FPA Financial

Investment Committee Policy Summary

November 2022

Economy and Stock Market Outlook

Eurozone's GDP rose by 0.2% qoq in 3Q

- Eurozone's GDP rose by 0.2% qoq in 3Q, following a 0.8% quarterly growth in the previous quarter, as shown in **Exhibit 1**.
- Among the larger Eurozone economies, Germany, France and Italy all contributed positively to the bloc's growth by recording GDP growth of 0.3% qoq, 0.2% qoq and 0.5% qoq respectively in 3Q, as shown in **Exhibit 1**.
- On a yoy basis, the Eurozone economy grew by 2.1%, a slowdown from the 4.3% annual growth in 2Q, as shown in **Exhibit 1**. During the year, the German, French and Italian economies recorded yoy GDP growth of 1.1%, 1.0% and 2.6% respectively, as shown in **Exhibit 1**.

Exhibit 1: Actual GDP growth for Eurozone, Germany, France & Italy

	Actual GDP growth			
	% change, qoq		% change, yoy	
Country	2Q 2022	3Q 2022	2Q 2022	3Q 2022
Eurozone	0.8	0.2	4.3	2.1
Germany	0.1	0.3	1.7	1.1
France	0.5	0.2	4.2	1.0
Italy	1.1	0.5	4.9	2.6

Source: Eurostat, Destatis, Insee, Istat

Eurozone Economic Outlook

- The energy shock is already having a major impact on activity, real incomes & sentiment and may on its own be sufficient to push some of the major economies and the region overall into recession over the winter quarters. In addition, the ECB has joined the growing group of central banks asserting that a slowdown in demand is necessary to address the underlying inflation issue. Their messaging has changed noticeably over the last three months and financial markets have reacted accordingly

- With energy use set to rise as cold weather spreads across the currency area, most economists expect Eurozone's economy to contract in the final three months of the year, and in the early months of next year.

- The higher utility bills, notwithstanding fiscal support from governments, will weigh on household consumption, business production, and investment. Further, weak 2023 growth across Europe reflects spillover effects from the war in Ukraine, with especially sharp downward revisions for economies most exposed to the Russian gas supply cuts, and tighter financial conditions.

- Most financial institutions have downgraded their forecasts on the Eurozone's GDP for 2022, ranging from 2.5% to 3.9%. Forecasts for 2023 have similarly been downgraded, ranging from -1.0% to 0.9% as shown in **Exhibit 2**.

Exhibit 2: Eurozone GDP forecasts for 2022 and 2023

Name of institution	GDP growth forecast	
	2022	2023
IMF Oct-22	3.1	0.5
OECD Oct-22	3.1	0.3
ECB Sep-22	3.1	0.9
AllianceBernstein Sep-22	2.8	-0.7
BNP Paribas Sep-22	2.8	0.3
DBS Oct-22	2.5	-0.4
Bank of Singapore Oct-22	3.9	-0.8
UOB Oct-22	2.7	-1.0
Wells Fargo Oct-22	2.9	-0.9
UBS Oct-22	NP	0.5

NP: not provided

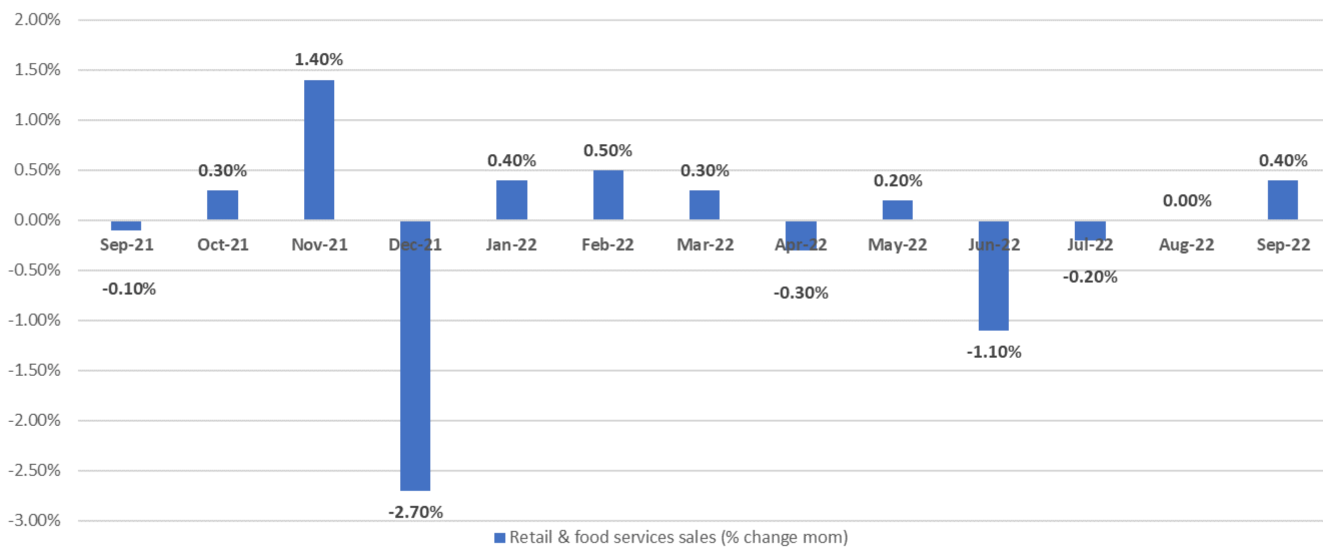
Source: respective financial institutions

