CIO Viewpoint
Equity

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Authors:
Ivo Višić
Senior Investment Officer

Lorenz Vignold-Majal
Investment Strategist

A look beyond the usual suspects

Key takeaways

- April was a tougher month for equities but May has been positive so far. Reactions to positive Q1 earnings surprises have however been underwhelming on average.
- Valuations of European equities look less stretched than the U.S. market, and several reasons make it likely this will continue, even in the event of further market weakness.
- We stay optimistic on the DAX but point to the risks around market concentration and de-globalisation. The MDAX looks cheap but relative earnings need to turn.

April breather but May tailwinds

After a strong Q1 for most major equity markets where the S&P 500 had reached a new all-time high on the last trading day of March, April (contrary to what historical seasonality would suggest) then turned out to be a kind of positivity tipping point and a much tougher month for broader equities (see Chart 1) than we have become used to since the remarkable rally that had started last November.

Risk-off sentiment among investors was a distinct reaction to fears of a geopolitical escalation in the Middle East, as well as growing doubts to whether the Fed will be able to cut rates at all this year with the latter having been fuelled by a series of hawkish developments as stronger incoming U.S. data became increasingly hard to ignore – including some key economic activity and labour market figures. Most significantly, March U.S. CPI data revealed that core inflation was running for a third consecutive month at a monthly rate of +0.4%, so making it quite tricky to argue that January and February prints were just temporary blips. In response, investors priced out the probability of rate cuts with the total extent of cuts expected by the December meeting having slid from 67bps (2.7 cuts of 25 bps) at the start April to 28bps (1.1 cuts) by the end (see Chart 2). On top of that, mid-April comments from Fed Chair Powell indicated that the FOMC might take longer than initially assumed to become confident enough to make the first rate cut.

While this backdrop on the one hand helped safe-haven assets like gold and the USD, on the other hand it resulted in the biggest 10-year U.S. Treasury yields monthly increase since September 2022 (+48bps). The 2-year U.S. Treasury yield closed the month above 5% for the first time since November last year. The S&P 500 (-4.2%) as well as the STOXX Europe 600 (-1.5%) both lost ground after a streak of 5 consecutive monthly gains. Consequently, equity market volatility spiked to its highest levels this year as indicated by the VIX (see Chart 3). The small-cap Russell 2000 (-7.1%) had its worst monthly performance in 18 months. Even the Magnificent 7 (-2.3%) were not immune but outperformed the S&P 500 again, pointing to a still quite narrow market leadership. Emerging equity markets that had been lagging in Q1 held up better over April compared to other regions – the MSCI EM index was up +0.3% but with China (MSCI China: +6.4%) and Latin America (MSCI LatAm: -4.0%) showing quite divergent trajectories (see Chart 4). From a sector perspective, apart from Utilities (+1.0%) and Energy (+0.5%) all remaining GICS level 1 sectors within the MSCI ACWI moved lower in April, while in Q1 only Real Estate had been in the red (see Chart 5).

More recently, broader equities have enjoyed some fresh tailwinds in May (S&P 500: +3.5% MTD; STOXX Europe 600, DAX and FTSE 100 at new record highs) owing to an FOMC meeting that avoided any hawkish surprises, a softer-than-expected payrolls print that boosted hopes of a soft landing for the U.S. economy and hopes of fading geopolitical risks in the Middle East. Each contributed to a revival of market Fed rate cut fantasies, with yields experiencing the longest run of declines since August. It is worth mentioning, however, that a very solid Q1 2024 earnings delivery has not been able to meaningfully increase investors' risk appetite, given the range of still unsettling broader issues as well as the material downward revisions and a strong equities run that characterised the leadup to the earnings season. As illustrated in Charts 6 and 7, individual S&P 500 firms' stock price reaction has been underwhelming despite strong surprises on earnings – being on average negative on the day after the announcement of better-than-expected earnings data, while earnings "misses" have been penalised more severely than history would suggest on either side of the Atlantic.

