MORNING BRIEFING
July 28, 2021

European Tour

Check out the accompanying chart collection.

(1) UK as a test case of virus variant vs vaccine. (2) Freedom vs mandates. (3) Economic Sentiment Indicator soaring in Eurozone. (4) Flash PMI highest in 21 years in Eurozone. (5) ECB following the Fed's lead on inflation targeting. (6) Like the Fed, ECB in no rush to tighten. (7) Better never than late? EU finally ready to provide pandemic fiscal stimulus. (8) EMU MSCI has been lagging US MSCI since last year's bottom. (9) US outpacing EMU in forward revenues and earnings race.

Europe I: UK Canary in a Coal Mine? What happens in the UK may be a litmus test for other advanced economies as the Delta variant spreads amid high vaccination rates. Nearly 90% of the adult population in the UK has received their first dose (more than 46 million people), and about 70% of adults have had both doses (more than 36 million). Cases are on the rise again in the UK, but hospitalizations and deaths remain relatively low. Whether or not UK hospitals get overwhelmed in coming weeks will be a bellwether for what's likely to occur in the rest of the vaccinated developed world as Delta spans the globe. Here's more:

(1) *New cases.* The highly contagious Covid-19 Delta variant is spreading rapidly in the UK. The 10-day moving average of new cases has soared from well below 10,000 at the beginning of June to above 40,000 (*Fig. 1*). New cases in France and Italy are also ticking up.

(2) *Hospitalizations.* Rising UK hospitalizations have yet to pick up steam as happened during previous pandemic peaks (*Fig. 2*). Italy's hospitalization downtrend may be bottoming, while France's hospitalizations remain on the decline for now. But if hospitalizations rise significantly in the UK, other European countries are likely to be next.

(3) *Effectiveness.* How effective are the vaccines against the Delta variant? Analyses from Public Health England yield conflicting answers. A June 14 analysis showed two doses of either the Pfizer-BioNTech or the Oxford-AstraZeneca vaccines to be highly effective against Delta-caused hospitalizations, while an analysis released on Friday suggests otherwise: In a sample of 3,692 people hospitalized with the Delta variant, 58.3% were unvaccinated and 22.8% were fully vaccinated, reported Reuters.

(4) *Freedom vs mandates.* Will Freedom Day—July 19, 2021, the day when all Covid-

related restrictions were lifted in England—go down in history as a dangerous public health experiment or a boldly justified economic reopening plan? Prime Minister Boris Johnson has said he wants Britons to judge for themselves whether to wear a face covering, dance at a nightclub, or attend a large social event.

In contrast to that "big-bang" approach, "France and Italy are considering or have implemented programs making vaccination or a recent negative test for Covid-19—or proof of recovery from Covid-19 in the previous six months—a mandatory requirement for entering public spaces such as museums, restaurants, and certain forms of transport," *reported* the *WSJ*. Further dampening summer fun, new social restrictions have been imposed in popular vacation destinations, including Spain's autonomous region of *Catalonia* and the Greek island of *Mykonos*.

Europe II: Recovery Accelerating (for Now). The post-pandemic economic recovery is accelerating in Europe, according to the latest indictors. It is too early to tell whether the Delta variant will slow the recovery, but such concerns already are weighing on business expectations. For now, however, supply-chain challenges pose a greater threat to potential growth than the virus as suppliers struggle to keep up with a post-lockdown pickup in orders. Here's more:

(1) *Economic Sentiment Indicator.* The Eurozone's Economic Sentiment Indicator (ESI) continued to soar in June, to the highest reading since May 2000 (*Fig. 3*). Real GDP in the region tends to correlate highly with the indicator and has nearly traced its path since 2019, which bodes well for Q2 output.

The overall ESI includes the following subindexes: industrial (40% weight), service (30), consumer (20), construction (5), and retail trade (5). Each of them is up significantly from last year's lows, with a touch of relative weakness remaining in the consumer indicator (*Fig. 4*). Among the components of industrial confidence, stocks of finished products and production expectations have deteriorated recently, while order volume has been strong (*Fig. 5*).

