**MORNING BRIEFING**
**August 4, 2022**

## Emerging Markets, Oil Refiners & Nuclear Power Plants

*Check out the accompanying chart collection.*

**Executive Summary:** Today, Jackie takes us on a quick world tour focusing on emerging economies. Many are ailing, but a few offer a safe haven from geopolitical storms. So does the US with its strong dollar, huge economy, and relatively calm body politic. … Also: Oil refiners had a stellar Q2 operating at near maximum capacity to meet surging demand. The industry is on track for another year of eye-popping revenues and earnings growth. … And in the disruptive technologies department, we highlight the potential of SMRs—small modular (nuclear) reactors.

**Emerging Markets: Facing Challenges.** Even though the S&P 500 has fallen 14.2% ytd through Tuesday's close, the US has been one of the safest places in the world to invest so far this year (a theme we call "TINAC," for "there is no alternative country"). Its currency is strong, the 10-year US Treasury offers a more attractive yield than other developed nations' benchmark bonds, and today's global challenges seem more surmountable here than in many other places around the world.

Unfortunately, what has helped the US has hurt many emerging market countries, particularly poor nations that face increasingly expensive dollar-denominated debt repayments and whose citizens can't afford the higher cost of food and energy. Investors have responded by pulling funds out of the emerging markets in each of the past five months. Outflows from emerging market stock and bond funds hit $9.8 billion in July, bringing the total outflows to almost $40 billion since March, according to an August 3 *WSJ* article citing Institute of International Finance data.

As a result, the US MSCI, which has lost 15.2% ytd through Tuesday's close, has outperformed the MSCI All Emerging Markets index, which has fallen 20.1% in dollars and dropped 16.0% in local currencies (*Fig. 1*).

As for the country-specific emerging market MSCIs, the indexes of those countries that export goods priced in dollars generally have fared better than the rest. The Brazil MSCI index is up 2.7% ytd in dollars and down 3.4% in local currency, outperforming most of its counterparts. The country is a large exporter of soybeans, iron ore, and oil.

The MSCI indexes of countries that benefit from tourism also have outperformed this year, helped by the resumption of international travel. Thailand's MSCI has fallen 7.5% ytd measured in dollars and is flat ytd in the local currency.

Conversely, other countries—e.g., Sri Lanka—are scrambling to pay for imported goods and meet their dollar-denominated debt payments, as they lack access to dollars. The MSCI of that Asian nation has fallen 68.2% ytd measured in dollars and 43.5% ytd in the local currency.

Let's take a quick world tour:

(1) *Interest rates: High, but not too high.* The 10-year US Treasury yield has risen to 2.75%, up from 1.19% a year ago. That's far more attractive than the yields on other developed countries' 10-year bonds: UK (1.91%), France (1.43), Sweden (1.38), Germany (0.81), and Japan (0.18) (*Fig. 2*).

And high US interest rates have helped boost the value of the US dollar relative to other currencies around the world (*Fig. 3*). However, a surging dollar has made soaring food and oil prices even more expensive to purchase for emerging countries that import those goods.

(2) *Uneven economic growth.* The manufacturing purchasing managers index (M-PMI) for emerging economies has weakened only modestly over the past two years. After peaking at 53.9 in November 2020, the emerging markets' M-PMI was 50.8 in July. It's moderately below the developed markets' M-PMI of 51.3 (*Fig. 4*).

But lumping all emerging markets into one basket obscures substantial differences among the economies. European emerging economies have been battered by the war in Ukraine. Here are their July M-PMIs: Kazakhstan (52.8), Turkey (46.9), Czech Republic (46.8), and Poland (42.1) (*Fig. 5*). The Ukraine war and high-stakes natural gas games with Russia have taken a toll on several developed European countries as well. Here is a handful that have seen their M-PMIs drop below the 50.0 level indicating contraction: France (49.5), Germany (49.3), Greece (49.1), Spain (48.7), Italy (48.5), and Denmark (38.0).

