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Morning Briefing

On Going Global, Volatile Oil & Earnings Revisions

Check out the accompanying chart collection.

Executive Summary: While we recommend a "Stay Home" versus "Go Global" investment allocation approach, we note that the EU MSCI is trading at a big discount to the US MSCI. But challenges constraining economic growth do abound in Europe. Today, Eric surveys the investment fundamentals vis-à-vis valuations in both EU and EM stock markets, finding the latter more attractive. … Also: Melissa surveys the forces making for a volatile global oil market. … And Joe updates us on the latest batch of analysts' net estimate revisions data for August—a month that saw net earnings estimates rise as net revenues estimates fell.

Global Economy I: Europe's Viral Malady. Our overarching global investment allocation theme is still to *Stay Home* versus *Go Global*, i.e. to overweight the US in global portfolios. The US economy is on better footing than the rest of the developed world. Its capital markets are the most robust, well capitalized, and well regulated globally as well. Despite our concerns about America's reckless path of fiscal policy, we do not see a comparatively better fiscal outlook abroad.

While the S&P 500 and Nasdaq Composite have been winning bets for a decade-plus, diversifying geographically has its benefits. Many of our accounts based in other domiciles ask for our thoughts on their home markets. Emerging market (EM) plays, given the convexity of their potential upside, also attract much interest.

While we use consensus estimates for quarterly corporate results to gauge the outlook for the US economy, we especially rely on analysts' estimates for revenues and earnings abroad as barometers for those countries' growth trajectories. Forward revenues and earnings tend to be highly correlated with actual earnings and economic growth, which is helpful for regions with less robust, or less current, economic metrics.

With that said, here are our thoughts on select global markets, via their MSCI indexes:

(1) *European fundamentals*. The Eurozone forward revenues per share (RPS) rapidly surpassed that of the US during the pandemic; however, that growth has petered out, while US forward revenues continues to hit new records (*Fig. 1*). UK forward RPS has remained below pre-pandemic levels for the better part of the last three years (*Fig. 2*). Analysts see the associated earnings growth in the Eurozone fading as well, evidenced by halting forward EPS. UK forward EPS has remained stagnant (*Fig. 3*).

The outlooks for both revenues and earnings in Europe suggest a weakening economic trajectory. Political instability, fiscal restraint, and strict regulatory environments further encumber Europe's growth prospects. On the country level, forward stock market metrics are unenticing. Southern Europe's recent economic outperformance may not be sustainable, now facing a weaker dollar and waning tourism while being inextricably linked to northern Europe's bureaucrats (*Fig. 4*).

The European Union (EU) MSCI is trading at 12.8 forward earnings, cheap relative to history (*Fig. 5*). So perhaps that's attractive to some investors who are struggling to stomach paying 21.6 times forward earnings for US stocks.

France has been the standout in terms of economic growth, and investors pay the associated premium for its earnings relative to the rest of Europe (*Fig. 6*). Meanwhile, French forward RPS is declining, while forward EPS and profit margins have been flat for several years, and earnings revisions have been deeply negative in recent months (*Fig. 7* and *Fig. 8*). Germany's forward EPS is actually at a record high, but the outlook is grim enough that investors apply a 11.9 times forward P/E on its stock market.

Across the English Chanel, the UK's forward metrics look even worse (*Fig. 9*).

(2) *Eurozone's challenges*. One reason we're still cautious on the Eurozone is weak productivity. A very inflexible labor market along with regulatory barriers to innovation create a wide gap between productivity growth in the US and Eurozone (*Fig. 10*). The relationship between employers and employees is tighter due to EU laws, hampering labor from shifting to where it is needed despite the monetary union putatively encouraging labor flows across borders.

Generally, the EU strings up a lot of cumbersome red tape, preferring to tax US businesses rather than create their own. Brussels is also embarking on a campaign to rein in individual country's finances. One reason that France's economy has been growing faster than those of its neighbors is fiscal stimulus—that thrust will soon fade (*Fig. 11*). Polarization between

the far left and far right will further hinder fiscal spending and increases our worries that political priorities will be in constant flux and create volatility. Demographics only exacerbate the challenges (*Fig. 12*).

The UK—despite its fiscal, monetary, and regulatory border with the rest of Europe—doesn't look much better. Prime Minister Sir Keir Starmer warned that the autumn budget is "going to be painful," reported the *FT*. Higher taxes and growth trade-offs are the likely prescription for the UK's budgetary ailments. Internal social strife has also reheated.

