Yardeni Research

October 2, 2024

Morning Briefing

The Economy That Roared

Check out the accompanying chart collection.

Executive Summary: The recent upward revisions to GDP and GDI are significant, suggesting an economy that's even stronger than many suspected. Eric explains how the various elements interconnect, with stronger GDP than first reported meaning greater output, which means higher productivity and lower labor costs and price inflation. The stronger GDI results from not stronger wages but stronger nonlabor income, which means more savings and support for consumer spending. Concerns about the labor market are misplaced. … Also: Melissa reports on China's latest stimulus measures and Japan's new prime minister. … And: Joe explains that S&P's quarterly index rebalancings have changed some component companies, resulting in apples-to-oranges comparisons to recent stats lacking much significance.

US Economy: An Even Louder Roar. The latest revisions to Gross Domestic Product (GDP) and Gross Domestic Income (GDI) suggest that the recent surge in productivity growth actually has been understated. Previously, the Bureau of Labor Statistics' (BLS) downward revision to payroll growth led the die-hard hard-landers to rejoice that surely economic growth couldn't be as strong as initially reported. They were wrong, again, as they have been since 2022.

In fact, higher productivity growth drove an even better economic outcome than first reported, underscoring our Roaring 2020s thesis. Actual and potential productivity growth continues to be widely underestimated by most mainstream economic models. Let's dig into the details:

(1) *Stronger growth means more output*. Q2 real GDP growth was revised 1.3% higher, from $22.9 trillion to $23.2 trillion (saar) at the end of last week. Real GDI was upped by 3.8%, from $22.3 trillion to $23.1 trillion (*Fig. 1*). Given the very close relationship between nonfarm business (NFB) output and real GDP, it is highly likely that output will be revised higher (*Fig. 2*).

From the *BLS*: "To measure labor productivity for the business and nonfarm business sectors, BLS uses value-added measures of output published by the Bureau of Economic Analysis (BEA); they are closely related to real gross domestic product (GDP)."

(2) *More output means higher productivity and cheaper labor*. More output for the same, or fewer, hours worked means worker productivity has likely been growing faster than 2.7% y/y (*Fig. 3*).

Meanwhile, the large upward revision to GDI stemmed from an increase in personal income. At first glance, one might assume that suggests that hourly compensation rose even more than expected, offsetting better productivity growth. Therefore, unit labor costs (ULC) at decade lows of 0.3% y/y isn't likely to be revised down (*Fig. 4*).

However, the increase to GDI personal income component was due to revisions in interest income, dividends, government transfers, and proprietors' income. Compensation (i.e., wages and salaries) was actually revised lower in 2023, aligned with the BLS' downward revision by 818,000 in payroll employment over the 12 months ended March 2024. Net interest income was also raised much higher for corporations.

In our September 4 *Morning Briefing*—just after the second estimate of GDI revised it lower to 1.3%—we wrote: "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. 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."

(3) *More income means more savings*. Let's take stock: So far, output, productivity growth, and ULC all are likely better than first thought. Furthermore, higher personal incomes for the same level of consumer spending means that consumers have been saving more. Indeed, the personal saving rate in Q2 was revised up to 5.2% from the initial 3.3%, as we wrote in yesterday's *Morning Briefing*. That provides more runway for consumer spending, as Fed Chair Jerome Powell suggested in his Monday comments at the National Association for Business Economics conference: That GDI wasn't as low as once thought "removes a downside risk to the economy," and the upward revision to the savings rate "suggests spending can continue at a healthy level."

All told, the consumer is doing well and the economy is growing at a robust pace thanks to investment in technological innovation. Concerns over the labor market are understandable given that the pandemic and Great Financial Crisis are fresh in many minds (or more likely, fresh in many charts). Yet where some see risk of deterioration, we see an economy that's adapting to a shortage of skilled labor by rapidly improving worker capabilities. Considering the concerning trend of aging demographics and rising dependency ratios in developed economies, this should be welcomed, not feared (*Fig. 5*).

Global Commodities: Rally on, China. China's latest round of economic stimulus has sent several global commodities markets flying.

Last week, the People's Bank of China lowered bank's reserve requirement ratio and key interest rates to boost liquidity and borrowing. The bank also recently announced measures intended to boost homebuying, including lower minimum downpayment requirements on purchases, allowing mortgage refinancing, and lowering mortgage rates.

