2024 Equities Outlook

US Equity Performance

As we approach the end of the year, the narrative on the US stock market has greatly changed since September/October and especially since the beginning of the year as major macroeconomic uncertainty has now shifted to what the cutting cycle will look like due to recent consensus that the rate cycle has reached its peak. This uncertainty is greatly influencing investors as just this past week, the dollar has been sold at the fastest pace in a year as market prices in more rate cuts next year.

Within the last 30 days, the SPX has recovered losses yielded since late July, with a bounce back of around 10%. These changes in narrative come as a result of geopolitical turmoil, and recent hard data releases which sparked a short-covering frenzy.

In the last month, many indicators have come in lower than expected in the US, namely, the PMI (purchasing managers' index) for October was at 46.7 compared to the 49 recorded in September, the NFP (nonfarm payroll) coming in lower than expected in October too (150,000 vs 180,000) showing signs of a looser labour market.

This is one of the major indicators of how equities will perform next year as it affects the the discounting factor, and how/to what extent lower rates will affect earnings and borrowing costs for corporates throughout the next year – investors are currently betting on a 'déjà-vu' of a mild US recession with bonds becoming more attractive.

Furthermore, the motivations behind rate cuts are another big question mark and potential indicator of performance. We can expect the SPX to maintain its current levels reached after the recent rally, or even inch higher into the 4650-4700 range, achieving a relatively subdued increase of 5%, below the election year average of 8%. In both predominant rate scenarios - quick cuts, or higher for longer - there are factors which will push and drag equities, which is why there is a projected small growth. It is also consensus that 2024 will be the year for fixed income with duration plays on the horizon as cutting cycles approach, taking some steam off equities.

If there are quick cuts, we could expect see valuations and earnings increasing healthily overtime, however, it is not all good news; if cuts come, they are for the "wrong" reasons. Namely, these quick cuts will be likely "forced" by either a stagnating economy, or a poor labour market, both factors which do not favour equity market performance. On the other hand, if rates are higher for longer, it is an indication that the economy is still very buoyant and robust, however the benefits of lower rates will not be experienced.

It is not a given that rates will fall quickly despite the FED's recent dovish remarks at meetings. One main point of concern would be the fact that the FED remains data dependent, and with only the latest data releases indicating that the rate hikes have started to have their desired effect, we might see the FED holding more than anticipated. This is also supported by the fact we are heading into an election year, where the FED's activity is mostly subdued, especially after the summer months, in order to avoid speculation about election manipulation. This view is currently expressed by the market as only two 25bps cuts are implied by July 31st, 2024. This is a reason why the lack of volatility that we have seen in the market in the last weeks is projected to plague next year too.

Geopolitical tensions in the Middle East seem to be cooling which puts pressure off of US commodities and safe heavens which would have been targeted in the event of Iranian intervention or similar further escalation. This in turn is quite favourable for US equities, as lower oil prices result in a lower inflation print, which will help rates fall quicker. However, this also results in an increase in disposable income for the consumer, which in turn can help

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continue dodging the recession which never came this year, favouring a higher for longer scenario, with a more gentle and "safe" cutting cycle.

European Equity Performance

The situation in Europe is very different to the one seen across the pond. Production has been stagnant for several months now, with German and other major European PMI figures disappointing continuously over the last quarter. The forecast for growth in the EU is considerably grimmer, with economic woes such as the one just described, default rates rising and the consumer being in a relatively weaker position compared to US consumers - an economic slowdown in the EU is in the picture for 2024. This is also supported by lending patterns which are pointing to a weaker capex in the next months, a great driver of the USA's economic robustness in the last 12 months, which is lacking in the Eurozone.

So far in 2023, Europe's main indexes had a broadly positive year, with the STOXX 600 gaining over 7% and the Euro STOXX 50 over 14%, much of the rally having taken place at the beginning of the year when Europe's economy was seen benefiting from China's reopening. Throughout 2023, European stocks performance slowed down, mainly driven by Germany's energy-intensive industry which relied on cheap gas and external demand for growth. This past week, German business morale rose for the third consecutive month, adding to signs of stabilisation of the eurozone's largest economy, but still off a low base. Separate data published on Friday confirmed that the German economy nonetheless contracted 0.1% in Q3. Overall, the base case for 2024 in Europe is a slowdown in growth; on Friday European stocks opened slightly lower showing signs of reversal from a small rally which started on Thursday following positive economic data. Room for growth in Europe is a possibility if energy prices ease and the European Central Bank employs some judiciously cautious rate cuts. We expect these cuts to come slightly earlier than those of the USA due to the USA's more robust economic position, however the timing of the cuts in the USA remains a mystery due to the factors highlighted above

