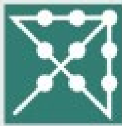
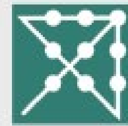
 Yardeni Research 

February 8, 2024

Morning Briefing

China, Small Caps & AI

Check out the accompanying chart collection.

Executive Summary: China's economic malaise has impacted the bottom lines of US-based multinational companies that do business there. Jackie sums up the effects reported and expected for the rest of the year by two such companies, Air Products & Chemicals and Estée Lauder. The former's top brass appears more pessimistic on the outlook for China than the latter's. … Also: Large-capitalization stocks have outperformed their smaller-cap peers since October 2022. Chalk up the divergence to their respective sector exposures. … And in our Disruptive Technologies spotlight this week: building the better AI. Competitors Alphabet, Meta, and Microsoft vie for AI offering superiority.

China: Slowdown Hits US Companies. You know things are serious when China's government officials take steps to bolster the country's stock market. This week, the China Securities Regulatory Commission banned brokerages from shorting stocks by borrowing them from institutional investors and encouraged companies to merge to boost market values. Despite the changes, the head of the commission was replaced. In addition, state-run investment funds purchased Chinese stocks to shore up the market, presumably encouraged by the political class. The funds bought just under $10 billion of local shares over the past month, according to a Goldman Sachs estimate in a February 6 *South China Morning Post* article.

The news was welcomed by investors in Chinese stocks: The China MSCI stock price index has risen 4.7% this week through Wednesday's close, while the CSI 300 has jumped 5.2%. However, the indexes remain down 34.1% and 29.6% since their 2021 peak (*Fig. 1*). We've long maintained that until the country addresses the underlying problem—the collapse of China's real estate market—its economy will continue to stagnate.

China's sluggish economy took a bite out of Air Products & Chemicals' and Estée Lauder's earnings last quarter, but the two very different companies had very different takes on what the rest of the year will hold. Here's a look at what their executives had to say about business in China on their recent conference calls to report quarterly earnings:

(1) *Deflated sales in China.* Air Products' results for its fiscal Q1 (ended December 31) came in below expectations in part because of the company's exposure to China. The company sells gases to a variety of different industries. Volumes in Asia were flat, and adjusted operating income fell 10% compared to operating income that rose 3% in the Americas and 36% in Europe. (Europe's sales were boosted by lower fuel costs, a new plant, and favorable currency translation.) Air Products' sales in Asia represent about 26.5% of the company's total sales.

"The challenging economic conditions in China and the weak electronics market continued to put pressure on the region," said COO Samir Serhan on Monday's earnings *conference call*. Later in the call, CEO Seifi Ghasemi added, "I [would] just like to caution everybody on the call that the economic situation in China is not as robust as people might think. … [W]e make products that are used instantaneously. We are a great leading indicator. And things are not really that exciting [in] that part of the world."

The executives don't anticipate any improvement during the second half of Air Products' fiscal year (ending September 30). "We expect things to be the way they are. I just hope that things don't get worse because of the geopolitical developments. But we are not factoring in any significant improvement in the world economy," said Ghasemi.

Air Products reported that fiscal Q1 adjusted earnings per share rose 7% y/y to $2.82 on sales that decreased 6% y/y to $3.0 billion, primarily due to the declining price of energy that is passed through to customers.

The company now expects earnings of $12.20-$12.50 a share in fiscal 2024, down from its previous guidance of $12.80-$13.10 a share and below analysts' consensus of $12.97. If the company hits its full-year target, adjusted earnings per share will rise 6%-9% y/y. The shares fell 15.6% on Monday on the lowered forecast.

(2) *A prettier picture.* Estée Lauder makes a very different product for a very different audience than Air Products, but the global cosmetics company also had difficulties in China during its fiscal Q2 (ended December 31). Estée Lauder's management, however, was much more optimistic than Air Products about prospects for the second half of its fiscal year. It announced plans to reduce global headcount by 3%-5%. The shares rose 12.0% on Monday.

"In the second half of fiscal 2024, we are positioned to return to strong organic sales growth and expand our profitability from the first half," said CEO Fabrizio Freda in the company's

earnings *press release*.

