Going Global

Global Strategy I: Greetings from London! I’ve gone global. I’m not staying home this week. Instead, I am visiting our accounts in London. I’m sure to get lots of questions about the possible impeachment of President Trump, as well as the status of his trade war and/or peace with China. I’ll be asking lots of questions about Brexit. A hard version of Brexit is still possible, and it would certainly initially hit the UK economy hard. However, it now seems that a soft Brexit is more likely. In any event, it’s hard to imagine London’s globalized financial community picking up and moving to Frankfurt, or even Paris. Then again, there is always Dublin, which has plenty of pubs.

As you might recall, in our 10/8 Morning Briefing, Joe and I wrote that we are getting cabin fever: “Cabin fever is a popular term for a relatively common reaction to being isolated in a building for a period of time. In our case, we have been isolated in the US, promoting a Stay Home investment strategy during most of the current bull market. It may be time to venture outside of our home market and Go Global for a while.”

That was a relatively contrarian call at the time. However, in yesterday’s What I Am Reading email, I provided links to four of the many articles written in recent days about the attraction of investing globally. Their headlines say it all:

“Investors looking beyond U.S. equity market for 2020” (11/8 Reuters)
“Is It Time to Shop for Stocks in Europe and Japan?” (11/8 Barron’s)
“Global investors flock to China, undeterred by trade war” (11/8 Reuters)
“Unloved Assets Join Market Rally in Latest Sign of Optimism” (11/10 WSJ)

The most recent article in this list observed: “Investors are piling into beaten-up assets from commodities to emerging-market stocks, powering a broad rally that reflects a brightening outlook for the global economy.” The article also noted the reasons for this development: “Driving the gains are signs of better-than-expected outcomes to several issues that have weighed on markets for most of the year. The U.S. and China are approaching an initial accord on trade; the world’s biggest central banks have slashed interest rates to curtail a
manufacturing slowdown; and the odds of a disorderly U.K. exit from the European Union are declining."

We’ve observed the same since early October. Most importantly, in our opinion, the Fed’s third cut in the federal funds rate this year, at the end of that month, was widely expected. We observed that emerging market economies (EMEs)—along with their bonds, stocks, and currencies—do well when the Fed is lowering interest rates. We also observed that their Purchasing Managers Indexes were outperforming those of the advanced economies this year (Fig. 1). European companies tend to benefit more than American ones from better growth in EMEs.

The forward P/E spread between the US MSCI, currently at 17.7, and the All Country World ex-US MSCI, at 13.6, has been widening since the beginning of the bull market, making Go Global increasingly attractive on a valuation basis (Fig. 2 and Fig. 3). Investors were held back by fears that the rest of the world was more at risk of falling into a recession than the US. Let’s not forget that the Fed was normalizing monetary policy last year, which did weigh on global economic growth, especially overseas. Trump’s escalating trade wars also weighed on foreign economies more than ours.

By the way, it’s important to note that the valuation spread between us and them has stalled with some volatility around a record high of 4.0pppts since 2018. There is certainly room for an increase in the forward P/E of the ACW ex-US MSCI.

Now investors around the world are much more relaxed about the Fed. New York Federal Reserve President John Williams said on Friday that the US economy is in a good place, reiterating his view that the interest-rate cuts made this year should appropriately address the potential risks of the trade war with China and a global economic slowdown. The Fed’s pivot from signaling three to four rate hikes for 2019 late last year to actually cutting the federal funds rate three times so far this year has been a great relief for investors. The global economy may benefit from that pivot more than the US economy does given the dire circumstances that might have befallen the global economy had the Fed persisted on its tightening course. Now Melissa and I expect that the Fed will press the pause button again and keep it pressed through next year’s election.

On the other hand, with Trump, you never know: It’s hard to make predictions since he never stops negotiating, even when deals are done. At the end of last week, it seemed like the Phase 1 agreement with China isn’t a done deal yet because the Chinese want Trump to also phase out his tariffs on China. On Saturday, he said trade talks with China are moving along “very nicely,” and said the leaders in Beijing wanted a deal “much more than I do.” Trump also described as “incorrect” reports about how much the US was ready to roll back tariffs on China. “If we don’t make that right deal, we’re not going to make a deal.”

Then again, the President views the Dow as his most reliable poll. He can see that it is at a record high mostly on news suggesting that he has at least stopped escalating his trade wars and may be de-escalating them. Since he clearly wants to win a second term, Trump will have to focus more on defending himself from the Democrats’ moves to impeach him and on
campaigning for a second term as the November 2020 presidential election approaches.

