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What to watch: Dutch elections in a time of recession, climate displacement and corporate earnings – calm before the storm?

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Executive summary

This week, we analyzed three important issues:

- First, the Netherlands holds **elections in a time of recession** – The former government led by long-serving Prime Minister Mark Rutte collapsed in early July when the four parties of the ruling coalition clashed over an immigration bill. Ahead of the vote on 22 November, migration, housing, climate policy and inflation have emerged as the key themes. While polls suggest the New Social Contract party is leading the race (19%), no party is likely to win more than 30 seats, so forming the next government will take months of negotiations. Meanwhile, the economy recorded its third consecutive quarter of contraction in Q3. We expect activity to only gradually recover from Q2 2024, with overall GDP growth at +0.7% in 2024.

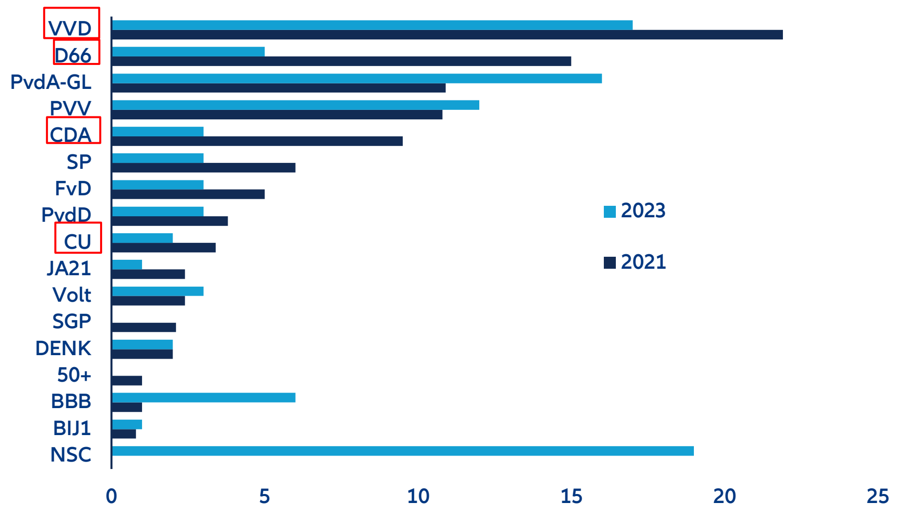
- Second, a recent agreement between Australia and Tuvalu addresses the increasingly urgent issue of **climate displacement** – Australia has agreed to welcome up to 280 migrants per year from the small Pacific island, in addition to providing funds for land reclamation around the island's capital and military aid. The agreement is a relatively small-scale example of the legal issues that will come with the massive human displacement caused by climate change. In our upcoming Climate Literacy Survey, respondents with higher climate literacy were more likely to believe that advanced economies should be responsible for the material damages caused by climate change. But it is sobering that 18% of our sample – and 31% of those that had below-average climate knowledge – chose to have no opinion over a phenomenon that will affect 1.2bn people in the next 30 years.

- Third, is the **Q3 earnings season the calm before the storm?** Easing input costs boosted companies' profitability in Q3, even as revenues entered a technical recession. But the positive earnings surprise is not clearing the clouds over the outlook for 2024-2025, when 20% of debt will need to be refinanced at higher rates. We calculate that US and Eurozone companies will see their interest coverage ratios drop by 1.5pps and 2.7pps, respectively, in aggregated terms. With the continued decline in earnings growth, this poses a dual threat to both debt-repayment capacity in 2024 and, more importantly, to medium-term debt sustainability. For now, we maintain our 2024 and 2025 equity return forecasts of 9% and 11% for the US, and 7% and 8% for the Eurozone, but remain very cautious with regard to the current market situation.

