Yardeni Research

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Morning Briefing

Going Global Slowly

Check out the accompanying chart collection.

Executive Summary: While we've long favored US stocks over global ones, recent developments in Germany and China have made us more sanguine on investing in economies abroad. We're maintaining our "Stay Home" investment approach but lightening up on the degree with which we would underweight the MSCI All Country World ex US index relative to the MSCI US index. Eric explains the changes in the macroeconomic and political backdrops of the EU and China that have decreased our bearishness on equity markets outside the US.

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

Strategy I: Time To Go Global? A much more favorable macroeconomic and political backdrop in the US had kept us icy on international stocks for the past 15 years, even during the recent rally in the MSCI All Country World (ACW) ex USA Index. However, just this month, developments in both the Eurozone—particularly Germany—and China have thawed our stance a bit toward investing in advanced foreign economies.

We've preferred to "Stay Home," favoring US large-cap stocks over international ones since at least 2010. The resilience of the US economy and favorable stock market fundamentals, including earnings growth, mean we're maintaining our Stay Home posture. However, we'd caution against continuing to shun international stocks, successful as that strategy has been, simply out of inertia. Given that developments abroad have allayed some of our macroeconomic concerns, providing more support for a "Go Global" strategy, it makes sense to consider reallocating some funds to international stocks.

In portfolio parlance, we're reducing our overweight on the MSCI US and paring our underweight of the MSCI ACW ex-US. Before we get into the macroeconomic factors underpinning this decision, consider some of the stock market fundamentals:

(1) *Relative performance*. The MSCI US index peaked relative to the MSCI ACW ex-US on

Christmas Eve of last year (*Fig. 1*). In dollar terms, the US index has fallen 12% versus the ACW ex-US since. That's been exacerbated by the dollar's losing 4.3% ytd (*Fig. 2*). In local currency terms, the US index is down roughly 9.5%.

The international catch-up trade has a very high ceiling. The MSCI US is still trading at more than 21 times forward earnings, whereas the MSCI ACW ex-US index is trading at just 14 times forward earnings (*Fig. 3*). Arguably, European and Japanese stocks should represent much more than a combined 21% of the global market cap anyway (*Fig. 4*).

(2) *Dollars versus local currency*. This argument is perhaps even stronger for international investors, as they stand to lose doubly if US stocks and the dollar both underperform. The dollar's underperformance could extend considering that its run since the pandemic means it may still be overvalued.

The reasons for the dollar's fall are perhaps a better indicator of the outlook from here. We think it's led by the outperformance of the euro and yen as their countries' long-term bond yields jumped (*Fig. 5*). The economic growth scare in the US may have some impact but probably a limited one since 10- and 30-year Treasury yields haven't fallen dramatically. The positive performance of the euro and yen are the results of the improving macro picture abroad, and a positive for the global economy. So unless the US government's tariff turmoil and federal firings spark a recession that the rest of the world avoids, we aren't overly worried about dollar downside.

(3) *Productivity and profit margins*. Another reason we've kept an underweight position on international stocks was the poor productivity growth abroad. While US productivity growth has been sustained since the Great Financial Crisis and accelerated after the pandemic, productivity growth has largely plateaued in the rest of the world for the past 17 years (*Fig. 6*).

However, forward profit margins suggest that may be changing. Analysts' consensus estimates for the MSCI ACW ex-US index forward profit margin have risen from 7.7% before the pandemic to 9.6% today (*Fig. 7*). That included 50bps of forward margin expansion over the past year.

Strategy II: German Rearmament. Trump 2.0 may finally have prodded Europe into getting its act together. Germany is looking to exempt expenditures above 1% of GDP from the debt brake as part of a €500 billion infrastructure and defense fund. The European Union (EU) has followed suit by removing limits on European countries and adding new defense loans, potentially allowing for up to €800 billion of defense spending through the end of the decade.

These measures should help Germany meet NATO's 2% of GDP defense spending target and instill fiscal stimulus into a very sluggish economy that needs it (*Fig. 8* and *Fig. 9*). Notably, the EU almost never has met NATO's 2% target. Markets have reacted swiftly, though nothing is set in stone and obstacles are emerging.

Consider the outlook for the European economy:

(1) *Debt deluge.* German bunds have sold off in anticipation of a flood of new debt issuance. The 10-year bund yield has risen from below 2.40% at the end of February to as high as 2.88% last Thursday (*Fig. 10*). French President Emmanuel Macron wants to raise defense spending to 3.0%-3.5% of GDP from its current 2.0% without raising taxes, another sign to the markets that the European economy finally will get the benefit of a looser fiscal stance.

(2) *Strings attached*. Germany's Green party rejected the defense and infrastructure spending package on Monday. Germany's center-right coalition of Christian Democrats and Social Democrats has until March 25 to pass the package; but it needs a two-thirds majority and is relying on the Greens. The Greens thus far have felt left out and emphasize the need for climate-related initiatives.

(3) *Alleviating our concerns.* Two broad factors have prevented us from upping our long-term opinion on Europe: fiscal conditions and political conditions (see our June 26 *Morning Briefing* titled "EU's Foundation Cracking?"). Brussels has been threatening to rein in already austere fiscal policies, which hampered the EU's recovery from the pandemic. Meanwhile, many European countries' internal politics, along with the EU's parliamentary politics, were fracturing. Increased tensions among parties led us to be concerned about the bloc's future.

If Germany successfully gets this spending package through, it will address both of our concerns and effectively remove barriers from shifting to a neutral stance on European equities.

