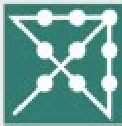

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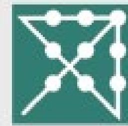

January 29, 2025

Morning Briefing

On Eurozone Stocks, BOJ Policy & More On AI Stocks

Check out the accompanying chart collection.

Executive Summary: Eurozone stock markets have been performing well and sport much lower valuations than the US stock market. But their valuations are lower partly for index composition reasons, Eric explains, and we still have plenty of economic and political concerns about the region. So we don't recommend rotating into Eurozone stocks, preferring our Stay Home investment stance. … Also: Melissa discusses the markets' reactions to the Bank of Japan's recent rate hike and the likely path of Japanese interest rates looking ahead. … And: Now that DeepSeek has rocked the world of AI and taken a chunk out of the Magnificent-7's collective valuation, Joe asks: Is it time for the S&P 493 and the Equal-Weight S&P 500 to shine?

Global Stocks: New Dawn for the Eurozone? Eurozone stocks have been off to the races this year. The best ytd performers among the MSCI country indexes all have been European (*Fig. 1*). While Eurozone stocks are still broadly trailing US stocks since the bear market bottomed in October 2022, MSCI Germany and MSCI Spain have nearly caught up with their US counterpart (*Fig. 2*). In fact, MSCI EMU (European Economic and Monetary Union) recently hit a record high—and not because of a quickly expanding valuation multiple (*Fig. 3*).

Most Eurozone country indexes trade between 10 times to 15 times forward earnings (*Fig. 4*). That's well below the US MSCI's 22.5 forward P/E. Relatively cheaper valuations have led some to call for rotation into Eurozone stocks, especially as US equities contend with purportedly frothy valuations.

We've been bearish on the Eurozone for economic and political reasons. To us, the stalwarts (Germany and France) are flashing worrying signals on both fronts. Fiscal spending is waning, political instability is growing, economic growth is slowing, and demographics are a headwind.

However, the stock market isn't the economy, and that's particularly true in the Eurozone.

Valuations are partially depressed due to the sector composition of the indexes. European indexes are heavy on low-valuation sectors like auto manufacturers and banks and have few growth and technology companies.

The tech companies that are domiciled in Europe have driven much of the outperformance. For instance, Germany's blue-chip DAX 40 is up 26% over the past year to a record high. Even MSCI Germany—which is less concentrated than the DAX 40—is up double-digit percentage points. But under the hood, two companies account for 27% of MSCI Germany's market capitalization, SAP and Siemens. Both benefit from the AI trade and aren't overly exposed to Germany's downtrodden economy. For instance, SAP derives nearly as much revenue from the Americas as it does from EMEA.

Much of the bearishness may be already priced into Eurozone indexes, leaving room for upside. But based on forward revenues, earnings, and profit margins, we're still far from changing our underweight recommendation relative to US stocks. We're sticking with our Stay Home (versus Go Global) investment strategy, preferring US large-cap stocks over international ones.

Here's more:

(1) *Forward revenues*. Analysts expect forward revenue growth to turn positive this year and next. However, they could be overly optimistic (*Fig. 5*). Consensus expectations implied more than a 2.0% y/y increase in forward revenues early last year, only to see them fall 0.5%.

(FYI: Forward revenues and earnings are the time-weighted averages of analysts' consensus estimates for the current and following year; the forward profit margin is imputed from forward revenues and earnings.)

(2) *Forward earnings*. Forward earnings have been relatively flat in the Eurozone since 2023 (*Fig. 6*). Net earnings revisions have also been deeply negative for much of the past year (*Fig. 7*). We prefer to overweight regions and sectors with improving fundamentals (e.g., rising forward earnings) as opposed to counting on valuation improvement.

(3) *Forward profit margins*. Analysts expect 8.8% y/y earnings growth in the year ahead relative to a 3.3% increase in revenues, suggesting margin expansion (*Fig. 8*). With the cost of labor rising, potential tariffs, and less government spending, it may be difficult for Eurozone stocks to make much headway in expanding their margins.

