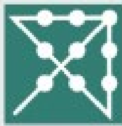
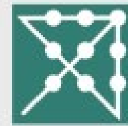
 Yardeni Research 

MORNING BRIEFING
December 6, 2023

Over There & Over Here

Check out the accompanying chart collection.

Executive Summary: Europe's economic outlook is brightening, Melissa reports, perhaps presenting investment opportunities. The ECB's monetary tightening has corralled inflation but also trampled GDP growth; this spring may bring monetary easing that enables revived growth. … Earlier fears of inadequate energy supplies for winter now appear ill-founded. … However, challenges remain in the form of higher energy costs and discord among EU nations over fiscal rules. … Also: Joe notes that the stock market's post-October 27 rally has taken a turn for the broader since November 13, with more sectors participating in gains and the S&P 500 Value and Equal Weight indexes way outperforming their counterparts.

Europe I: Winter Advisory Lifted. Melissa and I foresee brighter days on the horizon for Europe. Our expectation of a resurgence in economic growth as early as spring 2024—contingent on inflation receding and the European Central Bank (ECB) halting its monetary policy tightening—may be starting to materialize.

Earlier, we had advised caution, suggesting that it might be wise to weather the chilly season in European markets, as we were concerned about potential challenges to the region's energy resilience. However, our optimism has increased along with the gas in the region's storage facilities.

Our primary concern now shifts to how well the European economy will adapt as fiscal support diminishes, which we'll continue to monitor. Energy subsidies played a crucial role during the early stages of the Russian-Ukraine conflict, and pandemic-related supports prevented a severe recession. However, the energy shortages and fiscal supports also sparked inflation. The ECB's tight monetary policy since has cooled inflation but also has slowed economic growth. We anticipate a reversal of the ECB's tightening measures in the spring, providing the necessary momentum for an economic upswing.

For forward-thinking investors, now seems to be an opportune time to reenter the European equities market. Despite a surge in Europe's MSCI Index by 8.5% in euro terms during H1-2023, investor enthusiasm waned during the summer, with a slip of 8.5% from the peak on April 21 to a recent low on October 27 (*Fig. 1*). Yet there has been a 7.4% rebound since then through Monday's close.

Despite the upturn, the MSCI price index remains reasonably valued. The forward P/E has hovered around 12 since early this year. This is notably lower than in 2021 when the multiple was near 16 before European equities dropped, reflecting uncertainties during Russia's invasion of Ukraine and concerns about energy stability. We anticipate further valuation increases as Europe's energy situation stabilizes and interest rates begin to fall.

Europe II: ECB Tames Inflation. In Europe, both growth and inflation are in retreat—an outcome of the ECB's ten consecutive interest-rate hikes since July 2022, culminating in a pause at a 4.0% main deposit rate in its October 26 meeting. If the current inflation trend persists, Melissa and I think the ECB could initiate rate cuts as early as spring, setting the stage for later-year growth. While we are not banking on that yet, we are willing to bet that the most recent season of ECB hikes is over. Key points:

(1) *Growth stalls.* The Eurozone's real GDP growth contracted by 0.1% q/q Q3, influenced by headwinds from high inflation, elevated interest rates, and a less supportive fiscal environment (*Fig. 2*). This raises the likelihood of a technical recession if the weakness extends into Q4. Germany recorded a notable 0.1% quarterly decline, while France, Spain, and Italy narrowly escaped contraction.

(2) *Inflation eases*. The Eurozone's inflation continued its descent in November, marking the seventh consecutive month moving toward the ECB's 2.0% y/y target from levels above 10.0% a year ago (*Fig. 3*). Headline consumer price inflation dropped to 2.4% y/y from October's 2.9%, with nearly all items declining except for processed foods. Core inflation—excluding food, energy, alcohol, and tobacco—eased faster than expected, dipping to 3.6% y/y from 4.2%, driven by a significant drop in services prices.

(3) *ECB assesses*. Last week, ECB President Christine Lagarde *argued* that victory over high inflation could not yet be declared, as inflation could stage a comeback owing partly to rapid nominal wage growth. Indeed, despite economic contraction, unemployment remains at a record low (*Fig. 4*).

However, inflation appears to be falling more rapidly than anticipated by the ECB. Yesterday, Isabel Schnabel, ECB board member and formerly hawkish, *informed* Reuters that further interest-rate hikes are off the table due to a "remarkable" fall in inflation. However, she cautioned that surprises could occur in either direction and said that forecasting a cut several months out might be premature.

Europe III: Competing Developments. Europe has encountered contrasting economic

developments, marked by resilience in addressing the recent gas crisis contrasted with fiscal challenges. Here's more:

(1) *Full capacity.* Europe has managed to overcome the feared gas shortages that had been expected to spill over from the Russian-Ukrainian war. In fact, inventories peaked at 99.6% full on November 6, *reported* Reuters. This exceeds the 89.0% average of the previous decade by over 10ppts, positioning the region well for winter. Even under extreme conditions, projections suggest that inventories will remain substantial—at a minimum of 35% full—which is testament to the effectiveness of Europe's strategic gas management.

