Yardeni Research

MORNING BRIEFING
May 2, 2023

Global Economy Here & There

Check out the accompanying chart collection.

Executive Summary: We're not among the vocal doom-saying economic prognosticators. We say there's a 60% chance that the economy will land softly this year and pick up speed next year, fueled by productivity gains. … Also: We update our rolling recession watch, zeroing in on two loan-dependent industries likely to be rolled over next: autos and commercial real estate construction. … And: Melissa examines why inflation is stickier in Europe than in the US and discusses other economic headwinds facing the Eurozone. These headwinds and the Europe MSCI's current valuation make us less bullish on European stocks than we were last June.

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

US Economy I: Words of Warning. Bad times are coming. Jamie Dimon, the CEO of JP Morgan Chase, has been warning since last summer that American consumers will run out of the excessive saving they accumulated during the pandemic by the second half of this year. So he expects a recession in coming months, though a mild one.

On Sunday, April 30, Elon Musk, the CEO of Tesla and proprietor of Twitter, *tweeted*: "It is becoming harder for people to get car loans in the US, even when their credit is good. Understandable that banks are slow to extend credit when they're trying to avoid bankruptcy themselves!"

Also on Sunday, Charlie Munger said trouble is ahead for the US commercial property market, as US banks are packed with "bad loans" that will be vulnerable as "bad times come" and property prices fall. "It's not nearly as bad as it was in 2008," the 99-year-old investor told the Financial Times in an *interview*. "But trouble happens to banking just like trouble happens everywhere else."

Debbie and I are still assigning a 60% subjective probability to a soft-landing scenario and the remaining 40% to a hard-landing one for the rest of this year. We had predicted a 1.0% (saar) increase in real GDP for Q1-2023 (*Fig. 1*). It came in at 1.1%. That's a preliminary number that will be revised a couple of times. In any event, the reading isn't as soft as 1.1% suggests because real final sales rose 3.4% during the quarter, led by a 3.7% increase in real consumer spending.

For Q2, we are projecting a 1.0% increase in real GDP followed by 2.0% increases for the last two quarters of this year. If that scenario starts to unfold, we wouldn't be surprised to see the doomsters soon start pushing out their hard-landing scenario into 2024, when we expect a pickup in economic growth fueled by better productivity gains.

US Economy II: Rolling Recession Update. We think that a recession of the rolling variety actually started early last year when the Fed began raising interest rates aggressively, knocking the single-family residential industry off its foundation. Producers and providers of goods fell into a recession during H2-2022, when consumers unexpectedly pivoted from buying goods to purchasing services. That caused unintended inventory accumulation, which was cleared by cutting new orders and prices. Now the upturn in April's M-PMI and its components suggests that the goods recession may be bottoming (*Fig. 2*).

Up ahead, we agree with Musk and Munger that the auto and commercial real estate industries will be challenged by tightening lending standards. So the rolling recession will continue to roll for a while longer. Consider the following:

(1) *Autos.* Weekly data are available on auto loans at US commercial banks (*Fig. 3*). The series for all banks fell 0.6% y/y through the April 19 week to $516 billion. Total motor vehicle loans in consumer credit are available only through Q4-2022, when they rose to a record $1.4 trillion even though interest rates on those loans rose and lending standards were tightened (*Fig. 4*). The good news is that auto sales have been relatively subdued (*Fig. 5*). Since there hasn't been an auto sales boom, any bust is likely to be relatively mild.

(2) *Construction.* Weekly data are also available on commercial real estate loans at all banks (*Fig. 6*). They've been edging down recently from a record high of $2.92 trillion during the March 15 week.

Commercial construction put in place peaked at a record $131.8 billion (saar) during December 2022. It was down 4.8% from there through March. This is likely to be the latest cyclical peak in this series for a while. However, manufacturing construction put in place soared 62.3% y/y through March to yet another record high of $147.4 billion, fueled by the onshoring of production.

