CIO Viewpoint
Equity

August 9, 2024

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The return of volatility

Key takeaways

- July was characterized by two distinct chapters while the most recent early-August rout has seen some astonishing equity market moves.
- We reiterate our preference for a "market cap barbell" rather than trying to time the market in the prevailing environment where there are multiple uncertainties.
- We assume that the high dispersion of stock performance during the current earnings season may continue over upcoming earnings seasons as relative winners are likely to be those companies executing on margins in this challenging environment.

A July of two halves and then…

Following a generally positive H1 2024, July was characterized by two distinct chapters for equity investors. There was a strong start into the month for broader equity markets with the S&P 500 advancing in 10 of the first 11 sessions and reaching a series of all-time highs. The rally was partly the result of weak economic data that spurred speculation that the Federal Reserve (Fed) might cut interest rates in September, especially after a softer-than-expected July consumer price index (CPI) report showed the lowest monthly core CPI since January 2021.

However, as July progressed, a few disappointing results in the ongoing earnings season and concerns about a lack of clear evidence that higher AI spending is translating into actual returns, on top of some negative surprises on the macro data front, raised doubts about the soundness of the YTD Tech rally. This in turn triggered a significant selloff that took the Magnificent 7 into correction territory as the Mega Cap benchmark index ended the month of July over -10% below its peak. Overall, the July performance of Magnificent 7 was -0.6% in total return terms – the NASDAQ Composite was down -0.7%. In contrast, mounting hopes for rate cuts benefited the Small Cap space with the Russell 2000 having gained +10.2% in total return terms, underpinning a substantial rotation away from Mega Caps and into Small Caps. As a result, the July outperformance of the Russell 2000 over the NASDAQ Composite was the largest in any month since the unwinding of the dot-com bubble. The Tech Mega Cap slump and broad-based but choppy rotation weighed on broader equity markets – but despite losing ground towards the end of the month, both the S&P 500 (+1.2%) and the STOXX Europe 600 (+1.4%) still managed to eke out modest gains in July.

But early August witnessed some dramatic broader equity market moves across regions (see Chart 1) with bad news having most recently been negatively received by market participants (previously, it had often been taken positively because it was seen as increasing the probability of interest rate cuts). In early August the combination of weaker-than-expected U.S. economic data (e.g., a disappointing ISM Manufacturing print and more importantly a weaker-than-expected July jobs report), rising geopolitical risks and a consumer cooldown around the globe sent the implied Fed Funds rate for December 2024 to its lowest since early February (see Chart 2). At the same time, the market priced in a Fed September cut of 50 basis points (bps) and more than 200 bps of Fed rate cuts over the next 12 months – which has in the past only been the case before a U.S. recession. With the "hard landing" drumbeat getting louder the story has firmly shifted to growth fears that started to dominate by a huge factor over inflation worries. Additionally, some disappointing Mega Cap earnings results have also dragged on markets, in the technology space in particular. Most of the Big Tech companies have failed to enthuse investors, underlining the fears of possibly inflated valuations. Last but least, it is worth noting that the BoJ decision to raise rates together with the anticipation of accelerated Fed rate cuts, has led to a significant appreciation of the JPY which prompted an unwinding of the "carry trade" as well as a double-digit fall in Japanese equities including the worst single day decline in the Nikkei 225 since 1987.

But markets got a circuit breaker with the ISM Services that includes the bigger part of the economy having come in better-than-expected rebounding back into the expansionary territory. On top of that Deputy Governor Shinichi Uchida sent a strong dovish signal by playing down the chances of near-term rate hikes when markets are this volatile. We emphasize that while we agree that the U.S. economy is slowing, we believe that recession fears and rate cut expectations are overdone. We actually think the probability of a full-blown U.S. recession remains relatively low. One needs to consider that some one-off effects are explaining the weaker labor market in July. On top of that GDPNow recently upgraded its Q3 real GDP growth estimate from 2.5% to 2.9%. Finally, the better outturn of the latest initial jobless claims (August 8) suggests that the U.S. labour is not falling apart which seems to calm prevailing market fears.

