CIO Viewpoint
Equity

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Some fuel still in the tank

Key takeaways

- Market optimism has been sustained over Q1 gains but our index targets still imply a below historical average return potential for most regions over the next twelve month.
- We think the AI trade will broaden out. Its next two phases are pulling in more firms that can successfully show AI-adoption, and then those with productivity gains.
- In the ongoing Q1 2024 reporting season, earnings could beat downwardly-revised expectations. But corporate profitability could remain under pressure in coming quarters.

A quarter to remember

Against the backdrop of upbeat global economic data, fueling hopes of an economic "soft landing" scenario, and continuing excitement around artificial intelligence (AI), Q1 proved another strong quarter for risk assets (see Chart 1) with several major equity indices reaching new all-time highs. By contrast, sovereign bonds struggled in Q1, as stubborn inflation coupled with economic resilience led investors to dial back their expectations for Fed and ECB rate cuts this year. Consequently, equity valuations have decoupled from interest rate developments (see Chart 2).

Both the S&P 500 (+10.6% in Q1) and the STOXX Europe 600 (+7.8%) recorded sequential monthly gains throughout Q1. On top of that the S&P 500 posted double-digit quarterly back-to-back gains for the first time in over a decade and made gains in 16 out of 18 weeks for the first time since 1971. Even so, Japan was the best-performing equity region with the Nikkei 225 up +21.4%, its largest quarterly advance since Q2 2009. This took it past its previous record high dating back to 1989. Emerging market equities, although making gains, were clearly lagging with the MSCI EM Index up +2.4%.

It is noteworthy that the S&P 500 performance in Q1 was still largely driven by a modest number of AI-powered stocks that create fresh headlines on a daily basis. But this narrow market leadership at some point appeared to broaden somewhat as in March the equally weighted S&P 500 index and the Russell 2000 managed to outperform the market cap weighted S&P 500 as well as the NASDAQ 100 (see Chart 3).

From our point of view, the Europe/Eurozone trade represents another aspect of the rally broadening out into alternative corners of the market. Relatively cheap and under-owned European equities seem to have regained investors' interest with average allocations reaching levels not seen in years. As a result, the Eurozone equity market even outpaced its U.S. counterpart in Q1 (Euro STOXX 50: +12.9%), helped by regional macro data apparently finding a floor. The Eurozone Citi Economic Surprise Index (CESI) has recovered significantly over the past few quarters and in February surpassed its U.S. equivalent for the first time since last spring (see Chart 4).

We believe that the increasing disconnection from fundamentals in certain market areas could benefit flows into laggard regions and sectors. A catch-up trade could be supported by their sizeable existing valuation discounts. We feel however that a sustained broadening out will probably only materialize if market participants are more confident about a successful soft landing and central banks start cutting rates.

Equity markets had a rough start into Q2 and the optimism we have witnessed in Q1 obviously sits uneasily with general expectations of only modest economic growth over the next two years. Corporate profit margins of most cyclical sectors are also still very high in a historical context with little scope to expand. Despite usual favorable seasonality in April and May (see Chart 5), we think therefore that equity markets might be prone to setbacks in Q2. There will be several reality checks that even the most avid market bulls may not be able to overlook, especially since potential sources of positive surprises are becoming more limited while various risks are still all too apparent. However, the past six months have shown that equities remain the best vehicle to participate in technological advance.

We have raised our 12-month index forecasts, mainly driven by higher assumed price earnings (P/E) multiples as we believe that equity investors will require a materially-lower equity risk premium. This may be particularly the case in the U.S. market, due to significantly reduced U.S. recession risks and a further increase in the share of secular growth companies with recurring revenue streams that should make the S&P 500 less vulnerable to cyclical swings. Moreover, the S&P 500 can be seen as providing a convenient way of capitalizing on AI opportunities.

Our new index targets however still imply a below-historical average return potential for most regions, in the low to mid-single-digits (see Chart 6). This is in line with our expectations of rather meagre 2024 and only slightly better 2025 earnings growth prospects.

Given its marked valuation discount we see further catch-up potential for the European equity market, which is our preferred "Value" region. China might still exert a substantial drag the Asian region as an uneven Chinese economic recovery is encountering a challenging capital market environment. Nonetheless, we are still positive on Japan and India. From a sectoral perspective, we continue to like Communication Services companies that have AI exposure as well as the Consumer Discretionary sector.

