INVESTMENT STRATEGY

Equity Focus: The night is always darkest before dawn

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Edmund Shing, PhD
Global CIO
BNP Paribas Wealth Management

Stephan Kemper
Chief Investment Strategist
BNP Paribas Wealth Management – Private Banking Germany

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WEALTH MANAGEMENT

The bank for a changing world

In short: we remain confident

Key Points

- **US earnings season**: reporting is taking its usual course with both the number of positive earnings surprises and their magnitude close to long-term averages. There are some interesting underlying trends:
  - Profit margins are continue to decline. The current net profit margin stands at 11.6%, which is 30 bps below Q3 2022. If confirmed, this reading would mark the seventh straight quarter of declining net profit margin year-on-year.
  - Magnificent (Mag) 7 earnings are a mixed bag so far: Meta, Tesla and Google have suffered on the back of their earnings releases while Microsoft and Amazon have seen positive price reactions.
- **Time to reverse?** S&P's cap-weighted index outperformed its equal-weighted peer by 13% YTD. This is the widest margin of outperformance (at this point in the year) in 30+ years. With the Mag 7 losing their mojo (see above), we may see a reverse which would result in a SPX on index levels but extended sector & factor moves.
- **European earnings season:** roughly one-third of companies have reported so far. While EPS net breadth (+14%) is in line with last quarter, revenues are showing a large deterioration. Only 27% of companies have beaten consensus expectations for the top line versus 40% missing them, yielding a net negative breadth of sales misses of -12%. Style-wise, Value stocks are showing relative EPS strength (24% vs 3% for Growth stocks). There is a strong bias for large-caps, with a net 21% EPS beat.

Main recommendations

Upgrading EU Tech to Positive. Generative AI is set to expand global software spending by ~USD 150bn in the next 3 years. The uplift should be mainly driven by AI expanding the possibilities of business process automation. We believe that Europe's Semi industry is less affected by potential export controls to China. Given the attractive absolute and relative (to the US) valuation, we upgrade to Positive.

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

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

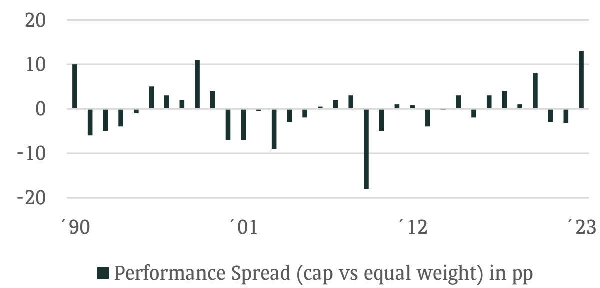
Be cautious/selective with expensive market segments, such as Consumer Staples, some large-cap US tech stocks and some Consumer Cyclicals: pricing power is weakening and operating profits are under pressure from rising costs. Some very high P/E ratios are difficult to justify.

The key risks are that the US Federal Reserve or the ECB could raise interest rates more than expected, triggering a sharper economic slowdown or even a recession. Liquidity is likely to fall in the coming months, especially in the US.

Our position this month

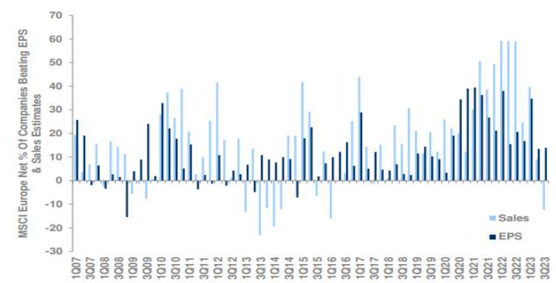
Change in our position since last month

BIGGEST OUTPERFORMANCE IN 30+ YRS



Source: BNP Paribas, Bloomberg

WEAK REVENUE BREADTH IN EUROPE SO FAR



Source: MSCI, Bloomberg, Morgan Stanley Research
Note: EPS beat / miss defined as +/-5% from consensus estimates

Focus on

Equity Outlook

Index & Macro Observations

Asian Equity View

Sector Views

Equity outlook

THE NIGHT IS ALWAYS DARKEST BEFORE DAWN

Equity markets recently entered official "correction" territory, defined as "falling by at least 10% from the last high". This is despite – or rather partially because - the US GDP grew substantially stronger than expected in Q3 (+4.9% yoy). Yields continued their upward trajectory and put further pressure on valuations.

