MORNING BRIEFING
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On Transports, Oil & Climate Change

Check out the accompanying chart collection.

Executive Summary: Does the recent rally in the S&P Transports signal that investors think transportation stocks have been beaten down enough so far this year? Will they continue to chug uphill despite the drag from slowing fundamentals? Jackie examines the challenges up ahead for shippers, truckers, railroads, and air freight and logistics companies; airlines, though, seem headed for blue skies. … Also: A look at the oil market's tug of war between China's downward pressure and Russia's upward pressure on prices. … And: Today's Disruptive Technologies segment focuses on news from the UN's international climate change conference, COP27.

Industrials: Transports Driving Higher. Until yesterday's selloff, transportation stocks had been rallying in recent weeks, confirming the uptrend that the S&P 500 and Dow Jones Industrial Average indexes both had enjoyed. Since bottoming on October 12, the S&P 500 index has risen 7.0% and the S&P 500 Transportation index has added 8.7% through Tuesday's close (*Fig. 1*). Likewise, the Dow Jones Industrial Average (DJIA) has jumped 15.4% since its low on September 26, and the Dow Jones Transportation Average (DJTA) has also climbed 15.4% from its low on September 30 through Tuesday's close (*Fig. 2*). Dow Theory apostles take comfort when the DJTA confirms the direction of the DJIA.

The transports and the broader indexes have moved in lockstep, both downwards and upwards, for most of this year. The question is whether the 20.6% ytd loss in the S&P 500 Transports adequately reflects the tough fundamentals that many industries in the index face. The amount of stuff that needs shipping has declined as imports have slowed and business inventories are high; meanwhile, labor and fuel costs are taking a bite out of profits.

Here are the S&P 500 Transport industries' performances, ytd and from their lows during 2022: Airlines (-12.7%, 21.6%), Railroads (-19.7, 11.0), Trucking (-17.0, 21.1), Transportation Composite (-20.6, 9.5), and Air Freight & Logistics (-25.0, 6.4) (*Fig. 3*).

Forward earnings for the S&P 500 Transports has dropped 5.5% from its record high during the July 7 week, which is ominous because it often leads the S&P 500's forward earnings, which is down 4.2% from its June 16 record (*Fig. 4*). (FYI: Forward earnings are the time-

weighted average of analysts' consensus operating earnings-per-share estimates for this year and next.)

Let's take a look at some industry fundamentals to help us assess whether the S&P 500 Transports' recent upward stock price trend might continue or be derailed by lower earnings:

(1) *Less to ship.* After surging in 2020 and 2021, inbound and outbound West Coast Port container traffic, using a 12-month sum, has slowed sharply. The number of containers shipped was 12.5 million in September, down from 13.3 million at its peak in June 2021 (*Fig. 5*). Slowing exports reflect the sluggish economy in China and Europe, while imports have fallen from their peak as US companies find themselves with excess inventories and the economy decelerates (*Fig. 6*).

(2) *Prices & earnings soften.* In the trucking industry, the amount being hauled continues to climb, but prices in the spot market are falling. The ATA Truck Tonnage Index climbed 5.7% y/y in September to its highest level since August 2019 (*Fig. 7*). The seasonally adjusted index may not reflect the slowdown experienced in most transportation areas because it's dominated by contract freight as opposed to freight hauled in the spot market, the association's *press release* states. Presumably, the contract freight market reacts more slowly to changes in the economy than the spot market. It's also notable that the not seasonally adjusted index in September was 3.8% below August's level.

Meanwhile, the price of truck transportation as measured by the Producer Price Index rose 16.3% in September, a large jump but less than the 24.9% gain enjoyed in May 2022 (*Fig. 8*). Going forward, prices may continue to decelerate because prices in the spot market have fallen by almost 25% y/y in September, according to data from DAT Solutions quoted in an October 29 *WSJ* *article*.

Analysts aren't very optimistic about 2023, when they expect the S&P 500 Trucking industry to post a 0.1% decline in revenues and a 2.2% decline in earnings (*Fig. 9*). Net earnings revisions were negative in October for the first time in more than a year, and the industry's forward P/E has come down sharply, from 31.2 in November 2021 to a recent 20.2 (*Fig. 10*).

Railcar loadings also have slowed from their 2021 surge (*Fig. 11*). Rail shipment of intermodal containers has dropped dramatically, to the lowest levels in more than 20 years (*Fig. 12*). The amount of lumber and wood products shipped by rail also has fallen, in step

with the drop in housing construction, and the amounts of chemicals and petroleum products, metals, and metal products shipped by rail have fallen as well. Conversely, rail shipments of coal and automobiles have increased (*Fig. 13*).