Europe I: The Price of a Baguette. Parisian bakers report that their electric bills have quadrupled since Russia invaded Ukraine, while the costs of flour, butter, and eggs all are up about 50%. “The headwinds facing boulangeries in France’s capital highlight why the European Central Bank [ECB] is facing a tougher struggle than the Federal Reserve,” according to an April 28 *Barron’s* article discussing why Europe’s inflation problem is stickier—more persistent and less likely to be tamed—than that of the US. Here are some of the points made and our own observations:

(1) *What’s behind inflation’s rise*. Expectations are that European inflation will outlast inflation in the US; one reason is that the ECB started raising interest rates later than the Fed did.

In a pressure cooker of pent-up demand and supply-chain shortages following the Covid-19 pandemic, Russia’s invasion of Ukraine during February 2022 sent European inflation boiling over. Europe’s limited gas supplies as a result of the war exerted upward pressure on prices generally. Looking ahead, the ECB is concerned that geopolitical tensions and fragmentation could push prices up further.

(2) *Inflation over there.* Headline inflation in the Eurozone peaked at a record-high rate of 10.6% in October and is now 6.9% (*Fig. 7*). (The flash estimate for April will be available this morning.) But the drop in Eurozone inflation has been driven almost entirely by lower energy prices due to a mild winter. Energy in the Eurozone CPI dropped from an extremely elevated rate above 40% in the months after the war began in March 2022 to -0.9% in March of this year (*Fig. 8*). Meanwhile, food, alcohol, and tobacco prices have shown no sign of abating, with the rate soaring to a new record high of 15.5% in March (*Fig. 9*).

French ECB policymaker Francois Villeroy de Galhau said during an April 25 *interview* that he expects that food price inflation will decline during H2-2023 but that headline inflation likely won’t fall to the ECB’s target until 2025.

(3) *When rates will fall.* With no sign of overall inflation easing anytime soon, the ECB is widely anticipated to raise interest rates during its meeting this week, on May 4, and to keep raising them at subsequent meetings. The Fed likely is nearly done raising rates.

Europe II: Winter Is Coming, Again. Europe’s economy avoided a recession during Q1-2023, when real GDP rose just 0.3% (saar). The region remained surprisingly resilient despite Russia’s war on Ukraine, the recent banking crisis, and the ECB’s fight against inflation. Rising factory output and falling energy costs helped to drive a slight rebound in overall output. Europe also benefited since late last year from less restrictive Covid-19 policies from China, its largest trading partner.

Our call last June suggesting overweighting European stocks turned out to be a good one. Melissa and I noted in the June 29 *Morning Briefing*: “[N]ow may be a good time to buy and hold European stocks given how cheap they’re trading relative to recent history.” That was as lots of smart money was building up short positions in Europe, only to *unwind* them soon after.

Looking ahead, Europe is not recession-proof. Inflation persists. The ECB is plugging along with its plans to continue to tighten monetary policy, as discussed above. European stocks have become less attractive now that stock prices have caught up with better-than-expected outcomes for energy and trade, and overall output. China’s less restrictive pandemic policies may ease supply-chain challenges for Europe, but increased domestic demand in China could increase competition for global liquified natural gas (LNG) resources. Geopolitical tensions and fragmentation could strain Europe’s ability to obtain other natural resources. It’s not hard to see these challenges sending shivers through European markets ahead of next winter.

For these reasons, Melissa and I now are less bullish on Europe than we have been. Here's more on the headwinds facing Europe:

(1) *Energy stores.* Energy prices have fallen from last summer’s peaks. The warm winter has mitigated the widely feared gas crisis spurred by the war in Ukraine. Europe also has found alternative sources of LNG. Imports of LNG from the US rose substantially early in 2023 compared to early last year.

However, Europe is not out of the woods, as its energy stores need to be replenished for next winter. “The European Union faces a potential shortfall of almost 30 billion cubic [meters] of natural gas in 2023—but this gap can be closed and the risk of shortages avoided through stronger efforts to improve energy efficiency, deploy renewables, install heat pumps, promote energy savings and increase gas supplies,” the IEA said in a December 2022 *report*.

Yet the IEA cautioned that “2023 may well prove to be an even sterner test for Europe because Russian supplies could fall further, global supplies of liquified natural gas will be tight—especially if Chinese demand for LNG rebounds—and the unseasonably mild temperatures seen at the start of the European winter are not guaranteed to last.”

