MORNING BRIEFING
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Can TINAC Survive A Global Recession?

Check out the accompanying chart collection.

Executive Summary: Prospects for a global recession have risen in the wake of recent geopolitical developments. Global economic indicators have been showing signs of weakness too. … If the global economy sinks into a recession, will the US economy follow suit, as typically has happened in the past? Not necessarily this time. We still expect no more than a "rolling recession" that hits different sectors at different times without an economy-wide downturn. … Our rationale for recommending overweighting US stocks in global portfolios still holds—i.e., there is no alternative country (TINAC). ... And: Joe clears up some confusion about Q2 earnings.

Global Economy I: Bad News. Over the long US weekend, the odds of a global recession increased significantly. Europe is facing soaring power costs and rationing as Russia continues to reduce its exports of natural gas to the region. China's haphazard "zero Covid" policy is depressing the country's economy, as is the country's ongoing property market debacle. OPEC+ reduced its production target minimally for October, signaling that the cartel is more concerned about propping up oil prices than it is about a global recession that would reduce oil prices along with oil demand.

Consider the following:

(1) *Europe.* Russia cut its main natural gas pipeline to Europe on Monday. The September 5 *WSJ* observed: "The cutoff, which the Kremlin blamed Monday on Western sanctions and said would be long-lasting, realizes the worst-case scenario Europe had been girding for since Russia invaded Ukraine in February." Electricity prices are soaring in the region.

After the financial markets closed last week, Russia's state-controlled Gazprom announced the shutdown of the Nord Stream pipeline to Germany. Kremlin spokesman Dmitry Peskov said Monday that problems pumping gas "arose due to the sanctions imposed against our country and against a number of companies by Western states, including Germany and Great Britain." He added, "We insist that the collective West, in this case the European Union, Canada, Great Britain, are to blame for the situation having reached the point where it is now." Gazprom said the Nord Stream closure would last indefinitely.

Until recently, Nord Stream was the main transit route for Russian gas, which met about 40% of the European demand before Russia invaded Ukraine.

(2) *China.* The latest result of China's "zero Covid" policy is that some 60 million people across China are facing partial or full lockdowns, according to Chinese media, from Chengdu to the southern economic powerhouse of Shenzhen to the oil-producing city of Daqing near Russia. The number of infections remains relatively small, with about 1,500 new cases on Sunday.

The September 5 *NYT* *reported*, "Nearly three years of on-and-off lockdowns have lashed the economy, sending unemployment soaring, especially among young people. The country is increasingly isolated, as the rest of the world largely abandons Covid restrictions. New subvariants are ever more transmissible. And the seemingly endless restrictions leave more ordinary Chinese people wearier by the day."

The lockdowns are only exacerbating the woes in China's property market. Country Garden Holdings, ranked for years as China's top real estate developer by contracted sales, reported a 96% drop in H1-2022 profits. The company's home sales are down by one third versus the previous year. The Guangdong-based company stated that the property market has slid rapidly into "severe depression." The August 30 *WSJ* *reported* that more than 30 Chinese real-estate companies—including China Evergrande Group and Sunac China Holdings Ltd.—have defaulted on their international debt. Many privately run developers this month issued profit warnings; some said they expect a greater-than-90% decrease in net profit, and a few expect to post losses.

(3) *OPEC+.* On Monday, OPEC+ announced a small oil production cut of 100,000 barrels per day to bolster prices. Just last month, OPEC+ decided to raise oil output by the same target of 100,000 barrels per day. It's literally a drop in the bucket. However, under the circumstances, the political message is clear: The cartel isn't ready to help the global economy weather the geopolitical storm coming out of Russia by allowing weakening oil demand to lower oil prices.

Last week, the G-7 countries agreed to cap Russian oil prices to reduce funds flowing into Moscow's war chest and bring down the cost of oil for consumers. However, neither India nor China is likely to participate in the sanction since they're reportedly purchasing Russian barrels at a discount already.

Global Economy II: Weak Data. We've been monitoring global economic indicators for signs of weakness. Here are some of the latest ones:

(1) *Global purchasing managers indexes.* During August, the global composite PMI edged down to 49.3, the first reading below the 50.0 demarcation between contraction and expansion since June 2020 (*Fig. 1*). The global composite PMI for manufacturing edged down to 50.3, while the comparable non-manufacturing index fell to 49.2. We expect these indicators to fall solidly below 50.0 in coming months. The only strong reading was 54.9 for the non-manufacturing sector of emerging economies.

