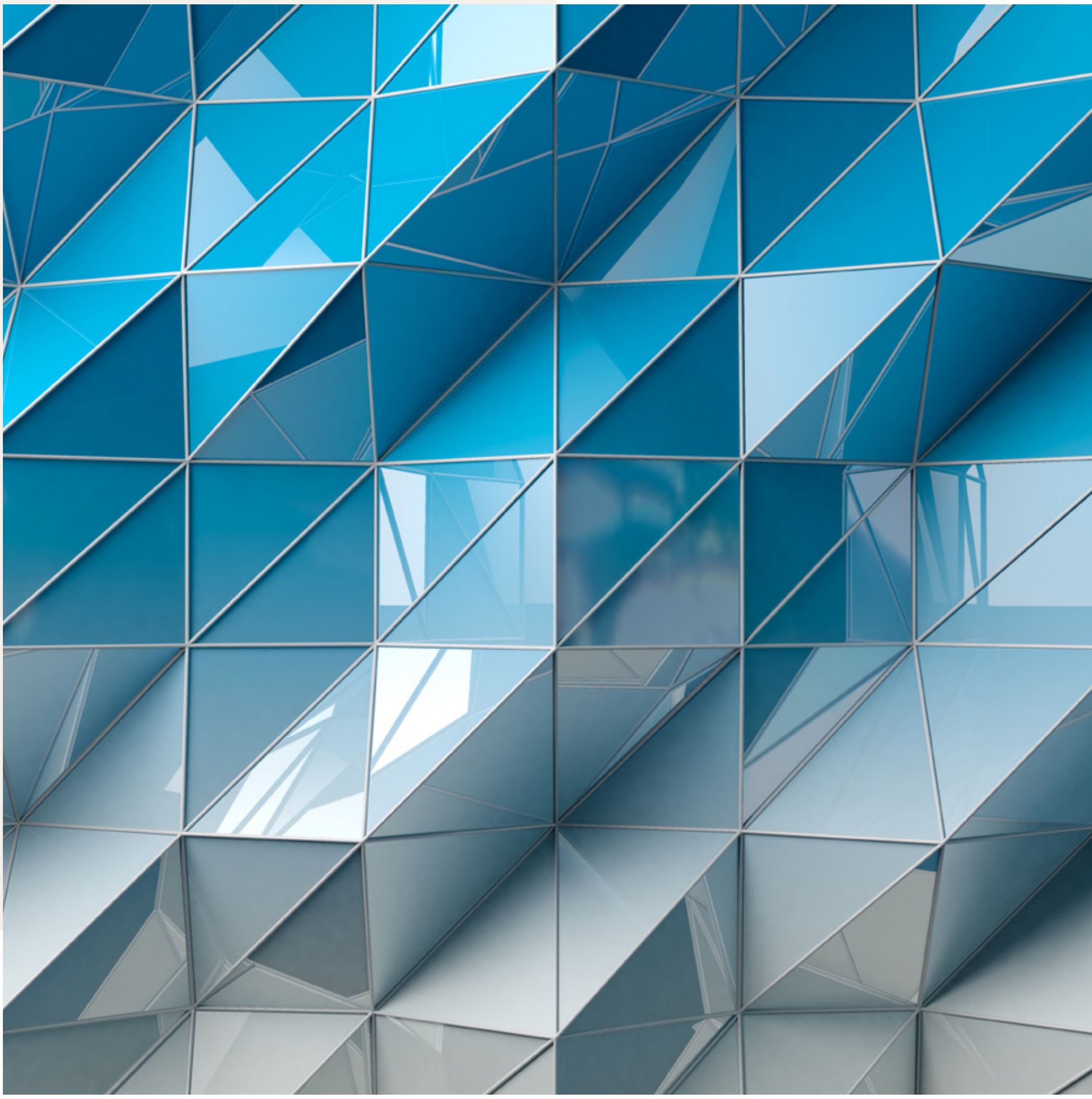
Overview Outlook - Summer



3rd Quarter 2024

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BANCO CARREGOSA

Editorial

By the *Chief Investment Officer*

Opportunities seem to outweigh threats on the current economic horizon.
The recent market rallies, driven by artificial intelligence (AI)-related companies, reveal a context where market downturns are seen as opportunities to strengthen positions and sustain a climate of investor optimism, in a virtuous cycle that in some cases challenges the fundamentals of companies. The behaviour of the stock market is becoming more and more dependent on the performance of this select group of companies rather than on the general macro-economic and financial conditions.

