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Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 098 // **January 30, 2023**

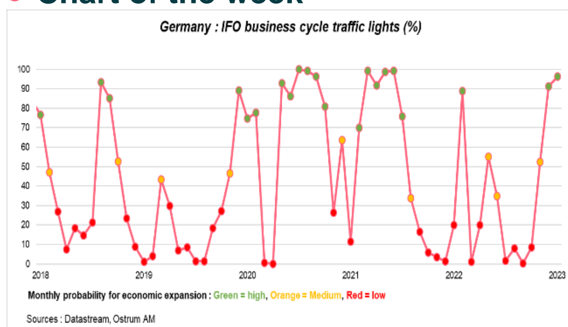
Topic of the week: European equity outlook after January surge

- **After a historical surge in January, analyst forecasts imply little upside for European equities looking out to end 2023;**
- **Investor sentiment improves as the European economy may avoid recession, spurring equity fund inflows;**
- **Rebalancing away from US growth leadership favors Europe;**
- **Earnings revisions dip crossing higher stock prices;**
- **Margins at historical highs may be hard to sustain but inflation backdrop provides some leeway for corporates.**

Market review: Silence is gold

- **Central banks faced with easing in financial conditions;**
- **T-note yields back above 3.5%, Bund yields near 2.25%;**
- **Sharp bounce in Nasdaq now up 10% YTD;**
- **Credit resists widening pressure on swap spreads.**

Chart of the week



Germany should avoid a regression given the figures available and the improvement in surveys since the end of the year. The IFO calculates each month the probability that the economy will expand. It has risen sharply since December to well above 66%. This is the result of a sharp fall in the price of natural gas, via a high level of stocks and abnormally mild temperatures, but also colossal measures taken by the government to protect households and businesses from the energy shock. Bruegel estimates them at 260 billion euros (between September 2021 and November 2022), or 7.4% of GDP, compared to 600 billion euros for the whole of the European Union.

Figure of the week

-1.3%

Source : Ostrum AM

It is the annual growth rate of the US M2 monetary aggregate, which recorded its first annual contraction since the first releases in January 1960.

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Topic of the week

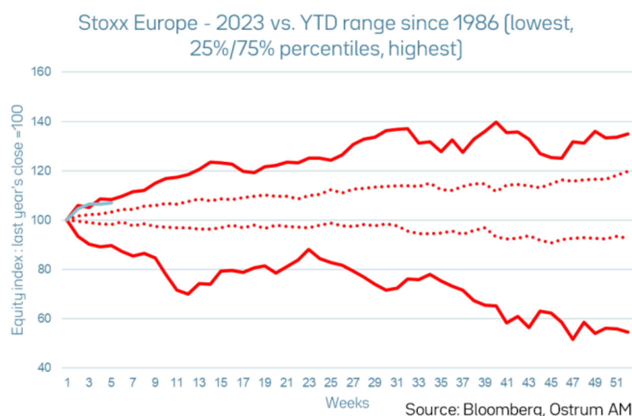
European equity outlook after January surge

European equities are off to a strong start in 2023. Investor sentiment has greatly improved as the European economy may avoid recession this winter. The rebalancing of global growth underpins European equity fund flows.

However, misguided expectations of a softer ECB have fanned the rally in equities at a time when the ability to sustain record margins is put into question.

Markets off to a strong start of year

After a tough year 2022, European equity markets are flying this year with high single-digit returns after just four weeks of trading. Stock price increases are indeed among the best year-to-date returns in History. The Stoxx Europe 600 is up 7.1% as of Friday 27 January. The narrower Euro Stoxx 50 benchmark is 10.1% higher than last year's close. So far in 2023, the stock index trajectory is tracking the high end of the range of historical price returns.



Survey points to little upside from here

Last week, Bloomberg ran a survey of sell-side strategists' forecasts for the Euro Stoxx 50 and the Stoxx Europe 600. According to survey participants, the party could soon be over for European equities after their best ever start to a year.