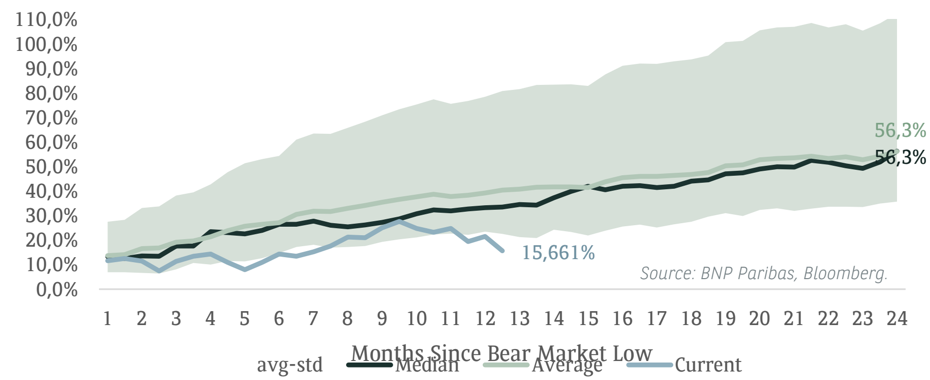
The earnings season – despite being slightly above average so far – has not provided much support yet. The earnings reports from mega-cap Tech are mixed, GOOG (-9.5%), META (-3.7%) and TSLA (-9.3%) all fell the day after reporting. MSFT (+3.1%) and AMZN (+6.8%) fared better, with AAPL and NVDA yet to report. Whilst not terrible, it was certainly more a case of the 'Mediocre 7' than the Magnificent 7. Apparently, the bar for tech was, as we had warned, higher than largely expected. The main reason for the weakness, in our view, was the lack of upward revisions to 2024 EPS guidance. But big tech wasn´t the only pocket of the market that was punished for missed expectations. On average, stocks that missed EPS estimates fell by 5.2% during a period ranging from two days before until two days after the reporting date, which is more than twice the 5-year average. In fact, the 20d rolling average of companies experiencing a 10%+ decline (mainly on earnings/guidance disappointments) picked up materially, reaching the 91st percentile score. Add ongoing geopolitical tensions to the mix and you have the perfect recipe for a really morose market.

So much for the bad news. On the flip side, we see several reasons for hope. Hence we stick to our constructive view on equities.

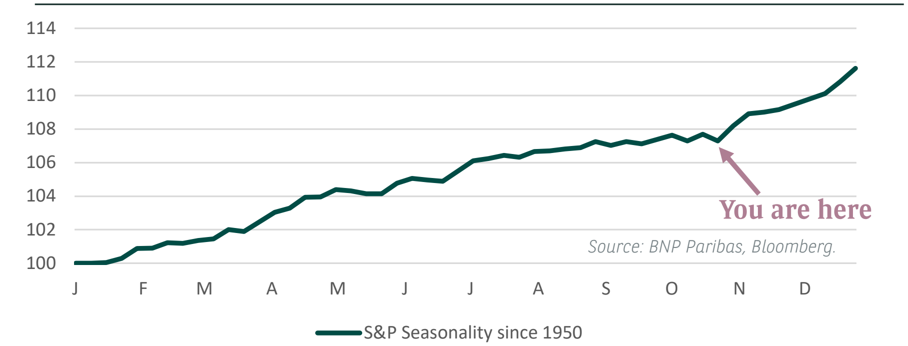
- Historically, there have been several instances of (geo)political turmoil and war. None of them have managed to derail equities in the long run.
- Corrections are – though painful – a regular occurrence in equities. Since 1928, there has been a 10% correction in the S&P 500 every 1.5 years.. Markets look increasingly oversold with many major indices trading below or close to a 14d RSI (Relative Strength index) level of 30. Combined with seasonality tailwinds, this should ignite a price recovery.
- As mentioned above, the broad trajectory of corporate earnings growth remains healthy. The same is true for the US economy. GDP growth was healthy so far and the job market is still resilient, creating something like 2.8 million jobs this year. In an economy that is still around two-thirds consumption driven, such a number should provide a cushion. Obviously, the Fed's hikes have not fully impacted the economy and we still forecast a mild recession ahead. Moreover, increasing signs suggest it will be very mild and should not distract companies too much, especially, as a lot of bad news already seems to be priced in. We acknowledge that the recent price action was painful. Yet, we still believe there are better times ahead and would advise not throwing in the towel yet.

Current preference for cheap and lagging countries and sectors

The weakest recovery from a bear market low since 1957



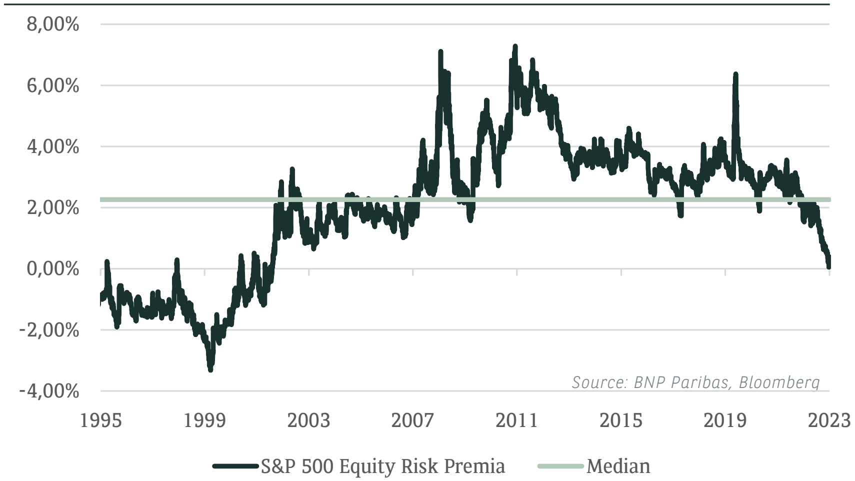
We are at the doorstep to the strongest period of the year



