Global Equity Views

Summertime blues

Peter Oppenheimer
+44(20)7552-5782 | peter.oppenheimer@gs.com
Goldman Sachs International

Guillaume Jaisson
+44(20)7552-3000 | guillaume.jaisson@gs.com
Goldman Sachs International

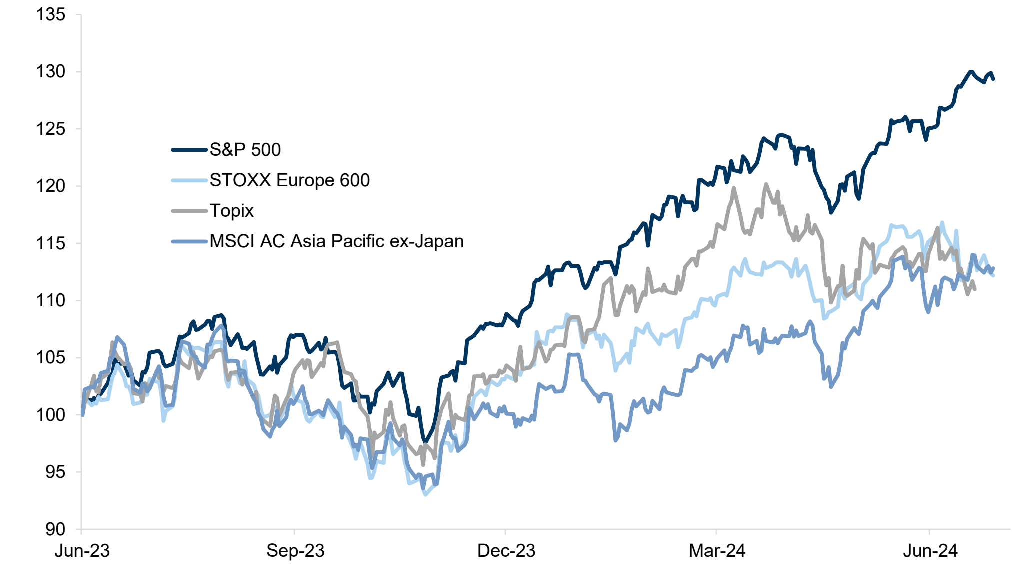
Sharon Bell
+44(20)7552-1341 | sharon.bell@gs.com
Goldman Sachs International

Marcus von Scheele
+44(20)7774-7676 | marcus.vonscheele@gs.com
Goldman Sachs International

Lilia Peytavin
+33(1)4212-1716 | lilia.peytavin@gs.com
Goldman Sachs Bank Europe SE - Paris Branch

1) The end of the first half of the year marks the end of a very powerful rally in risk assets that started in October last year that has taken global equities roughly 30% higher. The first half of 2024 has been the 21st best since 1900 for the US market.

Exhibit 1: H1 marks the end of a very powerful rally in risk assets that started in October last year
USD, indexed price performance



Source: Datastream, STOXX, Goldman Sachs Global Investment Research

The upswing reflected an inflection point in optimism that began with positive news on US inflation and growth and promoted a sharp recovery in equity prices as the combination of soft landing and rate cuts became priced. While the seven US rate cuts that were priced at the start of this year have since faded, equities have been buoyed by a string of positive macro surprises and optimism around AI helping the Nasdaq generate a Sharpe ratio of 2.3 over the last twelve months. Consequently, we did not have a 5% pullback since the correction in the second half last year.

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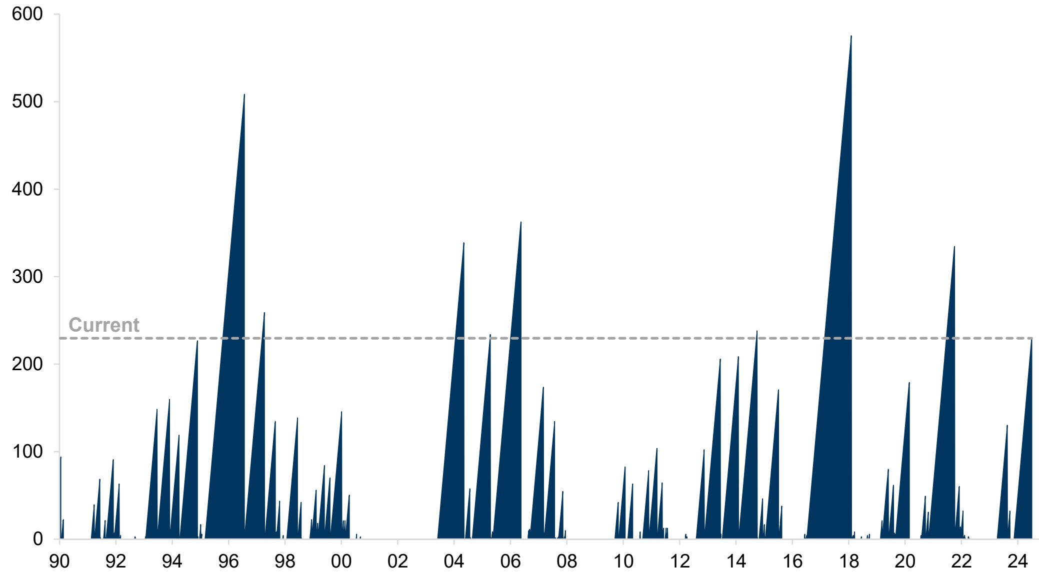
Exhibit 2: Good entry points are difficult to find. Since the correction in the second half of last year, we did not even have a 5% pullback.

