Yardeni Research

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Morning Briefing

More On The Carry Trade, The Eurozone & Earnings

Check out the accompanying chart collection.

Executive Summary: While carry traders likely have more yen-funded positions to unwind, we're not worried about another bout of extreme market volatility as a result. We don't see the conditions that sparked the great unwinding exacerbating, Eric explains. The Bank of Japan is unlikely to tighten dramatically with the yen's recent strength helping to tame inflation there. The yen is unlikely to rise dramatically more, tethered by tamer inflation in Japan and strong economic growth in the US. … Also: Melissa reviews the Eurozone's daunting economic challenges. … And: Joe gives us an overview of the strong Q3 earnings that analysts are forecasting for the S&P 500, the Magnificent-7, and the "S&P 493."

Market Risk: How Worrisome Is the Carry Trade? We believe a further unwind of the yen carry trade caused US stocks to sell off last week. Some of our accounts have asked us about the risk of further selling pressure. We don't think the carry trade is fully washed out. That said, macroeconomic conditions in Japan and the US lead us to believe that a third episode of the carry trade unwind is unlikely or won't be extreme. Here's why:

(1) *Carry-trade refresher*. Carry traders borrow cheaply in low-yielding currencies like the yen to buy assets in higher-yielding currencies. Many of those who've recently been unwinding their positions had bought US dollars, used to fund purchases of US momentum stocks. Some used the leverage to buy Japanese stocks, such as those in the Nikkei 225, which is why Japan's equity markets suffered alongside the Nasdaq and S&P 500.

The yen carry trade opportunity emerged from the Bank of Japan's (BOJ) highly unconventional, and stimulative, monetary policy. Near-zero interest rates were maintained even as the rest of the world's central banks raised rates to multi-decade highs. That sank the yen to a historically low 162 against the US dollar earlier this year. Carry traders reveled—until the Fed was expected to lower US interest rates as the BOJ began to raise Japanese rates.

The spread between 10-year Japanese government bond (JGB) yields and US Treasury yields has narrowed from 381bpts at the end of April to 282bpts today, boosting the yen to below 143 per dollar (*Fig. 1*). Traders had to sell their US tech stocks and Japanese stocks to pay back their borrowed yen. The fact that they had levered positions, enabled by borrowed funds, exacerbated the impacts of the unwinding. That resulted in a stronger yen and weaker stocks than fundamentals suggested.

Accordingly, there's been a strong inverse correlation between the yen and the Nasdaq 100 since last year (*Fig. 2*).

(2) *How big is the carry trade?* Our proxy shows there's plenty of leverage left in the system. Foreign deposits (net short-term foreign liabilities) in Japanese banks reached a record ¥99.5 trillion in Q1-2024. That's down to ¥89.7 trillion, still larger than the ¥74.3 trillion that sat in Japanese banks three years ago. This series is highly correlated with the yen (*Fig. 3*).

Roughly $622 billion are in Japanese banks as short-term deposits. Time to panic? We aren't sweating. Those liabilities have grown just 20% (in yen terms) over the past four years, or by a third from the February 2020 level. We suspect that many of these deposits are structural. The generational carry-trade opportunity, which built up over more than a decade, isn't likely to evaporate even as both Japan's and America's central banks "normalize" monetary policy.

We'll hedge our optimism, though. Some commentators have pointed to data showing leveraged funds' taking futures positions tied to the yen, which declined from a huge short to basically neutral during the August volatility (*Fig. 4*). They say that data show the carry trade is behind us. We don't prefer that series to estimate the size of the carry trade. Levered funds using futures are primarily quant funds that follow trends—which no doubt contributed to "Carry Trade Unwind, Part I"—but they rode the final innings of the wave and do not represent the main carry traders.

(3) *Why we are not panicking.* The BOJ meets in the two days following the Federal Open Market Committee's interest-rate decision on September 18. We expect the Fed will cut the federal funds rate (FFR) by 25 bps, and eventually ease slower and by less than the financial markets currently expect. FFR futures show the policy rate dipping below 3.0% in a year's time. We doubt the easing cycle will be that extreme—barring a recession of course, which we do not foresee (*Fig. 5*).

