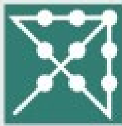

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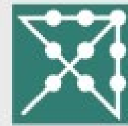

December 4, 2024

Morning Briefing

On France, Financial Stability & LargeCaps Vs SMidCaps

Check out the accompanying chart collection.

Executive Summary: French assets have been sending distress signals for months, and now unstable political dynamics and overly expansionary fiscal policy are coming to a head. … Also: Melissa reviews the Fed's latest *Financial Stability Report*, giving YRI's take on the Fed's market concerns. … And: Where are stock investors allocating funds to play the Trump 2.0 investment theme? Joe's data suggest SmallCaps, MidCaps, and cyclical sectors are increasingly in vogue.

Global Economies: Pass the Bordeaux. France's government is on the brink of collapse. The far-right National Rally party said on Monday that it was ready to trigger a no-confidence vote in the government over a proposed budget that includes $63 billion in tax hikes and spending cuts.

We wrote in our June 26 *Morning Briefing* titled "EU's Foundation Cracking?" that France faces two major issues: domestic political instability and overdrawn expansionary fiscal policy. Both are coming to a head now, and investors are readily fleeing French assets.

Consider these signs of distress:

(1) *Bond spreads*. Greek 10-year yields briefly fell below French OAT yields on Monday. Both are trading around 2.9%, or just over 80bps more than German bund yields (*Fig. 1*).

The difference between French and German bond yields is now roughly 15bps higher than when Emmanuel Macron and Marine Le Pen faced off in France's 2017 presidential election. Greece's 10-year yield was around 6.75% at that time; it had reached as high as 38.9% in the middle of the 2012 Eurozone crisis.

(2) *Debt dilemma*. The EU requires governments to maintain budget deficits below 3% of GDP and total debt below 60% of GDP. The rules were suspended during the pandemic

and after the Russia/Ukraine war kicked off, but they're back in play. French debt has reached 111% of GDP, and the budget deficit is running at 5.5% of GDP (*Fig. 2* and *Fig. 3*).

France has enjoyed better growth than most of the Eurozone nations since the pandemic (*Fig. 4*). That spurt is likely over.

(3) *Bread and circuses*. Hosting the Paris 2024 Olympic games provided a short-lived and relatively small boost to the French economy. France's S&P Global NM-PMI jumped from 50.1 to 55.0 in August, before falling to 49.6 by September (*Fig. 5*). It has since fallen to 45.7 as of November. The manufacturing PMI remained well below 50.0 since February 2023.

The Fed: In Banks We Trust. Created following the 2008 financial crisis, the Federal Reserve's quarterly *Financial Stability Report* (*FSR*) is intended to monitor financial system vulnerabilities to shocks. According to the November *report*, US financial stability is okay but not great. Thankfully, bank capital is in good shape and so are the credit markets. But the Fed's report still presents a laundry list of concerns.

On balance, we are more optimistic than the Fed on most points of concern. Below, we highlight the latest *FSR*'s major red flags and our thoughts on each:

(1) *Asset valuations*. Not wrong to be concerned, the Fed observes that the forward P/E ratio for the S&P 500 index is historically high. Equities are the largest asset market monitored in the Fed's report at $64.4 trillion through Q2-2024.

The last time that the S&P LargeCap 500's valuation approached where it is now (near 25) was during the late 1990s tech bubble. But the fact of a historically high P/E doesn't mean that valuations must stretch further for equity prices to rise. Earnings are a factor too. Likely, many investors share our expectation that the new administration's policies will be a net positive to domestic corporate earnings. But this is likely not yet reflected in analysts' official estimates.

For example, Goldman Sachs recently called Trump's impending tax cuts an "upside risk" to its S&P 500 earnings forecasts to the tune of 20.0%, according to a November 19 *Business Insider* *article*.

