Yardeni Research

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Morning Briefing

The Eurozone's Economy

Check out the accompanying chart collection.

Executive Summary: It's nice to buy stocks at relatively low valuations, but only if they aren't cheap for a reason. European stock markets may be climbing a wall of worry that's about to get steeper given a weakening economic and financial foundation, the likelihood that the European Central Bank will opt not to cut interest rates further, and several country-specific fiscal and political problems. Melissa discusses these and other reasons that Europe's low relative valuations might not be going higher anytime soon. Investors would be well advised to proceed with caution and focus on European stocks with earnings growth rather than just low forward P/Es.

Eurozone Economy I: Still Muddling Along at Best. In recent months, the EMU MSCI index has been propped up by strong defense spending in Germany, tourism-fueled growth in Spain, and low valuations relative to those of US equities and its own history. Investors have been buying European stocks valued at multiples that look cheap compared to US stocks'. But they're valued that way for good reason.

European equities seem to be climbing a wall of worry that is becoming more worrisome. The region's economic and financial foundation looks fragile, with GDP having slowed to stall speed in key economies. Disconcerting Eurozone storylines abound, including the French political and financial upheaval, German fiscal concerns, and the likely end of the European Central Bank's (ECB) rate-cutting cycle. Our advice to investors: Proceed with caution.

Consider the following:

(1) *Earnings & valuation: Prospects priced in, limited multiple upside.* Eurozone MSCI companies' aggregate forward P/E lifted from around 10 after the 2022 energy crisis to 14–15 today (*Fig. 1*). After negative earnings growth in 2025, analysts collectively expect stimulative fiscal policies to fuel an earnings rebound to growth of 14.1% in 2026 (*Fig. 2*). Yet much of that optimism likely appears to be baked into current valuations, leaving limited room for multiple expansion unless earnings deliver a further upside surprise.

That tentative optimism underpins the case for selective exposure across the bloc. Selectivity is particularly key in Germany, where the industrials and defense sectors appear to offer opportunities but valuations broadly sit mid-range historically (*Fig. 3*). France looks less appealing, with valuations stretched on a historical basis and net earnings revisions down (*Fig. 4* and *Fig. 5*). In contrast, Italy's valuations appear to have room to run, with net earnings revisions turning upward (*Fig. 6* and *Fig. 7*). And in Spain, the economic boom led by the tourism industry has been sparking earnings optimism and making for relatively attractive valuations (*Fig. 8* and *Fig. 9*).

(2) *GDP: Stall speed for some countries, potential recession for others*. Following a rise of more than 2.0% (saar) in Q1, Eurozone real GDP grew just 0.5% q/q and 1.5% y/y in Q2 2025 (*Fig. 10*). The Economic Sentiment Indicator (ESI) has been stuck near 95 since 2023. The ESI is the European Commission's composite confidence gauge that blends industry, services, consumers, retail trade, and construction sectors. A reading of 100 marks the long-term average; above/below that signals stronger/weaker sentiment relative to trend.

On a country basis, Germany's real GDP came in at just 0.2% y/y in Q2. Export headwinds and autos remain weak links for Germany. Italy grew a mere 0.4% y/y, with Italian National Institute of Statistics *pointing* to external drags. In France, a modest 0.8% y/y pace of Q2 GDP growth is overshadowed by a political upheaval that's depressing business and consumer confidence. The outlier is Spain, with relatively stunning 2.8% y/y growth in Q2 led by tourism (*Fig. 11*).

(3) *Consumer: Weak retail sales & underlying jobs data signal caution*. Retail sales across the bloc *fell* 0.5% m/m in July but is up 2.2% y/y, albeit lower than expectations. Among the bloc's major economies, Spain's consumer sector remains the most resilient (*Fig. 12*). The Eurozone unemployment rate (6.2%) is historically low, though German and French jobless rates have ticked up from their 2022 troughs (*Fig. 13*).

