PICTET WEALTH MANAGEMENT

Developed markets equities: 2023 outlook

Margin pressure will stifle 2023 earnings growth

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FLASH NOTE

SUMMARY

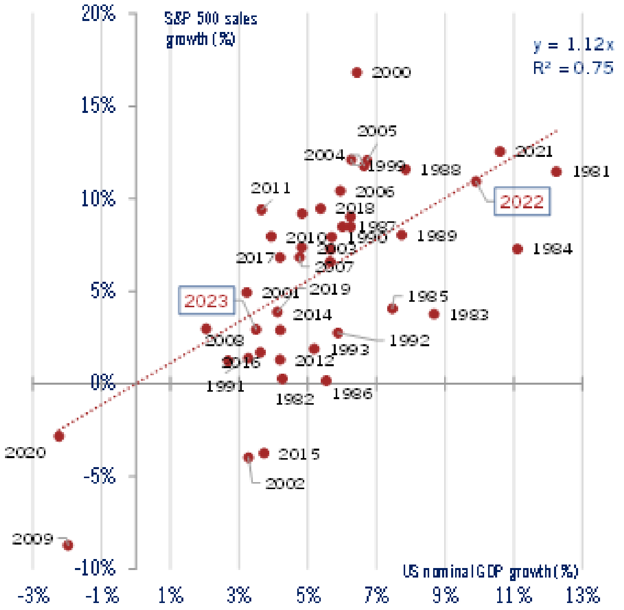
- 2023 could be an odd year with a shallow recession but with persistent inflation leading potentially to positive sales growth.
- Cash return to shareholders through buybacks and dividends is expected to slow in 2023 but still support equity returns.
- With wages increasing and less ability to pass higher costs to customers, margins are expected to contract in 2023, eating into the positive effects of continued sales growth and share buybacks.
- The expected slight decrease of 2023 earnings per share will make equity valuation the main driver of equity return. High valuation relative to historic and relative to the current yield regime is the main reason for our equity underweight in the US. In terms of valuation Europe is better positioned than the US despite our underweight in both regions

TOP LINE SHOULD REMAIN QUITE SUPPORTIVE

While our 2023 central scenario is for a shallow recession in Europe and in the US with negative real GDP growth, persistent inflation may still allow for GDP growth in nominal terms at 3.9% in the US, 5.1% in the euro area and 3.4% in Japan. There is a decent historic correlation between sales growth and nominal GDP growth (see chart 1) which, if it holds up, should support mid-single-digit growth in corporate revenues in 2023 across the DM equities space.

Our estimate of 3.9% 2023 sales growth in the US is slightly above consensus expectations of 2.7% but our estimates for Europe and Japan, at 3.5% and 3.0% respectively, are well above consensus expectations of below 1.5%. Such low consensus sales expectations are driven by nil growth in European cyclical sectors, low growth in US tech and negative growth in oil & gas in Europe (see chart 2). Our economists continue to expect higher oil prices next year (USD115 end of 2023), despite current weakness, which could provide some positive sales surprise in 2023 in this segment.

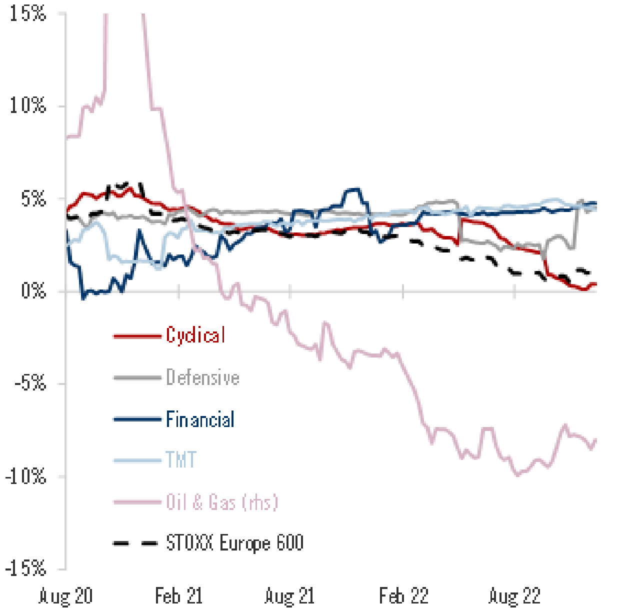
Chart 1: Elasticity of S&P 500 sales growth to US nominal GDP growth



