MORNING BRIEFING
June 27, 2023

Europe, What A Drag!

Check out the accompanying chart collection.

Executive Summary: The Eurozone's economic outlook has darkened, and we're not nearly as bullish on European equities as one year ago. … The ECB's interest rate hikes so far have triggered a technical recession, which is bound to worsen because the region's stubbornly high inflation implies no end to the tightening in sight. … Other red flags: Analysts have been cutting consensus earnings estimates; high interest rates have depressed demand for business loans to 2008 levels; Europe's energy resilience could be challenged this winter; and the GDP of Europe's biggest economy, Germany, is projected to contract this year. … Risks associated with China trade present yet another headwind for the European economy.

Europe I: Greetings from Dubrovnik! My wife and I started our vacation in Croatia last Thursday. We will be back in the USA this coming Thursday. There were no signs of a recession at Newark's International Airport, which was packed. So was our flight. Croatia's port cities of Split and Dubrovnik are teeming with cruise ships.

We started our trip in Zagreb for one day and Split for three days. Now we are in Dubrovnik for the rest of our stay. Croatia is beautiful and attracts lots of tourists this time of year. Tourism is the biggest industry here. Many Croatians have moved elsewhere in Europe for steady work year-round. The small country joined the European Union (EU) on July 1, 2013 and the Eurozone on January 1, 2023. The Croatians we met are complaining that they're plagued by the EU's inflation while their wages at home remain depressed because of the limited employment opportunities in Croatia.

I asked Melissa to update our outlook for Europe today, which she does below.

Europe II: Less Attractive. Last June, Melissa and I recommended that investors overweight their positions in Europe. That turned out to be a good call. However, last month, we turned less bullish on European equities. We're now advising investors to consider reducing their positions in European equities if they haven't already done so. Rising interest rates and numerous other challenges have caused a technical economic recession in Europe, diminishing the investment opportunities in the region's stock markets.

Growth should pick up in Europe over the long term, however. That could begin as soon as

H2-2024 if inflation recedes as we expect it will and the European Central Bank (ECB) ceases its monetary policy tightening. This coming winter will test Europe's energy resilience, especially if it's colder than last winter. Waiting out European markets through this season could be prudent.

European investors appear to be more optimistic than consumers and producers. Europe's MSCI Index is up 32.2% in dollar terms through Friday's close from a recent low on September 27, when Russia's war on Ukraine was escalating as winter was approaching (*Fig. 1*). However, Melissa and I believe that this increase is less reflective of investors' outlook and more of a valuation catch-up after fears that had depressed valuations failed to materialize (e.g., reduced Russian gas exports to Europe never caused the region to run out of gas, partly because it was a very mild winter).

Our Blue Angels Implied Price Index shows that European valuations have become less attractive (*Fig. 2* and *Fig. 3*). Analysts had been increasing their earnings expectations heading into 2023 despite all the negative headlines. However, since the beginning of this year, consensus estimates for the Europe MSCI's earnings per share (in local currency) have been declining, likely due to expectations of higher interest rates (*Fig. 4*).

Factors such as inflation, energy resilience, Germany's economic performance, China's impact on Europe, and risks in the banking sector will continue to shape the region's economic outlook. It's important for investors to closely monitor these developments to best assess the potential risks and opportunities in the European stock markets.

Europe III: Pricey Pasta. Parisians have to dig deeper in their pockets to buy a baguette, as we discussed in our May 2 *Morning Briefing*. Italians are holding crisis meetings to discuss the problem of rising pasta prices, reported a May 22 CNBC *article*. Europeans widely are battling high rates of inflation in food and other categories even though the energy crisis has taken a welcome summer break.

While headline inflation has decreased, certain price categories remain elevated despite the ECB's efforts to combat them. This means that the ECB's tightening cycle still has a long way to go, which poses the risk that higher interest rates could push the European economy deeper into recession. Here's more detail on the problem:

(1) *Price plunge.* Due to significantly lower energy prices since Russia invaded Ukraine in February 2022, European headline inflation has fallen dramatically. The yearly percent change in Eurozone consumer prices dropped from a peak of 10.6% during October 2022

to 6.1% during the latest reading in May (*Fig. 5*).

(2) *Lingering core.* However, core consumer inflation—which excludes food, alcohol, and tobacco—remains stubbornly high at 5.3% in May. Likely, this reflects a lag before the steep drop in energy prices lowers producers' costs enough that they can lower prices for consumers. Notably, the article highlighting increased pasta prices attributes the situation to producers' selling batches of pasta that were made back when raw material costs were higher.