Global Economy II: Opportunity in EMs? Emerging markets appear to have a much better setup. Forward RPS of the Emerging Market MSCI index surpassed that of the US MSCI in 2023 and hit continuous records (*Fig. 13*). Emerging market forward earnings have accelerated to a faster pace than US earnings growth (*Fig. 14*). That speaks to the convexity of EM outcomes. Profit margins tend to be more cyclical in emerging markets, but it's the only region that has kept up with margin expansion in the US (*Fig. 15*).

Two of the biggest beneficiaries of the artificial intelligence boom have been emerging markets—Taiwan and South Korea. They are the third and fourth largest countries in the MSCI regional benchmark, respectively. Recent pullbacks in their respective valuations haven't coincided with a deterioration in their fundamentals. Consider:

(1) Taiwan. Taiwan's forward revenues has been notching continuous new records; its forward EPS has been climbing toward a new all-time high, and its forward profit margins have been rising (*Fig. 16*). Analysts expect Taiwanese companies to grow earnings by more than 22% annually over both the short- and long-term (*Fig. 17*). The Taiwan MSCI index is trading at just 17.3 times forward earnings, down from above 20 times in recent months.

(2) *South Korea*. South Korean stocks haven't risen sustainably for the past few years. However, its forward EPS recently hit a new all-time high, and its net earnings revisions were positive in August (*Fig. 18* and *Fig. 19*). The South Korean MSCI index trading at just 8.7 times forward earnings with 39% annual growth expected long term (*Fig. 20*).

(3) *Weaker dollar*. Thriving export sectors, particularly in the semiconductor industry, have benefited both nations' economies. The weakening dollar, thanks to Fed rate-cut expectations, is ostensibly a barrier. We believe the US demand for their exports is highly inelastic however, and onshore production is likely still more expensive.

(4) *Geopolitics*. The biggest barrier to investing in South Korea or Taiwan is geopolitics.

China’s economy is in a rut, and the Chinese Communist Party (CCP) has no obvious answers to solve it. Gold purchases are soaring among retail investors given concerns about bad credits and few viable property investments. As poorly written loans fail to spur enough consumption or investment to clear the cost of borrowing, and overleverage prevents debt-financed growth, China’s economy will continue to languish (*Fig. 21*). That could be leading to the increased provocations in Taiwan—while South Korea borders one of China’s closest allies. There’s perhaps a good reason that stocks in East Asian EMs are cheaper than the fundamentals would lead one to expect.

Global Oil: Marked by Volatility. Concerns about the global economy's health are resurfacing, as highlighted in the International Energy Association’s (IEA) August 2024 oil market *report*. Global oil demand remains relatively weak. The gradual shift toward renewable energy sources could further dampen oil demand.

Meanwhile, ongoing geopolitical tensions in the Middle East have intensified supply concerns, supporting oil futures prices. Conflicts in critical oil-producing areas are intensifying supply worries.

Global oil supply should continue to more than cover expected demand growth, keeping prices stable. Nevertheless, oil market investors may be assigning too low of a geopolitical risk premium to oil prices, which could increase volatility when geopolitical tensions and conflicts worsen:

(1) *Price fluctuations from economies to geopolitics*. In July, Brent crude oil spot prices fell sharply due to weak global economic indicators. However, as of Monday, prices rose to $81.43 per barrel, driven by disruptions in Libyan oil production and escalating conflicts in the Middle East (*Fig. 22*).

Libya’s eastern government announced a shutdown in oil production and exports, CNBC *reported* on Monday. Libya produces about 1.2 million barrels per day, exporting more than 1.0 million bpd to the global market. The disruption is benefiting US crude oil as European buyers seek alternatives to Libyan supply.

Ongoing conflicts in the Middle East have intensified the oil market’s volatility. Iran has threatened to retaliate against Israel.

(2) *Shifting production dynamics*. Global oil supply reached 103.4 million barrels per day (mb/d) in July 2024, marking an increase of 230,000 barrels per day (kb/d), according to the

IEA's update. This increase was due to elevated OPEC+ production offsetting declines in non-OPEC+ production (*Fig. 23*).

Future supply expansion is expected to accelerate, with non-OPEC+ countries largely driving the increases. IEA projects non-OPEC+ production to rise by 1.5 mb/d in 2024 and again in 2025, reflecting their growing global energy influence. If voluntary cuts stay in place, OPEC+ production is anticipated to decline by 760 kb/d in 2024 but may increase by 400 kb/d in 2025. Voluntary production cuts should begin to unwind during Q4.

The contrasting strategies of OPEC+ and non-OPEC+ producers may lead to increased market fragmentation and competition, particularly if OPEC+ adjusts its output in response to rising non-OPEC+ production.

