December 11, 2024

Morning Briefing

Tariffs, Europe & Earnings

Check out the accompanying chart collection.

Executive Summary: Will the new tariffs expected under Trump 2.0 be inflationary, driving up US producers' input costs and the prices US consumers pay? We're not worried for several reasons that Eric explains, including the offsetting effects of the strong dollar. … Also: Many countries are facing political turmoil, fiscal instability, and weak economic outlooks these days. Melissa recaps the woes, which reinforce our Stay Home investment strategy. … And: The data are now available showing Q3 revenues, earnings, and margin results for S&P 500 companies collectively and by sector. Joe shares the notable takeaways.

Global Economy I: Tariffs vs the Dollar. The greenback might be the saving grace for US consumers and producers. The dollar is up 2.9% since the November 5 election (*Fig. 1*). Ostensibly, that appreciation is mostly due to expected tariffs, and the dollar would likely rise further if and when tariffs are enacted. A stronger dollar effectively offsets the price effects of a tariff, thereby making foreign countries "pay" the tariff by receiving fewer dollars for their imports to the US.

Theoretically, American consumers and some producers would "pay" the tariff if the dollar remained unchanged, or if other countries sold their appreciating foreign exchange (FX) reserves to offset currency devaluation. Dollars are the most commonly held reserve currency, at 58% of global FX reserves (*Fig. 2*).

The first scenario seems unlikely based on Trump 1.0 and current market dynamics. The second scenario is plausible, though foreign governments have limited ability to protect their currencies indefinitely. That's evidenced by Japan's struggle to defend the yen against the dollar over the past year or so. And most countries lack Japan's economic and balance-sheet strength.

Trump espouses the benefits of a weaker dollar, putatively to support American exporters. So if a weak-dollar policy is pursued through negotiations in a "Mar-a-Lago Accord" (think: Plaza Accord of 1985), then new tariffs could be inflationary.

Let's review how consumers and business might be impacted by potentially sweeping tariffs:

(1) *Inflation redux?* US consumers' real wages were crushed during the pandemic recession. Labor market frictions meant that all those seeking jobs didn't get one immediately, so fiscal stimulus was needed to offset lost wages. Then as workers found employment, high inflation meant that their wages didn't stretch as far. Real wages shrank as costs rose for food and most essential goods, squeezing the budgets particularly of lower- and middle-income households (*Fig. 3*).

Finally, as of 2023, real wage growth has been positive (*Fig. 4*). The employment-to-population ratio is near record highs with near-record prime-age labor force participation. So workers can bargain for higher wages at the same time that goods prices are deflating (*Fig. 5* and *Fig. 6*). In other words, middle America has enjoyed two strong years after being thrashed by policy choices from 2020-22. But workers still feel burned by depressed real wage growth, and any further affronts to their purchasing power will likely sour consumer sentiment.

(2) *Producers appeased*. Tariffs could raise input costs, but corporate profit margins surged to a record high under Trump 1.0 (*Fig. 7*). Deregulation and another corporate tax rate cut, along with the marginal impacts of favorable trade deals with allies, should more than offset the impacts of more expensive inputs. That's especially true as Europe and China's recessions depress global commodity prices.

Moreover, we expect already strong productivity growth to continue rising, which will put downward pressure on producers' unit labor costs. This will benefit both producers and consumers as lower costs of production get passed on to consumers via lower prices for goods.

All things considered, we aren't worried about tariffs creating an inflationary wave, even if the dollar doesn't strengthen enough to fully offset their impact.

Global Economy II: What's Wrong? Homegrown political turmoil along with fiscal instability have joined geopolitical crises as significant risks to global financial markets. Consider the following recent developments:

(1) South Korean President Yoon Suk Yeo's martial law stunt is the latest example of the

"Korean discount," which has pushed stock valuations to just 8 times forward earnings.

(2) The Bond Vigilantes have set their sights on French debt, driving French 10-year OAT yields up to near 3.0% last week, rates now comparable to debt-laden Greece's 10-year yields (*Fig. 8*).

