MORNING BRIEFING
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Global Economy Turning Up?

Check out the accompanying chart collection.

Executive Summary: The global economic outlook remains positive, though lackluster. The IMF forecasts 2.9% real GDP growth for the world economy next year versus a projected 3.0% this year and 3.5% in 2022, and the global economic indicators we track likewise suggest slow growth. … On the downside, global GDP growth has been less buoyed by US consumers since their mid-2021 pivot from splurging on goods to bingeing on services. Also weighing on global economic activity have been the slow growth of China's economy, hamstrung by its property sector, and Europe's economy, beset with poor sentiment, high inflation, and depressed lending and retail sales.

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

Global Economy I: Green Shoots Vs Shooting Wars. The global economy continues to face some serious challenges. Central banks around the world have tightened their monetary policies dramatically since early last year in response to soaring inflation. Inflation has moderated around the world, but it remains high, especially relative to the 2.0% y/y inflation targets of the major central banks. As a result, they remain committed to either raising interest rates further or keeping their restrictive level of interest rates higher for longer. Consequently, bond yields have been rising around the world.

The wars in Ukraine and now the Middle East have unsettled the geopolitical order. So far, the hostilities have been contained geographically. However, they could easily broaden. The allies of Ukraine in the West continue to provide enormous financial support and lots of military aid to that country. The conflict between Ukraine and Russia has turned into a proxy war between Russia and the West. Similarly, the war in the Middle East is a proxy war between Israel and Iran. It conceivably could turn into a direct confrontation between the two adversaries and cause the United States to join the fray on Israel's side.

China's economy remains challenged by the bursting of the country's property bubble. China's demographic profile is aging rapidly, which is depressing consumer spending and putting pressure on the government to spend more on social benefits. Europe's economy also is aging rapidly; additionally, Europe continues to struggle with the region's transition from fossil fuels to renewable energy sources. That transition was complicated by the sanctions placed on imports of Russian oil and gas when Russia attacked Ukraine. Germany's automakers have been scrambling to compete with foreign manufacturers of electric vehicles.

Soaring interest rates, weak commodity prices, and the strong dollar all have been weighing on many emerging market economies. Many of them are under pressure to choose sides in the global schism between Western democracies and the autocratic axis of China, Iran, North Korea, and Russia.

It's a messy world order for sure and is getting messier by the day. Yet there have been some green shoots in the global economy recently. Real GDP in the US probably grew by around 5.0% (saar) during Q3, led by surprisingly resilient and robust consumer spending. China's real GDP rose 4.9% y/y during Q3. That was better than expected, though it was slower than Q2's pace of 6.3%.

Global Economy II: The Big Picture. Two weeks ago, in its latest *World Economic Outlook*, the International Monetary Fund (IMF) left its forecast for global real GDP growth in 2023 unchanged at 3.0% but shaved its 2024 forecast to 2.9% from the 3.0% expected in July. World output grew 3.5% in 2022.

In commentary about the decision, IMF Chief Economist Pierre-Olivier Gourinchas said that the global economy has continued to recover from the effects of Covid-19, Russia's invasion of Ukraine, and last year's energy crisis, but that diverging growth trends suggest "mediocre" medium-term prospects. The forecasts point generally to a soft landing, he said, but the IMF remains concerned about risks related to China's property crisis, volatile commodity prices, geopolitical fragmentation, and a resurgence in inflation. Gourinchas told *Reuters* that it was too early to know how the war in the Middle East would affect the global economy: "Depending how the situation might unfold, there are many very different scenarios that we have not even yet started to explore, so we can't make any assessment at this point yet." But he did say that IMF research has shown that a 10% increase in oil prices would dampen global output by about 0.2% in the following year and boost global inflation by about 0.4%.

Debbie and I track several indicators of global economic activity. On balance, they show that global economic growth remains relatively slow. Let's review them:

(1) *Global production & exports.* Global industrial production rose just 0.5% y/y through July. Over the same period, the volume of global exports fell 2.5% (*Fig. 1* and *Fig. 2*). Both have

been relatively flat since the start of 2022. That reflects the weakness in China's economy and the pivoting of US consumers from bingeing on goods to services instead. In a sense, there has been a rolling recession in the global production and distribution of goods.

