MORNING BRIEFING
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China, Materials & Green Isn't Clean

Check out the accompanying chart collection.

(1) China's Xi gets a promotion. (2) Troubled Chinese real estate developers scramble to raise money. (3) China's new home sales and prices fall again in October. (4) Covid-19 cases still pop up despite China's zero-tolerance policy. (5) Beijing requires a negative Covid test before entering the city. (6) Chinese economy growing, but slower. (7) A look at top-performing sectors over past two decades. (8) Demand for materials used in Chinese construction could sag. (9) Demand for materials used in EVs and windmills should keep booming. (10) Examining the dirty side of clean energy.

China: Chairman-for-Life Xi. At last week's annual meeting, the Chinese Communist Party's (CCP) Central Committee rewrote history and described Chinese President Xi Jinping as a core leader who "promoted historic achievements and historic changes." Doing so put Xi on par with Mao Zedong and Deng Xiaoping. It also set Xi up to be named president for a third term next year, breaking with the recent precedent of Chinese presidents holding office for only two terms. Some believe the CCP has set Xi on the path to becoming Chairman for Life.

Despite Xi's elevation, not all is well in China. The country is dealing with a meltdown of its real estate market, resurgent Covid-19 hotspots and quarantines, and slowing economic growth. Will these hardships grow large enough to prompt the normally docile citizens of China to protest or even to dethrone Xi? That's unlikely, but we'll be watching for any such signs.

Here's Jackie's look at some of Xi's headaches and the recent data showing that China's economic growth has cooled:

(1) *China's real estate wreckage.* The financial woes of China Evergrande Group and other developers have weighed on China's real estate activity, which represents about a quarter of the country's GDP. China's new home sales fell 22.6% y/y in October, following a 15.8% drop in September. New home prices fell 0.3% m/m in October, marking the second consecutive monthly decline. And new construction starts by property developers dropped 7.7% y/y over the January-to-October period. Tales of vacant buildings and apartments are common.

The sector's woes are traced back to a government policy adopted last year to rein in excessive borrowing and speculation by limiting the amount of debt real estate developers can accumulate. The sector's recent problems have led policymakers to rethink their approach. They've reportedly discussed loosening lending rules to help struggling developers sell assets and avoid default, a November 10 *WSJ* *article* reported. Regulators also plan to allow high-quality developers to sell asset-backed securities (ABS) to repay outstanding debt, reopening the ABS market—which hasn't seen any issuance from developers since August, a November 17 Bloomberg *article* noted.

Meanwhile, headlines about the country's real estate giants describe companies scrambling to raise liquidity and struggling to make debt payments. Evergrande missed two bond interest payments, and its grace periods end on December 6 and December 28. It also needs to figure out how to either refund payments or deliver finished apartments to the more than one million buyers of Evergrande apartments.

Evergrande and its leaders have scrambled to raise cash. The developer sold its equity stakes in Shengjing Bank and in an online media company. Evergrande's billionaire founder and Chairman Hui Ka Yan is believed to have borrowed against two of his luxury residences in Hong Kong, each valued at around HK$800 million, to make the property company's interest payments, a November 15 Reuters *article* reported. The company has also sold two of its Gulfstream jets.

Other Chinese developers are struggling as well. At least six real estate developers have either defaulted on their debt or asked investors to wait longer for repayment, a November 10 *WSJ* *article* reported. They too are searching for liquidity at a time when the average yield for junk-rated Chinese corporate issuers' dollar debt hit a record high of 28.5% on Tuesday, a November 15 Reuters *article* reported.

Kaisa Group Holdings, the country's second largest developer, ended its interim dividend and is trying to sell property worth an estimated $12.8 billion. The company entered a 30-day grace period after failing to pay some of its bond creditors last week. Yango Group offered to exchange old notes for new notes. Sunac China raised about $653 million by selling shares at a discount and raised another $300 million by selling shares in its property management arm. Sunac also borrowed $450 million from its founder. And China Aoyuan sold its investments in Hong Kong apartments and parking spaces at a loss.