The financial markets have been experiencing a period of growing optimism. This has been supported by a significant increase in the value of key companies in the AI sector. This phenomenon has boosted the major stock indices and had a positive impact on investors' perceptions. The cyclical fluctuations in the economy, alternating between excesses of optimism and pessimism, illustrate the current period of positive momentum. In recent months, events that could have triggered significant market corrections have been quickly overcome, demonstrating the strength of investor buying interest.

To understand this year's stock market performance, it is essential to recognise the central role played by a select group of companies driven by the massification of AI. These companies, by virtue of their weighting in the indices, have driven the major markets to new all-time highs, reinforcing positive investor sentiment. This scenario creates an environment where any correction is seen as an opportunity to strengthen positions, supporting the market and increasing the confidence of those who favour the momentum type of investment.

An analysis of the winners in the massive AI trend shows that while some valuations may appear to be high, they are far from the excesses of the 2000 bubble. Current valuations have solid fundamentals and are in line with actual sales. Based on the most likely scenarios for economic development, these companies appear to offer an attractive risk-return profile, especially when viewed in the context of the growth style. The valuation of these companies is closely linked to future cash flows, making them sensitive to interest rates. The recent decline in interest rates after a period of highs should support their valuations, offsetting the headwind previously seen in 2022, which has since been more than offset by the favourable sales outlook.

These companies have the potential to thrive in different economic scenarios. In an overheated economic scenario, they benefit from high investment in AI despite high interest rates. In an economic slowdown scenario, the valuation of these companies may be supported by higher P/E multiples, given the impact of interest rates on the calculation of future cash flow. The main risk is a stagflation scenario, in which economic growth slows while inflation persists, limiting the ability of central banks to stimulate the economy through interest rate cuts. In recent months, the likelihood of such a scenario has diminished. Despite the bond-like characteristics of these shares, they compare favourably with long-term bonds. Leading companies in the AI market have the ability to pass on the impact of new waves of inflation in their prices, which distinguishes them favourably from traditional bonds.

Finally, the relative normality of the global economy suggests stability in the results expected from investments in high quality credit assets. However, a potential economic slowdown, a reduction in liquidity or geopolitical events could have a greater impact on high yield and emerging market debt, so allocations to these asset classes should remain selective.

Mário Carvalho Fernandes

Position

Classes	Subclasses	— —	—	Neutral	+	+ +
Liquidity	Sight deposits, Term Deposits			■	■	
Bonds	*Investment Grade* Europe				■	
	Investment Grade USA (EURHdg)			■	■	
	High Yield Global (EURHdg)			■	■	
	Global Emerging (EURHdg)		■			
Shares	Europe formerly UK			■		
	USA (EURHdg)			■	■	
	United Kingdom (EUR)		■			
	Emerging (EUR)	■	■			
Other	Gold, REITS, Infrastructures, etc.			■	■	

Macroeconomic Analysis

The US economy showed signs of a slowdown in the second quarter. The unemployment rate rose from 3.8% at the end of March to 4.1% at the end of June and the pace of job creation, excluding agricultural jobs, slowed to an average of 177,000 over the last three months, well below the 267,000 averaged in the first quarter. Indicators of economic activity, in particular business activity, such as the ISM manufacturing and services PMIs, fell from 50.3 and 51.4 respectively at the end of March to 48.5 and 48.8 at the end of June, both in contraction territory. Similarly, the slowdown in inflation in recent months confirms the economic slowdown: the monthly change in the consumer price index in June was negative 0.1%, the first deflationary figure since May 2020, amidst the lockdown and economic crisis dictated by the COVID-19 pandemic, suggesting a decline in US private demand. The year-on-year rate of inflation fell from 3.5% at the end of March to 3% in June. However, the Atlanta Federal Reserve's GDPNow is currently forecasting a 2.5% rise in GDP for the second quarter, due to be released on 25 July. This compares with a 1.4% rise in the first quarter. On 16 July, the IMF was slightly less optimistic for the US, with a 0.1 percentage point downward revision to 2024 growth of 2.6%.

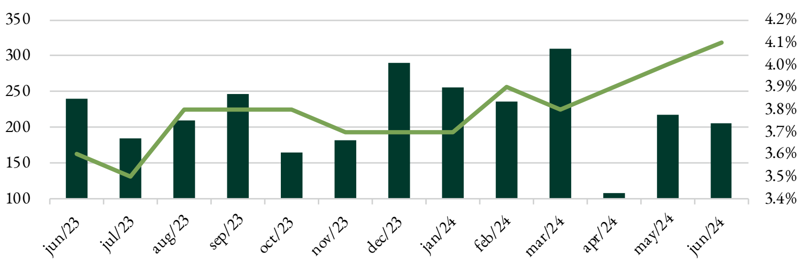
Meanwhile, the US Federal Reserve (Fed) forecast growth of 2.1% this year and an unemployment rate of 4% in its quarterly outlook on 12 June, down from 4.1% in June. Both of these institutions' forecasts for US economic growth are above 2%, suggesting a stronger second half of the year and a break from the current trend of slowing growth.

