Global Economy: More Slow-Mo

See the collection of the individual charts linked below.

(1) Powell’s Pivot and Pirouette will be tested this week. (2) The comforts of a Stay Home investment strategy. (3) Payroll employment zigs and zags the fixed-income markets. (4) One-and-done or none-and-done? (5) 50, 25, or zero bps? (6) Do the ECB and BOJ matter more than the Fed? (7) What’s wrong with Germany? (8) Sol y sombra: NM-PMI & M-PMI. (9) Leading to no good. (10) Forward revenues still on sunny side.

Global Economy I: Staying Home. The good news: The global economy isn’t in a freefall. The bad news: The global economy is in a free-slowdown. So why have the major world stock markets been performing so well, with the US leading the way so far this year? Is it all about Powell’s Pivot at the beginning of the year to a “patient” monetary stance, followed by Powell’s Pirouette to an “appropriate” stance in early June? Yes, probably. If Powell pivots back to a patient stance when he testifies before Congress on monetary policy on Wednesday and Thursday, will that crush stock markets? Not necessarily, as Melissa and I discuss in the next section.

In any event, Joe and I continue to be homebodies. We continue to recommend a Stay Home investment strategy rather than a Go Global one. We’ve been doing so during most of the current bull market, and that strategy has worked very well. Consider the following:

(1) Since the beginning. Here is the performance derby of the major MSCI stock price indexes (in dollars) since 3/9/09 through Friday’s close: US (342%), Emerging Markets (118), Japan (101), EMU (100), and UK (89) (Fig. 1). No contest: USA All the Way (even in women’s soccer)! Over this same period, the All Country World MSCI is up 209%, but only 113% excluding the US.

The trade-weighted dollar is up 8.3% over this same period. More relevant is that the All Country World currency ratio is up 0.8% since 3/9/09 (Fig. 2).

(2) So far this year. Here’s the same performance derby ytd in dollars: US (19.6%), All Country World (16.2), EMU (13.7), Emerging Markets (9.7), UK (9.7), and Japan (8.4) (Fig. 3). And here it is again ytd in local currencies: US (19.6), All Country World (16.3), EMU (15.8), UK (11.7), Emerging Markets (9.3), and Japan (7.1) (Fig. 4).

(3) Leading the way higher. The ratio of the US MSCI to the All Country World MSCI ex-US rose to record highs in both dollars and in local-currency terms at the end of last week (Fig. 5). This is especially impressive given that the forward P/E of the US MSCI has consistently exceeded the comparable valuation multiple of the All Country World ex-US since the second half of 2010 (Fig. 6).

That’s mostly because the S&P 500 has relatively more market capitalization in the Information Technology sector (currently at 21.6%), which has a relatively high earnings growth rate and P/E (Fig. 7). The sector’s stock price index is up 603% since 3/9/09, lagging only the 668% increase in the S&P
Global Economy II: Does the Fed Really Matter? All eyes will be on Fed Chair Jerome Powell on Wednesday and Thursday when he testifies before Congress on the outlook for monetary policy. By law, the Fed chair does this twice a year, usually during February and July.

Following the release of May’s weaker-than-expected employment report early last month, the widespread expectation was that the FOMC will cut the federal funds rate by 50bps from a range of 2.25%-2.50% down to 1.75%-2.00% at the 7/30-31 meeting of the committee.

Melissa and I view the 2-year US Treasury note yield as the market’s forecast for the federal funds rate a year ahead (Fig. 9). This yield plunged from 1.95% at the beginning of June to 1.77% last Wednesday. It jumped to 1.87% on Friday following the release of June’s better-than-expected employment report.

Now the widespread consensus is that the FOMC will still lower the federal funds rate at the July meeting but by 25bps rather than 50bps. After May’s report, we doubted that the FOMC would cut the rate at the 6/18-19 meeting, and we also doubted a rate cut at the July meeting. Especially after June’s employment data, we don’t see a good justification for a rate cut right now. Indeed, the Fed doesn’t have much ammo left and should save it for when it is really necessary to use it.

