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CIO Viewpoint
Equity

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Setting the course for Q4

Key takeaways

- Entering into Q4, we appear to be in a benign scenario where the Fed is cutting rates outside of a recession, with data so far confirming the resilience of the U.S. economy.
- As we don't expect a marked economic slowdown in the U.S. and Europe or a shock on the interest rate side, we have raised our equity index targets.
- Historically Cyclicals tended to underperform Defensives after the start of rate-cutting cycles. This time we expect Cyclicals to do well on the back of strong U.S. growth and an expected uptick in European growth.

Defying September seasonality

After September initially lived up to its reputation as being a difficult month for equities, broader markets have recovered (see Chart 1) owing to growing optimism about the likelihood of a soft landing for the U.S. economy. This mounting belief that the current economic cycle still has some stamina, together with the Fed's 50 basis points (bps) rate cut, has pushed some major benchmark indices up to new record levels – including the German DAX as well as the S&P 500 (which has now reached 41 all-time highs in 2024 so far).

A revived Small Caps performance is also observable with the Russell 2000 having outpaced the S&P 500 by a considerable margin since September 11 (see Chart 2). Moreover, we have seen a fresh bout of curve steepening as the 2s10s yield curve has moved to its steepest level since June 2022 (see Chart 3). This is in line with most of the recent Fed cutting cycles, which have been characterized by a steepening of the yield curve as well as longer-term bond yields moving lower. Over in Europe, concerns about political uncertainty and an economic downturn have not prevented an MTD advance of the STOXX Europe 600 with China-exposed stocks and markets having done well after the most recent monetary stimulus announcement of the PBoC.

We are still in an early phase of the current rate cutting cycle, but so far market participants appear to face a quite pleasant scenario where the Fed is easing outside of a U.S. recession, something which from a historical perspective has usually been a favourable setting for equities. In fact, Atlanta Fed's GDPNow forecast currently stands at an annualised rate of +2.9% for Q3 (see Chart 4), almost in line with the +3.0% achieved in Q2. So we are well away from recession territory – but the Fed's new dot plots suggest a further 50bps of rate cuts by end the of the year (see Chart 5).

Jerome Powell has conveyed a constructive picture on the U.S. economy and the flash S&P Global Composite PMI for September at 54.4 (vs. 54.3 expected) points to ongoing economic resilience, with all Composite PMI readings since May above 54.

Out of the last ten Fed easing episodes, four came with a soft landing while six were accompanied by a U.S. recession (see Chart 6). And it is eye-catching that every single cutting cycle with a recession outcome was preceded by an inverted yield curve. In contrast, soft landing outcomes were never preceded by a curve inversion.

The initial reaction of the S&P 500 after the start of Fed rate cuts has historically tended to be rather muted. Taking a different perspective, note also that the 12-month S&P 500 performance in the run-up to the first Fed rate cut has averaged approximately +8% during the last ten occasions. This compares with a rise of +26% this time around, the strongest advance for the S&P 500 in the year leading up to start of cuts, the next largest being the +24% rise before the 1995 easing cycle (see Chart 7).

S&P 500 performance after the start of rate cuts has, however, been clearly determined by the economic growth outcome. Unsurprisingly, the combination of rate cuts and a recession has on average led to a negative S&P 500 performance over the 12 months following the first rate cut. By contrast, S&P 500 returns outside recessions have averaged in the high teens (see Chart 8).

As a result, we believe that the combination of lower rates with (at least for the time being) a low recession likelihood and traditionally strong Q4 seasonality (see Chart 9) represents an encouraging starting point for equities entering into the final quarter of the year. But we also note that, if there was disappointing economic activity dataflow over the next months and evidence of a significantly softening labour market, then questions might return about whether the Fed is behind the curve. The risk is then that the next rate cuts could be regarded as confirmation of economic weakness, rather than a driver of stock upside. The fact that Utilities (despite the artificial intelligence "AI" hype) is the second strongest sector in the U.S. on a YTD basis in total return terms (see Chart 10) eventually reflects some underlying market nervousness that is looming below the surface. We think that in prevailing environment we might see a frequent "rotations back and forth" as some market participants wait on the sidelines to buy the dips in certain sectors.

Investors will obviously pay increasing attention to the U.S. elections over the coming weeks and closely watch the upcoming Q3 2024 corporate earnings season. History suggests a median pullback of around 4-5% in the month preceding a closely-contested election, like the one anticipated this year. Therefore, it would not come as a big surprise to see choppy markets as investors wait for the post-election clarity to solidify their convictions.

