Yardeni Research

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Morning Briefing

On Europe & S&P 500 Earnings

Check out the accompanying chart collection.

Executive Summary: The Eurozone is improving economically as the US remains cloaked in uncertainty, its exceptionality being questioned by some. Melissa explores the countervailing forces affecting the Europe's economic growth prospects and suggests that its equity markets might offer some opportunities at this juncture. … Also: Funds flow and equity market performance data suggest a rotation: Investment dollars have been exiting the US stock market and flying off to Europe. But is the rotation poised to reverse? … And: Joe examines recent estimate revisions activity. Even though last week's revisions for S&P 500 companies were upward on the whole, the broader trend in forward earnings remains downward.

Eurozone I: Improving at the Margins. The Eurozone economy is not exactly making a dramatic comeback, but it's no longer a total mess. Inflation is under control, interest-rate cuts are gaining traction, and long-overdue structural shifts—in defense, fiscal policy, and capital flows—are starting to show. Meanwhile, America's fiscal and monetary policy uncertainty and its trade-related upheaval have challenged the notion of US exceptionalism, sapping the dollar's value and strengthening the euro relative to the dollar.

Still, the Eurozone economy faces real headwinds: US trade shocks are unresolved, the euro's strength is hurting competitiveness, and any delays in executing fiscal spending could mute their intended boost. Meanwhile, inexpensive Chinese imports flooding into Europe's markets pose a clear and present danger, especially for the Eurozone's automakers, as William Pesek explained in yesterday's *Morning Briefing*.

Can Europe's economy stage a sustainable comeback? In our view, yes. Europe won't become a global-growth superstar overnight, but it is coming back from the brink. At this point, we think selective exposure to European equities makes sense. Consider the following:

(1) *Headwind: Economic powerhouses lag.* Eurozone GDP rose 1.2% y/y during Q1-2025—

in line with International Monetary Fund forecasts—but the recovery remains uneven and underwhelming (*Fig. 1*).

Strength was concentrated. Ireland led with a 10.9% y/y gain, followed by Spain with a 2.8% y/y gain. Germany and France barely budged. Germany contracted -0.2% y/y. France posted just 0.8% y/y growth.

Signs of soft consumer demand and a manufacturing drag are evident across the Eurozone (*Fig. 2* and *Fig. 3*). The Eurozone Economic Sentiment Indicator dipped to 93.6 in April from 95.0 in March, and April's Eurozone M-PMI was 49.0, up from 48.6 in March, though remaining below the 50 mark separating growth from contraction.

(2) *Headwind: Euro climbs as US exceptionalism fades.* The euro has appreciated by more than 10% against the US dollar since mid-January (*Fig. 4*). That currency move has taken an axe to the earnings of Europe's exporters. STOXX Europe 600 companies *earn* about 60% of revenue abroad—half of that from the US. A 10% appreciation in the euro typically shaves 2%–3% off corporate earnings, according to Reuters.

(3) *Headwind: Trade tensions threaten growth.* European Central Bank (ECB) board member Piero Cipollone recently warned that US tariffs—and any European retaliation—would be "recessionary for all parties." The Trump administration's 10% blanket tariff on nearly all imports plus higher category-specific levies on cars, pharmaceuticals, and machinery have disrupted key sectors. With about *half* of all EU exports to the US coming from those three industries, tariff drag is dampening already weak industrial sentiment (*Fig. 5*).

(4) *Tailwind: Rewiring trade relationships.* Even amid tensions, Brussels is still taking the diplomatic track. The EU and US are in talks on a €50 billion trade *deal* that could rebalance bilateral flows through increased European purchases of US LNG and agricultural products. But it's a frail handshake: Both sides have 90-day pauses on retaliatory tariffs, which could snap back if talks fail.

Elsewhere, trade diversification is progressing. India and the EU *reaffirmed* plans to finalize a free trade agreement by 2025's end. And China just lifted *sanctions* on EU lawmakers as it seeks closer ties with Europe amid its own tensions with the US.

(5) *Tailwind: Monetary easing gathers pace as inflation falls.* The Eurozone's headline inflation fell to 2.2% y/y in April, with core inflation rising slightly to 2.7% y/y (*Fig. 6*). That's

given the ECB room to cut its official deposit facility rate seven times, from 4.0% in June 2024 down to 2.25% in April (*Fig. 7*).

François Villeroy, Bank of France governor, recently *noted* that the ECB is on track to meet its 2% inflation target and still has ample room to support growth. ECB President Christine Lagarde recently *noted* that Chinese exports redirected from the US to Europe could further depress prices.

(6) *Tailwind: Fiscal spending grows.* Germany's newly *announced* €1 trillion stimulus package, focused on defense and infrastructure, is structurally significant. Some €500 billion of that is exempt from debt-brake rules and could be deployed in coming years. ("Debt-brake rules" require member states to keep their debt below certain limits.)

Across the EU, fiscal rules are being reworked to allow higher defense outlays, and some unused Covid-era funds may be redirected. The pickup in defense spending is targeted to be deployed by 2030, so it won't move the 2025 needle.

