MORNING BRIEFING
June 29, 2022

Relative Valuation & Dalio's Big Short

Check out the accompanying chart collection.

Executive Summary: Around the world, as inflation concerns, interest rates, and recession fears have risen, stock market valuations have fallen. They'll fall further if recessions actually materialize. Against this backdrop, we examine how the valuations of various indexes have fared relative to one another. … Also: For Europe, recession appears particularly likely given a brewing energy crisis, as Russia has been choking off natural gas supplies. Melissa assesses the ramifications for European households and businesses. … And: The ECB's hawkish turn has hurt most EMU MSCI sectors' valuations; we take a look at the deterioration relative to analysts' still-strong earnings and margin expectations.

Valuation: It's All Relative. As we've often observed, valuation—like beauty—is in the eye of the beholder. Since early last year, we've beheld significant declines in valuation multiples around the world. Investors have become increasingly concerned about inflation. It's turned out to be higher and more persistent than was widely anticipated. As a result, the major central banks (except for the Bank of Japan and the People's Bank of China) have been forced to pivot from their ultra-dovish monetary policy stances of the past several years to uber-hawkish ones. Rapidly tightening credit conditions have raised fears of a global recession.

So higher inflation and interest rates have weighed on valuation multiples. In addition, mounting worries about a recession have reduced the multiples that investors are willing pay for analysts' consensus expectations for earnings, which have been rising to record highs notwithstanding the rising risk of a recession. If a recession actually unfolds, valuation multiples could fall even lower along as analysts scramble to slash their earnings forecasts.

We've been covering this story for over a year now. Now, let's briefly update our regular comparison of forward earnings and forward P/Es on a relative basis (FYI: "forward earnings" is the time-weighted average of analysts' consensus estimates for this year and next, and "forward P/E" is the multiple based on forward earnings):

(1) *S&P 500 LargeCaps vs 'SMidCaps.'* Since mid-2020, just after the lockdown recession during March and April of that year, industry analysts have been raising their forward earnings estimates for the S&P 500, S&P 400, and S&P 600 companies (the latter two

a.k.a. SMidCaps) (*Fig. 1*). Converting all three forward earnings series to indexes equal to zero during the week of March 5, 2009 shows that they all dropped from their record highs just before the pandemic to about 100 around the end of May. Since then, they are up as follows through the June 23 week: S&P 500 (to 263.3), S&P 400 (to 389.6), and S&P 600 (to 507.3) (*Fig. 2*).

Forward earnings that strong are truly remarkable, though some of the recent strength in earnings obviously reflects the astonishing surge in inflation over the past year. Also remarkable have been the freefalls in the forward P/Es of the S&P 500/400/600 indexes, notwithstanding their soaring forward earnings (*Fig. 3*). Here are their forward P/Es as of Monday's close versus at the start of this year: S&P 500 (16.3, 22.5), S&P 400 (11.8, 19.7), and S&P 600 (11.5, 19.2).

The current ratios of the forward P/Es of the S&P 400 and S&P 600 to the S&P 500 both are down to 0.70 currently, the lowest in over 20 years (*Fig. 4* and *Fig. 5*). They had been over 1.00 from 2004-18. They are at significant discounts indeed given that the ratios of the forward earnings of the S&P 400 and S&P 600 to the S&P 500 have been rising since mid-2020.

(2) *S&P 600 vs Russell 2000.* By the way, the plunge in the forward P/E of the Russell 2000 has been much greater than that for the S&P 600 (*Fig. 6*). The former is down 51% since the start of last year through the June 16 week, while the latter is down 44% over this same period. The Russell 2000 has a lot more stocks of companies that are unprofitable than does the S&P 600. That explains why the former's valuation multiple has always been much higher than the latter's.

(3) *S&P 500 Growth vs Value.* Similarly, the forward P/E of the S&P 500 Growth index typically has exceeded that of the S&P 500 Value index (*Fig. 7*). The former has tumbled relative to the latter so far this year. The ratio of the forward P/Es of Value to Growth is up from 0.60 at the start of this year to 0.72 currently (*Fig. 8*). Some Growth index stocks have tumbled so much that investors, as well as index provider FTSE Russell, are starting to consider them to be value stocks.

(4) *Stay Home vs Go Global.* While forward earnings continue to soar into record-high territory for the US MSCI stock price index, they've been declining for the All Country World (ACW) ex-US MSCI, led by the Emerging Markets MSCI, since the start of this year (*Fig. 9*). On the other hand, they continue to climb in record-high territory for the UK and EMU MSCI indexes.

