INVESTMENT STRATEGY

Equity Focus: I love it when a plan comes together

January 2024

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The bank for a changing world

I love it when a plan comes together

Key Points

- **The S&P 500 is now up over 15% since October 27th.** A combination of strong consumer spending in stores, a rapid deceleration of inflation and a dovish tilt from the FED have all contributed to an extremely market-friendly backdrop for stocks - especially when you consider that US growth remains resilient, as per the strong November labor reports.
- **Markets have been increasingly pricing a US economic soft landing,** while revising down the risk of a higher-for-longer rate environment. In the wake of the recent dovish tilt from the Fed, that outlook has changed quickly. While inflation decelerated at an accelerated pace, growth has remained firm (albeit no too firm), real yields receded.
- **This better-than-expected macro environment**, which was further supported by a notable easing in financial conditions, drove a rerating of the rest of the market vs the Magnificent 7. The S&P 600 Small Cap index managed to beat the "Mag 7" by more than 5% over the last 4 weeks. The equal weighted S&P managed to beat its capital weighted counterpart by 1.2 %-points.
- **The January effect:** Pension and other switches make January the strongest month of the year for equity inflows. On average, investors allocate ~21bps of fresh new money to equities. This would average ~USD60bn worth of equity inflows in January even without switches out of money market funds.

Main recommendations

(+) **Upgraded parts of EU Staples to neutral.** A lot of headwinds from 2023 (e.g. cost of living pressures, input factor inflation, rising rates) are expected to ease in 2024, helping margins to recover.

Upgrade US Utilities to positive. Utilities continue to provide promising business updates and are working to transform their businesses towards sustainability. Valuations are low and positioning is light. We see room for further upside, if rates continue to fall.

(+) Stay diversified including in some cheap and solid cyclical stocks (European Financials).

Country-wise, we maintain our positive stance on the eurozone, UK, Japan and Latin America

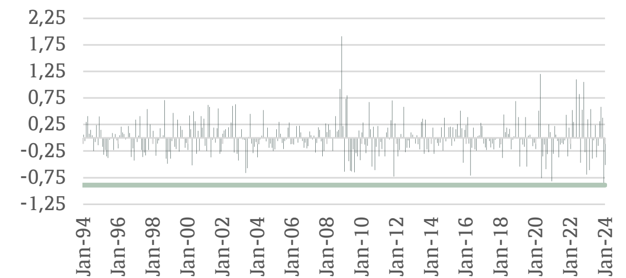
(-) Be cautious/selective with expensive market segments, such as Consumer Staples, some large-cap US tech stocks and some Consumer Cyclicals: pricing power is weakening and operating profits are under pressure from rising costs. Some very high P/E ratios are difficult to justify.

The key risks are that the US Federal Reserve or the ECB could keep interest rates high for longer than expected, triggering a sharper economic slowdown or even a recession.

Our position this month

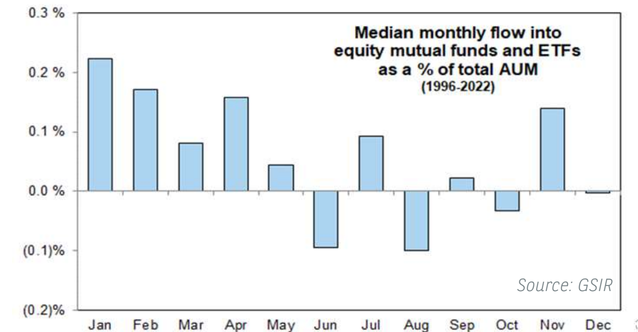
Change in our position since last month

NOVEMBER SAW THE BIGGEST DECLINE OF US FINANCIAL CONDITIONS IN 30YR+



Source: BNP Paribas, Bloomberg

THE "JANUARY" EFFECT



Focus on

Q4 2023 Earnings Season

Index & Macro Observations

Asian Equity View

Sector Views

Q4 Earnings Season outlook

WHAT TO WATCH FOR DURING THIS EARNINGS SEASON

Companies have been busy putting pressure on expectations as we approached Q4 earnings season. Both the number and the percentage of S&P 500 companies issuing negative EPS guidance for Q4 2023 is currently higher than average. 65% of companies which issued an update lowered the expectations, which is well above the longer-term averages. As a result, **analysts lowered their earnings estimates for Q4 2023** by a larger margin than average during the fourth quarter. On a per-share basis, estimated earnings for the fourth quarter decreased by 6.8% from September 30 to December 31, surpassing long term averages as well.

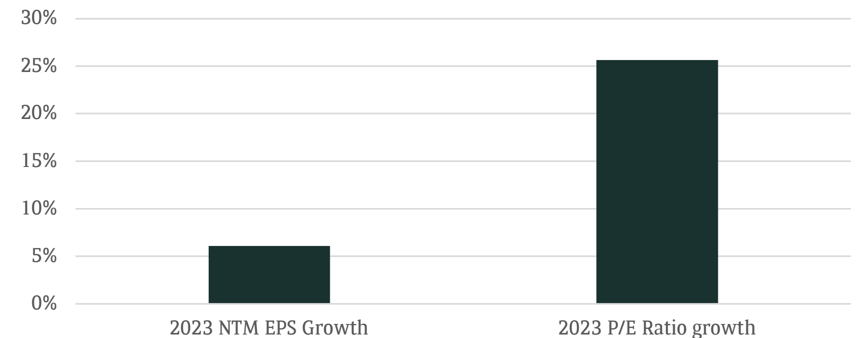
But Q4 is already history. What matters more is the outlook for 2024. In this respect, the Q4 earnings downgrades could be seen as an attempt to lower the bar for 2024. We saw several companies which not only lowered their guidance but also depreciated their inventories. Consequently, the consensus estimate for 2023 EPS stands fell by almost USD4 to USD219.31, which let to an increased earnings growth rate for 2024 of now 11,5% vs 9,5% as per end of September.

