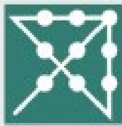
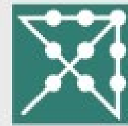


Yardeni Research



August 20, 2024

Morning Briefing

Global Growth Perspective: US Stands Out

Check out the accompanying chart collection.

Executive Summary: Not only isn't a recession headed down the pike, but the US economy is emerging from the pandemic tunnel with stronger potential GDP than it had prior to the pandemic. Today, Eric explains why he and Dr. Ed believe that potential GDP growth is 4.0% annually, more than twice FOMC members' latest consensus forecast for long-run real GDP of 1.8%. Why is the economy resetting at a higher level? The growing labor force and the productivity growth boom we expect—our Roaring 2020s thesis—provide tailwinds. … The global economy is also gaining steam, even though China's economy remains moribund.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

Global Growth I: Betting on US Growth. We've been describing much of the latest growth, inflation, and labor market data as reflecting a normalization to pre-pandemic trends rather than a freefall into a growth slowdown or recession. But while many of the good (and bad) pandemic-related distortions are fading, we believe that the US economy is not simply returning to where it left off pre-pandemic but actually resetting at a higher level. In other words, we think economic growth can remain stronger for longer without pressuring inflation higher. This has implications for US stocks, bonds, and commodities, both over the near term, as it affects what the Fed may do shortly, and over the longer term on a secular basis.

Tailwinds also appear to be emerging for the global economy, though with different winners and losers among countries and industries. China in particular doesn't appear to know how to rebuild from the rubble of its property bubble. But first, our perspective on the US economy.

A question we have been asking ourselves is whether America's potential growth has risen since before the pandemic. In other words, can the economy grow at a faster clip without

reigniting inflationary pressures? Our answer is “yes.”

This aligns with our views that: (1) strong immigration flows and record-high labor-force participation are growing the labor force (hence, the rise in the unemployment rate despite a healthy jobs market); and (2) productivity growth will boom over the rest of the decade as a result of widespread adoption of technologies like AI, automation, and robotics (as companies will need to augment their workforces with high tech despite the growing labor force).

This all sounds positive. Let's dig a little deeper into the data leading us to this conclusion:

(1) *Potential growth.* Empirically, potential GDP appears to have risen. Real GDP has been running around 3.1% y/y, its long-term average, as inflation has been falling to the Fed’s 2.0% target (*Fig. 1*). Productivity rose 2.7% y/y in Q2, suppressing unit labor costs to 0.5% y/y (*Fig. 2* and *Fig. 3*).

Potential GDP may be closer to 4.0%, well above the 1.8% long-run real GDP forecast in the FOMC's last *Summary of Economic Projections*. The forecasts will be updated at the September meeting of the Federal Open Market Committee (FOMC). Perhaps the FOMC members will realize that the economy is not operating above its potential and raise their forecasts. We aren't holding our breath.

(2) *Investment*. Productivity results from investment; business spending on software, R&D, and information process equipment has been soaring (*Fig. 4*). We expect the benefits of productivity-enhancing technologies to broaden from the picks-and-shovels providers (e.g., Nvidia) to non-tech companies, large-cap companies, and eventually to small- and medium-sized businesses as these tools are implemented.

During Walmart’s earnings conference call last week, management said the company used AI to catalog more than 850 million pieces of data, which would have required “nearly 100 times” its current headcount to complete in the same amount of time. This is just one example of AI being adopted and put into practice by non-tech companies.

(3) *Stock market breadth*. As non-tech companies within the S&P 493 (ex the Magnificent-7) increasingly find operational benefits from adopting AI, we expect the equal-weighted S&P 500 index to catch up to the market-weighted benchmark (*Fig. 5*). The companies that struggle to adopt these technologies will see margin compression from higher labor costs and lower returns on investments; they’ll likely limp through the rest of the decade (if AI-

adopting competitors don't put them out of business).

(4) *Higher for longer*. Higher potential GDP implies higher neutral interest rates, or levels consistent with a solid pace of growth and moderate inflation. That also implies that the federal funds rate (FFR) at its current level is likely not restrictive enough to spark a financial crisis on its own, and surely won't be as it is lowered. The speed at which the Fed raised the FFR in 2022 and 2023 was responsible for the mini banking crisis much more than the level of the FFR itself.

This means that the roughly 100bps of rate cuts priced into FFR futures over the next six months are highly unlikely (*Fig. 6*). From a rates perspective, 3-month SOFR futures are pricing in a deep cutting cycle next year (*Fig. 7*). Hawkish Fed comments and the perception that higher rates will cause a financial accident could further invert the spread between the December 2024 and 2025 contracts in the coming months. However, a steepening (disinversion) of this spread is a likely outcome within our stronger-for-longer economic outlook.

