GENERALI ASSET MANAGEMENT

FOCAL POINT

Resilient earnings growth to support equity returns and sector rotation

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Our Focal Point series explores topical issues on macro, markets and investment

- **Starting from Q3 2023, the US annual earnings growth momentum has been satisfactory, only slightly below the 10-year average (8.6% yoy vs 10.1%), supported by robust US economic growth. Analysts expect the Q2 2024 reporting season to show higher growth versus Q1 and better relative ex-US tech momentum, including the riskier EMU stocks.**
- **So far, the first US 180 firms have shown moderate earnings surprises. That said, this time US Q2 earnings estimates have been hardly revised down before the season started (+3pp better revisions vs historical average since 2011), so positive surprises are less probable. Political risk and softer macro could also affect guidance, though the latter has so far looked better than in Q1 for earlier reporters.**
- **Supported by our earnings models, we see 2024 earnings growth at 9% for the US and 7.5% for the EMU. For the latter, we are currently 4pp above consensus. We will probably have to make slight adjustments to the downside, due to following headwinds: French politics, trade frictions, and bumpy recovery overall. For 2025, we see 9% growth for US and 5% for EMU, below consensus by 5pp and 1pp, respectively.**
- **Judging by different macro indicators, US margins seem to be relatively safe near term. Moreover, corporate Cash Flow minus Capex spread remains very high, with net equity issuances very low and buybacks high. This translates into a positive medium-term technical picture for the market, which also supports our slight OW position in equities.**
- **In the short term, however, we do not exploit a bolder OW position due to rising risks: toppish ISM momentum, negative macro surprises, high US PE, declining banks' liquidity, and higher investor positioning. Over 12 months, we still expect positive total returns (TR) of 4% in the US and 7.0% for the EMU due to the decent earnings growth, ex-US valuations which remain fair-to-attractive, and more accommodative central banks.**

One year ago, the US earnings growth was negative (Q2 '23 at -2.8% yoy) due to the increase in interest rates, a stronger US dollar, still challenging inflation, and economic uncertainty (widespread predictions of a potential recession). Additionally, lingering supply chain disruptions caused by Covid continued to affect both production and distribution. Over the last quarters, the economic fundamentals have improved, while supply chain disruptions have been gradually resolved. As a result, US earnings have begun to accelerate, with an average earnings growth since Q3 2023 only slightly below the 10-year average (8.6% yoy vs 10.1%). Such growth was driven to a greater extent by mega-cap growth and Tech, while Energy & Materials were a big drag (-25% yoy on average).

As for the Q2 2024 reporting season, both ex-US tech sectors and the riskier EMU stocks are expected to show a slightly better earnings (EPS) momentum relative to the US Tech. The Tech EPS growth is indeed decreasing but from a very high level (17.8% yoy from 27% in Q1).

The consensus expects S&P 500 EPS growth in the quarter at 12.1% yoy, with a weakening in Q3 at 7.1%. Thereafter, it is expected to accelerate, with the average growth in Q3 ’24 - Q1 2026 at almost 15.6%.

In Europe, EPS growth is improving as well: for Q2, the consensus expects a slightly negative growth of -0.8% yoy for the Stoxx 600 index (-3.3% in Q1) and -2.1% in particular for companies domiciled in the euro area (from -4.7% in Q1). From Q3 ’24 to Q3 ‘25, annual EPS growth is expected to turn around and average 12.8% for Europe, albeit risks look higher than in the US: politics, trade, and bumpier recovery due to weak firms’ confidence.

In terms of the results achieved so far, the initial US 180 firms have shown decent EPS surprises (+4.5%), aligned to the average over the last nine quarters (5%), though below Q1 (+9%). Annual earnings growth has somewhat receded when compared to the same number of companies in the previous quarter (6.3% vs 8.4%). Within US sectors, materials have shown the highest EPS surprise of 8.3%, being followed by financials (6.5%). Both sectors show higher EPS surprises vs the average of the last nine quarters.

S&P 500: Q2 earnings reporting season (180 companies reported)

Sector	earnings growth,		sales growth, yoy		margin trend *	
	Q1 2024	Q2 2024	Q1 2024	Q2 2024	Q1 2024	Q2 2024
S&P 500	**8.4%**	**6.3%**	**3.8%**	**4.1%**	**4.6%**	**2.2%**
Median (all sectors)	4.6%	1.5%	3.4%	2.0%	1.2%	-0.5%
Median, ex. Energy	3.7%	1.9%	3.6%	2.0%	0.0%	0.0%
Median, ex. Energy & Materials	4.6%	2.3%	3.8%	2.7%	0.8%	-0.4%
Median, ex. Financials	3.7%	1.5%	2.7%	1.6%	1.0%	-0.1%

