SingAlliance

# Letter n°107

## Financial market review and outlook for the first half of the year.

***"Bull markets are born in pessimism, grow in skepticism, mature in optimism and die in euphoria." John Templeton.***

- From a stock market perspective, the timeline drawn up by the great fund manager John Templeton remains relevant. Bull markets were born of pessimism in the aftermath of the severe financial crisis of 2008. They found fresh impetus in the scepticism that followed Covid and the invasion of Ukraine. They are now mature, buoyed by the optimism associated with the potential of AI. Equity markets are at or near their peak but, as in 2023, this masks very contrasting trends.

  Bond markets, except for credit markets, are showing zero or barely positive performances again this year. Among commodities, the price of a barrel of Brent crude oil rose by 10% and gold by 12%, but apart from copper (up 14%), the prices of iron ore (down 20%), metals and agricultural products fell, sometimes significantly over the half-year.

- From an economic point of view, a slowdown in global growth is observed, and interest rates are now at levels that exceed inflation rates, risking penalizing economic activity. According to the IMF, global growth this year is expected to be 3.2%, the same as in 2023, a percentage below the 3.8% average of the 20 years preceding Covid. The United States is expected to grow by 2.6%, the Eurozone by 0.9%, Japan by 0.8%, India by 7%, and China by 5%.

- From a structural point of view, the states, constrained by high debt, can hardly resort further to fiscal stimuli.

In this Letter, we will analyse the evolution of different asset classes and the outlook.

**Stock markets**:

Continuing the trend of recent years, the performance of a few major stocks overshadows the rest of the markets, and the American market is strengthening its dominance. Since 2008, the earnings per share of American companies in the MSCI US index have increased by 160%, while those in the rest of the world have decreased by 2%.

***American market***:

The market capitalization of the 1,500 largest companies is equivalent to 2.2 times the US GDP, an unprecedented level, and for the first time, the top 6 of the S&P 500 represent 30% of the total market capitalization.

Despite interest rates at 5.25%, the American stock market is appreciating because liquidity remains abundant, allowing bubbles to develop. However, the development is uneven.

- A handful of stocks with significant increases:

The Nasdaq is at a high thanks to the appreciation of Nvidia, whose stock price in the first half has multiplied by 2.5, allowing its market capitalization to exceed $3 trillion. A few other companies in the sector also

performed very well, such as Micron, the 5th largest increase in the S&P 500, up 54% to $147 billion, and Applied Materials, up 46% to $199 billion.

Apple's appreciation was limited to 9%, but it remained the second largest market capitalization in the world at $3.378 trillion, behind Microsoft, which rose 19% to $3.414 trillion.

Another notable performance was META, classified in the communication sector, which saw a 42% increase to $1.293 trillion. In the same sector, Alphabet-Google recorded a 30% increase to $2.297 trillion. Amazon, the sixth star, classified in the discretionary consumer sector, appreciated by 27% in the first half to $2.081 trillion.

- Many stocks have decreased:

Not all technology companies are benefiting from the AI wave, so selectivity is crucial. The worst performer in the S&P index in the first half was Intel, down 38% to $182 billion. Accenture also declined by 14% to $191 billion, Adobe by 7% to $252 billion, Cisco by 6% to $191 billion, and Salesforce by 2% to $248 billion.

***In the first half of the year,*** 60% of S&P500 stocks appreciated, ***but on an equally-weighted basis, the S&P500 rose by 5% rather than 14%.***

In the ***second quarter***, the Russell 2000 declined by 3.6% to a level 17% lower than its peak in November 2021. ***The S&P 500 gained 3.9%, but excluding the AI sector, which increased by 14.7%, the market lost 1.2%.***

- Contrasting sector performances:

In the first half, only 2 of the 11 main sectors outperformed the S&P 500 index's 14.8%: technology (+29%) and communication (+26%). Performances were disappointing for real estate (-5%), materials (+1.5%), industrials and discretionary consumer goods (+5.8%), healthcare and “consumer staples” (+6.5%), financials and energy (+9%), healthcare, real estate, industrials, and materials.