There is no denying that valuations in the U.S. appear stretched as the S&P 500 equity risk premium is now lingering around levels last seen during the dot.com bubble (see Chart 8). But one might also argue that any further setbacks will likely be rather short-lived as long that the macro picture remains stable, and corporate earnings continue to grow. While the Q1 2024 earnings season has not been not able to act as a clear catalyst for broader equities, it certainly provided some arguments for an optimistic stance in terms of longer-term corporate earnings prospects – including announcements by big tech companies of new large-scale investments into datacentres which may underpin the scope of AI-induced productivity gains across the economy.

We would like to point out however that valuation levels of European equities appear less stretched compared to the U.S. market (see Chart 9) and are likely continue to see an improved relative risk-reward, even in the event of further market weakness, given that the spread between U.S. and European earnings growth is narrowing, consistent with the most recent rollover in their relative PMI momentum. In April the Eurozone Composite PMI reached an 11-month high and moved above its U.S. equivalent for the first time since April 2023 (see Chart 10). All the same, there is an increasing likelihood that the ECB will start cutting rates ahead of the Fed this time around, and by a greater cumulative magnitude. Last but not least, the rather downbeat Chinese equity market and China's mixed economic performance since January 2023 has been a bigger relative drag for European than U.S. equities. An improving China picture would be expected to help the Europe vs. the U.S. trade.

DAX still attractive despite recent rally

The German DAX is now up 22.3% since the beginning of Q4 2023, beating the STOXX Europe 600 Index by almost 7ppts. Notably, the DAX has managed to outperform despite experiencing larger earnings per share (EPS) downgrades than the broad European stock market. Only recently have relative EPS inflected again in the DAX's favour.

Consensus expects aggregate DAX EPS to grow only 1.5% this year. However, it foresees an acceleration in the following two years. The projected growth rates of 12% for 2025 and 11% for 2026 EPS are amongst the highest in Europe. Whether the DAX will manage to meet consensus expectations strongly depends on the delivery of its three largest EPS contributors. Consumer Discretionary (which is dominated by automobile companies), Financials and Industrials are expected to contribute two thirds of the index's aggregate earnings in 2024 and 2025 alone. These sectors make up half of the DAX's market cap.

Of the trio, Consumer Discretionary is the "problem child" currently. Analysts project EPS of the sector to decline -6% in 2024 before recovering by 9% next year. Put differently, they essentially forecast EPS to remain flat over the aggregate two-year span. Hence, Financials and Industrials need to step in and do the heavy lifting. They seem up to the task: Financials are projected to grow their EPS by 12% in 2024 and 11% in 2025. This looks achievable as high yields should continue to support net interest income. Meanwhile, expectations are significantly higher for the Industrials sector which is expected to grow EPS at rates of 21% and 17% respectively. Although German industrials are key players in fields such as automation, electrification, digitalization, intelligent infrastructure, defence, and aviation, and therefore less sensitive to the manufacturing cycle than their peers, they are certainly not immune to any significant slowing of global growth. However, they have proven their ability to generate high earnings growth over the last couple of years and should be able to sustain this in the current economic environment.

Therefore, we remain optimistic about the DAX earnings outlook. An improvement of the economic situation should also trigger meaningful EPS contributions from the Materials sector which we expect to see its earnings to rebound over the course of the year as customers start building up inventories again.

Hence, we see a good chance for earnings growth to exceed the current consensus of 1.5% in 2024. However, the 2025/2026 estimates of 12%/11% seem a touch too optimistic to us. Fortunately, valuations have room to expand further over coming months as investors become more confident about the state of the global economy and central banks start cutting rates.

Although the DAX has re-rated from depressed levels during the valuation-driven rally over the last few months, it is far from being expensive. The NTM P/E (next twelve months price/earnings) ratio of 12.7x is slightly below its 10-year median P/E (see Chart 11). The current NTM P/B (price/book) ratio sits at 1.6x which is in line with the 10-year median level.

Most DAX members are also still trading at discounts to history on P/E basis. Only 13 companies are trading at or above 10-year average levels of which only five are trading at premiums that exceed one standard deviation. By contrast, 9 companies are trading at least one standard deviation below their 10-year average P/Es. Compared to the STOXX Europe 600, the DAX trades at a NTM P/E discount of 11% which is in line with the 10-year median. However, measured against the S&P 500 the current discount of almost 40% is significantly larger than the median discount of 26% (see Chart 12). Indeed, compared to the U.S. index the DAX has only been cheaper on 9% of all trading days since 2014.