Like the truckers, railroad operators are expected to post meager earnings growth next year, 2.0%, as revenue is forecasted to be flattish, but the profit margin is expected to rise 0.4ppt to 28.0% from 27.6% in 2022 (*Fig. 14* and *Fig. 15*). The S&P 500 Railroads industry's forward P/E has shrunk as well, to 15.8, down from the April 2021 peak of 23.3 (*Fig. 16*).

(3) *Rough seas ahead?* Forward earnings for the S&P 500 Air Freight & Logistics industry is dreary too, and historically it's been a good indicator of where the S&P 500's forward earnings is headed (*Fig. 17*). Forward earnings for the S&P 500 Air Freight & Logistics industry has tumbled 14.3% from the June 30 record high compared to a 4.2% drop for the S&P 500.

Expeditors International of Washington reported Q3 earnings on Tuesday that beat expectations, sending its shares up 9.1% during Tuesday's trading session; but the report's details don't bode well for the broader economy. Airfreight tonnage volume fell 13%, and ocean container volume dropped 10% in the quarter, according to the company's November 8 *press release*. Expeditors also highlighted reductions in buy and sell rates, a "rebalancing" of capacity in the logistics freight markets, and high energy prices.

"[We] believe that inflation, high energy costs, and government fiscal and monetary measures will continue to exert pressure on global supply chains. Additionally, many shippers are now looking to shrink retail inventories that were overstocked earlier in the year in reaction to Covid-related supply chain disruptions," CEO Jeffrey Musser said in the press release. He also forecast that decelerating demand and an overall decline in rates "are likely to continue for the remainder of 2022 and into 2023." A shift toward slowing volumes and falling rates is occurring.

The sentiment from FedEx management was also gloomy when it warned on Tuesday that US package volumes in the current quarter are below its projections. The e-commerce boom inflated by the pandemic-related surge in shopping from home is now deflating, FedEx CFO Michael Lenz said at the Baird Global Industrial Conference, according to a November 8 Reuters *article*. The company expected consumers to shift their spending away from big-ticket purchases, but the "commencement and the speed and the depth of that shift was beyond what we certainly had anticipated." The company has responded by cutting

costs—including reducing vendors, deferring some projects, reducing flights, and parking planes.

(4) *Travelers save the day.* The S&P 500 Airlines industry stock price index has outperformed other transport industries in recent weeks. Airline traffic has rebounded to 90%-100% of 2019's traffic levels. But costs and fuel expense have risen as well. Consumers' wanderlust is expected to continue into 2023, when analysts are calling for the industry's still improving earnings to nearly double y/y as they recover from losses during the Covid years (*Fig. 18*).

Energy: China Drives Prices. A tug of war is playing out in the oil markets. On one side is China, stubbornly adhering to its zero Covid policy and self-inflicting damage on its economy. On the other side of the equation is Russia, threatening to end oil sales to Europe if Western nations place price caps on its oil exports.

This week, the downward pull of China is winning. The price of West Texas Intermediate crude oil is $85.56 a barrel, down 7.6% over the past three trading days. China's new Covid cases jumped above 8,000 on Wednesday, up from a more normal level of about 1,000 new cases a day last month, a November 9 *South China Morning Post* *article* reported. Granted, these are extremely small case counts given the country's population of more than 1.4 billion, but zero Covid policies require quarantines and lockdowns nonetheless.

Case counts have jumped in Guangzhou, Beijing, Inner Mongolia, Xinjiang, and other cities and regions. In Guangzhou, a city with 18 million people, 30,000 people were moved into centralized quarantine, and daily testing is required for anyone who visited a high-risk area. Door-to-door testing was done in one area of the city by 2,500 medical workers. Travel has ground to a halt.

The price of oil might have fallen even further were it not for the restrictions that western governments are expected to place on the transport and purchase of Russian oil beginning on December 5. The European Union (EU) is expected to ban most imports of Russian oil and bar companies from insuring or financing Russian oil anywhere in the world. The US and its allies are expected to allow Russian oil shipments if the crude is priced below a preset "capped" price that has yet to be determined. And finally, on February 5, the EU will impose restrictions on Russian refined fuels and impose a price cap on them as well.

The goal of these new rules is to limit Russia's profits from the sale of oil. The cap is reportedly in the $60-per-barrel area. Russia has said it won't sell its oil under the price cap.

It might develop ways to deliver its oil outside of the traditional G7 channels, perhaps using a "shadow" tanker fleet that doesn't require the insurance or ships provided by western European companies. Alternatively, Russia claims that it won't sell its oil in the market at all. It's a pretty dangerous game of chicken that we'll be watching.

Disruptive Technologies: COP27 and Carbon Trading. The environment is in the headlines this week, as world leaders are meeting in Egypt for the 27th Conference of the Parties to the United Nations Framework Convention on Climate Change (COP27).