No recession = attractive NTM return prospects

Given our macro base case (that we don't expect a marked economic slowdown in the U.S. and Europe or an interest rate shock), we have raised our NTM index targets. In the absence of an outright U.S. recession, investors will presumably look through stretched valuation levels – as long as long-term yields are not substantially rising, and corporate earnings keep growing. As economic activity seems unlikely to fall sharply elsewhere, we expect robust global earnings growth in 2024 and 2025. So far, the solid corporate earnings picture appears likely to cushion broad equity markets from major down-side risks. The prospect of monetary easing by major central banks along with robust labour markets should provide further support for the asset class. We believe that our forecast 100bps of further Fed cuts by September 2025 will be sufficient to prevent the labour market from a marked deterioration.

Note that the S&P 500 (excluding the Magnificent 7), U.S. Small Caps and the broader European market recorded their first cumulative quarterly YoY earnings growth for more than a year in Q2 2024. Consensus earnings forecasts currently also indicate that the significant earnings growth gap between the Magnificent 7 and the rest could gradually narrow from here. Hence, we are confident that market leadership may continue getting broader. This trend might also be supported by a potential rotation away from AI Mega Caps, given that some of these companies are still struggling to deliver returns on their massive capex, with market participants beginning to question the speed at which AI can be monetized. As a result, AI share prices might struggle to return to their previous all-time highs without convincing new evidence that recent large investments into AI capabilities are justified and will deliver excess returns for shareholders. Even so, even after an evident decline in Magnificent 7 earnings growth rate (from extraordinary levels) in Q2 2024, this group is expected to continue delivering good earnings growth for the time being (see Chart 11), supporting overall market sentiment.

On the back of an expected 10-11% NTM EPS growth, we reach a (September 2025) S&P 500 index target of 5,800, after applying an unchanged LTM P/E (last twelve months price/earnings ratio) of 21.6x, still well above what history would suggest as an adequate equity risk premium. To address this fact, as well as the AI issue, we had already earlier this year added a temporary growth premium of 15% to our fair S&P 500 P/E estimate of 18.5x. This was on the basis that we expected a better mid-term earnings growth potential for the index as the proportion of secular growth companies (with a greater share of recurring revenues streams) likely expanded further, making the benchmark possibly less vulnerable to cyclical shifts.

The earnings of most other regions are also anticipated to grow at healthy rates, but we assume that their large valuation discounts relative to the U.S. equity market will not expand further during our 12-month forecast horizon. While we see better growth opportunities in the U.S., we have a slight regional preference for Europe given the record high valuation discount it currently has versus the U.S (see Chart 12).

We think that Large Caps will continue to perform well in both the U.S. and Europe, helped by their decent long-term return prospects which are underpinned by their secular earnings strength and sound balance sheets. However, investors should consider adding Small and Mid Caps (SMIDs) as an expected economic growth uptick in 2025, acting on top of the anticipated changing interest rate environment with continuously declining bond yields, would be assumed to disproportionally spur on earnings of growth- and rate-sensitive smaller companies. SMIDs tend to be skewed more toward floating-rate liabilities and therefore benefit more directly in terms of debt service costs from falling interest rates. Consequently, we reiterate our preference for a "market cap barbell" of being invested into both ends of the market cap spectrum.

Overall, our new September 2025 index targets imply attractive return prospects for most regions, in the mid to high-single-digits (see Chart 13). Of course, the combination of a still possible U.S. recession and rich valuations in some pockets of the equity market exposes our base case to a certain degree of risk while disappointments on the AI-side could also induce a mean-reversion of valuation levels. A private consumption tailwind has also not emerged to a material extent yet, despite rising real incomes. On top of the U.S. elections, global geopolitical risks from military conflicts as well as tariff disputes could spark fresh market uncertainty and volatility.

Cyclicals vs. Defensives: where next?

After having dropped 25% in the U.S. and 16% in Europe in relative terms as a risk-off-move in the month after the early August turmoil, Cyclicals vs. Defensives have outperformed by 8% in the U.S. and Europe in the last two weeks as PMIs and labour market data indicated a resilient business cycle in the U.S. How will the pair perform moving forward? On September 18 the Fed began its cutting cycle with a first step of 50bps after the ECB had delivered two cuts of 25bps each. The yield curve is now dis-inverted in the U.S. and in Europe and the market reaction to the cuts has been positive with Cyclicals and Growth stocks performing well recently.

Based on analysis of the last six cutting cycles on both sides of the Atlantic (looking at Bundesbank before the establishment of the ECB) and putting recent patterns into perspective, we suggest where we expect the Cyclicals vs. Defensives performance to move. In the U.S. Cyclicals tend to lag Defensives in the 12 months following the first cut, amid both recessionary and non-recessionary easing cycles, but this may be because the Fed almost always commences rate cuts when economic momentum is decelerating. Since the 1970s the Healthcare sector has managed to outperform the S&P 500 80% of the time after the first rate cut in a cycle, while Tech only outperformed in 30% of instances.

