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Illumination: Equity strategy and market outlook

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Global perspectives: Outlook for 2020

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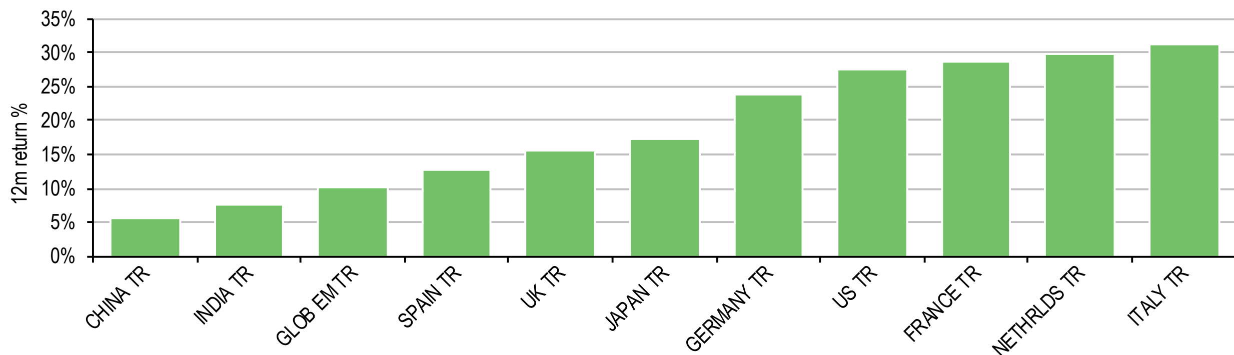
- **For many investors, 2019 will be a year which lacked resolution.** The US/China trade conflict, Brexit and a late-cycle slowdown in global economic activity remain ongoing issues. Frustratingly, investors have not been able to 'move on' from these issues during the year. In many respects it was simply the turn in monetary policy during the year that rescued market sentiment in Q3.
- **Nevertheless, the mega-cap segment of global equity markets continues to deliver double-digit ROE and high single-digit earnings growth.** This strong corporate performance has occurred despite the marked slowdown in global trade volumes and is a testament to the resilience of the largest business franchises. Current valuations for this group of equities suggest further outperformance over the medium term versus low-yielding government bonds.
- **Government bonds are unappealing at current low yields.** Bonds have also rallied strongly during the first part of 2019 as interest rate expectations fell. At present, government bond yields remain compressed even as the effects of 2019's loosening of monetary policy may bear fruit during H120. We believe government bonds are likely to continue to underperform equities in these circumstances.
- **Q120 is in our view likely to see the end of the US/China trade 'war' with the signing of a Phase 1 deal.** There are also signs that populism as a political movement has peaked and this tentatively represents a receding risk for investors. For example, the UK's Conservative Party has seized the middle ground in UK politics and at this stage appears likely to secure a majority for a centrist agenda, including exiting the EU with a deal on 31 January.
- **New Year resolutions of Brexit and the US/China trade dispute are likely to consolidate the recent gains in markets.** Declining political risk should also be expected to lower volatility and as a result encourage corporate investment in the real economy, IPOs and increased merger and acquisition activity**.**

Outlook for 2020

2019: A powerful rally but driven only by shifting expectations

At this point in 2019 it appears likely that the year will have delivered a rather strong overall performance in global equity markets, even if a significant part of this performance merely represents the clawing back of losses from the disappointing final quarter of 2018. Satisfying as this has been for investors, it has in our view been driven merely by the relief that a US recession this year has been avoided, as have worst-case scenarios in terms of the US/China trade conflict and Brexit.