Manufacturing PMIs for Latin American countries vary quite a bit, with Brazil's M-PMI jumping sharply (54.0) and Columbia's (49.5) and Mexico's (48.5) M-PMIs contracting slightly in July (*Fig. 6*). Brazil benefits from the dollars earned by Petrobras, the state-run oil company, and the country's miners. Mexico, on the other hand, is expected to be dragged into a recession, due in part to its close economic ties to the US, where demand for goods (including imported ones) seems to be slowing.

Meanwhile, July's PMIs held up relatively well in most emerging Asian countries: India (56.4), Thailand (52.4), Indonesia (51.3), Vietnam (51.2), Philippines (50.8), Malaysia (50.6), and China (50.4) (*Fig. 7*).

(3) *Descending into turmoil.* Some emerging market countries might wish that their worst problem was a PMI below 50.0. Panama and Sri Lanka, for example, suffer from inflation, capital outflows, and civil unrest. Panama's dollar-denominated market is down 18.4% ytd through Tuesday's close. Sri Lanka's has fallen by 43.5% ytd in local currency and by 68.2% ytd in dollars.

Sri Lanka has been plagued by inflation running north of 50% and a lack of foreign currency, which has led to shortages of fuel, food, and other imported goods. Last year, the government prohibited the importing of chemical fertilizer, which led to crop failures among the nation's farmers. The country then had to buy food from abroad, worsening its financial situation.

Sri Lanka suffers from political instability, as its President fled to Singapore last month. The Prime Minister declared a state of emergency across the country as protesters filled the streets and even stormed the presidential palace. The country failed to make an interest payment on its foreign debt in May, and it owes more than $51 billion to foreign lenders, including $6.5 billion to China.

Protestors are also hitting the streets in Panama. They too are upset about inflation and the prices of food and gasoline, which rose from $3.73 a gallon in January to $5.75 in July, a July 20 *FT* *article* stated. Protestors are also upset by politicians who have special advisors being paid for ambiguous services and by a video of "lawmakers celebrating the beginning of the legislative period with $340 bottles of Macallan whisky."

Argentina, Latin America's second largest country, has struggled with inflation north of 60%, shrinking currency reserves, a falling currency, and too much debt. The country has a deeply divided government, and the top economic position has changed hands three times over the past month. The cost of Argentina's imports has surged due to the rising price of energy. Meanwhile, its exports have been hurt by grain exporters who are "hoarding their harvest because they fear an imminent devaluation," a July 25 *FT* *article* reported.

Having watched inflation erode their savings and earnings, Argentinians have been protesting for a minimum living wage. And there are questions about whether the country can live up to a negotiated restructuring of the $44 billion of debt it owes the International Monetary Fund.

**Energy: Refiners Reporting Riches.** Over the past week, oil refiners reported banner Q2 earnings, boosted by high gasoline prices and a wide crack spread. Valero Energy's adjusted Q2 earnings was $4.6 billion, or $11.36 a share, up from $260 million, or 63 cents a share in Q2-2021. Marathon Petroleum's adjusted net income came in at $5.7 billion, or $10.61 a share, up from $437 million, or 67 cents a share in Q2-2021. The company's refining and marketing margin surged to $37.54, triple the $12.45 margin in the year-ago quarter. Here's a look at what drove results:

(1) *Running full tilt.* Refiners ran their operations non-stop to meet demand for gasoline during the summer driving season and for airplane fuel now that travelers have returned to the skies. Valero refinery's utilization rate increased to 94% in Q2, up from 89% in Q1 and 90% in Q2-2021. Marathon Petroleum's refineries ran at 100% utilization processing in Q2, up from 94% in Q2-2021. The company expects its utilization rate will return to 94% in Q3 as it performs maintenance in September.