Global Growth II: The Rest of the World. We continue to prefer the US financial markets to those of the rest of the world, which we call our *Stay Home* investment bias. Still, mounting evidence suggests the global economy could be gaining steam:

(1) *Global growth barometer (GGB)*. Our GGB averages the CRB raw industrials spot price index and the price of a barrel of Brent crude oil, which are highly sensitive to global economic growth. It's been moving sideways for the past two years (*Fig. 8*).

China's depressed economy is weighing on commodity demand and suppressing this metric. Even so, the MSCI All Country World stock index has charged 45% higher in local terms and 48% higher in dollar terms since its lows in October 2022. Excluding the US, the global stock index is up 38% over the same period.

(2) *Global production*. Global industrial production hit a new all-time high in May, for which the latest data are available (*Fig. 9*). It rose 1.8% y/y during May, near the historical average since China's entry into the World Trade Organization (WTO) in 2001 (*Fig. 10*). Emerging economies increasingly are becoming the world's largest producers, as production in OECD countries has been flat or declining for several years (*Fig. 11* and *Fig. 12*).

Production in the Eurozone, led by Germany, is cratering (*Fig. 13*). Laden with red tape, high labor costs, and an austere budget, German manufacturing is struggling to compete

with emerging markets. Meanwhile, South Korea and Taiwan are supplying the world with semiconductor chips, boosting Asia ex-China production.

(3) *Trade upswing*. The volume of global exports has been growing marginally this year, though the sum of real US exports and real US imports rose 6.4% in June (*Fig. 14*). The two series are highly correlated, suggesting that global trade is set to swing higher.

(4) *Global monetary growth*. Outside of China and Japan, money supply is starting to rise in most countries (*Fig. 15*). As global central banks wind down their tightening programs and cut interest rates, increased liquidity should help prevent financial crises from percolating.

(5) *Global fundamentals*. Some global stock markets have macroeconomic tailwinds at their backs, but do they have the earnings to support an investment consideration?

Forward revenues per share of the MSCI All Country World Ex-US index is starting to rise (in local currency) again after flattening for a couple years (*Fig. 16*). Japan has been a major contributor and perhaps distorted this metric, thanks to both its stock market strength and yen weakness.

Emerging markets and the developed world both are seeing increasing forward earnings per share, though earnings in developed markets such as the EU and UK are decelerating (*Fig. 17* and *Fig. 18*).

Global Growth III: China Is Flagging. We remain bearish on the Chinese stock markets, not just because of our aversion to a regime with such tight control over its capital markets and economic outcomes. China is stuck between a rock (domestic property recession) and a hard place (inability to stimulate demand). The Chinese Communist Party has resorted to telling the rocks to move:

(1) *Weak stimulus*. Chinese bank loans and M2 have cratered, falling to their lowest levels in at least two decades (*Fig. 19*). With US rates remaining historically high, China risks financial outflows if it eases too much. Meanwhile, China's foreign direct investment over the last 12 months is down 29% y/y, as capital has to stay home to avoid defaults from local government financing vehicles and therefore municipalities.

(2) *Weak domestic demand*. China retail sales are flailing, falling below industrial production, as the government has propped up its export sector but mostly ignored its consumer sector (*Fig. 20*). Dumping cheap goods into the global economy has hurt Chinese

companies' profit margins and led to weak industrial profits (*Fig. 21*).

(3) *Negative wealth effect*. The property bubble bust crushed the wealth of Chinese nationals, forcing them to retrench and pull back on spending. The Shenzhen real estate stock index remains in a multi-year bear market (*Fig. 22*).

(4) *Falling rates*. Rapidly declining interest rates aren't encouraging investment or spending, as the economy is overleveraged. Instead, households are investing in government bonds with few other places to put their capital, pushing rates further down (*Fig. 23*). The government is even now "encouraging" bond buyers to renege on transactions to prevent a bubble. The government has limited room to stimulate China's economy out of this hole.

(5) *Exporting deflation.* Chinese M1 money-supply growth (the most liquid assets investable immediately) tends to lead Chinese PPI by a year (*Fig. 24*). With the former making new lows, the latter should continue deflating and putting downward pressure on US import prices.

