MORNING BRIEFING
December 12, 2023

Global Economy Still In A Funk

Check out the accompanying chart collection.

Executive Summary: Recent global indicators show economic growth at a crawl, commodity prices remaining weak, and inflation moderating. Weighing on the pace of growth have been recessions in China and Europe. China's economic malaise is secular in nature and likely to last for a while given the challenges facing that country. But we expect the ECB to ease in the spring as inflation moderates, and the Eurozone's shallow recession to lift. US economic growth has been slowing from Q3's rapid pace, but a comeback in productivity growth could recharge it. … We continue to advise overweighting US stocks in global equity portfolios.

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

Global Economy: Secular or Cyclical Weakness? The global economy is growing, but at a slow pace. Much of the weakness is attributable to the recessions in China and Europe. US economic growth is slowing from Q3's rapid pace. Much of the weakness is structural in China but cyclical in the US and Europe.

In 2024, China's economic weakness is likely to persist and weigh on the global economy. But Europe should start to recover, as Melissa and I *discussed* last Wednesday. The US economy should continue to grow slowly, though we are inclined to anticipate upside surprises if productivity growth continues to make a comeback, as it did during Q2 and Q3 of this year. In our scenario, global inflation should continue to moderate. It might even fall to the 2.0% y/y rate targeted by the Fed for the US and the European Central Bank (ECB) for the Eurozone by the end of next year.

Yesterday, Debbie and I *discussed* the prospects for the economy over here. Today, let's look at the outlook over there:

(1) *Global growth indicators crawling*. According to the Netherlands Bureau for Economic Policy Analysis, global industrial production rose 0.5% y/y through September. However, it has been basically flat since early 2022, though at a record high (*Fig. 1*). That's when China was still imposing pandemic lockdowns, Europe's economy was hit by the shocks from Russia's invasion of Ukraine, and US consumers pivoted from buying goods to purchasing

services. The volume of global exports has also been flat since early 2022, but also at a record high.

Since December 2021, industrial production and the volume of exports among advancing economies are down 1.3% and 1.2% (through September of this year, the latest data available) (*Fig. 2*). Both have been essentially flat. Over this same period, the production and exports of emerging economies are up 4.9% and only 0.1%. The industrial production index for the members of the Organization for Economic Co-operation and Development (OECD) has also been flat since the end of 2021 (*Fig. 3*).

(The OECD, with 38 member countries, was founded in 1961 to stimulate economic progress and world trade. The OECD includes the following countries: Australia, Austria, Belgium, Canada, Chile, Colombia, Costa Rica, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, South Korea, Latvia, Lithuania, Luxembourg, Mexico, Netherland, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, United Kingdom, and the United States.)

The weakness in both production and exports during 2022 can be attributed largely to global supply-chain disruptions. The New York Fed's Global Supply Chain Pressure Index soared from 0.11 during October 2020 to 4.33 during December 2021 (*Fig. 4*). It was back down to 0.11 during October, the first reading above zero since January. Jammed ports and overwhelmed trucking systems depressed global production and exports during 2022. Inbound container traffic soared in US West Coast ports from mid-2020 through mid-2022 to new record highs (*Fig. 5*). It then dropped sharply during H2-2022 to pandemic lockdown levels. It has started to recover in recent months.

(2) *Commodity prices remain weak*. Commodity prices, especially those of industrial commodities and crude oil, have been weak, confirming that the global economy is weak. The price of a barrel of Brent crude oil has dropped 20% from September 27 through December 8 (*Fig. 6*). That's despite output cuts by Saudi Arabia and Russia since the summer and despite the mounting tensions between the US and Iran because of the Gaza war.

The CRB raw industrials spot price index is down 21% from its most recent peak of 689.0 on April 4, 2022 to 541.4 on December 8, near its lowest level since February 8, 2021. The spot price of copper is included in the CRB index, and it is down 10.5% since January 26 on mounting evidence that China's property crisis is worsening and weighing on Chinese

growth. The price of copper is highly correlated with the China MSCI stock price index, which is down a whopping 56.7% since February 17, 2021 (Fig. 7).

(3) *Global inflation moderating.* Headline and core inflation rates peaked last October for the 38 member countries of the OECD at 10.7% and 7.8%, respectively (Fig. 8). They were down to 5.6% and 6.5% in October. Energy and food inflation among the OECD, which peaked last year at 40.8% and 16.1%, fell to -4.8% and 7.4% during October (Fig. 9). The headline and core CPI inflation rates for the G-7 countries peaked last summer at 7.8% and 5.5%; they were down to 3.4% and 3.9% in October.

Experience suggests that recessions are necessary to bring down inflation. Yet that's not necessarily true, as inflation has fallen significantly in the US without a recession. However, inflation is a global phenomenon, especially the recent experience, which was largely triggered by the demand shock that overwhelmed goods markets around the world and their supply chains. That explains why goods inflation has dropped so quickly as soon as the buying binge for goods abated and the supply chains were normalized. Services inflation rates have been stickier, but they also are trending down.