Among the key elements to watch will be margins and factors that are likely to influence them. Analysts have lowered their expectations of the net profit margin to 11% (was 12.2% in Q3). We feel that this pessimism could be driven too much by an extrapolation of the precautionary downgrades we saw from some companies. As revenues are still expected to grow, we expect S&P 500 firms in aggregate to have benefitted from continued strong economic growth and subsiding input cost pressures, enabling them to beat consensus forecasts.

For 2024, economic growth is one key element to watch for in respect to EPS evolution as US economic growth explains more than 50% of the variability observed in S&P 500 EPS growth. We see a higher probability that the US economy avoids recession, which would provide another tailwind to EPS growth. Inflation is another key element, albeit its impact is mixed. While a headwind for sales, it often acts as a potential tailwind for margins. Upside risks to margin forecasts exist if input costs, including wages, grow less quickly than prices charged. Finally, US financing costs eased as rates fell from their recent highs. Consequently, the cost of new debt has declined, calming previous concerns about higher interest expense and the impact on margins.

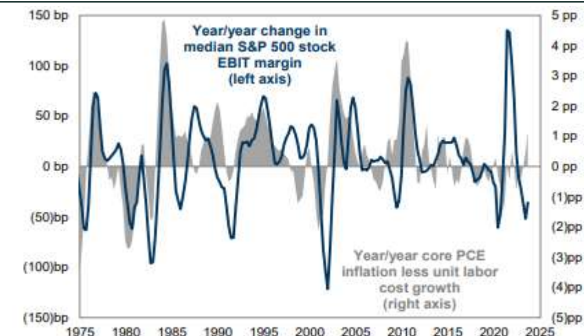
We see reasons to stick to our positive stance

Price gains in 2023 have been mainly driven by multiple expansion



Source: BNP Paribas, Bloomberg.

Slowing labor cost growth should support profit margins



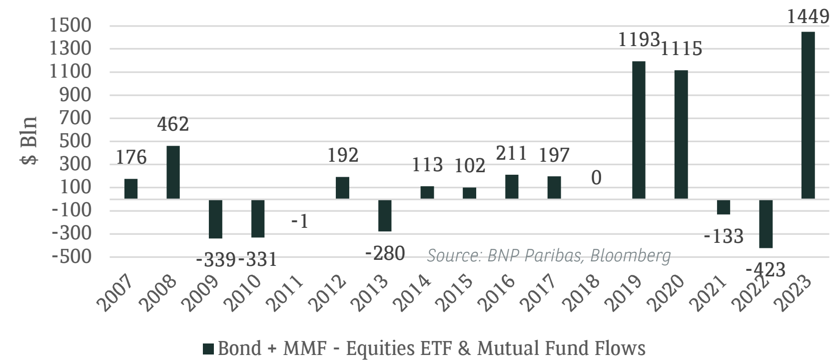
Source: Goldman Sachs Global Investment Research

Money Market Funds – the 6 trillion dollar gorilla?

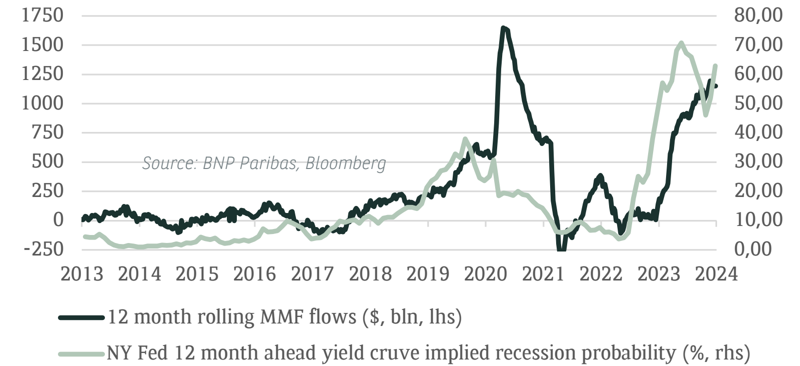
Driven by climbing interest rates, investors have put USD1.35 trillion into money market funds (MMF) in 2023 which pushed Assets managed by MMFs to a new high. This marks higher inflows than in the prior 3 years combined. On the other hand, global equities logged +USD172bn of inflows in 2023. This represents the weakest inflows in the past 4 years. This comes despite the recent rally and is especially remarkable as even the down-year 2022 saw larger inflows.

The market (via the yield curve) is still pricing in a 60% probability of a recession next year. We see chances for this number to fall during 2024. It is worth noting that there have been several instances over the last 10 years when investors have aggressively rotated out of money market funds as the probability of a recession dropped. While a large amount if such flows would likely move into bonds, even a small fraction could already have an impact on equities, given the total size of the money that may be moving.