Libya's production halt introduces additional uncertainty into the supply equation. Iran, Libya, and Venezuela are exempt from the latest voluntary curbs.

During his tenure, US President Joe Biden has flip-flopped on sanctions over both *Iran* and *Venezuela*, both of which have boosted their oil production during his term (*Fig. 24* and *Fig. 25*). Domestically, Biden has promoted a transition to renewable energy, yet US oil production has hit *record* levels under Biden. Increased US oil production has helped keep gas prices low (*Fig. 26*).

(3) *Green transition & EVs slowing global oil demand*. Global oil demand increased by 870 kb/d in Q2-2024, according to IEA data. The agency forecasts that demand growth will decelerate, with increases of less than 1 mb/d anticipated for 2024 and 2025 following much stronger growth of 2.1 mb/d in 2023. This slowdown is attributed to weaker macroeconomic conditions, including diminished industrial activity and a sluggish recovery in China. Demand in advanced economies, including in the US, has demonstrated resilience in recent months.

The rise of electric vehicles (EVs) is significantly reshaping global oil demand. A 2023 Nasdaq *article* noted that the IEA estimates around 60.0% of global oil demand is driven by transportation. EVs are displacing approximately 1.5 million barrels of oil per day. Electric cars are expected to displace around 2.5 million barrels of oil demand daily by 2025.

(4) *Supply to continue to outpace demand*. Global supply is expected to more than cover the slowed demand for oil next year even with the OPEC+ production curbs. The IEA expects global inventories will build by an average of 860 kb/d next year, assuming that the

cuts remain in place.

Strategy: EPS Estimate Increases Outweigh RPS Decreases. Last week, LSEG released its August snapshot of the industry analysts' consensus RPS and EPS estimate revisions activity over the past month. With these data, we create our Net Revenues Revisions Index (NRRI) and Net Earnings Revisions Index (NERI), captured in our *S&P 500 NRRI & NERI* report. There, a zero reading indicates that an equal percentage of estimates were raised as were lowered over the past three months, which encompasses an entire quarterly reporting cycle. Since analysts tend to revise their estimates to different degrees at different points in the three-month cycle, the three-month data are less volatile than a monthly series.

Below, Joe highlights what's most notable about the August crop of revisions data:

(1) *S&P 500 NERI still positive, but weaker m/m.* The S&P 500's NERI index was positive in August for a third straight month following six negative readings but weakened for the first time in seven months to 1.3% from a 27-month high of 2.2% in July (*Fig. 27*). However, it's still above the average reading of -1.9% seen since April 1985, when the data first were calculated.

(2) *Most sectors still have positive NERIs, but fewer improving m/m.* An impressive eight of the 11 S&P 500's sectors had a positive NERI in August. That compares to nine sectors with a positive reading in June and July, which was the highest in 30 months dating back to March 2022. Looking at August NERI data, just four of the 11 sectors' NERIs improved m/m (Consumer Discretionary, Information Technology, Real Estate, and Utilities), down from seven in July and 10 in June. The longest positive NERI streak, seven months, belongs to Information Technology, followed by Financials (six) and Health Care (five).

Here's how NERIs ranked for the S&P 500 and its 11 sectors in August: Information Technology (4.6%, 11-month high), Health Care (2.2), Consumer Discretionary (1.8), Utilities (1.8, 22-month high), Industrials (1.7), S&P 500 (1.3), Real Estate (0.9, 12-month high), Financials (0.8), Communication Services (0.7), Materials (-0.6), Energy (-2.6), and Consumer Staples (-3.3).

(3) *S&P 500 NRRI index for revenues still negative and at six-month low.* The S&P 500's NRRI index weakened to a six-month low of -2.5% in August from -1.5% in July (*Fig. 28*). August's negative reading was its ninth straight after eight positive monthly readings through November. The S&P 500's NRRI is below the average -0.1% reading since it was

first compiled in December 2004.

(4) *NRRI index positive for five sectors, but even fewer are improving.* Only four of the 11 S&P 500 sectors saw NRRIs improve m/m—the fewest in seven months. Sectors recording stronger NRRI readings m/m in August: Communication Services, Consumer Discretionary, Information Technology (its fourth straight month of improvement), and Utilities. Financials is on the longest positive NRRI streak, seven months, followed by Health Care (six). Materials has the longest negative NRRI streak at 24 straight months, followed by Consumer Staples (11) and Consumer Discretionary (nine).

