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CIO Strategy Bulletin

David Bailin
Chief Investment Officer, Citi Global Wealth

Steven Wieting
Chief Investment Strategist and Chief Economist

Joe Fiorica
Head of Global Equity Investment Strategy

Cecilia Chen
Global Equity Investment Strategy

Why We Expect Equity Performance to Broaden Out in '24

- As we look to 2024, equity investors are asking a key question: should they continue to favor big-tech or add exposure more broadly? While momentum trading into year-end may exacerbate the narrow tech rally in the near-term, we find reasons to expect the broadening story will gain traction.
- To get this call right, earnings will need to recover and expand beyond tech next year. How will this happen? We expect the recessions "rolling through industries" to "roll out" within 2024. Higher output and more stable input costs will help profit margins of many firms.
- While not a precondition for our market broadening view, modest Fed easing could be icing on the cake for the 2024 catch-up trade. Falling rates in the absence of a profit collapse would be supportive for a pick-up in M&A and IPO deal flow. Value created over the past two years is ripe to get scooped up by public and private firms sitting on significant deployable capital.
- Healthcare is a sector that never experienced an annual profit decline before 2023. The pandemic distortions and tech challenges from a new class of weight-loss drugs has dimmed performance. This portends a rebound in 2024.
- AI-dominant tech firms have led equity performance in 2023, but their spending should help the chip-equipment industry, in particular.

Why We Expect Equity Performance to Broaden Out in '24

The winning trade of 2023 appears simple: buy big tech and ignore everything else (**Figure 1**). While each of the largest 7 American tech darlings have idiosyncratic growth drivers and risks, this group – which comprises 17% of the MSCI AC World benchmark – was a clear beneficiary of AI-related fever.

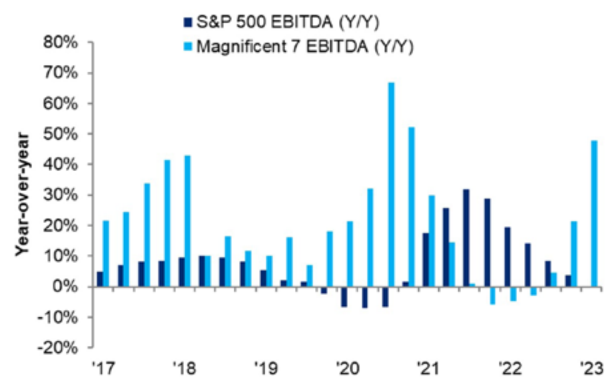
In 2023, investors have been willing to pay a huge premium for rising, high quality profits (**Figure 2**). As a group, the Magnificent 7 have overcome tighter financial conditions and higher interest rates by extending industry leadership and building upon their fortress balance sheets. They presently trade at nearly 30x forward earnings. In comparison, the broader market is 40% cheaper.

Looking Ahead

As we look to 2024, equity investors are asking a key question: should they continue to favor big-tech or add exposure more broadly? While momentum trading into year-end may exacerbate the narrow rally in the near-term, we find reasons to expect the broadening story will gain traction. To get this call right, earnings will need to recover and expand beyond tech next year. How will this happen? We expect the recessions "rolling through industries" to "roll out" within 2024. Higher output and more stable input costs will help profit margins of many firms.

Figure 1: Large cap growth has outperformed Value, SMID and non-US stocks YTD

Figure 2: There's a reason the Magnificent 7 have outperformed



Source: Bloomberg and Have as of November 16, 2023. Magnificent 7 refers to the largest 7 companies by market cap: Apple, Microsoft, Alphabet, Nvidia, Amazon, Meta, and Tesla. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

An earnings recovery will drive broader equity performance

2023 Backdrop

Two of the most cyclical industries, semiconductors and chemicals, tell the story for 2023. While hype around AI has drove the price of a handful of semiconductor stocks higher, profits for the broad semi group are actually on track to fall nearly 7%. Chemicals stocks within the Materials sector also saw earnings decline over 20% this year. As we look to 2024, both segments should experience recovery as electronics, industrial, and automotive manufacturing recovers globally.

In the world of travel and trade, 2023 was a story of significant divergence. Passenger airline profits rose 135% this year amid a surge in travel demand while a glut of goods saw earnings for air freight & logistics firms drop by 26%. As both travel and goods trade normalize in the absence of recession next year, Transportation profits are expected to rise by 8%.

2024

Mega-cap tech outperformance is understandable. Earnings growth for big tech has been far superior to the broad market for much of the past five years. While we don't expect the S&P 500 in aggregate to deliver an earnings recovery as strong as 2021, we believe that index-level profit growth for 2024 will power a catch-up across several sectors that underperformed in 2023.

