Illumination: Equity strategy and market outlook

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Global perspectives: Time to take stock

Analyst

Alastair George
+44 (0)20 3077 5700
institutional@edisongroup.com

- **It may be better to travel than to arrive.** The rally in global equities since December 2018 has now pushed market valuations to levels which are once again discounting a relatively benign outcome for the global economy. Market volatility, following its most recent surge in December, has fallen back to below-average levels. Similarly, in credit markets lower quality bond prices have rallied, leaving spreads to risk-free rates close to the lows for this cycle. Fear appears absent from financial markets.
- **Stronger survey data quash recession fears.** Above-consensus purchasing manager's (PMI) data in China and the US have for now at least quashed earlier concerns of a US recession. In terms of global growth prospects, we are encouraged by the recent improvement in the data, which are a little ahead of our earlier expectations of around mid-2019.
- **We believe it is time to take stock.** It has been a remarkably strong market performance in Q119, especially in the circumstances of very mixed incoming economic and corporate data. Although some of the near-term risks to growth, monetary policy and politics have either been resolved or kicked further down the road, the closure of global output gaps during the latter half of this decade provides a gravitational pull back towards a relatively cautious late-cycle investment strategy. We maintain a neutral view on equities but suggest that some profit-taking may be in order.
- **In addition to supporting the economy, easier credit conditions and lower market volatility should be conducive to increased equity issue and M&A activity.** The UK remains the largest single stock market in Europe, accounting for 30% of market cap and it also has the most active market for M&A; we would expect the current proposals for a meaningful delay to Brexit to facilitate increased UK corporate activity over coming quarters.

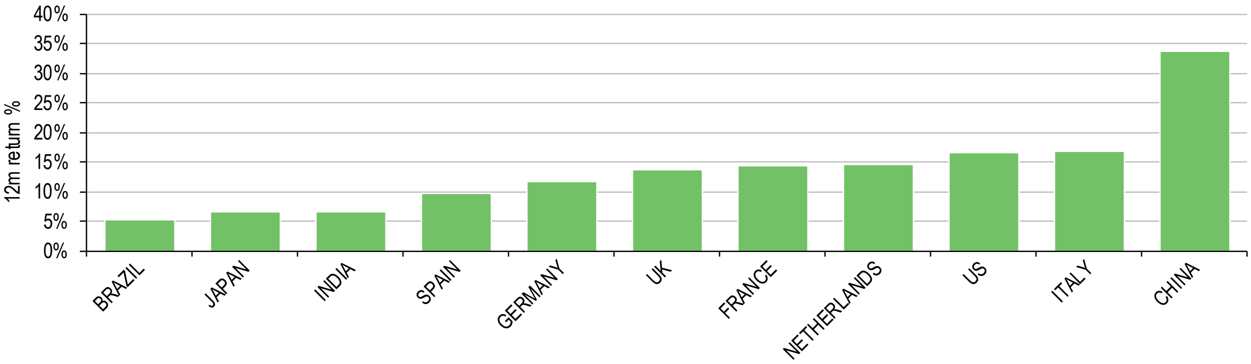
Time to take stock

Stronger survey data quashes recession fears

Equity market sentiment has performed a sharp U-turn in recent weeks. Above-consensus purchasing manager's (PMI) data in China and the US have for now at least quashed earlier concerns of a US recession. In terms of global growth prospects, we are encouraged by the recent improvement in the data, which are a little ahead of our earlier expectations of around mid-2019. In addition, US/China trade talks appear to be making some further progress and may now be down to details, albeit important ones, even if the timing of any US/China Presidential summit remains uncertain. In the meantime and importantly for equity markets, consensus earnings estimates for 2019 appear to have stabilised.

It seems that only a few days ago we were discussing the correlation between the inversion of the US yield curve and the likelihood of a US recession. We argued against the idea that the US yield curve was indicating an imminent US recession, as the inversion was largely driven by policy easing, including the use of forward guidance. Further QE, if required, has been ruled in as an option by policymakers on both sides of the Atlantic. A mini crisis in equity market confidence as bond yields fell at the end of Q119 has since given way to a further move higher in global equities, led by China's stock market which is now up over 30% year-to-date.

