MORNING BRIEFING
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Energy & Consumers

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Executive Summary: President Biden says he wants to bring down gas and other energy prices. But his actions on the margin have been ineffectual so far. We doubt he'll solve the problem without unshackling the US oil and gas industry's production. Environmentalists wouldn't be happy, but American citizens likely would. … And: We're starting to notice industry analysts trimming earnings estimates for companies in the S&P 500 Consumer Discretionary sector. We examine which industries have seen estimates drop the most. … Also: A look at some innovative new products for these high-energy-cost times.

Energy: Does Five Bucks a Gallon Stop Here? US gasoline prices are rapidly approaching $5.00 a gallon in many parts of the US, and consumers aren't happy. The weekly visit to the gas station can cost more than $100 to fill up a large SUV, and President Joe Biden is under pressure to do something about it. His actions to date have made little difference because they don't tackle the immediate need the market faces today: higher domestic oil production.

In our view, President Biden would be better served by encouraging oil companies to increase their production more quickly. Free markets are working: With a barrel of West Texas Intermediate crude oil selling north of $100, oil production is slowly starting to increase. But a nudge from the Commander-in-Chief to increase production faster wouldn't hurt. It might not go over well with the environmental crowd, but the average Jane and Joe Citizen would appreciate it.

Let's look at how much crude oil production has increased and what actions the President has taken in recent months as oil prices have climbed:

(1) *Production is slowly rising.* Oil industry executives may talk a lot about going green; but the reality is that when the price of oil is high, they pump more, and when the price of oil is low, they pump less. From June 20, 2014 through February 11, 2016, the price of oil fell from $107.95 a barrel to a low of $26.21 a barrel; after an adjustment period, domestic crude oil production responded by declining from a peak of 9.6 million barrels per day (mbd) in June 2014 to a low of 8.4 mbd in mid-2016 (*Fig. 1* and *Fig. 2*).

Over the next four years, oil prices recovered, and production did too. The fracking miracle sent US production up to 13.1 mbd in February 2020. The onset of Covid sent the price of a barrel of West Texas Intermediate crude oil briefly below zero to minus $37.00 on April 20, 2020 (the first and only negative reading) as storage capacity filled up. Again, the oil industry responded as you'd expect: Production fell to a low of 9.7 mbd in February 2021. And now that oil prices are north of $100 a barrel, US production is rising once again. It hit 11.9 mbd as of the week of June 3. The number of oil drilling rigs, which fell to a low of 172 in August 2020, has gradually increased to a recent 574 (*Fig. 3*).

US producers have slowly been spending more. In Q1, $94.4 billion (saar) was spent on mining exploration, shafts, and well structures, according to GDP data. That's a sharp rebound from $57.9 billion during Q3-2020 but far below the recent peak of $173.1 billion during Q4-2014 (*Fig. 4*).

Companies have plenty of cash to spend on boosting production; they've just been spending it elsewhere. Last year, 119 publicly traded exploration and production companies around the world spent 1% more on exploration and development in 2021 than in 2020, according to a June 2 *report* from the Energy Information Administration (EIA). Instead of increasing exploration and development sharply, they opted to reduce their net debt by $134 billion, the largest amount in any year since 2012. And dividends increased to $107 billion, 24% above the average paid out from 2015 to 2019.

(2) *Talking with Venezuela and Iran.* President Biden has taken a number of steps to increase the amount of oil in the market but with little success so far. For example, Biden has tried to open talks with Iran and Venezuela, two countries that have spare capacity but are prevented from exporting to the US because of sanctions.

Venezuela has the world's largest petroleum reserves, but its state-owned oil company, PDVSA, has been crippled by mismanagement. The country has also suffered under US sanctions put in place in 2019 after the US accused President Nicolas Maduro of election fraud. The sanctions forced American oil companies to stop drilling in the country and scared away bankers and customers, according to an October 7, 2020 *NYT* *article*.

The two nations' last round of talks, scheduled for October, was scrapped after the US took into custody a Venezuela-based businessman who helped the government bypass sanctions. But the Biden administration may be trying to soften relations. After administration officials visited Caracas in March, two American prisoners were released,

leaving eight still imprisoned in the country.

In May, the Biden administration said it would permit discussions between the Maduro government and Chevron about the possibility of future work if the government returns to negotiations with the opposition in hopes of having a free and fair election in 2024. In addition, sanctions on Carlos Eric Malpica, a former Venezuelan state oil official and nephew of the First Lady, were lifted, according to a Venezuelan opposition official cited in a May 17 *NYT* *article*. That said, Venezuela, Nicaragua, and Cuba were excluded from the US-hosted Summit of the Americas this week.

