Illumination: Equity strategy and market outlook

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Global perspectives: Fearful of missing out?

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This note was first published on 16 January. Given the developing situation in China, we have included a new section on coronavirus and its potential effects on markets.

- **In 2020, the biggest risk comes from elevated asset prices.** The resolution of the US-China trade dispute and the convincing victory for the UK's Conservative party in December's election set markets alight in the closing days of 2019. After a 29% gain in 2019, the median US equity starts 2020 on a forward P/E of 18.4x, close to the top of its range for this cycle. Continental European equities are similarly aggressively valued relative to their own trading range at present.
- **2019 was a year of unanticipated monetary easing in the US, eurozone and China.** In the US, the Federal Reserve cut rates and rapidly reversed its balance sheet contraction as repo rates surged in September. In the eurozone, the ECB responded to slowing growth by re-introducing quantitative easing (QE). China's bank reserve requirements have also been cut by the People's Bank of China. Nevertheless, we fear the sweet spot for central bank-linked equity gains may already have passed.
- **Despite the material reduction in equity and credit risk premia since the beginning of Q419,** survey data on both sides of the Atlantic remain stubbornly weak. For example, the US manufacturing purchasing managers' index (PMI) is currently at 47.2x, indicating a contraction in US manufacturing activity lies ahead, even as the S&P 500 continues to gain. European PMI indices also remain in contractionary territory despite the re-introduction of ECB QE.
- **In respect of portfolio risks related to coronavirus, in our view the key for investors is to focus on the economic costs of controlling the outbreak, rather than fearing mass panic.** A downgrade to Chinese GDP appears likely, in addition to a regional impact. Until cases have peaked, we believe travel and entertainment sectors are at risk of underperformance. Investors should monitor the spread of the disease outside China carefully, especially if further public health measures become likely.
- **A positive qualitative narrative of a broadly defined Trump policy de-escalation in a US Presidential election year is not wrong – but overemphasised, in our view.** It is getting worryingly late in the day for any expected recovery in economic activity to become evident in the incoming data. Given such a recovery already appears to be embedded in risk asset prices, we maintain a cautious position on global equities and credit.

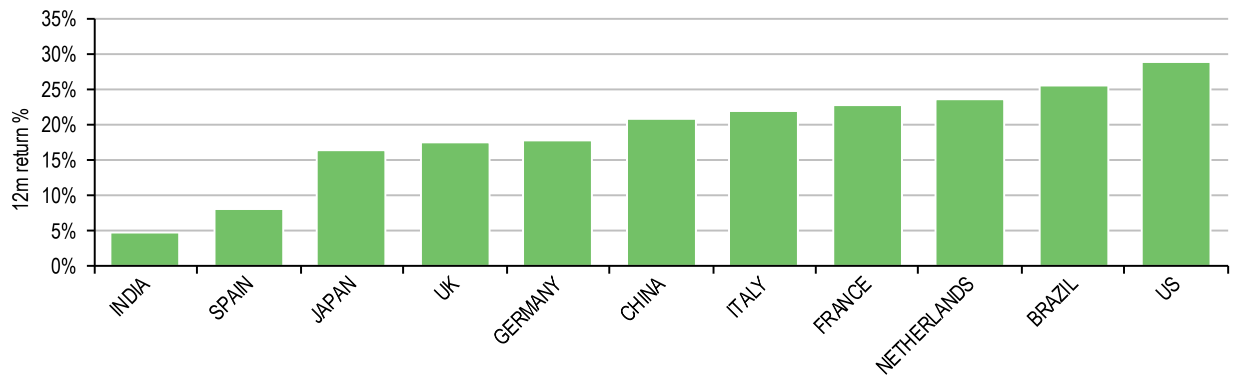
2020: Fearful of missing out?

Rich equity valuations risk disappointment, even if economy recovers

In our view investors have proved a little over eager to jump on the positive narrative of declining political risk in recent months. This has led to a sharp reduction in the risk premium for both global equities and credit markets. The situation is almost the reverse of 12 months ago when fears of a slowdown and overly tight monetary policy swept through markets. Then, at least cautious optimism seemed warranted, given the consistent track record of central banks in easing policy at the first sign of a slowdown. Now, market psychology appears to have swung too far towards optimism, as investors discount much-improved prospects for 2020 despite rather weak incoming economic data.

We certainly cannot take issue with the idea that there should be a positive response to the resolution of the US-China trade conflict, Brexit uncertainty or synchronised monetary policy easing. Not only have we previously highlighted that these fears were misplaced but each factor has steadily moved in investors' favour during the past 12 months. Starting from an oversold position at the end of 2018, 2019 ultimately proved to be a banner year for global equities (Exhibit 1).