Depressed valuations in the S&P SmallCap 600 and S&P MidCap 400 indexes (collectively, the "SMidCaps") are a result of weaker earnings growth but present a runway for stock price

appreciation. Forward P/Es for the S&P 400 and S&P 600 indexes suggest these stocks may have more upside than those in the S&P 500 should earnings per share turn higher under Trump 2.0 (*Fig. 6*, *Fig. 7*, and *Fig. 8*). We are more bullish on earnings growth broadening out from the Magnificent-7 stocks to the "S&P 493" than to the SMidCaps, for now.

(2) *Commercial real estate (CRE).* Current CRE prices on the books may not fully reflect the deterioration in market prices, observes the Fed. CRE is the fourth largest asset market (behind equities, residential real estate, and Treasuries) monitored in the Fed's report, at $21.9 trillion through Q2-2024.

Commercial property owners may be waiting on the sidelines rather than listing fallen assets and realizing losses. The pandemic-induced work-from-home (WFH) trend battered the office sector.

We agree with the Fed's report that there is a lag to be mindful of in CRE prices. Is it possible, however, that the WFH trend already has been absorbed? Maybe. US CRE prices fell 8.8% in 2023, according to the International Monetary Fund's stability data. This followed a less than 1.0% loss in 2022 and a 15.8% gain in 2021 (*Fig. 9*).

We also see a few reasons for optimism regarding the CRE market.

For one, lower interest rates driven by the Fed's latest rate-cutting cycle are sure to stoke buyers' interest and present refinancing options for owners. The latest Fed's *Senior Loan Officer Opinion Survey* indicates that demand for CRE loans remains weak but is markedly improved from Q2-2023 (*Fig. 10*).

For two, many CRE owners may find ways to repurpose less desirable office buildings. Senior living options will become more in demand over the next decade as the Baby Boomers age. Large data centers required to operate artificial intelligence are another compelling option for repurposing unused office space.

For three, many large companies recently have *called* their employees back to the office, or else!

(3) *Auto and credit card delinquencies*. Turning from asset valuations to borrowing by businesses and households, the *FSR* indicates some concerns about consumer credit, specifically auto loans and credit cards. Yet the recent rise in delinquencies for these loans

is likely not systemic.

These borrowers represent just a small share ($2.9 trillion) of the total of all credit markets ($41.5 trillion) in the Fed's purview.

(4) *Insurers and hedge funds*. Life insurers' leverage continued to hold a significant portion of illiquid and high-risk assets. In Q1-2024, hedge fund leverage approached the highest recorded since data tracking began in 2013. The asset size of these markets is not inconsequential at $20.9 trillion combined, especially compared to the $27.7 trillion in assets at banks and credit unions.

These markets are in the business of complex risk management and concern us too.

(5) '*White swan' events*. We are not as concerned as the report suggests the Fed is about any near-term risk of an unexpected US recession. But we do include on our worry list most of the Fed's near-term risks: rising geopolitical tensions (including in the Mid East), adverse cyber events, and fiscal and monetary policy uncertainty.

So while we share some of the Fed's concerns, we do take solace in the Fed's analysis of the capital stability and resilience of the larger banks.

Strategy: What's in Style Now? All three of the S&P market-capitalization indexes had suffered bear market declines of 24%-27% before bottoming near the end of 2022. Since then, all three have attained new record highs this year.

The S&P LargeCap 500 index took 24 months to reach a new record-high price in January 2024. Its path to a new record high was shorter than the S&P MidCap 400's 28 months (from November 2021 to March 2024). But it wasn't until investors' spirits soared the day after the November 5 elections that the S&P SmallCap 600 was swept to a new record high—along with many US stock market indexes—after 36 months (*Fig. 11*)! That was SmallCap's lengthiest recovery to a record high since the period following the Great Financial Crisis (44 months).