Meanwhile, the current equity risk premium (the difference between the inverse P/E ratio and the 10-year Bund yield) of 5.4% is 1.7ppts lower than the median since 2014 of 7.1% (see Chart 13). It has only been smaller during 1% of all trading days over the last 10 years. However, the theoretical risk compensation that investors receive for investing in the DAX seems still attractive compared to an equivalent of less than 1% in the U.S.

While we remain optimistic on the DAX, we point to some risks to our view. One is the high return concentration that has characterized the index's recent rally. So far this year the DAX's performance can largely be attributed to seven stocks which contributed almost 80% of the DAX's total advance. Similarly, over the last 12 months, the five largest contributors added almost 76%. As such the DAX has had its own "poor man's version" of the "Magnificent 7". Seeing more companies contributing positively to the index rally would certainly make us feel more comfortable.

A second, more structural, risk factor for the DAX is the slow process of de-globalisation. Given the international orientation of German businesses, the DAX naturally benefits from increasing global trade. Researchers have calculated the beta of DAX returns to global trade growth at 1.9. This is the second highest beta in Europe behind OMX Nordics (2.0) and a higher gearing than for the Euro STOXX 50 (1.6) and the S&P 500 (1.4). As such, a structural decline of world trade due to reshoring developments or another escalation of trade disputes between the U.S. and China would hurt the DAX disproportionally more than other indices.

MDAX needs relative earnings need to turn

In the foreseeable future we might see a comeback of the German mid-caps, which used to be the better choice compared to their large cap counterparts for many years but have underperformed for a couple of years now.

Between 2009 and 2020 the mid-cap index MDAX beat its large-cap counterpart in 10 out of 12 years. And in the other 2 years, it lagged the DAX by only tiny margins in 2014 and 2016. The accumulated outperformance of the MDAX over the DAX was 330ppts between 2009 and 2020 (see Chart 14).

Since then, however, the MDAX has consistently underperformed the DAX – by -1.7ppts in 2021, by -16ppts in 2022, and by -12ppts in 2023. So far this year the MDAX trails by -13ppts. The underperformance of small and mid-caps (smid) indices compared to blue chips can also be observed in the overall European market, but has been particularly marked in Germany.

We think multiple factors are to blame. Firstly, while being amongst the most internationally-exposed European smid cap indices, MDAX companies still generate 33% of their revenues in the domestic market. This is almost twice as much exposure as the DAX's 18%. As a result, the MDAX has been significantly more affected by the weakness of the German economy in recent years and structural challenges including high energy prices and the lack of skilled labour. MDAX companies are also more exposed to ailing Europe (53% incl. Germany vs. 39% for the DAX) and can benefit less from the robust U.S. economy (20% vs. 26%).

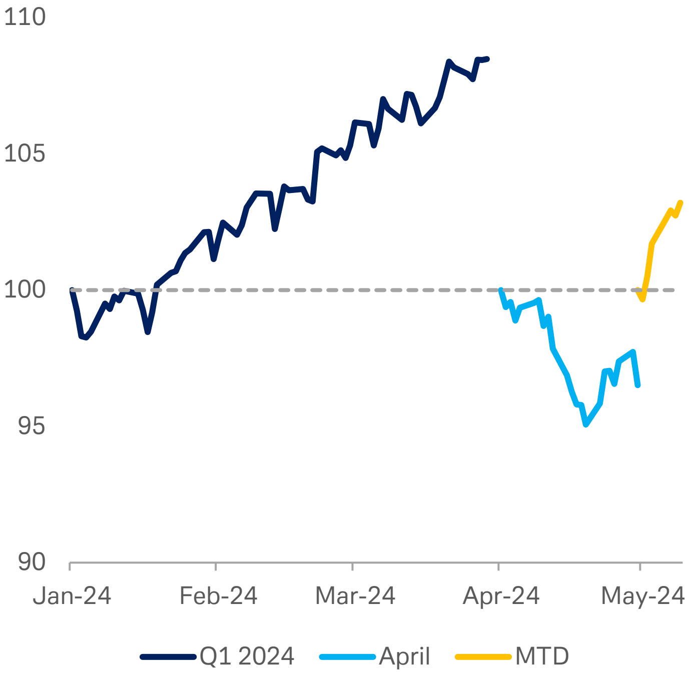
These dependencies are partly responsible for the earnings of German blue chips outgrowing those of their mid cap peers in recent years. Since mid-2022 analysts have raised their forecasts for DAX NTM EPS by 20% and lowered their forecasts for MDAX earnings by 11%. This is a decisive break from the previous long-term trend that had supported the MDAX's outperformance between the global financial crisis and the COVID-19 pandemic. From their trough in August 2009, mid caps' EPS grew by almost 300%, while DAX EPS increased only by 120%.