Full year fixed income vs equities flows



MMF flows often follow recession expectations

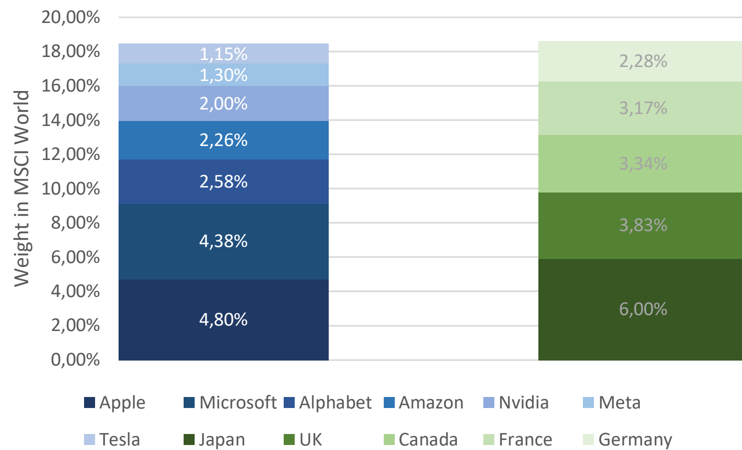


Source: GSIR

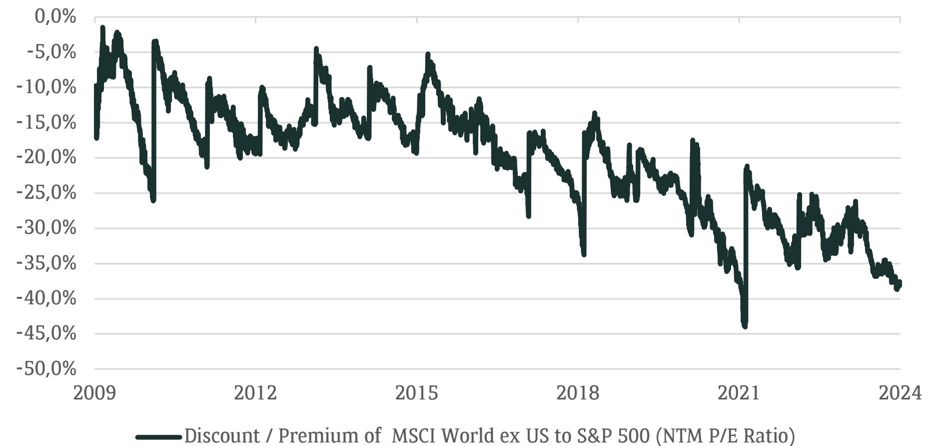
The magnificient heavyweights

THE WEIGHT OF THE ´MAG 7´IN THE MSCI WORLD GROWS AS THE VALUATION PREMIUM RISES

The ´Magnificient 7´ weight as much as 6 countries in the MSCI World



The discount of stocks outside the US to the SPX is close to record highs



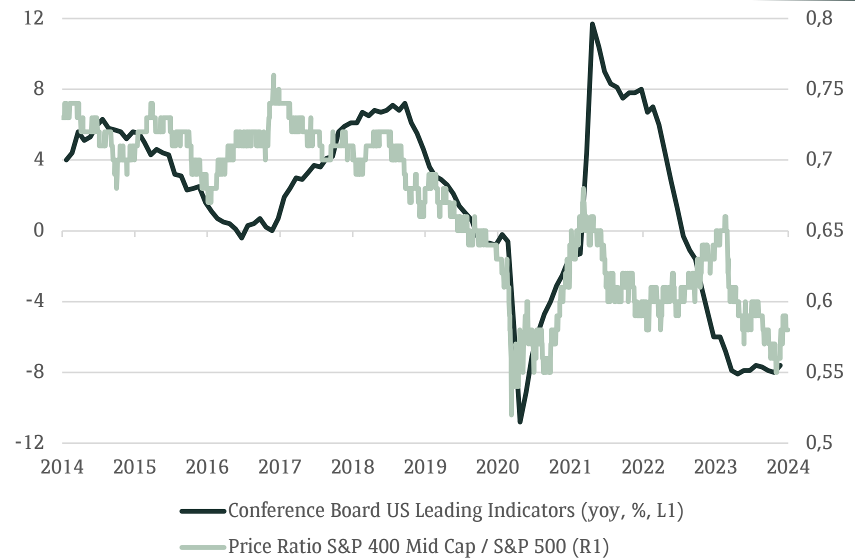
Source: BNP Paribas, Bloomberg

SMID Caps – Beneficiaries from an economic improvement

ON YOUR MARKS, GET SET, ...

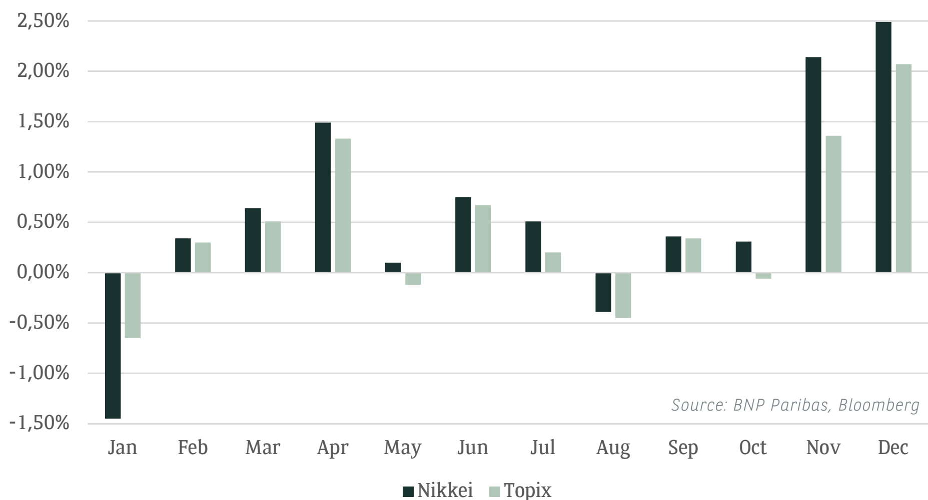
SMID Caps are trading close their 10 year lows, BUT...

