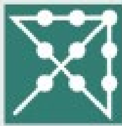

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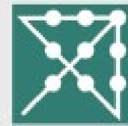

May 29, 2024

Morning Briefing

A Less Interest-Rate-Sensitive US Economy; A Less Investable Mexican Economy

Check out the accompanying chart collection.

Executive Summary: The US economy has been evolving, and it's time to retire some old rules of thumb about how it works. Sources of financing have diversified so much, Eric reports, that banks' lending standards imply less about credit conditions than they used to. And the shift from a mostly goods-producing economy to an increasingly services-providing one means that credit conditions in turn imply less about the state of the economy than they used to, as services providers depend less on credit than goods producers do. So banks' tightening lending standards no longer presage credit crunches or recessions. … Also: Melissa ventures to Mexico, where drug cartels are so entrenched in the economy that some might consider the country increasingly uninvestable.

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

US Economy I: Banks Versus Nonbanks. The resilience of the US economy has been impressive over the past two years in the face of the Fed's dramatic tightening of monetary policy. Nevertheless, there are still a few hardcore hard-landers predicting that the economy either is already in a recession or soon will be. They're convinced that there are long and variable lags between restrictive monetary policy and its depressing impact on the economy. Among them is one of our competitors who seems to give a lot of weight to the *Senior Loan Officer Opinion Survey* (SLOOS). SLOOS, she says, suggests that credit conditions remain tight.

Eric and I disagree with this assessment. Here is why:

(1) We aren't saying that SLOOS suggests credit is loose. We are saying that it has become a less important indicator of credit conditions in our economy than it used to be. That's because banks have become less important agents of capital allocation in our economy as nonbanks have become more important sources of financing (*Fig. 1*). Private debt and private equity funds have been growing rapidly in recent years. So have distressed asset funds that have plenty of money available to restructure overleveraged assets, buying at

significant discounts and then reselling at a premium.

(2) In addition, in recent years, economic growth has been driven by services and technology companies. They tend to have higher margins and cash flow and less debt than goods-producing companies, so they're not as affected by rising interest rates and tightening credit conditions.

(3) Of course, the housing market remains very interest-rate sensitive. But residential construction's share of nominal GDP has been falling (*Fig. 2*). It is currently only 4.0%, which is near the previous cyclical lows prior to the Great Financial Crisis (GFC).

(4) Auto sales also seem to have become less sensitive to credit conditions. Over the past 13 months, the total has fluctuated around 15.5 million units (saar) despite higher auto loan rates and slowing consumer credit for auto loans (*Fig. 3* , *Fig. 4*, *Fig. 5*, and *Fig. 6*). Americans have been buying the bigger and more expensive motor vehicles. Light trucks now account for 81% of retail unit auto sales, up from 50% during 2012-13 (*Fig. 7*).

In any event, personal consumption expenditures of new autos as a share of nominal GDP has also been falling (*Fig. 8*). It is currently only 2.6%, which is the lowest since the previous cyclical lows prior to the GFC.

In the following section, Eric reviews the evolution of the US economy from a goods-producing one to a more high-tech and services-providing one, making it less interest-rate sensitive.

US Economy II: Goods Versus Services. Last week's S&P Global flash PMI report for the US suggests that the manufacturing sector (i.e., the M-PMI) may be starting to recover from its rolling recession, or at least to bottom (*Fig. 9*). It rose to 50.9 in May. The flash PMI for US services (NM-PMI) was stronger, rising to 54.8. We are expecting a lackluster recovery in goods-producing industries that should continue to be offset by strength in services-providing ones.

Producing goods is capital intensive and requires lots of financing to start new projects and build manufacturing plants. Consumers often require financing for big-ticket purchases like autos. Typically, obtaining credit becomes tougher when the Fed raises interest rates. Banks pull back on lending, consumers are forced to retrench, and companies cut their payrolls to shore up their earnings. That script hasn't played out in response to the Fed's latest tightening round. That's because the economy's shift toward services and away from

goods has decreased its sensitivity to higher interest rates.