(4) *Manufacturing: Tentative hopes & soft orders*. The Eurozone manufacturing PMI (M-PMI) finally has edged back into expansion territory, rising to 50.7 in August. That's its first above-50 reading since 2022, but the recovery looks tentative (*Fig. 14*). In Germany, the M-PMI climbed to 49.8, its highest in more than three years but still in contractionary territory (*Fig. 15*). Meanwhile, industrial production shows signs of life as production edges higher but orders remain underwhelming (*Fig. 16*). IFO Institute's business expectations index has improved from its energy-crisis depressed lows of 2022, while its current situation index continues to lag (*Fig. 17*). German producer prices (PPI), at -1.5% y/y in July, highlight the disinflationary drag on that economy.

(5) *Inflation & policy: On target & on hold*. The Eurozone's headline Consumer Price Index (CPI) came in at 2.1% y/y in August, with the core excluding food and energy at 2.3% y/y—a hair above the ECB's target (*Fig. 18*). That firmly pins the bank in "wait-and-see" mode after its early 2025 rate cuts. Spain's inflation is running hot at a pace of 2.7% y/y in August (*Fig. 19*). Germany's "healthy" 2.1% CPI pace may not hold up if the disinflation evident in the latest PPI reading feeds through to consumer prices. Italy's inflation rate is hovering near 2.0% y/y. France is the outlier, with its inflation still running below 1.0% y/y.

Eurozone Economy II: Will Bond Vigilantes Cause a Debt Crisis? The European stock market may continue to climb its wall of worry, which includes the following concerns: France's political standoff and widening OAT–Bund spreads, Germany's faltering fiscal push against weak growth, and an ECB stuck on hold. Consider the following brewing dramas:

(1) *France: Much ado about much ado*. The September 9 *Financial Times* *discussed* how France's confidence vote drama has morphed from Paris politics into a financial market story. Investors are now talking about France in "periphery" terms as the spreads have widened between French government bonds (OAT) and German bunds, leaving OAT yields trading above the government bonds of Greece and near those of Italy. That's an inversion that would have been unthinkable a few years ago (*Fig. 20* and *Fig. 21*).

The *FT* ties French Prime Minister François Bayrou's fall and President Emmanuel Macron's parliamentary stalemate to fiscal drift, as deficit-cut plans are frozen and risk of a debt rating downgrade is back on the table. Debt dynamics are the crux: With debt/GDP rising to 113% last year, up from 101% in 2017, France desperately needs budget surpluses to steady its ship.

We advise caution in the French stock market as valuations already at the rich end collide with deteriorating earnings revisions and fiscal policy paralysis.

(2) *Germany*: *Fiscal promises.* In a September 4 article, Reuters *summarized* new economic forecasts from top German institutes: 2025 growth marked down to near-stall, with only a modest pickup in 2026–27, and even that relies on Berlin's deploying new public funds on time. The article quantifies the potential lift (roughly 0.6ppt added to 2026 GDP if spending lands) but notes the lag between appropriation and real-economy impact. Add US tariffs and trade frictions, and Germany's export machine still looks constrained. Reuters quotes RWI chief economist Torsten Schmidt saying that the government spending

programs “do not solve the fundamental competitiveness problems of the German economy.”

In our view, the much-touted fiscal “boost” is an air pistol , not a bazooka. On balance, the German stock market’s middling valuations make sense. Investors are advised to keep their expectations about the impacts of the German fiscal stimulus realistic.

(3) *ECB outlook: To cut no more*. As for monetary policy, a “pause” *signal* is identified in the September 8 *WSJ*: The ECB is all but certain to hold interest rates steady for a second straight time—with the deposit rate at 2.0%—while providing minimal forward guidance during its September 11 meeting. Inflation has held near the ECB’s 2.0% y/y target, and economic momentum remains soft but stable.