As for the euro zone, its main economy remains weak, with German GDP growing by 0.2% in the first quarter compared with the last quarter of 2023, but contracting by 0.2% compared with the same quarter last year. In mid-May, the German Council of Economic Experts cut its growth forecast for this year by 0.5 percentage points to just 0.2%, delaying the expected recovery of the euro zone's largest economy. The German manufacturing PMI rose from 41.9 in March to 43.5, but remains clearly in contraction territory, and the German services PMI rose from 50.1 to 53.1 over the same period. Reviving fears that Germany is now the "sick man" of Europe, as it became known in the late 1990s when its economy contracted and unemployment soared, largely due to the costs of German reunification, the IMF maintained its previous forecast of a meagre 0.2% growth for Germany in 2024, citing continued weakness in the industrial sector as the main reason for Germany's slow recovery. Labour market reforms brought prosperity back to the German economy in the decade after the 2008 global financial crisis. Meanwhile, the IMF estimates that the euro zone economy will grow by 0.9 per cent this year, supported in particular by the expected better performance of the French and Spanish economies.

The IMF has raised its 2024 growth forecast for China's economy from 4.6% to 5% and for India from 6.8% to 7%. However, China's second quarter GDP growth of just 4.7%, announced on 15 July, which was well below forecasts due to weak consumer spending and the ongoing property crisis, has cast doubt on the IMF's estimates.

The Portuguese economy continues to show resilience, mainly supported by the growth of the labour force, which currently stands at over 5 million people, gradually increasing from 4.5 million in 2013, with Portuguese economic activity outperforming the European average. This behaviour of our economy in relation to the European average is also supported by the good momentum of the tourism sector.

The US labour market



● Non farm Payrolls, in thousands (LHS) ● Unemployment rate (RHS)

Source: Bloomberg; Banco Carregosa

Non-farm payrolls correspond to jobs created in the US, excluding the volatile agricultural sector, and represent about 80% of workers contributing to GDP, and are a key indicator of consumer spending, which accounts for about two-thirds of economic activity. The pace of non-farm payroll growth slowed to an average of 177,000 per month in the second quarter, while the unemployment rate hit its highest level since November 2021, signaling a slowdown in the US economy. Recessions involve job losses and monthly job creation below 70,000 points to anaemic growth, usually below 1%.

Bond Market

The first six months of the year have confirmed that the return to normality that had been expected will have to wait. Geopolitical issues have become increasingly important, especially in a year when almost half the world goes to the polls. The French elections brought volatility to European sovereign debt, initially widening the spread on French and peripheral debt, which has now normalised, although France has not yet fully recovered.

Interest rates are expected to remain high for longer than originally forecast. More than 25 central banks have already cut rates this year. The Fed is expected to move in September.

The Fed is generally seen as being more proactive than other central banks, as it is usually the first to take action to try to reverse the cycle. This is usually the case in the event of common shocks, but this period is atypical. While some shocks are common, others are specific to a country or region. High energy prices, which also affected emerging markets, were the main shock in Europe. In the US, the shocks were different, more related to strong demand, partly due to fiscal stimulus and a resilient consumer. Markets have focused on the divergence between central banks, but economies are normalising and the big difference is the first cut, as the projected path for central bank rates over the next few years is downward.

The Fed's decisions will only be relevant to the ECB insofar as they affect financial conditions in the euro zone and, consequently, the outlook for inflation.

A hawkish Fed could lead to a sharp depreciation of the euro against the dollar. But only then would the ECB potentially be constrained by the Fed.

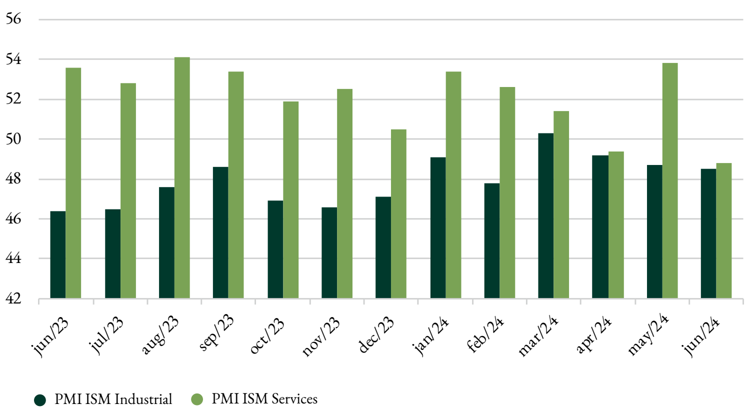
The economy has adapted to high interest rates. Despite the noise, economies have shown growth momentum. Unemployment rates are at record lows and wage growth has kept inflation anchored, making the job of central banks more difficult. Wages have historically risen more in the US than in Europe. As a result, consumer behaviour is very different from that in Europe.