Consider the economy's transformation:

(1) Goods have fallen to 31% of what's produced in America, per nominal GDP, while services have risen to 61% (the remaining portion of production is in structures and inventories) (*Fig. 10*). In the early 1950s, the former was over 50%, while the latter was under 40%.

(2) These macro-economic trends are driven by the all-important American consumer. Personal consumption expenditures make up 68% of nominal GDP—46% of that is services consumption, with the remaining 22% goods consumption (*Fig. 11*). During the 1950s, services consumption represented only about 25% of GDP and goods consumption about 40%.

As a share of total consumption since the early 1950s, spending on goods has fallen from about 60% to 33%, while spending on services has increased from just under 40% to 68% (*Fig. 12*).

(3) Fewer of America's businesses are producing consumer goods and more are producing conventional services as well as high-tech goods and services. More of America's goods consumption has been attributable to imports. As a result, manufacturing capacity and output have been flat since China joined the World Trade Organization in late 2021 (*Fig. 13*).

(4) Capital spending has shifted away from traditional manufacturing to high-tech industries. High-tech now accounts for half of all domestic nominal capital spending (*Fig. 14*). On an inflation-adjusted basis, business spending on information processing equipment exceeds spending on industrial equipment by 2:1 (*Fig. 15*).

Real investment in intellectual property (IP) has soared to a new high of $1.43 trillion (saar), while structures ($652 billion) and equipment ($1.25 trillion) have only recently returned to pre-pandemic highs (*Fig. 16*). IP now makes up more than 40% of nominal private nonresidential fixed investment (*Fig. 17*).

(5) The recent increase in corporate spending on manufacturing structures is undoubtedly tied to the Biden administration's fiscal packages. Investment in manufacturing structures more than doubled from $64 billion in Q3-2020 to $147 billion in Q1-2024. Most of these

new factories will be producing high-tech products such as semiconductors and electric vehicles.

(6) Services are still more labor-intensive than manufacturing. Soaring services spending in areas like restaurants, healthcare facilities, airlines, and hotels has boosted demand for workers. It's mostly lower-income households that have benefited from this, via rising real wages from jobs in these industries.

A record 22.3 million Americans are employed in healthcare and social assistance, 17 million work in leisure and hospitality, and 23 million work for government (mostly state and local). In contrast, all goods-producing industries combined employ just 22 million people, constituting only 10% of payroll employment, down from over 30% in the 1950s (*Fig. 18*).

Mexico I: Meet the Cartels. Mexico is a great place to invest for those who don't mind the increasing power of the drug cartels. About a third of the country is under cartel control, estimates the US military, and Mexico's current administration has been accused of cartel ties. The cartels profit from trafficking not only drugs but people. They facilitate illegal US/Mexican border crossings and are the reason Mexico is the number-one source of fentanyl entering the US as well as a major thru-trafficking hub for heroin and cocaine.

This year's election season could be Mexico's fiercest and most violent on record. More than 125 politically motivated killings *reportedly* have occurred so far this year. US companies are thinking twice about operating in Mexico because of the increasing security risks and costs, as the *Financial Times* recently *discussed*.

Most political pundits think it will continue to be "business as usual" for the cartels no matter who wins Mexico's upcoming presidential election. The winner of the forthcoming US election could matter more for the Mexican economy and the future of the country as an exporter.

Here's more:

(1) *Meet Sinaloa & Jalisco*. In a 2024 report, the US Drug Enforcement Administration redefined Mexico's leading Sinaloa and Jalisco cartels as "transnational" criminal organizations, involved not only in cross-border drug flow but also "arms trafficking, money laundering, migrant smuggling, sex trafficking, bribery, extortion, and a host of other crimes," reported the *Financial Times* article.

(2) *Meet Obrador*. Security experts say that Mexico's organized crime problem has gotten much worse during the five-and-a-half-year tenure of leftwing President Andrés Manuel López Obrador. Obrador has taken a soft stance toward the cartels; his "hugs, not bullets" policy advocates social programs for drug offenders. Indeed, Obrador may be hugging certain criminal organizations if the *accusations* are true that he accepted funding from them to win his election.

