Weekly Update

20-October-2021

Carlisle C. Wysong, CFA
Managing Partner

- Earnings propel the market higher; the other narratives fade away
- Earnings Growth is robust and beating expectations
- Investors are not doing what they are saying
- Don't believe the (ports going 24/7) hype
- Inflation continues to broaden
- Housing data is mixed but leaning upward
- The Fed is telling us (and themselves) what we already know
- Low natural gas storage is leading to more oil consumption
- Chart Crime(s) of the week
- Click here for the full note

	Last	5d %	YTD %	1yr %
SPX	4536	4.0%	22.0%	34.2%
QQQ	375.0	4.2%	19.9%	32.8%
US 10 YR	1.66%	1.54%	0.92%	0.82%
USD/DXY	93.6	94.0	89.9	92.6
VIX	15.5%	18.6%	22.8%	28.7%
Oil	84.25	4.5%	72.9%	102.3%

*10yr, DXY, and VIX are levels not changes
** Oil is front month futures, beware

The market moved back to the high end of its recent choppy range which happens to be just shy of all-time highs again. As usual, the narratives aligned for a rally. Most importantly, earnings season is off to gangbusters start. Investors even responded positively to good bank earnings…this never happens! And the negative narratives slid into the background. Investors think the China property bubble is containable (we maintain they will just jam the losses onto external investors and creditors). The political quagmire in DC is just that…the old "gridlock is good" theme (not to mention, Dem senators are reportedly working on ways to scrap any corporate tax hike). The Fed has seemingly acknowledged that inflation is, indeed, not transitory. And while this might typically lead to more monetary policy tightening, most investors think a prudent policy at this juncture will trump the continued spiking of the punch bowl. But going back to earnings, this is our near-term thesis. That growth is still expanding, and earnings are following suit.

- Earnings Growth is robust and beating expectations

Earnings season has started with a bang. Of the 69 companies in the S&P 500 that have reported, 86% have reported Earnings better than expected. The "beat" percentage for Revenues is similar at 81%. Blended Earnings (those reported plus expectations for the others) growth sits at 33%. Blended Revenue growth is at 14.1%. While these have ticked down from 1H (first half of the year), these are still phenomenal growth rates. Here is a chart showing the earnings expectations trajectory going back to Jan 1 of this year. Even with the delta virus-fear hitting the economy in late summer, growth expectations continued to climb. And they are on track to be eclipsed.

Exhibit 3. 2021Q3 Blended (Reported & Estimated) Earnings Growth

Sector	Today	1 Oct	1 Jul	1 Apr	1 Jan
Consumer Discretionary	7.3%	8.0%	15.0%	14.9%	11.5%
Consumer Staples	4.3%	3.5%	4.7%	5.9%	6.0%
Energy	1520.7%	1391.9%	1233.5%	923.2%	804.3%
Financials	31.9%	17.4%	14.8%	5.7%	-4.4%
Health Care	18.0%	15.3%	7.9%	9.6%	7.3%
Industrials	76.4%	79.0%	85.2%	80.8%	83.2%
Materials	92.4%	92.9%	70.2%	40.3%	22.9%
Real Estate	17.1%	17.5%	15.5%	7.9%	10.4%
Technology	28.9%	28.8%	22.1%	16.3%	12.1%
Communication Services	25.1%	23.8%	15.7%	11.8%	12.0%
Utilities	0.9%	0.2%	2.7%	3.8%	1.8%
S&P 500	**33.0%**	**29.4%**	**24.7%**	**19.5%**	**14.1%**

Source: I/B/E/S data from Refinitiv

- Investors are not doing what they are saying

Merrill sums up their Fund Manager Survey by saying it is the least bullish in a year. Global Growth expectations have turned negative for the first time since the onset of the virus-fear. Inflation and China are the most-feared bogeymen. Of course, investors are still Overweight equities! Long Big Tech and ESG (which is just Big Tech through a virtue-signaling lens) and short China and Emerging Markets are the most "crowded" trades. We find ourselves using this chart every month when the FMS is published. But it shows the hypocrisy of the market so darn well. Or it could mean that the investors are trying to be overly cute. We must admit part of our portfolio is structured in this manner: we expect short term strength followed by some medium-term malaise. But we are not "all-in" by any means – we still have our barbell approach combining different risk levels.

Chart 1: BofA FMS disconnect between growth optimism & allocation to stocks widens
Net % of asset allocators OW Equities vs net % investors predicting a stronger economy

Source: BofA Global Fund Manager Survey

BofA GLOBAL RESEARCH

For all the banter about global logistics problems and the reshoring (or even deshoring if that is a word) of overseas supply chains, the market has not reflected these worries. The dark blue line below shows that the valuations of foreign exposed stocks in the S&P 500 still trade at a lofty premium to more domestically oriented US stocks. Perhaps this reflects expected growth rates outweighing certain exposures. We doubt that. The behavior seems to mimic that of the Merrill Survey (above).