AI trade will broaden

For much of the last two years many recession indicators have been flashing red. The U.S. yield curve has been deeply inverted since July 2022 – the longest period on record. Also, the Conference Board's lead economic indicator has indicated a downturn for almost two years now. Consequently, the consensus forecast for a U.S. recession increased from 10% to 70% throughout 2022 and 2023 (see Chart 7). It has fallen to 35% since, but remains elevated in historical terms. Against this backdrop, it comes as no surprise that investors have in the recent past flocked to the largest of the large caps which are mature companies that are highly profitable, have superior returns on equity and a loyal client base that provides a comparably stable stream of earnings.

It is also possible to argue that the largest companies have suffered less from the rise in interest rates compared to small companies, due to their superior balance sheets and relatively smaller refinancing needs. Many of the biggest companies also have large cash reserves that yield attractive interest if parked in sight deposits. Some might therefore benefit from higher interest rates rather than being negatively impacted by higher borrowing costs.

Lastly, in the U.S. the largest companies have also been supported by growing interest in stocks that are exposed to artificial intelligence. These companies may be either directly involved in the AI value chain or own data that is highly valuable for AI training and that enables them to effectively use AI themselves.

So far, the AI trade has centred around companies that enable the technology by providing the infrastructure that is required to build and run AI. Key enablers include companies that design and produce semiconductors as well as other hardware, provide cloud services, run data centres, and create software. These companies are the easiest to identify as they sit at the beginning of the value chain and were amongst the first to report significantly higher earnings attributable to AI.

A group of international firms identified as key AI enablers has on average doubled in value since the launch of ChatGPT by OpenAI in November 2022. These gains were driven by both earnings upgrades and valuation expansion, but with contributions differing significantly between companies. For example, while companies providing servers and networking as well as chip foundries saw nearly no change in forward EPS estimates but significant valuation increases, memory chip producers and cloud providers have had earnings-backed rallies.

Clearly, being able to attribute to a firm's revenues or earnings to AI has been an essential decision-making criterion for investors.

This has been easier in some sectors than others. In Utilities, for example, potential benefits appear largely unpriced so far. The sector has been amongst the worst performing over the past two years (see Chart 8), although it is foreseeable that AI data centres will consume a lot of energy in the not-so-distant future. 20 GW of new electricity capacity globally may be needed for AI alone by 2028, equivalent of to 20 additional nuclear plants. Stock price sluggishness may imply that investors are sceptical that Utilities will be able to translate the additional demand for electricity into higher earnings given the strong regulation of the sector. Also, investors may stay away from Utilities due to the challenging macro backdrop.

We therefore think that the next phase of the AI trade should see the rallying of stocks of firms that have successfully adopted AI and can "show" AI-related earnings. The first to achieve this should be companies that can incorporate AI into existing product offerings, such as software and IT service providers as well as cyber security and automation firms. Notably, many of these firms are also enablers as they provide other companies with access to AI and thereby enable them to use the technology. Some of these firms are also infrastructure providers as they are active in multiple business areas. For these companies the AI trade has already begun.

The third phase of the AI trade will focus on companies that embrace AI to enhance labour productivity and ultimately make them more profitable. These firms will come from almost all industries, with those having large exposure to AI and also high labour costs the most likely to benefit. Academic research has identified finance and insurance, professional & business services, education services and real estate as the most exposed sectors. By contrast, transportation & warehousing, retail trade, accommodation, construction, and arts & entertainment are the least exposed. Put differently, these companies have the most (least) potential to become more productive by applying AI. Squaring sector exposure with labour costs shows that the Russell 1000 industries of Software & Services, Commercial & Professional Services, Banks, Insurance, and Financial Services have the highest earnings potential from AI adoption via cost reduction, as part of becoming more productive. Many of these companies have already mentioned AI application plans in the context of cost reductions or productivity enhancements during recent earnings calls.

As valuations of some of the "phase 1" stocks appear more and more stretched, we think investors should start screening for interesting phase 2 and potentially even phase 3 names. Opportunities are plentiful as many of these companies have not seen any AI effect to their stock prices yet. Ultimately, market breadth may also benefit from a broadening of the AI trade.

Q1 2024 earnings season preview

The Q1 2024 earnings season in the U.S. is about to kick off with some prominent names from the banking space due to report their results on Friday. It appears that an apparent general acceleration in global economic momentum in Q1 might result in better-than-expected earnings delivery in the U.S., and less bad earnings than feared in Europe (see Chart 9), especially since hurdle rates in both regions have come down noticeably year-to-date.