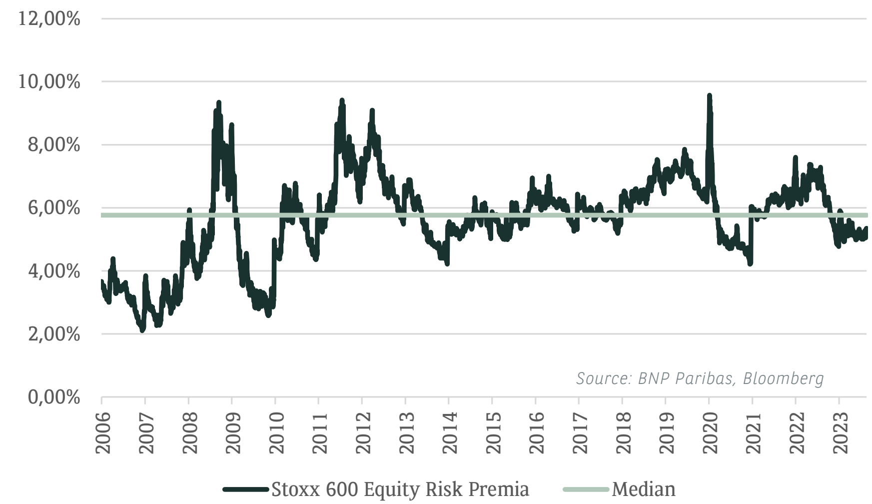
US large cap equities remain expensive

THE S&P 500 EQUITY RISK PREMIUM TRADES ALMOST 1 Z-SCORE BELOW ITS 30Y AVERAGE WHILE THE STOXX EUROPE ERP IS JUST A WHISKER BELOW THE AVERAGE

SPX basically offers no risk premia vs current bond yields



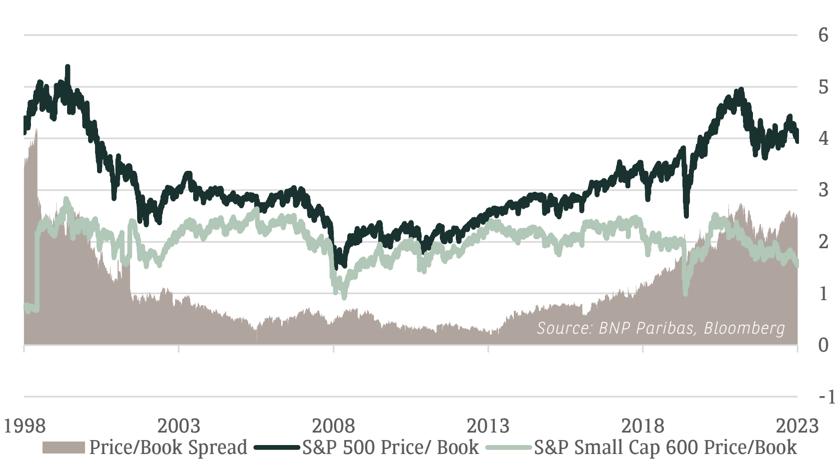
The SXXP still offers an average risk premium



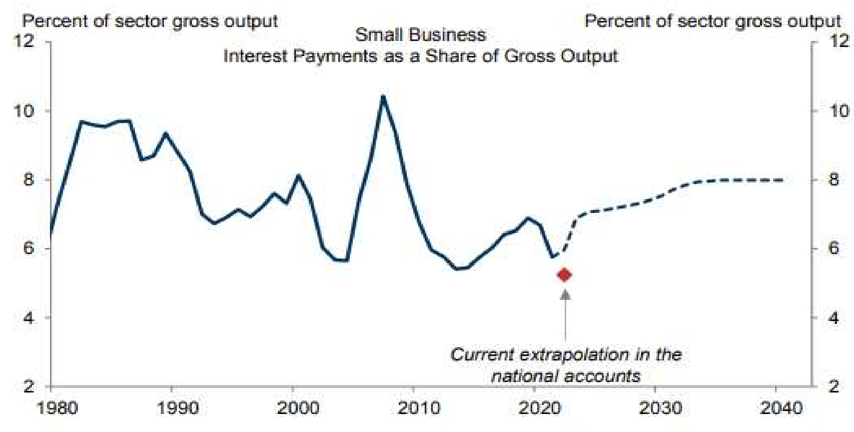
Where to find value outside US large caps (tech stocks)?

SMALL(ER) CAPS MAY BE BETTER POSITIONED THAN YOU THINK

The valuation gap is the largest since the dot.com bubble



The expected impact from rising rates looks manageable



Source: Department of Commerce, Goldman Sachs Global Investment Research

- Borrowing costs rose steeply in the wake of the Fed's tightening cycle. Small businesses are generally more vulnerable to funding stresses, which may explain the recent underperformance. But is the situation really dire? Based on Goldman Sachs' estimates, higher rates will increase the interest burden on small businesses by just over 1pp by 2024, from roughly 5.8% of revenues in 2021 to around 7% in 2024. Goldman Sachs see this share increasing to just under 8% as term loans gradually mature—above the pre-pandemic share of 6.8% but in line with mid-1990s levels. We thus feel that a lot of pessimism is already priced into US Small Caps.

