Moderate growth and decreasing rates: the fundamentals support equities, which already rallied well

Authors

Luca Paolazzi

Economist and Advisor
Ceresio Investors

George Lee

Portfolio Manager,
Belgrave Capital
Management

ceresio investors

At a glance

- **The nervousness of the markets**, manifested by sharp swings in bond prices and swings in share prices, **reflects uncertainty** about the outcome of monetary tightening
- **Will it end in a US recession?** In reality, the ongoing slowdown in the US is deliberate and necessary to lower the temperature of prices
- **The US real wage bill is rising at a steady pace** due to less erosion of purchasing power from inflation. Even i**n Europe there are employment records** and unemployment is at its lowest level
- **The Eurozone is slowing down**, weighed down by manufacturing, and remains at the tail end of the global convoy, while in Asia, **India is hot on the heels of China**
- **Wage dynamics diverge:** it remains higher in Europe while falling in the US. Margins suffer from higher cost increases for inputs that outputs
- The value of equities on **Wall Street has risen much more than nominal GDP:** one of many signs of rich valuations of listed companies. However, the indices are dominated by the Magnificent 7, which continue to deliver stratospheric profits
- **The debate on US stock market valuations continues** and European stocks should not be trading at such a historical discount to the US

Financial markets are seeking the right temperature

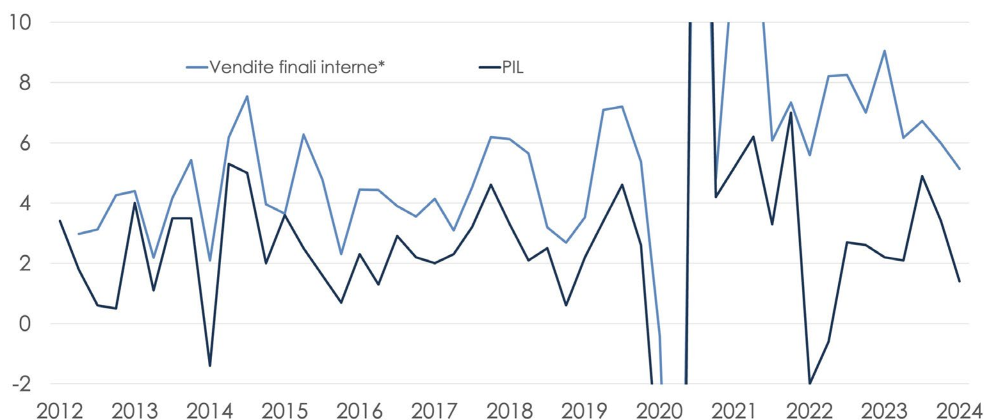
Too hot, too cold. The financial markets react to economic news about the US economy like a thermometer gone mad. A stronger-than-expected figure is immediately taken as a symptom of excessive effervescence; one below expectations worries as a sign of a coming recession.

The reason stems from the **conventional narrative** around the current phase of the business cycle and monetary policy. This narrative focuses on the effects of the interest rate hike, which is considered so drastic that it cannot fail to plunge the US into a fall in demand and production activity. And this is how the weaker-than-expected statistics are read. Whereas, somewhat schizophrenically with respect to this narrative, the fear of further hikes, or of a long postponement of cuts (i.e., in any case, of a monetary treatment with a stronger dosage), immediately revives the fears of an imminent sinking of growth.

In such a fluctuation, the present moment is on the **too cold side**: in June, the decline in consumer confidence, the rise in unemployment, the drop in consumer prices and the weakness of the ISM's order and production indicators were received as confirmation that there will be no happy ending to the ongoing monetary tightening story. But is this view correct?

In reality, we are facing the **desirable and desired slowdown**, with the labour market becoming less tight (much demand with little supply). Let us start with the leading indicator: **GDP**. The last change was 1.4 per cent annualised in the first quarter of 2024 over the previous one; and the current estimate for the recently ended second quarter is around 2.7%. **Final domestic sales** (i.e. GDP minus change in inventories and minus exports) give a more accurate, less volatile picture of the **strength of demand**, which is what counts. And it is a picture of a gradual slowdown towards pre-Covid dynamics (Chart 1).