(Dutch) elections in a time of a recession

The Netherlands will go to polls next week but forming the next government will take months of negotiations. The former government led by long-serving Prime Minister Mark Rutte collapsed in early July when the four parties of the ruling coalition clashed over an immigration bill to reduce asylum seekers. Of the 26 parties running in the upcoming elections, New Social Contract (NSC), founded only three months ago by the centrist and former Christian Democrats (CDA) MP Pieter Omtzigt, is leading the polls with 19% (Figure 1). Rutte's party VVD follows closely at 17%, only 1pp ahead of the coalition Labour+Greens (PvdA+GL) led by the former EU Commissioner Frans Timmermans, which could challenge a right-wing victory. However, Dutch voters tend to finalize their decisions very close to election day so the final results could differ from what polls predict. Smaller parties that played a role in previous coalition governments (i.e. CDA, the liberal-progressive D66 and the Christian Union (CU)) could also qualify to be part of the new administration. The farmer-citizen populist BBB party became the largest in all provinces in the March 2023 provincial elections while the nationalist Party for Freedom (PVV) can also count on a solid electoral base. However, no party is expected to win more than 30 seats (76/150 seats are required to obtain a majority but this has never happened so far) and coalition alliances have not been officially disclosed.

Figure 1: Voting intentions (as of 14 November 2023), %



Sources: Various voting polls, Allianz Research. Note PvdA and GL are running together since July 2023, in 2021 they had 5.7% and 5.3% of the votes respectively. Parties marked in red formed the Rutte IV coalition collapsed in July 2023.

Migration and housing are the key themes of this electoral campaign. The centrist and right-wing parties are confident in reducing or capping the number of migrants allowed in the country per year – including asylum seekers, labor migrants and students. Strictly connected to new arrivals, the structural lack of housing has also re-emerged as a hot topic, given the further push to demand. To address the issue of availability and affordability of both rental and owner-occupied homes, the previous government implemented the Housing Construction policy program. One of its objectives[1] is to build at least 981,000 dwellings up to 2030, despite increasing challenges stemming from higher construction costs and rising interest rates.

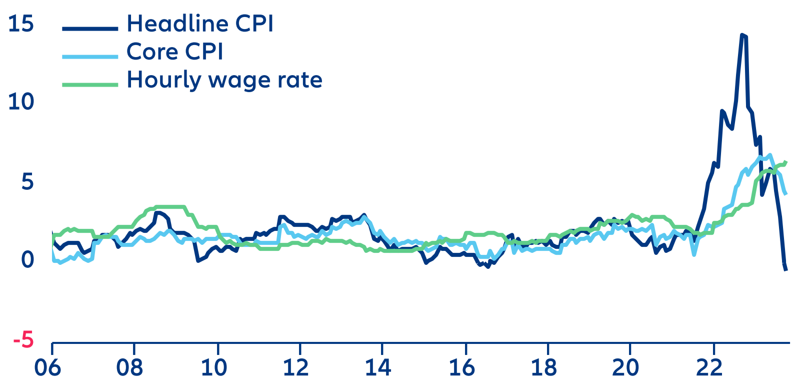
In addition, the new government will have to tackle climate policy and the issue of nitrogen emissions. The Netherlands is an extensive agricultural exporter[2] (second only to the US). This coupled with a dense population and heavy traffic leads to large nitrogen emissions. All major parties have promised to halve (or cut significantly) emissions by 2030. But the winning coalition will have to reach an agreement on which sectors to prioritize in the

[1] The other two objectives are to keep two-thirds of those dwellings affordable and to build at least 100,000 dwellings every year.
[2] The agriculture sector is responsible for 15% of carbon emissions and 45% of nitrogen deposition.

coming years. From an electorate point of view, the very high price of the green transition could cost "greener" parties some votes (Timmermans' coalition, for example, has presented targets more ambitious than the EU ones).

Declining inflation has also not really reduced concerns over the cost-of-living crisis. Price growth entered negative territory in October (-0.4% y/y) and reached its lowest level since September 2016 on the back of strong base effects from the peak reached last year (>14% in September and October 2022) and declining energy prices (Figure 2). But this has only partially alleviated households' loss of purchasing power since prices of food and alcohol were still up 8.7% y/y as of October 2023. In response to high inflation, negotiated wages are lagging behind but are expected to grow by more than +5% both in 2023 and 2024. Wage-price-setting dynamics should also remain in focus for the next government.