Looking at the matter with a more short-term focus, we see that 3 months after the first cut, Consumer Staples and again Healthcare outperformed 80% of the time, while Industrials and Consumer Discretionary only managed to do so in 40% of cases. That said, this time could be different as earnings growth on a broader base is ticking up amidst the prevailing rate cut cycle.

Looking at ECB cutting cycles since the 1980s (Bundesbank before 1999), Cyclicals in Europe were weak during the first 6 months following a cut, whether a recession occurs or not. However, if there is no recession, 12 months after the first cut Cyclicals outperform Defensives. Looking at Fed cutting cycles, European Cyclicals have tended to underperform Defensives, even outside of cuts made in a recessionary environment. Some of this may be because the European economic cycle sometimes lagged the one in the U.S., and European growth was therefore slowing while the Fed had already started to ease its monetary policy. This time the ECB has gone first and has delivered two cuts of 25bps before the Fed even started. What seems to matter most for the Cyclicals vs. Defensives performance in Europe, looking at 6m total returns since the 1970s, is whether economic activity is up or not, rather than the development of rates. Even though economic activity is muted at the moment, we expect an uptick in coming quarters. Additionally, after four quarters of earnings declines, the STOXX Europe 600 increased its EPS by 3% in Q2 and analysts expect earnings growth to increase in the upcoming quarters.

Summarizing, in the past Cyclicals have underperformed Defensives in the initial months after first rate cuts, especially in recessions. This time we expect Cyclicals to do well in the U.S. and Europe on the back of a robust uptick in growth momentum during the next quarters and on the back of increasing earnings.

Q3 2024 earnings season preview

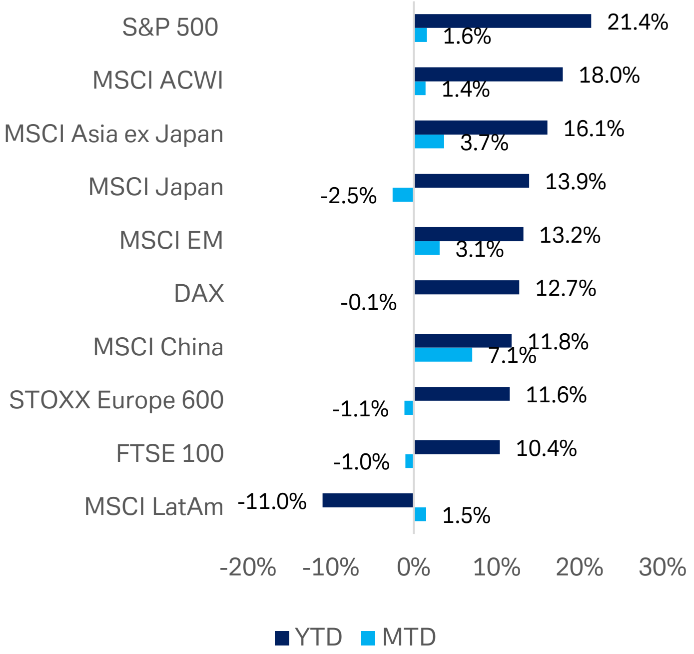
The Q3 2024 earnings season in the U.S. will kick off in two weeks. In contrast to Q2, where hurdle rates (not in line with the usual patter) were revised up over the quarter, the consensus aggregate Q3 2024 earnings growth forecast for the S&P 500 has come down since the beginning of July with companies being generally more pessimistic on their Q3 prospects compared to the previous quarter. Below the surface one can however observe a pronounced sectoral divergence.

Consensus forecasts are currently pointing to a +5.4% YoY increase in S&P 500 earnings in Q3 2024 on +4.1% higher revenues – this would mark the fifth consecutive quarter of positive aggregate earnings growth for the index. Since the beginning of the quarter, the aggregate Q3 earnings growth forecast has been revised down by 3.2ppt with consensus EPS estimates of eight out of eleven sectors having seen downward revisions – led by Energy (-16ppt), Materials (-11ppt) and Industrials (-8ppt). Nine sectors are expected to deliver positive YoY earnings growth figures for Q3 2024. While IT (+16%), Communication Services (+12%) and Healthcare (+11%) are expected to see double-digit YoY advance in earnings, Energy (-19%) and Materials (-2%) are anticipated to deliver YoY earnings declines in Q3 2024 (see Chart 14).

Over in Europe, the aggregate STOXX Europe 600 earnings forecast for Q3 2024 has come down by 4.5ppt since the beginning of July, now suggesting an earnings increase of +5.7% YoY which would still mark the second quarter of positive YoY earnings growth after four consecutive quarters of negative growth numbers. Financials (+2ppt) is the only sector that has seen upward revisions to Q3 2024 earnings forecasts. On a YoY basis Materials (+32%), Financials (+15%), Utilities (+14%) and Consumer Discretionary (+10%) are expected to experience double-digit earnings growth, while only Energy (-14%), Real Estate (-11%) and IT (-8%) should report negative earnings growth in Q3 (see Chart 15). Q3 2024 revenues of the STOXX Europe 600 are expected to decrease by -1.9% YoY, representing the six straight quarter of YoY revenue declines.

