MORNING BRIEFING
May 19, 2022

Retailers, Materials & Fintech

Check out the accompanying chart collection.

Executive Summary: First the good news: Retail sales rose solidly in both March and April. Now the bad news: Two retail giants missed their Q1 earnings marks, causing recession-fearing investors to jettison their stocks. Jackie recaps what their management teams had to say about the quarter. … Also: With recession fears running high among investors, why is the S&P 500 Materials sector in their good graces? It has outperformed the market and most other sectors ytd. Within Materials, we focus on one industry with a shiny outlook, Steel, and a single member, Nucor. … Also: A look at Walmart's foray into fintech.

Consumer Discretionary: The Spending Continues. Consumers may continue to shop until they drop, but stocks dropped yesterday on disappointing results from a couple of giant retailers. This week, we learned that consumers are still spending. But we also learned that retailers' profit margins were squeezed during Q1.

Consumers shopped online when they were shut in at home due to Covid, and now, armed with boosters, they're shopping in person. The spending spree lifted April retail sales by 0.9% m/m and 8.2% y/y (*Fig. 1*). It's an impressive pace of consumption even after adjusting for the 8.3% y/y CPI increase in April. Real retail sales still increased by 0.6% m/m in April, though they were flat y/y (*Fig. 2* and *Fig. 3*).

Here's the y/y nominal sales performance of the 13 retail sales categories in April: gasoline service stations (36.9%), food services & drinking places (19.8), miscellaneous store retailers (18.6), nonstore retailers (12.7), clothing & accessories stores (8.0), food & beverage stores (7.1), health & personal care stores (2.1), building materials & garden equipment (1.7), general merchandise stores (1.2), furniture & home furnishings stores (0.8), motor vehicles & parts (-1.7), electronics & appliance stores (-5.2), and sporting goods, hobby book & music stores (-5.4) (*Fig. 4* and *Fig. 5*).

As we were reminded by Target and Walmart earnings reports this week, rising sales are no guarantee of rising earnings. Inflation may have helped the retailers' top lines, but it also meant higher-than-expected expenses and lower-than-expected margins. In addition to cost inflation, supply-chain problems tripped up the nation's largest retailers, as did tough

comparisons to last year, when federal subsidies gave consumers free money to spend. And even Mother Nature conspired against retailers by delaying the arrival of spring in the Northeast.

Spooked by the retailers' earnings reports, the S&P 500 lost 4.0% on Wednesday, bringing its ytd loss to 17.8%. More negative news arrived after the market's close on Wednesday. Kohl's announced that its chief merchandising officer and chief marketing officer are both resigning. No reasons for the departures were given, but investors will hear from Kohl's tomorrow morning when it reports Q1 earnings. Meanwhile, here's what Walmart and Target executives had to say about their Q1 results:

(1) *Bit by inflation.* Walmart's customers are feeling the impact of inflation and they don't have stimulus dollars to help this year the way they did in 2021. Walmart's Q1 US same-store sales rose 3%, ahead of expectations, which prompted the company to boost its forecast for that measure to 3.5% for the full year, up from a previous estimate of 3.0%.

On the May 17 *conference call*, CEO Doug McMillon noted his concern that today's double-digit food inflation will continue and increase. Consumers have responded by spending more on food and less on general merchandise. Signs that consumers are pinching pennies: They're buying more private-label products and buying smaller volumes, like half a gallon of milk instead of a full gallon.

Meanwhile, Walmart stubbed its toe operationally. More employees returned from Covid leave than expected, so the company's wage expense was higher than planned. The company's inventory was up 32% in Q1, resulting in higher storage costs and the need to run sales, which hurt margins. And lastly, fuel costs were $160 million higher in the quarter than forecast. Altogether, it meant that Q1 operating income fell 22.7% y/y. While the company's revenue is expected to increase 4.5%-5.0% this year, operating income and earnings per share are expected to be relatively flat y/y.