Exhibit 1: Strong returns in equity markets year-to-date

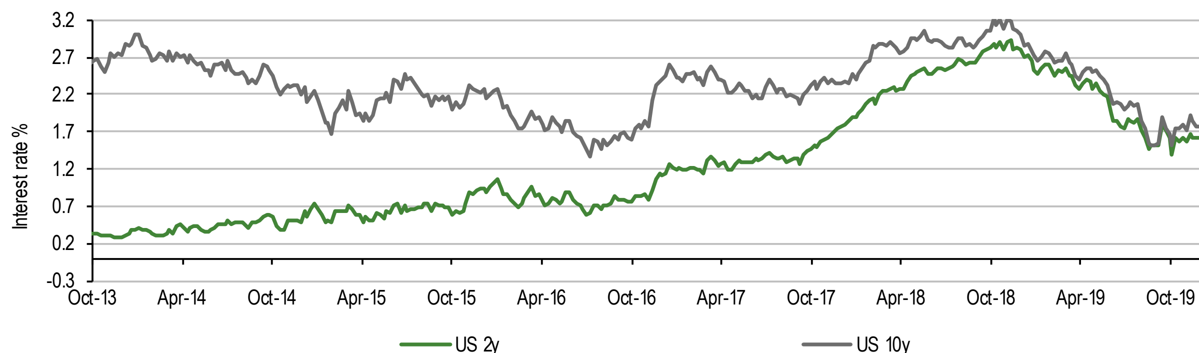


Source: Refinitiv. Note: Data as of 26 November 2019 in local currency excluding dividends.

Intellectually, it may feel however rather unsatisfactory to see markets once again wholly in thrall to the overtures of central banks and changes in the outlook for monetary policy. Yet again, it appears the primary driver of improved market sentiment was the reversal in the direction of global monetary policy over the past 12 months. Only a year ago the US Fed was focused on steadily increasing US interest rates, with balance sheet normalisation said to be on ‘auto-pilot’.

Since then, US interest rates have been cut by 75bp in response not to a recession but only indications of a slowing US economy. Fed policymakers may also have been spooked by the inversion of the US yield curve earlier this year. The US Fed’s ‘auto-pilot’ balance sheet contraction has also been abruptly reversed - the Fed’s balance sheet is now increasing once more. While this expansion has been described as a technical adjustment to increase bank reserves, investors can be forgiven for assuming this is a form of renewed QE, especially as the ECB also controversially restarted its asset purchase programme at the same time.

Exhibit 2: So much for rate ‘normalisation’ – US two-year yield down by 100bp from the peak



Source: Refinitiv, Edison calculations to 26 November 2019

During this cycle investors have been trained in an almost Pavlovian manner to associate easier monetary policy with higher asset prices, with little regard for the outlook for economic fundamentals. There was therefore a degree of inevitability that the recent loosening of monetary policy would place upward pressure on asset prices, despite some quite disconcerting PMI survey data indicating a marked slowdown in economic activity globally during the summer.

So much for the normalisation of monetary policy

However, despite this improvement in investor sentiment, we believe there will be many portfolio managers struggling to supress the uncomfortable sensation that global interest rates continue their 25-year downward trend with little prospect of 'normalisation'. The initial idea that unconventional monetary policy was a temporary jolt or thrust to push the economy onto a better trajectory does not accord with the observation that the influence of central banks on financial markets in the post-crisis era has only increased.

Monetary policies which were introduced as temporary or emergency interventions have become permanent. Ultimately, this raises the prospect of an uncertain end-state at the intersection of distributional politics and ever more 'innovative' monetary policy. In this regard, we note the recent push of some central banks into climate change politics; at first sight this seems to stretch the intended delegation of monetary policy to an independent technocratic institution into a rather broader field than originally intended.

However, the long-term fears of monetary policy overreach have been endemic for some years and must be balanced by the shorter-term factors during any portfolio asset allocation exercise. The substantial easing of US and eurozone monetary policy has shifted investor expectations in the second half of the year to towards an improving growth trajectory for the world economy in 2020. The market rally has not just been confined to equity markets; it is evident in declining risk premia across asset classes with high yield bonds and leveraged loans also delivering strong returns during 2019. Importantly, the US two-year/10-year government yield curve is no longer inverted.