Although we do not expect a bear market, we note that traditionally weak seasonality (see Chart 3) and reduced trading activity in August can exacerbate volatility, especially since markets are now facing some important weeks with a

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few blockbuster earnings announcements still due, as well as major economic data releases. Looming election events could also play out in ways that prove critical for the future market narrative. Additionally, geopolitical risks from conflicts in the Middle East as well as escalating trade disputes could lead to fresh bouts of market uncertainty. During first few trading days in August the VIX rose to its highest level since October 2022 (see Chart 4) while a clear rotation towards defensive sectors amid lower rates and a flight to quality was observable (see Chart 5). Please note that at one point on Monday, August 5th the VIX was trading at 65.73, up 42.34 points from Friday's close. The largest ever full day move since the launch of the index was the 21.57 points increase on March 12th 2020 around the initial Covid wave.

"Market cap barbell" addresses a dilemma

Over the first two quarters of 2024 and well into July, a continuing run into U.S. Mega Caps and Technology names, which had been the major beneficiaries of the excitement around artificial intelligence (AI) and large language models (LLMs), resulted in very extended positioning in the S&P 500. Stock concentration as well as crowding in momentum strategies reached multi-decade extremes while most other areas showed average or even below-average investor positioning.

It should thus not come as a big surprise that the historical performance spread between the market cap-weighted and the equal-weighted S&P 500 is very pronounced (see Chart 6) given that the largest 20 stocks had supplied roughly three quarters of S&P 500 YTD returns at some points. This is a reflection of superior earnings growth of the exclusive camp relative to the rest of the market over the past quarters. However, consensus earnings forecasts currently indicate that this significant earnings growth gap could gradually narrow from here. The Q2 2024 earnings of the Magnificent 7 companies for instance are expected to be up 26.8% YoY following a 51.2% YoY rise for the group in Q1. However, NTM EPS growth expectations are around 20% and as of now the market expects the Magnificent 7 to expand their aggregate earnings per share in 2026 by a similar rate (~12% YoY) as the S&P 500. We believe that these numbers will certainly be subject to revisions when analysts start to reassess the impact of AI on Big Tech.

Amidst the tech-driven pullback in mid-July, that was driven in part by concerns over potentially tougher restrictions on semiconductor exports to China, we saw investors riding on the so-called "Trump Trade" and moving heavily into segments like interest rate-sensitive Small Caps, given also that soft inflation data had helped to reignite hopes for quicker Fed rate cuts. This rotation away from Mega Caps towards Small Cap stocks sparked off the biggest 5-session Russell 2000 vs. NASDAQ Composite outperformance since the launch of the Russell 2000 back in 1979, possibly indicating that peak divergence might be behind us at least for the time being. We emphasise however that this rotation episode may not much affect the long-term trajectory/story (see Chart 7). And we believe that a sustained shift in market leadership within the S&P 500 is more likely this time to be due to winners stalling than laggards rallying. For the latter to happen, we would need to see significant evidence of reflation characterised by accelerating growth and rising bond yields for the right reasons. Instead, the growth/policy trade-off has worsened compared to the beginning of this year, when equities were supported by an improving economic activity environment. Instead, PMIs and other activity data have started to turn down relative to the optimistic expectations, with the CESI (Citi Economic Surprise Index) being deeply negative (see Chart 8).

We do not believe that Mega Cap underperformance is here to stay as still appealing future earnings prospects, and especially the AI story, may motivate investors to rotate back into Mega Caps at some point. Consequently, we would like to reiterate our preference for a "market cap barbell" rather than trying to time the market in the prevailing environment where there are multiple uncertainties. In other words, we like the idea of being invested into both ends of the market cap spectrum, trying to capitalise on the secular earnings strength and sound balance sheets of Large and Mega Caps, while at the same time benefiting from low valuations and decent cyclical earnings prospects for Small Caps. Note that consensus estimates are indicating Russell 2000 earnings to grow by 40% p. a. over 2024-2026 while the index is trading at a NTM P/E ratio of less than 26x – an almost -20% discount versus the Magnificent 7.

Last but not the least, it could be sensible to adapt also a Minimum Volatility strategy to diversify some of the accrued Momentum tail risk. As shown by recent market falls, elevated positioning and market concentration do not leave much scope for absorbing any kind of disappointment.