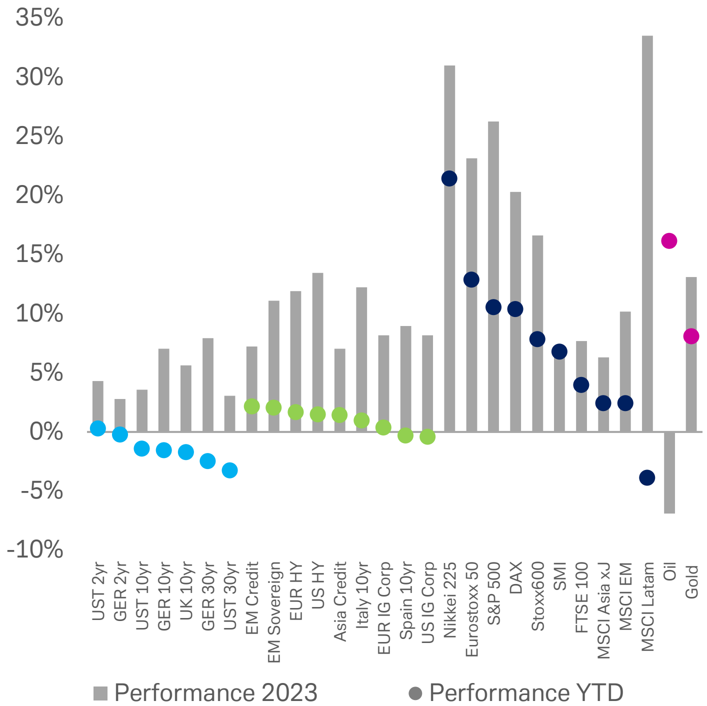
Overall, companies have been pessimistic on their Q1 guidance, compared to recent and historical levels, predominantly due to some tough comparables, softening pricing indicators and a lack of visibility concerning the consumer outlook. We note that the material differences in S&P 500 vs. STOXX Europe 600 YoY top- and bottom-line growth expectations largely reflect the divergence in absolute U.S. vs. Eurozone economic activity levels. While momentum in the Eurozone has picked up notably in Q1, the Eurozone Composite PMI is still significantly lagging its U.S. and UK equivalents.

Consensus forecasts are currently pointing to a +5% YoY increase of S&P 500 earnings in Q1 2024 on +3% higher revenues – this would mark the third consecutive quarter of positive aggregate earnings growth for the index. Since the beginning of the year the Q1 earnings growth forecast has been cut by 2.1ppt with Materials (-12ppt), Energy (-9ppt) and Industrials (-7ppt) having seen the strongest downward revisions. Seven out of eleven sectors are expected to deliver positive YoY earnings growth figures for Q1 2024. While Communication Services (+27%) and IT (+21%) are forecast to experience the strongest YoY increases of Q1 earnings, Energy (-25%) and Materials (-24%) are expected to take the lead in terms of YoY earnings declines (see Chart 10).

Looking at Europe, the STOXX Europe 600 earnings forecast for Q1 2024 has even been trimmed down by 4.7ppt YTD and now suggests an earnings decline of -11% YoY (the fourth consecutive quarter of negative YoY earnings growth) with Consumer Staples (-15ppt) and IT (-11ppt) EPS forecasts having seen the strongest reductions. On a YoY basis Utilities (-42%), Materials (-29%), Energy (-24%), Real Estate (-20%), Industrials (-18%) and IT (-15%) earnings are expected to see a double-digit declines, while only Consumer Staples (+3%) should report positive earnings growth in Q1 (see Chart 11). Q1 2024 revenues of the STOXX Europe 600 are expected to decline by -6% YoY.