Going with the flow – prefer buybacks

American households currently have 42% of their assets in stocks (96th percentile since 1952). We believe **that the current yield environment will continue to entice households to purchase yield-bearing assets instead of stocks**. The same is true **for pensions** who have really benefitted from rising yields. Since they discount their future liabilities using current market rates, their funding levels improve as the value of those liabilities decline. As a consequence, **there is less need to carry equity risk**.

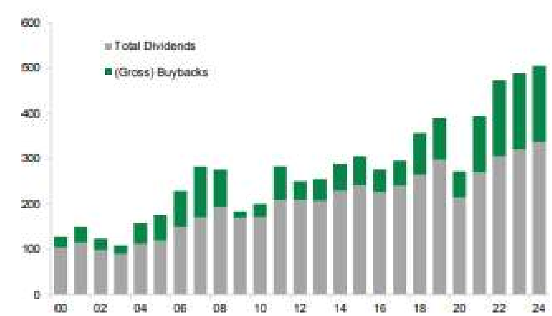
With households and pensions being net sellers of stocks, **corporations will retain their status as the largest source of equity demand in 2024.** GS expects that corporations will be net buyers of USD 550 billion in 2024 (+10% yoy). Buybacks will also play an important role in Europe, where GS expects the amount returned to shareholders via dividends and buybacks to reach an all-time high of EUR 505 billion in 2024.

With buybacks becoming an increasingly important source of equity demand, we feel it makes sense to be positioned accordingly in order to benefit from this trend.

Corporates will remain the strongest bid on equites

	Net US equity demand ($ billions)				
Category	2021	2022	1H23 ann.	2023E	2024E
Corporations	$ 281	$ 556	$ 420	**$ 500**	**$ 550**
Foreign Investors	(112)	(159)	59	**150**	**100**
Pension Funds	(377)	(252)	(631)	**(400)**	**(250)**
Mutual Funds	(317)	(389)	(235)	**(250)**	**(250)**
Households	1055	623	(91)	**(100)**	**(200)**
Life Insurance	(80)	(3)	(40)	-	-
Other	(49)	2	90	-	-
Equity ETF net purchases	*$ 732*	*$ 416*	*$ 237*	-	-
less					
Credit ETFs	204	193	200	**400**	**350**
US purchases of foreign stocks	197	186	(618)	**(500)**	**(400)**

Buybacks are becoming increasingly popular in Europe



STOXX 600 excluding Financials

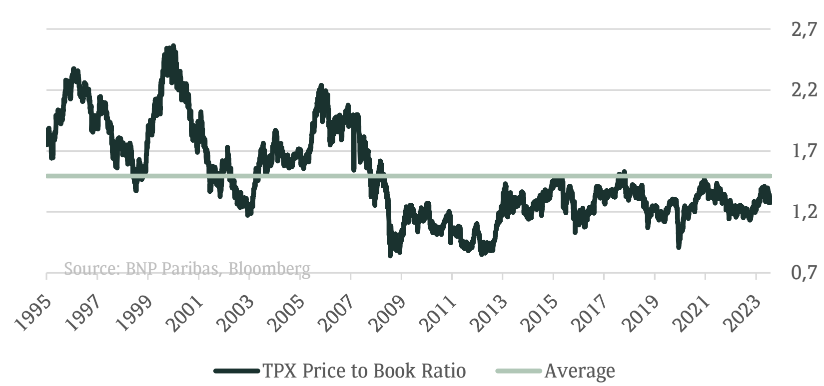
Source: Datastream, Factset, Goldman Sachs Global Investment Research

Corporate reforms in Japan – increasing the pressure

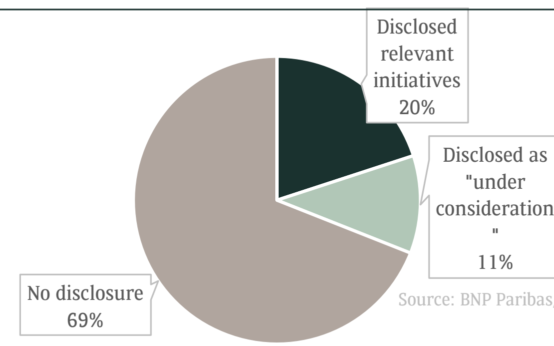
The Tokyo Stock Exchange (TSE) is stepping up its efforts to push through corporate governance reforms in Japan which, they hope, will eventually lead to a positive re-rating of domestic listed stocks. The TSE announced that, from the start of next year, it will begin to publish a list (to be updated monthly) of companies that have responded to its requests for corporate governance reform. The goal is quite clear, Yamaji Hiromi, CEO of JPX Group, told the Financial Times: "*In Japan . . . peer pressure or nudge is a very important method to push people to go forward.*"

Interestingly, the presentation **also broadened the target group of the measures**. While previously focused on companies with Price/Book ratios < 1, now "**everybody is a target**". So far, 69% of companies listed in TSE prime have not responded to the requests, leaving **much room for improvement, which should provide further upside catalysts for Japanese equities.**

Topix valuation remains well below long term averages



Plenty of targets to tap for the TSE reform agenda



Source: BNP Paribas,, Tokio Stock Exchange

A final, friendly reminder: equities remain the best long-term option

TINA is gone for good. TARA is the new mantra and rightly so. The current rise in yields offers interesting possibilities to defensive, income-oriented investors. Since the best guess for the expected return of a bond investment is the yield at which you buy it, investors are currently blessed with the best opportunity of this decade, at least.

