October 23, 2024

Morning Briefing

Still Staying Home

Check out the accompanying chart collection.

Executive Summary: We continue to recommend a Stay Home versus Go Global stock market strategy. While US stocks tend to command higher valuation multiples, that's for good reason. Using forward profit margin and revenues-per-share data from MSCI indexes around the world, Eric and Melissa demonstrate that American companies generally sport better fundamentals than their counterparts in both developed and emerging economies around the world. … Also: Joe reports that while the S&P 500's Q3 earnings per share took an unexpected dip last week, it was for company- and industry-specific reasons and doesn't bode poorly for the market broadly.

Global Strategy I: Paying for Profits. One reason US stocks command higher valuations than those of other developed markets is that US companies tend to have better profit margins (*Fig. 1* and *Fig. 2*). Wider margins result from both stronger productivity in the US and a heavier weighting toward technology companies at the index level (*Fig. 3*). If you think about it, these go hand in hand. America's latest productivity boom is driven by surging investment in technology like software and R&D, while the companies producing those at scale also tend to have wider margins (*Fig. 4*).

Consider the divergence between how well American companies keep their revenues versus companies in foreign markets:

(1) *Developed economies*. Few countries' stock markets compete with America's when it comes to forward profit margins (we derive forward margins from the time-weighted average of analysts' consensus revenues and earnings estimates for the current and following year, measured weekly). Among advanced economies, only MSCI Canada (14.1%) and MSCI Australia (13.4%) exceed the MSCI US's 13.1% forward profit margin (*Fig. 5* and *Fig. 6*).

Of course, both Canada and Australia are large commodities producers with a heavy weighting toward banks. Financials stocks tend to command better margins—the S&P 500 Financials sector has a 19.4% forward profit margin, for instance (*Fig. 7*).

(2) *Emerging economies*. Not many emerging market (EM) economies can compete with the US in terms of profit margins either. India's 12.3% forward margin is close and showing a strong uptrend (*Fig. 8*). But at 23.6 times forward earnings, India's MSCI index is even more expensive than American stocks. South Africa, another commodities-heavy economy, has 16.2% forward margins (*Fig. 9*). That makes more sense when considering that nearly half of its MSCI index is the global internet company Naspers.

(3) *US presidential election*. The outcome of the US November elections could change the dynamic, hurting US margins (*Fig. 10*). Should Vice President Kamala Harris win and the Democrats sweep both houses of Congress, higher corporate tax rates would depress margins. Of course, a sweep by either party is likely to put upward pressure on long-term bond yields and financing costs as they widen the deficit (through spending by the Democrats or tax cuts by the Republicans).

In our opinion, productivity growth will continue powering the US economy, expanding profit margins, tempering inflation, and keeping the debt levels in check relative to GDP. But a sweep by either party in November raises the risk of the US's post-pandemic stock market excellence dimming a bit.

Global Strategy II: Vote of Confidence for the US. Since 2010, we've maintained a Stay Home investment strategy versus Going Global. We expect that theme to continue to outperform.

Risks for both EMs and the US may emerge as the Federal Reserve balances its dual mandate, however. Let's look at the global indicators pointing to continued US strength, starting with forward revenues:

(1) *US forward revenues consistently outperform*. The US MSCI's forward revenues per share has surged 47.0% since the week of June 4, 2020. Compare that to the forward revenues per share of the All Country World (ACW) Ex-US MSCI (in local currency), which has increased by 10.2%. US companies' revenue growth prospects are a clear sign of economic resilience and strong consumer demand (*Fig. 11*).

Emerging markets have paled in comparison. Revenues of the ACW Ex-US index has grown just 8.3% since June 4, 2020. The Developed World MSCI's forward revenues has also failed to keep up, up 21.9% since June 4, 2020 (*Fig. 12*).

(2) *Global growth's a drag*. Global economic growth remains lackluster, dragged down by

China and Europe. Our YRI Global Growth Barometer has been trending weak since the start of 2023, alongside falling commodity prices (*Fig. 13*).

(3) *Global industrial production's a drag*. Global industrial production rose a mere 1.8% y/y through July—well below the long-term average of 2.5%. Despite stagnating over the past couple years, industrial production has been much stronger in the US than the rest of the G7.

(4) *EMs at risk of US protectionism*. The outlook for China and other exporting EMs could get bleaker if Trump 2.0 results revived US protectionism and tariffs.

(5) *Fed's coin toss could hurt EMs*. If the Federal Reserve holds US interest rates at current levels for an extended period, EMs could face the familiar double-edged threat of capital outflows and currency depreciation.