The forward P/Es of the major MSCI indexes around the world are much lower currently than those of the comparable US index (*Fig. 10*). Here were their latest readings during the week of June 16: US (16.3), Japan (12.4), EMU (11.3), Emerging Markets (11.1), and UK (9.8).

The valuation discrepancy is less comparing the forward P/E of the S&P 500 Value index (at 14.1 yesterday) to the ACW-ex US forward P/E (at 11.9) (*Fig. 11*). The severe selloff of growth stocks in the US—especially technology stocks, and particularly the MegaCap-8 stocks—has siphoned more air out of the valuation multiple of the US MSCI than out of the ACW ex US MSCI, which has fewer growth and more value components.

Europe I: On the Brink. Because of the energy shock resulting from the Ukraine war, Melissa and I see increasing odds that a recession is much more likely in Europe than in the US, as we wrote in Monday's *Morning Briefing*. Russia is reducing its exports of natural gas to Western Europe in retaliation for Europeans' support of Ukraine in its war against Russia.

Indeed, the *FT* *reported* last Wednesday: "The International Energy Agency has warned that Europe must prepare immediately for the complete severance of Russian gas exports this winter, urging governments to take measures to cut demand and keep ageing nuclear power stations open." Europeans could be forced to ration their available supplies of natural gas.

Even so, the European Commission (EC) forecasted on May 16 that the Eurozone's GDP will expand by 2.7% this year in the agency's first economic forecast since the war in Ukraine began. However, the forecast was made before Russia began significantly throttling back on its gas exports to Europe. In other words, any sudden cutoff of natural gas flows to Europe could result in yet another jump in energy prices and slower economic growth. Producers who depend on natural gas for energy or as an input could be forced to cut production or to shut down altogether in the event of major gas supply disruptions and rationing.

When we last *reviewed* the latest macroeconomic indicators for the Eurozone, on June 8, we wrote that the reopening of Europe following the era of Covid restrictions could offset some of the negative economic impacts of the Ukrainian war. Except for inflation, the latest data were not overly worrisome at that point, but we anticipated that the outlook could darken before it improves, especially if Russia turns off the gas taps.

Despite the plethora of negative outcomes outlined in media headlines, analysts' estimates

for Eurozone revenues and earnings remain upbeat, as we noted on Monday. Let's hope that reality does not catch the analysts off guard. European Central Bank (ECB) President Christine Lagarde recently *warned*: "While the correction in asset prices has so far been orderly, the risk of a further and possibly abrupt fall in asset prices remains severe."

Here's a recap of the latest unfavorable updates that heighten the potential for a worsening European energy crisis and recession:

(1) *Germany's alarm.* Germany, Europe's largest importer of Russian gas, has experienced a 60% drop in Russian natural gas supplies since early June. Gas networks in France and Italy also reported significant drops in recent weeks, *according* to the *WSJ*. Ukraine has been lobbying to join the European Union (EU), and its candidacy was officially accepted by the EU (along with Moldova's) on June 23. It could take Ukraine a decade or more to meet the criteria for joining the EU, *according* to Reuters. Surely, President Vladmir Putin was none too pleased by the EU's move, likely prompting the sharp reduction in gas flow.

On June 22, Berlin declared a phase-two emergency of its three-phase gas plan because Gazprom, Russia's state-run energy supplier, slowed its contractual deliveries to 40% of capacity in the previous week. Rationing would come in the third step. Germany also could allow utilities producers to automatically pass higher energy prices on to consumers in a push to lower demand. For now, Germany's gas storage remains slightly below target at 59% capacity since the last cold season. But Germany aims to reach 90% capacity ahead of winter, a goal in jeopardy if supplies fail to return to normal.

Economy Minister Robert Habeck called the restriction by Moscow "an economic attack." (CNBC *reported* on June 20 that Gazprom cited conflicting technical issues for the supply cuts.) Whatever the cause, increased use of coal in power stations has been ordered by Mr. Habeck, a Green Party leader, in keeping with the emergency energy plan. Political leaders also are debating delaying the closure of the three remaining nuclear reactors in Germany to help mitigate the shock.

Germany is scrambling to reduce its dependence on Russian gas. Nevertheless, German think tanks have calculated that a shutdown of Russian gas could trigger a hit of up to €220 billion in 2022 and 2023, or 6% of this year's GDP. (That's mostly according to a June 24 *article* in Reuters unless otherwise noted.) Germany's IFO index, a survey of business confidence, continued to trend lower in June, with the expectations component leading the way down.

