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All eyes on quality defensives

European equities | February 2024

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- **Equity markets have rallied, inflation is falling, interest rates are peaking, and 2024 rate cuts are already priced into markets**
- **A recession in the US remains likely, while Europe is better positioned**
- **Once interest rates are cut, a new market cycle will begin – although inflation and rates will remain higher than the past decade**

Equity markets have been strong recently, as the equity risk premium has fallen. The consensus expects more than 150 basis points (bps) of US interest rate cuts in 2024, which is more than the Federal Reserve (Fed) has indicated. The US high yield credit spread, the best indicator of risk appetite, shrank from 600bps to 350bps over 2023.[1] Monetary policy works with a lag: we have not yet felt the full effect of restrictive policy.

US inflation is falling: the Fed forecasts core inflation of 3.2% at end-2024, and 2.4% at end-2025.[2] Just as it takes a long time for rises to have an impact, so it will for cuts. The Fed forecasts restrictive policy even in 2025.

Capital expenditure and employment trends will determine whether the US will see a mild recession. Regional bank surveys point to cracks in capital expenditure and we are close to triggering the Sahm Rule (Figure 1), the Fed's indicator of when a recession is starting.[3]

Sentiment is bullish, however, with the US market on more than 20x forward earnings, and assuming 11% growth in 2024[4], the market has priced a soft landing. Any disappointment will prompt a reaction. If the Fed cuts rates early it may reignite inflation, prompting renewed rate hikes. Wage growth is almost 5%: earnings are above trend and the Institutional Brokers' Estimate System (IBES) suggests double-digit growth in 2024 and 2025.[5]

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[1] Datastream, January 2024

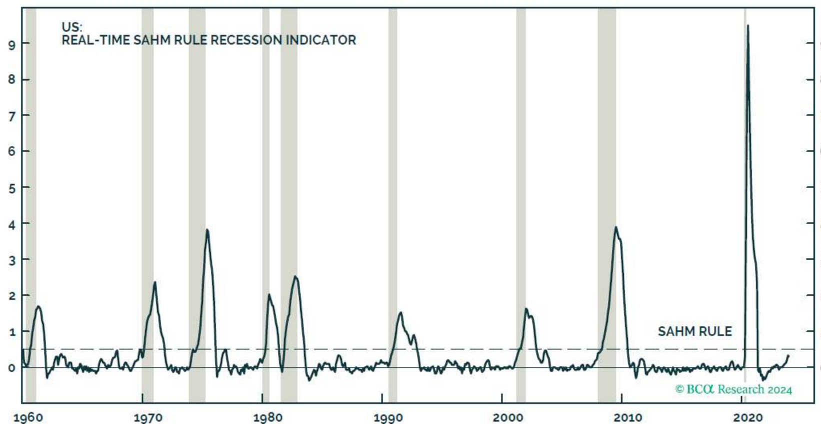
[2] US Federal Reserve, January 2024

[3] The Sahm Recession Indicator: the start of a recession is when the three-month moving average of the unemployment rate rises by at least 0.50 percentage points relative to its low in the previous 12 months

[4] Datastream, January 2024

[5] IBES, January 2024

Figure 1: Unemployment is close to triggering the Sahm Rule



Source: US Federal Reserve Bank of St Louis. Note, shaded areas denote NBER-designated recessions.

The risk for the market is the double effect of earnings being revised lower and a derating after strong performance. In 2023, earnings were revised lower but the market rose anticipating a recovery. Margins remain high. PPI is negative so nominal earnings should fall. The US economy has been kept afloat by the consumer, even as excess pandemic savings dwindled to a quarter of their peak.

Lagged effects of monetary policy were prolonged by these pandemic savings, both for consumers and businesses. Panic pandemic decisions meant homeowners were able to refinance cheaply. The Primary Market Corporate Credit Facility allowed companies to extend debt maturities and lower interest costs, denting the effect of rate hikes and diminishing the pain of any recession. Unlike 2008 there are few private sector imbalances.