(2) *Cash is flowing.* The jump in earnings also meant a surge in cash flow for the two refiners. Valero's business threw off adjusted net cash of $5.2 billion in Q2. Marathon reported EBITDA from continuing operations of $9.1 billion, up from $1.9 billion a year earlier.

Despite the billions of earnings and cash flow generated, capital spent to expand the traditional refining business was relatively minimal. At Valero, $355 million was used to grow the business in Q2, $300 million was used to reduce debt, and about $2.2 billion paid dividends and bought back stock. Cash on the balance sheet rose by $2.8 billion.

The company said on the earnings *conference call* that it will earmark about $800 million for capital investments to grow the company, and half of that will be put into expanding Valero's low-carbon fuels business. That leaves only $400 million earmarked for expanding Valero's traditional refining operations in 2022.

Marathon used $313 million to pay dividends and $3.3 billion to repurchase shares in the quarter. The company spent $546 million on capital expenditures, some of which is earmarked to expand its Galveston Bay refinery capacity by 40,000 a day.

Both companies are spending to build renewable fuel facilities, which can take animal fats, used cooking oil, and corn oil and process them into diesel that can be used in engines on the road today. The renewable diesel produced at the Valero facility claims that it reduces greenhouse gas emissions by up to 80% compared with traditional diesel fuel.

(3) *A look at the numbers.* At its peak on June 7, the S&P 500 Oil & Gas Refining & Marketing stock price index was up 73.4% from the start of 2022. Since peaking, the index has fallen 20.0%, leaving it up 39.0% ytd through Tuesday's close (*Fig. 8*). The shares appear to be following the crack spread of West Texas Intermediate crude oil, which peaked at $69.20 per barrel on April 28 and has since fallen to $39.40 (*Fig. 9*).

The industry's revenue climbed 69.8% last year and is expected to grow again by 41.2% this year before falling by 11.0% in 2023, according to analysts' consensus estimates (*Fig. 10*). Earnings follow a similar pattern. Analysts expect earnings to soar 400.0% this year, only to fall by 39.7% in 2023 (*Fig. 11*). The industry's forward P/E has fallen to only 6.8 from a peak of 170.4 in November 2020, when the industry was barely profitable (*Fig. 12*).

**Disruptive Technologies: Small Nuclear Gets The Nod.** The US Nuclear Regulatory Commission plans to certify the small modular reactor (SMR) designed by NuScale Power Corp. Even though it's far smaller than a traditional nuclear reactor, it is expected to generate nuclear power more easily and safely.

SMRs are "small enough that they can be assembled on a factory floor and then shipped to a site where they will operate, eliminating many of the challenges of on-site construction. In addition they're structured in a way to allow passive safety, where no operator actions are necessary to shut the reactor down if problems occur," ARS Technica *reported* on July 29.

NuScale is working with the Utah Associated Municipal Power Systems to deploy a SMR system in 2029. NuScale also received a $15 million private investment from Nucor, the steel manufacturer, which presumably is looking for ways to produce large amounts of electricity to run its mills without producing $CO_2$. And NuScale completed a reverse merger in May with a special-purpose acquisition company, Spring Valley Acquisition Corp. The new company's ticker: SMR, of course

We noted in the February 18, 2021 *Morning Briefing* that Bill Gates has embraced SMRs. He's an investor in and the chairman of TerraPower, which is building a small nuclear plant in Wyoming that uses molten salt to store energy.

