CEOs Discussing Tariffs

The next Morning Briefing will be sent on Tuesday, May 28.

See the collection of the individual charts linked below.

(1) In the trade war's trenches. (2) Coming back to America. (3) Leaving China, seeking new suppliers. (4) Earnings hits coming. (5) A letter of protest from sneaker companies. (6) The not-so-good earth for farmers. (7) Huawei getting chipped. (8) It was a really bad winter. (9) Department Stores on sale. (10) Home Improvement Retail fundamentals still improving.

Tariffs: Managing a Trade War. The trade front is heating up and getting ugly. Trade negotiations between the US and China have stalled. US tariffs were increased from 10% to 25% on $200 billion of Chinese imports. Another $300 billion in Chinese goods could soon be hit with the 25% levy. And the US is basically calling Huawei Technologies a spying arm of the Chinese government. Needless to say, tariffs are becoming a hot topic on company conference calls. Managements are discussing the financial impact of tariffs, and some are even changing the way they do business as a result of tariffs.

In some cases, production or sourcing is being moved out of China into low-cost nations. A few companies have announced that they're moving production back into the US. Some companies are hoping their suppliers will absorb the cost of tariffs. And when all else fails, a few companies are reducing their full-year forecasts. I asked Jackie to review some of the recent pronouncements from CEOs on all things tariff-related. Here is her take:

(1) Welcome back home. Stanley Black & Decker is harnessing technology to make moving some production back to the US economical. The company is building a $90 million plant in Fort Worth, Texas to make Craftsman wrenches, ratchets, and sockets; it opens late next year. Stanley currently has eight US plants making about 30% of its Craftsman tools, and hopes to ratchet that up to 50% within a few years. US plant automation innovations, including robots and fast-forging presses, should mean it can produce 25% more than Chinese plants that use older equipment. Total US production costs should be close to Chinese production costs, according to a 5/15 WSJ article.

Blue Line, an American chemicals company, and Lynas, an Australian miner, also want to bring production back to the US. They aim to build a rare-earth minerals separation plant in Texas, the first such plant built in the US in years, a 5/20 WSJ article reported.

The sole active rare-earth mine in the US today—in Mountain Pass, California—sends its ore to China for processing. Starting June 1, the end product shipped back to the US will be hit with a 25% tariff. Rare earth metals are often used in electronics, including electric cars, wind turbines, and military equipment. “The Trump administration worries a lack of domestic rare-earth supplies undermines a competitive modern economy and strong military,” the WSJ article stated.
China’s leaders know that their country’s production of rare earths could be used as leverage in negotiations. President Xi Jinping earlier this week visited one of the world’s largest suppliers of rare earths in China, the 5/21 WSJ reported. It’s highly unlikely his visit was coincidental.

(2) Searching for new suppliers. As noted above, the next phase of threatened tariffs would apply to another $300 billion of Chinese imports, including accessories and apparel. Retailers—saddled already with thin margins and brutal competition—aren’t happy.

Tariffs will affect Macy’s private-label clothing produced in China, and the company is “working hard” at moving the production out of China. Greg Foran, CEO of Walmart US, discussed tariffs in a Q1 conference call: “[O]ur merchant teams continue to work to develop appropriate mitigation strategies. … [W]e continuously look for best costs around the world.”

And Stanley CEO James Loree told the WSJ that he is ready to shift to suppliers outside of China if the two countries don’t reach a trade deal.

(3) Tariffs hurting forecasts. Companies are starting to factor tariffs into their earnings forecasts. For example, Kohl’s cut its FY earnings forecast owing partly to the recent boost in tariffs to 25% from 10% on its China-sourced home and accessories products.

Macy’s CEO Jeff Gennette said in the company’s 5/15 conference call that the three rounds of tariffs enacted in 2018 had no “meaningful” impact on its business and were factored into guidance. The increase of last year’s round of tariffs from 10% to 25% on May 10 will impact the company’s furniture business, but this too can be “mitigated.”

However, the threatened next tranche of tariffs on more than $300 billion of goods—including apparel and accessories—would have a bigger impact on Macy’s and its suppliers, and it’s not factored into the company’s 2019 forecast. Tariffs will affect Macy’s private-label clothing produced in China and the clothes that Macy’s buys from suppliers that are produced in China.