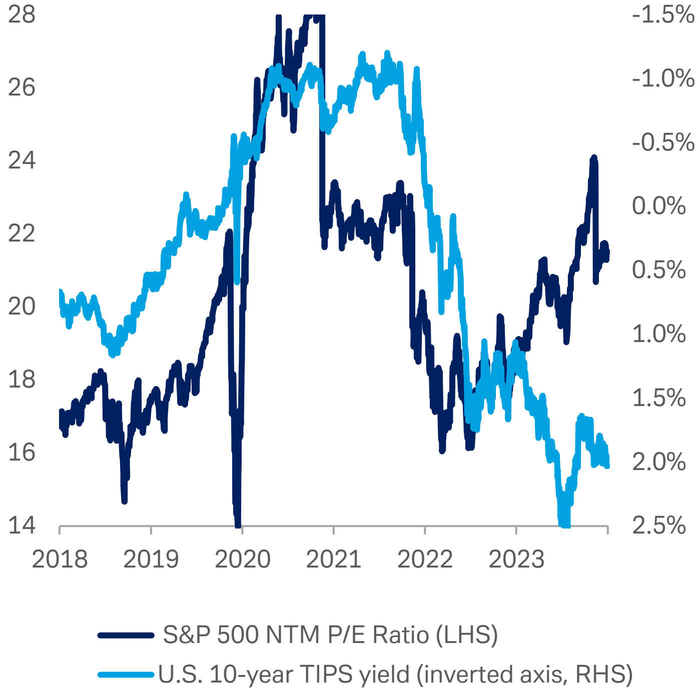
On a full-year basis, consensus earnings growth estimates have also slightly come down over the past three months, now indicating that aggregate FY 2024 earnings per share (EPS) will come in at +10% (S&P 500) and +5% (STOXX Europe 600) YoY. It is worth mentioning, however that – while still negative in Europe – NTM (next twelve months) net earnings revision ratios have started to improve most recently on both sides of the pond indicating that the downward revision trend is at least slowing (see Chart 12). Nonetheless, we emphasize that corporate profitability in many segments of the market is likely to be under pressure over the next couple of quarters, before the positive effect that was driven by COVID-related distortions is fully unwound, especially since the vast majority of corporates are facing tough comparables with approximately three-quarters of companies still having higher profit margins than before the pandemic. Risks to both pricing and to volumes are looming.

Chart 1: Multi-Asset Performance



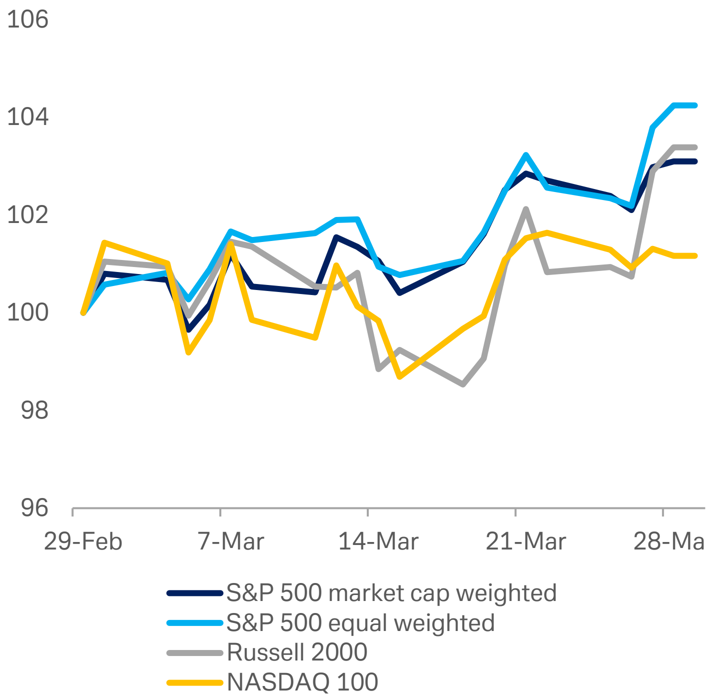
Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of April 9, 2024.

Chart 2: S&P 500 NTM P/E ratio and 10-year U.S. real rate



Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of April 9, 2024.

