Yardeni Research

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Morning Briefing

US Resilience, Eurozone Weakness & More On Earnings

Check out the accompanying chart collection.

Executive Summary: Why hasn't the Fed's tightening of monetary policy slammed the brakes on the US economy? Eric explains the structural economic shifts that have led to increased rate insensitivity as well as the implications for setting the federal funds rate going forward. … The Eurozone economy seems to have long Covid: Melissa reports that it been struggling to regain its pre-pandemic pace of growth. The European Central bank is tasked with a balancing act, both stoking growth and dampening inflation. … Germany's leadership is floundering, and its economic indicators are pointing south. … Also: Joe reports that the investment-style rotation away from large caps has healthy earnings support.

US Economy I: Less Rate Sensitive. One of the reasons the US economy hasn't slowed under the weight of a higher federal funds rate (FFR) is that it's driven mostly by the services-producing sector. About 61% of domestic production and two-thirds of consumption is in services (*Fig. 1* and *Fig. 2*). But even on the goods-producing side of the economy, the US is growing increasingly less sensitive to interest rates.

Producing goods tends to be capital intensive; businesses require financing to start new projects or build plants, while consumers typically finance big-ticket purchases like autos and homes. Yet despite having the highest interest rates since the dotcom bubble at the turn of the century, the US is undergoing a high-tech industrial boom. Real capital spending rose 3.7% y/y to a record high of $3.39 trillion (saar) in Q2 (*Fig. 3*).

Let's discuss why investment is booming in America and what it means for the Fed:

(1) *Construction vs manufacturing.* The goods-producing sector is not a monolith. While manufacturing PMIs have remained below 50.0 for much of the last two years, signaling a manufacturing recession, construction of manufacturing structures has jumped 2.4 times in real terms, from $64.8 billion in Q4-2020 to $155.1 billion in Q2-2024 (*Fig. 4*). Many of the factories being built are semiconductor fabrication plants (fabs) thanks to federal subsidies

from the CHIPS Act.

(2) *Record employment*. Construction of new fabs has helped foster record-high construction employment of 8.2 million workers (*Fig. 5*). However, manufacturing employment has been below 13.0 million workers since December 2008 and is dwindling as a portion of the overall goods-producing sector.

(3) *Tech boom.* Nondefense capital goods shipments, excluding aircraft, have been flat at around $885 billion (saar) in current dollars for the past two years (*Fig. 6*). Some die-hard hard-landers suggest that the lack of rising shipments (and falling shipments in real terms) means corporations are reining in activity and that a recession is near. The hole in that argument: Core capital goods shipments don't account for technology.

Business investment in information processing equipment—which includes datacenters—has climbed to $506.5 billion (saar) in real terms as of Q2 (*Fig. 7*). Investment in intellectual property—which includes software and R&D—rose 4.5% q/q (saar) to a new high of $1.46 trillion in Q2 (*Fig. 8*). Businesses are increasingly spending on software as a service (a.k.a. SaaS) and the cloud, which is subscription-based and akin to renting, reducing the need to borrow.

(4) *Defense-driven production*. Despite the shift from manufacturing to construction, industrial production rose to its highest level since 2018 in June (*Fig. 9*). The increase has been driven in part by defense and space production, which rose to an all-time high in June (*Fig. 10*). This manufacturing mostly stems from defense contractors and is highly technical; demand is also inelastic and not sensitive to interest rates because the US government is the buyer. The S&P 500 Aerospace and Defense industry index is up 86% from its low in October 2020 to a new record high as of Monday (*Fig. 11*). We expect the tense geopolitical landscape to remain a tailwind for defense stocks' performance.

(5) *Neutral rate.* Technology accounts for half of current-dollar capital spending (*Fig. 12*). We expect non-tech companies increasingly to invest in automation, AI, robotics, and other productivity-enhancing technologies to augment their employees, as skilled workers remain hard to come by. As the FFR has less of an impact on business spending, the Fed shouldn't be in any rush to lower this interest rate (*Fig. 13*). We agree with the John Michaelson's *WSJ op-ed* dated July 29 and titled "The Case Against Low Interest Rates."

Eurozone Economy I: Weak Indicators. Much of the Eurozone is struggling to regain its pre-pandemic pace of economic growth (*Fig. 14*). The Eurozone's GDP grew during Q2 by just 0.6% y/y.