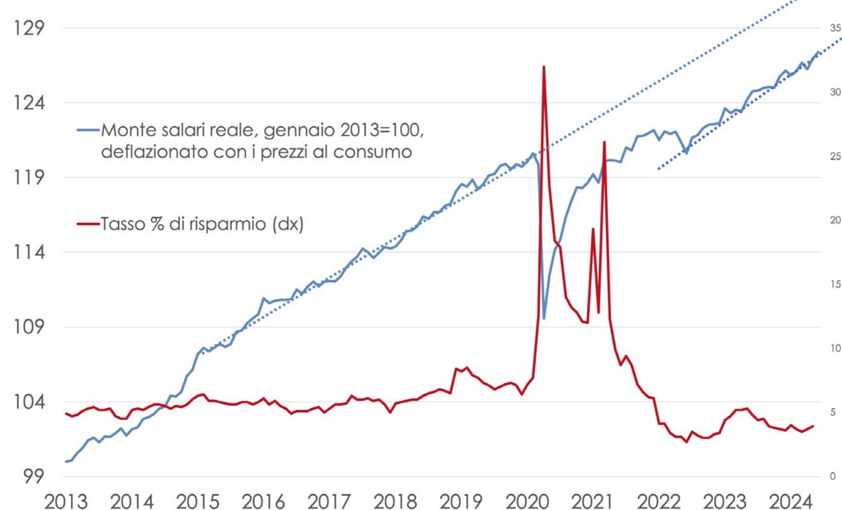
Chart 1 - U.S. growth still solid
(Var. % annualized, real destag. data)



* PIL meno scorte ed export
Fonte: elaborazioni REF Ricerche su dati US BEA

Another sign of robustness is in the **dynamics of real wages**, which continue to rise at a regular pace, albeit with monthly fluctuations, although the components are changing: lower increases in employment and hourly wages, constant weekly hours worked, lower inflation (Chart 2).

Chart 2 - In U.S. robust wages, savings less (Monthly data seasonally adjusted)

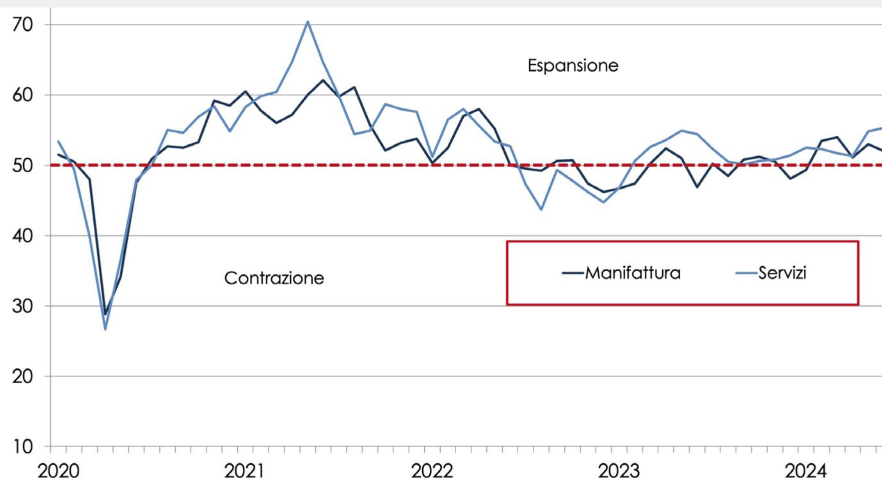


Fonte: elaborazioni REF Ricerche su dati US BLS, US BEA

This fuels **consumption**, which remains cautious on big ticket goods, often bought on debt and, even more so, postponed while waiting for better financial conditions when the promised rate cuts will occur. In the summer, families turn their purchases towards services, especially travel and holidays, according to the new post-pandemic order of preferences. All the more so as the **excess savings** accumulated during the hard weeks of lockdown are still plentiful and allow for thrift.

