MORNING BRIEFING
August 18, 2022

Consumers, Russia & The Metaverse

Check out the accompanying chart collection.

Executive Summary: With gasoline prices down in July, consumers had more money to spend on discretionary purchases, and retailers of most kinds benefited. Jackie taps Target's Q2 results for consumer-spending trends and takeaways . … Also: Waging war in Ukraine has cost the Russian economy a great deal, but Q2 GDP contracted much less than economists expected, buoyed by the high prices that Russia's energy exports fetched. … And: The Metaverse is hopping with diverse events—from concerts and celebrity-hosted parties to fashion shows and fine art sales. And everyone's invited.

Consumer Discretionary: Less Spent On Gas, More Spent On Stuff. Consumer spending continues to shift in correlation with how much consumers have to spend on gasoline. In July, the news was good: Consumers had more money to spend on things and experiences because the price of gasoline peaked during the June 13 week and has been falling ever since (*Fig. 1*).

July's retail sales excluding gasoline and auto sales increased 0.7% m/m (*Fig. 2*). When gas and auto sales were included, July's retail sales were flat m/m.

Spending at gasoline stations fell 1.8% m/m, and auto sales dropped 1.6%. That left consumers with more money to spend at non-store retailers (2.7% m/m) and at stores selling building materials, garden equipment, and supplies (1.5), miscellaneous items (1.5), health & personal care items (0.4), electronics & appliances (0.4), food and beverages (0.2), furniture and home furnishings (0.2), and sporting goods, hobbies, musical instruments, and books (0.1).

The large jump in spending at online retailers likely reflects the change in Amazon's Prime Day timing to July this year from June last year. The segment's sales were up 20.2% y/y in July. Outside of gas and autos, the only other areas to post m/m declines last month were stores selling clothing and accessories (-0.6%) and general merchandise (-0.7) (*Fig. 3*, *Fig. 4*, and *Fig. 5*).

Target warned investors in June that its Q2 results wouldn't meet expectations because consumer spending patterns had changed, and the retailer was stuck with excessive inventory. Most of that inventory now has been cleared out, and consumers are buying essentials and store brands, while also looking forward to celebrating the holidays, management said on the earnings conference call. Here’s a quick rundown of what Target execs have been seeing:

(1) *Sharp decline in results.* There’s no sugar-coating it: The need to run sales to move inventory hurt Target’s bottom line. Revenue increased 3.5% y/y in Q2 to $26 billion. However, the quarter’s gross margin dropped 8.9 percentage points y/y to 21.5, its operating margin shrank to 1.2%, and earnings dropped to $183 million from $1.8 billion a year ago.

(2) *Consumers prefer staples.* Target spent the last few weeks reducing the discretionary items it carries in inventory and has on order. Instead, it’s been stocking up on items in food and beverage, beauty, essentials (which includes the pets and health care categories), seasonal items, and fashion-forward items.

The company’s Q2 same-store sales increased 2.6% y/y, and here’s how certain categories fared: food and beverage (low double-digit increase), beauty (high single-digit increase), essentials (mid-single-digit increase), hardlines (down slightly), home (low single-digit decline), and apparel (low single-digit decline).

A pinched consumer has Target focused on offering customers savings. “Given the ongoing pressure our guests are facing from inflation, we’re leaning into value. This means we’re focused on providing great everyday pricing and strong opening price points across every category, including in our own brands,” said CEO Brian Cornell according to the conference call *transcript*. Consumers are “responding” to Target’s 12 private label brands, each of which generate more than $1 billion in revenue.

That said, Target’s management believes consumers are entering H2 ready to open their wallets for the holidays. The company will still be clearing out some remaining inventory in Q3; but in Q4, it faces easier comparisons to Q4-2021, when high costs were incurred. As a result, management didn’t change its earlier guidance for low- to mid-single digit revenue growth for fiscal 2022 (ending January 2023) and an operating margin rate of around 6% in the second half of the year.

