Yardeni Research

MORNING BRIEFING
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What's in Style?

Check out the accompanying pdf and chart collection.

(1) Work in progress. (2) Overweight stocks and cash, but underweight bonds. (3) Key assumption: Inflation peaks soon. (4) Risk is it doesn't. (5) Record negative real interest rates. (6) OMG moment ahead? (7) Cash for buying cheaper stocks and bonds. (8) The "CFO Put," again. (9) Fundamentals still looking great. (10) Three favorite S&P 500 sectors. (11) The MegaCap-8 still have a huge influence. (12) Hard to overweight them. (13) SMidCaps are still cheap. (14) Why we are not fans of Growth vs Value. (15) Gentler robots.

Strategy I: Bonds vs Stocks vs Cash. Joe and I aren't institutional investors. You are. Our number-one professional goal is to help you do your job. Some of you have asked us to provide a monthly summary of various portfolio allocation recommendations including weights for asset classes, sectors, and investment styles based on our analytical work. We've done so on an informal basis and found the exercise to be a good discipline. We aim to develop a more formal approach that we will update regularly. We welcome your comments and suggestions on our work in progress.

For now, let's start with our suggested allocation for a typical institutional balanced portfolio. We would overweight stocks, underweight bonds, and overweight cash relative to the portfolio's benchmark allocation. Here's why:

(1) *Bonds.* Our key assumptions are that the economy will continue to grow, while inflation remains persistently high through the first half of the year. The Fed would start raising interest rates in March in this scenario. We would expect to see the 10-year US Treasury bond yield rise above 2.00% soon on its way toward 2.50% later this year.

The main risk is that inflation will stay higher longer, which would continue to put upward pressure on bond yields. The Fed is clearly behind the inflation curve given that the real federal funds rate was -7.0% during December (based on the yearly percent change in the headline CPI), the lowest since the start of the data in July 1954 (*Fig. 1*). The 10-year Treasury bond yield was -5.6% during December on the same basis (*Fig. 2*). If inflation doesn't moderate on its own in coming months, the risk will be an "OMG moment," when investors bail out of bonds realizing that the Fed will have to raise interest rates much more than expected to bring inflation down.

(2) *Stocks.* Persistent inflation shouldn't be bearish for stocks unless and until the Fed is forced to stop it by raising interest rates to levels that cause a recession. Stocks provide some protection against inflation since revenues rise along with prices. Margins can get squeezed by rising costs, but that doesn't seem to be happening for now as companies raise their prices and boost their productivity.

Of course, while revenues and earnings may keep up with inflation, rising inflation tends to weigh on valuation multiples. There is an inverse correlation between the CPI inflation rate and the P/E of the S&P 500 (*Fig. 3*). The inflation-adjusted S&P 500 earnings yield is a related valuation metric that turned bearish during the second half of last year (*Fig. 4*). It was -0.85% during Q3-2021. Six of the past eight negative readings have been associated with bear markets.

(3) *Cash.* The stock market is likely to remain volatile through mid-year as the Fed finally tightens monetary policy. We would use the cash to buy stocks on dips. We would consider committing more of the cash to bonds once the yield rose to 2.50% if we start to see some signs that inflation is peaking, as we expect to see in coming months.

On the bullish side for stocks is that corporate income statements are showing record cash flows and corporate balance sheets have a record amount of cash (*Fig. 5* and *Fig. 6*). The former was at $3.2 trillion (saar) during Q3-2021, while the latter was $3.7 trillion (excluding holdings of equities and mutual funds) during the same quarter. The "Fed Put" may be kaput, but the "CFO Put" means that M&A activity could support elevated valuations.

Strategy II: Fundamentals. On our website, Joe and I maintain several chart publications that are relevant to analyzing the performance of the broad stock market as well as various investment styles. Before we discuss "what's in style," let's review the broad fundamentals of the stock market:

(1) *Forward revenues, earnings, and margins.* We continue to be impressed by the V-shaped upward trajectory of the forward revenues and forward earnings of the S&P 500/400/600 (*Fig. 7* and *Fig. 8*). We derive the forward profit margins by dividing forward earnings by forward revenues. The resulting margins for the S&P 500/600 continued to rise to record highs of 13.3% and 7.3% during the February 3 week. The margin of the S&P 400 has stalled recently at a record high around 8.5%. This is quite impressive in the face of rising cost pressures with shortages of labor and parts.

(2) *Revenues and earnings growth.* The growth rates of both revenues and earnings on a

per-share basis peaked last year for the S&P 500 at 16.2% and 50.5% (*Fig. 9* and *Fig. 10*). The current analysts' consensus is that they will be down to 8.4% and 8.9% this year. Those are solid growth rates, though they must include more inflation than has been the case in a long time.