The debate on what the Fed will do next will be resolved shortly. Indeed, Powell is likely to give the markets a big heads-up when he testifies this week. We wouldn’t be surprised if he made another pirouette back to a no-change stance for monetary policy. We wouldn’t be surprised if he proceeded with a 25bps cut either, but we would view it as a mistake.

In any event, does it really matter what the FOMC does at the next meeting? If they cut rates by 25bps, the committee is likely to indicate that another rate cut may not be forthcoming over the rest of this year.

More importantly, the 10-year US Treasury bond yield is down from 2.69% at the end of last year to 2.05% yesterday (Fig. 10). That probably has more to do with our “Modern Tether Theory” (MTT) of the bond yield than Fed policy. Since last year, we have argued that the US bond yield must be tethered to comparable bond yields in Japan and Germany, which fell to -0.16% and -0.37% at the end of last week.

The Fed may not matter as much as the European Central Bank (ECB) and the Bank of Japan (BOJ). While the Fed had been on course to normalize monetary policy from late 2015 through the end of 2018, the ECB and BOJ remained in ultra-easing mode. Their negative interest-rate policies made US bond yields at 3.00% look awfully attractive to foreign investors even on an unhedged basis. Around 2.00%, the US yield still looks mighty attractive.

Falling bond yields around the world have boosted valuation multiples for stocks around the world.

Global Economy III: A World of Hurt. The bottom line is that the ECB and the BOJ matter as much as the Fed to global financial markets. That means that these markets aren’t dependent just on the data that the Fed depends on but also on the data driving the monetary policies of the ECB and BOJ. For now, let’s focus on the latest batch of really awful European economic indicators as well as some of the global ones that are being weighed down by Europe:

(1) Germany. “Das ist nicht gut!” That’s the only suitable reaction to May’s data for German
manufacturing orders and production (Fig. 11). Orders dropped 2.2% m/m and 8.6% y/y to the lowest since February 2016. Factory output, excluding construction, rose 0.7% m/m, but was down 4.3% y/y. Meanwhile, the 12-month sum of German passenger car production plunged to only 4.8 million units during June, the lowest since September 2009 (Fig. 12). That’s down 14.5% y/y. What is the opposite of “wunderbar”?

(2) Eurozone PMIs. The good news: The Eurozone’s NM-PMI was solidly above 50.0, at 53.6, during June, with Germany at 55.8 (Fig. 13). The bad news: The Eurozone’s M-PMI was solidly below 50.0, at 47.6, with Germany at 45.0 (Fig. 14).

(3) Global PMIs. The global M-PMI fell to 49.4 during June (Fig. 15). In addition to Germany’s poor contribution, there was manufacturing weakness in the UK (48.0), China (49.4), and Japan (49.3). While the US remained above 50.0, at 50.6, it was the second weakest since September 2009. On the other hand, the global NM-PMI held up reasonably well, at 51.9 during June.

(4) OECD leading indicators. More troubling, perhaps, is that May’s batch of OECD leading indicators (OLI) continued to signal economic weakness ahead for the 36 member countries of the organization. The overall OLI fell to 99.0 in May, the lowest since September 2009 (Fig. 16). Showing similar weakness were the OLIs for the US (98.8), Europe (99.0), and Japan (99.3). These aren’t terrible readings, but they all are on the wrong side of 100.0.

Global Economy IV: World Revenues Stalling. Joe and I have been monitoring weekly S&P 500 forward revenues to see if it is starting to reflect the weakness in the global economy. We remain impressed by its resilience. It has been hovering in record-high territory throughout June (Fig. 17). This weekly series, reflecting the time-weighted consensus estimates for this year and next year, tends to be an excellent coincident indicator of actual quarterly revenues.

During the 6/27 week, industry analysts were expecting that S&P 500 revenues will grow 4.4% this year and 5.3% next year (Fig. 18). Those are solid growth expectations, and certainly don’t reflect much of a slowdown in global business for the S&P 500.

For the All Country World ex-US MSCI, revenues are expected to grow 3.6% this year and 4.5% next year. Again, those are relatively good growth rates (Fig. 19). Like the S&P 500 forward revenues, the US MSCI component of global forward revenues has stalled at a record high in recent weeks (Fig. 20). The Developed World ex-US MSCI forward revenues has stalled in recent weeks at a cyclical high, while the Emerging Markets forward revenues has dropped slightly from its record high during the 5/3 week.

