MORNING BRIEFING
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China, Staples & Drones

Check out the accompanying chart collection.

Executive Summary: Covid is ravaging China after the government suddenly abandoned its zero-Covid policy, leaving an under-exposed and under-vaccinated population vulnerable. Jackie reports on the tragic fallout. … The S&P 500 Consumer Staples sector was a top-performer last year, as investors viewed it as a relative safe haven. That might not remain the case given Consumer Staples' current valuation; its forward P/E actually rose over the past two years. … And: Our Disruptive Technologies focus this week is on the drones that are starting to dot the sky and how they'll be reshaping retailing, shipping, and war.

China: Looking Beyond Covid. When Covid hit US shores in 2020, experts extolled the importance of flattening the curve. It was important to reduce the rate of Covid infections so that everyone in the country didn't get sick at the same time and overwhelm hospitals. Fortunately, the curve did flatten in the US; but if you've ever wondered what would have happened had cases been allowed to spike, look no further than China.

The Chinese government lifted its zero-Covid policy last month, and the virus is spreading like wildfire through cities. Hospitals and morgues are overwhelmed, according to press reports. The official numbers of Covid cases and deaths are so low that they're widely discredited, most *recently* by the World Health Organization. Covid cases are expected to surge in the countryside later this month as city dwellers visit relatives in the country to celebrate the Lunar New Year for the first time in three years. It's a good bet that rural hospitals will be overwhelmed shortly thereafter.

The Chinese leadership clearly needed to do something different, as its zero-Covid policies were hurting the economy and fueling protests. China's official manufacturing purchasing managers index (PMI) for December fell to 47.0, and the nonmanufacturing PMI tumbled to 41.6 (*Fig. 1*). Every element of the manufacturing PMI was below 50: new orders (43.9), employment (44.8), and output (44.6) (*Fig. 2*).

Despite surging Covid cases and dour PMIs, China's stock market is rallying. It rose 2.2% Tuesday, and it has jumped 37.3% since bottoming on October 31, 2022 (*Fig. 3*). For the first time in over a year, optimism about China and its economic recovery may be justified.

The unorganized lifting of zero-Covid policies certainly will cause avoidable deaths. But six months from now, the country may find it has learned to live with the disease just as the rest of the world has. In addition, its central bank has opened the spigots and is providing financial support to the country's real estate developers.

Let's take a look at some of the anecdotes being carried in the press about the country's Covid struggles:

(1) *Covid peak in cities?* The surge of Covid cases in many cities may mean that the number of cases has peaked as the citizenry has achieved herd immunity. About 70% of Shanghai's 25 million citizens may already have been infected with Covid-19, estimated one a hospital executive quoted in a January 3 *South China Morning Post* (*SCMP*) *article*. One study suggests that the number of Covid cases already has peaked in China's major cities and will surge in rural areas in mid-to-late January, a January 3 CNN *article* reported.

Almost all the employees at Shenzhen Jiaoyang Industrial, a toymaker in Shenzhen, were sickened with Covid at the same time in early December. The virus also struck Foxconn Technology Group, Apple's iPhone contract manufacturer, in December. But iPhone production at the plant has been ramped up and is beginning to catch up to demand, a January 1 *WSJ* *article* reported. Some plants that are still reporting new cases of Covid among employees nonetheless are allowing employees to leave early for the Lunar New Year, which begins on January 21.

(2) *Health system overwhelmed.* With the official number of Covid cases and deaths vastly underreported, articles about overflowing emergency rooms and backed-up crematoriums better depict the unnecessary suffering caused by inadequate vaccination of the population and lack of planning before lifting zero-Covid policies. The number of patients in the emergency unit of Shanghai's Ruijun Hospital has doubled to 1,600 people per day, with 80% of patients sick with Covid-related illnesses, said the hospital representative in the *SCMP* article; treatment is being carried out in a "smooth, safe, and orderly manner," he said. But another, far less reassuring story is told by *video* and reporting describing patients waiting for hours outside of hospitals until space becomes available in emergency rooms.

Funeral homes are overwhelmed as well. Though she did not die from Covid, an elderly lady's corpse decomposed in a family's Shanghai house for five days before a hearse arrived, a January 3 Bloomberg *article* reported. The crematorium said it had received more than 500 corpses on that day, five times more than it typically handles. Furnaces at funeral homes are operating night and day, with the wait to have a relative cremated extending into

mid-January.

“A whole gray economy has emerged to cater to those who are desperate to bury their loved ones. Everything is an opportunity for profit: scalpers hawk queue numbers to skip lines for cremation, rent out hearses and offer all-in-one packages at exorbitant rates. Some trumpet their connections to workers at various crematories and hospitals,” the Bloomberg article reported.

