MORNING BRIEFING
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War & Peace

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Executive Summary: Horrific as it is, Russia's war in Ukraine hasn't stopped the US stock market from advancing; investors know that geopolitical crises can present buying opportunities. The war has had significant impacts on commodity prices, inflation expectations, and certain stock market sectors. … The Energy and Materials sectors are benefiting from analysts' higher revenues and earnings sights, and so are companies generally. Faster inflation is boosting revenues expectations to record highs, and the fact that earnings are following suit suggests most companies are able to pass their higher costs on to customers. ... Also: For auto makers and their suppliers, the war is escalating already extreme supply-chain challenges and upending the global playing field in multiple ways.

Strategy I: Global War Clouds. Russian author Leo Tolstoy wrote in his novel *War and Peace*, "The strongest of all warriors are these two—Time and Patience." Let's hope that time and patience are on the side of Ukraine in Putin's War, even though each passing day seems to be compounding the horrors of war. What makes this war particularly horrible is that civilians are getting killed and wounded as intended targets, not as random collateral damage. Russian forces may be losing the war on the ground, but that only emboldens the invaders to dig in around the major cities and to use hypersonic missiles to level them. The resulting death and destruction are hard to imagine, let alone to witness on television news programs. Hopefully, this madness will end soon.

Most unsettling, of course, are the analyses of the war that posit that Russian President Vladimir Putin, frustrated by his failing battle plan on the ground, will escalate the war by using chemical weapons or even tactical nuclear ones. Nuclear weapons were supposed to stop wars, according to the theory of deterrence, particularly the notion of mutually assured destruction. The problem is that Putin has been threatening to use tactical nuclear weapons to deter NATO from intervening with conventional forces to stop the brutal Russian invasion. No one can be sure whether Putin is crazy or crazy like a fox.

While this geopolitical crisis certainly is unsettling, it hasn't deterred advances in the US stock market, which remains more focused on the Fed's monetary policy stance. That's not to say that Putin's War has had no impact on the stock market. It has pushed commodity prices significantly higher, which has been bullish for the stocks of energy and materials companies. The war also has caused more investors to expect higher-for-longer inflation and to look for the buying opportunities in that scenario. Investors have learned over the years that geopolitical crises tend to present buying opportunities.

Consider the following gyrations in the financial markets over the four weeks since Russia first invaded Ukraine:

(1) *Commodities.* Both the CRB all commodities and raw industrials spot price indexes have continued to soar in record-high territory since February 24, when the invasion began (*Fig. 1*). That's unusual since these indexes are highly correlated with the global business cycle, which is bound to show slower growth as central banks are forced to tighten their monetary policies in response to higher inflation, attributable partly to rising commodity prices.

Indeed, one of the most economically sensitive commodity prices is that of copper, and it has been moving higher along with the CRB raw industrials spot price index (*Fig. 2*). That's surprising since the price of copper tends to be especially sensitive to developments affecting China's economy, which is clearly slowing, as the country's property market is falling into a depression.

Even the major tech companies in China are slashing jobs this year as they face economic and regulatory headwinds, *according* to the March 21 *WSJ*. There has been an unusual divergence since mid-2021 between the rising price of copper and the plunging China MSCI stock price index, led by falling tech shares (*Fig. 3*).

The war and the soaring prices of crude oil and natural gas explain why copper and other metal prices are so strong (*Fig. 4*). Soaring energy costs are forcing refiners to shut down their smelting operations. Of course, the war in Ukraine and the sanctions on Russia are also disrupting exports of aluminum, nickel, and palladium from Russia.

The bottom line is that rising commodity prices are reflecting a host of inflationary pressures rather than signaling booming global economic activity.

(2) *Bonds.* The 10-year Treasury bond yield is finally doing what we expected it to do last year, i.e., rise to 2.00% on the way to 2.50%, and then maybe 3.00%. The Fed's purchases of $120 billion per month in Treasuries and mortgage-backed securities last year explain why the reliably close relationship between the bond yield and the copper/gold price ratio (using nearby futures prices for both) wasn't reliable last year (*Fig. 5*). The former remained under 2.00% during 2021 even though the latter suggested that it should have been closer to 2.50%. On Monday, the yield rose to 2.32%, while the copper/gold ratio was at 2.44%.

