Yardeni Research

MORNING BRIEFING
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Braking Energy & Breaking China

Check out the accompanying chart collection.

Executive Summary: The Biden administration's energy policy is worrying us. The plan it's pursuing—a.k.a. "the transition"—is to pry Americans off fossil-fuel dependence by forcing up oil and gas prices. Such a crude plan is bound to have unintended consequences that put the overall economy at risk. Notably, the past six pre-pandemic recessions coincided with rapidly rising oil prices. This is one of the reasons that last week we raised our odds of a recession scenario to 40% from 30%. … And: More investors are agreeing with us that China is uninvestible. Amid economic woes, some self-inflicted, China is losing its foreign investors. We take a look at what's scared them away.

Energy: Traumatic Transition. The Biden administration is committed to a transition from fossil fuels to "clean" energy no matter the cost. The goal is to drive up the prices of fossil fuels by imposing government regulations to restrict their supply. The hope is that then the "free" market will force Americans to respond to higher fossil fuel prices by purchasing electric vehicles (EVs) and to become more reliant on electricity produced by renewable sources.

Last week in Tokyo, President Joe Biden said: "When it comes to the gas prices, we're going through an incredible transition … God willing, when it's over, we'll be stronger and the world will be stronger and less reliant on fossil fuels."

It's all wildly delusional. For most Americans, EVs aren't ready for prime time. They are too expensive. They take too long to charge. There aren't enough charging stations, and the electric power grid isn't ready to handle lots more of them. The costs of the commodities necessary to produce EVs, and especially their batteries, are soaring. Renewable sources of energy are unreliable and have lots of adverse environmental impacts. The geopolitical consequences of soaring fossil fuel prices are turning out to be nightmarish.

In other words, the "transition" is a nightmare. Yet "Jimmy-Joe Biden" is committed to it no matter how traumatic it might be. Former President Jimmy Carter's lame response to the energy crisis of the 1970s was to recommend that we turn down our thermostats and wear sweaters. Joe Biden welcomes the current policy-engineered crisis.

A week ago, we raised the odds of a mild recession from 30% to 40%. Among our biggest mounting concerns is that fossil fuel prices might continue to soar because that's the Biden administration's policy agenda. While April's headline PCED inflation rate showed signs of moderating, the same cannot be said for its energy component, which was up 30.4% y/y and 50.1% (saar) over the past three months. Now consider the following related developments:

(1) *Recessions have coincided with soaring oil prices.* Each of the six past recessions prior to the pandemic was associated with either soaring or at least rapidly rising oil prices (*Fig. 1*). The difference this time is that soaring fossil fuel prices are the intended consequences of the energy policies of the current administration (*Fig. 2* and *Fig. 3*).

(2) *Petroleum production and refining capacity are constrained.* The impact of those policies can be seen in US crude oil field production, which was 11.9mbd during the May 20 week. That's 1.2mbd below the record high of 13.1mbd during the February 21, 2020 week despite the high level of oil prices (*Fig. 4*). The US oil rig count has recovered from its trough in 2020 but remained relatively low at 574 during the May 27 week (*Fig. 5*).

US operable crude oil distillation capacity was down to 17.9mbd during March from a record high of 19.0mbd during the first four months of 2020 (*Fig. 6*). Capacity is the lowest since 2015. The fossil fuel industry has no incentive to invest in finding and producing more such resources given the government's hostility to their very existence.

As the industry reduces capital spending, fossil fuel prices are rising as demand outstrips supply. As a result, the fossil fuel companies are generating huge profits and cash flow that are benefitting their shareholders through dividends and buybacks. Thank you, President Joe Biden, Senator Elizabeth Warren, and Greta!

(3) *Petroleum inventories are low.* US stocks of crude oil and petroleum products totaled 1.15 billion barrels during the May 20 week, 10% below a year ago (*Fig. 7*).

(4) *Natural gas prices are soaring too.* Natural gas prices are also soaring in the US (*Fig. 8*). They are doing so even as consumption of natural gas has been relatively flat since 2019 (*Fig. 9*). The problem is that US exports of natural gas have been soaring in recent years (*Fig. 10*). That hasn't been a problem until this year as the administration's energy policies are restraining production while at the same time scrambling to provide natural gas to Europe to replace Russian natural gas.