The prospect of slow growth in the coming quarters translated into weaker sentiment towards UK equities, particularly due to the comparatively robust US economy which is more likely to achieve a 'soft landing' than Europe. Markets have priced this in as European shares are much cheaper than US shares: STOXX Europe 600 trades at over 12 times 12-month forward earnings, a 35.6% discount to the S&P 500 (.SPX). The current discount is just above a record gap of around 37% reached in July and more than twice the 20-year average discount of 16.3%.

A Peculiar Market

Despite the uncertainty about the timing of the first FED rate cut, it may be argued that today's market differs from past decades as it is characterised by distorted investor sentiment - equities do not worry about the great rate uncertainty as they used to. This might be explained through behavioural investor bias, due to the overconfidence gained due to the FED's constant support in recent decades. One statistic exemplifying this is that the average retail investor buying ETFs with his stimulus check post-covid achieved better risk adjusted return than the best hedge funds of the planet for 2 years, at essentially zero cost. The FED's support in recent decades has created one of the most attractive environments for owning equities in the last 100 years, shown by rising valuations and low volatility which we argue is a function of free FED puts. Essentially, the FED stepping in low levels of stress has led investors to believe that upside risk is a larger concern than downside and dips are a source of alpha.

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Goldman Sachs Research strategists argue that their macro forecasts imply a benign outcome for equities, but the current starting point will limit the potential appreciation for the benchmark US equity index in 2024 due to the currently high valuations. Namely, the S&P 500's price-to-earnings ratio trades in the 87th percentile since 1976.

It is wise to be fearful of both tails: we cannot underestimate the potential of equities to defy gravity given distortion in risk perception. But markets remain fragile, exposed to fickle investor sentiment, and persistent rate uncertainty.

The high multiples make the doubt arise of when this distorted perception of risk is going to be reality checked. This trend is so powerful that 2023 is the 5th best year in nearly 100 years for a simple strategy of buying S&P when down on the day and selling at the next day's close. This question has vexed many bears- very few will get the timing right of when things will crack and all those getting it wrong are missing gains. Since so few will get a crash timing right, a cheap systematic strategy is very sensible as systematic protection takes away timing risk.

Furthermore, there have been many recent debates on whether equities are 'shrivelling up'. We argue that keeping a long-term strategy by holding quality growth stocks is not 'doomed' by this era of 'de-equitization'. Economist Stuart Kirk similarly argues against this fallacy by shedding light on the gains of equity; for example, the FTSE 100 has risen around 70% in nominal terms in the two decades during which this so-called "de-equitization" has occurred, while the market capitalisation of American shares has quadrupled.

The Effect of Geopolitical Events on Equity

On the one hand, the effect of past geopolitical events and tensions such as 9/11, Brexit and prolonged Ukraine-Russia war have not had a tangible effect on corporate earnings. More generally, history tells us that geopolitical shocks that don't fundamentally impact the economy have tended to result in a 5% to 10% pullback in the S&P 500 but the market recovered from such losses within three months.

On the other hand, the conflict in the Middle East has especially benefited aerospace, defence and some Industrials but has also created greater uncertainty around global trade, demand for overseas travel and the risk of an oil embargo if the conflict is sustained. Most effects on equity are through the oil price spikes caused by geopolitical turmoil - Earnings for U.S. multinational companies may be affected if oil shocks and uncertainty cause growth to slow in Europe.

According to Chris Hyzy, Chief Investment Officer for Merrill and Bank of America Private Bank, "geopolitics used to be considered a lower-level financial risk. Now, it may be the top risk". He argues that the geopolitical tensions superposed to the uncertainty over the direction of the U.S. economy create a "fragile ground globally and in rare territory in terms of the business cycle at home," Hyzy says and adds "In a volatile world, understanding the risks and keeping a wide lens on the opportunities that develop are arguably more important than ever."

The contrasting perspectives of the importance of the geopolitical events on equity create high uncertainty and can drive spikes in market volatility. The key now as described by BofA and Goldman analysts (*'All you had to do was stay'*) is to find quality growth stocks and hold, while keeping the fundamentals under watch, namely economic growth, corporate profits, interest rates and inflation which will ultimately determine the direction of markets.

