Yardeni Research

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Morning Briefing

GDP vs GDI Debate; Mexico's Failing Democracy

Check out the accompanying chart collection.

Executive Summary: If you've heard that Gross Domestic Income is a better measure of economic activity than Gross Domestic Product, forget it. The two are sending divergent signals currently, with the former much weaker than the latter; but GDP is the one we trust the most currently. Eric explains why. … The US economy has become less interest-rate sensitive than it's been in the past, so another thing to forget about are the "long and variable lags" before the economy reacts to the latest round of tightening. They're not coming. … Also: Melissa updates us on the Mexico's stock market and political developments, warning investors to tread carefully there.

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

US Economy I: The GDP Vs GDI Debate. As you might know, Debbie, Eric and I have been bullish on US economic growth for some time. We've been bullish on US equities since early November 2022. As we discussed in yesterday's *Morning Briefing*, our productivity-led Roaring 2020s scenario was confirmed at the end of last week by the upward revision to Q2's real GDP growth and by July's personal income and outlays data. Neither was enough to dampen the pessimism of the economy's "nattering nabobs of negativity" (to quote former Vice President Spiro Agnew). Below, we discuss their latest protestations:

(1) *In GDP we trust*. Many pessimistic prognosticators correctly observe that Gross Domestic Income (GDI)—which measures economic activity via income such as wages and profits—was much lower than GDP last quarter. Real GDP rose 3.0% (saar) in Q2, while real GDI increased by 1.3%. That's the largest gap between the two since Q1-1993, and before that, Q1-1980 (*Fig. 1*).

In the past, wide discrepancies between the two sometimes have been followed by downward revisions in GDP. Many bears are seizing on that fact to claim that GDI more accurately measures economic output. However, GDP has often been well above GDI without a recession emerging or very close to GDI ahead of a slowdown. If 1.3% real GDI is concerningly low, then surely the -3.0% print in Q4-2022 followed by two quarters of real GDI below 0.5% should have heralded a recession (*Fig. 2*). Hardly: Since then, employment has risen to new records, wage growth is accelerating faster than inflation, and the S&P 500 has climbed to new all-time highs.

The Bureau of Economic Analysis (BEA) has found no predictive value in initial estimates of GDI and subsequent revisions to GDP. Most official organizations recommend averaging GDP and GDI during the initial estimate phases for the best read on the state of the economy; the resultant 2.1% quarterly annualized growth would be consistent with our positive outlook. The Atlanta Fed *GDPNow* model is forecasting 2.5% Q3 GDP, another signal that the economy is growing at a solid pace.

Periods when GDP beats GDI tend to be followed by periods of the inverse, so GDP and GDI equal out over time. That could very well be the case this time around. However, we believe GDI has persistently undershot GDP in the post-pandemic period for structural reasons. Namely, the interest component of GDI is poorly calculated (*Fig. 3*).

(2) *Interest income.* GDI counts government interest expense on Treasuries, Fed reverse repurchase agreements (reverse repo), and interest on reserve balances (IORB) as interest paid rather than income. So these interest expenses weigh on GDI. In actuality, they are providing a massive amount of income to mostly domestic investors.

Net interest income has been a huge benefit to corporations and households alike. Personal net interest income ex-mortgage payments has risen to $1.3 trillion. Net interest payments for US nonfinancial corporations have fallen below 9% of profits, lows not seen since the 1960s (*Fig. 4*). Interest paid on reserve balances has been a huge boon for money-market fund (MMF) investors: More than $6.2 trillion of cash earns over 5.0% in MMFs. More than $2.5 trillion of those assets are owned by retail investors (*Fig. 5*).

(3) *New regime.* Why wasn't this an issue for GDI in the past? When the Fed runs an ample reserve regime, as it does today, the renumeration of cash holdings is significant. This was not the case before the Great Financial Crisis (GFC), when the Fed operated in a scarce reserve regime and allowed supply and demand to set short-term rates. Today, there is $3.3 trillion earning 5.4% annualized, overnight and risk-free (*Fig. 6*). The Fed doesn't have to fund these payments because they are booked to the deferred asset account—its line item of negative remittances to the Treasury Department. This is another example of how

past monetary tightening cycles offer poor analogies for the current environment.

US Economy II: Less Interest-Rate Sensitive. We are sticking with GDP as our preferred indicator of economic growth. With that said, let's look at what drives it and what has made it less interest-rate sensitive than in the past, thus reducing the likelihood that the so-called "long and variable lags" of monetary policy tightening will cause a recession soon:

(1) More than two-thirds of nominal GDP derives from personal consumption expenditures (*Fig. 7*). This has been fairly constant since the turn of the century, a time roughly coinciding with the Asian Financial Crisis, dot-com bubble, and China's entrance to the World Trade Organization. US consumers spent more as foreign capital rushed into the US, boosting their purchasing power and pushing down savings. But the makeup of consumer spending has shifted dramatically: Services have risen to nearly 46% of overall GDP, while goods have slimmed to 22%. Goods were consumed at a higher rate than services entering 1970s and still represented a quarter of consumption entering the 1990s. Goods consumption spiked during the pandemic but quickly returned to its recent share.

