May 9, 2024

Morning Briefing

Robots, Real Estate & Energy Storage

Check out the accompanying chart collection.

Executive Summary: Rockwell's March-quarter results were surprisingly weak for a beneficiary of two broad investment themes—onshoring and automation. Customers' excess inventories were partly to blame. Now earnings are expected to decline this fiscal year. … Also: Jackie surveys the distressed office real estate market, where financing is suffering amid higher-for-longer interest rates. But leases for high-end office space are flying off the figurative shelves as companies try to entice employees back to the office. … And in our Disruptive Technologies segment: a novel approach to storing solar and wind energy, using compressed air.

Industrials: Too Many Robots? Two themes we watch closely are onshoring and automation. Rockwell Automation should be a beneficiary of these two important trends because it makes automation equipment for factories. But Rockwell reported an awful March quarter earlier this week and lowered its earnings forecast for the remainder of the year. Company officials blamed poor demand, reflecting customers' elevated inventory levels, which are being worked down.

The Rockwell earnings data point flies in the face of what would be expected from the strong ytd performance of its parent sector, the S&P 500 Industrials. The sector's price index has narrowly outperformed the S&P 500 so far this year. Here is the performance derby of the S&P 500 and its sectors ytd through Tuesday's close: Communication Services (18.8%), Information Technology (11.0), Energy (11.2), Utilities (9.6), Financials (9.3), Industrials (9.0), S&P 500 (8.8), Consumer Staples (7.4), Materials (6.3), Health Care (4.4), Consumer Discretionary (3.0), and Real Estate (-6.8) (*Fig. 1*).

Rockwell is a member of the S&P 500 Electrical Components and Equipment stock price index, which has gained 16.3% ytd through Tuesday's close, making it the second-best performing industry within the Industrials sector (*Fig. 2*). But the industry's strong performance owes much to Eaton's stock, which has risen 36.0% ytd through Tuesday's close. That far outpaces the ytd stock returns of Rockwell (-12.4%), Ametek (2.8), Generac Holdings (5.6), and Emerson Electric (10.4).

Here's a look at Rockwell's Q1 results and what management had to say about them:

(1) *Tough quarter all around.* Sales in Rockwell's fiscal Q2 (ended March 31) dropped 6.6% y/y to $2.1 billion, and adjusted EPS fell 16.9% to $2.50. Management also reduced its guidance for the year ending September. Sales for fiscal 2024 are now expected to fall 4.0%-6.0%, worse than the 0.5%-6.5% growth expected before. The company's estimate for adjusted EPS was trimmed to $10.00-$11.00, down from an earlier $12.00-$13.50.

Management blamed the weakness on customers' excess inventories: "[T]here is more excess inventory at our customers, particularly machine builders, than we originally expected. As a result, we are not yet seeing the accelerated order ramp this fiscal year and are reducing our full-year guidance," said CEO Blake Moret in the company's earnings *press release*. He elaborated on the *conference call*: "[O]rders are still expected to return to year-over-year growth in Q3 and continue to increase during the year, but the slower ramp is impacting shipments for the second half."

(2) *Problems in EVs?* In addition to a clogged inventory channel, Moret attributed the weakness to customers' changing the timing of their investments in EV factories. "While we are not seeing any EV or battery project cancellations, we are seeing push-outs of certain production start dates," he said. Rockwell's sales into the automotive industry dropped about 20% y/y last quarter.

Moret also cited a 25% y/y slowdown in sales to the semiconductor industry, due to "continued geopolitical pressures and temporary oversupply of legacy chips weighing on semi customers' capex investments."

Sales in the e-commerce and warehouse automation area fell last quarter by a percentage "in the high teens" on a y/y basis but grew on a sequential quarter basis. Sales into the food and beverage vertical dropped 20% y/y, and sales to customers in the life sciences industry declined in the high-single digits. Geographically, sales declined almost 30% y/y in China.

In response to the results, Rockwell is cutting costs, including laying off about 3% of its workforce. The actions will save $120 million next year.