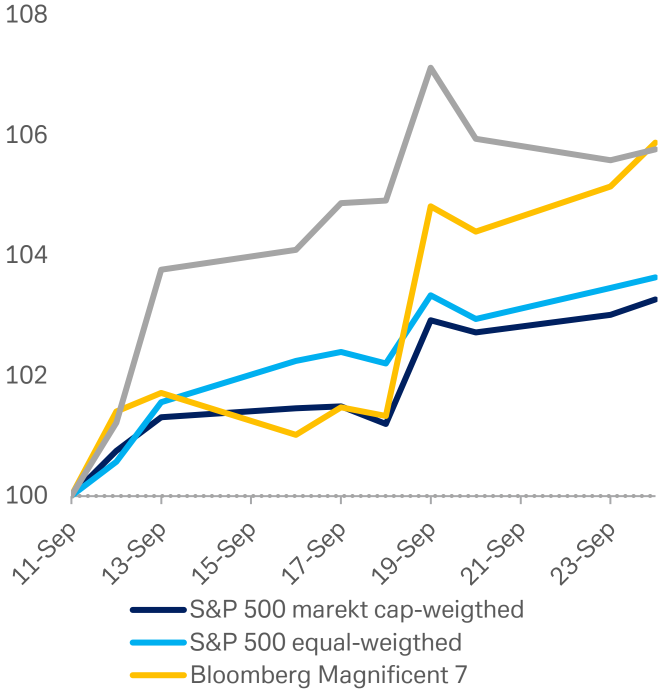
On an NTM basis, consensus earnings growth estimates are indicating that aggregate earnings per share (EPS) will grow at rates of +14% (S&P 500) and +9% (STOXX Europe 600) YoY. It is worth mentioning that, after having been in negative territory in June and July, S&P 500 NTM net earnings revision ratios have started to improve moving back to slightly positive levels in August while the corresponding STOXX Europe 600 metric has been deteriorating since beginning of Q2 in line with the weaker economic backdrop on that side of the Atlantic (see Chart 16).

Chart 1: Regional performance



Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of September 25, 2024.

Chart 2: Performance since September 11th

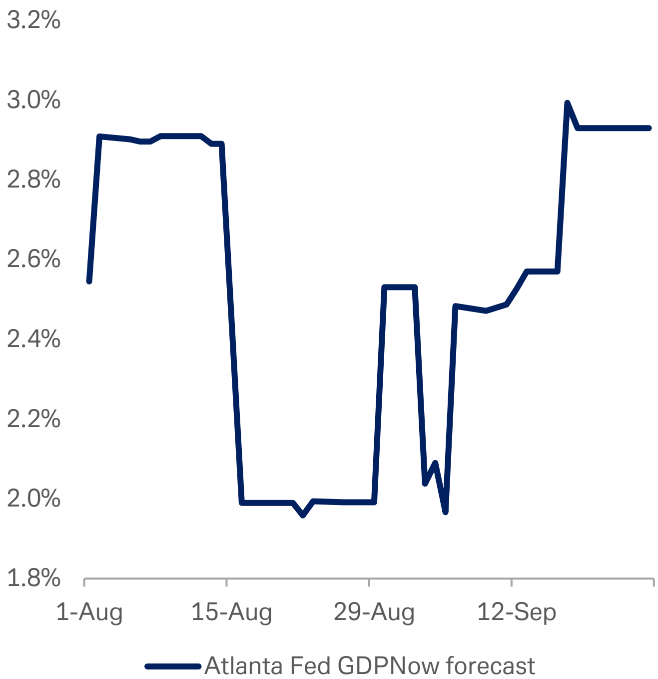


Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of September 25, 2024.