The saving grace for margins and Eurozone stocks may be easier monetary policy. The futures market expects the deposit rate to be cut three times (25bps each) this year to 2.25%, with the first cut likely to come on Thursday (*Fig. 9*). We think the ECB may cut four or five times, which will depress the euro and help exporters earn more euros for their dollar-denominated sales. Of course, an end to the Russia-Ukraine war is another possible positive catalyst.

While that sounds like a good setup, investing in a country that is cutting interest rates due to slowing economic growth is not without its perils. We question whether the Eurozone will be able to remain stable amid the current political tumult and whether their economies can handle slowing labor force growth and fiscal spending. China's continued attempt to export its way out of its recession is just another exogenous factor hurting the Eurozone. We retain our underweight recommendation.

Global Central Banks I: BOJ Takes (Another) Hike. For the first time since spooking the markets with a rate hike last July, the Bank of Japan (BOJ) hiked again last Friday, its third in less than a year. It raised Japan's key interest rate 25 basis points to 0.50%, its highest since September 2008 (*Fig. 10*). The market reaction was nonchalant this time.

Let's review what happened:

(1) *Last July's rate hike was a shocker.* The financial markets weren't expecting the BOJ's July rate increase, and it touched off a panicked unwinding of yen-funded carry-trade positions, rippling in global markets. The carry trade entails borrowing in one currency where interest rates are low and leveraging those funds in another currency market where interest rates are relatively high. The prevalence of traders borrowing in yen to buy assets in Brazil, Mexico, the US, etc. led to an increased beta (correlation) across risk assets.

With the recent rate-hiking cycle and yen appreciation, the return on yen-funded carry trades is lower. This is not only because the BOJ is hiking rates but also because the US, Europe, and other major economies have been lowering interest rates, closing the gap on potential returns.

(2) *This time, no surprises.* The BOJ widely telegraphed its intention to raise rates this time to minimize adverse reactions, which proved successful.

Post the July 31 decision, the Nikkei 225 index fell 21.2% from August 1 to an August 5 monthly low (*Fig. 11*).

Despite the January rate hike, the Nikkei is up 1.5% from a monthly low on January 15 through the January 28 close.

Notably, the 10-year Japanese government bond yield rose from a low of 0.79% on August 5, 2024 to 1.26% on January 15, before closing at 1.19% on January 28 (*Fig. 12*).

Global Central Banks II: BOJ Maintains Below Neutral Posture. We believe that wage and services inflation may prompt another one or two 25bps hikes this year. The BOJ would still like to be accommodative, just less so. It's possible that the next hikes will happen faster than the six-month pace that the bank has set so far given the recent quickening of inflation (detailed below). Much still depends on the path of Fed policy. Given our expectations for strong US growth and higher-for-longer interest rates, we believe the BOJ may hike less than many strategists think.

So far, Trump 2.0 seems inclined to hold pro-Japan policies, which could ease Japanese policymakers' concerns about inflationary pressures resulting from bilateral US protectionism.

Here's our thinking:

(1) *Why hike?* Data released before Friday's rate-hike decision showed that the CPI excluding fresh food rose from 2.6% y/y in November to 3.0% y/y in December. It was the first time that this rate topped 3.0% since October 2023. Excluding both fresh food and energy prices, the core CPI rose by 2.4% y/y in both November and December (*Fig. 13*). All those rates are above the bank's 2.0% target.

The BOJ has indicated that accelerating wage pressures will factor heavily into its rate decisions. Japanese contractual wages have risen well above the rate of inflation since January 2024. Wages rose 4.9% y/y through November (*Fig. 14*).

(2) *How much to hike?* BOJ Governor Kazuo Ueda *stated* on December 24 that "the Bank will maintain *accommodative* financial conditions by keeping the policy interest rate *lower* than the neutral interest rate." The January Monetary Policy Statement *confirmed* this: "Real interest rates are expected to remain significantly negative, and *accommodative* financial conditions will continue to firmly support economic activity." (Italics ours.)

