GENERALI ASSET MANAGEMENT

Equities: stay OW through Q2 earnings, but trim exposure

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Our Focal Point series explores topical issues on macro, markets and investment

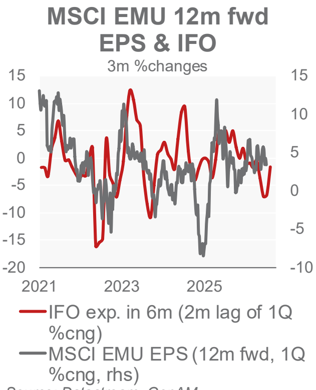
- **Equity markets remain supported by resilient global growth, still-favourable financial conditions and solid earnings (EPS), but the post-rally risk-reward has become less compelling amid renewed geopolitical uncertainty, interest rate risks and AI monetisation concerns.**
- **US earnings are the key anchor to global equities, with strong results in Q1 and Q2, positive revisions and margins underpinned by pricing power, productivity gains and contained labour costs.**
- **Corporate fundamentals look sound, also helped by positive free cash flows (after capex needs), moderate leverage and credit spreads alongside ongoing buyback and M&A activity.**
- **The EU is a laggard, but EPS growth is accelerating. A gradual H2 recovery and Germany's pro-growth policy agenda should provide further support.**
- **A capex super-cycle is underway, driven by substantial investment in AI infrastructure, data centres, semiconductors, as well as electrification and the energy transition, supporting a broader range of sectors. AI benefits remain uneven, favouring hardware and infrastructure over software and IT services, while hyperscalers face monetisation and capex scrutiny. Chinese AI competition is also on the rise.**
- **Our 12-month total-return forecasts are around +5.5% for the S&P 500 and +6% for the EA, with upside to around +16% and +11%, if ambitious IBES consensus estimates prove correct.**
- **We expect long-term returns to be lower than historical averages, reflecting elevated CAPE multiples and compressed equity risk premia.**
- **We keep an OW equity stance, albeit less aggressively, maintaining a cyclical sector bias and adding stronger diversification. Equity dispersion has surged, pointing to greater vulnerability and strengthening the case for broader sector and geographic diversification. Within equities, we are neutral Euro Area vs. the S&P 500 and US Technology; OW DAX, MDAX, Russell MidCap; and OW EMs, favouring Korea, Poland, slightly China/China Tech and tactically Indonesia.**

Despite the Iran conflict, the global macroeconomic backdrop remains steady, and is likely to improve in 2H26 if, as we assume, the re-escalation in Iran is contained. Emerging markets (EM) have shown greater resilience than in previous war episodes. The Euro Area is the weak spot, but stabilising sentiment, resilient domestic demand, solid labour markets, accumulated savings and **ongoing fiscal support provide some cushion.**

Germany's recently agreed **reform package** provides an additional medium-term tailwind. Regulatory easing, including the European Commission's call to relax bank leverage ratio constraints, and a more flexible EU competition policy should also support M&A and investment activity over time. This macro mix keeps the baseline constructive for equities, while the main risk scenario remains a broader geopolitical shock that would hit energy prices, confidence and margins.

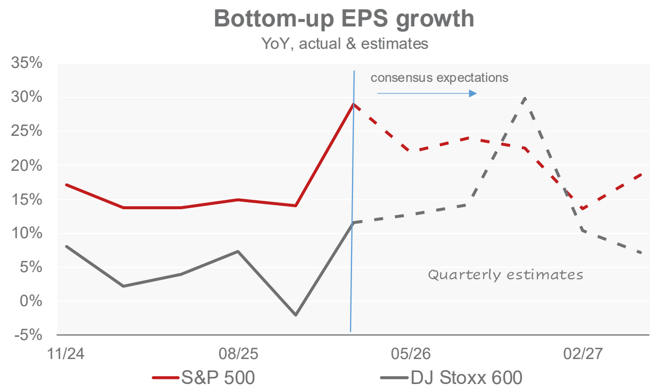
Earnings dynamics at the centre of equity resilience and positive returns

Profit growth is the key pillar supporting equity markets. In the US, Q1 EPS rose by around 27% year-on-year, with a high share of companies beating expectations. This triggered sizeable upward revisions, reinforcing the constructive outlook for 2026.



