July 24, 2024

Morning Briefing

Currencies, Central Banks, MegaCap-8 Earnings

Check out the accompanying chart collection.

Executive Summary: There are plenty of dollar detractors around, but their arguments don't hold much weight against a big reason that demand for the greenback will remain strong: Foreign investors need dollars to invest in US assets. Eric is confident that continued strong foreign demand for US stocks and bonds will keep the US dollar reigning supreme. … Also: Melissa globe-trots to check in on central banks in Europe, Japan, and China—where monetary policy remains restrictive, accommodative, and downright easy, respectively. … And: As the stock market leadership rotates away from the MegaCap-8, Joe shares how their vital stats compare to the rest of the market during the bull run to date.

Currencies I: Dollar Is in Demand. Amid myriad headwinds, the US dollar has proven resilient since the pandemic. The dollar index (DXY) is up 3.0% this year and 16.5% from its post-pandemic low in May 2021 (*Fig. 1*). While the DXY is still well off its highs seen in 2022, 2001, and the mid-1980s, it seems to have shaken a period of persistent weakness and entered a trend of sustained strength following the Great Financial Crisis.

We're moderately bullish on the dollar, despite a number of factors that historically would weigh on it. There's no shortage of bears out there to tell you why the greenback should be weaker, including unsustainable deficit spending, an increasingly wide trade deficit, and rampant inflation since the pandemic. More niche arguments are also made, like Japanese investors dumping dollars to repatriate their massive overseas investment portfolio. We sympathize with some of these worries, but they don't materially affect our current stance on the dollar.

Currencies are a zero-sum game, and the dollar is trade weighted. That means dollar strength (weakness) derives from the weakness (strength) of other currencies, namely the euro, yen, pound, and a few others. Underpinning our view on the dollar is that we're bullish on US assets vis-a-vis the rest of the world (ROW).

With that said, let's review foreign purchases of US assets, which drive dollar demand because they're funded via dollars:

(1) *Capital inflows*. Private and official accounts abroad plowed $820 billion into US publicly traded assets over the 12 months ended May (*Fig. 2*). After falling from a peak of $1.6 trillion in 2022 to just $571 billion from February 2023-24, private investors have bought $650 billion, and official accounts (governments) have bought $170 billion (*Fig. 3*).

(2) *Bonds.* Private foreign investors scoop up US bonds en masse, but not just Treasuries. Total private purchases of US bonds over the past 12 months include $442 billion of Treasury notes & bonds, $100 billion of agency mortgage-backed securities (MBS), and $290 billion of corporate credit (*Fig. 4*). Slightly lower-quality credits are particularly attractive to foreigners with the US yield curve inverted.

Meanwhile, private and foreign accounts scooped up US long-term Treasuries at an annual rate of $673 billion over the past three months (*Fig. 5*). Government investors abroad dumped Treasuries for most of the past decade, but with yields above 4.00% they're now big buyers (*Fig. 6*).

(3) *MBS & corporate credit*. Both private and official investors have started to sell agency MBS in the past few months, buying corporate bonds at an increasingly high rate (*Fig. 7* and *Fig. 8*). A dearth of new mortgages means that many products tied to MBS aren't paying out sufficiently high coupon payments.

(4) *Equities*. Private investors abroad are buying more and more US stocks, including $168 billion over the 12 months ended May (*Fig. 9*). As they tend to buy when stocks are doing well, we're mindful that this is a bit of a contrarian indicator.

(5) *Risks*. Are we worried about a mass-selling of US assets, putting pressure on the dollar? Could Trump 2.0 instigate a Plaza Accords 2.0 to force the US's major trading partners to weaken the greenback?

The ROW holds a significant portion (87%) of its US Treasuries in longer-term notes and bonds—it bought $603 billion of new Treasury securities from Q2-2023 to Q1-2024 (*Fig. 10*). The major holders of US debt, including Japan and China, have maintained steady holdings, though these have shrunk relative to the outstanding debt (*Fig. 11*). The financial media often points to China's dumping of roughly half-a-trillion dollars' worth of Treasuries over the past decade, but we note that the Chinese Communist Party increasingly prefers to

hold US debt in other global financial centers.