(3) *The elderly problem.* It’s well known that the elderly—particularly those with other underlying health conditions—are more likely to die from Covid than younger people. Yet in China as of December 14, only 42.4% of those aged 80 and over have had three courses of Covid vaccine.

Some elderly worry that the shots will exacerbate underlying medical conditions, and others have gotten mixed messages from doctors about whether to get the vaccine. But given that China demands conformity to the government’s agenda—even tracking protesters’ locations by their cell phones—why didn’t the government insist or even mandate that the elderly population receive Covid vaccines? Might the lapse have been intentional? A very dark thought to start off a new year.

Consumer Staples: Defensive No Longer? One of last year’s best performing sectors in the S&P 500 was Consumer Staples. Its slow but steady earnings made the sector a winner compared to other sectors that suffered sharp declines in their earnings and/or forward P/Es. But after a year of outperformance, the Consumer Staples sector has among the highest forward P/Es in the S&P 500 and among the slowest earnings growth forecast for 2023.

Let’s take a look at how the stats stack up as 2023 begins:

(1) *A banner 2022.* A stock price index’s full-year decline of 3.2% isn’t often something to crow about; but the S&P 500 Consumer Staples sector’s drop of just 3.2% over the course of 2022 was a winning hand among the S&P 500’s 11 sectors: Energy (59.0%), Utilities, (-1.4), Consumer Staples (-3.2), Health Care (-3.6), Industrials (-7.1), Financials (-12.4), Materials (-14.1), S&P 500 (-19.4), Real Estate (-28.4), Information Technology (-28.9), Consumer Discretionary (-37.6), and Communication Services (-40.4) (*Fig. 4*).

Industries within the S&P 500 Consumer Staples sector had a wide range of price performances last year. Even during uncertain times, consumers will find the funds to buy

food and maybe toss back a beer. Drug retailers faced tough comparisons to 2021, when consumers were visiting stores for their Covid vaccines and picked up some tissues or a pack of gum on the way out. The Personal Products industry has only one stock, Estee Lauder, which had a tough 2022 because of its exposure to China.

Here are 2022 returns for some of the industries in the Consumer Staples sector: Brewers (11.2%), Soft Drinks (5.2), Tobacco (2.8), Consumer Staples (-3.2), Household Products (-8.3), Hypermarkets & Super Centers (-11.7), Drug Retail (-28.4), and Personal Products (-33.0) (*Fig. 5*).

(2) *Very slow, but positive earnings.* Analysts collectively are forecasting earnings growth of 3.2% for the S&P 500 Consumer Staples sector in 2023, only a touch slower than the 3.9% earnings growth forecast for it in 2022 (*Fig. 6*). The sector's projected earnings growth for this year matches that of the S&P 500, 3.4%.

Here are analysts' consensus earnings growth estimates for the S&P 500 and its 11 sectors for 2023 and 2022: Consumer Discretionary (29.9%, -2.6%), Industrials (14.7, 30.8), Financials (12.7, -14.4), Utilities (7.3, 2.6), Communications Services (6.3, -16.7), S&P 500 (3.2, 7.7), Consumer Staples (3.2, 3.9), Information Technology (0.3, 9.0), Health Care (-3.3, 4.6), Materials (-11.4, 8.4), Energy (-13.2, 155.9), and Real Estate (-13.6, 2.5) (*Table 1*).

(3) *Slow growth, high P/E.* Investors were willing to pay up last year for the safety found in the S&P 500 Consumer Stapes sector. The sector served as a haven from falling stock prices in the broader market and earnings disappointments. This year may prove different. The forward earnings multiples of many of the S&P 500 sectors have come down sharply over the past two years, while the Consumer Staples sector's forward P/E actually is up slightly.

Here's the rundown of the S&P 500 sectors' current forward P/Es ranked by how much they've changed over the past two years: Health Care (17.2, 6.1%), Utilities (18.9, 1.8), Consumer Staples (20.9, 0.2), Financials (12.1, -17.3), Industrials (18.0, -24.8), Materials (15.7, -25.0), S&P 500 (16.7, -26.4), Information Technology (19.6, -28.6), Real Estate (33.9, -37.4), Communication Services (13.8, -40.6), Consumer Discretionary (20.6, -43.3), and Energy (9.5, -68.9) (*Table 2*).

