PICTET WEALTH MANAGEMENT

Developed markets equities: 2024 outlook

Christmas before Christmas

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FLASH NOTE

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SUMMARY

- Our forecast is for low- to mid-single digit growth in developed-market stocks' revenues in 2024 as nominal GDP growth is expected to remain positive.
- Margins are expected to remain fairly resilient as long as inflation decreases in an orderly way.
- After including buybacks, we expect earnings per share in the mid-single digits in 2024.
- Equity valuations could remain rich (in absolute terms and relative to fixed income), especially in the US, as earnings momentum is not expected to plummet and tightening refinancing conditions will bite only gradually.
- We see European stocks as providing the highest cash returns to shareholders. Dividend yields on Japanese stocks should outpace those in the US.
- Japanese equity valuations are already pricing in further improvements in sentiment, driven by incentives for companies to engage in buybacks and for domestic retail investors to invest in stocks tax free.
- The recent end-of-year rally has sent equity indices prices close to or above our end-2024 price targets. These targets will be reassessed as more data come in over the coming months.

SALES EXPECTED TO GROW MODESTLY IN 2024

We believe nominal GDP growth remains the main driver of sales growth. Even if the correlation is not perfect, it is good enough in our view to use for our sales growth forecasts *(see chart 1)*. With this in mind, we observe that the quality of economic growth is deteriorating as it is being driven more by prices (inflation) than by volume (real GDP), and more so in Europe than in the US. This leads us to formulate sales growth expectations in the low- to mid-single digits for developed-market

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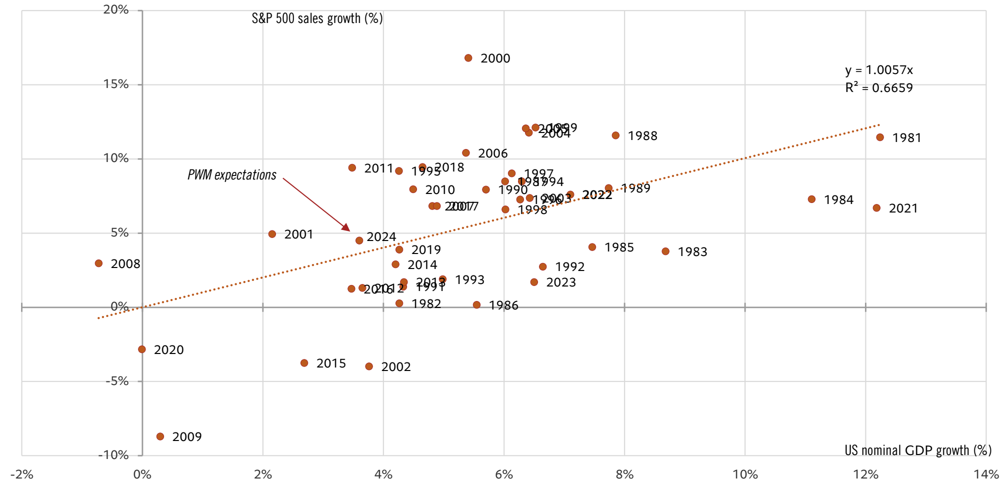
equities in 2024 (3% for the TOPIX, 3.5% for the Stoxx Europe 600 and 4.5% for the S&P 500). Such expectations are a bit lower than the US market consensus as at 7 December 2023. Consensus expectations for sales growth are fairly evenly balanced between defensive, tech-related and cyclical sectors.

Chart 1: S&P 500 sales growth vs. US nominal GDP growth (annual data, 2024 PWM forecasts)



Source: Pictet Wealth Management, FactSet, as at 9.11.2023

FURTHER MARGIN RESILIENCE

While they have dropped somewhat in 2023, corporate margins have actually proved quite resilient. This is true across all companies, not just a few listed big ones. US NIPA (National Income and Product Accounts) margin produced by BEA (Bureau of Economic Analysis) tracks the broadest set of US companies using tax filings and adjusting for inventories and capex. It shows that margins increased after the global financial crisis and have remained at a high level since the end of the covid crisis *(see chart 2).*

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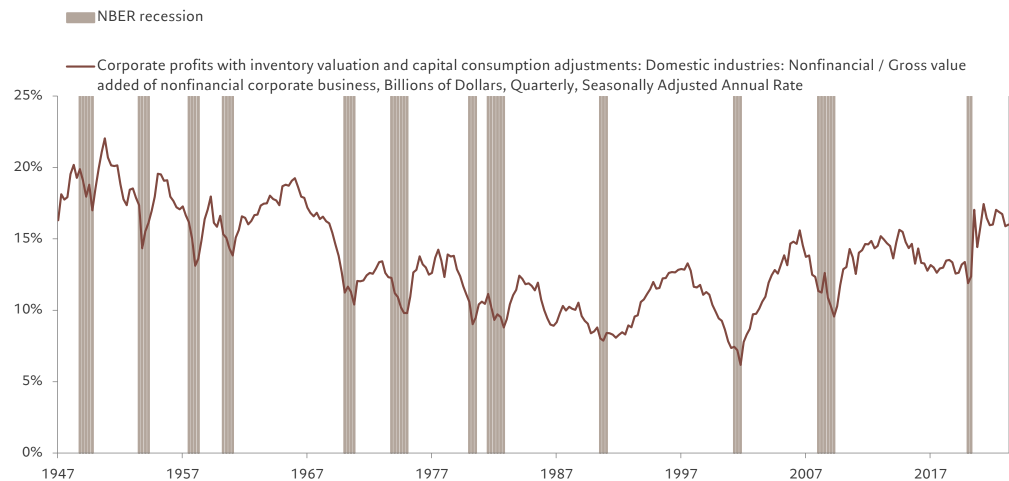
Chart 2: US corporate profit margins for non-financial companies