Q2 2024 earnings season update

We have now left the busiest weeks of the U.S. and European Q2 earnings season behind us and are entering the final stages. Going into this earnings season, respective earnings estimates on either side of the Atlantic had been cut much less than in the previous quarters as broadly-better activity indictors had pointed towards an improvement in terms of earnings delivery. Over the course of Q2, projected S&P 500 and STOXX Europe 600 Q2 earnings growth numbers had been revised down by -0.8 ppt and -0.3 ppt which compares to -3.1 ppt and -4.7 ppt for corresponding Q1 estimates during Q1. Looking at the remarkable YTD run of the S&P 500, it seems that flatter Fed easing projections were shrugged off (see Chart 9) in favour of focusing on earnings growth.

Beat ratios are currently running at 79% (S&P 500) and 55% (STOXX Europe 600), above their 10-year averages of 74%/54% levels. Aggregate S&P 500/STOXX Europe 600 earnings per share have come in +4%/+5% above expectations while revenues have surprised by +0.8%/+2%. In the U.S., ten out of eleven sectors are showing positive earnings surprises with Defensives earnings coming in stronger in both the U.S. and in Europe and U.S Cyclicals ex Tech lagging Defensives by a considerable margin in terms of YoY earnings growth.

Q2 2024 blended aggregate numbers are currently pointing to a +14% YoY increase in S&P 500 earnings, on revenue growth of +6%. Please note that Q2 S&P 500 ex. Magnificent 7 earnings are on track to rise approximately 5% on a YoY basis after five-quarter-streak of negative earnings growth (see Chart 10). Earnings convergence between Magnificent 7 has been mooted but has not materialized over the past quarters. Seven out of eleven sectors within the S&P 500 are expected to deliver positive YoY earnings growth numbers for Q2 2024. In Europe blended figures are indicating Q2 2024 earnings of the STOXX Europe 600 to grow by 4% YoY after four consecutive quarters

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of earnings declines, on -0.3% lower revenues with five sectors expected to deliver positive YoY earnings growth numbers.

We think that the more challenging macro backdrop that we describe above is likely to stay with us for the remainder of the year. With the business cycle currently losing some steam, labour markets softening from very tight levels, consumer spending slowing and pricing power fading earnings delivery in some areas may be hurt at some point. An increasing number of companies are cutting their guidance for the remainder of the year, in particular within industrials and the consumer space, with many citing the rollover in end demand and the continued weakness in China activity as reasons. Nonetheless, we believe that the current NTM consensus earnings growth projections of the S&P 500 (+13.6%) and STOXX Europe 600 (+8.5%) along with a favorable global earnings revision ratio trend should provide fundamental support for broader equity markets.

Given that valuations of the S&P 500 appear demanding, especially vs. real yields, robust earnings growth is needed to justify current multiples, while the margin for disappointment may be rather thin.Therefore, we assume that the high dispersion of stock performance during the current earnings season may continue over upcoming earnings seasons as relative winners are likely to be those companies executing on margins in this challenging environment. Market responses to earnings beats during Q2 reporting season in the U.S. and Europe have so far been more pronounced than usual (see Charts 11, 12) with individual S&P 500/STOXX Europe 600 firm stock prices on average performing far above their historical median levels on the day after the announcement of better-than-expected earnings data (rising by +1.7%/+1.4%, as of August 9).

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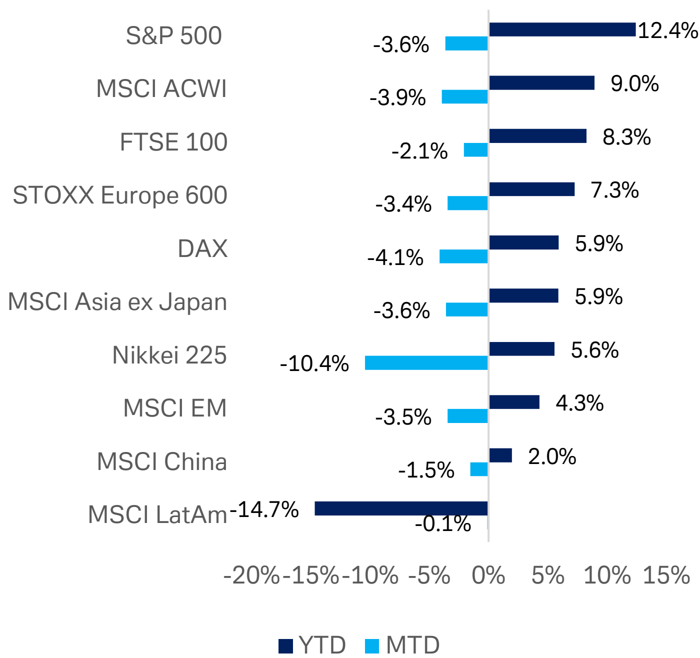
Chart 1: Regional performance

