MORNING BRIEFING
July 11, 2023

Stay Home Or Go Global?

Check out the accompanying chart collection.

Executive Summary: Global stock markets have climbed a wall of worry impressively this year despite all the global headwinds—including lackluster GDP growth, high inflation, and the tightening of many central banks' monetary policies—as well as regional headwinds in Europe and China. The markets' resilience may reflect investors' relief that worst-case scenarios didn't pan out. … Japan's stock market is a case in point. It's been soaring despite investors' uncertainty over the BOJ's next move. Will this holdout among central banks at long last lift its ultra-easy monetary policy and adjust its yield curve control program accordingly?

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

Global Strategy I: Weak Growth, Strong Stocks. The All Country World MSCI stock price index is up 11.2% in dollars so far this year through July 7 (*Fig. 1*). The US MSCI is up 14.8% over this period (*Fig. 2*). It makes sense that the US index would be up more than the global one since the US economy has been growing faster than most expected at the beginning of this year. More surprising is that the All Country World ex US MSCI is up 5.6% in local currency and 5.8% in dollars since the start of the year notwithstanding weaker-than-expected economic growth in Europe and China (*Fig. 3*).

That's all quite impressive, especially in the face of the ongoing tightening of monetary policy by the major central banks around the world. Some of the bullishness among global stock market investors may reflect relief that global economic activity hasn't weakened as much as was feared in response to the tightening of global monetary policies since early last year.

The dire consensus views on several major economies of the world during the second half of last year failed to pan out. It was widely believed that the US would fall into a recession in early 2023 as consumers ran out of excess savings accumulated during the pandemic, that the shortage of natural gas resulting from Russia's invasion of Ukraine would cause Western European economies to freeze in the dark last winter, and that the Chinese government's severe pandemic lockdowns would depress China's economy, exacerbate the country's property crisis, and disrupt global supply chains.

As these worst-case scenarios didn't play out, stock markets climbed the wall of worry impressively. In addition, foreign stock markets were extremely undervalued relative to the US. So they had more upside room from a valuation perspective. Consider the following:

(1) *Lackluster global growth.* Debbie and I like to monitor our daily Global Growth Barometer (GGB) to assess whether global economic activity is growing or slowing (*Fig. 4*). The GGB is the average of the Brent crude oil nearby futures price and the CRB raw industrials index (multiplied by 2 and divided by 10). Our GGB closely tracks the S&P Goldman Sachs commodity index (*Fig. 5*). However, we prefer our GGB because it does not include agricultural and lumber prices and because we can track the contributions of the CRB index (which does not include energy, food, or lumber commodities) and the price of oil to our GGB (*Fig. 6*).

Our GGB peaked near the beginning of last year at 130.7 on March 8. It fell to 99.9 by the end of 2022. On Friday, July 7, it was down to 94.5. By the way, both our GGB and the S&P Goldman Sachs index are inversely correlated with the trade-weighted dollar (*Fig. 7* and *Fig. 8*). The dollar tends to be strong (weak) when the global economy is relatively weak (strong) compared to the US. The dollar has been range-bound since the start of the year, even though the US economy has performed relatively well compared to the rest of the world.

(2) *European recession.* Figures from Eurostat, the EU's statistical agency, showed that the Eurozone's real GDP fell by 0.1% during Q1-2023 and Q4-2022 after revisions to earlier estimates. A technical recession is generally defined as two consecutive quarters of negative growth. With consumers under pressure from the higher energy and food prices, household final consumption dragged down GDP across the Eurozone by 0.3% after a larger 1.0% drop in the previous quarter.

On a y/y basis, the region's real GDP rose by 1.0%, the weakest since Q1-2021. This series is highly correlated with the Eurozone's economic sentiment indicator, which has been fluctuating below 100 since July 2022 (*Fig. 9*). Germany's IFO business confidence index also remained relatively depressed in June, at 88.5, led by weakness in its expectations index (83.6); its current situation index edged down to 88.5 (*Fig. 10*).