Exhibit 1: 2019 – a banner year for equities



Source: Refinitiv. Note: Price returns 31 December 2018 to 31 December 2019.

However, the sheer extent of this rebound in global markets and the resolution of practically all of the commonly discussed risks raises the possibility that it may be the fear of missing out that is now driving markets. We believe that in addition to the known risks, it is important the 'unknown unknowns' should also carry a risk premium. Most recently this was demonstrated, for a 48-hour period in the first few days of January at least, by renewed tensions in the Middle East holding markets hostage.

It has become a popular view that passive investment is the only option. However, at various times during this extended economic cycle there have been opportunities to tactically adjust risk exposures where a gap has arisen between market valuations and economic reality. Passive investment certainly has a cost benefit but can also imply a loss of control over an investor's risk/reward ratio if it means remaining permanently fully invested, regardless of equity valuations.

Exhibit 2: US high yield spread to risk-free rate – trading at cycle lows

Source: FRED St Louis Fed

Most recently, during 2019 markets became over focused on the near-term risks in both Q1 and Q3. At these times risk may have dominated the headlines but there was at the same point an opportunity to add to equity positions at expected returns substantially ahead of long-term government bonds.

This cycle may be atypical, given its continued reliance on monetary policy easing to keep it alive. Nevertheless, investors able to balance the competing dynamics of central bank policy, economic and earnings momentum and market valuations remain better positioned to deliver higher returns per unit of risk than those ignoring the valuation signals in our view.

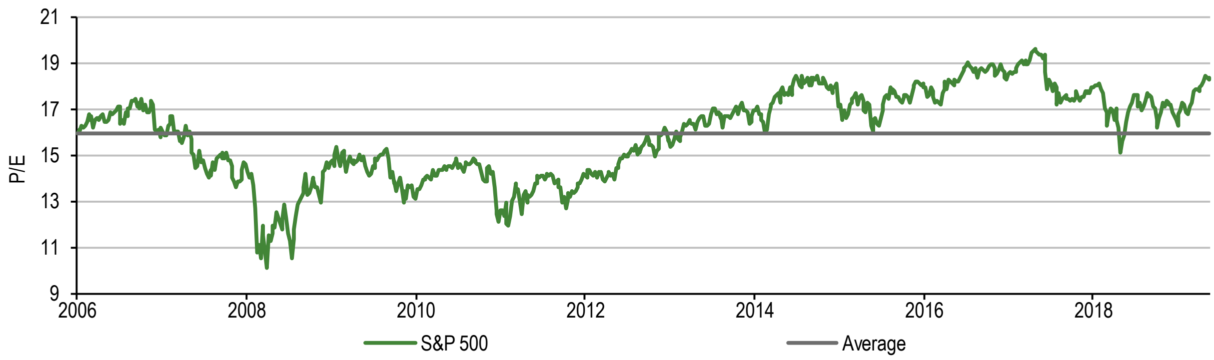
Declining risk premia should not be equated with improving prospects

At present, it is clearly tempting to view the recent turn in investor sentiment during Q419 as a precursor to better growth prospects ahead. Instead, we believe the recent rally was driven by a predictable decline in an excessive market risk premium for political developments, notably US-China trade and the UK's Brexit and related political uncertainties.

With both of these risks apparently now consigned to 2019 (despite a difficult period of negotiation for a future trade agreement between the EU and UK ahead), equity valuations have surged back to cycle highs in both the US and continental Europe. It is, in our view, time to book some gains.

In Exhibits 3 and 4, we show the one-year forward P/E estimate for these markets. An 18.4x forward P/E ratio for the median US stock is close to the peak level for this cycle and the picture is similar in continental Europe. UK equities trade in line with their 15-year average and the disconnect between UK and continental European valuations after the EU referendum is clearly visible in the exhibit.