Chart 3: 2s10s U.S. Treasury yield spread

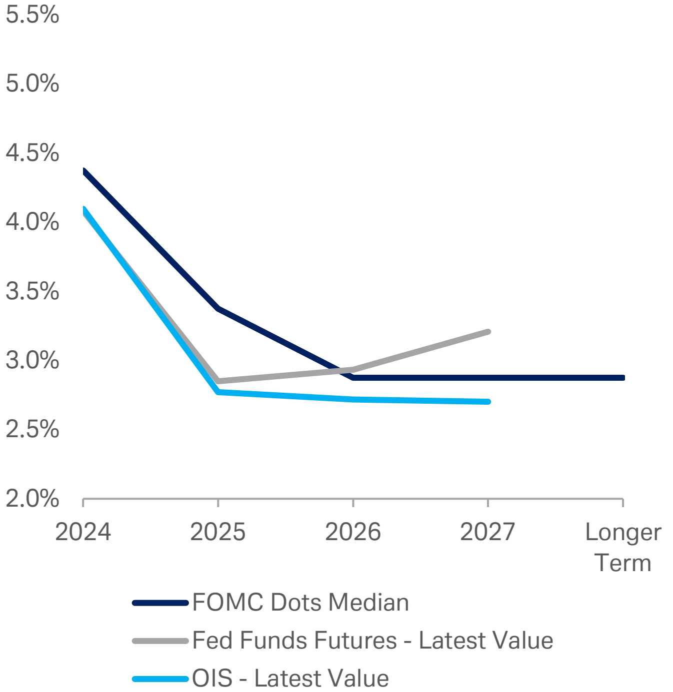
Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of September 25, 2024.

Chart 4: Atlanta Fed GDPNow forecast for Q3 GDP growth



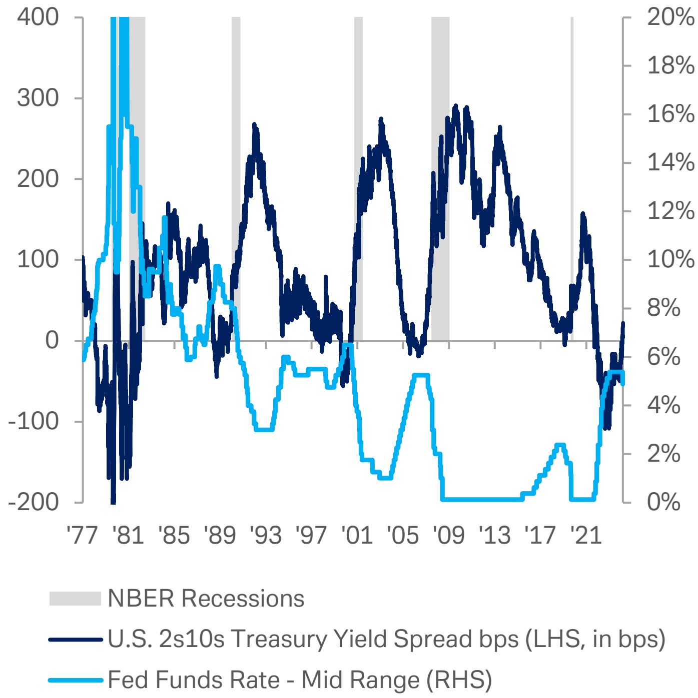
Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of September 25, 2024.

Chart 5: FOMC dot plot as of September 18th



Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of September 25, 2024.

Chart 6: U.S. Treasury yield spread, Fed funds rate and U.S. recessions



Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of September 25, 2024.

Chart 7: 12-month S&P 500 performance before first rate cut

First Fed rate cut of the easing cycle	12m S&P 500 performance before first cut
Apr-80	0.6%
Jun-81	19.0%
Oct-84	-1.5%
Oct-87	-5.9%
Jun-89	20.9%
Jul-95	24.2%
Sep-98	10.0%
Jan-01	-7.4%
Sep-07	15.0%
Jul-19	6.1%
Average	**8.1%**
Sep-24	26.2%

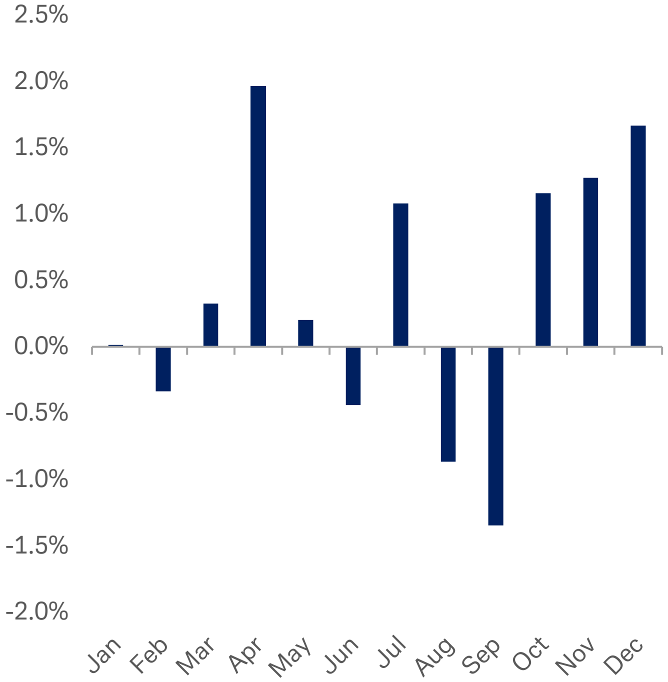
Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of September 25, 2024.