Walmart's shares fell 11.4% on Tuesday after its earnings release. The company and Costco Wholesale are the two constituents in the S&P 500 Hypermarkets & Super Centers industry. The industry's stock price index has fallen 11.6% ytd through Tuesday's close (*Fig. 6*). Prior to Walmart's earnings miss, the industry's revenue was expected to climb 7.4% this year and 5.3% in 2023 (*Fig. 7*). Earnings were forecast to climb slightly faster, by 9.5% this year and 8.5% in 2023 (*Fig. 8*). The industry's forward P/E, at 25.5, is near the top end of its 20-year range (*Fig. 9*).

(2) *Target feels Walmart's pain.* Many of the themes discussed on Walmart's Q1 earnings call were echoed in Target's Q1 results. While same-store sales for the quarter increased 3.3%, margins contracted due to higher expenses and the need to run sales to move inventory.

Consumers opted to spend on necessities. Sales in food and beverage, essentials, beauty, and luggage enjoyed strong growth. Conversely, comparable-store sales in apparel, home, and hardlines had small declines in the quarter. Target opted to run sales on excess inventory in those areas, which hurt Q1 gross margin by 3ppts compared to last year.

Higher shipping costs are also hurting Target's bottom line. Q1 freight and transportation costs were "hundreds of millions of dollars higher than our already elevated expectations," said COO John Mulligan in the company's *conference call* on Wednesday. Target now expects 2022's freight and transportation costs will be $1 billion higher than expected just three months ago.

Altogether, Target's Q1 operating margin came in at 5.3%, 4.5 ppts below the year-ago level, and the company expects a similar result in Q2. For the full year, the retailer is forecasting low- to mid-single-digit revenue growth and an operating margin around 6%, well below prior guidance of 8% or higher. Displeased investors sent Target shares hurtling almost 25% Wednesday.

Target is a member of the S&P 500 General Merchandise Stores industry, along with Dollar General and Dollar Tree. The industry's stock price index has fallen 3.1% ytd through Tuesday's close (*Fig. 10*). Prior to this week's news, investors were still optimistic about the industry's growth. Analysts were calling for revenue to grow 5.3% this year and 5.0% next year (*Fig. 11*). They were expecting earnings to climb 12.9% in 2022 and 9.4% in 2023, figures that undoubtedly will be revised lower now (*Fig. 12*).

Materials: Sending Mixed Messages. Earlier this week, Nucor, a steel manufacturer, agreed to buy C.H.I. Overhead Doors, a manufacturer of home and commercial garage doors, for $3 billion. The company's CEO called the deal "another step in our long-term strategy to expand into areas that are a natural extension of our business and leverage our efficient manufacturing model." A cynic might wonder whether the company is diversifying away from steel production to prepare for a downturn.

Recession fears undoubtedly have clipped Nucor's stock price. The sole constituent of the S&P 500 Steel stock price index, Nucor has seen its shares fall 28.8% from its April 21 high.

But they remain up 9.6% ytd through Tuesday's close (*Fig. 13*). The S&P 500 Steel stock price index is outperforming both the S&P 500 and the S&P 500 Materials sector on a ytd basis. It also enjoyed a 4.4% rally on Tuesday, again outperforming the broader market.

The industry has absorbed a ton of bad news in recent months. Auto production has been hampered by a lack of parts. Plane manufacturing has been held back by Boeing's missteps with the Max. Demand from Chinese manufacturers has been impeded by Covid-19 lockdowns in Shanghai and elsewhere. And energy producers, who should be building new capacity to take advantage of oil prices north of $100 a barrel, have been reticent to do so after being tarred and feathered by investors for not being green enough in recent years.

Imagine what could happen to Nucor's stock price if just a few of those negatives went right? News that there were no community Covid infections recorded in Shanghai for the third day in a row seemed to contribute to Tuesday's rally. The goal is to relax Shanghai's lockdown in phases starting on June 1. The city's businesses and production are expected to return to normal operations by late June, a May 17 *South China Morning Post* *article* reported.

