MORNING BRIEFING
December 15, 2022

The Fed, Consumers, China, & Fusion

Check out the accompanying chart collection.

Executive Summary: .FOMC sees rates headed higher for longer, but a soft economic landing remains in the cards. …. The Consumer Discretionary sector stands to profit from the drop in prices for gas, cotton, and shipping on the high seas. Lower inflation and higher wages should help, too. …. China's politicians may hope eliminating zero-Covid policies will boost the nation's economy. But the likely surge of Covid cases may prompt citizens to enter self-imposed isolation. …. Scientists reported a great advancement in nuclear fusion. But expect many more years of development before we'll know if fusion will become an economically feasible way to generate carbon-free electricity.

The Fed: Higher for Longer. The FOMC provided its latest *Summary of Economic Projections* (SEP) today after the committee announced a 50bps rate hike to a range of 4.25%-4.50% (table). At his press conference, Fed Chair Jerome Powell acknowledged that that the rate is now restrictive, but not restrictive enough.

The SEP included the "dot plot" showing the forecasts of the 19 participants of the FOMC. Seventeen of them predicted that the federal funds will rise to 5.00% or higher next year. The median forecast of the committee's participants is now 5.1%, up from 4.6% in the September dot plot. The good news is that the median forecast drops to 4.1% in 2024 and 3.1% in 2025.

The SEP anticipates that the FOMC's higher-for-longer restrictive policy will weigh on real GDP growth, which is projected to be just 0.5% next year and 1.6% in 2024. In this scenario, the unemployment rate is projected to rise from 3.7% now to 4.6% at the end of next year. Headline PCE inflation is expected to moderate from 5.6% this year to 3.1% in 2023, to 2.5% in 2024, and 2.1% in 2025.

This soft-landing forecast makes sense to us.

Consumer Discretionary: A Brighter 2023. Two airlines gave differing views of consumer demand earlier this week. JetBlue Airways warned that the strong last minute demand it anticipated for December "materialized below expectations," a December 13 CNBC *article* reported. That in addition to the impact of Hurricane Nicole in November means Q4 revenue per available seat mile will be at the low end of JetBlue's prior guidance of a 15% to 19% increase from 2019 levels.

Conversely, the United Airlines Holdings CEO said the airline isn't seeing a recession in its data, and business demand has plateaued. Investors opted to believe JetBlue's more pessimistic story line, and airline stocks (which are in the S&P 500 Industrials sector) fell on

Tuesday: American Airlines Group (5.2%), Delta Air Lines (4.0), JetBlue (7.7), Southwest Airlines (3.0), and United Airlines (6.9).

Before giving up on the US consumer, consider a number of reasons why the S&P 500 Consumer Discretionary sector could fare well in 2023. From the demand side of the equation, if employment remains strong, consumer spending may improve because the price of gas has dropped sharply in recent weeks. The price of a gallon of gasoline has fallen 34% from its June 13 peak of $5.11 to $3.35 (*Fig. 1*). That's not far from where it started in 2022 and it's in the neighborhood of where gas prices stood from 2011 through 2014. In addition, inflationary pressures as measured by the consumer price index have begun to recede. The CPI rose only 0.1% m/m in November, its smallest increase in three months (*Fig 2*). As a result, inflation-adjusted hourly earnings were up 0.5% in November, marking the fourth time in five months that wages rose more than inflation.

Costs for some retailers should come down sharply as well. Clothing retailers will benefit from the large drop in the price of cotton. The price has tumbled from $1.58 per pound at its peak in May 4, 2022 to a recent $0.79 (*Fig. 3*). Likewise, the price of transporting goods has also fallen in many areas as supply chains have untangled. There's no longer a long queue of ships waiting at sea for a slot to unload their goods at the West Coast ports. And with inventory levels high, we presume retailers won't need to pay extra to fly merchandise where it needs to go this year.

The yearly percentage cost increase for truck transportation has dropped by more than half from 24.9% at its peak in May 2022 to 11.1% in November (*Fig 4*). And the price to transport a 40 foot container by ship has tumbled to $2,139 as of December 8, down from $9,262 roughly a year ago, according to Drewry's World Container Composite *Index*.

Wall Street analysts are optimistic about 2023 earnings growth for industries in the S&P 500 Consumer Discretionary sector. The sector is expected to produce stronger earnings growth next year than the 10 other sectors in the S&P 500. Yet the Consumer Discretionary sector's stock price index has been among the worst performers of 2022. Let's take a look at the discrepancy.