[Paste Chart Here]

Source: PWM - CIO&MR, Factset, 15.12.2022

Chart 2: Stoxx Europe 600 2023 consensus sales growth by sector groups



Source: PWM - CIO&MR, Factset, 15.12.2022

BUYBACK LOSING MOMENTUM BUT STILL HEALTHY

Cash return to shareholders (the sum of buyback and dividends), has increased steadily since 2021 and reached attractive levels in 2022: above 4% in the US (see chart 3) and more than 5% in Europe (see chart 4). Over past years it has been quite unusual to have meaningfully higher cash return in Europe than in the US.

In the US dividend yield has almost recovered to its pre-pandemic level around 2% while buyback yield has lost steam as while technology has so far remained the main buyback source this is well below peak level reached in 2018. Over the past year, the loss of momentum in US technology buyback has been compensated by energy. In 2023, higher interest rates and taxes on buyback will prevent US buybacks going higher but we remain fairly positive with an estimated 3.5% cash return to shareholders.

In Europe, historically and excluding the pandemic, financials have been the main contributor of cash return to shareholders. In Q3 2022, European energy outpaced financials for the first time. Our 2023 forecast of 3.5% European cash return to shareholders is at par with the US, which would mean reversion to the historical trend, but includes more dividends than buybacks. Overall, our expectations in Europe may be conservative.

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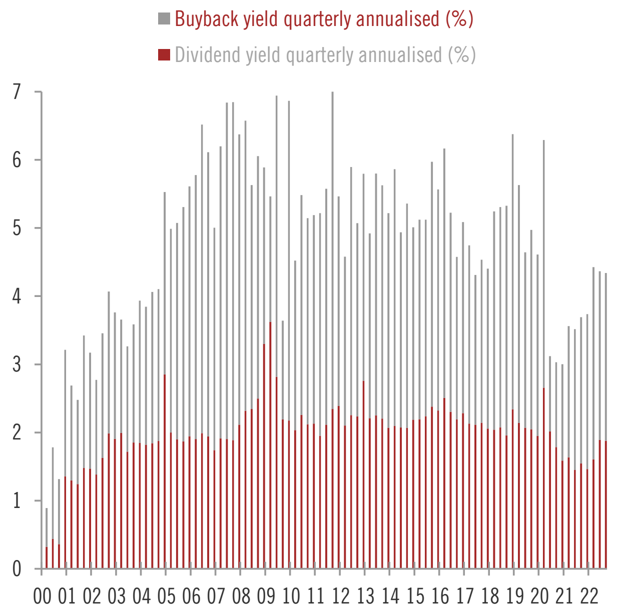
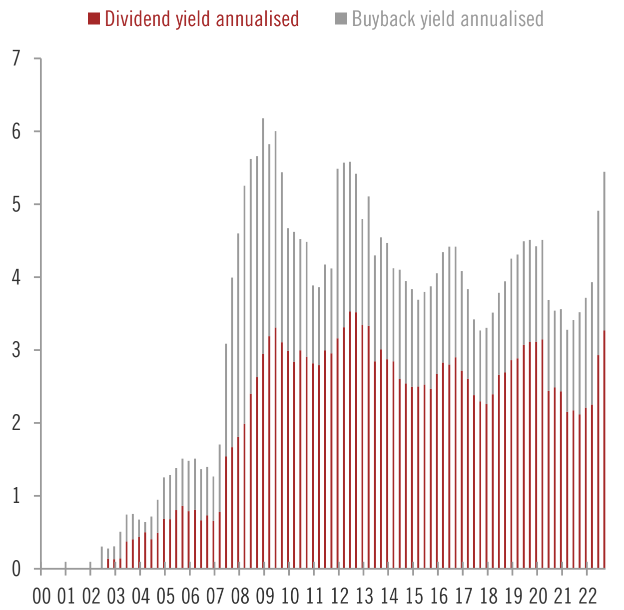
Chart3: S&P 500 cash return to shareholders %



