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Monthly Equity Market Topics

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In brief

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- **China valuations attractive, but risks abound**

The equity show goes on

Equity markets have gotten off to a flyer in 2024. We believe that this rally can persist, although the underlying drivers will likely look different compared to last year. The rising tide of an improved outlook is lifting all boats, but there is increasing dispersion in stock performance, driven by earnings. Those stocks that delivered relatively solid earnings growth over the fourth quarter of 2023 have outperformed in the first quarter of this year. That said, much of the market is not experiencing such strong earnings and, as a recent UBS report points out,[1] the gap between S&P 500 "tech plus" earnings per share (EPS) and non-tech EPS grew.[2] "Tech plus" EPS grew 42.5% year over year in Q4 2023 but is expected to slow to 12.2% by Q3 2024. The rest of the market had EPS growth of -0.2% in Q4 2023. It's expected to rise to +13.1% by Q4 2024. It's the improving earnings expectations for non-tech companies that we believe offers opportunity, but this is likely to be more idiosyncratic than broad based.

Despite strong earnings from a few individual companies, multiple expansion continued to drive markets in the United States, while performance in Europe has been more reliant on earnings. A confluence of falling inflation and improving growth is driving optimism and was reinforced by the US Federal Reserve, following its March meeting. Despite stronger than expected economic growth and some still sticky inflation data, a dovish Fed confirmed it expects to stick with three rate cuts in 2024. This is a clear sign that the Fed may accept an inflation rate above the 2% target rather than put the economy and jobs at risk to get prices under control, all of which is good news for equity investors.

Sentiment has turned decidedly positive and, while nobody appears to be too worried about abundance in the real world, there has been a recovery in commodity prices, and the old economy is coming out of its slumber. Many of these companies, after years of being starved of capital, have been forced to strengthen balance sheets and rationalize capacity. This newfound supply and capital discipline should stand them in good stead for a recovery in economic growth amid any resurgence of infrastructure and capex spending. Post-Covid destocking seems to have run its course, and PMIs globally are inflecting upward. Many are turning positive, including the recent US ISM manufacturing survey, which printed at the highest level since September 2022. We believe this augurs well for value stocks. In fact, energy, industrials, financials and materials all outperformed technology in the equal-weighted S&P 500 index over the quarter. For the MSCI World Equal-Weighted index, energy and financials outperformed, while industrials were in line with tech.

Confidence is high and easing financial conditions should support equities. Continued fiscal support, lower mortgage rates and capex, including AI-related spending, are also supportive, but there are a few cautionary points to consider.

- Consumer confidence, especially for the low-end consumer, is waning.
- Employment is slowing amid falling temp employment, shorter work weeks and downward payroll revisions.
- Small business confidence levels are low.
- Vehicle sales have slowed, and credit card delinquencies are rising.

Some parts of the market may be rich, helped by flows into tech sector ETFs since the start of Q4 2023, which, according to Strategas, are four to five times higher than the next best sector. Broadening economic growth and a sharper focus on fundamentals from discerning investors should provide support for previously less-loved companies.

Europe offering opportunity as it emerges from its slumber

We believe European equities are trading at very attractive valuations and there are several catalysts that could spark a recovery. Europe has only very recently started benefiting from rising real wages, a trend already well established in the US and Japan. Europe looks likely to achieve a soft landing even though growth has at times flirted with stall speed, but labor markets have remained robust. Broadening economic growth further supports Europe playing catch up with the US. We believe this, coupled with significantly lower natural gas prices and the ECB moving to ease rates, improves the outlook for those more cyclical and rate-sensitive sectors that have struggled over the past year. After a period of quiescence, Europe has seen a recent rebound in mergers and acquisitions as valuations remain attractive and trade at a steep discount to those in the US, not all of which can be explained by sector differences or US structural benefits.

China valuations are attractive, but risks abound

Despite the attractive valuation, we still hold a cautious stance toward the broad Chinese equity market. In our view, it is still too early to bet big on Chinese equities and the focus should be placed on security selection. Chinese equities offer very reasonable valuations, but is that enough? The economy has started the year showing signs of stabilization as exports and consumer spending hold up better than expected. Over and above the geopolitical risks, there remain significant concerns over property markets as well as falling infrastructure spending and lower direct foreign fixed investment. While tackling the debt pile is commendable, the path to getting there is less clear. With the conclusion of the National Party Congress (NPC), it is evident that there will be no major stimulus but rather a modest economic reform program to support income and consumption growth with a focus on productivity, technology, health care and higher-end manufacturing.

While there remains scope for further interest rate easing, curbing two of China's largest economic growth drivers (infrastructure and property) since joining the WTO suggests a slowdown in economic activity. The question is, can China fill the gap by expanding its share of global manufacturing? While a continued focus on the Belt and Road Initiative may provide some demand appetite, the rest of the world is less enamored of China's manufacturing prowess (*e.g.*, recent anti-dumping rhetoric around Chinese EV's in Europe and companies seeking to incrementally broaden their manufacturing and supply chains beyond China).

Getting Chinese consumers to open their wallets is proving to be a struggle and will be crucial for Chinese equity markets as the government seeks to boost consumption. Chinese state-owned enterprises (SOEs) have significantly outperformed private companies over the last two years. However, the NPC called out the need to improve the business environment for private companies while continuing to reform SOEs.

Long term, we feel this is broadly positive for equities but, near term, there are concerns over China's ability to pull this off. It is supportive for technology, manufacturing, health care and consumer stocks. The the level of uncertainty and difficulty in quantifying some of these risks raises the bar significantly for allocating capital to the broad equity market. There is also the added concern of stepping in front of flows as foreign investors withdraw. However, we believe there are opportunities and some very good businesses, but it is the time to be patient and very selective in taking exposure. ◢

Endnotes

[1] Source: What are the warnings signs for tech?, UBS, March 2024.

[2] Tech plus includes tech-related companies not in the tech sector, *e.g.*, Meta, Amazon and Alphabet.

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