Yardeni Research

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Morning Briefing

On China, Global Wages & The S&P 493

Check out the accompanying chart collection.

Executive Summary: China's stock market has lost 8% over the past week. Investors appear to have lost faith that the government's stimulus will be the answer to that economy's problems. Eric explains the dubious prospects of trying to stimulate a highly indebted country out of a collapsed property bubble with easier financing. And China's monetary policy is highly dependent on what the Fed does. If China eases more than the Fed, it risks foreign capital flight. … Also: Melissa looks at wage growth trends in the US and around the world. … And: Joe's data show the stock market's leadership broadening beyond the Magnificent-7 to the "S&P 493."

China: The Year of the State Planner. The quick knee-jerk rally in Chinese equities already looks like it's getting a leg cramp.

After the Communist Party of China (CCP) announced its first round of stimulus measures on September 24, several commentators suggested that the time to invest in China is now. We issued caution, *writing* on September 26 that the resulting economic stimulus "may be offset by Chinese government actions that chill the willingness of consumers and companies to spend and invest in the country."

The Shanghai Composite stock index is now down 8.3% from its recent high on October 8 (*Fig. 1*). It has climbed 8.1% this year and 9.0% over the past five years. It was recently reported by *Reuters* that China may raise $850 billion (roughly 6 trillion yuan) in special government bond over three years. Regardless, it would require much more than interest-rate cuts, looser financing terms, and fiscal stimulus to convince us to invest in China over the US or even India.

With that said, here's more on China's policy predicament and stock market:

(1) *Dire straits*. It will be a heavy lift for the CCP to stimulate an economy that is broadly

deleveraging. Growth in Chinese bank loans fell to the lowest level in more than two decades in September, at 8.1% y/y (*Fig. 2*). Lending peaked in early 2023 and has fallen off since. And growth in M1 money supply—the narrower measure of money supply that represents cash in deposit accounts that Chinese consumers usually use to invest—declined by a record 7.4% y/y last month (*Fig. 3*).

(2) *Fighting the last war*. The Chinese government is attempting to spur consumer spending by boosting the wealth effect and increasing financial market liquidity. We doubt that's the most effective remedy for China's ailments.

Stimulating a highly indebted country out of a collapsed property bubble with easier financing conditions may not be the best solution, as Uncle Sam learned following the Great Financial Crisis (GFC). It takes time for consumers and businesses to rebuild their balance sheets and grow comfortable with borrowing after a massive leveraging comes undone. And China has much more work to do than the US did. China's nearly $36 trillion in outstanding bank loans is roughly three times the amount outstanding in the US today (*Fig. 4*).

Just as the US struggled to stimulate growth and inflation after the GFC using quantitative easing, China will struggle unless it unleashes a fiscal bazooka such as helicopter money comparable to the three rounds of free money dropped by the US government during the pandemic. China's producer prices deflated further in September, down 2.8% y/y, while consumer prices rose just 0.4% (*Fig. 5*).

Consumer confidence has also collapsed in China and will need more than higher stock prices to encourage spending. But China's options may be limited.

(3) *US privilege is China's disadvantage*. The Chinese government announced its first flurry of stimulus on September 24.

The Fed's interest-rate cutting and dovish forward guidance likely emboldened China to ease policy. It is no surprise that China announced its stimulus package less than a week after the Fed's 50bps rate cut. Since the Fed's September meeting, futures contracted tied to the federal funds rate (FFR) have priced out some 60bps of rate cuts over the next year (*Fig. 6*). But if US inflation gets stuck high enough above 2.0% to prevent the Fed from easing further, the CCP's options may be limited.

If China eases more than the Fed, it risks foreign capital fleeing the country. Foreign investors pulled cash from China as the Fed and other developed economy central banks hiked interest rates in 2022 and 2023 (*Fig. 7*). Only this year did investors start to bring cash back. But with foreign direct investment flows still negative and with more investors growing skittish on China's prospects, capital could flee again.

(4) *Valuation is not a catalyst*. Just because something is cheap does not mean it's on sale. The China MSCI index is trading at 10.5 times forward earnings (*Fig. 8*). That's roughly half the valuation of large-cap US stocks and cheaper than most other emerging markets. Many money managers thought it wouldn't hurt to take a flyer on the world's second biggest economy at these prices.