(2) *Flash purchasing managers surveys.* "Eurozone flash PMI hits 21 year high as economy reopens" was the headline of July's Flash Eurozone Purchasing Managers Index report. The composite PMI continued to accelerate, reaching 60.6 this month from 47.8 at the start of the year (*Fig. 6*). The NM-PMI showed service-sector growth at its fastest pace in 15 years this month.

The M-PMI showed factories' activity expanded at a slower, though still robust, rate this month, with the slowdown linked to supply-chain delays—a major concern hampering production and pushing costs higher. Higher costs have led to near-record increases in average selling prices for goods and services. Also weighing on the outlook is the Delta variant, with rising case numbers leading to slipping business optimism.

(3) *Industrial production.* The Eurozone's industrial production index was 103.2 during February 2020, just before the pandemic triggered lockdowns (*Fig. 7*). It plunged to 74.0 during April of last year. As the lockdown restrictions were gradually lifted, it rebounded to 103.0 at the start of this year. It has been hovering around that level since May as a result of both variant concerns and supply-chain disruptions.

(4) *Retail sales.* The volume of retail sales excluding automobiles and motor vehicles in the Eurozone took a dive last year during the lockdowns (*Fig. 8*). It then rebounded dramatically. Another round of selective social-distancing restrictions caused sales to swoon late last year and early this year. But by May, sales were back at a record high.

(5) *Germany Ifo.* German business confidence in July edged down for the first time since January, depressed by concerns about Covid-19 case counts and raw materials supplies (*Fig. 9*). Ifo's business climate index slipped to 100.8 in July after climbing steadily from 90.6 in January to 101.7 in May—the best reading since November 2018.

While the current situation component continued to climb, the expectations component turned lower this month (*Fig. 10*). Ifo reports that almost two-thirds of all manufacturing companies are experiencing supply concerns. Fears that the service sector could be hit by another wave of Covid as variants spread were especially evident in the Ifo's expectations component.

Europe III: Fiscal & Monetary Policies Remain Easy. Now let's review the latest economic policy developments in Europe:

(1) *Monetary red light.* The European Central Bank (ECB) *announced* its decision to keep interest rates lower for longer on July 22 following the Governing Council's routine Monetary Policy meeting. It wasn't hard to see that coming. Back on July 8, the ECB had *announced* that it would target a symmetric goal of 2% inflation in the medium term rather than its previous "below but close to 2%." Like the Fed, the ECB has promised to tolerate short-term overshoots to its inflation goal. The strategy change came as the ECB completed the policy review begun in January 2020 (its first since 2003). The ECB mentioned the word

“symmetric” three times in its latest press release.

With the outcome of the Delta variant unknown, the ECB now has a new excuse to hold rates low despite rising inflation (*Fig. 11*). During her press conference, ECB President Christine Lagarde said that the “pandemic continues to cast a shadow, especially as the delta variant constitutes a growing source of uncertainty. Inflation has picked up, although this increase is expected to be mostly temporary.” She added that the Delta variant could dampen the recovery in services, especially tourism and hospitality.

Melissa and I continue to think that the ECB is unlikely to change its policy course before the Fed changes its, as we noted in our June 23 *Morning Briefing*.

Also reiterated at the meeting: the ECB’s pledges to continue purchasing up to €1.85 trillion of eurozone debt under its emergency bond-buying program through at least March 2022 and to maintain the €20 billion monthly pace of purchases under its asset purchase program. Like the Fed, the ECB has promised to taper its bond purchases ahead of lowering interest rates. In the case of the ECB, tapering could be a long ways away.

(2) *Fiscal green light.* The first disbursements from the European Union’s (EU) €800 billion “green” economic recovery plan are set to be released in the coming weeks. On July 13, the investment plans of 12 member states (Austria, Belgium, Denmark, France, Germany, Greece, Italy, Latvia, Luxembourg, Portugal, Slovakia, and Spain) were adopted by EU finance ministers, *reported* Reuters. Plans from the remaining 15 countries will be assessed at a later date.

