Yardeni Research

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Morning Briefing

On Homebuilders, China & AI

Check out the accompanying chart collection.

Executive Summary: The interest-rate-sensitive S&P 500 Homebuilding industry index counterintuitively sank after the Fed launched its new easing cycle; the stocks had already rallied in anticipation of the move. Jackie examines whether the correction was warranted. The industry's forward revenues and earnings are historically high, and KB Homes reported a decent August quarter. But do valuations capture the potential new competition from existing homes amid lower mortgage rates? … Also: China has been trying to stimulate its economy with a raft of new measures. But several business- and consumer-unfriendly government policies undermine its objectives. … And a look at the surprising underperformance of the largest AI-investing ETFs.

Consumer Discretionary: What's Priced into Homebuilders Stocks? Last week, the Federal Reserve kicked off an interest-rate-cutting cycle by reducing the federal funds rate by 50bps. The futures market is anticipating another roughly 200bps of interest-rate cuts over the next 12 months (*Fig. 1*). Consumers have already begun to respond. Mortgage refinancings rose more than 20% w/w and 175% y/y off of historically low levels. Home purchase applications rose only 1.4% w/w and was up 2.0 y/y, again off of historically low levels (*Fig. 2*).

In a classic case of "buy the rumor, sell the news," interest-rate-sensitive stocks may already have priced in the benefit of future rate cuts. The sharp gain in the S&P 500 Homebuilding industry's stock price index is telling: 29.8% ytd through Tuesday's close, nearly 50% higher than the S&P 500's 20.2% ytd climb (*Fig. 3*). Following the Fed's announcement last Wednesday, however, the Homebuilding index has underperformed, falling 0.7% from its close the day before the Fed's announcement through Tuesday compared to the S&P 500's 1.7% increase.

Analysts are optimistic about the industry's future. They're calling for revenues growth of 5.1% this year and 6.6% in 2025 and earnings growth of 7.3% and 8.2% in 2024 and 2025 (*Fig. 4* and *Fig. 5*). Forward revenues has finally surpassed the last peak, prior to the housing bust in 2006 (*Fig. 6*). Forward earnings has far surpassed 2006 levels and has almost surpassed the peak near end of the pandemic, when it seemed that everyone wanted a home with more space (*Fig. 7*).

Let's take a look at what KB Home executives had to say on Tuesday's earnings *conference call* about its fiscal Q3 (ended August):

(1) *Strong growth misses the mark.* KB Home reported a 10.4% y/y increase in revenues and also boosted its 2024 housing revenue forecast to $6.85 billion to $6.95 billion, up from a prior range of $6.7 billion to $6.9 billion. KB forecasted an 8.7% y/y increase in 2025 housing revenue to about $7.5 billion.

KB's stock sold off in aftermarket trading, nonetheless. The company's earnings per share (EPS) of $2.04 missed analysts' target by two cents. And while share buybacks boosted EPS growth to 12.9% y/y, KB Home's net income increased only 4.9%.

Also of possible concern: Net orders for new homes were largely unchanged y/y, at 3,085, with declines in the Southwest and the Southeast offset by increases in the West Coast and Central US regions. The backlog of 5,724 was down 18.3% y/y.

(2) *Demand improved in August.* Demand began to soften in late June through July as interest rates remained elevated and concerns about the economy increased. The company adjusted its pricing to "hold its pace" of sales. In August, interest rates moderated, demand strengthened, and weekly net orders improved sequentially in each of the month's last three weeks.

"We continue to see solid sales quarter-to-date in September," said CEO Jeffrey Mezger on the earnings conference call. The Fed's interest-rate cut should further "benefit consumer confidence and affordability." KB Home reduced mortgage concessions offered to buyers in August and expects to further reduce concessions in the current quarter because lower interest rates have improved home affordability. The gross margin should improve as a result.