Global equities. Cumulative number of days without a 5% correction*



*Looking at 1 year rolling max drawdown

Source: Datastream, Worldscope, Goldman Sachs Global Investment Research

2) As we enter the second half of the year, the risks for equity holders are rising. It is also an unusual environment; with elevated valuations and an increased focus on political risk, the fear of losing out after a rally may fade. Equities have also outperformed bonds sharply since the October 23 low as interest rate expectations have been revised up. Nonetheless, it should be stressed that it is unusual for 2H returns to be weak following 1H returns as strong as we have seen this year.

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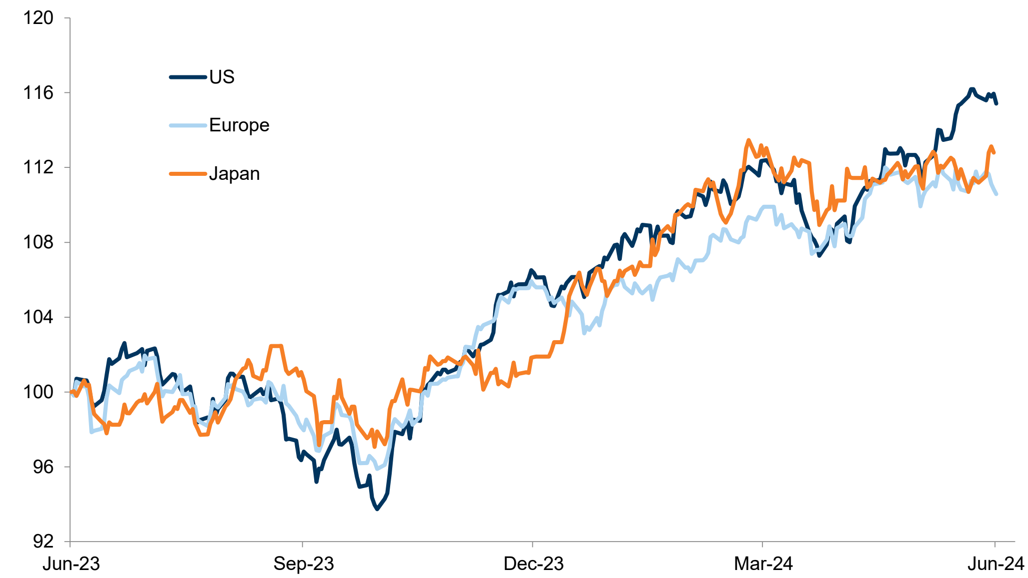
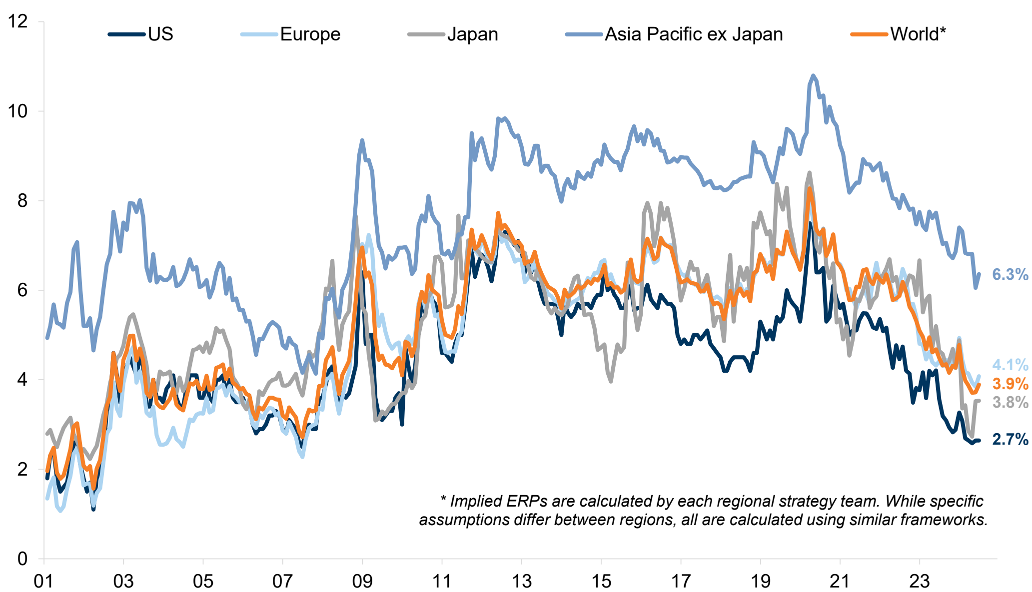
Exhibit 3: 60/40 equity/bond portfolio performance across regions last 12m
Relative total return performance indexed to 100 12m ago



Source: Datastream, Goldman Sachs Global Investment Research

At the same time, equity risk premia have fallen sharply, offering little buffer against bonds in the event of any shocks.

Exhibit 4: Equity risk premia remain very low
Global market implied ERP (%)



Source: Goldman Sachs Global Investment Research

3) While fading interest rate optimism has, so far, been offset by strong growth and earnings (particularly for the biggest companies), growth momentum has recently started to slow. Macro surprises have turned negative across regions over the past month, a trend which continued last week with weaker US housing data and European