**Global Strategy II: Risk-On Hurts Bonds.** Joe and I have counted 65 panic attacks since the start of the current bull market in stocks. All were followed by relief rallies. While we count three minor panic attacks this year, the latest big one occurred late last year from 9/20 through 12/24, when the S&P 500 plunged 19.8% (Fig. 4). The relief rally since then in the S&P 500 has been extraordinary (Fig. 5). Here is the performance derby of the S&P 500 and its 11 sectors since the Christmas Eve low through Friday's close: Information Technology (49.3%), Industrials (35.6), Communication Services (33.9), Financials (33.5), Consumer Discretionary (31.9), S&P 500 (31.6), Materials (27.3), Real Estate (26.0), Consumer Staples (24.6), Utilities (19.6), Health Care (17.8), and Energy (12.0).

There have also been significant mood swings in the bond market. The one over the past 12 months has been especially intense. The 10-year US Treasury bond yield peaked last year at 3.24% on 11/8. It dropped to a recent low of 1.47% on 9/4 as investors fretted about a recession (Fig. 6). Those fears were heightened when the yield curve inverted during the late summer (Fig. 7).

Those concerns have clearly diminished since. The bond yield was back up to 1.94% on Friday, or 39bps above the federal funds rate. It was 62bps below the federal funds rate at the end of August.

Apparently, the recent inversion of the yield curve was a false alarm, as Melissa and I argued in our 4/7 Topical Study, “The Yield Curve: What is it Really Predicting?” It didn’t lead to a recession this time because Fed officials recognized they were on the wrong course and changed it at the beginning of this year. Now both the bond yield and the yield curve confirm that the economy is likely to continue to grow. So the stock market is reading the signals from the credit markets as bullish ones.

Since last year’s peak in the US bond yield, it seemed that it was getting dragged down by negative government bond yields in Germany and Japan. Now it seems that the backup in the US bond yield is putting some upward pressure on comparable German and Japanese yields (Fig. 8). Both still are slightly negative, but the German yield is up from a record low of -0.72% on 8/15 to -0.25% yesterday. The Japanese yield is up from a record low of -0.29% on 9/4 to -0.07% yesterday.

**Global Strategy III: Still No Oomph in Germany.** It’s unlikely that the latest batch of German economic indicators caused the backup in the German bond yield. At best, the latest numbers suggest that the German economy may be finding a bottom, but there’s no sign of a V-shaped recovery. An L-shaped outlook is more consistent with the latest stats:

1. **Production and orders.** German manufacturing output, excluding construction, fell 0.6% m/m and 4.3% y/y during September to the lowest reading since December 2016 (Fig. 9). The sort-of good news was that new factory orders rose 1.3% m/m during September, but it was still down 5.4% y/y.
(2) **Exports.** The widespread view is that Germany’s weakness reflects the weakness in the global economy. The data show that the country’s exports actually rose to a record high during March 2019 (**Fig. 10**). They have stalled since then, though in record-high territory.

(3) **Auto output.** Debbie and I have been closely monitoring the 12-month moving sum of German auto production. The good news is that it seems to have found a bottom around 4.7 million units over the three months through October (**Fig. 11**). But that’s the lowest since February 1998.

**Global Strategy IV: Into the Weeds of Valuation.** They say that the devil is in the details. That seems to be the case when Joe and I compare the forward P/Es of the major sectors of the US MSCI and the ACW ex-US MSCI.

Here are the latest readings as of the 10/31 week, first for the US followed by the rest of the world: MSCI Composite (17.7, 13.6), Communication Services (18.5, 15.9), Consumer Discretionary (22.3, 14.8), Consumer Staples (19.8, 19.0), Energy (16.2, 10.6), Financials (12.3, 10.0), Health Care (15.5, 19.2), Industrials (17.4, 14.9), Information Technology (20.3, 17.7), Materials (17.3, 12.5), and Utilities (19.6, 13.9) (**Fig. 12**).

Strictly on a valuation basis, if you plan on going global, the following sectors are relatively cheaper over there than over here, starting with the best to the worst values: Energy (35% cheaper), Consumer Discretionary (34), Utilities (29), Financials (19), Communication Services (14), Industrials (14), Information Technology (13), Consumer Staples (4), and Health Care (24% more expensive).