(3) Europe remains in disarray, as we've noted before (see, for example, the *Morning Briefings* of *November 20* and *December 4*). European Central Bank President Christine Lagarde addressed solutions in *The Economist* last week with an *op-ed* titled "How to turn European savings into investment, innovation, and growth." Lagarde's main concern is the weakness in productivity and private investment across European nations (*Fig. 9*).

Europe's stagnation is the result of insufficient leadership from its major economies. The economic woes in Germany and France have compounded the Eurozone's challenges and shrunk its growth prospects. The European Commission forecasts just 1.5% and 1.3% real GDP growth, respectively, for the European Union and euro area next year.

(4) The global tariffs that are expected under Trump 2.0 are worrisome for some emerging market economies, particularly Mexico. We recently discussed Mexico's populist shakeup, which raises concerns about growing corruption at the top (see the November 6 *Morning Briefing*).

(5) Meanwhile, India's once-bright global growth trajectory has been dimmed by a slowdown in public expenditure as the country sorts out its homegrown *political drama*. India's economy grew just 5.6% y/y in Q3, a significant slowdown from the 10.2% pace during the final quarter of 2023 (*Fig. 10*).

Despite concerns about frothy valuations in domestic markets, these political upheavals are further reason to stay home in US stocks. Let's take a closer look at the most pressing issues in foreign economies:

(6) *What's wrong with Germany?* Germany's economic troubles point increasingly to structural weaknesses rather than just a cyclical downturn.

Last week, the OECD lowered its real GDP growth forecast for Germany in 2025 to a mere 0.7% from 1.1%, following a likely no-to-little-growth ending to 2024 (*Fig. 11*). Deteriorating demand caused Germany's service-sector PMI to contract in November for the first time since February (*Fig. 12*). German industrial production fell in October, with energy and auto production declining further (*Fig. 13*). Production dropped 1.0% m/m and 4.7% y/y. Incoming industrial orders fell 1.5% in October.

Volkswagen and other industrial giants are planning to shut down German factories and cut jobs. German consumer confidence has also dropped sharply, the GfK Consumer Climate Indicator fell 4.9 points in December to -23.3 (*Fig. 14*).

The political instability in Germany is likewise unsettling. Chancellor Olaf Scholz's ruling coalition recently fractured. A snap election is expected in February. The probable next leader, Friedrich Merz, is expected to ease fiscal constraints by issuing new debt to stimulate the economy. We believe the German economy could use fiscal support. Forming a new majority coalition to govern effectively could take until spring, though, leaving the country politically paralyzed in the interim.

(7) *What's wrong with France?* France is also in political limbo until June, when elections are constitutionally allowed. After a vote of no confidence, French Prime Minister Michel Barnier resigned last week. President Emmanuel Macron will appoint a successor soon, but the next French leadership will struggle to accomplish much without majority support in the parliament.

France's economic outlook is dim. Real GDP growth expected to stall in 2025 and consumers are increasingly pessimistic (*Fig. 15*). In November, household consumer confidence dropped to 90 points from 93 in October, remaining well below the long-term average (*Fig. 16*).

(8) *What's wrong with South Korea?* South Korea's political turmoil accelerated dramatically last week when President Yoon declared martial law on December 3 in an apparent attempt to block the opposition's 2025 budget bill, which included major government cuts. South Korea's parliament voted unanimously to cancel the decree just hours after it was issued.

Yoon's power grab was motivated by fears that the cuts would leave South Korea vulnerable to threats from North Korea. He's now facing renewed impeachment calls from opposition lawmakers (after an initial failed impeachment vote). Critics argue that martial law should be invoked only in times of extreme crisis, not to suppress political opposition.

The political instability has compounded South Korea's economic challenges. The country's semiconductor, steel, and chemical sectors are suffering from overcapacity due to China's market flooding, and factories are closing. China is effectively exporting deflation to South

Korea, which is exacerbating the situation (*Fig. 17*). Trump's potential global tariffs could further disrupt South Korea's economy, deepening its economic woes.

With the political outlook remaining uncertain, weak fiscal spending and declining investor confidence are likely to stifle South Korea's economic recovery (*Fig. 18*).

