**MORNING BRIEFING**
**September 12, 2023**

## Europe Agonistes

*Check out the accompanying chart collection.*

**Executive Summary:** Will 2024 bring improved prospects for Europe's economy and stock market? While analysts still project a resumption of earnings growth for Europe MSCI companies collectively next year, their 2023 earnings estimates have been falling and the Net Earnings Revisions Index turned negative in August. The outlooks for Europe's economy and stock market hang in the balance of several uncertainties: whether the ECB can corral inflation without precipitating a recession, whether Europe's shored up energy reserves will suffice this winter, whether Germany's economic performance improves, and how well relying on China to meet green energy goals works out.

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

**Europe I: Winter Advisory.** Brighter days may be on the horizon for Europe. A resurgence of economic growth could begin as soon as spring 2024, provided that inflation recedes as Melissa and I anticipate and that the European Central Bank (ECB) halts its monetary policy tightening in response. However, for now, the upcoming winter could challenge Europe's energy resilience, especially if is very cold. It might be prudent to wait out the chilly season in European markets.

Investors in European stocks seemed more optimistic than European consumers and producers during the first half of this year. Europe's MSCI Index surged 8.5% in euro terms during H1-2023 (*Fig. 1*). However, this surge reflected a valuation catch-up after Europe was spared the gas shortage widely expected last winter. Investors' enthusiasm cooled during the summer, with Europe's MSCI Index slipping 3.6% in euro terms from its recent peak on April 21 through Friday's close.

Analysts' consensus estimate for the Europe MSCI's 2023 earnings growth rate has slipped into negative territory recently, at -1.8% (*Fig. 2*). While the estimate for 2024 earnings growth has remained positive so far this year, it has plateaued around 6.5%. In August, the Net Earnings Revisions Index of the Europe MSCI turned negative again following three positive readings (*Fig. 3*).

Factors like inflation, energy resilience, Germany's economic performance, China's influence on Europe, and potential banking sector risks will continue to shape the region's economic forecast—and therefore the potential risks and opportunities in European stock markets as well.

**Europe II: Inflation Challenge.** Given the persistence of high inflation in the Eurozone, the European Central Bank (ECB) remains committed to tight monetary policy. But the ECB may be up against formidable forces that lie beyond its sphere of influence, notably the prospect of surging energy prices in the event of a harsh winter. Elevated interest rates that curtail lending at a time of resurgent energy inflation could well plunge the European economy into a recession.

Let's have a closer look at this dicey situation:

(1) *Moderating headline CPI.* The headline CPI inflation rate declined again in July, from a peak of 10.6% in October 2022, primarily due to significantly lower energy prices. However, inflation remains on the high side, showing a 5.3% increase compared to the previous year (*Fig. 4*).

(2) *Stubborn core CPI.* Eurozone core inflation—excluding energy, food, alcohol, and tobacco prices—proved stubborn in June, rebounding slightly to 5.5% and holding at that rate in July after a slight dip in May to 5.4% (*Fig. 5*).

(3) *Determined ECB.* While the headline CPI inflation rate may have reached its peak in the Eurozone, along with energy prices in recent months, the ECB remains unwavering in its efforts to curb inflation. However, the path ahead is long as the ECB strives to achieve its 2.0% target. Currently, the ECB's main refinancing rate stands at 4.25%, surpassing levels seen since the period preceding the 2009 financial crisis. Notably, the central bank has raised rates nine times after maintaining them at zero from early 2016 through mid-2022 (*Fig. 6*).

(4) *Sluggish lending*. The ECB's tightening has curtailed Eurozone bank lending. Total outstanding loans at the Eurozone's monetary financial institutions dipped by €30.6 billion over the past three months through July (*Fig. 7*).

(5) *Lagarde on guard*. Admitting to a miscalculation, ECB President Christine Lagarde conceded in a September 4 *speech*, "We underestimated both the dynamics of inflation and its persistence." This admission implies that the ECB sees a need to make up for lost tightening and suggests that the timing may be less than ideal. Lagarde went on to say, "We

are entering a world of major transitions in labor markets, energy markets, and geopolitics, all of which can lead to larger and more frequent relative price shocks."

(6) *Toss-up meeting*. However, some economists argue that a pause in the rate hikes at this week's monetary policy meeting would be prudent (as expressed in this *analysis* and this *perspective*). They point to the turning tide in inflation, and they recall Lagarde's July statements suggesting that the additional tightening phase was over. It's worth noting that these July remarks came several months before Lagarde's recent comments.

In our opinion, the ECB won't stop tightening to avert a hard landing as long as inflation remains too high. Even if this week's meeting results in a pause, we doubt that would mark the end of this round of tightening. After all, the ECB's paramount objective, to bring inflation in line with its target, has yet to be realized.

**Europe III: Energy Security.** Europe's long-term price stability and energy security remain uncertain, as discussed in a September 7 CNN *article*. Europe continues to count on Russia for a portion of its energy supplies and will likely become increasingly reliant on China as a partner in it shift toward renewable energy.

