July 25, 2024

Morning Briefing

Large Caps & Electric Trucks

Check out the accompanying chart collection.

Executive Summary: Expectations of Fed easing have turbocharged small- and mid-cap stocks: The S&P 400 MidCaps and S&P 600 SmallCaps have left the S&P 500 in the dust over the past two weeks. Today, Jackie points out the huge advantages that large caps have over their smaller counterparts, including the financial flexibility afforded by hordes of cash as well as better prospects for revenues, earnings, and profit margins. … In our Disruptive Technologies segment: a look at the fraught road ahead for electric truck adoption as well as the opportunities some manufacturers see.

Strategy: Beware Whiplash. Small- and mid-capitalization stocks are having a moment, with the S&P 400 MidCap index and S&P 600 SmallCap index up 8.9% and 4.7%, respectively, from July 10 through Tuesday's close. Their performances have far outpaced that of the S&P 500 LargeCap index over the same period, down 1.4% (*Fig. 1*). Investors and analysts are hopeful that the end of the Federal Reserve's tightening cycle will bring better days for smaller companies, particularly those that rely on debt to fund operations.

We're not convinced. Larger companies—particularly in the technology sector—have advantages that their smaller counterparts can't replicate. Notably, S&P 500 companies have both large stockpiles of cash and highly valued stock. According to their latest quarterly financial statements, Alphabet has $111 billion of cash and short-term investments on its balance sheet, while Amazon has $87 billion, Microsoft $80 billion, Apple $67 billion, and Meta $58 billion.

Large-cap companies' cash hordes make it possible to fund the huge capital expenditures and R&D budgets necessary to maintain a competitive advantage in today's world. This has become particularly important during the development of artificial intelligence. Data centers and Nvidia chips aren't cheap. Google announced that it spent $13 billion in Q2 alone on capital expenditures, and it expects to spend $12 billion or more in each of the remaining quarters of this year. It's tough for small companies to compete with that financial fire power.

Large companies’ financial flexibility also makes it easier to acquire smaller companies with important new technology or business lines. Microsoft didn’t bat an eye when investing $10 billion in OpenAI, the developer of ChatGPT last year. Small companies are being acquired by global buyout shops as well, which are sitting on record amounts of dry powder: $1.2 trillion in 2023, up from $800 billion in 2019, according to a March 11 Bain & Co. *report*. That capital has been piling up faster than worthy acquisition targets can be found. More than a quarter of buyout shops’ capital has been sitting around uninvested for four years or more, up from 18% in 2019.

All this leads us to wonder whether the fastest growing, highest potential companies have already found dance partners, making them either part of large-cap companies or owned by private equity investors. That, of course, implies that the laggards are left to trade in the S&P 400 and S&P 600—suggesting that investors will return to larger-cap alternatives sooner rather than later.

Here's a look at some of the statistics behind the rotation into small- and mid-cap stocks:

(1) *Big stocks poised for better revenues growth.* The S&P 400 MidCaps had the strongest forward revenues-per-share growth from 2021 through 2023 among the three cap-size S&P indexes. (“Forward” revenues is industry analysts’ consensus revenues forecast as calculated for the coming 12 months, by time-weighting their annual estimates.) But since late 2022, the forward revenues growth of both it and the S&P 600 SmallCaps has plateaued, while the S&P 500’s has kept climbing (*Fig. 2*).

(2) *Big stocks poised for better earnings growth.* The forward operating earnings per share of the S&P 600 SmallCaps and S&P 400 MidCaps have been flat to down y/y over the past three years and haven’t made new highs since June 2022. Meanwhile, the S&P 500’s forward operating earnings per share has risen sharply, by 13.3% y/y and has been hitting new record levels since September 2023 (*Fig. 3*).

Just as importantly, the S&P 500’s Information Technology sector and its Communication Services sector are expected to produce earnings growth as great or greater than the earnings growth forecast for those sectors in the S&P 400 and S&P 600. That's important because the Information Technology and Communication Services sectors have a much larger impact on the S&P 500 than they do for the smaller-cap indexes.

