MORNING BRIEFING
September 8, 2022

Bad Times In Europe & China

Check out the accompanying chart collection.

Executive Summary: European governments aren't about to leave their people out in the cold after Russia suspended its gas deliveries to Germany indefinitely. Jackie examines plans they've pulled together to keep people warm, businesses open, and utilities financially viable. … Also: China has been fighting to vanquish Covid via strict lockdowns whenever and wherever the slippery foe appears. The government's failure to rid the country of Covid is one problem leaders will want to keep swept under the rug when the Chinese Communist Party meets in mid-October. Another is a UN report shining a spotlight on China's outrageous human rights abuses perpetrated against Uyghurs.

Europe: Gas Crisis. On Friday, Russia extended its suspension of natural gas deliveries to Germany through Nord Stream I indefinitely, in reaction to the G-7's plan to cap oil prices. The move sent energy prices surging in Europe once again. The Dutch month-ahead wholesale natural gas price was up 30% in early trading on Monday. But it's notable that even after the recent pop, the Dutch gas price remains 29% off its August 26 peak (*Fig. 1*). Likewise, even as OPEC announced a 100,000 bpd cut to production on Monday, the price of Brent crude oil futures remains 27% below its 2022 peak of $127.98 per barrel (*Fig. 2*).

Governments have scrambled in recent days to engineer plans to help their citizens pay to stay warm and keep the lights on this winter. They are also coming to the rescue of utilities facing margin calls as the market moves violently. Here's a roundup of the latest moves:

(1) *New British PM goes to work.* New British Prime Minister Liz Truss hadn't yet stepped foot into 10 Downing Street when her plan to help British citizens afford energy was floated in the news.

A typical British household's gas and electricity bill is expected to rise from £1,971 to £3,549 in October. The government is expected to subsidize bills over £2,500, a September 6 BBC *article* reported. The news agency didn't know how long the government will provide support, but the total package is expected to cost about £100 billion; the exact tally depends on gas and electricity prices this winter and how much additional support is offered to the most vulnerable citizens. The plan's details are expected to be released today. The price tag could also rise when the government announces how it plans to support businesses, many of which have fixed-rate deals that expire this October.

The government is expected to borrow to pay for the plan. There's some concern about the UK's debt levels since it already borrowed £60 billion to £70 billion to fund the Covid furlough plan, and it's expected to borrow more to fund tax cuts and increased defense spending. The British pound has fallen to its lowest level against the dollar since 1985 (*Fig. 3*).

(2) *Third time's a charm?* Germany said on Sunday that it will spend at least €65 billion ($64.7 billion) on a package of payments to the most vulnerable citizens and tax breaks to energy-intensive businesses. This is the country's third round of support related to the energy crisis.

The government will make one-off payments to pensioners, people on benefits, and students, and the country will cap energy bills, said German Chancellor Olaf Scholz according to a September 5 BBC *article*. The country also plans to give tax breaks to about 9,000 energy-intensive businesses valued at €1.7 billion. These plans would be funded in part by a windfall tax on energy companies and implementing a 15% global minimum corporate tax.

Including this new package of subsidies and payments, Germany will have spent about €100 billion to give its citizens relief from surging energy prices. That follows the €300 billion the country spent on Covid relief.

Germany's gas storage has reached 85% of capacity on Saturday, a month earlier than expected thanks in part to corporations' consumption reductions. The country also announced intentions to keep two nuclear plants open in reserve mode beyond their scheduled closures around year-end. Germany uses the euro, which has dropped to a 20-year low against the dollar (*Fig. 4*).

(3) *Countries funding utilities' margin calls.* EU energy ministers are set to meet on Friday to discuss how to "ease the burden of energy prices across the bloc," the September 5 BBC article reported. Price caps on imported gas and emergency liquidity support for energy market participants are on the agenda, a September 4 Reuters *article* stated.

European power producers are facing a major cash crunch as margin calls on their hedges are forcing them to pony up more cash. The September 4 Reuters article explained: "Utilities sell most of their power a few years in advance to guarantee a certain price, in an arrangement which requires them to deposit a ‘minimum margin’ into an account as a safety net in case they default before the power is produced and actually enters the market.

“A margin call occurs if the funds in the account fall below the minimum margin requirement for a trade, forcing the company to secure it with more cash. Soaring European power prices in recent months have triggered margin calls, putting a liquidity squeeze on market participants.” Norway’s Equinor ASA *told* Bloomberg on Tuesday that margin calls for European energy trading totaled at least $1.5 trillion and warned that cash shortages at the utilities could lead to a “Lehman Brothers” moment.