Covid support schemes have only delayed the effect of monetary policy changes, not avoided it. Consumer credit is weakening, new loans are performing worse than old, delinquencies on car loans are deteriorating, and so is credit card debt.

Europe

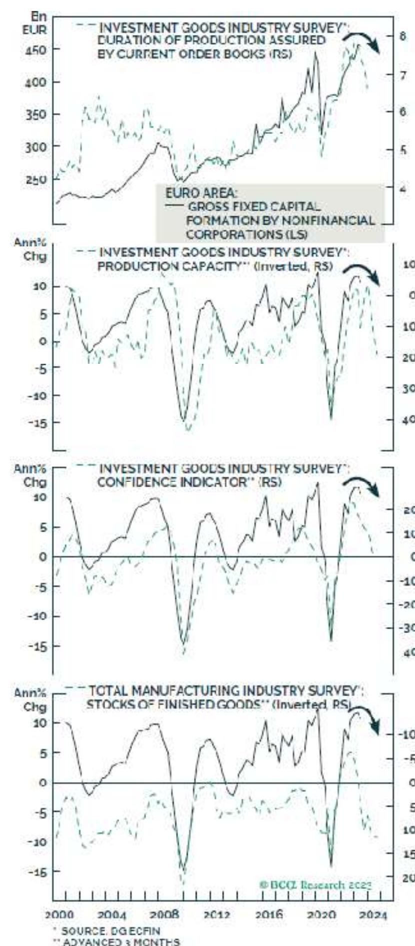
In Europe, improved industrial activity – inventories bottoming and real wages picking up – may not last. Weak credit, falling capital expenditure and a negative fiscal impulse will bring a weaker 2024. However, the German manufacturing PMI has picked up due to recovering inventories. Global and Swedish new orders-to-inventories ratios are also up, consistent with short-term upturns in European manufacturing and Korean exports, indicating greater European activity. However, this may not be sustained.

Capital expenditure intentions are weakening, fiscal policy is restrictive and falling inflation is helping real wage growth, but this is unlikely to continue. Real wages shrank as inflation exceeded nominal wage growth. Credit flows, a negative fiscal effect of -0.8% of European GDP[6] (twice that experienced in 2023) and lower capital expenditure will undermine economic

[6] Bloomberg Finance LP/S&P Global, January 2024

improvement. Money supply has shrunk by 10%. It is a matter of time before this impacts the wider economy. Leading indicators of capital expenditure for 2024 are negative (Figure 2). The European Commission's Industry Survey points downwards. Inventories of finished goods send the same message.

Figure 2: Leading indicators are collapsing



Source: DG ECFN, January 2024

Nominal wage growth will weaken as jobs growth deteriorates. The employment components of PMIs suggest a fall in demand for workers, so wage growth will roll over. Tight monetary policy will bite, and as in the US it will remain tight even if the ECB cuts rates in Q2.

United States

The Fed has never before cut rates with inflation above 2% unless unemployment was over 5%. We are still on track for a mild recession unless rates are cut aggressively. Easy money is gone, and in the next recession rates will not fall to zero as they did in 2009. The market expects the Fed and the ECB to cut rates before a recession, but this is unlikely. Rates are likely to be higher over the course of the next decade than the last, when they were artificially low. The neutral rate of interest may be higher than central banks claim. The Fed adheres to its 2.5% long-term nominal funds rate yet the five-year/five-year forward suggests this is not credible.

The US equity risk premium is low largely due to the "Magnificent Seven"[7], but not entirely. The stock market does not reflect the level of interest rates and this will become apparent if we enter a recession. US consumption will not fall because population growth is 0.5% per year (1.2% including migration). Private non-residential investment has a bigger swing effect though it is only 18% of US GDP compared to 70% for consumption.[8] Tightening lending conditions mean less capital expenditure. The market is pricing no recession so there's no room for disappointment. Liquidity continues to dry up (Figure 3).