Source: PWM - CIO&MR, Factset, 15.11.2022

Chart 4: MSCI Europe cash return to shareholders %



Source: PWM - CIO&MR, Factset, 15.11.2022

MARGIN CONTRACTION TO MATERIALISE IN 2023

Corporate margins collapsed in 2020 during the pandemic but bounced back sharply in 2021 when inflation started to pick up. There is a positive relationship between increasing inflation and increasing margins (see chart 5). Indeed, during the first stage of an inflationary phase, costs remain relatively fixed but sales are boosted by inflation which supports margins. The 2021 inflation surge even made it possible for European companies to largely bridge the structural margin gap with the US (see chart 6). In 2022, margins were resilient around peak level as high inflation remained sticky.

Margins pressures started to materialise during the Q3 22 reporting season and are expected to intensify in 2023. Indeed, wage costs are still increasing and corporations' ability to pass on cost increases to customers will decline next year with decreasing inflation. Our central forecast is for EBIT margin to contract from 16.6% to 15.5% in the US, leading to a negative earnings growth contribution of 6.6%. In Europe, margin contraction is expected to weigh on earnings by 5%. Overall, our core scenario points towards **a slight decrease in earnings per share in 2023**, with margin compression counterbalancing the positive effects of sales growth and share buybacks. Margin compression is the main factor that explains why our 2023 earnings outlook is more cautious than consensus expectations: as of 15 December 2022, consensus expects 2023 earnings per share to increase 3.7% on the S&P 500, 0.7% on the Stoxx Europe 600 and 5.6% in Japan. 2023 earnings have been revised down since July 2022 in the US and since September 2022 in Europe.

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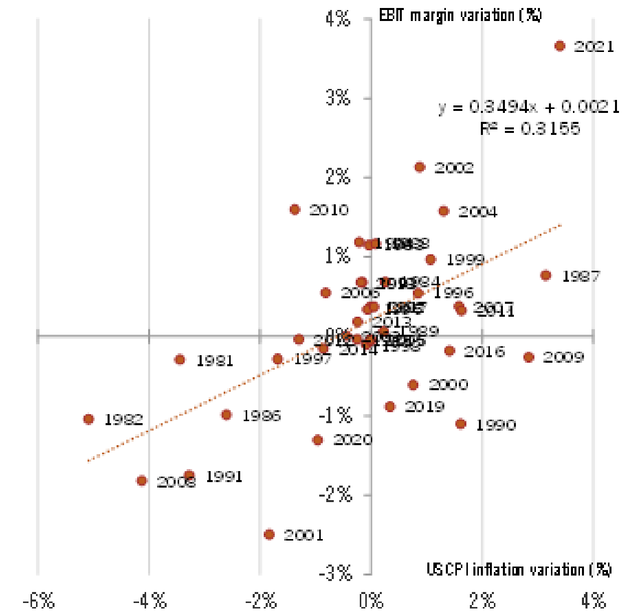
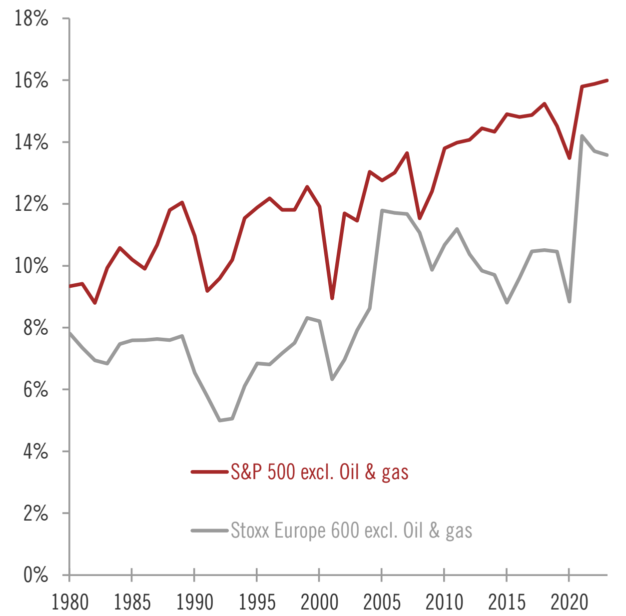
Chart 5: S&P 500 EBIT margin variation vs. CPI inflation variation by year