If that were not enough, mid caps have also been hit harder by monetary tightening due to their relatively higher level of leverage. The net debt to EBITDA ratio stands at 3.5 for the MDAX and at 1.5 for the DAX. Meanwhile, the market has adjusted its valuations to the new interest rate environment. Indeed, the MDAX NTM P/E ratio has declined from peak levels of 42x in 2020 to around 16x now, with 10-year Bund yields rising from -0.5% to +2.5% over the same period. Relative valuations have also followed the same trajectory. The 24% premium for German mid-caps over their blue chip counterparts is below the 10-year median level of 34% (see Chart 15).

The MDAX looks also cheap compared to its own history. The current NTM P/E ratio is over 6% lower than the 10-year median. On NTM P/B the discount widens to 27%. Digging deeper below the MDAX surface reveals a wide spectrum of valuations on a company basis. Nevertheless, most companies are trading at depressed levels compared to history. 29 of 39 companies that have a sufficiently long time series of earnings are currently trading at or below their 10-year average P/E levels. 10 companies are trading above their average levels, but only for 6 companies do current valuations exceed the 10-year average by more than one standard deviation.

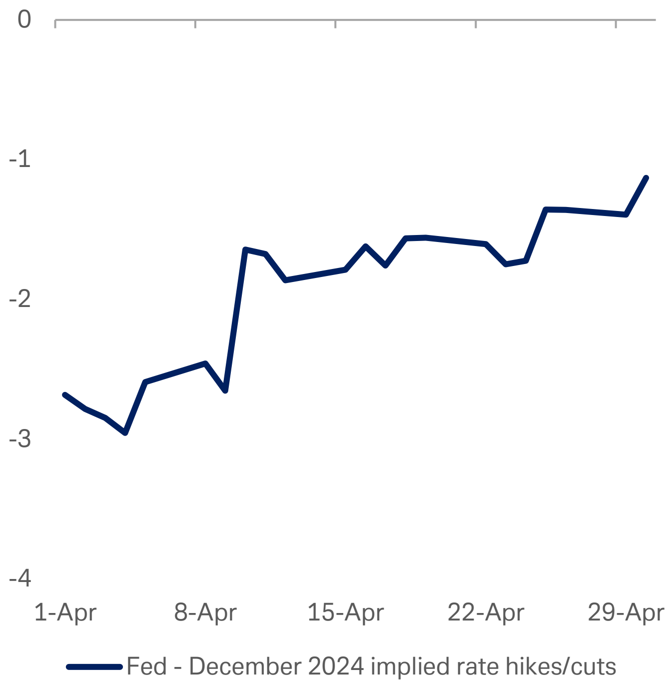
Looking forward, we think that German mid-caps could trough over the next couple of months. If relative earnings turn, stock prices should follow according to the historical playbook (see Chart 16). Moreover, the MDAX has de-rated considerately and looks cheap on many metrics which should provide the basis for a recovery, especially once the economic cycle accelerates in earnest and the German economy heals. First interest rate cuts by the ECB should also support the index.

Chart 1: MSCI World performance



Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of May 10, 2024.