Source: Pictet Wealth Management, Federal Reserve of Saint Louis (FRED), as at 30.06.2023

Margins go down in recessions, but our macroeconomic scenario is more for a slowdown than a recession in the developed world overall in H1, followed by a modest recovery in H2. This should prevent margins from declining too much. And inflation should help margins as well, just as it did this year. Indeed, as long as inflation recedes only slowly, companies should be able to pass on their additional costs to customers.

There are still some differences in the outlook for margins across countries. Tech-related sectors and the advance taken by US companies in exploiting artificial intelligence (AI) offer the US a competitive advantage over the rest of the world. As a result, we expect flat margins for US equity indexes in 2024 and a small contraction in Europe and Japan.

BUYBACKS SEEN AS BOOSTING EARNINGS PER SHARE

Buyback activity in the US and Europe has declined since the peak reached at the beginning at 2022, but remains at a fairly high level: above its pre-pandemic level in Europe and slightly below it in the US *(see chart 3).* In 2024, we see a buyback yield of 1.5-2% in both Europe and the US. We expect the buyback yield in Japan to increase to 1%, a level not seen before, thanks to stock market reforms designed to encourage companies to boost their price-to-book value. An easy way to achieve this is to shrink the balance sheet and give cash back to shareholders.

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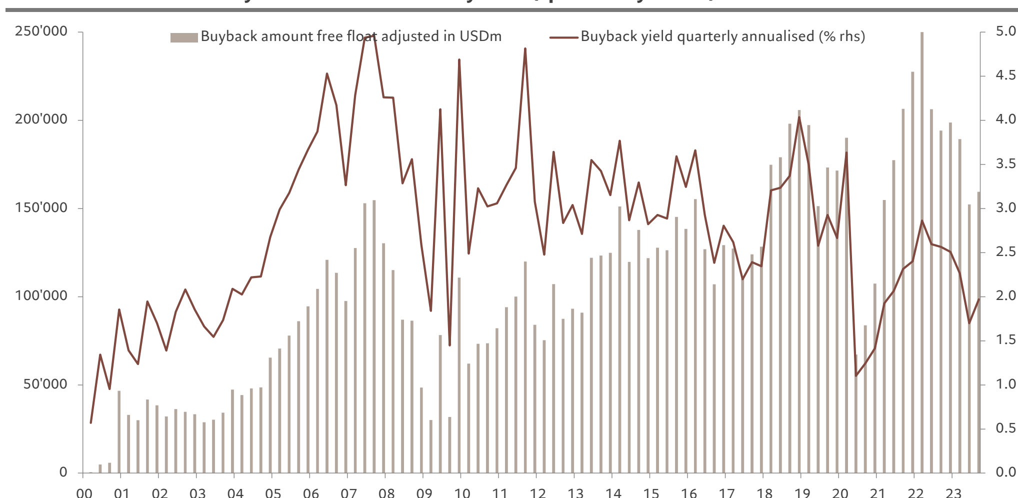
Chart 3: S&P 500 buyback volume and yield (quarterly data)



Source: Pictet Wealth Management, FactSet, as at 30.09.2023

After buybacks, our forecast for earnings per share (EPS) growth in 2024 stands at 6.2% for the S&P 500, 4% for the Stoxx Europe 600 and 3.5% for the TOPIX. Such figures are more conservative than consensus, which stood at 11.2%, 7% and 8%, respectively, at 7 December 2023.

RICH EQUITY VALUATIONS TO REMAIN FOR A WHILE

The biggest surprise of 2023 were equity valuations, which remained high despite strong inflation. This contrasts with previous bouts of high inflation, which dragged valuations down. Equity valuations are now high in absolute terms, relative to history and relative to sovereign and credit yields, especially in the US.

Yet we expect the 12-month forward price-earnings ratio (PER) to remain a high 18x for the S&P 500, 12x for the Stoxx Europe 600 and 14x for the TOPIX. In our view, there are two main factors behind the resilience of valuations: earnings momentum and the schedule for refinancing debts. Historically, equity market valuations have tended to decline when earnings go down. By contrast, we expect mid-single digit earnings growth next year. Calculations of the equity risk premium usually focus on the spot yield for sovereign bonds or credit. But such an approach overlooks the fact that companies (especially big ones) managed to lock in low financing costs during covid, with only a small proportion of this due to be refinanced over the next two years. For example, debt to be refinanced on the S&P 500 is expected to be 7% of the total outstanding in 2024 and 9% in 2025.

