Illumination: Equity strategy and market outlook

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Global perspectives: Markets cut to the chase

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- **Equity market investors appear to have skipped to the final scenes of the pandemic movie.** Market pricing is consistent with the view that COVID-19 effects will be relatively short-lived. However, bond markets have discounted a relatively long period of lower interest rates and gold is nudging new highs. We remain neutral on equities for now but acknowledge the very recent uptick in COVID-19 cases around the globe.
- **Global sector valuations highlight the extent of the rebound in markets in recent weeks.** The global technology sector is now trading at an all-time price/book high for the past five years. Similarly, sectors perceived as defensive such as pharmaceuticals have also strongly outperformed. The global industrials sector remains at a modest discount to its historical price/book multiple, and for long-term investors may be of greater interest than 'headline' technology stocks.
- **Global growth stocks over-hyped in 2020?** The sheer extent of the outperformance of 'growth' indices over 'value' since 2015 is in our view a concern as on a global basis faster-growing companies are now trading several standard deviations above their 10-year price/book average.
- **The astonishingly rapid deterioration of the US/China relationship has serious implications for geopolitical stability over the medium term.** Any continuation of the trends in sanctions, tariffs and trade barriers creates the risk of a real division in the world economy between the Western and China spheres of influence. This would represent a structural break from a long period of global integration and may have major implications for the direction of inflation and corporate profit margins over the long term.
- **We maintain a neutral view on global equities. Investors are being asked to balance fiscal and monetary support for markets against the significant uncertainty in the trajectory of COVID-19 cases.** Progress is being made on treatment options and vaccines and the political agenda has shifted towards keeping economies open with more specific restrictions for higher-risk activities. If this remains the case, economic activity is likely on balance to continue to improve over the remainder of 2020.

Markets cut to the chase – should you?

Q220 was one of the best performing periods for global markets in history, despite the enormous economic destruction wreaked by the public health measures introduced to combat the spread of COVID-19. Equity market investors appear to have skipped to the final scenes of the pandemic movie. Market pricing is consistent with the view that COVID-19 effects will be relatively short-lived. However, bond markets have discounted a relatively long period of lower interest rates and gold is nudging new highs.

While equity valuations may have run ahead of the events on the ground in the short term, the continued progress in re-opening the global economy, combined with enormous fiscal and monetary support, is on balance likely to maintain market sentiment. We remain neutral on equities for now but acknowledge that the very recent uptick in COVID-19 cases around the globe is clearly a risk to our view.

Furthermore, the strong market rebound since March suggests that any gains from current levels are likely to be modest. During the summer, markets are likely to be range-bound, provided the growth in COVID-19 case numbers remains sufficiently low and the more economically damaging restrictions on movement can be avoided in future.

Given the economic costs, we believe governments will try to avoid imposing further lockdowns except where high case numbers make this impossible. We also highlight that while it is not at present our most likely scenario, a serious second wave of cases over the winter which would trigger further lockdowns cannot be wholly excluded at this time.

Cutting to the chase – forward-thinking or premature?

While it is claimed that attention spans are steadily getting shorter in the 21st century, the rapidity of the stock market recovery from COVID-19 is still remarkable. At first sight it may appear at odds with bond market pricing, where yields have remained much lower than at the year end.

However, in a world where central banks effectively dictate term yields through forward guidance and asset purchases, we believe currently low yields are less a reflection on the outlook for growth as they are for the stated intentions of central banks globally. The underperformance of the banks and insurance sectors during the rally is consistent with this view.

Post-lockdown, coronavirus infections have declined in most developed nations even if the risk of a possible second wave of infections is now coming to the fore. Nevertheless, the decline of approximately 120bp in US interest rates across the yield curve, and hugely expanded central bank balance sheets, are here to stay. As infection rates decline, it is a scenario of recovery to a ‘new normal’ with lower risk-free rates, less the residual damage from the impact of public health measures, which markets seem to be factoring in.