Disruptive Technologies: Drones Take Flight. Walmart and Amazon seem to be inching forward with the use of drones to make fast deliveries. Unfortunately, drones are also being

used in the Ukraine war to identify and kill the enemy and to destroy infrastructure more easily. Welcome to the double-edged sword of new technology. Here's a look at some of the recent drone-related news:

(1) *Old retailer, new tech.* Walmart is expanding the drone delivery service it started in 2021 in Arkansas to Arizona, Florida, Virginia, Texas, and Utah. The retailer's goal was to have 34 participating stores in 23 cities by the end of last year. It aims to deliver more than one million packages by drone each year.

In Texas, drone delivery is available to customers living within 11 miles of certain Dallas-area stores. Drones can deliver items weighing up to 10 pounds in as little as 30 minutes for a $3.99 fee, a December 15 Supermarket News *article* reported. There are no minimum orders, and items as delicate as eggs can be flown. A flight engineer manages the drone and uses a cable to lower a package from the drone to the best spot near the customer's home. Walmart has partnered with DroneUp.

(2) *Internet companies play catchup.* Drone delivery services being developed by Amazon and Alphabet units are taking off a bit more slowly. Amazon Prime Air began operations late last year in two locations outside of Sacramento, California and Austin, Texas. The Internet retailer's drones boast a "sense-and-avoid" system that allows the drones to operate out of the sight of humans and reliably avoid other aircraft, people, and obstacles, a December 30 The Street *article* reported. But the article also noted that at least eight of Amazon's drones crashed over the past year, with one sparking a 20-acre brush fire in Oregon. Amazon, which is using MK27-2 drones, aims to make deliveries in less than an hour.

Alphabet owns Google and Wing, a drone delivery service that makes deliveries for a Walgreens and The Star, a small retailer, both in suburban Texas near Dallas. A Wing drone can carry up to three pounds and has a three-foot wingspan. The delivery company also has operations in Australia and Finland.

(3) *Fighting drones.* We're getting a look at the evolution of modern warfare in Ukraine, where drones are playing a large role. Russia has been using Iranian-manufactured drones since this fall, Ukraine officials say, despite denials from Iranian officials. Russia reportedly uses Iran's Shahed-136 drones, which are equipped with a warhead on its nose and are hard to detect by radar because they have an 8.2-foot wingspan, a January 3 BBC *article* explained.

With a range of 1,550 miles, the drone can fly at 115 miles per hour and has been used to

hit both military and civilian targets in Ukraine, including electric power stations. The Ukrainian forces defend themselves by using machine guns, portable anti-air missiles, and electronic jamming devices. Ukrainian forces have become skilled at shooting down Russia's drones, but the defensive missiles they use can cost $140,000-$500,000, while a drone may cost only $20,000, a January 3 *NYT* *article* pointed out. As a result, drones may give Russia a long-run advantage. But drones have helped boost the impact of the much smaller Ukrainian military too.

The US is supplying the Ukraine with Switchblade kamikaze drones, but it's unknown whether they've been used. It's believed that the Ukrainian military used some type of drone to attack a Russian military base in western Crimea, an airbase near Sevastopol, ships in the Sevastopol harbor, and airbases hundreds of miles inside Russian territory.

Ukrainian forces have used the Turkish-made Bayraktar TB2, which is the size of a small plane and carries cameras and laser-guided bombs, the BBC article reported. Used to sink the Russian warship in the Black Sea last April, the drone can fly for 186 miles and has a speed of 140 miles per hour. Drones are being used by both armies to identify enemy targets and guide missiles toward them, eliminating the need to send out a special forces unit of humans.

We may just be starting to see how drones will change the way wars are fought.

Calendars

US: Thurs: ADP Employment 150k; Challenger Job Cuts; Initial & Continuous Jobless Claims 230k/1.705m; S&P Global C-PMI & NM-PMI 44.6/44.4; Natural Gas Storage; Crude Oil Inventories. **Fri:** Payroll Employment Total, Private, and Manufacturing 200k/178k/10k; Average Hourly Earnings 0.4%m/m/5.0%y/y; Average Weekly Hours 34.4; Unemployment Rate 3.7%; Factory Orders -0.8%; ISM N-PMI 55.0; Baker-Hughes Rig Count; Cook. (Bloomberg estimates)

Global: Thurs: Eurozone PPI -0.9%m/m/27.5%y/y; Germany Trade Balance 7.5b; Italy CPI 0.1%m/m/11.6%y/y; UK C-PMI & NM-PMI 49.0/50.0; Canada Trade Balance $0.61b; Japan Consumer Confidence; Japan NM-PMI 51.7 **Fri:** Eurozone CPI Flash Estimate 9.7% y/y; Eurozone Retail Sales 0.5%m/m/-3.3%y/y; Eurozone Business & Consumer Survey 94.7; Germany Factory Orders -0.5%; Germany Retail Sales 1.0%m/m/-2.8%y/y; France Consumer Spending 1.0%; Canada Employment Change 8.0k; Canada Unemployment