Compared with the December survey, the average forecast for the Euro Stoxx 50 by year-end 2023 has nevertheless risen by 107 points to 4,066. The median projection stands at 4,150. With the spot price hovering about 4,150, potential upside from here looks indeed limited. Two forecasters expect the Euro Stoxx 50 to plummet to 3,200, ending 2023 below the late September 2022 lows (3,279). A 3,200-handle on Euro Stoxx 50 could be envisaged in the context of a sharp profit recession or unexpected outsized monetary tightening. The range of forecasts spans from 3,200 (23% loss from last close) to 4,450 (6.5% gain). In addition, 12 forecasts out of 20 responses point to a loss.

As concerns the Stoxx Europe 600 index, the picture looks similar. The average forecast stands at 449 by December 2023 with a median estimate at 465, which would imply a meagre 10-point gain from current levels (455). The breadth of forecasted outcomes ranges from 380 (16.5% loss) to 510 (12% gain).

In sum, there is a narrow path forward to sustain the early January gains. In the following, we look at factors that could shape this year's equity returns in Europe.

Recession fears recede, boosting investor sentiment

The equity market is the most growth-sensitive asset class. Growth expectations thus play a key role in price discovery in the stock market. Swings in stock prices most often foreshadow economic turning points and may even amplify business cycles.

A few months ago, the market consensus was for a deep recession this winter in Europe as energy costs (chief among them natural gas) and persistent price pressures threatened to disrupt activity. However, fiscal support across the region, a surge in LNG imports from the US and Qatar, energy saving plans and mild weather conditions added up to cushion the energy blow. Late last year, the reopening of China, with the end of zero-covid policy, further boosted investor sentiment.

The perception of downside risks thus receded considerably as shown by the sharp turnaround in the expectations component of the ZEW investor survey. In September 2022,

euro area growth expectations were extremely depressed, even lower than the March 2020 trough upon the outbreak of covid.

Since September, economic data has come in much better than anticipated. The euro area economy may skirt recession in the six months to March 2023. Unsurprisingly, cyclical sectors have turned the corner, beating defensive sectors handsomely in the past few months. The outperformance of cyclicals implies that growth in the euro area economy should accelerate.

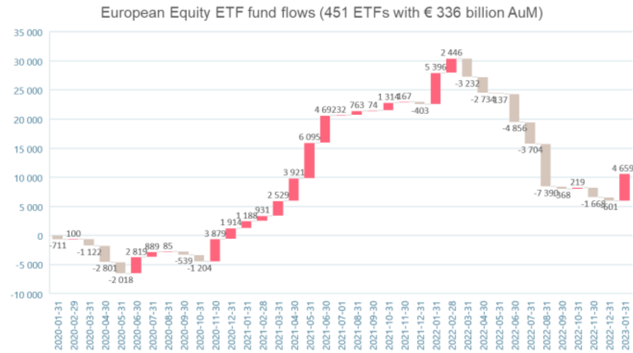
ECB rate expectations spurred stock prices early on in 2023. Disinflation over the coming months remains an overarching investment theme for market participants. Euro area inflation indeed slowed to 9.2% in December though the core measure is still creeping higher at 5.2%. The hope is that the ECB will soon downshift rate tightening from 50 bp moves to standard 25 bp hikes. There could be a lot of wishful thinking in these expectations for slower rate increases, but the market proved extremely sensitive to rumors of smaller hikes from March. However, no ECB policymaker has committed to curb the pace of monetary tightening at this juncture. Current guidance remains for 50 bp hikes in February and March with the risk of further adjustments to ECB rates. As such, a resilient economy and sticky core inflation argue for higher rates. Policy rates rising to 4% is a possibility.

Global growth rebalancing favors Europe

The turn of the year unveiled new dynamics in the European equity market. The rotation out of the US equity market appears to be gaining traction as the geopolitical premium is taken out of dollar-denominated assets. The US market is considered a safe haven within global equity universe. But the US news flow has turned. Big tech firms and banks announced restructuring and layoffs last year. In turn, China, once called “uninvestable”, is now reopening after months of recession due to a crippling zero-covid policy, a sharp real estate crisis, a government crackdown on technology giants, and a slowdown in FDI flows.

Despite the regional challenges, Europe hence appears well positioned to benefit from the global growth rebalancing. The European response to the US Inflation Reduction Act will be important in that regard. In Davos, EC President Ursula von der Leyen discussed the “Net Zero Industry Act” (NZIA) which is expected to boost growth and spur investment in select industries including renewable energy, carbon capture and battery storage. The objective is also to onshore supply chains in solar and hydrogen businesses. The NZIA will be unveiled in greater detail at the EU summit scheduled on February 9th-10th.