The *WSJ* recently wrote that Japan's Government Pension Investment Fund might start shifting more of its $1.5 trillion of holdings back into Japanese assets. But that would be a slow move for Japan's "whale," and we doubt that 1% yields on Japanese government bonds (JGBs) will inspire a massive rotation.

Treasuries are the most liquid market in the world, with few if any competitors. With the European Union (EU) struggling to manage its own finances—and political stability—the dollar is likely to remain supreme. We also continue to prefer US assets to ROW assets, as we have since at least 2010. Accordingly, we're confident that demand for US stocks and bonds will continue to prop up the greenback.

Global Central Banks I: ECB Remains Restrictive. The European Central Bank's (ECB) latest decision to hold interest rates following its first cut in nine months underscores its balancing act: curbing inflation while managing potential economic headwinds.

On July 18, the ECB decided to keep its benchmark interest rates unchanged: The main refinancing operations remain at 4.25%, the marginal lending facility at 4.50%, and the deposit facility at 3.75%. This decision follows a June 6 reduction in the main interest rate from 4.00% to 3.75%. The June cut to 3.75% ended a nine-month hold at 4.00% (*Fig. 12*). Despite a still substantial balance sheet, the ECB has allowed assets to shrink significantly since mid-2022 (*Fig. 13*).

During the bank's June *press conference* Q&A, ECB President Christine Lagarde remarked that "the question of September and what we do in September is wide open." Markets *anticipate* another rate cut as early as September. Our view is that the ECB may need to lower interest rates to avoid the negative effects of prolonged high borrowing costs.

Fiscal policy is also set to influence financing conditions. EU governing bodies are pushing to lower member states' government debt, which could give the ECB more room to reduce rates. However, potential inflationary pressures from higher global tariffs under a new US regime could increase global and Eurozone inflation.

In her latest press conference, Lagarde provided the following key insights:

(1) *Underlying inflation remains high*. Lagarde noted that services and wage inflation rates are still elevated, and headline inflation remains above the ECB's 2.0% target (*Fig. 14* and

Fig. 15). The ECB doesn't expect headline inflation to fall to 2.0% until the second half of next year (Fig. 16). If wage growth doesn't decline as expected, restrictive policy will likely continue.

(2) *Less loan demand.* The average interest rate on new loans to firms edged down to 5.1% in May, while mortgage rates held at 3.8% (Fig. 17). The latest lending survey showed slightly tighter standards for corporate loans and moderately eased standards for mortgages. Demand for corporate loans fell slightly, while household mortgage demand rose for the first time since early 2022.

(3) *Less drag monetary drag*. Lagarde expects the Eurozone's economic recovery to be supported by consumption, driven by higher real incomes from lower inflation and higher nominal wages.

(4) *More fiscal tightening.* Lagarde welcomed the European Commission's guidance for stronger fiscal sustainability and the Eurogroup's statement on the fiscal stance for 2025. Fully implementing the EU's revised economic governance framework will help governments reduce budget deficits and debt ratios sustainably.

Global Central Banks II: BOJ Remains Accommodative. The Bank of Japan (BOJ) maintained accommodative interest rates after its April 26 and June 14 meetings, following a significant policy shift. On March 19, the BOJ ended its negative interest-rate policy, setting its short-term rate between 0.0% and 0.1%.

The BOJ also discontinued its yield-curve-control (YCC) program and ceased purchases of risky assets including equities-linked ETFs and J-REITs (Japanese real estate investment trusts). However, it continues to buy JBGs as needed with assets from its substantial balance sheet (Fig. 18). Two types of forward guidance were removed: one promising continued quantitative and qualitative monetary easing with YCC and another committing to expanding the monetary base.

Inflation remains above the BOJ's 2.0% target. The CPI less fresh food and energy rose 2.1% y/y through June (Fig. 19).

The 10-year JGB yield rose above 1.00% in May, the first time since November 2011 (Fig. 20).

Consider the following:

(1) *Zero-inflation trap*. BOJ Governor Kazuo Ueda focused on Japan's struggle to escape a long period of zero-to-low inflation despite extensive nontraditional interventions. He noted that by the time the zero-inflation trap set in, the BOJ had exhausted its leverage over short-term rates.