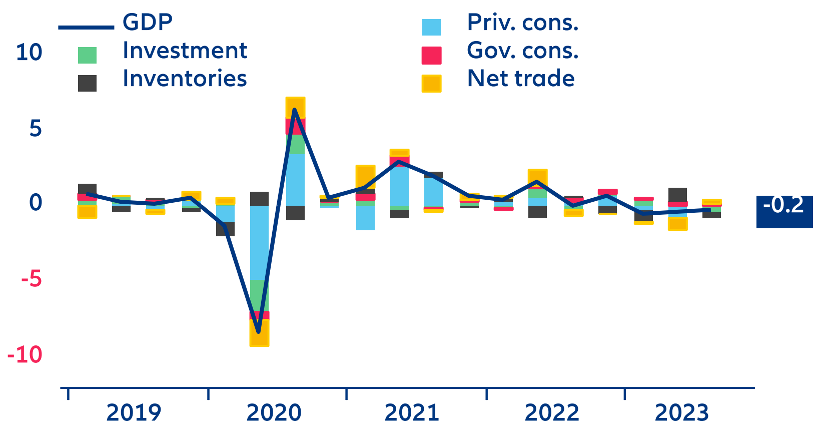
Figure 2: Inflation and hourly wages (% y/y)



Sources: LSEG Datastream, Allianz Research

This week, the Netherlands recorded its third consecutive quarter of contraction in Q3 (-0.2% q/q) and the economy is likely to continue to suffer in the coming quarters (Figure 3). We expect activity to gradually recover from Q2 2024, with overall GDP growth at +0.7% in 2024. The GDP estimate released earlier this week confirmed activity shrunk again in Q3, continuing the technical recession seen in the first half of the year (Q1 and Q2 were revised downward to -0.5% and -0.4%, respectively). Despite GDP growth staying at +5.8% compared to end-2019 (EZ average +3.0%), the Netherlands' faster post-Covid rebound is now narrowing compared to Eurozone peers. Moreover, cyclical challenges are adding to the enduring idiosyncratic issues listed above.

Figure 3: Contribution to quarterly GDP growth (pps)



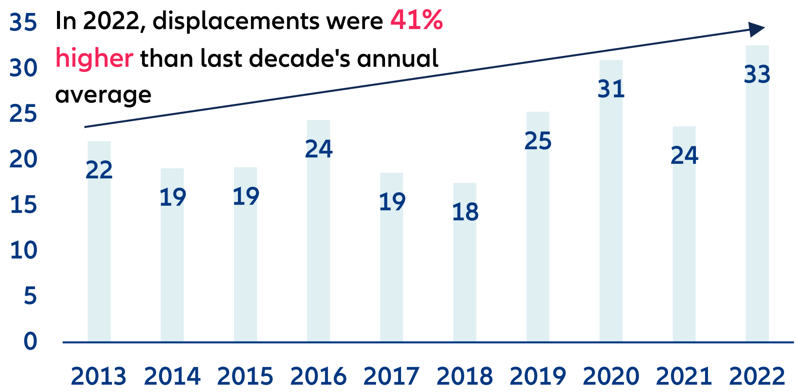
Sources: LSEG Datastream, Allianz Research

Climate migrants – no place to call home

Tuvalu just signed a security and migration pact with Australia to address what will become one of the most important political issues in the coming years: climate displacement. Facing an existential threat from rising sea levels – 95% of its land area is expected to be flooded by 2100 – the small Pacific island has been very vocal about the dangers of climate change. Against this backdrop, Australia has agreed to welcome up to 280 migrants per year from Tuvalu, currently home to 11,200 inhabitants (the cap is meant to deter brain drain), in addition to providing funds for land reclamation around the island's capital and military aid. At the same time, a constitutional change adopted by the island asserts that the country's statehood will remain in perpetuity in the future to preserve its Polynesian culture as well as the fishing rights to a maritime area larger than the surface of France.

Tuvalu is a relatively small-scale example of the legal issues that will come with the massive human displacement caused by climate change. In 2022 alone, disaster-related displacements were 41% higher than the annual average of the last decade (Figure 4). Today, 1% of the world's territory is a barely livable hot zone but this is projected to increase to 19% in 40 years. According to the Intergovernmental Panel on Climate Change, countries in South Asia, tropical sub-Saharan Africa and parts of Central and South America will be affected the most by the impact of deadly heat stress. Additionally, according to the European Institute of Peace, climate change threatens the livelihoods of 1.2bn people that will be displaced by 2050 because of climate stressors such as changing rainfall patterns, heavy flooding and rising sea levels making territories uninhabitable. In this context, creating secure and dignified legal pathways for mass climate migration and building climate resilience is essential.