A policy brief on the website of Brugel, a Europe-focused think tank, *wrote* that European gas stores will need to be 90% full by October 2023 to allow for naturally occurring demand.

But overly low stores could be offset by demand-dampening policies that reduce consumption by 13% (relative to the average of the past five years), Brugel estimates. Strong economic growth in China, for example, could tighten LNG markets, the brief also noted.

(2) *German reactors closed.* On April 14, the German government went ahead with its plan to close the remaining three nuclear reactors. In an April 14 letter to Germany's chancellor Olaf Scholz, scientists wrote: "In view of … the obvious energy crisis in which Germany and Europe find themselves due to the unavailability of Russian natural gas, we call on you to continue operating the last remaining German nuclear power plants." In the absence of nuclear power, electricity prices are bound to rise, they said. In effect, they called Scholtz a *dummkopf*.

(3) *China monopoly.* It's not just energy shortages that are putting Europe's economic future at risk. Europe's fate also could depend on geopolitical tensions and further fragmentation from China. Europe depends on China for 98% of its rare earth supply, observed ECB Chair Christine Lagarde in an April 28 *speech*. Indeed, Beijing is reportedly *crafting* plans to potentially block exports of technology needed to process and magnetize certain rare earth metals. Supply disruptions on these fronts could affect critical sectors in the economy, such as the automobile industry and its transition to electric vehicle production," Lagarde added. She expects that if "global value chains fragment along geopolitical lines, the increase in the global level of consumer prices could range between around 5% in the short run."

(4) *Banking crisis ongoing.* Despite policymakers' attempts to inspire confidence in the banking system, stocks of European banks continue to be hit by the turmoil sparked by Silicon Valley Bank and the collapse and subsequent government-brokered takeover of Switzerland's Credit Suisse.

(5) *Stock prices.* The Europe MSCI Index is up 37.9% in dollar terms through Friday's close from a recent low on September 27, when Russia's war on Ukraine was escalating (*Fig. 10*). Our Blue Angels Implied Price Index shows that European valuations have become less attractive (*Fig. 11*). Heading into 2023, analysts had been increasing their earnings expectations despite all the bad headlines (*Fig. 12*). Since the start of this year, however, consensus estimates for the Europe MSCI's earnings per share (in local currency) have been dropping, likely because analysts anticipate higher interest rates.

Europe III: From Green to Beige Shoots. With Europe's energy markets easing and factory orders rising, an increase in consumer demand would seem likely to follow. But because inflation broadly is still high, these positive developments have barely shown up in consumer sentiment so far. Here's a look at the latest economic indicators, which seem to be more beige than green this spring:

(1) *Eurozone output.* Last fall, a recession in the Eurozone, caused largely by the cost of Russia's pullback on natural gas supplies, was widely expected. But Europe made it through winter relatively unscathed. Real GDP rose at an annualized rate of 0.3% in Q1, after contracting by 0.2% in Q4-2022 (*Fig. 13*). On a y/y basis, output rose 1.3%. Growth this year has partly been driven by factories that have reversed a reduction in output, as energy prices surged last year. But depending on how the energy crisis shakes out next winter, factory output may face a pullback again later this year.

(2) *Eurozone sentiment.* The Eurozone's economic sentiment indicator (ESI) fell below 100 during July 2022 on fears of energy shortages during the winter, which did not happen (*Fig. 14*). It bottomed at 93.8 in October, rebounded to 99.3 in March, and stayed there in April. That reading is consistent with no growth in the region's real GDP on a y/y basis. Sentiment could fall again if the energy outlook darkens further as the ECB tightens. Consumer sentiment has been weak, as mirrored in the volume and value of retail sales (*Fig. 15* and *Fig. 16*). However, the ESI's consumer component has rebounded by 10.9pts since September's record low of -28.8.