(2) *Entrenched low inflation*. Ueda observed that when firms don't expect peers to raise prices, they keep prices and wages unchanged despite small changes in costs or demand. This entrenches overall inflation or inflation expectations around zero.

Japan's wage inflation remained below 2.0% for decades until the end of last year. In May, the yearly percentage change in Japan's average monthly contractual cash earnings for all industries rose sharply to 4.8% (*Fig. 21*).

(3) *Re-anchoring inflation expectations*. Ueda stated that progress had been made in moving away from zero inflation and lifting expectations, but now the challenge is to re-anchor them at the 2.0% target.

Global Central Banks III: PBOC Keeps it Easy. The People's Bank of China (PBOC) recently adjusted its monetary policy to support economic growth and stabilize key sectors.

On Monday, the PBOC cut its seven-day reverse repo rate by 10 basis points to 1.7%, the first cut since February 2024. In addition to this surprise, the one-year loan prime rate (LPR) and the five-year LPRs were lowered by 10 basis points to 3.35% from 3.45% and to 3.85% from 3.95%, respectively. Most loans in China are based on the one-year LPR, while the five-year rate influences the pricing of mortgages. The PBOC also eliminated the nationwide policy floor for commercial mortgage rates to stabilize the property market. These adjustments reflect the PBOC's strategy to stimulate growth, as shown by the size of its balance sheet (*Fig. 22*).

Chinese officials indicated that the central bank will maintain a stable "easy" monetary policy for the rest of the year. Following the July 21 rate cut, China's President Xi expressed support for the PBOC's efforts.

Strategy: Reading MegaCap-8's Vitals. At Friday's close of trading, the aggregate market capitalization for the MegaCap-8 group of stocks (Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Nvidia, and Tesla) was down 7.8% from its record high on July 10. Investors rotated away from them last week to the S&P 600 SmallCap and the S&P 400

MidCap indexes (collectively, the "SMidCaps") and to a lesser extent the S&P 492 (the S&P 500 minus the MegaCap-8). Despite last week's mini-correction in the MegaCap-8 stocks, they remain in an exceptional bull market since October 12, 2022 when the S&P 500's price index bottomed.

Our accounts often ask how well the MegaCap-8 has performed since the bull market started in October of 2022, and how that stacks up to the performances of the S&P 500 and the S&P 492. Joe addresses that below as well as draws comparisons among these three groups' forward revenues, forward earnings, and forward profit margins ("forward" stats refer to industry analysts' estimates for the coming 12 months). On all four counts, the MegaCap-8 and the S&P 500 have improved; but for the S&P 492, the forward profit margin has actually fallen over the course of the bull market to date, as Joe shows below:

(1) *Market capitalization.* Since the bull market began on October 12, 2022, the MegaCap-8's aggregate market cap has soared 106.6%. That stellar performance has benefited the S&P 500, which has risen 50.4% since then. Without the MegaCap-8, the S&P 492 has risen just 19.0% (*Fig. 23*).

(2) *Forward revenues and earnings.* Since the start of the bull market, the consensus forward revenues forecast for the MegaCap-8 has risen 19.0%. That compares to a gain of 8.7% for the S&P 500 and 7.4% for the S&P 492. Forward earnings for the MegaCap-8 has soared 50.4% over this same period. That compares to an 11.2% rise for the S&P 500 but only a 4.0% gain for the S&P 492. The S&P 492's forward earnings has risen less than its forward revenues, pressuring its forward profit margin downward.

(3) *Forward profit margin.* The MegaCap-8's forward profit margin rose to a new record high of 24.1% during the July 19 week. That's well above the 13.3% for the S&P 500 and the 11.9% for the S&P 492. The MegaCap-8's forward profit margin has soared nearly 27% from 19.0% on October 12, 2022 to 24.1%—well ahead of the S&P 500's 2.3% margin gain (to 13.3% from 13.0%) and the S&P 492's 2.3% margin decline (to 11.9% from 12.3%, stalled 0.8pt below its 12.7% record high in June 2022) (*Fig. 24*).

Is there a new record high ahead for the S&P 500's forward profit margin? It has been 25 months since the S&P 500's forward profit margin was last at a record high of 13.4%. We're expecting the Q2-2024 earnings season to deliver another strong earnings surprise and upward forward earnings estimate revisions; that could propel the forward profit margin further along the improvement path it's been on since bottoming at 12.3% during the March 30, 2023 week (*Fig. 25*).