Countries have rushed to provide support. Germany has earmarked €7 billion in loans for companies, including utilities, that face liquidity issues. Germany’s Uniper SE last week requested another €4 billion of funding in addition to the €9 billion it had previously received, the Bloomberg article noted. Austria provided a €2 billion credit facility to cover the trading positions of Vienna’s municipal power utility.

Switzerland’s largest renewable electricity producer, Axpo, and Finnish utility, Fortum, said Tuesday that they’ve been granted new state-backed credit lines totaling €33 billion. And Centrica, owner of British Gas, is in negotiations with bankers to line up additional credit lines. Also, the EU is considering offering pan-European credit-line support for energy market players facing margin calls, the September 4 Reuters article explained.

(4) *Companies take it on the chin.* Companies across the continent are feeling the pinch of higher energy prices. Dutch bakery owners will have to shut their doors if prices stay this high for much longer, reported a September 6 Reuters *article*. Many bakers have power contracts that are set to expire. Their monthly bills could jump from €3,000 to €30,000. That’s a lot of dough.

Dutch online grocery delivery company Picnic is halting deliveries of frozen foods, like frozen pizzas, meals, and ice cream. It’s no longer economical to buy dry ice because high energy prices have hurt their dry ice supplier so much, the Reuters article reported.

Energy-intensive smelters continue to shut down. The latest moves come from Slovenia’s Talum, which is cutting production to a fifth of capacity, and Alcoa, which is closing one of its lines in its Lista plant in Norway, a September 1 Reuters *article* reported. Almost 1 million tonnes of European primary aluminum capacity has been closed so far. However, reduced production in Europe and the US has been more than offset by increased production in China, Reuters noted. And that helps to explain why the price of aluminum has fallen 19%

ytd (*Fig. 5*).

China I: Covid Strikes Again. Chinese officials undoubtedly want to put on a good show when the Chinese Communist Party meets in Beijing on October 16. They don't want Covid cases to distract from the party's shindig. So let's shine a light on what Chinese leaders would like everyone to ignore.

China only has 1,695 Covid cases as of October 6, but officials have shut down cities and encouraged citizens not to travel during the upcoming holiday weekend. It all seems so 2020.

At least 34 cities are partially or completely locked down, including Tibet's Lhasa, Qinghai's Xining, Xinjiang's Urumqi, Henan's Shijiazhuang, Guizhou's Guiyang and Heilongjiang's Harbin, according to a September 6 *Asia Times* *article*. It explains that many cities have adopted a "silent management mode" policy, which requires daily Covid tests, avoiding leaving home except for essential activities, and refraining from gatherings.

Shenzhen, which had 36 Covid cases on Monday, adopted the silent management mode. It closed its entertainment premises, encouraged workers to work from home, and halted restaurant dining and most subway lines. One girl tested positive in Shanghai on Tuesday. But instead of locking down the whole city, the government responded just by requiring residents in two districts to complete two Covid tests in three days.

Chengdu, a city with 21.2 million residents in southwestern China, has been locked down since last Thursday, a September 7 Reuters *article* reported. There was outrage over pictures showing people forced to stay in their residences even as the city was being hit by a 6.8 magnitude earthquake on Monday. Authorities subsequently said that residents under Covid lockdown may leave their homes during emergencies such as earthquakes.

Beijing had 14 locally transmitted cases reported on Tuesday. In Yizhuang, an economic and technological development zone outside Beijing, Communist Party officials and residents were told not to leave unnecessarily during the mid-autumn festival or the week-long holiday in early October, in an effort to "create a safe and stable social environment for the party congress." Chinese officials undoubtedly have been concerned as they've watched new Covid cases in Hong Kong recently surge past 10,000 a day.

China II: UN Confirms Human Rights Violations. A United Nations' August 31 *report* concludes that there were "serious human rights violations" in the Xinjiang Uyghur

Autonomous Region (XUAR) from 2017 to 2019 related to the government’s counter terrorism and counter extremism policies affecting Uyghur and other predominantly Muslim communities. The Chinese government “indicates” that all the detainment centers used in its counter-terrorism program are closed and no longer in use. But the UN hasn’t been given access to the region to confirm the assertion.

The UN report recommends that: 1) China release people held in violation of their human rights and amend its policies; 2) businesses determine whether the companies they do business with are respecting human rights; 3) surveillance and security companies assess whether their products and services could contribute to human rights abuses; and 4) the international community support efforts to promote human rights in the XUAR region, refrain from returning members of the Uyghur and Muslim minorities to China, and provide them with medical and psychological support.