(2) *Commodity prices.* We calculate a crude Global Growth Barometer (GGB). It is the average of the nearby price of a barrel of Brent crude oil and the CRB raw industrials index (multiplied by 2 and divided by 10) (*Fig. 3* and *Fig. 4*).

Our GGB fell sharply from the summer of 2022 through the summer of 2023. It then rebounded a bit through September but has stalled since then. The price of oil tends to have more geopolitical noise than does the CRB index, which has been falling since it peaked last year on April 4.

The CRB index is highly correlated with the price of copper (which is one of the components of the index) and the Emerging Markets MSCI stock price index (in dollars) (*Fig. 5* and *Fig. 6*). They've all been weak recently, notwithstanding better-than-expected growth rates in the real GDPs of China and the United States. That's because the recession in China's property sector has depressed global demand for commodities. The rolling recession in the US goods sector has been doing the same.

(3) *Global PMIs.* The global composite PMI and its components covering advanced and emerging economies all peaked earlier this year (*Fig. 7*). The composite did so during May at 54.4 and fell to 50.5 in September. Emerging economies have slightly outperformed advanced ones.

In the manufacturing sector, the composite and its advanced economies component have been under 50.0 since last September, while the emerging economies have been mostly above 50.0 since the start of this year.

In the non-manufacturing sector, the PMIs are down from earlier this year and just north of 50.0.

Global Economy III: The Downside of US Economic Strength. As we mentioned above and discussed previously, consumers went on a post-lockdowns spending spree on goods and then pivoted around mid-2021 to do the same on services. US retailers reordered to restock their depleted inventories, which jammed the ports and trucking industry. By the time that the goods were delivered in late 2021, retailers were stuck with them and had to discount their prices to reduce their bloated inventories.

That explains the flattening of global industrial production, the volume of global exports, and global M-PMIs. Apparently, spending on services by US consumers doesn't have as much of a multiplier effect on the global economy as does their spending on goods. Of course, my wife and I did boost the economies of Croatia and the Scandinavian countries when we vacationed for a week in June and in September. So did lots of the other tourists who swarmed all over Europe this past summer.

Global Economy IV: China's Bubble Trouble. China's real GDP expanded 2.9% y/y through Q4-2022—marking one of its slowest growth rates in several decades (*Fig. 8*). That missed the government's initial goal of around 5.5%. The Chinese economy was depressed by the country's stringent zero-Covid policy that restricted people's movements and disrupted supply chains. Growth picked up during the first three quarters of this year following the two-month Covid-19 lockdown at the end of last year.

China's economic recovery has been weighed down by a slump in its real estate sector, with major property developers China Evergrande Group and Country Garden Holdings Co. saddled with heavy debts. The real estate market accounts for some 30% of China's GDP. Evergrande filed for bankruptcy in a New York court in August. During the first nine months of 2023, investment in real estate development dropped 9.1% y/y. Industrial production grew 4.0%, while retail sales of consumer goods rose 6.8% and fixed-asset investment increased 3.1%.

August marked the second time this year that China's central bank cut its benchmark lending rate to shore up the economy. Unlike most other central banks, the People's Bank of China is much more concerned about deflation than inflation. Over the past 12 months through September, the country's CPI was unchanged, while its PPI was down 2.5% (*Fig. 9*).

Global Economy V: Europe's Challenges. Real GDP rose just 0.5% y/y through Q2 in the Eurozone (*Fig. 10*). The outlook remains lackluster, since the region's Economic Sentiment Indicator—which tends to be highly correlated with real GDP growth—fell in September to 93.3, the lowest reading since November 2020.

The Eurozone's headline and core CPI inflation rates remained elevated at 4.3% and 4.5% through September (*Fig. 11*). The European Central Bank (ECB) has responded to inflation by raising the ECB's official deposit rate from -0.50% during the first half of 2022 to 4.00% currently.

