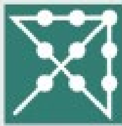
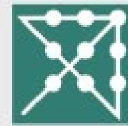
 Yardeni Research 

November 6, 2024

Morning Briefing

Global Bonds, Emerging Markets & S&P 500 Margins

Check out the accompanying chart collection.

Executive Summary: Bond Vigilantes are everywhere these days, selling sovereign bonds and lifting yields in developed countries around the world. Eric leads a tour of global bond markets. … Also: Melissa recaps takeaways from the IMF's newly published *World Economic Outlook*, which projects global real GDP growth of a steady 3.2% both this year and next. It might be time to reduce exposure to some EM equity markets, especially Mexico's. … Also: Joe finds strong profit margin improvement in his analysis of S&P 500 companies' Q3 earnings reports. The Magnificent-7's margins hit a new record high.

Global Economy I: Global Bond Selloff. The Bond Vigilantes are multinational, as Europe has suffered collateral damage from the US Vigilantes' fight with the Fed. Long-term sovereign debt yields are rising across developed economies, despite much slower growth and lower inflation than in the US (*Fig. 1*).

On one hand, perhaps this presents an income opportunity in global sovereign debt. On the other, the volatility may be too much to stomach for such a "safe" asset class. Let's unpack what's going on in global bond markets:

(1) *United Kingdom*. Gilt yields have tracked moves in the US Treasury market quite closely for the past two years. The 10-year gilt now yields more than 4.5%—a one-year high—versus 4.3% for the comparable Treasury bond. The Bond Vigilantes set up a nice outpost in London when they booted Prime Minister Liz Truss out of office in 2022 (after she served just two months) due to her concerning debt-fueled spending plans.

Now UK Chancellor Rachel Reeves has a new fiscal plan to increase spending by £70 billion per year through 2030, financed by a mix of borrowing and higher taxes. The plan has heightened inflation concerns, but the Bank of England is still widely expected to cut rates for the second time this year on Thursday (*Fig. 2*). Both the UK and US bond markets appear to be in similar boats.

(2) *Germany*. 10-year German bunds are yielding 2.4%, up from around 2.0% at the start of October. All things considered, that's quite high. Real GDP has been declining on a y/y basis for a full year, the IFO business survey is in recession territory, and industrial production has been declining since June 2022 (*Fig. 3* and *Fig. 4*). Germany's debt load is also quite low, at just 63% of GDP. Its federal deficit is currently running at 2.6% of GDP, below the EU's 3.0% cap (*Fig. 5* and *Fig. 6*).

Yet the global bond selloff is raising yields. Perhaps the German Bond Vigilantes are worried that German wages and salaries rose at a record-high 5.7% y/y in August, while consumer inflation remains elevated at 2.4% (*Fig. 7*).

(3) *Italy and France*. It used to be very risky to own Italian debt. Investors were compensated for that risk with higher yields than available on other Eurozone bonds. Now 10-year BTPs yield just 128bps more than German bunds (*Fig. 8*). That's relatively close to the 75bps that French OAT yields trade above bunds.

In France, the success of Marie Le Pen's right-wing party has raised the compensation investors demand to own French debt. By most measures, France actually has quite a large debt load, but investor demand for safe-haven assets helps to bid up OATs and suppress yields. France's economic growth has also been much stronger than some of its neighbors', up 1.3% y/y in Q3 and not dipping negative since the pandemic (*Fig. 9*).

(4) *China*. The Chinese Communist Party (CCP) has struggled to encourage economic growth with its stimulus plans to date. Industrial profits remain negative, though industrial production and retail sales are ticking higher (*Fig. 10*). However, the 10-year government bond yield is around record lows of 2.1% (*Fig. 11*). With the property market (and consumer confidence) collapsed, investors remain pessimistic on China's growth prospects (*Fig. 12*).

(5) *Japan*. The 10-year JGB yield has fallen from 1.1% in July to around 0.9%, as the expectations for tightening by the Bank of Japan have fallen. The difference between US Treasury and JGB yields therefore has widened, putting pressure on the yen versus the dollar (*Fig. 13*).

