MORNING BRIEFING
September 22, 2021

Animal Farm

Check out the accompanying chart collection.

(1) Gray rhinos, black swans, and blue angels. (2) Evergrande's troubles started about a year ago with its first liquidity scare. (3) "Three red lines" regulation worsened liquidity crunch for property developers in recent months. (4) More cracks in the Great Wall of China. (5) Will this be the Great Fall of China? (6) Xi Jinping, Mao Zedong, and George Orwell. (7) Xi's hard left turn. (8) Nine gray rhinos. (9) S&P 500 forward revenues, earnings, and profit margin all at record highs.

China I: Gray Rhinos and Black Swans. Michele Wucker's book *The Gray Rhino: How to Recognize and Act on the Obvious Dangers We Ignore* was published in 2016. It is especially relevant to 2021. She defines a "gray rhino" as "a highly probable, high impact yet neglected threat: kin to both the elephant in the room and the improbable and unforeseeable black swan. Gray rhinos are not random surprises, but occur after a series of warnings and visible evidence. The bursting of the housing bubble in 2008, the devastating aftermath of Hurricane Katrina and other natural disasters, the new digital technologies that upended the media world, the fall of the Soviet Union … all were evident well in advance."

More recently, the pandemic started as a black swan event early last year. This year's white rhino is Evergrande. Consider the following:

(1) *The rhino's first appearance.* Evergrande is the second-largest property developer in China. It is also the world's most indebted developer. According to an *article* on Bloomberg yesterday, it had a liquidity scare in August 2020 when it reportedly sent a letter to the provincial government of Guangdong, warning officials that it might default on payments due in January 2021 with dire consequences for the entire financial sector. The article observed:

"Reports of the plea for help emerged on September 24 [in 2020], sending Evergrande's stock and bonds tumbling even as the company dismissed the concerns. The letter, which was widely circulated on social media, was verified to Bloomberg at the time by people familiar with it, but Evergrande later disputed its authenticity. Crisis was averted soon … when a group of investors waived their right to force a $13 billion repayment."

Bloomberg also reported that "Beijing was said to have instructed authorities in Guangdong to map out a plan to manage the firm's debt problems, including coordinating with potential buyers of its assets. Regulators in September last year signed off on a proposal to let Evergrande renegotiate payment deadlines with banks and other creditors, paving the way for another temporary reprieve."

(2) *Reining in the rhinos.* This year, the September 15 *WSJ* reported: "Worried about a housing bubble, China's government has repeated the mantra that 'homes are for living in, not for speculation,' for almost half a decade, but pressure on real-estate developers has intensified in roughly the last year. Regulators have capped banks' exposure to real estate, both in loans to developers and mortgages; introduced a system of 'three red lines' that restricts more indebted developers from taking on new debts; and overhauled land auctions. Local governments have also introduced their own curbs to help rein in the market."

(3) *Wounded rhinos.* Those credit-tightening measures have hit property developers hard. As of mid-August, developers had defaulted on $6.2 billion of high-yield debt this year, a higher total than the previous 12 years combined. Bad property loans at commercial banks are the highest in more than a decade. National home sales by value tumbled 19.7% y/y in August, the largest drop since April 2020. Growth in home prices and real-estate investment has slowed, while construction starts fell 3.2% in January-August, compared to a year earlier.

Monday's *South China Morning Post* reported that more cracks are starting to show among other Chinese developers. The yields on Chinese junk-rated companies are soaring. By one measure, they are up from 10.5% on June 30 to 15.8% last week. It's starting to play out as an old-fashioned credit crunch that could burst China's housing bubble.

(4) *Bad assumption.* In recent days, we've suggested that the Chinese government will have no choice but to intervene by selling pieces of Evergrande to other property companies in China. The problem with that notion is that its competitors may be turning into wounded rhinos as well. If so, then the Chinese government will be forced to reconsider the size and scope of the measures that will be necessary to avert the Great Fall of China, or at least a crash in its real estate sector.