(3) *Revenues and earnings revisions.* Upward revisions in S&P 500 revenues and earnings peaked last year along with the growth rates in actual revenues and earnings (*Fig. 11* and *Fig. 12*). Both remained solidly positive during January.

Strategy III: Sectors. During the late 1990s, we favored overweighting the S&P 500 TMT sectors—i.e., Telecom, Media, and Technology. During the bull market of the 2000s, we recommended overweighting MEI—i.e., Materials, Energy, and Industrials. This year, we are keen on EFT—i.e., Energy, Financials, and Technology. Here's why:

(1) *Energy.* Climate activists have succeeded in forcing fossil fuel producers in the US and Europe to slash their capital spending on finding and extracting oil and gas. US frackers have yet to boost their production in response to surging oil prices, suggesting that they can't—simply because their wells are increasingly less productive because they are running dry. A February 3 *WSJ* *article* titled "Oil Frackers Brace for End of the U.S. Shale Boom" concluded: "[T]he era in which U.S. shale companies could quickly flood the world with oil is receding, and that market power is shifting back to other producers, many overseas."

Spare capacity now is largely confined to countries that are vulnerable to geopolitical turmoil. Unnerving the oil market so far this year were a drone strike in Abu Dhabi and tensions between Russia and the West over Ukraine.

The S&P 500 Energy sector has been the worst performing one of the S&P 500's 11 sectors since the start of the current bull market during March 2009. It was the best performer during January, with a gain of 19.0%. That's because the price of a barrel of Brent crude rose $11.27 during the month, following a rise of $8.64 from its recent low during December 1 through the end of 2021. The sector's companies reported better-than-expected earnings and cash flow during Q4-2021 thanks to higher revenues and lower costs.

The ratio of the S&P 500 Energy stock price index to the S&P 500 stock price index fell to a record low during 2020 (*Fig. 13*). It remains well below its average since 1970.

(2) *Financials.* The S&P 500 Financials share of the market cap of the S&P 500 rose from

10.7% at the end of last year to 11.3% at the beginning of February (*Fig. 14*). This series has been highly correlated with the 10-year Treasury bond yield, which should continue to rise this year. Loan demand is starting to rise for the commercial banks. M&A activity hit a record high last year and is likely to hit another record high this year.

The ratio of S&P 500 Financials to the S&P 500 has yet to recover from its crash during the Great Financial Crisis (*Fig. 15*). It did make a new low during 2020 and has recovered a bit since then.

(3) *Technology.* The ratio of the S&P 500 Information Technology sector to the S&P 500 has rebounded in recent years back to its record high in 1999 (*Fig. 16*). Much of the surge in that ratio is attributable to three of the MegaCap-8 stocks that are in the sector, namely Apple, Microsoft, and Nvidia. Nevertheless, we continue to recommend overweighting the sector, which should benefit from a capital-spending boom to boost productivity in the face of chronic labor shortages. During Q4-2021, technology accounted for a record 52.0% of current-dollar capital spending (*Fig. 17*).

Strategy IV: Other Styles. Here is a brief recap of the other three major investment styles that we have recently discussed:

(1) *LargeCaps vs SMidCaps.* We have previously observed that the MegaCap-8 stocks have had a huge impact on the four major investment styles. They account for large market-cap shares of the S&P 500 Communication Services, Consumer Discretionary, and Information Technology sectors. They still account for about 25% of the market-cap share of the S&P 500. During the latest earnings season, a couple of them disappointed (Netflix and Meta), while others delivered better-than-expected results (Alphabet, Amazon, and Microsoft).

Last Friday, the S&P 500 was trading at a forward P/E of 20.3 and 18.2 with and without the MegaCap-8. We've previously observed that from a valuation perspective, the S&P 400/600 MidCaps and SmallCaps have gotten cheaper and cheaper because their forward earnings have soared while their stock price indexes have floundered (*Fig. 18*). Their forward P/Es were down to 14.8 and 13.8 yesterday.

(2) *Growth vs Value.* The MegaCap-8 stocks collectively account for about 50% of the market cap of the S&P 500 Growth composite—the forward P/Es of which were 29.9 and 24.8 on Friday (*Fig. 19*). The forward P/E of Value was 16.5 on Friday.

Joe and I aren't fans of the Growth vs Value investment style. We prefer the others, particularly Sectors. As we discussed above, two of the three sectors we favor overweighting (Energy and Financials) are mostly in Value, while the third (IT) is mostly in Growth.

(3) *Stay Home vs Go Global.* Joe and I are working on a more detailed analysis of this investment style for next week. Stay tuned.

Disruptive Technologies: Softer, Gentler Robots. Move over, R2-D2. Future robots won't be the hard, metallic machines that we're used to seeing today. Scientists are working on softer robots that are malleable, fluid, and can take on a whole new set of tasks. To make these softer robots, scientists are developing new materials and new manufacturing methods. Doing so should enable robots to pick and pack the most delicate items, work next to humans with less risk of injury, and perform delicate surgeries.

