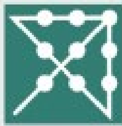

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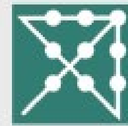

January 15, 2025

Morning Briefing

Updates On China, The UK & Earnings

Check out the accompanying chart collection.

Executive Summary: China gargantuan trade surplus won't shrink until policymakers stimulate domestic demand. Yuan depreciation now risks capital flight. … In the UK, gilt yields have reached multi-year highs, raising the government's borrowing costs to levels that might jeopardize its borrowing plans. … Joe has good news for US investors: If the upcoming Q4 earnings season follows the historical pattern, analysts' already lofty earnings estimates are too low. Joe thinks S&P 500 companies could turn in aggregate y/y earnings growth as steep as 12%.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

China: The Mother of All Trade Surpluses. China's strategy to export its way out of a domestic demand problem has led to a $992 billion trade surplus in 2024. Exporters may be front-running likely tariffs under Trump 2.0 and buying up relatively cheap commodities. But we still view this as a sign of the unsustainability of China's growth model. Here's more:

(1) *Export boom*. Chinese exports rose 10.7% y/y in December, beating analyst expectations of 7.0% (*Fig. 1*). Imports rose 1.0% y/y, also better than the expected decline. China's trade surplus therefore reached $104.84 billion in December alone.

(2) *No sign of import boom*. Growth in Chinese M2 money supply and bank loans both continue to fall (*Fig. 2*). Until China is able to stimulate its domestic consumer spending and bring retail sales growth above industrial production growth, it's unlikely that the trade surplus will shrink meaningfully (*Fig. 3*). It's also unlikely that China will be able to even fabricate its GDP growth to reach its target if this continues (*Fig. 4*).

(3) *Yuan depreciating*. The Chinese yuan dropped below the key 7.30 level to 7.33 versus the dollar (*Fig. 5*). While not a major depreciation, China had previously instructed state-owned banks to support the yuan at 7.30. China may be trying to front-run further weakness

that's likely to occur as tariffs on Chinese goods are ramped up. However, China may have to deal with capital flight if its currency drops much more.

United Kingdom: What's Boosting Gilt Yields. UK bond buyers are sending a clear signal to His Majesty's Treasury: There's no more room for new borrowing plans. As yields rise in the UK, they squeeze projected borrowing costs and essentially eliminate fiscal space.

UK long-term gilt yields have risen to multi-year highs in recent days. As of last Friday, the 10-year yield rose to 4.84%—the highest since 2008—and the 30-year yield rose to 5.41%, the highest this century (*Fig. 6*).

Yields are higher than when Prime Minister Liz Truss attempted to slash taxes without any offsets during her brief tenure in 2022 (a.k.a. the "Truss Moment"). However, they've lacked the velocity of that move. Then, the 30-year gilt yield gained 155bps in less than three weeks, from 3.45% on September 8 to 5.00% on September 27. The Bank of England (BOE) was forced to *intervene* with emergency UK gilt purchases.

The recent climb in yields has been an orderly march over months, not weeks. The 30-year gilt yield is up 91bps from 4.50% at the start of October. The global bond selloff has helped lift yields this time around as well (*Fig. 7*). Currently, there is no indication that the BOE will step in to calm markets with bond purchases.

Could this be a new normal for gilt yields? It's possible given global, inflationary, and economic factors. BOE interest-rate cuts throughout the year may help drag yields down; however, that plan backfired for the US as Fed rate cuts helped boost long-term Treasury yields. If the UK government is forced to adjust its plans for more borrowing, that could also cause gilt yields to fall. It would put economic growth at risk though, too.

The UK sterling's recent fall also could attract foreign capital inflows, reversing yields' sharp rise. While rising yields and a falling currency recall an emerging-market-style loss in confidence, those facts more likely reflect the pound's overvaluation relative to the dollar last year.

Let's consider the forces putting pressure on gilt yields:

(1) *Tracking global yields.* Likely, some of the gilt yield rise reflects the path of global bonds, especially Treasuries. Expectations for stickier inflation are increasing globally, both due to

a potential trade war sparked by Trump 2.0 but also easier monetary policy from most central banks. In the US, 10-year yields have risen 100 basis points (bps) since September 13, 2024 (*Fig. 8*).