Putting aside the numerous risks of doing business in China, forward earnings has been relatively flat for the past 15 years (*Fig. 9*). Earnings have persistently disappointed since 2022 as well (*Fig. 10*). It's easier to fudge national growth numbers with local government projects; it's harder to fudge corporate earnings.

(5) *The 800lb panda in the room*. China's demographics are rapidly Japanifying. Its working age population is faltering after the one-child policy backfired and today's citizens are averse to having kids for financial reasons (*Fig. 11*). The CCP will either have to encourage immigration despite preferring homogeny and restrictiveness or transfer wealth to the lower classes. Perhaps some "socialist" fiscal policy might actually be useful for China's state planners.

Global Wage Growth I: In a Sweet Spot. Finding a high-paying job in the US is easier these days. There are more of them thanks to inflation. For example, in 2024 Walmart store managers earn about $128,000 a year on average, up from $117,000 in 2023 and about $92,000 in 2014.

Wage growth across the US has surged over the past decade, but its pace has slowed in recent years (*Fig. 12*). The Fed has no official wage growth target, but it prefers wage gains around 3.5% y/y, aligning with its 2.0% y/y consumer price inflation target plus productivity growth of around 1.5%.

Here's a snapshot of key y/y wage developments:

(1) *Average hourly earnings (AHE).* The Bureau of Labor Statistics (BLS) reported a 4.0% y/y rise in average hourly earnings through September 2024 for all workers, with production and non-supervisory workers seeing a 3.9% increase. The latter account for about 80% of payrolls and have lower wages than the remainder of employed workers. The higher-wage

workers AHE rose 4.2% in September. These wage gains have eased from their 2022 recent peaks of 5.9% for all workers and 7.0% and 5.9% for lower- and higher-wage workers during the pandemic inflation crisis. It's worth noting that AHE can vary due to shifts in workforce composition as well as changes in actual earnings. That helps to explain some of the volatility in AHE inflation during the pandemic.

(2) *AHE lower- vs higher-wage workers*. A shortage of lower-wage workers during the pandemic pushed their wages up 7.8% y/y during April 2020, while higher-wage earners saw a more modest 3.2% increase (*Fig. 13*). A significant spread reappeared in March 2022, with lower-wage workers' wages rising 7.0% versus 3.8% for higher earners.

Lower-wage workers represent a larger share of payrolls and tend to grow their wages quicker than higher earners (*Fig. 14*). But because higher-wage earners punch above their weight in terms of their representation in aggregate earnings, their often-slower wage growth distorts overall AHE growth.

(3) *Real AHE*. Adjusted for inflation, real AHE rose 1.6% y/y through September (*Fig. 15*). Real AHE for lower-wage workers rose 3.2% from August 2022 to August 2024 compared to an increase of just 1.9% for higher-wage workers. These figures exclude benefits and bonuses, which tend to bolster the pay of higher earners more.

(4) *Employment Cost Index (ECI).* The BLS's ECI—which encompasses wages, benefits, and bonuses—recorded a 3.9% increase in total compensation for all civilian workers in Q2, a decline from the 5.5% peak in 2023. Wages and salaries rose by 4.0%, while benefits increased by 3.5%.

(5) *Atlanta Fed's Wage Growth Tracker (WGT)*. The WGT, which factors in worker composition changes, rose 4.7% through September—surpassing AHE but down from its 6.7% peak in August 2022 (*Fig. 16*). The largest wage gains in the WGT tend to be and have been for 16-24 year olds, who tend to earn less than more experienced workers. Job switchers also tend to experience larger wage gains than job stayers. However, switchers' wage growth premium has come down since peaking in 2022, indicating a normalized balance of supply and demand for workers.

(6) *AHE vs WGT*. AHE growth has tended to skew lower because it gives more weight to high earners based on their share of total earnings. This disparity helps explain why AHE has lagged WGT in recent years. Since March 2020, the post-pandemic labor shortage has highlighted a significant divergence in wage growth, with lower-wage workers experiencing

cumulative increases of 27.1%, notably exceeding the 14.1% rise for higher-wage earners (*Fig. 17*). On a y/y basis, the AHE (wages only) correlates well with the ECI (total compensation), though AHE tends to exceed ECI because benefits and bonuses typically grow slower than wages.

