Yardeni Research

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Morning Briefing

On Korea, Europe
& US Earnings

Check out the accompanying chart collection.

Executive Summary: With South Korea's new president promising financial reforms that are bound to reward shareholders, the country's stock market is sailing on a wave of optimism. The days of the long-standing "Korea discount" may be numbered, William reports. … Also: Melissa examines what the ECB's recent rate cut telegraphs about the central bank's intent going forward and the challenges it faces. … And Joe reports that S&P 500 companies' collective forward earnings hit another record high last week, after not having done so since the week of Trump's "Liberation Day." However, analysts' Q2 earnings sights are still low, despite last week's uptick.

South Korea I: Losing the Discount? As South Korea's new president gets to work, its stock market is enjoying a burst of optimism that the nation is about to get its financial act together.

For decades, the stock market of *Asia's No. 4 economy* has suffered a "Korea discount" depressing valuations relative to Asian peers'. Proximity to North Korea is one explanation. The bigger problem is the economic dominance of a handful of family-owned conglomerates with weak governance standards. While not publicly traded themselves, these politically connected behemoths have propelled Korea into the orbit of the *top-12 economies*. Yet their monopolistic ways hog the economic oxygen startups need to grow, prosper, and disrupt. The culprits include *Samsung*, Daewoo, Hyundai, LG, Lotte, and SK.

Enter new President Lee Jae-myung, who's pledging to level playing fields and increase competitiveness against Chinese companies encroaching on Korea's strongest industries. Here's a deeper dive into the suddenly fluid situation:

(1) *New management*. Lee vows to improve governance and shareholder returns, taking a page from Japan's decade-long effort to strengthen capital markets. On June 4, his first day in office, foreign funds propelled *Korean stocks higher* on expectations that Lee's election

will end six months of political chaos and the power vacuum that followed.

(2) *Political bedlam*. The crisis began on December 3, when President Yoon Suk Yeol *declared martial law*, claiming it was a "*desperation*" attempt to get opposition lawmakers to pass his legislative agenda. The stunt led to Yoon's impeachment and removal from office.

Lee's election is a chance to turn the page. The Korea MSCI is the best performing stock price index of MSCI's country indexes so far in June, with a gain of 8.5% (US$) and 6.3% (local currency) through Monday's close (*Fig. 1*). And the return of US-based funds "signals a *structural improvement* in the foreign demand cycle, helped by a stabilizing won-dollar exchange rate," Lee Kyung-min of Daishin Securities told *The Korea Economic Daily*.

Lee's focus, noted Jeremy Chan of Eurasia Group, "will remain primarily on protecting the interests of retail investors" over institutional giants. Yet Lee's to-do list is a daunting one. While Korea Inc. veered inward for *122 days*, China slid further into deflation and US President Donald Trump launched an epic trade war.

The immediate emergency is stabilizing Korean GDP, which *contracted 0.2% y/y* in the first quarter. Trump's *tariffs on China* (30%), *autos* (25%), and *steel and aluminum* (50%) are taking a toll on the *$1.7 trillion economy*.

South Korea II: Taking on the Goliaths. Lee must also act swiftly to wrest control from the *family-controlled Goliaths* known as "*chaebols*." This involves strengthening antitrust enforcement to reduce *chaebols*' ability to marginalize small to mid-sized companies that they deem to be threats.

Lee must work harder than his five elected predecessors to reduce bureaucracy, incentivize innovation, and phase out seniority-based promotions and pay. He must *empower women* to diversify the workforce and boost a *sliding birthrate*.

Here's more:

(1) *Long to-do list*. Lee has pledged to revise Korea's commercial code to phase out rubber-stamp directors and strengthen boards' fiduciary responsibilities to shareholders.

Yoon tried his hand at some of this, rolling out a "*Corporate Value-Up*" program, modeled after Japan's governance push. But Yoon was all talk; Lee must do much better, and fast.