(3) *Industrial production and German orders.* Until the war jacked up energy prices, Europe's industrial production on a y/y basis had fully recovered to pre-pandemic levels (*Fig. 17*). Manufacturers had to reduce their production late last year to conserve energy. Energy prices have come way down since late last year, but likely would need to stay at lower levels through year-end for factories to affordably raise output on a sustainable basis. Incoming orders for manufacturers in Germany, the EU's largest economy, rose early this year along with industrial production (*Fig. 18* and *Fig. 19*).

We will see how the energy, banking, and geopolitical crises play out ahead. But even if Europe's headwinds turn out to be milder than expected, we would rather market-weight than overweight Europe for now.

Calendars

US: Tues: Job Openings 9.68m; Factory Orders 1.3%; API Weekly Crude Oil Inventories. **Wed:** ADP Employment 143k; ISM NM-PMI 51.8; S&P Global C-PMI & NM-PMI 53.5/53.7;

MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Fed Interest Rate Decision 5.25%. (Bloomberg estimates)

Global: **Tues:** Eurozone Headline & Core CPI Flash Estimates; 0.9%m/m/7.0%y/y & 1.1%m/m/5.7%y/y; Eurozone, Germany, France, Italy, and Spain M-PMIs 45.5/44.0/45.5/49.0/49.0; Germany Retail Sales 0.4%; UK M-PMI 46.6; Italy CPI -0.1%m/m/7.8%y/y; Italy PPI; UK Nationwide HPI -0.3%m/m/-3.6%y/y; Australia Retail Sales; RBA Interest Rate Decision 3.60%; Enria; Lowe. **Wed:** Eurozone Unemployment Rate 6.6%; Italy Unemployment Rate 8.0%; UK BOE Quarterly Bulletin; Jochnick; McCaul; Wuermeling; Balz; Ellis. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell last week for two of these three indexes, but all three remain above their lows during February and March. Through the week ending April 28, LargeCap's forward earnings rose 0.4% w/w for its sixth gain in the last eight weeks and is now 1.2% above its 54-week low during the week of February 10. MidCap's fell less than 0.1% w/w to 0.4% above its 55-week low during the week of March 10. SmallCap's was down 0.1% w/w to 1.5% above its 72-week low during the March 17 week. For a 44th 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 4.7% below its record high at the end of June; MidCap's is 7.8% below its record high in early June; and SmallCap's is 12.3% below its mid-June record. Forward earnings momentum remains near two-year lows. The yearly rate of change in LargeCap's forward earnings was negative for a 13th straight week, and dropped to a 27-month low of -3.1% 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 -4.8% y/y is at a 29-month low, which compares to a record high of 78.8% in May 2021 and a record low of -32.7% in May 2020. SmallCap's rate of -7.8% y/y is at a 30-month low during the April 28 week, but down from a record high of 124.2% in June 2021; it compares to a record low of -41.5% in June 2020. Analysts' consensus earnings forecasts for 2023 and 2024 have been heading lower since last June. Here are the latest consensus earnings growth rates for 2023 and 2024: LargeCap (0.9% and 11.9%), MidCap (-10.9, 13.9), and SmallCap (-8.3,15.1).

S&P 500/400/600 Valuation (*link*): Valuations mostly ticked lower w/w through the April 28 week for these three indexes. LargeCap's forward P/E was flat for a third week at 18.2, which matches its nine-month high of 18.2 in early February. It's up 3.1pts from its 30-month low of 15.1 at the end of September, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E fell 0.1pt to 13.4, which is 0.7pts below its recent 10-month high of 14.7 in early February. It's now 2.3pts above its 30-month low of 11.1 at the end of September, which 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 dropped 0.1pt to 12.8 and remains 1.5pts below its recent 12-month high of 14.3 in early February. It's 2.2pts 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 P/E is at a 26% discount relative to LargeCap's, not much improved from a 23-year-low 28% discount last July. It had been at a 21% discount during the March 17 week, which was near its best reading since November 2021. SmallCap's 30% discount to LargeCap's P/E last week is also not much improved from a 21-year low of 32% in April 2022. That compares to a 22% discount during the March 10 week, which was near its lowest since August 2021. 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 98th straight week; the current 5% discount has weakened from 1% during the March 31 week. That 1% discount had been its lowest since July 2021 and an improvement from its 20-year-low 9% discount in December 2021.