(3) *Supply chain improving.* Target’s COO John Mulligan believes the supply chain is much improved compared to last year but still not normal. “There are early signs that both costs and volatility may have peaked. More specifically, lead times in global shipping have begun

to decline. Spot rates to move shipping containers have fallen somewhat. And in light of the reduction in petroleum prices we've seen recently, fuel surcharges have been easing compared with the peak rates we saw earlier in the second quarter."

Target continues to request delivery of inventory earlier than it has historically. As a result, the company has "secured temporary capacity to store and stage shipping containers near the ports." Having the inventory in the country earlier should reduce the company's reliance on air freight.

Russia: Saved By Pricey Oil. When Russia went to war with Ukraine on February 24, the EU, UK, and US imposed hefty economic sanctions that they hoped would limit Russia's ability to fund the war. Almost six months later, the war continues unabated, as do the sanctions.

The Central Bank of the Russian Federation's assets have been frozen, Russian banks were kicked out of the Swift messaging system, and more than 1,000 Russian business leaders and politicians have been sanctioned. The US, UK, and EU have banned the export of goods that could be used by the Russian military, Russian flights have been banned, and many international companies have ended their business operations in the country. The US has banned all oil and gas imports from Russia, and the EU has said it will ban all imports of oil brought in by sea from Russia by the end of this year.

Economists polled by Reuters thought Russia's Q2 GDP would fall 7%, but it dropped only 4%. High energy prices and Russia's oil and gas exports helped to soften the blow. Let's take a deeper look at what's driving Russia's economy:

(1) *The oil buffer.* Russia is the world's third-largest oil producer, behind the US and Saudi Arabia, according to the Energy Information Administration's *data*. The country's total oil exports fell to 7.4 mbd in July, down from 8.0 mbd at the start of the year, less of a drop than was expected because the country has successfully rerouted its oil exports, an August *report* by the International Energy Agency (IEA) stated. Russian crude oil sold to the US, UK, EU, Japan, and Korea has dropped by nearly 2.2 mbd since the war began. But two thirds of those oil flows have been rerouted to India, China, and other markets. The EU embargo on Russian crude and product imports will take full effect in February 2023, and Russia then will have to find a new home for an additional 2.3 mbd of crude oil and crude products.

The price of a barrel of Brent crude oil spiked to $127.98 on March 8, up from $96.84 when the war began. Since the peak, the price has fallen 27.8% to $92.34 (*Fig. 6*). The IEA report estimates that Russia's export revenue from oil fell to $19 billion in July, down from $21 billion the prior month, due to lower oil prices and volumes. We'll be watching to see whether the recent drop in oil prices puts additional pressure on the Russian economy.

(2) *Interest rates normalizing.* After Russia invaded Ukraine and international sanctions were imposed on Russia, the country's central bank acted swiftly to prevent an even more dramatic economic meltdown than was occurring. It hiked the country's key interest rate to 20.0% from 9.5% in hopes of curbing the ruble's dramatic slide against the dollar (*Fig. 7* and *Fig. 8*). It also hoped to tame inflation, which has spiked to 15.1% as of July (*Fig. 9*). That's down slightly from the peak of 17.8% in April. Russia's central bank forecasts inflation in the ranges of 12%-15% this year and 5%-7% in 2023.

Higher interest rates, increased liquidity, capital controls, and foreign sales of oil and gas have helped to stabilize the ruble, which is 32% higher today than it was on February 23. Russia's current account surplus more than tripled over the first five months of the year to $110 billion due to oil sales, a June 16 *WSJ* *article* reported. The Institute of International Finance estimated that "if commodity prices remain high and Russia's oil and exports hold up, Moscow could receive more than $300 billion in payments for its energy sales this year—roughly equivalent to the amount of Russia's foreign reserves frozen by Western sanctions."

As the economy has stabilized, Russia's central bank has gradually lowered the country's key interest rate, most recently in July by 150bps to 8.0%. That's lower than where it stood just before Russia's invasion of Ukraine, and the central bank indicated that more rate cuts might be forthcoming. Likewise, the yield on Russia's 10-year bond has fallen from its recent peak of 13.63% on March 23 to 8.94% yesterday (*Fig. 10*).