That makes sense since the Fed will be cutting its monthly bond purchases to zero starting next month.

Why has the copper/gold ratio worked so well as a bond yield indicator? The copper futures price and the expected inflation spread between the 10-year nominal and TIPS yields closely track each other (*Fig. 6*). The latter remained at 2.9% yesterday, the highest since the start of the data in 2004.

Meanwhile, the price of gold and the 10-year TIPS yield closely track one another too, but inversely so (*Fig. 7*). The nominal bond yield is the sum of the TIPS yield and the expected inflation spread, with the reciprocal of the gold price reflecting the TIPS yield and the copper price reflecting the inflation expectations.

Think of the copper/gold ratio as a risk-on versus risk-off indicator for the bond market. What's different this time is that expected inflation is rising even though the outlook for global economic growth is deteriorating. Supply constraints, not booming economic activity, are what's driving up commodity prices. Rising inflationary expectations are driving up bond yields. It all adds up to higher-than-expected inflation and lower-than-expected economic growth—a.k.a. stagflation.

By the way, the bond yield is also highly correlated with the ratio of the nearby futures prices of Brent crude oil to gold (*Fig. 8*). It suggests that the bond yield is heading to 2.80%.

Strategy II: Blue Skies. There are no apparent war clouds in analysts' expectations for earnings. On the contrary, some of them are raising their expectations for both the revenues and earnings of the companies they follow, particularly in the Energy and Materials sectors. Companies paying more for their commodities are expected to pass these costs onto their customers through higher prices.

Joe and I know all this because we carefully track on a weekly basis the revenues and earnings forecasts of analysts who cover the companies in the S&P 500/400/600 indexes. Here are some of the most important latest developments:

(1) *Quarterly earnings expectations.* For all three indexes, analysts continue mostly to raise their earnings expectations for each of this year's four quarters (*Fig. 9*). As of the March 17 week, here are the Q1-Q4 projected y/y growth rates for the S&P 500 (5.3%, 6.0%, 9.7%, 12.1%), S&P 400 (16.2, 8.9, 7.9, 9.2), and S&P 600 (11.6, 5.1, 13.1, and 9.1) (*Fig. 10*).

(2) *Forward revenues and forward earnings.* The faster pace of inflation is helping to drive the forward revenues of companies in the S&P 500/400/600 indexes to new record highs (*Fig. 11*). Notwithstanding rapidly rising costs as well as shortages of parts and labor, their forward earnings, too, are continuing to achieve record highs (*Fig. 12*). This suggests that most of the 1,500 companies in these three indexes are able to pass those increasing costs on to their customers by raising their prices.

(3) *Forward profit margins.* During the economic recovery of 2020 and 2021, all three indexes' forward profit margins (which we calculate from analysts' revenues and earnings estimates) had V-shaped recoveries (*Fig. 13*). That's not unusual since productivity tends to rebound smartly during recoveries. What is unusual is that all three margins rose so rapidly to new record highs at the beginning of this year. So far this year, they've stalled around their record highs of 13%, 9%, and 7%, respectively.

(4) *Valuations.* While the stock market's fundamentals remain remarkably resilient, higher-for-longer inflation has eroded the forward P/Es of the S&P 500/400/600 indexes since the spring of 2021, when inflation started to rear its ugly head (*Fig. 14*).

Global Autos I: New Auto Supply-Chain Disruptions. First it was the chip shortage and other persistent supply-chain problems that drastically slowed carmakers' production schedules during the pandemic. Now even before those problems have let up, new supply-chain challenges have come from Russia's war on Ukraine and the renewed resurgence of Covid-19 in China. *European* and *Asian* production recently has been hit especially hard. Not surprisingly, all of the car brands with below-average inventories are imports, Cox Automotive recently *noted*.