(2) *Wider UK spreads.* The UK's bond-market woes have been more pronounced than those of other Western countries, so there is some sovereign-specific risk being priced in. The spread between UK and German government bond yields, for instance, has risen to a multi-decade-high 230bps (*Fig. 9*).

(3) *More borrowing*. The rise in gilt yields began in October, when Chancellor Rachel Reeves laid out the Labour Party's fiscal-year budget. Reeves became Chancellor of the Exchequer on July 2024, appointed by Prime Minister Keir Starmer following the Labour Party's 2024 general election win.

In her first budget proposal, Reeves *wrote* in the *FT* on October 24 that she would use the October 30 budget to implement a new fiscal rule aiming to provide more investment for infrastructure. Separately, the *FT* *said* that she would aim to fund about 20 billion pounds per year of incremental investment with increased borrowing.

"Reeves has been eyeing changes to Britain's domestic budget rules to make it easier to finance public investment, potentially by using a looser definition of public debt that allows a wider range of public assets to be offset against borrowing," Reuters *explained*.

But any spending buffer in the next fiscal year budget that would have been "allowed" under the new fiscal rules could be eaten away by higher borrowing costs. In that case, Reeves would need to raise tax revenues to cover the additional spending. Not only would that likely be politically unpalatable but it could undermine economic growth.

Despite the bond market turmoil, economic growth remains the government's top priority, Reeves *said* during a visit China this week. She *added* that the new fiscal rules set out in the October budget are "non-negotiable."

(By the way, it hasn't helped the credibility of the UK Labour Party that incoming US President Trump's favored adviser Elon Musk has *called* for a national UK public inquiry into the recently uncovered UK coverup scandals. Starmer's party prefers more local investigations.)

(4) *Recession and stagflation concerns.* Higher yields for this historically safe asset class

normally would be considered an attractive investment. In this case, the markets are attributing higher risk to UK government bonds because the nation's economic fundamentals are weakening.

The UK could be facing a recession, or worse, stagflationary conditions. Real GDP rose a mere 0.9% y/y and 0.1% q/q during Q3-2024 (*Fig. 10*). Meanwhile, both the UK headline and core CPI rebounded from a rate of 3.2% y/y and 1.7% y/y during September 2024 to 3.6% and 2.6% through November 2024.

(5) *BOE's cut to cuts.* Long-term inflation risks are reflected especially in the rising 30-year UK gilt yields noted above. To combat these risks, the BOE raised its main interest rate from 0.10% to 5.25% over the period December 2021 to August 2023. The bank cut rates twice during 2024, bringing its main rate back down to 4.75% on economic growth concerns.

Recent forecasts for rate cuts have fallen from two or three to just one, indicating that the BOE sees sticky inflation as a persistent problem, pushing UK gilt yields up.

(6) *BOE's unwinding*. Further, the BOE previously was a net buyer in the UK gilt market. The bank has reduced its holdings of gilts since March 2022, and it has yet to complete its unwinding of pandemic-induced gilt purchases (see *chart*).

Net selling by the BOE and the anticipated increase in the supply of government bonds have contributed to lower gilt prices.

(7) *Sterling falls*. Weakening fundamentals and higher capital outflows have pushed the sterling lower. The weaker currency should attract foreign buyers considering the sterling's soundness. From September 30 until now, the UK currency has fallen almost 10.0% to $1.23 dollars per pound, the lowest in over a year (*Fig. 11*).

US Strategy: Don't Be Surprised by Strong Q4 Earnings Surprises. Joe has been tracking the quarterly earnings forecast for S&P 500 companies collectively each week since the data series started in Q1-1994. Each reporting season brings a typical playbook: Industry analysts cut their estimates gradually until the final month of the quarter, when some companies warn of weaker results. The combination of falling forecasts for companies that have underperformed earlier expectations, steady forecasts for those holding good news close to their vests, and insufficient estimate increases so close to reporting time to balance out the lowered expectations invariably creates an "earnings hook" pattern in the

charted estimate/actual data as reported earnings exceed the latest estimates—i.e., a positive earnings surprise.

In other words, the final month of quarters usually sets the stage for better-than-expected earnings reports. Will Q4-2024 prove true to form? Joe believes so. Below, he digests the consensus' outlook for earnings growth and profit margins:

(1) *Revisions as usual for the Q4-2024 estimate.* During the last week of December, the S&P 500's Q4-2024 EPS estimate of $61.80 was down 3.2% from $63.86 at the start of the quarter in October (*Fig. 12*). Nearly all of Q4's decline occurred by mid-November, as EPS then stabilized until the end of the year. That decline was a pinch smaller than the 3.6% drop for Q3-2024 and matched the average quarterly decline of 3.2% over the past three years. It also compared favorably to the 3.9% average decline over the 123 quarters since consensus quarterly forecasts were first compiled 30 years ago.

