Yardeni Research

MORNING BRIEFING
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Around The World

Check out the accompanying chart collection.

Executive Summary: Zooming out to assess big-picture data for major global economies, we conclude that Germany and China look most vulnerable to a recession next year. The US wouldn't be immune to a global recession, but certain factors help insulate it. These include heavy capital inflows resulting from foreign investors'—correct—perception that US financial markets offer the safest harbor there is. Overweighting the US in global portfolios remains prudent. … Also: Germany's economy faces duress this winter as heating the country becomes a challenge, and China's economy is suffering at the hands of homegrown problems related to housing, lockdowns, and demographics.

Global Economy I: Our TINAC Thesis & Stay Home Strategy. Our basic premise about the outlook for the global economy through the end of 2023 is that a recession is more likely to occur in Europe and China than in the US. Of course, a global recession that starts abroad could push the US economy into a recession if it is already vulnerable to one. On the other hand, global investors might conclude that the US is the only major safe harbor from storms blowing around the world. If so, then their capital inflows could help to insulate the US economy from a global recession.

Granted, that would be an unusual development since economic booms and busts around the world tend to be synchronized ones. However, the US could buck a global recessionary cycle if enough global investors embrace our "TINAC" thesis—i.e., "there is no alternative country." Melissa, Jackie, and I believe that TINAC has already been in play so far this year given the strength of the dollar and solid net capital inflows. If TINAC continues to insulate the US from the troubles of the rest of the world, then our "Stay Home" investment strategy should continue to outperform the "Go Global" alternative, as it has since 2009.

Consider the following big picture:

(1) *Leading and coincident indicators.* This morning, the OECD will release its July leading indicators for its 36 member countries, which tend to have developed economies, along with a few for the big emerging market economies (EMEs) that aren't OECD members. The series starts in mid-1961.

June data show that the overall index fell from a recent peak of 101.0 in July 2021 to 99.5, the lowest reading since December 2020 (*Fig. 1*). Dominating the index are the US (99.4), Europe (99.3), and Japan (100.6) (*Fig. 2*). Generally, the business cycles of these major economies tend to be synchronized, but there have been times when one of the three major economies outperformed or underperformed the other two.

Similar synchronization can be seen among the major and minor European economies (*Fig. 3* and *Fig. 4*). They all have been rolling over during the first six months of this year, with OECD leading indicator index readings either close to 100 or slightly below it. Both Australia (98.3) and Canada (99.6) are also rolling over (*Fig. 5*). And the same can be said of the BICs: Brazil (98.1), India (100.1), and China (98.3) (*Fig. 6*). (The BICs are not members of the OECD.)

The bottom line of the OECD data is that the global economy has been weakening during the first six months of this year but hasn't fallen into a recession so far. Neither the US nor any other major OECD economy stands out from the pack as a leader or a laggard.

(2) *Global PMIs.* We have access to the JP Morgan global purchasing managers indexes (PMIs) since January 2018 through July of this year (*Fig. 7* and *Fig. 8*). Not surprisingly, the global composite PMI is highly correlated with the OECD's leading indicator. This global C-PMI has been falling in a sawtooth pattern from a high of 58.5 during May 2021 to 50.8 during July, the lowest since June 2020. So it too is signaling a global slowdown rather than a recession.

The global manufacturing PMI fell to 51.1 in July from 54.3 at the start of the year. The global nonmanufacturing PMI fell to 51.1 in July from 54.7 at the start of this year. All of these readings are consistent with a global slowdown. They might be pointing toward a recession, though certainly not definitively.

(3) *Commodity prices.* The same can be said about industrial commodity prices, especially the price of copper. Since the start of the year through Friday of last week, the CRB raw industrials spot price index is down 6%, while the nearby futures price of copper is down 20% (*Fig. 9*). Copper is especially sensitive to housing and auto sales. The world economy may not be in a recession, but housing activity almost certainly is in a recession around the world. Auto sales have been depressed by a shortage of auto inventories because supply-chain disruptions have disrupted auto production.

Interestingly, the CRB raw industrials spot price index tends to track the Emerging Markets

MSCI stock price index (in dollars) very closely (*Fig. 10*). The latter is down 19% since the start of this year through Friday. This relationship suggests that most emerging markets haven't emerged from their dependence on producing and exporting commodities.

(4) *World production and exports.* The CPB Netherlands Bureau for Economic Policy compiles monthly indexes of world industrial production and world volume of exports. Both are available from January 1991 through May of this year. The production index peaked at a record high in February of this year (*Fig. 11*). It is down 2.9% since then through May. The volume of exports reached a new record high in May.

(5) *Capital flows.* Previously, we observed that US private net capital inflows from overseas totaled a near-recent record high of $1.6 trillion over the 12 months through May, while official net capital flows were -$226 billion (*Fig. 12*). On balance over this period, private foreigners purchased $797 billion in US bonds, $331 billion in US bank liabilities, and $73 billion in US Treasury bills. They sold $162 billion of US equities. (See our *Treasury International Capital System*.)