Sector	earnings surprise %		sales surprise %		margin trend *	
	Q1 2024	Q2 2024	Q1 2024	Q2 2024	Q1 2024	Q2 2024
S&P 500	**9.0%**	**4.3%**	**1.0%**	**1.0%**	**8.0%**	**3.3%**
Median (all sectors)	8.9%	3.6%	0.6%	0.5%	8.3%	3.0%
Median, ex. Energy	9.3%	3.7%	0.7%	0.6%	8.6%	3.1%
Median, ex. Energy & Materials	9.8%	3.6%	0.6%	0.5%	9.2%	3.0%
Median, ex. Financials	8.3%	3.3%	0.6%	0.5%	7.7%	2.9%

Source: Bloomberg, GenAm calculations
Note: proxy for margin trend = earnings growth - sales growth

Overall, for US Q2 reporting season, consensus expects the highest growth coming from Communication Services (24%), Healthcare (22.5%) and Technology (17.8%).

In Europe (Stoxx 600), the EPS picture is improving: the average surprise of the first EU 151 results is at +3.9%, while the comparable number of companies had a negative surprise in Q1 (-4.1%). EU utilities have shown the highest EPS surprise of 101%. In terms of earnings growth for the Stoxx 600, there is a clear improvement so far, too: +3.9% yoy vs -5.5% of the comparable number of companies in Q1.

Stoxx 600: Q2 earnings reporting season (151 companies reported)

Sector	earnings growth,		sales growth, yoy		margin trend	
	Q1 2024	Q2 2024	Q1 2024	Q2 2024	Q1 2024	Q2 2024
Stoxx 600	**-5.5%**	**3.9%**	**-6.6%**	**-1.3%**	**1.1%**	**5.2%**
Median (all sectors)	-6.3%	3.3%	-9.2%	-0.5%	2.9%	3.8%
Median, ex. Energy	-6.1%	3.5%	-8.1%	0.0%	2.0%	3.5%
Median, ex. Energy & Materials	-6.1%	3.6%	-9.2%	0.5%	3.1%	3.1%
Median, ex. Financials	-6.5%	3.5%	-8.3%	-0.6%	1.8%	4.0%

Sector	earnings surprise		sales surprise		margin trend	
	Q1 2024	Q2 2024	Q1 2024	Q2 2024	Q1 2024	Q2 2024
Stoxx 600	**-4.1%**	**3.9%**	**-8.0%**	**-1.3%**	**3.9%**	**5.2%**
Median (all sectors)	-3.1%	3.3%	-1.1%	-0.5%	-2.0%	3.8%
Median, ex. Energy	-2.7%	3.5%	-0.5%	0.0%	-2.2%	3.5%
Median, ex. Energy & Materials	-2.7%	3.6%	0.0%	0.5%	-2.7%	3.1%
Median, ex. Financials	-3.5%	3.5%	-1.2%	-0.6%	-2.3%	4.0%

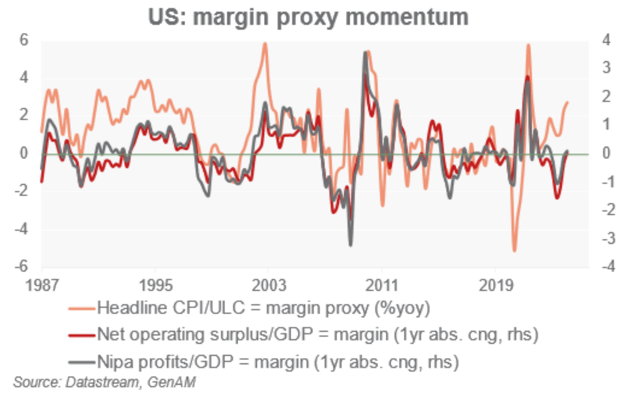
Source: Bloomberg, GenAm calculations
Note: proxy for margin trend = earnings growth - sales growth

For the US (S&P 500), we see only a slight weakening so far in the EPS growth when analysing the median stock: 8% in Q1 vs. the current 7.4%. Still, Magnificent 7 is expected to grow at +30% yoy, while the rest of the S&P500 (493 companies) is projected to be positive at +5%. Thus, the gap between M7 and the S&P 493 is expected to narrow: in Q1, M7 yoy EPS growth was at +52.5% vs. zero growth for the S&P 493. In contrast to the US Tech, consensus expects negative Q2 EPS growth for EU technology stocks (-31.2% yoy: the worst within EU sectors). On the contrary, EU Utilities are expected to have a higher growth compared to their US peers (17.5% vs 5.1%).

