Illumination: Equity strategy and market outlook

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Global perspectives: Proceed with caution

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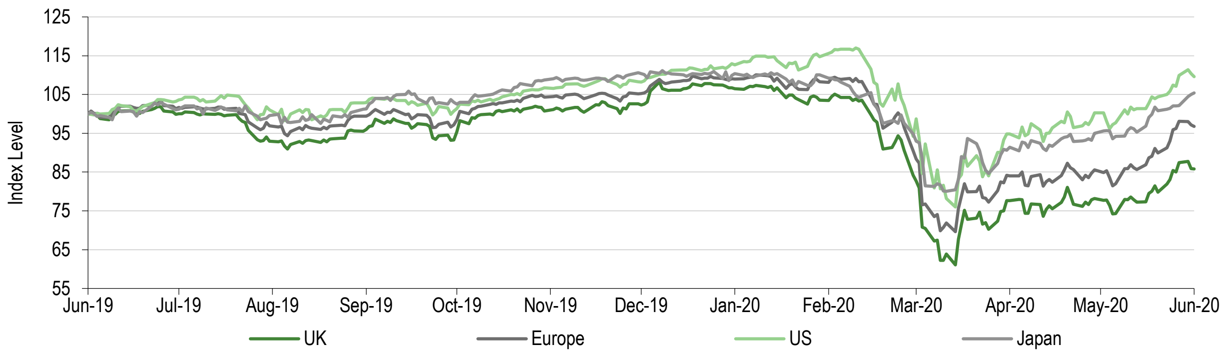
- **US COVID-19 cases reach a new daily high, reminding investors that the epidemic is not over.** Public policy is however shifting away from costly lockdowns and towards less intrusive forms of virus control. The economic benefits of this policy shift are clear. However, the ultimate biological effectiveness of this new approach remains uncertain. The risk of a second wave of infections remains in place.
- **Global earnings estimates have stabilised at lower levels**. Cuts to consensus forecasts have been severe with US equities now expected to deliver a decline in EPS of 10% in 2020 while net profits in Europe are expected to fall 25%. The relative resilience of US corporate profits is also reflected in the sharper rebound in US markets.
- **Equity valuations remain remarkably robust, given the circumstances**. Valuations for the largest 600 global corporations have bounced sharply while European equities have lagged, reflecting the weaker corporate performance. Liquidity-driven bargains are no longer on offer.
- **We remain cautious on equity markets and believe investors should proceed with caution.** We view the outlook for COVID-19 as still uncertain and we note the recent US infection data with some concern. Global equity valuations are now discounting a progressive re-opening of the economy. This is only one scenario in our view and at this stage a fits-and-starts trajectory cannot be ruled out.

Proceed with caution

We believe developed market policies for combating COVID-19 are shifting away from lockdowns and towards minimally acceptable strategies such as mask wearing, hand washing and contact tracing. Compared to full lockdowns, the economic cost of these policies is significantly reduced. As a result, markets have been rising even as the biological effectiveness of a less intrusive approach remains unproven. Daily cases in the US have recently risen to a new high. At the same time, valuations for the largest global companies have rebounded sharply and we feel the risks at this point are balanced at best. The flood of central bank liquidity and lower long-term interest rates offsets lower 2020 earnings, which in turn reflect the deepest global recession of the post-war era. While fear of missing out seems to be driving markets higher, we retain a cautious position on equities globally.

Exhibit 1: Looser monetary and fiscal policy mix has driven recovery in equity markets

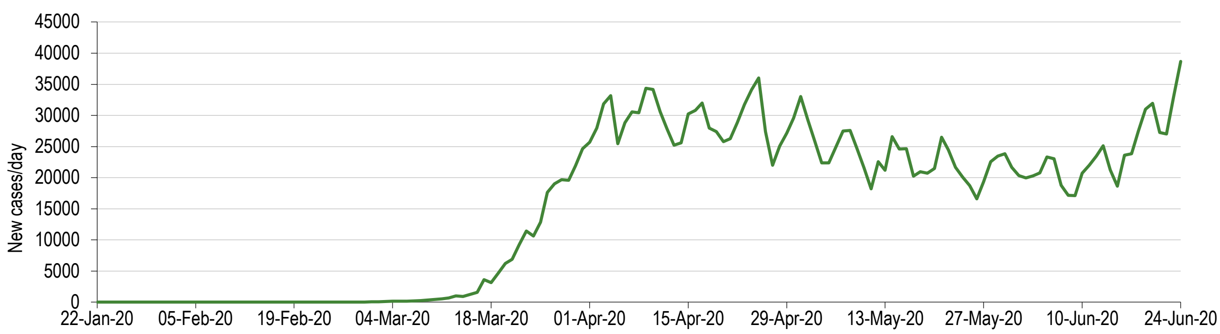


Source: Refinitiv. Note: Price return in US dollars.

