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Morning Briefing

EU's Foundation Cracking?

Check out the accompanying chart collection.

Executive Summary: The European Union is trying to rein in bloc nations' budgets just as protectionist parties swell in European elections. Rising fiscal and political risks are weighing on European asset prices. We expect those headwinds to be tailwinds for US assets. We reiterate our Stay Home investment strategy recommendation.

Europe I: Frexit? Political and fiscal risk are bubbling up in European financial markets. There's a pan-European shift toward populism and protectionism, which adds stagflationary risk. Markets are also contending with the European Union's (EU) attempt to rein in the bloc's finances, country by country.

European stock markets have suffered in recent weeks as a result. On May 15, French and German stocks hit their highest levels (in dollar terms) since before Russia invaded Ukraine. Since then, France's MSCI has fallen 7.5% and Germany's MSCI 4.8% through Monday's close (*Fig. 1*). However, headwinds in European markets are likely to be a tailwind for US assets.

Let's review the recent relevant developments in Europe:

(1) *Elections.* After French President Emmanuel Macron's centrist/liberal Renaissance party was swept by Marine Le Pen's far-right Rassemblement National (RN, or National Rally) in EU elections, Macron dissolved France's legislative body and called for snap elections.

RN's policy is a mix of more spending on entitlement programs, lower income taxes, and anti-immigration measures. It's also, as the name suggests, nationalist and less amenable to the EU. A cocktail of higher outlays, lower revenues, fewer workers, and disrupted trade not only is inflationary but also is tough to swallow when the EU is making France the poster child of fiscal unsustainability. There's growing friction between the policies favored at the national level and the bloc level. The outcome of the two-stage French elections (first vote on June 30, runoffs on July 7) could have major consequences. Nonetheless, Macron's second term doesn't end until 2027.

(2) *Widening spreads.* The difference between French and German bond yields has widened to the most since Macron and Le Pen faced off in the 2017 presidential election. The 10-year OAT-Bund spread, the difference between French and German debt yields, surged from 49bps on June 7 to 78bps by June 14 (*Fig. 2*). It's remained above 70bps since then.

(3) *Budgetary bludgeon.* The EU requires governments to maintain budget deficits below 3% of GDP and total debt below 60% of GDP. The rules were suspended during the pandemic and after the Russia/Ukraine war kicked off but are back in play.

French debt has reached 111% of GDP, and the budget deficit is running at 5.5% of GDP (*Fig. 3* and *Fig. 4*). Germany's debt load is just 64% of GDP and its deficit 2.1%. Projections from the International Monetary Fund (IMF) show France's debt climbing to 115% of GDP over the next five years while Germany's sinks below 60%. Italy and Belgium are also in the EU's crosshairs, both running deficits at 4.4% of GDP.

(4) *De-growth*. Plaudits to Germany for its commitment to austerity, but the lack of fiscal stimulus is one reason that its real GDP has been negative on a y/y basis for the past three quarters. France's economy grew 1.3% y/y in Q1, and the Eurozone's grew 0.4%, but Germany's sagged by 0.2% (*Fig. 5*).

(5) *Short on funds.* French banks are big players in the global funding markets, selling unsecured debt and swapping dollars for euros. So far, the swap market isn't signaling any increase in concern about French deficits. Swap spreads for investors lending euros to borrow dollars haven't widened much—though that market finds solace in the Fed's FX swap lines established during the pandemic (*Fig. 6*).

(6) *Central banks.* European central bankers are lowering interest rates further below the Federal Reserve's federal funds rate (FFR). The Swiss National Bank recently cut its benchmark rate by 25bps to 1.25%, its second cut of the year. The European Central Bank is likely one-and-done after its June 25bps cut, but 3.75% is well below the current 5.25%-5.50% FFR range. The Bank of England (BOE) could cut its policy rate from 5.25% as soon as August. The differential between US and global rates is growing, encouraging flows into the US (*Fig. 7*).

The divergence between European and US interest rates is putting downward pressure on European currencies.

(7) *Stay home*. The political and fiscal shifts in Europe are a boon for US assets, in our opinion, and support our Stay Home investment strategy recommendation versus the Go Global alternative (*Fig. 8*).

As differentials between yields on European and US bonds widen, and Europe issues less debt, global investors will continue to pour their savings into Treasuries. One reason that France got away with its expansionary fiscal policy—resulting in yields lingering around 3.1%—is that global investors are starved for safe assets, particularly since Germany doesn't supply much of any (*Fig. 9*). We're sticking with our Stay Home strategy.

Europe II: Across the Channel. The UK's next Prime Minister will be elected on July 4 and immediately face a stagnant economy with little fiscal room to stoke it. Polls show voters favor Keir Starmer's Labour party over Rishi Sunak's Conservative party, which would end the succession of five conservative Prime Ministers since 2016.