.... we prefer to wait for a confirmation of economic improvement before we further increase our allocation



Japan

BEWARE THE IDES OF JANUARY



While January is broadly considered a good month for equities from a seasonal perspective, Japan is an excemption to this rule. Based on 20-year seasonality, January does tend to be one of the worst months for performance in the Japanese equities market. The 20-year average for TOPIX is -0.65%, while the average for Nikkei is -1.45%.

Investors should be aware of this effect to not get spooked by a relative underperformance of Japan vs other markets during January. We stick to our positive stance and would see any weakness as opportunity to increase positions

Sector Allocations – Overview

Reco	Sector (Level 1)	Industry (Level 2) +	Industry (Level 2) =	Industry (Level 2) -
	Materials	Materials		
	Utilities	Utilities		
	Health Care	Pharma + Biotech HC equip. & services		
	Financials	EU Banks EU Insurance EU Div. Financials	US Banks US Insurance US Div. Financials	
	Energy	US MLPs (Energy Infrastructure		
	Real Estate	EU Real Estate	US Real Estate	
	Communication Services		Telecoms Media & Social Networks	
	Industrials		Commercial Services Capital Goods Transportation	
	Technology	EU Technology	Technology	
	Consumer Discretionary		Luxury Goods Consumer Services Retail Automobiles Leisure	
-	**Consumer Staples**		EU Food & Beverages EU Food Retail	US Food & Beverages US Food Retail Household & Personal Care Products

- **We downgrade Energy to neutral**
- **We upgrade US Utilities to positive**
- **We upgraded parts of the EU Staples complex to neutral**
- **Gold Miners are still substantially lagging the price evolution of the underlying commodity and offer interesting opportunities (see the last edition for more details)**
- **Please refer to *the Thoughts and Convictions* section on the next page for brief comments on our key convictions**

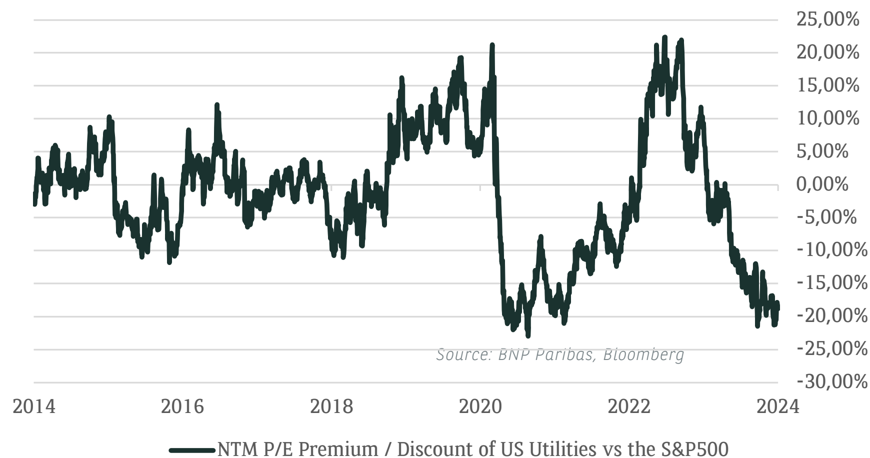
Sector Allocations – Thoughts and Convictions

Overall view on Equities	Region	Sector / Style in Focus	View	Comments
+	Global (+)	Materials	+	Like Energy, Materials could not withstand the price correction in many metals. With the US being more likely to narrowly miss a recession, PMIs should start to recover sooner which should help metals. More demand support is expected from the energy transition. Thus, we do especially like exposure to those metals / miners (e.g. Copper miners)
		Utilities	+	EU Utilities continue to provide promising business updates and are working to transform their businesses towards sustainability. In the US, new a spending cycle seems to emerge which is driven by the need to improve reliability and capable to handle the ongoing energy transition. Those investments should support earnings growth.
		Healthcare / Biotech	+	The sector is currently experiencing some notably dispersion which is mainly driven by the impact of anti-obesity drugs (AOM). While certain companies have soared on the back of extremely positive assumptions regarding the AOM TAM, others suffered as their TAM is expected to shrink on the bac of an overall improved health. We consider this as overdone and would expect a correction as demographic trends are still pointing towards structural growth for the entire sector
		Energy	=	The fundamentals of the oil & gas markets have turned relatively 'soft'. Interest rates and inflation expectations are fading tailwinds while expectations for earnings and cash distributions may be too high. High OPEC spare capacity should provide further drag on the sector. The sector is still highly cash-generative and valuations are not demanding. However, we see less room for outperformance against this backdrop. We do still like MLPs in the US.
		Consumer Staples	-	A lot of headwinds from 2023 (e.g. cost of living pressures, input factor inflation, rising rates) are expected to ease in 2024, helping margins to recover. This in combination with a healthy combination should support margins of Food Producers as well as Retailers. We upgrade both industries to neutral.
	US (=)	Technology	=	The Sector is still heavily dominated by too expensive maega cap names. We prefer to look at subsectors which structural growth trends such as Cyber Security and Seminconductors.
	Europe (+)	Technology	+	The majority of European Software companies are active in the application layer of the AI value chain. We expect a growing demand as AI enables users to overcome traditional software limitations when it came down to process automation. This potential does not seem to be not fully appreciated by the market yet.
		Banks	+	European Banks continue to outperform the market on the back of improved earnings estimates. We see further re-rating potential driven by the high number of expected rate cuts from the ECB. Lower rate cuts should support banks net interest income. At the same time, the recent retreat in rates should help reviving loan growth will bringing relief to borrowers which should translate in lower future losses in the loan books.
		Real Estate	+	Despite the recent rally, EU Real Estate is still trading > 40% below both its pre- and post covid highs. Valuations are still looking cheap, and we see room for recent asset price write downs to reverse. Keep in mind that the sector was trading at a price/book ratio of ~ 1 the decade pre covid while today it is only at 0.66. Due to structural trends (anemic new building activity, demographics etc) we´re especially constructive on residential RE. Beyond, we like Logistics and Data Centers while being a bit more cautious on Office and Shopping RE.

