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CIO Viewpoint
Equity

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Half time… much still to play for

Key takeaways

- Equities remain the most convenient way to capitalize on AI-driven technological progress. Mega Cap Tech valuations are not yet historically at bubble levels.
- European Small Caps may now start to perform better. A "Barbell" approach, combining them with Mega Cap Tech stocks, would have various merits.
- The U.S. Q2 earnings season kicks off next week. S&P 500 Q2 earnings expectations have risen since the beginning of April, but with marked sectoral divergence.

Q2: continuation of the narrow U.S. rally

After a pretty weak start in April, U.S. equity markets continued to advance over the remainder of Q2 against the backdrop of a solid Q1 earnings season, moderating inflation and jobs data that added further momentum to the "goldilocks" drumbeat. Moreover, the most recent U.S. CPI release (for May) showed the slowest MoM core CPI rise in almost two years which helped to cement market expectations that Fed rate cuts are still on the cards.

As a result, the S&P 500 rose +4.3% in Q2, reaching a number of fresh all-time highs as well as posting a third consecutive quarterly gain. It is noteworthy, however, that broader U.S. equity market gains were once again characterized by a rather narrow leadership being largely driven by another very strong quarter for the Magnificent Seven (+16.9%). By contrast, the equal-weighted S&P 500 (-2.6%) lost ground in Q2 (see Chart 1). So quite different story depending on one's angle, and a continuation of the Q1 story of Mega Cap Tech outperformance and weakness elsewhere.

Across the pond, the ECB announced its first interest rate cut since the pandemic, lowering the deposit rate by 25 basis points (bps) to 3.75% at their June meeting. Even so, European markets still experienced challenging closing weeks in Q2 due to the snap legislative elections in France with the CAC 40 (-6.6%) recording its worst quarterly performance in two years and the Franco-German 10-year spread widening by the largest quarterly amount (+29bps) since the Euro sovereign crisis. Nonetheless, the STOXX Europe 600 was able to end Q2 in the green (+1.6%). In Japan, the Nikkei was down -1.9% in Q2, after a very strong over 20% gain in Q1 (see Chart 2).

From a sector perspective, Real Estate and Materials are the only sectors on a MSCI ACWI basis that have delivered a negative price performance YTD, while the Q2 performance shows a very narrow leadership with IT clearly leading the pack. Apart from that only Communication Services and Utilities are in the green (see Chart 3).

Attractive NTM return prospects

Despite the undeniably-stretched valuations observable in the U.S., where the combination of falling inflation, fading recession fears and AI enthusiasm has shrunk the premium that investors require for taking on the additional risk of owning equites over bonds (equity risk premium) to the lowest levels since the late 1990s (see Chart 4), market performance in the first six months of 2024 has once more underpinned the argument that equities remain the most convenient vehicle to capitalize on the AI-driven technological progress wave.

Backed by an expected NTM EPS (next twelve months earnings per share) growth of 11%, we have lifted our 12-month (June 2025) S&P 500 index target to 5,600, applying an unchanged LTM P/E (last twelve months price/earnings ratio) of 21.5x which is clearly exceeding what a "historically common" equity risk premium would suggest. To account for the valuation stretch as well as the implicit option on AI potential, we have added a temporary growth premium of 15% to our fair S&P 500 P/E estimate of 18.5x to reflect superior expected mid-term earnings growth, because the index may become less vulnerable to cyclical swings – as the proportion of secular growth companies (with a greater share of recurring revenues in revenue streams) increases further. Likewise, ex-U.S. earnings should grow at healthy rates, while we assume that the extreme valuation discounts relative to the U.S. equity market (see Chart 5) will not expand further from here.

Overall, our new June 2025 index targets imply attractive return prospects for most regions, in the mid-single-digits (see Chart 6). Of course, our base case is exposed to an array of risks from internal as well as external factors. With regard to the former we would highlight that an eventual "AI fatigue" could lead to mean-reverting valuation levels. An initial rate cut by the Fed could also trigger some significant sector and style rotation. Moreover, aggregate profit margins are still very high, giving them little scope to widen further. On the external side various elections could cause volatility spikes but with possible corrections expected to be rather short-lived. Global geopolitical risks (from military conflicts as well as tariff disputes) could however spark fresh market uncertainty. Finally, the consumer space might be challenged by the exhaustion of accumulated savings from the Covid period.