Retail Sales Rose Slightly in September

- Retail sales, as a good indication of consumer demand, rose by 0.4% in September compared with the previous month. Eurostat also revised upwards retail sales for August to 0.0% month-on-month (mom) from the previously reported -0.3% as shown in **Exhibit 3**.

- The monthly increase in September was driven mainly by purchases through the internet, which rose by 2.6% mom after a 4.1% monthly slump during the holiday season in August. Conversely, sales of petrol which rose by 2.1% mom in August when people travel for vacation, fell by 0.6% mom in September.

Exhibit 3: Eurozone Monthly Retail And Food Services Sales (% change mom)



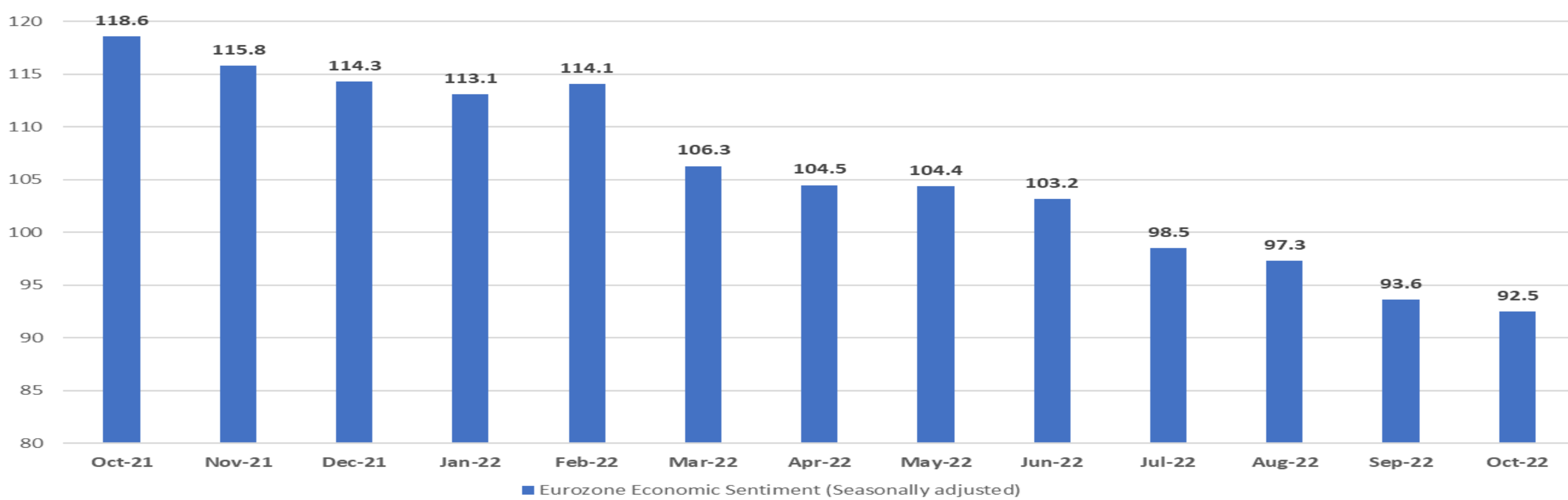
Source: Data compiled from Eurostat

Economic Sentiment Deteriorated in October

- Economic sentiment in the eurozone deteriorated again in October, weighed by high inflation and a darkening outlook for the economy. The European Commission said that its economic sentiment indicator--an aggregate measure of business and consumer confidence--declined to 92.5 in October from a revised reading of 93.6 in September, the lowest reading since November 2020 as shown in **Exhibit 4**.