Figure 4: Disaster displacements – Highest figure in a decade, in mn



Sources: IOM, Allianz Research

In our latest Climate Literacy Survey, 30.2% of respondents say advanced economies should provide material compensation for the costs of climate change, given their larger contributions to greenhouse gas emissions. In the run up to COP28, we surveyed a representative sample of 1,000 people each in Brazil, China, France, Germany, India, Italy, the UK and the US[3] about their knowledge of climate issues and their attitudes, preferences and preferred climate-mitigation-related actions. When asked who should be responsible for the physical damages of climate change faced by countries such as Tuvalu, the share of those who consider it the responsibility of advanced economies increases with levels of climate literacy (as shown in Figure 5). Overall, 30.2% of our respondents say advanced economies as higher emitters should be accountable; this share rises to 40.9% in Brazil and 37.5% in China. Interestingly, though China is not necessarily considered an "advanced economy", it is the world's second-largest economy and currently the highest carbon emitter – albeit not in per capita terms. In contrast, 29.2% of overall respondents believe each country should fend for themselves, but this number is even higher in China and India: 41.7% and 33%, respectively. It is also sobering to see that 18.1% of our sample – and 31% of those that have below-average climate knowledge – chose to have no opinion on a phenomenon that will affect 1.2bn people in the next 30 years, perhaps suggesting the relatively low level of global awareness around the very real risks of climate displacement. In this context, the agreement between Tuvalu and Australia is a timely reminder of the urgency of the issue, and could present a roadmap for further international cooperation to fairly share the costs of climate change.

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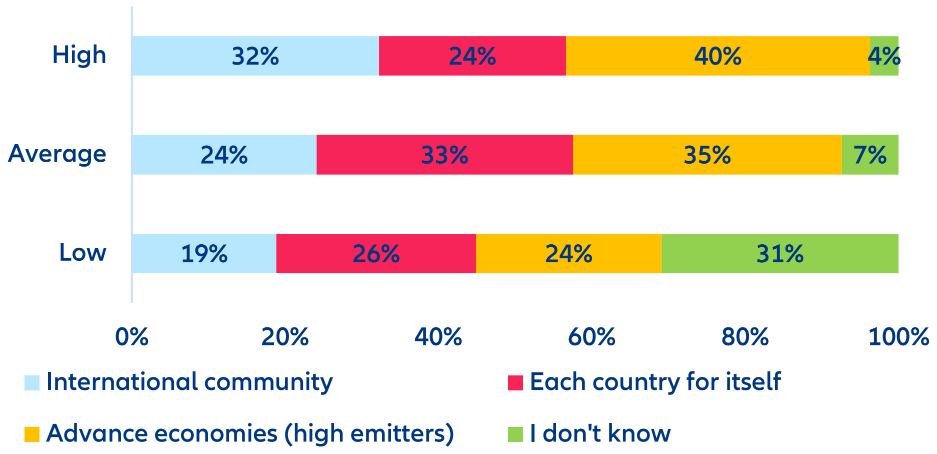
[3] *See our 2021 [Allianz Climate Literacy Survey] for details on methodology.*

Figure 5: Climate change poses existential threats to countries like Tuvalu. By 2100, 95% of its land will be uninhabitable because of rising sea levels. Who should pay for the physical damages of climate change? By climate literacy level, in %