On the other hand, if the Fed opts to further cut rates, the risk shifts to overstimulating the US economy. Such a scenario could ignite a fresh rally in equity markets, potentially leading to a meltup, as we discussed in Monday's *Morning Briefing*.

Global Strategy III: World Growth Tour. Our latest global expedition reinforces the idea that there's no place like home.

Here's a roundup of selected countries' forward revenues per share and growth outlook:

(1) *The soft ABCs of global commodities*. The export-heavy economies of Australia and Brazil are reeling from China's economic slowdown. China's reduced demand for Australia's iron ore has sharply reduced Australian exports. Coal and natural gas demand is also down, though gold exports have offered some relief.

After a slight recovery post-pandemic, Australia's revenues and GDP growth have slowed, with GDP growth at just 1.0% y/y, below the pre-pandemic range of 2.0%-3.0% (*Fig. 14*).

Brazil's iron ore exports similarly suffered from China's weaker demand (*Fig. 15*). Flooding this year hurt soybean exports, and recent dips in oil exports reflect an oversupplied global market and slowing demand.

(2) *Mexico, a deceptively bright spot.* Mexico defies the exporter slowdown, with forward revenues per share up 8.8% since January 3, thanks largely to US nearshoring (*Fig. 16*).

Whereas China used to represent the majority share of total US imports, Mexico has held that honor since early 2023. Of course, some of that increase in volume has resulted from Chinese companies shifting supply chains to avoid tariffs.

Mexico is no investing Eden, however. Cartel violence, political corruption, and China's potential backdoor influence keep us cautious on Mexican assets. In addition, a Trump 2.0 administration could upend the trade agreement negotiated during his first term.

(3) *Eurozone drags as Germany stumbles.* Eurozone GDP edged up by just 0.6% y/y in Q2 (*Fig. 17*). Forward revenues per share rose 3.9% from January 3 through October 21, trailing the US's 4.8% jump.

The region faces a tough combination of high interest rates, weakened demand at home and abroad, scaled back fiscal support, and significant drag from Germany's struggling industrial sector. The forward revenues of the economy we call "the sick man of Europe" have stayed flat since mid-2022, and real GDP growth was zero y/y in Q2. Joe is looking into whether the October spike in revenues was due to an index composition change. Stay tuned.

(4) *The sun rises and sets in Japan.* Japan's forward revenues per share (in yen) surged by 34.2% from June 4, 2020 through the latest week (*Fig. 18*). However, this increase has had a muted impact on annual real GDP output compared to other countries. This is likely due to Japan's private consumption constituting a smaller share of GDP than in other nations. Conversely, Japan's public debt remains significantly high as a percentage of GDP.

(5) *China's misses the mark.* China's economy continues to struggle; recent data releases haven't inspired optimism. Real GDP growth fell short of the government's 5.0% target in Q2 for the second consecutive quarter; it was the weakest performance since early 2023 (*Fig. 19*). Industrial production was also down y/y in Q2.

The Chinese government's stimulus efforts to revive the struggling real estate market and boost domestic demand are unlikely to yield results anytime soon, as Eric discussed in yesterday's *Morning Briefing*. And President Xi shows little inclination to send "helicopter money" directly to consumers, which could improve consumer spending sooner.

(6) *Don't forget about the Golden Elephant*. India's economy is projected to grow by nearly 7.0% this year, fueled by robust public investment and resilient private domestic consumption. Forward revenues momentum, too, looks strong (*Fig. 20*). The outlook

remains positive despite global challenges, with easing inflation and favorable monsoon conditions bolstering growth. Investors are paying up for these conditions, however, and we're hesitant to buy stocks in EM indexes that are more expensive than American stocks.

Strategy: Don't Fear S&P 500's Q3 Earnings Growth Jitters. Analysts' consensus forecast for what S&P 500 companies collectively earned during Q3-2024 on a per-share basis unexpectedly fell 0.6% last week to $60.13 from $60.47 a week earlier (*Fig. 21*). The surprising decline occurred even though strong results reported early by the big banks were already baked into the earnings pie. The sudden dip in S&P 500 Q3 EPS caused the S&P 500's y/y proforma Q3 earnings growth rate also to fall unexpectedly, to 4.0% from 4.9%. A week earlier, the growth forecast had been down only 0.1ppt from 5.0% at the beginning of the month before earnings season started.

Joe carved the S&P 500's Q3 earnings down to the sector level to uncover what's happening. He found that the unexpected drop does not foretell a broader slowdown but occurred for company- and industry-specific reasons:

(1) *Energy & Boeing strike again.* Analysts following Energy industry companies and strike-affected Boeing have been making heavy last-minute estimate cuts ahead of the quarterly earnings releases. More typically, analysts are confident of their estimates during the third week following a quarter's end and stand pat as they await the earnings reports.