Despite all the arguments for investing in bonds now, do not forget that **bonds rarely outperform equity returns**, not even in the short term.

The relative analysis from Macrobond is based on the S&P 500 and 10-year US government debt, looking at historic performance going back to 1871. Bonds and stocks are analysed on a total return basis, i.e. including interest, dividends and distributions as well as capital gains. Even on a 1-year basis, there's only about a 1 in 3 chance that bonds will outperform stocks.

Sector Allocation – EU Tech upgraded

AVOID WEAK LINKS WITH POOR PROFITS AND/OR BALANCE SHEETS

- **Big Tech consolidating.** 'Big Tech' valuations are rich now and the sector is correcting somewhat. To gain exposure to AI, remember that there are many other ways, such as related semiconductors and/or sectors that should benefit from AI, such as Health Care, select Industrials and some Financials.

- **Buy EU 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.

- **Led by steep price cuts from Tesla,** the average selling price for EVs in the US has declined 22% over the past year and now sits only 6% higher than the average selling price for all vehicles. This trend, which also exists in Europe, puts further pressure on legacy carmakers. We advise caution on mass carmakers and we would either focus on premium brands and/or original equipment manufacturers (OEMs) with a convincing EV strategy.

Reco	Sector (Level 1)	Industry (Level 2)		
		+	=	-
+	Energy	Energy		
+	Materials	Materials		
+	Health Care	Pharma + Biotech HC equip. & services		
=	Utilities	EU Utilities	US Utilities	
=	Financials	EU Banks EU Insurance EU Div. Financials	US Banks US Insurance US Div. Financials	
=	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			Food & Beverages Food Retail Household & Personal Care Products

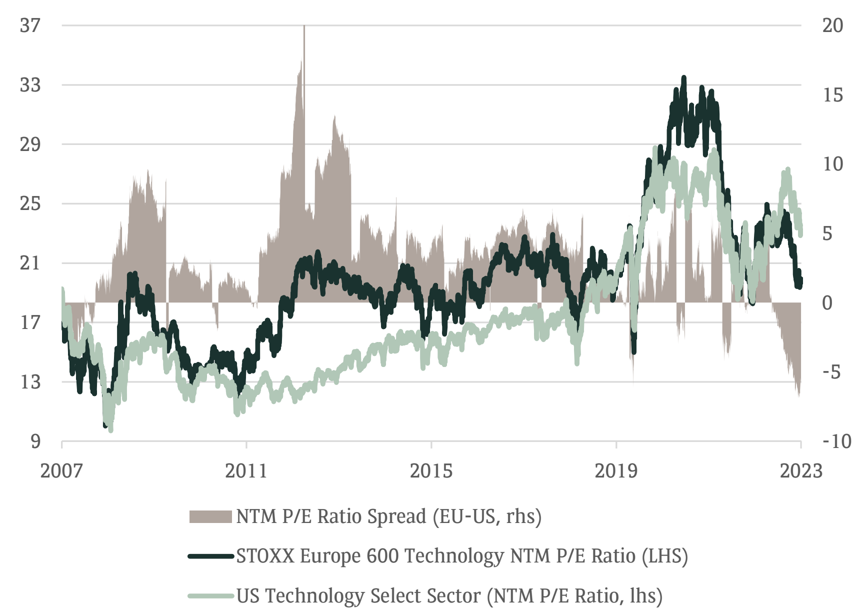
↗ EU Tech to Overweight: underappreciated and undervalued

Software is and was primarily a tool to increase productivity. It is used to perform tasks faster and cheaper than humans. However**, there have been limitations to the degree of efficiency gains which traditional software could achieve.** Among other issues, software was unable to reliably understand natural human language, limiting its use e.g. in automating email notifications to service centres or automate call centres entirely. Another meaningful barrier was simply the requirement to code in order to fully leverage on computing powers.

This is about to change with the introduction of Generative AI. Latest models have yielded impressive results in understanding and processing human language. This enables some new/enhanced use-cases for software in fields such as customer experience (e.g. chatbots), software development and information management. **Morgan Stanley expects ~~that~~ Generative AI ~~is set~~ to expand global software spending by about USD 150bn over the next three years.**

As corporate investments are mainly driven by increasing efficiency and productivity, we see two main areas of focus: firstly, hardware is a necessity to be able to handle the increased AI driven (computing) workload; and secondly the application layer.

From premium to discount: EU vs US Tech valuations



Source: BNP Paribas, Bloomberg

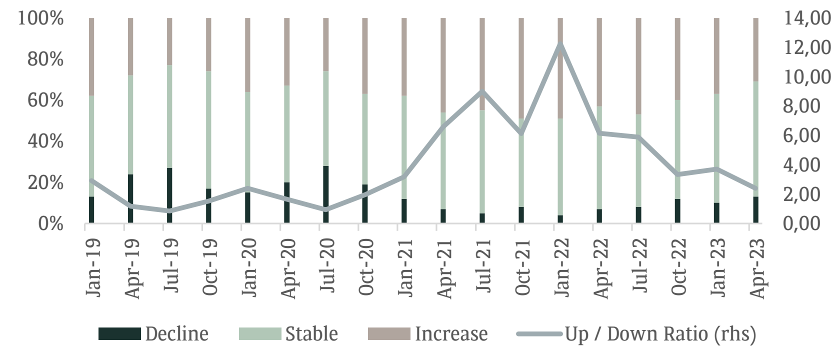
↗ EU Tech to Overweight: underappreciated and undervalued

As with the mobile internet, only once the hardware (i.e. networks and smartphones) became popular and powerful enough, the application market began to flourish and eventually became the biggest market. We believe that this is likely the playbook for the upcoming AI cycle as well, meaning that in the age of AI too, **application providers should be able to capture the greatest value in the long term**. We therefore expect European software, with its legacy in enterprise application software, to grow in relevance as the cycle plays out.

