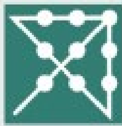
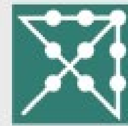
 Yardeni Research 

November 20, 2024

Morning Briefing

Europe Is A Mess

Check out the accompanying chart collection.

Executive Summary: In our framework of three possible scenarios, Ed and Eric assign the lowest subjective odds, 20%, to a catchall bucket of crises that could seriously derail financial markets. They include a 1970s-style geopolitical crisis, a US debt crisis, and now a 1930s-style geopolitical calamity as hostilities escalate in the Ukraine/Russia war. … Also: Melissa reports on the Eurozone's political and economic challenges. Our low hopes for solutions keep us cautious on investing in stocks across the pond. … And: Analysts' revenues and earnings estimates for S&P 500 companies typically drop as a year progresses. Joe's data suggest that 2024 won't be an exception—but 2025 very well could be.

Europe I: World War 2.5. Eric and I have been looking for historical analogies to the current decade. Today, we need to consider a new historical analogy, i.e., the 1930s, which led up to World War II, which started on September 1, 1939, when Germany invaded Poland. The rest, as they say, is history. They also say that "history doesn't repeat itself, but it often rhymes." Mark Twain said it first.

We can make room for this unhappy prospect in our three-scenarios framework. We currently assign a 20% subjective probability to a 1970s-style geopolitical crisis, 25% to a 1990s-style stock market meltup, and 55% to 1920s-style Roaring 2020s boom times, led by productivity growth. We recently stuffed a possible US debt crisis into the first scenario. Now we can also add a 1930s-style calamity into this catchall bucket for everything that could go seriously wrong.

Consider the following developments on the Western front (as viewed from Russia):

(1) *On August 6*, Ukraine launched a surprise attack on the Kursk region of western Russia, which has struggled to respond quickly and effectively to Ukraine's offensive. Russian President Vladimir Putin doesn't have enough troops to defend his country at the same time as he is invading Ukraine.

(2) *On October 18*, US Select Committee on Intelligence Chairman Michael R. Turner

appealed to President Joe Biden to respond immediately to reports suggesting that North Korean troops could soon be fighting alongside Kremlin forces. According to Bloomberg, unnamed sources believe Pyongyang may deploy as many as 100,000 troops.

(3) *On November 4*, US officials told the Reuters news agency that North Korean troops were engaged in combat in the Kursk region of Russia.

(4) *On November 6*, Russian lawmakers voted to ratify a mutual defense treaty with North Korea, first proposed during Russian President Vladimir Putin's visit to Pyongyang in June.

(5) *On November 17*, President Joe Biden authorized the first use of US-supplied long-range missiles by Ukraine for strikes inside Russia. The weapons are likely to be deployed initially against Russian and North Korean troops in defense of Ukrainian forces in the Kursk region of western Russia, the officials said.

(6) *On November 18*, CNN reported, "Sweden and Finland have updated guidance to their citizens on how to survive war, as NATO allies bolster defense measures against the backdrop of the Ukraine conflict. Both nations joined the transatlantic alliance in the past two years, after Russia invaded its neighbor. Many European countries have since ramped up military spending to bolster long-term security in the region."

(7) *On November 19*, Russian President Vladimir Putin lowered the threshold for a nuclear strike in response to a broader range of conventional attacks. Russia had been warning the West for months that if Washington allowed Ukraine to fire US, British, and French missiles deep into Russia, Moscow would consider those NATO members to be directly involved in the war in Ukraine.

(8) *On November 13,* incoming President Donald Trump met with President Joe Biden. We presume that they discussed the latest escalation in the Ukraine/Russia war. Putin must presume the same.

For now, we are maintaining our 20% subjective probability of the 1930s/1970s-style scenario.

Europe II: Rudderless. No bloc functions at its best when its economic engines are sputtering. That's what's happening in Europe, and there are plenty of reasons why.

Before we get to the causes, two symptoms are an underperforming stock market and a

devalued currency. European stocks have *underperformed* the US stocks in eight of the last ten years. The MSCI Eurozone has been trading sideways since March 2024, and its investors now await confirmation of a Trump 2.0 global trade war with Europe at the front lines (*Fig. 1*). Nearly at parity to the US dollar, the euro has sunk on expectations that the European Central Bank (ECB) will lower interest rates on growth concerns while the US strengthens (*Fig. 2*).