(3) *Automation remains in demand.* Rockwell officials said they are taking market share in

their major product lines globally and remain optimistic because managers still want to increase automation. “[A] couple of customers … [who] have come off of discussions with labor … have made it clear that they want to complement their people with technology to a greater extent over the next few years. And those have resulted in multimillion dollar wins for Rockwell, as a result of moving more aggressively and adding technology to complement their scarce resources,” said Moret.

Rockwell shares are about 2.3% lower than where they stood prior to the earnings release on Tuesday.

(4) *A look at earnings.* Analysts expect Rockwell’s fiscal 2024 earnings will drop slightly to $11.87 from $11.95 last fiscal year. Three months ago, they were expecting the company to earn $12.32 a share in the current fiscal year. Analysts see earnings growing again in fiscal 2025 to $13.88.

Analysts are more optimistic about the results of other companies in the S&P 500 Electrical Components & Equipment industry. The industry’s collective revenue is forecast to climb 9.1% this year and 6.4% in 2025, while earnings are expected to jump 12.2% this year and 10.5% in 2025 (*Fig. 3* and *Fig. 4*).

The industry’s price index reflects a lofty forward P/E of 24.2, near the top of its two-decade range (*Fig. 5*).

Real Estate: The $1 Trillion Cloud. High interest rates are rarely a welcome development in business; but for the distressed office real estate market, this year’s higher-for-longer rate environment may be the proverbial nail in the coffin. High rates likely have dashed many hopes of refinancing office property loans and selling properties at prices enabling debt repayment.

Some $117 billion of commercial mortgages on US office properties comes due this year, a January 1 *FT* *article* reported. Moody’s Analytics estimates that 224 of the 605 buildings with mortgages maturing soon will have trouble refinancing, either because they are over leveraged or because they have poor rental performance, the article stated. (FYI: The amount of mortgages coming due in 2024 on ALL commercial real estate [CRE] is much larger, almost $1 trillion, according to some estimates. CRE encompasses office real estate as well as multifamily housing, hospitality, retail, warehouses, and many other business properties—each of which has different occupancy rates and fundamentals.)

In a foreboding sign, the 30+-day delinquency rate on office building loans in commercial mortgage-backed securities continues to tick up, jumping to 7.4% in April from 6.6% in March and just 2.7% in April 2023, a May 2024 *report* by Trepp states. The default rate is an even more concerning 20% on the roughly 37% of CMBS office loans that have floating interest rates, a May 2 Wolf Street *article* reported. Roughly 17% of CMBS loans are office loans, Cohen & Steers analysts *estimate*.

In Q1 earnings conference calls, real estate advisors CBRE and Jones Lang LaSalle called out the strength they're seeing in leases for Class A office buildings. Meanwhile, investors are raising funds in preparation to pounce on distressed properties that hit the market. Let's take a look at both sides of the office market and what Fed Governor Lisa Cook had to say yesterday regarding banks' exposure to office real estate:

(1) *High-end office space in demand.* Companies in the post-pandemic era are examining whether they can operate with less office space. So it may seem counterintuitive that leasing revenue rose last quarter in every region of the country. CBRE executives attributed the stronger-than-expected strength to the health of the economy and the easy y/y comparisons: "Office leasing grew by double digits globally as a resilient economy and progress on return-to-office plans have emboldened tenants to make occupancy decisions. We have continued to see strong momentum in US leasing in April," said CFO Emma Giamartino on CBRE's earnings *conference call*.

Giving more color on the US leasing market, Giamartino said: "Financial services companies are leading the recovery, with active demand up more than 20% year-over-year across US gateway markets, reflecting their considerable progress in bringing employees back to the office. Tech companies continue to lag, with demand 50% below pre-Covid levels."

Besides trying to make do with less space, companies also are trying to entice more employees back into the office. To that end, many are reconfiguring or upgrading their office space, which explains why Class A real estate is outperforming older, less desirable office real estate.

"The assets that are really in distress are B & C office buildings, and there aren't a lot of buyers in the market for those assets right now. We do expect that there will be buyers for those assets in the market, but the pricing probably has to come down more than it has," explained CBRE CEO Bob Sulentic.