The Information Technology sector's market capitalization is 31.9% of the S&P 500, but

only 9.5% of the S&P 400 and 12.9% of the S&P 600 (*Fig. 4*). Likewise, the Communication Services sector represents 8.9% of the S&P 500's market capitalization, but only 1.6% of the S&P 400 and 2.8% of the S&P 600 (*Fig. 5*).

Conversely, two sectors in the S&P 400 MidCap that might have earnings growth that's faster than the same sectors in its larger-cap counterpart are Consumer Staples and Energy. But they are far smaller contributors to the indexes (*Fig. 6* and *Fig. 7*).

Here's the performance derby for the three indexes' 11 sectors' forecasted forward earnings growth: Communication Services (S&P 400: 6.3%, S&P 500: 16.1%, S&P 600: -53.9%), Consumer Discretionary (10.2, 13.6, 14.3), Consumer Staples (12.3, 5.8, 6.7), Energy (15.2, 3.6, 7.3), Financials (10.5, 9.8, 7.2), Health Care (13.6, 14.9, 34.6), Industrials (9.4, 11.8, 20.3), Information Technology (19.3, 20.8, 20.9), Materials (5.7, 9.4, 7.5), Real Estate (8.6, 5.9, 182.3), and Utilities (6.3, 10.0, 3.9).

(3) *Big stocks poised for better for margins.* Large-cap stocks are also producing wider forward profit margins. The S&P 500's forward profit margin was 13.3% as of July 18, compared to the 6.4% margin of the S&P 600 SmallCaps and the 8.4% margin of the S&P 400 MidCaps (*Fig. 8*). We calculate forward profit margins by dividing analysts' expected forward operating earnings per share by their expected forward revenues per share.

(4) *Yet big guys aren't feeling the love.* Large caps also have been receiving the most love from investors—until recently, of course. The S&P 500's forward P/E was 20.9 as of Tuesday's close, roughly five percentage points higher than the S&P 600 SmallCaps' forward P/E, 14.9, and the S&P 400 MidCaps' multiple of 15.4 (*Fig. 9*). The SmallCaps and MidCaps have underperformed the S&P 500 for most of the past decade (*Fig. 10*).

Normally, we'd grow concerned that a high P/E might be a contrarian indicator. However, the S&P 500 as a percent of the total value of US stocks is lower than it has been historically. At 51.6% currently, it isn't far from its low of 46.5% hit in Q3-2013. Yet it is far from the highs that marked the top of the dot.com bubble in Q1-1999 (64.6), and it's nowhere near the high of 68.8 reached in the early 1980s (*Fig. 11*).

Disruptive Technologies: Electric Trucks in the Slow Lane. Adopting electric trucks, while fine in theory, has been problematic in practice. They're expensive to buy and operate, and recharging stations are few and far between. Moreover, the fate of federal regulations pushing to reduce emissions from trucks—which were expected to boost the adoption of electric and hydrogen trucks—is uncertain after the recent Supreme Court ruling

that overturned the Chevron doctrine.

Indeed, fewer electric trucks are being bought this year than last if Volvo Group's experience is typical. The company recently *reported* that 1H-2024 saw a 14% y/y decline in net orders of fully electric trucks, to 1,293.

That said, slow progress toward more electrified trucking is occurring. Longer lasting, more powerful batteries are being designed, and infrastructure is very slowly being rolled out. Let's take a look at some of the developments:

(1) *Better batteries.* Daimler Trucks, Accelera by Cummins, and PACCAR have a joint venture, Amplify Cell Technologies, that began building a 2-million-square-foot factory to build lithium-iron-phosphate battery cells for commercial electric trucks in Mississippi. The plant, which should begin production in 2027, is expected to cost between $2 billion and $3 billion.

The JV claims the batteries they produce will be lower cost and longer lived than current batteries, and they won't require nickel or cobalt. Each of the three companies will have a 30% take, and China-based EVE Energy, the technology partner, will have a 10% ownership stake, a July 2 Electrek *article* stated.

Meanwhile, some companies have received grants from the Department of Energy to convert part of their existing plants to manufacture electric trucks and/or parts. Volvo Technology of America received a $208 million award to update its plants in Pennsylvania and Virginia so they can build heavy-duty electric trucks and powertrains in addition to the traditional trucks they already produce. The facilities will also be converted to zero-emission sites, a July 22 AutomotiveDive *article* reported.

