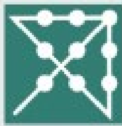

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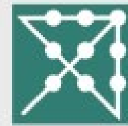

August 14, 2024

Morning Briefing

The ABCs Of Global Commodities

Check out the accompanying chart collection.

Executive Summary: While the US federal budget deficit is on an unsustainable course, there's good news about it: Income-tax receipts are up y/y—more evidence that no recession is on the horizon. And while spending also is up y/y, the net result is a lower deficit than at this time last year. For bonds, that means the 10-year Treasury yield won't likely retest last fall's highs near 5.00% anytime soon. … Australia, Brazil, and Canada are big exporters of commodities; Melissa surveys the export landscape for each by commodity and trading partner. … And Joe recaps the Q2 earnings, revenues, and profit margins to date for the S&P 500 and its 11 sectors.

US Economy: Federal Budget Update. Yesterday, the US Treasury Department updated the federal budget through July. The good news is that revenues are rising faster than expected, led by individual income taxes, helping to bring the 12-month budget deficit to $1.6 trillion from $2.3 trillion a year ago over the same period (*Fig. 1*). However, some of the improvement was related to timing shifts and deferred taxes.

The bad news is that deficit-financed outlays remain on an unsustainable course, led higher by record net interest outlays. Offsetting the climbs in most of the major outlays is the fall in income security outlays, which are down to $674 billion over the past 12 months compared to $781 billion over the same period a year ago. That's another sign that the economy, and the labor market in particular, are doing well.

Here's more:

(1) *Rising revenues*. Total receipts were up 8% y/y to a 12-month sum of $4.84 trillion (*Fig. 2*). While we can't put lipstick on the pig that is unsustainable deficit spending, our Roaring 2020s scenario calls for strong economic growth and productivity, which would help to keep the deficit in check by boosting revenues somewhat.

(2) *Out-of-order outlays.* Outlays fell 4.6% y/y to a 12-month sum of $6.43 trillion in July, though they remain on an upward trend driven by net interest costs, Social Security, and

Medicare (*Fig. 3*). Net interest costs totaled $861 billion over the last 12 months, just $8 billion less than national defense (*Fig. 4*).

(3) *What it means for bonds*. The 10-year Treasury yield is down below 3.90% early Tuesday after cooler-than-expected July PPI buoyed hopes for more Fed interest-rate cuts. As long as the federal budget deficit is supported by strong tax receipts, bond yields won't likely retest last fall's highs near 5.00% anytime soon. And by the way: There's no recession evident in tax receipts.

Global Commodities I: ABC's Export Roundup by Commodity. Characterizing the commodities-exporting landscape for Australia, Brazil, and Canada (the "ABCs") are mixed performances in global markets and commodity-specific demand: Australia is grappling with declining coal and natural gas demand, yet its iron ore and gold exports remain stable. Brazil is seeing crude oil surpass soybeans as its top export. Canada is experiencing growth in crude oil and gold exports.

Export performance across these nations is highly tied to commodities prices. Australia faces declining corporate profits due to weaker global demand for its coal and natural gas exports. Brazil's shift toward crude oil exports is enhancing profitability as oil prices remain elevated by historical measures despite declining soybean prices. Canada continues to show resilient profit margins, driven by crude oil prices.

Our analysis of ABC global exports suggests that overweighting oil and gold might be worth portfolio managers' consideration. Key points:

(1) *Lots of moving parts*. The ABC countries collectively exported $1.27 trillion to the global market over the 12-month period ended in April, per the International Monetary Fund's (IMF) *Direction of Trade Statistics*. Canada led with $565.4 billion in exports, followed by Australia at $355.8 billion, and Brazil at $345.6 billion. Australia's and Canada's exports declined y/y, while Brazil's increased. Of the three, Canada's export trends correlate most closely to the S&P GSCI commodities spot price, reflecting the country's significant dependence on crude oil exports (*Fig. 5*).

(2) *Demand falling for Australian coal & gas*. Australia's role as a top exporter of iron ore, coal, and natural gas is well established. However, the value of Australia's resource and energy exports is expected to decrease from 2022-23 to 2023-24, according to Australian Government *forecasts*.

Despite dramatic downturns in coal and natural gas exports in Australian dollar terms in recent years, Australia's gold and iron ore exports have been relatively stable (*Fig. 6*). Rising geopolitical tensions have bolstered gold exports, while China's initiatives to stabilize its real estate market have sustained iron ore demand.