As Jackie *noted* last week, we remain cautious about the potential for consumer-led growth and a revival of the property markets in China. To offset structural weaknesses, the government under the leadership of Xi Jinping is likely to continue shooting bazookas to bolster China's stock market and exports and to fund its frontier technology development efforts. Stronger export demand—for example, for Chinese made electric vehicles (EVs)—could continue to boost global raw material markets, counterbalancing the shortfall from chronic property market weakness. Global commodities prices are already confirming this scenario:

(1) China's MSCI stock price index is highly correlated with the price of copper (*Fig. 6*). Copper's nearby futures price, a bellwether for industrial growth, surged 6.1% from September 20 to September 27 to $4.54 per pound (*Fig. 7*).

(2) The iron ore price rose $9.44 per metric ton to $93.42 from September 20 to September 27, signaling investor confidence in the China stimulus (*Fig. 8*). While still below the January 3 high of $130.49, the price has rebounded from the recent low of $81.91 on September 23.

(3) China's bazookas of monetary and fiscal policy coupled with mounting hostilities in the Middle East have been supporting the Brent crude oil price. Last week, it ended at $71.98 per barrel, up from $69.19 on September 10—which was the lowest since December 2021 (*Fig. 9*).

Earlier this month, OPEC+ downgraded its demand forecast for both this year and 2025. The group is set to meet on October 2, with a *planned* production hike on December 1 looming. So the oil price may not get as much of a boost from China's stimulus as the prices of other commodities.

(4) The prices of agricultural commodities such as soybeans and corn rose last week on the China news as well (*Fig. 10* and *Fig. 11*). Chinese consumers might not go on a buying binge after they refinance their mortgages, but they might eat better.

Global Economy: Inflation Roundup. Global inflation is cooling, but regional differences persist. Advanced economies like the US and Europe are stabilizing at low inflation rates, while central bankers in emerging markets are still battling persistent price pressures. Japan, after years of deflation, is coping with an inflationary uptick, and China's exceptionally low inflation may quickly shift as government stimulus measures take hold.

As global inflation generally has cooled off, most central banks have pivoted toward interest-rate cutting. In September 2024, 21 central banks reduced rates, the most since the onset of the pandemic. This suggests that central banks are prioritizing fueling economic growth over preventing a potential resurgence of inflation.

Despite slower inflation, global prices remain much higher than before the pandemic and the European energy crisis of winter 2022-23, posing challenges for central bankers and disgruntling consumers. Let's take a closer look at inflation trends across key regions:

(1) *Globally, the Great Inflation Moderation*. Headline CPI inflation on a global scale has continued to drop, falling from 10.7% y/y during October 2022 to 4.7% by August 2024 (*Fig. 12*). Core inflation topped out at 7.7% during October 2022 and fell to 5.5% through July, nearly matching the headline rate as food and energy prices moderated (*Fig. 13*).

(2) *US, easing but elevated core*. In the US, the headline CPI dropped from a peak of 9.1% y/y in June 2022 to 2.5% in August, nearing the Federal Reserve's 2.0% target (*Fig. 14*). The core rate moderated from 6.6% during September 2022 to 3.2% in August, sticking above the Fed's preferred rate.

(3) *Eurozone, not just energy relief*. For the first time in three years, yesterday's Eurozone data release showed that headline CPI inflation fell below the ECB's 2.0% target to 1.8% y/y in September. The European Central Bank (ECB) successfully reined in inflation from its peak of over 10.0% y/y in late 2022 to 1.8% through September (*Fig. 15*). The decline in services inflation has uncoupled from trends in US inflation due to the economic slowdown in Eurozone economies, predominantly in the north (i.e., Germany) (*Fig. 16*).

The ECB held its deposit facility rate at 4.0% for about nine months until lowering it to 3.75% in June. It has not cut further through September but prior to the below target inflation data release, the bank indicated more cuts are likely at the October 17 meeting.

(4) *Brazil, warm but cooling*. Brazil's CPI peaked at 5.2% y/y in September 2023 before falling to 4.2% by August, remaining above the central bank's 4.0% target (*Fig. 17*). The central bank lowered its key interest rate from 13.75% during August 2023 to 10.50% by May 2024. However, in September, it reversed course and raised the rate to 10.75%.

(5) *India, peaks and valleys*. India's headline CPI inflation climbed slightly in August to 3.7% from July's five-year low of 3.5%, driven by lower prices for food and fuel (*Fig. 18*). Persistent food inflation concerns India's central bankers. The Reserve Bank of India targets a 4.0% headline inflation rate, plus or minus 2.0%, and has held the main policy rate at 6.5% for the nine months through August.