Such "not-too-hot-not-too-cold" revisions activity implies yet another strong earnings surprise. With the earnings hook, Q4's final earnings growth rate could be as high as 12%.

(2) *S&P 500 earnings growth streak at six quarters.* Analysts expect the S&P 500's earnings growth rate to be positive on a frozen actual basis for a sixth straight quarter following three y/y declines through Q2-2023. They expect 8.2% y/y growth in Q4-2024, compared to 8.2% in Q3-2024, 11.3% in Q2-2024, and 6.6% in Q1-2024 (*Fig. 13*). On a pro forma basis, they expect a sixth straight quarter of positive y/y earnings growth, up 9.5% (versus 9.1% in Q3-2024, 13.2% in Q2-2024, and 8.2% in Q1-2024).

(3) *Seven sectors expected to show y/y growth.* Seven of the S&P 500's 11 sectors are expected to record positive y/y percentage earnings growth in Q4-2024, the same number as in Q3-2024. Analysts expect three sectors to post small y/y earnings declines, but we think the typical surprise hook will flip those sectors to positive y/y earnings growth. That would push Q4's final count of sectors with y/y earnings growth to 10, the most since easy y/y comparisons to pandemic-impacted results helped 10 sectors hit that mark in Q4-2021.

The seven sectors that analysts currently see posting positive y/y growth all are expected to record double-digit percentage gains. That's up from five sectors with double-digit gains in the past three quarters through Q3-2024.

Communication Services has the highest expected y/y growth for a second straight quarter, 22.7%, ahead of Financials (18.0%), Information Technology (15.3), Consumer

Discretionary (12.9), Health Care (12.1), Real Estate (10.7), and Utilities (10.5). Energy is the biggest laggard with a forecasted y/y earnings decline of 28.4%, well behind the Industrials (-3.4), Materials (-2.1), and Consumer Staples (-1.2) sectors.

(4) *Y/y growth streaks: winners and losers.* Health Care is expected to be positive for a third straight quarter and at another strong double-digit percentage rate. Boeing's strike has hurt the Industrials sector, which is now expected to report a second quarter of falling earnings y/y after rising for 13 straight quarters through Q2-2024. Consumer Discretionary and Financials are expected to rise for an eighth straight quarter, followed by seven quarters of growth for Communication Services and Information Technology. Energy is expected to report falling y/y earnings during Q4-2024 for the seventh time in eight quarters. Materials is expected to mark its tenth straight y/y decline in quarterly earnings.

(5) *Most MegaCaps still growing faster than the S&P 500.* The Magnificent-7 group of stocks is expected to record y/y earnings growth of 19.9% in Q4-2024 (*Fig. 14*). That's down from 27.6% during Q3-2024 and a peak of 28.1% during Q2-2023 when Nvidia's easy comparisons finally aged out at nearly 600% y/y. Amazon is Q4's biggest expected earnings grower, rising 50.4% y/y, ahead of Nvidia (37.2%), Alphabet (27.3), and Meta (24.7). Three Magnificent-7 companies became less-than-magnificent earnings growers last year and are expected to lag again in Q4: Tesla (4.8%), Apple (5.7), and Microsoft (6.9).

(6) *S&P 493 earnings growth positive again without faster growing MegaCaps.* S&P 500 earnings excluding the Magnificent-7, a.k.a. "the S&P 493," are expected to rise 7.1% in Q4. That rate is still hobbled by Boeing's strike, which caused S&P 493 earnings to rise just 3.9% y/y in Q3-2024 following gains of 7.6% in Q2 and 0.6% in Q1. The surprise hook could result in near double-digit percentage y/y growth for the S&P 493 in Q4-2024, which would be the highest rate since it rose 10.6% y/y 11 quarters ago in Q2-2022.

(7) *Profit margin gains continuing.* The S&P 500's quarterly profit margin is expected to improve to a 12-quarter high of 13.1% in Q4 from 12.9% in Q3 (*Fig. 15*). That compares to the 13.5%-13.8% readings during Q2- to Q4-2021 when companies enjoyed immense pricing power amid supply-chain shortages. The collective profit margin for the S&P 493 is expected to edge up to a four-quarter high of 11.7% in Q4 from a Boeing strike-challenged 11.6% in Q3.