Financed through borrowing and disbursed in grants and loans, the unprecedented plan could boost public investment to 3.5% of the region’s GDP next year, the highest in over a decade, according to the Reuters article. Italy and Spain are to receive the highest level of funds. Initially, a percentage of the approved amounts will be disbursed. Future disbursements will be conditioned on the implementation of the plans, which must show progress on EU targets, including a “green” transition.

Europe IV: Taking Stock. Since the S&P 500’s March 23, 2020 low through Monday’s close, here is the performance derby of the major MSCI stock price indexes in local currencies and in dollars: US (102.3%, 102.3%), All Country World (82.6, 89.2), EMU (67.7, 83.9), EM (61.2, 68.8), ACW ex-US (58.5, 72.4), EAFE (55.9, 71.1), Japan (51.4, 52.8), and UK (38.4, 66.5). (See *Table 1* and *Table 2*.)

The EMU has lagged the US over this period. While the forward revenues of the US MSCI has been rising in record-high territory since June of this year, the comparable metric for the EMU remains surprisingly depressed near last year's low (*Fig. 12*).

The forward earnings of the EMU MSCI has rebounded more impressively than the index's forward revenues (*Fig. 13*). But it hasn't fully recovered, while the forward earnings of the US MSCI has been rising in record-high territory since early this year. The forward profit margin of the EMU MSCI rose above its pre-pandemic high recently to 8.0% during the week of July 15, while the US forward profit margin reached yet another record high that same week at 12.8% (*Fig. 14*).

Calendars

US: Wed: Goods Trade Balance Advance, Retail & Wholesale Inventories, MBA Mortgage Applications, Crude Oil Inventories, FOMC Interest Rate Decision 0.25%, FOMC Press Conference **Thurs:** GDP 8.6%, GDP Price Deflator & Core PCED 5.4%/5.9%, Initial & Continuous Jobless Claims 380k/3.20m, Pending Home Sales 0.3%. (Bloomberg estimates)

Global: Wed: Germany Consumer Climate 1.0, France Consumer Confidence 102.0, 11UK HPI 0.6%m/m/12.1%y/y, Canada Headline & Core CPI 3.2%/2.4% y/y. **Thurs:** Eurozone Business & Consumer Survey 118.5, Germany Unemployment Change & Unemployment Rate -28k/5.8%, Germany CPI 0.5%m/m/3.3%y/y, Spain CPI 0.4%m/m/2.6%y/y, Japan Unemployment Rate 3.0%, Japan Industrial Production 5.0%, Japan Retail Sales 0.2%, ECB Publishes Account of Monetary Policy Meeting. (Bloomberg estimates)

Strategy Indicators

S&P 500 Q2 Earnings Season Monitor (*link*): With nearly one-third of the S&P 500 companies finished reporting revenues and earnings for Q2-2021, revenues are beating the consensus forecast by a well-above-trend 4.1%, and earnings have exceeded estimates by 17.0%. At the same point during the Q1 season, revenues were 2.9% above forecast and earnings beat by 23.3% in large part due to reversals of loan loss reserves at the banks. At first glance, the S&P 500's earnings surprise appears to have weakened q/q, but is actually about the same excluding the Financials. The S&P 500's Q2 earnings surprise excluding

Financials is 12.3% compared to 12.2% during Q1. For the 153 companies that have reported Q2 earnings through mid-day Tuesday, the aggregate y/y revenue and earnings growth rates and the percentage of companies reporting a positive revenue and earnings surprise have improved significantly from their Q1 measures due to the low base a year earlier when the US economy was shut down due to Covid-19. The small sample of Q2 reporters so far has a y/y revenue gain of 18.9% and an earnings gain of 123.4%. A whopping 89% of the Q2 reporters so far has reported a positive earnings surprise, but a tad lower 86% has beaten revenues forecasts. Slightly more companies have reported positive y/y earnings growth in Q2 (92%) than positive y/y revenue growth (90). These figures will change markedly as more Q2-2021 results are reported in the coming weeks. The y/y growth rates will more than likely mark the peak of the recovery from the Covid-19 shutdown.