(6) *Mexico, stubbornly high*. Mexico's inflation rose from 4.3% in September 2023 to 5.0% in August but remains below the recent peak of 5.6% y/y in July (*Fig. 19*).

(7) *China, subdued for now*. China's inflation remains remarkably low, with the headline CPI at just 0.6% y/y in July (*Fig. 20*). Weak domestic demand is suppressing inflation, but the recent stimulus could soon push prices higher.

(8) *Japan, deflation no more.* Japan, after decades of deflation, has seen inflation rise to a 10-month high of 3.0% in July 2024, but August's rate declined to 2.8% (*Fig. 21*). Data released on Monday showed that Japan's industrial output dropped in August, signaling lower price pressures ahead.

Japan: New PM Shakes Markets. Shigeru Ishiba is poised to become Japan's new prime minister after winning the Liberal Democratic Party's leadership contest on September 27, succeeding outgoing leader Fumio Kishida.

Ishiba, a former defense minister, has called for a snap general election on October 27 to unify the party. His leadership comes at a pivotal moment for Japan, as the country grapples with economic challenges such as slow growth and evolving monetary policy.

The financial markets reacted swiftly, with the Japan MSCI stock price index falling below its 200-day moving average following Ishiba's victory (*Fig. 22*). Investors are concerned about his support for the Bank of Japan's tighter monetary policies and potential corporate tax hikes.

Strategy: September Shuffle. Before the third week of September, the analysts' consensus for the S&P 500 companies' Q3-2024 earnings growth forecast implied a 4.9% y/y gain; it's now down to a 4.4% gain as of the end of last week (*Fig. 23*). Also last week, the consensus annual forecasts of S&P 500 EPS for 2024-26 dropped at a faster w/w rate of 0.5%. That caused LargeCap's forward earnings forecast to fall for a second straight week for the first time since December. It's now 0.3% below its record high during the September 13 week.

What's going on? At face value, it might appear that consensus estimates are declining faster than usual, raising concerns about too-high estimates in the first place or an inadequate pace of Fed easing. However, that's not the case. S&P's quarterly rebalancing of indexes is the disruptive force, as Joe discusses below:

(1) *S&P's quarterly rebalancing.* Prior to the opening of trading on September 23, S&P Dow Jones Indices instituted a number of index changes associated with its regularly scheduled quarterly *rebalancing*. Three S&P 500 membership changes were made: The Information Technology sector gained Dell and Palantir, and the Financials sector picked up Erie Indemnity. Moving out of the S&P 500 were American Airlines (Industrials), Etsy (Consumer Discretionary), and Bio-Rad Laboratories (Health Care).

(2) *Yet another "seasonal" blip in consensus forecasts.* S&P's index changes typically cause a blip in the w/w percent change of the forecasts (*Fig. 24*). That's because the comparisons with the prior week's data is apples-to-oranges: the index's company roster as reconfigured on September 23 versus the old list of companies the week before that.

S&P also rebalances the S&P 400 MidCap and S&P 600 SmallCap indexes. The impact on those indexes tends to be greater, as evidenced by SmallCap's 1.6% w/w decline, which was its biggest w/w drop in nearly a year.

(3) *Getting growthier and more expensive.* The latest index changes seem to have followed S&P's usual m.o.: Companies on the decline (with generally lower forward P/Es) are replaced by those with better growth prospects (and higher forward P/Es). Assuming that forecasts for the rest of the index are unchanged w/w, replacing low-P/E companies with high-P/E companies reduces the aggregate earnings forecast.

Replacing the index's underperformers with higher achievers results in a stronger portfolio of growth, which should improve consensus expectations in the future. We're not concerned about the latest week's change in consensus forecasts. Blips are typical following S&P's quarterly rebalancings, but they tend to be more extreme for the SmallCaps and MidCaps than LargeCaps.

Calendars

US: Tues: ISM M-PMI & Price Index 47.6/53.5; JOLTS Job Openings 7.64m; Construction Spending 0.2%; Atlanta Fed GDPNow 3.1%; Bostic; Barkin; Colins; Cook. **Wed:** ADP Employment Change 124k; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; OPEC Meeting; Bowman; Barkin. (FXStreet estimates)

Global: Tues: Eurozone Headline & Core CPI 1.8%/2.7%y/y; Eurozone, Germany, France, Italy, and Spain M-PMIs 44.8/40.3/44.0/49.0/50.2; UK M-PMI 51.5; Schnabel; Nagel. **Wed:** Eurozone Unemployment Rate 6.4%; Italy Unemployment Rate 6.6%; Spain Unemployment Change 181k; De Guindos; Schnabel; Lane; Elderson; Balz; Pill; Noguchi. (FXStreet estimates)