The supply-chain challenges could restructure the way autos are sold. Automakers and dealers are enjoying high per-car profits, and customers are accepting a new make-to-order system rather than expecting to buy off the inventory on the lot. Cox Automotive's annual Car Buyer Journey Study *explored* the effects of the new car-buying processes on the customer experience. Car buyers remain satisfied with all but two aspects: inventory frustrations and purchase price.

Here's more on what's disrupting the auto industry:

(1) *Russia's war on Ukraine.* The crisis in Ukraine could exacerbate car price inflation and redistribute global automakers and suppliers around the globe, shrinking the auto industries of European countries. That could severely impact the European economy, as auto jobs are

an important source of employment. Germany's biggest exports are motor vehicles, supporting a network of vehicle suppliers around Europe.

Many automakers rely on crucial component suppliers in Russia and the Ukraine. Volkswagen, BMW, and Porsche said they would be forced to curtail production as a result, the *NYT* *reported* on March 1. AutoAnalysis estimates that Ukrainian factories account for 20% of Europe's wire harness supply, which is necessary for vehicle assembly.

Other effects of the war on automakers and their suppliers include: 1) shortages of the neon gas and palladium—of which Russia and Ukraine are critical suppliers—needed to manufacture semiconductor chips; 2) production interruptions of Ukrainian factories, such as those of Leoni, a large German maker of electronic components discussed in the *NYT* article; 3) manufacturers pulling production out of Russia in a show of solidarity with Ukraine—perhaps permanently (resuming Russian operations would likely mean PR backlash); 4) European factory shutdowns because of war-heightened gas prices; and 5) Volkswagen and other carmakers *searching* for alternative suppliers, which could affect the European automotive ecosystem in the future.

(2) *Covid-19 resurgence in China.* In the last few days, mainland China has seen its worst Covid outbreak since early on in the pandemic, *reported* CNBC on March 16. Renewed lockdowns will impact the Chinese economy and global supply chains, but how extensively is unknowable yet. So far, local factory checks revealed a limited impact on the production of chips and autos among other industries. For autos, the current picture of plants is mixed. A "couple of Shanghai-based names saw bigger disruption, while BYD's Shenzhen plant is operating normally as of 14th March."

(3) *Chip shortage.* It's old news that the semiconductors needed for car computers are hard to find. But the issues above are exacerbating an already challenging situation. Research firm IHS Markit (now a part of S&P Global) expects about 3.5 million fewer vehicles to be made globally this year owing to semiconductor chip constraints, *reported* CNBC on March 7.

Global Autos II: Shortage of New Cars in US. Used vehicle inventory is plentiful. Then why did the CPI for used vehicle retail prices and the Manheim used car price index spike 41.2% y/y and 36.7% y/y, respectively, in February (*Fig. 15*)? Because dealer lots are short of new vehicles. The CPI for new vehicles also shot up during February, by 12.4% y/y (*Fig. 16*).

Here are some more auto stats to consider, based on a Wolf Street *article* citing Cox Automotive's data for *used* and *new* vehicles:

(1) The total supply of unsold used vehicles on dealer lots across the US climbed to 2.62 million units as of March 1, about 5% above a year ago. In contrast, the total US supply of available unsold new vehicles stood at 1.07 million units at the start of March, down 59% from the comparable period in 2021.

(2) Used vehicle sales picked up from the previous month and drove February's days' supply down to 51 from 55 last month, but days' supply was still up 11% y/y. The days' supply of unsold new vehicles was 34 at the start of March, down from 37 in early February and 50% below a year ago.

(3) At the end of February, the average listing price for used vehicles was $27,608, up 28% y/y and close to the December 2020 peak of about $28,000. The average listing price for new vehicles rose to $44,704 as of February's end, up 12% y/y.

(4) Demand for new vehicles has taken a hit from the high prices and low supply. But it has not been low enough to allow for inventory to build at those prices. In February of this year, a historical low of 1.05 million new vehicles were sold, down 22% y/y, according to the Bureau of Economic Analysis. Nevertheless, some buyers were motivated by attractive trade-in offers.