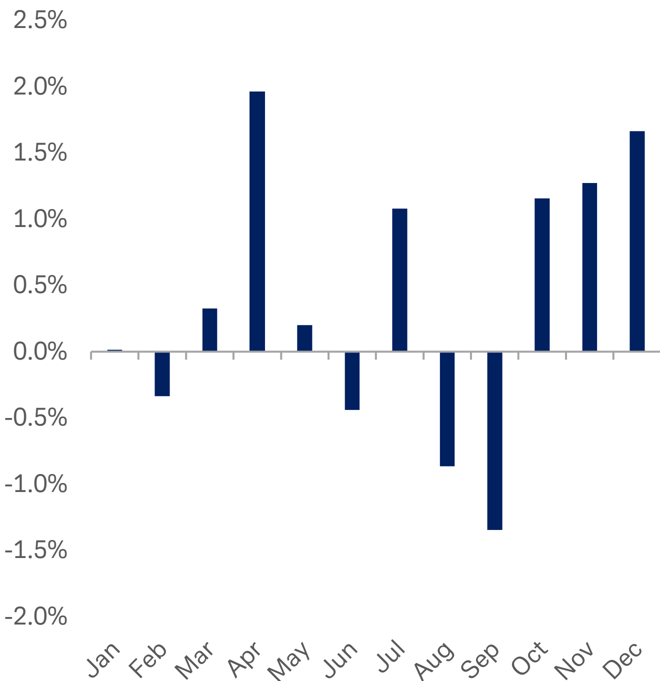


Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of August 9, 2024.

Chart 2: Fed rate expectations

Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of August 9, 2024.

Chart 3: Seasonal Performance MSCI ACWI (1990-2023)



Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of August 9, 2024.