The European Central Bank (ECB) is currently balancing the need to stimulate GDP while also curbing inflation. Underscoring how difficult that is, the ECB decided at its most recent policy meeting in July to hold interest rates at current levels after having cut them in June for the first time in nine months. Eurozone headline CPI rose 2.5% y/y in June, still above its 2.0% target (*Fig. 15*). Price pressures are especially persistent in services (*Fig. 16*). Nevertheless, financial markets still expect the ECB to lower interest rates at its September meeting.

Geopolitical uncertainties and shifting trade tensions have taken a toll on the Eurozone's export-oriented economies. Manufacturers are facing competition from cheaper Chinese goods. China's production levels continue to exceed domestic demand significantly, especially in certain industries—namely, automobiles, chemicals, machinery, and semiconductors. While Chinese dumping has challenged European companies' ability to maintain profitability and market share, it has also aided in tamping down global price pressures for manufactured goods prices.

Here's more:

(1) The Citigroup Economic Surprise Index (CESI) for the Eurozone fell to -55.7 as of July 29, a significant drop from a recent peak of 57.1 on March 6 (*Fig. 17*).

(2) Consistent with weak output growth, the Eurozone Economic Sentiment Indicator (ESI) increased slightly to 95.8 in July from 94.9 a year earlier (*Fig. 18*). The Eurozone's Employment Expectations Indicator (EEI) declined markedly this month, to 97.8 from 103.4 in July 2023 (*Fig. 19*). The Eurozone's Employment Expectations Indicator (EEI) has exceeded the ESI since December 2021.

(3) The HCOB Eurozone Manufacturing PMI slid to 45.6 in July, down slightly from 45.8 in June and marking the 16th-straight month of contraction, reflecting significant reductions in new business and workforce. The services sector has been more resilient (*Fig. 20*).

(4) The Eurozone's flash Consumer Confidence Indicator improved to -13.0 in July from -15.2 a year ago, closer to its long-term average (*Fig. 21*).

(5) Household real consumption per capita in the Eurozone increased by 0.2% q/q during Q1, after a slight increase of 0.1% in the previous quarter, *according* to the European

Commission. Household real income per capita increased in the Q1-2024 by 1.5% q/q, after an increase of 0.7% in Q4-2023.

Eurozone Economy II: Germany's Leadership Is M.I.A. *The Economist* recently published a compelling *article* titled "Germany's failure to lead the EU is becoming a problem," highlighting Germany's struggles under Chancellor Olaf Scholz, criticized as overly cautious and indecisive. The coalition government of Social Democrats, Greens, and Free Democrats is fraught with internal conflicts, impeding a unified stance on crucial EU matters.

Germany's hefty expenditures on energy subsidies have sparked tensions with other member states. Germany's tentative approach to the Ukraine crisis and other geopolitical issues has cast doubt on its commitment to EU leadership. *The Economist* argues that Germany's current political and economic strategies are undermining its capacity to steer the EU effectively, potentially threatening the union's cohesion.

Germany's recent economic indicators signal a downturn, which could spell trouble for the rest of the Eurozone:

(1) Germany's real GDP fell slightly during Q2, declining by 0.1% y/y.

(2) German business confidence, per the Ifo Business Climate Index, plummeted to a five-month low in July (*Fig. 22*).

(3) Germany's manufacturing sector gauge, the HCOB Manufacturing PMI, fell to 42.6 from 43.5 in June (*Fig. 23*). This drop marks an accelerated contraction, with production and new orders declining at their steepest rates in several months. Additionally, the sector experienced a notable reduction in employment, and the outlook for manufacturing growth has become increasingly subdued.

Strategy: Style Rotation Amid Earnings Recoveries for S&P 493 & SMidCaps. The stock market's recent style rotation from Growth to Value and from the S&P 500 LargeCaps to the S&P 600 SmallCaps and S&P 400 MidCaps (collectively, the "SMidCaps") appears to be the real deal rather than another false start. Investors expect the SMidCaps' earnings growth to continue recovering from pandemic-induced weakness through year-end before improving to a double-digit percentage rate in 2025. All three S&P market capitalization styles experienced earnings and margin pressure when inflation surged in 2021 and 2022 following the pandemic recovery.

The Magnificent-7 group of companies (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla)—some of which had embarked on aggressive cost-cutting and layoffs during that period—suffered five quarters of y/y earnings decline (from Q1-2022 through Q1-2023) versus the S&P 500's three straight quarters (from Q4-2022 through Q2-2023) and the S&P 493's (the S&P 500 minus the Magnificent-7) four quarters (from Q4-2022 through Q3-2023).