US Economic Indicators

Construction Spending (*link*): Construction spending unexpectedly fell in August, led by a sharp drop in single-family projects, though easing borrowing costs could boost activity in coming months. *Total construction spending* slipped 0.1% in August (vs an expected 0.1% gain), after falling 0.5%. It's within 1.6% of May's record high, and up 4.1% y/y. *Private residential* investment declined 0.3% in August, with *new single-family homes* falling 1.5% and *new multi-family* units 0.4% lower. Versus a year ago, however, the former increased 0.8%, while the latter sank 7.5%. *Private nonresidential* construction edged down 0.1% in August, led by declines in educational (-1.1%) and health care (-0.8) facilities; partially offsetting those declines were gains in religious (1.5) and communication (1.3) structures. *Private nonresidential* construction remains stalled at record highs, while *total public construction* spending ticked up 0.1% and 8.1% y/y in August to a new record high.

JOLTS (*link*): *Job openings* have come down steadily since March 2022's 12.2 million peak but remain above where they were before the pandemic. Job openings rose unexpectedly to 8.04 million in August, after dropping to 7.71 million in July, which was the weakest since

January 2021. Openings remain at relatively high levels but down sharply from the series' peak. Prior to the pandemic in early 2020, the highest level of job openings recorded was 7.6 million. Openings reached 10.0 million in June 2021 for the first time in the history of the series going back to 2000. There were 7.1 million people unemployed in August, so there were 1.1 available jobs for each unemployed person. This ratio was at a recent high of 2.0 during March 2022. *By industry*, the number of job openings rose in construction (+138,000), state & local government excluding education (+78,000), transportation, warehousing & utilities (+77,000), and professional & business services (65,000). They fell in other services (-93,000) and finance & insurance (-41,00). *Separations* include quits, which are generally voluntary separations initiated by employees—serving as a measure of workers' willingness or ability to leave jobs. *Total quits* have been in a downtrend since peaking at 4.5 million during April 2022, falling to 3.1 million in August—the lowest since summer 2020.

Global Economic Indicators

US Manufacturing PMI (*link*): The ISM M-PMI continued to point to a contraction in manufacturing for the sixth successive month and 22nd time in the past 23 months. "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* was 47.2 in September, matching August's rate, after a four-month decline from 50.3 in March to an eight-month low of 46.8 in July. According to ISM, the *overall economy* continued its expansion for the 53rd 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 *production* (to 49.8 from 44.8) and new orders (46.1 from 44.6) measures remained in contractionary territory, though declined at a slower pace, with the production gauge just shy of the breakeven point of 50.0. Meanwhile, factory *employment* (43.9 from 46.0) declined at a faster rate during September, remaining in contractionary territory for the fourth consecutive month, with respondents in the survey reporting that their companies were "continuing to reduce head count through layoffs, attrition and hiring freezes." The *supplier deliveries* (52.2 from 50.5) measure remained above 50.0—a reading that indicates slower deliveries. Meanwhile, companies liquidated inventories (43.9 from 50.3) last month. *Turning to prices,* manufacturers faced lower input (to 48.3 from 54.0) prices in September for the first time this year.

Eurozone CPI Flash Estimate (*link*): The *Eurozone CPI* is expected to slow to 1.8% y/y in

September, down from 2.2% in August and 2.6% y/y in July. It would be the lowest rate since April 2021. Meanwhile, the *core CPI* is forecast to slow to 2.7% in September, matching this April's rate, which was the lowest since February 2022. The headline and core CPIs are down sharply from their recent peaks of 10.6% in October 2022 and 5.7% in March 2023. Looking at the components, the *services* rate is expected to ease to 4.0% from 4.1% in August, and has hovered between those two rates the past five months. *Energy* prices are expected to fall deeper into negative territory in September, to -6.0%, after dropping below zero in August (-3.0% y/y) for the first time since April. Meanwhile, the rate for *food, alcohol & tobacco* is forecast to edge up to 2.4%—from 2.3% in July and August. The rate for non-energy industrial goods remained at 0.4% in September, following gains of 0.7% in each of the prior three months; it was at 1.1% in March. Among the four *largest Eurozone countries*, all are expected to show an easing in September's CPI: Germany (1.8% y/y from 2.0% y/y), France (1.5. from 2.2), Italy (0.8 from 1.2) rate, and Spain (1.7 from 2.4).

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