Exhibit 1: Year-to-date market performance

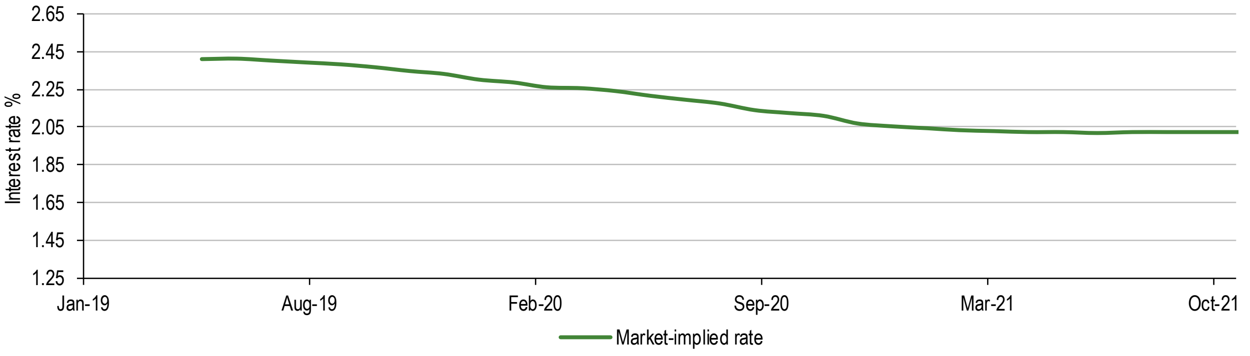


Source: Refinitiv. Note: Index in US dollars.

This significant rally in global equities has, in our view, been driven by an unwind of a number of interlinked risk premia, which gained prominence in Q418. Foremost was the fear of overly tight US monetary policy, closely followed by declining 2019 global GDP and profits growth forecasts. By December 2018, the combination of these factors had pushed developed market equities to a three-year low in valuation terms, a relatively attractive level in hindsight given the likelihood that the US Fed and ECB would indeed respond to evidence of a loss of economic momentum and loosen policy accordingly.

It would be easy to understate the scope of the shift in US Fed policy. It was only a few months ago that the US Fed was considered by investors to be monotonically raising interest rates and reducing the size of its balance sheet, with a relatively predictable funding squeeze exerting pressure not only on US markets but also in developing nations. Pleas from EM central bankers for the Fed to ease the pace of policy tightening were largely ignored during 2018. Now, market-implied rates indicate that the peak in US interest rates may already have been reached in this cycle with rates forecast to fall further over coming quarters, Exhibit 2.

Exhibit 2: Markets pricing in further modest cuts to US interest rates over coming 12m



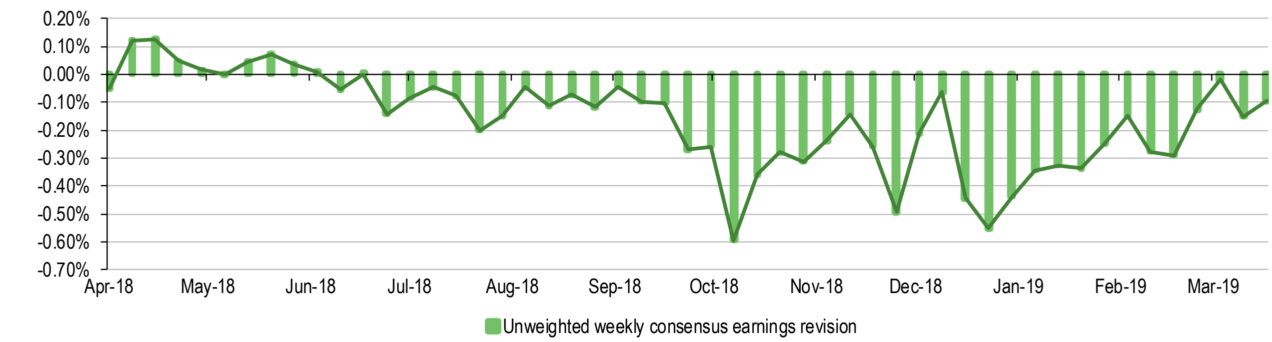
Source: Refinitiv

A lag between the easing of global monetary policy, rising investor confidence and the real economy was inevitable. During Q119 this meant investors had to endure an uncomfortable but not necessarily illogical period of rising equities, poor incoming economic data and falling earnings estimates.

However, this period is now drawing to a close, in our view. Survey data are starting to improve and we expect hard economic will also improve over coming months. We note for example that the Atlanta Fed's GDP nowcast has been rising strongly during recent weeks and is now indicating US Q1 GDP growth of 2.3%, from only 0.3% as recently as the end of February. China's 6.4% GDP growth rate in Q119 was ahead of expectations, aided by a surge in industrial production during March.