Rate 5.2%. (Bloomberg estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The Bull-Bear Ratio fell for the third week to 1.08 this week after climbing the prior two weeks from 1.22 to 1.37 (which matched its highest reading since the August 23 week). It was at 0.57 in early October, which was the lowest since March 2009. *Bullish sentiment* fell from 43.3% (the highest since the 45.1% during the August 23 week) during the week of December 6 to 36.6% this week—the lowest reading since early November—while *bearish sentiment* climbed from 31.4% in mid-December to 33.8% this week, the highest since early November. The *correction count* has climbed steadily from 24.3% in early December to 29.6% this week, though is still well below its late September peak of 40.3%. Turning to the AAII Sentiment Survey (as of December 29), optimism about the short-term direction of the stock market rose to a five-week high, with the *percentage expecting stock prices to rise* over the next six months jumping 6.2ppts to 26.5%. It remained below its historical average of 37.5% for the 52nd consecutive week, and remained at an unusually low level for the fifth straight week despite this week's jump. The *percentage expecting stocks to fall* over the next six months fell from 52.3% to 47.6%, with pessimism remaining above its historical average of 31.0% for 55 of the past 58 weeks. It was at an unusually high level for the fourth successive week. The *percentage expecting stock prices will stay essentially unchanged* over the next six months slipped 1.5ppts to 25.9%, the lowest percentage since the 21.2% reading during the October 20th week.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin remained steady last week at a 20-month low of 12.6%. That's down 0.8ppts 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 2.3pts from 10.3% during April 2020, which was the lowest level since August 2013. Forward revenues ticked up 0.1% w/w and is now 0.4% below its record high in mid-October. Forward earnings was unchanged w/w near late December's 10-month low, and is 4.7% 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 30-month low of 2.7%. 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 dropped 0.2ppt w/w to a 30-

month low of 4.0%. 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. During 2022, analysts' revisions to their forecasts for 2022 revenues outpaced their revisions for 2022 earnings, so the imputed 2022 profit margin estimate that we calculate from those forecasts fell 0.8ppt to 12.4% (unchanged w/w). They expect revenues to rise 11.6% (unchanged w/w) in 2022 and 2.5% in 2023 (unchanged w/w) compared to the 16.5% gain reported in 2021. They expect earnings gains of 7.7% in 2022 (unchanged w/w) and 3.2% in 2023 (down 0.2ppt w/w) compared to an earnings gain of 50.5% in 2021. Analysts expect the profit margin to drop 0.5ppt y/y to 12.4% in 2022 (unchanged w/w) compared to 12.9% in 2021 and to improve 0.1ppt y/y to 12.5% in 2023 (unchanged w/w). The S&P 500's weekly reading of its forward P/E fell 0.4pt w/w to a seven-week low of 16.7. That remains above its 30-month low of 15.3 in mid-October and is down from a four-month high of 18.2 in mid-August. It 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 0.05pt w/w to a seven-week low of 2.19, 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 eight sectors and forward earnings rose for six sectors. The forward profit margin fell 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. Consumer Staples, Financials, and Health Care are the only sectors with forward revenues at a record high this week. None of the sectors have forward earnings at a record high this week, but Consumer Staples, Energy, Financials, Industrials, and Utilities still remain close to their recent record highs. Since mid-August, all sectors have forward profit margins retreat from their record highs. Those of Industrials and Tech remain close to their post-pandemic highs, and Energy's is now down 0.5ppt from its 12.8% record high in late November. 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. Energy and Industrials are the only two sectors expected to see margins improve y/y for full-year 2022, followed by these five sectors in 2023: Communication Services, Consumer Discretionary, Financials, Industrials, and Utilities. Here's how they rank based on their current forward profit margin forecasts along with their record highs: Information Technology (23.9%, unchanged w/w at a 20-month low and down from its 25.4% record high in early June), Financials (18.0, unchanged w/w and down from its 19.8 record high in August 2021), Real

Estate (17.3, unchanged w/w and down from its 19.2 record high in 2016), Communication Services (14.0, unchanged w/w and down from its 17.0 record high in October 2021), Utilities (13.7, down 0.1pt w/w and down from its 14.8 record high in April 2021), Energy (12.3, unchanged w/w and down from its 12.8 record high in November), S&P 500 (12.6, unchanged w/w at a 20-month low and down from its record high of 13.4 achieved intermittently from March to June), Materials (11.4, unchanged w/w at a 21-month low and down from its 13.6 record high in June), Health Care (10.1, unchanged w/w at a 30-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 (7.3, unchanged w/w at a 32-month low and down from its 8.3 record high in 2018), and Consumer Staples (7.1, unchanged w/w at a 56-month low and down from its 7.7 record high in June 2020).