Chart 3: March Performance – broadening of the rally

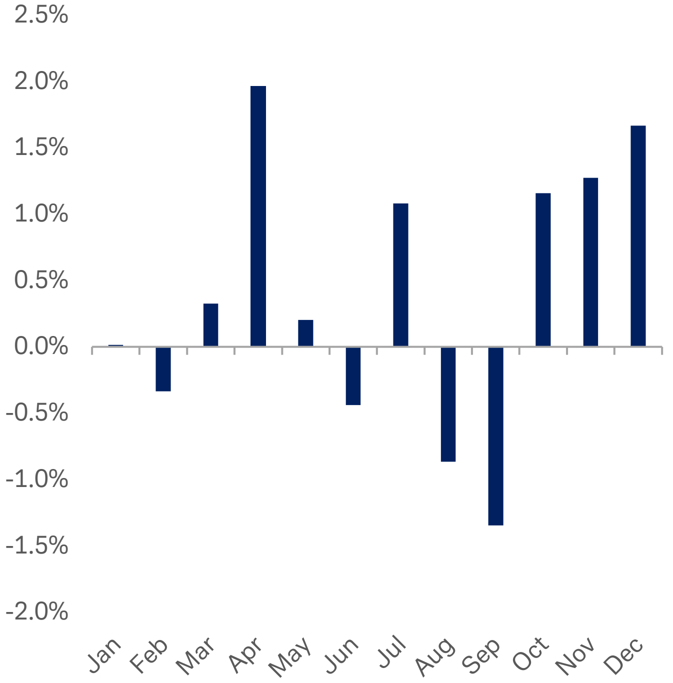


Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of April 9, 2024.

Chart 4: U.S. vs. Eurozone CESI

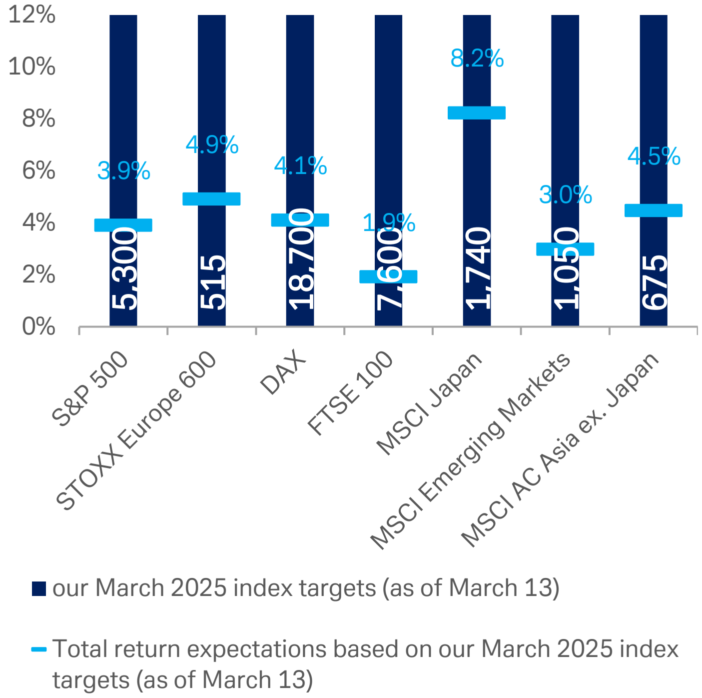
Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of April 9, 2024.

Chart 5: : Average performance MSCI ACWI (1990-2023)



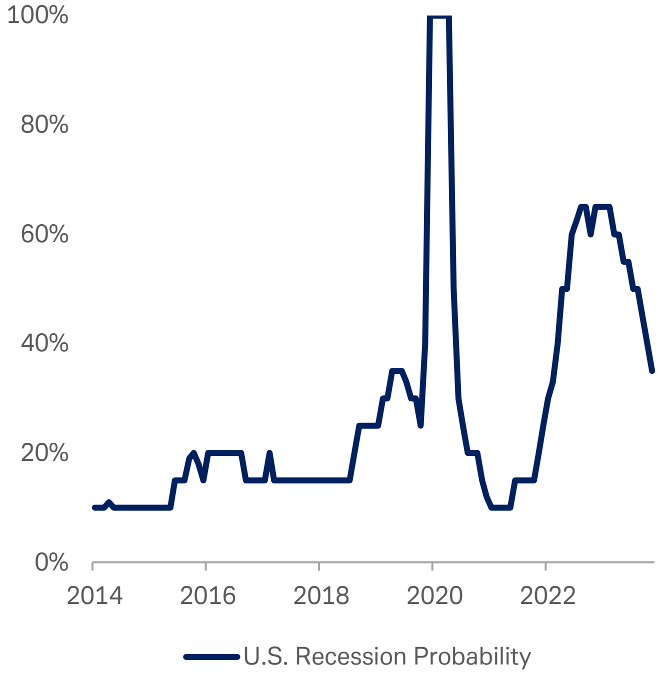
Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of April 9, 2024.