Much has changed since last year's gathering. Most notably, the Ukraine war has turned natural gas supplied by Russia into a political pawn that the country has withheld from Europe for opposing the war. The elevated price of natural gas has increased Europeans' use of coal and even wood to generate electricity and heat. As a result, European emissions of carbon dioxide have increased over the first nine months of this year by 4.2% y/y—not a move in the right direction.

Here's more important news from COP27:

(1) *No shows.* As notable as the list of attending countries is the list of non-attendees. China's newly reelected President Xi Jinping is a no-show, yet China is the world's top emitter of CO2. China suspended climate talks with the US after House Speaker Nancy Pelosi (D-CA) visited Taiwan. US climate envoy John Kerry did speak with his Chinese counterpart during the COP27 conference, though formal discussions have yet to be reestablished. China's stance is that the US would need to rethink its posture on Taiwan for official talks to restart. Also notably absent was Russian President Vladimir Putin, for obvious reasons.

(2) *Greenwashing.* Companies, countries, and organizations making big empty promises have been called out by a new UN report. Companies claiming to be "net zero" shouldn't also continue to build or invest in new fossil fuel assets, a November 8 *FT* *article* reported, and their decarbonization plans shouldn't support new coal, oil, or gas supplies. For example, Glasgow Financial Alliance for Net Zero (GFANZ) should not permit investors like BlackRock and Vanguard to join because they invest in fossil fuels. The net-zero target must cover all of a company's emissions across businesses and supply chains.

Additionally, the UN report encourages companies to prioritize emissions cuts, not just CO2 removals, and discourages the buying of cheap carbon credits to avoid actually reducing their emissions.

Kerry is working on a plan that would give regional or state governments carbon credits if they reduced their power sectors' CO_2 emissions. The governments then could sell the carbon credits to companies looking to offset their CO_2 emissions. While voluntary, the program theoretically would help governments fund the transition to greener energy.

(3) *Developing nations want funds.* Leaders from developing nations want developed nations and oil companies to fund their transition to green energy.

"The oil and gas industry continues to earn almost $3 billion daily in profits," said Gaston Browne, Antigua's prime minister, speaking on behalf of the Alliance of Small Island States, according to a November 8 Reuters *article*. "It is about time that these companies are made to pay a global carbon tax on their profits as a source of funding for loss and damage."

(4) *Falling carbon prices.* The price of carbon credits in the EU has been all over the map this year. After the invasion of Ukraine, the price crashed 35% from €95 to €55 in March. The price surged again to almost €100 in August, only to fall again and trade recently around €76.

Carbon credit prices have fallen presumably because Europeans have used less energy as the price of natural gas surged due to Russia cutting off natural gas supplies to Europe. The spike in energy prices prompted industrial and retail users to conserve as much energy as possible. The price of carbon credits also softened in anticipation of the continent's likely recession and due to the EU's plans to sell an increased number of carbon credits in upcoming years to raise €20 billion to help fund its transition away from Russian fossil fuels.

Supporting the price are more buyers of carbon credits looking to offset the increased use of coal to generate electricity. And while there have been warm days during the fall, the anticipation of winter weather may send carbon credit prices higher once again.

Calendars

US: **Thurs:** Headline & Core CPI 0.6%m/m/8.0%y/y & 0.5%m/m/6.5%y/y; Initial & Continuous Jobless Claims 220k/1.475m; Federal Budget Balance -$90.0b; Natural Gas Storage; Baker-Hughes Rig Count; Williams; George; Waller. **Fri:** Consumer Sentiment Headline, Current Conditions & Expectations 59.5/64.0/56.0. (Bloomberg estimates)