The real neutral interest rate is the rate that would neither accelerate nor slow an economy. That's in theory. In practice, it cannot be measured, but that doesn't stop economists from

trying to estimate it. The most recent *study* on the real neutral rate on the BOJ's website, dated October 2024, estimates that the rate is somewhere in the -1.0% to +0.5% range (see Figures 2 and 3 on pages 15 and 16). Adding inflation, that corresponds to a nominal policy rate of 1.0% to 2.5%. Our expectations are toward the lower end.

Coincidentally, former BOJ board member Makoto Sakurai said on Tuesday that he expects the BOJ to hike the policy rate to 0.75% in June or July and eventually to 1.5%.

(3) *When to hike?* The BOJ's hiking timeline depends on the incoming inflation data relative to the bank's projections in its January outlook. It's similar to evaluating US CPI and PCED inflation relative to the Fed's Summary of Economic Projections.

For fiscal 2025, the BOJ expects the headline (ex-fresh food) and core (ex-fresh food and energy) CPI to end at annualized rates of 2.4% and 2.1%, respectively, both up from October's estimates. This pace seems to be highly attainable based on the latest inflation data.

(4) *What will Trump 2.0 bring?* The bank is hiking rates now not only because inflation is rising but also because it feels it can do so while currency markets are relatively calm. Japanese bankers feared currency markets would go haywire if President Trump came in too aggressively on protectionist trade policies, which so far has not been the case.

We sense that Trump's policies will lean pro-Japan. Already, the President is partnering with Softbank, Japan's largest financier. Softbank has been charged with funding for Trump's Stargate venture. The joint venture between Softbank, Open AI, and Oracle will *deploy* $100 billion now and $500 billion eventually to build new AI infrastructure, including data centers and physical campuses. Trump will use executive orders and emergency declarations to push through construction and energy access.

If the US is all in with Japan on arguably one of the most important initiatives of our time, AI, then it must be all in on Japan.

Strategy: DeepSeek Won't Sink AI Trade. DeepSeek may be made in China, but the development of its cheaper and better open-source large language model (LLM) represents capitalism at its finest: AI's high profit margins attracted competition and fostered innovation. DeepSeek's achievement was accomplished using Nvidia's cheaper, lower-margin chips that were not subject to Chinese export restrictions. DeepSeek's performance, which Jackie scooped in last Thursday's *Morning Briefing,* ranks strongly relative to the

models from OpenAI and others and at a significantly lower cost. The news shook the foundation of the AI trade on Monday as investors punished Nvidia and dumped AI energy-related stocks.

Here's more:

(1) *Setting the profit margin bar higher.* We don't think AI's apple cart has been overturned by DeepSeek's performance. A wider choice of picks and shovels, i.e., lower-cost AI alternatives, will allow the less deep-pocketed companies in the S&P 493 (i.e., the S&P 500 excluding the Magnificent-7) to re-tool their businesses as well. The potential for data processing energy, semiconductor, and datacenter costs to decline amid increased competition means the S&P 493's profit margins could improve faster than analysts anticipate.

(2) *Signs of life in S&P 493?* The Magnificent-7 trade worked well in the weeks following the election. At its peak in late December, the Magnificent-7 had been up as much as 13% since November 5, well ahead of the S&P 500 (4%) and the S&P 493 (1%). Now the Magnificent-7 is up just 6.5% since the election but still ahead of the S&P 500 (4.0%) and the S&P 493 (3.5%) over that timeframe (*Fig. 15*).

On a ytd basis, however, the Mag-7 is no longer outperforming after its sharp 3.5% decline on Monday. The group is now down 1.4% ytd and lagging the S&P 493 (up 4.1% ytd) and the S&P 500 (2.2%).

(3) *Signs of life in Equal Weight?* Investors expecting the equal-weight indexes to outperform also saw some encouraging signs Monday. Up until then, the S&P SmallCap 600's equal-weight indexes had done better since the election than those of the S&P LargeCap 500 and S&P MidCap 400.

The equal weight/market weight (EW/MW) price index ratios for the various S&P market-cap groups shows that SmallCap's EW index has outperformed the MW index by 0.5% since the election (*Fig. 16*). MidCap's EW is lagging slightly now, by just 0.1%. However, LargeCap's equal-weight price index may be making another attempt to outperform its market-weight counterpart. It's now trailing by -1.9% since the election, but that's a big improvement from its -4.7% reading near the end of December.