Costs of lockdowns rising in political prominence

The duration of lockdowns and social distancing has exceeded our original expectations by some margin. However, governments have in recent weeks shown an increased determination to re-open national economies, despite the likely implications for the spread of coronavirus, including further clusters of new cases. New cases in the US have recently reached new highs as cases escalate in states which re-opened their economies early, Exhibit 2. Should this trend continue, the risk of a second wave remains in place.

Exhibit 2: US daily infection rates make new highs after initial stabilisation



Source: The COVID Tracking Project

In part, governments face a difficult choice as the full benefit of lockdown – eradication - has not been achieved, with the notable exception of New Zealand for a brief period at least. However, lockdown fatigue risks an ineffective public response in the event of a serious second wave of cases while the costs of shuttering national economies are becoming more prominent. Public movement and contact have in any case been rising, as compliance diminishes the longer lockdowns remain in place.

It may be difficult for many to place a monetary value on life, although this is something which has been common practice in clinical decision-making in respect of end-of-life care. Academic estimates for the UK suggest the economic costs of lockdown have dwarfed the value of the lives saved in almost every scenario for the spread of the virus. Such estimates also exclude the longer-term impact on GDP from interrupted education and training and the disruption of the jobs market.

Public policy is therefore moving towards a minimally acceptable approach, while retreating from earlier promises to 'beat' the virus. Nevertheless, the extent of the restrictions on public behaviour will remain meaningful, such as the wearing of masks on public transport and the strict requirement for self-isolation in the event of symptoms of COVID-19. As an example of how the political balance has shifted, the controversial 2m distancing rule has been abandoned in the UK to facilitate the re-opening of the hospitality, leisure and education sectors despite an apparent lack of formal scientific evidence supporting this decision.

Few nations are coming out of lockdown because the virus has been fully supressed while contact tracing efforts in Europe have at times appeared woefully ineffective. The UK has pursued a smartphone-based approach and failed to deliver the necessary software. In France, the official app has reportedly resulted in only 14 self-isolations nationally. One might question whether a traditional approach of using people rather than software and publicising the approximate location of new case clusters might have been more straightforward. It also remains unclear whether asymptomatic cases are particularly infectious, following the WHO's comments last month.

For investors, in our view the key to understanding the market reaction to COVID-19 has been to acknowledge the political dimension in the linkage between the spread of the virus and the ensuing public policy response. At this point provided the healthcare system does not again become at risk of overload, the political balance is, in our view, less likely to shift back to a lockdown-based approach.

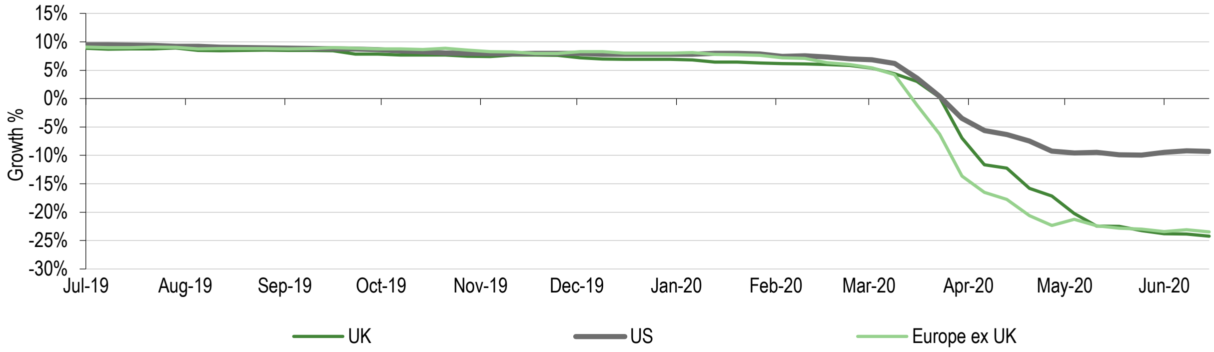
Nevertheless, the public is likely to continue to maintain their guard in terms of behaviours with greater risk potential, particularly those involving larger crowds, thus dampening demand for services in these sectors. It is also the case that the new normal does not look like the old normal and will in many regards be inferior and therefore continue to impact social economic activity.