(3) *Uphill battle.* ECB Vice-President Luis de Guindos acknowledged in a June 25 *interview* that headline and underlying inflation will likely decrease over the medium term but emphasized that the ECB's price-stability target of 2.0% has not yet been achieved. If a significant decline in credit demand leads to a slowdown in economic activity, he said, then the "finishing line is in sight."

The growth of bank lending in the Eurozone seems to have been halted by the ECB's rate hikes. The ECB has raised interest rates 400bps from -0.5% in July 2022 to 3.5% at this June's meeting (*Fig. 6*).

According to a survey conducted by the ECB between March 22 and April 6, net demand for loans to businesses fell the most during Q1-2023 that it has since year-end 2008, at the height of the Great Financial Crisis. Furthermore, total loans outstanding at the Eurozone's monetary financial institutions decreased by 0.2% over the past three months through April (*Fig. 7*).

However, the ECB finds itself in a challenging situation as it contends with factors beyond its control, such as Europe's energy dependency, which calls for a combination of luck and strategic redirection. In response to inflation, the European Commission has urged member states to scale back the fiscal support measures they implemented in response to the energy crisis. Guindos stated that if governments fail to do so, an even tighter monetary policy stance would be necessary.

Europe IV: Energy Threat. The invasion of Ukraine by Russia in February 2022 initially caused a steep increase in gas prices in Europe. Russia's energy war on Europe, aiming to disrupt support for Ukraine, was widely expected to exacerbate Europe's energy crisis. But Europe has successfully weathered the storm, for reasons discussed in an *article* in the June 23 *The Atlantic*. However, the question remains: Will Europe encounter renewed energy difficulties in the coming winter?

Here's a recap of the key contributors to Europe's energy stability cited by the article as well as potential challenges that we observe on the horizon:

(1) *Favorable circumstances.* Europe's energy resilience can be partly attributed to a stroke of luck. The availability of sufficient gas inventories coupled with milder-than-expected winter weather resulted in lower heat demands than initially projected, easing the strain on energy supplies.

(2) *New sources.* To enhance energy security, European countries adopted strategies to reduce consumption and diversify their energy sources—such as redirecting liquefied natural gas shipments from the US, the Persian Gulf, and West Africa to Europe, bolstering the region's energy supply. Additionally, Germany invested in the construction of new gas-receiving terminals, further enhancing its energy infrastructure.

(3) *Government support.* EU governments played a crucial role by allocating nearly 800 billion euros ($860 billion) in subsidies to offset soaring fuel bills in 2022. This relief helped businesses and households navigate the period of high gas price inflation.

That relief may not be available next winter if fiscal policymakers heed the European Commission's guidance (and the ECB's wishes) to pull back on energy supports because of the risk of higher sustained core inflation.

(4) *Next winter.* Despite the progress made, challenges loom. Germany's nuclear-power plants, which played a significant role in mitigating the energy shock last winter, were taken offline in April. If the upcoming winter proves colder than anticipated, Europe's resilience may be put to the test. A *study* mentioned in *Hydro Review* highlighted the importance of nuclear power during the cold winter of 2021, indicating the potential impact of weather conditions on Europe's energy landscape.

(5) *Seismic activity.* Europe's natural gas prices are susceptible not only to geopolitical manipulations and harsh weather conditions but also seismic activity. Recent *reports* of the Netherlands closing Europe's largest gas site due to earthquake risks caused a spike of nearly 30% in natural gas prices on June 15. The decision to permanently shut down the Groningen gas field, which has been a crucial gas source for Western Europe, further underscores the need to address vulnerability.

Europe V: German Drag. Germany, Europe's largest economy and a key player in manufacturing, faces significant impediments to both its own growth and that of the broader

European economy.

Europe's soaring energy inflation hit German manufacturers, heavily reliant on energy, hard. Even as energy prices have started to decline, manufacturers continue to grapple with reduced demand, particularly from China, a crucial market. Moreover, Germany faces long-standing structural challenges such as transitioning to renewable energy sources, shifts in global supply chains, and a shortage of skilled labor, all of which have increased production costs.

The economic institute IFO forecasts Eurozone GDP will expand by 0.6% in 2023, while Germany's GDP will contract 0.4%. Manufacturing accounted for approximately 20% of German GDP in 2021, the June 23 *WSJ* *observed*.