Let's take a closer peek at what the next generation of robots might look like:

(1) *Studying the animal kingdom.* Scientists designing soft robots are taking a page out of Mother Nature's book and examining how animals and plants move. Bioinspiration—or biomimicry—has been used to develop a number of materials that help these robots move around their environment just like animals.

The pros at Stanford University found inspiration in the gecko: They've developed a material that grips like a gecko's feet to help robots scale walls. Working with NASA's Jet Propulsion Laboratory, the Stanford scientists have used the material in a device to help robots in space grab ahold of space junk. (Suction cups don't work in the vacuum of space, and most tapes don't work in the extreme cold temperatures.) The scientists' device can grip very softly so that space-borne objects don't bounce away, a June 28, 2017 *article* by the university stated.

The Navy was inspired by sharks when it developed the GhostSwimmer robot. Using its tail for propulsion, the robot looks and swims like a small shark, a December 16 *Wired* *article* reported. The GhostSwimmer can explore waters 10 inches to 300 feet deep, and it's expected to be used for intelligence and surveillance. China, too, has a swimming robot, inspired by the hadal snailfish, according to a March 23 *article* in *PhysicsWorld*. The Chinese scientists hope to use it to explore ocean depths where the pressure is too great for traditional exploration vessels.

(2) *New materials and manufacturing methods, too.* Soft robots are often made with plastics that don't break down and aren't environmentally friendly. Scientists at the Johannes Kepler University in Austria created a biodegradable gel made with gelatin, sugar, citric acid, and glycerol. The material stretches up to six times its original length, a February 5 *Popular Science* *article* reported. The scientists then used the material in a modified 3D printer to make a soft, finger-like device that moved by compressed air. Controlled by a Raspberry Pi and a PlayStation 4 controller, the finger can push objects away.

The gelatin material won't work in extremely high temperatures or with water, but its widely available ingredients make it inexpensive and easy to produce. The developers envision it being used to make robotic toys to reduce harm to children or in food manufacturing.

Besides requiring new materials and the use of 3D printing, soft robots require new electronics. Microfluidic circuits, for example, are being used to make fingers in a soft robotic hand move independently. Scientists from the Korea Institute of Machinery and Materials created a new lithium *battery design* that replicates the scaly look of snakeskin and can bend and stretch.

Soft sensors that can stretch and move with the user are being developed for soft robotics, smart clothing, and bio-compatible medical devices, according to a January 24 *Science Daily* *article*.

(3) *Soft robots in medicine.* Scientists have created wearable soft robotics that can help patients maintain the function of their arms and hands. The robotic system can detect subtle movements like the partial flex of a finger and pneumatically move a glove that completes the intended action, e.g., closing a hand tightly around a handle to lift a cup of coffee, according to a February 8 *press release* from Brown University.

The scientists involved, who hail from Brown, Harvard University, and Massachusetts General Hospital, ultimately hope to use electrodes in a patient's brain to send signals to the soft robotics, to restore their ability to reach and grasp. The device could be used to help patients with ALS (a.k.a. Lou Gehrig's disease) or those who have had a stroke or spinal cord injury.

(4) *Soft pickers.* Soft robotic systems are picking and placing food and other delicate items more carefully on conveyer belts. Privately held *Soft Robotics* uses artificial intelligence in robot grippers sensitive enough to grab rolls and raw chicken pieces without mishap.

A group of scientists out of North Carolina State University is developing a robot gripper able to grasp objects as fragile as an egg yolk and as small as a human hair. The video in this February 3 *New Atlas* article is impressive.

Calendars

US: Thurs: Headline & Core CPI 0.5%m/m/7.3%y/y & 0.5%m/m/5.9%y/y; Initial & Continuous Jobless Claims 230k/1.615m; Federal Budget Balance $25.0n; OPEC Monthly Report. **Fri:** Consumer Sentiment 67.5; Baker-Hughes Rig Count; Fed Monetary Policy Report. (Bloomberg estimates)