New academic research on the susceptibility of the population to COVID-19 is shifting the public health debate, with clinical data indicating that a significant number of people may have a degree of T-cell immunity to COVID-19 from exposure to other coronaviruses. In theory, this is encouraging for the success of the current re-opening strategies in Europe.

We note with interest that markets have not responded to the recent surge in US cases, with close to one-half of US states re-imposing restrictions on the hospitality and leisure sectors. This highlights the high level of uncertainty in plotting the trajectory of the pandemic. The recent re-introduction of quarantine requirements by a number of states in Europe, still mindful of the risk posed by returning holidaymakers following the ski-resort source of many infections earlier in the year, should also keep investors alert to the risk of a second wave.

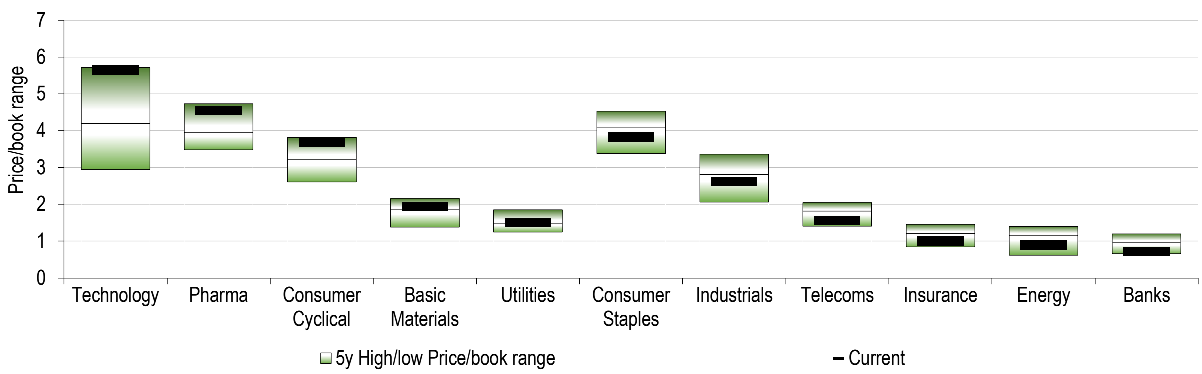
However, it remains the case that for investors the primary concern remains disruptive public health measures such as lockdowns and not the virus. At present, the political focus has moved towards re-opening the global economy but with sufficient public health protection measures in place to minimise the risk of a major outbreak, pending a vaccine in 2021. Masks, plastic screens and hand sanitiser have become an accepted prequel to many social activities.

Tech looks overbought, sweet spot may be IP-led industrials

Global sector valuations highlight the extent of the rebound in markets in recent weeks and in our view demonstrate that markets are fully up with, if not ahead of the recent improvement in economic momentum. Exhibit 1 shows the global technology sector is now trading at an all-time price/book high for the past five years. Similarly, sectors perceived as defensive, such as pharmaceuticals, have also strongly outperformed the overall market year-to-date and are also trading at the top of previous valuation ranges. We note that banks, energy, insurance and telecoms stocks (the latter perhaps because of the perceived risks of relatively high debt loads in the sector) have in contrast underperformed and are at a discount to their five-year price/book average.

The global industrials sector remains at a modest discount to its historical price/book multiple. At prevailing market valuations, companies supplying key components for global manufacturing based on strong intellectual property, technology or market positions within this sector may be of greater interest for long-term investors than the 'headline' technology stocks.

Exhibit 1: Historical price/book trading range and current valuations for global sectors



Source: Refinitiv, Edison calculations. Note: Chart sorted left to right by current price/book versus five-year average.

Global growth stocks over-hyped in 2020?

Growth investing has been fabulously successful in recent years as the strong operating performance of Web 2.0 digital economy franchises has led to steady multiple expansion and extraordinary price performance. In consequence, since 2015 global 'value' indices have underperformed 'growth' indices by a historically large margin.

This gap has only widened during 2020 as the digital economy benefits from the acceleration of trends towards digital living and working from home. Furthermore, the perceived quasi-monopoly status of these growing technology franchises has become even more highly valued on a relative basis as long-term interest rates have been pushed lower by central bank policy. Nevertheless, there are now some similarities with the Y2K era which we think are worthy of discussion.