CALENDARS

US. Tues: Job Openings 7.473m, NFIB Small Business Optimism Index 103.1, Bullard. Wed: Wholesale Inventories 0.4%, MBA Mortgage Applications, DOE Crude Oil Inventories, FOMC Minutes, Powell Testifies Before House Finance Services Committee, Bullard. (DailyFX estimates)

Global. Tues: China New Yuan Loans ¥1675b, China Aggregate Financing ¥1900b, Japan Machine Tool Orders, Mexico CPI 3.95% y/y. Wed: UK GDP 03%m/m/0.1%3m/3m, Headline & Manufacturing Industrial Production 1.5%/1.1% y/y, China CPI & PPI 2.7%/0.3% y/y, BOC Rate Decision 1.75%. (DailyFX estimates)

STRATEGY INDICATORS
S&P 500/400/600 Forward Earnings (link): Forward earnings mostly edged lower last week for the S&P indexes, but they remain in the up trends that began during March. LargeCap’s has risen during 17 of the past 21 weeks; MidCap’s 13 of the past 17 weeks; and SmallCap’s 11 of the past 15 weeks. LargeCap’s dropped 0.2% w/w from a record high, while MidCap’s and SmallCap’s are 0.6% and 5.6% below their mid-October highs. At their bottoms, LargeCap’s forward EPS had been the most below its record high since June 2016, and MidCap’s was the lowest since May 2015. SmallCap’s had not been this far below since October 2010. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act, but tumbled as y/y comparisons became more difficult. In the latest week, the rate of change in LargeCap’s forward earnings dropped to a 31-month low of 3.8% y/y from 4.2%. That’s down from 23.2% in mid-September, which was the highest since January 2011. MidCap’s y/y change was steady at 3.5%, which compares to a 34-month low of 3.0% in mid-June and 24.1% in mid-September (the highest since April 2011). SmallCap’s -1.9% y/y is the lowest since January 2010. That compares to an eight-year high of 35.3% in early October. Analysts had been expecting double-digit percentage earnings growth for 2019 last October, but those forecasts are down substantially since then. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, 2.4%, 11.6%), MidCap (22.7, 0.9, 14.4), and SmallCap (22.4, 2.1, 19.0).

S&P 500/400/600 Valuation (link): Valuations rose across the board last week for all three S&P market-cap indexes. LargeCap’s forward P/E gained 0.3 point w/w to a 16-month high of 17.0, up from a five-year low of 13.9 during December. That also compares to a 16-year high of 18.6 during January 2018—and of course is well below the tech-bubble record high of 25.7 in July 1999. Last week’s level remains above the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap’s forward P/E rose to a nine-week high of 15.9 from 15.8. That’s down from a seven-month high of 16.3 in early April, but up from 13.0 during December, which was the lowest reading since November 2011. MidCap’s P/E is down from a 15-year high of 19.2 in February 2017 and the record high of 20.6 in January 2002. However, MidCap’s P/E has been at or below LargeCap’s P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap’s P/E improved to an eight-week high of 16.5 from 16.4 and is well above its seven-year low of 13.6 during December. That’s still well below its 51-week high of 20.2 in December 2017 (which wasn’t much below the 15-year high of 20.5 in December 2016, when Energy’s earnings were depressed). SmallCap’s P/E was below LargeCap’s P/E for an eighth straight week, after being below for much of December for the first time since 2003.