US Economic Indicators

Durable Goods Orders & Shipments (*link*): Core capital goods orders and shipments set new record highs yet again in June. Nondefense capital goods orders ex aircraft (a proxy for future business investment) has increased every month but one since bottoming last April, climbing 0.5% in June and 27.0% over the period. Core capital goods shipments (used in calculating GDP) followed an identical pattern, advancing 0.6% and 24.0% over the comparable periods. Orders for total durable goods advanced for the 13th time in 14 months, rising 0.8% in May and 59.1% over the period to its highest reading since July 2014, despite a shortage of semiconductors causing a 12.3% ytd decline in motor vehicle orders. Meanwhile, durable goods billings excluding transportation has declined only once since bottoming last April, up 0.3% in June and 30.7% over the period to a new record high. Markit's flash estimates for July were good news for the manufacturing sector. July's M-PMI (to 63.1 from 62.1) set another new record high, led by an acceleration in new orders across the manufacturing sector, as new and existing customers ramped up their spending. Firms also saw a stronger uptick in foreign client demand. In addition, production accelerated during the month despite further reports of material shortages.

Regional M-PMIs (*link*): Five Fed districts have now reported on manufacturing activity for July (New York, Philadelphia, Kansas City, Dallas, and Richmond) and show the manufacturing sector expanded at a faster pace—with the New York region accelerating at a record high. The composite index is moving back toward April's record high of 33.4 this month, climbing to 29.8 after easing the prior two months to 26.4 during June. The New

York (to 43.0 from 17.4) manufacturing sector grew at more than double June's pace, while measures for both Kansas City (30.0 to 27.0) and Richmond (27.0 from 26.0) have moved back to within a hair of their record highs of 31.0 and 28.0, respectively; measures for both Philadelphia (21.9 from 30.7) and Dallas (27.3 from 31.1) slowed—though remained robust. The new orders (to 25.6 from 24.6) measure shows billings growth remained at June's pace, not far from April's recent high of 30.7. Growth in New York (33.2 from 16.3) billings were at a near-record rate, double June's pace, while Kansas City's (26.0 from 22.0) continued to accelerate. Orders in the Dallas (to 26.8 from 26.7) region matched June's pace, while orders growth in the Philadelphia (17.0 to 22.2) and Richmond (25.0 from 36.0) regions slowed, though were still robust. Meanwhile, factories added to payrolls at a record rate (to 27.3 from 23.0) this month, with Richmond (36.0 from 23.0) accelerating at its best pace on record, while both the Philadelphia (29.2 from 30.7) and Kansas City (27.0 from 26.0) measures were just below their record highs of 30.8 and 29.0 posted during April of this year. New York (20.6 from 12.3) manufacturers hired at the fastest pace since June 2018, while Dallas' (23.7 from 22.9) moved back toward their record high of 31.3 posted in April.

Regional Prices Paid & Received Measures (*link*): We now have prices-paid and -received data for June from the Philadelphia, New York, Richmond, Kansas City, and Dallas regions, and they all show inflationary pressures remain intense. The Philadelphia, New York, Kansas City, and Dallas measures are all diffusion indexes, while Richmond's measures are average annualized inflation rates (which we multiply by 10 for easier comparison to the other regional measures). The average of the five show the overall prices-paid (to 81.9 from 84.1) measure held around May's record pace, while the prices-received (49.7 from 44.2) measure accelerated at its fastest pace on record. Both the Richmond prices-paid (to 111.6 from 85.7) and prices-received (69.3 from 47.0) gauges accelerated to new record highs in July. Meanwhile, New York's prices-paid gauge eased for the second month to 76.8 from May's record high of 83.5, while the prices-received (to 39.4 from 33.3) gauge accelerated to a new record high. Kansas City's price data followed a similar script—with its prices-paid (to 78.0 from 79.0) gauge easing for the second month since reaching a record high 86.0 in April and its prices-received measure reaching a new record high of 52.0. Meanwhile, both the Dallas prices-paid (to 73.5 from 80.8) and -received (40.9 from 42.8) gauges held near their June record highs, while Philadelphia's prices-paid (to 69.7 from 80.7) and prices-received (46.8 from 49.7) measures eased this month from their June readings, which were the highest since June 1979 and October 1980, respectively.

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