Goldman Sachs Exchanges

Hedge Funds Are Cautious on Stocks amid Rates and Energy Volatility

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C: This is The Markets. I'm Chris Hussey, and today is Wednesday, October 7th, and I'm here in the Goldman Sachs trading floor with Mark Wilson, who is head of European Equities, Franchise Sales and Hedge Fund Coverage within our FICC and Equities Group. Mark, thanks so much for joining us.

Mark Wilson: Thanks for having me, Chris.

Chris Hussey: Okay, Mark always great to have you here. Let's kick it off with the two headwinds in the market today.

Rates have been going higher, oil's been going higher. Europe, of course, is exposed to both. What is Europe exposed to most, and what are clients caring about most here?

Mark Wilson: In Europe, we are more vulnerable to the energy shock, and so the inflationary pressure is higher. If you think about the feed through to the markets, on six-month correlations, Euro stocks and 10-year Bund yields are about negative 70% correlated right now. You haven't seen that degree of negative correlation since back to the 1990s, so this is really a bit of a regime shift.

You're right to ask the question though, because obviously over the last couple of weeks we've had a much more idiosyncratic event in Europe. OAT spreads versus Bunds have blown out, and some of the social, but mainly political issues focused around the upcoming budget in France have been a real problem.

And so that's a major European specific issue, which is now there, and I think will be an ongoing feature over the next few months as we get towards the presidential elections in France in the first half of next year.

Ultimately, here and now, the two things which clients are most focused on are the price behavior of that OAT-Bund spread, and also the energy and gas inventory stock situation as we head in towards winter.

Chris Hussey: Okay, Mark, I get it. Oil more important than rates in Europe, but we also know that rates matter a lot to stocks. What are you seeing from clients around how rates are impacting stock valuation and positioning?

Mark Wilson: In terms of equities specifically, and this isn't just common to Europe, you've seen a very logical de-rating in equity markets. So, S&P multiple has come down, same is true in Europe. If you look at the more rate sensitive parts of the market, if you look at European renewables, for example, they've de-rated at well over 20%, and so you've seen this quite logical re-rating, de-rating specifically, in equities in response to higher rates.

You mentioned positioning. I think the most standout piece of information that we've been thinking about the last couple of weeks is just how much this has caused investors to reappraise their equity exposure and their equity risk. So, to put a number on this, we look at our fundamental hedge funds and their net exposure to the markets, and if you look at US-specific fundamental long-short clients today, their net length is in the north percentile on a one-year look-back.

It's at a two and three percentile on a three-year and five-year look-back. I think globally, global fundamental long shorts, these are anywhere from nought to 9% in terms of their net length and exposure to the market. So positioning has been really cut in response to rates and a bunch of other uncertainties that are out there.

Chris Hussey: Yeah. That, that is, that is a fascinating number, and nought, for our audience, is zero in England. So, let me

expand, though, onto your energy comment, cause you make an interesting energy comment around how Europe is so exposed here. What many people don't realize is nat gas is the exposure as much as oil, and there have been, our commodities team has written about the potential for nat gas to really spike maybe five, ten times what you have to pay for nat gas in the US.

Are you seeing that in the industrial complex of Europe yet? Are you seeing these in the numbers, or is this just something people are scared about and it's not something in the numbers yet?

Mark Wilson: So it is in the numbers. Europe has definite competitive issues related to higher energy price costs, but this isn't new news. Europe trades cheaper. Part of it is this phenomena. These competitive threats are impacting industry and impacting the market.

I do think, though, the starting point matters, and Europe is a lot cheaper than other global markets, especially the US, and so some of that is already in the price, and I don't think it's an impediment to performance. European banks have beaten Mag Seven on a one-year, three-year, four-year look-back, and so there's the opportunity for performance, but it's certainly a competitive headwind and issue for Europe.

Chris Hussey: All right, Mark. 25 years ago, you were brokering me as a US analyst in Europe, so I know you know the US markets well. I know now --

Mark Wilson: You're aging us both, Chris.

Chris Hussey: Well, I know that you now know the European markets really well. So, I want you to compare US versus Europe here. Talk to me. Is Europe a value trap here with all the headwinds that they're facing, or is Europe an opportunity because it's so cheap?

Mark Wilson: So part of the European discount is certainly because of the index composition. We have less tech, we have less high-growth companies, and so inevitably there is a value element to it. The European market has been holding its own. I

mean, it's kept up with the US this year, and part of that is because there are some clear investment cycles within Europe, within industrials, within renewables, within defense.

