MORNING BRIEFING
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On China, Banks & Solar

Check out the accompanying chart collection.

Executive Summary: China's economy is ailing, but you wouldn't know it to hear President Xi's speech before the Chinese Communist Party's annual National Congress. Jackie puts into perspective the points he made and, more importantly, the ones he omitted. … Also: Big banks' Q3 earnings reports showcase their resilience so far in the current higher interest-rate environment, but leveraged loans could be a problem area in the future if companies have trouble making higher interest payments. ... And: A look at solar energy's sunny future: With new technologies making panels lighter and more versatile, the sky's the limit to their potential applications.

China: What Xi Isn't Saying. At the 20th National Congress of the Chinese Communist Party this week, what President Xi Jinping didn't say is perhaps more important than what he did. Xi rattled off the expected banalities during his nearly two-hour speech. His zero Covid policy will continue, economic growth and self-reliance remain priorities, as does reunification with Taiwan. Battling poverty, enhancing ecological conservation, safeguarding national security, and modernizing the military all are Party goals. What Xi didn't say: China's economy is a mess.

Real estate debt totaling in the billions of dollars needs to be restructured so it doesn't weigh on economic growth for years. Yet Xi's speech failed to include a large, cohesive plan to address the problem. Foreign companies are decamping for countries that don't face US tariffs, Covid lockdowns, and scattered water and energy shortages. Chinese youth unemployment is at 18.7%. And it's a safe bet that economic growth has slowed far below the country's 5.5% y/y GDP target.

Here are some excerpts from the English translation of Xi's *speech* and some details that he left out for obvious reasons:

(1) *Economic growth.* Xi touted the progress that the Chinese economy has made during the years he has led the nation. "In the past decade, China's GDP has grown from 54 trillion yuan to 114 trillion yuan to account for 18.5 percent of the world economy, up 7.2 percentage points. China has remained the world's second largest economy, and its per capita GDP has risen from 39,800 yuan to 81,000 yuan. It ranks first in the world in terms of

grain output, and it has ensured food and energy security for its more than 1.4 billion people. The number of permanent urban residents has grown by 11.6 percentage points to account for 64.7 percent of the population."

What Xi failed to mention was that Q2 real GDP fell 2.6% (not annualized), as much of the economy was shut down due to Covid (*Fig. 1*). Q3 GDP was expected by some to grow roughly 3%, but given that the data release expected on Tuesday was postponed, we presume the result was far lower than the estimate. The 13.7% drop in the CRB Raw industrials spot index this year and the 64% drop in the Drewry benchmark for shipping container prices also imply that all's not well (*Fig. 2*). As does the 32.7% ytd decline in the China MSCI share price index (*Fig. 3*).

(2) *International heft.* Xi boasted about China's relationships with other countries. He specifically noted: "As a collaborative endeavor, the Belt and Road Initiative has been welcomed by the international community both as a public good and a cooperation platform."

Xi's speech didn't note that many countries that borrowed money under the Belt and Road Initiative are now struggling to repay China about $1 trillion of debt. Some have called the program China's "debt-trap diplomacy."

Xi also opted to exclude to China's failure to warn the world that its people were coming down with a new disease, Covid-19. Instead, he said: "We have demonstrated China's sense of duty as a responsible major country, actively participating in the reform and development of the global governance system and engaging in all-around international cooperation in the fight against Covid-19. All this has seen us win widespread international recognition. China's international influence, appeal, and power to shape have risen markedly."

(3) *Keeping the peace.* Xi noted the Party's accomplishments in maintaining peace within the country's borders. "We have effectively contained ethnic separatists, religious extremists, and violent terrorists and secured important progress in the campaigns to combat and root out organized crime," he said.

No reference was made of China's treatment of the Uyghurs and members of other Muslim communities who are incarcerated in the Xinjiang region. China committed "serious human rights violations" in their treatment of these minorities, an August 31 UN report noted.

(4) *Protector of the environment.* In a number of areas, Xi waxed poetic about the country's devotion to preserving the environment. At one point he said: "China is committed to sustainable development and to the principles of prioritizing resource conservation and environmental protection and letting nature restore itself. We will protect nature and the environment as we do our own lives." The country's goals include establishing "eco-friendly ways of work and life; steadily lower carbon emissions after reaching a peak; fundamentally improve the environment; largely accomplish the goal of building a Beautiful China."

While the country has rolled out solar panels and wind turbines to generate green energy, it is still tied to using coal and other CO_2-producing fuels. China has produced 2.93 billion tons of coal from January to August, an 11% y/y increase, as it aims to avoid the power outages it suffered through last year, an October 12 *Global Times* *article* reported. The country's coal imports dropped 14.9% to 168.0 million tons. The country had the highest CO_2 emissions in the world in 2020, 11.7 billion tons, followed by the US, which emitted 4.5 billion tons, World Population Review has *reported*.