However, political turmoil has not helped the Eurozone's fiscal turnaround story. The Eurozone will need stable leadership to effectively implement the coming fiscal stimulus.

Eurozone II: Peak Global Rotation? Flows are telling: During the final week of April, European equity funds saw $14.6 billion in inflows—the largest since March 2024—while US equity funds lost $15.5 billion, *reported* Reuters.

This major shift in fund flows reflects investors' waning confidence in US macro policy and their search for global alternatives. From the start of 2021 to the end of 2024, the US MSCI delivered a 53.1% increase. How did the MSCI EMU Index perform over that timeframe? Not nearly so well: up 27.2% in local currency but just 7.7% in dollar terms. That outperformance gap, driven by US last year's monetary stimulus and popularity of Big Tech stocks, has reversed as global economic conditions have diverged. This year to date, the US MSCI is down 4.0%, while the EMU MSCI is up 5.7% in local currency and 19.8% in US dollars.

Will European stocks continue to outperform? They are no longer cheap, as inflows have pushed valuations up across industry sectors and market-capitalization sizes. Further, the US could return as a competitive investment story if trade deals are struck and global tariffs are removed, or if the Federal Reserve cuts interest rates. Those developments could drive a dramatic rotation of global funds back into US equities.

Here's more:

(1) *EMU stocks depend on earnings momentum*. During the height of the recent Eurozone energy crisis, following the onset of Russia's war on Ukraine, the MSCI EMU touched a forward earnings valuation multiple of 10. It is now at nearly 15, the highest since December 2021 and roughly at the top of its range looking back to mid-2002 (*Fig. 8*).

Sustained equity outperformance will ultimately depend on improving economic data and renewed earnings momentum. Forward earnings per share hasn't moved up much in recent months, especially as compared to the post-pandemic recovery period (*Fig. 9*).

(2) *Opportunity zones*. For now, areas of opportunity worth considering include the Eurozone's defense sector. Brussels *wants* at least 50% of its military procurement to be sourced domestically.

Investors have launched the forward P/E higher recently for the EMU MSCI Aerospace & Defense industry, which rose from 22 at the start of the year to a near-record-high 28.1 during the March 26 week (*Fig. 10*). It's down 4ppts since then to 24.1, but still well above the 13.4 for the MSCI EMU. Analysts expect Aerospace & Defense's revenues (STRG) to rise 12.1% over the next 12 months, nearly four times the rate expected for all of the EMU MSCI (*Fig. 11* and *Fig. 12*). Analysts also expect the industry to deliver much higher earnings growth (STEG) over the next 12 months, 21.6% versus only 6.0% for the EMU. The industry's long-term earnings growth (LTEG) forecast of 25.8% is more than double the EMU's 11.6%.

For some perspective on just how impressive growth expectations are for EMU's Aerospace industry, let's look at the same forecasts for the US's Magnificent-7 stocks (*Fig. 13*). You might be shocked too. The EMU Aerospace and the Magnificent-7 have similar 12.1% revenue growth readings, but EMU Aerospace's earnings are expected to rise at a faster rate in the next 12 months, 21.6% compared to the Mag-7's 17.2% forecast. Over the next five years? Aerospace's earnings are expected to rise at annualized 25.8% rate, well above the Mag-7's 17.8%. The message analysts are sending is that Europe's military buildup may last longer than the AI boom.

Strategy: LargeCap's Forward Earnings Still Trending South. Each week, we track consensus earnings expectations for the S&P 500 LargeCap, S&P 400 MidCap, and S&P 600 SmallCap indexes. During the May 2 week, forward earnings for the "SMidCaps" (our nickname for the latter two collectively) dropped for a fourth straight week, but LargeCap's rose for the first time in four weeks (*Fig. 14*). Despite that uptick, the broad trend of LargeCap's forward earnings remains downward.

We can attribute LargeCap's w/w gain largely to the Q1 earnings-surprise "hook" registered by the S&P 500 Communication Services sector (*Fig. 15*). That caused the S&P 500's forward earnings and the analysts' consensus for 2025 earnings to rise w/w, an aberration that outweighed the broader w/w declines in the consensus forecasts for Q2 to Q4.

(As a reminder, "forward earnings" is the time-weighted average of analysts' consensus estimates for the current and following years. A "hook" refers to the chart pattern made by the earnings data series at the point where estimated results are replaced by actual just-reported results; earnings surprises result in hooks.)

With the Q1 earnings reporting season just over 78% complete, more downward estimate revisions are on the way after analysts hear what the companies left to report have to say. We still think the April 4 week marked the peak in forward earnings for these three indexes. Analysts are still in their first round of estimate cutting resulting from Trump's Tariff Turmoil, and the first cuts are typically the deepest.

While investor sentiment is broadly negative, most sectors have been posting better estimate-revisions data than the S&P 500 aggregate, as Joe shows below:

(1) *Seven sectors outperform S&P 500's Q2 revenues revisions.* While the S&P 500's Q2-2025 revenues forecast has dropped 0.6% in the five weeks since the March 31 week, only four of the 11 sectors are lagging the index (*Fig. 16*). Among the seven outperforming sectors, Utilities leads, with its Q2 revenues forecast rising 0.5%, ahead of the 0.3% gains for Health Care and Communication Services. Information Technology (-0.1%) was also ahead of the S&P 500's Q2 revenue forecast decline.

