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Morning Briefing

Eurozone, China & Q2 Earnings

Check out the accompanying chart collection.

Executive Summary: A sea of troubles for European economies—including sagging growth, political headwinds, and an EC crackdown on fiscal miscreants—reinforces our Stay Home (versus Go Global) equity investing bias. … Chinese companies are evading US import tariffs by funneling their exports through intermediary countries before they reach US consumers, jeopardizing the US, Mexico, and Canada free-trade alliance. … Our analysis of tariff-related events and IMF trade statistics points to a grim outlook for direct exports from China to the US. … Also: Joe notes an anomaly in the S&P 500's Q2 EPS estimate revisions over the course of the quarter: They didn't decline as usual but remained unchanged. That bodes well for earnings surprises.

European Economy: A Rock & A Hard Place. European economies are losing their post-pandemic steam. Growth is sagging in core countries like Germany, while periphery nations are relying on tourism, which fuels inflation and social strife. Political headwinds are hitting already wobbly foundations—right- and left-wing parties are dominating parliamentary elections, and the European Commission is gearing up to punish countries for unsustainable fiscal policies.

Consider the European economic backdrop and why we're hesitant to switch our equity investing bias to Go Global from Stay Home:

(1) *Manufacturing slump.* The manufacturers of the major Eurozone economies are struggling with fierce competition from China and other emerging economies. Industrial production in Germany, Europe's premier exporter, fell 2.5% m/m in May (-6.7% y/y) to the lowest level since August 2010 (*Fig. 1*). Production data includes construction.

German factory new orders fell 1.6% m/m (-8.6% y/y) in May to their lowest level since November 2012 (*Fig. 2*). Germany's IFO Business Climate Index remained relatively weak in June at 88.6 (*Fig. 3*).

(2) *Domestic demand.* Retail sales in the broader Eurozone has held up better than production since the pandemic but still remained generally weak in 2023 and 2024. The volume of Eurozone retail sales, which excludes autos and motorcycles, has been below its 2021 base level since November 2022, most recently at 99.4 in May (*Fig. 4*).

(3) *Growth woes.* Eurozone real GDP rose 1.2% q/q (saar) in Q1-2024, registering just a 0.4% y/y increase (*Fig. 5* and *Fig. 6*). Quarterly growth was negative in Q4-2023. Annual growth has come in below 1.0% for each of the last four quarters.

Periphery countries in southern Europe (i.e., Italy, Spain, Greece, and Portugal) are broadly comparative growth winners. Spain has led the way with a 5.8% y/y rise in Q1 (*Fig. 7*).

(4) *Tourism boom.* Historically weaker economies in the south of Europe can attribute some of their post-pandemic growth to foreign travelers. However, tourism-fueled growth isn't a panacea. On the downside, it fans inflation and prices out domestic consumers; the *WSJ* recently reported on the dichotomy between happy travelers and fuming locals.

The strong dollar has boosted American tourism in many countries. The US real broad effective exchange rate, which adjusts exchange rates by relative consumer price indexes, is around its highest level since at least 1994 (*Fig. 8*). In June, 25.6% of consumers surveyed by The Conference Board said they intend to take a vacation by airplane within the next six months. They're putting those plans into action—a record 3 million passengers were screened by the Transportation Security Administration at US airports on July 7.

(5) *France*. France's growth has soared past Germany's in the post-pandemic period, but much of that growth was driven by fiscal spending. France is running a budget deficit equal to 5.5% of GDP, whereas Germany's deficit is just 2.1% (*Fig. 9*). Now France must wrestle with the European Union's (EU) Excessive Procedure and a legislative body with huge compositions of the far-left New Popular Front and the far-right National Rally.

The financial markets aren't thrilled by the prospects. The spread between 10-year German and French government bond yields has remained at the highest levels since the French presidential election in 2017, above the March 2020 highs of 65 basis points (*Fig. 10*). And the French CAC 40 stock index is down around 4.6% in the past month.

Considering that the outlook for the brightest of the core Eurozone bunch has dulled considerably, we're not looking to pile into European stocks anytime soon.

Trade I: How China Evades US Tariffs. Chinese companies are circumventing US tariffs by rerouting their products through intermediary countries with more favorable US trade terms before final exportation. Also, more Chinese companies are moving their production facilities to Vietnam and Mexico to accomplish the same goal. China's increasingly opaque trade tactics jeopardize the US, Mexico, and Canada free-trade alliance.

Here's more:

(1) To mitigate declining direct exports to the US, China has significantly boosted exports to Mexico and Vietnam. From August 2022 to March 2024, Chinese exports to the US fell by 19%. However, factoring in increased exports to Vietnam and Mexico, the net loss narrows to 13%, assuming that Chinese exports to these two countries end up in the US (*Fig. 11*).