Arguably, the US didn't need a recession to bring inflation down because the recessions in China and Europe have done that job for it. Let's turn to those two economies.

(4) *China's challenges*. Jackie and I often have discussed the downsides of investing in China. The country prospered from the 1980s through 2013. That was the year that Xi Jinping became the president of China. A few years after assuming office, Xi turned increasingly hostile to the free market entrepreneurial spirit that his predecessors had embraced to stimulate widespread prosperity. The Chinese Communist Party (CCP) took back control of the economy. The problem is that the economy had spun out of control, particularly in the real estate sector.

Provincial governments raised revenues for infrastructure spending by selling land to developers who built ghost cities of empty apartments that were purchased by individuals as investments. The Chinese have a high saving rate and purchased stakes in trusts that are exposed to real estate. They also invested in the stock market. Recently, we've noted the significant negative wealth effect that China's consumers are experiencing. As noted above, the China MSCI stock price index is down 56.7% since February 17, 2021. Apartment prices are falling in an illiquid market for such properties.

Just as China's property market engine has stalled, so too has its export engine. The CCP's

hostile domestic policies toward entrepreneurs and belligerent foreign policies toward democracies have depressed foreign investments in China and China's exports. The country is no longer viewed as a dependable business partner nor as a reliable source of goods, especially vital parts.

China's exports have been flat since December 2021 through November of this year (*Fig. 10*). That partly reflects slower global economic growth. Imports have also been flat since March 2021. That undoubtedly reflects a weaker domestic Chinese economy.

(5) *Europe's shallow recession*. Last week, Melissa and I reviewed the economic outlook for the Eurozone. It's quite bleak currently, but we expect that more secure sources of energy, lower inflation, and lower interest rates will revive economic growth during H2-2024. The latest data suggest that the region is in a shallow recession currently. Real GDP fell 0.4% (q/q saar) during Q3 (*Fig. 11*).

The Eurozone's Economic Sentiment Indicator suggests that GDP might be falling again during Q4. So does the volume of retail sales there, which has been falling since November 2021 (*Fig. 12*).

Also weighing on the region's economic growth is the weakness in Germany's manufacturing sector. Manufacturing orders fell 3.7% m/m and 7.3% y/y during October (*Fig. 13*). New orders were down in major sectors, including fabricated metal products, electrical equipment, and the key automotive industry. Machinery and equipment manufacturing orders dove 13.5% in October. Manufacturing production fell 0.4% m/m and 3.5% y/y.

As we wrote last week, we are expecting that the ECB will start easing its monetary policy next spring as inflation continues to moderate in the Eurozone. Both the 2-year and 10-year German government note yields dropped sharply in recent days to 2.80% and 2.27%, well below the ECB's 4.00% deposit rate (*Fig. 14*).

Global Strategy: Go Home or Go Global? Joe and I continue to recommend overweighting the US in global portfolios. Europe should also be overweighted. We would remain underweighted in the emerging market economies—especially China, even though its stocks look relatively cheap at the current valuation of the China MSCI. On the other hand, India's MSCI stock price index is at a record high partly because it is a primary beneficiary of China's woes (*Fig. 15*). Here are a few related observations:

(1) The Stay-Home versus Go-Global MSCI stock price index ratios in dollars and in local currencies have been trending higher since 2010 (*Fig. 16*). Both are at or near their record highs during the 2021-22 period.

(2) Contributing to the outperformance of the US MSCI have been the various country indexes' forward earnings (*Fig. 17*). The one for the US is up 264.3% since March 9, 2009, to a record high. Meanwhile, the other major market indexes' forward earnings are up less than 100% over this period and have stalled below their record highs for the past two years. The US tends to have the highest forward profit margin of the major markets around the world (*Fig. 18*).

(3) The forward P/E of the US MSCI tends to be much higher than those of the other major MSCI markets (*Fig. 19*). That's mostly because there are more growth stocks with higher valuation multiples in the former than in the latter. The forward P/E of the All Country World ex-US MSCI tends to track that of the S&P 500 Value index quite closely (*Fig. 20*). The two have diverged more than usual after the pandemic.

(4) The Emerging Market MSCI (in local currency) is highly correlated with the CRB raw industrials spot price index (in dollars) (*Fig. 21*). Given the lackluster outlook for global economic activity, industrial commodity prices are likely to remain depressed, suggesting not much upside for the Emerging Markets MSCI.

(5) The EMU MSCI, for the European Monetary Union, has been showing some relative strength in recent days as investors seem to believe that the ECB will be lowering interest rates before the Fed does so in 2024.