China Economy: Losing Battles. It's hard to argue that China is a growing foreign investment opportunity right now given the government's trashing of the economy via authoritarian Covid restrictions. China's MSCI has tumbled 46.9% since hitting a post-pandemic record high on February 17, 2021 (*Fig. 11*). Additionally, China faces mounting geopolitical risks as the leadership considers an invasion of Taiwan and external policy risks as it maintains easy monetary policy while other global central banks tighten, threatening capital outflows.

Is China even investible?, recently *wondered* *The Economist*. Many foreign Chinese market participants have moved their assets elsewhere, depressing asset prices and the local currency. Here are some of the reasons they're fleeing:

(1) *China vs capital flows.* April was the third consecutive month of substantial outflows from China's bond market, *according* to the *WSJ*. Over the three months, foreign investors reduced their holdings by about 301.4 billion yuan, or $45.0 billion. Similarly, foreign equity investors sold a net 33.2 billion yuan, or $4.9 billion, of Chinese domestic stocks through the Stock Connect trading link with Hong Kong from the start of March through May 20.

China has tightened its capital controls ever since a rush for the exits occurred during 2015. Moreover, overall foreign holdings of onshore assets denominated in yuan stood at $1.2 trillion in December, data from China's central bank shows. So while the three-month net outflows of near $50.0 billion in bonds and equities are modest relative to the foreign held assets outstanding, they do beg the question: Do they represent a pivotal turn in China's investment landscape or an inconsequential blip? Reuters did *report* that foreign inflows rose yesterday ahead of Covid restrictions easing.

(2) *PBOC vs the Fed & ECB.* Likely, however, the net foreign outflows seen lately do represent a significant longer-term trend because the decreasing attractiveness of China's bond yields over other major global offerings is a natural consequence of the current global monetary policy regime. China has continued to loosen monetary policy while other major global central banks—including the US Federal Reserve and European Central Bank—tighten. At the same time, investors are seeking higher risk premiums for Chinese assets given perceived heightened geopolitical risks for the region.

Chinese central bankers are caught between the risk of further incenting capital flight and the risk that households and businesses remain wary of taking on new loans. But it seems that the latter has taken precedence for the People's Bank of China (PBOC). In an unexpected policy move last Friday, May 20, the PBOC cut its benchmark rate for loans of five years or more to 4.45% from 4.60%, *reported* the *WSJ*. The central bank kept its rates on medium-term loans for commercial banks and one-year loans unchanged.

The cut to the five-year rate, largely used to price mortgages, primarily was targeted at reviving China's struggling housing market. It is questionable how effective that might be, however, as many Chinese remain shuttered at home given the country's recently renewed widespread Covid-19 lockdowns. New bank loans to businesses and households fell in April to about one-fifth of the amount extended in March, the article noted.

(3) *GDP vs zero Covid.* "Not a single car was sold in Shanghai in all of April, according to the Shanghai Automobile Sales Association," the *WSJ* observed. Shanghai, a city of 25 million people, has been held on lockdown for the past two months along with full or partial Covid closures across other Chinese cities. Reportedly, the Shanghai lockdown will be *lifted* today, but there is no telling what closures could happen again soon, as China remains committed to its zero-Covid strategy.

"In April, the epidemic had a relatively big impact on the economic operation, but this impact was short-term and external," Fu Linghui, a spokesperson at China's statistics bureau, said at a press conference in Beijing last week, *according* to Reuters. Industrial production fell 2.9% y/y in April, the first yearly decline since February 2020. Retail sales fell 11.1% in April, the largest contraction since March 2020 (*Fig. 12* and *Fig. 13*). China's jobless rate rose to 6.1% in April, the highest since February 2020. Property values dropped 46.6% from a year ago, the fastest pace since at least 2010. (For more, see our *Country Briefing: China*.) Declining domestic consumption is a *drag* on sales of multinationals in China too.