Let's take a look at the S&P 500 Materials sector in general and its Steel industry constituent specifically:

(1) *Materials outperform.* In a market afraid that higher interest rates will lead to a recession, it's more than a little surprising that the S&P 500 Materials sector has outperformed the broader market and most other sectors so far this year. Here's the performance derby for the S&P 500 and its 11 sectors ytd through Tuesday's close: Energy (50.3%), Utilities (0.7), Consumer Staples (-1.0), Materials (-6.7), Health Care (-7.0), Industrials (-10.3), Financials (-12.8), S&P 500 (-14.2), Real Estate (-16.8), Information Technology (-20.7), Communication Services (-24.4), and Consumer Discretionary (-25.9) (*Fig. 14*).

Some of the industries within the S&P 500 Materials sector are benefitting from price increases related to production disruptions caused by the Russia/Ukraine war. The S&P 500 Fertilizers & Agricultural Chemicals stock price index has risen 34.0% ytd. Conversely, other industries, like Copper and Construction Materials, have fallen sharply (-9.8% and -22.3% ytd) on concerns that the US housing market is about to get clobbered by higher interest rates.

The S&P 500 Gold and S&P 500 Steel industry stock price indexes are still in positive territory but far from their highs of early April. At its peak on April 18, the S&P 500 Gold

stock price index was up 37.7% ytd, and now it's up only 5.6%. As we mentioned above, the S&P 500 Steel stock price index was up 53.8% ytd at its peak on April 21, and now its gain has withered to 9.6% ytd (*Fig. 15*).

Related commodities have also taken a nosedive. At a recent $4.24 per pound, the price of copper is down 14% from its $4.93 high this year (*Fig. 16*). The price of US Midwest domestic hot-rolled coil steel has fallen 11% from its 2022 high and 29% from its 2021 peak (*Fig. 17*). And despite the sharp rise in US prices, gold has dropped 11% from this year's high (*Fig. 18*). Here's the price performance of these commodities ytd through Tuesday's close: copper (-4.8%), steel (-4.0), gold (1.1).

(2) *Can Nucor grow past peak?* Nucor's Q1 earnings didn't quite surpass its record Q4 results, but they were strong on a y/y basis, and the company predicted that Q2 results would take out last year's peak earnings level. Nucor reported Q1 revenue of $10.5 billion and earnings of $2.1 billion, a massive y/y jump from the $7.0 billion of revenue and $942.4 million of net income reported in Q1-2021. Earnings were down ever so slightly from record Q4 earnings of $2.3 billion.

Last quarter's results were driven by a 68% y/y jump in average sales price per ton, while the amount of steel actually shipped to outside customers decreased 11% y/y to 6.4 million tons. Operating rates slipped to 77% in Q1-2022 from 89% in Q4 and 95% in Q1-2021. Management said that while end demand remained "strong," the average realized selling price in sheet "softened in the first quarter reflecting increased import volumes coupled with modest destocking."

Management said Q2 results would surpass those of Q4, which was the most profitable in the company's history. The company cited the strength in the nonresidential construction markets. Strength in the digital and green economies are "creating significant demand for distribution centers, warehouses, server storage, facilities and EV-related facilities as well," said Chad Utermark, Nucor's head of fabricated construction products, on the April 21 *conference call*. He also highlighted demand from the new manufacturing plants being built across the country.

(3) *Wall Street's take.* Analysts are optimistic about the S&P 500 Steel industry's 2022 earnings, expecting growth of 18.0%. Early last year, analysts were expecting a sharp drop in earnings this year. But over past 12 months, 2022 forecasts have grown increasingly more optimistic (*Fig. 19*). Analysts' pessimism has been pushed off to 2023, when earnings are expected to fall 54.2% (*Fig. 20*).

The S&P 500 Steel industry's forward P/E, at 6.1, implies that the industry is enjoying peak earnings. The industry's forward P/E tends to fall when earnings approach a peak and to rise when earnings drop sharply during a recession (*Fig. 21*).