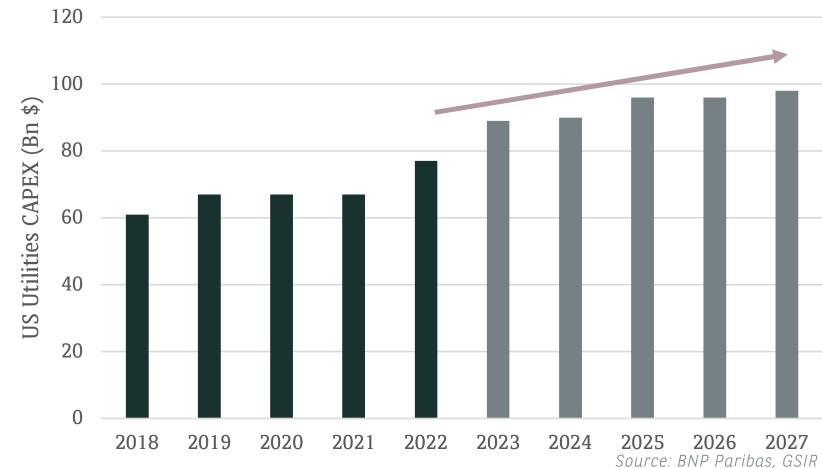
Upgrading US Utilities to positive

VALUATIONS ARE CLOSE TO COVID LOWS WHILE INCREASING CAPEX INCREASES THE PROSPECTS OF SOLID EPS GROWTH

Relative valuations are close to Covid lows



CAPEX is set to increase which should support earnings growth

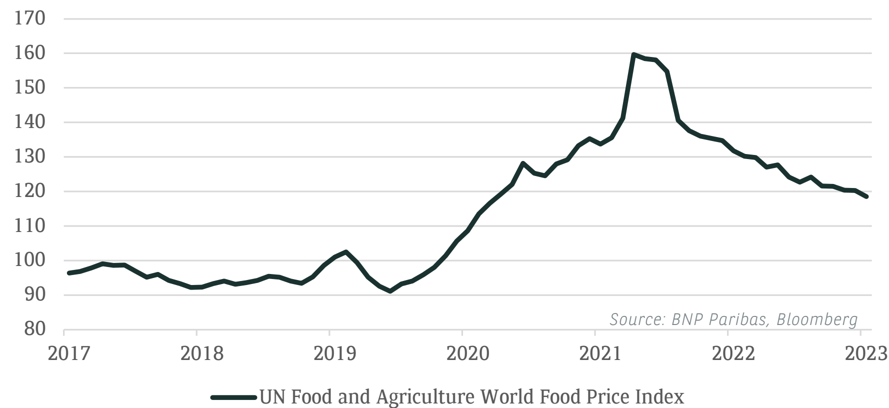


We see signs of US Utilities entering a new a spending cycle, driven by significant needs to maintain, harden, and expand the grid in order to support reliability as we continue to progress on the Energy transition. Those investments should support an average of 6% earnings growth for the sector, according to Goldman Sachs. As relative valuations vs the S&P 500 valuations remain close to COVID-19 era lows, we do not see this reflected in current prices. Falling yields should provide further support to valuations