The M-PMIs and NM-PMIs for the Eurozone and the United Kingdom were all around 50.0 plus/minus 2.0 during August (*Fig. 2* and *Fig. 3*). The trend in all of them has been downwards since the start of this year.

In the US, August's M-PMI compiled by ISM was 52.8, a bit better than the 51.5 provided by S&P Global (*Fig. 4*). There was a significant divergence between August's NM-PMIs reported by ISM (56.9) and those reported by S&P Global (43.7) (*Fig. 5*).

(2) *European consumer confidence and retail sales.* The consumer confidence component of the Eurozone's economic sentiment indicator edged up to -24.9 in August from -27.0 in July, the lowest reading since the start of the data in January 1985 (*Fig. 6*). Soaring energy bills are clearly depressing consumer confidence in the region. This is only just starting to weigh on the volume of retail sales (excluding autos and motorcycles), which in July was basically flat m/m and down 0.9% y/y (*Fig. 7*).

(3) *German new orders.* In Germany, new factory orders fell 1.1% m/m in July, led by a 16.9% plunge in consumer goods orders (*Fig. 8*). Germany's passenger car production remains extremely depressed at 3.1 million over the past 12 months through July (*Fig. 9*). That may reflect parts shortages from suppliers in Ukraine and Russia.

(4) *Commodity prices.* Our trusty CRB all commodities and raw industrial spot price indexes are down 10% and 11%, respectively, through Friday from their recent peaks during early June (*Fig. 10*). They confirm the weakening of the global economy, as does the price of copper, which is down 25% since early June through Friday (*Fig. 11*).

Global Economy III: TINAC In A World Of Hurt. Joe and I continue to recommend overweighting the US in global equity portfolios. During the previous bull market, we often explained why we preferred a Stay Home investment strategy over the alternative Go Global one. We've remained in the Stay Home camp post-bull market, but we have rebranded the rationale as "TINAC," i.e., "there is no alternative country." We've done so for all the reasons discussed above.

In the past, global economic booms and busts tended to be synchronized. The economies of the US, Europe, Japan, Australia, Canada, and the major emerging market countries tended to cycle in unison. We think that the US can skirt a global recession led by Europe and China later this year and early next year. Instead, the US should continue to experience a rolling recession, as we discussed in the Morning Briefings dated *September 6* ("Back To The Old Normal?") and *August 30* ("Anatomy Of A Rolling Recession").

Consider the following:

(1) The currency markets seem to agree with us. The JP Morgan trade-weighted dollar is up 9% ytd and 11% y/y (*Fig. 12*). Contributing to that strength is the perception that the US economy is in better shape and can handle geopolitical stresses much better than all the other major economies. Getting whacked are the euro, pound, and yen (*Fig. 13*, *Fig. 14*, and *Fig. 15*). The Emerging Markets MSCI currency index is also falling (*Fig. 16*).

(2) While forward P/Es are cheaper overseas, the ratios of the US MSCI stock price index relative to the All Country World ex-US MSCI stock price index—in both US dollars and local currencies—remain on the uptrends they've held since the start of the previous bull market in early 2009 (*Fig. 17*).

Strategy: Q2 Operating Earnings Confusion. There was a confusing divergence in the S&P 500's y/y operating EPS growth rates for Q2 as calculated by I/B/E/S and by S&P. S&P 500 earnings rose 9.8% y/y in Q2 according to I/B/E/S but *fell* 9.8% y/y according to S&P (*Fig. 18*).

I asked Joe to explain the major difference:

I/B/E/S bases its operating earnings actual figure on how the majority of analysts present their forecasts, while S&P adheres to a more rigid definition that does not consider analysts' majority rule. As a result of this different methodology, S&P's Q2 actual included the mark-to-market writedowns, or paper losses, in Berkshire Hathaway's equity investments. I/B/E/S' actual matched the analysts' consensus and did not include the writedown. The company is the sixth largest in the S&P 500 by market cap, which helps explain the impact; it's included in the S&P 500 Financials sector.

For the S&P 500, I/B/E/S' Q2 operating EPS actual figure of $57.94 was 23.4% higher than S&P's $46.97. That was the biggest divergence between the two actuals since Q1-2010, when the Energy sector took significant writedowns in the value of oil & gas. Also during Q2, I/B/E/S's actual of $10.20 for the Financials sector was 195.7% higher than S&P's $3.45. That was the highest on record for the sector since operating EPS comparisons began in Q4-2009 (*Fig. 19*).