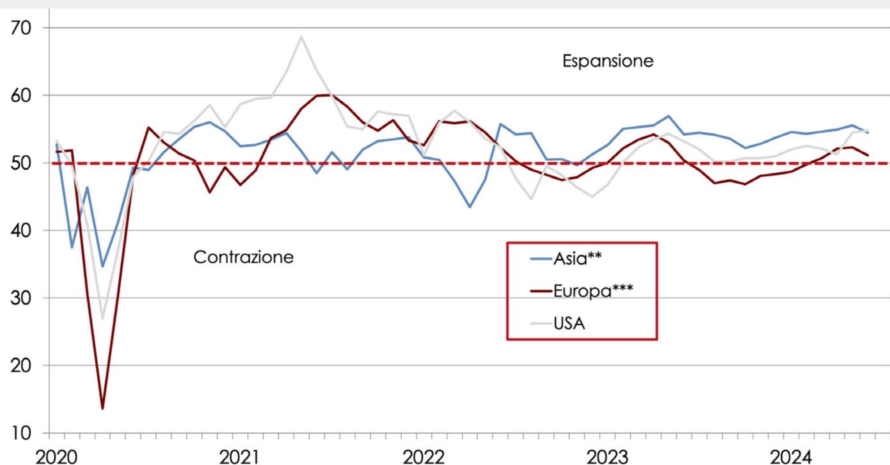
Finally, the **manufacturing and tertiary production** as measured by the PMI tells a very different story from the ISM. A much more positive, accelerating story, driven by services (the flipside of consumer preferences), and with manufacturing playing its part (Chart 3). In short, as Mark Twain would have said, reports of the death of the US recovery are exaggerated.

Chart 3 - In America services+manufacturing OK (SME output, >50=expansion)

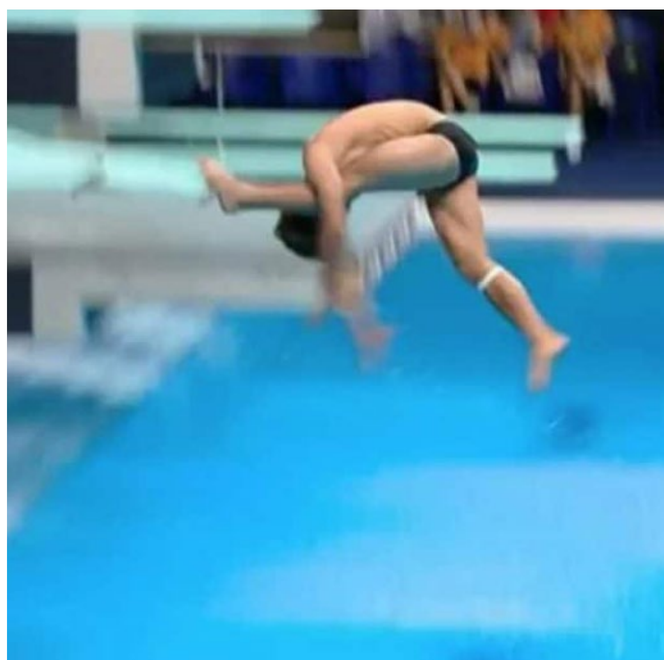


In the **Old Continent** (which is more and more an old continent), we are facing the repetition of a story that is not new. In fact, coming this side of the Atlantic we have to note a further worsening of Eurozone activity, which has its epicentre in the two main economies, a sort of cyclonic depression or, for Addams Family lovers, a storm cloud that guarantees bad weather. France and Germany continue to suffer from weak demand and production, only alternating between which is doing worse. And they end up pulling down the others, even if they record better data, and so the whole, such that the single currency economic system remains at the bottom of the global convoy (Chart 4).