It seems a stretch now to expect the S&P 493's profit margin to beat its 12.9% record highs of H2-2021. However, analysts currently expect it to improve to 12.7% by Q3-2025. That's before any possible corporate tax rate cuts. Higher oil prices could see Energy sector

earnings grow meaningfully during Q3-2025 for the first time in 10 quarters.

The Magnificent-7’s quarterly profit margin is expected to drop to 24.2% in Q4 from a record-high 25.5% in Q3. Here’s how the Magnificent-7’s expected Q4 profit margins stack up along with their Q3 margin actuals: Nvidia (54.9% in Q4-2024, 57.2% in Q3-2024), Meta (37.4, 38.6), Microsoft (34.0, 37.6), Apple (28.9, 26.3), Alphabet (27.2, 29.8), Tesla (9.6, 10.0), and Amazon (8.5, 9.7).

Calendars

US: Wed: Headline & Core CPI 0.3%m/m/2.8%y/y & 0.2%m/m/3.3%y/y; Empire State Manufacturing Index 4.5; MBA Mortgage Applications. **Thurs:** Retail Sales Headline & Ex Autos 0.6%/0.4%; Jobless Claims 210k; Import & Export Price Index 0.1%/0.2%; Philadelphia Fed Manufacturing Index -5. (FXStreet estimates)

Global: Wed: Eurozone Industrial Production 0.4%m/m/-1.9%y/y; Germany GDP -0.2%; Germany Wholesale Prices 0.1%; France CPI 0.2%m/m/1.8%y/y; Spain CPI 0.4%m/m/2.8%y/y; UK Headline CPI 0.4%m/m/2.7%y/y; UK Core CPI 3.4%y/y; UK Input & Output PPI 0.2%/0.1%; UK Retail Price Index 0.6%m/m/3.7%y.y; De Guindos. **Thurs:** Germany CPI 0.4%m/m/2.6%y/y; Italy CPI 0.1%m/m/1.4%y.y; UK GDP 0.2%m/m; UK Total & Manufacturing Industrial Production 0.1%m/m/-1.0%y/y & 0.0%m/m/-0.4%y/y; ECB Monetary Policy Meeting Accounts. (FXStreet estimates)

US Economic Indicators

NFIB Small Business Optimism Index (*link*): Optimism continued to soar in December, while the Uncertainty index plunged 12 points in December to 86. “Optimism on Main Street continues to grow with improved economic outlook following the election,” noted Bill Dunkelberg, NFIB’s chief economist. “Small business owners feel more certain and hopeful about the economic agenda of the new administration. Expectations for economic growth, lower inflation, and positive business have increased in anticipation of pro-business policies and legislation in the new year.” The *Small Business Optimism Index (SBOI)* rose for the fourth straight month by 13.9 points, from 91.2 in August to 105.1 in December—the second straight month above the 51-year average of 98 to the highest level since October 2018! In December, seven of the 10 *components of the SBOI* rose, while two fell and earnings

trends was unchanged at 26%. The biggest gain occurred in expect the economy to improve (+16ppts to 52%), followed by sales expectations (+8 to 22), now is a good time to expand (+6 to 20), plans to increase inventories (+5 to 6), expected credit conditions (+3 to -2), plans to increase employment (+1 to 19) and current inventory too low (+1 to -1). Both capital outlay plans and current job openings slipped 1.0ppt to 35% and 27%, respectively. Inflation (23%) remained the single most important problem for small business owners in December, with quality of labor (19), taxes (17), and cost of labor (11), and government regulations (7) once again rounding out the top five. The net percentage of owners *raising selling prices* remained at 24% in December, after slipping from 22% to 21% in October, while a net 28% plan price hikes in the next three months, remaining at November's percentage but up from a recent low of 24% in July; it was at 33% in March. Turning to *compensation*, a net 29% reported raising compensation in December, after bounding between 31% and 33% the prior few months, while a net 24% plans to raise compensation in the next three months, down from 28% in November; it was at a low for the year of 18% during both July and May.

Contact us by *email* or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Eric Wallerstein, Chief Markets Strategist, 201-661-3575
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-241-6502
Melissa Tagg, Senior Global Investment Strategist, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-228-9102