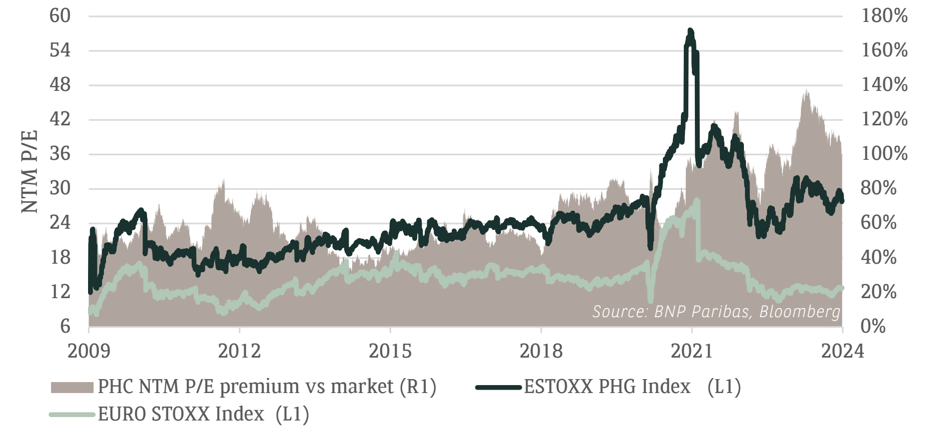
Upgrades in the staples sector

EU FOOD & BEVERAGES AS WELL AS EU FOOD RETAIL ARE UPGRADED TO NEUTRAL ON VALUATIONS AND AN IMPROVED MARGIN OUTLOOK

Global Food Prices are back to 2021 levels



PHG are trading close to a 15 year valuation premium high

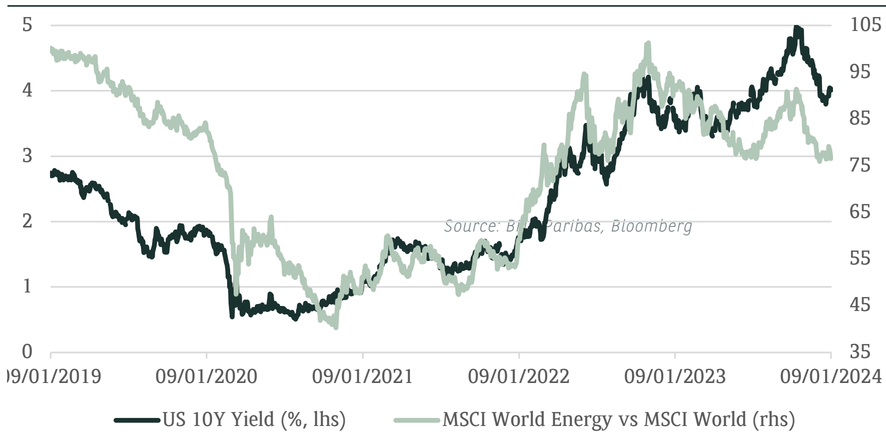


Several headwinds from 2023 (e.g. cost of living pressures, input factor inflation, rising rates) are expected to ease in 2024. While there are some notable exceptions (robusta coffee, cocoa, sugar), it is generally the case that most relevant commodity inputs have been either stable or declining as of late, which should help margins. Looking at key macro indicators (consumer confidence, unemployment, GDP), they suggest that the average consumer should be stable and arguably improved compared with 2023, helping volumes. Based on the recent valuation normalization, we upgrade EU Food & Beverages (Ingredients are our most favored sub-sector) & EU Food Retail to Neutral. Personal & Household Goods (PHG) remain on Underweight due to expensive valuations.

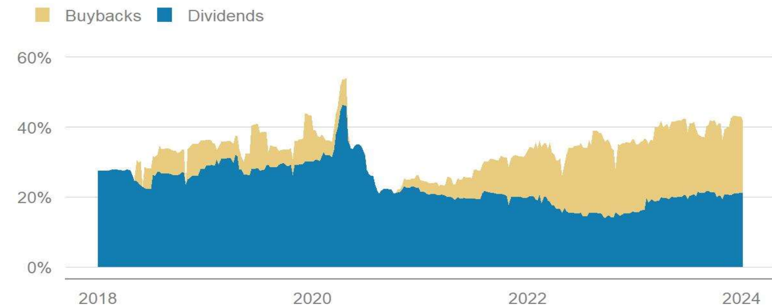
Downgrading Energy to neutral

THE FUNDAMENTALS OF THE MARKET WILL BE LESS SUPPORTIVE GOING FORWARD

Global Food Prices are back to 2021 levels



Cash distribution levels are expected to remain historicaly high

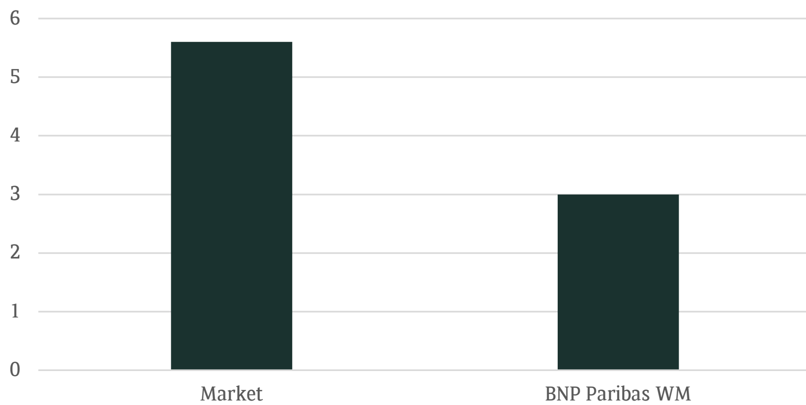


While we still expect oil prices to recover during the next 12 months, interest rates and inflation expectations are unlikely to provide the tailwinds they did in 2023. Also, we see rising risks of modest negative revisions to consensus estimates for earnings and shareholder distributions. Geopolitical risk events will provide less support going forward. Thanks to ample OPEC spare capacity, oil prices (and hence Energy equities) have become less sensitive to geopolitics. The sector is still highly cash-generative and valuations are not demanding. However, we see less room for outperformance against this backdrop. We do still like MLPs in the US as US energy infrastructure benefits from increasing exports which lead to more oil & gas being transported toward export hubs along the costal line.