Scrambling to find alternative gas sources, Germany is seeking emergency delivery solutions for liquefied natural gas (LNG). Reuters *reported* on June 24 that Gazprom's recently completed and unused Nord Stream 2 pipeline, intended for Russian gas to flow directly to Germany, could be converted for carrying LNG to Germany from elsewhere.

(2) *Households squeezed.* Household spending could suffer dramatically from the rise in gas prices against a backdrop of stagnant wage growth and rising consumer prices across the board. For example, the *WSJ* *reported* that union wages in Germany excluding one-time payments rose just 1.1% in Q1, well below the increase in consumer prices. Europe's job retention schemes during the pandemic meant that there was not as much wage negotiation going on as there would have been if more layoffs, quits, and rehiring occurred.

Meanwhile, the German government warned last week that households could see their natural gas bills triple from last year—on top of the broader consumer inflation also happening. Certainly, the squeeze on European households is not *limited* to Germany.

Indeed, one of the most troubling inputs to the Eurozone's Q1 GDP was the decline in household spending (*Fig. 12*). Despite being pressured by squeezed households, the Eurozone's real GDP expanded 0.6% (not annualized) during Q1, twice the 0.3% previous estimate and above Q4-2021's downwardly revised pace of 0.2%. Still, growth is considerably below the 2.3% and 2.2% rates posted during Q3 and Q2, respectively, following Q1-2021's 0.1% dip.

(3) *Producers pressured.* Europe's producers of chemicals, fertilizer, steel, and other energy-intensive goods have come under pressure since Russia's invasion, *wrote* the *WSJ*. Manufacturers need natural gas not only as an energy source, but also as a raw material in production. Natural gas sets the price of electricity in Europe, "hitting factories with a double-whammy" as gas prices increase, the article observed. In the event of energy rationing, the country likely would require industrial firms to ration before private households and critical services, putting manufacturers at risk of disruption or closure.

Indeed, new figures on manufacturing and services activity darkened for Europe, as it faces not only supply shortages left over from the pandemic, but also a looming Energy crisis and the prospect of higher interest rates ahead. S&P Global reported on June 23 that Europe's composite purchasing managers index—which covers activity in both the manufacturing and services sectors—fell to a 16-month low of 51.9 in June from 54.8 in May (*Fig. 13*). The index is barely holding above the 50.0 mark between expansion (above) and contraction (below). June's slowdown was the sharpest recorded since November 2008, during the

peak of the financial crisis, observed S&P Global's Chris Williamson, *according* to the *WSJ*.

Europe II: The Big Short. On June 23 Bloomberg *reported* that "Ray Dalio's Bridgewater Associates has built a $10.5 billion bet against European companies, almost doubling its wager in the past week to its most bearish stance against the region's stocks in two years." Given the concerns we discussed above, it seems like a good strategy to short Europe over the near term, especially if tensions between Russia and Europe escalate.

For those with a long-term investment horizon, however, now may be a good time to buy and hold European stocks given how cheap they're trading relative to recent history. But it could take some time for the gas shortage, rising interest rates, resulting inflation, and a likely recession to shake out.

Recently, lots of downside action has been occurring in Europe's financial markets as the ECB has turned increasingly hawkish:

(1) *ECB's tightening spree.* Financial conditions are tightening. On June 9, the ECB signaled that it would make its first interest rate hike since 2011 at its July 20-21 meeting, with a larger move likely on September 8, followed by further gradual hikes. The ECB also will end its large-scale bond-purchasing program on July 1, but reducing the bank's balance sheet isn't currently on the table.

However, the policy-setting situation in Europe just became more complex when heavily indebted countries' bond yields suddenly went vertical. On June 15, the ECB held an emergency meeting to address the sharp rise in the Italian 10-year government bond yield to nearly 4.0%, or 204bps above Germany's 10-year yield, in advance of the ECB's actions (*Fig. 14*).

As an interim measure, the ECB said it would sell some pandemic-stimulus-purchased bonds and buy up weak Eurozone countries' bonds instead, to stimulate those asset prices and lower yields. Over the longer term, the ECB promised to implement an "anti-fragmentation instrument" to lessen the divergence in yields. Lagarde tried to temper expectations for the new instrument, however, arguing that the ECB's job is to achieve price stability, not favorable financing conditions or budgets.