A *deus ex machina* has entered the scene, but we have low confidence in his ability to right this ship. Former Italian Prime Minister and former ECB President Mario Draghi has drafted a plan to save the bloc from its demise, as we wrote in our September 11 *Morning Briefing*. Buried in the details of Draghi's long-winded *plan* is a new Department of Government Efficiency for the European Commission. That sounds coincidentally familiar to tech billionaire Elon Musk's Trump-appointed role heading up a new department, the Department of Government Efficiency (DOGE). In a post on X, Musk *applauded* Draghi's efforts, calling the critique "accurate." Musk commented: "Things should be default legal, rather than default illegal" to "revitalize growth and strengthen competitiveness" in the Eurozone.

We are all for removing red tape, but implementing drastic changes in a deeply fractured Eurozone will be like trying to pivot the *Titanic* without a rudder. We just don't see enough chance of a turnaround in the plan or investment opportunities in the Eurozone's equity valuations to warrant a holiday stock-shopping trip across the pond (*Fig. 3*).

Regarding the headwinds keeping Europe's economy adrift, some are specific to two of the region's major economies, Germany and France. Let's start with those:

(1) *Political disarray in Germany.* German Chancellor Olaf Schulz finds his government at a crossroads after having fired his finance minister on November 7, effectively dissolving his parliament's three-party coalition composed of the Social Democrats (SPD), the pro-business Free Democrats (FDP), and the environmentalist Greens Party. Former Finance Minister Christian Lindner sealed both his and the collapsed government's fate when he recently wrote a paper *outlining* budget proposals that Schulz's SPD and Greens fundamentally would never accept.

Schulz's initial response before letting Lindner go was to offer a compromise if the FDP would agree to lift Germany's "debt brake," which limits Germany's fiscal debt. The deal was one that Schulz knew the FDP would never take. Now a vote of no confidence in Schultz's government is likely in or around January. If Schultz loses the vote, fresh parliamentary elections will be held around March, leaving the failed government in limbo until then.

(2) *German industrial production hasn't found a bottom*. Germany's industrial production fell 4.6% y/y in September as its large manufacturers announced closures and the governing coalitions collapsed, according to data released early in November (*Fig. 4*). Production remains below its pre-pandemic level. Recovery in production has been especially trying for German auto manufacturers (*Fig. 5*). Exports also fell in September.

(3) *German autos on the skids*. Ahead of Trump's 2.0 tariffs, German auto companies already are doing poorly due to rising energy costs, competition from Chinese electric vehicles (EVs), and weakened demand for EVs globally. Reflecting the frailty of Germany's auto sector, Volkswagen is set to *close* three German factories, cutting costs by an unprecedented $4.3 billion.

(4) *Gridlock in France*. French President Emmauel Macron lacks much power without a majority in parliament. He called for a *dissolution* of parliament at the end of July; having lost that vote, he can't do so again until at least a year has passed after the last vote. The leftist party New Popular Front holds the most seats in parliament without an absolute majority, followed by Macron's centrist party and the far-right National Rally in third.

(5) *Trump's tariffs loom*. If Trump follows through on his campaign promises to put a blanket 10%-20% tax on all global imports (with a harsher rate for Chinese imports), German exports to the US could drop by an *estimated* 15%. This could plunge Germany's economy deeper into the recession that is expected this winter even without the tariff imposition.

(6) *No Roaring 2020s productivity boom.* Other than the entrepreneurial spirit, there are several reasons why productivity growth is so much stronger in the US than in Europe (*Fig. 6*). A stringent regulatory regime and higher taxes discourage company formation and technological investment, for instance. While US real fixed investment in equipment was marginally higher ($525 billion) in 1995 than the Eurozone's (€391 billion), US investment has accelerated to $1.549 trillion as of Q3. Eurozone gross capital formation, meanwhile, has grown to only €611 billion (*Fig. 7*).

The fragmentation across Eurozone countries' real economic markets and financial markets is another barrier. It's also very difficult to fire workers in the Eurozone, which is one reason why productivity plummets during recessions (*Fig. 8*). A very inelastic labor force naturally leads to inefficiencies; much better is a labor force in which workers flow freely to where they're needed most.

(7) *No wind in the sails for energy*. By 2027, Europe is "dead set" on removing Russia as a

cheap source of energy in response to the war in Ukraine "even as purchases of Russian liquefied natural gas increase," noted an oilprice.com *article*. Europe also is actively reducing its coal generation and looking to replace it with wind and solar.