US corporate earnings are more reliant on global production than is obvious. Nearly 40% of S&P 500 revenues are earned abroad. Therefore, drivers of international growth, like global consumption and trade, will matter nearly as much as American economic activity to determine their profitability. This also explains 2023 performance, where manufacturing and trade experienced the most challenging backdrop relative to soaring tech and consumer activity.

Earnings breadth is the most important ingredient for market broadening. In 2Q 2023, profits fell 6% year-over-year. Less than half of the 11 US sectors delivered positive growth in the first half of 2023 (**Figure 3**). As we look to 2024, most sectors should return to profitability (**Figure 4**). Major beneficiaries include manufacturing, trade, and health care sectors that saw their businesses take part in rolling recessions in ’23.

Falling inflation should support profit margins

As we wrote last week, we have high conviction that inflation will continue to normalize through 2024. While GDP growth was actually stronger in 2023 relative to 2022, profits suffered mostly due to inventory overhangs and lingering cost pressures (**Figure 5**). Labor costs in particular were a key sore spot for corporate executives across several sectors, where organized labor was able to negotiate significant concessions in the backdrop of a very tight job market.

While we don’t expect a return to the post-global financial crisis (GFC) deflationary environment, 2024 should present a weaker labor market and downward pressure on wage growth. There is a clear negative relationship between unit labor costs and profit margins. This is consistent with modest margin expansion.

Figure 3: Most sectors should deliver positive EPS growth next year

Figure 4: Consensus EPS growth by sector

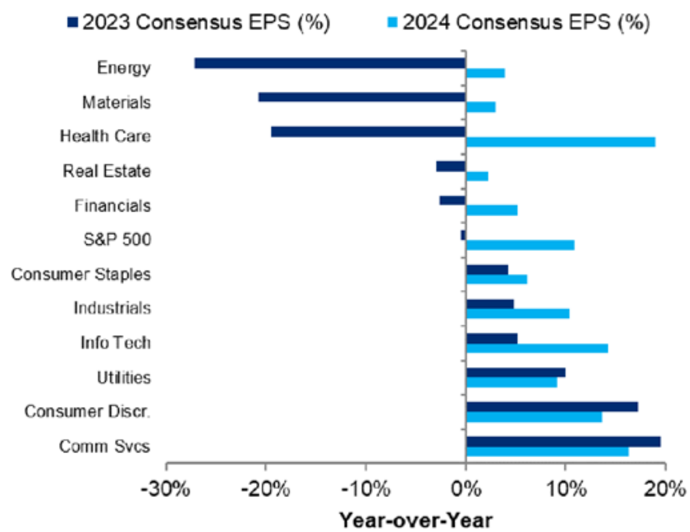


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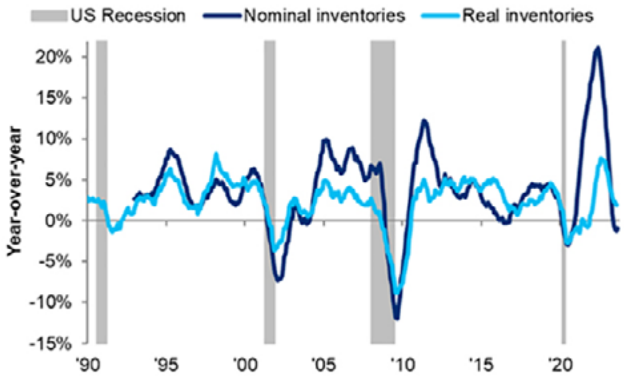
Figure 5: The post-COVID inventory overhang has dramatically improved this year



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Falling rates would help markets too

While not a necessary precondition for our market broadening view, modest Fed easing could be icing on the cake for the 2024 catch-up trade. Inflation normalization could create room for the Fed to move rates from moderately restrictive to neutral, taking some pressure off of financing costs for highly levered projects. Falling rates in the absence of recession would also be supportive for a pick-up in M&A and IPO deal flow, as value created over the past two years is ripe to get scooped up by public and private firms sitting on significant deployable capital.

What's priced in?

While a wider range of sectors may deliver positive earnings growth next year, it's unlikely that the average S&P 500 firm will out-grow mega-cap tech any time soon. Indeed, analyst consensus expects the Magnificent 7 to deliver nearly double the EBITDA growth versus the remaining 493 S&P 500 firms next year (16% vs 9%). Valuations already reflect these relative growth rates, however, with the big 7 trading at 29x '24 EPS versus 16.6x for the rest of the large cap market. Said another way, both groups trade at a nearly identical PEG ratio (PE/Growth) of 1.8.

