Daily Research Update

March 27, 2024

Equities	Chg	Bonds	Yld	FX	Spot	Commodities	Spot
S&P500	-0.28%	UST 2Y	4.59%	EURUSD	1.08	Gold $/oz	2,177.10
NASDAQ	-0.42%	UST 10Y	4.23%	USDJPY	151.54	WTI Crude $/bbl	81.15
Stoxx600	+0.24%	Barclays US IG	5.28%	GBPUSD	1.26	Brent Crude $/bbl	85.69
MSCI AxJ	+0.49%	Barclays US HY	7.70%	USDCNH	7.25	Copper $/lb	400.45

Source: Bloomberg

Please note: We have published our latest FX forecasts, as of March 26, 2024. The new forecasts take into account the recent surprise move by the Swiss National Bank to cut interest rates. For more information, please contact your Relationship Manager.

Key Points

- After a worrying acceleration in January, core PCE services inflation in the US should cool in February, as the first month of the year is typically distorted by seasonal effects. Goldman Sachs expects price growth of most components of the core PCE services basket to continue to come down throughout the year.

- Valuation of European equities has some more room to expand even as the 12% gain in the Stoxx 600 index over the past six months was driven entirely by valuation. Better growth prospects and easier monetary policy should drive valuation expansion for European equities this year.

Macroeconomic Data Overnight

New orders for manufactured durable goods in the US rose by 1.4% MoM in February, surpassing market expectations of a 1.1% rise after the reading fell -6.9% in January. Orders rebounded for transportation equipment (3.3% MoM vs. -18.3%) and capital goods (1.9% vs. -17.1%). Excluding transportation, new durable goods orders increased 0.5%. Core durable goods, which exclude defense and aircraft due to their volatile nature, increased 0.7% MoM after a -0.4% decrease in January, surpassing estimate of a 0.1% increase. Core durable goods orders is often seen as a proxy for corporate capex and should allay market fears of a sharp slowdown in the US.

The GfK Consumer Climate Indicator for Germany edged up to -27.4 in the forecast for April from -28.8 in March, slightly above market forecasts of -27.9. A reading of 10 indicates optimism, and was last seen in 2019. The survey, taken from February 29 to March 11, shows expectations for income rose modestly to -1.5 vs. -4.8 in February, as did those for economic prospects (-3.1 vs. 6.4). Willingness to buy was -15.3 compared with -15 in February. All this points to a sluggish recovery in consumer sentiment.

In the US, the Conference Board Consumer Confidence Index remains essentially unchanged at 104.7 in March vs. 104.8 in February. The Present Situation index improved to 151 from 147.6 the month prior, but the Expectations Index, which reflects consumers' short-term outlook for income, business, and labour market conditions, fell to 73.8 vs. 76.3 last month. An Expectations Index of below 80 often signals a forthcoming recession, according to the Conference Board. The Expectations index has been criss-crossing the 80 mark since 2022.

Core PCE services inflation to cool in Feb after spike in Jan

Personal Consumption Expenditure (PCE) services ex-housing price inflation, or core PCE services, in the US rose 0.6% MoM in January. This is a significant acceleration from an average of 0.2% in the second half of 2023, and brings the year-on-year increase to a worrying 3.5%. Goldman Sachs (GS) points out this is largely due to the 'January effect', and expects the February print, due at the end of this week, to show a sequential slowdown, considering the February CPI and PPI prints released earlier in the month.

By subcomponents of core PCE services, food and accommodations, and healthcare services were the key drivers of the pickup in sequential inflation in January. GS expects sequential inflation in these items to slow in February to bring the annual rate of price growth to levels consistent with the 2% target. Financial services inflation contributed to almost one-third of the increase in January because equity prices have risen further, which means higher fees. This component is expected to remain firm as equity prices have risen further, but GS expects it to slow after March.

Healthcare PCE inflation has risen somewhat over the last year, compensating for having not kept up with broader inflation in the years before 2023. Healthcare price adjustments tend to be infrequent due to the long duration of contracts, especially for hospitals. These pent-up pressures argue for some further acceleration in healthcare services prices in 2024, and GS expects healthcare services inflation to increase from the current rate of 2.8% YoY to 3.1% by December.