These recent results were not as bad as was widely anticipated last summer.

(3) *China's anemic recovery.* The Chinese government lifted its strict pandemic lockdown requirements at the end of last year. The widely expected strong rebound in the country's

economy was disappointing. The official manufacturing index rose above 50.0 during the first three months of this year (*Fig. 11*). It has been back under that breakeven level since then through June. The services PMI rebounded more significantly, to a high of 56.9 during March, but was back down to 52.8 in June.

On Monday, we learned that China's PPI for total industrial products fell deeper into deflationary territory with a reading of -5.4% y/y (*Fig. 12*). The CPI was flat y/y during June and could also turn negative in coming months.

The price of copper tends to be especially highly correlated with China's economic activity and MSCI stock price index (*Fig. 13*). Both prices rose sharply when the government ended the lockdowns but have given back much of those gains in recent months.

China has at least two chronic problems that are likely to weigh on economic growth for several years. The country's rapidly aging demographic profile is already depressing retail sales growth (*Fig. 14*). China's property sector has been thrust into a severe debt crisis over the past two years. It was initially triggered by government moves to rein in ballooning debt, with many developers defaulting on payments as they struggled to sell apartments and raise funds. The country's real estate property crisis is likely to persist.

(4) *Submerging emerging economies.* The weakness in China's stock market has weighed on the Emerging Markets MSCI stock price index, which is up just 2.5% ytd in local currency and 3.3% in dollars (*Fig. 15*). The CRB raw industrials spot price index is highly correlated with the Emerging Markets MSCI in both local currency and in dollars (*Fig. 16*). The latter doesn't do well when industrial commodity prices are weak, as they are currently.

Global Strategy II: US vs the World. Let's have a closer look at the performance of the US MSCI to the rest of the world:

(1) *Performance derby.* Since the start of the bull market on October 12, 2022, the US MSCI is up 22.8%. Here is the performance derby in dollars and in local currency for the major MSCI stock price indexes: EMU (39.3%, 23.5%), Europe (30.7, 15.9), US (22.8, 22.8), Japan (25.7, 21.7), All Country World (22.4, 19.2), UK (22.0, 5.3), All Country World ex US (21.7,13.7), and Emerging Markets (13.3, 10.7).

(2) *Relative performance.* Joe and I track the ratios of the US MSCI to the ACW ex US in both local currency and in dollars (*Fig. 17*). Both ratios have been on uptrends since 2009, confirming our preference for a Stay Home investment strategy over a Go Global one.

That's especially true for the ratio in dollars.

We're sticking with our Stay Home strategy recommendation.

(3) *Valuation.* We may be overstaying our welcome in the Stay Home approach of overweighting the US in global portfolios. After all, the forward P/E of the US MSCI was 19.4 at the end of June, well above those of the UK (10.2), EMU (12.1), Emerging Markets (12.2), and Japan (14.6) (*Fig. 18*). The ratio of the US forward P/E to the ACW ex-US valuation multiple remains historically high at 1.52 (*Fig. 19*). That's still true if we remove the MegaCap-8 stocks from the US MSCI: The index's forward P/E is 19.4 with them and 16.5 without them.

Japan I: Hot Stock Market. One of the hottest markets in the world in recent weeks has been Japan's Nikkei (*Fig. 20*). This index has a strong inverse correlation with the yen, which has been very weak recently because the Bank of Japan (BOJ) is lagging all the other major central banks in normalizing its monetary policy, as Melissa discusses below.

The Japan MSCI soared 7.6% during June as its forward P/E jumped from 14.0 to 14.6. The rally was fueled by news on Monday, June 19 that Warren Buffett's Berkshire Hathaway added to its holdings in Japan's five biggest trading houses. That likely underpinned the strong buying momentum that propelled the nation's stock market to multi-year highs.