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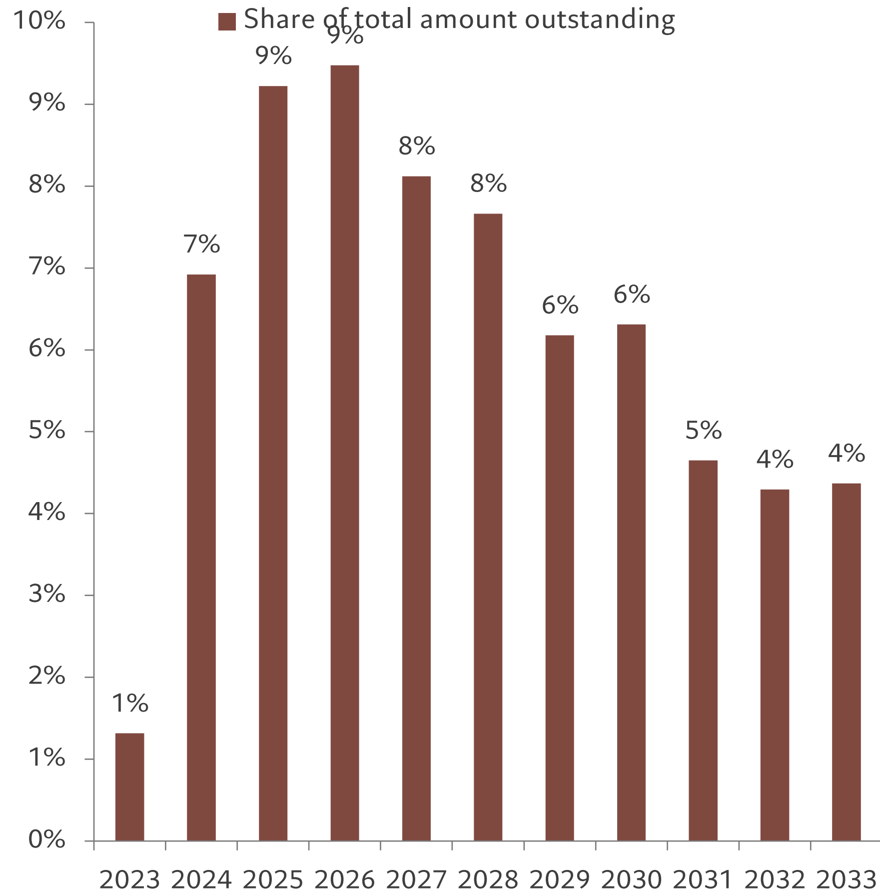
Chart 4: S&P 500 debt maturity schedule



Source: Pictet Wealth Management, Bloomberg Finance L.P., as of 30.09.2023

Our forward PER forecast for the S&P 500 is currently six points higher than for the Stoxx Europe 600. The gap shrinks to four points if one adjusts for sector differences. Either way, the valuation gap is around the highest it has been for 20 years and reflects the strong earnings growth being enjoyed by predominantly US tech companies.

Valuations on the Topix are two points above those on the Stoxx Europe 600 as Japanese equities continue to price in positive economic and regulatory developments.

EUROPE IS THE WINNER WHEN IT COMES TO CASH RETURNS

The one area where European stocks beat the US is in cash returns to shareholders (dividends and buybacks combined). For quite a while, the US and Europe provided a similar cash return to shareholders of around 4%, with more buybacks than dividends in the US and the opposite in Europe. But we think Europe could take the lead in 2024, with a 5.4% cash return to shareholders (a 3.9% dividend yield and 1.5% buy-back yield). This compares with our cash return forecasts of around 3.4% for the US and Japan. We see higher dividend yields on the TOPIX than the S&P 500 next year.

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THE JAPANESE PARADOX

As mentioned, valuations on the TOPIX are now higher than on the Stoxx Europe 600 and it is hard to see them going much further. At the same time, stock market reforms have been pushing quoted Japanese companies to increase share buybacks further. This should ensure Japanese stocks offer a higher cash return to shareholders than US ones in 2024.

The performance of Japanese equities over the past two years is also a mirror image of yen weakness, and thus is tied to the foreign earnings of Japanese exporters. Japanese stocks could suffer if we see substantial rate cuts in the US and the Bank of Japan move away from policy dovishness.

Foreign investor flows are still the main driver of ups and downs in Japanese equities. While foreign investor flows remain volatile, the authorities have been encouraging domestic investors to invest in Japanese shares through tax incentives, although it could still take time to see the full effect.

CONCLUSION

Our forecast of mid-single digit EPS growth for developed-market equites next year is more conservative than consensus. If we can easily accommodate rich equity valuation in this scenario, the end of year 2023 rally already sent valuation at level looking already compelling. Cash returns to shareholders will remain attractive, more so in Europe and Japan than in the US.

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