Let's explore indicators of weakness within the Eurozone and Germany:

(1) *Eurozone output.* The Eurozone has experienced a mild technical recession, with a decline in seasonally adjusted real GDP for two consecutive quarters. During Q1, the Eurozone's real GDP contracted by 0.4% (saar) during both Q4-2022 and Q1-2023 (*Fig. 8*). Notably, government spending witnessed the largest decline since Q1-2020, while domestic demand, household spending, and exports also showed negative growth. This indicates weakened economic sentiment and consumption in the region.

(2) *Eurozone sentiment.* The Eurozone's economic sentiment indicator (ESI) dipped below 100 during July 2022 due to concerns over winter energy shortages and remained depressed through May, reflecting current concerns over rising interest rates (*Fig. 9*).

Consumer sentiment in the Eurozone has been consistently weak, and this sentiment is reflected in the volume and value of retail sales, as evident from the latest available data in April (*Fig. 10* and *Fig. 11*).

(3) *Industrial performance.* Germany's energy-intensive manufacturing sector has experienced a decline in production, with a significant decrease of 12.9% compared to the previous year. In contrast, the overall Eurozone's factory output has slightly surpassed the previous year's levels, reported the June 23 *WSJ*.

The backlog of unfilled orders, built up during the pandemic, is gradually diminishing, posing challenges for manufacturers to maintain productivity. Incoming orders for German manufacturers have declined, indicating sluggish demand (*Fig. 12* and *Fig. 13*).

(4) *Business confidence.* Germany's IFO business confidence index, encompassing both manufacturing and service industries, fell to a recent trough during October 2022, then experienced a brief recovery through April of this year. From there, the index declined through June (*Fig. 14*). Both the current situation and expectations indexes have witnessed recent drops, reflecting uncertainties and dampened confidence among businesses in Germany (*Fig. 15*). Today, we learned that German business confidence suffered another setback in June, as Debbie discusses in the Global Economic Indicators section below.

(5) *Depressing PMIs.* While we were in the process of writing this, the release of Eurozone flash PMI estimates confirmed our pessimism about the European economic outlook. The flash PMI estimates indicate that economic activity in the Eurozone has slowed almost to a standstill (*Fig. 16*). Manufacturing activity has further contracted, and growth in the service sector has decelerated sharply.

Unsurprisingly, Germany's Manufacturing PMI has further deteriorated. Additionally, Germany's Non-Manufacturing PMI has declined for the first time in several months.

The somewhat positive news is that the decline in demand for manufactured products has led to an increase in manufacturing price discounts, with input prices dropping the most since July 2009. However, input costs in the service sector have continued to rise above the survey's long-term average rate.

Europe VI: China Chill. The economic slowdown in China and the deteriorating relations between Beijing and Europe are serious enough potentially to affect Europe's growth prospects. The European Commission recently unveiled its strategic economic-security approach, which aims to mitigate the risks associated with conducting business with China and Russia. This approach calls for member states to implement stricter controls to manage the risks involved in engaging with these countries, the *WSJ* wrote on June 21.

The business landscape in China has become increasingly challenging for European companies, as highlighted by a survey conducted by the EU's Chamber of Commerce in China. The survey revealed that nearly two-thirds of the respondents experienced greater difficulties in conducting business over the past year.

Moreover, more than 10% of the participants already have shifted their investments away from China, with an additional 7% considering similar actions. Among the top challenges cited by 36% of the respondents was the economic slowdown in China. Jens Eskelund, the president of the Chamber, expressed concerns about China's newly implemented espionage laws, which are perceived as ambiguous and pose difficulties for international companies in navigating the business environment.

Europe VII: Wobbly Banks. In the wake of the Silicon Valley Bank scare earlier this year and its subsequent impact on Europe, concerns surrounding the European banking sector have resurfaced. This was further emphasized by the recent emergency rescue of Credit Suisse.

The ECB's Guindos recently *highlighted* the presence of imminent risks: "The current outlook poses significant challenges, increasing the uncertainties surrounding the profitability and resilience of banks. Although higher interest rates have the potential to enhance banks' net interest income, their advantages might be somewhat diminished due to a deceleration in lending growth and the inversion of the yield curve."