(3) *Stocking up on land.* KB spent $845 million on land acquisition and development, a 50% y/y increase. Of that amount, more than $425 million was used to acquire new land. The company's lot position is up 21% y/y, and its community count at the end of Q3 was up 10% y/y.

While housing inventories are ticking up for the overall housing market, homes are selling pretty quickly in most markets. And in the market for affordable homes where KB competes, inventory remains "pretty limited." There's currently a 4.2 months' supply of homes in the entire market (not just for affordable homes), up from 1.6 months at the low in January 2022 (*Fig. 8*). (That is, it would take 4.2 months to sell all of the homes for sale assuming the current pace of sales.)

After rallying sharply this year, homebuilders' stock prices may not reflect the risk that low interest rates could prompt existing homeowners who were previously reluctant to relinquish low-rate mortgages to list their homes, resulting in a surge of inventory that competes with the homebuilders' new homes.

China: Close, But No Cigar. On Tuesday, China announced a raft of policies aimed at boosting the economy and encouraging consumption. The People's Bank of China (PBoC) cut its seven-day reverse repo rate from 1.7% to 1.5%. The central bank will also cut the amount of funds that lenders must hold in reserve by 0.5ppt, with more cuts expected later this year. And regulators will recapitalize China's largest commercial banks; their margins and profits had been eroded by fee reductions and interest-rate concessions. On Wednesday, the central bank trimmed the cost of medium-term loans it provides to banks.

Regulators directly targeted the real estate market by lowering the down payment required on second homes from 25% to 15%. It will also offer better terms on loans to state-owned enterprises that are buying unsold apartment inventory from property developers. (The program launched in May has seen slow adoption, with local governments borrowing only Rmb24.7 billion out of the Rmb500 billion local banks made available, according to an August 20 *FT* article.)

The Chinese stock market received some love as well. Regulators will provide the equivalent of $71 billion to help brokers, insurance companies, and funds buy stocks. The PBoC will also provide $114 billion to help companies buy back shares. Stock investors applauded, sending the CSI 300 5.9% higher on Tuesday and Wednesday (*Fig. 9*).

The good that these policies do may be offset by Chinese government actions that chill the willingness of consumers and companies to spend and invest in the country.

China's recent threat to put Tommy Hilfiger's parent on the national security blacklist doesn't scream "come and invest in our country." Neither does the detainment of an economist who criticized leaders in a private online chat. And China's plan to increase its retirement age certainly won't improve consumer confidence or encourage people to start spending. It's almost as if China were writing a guidebook for economies on how to be one's own worst enemy.

Here's a deeper look at government policies that may hurt future business investment and consumer spending in China more than the PBoC's latest initiatives will help:

(1) *How to scare corporations.* China's commerce ministry has threatened to put PVH, the parent company of Calvin Klein and Tommy Hilfiger, on its national security blacklist for not purchasing cotton from its western Xinjiang region. The company has 30 days to defend itself against the accusation that it has been discriminating against Xinjiang-related products over the past three years.

What was PVH thinking? Merely that it wants to sell its China-made goods in US markets: The US bans goods made in Xinjiang unless importers can prove that they were not made using the forced labor of the Muslim Uyghur population. So China's blacklist threat places PVH between a rock and a hard place.

Five other companies are on China's national security blacklist, including Lockheed Martin and Raytheon Technologies due to their sale of weapons to Taiwan. But they have no business in China at risk. PVH, on the other hand, has stores and warehouses in China. If placed on the list, the company could "face fines, have its activities in China restricted, or face other unspecified penalties," a September 24 *FT* article reported.

(2) *How to scare CEOs.* Chinese officials placed a prominent Chinese economist under investigation and detention after his posts in a private chat group on WeChat criticized Xi Jinping's management of the economy. Zhu Hengpeng, who was the deputy director of the Institute of Economics at the state-run Chinese Academy of Social Sciences, was detained this spring, a September 24 *WSJ* article reported.

