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MARKET OVERVIEW OCTOBER 2024

From Dominique Marchese, Head of Equities & Fund Manager

A MORE PROMISING START TO THE SEASON

Investors were wary of September, with some even anticipating a rather gloomy scenario for the U.S. economy (recession), emphasizing the overvaluation of stocks given the expected earnings growth. However, economic concerns proved excessive: financial easing by major central banks, including the U.S. Federal Reserve (Fed) on September 18, continued disinflation driven by falling oil prices, and a vast stimulus plan presented by Beijing, all supported global economic growth, maintaining it around 3%. The concern over stock valuation is primarily related to the impact of artificial intelligence (AI) on the economy's potential growth (productivity gains).

CONFIRMATION OF THE CENTRAL SCENARIO

In our previous monthly letter, we explained why we didn't question the central scenario of a soft landing for the U.S. economy and considered market concerns about the global cycle in early August to be excessive. U.S. consumption is indeed slowing (a more balanced job market, pandemic savings exhausted), but companies' high profitability limits their need to adjust employment and cut investments. Additionally, ongoing disinflation improves real household incomes (after inflation). We note that the rise in U.S. unemployment from a low point is more the result of an increase in the labor force, mainly due to immigration (net inflows of 31 million people in 2023, according to the Congressional Budget Office), rather than job destruction. **We also highlight once again the productivity gains and unit labor costs compatible with a trend inflation near 2%.**

Although the U.S. elections on November 5 create economic uncertainty, **it's important to understand that the renewal of the entire House of Representatives and one-third of the Senate is as critical as the choice of the 47th President.** Each party needs a majority in both chambers of Congress to implement its fiscal and budgetary programs. While Kamala Harris seems to have a slight lead in the polls, projections for the two chambers are less clear. For the Democratic Party, holding the White House without controlling the legislature would likely mean a less expansionary fiscal policy than their program suggests ($1.7 to $2 trillion in social promises over ten years, according to estimates from the Committee for a Responsible Federal Budget). **In other words, the U.S. elections may ultimately have little impact on business sentiment and consumer confidence, though the risk remains of some support programs expiring in 2025 due to a lack of political consensus, particularly measures adopted under Donald Trump's presidency.**

After announcing its pivot at the Jackson Hole symposium in August, the Fed decided to ease its monetary policy by 50 basis points (-0.5%) to honor its dual mandate of price stability and full employment. According to Fed projections by the end of 2025, the Fed funds rate is expected to converge toward its neutral zone faster than anticipated (around 3% versus the current range of 4.75%-5%), with inflation reaching 2.1%, close to the target. **It's important to note that long-term real interest rates in dollars have contracted significantly in recent months** (10-year real sovereign rate at 1.5% versus a peak of 2.3% last April and nearly 2.6% in the fall of 2023), providing positive support for the economy and theoretical valuation of long-duration assets, particularly growth stocks.

In Europe, the recovery announced in the first half of the year has lost steam. Germany is in an industrial recession, and the business climate in France has deteriorated significantly following the political crisis of the summer, while public finances seem out of control (the small GDP rebound linked to the Olympic Games will inevitably be followed by a contraction in the fourth quarter). While inflation is being addressed - with wages and services starting to slow - the European Central Bank (ECB) unanimously cut its key rates by 25 basis points on September 12 (deposit facility rate at 3.5%), a noteworthy decision. Germany's disastrous economic performance (GDP stagnant over the past five years) convinced inflation hawks to ease financial conditions. Will this second round of monetary easing be enough to restart the economic engine? The answer is uncertain.

In closing our global economic overview, China announced a vast stimulus program that has revived its financial markets. While the program addresses monetary and fiscal policies, it doesn't resolve China's structural economic issues nor governance challenges. However, it supports the distressed real estate market, reinforces Beijing's growth target (5%), and reduces short-term uncertainty for key trade partners, including European exporters suffering for several quarters (China represents 6% of Germany's exports, for example). **The**

scope of the stimulus plan is significant: the recapitalization of major commercial banks alone represents 0.8% of GDP.

THE EUROPEAN UNION : THE WEAK LINK

Let's focus a bit longer on the weak link in global growth: Europe. **The strong response from EU institutions (Council, Commission, Parliament) to the 2020-2021 pandemic seemed to herald a major policy** shift based on an ambitious recovery plan of more than €750 billion, intended not only to save economies devastated by repeated lockdowns but also to build the foundations for more innovation and long-term potential growth. It was an exceptional opportunity, marked by the issuance of joint debt, breaking the resistance of countries opposed to further federalism. **Yet the mountain gave birth to a mouse. European growth has not materialized. A large portion of the allocated funds has not been used due to a lack of projects and qualified personnel - quite a paradox!** Moreover, despite questionable political decisions that worsened the 2022 energy crisis, the new Commission seems unwilling to reconsider the policies that have exacerbated the EU's economic decline compared to the U.S. and China.

Besides Spain, buoyed by mass tourism, and Italy, benefiting from EU funds, the two heavyweights, Germany and France, are in crisis. Their leaders seem incapable of reversing a decade of ineffective European policies in terms of economic results, aside from deregulation directives that boosted consumer purchasing power at the expense of industries weakened by globalization. **The belated realization during the pandemic of the need to reindustrialize the Union to regain lost sovereignty has led to timid results**. The reshoring process is hindered by high energy prices (electricity costs two to three times higher than in the U.S.), production costs, and two decades of environmental lobbying against so-called polluting industries. Where are the essential mining projects for the energy transition and digital revolution?

The EU is completely missing out on the great revolution of the 2020s, namely AI, by prioritizing standards over innovation - its specialty after already missing the boat on cloud and big data (the hyperscalers are predominantly American). Among the top 50 tech companies globally, only four are European. More troubling: 30% of unicorns (startups valued at over $1 billion) leave the EU to relocate to the U.S., benefiting from a more favorable ecosystem for innovation and business.