The differential between US and Japanese bond yields has mostly been Fed-driven to this point. Weaker-than-expected US labor market data in particular have impacted yields and the yen. BOJ Governor Kazuo Ueda piled on recently by reiterating the BOJ's commitment to raising rates. But we don't expect Gov. Ueda to rebrand the central bank that's long been the world's most dovish into a hawk.

The BOJ might not need to do much more, anyway. Japanese inflation is heavily driven by imports. Japan's services CPI hit a peak of 2.3% y/y in November 2023 (*Fig. 6*). Goods CPI reached 7.2% in January 2023. After sinking to 2.1% at the start of this year, goods CPI has rebounded to 4.0% as of July. The weak yen raised the cost of imports such as food, energy, and manufacturing inputs. The yen has strengthened by roughly 12% in the past couple months—that should help keep inflationary pressures in check.

The yen carry trade was a vestige of the pandemic period of free money. As the BOJ has only just started monetary tightening, it makes sense that financial markets are coming under pressure. We expect tamer inflation pressures in Japan and stronger growth data in the US to prevent the yen from strengthening dramatically from here.

Eurozone: Flatlining. The Eurozone economy is running on fumes. European stock markets are losing their spark, bond yields are under downward pressure, and the European Central Bank (ECB) is walking a tightrope between stabilizing inflation and maintaining economic growth. Fiscal support from the pandemic is fading, and the region is grappling with the structural headwind of an aging population. Inflation remains stubborn, unemployment low, and Germany—once the bloc's economic powerhouse—is on the brink of recession.

Former ECB President Mario Draghi recently *called for* unprecedented action to support the flailing Eurozone economy, as discussed below. One of the key focuses of his voluminous report was Europe's productivity gap with the US (*Fig. 7*).

We agree with Mr. Draghi that Europe faces a mountain of challenges to return to a positive growth trajectory and catch up to the US. That's why we have been cautious on Eurozone markets and overweight the US. Here's a closer look at why:

In light of the challenges, a cautious stance in Eurozone markets might still be prudent. Here's a closer look at what lies beneath:

(1) *Stocks losing momentum*. The EMU MSCI has drifted 5.7% lower since May 15, after posting a 45.8% gain since September 2022 (*Fig. 8*). Slightly broader than the Eurozone,

the EMU index includes the stock markets of two countries that have not yet adopted the euro, namely Denmark and Sweden.

The France, Germany, and Italy MSCI indexes rose 32.8%, 47.8%, and 71.1% in euros from September 29, 2022 through September 2, 2024 before each erased a portion of those gains through September 6 (*Fig. 9*).

(2) *Fundamentals tracking sideways*. Currently, the EMU MSCI index seems appropriately valued at a forward P/E multiple below 15, representing a discount from the historical average (*Fig. 10*).The time-weighted average of EMU MSCI revenues per share grew 5.0% from a recent low on February 1, 2023 through February 21, 2024, and has moved virtually sideways since then (*Fig. 11*).

From a recent low on February 21, 2024 through August 1, the EMU MSCI forward profit margin increased from 9.2% to 9.5%, but has failed to gain as much ground since through September 6 (*Fig. 12*). The EMU MSCI's forward earnings per share gained 3.0% ytd, but the series seems to have peaked during the summer (*Fig. 13*).

Comparably, the All Country World MSCI's forward revenues and earnings per share (including the EMU countries) are collectively tracking higher since the summer (*Fig. 14* and *Fig. 15*).

(3) *Bond yields pressured downward by global forces*. Eurozone bond yields are being pulled by the gravitational forces of the global economy, particularly by weak US jobs data and heightened global expectations of central bank rate cuts (*Fig. 16*).

US 10-year bond yields fell from a recent high on April 25 of 4.70% to 3.72% on September 6. In turn, German, French, Italian, and Spanish 10-year bond yields have fallen from recent highs around July 1, 2024. Sovereign bond issuance is also expected to fall in the Eurozone, supporting prices and weighing on yields.

(4) *Flat-to-sluggish indicators*. Q2's real GDP growth was a disappointing 0.6% y/y, dragged down by Germany's result. Eurozone retail sales (excluding autos and motorcycles) edged up slightly in July after trending mostly flat since early 2023, signaling hesitant consumer confidence (*Fig. 17*).

