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Morning Briefing

As The World Turns

Check out the accompanying chart collection.

Executive Summary: We expect global economic growth to continue to muddle along, neither booming nor busting, through 2025. Today, we review the key economic indicators we monitor to assess the strength of global growth, including world production and exports, commodity prices, and trade. … Also: Joe looks at how much the top-capitalization stocks in the top-performing country MSCIs have been boosting those indexes' ytd performances. … And: Melissa reports on the ECB's first interest rate cut since 2019, which will likely be "one and done," and on the rising popularity in European country politics of nationalist parties—which could threaten the EU's cohesion.

Global Economy: Still Muddling. Is global economic growth improving? It might be, though the outlook probably remains lackluster. Muddling along rather than experiencing either a boom or a bust seems to be the most likely trajectory for the global economy over the rest of this year through 2025. The US economic outlook remains upbeat, in our opinion. The recent rate cut by the European Central Bank (ECB) might provide a small lift to the Eurozone's economy. But the ECB might be one-and-done for a while.

At the end of last month, the International Monetary Fund (IMF) raised its 2024 growth-rate projection for China's real GDP from 4.6% to 5.0%. Next year, the IMF expects 4.5% growth in China. Nevertheless, the IMF warned: "Risks to the outlook are tilted to the downside, including from a greater or longer-than-expected property sector readjustment and increasing fragmentation pressures." On May 17, China announced steps to stabilize its crisis-hit property sector, with the central bank facilitating 1 trillion yuan ($138 billion) in extra funding and easing mortgage rules, and local governments set to buy "some" apartments.

Here are some observations on a few of the key global economic indicators that Debbie and I regularly follow:

(1) *World production and exports.* Global industrial production continues to grow in record-high territory (*Fig. 1*). It rose 1.2% y/y during March, half as much as the series' average

over time since 2001 (including recessionary periods) (*Fig. 2*). It's been muddling along between zero and 2.1% since November 2022.

(2) *Commodity prices.* We compile a Global Growth Barometer (GGB) simply by averaging the CRB raw industrials spot price index and the price of a barrel of Brent crude oil (*Fig. 3* and *Fig. 4*). These commodities are very sensitive indicators of global economic growth. Our GGB has been moving sideways for the past two years. That's consistent with a muddling economic performance.

(3) *Trade indicators.* The volume of global exports has been volatile but relatively flat in record-high territory for the past three years (*Fig. 5*). This series is highly correlated with the sum of real US exports and real US imports, which has also been moving in a sideways range but showing some improvement in recent months. The former was down 1.3% through March, while the latter was up 3.8% through April (*Fig. 6*).

Global Strategy: Are SuperCap Stocks Outperforming Globally Too? SuperCap stocks—i.e., the highest-capitalization companies in a market index, with the potential to skew the index's performance statistics with their heft—have hugely boosted the US stock market's performance again this year. As a result, only two sectors—both laden with SuperCaps—lead the S&P 500's ytd gain through last Friday. That has some investors worried that there are not enough legs to support the market's gains.

We're venturing abroad today to look at this year's top performing MSCI countries to see how their SuperCap stocks are contributing to their ytd performance.

It's a sweep so far by countries in the Asia-Pacific region: The Taiwan MSCI index leads with a gain of 26.8% ytd in local currency, followed by Japan (18.9%) and India (13.2%). Not far behind in fourth place is the US, with a gain of 12.0%. MSCI's country index tear sheets provide a look under the hood at how each index's biggest companies have performed relative to their country's MSCI index.

But first, it's helpful to know how much of these MSCIs their 10 largest-cap companies represent. Taiwan is weighted very heavily toward SuperCaps, with 67.3% of its MSCI represented by its 10 highest-cap companies. The SuperCap representation in India's MSCI is 35.9%, Japan's 26.9%, and the US's 32.3%.

Here's what else Joe found when he dug deeper:

(1) *Taiwan.* After struggling to rise through January, the Taiwan MSCI index has since surged higher and now leads all MSCI country indexes with a gain of 26.7% ytd. While all of Taiwan's top 10 companies are up so far ytd, the country's gain is led by just four, including its two biggest market-capitalization companies (*Fig. 7*).

Hon Hai Precision, at a 5.1% country weight, leads Taiwan with a gain of 72.7% ytd. It's followed by a 48.9% rise for Taiwan Semiconductor Manufacturing (TSM), which at 47.8% is a whopper of a country weighting. TSM is assigned to the Information Technology sector, which accounts for 77.1% of the country's market cap, followed by Financials at 12.1%.

(2) *Japan.* The Japan MSCI index has performed well since the year started but lost its lead to Taiwan's rally. Still, the Japan MSCI is up 18.7% ytd in local currency terms through Monday's close (*Fig. 8*).

Among the top 10 companies—which account for 26.9% of the country index's market cap—Toyota is the biggest, with a relatively low country weight of 5.6%. The gains are widespread among Japan's biggest companies, with seven of the top 10 companies beating the index and nine in positive territory. Hitachi, which is Japan's best top 10 performer with a gain of 67.7%, ranks fifth in size and has a country weight of just 2.5%. Japan's two biggest companies, Toyota Motor and Mitsubishi UFJ Financial, have risen a country-beating 25.6% and 34.8%, respectively.