Yesterday, official data from the National Bureau of Statistics data showed that China's manufacturing Purchasing Managers' Index (PMI) activity contracted less slowly in May (49.6) than in April (47.4) as virus restrictions eased in major manufacturing hubs. But that was still a contraction, with a reading below 50 for the third month in a row. The non-manufacturing PMI continued to plummet, sinking to 36.2 in April—the lowest since February 2020 (*Fig. 14* and *Fig. 15*).

On April 29, China's Politburo, the top policymaking body of the ruling Chinese Communist Party (CCP), said in a statement that it would expand its supportive fiscal and monetary policies while also refining its regulatory policies, specifically those aimed at tech firms and property developers, *reported* Reuters. One of those efforts may be to use digital yuan *handouts* to stimulate the broader economy, as some areas in China have done. The country is still striving to hit its GDP growth target of 5.5% while analysts are *slashing* their GDP forecasts. (This just in: China's cabinet released 33 measures aimed at reviving its economy, Reuters *reported*, in line with its April 29 statement.)

CNN *reported* on April 28 that China's President Xi Jinping recently insisted that the nation put forth "all-out efforts" on infrastructure to boost the economy. The article added that infrastructure investment had increased 8.5% in Q1-2022 from a year earlier.

Premier Li Keqiang *told* a State Council meeting on May 25 that the challenges now are "greater than when the pandemic hit hard in 2020." *According* to the *WSJ*, Li recently suggested that he may disagree with Xi's continued zero-Covid approach.

(4) *Xi vs the world (except Putin).* Perhaps a bigger risk to China's economy than even the lockdowns is geopolitical. President Xi sides with Russia's President Vladimir Putin on the war in Ukraine. Chinese officials claim that Russia is defending itself against American aggression and encirclement by NATO, *writes* *The Economist*. China's support for Russia in Ukraine echoes its ideological claim to Taiwan, which the government has said it will take back by any means necessary.

Not unlike Russia (see *here* and *here*), China is doing a banner job at whitewashing its motives and human rights atrocities via its domestic state-controlled media and even beyond its borders through its widespread state-controlled *Internet content*.

The CCP's congress, to be held this fall, is expected to grant President Xi another five years in office. Some say, *observed* *The Economist*, that China's ideological posturing both on Taiwan and its zero-Covid policy will calm after Xi secures his place. On the other hand, if Xi remains unrelenting on these matters, then foreign investors are rightly concerned about China's relative global growth potential.

Signaling that China is prepared to insulate itself for the cause, a directive from CCP leaders in March said that the government would block promotions for senior officials if they, their spouses, or their children hold significant assets abroad, *reported* the *WSJ*. The Chinese government is seeking to protect itself from vulnerability to sanctions like those recently aimed at Russian oligarchs. To comply, senior Chinese officials recently have sold assets in foreign holdings.

On an uglier note, President Biden said on May 23 that the US would intervene militarily if China attempts to take Taiwan by force, but the White House quickly downplayed its comments, *reported* CNN. "We agree with the One China policy … but the idea that it can be taken by force, just taken by force, is [just not] appropriate," Biden said.

Coinciding with Biden's recent visits to Japan and South Korea, China *held* military exercises in the disputed South China Sea. Beijing was particularly *displeased* with Japan's hosting of a summit of the Indo-Pacific strategic group dubbed "the Quad," which includes India and Australia, during Biden's visit. China's Taiwan Affairs Office spokesperson Zhu Fenglian slammed back: "We urge the US to stop saying or doing anything in violation of the one-China principle ... Those who play with fire will certainly burn themselves."

Biden followed up his Asian tour with a May 27 speech to Navy graduates, *reported* Reuters. He indicated that the South China Sea is a zone of military interest for the Indo-Pacific allies, saying: "'You'll … ensure freedom of navigation of the South China Sea." He added: "You're going to help … our allies in Europe and … our allies in the Indo-Pacific."

(5) *SEC vs China & Co.* Soon Americans may not be able to invest in some Chinese companies on US exchanges even if they wanted to, as mass delisting of Chinese firms could take place in the coming year, *reported* the *WSJ*. To avoid this fate, Beijing may have just a few weeks left to come to an agreement with US regulators.