Barbell: keep Mega Caps, add Small Caps

Given the unprecedented rally of some U.S. Mega Cap Tech names that has been driving the broader equity market, the question arises: how much upside is still on the cards, now the easy money has been made? It appears likely that the overall trend will persist as long as the macro picture remains stable, the Tech-heavyweights continue to deliver on earnings and they keep launching new, exciting products and services. The latest news flow has been quite encouraging – new product releases and ever more powerful large language models (LLMs) are continuing to fuel AI enthusiasm within the investment community. On top of this, substantial data centre investment announcements may bolster optimism around potentially transformative productivity gains, with the hope being that these could result in higher margins and softer inflationary headwinds, while associated Capex needs could have a meaningful positive macro effect. However, we emphasise that it is premature to assume an imminent AI-driven impact on the economy as a whole.

We believe that the significant underperformance of Small Caps represents an opportunity to engage with this category – particularly in Europe (as discussed below). We believe that Small Cap stocks should benefit from stabilizing bond markets and likely peaking yields in the U.S. and Europe. Re-accelerating economic momentum in Europe may act as a catalyst for Small Caps in the region that show favourable valuations and at the same time are expected to deliver strong earnings growth over coming quarters and years. We believe that European Small Caps provide a cyclical hedge and could complement to Mega Caps (expected to do well owing to strong secular earnings growth, AI exposure, sound balance sheets and superior pricing power) as part of a "Market Cap Barbell Strategy".

AI is not a bubble (yet), a historical perspective

Historically, new innovations have often been accompanied by stock market bubbles. A study from 2000 found that, out of a sample of 51 major technology innovations that were introduced between 1825 and 2000, 37 caused distortions in the stock market.

In the 1840s for example speculation built up in railway stocks in the UK amid a rapid expansion of the railway system following the opening of the first locomotive-hauled public railway in 1825. The bubble burst in the 1850s and stocks fell by an average of 85% from their peaks. During the 20th century, several bubbles formed in stocks associated with consumer products. First came the bubble in radio stocks in the 1920s/30s that followed the surge in demand for radios and broadcasting. Between 1923 and 1930, 60% of U.S. households purchased radios and consequently radio stations mushroomed across the country. This increased the scope for advertising and the adoption of other products as they came to market. The valuations of broadcasting shares skyrocketed in the 1920s but soon crashed back to earth. Some stocks lost as much as 98% over a span of less than five years and most radio manufacturers went out of business. Later, during the 1980s, hundreds of companies entered the market for PCs. However, in 1983 several producers announced losses, which led to a broad decline in share prices.

Over the following years many companies left the industry, which became dominated by a few of the surviving firms.

Famously, the pattern repeated itself during the dotcom bubble in the late 1990s as investors flocked to stocks (seemingly) related to the internet. 13 large caps increased in value by over 1,000% in 1999 alone, driving the Nasdaq to increase fivefold from 1995 to 2000. However, as the bubble burst in 2000, the index lost 34% within a month and 80% before it eventually troughed in October 2002.

Given the long history of stock market bubbles associated with technological innovations and the recent rally of the IT sector, particularly of stocks seen as the epicentre of artificial intelligence (AI) revolution, investors understandably wonder whether the sector is currently in a bubble. We think it is not (yet)! Valuations of the largest U.S. technology companies are high. Nevertheless, they are not close to levels reached at the peak of the dotcom bubble. The Magnificent Seven, which many see as the major drivers and beneficiaries of the AI evolution, have traded at a peak NTM P/E of 44.1x which compares to S&P 500 Information Technology NTM P/E of 59.1x at the height of the dotcom bubble (see Chart 7).

Aside from a less stretched valuation, an important difference between the current tech leaders and those from 25 years ago is that the current group is already very profitable. They are also able to invest in their business or acquire smaller companies even in the current interest rate environment, as their cash reserves are higher than their dotcom predecessors. Furthermore, the aggregate Magnificent Seven 12-month trailing return on equity and net profit margin are standing at 33% and 21%, respectively, both topping the equivalent S&P 500 Information Technology dotcom levels by a substantial extent. Over the last three years they have grown their EPS at an average CAGR of 39%, while revenues grew at a 24% rate. This has made these companies into earnings-generating machines.

However, we caution against projecting similar sales growth and profitability rates into the future. According to research, there have been only 121 S&P 500 companies since 1985 that have been able to maintains a sales growth rate of 20%+ for 5 consecutive years, while only 4 companies managed to have EBIT margins above 50% for 5 years in a row.

European small caps – also beautiful

European Small Caps (STOXX Europe 200 Small Index) recorded a dismal performance since their peak mid-November 2021 and last trough end October 2023. During this time the sub-index of the STOXX Europe 600 has delivered -29% (total return) in EUR terms, underperforming the STOXX 200 Large Index, the corresponding large cap benchmark – by 26 ppts (see Chart 8). The difference in performance, however, is not surprising in view of the characteristics of these market segments.