Calendars

US: Wed: New Home Sales 810k; MBA Mortgage Applications; Crude Oil Inventories; Gasoline Production; Powell; Daly. **Thurs:** Durables Goods Orders, Total, Ex Defense, and Core Capital Goods -0.5%/0.1%/0.5%; Initial & Continuous Jobless Claims 212k/1.41m; IHS Markit M-PMI & NM-PMI Flash Estimates 56.3/56.0; Kansas City Manufacturing Index; Natural Gas Storage; Natural Gas Storage; Waller; Evans. (Bloomberg estimates)

Global: Wed: UK Headline & Core CPI 0.6%m/m/5.9%y/y/0.5%m/m/5.0%y/y; UK PPI Input & Output Prices 1.2%m/m/13.9%y/y/0.9%m/m/10.1%y/y; UK Annual Budget Release; ECB Non-Monetary Policy Meeting; BOJ Monetary Policy Meeting Minutes; Nagel; Bailey; Kataoka. **Thurs:** Eurozone, Germany, France C-PMI Flash Estimates 53.9/53.7/54.3; Eurozone, Germany, France M-PMI Flash Estimates 56.0/55.8/55.0; Eurozone, Germany, France NM-PMI Flash Estimates 54.2/53.8/55.0; UK C-PMI, M-PMI, and NM-PMI Flash Estimates 58.7/57.0/58.0; ECB Economic Bulletin; EU Leaders Summit; Beerman. (Bloomberg estimates)

Strategy Indicators

S&P 500 Sectors Net Earnings Revisions (*link*): The S&P 500's NERI weakened m/m in March for a second month after rising in January for the first time in six months. It dropped to a 20-month low of 3.9% from 5.1% in February, but was positive for a 20th month following 13 straight negative readings. That exceeds the prior 18-month positive streak during the cycle that ended October 2018 (during which NERI had reached a tax-cut-induced record high of 22.1%, in March 2018). March's reading compares to a record-high 23.1% in July 2021 and an 11-year low of -37.4% in May 2020. Seven of the 11 S&P 500 sectors had positive NERI in March, down from eight a month earlier and the lowest count since it was zero in July 2020. Six sectors had NERI readings at post-pandemic 20-month lows during the month. Just three had NERI improve m/m, up from two rising in February. Among the underperforming sectors, Consumer Staples turned negative m/m, Utilities was negative for a third month and Communication Services for a fifth month. Here are the March NERIs for the S&P 500 and its sectors compared with their February readings: Energy (29.7% in March, down from 17.5% in February [13-month low]), Financials (11.6, 13.9), Information Technology (8.8 [20-month low], 10.5), S&P 500 (3.9 [20-month low], 5.1), Industrials (1.9, 1.6), Health Care (1.0 [20-month low], 2.4), Real Estate (0.8 [11-month low], 4.0), Consumer Discretionary (0.5 [20-month low], 5.5), Consumer Staples (-1.5 [20-month low], 2.3), Materials (-2.8, -3.8 [19-month low]), Utilities (-3.1 [20-month low], -2.1), and Communication Services (-12.2 [20-month low], -9.6).