Source: Datastream, GenAM

European sectors	12m fwd EPS ch. from 25/2/2026 (%)	TR from 25/2/2026 (%)	Q1 EPS surprise (%)
Energy	56.3	10.9	13.4
Semiconductors	28.8	25.9	5.2
Metals & Mining	19.6	-7.2	35.6
Mat: Constr.Mat.	13.1	-5.2	-51.0
Software	13.0	-2.3	5.4
MSCI Europe	**9.6**	**3.6**	**5.2**
Banks	9.7	12.6	3.6
KG: Aero/Defense	8.3	-6.0	2.4
Capital Goods	6.6	-2.0	-5.7
Utilities	6.0	1.9	3.4
Food	3.7	-5.3	8.0
Telecom	3.3	-9.3	17.4
Pharma	3.1	-1.8	8.2
Auto	-6.2	-12.6	-9.0
Cons. Durables	0.2	-2.5	6.7
RE Mgmt & Dev.	-4.7	-14.9	6.4
Cons. Services	-4.0	14.6	-3.0



Source: LSEG I/B/E/S, GenAM

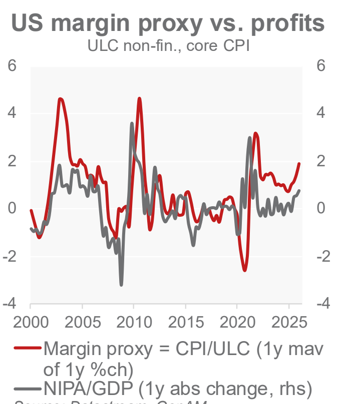
The earnings recovery has also broadened: our median-stock analysis points to US earnings growth accelerating to 13.3% in Q1 2026 from 9.5% in Q4 2025, while beat ratios improved as well. This signals a healthier earnings backdrop and suggests the recovery is extending beyond a narrow group of market leaders. Q2 is expected to deliver another strong reporting season. US EPS growth should remain in the high-20% YoY range, led by Technology, while the rest of the index should contribute around 9 pp. Early guidance has been strikingly positive, pointing to a solid earnings read-out, although elevated expectations may limit the scope for positive surprises. In Europe, profit momentum also improved in Q1. Positive surprises and revisions broadened beyond Energy and Tech into Industrials, Materials and Banks, pointing to a healthier profit cycle. EU EPS growth is set to accelerate to 12–14% YoY in Q2, supported by sustained upward revi-

Analysis of the median stock: Q1 2026 reporting season

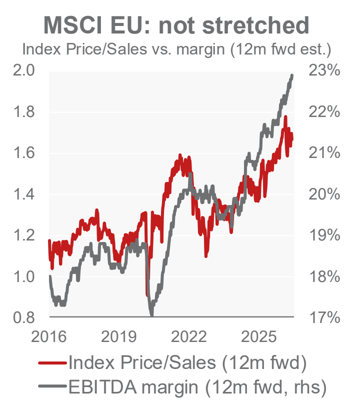
Median stock	Earnings Growth		Sales Growth		margin trend *		availability
	Q4 2025	Q1 2026	Q4 2025	Q1 2026	Q4 2025	Q1 2026	Q1 2026
S&P	9.5 %	13.3 %	7.3 %	8.8 %	2.2 %	4.5 %	95.6%
Stoxx	2.8 %	4.2 %	1.6 %	1.3 %	1.2 %	2.9 %	81.9%
Euro Stoxx	2.6 %	5.0 %	1.5 %	1.5 %	1.1 %	3.6 %	89.8%
Topix	9.5 %	18.9 %	4.8 %	6.3 %	4.7 %	12.6 %	95.5%

Median stock	Earnings Surpr		Sales Surpr		margin trend *		availability
	Q4 2025	Q1 2026	Q4 2025	Q1 2026	Q4 2025	Q1 2026	Q1 2026
S&P	3.1 %	5.7 %	1.3 %	1.7 %	1.8 %	4.0 %	95.6%
Stoxx	1.3 %	3.3 %	0.4 %	0.2 %	0.9 %	3.2 %	81.9%
Euro Stoxx	0.8 %	2.1 %	0.4 %	0.3 %	0.4 %	1.9 %	89.8%
Topix	8.1 %	12.6 %	0.9 %	1.3 %	7.2 %	11.3 %	95.5%

Note: numbers for Q1 2026 are calculated only for the companies which have so far reported in Q4 2025
proxy for margin trend = earnings growth - sales growth
Source: Bloomberg, GenAM calculations