The Economic Sentiment Indicator also has trended mostly flat this year, while the Industrial Production Index has slipped, reflecting the ongoing challenges facing manufacturers (*Fig.*

18 and *Fig. 19*).

Unemployment remains historically low at 6.4% as of July 2024 (*Fig. 20*). However, inflation remains a concern, with the core rate persisting at 2.8% y/y as of August. Only Italy has a core rate (2.3% y/y) near the ECB's 2.0% y/y target (*Fig. 21*).

(5) *Germany stuck in neutral*. Germany's economic engine is sputtering in 2024. After a mild contraction in 2023, the quarterly percent change (saar) for Q2-2024 declined 0.3%. On a yearly percentage change basis, Q2-2024 real GDP resulted in 0.0% growth (*Fig. 22*).

The industrial sector, once the backbone of Germany's economy, continues to wrestle with weakened production (*Fig. 23*). Unemployment at 6.0% during August stands at its highest in over three years. Inflation, however, has cooled (*Fig. 24*).

Germany's auto industry, led by Volkswagen, is a global leader in the production of electronic vehicles, but the outlook is dimming. Volkswagen faces fierce competition from cheaper Asian manufacturers. The recent scrapping of labor agreements with IG Metall has ignited fears of strikes and job losses, adding to the uncertainty.

(6) *ECB holding rates*. The delicate balance between curbing inflation and supporting growth requires careful avoidance of either stalling or overheating the Eurozone economy. The ECB's strategy remains focused on maintaining inflation near its 2.0% target, even after successfully reining in inflation from its peak of over 10.0% in late 2022.

The ECB maintained an official deposit facility rate at 4.0% for roughly nine months, from September 2023 through June 2024. It lowered the rate to 3.75% during June but has refrained from cutting it further through September (*Fig. 25*).

(7) *ECB tightening balance sheet*. However, the ECB's balance-sheet tightening signals its commitment to normalizing monetary policy after years of ultra-accommodative measures. By August, the unwinding of massive stimulus programs had shrunk the bank's balance-sheet assets to around €6.5 trillion from a pandemic-era peak of €8.8 trillion (*Fig. 26*).

(8) *Fiscal policy pulling support*. Fiscal policy in the Eurozone has been the ballast for much of 2023, with energy subsidies and price caps helping to cushion the blow of inflation and the energy crisis. With fiscal support waning, the Eurozone must carefully manage its resources to ensure continued growth while safeguarding its financial stability amid the economic challenges of an aging population.

(9) *Demographic crossroads*. The aged dependency ratio—measuring those 65 and older relative to the working-age population—climbed from 25.9% a decade ago to 33.9% by year-end 2023. The aging population presents looming challenges for sustaining an adequate workforce, needed social services, and economic growth.

(10) *Draghi's unprecedented proposal*. On September 9, former ECB President Mario Draghi called on the EU to launch a massive investment initiative, proposing spending twice what was invested post-WWII. He urged issuing new joint debt to fund industrial and defense sectors despite resistance from some member states. He also stressed the importance of embracing AI and emerging technologies to drive productivity and maintain global competitiveness. One pathway Draghi describes is to relax the regulatory regime in Europe. We're all ears, but it will take much more than a single report to get Europe back on the right track.

Strategy: Record-High Q3 Earnings Expected Amid Growth Scare. With three weeks before the Q3 earnings season kicks off, let's review the consensus forecasts for revenues and earnings growth and the profit margin for three groups: S&P 500 index, the Magnificent-7 stocks, and the S&P 493 (the S&P 500 minus the Magnificent-7).

The y/y growth rate comparisons are challenging for the S&P 500 and the Magnificent-7, as the year-ago quarter saw record-high quarterly EPS for the S&P 500 and the beginning of massive spending on artificial intelligence (AI). However, Q3 is expected to deliver record high earnings across the board. Here's what Joe found:

(1) *Record-high quarterly earnings in transitional growth slowdown.* The consensus of analysts expects record earnings in Q3-2024 for the S&P 500 and the Magnificent 7. The S&P 493 is expected to record a nine-quarter high in total earnings, only 2% shy of its Q2-2022 record high. It should hit a new record too after the usual positive surprise bias.