This certainly helps to explain the strength of the US dollar index (ticker symbol DXY), which is up 18% since May of last year.

(6) *Staying home.* From a valuation perspective, the All Country World (ACW) ex-US MSCI was selling at a 32% discount relative to the US MSCI at the end of July (*Fig. 13* and *Fig. 14*). From 2002 through 2015, the normal discount was 15% on average. The former tends to trade more like the S&P 500 Value index and is currently at a valuation discount of 20% to it rather than the normal discount of 0%-10% (*Fig. 15* and *Fig. 16*).

From a fundamental perspective, both the forward revenues and forward earnings of the US MSCI have been significantly outperforming the comparable stats for the MSCIs of the Emerging Markets, EMU, and the UK (*Fig. 17* and *Fig. 18*). The ratio of the US MSCI's forward earnings to the ACW ex-US MSCI's forward earnings has nearly doubled since early 2000 from 3.5 to 6.6 currently (*Fig. 19*). This certainly explains why the comparable ratios of the two stock price indexes (in both local currencies and in US dollars) remain on their strong uptrends that started in 2009 (*Fig. 20*). In other words, Stay Home continues to outperform Go Global. We recommend continuing to overweight the US in global portfolios.

Global Economy II: Europe In General, Germany In Particular. Real GDP in the Eurozone rose 2.0% (saar) during Q1 and 2.8% during Q2. At the same time, real GDP fell 1.6% and 0.9% in the US. The difference has mostly been attributed to the fact that the

Eurozone economy was reopened from the Covid lockdowns after the US economy was reopened. In any event, it is now widely expected that the Eurozone faces a cold and dark winter because Russia has cut back its deliveries of natural gas to the region.

Germany is the country most dependent on Russian gas and most likely to fall into a severe recession. Consider the following recent economic developments in Germany:

(1) German data have actually been mixed, with manufacturing production up 0.8% m/m in June and manufacturing new orders down 0.4% m/m (*Fig. 21*). Both are volume rather than value indexes, which explains why German exports have been soaring during the first six months of this year to a new record high in June. The prices of those exports have been soaring.

(2) The Economic Sentiment Indicators for Germany are also mixed. The industrial and services components remained relatively high in July, with readings of 11.1 and 11.7 (*Fig. 22*). However, the consumer and retail trade components have crashed recently to readings of -25.2 and -18.4.

Global Economy III: EMs In General, China In Particular. Many emerging markets may be at risk of political and social instability, as inflation around the world has significantly boosted the cost of food and fuel. A few benefitted from the jump in commodity prices over the past couple of years, but many of those commodity prices seem to have peaked around mid-June.

China seems to be dodging these global problems. However, it has homegrown problems that are weighing on its economy, including the bursting of the country's massive housing bubble, the ongoing pandemic-related lockdowns, and a rapidly aging demographic profile.

The country's saber-rattling about Taiwan runs the risk of triggering a war between China and Taiwan, including whatever allies decide to join the fray directly or indirectly. China also has chosen to take sides with President Vladimir Putin over his war with Ukraine, which could spread to all of Europe.

Currently, the country continues to experience a trade boom, with record exports and a record trade surplus thanks in large measure to American and European consumers (*Fig. 23* and *Fig. 24*). China's geopolitical aspirations and reckless behavior are jeopardizing trade, one of the few remaining sources of economic growth available to the country.

Calendars

US: Tues: Productivity & Until Labor Costs -4.6%/9.0%; NFIB Small Business Optimism 89.5; API Weekly Crude Oil Inventories; EIA Short-Term Energy Outlook. **Wed:** Headline & Core CPI 0.2%m/m/8.7%y/y & 0.5%m/m/6.1%y/y; Wholesale & Retail Inventories 1.9%/0.9%; Federal Budget Balance -$76.5b; MBA Mortgage Applications; Crude Oil Inventories. (Bloomberg estimates)

Global: Tues: Japan PPI 0.4%m/m/8.4%y/y; Japan Machine Tools; Australia Westpac Consumer Sentiment; China CPI -0.1%m/m/2.4%y/y; China PPI 6.0% y/y. **Wed:** Germany CPI 0.9%m/m/7.5%y/y; Italy CPI 0.4%m/m/7.9%y/y; RICS House Price Balance 60%. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell w/w for LargeCap and SmallCap, but rose for MidCap. LargeCap's decline was its fourth straight and its fifth in six weeks. None of these three indexes had forward earnings at a record high for a sixth straight week. LargeCap's has fallen in seven of the past 14 weeks and is now 1.3% below its record high at the end of June. MidCap's has dropped in six of the past eight weeks and is 1.1% below its record high in early June. SmallCap's five declines in the past seven weeks puts it 1.6% below its record high in mid-June. In the latest week, the rate of change in LargeCap's forward earnings fell to a 16-month low of 11.9% y/y from 12.0%; that's down from a record-high 42.2% at the end of July 2021 and up from -19.3% in May 2020, which was the lowest since October 2009. The yearly rate of change in MidCap's forward earnings dropped w/w to a 16-month low of 24.2% y/y from 25.6%. That's down from a record high of 78.8% at the end of May and compares to a record low of -32.7% in May 2020. SmallCap's rate fell to a 17-month low of 21.8% y/y from 26.8%. It's down from a record high of 124.2% in June 2021 and up from a record low of -41.5% in June 2020. Companies have been beating consensus estimates quite handily since the Q2-2020 earnings season, causing analysts' consensus earnings forecasts for 2021 to 2023 to improve instead of decline as is typical, but their forecasts are likely to head lower now. Here are the latest consensus earnings growth rates for 2022 and 2023: LargeCap (8.4%, 8.4%), MidCap (14.1, 4.7), and SmallCap (12.7, 8.8).