(2) *Wooing global capital*. For years, Seoul has lobbied index giant MSCI to upgrade its stock market to developed-market status. This would pull powerful waves of international capital Seoul's way—and get Korea out of the orbit of China and India.

To no avail. Though Korea *lifted its short-selling* ban in March, MCSI is calling for increased transparency, fewer outdated regulations, looser limits on corporate ownership, and increased currency-trading hours.

Yoon's martial law gambit reminded investors why the Korea discount persists. But Lee's determination to prepare the stock market for global prime time is putting Korea in the spotlight for all the right reasons.

Global Central Banks: ECB Wins Inflation Battle—But Not the War. Eurozone equity markets rallied on Friday, as investors applauded the European Central Bank's (ECB) Thursday, June 5 interest-rate cut. The cut reflected an inflation victory: In the face of fragile economic growth and trade uncertainty, the ECB grabbed at perhaps the last opportunity to lower rates as inflation fell below the bank's targeted 2.0% y/y.

Could this be the last rate cut for a while, after eight cuts so far? Melissa and I think so. On Saturday, ECB policymaker and Croatia's Central Bank Chief Boris Vujcic *said* as much. On Sunday, ECB policymaker Joachim Nagel *said* that the bank can take its time on policy because rates are now "neutral" rather than "restrictive."

However, ECB head Christine Lagarde hesitates to celebrate sub-target inflation prematurely. She *told* reporters: "Victory laps are always nice, but there is always another battle." Lagarde is wary of overly aggressive cuts. Long awaited Eurozone fiscal stimulus, particularly on defense spending and taxes, could push inflation higher just as a US trade deal is reached—and the potential diminishes for a deflationary tariff-induced recession. Taken together, fiscal spending might not have a deflationary offset if a happy end to US trade tensions boosts the confidence and spending of consumers and businesses.

Another reason that inflationary risks might come to the fore: Further war-related energy *sanctions* on Russian oil could cause a second mini-energy crisis as Europeans are forced to find alternative energy sources to replace the remaining Russian flows to Europe, as we discussed in our June 4 *Morning Briefing*.

Here's a closer look at the situation confronting the ECB:

(1) *ECB's cautious victory lap.* On June 5, the ECB cut its key interest rate by 25 basis points (bps) from 2.25% to 2.00%, continuing a long-standing easing cycle that began after borrowing costs peaked at 4.0% in September 2023 (*Fig. 2*). The latest rate cut signifies that the ECB views shoring up weak economic growth as the higher priority over mitigating inflationary risks. That order may be reversed if trade uncertainty resolves.

In the background, the ECB is unwinding its asset purchase portfolios "at a measured and predictable pace," as principal payments from maturing securities are no longer reinvested. Ostensibly, such tapering, a restrictive monetary tool, seems inconsistent with the easing represented by the recent rate cuts. The bank, however, is likely aiming to lower assets on the balance sheet near normal before pausing rates to avoid a net restrictive posture. Total assets have come a long way down from near €9 trillion during 2022 to near €6 trillion through May, closer to the €5 trillion pre-pandemic level (*Fig. 3*).

(2) *Inflation marches lower.* For the first time since September 2024, Eurozone headline inflation fell below 2.0% in May to 1.9**%** y/y. That's substantial progress since inflation peaked above 10.0% during the October 2022 energy crisis (*Fig. 4*).

In the baseline of the new ECB projections, headline inflation is set to average 2.0% in 2025, 1.6% in 2026, and 2.0% in 2027.

(3) *Growth is in the trenches.* Eurozone real GDP growth, at an annualized rate of 1.2% through Q1, remains subdued (*Fig. 5*). It is, however, showing signs of life after a close call with a recession at the end of 2023. For this year, the ECB sees real GDP averaging just 0.9% during 2025, *reflecting* a stronger-than-expected Q1 and weaker prospects for the remainder of the year. Staff see real GDP growth averaging 1.1% in 2026 and 1.3% in 2027, boosted by anticipated fiscal and defense spending.