Chart 2: Fed rate hike/cut expectations

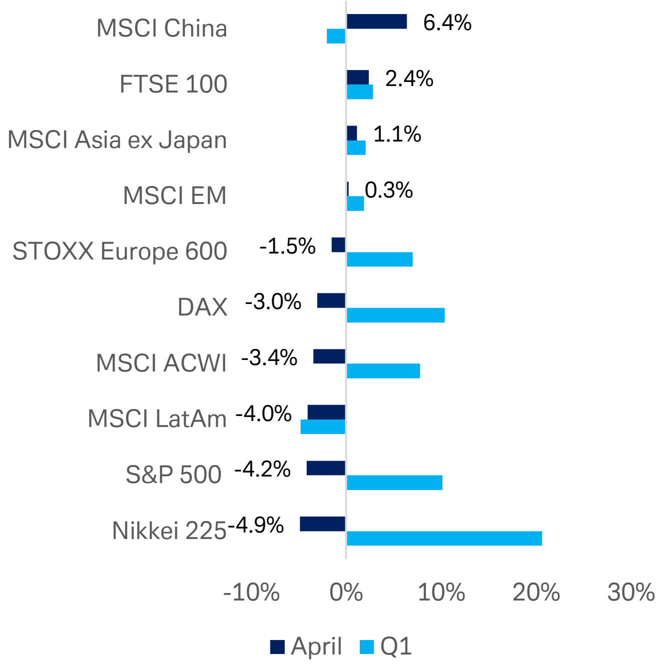


Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of May 10, 2024.

Chart 3: Cboe VIX Index

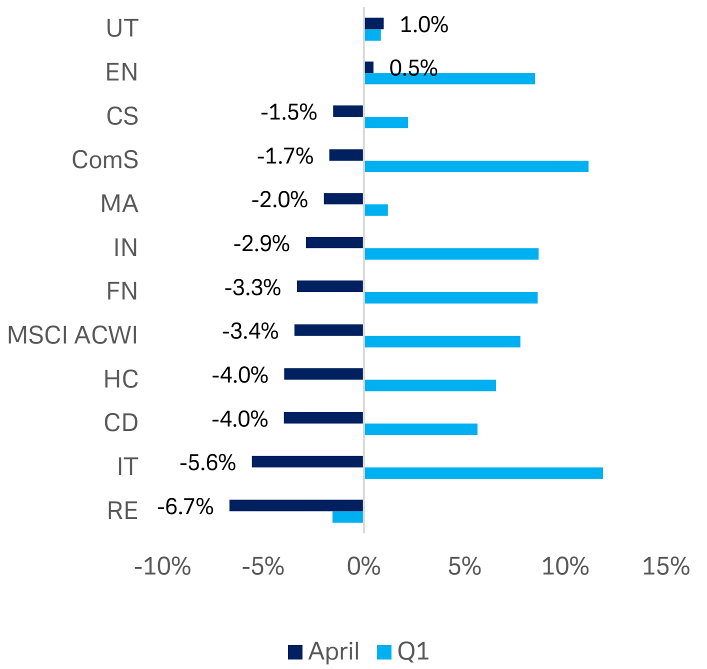
Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of May 10, 2024.

Chart 4: Regional performance



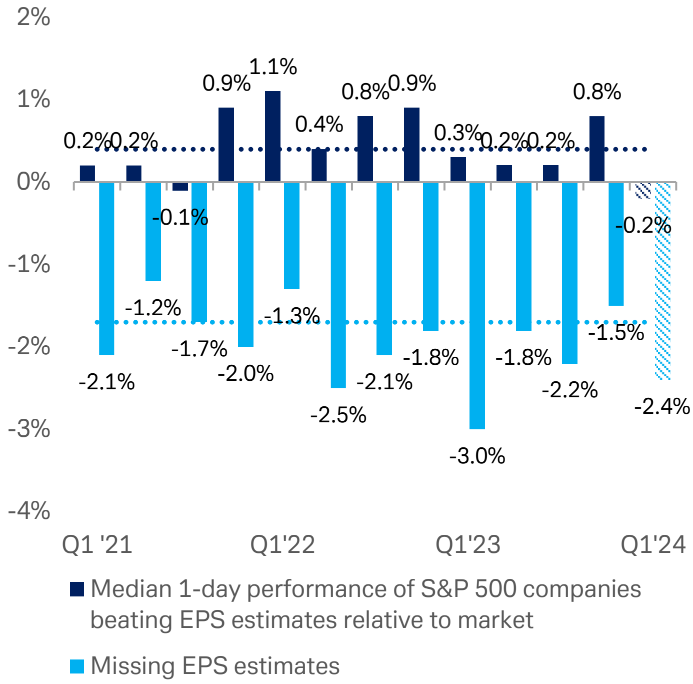
Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of May 10, 2024.