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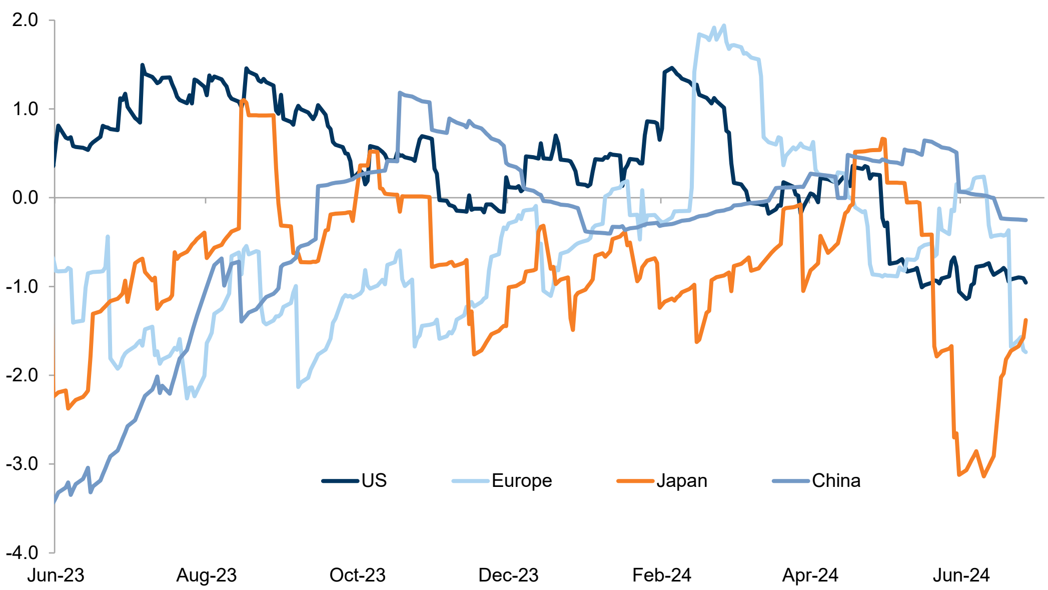
PMIs. Overall, the pace of US GDP growth has decelerated from 4.1% in 2023H2 to an estimated 1.7% in 2024H1 and US unemployment has ticked up from 3.5% to 3.8% on a 3-month moving average basis. The impulse from financial conditions is turning more positive at a time when we expect the drag from inventories and net trade to end, hence our economists expect a moderate pickup in H2 growth momentum. However, the period of weaker growth is likely to endure, as real income growth has slowed, and consumer sentiment has softened. Election concerns in the US and Europe may also hit consumer and business confidence in coming months.

Exhibit 5: Macro surprises have turned negative

Macro surprises (MAP). Europe = 75% Euro Area + 25% UK



Source: Goldman Sachs Global Investment Research

Most recently, our asset allocation team have stressed that despite the weaker growth momentum, ‘bad news is good news’, as equity correlations with macro surprises have remained negative. However, there is a growing risk that this optimism fades with the prospect of only a modest pace of interest rate cuts. Election concerns and further weakening in the labour market might tip this relationship into a ‘bad news is bad news’ regime.

4) Elevated valuations also leave equities more vulnerable to disappointments. While we acknowledge that valuations are a poor indicator of near-term returns, they do tend to amplify the impact of moves in the market if other fundamentals start to shift. US equity valuations, in particular, have become stretched. The market capitalisation of the S&P 500 has diverged dramatically from other markets since the end of the financial crisis. While this has reflected stronger fundamental profit growth, the current level of valuations implies such ‘exceptionalism’ is already expected to continue well into the future.

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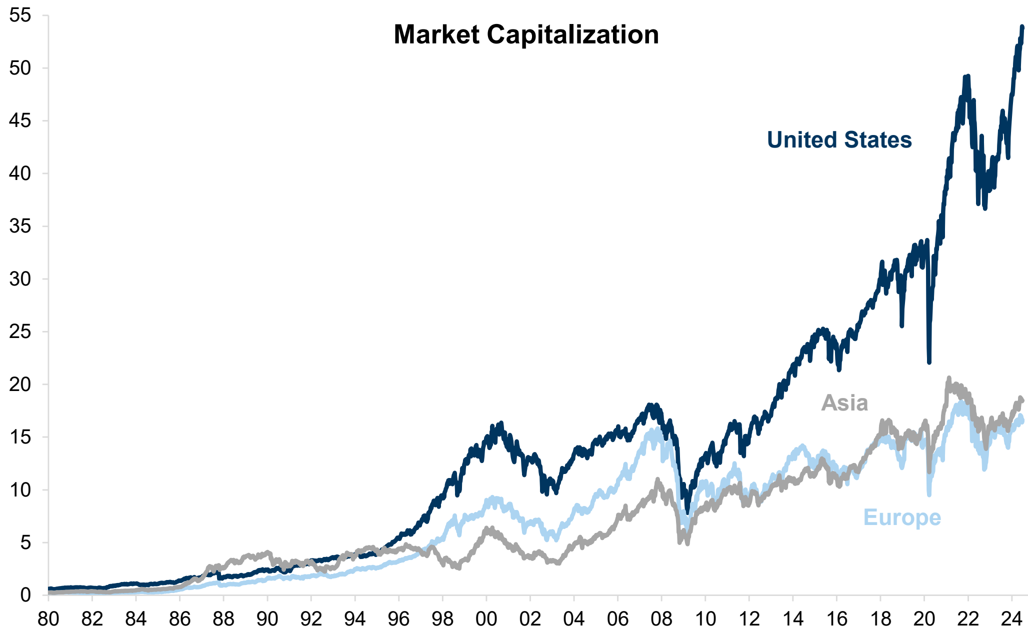
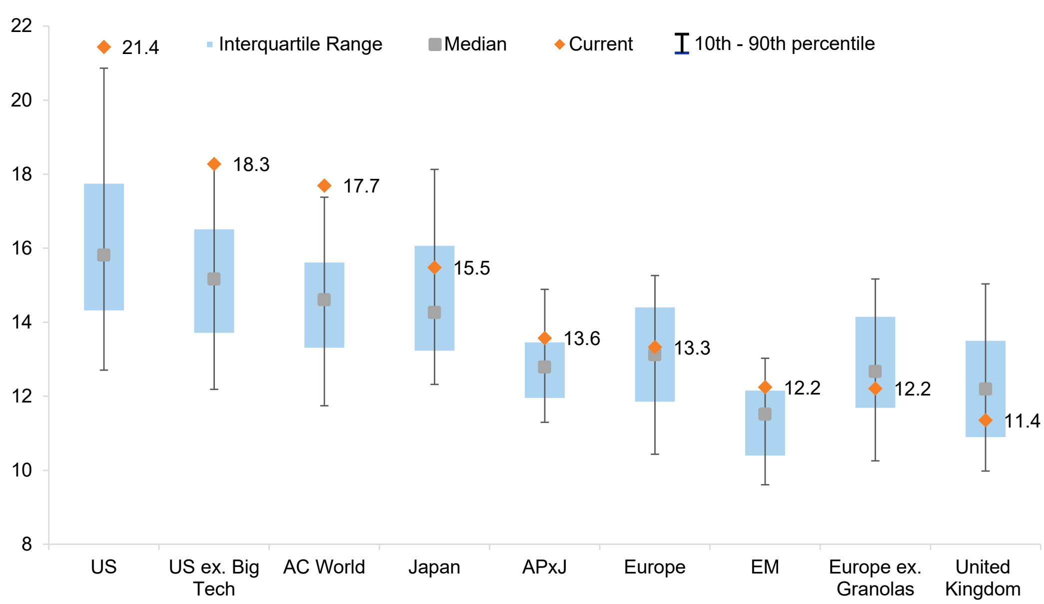
Exhibit 6: The rise in the relative size of the US equity market has reflected the dominance of the US economy
Market Cap ($ trillion). Asia incl. Japan