Some positive signs of Eurozone economic growth recently have emerged, including April's near 5.0% y/y rise in German industrial factory orders from strong domestic demand (*Fig. 6*).

(4) *Fiscal front line fires the bazookas.* Europe's fiscal frontline is arming itself with unprecedented spending, and with that comes clear inflationary risks. Germany's new grand coalition has removed defense spending above 1.0% of GDP from the "debt-brake" and *unleashed* a €500 billion infrastructure investment bazooka.

The European Union's *unprecedented* €800 billion ReArm plan, including a €150 billion fiscal loan instrument, is likely to throw a log on the inflation fire. And Germany's new €46 billion tax relief *package* adds another layer of fiscal stimulus.

(5) *Edging towards trade battlefield ceasefire*. Meanwhile, after months of escalating tariff threats, EU and US negotiators are edging closer to a trade truce. The US administration's tone on Eurozone trade is easing ahead of the July 9 trade-talk deadline.

Referring to Eurozone movement to reach NATO defense spending targets, US Trade Representative Jamieson Greer *said* last week that the EU had provided "a credible starting point" for trade talks and that negotiations were advancing quickly. Just a couple of weeks ago, President Trump had threatened 50% tariffs on all European goods.

If a deal is secured in the coming weeks, the inflationary pressure from Europe's aggressive fiscal stimulus would outweigh the disinflationary drag from tariff-related uncertainty. The ECB's June 5 statement observed: "[I]f trade tensions were resolved with a benign outcome, growth and, to a lesser extent, inflation would be higher than in the baseline projections."

François Villeroy de Galhau, Governor of the Bank of France and member of the ECB Governing Council, echoed this sentiment, stating recently that he does not believe deflation is a threat today.

That's all the more reason for the ECB to lay down its interest-rate paring knife for a while.

US Strategy I: Record-High S&P 500 Forward Earnings Resume. After a brief timeout from successively hitting new record highs for eight weeks, a streak that ended with the April 3 week, the S&P 500's forward earnings resumed that pattern last week (*Fig. 7*).

When S&P 500 forward earnings last hit the record-high mark during the April 3 week nine weeks earlier—which also marked Trump's euphemistically named "Liberation Day"—industry analysts' earnings expectations reflected more bark than bite from Trump's Tariff Turmoil. Forward earnings fell just 0.9% from its April 3 record high to its subsequent low three weeks later (during the April 24 week).

However, the S&P 500's price index bore all the bite marks of the tariff uncertainty. The index narrowly avoided falling into a bear market on April 8, bottoming then at 19.8% below its February 19 record high (20.0% and above is bear market territory). The index since has reclaimed nearly all of that lost ground: As of Monday's close, it has improved to just 2.2%

below its February high.

While none of the S&P 500 sectors have recovered fully to record-high forward earnings or index prices yet, most are just a short path back into that club, as Joe shows below:

(1) *Many sectors nearly have record-high forward earnings.* During the May 29 week (the latest available), very few sectors were in the forward earnings doghouse (*Fig. 8*). Tariffs have not been the roadblock to higher earnings that investors had expected (at least, not yet?).

Seven of the 11 sectors are less than 2.4% from their forward earnings record highs and could be readmitted into the record-high club a month from now when Q2 reporting season begins. The highly cyclical Energy and Materials sectors face a longer trudge back. Their forward earnings are still in deep bear markets, down 41.8% and 27.4% from their respective record-highs during mid-2022.

While Trump's tariffs haven't affected forward earnings much yet, that's not to say they won't. China remains the US's biggest trading partner and still controls many crucial supply chains.

(2) *A few sectors remain in an index price correction.* The market's rebound since April 8 has followed along with the forward earnings and pulled all the sector price indexes higher. None are in a bear market any longer. More than half of the sectors are less than 4% from a new record high, and five are still in or near a correction (*Fig. 9*).

Here's how far the sectors remain below their record-high index prices: Industrials (-0.1%), S&P 500 (-2.2), Information Technology (-2.3), Financials (-2.3), Consumer Staples (-2.5), Utilities (-2.8), Communication Services (-3.5), Materials (-9.9), Consumer Discretionary (-12.0), Health Care (-14.7), Energy (-15.4), and Real Estate (-19.3).