“[W]e’re working very closely with (suppliers) on the potential impact to our shared customers. At Macy’s, fortunately, we operate at a scale. We feel like we’re going to be able to come up with solutions that work best for us and our brand partners,” Gennette said. Reading between the lines, it sounds like Macy’s is hoping some of its suppliers will eat at least part of the expected price increases due to tariffs, some of the price increase will be borne by Macy’s, and prices paid by consumers may rise on certain non-commodity items.

(4) A formal protest. The footwear industry sent President Trump a letter asking him to remove footwear from the list of items that could be hit with a 25% tariff this summer, according to a 5/21 article in Quartz. They claim the tariffs will be passed along to consumers and will act like a “significant tax increase” amounting to $7 billion in additional costs to consumers every year. In addition, tariffs will “threaten the very economic viability of many companies in our industry.”

Moving production out of China quickly is not an option, the letter states. The industry “has been moving (production) away from China for some time now” however, sourcing changes require years of planning. The letter is signed by Adidas America, Crocs, Dr. Scholl’s, Foot Locker, Hush Puppies, Johnston & Murphy, Nike and many others.

(5) Pain in the Great Plains. The US imposition of tariffs led China to retaliate by imposing tariffs on US agricultural products. Chinese tariffs, swine flu, and many years of bumper crops have depressed US
crop prices and farmers' incomes. When farmers are hurting, they don’t buy new Deere tractors.

“Deere said it would reduce production of farm equipment this year to lower inventories at its dealerships. Deere expects about $3.3 billion in profit and a 5% increase in equipment sales this year, down from previous estimates for $3.6 billion in profit and a 7% rise in equipment sales in 2019,” a 5/17 WSJ article stated. In addition, the forecast for income from Deere’s lending arm was lowered by $50 million to $600 million.

(6) Semis getting chipped. The US Commerce Department last week added Huawei Technologies—the world’s largest supplier of telecom gear and the second-largest maker of smart phones—to its “Entity List, requiring a special license for US companies to sell equipment to Huawei. “The move came just after President Trump signed an executive order that bans telecommunications-network gear and services from unnamed companies considered ‘foreign adversaries’—a move widely assumed to be targeted primarily at Huawei and its Chinese peer ZTE,” a 5/16 WSJ article reported.

The shares of chip makers sold off because they sell more than $10 billion in semiconductor components to Huawei. Fortunately, the administration granted Huawei a temporary exemption on Monday and the markets bounced back. But we don’t expect it will be the last we’ll hear on the subject.

(7) Measuring the pain. Almost three-quarters of American businesses operating in China said the increases in US and Chinese tariffs “are having a negative impact on their businesses,” according to a survey conducted from May 16-20 by the American Chambers of Commerce in China and in Shanghai. Companies were experiencing lower demand for products (52.1%), higher manufacturing costs (42.4), and higher sales prices for products (32.2), according to the roughly 250 companies that responded to the survey.

About 40% of respondents are considering relocating or have relocated manufacturing facilities outside of China. Among those who are moving, 24.7% are relocating to Southeast Asia and 10.5% to Mexico. Fewer than 6.0% of respondents were considering relocating to the US.

Roughly a third of respondents plan to manufacture in China just what is needed to serve the Chinese market and another third plan to delay or cancel future investments there.

Retailing I: Blame the Weather. Normally, we’d be highly skeptical of retailers blaming the weather for disappointing sales. But this time, Mother Nature may indeed be at fault. Let’s take a look:

(1) Retailers feeling the chill. In the Q1 earnings conference call, Kohl’s CFO Bruce Besanko attributed the retailer’s 3.4% same-store sales decline to a combination of “unfavorable weather, soft home category sales and less productive key promotional events. Weather was challenging during the quarter resulting in suppressed demand for our spring seasonal goods, which were down high single-digits; while in contrast all goods were up high single digits.” As the weather turned, CEO Michelle Gass said the company saw an “improvement in demand” and March, and April sales were flat versus last year.