Source: Datastream, Worldscope, Goldman Sachs Global Investment Research

As Exhibit 7 shows, the current forward multiple of 21.6 is above the previous range over the past 20 years.

Exhibit 7: The current environment suggests there is more risk for equity investors, particularly in the US
12m fwd P/E multiple. MSCI Regions. Data for the last 20 years.

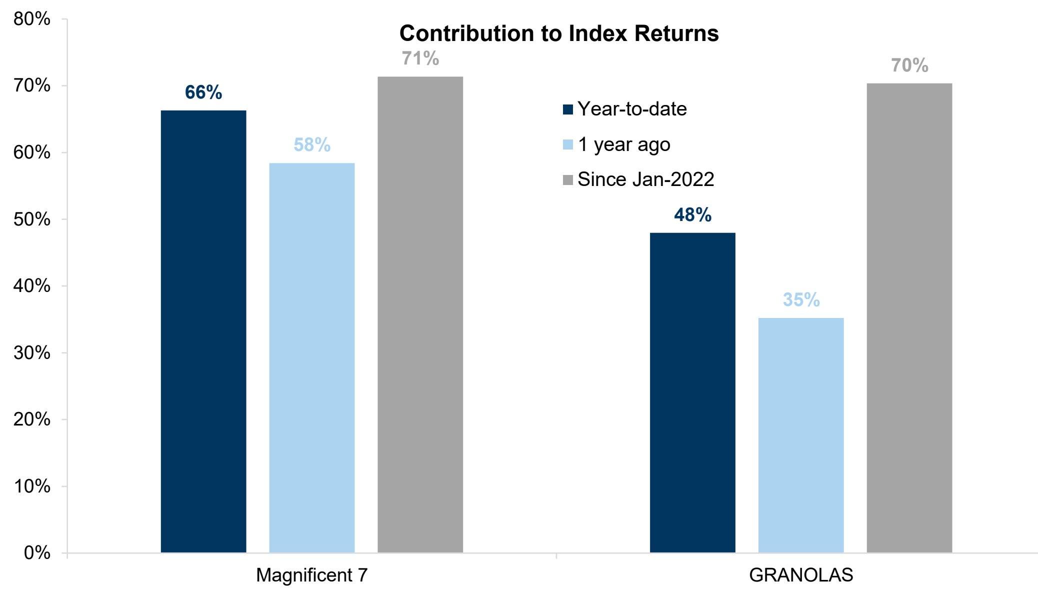


Source: FactSet, Goldman Sachs Global Investment Research

This partly reflects the higher valuations of the dominant tech stocks, but even excluding these, the US market trades at over 18x, well above its 20-year average, despite higher interest rates than has been typical over that period.

5) In addition to stretched valuations, increased concentration of equity markets considerably increases risks. While the prominence of the US equity market, of the technology sector, and of the largest companies does not reflect 'irrational exuberance', but a long period of superior fundamentals (see Concentration Conundrum), it nonetheless raises the risks for investors. While growing stock concentration has been a feature of many markets, it gets the most attention, and has the most impact, in the US where the top 7 companies have contributed to over 60% of the return in the S&P 500 year to date, although the high weight of the GRANOLAS in Europe has also been a feature.

Exhibit 8: The contribution of the Magnificent 7 and the GRANOLAS to aggregate index returns is very high



Source: Datastream, Goldman Sachs Global Investment Research

In the S&P 500 the degree of stock concentration is extreme; the top 10 companies have the highest weight in the index since 1929.