High interest rates have two effects. If consumers are in debt, they may find it difficult to meet their obligations. On the other hand, if they have assets, they are in a better position than in the past because their liquidity is remunerated. Stock markets are rising, house prices are rising, cryptocurrencies are rising, and bond cash flow is at its highest for many years.

Over the medium term, inflation should fall towards central banks' targets. Yield curves should normalise, with short-term rates falling more than long-term rates and default rates rising from their lows.

In terms of positioning, our view is that financial subordinated debt is the most rewarding for the investor and is in a well-capitalised sector. Investors unwilling to take this risk should increase duration in both investment grade and high yield, and be selective in the latter to avoid defaults.

Economic activity in the US, as measured by the ISM



Source: Bloomberg; Banco Carregosa

The US ISM manufacturing PMI index contracted in June for the third consecutive month and for the 19th time in the last 20 months, confirming a slowdown in the US economy in the second quarter. The ISM services PMI contracted last month, falling sharply from 53.8 in May to 48.8 in June, converging with the manufacturing PMI, the sharpest contraction since May 2020. The fall in the index in June is the result of a marked decline in business activity, a contraction in new orders for the second time since May 2020 and a continued contraction in employment. An index above 50 indicates expansion in the industrial or service sector of the economy, while an index below 50 indicates contraction in the respective sectors.

Equity Outlook

The second quarter was again positive for most equity markets, particularly in the US. After a negative April in response to some persistent inflation, the market was supported by the publication of data showing a healthy pace of growth in the major economies and by the results of the largest listed companies.

In Europe, however, gains were much more limited this quarter, mainly due to the political impact of the European elections on the French market, which lost almost all the gains it had made since the beginning of the year.

It should be stressed, however, that the performance of the indices does not reflect the average reality of listed companies, as most of their return was explained by a small number of stocks, generally the large technology companies.

In the US, for example, around 75% of the performance of the S&P 500 in the first half of the year was due to the performance of just 10 of its members. The cumulative weight of the 10 largest companies in the S&P 500 is at an all-time high of over 30%.

This reality is also reflected in a sharp divergence in earnings estimate revisions. Taking the S&P500 as an example, over the past 12 months, the top 5 companies with significant exposure to AI have seen their earnings estimate for 2024 revised upwards by an average of 38%, while for the remaining 495 companies, the average revision has been negative by as much as 5%. This results in diverging valuations, with the technology sector trading well above 10-year median multiples, while other sectors are trading at historically normal or even low levels.

Development in the last 3 months

	31-mar	30-apr	31-may	30-jun	Last 3 months	Last month (jun)
Equity						
S&P 500	5 254.35	5 035.69	5 277.51	5 460.48	3.92%	3.47%
Nasdaq 100	18 254.69	17 440.69	18 536.65	19 682.87	7.82%	6.18%
DAX 40	18 492.49	17 932.17	18 497.94	18 235.45	-1.39%	-1.42%
Stoxx 600	512.67	504.89	518.17	511.42	-0.24%	-1.30%
Nikkei 225	40 369.44	38 405.66	38 487.90	39 583.08	-1.95%	2.85%
Shanghai Composite	3 010.66	3 104.82	3 086.81	2 967.40	-1.44%	-3.87%
MSCI World	3 436.78	3 305.30	3 445.17	3 511.78	2.18%	1.93%
MSCI Emerging	1 040.39	1 045.95	1 048.96	1 086.25	4.41%	3.55%
Long-term interest rates						
Yield Treasury 10 yr	4.20%	4.68%	4.50%	4.40%	19.6 pb	-10.2 pb
Yield Bund 10 yr	2.30%	2.58%	2.66%	2.50%	20.2 pb	-16.4 pb
Yield OT Portugal 10 yr	3.01%	3.21%	3.26%	3.25%	24.2 pb	-1.2 pb
Short-term interest rates						
3-month USD Libor	5.56%	5.59%	5.60%	5.59%	2.6 pb	-1.8 pb
3-month Euribor	3.89%	3.83%	3.79%	3.71%	-18.1 pb	-7.4 pb
Exchange						
EUR/USD	1.0789	1.0666	1.0848	1.0713	-0.70%	-1.24%
EUR/GBP	0.8546	0.8538	0.8515	0.8473	-0.86%	-0.50%
Commodities						
Brent	84.57	84.91	80.87	85.00	0.51%	5.11%
WTI	80.89	80.61	76.73	81.54	0.80%	6.27%
Gold	2 229.87	2 286.25	2 327.33	2 326.75	4.34%	-0.02%