- The worsening of the overall sentiment in October resulted from marked deteriorations in services and manufacturing confidence, only partly offset by slight improvements in retail and consumer confidence. The economic sentiment indicator fell in Germany and Italy, remained unchanged in France and improved in Spain.

<u>Exhibit 4: Eurozone Economic Sentiment (Seasonally adjusted)</u>



Source: Data compiled from Eurostat

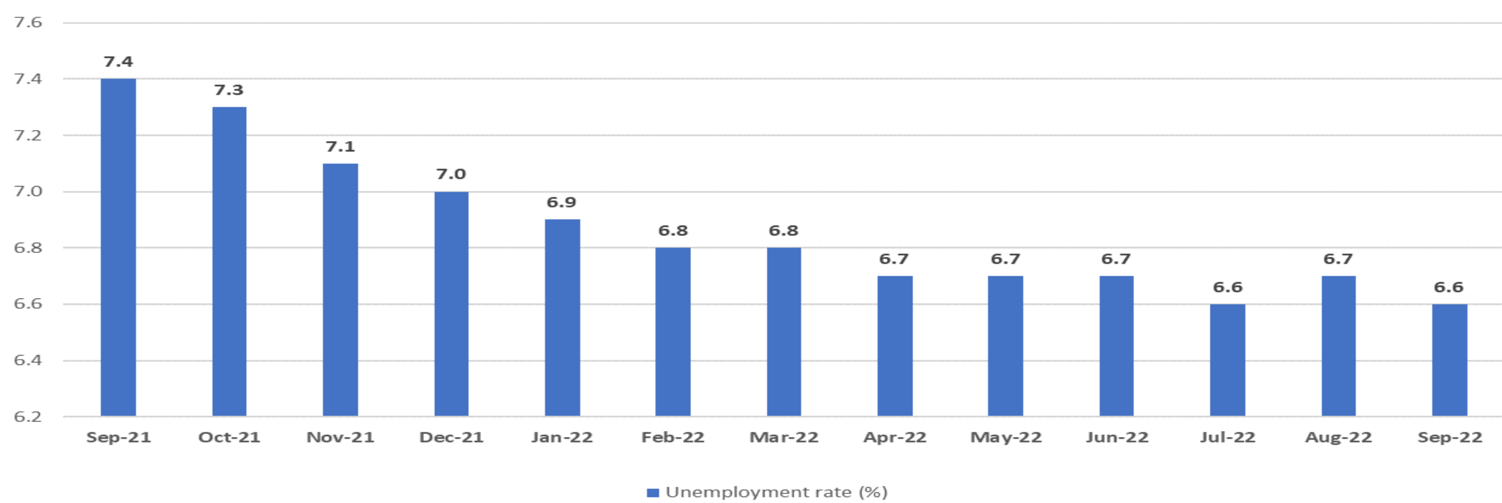
Unemployment Rate Declined Slightly In September

- According to Eurostat, the eurozone jobless rate fell to 6.6% in September from a revised reading of 6.7% in August as shown in **Exhibit 5**. The reading matched economists' consensus forecast in a poll by The Wall Street Journal.

- The number of unemployed people fell by 66,000 in September to 10.99 million, the statistics agency said. The youth unemployment rate--among people under 25--rose to 14.6% in September from a revised reading of 14.4% in August, Eurostat said.

- The eurozone unemployment rate stands at a record-low level. Economists expect joblessness to increase as the region's economy falls into a recession around year-end, but any rise in unemployment is likely to be modest.

Exhibit 5: Eurozone Monthly Unemployment Rate (%)