And what I'd say is the last few years have had a series of ongoing challenges to Europe, and Europe is slow to respond, but Europe is responding. So when you go back to COVID, there was a very large fiscal mobilization. Pretty soon afterwards, you had the Russia-Ukraine conflict and a real acknowledgment of a need for energy independence domestically.

Not long after that, you had the challenge of the Iranian conflict and the obvious heightened energy issues, and the AI cycle in of itself is a challenge to Europe to respond, to have its own deployment. And so, within Europe, these forcing mechanisms have continued to compound and to drive action and to drive response.

And so what I'd say is there are real themes to invest behind. That industrial theme, the rearmament of Europe, the drive for energy independence. And demographics has been one of the key issues for Europe and one of the key bear theses and one of the key planks of this value trap argument. This argument around demographics is destiny, I think, is somewhat being debunked when we think about the real power of AI and the deployment of AI, which will be very prevalent soon.

Demographics times agents deployed in the economy could be a real uplift to demographically challenged areas. And so I think there's increasing hope that actually the European market offers real opportunity, and as the strategy to respond to these challenges becomes more evident.

Chris Hussey: Okay. Third quarter earnings season is right upon us. We're going to kick it off in the United States tomorrow. Europe and the US, and the world more generally, is this peak earnings, or is this another opportunity to buy the earnings growth?

Mark Wilson: So, I'm pretty sure in the US we have peak earnings growth for the third quarter.

I think 27% earnings growth in the US, which is topping an amazing run in terms of earnings growth. And that's a clean earnings number, not taking benefit for all these one-time gains. Europe has actually been similarly strong, so we're forecasting 22% earnings growth year on year for the second half of this year.

It's aided a little bit by the energy benefit, so there's a big composition within the index of energy companies. Clean of the energy stocks, we're still looking at 15% earnings growth. So yes, I think the second derivative is slowing, especially in the US, but the earnings growth environment speaks to that high nominal growth environment that we spoke about at the beginning.

And given that we're now transitioning, about to transition into a new calendar year, and you've seen this very significant multiple compression, I do think where you see high nominal growth, where you see high corporate earnings and a more reasonable multiple, the market setup is still pretty favorable.

Chris Hussey: All right, Mark, let's put a bow on it. What's the trade?

Mark Wilson: So I'm going to give you two, Chris.

Chris Hussey: I love it.

Mark Wilson: The first one is US-focused. There's been a lot of commentary around the narrowness of the US market performance, and the largest stocks in the index have been the largest spenders.

There's been a huge amount of focus on the ROIC and the returns in which these spenders may garner, and I think that the momentum around real AI adoption is beginning to come through, whether it's Muse and other products in the consumer hands, or whether it's some of the enterprise adoption that we're beginning to see, the numbers are clear.

And I do think that some of the hyperscaler revenue growth is really lagging by three, four, five, six quarters, the very strong CapEx spend north of 100% that we're seeing, the very, very

strong cloud revenue backlog that we're seeing, again, north of 100%. And so, I think as we begin to see some of this ROIC and the real return on spend come through, I absolutely want to be long US mega cap tech.

The second one is German fiscal spend beneficiaries. We know how strong the US growth story has been. German manufacturing PMIs are actually outpacing the US right now. Part of that is because as the rest of the world worries about fiscal space, the Germans are able to fiscally expand, and that's driving significant investment across broad industrial complex in Germany.

Through this year, you've seen 13 to 14% estimates revisions for EPS, yet those stocks have derated over 20% as well. So right now you're paying low teens multiple for a group of companies that is going to grow earnings in line with the US market over the next 12 and 24 months, so I want to be long that basket of German fiscal spend beneficiaries.

Chris Hussey: I love it. US mega cap tech, the harvesters, and the German fiscal beneficiaries. Great.

Okay, Mark, last question. What are you watching for next week?

Mark Wilson: So, first order I think is going to be CPI next Wednesday. It's going to be all important when we think about what might break this trend of, higher yields. Good news on the inflation front is going to be key.

I do think there's a window of opportunity for some news and a break in the Iran conflict given the timing now ahead of the midterms. And then I think all importantly, you mentioned it before, we're going to go into third quarter earnings. We've been in this unique period where really the micro is driving the macro, and I think as we learn more about the state of the AI trade as we go through corporate earnings, that's going to be all important.

Chris Hussey: Mark Wilson, you are always a wealth of information. Thanks so much for joining us.

Mark Wilson: Great to see you, Chris. Thank you.

Chris Hussey: That does it for this week's episode of The Markets. I'm Chris Hussey. Thanks for listening.

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