European equity fund flows have started to recover from a dreadful series of outflows lasting more than 40 weeks throughout 2022. Equity ETF inflows also show tentative signs of turning the corner.



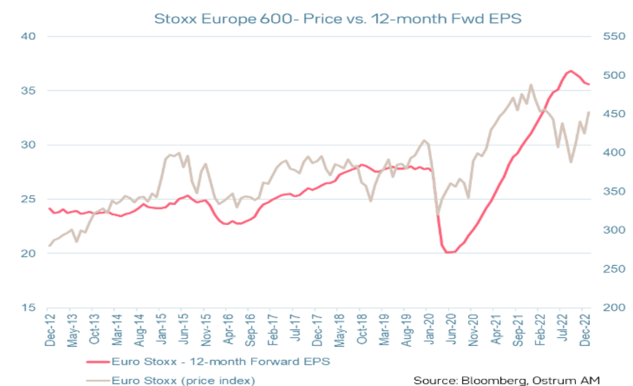
Source: Bloomberg, Ostrum AM.

Improved demand for equities could also unlock equity financing in Europe after a horrible year 2022. Issuance of equities, equity-linked products and rights issues in Western Europe totaled a mere 79 billion euros last year. This compares to 130-160 billion euros on “average” years and 200+ billion euros in bonanza years.

In the same vein, the euro was hit hard by the collapse in the terms of trade of the euro area last year. The euro-dollar exchange rate is seen as an important harbinger of global rebalancing. The euro is now a consensus long trade in the fast money or hedge fund community.

The earnings outlook: the case for resilient margins

Higher stock prices have coincided with persistent pessimism towards earnings in 2023-2024. EPS forecasts are clearly at odds with cyclical indicators. The outlook for margins is central to the forecast for a profit recession.



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Corporate margins are elevated, anyway you cut it. This is true across European sectors. The ability to grow margins since covid despite global supply-chain disruptions, increased input costs and availability issues or hiring difficulties and wage pressures is truly remarkable. Current

inflation likely provided headroom to pass on costs to customers.

Looking at margins at the sector level in Europe, the increase in profitability in the past two to three years jumps off the page. Across the 20 sectors in the Europe Stoxx 600 benchmark, the median expansion in operating margins from 2017-2019 average is 2.59 pp. Likewise, EBITDA margins are up about 2 pp over this period to record levels. There are just three sectors with falling margins: healthcare (-0.1 pp), the food & beverages industry (-0.5 pp) and utilities (-2.2 pp).

	EBITDA Margin (%)			Operating Margin (%)		
	2017-19 Avg	1Q 2023	Change	2017-19 Avg	1Q 2023	Change
InduGd&Ser	12.2	14.2	2.0	7.4	10.1	2.7
Chemicals	16.1	15.2	-0.9	9.1	10.3	1.2
Per&HouGds	21.6	23.3	1.7	17.3	17.7	0.5
Technology	18.0	19.6	1.6	11.2	13.2	2.0
Auto&Parts	12.7	16.7	4.1	6.0	8.9	2.9
HealthCare	25.3	24.8	-0.5	16.5	16.5	-0.1
Utilities	17.4	11.4	-6.0	8.2	5.9	-2.2
Oil&Gas	14.1	19.4	5.3	3.9	14.3	10.4
Food&Bevrg	21.2	20.7	-0.5	15.8	15.3	-0.5
Constr&Mtr	12.2	14.5	2.3	6.9	9.2	2.3
Telcomm	9.5	32.6	23.1	6.1	11.1	5.1
Retail	9.2	14.4	5.1	4.8	8.1	3.3
Media	18.6	20.2	1.6	10.9	13.4	2.6
BasicResou	16.8	22.2	5.4	11.0	18.4	7.4
Trav&Leisr	7.6	12.7	5.2	-0.8	6.3	7.1
Market median	16.1	19.4	1.97	8.2	11.1	2.59

Source: Blooomberg, Ostrum AM

There is nevertheless a growing consensus calling for lower earnings due to a normalization in margins. Mean reversion may happen eventually, but the inflationary backdrop provides some leeway for firms.