Strategy: S&P 500 Q3 Revenue, Earnings & Margin Results. With just three S&P 500 companies left to report Q3 results, S&P and I/B/E/S last weekend compiled their near-final Q3 revenues and earnings-per-share data for the companies in the S&P 500 and its 11 sectors. Using the revenues and earnings actuals, we can also derive their profit margins.

The results according to S&P and those according to I/B/E/S often don't match up owing to their different methodologies. But let's see how the S&P 500 and its sectors did during Q3, according to each data series:

(1) *S&P 500 Q3 revenues & EPS.* S&P 500 companies' aggregate operating earnings per share rose to a record high of $63.30 during Q3 for a second straight quarter according to I/B/E/S (*Fig. 19*). Earnings rose 8.4% y/y and growth was positive for a fifth straight quarter (*Fig. 20*).

S&P's version of operating earnings per share was a record high $59.40 during Q3, up 13.7% y/y and positive for a seventh straight quarter. Since Q1-1993, the two series have diverged an average of 5.2%. During Q3, I/B/E/S's operating EPS actual figure of $63.30 was 6.6% higher than S&P's $59.40. That continues the trend since Q4-2022 of relatively small divergences between the two actuals.

During Q3, S&P 500 revenues per share rose to a record high of $500.80, its first since Q4 - 2023 (*Fig. 21*). Revenues rose 6.9% y/y, up from 5.8% during Q2 and the fastest rate of growth since Q2-2023 (*Fig. 22*).

(2) *Q3 revenue & earnings growth by sector*. More S&P 500 sectors grew revenues y/y in Q3 than earnings. Revenues growth was positive for nine of the 11 S&P 500 sectors (*Fig. 23*). That's down from 10 sectors in Q2, which was the highest count since Q4-2022. Earnings growth was positive in Q3 for just seven sectors, unchanged from Q1 and Q2 (*Fig. 24*).

Here are their y/y earnings and revenue growth rates for Q3-2024: Communication Services (28.3% earnings growth, 10.2% revenues growth), Information Technology (18.5, 16.5), Utilities (15.4, 4.3), Health Care (15.3, 12.3), S&P 500 (8.4, 6.9), Consumer Discretionary (6.6, 4.4), Consumer Staples (5.7, 2.6), Financials (5.6, 17.9), Real Estate (-8.8, 5.2), Industrials (-11.0, -1.6), Materials (-11.3, 0.3), and Energy (-26.7, -4.9).

(3) *Record- or near-record high revenues in Q3 for many sectors.* The S&P 500's Q3 revenues was at a record high for the first time since Q4-2023, powered by a relatively broad swath of its 11 sectors. New record highs for quarterly revenues occurred in Q3 for six sectors: Communications Services, Consumer Staples, Financials, Health Care, Information Technology, and Real Estate. Remaining close to their highs were Consumer Discretionary and Industrials.

(4) *Record-high EPS for five sectors.* Q3-2024 marks a breakout quarter for the S&P 500, as these five sectors posted record-high EPS: Communication Services, Consumer Discretionary, Consumer Staples, Information Technology, and Real Estate. During Q2-2024, none of the sectors hit that mark for a second straight quarter.

(5) *Record-high profit margin for two sectors.* The S&P 500's quarterly profit margin rose q/q for a third straight quarter to a nine-quarter high of 12.6% in Q3 from 12.4% in Q2 (*Fig. 25*). The profit margin improved q/q for just four of the 11 sectors, down from six in Q2, but Communication Services (20.1%) and Consumer Discretionary (10.0) delivered post-pandemic or record highs, the first for any sector since Q3-2023. Among the remaining nine sectors, Utilities (17.4%) improved to a 12-quarter high, Energy (8.5) fell to 13-quarter low, and Real Estate (25.8) dropped to a seven-quarter low. Information Technology's 25.9% margin is the highest overall and exceeded Real Estate's in Q3 for the first time ever.