Calendars

US: Tues: Consumer Confidence 104.0; Durable Goods -1.3%; Richmond Fed Manufacturing Index; New Home Sales 657k; S&P/CS HPI 20-City Index 0.5%m/m/1.5%y/y; API Weekly Crude Oil Inventories. **Wed:** MBA Mortgage Applications; Goods Trade Balance Advance; Crude Oil Inventories & Gasoline Production; Fed Stress Test Results; Powell. (Bloomberg estimates)

Global: Tues: Italy Business & Consumer Confidence 102.2/105.3; Canada Headline & Core CPI 4.2%/3.9%y/y; Australia CPI 6.1%y/y; Japan Core CPI 3.4%y/y; Lagarde; Elderson; Schnabel; Panetta; Dhingra; Tenreyro; Kozicki. **Wed:** Germany Gfk Consumer Climate -23.0; France Consumer Confidence 84; Italy CPI -1.2%m/m/8.3%y/y; Italy PPI -6.2%m/m/-9.4%y/y; Spain Retail Sales 0.6%; Japan Retail Sales 5.4%y/y; BoE Quarterly Bulletin; Lagarde; Enria; De Guindos; Lane; Pill; Bailey. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week for two of these three indexes; but for a 52nd straight week, none were at a record high. During the May 4 week, all three had risen simultaneously for only the third time since they peaked at record highs last June. However, all three are up from their lows during February and

March. Through the week ending June 23, LargeCap's forward earnings edged down to 2.8% above its 54-week low during the week of February 10. MidCap's rose to 3.0% above its 55-week low during the week of March 10, and SmallCap's jumped to 1.7% above its 72-week low during the March 17 week. The forward earnings downtrend since mid-2022 for these three indexes has been relatively modest this time around compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. LargeCap's is now 3.2% below its record high at the end of June 2022; MidCap's is 5.3% below its record high in early June 2022; and SmallCap's is 12.1% below its mid-June 2022 record. Forward earnings momentum remains near two-year lows. The yearly rate of change in LargeCap's forward earnings was negative for a 21st straight week, and at a 29-month low of -3.2% y/y during the June 23 week; 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 -4.7% y/y is up from a 31-month low of -5.9% several weeks earlier, which compares to a record high of 78.8% in May 2021 and a record low of -32.7% in May 2020. SmallCap's -11.1% y/y rate is up from a 32-month low of -12.9% a week earlier, 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 had been heading steadily lower since last June, but 2023's estimates briefly ticked higher during the Q1 reporting season as analysts incorporated the strong earnings beats into their forecasts. Here are the latest consensus earnings growth rates for 2023 and 2024: LargeCap (0.7% and 11.8%), MidCap (-9.9, 12.9), and SmallCap (-9.5,13.6).

S&P 500/400/600 Valuation (*link*): Valuations fell for these three indexes through the June 23 week. LargeCap's forward P/E dropped 0.3pts w/w to 18.7 from a 14-month high of 19.0. It's up 3.6pts 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 0.4pt to 13.3 from a 15-week high of 13.7, and is 1.4pt below its recent 10-month high of 14.7 in early February. It's now 2.2pts 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 fell 0.5pt to 13.0 from a 15-week high of 13.5, which compares to a 19-week low of 12.5 during the May 12 week and is now 1.3pts below its recent 12-month high of 14.3 in early February. It's 2.4pts 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 29% discount to LargeCap's P/E was at a 24-year-low discount during the June 23 week. It had been at a 21% discount during the March 17 week, which was near its best reading since November 2021. SmallCap's 31% discount to LargeCap's

P/E last week is not much above its 21-year low of 32% in April 2022. That compares to a 22% discount during the March 10 week, which was near its lowest discount 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 106th straight week; the current 3% discount is near 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 estimate declines accelerated considerably for the three quarters ending through Q4-2022 before easing for Q1-2023. Looking ahead to Q2-2023, analysts are forecasting that the S&P 500's y/y earnings growth rate will mark its cyclical bottom with an 8.6% decline, down from -2.8% y/y in Q1-2023. On a pro forma basis, they expect the y/y earnings decline to bottom at -5.6% in Q2, down from a 0.1% gain in Q1-2023. S&P 500 ex-Energy earnings are forecasted to be flat y/y in Q2-2023, up from the 1.6% decline in Q1-2023 and the 7.4% drop in Q4-2022. Six sectors are expected to record positive y/y percentage earnings growth in Q2-2023, up from five sectors doing so in Q1-2023 and only two in Q4-2022. Here are the S&P 500 sectors' expected earnings growth rates for Q2-2023 versus their nearly final earnings growth rates for Q1-2023: Consumer Discretionary (26.1% in Q2-2023 versus 56.1% in Q1-2023), Financials (9.5, 7.8), Communication Services (9.5, -9.0), Industrials (6.2, 27.0), Utilities (2.8, -21.8), Consumer Staples (1.8, 0.4), S&P 500 ex-Energy (0.0, -1.6), Information Technology (-3.1, -8.3), Real Estate (-4.9, -6.2), S&P 500 (-5.6, 0.1), Health Care (-15.8, -14.8), Materials (-27.7, -22.2), and Energy (-44.4, 21.0).