The US Securities and Exchange Commission and the Public Company Accounting Oversight Board want China to allow routine inspection of the auditors of US-listed Chinese companies, a decades-old requirement under US law that hasn't been met by China in certain circumstances for "national security" reasons. Because of a bill passed in the House and the Senate that would shorten deadlines requiring noncompliant Chinese firms to do so, Chinese companies could be delisted starting in March 2023 as 2022 annual reports are published.

Calendars

US: Wed: Job Openings 11.4m; ISM M-PMI & Price Index 54.5/87.5; Construction Spending 0.5%; MBA Mortgage Applications; API Weekly Crude Oil Inventories; Beige Book; Williams; Bullard. **Thurs:** ADP Employment 295k; Nonfarm Productivity & Unit Labor Costs -7.5%/11.6%; Factory Orders 0.7%; Initial & Continuous Jobless Claims 210k/1.31m; Natural Gas Storage; Crude Oil Inventories & Gas Production; OPEC Meeting; Mester. (Bloomberg estimates)

Global: Wed: Eurozone, Germany, France, Italy, and Spain M-PMIs 54.4/54.7/54.5/53.6/52.5; Germany Retail Sales 0.3%m/m/4.0%y/y; UK M-PMI 54.6;

Australia Retail Sales; BOC Rate Decision 1.50%; Lagarde; Lane; Adachi. **Thurs:** Eurozone PPI 2.3%m/m/38.6%y/y; Spain Unemployment Rate; Wuermeling; Buch; Beaudry. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Two of these three indexes had forward earnings at a record high last week. LargeCap's fell 0.5% below its record high a week earlier and was down w/w for the second time in four weeks. The latest declines are attributable to Q1 earnings misses and lowered future guidance for Walmart and Amazon. MidCap's was at a record high for a 25th straight week. SmallCap's rose for the tenth time in 11 weeks, and was at a record high for a fifth week. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 99 of the past 105 weeks, with the down weeks due to Tesla's addition to the index in December 2020, Amazon's earnings misses for Q1-2022 and Q2-2021, Walmart's Q1-2022 miss, and index changes last September and December. MidCap's forward earnings is up in 99 of the past 103 weeks, and SmallCap's posted 95 gains in the past 104 weeks. SmallCap had been steadily making new highs each week until mid-December, but then dropped 1.4% below its record by early March. Forward earnings for these indexes had been on an uptrend from November 2019 until February 2020, before tumbling to a bottom by June 2020 due to the Covid-19 economic shutdown. LargeCap's forward earnings has risen 67.7% from its lowest level since August 2017; MidCap's is now up 141.0% from its lowest level since May 2015; and SmallCap's has soared 201.1% from its lowest point since August 2013. In the latest week, the yearly rate of change in LargeCap's forward earnings weakened to a 13-month low of 19.0% y/y from 20.1%; that's down from a record-high 42.2% at the end of July 2021 and up from -19.3% in May 2020, which was the lowest since October 2009. The yearly rate of change in MidCap's forward earnings dropped to 34.8% y/y from 35.3% a week earlier, but is near its 13-month low of 34.6% the week before that. That's down from a record high of 78.8% at the end of May and compares to a record low of -32.7% in May 2020. SmallCap's rate ticked down to a 14-month low of 35.5% y/y from 35.6%. It's down from a record high of 124.2% in June 2021 and up from a record low of -41.5% in June 2020. Companies have been beating consensus estimates quite handily since the Q2-2020 earnings season, causing analysts' consensus earnings forecasts for 2021 and 2022 to improve instead of decline as is typical. Here are the latest consensus earnings growth rates for 2022 and 2023: LargeCap (9.6%, 9.2%), MidCap (15.5, 6.3), and SmallCap (13.7, 11.8).