Exhibit 1: Foreign-exposed stocks trade ~1 std. deviation rich vs. domestic counterparts
Rel. fwd P/E top 50 S&P500 by foreign vs. domestic sales, sector-neutral (2010-present)

Source: BofA US Equity & Quant Strategy

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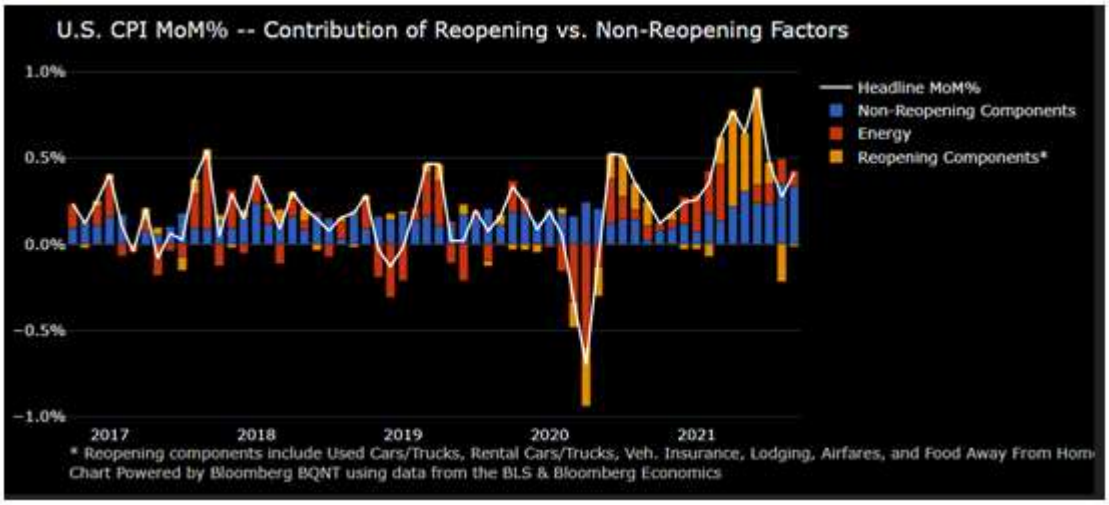
- Don't believe the (ports going 24/7) hype

Logically, we can assume that people think the logistics problems are going to be corrected. Perhaps the new 24/7 work schedule at the ports in LA will help? Hardly. This is a political ruse. Only one terminal at Long Beach (out of seven and none at the port of Los Angeles) is currently operating 24/7. And it is only Monday through Thursday. Moreover, some are reporting that California regulations are to blame as half the trucks are now banned for emissions or union reasons. There is a lot of debate around this…obviously it is very partisan. The truth probably sits in the middle (as it usually does), so it is likely partially to blame.

