MARKET *view*

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Exciting times: Q3 2022 earnings season

> *The month of October 2022 shows again that the long-term high performance of equities can depend significantly on a few days, weeks and months.*

Good news first: despite high inflation and recession concerns, the MSCI World Net Total Return Index (in US dollars) is up 7.2% and the S&P 500 (in US dollars) is up 8% in October 2022. The MSCI World comprises 1,511 individual stocks and provides a good overview of the stock market developments in 23 developed economies. The market capitalization of U.S. stocks is so large that the U.S. share in the index is around 70%.

So, let us focus on the US. As of 4 November 2022, 85% of S&P 500-listed companies had reported their quarterly earnings. According to Factset, earnings per share grew by 2.2% year-on-year. This is the lowest growth rate since the third quarter of 2020. As a result of the supply shock, consumer demand is getting weaker, as high inflation leads to declining purchasing power. In addition, the Federal Reserve and the ECB have recently raised interest rates sharply due to record high inflation. Higher interest rates will lead to a decline in investment. In Europe, the probability of a recession is around 85%; in the US, it is now around 60%. This means that there is still a 40% chance a recession can be avoided on the other side of the Atlantic.

Some earnings of "big tech" companies in the US have been surprisingly poor in the third quarter of 2022. Take Meta. The company is suffering from growing competition from innovative video apps like TikTok. Meta's revenues fell by 4%. The market is also increasingly critical of CEO Mark Zuckerberg's high investments in the Metaverse. On 27 October 2022, Meta's share price fell 31.9% in a single day. At ODDO BHF Trust we are quality investors. That is why we do not hold Meta. But even higher quality companies are not immune to the supply shock. Alphabet's revenues in the third quarter were still up 6% year-on-year, but growth is clearly slowing down. According to CEO Sundar Pichai, the main reason for this is the decline in the online advertising business.

Microsoft earned more than half of its revenues in the cloud business for the first time. However, the company warned that the high growth of its Azure cloud platform is slowing but is still expected to be 37% instead of 42% for this year. In addition, software sales to PC manufacturers fell by 15%. Research and consulting firm Gartner expects PC sales to decline by more than 19%.

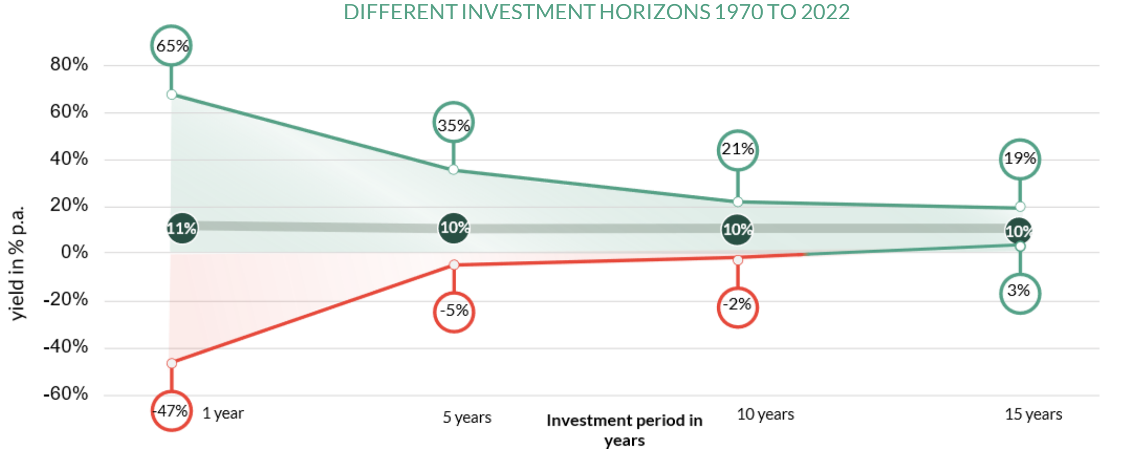
This had clear consequences for us: in our Polaris funds, the weight of "big tech" stocks – Apple, Amazon, Microsoft, Alphabet, Meta – is currently significantly lower than in the market-wide MSCI World Index. In particular, we expect the online advertising business to continue to be weak in the fourth quarter. In a period of low growth, companies need to reduce spending. And the first budgets to go after are marketing and advertising.

We also remain cautious on banks. They are currently suffering from a weakness in the M&A consulting business and rising provisions for non-performing loans. At Goldman Sachs, JP Morgan and Morgan Stanley, for example, M&A commissions declined by -41%, -31% and -46% respectively in the third quarter. This, too, had consequences for our investment decisions: in the financial sector, we have been focusing on insurance for some time. When we buy banks, we only buy those that benefit from rising interest margins and suffer less from falling commissions. Stock picking is crucial here.

Another key finding of the current earnings season is that profit margins - outside the energy sector - are falling significantly in the US. The strong dollar is also weighing on US corporate earnings. In the ODDO BHF Group's Global Investment Committee, we have therefore lowered our outlook for American equities and raised our outlook for European equities. European equities also benefit from their lower valuation: while US equities continue to trade above their long-term averages in terms of price/book value, the Shiller price/earnings ratio and other valuation measures, European equities are already trading below their long-term valuation levels.

Equities as measured by the MSCI World Net Total Return Index (in US dollars) have grown by more than 10% per annum on average since 1969 with high volatility and high risk (see Chart 1). The month of October 2022 shows again that the high long-term performance of equities can depend significantly on a few days, weeks and months. Yes, current times are exciting, but the following advice stands: long-term investors should hold a significant portion of their portfolios in stocks. Now is not the time to underweight equities.

CHART 1: MSCI WORLD (USD): MAXIMUM, MEAN AND MINIMUM ANNUAL RETURNS FOR DIFFERENT INVESTMENT HORIZONS 1970 TO 2022



Graph 1: The graph shows the annual returns of the MSCI World over a period of 1, 5, 10 and 15 years. The returns were calculated on a monthly rolling basis over the period 31.12.1969 to 30.08.2022. It shows that those who held the MSCI World for 1 year from September 1985 to August 1986 achieved a return of +65%. Investors who held the MSCI World from March 2008 to February 2009, on the other hand, suffered a loss of -47%. The graph shows that the variation between the maximum and minimum return decreases with the length of the investment period. Source: Refinitiv Datastream

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