## Calendars

**US: Thurs:** Trade Balance -$80.1b; Initial & Continuous Jobless Claims 259k/1.37m; Natural Gas Storage; Mester. **Fri:** Employment Total, Private & Manufacturing 250k/223k/15k; Average Hourly Earnings 0.3%m/m/4.9%y/y; Average Weekly Hours 34.5; Unemployment Rate 3.6%; Baker-Hughes Rig Count. (Bloomberg estimates)

**Global: Thurs:** Germany Factory Orders -0.8%; Japan Household Spending 0.2%m/m/15%y/y; Canada Trade Balance $4.8b; BOE Interest Rate Decision 1.75%; ECB Economic Bulletin; RBA Monetary Policy Statement; Bailey. **Fri:** Germany Industrial Production -0.3%; France Industrial

Production -0.2%; Italy Industrial Production -0.2%m/m/4.0%y/y; Spain Industrial Production 3.4% y/y; UK Halifax House Price Index; Japan Leading & Coincident Indicators; Pill. (Bloomberg estimates)

## Strategy Indicators

**Stock Market Sentiment Indicators** (*link*): The BBR advanced this week for the fourth week, from 0.76 to 1.37 over the period, to its highest reading since the February 1 week—as bulls now far outnumber bears. It was at 0.60 six weeks ago, which was the lowest since the week of March 10, 2009's 0.56. The BBR had been bouncing around 1.00 since late February before its recent move up. Bullish sentiment rose this week for the fourth week by 10.6ppts (to 41.1% from 30.5%); it was at 26.5% six weeks ago—which was the fewest bulls since early 2016. Meanwhile, bearish sentiment fell for the fifth time in six weeks by 14.0ppts (30.1 from 44.1). The correction count edged up to 28.8% after falling the prior two weeks from 31.0% to 27.8%—trading in a narrow range between 27.1% and 31.0% the past eight weeks. In the meantime, the AAII Sentiment Survey (as of July 28) showed the percentage expecting stocks to rise over the next six months fell to 27.7% after advancing the prior two weeks from 19.4% to 29.6%, which was a seven-week high. The pullback puts optimism right at the breakpoint between typical and unusually low readings. Bullish sentiment remained below its historical average of 38.0% for the 36th straight week. The percentage expecting stocks will fall over the next six months dropped for the third week to 40.1% after rebounding from 46.7% to 52.8% the prior week—putting pessimism back within its typical rage of readings for the first time since June 2, 2022. (The breakpoint between typical and unusually high readings is currently 40.5%.) The current reading has been above its historical average of 30.5% for 35 out of the past 36 weeks.

**S&P 500 Earnings, Revenues, Valuation & Margins** (*link*): The S&P 500's forward profit margin fell 0.1ppt w/w to 13.1%, down to its lowest level since July 2021 and from its record high of 13.4% achieved intermittently from March to June. Since the end of April 2020, it has exceeded its prior record high of 12.4% in September 2018. It's now up 2.8ppts from 10.3% during April 2020, which was the lowest level since August 2013. Forward revenues and earnings both were back at record highs after ticking down briefly in early February. 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 0.2ppt w/w to a 21-month low of 6.8%. 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 tumbled 0.6ppt w/w to a 24-month low of 8.1%. 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 0.4ppt to 12.8%. They expect revenues to rise 11.9% (down 0.1ppt w/w) in 2022 and 4.0% in 2023 (down 0.2ppt w/w) compared to the 16.4% gain reported in 2021. They expect earnings gains of 10.1% in 2022 (down 0.5ppt w/w) and 7.7% in 2023 (down 0.5ppt w/w) compared to an earnings gain of 51.0% in 2021. Analysts expect the profit margin to drop 0.2ppt y/y to 12.8% in 2022 (down 0.1ppt w/w) compared to 13.0% in 2021 and to improve 0.5ppt y/y to 13.3% in 2023 (down 0.1ppt w/w). The S&P 500's weekly reading of its forward P/E rose 0.5pt w/w to a seven-week high of 17.2, up from a 26-month low of 15.8 a month earlier. 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 a seven-week high of 2.25, up from a 26-month low of 2.10 during June. 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 five of the 11 S&P 500 sectors, forward earnings gain for one sector, and the forward profit margin edge higher for one sector. Energy is the only sector with forward earnings at a record high now. Consumer Staples, Financials, and Health Care are the only sectors with forward revenues at a record high this week. Most of the other sectors are below recent record highs in their forward revenues, earnings, and profit margins. Energy still has forward revenues well below a record high, and Utilities' forward revenues and margin are lagging too. 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. Six sectors now are expected to see margins decline y/y in 2022: Communication Services, Consumer Discretionary, 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 (25.0%, down from its 25.4% record high in early June), Financials (18.4, down from its 19.8 record high in August 2021), Real Estate (18.0, down from its 19.2 record high in 2016), Communication Services (15.4, down 0.5ppt w/w and from its 17.0 record high in October), Utilities (13.9, down from its 14.8 record high in April 2021), Materials (13.0, down 0.1ppt w/w and from its 13.6 record high in early June), S&P 500 (13.1, down 0.1ppt w/w and from its record high 13.4 achieved intermittently since March), Health Care (10.8, down from its 11.5 record high in early March), Industrials (10.2, down from its 10.5 record high in December 2019), Energy (11.9, down from its 12.0 record high a week earlier), Consumer Discretionary (7.4, down 0.1ppt w/w and from its 8.3 record high in 2018), and Consumer Staples (7.3, down from its 7.7 record high in June 2020).