Emerging Markets Outlook

With regards to emerging markets, besides the Middle East, there has been rising tension between US and China which has had effects on the semiconductor industry. Concerns over China's uncertain economy have created a

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shift in investors' equity allocation as there has been a gravitation towards US equity and an exodus from emerging markets. The 'avoid China' theme has become a self-fulfilling prophecy and auto-conviction of investors. A net 0% of investors with $616 billion in assets under management expect stronger economic growth for the country in the near future. This uncertainty towards China and exodus of funds which redirect to US equities have contributed to the US outperforming global peers, while the MSCI Emerging Markets Index has only gained 2%.

Essentially, emerging markets trade at a discount to US equities and have relatively attractive dividend yields but the risk is too elevated, so it is best to stay cautious of EM and keep China US protectionism in mind when analysing semiconductor stocks which is one of the most important industries in today's market.

Sector Allocation & Trade Pitch

The general overperformance of the US equity market is characterised by a high concentration in tech large cap US companies (the Big 7). To assess the growth of the US stock market excluding these large cap tech stocks we look at the movement of the S&P600 which is up 1.77% YTD, down 3.14% on 1 year while S&P500 is almost 19% up YTD and 15% up over 1 year. In other words, there has not been significant overall performance in US equities which are not part of the Big 7. In this period of future rate uncertainty and distorted investor sentiment, it is especially crucial to focus on quality small cap stocks in specific industries which in turn are not influenced by geopolitical instability.

However, it seems that this pattern might not persist. Namely, after Nvidia Corp comfortably beat earnings expectations this week (EPS by 18.7%), stock price went down on the same day, indicating that the market was expecting a big beat. In other words, the stock price was almost in a bubble-like territory, where speculations were fully priced in. despite Nvidia's dropping stock price this past week, its revenue just soared 206% year over year. This could be related to this distorted investor sentiment and a valuation 'disconnected from reality'.

Within the U.S., healthcare is forecast to outperform, and Morgan Stanley prefers industrials relative to other cyclical sectors. In the USA, it could also be interesting to look at financials as a sector to outperform if rates fall sharply. Banks in the USA did not benefit from high rates like EU banks, with NII being much lower. A higher rate environment was detrimental, with higher rates leading to higher loan delinquency, and big losses. When rates go down, we can expect these numbers to plunge, causing a positive effect on bank's balance sheet, which should be reflected in the stock price. In the event that rates stay higher for longer sectors which are highly impacted by the effects of these should be avoided, namely real-estate.

In Europe, the industries which are expected to outperform, are long duration. Companies which are highly in debt will benefit the most from cuts too. Sectors such as utilities and pharmaceuticals are the one most primed to succeed in 2024, notwithstanding the fact it should still be a difficult year for equities, especially in Europe. As rates fall, the market already pricing in 90bps of cuts in 2024, we should start to exit the risk off environment, as the landscape clears and Europe gets back on track for solid growth. This could be an opportunity to allocate some funds into growth stocks, which have suffered and underperformed their value counterparts by 13% since the start of the starting cycle.

This type of performance in global markets is an indication that systematic risk has received a lot more attention than idiosyncratic risk in the last year, with a general underperformance of stocks with only a few winners. This is why there are probably good companies which are very undervalued right now and are trading at certain levels just due to the current macro-narrative and the overall health of their economy, rather than idiosyncratic factors, which would prove said firm to be a viable investment in today's market.

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One name that we recommend as an investment opportunity is RWE AG. The German energy giant has experienced great balance sheet stability thanks to top tier trading and outstanding earnings, and green momentum in the last years, especially compared to its peers. We expect their renewable pipeline to continue being very successful in 2024 due to auction wins, good organic building, good diversification, and M&A. Another reason to be confident about RWE's future performance is the expected renewables growth in Europe coupled with coal closures, and RWE's dividend increase. Being a high duration stock, it is in the perfect macro environment. It is consensus that 2024 will be the year for going long duration with rates coming down in the next 12 months. This is why fixed income will likely be next year's protagonist, however this does not hurt our trade. This is shown by the strong correlation there is between utilities performance and bond yields. We have a target price of around 52€, implying an upside of around 35%.

The main risks to our trade view are changes in the political and regulatory environment, and persistence of higher rates, however the latter does not seem viable at the moment due to the EU's persistent economic woes. Idiosyncratic risks include delays in the execution for their business plan and renewables growth ambitions as well as competitive market dynamics which could limit margins and growth.

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