Source: Bloomberg; Banco Carregosa

In the US, the market currently expects earnings growth to accelerate to 9% in the second quarter, the fastest pace in two years, and to accelerate further by the end of the year, which is obviously positive but limits the potential for estimate upgrades in the upcoming earnings season.

These prospects translate into a very positive level of market sentiment by historical standards. For this optimistic outlook to materialise, several elements will have to coincide, namely two: (i) that the currently expected trajectory of economic growth and inflation - almost Goldilocks - does not change significantly; (ii) That the market's view of AI is maintained, which requires that significant examples of the technology's adoption continue to emerge to justify the massive investment in AI support infrastructure that is leading to earnings estimate upgrades for companies with significant exposure to the topic.

In an environment where economic growth is unlikely to accelerate and interest rates are likely to remain relatively high for some time, we recommend investing in quality companies, i.e. those with low growth and margins, strong balance sheets and growing cash flows. From a sector perspective, we favour sectors that are exposed to secular growth trends and less dependent on consumer discretionary, such as technology, healthcare, and consumer staples.

Outlook for Alternatives

After significant weakness in the fourth quarter of 2023, the oil price stabilised above $80/bbl in the first half of 2024. It is expected to move sideways in the coming months, supported by geopolitical risks. Oil demand is expected to rise in the third quarter, driven by increasing mobility and consumption in emerging markets, particularly in Asia and the Middle East. OPEC is expected to postpone the replacement of spare capacity, while production growth in the US will be limited due to the slowdown in CapEx, with Brent forecast at $75-90/bbl.

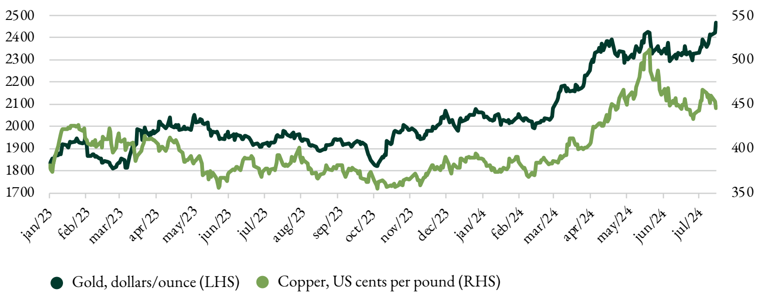
In the copper market, the long-term outlook is positive due to the energy transition, after a rise of more than 13% in the first half of the year. However, weak demand in China suggests that a sustained appreciation will not take place until 2025, when supply begins to decline.

Gold remains an attractive investment, having reached historic highs in the second quarter, driven by robust central bank buying, particularly in China, geopolitical and economic risks, and expectations of falling interest rates.

In the property market, less cyclical sectors are seen as attractive, despite ongoing challenges in the office sector. A potential rise in inflation would favour investment in infrastructure, given its de-correlation and inflation protection, with data centres being a key growth area.

Investment in macro events, relative value and long/short funds is seen as an attractive way to take advantage of the turn in the interest rate cycle and to manage political and geopolitical uncertainty. Investment in private debt and equity markets is also highlighted, with much of the development in AI and healthcare taking place in these markets.

Gold and copper price trends



Source: Bloomberg; Banco Carregosa

Copper is an industrial metal and its appreciation indicates economic growth, while its depreciation indicates economic slowdown. Meanwhile, the price of gold, a precious metal, tends to rise during periods of heightened uncertainty and vice versa. A recession or an increase in geopolitical tensions exacerbates uncertainty and increases the appeal of gold. Lower interest rates to mitigate a recession benefit gold, a financial asset that doesn't generate income, only capital gains. In short, gold and copper prices theoretically move in tandem, but over the past 18 months the correlation has been positive. And if the rise in gold has signalled a recession, the rise in copper has denied it. Admittedly, increased buying by some central banks, notably the People's Bank of China, can explain some of gold's rise. Meanwhile, negative monthly inflation in the US in June boosted gold as it anticipated interest rate cuts and was also a sign of an economic slowdown, contributing to the depreciation of copper.

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