The Information Technology sector makes up just 15.0% of the country's market cap, which ranks third behind the 23.2% and 18.4% shares for the Industrials and Consumer Discretionary.

(3) *India.* The India MSCI index has been a relatively steady performer this year and now ranks third with a 13.2% gain (*Fig. 9*). Under the hood, however, India's gains are narrowly based. While seven of India's top 10 are in positive territory ytd, just two companies from the bottom half of India's top 10 are beating the country's index: Mahindra & Mahindra leads the top 10 with a gain of 64.0% ytd, followed by a 38.3% rise for Bharti Airtel.

Within India, the Information Technology sector has a 10.6% share, ranking fourth behind Financials (24.7%), Consumer Staples (13.0%), and Energy (10.7%).

Europe I: ECB's Hawkish Rate Cut (One & Done). The ECB cut interest rates for the first time since 2019 last week on June 6. Despite the rate cut, the euro rose as investors speculated that the ECB might be done easing for a while (*Fig. 10*). Further, German 10-

year yields rose on the news (*Fig. 11*). However, the euro changed direction and fell over the weekend while German yields paused on Monday due to chaotic outcomes in the European Union (EU) elections, as discussed in the next section.

ECB President Christine Lagarde elaborated on the rate-cut decision in a blog *post* "Why We Adjusted Interest Rates." Lagarde signaled that further cuts this year are improbable, albeit data dependent. "We still need to have our foot on the brake for a while," she said. The blatantly hawkish stance contrasted with many forecasters' expectations of up to three ECB rate reductions in the current year. The ECB continues to run quantitative tightening—assets on its balance sheet have fallen to €6.5 trillion from €8.8 trillion since peaking during May 2022 (*Fig. 12*).

Here's our take on the ECB's rationale for the rate cut, followed by the caveats the central bank offered to explain its hawkishness, which should continue through the remainder of the year:

(1) The key policy rate was cut by 25bps in June, to 3.75% from 4.00%, where it had been since September 2023. The ECB began tightening monetary policy in July 2022, raising the main deposit facility rate 4.5ppts in a little over a year, the fastest pace ever (*Fig. 13*).

(2) Lagarde observed that the Eurozone's overall CPI inflation rate, at 2.6% y/y in May, has dropped a lot since surging to a peak of 10.6% in October 2022, boosted that year by soaring energy and food prices because of Russia's invasion of Ukraine (*Fig. 14*).

(3) "We decided to moderate the degree of monetary policy restriction," Lagarde explained. The ECB is lowering inflation-adjusted interest rates, attempting to navigate a soft landing. That should boost lending.

The growth in loans to nonfinancial corporates by monetary financial institutions declined from 8.1% y/y during August 2022 to -1.3% during October 2023 and rose slightly to -0.3% during April of this year (*Fig. 15*). On the same basis, loan growth for house purchases dropped from 5.9% in Q2-2022 to -0.3% in Q1-2024 (*Fig. 16*).

(4) "The cost of business loans and mortgages went up steeply," Lagarde pointed out. Nonfinancial corporate borrowing rates skyrocketed from 1.79% in July 2022 to 5.27% in October 2023, before dropping back to 5.18% most recently (*Fig. 17*).

Mortgage rates followed the same pattern: They rose sharply from 2.15% in July 2022 to a

peak of 4.02% in November 2023, the highest since April 2009, before falling to the current 3.80%.

(5) But prices are "still going up markedly" in the services sector, Lagarde warned, indicating that the ECB could be "one-and-done" for now. The yearly percentage change in services prices peaked at 5.6% in July 2023, fell to 3.7% in April of this year, then rose again to 4.1% in May (*Fig. 18*).

(6) And wages and pensions are now keeping up with inflation. If there was one chart that influenced the ECB's hawkishness, it would be the one showing labor compensation relative to prices (*Fig. 19*). Wages didn't keep up with inflation in the Eurozone from Q4-2021 until Q3-2023. The gap has since reversed, and the annual compensation rate is now at least 2.5ppts higher than the annual rate of inflation.

(7) Lagarde referred to the ECB as "the guardian of the euro." In other words, the ECB has another mandate to preserve the euro (and the fragile European Monetary Union).

The ECB's hawkish message suggests that the central bank does not view the Eurozone economy as weak enough to warrant risking significant euro depreciation by continuing to lower interest rates. While beneficial for Eurozone exports, euro depreciation increases the cost of imports, which boosts inflation.

(8) The ECB is committed to low and stable inflation for the benefit of all Europeans, Lagarde concluded. The ECB must maneuver rates in a way that balances the risks and benefits for both core and periphery countries in the bloc.

For example, further easing could risk destabilizing Italian debt, leaving fiscally prudent Germany holding the bag. German 10-year bond yields currently are about half that of Italian ones (*Fig. 20*). The ECB is limited in how far down it can take German rates, and Italy's risk premium is justified by its sovereign debt load at nearly 140% of GDP for 2023. Germany's remains at 63.6%.