(2) Recent media reports underscore how significant the shifting trade winds have grown. Analysis of US Census Bureau data by *Forbes* *reveals* Vietnam as a major beneficiary of reduced US imports from China, capturing significant market share across various product categories. Additionally, Reuters *reports* a strong correlation between US imports from Vietnam and Vietnam's imports from China, indicating a strategic trade relationship heightened during the Trump administration.

Recent statements from former Mexican trade ambassador to China, Jose Luis, *published* in China's *Global Times*, highlight Mexico's role as a strategic hub for Chinese companies in accessing the North American market. Over the past three years, 1,500 new Chinese firms have invested in Mexico, particularly in energy infrastructure, electric vehicles (EV) production, and lithium refining.

(3) China's global exports contracted by 7% from a peak in September 2022 to March 2024 (*Fig. 12*). There were significant declines in exports not only to the US but also to South Korea and the EU.

Trade II: US-China Trade War Fallout. Chinese exports to the US have encountered several challenges since July 2018, when the Trump administration first imposed Section 301 tariffs on Chinese goods.

Currently, Section 301 tariffs on China amount to $77 billion out of the $79 billion in tariffs imposed annually under both the Trump and Biden administrations, based on initial import values, *according* to a June 26 Tariff Tracker maintained by Tax Foundation.

To assess US-China trade dynamics, we align tariff-related events with the International Monetary Fund's (IMF) free-on-board trade statistics (*Fig. 13*). Our conclusion: The geopolitical outlook for direct exports from China to the US looks grim. Consider the following:

(1) Chinese exports to the US plummeted 14% following the initiation of Section 301 tariffs, hitting a low around May 2020 amid the global pandemic, based on a 12-month sum in US dollar terms.

(2) Exports expanded by 57% from May 2020 to August 2022 as global conditions improved post-pandemic, bolstered by the Trump administration's "Phase-One" trade deal reducing tariffs on Chinese goods shipped to the US. However, in February 2022, the US Trade Representative (USTR) *criticized* China for non-compliance with the deal's terms, a stance continued by the Biden administration.

Rising trade tensions coincided with the onset of the Russia-Ukraine war and subsequent global economic slowdown and European energy crisis. Exports peaked in August 2022, coinciding with then-US House Speaker Nancy Pelosi's *controversial visit* to Taipei; her visit exacerbated both trade and military tensions between the US and China, leading to a *suspension* of military talks until December 2023.

(3) In May 2024, following a statutory review, the Biden administration opted to maintain Section 301 tariffs and imposed higher rates on select Chinese goods, with the impact on Chinese imports to the US still unknown (IMF trade data are available only through March 2024).

(4) Looking ahead, former President Donald Trump has floated imposing a 60% tariff on all US imports from China if re-elected in 2025, along with a proposed 10% tariff on imports from all countries.

Although such extreme measures may not materialize, a recent report from the USTR signals potential challenges for the United States, Mexico, and Canada free-trade agreement dubbed "USMCA," originally established under Trump's tenure. Chinese automotive companies in Mexico are seen as exploiting low labor costs and tariff avoidance strategies. If Trump is re-elected, he might also threaten to upend the USMCA over China's backdoor trade tactics in Mexico.

Earnings: A Positive Outlook for Q2 Earnings Growth. Joe has been tracking the quarterly earnings forecast for S&P 500 companies collectively each week since the series started in Q1-1994.

The typical playbook: Industry analysts cut their estimates gradually until reality sets in during the final month of the quarter, when some companies warn of weaker results. The combination of falling forecasts for companies that have underperformed earlier expectations, steady forecasts for those holding good news close to their vests, and insufficient estimate increases so close to reporting time to balance out the lowered expectations invariably creates an "earnings hook" pattern in the charted estimate/actual data as reported earnings exceed the latest estimates—i.e., a positive earnings surprise. In other words, the final month of quarters usually sets the stage for better-than-expected earnings reports.

What does the consensus forecast data say about the upcoming Q2 earnings reporting season? Interestingly, the playbook was discarded. Joe explains:

(1) *Q2 estimate unchanged over the course of the quarter.* The S&P 500's Q2-2024 EPS estimate of $59.22 didn't change from the start to the end of the quarter (*Fig. 14*). Typically, there's a decline as the quarter progresses (a 2.4% drop for Q1-2024, a 5.9% drop for Q4-2023, and an average decline of 4.0% in the 120 quarters since consensus quarterly forecasts were first compiled in 1994). The quarter's 0% change is great news and implies yet another strong earnings surprise.

In Q2-2024, analysts expect the S&P 500's earnings growth rate to be positive on a frozen actual basis for a fourth straight quarter following three y/y declines through Q2-2023. Their 8.5% y/y growth expectation for Q2-2024 compares to 6.6% y/y growth in Q1-2024, 7.5% in Q4-2023, 4.3% in Q3-2023, -5.8% y/y in Q2-2023, -3.1% in Q1-2023, and -1.5% in Q4-2022 (*Fig. 15*). On a pro forma basis, they expect a fourth straight quarter of positive y/y growth as well, with earnings forecasted to rise 10.1% (versus 8.2%, 10.1%, 7.5%, -2.8%, 0.1%, and -3.2% for the previous six quarters). When the dust finally clears on the Q2-2024 earnings season, we think y/y growth has an even chance of crossing into the double-digit percentage territory on both bases.