Chart 4: Cboe VIX Index

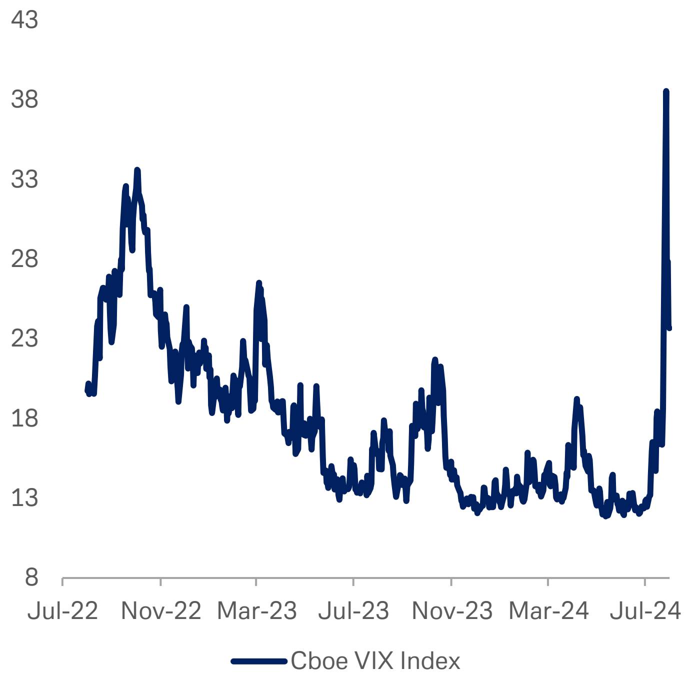


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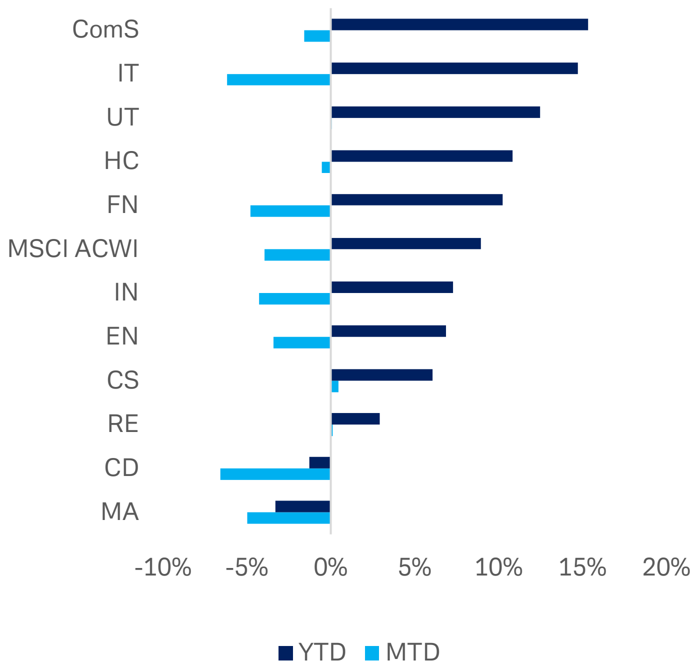
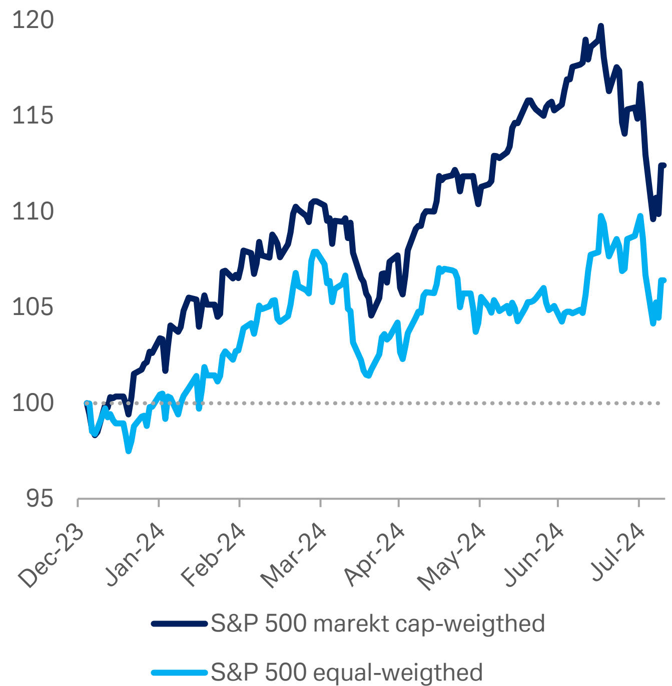
Chart 5: Sectoral performance – MSCI ACWI



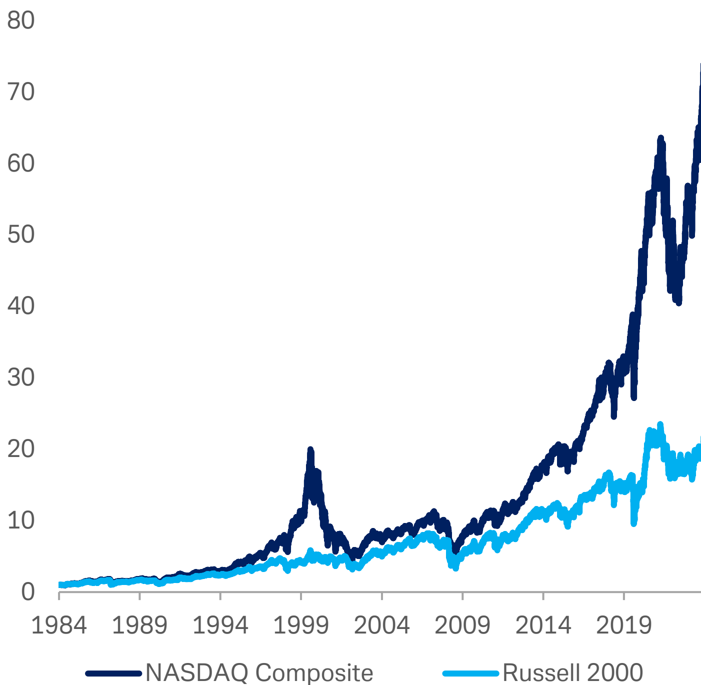
Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of August 9, 2024.