The ability to slow margin compression will be key to extend the equity rally. Overall profit growth may turn negative in 2023 but year-on-year earnings comparisons will start the year from a high base given elevated sales growth (carry-over effect). Inflation does cushion turnover growth, hence mitigating the dampening impact on earnings from potential margin compression.

That said, in the wake of ECB tightening, financing costs will certainly roll higher and start denting free cash-flows. The current level of free cash-flow yields on European equities is still high at 5.7%, but the excess yield over corporate bonds and cash instruments may no longer be sufficient for risk-averse investors.

A peek at equity valuations

Stock market valuations have richened. At 12.7x 12-month forward earnings, the Stoxx Europe 600 trades below the 10-year median of 14.4x. At September 2022 lows, PE multiples were a mere 10.5x. European equity valuations are hence fair to cheap on this metric and hint at modest potential upside, as long as earnings forecasts do not fall off a cliff. However, a comparison of current equity yield to real Bund yield offers no premium over the 10-year median of 7.8%. As ECB tightening pushes real yields higher, the valuation of European equities will richen past the 10-year median risk premium (equity yield minus real Bund yield).

Conclusion

European equities are enjoying their best ever start to a year in 2023. Many pundits forecast little upside from current levels. Investor sentiment towards European equities has improved as the euro area may avoid recession this winter. A growth rebalancing theme is benefitting European markets.

On the micro side, earnings forecasts are nevertheless falling as analysts worry about firms' ability to sustain record margins. We think that inflation provide some leeway for corporates to accommodate cost pressures. Margin erosion should be limited.

The risk of a market drawdown could rather be that stronger growth and sticky inflation call for further ECB tightening.

Axel Botte

Market review

Silence is gold

Government bond yields rise ahead of central bank meetings, volatility wanes in equities as Nasdaq rebounds

The blackout period observed by the major central bankers a few days ahead of Fed, ECB and BoE meetings is proving more effective than officials' daily interventions in guiding the interest rate markets higher. As the policy decisions approach, the T-note yields are drifting higher above the 3.50% threshold whilst the yield on German Bunds get closer to 2.25%, amid modest yield curve steepening pressure. The yield on 10-year Japanese government bonds is back near the ceiling of 0.50%. Meanwhile, the equity markets are well oriented in the United States, especially technology stocks despite mediocre quarterly earnings publications. The FANG index has recovered 17% since the start of the year. European markets went up another 1% last week, consolidating their solid January outperformance.

In this context, despite the record bond issuance in January, credit spreads continue to tighten on investment grade bond markets and, even more so, on European high yield. The increase in swap spreads in the euro area is nevertheless causing spreads on covered bonds and agency debt to widen. Higher swap spreads have often been a leading risk-off signal.

The Fed and then the ECB will meet this week as the sharp run-up in asset prices since the start of the 4th quarter seems to undo at least part of the monetary tightening implemented by central banks. The prospect of a status quo on interest rates after the spring has considerably reduced financial volatility and term, credit or inflation risk premia. The ensuing easing of financial conditions is delaying the reduction in the output gap required to ensure the convergence of inflation towards the 2% target. In addition, the current disinflation environment is essentially traceable to the cyclical decline in energy prices and government measures to limit energy bills for households. However, the supply-demand balance on the global oil market is uncertain for 2023 given the expected recovery in Chinese petroleum demand and the prospects for OPEC+ output. Central banks probably have no other choice but to reiterate, or even strengthen, their message regarding the interest rate path that is receiving pushback from market participants. A premature return of inflationary pressures would force central banks to act further and more abruptly.

The latest data releases depict relative high growth in the United States, even if GDP growth at 2.9% (annualized rate) in the 4th quarter came with slower household consumption and a decline in the business investment spending. The 1st quarter of 2023 will show deceleration in activity. At the same time, the euro area likely avoided recession thanks to government policy measures and sound management of the energy issue during the winter. After the stagnation recorded last quarter in Germany, Spain announced encouraging GDP growth of 0.2%. The recovery will then build on European investments put forward by the Commission in response to the Inflation Reduction Act enacted in the United States. In the United Kingdom, despite the near-stagflation economic backdrop, the BoE has regained the market's trust. The peak in rates projected at 4.5% this summer seems in line with the intentions of the MPC.