In the US, large-cap growth indices have in the past decade outperformed similarly constructed value indices by over 150%, following a prior decade of underperformance. It is not the principle of outperformance but the recent extent, which raises questions for prospective returns for growth stocks. A tendency for long-term outperformance by growth stocks at the price of higher volatility should in fact be expected, as the growth segment of the stock market is qualitatively riskier.

However, the degree of recent outperformance is quite unusual, at least over the past 25 years. The previous speculative peak in growth stocks occurred in 1999 and gave rise to a 75% outperformance, which was fully unwound over the following cycle up to 2008. The magnitude of growth stock outperformance of 40% just in 2020 alone is therefore not entirely dissimilar to that of the dot-com bubble.

The dot-com comparison is not perfect but certainly sufficiently close to justify discussion in our view, rather than a 'it's different this time' dismissal. Seen through the eyes of history, the dot-com boom now appears as an obvious speculative mania, but not every beneficiary of the bubble was a speculative stock, nor were the investment ideas always wrong. It was also not as easy as it now looks to go against the grain and underweight the new economy stocks as the bubble expanded.

Technology and the internet did prove to be the defining theme of the 21st century. The integration of technology, telecom networks and media (TMT) proved to be the correct business model. The high market value placed on search and views for advertisers was hardly a conceptual investment error, even if the timing was much too early. That the gains from the internet would end up concentrated in the hands of just a few global players barely a decade later, in what was originally thought to be a competitive arena with no barriers to entry, would however have been a surprise to many start-up investors.

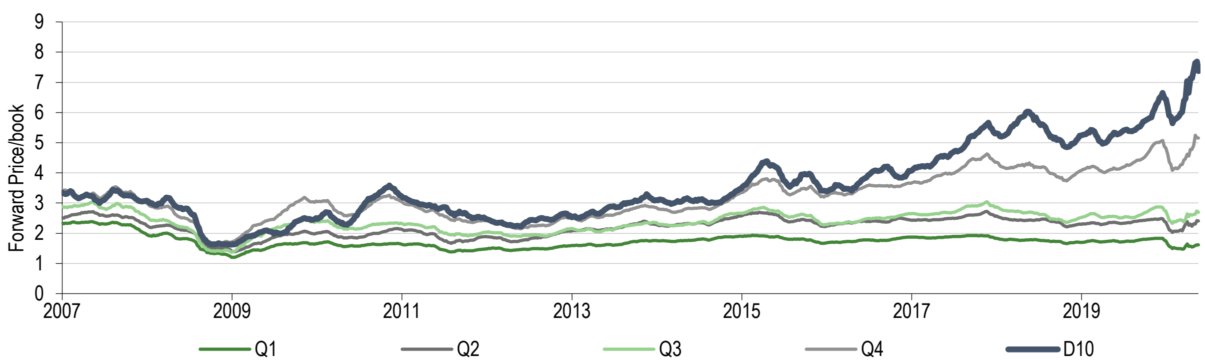
In addition to start-ups, the original internet bubble also resulted in an ultimately transient but large surge in valuations of a wide variety of large-cap and profitable stocks deemed relevant to the new economy, spanning the TMT sectors. An underlying corporate investment bubble in technology infrastructure generated supernormal but temporary profits and margins for a narrow range of technology hardware suppliers.

Yet the collapse of the hardware investment cycle in 2001 vaporised this supernormal profitability of many technology manufacturers in a matter of a few quarters, while revenues from the advent of social media and the rapid growth of e-commerce had to wait for several further rounds of broadband and mobile handset innovation before adoption took off almost a decade later.

The challenge for value investors is that while it is relatively easy to spot periods of high (or low) valuations in hindsight, in real time there are few indications that sentiment will stage a reversal. The trigger may only be visible after the event. Nevertheless, we are increasingly concerned that on a global basis valuations of the fastest-growing large-cap stocks are becoming disconnected from the remainder of the stock market and the accidental but beneficial kicker from COVID-19 is unlikely to be repeated.