US Strategy II: Low Q2 Earnings Expectations Remain. Last week's data show that analysts still expect the S&P 500 to record relatively low earnings growth of 5.6% y/y in Q2 (*Fig. 10*). That was up just 0.1ppt since the week before.

The not particularly bullish analysts collectively forecast that only two of the 11 sectors will grow Q2 earnings faster y/y than the broad S&P 500 index: Communication Services and Information Technology. Among the other nine sectors, only Energy's Q2 earnings is expected to decline y/y at a double-digit percentage rate. The rest are expected to post relatively low single-digit percentage gains or declines in earnings.

Here's how the sectors' y/y Q2 earnings growth forecasts rank: Communication Services (31.1%), Information Technology (17.1), Health Care (4.9), Real Estate (2.7), Industrials (2.1), Financials (2.0), Utilities (0.0), Consumer Staples (-2.5), Consumer Discretionary (-3.6), Materials (-4.4), and Energy (-25.3).

Calendars

US: Wed: Headline & Core CPI 0.2%m/m, 2.5%y/y & 0.3%m/m, 2.9%y/y; Federal Budget Balance -$325.3b; MBA Mortgage Applications. **Thurs:** Headline & Core PPI 0.2%m/m, 2.6%y/y & 0.3%m/m, 3.1%y/y; Initial Claims 240k; WASDE Report. (Source: FX Street)

Global: Wed: Lane. **Thurs:** UK GDP -0.1%m/m, 0.7%3m/3m; UK Headline & Manufacturing Industrial Production -0.4%m/m, -0.4%y/y & -0.8%m/m, -0.4%y/y; De Guindos; Schnabel; Elderson. (Source: FX Street)

US Economic Indicators

NFIB Small Business Optimism Index (*link*): "Although optimism recovered slightly in May, uncertainty is still high among small business owners," noted Bill Dunkelberg, NFIB's chief economist. "While the economy will continue to stumble along until the major sources of uncertainty are resolved, owners reported more positive expectations on business conditions and sales growth." The *Small Business Optimism Index (SBOI)* rose for the first time in five months, to a three-month high of 98.8 in May, after a four-month drop of 9.3 points—from December's recent high of 105.1 to 95.8 in April—with expected business conditions and sales expectations the major contributors last month's level. May's reading was slightly above the 51-year average of 98.0. Meanwhile, the *Uncertainty Index* rose two points to 94, after falling the prior two months, from February's reading of 104—which was the second highest on record—to 92 in April. It's down 16 points from October 2024's record high of 110, though remains well above its historical average of 68. In May, seven of the 10 *components of the SBOI* rose, while only two fell—with current job openings unchanged at 34%. Sales expectations (+11ppts to 10%), expect the economy to improve (+10 to 25), and current inventory (+7 to 1) were the biggest positive contribution to the SBOI in May, followed by plans to make capital outlays (+4 to 22), plans to increase inventories (+3 to -1), expected credit conditions (+3 to -4), and now is a good time to expand (+1 to 10); earnings trends (-5 to -26) and plans to increase employment (-1 to 12) subtracted from May's SBOI. Taxes (18%) was the *single most important problem for small business owners* in May with quality of labor (16), and inflation (14) rounding out the top three, while cost of labor, government regulation, poor sales, and insurance costs, were all at 9%. The bottom five ranged from 4% to 6%. The net percentage of owners *raising selling prices* remained at 25% in May, after increasing from 22% in January to 32% in February—which was the highest percentage since May 2023—while a net 31% plan price hikes in the next three months, up from 28% in March, and the highest since last March's 33%. Turning to *compensation*, a net 26% reported raising compensation in May, down from 33% in April and 38% in March, while a net 20% plan to raise compensation in the next three months, up from 17% in April and 19% in March; it peaked recently at 28% in November.

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