President Biden has also hoped to reenter the 2015 nuclear agreement with Iran, but he's been unwilling to remove Iran's Islamic Revolutionary Guards Corps from the US foreign terrorist organization list. Iran wants the guards off the list before it complies with the nuclear deal. The US withdrew from the nuclear deal in May 2018 when the Trump administration imposed sanctions, aimed at weakening Iran's Islamist regime, that barred dealing with the country, including its oil industry.

(3) *Saudis: Pariahs no more.* As a presidential candidate, Biden said he would make Saudi Arabia a pariah nation and punish the country for the role that Saudi Crown Prince Mohammed bin Salman played in the 2019 murder of journalist Jamal Khashoggi. But as president and with oil selling north of $100 a barrel, Biden has taken a more conciliatory approach: He plans to meet with Saudi Arabian and other Middle Eastern oil-producing countries' leaders later this month, presumably to talk oil and weapons. The Saudis want more equipment, including the Patriot anti-missile systems and new security guarantees.

The Biden administration has been successful at pressuring the Saudis to increase production. OPEC+ recently announced plans to produce at a rate of 650,000 barrels a day in July and August instead of September as previously planned. But that didn't stop the price of oil from heading higher in the face of expected drops in Russian oil production, hobbled by sanctions. Russia's production could fall by up to 3mbd later this year, estimates the International Energy Agency.

(4) *Environmental goals remain paramount.* In another effort to lower energy prices, President Biden ordered the release of one million barrels of oil a day from the Strategic Petroleum Reserve for six months. The market yawned, and oil prices headed higher.

Now the Biden administration is considering imposing an oil and gas windfall tax on industry profits to fund a subsidy for American consumers who struggle to buy energy, a June 4

Oilprice.com *article* reported. It would apply to oil both produced domestically and imported.

In our view, the administration and the American people would be better served if Biden were to set aside his environmental priorities for now, given the economic urgency, and encourage US producers to spend more on exploration and development and open their taps wider. The administration could also provide incentives for oil and gas players to build new or expand existing refineries. US refinery capacity utilization has jumped up to 91.3% in March (*Fig. 5*).

President Biden could take a page out of President Trump's book and invite America's oil giants to the White House. He could ask them how much they plan to increase capital spending and production this year and praise them for helping the nation—with news cameras rolling, of course.

That's unlikely to happen because Biden remains committed to environmental goals. On the first day of Biden's presidency, he issued an executive order canceling the Keystone XL pipeline, which would have transported 800,000 barrels of oil per day from Canada to the Gulf Coast. Shortly after becoming president, Biden signed an executive order to pause the issuing of new leases on federal land and water, a move that has since been debated in the courts. Drilling on federal land and water represents about 24% of the oil and gas production in the US, primarily from the Gulf of Mexico. Last month, he canceled oil drilling leases in the Gulf of Mexico and Alaska.

If Biden were to encourage and incent more domestic oil production, it would certainly catch the industry by surprise. Chevron CEO Mike Wirth *told* Bloomberg on June 3: "We haven't had a refinery built in the United States since the 1970s. My personal view is that there will never be another refinery built in the United States." Building a refinery can take a decade, and getting a return on investment can take additional decades, he said. Without support from the government, it's unclear why a company would ever risk shareholder capital by building a new one.

"We need to sit down and have an honest conversation, a pragmatic and balanced conversation, about the relationship between energy and economic prosperity, national security, and environmental protection. We need to recognize that all of those matter," Wirth said. Biden should give him a call.

Consumer Discretionary: Trimming Beginning. Forward earnings have held up remarkably well for the S&P 500's sectors and industries of late. But just recently, analysts

have started trimming their earnings estimates for companies in the S&P 500 Consumer Discretionary sector, so the sector's forward earnings has been declining. ("Forward earnings" is the time-weighted average of analysts' operating earnings-per-share estimates for this year and next.) Given the recent disappointing news out of Amazon, Walmart, and Target, this isn't unexpected. Here's a look at how the numbers are moving:

(1) *Most earnings still growing.* Most of the S&P 500's sectors' forward earnings are still expected to climb—even those that are being trimmed. Here's the performance derby for the S&P 500 and its 11 sectors' forward earnings growth estimates: Energy (37.1%), Industrials (27.8), Consumer Discretionary (21.4), Information Technology (11.6), S&P 500 (10.0), Materials (8.4), Consumer Staples (5.6), Utilities (4.6), Communications Services (4.3), Health Care (3.5), Financials (-0.6), and Real Estate (-6.0) (see *table* and *Fig. 6*).

(2) *Some estimates rise, others fall.* It's normal for forward earnings to move around during the year. This year, the S&P 500 Energy sector has been seeing forward earnings rise, reflecting analysts' upward earnings revisions given the rising price of crude oil. Conversely, the Consumer Discretionary sector's forward estimates have declined as analysts' estimates have been trimmed, likely reflecting the rising crude oil prices and inflation.