Chart 6: Our March 2025 Index targets



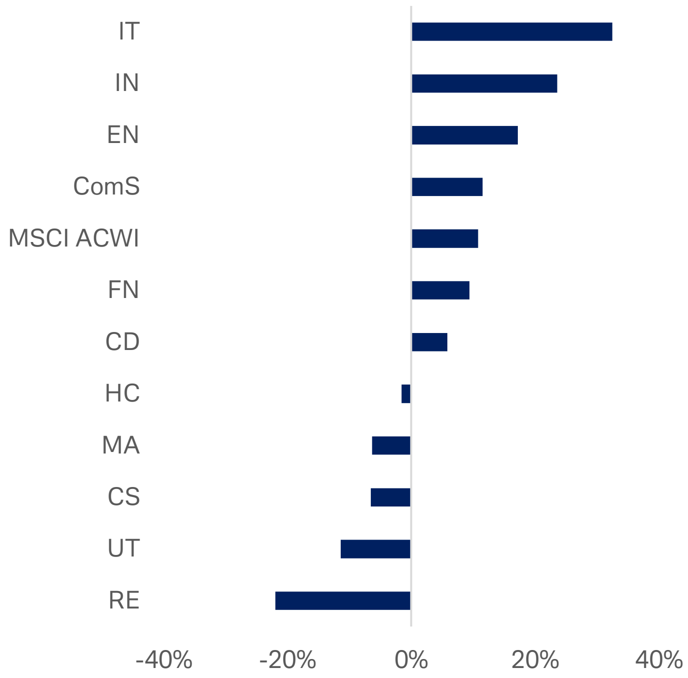
Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of March 13, 2024.

Chart 7: U.S. recession probability



Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of April 9, 2024.

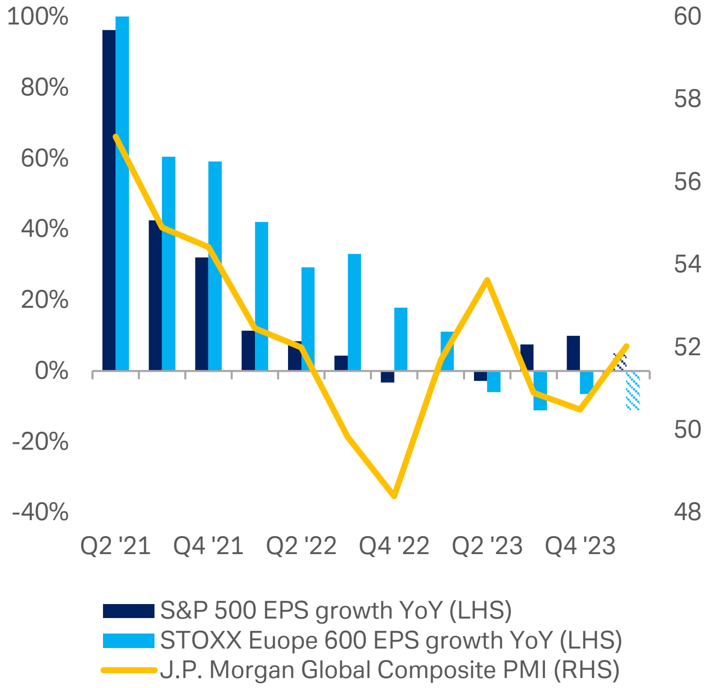
Chart 8: MSCI ACWI 2-year sector performance



Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of April 9, 2024.

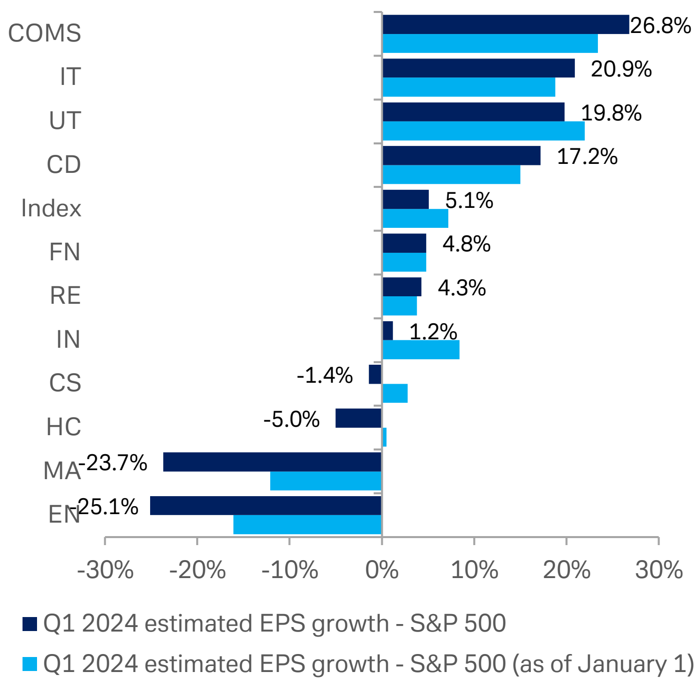
Notes: CD = Consumer Discretionary, ComS = Communication Services, CS = Consumer Staples, EN = Energy, FN = Financials, HC = Healthcare, IN = Industrials, IT = Information Technology, MA = Materials, RE = Real Estate, UT = Utilities