**CALENDARS**

**US. Tues:** Small Business Optimism Index 102.0, Clarida, Kashkari, Harker. **Wed:** Headline & Core CPI 1.7%/2.4% y/y, MBA Mortgage Applications, Monthly Budget Statement -$128.2b, Powell, Kashkari. (DailyFX estimates)

**Global. Tues:** Eurozone ZEW Survey Current Situation & Expectations -22.0/-13.0, UK Employment Change (3m/3m) & Unemployment Rate (3m) -102k/3.9%, Mersch. **Wed:** Eurozone Industrial Production -0.2%m/m/-2.3%y/y, Germany CPI 0.1%m/m/1.1%y/y, UK Headline & Core CPI 1.6%/1.7% y/y, China Industrial Production 5.4% y/y, China Retail Sales 7.8% y/y, Japan GDP 0.9%(saar), Australia Employment Change & Unemployment Rate 16k/5.2%. (DailyFX estimates)

**STRATEGY INDICATORS**

**S&P 500/400/600 Forward Earnings (link):** Forward earnings edged lower for all three of these indexes last week for the first time since early August. These indexes began a forward-earnings uptrend during March, but only LargeCap is near a record high. LargeCap’s forward earnings has risen during 28 of the past 39 weeks, MidCap’s 19 of the past 35 weeks, and SmallCap’s 17 of the past 33 weeks. LargeCap’s is just 0.3% below its record high eight weeks ago, while MidCap’s and SmallCap’s are 5.2% and 8.9% below their October 2018 highs.
MidCap’s forward earnings is near a 17-month low now, while SmallCap’s forward earnings is near September’s 17-month low because analysts are now including a large goodwill writeoff in their 2019 annual forecast for Frontier Communications. At their bottoms earlier in 2019, LargeCap’s forward EPS had been the most below its record high since June 2016 and MidCap’s was the lowest since May 2015. During mid-September, 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 began to tumble in October as y/y comparisons became more difficult. In the latest week, the rate of change in LargeCap’s forward earnings edged up to 1.1% y/y from a 38-month low of 1.0%. That’s down from 23.2% in September 2018, which was the highest since January 2011. MidCap’s -4.9% y/y change is the lowest since December 2009 and down from -4.1% a week ago. That compares to 24.1% in September 2018 (the highest since April 2011). SmallCap’s -7.9% y/y change is up from -9.6% in mid-September, which was the lowest since December 2009 and compares to an eight-year high of 35.3% in October 2018. 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%, 0.6%, 10.1%), MidCap (22.7, -6.8, 12.7), and SmallCap (22.4, -17.7, 36.4).

S&P 500/400/600 Valuation (link): Valuations rose last week for all three of these S&P market-cap indexes, and continue to improve from their three-month lows during the late summer. LargeCap’s forward P/E rose 0.2pt w/w to a 21-month high of 17.5. That compares to a five-year low of 13.9 during December and 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 was up 0.3pt w/w, to a 20-month high of 16.9, and is 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 rose 0.3pt w/w to an eight-week high of 17.7, but remains below the 12-month high of 17.8 in mid-September. That’s still well above its seven-year low of 13.6 during December and compares to its 15-year high of 20.5 in December 2016, when Energy’s earnings were depressed. SmallCap’s P/E was above LargeCap’s again for a fourth week, primarily due to substantially lower forward earnings for Frontier Communications. It had been below for four months through the end of August—the first time that has happened since 2003.

S&P 500 Sectors Quarterly Earnings Outlook (link): With the Q3 earnings season now slowing and awaiting retailers’ results, Q3’s blended estimate/actual improved for a fourth straight week. The S&P 500’s Q3-2019 EPS forecast jumped 25 cents w/w to $42.20. That represents an earnings decline of 1.1% y/y compared to the prior week’s forecasted earnings drop of 1.7%. While the consensus Q3 EPS estimate is below our recently reduced forecast of $42.25 and slightly negative y/y earnings growth of 1.0%, it’s above the $41.31 reported for Q2. On a pro forma basis, Q3 earnings are expected to decline 0.5% y/y, which would be the first drop in 13 quarters and compares to y/y gains of 3.2% in Q2, 1.6% in Q1, 16.9% in Q4-2018, and 28.4% in Q3-2018 (which marked the peak of the current earnings cycle). Seven of
the 11 sectors are expected to record positive y/y earnings growth in Q3-2019, with none rising at a double-digit percentage rate. That compares to seven positive during Q2, when three rose at a double-digit percentage rate. The same seven sectors are expected to beat the S&P 500’s Q3 earnings decline of 0.5% y/y, up sharply from just three beating the S&P 500 during Q2. Consumer Staples, Industrials, Materials, Real Estate, and Utilities are the only sectors expected to post better (or less worse) growth on a q/q basis during Q3. On an ex-Energy basis, the consensus expects earnings to rise 2.1% y/y in Q3. That compares to ex-Energy gains of 3.9% in Q2 and 3.0% in Q1, and is well below the 14.2% y/y gain in Q4-2018. Here are the latest blended Q3-2019 earnings growth rates versus their Q2-2019 growth rates: Health Care (9.4% in Q3-2019 versus 10.3% in Q2-2019), Utilities (6.7, 1.1), Real Estate (5.6, 3.1), Consumer Staples (3.2, 1.7), Industrials (3.4, -9.5), Financials (2.6, 10.0), Consumer Discretionary (0.8, 2.7), Communication Services (-1.5, 17.6), Information Technology (-2.4, -2.2), Materials (-11.9, -12.7), and Energy (-37.8, -8.9).