Chart 6: Market cap & equal-weighted S&P 500 YTD



Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of August 9, 2024.

Chart 7: NASDAQ Composite vs. Russell 2000



Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of August 9, 2024.

Chart 8: Citi Economic Surprise Index – U.S.

Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of August 9, 2024.

Notes: CD = Consumer Discretionary, ComS = Communication Services, CS = Consumer Staples, EN = Energy, FN = Financials, HC = Healthcare, IN = Industrials, IT = Information Technology, MA = Materials, RE = Real Estate, UT = Utilities

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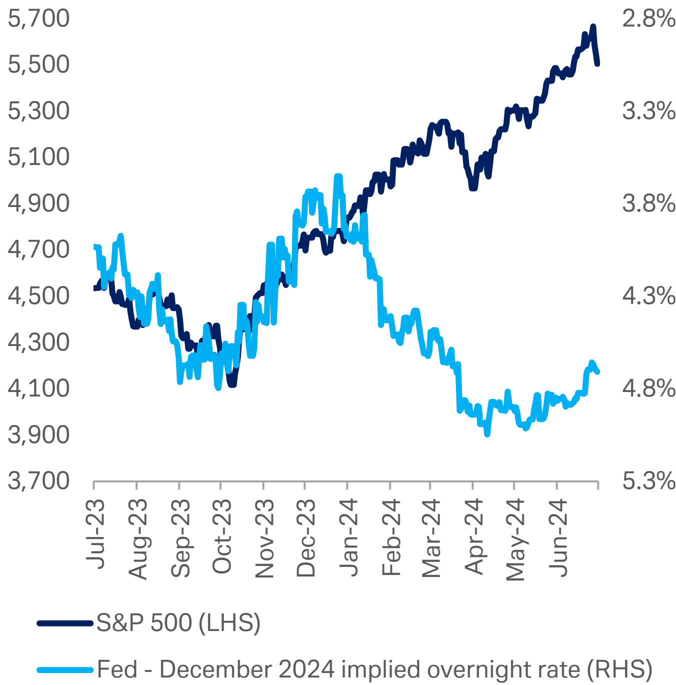
Chart 9: Equity market and rate expectations

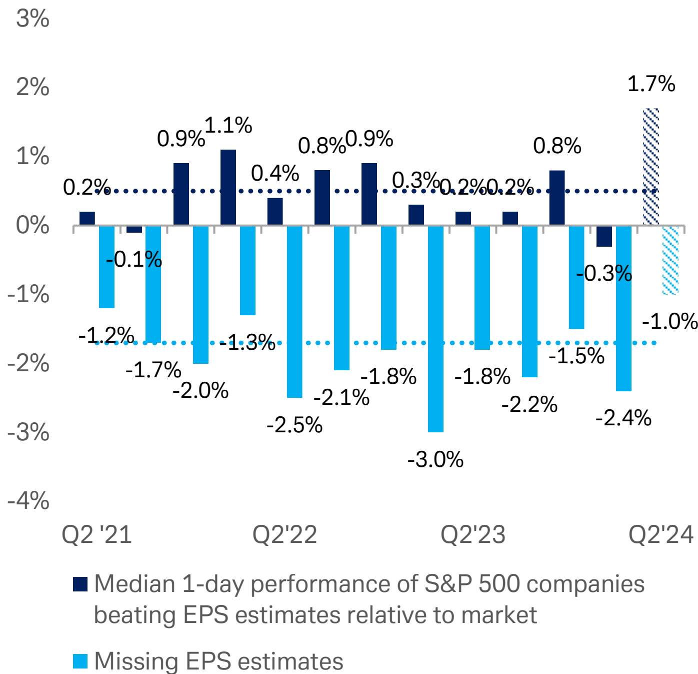


Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of August 9, 2024.