Importantly for equity investors, earnings estimates also now appear to have stabilised on a global basis, following a six-month period of downgrades which was at its most severe in January 2019. We have observed in the past that equities are much more sensitive to the direction of travel of consensus estimates (which are themselves in many respects a proxy for corporate profits guidance), rather than the absolute level of growth. With profits forecasts now stable, the risk of a relapse in market valuations is now reduced, compared to earlier in the year, Exhibit 3.

Exhibit 3: Global earnings revisions – earnings forecasts have now stabilised



Source: Refinitiv, Edison calculations. Note: Equal-weighted revision index.

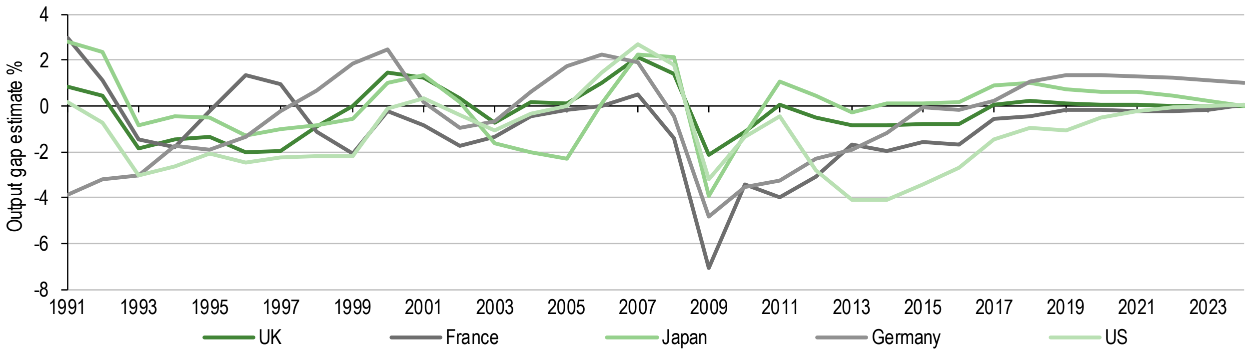
Consensus forecasts now indicate 6–7% 2019 earnings growth for the US, Europe ex-UK and the UK, having fallen from closer to 10% in October 2018. 2019 is therefore hardly a banner year for profits growth while the benefits of President Trump's US corporate tax cuts are now clearly behind us. However, this level of growth and profitability should be sufficient, given the currently easier outlook for monetary policy, to provide support for equities at current valuation levels.

However, investors' expectations for further short-term gains should, in our view, be tempered by the sheer extent of the global equity rally since December. While 2019 consensus forecasts have stopped falling, they are of course still lower than in October 2018, which has accentuated the rise in equity valuations as markets have enjoyed the recovery.

Equity valuations no longer a reason to ignore the risks

While there was in hindsight a rather large trading opportunity in global markets during the past six months, following the recovery in markets the longer-term picture for equities is little changed. Profits growth and GDP forecasts have been adjusted lower, correctly in our view, while global monetary policy is correspondingly easier. Each factor offsets the other and given the magnitude of their respective changes largely cancel each other out.