Since the AI-spending boom began during the tail end of Q1-2023, the Magnificent-7 has outperformed every other index. The group's aggregate revenue and earnings growth rates accelerated sharply then and have powered the improvement in the S&P 500's quarterly earnings growth rates despite continued weakness in the S&P 493.

Today, Joe revisits the recent quarterly earnings growth rates for the indexes and takes a look at their forecasts for Q2-2024 and beyond:

(1) *S&P 500 quarterly earnings growth rate accelerating.* The S&P 500 LargeCap's aggregate quarterly earnings fell on a y/y basis during the three quarters from Q4-2022 through Q2-2023. It has been positive since then, largely powered by AI-fueled profits for the Magnificent 7. The LargeCap's y/y quarterly earnings growth is expected to be positive for a fourth straight quarter in Q2-2024, rising 8.7% y/y (*Fig. 24*). That's the fastest rate of growth since Q4-2021.

Looking ahead at future quarters, the consensus of analysts expects earnings growth of 6.8% in Q3-2024 and 13.8% in Q4-2024 before rates in the 14%-15% range during 2025's quarters.

(2) *Magnificent-7 growth rate slowing but expected to remain strong.* The Magnificent-7's y/y quarterly earnings has been rising at a double-digit percentage rate since Q2-2023. It peaked at 54.8% during Q4-2023 before slowing to 49.2% in Q1-2024. Analysts expect the Magnificent 7's earnings growth to decelerate even further to 35.5% in Q2-2024, 19.2% in Q3-2024, and 18.4% in Q4-2024. It's expected to settle at a healthy 14%-19% rate during 2025's quarters despite difficult y/y comparisons.

(3) *S&P 493 earnings growth to accelerate in Q2*. The S&P 493 had negative y/y earnings comparisons during the four quarters from Q4-2022 through Q3-2023. Earnings growth was barely positive in Q4-2023 (0.4%) and Q1-2024 (0.5%) but is expected to leap to 6.9% in Q2-2024 before slowing to 4.0% in Q3-2024. Easier y/y comparisons are expected to lead

to 13.4% growth in Q4-2024 and 12.8% in Q1-2025 for the S&P 493. Those would be the strongest y/y earnings growth rates for the S&P 493 since its earnings rose 32.6% y/y in Q4-2021—reflecting its growth deceleration from a peak of 92.2% during Q2-2021.

(4) *SMidCap earnings growth still negative in Q2 but about to turn positive soon.* Earnings growth for the SMidCaps is expected to lag the larger market capitalization indexes for a bit longer. The consensus expects y/y quarterly earnings growth to remain negative in Q2-2024 for the MidCap (-4.1%) and SmallCap (-11.9%) indexes, before turning slightly positive for them in Q3-2024 for the first times since Q1-2023 and Q4-2022, respectively (*Fig. 25*). They expect the SMidCap's quarterly y/y earnings growth rates to exceed LargeCap's during Q1-2025 for the first time since Q2-2022.

Whether SMidCap's future growth eventually exceeds LargeCap's depends primarily on how analysts react to the Magnificent-7's Q2 earnings reports. Either way, investors should be pleased to hear that earnings growth will be positive again in H2-2024 for *all* of the S&P's market capitalization indexes as well as the S&P 493 and the Magnificent-7. Mission accomplished.

Calendars

US: Wed: Fed Interest Rate Decision 5.50%; ADP Employment Change 166k; Employment Cost Index 1.0%; Pending Home Sales 1.6%; Chicago PMI 44.1; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. **Thurs:** Productivity & Unit Labor Costs 1.5%/1.6%; Initial Claims 239k; ISM M-PMI & Price Index 49.0/52.5; Atlanta Fed GDPNow 2.8%; Construction Spending 0.2%; Total Vehicle Sales. (FXStreet estimates)

Global: Wed: Eurozone Headline & Core CPI 2.4%/2.8%y/y; Eurozone PPI; Germany Retail Sales; Germany Unemployment Change & Unemployment Rate 16k/6.0%; Germany Import Price 0.1; France CPI 0.3%; Japan Household Confidence 36.5; Japan Housing Starts -2.3%; Japan M-PMI 49.2; BoJ Outlook Report; China Caixin M-PMI 51.6. **Thurs:** Eurozone, Germany, France, Italy, and Spain M-PMIs 45.6/42.6/44.1/46.2/51.9; Eurozone Unemployment Rate 6.4%; ECB Economic Bulletin; UK M-PMI 51.8; BoE Interest Rate Decision 5.00%; Bailey; Pill. (FXStreet estimates)