Home Depot executives blamed weather and lower lumber prices for the 2.5% increase in same-store sales versus the 4.2% analysts expected. “The weather in February impacted our business. 17 of 19 regions were negative. The majority of our selling departments were negative. Our transactions were negative 2.5% for the month of February alone. ... Those sales are coming back as the weather improves,” explained CFO Carol Tome during the Q1 conference call.

Macy's was an exception. Its executives didn’t think weather had hurt or helped Q1 sales.
(2) Cold and rainy on the farm. Deere’s results have been hurt by the tough time farmers are having this year and weather hasn’t helped. “Cold, wet weather in the Midwest is also delaying spring planting, raising questions about how much revenue farmers will generate this year. The US Agriculture Department estimates just one-third of the expected corn crop has been planted, compared with a 66% average for this time of the year,” a 7/15 WSJ article stated.

(3) Weather hurt deliveries. UPS cited severe winter weather in the US Northeast and Midwest when reporting Q1 results. “Operating profit in UPS’ U.S. domestic business, its biggest, dropped to $666 million in the quarter ended March 31, from $756 million a year earlier, largely due to an $80 million hit from weather-related disruptions,” a 4/25 Reuters article explained.

(4) Uncle Sam confirms it too. This past January through March was the 113th wettest period out of 125 seasons from 1895 through 2019 for the US, according to the National Centers for Environmental Information’s website. Let’s hope Mother Nature is kinder this summer!

Retailing II: By the Numbers. The old market saw “Sell in May and go away” is proving its mettle. May has been an awful month for many retailers and the broader market. However, the declines have taken only a bit of the shine off of 2019’s strong stock market returns ytd.

Here’s the performance derby for the S&P 500 sectors mtd through Tuesday’s close: Real Estate (0.7%), Utilities (0.0), Consumer Staples (-0.6), Health Care (-0.3), Communication Services (-1.9), S&P 500 (-2.8), Energy (-3.2), Financials (-3.2), Consumer Discretionary (-3.5), Industrials (-3.5), Materials (-4.9), and Information Technology (-5.0) (Fig. 1).

S&P 500 returns ytd look much more attractive as stocks rebounded from the harsh selloff in late 2018. Here’s the ytd performance derby for the S&P 500 sectors: Information Technology (20.6%), Communication Services (18.5), Consumer Discretionary (17.5), Industrials (17.1), Real Estate (16.8), S&P 500 (14.3), Financials (13.7), Consumer Staples (13.1), Energy (11.7), Utilities (10.8), Materials (8.1), and Health Care (2.9) (Fig. 2).

The S&P 500 Consumer Discretionary Retail Composite has held onto most of its gains this year, up 17.1% ytd. Here’s a look at various retail industries and the forecasts for their revenue and earnings this year:

(1) Apparel, Accessories & Luxury Goods. The S&P 500 Apparel Accessories & Luxury Goods index (CPRI, HBI, PVH, RL, TPR, UA, UAA, and VFC) is up 17.1% ytd even after declining 5.4% mtd (Fig. 3). Analysts’ 2019 revenue growth estimate has remained relatively steady at 5.1% y/y, but the 2019 earnings growth consensus has been trimmed to 6.3% from 11.7% last August (Fig. 4 and Fig. 5). Earnings growth is expected to accelerate to 11.0% next year.

(2) Department Stores. The Consumer Discretionary sector’s worst-performing stock price index and third-worst-performing industry we track, the S&P 500 Department Stores index is down -16.2% ytd and -15.0% mtd, ahead of only Copper (-15.9%) and Agricultural & Farm Machinery (-15.9) (Fig. 6). Revenue is barely expected to grow this year (0.5) or next (0.8). And earnings growth is forecast to drop 9.1% this year and barely budge (0.4) in 2020 (Fig. 7 and Fig. 8). One thing this industry offers: a bargain-basement forward P/E of 9.0, near its lows dating back to 1995 (Fig. 9).

(3) General Merchandise Stores. The S&P 500 General Merchandise Stores’ stock price index is having a much better year, up 10.1% ytd despite falling 6.8% in May to date (Fig. 10). Analysts’ revenue forecast has climbed over the past year to 4.3%, while earnings have come under pressure. Nonetheless, earnings are expected to grow 5.7% this year and 9.6% in 2020 (Fig. 11 and Fig. 12).
Home Improvement Retail. The S&P 500 Home Improvement Retail Stock price index has climbed 13.1% ytd even after falling 4.8% so far in May (Fig. 13). Both revenue and earnings growth estimates have been trimmed but remain among the sector’s healthiest. Revenue is forecast to grow 2.5% this year, and earnings to climb 6.5% in 2019 and 11.1% next year (Fig. 14 and Fig. 15). While its forward P/E commands a premium to the S&P 500, it’s still within the past five years’ range (Fig. 16).