By the way, the publicist for Wucker's book stated that it was the #1 best-selling English language book in China in 2016.

China II: George Orwell's Playbook. George Orwell published *Animal Farm: A Fairy Tale* in 1945. Wikipedia describes the book as follows: "The book tells the story of a group of farm animals who rebel against their human farmer, hoping to create a society where the animals can be equal, free, and happy. Ultimately, the rebellion is betrayed, and the farm ends up in a state as bad as it was before, under the dictatorship of a pig named Napoleon."

The US publishers dropped the subtitle when it was published in 1946. Orwell suggested the subtitle used for the French translation of the book, "*Union des Républiques Socialistes Animales*," which abbreviates to "URSA," the Latin word for "bear," a symbol of Russia.

A modern-day version of Orwell's playbook for dictators is now playing out in China. An excellent summary is provided in a September 20 *WSJ* *article* titled "Xi Jinping Aims to Rein In Chinese Capitalism, Hew to Mao's Socialist Vision." Chinese President Xi Jinping is a fan of Mao Zedong, whose autocratic rule of China from 1943 to 1976 was marked by policy disasters and bloody power struggles. In March 2018, the Chinese Communist Party (CCP) unveiled plans to let Xi remain president indefinitely. He is also party chief and military-commission chairman. These two additional powerful positions aren't subject to formal term limits.

On July 1, 2021, when the CCP celebrated its centenary, Xi wore a Mao suit and stood behind a podium adorned with a hammer and sickle, pledging to stand for the people. After the speech, he sang along with "The Internationale" broadcast across Tiananmen Square. In China, the song long has symbolized a declaration of war by the working class on capitalism.

This year, Xi has launched a multi-front campaign against private enterprise. An August 1, 2021 Bloomberg *article* called the government's recent assault on capitalism "progressive authoritarianism." In the August 23 *Morning Briefing*, we concluded:

"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."

Strategy I: More Gray Rhinos. In Monday's *Morning Briefing*, Joe and I compiled a list of nine potential gray rhinos that could unsettle the stock market. At the top of the list is Evergrande:

(1) Evergrande could be China's Lehman or LTCM.
(2) Inflation has yet to show signs of peaking.
(3) The Fed is expected to start tapering before the end of this year.
(4) The debt ceiling has to be raised so that the Treasury can pay the bills.
(5) The Dems are pushing trillion-dollar spending and tax proposals through Congress.
(6) Parts shortages are forcing companies to scale back their production.
(7) Valuation remains elevated.
(8) There are plenty of geopolitical risks.
(9) And oh yeah, the pandemic is still out there.

Nevertheless, we concluded: "We acknowledge that there are both technical and fundamental issues weighing on the market over the near term. We expect that most of them will be cleared up by the end of October, setting the stage for the traditional year-end Santa Claus rally."

So we don't expect that these gray rhinos will kill the bull that's been charging in the stock market since March 2009. Indeed, we recently raised our 2022 year-end target for the S&P 500 to 5200. Then again, we don't have a list of black swans since they are unforecastable by definition.

Strategy II: Blue Angels. We've discussed gray rhinos and black swans; now let's talk about blue angels. That is, let's turn to our Blue Angels analysis, which tracks the S&P 500 price index relative to the S&P 500's forward earnings per share (i.e., the time-weighted average of consensus estimates for this year and next) multiplied by forward P/Es of 10 to 24 in increments of 2 (*Fig. 1*). It shows that forward earnings continued to rise to yet another record high through the September 20 week. Earlier this year, the S&P 500 was following the Blue Angel flight pattern represented by a 22.0 forward P/E; with Monday's selloff, the forward P/E fell to 20.3 (*Fig. 2*).

A closer look at the fundamentals of the S&P 500 shows that forward revenues remained on a steep uptrend in record-high territory through the September 16 week (*Fig. 3*). The same can be said about forward earnings, which is now up to a record-high $214.80 per share. The forward operating profit margin was unchanged at 13.2% during the September 16 week, which was unchanged from the week before—and also at a record high. These metrics all augur well for Q3's earnings season next month.