European Small Caps have tended to be more cyclical with their relative performance versus Large Caps moving in tandem with the ups and downs of business cycle indicators in the past. More importantly, these two groups on average display some significant balance sheet differences. Excluding Financials and Real Estate companies, as these would impair the comparability of the two indices, the Small Cap index contains more levered companies. Compared to their large peers, Small Caps' net debt-to-EBITDA ratio is 30% higher at 1.3x.

In addition, approximately half of Small Cap debt is financed at floating rates which is a significantly higher share than for Large Caps. Small Caps' profitability was therefore more severely affected as bond yields began to rise across Europe.

The prospect of declining profitability has meant a double whammy for the Small Cap index that was trading at a NTM P/E-valuation of more than 20x in 2021 – a more than 40% premium compared to its own 10-year median as well as to the Large Cap equivalent. Despite its recent recovery, the STOXX 200 Small Index multiple is currently standing at 12.7x, roughly 20% lower than it had been typically in the past (see Chart 9).

Since then, European Small Caps have gained momentum on the back of the expected ECB cutting cycle which should alleviate rate headwinds and support a re-acceleration of the European economy – based on rising real wages, improving consumer sentiment, normalised energy prices, ongoing fiscal support, and a stabilisation of growth in China – in H2 of this year. The earnings outlook has thus turned the corner and Small Caps could return to superior earnings growth and regain a premium to their large peers. Negative earnings revisions have faded, and consensus estimates point to 10% and 14% YoY EPS growth in 2024 and 2025, which is almost 6 ppts and 4 ppts ahead of Large Caps. Further impetus could come from the merger and acquisitions (M&A) space. According to M&A experts, volumes are expected to pick up further in the second half of 2024 after a period of sluggish activity.

Overall, the improving backdrop has sent the STOXX 200 Small Index on a remarkable rally since its trough at the end of October 2023, thereby outpacing the STOXX 200 Large Index by a small margin. Despite the recent slight outperformance, the NTM P/E discount of Small Caps has however widened, which could mark an attractive entry point for investors.

Q2 2024 earnings season preview

The Q2 2024 earnings season in the U.S. will kick off next week with some major names from the banking universe releasing their numbers. In contrast to Q1, where hurdle rates came down noticeably over the quarter, aggregate Q2 2024 earnings growth estimates for the S&P 500 have been revised up since the beginning of April with companies having overall been much less pessimistic on their Q2 prospects compared to the previous quarter as the number of companies lowering their EPS guidance stands below its 10-year average level. Below the surface one can however observe a quite pronounced sectoral divergence.

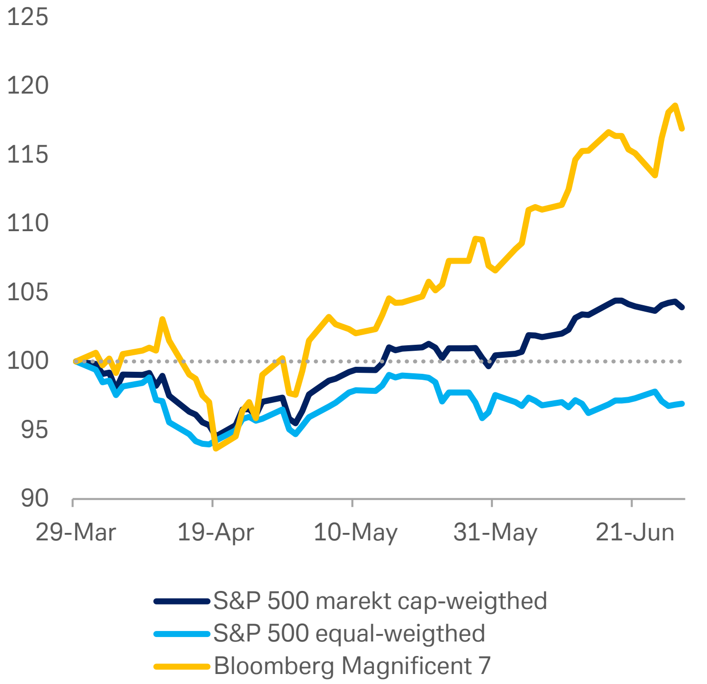
Consensus forecasts are currently pointing to a +10.6% YoY increase of S&P 500 earnings in Q2 2024 on +4.2% higher revenues – this would mark the fourth consecutive quarter of positive aggregate earnings growth for the index. It is however worth noting that a bulk of the earnings growth is again attributable to Mega Cap Tech, which continues to benefit from the developments around AI. Since the beginning of the quarter the aggregate Q2 earnings growth forecast has been revised up by 0.2ppt with consensus EPS estimates of six out of eleven sectors having seen upward revisions – Energy (+3ppt), Communication Services (+3ppt) and Consumer Discretionary (+2ppt), Financials (+2ppt), IT (+2ppt) and Utilities (+0.3ppt). Eight sectors are expected to deliver positive YoY earnings growth figures for Q2 2024.