(5) *Boosting business.* Xi's speech emphasized the Party's support for businesses. We will "encourage entrepreneurship and move faster to help Chinese companies become world-class outfits. We will support the development of micro, small, and medium enterprises." (Ask former Ant Group investor Jack Ma if he felt that support.) Of course, Xi has actually come down hard against entrepreneurs. Government regulation and supervision of business has increased significantly in recent years under Xi.

(6) *Supporting workers.* Xi spent a chunk of his presentation on how the Party will help workers. He said: "We will ensure more pay for more work and encourage people to achieve prosperity through hard work. We will promote equality of opportunity, increase the incomes of low-income earners, and expand the size of the middle-income group. … We will protect lawful income, adjust excessive income, and prohibit illicit income. … We need to intensify efforts to implement the employment-first policy and improve related mechanisms to promote high-quality and full employment. We will refine the public services system for employment and the system of providing employment support for key groups and do more to help those in difficulty find employment and meet their basic needs. ... We will further improve the multi-tiered social security system that covers the entire population in urban and rural areas and see that it is fair, unified, reliable, well-regulated, and sustainable."

Xi also gave a shoutout to China's youth: "A nation will prosper only when its young people thrive. China's young people of today are living in a remarkable time. They have an

incomparably broad stage on which to display their full talents, and they have incomparably bright prospects of realizing their dreams." The 18.7% unemployment rate among those aged 16 to 24 years old in August was left out of the speech (*Fig. 4*).

(7) *Taiwan.* Xi reiterated the Party's focus on reunification with Taiwan, stating that the plan is to establish in Taiwan the same one-country, two-systems framework used in Hong Kong and Macau. "Resolving the Taiwan question and realizing China's complete reunification is, for the Party, a historic mission and an unshakable commitment. It is also a shared aspiration of all the sons and daughters of the Chinese nation and a natural requirement for realizing the rejuvenation of the Chinese nation."

And just in case the politicians in Washington DC weren't paying attention, Xi added: "Taiwan is China's Taiwan. Resolving the Taiwan question is a matter for the Chinese, a matter that must be resolved by the Chinese. We will continue to strive for peaceful reunification with the greatest sincerity and the utmost effort, but we will never promise to renounce the use of force, and we reserve the option of taking all measures necessary. This is directed solely at interference by outside forces and the few separatists seeking 'Taiwan independence' and their separatist activities; it is by no means targeted at our Taiwan compatriots. The wheels of history are rolling on toward China's reunification and the rejuvenation of the Chinese nation. Complete reunification of our country must be realized, and it can, without doubt, be realized!"

Taiwan's presidential office, not surprisingly, is opposed to Xi's plan for the island nation, and its response to Xi's speech underscored Taiwan's commitment to independence, democracy, and freedom.

Financials: An Eye on Leveraged Loans. The big banks' Q3 earnings reports have been pleasantly surprising. Net interest income rose sharply y/y in the quarter, as the Federal Reserve has raised interest rates while banks have kept the interest they pay on deposits extraordinarily low. Some managements started increasing loan loss reserves in Q3, but the banks' writeoffs and defaults so far have remained minimal.

But these are early days in the higher-interest-rate environment. The Fed has indicated that it's not done raising rates. Companies with low credit ratings and floating-rate debt are just starting to feel the pinch of higher interest expense.

And there's a lot of floating rate debt out there. Last year, leveraged loan issuance totaled $615 billion, 22% higher than the previous record year's issuance, a January 3 S&P Global

report noted. As a result, the total amount of leveraged loans outstanding rose to a record $1.4 trillion in 2021. But then this year, leveraged loan issuance dropped sharply to $195 billion in H1-2022, down from $495 billion in H1-2021.

Last year, bankers sliced and diced some of the leveraged loans and packaged them into a record amount of collateralized loan obligations (a.k.a. CLOs). Exchange traded funds (ETFs) were created to buy leveraged loans and articles written about them had headlines like: "Opportunity Beckons with Leveraged Loan ETFs."

So far, leveraged loans are holding their own as their interest rates float and adjust to the current rate environment, unlike fixed-rate high-yield bonds. Some of the leveraged loan ETFs tracked online have fallen 3.8% to 6.8% ytd, which isn't bad compared to high-yield bond ETFs, which have dropped more than twice as much, by 13%-15% ytd.