(3) *Energy and metals prices send Australian profits lower*. Australian companies have faced profitability challenges in 2024. The Australian MSCI forward profit margin fell from a post-pandemic peak of 16.6% during the week of June 16, 2022 to 13.9% during the week of August 9, largely driven by reduced demand for Australia's coal and natural gas exports. This trend is clearly reflected in the weekly moving average of the S&P GSCI Energy & Metals spot price index, which is strongly correlated with Australian corporate profits (*Fig. 7*).

(4) *Brazil's oil exports to surpass soybeans*. Brazil continues to be a major exporter of agricultural and mineral commodities. As of June 2024, its *top exports* were soybeans, crude petroleum, and iron ore.

A shift has occurred in Brazilian resource exports post-pandemic. In November 2021, the 12-month sum of iron ore exports ($45.3 billion) exceeded soybean ($37.4 billion) and crude oil exports ($29.2 billion), respectively. By July 2024, crude oil and iron ore had switched places: crude oil ($48.2 billion), soybeans ($48.1 billion), and iron ore ($32.7 billion) (*Fig. 8*).

Severe spring flooding in Brazil, particularly in Rio Grande do Sul, significantly dampened soybean production and exports. What will happen to the supply/demand balance when soybean production recovers from the flooding remains uncertain.

Since peaking at the end of 2021, Brazil's iron ore exports have seen reduced demand from China, mirroring the slowdown in China's economy. However, demand began to rebound in July 2023 as China started supporting its property sector. Meanwhile, Brazil's oil exports have surged along with record production in its oilfields. Whether this trend will continue is uncertain; a state-led *push* toward renewables in the oil sector could hinder future production.

(5) *Brazil benefits from shift in mix*. The MSCI Brazil forward profit margin has improved in 2024, supported by the shifting composition of exports. In recent months, the forward profit margin has become more correlated with stable crude oil prices than falling soybean prices (*Fig. 9*).

(6) *Canada's oil expansion*. In June 2024, Canada's merchandise exports climbed by 5.5%, the largest monthly increase since February 2024, driven by increased crude oil and unwrought gold shipments, *according* to Statistics Canada. Canada's energy product exports, while still below their January 2023 global energy crisis peak, remain historically high. The expansion of the Trans Mountain pipeline, which began its first shipment on May 22, has boosted crude oil exports to Asia. Additionally, Canadian metals exports have steadily risen since the pandemic, fueled by strong global demand amid ongoing geopolitical tensions (*Fig. 10*).

(7) *Canadian profits resilience*. Canadian corporations have maintained strong profitability in 2024, buoyed by rising oil export volume and stable oil prices. The Canada MSCI forward profit margin is correlated with the weekly moving average of the S&P GSCI crude oil spot price, which remains elevated by historical measures despite a downturn after the 2022 energy crisis high (*Fig. 11*).

Global Commodities II: ABC's Export Roundup by Key Trading Partner. China is the leading importer of exports from Australia and Brazil and the second largest from Canada. However, the US is far more critical to Canadian exports than China and is also a key market for Brazilian exports. China's recent property-driven economic slowdown, compared to the strength of the US economy, has contributed to the decline in demand for Australian energy exports and Brazilian soybeans, while Canada has benefited from its expanded oil pipelines and stable US demand for crude oil.

Australia and Brazil have more favorable trade terms with China than Canada does due to their free trade and bilateral trade agreements, respectively. While Canada has explored the possibility of a free trade agreement with China, strong public opinion and Canada's deep trade ties with the US—solidified by the United States-Canada-Mexico Agreement—have stymied a Canada-China agreement.

(1) *Australian & Brazilian exports tied to China*. China continues to be a crucial importer for Australia (37% of Australian world exports) and Brazil (31% of Brazilian world exports), but less so for Canada (4% of Canadian world exports), according to the IMF (*Fig. 12*). The values of Australian and Brazilian exports to China in US dollar terms have rebounded after a decline at the end of 2022 amid geopolitical tensions and China's economic slowdown (*Fig. 13*).

(2) *Canadian exports tied to US.* Canada is much more reliant on the US (78% of Canadian world exports) as an export partner than Australia (4%) or Brazil (11%) (*Fig. 14*). The US

dollar value of Canadian exports to the US exceeds that of Australian and Brazilian exports combined by hundreds of billions of dollars on a 12-month-rolling-sum basis (*Fig. 15*).

Strategy: S&P 500 Q2 Revenue & Earnings Surprise Results. On Monday, Home Depot posted the first of the S&P 500 companies' results for fiscal quarters ended in July, leaving 9% of 500 companies left to do so. Over the weekend, S&P and I/B/E/S compiled Q2's near-final revenues- and earnings-per-share (RPS and EPS) data by S&P 500 sector, which we use to derive profit margins.