European Banks

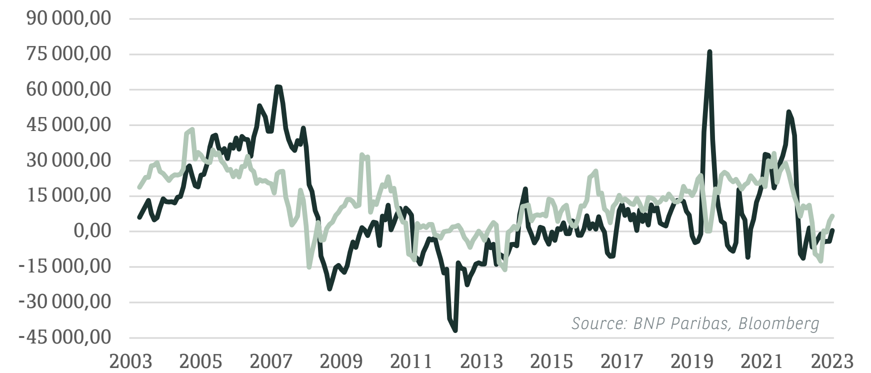
RATE CUT EXPECTATIONS LOOK OVERDONE, LEAVING ROOM FOR EARNINGS UPGRADES

The market is expecting almost twice as many rate cuts than us



Source: BNP Paribas, Bloomberg

Bank loans growth recently found a floor and seems to recover



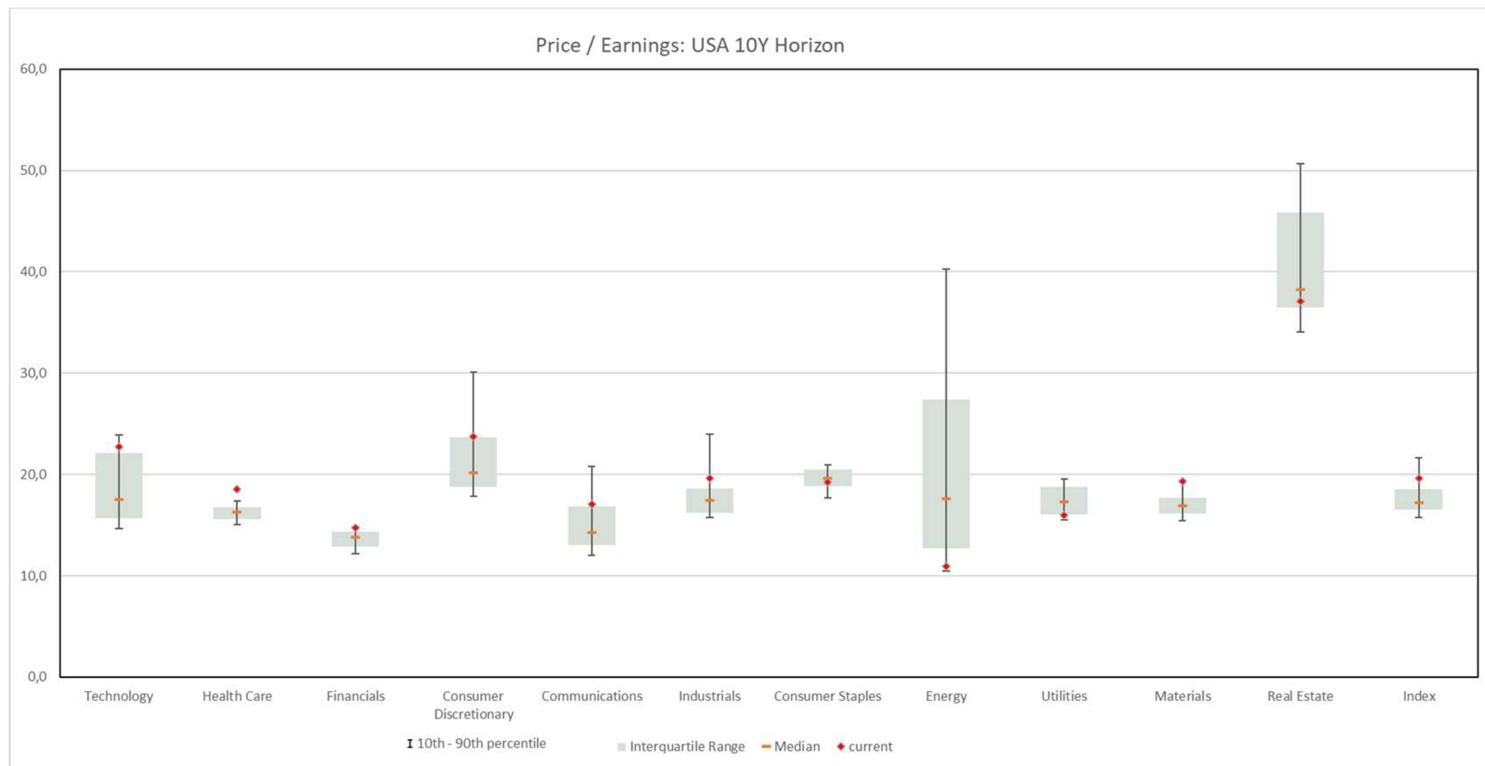
Source: BNP Paribas, Bloomberg

Index Valuations

Index	Level	1yr Range	EPS	5yr Z-Score	EPS change 4 weeks	PE Ratio	5yr Z-Score	PB Ratio	5yr Z-Score	Div Yield	5yr Z-Score	ROE	5yr Z-Score	Earnings Yield	5yr Z-Score	Equity Risk Premium	5yr Z-Score	vs. ACWI	5yr Z-Score
MSCI ACWI	720		41,69		7,72	17,31		2,65		2,20		14,43		5,79		1,78		n.a.	n.a.
MSCI World	3154		173,45		6,36	18,18		2,90		2,09		14,94		5,50		1,49		1,06	
MSCI Emerging Markets	997		81,50		16,42	12,23		1,51		3,18		12,10		8,18		4,16		0,69	
S&P 500	4757		232,93		6,84	20,43		4,07		1,54		18,51		4,90		0,88		1,23	
S&P 500 Equal Weighted	6385		366,18		6,06	17,37		2,78		2,11		14,86		5,74		1,72		1,01	
Russell 2000	1968		74,18		23,08	26,56		1,52		n.a.		4,54		3,77		-0,24		1,41	
NASDAQ 100	16679		654,10		9,94	25,48		6,46		0,88		22,28		3,92		-0,09		1,60	