The global office vacancy rate ticked up to 16.5% in Q1 from 16.2% in Q4 and 15.3% in Q1-2023, according to Jones Lang LaSalle CEO Christian Ulbrich on the company's Q1 earnings *conference call*. The increase was driven mainly by North America, where companies entered new leases for space that's 10%-15% smaller than was leased under their old contracts. Global leasing volumes were up 7% y/y and up 14% in the US compared to a very soft quarter a year ago. In the best properties, rents are increasing.

(2) *High rates choke off financing activity.* Higher interest rates are throttling the refinancing of existing loans and the financing of new transactions. Revenue from CRBE's property sales globally declined 11% in Q1.

"The market will adapt to a higher-for-longer interest rate environment. Pricing for the very best assets is beginning to stabilize in the US, UK, and Australia, but prices have declined 15% to 35% from peak levels," said Ulbrich.

(3) *Vultures are circling.* At the right price, any office building can look like a gem. So, the distress in the commercial real estate market has prompted institutional investors to raise funds with hopes of buying properties at marked down prices.

Artemis Real Estate Partners closed a $2.2 billion fund last year to buy distressed properties, and SL Green Realty, New York's largest office landlord, plans to raise a $1 billion opportunistic debt fund focused on New York City, a February 12 *WSJ* *article* reported. In addition, private equity firms have a record $544 billion in cash available in their global real estate funds available for purchases.

The biggest impediment to completing deals may be getting buyers and sellers to agree on a price given the dearth of transactions occurring in the market. Last year, RXR Realty gave the keys to 61 Broadway back to the banks that had made a $240 million loan in 2019. The 33-story office building built in 1914 was 59% occupied, a May 26 Globest *article* reported.

RXR already took its equity out of the building in 2016 when it sold a 49% stake to China Orient Asset Management. But it decided to turn over the building and other older properties it owned, deeming them obsolete in the current market environment. "RXR has decided not to invest in its older buildings unless it can find a way to convert them to another use—most likely residential—or has determined in its evaluation that the asset can still prosper as a low-rent alternative to newer office buildings," the article reported.

But that's not to say the firm isn't looking for opportunities. RXR is partnering with Ares

Management on a joint venture to invest $500 million in New York's distressed office properties, a February 6, 2024 CoStar News *article* reported. Those with dry powder are in the catbird seat.

(4) *Will banks muddle through?* Fed Governor Lisa Cook delivered a *speech* yesterday titled "Current Assessment of Financial Stability." CRE was included among a handful of risks that she's monitoring.

As of Q4, banks held a bit more than half of the $6 trillion in outstanding debt backed by CRE (*Fig. 6*). CRE loans make up about 5% of assets at large banks, slightly below where the percentage has stood over the past 20 years. More concerning: CRE loans make up about 30% of assets at small banks, which is toward the high end of the 20-year range.

"Those high concentrations have caused us to step up our supervisory work with community and regional banks that have significant CRE concentrations and to augment our regulatory data for this sector," said Cook. "For instance, data available from SEC Form 10-Q filings suggest that office exposures account for a small share of most regional banks' CRE loans. All told, I view CRE risks currently as sizable but manageable, and I will be paying close attention to the sector in the short and medium run."

We can only hope she's right.

Disruptive Technologies: Blowing Hot Air. Engineers are working to develop long-duration energy storage to even out the intermittent flow of energy generated by solar panels and wind turbines. Hydrostor has developed a system that uses compressed air to store energy for eight hours or longer. It has come up with a novel system that is more efficient than older plants being used in Germany and Alabama. Likewise, China has introduced compressed air energy storage systems.

Here's a look at these advancements in energy storage:

(1) *How it works.* In the Hydrostor system, surplus electricity powers a compressor, which produces hot compressed air. The heat is extracted from the air and captured in a "thermal management system." The compressed air is then pumped underground, where it pushes water up a shaft into a reservoir. When energy is needed, the reservoir water is released down into the cavern, which pushes the condensed air to the surface. There, the condensed air mixes with the stored heat and turns turbines to generate electricity. A nifty diagram in a May 2 Inside Climate News *article* illustrates the process.