While Communication Services (+22%), Healthcare (+20%), IT (+17%) and Energy (+13%) are expected to see double-digit YoY advance in earnings, Materials (-9%) and Real Estate (-3%) are assumed to take the lead in terms of YoY earnings declines in Q2 2024 (see Chart 10).

Over in Europe, the aggregate STOXX Europe 600 earnings forecast for Q2 2024 has come down slightly by 0.9ppt since the beginning of April, now suggesting an earnings increase of +1.4% YoY (after four consecutive quarters of negative YoY earnings growth) which is in line with the acceleration in economic activity momentum one could witness over Q2. Utilities (+11ppt) and Financials (+4ppt) are the only sectors that have seen upward revisions to Q2 2024 earnings forecasts. On a YoY basis Utilities (+18%) and Energy (+13%) are expected to experience double-digit YoY earnings growth, while only IT (-25%), Industrials (-8%) and Real Estate (-2%) should report negative earnings growth in Q2 (see Chart 11). Q2 2024 revenues of the STOXX Europe 600 are expected to rise by +1.6% YoY, following four straight quarters of YoY revenue declines.

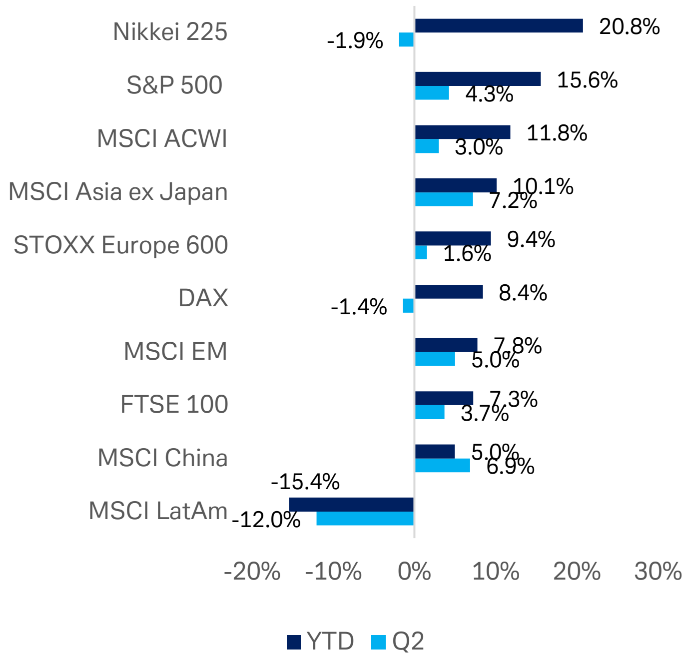
On a full-year basis, consensus earnings growth estimates have improved over the past three months, now indicating that aggregate FY 2024 earnings per share (EPS) will come in at +11% (S&P 500) and +5% (STOXX Europe 600) YoY. It is worth mentioning that, after having been in positive territory since March (S&P 500) and April (STOXX Europe 600), respectively, 2024 net earnings revision ratios have started to weaken, most recently falling back to negative levels on both sides of the Atlantic indicating that the upward revision momentum is at least slowing (see Chart 12).

Chart 1: Q2 2024 performance



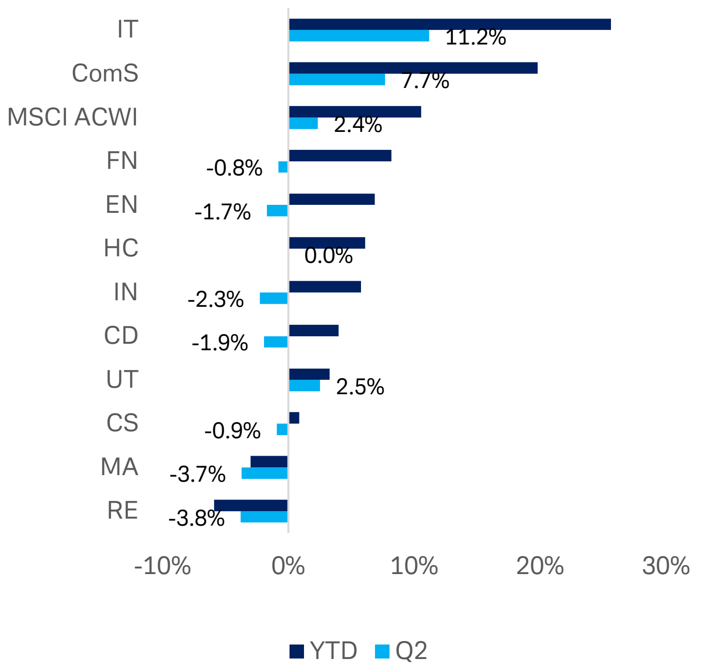
Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of July 2, 2024.