Here are the sectors' profit margin results: Information Technology (25.9% in Q3-2024, 25.8% in Q2-2024), Real Estate (25.8, 30.0), Communication Services (20.1, 15.8), Utilities (17.4, 13.8), Financials (13.8, 14.6), S&P 500 (12.6, 12.4), Consumer Discretionary (10.0, 9.3), Industrials (9.3, 10.5), Materials (9.0, 11.1), Energy (8.5, 9.2), Health Care (8.2, 8.3), and Consumer Staples (7.0, 7.0).

Calendars

US: Wed: Headline & Core CPI 0.2%m/m/2.7%y/y & 0.3%m/m/3.3%y/y; Federal Budget -$325.0b; MBA Mortgage Applications; 10-Year Note Auction; Crude Oil Inventories & Gasoline Production; OPEC Monthly Report. **Thurs:** Headline & Core PPI 0.3%m/m/2.5%y/y & 0.2%m/m/3.3%y/y; Jobless Claims 221k; Fed's Balance Sheet; 30-

Year Bond Auction; IEA Monthly Report. (FXStreet estimates)

Global: **Wed:** Canada BoC Interest Rate Decision 3.25%; Australia Unemployment & Participation Rates 4.2%/67.1%; Balz. **Thurs:** ECB Interest Rate Decision 3.15%; UK Gfk Consumer Confidence -18; Japan Industrial Production 3.0%; Japan Tankan Large Manufacturers & Non-Manufacturers Indexes 13 & 28; Lagarde. (FXStreet estimates)

US Economic Indicators

NFIB Small Business Optimism Index (*link*): "The election results signal a major shift in economic policy, leading to a surge in optimism among small business owners," noted Bill Dunkelberg, NFIB's chief economist. "Main Street also became more certain about future business conditions following the election, breaking a nearly three-year streak of record uncertainty." The *Uncertainty Index* sank 12 points in November to 98 from October's record high of 110. The *Small Business Optimism Index (SBOI)* rose for the third straight month by 10.5 points, from 91.2 in August to 101.7 in November, after 34 months of remaining below the 50-year average of 98. The SBOI rose 8 points in November alone, to its highest reading since June 2021. In November, nine of the 10 *components of the SBOI* rose, with current inventory unchanged at -2%. The biggest gain occurred in expect the economy to improve (+41ppts to 36%), followed by sales expectations (+18 to 14), now is a good time to expand (+8 to 14), earnings trends (+7 to -26), plans to make capital outlays (+6 to 28), plans to increase employment (+3 to 18), and plans to increase inventories (+3 to 1), with current job openings (36) and expected credit conditions (-5) both ticking up a percentage point. Inflation (20%) remained the single most important problem for small business owners in November, with quality of labor (19), taxes (14), and cost of labor (11), and government regulations (8) once again rounding out the top five. The net percentage of owners *raising selling prices* rose to 24% in November, after slipping from 22% to 21% in October, while a net 28% plan price hikes in the next three months, up from 26% in October and 25% in September; it was at 33% in March. Turning to *compensation*, a net 32% reported raising compensation in November, bouncing in a relative flat trend between 31% and 33% the past few months, while a net 28% plans to raise compensation in the next three months, up from 23% in both October and September; it was at a low for the year of 18% during both July and May.

Productivity & Unit Labor Costs (*link*): There were no revisions to the preliminary estimates for Q3 productivity, but there was an easing in the rate of labor costs. *Nonfarm productivity* increased an unrevised 2.2% (saar) during Q3, with both *output* and *hours* *worked* unrevised at 3.5% and 1.2%, respectively. Meanwhile, *hourly compensation* was revised downward to 3.1% (saar) from 4.2%, while *unit labor costs* rose a revised 0.8%, less than half the preliminary estimate of 1.9%. *Versus a year ago*, productivity rose 2.0% during Q3, slowing from 2.4% and 2.8% the prior two quarters, with output rising 2.8% and hours worked up 0.7% from a year ago. Hourly compensation slowed to 4.3% y/y from 4.8% and 6.2% during Q2 and Q1, respectively, while unit labors costs eased to 2.2% from 2.3% and 3.3% over the comparable periods.

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