Eurozone private-sector loans peaked at a record €13.1 trillion during September 2022, falling by €84 billion through August of this year (*Fig. 12*). The volume of retail sales (excluding automobiles and motorcycles) fell 1.3% y/y during August to the lowest since April 2021 (*Fig. 13*).

Calendars

US: **Tues:** M-PMI & NM-PMI Flash Estimates 49.5/49.9; Richmond Fed Manufacturing Index 3.0; API Weekly Crude Oil Stock. **Wed:** New Home Sales 680k; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Powell; Bullock. (FXStreet estimates)

Global: **Tues:** Eurozone, Germany, and France C-PMI Flash Estimates 47.4/46.5/44.2; Eurozone, Germany, and France M-PMI Flash Estimates 43,7/40.0/44.8; Eurozone, Germany, and France NM-PMI Flash Estimates 48.6/50.0/44.6; Germany Gfk Consumer Climate -26.8; UK C-PMI, M-PMI & NM-PMI Flash Estimates 48.8/44.6/49.5; UK Employment Change 3m/3m -198k; UK Unemployment Rate 4.3%; UK Claimant Count Change 2.3k; UK Labor Productivity 0.7%; Australia CPI 1.1%q/q/53%y/y; Lagarde; Bullock. **Wed:** Germany Ifo Business Climate Index, Current Assessment, and Expectations 85.9/88.5/83.3; Japan Leading & Coincident Indicators; BoC Interest Rate Decision 5.00%; Macklem; Lagarde. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose for all three of these indexes during the October 20 week. LargeCap's forward earnings was at a record for a fourth straight week after first hitting that mark during the September 15 week for the first time in 15 months, dating back to the June 24 week of 2022. MidCap's improved to 3.7% below its record high in early June 2022, and SmallCap's rose to 7.2% below its mid-June 2022 record. Through the week ending October 20, LargeCap's forward earnings has risen 7.0% from its 54-week low during the week of February 10; MidCap's is 4.8% above its 55-week low during the week of March 10; and SmallCap's is 7.3% 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 steadily ticking higher now. The yearly rate of change in LargeCap's forward earnings has improved to 2.6% 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 -0.4% 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 -4.6% 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 of 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 (0.8% and 12.4%), MidCap (-12.3, 13.6), and SmallCap (-7.1, 11.8).

S&P 500/400/600 Valuation (*link*): Valuations moved lower for these three indexes during the October 20 week. LargeCap's forward P/E was down 0.4pt w/w to a seven-month low of 17.5. That's down from its 18-month high of 19.6 during the July 28 week. It's still up 2.4pts 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 0.3pt w/w to a 12-month low of 12.4. It's now 2.3pt below its 10-month high of 14.7 in early February, and up 1.3pts 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 fell 0.4pt w/w to a 12-month low of 11.5, and is now 2.8pt below its recent 12-month high of 14.3 in early February. It's up 0.9pts 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 29% 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 is at a 23-year low discount of 34%, which 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 123rd straight week; the current 7% discount is 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 turned slightly negative w/w in the usual performance right before the start of the earnings season. They're forecasting that the S&P 500's earnings will drop 0.3% y/y in Q3-2023. That's up from a 5.8% 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 1.1% in Q3, up from a 2.8% decline in Q2-2023. S&P 500 ex-Energy earnings are forecasted to be up 5.7% 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 final earnings growth rates for Q2-2023: Communication Services (34.6% in Q3-2023 versus 15.7% in Q2-2023), Consumer Discretionary (22.1, 57.0), Financials (18.1, 9.3), Utilities (10.7, 0.6), Industrials (6.1, 15.7), Information Technology (6.0, 5.0), S&P 500 ex-Energy (5.7, 3.6), Consumer Staples (2.6, 8.5), S&P 500 (1.1, -2.8), Real Estate (-7.8, -2.1), Health Care (-19.5, -26.7), Materials (-20.6, -26.4), and Energy (-33.2, -47.5).

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