ZF Axl Drives Marysville received $158 million to convert part of its combustion engine driveline component production to produce EV components. And a grant for $75 million was given to Cummins to retrofit part of its Columbus, Indiana plant to produce zero-emission components and electric powertrain systems.

(2) *Better charging.* The Technical University of Munich and its partners from research institutions and industry have developed a megawatt charger that can juice up long-distance cargo trucks to run for 4.5 hours in 45 minutes, which is the required break time for German drivers, a July 23 *article* in Trans.info reported.

Another research organization believes the development of long-distance shipping via electric trucks will occur only if chargers are installed every 50 kilometers. Doing so would allow for easy access to chargers and allow trucks to carry smaller, lighter batteries.

Separately, the German government is going to hold auctions in September for the right to set up electric truck charging infrastructure along the country's infamous Autobahn. Electric vehicles make up just 2.1% of Germany's commercial truck fleet.

Back in the US, the New Jersey Department of Environmental Protection (DEP) received a $250 million federal grant to apply toward installing electric truck charging stations along Interstate 95. New Jersey is part of the Clean Corridor Coalition, which aims to install chargers for commercial and medium to heavy electric trucks along the highway in Connecticut, Delaware, and Maryland, a July 22 *article* in NJ.com reported. The NJ DEP was one of 25 applicants to receive funding, which is part of the Biden administration's Inflation Reduction Act.

(3) *Supreme Court uncertainty.* Earlier this year, the Environmental Protection Agency (EPA) announced a new rule that was expected to encourage the adoption of electric trucks by limiting the amount of pollution generated by a manufacturer's truck lineup beginning in 2027, a March 29 *NYT* *article* reported. The rule would allow manufacturers to determine how to meet the new standards, giving them the option to produce hybrids, hydrogen, and/or electric trucks or to increase the fuel efficiency of traditional trucks.

However, the rule's adoption may be challenged after the Supreme Court's recent decision to limit the deference to federal agencies' regulatory authority, widely known as the "Chevron deference." The Supreme Court decision may make it easier to challenge the EPA's rule and push legislators to enact new rules to achieve the same goal. Eleven states have enacted regulations that are tougher than the EPA rules, requiring that half of all new heavy-duty vehicles sold be all-electric by 2035, the *NYT* noted.

Calendars

US: Thurs: GDP & GDP Price Index 1.9%/2.6%; Durable Goods Orders Total & Core 0.4%/0.2%; Kansas City Manufacturing Survey; Initial Jobless Claims 239k. **Fri:** Personal Income & Spending 0.4%/03%; Headline & Core PCED 0.1%/0.2%; Consumer Sentiment Headline, Current Conditions, and Expectations 66.0/64.1/67.2; University of Michigan One-Year & Five-Year Inflation Expectations 2.9%/2.9%; Baker-Hughes Rig Count. (FXStreet

estimates)

Global: **Thurs:** Germany Ifo Business Climate Index 88.9; Eurogroup Meetings; Lagarde; Nagel. **Fri:** Japan Leading & Coincident Indicators 0.2%/1.3%; France Consumer Confidence; Spain Unemployment Rate 11.4%; BoE Quarterly Bulletin. (FXStreet estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The *Bull-Bear Ratio* rose for the second week, jumping to a 16-week high of 4.31 this week, up from 3.50 two weeks ago. It was at 4.43 16 weeks ago—which was the highest reading since February 5, 2018. *Bullish sentiment* climbed for the second week from 62.7% to 64.2% this week, exceeding the end of March's peak rate of 62.5% for the most bulls since late 2020. Meanwhile, *bearish sentiment* fell for the second week, from 17.9% to 14.9% this week, which again was the fewest bears since just 14.1% in late March 2024 (which also saw the last high for the bulls, which was just exceeded). The *correction count* edged up for the second week from 19.4% to 20.9%, at the upper end of the narrow range around 20% of the last seven weeks. Turning to the *AAII Sentiment Survey* (as of July 18), neutral sentiment among individual investors about the short-term outlook for stocks decreased during the latest week, while both optimism and pessimism increased. *Bullish sentiment* jumped 3.6ppts to 52.7%—unusually high for the second straight week; the latest reading is above its historical average of 37.5% for the 36th time in 37 weeks and the highest since December 21, 2023 (52.9%). *Bearish sentiment* increased 1.7ppts to 23.4%—remaining below its historical average of 31.0% for sixth successive week. Neutral sentiment sank 5.3ppts to 23.8% below its historical average of 31.5% for the 11th time in 18 weeks. It was last slower on October 12, 2023 (23.5%).