The ECB introduced the Transmission Protection Instrument (TPI) in July 2022, aiming to counter disorderly market dynamics and potential sovereign crises. However, questions have arisen regarding its fairness in some situations—e.g., if the ECB were to purchase bonds from the crisis-hit country while selling bonds from another more financially stable nation.

Europe II: Fractured Future. The June 6-9 European Union Parliamentary elections showed a shift toward nationalist parties, threatening the EU's cohesion. French President Emmanuel Macron responded to this political upheaval by announcing emergency elections due to Marine Le Pen's nationalist party surpassing his pro-Europe party.

Alice Weidel, co-leader of Germany's far-right Alternative for Germany (AfD) party, hailed the party's success amid growing anti-European sentiments following the election. AfD secured second place, overtaking Chancellor Olaf Scholz's party, while Dutch Prime Minister Geert Wilders saw his European Parliament seats rise from one to seven. Italy's populist Prime Minister Giorgia Meloni's party quadrupled its vote share from the level in the 2019 elections.

Melissa, Eric, and I think that instability and disagreements within the EU will increase volatility, which could spook investors away from European assets. Europe's MSCI Index fell 0.6% in local terms and dropped a greater 1.0% in dollar terms on Monday. Certain sectors are likely to benefit while others languish.

Here's our initial assessment in brief:

(1) Right-wing fiscal perspectives will likely slow further initiatives toward fiscal integration among member nations and encourage domestic stimulus.

(2) Increased uncertainty and discord in Parliament will impede policy advancement on both ends of the spectrum, complicating investment decisions.

(3) Nationalist governments could disregard EU rules on fiscal debt limits.

(4) Government investment is likely to shift away from the green energy transition and toward security and defense.

(5) We see a risk of higher inflation, particularly if trade or immigration barriers are erected among member states or foreign entities.

Calendars

US: Wed: FOMC Interest Rate Decision 5.50%; FOMC Economic Projections; Headline & Core CPI 0.1%m/m/3.4%y/y & 0.3%m/m/3.9%yy; Consumer Inflation Expectations; Federal

Budget Balance -$268.0b; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; IEA Monthly Report; WASDE Report. **Thurs:** Headline & Core PPI 0.1%m/m/2.2%y/y & 03%mm/2.3%y/y; Initial Claims 222k; Fed's Balance Sheet; Natural Gas Storage; Yellen; Williams. (FXStreet estimates)

Global: **Wed:** Germany CPI 0.1%m/m/2.4%y/y; UK GDP 0.0%m/m; UK Headline & Manufacturing Industrial Production -0.1%/-0.2%; UK RICS House Price Balance -5%; Australia Westpac Consumer Sentiment; Australia Employment Change 30k; Australia Unemployment & Participation Rates 4.0%/66.7%; Eurogroup Meetings; E Guindos; McCaul; Schnabel; Tuominen; Nagel; Mauderer; Balz; Macklem. **Thurs:** Eurozone Industrial Production 0.1%; Germany WPI 0.3%; Spain CPI 0.3%m/m/3.6%y/y; BoJ Interest Rate Decision 0.10%; Eurogroup Meetings; De Guindos; Lane; Schnabel. (FXStreet estimates)

US Economic Indicators

NFIB Small Business Optimism Index (*link*): "The small business sector is responsible for the production of over 40% of GDP and employment, a crucial portion of the economy," noted Bill Dunkelberg, chief economist of NFIB. "But for 29 consecutive months, small business owners have expressed historically low optimism and their views about future business conditions are at the worst levels seen in 50 years. Small business owners need relief as inflation has not eased much on Main Street." May's *Small Business Optimism Index* (SBOI) rose for the second straight month in May to 90.5, which was the highest reading this year, after declining by 1.6 points the first three months of this year to 88.5 in March—which was the lowest level since December 2012. It remains below its 50-year average of 98.0 for the 29th consecutive month. In May, five of the 10 components rose in May, while three fell and two were unchanged—now is a good time to expand (at 4%) and plans to increase inventories (-6). The five *positive contributions* to the SBOI were led by expect the economy to improve (+7ppts to -30%), plans to increase employment (+3 at 15); both current job openings (at 42%) and expected credit conditions (-7) increased 2ppts during the month, while capital outlay plans climbed a percentage point to 23%. The *negative contributions* to the SBOI were led by current inventories (-4ppts to -8%), followed by earnings trends (-3 to -30), and sales expectations (-1 to -13). Inflation (22%) remained the *single most important problem* for small business owners in May, with quality of labor (20), taxes (13), cost of labor (10), and government regulations (9) rounding out the top five—the same top five as in April. The net percentage of owners raising *selling prices* was unchanged at 25% in May, down from 28% in March, while a net 28% plan price hikes in

the next three months, up from 26% in April but down from March's 33%. Turning to *compensation*, a net 37% reported raising compensation in May, a tick below March and April's 38%, while a net 18% plan to raise compensation in the next three months, down from 21% the prior two months.

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