Chart 2: Regional performance



Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of July 2, 2024.

Chart 3: Sectoral performance – MSCI ACWI



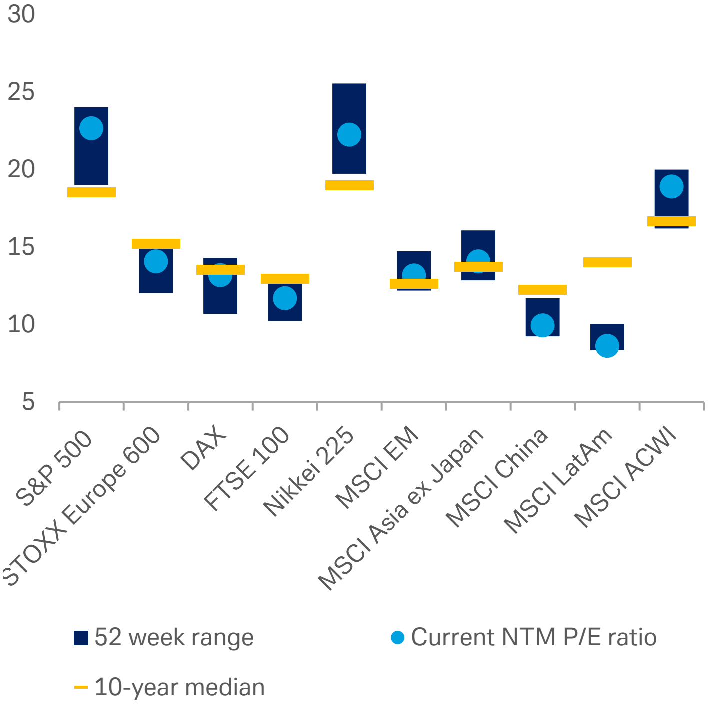
Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of July 2, 2024.

Chart 4: U.S. equity risk premium

Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of July 2, 2024.

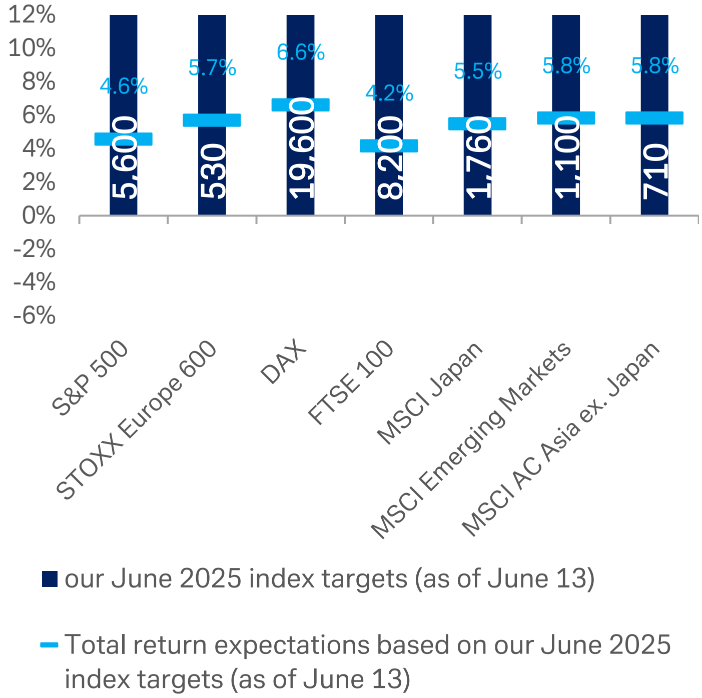
Notes: CD = Consumer Discretionary, ComS = Communication Services, CS = Consumer Staples, EN = Energy, FN = Financials, HC = Healthcare, IN = Industrials, IT = Information Technology, MA = Materials, RE = Real Estate, UT = Utilities

Chart 5: Regional NTM price-to-earnings ratios



Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of July 2, 2024.

Chart 6: Our June 2025 index targets



Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of June 13, 2024.