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin remained steady w/w at a 25-month high of 13.3% during the July 18 week. That's up from a 24-month low of 12.3% during the March 30, 2023 week and just 0.1pt below its record high of 13.4% achieved intermittently in 2022 from March to June. It's now 3.0pts above its seven-year low of 10.3% during April 2020. Forward revenues rose less than 0.1% w/w to a hair below its record high during the July 4 week. Forward earnings rose 0.1% w/w to a new record high. It had hit that mark during the September 21, 2023 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 remained steady w/w at a 21-month high of 5.6%. It has gained 3.3pts 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 was unchanged w/w at a 33-month high of 13.2%. It's now 9.9pts 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 at 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 4.7% in 2024 (unchanged w/w) and 5.9% in 2025 (up 0.1pt w/w) compared to a revenues gain of 2.2% in 2023. They expect an earnings gain of 10.3% in 2024 (unchanged w/w) and a 14.9% rise in 2025 (unchanged w/w) compared to an earnings gain of 2.5% in 2023. Analysts expect the profit margin to rise 0.7ppt y/y to 12.6% in 2024 (unchanged w/w), compared to 11.9% in 2023, and to rise 1.0ppt y/y to 13.6% in 2025 (unchanged w/w). The S&P 500's weekly reading of its forward P/E fell 0.2pts w/w to 21.4 from a 31-month high of 21.6. 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 0.02pts w/w to 2.84 from a 31-month high of 2.86. That's up from a six-month low of 2.22 during the October 26, 2023 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 July 18 week, forward revenues and earnings rose for five sectors. This led to rising forward profit margins w/w for eight of the 11 sectors. These three sectors had forward revenues at a record or post-pandemic high this week: Communication Services, Health Care, and Information Technology. Financials' forward revenues would be at a record high too when adjusted for the incoming transfer of five former Tech sector firms in March 2023. Five sectors remain less than 1.0% below their recent post-pandemic highs: Consumer Discretionary, Consumer Staples, Industrials, Real Estate, and Utilities. The two remaining sectors have forward revenues more than 5.0% below their post-pandemic highs: Energy and Materials. Two sectors have record-high forward earnings this week: Communication Services and Information Technology. Financials would be too adjusted for GICS changes in March 2023. Just two sectors still have forward earnings down more than 21.2% from their post-pandemic highs: Energy and Materials. Four sectors are less than 1.0% from their recent record highs in forward earnings: Consumer Discretionary, Consumer Staples, Industrials, and Utilities. The remaining two sectors, Health Care and Real Estate, are 6.8% and 3.3% below their highs. Looking at the forward profit margin,

nearly all of the sectors are showing signs of recovering from their early 2023 forward profit margin lows. Information Technology is the only sector with a forward profit margin at a record high this week. In recent weeks, Communication Services, Consumer Discretionary, and Industrials were in that camp as well. Energy's forward margin is not much above its 23-month low of 10.4% in February, while those of Consumer Staples and Health Care remain at or slightly above 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 (27.3%, record high), Financials (19.2, up 0.1pt w/w and down from its 19.8 record high in August 2021), Communication Services (17.8, record high), Real Estate (17.2, up 0.1pt w/w and down from its 19.2 record high in 2016), Utilities (14.0, down from its 14.8 record high in April 2021), S&P 500 (13.3, a 25-month high and just 0.1pt below its record high of 13.4 achieved intermittently in 2022 from March to June), Materials (11.6, up 0.4pt to a 20-month high and down from its 13.6 record high in June 2022), Energy (10.6, down 0.1pt w/w from its recent six-month high of 10.9 and down from its 12.8 record high in November 2022), Industrials (10.8, matches its prior record high from September 2023), Consumer Discretionary (9.1, a record high this week), Health Care (8.7, up 0.2pts from its record low at the end of April 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).