As we look towards 2020 the recent rally in risk assets counts against the prospect of further large gains in the short term as risk premia have already shrunk considerably. In particular, the onus is now on the economy and politicians to deliver on what has already been priced in during recent weeks.

New Year's resolutions: US/China trade deal and Brexit?

Fortunately, it does appear that two totemic issues for 2019 are on the verge of becoming non-issues in early 2020. In respect of Brexit, at the time of writing the very strong showing of the UK Conservative Party in the polls leading up to the election on 12 December is suggestive of a workable majority for a new Conservative administration. In this event, the UK Parliament would be able to pass legislation implementing PM Johnson's Brexit deal and the UK would leave the EU on 31 January 2020. We believe this would be a New Year's resolution which would allow scope for the recent rally in UK assets and sterling to be underpinned and extended during the coming year.

In respect of the US/China 'Phase 1' trade deal negotiations, China's initiative this week to announce a policy aimed at increasing protections for intellectual property should be welcomed by US negotiators, even if it was inevitable – if only to protect China's own increasing investment spend in technology research and development. We believe markets now expect a conclusion to these Phase 1 negotiations, even if a formal announcement may slip into the New Year.

Recent comments from US President Trump indicate that talks are at the final stages and we note the marked reduction in the volume of criticism of China in Trump's twitter feed during November. However, with the US stock market already at all-time highs much of this good news on trade would

appear to be discounted in market prices and we expect any move higher on a formal announcement would be modest.

Furthermore, we view the signing of this Phase 1 deal as coincident with the effective start of Trump's 2020 US Presidential election campaign. If so, Trump's attention is likely to turn towards domestic political considerations and he may be less likely to initiate further international confrontations which would risk unpredictable consequences for his election campaign. This would be a welcome cause of lower volatility in financial markets during 2020. Improved certainty on trade and an improvement in the US/China relationship may also trigger increased global business investment.

Mega-cap corporate performance balances macro concerns

A decade after the severe market downturn of 2009 there remains a minority but vocal view within the investment community that the global economic expansion in this decade has been built on poor foundations. The economic edifice is said to be at risk of crumbling, once the ineffectiveness of monetary policy in continuing the expansion has been demonstrated. Empirically, the steady declines in global government bond yields and absence of inflationary pressure in this cycle prevent this thesis being dismissed out of hand.

However, an exclusive focus on macro worries also diverts attention from an important source of returns for investors. It appears the largest global companies continue to operate in a benign environment, with strong profitability and growth expectations. Current valuations suggest that if these expectations are fulfilled, over the medium term there remains a wide performance advantage over currently low government bond yields.

One particular idea which has been circling since the early years following the financial crisis has been that equities are overvalued and were it not for central bank support, markets would surely collapse along with corporate profits. Regardless of the merits of this line of thought, it has been an expensive view to put into practice from an opportunity cost perspective. Not only have equity markets continued to rise during an exceptionally long US economic expansion, but the largest companies within the corporate sector globally have delivered double-digit returns on equity and significant profits growth over the same period.

Furthermore, central banks have demonstrated little appetite for stepping back from market and economic intervention, instead preferring a policy of reacting proactively to any perceived or actual slowdown in growth.

Nevertheless, at times during this cycle we have been cautious on equities. We sensed opportunities to lower equity allocations ahead of times of risk aversion – such as 2015/16 or earlier this year – but it has been essential for portfolio performance to regain equity exposure before sentiment turns positive. Most recently, since September there has been a significant rally in global risk assets as investors once again give central banks the benefit of the doubt as monetary policy is eased.

The US stock market in particular has defied all pessimistic prognoses, being at the epicentre of 'bad' reasons for going up (Fed QE) and 'good' reasons for rising, such as the incredible growth of corporate profits and a very lucrative maturation of the US technology sector. Wage growth globally has remained muted, easing pressure on profit margins, while demand continues to recover.