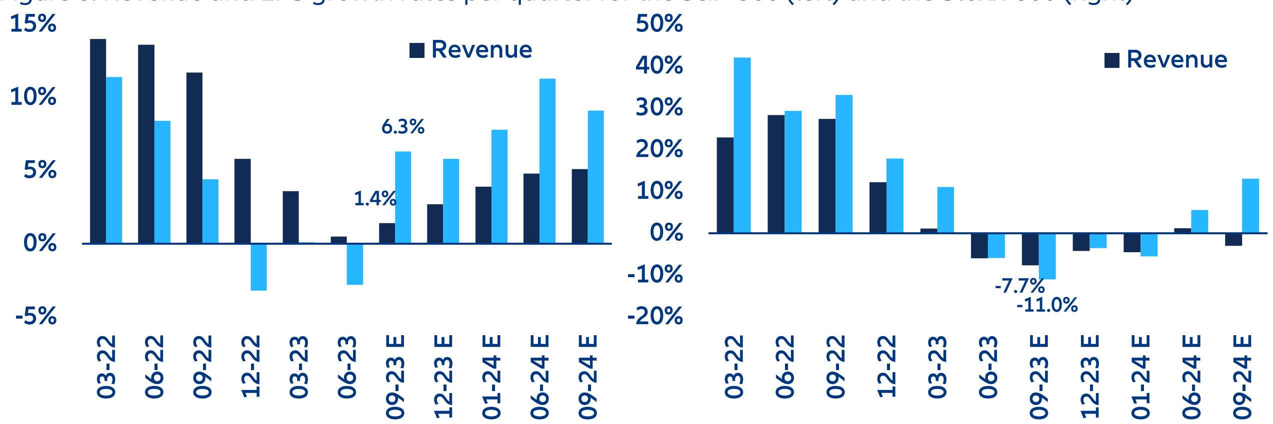


Sources: Qualtrics, Allianz Research

Corporate earnings: calm before the storm?

Easing input costs boosted companies' profitability in Q3, even as revenues entered a technical recession. Global revenues declined for the second consecutive quarter in Q3 (-1.3% y/y after -1.9% y/y in Q2 2023) as pricing power has diminished across most sectors. European companies posted the largest drop (at -7.1% y/y vs 0.0% for APAC and +0.3% for the US), with losses amplified by base effects from last year's strength in the USD. However, the bottom line surprised on the positive side in almost every region (+8.5% y/y on average worldwide, vs a decline of -1.1% y/y in Q2), helped by the sharp reduction in transportation costs, energy bills and certain raw materials from last year's record highs. US corporates were the big winners in terms of profit growth (+6.0% y/y), especially boosted by the consumer discretionary and financial sectors. In fact, with an earnings surprise factor of 7.1% in the quarter, 81% of companies in the S&P 500 index reported earnings per share (EPS) above analysts' expectations, above the previous four-quarter average of 73% and the long-term average of 66%.

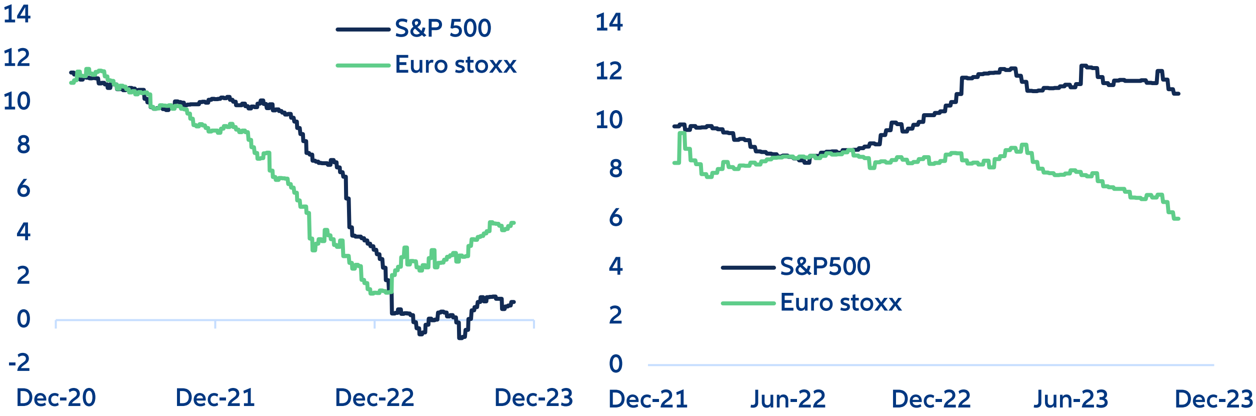
Figure 6: Revenue and EPS growth rates per quarter for the S&P-500 (left) and the Stoxx-600 (right)