S&P 500/400/600 Valuation (*link*): Valuations remained steady for the SMidCaps last week, but LargeCap's rose last week to its highest level since late May. LargeCap's forward P/E rose 0.2pts to 17.5 from 17.3 a week earlier, which compares to a 26-month low of 15.3 in mid-June and a six-month high of 21.5 in early November. LargeCap's forward P/E also compares to an 11-year low of 11.1 during March 2020. MidCap's was unchanged w/w at 12.7, which is up from a 27-month low of 11.1 in mid-June. That's down from a 13-week high of 17.1 in early November. It had been at a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's was steady w/w at 12.2, up from its mid-June reading of 10.7, which was the lowest since it bottomed at a record low of 10.2 in November 2009 during the Great Financial Crisis. That compares to a 13-week high of 16.1 in early November and its record high of 26.7 in early June 2020 when forward earnings was depressed. LargeCap's forward P/E in February 2020—before Covid-19 decimated forward earnings—was 18.9, the highest level since June 2002. Of course, that high was still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's P/E was below LargeCap's P/E yet again last week, as it has been for most of the time since August 2018. In contrast, it was last solidly above LargeCap's from April 2009 to August 2017; MidCap's current 28% discount to LargeCap is near its biggest since September 2000. SmallCap's P/E was below LargeCap's for a 103rd straight week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 30% reading is near its biggest discount since February 2001. SmallCap's P/E had been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for a 60th straight week; the current 3% discount is up from a 9% discount in December but remains near its lows during 2000-01.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Since the Q3-2020 earnings season, analysts as a whole have been raising their consensus forecasts for future quarters instead of lowering them as is the norm through the earnings warnings seasons. That six-quarter streak of positive revisions throughout the quarter officially ended with Q1-2022, and the declines have accelerated for Q3-2022. In the latest week, the Q3-2022 earnings-per-share forecast tumbled 117 cents w/w to $57.05, and is now 4.1% below its $59.49 forecast at the start of the quarter. Analysts expect S&P 500 earnings growth to weaken to 5.9% y/y on a frozen actual basis and 6.6% on a pro forma basis. That's down from Q2-2022's blended actual/estimate of an 8.9% y/y gain on a frozen actual basis and 9.2% y/y on a pro forma basis. Double-digit percentage growth is expected for just four sectors in Q3-2022, and six are expected to record a y/y decline. That compares to Q2-2022's count of four sectors with double-digit growth, three with a single-digit gain, and four with a y/y decline. Here are the

S&P 500 sectors' latest earnings growth rates for Q3-2022 versus their blended Q2-2022 growth rates: Energy (121.8% in Q3-2022 versus 296.5% in Q2-2022), Industrials (28.4, 31.7), Consumer Discretionary (21.3, -12.4), Real Estate (10.3, 13.0), Materials (7.2, 18.0), S&P 500 (6.6, 9.2), Information Technology (-0.4, 2.9), Consumer Staples (-2.0, 0.9), Health Care (-3.3, 8.6), Utilities (-5.9, -3.8), Financials (-8.8, -21.2), and Communication Services (-13.9, -13.1).

S&P 500 Q2 Earnings Season Monitor (*link*): With 87% of S&P 500 companies finished reporting revenues and earnings for Q2-2021, the revenue and earnings surprises are historically strong but near their lowest levels since the pandemic recovery began. Revenues are beating the consensus forecast by 2.8%, and earnings have exceeded estimates by 6.0%. At the same point during the Q1 season, revenues were 2.7% above forecast and earnings beat by 7.8%. For the 435 companies that have reported Q2 earnings through mid-day Monday, the aggregate y/y revenue and earnings growth rates have slowed from their Q2-2021 to Q1-2022 readings. Collectively, the companies have a y/y revenue gain of 15.4% and an earnings gain of 11.2%. Just 70% of the Q2 reporters so far has reported a positive revenue surprise, and 77% has beaten earnings forecasts. Markedly fewer companies have reported positive y/y earnings growth in Q2 (60%) than positive y/y revenue growth (81%). These figures are bound to change as more Q2-2022 results are reported in the coming weeks, particularly from the struggling retailers. While we expect y/y growth rates to remain positive in Q2, we think revenue and earnings surprises will moderate q/q going ahead due to the slowing economy, rising inventories, and higher costs.

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