(1) *Glum consumer stocks.* The S&P 500 Consumer Discretionary sector's stock price index has turned in the second worst performance of the 11 S&P 500 sectors ytd and it has lagged far behind the S&P 500. Here is the performance derby for the S&P 500 and its 11 sectors ytd through Monday's close: Energy (52.6%) Utilities (0.6), Consumer Staples (-0.9), Health Care (-1.3), Industrials (-5.0), Materials (-10.1), Financials (-10.8), S&P 500 (-16.3), Information Technology (-23.7), Real Estate (-25.6), Consumer Discretionary (-32.7), and Communication Services (-38.2) (*Fig. 5*).

The stock price indexes of industries in the S&P 500 Consumer Discretionary sector have had very varied results this year. Results range from almost flat on the year (Automotive Retail) to down almost 50% (Automotive Manufacturing). Here's the performance derby for some of the S&P 500 Consumer Discretionary industries ytd through Monday's close: Apparel Retail (3.4%), Automotive Retail (-0.5), Restaurants (-5.6), Specialty Stores (-10.0), General Merchandise Stores (-18.4), Hotels, Resorts, & Cruise Lines (-18.5), Home Improvement Retail (-20.8), Homebuilding (-21.5), and Internet & Direct Marketing Retail (-45.3) (*Fig. 6*, *Fig. 7*, and *Fig. 8*).

(2) *Investors ignore estimates*. The Consumer Discretionary stock price index is about to end 2022 close to its lows of the year even though analysts are forecasting strong 2023 earnings growth for the sector. Stock prices usually start pricing in earnings forecasts roughly six months ahead of time. With Consumer Discretionary shares near their nadir, investors appear to be expecting the sectors' earnings estimates to be revised downward in the coming weeks and months.

First, let's take a look at what analysts are forecasting for the S&P 500 sectors' 2023 earnings growth: Consumer Discretionary (30.7%), Industrials (14.4), Financials (12.4), Communication Services (6.5), Utilities (5.6), S&P 500 (3.7), Consumer Staples (3.4), Information Technology (0.8), Health Care (-2.9), Materials (-9.3), Energy (-12.0), and Real Estate (-13.3).

The Consumer Discretionary sector owes its outsized 2023 earnings growth forecasts to the expected rebound in Amazon's earnings next year. According to Joe's calculations, the S&P 500 Consumer Discretionary sector's earnings are forecast to grow 30.9% in 2023, which includes Amazon's earnings. But if the Internet retailer's earnings are taken out of the mix, the sector's earnings growth estimate for next year drops to a still respectable, but much smaller, 14.7%.

Here are 2023 earnings growth estimates for some of the other industries within the Consumer Discretionary sector: Internet & Direct Marketing Retail (1842.6%), General Merchandise Stores (35.8), Auto Parts & Equipment (27.2), Footwear (26.4), Apparel Retail (14.4), Leisure Products (11.4), Restaurants (10.8), Specialty Stores (9.9), Automotive Retail (9.7), and Apparel & Accessories (9.6). The Hotels and Casinos & Gaming industries would also presumably be on the list were they not rebounding from losses in 2022.

The exceptions to this rosy picture are Consumer Discretionary industries related to the home and/or affected by high interest rates. Many of those industries are expected to show a decline in earnings next year compared to 2022: Automobile Manufacturers (3.9%), Home Improvement Retail (1.9), Housewares & Specialties (-5.8), Household Appliances (-10.2), Home Furnishings (-20.5), and Homebuilding (-33.4).

(3) *Putting the pieces together*. The S&P 500 Consumer Discretionary sector is expected to report revenue growth of 10.9% in 2022 and 6.5% in 2023 (*Fig. 9*). The sector's earnings are expected to flip from a decrease of 1.9% this year to an increase of 30.9% in 2023 (*Fig. 10*). While earnings estimates have fallen sharply through the past year for 2022, they've risen over the past year for 2023. However, the sector's profit margin has been declining since March when it was at 8.2% to a more recent 7.4% (*Fig. 11*). The sector's forward P/E has fallen sharply from a high of 40.5 in July 2020 to a recent 23.3 as earnings that shrank—or disappeared—during the Covid pandemic have recovered (*Fig. 12*).