Chart 4 - Europe bringing up the rear (Composite PMI*, output, >50=expansion)



The transmission of the braking impulses between the European countries is given by the production chains, especially those of the automotive industry, whereby the transition towards electrification proves to be what was already clearly apparent in 2019: a backwards triple pike into a pool that risks being drained by Chinese competition.
Instead, the Asian locomotive marches without stumbling. The most powerful expansionary impulses come from **India**, which has now become a real economic powerhouse, weighing more than twice as much as Japan and 40 per cent as much as China (and with a much higher growth rate than the latter). According to Indian companies, the demand for their products comes from the rest of Asia, Australia, Europe, Latin America, the Middle East and the United States: one would think that the subcontinent enclosed between the Indus and the Ganges is turning into the **world's new factory**, undermining the Chinese giant. That giant does not have feet of clay, as many believe, and is restarting precisely thanks to manufacturing, which boasts some technological firsts not only in electric vehicles (with solid evidence of the resetting to zero of the sector's past hierarchies and the risk of death for the most illustrious brands that have made automobile history) or in electronics and communication, but also in aerospace (it came first in the new race to the Moon).



Ruinous fall of a diver,
FINA World Championships Budapest 2022

Image of the Chang'E-4 mission (2019)
(Credit: CLEP/CNSA; NASA)

Inflation is falling at two speeds

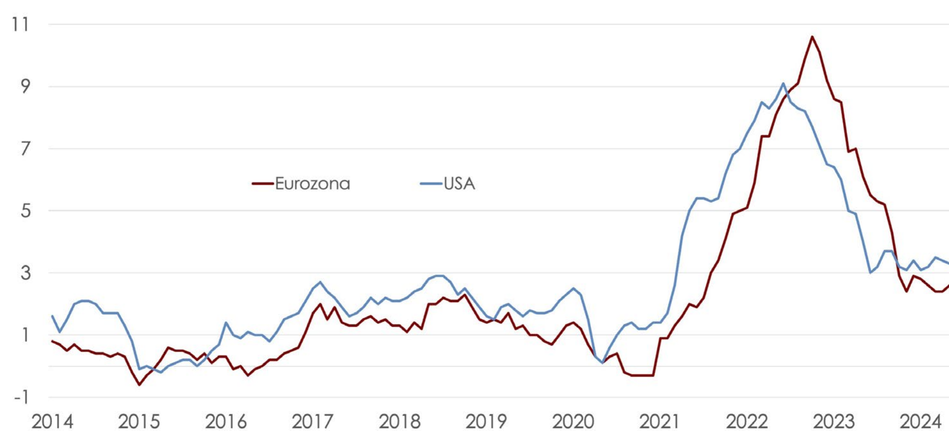
The **reversal of the inflationary flare-up** of 2021-22 is continuing, revealing that it was precisely a flare-up due to multiple and coincidental factors (bottlenecks in value chains, war with energy and food shocks, difficulties in restoring headcount after lockdowns), and not the beginning of a new spiral.

However, the return to normality has **three characteristics**: the era of the deflationary threat experienced from 2008 to 2019 has definitively ended; the pace of consumer price increases was first faster in the eurozone, now it is in the US; and margins, which had been expanding, are contracting.

Already in 2019, it was evident that some of the conditions for pushing towards **deflation** were no longer present, such as the shortage of jobs and the disposal of debts accumulated during the 2000-2007 credit bubble. The recent flare-up in prices served to acknowledge the **changed environment**. This means that, at least for a while, we will live in an environment of moderate cost-of-living increases.

The surge in the change in consumer prices was greater and faster in Europe than in the US, and equally faster and more intense was the cooling in the first phase (Chart 5).

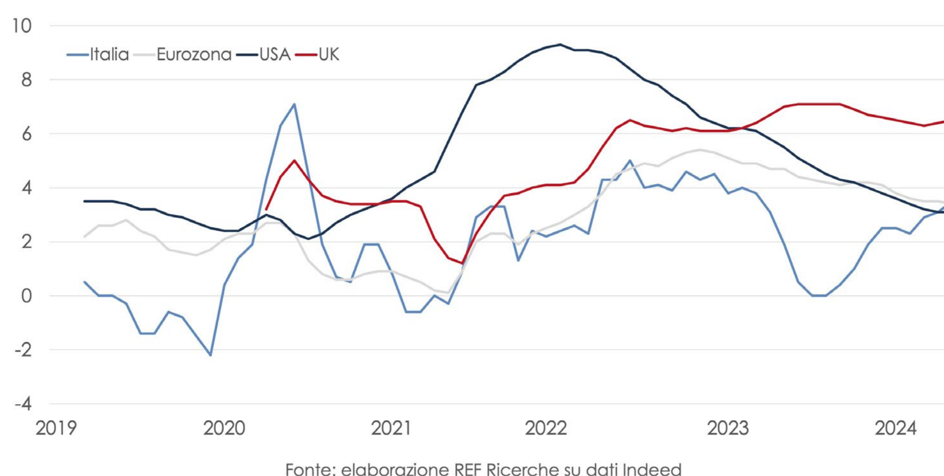
Chart 5 - Inflation, the U.S.-Eur gap.
(Annual % change in consumer prices)