However, this success is tempered by the challenge of coping with higher gas prices over the medium term. Europe faces a shift from relatively inexpensive Russian pipeline gas to costlier liquefied natural gas from diverse sources, including Asia.

(2) *Fiscal quandary*. On the fiscal front, the European Union (EU) is grappling with divergent views on new fiscal rules, with a consensus unlikely in 2023 and negotiations extending into 2024, *reported* Reuters. Germany, traditionally fiscally prudent, faces its own crisis due to recent legal rulings threatening €60 billion ($66 billion) in climate spending, as recently *discussed* in *The Economist*. This jeopardizes domestic demand, the energy transition, and geopolitical goals.

Germany's insistence on stringent fiscal guidelines for all EU members further complicates the situation, as other countries seek a more flexible approach. The EU's Stability and Growth Pact, suspended since 2020, is set to be reinstated in 2024, reflecting the post-pandemic reality of higher public debt and the imperative for increased climate-related investments.

The pact imposes limits on budget deficits (3% of GDP) and debt (60% of GDP), with potential disciplinary action for noncompliance. Many European governments currently exceed those thresholds.

Strategy: The Growth Versus Value Gap. The S&P 500 has rallied sharply since its bottom on October 27, leaving behind the summer swoon on fears of a "higher for longer" interest-rate policy. The index's surge since October 27 began as those interest-rate fears waned, with the initial phase led by Growth stocks, primarily the MegaCap-8 (i.e., Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Nvidia, and Tesla). That rally has broadened out since November 13 following the release of October's CPI. Higher-for-longer fears have given way to rising expectations of an economic soft landing, and various jobs-related data

releases have even stoked hopes of interest-rate cutting in 2024.

The S&P 500 Value and Equal Weight indexes are benefitting from those changes in perception. So are more of the S&P 500's sectors. The increasing breadth is welcome news for investors who were left behind when the MegaCap-8 dominated the S&P 500's performance for much of 2023 following last year's bottom on October 12 (*Fig. 5*).

(1) *Value now leads Growth following CPI's release.* Since November 13, the S&P 500 Value index has risen 5.4%, more than double Growth's 2.1% gain. Value's strong performance has vaulted the index into the top spot for performance during the rally since October 27: Value's gain has improved to 12.5% from a 9.8% rise for the now-lagging Growth index. In fact, the S&P 500 Value index closed at a record high on Friday (*Fig. 6*)!

In contrast, the S&P 500 stands (as of Monday's close) 4.7% below its January 3, 2022 record high of 4796.56. The Growth index has fared worse by this measurement: It remains mired in a 14.9% correction from its record high on December 27, 2021.

(2) *Equal Weight index surging now*. Since November 13, the S&P 500 Equal Weight index has jumped 6.9%, nearly double the 3.6% rise for the S&P 500's market-weighted index (*Fig. 7*). Comparing the two indexes' gains since October 27, Equal Weight still beats the market-weighted index but not by nearly as much: Its 12.3% rise compares with the latter's 11.0% rise (*Fig. 8*).

(3) *Sector breadth is improving too.* Prior to the release of the October CPI on November 14, 10 of the S&P 500's 11 sectors were up from the index's October 27 low through November 13. However, just four sectors were ahead of the index then: Communication Services, Consumer Discretionary, Financials, and Information Technology. Three of these sectors, all but Financials, are home to the MegaCap-8 group of stocks.

The release of the October CPI upset that order. While the number of sectors rallying since October 27 has dropped to nine as of Monday's close, five are now ahead of the S&P 500. Some of LargeCap's traditional Value sectors—e.g., Financials, Real Estate, and Industrials—have surged since then, while Growth-oriented Communication Services and Information Technology have faltered.

Here's how the S&P 500's 11 sectors have performed since November 13: Real Estate (12.0), Financials (6.7), Materials (6.3), Industrials (6.0), Utilities (5.8), Consumer

Discretionary (4.9), Health Care (3.9), S&P 500 (3.6), Consumer Staples (2.3), Information Technology (1.9), Energy (-0.2), and Communication Services (-0.2).

That strong performance since November 13 has increased the number of sectors outperforming the S&P 500 since October 27 to five. Here's their performance ranking since October 27: Real Estate (18.0), Financials (14.6), Consumer Discretionary (13.9), Information Technology (13.4), Industrials (12.6), S&P 500 (11.0), Materials (9.5), Communication Services (8.5), Health Care (7.1), Utilities (7.0), Consumer Staples (6.3), and Energy (-1.1) (*Fig. 9*).