Moreover, Europe remains especially exposed to the volatility of global liquified natural gas (LNG) markets; LNG makes up much of Europe's energy reserves and imports currently. As a result, Europe is highly vulnerable to price fluctuations in the LNG market. Supplies are tight, and there is a potential for disruptions like the recent *spike* in European gas prices as a result of Australian LNG supplier strikes.

LNG is commonly traded on exchanges, with contracts based on volumes and no explicit reference to its origin. LNG's inherent flexibility and tradability mean that Russia still has a role to play as a source. In fact, Russia supplied 13.2% of the European Union's LNG supply in 2023, *according* to Eurostat.

The good news is that LNG terminals coming online from the US and Quatar should help to rebalance the market, *noted* Reuters. Also, EU gas demand is expected to move lower as renewable energy sources increasingly come onto the energy scene.

In its pursuit of enhanced energy independence, Europe is banking on a green energy transformation, embodied by the ambitious "Green Deal." This initiative necessitates substantial investments in renewable energy sources. However, sluggish progress toward meeting the Green Deal's emission targets may compel Europe to depend more on China.

China has secured vital resources—including lithium for batteries and steel for wind turbines—and established manufacturing capabilities for green technologies, according to the CNN article.

China could leverage its energy influence in Europe to advance its geopolitical objectives, such as Chinese President Xi's aspirations regarding the reunification of China and Taiwan. Furthermore, it's worth noting that renewables themselves are not impervious to challenges, even without China's involvement. As reported in a recent Bloomberg *article*, a few weeks of cloudy and rainy weather can significantly affect power output from both wind turbines and solar panels.

**Europe IV: German Gloom.** Germany, the powerhouse of Europe's economy, appears to be on the brink of further contraction as its manufacturing sector continues to weaken. German manufacturers, heavily reliant on energy, have borne the brunt of surging energy costs in the wake of Russia's invasion of Europe. Additionally, Germany faces persistent structural challenges, including an international trade environment that has depressed demand for German goods and a shortage of skilled labor, which has driven up production costs.

Let's delve into key indicators highlighting the weaknesses within the Eurozone in general and Germany in particular:

(1) *Eurozone*. GDP grew a meager 0.5% (seasonally adjusted annual rate) during Q2-2023 following several quarters of sluggish growth (*Fig. 8*). On Monday, as we were writing this piece, the European Union lowered its GDP growth forecast for this year to 0.8% from its 1.1% forecast in the spring, the commission *said*. For next year, the growth expectation was lowered to 1.3% from 1.6%.

IFO, the economic institute, *projected* on September 7 that Germany's GDP would contract by 0.4% in 2023. It's worth noting that manufacturing contributed to approximately 20% of German GDP in 2021, the *WSJ* recently *observed*.

(2) *Eurozone sentiment eroding.* The Eurozone's economic sentiment indicator (ESI) has remained below 100 since July 2022, deteriorating further as the war in Ukraine intensified and concerns grew over a harsh winter. It continued to decline through August this year, reflecting ongoing worries related to rising interest rates (*Fig. 9*). Consumer sentiment in the Eurozone has been consistently weak; that's reflected in the volume and value of retail sales, which have slightly picked up in recent months but remain depressed through July

(*Fig. 10*).

(3) *Industrial performance weaking.* German industrial production declined during July compared to the previous month, and it's down 4.0% since February 2022, the month of Russia's Ukraine invasion (*Fig. 11*).

Germany's energy-intensive manufacturing sector also saw production dip during July as manufacturers adjusted to decreased demand and rising costs. Manufacturing orders dropped more on a m/m basis in July than in any other month since April 2020 as the backlog of orders from the pandemic era diminished (*Fig. 12*).

On a y/y percentage change basis, Eurozone industrial production has bounced around zero since late 2022 (*Fig. 13*).

(4) *Business confidence declining.* Germany's IFO business confidence index, encompassing both manufacturing and service sectors, reached a recent low in October 2022 before briefly rebounding through April of this year. Since then, the index has steadily declined through August (*Fig. 14*). Both the current situation and expectations indexes have dropped recently, reflecting uncertainty and reduced confidence among German businesses (*Fig. 15*).

(5) *PMIs disappointing*. The latest Eurozone PMI data indicate continued weakening of economic activity across the region, providing further confirmation of our pessimistic outlook for the European economy (*Fig. 16*). While the pace of manufacturing activity decelerated somewhat in August compared to previous months, the pace of activity in the service sector slowed sharply.

Germany's manufacturing PMI remained in contractionary territory during August, and now Germany's non-manufacturing PMI has joined it there, plummeting below 50 during August (*Fig. 17*). The data adds to Germany's economic woes and dashes hopes of stability in the Eurozone region's services sector.