(3) *GDP shrinking nonetheless.* Surging oil and gas revenue couldn't prevent Russia's GDP from declining 4.0% y/y in Q2, a sharp change from the 3.5% y/y increase in Q1. A July 22 Reuters *article* reported that Russia's central bank expects the country's GDP will shrink 4%-6% this year (improved from its late April forecast of a 8%-10% contraction) and 1%-4% next year (a wider range than the 3% shrinkage expected earlier). Likewise, the International Monetary Fund recently upped its estimate for Russia's GDP this year, by 2.5 percentage points to a 6.0% contraction.

Russian manufacturing output fell 4% q/q during Q2, with production in imports-dependent sectors dropping more than 10%, an August 16 CNBC *article* reported. Retail sales fell 11%

q/q. The country's economy is somewhat insulated by the fact that the Russian state accounts for more than 60% of GDP, while private enterprise makes up the remainder, the article noted.

(4) *Capital punishment.* The Ukraine war has been costly for US investors in Russian equities. The US government has banned US citizens from buying Russian shares. US investors who want to sell Russian shares they own must find an overseas buyer. Likewise, MSCI expelled Russia from its indexes on March 9, which means a total loss for holders.

Disruptive Technologies: What's New In The Metaverse. The number of folks giving concerts in the metaverse continues to grow since we first wrote about Marshmello and Travis Scott performing on Fortnite in 2020. They been followed by Ariana Grande and Grimes, each of whom has given performances in this new virtual concert hall with no capacity constraints.

Snoop Dogg created Snoopverse for The Sandbox and in April released an exclusive music video of his song "House I Built" on the platform. He's expected to hold a full concert later this year. Warner Music Group has also partnered with Sandbox, where it will create the "first music themed world," a combination of a musical theme park and a concert venue.

And perhaps the ultimate recognition of this medium: MTV has created a video music award for the best musical performance in the metaverse, an August 12 *WSJ* article reported. Let's take a look at some of the other ways creative types are using the metaverse:

(1) *Watch the catwalk.* Metaverse Fashion Week, held in March, was the first fashion week in the metaverse. Bulova, Tommy Hilfiger, Dolce & Gabbana, and others were hosted on Decentraland. It follows the Fabric of Reality show in 2020 and Gucci's Garden on Roblox in 2021. Metaverse Fashion Week attracted 108,000 unique attendees and wasn't the same as a traditional fashion show. Cats replaced models in the Dolce & Gabbana show. Models on the Unxd runway could fly after emerging from blooming lotuses. And an after-party allowed attendees' avatars to participate in a dance-off, explained a March 29 *Vogue Business* article.

(2) *Meet Paris.* Paris Hilton launched Paris World on Roblox last year, and now she's launching another "land" on The Sandbox. On Sandbox, she'll create her virtual Malibu mansion, where she can plan social and community events like rooftop parties and glam social experiences. On Roblox's Paris World, all of Paris' fans around the world can attend as she DJs, and she envisions being able to sell digital wearables and working with brands

in the future to monetize the site.

“At the Neon Carnival we had almost half a million people there and in the real life party there was 5,000. That’s the power of the metaverse where you can have people from all around the world be able to enjoy and experience things that are usually … exclusive events,” she said in an August 10 CNBC *interview*. Now, that’s hot! (as Paris has been known to say).

(3) *Check out some art.* Decentraland is holding its third Metaverse Art Week from August 24-28. Dubbed “The World is Made of Code,” the event looks at the relationship between man and nature and how that relates to the metaverse, according to an August 14 *item* on NFT Evening. It will include exhibitions, art designs, discussion panels, and live performances. OpenSea, SuperRare, Sotheby’s, and creators like Damien Hirst are involved.