Yesterday at an ECB forum, Lagarde said that any beneficial financing conditions afforded to weaker Eurozone countries would come with "safeguards" to preserve "sound fiscal policy," *reported* Reuters. Sources also told Reuters that the ECB "would likely drain cash

from the banking system to offset the new bond purchases, so as not to increase the overall amount of liquidity."

(2) *Prices sink ahead of earnings.* The EMU MSCI index fell 20.1% (in local currency) from its record high on November 27 through Friday's close (*Fig. 15*). The index dropped below its 200-day moving average on February 11 and was trading 12.4% below it at Friday's end. Interestingly, all of the index's sectors are trading at or below their 200-day moving averages except Communication Services and Energy, which are trading just above it.

The EMU MSCI index is trading at a low forward P/E multiple of just below 12, down from just over 17 in mid-2020 when pandemic lockdowns began to lift. In fact, forward earnings expectations continued to rise through June 16, as noted above.

Leading the way in earnings expectations is the EMU MSCI's Energy sector, which makes sense given that Europe is about to become much more dependent on domestic energy firms than it was before the war. Most sectors' earnings expectations also are on the way up or flatlining except for those of Real Estate and Communications Services.

The EMU MSCI sectors' profit margin estimates (which we calculate from analysts' consensus revenues and earnings estimates) also remain near recent record highs, led by energy firms. That suggests that most European firms are having no problems passing their inflation-boosted costs through to their selling prices.

Calendars

US: Wed: Real GDP -1.5%; GDP Price Index & Core PCE Price Index 8.1%/5.1%; Corporate Profits; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Powell; Bullard; Mester. **Thurs:** Core PCED 0.4%m/m/4.8%y/y; Personal Income & Consumption 0.5%/0.4%; Initial & Continuous Jobless Claims 228k/1.31m; Chicago PMI 58.0; Natural Gas Storage; OPEC Meeting. (Bloomberg estimates)

Global: Wed: ECB Business & Consumer Confidence 103.0; Germany CPI; Spain CPI; Spain Retail Sales -1.9% y/y; China M-PMI 48.6; Japan Industrial Production -0.3%; Japan Household Confidence; De Guindos; Schnabel; Bailey; Balz. **Thurs:** Eurozone Unemployment Rate 6.8%; Germany Retail Sales 0.5%m/m/-2.0%y/y; Germany CPI 0.3%m/m/7.9%y/y; Germany Import Prices 1.6%m/m/31.5%y/y; Germany Unemployment

Change & Unemployment Rate -6k/5.0%; Italy Unemployment Rate 8.4%; UK GDP 0.8%q/q/8.7%y/y; Canada GDP 0.3%m/m; Japan Unemployment Rate 2.5%; Japan Large Manufacturers & Non-Manufacturers 17/14; China Caixin M-PMI 50.1; Lagarde. (Bloomberg estimates)

Strategy Indicators

S&P 500 Sectors Basic Share Outstanding Q1-2022 (*link*): With the Q1-2022 earnings season finished, the S&P 500's aggregate basic share count declined for a third straight quarter and was down 0.2% q/q in Q1. However, the q/q decline still remains below the 0.4% average drop recorded during 2018-19 before the pandemic. In the five quarters from Q2-2020 to Q2-2021, share counts rose primarily because the Energy, Leisure, and Transportation firms issued shares to recapitalize their businesses during the Covid-19 economic shutdown. During Q1-2022, shares outstanding declined q/q for eight of the 11 sectors, unchanged from Q4-2021 and up from just three sectors declining during Q2-2021. Six of the 11 sectors reduced share counts at a faster rate or issued shares at a slower rate during Q1, down from eight doing so during Q4. Q1's exceptions: Communication Services, Financials, Industrials, Tech, and Utilities. Here's how the sectors ranked by their share count decline during Q1: Materials (-0.8% [eight-year high]), Financials (-0.7), Consumer Discretionary (-0.6 [13-quarter high]), Health Care (-0.4 [11-quarter high]), Industrials (-0.3), Consumer Staples (-0.3), Information Technology (-0.2), and Energy (-0.1 [eight-quarter high]). Here's the ranking for the three sectors that continued to increase their share count: Real Estate (0.9), Communication Services (0.7 [seven-quarter high]), and Utilities (0.2).