(2) Private fixed investment in intellectual property (IP) has more than doubled over the same period to 5.5% of GDP. Investments in software and R&D, the predominant subcategories of IP, have surged since the GFC (*Fig. 8*). IP's contribution to GDP now surpasses those of nonresidential equipment investment (which includes info processing equipment, another high-tech sector), residential investment, and structures. And that's excluding R&D that's booked overseas by US corporations for tax purposes. Software tends to be rented, requiring no large capital investment for the majority of companies using cloud services such as Amazon Web Services or Google Cloud.

(3) US consumers increasingly prefer services to goods, and US producers are providing more services or investing in high-tech sectors that require less financing. As the US economy shifts away from capital-intensive businesses, its sensitivity to higher interest rates decreases. It's no surprise that weakness in the goods producing sector, consistent with several years of the ISM M-PMI remaining below 50.0, hasn't made much of a dent in overall economic activity. It's also no surprise that higher interest rates haven't put inordinate pressure on US growth. We expect this to remain the case.

Mexico I: Mexican Muddle. Melissa and I first raised concerns about Mexican markets on May 29, noting that the once-promising economic indicators and the "nearshoring" narrative were losing their luster. The increasing grip of domestic organized crime and the growing influence of Chinese "backdooring" into Mexico were overshadowing these positive developments. Today, we're further outlining why investors should tread carefully before investing in Mexico domiciled companies:

(1) *Liquidity mirage*. One of our contacts, a former Mexican equity analyst, corroborates our concerns, highlighting that companies domiciled in Mexico are virtually uninvestable due to illiquidity. Dominant Mexican families retain major ownership, resulting in meager public float and daily trading volumes, even among top-market-cap firms. Additionally, the nearshoring narrative is facing significant infrastructure challenges, the analyst believes.

(2) *Market rollercoaster*. The Mexican stock market has experienced turbulent highs and lows this year, with high inflation and political instability damping investor enthusiasm (*Fig. 9*). Claudia Sheinbaum's imminent leadership as Mexico's president, starting October 1, is unlikely to restore confidence in the market.

(3) *Risky business*. Morgan Stanley Research's August note "Downgrade Mexico to Underweight" highlighted concerns about President Andrés Manuel López Obrador's (AMLO) proposed judicial reform. This reform is expected to increase Mexico's risk premium, *according* to the *WSJ.*

(4) *Authoritarian overtones*. AMLO's Morena party, with its progressive agenda, continues to wield significant influence, raising concerns about authoritarian tendencies. Under Morena rule, cartels have thrived and backdoor dealings have proliferated, further undermining investor trust.

(5) *Seat shuffle*. In the last election, Morena manipulated seat allocations to secure 74% control of the lower house despite winning only 54% of the votes. Critics argue that this maneuver undermines democracy. The judiciary tribunal, under AMLO's influence, is expected to decide whether Morena and its allies should be treated as a coalition.

(6) *Final act*. As AMLO's term winds down, he is pushing for sweeping reforms, including electing all judges by popular vote. If not enacted before his departure, the Morena party, under Claudia Sheinbaum, is likely to continue these so-called reforms. US Ambassador Ken Salazar and the American Chamber of Commerce in Mexico have *criticized* the reforms as a threat to judicial independence and a potential strain on trade relations with the US. Sheinbaum, however, defends them as a legitimate enhancement of democracy.

(7) *Musk's reality check*. Elon Musk, in his 2023 *biography* by Walter Isaacson, revealed why Tesla abandoned plans to build a new gigafactory in Mexico: Musk realized that

success would require moving engineering operations to Mexico to closely integrate them with production. He noted, “Tesla engineering will need to be on the line to make it successful, and getting everyone to move to Mexico is never going to happen.” Additionally, concerns over potential political instability and tariffs, especially if Donald Trump were to return to office, influenced the decision to keep key operations in the US.

Mexico II: Growth & Challenges. Mexico’s present economic situation shows both positive and challenging aspects. Although the country is experiencing strong GDP growth and steady job creation, a closer look reveals slowing industrial production and high inflation:

(1) *Growth and employment*. Mexico experienced modest but steady real GDP growth of 1.0% y/y in Q2 (*Fig. 10*). Although total employment increased that quarter, jobs growth has slowed this year (*Fig. 11*).

(2) *Inflationary pressures*. Inflation reached a rate of 5.6% y/y during July, fueled by *rising* labor costs and a stronger peso (*Fig. 12* and *Fig. 13*). The peso has moved up since early 2022, but it depreciated in recent months due to the uncertainty over the presidential election.

(3) *Industrial and export performance*. Mexico’s industrial and export sector growth is fragile. Industrial production saw a slight rebound in recent months after falling slightly from record highs during 2023 (*Fig. 14*). Total global exports from Mexico fell 1.1% y/y during the first four months of 2024, with oil exports down 8.7% and manufacturing down 0.7%, according to a July Dallas Fed Mexican economic *update*.