But if interest rates remain high and the economy weakens, some leveraged companies are bound to find that they can't make their new, higher interest payments. Default rates for US leveraged loans could rise to 9% next year if the Fed "stays on its aggressive monetary-policy path," according to a UBS Group analyst quoted in an October 14 Bloomberg *article*.

At Citigroup, markdowns and losses on leveraged loans totaled $110 million in Q3. And US banks as a whole wrote down $1 billion of leveraged and bridge loans in Q2, with some of that pain caused by write-downs on loans funding the leveraged buyout of Citrix Systems. We'll keep an eye on this space.

Disruptive Technologies: Solar's Slow But Steady Progress. The promise of solar panels on every roof hasn't become a reality, but progress toward it is being made. Most recently, Tesla received some positive *press* when its solar roof on a Florida home in the path of Hurricane Ian remained intact and the accompanying Tesla Powerwall, which was covered by floodwaters, continued to work.

Solar panels remain pricey, but scientists are working on ways to bring the cost down. Here's a look at some recent advancements:

(1) *Swapping silver for copper.* Australian startup SunDrive swapped out the expensive silver used in most solar cells for less expensive and more abundant copper, while maintaining the cells' energy efficiency. The company believes it will be able to make further improvements to the cells, boosting their efficiency beyond their current 26.4%.

"Copper is around 100 times cheaper per kilogram and around 1,000 times more abundant than silver. And aside from the abundancy and cost benefits of copper, we have found we can improve the efficiency above and beyond what is attainable with silver," SunDrive co-founder Vince Allen told *PV Magazine* in a September 5 *article*. The company, which has received funding from Blackbird, Grok Ventures, Main Sequence, and Virescent Ventures, counts Tesla Chair Robyn Denholm as one of its board members.

(2) *Printing out solar panels.* Scientists at Australia's University of Newcastle have developed paper-thin solar panels that can be printed out in a sheet and rolled up because they are so flexible. They were used to power a Tesla that was driven around the perimeter of Australia. Eighteen solar sheets measuring 20 meters by 1 meter were laid out on the ground every day of the trip and required 10 hours of sunlight to power the next day's drive.

While expecting drivers to lay huge panels out in the sun for a day before using their cars isn't practical, the concept of thin, rollable panels holds promise. The solar cells' efficiency is expected to increase, so the surface area needed to charge a car can shrink, making the panels more manageable. But in their current state, the solar cells are more likely to be used on commercial factory roofs and other large-scale installations.

It's exciting to think that these solar cells could be incorporated into the coating of cars or used on the side of buildings. And because they are manufactured using conventional, 2D printers that might otherwise produce newspapers or packaging, the solar panels are cheap and fast to make, a September 2 *article* on the University's website stated. The printer used in the University's lab was previously used to manufacture wine labels.

Another advantage is that the printed panels are made primarily of PET, a material that can be recycled, unlike traditional silicon panels.

(3) *Solar on cars.* Aptera is designing a two-seater car that looks like an egg with a tail. But what makes it exciting are the lightweight solar panels that cover the roof and sides. The solar panels can bend in two different directions and are strong enough to survive rain, snow, and hail. They're being designed to last more than 15 years without yellowing or aging, and they're 50% lighter than the competition's products.

The solar cells available on the market today are about 24% efficient, and cells that are 30% efficient are coming in the near future, an October 10 CleanTechnica *article* reported. "At 40% efficiency (something that's in active development), the power you can get from a car's surface will double. If they can get as far as 90% efficiency (a real possibility) a vehicle

like the Aptera could add 120 miles of range on a good day." Traditional auto manufacturers will add solar panels to their cars when they can add 40-50 miles to an electric car's range per day, the article speculates.

Calendars

US: Thurs: Leading Indicators -0.3%; Initial & Continuous Jobless Claims 230k/1.375m; Philadelphia Fed Manufacturing Index -5.0; Existing Home Sales 4.70mu; Natural Gas Storage; Federal Budget Balance -$173.5b; Bowman; Cook; Jefferson. **Fri:** Baker-Hughes Rig Count; Williams. (Bloomberg estimates)