Calendars

US: Tues: Weekly Crude Oil Inventories; Barr; Bostick. **Wed:** MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; FOMC Meeting Minutes. (FXStreet estimates)

Global: Tues: Eurozone Headline & Core CPI 0.0%m/m/2.6%y/y & -0.2%m/m/2.9%y/y; Germany PPI 0.2%; Buba Monthly Report; Canada CPI 0.4%m/m/2.2%y/y. **Wed:** Japan M-PMI Flash Estimate 49.8; Canada PPI -0.5%; Canada RMPI -0.9%. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): LargeCap's forward earnings rose 0.1% w/w to a new record high. It has achieved new record highs for 33 straight weeks and in 44 of the 49 weeks since mid-September; last week now matches the lengthiest string of record-high forward earnings for LargeCap in six years (since the March 16 week of 2018, when it hit record highs for 34 straight weeks). MidCap's declined for a third straight week, falling 0.2% w/w to 2.2% below its record high in early June 2022, but has risen in 17 of the past 22 weeks. SmallCap's fell for a second straight week, declining 0.2% w/w to 10.0% below its

mid-June 2022 record, but has posted gains in 16 of the past 23 weeks. Through the week ending August 9, LargeCap's forward earnings has soared 17.7% from its 54-week low during the week of February 1, 2023; MidCap's is 6.3% above its 55-week low during the week of March 10, 2023; and SmallCap's is 4.1% above its 72-week low during the March 17, 2023 week. These three indexes' forward earnings downtrends since mid-2022 have been relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Their forward earnings momentum has improved from three-year lows just over a year ago, but LargeCap's is improving faster than the SMidCap's. Here are the latest consensus earnings growth rates for 2024 and 2025: LargeCap (9.5%, 15.2%), MidCap (0.2, 17.3), and SmallCap (-6.6, 19.0).

S&P 500/400/600 Valuation (*link*): Valuations were higher during the August 16 week for these three indexes, but remain at near recent multi-year highs. LargeCap's forward P/E rose 0.8pt w/w to a four-week high of 20.9 from a 14-week low of 20.1. That's just 0.5pts below its 30-month high of 21.4 during the July 12 week, but is up 3.9 pts from a seven-month low of 17.0 during the October 27 week. It's now up 5.8pts from its 30-month low of 15.1 at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E rose 0.4pt w/w to 15.4 from a five-week low of 15.0, but is down from a 17-week high of 15.7 during the July 26 week. It's down 0.6pt from a 27-month high of 16.0 at the end of March and up 3.1pts from a 12-month low of 12.3 at the end of October. These compare to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E gained 0.4pt w/w to 14.9 and is down from a 32-month high of 15.4 during the July 26 week. It's up 4.3pts from its 14-year low of 10.6 in September 2022 and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's 26% discount to LargeCap's P/E is up from a 25-year-low 29% discount during the July 5 week. It had been at a 19% discount during the March 2, 2023 week, which was near its best reading since October 14, 2021. SmallCap's 29% discount is up from a 24-year low 34% discount during the July 5 week. That compares to a 20% discount during the March 2, 2023 week; that one was near its lowest discount since August 2021. The SMidCap's P/Es had been mostly above LargeCap's from 2003 to 2018.

US Economic Indicators

Leading Indicators (*link*): Leading Economic Indicators (LEI) fell again in July, not posting

a gain since February 2022 (29 straight months). The LEI sank 0.6% in July, following a 0.2% decline in June and a 0.5% setback in May. The LEI is down 15.3% from December's 2021 record high, falling below the prior-cycle low recorded during April 2020—sinking to its lowest level since November 2016 in July. Over the six months through July, the LEI fell 2.1%, smaller than the 3.1% drop over the six-month period between July 2023 and January 2024. According to the report, the six-month annual growth no longer signals recession ahead. Of the 10 components of the LEI, five contributed negatively, while two contributed negatively; jobless claims (0.00), consumer goods orders (0.01), and nondefense capital goods orders ex-air (0.01) were neutral. ISM new orders (-0.17ppt) was the biggest drag on the LEI in July, followed by the interest-rate spread (-0.14), consumer expectations (-0.13), the average workweek (-0.12), and building permits (-0.12). Partially offsetting these declines were the leading credit spread (0.11) and stock prices (0.09).

Coincident Indicators (*link*): The Coincident Economic Indicators (CEI) index was unchanged at June's record high in July. July's flat reading in the CEI followed gains of 0.2% and 0.4% during June and May, respectively. The CEI fell 0.1% in April, only the third decline posted during the past 20 months through July. The CEI expanded 0.9% during the six-month period between January and July of this year, an acceleration from the 0.5% growth rate over the previous six-month period. Three of the four components of the CEI—payroll employment, real personal income less transfer payments, and real manufacturing & trade sales—all increased again in July, while industrial production posted its largest negative contribution to the CEI since the start of the year. Production was the largest positive contributor the prior couple of months.

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