With Trump soon to return as POTUS, Joe provides an early read on where investors have been allocating their investment dollars:

(1) *SMidCap and cyclical sector price indexes are leading so far.* The S&P 600 SmallCap price index has soared 7.9% since November 5 through Monday's close (*Fig. 12*). That's

ahead of the 6.4% surge for the S&P MidCap 400 and the 4.6% rise for the S&P LargeCap 500.

The SMidCap sectors have dominated too. Among the top 10 performers of the 33 S&P 500/400/600 sectors, eight are in the SMidCap indexes. These are the top 10 performing sectors: MidCap Energy (11.3%), MidCap Financials (11.3), LargeCap Consumer Discretionary (10.4), SmallCap Financials (10.1), SmallCap Information Technology (9.1), SmallCap Industrials (9.1), LargeCap Financials (8.7), SmallCap Materials (8.4), MidCap Consumer Discretionary (8.4), and SmallCap Consumer Staples (8.2).

Despite Trump's background in Real Estate, that sector has performed poorly along with Health Care. These are the worst performing S&P 500/400/600 sectors since the election: LargeCap Health Care (-0.7), MidCap Health Care (-0.4), LargeCap Materials (0.8), LargeCap Real Estate (1.1), MidCap Real Estate (1.1), and SmallCap Real Estate (1.6).

(2) *Will future forward earnings justify current valuation?* When the S&P 500 LargeCap's price index first returned to a record high in mid-January, forward earnings had already been making new record highs for four months since September 2023 (*Fig. 13*). Past cycles have had forward earnings attain new record highs *after* the price indexes did so. That's the pattern the SMidCaps are following now. The S&P 400 MidCap price index returned to a record high in March, but its forward earnings was still 6% below its June 2022 record high. Fast forward eight months to today, and MidCap's forward EPS is now less than 2% from a new record.

The S&P SmallCap 600 index has a steeper and longer path back to record-high forward earnings. Following the election, SmallCap's forward EPS was at an eight-month low of 11.8% below its June 2022 record high. Judging by SmallCap's post-election gain of 7.9% so far, investors are betting that Trump's policy changes will propel SmallCap's forward earnings back to record highs sooner rather than later.

Calendars

US: Wed: ADP Employment Change 166k; ISM NM-PMI 55.5; Factory Orders 0.3%; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Beige Book; Powell. **Thurs:** Initial Claims 215k; Trade Balance -$75,7bl OPEC Meeting; Fed's Balance Sheet; Natural Gas Storage; Barkin. (FXStreet estimates)

Global: Wed: Eurozone, Germany, and France C-PMIs 48.1/47.3/44.8; Eurozone, Germany, and France NM-PMIs 49.2/49.4/45.7; Eurozone PPI 0.4%; UK C-PMI & NM-PMI 49.9/50.0; Lagarde; Nagel; Bailey. **Thurs:** Eurozone Retail Sales -0.4%; Germany Factory Orders-2.0%; France Industrial Production 0.3%; Japan Household Spending 0.4%m/m/-2.6%y/y. (FXStreet estimates)

US Economic Indicators

JOLTS (*link*): *Job openings* in October rose more than expected after sinking in September to the lowest level since January 2021. October job openings rose 372,000 to 7.744 million after falling 489,000 in September to 7.372 million; openings were 941,000 below a year ago. 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. Job openings have been on a steady downtrend since March 2022's 12.2 million peak. There were 7.0 million people unemployed in October, so there were 1.1 available jobs for each unemployed person for the fourth successive month. This ratio was at a recent high of 2.0 during March 2022. *By industry*, the biggest gains in job openings in October were led by professional & business services (209,000), accommodation & food services (162,000), leisure & hospitality (129,000), and information services (87,000). The biggest declines occurred in wholesale trade (-37,000), other services (-37,000), arts, entertainment & recreation (-33,000), and federal government (-26,000). *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 on a downtrend since peaking at 4.5 million during April 2022, falling to 3.2 million in September—which was the lowest since summer 2020; quits rose 228,000 in October to 3.3 million.

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