(3) *Meet Sheinbaum*. Mexico's next *general election* is slated to occur on June 2, including the office of Mexico's next president to replace Obrador and to serve one six-year term. The former mayor of Mexico City, Claudia Sheinbaum, is the projected winner. Sheinbaum is backed by leftist Obrador's Morena Party and has pledged to continue his anti-war-on-drugs policies (i.e., more hugs).

(4) *Meet the opposition*. Senator Xóchitl Gálvez, the second-place hopeful for the seat as Mexico's first female president, leads the opposition party. Galvez promises to confront the cartels under her party, the Strength and Heart for Mexico coalition.

(5) *No introduction needed*. Speaking of upcoming elections, the US presidential election could be significant for Mexico. Incumbent President Joe Biden is considered a friend of the Mexican government under Obrador's party, while contender and former president Donald Trump is not. Trump has outlined the harsh stance he'd take toward Mexico if elected again, placing import tariffs on the country, deploying the US military in the war against fentanyl in Mexico, and deporting Mexican and other illegal immigrants.

Mexico II: China's Backdoor. "Friendshoring" with allies has become a popular strategy encouraged by the Biden administration for companies to reduce national-security-related sourcing risks from abroad. At the same time, "backdooring" is becoming a popular strategy for Chinese companies. By taking up residence in Mexico's hundreds of *flourishing* industrial parks, many Chinese manufacturers are stamping "made in Mexico" on their products, avoiding US tariffs on China.

The Biden administration's new tariffs on Chinese electric vehicles and other strategic sectors will likely accelerate a shift of Chinese production to places including Mexico and Vietnam to avoid them, as Reuters recently *discussed*.

The Chinese origin of the capital coming into Mexico may be uncomfortable for the policies of some countries, according to international trade legislation, Mexico's former vice-minister for external trade Juan Carlos Baker Pineda recently *told* the BBC. However, "those

products are, to all intents and purposes, Mexican," he added.

Consider the following:

(1) *From Mexico into the US*. Mexico enjoys tariff-free imports into the US under the US-Mexico-Canada agreement on trade. Mexico overtook China as the top source of imports into the US in 2023 (*Fig. 19*).

(2) *From China into Mexico*. Accurate foreign direct investment (FDI) flows from China into Mexico are hard to come by, *observed* *The Economist* in November 2023. But we're certain they have picked up in recent years. During 2022, FDI from China into Mexico approximated $296.5 million, *by* some measures. That compares with a mere $500 million over the four years from 2000 to 2004, according to *The Economist*. Both estimates comport with data from Mexico's Secretariat of Economy (see the first chart in this SiiLA *article*). But with the possibly cartel-linked Mexican government being the source of these data, it is not inconceivable that China's actual investment in Mexico could be much higher.

Chinese investment in Mexico's industrial real estate has surged, with a fivefold increase in occupied square meters by Chinese companies between 2019 and 2023, according to the latest SiiLA data. The latest data also indicate that the Mexican industrial real estate market has reached a 98% occupancy rate.

More industrial parks are to be built in the coming years to house all of the incoming investment. China's Lingong Machinery Group, which makes diggers and other construction equipment, announced late last year that it would build a factory that it estimates will generate $5 billion in investment. The same day Trina Solar, a solar-panel manufacturer, said it would invest up to $1 billion in the same northern Mexican state of Nuevo Leon, reported *The Economist*.

(3) *Poison from China*. China's manufacturers are not the only organizations "backdooring" through Mexico. For years, "China has been the principal supplier of [fentanyl] and its precursor agents to the United States—either directly or indirectly through Mexico, and to a lesser extent, Canada," wrote Brookings in a July 2020 *report* titled "Fentanyl and geopolitics. Controlling opioid supply from China."

Mexico III: Eyes of the Beholder. Melissa and I could go on to review in detail Mexico's latest economic data, including its fifth fastest growing *real GDP* of the G-20 nations last year, unsurprisingly record high industrial production indicators, and increasing government

investment (*Fig. 20*, *Fig. 21*, and *Fig. 22*). That's all bullish.