Source: Datastream, GenAM

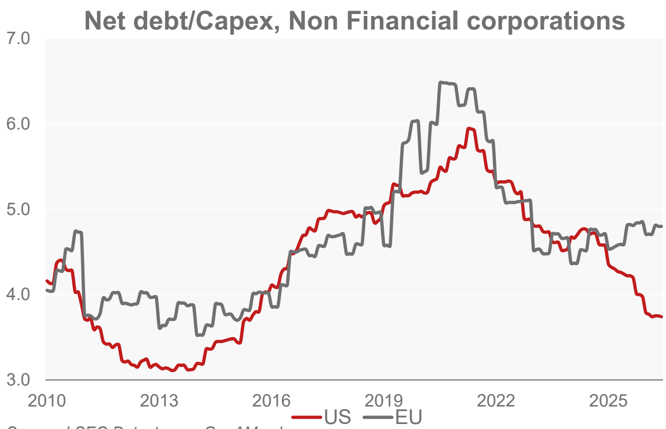


Source: Datastream, GenAM

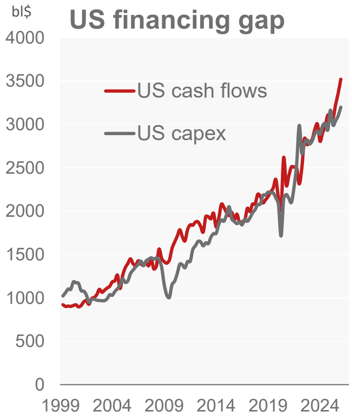
sions and leaving scope for modest positive beats. **For 2026, we expect EPS growth of 18.5% in the US and 11% in EMU, still 4% and 7% below consensus, respectively.**

Profitability Drivers

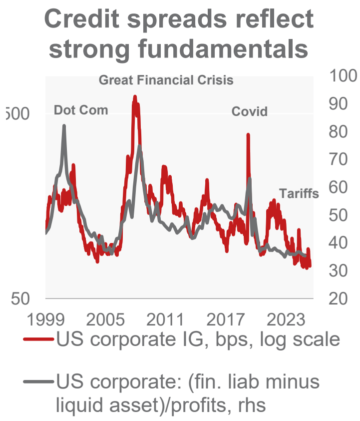
Corporate fundamentals remain sound, especially in the US. Balance sheets are healthy, with moderate leverage, strong interest coverage and ample liquidity. Cash flow generation continues to exceed investment needs, sustaining M&A activity and shareholder distributions through buybacks. That said, the US net offering — buybacks minus IPOs — has turned less supportive due to a sharp rebound in IPO activity. As long as macro and financial conditions, together with EPS momentum, stay supportive, this should be manageable for the US. The EU and Japan, in contrast, still show little evidence of net offering pressure versus history, which strengthens their diversification appeal within equity portfolios.



Source: LSEG Datastream, GenAM calc.

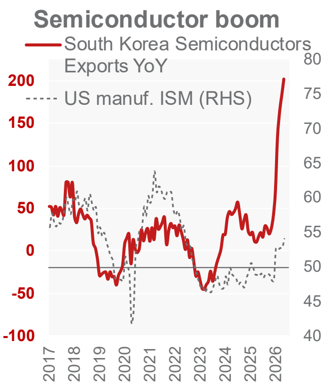


Source: FRED eco data, GenAM calculations

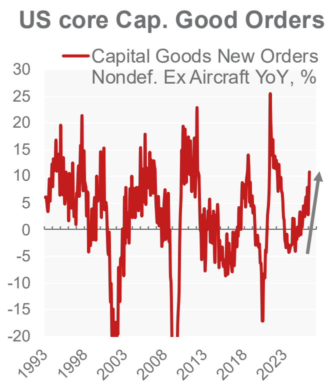


Source: LSEG, GenAM

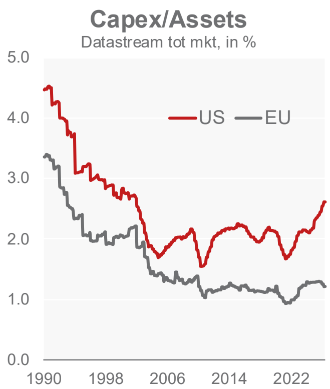
Solid corporate profitability is underpinned by several structural factors. Since the pandemic, companies have strengthened **pricing power** and enhanced **supply chain resilience.** At the same time, **labour cost** pressures remain manageable, and technology investments have lifted **productivity**. Structural tailwinds from **lower corporate tax rates** and **supportive financial conditions** have helped sustain elevated profit levels. Moreover, large US fiscal deficits and higher fiscal spending in the EU and Japan contribute to good corporate profit momentum.



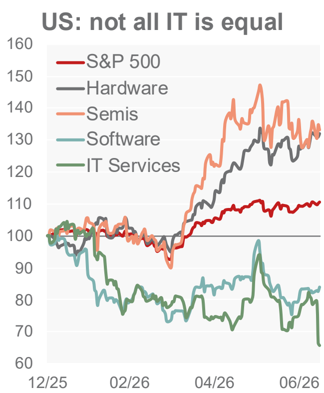
Source: Korea customs, ISM, BBG, GenAM



Source: US Census Bureau, BBG, GenAM



Source: LSEG Datastream, GenAM calc.