CALENDARS

US. Thurs: Jobless Claims 215k, New Home Sales 675k M-PMI & NM-PMI Flash Estimates 52.7/53.5, Kansas City Fed Manufacturing Index 7, EIA Natural Gas Report, Kaplan. Fri: UK Retail Sales Including & Excluding Fuel 4.5%/4.3% y/y. (DailyFX estimates)

Global. Thurs: Eurozone, Germany, and France C-PMI Flash Estimates 51.7/52.0/50.3, Eurozone, Germany, and France M-PMI Flash Estimates 48.1/44.8/50.0, Eurozone, Germany, and France NM-PMI Flash Estimates 53.0/55.4/50.8, Germany GDP 0.4%/q/0.7%/y/y, Germany Ifo Business Climate, Current Assessment, and Expectations Indexes 99.1/103.5/95.0, Japan Headline, Core, and Core-Core CPI 0.9%/0.9%/0.6% y/y, ECB Releases Minutes of April Policy Meeting, European Parliamentary Elections, Guindos. Fri: Durable Goods Orders Total, Ex Transportation, and Core Capital Goods -2.0%/0.2%/-0.1%, Baker Hughes Rig Count. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (link): The Bull/Bear Ratio (BBR) sank further below 3.00 this week, as bullish sentiment dropped below 50.0% for the first time in 14 weeks. The BBR slumped for the third week to 2.88 from 3.16 three weeks ago—which was the first reading above 3.00 since October. Bullish sentiment slid 6.9ppts the past three weeks, from 56.4% to 49.5%, with all moving to the correction camp, which climbed 7.5ppts (to 33.3% from 25.8%) over the period. Bearish sentiment edged lower over the same time span, from 17.8% to 17.2% (the fewest bears since late March 2018); it bounced in a range between 20.4% to 21.5% from late January through late March. The AAII Ratio declined to 43.1% last week after increasing the prior two weeks from 62.4% to 65.0%. Bullish sentiment sank to 29.8%, after rising the prior two weeks from 33.5% to 43.1%, while bearish sentiment rose for the third week from 20.2% to 39.3%.

AC World ex-US MSCI (link): This index has dropped 4.4% in dollar terms so far in May, but is still up 7.3% ytd. In local-currency terms, the index is down 3.9% in May compared to an 8.5% gain for all of 2019. The US dollar price index is up 9.8% since its December low and has improved to 16.1% below its cyclical high in January 2018. It had been down as much as 23.6%—and in a bear market—in December. The local-currency price index is up 10.8% since its December low to 9.2% below its record high in January 2018. It had been down as much as 18.1% on December 26. Local-currency forward revenues is down 0.4% from its record high in early May, but is up 16.7% from a five-year low in March 2016. Local-currency forward earnings improved to 3.5% below its record high in early November. Revenues are expected to rise 3.2% in 2019 and 5.0% in 2020 following a gain of 7.3% in 2018, and earnings are expected to rise 5.0% (2019) and 9.6% (2020) after rising 4.6% (2018). The industry analysts’ sales forecasts imply short-term 12-month forward revenue growth (STRG) of 3.8%, down 0.2ppt m/m. Their STRG forecast compares to a seven-year high of 6.8% in March 2017 and is up from a cyclical low of 2.3% in March 2016. Their short-term 12-month forward earnings growth (STEG) forecast improved 0.5ppt m/m to 7.3%. That’s up from a 10-year low of 6.0% in February, and compares to a four-year-high forecast of 14.1% in March 2017. The profit margin estimate implied by analysts’ earnings and revenue estimates rises to 7.7% in 2019 and to 8.1% in 2020 from 7.6% in 2018. The forward profit margin forecast remained steady m/m at 7.9%, which is down from 8.0% in
February and a nine-year high of 8.3% in October. The Net Earnings Revision Index (NERI) for the AC World ex-US MSCI was negative in May for a 14th straight month following six positive readings. It improved to -6.4% from -8.0% in April and is up from its 33-month low of -8.4% in January. That compares to a 76-month high of 2.7% in May 2017 and a 51-month low of -11.3% in March 2016. The forward P/E of 12.7 is up from a five-year low of 11.4 in late December, which then was the lowest reading since June 2013. That compares to a 31-month high of 14.8 in January 2018, a six-year high of 15.3 in April 2015, and a cyclical bottom of 12.3 in January 2016. The index’s current 13% discount to the World MSCI P/E is up from its record-low 15% discount during early November.