Chart 10: Quarterly earnings growth YoY

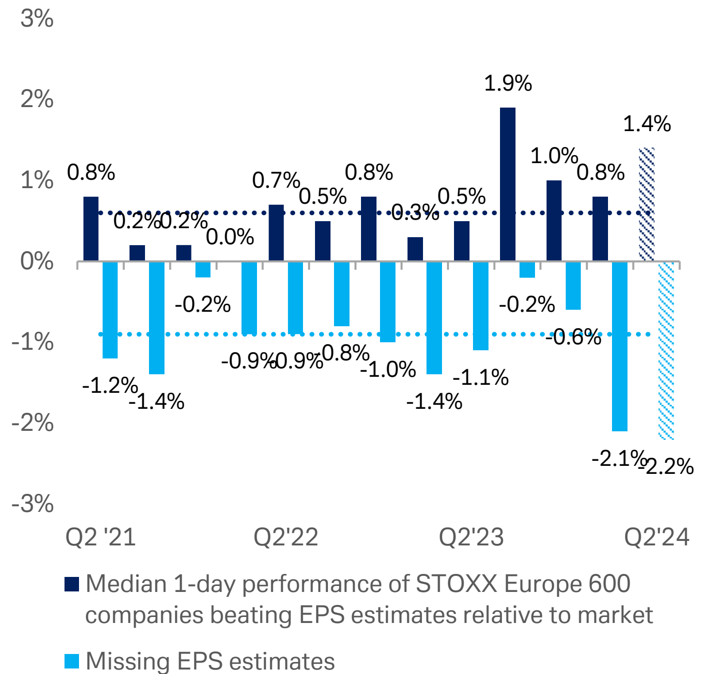
Source: LSEG, Deutsche Bank AG. Data as of August 6, 2024.

Chart 11: Stock price reaction on EPS beats/misses S&P 500



Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of August 9, 2024.

Chart 12: Stock price reaction on EPS beats/misses STOXX Europe 600



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Glossary

The barbell strategy is an investment concept that suggests that the best way to strike a balance between reward and risk is to invest in the two extremes.

Beta is a statistical measure of the volatility of a stock versus the overall market.

CAGR stands for compound annual growth rate.

The Citigroup Economic Surprise Index (CESI) represents the sum of the difference between official economic results and forecasts.

Cyclical stocks are affected by the business cycle, typically including goods and services the purchase of which is discretionary.

The DAX is a blue-chip stock-market index consisting of the major German companies trading on the Frankfurt Stock Exchange; other DAX indices include a wider range of firms.

Defensive stocks provide more consistent dividends and stable earnings regardless of the state of the overall stock market.

Earnings per share (EPS) are calculated as a companies' net income minus dividends of preferred stock all divided by the total number of shares outstanding.

Earnings surprises occur when a reported earning deviate from the consensus estimate either positively or negatively.

The European Central Bank (ECB) is the central bank for the Eurozone.

The Euro (EUR) is the sole legal tender in the EU member states that have adopted it.

The Eurozone is formed of 20 European Union member states that have adopted the euro as their common currency and sole legal tender.

The Federal Reserve (Fed) is the central bank of the United States. Its Federal Open Market Committee (FOMC) meets to determine interest rate policy.

The FTSE 100 Index tracks the performance of the 100 major companies trading on the London Stock Exchange.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Growth stocks are those of companies seen as likely to have above-average earnings or revenues growth.

Large language models (LLMs) are a category of foundation models trained on immense amounts of data making them capable of understanding and generating natural language and other types of content to perform a wide range of tasks.

"Magnificent 7" is a term for the most dominant tech companies. The group is made up of mega-cap stocks Apple, Alphabet, Microsoft, Amazon.com, Meta Platforms, Tesla and Nvidia.

Month-to-date (MTD).

The MSCI ACWI Index captures large- and mid-cap companies across 23 developed- and 23 emerging-market countries.

The MSCI Asia ex Japan Index captures large- and mid-cap representation across 2 of 3 developed-market countries (excluding Japan) and 8 emerging-market countries in Asia.

The MSCI EM Index captures large and mid cap representation across 23 emerging markets countries.

The MSCI Emerging Markets Asia Index captures large and mid cap representation across 8 Asian Emerging Markets countries including China, India, Indonesia, Korea, Malaysia, the Philippines, Taiwan and Thailand.

The MSCI Europe Index includes large and mid cap stocks across 15 developed markets countries in Europe.

The MSCI LatAm Index includes large and mid-cap firms in five Latin American countries.