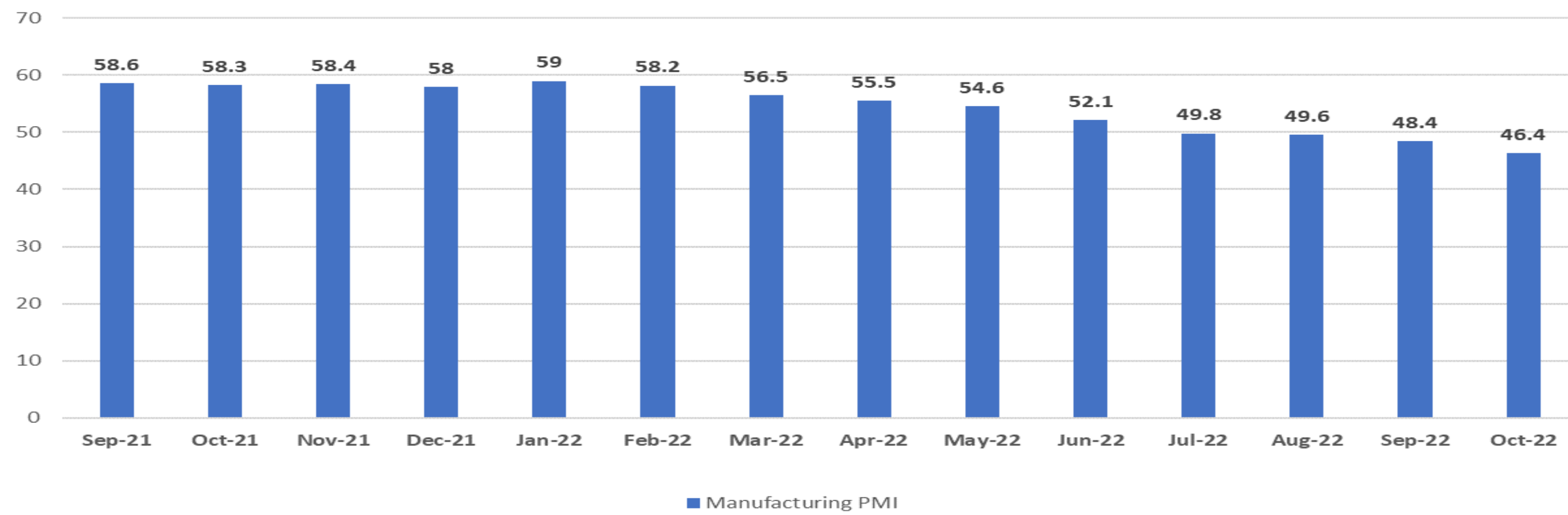


Source: Data compiled from Eurostat

Eurozone Factory Downturn Deepened In October

- S&P Global's final manufacturing Purchasing Managers' Index (PMI) fell to a 29-month low of 46.4 in October from September's 48.4, below a preliminary reading of 46.6 and further below the 50.0 mark separating growth from contraction as shown in **Exhibit 6**.
- According to S&P Global Market Intelligence, the euro zone goods-producing sector moved into a deeper decline at the start of the fourth quarter. The PMI surveys are now clearly signalling that the manufacturing economy is in a recession

Exhibit 6: Eurozone Monthly Manufacturing PMI



Source: Data compiled from ISM

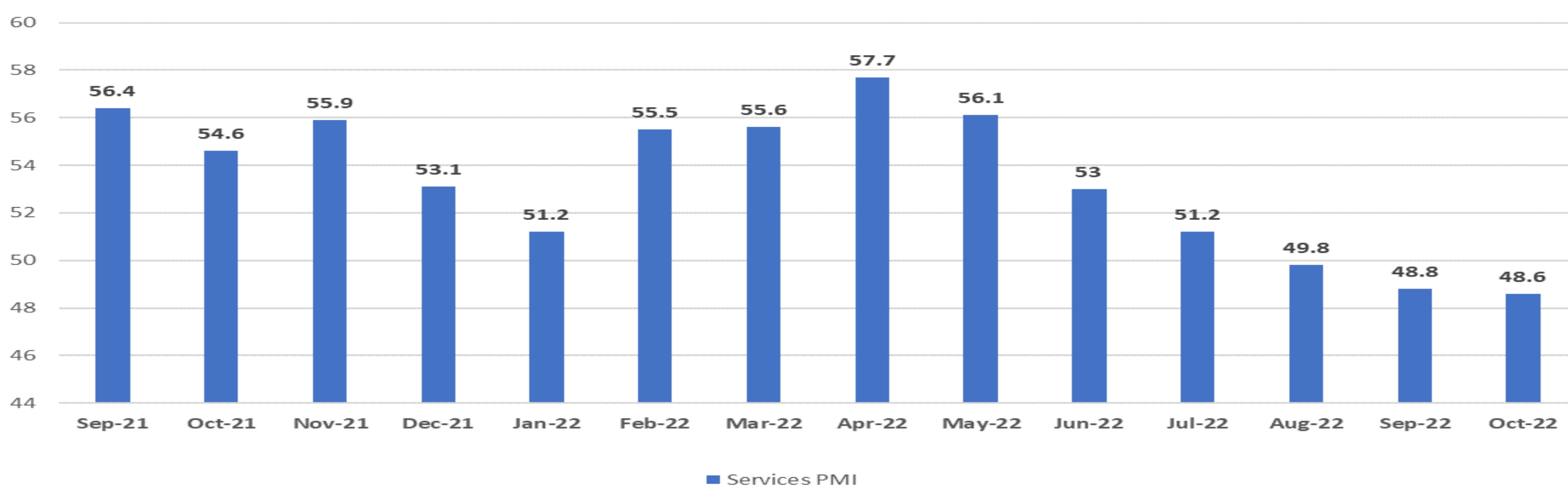
Eurozone Services PMI fell in October

- S&P Global's final Services Purchasing Managers' Index (PMI) nudged down to a 20-month low of 48.6 from 48.8, although above the 48.2 flash estimate as shown in **Exhibit 7**.