S&P 500 Sectors Quarterly Earnings Outlook (link): With the Q2 earnings season on deck, the consensus forecast has held up well despite concerns about the trade war’s impact on earnings. Revisions activity remains light for the current quarter: Last week saw the S&P 500’s Q2-2019 EPS forecast drop nine cents w/w to $40.35. That’s still in line with our forecast of $41.00, which assumes there will be yet another earnings hook during the reporting season. The consensus’ $40.35 estimate is down 2.4% since the start of the quarter, which represents an earnings decline of 1.6% y/y. On a pro forma basis, it represents flat earnings y/y, compared to a gain of 0.3% a week earlier and 2.9% at the end of Q1. If Q2 earnings growth is positive, it would be the 12th straight y/y rise, compared to 1.6% in Q1, 16.9% in Q4, and 28.4% in Q3 (which marked the peak of the current earnings cycle). Five of the 11 sectors are expected to record positive y/y earnings growth in Q2-2019, with only one rising at a double-digit percentage rate. That compares to six positive during Q1, when one also rose at a double-digit percentage rate. Five sectors are expected beat the S&P 500’s Q2 growth rate, the same as during Q1. However, Communication Services and Utilities are the only sectors to post better growth on a q/q basis during Q2, just as they did during Q1. Here are the latest Q2-2019 earnings growth rates versus their Q1-2019 growth rates: Communication Services (16.4% in Q2-2019 versus -9.9% in Q1-2019), Financials (5.1, 8.0), Health Care (3.0, 10.3), Utilities (2.2, -0.5), Real Estate (1.0, 6.3), Consumer Discretionary (-0.1, 8.1), Industrials (-0.3, 6.9), Energy (-4.0, -26.1), Consumer Staples (-1.2, 1.0), Information Technology (-7.9, -1.1), and Materials (-30.8, -13.4). On an ex-Energy basis, S&P 500
earnings are expected to rise 0.2% y/y in Q2, down from 3.0% in Q1 and well below the 14.2% y/y gain in Q4. Q2’s forecasted gain would mark the lowest ex-Energy growth rate since Q2-2016.

S&P 500 Q2 Earnings vs Past Quarters Trend (link): Earnings estimate revisions activity for Q2-2019 returned to the usual pattern of falling just before the earnings reporting season, but the decline has not been as bad as pundits feared. With the June-quarter books closed, the current Q2-2019 EPS forecast of $41.34 is down just 2.4% over the 14 weeks since the quarter’s start. That’s less than the average decline of 4.1% over the same time period in the 100 quarters dating back to 1994. It’s also markedly better than the 7.1% drop for Q1-2019 and the 4.0% decline for Q4-2018. Analysts expect EPS for Q2-2019 to be down 1.6% y/y on a frozen actual basis, which would mark its first y/y decline since Q2-2016. However, we think the positive surprise bias will appear again and that y/y growth will be positive for a 14th straight quarter. Since 1994, the Q2 earnings surprise has averaged 2.8% and has been positive in 22/25 years, with the last miss occurring in 2008. Q2-2019 should mark the S&P 500’s record 42nd straight quarter of positive surprises—a streak dating back to Q1-2009.

GLOBAL ECONOMIC INDICATORS

Global Composite PMIs (link): Global economic activity in June held steady at May’s pace—which was the weakest since June 2016—as a downturn in manufacturing was offset by an expansion in the service sector. The JP Morgan Global Composite Output Index (C-PMI) was unchanged at 51.2 last month after falling the prior two months from March’s 52.7; it peaked at 54.8 in February 2018. Global PMIs show the service sector (to 51.9 from 51.6) continued to outpace the manufacturing sector (49.4 from 49.8)—which contracted for the second consecutive month. (The global manufacturing index signaled contraction in 18 out of 30 countries, whereas the service sector’s highlighted downturns in only three of the 13 nations covered.) June C-PMIs revealed that growth in the emerging economies was slower than growth in the developed economies, as the former eased for third straight month, from 52.9 in March to 50.9 in June, while the developed nations’ increased for the first time in four months, ticking up from 51.1 to 51.3. They peaked at 53.5 and 55.4, respectively, during January and February of last year. Looking at C-PMIs, the Eurozone (52.2) as a whole—including Ireland (54.4), France (52.7), Germany (52.6), and Spain (52.1)—were all above the global average of 51.2, as were the US (51.5) and Australia (52.5). Growth was below the global average of 51.2 in Japan (50.8), India (50.8), China (50.6), and Italy (50.1). The UK (49.7), Brazil (49.0), and Russia (49.2) all saw contractions.

