Yardeni Research

MORNING BRIEFING
January 18, 2023

Some Happy Developments

Check out the accompanying chart collection.

Executive Summary: When the equal-weighted S&P 500 price index outperforms the market-cap-weighted one, that signals rising stock market breadth. That's what's been happening since October 12, the date that the bear market probably ended. … Also: Wall Street has turned more bullish on prospects for Europe's economy and stock markets in the wake of two big happy developments there. We're in the bullish camp. … European economic indicators suggest a budding recovery—with improving energy markets tempering inflation as well as bolstering industrial production and both consumer and business sentiment.

Weekly Webcast. If you missed Tuesday's live webcast, you can view a replay *here*.

US Strategy I: Equal-Weighted S&P 500 Index Outperforming. The S&P 500 comes in two flavors, i.e., the widely followed market-cap-weighted index (MW) and the equal-weighted index (EW) (*Fig. 1*). They track one another closely. Nevertheless, the ratio of the EW to the MW indexes provides some interesting insights into the stock market (*Fig. 2*). It is a measure of the breadth of the market. When the ratio is rising (falling), breadth is broadening (narrowing).

Stock market technicians tend to raise a warning flag when they see the ratio decline during a bull market since that indicates that fewer stocks are participating in the rally and those that are participating tend to be the ones with the most market capitalization. That describes what happened during the second half of the 1990s and the second half of the 2010s.

The ratio plunged during the pandemic year of 2020 when the MegaCap-8 stocks massively outperformed the rest of the market because they were deemed to be among the few companies that would benefit from the economic consequences of the health crisis. Since the end of the bear market last year on October 12 (assuming we are right that it ended then), EW has outperformed MW.

Consider the following performance derbies since January 3, 2022, which was the peak of the previous bull market:

(1) *January 3, 2022–January 13, 2023.* Since the start of the bear market through last week's close, the MW index was down 16.6%, while the EW index was down 8.4%. That's a rather startling divergence.

(2) *October 12, 2022–January 13, 2022.* Much of that divergence occurred since last year's bear market bottom as the MW rose 11.8%, while the EW increased 16.4%. We think it is a bullish development to see the rally broaden to include more stocks. It tends to confirm our view that the bear market bottomed on October 12.

(3) *January 3, 2022–October 12, 2022.* Since the start of the bear market through its low last year, the MW index was down 25.4%, while the equal-weighted index was down 21.3%.

(4) *S&P 500 sectors since October 12, 2022.* The outperformance of the EW index relative to the MW index since October 12 of last year is attributable to four sectors, namely Communication Services, Consumer Discretionary, Information Technology, and Health Care. The first three, on a market-cap basis, were weighed down by the MegaCap-8.

Here is the performance derby for the S&P 500 EW versus MW and the 11 sectors since October 12: S&P 500 (16.4%, 11.8%), Communication Services (13.9, 6.9), Consumer Discretionary (19.8, -0.8), Consumer Staples (9.5, 10.8), Energy (10.9, 12.0), Financials (15.4, 19.4), Health Care (16.4, 11.1), Industrials (19.6, 20.9), Information Technology (17.2, 11.5), Materials (20.6, 22.5), Real Estate (13.3, 16.6), and Utilities (15.9, 16.1).

US Strategy II: Trader's Corner. Here is Joe Feshbach's latest call on the stock market: "The market has rallied according to plan, accompanied by improving breadth numbers. The put/call ratio has moved back to neutral. I would've preferred to have seen the rally be met with more skepticism. So while the market should eventually get to the upper end of its trading range, the path could get a bit bumpy soon. The stochastic chart I alluded to last week remains bullish, and I believe it is signaling a very good probability that the S&P 500's two recent highs at 4100 will eventually be surpassed."

Europe I: Spring Is Coming. "[N]ow 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," Melissa and I *wrote* on June 29 of last year. Going long Europe is working out well, as the region's prospective economic positives seem to be materializing even faster than we anticipated.

(By the way, on June 23, 2022 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.")

Two unpredictable situations have played out in Europe's favor so far. Firstly, a warm winter there has mitigated the widely feared gas crisis spurred by the war in Ukraine; it hasn't become much of a crisis after all. Secondly, China—a major trading partner of Europe—has abandoned its restrictive zero-Covid policies; had it not done so, the fear was that supply-chain issues would worsen Europe's fate, along with weaken European exports to China.

Indeed, Europe is not recession-proof. Inflation persists. The European Central Bank is plugging along with its plans to continue to tighten monetary policy. But we remain sanguine about the European economy and European stocks (see our December 7 *Morning Briefing*).