EU Tech hardware (mainly semiconductors) on the other hand, should benefit from the growing need for computing power. Not only for AI but for ~~the~~ cars of the future, too. Software-Defined-Vehicles (SDV) will replace traditional Internal Combustion Engines (ICEs) going forward, using a myriad of independently-built microcontrollers but ~~are~~ lagging full system oversight. SDVs though may be seen as the backbone for new functionalities and developments, such as connected cars, centralised compute and even self-driving cars (including mobile entertainment and /or office solutions).

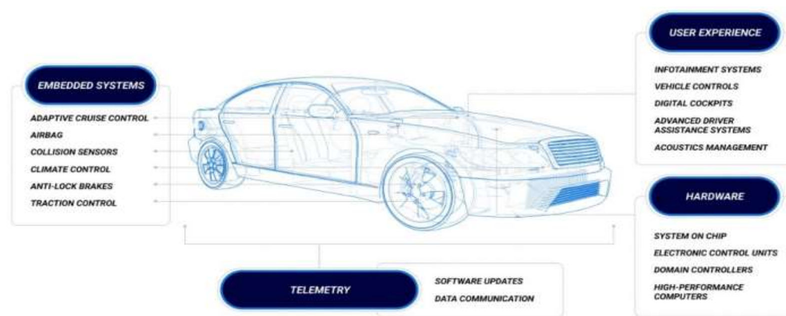
To sum ~~it~~ up, we see Europe´s Technology industry as well placed to benefit from these long-term trends. Those prospects aren´t fully reflected in today's valuation though, which look cheap both vs its own history and relative to US peers. **<u>We upgrade to OVERWEIGHT.</u>**

CIO IT spending budget plans over the next 3 years (as % of revenues) indicating above pre-COVID growth



Source: BNP Paribas, Bloomberg

The Software-Defined-Vehicle ecosystem



Source: Blackberry

Energy – Benefitting from a higher-for-longer oil price

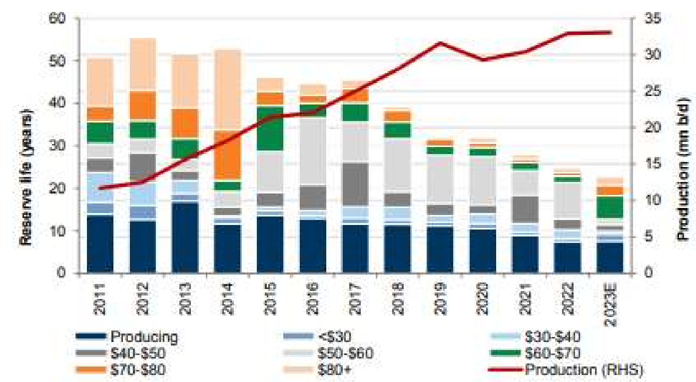
Last month we outlined our reasoning for **our constructive view on energy stocks**. Among other, the key reasons are:

- higher-for-longer rates are limiting the flow of capital into new projects and/or maintenance investments
- institutional- and policy-led pressures are driving an accelerated transition away from fossil fuels

A recent study from Goldman Sachs revealed additional evidence, supporting our view. After years of underinvestment, **the resource life of Oil & Gas Industry Top Projects** (recoverable resources/production) **halved – from >50 years to 23 years - since the end of the 2004-14 'super-cycle'.** Furthermore, as we envisaged, cost curves are becoming smaller and steeper, too. Based on an assumed cost of capital of 15%, incentive pricing for oil and LNG reached USD 80/bbl and USD 11/mcf* respectively.

Those developments should provide medium-term support for oil prices. **We thus reiterate our overweight rating.**

Ongoing underinvestments have halved the oil industry reserve life # since 2014



Source: Goldman Sachs Global Investment Research

*thousand cubic feet

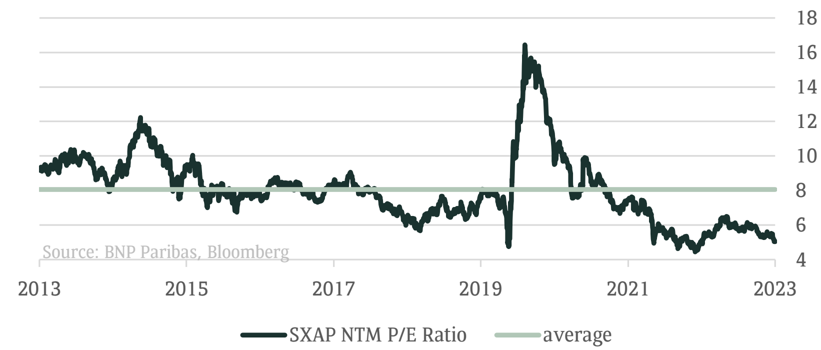
Automotives – Are legacy car makers losing their grip?

