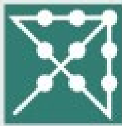

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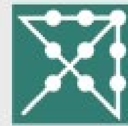

February 19, 2025

Morning Briefing

European Renaissance?

Check out the accompanying chart collection.

Executive Summary: The EU is suffering economically, its growth slowed by internal hurdles that act as unintended tariffs. Melissa examines a grand new plan to reinvigorate economic growth, but YRI is skeptical of its success. Investors in European stock markets, on the other hand, seem suddenly optimistic on the region's outlook unless bargain-basement valuations are the appeal. ... Also: Eric explores the market ramifications of Europe's finally spending on its own economic and defense security. … And: How did S&P 500 companies fare last quarter? Judging by the results in hand so far, very well: Nearly three-fourths grew their revenues from year-ago levels, and almost as many grew earnings.

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

Eurozone I: The EC's Grand Plan To Revive Growth. Forget the US—Europe's real enemy is self-imposed stagnation. That's the conclusion of Mario Draghi, former prime minister of Italy and former president of the European Central Bank (ECB), in a February 14 *opinion piece* for the *Financial Times*. Draghi argues that internal barriers within Europe, from regulatory red tape to national protectionism, do more harm to economic growth than any tariff the US could levy. According to the International Monetary Fund, Europe's internal hurdles act as an effective tariff: a staggering 45% for manufacturing and an even more crippling 110% for services.

But fear not, dear reader—help is on the way from Brussels. Ursula von der Leyen, president of the European Commission (EC), is spearheading a fresh initiative aimed at reviving the European Union's (EU) flagging economic fortunes. If the EU were graded on its ability to churn out reports and blueprints, it would make the High Honors roll. But execution? That's another story.

To kickstart the revival, von der Leyen tasked Draghi with drafting a comprehensive *report* on European competitiveness. This report, 80-some pages long, forms the backbone of the EC's bold new five-year plan, the so-called *Competitiveness Compass*. The ambition of this sprawling vision for Europe's future is evident. But the EU's economic revival will take more

than a fancy new compass. It will require the kind of political unity that the EU has never fully achieved.

The *Compass*, unveiled during von der Leyen's January 21 *keynote* address at the World Economic Forum, presents several pillars that could redefine Europe's economic landscape if only they were more than repackaged failed initiatives. Here's why we say so:

(1) *A centralized fiscal union: Been there, done that*. To start, von der Leyen aims to tackle Europe's chronic underinvestment in innovation by establishing a centralized fiscal union. "We do not lack capital. We lack an efficient capital market," von der Leyen noted, lamenting the inefficient deployment of savings into early-stage, high-risk technologies with the potential to reshape industries.

Indeed, the EU sits on an enormous capital pool—€1.4 trillion in household savings, nearly double that of the US. The EU plans to unify EU capital markets by creating a Savings and Investments Union that facilitates cross-border investment and provides fiscal support for national governments.

But the road is already paved with disappointment. A similar vehicle launched in 2020, the Capital Markets Union (CMU), has failed to deliver thus far. A recent European Parliament report noted the CMU's dismal performance, urging greater supervisory integration or abandonment of the initiative altogether. Are Draghi and von der Leyen making the same mistake again but hoping for a different result?

(2) *A centralized, but optional, regulatory regime: Deregulatory in theory only?* Next up is a move to simplify the EU's regulatory maze. While European businesses have long battled 27 different national regulatory frameworks, the Commission's proposed solution is to give them a 28th set of rules to follow, if they wish. This new framework, optional for member states, would centralize EU corporate law, insolvency, labor law, and taxation under a single banner, with the goal of eliminating the costly and time-consuming differences between member states.

Von der Leyen framed the proposal as a deregulatory push, but it's not as liberating as that sounds: To do any good, the new regime must be adopted by national governments. The Commission seems confident of widespread adoption because the new laws are "better." But deeper integration of the member states is an idea floated in various forms since 2010, and it faces formidable opposition from member states with their own entrenched interests.

(3) *A centralized energy directive: High hurdles*. Then there's the EU's energy strategy. Energy independence is a top priority for the EU given that recent years' geopolitical turmoil—most notably Russia's invasion of Ukraine—has jeopardized energy imports. Von der Leyen has called for the removal of remaining energy trade barriers among member countries to create a truly integrated energy union across the bloc.

The Commission's plan to centralize energy policy will focus on expanding renewable energy resources and improving storage and distribution. While the EU has made strides in wind and solar power generation, it has struggled with the all-important tasks of storing and efficiently utilizing this energy across borders.