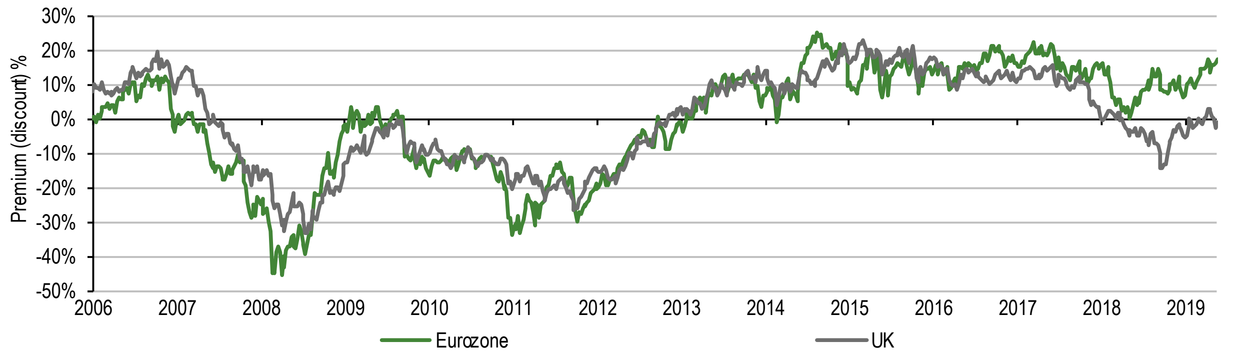
Exhibit 3: US equities closing in on peak median forward P/E ratio



Source: Refinitiv, Edison calculations

The argument for taking an overweight allocation to global equities at this point cannot therefore be based on low or even average valuations. In our view central banks, whose significant policy easing of 2019 brought many investors back into the markets, are not likely to continue to ease policy and risk a further juicing of asset prices, absent a meaningful growth or inflation scare.

Exhibit 4: Eurozone P/E 17% above average while UK equities trade in line



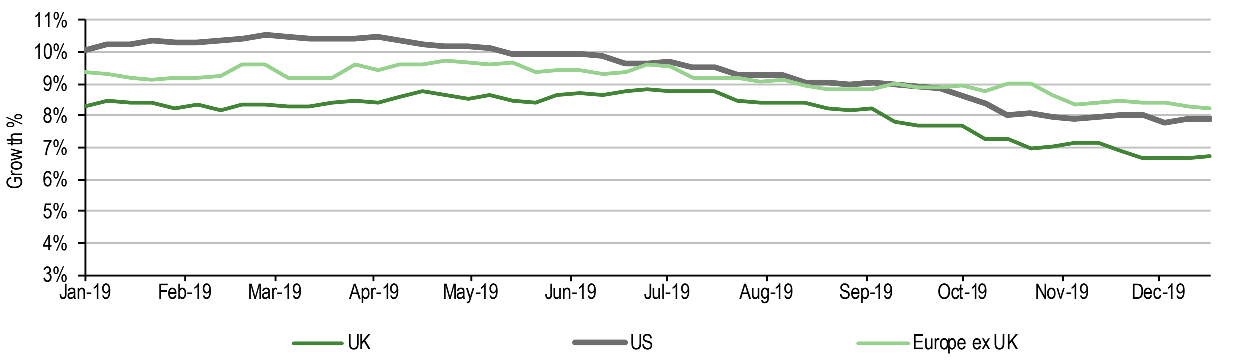
Source: Refinitiv, Edison calculations. Note: Chart shows median 12m forward P/E versus 15-year average.

Upgrades to outlook necessary to validate market gains

Without valuation or central bank support, any bullish view on equities can only be based on cogent arguments for a consensus-beating period for economic and corporate profits forecast upgrades. In this regard, while the situation is not as fragile as it was during autumn, the current incoming data is hardly encouraging.

It is true that 2020 earnings estimates appear to have stabilised during December, although the first few weeks of the new year will be an important test to confirm this stabilisation was not just because of the holiday period. Consensus forecasts now call for 6–8% earnings growth across US and European markets. These are not especially exciting growth figures, given the relatively high valuations of equity markets, but are consistent with maturity of the profit cycle. For example, EBIT margins for non-financials are expected to remain close to record levels.

Exhibit 5: 2020 Single-digit consensus earnings growth consistent with cycle maturity



Source: Refinitiv, Edison calculations

However, in terms of the outlook for the economy, we remain concerned that as we enter the year with sub 2% GDP forecasts for each of the major developed markets, there is a limited growth buffer against renewed recessionary fears, should there be any downgrades.

We note that despite the improvement in equity market sentiment, developed market government bond yields have barely changed over the past six months and remain close to their 10-year lows. US two-year rates are also unchanged over the same period and at 1.6% are only 20bp below 10 year rates, indicating only a modest GDP growth trajectory.

Bond investors may not be infallible, but in contrast to the relative exuberance on display in equity markets, there is clearly a sense of limited change in the longer-term outlook for economic growth and inflation, which in our view should not at this stage be wholly ignored.