Let's first review the positive turn in current events for Europe before updating the region's latest economic indicators:

(1) *Lack of snow melts away recession risks.* Europeans' fears about the gas crisis leaving them in the cold and dark this winter were all for naught. Unusually warm temperatures have left Alpine ski resorts snowless. Reuters *reported* that temperatures in Switzerland averaged the warmest on record during 2022. It was the *warmest* Christmas Eve in Budapest and the warmest New Year's Eve in France on record. French and Spanish ski resorts also were closed over the winter holiday owing to a lack of snow.

(2) *Europe buys time to winterize.* Certainly, the warmer weather provided European governments with more room to resolve their energy problems, but are they over yet? Probably not. One of the problems is that Europe's gas reserves are meant to solve seasonal issues; they are not strategic reserves to prevent embargoes or blockades. But the more gas remaining at the end of this season, the less gas needed to fill the tanks for next winter, which will buy Europe a good amount of time to sort out its energy strategies going forward.

It wasn't just lucky weather that helped Europe avert an economic meltdown this season. Governments scrambled to unwind their reliance on Russian energy, especially natural gas, as Bloomberg *discussed*. The European Union is no longer importing coal and crude oil from Russia, and gas deliveries have been significantly curtailed. Some of the gap has been filled by increasing supplies from Norway and shipments of liquefied natural (LNG) gas from Qatar, the US, and other producing countries. New LNG facilities in Germany are becoming operational. And renewable capacity expansion also is also expected to help plug the energy holes.

China's zero-Covid policies lessened global competition for LNG shipments (and eased global price pressures) as consumption there dwindled. But China has turned to more affordable fuel options, including coal, pipeline gas and domestic production, Bloomberg observed. So plenty of affordable LNG may remain available for Europe's taking.

(3) *Surplus & high prices cool gas prices.* Both higher-than-average gas prices and higher-than-average temperatures helped curb consumption this winter as LNG inflows reached record highs. Europe's gas inventories are at the second highest level in a decade, *reported* Reuters. Gas Infrastructure Europe's Aggregated Gas Storage Inventory *shows* that the EU's gas tanks are over 80.0% full as of January 16, whereas winter drawdowns normally would have depleted much more of the reserves. In following with the seasonal gas surplus, benchmark natural gas prices in Europe reached the lowest level since before the war, Bloomberg *reported* on January 2.

(4) *Sanctions on Russian energy heat up.* On February 5, Europe is planning to block imports of Russian diesel and other refined products, the *WSJ* has *reported*. That same day, the Western allies are preparing to cap prices on Russian exports of refined petroleum. Two price limits will be set: one for high-value products like diesel and one for low-value exports like fuel oil.

Already, the EU and its allies have capped prices on Russian crude. But as we had expected, the price cap didn't have much impact because it was set at $60 per barrel, not much lower than the current oil price. Also so-called shadow tankers outside the jurisdiction of the cap-setting countries carried oil to destinations in Asia that had no cap. But Europe's blockade may reverberate around the globe this time because of the specialized tankers needed to carry petroleum products across the sea.

(5) *As China turns, so does the consensus.* More lucky news for Europe is the China reopening story. China is the EU's leading trading partner, representing about 16% of all goods trade, Reuters *noted*. That's led analysts to jettison their previous recommendations to underweight Europe, which reflected not just the war but also supply-chain pressures and lower demand from China. Goldman Sachs expects China's Covid policy pivot to mitigate European recession risks. AXA Investment Managers says that China demand will offset downside risks elsewhere. Chinese travel could benefit European luxury stocks, says UBS.

Europe II: Green Shoots. With Europe's energy markets easing and consumers feeling less squeezed, consumer demand could start picking up. Manufacturers could start to see orders rebound. Inflation broadly is still high in the region but should moderate this year, as fiscal policymakers have eased up on their stimulus efforts and as the European Central Bank (ECB) policymakers have been aggressively raising interest rates.

Here's a look at the latest economic indicators, which are starting to show green shoots:

(1) *Europeans turning more optimistic.* The European Economic Sentiment Index (ESI) rebounded in November and December after dropping from June through October (*Fig. 3*). The consumer component of the ESI has recently turned upward after falling for several months (*Fig. 4*).

Probably the best news about Europe lately has also been the most recent—Germany's IFO surveys. The IFO Business Confidence index turned significantly higher during the final three months of last year (*Fig. 5*). This occurred following six consecutive falls in survey respondents' assessment of the current situation through November. Expectations also improved noticeably.

(2) *Inflation could be moderating.* Recently, we wrote that inflationary pressures in Europe should ease over the longer term as the war-related, energy-related, and supply-chain challenges abate. That may be starting to happen. The Eurozone CPI had soared 10.6% y/y during October, surpassing the previous several months' record highs. But it eased to 10.1% in November and 9.2% in December, according to the flash estimate, led by falling energy prices (*Fig. 6* and *Fig. 7*). Excluding energy, food, alcohol, and tobacco, the CPI slowed as housing prices moderated, undoubtedly in part due to the ECB's efforts to moderate inflation (*Fig. 8* and *Fig. 9*). (The Eurozone's final reading for December's CPI is due out this morning.)