US Economic Indicators

Consumer Confidence (*link*): Consumer confidence in June sank to its lowest level since February 2021 as expectations plunged to its lowest level in nearly a decade. The Consumer Confidence Index dropped in June for the second successive month and the fourth time this year, to 98.7, down 9.9 points the over past two months and 16.5 points ytd. The index's expectations component declined for the fifth time this year, plunging 29.0 points during H1, to 66.4—the lowest level since March 2013. Meanwhile, the present situation component has been in a flat trend for the past nine months, ticking down from 147.4 to 147.1 this month—virtually matching its 147.0 average over the prior eight months.

The report cites inflation, particularly rising gas and food prices, as the major concern. Focusing on the six-month outlook, consumers are pessimistic: Consumers' perception of short-term business conditions took a big hit this month, with the percentage expecting business conditions to worsen (29.5 from 26.4) shooting up to its highest reading since March 2009 and the percentage expecting business conditions to improve (14.7 from 16.7) sinking to its lowest percentage since April 2016. Consumers' short-term financial prospects also deteriorated—with the percentage of consumers expecting their incomes to increase (to 15.9% from 17.9%) falling and the percentage expecting their incomes to decrease (15.2 from 14.5) rising. As for the jobs outlook, the percentage expecting more jobs to be available (16.3 from 17.5) was the lowest since the end of 2019, while the percentage anticipating fewer jobs (22.0 from 19.5) was the highest since the start of 2021—with nearly two-thirds expecting no change, the same as over the past several months.

Regional M-PMIs (*link*): Five Fed districts (New York, Philadelphia, Kansas City, Dallas, and Richmond) now have reported on manufacturing activity for June and show the manufacturing sector moved further into contractionary territory. The composite index dropped to -5.8 this month after dipping into negative territory in May for the first time in two years—falling to -0.5 from 16.5 in April. Activity in the Kansas City (to 12.0 from 23.0) region expanded at half May's pace, while growth in the New York (–1.2 from -11.6) region moved back toward expansionary territory, and activity in the Philadelphia (-3.3 from 2.6) area contracted for the first time since spring 2020. Meanwhile, activity in the both the Dallas (-17.7 from -7.3) and Richmond (-19.0 from -9.0) regions plunged further into negative territory. June saw orders (-12.1 from 3.1) growth in negative territory for the first time since May 2020, as Richmond (-38.0 from -16.0) orders continued to plummet, while billings in the Philadelphia (to -12.4 from 22.1), Kansas City (-8.0 from 15.0), and Dallas (-7.3 from 3.2) regions swung from positive to negative. Meanwhile, New York's (5.3 from -8.8) moved from negative to positive, though that swing wasn't as dramatic. Employment (20.7 from 20.5) continued its strong readings, with hirings at the Philadelphia (28.1 from 25.5), Richmond (23.0 from 8.0), New York (19.0 from 14.0), Kansas City (18.0 from 34.0), and Dallas (15.2 from 20.9) factories robust, though hirings in the latter two regions did slow in June.

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. (Note: The Philadelphia, New York, Kansas City, and Dallas measures are 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 prices-paid measure remains in a volatile flat trend, falling to 80.8 this month after climbing from 81.2 in February to 87.5 in May; it's been bouncing in a range between 80.0 and 89.5 since

mid-2021. Regionally, the prices-paid measure in the New York region accelerated to 78.6 in June after easing from a record-high 86.4 in April to 73.7 in May, while Philadelphia's gauge eased for the second month to 64.5 from April's record-high 84.6 and Richmond's slowed to 132.2 from May's record-high 151.3. Kansas City's (71.0 from 72.0) measure barely budged in June, but it was down from April's 83.0—which was near its record high of 88.0 last May. Meanwhile, the Dallas region's gauge sank to a 17-month low of 57.5; it was at a record high of 83.3 in November. Turning to prices-received, this gauge accelerated to 58.4 after easing from a record-high 60.2 in March to 55.4 in May. Regionally, New York's eased for the third month, from a record-high 56.1 in March to 43.6 this month, with Philadelphia's at 49.2 this month, down from a record-high 62.9 in October; Dallas' measure eased to a 15-month low of 33.8, after reaching a record-high 50.9 in October. Richmond's (114.2 from 95.7) climbed to a new record high this month, while Kansas City's accelerated to 51.0 after easing from a record-high 57.0 in April (which matched last July's high) to 42.0 in May.

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, 732-497-5306
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

Copyright (c) Yardeni Research, Inc. Please read complete copyright and hedge clause.