The global cosmetics company reported sales in the December quarter that declined 7.4% y/y to $4.3 billion and adjusted earnings per share of 88 cents—almost half of the $1.54 reported a year earlier but above the consensus expectation of 55 cents. Much of the decline was attributed to the drop in sales to Chinese customers, both within China and purchasing the products abroad while traveling.

Organic sales in the company's global travel retail business declined 28%, hurt by a drop in sales and destocking of inventories. The company also called out a slowdown of sales of prestige beauty products in Mainland China.

But better days lie ahead, with the destocking expected to end in April. "We expect organic net sales for our third quarter to increase 3% to 5% as both our businesses in Asia travel retail and in Mainland China are expected to return to growth."

The company remains committed to growing in the country. "We have a strong business in China, we have strong market share, and we are determined to continue to invest for the long term in China," said Freda on the call.

The company's forecasts fiscal Q3 (ending March 31) adjusted EPS of $0.36-$0.46, reflecting a 3%-24% y/y decline. For the full year, the company is calling for adjusted EPS of $2.08-$2.23, below the company's earlier forecast of $2.17-$2.42 and below the $2.79 earned in fiscal 2023.

Strategy: Is Smaller Better? The S&P 500 has enjoyed a banner rebound since the market bottomed in October 2022. Investors have piled into large-cap stocks, leaving small and mid-cap stocks for dead.

From October 12, 2022 through Tuesday's close, the S&P 500 has gained 38.5%, outpacing the S&P MidCap 400 and S&P SmallCap 600 indexes' 22.0% and 15.7% gains. The trend has continued this year, with the S&P 500 rising 3.9% ytd through Tuesday's close, compared to the 1.2% decline in the S&P 400 and the S&P 600's 4.4% drop (*Fig. 2*).

Here's a quick look at some of the factors driving the performance divergence:

(1) *Thank the tech sector.* The S&P 500 owes its outperformance to its outsized 38.4% combined allocation to the Information Technology and Communication Services sectors,

which posted shocking gains of 77.7% and 67.5% since the market's 2022 low. The S&P 500's allocation to Technology and Communications Services is far larger than S&P 400's and the S&P 600's allocations to the two sectors, 12.2% and 15.0% as of January 31, according to S&P Global.

The S&P SmallCap 600 and S&P MidCap 400 indexes are far more exposed to the Financials and Industrials sectors than they are to Technology. Here are the sector allocations for the S&P 400, 500, and 600 indexes: Industrials (S&P 400: 21.1%, S&P 500: 8.6%, S&P 600: 17.7%), Financials (16.3, 13.1, 18.5), Consumer Discretionary (15.5, 10.3, 14.7), Information Technology (10.5, 29.5, 12.2), Health Care (7.8, 12.8, 10.7), Real Estate (7.4, 2.4, 7.5), Materials (7.2, 2.3, 5.6), Energy (5.0, 3.8, 4.6), Consumer Staples (4.5, 6.1, 3.8), Utilities (3.1, 2.2, 2.0), and Communication Services (1.7, 8.9, 2.8).

(2) *Small-cap earnings shine in 2025.* Large-cap stocks are expected to have faster growth this year, but their earnings growth will be overshadowed by small and mid-cap stocks' growth in 2025 if analysts' forecasts are correct. Here are the earnings growth levels implied by analysts' consensus forecasts for the indexes' companies in 2024 and 2025: S&P 400 (8.1%, 15.1%), S&P 500 (9.6%, 13.4%), and S&P 600 (7.4%, 17.6%) (*Fig. 3*, *Fig. 4*, and *Fig. 5*).

(3) *Value outside the S&P 500.* Despite the faster earnings growth expected in 2025, the S&P SmallCap 600 and S&P MidCap 400 have far lower forward P/Es than the S&P 500. The S&P 400 has a forward P/E 15.0, and the S&P 600 has a forward P/E of 14.3, well below the S&P 500's forward multiple of 20.2 (*Fig. 6*).