Fonte: elaborazioni REF Ricerche su dai Eurostat, US BLS

Now, in the last mile towards the 2% target (which is conventionally taken as a synonym for monetary stability) the reverse is being observed: in the US consumer prices are calming down more rapidly than in the Eurozone. This inversion stems from the **wage-setting mechanisms**, labour costs being by far the most important component in the formation of service prices, which constitute the last pocket of resistance to current disinflation. And wages in the Eurozone, which had never risen as much as in America, are even accelerating, albeit slightly, while those in the US continue to decelerate (Chart 6).

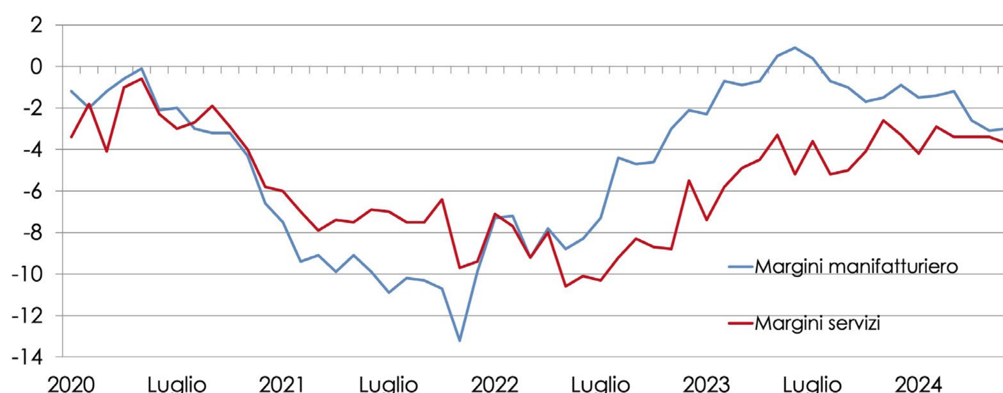
Chart 6 - The long echo of wages
(Wages offered, annual % change, 3-term moving average)



Fonte: elaborazione REF Ricerche su dati Indeed

Finally, **profit margins** had benefited from the more favourable demand conditions, when companies could easily pass cost increases on to customers and even skim off the top. Now that many costs have come down and markets have become less receptive, they have had to discount, or have preferred to trim margins rather than pass on the cost increases. Thus we observe globally a more widespread increase in input prices than in output prices, and thus a contraction of margins, albeit from very high levels (Chart 7).

Chart 7 - Margins are shrinking
(2020-24, global economy, PMI input and output prices*)



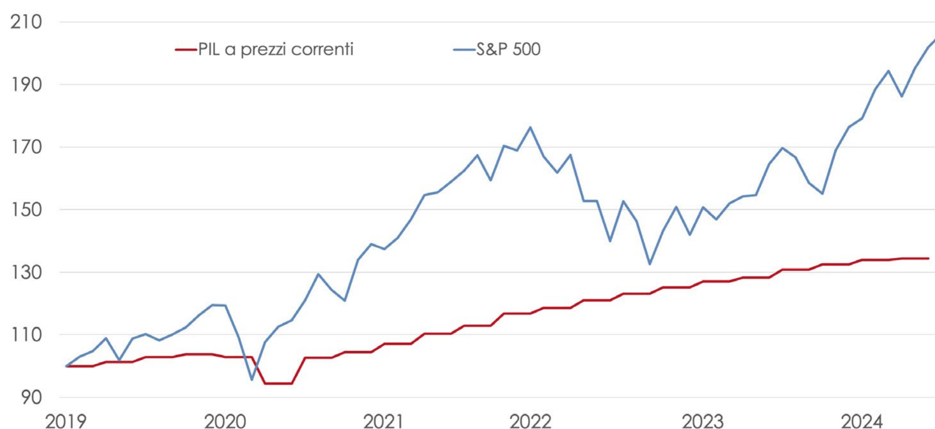
*Differenza tra output e input; calo=riduzione margini
Fonte: elaborazione su dati IHS Markit

And the stock markets? They go up!