- High operating expenses due to energy, wages and transport costs pushed services firms to raise charges sharply again. The output prices index was 62.7 compared to September's 63.2, the fifth highest reading in the survey's 24-year history.

- According to S&P Global Market Intelligence, October PMI data suggest inflationary pressures remained extremely elevated across the euro zone

Exhibit 7: Eurozone Monthly Services PMI



Source: Data compiled from ISM

F • P • A

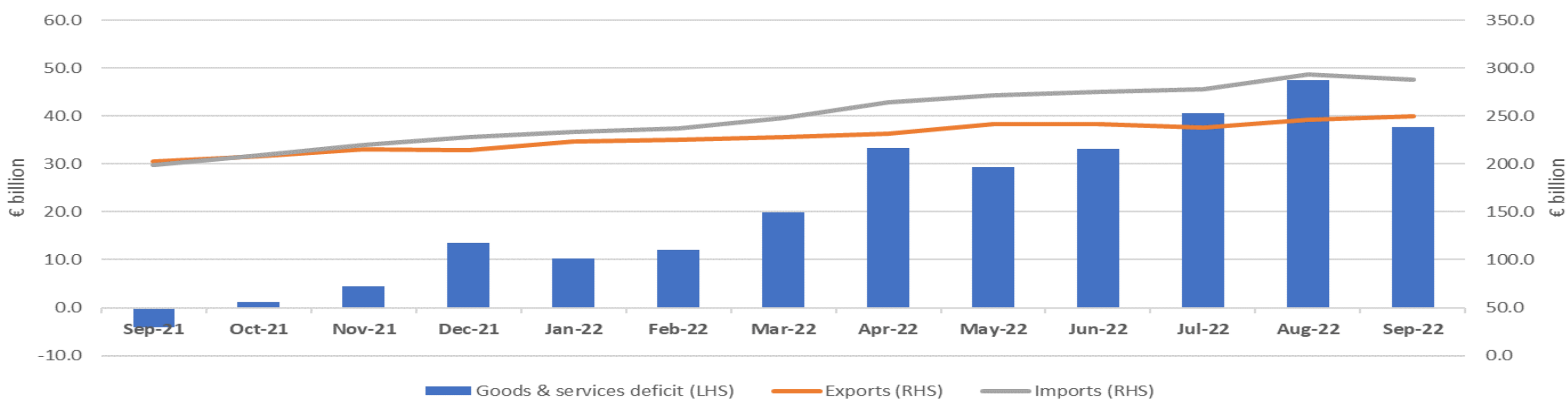
"Regenerating Opportunities"

Eurozone Trade Deficit Narrowed in September

- According to Eurostat, the eurozone posted a trade deficit in September as imports increased due to high energy costs. Adjusted for seasonal swings, the trade deficit was EUR37.7 billion in September compared with a EUR47.6 billion deficit in August as shown in **Exhibit 8**.

- On a monthly basis, eurozone exports rose a seasonally adjusted 1.6%, while imports decreased by 2.0%. Data for the EU showed the trade deficit for energy increased to EUR491.4 billion in the first nine months of the year compared with a deficit of EUR179.6 billion in the same period a year ago, underscoring the higher costs of imported energy since the outbreak of war in Ukraine.

<u>Exhibit 8: Eurozone Monthly Goods And Services Deficit, Exports And Imports (in € billion)</u>



Source: Data compiled from Eurostat

Economy: Summary of our views

- In summary, Eurozone's GDP rose by 0.2% qoq in Q3, following a revised 0.8% expansion in the previous quarter. Compared with the same quarter of the previous year, seasonally adjusted GDP increased by 2.1% in the Eurozone, after a 4.3% yoy increase in the previous quarter. However, most financial institutions have revised their full year forecasts downwards and projected annual growth of between 2.5% and 3.9% for 2022 and -1.0% and 0.9% for 2023.

- Recent economic indicators have shown that the possibility of a recession is growing. Retail sales rose by 0.4% mom in September, underlining sustained consumer demand in the third quarter. The economic sentiment in the eurozone fell from 93.6 in September to 92.5 in October, weighed by high inflation and a darkening outlook for the economy.