S&P 500/400/600 Valuation (*link*): Valuations rose slightly for these three indexes last week. LargeCap's forward P/E rose 0.4pts to 16.8 from a 25-month low of 16.4. That's still down from a six-month high of 21.5 in early November. LargeCap's forward P/E also compares to a 19-year high of 22.7 in January 2021 and is up from 13.3 in March 2020, which was the lowest since March 2013. MidCap's rose 0.2pts to 12.2 from a 25-month low of 12.0. That's down from a 13-week high of 17.1 in early November and is 10.7pts below its record high of 22.9 in June 2020. SmallCap's rose 0.2pt w/w to 11.8 from a 26-month low of 11.6. That's down from a 13-week high of 16.1 in early November and is now down 14.9pts from its record high of 26.7 in early June 2020 when forward earnings was depressed. During March 2020, MidCap's 10.7 and SmallCap's 11.1 were their lowest readings since March 2009. LargeCap's forward P/E in February 2020—before Covid-19 decimated forward earnings—was 18.9, the highest level since June 2002. Of course, that high was still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's P/E was below LargeCap's P/E yet again last week, as it has been for most of the time since August 2018. In contrast, it was last solidly above LargeCap's from April 2009 to August 2017; MidCap's current 28% discount to LargeCap is near its biggest since September 2000. SmallCap's P/E was below LargeCap's for a 93rd week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 30% reading is near its biggest discount since February 2001. SmallCap's P/E had been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for a 50th straight week; the current 3% discount is up from a 9% discount in December but remains near its lows during 2000-01.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Since the Q3-2020 earnings season, analysts as a whole have been raising their consensus forecasts for future quarters instead of lowering them as is the norm through the earnings warnings seasons. That six-quarter streak of positive revisions throughout the quarter officially ended with Q1-2022. In the latest week, the Q2-2022 earnings-per-share forecast fell 29 cents w/w to $55.18, and is now down 1.3% from its $55.92 forecast at the start of the quarter. Analysts expect S&P 500 earnings growth to weaken substantially to 4.6% y/y on a frozen actual basis and 5.4% on a pro forma basis. That's down from Q1-2022's 11.6% y/y on a frozen actual basis and an 11.9% y/y gain on a pro forma basis. Double-digit growth is expected for just three sectors in Q2-2022, and five are expected to record a y/y decline. That compares to Q1-2022's count of seven sectors with double-digit growth, one with a single-digit gain, and three with a y/y decline. Here are the S&P 500 sectors' latest earnings growth rates for Q2-2022 versus their Q1-2022 growth rates: Energy (198.9% in Q2-2022 versus 268.8% in Q1-2022), Industrials (29.9, 40.3), Materials (19.4, 46.2), S&P 500 (5.4, 11.2), Real Estate (4.1, 27.3), Health Care (3.2, 18.3), Information Technology (2.1, 14.1), Consumer Staples (-1.2, 7.2), Consumer Discretionary (-1.5, -27.8), Utilities (-12.2, 24.7), Communication Services (-13.1, -2.8), and Financials (-18.2, -17.1).

US Economic Indicators

Consumer Confidence (*link*): Consumer confidence dipped a bit in May to 106.4 after rising the prior two months to 108.6 in April; it had tumbled 9.5 points (to 105.7 from 115.2 in December) the first two months of this year. May saw both the present situation (to 149.6 from 152.9) and expectations (77.5 from 79.0) components take a step back, though Lynn Franco, senior director of economic indicators at The Conference Board noted, “The decline in the present situation component was driven solely by a perceived softening in labor market conditions. By contrast, views of current business conditions—which tend to move ahead of trends in jobs—improved. Overall, the present situation index remains at strong levels, suggesting growth did not contract further in Q2.” Meanwhile, the expectations component was not far from March’s 76.7—which was the lowest since February 2014—and down from 95.4 at the end of last year. Consumers’ appraisal of current conditions improved somewhat in May, with the percentage saying business conditions were good (to 21.1% from 20.8%) up slightly and those saying conditions were bad (20.7 from 22.2) down. Meanwhile, looking at expectations six months from now, it was a mirror image: The percentage of consumers expecting business conditions to improve (17.7 from 18.6) fell, while the percentage expecting business conditions to worsen (24.9 from 21.7) rose. Turning to the labor market, consumers’ assessment was less positive in May, with the percentage of consumers saying jobs were “plentiful” (51.8 from 54.8) falling and the percentage saying jobs are “hard to get” (12.5 from 10.1) rising. Consumers were a bit less pessimistic about the short-term labor market, with the percentage expecting more jobs (18.5 from 18.4) little changed and the percentage expecting fewer jobs (18.7 from 19.8) slightly lower. Franco warned that surging prices and additional interest-rate hikes pose downside risks to consumer spending this year. In May, purchasing intentions for cars, homes, and major appliances cooled, while vacation plans softened.