Global: Thurs: Germany PPI 1.3%m/m/44.7%y/y; France Business Survey 101; EU Leaders Summit; UK Gfk Consumer Confidence -52; Japan Core CPI 3.0%y/y. **Fri:** UK Headline & Core Retail Sales -0.5%m/m/-5.0%y/y & -0.3%m/m/-4.1%y/y; Canada Headline & Core Retail Sales 0.2%/0.4%; EU Leaders Summit; Beerman. (Bloomberg estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The *Bull-Bear Ratio* was below 1.00 for the fifth successive week this week, edging up to 0.78 after falling steadily from 1.15 in mid-September to 0.57 last week—which was the lowest since March 2009. *Bullish sentiment* increased for the first time in five weeks to 31.3% after falling the prior four weeks from 32.4% to 25.0%—which was the fewest bulls since early 2016. *Bearish sentiment* exceeded bullish sentiment for the fifth week, though fell for the first time in five weeks, by 3.8ppts to 40.3%, after rising the prior four weeks by 15.9ppts (to 44.1% from 28.2%). It was the largest group for the third consecutive week, unseating the correction count—which had the top spot the prior four weeks. The *correction count* sank for the third week by 11.9ppts (28.4% from 40.3%). In the meantime, the *AAII Sentiment Survey* (as of October 13) showed optimism falling and remaining unusually low once again, with this week's bullish sentiment percentage among the 60 lowest readings in the survey's history. Pessimism rose a bit after falling below 60% the prior week and continues to be unusually high. The *percentage expecting stocks will rise over the next six months* dropped 3.6ppts to 20.4% after climbing the prior two weeks by 6.2ppts (to 23.9% from 17.7%), with optimism remaining below its historical average of 38.0% for the 47th consecutive week; it was unusually low for the seventh successive week and the 30th time in 41 weeks. (The

breakpoint between typical and unusually low readings is currently 27.6%.) The *percentage expecting stocks to fall over the next six months* rose 1.2ppts to 55.9% after falling the prior two weeks from 60.9% to 54.8%. Bearish sentiment has been above its historical average of 30.5% in 46 of the last 47 weeks, and is at an unusually high level for the 31st time in 39 weeks. (The breakpoint between typical and unusually high readings is currently 40.7%.)

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin dropped 0.1ppt w/w last week to a 16-month low of 12.9%. That's down 0.5ppts 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 2.6ppts from the pandemic lockdown-impacted 10.3% during April 2020, which was the lowest level since August 2013. Forward revenues rose to a fresh record high last week even as forward earnings fell 0.3% w/w to a six-month low and to 2.0% 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 started taking off, in February 2020. The consensus expectations for forward growth remained steady w/w at a 26-month low of 5.1% as the heaviest part of the Q3 earnings season approached. That's down from a record high of 9.6% growth at the end of May 2021 and compares to 0.2% forward revenues growth during April 2020, which was the lowest reading since June 2009. However, forward earnings growth was down 0.2ppt w/w to a 27-month low of 6.9%. 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 fallen 0.6ppt to 12.6%. They expect revenues to rise 11.9% (up 0.1ppt w/w) in 2022 and 4.0% in 2023 (unchanged w/w) compared to the 16.5% gain reported in 2021. They expect earnings gains of 8.7% in 2022 (down 0.3ppt w/w) and 6.8% in 2023 (down 0.2ppt w/w) compared to an earnings gain of 50.5% in 2021. Analysts expect the profit margin to drop 0.4ppt y/y to 12.6% in 2022 (unchanged w/w) compared to 13.0% in 2021 and to improve 0.3ppt y/y to 12.9% in 2023 (down 0.1ppt w/w). The S&P 500's weekly reading of its forward P/E tumbled 0.9pt w/w to a 30-month low of 15.3 from 16.2. That compares to a 15-week high of 18.2 in mid-August and is now below its prior 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 tumbled 0.12pt w/w to a 31-month low of 1.98 from 2.10. That's down from a 15-week high of 2.38 in mid-August. 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 nine of the 11 S&P 500 sectors and forward earnings rise for six sectors. However, the forward profit margin moved lower for all 11 sectors. Nearly all of the sectors are below recent record highs in their forward revenues, earnings, and profit margins. Consumer Staples and Financials are the only sectors with forward revenues at a record high this week, and Utilities is the only sector with forward earnings at a record high. Energy still has forward revenues well below a record high, and Utilities' forward revenues and margin are lagging too. Since mid-August, all sectors have forward profit margins below their record highs. Those of Energy and Industrials remain closest to their post-pandemic highs. Only three sectors posted a higher profit margin y/y during 2020: Consumer Staples, Tech, and Utilities; during 2021, all of the sectors but Utilities posted a y/y improvement. Just four sectors are expected to see margins improve y/y for full-year 2022, followed by seven sectors in 2023. Here are 2022's gainers: Energy, Industrials, Materials, and Utilities. Here's how they rank based on their current forward profit margin forecasts along with their record highs: Information Technology (24.5%, down from its 25.4% record high in early June), Financials (18.3, down 0.1ppt w/w and from its 19.8 record high in August 2021), Real Estate (18.3, down from its 19.2 record high in 2016), Communication Services (15.2, down 0.1ppt w/w and down from its 17.0 record high in October 2021), Utilities (13.8, down from its 14.8 record high in April 2021), S&P 500 (12.9, down 0.1 ppt w/w and from its record high of 13.4 achieved intermittently from March to June), Materials (12.2, down 0.1ppt w/w and from its 13.6 record high in June), Health Care (10.5, down from its 11.5 record high in March), Industrials (10.2, down from its 10.5 record high in December 2019), Energy (11.8, down 0.3ppt w/w and from its 12.3 record high in August), Consumer Discretionary (7.5, down from its 8.3 record high in 2018), and Consumer Staples (7.2, down from its 7.7 record high in June 2020).