China: Covid Continues. The Chinese government has lifted Covid restrictions on its people in response to protests, but that doesn't mean the worst has passed for the nation. Recall that US citizens self-isolated during many periods over the past two years as the disease ebbed and flowed in our country. Anecdotal reports from Beijing indicate that the city's citizens are doing the same. Travel remains largely grounded, stores and restaurants

stand empty, and companies are maintaining "closed-loop" policies, to isolate workers from the outside world. It's less clear how China's citizens in other cities and in the countryside are faring.

The surge in cases initially spooked Chinese stocks. But the MSCI China stock price index has rallied 34.0% from its October 31 low to a three-month high through Monday's close (*Fig. 13*). Covid is going to have to run its course before Chinese consumers and businesses open their wallets again. Here are some anecdotes from recent reports in the news:

(1) *Restrictions lifted*. China's policy shift—from zero-Covid to no restrictions—has been amazingly fast. Those who have mild or asymptomatic cases are allowed to quarantine at home instead of being forced to move into state-run facilities. Frequent testing is a thing of the past. As are forced lockdowns where cases are detected. People no longer need to present a health code app on their phones to enter restaurants or shopping malls. And restrictions on travel between provinces have come to an end.

The country will no longer use a nationwide mobile tracking app that had been collecting data on users' travel since 2020. It notified users if they were exposed to Covid and needed to test or quarantine. Regional or local apps may stay in use depending on the local government.

(2) *Need more and better boosters*. Only about 77% of the elderly population has had one Covid vaccination by late November and even fewer, 40%, has received a booster shot. Airfinity, a British health risk analysis firm, estimates that up to 2.1 million lives could be at risk now that the zero-Covid policy has been lifted. It blames the low elderly vaccination rate and the lack of general immunity in the population because there have been few previous cases of natural infection, a December 12 *South China Morning Post* article reported. Airfinity bases its estimate on Hong Kong's experience during last February's wave of Covid in that city.

The Institute for Health Metrics and Evaluation at the University of Washington also warned that the less effective Chinese vaccines, combined with the lack of widespread availability of antiviral medicines, and the unboosted elderly population will lead to a considerable death toll. Those who are 60 and older and have received all of their Sinovac vaccinations have a 0.21 percent fatality rate if they come down with Covid, compared to the 0.01 fatality rate of these who received the BioNTech mRNA vaccine.

China has approved Pfizer's antiviral Paxlovid but it has not approved mRNA shots from US companies. Chinese pharmaceutical companies are studying mRNA vaccines produced by its domestic companies that may be available as soon as April. It would have been wiser for the government to roll out a booster shot program before it lifted zero-Covid policies or at least to have dropped restrictions in the spring or summer when cases generally fall.

(3) *Hospitals fill up*. As we've seen firsthand, deaths can occur because hospitals get so overwhelmed that they can't effectively care for patients suffering from Covid or other diseases. China has 10 intensive care unit beds per 100,000 people, compared to 7.1 in Hong Kong and nearly 35 in the US, the *SCMP* article reported. There is concern that ICU

availability is even lower—or nonexistent—in some parts of the Chinese countryside. Recall that in the US the goal was to flatten the curve, so that the health care system could handle the surge in Covid cases.

A December 11 Bloomberg *article* stated that Beijing residents are "flocking" to hospitals, which are struggling to find enough staff and suspending non-covid treatments. "Long lines have formed outside of hospitals and people are struggling to find medicine, while delivery services had been interrupted as couriers become sick," the article relayed. China's State Council has urged medical institutions to offer online services.

There are reports that hoarding of fever and pain-relief drugs are causing shortages of those products in Hong Kong. Stock of Panadol, which treats fever, and traditional Chinese medicine Lianhua Qingwen is hard to find. Canned yellow peaches, which are high in vitamin-C are also in great demand as a defense against the disease despite any evidence of their efficacy.

(4) *Businesses adapt*. The official tally of the number of new cases has been dropping because few tests are being administered. Anecdotally, however, Covid cases in Beijing and Wuhan have increased sharply and businesses are short staffed as a result. More than half of the staff at a Beijing mall and a hotel have Covid, a senior executive at a firm that manages one of Beijing's largest retail operations told Reuters in a December 13 *article*. The mall remains open, but the staff was split into two teams that alternate shifts. JD.com has sent test kits to its staff and is asking those who are sick to stay home. LVMH is offering paid leave for those who are ill. It's like a bad flashback.