DeepSeek's news is timely, arriving just ahead of Q4 results for five of the Magnificent-7 companies. Investors are sure to tune in closely to hear what these companies'

management teams think about DeepSeek and its impact on the AI revolution in the US as well as what the managements of the S&P 493 companies have to say about the outlooks for their AI spending and timelines for improving profit margins. Stay tuned.

Calendars

US: Tues: Consumer Confidence Index 106.0; Richmond Fed Manufacturing Index -8; Durable Goods Orders Total, Ex Defense 0.8%/0.4%; S&P Shiller Home Price Index 0.2%m/m/4.1%y/y. **Wed:** Fed Interest Rate Decision 4.50%; Trade Balance -$105.4b; Wholesale Inventories 0.1%; Retail Inventories Ex Autos 0.4%; MBA Mortgage Applications. (FXStreet estimates)

Global: Tues: France Consumer Confidence 90; Spain Unemployment Rate 11.1%; Australia CPI 0.3%m/m. **Wed:** Germany Gfk Consumer Confidence -20; Italy Consumer & Business Confidence 96.0/85.5; Spain GDP 0.6%q/q/3.2%y/y; Japan Consumer Confidence 36.5; BoC Interest Rate Decision 3.00%. (FXStreet estimates)

US Economic Indicators

Consumer Confidence (*link*): “Consumer confidence has been moving sideways in a relatively stable, narrow range since 2022. January was no exception. The Index weakened for a second straight month, but still remained in that range, even if in the lower part,” noted Dana Peterson, chief economist at the Conference Board. *Headline consumer confidence* dropped 5.4 points in January to 104.1, while December's reading was revised up by 4.8 points to 109.5, but was still lower than the prior month (112.8). The *present situation* component plunged 9.7 points this month to 134.3, while the *expectations* component slipped 2.6 points to 83.9—holding above the threshold of 80 that usually signals a recession ahead. All five components of the index declined in January, with consumers' assessments of the present situation showing the largest decline. Consumers' assessments of *current business conditions* worsened in January, with 18.4% of consumers saying business conditions were "good," down from 20.1% in December and 15.4% saying they’re bad, unchanged from December. *Turning to the labor market*, consumers’ appraisals also deteriorated, with 33.0% saying *jobs were plentiful*, down from 37.1% in December, while 16.8% said *jobs were hard to get*, up from 14.9% last month. Consumers turned less optimistic on their assessment of *short-term business conditions* six months from now, with

20.9% of consumers expecting business conditions to improve, down from 22.7% in December and 18.7% expecting business conditions to worsen, up from 17.3% last month. Consumers' assessment of the *labor market outlook* remained pessimistic this month, with 19.4% of consumers expecting more jobs to be available, down slightly from December's 19.8%, and 20.3% predicting fewer jobs, flat with December. Consumers' assessments of their income prospects were less optimistic in January, as 18.3% of consumers expect their incomes to increase, falling from December's 19.0%, while 11.9% expected their incomes to decline, down from 12.1% last month. As for *inflation expectations,* the 12-month expected inflation rate climbed from 5.1% to 5.3% in January—reflecting stickier inflation in recent months. The report notes that references to inflation and prices continue to dominate write-in responses.

Durable Goods Orders & Shipments (*link*): Durable goods orders continued to drop in December, led by declines in transportation equipment orders, mainly Boeing-related. *Durable goods orders* contracted four of the final five months of 2024 by 2.2% in December (vs consensus estimates of a 0.8% gain) and 4.4% over the period, while *durable goods orders ex transportation* rose 0.3% and 1.3% over the comparable periods. Transportation orders tanked 7.4% in December after plunging 5.4% in November—led by sharp declines in non-defense aircraft. Meanwhile, *nondefense capital goods orders excluding aircraft* (a proxy for future business investment) climbed 0.5% in December, building on November's 0.9% gain—which was the strongest monthly gain in two years, while *nondefense capital goods shipments excluding aircraft* (used in calculating GDP) rose the final three months of 2024, by 0.5% in December and 1.4% over the period.

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