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## Calendars

**US: Tues:** NFIB Small Business Optimism 91.6; API Weekly Crude Oil Inventories; EIA Short-Term Energy Outlook; OPEC Monthly Report. **Wed:** Headline & Core CPI 0.6%m/m/3.6%y/y & 0.2%m/m/4.3%y/y; Federal Budget Balance -$254b; MBA Mortgage

Applications; Crude Oil Inventories & Gasoline Production; IEA Monthly Report. (FXStreet estimates)

**Global:** **Tues:** Eurozone Headline & Core CPI; Eurozone Economic Sentiment -6.2; Germany Economic Sentiment  & Current Conditions -15.0/-75.0; Germany ZEW UK Unemployment Rate 4.3%; UK Average Earnings Index Including & Excluding Bonus 7.8%/8.2%;UK NIESR GDP Estimate; Japan PPI 0.1%m/m/3.2%y/y. **Wed:** Eurozone Industrial Production -0.7%m/m/-0.4%y/y; UK GDP -0.2%m/m/0.4%y/y; UK Headline & Manufacturing Industrial Production -0.6%m/m/0.5%y/y & -1.0%m//m/2.7%y/y; UK Trade Balance -15.9b; UK NIESR Monthly GDP Tracker; Japan Core Machinery Orders -0.9%m/m/-10.7%y/y; Australia Employment Change 24.3k; Australia Unemployment & Participation Rates 3.7%/66.7%; Woods. (FXStreet estimates)

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## Strategy Indicators

**S&P 500/400/600 Forward Earnings** (*link*): Forward earnings rose last week for all three indexes simultaneously for a third straight week. While it's been 62 weeks since any of these indexes has hit a record high, all three are up from their lows during February and March, and LargeCap's is a now just hair away from a new record. LargeCap's forward earnings is now 0.1% below its record high at the end of June 2022; MidCap's is 4.7% below its record high in early June 2022; and SmallCap's is struggling at 11.7% below its mid-June 2022 record. Through the week ending September 8, LargeCap's forward earnings has risen 6.1% from its 54-week low during the week of February 10; MidCap's is 3.7% above its 55-week low during the week of March 10; and SmallCap's is 2.2% above its 72-week low during the March 17 week. These three indexes' forward earnings downtrend since mid-2022 has been relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Forward earnings momentum remains near two-year lows but is no longer worsening. The yearly rate of change in LargeCap's forward earnings has improved to 0.8% y/y from a 29-month low of -3.2% y/y during the June 23 week. Those levels compare to a record-high 42.2% at the end of July 2021 and, on the downside, to -19.3% in May 2020, which was the lowest since October 2009. MidCap's rate of -4.4% 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% in mid-June and 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 June last year, but the 2023 estimate for the S&P 500 ticked higher during the

Q1 and Q2 reporting seasons as analysts incorporated the strong earnings beats into their forecasts. Here are the latest consensus earnings growth rates for 2023 and 2024: LargeCap (1.5% and 12.0%), MidCap (-12.0, 13.5), and SmallCap (-11.0, 12.8).

**S&P 500/400/600 Valuation** (*link*): Valuations fell for these three indexes during the September 8 week. LargeCap's forward P/E dropped 0.3pt w/w to 18.6, and remains below its 18-month high of 19.6 during the July 28 week. It's up 3.5pts from its 30-month low of 15.1 at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E fell 0.5pt w/w to an 11-week low of 13.5, and is down from its 21-week high of 14.4 during the July 28 week. It's now 1.2pt below its recent 10-month high of 14.7 in early February and up 2.4pts from its 30-month low of 11.1 at the end of September 2022, 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 tumbled 0.7pt to an 11-week low of 13.1, which compares to a 21-week high of 14.1 during the July 28 week and is now 1.2pt below its recent 12-month high of 14.3 in early February. It's up 2.5pts from its 14-year low of 10.6 in September 2022 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 improved from 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 117th 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 through Q1-2023 before easing for Q2-2023. Looking at Q3-2023, the revisions pendulum has turned positive again as analysts have now increased their estimates since the beginning of the quarter 10 weeks ago. They're now forecasting that the S&P 500's earnings will rise 0.2% y/y in Q3-2023. That's up from a 5.4% decline in Q2-2023, which likely marked the cyclical bottom for earnings growth. On a pro forma basis, they expect a y/y earnings gain of 2.0%

in Q3, up from a 2.9% decline in Q2-2023. S&P 500 ex-Energy earnings are forecasted to be up 7.4% y/y in Q3-2023, an improvement from the 3.6% gain in Q2-2023, the 1.6% decline in Q1-2023, and the 7.4% drop in Q4-2022. Seven sectors are expected to record positive y/y percentage earnings growth in Q3-2023, unchanged from Q2-2023's count. However, that's up from five sectors that did so in Q1-2023 and up from only two in Q4-2022. Here are the S&P 500 sectors' expected earnings growth rates for Q3-2023 versus their nearly final earnings growth rates for Q2-2023: Communication Services (34.6% in Q3-2023 versus 16.0% in Q2-2023), Consumer Discretionary (22.0, 55.1), Financials (15.2, 9.9), Utilities (13.3, 0.6), Industrials (11.9, 15.7), S&P 500 ex-Energy (7.4, 3.6), Information Technology (5.5, 5.0), S&P 500 (2.0, -2.9), Consumer Staples (1.4, 8.6), Real Estate (-6.7, -2.2), Health Care (-9.7, -26.7), Materials (-19.8, -26.4), and Energy (-37.4, -47.7).

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