Hirst is an artist who in July 2021 created 10,000 individual physical prints, each with multi-colored dots. Each of the prints could be purchased for $2,000, and the buyers had a year to decide if they wanted to keep the physical print or the corresponding NFT. If the NFT is chosen, the physical artwork will be destroyed in September. As of August, 4,851 of the buyers chose the NFT, and 5,149 opted for the physical artwork, an *article* on MyArtBroker stated. The value of the NFT rose to about $20,000 last year and is now closer to $9,000.

Calendars

US: Thurs: Leading Indicators -0.5%; Philadelphia Fed -5.0; Existing Home Sales 4.89mu; Initial & Continuous Jobless Claims 265k/1.438m; Natural Gas Storage; George. **Fri:** None. (Bloomberg estimates)

Global: Thurs: Eurozone Headline & Core CPI 0.1%m/m/8.9%y/y & -0.2%m/m/4.0%y/y; UK Gfk Consumer Confidence -42; Japan CPI; Schnabel. **Fri:** Germany PPI 0.6%m/m/32.0%y/y; UK Headline & Core Retail Sales -0.2%m/m/-3.3%y/y & -0.2%m/m/-3.1%y/y; Canada Headline & Core Retail Sales 0.3%/0.9%. (Bloomberg estimates)

Strategy Indicators

Stock Market Sentiment (*link*): The BBR advanced this week for the sixth week, from 0.76 to 1.64 over the period, to its highest reading since early January—as bulls now far outnumber bears. It was at 0.60 eight weeks ago, which was the lowest since the week of March 10, 2009's 0.56. Bullish sentiment rose this week for the sixth week by 14.5ppts (to 45.0% from 30.5%); it was at 26.5% eight weeks ago—which was the fewest bulls since early 2016. Meanwhile, bearish sentiment fell for the seventh time in eight weeks by 16.6ppts (27.5 from 44.1). The correction count matched bearish sentiment, falling for the fourth time in five weeks from 31.0% to 27.5%—remaining in a narrow range between 27.1% and 31.0% for the past 10 weeks. In the meantime, the AAII Sentiment Survey (as of August 11) showed the highest optimism and the lowest pessimism since March. The percentage of investors expecting stocks to rise over the next six months climbed to 32.2%—the highest since the 32.8% of the March 24 week; it was at 18.2% seven weeks ago. Still, bullish sentiment remains below its historical average of 38.0% for the 38th straight week. The percentage expecting stocks will fall over the next six months dropped for the fifth week to 36.7%—the lowest since March 31 (27.5%)—though has been above its historical average of 30.5% for 37 out of the past 38 weeks. The report notes that bullish and bearish sentiment as well as the bull-bear spread are currently within their typical ranges.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin remained steady w/w at a 13-month low of 13.1% last week, down 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 edged down less than 0.1% from its record high a week earlier, but forward earnings was down 0.3% w/w to 1.6% below its record high in mid-June. Both had been making new highs since the beginning of March 2021; prior to that, they peaked just before Covid-19 in February 2020. Since the Q2-2021 earnings season, actuals have exceeded estimates by a big margin as analysts played catch-up with their lowball estimates from the Covid-19 shutdown period. Forward revenues growth remained steady w/w at a 22-month low of 6.1%. 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 was down 0.3pts w/w to a 24-month low of 7.8% from 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 12.0% (unchanged w/w) in 2022 and 3.9% in 2023 (unchanged w/w) compared to the 16.4% gain reported in 2021. They expect earnings gains of 9.7% in 2022 (unchanged w/w) and 7.3% in 2023 (down 0.3ppt 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 (unchanged w/w) compared to 13.0% in 2021 and to improve 0.4ppt y/y to 13.2% in 2023 (unchanged w/w). The S&P 500's weekly reading of its forward P/E rose 0.3pt w/w to a 14-week high of 18.0, up from a 26-month low of 15.8 eight weeks ago. 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 0.03pt w/w to a 14-week high of 2.35, 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 six sectors, and the forward profit margin move higher for five sectors. Most of the sectors are below recent record highs in their forward revenues, earnings, and profit margins. Energy, Real Estate, and Utilities are the only sectors 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. Energy is the only sector with its forward profit margin at a record high. 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. Seven sectors are now expected to see margins decline y/y in 2022: Communication Services, Consumer Discretionary, Consumer Staples, Financials, Health Care, Information Technology, and Real Estate. Here's how they rank based on their current forward profit margin forecasts along with their record highs: Information Technology (24.7%, down 0.2ppt w/w and from its 25.4% record high in early June), Financials (18.4, down from its 19.8 record high in August 2021), Real Estate (18.2, up 0.1ppt w/w and down from its 19.2 record high in 2016), Communication Services (15.3, down 0.1ppt 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 (12.9, up 0.1ppt w/w and down from its 13.6 record high in early June), S&P 500 (13.1, down from its record high 13.4 achieved intermittently since March), Health Care (10.6, down 0.2ppt w/w and from its 11.5 record high in early March), Industrials (10.3, up 0.1ppt w/w and down from its 10.5 record high in