(2) *Revenues y/y growth rate to slow in Q3.* The Magnificent-7 is expected to record its slowest y/y revenues growth in four quarters—13.5%, down from a peak of 14.8% y/y in Q4-2023. The S&P 500 and S&P 493 should also see y/y revenues growth slow, to 4.1% and 3.2%, from six-quarter highs in the previous quarter. However, all three groups should grow revenues y/y for the 16th straight quarter (*Fig. 27*).

(3) *Earnings y/y growth rate to slow in Q3.* Analysts expect the Magnificent-7 to post a sixth straight quarter of y/y earnings growth, but growth is forecasted to slow sharply to 18.3% from a 57.1% y/y peak in Q4-2023. With forecasts of 5.3% and 2.2%, the S&P 500 and the

S&P 493 should see earnings growth slow in Q3 from Q2's strongest y/y pace in 10 and eight quarters, respectively, marking their fifth and third straight quarters of growth (*Fig. 28*).

(4) *Mixed direction for Q3 margin forecasts.* The Magnificent-7's profit margin is expected to edge down 0.3ppt q/q to 23.3% in Q3 from a record-high 23.7% in Q1-2024. Q1's record-high margin compares to a pre-AI spending boom margin of 17.8% a year earlier! Profit margins for the S&P 500 and S&P 493 are expected to improve again in Q3, but markedly slower than the gains seen during five of the prior six quarters. The S&P 500 is expected to hit a nine-quarter-high profit margin of 12.9%, albeit below its 13.7% record high in Q2-2021. The S&P 493's profit margin is forecasted to hit a four-quarter high of 11.7%, down from a 12.6% record high in Q2-2022. By the way, analysts expect a new record-high profit margin for the S&P 493 in Q2-2025 (*Fig. 29*).

Calendars

US: Wed: Headline & Core CPI 0.2%/0.2%; Headline CPI 2.6%y/y; 10-Year Note Auction; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. **Thurs:** Headline & Core CPI 0.2%/0.2%; Initial Claims 229k; Federal Budget Balance -$338.3b; IEA Monthly Report; WASDE Report. (FXStreet estimates)

Global: Wed: UK GDP 0.2%m/m; Headline & Manufacturing Production 0.3%/0.2%; Japan PPI 0.0%m/m/2.8%y/y; China New Loans 810b; McCaul; Buch; Tamura. **Thurs:** ECB Interest Rate Decision 3.65%; ECB Deposit Facility Rate 3.50%; Germany WPI 0.1%; Spain CPI 0.0%m/m/2.4%y/y; ECOFIN Meetings; Lagarde; Jochnick; McCaul; Breeden; Buch. (FXStreet estimates)

US Economic Indicators

NFIB Small Business Optimism Index (*link*): "The mood on Main Street worsened in August, despite last month's gains," noted Bill Dunkelberg, NFIB's chief economist. "Historically high inflation remains the top issue for owners as sales expectation plummet and cost pressures increase. Uncertainty among small business owners continues to rise as expectations for future busine conditions worsen." August's Small Business Optimism Index (SBOI) dipped to 91.2 after climbing the prior four months, from 88.5 in March (the lowest level since December 2012) to 93.7 in July—which was the highest reading since February

2022. The index remains below its 50-year average of 98.0 for the 32nd consecutive month. In August, only two of the 10 components rose, while eight fell. Dragging the SBOI lower: sales expectations (-9ppts to -18%), earnings trends (-7 to -37), expect economy to improve (-6 to -13), plans to increase inventories (-3 to -1), plans to increase employment (-2 to 13), expected credit conditions (-1 to -8), current inventory (-1 to -5), and now is a good time to expand (-1 to 4). Contributing positively were current job openings (+2 to 40) and plans to make capital outlays (+1 to 24). Inflation (24%) remained the single most important problem for small business owners in August, with quality of labor (21), taxes (13), cost of labor (9), and government regulations and poor sales (both 8%) rounding out the top six. The net percentage of owners raising selling prices sank to 20% from 22% in July and 27% in June, while a net 25% plans price hikes in the next three months, up from 24% in July; it was at 33% in March. Turning to compensation, a net 33% reported raising compensation again in August, down from 38% in June, while a net 20% plans to raise compensation in the next three months, up from 18% in July but down from June’s 22%.

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