**S&P 500 Q2 Earnings Season Monitor** (*link*): With over 71% of S&P 500 companies finished reporting revenues and earnings for Q2-2021, the revenue and earnings surprises are at their lowest levels since the pandemic recovery began. Revenues are beating the consensus forecast by 2.5%, and earnings have exceeded estimates by 5.6%. At the same point during the Q1 season, revenues were 2.1% above forecast and earnings beat by 6.8%. For the 356 companies that have reported Q2 earnings through mid-day Wednesday, the aggregate y/y revenue and earnings growth rates have slowed from their Q2-2021 to Q1-2022 readings. Collectively, the companies have a y/y revenue gain of 15.0% and an earnings gain of 10.9%. Just 68% of the Q2 reporters so far has reported a positive revenue surprise, and 77% has beaten earnings forecasts. Markedly fewer companies have reported positive y/y earnings growth in Q2 (59%) than positive y/y revenue growth (81%). These figures are bound to change as more Q2-2022 results are reported in the coming weeks, particularly from the struggling retailers. While we expect y/y growth rates to remain positive in Q2, we think revenue and earnings surprises will moderate q/q due to the slowing economy, rising inventories, and higher costs.

## US Economic Indicators

**US Non-Manufacturing PMIs** (*link*): ISM's NM-PMI was a surprise on the upside in July, while prices continued to ease from April's record rate. The NM-PMI picked up to 56.7 (vs 53.5 consensus estimate) in July after easing steadily from 58.3 in March to 55.3 in June; the index was at a record high of 68.4 in November. Of the four components, the business activity (to 59.9 from 56.1) and new orders (59.9 from 55.6) measures were the strongest since January and March, respectively, while supply bottlenecks continued to ease, with the supplier deliveries' measure dropping precipitously from 75.7 in October and November to an 18-month low of 57.8 in July. Meanwhile, the employment (49.1 from 47.4) gauge has bounced around the breakeven level of 50.0 the past four months, though was mostly below. The price index eased for the third month since reaching a record-high 84.6 in April, dropping to a 17-month low of 72.3 in July, with nearly two-thirds of the slowing occurring last month.