(3) *Industrial production meltdown averted.* Europe's industrial production on a y/y basis had fully recovered to pre-pandemic levels until the war on Ukraine heated up energy prices (*Fig. 10*). Manufacturers have had to reduce their production not only out of concern for a possible drop in demand on the heels of the widely anticipated recession but also to conserve energy.

Sure, energy prices have come way down since last November, but likely "would have to stay at lower levels for months for factories to raise output significantly, and for the benefits to trickle down to consumers, analysts and companies," *wrote* the *WSJ* on January 6. "The worst-case scenario that threatened us this summer has been avoided so far … a complete meltdown of the heart of European and German industry has been averted," German Economy Minister Robert Habeck said earlier this month.

(4) *German orders stagnant & auto production healthy.* Incoming orders for manufacturers in Germany, the EU's largest economy, fell during November after a slight uptick in the previous month (*Fig. 11*). German automakers are seeing an upturn in demand (*Fig. 12*). That's mainly because they still have a backlog of orders from the post-pandemic supply-chain pileup. Automakers may have averted a rougher road ahead as gas prices ease up.

(5) *Growth could turn up soon.* Eurozone real GDP for Q3-2022 was revised up slightly from the initial flash estimate (*Fig. 13*). On an annual basis, growth was up 2.3% y/y (revised up from 2.1%). Now that energy prices are down sharply and China has reopened, Europe's growth prospects are looking up.

(6) *Labor market remains strong.* The unemployment rate in the Eurozone, now at 6.5%, has dropped well below even pre-pandemic levels (it was 7.2% when the pandemic began in March 2020). Europe's labor market never took a dramatic hit during the pandemic largely because job-retention schemes maintained worker-employer bonds. The labor market remains exceptionally strong considering all the ups and downs that Europe recently has encountered.

(7) *Stock prices catching up with analysts.* The Europe MSCI Index is up 31.5% in dollar terms through January 16 from a recent low on September 27 as Russia's war on Ukraine escalated (*Fig. 14*). Our Blue Angels Implied Price Index shows that European valuations are still attractive but slowly becoming less so as investors' price expectations catch up to analysts' positive views (*Fig. 15*). Analysts have been raising their earnings expectations for months despite all the bad headlines (*Fig. 16*).

Calendars

US: Wed: Headline & Core PPI -0.1%m/m/6.8%y/y & 0.1%m/m/5.6%y/y; Retail Sales Total, Core, and Control Group -0.8%/-0.4%/-0.2; Headline & Manufacturing Industrial Production -0.1%/-0.2%; Capacity Utilization 79.6%; Business Inventories 0.4%; NAHB Housing Market Index 31; TIC Net Long-Term Transactions; MBA Mortgage Applications; Beige Book; IEA Monthly Report; Harker; Logan. **Thurs:** Housing Starts & Building Permits 1.359mu/1.370mu; Philadelphia Fed Manufacturing Index -11; Initial & Continuous Jobless

Claims 214k/1.66m; Crude Oil Inventories & Natural Gas Storage; Williams; Brainard. (Bloomberg estimates)

Global: **Wed:** Eurozone Headline & Core CPI -0.3%m/m/9.2%y/y & 0.6%m/m/5.2%y/y; UK Headline & Core CPI 0.4%m/m/10.6%y/y & 0.4%m/m/6.3%y/y; UK PPI Input & Output 0.2%m/m/18.0%y/y & 0.3%m/m/16.4%y/y; Japan Trade Balance -¥1.65t; BOJ Interest Rate Decision -0.10%; Australia Employment Change 22.5K; Australia Unemployment & Participation Rates 3.4%/66.8%; World Economic Forum Annual Meetings. **Thurs:** Eurozone Current Account; ECB Publishes Account of Monetary Meeting; Schnabel; Lagarde. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell simultaneously w/w for all three of these indexes as analysts' revision activity returned following the winter holiday. LargeCap's dropped to a 46-week low and is down in 10 of the past 15 weeks. MidCap's fell to a 44-week low and has dropped in 15 of the past 17 weeks. SmallCap's was down to a three-week low, but that's not much above its 13-month low in mid-December. For a 29th straight week, none of these three indexes had forward earnings at a record high. However, forward earnings remains on a modest downtrend for these three indexes compared to their deep declines during the Great Virus Crisis and the Great Financial Crisis. LargeCap's is 4.5% below its record high at the end of June; MidCap's is 6.8% below its record high in early June; and SmallCap's is 9.6% below its mid-June record. Forward earnings momentum remains near two-year lows. The yearly rate of change in LargeCap's forward earnings was down to a 22-month low of 2.1% y/y; that compares to a record-high 42.2% at the end of July 2021 and is up from -19.3% in May 2020, which was the lowest since October 2009. MidCap's rate of 4.3% y/y is near a 23-month low, down from a record high of 78.8% in May 2021, and compares to a record low of -32.7% in May 2020. SmallCap's rate of -0.9% y/y is at a 25-month low, down from a record high of 124.2% in June 2021. It had been at a record low of -41.5% in June 2020. Analysts' consensus earnings forecasts for 2023 have been heading lower since June. Here are the latest consensus earnings growth rates for 2022 and 2023: LargeCap (5.4%, 4.0%), MidCap (15.7, -4.9), and SmallCap (5.2, 3.0).