Disruptive Technologies: Alphabet & Meta Embrace AI. Just as *Microsoft did*, Meta and Alphabet appeared to use their quarterly earnings conference calls as an opportunity to flag just how much they are pushing artificial intelligence (AI) capabilities throughout their services. Here's a look at what they're touting:

(1) *Alphabet launches Gemini.* Introduced in December, Alphabet's Gemini is an AI model that understands text, images, audio, video, and code, and it can run on everything from mobile devices to data centers. Gemini powers Bard and is considered a large improvement over Alphabet's previous AI offering.

When Tom's Guide *compared* Alphabet's Bard with Gemini to OpenAI's GPT-3.5, it found the two AI competitors to be neck and neck in terms of capabilities, giving very similar answers to the same questions. But in the end, Tom's Guide gave the crown to Bard with

Gemini. That says a lot about how far Google's offering has come over the past year; early last year, Chat GPT was considered the superior system.

When Gemini is used in Google Search, it can serve up answers to complex questions, like comparisons, and offer answers from multiple perspectives. Alphabet is also using AI to power its Circle to Search feature, which searches whatever is circled on an Android phone without switching apps.

Alphabet's AI tools help advertisers develop ad campaigns faster and more easily. Available in 40 languages and in 230 countries, Bard can help users summarize, code, and plan. In Google Cloud, the company offers Vertex AI, which helps customers develop AI apps quickly. It also offers Duet AI to help developers build apps, detect security threats, and manage and analyze data. "It's helping Wayfair GE Appliances and Commerzbank write better software, faster with AI code completion, code generation, and chat support," said CEO Sundar Pichai.

AI lets YouTube video creators swap in a new backdrop, remove background extras, and translate the video into other languages all from a phone and without a big budget. Google's Imagen 2 uses AI to turn text into images.

None of this is cheap. Alphabet spent $11 billion in Q4 on capex, which "was overwhelmingly [an] investment in our technical infrastructure," said President Ruth Porat. And capex spending will be "notably larger" this year than it was in 2023.

(2) *Meta won't be outdone.* Meta made clear on its Q4 earnings conference call that it too is pushing AI into all of its tools and services.

"Now moving forward, a major goal, we'll be building the most popular and most advanced AI products and services. And if we succeed, everyone who uses our services will have a world-class AI assistant to help get things done, every creator will have an AI that their community can engage with, every business will have an AI that their customers can interact with to buy goods and get support, and every developer will have a state-of-the-art open-source model to build with," said CEO Mark Zuckerberg.

Zuckerberg believes we'll use new computing devices to interact with AIs so that we don't have to take out our phones. These devices will be able to "see what you see and hear what you hear, like smart glasses," which Meta just happens to offer.

Meta has already launched Meta AI (its AI assistant), AI Studio (which lets developers create chatbots for Meta's messaging services), Creator AI (which creates images), AI for businesses, and Ray-Ban Meta smart glasses. As they are improved in coming months, Meta will roll out these services more widely. The company has begun testing more than 20 GenAI features across its apps.

The company is also using AI in its advertising business. AI is helping Meta improve its rankings, and it's helping advertisers automate advertising campaigns and create the advertisements.

All of this costs money. The company expects it will need to hire people to support its AI efforts and expand its AI infrastructure capacity. The company plans to spend $30 billion to $37 billion on capital expenditures in 2024, $2 billion more than the prior spending range it gave.

"We expect growth will be driven by investments in servers, including both AI and non-AI hardware, and data centers as we ramp up construction on sites with our previously announced new data center architecture," said CFO Susan Li. "[W]e expect our ambitious long-term AI research and product development efforts will require growing infrastructure investments beyond this year."

Calendars

US: Thurs: Initial Claims 221k; Wholesale Inventories 0.4%; Atlanta Fed GDPNow 3.4%; WASDE Report; Barkin. **Fri:** Baker-Hughes Rig Count. (FXStreet estimates)

Global: Thurs: Spain Consumer Confidence; ECB Economic Bulletin; Elderson; Lane; Mann; Bullock; Dhingra. **Fri:** Germany CPI 0.2%m/m/2.9%y/y; Italy Industrial Production 0.8%; Canada Employment Change 15k; Canada Unemployment Rate 5.0%; Nagel. (FXStreet estimates)

Strategy Indicators

Stock Market Sentiment Indicators (***link***): The *Bull-Bear Ratio* fell to 3.18 this week, after rising the prior two weeks to 3.43—the highest since August 2021. *Bullish* sentiment fell