Expect more details in February, but don't be surprised if the EC reintroduces many of the same ideas that underpin the *Green Deal* that itself is on the brink of failure.

Eurozone II: Europe's Enemy #1 Is Not Trump. Europe's red tape is nothing new, but it has garnered renewed attention considering recent developments, particularly the return of US President Donald Trump to office. Conventional wisdom might suggest Europe should be worried.

But James Bianco, president of Bianco Research, LLC, shared a contrarian view worth some consideration in a recent LinkedIn *post*: "The best thing to happen to Europe is Donald Trump. Trump's presence will force much-needed change in Europe/Germany." With Trump back in the political spotlight, Bianco argues, his tariff threats and deregulatory policies might be the catalysts Europe needs to dismantle its trade barriers and revise its suffocating regulatory framework. Such reforms are what Europe long has needed to spark economic growth.

Indeed, investor optimism seems to be building. Bianco points to the upward momentum of the Stoxx Europe 600 (9.0%) and Germany's DAX (18.4%) indexes since the November 4, 2024 US election. But do these outperformances reflect genuine expectations of a turnaround in Europe's growth prospects or are investors simply drawn to European equities that have been battered into undervaluation (*Fig. 1*)?

Our read: It's likely the latter. While the long-term investment horizon could offer opportunities in Europe's beleaguered equities, the region's growth prospects aren't exactly lighting up the horizon. A near-term economic rebound still seems unlikely. The state of the Eurozone economy remains grim.

A few key metrics illustrate just how much work lies ahead:

(1) *Eurozone earnings growth is weak.* Eurozone earnings growth remains sluggish, underpinned by deep-seated structural challenges in key sectors (*Fig. 2*).

(2) *Eurozone real GDP growth is dismal*. The Eurozone's economic growth continues to lag that of the global economy (*Fig. 3*).

(3) *Eurozone manufacturing and services are struggling***.** Both the manufacturing and services sectors are finding it difficult to regain pre-energy-crisis levels of activity (*Fig. 4*).

(4) *Eurozone productivity and investment are tepid*. Productivity growth remains underwhelming, compounded by persistently low investment across the region (*Fig. 5*).

Eurozone III: European Renaissance 2.0, Defense Edition. Vice President JD Vance proposed an inverse Marshall Plan at the Munich Security Conference. He said what many American economists have been suggesting for years: The EU must have the gall to spend what's needed to generate their own economic and defense security.

We do not believe the US security umbrella is vanishing under Trump 2.0; instead, we think the administration is attempting to alleviate the strains of US hegemony on America's trade balance and fiscal deficit. If Europe can pony up to help Ukraine, defend itself, and spur economic growth, then the US government can spend less to those ends, while the American private sector—including S&P 500 companies—can benefit from greater global demand.

In response to Vance's comments, NATO Secretary General Mark Rutte said the alliance's defense spending target would rise from its current 2%-of-GDP guideline for nations to "considerably more than 3%." European leaders, including British prime minister Keir Starmer, are now gathering in Paris for an emergency summit on the Russia–Ukraine war. An increase in EU defense spending is likely to be bazooka-style, large and fast. Consider some of the possible ramifications for the global economy and markets:

(1) *Peace dividend*. We believe that a significant coordinated fiscal impulse from the Eurozone could offset a slowing one in the US. "Coordinated" is the operative word, as national schemes like Italy's superbonus largely used up the Eurozone's fiscal space without a commensurate increase in sustainable growth or productivity. Meanwhile, spending on infrastructure, energy, and defense is likely to make its way to US companies

and exports. In fact, the US may be able to lower its own defense spending while increasing defense-related imports, a win on two Trump 2.0 fronts.

Defense constitutes $1.1 trillion of US government spending annually, as of Q4, or 3.7% of GDP. Meanwhile, the Eurozone spends less than 330 billion euro annually (projected as of Q4), below NATO's 2%-of-GDP guideline (*Fig. 6*). Rebalanced trade and more productive fiscal spending worldwide are now probable outcomes.

(2) *Debt.* The spending would likely be financed by large-scale debt issuance. The EU's debt-to-GDP ratio was 81.7% at the end of 2023; we think it could reach 90% by the end of the decade even as strong growth offsets some of the issuance (*Fig. 7*). That's likely to result in higher yields on German bunds, French OATs, etc. (*Fig. 8*). We do not think the Brussels-born constraints on national-level fiscal spending will be enforced.