Source: PWM - CIO&MR, Factset, 15.12.2022

Chart 6: S&P 500 and Stoxx Europe 600 EBIT margin excluding Oil & gas



Source: PWM - CIO&MR, Factset, 19.12.2022

VALUATION IN HIGHER YIELD ENVIRONMENT

From the end of 2021 to mid-December 2022, 12-month forward Price Earnings Ratio (PER) lost 24% in Europe, 20% in the US and 10% in Japan. War in Ukraine was the catalyst for the European derating. At 12x 12-month forward earnings mid-December, European valuation is exhibiting a discount relative to Japan but is trading at par with its own average since 1988, excluding the TMT bubble of the 90s (see chart 7).

Valuation derating in the US started later and was mainly the consequence of sticky inflation pushing interest rates higher and consequently weighing on rich equity valuation especially in big tech names. Unlike Europe, US equity valuation at 17.1x 12-month forward earnings is currently trading above the historical average of 15.0 ex-TMT bubble (see chart 7).

In 2022, the yield environment has changed with hawkish central banks determined to fight inflation. Higher yields tend to decrease the relative attractiveness of equities relative to fixed income. A simple illustration of that is chart 8 where we plot the difference between 12-month forward earnings yield and 10-year sovereign yield. This measure of equity risk premium is at a decade low in the US at around 2% but is still quite generous in Europe at around 6%.

In our view, the new rate environment gives potential for further valuation downside in the US whereas the adjustment was made in Europe. Our fair value PE in the US stands at 15.5x, i.e. a 6.5% earnings yield – a level that can accommodate either sovereign yield around 4% (slightly higher than current levels) and a 2.5% equity

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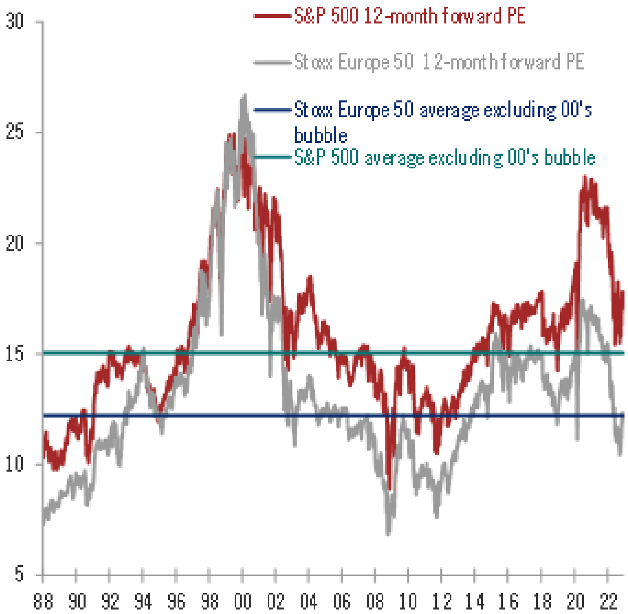
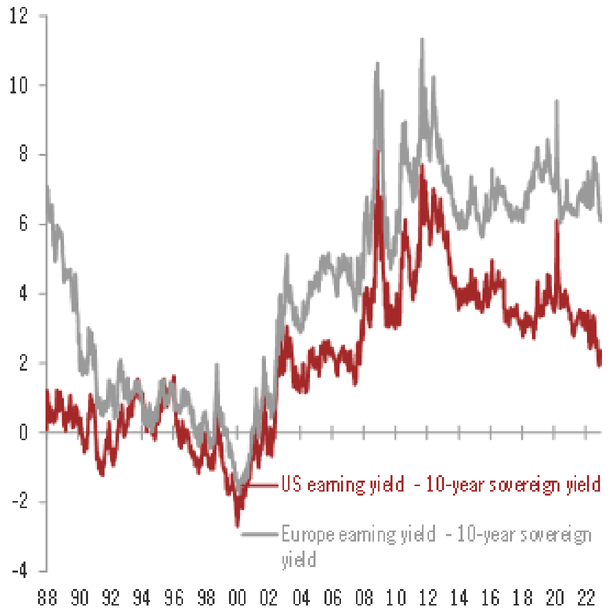
risk premium, or 3.5% sovereign yield and a more standard risk premium of 3%. A valuation rerating relative to the US could better support European equities.