(4) *Trade with the US.* Trade with the US remains crucial, with two-way trade at a record $415.38 billion through June, reported an August 10 *Forbes* *article*.

Calendars

US: Wed: JOLTs Job Openings 8.00m; Factory Orders 4.5%; Trade Balance -$78.4b; MBA Mortgage Applications; Beige Book; API Weekly Crude Oil Inventories. **Thurs:** ADP Nonfarm Employment Change 136k; Initial Claims 225k; Nonfarm Productivity & Unit Labor Costs 2.3%/0.9%; ISM NM-PMI 50.9; S&P Global C-PMI & NM-PMI 54.1/55.2; Auto Sales; Fed’s Balance Sheet; Crude Oil Inventories & Gasoline Production. (FXStreet estimates)

Global: Wed: Eurozone, Germany, and France C-PMIs 51.2/48.5/52.7; Eurozone, Germany, France, and Italy NM-PMIs 53.3/51.4/55.0/52.4; Eurozone PPI 0.3%; UK C-PMO & NM-PMI 53.4/53.3; BoC Interest Rate Decision 4.25%; Mauderer; Elderson. **Thurs:** Eurozone Retail Sales 0.1%; Germany Factory Orders -1.6%; Japan Household Spending -0.2%m/m/1.2%y/y; Tuominen; Bullock. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): LargeCap's forward earnings rose 0.3% w/w to a new record high. It has achieved new record highs for 35 straight weeks and in 46 of the 51 weeks since mid-September; last week is now the lengthiest string of weekly record-high forward earnings for LargeCap in nearly 19 years (since the November 11 week of 2005, when it hit record highs for 42 straight weeks). MidCap's rose for a second week following three straight declines, gaining 0.2% w/w to 2.0% below its record high in early June 2022, but has risen in 18 of the past 23 weeks. SmallCap's fell for a fourth straight week, declining 0.3% w/w to 10.3% below its mid-June 2022 record. Through the week ending August 30, LargeCap's forward earnings has soared 18.3% from its 54-week low during the week of February 1, 2023; MidCap's is 6.7% above its 55-week low during the week of March 10, 2023; and SmallCap's is 3.8% 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 MidCap's and SmallCap's (a.k.a. "SMidCaps"). Here are the latest consensus earnings growth rates for 2024 and 2025: LargeCap (9.5%, 15.3%), MidCap (0.1, 17.2), and SmallCap (-7.8, 19.5).

S&P 500/400/600 Valuation (*link*): Valuations were relatively unchanged during the August 23 week for these three indexes, but remain at near recent multi-year highs. LargeCap's forward P/E was unchanged w/w at a seven-week high of 21.1 and is up 1.0pts from a 14-week low of 20.1 during the August 9 week. It's just 0.3ptbelow its 30-month high of 21.4 during the July 12 week, but is up 4.1pts from a seven-month low of 17.0 during the October 27 week. It's now up 6.0pts 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 was unchanged w/w at a 22-week high of 15.8. It's just 0.2pt below its 27-month high of 16.0 at the end of March and up 3.5pts 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 0.1pt w/w to 15.4 and is just a hair below its 32-month high of 15.4 during the July 26 week. It's up 4.8pts 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 25% 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

US Manufacturing PMI (*link*): "Demand remains subdued," noted Timothy Fiore, chairman of the ISM survey," as companies show an unwillingness to invest in capital and inventory due to [high interest rates] and election uncertainty." The *M-PMI* edged up to 47.2 in August after a four-month decline from 50.3 in March to an eight-month low of 46.8 in July. It was below the breakeven point between contraction and expansion for the 22nd time in the past 23 months. According to ISM, the *overall economy* continued its expansion for the 52nd month after a one-month contraction in April 2020. (A Manufacturing PMI above 42.5% over a period of time generally indicates an expansion of the overall economy.) Both the new orders (44.6 from 47.4) and *production* (to 44.8 from 45.9) measures fell deeper into contractionary territory in August. Meanwhile, factory *employment* (46.0 from 43.4) continued to contract, though at a slower pace. The *supplier deliveries* (50.5 from 52.6) measure remained above 50.0—a reading that indicates slower deliveries. *Turning to prices,* manufacturers faced higher input (to 54.0 from 52.9) prices in August, likely reflecting soaring freight rates.

Construction Spending (*link*): Construction spending fell short of expectations again in July, as higher mortgage rates and increased supply weighed on single-family homebuilding. Still, total spending remains in record territory. *Total construction spending* slipped 0.3% in July (vs an expected 0.1% loss), after showing no change in June from May's record high. Private residential investment declined 0.3% in June, with *new single-family homes* falling 1.9% and *new multi-family* units unchanged. Versus a year ago, however, the former increased 4.0%, while the latter sank 6.7%. *Private nonresidential* construction slipped 0.2% in July, led by declines in religious (-2.2%) and health care (-2.0) facilities; partially offsetting those declines were gains in water supply (2.0) and transportation (1.4) structures. Private nonresidential construction remains stalled at record highs. *Total public construction* spending ticked up 0.1%, only fractionally below May's record high; it's up 8.1% y/y.

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