The *utilities* sector is up because the development of AI is expected to drive growth in electricity demand. Notable performers include Constellation Energy, the second largest increase in the S&P 500 (+71%), and Nextera (+17% to $145 billion).

*Food consumption* outperformed discretionary spending on cars, durable goods, and restaurants, reflecting greater consumer caution.

Walmart appreciated by 29% to $548 billion, and Costco also by 29% to $381 billion. Defensive stocks like Colgate (+22%) and Procter & Gamble (+13%) also performed well.

Conversely, Nike's market capitalization fell by 31%, the second worst performance in the S&P index, to $115 billion. Starbucks declined by 19% to $87 billion, and McDonald's by 14% to $179 billion.

Companies related to *leisure or tourism* performed well: Booking increased by 12% to $133 billion, Airbnb by 11% to $99 billion, and Marriott by 7% to $69 billion.

The evolution in the *pharmaceutical* sector is mixed and remains linked to the launch of new products. Eli Lilly exemplifies this with the 4th largest increase in the S&P 500 (+55% to a market capitalization of $862 billion), along with Boston Scientific (+33% to $113 billion). On the other hand, Pfizer's stock dropped by 3% to $158 billion, as did Bristol-Myers Squibb (-19% to $82 billion), Johnson & Johnson (-7%), and Abbott (-6%).

- Outlook:

There are two arguments in favor of tech. Firstly, operating margins, thanks to tech stocks, exceed 30% for the S&P 500, whereas an equally weighted S&P would be at 15%, and the Russell is barely above 10%. Secondly, the expected earnings growth for the top 6 is 30%, while that for the entire tech sector is 20%, significantly higher than the S&P 500's 10% this year. Excluding technology, the increase would be only 5%, with a market P/E ratio excluding the top 6 at 19x, which is considered high.

***European market***:

- Similar to the American market, with highly concentrated gains:

The market's appreciation since the beginning of the year, like in the United States, relies on a few stocks, notably the Danish company Novo Nordisk, the largest European capitalization, up 40%, and ASML, the largest capitalization in the Eurozone, up 50%, with a capitalization of €390 billion.

The tech sector remains underrepresented in Europe. After ASML, SAP, up 36% to €230 billion, is the second-largest European tech company, but its capitalization is not even a tenth of the large American companies. Noteworthy is the disappointing performance of Dassault Systèmes, down 20% to €46 billion.

European capitalizations are far from American ones. LVMH, the second-largest capitalization in the Eurozone, is worth only $350 billion, and Total, at €150 billion, the fourth-largest European capitalization, is not even a third of Exxon's value.

- Many disappointments:

Aside from a few tech stocks, some financial stocks, and a few healthcare stocks, the European market shows lackluster performances.

While the market appreciated by 7%, property and “utilities” stocks fell by 4.5%, “consumer staples” stocks fell by 3.5%, materials and consumer discretionary stocks appreciated by less than 3%, energy stocks by 5% and communications stocks by 5%.

In the first half, some large *industrial* stocks performed well. Companies related to defense like Safran (+24%) and those benefiting from the energy transition like Schneider Electric (+23%) and ABB (+34%) were notable performers.

However, Airbus was disappointing, falling behind in its deliveries due to subcontracting issues. The stock fell by 8%, is not cheap, but is worth monitoring. Vinci also saw a decline of 13% during the semester.

*Luxury* stock performances have become very contrasting, as global demand slows and becomes more selective. According to Bain, the luxury market is expected to grow between 0% and 4% in 2024. Richemont exemplifies this with an organic sales increase of only 1% as of 30 June. While Ferrari's stock is up 25%, Richemont is up 21%, partly after Bernard Arnault's announcement of stock acquisitions, and Hermès is up 12%, LVMH has declined by 3%, and Kering by 15%. In cosmetics, L'Oréal has dropped 9%. Hermès remains the strongest company in the sector, with expected profit growth of just over 10%, but it trades at 50 times earnings. Caution is advised in the luxury sector, especially in accessible luxury brands like Burberry, Hugo Boss, and Swatch, which are suffering from the Chinese slowdown.

In the *automotive* sector, Porsche's stock should be monitored, having lost 13% in the first half as sales fell by 10% in the second quarter due to the Chinese market. For the year, operating margin forecasts between 15% and 17% are expected to be met.