- Unemployment rate fell to 6.6% in September from a revised reading of 6.7% in August, reaching a record-low level.

- The decline in manufacturing PMI was sharp and fell to a 29-month low of 46.4 in October from September's 48.4 while the services PMI nudged down to a 20-month low of 48.6 in October from 48.8 September. October PMI data suggest inflationary pressures remained extremely elevated across the euro zone.

- In September, the high energy prices boosted its import bill and pushed the Eurozone's trade deficit to reach nearly 38 billion euros.

- Overall, although supply bottlenecks have recently eased, they are still weighing on activity and are assumed to dissipate only gradually. However, there are risks that lean more toward the negative, especially if the energy situation becomes chaotic and disrupts European industrial sectors, where growth is more dependent on trade and manufacturing. Considering the above, we are neutral on the Eurozone economy.

Eurozone Equities

- Over the period from 02.09.22 to 18.11.22, the Eurozone equities represented by the Euro Stoxx 50 index rose by 10.73% to 3,924.84 and DJ Stoxx 600 index rose by 4.17% to 433.33. In the same period, the German DAX rose by 10.59% to 14,431.86, the French CAC rose by 9.85% to 6,644.46 and the Italian FTSE MIB rose by 12.57% to 24,675.18.

- The MSCI European Economic & Monetary Union (EMU) index was recently trading at a forward PE multiple of 10.96x as of 31.10.22, as shown in **Exhibit 9**. The implied forward earnings yield of 9.12% is in excess of the benchmark German 10Y bond yield of 2.017% as of 18.11.22.

- German, French and Italian equities recently traded at attractive valuations. The MSCI Germany, MSCI France and MSCI Italy were recently trading at a forward PE of 9.85x, 11.28x and 7.50x respectively as of 31.10.22, as shown in **Exhibit 9**. The corresponding forward earnings yield were 10.15%, 8.87% and 13.33% respectively. Meanwhile, the German, French and Italian 10-year bond yields were 2.017%, 2.488% and 3.893% as of 18.11.22

- Thus, German, French and Italian equities are attractive from an earnings/bond yield perspective. Moreover, the dividend yields on the MSCI Germany, MSCI France and MSCI Italy indices of 3.86%, 3.01% and 5.11% are also in excess of the respective 10-year bond yields, as shown in **Exhibit 9.**

Exhibit 9: Eurozone valuation indicators

As of 31.10.22	MSCI index			
	EMU	Germany	France	Italy
Fwd PE (x)	10.96	9.85	11.28	7.5
Implied fwd earnings yield	9.12%	10.15%	8.87%	13.33%
Dividend yield	3.36%	3.86%	3.01%	5.11%
10Y bond yield*	2.017%		2.488%	3.893%

**As of 18.11.22*

Source: MSCI, WSJ

Eurozone Equities

DWS, Goldman Sachs, UBS, Fidelity and Morgan Stanley are neutral on European equities

- **DWS**
  - DWS believes the war in Ukraine and its consequences are still a heavy burden on the European economy. The risks are shown in the record-high valuation discount of European versus U.S. stocks.
  - Currently, it can, not be ruled out that corporate earnings growth might come in worse than already discounted. At the moment, DWS regard dividend and commodity stocks as promising. On European equities, DWS is neutral in the short term and positive on the long term

- **Goldman Sachs**
  - Goldman Sachs expects European markets to present a high degree of volatility over the winter months, and that may create more medium to long-term relative value opportunities and dislocations that may be exploited through both public and private markets.
  - With sanctions against Russia expected to remain in place and potentially worsen, Europe's energy challenges are likely to persist, at least until the transition to alternative sources of energy and renewables advances significantly. This adds up to a potentially long period of suppressed growth for the continent, with increased divergence across member states which in turn could bring about increased tensions within the EU and particularly the Eurozone.

Eurozone Equities

- **UBS**
  - UBS noted that Eurozone equities are down 22% from their 2021 highs in euros (down 34% in USD) and P/E valuations have fallen by 34%.
  - This leaves EMU equities trading on 10.6x forward P/E, a 20% discount to its own 20-year average. The P/E discount to global equities is also close to the bottom of its range over the last 20 years.
  - So, the uncertain outlook for the Eurozone is partly priced in, in its view