The Toronto-based company plans to install a project in Australia that will discharge 200 megawatts of electricity for up to eight hours. Construction begins at the end of this year, and it should be running by mid-2027, the article stated. The company also plans a project in California that will generate 500 megawatts of electricity, also for eight hours. The project is still working on permits but aims to begin construction next year. California estimates that it will need 4 gigawatts of long-term energy storage as part of its goal of using 100% clean electricity by 2045.

(2) *Older plants at home and abroad.* Both Germany and Alabama have compressed air plants to store energy, but they aren't as efficient as what Hydrostor is proposing. The older plants release the heat created when the air is compressed into the atmosphere. Then when the compressed air is released, the plants burn natural gas to produce the heat necessary, a December 2, 2021 Inside Climate News *article* explained.

(3) *China's bigger plants.* The world's largest condensed air storage plant is currently in China's Shandong Province. The plant is able to generate 300 megawatts of electricity for six hours. It claims to have the highest efficiency and lowest cost as well, reported a May 6 *article* in *China Daily.* The country built another, smaller compressed air plant two years ago in northern China.

Calendars

US: Thurs: Initial Claims 211k; Fed's Balance Sheet. **Fri:** University of Michigan Consumer Sentiment 76.3; Federal Budget Balance $265.5b; Baker-Hughes Rig Count; WASDE Report; Barr; Bowman; Goolsbee. (FXStreet estimates)

Global: Thurs: BoE Interest Rate Decision 5.25%; Japan Leading & Coincident Indicators; Japan Household Spending -0.3%m/m/-2.3%y/y; De Guindos; McCaul; Bailey; Pill. **Fri:** Italy Industrial Production 0.3%; UK GDP 0.1%m/m/0.4%q/q; UK Industrial & Manufacturing Production -0.5%/-0.5%; Canada Employment Change 20.9k; Unemployment Rate 6.2%; China CPI & PPI 0.1%& -2.3% y/y; Elderson; Pill; Dhingra. (FXStreet estimates)