Theresa May guided the UK through the initial throes of Brexit during 2016 until Boris Johnson ascended in 2019. His tenure spanned the pandemic until his resignation in 2022. Subsequently, Liz Truss held office for a brief six-week period in October and September 2022 before abruptly resigning. Truss' mini-budget—a £45 billion tax-cut strategy that was to be financed via borrowing—precipitated a sharp decline in the pound, amplifying concerns over inflation and financial stability.

Rishi Sunak has led the UK since. The current cost-of-living crisis and sorry state of public finances have incited demand for change.

The UK budget is under pressure for a host of reasons, including costly government programs, an aging population, higher interest rates, energy insecurity, and geopolitical challenges. All of these issues call for tough-to-stomach fiscal prudence, whether it be through raising taxes or scaling back on spending elsewhere. Here's more:

(1) *Heavy tax burden*. The UK's tax burden is set to rise to a post-war high of 37.7% of GDP in 2027-28, according to a March 2023 report by the Office for Budget Responsibility.

(2) *Ballooning debt.* The government provided major fiscal support in 2008 during the Great Financial Crisis (GFC) and again in 2020 when the pandemic hit. That support helped to

grow the UK's public debt (excluding public banks) to 99.8% of GDP from below 40.0% during the early 2000s (*Fig. 10*).

(3) *High interest costs*. In May 2024, the interest payable on central government debt was the second highest for any May since monthly records began in 1997, according to an Office for National Statistics *report*. Last year, the UK *allocated* about 10.0% of its government revenue to service its debts.

Europe III: UK's Growth Woes. Only about one in five Britons says the UK's economic situation is good, *according* to Pew Research Center. One geopolitical crisis after another (i.e., the GFC in 2008, Brexit in 2016, the pandemic in 2020, and the energy crisis in 2022) has crippled business investment and slowed productivity growth. We do see a few encouraging signs for the UK economy but also plenty of evidence that economic malaise persists:

(1) *Out of recession*. After a brief technical recession at the end of last year, real GDP grew 2.5% on a q/q basis in Q1 but was up just 0.2% y/y (*Fig. 11*).

(2) *Less inflation*. The technical recession did help slow price pressures—the headline inflation rate touched the BOE's 2.0% y/y target during May (*Fig. 12*). Following Russia's invasion of Ukraine, the rate of inflation soared, reaching 11.1% y/y by October 2022.

But inflation rates remain too high in several areas, including services and rent (*Fig. 13*).

(3) *Moderate real wage growth*. Real wage growth—measured as regular pay less the Retail Price Index (RPI)—bottomed in deflationary territory when the RPI peaked in 2022. Consumers are starting to feel pressures ease, as real wage growth climbed to 2.5% y/y in April 2024 (*Fig. 14*).

(4) *High interest rates*. The BOE raised interest rates from 0.1% during November 2021 to 5.25% during August 2023. Over the same period, the 10-year yield on UK government bonds rose from 1.0% to 4.2%. The BOE is expected to maintain rates at a 16-year high for at least the next couple of months.

(5) *Weak capex*. The UK's quarterly private capital spending growth was especially weak at the end of last year on a y/y basis. It was also quite weak in the years leading up to the pandemic after the UK voted to leave the European Union in 2016 (*Fig. 15*).

(6) *Stagnating productivity*. Output per hour worked has stagnated since around early 2018 (*Fig. 16*).

(7) *Weak recovery in labor force participation*. Many Britons who left the labor force following the pandemic have yet to rejoin it. The labor force participation rate for working-age folks stands at 77.7% compared to a pre-pandemic peak of 79.5% in January 2020 (*Fig. 17*).

Europe IV: European Stocks Lagging US Stocks. The Europe MSCI price index has lagged the S&P 500 on several fronts this year. In terms of ytd performance, the former is up 5.3% in US dollars, the latter is up 14.2% to a record high. The Europe MSCI has slipped 2.4% from its 17-year high on June 6 and stands at 4.8% below its all-time record high on October 31, 2007.

Of the Europe MSCI's 11 sectors, four are ahead of the region's stock price index ytd and six are in positive territory ytd (*Fig. 18*). That compares with two S&P 500 sectors ahead of the broad index ytd (Communication Services and Information Technology) and ten up ytd (*Fig. 19*).

Let's also compare the recent trends in the consensus revenues and earnings outlooks for the two indexes' component companies in aggregate. While we typically focus solely on year-ahead "forward" data, today we also compare revenues and earnings on a calendar 2024 basis, as the US is performing unexpectedly stronger than usual in that regard—which has the effect of boosting its forward metrics. (FYI: Forward revenues and earnings are the time-weighted average of industry analysts' consensus estimates for the current year and following one.)

Here's how their consensus revenues and earnings forecasts have performed ytd:

(1) *Comparing consensus 2024 revenues & earnings trends.* In Europe, Financials is the only sector with 2024 revenues estimates that have risen ytd. On the earnings front, analysts have cut their 2024 estimates for all 11 sectors so far this year (*Fig. 20* and *Fig. 21*). The US's S&P 500 sectors are performing better: Four of the 11 sectors have higher 2024 revenues forecasts now than at the start of the year, and six have seen their 2024 earnings forecasts increase (*Fig. 22* and *Fig. 23*).