- **Fidelity**
  - Fidelity noted that the Q3 corporate reporting season is underway with earnings outcomes consistent with previous quarters. With close to 65% of results being disclosed, companies have managed to deliver both a strong top-line and healthy (but narrower) earnings beat. According to data by Morgan Stanley Research, almost 59% companies have beaten consensus expectations at the top-line, with around 20% of companies delivering better-than-expected EPS.
  - At sector level, financials and utilities companies delivered the strongest results, while firms within the real estate, communication services, consumer discretionary and industrials sectors were lagging. In October, equity markets derived strength from healthy corporate results.
  - However, what is particularly striking is the scale of the negative price action witnessed by companies that missed expectations. At a single stock level, price action in response to results was negatively skewed for both EPS and sales results. Aggregate earnings revisions in the region have fallen into negative territory, amid fragile short-term confidence.
  - The underlying performance of businesses is likely to vary dramatically, which emphasises the importance of fundamental analysis in identifying underlying drivers of growth and business quality.

Eurozone Equities

- **Morgan Stanley (MS)**
  - MS noted that so far this year, European earnings have stood out for their remarkable resilience, with the region enjoying double digit upgrades due to currency weakness and the energy sector's doubled profitability.
  - Looking ahead, MS expects this resilience to persist. Currency effects are even more supportive in Q3 2022, and the global and domestic economies have yet to show a more material slowdown that would be associated with recessionary conditions.
  - In Q3 2022, MS expects 50% of sectors to beat expectations versus just 13% that could miss. Longer term, however, MS paints a gloomier picture on the profit outlook, projecting downside risks to 2023 consensus forecasts across 70% of European sectors.
  - MS remains cautious on European earnings and note that most of their models are predicting a meaningful drop in profits next year. Specifically, consensus earnings look optimistic based on the indicators tracked by MS.
  - MS also sees downside risks in corporate revenues and margins. Over the past 12 to 18 months, strong corporate pricing power has allowed companies to pass on rising input costs from high inflation to consumers, increasing profitability. However, weakening demand is expected to erode pricing power, leaving companies squeezed between rising input costs and slowing output prices. Accordingly, MS suggests that 2023 could see the largest fall in European margins since the global financial crisis.

Eurozone Equities

Franklin Templeton, JPMorgan and HSBC are negative on European equities

- **Franklin Templeton**
  - Franklin Templeton noted that Europe faces headwinds to consumer and business activity due to higher energy prices and a hit to confidence because of the war in Ukraine.
  - Corporate earnings results may disappoint, and geopolitics pose an ongoing threat to regional equities. As European Central Bank (ECB) interest rate rises continue, Franklin Templeton maintains its more definitive bearish stance to reflect the risk of recession among growing reasons for concern regarding this region

- **JPMorgan**
  - JPMorgan remains moderately underweight European equities. The euro area faces an energy crunch that is exacerbating an already weak growth outlook. European stocks are heavily exposed to cyclical industries, which face headwinds from slowing goods demand.
  - JPMorgan acknowledges that European valuations are among the cheapest across global markets and provide a potential offset as earnings forecasts come down.
  - But a negative growth outlook (its base case sees recession in 2023), coupled with a hawkish ECB, suggests little reason to be optimistic about the region. For now, JPMorgan don't think a weaker euro will help much, and thus it sees scope for further declines in European equities

- **HSBC**
  - HSBC remains underweight in Eurozone equities. The bank believes an acute energy crisis and a hawkish ECB are likely to impact both valuations and earnings growth.
  - While the Eurozone is unequally impacted by the effects of gas shortages, risk premia are likely to remain elevated while the conflict in Ukraine lingers on

Eurozone Equities

- Yahoo Finance reported that forecasters slashed targets for the Stoxx Europe 600 Index in the past month, with the average prediction of 406 points in a Bloomberg survey
- Goldman Sachs believes that a more friendly momentum on the growth/inflation/policy mix or an investor capitulation will be needed for a genuine bear market trough near term and expects the Stoxx Europe 600 to reach 360 by 2022.
- BofA noted that even after the sharp selloff this year, equities have not yet priced for the continued loss in growth momentum it expects to see over the coming months. BofA expects earnings to slide 20% over the next year, dragged lower by margin pressure and slowing economic growth and expects the Stoxx 600 to close closing at 380 for 2022
- The latest index targets by financial institutions suggest that the Stoxx Europe 600 is expected to reach between 360 to 406 by end-2022, as shown in **Exhibit 10**. This would imply an expected return of between -6.3% and -16.9% from the index's closing level of 433.33 as of 18.11.22.