(2) *Playing Whac-A-Mole with Covid.* China's zero-tolerance policy regarding Covid-19 continues as it works to snuff out a mini-outbreak that started in mid-October. Recent weeks

have seen roughly 100 new cases reported a day, but that fell to 31 on Tuesday and 22 on Monday, Reuters *reported*.

The pressure is on to keep Covid-19 cases low ahead of the 2022 Winter Olympics, which is poised to kick off in February in Beijing. Anyone entering the city from other parts of the country will be required to show a negative test result from the prior 48 hours, and the number of flights into Beijing from areas in China with moderate to high Covid risk will be reduced.

Cases in Dalian, a northeastern Chinese city, have led to the quarantining of 1,500 students attending a local university, a November 15 AP *article* reported. There was a huge outcry this week after a home video captured health workers in Shangrao, a central Chinese city, killing a quarantined person's pet dog. The China Small Animal Protection Association subsequently called for the quarantine system to care for pets whose owners are quarantined.

China's Covid case counts pale in comparison to the large numbers of cases in the US and Europe. But they're worth watching because Xi has taken credit for keeping Covid cases low. Any reversal would reflect badly on him.

(3) *Economy growing, but slower.* Covid-19 lockdowns, supply-chain knots, energy disruptions in October, and a crumbling real estate sector have reduced Chinese economic growth to low-single-digit rates, down from rates in the mid-single digits. Industrial production in October rose 3.5% y/y, faster than September's 3.1% increase. But in 2019, the country's industrial production rose 6.9% on a December-over-December basis (*Fig. 1*).

China's manufacturing purchasing managers index indicated contraction (levels under 50.0) across the board in October: composite (49.2), new orders (48.8), employment (48.8), and output (48.4) (*Fig. 2*). Other signs of slowing economic activity are found in the country's electricity output, which has fallen from 20.4% in March to 4.5% y/y in October, using a three-month moving average (*Fig. 3*). Likewise, railways freight traffic has been subdued, falling 0.1% in September and rising 0.7% y/y in October (*Fig. 4*). And the output of cement, corrugated steel bar, and steel—all items used in construction—have fallen sharply, though corrugated steel bar moved higher in October (*Fig. 5*, *Fig. 6*, and *Fig. 7*).

The country's growth has been supported by strong exports, which rose 24.3% in October y/y, well above 2019 levels in the wake of the Trump tariffs, when exports only grew 0.9% on average per month (*Fig. 8*). Retail sales grew 4.9% in October y/y and only 3.4% when adjusted for inflation (*Fig. 9*). Real retail sales' 24-month growth, at an annual rate, has fallen sharply from north of 10% in the years prior to 2013 and from its peak of 19.4% in February 2010 to almost zero in October (*Fig. 10*). China's October jobless rate was unchanged at 4.9%.

The country's stock market has trailed far behind US stock markets. The China MSCI stock price index is down 13.1% ytd through Tuesday's close, while the S&P 500 has risen 25.2% (*Fig. 11*). Analysts are forecasting that companies in the China MSCI index will grow revenue 9.7% and earnings 16.2% in 2022 (*Fig. 12* and *Fig. 13*). The index's forward P/E (i.e., based on forward earnings, or the time-weighted average of consensus estimates for this year and next) has fallen to 12.9 from 18.3 earlier this year.

Materials: China's Slowdown Bodes Poorly for Sector. If we asked you which S&P 500 sectors were the top performers since the start of 2001, Consumer Discretionary—home to Amazon—would be a reasonable and correct guess. As would Information Technology, given that it's home to Systems Software, Semiconductor Equipment, and Semiconductors. Less expected is the S&P 500 Materials stock price index's appearance near the top of the leader board (*Fig. 14*).

Here's the performance derby from the start of 2001 through Tuesday's close for the S&P 500 sectors: Consumer Discretionary (588.5%), Information Technology (522.0), Materials (326.2), S&P 500 (256.1), Health Care (250.9), Consumer Staples (217.7), Industrials (216.5), Energy (82.1), Financials (67.6), Utilities (57.4), and Communication Services (42.1). Real Estate wasn't an official index until October 2001, but it is up 201.1% since its creation then.