He joins a growing list of executives—both Chinese and foreign—that the country has detained. A senior executive from Taiwan's Formosa Plastics Group has been banned from leaving Mainland China since arriving in Shanghai earlier this month, a *South China Morning Post* article reported on September 19. The head of China Evergrande's electric vehicle unit was detained earlier this year. In 2023, more than a dozen senior executives went missing, faced detention, or were subject to corruption probes, a November 10 CNN article reported. When Jack Ma, perhaps China's most high-profile tech entrepreneur, disappeared from public view and underwent "supervisory interviews" in 2020 after criticizing the country's regulators and state-owned banks in a speech, it became instantly clear that no one was immune.

This high-risk environment combined with the sluggish economy have sharply cut venture capital (VC) fundraising and new startups being founded. In 2017, Rmb124.9 billion of VC funds were raised; last year only Rmb16.6 billion was, according to a September 12 *FT* *article*. Likewise, the number of new companies started peaked in 2018 at 51,302; it was down to 1,202 last year. The numbers are on track to fall further this year.

Foreign direct investment (FDI) into China has dropped sharply over the past year too. It peaked at $87.8 billion in Q2-2023 on a quarterly basis; it has subsequently fallen sharply and turned negative in the past two quarters. FDI fell to -$27.1 billion in Q2-2024 (*Fig. 10*).

(3) *How to depress consumers.* No one likes to be told that retirement is going to be later than expected, but that's what happened in China. Starting in January 2025, the retirement age for men in all jobs will jump from 60 to 63. For women in blue-collar jobs, the retirement age will rise from 50 to 55. For women in white-collar jobs, the retirement age will jump from 55 to 58.

The policy was changed because life expectancies have increased since the policy was established in the 1950s. The move will also increase the working population that pays into China's pension system, a September 24 Benzinga *article* explained. The pension system has come under pressure as China's birth rate has decreased and its population has aged, leaving fewer young working people to pay into the system to fund disbursements to retirees (*Fig. 11*).

The policy change will extend the life of the pension fund, which was estimated to run out of funds in 2035 if no action was taken. However, it could also exacerbate the high unemployment rate among young workers (*Fig. 12*). And it's unlikely to put either the old or young in a spending mood. China's consumer confidence was already depressed before the change was announced, at 86.0 versus a 105.9 average over time (*Fig. 13*).

Disruptive Technologies: AI & ETFs. Exchange-traded fund (ETF) companies seem to like nothing better than jumping on an investable trend. So we weren't surprised to learn that there are 41 ETFs with assets of $10.9 billion that invest based on AI themes, according to *etf.com*. We were surprised that these 41 funds' assets under management (AUM) aren't bigger. We were also surprised that the five largest ones collectively underperformed the S&P 500 both ytd and over the past three years.

Here are the five largest AI ETFs, their AUMs, and their ytd and three-year performances: Global X Robotics & Artificial Intelligence ($2.6 billion, 9.9%, -20.5%), Global X Artificial Intelligence & Technology ($2.2 billion, 17.5%, 15.9%), ROBO Global Robotics and Automation Index ($1.1 billion, -3.2%, -19.5%), ARK Autonomous Technology & Robotics ($748.8 million, 2.8%, -27.7%), and iShares Future AI and Tech ($607.7 million, 0.2%, -22.7%).

Many of the ETFs appear to be underperforming because AI and robotics investments are being lumped together. Robotics companies haven't fared nearly as well as AI poster child Nvidia.

The top performing large ETF in this category, Global X Artificial Intelligence & Technology, avoids robotics exposure and invests in developers of products incorporating AI systems, like software programmers and social media platforms. Its top holdings: ServiceNow, IBM, Alibaba, Oracle, and Meta.

