and his CCP seem to have decided that the state must do everything in its power to increase the birth rate in China. That means that the cost of having children has to be lowered at the same time as incomes are boosted for more families. That requires reducing income inequality so that the rich don’t drive up the prices of goods and services that are necessary for childrearing. The result has been a barrage of regulations on business. They are seemingly unrelated. The common theme though is to change China’s destiny by changing its demographic profile with more babies.

An August 1, 2021 Bloomberg *article* called the government’s recent assault on capitalism “progressive authoritarianism.” It observed: “From exhausted couriers in the gig economy, to stressed parents struggling with ever-rising housing prices and tuition fees, to small businesses battling tech monopolies, Xi is swinging the cudgel of state power in support of the squeezed middle class.” Xi previously declared that China had begun a “new development phase” this year, entailing: (i) national security (including control of data and greater self-reliance on technology), (ii) common prosperity (aiming to curb inequalities), and (iii) stability (reducing discontent among the middle class).

Here are some of the latest developments:

(1) *Private tutoring.* Last month, the government ordered tutoring companies to become nonprofits and banned them from pursuing IPOs or taking foreign capital. FP's *China Brief* dated July 28, 2021 explains why the Chinese government is cracking down on the private tutoring industry in China as follows:

"If the new regulations work to lessen the cost burden on parents and the strain on children, the government hopes it can reverse demographic decline. The price of raising children in China is a powerful factor restricting family size, even after the government increased family-planning limits. Authorities are concerned not only about growth but also about so-called population quality—they want well-off families, not the rural poor, to have more children."

In China, higher education hinges on the *gaokao*, the all-important college entrance examination. Chinese parents can spend thousands of dollars a year on private tutoring just to keep their kids competitive. The government's program includes measures to encourage extracurricular activities while reducing the stress of curriculum cramming. The state has also prohibited nonprofit tutoring firms from holding lessons on holidays or during winter and summer vacations. By the way, a year ago, the CCP restricted the study of US and world history to prevent the influence of foreign ideas.

(2) *Technology.* Among the most successful companies in China are those in the technology sector. Their executives are among the richest people in China. So they are natural targets in the government's campaign to force greater income equality. On Friday, the state-run *Economic Daily* stated that China's regulatory crackdown on the country's technology sector, which so far has wiped out around US$1.5 trillion of value from tech stocks, is a short-term cost that must be paid to ensure the healthy long-term growth of the digital economy.

The August 20 *South China Morning Post* observed: "Regulators in Beijing have rushed to publish new regulations and initiate new campaigns to clip the wings of Big Tech. Since last year, regulators have revoked approval to go public, levied a huge antitrust fine, forced a company to relinquish exclusive deals, initiated a cybersecurity probe just days after an overseas listing, and signed the death warrant of an entire industry sector with just one single policy change."

China III: Taiwan. President Joe Biden's disastrous withdrawal from Afghanistan provoked a belligerent response by China. Chinese state-run media *Global Times* published an *editorial* on August 16 blaming the defeat of the Afghan government on the withdrawal of US forces. The article suggested that the US would not defend Taiwan should Beijing invade the island and that Taiwan could see the same "fate" as Afghanistan. The Chinese military conducted assault drills near Taiwan on Tuesday in response to "interference from external forces," Chinese state media said.

By the way, in a Tuesday night speech, Hassan Nasrallah, secretary-general of Hezbollah, *said* the Israelis are watching most closely and drawing conclusions" from the aftermath in Afghanistan. "In order not to have Americans fighting for other [nations], Biden was able to accept a historic failure. When it comes to Lebanon and those around it, what will be the case there?" Nasrallah said, according to *The Times of Israel*.

Movie. "Stillwater" (-) (*link*) is a movie that turns the old proverb on its head. In this case, still waters don't run deep. It stars Matt Damon as the oil-rigger father of an American girl who was convicted of murdering her college roommate in Marseille, France. It's loosely based on what really happened to Amanda Knox in Italy. Damon's acting is stiff and one-dimensional as he does his best to find evidence of his daughter's innocence. She is played by an actress who must have studied melodrama.

Calendars

US: Mon: C-PMI, M-PMI, and NM-PMI Flash Estimates 58.3/62.8/59.4, Existing Home Sales 5.81mu, Chicago Fed National Activity Index. **Tues:** New Home Sales 690k, Richmond Fed Manufacturing Index, API Weekly Crude Oil Inventories. (Bloomberg estimates)

Global: Mon: Eurozone, Germany, France C-PMI Flash Estimates 59.7/62.2/56.5, Eurozone, Germany, France M-PMI Flash Estimates 62.0/65.0/57.3, Eurozone, Germany, France NM-PMI Flash Estimates 56.5/57.32/57.0, Eurozone Consumer Confidence -5.0, UK C-PMI, M-PMI, and NM-PMI Flash Estimates, Germany Buba Monthly Report. **Tues:** Germany GDP 1.5%q/q/9.6%y/y, Japan CPI. (Bloomberg estimates)