Calendars

US: Wed: ADP Employment Change 128k; Nonfarm Productivity & Unit Labor Costs 4.7%/-0.8%; Trade Balance -$64.1b; MBA Mortgage Applications; Weekly Crude Oil Inventories & Gasoline Production. **Thurs:** Initial Jobless Claims 223k; Consumer Credit $9.0b; Wholesale Inventories -0.2%; Fed's Balance Sheet. (FXStreet estimates)

Global: Wed: Eurozone Retail Sales 0.2%m/m/-0.9%y/y; Germany Factory Orders 0.0%; China Trade Balance; Canada Trade Balance $1.5b; BoC Interest Rate Decision 5.00%; BoE Financial Stability Report; BoE FPC Meeting Minutes; Bailey; Mauderer; Nagel. **Thurs:** Eurozone GDP 0.1%q/q/-0.1%y/y; Eurozone Employment Change 0.3%q/q/1.4%y/y; Germany Industrial Production 0.5%; France Trade Balance -8.5b; Italy Retail Sales 0.1%; Italy Industrial Production -0.3%; Eurogroup Group Meetings; UK Halifax House Price Index 0.3%; Japan Leading & Coincident Indicators; Japan DP -0.5%q/q/-2.1%y/y; Japan Household Spending -0.2%m/m/-3.0%y/y; Wuermeling; Gravelle; Machlem. (FXStreet estimates)

US Economic Indicators

JOLTS (***link***): Job openings were a surprise on the downside, sliding to its lowest level since March 2021, as the job market cools. *Job openings* sank 617,000 to 8.73 million (vs 9.30 million expected) and have declined in eight of the first 10 months of this year by 2.5 million. While there are still lots of job openings, they have declined steadily from the series peak of 12.0 million last March. Prior to the pandemic, in early 2020, the highest level of job openings recorded was 7.6 million. Openings reached 10.0 million in June 2021 for the first

time in the history of the series going back to 2000. There were 6.5 million people unemployed in October, so there were 1.34 available jobs for each unemployed person, the lowest since August 2021. This ratio was at a recent high of 2.01 during March 2022. By industry, the *biggest decreases* in job openings during October occurred in health care & social assistance (-236,000), finance (-168,000), accommodations & food services (-124,000), retail trade (-102,000), and real estate (-49,000)—industries in which hiring had been the strongest. Professional & business services (+93,000) and information services (+39,000) were the only industries posting notable increases in job openings. Separations include quits, which are generally voluntary separations initiated by employees—serving as a measure of workers' willingness or ability to leave jobs. Total quits have been in a downtrend since peaking at 4.5 million during April 2022, falling to 3.6 million in October—back near pre-pandemic levels. Hirings were little changed at 5.9 million in October versus a recent peak of 6.8 million during February 2022.

Global Economic Indicators

Global Composite PMIs (*link*): "November saw the global economy edge back into growth territory, as a stabilization in new order intakes supported a mild increase in output," according to the latest survey. Meanwhile, employment growth was at a near-standstill. The *C-PMI* increased for the first time in six months to 50.4 in November, following a five-month decline of 4.3 points (to 50.0 from 54.3). The service sector continued to outperform the manufacturing sector. The *NM-PMI* edged up to 50.6 in November, after falling the prior five months from an 18-month high of 55.3 in May to 50.4 in October—remaining above the 50.0 demarcation line between expansion and contraction for the 10th successive month. Meanwhile, the *M-PMI* remained below 50.0 for the 15th straight month, though did tick up to 49.3 in November from 48.8 in October; it's down sharply from its peak of 56.0 during May 2021. Geographically, seven of the 14 countries for which November C-PMI data were available recorded expansions, with the strongest rates of expansion recorded in India (57.4) and Russia (52.4), with expansions also visible in Ireland (52.3), China (51.6), US (50.7), Brazil (50.7), and the UK (50.6). France (44.6), Germany (47.8), Italy (48.1), Spain (49.8), and Japan (49.6) were among the countries experiencing contractions. *Turning to pricing*, both input costs and output charges increased in November—the former at a slower pace and the latter at a faster pace—with both price measures higher (on average) in developed nations than emerging markets.

US Non-Manufacturing PMI (*link*): The US service sector expanded at a faster rate in November, as business activity and employment picked up. The ISM NM-PMI was above

50.0 for the 11th successive month in November, improving to 52.7 from 51.8 in October. It was at a recent low of 50.3 in May. Of the *four components* of the NM-PMI, the *business activity* (to 55.1 from 54.1) gauge remained at a high level, while the employment (50.7 from 50.2) measure moved up from October's five-month low. The *new orders* measure held steady at 55.5 last month, after sinking 5.7 points to a nine-month low of 51.8 in September, suggesting that demand for services is likely strengthening. The *supplier deliveries* (49.6 from 47.5) measure continues to hover just below 50.0, remaining in the proximity of March's record-low 45.8—which was the fastest delivery performance since April 2009. It peaked at 75.7 in the fall of 2021. On the *inflation* front, the price index eased slightly for the second month to 58.3 in November from 58.9 in September, holding near June's 54.1—which was the lowest since March 2020. It was at a record-high 84.5 at the end of 2021.

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