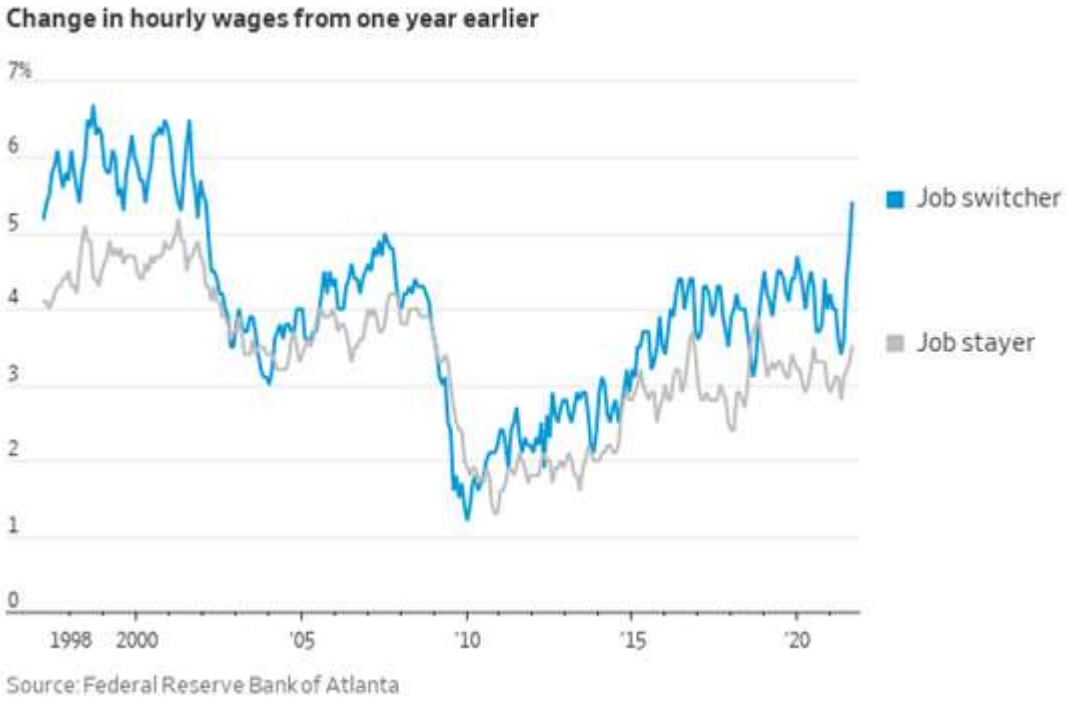
- Inflation continues to broaden

Here is another chart breaking down the internals driving monthly inflation increases. You can see that non-Reopening components are the current drivers of inflation. Energy is still relatively mild, but we suspect this data is lagging.



Social Security Benefits are going to be adjusted higher by 5.9% in 2022. This is a standard Cost of Living Adjustment (COLA). It is standard in that the adjustment happens every year. It is not standard in that this is the largest COLA increase since 1982.

The Atlanta Fed breaks down wage inflation between those who have stayed with their jobs and those who have switched jobs. Unsurprisingly, Job Switchers are getting paid a lot more. Job mobility and flexibility were thought to be deflationary. But a massive worker shortage trumps these effects. We are still waiting for Johnny Paycheck to get off the couch (squarely an "if" now vs a "when" back in the summer).



The media is having a field day with the number of labor strikes that have popped up. Obviously, workers are feeling more emboldened. But we need some perspective. There have been 12 strikes this year of 1,000 or more workers. The average for the last 10 years has been about 25. Going back to the 70's, the average per year was about 300.

- Housing data is mixed but leaning upward

A monthly RE/MAX report shows some relative/seasonal strength in the Housing market in September. Home Sales dropped 7% vs August. But this is half the usual drop as summer ends. The median sales price was $329k which was about a 1% drop. The average days-on-the-market is 25 days compared to 39 days a year ago.

The Housing Market Index (survey of single-family homebuilders) bounced four points to get back near the spring and early summer levels…basically before the delta virus-fear. Supply chain issues and higher costs are still constraints. Sales Conditions remains the strongest subcomponent of the survey with a reading of 87. Sales Expectations are right behind it at 84. Buyer Traffic is the weakest of the three components at 65. But it is showing the same rebounding trend from the delta months.

Housing Starts in September slowed a touch from August. Permits also slowed. Both are in the middle of the range for the last year, so it is hard to glean too much. Of course, the level is much higher than pre-virus-fear yet a far cry from the 2005-06 peak (1.56mm houses now vs about 2.25mm back then).

We would like to see some weakness in the Housing stocks or more strength in the Housing data before we jump back into the sector.

- Other Economic data is mixed with strong Retail Sales against weaker sentiment

Retail Sales in September increased 0.8% vs August after stripping out cars. This was twice the expectation but still a drop from the 2% increase in August.

Empire State Manufacturing for October disappointed but it remains at a decent level.

Business Inventories are sitting at 0.6% of sales which is only slightly above the long-run average.

Consumer Sentiment (U Michigan) continues to deteriorate since the post-pandemic high set in April of this year.

- China continues to slow

China GDP slowed dramatically in the 3Q. The reported number was 4.9% growth vs 7.9% in 2Q. Obviously, these numbers are fake, but the slowing trend is not. Industrial Production for Sept followed suit with only 3.1% growth vs 5.3% in August. Retail Sales was the one strong data point. While the 4.4% increase in September is much higher than August's 2.5%, it still pales in comparison to July's 8.5% (never mind the mid 30% increases seen in 1Q.) Most economists (professional guessers) think this China slowness continues into 2022 which should translate into a 4.4% hit to US earnings.

- The Fed is telling us (and themselves) what we already know

The Fed's Beige Book, a collection of regional economic data sent to the Fed two weeks before the next FOMC meeting (Fed Open Market Committee), did not tell us anything we do not already know. The regional Fed banks are worried about supply shortages and price increases. So much for inflation being transitory (as we have previously pointed out, the Fed no longer uses this term)! The one bright spot was that Consumer Spending remains robust. We already knew this, too (see Retail Sales data above). None of this changes our

view: we expect the current 4Q to have accelerating growth with an eventual slow down with a less accommodating Fed next year.