Let's see how the S&P 500 and its 11 sectors did during Q2:

(1) S&P 500 *Q2 EPS: S&P vs I/B/E/S.* S&P 500 Q2 operating EPS rose to a quarterly record high (of $60.19) for the first time since Q3-2023 according to I/B/E/S; the growth rate of 10.9% y/y was the highest since Q1-2022 and was positive for a fourth straight quarter. S&P's version of Q2 operating EPS was a record-high $58.86, up 7.3% y/y and positive for a sixth straight quarter.

(2) *S&P 500 Q2 revenue & earnings surprise metrics.* The S&P 500's meager revenues beat (relative to analysts' consensus forecasts) of 1.1%, unchanged from Q1's level, is among the weakest since the pandemic (*Fig. 16*). The 4.6% earnings beat is the lowest in six quarters and down from a 10-quarter high of 9.2% during Q1-2024 (*Fig. 17*).

Another measure we follow, the percentage of S&P 500 companies beating revenue forecasts, ticked down to a 17-quarter low of 59% from 60% in Q1. Revenue beats have been weak since Q2-2023 (*Fig. 18*). On the other hand, the percentage of S&P 500 companies beating earnings forecasts has remained relatively high over the past six quarters. It also ticked down q/q, but to 77.4% from 78.0% in Q1 (*Fig. 19*).

(3) *Revenue and earnings surprise by sector.* All 11 S&P 500 sectors beat earnings forecasts in Q2, and nine beat revenues estimates. Here's how the actual results so far compare to consensus forecasts: Real Estate (9.9% EPS surprise, 0.6% RPS surprise), Utilities (8.6, -2.9), Consumer Discretionary (6.8, 0.7), Financials (5.8, 3.5), Materials (4.9, 1.0), Communication Services (4.7, 0.1), Industrials (4.4, 0.6), Energy (4.3, 2.4), Health Care (3.3, 3.1), Consumer Staples (2.9, -0.4), and Information Technology (2.6, 0.9).

(4) *Revenue and earnings growth by sector.* Ten of the 11 S&P 500 sectors grew revenues y/y during Q2—the most since Q4-2022 and more than the seven that grew earnings, unchanged from Q1's count (*Fig. 20*).

Here are the sectors' blended y/y growth rates so far: Health Care (20.9% EPS growth, 9.1% RPS growth), Information Technology (18.7, 11.9), Financials (15.7, 7.1), Utilities (15.4, 5.1), Consumer Discretionary (8.7, 1.1), Communication Services (8.4, 9.5), Consumer Staples (2.0, 1.6), Energy (-0.1, 8.7), Real Estate (-1.6, 0.8), Industrials (-4.1, 1.0), and Materials (-9.7, -1.3).

(5) *Record- or near-record-high revenues for many sectors.* The S&P 500's Q2 revenues was just 0.3% below its record high in Q4-2023, powered by cross-sector breadth. Financials and Health Care posted new record highs and six others nearly did so: Communications Services, Consumer Discretionary, Industrials, Information Technology, Real Estate, and Industrials. All but Utilities saw q/q RPS improvement, way better than Q1's two sectors.

(6) *No sectors had record-high EPS.* Although the S&P 500's EPS hit a record high in Q2, no sector followed suit (for a second straight quarter), but five can nearly make that claim: Consumer Discretionary, Consumer Staples, Financials, Information Technology, and Real Estate (*Fig. 21*). On a positive note, EPS improved q/q for eight sectors, up from Q1's six. Three sectors saw EPS weaken in Q2: Communication Services, Information Technology, and Utilities.

(7) *Profit margins improve in Q2, but no record highs yet.* The S&P 500 companies' aggregate quarterly profit margin rose to a three-quarter high of 12.3% from 12.0% in Q1 (*Fig. 22*). Margins improved q/q for six sectors, but none hit a record high, the case for a third straight quarter. Not since Q3-2023 has any sector had a record-high quarterly profit margin (Consumer Discretionary and Financials did then). During Q2, higher AI revenues shrank profit margins for Communication Services and Information Technology.

The sectors' q/q profit margin readings: Real Estate (30.3% in Q2-2024, 30.6% in Q1-2024), Information Technology (25.1, 25.9), Communication Services (15.9, 18.5), Financials (14.6, 14.5), Utilities (13.6, 14.9), S&P 500 (12.3, 12.0), Materials (10.9, 9.4), Industrials (10.6, 8.7), Energy (9.3, 9.8), Consumer Discretionary (9.3, 8.1), Health Care (8.3, 6.6), and Consumer Staples (7.0, 6.9).