The NASDAQ Composite Index measures all NASDAQ domestic and international based common type stocks listed on The NASDAQ Stock Market. Today the NASDAQ Composite includes over 2,500 companies

The NASDAQ 100 Index is a collection of the 100 largest, most actively traded companies listed on the Nasdaq stock exchange.

The net profit margin measures how much net income or profit is generated as a percentage of revenue.

Next twelve months (NTM) refers to any financial measure that is being forecasted for the immediate next twelve months from the current date.

The Nikkei 225 is the leading and most-respected index of Japanese stocks.

The Purchasing Managers' Index (PMI) is an index of the prevailing direction of economic trends in the manufacturing and service sectors. It consists of a diffusion index that summarizes whether market conditions are expanding, staying the same, or contracting as viewed by purchasing managers.

Price/book (P/B) ratios measure a company's share price relative to its tangible assets.

Price/earnings (P/E) ratios measure a company's current share price relative to its per-share earnings.

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Quarter-to-date (QTD).

Real rates adjust changes of values for factors such as inflation.

The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe.

The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

The S&P 500 Equal Weight Index is the equal-weight version of the widely-used S&P 500. The index includes the same constituents as the capitalization weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight – or 0.2% of the index total.

The STOXX Europe 600 Index includes 600 companies across 18 European Union countries.

U.S. is the United States.

USD is the currency code for the U.S. Dollar.

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

Value stocks are those that appear to be trading lower than justified by their fundamentals (e.g. sales and earnings).

The VIX Index is a measurement of volatility implied by S&P 500 Index options.

Volatility is the degree of variation of a trading price series over time.

Year-to-date (YTD).

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Historical performance

Performance	9.8.2019 – 9.8.2020	9.8.2020 – 9.8.2021	9.8.2021 – 9.8.2022	9.8.2022 – 9.8.2023	9.8.2023 – 9.8.2024
S&P 500	14.8%	32.3%	-7.0%	8.4%	19.1%
S&P 500 equal-weighted	3.8%	40.4%	-5.4%	4.1%	9.7%
Russell 2000	3.7%	42.4%	-14.4%	0.9%	8.0%
NASDAQ Composite	38.3%	35.0%	-15.9%	9.7%	21.6%
STOXX Europe 600	-2.2%	29.5%	-7.4%	5.6%	8.5%
DAX	8.4%	24.2%	-14.0%	17.1%	11.9%
FTSE 100	-16.8%	18.2%	5.0%	1.3%	7.6%
Nikkei 225	8.0%	24.6%	0.6%	15.0%	8.8%
EUROSTOXX 50	-2.4%	28.4%	-11.1%	16.2%	8.6%
MSCI Asia ex Japan	18.2%	17.2%	-22.7%	-0.3%	3.8%
MSCI EM	11.0%	18.8%	-22.6%	0.7%	3.8%
MSCI China	31.6%	-1.0%	-30.7%	-3.8%	-12.2%
MSCI LatAm	-27.5%	23.1%	-10.5%	10.4%	-10.2%
Magnificent Seven	126.3%	61.7%	-9.7%	34.2%	42.1%
MSCI ACWI Energy	-29.8%	24.2%	28.3%	12.6%	2.8%
MSCI ACWI Financials	-12.0%	42.3%	-11.9%	5.6%	16.2%
MSCI ACWI Industrials	1.8%	33.7%	-13.6%	14.0%	12.1%
MSCI ACWI Communication Services	16.9%	29.6%	-28.9%	9.9%	21.5%
MSCI ACWI Consumer Staples	2.8%	11.8%	-3.6%	2.2%	1.8%
MSCI ACWI Consumer Discrettionary	23.0%	28.8%	-19.6%	6.5%	0.8%
MSCI ACWI Utilities	1.7%	8.6%	3.0%	-10.0%	12.2%
MSCI ACWI Information Technology	43.9%	37.5%	-14.7%	14.1%	30.2%
MSCI ACWI Materials	10.5%	33.8%	-17.8%	6.1%	-0.2%
MSCI ACWI Healthcare	19.6%	20.9%	-7.2%	3.6%	10.5%
MSCI ACWI Real Estate	-9.8%	21.6%	-12.5%	-13.8%	7.2%

Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of August 9, 2024.

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