We have divided the largest 2,000 global corporations into quartiles based on consensus forecast revenue growth rates and plotted the prospective price/book multiple in Exhibit 2.

Exhibit 2: Price/book valuations of faster-growing global stocks have surged since 2015



Source: Refinitiv, Edison calculations. Note: Chart shows median p/book multiples by growth quartile and top decile (D10).

While the median forward price/book multiples for slower-growing companies has remained close to their respective averages for the period, the median forward price/book multiple for the fastest-growing quartile is now over two standard deviations above its long-term average. Furthermore, Exhibit 1 shows the re-rating has been even sharper for the top decile of growth stocks (D10).

In absolute terms, the median large-cap growth stock was valued at 3x book value in 2015 and is valued at 5x book value today. It is a testament to the power of modern monetary and fiscal policies that this exuberance is being observed just ahead of the largest global recession since WWII.

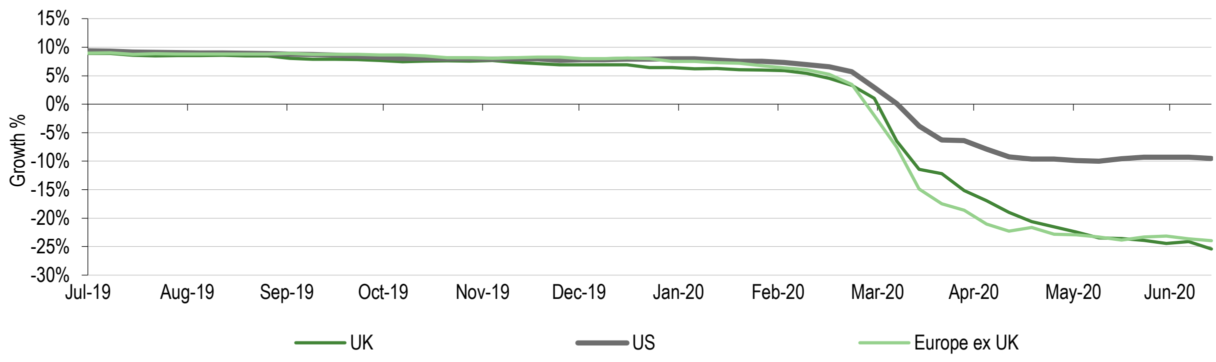
Clearly, this situation has not arisen by chance and there have been good reasons for favouring growth stocks in the past. At the core of the growth stock phenomenon of recent years has been the new class of digital defensives – scale and high margin software and hardware businesses which have grown at multiples of GDP growth rates. Execution has been strong and these businesses have determinedly invested to see off competitive threats. Digital trends have only accelerated, due to the advent of COVID-19.

The qualitative investment case has therefore remained compelling for many investors. Nevertheless, balanced against these attractive qualitative elements of growth stock investing are the quantitative valuations now several standard deviations above average. These appear to indicate that the merits of this segment of the stock market are now firmly embedded in current market pricing.

Recession conditions remain in place

It remains the case that there will be a quite extraordinary economic contraction during 2020 and even assuming a relatively sharp recovery following the crisis, consensus forecasts are indicating zero GDP growth is likely to be recorded in developed markets in the 2019–2021 period. This shortfall in GDP versus earlier expectations has crushed corporate profits expectations, particularly in Europe, which remain 16% lower for 2021 compared to January, highlighting the only partial recovery from the contraction expected in 2020, shown in Exhibit 1.

Exhibit 3: Global 2020 consensus earnings forecasts



Source: Refinitiv, Edison calculations

Given the societal progress being made in adapting to a post-COVID environment, it may now be rational to look through near-term earnings, but strictly where the longer-term investment case is unimpaired by behavioural changes such as the surge of online commerce or new working from home (WFH) trends. WFH appears to be increasingly 'sticking' as the corporate sector now understands the productivity advantages and values both the lower risk and cost of this way of working.