*Consumer* stocks have had quite disappointing performances: Nestlé is down again by 6%, though still relatively expensive, and brewers are all declining, with Anheuser down 7%, Heineken down 2%, and Carlsberg down 1%. Diageo has fared worse in other beverages, down 13%.

The *healthcare* and personal care sectors also show contrasting performances. Besides Novo Nordisk, already mentioned as a star, AstraZeneca is up 17%, and Novartis, after a long period of underperformance, is up 13%. In contrast, Merck, GSK, Roche, and Sanofi are more disappointing with gains ranging from 7% to 0.

In the second quarter, the EuroStoxx lost 3.6%, the CAC 40 fell by 8.8%, while the DAX only declined by 1.4%. The CAC 40 has dropped 4.5% since the announcement of the dissolution, and a cautious short-term approach is advised.

***Emerging markets***:

Valuations remain low, with a P/E ratio of 12x. Recent performances have been disappointing, but typically these stocks outperform during periods of declining US interest rates. A recovery can therefore be expected starting from the fourth quarter when the rate cuts are initiated in the United States.

**Bond markets**:

***Inflation trends***:

In the United States, inflation, as measured by the PCE index, is at 2.6% compared to 4% a year ago, thus approaching the 2% target.

In Europe, inflation in June was at 2.5%, gradually approaching the 2% target.

In China, deflation still threatens, with the consumer price index in June up only 0.2% year-on-year, and producer prices falling by 0.8% year-on-year.

***Short-term interest rate trends***:

Expectations were high at the beginning of the year, with many operators anticipating 6 interest rate cuts. However, the Fed and the Bank of England did not lower their interest rates. The ECB and the Bank of Canada each made only one cut, with the former lowering rates from 4% to 3.75% and the latter to 4.75%.

By the end of the year, two rate cuts are expected in Europe and two in the United States, in September and December. Rate cuts are also anticipated in the UK, where the rate is at 5.25%, but inflation has returned to 2%. The only restraint is in service sector inflation, which remains at 5.7%.

In Switzerland, 2 rate cuts have been decided since the beginning of the year as inflation rapidly dropped to 1.3% in June, now below the 2% target.

In Japan, the central bank, faced with a sharp decline in the yen and inflation hovering around 2%, may raise rates faster than expected. However, they will proceed cautiously because a 1-point increase in rates means nearly $25 billion in additional interest on debt.

***Long-term interest rate trends***:

In the United States, the 10-year yield fell from 4.7% at the end of April to 4.2% at the end of June and is expected to be below 4% by the end of the year.

In Europe, the France-Germany spread on the 10-year yield was below 50 basis points until June, then peaked at 82 basis points, and recently stood at 70 basis points. Short-term caution is advised regarding French banks and yields.

***Impact of rates on financial costs***:

Concerns persist about corporate debt in a high-rate environment. However, a recent study by Janus Henderson on globally listed companies shows that overall debt levels are not problematic, as interest payments account for only 12.4% of operating profit and net debt is less than 50% of equity.

***Impact of interest rates on stock values***:

In the US financial sector, notable performances include American Express up 24% to $170 billion, Citigroup up 23% to $123 billion, Wells Fargo up 21% to $213 billion, JP Morgan up 19%, Bank of America up 18% to $320 billion, and strong showings from Goldman Sachs and Morgan Stanley.

We remain cautious about regional banks, which are affected by difficulties in commercial real estate and office space, and prefer large banks. As expected, the KBW Regional Banks Index is down 12% this year,

reflecting the challenges faced by these smaller institutions, which hold a quarter of sector loans, double the share of the top 25 banks.

In the European financial sector, we have favored Southern European stocks for several months, benefiting from interest rate dynamics. Unicredit is up 41%, Intesa San Paolo up 31%, Banco Santander and BBVA up 15%. We maintain caution towards French financial stocks, despite BNP Paribas, the largest bank in the eurozone, experiencing a 5% decline in the first half.

It's noteworthy how the market capitalization of major European banks pales in comparison to their American counterparts. BNP Paribas' €70 billion market cap is significantly smaller than JP Morgan's $600 billion.