Zero rates? **Buy stocks!** High rates? Buy stocks! Inflation? Buy shares. High Growth? Buy equities! Slowdown? Buy shares! Recession? Sell shares! Rising Rates? Sell shares (or even buy them)!
Going through the financial investor's many options has never been easier. Only in one and a half cases out of the seven just listed is it better to stay away from equities. While for bonds the game is more complicated: you can gain or lose quickly, with a volatility worthy of the riskiest securities even when the issuer is a triple-A sovereign, even if the trend remains one of falling rates.

Stock prices have risen, however, very high. And there those who suffer from vertigo may wish to get out, at least for a while. Indeed, there are many signs of **'irrational exuberance'**, a term coined by Alan Greenspan when he was Fed Chairman almost three decades ago. For example, the comparison with GDP (Chart 8).

Chart 8 - Stocks vs. GDP: no history!
(U.S., beginning of 2019=100)



Fonte: elaborazione su dati OCSE

There are **structural reasons** that tend to make the usual comparisons for measuring the fair value of shares less valid. They concern the **dominance of certain companies** (the Magnificent 7) in the digital sector that have stratospheric margins and are expanding into ever new fields. It is mainly they who are pulling up the whole stock market. And there is no end in sight to their success.
There is an eighth condition for not having too many stocks in your portfolio: **political uncertainty**. The US presidential election on 5 November would indeed be quite a test for the nerves of the markets. That is, until the assassination attempt on Donald Trump, which may have given him a decisive edge over Joe Biden. But never say never!

James Bond, Never Say Never Again, 1983

The debate about equity market valuations continues

It is of course based on the US markets, and this is to be expected - the S&P500 trades on a prospective P/E of over 20x, which is, historically speaking, high. However, elsewhere in the world this just isn't the case; European equities trade on just 14x earnings, a 30% discount to the US.

This is partly mechanical, an issue of sector composition: high P/E tech stocks make up a third of the US market but barely 10% in Europe. But the real underlying difference has been the growth in earnings, or to be more specific earnings per share. Since 2006, S&P500 earnings per share have risen threefold, but in Europe they have stagnated, only recently regaining the pre-financial crisis level. European growth was lower, margins were lower, free cash flow generation was poorer, and with the need to rebuild balance sheets post financial crisis, the share count was rising.

And that is the real key to equity valuations. The P/E multiple is driven by earnings per share growth. US-listed stocks have been enjoying strong profit growth, and use their free cash flow to reduce the share count. But in Europe earnings weren't growing, and the share count was rising; of course the market ended up on a big P/E discount!

But since around 2019, something has changed in Europe. Revenue growth has been better and profit margins have expanded. Balance sheets are fixed, so the resulting free cash flows can be doled out to shareholders. Earnings up, share count down, and guess what? In the last five years, European earnings per share have grown more in-line with their American peers.

Whichever way you look at it, valuations don't reflect this. We mentioned earlier that the P/E discount is 30%. Looking at cash on cash returns, a US equity holder gets around 3% back each year, adding together dividends and buybacks; in Europe this is almost 5%, with 3% in dividends now supplemented with 2% in buybacks. And if we look at the equity risk premium, which is to say the spread between the earnings yield of the equity market and the sovereign bond yield, Europe is 4.5% cheaper than the US. This is the cheapest it has ever been, and compares with an average since 1990 of around 1.5%.

This isn't to say that Europe and US stocks should trade pari passu. With higher weightings to the faster growing tech stocks, the US market does deserve to be on a higher multiple. But we can draw two conclusions: not all equities globally are expensive; and European stocks shouldn't trade at such a historic discount to the US.

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