Disruptive Technologies: Fintech in Aisle One. During Walmart's Q1 earnings conference call, CEO Doug McMillon mentioned the company's completed acquisition of two small fintech companies, One Finance and Even Responsible Finance. It's the firm's latest effort to break into the world of banking. Here's a quick update:

(1) *Hello, Hazel.* Last fall, Walmart started Hazel, a financial services joint venture with Ribbit Capital, a firm known for investing in Robinhood Markets, Credit Karma, and other digital financial businesses. The venture, in which Walmart has a majority stake, is headed by two former Goldman Sachs bankers, Omar Ismail and David Stark. They previously headed Marcus, the startup Goldman launched to break into the world of consumer banking.

(2) *Buying businesses.* In January, Walmart announced plans to purchase Even and One. One is an online financial services firm that depends on its relationship with Costal Community Bank to offer customers online banking services. Like other neobanks, One offers higher interest rates on its savings accounts and lower fees than traditional banks. The firm also offers budgeting services.

At the same time, Walmart announced plans to acquire Even. Walmart is a customer of Even, which is used by employers to offer workers early access to up to 50% of their paychecks. Even also offers a savings account and budgeting tools. The newly formed company, renamed "ONE," is expected to have about $250 million of cash after the deals closed.

"Around the world, we can help our customers and members transact seamlessly, digitally, and help them strengthen their lives financially," McMillon said on Tuesday. Walmart has roughly 1.6 million employees and over 100 million US shoppers a week. In 2015, the retailer began to offer employees and customers a mobile payment app inside its shopping app, but it hasn't gained widespread acceptance.

Banking industry executives undoubtedly will be watching to see if Walmart's joint venture is the ONE that helps it break into financial services.

Calendars

US: Thurs: Leading Indicators 0.3%; Initial & Continuous Jobless Claims 200k/1.32m; Philadelphia Fed Manufacturing Index 18.0; Existing Home Sales 5.66mu; Natural Gas Storage. **Fri:** Baker-Hughes Rig Count. (Bloomberg estimates)

Global: Thurs: Eurozone Current Account; UK Gfk Consumer Confidence -39; Japan CPI 2.1% y/y; PBOC Loan Prime Rate; ECB Publishes Account of Monetary Policy Meeting; Guindos; Balz; Wuermeling. **Fri:** Eurozone Consumer Confidence Flash -21.5; Germany PPI 1.4%m/m/31.5%y/y; UK Retail Sales Total & Core -0.2%m/m/-7.2%y/y & -0.2%m/m/-8.4%y/y; UK CBI Industrial Trends; Canada Wholesale Sales 0.9%; Fernandez-Bollo; Pill; Nagel. (Bloomberg estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) moved further below 1.00 this week as bullish sentiment held near recent lows and bearish sentiment continued to climb. The BBR fell for the third week, dropping to 0.65 this week—the lowest since mid-February 2016—after bouncing around 1.00 since late February. Bullish sentiment ticked up to 27.8% this week after declining four of the prior five weeks by 11.5ppts (to 27.6% from 39.1%), while bearish sentiment rose for the fifth time in six weeks, by 12.0ppts (43.0 from 31.0) over the period to its highest percentage since October 2011. The correction count dropped for the third time in four weeks, from 34.6% to 29.2%; it was as high as 40.0% in early February. The AAII Ratio was little changed at 33.2% last week, after rising from 21.7%—which was the lowest since March 2009—to 33.7% the previous week. Bullish sentiment fell to 24.3% last week, after rising from 16.4% to 26.9% the prior week, while bearish sentiment fell for the second week from 59.4% to 49.0% over the period.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin ticked back up last week to match its record high of 13.4%. 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 0.1ppt w/w to 8.0%. That's down from a record high of 9.6% growth at the end of May 2021, but compares to its recent 12-month low of 7.1% from early December. Still, that's up from 0.2% forward revenues growth during April 2020, which was the lowest reading since June 2009. Forward earnings growth ticked up 0.1ppt w/w to 9.8%. 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 down 0.1ppt to 13.1%. They expect revenues to rise 10.9% (up 0.3ppt w/w) in 2022 and 4.9% in 2023 (down 0.2ppt w/w) compared to the 16.4% gain reported in 2021. They expect earnings gains of 10.5% in 2022 (up 0.5ppt w/w) and 9.6% in 2023 (down 0.3ppt w/w) compared to an earnings gain of 51.0% in 2021. Analysts expect the profit margin to remain flat in 2022 at 13.1% (up 0.1ppt w/w) compared to 13.1% in 2021 and to improve 0.6ppt y/y to 13.6% in 2023 (down 0.1ppt w/w). The S&P 500's weekly reading of its forward P/E fell a whopping 1.6pts w/w to a 25-month low of 16.7 from 18.3. 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 tumbled 0.21pt w/w to a 22-month low of 2.23 from 2.44. That compares to 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 and earnings rise for eight of the 11 S&P 500 sectors, and the forward profit margin move higher for six sectors. 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 rose 0.3ppt w/w to a record high of 11.4%, exceeding it prior 11.2% record from August 2007. Financials and Utilities have forward earnings at 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. During 2021, all but the Utilities sector posted a y/y improvement. Five sectors are now expected to see margins decline or remain flat y/y in 2022: Communication Services, Consumer Staples, Financials, Health Care, and Real Estate. Here's how they rank based on their current forward profit margin forecasts along with their record highs:

Information Technology (25.4%, matched its record high this week for the first time since late February), Financials (18.9, down from its 19.8 record high in August 2021), Real Estate (16.9, down from its 19.2 record high in 2016), Communication Services (16.1, down from its 17.0 record high in October), Utilities (13.9, down from its 14.8 record high in April 2021), Materials (13.6, a new record high this week), S&P 500 (13.4, matches its 13.4 record high from March and April), Health Care (11.0, down from its 11.5 record high in early March), Industrials (10.3, down from its 10.5 record high in December 2019), Energy (11.4, a new record high this week), Consumer Discretionary (7.7, down from its 8.3 record high in 2018), and Consumer Staples (7.4, down from its 7.7 record high in June).

US Economic Indicators

Housing Starts & Building Permits (*link*): Both housing starts and building permits sank to five-month lows in April, while homebuilders' optimism this month dropped to its lowest level in two years. Housing starts edged down 0.2% last month, following March's 2.8% drop to 1.724mu (saar), as single-family starts tumbled 7.3% in April and 9.3% over the period to a six-month low of 1.100mu (saar). Meanwhile, multi-family starts soared for the second time in three months, by 15.3% m/m and 22.6% over the period to 634,000 units (saar), the highest since the late 1980s. Building permits dropped 3.1% last month to 1.819mu (saar), led by a 4.6% plunge in single-family permits, building on March's 3.4% loss for a two-month decline of 7.8% to 1.110mu (saar)—the lowest since October. Multi-family permits remain on a volatile uptrend, dipping 1.0% in April to 709,000 units (saar), following a two-month rebound of 11.2%. Despite the recent weakness, both total starts (14.6% y/y) and permits (3.1) remain above year-ago levels. In April, housing under construction soared to a record-high 1.642mu, while completions fell 5.3% to 1.295mu. Data for May show builders' confidence fell for the fifth time this year, from 84 at the end of 2021 to a 23-month low of 69 this month—on affordability concerns. "The housing market is facing growing challenges," notes Robert Dietz NAHB's chief economist. "Building material costs are up 19% from a year ago, in less than three months mortgage rates have surged to a 12-year high, and based on current affordability conditions, less than 50% of new and existing home sales are affordable for a typical family." Here's a look at the ytd changes in the three components of NAHB's Housing Market Index: current sales (-12 points to 78 in May), traffic of prospective homebuyers (-19 points to 52), and future sales (-22 points to 63)—with nearly half the decline in the latter (-10 points) occurring in this month alone.

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

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