Industry consolidation and the natural quasi-monopolies prevalent in 'Big Tech' business models have also supported profit margins. There has not been any evidence of mean reversion in profit margins to date. Furthermore, the deliberate and determined reinvestment of strong operating cash flows into maintaining and enhancing US and China's technology company franchises has thus far been highly value accretive.

Given the global nature of the very largest businesses, dropping the traditional division of the corporate sector according to national exchanges makes sense if we wish to assess just the very largest of the world's organisations by market value. Currently, the group of the largest 600 companies worldwide offers consensus expectations for 2020 profits growth of close to 10%, exceeding the median profits growth forecast for developed markets of just 8%. Furthermore, a free cash flow yield of 4%, which is stated after tax and growth capex, does not appear overly demanding from a valuation perspective in the context of sub-2% 10-year bond yields in all major developed market regions at the present time.

Taken as a group, the world's largest 600 companies are expected to generate a median return on equity of 16%, a similar level to that which has been consistently recorded over the past five years. This group has also demonstrated greater earnings forecast resilience than markets as a whole, as 2019 forecasts amongst this group of companies have dropped by only 6% over the prior 12 months, compared to 11% for developed markets.

In terms of valuations, given the above-average corporate performance of this group, we do not believe a median P/E ratio of 17x is especially demanding. The price to book multiple of 2.5x should not be described as cheap, but at the same time it appears justified to a large degree by this cohort of companies' 16% expected ROE. From a qualitative perspective, the world's largest companies also offer the greatest level of liquidity and, in general, better corporate governance than smaller peers. The benefits of scale offered by global franchises should be clear – yet these stocks do not appear to be valued at a premium at this point.

We continue to believe that despite the unresolved political risks of Brexit and US/China trade, politicians are stumbling towards conclusions that lower uncertainty and risk premia. The greatest risk of the dominance of these political narratives in the media is in our view the distraction of investors from the strength of corporate profitability and profits growth among the largest global companies. While populist movements may eventually impact profitability, the power of the largest companies to shape their own environment should equally not be underestimated, in our view.

In the context of very low government bond yields, we believe the total expected return on this large-cap cohort of the stock market, which represents two thirds of global market value, is sufficient reason to remain at least neutral on the outlook for global equities, even if the prospects for gains in the short term have been eroded by recent strong price performance.

To become more positive for the short term we would need to now see some stability in 2020 profits forecasts for the markets as a whole following the recent strong performance of equities. However, even after factoring the extraordinary length and maturity of this business cycle, long-term equity investors who have the capacity to take the attendant risks may, in our view, outperform bond investors given starting valuations, the quality of the business franchises of the leading global firms and, in particular, the current very low yields of government bonds.

Conclusion

In our view the impact of the easing of monetary policy during 2019 is still only likely to start to feed into the real economy by early 2020. The prospect of an improvement in economic conditions is now driving a substantial positive shift in investor expectations, leading to a reduction in risk premia and higher asset prices across asset classes.

While the US/China and Brexit political risks remain unresolved for now, we believe markets are also rationally looking towards resolution of these risks in early 2020. The US/China trade conflict appears to be moving towards a Phase 1 trade deal and the UK's Conservative Party is sufficiently ahead in polling that in 2020 both a resolution to Brexit and a re-centring of British politics are now reasonable prospects. Nevertheless, based on the rally in global markets during the autumn, a

significant proportion of this political good news is in the price, in our view. The prospect of lower political risk in 2020 may also correspond to a period of lower day-to-day volatility which is typically associated with stronger IPO and merger and acquisition activity.

Longer term, we believe the cohort of the largest global equities appears priced to offer returns in excess of the very low yields on government bonds. We remain neutral on the outlook for equities, with the near-term risks of a relapse in confidence given the recent rally balanced against the longer-term view. However, government bond yields appear at risk of further increases should the incoming economic data continue to improve.

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