The recent valuation excesses in US fixed income markets (low point at 3.32% on the T-note) have dissipated. Panic hedging of speculative positions selling T-notes sparked by the BoJ's non-decision gave way to new short positions ahead of the February FOMC. The US 10-year yield is trading around 3.54%. Jerome Powell is unlikely to deviate from the hawkish message delivered in December, especially as financial conditions, including the US dollar, have eased in the past six weeks. A 25 bp increase in the Fed funds rate is warranted. The Fed will insist on the need to keep a restrictive monetary policy bias. As markets price in a prolonged status quo on rates, the market's rate outlook looking out to 2024 will have to be reassessed. The tense political context in the US Congress given the debt ceiling debate is however underpinning longer-dated US bond yields. The US 30-year yield is unchanged over the week at 3.66%. The US 1-year CDS is even trading around 70 bps. In the euro area, the ECB will act in accordance with the December communication by raising its rate by 50 bps. The deposit rate is generally seen as a floor level for the Bund, which should therefore resume its upward path towards 2.5% then 3% by next spring. Sovereign spreads resisted the rise in Bund yields with spreads widening by 2 to 4 bps over the past week. French 10-year bonds hover about 46 bps against the German Bund benchmark, Italy is trading about 185 bps. The bond market is weighing the possibility of an upgrade in Greece's sovereign credit rating, which would bring the sovereign closer to investment grade status. Despite this apparent stability in sovereign debt markets, swap spreads have stopped narrowing of late. The 10-year swap spread is trading at 65 bps now. This has been a signal to watch, often a precursor to volatility across bond markets. Securities linked to the swap spread market such as covered bonds and agency debt underperformed investment grade credit last week.

US equities cut their sizeable underperformance to Europe last week. Tech, up 4% last week, seems to be ignoring weak earnings momentum. Europe markets were up 1% thanks to the strong performance of banks supported by the rebound in interest rates.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	30-Jan-23	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	2.66%	+6	-11	-11
EUR Bunds 10y	2.29%	+9	-28	-28
EUR Bunds 2s10s	-37.1bp	+3	-16	-16
USD Treasuries 2y	4.25%	+2	-18	-18
USD Treasuries 10y	3.55%	+4	-33	-33
USD Treasuries 2s10s	-70.1bp	+2	-14	-14
GBP Gilt 10y	3.35%	-1	-32	-32
JPY JGB 10y	0.48%	+9	+8	+8
€ Sovereign Spreads (10y)	**30-Jan-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	46.51bp	+1	-8	-8
Italy	186.92bp	+5	-26	-26
Spain	99.83bp	+3	-9	-9
Inflation Break-evens (10y)	**30-Jan-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2.32%	+3	-23	-23
USD 10y Inflation Swap	2.52%	+4	-1	-1
GBP 10y Inflation Swap	3.67%	+7	-24	-24
EUR Credit Indices	**30-Jan-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	151bp	-5	-19	-16
EUR Agencies OAS	76bp	+3	-6	-3
EUR Securitized - Covered OAS	82bp	+3	-6	-1
EUR Pan-European High Yield OAS	460bp	-8	-58	-52
EUR/USD CDS Indices 5y	**30-Jan-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	80bp	+0	-11	-11
iTraxx Crossover	416bp	-1	-58	-58
CDX IG	73bp	+0	-9	-9
CDX High Yield	438bp	+4	-46	-46
Emerging Markets	**30-Jan-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	439bp	-3	-11	-13
Currencies	**30-Jan-23**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.089	0.129	1.691	1.7
GBP/USD	$1.237	-0.049	2.400	2.4
USD/JPY	JPY 130	0.384	0.730	0.7
Commodity Futures	**30-Jan-23**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$85.4	-$2.8	-$0.5	-0.59
Gold	$1 928.5	-$2.5	$104.5	5.73
Equity Market Indices	**30-Jan-23**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	4 071	2.47	6.02	6.0
EuroStoxx 50	4 144	-0.16	9.24	9.2
CAC 40	7 069	0.53	9.20	9.2
Nikkei 225	27 433	1.96	5.13	5.1
Shanghai Composite	3 269	1.29	5.83	5.8
VIX - Implied Volatility Index	19.78	-0.15	-8.72	-8.7

Source: Bloomberg, Ostrum AM

Additional notes

Ostrum Asset Management

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