Global Wage Growth II: Global Wage Highlights. Emerging markets have been seeing a sharp rise in wage growth, driven by economic expansion and demand for skilled workers. Wage increases in developed nations have been more restrained, as these countries have been focused on stabilizing their economies and curbing inflation. In other words, central bankers in emerging markets have more work to do to balance growth and price stability.

Here's a closer look at y/y wage trends outside the United States:

(1) *Japan's aging problem*. In Japan, wage growth hit 5.4% y/y during August 2024, driven higher by labor shortages from an aging population and government efforts to stimulate economic activity (*Fig. 18*). After a prolonged period of wage stagnation, workers are finally seeing gains, with real wages rising 2.6% as inflation settles at 2.8%.

(2) *Europe's mixed picture*. In the UK, wages have grown 5.0% y/y through August, supported by labor shortages and inflationary pressures. Real earnings rose 1.4% after adjusting for the Retail Price Index (*Fig. 19*). Germany is seeing a moderate recovery, with wage growth of 4.9% comfortably outpacing CPI inflation at 2.6% (*Fig. 20*).

(3) *Emerging markets' surge.* Emerging markets are seeing the most substantial wage growth. India's wages *increased* by 9.7% in 2023 and are projected to rise 9.5% in 2024. With inflation slowing, real wage growth is expected to accelerate. In Brazil, wage growth *exceeded* 8.5% for several months earlier this year, as strong domestic demand and stable inflation around 5.0% supported higher earnings.

Strategy: S&P 493 Hitches Ride on Magnificent-7's Bull. Happy second birthday to the bull market! It turned two years old on Friday. There's always one group of stocks in every bull market that greatly outperforms the rest of the index from the start. This time, that group is the Magnificent-7 stocks, which have soared due to substantially improved fundamentals, including profit margins. As the bull ages, other groups hitch a ride when their prospects improve and/or when the market leaders become too expensive. With interest rates now heading lower, the entire rest of the market—i.e., the S&P 493--should enjoy improving fundamentals and stock price gains.

Indeed, the recent improvement in the S&P 493's returns suggests investors are looking there for growth at a reasonable price. For now, however, the Magnificent-7 continues to lead the way, as Joe shows below:

(1) *Bull market performance to date.* Since the bull left the gate on October 12, 2022, the MegaCap-7 has risen 102.5% through Monday's close (*Fig. 21*). That's still well ahead of the 56.1% gain for the S&P 500 and the 42.2% rise for the S&P 493. However, the Fed's pivot to a rate-cut cycle should help to improve the S&P 493's fundamentals too. Their share price performances suggest investors believe so.

(2) *Rolling one-year performance improving for S&P 493.* While MegaCap-7 is still ahead in terms of rolling one-year performance, it has lost ground to the S&P 493 and the S&P 500 (*Fig. 22*). The Magnificent-7's y/y gain has dropped to 44.8% from nearly 75.0% at the start of the year. Over the same period, the 493's rolling one-year performance has doubled from 15.0% y/y at the start of 2024 to 31.2% now.

(3) *Will S&P 493 beat the Magnificent-7?* That's a tough call considering how well the Magnificent-7 companies historically have expanded their revenues, earnings and profitability.

However, the Magnificent-7 stocks have been volatile and susceptible to bouts of price weakness primarily due to concerns about their valuations and slowing rates of growth. Their rolling one-year performance has nearly matched or fallen below those of the S&P 500 and S&P 493 more than a few times in the past, when investors lightened their positions and rotated into the S&P 493—specifically during late 2016, 2018-19, and 2021-23.

While the Magnificent-7 has led the way since mid-2023, the S&P 493 is now beginning to catch up.