Global: **Thurs:** Italy Industrial Production -1.5%m/m/0.9%y/y; Japan PPI

0.6%m/m/8.8%y/y; ECB Economic Bulletin; Enria; Tenreyro; Ramsden; Macklem. **Fri:** Germany CPI 0.9%m/m/10.4%y/y; UK GDP -0.4%m/m/-0.5%q/q/2.1%y/y; UK Industrial & Manufacturing Production -0.2%m/m/-4.3%y/y & -0.4%m/m/-6.6%y/y; UK Trade Balance –£18.75b; European Union Economic Summit; DeGuindos, Panetta; Lane; Nagel; Tenreyro; Haskel. (Bloomberg estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The *Bull-Bear Ratio* was below 1.00 this week for the eighth successive week, holding at 0.96 for the second week, after falling steadily from 1.15 in mid-September to 0.57 four weeks ago—which was the lowest since March 2009. *Bullish* sentiment dipped for the second week to 35.2% after increasing the prior two weeks from 25.0% (the fewest bulls since early 2016) to 36.9%. *Bearish* sentiment exceeded bullish sentiment for the eighth week, though fell for the fourth week, by a total of 7.5ppts (to 36.6% from 44.1%). It was the largest group for the sixth consecutive week, unseating the correction count—which held the top spot for the prior four weeks. The *correction count* increased for the second week to 28.2% after retreating the prior four weeks by 15.7ppts (24.6% from 40.3%). In the meantime, the *AAII Sentiment Survey* (as of November 3) showed pessimism about the short-term direction of the stock market plummeted to its lowest level in more than seven months, while the latest survey also reported a large gain in neutral sentiment to its highest percentage since April 21, 2022 (37.3%). The *percentage expecting stocks to fall over the next six months* plunged for the second week, by 12.8ppts during the November 3 week and 23.3ppts over the period, to 32.9%, the lowest since March 31. Even with the drop, bearish sentiment remains above its historical average of 30.5% in 49 of the last 50 weeks. The *percentage expecting stocks will rise over the next six months* climbed for the third week to 30.6% after falling from 23.9% to 20.4% the previous week, though optimism held below its historical average of 38.0% for the 50th consecutive week. The *percentage expecting stock prices will stay essentially unchanged over the next six months* jumped 8.8ppts to 36.5%, the highest since this April 21's 37.3%. The latest reading puts neutral sentiment above its historical average of 31.5% for just the third time in 28 weeks.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin fell 0.1ppt last week to an 18-month low of 12.7%. That's down 0.7ppts 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 2.4pts from 10.3% during April 2020, which was the lowest level since August 2013. Forward

revenues dropped 0.1% w/w to a 12-week low and is now 0.8% below its record high in mid-October. Forward earnings fell 0.6% w/w to an eight-month low and to 4.1% 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. The consensus expectations for forward revenues growth tumbled 1.0ppt w/w to a 27-month low of 3.6% as companies have guided forecasts lower during the Q3 earnings season. 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. Forward earnings growth tumbled 0.9ppt w/w to a 28-month low of 4.8%. 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 0.7ppt to 12.5% (unchanged w/w). They expect revenues to rise 11.6% (unchanged w/w) in 2022 and 2.9% in 2023 (down 0.6ppt w/w) compared to the 16.5% gain reported in 2021. They expect earnings gains of 7.9% in 2022 (down 0.2ppt w/w) and 4.3% in 2023 (down 1.3ppt w/w) compared to an earnings gain of 50.5% in 2021. Analysts expect the profit margin to drop 0.5ppt y/y to 12.5% in 2022 (unchanged w/w) compared to 13.0% in 2021 and to improve 0.2ppt y/y to 12.7% in 2023 (down 0.1ppt w/w). The combination of a rising market in the face of falling revenue and earnings forecasts caused valuations to jump w/w. The S&P 500's weekly reading of its forward P/E fell 0.3pt w/w to 16.5, but is up from a 30-month low of 15.3 in mid-October. That's down from a 15-week high of 18.2 in mid-August and 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 0.04pt w/w to 2.09, but is up from a 31-month low of 1.98 in mid-October. That's down from a 15-week high of 2.38 in mid-August and 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 five of the 11 S&P 500 sectors as forward earnings and the forward profit margin rose for just three. 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. Utilities is the only sector with forward earnings at a record high. Forward earnings for Consumer Staples, Energy, and Financials remain close to their recent record highs. Since mid-August, all sectors have forward profit margins below their record highs. Those of Energy, Industrials, and Tech 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 three sectors are expected to see margins improve y/y for full-year 2022, followed by six sectors in 2023. Here are 2022's gainers: Energy, Industrials, and Utilities. Here's how they rank based on their current forward profit margin forecasts along with their record highs: Information Technology (24.1%, down 0.1ppt w/w to a 18-month low and from its 25.4% record high in early June), Financials (18.1, down 0.1ppt w/w and from its 19.8 record high in August 2021), Real Estate (17.5, down 0.4ppt w/w to a five-month low and from its 19.2 record high in 2016), Communication Services (14.3, down 0.2ppt w/w to a 21-month low and down from its 17.0 record high in October 2021), Utilities (13.8, up 0.1ppt w/w and down from its 14.8 record high in April 2021), S&P 500 (12.7, down 0.1ppt w/w to a 12-week low and from its record high of 13.4 achieved intermittently from March to June), Materials (12.1, down 0.4ppt w/w to a 19-month low and from its 13.6 record high in June), Energy (12.2, up 0.1ppt w/w and down from its 12.3 record high in August), Health Care (10.3, down 0.1ppt w/w to a 27-month low and from its 11.5 record high in March), Industrials (10.0, down 0.1ppt w/w to a 14-month low and from its 10.5 record high in December 2019), Consumer Discretionary (7.4 [10-week low], down from its 8.3 record high in 2018), and Consumer Staples (7.2 [54-month low], down from its 7.7 record high in June 2020).

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