Chart 8: 12-month S&P 500 performance after first rate cut

First Fed rate cut of the easing cycle	12m S&P 500 performance after first cut
Apr-80	23.7%
Jun-81	-15.7%
Oct-84	12.5%
Oct-87	23.2%
Jun-89	13.9%
Jul-95	18.7%
Sep-98	20.9%
Jan-01	-13.5%
Sep-07	-20.6%
Jul-19	8.3%
Recession Average	-0.7%

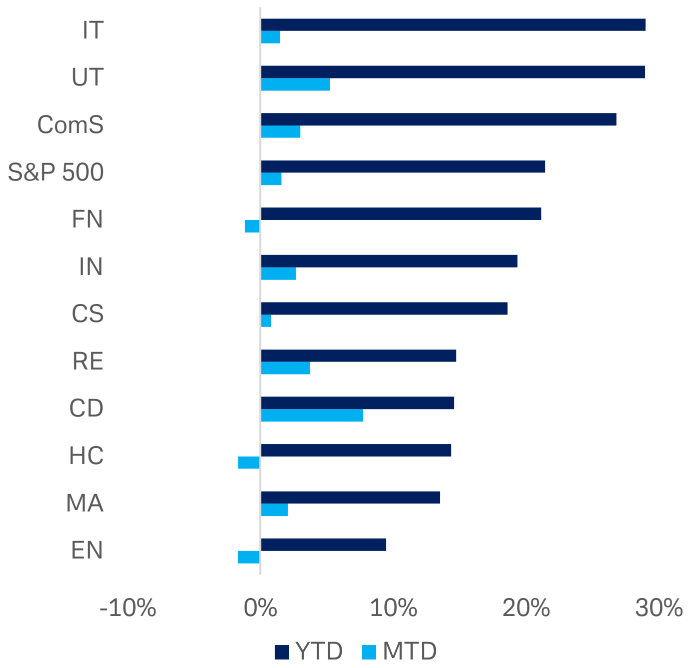
Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of September 25, 2024.

Chart 9: Seasonal Performance MSCI ACWI (1990-2023)



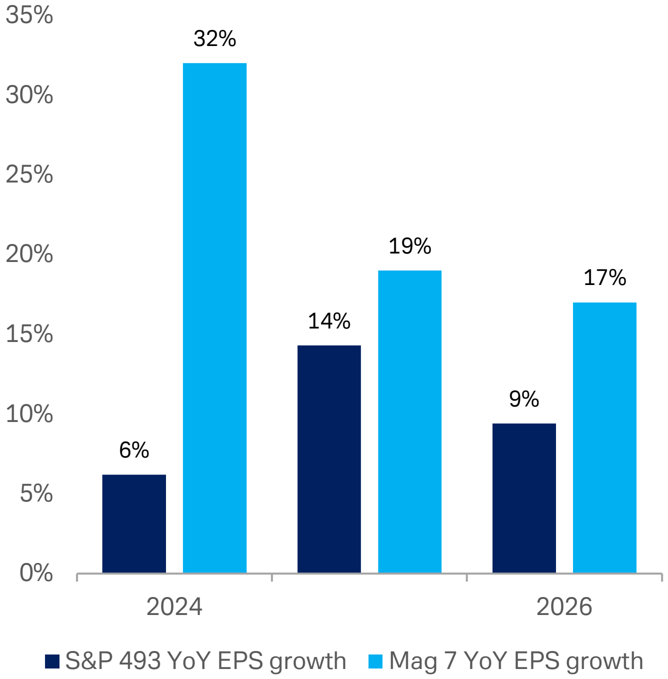
Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of September 25, 2024.

Chart 10: Sectoral performance – S&P 500



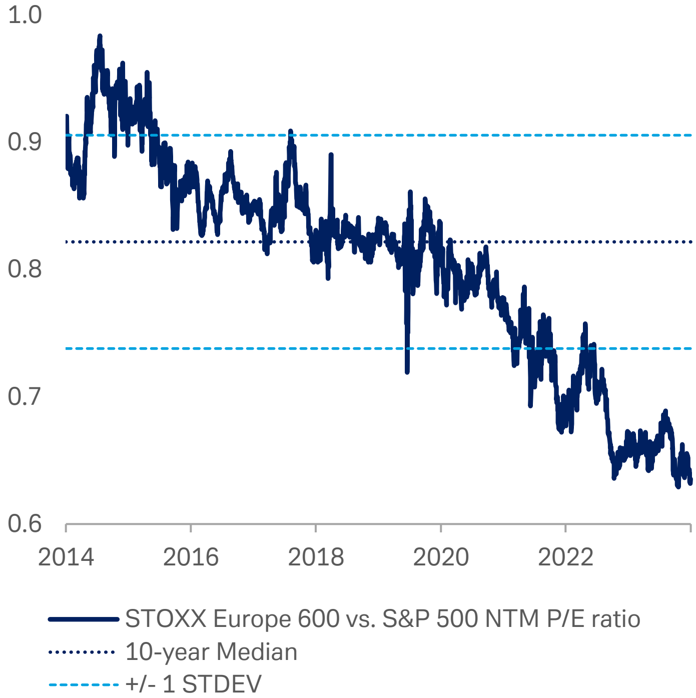
Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of September 25, 2024.