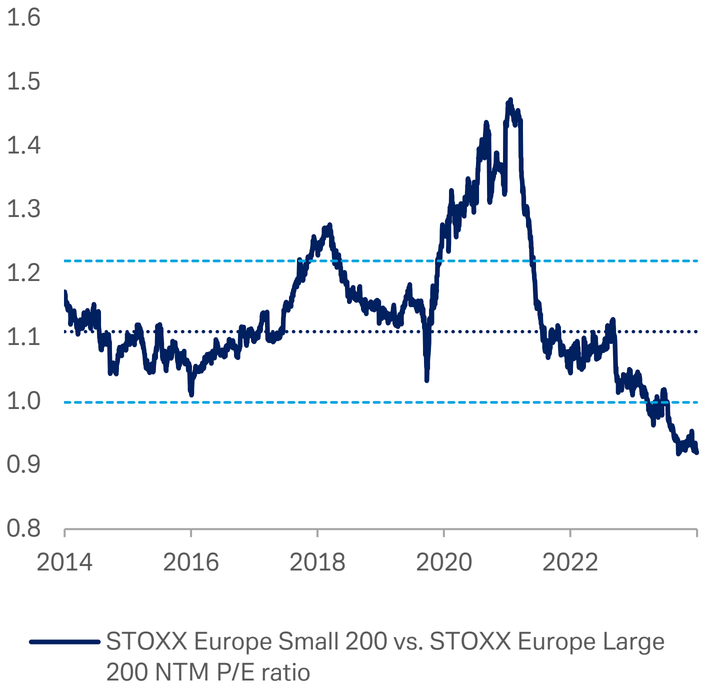
Chart 7: NTM price-to-earnings ratios

Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of July 2, 2024.

Chart 8: Performance STOXX Europe Small 200 vs. Large 200

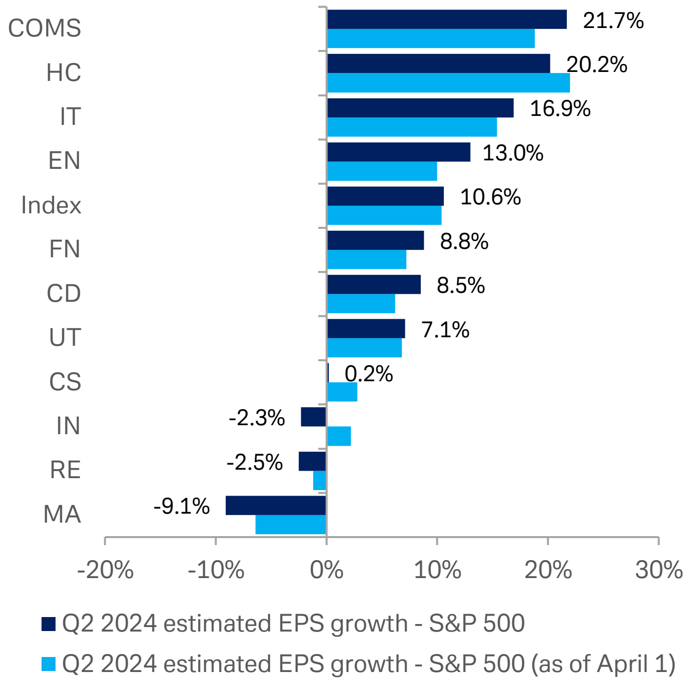
Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of July 2, 2024.

Chart 9: NTM P/E ratio relative – STOXX Europe Small 200 vs. Large 200



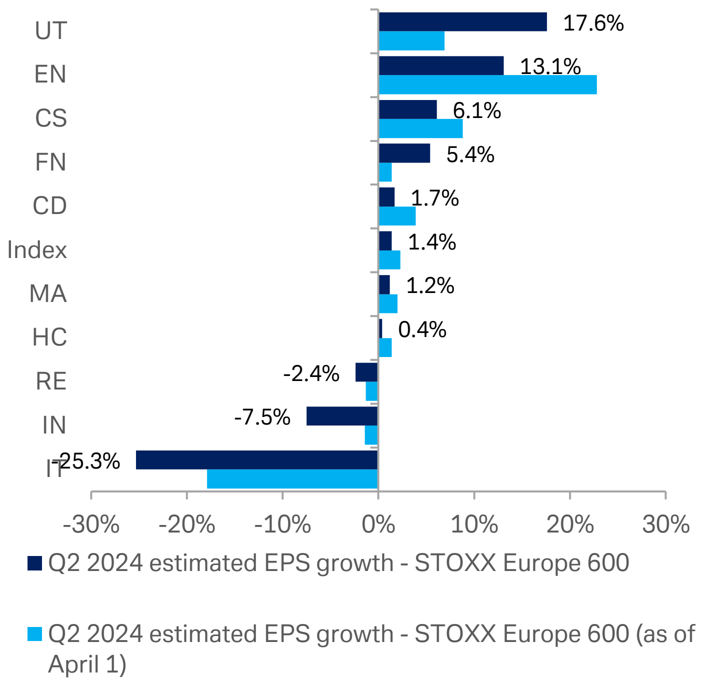
Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of July 2, 2024.