Calendars

US: Wed: Headline & Core CPI 0.2%m/m3.0%y/y & 0.2%m/m/3.2%y/y; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. **Thurs:** Retail Sales Headline &

Core 0.4%/0.1%; Wholesale Sales -0.6%; Industrial Production -0.2%; Capacity Utilization 78.5%; NY Empire State Manufacturing Index -5.9; Philadelphia Fed Manufacturing Index 5.6; Atlanta Fed GDPNow 2.9%; Business Inventories 0.3%; NAHB Housing Market Index 42; Initial Claims 235k; Import Prices -0.1%; Natural Gas Storage; Harke. (FXStreet estimates)

Global: **Wed:** Eurozone GDP 0.3%q/q/0.6%y/y; Eurozone Industrial Production 0.4%; UK Headline & Core CPI 2.3%/3,4%y/y; UK PPI Input & Output -0.3%/0.1%; Japan GDP 0.6%q/q/2.1%y/y; Japan GDP Price Index 2.6%y/y; China Industrial Production 5.3%y/y; China Retail Sales 2.6%y/y; China Unemployment Rate 5.1%; NBS Press Conference. **Thurs:** UK GDP 0.1%m/m/0.6%q/q; UK Headline & Manufacturing Industrial Production 0.1%/0.1%; Japan Industrial Production -3.6%; UK Labor Productivity -0.3%. (FXStreet estimates)

US Economic Indicators

NFIB Small Business Optimism Index (*link*): "Despite the increase in optimism, the road ahead remains tough for the nation's small business owners," notes Bill Dunkelberg, NFIB's chief economist. "Cost pressures, especially labor costs, continue to plague small business operations, impacting their bottom line. Owners are heading towards unpredictable months ahead, not knowing how future economic conditions or government policies will impact." July's *Small Business Optimism Index* (SBOI) rose for the fourth straight month, to 93.7—the highest reading since February 2022—after declining 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 31st consecutive month. In July, five of the 10 components rose, two fell, while three were unchanged. Contributing positively to the index in July were expect the economy to improve (+18ppts to -7%), plans to increase inventories (+4 to 2), sales expectations (+4 to -9), current job openings (+1 to 38), and now is a good time to expand (+1 to 5), while two contributed negatively, current inventory (-2 to -4) and earnings trends (-1 to -30). The remaining three components were unchanged—capital spending plans (at a net 23%), plans to increase employment (15), and expected credit conditions (-7). Inflation (25%) remained the *single most important problem* for small business owners in July, with quality of labor (19), taxes (16), cost of labor (9), and government regulations and poor sales, both at 8%, rounding out the top six. The net percentage of owners raising *selling prices* sank to 22% from 27% in June, while a net 24% plans price hikes in the next three months, down from 26% in June and 33% in March. Turning to *compensation*, a net 33% reported raising compensation in July, down from 38% in June, while a net 18% plans

to raise compensation in the next three months, down from 22% in June and matching May's rate.

PPI (*link*): Both the headline and core PPIs were below expectations in July. *Final demand* rose 0.1% in July (vs 0.2% expected), following no change in May and a 0.5% acceleration in April. July's yearly inflation rate was 2.2% (vs 2.3% expected), and easing from June's 2.7%, which was the highest since March 2023. It was at a recent low of 0.8% in November. *Core prices* were flat in July (vs 0.2% expected), with the yearly rate easing to 2.4% (vs 2.7% expected) and down from June's 3.0%. Excluding trade services from the core group, the rate edged up to 3.3% after easing from 3.4% in May (the highest since last April) to 3.2% in June. *Final demand services* in July fell 0.2%, the first decline this year, after rising 0.4% in both June and May and 0.6% in April—which matched January's gain, the biggest monthly increase since last July. Last month's decline can be traced to the index for final demand trade services, which sank 1.3%. The services' yearly rate eased to 2.6% in July, after accelerating from 1.8% at the end of last year, which was the lowest since January 2021, to 3.5% in June—which was the highest since February 2023. *Final demand goods* rose 0.6% in July, the most since February's 1.1%, after falling three of the prior four months by 1.0% over the period. Nearly 60% of July's gain can be traced to final demand energy, which rose 1.9%. The PPI for *personal consumption* eased for the second month, from May's 15-month high of 3.0% to 2.4% in July; it was at 0.9% in November. The yearly rate for *personal consumption excluding food & energy* rose from a recent low of 2.1% in November to 3.2% y/y in June—which was the highest since April 2023—easing to 2.6% in July. The former and latter reached record highs of 10.4% and 8.1%, respectively, in March 2022.

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