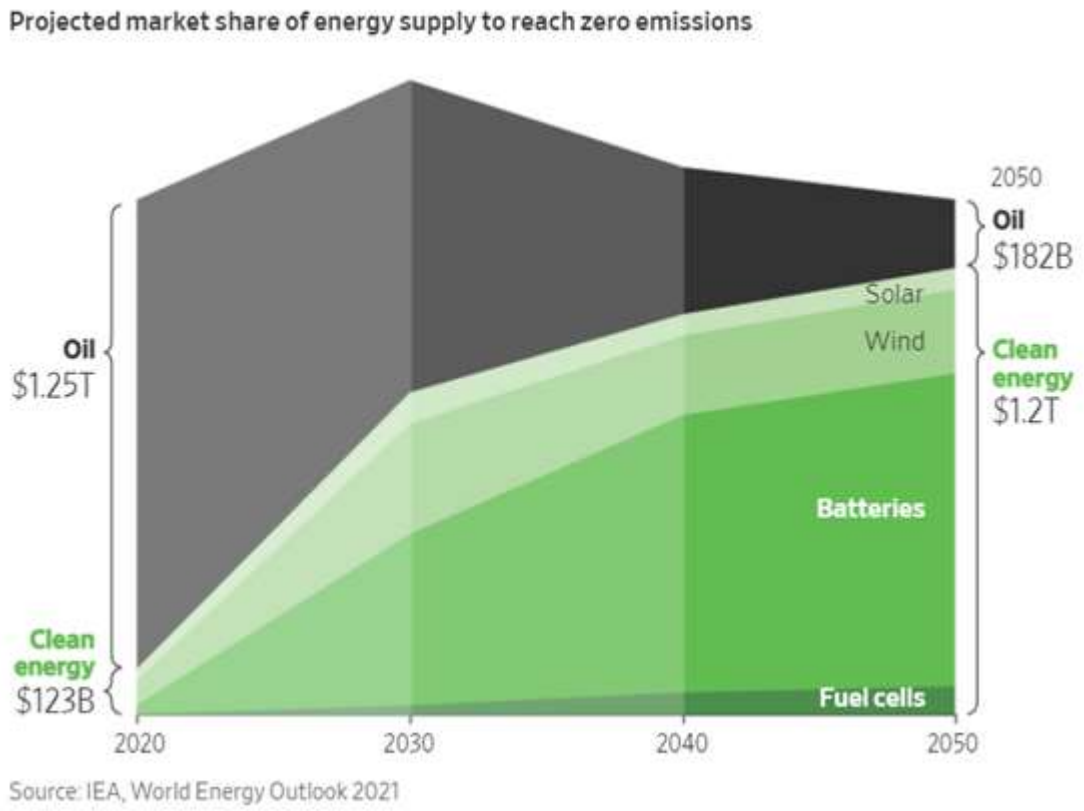
- Low natural gas storage is leading to more oil consumption

The natural gas storage problems globally are causing a spike in crude oil demand. Power-generation companies and manufacturers are starting to switch their energy source from natural gas (or liquified natural gas aka LNG) to crude oil. The IEA (International Energy Agency, not to be confused with the EIA which is the Energy Information Administration inside the DOE) just said that it expects the shifting of natgas to oil will boost demand for the latter by as much as 500k bpd (barrels per day). Be careful of what you wish for has never been more true.