Global Economy II: IMF's Underwhelming Forecasts for EMs (Ex India). The International Monetary Fund's (IMF) October 2024 *World Economic Outlook* paints a lukewarm picture of global economic growth prospects, with global real GDP pegged at a steady 3.2% for both 2024 and 2025. Headwinds stem from cautious monetary policies and rising geopolitical tensions.

Advanced economies are weighing down the global forecast, with their real GDP growth projected at just 1.8% in 2024 and 2025. Emerging markets (EMs) and developing economies are projected to outpace the developed world with 4.2% growth for both years—still not much to celebrate. And EMs outside of India are expected to grow at paces typically associated with advanced economies, not dynamic EMs.

Let's dive into the IMF's forecasts for some key EM players, each navigating unique challenges and opportunities:

(1) *India*. The global growth leader, India's economy is set to expand by 7.0% in 2024, tapering to 6.5% in 2025. Strong public investment and robust domestic demand fuel the exceptional pace.

(2) *China*. Facing headwinds in its property sector and weakening global demand, China's growth forecast has been trimmed to 4.8% for 2024 and 4.5% for 2025, both below Beijing's 5.0% target.

(3) *Brazil*. Benefiting from stable commodity exports, Brazil is expected to grow by 3.0% in 2024 and 2.2% in 2025.

(4) *Taiwan*. Taiwan's economy should see growth of 3.7% in 2024 and 2.7% in 2025, supported by its pivotal role in global semiconductors.

(5) *Australia*. The IMF projects growth of 1.2% in 2024 and 2.1% in 2025 with commodity exports and resilient domestic demand supporting the economy.

(6) *South Korea*. Predicted to grow by 2.5% in 2024 and 2.2% in 2025, South Korea benefits from semiconductor exports and demand for electric vehicles, despite military tensions with North Korea.

(7) *Mexico*. With one of the weakest forecasts among major EMs, Mexico's growth is projected at just 1.5% in 2024 and 1.3% in 2025, as political instability weighs on economic prospects.

Global Economy III: Time To Reduce EM Risk? EM equities have shown notable strength recently, buoyed by supportive global financial conditions and targeted policy measures. But despite the IMF's lukewarm global growth outlook—India excluded—the current environment suggests a cautious approach to EMs.

Valuations in EM stock markets aren't all that compelling. More protectionist US trade policies and increasing global tensions broadly are potential headwinds, as we highlighted in our October 30 *Morning Briefing*. Jolts to China's economy and markets from the government's recent stimulus likely won't build sustainable momentum.

Here's more:

(1) *EM index performance*. The MSCI EM equity index (in US dollars) has rebounded impressively since its October 26, 2023 low, gaining 24.0% (*Fig. 14*). At a sub-15 P/E multiple, the index trades near its historical average. Analysts' consensus revenue per share has been flat since mid-2020 (*Fig. 15*). But forward profit margins improved to 8.2% by early November from February's 6.8%. Forward earnings per share are slightly up since late last year (*Fig. 16*).

(2) *EM index composition*. Notably, Chinese firms represent more than a quarter of the MSCI EM equity index's *composition* at 27.3%, followed by Taiwanese stocks at 19.0% and Indian stocks at 18.8%.

(3) *EM bond outflows*. With the Fed's pace of easing likely to slow, EM bond ETFs faced October outflows as investors reassessed global risks. The iShares J.P. Morgan USD EM Bond ETF saw its largest outflows since March, Bloomberg data *show*, indicating rising caution around EM debt.

Global Economy IV: Mexico's Dangers. As the dust settles after Mexico's latest elections, the political landscape is turning rougher, with heightened volatility in equity markets expected as President Claudia Sheinbaum aggressively reinforces her predecessor's *policies*. Recently, we asked whether Mexico was becoming "un-investable." Today, we remove the question mark.