Calendars

US: Wed: Existing Home Sales 5.98mu, MBA Mortgage Applications, Crude Oil Inventories, Fed Interest Rate Decision, FOMC Economic Projections. **Thurs:** Leading Indicators 0.7%, C-PMI, M-PMI, and NM-PMI Flash Estimates 58.3/61.5/55.0, Kansas City Manufacturing Index, Initial & Continuous Jobless Claims 320k/2.65m, Chicago Fed National Activity Index. (Bloomberg estimates)

Global: Wed: Eurozone Consumer Confidence -5.8, Wuermeling, Mauderer, Woods. **Thurs:** Eurozone, Germany, and France C-PMI Flash Estimates 58.5/59.2/55.8, Eurozone, Germany, and France M-PMI Flash Estimates 60.3/61.5/57.0, Eurozone, Germany, and France NM-PMI Flash Estimates 58.5/60.2/56.0, UK Spain GDP 2.8%q/q/19.8%y/y, UK M-PMI 59.0, UK Gfk Consumer Confidence -8, Canada Headline & Core Retail Sales -1.2%/-1.5%, Japan CPI, BOE Interest Rate Decision & QE Total 0.10%/£875b, ECB Economic Bulletin, Elderson, Wuermeling. (Bloomberg estimates)

Strategy Indicators

S&P 500 Sectors Net Earnings Revisions (*link*): The S&P 500's NERI weakened in September for a second straight month, but remained near July's record high. September's monthly reading was its seventh highest dating back to the start of the data series in March 1995, with five of them occurring in the past five months. NERI dropped to 20.2% in September from 21.8% in August and from a record-high 23.1% in July, but was positive for a 14th month following 13 straight negative readings. September's reading compares to an 11-year low of -37.4% in May 2020 and its prior tax-cut-induced record high of 22.1% in March 2018 when it was positive for 18 straight months through October 2018. All 11 of the S&P 500 sectors had positive NERI in September, up from 10 sectors during July and August. Five of the 11 sectors had NERI improve m/m in September, up from four in August and down from eight in June-July and ten in May. Nearly all sectors had NERIs in the double digits and remained near multi-year or record highs during the month. Here are the sectors' September NERIs compared with their August readings: Energy (28.2% in September, down from 34.2% in August [16-year high]), Information Technology (25.5, 26.1 [12-year high]), Financials (24.9, 25.7), Industrials (23.2, 25.4), Real Estate (22.6, 23.2 [record high]), Consumer Discretionary (21.8, 24.2), S&P 500 (20.2, 21.8), Communication

Services (19.7 [3-year high], 19.6), Materials (16.8, 21.4), Health Care (14.3, 15.2), Consumer Staples (7.1, 8.7), and Utilities (2.6, 0.0).