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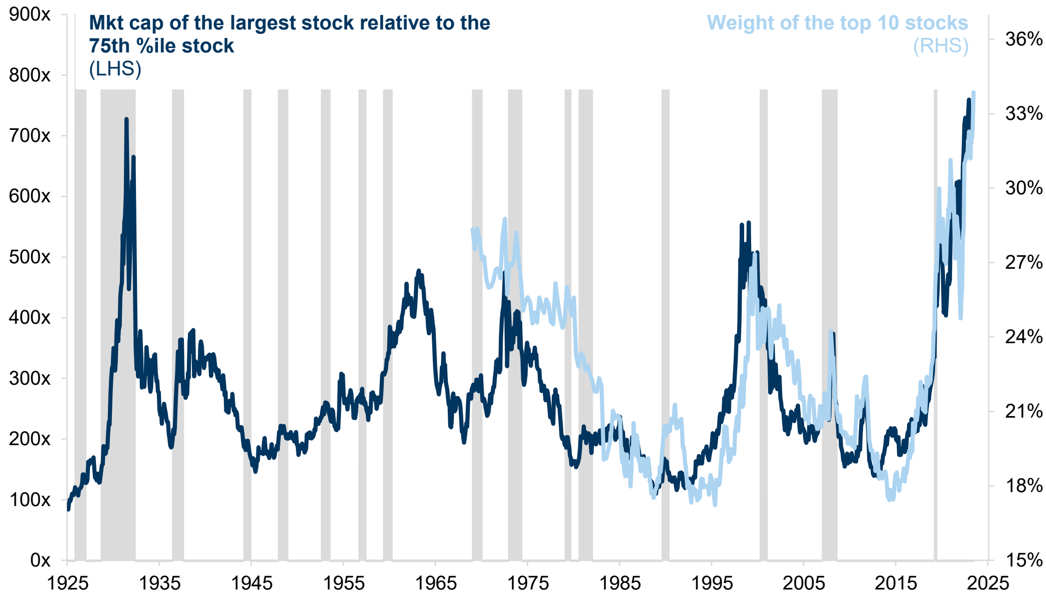
Exhibit 9: Periods of extreme market concentration during the past century



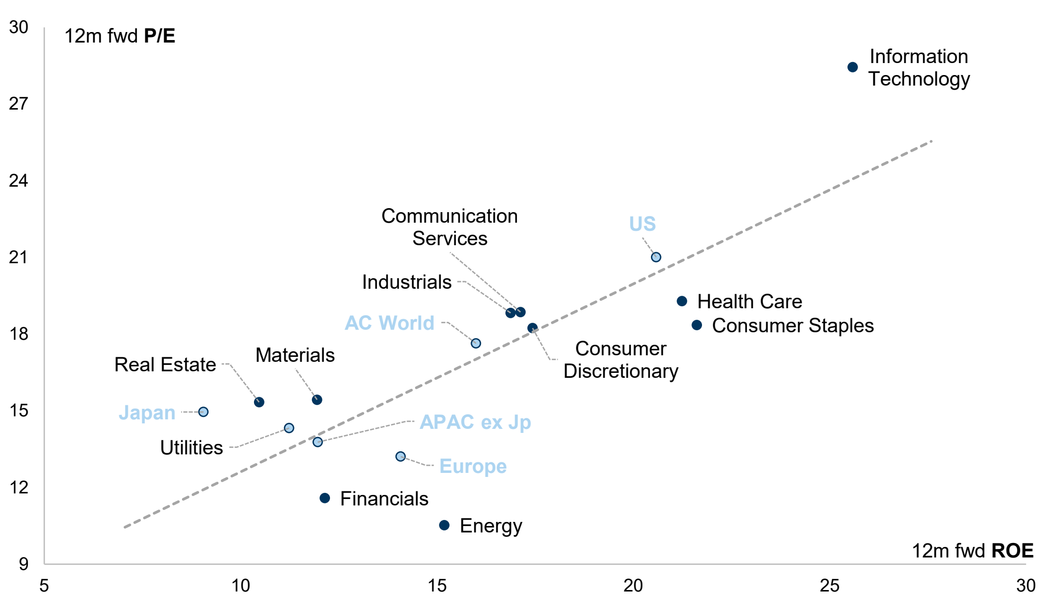
Universe consists of US stocks with price, shares, and revenue data listed on the NYSE, AMEX, or NASDAQ exchanges. Series prior to 1985 estimated based on data from the Kenneth French data library, sourced from CRSP, reflecting the market cap distribution of NYSE stocks

Source: Compustat, CRSP, Kenneth R. French, Bloomberg, Goldman Sachs Global Investment Research

Valuations of the leading technology companies, while not bubble like in our view, have nonetheless gone up sharply this year. The five mega-cap tech stocks in the US trade at 8x EV/Sales, compared with 3x for the median S&P 500 stock while the PE is higher relative to ROE for the information technology sector compared to others (Exhibit 10).

Exhibit 10: Valuations, while not bubble like, in our view, have nonetheless gone up sharply this year, in particular in the US

12m fwd P/E and 12m fwd ROE



Source: FactSet, Goldman Sachs Global Investment Research

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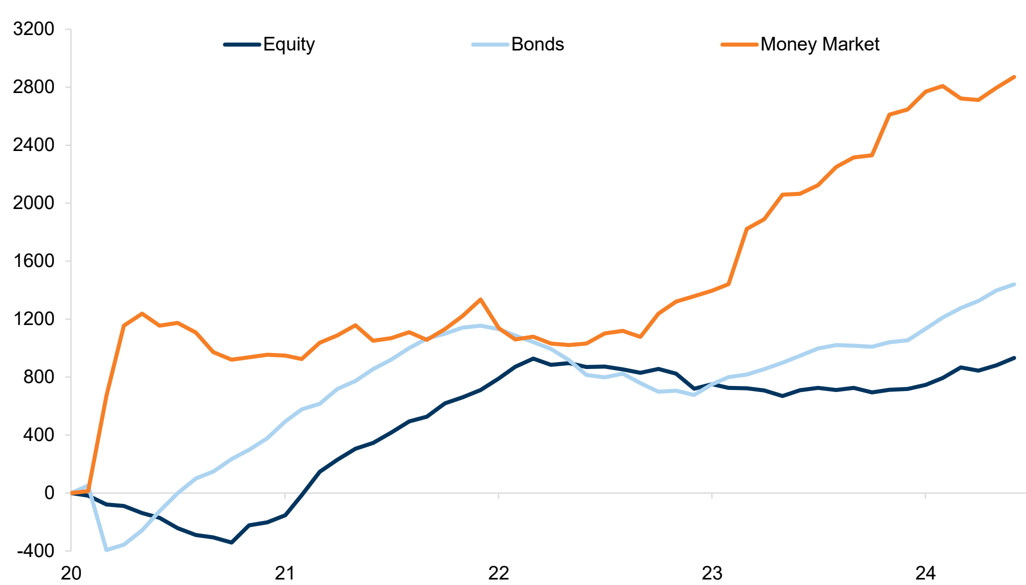
6) This concentration makes earnings growth as we enter Q2 earnings a significant potential catalyst for equity direction. Recent concerns about the AI related capex boom have surfaced and Micron's weakness following results last week and high volatility in Nvidia's stock is likely starting to reflect this anxiety. With ChatGPT usage waning (it peaked at about 2 billion visits each month in April this year and has recently slowed to around 600 million a month) there is likely to be significant focus on company outlook statements around AI. Another area of the market that has experienced some weakness recently is in consumer facing companies where disappointments in Nike and L'Oreal, while stock specific, might lead to heightened focus on any signs of broader consumer weakness in the quarterly numbers.