We're not alone in re-evaluating Mexico's investment appeal. The MSCI Mexico Index has traded below its 200-day moving average since June, when electoral risks started to loom large (*Fig. 17*). Meanwhile, the peso has quickly sunk to its weakest levels against the dollar since mid-2022.

(1) *Constitutional reforms*. Recent reforms have weakened Mexico's governmental checks and balances, undercutting its investment appeal. The National Regeneration Movement—a.k.a. Morena—has swiftly pushed laws through Congress with minimal debate, including a controversial measure to make Supreme Court judges subject to election that invites

influence by organized crime at the judicial level.

(2) *Judiciary restrictions*. Effective November 1, a new law restricts the Supreme Court from overturning constitutional amendments passed by two-thirds majorities in Congress and state legislatures. Pushed by Morena's legislative majority, the changes are grounded in Sheinbaum's and Morena's belief that elected officials should remain unchallenged by the judiciary. Until now, the judiciary was the only branch not under Morena's control.

(3) *Morena's party line*. Committed to following former President Andrés Manuel López Obrador's (AMLO) agenda, Sheinbaum is likely to continue eroding judicial independence. Under AMLO, Morena tried but failed to prioritize state-owned utilities over private ones in energy markets.

With Mexico's stock market liquidity already limited, its ranks of outperformers may grow even thinner as these legislative changes take root.

US Strategy: Strong Q3 Margin Improvement. With 383 of the S&P 500 companies having reported their Q3 earnings through midday Tuesday, the Q3-2024 earnings season is nearly 77% complete. The aggregate revenue and earnings surprises so far are among the strongest since the pandemic recovery in 2021, and profit margins show improvement even with the lower results from Boeing and the Energy sector. Revenues for the 383 reporting companies are ahead of forecasts by 1.6% (a five-quarter high), and the earnings beat is a very healthy 7.9% (*Fig. 18* and *Fig. 19*).

However, the aggregate Q3 y/y revenue and earnings growth rates for the 383 reporting companies has slowed from Q2's pace—to 4.6% from 5.2% for revenues and to 9.1% from 13.3% for earnings growth.

On a very bullish note, 74% of companies have positive y/y revenues growth, the most in nine quarters (*Fig. 20*). And 68% have positive y/y earnings growth, matching the highest readings of the past 11 quarters (*Fig. 21*).

Below, Joe dissects the results to uncover the underlying trends in the S&P 500 and weighs in with his thoughts:

(1) *Magnificent-7.* With all but superstar Nvidia reporting Q3 results so far, it was a better quarter for the group than Q2. Tesla had the sole top-line miss, but all six companies' earnings beat estimates. On a blended basis (using actuals for the six companies that have

reported and a forecast for Nvidia), the Magnificent-7's aggregate earnings surprise was 10.8% and its y/y earnings growth 24.6%—both well above the S&P 500's. The group's y/y revenue growth of 5.0% rate is also ahead of the S&P 500, though its 1.6% revenue surprise only matches the index's.

Among the six Magnificent-7 companies that have reported, three had double-digit percentage earnings surprises and y/y earnings growth: Alphabet, Amazon, and Meta. Here are the Q3 earnings surprises and y/y earnings growth rates for the Magnificent-6: Amazon (25.2% earnings surprise, 52.1% y/y earnings growth), Tesla (23.2, 9.1), Alphabet (14.9, 36.8), Meta (14.8, 37.4), Microsoft (6.5, 10.4), and Apple (2.4, 12.3).

Most of the Magnificent-6 companies continued to record relatively strong revenues growth during Q3: Microsoft (1.7% revenues surprise, 16.0% y/y revenues growth), Alphabet (2.3, 15.1), Amazon (1.1, 11.0), Meta (0.8, 18.9), Apple (0.4, 6.1), and Tesla (-0.8, 7.8).

(2) *S&P 500 profit margins moving higher.* The S&P 500's Q3 reporters to date collectively had a Q3 profit margin of 13.1%, well above the 12.3% consensus forecast and up from 12.5% a year earlier (*Fig. 22*). That would be a record high if we put a mask on the S&P 500's 13.5%-13.8% readings during the supply-chain disruptions of 2021! By the way, 13.1% is also the current blended forecast for all of the S&P 500 companies and could improve further as the remaining 23% of the companies report Q3 results.