Source: S&P, Datastream, GenAM

A further tailwind comes from a developing **capex super-cycle**, driven by sizeable investment in AI infrastructure, data centres, semiconductors, electrification, the energy transition and related sectors. The **US is setting the pace**, while Europe remains held back by structural bottlenecks, notably regulatory complexity, energy availability and capital allocation efficiency. This divergence is likely to widen regional profitability and growth gaps. At the same time, AI adoption is broadening beyond the US, creating spillovers across a wider range of regions and sectors.

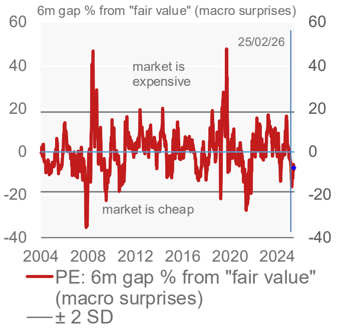
Still, the scale of AI capex creates execution risk: benefits remain unevenly distributed across the AI value chain. Hardware and “pick-and-shovel” beneficiaries look better supported, while IT services and software names have yet to prove that AI adoption can translate into sustained revenue growth and margin expansion (see right chart above).

Conversely, scrutiny is highest for the five hyperscalers. Their sharp capex increases are set to weigh on near-term free cash flow, while funding needs are shifting more visibly toward debt and equity markets. Although AI’s long-term EPS potential remains compelling, the timing and scale of returns remain uncertain. This raises the risk of overinvestment, lower incremental returns and a more selective view on AI winners. Lower-cost Chinese AI models add another risk, as corporates seek to reduce technology spending and challenge the economics of more expensive US large language models (LLMs).

Market Outlook

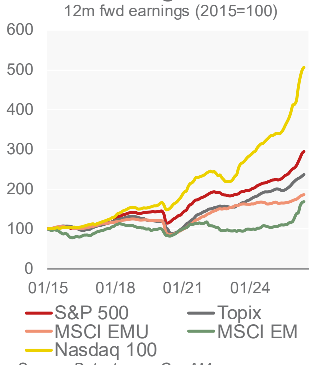
US valuations remain well above historical norms on a long-term view, while Europe and EMs look less stretched. Near term, however, high margins, positive revisions and strong earnings momentum still support valuations. Given the risks discussed above, US equities — especially technology — entered this phase from relatively low PE levels versus norm, with subsequent profit upgrades further improving fair value estimates. In the short-term, both the S&P 500 and US Tech look undervalued, as strong relative profit momentum versus other regional indices and low valuation (PE) versus economic trend (index of macro surprises; see left chart below) partly offset AI concerns. Moreover, unlike the five Tech hyperscalers, the 23 largest US Tech stocks show a much healthier free-cash-flow trend for this year and next (see right chart below).

S&P 500 PE & macro surprises



Source: Datastream, GenAM calculations

Earnings trend

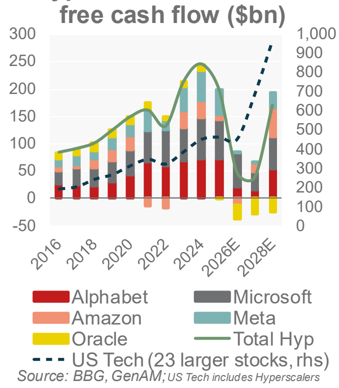


Source: Datastream, GenAM

Corp financing surplus yoy and S&P yoy

Source: FRED eco data, GenAM calculations

Hyperscalers & US Tech free cash flow ($bn)



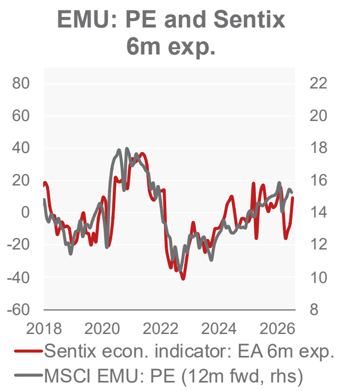
Source: BBG, GenAM; US Tech includes Hyperscalers

EMs offer the most attractive valuation profile, supported by stronger growth and favourable EPS revisions. Europe looks more balanced, helped by lower multiples and potentially fewer headwinds from the strong trade-weighted euro, while the US delivers stronger profit growth but at demanding valuations.