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. Analysts expect the S&P 500's earnings growth rate to decelerate q/q for a seventh straight quarter in Q1-2023 to -5.3% y/y from -1.6% in Q4-2022 on a frozen actual basis and to -1.9% from -3.2% on a pro forma basis. Four sectors are expected to record positive y/y percentage earnings growth in Q1-2023, up from only two sectors doing so in Q4-2022. Here are the S&P 500 sectors' latest expected earnings growth rates for Q1-2023 versus their final Q4-2022 growth rates: Consumer Discretionary (49.1% in Q1-2023 versus -15.6% in Q4-2022), Industrials (23.2, 41.4), Energy (17.4, 59.1), Financials (7.3, -8.9), Consumer Staples (-0.9, -2.5), S&P 500 (-1.9, -3.2), Real Estate (-8.8, -3.2), Communication Services (-6.7, -28.2), Information Technology (-11.7, -10.0), Utilities (-12.2, -4.6), Health Care (-18.0, -2.7), and Materials (-27.5, -20.4).

US Economic Indicators

US Manufacturing PMI (*link*): "The manufacturing sector contracted again; however, the M-PMI improved compared to the previous month," noted Timothy R. Fiore, chairman of ISM. "The April composite index reading reflects companies continuing to manage outputs to better match demand for the first half of 2023 and prepare for growth in the late summer/early fall period," he added. ISM's April M-PMI continued to contract, though at a slower pace, after sinking to its lowest level in nearly three years in March—remaining below the break-even point of 50.0 for the sixth successive month. Since peaking at 63.8 in March 2021, the M-PMI dropped to a 34-month low of 46.3 this March, ticking up to 47.1 in April. Excluding the pandemic, March's reading was the lowest since mid-2009. Both the *new orders* (to 45.7 from 44.3) and *production* (48.9 from 47.8) components continued to contract, though at a slower pace, the latter moving closer to 50.0. In the meantime, the *employment* (50.2 from 46.9) gauge moved out of contractionary territory after posting its weakest showing since July 2020 in March. The *supplier deliveries* (44.6 from 44.8) measure for April fell to its lowest level since March 2009's 43.2—down sharply from May 2021's peak of 78.8. (A reading below 50.0 indicates faster deliveries to factories.) Meanwhile, inventories (46.3 from 47.5) contracted at the fastest pace since August 2020, as businesses are slow to restock shelves on fears of weakening demand. ISM's *prices-paid* measure accelerated in April to a nine-month high of 53.2, after slowing to 49.2 in March, following an upswing from a 32-month low of 39.4 at the end of last year to 51.3 this February; it peaked at 92.1 in mid-2021—which was the fastest since the summer of 1979.

Construction Spending (*link*): Construction spending remained stalled at record highs in March, as strength in private nonresidential and state & local government investment offset the sharp decline in private residential construction. *Total* construction spending climbed 0.3% in March after a three-month dip of 0.6%, holding within 0.3% of November's record high. *Private construction* investment rose 0.3%, after a 1.6% three-month drop, to within 1.3% of last July's record high. *Public construction* spending increased for the 10th straight month, by a total of 15.0%, to yet another new record high, though the pace slowed in March, ticking up 0.2%—the weakest of the 10-month stretch. *Within private construction* spending, *residential* investment contracted for the 10th successive month since reaching a record high last May, slumping 12.4% over the period after not posting a decline since May 2020. The weakness in residential investment was driven by *single-family* construction spending, which hasn't recorded a gain since last April, plunging 23.8% during the 10 months through March. *Home improvement* spending has been volatile, edging up 0.3% in March, after a two-month drop of 5.6%, following a 3.1% gain the final two months of 2022;

it is 10.8% below last July's record high. Meanwhile, *multi-family* construction has soared 22.1% over the eight months through March to a new record high. Private *nonresidential* spending has advanced for the 10th time in 11 months, by 21.6%, reaching another new record high in March; manufacturing and health care investment hit new record highs, while office, commercial, and transportation building came in just below record highs.

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