(2) *Eight sectors, maybe more, to show y/y growth.* Analysts' forecasts imply positive y/y percentage earnings growth in Q2-2024 for eight of the S&P 500's 11 sectors, the same number as in Q1-2024 and Q4-2023. But with several sectors expected to post only a small decline, we think the final count could be as high as ten. That would be the most since the ten in Q4-2021, which reflected easy y/y comparisons coming out of the pandemic recovery.

Four sectors are expected to record double-digit percentage gains (down from five in Q1-2024): Communication Services (21.7%), Health Care (20.2), Information Technology (16.9), and Energy (11.4). They're followed by: Consumer Discretionary (8.4), Utilities (6.9), Financials (6.7), Consumer Staples (0.2), Industrials (-2.5), Real Estate (-2.5), and Materials (-9.4).

(3) *Y/y growth streaks: winners and losers.* The S&P 500's Energy and Health Care sectors are expected to record positive y/y earnings growth during Q2-2024 after successive declines (five and six quarters, respectively). Analysts expect Industrials' 12-quarter string of positive y/y growth to end in Q2-2024, but the usual positive surprise hook could extend its streak to 13 quarters. Four sectors should post y/y growth after a string of growth quarters, a sixth for Consumer Discretionary and Financials and a fifth for Communication Services and Information Technology. Analysts expect Materials to mark its eighth straight y/y decline in quarterly earnings.

(4) *MegaCaps still growing faster than the S&P 500.* The MegaCap-7 group of stocks (i.e., Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla) is expected to record y/y earnings growth of 28.3% in Q2-2024—down from levels in the 50%-56% ballpark for the three prior quarters but close to the year-earlier 28.0%. Looking ahead to Q3-2024, analysts expect y/y earnings growth to decelerate even further to 15.7% as four of the MegaCap-7 companies slow to single-digit growth and Nvidia's forecasted growth drops to 71.9% from 132.5% in Q2-2024.

(5) *S&P 500 Q2 growth still positive minus faster growing MegaCaps.* Looking at the data without the MegaCap-7 group is telling as well. S&P 500 earnings excluding the MegaCap-7 are expected to rise 5.7% in Q2 after Q1 growth of 0.1% ended a six-quarter string of declines. We think the typical earnings surprise hook again in Q2-2024 will easily result in high-single-digit percentage y/y growth for the S&P 500 excluding the MegaCap-7.

Calendars

US: Wed: Atlanta Fed GDPNow 1.5%; MBA Mortgage Applications; Wholesale Inventories 0.6%; Crude Oil Inventories & Gasoline Production; OPEC Monthly Report; Powell; Bowman; Goolsbee; Cook. **Thurs:** Headline & Core CPI 3.1%/3.4$ y/y; Jobless Claims 236k; Federal Budget Balance; Natural Gas Storage; IEA Monthly Report; Bostic. (FXStreet estimates)

Global: **Wed:** Italy Industrial Production 0.2%; Japan Core Machinery Order 1.0%; Nagel; Mauderer; Pill; Nagel; Mann. **Thurs:** Germany CPI 0.1%m/m/2.2%y/y; UK GDP 0.2%m/m; UK Headline & Manufacturing Industrial Production 0.3%0.3%; ECOFIN Meetings; Eurogroup Meetings. (FXStreet estimates)

US Economic Indicators

NFIB Small Business Optimism Index (*link*): Small business optimism jumped to six-month high in June, though inflation concerns linger. June's *Small Business Optimism Index* (SBOI) rose for the third straight month in June to 91.5, which was the highest reading this year, after declining by 3.4 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 30th consecutive month. In June, four of the 10 components rose, led by current inventory (+6ppts to a net -2%), expect the economy to improve (+5 to -25), plans to increase inventories (+4 to -2), and earnings trends (+1 to -29), while only current job openings (-5ppts to a net 37%) fell. The remaining five components were unchanged—capital spending plans (at a net 23%), plans to increase employment (15), now is a good time to expand (4), expected credit conditions (-7), and sales expectations (-13). Inflation (21%) remained the *single most important problem* for small business owners in June, with quality of labor (19), taxes (14), cost of labor (11), and government regulations (10) rounding out the top five—the same top five as in May. The net percentage of owners raising *selling prices* rose to 27% from 25% in May and April, while a net 26% plans price hikes in the next three months, down from 28% in May and 33% in March. Turning to *compensation*, a net 38% reported raising compensation in June, a tick above May's 37%, while a net 22% plans to raise compensation in the next three months, up from 18% in May though lower than the 30% posted in November.

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