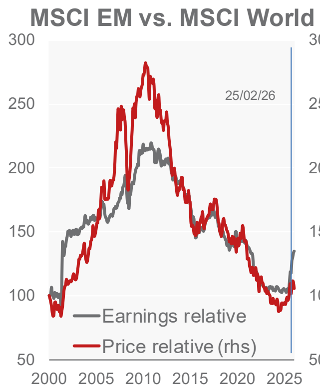
Our 12-month total-return forecasts are around **5.5% for the S&P 500** (target **~7,700**) and **6% for the Euro Area**, with upside to around 16% (**~8,800**) and 11%, if IBES consensus estimates prove correct.

However, a **longer-term perspective argues for more caution**. US equities appear structurally expensive, as indicated by elevated CAPE multiples (nearly 40X) and compressed equity risk premia. **AI EPS** may be running ahead of trend, with rising competition and capex needs challenging future margin expansion and valuation. As a result, **expected long-term returns are likely to be lower than historical averages**: around **6.5% vs. 10-12% over recent decades**.

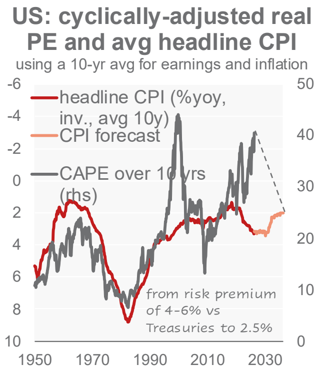
Source: Datastream, GenAM



Source: Datastream, GenAM



Source: Datastream, GenAM



Source: Shiller data, Datastream, GenAM calc.

Slight OW Equity, favouring a diversified allocation

Despite the recent rally, Iran-related tensions and rising AI doubts, we stay **OW equities, but less aggressively**, with a cyclical sector bias and stronger diversification. Equity dispersion has surged, while rotation has triggered a sharp drawdown in momentum strategies this month. The main shift has occurred within IT, where semiconductor stocks have entered a bear market after a massive Q2 rally. Dispersion does not necessarily signal a correction, but it often points to greater vulnerability and strengthens the case for broader sector and geographic diversification.

We keep the Euro Area neutral versus the US and US Tech, while staying OW **DAX** and **MDAX** on German reforms. Despite risks, the **US**, including **technology** and US Russell Mid Cap, could keep benefiting from strong profit momentum. **EMs** remain **overweight,** with Korea and Poland preferred. We add a tactical OW in Indonesia, where excessive underperformance, attractive valuations and limited MSCI downgrade risk create a buy opportunity, despite weak policy visibility. We retain a **slight OW** in **China and China Tech:** attractive valuations, light and rebuilding investor positioning, policy support and rising AI-led competitiveness offer upside, while lingering property weakness and geopolitical risks, including US tariff retaliation, argue for only a modest OW.

Sector-wise, we keep a **cyclical tilt in Europe.** We overweight banks, diversified financials, consumer services, capital goods, materials, and selected tech areas such as software and semiconductors. Among defensives, we favour Pharma. We remain underweight Energy, Staples, Real Estate and Hardware.

We favour complementing core exposures with thematic allocations, including AI beneficiaries beyond the hyperscalers, and commodity-related strategies such as a US **gold-stock basket** (price/earnings at 50% discount to history) and **nuclear/uranium**, which add portfolio balance and exposure to structural demand trends.

Conclusion

Equities remain supported by resilient global economic growth, firm earnings momentum and healthy corporate fundamentals. AI is the dominant structural theme, driving a broad capex cycle. Still, elevated US CAPE multiples, compressed risk premia and high mega-cap concentration leave little room for disappointment, while rising equity dispersion points to a more fragile market backdrop and reinforces the need for broader sector and geographic diversification.

We therefore keep a **slight equity overweight**, but we pair it with stronger diversification.

Our 12-month base case points to upside of around +**5.5% for the S&P 500** and +**6% for the Euro Area.** In the upside scenario, these returns could rise to **+16%** and **+11%,** if IBES estimates are met. Beyond that horizon, stretched US valuations and compressed risk premia argue for below-average long-run returns.

The main risks to our constructive view are a severe **escalation in geopolitical tensions**, especially in the Middle East, which could lead to a sustained energy shock, weaker-than-expected growth in Europe and Asia, and **higher-for-longer interest rates**. The latter would challenge current valuations, especially in growth sectors (Tech, Staples, Pharma, etc.).

An additional market-wide concern is that **AI-related investment** fails to deliver the **high returns currently expected,** while large-scale US capex programmes could face tighter financing conditions and increasing competition.

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