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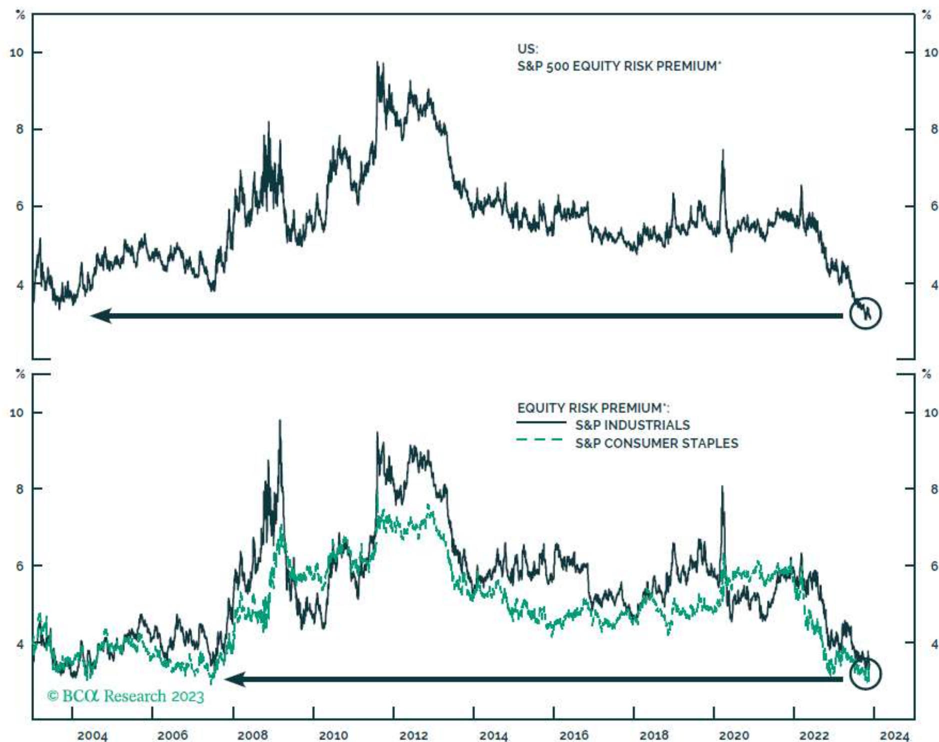
[7] Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA and Tesla

[8] Bloomberg, as at January 2024

Figure 3: US equities offer an extremely low risk premium – and not just due to tech stocks



Source: BCA Research, 2023. *Equity risk premium defined as the difference between the 12-month forward earnings yield and US 10-year TIPS yields

The US has not yet triggered the Sahm Rule, but unemployment is rising in cyclical economies. The voluntary quit rate has fallen, indicating rising unemployment, and though initial claims have not risen, continuing claims are high. Companies are not yet laying people off, but they are reluctant to hire.

Higher rates mean tougher lending standards for business. Commercial and industrial loans were flat in 2023. Loan growth lags bank lending standards by a year, so we expect lower business lending this year. Bankruptcy filings are the highest since 2010. The 12-month trailing default rate for high-yield borrowers has risen from 1.2% to 5.2%.[9] Credit losses on credit cards and auto loans have risen for seven quarters. US banks are well capitalised, but we expect problems if a recession comes.

China

China's problem is property: the US property market is worth $60 trillion, double GDP, while the Chinese property market is $100 trillion, six times GDP. Most consumer savings have gone into property markets, but 130 million units lie empty. Housing starts and home sales were 20%