Exhibit 10: Eurozone index targets and earnings growth forecasts

Name of institution	Reference index	Current level	Target level	Expected returns*
Bloomberg Survey	Stoxx Europe 600	433.33	406	-6.3%
Bank of America			380	-12.3%
Goldman Sachs			360	-16.9%

**Closing price as of 18.11.22*

Source: Yahoo Finance, WSJ, FPA Financial

Eurozone Equities

We would like to highlight several risks which could limit potential upside. These include the persistent recessionary fears, the rising Eurozone inflation and Russia-Ukraine Conflict & the energy crisis.

Persistent Recessionary Fears

- The euro area faces an energy crunch that is exacerbating an already weak growth outlook. As European stocks are heavily exposed to cyclical industries, it faces headwinds from slowing goods demand. Hence, there is a possibility that consumers and businesses may cut their spending. This may negatively impact companies' profitability and weigh on investors' sentiments

Rising Eurozone inflation

- Record high levels of inflation led the European Central Bank (ECB) to hike its policy rate in July, September and November. The ECB also signalled that further increases were needed to return inflation to its 2% medium-term target.
- Strong Eurozone inflation has triggered a rise in bond yields which reduce equities' attractiveness against bonds. Further, the rise in input costs could potentially reduce corporate profit margins.

Eurozone Equities

Russia-Ukraine Conflict and the Energy Crisis

- European gas supplies remained in focus after Russia indefinitely suspended the NordStream One pipeline, exacerbating the squeeze on Europe's energy supplies and deepening the recession risks in the region. The situation worsened as NordStream pipelines were severely damaged by two explosions.
- Actions are being taken to mitigate the impact of higher prices. In September, the European Council introduced measures to reduce electricity demand and to collect & redistribute the energy sector's surplus revenues to customers.
- However, Europe's energy challenges are likely to persist which, coupled with a hit to Eurozone economic sentient from the war in Ukraine, creates headwinds for consumer and business activity. Corporate earnings results may also disappoint, and geopolitics pose an ongoing threat to regional equities.
- We noted that Germany has typically relied on Russia for more than 40% of its imported gas since 1990, with some years exceeding 60%. For France, the proportion of Russian imports has decreased from a bit more than 30% in the 1990s to less than 20% since the early 2000s. In addition, For Italy, the country's reliance on Russian gas imports is also high, although not as concentrated as Germany's.
- As geopolitical tensions continue to develop, countries have made significant efforts to diversify their energy supply. But for some, such as Germany, the negative effects from the embargo on Russian oil and the damages on the Nord Stream gas pipelines are hard to mitigate.

Eurozone Equities: Summary of our views

- On the stock market, we note that Eurozone equities rose since our last Asset Allocation Meeting as Euro Stoxx 50 and Stoxx Europe 600 rose by 4.06% and 0.24% respectively.

- During the period, with the region enjoying gains due to currency weakness and a doubling of profitability for the energy sector, European earnings have stood out for their remarkable resilience.

- However, it was reported that forecasters have slashed its Stoxx Europe 600 targets, with the average prediction of 406 points in a Bloomberg survey, the worst performance since the global financial crisis. Goldman and Bank of America have also cut its year-end target to 360 and 380 respectively, citing that the impact of rising yield on earnings and the political turmoil in the UK could weigh on sentiments.

- The war in Ukraine and its consequences are still a heavy burden on the European economy. In addition, the energy crisis and a hawkish ECB are likely to impact both valuations and earnings growth.

- However, the Eurozone equities could be attractive in terms of valuation. We note that the MSCI EMU is trading at a forward PE of 10.96x, below the long-term average 19.40x. Further, the forward earning yield are also in excess of the bond yield, suggesting attractiveness from an earning/bond yield perspective.

- Considering the above, we are neutral on Eurozone equities

Our Contact Details

Please contact our wealth managers for further information at:

FPA Financial Corporation Pte Ltd
60 Paya Lebar Road,
#11-02 Paya Lebar Square
Singapore 409051
Tel: (65) 6323 1788 Fax: (65) 6323 1768
www.FPAFinancial.com

Disclaimer:

The research data, information, or opinion expressed herein may include those that are provided by third parties. They are provided by sources we believe to be reliable, but we do not guarantee their accuracy, timeliness, completeness or suitability for any particular purpose. Any research data, information, or opinion expressed does not constitute a solicitation for the purchase or sale of any investment.

The opinions or recommendations expressed herein are premised upon reasonably available data at the relevant time. Please note that markets and the value of investments may experience significant fluctuations in short periods of time, which may render the opinions or recommendations incomplete, inaccurate or inappropriate. You should take into account such fluctuations or other material events before relying on the opinion or recommendation for assessing your investment decisions. We shall not be howsoever liable for any opinions or recommendations being incomplete, inaccurate or inappropriate due in whole or in part to subsequent unforeseen events.