Chart 11: S&P 493 and Magnificent 7 YoY EPS growth



Source: LSEG, Deutsche Bank AG. Data as of September 25, 2024.

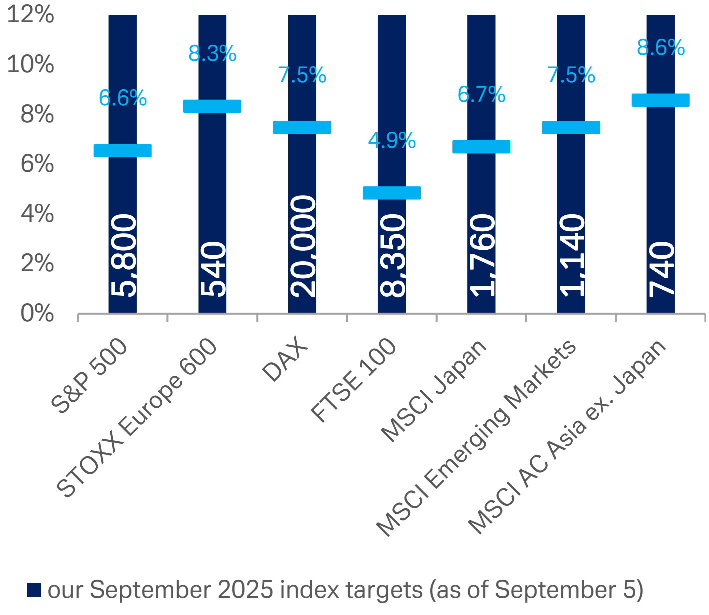
Chart 12: STOXX Europe 600 vs. S&P 500 NTM P/E ratio relative



Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of September 25, 2024.

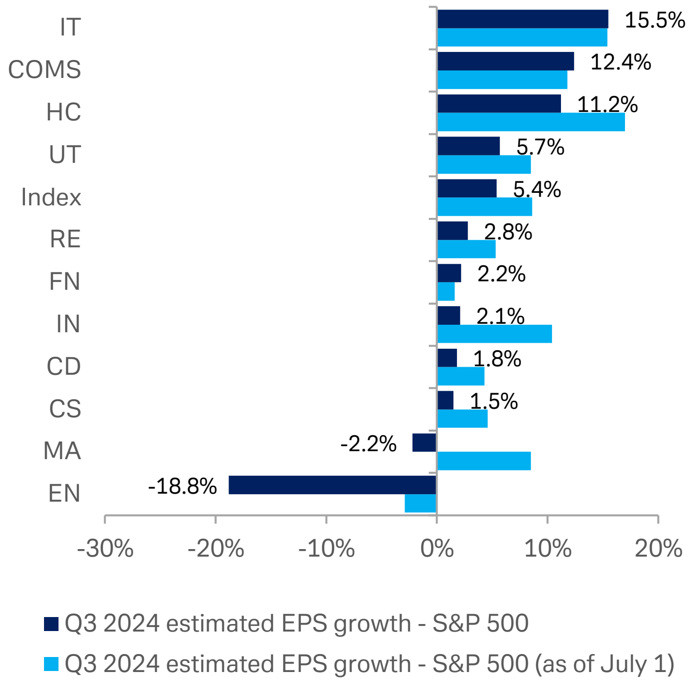
Notes: CD = Consumer Discretionary, ComS = Communication Services, CS = Consumer Staples, EN = Energy, FN = Financials, HC = Healthcare, IN = Industrials, IT = Information Technology, MA = Materials, RE = Real Estate, UT = Utilities