MSCI USA Growth	19710		363,61		10,47	28,81		9,14		0,45		28,90		1,84		-2,17		1,90	
MSCI USA Value	12422		211,05		5,40	16,21		2,67		2,55		15,22		1,70		-2,31		0,95	
STOXX Europe 600	477		35,22		3,34	13,55		1,83		3,73		12,87		7,38		5,19		0,77	
STOXX Europe Mid 200	514		38,98		4,44	13,19		1,50		3,92		10,31		7,58		5,39		0,74	
STOXX Europe Small 200	321		23,12		8,17	13,87		1,35		3,28		8,62		7,21		5,02		0,76	
DAX	16688		1454,95		4,20	11,47		1,43		3,49		11,12		8,72		6,53		0,65	
FTSE 100	7684		629,83		2,08	12,20		1,69		4,59		13,67		8,20		4,42		0,70	
CAC 40	7427		573,33		1,80	12,95		1,79		3,39		13,17		7,72		5,53		0,74	
FTSE MIB	30409		3553,12		-2,38	8,56		1,21		5,82		14,80		11,68		9,50		0,49	
Nikkei 225	33763		1735,93		1,90	19,45		1,84		1,90		9,40		5,14		4,56		1,07	
Hang Seng	16190		1944,76		8,61	8,32		0,90		4,69		10,99		12,01		9,52		0,46	

Sector Valuations - US

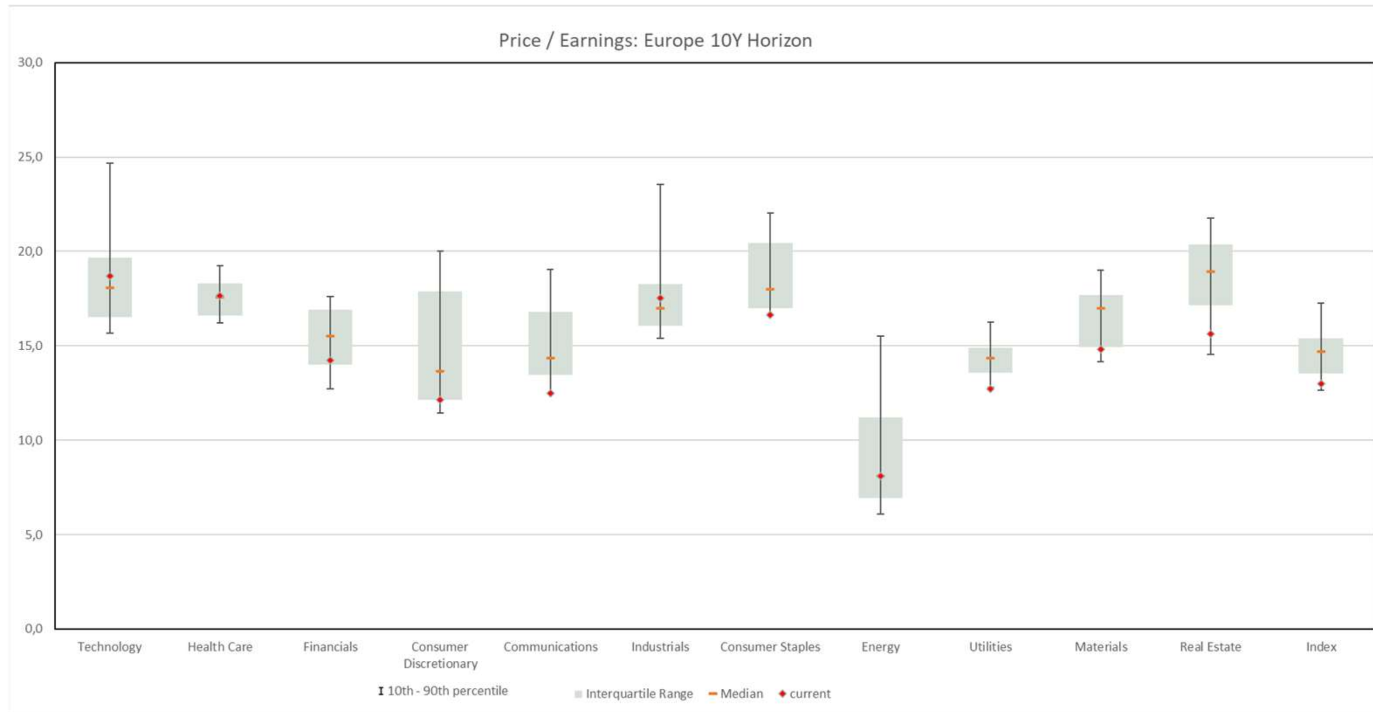
MOST OF THE SECTORS IN THE US ARE AT THE TOP OR EVEN ABOVE THEIR 90TH PERCENTILE



Source: BNP Paribas, Bloomberg

Valuations - EU

EUROPEAN SECTORS CONTINUE TO SCREEN CHEAP VS HISTORY ACROSS THE BOARD



s, Bloomberg

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