In terms of Q2 earnings, the consensus is expecting 9% y/y growth for the S&P500, which would be the strongest quarter since 4Q 2021. The biggest six tech companies (AMZN, AAPL, GOOGL, META, MSFT, and NVDA) are expected to see earnings grow 30% y/y, compared with 5% for the rest of the market. Any disappointments are likely to be heavily punished.

7) The focus on earnings might also be more critical this quarter since there has been an increase in risk positioning. As reported here: Hedge funds and mutual funds have boosted exposures to equities this year, with hedge fund net leverage rising near its highest level over the past year and mutual fund cash balances dropping to record lows. In addition to higher equity exposures, funds have also begun to raise their exposures to pockets of the market that represent the next phases of the AI trade.

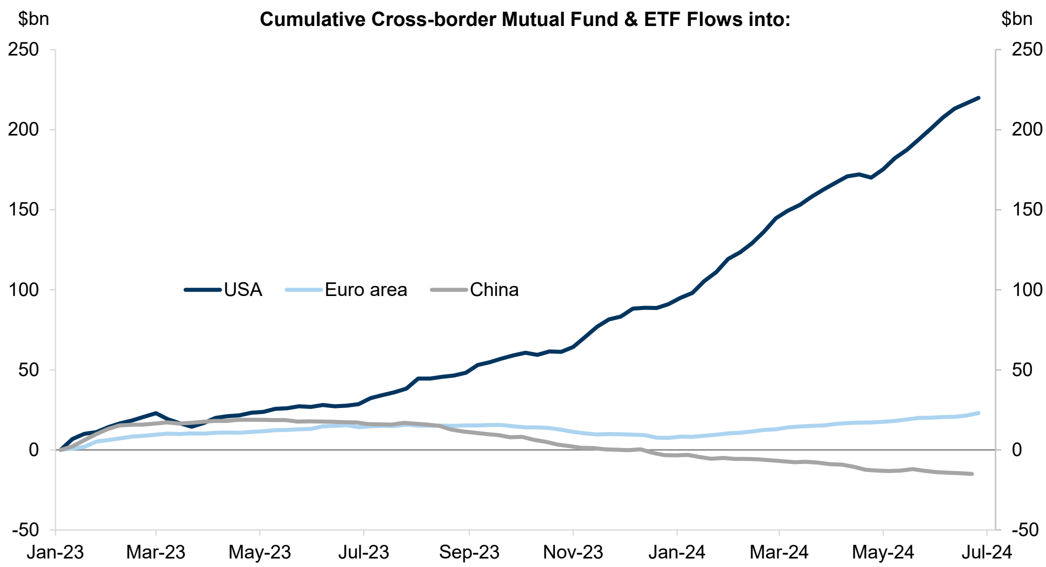
Exhibit 11: Cumulative global fund flows across assets
Monthly flows ($bn). MTD sum of weekly flows when monthly not yet available



Source: EPFR, Haver Analytics, Goldman Sachs Global Investment Research

Furthermore, cumulative cross boarder and ETF flows have largely been concentrated in the US, further reinforcing the risks of any disappointments.

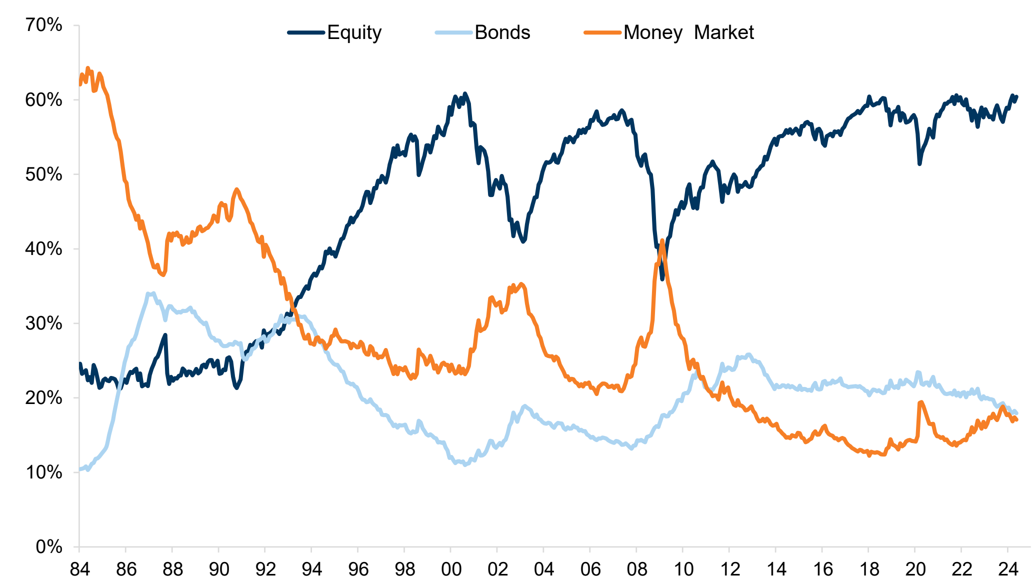
Exhibit 12: Cumulative cross boarder and ETF flows have largely been concentrated in the US