Here's how forward earnings estimates for the S&P 500 and its 11 sectors have changed over the last 13 weeks: Energy (47.3%), Materials (9.9), Industrials (6.3) Real Estate (6.0), S&P 500 (3.9), Financials (3.2), Information Technology (2.8), Utilities (2.3), Consumer Staples (0.1), Communications Services (-0.6), Health Care (-2.1), and Consumer Discretionary (-4.5).

(3) *Where the disappointments lie.* Within the Consumer Discretionary sector, forward earnings have dropped most sharply in the Internet & Direct Marketing Retail industry, by 39.2%. Amazon dominates that industry, and analysts' consensus 2022 earnings forecast for the behemoth has been slashed to $0.83 a share from $2.44 a share just three months ago, according to *WSJ* data, after Amazon recently reported its first quarterly loss in seven years.

Other industries in the Consumer Discretionary sector that have had negative earnings revisions include Casinos & Gaming (-22.8%), Household Appliances (-7.8), General Merchandise Stores (-6.1), Apparel & Accessories (-3.5), Computer & Electronics Retail (-2.9), Restaurants (-2.6), Apparel Retail (-1.4), and Auto Parts & Equipment (-0.4).

Hypermarkets & Supercenters and Drug Retail both are part of the S&P 500 Consumer

Staples sector, and their forward earnings estimates have slipped by 0.2% and 2.3%, respectively. Two other industries with notable forward earnings declines are in the S&P 500 Health Care sector: Pharmaceuticals (-4.7%) and Biotechnology (-4.4).

Disruptive Technologies: Fighting High Energy Prices. With crude oil north of $100 a barrel and natural gas rapidly approaching $10 MMBtu, running a home is becoming expensive. It’s time to move beyond changing to LED light bulbs and installing better insulation. Tech pros have come up with some interesting ways to both help the environment and keep energy usage (and bills) down. Here’s a look at some that caught our eye:

(1) *Roofs get cool.* Starting at the top, owners in warm climates might consider a cool roof. Cool roofs are made of tiles, coverings, and coatings that reflect the sun’s light rather than absorb it, keeping them 50-60 degrees cooler than a traditional roof, according to a Constellation Energy Resources *blog*. Cool roofs aren’t recommended for cooler climates because they would result in higher heating bills.

Adelaide, Australia is testing a ceramic coating developed by NASA called Super Therm on two buildings because it blocks 99% of UV rays, 92% of visual light, and 99.5% of infrared radiation.

(2) *Heat pumps and data centers.* Europe is pushing residents to switch to electric heat pumps from gas-fired heaters as winter approaches. Beyond higher gas prices, there’s the risk that Russia will shut off the flow of natural gas to the continent. EU leaders say it may aim for 13% energy savings by 2030.

An alternative to heat pumps involves tapping into the heat generated by data centers. Espoo, a town in southern Finland, will use the excess heat generated by a data center Microsoft is building, a June 5 *WSJ* *article* reported. Likewise, Viborg, Denmark will use heat from an Apple data center.

(3) *Blocking the rays.* While shades and curtains still work to block out heat and cold, techies have developed a reflective film that attaches to windows and reduces the amount of incoming heat while retaining the outgoing view. The *Gila Platinum Heat Control Window Film* claims to “reject” up to 71% of solar energy and block up to 99% of UV rays. Window films are inexpensive and can reduce utility bills by 30%-40%, notes an *article* on Angi.com. But they can cause double-paned windows to fog and may void window warranties.

Calendars

US: Thurs: Initial & Continuous Jobless Claims 210k/1.305m; Natural Gas Storage. **Fri:** Headline & Core CPI 0.7%m/m/8.3%y/y & 0.5%m/m/5.9%y/y; Consumer Sentiment Total, Present Situation, and Expectations 58.0/62.5/54.5; Federal Budget -$120b; Baker-Hughes Rig Count; WASDE Report. (Bloomberg estimates)