US Economic Indicators

Regional M-PMIs (*link*): Four Fed districts have reported on manufacturing activity for June—New York, Philadelphia, Kansas City, and Dallas—and show *manufacturing activity* (to -10.6 from -18.1) fell at a slightly slower pace in June. The New York (to 6.6 from -31.8) region showed a big swing from contraction to expansion, while the Dallas (-23.2 from -29.1) region continued to contract, though at a slower pace. Meanwhile, Kansas City's (-12.0 from -1.0) manufacturing activity fell deeper into negative territory, while Philadelphia's (-13.7 from -10.4) fell at a slightly faster pace than in May. New orders (-9.6 from -16.8) fell at a slower pace, with billings in the New York (3.1 from -28.0) region showing a return to expansion in June, while Kansas City's (-14.0) and Dallas' (-16.6 from -16.1) orders fell at the same pace as they did in May, and Philadelphia's (-11.0 from -8.9) contracted at a slightly faster pace than in May. *Employment* (-3.5 from 1.2) slipped into negative territory this month, as hirings in the Kansas City (-12.0 from 7.0) area swung from positive to negative, while New York's (-3.6 from -3.3) fell at a steady pace and Dallas (2.2 from 9.6) factories hired at a slower pace. Meanwhile, hirings in the Philadelphia (-0.4 from -8.6) area moved back toward the breakeven point of zero. Looking at *prices-paid* indexes, both the Dallas (1.4 from 13.8) and Kansas City (4.0 from 16.0) regions are in a freefall, fast approaching zero, while Philadelphia's (10.5 from 10.9) measure held steady, not far from April's 8.2 reading—which was its lowest since mid-2020. New York (22.0 from 34.9) posted its lowest reading since August 2020. The *prices-received* index in the Dallas (-1.9 from 0.4) region dropped below zero, while New York's (9.0 from 23.6) eased to its lowest reading since October 2020 and Kansas City's (3.0 from 16.0) to the lowest since July 2020. Philadelphia's (0.1 from -7.0) moved up to zero, holding near recent lows.

Global Economic Indicators

Germany Ifo Business Climate Index (*link*): "The weakness in the manufacturing sector is steering the German economy into turbulent waters," noted Clemens Fuest, Ifo's president. Germany business confidence suffered another setback in June, falling for the second month after a six-month climb. "Expectations were markedly pessimistic, and companies' assessments of their current situation were worse," commented Fuest after release of the data. German business *confidence* fell for the second month to 88.5 in June, after climbing the prior six months from 85.1 last October to 93.5 this April—which was the highest since February 2022. *Expectations* took the biggest hit over the two-month period, dropping 8.3 points to 83.6, after a seven-month upswing of 15.4 points—from 76.5 last September to 91.9 this April. Meanwhile, *current conditions* remained around recent lows, slipping 1.8 points the past three months—to 93.7 this month. The *manufacturing* sector saw its business climate index deteriorate again this month, sinking 16.5 points over the past three months to -9.9 this month—which followed a five-month surge of 20.9 points (to 6.6 from -14.3). The expectations component tumbled 25.7 points over the past two months to -28.1 this month—after climbing the prior six months by 35.8 points (to -2.4 from -38.2), while current conditions dipped 8.9 points over the past three months to 10.2 in June. The *service sector* saw its business climate index (to 2.7 from 8.9 in March) drop 6.2 points over the past three months, with expectations (to -15.4 from -4.1) sliding 11.3 points over the period, while the current conditions component (22.5 from 22.8) was little changed. Sentiment in the trade sector lost 10.1 points (to -20.2 from -10.1 in March) over the past three months, as the current conditions (-5.6 from 8.1) component dropped further below zero over the period and expectations (-33.7 from -26.7) deteriorated. The *construction* sector remained entrenched in negative territory, falling from -16.7 in April to -20.1 this month, as the expectations component remains deep in negative territory, at -34.8, though is up from its recent low of -47.1 last October. Meanwhile, current conditions have tumbled from 33.4 last February to -4.0 this June, falling below zero in May for the first time since December 2015.

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