Chart 9: Global Composite PMI and quarterly EPS growth YoY



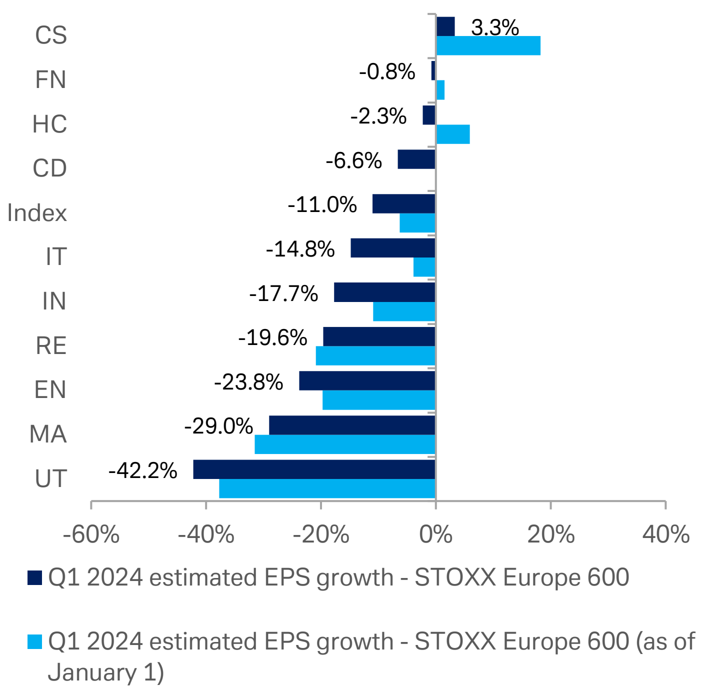
Source: LSEG Refinitiv, Bloomberg Finance L.P., Deutsche Bank AG. Data as of April 9, 2024.

Chart 10: Q1 2024 EPS growth – S&P 500



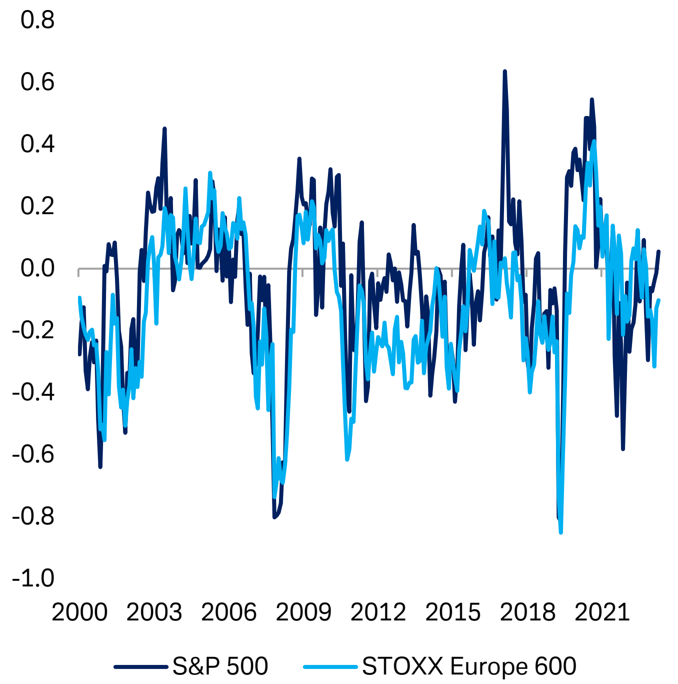
Source: LSEG Refinitiv, Deutsche Bank AG. Data as of April 3, 2024.

Chart 11: Q1 2024 EPS growth – STOXX Europe 600



Source: LSEG Refinitiv, Deutsche Bank AG. Data as of April 3, 2024.