Global Non-Manufacturing PMIs (link): June saw the rate of expansion in the global services economy pick up slightly after slowing to a 33-month low in May. JP Morgan’s Global NM-PMI edged up to 51.9 last month after falling from 53.7 to 51.6 the previous two months—as the NM-PMI for developed nations increased for the first time in four months to 52.0, while the NM-PMI for emerging nations fell to a 19-month low of 51.5. Among the 13 countries for which data are available, the strongest performers—Ireland (56.9), Germany (55.8), Spain (53.6), and France (52.9)—all were based in the Eurozone. Australia (52.6), China (52.0), and Japan (51.9) also registered growth at or above the global average. Expansions were also seen in the US (51.5), Italy (50.5), and the UK (50.2). Meanwhile, the service sectors in India (49.6) and Russia (49.7) moved from expansion to contraction, while Brazil’s (48.2) saw its rate of decline ease.

US Non-Manufacturing PMIs (link): A tale of two surveys: ISM’s June survey still reveals a good deal of strength in the service sector, while IHS Markit’s shows growth remains subdued. ISM’s NM-PMI (to 55.1 from 56.9) eased a bit last month, though remains at a relatively high level, down from September’s peak rate of 60.8. Three of the four components took a step back last month, while supplier deliveries (51.5 from 49.5) improved for the first time in four months, moving back above the breakeven point of 50.0. The business activity (58.2 from 61.2), new orders (55.8 from 58.6), and employment (55.0 from 58.1) components all eased in June, but still reflected solid growth. Meanwhile,
IHS Markit’s NM-PMI (51.5 from 50.9) indicates service activity expanded at a slightly faster pace in June, though was its second-slowest since August 2016 (behind May). According to the report: “A major change since the first quarter has been a broadening-out of the slowdown beyond manufacturing, with the service sector growth now also reporting much weaker business activity and orders trends than earlier in the year.” Trade wars and geopolitical concerns, as well as forecasts of slower economic growth, continued to top the list of companies’ worries about the year ahead. Therefore, progress in US-China trade talks could be key to helping lift confidence in coming months.

**Germany Manufacturing Orders** (link): German factory orders in May plunged to their lowest reading since February 2016. Total billings contracted for the third time in five months, by 2.2% m/m and 7.1% ytd. Foreign orders continued to slide, dropping 4.3% in May and 7.0% ytd—with orders from both inside (-1.7% m/m & -5.6% ytd) and outside (-5.7 & -7.8) the Eurozone heading south. Domestic orders rose for the first time this year, advancing 0.7% in May, though were down 7.3% ytd. Here’s a look at the ytd performance in orders by industry grouping: Capital goods orders have plunged 9.4% ytd, with both domestic (-9.6% ytd) and foreign (-9.2) orders in the red and the latter showing declines from both inside (-4.2) and outside (-11.4) the Eurozone. Intermediate goods orders also bled red, sinking 4.9% ytd, with domestic and foreign orders sliding 5.0% and 4.9%, respectively, over the period. The decline in foreign orders was driven by billings from inside (-2.2) the Eurozone, though orders from outside (-7.8) the Eurozone, though orders from outside (-2.2) the Eurozone were also down so far this year. Consumer goods orders were a mixed bag, climbing 0.9% ytd, with domestic and foreign orders falling 3.4% and foreign orders climbing 4.1% over the period. The increase in the latter was led by an 11.4% ytd surge in orders from outside the Eurozone—with billings for both durable (15.9% ytd) and nondurable (10.1) goods posting double-digit gains; foreign billings from within the Eurozone fell 4.6%.

**Germany Industrial Production** (link): Factory output in May eked out a gain after posting its biggest decline in nearly four years in April. Germany’s headline production—which includes construction—ticked up 0.3% after sliding 2.0% in April to its lowest level since March 2017. Excluding construction, May’s gain was more than double that at 0.7%, as construction output sank 2.4%. Manufacturing output expanded 0.9% in May after contracting 1.9% in April; these firms rely on exports and have been especially hard hit by the trade wars, pushing production down 4.1% y/y. There were some signs of life in both capital (2.0% m/m & -2.4% y/y) and consumer (1.1 & -6.4) goods orders in May, though output for both was still below year-ago levels. IHS Markit’s M-PMI (to 45.0 from 44.3) for June shows manufacturing activity contracted for the sixth straight month, though at a slower pace. According to the report, weaker external demand and a slowdown in the auto industry continued to weigh on orders, which in turn led to declines in both output and employment.

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