(2) *Energy's y/y growth earnings has been on a roller-coaster ride.* The sector had recorded slightly positive y/y earnings growth of 1.3% in Q2-2024 following double-digit percentage declines for four straight quarters. It's now expected to backslide into an earnings decline of 27.3% in Q3-2024. That's down from a forecasted 21.7% decline at the start of the month as the sector's total expected earnings has tumbled another 5.6% since then. The sector isn't expected to record positive y/y earnings growth until Q2-2025 and will become less of a drag on S&P 500 growth after Q4-2024.

(3) *Boeing analysts assess strike's impact (again).* Analysts following Boeing have been hard at work lately while Boeing's workers haven't. The strike, now over, deeply impacted Q3 forecasts. The consensus loss of around $1 per share at the start of the month has tumbled to a loss of over $10 now. As a result, the Industrials sector's total expected Q3 earnings fell by 9.5%, which dropped its Q3 y/y growth rate to -7.6% from 2.1% when October began.

(4) *Unwinding the growth jitters.* The S&P 500's earnings metrics look considerably better

when the bad news from Energy and Boeing are filtered out of the index. While analysts currently expect just 4.0% growth for the S&P 500 in Q3-2024, the growth rate improves to 6.5% excluding the Energy sector and to 7.8% excluding Industrials too.

Removing the impacts of Energy and Industrials also improves the S&P 500's earnings momentum. The total expected Q3 earnings for the S&P 500 ex-Boeing and Energy has risen 0.2% since October 1 versus dropping 0.9% with them. That 0.2% improvement is paced by a 4.7% pickup in Financials' total earnings so far and should spread, as is typical, when other sectors' firms begin releasing results.

Here's how much total Q3 earnings forecasts have changed since October 1 for the sectors and for the S&P 500 with Energy and Industrials removed: Financials (4.7%), Real Estate (0.5), Communication Services (0.3), S&P 500 ex-Energy & Industrials (0.2), Consumer Staples (0.0), Consumer Discretionary (0.0), S&P 500 ex-Industrials (-0.2), Information Technology (-0.3), Utilities (-0.4), S&P 500 ex-Energy (-0.6), S&P 500 (-0.9), Materials (-1.4), Energy (-7.1), and Industrials (-9.5).

Calendars

US: **Wed:** Existing Home Sales 3.88mu; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Beige Book; IMF Meetings; Barkin. **Thurs:** Initial Claims 243k; M-PMI & NM-PMI Flash Estimates 47.5/55.0; New Home Sales 717k; KC Fed Manufacturing Index. (Trading Economics estimates)

Global: **Wed:** Eurozone Consumer Confidence -12.0; Lagarde; Bailey; Lane; Breeden. **Thurs:** Eurozone C-PMI Flash Estimate 49.7; Eurozone, Germany, and France M-PMI Flash Estimates 45.1/40.7/45.1; Eurozone, Germany, and France NM-PMI Flash Estimates 51.5/50.6/49.9l; UK M-PMI & NM-PMI Flash Estimates 51.5/52.3; UK Gfk Consumer Confidence -20; Lane; Woods; Bailey; McCaul. (Trading Economics estimates)

US Economic Indicators

Regional M-PMIs (*link*): The *Richmond Fed* was the third regional Fed bank to report on manufacturing activity for October and showed the sector remained depressed. Its *composite* index (to -14 from -21) improved, though remained in contractionary territory, with its three component indexes following suit: shipments (-8 from -18), new orders (-17 from -23), and employment (-17 from -22); all three declined at slower rates. Meanwhile, *local business conditions* (-13 from -18) increased modestly, though also remained in negative territory, while the index for *future local business conditions* (21 from -6) improved considerably—moving well above the breakeven point of zero. The *future* indexes for new orders (35 from 7) and shipments (22 from 15) moved further above zero, while the employment (4 from -12) gauge moved from negative to positive. *Turning to pricing*, both the current and expected price measures are percent changes over the latest 12-month period. The average growth rate of current prices paid (to 2.70% from 3.36%) and future prices paid (2.72% from 2.89%) both eased, while the growth rate of current prices received (1.71% from 1.57%) measure accelerated though remained low, while the rate of future prices received (1.40% from 1.96%) eased. Previously, the *New York Fed* (the first to report on October manufacturing activity in its region) revealed that the sector fell back into contractionary territory after a brief move above in September. The *Philadelphia Fed* (second to report) showed improved activity, posting its second successive gain.

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