Chart 13: Our September 2025 index targets



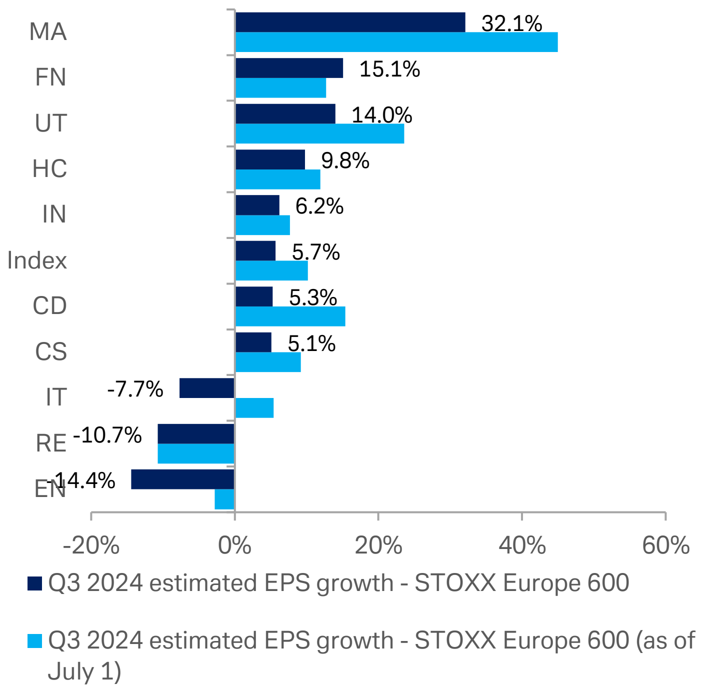
Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of September 5, 2024.

Chart 14: Q3 2024 EPS growth – S&P 500



Source: LSEG, Deutsche Bank AG. Data as of September 20, 2024.

Chart 15: Q3 2024 EPS growth – STOXX Europe 600



Source: LSEG, Deutsche Bank AG. Data as of September 24, 2024.

Chart 16: NTM net earnings revision ratios

Source: LSEG Datastream, Deutsche Bank AG. Data as of September 25, 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 FOMC Dot Plot is comprised typically of 19 dots: seven members of the Board of Governors of the Federal Reserve System and presidents of the 12 regional banks. Each is asked to indicate where they believe the Federal Funds rate should be in the future.

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

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.

"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 Composite Index measures all NASDAQ domestic and international based common type stocks listed on The NASDAQ Stock Market. Today the NASDAQ Composite includes over 2,500 companies

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

The 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 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.

Glossary

Quarter-to-date (QTD).

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

The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe.

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.

Treasuries are bonds issued by the U.S. government.

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).

The yield curve shows the different rates for bonds of differing maturities but the same credit quality.

Yield curve inversion is when longer-term debt has a lower yield than short-term debt.

Historical performance

Performance	25.9.2019 - 25.9.2020	25.9.2020 - 25.9.2021	25.9.2021 - 25.9.2022	25.9.2022 - 25.9.2023	25.9.2023 - 25.9.2024
S&P 500	10.5%	35.1%	-17.1%	17.4%	32.2%
S&P 500 equal-weighted	-1.5%	44.6%	-15.1%	9.6%	24.2%
Russell 2000	-4.9%	52.4%	-25.3%	6.2%	24.6%
NASDAQ Composite	35.1%	37.9%	-27.8%	22.1%	36.2%
STOXX Europe 600	-8.3%	30.3%	-15.7%	15.4%	15.2%
DAX	1.9%	24.6%	-20.9%	25.4%	22.6%
FTSE 100	-19.9%	20.7%	-0.5%	8.6%	8.7%
MSCI Japan	0.8%	29.8%	-8.6%	24.5%	11.9%
EUROSTOXX 50	-10.7%	32.6%	-19.5%	24.5%	17.9%
MSCI Asia ex Japan	12.5%	16.0%	-28.3%	4.8%	20.1%
MSCI EM	5.3%	19.5%	-28.4%	5.7%	18.2%
MSCI China	24.7%	-5.9%	-34.1%	-0.7%	4.3%
MSCI LatAm	-30.5%	24.0%	-7.6%	8.8%	-1.7%
Magnificent Seven	135.0%	56.2%	-25.5%	55.7%	60.6%
S&P 500 Energy	-48.7%	68.7%	40.4%	27.9%	-1.6%
S&P 500 Financials	-16.2%	62.7%	-18.8%	8.7%	33.4%
S&P 500 Industrials	-1.4%	31.9%	-15.9%	20.6%	31.6%
S&P 500 Communication Services	13.5%	44.4%	-39.9%	33.5%	38.8%
S&P 500 Consumer Staples	3.9%	13.6%	-1.5%	2.1%	20.0%
S&P 500 Consumer Discrettionary	24.8%	24.6%	-22.0%	11.0%	26.6%
S&P 500 Utilities	-8.9%	10.9%	10.1%	-12.0%	26.2%
S&P 500 Information Technology	41.6%	37.3%	-21.2%	34.6%	49.2%
S&P 500 Materials	8.0%	29.6%	-15.4%	15.5%	21.5%
S&P 500 Healthcare	15.0%	28.1%	-7.0%	6.6%	17.8%
S&P 500 Real Estate	-11.4%	33.5%	-18.2%	-7.8%	30.0%

Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of September 25, 2024.

Important information

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