Exhibit 4: Global output gaps have shrunk

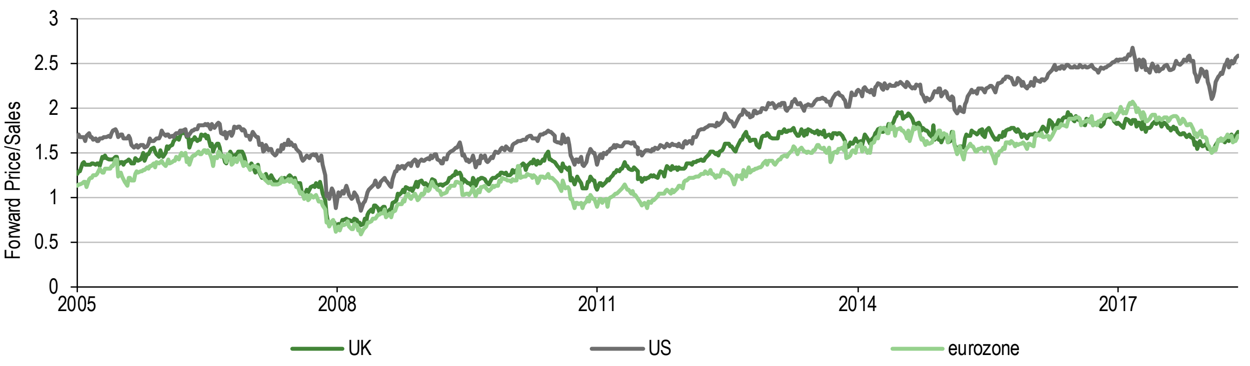


Source: Refinitiv, IMF

Following the market squall earlier in the year, it is time to take stock of the longer-term view. It remains the case that global output gaps have shrunk considerably during the second half of the current decade, Exhibit 4, providing correspondingly less room for manoeuvre for central banks to support the economy by running very loose monetary policy in future. Although current inflation pressures appear modest, any rise in inflation is likely to appear with a significant lag. The recent and sustained political pressure on the US Fed from President Trump is clearly unfortunate in this regard, as the communications challenge of running a forward-looking monetary policy to manage inflation in several years' time was already significant.

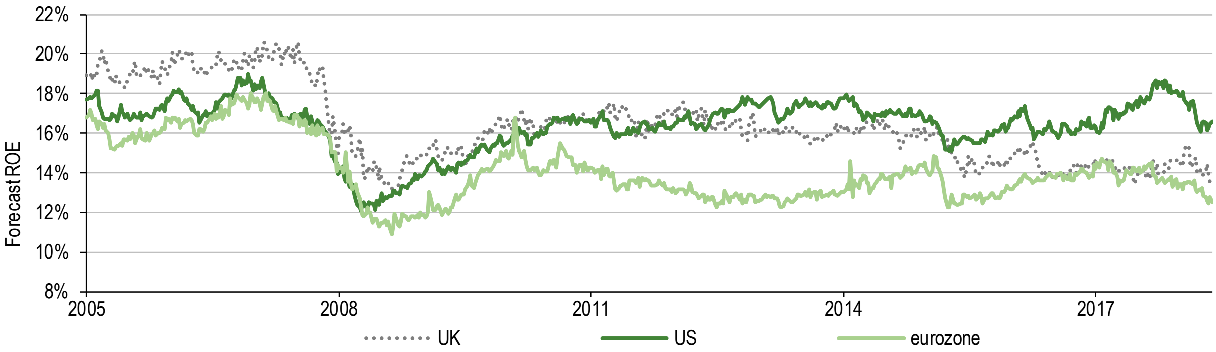
In line with the closing of output gaps, unemployment in the US and UK has reached its prior cycle low and while wage growth may not be an immediate cause for concern from an inflationary perspective, the trend would appear to be for higher rather than lower real rates over the medium term in the US and UK, even if the eurozone taken as a whole appears to have a greater degree of slack in the labour market.

Exhibit 5: Developed market price/sales ratios remain close to record highs



Source: Refinitiv, Edison calculations

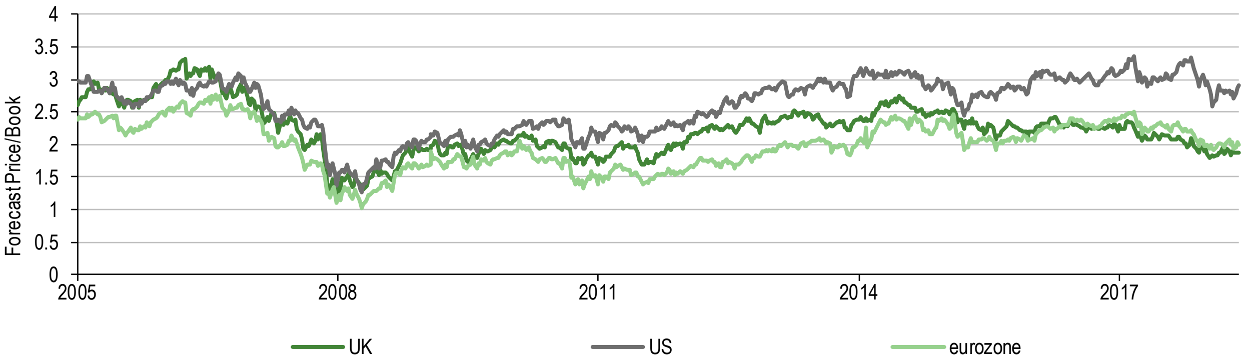
Exhibit 6: Only US equities have maintained pre-crisis levels of ROE post-GFC



Source: Refinitiv, Edison calculations. Note: Equal-weighted based on 12-month forward consensus forecasts

In our view it is still the case that developed market equities are benefiting from unusually low real interest rates. The benefits are twofold, as in addition to lowering the expected return on risk assets ultra-loose monetary policy has supported consumer spending and thereby corporate profits and margins. In particular, price/sales multiples remain elevated in developed markets. Since 2014, price/sales multiples have risen compared to the 2010–13 period, reflecting in our view the unanticipated continuation of ultra-low interest rates even as the post-global financial crisis (GFC) recovery picked up speed, Exhibit 5.