While calling out China’s human rights violations is important, the report’s recommendations lack any enforcement or punishment mechanism. That said, let’s dive into its findings:

(1) *Some background.* XUAR is China’s largest region, covering one sixth of the country and home to 25.9 million people. In 1953, the region’s population was 75% Uyghurs and 7% Han, China’s predominant ethnic group. Today, XUAR’s population is 45% Uyghur and 42% Han, presumably because of government incentives to encourage Han migration into the area and potentially because of government policies that have limited Uyghur childbirth.

In 2018, the UN Committee on the Elimination of Racial Discrimination estimated that the number of people detained in the XUAR region ranged from tens of thousands to over a million; some researchers put the figure closer to 10%-20% of the area’s adult Uyghur population, which at the high end is roughly 2 million people. The Chinese government has declined to release any data.

In addition to finding documents describing Chinese policies in the region, the UN interviewed 40 individuals with direct knowledge of what was occurring, both detainees and workers.

(2) *Training or detention.* In 2018, China acknowledged the existence of Vocational Education and Training Centers (VETCs). The following year, China said that it had established the centers to “eradicate the breeding ground and conditions for the spread of terrorism and religious extremism.” The centers are residential, and individuals are given a choice between going there or to a prison. Interviewed detainees said they were not allowed

to leave the facilities, which were staffed by armed guards. To visiting foreign delegations, one former detainee was instructed to say that everything was fine and that they were allowed to return home at night. They stayed in the centers anywhere from 2-18 months.

People were “referred” to VETCs for reasons as innocuous as having too many children, being an unsafe person, being born in certain years, wearing a veil or beard, having applied for a passport but not having left the country, being an ex-convict, having foreign connections, attempting to cancel their Chinese citizenship, having dual registration in a neighboring country, having downloaded WhatsApp, and simply to fulfill a quota.

Detainees were not told what their offenses were but were asked to choose them from a list. One interviewee said, “I was not told what I was there for and how long I would be there. I was asked to confess a crime, but I did not know what I was supposed to confess to.” They did not appear to have access to lawyers.

At the centers, detainees were tortured, interrogated, indoctrinated in political teachings, and “rehabilitated” in a program based on self-criticism. They were denied food, forbidden to speak their own language or pray, and administered injections or pills that made them drowsy. Blood samples were collected regularly. Women reported instances of rape. Families often were not told where their relatives were being held, and a registry of thousands of missing people in Xinjiang has been created by exiled family members.

(3) *Religious restrictions & surveillance.* Separately, the report found increasing restrictions on Muslim religious practices in the region. Islamic religious sites have been destroyed, and the Uyghur language is prohibited. The UN has not been given access to the region to investigate these reports.

The government also has installed a large surveillance system across the region developed with the help of private technology companies. It includes using biometric data collection, including iris scans and facial imagery, a large network of surveillance cameras, and broad access to “personal communication devices and financial histories.” The system informs authorities when Islamic religious materials are downloaded and when residents communicate with people abroad. Both actions could trigger government detainment.

The report noted that the birth rate for Uyghurs dropped sharply from 2016 to 2018, far more sharply than births declined in China overall. There was also a sharp rise in sterilizations and IUD placements in XUAR in 2017 and 2018. In 2018, 243 per 100,000 inhabitants of XUAR were sterilized compared to 32.1 per 100,000 in China as a whole.

These data suggest what interviewees confirmed: Minority women were subjected to forced abortions, sterilizations, and IUD placements after families reached permitted numbers of children. Women spoke of harsh punishment, including internment, for violating family planning policy.

The report also notes indications that the government has forced minorities to work and linked those work programs to the VETC system.

It's almost assured that this report will not be on the agenda when the Chinese Communist Party meets on October 16.

Calendars

US: Thurs: Initial & Continuous Jobless Claims 240k/1.45m; Consumer Credit $33.0b; Crude Oil Inventories; Natural Gas Storage; Powell. **Fri:** Wholesale Sales & Inventories 1.4%/0.8%; Baker-Hughes Rig Count; George; Waller. (Bloomberg estimates)