Chart 5: Sectoral performance – MSCI ACWI



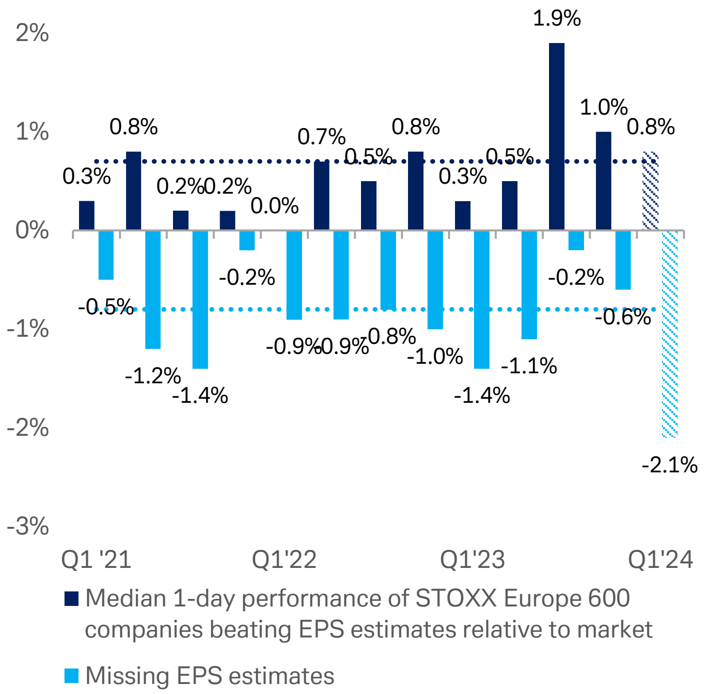
Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of May 10, 2024.

Chart 6: Stock price reaction on EPS beats/misses S&P 500



Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of May 10, 2024.

Chart 7: Stock price reaction on EPS beats/misses STOXX Europe 600



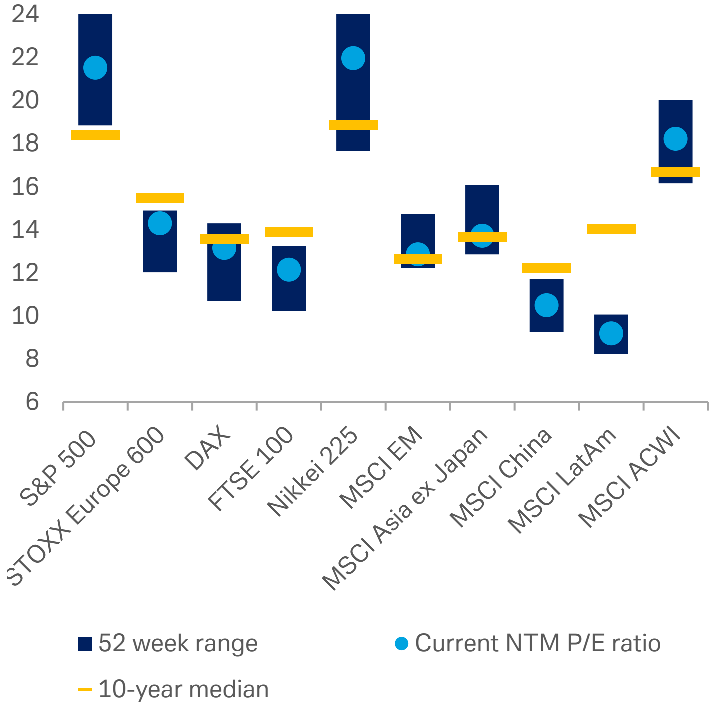
Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of May 10, 2024.

Chart 8: Equity risk premium – S&P 500

Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of May 10, 2024.