Led by steep price cuts from Tesla, the **average selling price for EVs in the US has declined 22% over the past year** and now sits at only 6% higher than the average selling price for all vehicles. This trend, which also exists in Europe, puts further pressure on legacy car makers (LCM). **Car pricing discipline among Chinese producers is expected to stay weak in the light of potential oversupply of light vehicles.**

More importantly, **LCMs are at risk of falling behind on their EV transformation strategies**. While having a market share of up to 75% on ICEs, they struggle to grab more than 30% market share on EVs globally. In China, the world's biggest EV market, no LCM has a market share above 10%. Chinese consumers are becoming less brand loyal and willing to "trade-down". Local EV producers are often cheaper (we estimate the price advantage to be ~ EUR 5k globally per car) and are equipped with (very) good technology (infotainment, ADAS etc).

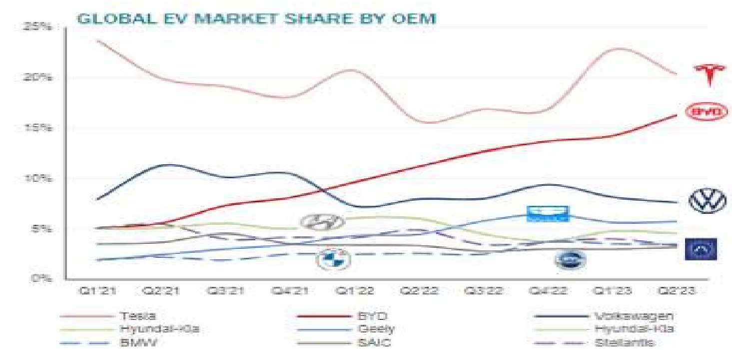
We thus advise caution on mass carmakers. Just being cheap is no reason to buy. We would either focus on premium brands and/or car manufacturer with a convincing EV strategy.

Cheap for a reason? LCMs are facing some serious headwinds



Source: BNP Paribas, Bloomberg

LCMs are struggling on their EV strategy execution?



Source: BNP Paribas Exane

Materials – China's green upside surprise

Despite the well-documented challenges in China's macroeconomic environment so far in 2023, **Chinese demand for most major commodities has been robust** - copper up 8%, iron ore up 7% and oil up 6% - coming ahead of initial expectations and largely being realized# before the current policy easing phase. This may come as a surprise to many given the macro backdrop.

However, the Chinese economy has revealed a tale of two economic stories beneath the surface. While sectors such as Real Estate have faced challenges, **growth has been weighted toward services and green sectors**. This has been particularly beneficial for mobility-tied commodities (oil) and green raw materials (copper and aluminium).

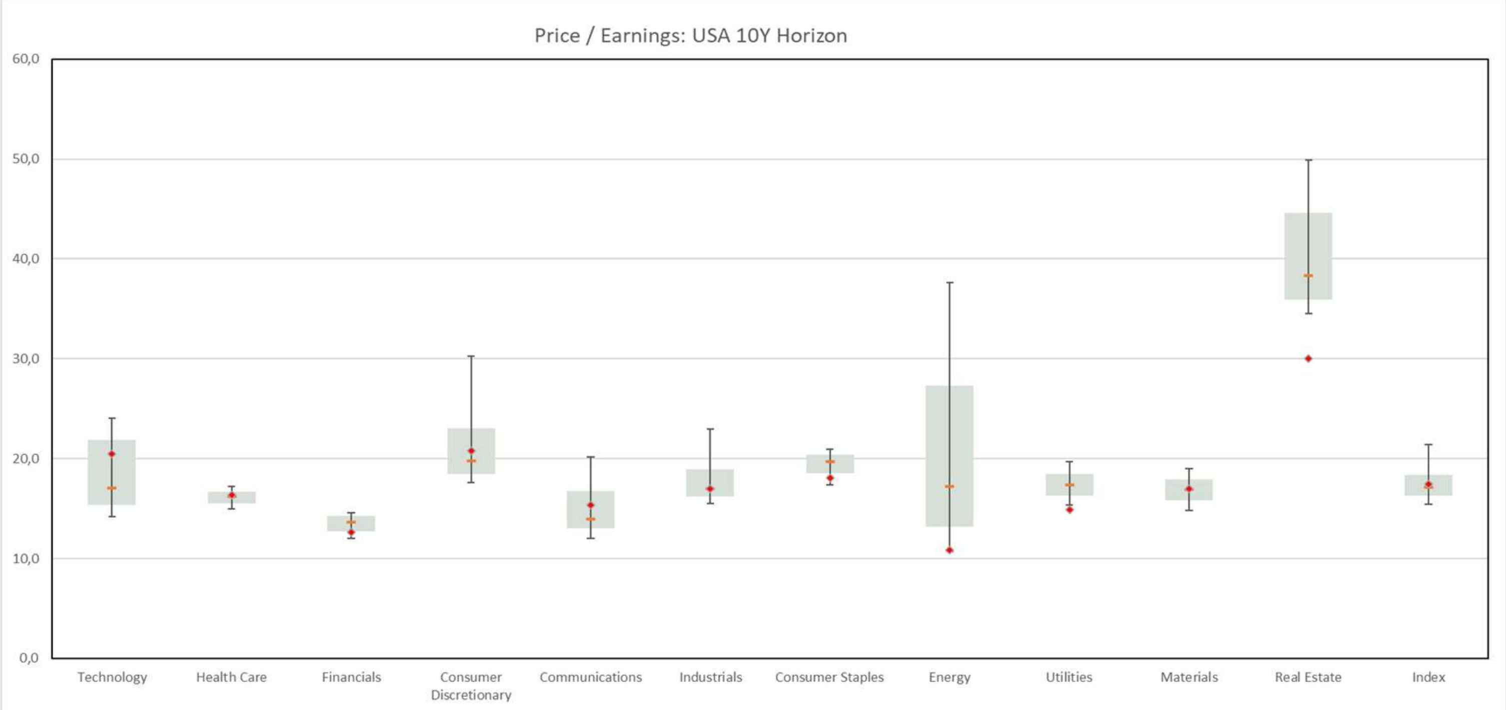
We expect these trends to persist and even fueled by recently announced policy support measures. We thus consider China as a **positive demand-side factor for commodity prices** in the foreseeable future. This should support commodity prices and profits from miners alike. → **we reiterate OVERWEIGHT on Materials**