Europe's hoped-for and well invested green energy transition won't scale up in time for winter. Moreover, green energy solutions like wind turbines and solar generation are *problematic* given their intermittency problem—i.e., a lack of wind and sun at times when energy is needed most, such as winter. Solar generation drops more than 50% in the wintertime.

(8) *ECB's hands are tied*. A few more interest-rate cuts by the ECB won't likely be enough to revive growth in the Eurozone. In October, the ECB lowered its main interest rate to 3.25% (*Fig. 9*). The bloc's central bankers recently *called* for rates to be lowered to a neutral level they peg at around 2.0%. But if global tariffs or a winter energy crisis were to revive Eurozone inflation, it would cause quite a predicament for the dovish central bankers.

(9) *Not enough babies*. A problem for future decades is the drop in fertility rates across the Eurozone. Responding to an infographic showing fertility data by country, Musk *posted* on X that "Europe is dying." Birth rates for 2022 were lower than the 2.1 rate needed to replace the population, according to the data's source report (by Eurostat and the Institute for Health Metrics and Evaluation). France's birth rates have fallen to the *lowest* since post-WWII.

Strategy: Will 2025 Bring Rising Estimates? Analysts typically lower their consensus forecasts steadily as years progress, with only eight exceptions since 1995 (*Fig. 10*). This year is not likely to be the ninth, owing partly to the recent drop in oil prices and Boeing's strike. But 2025 could be, suggests Joe's data.

Below, Joe reviews how the analysts following S&P 500 companies have adjusted their 2025 forecasts so far this year, looking at aggregate revenues, earnings, and the implied profit margins for the S&P 500 and its 11 sectors, both for 2025 and for the 12 months ahead (i.e., "forward" data, captured by time-weighting the analysts' consensus estimates for the current year and following one):

(1) *2025 revenues and earnings forecasts unchanged ytd.* The S&P 500's consensus aggregate 2025 revenues forecast is now flat ytd after being up around 1% following the Q2 earnings season. Typically, the following-calendar-year forecasts would be about 1%-2% lower by now. Five sectors have posted gains in their 2025 consensus revenues forecasts

so far: Information Technology (9.2%), Communication Services (4.0%), Health Care (3.7), Real Estate (0.8), and Financials (0.4) (*Fig. 11*). Many of the rest have continued to experience revenue estimate cuts in recent weeks, dropping their ytd declines to new lows: Industrials (-5.3), Consumer Discretionary (-3.5), Energy (-2.7), Materials (-1.8), Consumer Staples (-0.5), and Utilities (-0.6).

The S&P 500's consensus aggregate earnings forecast for 2025 is also unchanged ytd instead of declining as is typical. These five sectors have higher 2025 earnings forecasts ytd, beating the S&P 500 by that measure: Communication Services (8.9%), Information Technology (8.2), Utilities (2.5), Financials (2.0), and Real Estate (0.7) (*Fig. 12*). Among the biggest laggards are Energy (-21.4), Industrials (-6.5), Materials (-6.3), Consumer Staples (-3.6), Health Care (-3.1), and Consumer Discretionary (-0.5). Since Q3 ended, most of the winners continued to improve as most laggards dropped further behind.

(2) *Forward revenues and earnings up broadly, led by four sectors.* Consensus forward forecasts typically move higher as the year progresses and more of the following year's (typically higher) estimates get folded in. The S&P 500's aggregate forward revenues forecast has gained 5.0% ytd as nine of the 11 sectors' forward revenues also moved higher. These four top the S&P 500 by this measure: Information Technology (18.5%), Health Care (9.9), Communication Services (9.4), and Financials (5.4) (*Fig. 13*). Among the biggest laggards ytd are the Energy (-4.2%), Industrials (-0.3), and Materials (0.6) sectors.

Looking at the forward earnings for the S&P 500 and its 11 sectors, Energy is the lone sector with forward earnings down ytd (*Fig. 14*). The S&P 500's forward earnings has risen 11.3% ytd, more than its usual 8.0%-9.0% by this point in the year. The leading sectors: Information Technology (23.4%), Communication Services (22.5), Consumer Discretionary (14.5), and Financials (12.6).