**S&P 500 Q3 Earnings Season Monitor** *(link)*: With the Q3-2019 earnings reporting season now 89% complete, S&P 500 revenues and earnings are beating the consensus forecasts by 0.9% and 4.8%, respectively. At the same point during the previous earnings season for Q2, revenues and earnings had beaten forecasts by a higher 1.3% and 6.1%, respectively. However, a higher percentage of companies has recorded a positive earnings surprise in Q3 than in Q2—75% versus 74%. A slightly higher percentage of companies showed a positive revenue surprise—58% versus 57%. The 446 companies in the S&P 500 that have reported through mid-day Monday collectively have recorded an earnings decline of 0.2% y/y, dragged down by Micron Technology’s earnings deceleration. On the revenue side, results are 3.7% higher than a year earlier. Ex-Micron, y/y earnings growth for the S&P 500 jumps 1.0ppt to 0.8% and revenue growth improves 0.2ppt to 3.8%. Adjusting for the dismal y/y growth declines for the Energy sector, Q3’s S&P 500 ex-Energy revenue growth improves 1.2ppt to 4.9% and earnings growth rises 2.7ppts to 2.5%. Overall, Q3 earnings growth results are positive y/y for 62% of companies versus a higher 66% at the same point in Q2, and revenues have risen y/y for 69% compared to a lower 67% in Q2. These figures will continue to change slightly as more Q3-2019 results are reported in the coming weeks. However, y/y earnings growth is likely to trail revenue growth for a third straight quarter, something that hasn’t happened since the last Energy “recession” in H1-2016. Regardless, what companies say about their expectations for Q4-2019 and their early peek at 2020 prospects will be investors’ main focus.

**GLOBAL ECONOMIC INDICATORS**

**UK GDP** *(link)*: The UK economy dodged a recession last quarter, but growth remains weak. Real GDP moved from negative to positive territory during Q3, despite falling the final two months of the quarter; the yearly rate was the weakest since 2010. Real GDP expanded 1.2% (saar) last quarter after contracting 0.9% during Q2—which was the first negative quarter since Q4-2012. The economy rose only 1.0% y/y last quarter, the weakest rate since Q2-2012, slowing from 2.1% at the start of this year. Real household consumption accelerated 1.6% (saar) last quarter, improving steadily from Q4-2018’s 0.7%. Real gross fixed capital formation contracted for the second quarter, falling 0.9% (saar) last quarter, narrowing from Q2’s -3.7%. Government expenditures rose 1.2% (saar), its weakest quarter since Q2-2018 and about a
quarter of Q2’s pace. Trade was a positive to Q3 growth, as exports (22.3%, saar) blew past the increase in imports (3.3). Meanwhile, looking at the sectors, the manufacturing sector remained a drag on growth again last quarter.

**UK Industrial Production** ([link](#)): Output has weakened since reaching a cyclical high in March of this year. Headline production fell 0.9% during the two months through September, after little growth the prior two months. Since peaking in March, output is down 2.8%, with manufacturing contracting 4.2%. The main industrial groupings show the decline is widespread, with consumer nondurable (-6.0% since March), consumer durable (-4.4), intermediate (-4.0), and capital (-2.6) goods production all down over the six-month period; energy (0.6) output eked out a small gain. Looking ahead, IHS Markit’s M-PMI in October remained below 50.0 for the sixth month, though has improved the past two, from a recent low of 47.4 in August to a six-month high of 49.6 last month. The report noted, “The manufacturing downturn continued at the start of the final quarter as uncertainties surrounding Brexit, the economic outlook and domestic politics all took their toll.”

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, 570-775-6823

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