Japan II: BOJ Policy Uncertainties. On June 16 in its *Statement on Monetary Policy*, the BOJ upheld its long-standing ultra-loose monetary policy, including its yield curve control (YCC) bond-purchasing plan. Financial market participants are wondering how long it will keep doing so.

Inflation in Japan has been surpassing the BOJ's 2.0% inflation target in recent months, as discussed below, and recent wage inflation has been substantial. In April, when Governor Kazuo Ueda took his post, the BOJ *removed* its promise to keep interest rates at current or lower levels. That was widely viewed as a first step toward normalizing monetary policy. But Governor Ueda *defended* the BOJ's decision not to change rates or the YCC in June.

Now market watchers are carefully scanning the horizon for hints of the BOJ tweaking its YCC policy, by slowing the pace of bond purchases or eliminating the aspect of the program that targets long-term interest rates altogether. Likely, this change is forthcoming. YCC will have to end eventually, as already the BOJ owns a large share of the Japanese bond market, a Bloomberg article recently *observed*. The BOJ's new quarterly growth and inflation projections are due at its next rate review on July 27-28.

Let's dive into where the BOJ currently stands:

(1) *Unchanged policy.* The BOJ maintained its ultra-loose monetary policy last month, keeping the short-term interest rate target at -0.1% intact and not changing its YCC policy. Governor Ueda championed the BOJ's stance, highlighting underlying inflationary softness despite headline inflation exceeding 3.0%. Notably, Japan's CPI inflation rate excluding fresh food has consistently overshot the BOJ's 2.0% target for the past 14 months (*Fig. 21*).

(2) *Uncertain inflation.* Governor Ueda cautiously articulated a guarded outlook on inflation stability in the years ahead. Nevertheless, he acknowledged that once the central bank attains sufficient confidence that it can achieve a sustainable rate of inflation, that could potentially serve as a catalyst for policy adjustments.

Paving the way for wage inflation to surge, workers have been *basking* this year in the glow of the most substantial pay hikes witnessed in 30 years, courtesy of annual negotiations with premier Japanese firms. That's according to a survey conducted by Rengo, Japan's umbrella trade union group, Reuters *reported* on July 5. But the bank will want to see real wages consistently rising as inflation stabilizes. Real contractual earnings per employee per month in Japan declined 1.5% on a yearly basis through May (*Fig. 22*). Nominally, the same figure rose 1.7%.

(3) *U-shaped recovery?* The bank expects a measured recovery in Japan's economy around the midpoint of fiscal 2023, propelled by pent-up demand. Earlier this month, Q1 growth in Japan was revised upward to an annualized 2.7% from estimates of 1.6%, according to a Reuters *survey*. Real GDP rose 1.8% y/y through Q1 (*Fig. 23*). Factors such as fluctuating commodity prices and the deceleration of overseas economies loom large as potential impediments to growth, according to the BOJ's statement.

(4) *Uncertain curve.* On June 25, a summary of opinions from the BOJ's June meeting showed that a BOJ policymaker called for an early revision to its controversial YCC, *reported* Reuters. The policymaker said that the bank needs to prevent sharp fluctuations in interest rates in the future phase of an exit from current monetary policy. Like the April statement change, any shift in the YCC policy could indicate that the tide slowly could be turning for the BOJ's ultra-loose monetary policy. The YCC aims to anchor 10-year Japanese government bond yields around the zero mark through appropriate purchases of government bonds.

In December, the BOJ *widened* the band around its yield target. The central bank stressed that this change was not a step toward abandoning the YCC but was intended to strengthen market functioning. Meanwhile, the assets on the bank's balance sheet remain unprecedentedly high, having risen from around 450 trillion yen during 2016 at YCC's start to nearly 750 trillion yen today (*Fig. 24*).

(5) *Unconventional contrasts.* In stark contrast to the BOJ's unyielding ultra-easy policy stance, the US Federal Reserve has been tightening over the past year—most recently keeping rates unchanged after an aggressive series of hikes—while the European Central Bank has taken the bold step of raising its main rates to their loftiest levels in over two decades. It's likely that the BOJ won't be as aggressive as those two counterparts but will be on a normalizing path soon too.