Here are Q2-2022's y/y operating earnings growth rates for the S&P 500 and its sectors according to I/B/E/S and S&P: Energy (294.3% according to I/B/E/S, 347.5% according to S&P), Industrials (31.9, 21.5), Materials (16.1, 15.3), Real Estate (13.6, -10.8), Health Care (7.6, 6.0), Information Technology (3.1 ,-3.1), Consumer Staples (2.1 ,-9.5), S&P 500 (9.8, -9.8), Utilities (-3.9, -0.3), Consumer Discretionary (-15.3, -21.8), Communication Services (-18.4, -17.5), and Financials (-20.7, -78.3).

Calendars

US: Wed: Trade Balance -$70.5b; MBA Mortgage Applications; Beige Book; Brainard; Mester. **Thurs:** Initial & Continuous Jobless Claims 240k/1.45m; Consumer Credit $33.0b; Crude Oil Inventories; Natural Gas Storage; Powell. (Bloomberg estimates)

Global: Wed: Eurozone GDP 0.6%q/q/3.9%y/y; Germany GDP 0.1%q.q/1.8%y/y; Germany Industrial Production -0.5%; Italy Retail Sales; UK Halifax Price Index; Canada Trade Balance $3.5b; Japan GDP 0.7%q/q/2.9%y/y; Japan Leading & Coincident Indicators; BOE MPC Treasury Committee Hearings; BOC Rate Statement; Fernandez-Bollo; Jochnick; Bailey; Mann; Pill; Tenreyro; Lowe. **Thurs:** France Nonfarm Payrolls 0.5%q/q; France Trade Balance –€13.6b; China CPI & PPI 2.8%/3.2% y/y; ECB Interest Rate Decision & Deposit Facility Rate 1.00%/0.50%; Fernandez-Bollo; Rogers. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Last week, forward earnings rose w/w for LargeCap for a fourth straight week, but MidCap's fell for the first time in five weeks. SmallCap's gained for the first time in five weeks. For an ninth straight week, none of these three indexes had forward earnings at a record high. LargeCap's forward earnings is now

1.0% below its record high at the end of June. MidCap's is 0.3% below its record high in early June, and SmallCap's latest gain puts it 2.6% below its record high in mid-June. In the latest week, the yearly rate of change in LargeCap's forward earnings improved to 11.0% y/y from a 17-month low of 10.9%; 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 17-month low of 21.6% y/y from 22.6%. 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 rose to 16.4% y/y from a 17-month low of 16.1%. 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 stall or head lower now. Here are the latest consensus earnings growth rates for 2022 and 2023: LargeCap (8.3%, 8.1%), MidCap (16.4, 2.3), and SmallCap (10.9, 8.8).

S&P 500/400/600 Valuation (*link*): Valuations fell again for a third straight week for all three of these indexes from their highest levels since late April. LargeCap's forward P/E fell 0.6pt to a seven-week low of 16.5 from 17.1, which compares to a 16-week high of 18.1 in early August, a 26-month low of 15.3 in mid-June, and an 11-year low of 11.1 during March 2020. MidCap's forward P/E was down 0.5pt w/w to a seven-week low of 12.0 from 12.5, which compares to a 16-week high of 13.2 the week before that, a 27-month low of 11.1 in mid-June, a record high of 22.9 in June 2020, and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E dropped 0.7pt w/w last week, to a seven-week low of 11.6 from 12.3. That's down from a 16-week high of 12.8 the week before that and 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 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 27% discount to LargeCap is near its biggest since September 2000. SmallCap's P/E was below LargeCap's for a 107th 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 64th 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 S&P 500 earnings-per-share forecast fell 8 cents w/w to $56.23, and is now 5.5% below its $59.49 forecast at the start of the quarter. Analysts expect S&P 500 earnings growth to weaken to 4.3% y/y on a frozen actual basis and 5.1% on a pro forma basis. That's down from Q2-2022's blended actual/estimate of a 9.8% y/y gain on a frozen actual basis and 8.5% y/y on a pro forma basis. Double-digit percentage growth is expected for just four sectors in Q3-2022, and y/y declines are expected for six. That compares to Q2-2022's count of four sectors with triple- and 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 (120.3% in Q3-2022 versus 296.7% in Q2-2022), Industrials (28.0, 31.5), Consumer Discretionary (17.7, -12.3), Real Estate (10.6, 13.0), Materials (6.6, 17.4), S&P 500 (5.1, 8.5), Information Technology (-3.3, 1.5), Consumer Staples (-2.9, 2.0), Health Care (-4.0, 8.7), Utilities (-7.0, -3.7), Financials (-8.9, -19.1), and Communication Services (-15.8, -20.3).