(3) *Forward profit margin recovery also broad.* It has been a very good year so far for forward profit margins, which we derive from forward earnings and revenue estimates. The S&P 500's profit margin improved 6.0%, powered by four sectors' gains: Communication Services (11.9%), Consumer Discretionary (11.3), Financials (6.8), and Utilities (6.7). Only the forward margins of Health Care (-2.5) and Energy (-13.7) have fallen ytd (*Fig. 15*).

Here is a summary of the ytd percent changes in forward revenues, earnings, and profit margin forecasts: S&P 500 (upward revisions of 5.0% to revenues estimates, 11.3% to earnings estimates, 6.0% to profit margins), Communication Services (9.4, 22.5, 11.9), Consumer Discretionary (2.9, 14.5, 11.3), Consumer Staples (2.9, 3.7, 0.7), Energy (-4.2, -

17.3, -13.7), Financials (5.4, 12.6, 6.8), Health Care (9.9, 7.1, -2.5), Industrials (-0.3, 5.2, 5.5), Information Technology (18.5, 23.4, 4.1), Materials (0.6, 4.6, 4.0), Real Estate (4.5, 10.2, 5.4), and Utilities (2.2, 9.0, 6.7).

Calendars

US: Wed: MBA Mortgage Application; Crude Oil Inventories & Gasoline Production; Bowman; Cook. **Thurs:** Leading Indicators -0.3%; Philadelphia Fed Manufacturing Index 6.3; Kansas City Fed Manufacturing Index; Existing Home Sales 3.94mu; Initial Jobless Claims 220k; 10-Year TIPS Auction; Fed's Balance Sheet; Barr; Goolsbee. (FXStreet estimates)

Global: Wed: Germany PPI -0.1%; UK Headline & Core CPI 2.2%/3.1%y/y; UK PPI Input & Output 0.5%/-0.1%; UK House Price Index 2.9%y/y; ECB Financial Stability Review; Lagarde; De Guindos; Ramsden. **Thurs:** Eurozone Consumer Confidence -12.0; France Business Survey 95; UK Gfk Consumer Confidence -22; UK CBI Industrial Trends Orders -25; Japan M-PMI 49.5; Elderson; Lane; Mann; Bullock. (FXStreet estimates)

US Economic Indicators

Housing Starts & Building Permits (*link*): Housing starts fell more than expected in October as high mortgage rates and hurricanes sent single family starts lower, though builders' confidence improved markedly in November. *Housing starts* sank a larger than expected 3.1% (steeper than consensus estimates of -1.8%) in October to 1.311mu (saar), led by a 6.9% slide in *single-family* starts to 970,000 units (saar), as these starts plunged 28.7% in the Northeast and a weather-related 10.2% in the South. *Multi-family starts*, buildings with *five units or more*, increased 9.8% last month to 326,000 units (saar), after falling the prior two months by 21.0%. *Total starts* fell 4.0% y/y, with multi-family down 12.6%y/y and single-family 0.5% lower. Meanwhile, *building permits*, a proxy for future construction, slipped 0.6% in October to 1.416mu (saar), led by a 3.0% drop in multi-family units, while single family permits showed a 0.5% uptick to 968,000 units. On a year-over-year basis, permits fell 7.7%, led by a 20.9% drop in multi-family permits; single-family permits fell only 1.8%. *Builder confidence* in November climbed to a seven-month high, led by a big upward move in sales expectations.

Global Economic Indicators

Eurozone CPI (*link*): The *Eurozone CPI* accelerated 2.0% y/y in October, matching its flash estimate, after slowing from 2.6% in July to 1.7% in September—which was the lowest rate since April 2021. Meanwhile, the *core CPI* was unchanged at 2.7% in October. 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 ticked up from 3.9% to 4.0% y/y in October, fluctuating in a narrow band around 4.0% since May. *Energy* prices fell -4.6% y/y in October, narrowing from September's -6.1%; it had dropped below zero in August (-3.0% y/y) for the first time since April. Meanwhile, the rate for *food, alcohol & tobacco* moved up to 2.9% y/y from 2.3% in July and August. The rate for non-energy industrial goods ticked up to 0.5% from 0.4% in August and 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 showed slightly higher CPI inflation rates in October than during September: Germany (2.4% y/y from 1.8% y/y) showed the biggest yearly gain, followed by Spain (1.8 from 1.7), France (1.6 from 1.4), and Italy (1.0 from 0.7).

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