3.4ppts to 54.3%, after climbing 9.2ppts (to 57.7% from 48.5%) the prior two weeks—which was the most bulls since summer 2021, when they exceeded 60.0%. Meanwhile, *bearish* sentiment edged up to 17.1%, after falling the prior two weeks by 2.2ppts (to 16.9% from 19.1%), which was the fewest bears since summer 2021. The *correction count* rose to 28.6%, following a decline of 7.0pts (to 25.4% from 32.4%) the prior two weeks. Turning to the *AAII Sentiment Survey* (as of February 1), the short-term outlook for stocks soared in the latest survey, while neutral sentiment plunged and pessimism posted a small decline. The *percentage expecting stock prices to rise over the next six months* catapulted 9.8ppts to 49.1%, an unusually high level—remaining above its historical average of 37.5% for the 13th successive week. The *percentage expecting stocks to fall over the next six months* slipped 1.6ppts to 24.5%, below its historical average of 31.0% for the 13th straight week. The *percentage expecting stock prices will stay essentially unchanged over the next six months* sank 8.2ppts to 26.4%, the lowest since December 7, 2023—dropping below its historical average of 31.5% for the first time in three weeks.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*):The S&P 500's forward profit margin was unchanged w/w at 12.7% during the February 1 week, and is now just 0.1pt below its 11-month high of 12.8% during the September 21, 2023 week. That's up from a 24-month low of 12.3% during the March 30, 2023 week, but is down 0.7pt from its record high of 13.4% achieved intermittently in 2022 from March to June. It's now 2.4pts above its seven-year low of 10.3% during April 2020. Forward revenues rose 0.5% w/w to its first record high in four weeks. Forward earnings jumped 1.0% higher w/w to its first record high in four weeks too. It had hit that mark during the September 21 week for the first time since the June 16, 2022 week. Revenues and earnings had been steadily making new highs from the beginning of March 2021 to June 2022; prior to that, they peaked just before Covid-19 in February 2020. The consensus expectations for forward revenues growth was steady w/w at 4.9%. It's now 0.2pt below its 15-month high of 5.1% in early January and up 2.6pts from its 33-month low of 2.3% during the February 23, 2023 week. 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. The forward earnings growth forecast dropped 0.2pt w/w to 10.6%. That's down from a 26-month high of 11.5% in early January and is now 7.1pts above its 31-month low of 3.5% in mid-February. 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. Analysts expect revenues to rise 4.6% in 2024 (down 0.1pt w/w) and 5.7% in 2025 (up 0.1pt w/w) compared to a forecasted revenues gain of 2.1% in 2023. They expect an earnings gain of 9.6% in 2024 (down 0.5pt w/w) and a 13.4% rise in 2025 (up 0.2pt w/w) compared to a forecasted earnings gain of 1.9% in 2023. Analysts expect the profit margin to rise 0.5ppt