Chart 10: Q2 2024 EPS growth – S&P 500



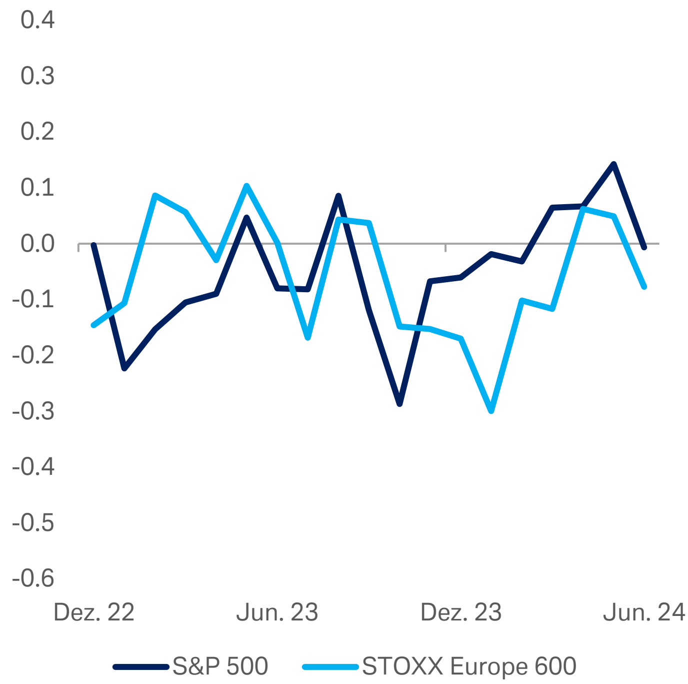
Source: LSEG, Deutsche Bank AG. Data as of June 28, 2024.

Chart 11: Q2 2024 EPS growth – STOXX Europe 600



Source: LSEG, Deutsche Bank AG. Data as of July 2, 2024.

Chart 12: 2024 Net earnings revision ratios



Source: LSEG Datastream, Deutsche Bank AG. Data as of July 2, 2024.

Notes: CD = Consumer Discretionary, ComS = Communication Services, CS = Consumer Staples, EN = Energy, FN = Financials, HC = Healthcare, IN = Industrials, IT = Information Technology, MA = Materials, RE = Real Estate, UT = Utilities

Glossary

The barbell strategy is an investment concept that suggests that the best way to strike a balance between reward and risk is to invest in the two extremes.

Beta is a statistical measure of the volatility of a stock versus the overall market.

CAGR stands for compound annual growth rate.

Cyclical stocks are affected by the business cycle, typically including goods and services the purchase of which is discretionary.

The DAX is a blue-chip stock-market index consisting of the major German companies trading on the Frankfurt Stock Exchange; other DAX indices include a wider range of firms.

Defensive stocks provide more consistent dividends and stable earnings regardless of the state of the overall stock market.

Earnings per share (EPS) are calculated as a companies' net income minus dividends of preferred stock all divided by the total number of shares outstanding.

Earnings surprises occur when a reported earning deviate from the consensus estimate either positively or negatively.

The European Central Bank (ECB) is the central bank for the Eurozone.

The Euro (EUR) is the sole legal tender in the EU member states that have adopted it.

The Eurozone is formed of 20 European Union member states that have adopted the euro as their common currency and sole legal tender.

The Federal Reserve (Fed) is the central bank of the United States. Its Federal Open Market Committee (FOMC) meets to determine interest rate policy.

The FTSE 100 Index tracks the performance of the 100 major companies trading on the London Stock Exchange.

A Goldilocks economy has steady economic growth, preventing a recession, but not so much growth that inflation rises by a great deal.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Growth stocks are those of companies seen as likely to have above-average earnings or revenues growth.

Large language models (LLMs) are a category of foundation models trained on immense amounts of data making them capable of understanding and generating natural language and other types of content to perform a wide range of tasks.

"Magnificent 7" is a term for the most dominant tech companies. The group is made up of mega-cap stocks Apple, Alphabet, Microsoft, Amazon.com, Meta Platforms, Tesla and Nvidia.

Month-to-date (MTD).

The MSCI ACWI Index captures large- and mid-cap companies across 23 developed- and 23 emerging-market countries.

The MSCI Asia ex Japan Index captures large- and mid-cap representation across 2 of 3 developed-market countries (excluding Japan) and 8 emerging-market countries in Asia.

The MSCI EM Index captures large and mid cap representation across 23 emerging markets countries.