US Economic Indicators

Consumer Confidence (*link*): "Confidence increased in July, but hot enough to break free of the narrow range that has prevailed over the past two years," noted Dana Peterson, chief economist at the Conference Board. "Even though consumers remain relatively positive about the labor market, they still appear to be concerned about elevated prices and interest rates, and uncertain about the future; things may not improve until next year," she cautioned. *Headline* consumer confidence slipped to 100.3 in July, from a downwardly revised 97.8 in June (from 100.4)—which was back near April's 97.5, the lowest reading since July 2022. The *present situation* component dipped from 135.3 in June to 133.6 this month, the lowest since April 2021, while the *expectations component* climbed from 72.8 in June to a six-month high of 78.2 in July. The expectations component remains below 80—the threshold that usually signals a recession ahead. Consumers' assessment of *current business conditions* was slightly less positive this month, with the percentage of consumers saying *business conditions* were "good" at 18.8%, a tick below June's 18.9%, while 18.3% observed *business conditions were bad*, up from June's 18.1%. *Turning to the labor market*, consumers' appraisal deteriorated in July, with 34.1% saying *jobs were plentiful*, down from 35.5% in June, while 16.0% said *jobs are hard to get*, up from 15.7% in June. Consumers' assessment of *short-term business conditions* six months from now was more optimistic in July, with 14.8% of consumers expecting business conditions to improve, up from 13.2% in June, and 16.7% expecting business conditions to worsen, down from 17.6% in June. Consumers' assessment of the *short-term labor market* was slightly less negative this month, as 14.5% of consumers expected more jobs to be available, up from 13.1% in July, while 16.7% anticipated fewer jobs, down from 18.3% in June. Consumers' *short-term financial prospects* reading was less pessimistic this month: The percentage of consumers expecting their incomes to improve fell to 15.6% in July from 16.2% in June, while the percentage expecting their incomes to decrease ticked down to 11.6% from 12.3%.

JOLTS (*link*): *Job openings* held steady at 8.2 million in June, still a relatively high level but down from the series peak of 12.2 million in March 2022. Prior to the pandemic in early 2020, the highest level of job openings record was 7.6 million. Openings reached 10.0 million in June 2021 for the first time in the history of the series going back to 2000. There were 6.8 million people unemployed in June, so there were 1.2 available jobs for each unemployed person. This ratio was at a recent high of 2.0 during March 2022. *By Industry*, accommodation & food services (+120,000) and state & local government, excluding education (+94,000) posted the biggest gains, followed by transportation, warehousing, and utilities (+62,000), wholesale trade (+47,000) and retail trade (+43,000). Industries posting the biggest declines were recorded in durable goods manufacturing (-88,000), construction (-71,000), health care & social assistance (-62,000), finance & insurance (-39,000), and professional & business services (-27,000). *Separations* include quits, which are generally voluntary separations initiated by employees—serving as a measure of workers' willingness or ability to leave jobs. *Total quits* have been in a downtrend since peaking at 4.5 million during April 2022, falling to 3.3 million this June. Quits in June were led by declines in construction (-64,000), state & local government education (-55,000), and accommodations & food services (-36,000) jobs.

Global Economic Indicators

Eurozone Economic Sentiment Indicators (*link*): The Economic Sentiment Indexes (ESIs) for the both the *EU* (+0.1 points to 96.4) and Eurozone (-0.1 to 95.8) were broadly stable in July. ESIs among the *six largest EU economies* were mixed this month, with Spain (+1.7 points to 104.1) posting the biggest gain, followed by Italy (+0.4 to 100.1), while France (-2.2 points to 94.8) and Poland (-1.8 to 99.6) were the biggest drains. Economic sentiment was broadly stable in Germany (+0.2 to 92.3) and the Netherlands (-0.2 to 99.6). By *sector*, for the overall EU, the consumer (+0.7 to -12.2) and construction (+0.4 to –8.0) sentiment posted gains in July, while retail trade (-1.1 to -7.6) and services (-0.9 points to 5.4) sentiment deteriorated and industry (-0.1 to -9.8) confidence was broadly stable.

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