Policymakers appear unanimously to believe that uncertainty from global trade dynamics and an uneven recovery warrant a cautious monetary policy stance. Though the markets appear to reflect expectations for a small chance of a rate cut later this year, the ECB’s “data-dependent, meeting-by-meeting” approach—echoing its June phrasing—suggests that it’s firmly in pause mode unless inflation or economic growth weakens sharply.

However, the Federal Reserve’s expected plunge into a renewed rate-cutting cycle in coming weeks complicates the equation of comparing the relative attractiveness of interest rates globally.

For investors in Eurozone equity markets, earnings could be disappointing in coming quarters, in our opinion.

Calendars

US: **Thurs:** Headline CPI 0.3%m/m, 2.9%y/y; Initial Claims 234k; Federal Budget Balance -$305.7b; Fed’s Balance Sheet; IEA Monthly Report. **Fri:** University of Michigan Consumer Sentiment Index 58.0. (Source: FX Street)

Global: **Thurs:** ECB Interest Rate Decision 2.15%; Eurozone Deposit Facility Rate 2.00%; Lagarde. **Fri:** Germany CPI 0.1%m/m, 2.2%y/y; France CPI 0.5%m/m, 0.8%y/y; UK GDP 0.0%m/m, 0.3%3m/3m, 1.1%y/y; UK Industrial Production 0.0%; Japan Industrial Production -1.6%; Nagel. (Source: FX Street)

Strategy Indicators

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): During the September 4 week, the S&P 500's forward revenues dropped 0.2% w/w, ending its streak of five straight weekly record highs. However, forward earnings jumped 1.1% to a new record high. The forward profit margin rose 0.1ppt to a new record high of 13.9%. It's now 3.6ppts above its seven-year low of 10.3% during April 2020. The consensus expectations for forward revenues growth rose 0.1ppt w/w to a 36-month high of 6.1%. It has gained 3.8ppts from its 33-month low of 2.3% during the February 23, 2023 week. That's down from a record high of 9.6% growth at the end of May 2021 and compares to 0.2% forward revenues growth during April 2020, which was the lowest reading since June 2009. The forward earnings growth forecast rose 0.3ppt w/w to a 31-week high of 12.7%, up 1.8ppts from its 15-month low of 10.9% during the May 29 week. From a longer-term perspective, that's a bit stronger than its 20-year average of 11.4% and slowing from a 38-month high of 14.3% during the December 12 week. That's also down from its 23.9% reading at the end of April 2021, which was boosted by the recovery from the pandemic to its highest reading since June 2010 and up substantially from its record low of -5.6% at the end of April 2020. Analysts expect revenues to rise 5.6% in 2025 (unchanged w/w) and 6.2% in 2026 (up 0.1ppt w/w), compared to a 4.9% rise in 2024. They expect an earnings gain of 11.2% in 2025 (up 0.1ppt w/w) and a 13.4% rise in 2025 (up 0.1ppt w/w) compared to 2024's earnings gain of 11.4%. Analysts expect the profit margin to rise 0.6ppt y/y to 13.2% in 2025 (up 0.1ppt w/w) and 0.9ppt y/y in 2026 to 14.1% (up 0.1ppt w/w), compared to 2024's 12.6%. Looking at valuation data as of September 4, the S&P 500's weekly forward P/E dropped 0.3pt w/w to 22.2 from a 55-month high of 22.5 and is up 3.0pts from its 16-month low of 19.2 during the April 17 week. It's now 6.9pts above its 30-month low of 15.3 in October of 2022. It also compares to 23.1 in early September 2020, which was the highest level since July 2000, and to a 77-month low of 14.0 in March 2020. The S&P 500 weekly price-to-sales ratio dropped 0.01pt w/w to 3.09 from a record high of 3.10. That's up from a six-month low of 2.22 during the October 26, 2023 week and compares to a 49-month low of 1.65 in March 2020.