Intelligent Alpha has created an ETF that uses AI to pick stocks. The fund, Intelligent Livermore ETF, uses ChatGPT, Claude, and Gemini as an investment committee. The committee is "taught" the investment practices used by great investors like Warren Buffett, predicts which investment style will perform best, and invests accordingly for long-term capital appreciation. Its top five holdings: PDD Holdings, Meta, Nvidia, Taiwan Semiconductor Manufacturing, and Procter & Gamble. And as you might expect, Intelligent Alpha has four more AI-powered ETFs slated to launch over the next three to six months.

Calendars

US: Thurs: GDP & GDP Price Index 3.0%/2.5%; Corporate Profits 1.7%q/q; Initial Claims 224k; Headline & Core Durable Goods Orders -2.8%/0.1%, Kansas City Manufacturing Index; Pending Home Sales 0.5%; Fed Balance Sheet; Powell; Barr; Williams; Collins; Bowman; Yellen. **Fri:** Personal Income & Spending 0.4%/0.3%; University of Michigan Consumer Sentiment Index Total, Current Conditions & Expectations 69.4/62.9/73.0; University of Michigan 1-Year & 5-Year Inflation 2.7%/3.1%; PCE Price Index 0.2%; Atlanta Fed GDPNow 2.9%; Wholesale Inventories 0.2%; Baker-Hughes Rig Count. (FXStreet estimates)

Global: Thurs: Germany Gfk Consumer Climate -22.6; Italy Business Confidence; Japan CPI; ECB Economic Bulletin; RBA Financial Stability Review; Lagarde; Schnabel; Buch;

Elderson; McCaul; De Guindos. **Fri:** Eurozone Business & Consumer Survey 96.5; Germany Unemployment Change & Unemployment Rate 13k/6.0%; France CPI -0.7%; Spain GDP 0.8%q/q/2.9%y/y; Spain CPI 1.9%y/y; Japan Leading & Coincident Indicators 0.4%3.0%; UK CBI Distributive Trade Survey -20; Lane; Nagel. (FXStreet estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The *Bull-Bear Ratio* climbed again this week to 2.29, after sinking from 2.42 to 1.92 two weeks ago—which was the lowest since November 2023. *Bullish sentiment* climbed 9.0ppts to 52.5% over the two-week period, after falling the prior two weeks from 53.2% to 43.5%—its lowest percentage since last August. Meanwhile, *bearish sentiment* was unchanged this week, at 22.9%, up 1.3ppts from 21.6% three weeks ago, remaining in a narrow range. The *correction count* fell for the second week, by 9.3ppts to 24.6%, after increasing the prior two weeks from 24.2% to 33.9%. In the *AAII Sentiment Survey* (as of September 19), bullish sentiment among individual investors about the short-term outlook for stocks increased during the latest week, while bearish and neutral sentiment decreased. *Bullish sentiment* jumped 11.0ppts to 50.8%, unusually high, and above its historical average of 37.5% for the 45th time in 46 weeks. *Bearish sentiment* sank 4.5ppts to 26.4%—below its historical average of 31.0% for the fifth time in six weeks. Meanwhile, while *neutral sentiment* dropped 6.5ppts to 22.8%, below its historical average of 31.5% for the 11th straight week.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin remained steady for a third straight week at a record high of 13.4% during the September 20 week. That's its first record since the June 9, 2022 week, and it is now 3.1ppts above its seven-year low of 10.3% during April 2020. Forward revenues ticked down 0.1% w/w, and forward earnings fell 0.3%. Revenues and earnings have been steadily making new record highs for just over 12 months now. That compares to its prior 16-month string of record highs from 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 5.7% and is down from a 23-month high of 5.8% during the August 1 week. It has gained 3.4ppts 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 down 0.2ppt w/w to 13.9% from a 35-month high of 14.1%. It's now 10.6ppts 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 4.6% in 2024 (down 0.1ppt w/w) and 5.7% in 2025 (down 0.1ppt w/w) compared to a revenues gain of 2.2% in 2023. They expect an earnings gain of 9.8% in 2024 (down 0.2ppt w/w) and a 15.1% rise in 2025 (down 0.1pt w/w) compared to an earnings gain of 2.5% in 2023. Analysts expect the profit margin to rise 0.6ppt y/y to 12.5% in 2024 (unchanged w/w), compared to 11.9% in 2023, and to rise 1.1ppts y/y to 13.6% in 2025 (unchanged w/w). The S&P 500's weekly reading of its forward P/E rose 0.3pt w/w to 21.1, and is up 1.4pts from a 14-week low of 19.7 during the August 8 week. It's now 0.5pt below its 31-month high of 21.6 during the July 11 week and is up 5.8pts 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 rose 0.04pt to 2.83, and is up 0.20pt from a 14-week low of 2.63 during the August 8 week. It's now 0.04pt from a 31-month high of 2.86 during the July 11 week. 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*): During the September 20 week, forward revenues rose for one of the 11 S&P 500 sectors and forward earnings rose for two sectors. This led to rising forward profit margins w/w for three sectors. None of the sectors posted record-high forward revenues this week. These six sectors had record-high forward revenues during the past few weeks: Communication Services, Consumer Staples, Health Care, Industrials, Information Technology, and Real Estate. 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. Energy and Materials are the biggest laggards at 5.4% and 12.8% below, respectively. None of the sectors have record-high forward earnings this week, down from these three sectors in that club a week earlier: Industrials, Information Technology, and Utilities. These five sectors are less than 1.8% below their recent records: Communication Services, Consumer Discretionary, Consumer Staples, Financials, and Real Estate. Health Care's forward earnings is 3.7% below its high and improving now after stalling since late 2022. Forward earnings remains depressed for Energy and Materials; both are more than 21.5% below their post-pandemic highs. Looking at the forward profit margin, 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 post-pandemic or record high this week. A week earlier, the Consumer Discretionary, Financials, and Industrials sectors were in that club. Among the laggards, Energy's forward margin has fallen 0.7ppt from its six-month high of 10.9% in mid-