US Economic Indicators

US Non-Manufacturing PMIs (*link*): ISM's NM-PMI continued its upward move, while prices continued to ease from April's record rate. The NM-PMI climbed for the second month, to 56.9, after easing steadily from 58.3 in March to 55.3 in June; the index was at a record high of 68.4 in November. Of the four components, the new orders (61.8 from 59.9) and business activity (to 60.9 from 59.9) measures were both the strongest since December. Supply bottlenecks continued to ease, with the supplier deliveries' measure dropping precipitously from 75.7 in October and November to a 30-month low of 54.5 in August. Meanwhile, the employment (50.2 from 49.1) gauge continues to bounce around the breakeven level of 50.0, though ticked back above in August, after two months below, matching May's rate. The price index eased for the fourth month since reaching a record-high 84.6 in April, dropping to an 19-month low of 71.5 in August.

Global Economic Indicators

Global Composite PMIs (*link*): Global demand contracted in August for the first time since June 2020, with downturns occurring in all sectors except financial services. The C-PMI dropped to 49.3, remaining on a volatile downtrend since peaking at 58.5 last May, as the NM-PMI (to 49.2 from 51.1) dropped below the demarcation line between contraction and expansion for the first time since June 2020. Meanwhile, the M-PMI sank to 50.3 in August, the lowest since mid-2020—fast approaching contractionary territory; it peaked at 56.0 last May. In August, C-PMIs showed growth contracted in five of the 14 countries covered—all advanced economies, with the US at the bottom of the PMI rankings: US (44.6), Germany (46.9), Japan (49.4), UK (49.6), and Italy (49.6). The C-PMI for developed nations sank to 46.9 from a recent peak of 61.1 last May, while the C-PMI for emerging economies was in expansionary territory for the third month, easing a bit from 55.2 in June to 53.4 in August, with expansions in India (58.3), Brazil (53.2), and China (53.0) solid. As for inflation, both input and output prices eased in August, with the former the weakest in 18 months and the latter since April 2021; rates in developed nations were noticeably higher than emerging countries, according to the report.

Eurozone Retail Sales (*link*): Eurozone retail sales, which excludes motor vehicles & motorcycles, rose in July, though remained on a downtrend. Sales edged up a smaller-than-expected 0.3% after falling in two of the prior three months by 1.7%; the latest reading is 2.7% below last June's record high. Non-food products excluding fuel was the only component recording a decline in July, sliding for the fourth time in five months, by 0.4% m/m and 1.2% over the period. Meanwhile, automotive fuel sales climbed 0.4% after a 1.2% decline and no change the prior two months, while sales of food, drinks & tobacco posted its first increase in four months, though ticked up only 0.1%. Overall sales are down 0.9% y/y, led by declines in food, drinks & tobacco (-2.4% y/y) and non-food products excluding fuel (-0.9); sales of automotive fuels (0.6) were slightly above year-ago levels. Data are available for three of the Eurozone's largest Eurozone economies, with only Germany (1.9) showing a gain, following a loss of 1.5% and a gain of 1.5% the prior two months. Sales in Spain fell for the third successive month, by 1.0% m/m and 1.3% over the period, and dropped for the second month in France, by 0.9% m/m and 1.1% over the two-month span. Compared to a year ago, sales were down in Germany (-2.7) and Spain (-1.3), and up in France (1.9).

Germany Manufacturing Orders (*link*): The volume of German factory orders contracted for the sixth consecutive month in July, sinking 1.1% m/m and 9.4% over the period, after starting the year with a 3.0% gain. Domestic orders fell 4.5% in July, while foreign orders rose 1.3% as a 6.5% increase in orders from outside the Eurozone more than offset a 6.4% drop from within the Eurozone. Here's a look at movements in domestic orders, along with the breakdown from both inside and outside the Eurozone for the main industry groupings, respectively, year to date: consumer durable goods (+6.9%, -22.1%, -6.2%), intermediate goods (-1.9, -8.6, -4.9), capital goods (-19.9, -5.4, +4.8), and consumer nondurable goods (-22.4, -15.7, -1.2).

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