EMU MSCI (link): The EMU’s MSCI price index is down 4.8% in dollar terms so far this month, but is still up 9.0% in 2019. In euro terms, the price index is down 4.4% in May, compared to an 11.6% gain ytd. The US dollar price index is up 12.4% since its December low and has improved to 17.4% below its cyclical high in January 2018. It had been down as much as 26.5% and in a bear market in December. The local-currency price index is up 14.6% since its December low to 8.8% below its cyclical high in January 2018. It had been down as much as 20.5% on December 27. Euro-based forward revenues weakened 0.2% m/m and is now down 1.4% from its five-year high in early November. That’s still 5.0% above its six-year low in May 2016, but remains 6.2% below its record high (September 2008). Euro-based forward earnings had stalled from 2011 to 2016 before reaching its highest level in 10 years during early November. It was unchanged m/m and remains 2.4% below its 10-year high in November and 17.6% below its record high (January 2008). Analysts expect revenues to rise 2.7% in 2019 and 4.1% in 2020, above the 2.0% in 2018. They’re also looking for faster earnings growth. Earnings are expected to rise 4.6% in 2019 and 10.0% in 2020 following a gain of 3.6% in 2019. However, forecasted STRG of 3.3% is down from 3.5% a month earlier, which compares to a six-year high of 5.0% in April 2017 and a cyclical low of 2.0% in May 2016. Forecasted STEG dropped 0.1ppt m/m to 7.0%, which compares to a 78-month high forecast of 21.0% (February 2017) and a seven-year low of 5.7% (April 2016). STEG had been higher than LTEG (currently 9.2%) from July 2016 to May 2017, but is trailing now. The forward profit margin was steady m/m at 7.8%, which compares to a nine-year high of 7.9% in January and a cyclical bottom of 6.2% in May 2013. The implied profit margin is expected to improve to 7.6% in 2019 and 8.0% in 2020 from 7.5% in 2018. NERI was negative in May for an eight straight month and in 19 of the past 22 months. NERI improved m/m to -4.2% from -7.1%, and remains above December’s 31-month low of -8.7%. That compares to an 11-year high of 8.1% in May 2017. The P/E of 12.9 is up from 11.3 in early January, which was then its lowest reading since July 2013. That’s down from a nine-month high of 14.9 in January 2018 and compares to a 13-year high of 16.4 in April 2015 and a 30-month low of 12.2 in February 2016. The current valuation represents a 12% discount to the World MSCI’s P/E now, up from February’s 14% discount, which was then the lowest since August 2016. That compares to a record-low 25% discount during 2011 and is well below the 1% premium during April 2015—the post-euro-inception record high.