Global: Thurs: France Nonfarm Payrolls; Japan PPI 0.5%m/m/9.8%y/y; Japan Machine Tool Orders; China PPI & CPI 7.7%/1.8% y/y; China New Loans & M2; ECB Interest Rate Decision & Deposit Facility Rate 0.00%/-0.5%; Enria; Rogers; Machlem. **Fri:** Italy Industrial Production -0.2%m/m/-1.1%y/y; Spain CPI 0.6%m/m/5.6%y/y; Canada Employment Change & Unemployment Rate 30k/5.2%; Nagel; Buch. (Bloomberg estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) was below 1.00 for the sixth successive week this week—slipping to 0.89 this week, after climbing the prior two weeks from 0.65 (the lowest since mid-February 2016) to 0.93 over the period. The BBR has been bouncing around 1.00 since late February. Bullish sentiment climbed for the fourth week by 8.1ppts (to 35.7% from 27.6%)—with most of the gain occurring last week (35.2% from 28.2%). The 27.6% reading four weeks ago was the lowest since early 2016. Bearish sentiment increased to 40.0% this week after falling the prior two weeks from 43.0% (the highest since October 2011) to 38.0%. The correction count declined for the fifth time in seven weeks by 10.3ppts (24.3 from 34.6); it was as high as 40.0% in early February. The AAII Ratio jumped to 46.4% last week after falling from 34.0% to 27.1% the previous week, with bullish sentiment rebounding from 19.9% to 32.0% and bearish sentiment sliding from 53.5% to 37.1%.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin remained steady w/w at a 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 fell 0.5ppts w/w to 7.5%. That's down from a record high of 9.6% growth at the end of May 2021, and is near 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 down 0.2ppt 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 11.1% (down 0.1ppt w/w) in 2022 and 4.9% in 2023 (unchanged w/w) compared to the 16.4% gain reported in 2021. They expect earnings gains of 10.7% in 2022 (unchanged w/w) and 9.5% in 2023 (down 0.1ppt w/w) compared to an earnings gain of 51.0% in 2021. Analysts expect the profit margin to remain steady at 13.1% in 2022 (unchanged w/w) compared to 13.1% in 2021 and to improve 0.5ppt y/y to 13.6% in 2023 (unchanged w/w). The S&P 500's weekly reading of its forward P/E rose 0.4pt w/w to 17.3 from 16.9 and is up from a 25-month low of 16.7 the week before that. 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 ticked up 0.06pt w/w to 2.31 and is up from a 22-month low of 2.22 the week before that. 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 rise for nine of the 11 S&P 500 sectors, forward earnings go up for eight sectors, and the forward profit margin move higher for eight 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 0.1ppt w/w to a new record high of 11.7%, exceeding its prior 11.2% record from August 2007. Utilities has forward earnings at a record high, but its forward revenues and margin 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%, matches its prior record high from late February), Financials (19.0, down from its 19.8 record high in August 2021), Real Estate (17.0, down from its 19.2 record high in 2016), Communication Services (16.1, down from its 17.0 record high in October), Utilities (13.8, down from its 14.8 record high in April 2021), Materials (13.6, record high), S&P 500 (13.4, matches its record high achieved intermittently since March), Health Care (11.0, down from its 11.5 record high in early March), Industrials (10.4, down from its 10.5 record high in December 2019), Energy (11.7, 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 2020).

Global Economic Indicators

Eurozone GDP (*link*): Economic activity in the Eurozone during Q1 was revised up to real GDP growth of 0.6% (2.4%, saar), double the preliminary estimates and more than double Q4's 1.0%. However, that result pales in comparison to the annualized gains of 9.6% and 8.9% during Q3 and Q2-2021, respectively. Trade drove the acceleration in Q1 real GDP, as exports expanded 1.5% (saar) and imports contracted 2.3%, their first decline since Q2-2020. Domestic demand expanded only 0.8% (saar). Real gross fixed capital formation (0.2%, saar) was at a standstill during Q1, while household consumption contracted 2.7% (saar) following a 1.0% shortfall during Q4-2021. Consumers spent at a double-digit rate during both Q3-2021 and Q2-2021. Meanwhile, real government spending (-1.4%, saar) fell for the first time in a year. On a y/y basis, real GDP improved to 5.4% from 4.7% and 4.0% the prior two quarters.

Germany Industrial Production (*link*): Headline German industrial production, which includes construction, rebounded a smaller-than-expected 0.7% in April, after a revised 3.7% shortfall (from -3.9%) in March, with the Economy Ministry cautioning the outlook remained greatly uncertain, citing the war in Ukraine and higher energy and raw materials prices causing shortages. Germany's measure excluding construction (which the overall Eurozone uses) jumped 1.1% after plunging 4.5% in March. Construction output contracted for the third consecutive month in April, by 2.1% m/m and 3.5% over the period. Manufacturing output rose 0.4% in April after plunging 4.0% in March—which was the first decline in six months. There were widespread gains in output during April among the main industrial groups, led by a 16.0% rebound in energy, after March's 10.8% plunge, followed by a 4.0% jump consumer durable goods production, which more than reversed March's

2.3% drop. Also moving higher in April was output of capital (0.9%) and intermediate goods (0.4) goods; production of consumer nondurable (-2.3) goods was the outlier. Compared to a year ago, consumer nondurable goods (10.1% y/y), energy (5.4), and consumer durable goods (2.9) were in the black, while capital (-6.9) and intermediate (-3.3) goods production were in the red.

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