Sources: Refinitiv as 14 Nov 2023, Allianz Research

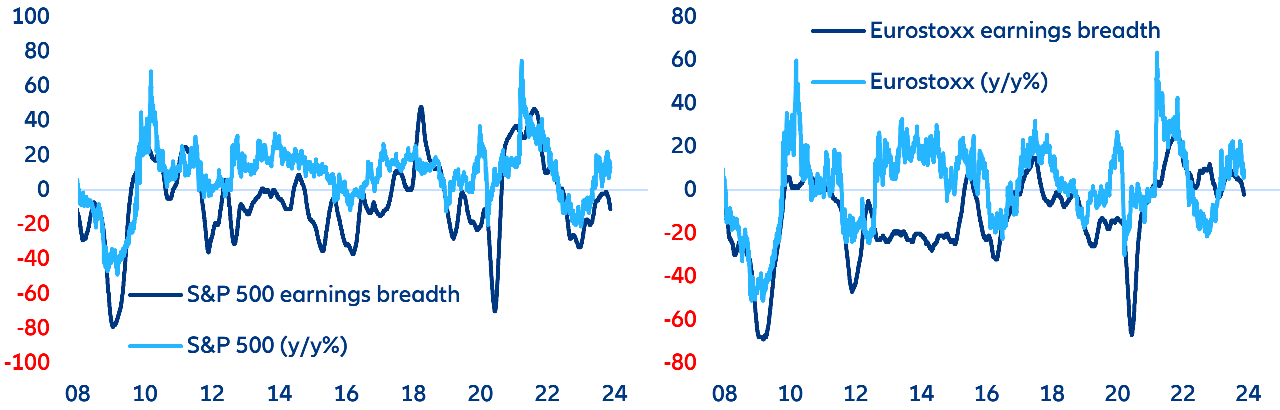
But the positive earnings surprise is not clearing the clouds over the outlook for 2024-2025, when 20% of debt will need to be refinanced at higher rates. Around 20% of the publicly traded corporate debt in the US and in the Eurozone will mature between 2024 and 2025. This debt has an average coupon of less than 3.5% while the current market yields are above 6.5% and 6.0% for IG in the US and the Eurozone, respectively. Refinancing at higher rates will put net profit margins at risk. In this context, expectations for EPS growth in 2024 for S&P 500 companies have now decreased by 53bps compared to September, while those for Stoxx Euro companies are down 92bps basis points (Figure 7).

Figure 7: Evolution of EPS growth expectations for 2023 full year (left chart) and 2024 (right chart)



Sources: LSEG Datastream, Allianz Research. EPS growth forecasts for a given year start to be reported in t-3, normally with long-term averages, but the movements (not levels) in the year t-1 are usually a good indicator of market sentiment.

Figure 8: Earnings breadth for the S&P-500 and Stoxx Euro



Sources: LSEG Datastream, Allianz Research. See footnote 4 for the definition of earnings breadth.

As shown in Figure 8, this has been a widespread phenomenon as the earnings-revision breadth[4] has deteriorated again on both sides of the Atlantic[5]. This sets the stage for a third consecutive year with below-average EPS growth in many sectors, and in terms of compounded performance, one of the worst three-year periods since 2000 for both the US and the Eurozone. Real estate in the US has seen the largest adjustment (more than 300bps) due to its high sensitivity to interest rates, while financials and consumer staples have both seen an adjustment of more than 150bps. The energy and materials sectors also continue to face high volatility. In the Eurozone, expectations for 2024 were already low so the adjustments in these sectors have not been as large as those seen in telecommunications and health care.

Companies in the US and the Eurozone will see their interest coverage ratios drop by 1.7 and 2.7, respectively in aggregated terms[6]. The deterioration in ICR[7] is already visible (Figure 9). Based on current earnings expectations for 2024, our forecasts for interest rates and the share of debt that will mature next year, we find that the utilities and real estate sectors in the US will see their ICR fall below 3.0x (a decrease of -0.55), with only the

4 Calculated as the net share of companies in a given index for which analysts have revised upwards (downwards) the expected forecasts for the following 12M in the last 3M.
5 2024 EPS growth have also adjusted for EM (-22bps, still expecting a big rebound) and the UK (-86bps for the FTSE)
6 See footnote to Table 1 to fully understand the sample used.
7 ICR has been calculated as EBIT divided by net interest expenses. Therefore, the higher it is, the better is the interest coverage capacity.