It is worth noting that this time US Q2 earnings estimates have been hardly revised down before the season started (+3pp better revisions vs historical average.), so positive surprises should be less probable as the season gets more mature and additional companies report. Political risk and softer macro could also affect US firms’ guidance, though the latter has so far looked better than in Q1: the ratio of negative to positive preannouncement in Q1 was at 3 vs 1.9 for Q2 reporting season, which is even slightly below the long-term median since 2001 at 2.2.

We see profit margins to stay resilient

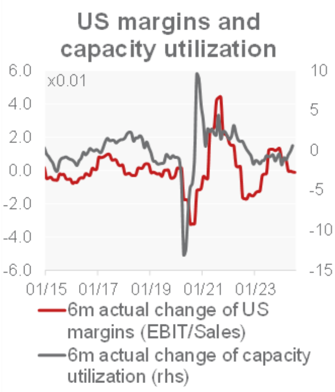
The S&P earnings growth (yoy) has bottomed out in Q3 2023 - both NIPA profits and trailing earnings – EPS - and



Source: Datastream, GenAM

we expect an average growth of around 7% in the next quarters - as predicted by our proprietary models.

There has been a notable decline in US unit profits over the past few quarters, but there are indications that this trend is beginning to reverse. Additionally, NIPA profit margins on GDP (NIPA measures the profits of all US firms as included in the GDP) have rebounded and are forecast to remain resilient in the next months: financing conditions are supportive together with the trend in unit labour cost (ULC) vs. CPI (see chart on previous page). Increasing levels of US capacity utilization should also support both the US



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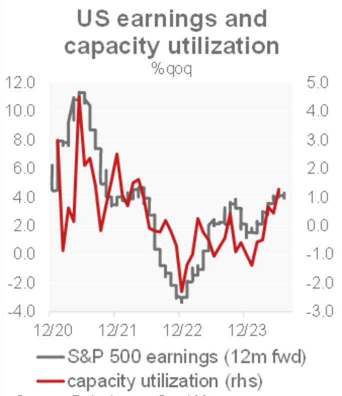
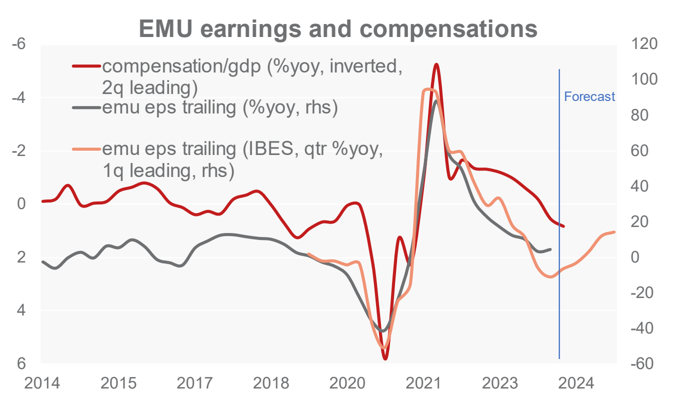


Source: Datastream, GenAM

margins and earnings. Other than this, as reported by company CEOs, the persistently tight labour market is driving companies to seek higher productivity, both by re-engineering their processes and by investing in technology, AI included. Lastly, the US macro momentum, while decelerating, remains quite resilient and capex is still subdued. The latter should improve as inflation declines, and the Fed's policy becomes more accommodative.

In the euro area (EA), the contribution of unit profits to the GDP deflator has continued to decrease given that the exceptional factors that contributed to margin expansion are fading. EMU Gross operating surplus (GOS, i.e., EBITDA at a macro level) on GDP has already slowed down



Source: LSEG, I/B/E/S, GenAM calc

significantly in the last quarters as compensation on GDP increased substantially. But this has already been fully reflected in the negative year-on-year changes in trailing EPS and in the last four quarterly reporting seasons. Based on our EMU earnings forecast, we do not expect profit margins to weaken appreciably in the next quarters. Indeed, EA quarterly profits have most probably reached a cyclical bottom. With EA activity back in expansionary territory, we expect positive earnings growth in 2024, with the short-term risk coming from current negative macro surprises, an uncertain decline in inflation, French politics and trade frictions triggered by a possible Trump election. On the contrary, better global momentum ahead, a resilient labour market and a weaker TW euro represent tailwinds. Furthermore, we see the chance of a better inventory cycle ahead for both the US and Europe as a result of declining uncertainty about future interest rates (lower MOVE index, i.e. US bonds' volatility) as well as corporate investment needs in the AI, Tech, infrastructure and transition fields.

Comprehensive earnings assessment

As mentioned above, among other qualitative considerations for our earnings assessment, we derive insights from our proprietary earnings models.