[9] BCA Research, 2023

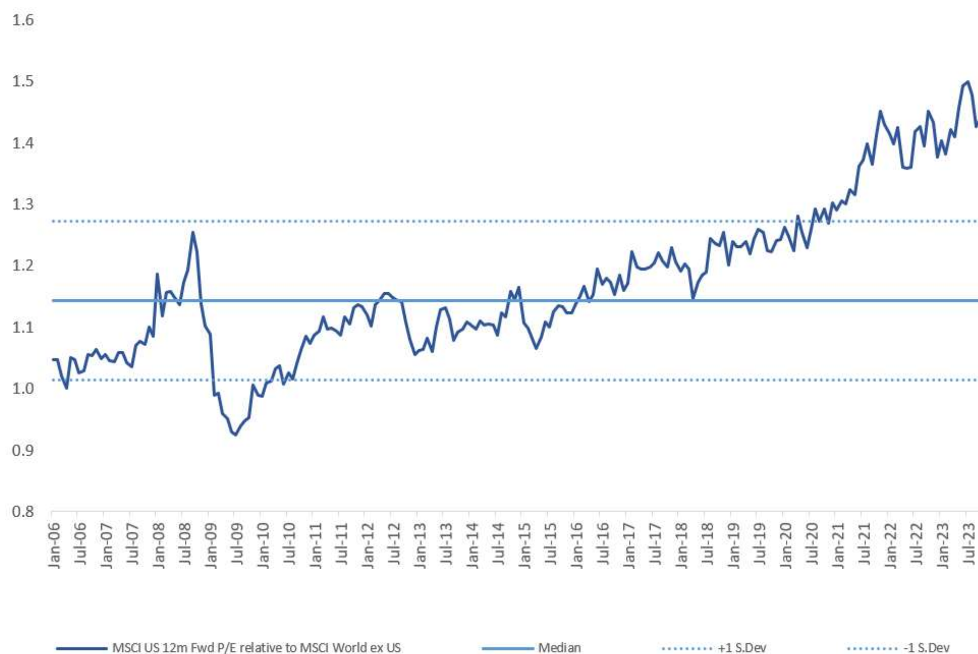
lower in 2023 than 2022. The Chinese GDP deflator is -1.4%: deflation is persistent so real borrowing costs have risen, though nominal lending rates have fallen.[10]

Local government revenues are falling as land sales collapse. New credit was 27% of GDP in 2023 – but this is not helping a recovery. Debt costs are 21% of disposable income so consumers and businesses are unwilling to borrow more. It is difficult for consumption – 38% of GDP – to take up the slack when capital expenditure (42%) and exports (20%) are falling. China's construction and infrastructure boom drove 20 years of global growth. Of the world's 2.6% real annual growth over the past 10 years, 1.1% came from China – only 0.6% came from the US and 0.2% from the eurozone. Without real estate and infrastructure investment, China's contribution will be 0.5% at best.[11]

Where do we go from here?

The US market has never looked so expensive relative to the rest of the world, and relative to bonds. Defensives are poised for outperformance – in November and December yields fell but defensives suffered. A weak China is driving emerging markets to new lows relative to developed markets. The Eurostoxx 50 added 20% in 2023 but primary equity capital markets business halved. Smaller companies rallied in late 2023 and the UK equity market looks cheap. Liquidity continues to fall with G5 balance sheets shrinking by $5.2 trillion over the past six quarters. Yield curves in western bond markets inverted 15 months ago.

Figure 4: MSCI US 12-month FWD P/E relative to World ex US



Source: Bloomberg, January 2024

[10] BCA Research, 2023

[11] BCA Research, 2023

Once we get to the other side, the picture gets more positive. Reshoring manufacturing to the US will lead to capital expenditure. McKinsey says net zero requires $275 trillion of US spending between now and 2050. The retirement of baby boomers will drive down savings and raise interest rates.

The same is true to a lesser degree in Europe. Two-thirds of European companies expect to increase operations in Europe over the next three years, while almost the same proportion expect to increase R&D spending. Europe has under-invested in its capital stock since the global financial crisis. This is particularly acute in Germany where the age of corporate capital stock is more than seven years. Meanwhile, the private sector in Europe is liquid and cash-rich, with financial assets more than 450% of GDP. Inflation and risk-free rates will be higher than the last decade: reshoring is inflationary, as is a labour shortage.

In conclusion, the short-term picture may be challenging with defensive stocks outperforming. However, when aggressive interest rate cuts begin, Europe may again outperform. Longer term, the NextGenerationEU plan, the use of AI to boost productivity, and increased capital expenditure may kickstart European growth.

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