(5) *Gloom remains*. While Covid continues to spread, consumers and businesses are unlikely to boost spending. And unlike the US government, the Chinese government hasn't doled out cash to help its population during the pandemic.

China's urban unemployment rate was low in October at 5.5%, but the rate for those 16-24 years old has jumped sharply to 17.9%, up from 9.9% in early 2019 (*Fig. 14*). Retail sales dropped by 0.5% y/y in October (*Fig. 15*). Bank loans have fallen by 6.3% in November from the peak in March (*Fig. 16*). And China's official manufacturing purchasing managers index has fallen to 48.0, with new orders falling to 46.4 (*Fig. 17*).

Of course, these data are backward looking and investors buying shares today may be looking out six months from now, hoping Covid cases will subside. We hope they're right, but we fear there may be better buying opportunities ahead.

Disruptive Technologies: Nuclear Fusion's Long Road. Lawrence Livermore National Laboratory's National Ignition Facility (NIF) announced that a nuclear fusion reaction in its labs generated more energy than was needed to spark the reaction. In the scientific community this is a BIG deal. It was an accomplishment that some naysayers thought might never happen and the press release contained praise from no fewer than four US senators and two congresspersons.

That said, nuclear fusion has a long way to go before being tapped as a carbon-free way to generate electricity. The net energy created only includes the energy that entered the reaction chamber, 2.05 megajoules, and the amount of energy produced by the reaction,

about 3.0 megajoules. It doesn't include the 300 megajoules of energy needed to generate the laser pulse that sent the energy into the chamber, an excellent December 13 *NYT* *article* explained. The upshot: The math still doesn't work, but the science is one step closer than it was before.

We've highlighted nuclear fusion and some of the small, private companies working to make it a reality in our *March 31, 2022*, *December 2, 2021*, and *August 1, 2019* Morning Briefings. The NIF news will certainly mean that more funds will be raised by startup companies searching for the holy grail. This year about $4.8 billion in funding from private investors and government sources was funneled into the industry, up 139% from last year, according to the Fusion Industry Association's annual *survey*.

The survey also found that 93% of the companies responding to the survey believed that "fusion electricity" will be on the grid in the 2030s or before. Kimberly Budil, the director of Lawrence Livermore National Laboratory, thought it would take a "few decades of research on the underlying technologies" before a fusion-powered power plant would be possible.

Companies are taking different approaches to nuclear fusion. "Eight companies, including Focused Energy and First Light Fusion, aim to use lasers to initiate fusion reactions," a December 13 Reuters *article* reported. "About 15 companies, including Commonwealth Fusion Systems and TAE Technologies, aim to use powerful magnets to confine fusion fuel in the form of plasma, a fourth state of matter that contains charged particles. About 10 companies are trying other methods, including a combination of magnets and lasers." The race continues.

Calendars

US: Thurs: Retail Sales Total & Control Group -0.1%/0.2%; Headline & Manufacturing Industrial Production 0.1%/-0.1%; Capacity Utilization 79.8%; Business Inventories 0.4%; NY Empire State Manufacturing Index -1.00; Philadelphia Fed Manufacturing Index -10.0; Initial & Continuous Jobless Claims 230k/1.671m; TIC Net Long-Term Transactions; Natural Gas Storage. **Fri:** C-PMI, M-PMI, and NM-PMI Flash Estimates 47.0/47.7/46.8; Baker-Hughes Rig Count. (Bloomberg estimates)