US Economic Indicators

New Home Sales (*link*): New home sales (counted at the signing of a contract) slumped to a seven-month low as home buyers continue to deal with an unaffordable housing market. *New home sales* fell for the second month in June, by 0.6% m/m and 15.5% over the period, to 617,000 units (saar), sinking to its lowest level since November and below the consensus estimate of 640,000 units. June sales were 7.4% below year-ago levels. At June's sales pace, it would take 9.3 months to clear the *supply of houses* on the market, up from 9.1 months in May and 7.7 months in April. *Regionally*, sales rose in the West (+1.4% to 149,000 units, saar) and South (+0.3 to 375,000) and fell in the Northeast (-7.7 to 12,000) and Midwest (-6.9 to 81,000). Of the 617,000 *homes sold* in June, 299,000 were completed, 244,000 were under construction, while 74,000 weren't started. Of the 476,000 *homes for sale* during June, 102,000 had been completed, 274,000 were under construction, and 100,000 hadn't yet broken ground.

Global Economic Indicators

US PMI Flash Estimates (*link*): Business activity in the US accelerated at its fastest pace since April 2022 in July, according to flash estimates, led by the service sector, while the manufacturing sector lost momentum; price pressures cooled. The *C-PMI* (to 55.0 from 54.8) reached a 27-month high this month, with output rising for the 18th consecutive month, as the pace of expansion improved markedly in recent months after slowing in June. The NM-PMI (56.0 from 55.3) advanced to a 28-month high, while the *M-PMI* (49.5 from 51.6) fell to a seven-month low, slipping back below the 50.0 breakeven point between expansion and contraction for the first time since December. The M-PMI (49.5 from 52.1) *output measure* fell to a six-month low. According to the report, the overall C-PMI is running at a level broadly consistent with the economy growing at an annualized rate of 2.5%. Turning to pricing, the July survey showed *input costs* accelerated, due to rising raw materials, shipping, and labor costs, warning that these costs could feed through to higher *selling prices* if sustained or cause a squeeze on margins.

Eurozone PMI Flash Estimates (*link*): "Eurozone economic recovery fades further in July" was the headline of July's flash estimate report. The *Eurozone's C-PMI* eased to a five-month low of 50.1 in July from 50.9 in June, with the M-PMI (45.6 from 45.8) sinking to a seven-month low—as did the manufacturing output index (45.3 rom 46.1). The NM-PMI (51.9 from 52.8) slipped to a four-month low, though remained in expansionary territory. Looking at the two largest Eurozone economies, *Germany's C-PMI* (to 48.7 from 50.4) slipped into contractionary territory this month, with the M-PMI (42.6 from 43.5) sinking to a three-month low and the M-PMI Output Index (42.2 from 45.1) to a nine-month low. The NM-PMI (52.0 from 53.1) remained above the breakeven point of 50.0, though slipped to a four-month low. *France's* private sector came close to stabilizing in July, with its C-PMI (to 49.5 from 48.2) falling just short of 50.0. The NM-PMI (50.7 from 48.8) moved back into expansionary territory, while both the M-PMI (44.1 from 45.3) and M-PMI Output Index (44.1 from 45.3) both falling to six-month lows. *Growth in the rest of the region* continued to outperform the two largest Eurozone economies, though the increase in output was the slowest since January. Turning to pricing, *input* prices in the overall Eurozone accelerated to a three-month high, with the latest rise sharper than the series average. Meanwhile, *output* prices rose at a softer pace as falling demand limited company pricing power. The report noted that the patterns were broadly similar across Germany, France, and the rest of the Eurozone.

Japan PMI Flash Estimates (*link*): Private-sector activity in Japan returned to growth in

July. The *C-PMI* (to 52.6 from 49.7) moved back above 50.0 this month, as the NM-PMI (53.9 from 49.4) returned to growth, with the measure climbing to a three-month high. Service providers experienced a solid rise in new business. Meanwhile, the M-PMI (49.7 from 50.4) fell back below the breakeven point of 50.0, falling at its fastest pace since February. Meanwhile, there were positive movements in employment, as both manufacturing and services companies experienced a sustained rise in headcounts and staffing levels rose for the tenth successive month. Turing to pricing, input prices remained stubbornly high this month, mostly among manufacturers, who posted the steepest rise in cost burdens since April 2023.

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