Calendars

US: Wed: Import Prices -0.3%; MBA Mortgage Applications; API Weekly Crude Oil Inventories. **Thurs:** Retail Sales Total & Core 0.3%/0.2%; Initial Claims 241k; Industrial Production -0.1%; Capacity Utilization 77.9%; Business Inventories 0.3%; Atlanta GDPNow 3.2%; NAHB Housing Market Index 43; Philadelphia Fed Manufacturing Index 4.2; Fed's Balance Sheet; Crude Oil Inventories & Gasoline Production; Goolsbee. (FXStreet estimates)

Global: Wed: Italy CPI -0.2%m/m/0.7%y/y; UK Headline & Core CPI 1.9%/3.4% y/y; UK Input & Output PPI -0.5%/-0.3%; Australia Unemployment Rate 4.2%; RBA Bulletin; Lagarde. **Thurs:** ECB Interest Rate Decision & Deposit Facility Rate 3.40%/3.25%; Eurozone Headline & Core CPI -0.1%/m/1.8%y/y & 01%m/m/2.7%y/y; China GDP 4.6%y/y; China Industrial Production 4.6%y/y; China Retail Sales 2.5%y/y; China Unemployment Rate 5.3% EU Leaders Summit; McCaul; Lagarde; Woods. (FXStreet estimates)

US Economic Indicators

Regional M-PMI (*link*): The New York Fed was the first regional Fed bank to report on manufacturing activity in its district during October; its findings: The sector fell back into contractionary territory after a brief move above in September. The *headline general business conditions* sank to -11.9 from 11.5 in September—which was first reading in expansionary territory since last November and the highest level since April 2022. September's reading was up from a recent low of -43.7 at the start of this year. Both the *new orders* (-10.2 from 9.4) and *shipments* (-2.7 from 17.9) measures fell back below zero, dropping by 19.6 points and 20.6 points, respectively, with the former falling deeper into contractionary territory than shipments—which were just below the breakeven point of zero. Meanwhile, companies are liquidating *inventories* (-7.5 from 0.0) again after leveling off in September. Turning to the labor market, conditions improved, with small increases in both *employment* (4.1 from -5.7) and the average workweek (4.7 from 2.9) for the first time in a year. *As for pricing*, both the prices-paid (29.0 from 23.2) and prices-received (10.8 from 7.4) measures remained modest but did pick up slightly. Looking ahead, firms expect conditions to improve over the next six months, with the index of future business activity (38.7 from 30.6) measure climbing 8.1 points to a multi-year high—with 54.8% of respondents expecting conditions to improve and only 16.0% expecting them to deteriorate over the period. Capital spending plans (9.7 from -2.1) moved back above zero after dipping below zero for the first time since 2020.

Global Economic Indicators

Eurozone Industrial Production (*link*): Eurozone industrial production recovered in August, led by capital and consumer durable goods output, while both Germany and France posted sizable production gains during the month. *Headline* production, which excludes construction, rebounded 1.8% in August, following a 0.5% loss and a 0.3% gain the prior two months. Among the *main industrial groups*, there were widespread gains in August, with only intermediate goods output posting a decline, which it has done during most of this year. Meanwhile, *capital goods* production jumped 3.7% in August, after falling two of the prior three months by a total of 2.9%. *Consumer durable goods* production has been volatile, though did climb 1.7% in August after falling two of the prior three month by 2.3%. *Energy* output was in the plus column three of the past four months through August, rising 0.4% m/m and 2.5% over the period, while *consumer nondurable goods* production advanced for the fourth time in five months, by 0.2% m/m and 5.2% over the period. *Compared to a year ago*, total production barely budged, edging up only 0.1%, with volatility in the main industrial groups, with energy (2.6% y/y) and consumer nondurable goods (2.0) posting the largest gains, with capital goods (0.2) production basically flat. Offsetting these gains were declines in consumer durable goods (-4.8) and intermediate goods (-2.7) production. Looking at the *largest Eurozone economies*, production rose on both a monthly and a yearly basis in August only in France (1.4% m/m & 1.1% y/y), while Germany (3.3 & -2.5) posted the biggest monthly gain during August, though was still in the red versus a year ago. Meanwhile, Italy (0.1 & -3.2) and Spain (-0.4 & -1.3) were near zero on a monthly basis though contracted versus a year ago.

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