Emerging Markets MSCI (link): The EM MSCI price index has tumbled 7.9% in US dollar terms so far in May to a gain of just 2.9% ytd. In local-currency terms, EM is up 4.2% ytd despite a 7.1% drop this month. The US dollar price index is up 6.9% since its October low and is back in a bear market now at 21.5% below its cyclical high in January 2018. It had been down as much 26.6% last October from its cyclical high. The local-currency price index is up 7.5% since its October low to 15.0% below its cyclical high in January 2018. It had been down as much as 20.9% on October 29. Local-currency forward revenues is down 1.2% from its record high in early May, but is still up 21.7% from a four-year low in June 2016. However, local-currency forward earnings fell 0.5% m/m to 7.2% below its record high in early October. Still, it’s up an impressive 30.4% from its six-year low in April 2016. Revenue growth is expected to slow markedly to 5.6% in 2019 and 7.5% in 2020 from a 12.0% gain in 2018. That’s expected to lead to earnings gains of 4.9% in 2019 and 13.9% in 2020, following a 7.2% gain in 2018. Forecasted STRG was down 0.1ppt m/m to 6.4%, which compares to a 34-month low of 5.8% in February and a four-year high of 9.6% in January 2017. STEG remained steady m/m at 8.9%; that’s up
from a 10-year low of 6.6% in late January but remains well below its cyclical peak of 17.5% in March 2017 and is below LTEG (14.1%) again. The implied profit margin is expected to remain steady y/y at 6.4% in 2019 before improving to 6.8% in 2020. The forward profit margin remained steady m/m at 6.5%, which is down from a six-year high of 7.4% in May 2018. It's now 3.8ppt below its 10.3% record high in December 2007 and compares to a record low of 6.0% in February 2016. NERI was negative for a 16th month in May, but improved to -6.4% from -6.9% in April. NERI had been positive for only three months through January 2018 after 80 months of negative readings through October 2017, and compares to an 83-month low of -10.2% in March 2016. Emerging Markets’ forward P/E of 11.6 is up from a 56-month low of 10.0 at the end of October and compares to an eight-year high of 13.1 in January 2018. The index is trading at only a 21% discount to the World MSCI P/E, which is near the best levels since early 2013. That’s up from a four-year-low 27% discount in late October, and compares to a 10-year-low 30% discount in August 2016.

MSCI World & Region Net Earnings Revisions (link): Analysts’ recent earnings revisions through May suggest improving optimism about profits across the world as nearly all areas continued to rise from their recent three-year-lows to seven-month highs. The AC World MSCI’s NERI was negative for an eighth month following 20 straight positive readings through September, but improved to a seven-month high of -6.4% from -7.0% in April. That’s up from a 33-month low of -8.4% in January. EM Eastern Europe remains in the lead among all regions, and turned positive for the first time in five months. The US was positive for the first time in seven months, as its NERI improved to 0.1% from -4.4%, but remains well below its corporate-tax-rate-cut-boosted record high of 21.8% in March 2018. Here are May's scores among the regional MSCIIs: EM Eastern Europe (0.5% in May, up from -2.1% in April), United States (0.1, -4.4), Europe ex-UK (-3.3, -7.3), EM Latin America (-4.1 [20-month low], -2.3), EMU (-4.2, -7.1), Europe (-4.5, -7.3), AC World (-4.6, -7.0), EAFE (-6.3, -8.5), AC World ex-US (-6.4, -8.0), Emerging Markets (-6.4, -6.9), and EM Asia (-6.6, -8.0).

MSCI Countries Net Earnings Revisions (link): NERI was positive for 11/44 MSCI countries in May, the highest reading since October and up from seven in April. That compares to just three during February, which was the lowest count since March 2016. NERI improved m/m in April for 28/44 countries, one of the highest counts since July 2018 and up from 24 in April. That compares to 8/44 improving in December, which was then the lowest count since April 2018. Among the countries with improving NERI in May, the Netherlands was at a 104-month high (October 2010), followed by: the Philippines (17-month high), Poland (14), Hong Kong (10), Italy (10), and Peru (10). Among countries with weaker NERI m/m, Thailand was at a 61-month low, followed by Turkey (54), Chile (37), India (27), and Belgium (11). NERI turned positive in May for four countries: Hong Kong, Italy, the Philippines, and the Netherlands. The three-month positive NERI streak for Argentina is now the best among countries, followed by two-month streaks for the Czech Republic, Egypt, Greece, and Sweden. NERI turned negative for three countries: Brazil, New Zealand, and Pakistan. South Africa’s NERI has been negative for 61 straight months, followed by the negative streaks of Mexico (31-months), Denmark (22), and Germany (22). The highest NERI readings in May: Egypt (4.2% [6-month high]), Argentina (2.5), Greece (2.3), Italy (2.0 [10-month high]), the Philippines (1.3 [17-month high]), and Hong Kong (1.0 [10-month high]). The weakest NERIs occurred this month in Thailand (-14.4) [61-month low], Korea (-11.9), Germany (-11.3), Japan (-10.3), and the United Kingdom (-10.1).

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