Source: EPFR, Haver Analytics, Goldman Sachs Global Investment Research

On the flipside though there is a lot of money now parked in money market funds that could shift if/when the Fed cuts. The view of 'a lot' though depends on perspective. Since 2000 almost 3 Trillion are in Money Market funds: But in terms of allocation, arguably Money Market funds are not that big compared to the 80s/90s or 00s.

Exhibit 13: US mutual funds & ETFs - AUM breakdown into equity, bonds and money market
US domiciled mutual funds (as of Mar-24)



Source: ICI, Haver, Goldman Sachs Global Investment Research

8) Politics is also becoming a central focus. Earlier in the year, elections were a classic example of a 'known unknown' – there was plenty written about this being the year that

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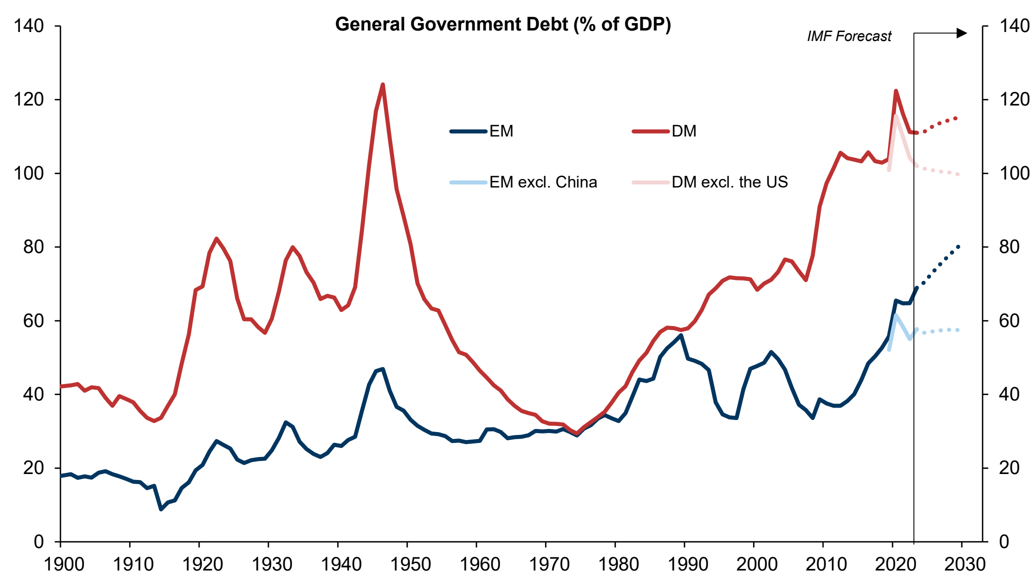
sees the highest numbers of people around the World voting in history, but little actual news that translated into market pricing. So far, several elections have thrown out surprises; Mexico, South Africa, Brazil, and the early elections called in the UK and France. On top of this, the first presidential debate shifted prediction market probabilities in favor of a Trump victory. We think focus on that aspect of the agenda is likely to increase as the election approaches and remains a major risk to hedge.

9) The focus on elections has also stimulated more focus on government borrowing and debt. No political outcomes are likely to tackle the rising debt levels that dominate most of the main developed economies and are a growing feature of emerging economies.

Exhibit 14: Both EM and DM Debt Ratios are Expected to Climb in the Medium Term Driven by the US and China

IMF general government debt (% of GDP) projections



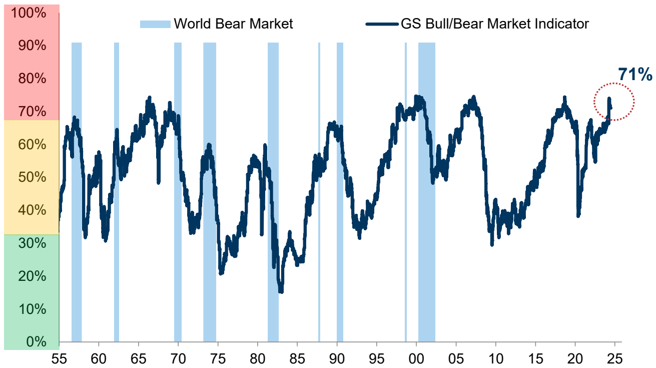
Source: IMF, Goldman Sachs Global Investment Research

While this may be important, but less urgent in terms of market implications, it is an issue that may result in risk at the long end of the yield curves, particularly in countries like France where, even in the case of a hung Parliament, efforts to constrain the budget will be difficult to agree upon.

10) The vulnerability to a period of higher volatility or correction is reflected in a fundamental indicator. Our Bull/Bear indicator (GSBLBR) is back to flashing red.

The components in this index reflect different factors that tend to correspond with inflection points in markets, particularly when combined. Currently, the combination of the slope of the yield curve, high valuations, and low unemployment (with a modest degree of weakening) are all at high levels of risk. To be clear, none of this suggests a bear market is imminent – with the prospects of rate cuts and continued growth, this is not likely - but it does offer a warning signal that a correction and period of higher volatility and lower returns is now more likely.