But instead, we're considering the possibility that Mexico might deserve a label we've used for China in the past. Is Mexico becoming "uninvestable"? Or is it especially attractive now if Mexico can pick up more of the slack in US-China trade? Might extra security be an acceptable cost of doing business in Mexico? Or is the increasing cartel control too much of a risk? Investors will need to decide.

Nevertheless, here's a bit more insight into Mexican equities:

(1) *Equity prices rising*. Mexico's MSCI stock price index (in local currency) is up 14.2% through Friday's close since hitting a recent low on October 23 (*Fig. 23*).

(2) *Valuation historically low*. Though the country's MSCI equities index and valuation have risen since then, the market remains attractively valued from a historical perspective. As of May 27, its stocks collectively are trading at a forward P/E of 12.3, below recent years' usual valuations around 14.0 (*Fig. 24*).

(3) *Peso remarkably strong*. The Mexican peso has been among the best performing currencies in the post-pandemic world, not only because of the country's economic strength but also because the Bank of Mexico led the pack in its tightening cycle (*Fig. 25*). Benchmark interest rates at 11% have lured in capital, including from speculative carry-traders selling lower-yielding currencies in exchange for the higher-yielding peso (*Fig. 26*).

Calendars

US: Wed: Richmond Fed Manufacturing Index -2; MBA Mortgage Applications; Beige Book; Williams; Bostic. **Thurs:** GDP & GDP Price Index 1.3%/3.1%; Headline & Core PCED 3.4%/3.8% q/q; Corporate Profits 3.9%; Goods Trade Balance -$91.8b; Jobless Claims 218k; Pending Home Sales 0.1%; Wholesale Inventories -0.1%; Natural Gas Storage & Gasoline Production; Fed's Balance Sheet; Williams; Bailey; Logan. (FXStreet estimates)

Global: Wed: German CPI 0.2%m/m/2.8%y/y; Germany Gfk Consumer Climate Index -22.5; France Consumer Confidence; Spain Retail Sales; Italy Consumer & Business Confidence; Japan Household Confidence 38.9. **Thurs:** Eurozone Business & Consumer Survey 96.0; Eurozone Consumer Confidence -14.3; Eurozone Unemployment Rate 6.5%; Eurogroup Meeting; Spain CPI 3.7y/y; Italy Unemployment Rate 7.3%; Japan

Unemployment Rate 2.6%; Japan Industrial Production 1.5%; Japan Retail Sales 1.8%; China M-PMI & NM-PMI 50.5/51.5. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week simultaneously for all three of these indexes, and has done so in five of the past six weeks. LargeCap's forward earnings rose 0.4% w/w to a new record high. It has achieved new record highs for 21 straight weeks and in 32 of the 37 weeks since mid-September; last week marks the lengthiest string of record-high forward earnings for LargeCap in 22 months (since the April 29 week of 2022, when it hit record highs for 22 straight weeks). MidCap's rose 0.3% w/w and improved to 3.4% below its record high in early June 2022. SmallCap's rose 0.4% w/w to 10.8% below its mid-June 2022 record. Through the week ending May 23, LargeCap's forward earnings has soared 14.3% from its 54-week low during the week of February 1, 2023; MidCap's is 5.1% above its 55-week low during the week of March 10, 2023; and SmallCap's is 3.3% above its 72-week low during the March 17, 2023 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. Their forward earnings momentum has improved from three-year lows ago a year, but LargeCap's is improving faster than the SMidCap's. Here are the latest consensus earnings growth rates for 2024 and 2025: LargeCap (10.3%, 14.1%), MidCap (3.2, 16.4), and SmallCap (-3.5, 18.7).