Calendars

US: Tues: Headline & Core CPI 0.0%m/m/3.1%y/y & 0.3%m/m/4.0%y/y; NFIB Small Business Optimism; API Weekly Crude Oil Inventories. **Wed:** Fed Interest Rate Decision 5.50%; FOMC Economic Projections; Headline & Core PPI 0.1%m/m/1.0%y/ & 0.2%m/m/2.3%y/y; MBA Mortgage Applications; OPEC Monthly Report; Crude Oil Inventories & Gasoline Production. (FXStreet estimates)

Global: Tues: Germany ZEW Economic Sentiment 8.8; Germany WPI -0.1%; UK Average Earnings Index Including & Excluding Bonuses 7.8%/7.4%; UK Unemployment Rate 4.2%; UK Claimant Count Change 20.3k; Japan Tankan Survey. **Wed:** Eurozone Industrial

Production -0.3%/m/-4.5%y/y; UK GDP -0.1%m/m/0.6%y/y; UK Headline & Manufacturing Production -0.1%mm/1.1%y/y & 0.0%/m/1.9%y/y; UK NIESR Monthly GDP Tracker; UK RICS House Price Balance -57%; Japan Industrial Production 0.5%; Japan Core Machinery Orders -0.5%m/m/-5.1%y/y; Australia Employment Change 10k; Australia Unemployment & Participation Rates 3.8%/66.9%; RBA Bulletin; Jones. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose for two of these three indexes for a third straight week. LargeCap's forward earnings rose 0.3% w/w to a new record high 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 rose 0.2% w/w to 5.0% below its record high in early June 2022, and SmallCap's dropped less than 0.1% w/w to 10.9% below its mid-June 2022 record. Through the week ending December 7, LargeCap's forward earnings has risen 8.2% from its 54-week low during the week of February 10; MidCap's is 3.4% above its 55-week low during the week of March 10; and SmallCap's is 3.1% above its 72-week low during the March 17 week. These three indexes' forward earnings downtrends since mid-2022 have 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 a 13-month high of 6.0% 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 0.6% 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 -2.2% y/y rate is at a 10-month high; it's 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. Following the Q3 season, they've kept LargeCap's 2023 estimate little changed and have trimmed SMidCap's. Here are the latest consensus earnings growth rates for 2023 and 2024: LargeCap (1.2% and 11.4%), MidCap (-12.6, 10.4), and SmallCap (-8.8, 7.6).

S&P 500/400/600 Valuation (*link*): Valuations were mostly steady for these three indexes during the December 8 week. LargeCap's forward P/E was unchanged w/w near a three-

month high of 18.8 and is up from a seven-month low of 17.0 during the October 27 week. That's down from its 18-month high of 19.6 during the July 28 week. It's still up 3.6pts 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 was steady w/w at a three-month high of 13.9 and is up from a 12-month low of 12.1 at the end of October. It's now 0.8pts below its 10-month high of 14.7 in early February and up 2.8pts 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 rose 0.2pt w/w to a three-month high of 13.4 and is up from a 12-month low of 11.3 at the end of October. It's now 0.9pt below its recent 12-month high of 14.3 in early February. It's up 2.8pts 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 26% discount to LargeCap's P/E is up from 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 29% discount is up from a 23-year-low 34% discount at the end of October, which compares to a 22% discount during the March 10 week; that one 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 129th straight week; the current 4% 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 and Q3-2023. Looking at Q4-2023, the revisions pendulum has turned negative again in the usual performance right before the start of the earnings season ahead of the typical earnings surprise hook. Analysts are forecasting that the S&P 500's earnings will rise 3.5% y/y in Q4-2023. That's below the 4.6% gain in Q3-2023 and up from a 5.8% decline in Q2-2023, which marked the cyclical bottom for earnings growth. On a pro forma basis, they expect an y/y earnings gain of 5.0% in Q4, down from a 7.2% gain in Q3 and up from a 2.8% decline in Q2-2023. S&P 500 ex-Energy earnings are forecasted to be up 8.1% y/y in Q4-2023. That compares to a 12.6% gain in Q3-2023, a 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 Q4-2023, unchanged from

Q3-2023's and Q2-2023's count, but we think that count could improve to a seven-quarter high of eight sectors at the end of Q4's reporting season. That compares to just two sectors doing so a year earlier in Q4-2022. Here are the S&P 500 sectors' expected blended earnings growth rates for Q4-2023 versus their final earnings growth rates for Q3-2023: Communication Services (48.9% in Q4-2023 versus 46.5% in Q3-2023), Utilities (22.7, 10.3), Consumer Discretionary (20.1, 42.4), Information Technology (16.3, 15.3), Real Estate (11.1, -5.4), Financials (9.4, 23.5), S&P 500 ex-Energy (8.1, 12.6), S&P 500 (5.0, 7.2), Consumer Staples (1.3, 6.9), Industrials (-0.5, 12.0), Health Care (-18.2, -17.3), Materials (-20.0, -18.1), and Energy (-22.5, -33.0).

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

Copyright (c) Yardeni Research, Inc. Please read complete copyright and hedge clause.