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin was steady at a record high of 13.4% 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 3.1ppts from 10.3% during April 2020, which was the lowest level since August 2013. Forward revenues and earnings were both back at record highs after ticking down briefly in early February. They have 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 0.2ppt w/w to 8.1%, up from its 12-month low of 7.1% from early December. That's down from a record high of 9.6% growth at the end of May 2021. 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 0.4ppt w/w to 9.5%. It remains above its 16-month low of 8.2% in early December. 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. So far this year, analysts' revisions to their forecasts for 2022 revenues have outpaced their revisions for 2022 earnings, so the imputed 2022 profit margin estimate that we calculate from those forecasts has ticked lower. They expect revenues to rise 9.5% (up 0.3ppt w/w) in 2022 and 5.4% in 2023 (unchanged w/w) compared to the 16.4% gain reported in 2021. They expect earnings gains of 9.7% in 2022 (up 0.5ppt w/w) and 9.7% in 2023 (down 0.1ppt w/w) compared to an earnings gain of 51.5% in 2021. Analysts expect the profit margin to remain steady in 2022 at 13.2% (unchanged w/w) compared to 13.2% in 2021 and to improve 0.5ppt y/y to 13.7% in 2023 (unchanged w/w). The S&P 500's weekly reading of its forward P/E rose 0.3pt w/w to 18.9 from a 23-month low of 18.6. 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 0.04pt w/w to 2.53, and remains barely above its 15-month low of 2.48 at the end of February. That's down from a record high of 2.88 at the end of 2021 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 nine of the 11 S&P 500 sectors, forward earnings rise for four, and the forward profit margin rise for two and fall for nine. Nearly all sectors are at or near record highs in their forward revenues, earnings, and profit margins. Energy still has forward revenues and earnings well below record highs, but its profit margin of 10.1% last week was up 0.4ppt w/w to its highest reading since March 2008. Financials 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. Four sectors are expected to see margins decline or remain flat y/y in 2022: Communication Services, Consumer Staples, Financials, and Real Estate. Here's how they rank based on their current forward profit margin forecasts along with their record highs: Information Technology (25.3%, down from its 25.4% record high a week earlier), Financials (18.7, down from its 19.8 record high in August 2021), Real Estate (16.3, down from its 19.2 record high in 2016), Communication Services (16.4, down from its 17.0 record high in October), Utilities (14.2, down from its 14.8 record high in April 2021), Materials (13.3, down from its 13.4 record high in December), S&P 500 (13.4, a record high this week), Health Care (11.3, down from its 11.5 record high a week earlier), Industrials (10.2, down from its 10.5 record high in December 2019), Energy (10.1 [15-year high], down from a record-high 11.2 in 2007), Consumer Staples (7.5, down from its 7.7 record high in June), and Consumer Discretionary (8.1, down from its 8.3 record high in 2018).

US Economic Indicators

Regional M-PMIs (*link*): Three Fed districts (New York, Philadelphia, and Richmond) now have reported on manufacturing activity for March and show the manufacturing sector is growing at a slower pace than last fall. The composite index (to 9.5 from 6.7) did show a slight acceleration this month, though at a pace that was only around one-third of November's (27.0). Growth in both the Philadelphia (27.4 from 16.0) and Richmond (13.0 from 1.0) regions accelerated this month, the latter from near zero. Meanwhile, New York's (-11.8 from 3.1) manufacturing sector contracted for only the second time since mid-2020, posting its weakest performance since May 2020's -48.5 reading at the height of the pandemic. The new orders (8.2 from 4.2) measure improved a bit from February's 21-month low as orders in the Philadelphia (25.8 from 14.2) region accelerated at a four-month high and Richmond's (10.0 from -3.0) measure moved from contraction to expansion. Meanwhile, New York (-11.2 from 1.4) billings contracted at the fastest pace since May 2020. Jobs' (25.5 from 25.1) growth continued at a healthy pace, with factory hirings in the Philadelphia (38.9 from 32.3) region accelerating at a record rate, while Richmond's (23.0 from 20.0) expanded at a steady, though robust, pace. Meanwhile, New York factories (14.5 from 23.1) hired at roughly half the pace of recent highs. Turning to prices, Philadelphia's prices-paid measure accelerated from 69.3 in February to 81.0 this month—the highest since mid-1979—while its prices-received (54.4 from 49.8) measure picked up a bit, though was below the November reading of 62.9, which was close to its record high of 63.8 in the mid-1970s. New York's input prices eased for the fourth month, from 83.0 in November—which was near last May's record high of 83.5—to 73.8 in March, while its prices-received (56.1 from 54.1) gauge reached a new record high this month. Prices-paid in the Richmond (110.5 from 122.7) region eased for the second month since reaching a record high of 143.2 in January, with Richmond's prices-received (87.7 from 91.6) gauge also slowing for the second month from its January record high, of 112.7. (Note: The Philadelphia and New York measures are diffusion indexes, while Richmond's measures are average annualized inflation rates—which we multiply by 10 for easier comparison to the other regional measures).

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