For the leisure sector, protocols and restrictions for international travel remain under discussion. Rules will undoubtedly be subject to change in the event of any second wave of cases, adding to uncertainty for travellers. In England, the opening of bars and restaurants is welcome but is still subject to so many restrictions on household mixing and behaviour that it may feel alien to many. Live performances remain prohibited, as does cricket. Even after the easing of the lockdown office workers are still expected to work from home, in part to allow social distancing on public transport. With the profitability of the hotel and leisure industry critically dependent on utilisation rates, margins are likely to remain under pressure in these sectors over the summer.

2020 consensus earnings estimates have stabilised at lower levels

We note that earnings estimates have stabilised at lower levels around the globe and this does provide comfort, for the short term at least, that the initial COVID-19 effects have now been fully embedded in market expectations. Nevertheless, the downgrades have been severe, reflecting the magnitude of the extraordinary slowdown in GDP growth.

Exhibit 3: Consensus 2020 earnings growth forecasts have stabilised following steep reductions



Source: Refinitiv, Edison calculations. Note: 2018 = 100.

The median corporate EPS growth forecast for the US has been downgraded by 20% and a fall of 10% in profits is currently forecast for 2020. In Europe and the UK, earnings forecasts have been cut even further. A full 30% has been lopped off earnings forecasts, which now indicate a 25% decline is due this year.

This corporate underperformance in Europe is unfortunate and to some degree the result of long-standing differences in the sector composition between the US and Europe. The US has in recent decades managed to secure the lion's share of the faster growing, newer global business franchises. These businesses are also often based within the digital economy which has been least affected by the outbreak of coronavirus and in some cases benefited from an accelerated shift to home working and on-line shopping.

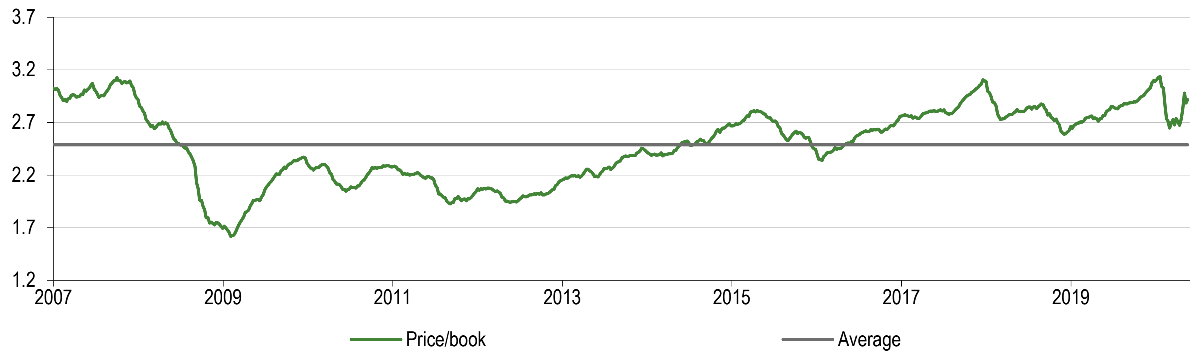
Furthermore, new economy business models have focused on reducing cyclicality by shifting to subscription-oriented sales, in addition to building effectively dominant business franchises in these major growth areas of the global economy. That this has been tolerated by US competition authorities in this decade is a matter of public policy; but for investors the attraction of these growing and defensive profit streams should be clear.

As a result, 2020's discrepancy between the performance of the US and European corporate sector both in terms of earnings resilience and price performance is stark. When considering lower valuations in Europe versus the US, the debate should in our view be framed in the context of the larger downgrades, cyclicality and lower quality of European earnings to date.

Global valuations recover while Europe lags for a reason

We note that while COVID-19 uncertainty remains outstanding, the median 12-month forward price/book multiple for the world's largest 600 stocks has rapidly recovered to levels sustained for only relatively brief periods during this cycle despite widespread earnings downgrades. The determination of central banks to aggressively purchase securities and force interest rates down across all maturities by cutting rates and implementing forward guidance has been the critical offset to the expected reduction in profitability.