Strategy Indicators

Stock Market Sentiment Indicators (***link***): The *Bull-Bear Ratio* rose for the second week to 2.67 this week, after falling from 4.43 five weeks ago—which was the highest reading since February 5, 2018—to 2.15 two weeks ago. *Bullish* sentiment slipped for the second week to 50.0%, after retreating the previous three weeks from 62.5% to 46.2%, which was the lowest percentage since late October. Meanwhile, *bearish* sentiment slipped for the second week to 18.7% this week, after climbing to 21.5% two weeks ago from 14.5% in each of the prior two weeks; it was at 14.1% five weeks ago—which was the fewest bears since 12.6% in late January 2018. The *correction count* fell to 31.3% this week after climbing the prior four weeks from 23.4% to 33.3%, which was the highest since early October 2023. Turning to the *AAII Sentiment Survey* (as of May 2), optimism among individual investors about the short-term outlook rose during the latest reporting week, while pessimism and neutral sentiment decreased. The *percentage expecting stock prices to rise over the next six months* rebounded 6.4ppts to 38.5%, above its historical average of 37.5% for the 25th time in the past 26 weeks, after dipping below last week. The *percentage expecting stocks to fall over the next six months* fell 1.4ppts to 32.5%, with pessimism above its historical average of 31.0% for the third consecutive week. The *percentage expecting stock prices will stay essentially unchanged over the next six months* dropped 4.9ppts to 29.0%, falling below its historical average of 31.5% for the fifth time in seven weeks.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin rose 0.2pt w/w to an 18-month high of 13.1% during the May 2 week. That's up from a 24-month low of 12.3% during the March 30, 2023 week and just 0.3pt below its record high of 13.4% achieved intermittently in 2022 from March to June. It's now 2.8pts above its seven-year low of 10.3% during April 2020. Forward revenues rose 0.4% w/w to a new record high. Forward earnings jumped 1.5% w/w to a new record high as well. 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 rose 0.1pt w/w to an 18-month high of 5.3%. It has gained 3.0pts 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 jumped 0.5pt w/w to a 30-month high of 12.1%. It's now 8.8pts above its 31-month low of 3.3% during the February 16, 2023 week. 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 4.5% in 2024 (unchanged w/w) and 5.7% in 2025 (unchanged w/w) compared to a revenues gain of 2.2% in 2023. They expect an earnings gain of 10.2% in 2024 (up 0.6pt w/w) and a 14.0% rise in 2025 (down 0.2pt w/w) compared to an earnings gain of 2.3% in 2023. Analysts expect the profit margin to rise 0.7ppt y/y to 12.6% in 2024 (up 0.1pt w/w), compared to 11.9% in 2023, and to rise 1.0ppt y/y to 13.6% in 2025 (up 0.1pt w/w). The S&P 500's weekly reading of its forward P/E fell 0.5pt w/w to a 15-week low of 19.7 and is down from a 26-month high of 21.1 at the end of March. That's 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 a 13-week low of 2.58 and is down from a 25-month high of 2.71 at the end of March. 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 11 S&P 500 sectors during the May 2 week, ten had forward revenues that rose w/w, and all 11 had forward earnings that moved higher. This led to a broad gain in forward profit margins too, as ten sectors moved higher w/w on that measure. Six sectors have forward revenues at post-pandemic or record highs this week: Communication Services, Consumer Staples, Health Care, Industrials, Information Technology, and Real Estate. Among the remaining five sectors, Consumer Discretionary and Utilities are less than 1.7% from their recent record highs and only three have forward revenues more than 5.0% below their post-pandemic highs: Energy, Financials, and Materials. When adjusted for the incoming transfer of five former Tech sector firms in March 2023, Financials' forward revenues would be at a record high. Five sectors have record-high forward earnings this week: Communication Services, Consumer Discretionary, Consumer Staples, Industrials, and Information Technology. Utilities was in that camp in very recent weeks, and Financials would be too when adjusted for GICS changes in March 2023. Among the remaining four sectors, two have forward earnings down more than 10.0% from their post-pandemic highs: Energy and Materials. Looking at the forward profit margin, nearly all of the sectors are showing signs of recovering from their early 2023 forward profit margin lows. Communication Services, Consumer Discretionary, and Information Technology are the only sectors with their forward profit margin at a record high this week. In recent weeks, Industrials was in that camp as well. Energy's forward margin is improving now from its 23-month low of 10.4% in February, 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 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 (26.6%, a new record high this week), Financials (18.9, down from its 19.8 record high in August 2021), Communication Services (17.8, up 0.7pt w/w to a new record high this week), Real Estate (16.6, down from its 19.2 record high in 2016), Utilities (13.8, down from its 14.8 record high in April 2021), S&P 500 (13.1, up 0.2pt w/w to an 87-week high, but down from its record high of 13.4 achieved intermittently in 2022 from March to June), Materials (11.0, up 0.2pt w/w to a 28-week high, but down from its 13.6 record high in June 2022), Energy (10.9, down from its 12.8 record high in November 2022), Industrials (10.7, down from its 10.8 record high in early April), Consumer Discretionary (19.0, up 0.2pt w/w to a new record high this week), Health Care (8.6, up 0.1pt w/w from a record low and down from its 11.5 record high in February 2022), and Consumer Staples (6.9, down from its 7.7 record high in June 2020).

Global Economic Indicators

Germany Industrial Production (*link*): German industrial production fell for the first time this year, though the decline was less than expected. Germany's *industrial production* measure, which includes construction, fell 0.4% March (vs -0.6% expected), after rebounding 3.0% the first two months of the year. *Excluding energy and construction*, production also fell 0.4%, as a 4.2% drop in energy output more than offset a 1.0% gain in construction output. *Within industry*, March's decline was led by declines in consumer (-1.4%) and intermediate (-0.6) goods output, while capital (0.1) goods production was little changed. Overall output fell 3.3% y/y, narrowing from February's 5.3% drop. Germany's industrial production report comes on the heels of the factory orders report showing that Germany *factory orders* unexpectedly declined 0.4% in March as *domestic demand* (-3.6%) sank, although *foreign orders* (2.0) rose—led by a double-digit gain in orders from within the Eurozone (10.6%); orders from outside the Eurozone (-2.9) contracted. Meanwhile, Germany's M-PMI remained deep in contractionary territory at the start of Q2, though April's (42.5) M-PMI showed a slight easing from March's (41.9) rate of decline.

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