The Materials industries that beat the S&P 500's performance since the start of 2001 are Specialty Chemicals (1,360.1%), Metal & Glass Containers (1,250.4), Industrial Gases (1,096.4), Steel (483.9), Construction Materials (325.9), and Paper Packaging (279.2).

That said, after surging this year, the S&P 500 Materials sector's revenue and earnings growth are expected to slow sharply next year. The sector's revenue is forecast to jump 25.3% this year and only 2.8% in 2022, while its earnings are forecast to soar 84.9% this year and increase 2.1% in 2022 (*Fig. 15* and *Fig. 16*).

The S&P 500 Steel industry is among those that will face tough comparisons next year to 2021 results. The stock price index is near all-time highs, having risen 110% this year (*Fig. 17*). But after expecting the industry's earnings to rise nearly 600% this year, analysts are calling for earnings to drop 27.9% in 2022 (*Fig. 18*). The industry's forward P/E has also collapsed to 6.4, down from 16.1 at the start of 2021, often a sign that investors believe an industry is experiencing peak earnings (*Fig. 19*).

The price of steel may be under pressure next year because of the drop in Chinese apartment construction and because the US is moving to ease tariffs on steel produced and imported from the European Union and Japan.

Companies producing materials used in the green economy should dodge the sector's slowdown, however. As we discuss below, the demand for materials used in electric vehicles, windmills, and solar panels—such as copper and lithium—is expected to continue to grow in upcoming years. The S&P 500 Copper industry's stock price index, for example, reflects this: It's near recent highs, and its earnings are expected to grow 10.9% next year.

The S&P 500 Construction Materials industry's stock price index is also near an all-time high, and its earnings are forecast to grow 21.7% in 2022. Its constituents sell their products primarily in the US, which should benefit from President Biden's infrastructure bill, and they don't have exposure to the Chinese market.

Disruptive Technologies: Green Doesn't Mean Clean. We are big fans of technology, particularly technology that can help address climate change. That said, we were reminded by a thought-provoking *article* in *Der Spiegel* that sourcing the metals needed to produce or store green energy—using windmills, solar panels, electric cars, lithium-ion batteries, high voltage power lines, and fuel cells—can cause quite a bit of damage to the Earth and produce a hearty amount of carbon dioxide (CO_2).

These metals are most likely being dug out of the ground and processed by CO_2-spewing machines, then shipped across an ocean in a CO_2-spewing ship, before they're installed in a green windmill or vehicle. The mining process also requires huge amounts of land, electricity, and water, often in developing regions of the world where water is dear and governments unstable.

Wind turbines, for example, use neodymium, a rare earth metal. The production of one ton of neodymium produces 77 tons of CO_2, while the production of a ton of steel emits only 1.9 tons of CO_2, the article states.

The amount of metal needed to run our new green world is growing larger every year. The International Energy Agency (IEA) estimates that global demand for critical raw materials will quadruple by 2040, and lithium demand alone could be 42 times greater. Meanwhile, finding new deposits and extracting metals from older mines is getting tougher and more costly, as the easiest targets have already been mined.

The article reports that a medium-sized offshore wind turbine contains 67 tons of copper. There are 11 tons of silver in a solar panel park that's 1,000 square meters. "An electric car requires six times as many critical raw materials as a combustion engine—mainly copper, graphite, cobalt and nickel for the battery system. An onshore wind turbine contains around nine times as many of these substances as a gas fired power plant of comparable capacity," it states.

Hopefully, the mining industry will get greener along with the rest of the world, perhaps by employing hydrogen fuel to power its huge excavators and ships. Recycling electronics and batteries could also help reduce the amount of mining of new metals. And despite the dirty business of mining metals, the IEA believes the Earth still benefits when electric vehicles are driven. An internal combustion vehicle produces twice as much CO2 over its life cycle of 200,000 kilometers than is produced by an electric car that requires lithium in its batteries.

But clearly, more needs to be done before we can feel good about going green.