Calendars

US: Wed: New Home Sales 643k; MBA Mortgage Applications; Goods Trade Balance -$98.0b; Wholesale Inventories 0.5%; M-PMI & NM-PMI Flash Estimates 51.5/54.5; Atlanta Fed GDPNow 2.7%; Crude Oil Inventories & Gasoline Production; Logan; Bowman. **Thurs:** GDP & GDP Price Index 1.9%/2.6%; Durable Goods Orders Total & Core 0.4%/0.2%; Kansas City Manufacturing Survey; Initial Jobless Claims 239k. (FXStreet estimates)

Global: Wed: Eurozone, Germany, and France M-PMI Flash Estimates 46.0/44.1/45.7; Eurozone, Germany, and France NM-PMI Flash Estimates 52.9/53.3/49.7; Germany Gfk Consumer Climate -21.1; UK M-PMI & NM-PMI Flash Estimates 51.1/52.5; BoC Rate Decision 4.50%; Eurogroup Meetings; De Guindos. **Thurs:** Germany Ifo Business Climate Index 88.9; Eurogroup Meetings; Lagarde; Nagel. (FXStreet estimates)

US Economic Indicators

Existing Home Sales (*link*): "We're seeing a slow shift from a seller's market to a buyer's market," noted Lawrence Yun, NAR's chief economist. *Existing home* sales in June fell for the fourth successive month, by 5.4% in June and 11.2% over the period, to 3.89 million units (saar), as mortgage rates remain high. They had increased three of the prior four months by an impressive 13.8% over the period to 4.38mu (saar), up from its recent low of 3.85mu. June sales are 5.4% below a year ago. *Single-family* sales dropped 5.1% in June and 11.3% over the four months ending June to 3.52mu (saar), after soaring three of the previous four months by 15.4% from 3.44mu to 3.97mu; June sales were 4.3% below last June's pace. *Multi-family* sales tumbled 7.5% in June to 370,000 units (saar), down 14.0% versus a year ago. *Regionally*, existing home sales in June fell in all four regions, with the Midwest (-8.0% to 920,000 units, saar) posting the biggest decline, followed by the South (-5.9 to 1.76mu), West (-2.6% to 740,000), and the Northeast (-2.1 to 470,000). Total *housing inventory* at the end of June was 1.32 million units, up 3.1% from May and 23.4% from last June's 1.07 million units—with unsold inventory at 4.1 months' supply at the current sales pace, up from 3.7 months in May and 3.1 months in June 2023. The last time unsold inventory posted a four-month supply was 4.5 months' in May 2020. The *median price* of an existing home for all housing types in June was $426,900—the second straight month it reached an all-time high and up 4.1% from the median price in June 2023. Last month was the twelfth successive month of y/y price gains. All four regions registered price gains in

June.

Regional M-PMIs (*link*): The *Richmond Fed district* has now released manufacturing data for July, and shows manufacturing activity deteriorated and firms were less optimistic about local business conditions. This report follows the *New York Fed's survey* of manufacturing activity for the month, which showed activity contracted for the eighth straight month, while the *Philadelphia survey* saw the general activity measure expand and the future general activity reach its highest reading since July 2021. Looking at the *Richmond* survey for this month, the *composite manufacturing index* contracted again in June, falling 7 points (to -17 from -10), with both the shipments (-21 from -9) and new orders (-23 from -16) measures falling deeper into contractionary territory—and shipments falling notably. Employment (-5 from -2) continued to decline. Meanwhile, the future indexes for both shipments (22 from 21) and new orders (20 from 23) remained solidly in positive territory, while local business conditions (7 from 9) were slightly less optimistic in June than in May. *Turning to pricing*, the Richmond Fed reports the prices measures as the current price changes over the last 12 months. Both the *current prices-paid* (to 3.00% from 3.58%) and *current prices-received* (1.31 from 2.35) measures eased in June, with the *future prices-paid* (3.20 from 3.30) and *future prices-received* (1.29 from 2.14) measure following a similar pattern.

Contact us by *email* or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Eric Wallerstein, Chief Markets Strategist, 201-661-3575
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-241-6502
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, 570-228-9102