(3) *Magnificent-7 margins at a record high.* The Magnificent-7's blended Q3 profit margin of 25.3% is a new record high and well exceeds the prior record of 23.7% during Q1. Margins rose q/q for all six Magnificent-7 reporters to date—Amazon's to a record high—up from just two the prior quarter: Meta (38.6% quarterly profit margin, 15-quarter high), Microsoft (37.6, four-quarter high), Alphabet (29.8, 13-quarter high), Apple (26.3), Tesla (10.0, five-quarter high), and Amazon (9.7, record high).

Nvidia is expected to report a Q3 profit margin of 55.9%; but with a big positive surprise, the Magnificent-7's collective profit margin could easily exceed 26%.

(4) *S&P 493 profit margins rising too.* With 377 of the S&P 493 reporting so far, the S&P 493's Q3 profit margin of 11.6% (including Boeing's loss) is the highest since Q3-2022 and compares to a forecasted 11.0% and 11.4% a year earlier. That's still below the group's record high of 12.9% during 2021.

(5) *S&P 493 excluding Boeing and Energy.* Looking at the S&P 493 excluding the noisy

results from Boeing and Energy reveals a Q3 profit margin of 13.9%. That compares to a 13.1% forecast and 12.9% a year earlier. Boeing's strike lowered the S&P 500's Q3 earnings growth rate to 9.1% from 10.4%. Even with Boeing's large loss in Q3, the Industrials sector's 8.7% profit margin is down just 0.5ppt from a year ago. Among Q3's lagging sectors, Energy's Q3 margin of 7.9% is down materially from 9.6% a year earlier, and Materials' 8.8% is down from 9.7%.

Calendars

US: Wed: MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. **Thurs:** Fed Interest Rate Decision 4.75%; Nonfarm Productivity & Unit Labor Costs 2.3%/0.9%; Initial Claims 220k; Consumer Credit $14.3b. (FXStreet estimates)

Global: Wed: Eurozone, Germany, and France 49.7/48.4/48.3; Eurozone, Germany, and France NM-PMIs 51.2/51.4/48.3; Germany Factory Orders 1.6%; Eurozone PPI -0.5%m/m/-3.5%y/y; Lagarde; De Guindos; Nagel; Buch; Rogers. **Thurs:** Eurozone Retail Sales 0.4%; Germany Industrial Production -1.1%; Spain Industrial Production; BoE Interest Rate Decision 4.75%; UK Halifax House Price Index 0.2%; Lane; Schnabel; Buch; Elderson; Bailey. (FXStreet estimates)

US Economic Indicators

US Non-Manufacturing PMI (*link*): The US service sector exceeded expectations again in October, jumping its highest reading since August 2022. The ISM N-PMI expanded for the fourth consecutive month by 1.4 points in October and 7.2 points (to 56.0 from 48.8) over the period—with October's reading beating the 53.8 reading expected. The *business activity/production* index dipped to 57.2 after rising from 49.6 in June to 59.9 in September, while new orders slipped to 57.4 in October after climbing from 47.3 in June to 59.4 in September. Both measures, however, remain at relatively high levels. Meanwhile, the *employment* measure was in expansionary territory for the third time in four months, climbing to 53.0 in October after slipping below 50.0 in September (to 48.1). The *supplier deliveries* (56.4 from 52.1) measure rose 4.3 ppts in October—indicating "slower" supplier deliveries after two months in contraction or "faster" territory. (Supplier deliveries is the only ISM component that is inversed—with a reading above 50.0 indicating slower deliveries, which is typical as the economy improves and customer demand increases.) On the

inflation front, the price index (to 58.1 from 59.4) slowed slightly, after accelerating the prior three months. It was at a recent high of 64.0 at the start of this year. Its record high was 84.5 at the end of 2021.

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