Strategy Indicators

Global Stock Markets Performance (*link*): Last week saw the US MSCI index drop 0.7% for it biggest decline in five weeks and end the week at 0.8% below its record high on August 16. The US ranked 22nd of the 49 global stock markets that we follow in a week when 13 of the 49 countries rose in US dollar terms. The AC World ex-US index underperformed with a decline of 3.5% as all regions fell. EMEA was the best-performing region last week, albeit with a decline of 1.3%, ahead of EM Eastern Europe (-2.4%), EMU (-2.9), and EAFE (-3.0). BRIC (-5.8) was the biggest underperformer, followed by EM Latin America (-5.2) and EM Asia (-4.9). Argentina was the best-performing country last week with a gain of 6.9%, followed by the Philippines (5.2), Portugal (4.2), Hungary (4.0), and Colombia (3.0). Peru and South Africa were the worst performers with declines of 8.5%, followed by China (-7.8), Brazil (-7.0), and Australia (-5.8). EMEA has risen 18.1% ytd and is ahead of the 17.7% gain for the US in the race for the top-performing region so far in 2021. Other regions ahead of the 3.9% ytd gain for the AC World ex-US: EM Eastern Europe (14.5), EMU (11.6), and EAFE (7.4). The following regions are lagging: BRIC (-10.8), EM Asia (-8.3), and EM Latin America (-3.5). The top-performing countries ytd: Argentina (26.5), the Netherlands (26.3), Austria (25.4), the Czech Republic (25.4), and Hungary (24.5). The biggest laggards of 2021 so far: Peru (-33.1), China (-19.9), Colombia (-17.5), New Zealand (-15.0), and Turkey (-14.8).

S&P 1500/500/400/600 Performance (*link*): LargeCap dropped 0.6% last week, but that was less than the 2.0% and 2.1% declines for MidCap and SmallCap, respectively. LargeCap ended the week 0.8% below its record high on August 16, while MidCap and SmallCap finished 3.4% and 6.6% below their respective record highs on May 7 and June 8. Just six of the 33 sectors were higher for the week, down from 19 rising a week earlier. LargeCap Utilities and LargeCap Health Care rose 1.8% for the best performances of the week, followed by MidCap Health Care (0.9%), LargeCap Real Estate (0.5), and LargeCap Tech (0.4). SmallCap Energy was the worst performer with a decline of 10.1%, followed by LargeCap Energy (-7.3), MidCap Energy (-6.2), MidCap Materials (-4.9), and SmallCap Materials (-3.5). LargeCap took the lead in the 2021 derby this week with a gain of 18.3% ytd, ahead of SmallCap (18.1), and MidCap (16.0). Thirty-two of the 33 sectors are higher ytd, paced by these best sector performers: SmallCap Consumer Discretionary (36.5), MidCap Energy (31.7), SmallCap Energy (29.4), LargeCap Real Estate (28.9), and LargeCap Financials (27.6). The biggest laggards so far in 2021: MidCap Communication Services (-0.1), MidCap Tech (4.7), MidCap Consumer Staples (5.5), MidCap Health Care (7.6), and LargeCap Consumer Staples (8.2).

S&P 500 Sectors and Industries Performance (*link*): Five of the 11 S&P 500 sectors rose last week, and six outperformed the composite index's 0.6% decline. That compares to a 0.7% gain for the S&P 500 a week earlier, when eight sectors rose and six outperformed the index. Utilities and Health Care rose 1.8% for the biggest gains of the week, ahead of Real Estate (0.5%), Tech (0.4), Consumer Staples (0.4), and Communication Services (-0.4). The worst performers this week: Energy (-7.3), Materials (-3.1), Industrials (-2.3), Financials (-2.3), and Consumer Discretionary (-2.2). With respect to 2021's performance, the S&P 500 has risen 18.3% so far, with all 11 sectors higher ytd and six beating the broader index. Real Estate is now the leading sector with a gain of 28.9% ytd, followed by Financials (27.6), Communication Services (24.5), Energy (20.2), Health Care (19.7), and Tech (19.3). This year's laggards to date, albeit with gains: Consumer Staples (8.2), Consumer Discretionary (8.4), Utilities (11.0), Materials (15.3), and Industrials (15.6).

S&P 500 Technical Indicators (*link*): The S&P 500 fell 0.6% last week and weakened relative to its 50-day (50-dma) and 200-day moving average (200-dma). It was above its 50-dma for a ninth week after dropping below a week earlier for the first time since February. It was above its 200-dma for a 60th straight week last week after being below for 13 weeks through late May of 2020. The S&P 500's 50-dma rose last week for a 41st straight week as the price index weakened to 2.0% above its rising 50-dma from 3.1% a week earlier. That compares to an eight-month low of 0.4% below its rising 50-dma during mid-June; the index is still down from its 19-week high of 5.8% above during mid-April. The index mostly has been trading above its 50-dma since late April 2020; in June 2020, it was 11.7% above, which was the highest since its record high of 14.0% in May 2009. That compares to 27.7% below on March 23, 2020—its lowest reading since it was 29.7% below on Black Monday, October 19, 1987. The price index was above its 200-dma for a 60th week last week, but dropped to 10.2% above its rising 200-dma from 11.4% a week earlier. It had been at an eight-month low of 9.2% during mid-June. That compares to 17.0% above in early December, which was the highest since November 2009 and up from the 26.6% below registered on March 23—the lowest reading since March 2009. At its worst levels of the Great Financial Crisis, the S&P 500 index was 25.5% below its 50-dma on October 10, 2008 and 39.6% below its 200-dma on November 11, 2008.