Global: Thurs: France Nonfarm Payrolls 0.5%q/q; France Trade Balance –€13.6b; China CPI & PPI 2.8%/3.2% y/y; ECB Interest Rate Decision & Deposit Facility Rate 1.00%/0.50%; Fernandez-Bollo; Rogers. **Fri:** France Industrial Production -0.5%; Canada Employment Change & Unemployment Rate 15k/5.0%; Euro Summit; Mauderer. (Bloomberg estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The BBR slipped this week for the third week, to 1.00, as bullish and bearish sentiment converged. It had advanced the previous six weeks from 0.76 to 1.64, which was the highest reading since early January. (It was at 0.60 11 weeks ago, which was the lowest since the week of March 10, 2009's 0.56.) Bullish sentiment has tumbled 15.4ppts the past two weeks to 29.7%—back near the 26.5% 11 weeks ago, which was the fewest bulls since early 2016. The percentage had jumped the prior seven weeks by 14.6ppts (to 45.1% from 30.5%). Meanwhile, bearish sentiment fell to 29.7% after climbing the prior two weeks to 30.1%; it fell seven of the prior eight weeks by 16.6ppts (27.5 from 44.1). The correction count advanced for the second week to 40.6%—

the highest since early March 2020—after sinking five of the prior six weeks from 31.0% to 25.3%, which was the lowest since early June. In the meantime, the AAII Sentiment Survey (as of September 1) reports optimism about the short-term direction of the stock market was at an eight-week low, while pessimism climbed to an eight-week high. The percentage expecting stocks will rise over the next six months dropped for the second week by 11.4ppts to 21.9% after rising to 33.3% two weeks ago—which was the highest since December 30, 2021 (37.7%). It remains below its historical average of 38.0% for the 41st straight week. The percentage expecting stocks will fall over the next six months increased for the third week, by a total of 13.7ppts to 50.4%—with 8.0ppts occurring during the latest week. That followed five weeks of decline in the percentage expecting stocks to fall, from 52.8% to 36.7%, which was the lowest since March 31 (27.5%). The measure has been above its historical average of 30.5% for 40 out of the past 41 weeks, with the report noting that it's at an unusually high level for the 25th time in 33 weeks. (The breakpoint between typical and unusually high readings is currently 40.5%.)

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin ticked up 0.1ppt w/w last week to 13.1% from a 13-month low of 13.0%, but remains 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 rose to a new record high, and forward earnings gained 0.7% to 1.0% below its record high in mid-June. Both had been steadily making new highs from the beginning of March 2021 to mid-June; prior to that, they peaked just before Covid-19 in February 2020. Forward revenues growth dropped 0.4ppt w/w to a 23-month low of 5.7%. 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 steady w/w at a 24-month low of 7.4%. 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% (down 0.2ppt w/w) in 2022 and 4.1% in 2023 (up 0.3ppt w/w) compared to the 16.4% gain reported in 2021. They expect earnings gains of 9.7% in 2022 (up 0.1ppt w/w) and 7.2% in 2023 (unchanged 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 (up 0.1ppt w/w) compared to 13.0% in 2021 and to improve 0.3ppt y/y to 13.1% in 2023 (down 0.1ppt w/w). The S&P 500's weekly reading of its forward P/E fell 0.9pt w/w to a six-week low of 16.8. That compares to a 15-week high of 18.2 several weeks earlier and is up from a 26-month low of 15.8 in late June. That also 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 fell 0.12pt w/w to a seven-week low of 2.19. That compares to a 15-week high of 2.38 several weeks earlier and is up from a 26-month low of 2.10 during June. That also 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 ten of the 11 S&P 500 sectors, forward earnings rise for eight sectors, and the forward profit margin rise for seven sectors. Nearly all of the sectors are below recent record highs in their forward revenues, earnings, and profit margins. Energy and Utilities are the only sectors with forward earnings at a record high now. Five sectors have forward revenues at a record high this week: Consumer Discretionary, Consumer Staples, Financials, Health Care, and Industrials. All sectors now have forward profit margins that are below their record highs, but those of Energy and Industrials remain closest to their post-pandemic highs. Energy still has forward revenues well below a record high, and Utilities' forward revenues and margin are lagging too. Only three sectors have posted a higher profit margin y/y so far during 2020: Consumer Staples, Tech, and Utilities; during 2021, all of the sectors but Utilities posted a y/y improvement. Seven sectors are expected to see margins decline y/y for full-year 2022, followed by four sectors in 2023. Here are 2022's decliners: 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%, up 0.1ppt w/w and down from its 25.4% record high in early June), Financials (18.5, up 0.1ppt w/w and down from its 19.8 record high in August 2021), Real Estate (18.3, down 0.1ppt w/w and down from its 19.2 record high in 2016), Communication Services (15.3, up 0.1ppt w/w and down from its 17.0 record high in October), Utilities (13.9, down from its 14.8 record high in April 2021), S&P 500 (13.1, up 0.1ppt w/w and down from its record high of 13.4 achieved intermittently from March to June), Materials (12.8, down 0.1ppt w/w and from its 13.6 record high in early June), Health Care (10.6, down from its 11.5 record high in early March), Industrials (10.3, down from its 10.5 record high in December 2019), Energy (12.2, down from its 12.3 record high in early August), Consumer Discretionary (7.5, up 0.1ppt w/w and down from its 8.3 record high in 2018), and Consumer Staples (7.3, up 0.1ppt w/w and down from its 7.7 record high in June 2020).