y/y to 12.5% in 2024 (unchanged w/w), compared to 12.0% in 2023, and to rise 0.9ppt y/y to 13.4% in 2025 (unchanged w/w). The S&P 500's weekly reading of its forward P/E fell 0.3pt w/w to 19.8 from a 23-month high of 20.1. That up from a 30-month low of 15.3 in October of 2022. It also compares to 23.1 in early September 2020, which was the highest level since July 2000, and to a 77-month low of 14.0 in March 2020. The S&P 500 weekly price-to-sales ratio fell 0.03pt w/w to 2.52 from a 21-month high of 2.55. That's up from a six-month low of 2.22 during the October 26 week and compares to a 31-month low of 1.98 in October 2022. That 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 S&P 500 sectors during the February 1 week, forward earnings rose w/w for all 11 sectors, forward revenues rose for all but the Energy sector, and the forward profit margin rose for all but Health Care and Real Estate. Four sectors have forward revenues at post-pandemic or record highs this week: Communication Services, Consumer Staples, Health Care, and Information Technology. Among the remaining seven sectors, just three have forward revenues more than 5.0% below their post-pandemic highs: Energy, Financials, and Materials. Five sectors have forward earnings at a record high this week: Communication Services, Consumer Discretionary, Consumer Staples, Information Technology, and Utilities. Among the remaining six sectors, only Energy and Materials have forward earnings down more than 10.0% from their post-pandemic highs, while Financials exited that club in early October. Among the 11 sectors, only Industrials has weathered a broad margin retreat from post-pandemic or record highs. Now nearly all of the sectors are showing signs of recovering from their early 2023 lows. Consumer Discretionary and Information Technology are the only sectors with their forward profit margin at a record high this week. The forward profit margins of Communication Services and Industrials remain close to their post-pandemic high. Energy's has fallen to a 21-month low, while those of Consumer Staples and Health Care remain at or close to their record lows. The annual profit margin is expected to fall y/y in 2024 for Energy, Materials, and Real Estate and to improve for the other eight sectors. Here's how the S&P 500 and its 11 sectors rank based on their current forward profit margin forecasts along with their record highs: Information Technology (26.0%, a new record high this week), Financials (18.4, down from its 19.8 record high in August 2021), Real Estate (16.5, down from its 19.2 record high in 2016), Communication Services (16.6, down from its 17.0 record high in October 2021), Utilities (13.6, down from its 14.8 record high in April 2021), S&P 500 (12.7, down from its record high of 13.4 achieved intermittently in 2022 from March to June), Energy (10.5, a 21-month low and down from its 12.8 record high in November 2022), Materials (10.8, down from its 13.6 record high in June 2022), Industrials (10.6, down from its record high 10.8 in September

2023), Health Care (8.9, a record low and down from its 11.5 record high in February 2022), Consumer Discretionary (8.5, a record high this week), and Consumer Staples (6.9, down from its 7.7 record high in June 2020).

S&P 500 Q4 Earnings Season Monitor: With 284 companies having reported Q4 results through the mid-day Wednesday, the Q4-2023 earnings season is nearly 58% complete. The current indications suggest a weaker earnings surprise but stronger y/y earnings growth than in Q3-2023. The similar measures for revenues are outperforming. Revenues are ahead of the consensus forecast by 1.4%, and earnings have outpaced estimates by 6.9%. At the same point during the Q3 season, revenues were 0.9% above forecast, and earnings had beaten estimates by 8.4%. Among the 284 reporters so far, the aggregate y/y growth rates have improved since Q3-2023 for both revenues and earnings: to 3.7% from 1.6% for revenues growth and to 5.9% from 3.1% for earnings growth. On a positive note, aggregate y/y earnings growth among the companies that have reported so far is outpacing their revenues growth for a second straight quarter after lagging for six quarters through Q2-2023. The y/y earnings growth results to date are heavily impacted by declines for ExxonMobil, Merck, and Pfizer. Without these three companies, y/y earnings growth nearly doubles to 10.7% from 5.9%. Just 63% of the 230 companies has reported a positive revenues surprise, while 81% has reported an earnings beat. While we expect y/y revenues growth rates to remain positive yet again in Q4 and for a 13th straight quarter, earnings growth will be positive on a y/y basis for only a second straight quarter following three declines. Fewer companies have been reporting positive y/y earnings growth in Q4 (60%) than positive y/y revenues growth (65%). These figures will continue to change as more Q4-2023 results are reported in the coming weeks.

Global Economic Indicators

Germany Industrial Production (*link*): German industrial production continued to slide in December, sinking to its lowest level since June 2020 and 10% below its pre-pandemic level. It's at the lowest level since 2010, excluding the pandemic shock. German industry remains stuck between cyclical and structural weakness. Germany's *headline production*, which includes construction, dropped for the seventh successive month, by 1.6% (vs -0.5% expected) in December and 5.7% over the period. It's down 7.3% from its recent peak last February. December's weakness was spread across all sectors, with the exception of the auto industry. Output in energy-intensive industries was especially weak, dropping 5.8%, in December, led by a sharp drop in chemicals (7.6%) output, with construction (-3.4) another big drag. Meanwhile, auto output posted a solid gain of 4.0%. Finance Minister Christian

Lindner warned, “We are no longer competitive. We are getting poorer because we have no growth. We are falling behind.”

Contact us by *email* or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-241-6502
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-228-9102