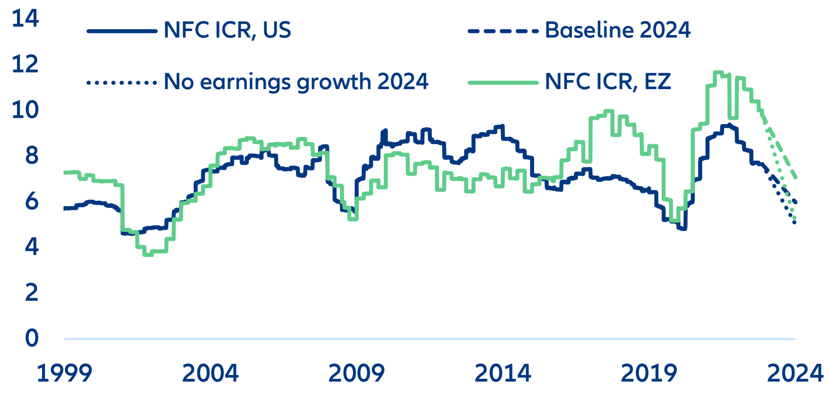
telecommunications sector marginally improving its ICR (to slightly above 4.0x). In the Eurozone, the ICR will be lower than in 2023 (at 7.1x vs 9.8x today), but with wider variability across sectors. While the change in the ICR of the real estate sector can be surprising, it is currently in negative territory due to the large losses of some of the sector's giants; as a result, it will experience an increase in 2024. However, in an alternative scenario of no EPS growth, the interest coverage ratio would fall by an additional -1 in the US and -1.9 in the Eurozone to one of its lowest levels of the century (in fact, if we exclude 2008 and 2020, driven by sharp earnings fall rather than by increase in interest rates, it would be the lowest since 2003, see Table 1 and Figure 9). In the context of the continued decline in earnings growth, this poses a dual threat to both debt-repayment capacity in 2024 and, more importantly, to medium-term debt sustainability. This poses downside risks to current equity pricing and, to a lesser extent, to our baseline equity growth forecasts of +9% and +11% for 2024 and 2025 in the US, and +7% and +8% in the Eurozone, based on the expected normalization of monetary policy from summer 2024 in the US and shortly thereafter in the Eurozone.

Table 1: Interest coverage ratio by sectors in the S&P-500 and the Stoxx Euro, under two scenarios (baseline and no EPS growth rate)

	S&P 500			Stoxx-600		
	Current	Baseline 2024	No EPS growth 2024	Current	Baseline 2024	No EPS growth 2024
Basic Materials	9.1	7.1	6.4	6.4	7.4	4.7
Consumer Discretionary	6.4	5.2	4.1	23.9	11.4	6.5
Consumer Staples	8.8	5.7	4.4	5.6	7.2	5.7
Energy	15.5	10.9	10.7	16.2	7.7	7.6
Health Care	9.6	8.3	5.1	7.1	7.8	4.9
Industrials	8.2	6.3	4.7	12.4	5.1	4.8
Real Estate	3.6	3.1	2.4	-6.5	2.4	-4.1
Technology	24.4	17.0	12.1	25.8	13.3	13.0
Telecommunications	4.1	4.6	3.4	3.0	3.8	3.2
Utilities	3.3	2.8	2.4	4.4	3.3	2.4
Overall	8.1	7.4	5.6	9.8	7.1	5.2

Sources: IBES, LSEG Datastream, Allianz Research. Aggregate numbers exclude financials in the US, and financials and real estate in the Eurozone. No earnings growth for real estate does not represent an improvement on the indicator: due to the negative EBIT, a larger interest expense increases the denominator, making it less negative. These numbers include various initial assumptions (esp. on interest rates and debt refinancing), the change of which would alter this picture.

Figure 9: Historic evolution of aggregate ICR for US and EZ larger caps (ex-financials)



Sources: LSEG Datastream, Allianz Research. Legend is common for the dashed and dotted lines.

These assessments are, as always, subject to the disclaimer provided below.

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