Exhibit 15: GS Bull/Bear Market Indicator (GSBLBR)



Source: Shiller, Haver Analytics, Datastream, Goldman Sachs Global Investment Research

Exhibit 16: Details of components of the GS Bull/Bear Market Indicator
GS Bull/Bear Market Indicator = Average percentile

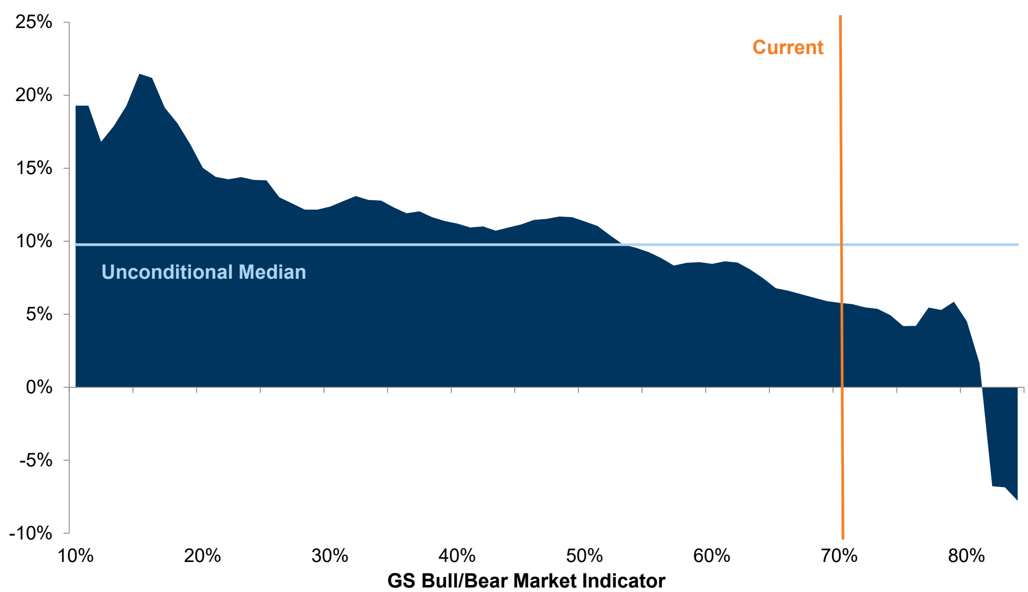
	Level	Percentile
0-6 quarter yield curve	-0.9	95%
Shiller PE	35.0	95%
Unemployment	4.0	84%
Private sector Financial Balance	3.3	67%
Core Inflation	3.4	61%
ISM	48.7	24%
GS Bull/Bear Market Indicator		**71%**

Note: 100th percentile means these variables are at their highest level, except for Private sector Financial Balance, yield curve and unemployment where 100% means they are at their lowest.

Source: Haver Analytics, Datastream, Robert Shiller, Goldman Sachs Global Investment Research

As Exhibit 17 shows, based on data since 1955, the median 12 month forward returns for the S&P500 is in the low single digits following periods when the Bull/Bear market indicator is at current levels; this is close to our US strategy teams current 12-months forward forecast of 5700.

Exhibit 17: Our GS Bull/Bear Market Indicator implies ~5% returns over one year
Global Equities; Median S&P 500 12m fwd return (since 1955, median on a +/- 10% band)



Source: Datastream, Goldman Sachs Global Investment Research

Within markets, we have seen growing evidence of stock dispersion. As market volatility potentially rises, we continue to look at hedges and increased diversification to help protect risk adjusted returns.

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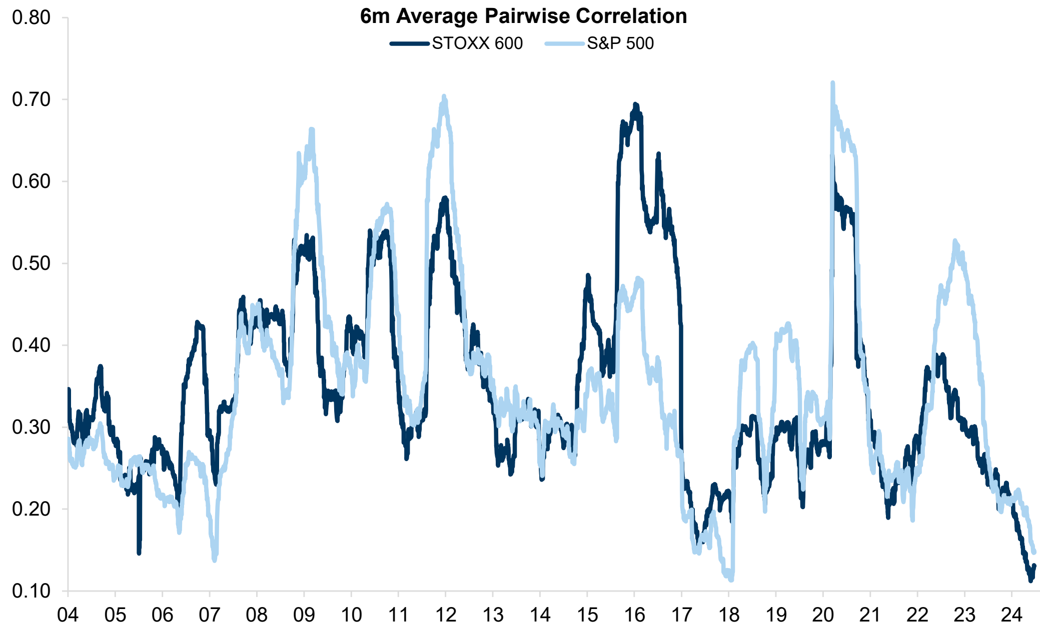
Exhibit 18: Pairwise correlations of stocks in many major markets have fallen sharply



Source: Bloomberg, Goldman Sachs Global Investment Research

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