S&P 500 Sectors & Industries Forward Profit Margin Since Peak (*link*): Since the S&P 500's forward profit margin peaked at a record high 13.4% during the June 9 week, it has fallen 6.4% to 12.6% through the December 29 week. The drop has been paced by four of the 11 sectors, though all but the Energy sector is down since the peak. Here's the sector performance since the June 9 peak: Energy (up 3.3% to 12.3%), Utilities (down 0.8% to 13.7%), Industrials (down 3.1% to 10.1%), Consumer Staples (down 3.1% to 7.1%), Real Estate (down 3.3% to 17.3%), Financials (down 5.6% to 18.0%), Information Technology (down 6.0% to 23.9%), S&P 500 (down 6.4% to 12.6%), Consumer Discretionary (down 6.5% to 7.3%), Health Care (down 8.1% to 10.1%), Communication Services (down 13.0% to 14.0%), and Materials (down 15.9% to 11.4%). These are the best performing industries since the June 9 peak: Wireless Telecommunication Services (up 47.3% to 10.0%), Oil & Gas Refining & Marketing (up 31.6% to 4.5%), Oil & Gas Equipment & Services (up 15.7% to 10.6%), Airlines (up 15.1% to 4.7%), and Hotels, Resorts & Cruise Lines (up 12.7% to 11.1%). The worst performing industries since the June 9 peak: Copper (down 40.3% to 11.5%), Alternative Carriers (down 39.4% to 5.3%), Commodity Chemicals (down 39.1% to 6.2%), Home Furnishings (down 34.5% to 5.8%), and Gold (down 30.9% to 13.2%).

US Economic Indicators

JOLTS (*link*): Job *openings* in November fell for the sixth time since reaching a record high in March, though remained at a high level. Openings declined 54,000 m/m and 1.4 million over the period to 10.5 million openings. There were 6.0 million unemployed in November, so there were 1.7 available jobs for each unemployed person that month, matching October's reading; it was at 2.0 in July. By industry, the *biggest decreases* occurred in

accommodations & food services (-89,000), finance & insurance (-75,000), health care & social assistance (-62,000), and the federal government (-44,000) while the *biggest increases* in openings during November were in professional & business services (212,000), nondurable goods manufacturing (39,000), and retail trade (37,000). *Hirings* fell for the seventh time in nine months, by 56,000 in November and 777,000 over the period, to 6.1 million. Meanwhile, the number of *quits* rose in November for the first time in eight months, by 126,000 to 4.2 million, after a seven-month slide of 402,000, moving back toward its record-high 4.5 million during November 2021, a sign that workers are confident they can leave their jobs and find employment elsewhere.

US Manufacturing PMI (*link*): ISM's December M-PMI contracted for the second month following 29 consecutive months of expansion, as spending is shifting away from goods toward services. Since peaking at 63.7 in March 2021, the M-PMI has dropped to a 31-month low of 48.4, with new orders and production pushing the index lower. The *new orders* (to 45.2 from 47.2) measure was in negative territory for the fourth straight month, falling to its lowest reading since the height of the pandemic, while the *production* (48.5 from 51.5) gauge fell below the break-even point of 50.0 for the first time since May 2020; these two measures peaked at 67.4 and 66.4, respectively, the highest since December 2020 and March 2021. Supply chains continue to improve at a rapid rate, with the *supplier deliveries* measure plummeting from 78.8 during May 2021 to 45.1 by December 2022—the lowest since March 2009. (A reading below 50.0 indicates faster deliveries to factories.) The *backlog of orders* subindex was little changed at 41.4 last month, down from a recent high of 70.6 during May 2021. *Inventories* (51.8 from 50.9) accumulated at a slightly faster pace in December, though slower than July's 57.3. In the meantime, the *employment* (51.4 from 48.4) measure rose back above 50.0, bouncing around that level for several months. (This index is a poor predictor of BLS manufacturing payrolls data.) ISM's *prices-paid* measure fell further below 50.0, to a 32-month low of 39.4 from a recent high of 87.1 in March 2022; it was at 92.1 in mid-2021—which was the fastest since the summer of 1979.

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