Exhibit 7: Diverging price/book valuations reflect weakening ROE trends in Europe

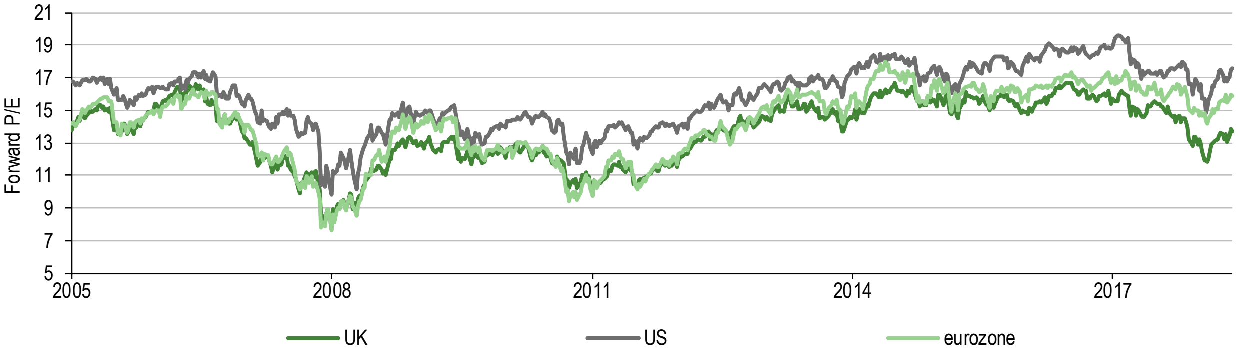


Source: Refinitiv, Edison calculations. Note: Equal-weighted based on 12-month forward consensus forecasts.

We also observe that it is not the case in all markets that ROE has been sustained at high levels, as has been the case in the US. In the UK, there has been a downward trend in forecast ROE for much of this decade, a trend that clearly predates the referendum vote for Brexit. In fact, the equal-weighted average forecast ROE for UK equities is at its lowest level since the global financial crisis, Exhibit 6.

Similarly in the eurozone, there has also been a meaningful decline in forecast ROE during the past 12 months. Current ROE forecasts in the eurozone are amongst the lowest of this decade. As a result of these declines in profitability, we do not subscribe to the view that UK or European equities are in reality especially cheap compared to the US on a price/book basis at present. For the eurozone, this is corroborated by the forecast P/E which remains close to its high of the last 15 years.

Exhibit 8: 12-month forward P/Es no longer suggest a near-term trading opportunity



Source: Refinitiv, Edison calculations. Note: Equal-weighted based on 12-month forward consensus forecasts

It is unfortunately still the case that European markets remain the poor relation to the US, both in terms of ROE performance and prospective revenue growth due at least in part to the US's role as the dominant capital market for the global technology sector. For this reason, we expect the valuation premium between the US and Europe to persist. On an absolute basis, the recent recovery in market valuations has now fully exhausted the late-cycle trading opportunity which was evident in January, in our view.

Conclusion

Given the recent improvement in survey data in the US and China, we believe incoming economic data are likely to be supportive of global equity markets at current levels during Q219. Yet there is a distinction between support and progress. For this reason we maintain a neutral view on equities. Investors will now need to look to specific stock or sector calls to deliver outperformance. While retaining a neutral view on equities, we believe it is a good time to take profits on positions that have performed strongly since the start of the year.

In addition to supporting the economy, easier credit conditions and lower market volatility should also be conducive to increased equity issue and M&A activity. The UK remains the largest single stock market in Europe, accounting for 30% of market cap and also has the most active market for M&A; we would expect the current proposals for a meaningful delay to Brexit to facilitate increased UK corporate activity over coming quarters.

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
1,185 Avenue of the Americas
3rd Floor, New York, NY 10036
United States of America

Sydney +61 (0)2 8249 8342
Level 12, Office 1205, 95 Pitt Street,
Sydney NSW 2000
Australia

Frankfurt +49 (0)69 78 8076960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
1,185 Avenue of the Americas,
3rd Floor, New York, NY 10036
United States of America

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Level 12, Office 1205, 95 Pitt St,
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Australia