Chart 7: 12-month forward Price Earnings Ratio (PER)



Source: PWM - CIO&MR, Factset, 15.12.2022

Chart 8: difference 12-month forward earnings yield – 10-year sovereign yield



Source: PWM - CIO&MR, Factset, 15.12.2022

EQUITY EXPOSURE STILL LIGHT ENTERING 2023

Our 2023 equity outlook remains uninspiring but nor is it dreadful. Sentiment indicators based on surveys polling institutional or retail investors point towards significant bearishness even if we moved away from the troughs over the past two months. Valuations are already significantly adjusted but also equity positioning that was trimmed down in most of 2022.

Risk parity strategies suffered in 2022 from synchronised poor returns and high volatility in both equities and bonds, which has led to below average equity allocation but also to trough level leverage. Trend-following strategies (CTA) remain overall net short equities and for hedge funds overall beta to equities remains in the bottom of the range since 2005 (see chart 9).

Entering 2023, low equity positioning will tend to limit the depth of another leg down provided the recession turns out to be shallow.

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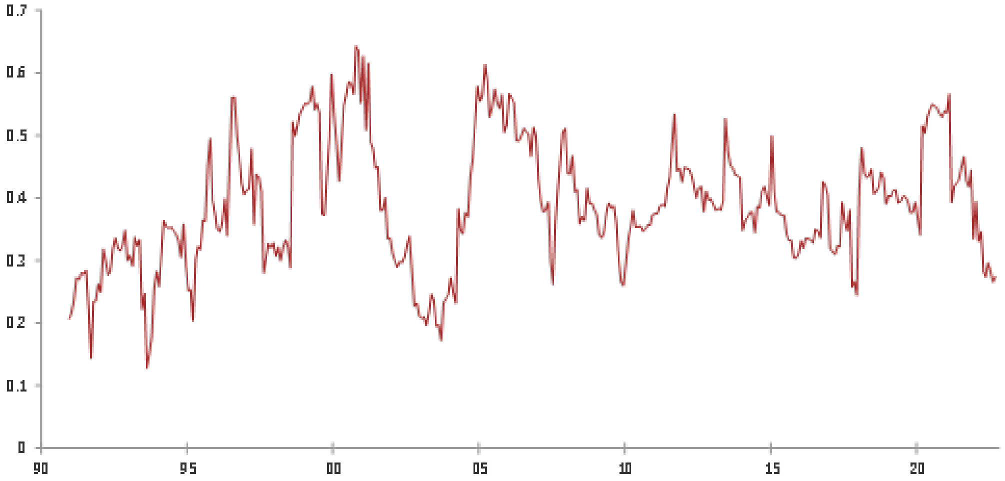
Chart 9: 12-month beta of HFRI fund weighted index to MSCI AC World



Source: PWM - CIO&MR, Factset, 30.11.2022

CONCLUSION

Due to differences in valuation, we have a slight preference for European equities over US ones, but we remain underweight in both places. We remain neutral UK and Japanese equities. Stock indexes in both of those locations should benefit from China's reopening in 2023: Japan thanks to its business position in Asia, and UK blue chip indexes through exposure to commodities where we are more bullish than consensus.

Our core scenario can be challenged by the depth of the recession and/or the hawkishness of central banks. Lower yields could support higher valuation but with the risk that a stronger recession will weigh more on earnings.

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