S&P 500/400/600 Valuation (*link*): Valuations were mostly lower during the May 24 week for these three indexes and remain slightly below their recent two-year highs. LargeCap's forward P/E was unchanged w/w at 20.6. That's down from a 27-month high of 20.9 at the end of March and up from a seven-month low of 17.0 during the October 27 week. It's now up 5.5pts 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 to 15.4. That's down from a 27-month high of 16.0 at the end of March. That's up 3.1pts from a 12-month low of 12.3 at the end of October. It's now up 4.3pts from its 30-month low of 11.1 at the end of September 2022; these compare 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 was down 0.3pts w/w to 14.4 from a 28-month high of 14.7. It's up 3.8pts 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 25% discount to LargeCap's P/E is up from its 24-year-low 29% discount during the June 1, 2023 week. It had been at a 19% discount during the March 2, 2023 week, which was near its best reading since October 14, 2021. SmallCap's 30% discount is up from a 23-year-low 34% discount during the October 19, 2023 week, which compares to a 20% discount during the March 2, 2023 week; that one was near its lowest discount since August 2021. The SMidCap's P/Es had been mostly above LargeCap's from 2003 to 2018.

US Economic Indicators

Consumer Confidence (*link*): Consumer confidence improved in May after deteriorating the prior three months. *Headline* consumer confidence increased to 102.0 this month after falling 13.4 points from 110.9 in January to 97.5 in April, which was the lowest reading since July 2022. The *present situation* component climbed to 143.1 this month, following a three-month drop of 14.3 points (to 140.6 from 154.9), while the *expectations* component rose for the first time in five months, climbing to 74.6 in May after sinking the prior four months by 13.1 points (to 68.8 from 81.9). Despite May's increase, the expectations measure remained below 80—a threshold the report notes usually signals a recession ahead. *Short-term business conditions* on balance were slightly less positive this month: The percentage of consumers expecting conditions to improve slipped to 20.3% from 20.8% last month, while 17.6% expect business conditions to worsen, unchanged from April. Meanwhile, consumers' assessment of the *current labor market* improved on balance in May, with 37.5% of consumers saying jobs were plentiful, down from 38.4% in April, and 13.5% saying jobs were hard to get, down from 15.5% last month. Consumers' assessment of *short-term business conditions*, six months from now, were less pessimistic, with 13.3% expecting business conditions to improve, down from 13.4% in April, and 16.8% expecting them to worsen, down from 19.1%. Consumers' assessment of the *short-term labor market* was also less pessimistic this month, with 12.6% expecting more jobs to be available six months from now, up from 12.3% in April, and 18.2% anticipating fewer jobs, down from 19.8% last month. Consumers' *short-term financial prospects* in May improved: The percentage of consumers expecting their incomes to improve edged up to 16.9% from 16.8% in April, while the percentage expecting their incomes to decrease fell to 11.0% from 14.0%. Dana Peterson, chief economist at The Conference Board, noted that in May's *write-in responses* consumers cited prices, especially for food and groceries, as having the greatest impact on their view of the US economy, with 12-month inflation expectations ticking up to 5.4%. Also, the percentage of consumers expecting interest rates to rise over the year ahead climbed to 56.2% from 55.2% in April.

Global Economic Indicators

Germany Ifo Business Climate Index (*link*): German business confidence came in below expectations in May after showing signs of life the prior three months. The *business climate index* was unchanged at 89.3 (vs 90.4 expected) this month, after climbing from 85.2 in January—which was the lowest level since May 2020—to 89.3 this April. The *expectations* component (to 90.4 from 83.4 in January) climbed for the fourth month to a 13-month high, while the *current situation* component has hovered between 88 and 89 the past three months, not far from February's 86.9—which was the lowest since July 2020. *Trade's* business sentiment took a "significant step upward," according to the report, with the improvement in the current situation driven primarily by the wholesale segment, while expectations also improved considerably—though were still marked by some skepticism. In *manufacturing*, the business climate index improved for the third straight month, with companies considerably more satisfied with their current business, while the outlook was less pessimistic than in prior months. Meanwhile, the *service sector* took a slight step back, with current business conditions deteriorating a bit, though expectations improved as companies reported additional orders. *Construction's* business climate saw progress for the fourth straight month, with companies more satisfied with their current business situation and their expectations somewhat less pessimistic.

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