The MSCI Emerging Markets Asia Index captures large and mid cap representation across 8 Asian Emerging Markets countries including China, India, Indonesia, Korea, Malaysia, the Philippines, Taiwan and Thailand.

The MSCI Europe Index includes large and mid cap stocks across 15 developed markets countries in Europe.

The MSCI LatAm Index includes large and mid-cap firms in five Latin American countries.

The Nasdaq 100 Index is a collection of the 100 largest, most actively traded companies listed on the Nasdaq stock exchange.

Net earnings revision ratio represents the number of forward earnings estimates up less number of estimates down, expressed as a percentage of the total number of forward earnings estimates.

The net profit margin measures how much net income or profit is generated as a percentage of revenue.

Next twelve months (NTM) refers to any financial measure that is being forecasted for the immediate next twelve months from the current date.

The Nikkei 225 is the leading and most-respected index of Japanese stocks.

The Purchasing Managers' Index (PMI) is an index of the prevailing direction of economic trends in the manufacturing and service sectors. It consists of a diffusion index that summarizes whether market conditions are expanding, staying the same, or contracting as viewed by purchasing managers.

Price/book (P/B) ratios measure a company's share price relative to its tangible assets.

Price/earnings (P/E) ratios measure a company's current share price relative to its per-share earnings.

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Quarter-to-date (QTD).

Real rates adjust changes of values for factors such as inflation.

The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

The S&P 500®Equal Weight Index is the equal-weight version of the widely-used S&P 500. The index includes the same constituents as the capitalization weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight - or 0.2% of the index total.

The STOXX Europe 600 Index includes 600 companies across 18 European Union countries.

The STOXX Europe Small/Large 200 Index are fixed component indices designed to provide a representation of small/large capitalisation companies in Europe.

U.S. is the United States.

USD is the currency code for the U.S. Dollar.

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

Value stocks are those that appear to be trading lower than justified by their fundamentals (e.g. sales and earnings).

The VIX Index is a measurement of volatility implied by S&P 500 Index options.

Volatility is the degree of variation of a trading price series over time.

Year-to-date (YTD).

Appendix

Performance	2.7.2018 - 2.7.2019	2.7.2019 - 2.7.2020	2.7.2020 - 2.7.2021	2.7.2021 - 2.7.2022	2.7.2022 - 2.7.2023
S&P 500	9.0%	5.3%	39.1%	-12.1%	16.3%
S&P 500 equal-weighted	6.6%	-5.6%	48.8%	-10.7%	10.1%
STOXX Europe 600	3.3%	-5.4%	24.0%	-10.9%	13.5%
STOXX Europe Small 200	2.4%	-2.6%	38.3%	-20.8%	6.2%
STOXX Europe Large 200	8.1%	-3.1%	24.5%	-5.6%	18.4%
DAX	2.4%	0.7%	24.1%	-18.1%	26.0%
FTSE 100	0.2%	-17.4%	14.1%	0.6%	5.1%
MSCI Japan	-4.7%	-2.0%	27.9%	-5.9%	24.6%
S&P 500 IT	13.5%	32.6%	42.2%	-15.4%	38.5%
MSCI Asia ex Japan	-1.0%	0.9%	31.2%	-25.9%	-2.7%
MSCI EM	0.4%	-3.8%	32.4%	-26.7%	-0.3%
MSCI China	-7.6%	12.1%	18.2%	-30.4%	-18.6%
MSCI LatAm	16.9%	-31.5%	34.9%	-22.7%	20.6%
Magnificent Seven	1.2%	99.6%	77.7%	-19.9%	55.8%
MSCI ACWI Energy	-10.1%	-35.7%	34.4%	14.9%	8.7%
MSCI ACWI Financials	1.4%	-19.5%	44.5%	-14.0%	8.0%
MSCI ACWI Industrials	5.8%	-9.1%	42.7%	-20.4%	22.9%
MSCI ACWI Communication Services	12.4%	8.1%	38.9%	-30.8%	8.8%
MSCI ACWI Consumer Staples	8.9%	-2.3%	17.0%	-5.7%	4.6%
MSCI ACWI Consumer Discrettionary	4.4%	9.8%	42.4%	-29.2%	16.8%
MSCI ACWI Utilities	11.6%	-3.6%	10.2%	1.7%	-3.7%
MSCI ACWI Information Technology	10.1%	29.4%	44.6%	-21.8%	33.3%
MSCI ACWI Materials	-1.6%	-6.0%	43.9%	-19.9%	9.2%
MSCI ACWI Healthcare	9.3%	13.3%	21.6%	-6.0%	3.5%
MSCI ACWI Real Estate	8.9%	-11.6%	21.0%	-14.8%	-10.6%

Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of July 2, 2024.

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