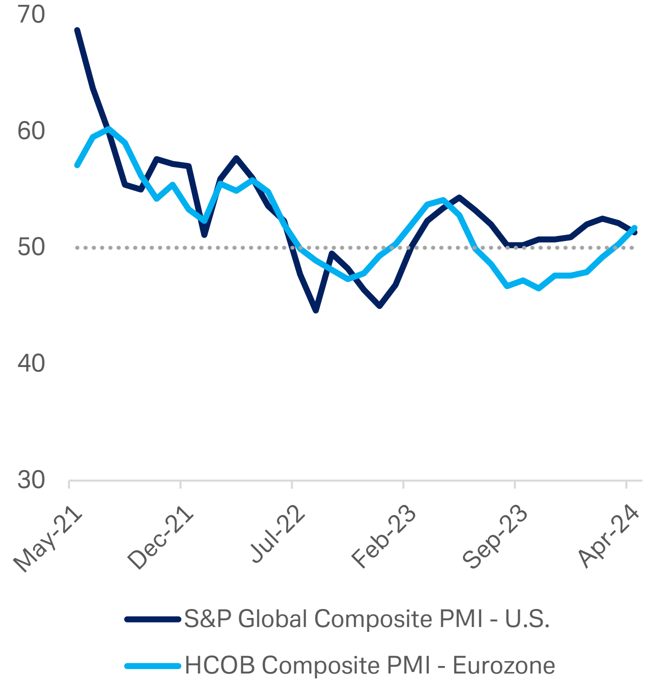
Notes: CD = Consumer Discretionary, ComS = Communication Services, CS = Consumer Staples, EN = Energy, FN = Financials, HC = Healthcare, IN = Industrials, IT = Information Technology, MA = Materials, RE = Real Estate, UT = Utilities

Chart 9: Regional NTM price-earnings-ratios



Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of May 10, 2024.

Chart 10: U.S. vs. Eurozone Composite PMI

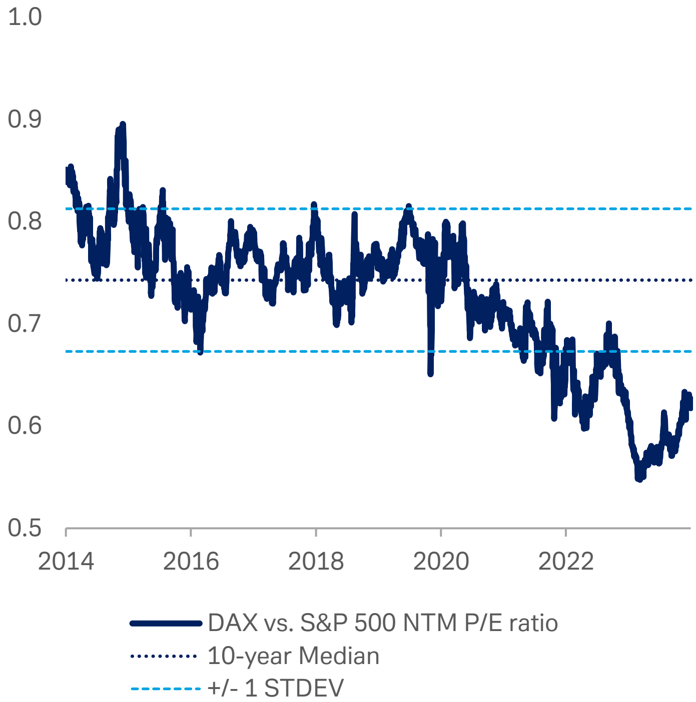


Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of May 10, 2024.

Chart 11: DAX NTM P/E-ratio

Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of May 10, 2024.

Chart 12: DAX vs. S&P 500 NTM P/E-ratio relative

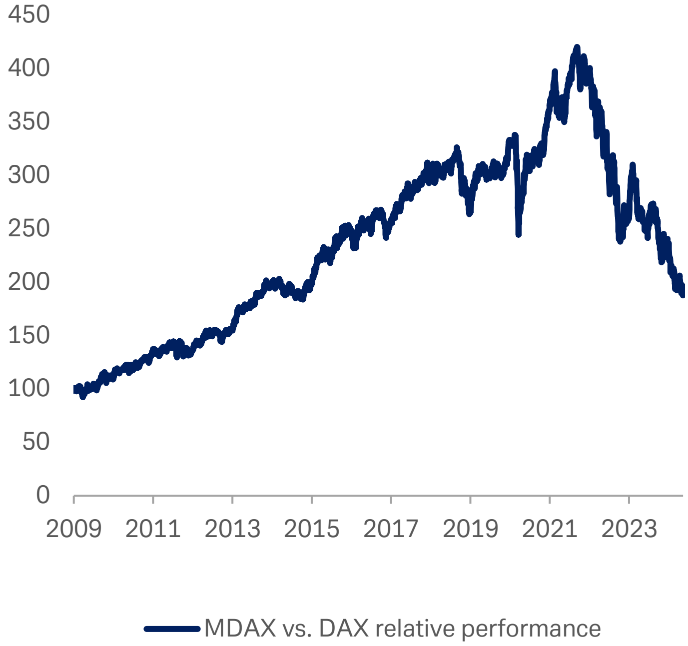


Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of May 10, 2024.