As we published in the November Quadrant, we expect actual 2024 EPS will come in at a modest +5% as recessions in industry activity continue before ending in the year. We expect this will be followed by +7% gain in 2025. Given a loftier valuation starting point, big tech faces a higher bar to deliver strong growth than firms and sectors that have seen their share prices underperform earnings expectations .

Technology: play the AI capacity buildout

In our upcoming Outlook 2024, we highlight the opportunity to invest in the buildout of AI capacity next year. While mega-cap chipmakers have a clear lead in the development and design of GPUs required for AI applications, these companies don't actually make the chips themselves. A complex, global supply chain is vital to the delivery of AI-optimized CPU and GPU chips into data centers and supercomputers. Indeed, as we see the global semi cycle forming a bottom, the alignment of both cyclical and secular tailwinds is poised to support semiconductor equipment firms in particular in 2024 (**Figure 6**).

Health Care: Weight loss is just half the story

Not all of the 2024 catch-up opportunities are cyclical. The health care sector is a notoriously defensive sector that has for decades delivered consistent, positive earnings and sales growth. That was until the distortions of COVID and some other factors that hit 2023. Yet we also expect health care earnings to return to growth next year.

An ongoing hangover from COVID, dried up capital markets, rising financing costs, surging wages and US policy uncertainty have all contributed to the sector's first earnings recession in decades. Despite these headwinds, novel medical advancements continue to improve lives. Aging populations globally will continue to spend more on health care in the coming decade. In the US alone, 10,000 people are turning 65 each day, according to the AARP.

One key exception to this year's health care malaise is the explosion in use of anti-obesity drugs, known generically as GLP-1s. A duopoly of GLP-1 providers have seen their share prices surge this year as it turns out these drugs not only help with weight loss, but recent studies have shown these medications have the potential to lead to fewer heart attacks, strokes, and improved overall cardiovascular health (**Figure 7**).

Much like the release of Chat-GPT initially impacted the shares of education companies, call centers, and other staff-heavy services firms, excitement around GLP-1s has driven declines in companies with exposures to heart medication and sleep apnea equipment. While the use cases for deployment of GLP-1s continue to grow and manufacturing is ramping up, we also see an opportunity to invest in other forms of health care innovation which have meaningfully lagged for the past 2 years. Life sciences tools companies which help administer and facilitate drug trials remain well off their highs. An easing of rate pressures and a recovery in venture financing would be especially supportive for early-stage biotech firms.

Figure 6: Fabless semis have surged ahead of their key suppliers

Figure 7: An extremely narrow health care rally has left a lot of innovative firms trading well off their highs

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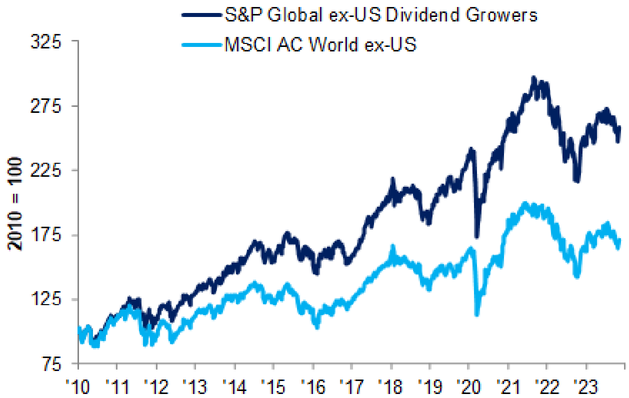
Will US leadership give way to an international broadening?

Non-US markets have delivered lackluster performance for over a decade. This divergence in performance and valuation appears justified. US equities in aggregate have grown dividend payouts by 193% since 2010, while developed equities outside the US have returned only 43% to shareholders. Banks in places like Europe, or state-owned enterprises across emerging markets, are often required to manage to regulatory constraints as much as profits. Dominance of US tech giants in an otherwise muted global growth environment have established the US equity market as reliable source for outperformance. Growth scares, pandemics and geopolitical flare-ups have all seen flights to safety into USD-denominated assets.

Despite these headwinds, we believe international indices mask significant potential opportunity present within regional equity markets. As we wrote in September Quadrant, fast-growing firms outside the US have kept pace with and even outperformed their high-flying US counterparts. The small but vibrant tech sectors in Europe and Japan, or international consumer names tied to a rising Asian middle class, are two examples of secular themes that continue to drive outperformance. Strategies that focus on quality or consistent dividend growth have also performed better than passive non-US benchmarks (**Figure 8**). We therefore continue to believe that non-US equities have a place in portfolios, but we prefer an active or thematic lens during allocation.

Figure 8: Quality or dividend growth overlays can generate significant outperformance relative to passive



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Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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