In labour-intensive services categories like food and accommodation, recreation, and professional services, further disinflation is in the pipeline. In contrast to medical services inflation, these components saw outsized price growth during the pandemic due to staff shortages. However, the jobs-workers gap for labour-intensive industries has fallen considerably from a peak of 4.7% in 2022 to 1.7% now, close to pre-pandemic levels. Although labour market rebalancing is well in progress, its effects on wages and inflation tend to be lagged. Ultimately, GS expects inflation in labour intensive categories to fall from the current rate of 4.2% to 3.9% by the end of the year, and in other core services to fall from the current 4.1% to 3.1%. Overall, core services ex-housing inflation is expected to fall to 3.3% by end-2024 and further to 2.6% by end-2025. This brings overall core PCE inflation (services and goods) to 2.4% YoY by end-2024 and 2.0% by end-2025.

Growth and monetary easing pave way for P/E expansion

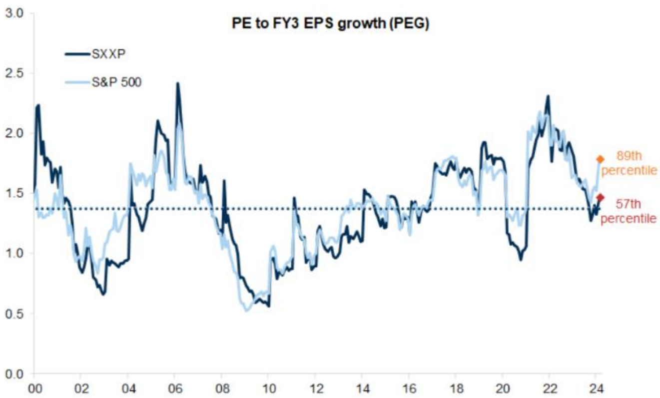
Goldman Sachs' (GS) top down modelling implies a price target of 540 for the Stoxx 600 by the end of the year, representing 6% price gain from current levels or 9% return including dividends. The modelling implies 2.2% expansion in Stoxx 600 forward P/E in 12 months, from the current 13.5x to 13.8x, which is in line with the long-run average of European equities. EPS growth, the other factor that drives the index target, is expected to be 3% in 2024 and 4% in 2025, based on GS estimates.

European equities have risen 12% over the past 6 months, driven almost entirely by P/E expansion, in fact, 2024 EPS estimate has been revised down 5% over this period. Still, valuations have not moved ahead of growth and should continue to expand moderately as economic activity rebounds, in the view of GS. History shows that Stoxx 600 P/E has closely tracked changes in PMI, and GS economists expect only a modest improvement in global manufacturing, which argues for limited valuation expansion, consistent with GS top-down modelling. But recent early cycle indicators such as freight volumes signal a cyclical inflection, to which Europe is particularly sensitive.

Rate cuts by central banks should support valuations. Based on the six Fed cutting cycles since 1980, the S&P 500 index 12-month forward P/E rose by an average of 9% one year after the first cut, and 18% outside of recessionary periods. There are fewer historical observations on the European side, but the Stoxx 600 forward P/E rose on average 19% in the three cutting cycles of the European Central Bank. At 13.8x, Stoxx 600 current forward P/E is well below the 15.8x at the beginning of 2022.

Over the past two years, the valuation gap between Europe and the US has considerably widened, with European equities now trading around their deepest discount (36%) in history. Even excluding the Magnificent 7, the S&P 500 trades at 18.5x, around the top of its historical range. The one valuation metric on which Europe has historically traded in line with the US is the PE/growth ratio (PEG ratio). (In this case, GS refers to the 12-month forward PE / FY3 EPS growth.) In other words, US equities commanded a premium due to their superior long-term profit growth expectations. However, US PEG ratio has now surged ahead, and divergence in long-term economic growth expectations between the two regions fails to justify this, as the gap in long-term growth expectations between US and Europe has not widened. The decoupling in the US PEG ratio is attributable to US tech stocks, which have seen their PEG surge ahead of the market.

PEG ratios of US and European markets break from trend as US surges ahead



Source: Goldman Sachs, March 2024

IMPORTANT NOTE