Regional M-PMIs (*link*): Five Fed districts (New York, Philadelphia, Richmond, Kansas City, and Dallas) now have reported on manufacturing activity for May and show the manufacturing sector slowing to a near standstill. The composite index fell to -0.5 in May after accelerating from 11.3 in January to 16.5 in April, with activity in the New York (to -11.6 from 24.6), Richmond (-9.0 from 14.0), and Dallas (-7.3 from 1.1) regions swinging from expansion to contraction, while the Philadelphia (2.6 from 17.6) area experienced a notable slowdown. Meanwhile, Kansas City (23.0 from 25.0) manufacturing activity continued to increase at a robust pace. Orders (3.1 from 14.2) growth in May expanded at one-fifth April's rate, as billings in the New York (-8.8 from 25.1) area contracted for the third time this year, while orders in the Richmond (-16.0 from 6.0) area contracted for the second time and Dallas' (3.2 from 12.2) moved closer to the demarcation line between expansion and contraction. Meanwhile, Philadelphia (22.1 from 17.8) and Kansas City (15.0 from 10.0) billings remained robust. Employment (20.5 from 22.9) growth remains solid, with hirings at Kansas City (34.0 from 19.0) and New York (14.0 from 7.3) factories basically double the April pace, while hirings in the Philadelphia (25.5 from 41.4) and Dallas (20.9 from 24.6) regions slowed though were comparable to New York's rate. Hirings in the Richmond (8.0 from 22.0) region ran at roughly a third of its April rate.

Regional Prices Paid & Received Measures (*link*): We now have prices-paid and -received data for May from the Philadelphia, New York, Richmond, Kansas City, and Dallas regions. (Note: The Philadelphia, New York, Kansas City, and Dallas 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.) The prices-paid measure climbed for the third month to 87.5 in May after falling from a record-high 89.2 in November to 81.2 by February. The prices-paid measure for the Richmond (151.3 from 118.3) region soared to a new record high, while the New York (to 73.7 from 86.4) measure slowed from April's record high. Meanwhile, Philadelphia's (78.9 from 84.6) also eased from its April rate—which was the highest since mid-1979 (85.4). It was at a record high of 91.1 during March 1974. Kansas City's (72.0 from 83.0) continued to remain below its record high of 88.0 posted a year ago, while Dallas' (61.8 from 61.5) was below its record high of 83.3 in November. Turning to prices-received, its gauge eased for the second month from March's record-high 60.2, slowing to 55.4 in May. Regionally, New York's (45.6 from 49.1) gauge eased for the second month from March's record high of 56.1, while Kansas City's (42.0 from 57.0) eased from its record reading in April. Philadelphia's (51.7 from 55.0) measure slowed for the first time in four months; it was at 62.9 in November—which was close to its record high of 63.8 in the mid-1970s—while Richmond's (95.7 from 89.3) gauge accelerated this month, though was below January's record high of 112.7. The Dallas (41.8 from 43.5) region's measure remained in a volatile flat trend below its record high of 50.9 in October.

Global Economic Indicators

Eurozone CPI Flash Estimates (*link*): The headline CPI rate for May is expected to accelerate to a new record high of 8.1% y/y, up from 7.4% in both April and March—6.1ppts above last May's 2.0%. The rate was at -0.3% at the end of 2020. Looking at the main components, once again energy is anticipated to record the largest gain, accelerating 39.2% y/y after slowing from a record-high 44.3% in March to 37.5% in April. The rate for food, alcohol & tobacco is forecast to climb to a record-high 7.5% y/y in May, having risen steadily from June 2021's 0.5%, while the rate of non-energy industrial goods is expected to accelerate to a record-high 4.2%. The services rate is predicted to pick up for the fourth month, from 2.3% in January to 3.5% in May—the highest since January 1996. Of the top four Eurozone economies, two beat the Eurozone's 8.1% rate, Germany (8.7% y/y) and Spain (8.5)—though Spain's is down from its March rate of 9.8%—while two lagged, Italy (7.3) and France (5.8); France's rate was the second lowest of all the Eurozone economies' rates.

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