(3) *Tech*. Shares of Rheinmetall, a German automotive, defense, electronics and engineering firm, rose 12.1% today and are up 124% over the past year. It has an American subsidiary, American Rheinmetall, which builds high-tech tanks. Perhaps the US auto sector can be repurposed to produce more high-tech goods, aiding employment and production in the Rust Belt. American defense and aerospace production has risen to new record highs for months (*Fig. 9*).

(4) *Dollar*. A "European Renaissance 2.0" could weaken the dollar in a way that doesn't threaten its reserve status, as favored by Trump 2.0. Treasury Secretary Scott Bessent has sought to "fix" the practice of foreign governments' artificially weakening their currencies against the dollar, so as to help US exporters maintain international competitiveness.

The euro is down 3.0% against the dollar over the past year but up 1.7% over the past month (*Fig. 10*). While parity looked possible for a moment earlier this year, there are now a number of possible tailwinds for the euro over the long term.

Strategy: An Earnings Season for the Masses. Through midday Tuesday, 78% of the S&P 500's companies have reported December-quarter earnings. Among the 390 reporters so far, the aggregate revenue surprise relative to analysts' consensus estimate is lighter than usual at 0.6%, but the earnings beat is a hearty 6.6% (*Fig. 11* and *Fig. 12*). Moreover, the vast majority of the index continues to report positive y/y growth.

Below, Joe shares additional data on how the S&P 500 companies collectively fared last quarter and how the Boeing strike impacted the aggregate Q4 results:

(1) *Wider swath of companies growing now*. While the S&P 500's aggregate revenue surprise for Q4 has underwhelmed so far, close to three-fourths of the index's members have shown positive y/y growth in revenues despite declining inflation. In fact, the percentage of S&P 500 reporters to date that achieved y/y revenues growth last quarter, 73.5%, is the greatest in more than two years. If it doesn't change measurably when the rest of the Q4 results are in, the S&P 500 will reach its highest quarterly reading by this measure since Q3-2022 (*Fig. 13*). Likewise, the percentage of S&P 500 companies with positive y/y earnings growth rose to 71.8% from 66.3% in Q3 (*Fig. 14*). That's the first reading above 70% since Q4-2021, and we expect this measure to remain strong in the coming quarters.

(2) *Boeing overshadows results again*. Looking at the earnings surprise results so far for the S&P 500's 11 sectors shows broad-based beats (*Fig. 15*). Industrials was the only sector to miss on the bottom line, and that was primarily due to Boeing's miss. Without Boeing, the sector's earnings surprise improves from a miss of 2.0% to an earnings beat of 3.5%. In addition, Industrials' Q4 earnings growth improves when Boeing is excluded, from a decline of 5.9% y/y to a 4.3% gain.

Boeing's earnings miss in Q4 was large enough to tamp down the overall S&P 500's figures as well. Without Boeing, the S&P 500's earnings surprise improves to 7.1% from 6.5%, and y/y earnings growth improves 1.0ppt to 14.0% from 13.0%.

(3) *S&P 500 on target for record-high quarterly EPS.* The S&P 500's blended Q4 EPS (i.e., estimates blended with actual results reported so far) slipped 52 cents w/w to $64.19 from $64.71 a week earlier (*Fig. 16*). Despite that minor hiccup, the S&P 500 is still on track to post its third straight quarter of record-high EPS. As the remaining 110 companies release their results over the next month, the blended actual should start moving higher again.

Calendars

US: Wed: MBA Mortgage Applications; Housing Starts & Building Permits 1.40mu & 1.46mu; FOMC Minutes. **Thurs:** Leading Indicators -0.1%; Jobless Claims 215k; Philadelphia Fed Manufacturing Index 16.3; Barr; Golsbee; Musalem. (FXStreet estimates)

Global: Wed: UK Headline & Core CPI 2.8% & 3.6%y/y; UK Input & Output PPI 0.7% & 0.2%; Eurozone Non-Monetary Policy ECB Meeting. **Thurs:** Eurozone Consumer Confidence Flash -13.9; Germany PPI 0.6%m/m,1.3%y/y; UK Gfk Consumer Confidence -

24; Japan M-PMI Flash Estimates 49.0. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): During the February 14 week, forward earnings fell for all of these three indexes simultaneously for a second straight week for the first time in 14 months. LargeCap's forward earnings dropped a hair less than 0.1% w/w to 0.3% below its record high. MidCap's fell 0.8% w/w to 0.7% below its record high in early June 2022. SmallCap's weakened 0.1% w/w to 11.7% below its June 2022 record. LargeCap's forward earnings has soared 22.2% from its 54-week low during the week of February 1, 2023; MidCap's is 8.1% above its 55-week low during the week of March 10, 2023; and SmallCap's is just 2.1% above its 72-week low during the March 17, 2023 week. These three indexes' forward earnings downtrend from mid-2022 to early 2023 was relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Here are the latest consensus earnings growth rates for 2024, 2025, and 2025: LargeCap (10.9%, 10.3%, 13.9%), MidCap (-0.5, 11.3, 16.3), and SmallCap (-12.5, 14.5, 18.2).