Strategy III: Chinese Consumption Soon? We've long believed that until China figured out how to spur domestic demand, it would be uninvestable over any long-term horizon. Consumer confidence has been crushed for years, especially after the property bubble burst and evaporated most households' savings (*Fig. 11*). The most likely way of achieving greater domestic demand would be to increase fiscal stimulus to households. China's cultural and political institutions thus far have prevented such a reallocation of capital.

The latest announcement on China's annual economic targets and a seeming newfound commitment to the consumer may show that the Chinese Communist Party (CCP) has finally accepted what it takes to internally balance its economy. Consider the following:

(1) *New targets, more lending*. China's roughly 5% real GDP growth target for 2025 will be accomplished via more government spending. The CCP recently raised its budget deficit plan from 3% of GDP to 4% (*Fig. 12*). The larger deficit will be funded via ultra-long-term government debt and local government debt. More money will be raised to recapitalize the state banks. Overall, China's total social financing is likely starting a new uptrend after falling for two-plus years (*Fig. 13*). That's a positive for global liquidity and stimulus.

(2) *Consumer in need*. Retail sales have been weaker than industrial production, as China targets manufactured exports to grow its economy rather than households (*Fig. 14*). Hopes that stimulus measures thus far were starting to take hold quickly faded when February's CPI fell into deflation for the first time in roughly a year (*Fig. 15*).

We're not yet convinced that China is ready to stimulate its household sector enough to increase domestic demand. It also does not appear to be willing to stop artificially boosting industrial capacity. China lowered its inflation target from 3% last year to 2% in 2025, a sign that the export-led strategy will continue. However, we believe the drip-drops of stimulus and increasing focus on the consumer are likely to build up enough counterweight to offset the effects of a trade war, which is a positive for the global economy and markets. So while we're not bullish on investing in China, we are incrementally less bearish and therefore more positive on global markets broadly.

Calendars

US: Tues: Small Business Optimism Index 101; JOLTS 7.71m. **Wed:** CPI Headline & Core CPI 0.3%mm, 2.9%y/y & 0.3%m/m, 3.2%y/y; MBA Mortgage Applications; Monthly Budget Statement -$31.5b; 10-Year Note Auction. (FXStreet estimates)

Global: Tues: Japan Machine Tool Orders 4.7%y/y; Eurogroup Meeting. **Wed:** BoC

Interest Rate Decision 2.75%; Lagarde; Lane; Jones. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): During the March 7 week, forward earnings rose for two of these three indexes for a third straight week, after falling for all three simultaneously for two straight weeks for the first time in 14 months. LargeCap's forward earnings rose 0.3% w/w to its second record high since the January 31 week. MidCap's rose 0.2% w/w to 0.4% below its record high in early June 2022. SmallCap's posted its sixth straight weekly decline, tumbling 0.8% w/w to a 40-month low and is now 13.9% below its June 2022 record. LargeCap's forward earnings has soared 23.0% from its 54-week low during the week of February 1, 2023; MidCap's is 8.5% above its 55-week low during the week of March 10, 2023; and SmallCap's is now 0.4% below 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 2026: LargeCap (10.1%, 11.0%, 14.2%), MidCap (-0.8, 11.0, 16.3), and SmallCap (-11.8, 9.5, 19.2).

S&P 500/400/600 Valuation (*link*): Valuations tumbled w/w for these three indexes as all crashed through their four-month lows during the January 10 week to six-month lows. LargeCap's forward P/E dropped 0.7pt w/w to a 26-week low of 20.8, and is now 1.5pt below its 43-month high of 22.3 during the December 6 week. It's up 3.8pts from a seven-month low of 17.0 during the October 27, 2023 week and 5.7pts 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 fell 0.6pt w/w to a 26-week low of 15.0, and is now 2.1pts below its 40-month high of 17.1 during the November 29 week. It's up 2.7pts 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 down 0.4pts w/w to a 26-week low of 14.9, and 2.2pts below its 41-month high of 17.1, also during the November 29 week. It's up 4.3pts 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 P/E has weakened to a seven-month low 28% discount to LargeCap's P/E, which compares to a 19% discount during the March 2, 2023 week, which matched its best reading since October 14, 2021. It's well above its 25-year-low 29%

discount during the July 5, 2024 week. SmallCap's P/E is at a 28% discount to LargeCap's P/E, up from a 17-week low 29% several weeks earlier, which compares to a 23% discount during the November 29 week, which was its best reading since the March 2, 2023 week. It's now 6ppts above its 24-year-low 34% discount during the July 5, 2024 week. SmallCap's P/E is a whisker below MidCap's 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.

Global Economic Indicators

Germany Industrial Production (*link*): German industrial production in January was a surprise on the upside, while December's decline was smaller than first reported. Germany's *industrial production*, which includes construction, rebounded 2.0% in January, stronger than the 1.5% consensus estimate. Meanwhile, output contracted 1.5% in December, narrowing from the preliminary estimate of a 2.4% downfall. *January Industrial production* was above the fourth-quarter average, raising hopes that output could edge higher during Q1. Versus a year ago, headline production fell 1.6% in January, narrowing from December's 2.2% drop. There was significant production growth in the automotive (+6.4%) industry during January, as well as machine maintenance & assembly (15.6), and the food industry (7.5). Partially offsetting those gains was a 7.7% drop in fabricated metals. *By sector*, there were widespread gains, led by a 3.3% jump in *intermediate* goods production, while both *capital* and *consumer* goods output rose 2.4% during the month. *Production excluding energy and construction* rose 2.6% during January and was down 1.7% on a calendar-adjusted basis.

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