As a first step to access the US earnings growth for the 2024-2025 period, we estimate the NIPA earnings (profits for the overall US economy), which tend to lead S&P 500 IBES by 1-2 quarters. Based on our macro forecasts, NIPA profits' growth should be particularly strong for Q2 (+7.9%), then decrease somewhat to 3% towards the end of 2024. During 2025, NIPA growth is expected to average 3.5% yoy growth. Independent variables in our proprietary model are ISM, CPI, unit labour costs (ULC), and US yield curve steepness (10y-2y). We expect US GDP growth in 2024 to

	US NIPA profits			S&P earnings		EMU earnings	
	%GDP	bl$	yoy	level	yoy	level	yoy
2023 Q1	11.8	3,165.1	4.6	215.8	2.6	15.9	16.9
2023 Q2	11.7	3,172.1	-2.7	214.8	-0.7	16.1	12.8
2023 Q3	11.9	3,280.7	-0.6	216.2	-0.9	16.4	10.5
2023 Q4	12.2	3,414.2	5.1	216.8	-0.6	16.5	3.7
2024 Q1	12.0	3,393.1	7.2	223.2	3.4	16.6	4.3
2024 Q2	**12.0**	**3,423.0**	**7.9**	**231.5**	**7.8**	**17.2**	**6.8**
2024 Q3	**12.1**	**3,447.2**	**5.1**	**235.6**	**9.0**	**17.6**	**7.5**
2024 Q4	**12.2**	**3,513.7**	**2.9**	**234.8**	**8.3**	**17.6**	**6.7**
2025 Q1	**12.2**	**3,528.6**	**4.0**	**238.9**	**7.0**	**17.5**	**5.4**
2025 Q2	**11.9**	**3,551.6**	**3.8**	**247.2**	**6.8**	**18.0**	**5.1**
2025 Q3	**12.1**	**3,557.7**	**3.2**	**252.8**	**7.3**	**18.5**	**5.4**
2025 Q4	**12.1**	**3,615.5**	**2.9**	**251.5**	**7.1**	**18.5**	**5.1**

Source: LSEG, GenAM calculations
forecasts in bold

be at 2.4%, which is slightly above the historical average since 2010 (2.3%). 2025 should see a lower GDP growth of 1.8%. In contrast, we forecast a more muted real GDP growth in the EA at 0.8%, which should see some acceleration in 2025 at 1.4% (slightly higher than the historical average since 2010 at 1.3%).

The second step involves utilising NIPA profits to forecast IBES earnings for both S&P 500 and EMU.

Additionally (3rd step), we employ an alternative set of models that give more weight to the recent trend of macro variables: oil, trade-weighted Euro and USD, NIPA, yields, industrial production, unemployment, ISM, and exports.

Supported by our models, we see 2024 earnings growth at 9% for the US and 7.5% for the EMU: for the latter, we remain above consensus by 4pp, albeit as downside risks are materializing, we may have to make some negative revisions to our estimates. We refer to risks already cited above and a bumpy recovery overall. Last PMIs and IFO are indeed providing reason of caution. For 2025, we see 9% growth for US and 5% for EMU, below consensus by 5pp and 1pp, respectively.

Increased chances of sector and country rotation

As previously noted, the relevant development is the rotation we are starting to see from US Tech (neutral stance) to ex-US countries and into other sectors. To be sure, US Tech is still backed by good EPS momentum, peaking yields, and negative macro surprises. But the sector is also characterized by elevated positioning, while other US sectors and European indices, on the contrary, are near the historical average or slightly below. As the cycle will prove to be resilient - still good level in the world leading index and Sentix, probable inventory restocking, bottoming capex, very positive free-cashflow and better financial conditions ahead – a better earnings growth outside the US Tech (and consequent performance rotation) can linger, supporting a higher number of market opportunities and diversification potential in the quarters ahead.

Indeed, we expect central banks' policies to become more accommodative, which in the end would trigger lower bond volatility and probably some outflows from MMF (money mkt funds) into bonds and equity funds. Finally, as previously stated, corporate Cash Flow minus Capex spread also remains very high, with net equity issuances low and buybacks high. This translates into a very positive technical picture for the markets, which significantly limits the chances of a prolonged downside from here.

We see our OW particularly justified over 12 months

In the near term, we are adopting a more cautious approach. The US cycle is resilient, but macro surprises are negative, along with toppish banks' liquidity at the Fed. Furthermore, the positioning looks higher and US valuations are not far from our 1-year target. Finally, inflation uncertainty could eventually continue to linger for a while, triggering a prolonged cautious stance by central banks. Geopolitical risks also appear to be on the rise again: imminent US election and tight Democrats-Republican odds, Israel and Ukrainian conflict and French political chaos.

In light of the aforementioned factors, we decided not to adopt a more aggressive OW position. Over the next 12 months, we still expect positive total returns (TR) of 4% in the US and 7% for the EMU due to the decent earnings growth, ex-US valuations that remain fair-to-attractive, and more accommodative central banks.

Imprint

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