Chart 12: NTM net earnings revision ratio



Source: LSEG Refinitiv Datastream, Deutsche Bank AG. Data as of April 9, 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 Citigroup Economic Surprise Index (CESI) represents the sum of the difference between official economic results and forecasts.

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.

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 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.

Quarter-to-date (QTD).

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

The Russell 1000 Index measures the performance of the large-cap segment of the US equity universe including approximately 1,000 of the largest securities based on a combination of their market cap and current index membership.

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

Glossary

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

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).

A yield curve is a line that plots yields, or interest rates, of bonds that have equal credit quality but differing maturity dates.

Appendix

Performance	9.4.2019 - 9.4.2020	9.4.2020 - 9.4.2021	9.4.2021 - 9.4.2022	9.4.2022 - 9.4.2023	9.4.2023 - 9.4.2024
2-year U.S. Treasuries	5.5%	0.3%	-3.4%	0.7%	2.6%
10-year U.S. Treasuries	16.7%	-5.2%	-7.4%	-2.0%	-3.7%
30-year U.S. Treasuries	35.4%	-15.1%	-7.7%	-10.5%	-10.1%
2-year Bunds	-0.7%	-0.7%	-1.8%	-2.7%	1.7%
10-year Bunds	2.1%	-0.2%	-7.9%	-9.4%	0.4%
10-year Gilts	7.4%	-3.3%	-6.0%	-9.2%	-0.7%
10-year BTPs	7.8%	8.8%	-9.4%	-7.8%	6.1%
10-year Spanish Government Bonds	2.2%	4.8%	-8.1%	-8.8%	3.7%
EUR IG Corp	-2.3%	7.7%	-6.6%	-6.2%	5.6%
EUR HY	-7.4%	18.1%	-3.7%	-4.2%	10.6%
U.S. IG Corp	7.6%	6.2%	-7.1%	-2.5%	2.5%
U.S. HY	-4.6%	20.8%	-2.8%	-1.8%	10.6%
Asia Credit	2.7%	8.9%	-8.3%	-0.9%	4.1%
EM Credit	-0.5%	15.3%	-10.5%	-1.7%	6.6%
EM Sovereign	-5.7%	15.3%	-10.1%	-4.7%	10.3%
S&P 500	-3.1%	48.0%	8.7%	-8.5%	26.7%
DAX	-10.9%	44.2%	-6.2%	9.2%	16.7%
Eurostoxx 50	-15.3%	37.5%	-3.0%	11.7%	16.4%
STOXX Europe 600	-14.0%	31.8%	5.4%	-0.4%	10.6%
Nikkei 225	-11.3%	53.9%	-9.3%	2.0%	44.5%
SMI	-1.4%	18.9%	11.3%	-10.2%	2.9%
FTSE 100	-21.3%	18.4%	10.9%	0.9%	2.8%
MSCI EM	-18.8%	49.9%	-15.2%	-12.5%	6.3%
MSCI Asia ex Japan	-15.1%	50.5%	-18.2%	-10.1%	2.2%
MSCI LatAm	-40.4%	38.3%	12.5%	-17.6%	18.3%
Russell 2000	-20.1%	79.9%	-11.1%	-12.0%	18.2%
NASDAQ 100	8.9%	68.1%	3.5%	-8.8%	38.6%
MSCI ACWI Energy	-42.3%	28.8%	40.4%	2.2%	14.7%
MSCI ACWI Financials	-21.3%	46.1%	4.8%	-11.6%	23.8%
MSCI Word Industrials	-16.7%	56.0%	-6.1%	-1.5%	25.4%
MSCI ACWI Communication Services	-5.9%	55.8%	-13.4%	-13.8%	29.4%
MSCI ACWI Consumer Staples	-3.4%	18.6%	6.0%	-2.6%	-4.0%
MSCI ACWI Consumer Discrettionary	-9.6%	71.8%	-12.6%	-12.0%	20.2%
MSCI ACWI Utilities	-2.0%	14.0%	9.2%	-8.7%	-3.0%
MSCI ACWI Information Technology	8.4%	71.3%	0.1%	-5.2%	39.7%
MSCI ACWI Materials	-19.3%	61.9%	4.2%	-13.4%	8.2%
MSCI ACWI Healthcare	4.7%	23.3%	14.0%	-6.2%	5.0%
Oil	-63.6%	58.4%	78.1%	-9.7%	12.8%
Gold	29.1%	3.6%	11.7%	3.1%	17.7%

Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of April 9, 2024.

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