Stronger than expected on "green" demand

Source: BNP Paribas, Goldman Sachs

Valuations - US

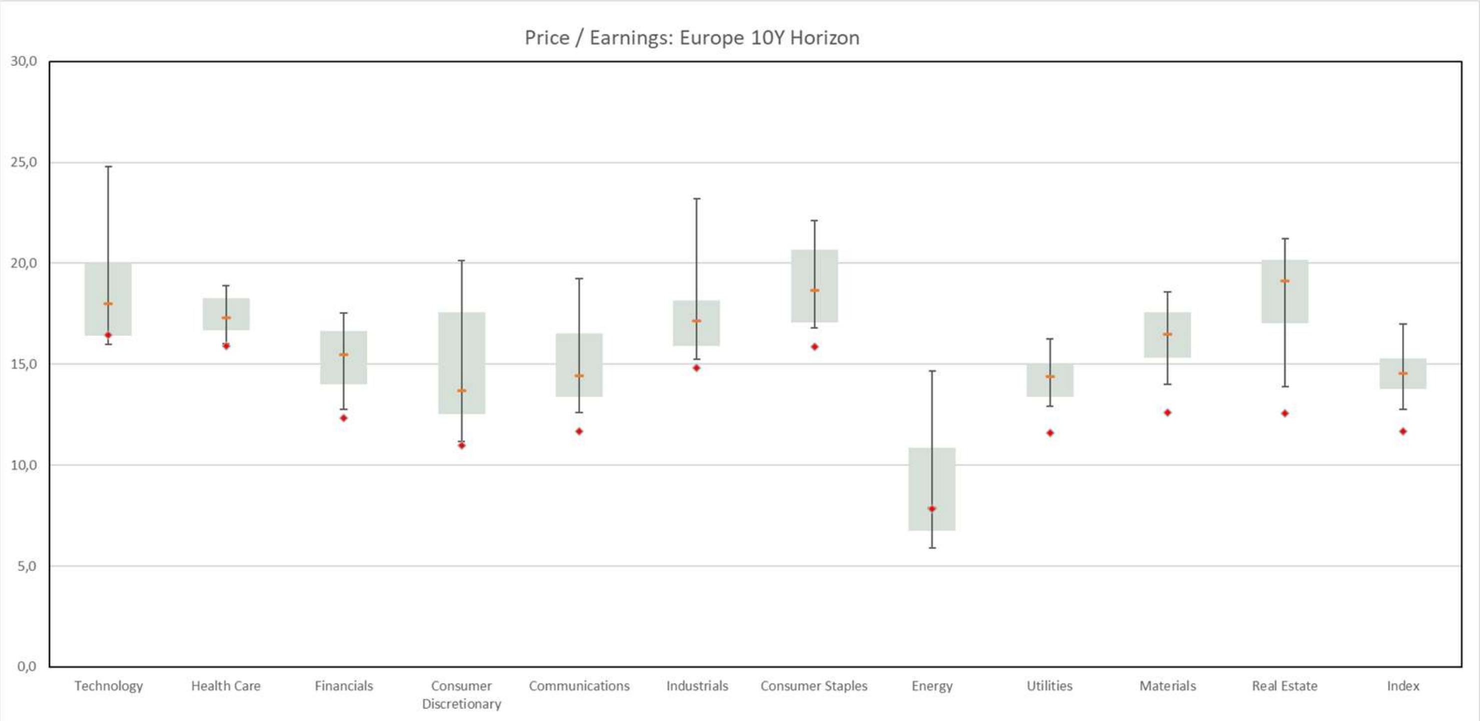
DESPITE THE RECENT CORRECTION, TECH & CONSUMER DISCRETIONARY ARE STILL TRADING RICH VS HISTORIC MEASURES



Source: BNP Paribas, Bloomberg

Valuations - EU

EUROPEAN SECTORS ARE SCREENING CHEAP VS HISTORY ACROSS THE BOARD



Source: BNP Paribas, Bloomberg

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