Among the worst performers, Energy continues to melt down. The sector's Q2 revenue forecast has tumbled 4.3%, followed by declines for the Consumer Discretionary (-1.3%), Industrials (-1.3), and Financials (-0.6) sectors.

(2) *Seven sectors also lead on Q2 earnings revisions.* Analysts continue to trim their Q2 earnings forecasts faster than their Q2 revenues estimates, with ten of the 11 sectors posting declines since the March 31 week (*Fig. 17*). The aggregate earnings estimate for the S&P 500 companies has fallen 3.1%, down from a 2.4% decline a week earlier and steeper than the 0.6% revenues decline.

However, just four sectors are underperforming the S&P 500. With a gain of 0.3% in its Q2 earnings estimate, Utilities is the only sector analysts are more positive about than they were five weeks earlier. Also ahead of the S&P 500's 3.1% drop are the Communication Services (-0.7%), Information Technology (-1.1), Financials (-2.8), Consumer Staples (-2.9), Real Estate (-2.9), and Materials (-3.0) sectors.

Three of the four sectors with the worst Q2 revenue forecast declines are also the worst in terms of Q2 earnings. Among them, Energy's Q2 earnings forecast has tumbled 14.6%, markedly worse than the declines for the Consumer Discretionary (-5.7), Industrials (-5.2), and Health Care (-3.2) sectors.

(3) *Quarterly growth forecasts still falling.* Analysts now expect revenues growth to slow to 3.6% y/y in Q2 for the S&P 500 (*Fig. 18*). They think Q2 will mark the lowest y/y quarterly revenues growth rate of the year, slowing a full percentage point q/q from Q1's blended forecast of 4.6%. That Q2 estimate of 3.6% has fallen 1.0ppt from a 4.7% forecast for Q2 growth at the year's start. For the back half of 2025, analysts think revenues growth will re-accelerate to 4.1% in Q3 and 4.9% in Q4—but even those forecasts are down significantly, about 1.5ppts since the year began.

On a proforma same-company basis, analysts now think S&P 500 earnings will rise 6.9% y/y in Q2, down from a forecasted 7.3% a week earlier and 12.0% at the year's start (*Fig. 19*). That's also well below Q1's current blended forecast of 13.6%, which would be a record high. Their H2-2025 estimates continue to fall. They're now expecting y/y earnings growth of 8.6% in Q3 and 7.2% in Q4. Just several weeks earlier, analysts had been forecasting double-digit percentage gains in H2-2025.

Calendars

US: **Tues:** Goods & Services Trade Balance -$129b; Atlanta Fed GDPNow 1.1%. **Wed:** Fed Interest Rate Decision 4.50%; Consumer Credit Change $10.9b; MBA Mortgage Applications. (FXStreet estimates)

Global: **Tues:** Eurozone PPI -1.4%m/m, 2.0%y/y; Eurozone, Germany & France C-PMIs 50.1, 49.7 & 47.3; Eurozone, Germany & France NM-PMIs 49.7, 48.8 & 46.8; France Industrial Production 0.4%; UK C-PMI & NM-PMI 48.2 & 48.9; China Caixin NM-PMI 51.7; Panetta; Breeden. **Wed:** Eurozone Retail Sales 0.0%m/m, 1.6%y/y; Germany Factory Orders 1.3%; Italy Retail Sales 0.2%. (FXStreet estimates)

Global Economic Indicators

Global Composite PMIs (*link*): Global economic growth slowed to a 17-month low in April, while business optimism sank to its lowest level in nearly five years, impacted by rising levels of economic uncertainty and trade volatility. The *Global C-PMI Output Index* sank for the third time in four months, from 52.6 at the end of 2024 to 50.8 in April—a reading below its long-run average (53.2) for the 11th straight month. The *service sector* expanded for the twenty-eighth successive month, though slowed to a 17-month low of 50.8 last month—one of the weakest levels during the current growth sequence. The manufacturing PMI sank back below the breakeven point of 50.0, declining from 50.6 in February to 49.8 in April. *Regionally*, there was a slowdown, with rates of expansion slowing in the US, the Eurozone, China, and Australia, while both the UK and Brazil fell back into contraction territory and Canada recorded a steep downturn. Meanwhile, the report noted that India saw a slight acceleration in growth, posting the strongest rate of expansion. Levels of *new business* slowed sharply in April, with the *service sector* posting its weakest growth since November 2023, while *manufacturing* new orders contracted for the first time in four months—though only slightly. Meanwhile, *new export* business contracted in April at the fastest pace since December 2022, after rising in March for the first time in 10 months, with both the manufacturing and services sectors contracting. *Turning to pricing*, average *input costs* rose again in April, "extending the current sequence of increase to almost five years." According to the report, the rate of cost inflation slowed to a three-month low—broadly in line with the long-run series average. Part of the increase in higher costs was passed on to clients in the form of higher charges, as highlighted by a further solid increase in average output prices.

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