Calendars

US: Thurs: Leading Indicators, Initial & Continuous Jobless Claims 260k/2.12m, Philadelphia Fed Manufacturing Index 24.0, Kansas City Fed Manufacturing Index, Natural Gas Storage. **Fri:** Baker-Hughes Rig Count, Clarida, Waller. (Bloomberg estimates)

Global: Thurs: UK Gfk Consumer Confidence -18, Japan Core CPI 0.1% y/y, Panetta, Balz, Ellis. **Fri:** Germany PPI 1.9%m/m/16.2%y/y, France Unemployment Rate 7.8%, UK Headline & Core Retail Sales 0.5%m/m/-2.0%y/y & 0.6%m/m/-3.1%y/y, Canada Headline Core Retail Sales -1.7%/-1.0%, Lagarde, Weidmann. (Bloomberg estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) climbed for the fourth week this week to 2.67 after falling from 1.85 to 1.81 four weeks ago. Bullish sentiment increased for the sixth week this week by 16.8ppts (to 57.2% from 40.4%); the 40.4% reading six weeks ago was the lowest percentage since early April 2020. Meanwhile, the correction count edged up to 21.4% after a five-month decline of 15.9ppts (to 21.2% from 37.1%); the 37.1% percentage six weeks ago was the highest since March 2020. Bearish sentiment slipped for the second week to 21.4% this week after a slow climb from 22.1% to 24.1% the prior five weeks—which was the most bears since May 2020. The AAII Ratio climbed for the second week last week to 66.7% (highest since the end of June) from 57.5%, with bullish sentiment climbing from 39.8% to 48.0% and bearish sentiment falling from 29.4% to 24.0% over the two-week period.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin ticked down last week to 13.2% from a record high of 13.3%. 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 Q2-2021 earnings season came in way better than expected, analysts have been playing catch-up with their lowball estimates from the Covid-19 shutdown period. Prior to this catch-up period, consensus S&P 500 forecasts had been falling at rates paralleling the declines during the 2008-09 financial crisis. Forward revenues growth edged up 0.1ppt w/w to 7.5% from an 11-month low of 7.4%. That's down from a record high of 9.6% growth at the end of May and should continue to move lower due as base effects subside. Still, that's up from 0.2% forward revenues growth during April 2020, which was the lowest reading since June 2009. Forward earnings growth remained steady w/w at a 13-month low of 10.0%, 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 was 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 15.8% in 2021 (up 0.2ppt w/w) and 7.0% (up 0.1ppt w/w) in 2022 compared to the 2.1% decline reported in 2020. They expect earnings gains of 49.5% in 2021 (up 0.4ppt w/w) and 7.9% in 2022 (down 0.1ppt w/w) compared to a 13.4% decline in 2020. Analysts expect the profit margin to rise 3.0ppts y/y in 2021 to 13.1% (unchanged w/w) from 10.1% in 2020 and to improve 0.1ppt y/y to 13.2% in 2022 (unchanged w/w). The S&P 500's weekly reading of its forward P/E ticked down 0.1pt w/w to 21.4 from a four-month high of 21.5, but is up from a 17-month low of 20.4 in mid-October. 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 fell 0.02pt w/w to 2.83 from a new record high of 2.85. That's up from a four-month low of 2.69 in mid-October and compares to its prior 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 ten of 11 S&P 500 sectors and forward earnings rise for seven. Forward earnings rose 2.4% w/w for the Consumer Discretionary sector, and Real Estate surged 5.7% higher. Seven sectors are at or near record highs in their forward revenues, earnings, and profit margin: Consumer Discretionary, Consumer Staples, Health Care, Industrials, Information Technology, Materials, and Utilities. Energy still has forward revenues and earnings well below record highs, but its profit margin is the highest since June 2011. 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. Five sectors are expected to see margins decline or remain flat y/y in 2022: Communication Services, Financials, Health Care, 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, two sectors are at record highs. Here's how they rank based on their current forward profit margin forecasts along with their record highs: Information Technology (25.0%, down from its 25.1% record high a week earlier), Financials (18.9, down from its 19.8 record high in early August), Communication Services (16.8, down from its 17.0 record high in early October), Real Estate (16.6, down from its 19.2 record high in mid-2016), Utilities (14.6, down from its 14.8 record high in early May), Materials (13.4, record high this week), S&P 500 (13.2, down from its 13.3 record high a week earlier), Health Care (11.1, down from its record high of 11.2 in April 2018), Industrials (10.2, down from its record high of 10.5% in mid-December), Consumer Staples (7.6, down from its 7.7 record high in early June), Consumer Discretionary (7.9, down from its 8.3 record high in mid-2018), and Energy (9.1 [10-year high], down from a record high 11.2 in mid-2007).