S&P 500/400/600 Valuation (*link*): Valuations were mostly unchanged for these three indexes and remained above their 17-week lows during the January 10 week. LargeCap's forward P/E rose 0.4ppt w/w to a 10-week high of 22.2, and is just 0.1pt below its 43-month high of 22.3 during the December 6 week. It's up 5.2pts from a seven-month low of 17.0 during the October 27, 2023 week and 7.1pts from its 30-month low of 15.1 at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E was unchanged w/w at 16.1 and is 1.0pt below its 40-month high of 17.1 during the November 29 week. It's up 3.8pts from a 12-month low of 12.3 at the end of October last year and compares to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E was steady w/w at 15.8 and 1.3pts below its 41-month high of 17.1, also during the November 29 week. It's up 5.2pts from its 14-year low of 10.6 in September 2022 and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's 27% discount to LargeCap's P/E compares to 22% during the November 29 week, which was the lowest since the March 9, 2023 week and up from a 25-year-high 29% discount during the July 5, 2024 week. It had been at a 19% discount during the March 2, 2023 week, which was near its best reading since October 14, 2021. SmallCap's 28% discount compares to 23% during the November

29 week, which was the lowest since the March 9, 2023 week and up from a 24-year-low 34% discount during the July 5, 2024 week. That compares to a 20% discount during the March 2, 2023 week; that one was near its lowest discount since August 2021. SmallCap's 2% discount to MidCap's is narrowing again and remains among the smallest since July 2021. Prior to that, from 2003 to 2018, SmallCap's P/E had been mostly above Midcap's, and both were above LargeCap's.

US Economic Indicators

Regional M-PMI (*link*): The New York Fed was the first regional Fed bank to report on manufacturing activity in its district for February. Manufacturing activity in the region rose, along with inflation—the prices-paid measure jumped to its highest level in roughly two years. The *headline general business conditions* rebounded 18.3 points in February to 5.7 from -12.6 in January. February's survey saw both the *new orders* (to 11.4 from -8.6) and *shipments* (14.2 from -1.7) measures move from contraction to expansion, while inventories (8.7 from 5.8) posted a small accumulation. Delivery times (5.4 from 3.5) were slightly longer this month, while supplier delivery (-2.2 from 0.0) was slightly lower. Turning to the *labor market*, conditions showed a small decline in *employment* (-3.6 from 1.2), while the average workweek (-1.2 from -15.1) held fairly steady. *As for pricing*, both the prices-paid (40.2 from 29.1) and prices-received (19.6 from 9.3) measures climbed for the second successive month. *Looking ahead*, firms were fairly optimistic that conditions would improve over the next six months, though optimism declined noticeably. The index of *future business activity* fell 14.5 points (to 22.2 from 36.7). Still, 43.2% of the respondents expect conditions to improve, and only 21.0% expect them to deteriorate over the period. *Capital spending plans* (10.9 from 15.5) remained soft in February.

NAHB Housing Market Index (***link***): "While builders hold out hope for pro-development policies, particularly regulatory reform, policy uncertainty and cost factors created a reset for 2025 expectations in the most recent HMI," noted Carl Harris, chairman of the board of NAHB. Tariff concerns and high mortgage rates pushed homebuilders' confidence to a five-month low in February. The *housing market index* (HMI) sank to 42 in February after rising from 39 in August—which was the lowest reading since December 2023—to 47 by January. The three HMI components all moved lower in February, led by sales expectations (-13 points to 46), current sales (-4 to 46), and traffic of prospective buyers (-3 to 29). (Any reading below 50 is considered negative.) The sales expectations component is in a tailspin, tumbling from December's reading of 66—which was the highest since April 2022.

The February survey indicates that the *share of builders cutting prices* fell to 26% in February, down from 30% in January and the lowest percentage since May 2024. Meanwhile, 59% of builders used sales incentives this month, a slight decline from last month's 61%.

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