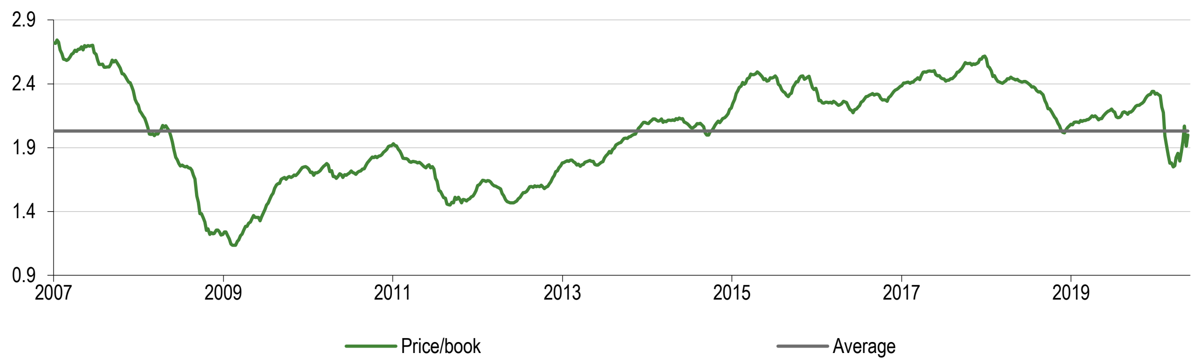
Exhibit 4: Median price/book of largest global corporations close to 15-year highs



Source: Refinitiv, Edison calculations. Note: 12-month forward estimated price/book.

In Europe, valuations have recovered but remain well below those prevailing before the outbreak of COVID-19, having returned to the average of the past 15 years despite the reduction in Eurozone and UK long-term interest rates. While it is natural to ask if this represents an opportunity compared to the US, we believe this is instead a rational response to the much deeper cuts to earnings forecasts in the region. Furthermore, although the rhetoric has calmed in recent days both Brexit and the north/south divisions within the EU have appeared at risk of being amplified by the rapid contraction in GDP resulting from COVID-19.

Exhibit 5: Europe median 12-month forward price/book



Source: Refinitiv, Edison calculations

Conclusion

As 2020 unfolds, we continue to re-test our judgements on the spread of coronavirus and the extent of the resulting public health measures. At this stage, we believe investors should not drop their guard. Lockdowns may be falling out of favour but case numbers in the US are rising again. While Europe has lagged the recovery in US markets, the impact of COVID-19 is of a larger magnitude and in consequence consensus EPS forecasts for Europe now call for a decline of 25% for 2020. Even as a rebound is expected in 2021, this still leaves European forecasts 24% lower than prior expectations over this longer two-year period.

It is quite proper to question this cautious stance as markets rise, lockdowns are released and central banks appear intent on backstopping financial markets and the economy. It can also be argued that the enormity of the COVID-19 shock is matched by the enormity of the fiscal and monetary response to it. Nevertheless, at current valuations global equity risks appear at best balanced in our view, even allowing for the expected looser trajectory of monetary policy over the next 36 months.

Equity allocations should in our view remain focused on opportunities where there is a compelling medium-term case. A vaccine for COVID-19 is potentially on the horizon for 2021 and investments will have terminal values calculated many years later. In a new and uncertain situation there is a risk of unintentionally acting as a short-term investor, as the research effort becomes inadvertently consumed by the novel factor. Panic buying can be as damaging to portfolios as panic selling.

Over-focusing on COVID-19 may also lead to a bias towards creating a portfolio of 'recovery trades' highly contingent on the precise trajectory of viral infections and the economy but at odds with what can reasonably be predicted in a quantifiable manner at this stage of the epidemic. Secondary damage to portfolio performance arises by distracting attention from longer-term themes and proven investment processes.

Given the unquantifiable uncertainties still surrounding COVID-19 we believe that tilting portfolios towards recovery trades at the expense of longer-term investments should be avoided. At current equity valuations there appears to be only a very modest risk premium on offer at present. We believe investors should instead proceed to invest in their best ideas only and with caution, leaving a margin of safety in terms of portfolio risk and portfolio liquidity, should there be a more significant second wave of infections later in the year.

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