Global: Thurs: France CPI 0.4%m/m/6.2%y/y; France Business Survey 100; UK Gfk Consumer Confidence -43; ECB Interest Rate Decision & Deposit Facility Rate 2.50%/2.00%; BOE Rate Decision 3.50%; EU Leaders Summit. Lagarde. **Fri:** Eurozone Headline & Core CPI -0.1%m/m/10.0%y/y & 0.6%m/m/5.0%y/y; Eurozone, Germany, and France C-PMI Flash Estimates 48.0/46.5/48.9; Eurozone, Germany, and France M-PMI Flash Estimates 47.1/46.3/48.2; Eurozone, Germany, and France NM-PMI Flash Estimates 48.5/46.3/49.1; Eurozone Trade Balance – € 44.5b; UK M-PMI & NM-PMI Flash Estimates; UK Headline & Core Retail Sales 0.3%m/m/-5.6%y/y & 0.3%m/m/-5.8%y/y; Italy CPI 0.5%m/m/11.8%y/y; BOE Quarterly Bulletin. (Bloomberg estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The Bull-Bear Ratio rose for the second week from 1.22 to 1.37 this week, returning to its reading three weeks ago which was the highest since the August 23 week. It was at 0.57 in early October, which was the lowest since March 2009. Bullish sentiment slipped to 42.9% this week after jumping from 38.4% to 43.3% last week—which was the highest since the 45.1% during the August 23 week. Meanwhile, bearish sentiment fell to 31.4% after climbing the prior two weeks from 30.5% to 43.4%. The correction count climbed to 25.7% after retreating from 30.1% to 24.3% last week. Turning to the AAII Sentiment Survey (as of December 8), pessimism about the short-term direction of the stock market rose to a four-week high, while optimism held around the same level. Neutral sentiment fell slightly but remained above average. The *percentage expecting stocks to rise* over the next six months ticked up to 24.7%, after falling the prior two weeks from 33.5% to 24.5%, with bullish sentiment remaining below its historical average of 37.5% for the 49th consecutive week. The *percentage expecting stocks to fall* over the next six months rose for the second week to 41.8% from 40.2%, with pessimism remaining above its historical average of 31.0% 52 of the past 55 weeks. It is back at an unusually high level for the first time in four weeks. The *percentage expecting stock prices will stay essentially unchanged* over the next six months slipped 1.7ppts to 33.5%, with neutral sentiment above its historical average of 31.5% for just the third time since the end of July.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin remained steady last week at 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 ticked down less than 0.1% w/w and is now 0.8% below its record high in mid-October. Forward earnings remains near mid-November's nine-month low, and edged down 0.1% w/w 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 was unchanged w/w at a 29-month low of 2.8%. 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 ticked down 0.1ppt w/w to a 31-month low of 4.4%. 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 fallen 0.7ppt to 12.5% (unchanged w/w). They expect revenues to rise 11.6% (down 0.1ppt w/w) in 2022 and 2.6% in 2023 (unchanged w/w) compared to the 16.5% gain reported in 2021. They expect earnings gains of 8.1% in 2022 (up 0.1ppt w/w) and 3.7% in 2023 (down 0.1ppt w/w) compared to an earnings gain of 50.5% in 2021. Analysts expect the profit margin to drop 0.4ppt y/y to 12.5% in 2022 (unchanged w/w) compared to 12.9% in 2021 and to improve 0.2ppt y/y to 12.7% in 2023 (unchanged w/w). The S&P 500's weekly reading of its forward P/E tumbled 0.7pt w/w to 17.2 from a 15-week high of 17.9, but remains above its 30-month low of 15.3 in mid-October. That's down from a four-month 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 0.08pt w/w to 2.19 from a 14-week high of 2.27, but that's still up from a 31-month low of 1.98 in mid-October. That's down from a four-month 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*): Looking at the 11 S&P 500 sectors, last week saw consensus forward revenues rise for four sectors and forward earnings rose for seven sectors. The forward profit margin rose for Utilities and was unchanged for the remaining 10 sectors. Nearly all of the sectors are below recent record highs in their forward revenues, earnings, and profit margins. Financials and Health 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, but Consumer Staples, Energy, Financials, and Industrials remain close to their recent record highs. Since mid-August, all sectors have forward profit margins retreat from their record highs. Energy's is down just 0.1ppt from its record high in late November and those of Industrials and Tech remain close 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 five 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 (24.2%, unchanged w/w at an 18-month low and down from its 25.4% record high in early June), Financials (18.1, unchanged w/w and down from its 19.8 record high in August 2021), Real Estate (17.4, unchanged w/w and down from its 19.2 record high in 2016), Communication Services (14.2, unchanged w/w and down from its 17.0 record high in October 2021), Utilities (13.8, up 0.1pt w/w and down from its 14.8 record high in April 2021), Energy (12.7, unchanged w/w and down from its 12.8 record high in November), S&P 500 (12.7, unchanged w/w at a 19-month low and down from its record high of 13.4 achieved intermittently from March to June), Materials (11.5, unchanged w/w at a 20-month low and down from its 13.6 record high in June), Health Care (10.1, unchanged w/w at a 29-month low and down from its 11.5 record high in March), Industrials (10.1, unchanged w/w and down from its 10.5 record high in December 2019), Consumer Discretionary (7.4, unchanged w/w and down from its 8.3 record high in 2018), and Consumer Staples (7.1, unchanged w/w at a 54-month low and down from its 7.7 record high in June 2020).

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