Calendars

US: Tues: NFIB Small Business Optimism Index; Weekly Crude Oil Inventories; Bullard. **Wed:** Headline & Core CPI 0.3%m/m/3.1%y/y & 0.3%m/m/5.0%y/y; Real Earnings -0.1%; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Beige Book; WASDE Report; Mester. (Bloomberg estimates)

Global: Tues: Eurozone Economic Sentiment; Germany CPI 0.3%m/m/6.1%y/y; Germany ZEW Economic Sentiment & Current Conditions -10.0-59.4; Italy Industrial Production 0.7%m/m/-1.0%y/y; UK NIESR GDP Estimate; UK Employment Change 3m/3m 158k; UK Claimant Count Change -8.6k; UK Average Earnings Including & Excluding Bonus 6.8%/7.1%; UK Unemployment Rate 3.8%; Japan Machine Tool Orders; Japan Core Machinery Orders 1.0%m/m/-0.2%y/y; Japan PPI 0.1%m/m/4.3%y/y; China New Loans ¥2.34b; China Total Social Financing ¥3.00b; China M2 11.1%y/y. **Wed:** Germany Current Account Balance; Spain CPI 0.6%m/m/1.6%y/y; China Trade Balance; BoC Interest Rate Decision 5.00%; BoE FPC Meeting Minutes; BoE Stability Report; Kashkari; Lane; Bailey; Rogers; Macklem. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week for all three of these indexes simultaneously for a second straight week and only the fifth time since last June 2022. While none were at a record high for a 54th straight week, all three are up from their lows during February and March. Through the week ending July 7, LargeCap's forward earnings improved to 2.9% above its 54-week low during the week of February 10. MidCap's rose to 3.2% above its 55-week low during the week of March 10, and SmallCap's jumped to 2.1% 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 3.1% below its record high at the end of June 2022; MidCap's is 5.2% below its record high in early June 2022; and SmallCap's is 11.8% 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 23rd straight week, and up to -3.1% y/y from 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% in early June, which compares to a record high of 78.8% in May 2021 and a record low of -32.7% in May 2020. SmallCap's -9.4% 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 (0.5% and 11.7%), MidCap (-10.3, 13.0), and SmallCap (-9.5, 13.5).

S&P 500/400/600 Valuation (*link*): Valuations fell for these three indexes through the July 7 week. LargeCap's forward P/E dropped 0.6pts w/w to 18.9 from a 15-month high of 19.1. It's up 3.4pts 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 0.2pt to 13.7 from a 17-week high of 13.9, and remains 1.0pt below its recent 10-month high of 14.7 in early February. It's now up 2.6pts from 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 ticked down 0.2pt to 13.3 and remains close to its 15-week high of 13.5 in mid-June, which compares to a 19-week low of 12.5 during the May 12 week and is now 1.0pt below its recent 12-month high of 14.3 in early February. It's now 2.7pts 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 27% discount to LargeCap's P/E remains near its 24-year-low 30% 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 30% 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 108th 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 8.9% 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 -6.4% in Q2, down from a 0.1% gain in Q1-2023. S&P 500 ex-Energy earnings are forecasted to be down 0.1% 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 final earnings growth rates for Q1-2023: Consumer Discretionary (27.5% in Q2-2023 versus 56.2% in Q1-2023), Communication Services (9.3, -8.9), Industrials (6.7, 27.1), Financials (5.4, 7.7), Consumer Staples (1.9, 0.4), Utilities (1.6, -21.8), S&P 500 ex-Energy (-0.7, -1.6), Information Technology (-3.0, -8.3), Real Estate (-4.9, -6.2), S&P 500 (-6.4, 0.1), Health Care (-15.9, -14.8), Materials (-29.0, -22.2), and Energy (-45.5, 21.0).

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