Chart 13: DAX equity risk premium

Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of May 10, 2024.

Chart 14: MDAX vs. DAX relative performance

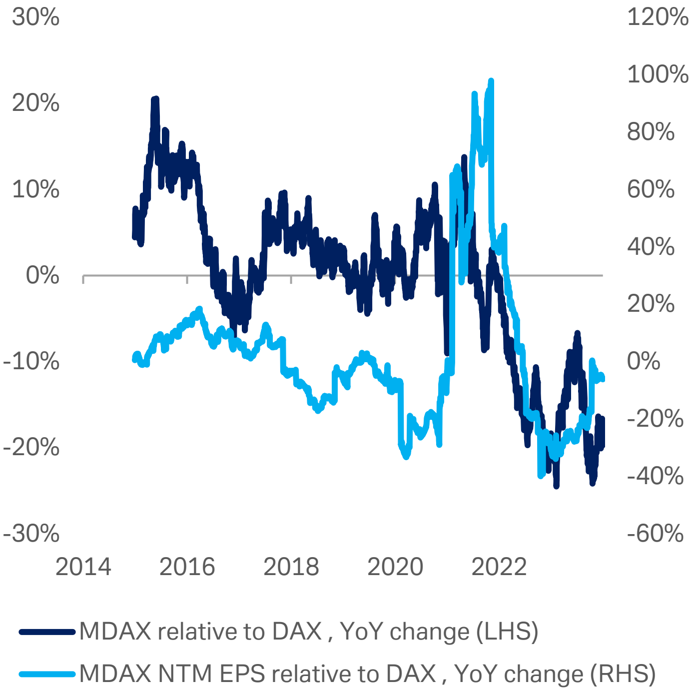


Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of May 10, 2024.

Chart 15: MDAX vs. DAX NTM P/E-ratio relative

Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of May 10, 2024.

Chart 16: MDAX vs. Dax relatives



Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of May 10, 2024.

Glossary

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

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 2000 Index measures the performance of the small-cap segment of the US equity universe including approximately 2,000 of the smallest 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).

Appendix

Performance	10.5.2019 - 10.5.2020	10.5.2020 - 10.5.2021	10.5.2021 - 10.5.2022	10.5.2022 - 10.5.2023	10.5.2023 - 10.5.2024
S&P 500	1.7%	43.0%	-4.5%	3.4%	26.0%
STOXX Europe 600	-9.6%	30.6%	-5.6%	10.3%	12.3%
MSCI ACWI	-4.1%	44.1%	-11.6%	4.5%	19.5%
FTSE 100	-17.6%	20.0%	1.7%	6.9%	8.8%
Nikkei 225	-5.5%	46.3%	-11.4%	11.3%	31.3%
DAX	-9.6%	41.2%	-12.1%	17.4%	18.4%
MSCI Asia ex Japan	-6.8%	45.5%	-26.7%	-1.8%	6.9%
MSCI EM	-11.8%	47.7%	-25.2%	-2.7%	8.6%
MSCI LatAm	-38.9%	55.6%	-14.5%	6.5%	8.1%
MSCI China	-0.2%	30.1%	-40.0%	0.1%	-3.8%
Bloomberg Magnificent 7	65.4%	85.7%	3.6%	13.2%	64.5%
Russell 2000	-15.5%	66.4%	-20.4%	-0.1%	17.9%
MDAX	-6.0%	35.4%	-13.6%	-2.4%	-1.9%
Euro Stoxx 50	-13.5%	38.3%	-11.6%	21.2%	18.1%
10-year U.S. Treasuries	16.6%	-5.1%	-9.6%	0.0%	-3.8%
10-year Bunds	3.2%	-2.3%	-9.4%	-7.9%	0.7%

Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of May 10, 2024.

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