Here's how the NRRIs of the S&P 500 and its sectors ranked in August: Real Estate (2.4%), Health Care (2.2), Financials (0.6), Information Technology (2.8, 26-month high), Energy (0.8), S&P 500 (-2.5, six-month low), Utilities (-2.7, six-month high), Consumer Discretionary (-5.9), Industrials (-6.0, 19-month low), Communication Services (-6.9), Materials (-8.9), and Consumer Staples (-10.6).

Calendars

US: Wed: MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Bostic; Waller. **Thurs:** GDP & GDP Price Index 2.8%/2.3%; Real Consumer Spendin 2.3%; Headline & Core PCED 2.6%/2.9%q/q; Jobless Claims 234k; Wholesales Inventories 0.2%; Pending Home Sales 0.2%; Fed's Balance Sheet; Natural Gas Storage; Bostic. (FXStreet estimates)

Global: Wed: Germany Gfk Consumer Climate -18.1; France Consumer Confidence 92; Italy Industrial Sales; Eurogroup Meetings; Japan Leading & Coincident Indicators -2.6%-3.4%. **Thurs:** Eurozone Business and Consumer Survey 95.9; Germany CPI 0.0%m/m/2.3%y/y; Spain CPI 0.2%m/m/2.5%y/y; Japan Industrial Production 3.7%; Japan Retail Sales 0.5%; Japan Unemployment Rate 2.6%; Japan Household Confidence 36.9; Eurogroup Meetings; Lane; Nagel; Schnabel. (FXStreet estimates)

US Economic Indicators

Consumer Confidence (*link*): "Overall consumer confidence rose in August but remained within the narrow range that has prevailed over the past two years," noted Dana Peterson,

chief economist at the Conference Board. *Headline consumer confidence* rose for the second month to 103.3 in August, after slipping from 101.3 in May to 97.8 in June. It was at 97.5 in April, which was the lowest reading since July 2022. The *present situation* component edged up to 134.4 this month after dropping five of the prior six months, from 154.9 in January to 133.6 in July, which was the lowest since April 2021. Meanwhile, the expectations component advanced in three of the past four months, from 68.8 in April to 82.5 this month—the highest since last August. Consumers' assessments of *current business conditions* were more positive in August, with 20.8% saying business conditions were good, up from 19.2% in July, while 17.7% viewed business conditions as bad, down from 18.2% in July. *Turning to the labor market*, consumers' appraisals deteriorated again in August, with 32.8% saying *jobs were plentiful*, down from 33.4% in July, while 16.4% said *jobs are hard to get*, an uptick from July's 16.3%. Consumers' assessment of *short-term business conditions* six months from now was more optimistic again in August, with 18.4% of consumers expecting business conditions to improve, up from 15.2% in July, while 15.6% expect business conditions to worsen, down from 16.2% in July. Consumers' assessment of the *short-term labor market* was slightly less optimistic this month, as 16.1% of consumers expected more jobs to be available, up from 15.2% in July, though 17.5% anticipated fewer jobs, up from 16.4% in July. Consumers' assessments of their *income prospects* were more pessimistic this month: The percentage of consumers expecting their incomes to improve fell to 16.9% in August from 17.2% in July, while the percentage expecting their incomes to decrease climbed to 12.7% from 11.6% in July. As for *inflation expectations*, the 12-month expected inflation rate sank to 4.9%—the lowest since March 2020, consistent with slower overall inflation, though mentions of prices and inflation topped write-in responses. Meanwhile, the share of consumers expecting *higher interest rates* over the next 12 months eased for the third straight month to a six-month low of 46.5%, while the share expecting *lower rates* increased to 31.5%—the highest since April 2020.

Regional M-PMIs (*link*): The *Richmond Fed* has now released manufacturing data for August and reported manufacturing activity contracted at a faster rate, posting its weakest reading since the pandemic. 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* posted its first negative reading since the start of this year, with the general activity index plummeting 20.0 points to -7.0. *Kansas City's* data showed manufacturing activity declined at a slower pace than in July, while expectations for future activity remained positive. Looking at August's *Richmond survey*, the composite manufacturing (to -19 from -17) fell deeper into contractionary territory, led by new orders (-26 from -23) and employment (-15 from -5), which continued to deteriorate. The shipments (-15 from -21) measure continued to contract, though at a slightly slower pace. Firms grew

less optimistic about local business conditions this month, while the index for future local business conditions (-18 from 7) took a sharp swing into negative territory. Meanwhile, the expectations components were more favorable, with both the shipments (23 from 21) and new orders (14 from 20) remaining solidly in positive territory, though employment (-7 from 3) showed job cuts.

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