Global: Thurs: Elderson; De Guindos; Lane; Wuermeling; Bailey; Lowe. **Fri:** Germany CPI 0.4%m/m/4.9%y/y; UK GDP UK 1.1%q/q/6.4%y/y; UK Business Investment 2.6%; UK Industrial & Manufacturing Production 0.1%m/m/0.6%y/y & 0.1%m/m/1.7%y/y; UK Trade Balance –£12.5b; Elderson. (Bloomberg estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) remained below 2.00 this week for the fifth straight week and the ninth time in 10 weeks. It ticked down to 1.32 this week after rising to 1.43 last week—following a three-week drop from 2.15 to 1.31 (which was the lowest since mid-April 2020). Bullish sentiment slipped to 34.1% this week, indicating the fewest bulls since early April 2020, after a small rebound to 35.7% last week; it had dropped by 15.7ppts (to 34.9% from 50.6%) the prior three weeks. Meanwhile, the correction count rose for the fifth successive week by 14.1ppts (40.0% from 25.9%) to its highest percentage since early March 2020. Bearish sentiment ticked up from 25.0% to 25.9% this week; two weeks ago it was at 26.7%—which was the highest since May 2020. The AAII Ratio rebounded to 37.7% last week after sliding the prior four weeks from 55.2% to 30.4%—which the lowest since late July 2020. Bullish sentiment rose for the second week to 26.5% after falling the prior three weeks from 37.7% to 21.0%, while bearish sentiment sank to 43.7% last week after rising from 30.5% to 52.9% the previous four weeks.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin was steady at a record high of 13.3% last week. Since the end of April 2020, it has exceeded its prior record high of 12.4% in September 2018. It's now up 3.0ppts from 10.3% during April 2020, which was the lowest level since August 2013. Forward revenues and forward earnings per share were also at record highs. They've both been making new highs since the beginning of March 2021 after peaking just before Covid-19 in 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 rose 0.1ppt w/w to 7.7%, and is up from its 12-month low of 7.1% in early December. That's down from a record high of 9.6% growth at the end of May 2021 and should continue to move lower 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 rose 0.1ppt to 8.9%. It remains above its 16-month low of 8.2% in early December, but should also continue to move lower due to base effects. That's down from its 23.9% reading at the end of April 2021, 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, this year analysts have been raising their consensus forecasts for 2021 and 2022 revenues and earnings growth; the imputed profit margin estimate that we calculate from those forecasts has been rising too. They expect revenues to rise 8.4% (up 0.4ppt w/w) in 2022 and 5.6% in 2023 (up 0.1ppt w/w) compared to preliminary 16.5% (up 0.3ppt w/w) gain reported in 2021. They expect earnings gains of 8.9% in 2022 (up 0.1ppt w/w) and 10.1% in 2023 (down 0.1ppt w/w) compared to a preliminary earnings gain of 51.1% in 2021 (up 0.6ppt w/w). Analysts expect the profit margin to rise 0.1ppts y/y in 2022 to 13.2% (unchanged w/w) from a preliminary 13.1% in 2021 (unchanged w/w) and to improve 0.5ppt y/y to 13.7% in 2023 (down 0.1ppt w/w). The S&P 500's weekly reading of its forward P/E jumped 0.8pt to 20.3 from a 21-month low of 19.5. That's down from an eight-month high of 21.7 at the end of 2021 and 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 rose 0.11pt w/w to 2.70 from an 11-month low of 2.59, but is down from a record high of 2.88 at the end of 2021. That's up from its four-month low of 2.69 in mid-October and compares to its prior record high of 2.86 at the end of November 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 and earnings rise for all 11 S&P 500 sectors, and the forward profit margin rise for nine sectors and fall for two. Nearly all sectors are at or near record highs in their forward revenues, earnings, and profit margin. Energy still has forward revenues and earnings well below record highs, but its profit margin is near its highest reading since November 2008. 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, all but the Utilities sector posted a y/y improvement. Three sectors are expected to see margins decline or remain flat y/y in 2022: Communication Services, Financials, and Real Estate. Here's how they rank based on their current forward profit margin forecasts along with their record highs: Information Technology (25.2%, a new record high this week), Communication Services (16.6, down from its 17.0 record high in October), Real Estate (16.9, down from its 19.2 record high in 2016), Utilities (14.6, down from its 14.8 record high in April), Materials (13.2, down from its 13.4 record high in December), S&P 500 (13.3, a record high this week), Health Care (11.4, a record high this week), Industrials (10.2, down from its 10.5 record high in December 2019), Consumer Staples (7.6, down from its 7.7 record high in June), Consumer Discretionary (8.1, down from its 8.3 record high in 2018), and Energy (9.2, down from its 13-year high of 9.3 a week earlier and down from a record-high 11.2 in 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 24.8% and 62.2%, respectively, since then to new record highs. The forward profit margin has risen 3.3ppts to a record high of 13.3%. That exceeds its prior pre-Covid record of 12.4% in late 2018. During the latest week, consensus forward revenues and earnings rose for all 11 S&P 500 sectors, and the forward profit margin rose for nine sectors and fell for two. 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 50.6%, forward earnings up 2,328.7%), Materials (36.7, 104.9), Information Technology (32.2, 53.2), Industrials (28.5, 78.4), Communication Services (26.8, 57.3), S&P 500 (24.8, 62.2), Financials (22.3, 68.9), Health Care (19.9, 36.6), Consumer Discretionary (19.7, 107.4), Real Estate (15.8, 37.4), Consumer Staples (15.2, 22.0), and Utilities (2.7, 8.2).

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