S&P 500/400/600 Valuation (*link*): Valuations moved higher w/w for these three indexes. LargeCap's forward P/E rose 0.4pt to a six-week high of 17.4 but remains 0.3pt below its four-month high of 17.7 in early December. It's up 2.3pts from its 30-month low of 15.1 at the end of September, which compares to a four-month high of 18.1 in early August and an 11-year low of 11.1 during March 2020. MidCap's forward P/E rose 0.6pt to a nine-month high of 13.9. That's up 2.8pts from a 30-month low of 11.1 at the end of September and compares to 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 rose 0.7pt w/w to a nine-month high of 13.4 to 2.8pts above its 14-year low of 10.6 at the end of September and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's current 21% discount to LargeCap is near its biggest since September 2000. SmallCap's current 23% 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 an 83rd straight week; the current 3% discount is an improvement from its 9% discount in December 2021 but remains near its lows during 2000-01.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Following the Q3-2020 earnings season when the US economy emerged from the Covid shutdown, analysts began raising their consensus forecasts for future quarters instead of lowering them as is the historical norm. That six-quarter streak of positive revisions throughout the quarter ended during Q1-2022, and the declines began to accelerate considerably beginning with Q3-2022. The S&P 500's earnings growth rate weakened q/q in Q3 to 4.0% y/y from 9.9% in Q2 on a frozen actual basis, and to 4.4% from 8.4% on a pro forma basis. Just four sectors recorded double- and triple-digit percentage growth in Q3-2022, two have a single-digit gain, and five have y/y declines. Looking ahead to Q4, analysts expect further deterioration; a 2.2% y/y decline is expected for the S&P 500, with just four sectors expected to record positive y/y earnings growth and seven expected to decline. Here are the S&P 500 sectors' latest expected earnings growth rates for Q4-2022 versus their Q3-2022 growth rates: Energy (63.4% in Q4-2022 versus 140.9% in Q3-2022), Industrials (42.1, 19.6), Real Estate (6.9, 14.8), Utilities (3.6, -7.1), S&P 500 (-2.2, 4.4), Consumer Staples (-2.8, 1.3), Health Care (-6.4, 1.5), Financials (-7.6, -16.4), Information Technology (-8.7, -0.2), Consumer Discretionary (-15.8, 13.3), Communication Services (-21.6, -26.1), and Materials (-22.6, -7.8).

US Economic Indicators

Regional M-PMIs (*link*): The New York Fed has provided the first glimpse of manufacturing activity for January and showed growth collapsed to its lowest level since mid-2020 and the fifth worst in the survey's history. Companies expect a slight improvement in business conditions over the next six months. January's *composite index* fell sharply for the second month, by 21.7 points in January and 37.4 points over the period, to -32.9. It was at 4.5 in November, which was the first reading in positive territory in seven months. Both new orders (to -31.3 from -3.6) and shipments (-22.4 from 5.3) fell sharply this month, while delivery times (0.9 from 1.9) held steady and inventories (4.5 from 3.7) accumulated at a slightly faster rate. As for the labor market, employment (2.8 from 14.0) was at a near standstill, while the average workweek (-10.4 from -4.5) was shortened further. The prices-paid index eased to a 26-month low of 33.0 this month, down from last April's record high of 86.4, while the prices-received measure eased to a 24-month low of 18.8 from last March's record high of 56.1. Looking ahead, *the index of future business conditions* climbed in January for the second month to 8.0 from 6.3 and -6.1 the prior two months. Both new orders (to 10.4 from -6.4 in November) and shipments (16.9 from -10.0) measures swung from negative to positive over the two-month period, while the employment gauge eased to 9.7—the slowest pace in hirings since April 2020. The prices-paid (45.5 from 55.1) measure slowed a bit to a six-month low, while the prices-received gauge eased to 33.9. Both measures have been in volatile flat trends around recent lows the past few months. The prices-paid and prices-received measures were at record highs of 76.7 and 62.1, respectively, last January.

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