US Economic Indicators

Merchandise Trade (*link*): The real merchandise trade deficit continued its narrowing trend in July after holding steady in May at -$116.6 billion. July's deficit narrowed dramatically to -$103.5 billion from a record-high -$135.8 billion during March. Trade was a major drag on Q1 real GDP, but was the biggest positive contributor during Q2; it's likely to contribute positively again this quarter. July's $103.5 billion deficit is a big narrowing from Q2's average monthly gap of $115.5 billion and Q1's $122.4 billion. Real exports rose for the fourth time in five months, by 3.2% in July and 8.2% over the period to another new record high, while real imports fell for the fourth successive month, by 2.1%m/m and 8.0% over the period. *Looking at exports,* real exports of industrial supplies & materials shot up 16.6% during the five months through July to a new record high, after slumping 8.0% the first two months of the year, while exports of nonfood consumer goods ex autos dipped for the second month by 4.7%, though that followed a four-month surge of 11.5%. Meanwhile, both exports of capital goods orders ex autos and auto exports remain on volatile modest uptrends. Foods, feeds & beverage exports are moving sideways, but the swings are wide. *As for import trends,* the measures for capital goods ex autos is climbing back toward March's record high, while imports of foods, feeds & beverages and of nonfood consumer goods ex autos both are down sharply after hovering just below record highs; the former plunged 5.1% in July, while the latter tumbled 17.4% during the four months through July. Auto imports are on a volatile uptrend, picking up some ground in July. Imports of industrial supplies & materials has recovered 2.4% after dropping 9.0% in April.

Global Economic Indicators

Eurozone GDP (*link*): Economic activity in the Eurozone during Q2 was revised up to 3.1% (saar), outpacing gains of 2.7% during Q1 and 1.9% during Q4-2021. However, that result pales in comparison to the annualized gains of 8.7% and 7.9% during Q3-2021 and Q2-2021, respectively. Domestic demand expanded 3.9% (saar) last quarter, after showing no growth during Q1. Consumers were the biggest contributors to growth last quarter, with household consumption rebounding 5.0% (saar) from no growth the prior two quarters; this spending had expanded at double-digit rates during both Q3-2021 and Q2-2021. Meanwhile, real gross fixed capital formation rebounded 3.6% (saar) during Q2 after contracting 3.4% during Q1; it had finished 2021 strong—jumping 14.8% (saar). Real government spending picked up, rising 2.5% (saar) after slowing to 0.9% during Q1 from Q4's 2.6% gain. Trade was a drag on growth last quarter as imports (7.4%, saar) outpaced exports (5.4). On a y/y basis, real GDP growth slowed to 4.2% after accelerating the prior two quarters from 3.7% during Q3-2021 to 5.4% during Q1-2022.

Germany Industrial Production (*link*): Headline German industrial production, which includes construction, continued its up-and-down pattern, falling 0.3% in July after a 0.8% gain and a 0.1% loss the prior two months. Meanwhile, Germany's measure excluding construction (which the overall Eurozone uses) contracted 0.7% after a three-month gain of 3.3%. Manufacturing production sank 1.0% in July, after a three-month spurt of 3.7%, with output declining among all of the main industry groupings. Consumer goods production posted the biggest drop, falling 2.4%, followed by an 0.8% drop in capital goods orders and a 0.6% shortfall in intermediate goods production. The decline in consumer goods production was driven by a 3.0% drop in nondurable goods output—which was partially offset by a 0.8% uptick in durable goods production. Outside industry, energy and construction output climbed 2.8% and 1.4%, respectively. Overall production was 1.1% below a year ago, on widespread weakness: Intermediate goods (-3.3% y/y), consumer durable goods (-1.6), and consumer nondurable goods (-1.0) output all were below year-ago levels, while capital goods (-0.1) production was virtually flat and energy output was up 6.0%. According to Statistics office Destatis, industry continues to suffer not only from the effects of the war but also from the supply-chain disruption caused by the pandemic and, more recently, by the drought that restricted shipping on Germany's most important inland waterways such as the Rhine.

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