June to a 30-month low of 10.2%; Consumer Staples' is 0.2ppt above its seven-year low of 6.7% in March 2023; and Health Care's is 0.3ppt above its 8.5% record low in April. 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 (27.6%, a record high this week), Financials (19.4, down from its 19.8 record high in August 2021), Communication Services (18.0, down from its 18.1 record high during the August 8 week), Real Estate (17.3, down 0.1ppt w/w and down from its 19.2 record high in 2016), Utilities (14.1, down from its 14.8 record high in April 2021), S&P 500 (13.4, a record high this week), Materials (11.2, down 0.1ppt w/w and down from a 20-month high of 11.6 in July and from its 13.6 record high in June 2022), Energy (10.2, down from a six-month high of 10.9 in June and its 12.8 record high in November 2022), Industrials (10.9, a record high this week), Consumer Discretionary (9.2, a record high this week), Health Care (8.8, up 0.3ppt 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) fell in August after a double-digit gain in July—to its highest level since early 2022. *New home sales* sank 4.7% in August to 716,000 units (saar), after jumping 10.3% in July to 751,000 units. At August's sales pace, it would take 7.8 months to clear the *supply of houses* on the market, up from 7.3 months in July. *Regionally*, sales fell in three of the four regions: Northeast (-27.3% to 24,000 units), West (-17.8 to 152,00), and the Midwest (-5.8 to 81,000), while only the South (+2.7 to 459,000) continued to post gains. Of the 716,000 *homes sold* in August, 372,000 were completed, 248,000 were under construction, while 96,000 weren't started. Of the 467,000 *homes for sale* during August, 105,000 had been completed, 260,000 were under construction, and 102,000 hadn't yet broken ground. *Looking ahead*, there are promising developments for home sales, with mortgage rates dropping for the eighth consecutive week—the longest stretch since 2018-19—while the Conference Board reports that the share of consumers planning to buy a home in the next six months rose to a one-year high this month.

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