December 2019), Energy (12.3, up 0.2ppt w/w to a new record high), Consumer Discretionary (7.4, down from its 8.3 record high in 2018), and Consumer Staples (7.2, down 0.1ppt w/w and from its 7.7 record high in June 2020).

US Economic Indicators

Retail Sales (*link*): Retail sales were flat in July after climbing the first six months of this year by 7.6% to a new record high. Meanwhile, real retail sales (deflated by the CPI) ticked up 0.1% last month after a two-month slide of 1.1%; real sales are up 2.1% ytd. A drop in gasoline prices pushed sales at gasoline stations down 1.8% in July, after soaring 25.0% during the five months through June, while autos were also a drag on overall retail sales, falling 1.6% in July and 4.5% during the three months through July. Excluding autos & gasoline, sales haven't posted a decline this year, climbing 0.7% m/m and 7.1% ytd to another new record high. The control group—which excludes autos, gasoline, building materials, and food—rose for the seventh time this year, by 0.8% in July and 6.6% ytd, to a new record high. Of the 13 nominal retail sales categories, nine rose during July, while four fell. Here's a snapshot of the sales performances of the 13 categories during July as well as the performances versus a year ago and relative to their pre-Covid levels: nonstore retailers (2.7%, 20.2%, 65.3%), miscellaneous store retailers (1.5, 17.8, 44.2), building materials & garden equipment & supplies (1.5, 10.1, 31.9), electronics & appliance stores (0.4, -9.9, 3.0), health & personal care stores (0.4, 3.4, 14.8), furniture & home furnishings (0.2, 2.1, 18.2), food & beverage stores (0.2, 8.4, 21.8), food services & drinking places (0.1, 11.6, 26.0), sporting goods & hobby stores (0.1, 3.9, 38.9), clothing & accessories stores (-0.6, 2.3, 13.9), general merchandise stores (-0.7, 0.5, 11.1), motor vehicles (-1.6, 2.1, 20.7), and gasoline stations (-1.8, 39.9, 60.5).

Business Sales & Inventories (*link*): Nominal business sales in June climbed to another new record high, while May real business sales (reported with a lag) continued to drift lower, though remained at a relatively high level. Nominal business sales expanded for the ninth time in 10 months, expanding 1.3% in June and 13.6% over the period. Meanwhile, real business sales fell 0.9% in June after a 0.2% uptick and a 1.3% decline the prior two months, with sales down 1.6% ytd—3.4% below its record high posted during March 2021. Real sales for wholesalers fell for the fourth month since reaching a new record high in January, down 4.1% over the period, while real sales for retailers continued to bounce between positive and negative in the early months of this year, though are 7.8% below last March's record high. Meanwhile, real manufacturing sales have dropped the first five months of this year, down 0.2% in May and 3.0% over the period. In the meantime, the real inventories-to-sales ratio moved up to 1.47 in May from its recent low of 1.38 to its highest reading since June 2020. The nominal ratio was unchanged at 1.30 in June, up from a near-record low of 1.26 in October and November.

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