In contrast to the US, eurozone long-term rates have been rising in recent months. 10-year German government bunds currently yield -0.21%, over 50bp higher than the August lows of -0.74%, levels that may have prompted the ECB to re-introduce QE during Q319. Eurozone two-year rates have also continued to drift higher and are now at -0.6%, having been as low as -0.93% in August 2019.

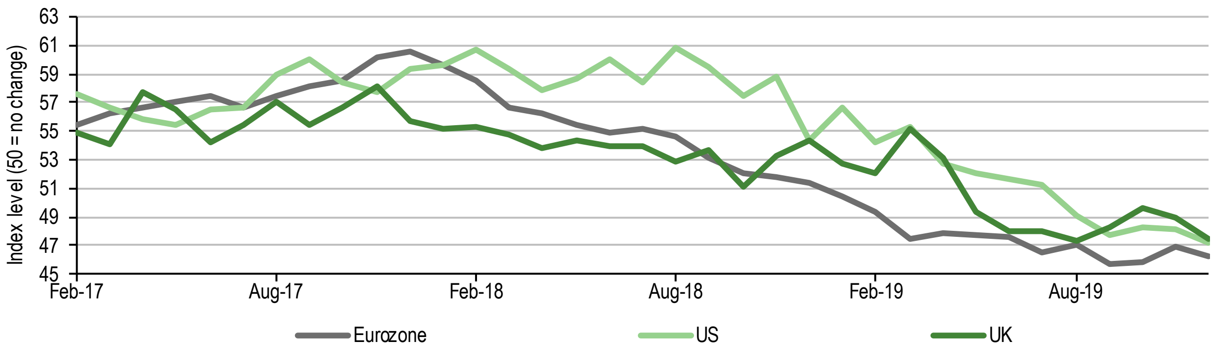
In part, this improved sentiment towards growth from eurozone bond investors will have been due to the avoidance of a no-deal Brexit during Q4 and the progress in the US-China trade conflict, which was disproportionately affecting the German and eurozone export sector.

Nevertheless, consensus forecasts across the major economies of the eurozone suggest real GDP growth will struggle to exceed 1% in 2020. Such an anaemic growth performance appears insufficient to maintain equity investors' Keynesian 'animal spirits', in the absence of further upgrades.

Time is running out for looser policy to feed into real economy

However, expectations for an improvement in the data remain in the realm of economic modelling, as actual evidence of improving data remains unfortunately scant. During the growth scare in Q319 we highlighted the possibility of a turn in the data around Q419 or Q120, given the typical time-lags between an easing of financial conditions and the resulting improvement in the real economy. It is unfortunately getting rather late in the day, in our view, for this modelled improvement to turn into a reality.

Exhibit 6: Manufacturing PMI data still at recessionary levels in the US and EU



Source: Refinitiv

At present, manufacturing survey data remain remarkably subdued, especially given the improvement in investor sentiment. Purchasing manager's indices remain locked deep in contractionary territory – at levels matched only by 2015 and the run-up to the financial crisis of 2008 (Exhibit 6). The risk is that time is running out for the stimulus from 2019's credit impulse to show up in the economic data.

Clearly, we cannot rule out an improvement in the data in coming months; but even if it occurs, it would appear fully embedded in market expectations. This leads us to the conclusion that equity risks are now asymmetric. Disappointments are likely to be more harshly punished than data that surprises to the upside.

In our view, the better position to take is one of cautious pessimism, rather than falling victim to a fear of missing further upside. This is after a quite exceptional 12-month equity rally. It is not a portfolio thought crime to reduce exposure to under-priced risks, in our view.

In this environment of low risk premiums and easing political risks, an increase in corporate activity is likely during H120, should volatility remain low. Investors should therefore continue to screen portfolios for potential M&A targets or other corporate activity.

Coronavirus: Markets wake up to the risks

It is too early to be certain on the relative infectiousness or mortality rate of the new coronavirus first observed in China in early December. Nevertheless, there have been close to 6,000 confirmed cases and 40m people in China currently facing travel restrictions as authorities attempt to control the spread of the virus. At the present time, in our view the key for investors is to focus on the economic costs of controlling the outbreak, rather than fearing mass panic. A downgrade to Chinese GDP for Q120 appears likely. Until cases have peaked, we believe sectors such as travel and entertainment are at risk of underperformance.

During January, it has been a surprise to us just how resilient markets have been in the face of adverse coronavirus headlines, given the precedent of SARS and its impact on markets in 2003. At this early stage, basic parameters such as the R0 value (the number of new infections per infected human) and mortality rate remain subject to a high degree of uncertainty.