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin remained steady last week at a record high of 13.2%. Since the end of April, it has exceeded its prior record high of 12.4% in September 2018. It's now up 2.9ppts from 10.3% during April 2020, which was the lowest level since August 2013. Forward revenues and earnings per share 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 remained steady w/w at 8.5%. 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 of 15.0% was also steady w/w 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 have been raising their forecasts this year for 2021 and 2022 revenues and earnings growth and the profit margin. They expect revenues to rise 14.9% in 2021 (down 0.1ppt w/w) and 6.8% (unchanged w/w) in 2022 compared to the 2.1% decline reported in 2020. They expect earnings gains of 46.1% in 2021 (unchanged w/w) and 9.2% in 2022 (up 0.1ppt w/w) compared to a 13.3% decline in 2020. Analysts expect the profit margin to rise 2.7ppts y/y in 2021 to 13.0% (unchanged w/w) from 10.2% in 2020 and to improve 0.2ppt y/y to 13.2% in 2022 (unchanged w/w). The S&P 500's weekly reading of its forward P/E dropped 0.1pt w/w to 21.1, barely up from a 14-week low of 20.9 in mid-August. That compares to 23.1 in early September 2020, 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 dropped 0.02pt w/w to 2.78. That compares to a record high of 2.81 at the beginning of September 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 rise for eight of 11 S&P 500 sectors and forward earnings rise for seven. Seven sectors are at or near record highs in their forward revenues, earnings, and profit margin: Communication Services, Consumer Discretionary, Consumer Staples, Health Care, Industrials, Information Technology, and Materials. Energy still has all measures below record highs. Financials, Real Estate, and Utilities have forward earnings at or near record highs, but their forward revenues and margins 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 Utilities. Health Care's margin is expected to remain unchanged y/y in 2022, but three sectors are expected to see margins decline: Financials, Materials, and Real Estate. The forward profit margin was at record highs during 2018 for 8/11 sectors, all but Energy, Health Care, and Real Estate. Currently, seven 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 (24.9%, record high), Financials (19.2, down from its 19.8 record high in early August), Communication Services (16.7, record high), Real Estate (16.5, down from 17.0), Utilities (14.5, down from its 14.8 record high in early May), Materials (13.3, record high), S&P 500 (13.2, record high), Health Care (11.0, down from 11.2), Industrials (10.2, down from its record high of 10.5% in mid-December), Consumer Staples (7.6, 7.7), Consumer Discretionary (8.0, down from 8.3), and Energy (7.6, 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 18.5% and 52.4%, respectively, since then to new record highs. The forward profit margin has risen 3.1ppts to a record high of 13.2%, exceeding its prior record high of 12.4% in late 2018. During the latest week, ten of the 11 sectors posted gains or remained steady at 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: Energy (forward revenues up 28.2%, forward earnings up 1,598.0), Materials (27.5, 92.9), Information Technology (25.2, 43.4), Communication Services (25.0, 56.1), Industrials (22.7, 70.4), S&P 500 (18.5, 52.4), Financials (17.4, 66.9), Health Care (14.1, 25.8), Consumer Discretionary (13.8, 93.8), Consumer Staples (11.2, 18.5), Real Estate (9.7, 27.0), and Utilities (0.5, 4.8).

US Economic Indicators

Housing Starts & Building Permits (*link*): Housing starts rose more than expected last month—likely reflecting an easing in lumber prices—though the housing market still faces headwinds from land and labor shortages. Housing starts rebounded 3.9% to 1.615mu (saar) in August from July's 6.2% drop. August's gain was the third in four months, for a total gain of 6.7%—fluctuating in a flat trend just below March's 15-year high of 1.725mu. Multi-family starts jumped 20.6% to a 19-month high of 539,000 units (saar) last month after a 9.9% drop in July, while single-family starts slumped for the second successive month, by 2.8%m/m and 7.3% over the period, to 1.076mu. Building permits—a good leading indicator of housing starts—advanced for the second month, by 6.0% in August and 8.4% over the period to 1.728mu (saar) after a three-month slide of 9.2%. Multi-family permits soared 15.8% in August and 27.7% during the two months ending August to 674,000 units (saar)—the most since January 1990. Single-family permits increased for the first time in five months, ticking up 0.6% in August to 1.054mu (saar) after plunging 12.2% the prior four months. Meanwhile, backlogs continued to climb, as the number of single-family starts under construction though not yet completed was the highest since 2007, while those authorized but not yet started was the highest since 1979. NAHB's September Housing Market Index (HMI) shows builders' confidence was little changed at 76 this month after drifting lower since reaching a record high in November—dropping from 90 to 75 by August. The traffic of prospective homebuyers ticked up 2 points this month, while present sales was a point higher; future sales held steady. Here's a look at all three components of the HMI in September relative to their record highs in November: traffic of prospective homebuyers (to 61 from 77 in November), current sales (82 from 96), and future sales (81 from 89)—with the latter holding steady the past several months.

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