S&P 500 Sectors Technical Indicators (*link*): Eight of the 11 S&P 500 sectors traded above their 50-dmas last week, down from 10 a week earlier. Consumer Discretionary and Industrials dropped below their 50-dmas last week. They joined Energy, which was below for a seventh straight week. That compares to all 11 sectors above at the beginning of May and just four above at the end of January. Eight sectors have a rising 50-dma, unchanged from a week earlier. These three sectors remained in the falling 50-dma doghouse last week: Energy, Industrials, and Materials. Looking at the more stable longer-term 200-dmas, Energy dropped below in the latest week, ending a 23-week period when all 11 sectors had been above. However, all 11 sectors have had rising 200-dmas for 23 straight weeks. For perspective, back in April 2020, just one sector (Health Care) was trading above its 200-dma. Energy's 200-dma finally turned higher in mid-December after mostly falling since October 2018.

US Economic Indicators

Leading Indicators (*link*): Leading indicators continues its sharp ascent, soaring to yet another record high last month. July's Leading Economic Indicators (LEI) hasn't posted a decline since bottoming last April, climbing 0.9% in July and 19.8% during the past 15 months—averaging monthly gains of 1.0% the past five months. All 10 indicators contributed to the increase in July's LEI, led by ISM's new orders diffusion index (+0.19pt), leading credit index (+0.19), interest rate spread (+0.14), S&P 500 (+0.11), and consumer expectations (+0.10)—with building permits and the average workweek contributing a solid +0.7 points. Jobless claims and real consumer goods orders were small contributors. The Conference Board notes, "While the Delta variant and/or rising inflation fears could create headwinds for the US economy in the near term, we expect real GDP growth for 2021 to reach 6.0% year-over-year, before easing to a still robust 4.0% growth rate for 2022."

Coincident Indicators (*link*): The Coincident Economic Index (CEI) has increased 12 of the 15 months since bottoming last April, with the only decline occurring this February (-0.7%); it was unchanged the last two months of 2020. The CEI has accelerated the past two months, climbing 0.6% in July, following a 0.4% gain in June and 0.1% in both May and April. Since bottoming last April, the CEI is up 13.8% to within 1.7% of February 2020's record high. Once again, all four components of the CEI contributed positively, led by employment and industrial production. Here's a look at how the four components performed in July: 1) Employment in July was once again stronger than expected, with nonfarm payrolls rising at an 11-month high of 943,000 while there were upward revisions to both June and May payrolls, for a net gain of 119,000! Private payrolls expanded 703,000—with revisions in June and May adding 146,000 jobs. 2) Industrial production in July got a boost from automakers as they either shortened or cancelled their typical July factory shutdowns, the Fed reported, as they continued to struggle with the global semiconductor shortage. Headline industrial production expanded a larger-than-expected 0.9% last month, with manufacturing output jumping 1.4%, as production of motor vehicles & parts rebounded

11.2% following June's 5.9% shortfall. 3) Real personal income less transfer payments increased for the fifth successive month in July, by 0.2% m/m and 1.3% over the period—just a tick below last February's record high. 4) Real manufacturing & trade sales recovered 0.7% during the two months ending July, after a two-month decline of 2.6%; these sales are currently 1.9% below the record high posted this March. (Note: Latest data for both real personal income less transfer payments and real manufacturing & trade sales are estimated using statistical imputations to address the problem of lags in available data.)

Regional M-PMIs (*link*): Two Fed districts have now reported on manufacturing activity for August (New York and Philadelphia) and show the manufacturing sector expanded at a slower pace, as growth in the New York region eased from July's record rate. The composite index fell to 18.9 this month after accelerating from 24.1 to 32.5 last month, as the New York (to 18.3 from 43.0) manufacturing sector grew at less than half July's record rate, while Philadelphia's (19.4 from 21.9) basically matched July's pace. New orders (to 18.8 from 25.1) expanded at a respectable, though slower, pace this month, with Philadelphia's (22.8 to 17.0) rate showing a slight acceleration, while the growth rate in New York (14.8 from 33.2) billings was cut in half. Meanwhile, employment (to 22.7 from 24.9) growth slowed a bit from July's near-record rate, as New York (12.8 from 20.6) factories hired at a slower pace this month—after reaching its highest rate since mid-2018 last month—though Philadelphia (32.6 from 29.2) manufacturers hired at a new record rate. Inflationary pressures remain elevated, with Philadelphia's prices-received (53.9 from 46.8) measure climbing to its highest rate since 1974 this month, while the prices-paid measure rose from 69.7 to 71.2, not far from June's 80.7—which was the highest since the end of 1979. New York's prices-paid measure eased for the third month to 76.1 from May's record high of 83.5, while the prices-received measure accelerated to a new record high of 43.0.

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