Indications are that as the outbreak is at a relatively early stage in China it will take some time to bring it under control there. Nevertheless, while there have been some cases outside China there does not appear at this stage to be an epidemic of viral pneumonia in other nations – where public trust in data collection and case reporting is relatively higher.

The number of reported cases is likely to escalate sharply as the awareness of the disease grows but estimates of the mortality rate may also decline as testing becomes more widespread for milder cases. In particular, China’s currently reported case mortality rate of 2.9% may significantly overstate the actual danger from infection, as the number of undiagnosed and minor cases may yet be much larger than the 6,000 confirmed cases to date.

On the critical assumption that the mortality rate is ultimately similar to other viral respiratory diseases such as influenza, scenarios of mass panic are less likely to develop. Work to find a vaccine, building on the research for a SARS vaccine, may bear fruit within a two-year period. In such a scenario, economies will be affected by the measures taken to reduce transmission but provided these are not as draconian as those currently imposed in China, the economic impact would be relatively modest.

We believed a cautious portfolio positioning was appropriate prior to the news on coronavirus. The outbreak is a reminder that risk assets should be discounted for unknown as well as known risks. Our cautious view remains largely premised on the fact that forward multiples of US and continental European stocks are close to the top of their ranges for this cycle, suggesting an economic upturn is fully discounted and relatively little margin of safety is on offer for unanticipated events.

There is insufficient data on this viral outbreak to suggest a radically bearish change to our cautious view at this time. However, investors should now apply a discount to sectors where the economic impact of attempts to control the coronavirus outbreak is likely to hit hardest.

In this regard, consensus GDP forecasts for China’s growth during 2020 are likely to come under pressure with spill-over effects across the region. Travel, discretionary and entertainment-related sectors are also likely to underperform until a peak is seen in the rate of infections and restrictions on travel and social contact lifted. We note it may also take some months, rather than days or weeks, for the evidence for any reduction in the rate of infection to be visible in the data.

The risk to a nuanced portfolio response to this viral outbreak is a much greater rate of infection outside China, which would suggest rapid human-to-human transmission despite public awareness measures. In this respect the coming weeks will be critical; should cases outside China remain low and there is no need for precautionary curtailment of normal civilian activities, the effect on the world economy and markets is likely to be modest. However, if the data show a sharp rise in infections or a surge in hospitalisations outside China, the situation would be much more serious for markets.

At present, there is sufficient uncertainty that while this more bearish scenario cannot be wholly excluded, it looks less likely given the 10–14 day incubation period and that the virus was effectively in unimpeded worldwide circulation between early December and mid-January.

Conclusion

2019 was the year in which markets were buffeted by political risk. The risk in 2020 is high asset prices that are still yet to be validated by any meaningful improvement in the data. We understand it is not easy to reduce equity exposure when so many political risks appear to be resolved, or at least mitigated, and the occasional 'green shoot' appearing in the survey data. It is even more difficult, especially in an institutional context, to argue the case for reducing risk exposures in the absence of any obvious near-term danger to the outlook, other than the recent coronavirus outbreak.

Equity market valuations are close to cycle highs and credit risk premium lows. Furthermore, the primary and most effective joker card for short-term gains regardless of the outlook – which is an unanticipated dovish shift in central banks' policies – has already been played aggressively during 2019. We believe central banks are unlikely to add significantly to current policy initiatives, at least for the remainder of Q120.

There is little sign of any real threat to the profitability of some of the world's largest global corporations, which are also the primary beneficiaries of lower political risks and easing trade tensions. Within a cautious portfolio positioning, we would emphasise holdings that have the benefits of market liquidity should volatility increase and a sustainable, high-margin business model should be preferred over generic market exposure and cyclical risks.

2020 may yet prove to be the year in which active managers can outperform. Although January is a seasonally slower period, lower risk premiums and volatility are typically associated with increased corporate activity and this should also be a focus for equity investors at this point.

In respect of portfolio risks related to coronavirus, in our view the key for investors is to focus on the economic costs of controlling the outbreak, rather than fearing mass panic. A downgrade to Chinese GDP for Q120 appears likely, in addition to a regional impact. Until cases have peaked, we believe travel and entertainment sectors are at risk of underperformance. Investors should monitor the spread of the disease outside China carefully, especially if further public health measures become likely.

We have a neutral view on government bond markets as yields are low but unlikely to move significantly higher until there is much greater confidence in the outlook for economic activity. Despite investors' new-found appetite for risk, current survey data on both sides of the Atlantic points to a still dismal picture for manufacturing activity for the coming quarter and time is running out for 2019's monetary stimulus to demonstrate its effect on the real economy.

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