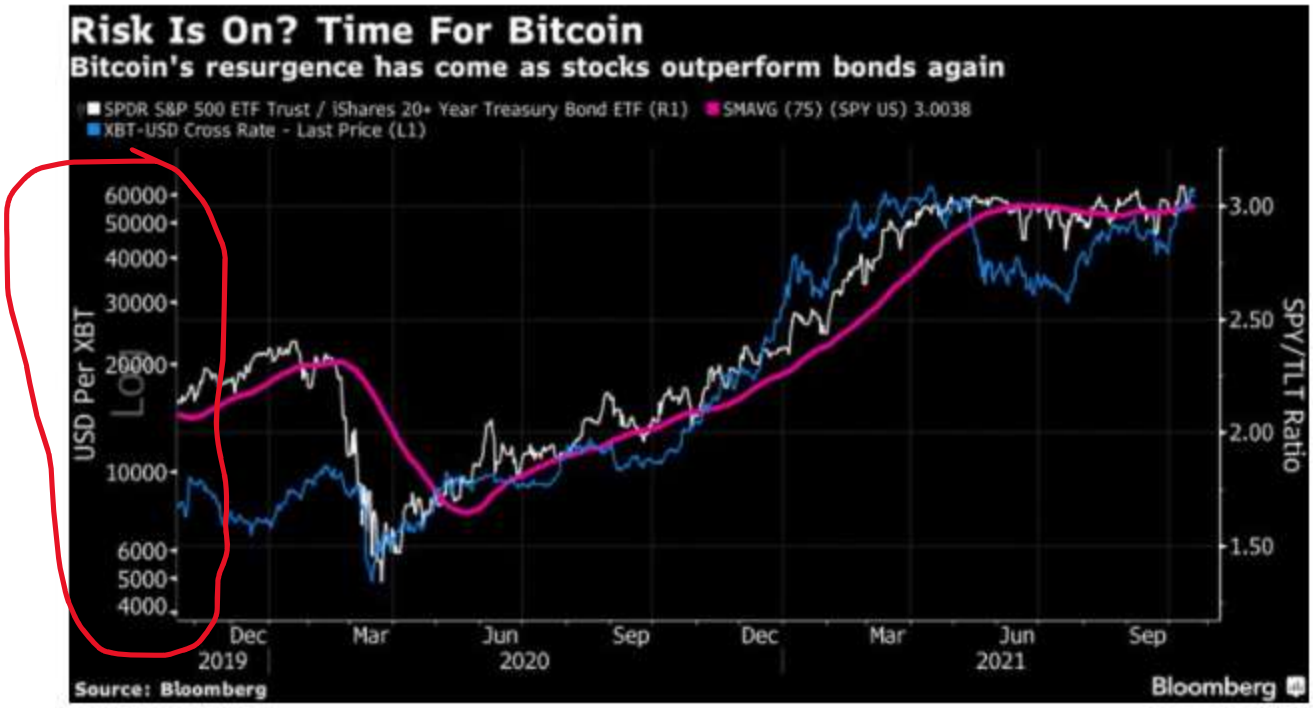
Two noteworthy tidbits in energy: Mongolia has 10% of the world's coal reserves. China expects to have new shipments from its neighbor in the next three to six months. Aluminum is the most polluting commodity to produce (it is alumina and electricity).

- Chart Crime(s) of the week

All charts looking 30 years into the future are criminal. But throwing Batteries in there with no explanation of where they get their power is beyond the pale.



And we cannot overlook the Bloomberg Opinion chart below. Other than the conclusion being wrong, just look at the left axis and the spacing of the numbers.



- Quick Hits
  - President Erdogan of Turkey fired the remaining members of the central bank that think interest rate hikes are necessary to stem inflation. Erdogan thinks interest rates must be cut to stop inflation. He is the only person on earth to believe this.
  - Erdogan believes in ESP.
  - United Wholesale Mortgage has abandoned its plan to accept Bitcoin as a payment. Only six customers have participated in its pilot program.
  - An NBER (National Bureau of Economic Research which is an entity combining govt and academia…yuck) working paper shows that companies are more likely to be included in S&P indices after they pay for S&P bond ratings.
  - Gas prices in California are about 50% higher than in Texas.
  - Budweiser has signed the Redskins QB, Taylor Heinicke, to an endorsement deal. Heinicke had been lobbying Heineken for a deal.
  - New York City is moving a statue of Thomas Jefferson out of city hall.

Trading: We added a little to one of our health care Reopening names. We added to a couple of our more boring Equity Income stocks (near the conservative end of our barbell strategy). We reallocated a little of our long Energy trade. We trimmed a big winner and shifted some to a big loser. This can be dangerous if the fundamentals and news are going against you. But we think the move is unwarranted given the absence of news (news is to the contrary, actually). We cut some of our loser Put positions. We will look to add these back if the insanity continues. We added one short Volatility trade (in Gold) and closed out a short Volatility trade (in Facebook). In general, we will keep our Trading bucket biased towards Reopening. We moved one of our Trading names into our Alpha model. The idea here is that we have more conviction on the name so we can look to hold it through the ups and the downs (whereas in the Trading bucket we will be more quick to cut).

TSLAQ: Tesla reported earnings which were pretty much a non-event after the deliveries number was released six weeks ago. But the conference call was full of gems, as usual. For starters, Elon musk decided not to partake. And the analysts on the call had a "bad connection" so they were dropped. The rest of the call was scripted from retail investors. Tesla accused the NHTSA of engaging with short sellers to hurt the stock. They alluded to a $25k in the near future. The Model 3 was supposed to be a $30k car and its average selling price is about $50k. They talked about a new and improved Cybertruck even though it has never existed. And Tesla Insurance is still being pitched (after years of nothing).

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