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 20.6% and 55.7%, respectively, since then to new record highs. The forward profit margin has risen 3.1ppts to 13.2%, down from a record high of 13.3% a week earlier, which exceeded its prior record of 12.4% in late 2018. During the latest week, all 11 sectors posted gains in either their forward revenues, earnings, or profit margin. Here's how the S&P 500 and its 11 sectors rank by their changes in forward revenues and forward earnings since May 28, 2020: Energy (forward revenues up 37.4%, forward earnings up 2,074.3%), Materials (32.0, 100.8), Information Technology (26.4, 45.5), Industrials (24.8, 74.0), Communication Services (23.9, 55.5), S&P 500 (20.6, 55.7), Financials (19.0, 67.0), Health Care (16.6, 29.1), Consumer Discretionary (15.1, 92.9), Real Estate (12.4, 31.4), Consumer Staples (12.4, 19.5), and Utilities (0.8, 5.7).

US Economic Indicators

Housing Starts & Building Permits (*link*): Single-family housing starts posted another steep decline in October, while the construction backlog soared, jumping to a 15-year high. Meanwhile, builder confidence improved for the third month in November, though NAHB notes, "supply-side challenges, including building material bottlenecks and lot and labor shortages, remain stubbornly persistent." Single-family housing starts contracted for the fourth month, by 3.9% in October and 10.5% over the period, to 1.039mu (saar)—the lowest since August 2020. Multi-family starts remain in a volatile flat trend, rebounding 7.1% last month to 481,000 units (saar), after a 7.4% drop and a 7.8% jump the prior two months. Building permits—a good leading indicator of housing starts—climbed 4.0% in October to 1.650mu (saar), after tumbling 7.8% in September and rising 5.6% in August. Permits are 12.4% below their cyclical high of 1.883mu at the start of this year. Single-family permits increased 2.7% last month to 1.069mu (saar) after sinking five of the prior six months by 12.8%. Volatile multi-family permits rose 6.6% in October to 581,000 units (saar), following an 18.8% drop and a 15.3% advance the previous two months. NAHB's November Housing Market Index (HMI) shows builders' confidence improved for the third month by 8 points (to 83 from 75 in August); it's 7 points below last November's record high of 90. Two of the three components of the HMI moved higher this month—the traffic of prospective homebuyers (to 68 from 65) and present sales (89 from 86)—while the measure for future sales was unchanged at 84. They were at record highs of 77, 96, and 89, respectively, last November.

Global Economic Indicators

Eurozone CPI (*link*): October's CPI headline rate accelerated for the fourth month to 4.1% y/y—the highest since July 2008—after slowing from a then-30-month high of 2.0% in May to 1.9% in June. Looking at the main components, once again energy (23.7% y/y) posted the biggest gain—recording its largest year-over-year increase on record, while the services inflation rate picked up for the fourth successive month, from 0.7% in June (which was the slowest since the end of 2020) to 2.1% y/y in October. Meanwhile, the yearly rate for food, alcohol & tobacco eased to 1.9% y/y from 2.0% the prior two months, while the rate for non-energy industrial goods slowed for the second month to 2.0% y/y after accelerating from 0.7% in July to 2.6% in August—which was the highest rate since the mid-1990s. Of the top four Eurozone economies, rates for Spain (5.4% y/y) and Germany (4.6) were above the headline rate of 4.1%, while rates for France (3.2) and Italy (3.2) were below.

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