**Manufacturing Orders & Shipments** (*link*): Factory orders were better than expected again in June, and shipments were also strong—the latter climbing to a new record high. Meanwhile, both core capital goods orders and shipments reached new record highs again in June, as companies have been attempting to boost productivity to compete with high inflation and a tight labor market. Nondefense capital goods shipments excluding aircraft (used in calculating GDP) has climbed every month but one since its April 2020 bottom, rising 0.7% in June and 33.5% over the period. Meanwhile, core capital goods orders (a proxy for future business investment) has advanced during all but four months since April 2020, up 0.7% and 33.3% over the comparable periods. Total factory orders climbed for the ninth successive month in June, up 2.0% m/m (virtually double the consensus estimate) and 12.9% over the period to within 1.3% of July 2014's record high. Machinery billings hit yet another new record high, with the industrial equipment component near record highs and construction orders on an upswing. Electrical equipment, appliances & components also reached a new record high. Orders remained on uptrends for both computers & electronic products and motor vehicles & parts, though the latter did dip a bit recently. Overall factory shipments continued to reach new record highs in June, jumping 1.2% m/m and 14.8% y/y.

**Auto Sales** (*link*): Auto sales in July edged up for the second month to 13.5mu (saar) after slumping from 15.2mu at the start of this year to 12.9mu during May. Sales have averaged 13.9mu (saar) per month over the first seven months of this year versus 15.1mu for all of last year—with last year's sales reaching a high of 18.5mu and a low of 12.4mu. Domestic light-truck sales advanced for the second month to 8.3mu (saar) in July from 7.9mu in May—considerably below April's 8.9mu and January's 9.4mu; these sales were at 11.0mu last April. Meanwhile, domestic car sales continue to remain around 2.0mu, holding at that level in July. Sales are not far from the 1.4mu record low during the pandemic. Sales of imports remain on a volatile downtrend, averaging 3.4mu (saar) the first seven months of this year, with a high of 3.8mu in January and a low of 3.0mu in May; July sales were 3.3mu.

## Global Economic Indicators

**Global Composite PMIs** (*link*): Global demand in July slowed to a 25-month low as growth in the developed nations contracted for the first time since June 2020, while growth in the emerging nations held close to June's 11½-year high. The C-PMI eased to 50.8 in July after climbing from 51.2 in April to 53.5 in June, with the measure remaining above the breakeven point between expansion and contraction for the 25th successive month. The C-PMI for the developed nations sank to 49.0 from a recent peak of 61.1 last May. In July, growth contracted in the US (to 47.7) for the first time since June 2020 and decreased minimally in the Eurozone (49.9), on average—with contractions in Germany (48.1) and Italy (47.7) offset by expansions in France (51.7) and Spain (52.7), which both eased from June's pace. Growth in Japan (50.2) was at a virtual standstill. Meanwhile, the emerging market C-PMI eased a bit from June's 55.2, but remains healthy at 54.0. China (54.0), India (56.6), and Brazil (55.3) all experienced solid expansions in July, while Russia (52.2) saw growth rise for a second month after contracting from March through May. According to the report, input prices rose at the slowest pace in five months, while output prices eased to a 10-month low—though both measures remained well above their respective long-run averages.

**Eurozone Retail Sales** (*link*): Eurozone retail sales in June fell for the second time in three months, by 1.2% m/m and 2.0% over the period—and is 3.3% below last June's record high. All categories were in the red in June. Sales of nonfood products posted the biggest decline, contracting 2.6% in June and 4.3% from its record high a year ago, while sales of food, drinks & tobacco dropped for the third month, by 0.4% and 3.3% over the period to its lowest level since January 2020. Meanwhile, automotive fuel sales fell for the third time in four months, by 1.1% m/m, though only 0.6% over the period; sales are up 1.4% y/y. Data are available for the four largest Eurozone economies and show sales were down across the board. Germany posted the biggest decline, falling for the second time in three months by 1.6% m/m and 5.8% over the period to a 16-month low. Sales in France sank 1.2% in June, though had increased during four of the first five months of the year by 2.1% to a new record high. Retail sales in Italy have seesawed over the first six months of the year, falling 1.1% both in June and ytd. Meanwhile, Spain sales have also been volatile this year, slipping 0.4% in June though climbing 1.0% ytd. Compared to a year ago, sales were down in Germany (-8.8% y/y) and Italy (-2.8) and were up in France (0.6) and Spain (0.4)—though barely.

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