S&P 500 Sectors Revenues, Earnings, & Margins (*link*): During the September 4 week, the Consumer Staples sector experienced some one-time blips in its data as its low-margin Drug Retail industry stopped trading when Walgreens (WBA) was taken private. Looking at the other 10 S&P 500 sectors: all but Energy posted gains in their forward revenues; all 10 posted gains in their forward earnings; and the forward profit margin rose for all but Communication Services. These eight sectors had post pandemic- or record-high forward revenues this week: Communication Services, Consumer Discretionary, Financials, Health

Care, Industrials, Information Technology, Real Estate, and Utilities. Consumer Staples' would be at a record high too, if adjusted for Drug Retail's exit in late August. Energy's is improving now from its three-year low in May, but remains depressed at 29.6% below its September 2008 record and 17.0% below its cyclical high in October 2022. Materials' has improved to a 25-month high to 4.0% below its June 2022 record high. These seven sectors had record-high forward earnings this week: Communication Services, Consumer Discretionary, Financials, Industrials, Information Technology, Real Estate, and Utilities. Consumer Staples' is now 0.9% below its record high due to Drug Retail's exit, and Health Care's has improved to 1.6% below its April 3 record. Forward earnings remains depressed for the last two sectors, Energy and Materials, but have improved in recent months to 38.4% and 22.6% below their respective highs during 2022. Looking at the forward profit margin, six sectors rose w/w. These two sectors were at record highs: Financials and Information Technology. These four sectors remain close: Communication Services, Consumer Discretionary, Industrials, and Utilities. Consumer Staples, Energy, Materials, and Real Estate are improving somewhat from their recent multi-year lows, but Health Care's is still at a record low. Here's how the S&P 500 and its 11 sectors rank based on their current forward profit margin forecasts along with their record highs: Information Technology (28.0%, up 0.2ppt w/w to its fifth straight record high and for the first time since September 2024 when low-margin Dell's addition to the index lowered the margin 1.3ppts then to 26.3%), Financials (20.8, at a record high), Communication Services (19.4, down from its 19.8 record high during the August 7 week), Real Estate (16.7, up 0.1ppt w/w to a six-month high and down from its 19.2 record high in 2016), Utilities (14.8, up 0.1ppt w/w to a 43-month high and 0.3ppt below its 15.1 record high in April 2021), S&P 500 (13.9, up 0.1ppt w/w to a new record high), Materials (10.9, up 0.1ppt w/w to a seven-month high and up 0.5ppt from 51-month low in late February and down from a 20-month high of 11.6 in July 2023 and a 13.6 record high in June 2022), Consumer Discretionary (9.3, down from a record high 9.4 in early April), Energy (8.9, up 0.1ppt w/w and 0.4ppt from a 55-month low of 8.5 during the during the May 15 week and down from its 12.8 record high in November 2022), Industrials (11.2, down from its 11.3 record high in early January), Health Care (8.1, at a record low and down from its 11.5 record high in February 2022), and Consumer Staples (7.1, up 0.4ppt w/w from a 21-month low due to Drug Retail's exit and down from its 7.7 record high in June 2020).

US Economic Indicators

Producer Price Inflation (*link*): The PPI was a surprise in August, falling 0.1% during the month, below the consensus estimate of a 0.3% gain and down from July's 0.7% increase.

August’s decline reflects a 0.2% drop in prices for *final demand services*, the largest shortfall since April, and helped offset the 0.1% gain in prices for *final demand goods*. The yearly percent change for the *headline rate* was 2.6% in August, slowing from July’s 3.1% and below the consensus estimate of 3.3%. It was at 3.8% at the start of this year. Prices for *final demand less food, energy, and trade services* rose 0.3% last month, half July’s 0.6% gain. The *yearly rate* remained below 3.0% for the fifth month, though accelerated from 2.5% in June to 2.8% in August. It was at 3.6% in February. The PPI for *personal consumption* and *personal consumption ex food and energy* were at 2.6% and 2.9%, respectively, in August, with both easing from 3.9% at the start of this year.

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