**Commodities**:

***Rise in oil prices***:

As a result of a 10% increase in oil prices, oil-related stocks saw gains in the first half of the year, especially in the United States. Exxon, the largest in the sector with a $510 billion market cap, gained 17%. Chevron, valued at $290 billion, saw a more modest increase of 5%. Pure production companies, which are more sensitive to crude oil prices, outperformed integrated majors. Examples include Valero Energy, up 21%, and Marathon Petroleum Corp, up 17%.

However, Schlumberger, the leader in oilfield services, declined 9% over the semester.

European oil stocks, despite the rise in oil prices, did not perform as well. Shell saw a 10% increase, but BP, Total, and Eni registered respective performances of 2%, 1%, and -6%. BP issued a profit warning due to weak profitability in refining operations in the second quarter.

Nevertheless, these stocks remain attractive as we maintain a positive outlook on oil prices, which serve as a hedge against geopolitical uncertainties.

***Energy transition***:

Last year, we extensively studied the challenges faced by companies in the sector, including competition from China and overcapacity issues. Vestas, a major Danish wind energy player, continues to decline, down 25%. Caution is advised, especially considering that a re-election of Trump could adversely affect prospects in these sectors.

***Metal prices trend***:

In the metals sector, while Freeport-McMoRan appreciated by 14% in the first half of the year, reaching a market cap of $70 billion, European metal-related stocks showed disappointing performances. Rio Tinto fell by 11% and Glencore by 4%. Given the sector's acquisition activities, these stocks warrant consideration.

**Currencies**:

The dollar is at a high level, reminiscent of the mid-1980s and early 2000s.

During the second quarter, the Yen depreciated by 5.9% against the dollar. South American currencies also saw declines: the Brazilian real by -10.3%, the Mexican peso by -9.6%, and the Argentine peso by -5.8%. The Euro and Yuan were relatively stable, each losing only 0.7% against the dollar. The Indian Rupee remained stable against the dollar. The Swiss Franc appreciated by 0.3%. Gold rose by 5% and silver by 18%.

The upcoming rate cut process in Great Britain could potentially weaken the pound.

The Swiss National Bank has already cut its interest rates twice, currently at 1.25%. Therefore, the Swiss Franc is expected to appreciate gradually as the interest rate differential narrows with other major currencies.

**Conclusion**: ***"When one believes with the firmest faith that one possesses the truth, one must know that one believes it, not believe that one knows it." Montaigne.***

- ***Valuations***:

The American market is valued at 21 times earnings, the Japanese market nearly 16 times, the European market at 14 times, and emerging markets at 12 times earnings.

- ***Undeniable American dominance***:

Despite critics and those forecasting American decline, since World War II, S&P500 company profits have grown by over 8% annually, driven by real GDP growth of 3% and productivity gains of 2% per year.

The Dow Jones, at 1000 in 1982, now stands at 40,950. In this period, GDP has multiplied by 8 and profits by nearly 15 times.

The US market now represents 60% of global market capitalization, up from 40% in 2008. Nvidia, Microsoft, and Apple alone account for 10% of the global market.

Compared to major American firms valued above $3 trillion, top international firms appear modest. Novo Nordisk, Europe's largest market capitalisation, is at €589 billion, ahead of ASML at €390 billion. Tencent, China's largest market capitalisation, is $450 billion ahead of Industrial & Commercial Bank of China. Toyota, Japan's No. 1 listed company, has a market capitalisation of $320 billion, ahead of Mitsubishi at $137 billion. Reliance Industry, India's largest listed company, is at $257 billion, ahead of Tata at $169 billion.

In Russia, the largest capitalisation, Sberbank, does not exceed $71 billion, ahead of Rosneft at $63 billion. In South Korea, Samsung has a market capitalisation of $370 billion, ahead of Hynix at $120 billion.

The depth and dynamism of the US market are therefore incomparable.

- ***Outlook***:

In the coming months, a sectoral rotation is possible. Potential upside could resemble the post-dot-com bubble recovery, focusing on small caps, energy, and emerging markets. Further details will follow in upcoming communications.

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