S&P 500 Q3 Earnings Season Monitor (*link*): The Q3-2022 earnings season is off to the poorest start of a quarterly reporting season since Q1-2020, assessed by the four surprise metrics we measure for both earnings and revenues. With nearly 13% of S&P 500 companies finished reporting revenues and earnings for Q3, revenues are ahead of the consensus forecast by just 1.1%, and earnings have exceeded estimates by 5.7%. At the same point during the Q2 season, revenues were 1.6% above forecast and earnings had beaten estimates by 4.5%. Excluding Financials, Q3's revenue surprise falls sharply to 0.8% from 1.1%, and the earnings surprise drops to just 3.5% from 5.7%. For the 62 companies that have reported Q3 earnings through mid-day Wednesday, the aggregate y/y revenue and earnings growth rates have slowed from their readings of Q2-2021 to Q2-2022. The small sample of 62 reporters so far collectively has a y/y revenue gain of 8.6% but an earnings gain of only 0.3%. Just 61% of the Q3 reporters so far has reported a

positive revenue surprise, and 74% has beaten earnings forecasts. Furthermore, significantly fewer companies have reported positive y/y earnings growth in Q3 (58%) than positive y/y revenue growth (87%). These figures will change markedly as more Q3-2022 results are reported in the coming weeks, particularly from non-Financial firms with greater exposure to the strong dollar. While we expect y/y growth rates to remain positive in Q3, we think the revenue and earnings surprises will deteriorate q/q due to the slowing economy, missed deliveries, higher costs, and currency translation.

US Economic Indicators

Housing Starts & Building Permits (*link*): Housing starts tumbled more than expected in September as rising mortgage rates depressed activity. *Housing starts* slumped 8.1% last month to 1.439mu (saar) after a surprise 13.7% jump in August, which followed a 12.6% plunge in July; starts are down 18.6% ytd. Single-family starts dropped 4.7% in September to 892,000 units (saar), the lowest since May 2020, while volatile multi-family starts contracted 13.2% to 547,000 units (saar)—with the former down 26.4% ytd and the latter down 1.6%. *Building permits* edged up 1.4% in September to 1.564mu (saar) after contracting four of the prior five months by 17.9%. Single-family permits haven't posted an increase since February, dropping 27.6% over the period to 872,000 units (saar), the lowest since mid-2020, while multi-family permits climbed for the third time in four months by a total of 7.5% to 692,000 units (saar). Year-to-date, single-family permits are down 22.0% and multi-family are 11.1% lower. Last month, *housing under construction* rose to a record-high 1.710mu, while *completions* rose 6.1% to 1.427mu after falling 4.7% in August. On Tuesday, NAHB reported that *homebuilders' confidence* dropped for the 10th time this year, by 8 points in October and 46 points ytd, to 38—half the level of just six month ago and the lowest since May 2020 during the height of the pandemic.

Global Economic Indicators

Eurozone Consumer Price Index (*link*): The *headline CPI* rate for September accelerated to yet another new record high of 9.9% y/y, up from 9.1% in August and 6.5ppts above last September's 3.4%. For perspective, the rate was as low as -0.3% at the end of 2020. Looking at the main components, once again *energy* recorded the largest gain, accelerating 40.7% y/y, after slowing from 42.0% in June to 38.6% by August; the rate was at a record high of 44.3% in March. The rate for *food, alcohol & tobacco* soared to a record-high 11.8%

in September—accelerating steadily from June 2021's 0.5%—while the rate for *non-energy industrial goods* reached a new record high of 5.5%. The *services* rate to picked up to 4.3% y/y—the highest since the start of 1994. Of the *top four Eurozone economies*, only Germany's (10.9% y/y) rate was above the Eurozone's rate of 9.9%, accelerating to a new record high. Meanwhile, rates in Italy (9.4), Spain (9.0), and France (6.2) were below the Eurozone's 9.9%, with Italy's rate reaching a new record high. Rates in Spain and France have eased from their July record highs of 10.7% and 6.8%, respectively.

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