(2) *Comparing forward revenues trends.* The Europe MSCI's forward revenues is well below its 2008 peak prior to the GFC and has been backsliding since its recent peak in 2023. Only

three of its 11 sectors are up ytd: Financials, Health Care, and Industrials (*Fig. 24*). That compares to nine of the 11 S&P 500 sectors, all but Energy and Materials (*Fig. 25*).

(3) *Comparing forward earnings trends.* Forward earnings have risen this year for six of the 11 Europe MSCI sectors (*Fig. 26*). While that's three sectors more than its rising revenue count, it falls short of the S&P 500's ten sectors (all but Energy) (*Fig. 27*).

Calendars

US: **Wed:** New Home Sales 650k; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Fed Bank Stress Test Results. **Thurs:** GDP & Price Index 1.3%/3.1%; Atlanta Fed GDPNow (Q2) 3.0%; Headline & Core Durable Goods Orders -0.1%/0.1%; Kansas City Fed Manufacturing Index; Trade Balance -$96.0b; Jobless Claims 240k; Pending Home Sales; Wholesale Inventories 0.2%; Fed Bank Stress Results. (FXStreet estimates)

Global: **Wed:** Germany Gfk Consumer Climate Index -19.9; France Consumer Confidence; Spain Consumer Confidence; Lane. **Thurs:** Eurozone Business and Consumer Sentiment 96.3; Japan Unemployment Rate 2.6%; Japan Industrial Production 2.0%; BoE Stability Report; Euro Summit; Eurogroup Meetings; Elderson; Bailey. (FXStreet estimates)

US Economic Indicators

Consumer Confidence (*link*): "Confidence pulled back in June but remained within the same narrow range that's held throughout the past two years, as strength in current labor market views continued to outweigh concerns about the future," noted Dana Peterson, chief economist at the Conference Board. "However, if material weaknesses in the labor market appear, confidence could weaken as the year progresses," she cautioned. *Headline* consumer confidence dipped to 100.4 in June from May's 101.3, after dropping 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 edged up for the second month to 141.5 this month, following a three-month drop of 14.3 points (to 140.6 in April from 154.9 in January). Meanwhile, the *expectations* component fell to 73.0 this month, after rising to 74.9 in May; the measure had dropped the prior four months by 13.1 points (to 68.8 in April from 81.9 in December). The expectations component has been below 80—the threshold which usually signals a recession ahead—for five consecutive months. *Short-term business conditions* on balance were slightly less positive this month: The percentage of consumers expecting conditions to improve slipped to 19.6% from 20.8% last month, while 17.7% expect business conditions to worsen, down from 18.4% in May. Meanwhile, consumers' assessment of the *current labor market* improved on balance in June, with 38.1% of consumers saying jobs were plentiful, up from 37.0% in May, and 14.1% saying jobs were hard to get, little changed from 14.3% last month. Consumers' assessment of *short-term business conditions*, six months from now, was less optimistic in June, with 12.5% of consumers expecting business conditions to improve, down from 13.7% in May, and 16.7% expecting business conditions to worsen, little changed from May's 16.9%. Consumers' assessment of the *short-term labor market* was slightly less negative this month, as 12.6% of consumers expected more jobs to be available, down from 13.1% in May, while 17.3% anticipated fewer jobs, down from 18.8% last month. Consumers' *short-term financial prospects* in June deteriorated: The percentage of consumers expecting their incomes to improve fell to 15.2% in June from 17.7% in May, while the percentage expecting their incomes to decrease ticked up to 11.7% from 11.5%.

Regional M-PMIs (*link*): The *Richmond Fed* has released manufacturing data for June, and showed a contraction in activity. This follows reports from the *New York Fed*, which also experienced a contraction, though at a lesser rate than in May, while the *Dallas* and *Philadelphia* regions showed steady growth. Turning to the *Richmond* survey, the composite index (to -10 from 0) showed a contraction in manufacturing activity, with the shipments (-9 from 13) and new orders (-17 from -6) measures falling noticeably, while the employment (-2 from -6) gauge showed a slowing in the pace of declines. Firms were pessimistic about *local business conditions* (to -15 from 3), though the index of *future local business conditions* (10 from 6) improved—with the shipments (26 from 25) and new orders (22 from 25) measures solidly in positive territory, indicating improvements over the next six months. Turning to pricing, the Richmond Fed reports the prices-paid measure as current price changes over the last 12 months. Both the prices-paid (4.01% from 2.92%) and prices-received (2.58 from 1.63) measures showed an acceleration in prices, though remained relatively low from their recent peaks of 15.3% and 10.6%, respectively, during May 2022 and June 2022.

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