The competitiveness report by Mario Draghi, former ECB president (2011-2019) and Italian Prime Minister (2021-2022), was met with little enthusiasm by European leaders and European Commission President Ursula von der Leyen. It emphasizes the urgent need to complete the single market and boost investments (€800 billion per year needed, or 5% of the EU's GDP, staggering sums that make political consensus unlikely). The EU's economic growth gap with the rest of the world has been widening for 20 years. **Productivity gains are practically non-existent, explaining 70% of the GDP per capita gap with the U.S.** The most worrying part is that the new Commission, whose members await confirmation by the European Parliament, seems set to continue past policies without reconsideration. The choice of Danish politician Dan Jørgensen, a staunch opponent of nuclear power, as energy commissioner doesn't bode well for the competitiveness of European industries. **The electrification of the economy, driven by decarbonization and the large-scale deployment of AI, requires a coherent strategy - to borrow a phrase from the Draghi report - and technically sound solutions** (U.S. data centers, for example, prioritize contracts with nuclear plants rather than intermittent energy producers). The new European Commission seems ill-prepared to effectively combat the Union's industrial decline. Yet worrying announcements of project delays or cancellations, particularly in Germany (Intel, Volkswagen, and ACC in batteries, in recent press releases), are multiplying. Will the industrial crisis, worsened by the 2022-2023 energy shock, act as a salutary catharsis? We all hope so, but in the meantime, we must recognize that European financial markets have lost their appeal compared to the rest of the world. **The discount on European stocks is unlikely to close compared to U.S.** markets. Only the most international companies, in terms of both production capacity and final markets, will come out on top. **Given the already weak economic activity in the Union, the benefits we can expect from easing financial conditions, falling oil prices (disinflation and rising real household incomes), and the Chinese stimulus plan, a slight improvement is likely in 2025. However, in the long term, the European project is clearly threatened by political paralysis and blindness.**

STOCK VALUATIONS : THE IMPORTANCE OF AI

A few words on the valuation of U.S. indices, which rightfully concerns many investors. Given the construction of stock indices based on market capitalization, we cannot assess the valuation of U.S. and global indices without mentioning the major U.S. tech leaders, particularly the "Magnificent Seven" (Alphabet, Amazon.com, Apple, Microsoft, Meta, Nvidia, Tesla). **The U.S. accounts for nearly 65% of the main global index; the five largest listed companies - Microsoft, Apple, Nvidia, Alphabet, and Amazon.com - alone account for 18%. Technology and related sectors make up 40% of the U.S. market, with expected earnings growth of over 20% next year, which explains the high expectations for U.S. market results next year, around 15%, despite the consensus soft landing scenario.** Excluding technology, expected earnings growth for the rest of the market is 11%, a more reasonable figure, though we believe financial analysts may be too optimistic given the economic slowdown. Nevertheless, we maintain that slow-growing unit production costs justify betting on maintaining high profit margins.

As a result, the entire question of overvaluation of indices boils down to the decisive role of AI in the economy. According to a 2021 OECD study, confirmed by others, AI could add 1% to 2% of annual economic growth by 2030, depending on its speed and depth of adoption. For the U.S., Goldman Sachs estimated AI's impact at 1.5% to 2% annually over the next decade. The implications would be significant. Therefore, an

Pure Capital S.A., société de gestion régulée par la CSSF (Luxembourg)
www.purecapital.eu | info@purecapital.eu

Siège social Luxembourg
2 rue d'Arlon, L-8399 Windhof | T : +352 26 39 86

Succursale Belgique
Sneeuwbeslaan 20, B-2610 Wilrijk | T: +32(0)3 246 04 65

equity investor convinced of the AI revolution, capable of boosting productivity gains and improving the economy's growth profile over the long term (at least five years), would adopt a long-term view and wouldn't be overly concerned about generous yet not excessive valuations. The U.S. market's 12-month forward price-to-earnings ratio (21.6) exceeds the five-year historical average (19.5), but this is largely due to the "Magnificent Seven." The valuation of hyperscalers reflects their central role in AI. "The winner takes all," as Americans say: we noted in our previous monthly letter the significant investments required for AI deployment - formidable barriers to entry for tech leaders but benefiting the entire value chain, including the energy sector, in a technological revolution that will unfold over many years. The main risk faced by hyperscalers is regulatory, as evidenced by numerous lawsuits filed against their dominant positions on both sides of the Atlantic. **Hence, we emphasize greater portfolio diversification compared to ultra-concentrated - and thus riskier - indices, focusing on sectors directly benefiting from the AI revolution**: electrical equipment suppliers for data centers, semiconductors, electricity producers, data infrastructures, etc., which still offer reasonable valuations.

CONCLUSION

If we set aside the geopolitical backdrop, which remains a source of concern (Ukraine, escalation in the Middle East), the flow of economic events in September was rather favorable for financial markets: widespread monetary easing (except in Japan), reduced exaggerated fears over the U.S. economic cycle, Beijing's stimulus plan reigniting Asian markets, and, to top it all off, a drop in oil prices fueling the disinflation process and benefiting oil-importing countries. The picture is more troubling in the European Union, where its two heavyweights, France and Germany, are facing crises—France with the loss of control over public finances, and Germany with the reevaluation of its mercantilist model. However, we remain cautiously optimistic for a cyclical rebound next year, driven by the positive impact of disinflation on real household incomes and the easing of financial conditions.

To navigate through this sea of uncertainties but also opportunities, optimal portfolio diversification remains essential.

Pure Capital S.A., société de gestion régulée par la CSSF (Luxembourg)
www.purecapital.eu | info@purecapital.eu

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