In respect of the trajectory of control measures, with the notable exception of certain US states governments are shifting away from lockdowns towards less intrusive measures to control the spread of COVID-19. Uncharitably, this could be described as 'muddle-through' but it is the scenario which would enable most of the economy to re-open, provided case numbers remained tolerably low.

This muddle-through scenario is also now our base case. Significant progress is being made in respect of COVID-19 vaccine and treatment options. Social distancing rules and protocols for temperature checks and mask-wearing are being refined and have public support. Several vaccines look set to appear on the horizon for early 2021. While there are clearly some risks, including the recent quarantine requirements for intra-European travel, there will also be pent-up demand to be released once consumers regain the confidence to re-start social, leisure and travel activities under new health protocols.

Implications of the souring US/China relationship for global markets

In addition to COVID-19 risks, the astonishingly rapid deterioration of the US/China relationship even in recent weeks has serious implications for geopolitical stability over the medium term and should be considered carefully by investors in global markets. If these trends in sanctions, tariffs and trade barriers (most recently those impacting the telecoms hardware sector) continue, then regardless of the reasons or intentions, the risk of a real division in the world economy between the Western and China spheres of influence can only grow.

For example, the recent US sanctions in respect of Hong Kong and naval declarations in respect of the South China Sea come after several years of protectionist rhetoric and the imposition of tariffs on trade between the US and China. Compared to only January of this year, when the ink was barely dry on a Phase I trade deal, the US/China relationship has soured significantly. In our view, the US concerns towards China extend beyond Trump's administration, as China seeks international influence commensurate with its economic weight and in conflict with US policy objectives.

During the recent equity rally, investors have chosen to ignore these developments. In more normal times we suspect they would have dominated the headlines and caused ripples in markets, similar to the on/off trade deal newsflow of 2019.

After biding its time for many years, China has in many respects merely revealed the strength of its hand and is now willing to risk external criticism and sanctions to achieve long sought after and in its eyes domestic policy objectives. Having revealed its hand, it will be difficult if not impossible to go back to the previous status quo. At this point, each 'wolf-warrior' style comment from China will only harden Western public and political opinion.

Following a two-decade period of progressively tighter integration of global supply chains, the potential magnitude of this cooling of relations between the world's two superpowers on the world economy should not be underestimated, in our view. Arguably, the opening of China's labour force to the world heralded an extended period of low goods inflation and reduced the bargaining power of the developed market labour force. While demographic change also played a role, this contributed to a very long period of ever-declining long-term interest rates and high corporate profit margins, widening the gap between rich and poor and creating the conditions for populism along the way.

These are big, long-term trends for which it is not possible to put reliable quantitative estimates at this time. However, qualitatively, should the process of globalisation continue to reverse course, this immediately calls into question the very low medium-term inflation expectations currently embedded in long-term bond yields. Trade barriers create economic scale inefficiencies and improve the negotiating position of local labour, which in the longer term may create the conditions for higher prices and lower corporate profit margins.

Investors right to feel whipsawed but should look to a post-COVID future

We fully understand that investors may feel whipsawed by equity markets over the past two quarters. Prior to COVID-19, investors were positioned for a period of economic expansion in 2020. Then, following a stampede for portfolio liquidity, central banks stepped in leaving many investors rueing not participating more fully in the ensuing rally. There is in our view a strong likelihood of rising infection rates but on balance this is likely to be controlled by continued social distancing measures and regional lockdowns rather than knee-jerk national restrictions on movement. While the risk of re-imposition of extensive and widespread further lockdowns is not zero, it is not our base case. In our view, the political agenda has shifted to keeping economies open where possible. Economic activity is therefore likely to continue to improve over the remainder of 2020 with fiscal and monetary support, which balances the risks of further restrictions on higher-risk social activities such as travel, leisure and hospitality.

The freefall in markets during March stopped when central banks stepped in to act as buyers of last resort and underpinned pricing in credit markets, thus preventing a liquidity freeze such as that seen in the 2008 financial crisis. Based on previous experiences post-2009, in the absence of inflationary pressure central banks are only likely to withdraw monetary stimulus very cautiously and gradually. This is also due to the proportionally greater COVID-19 impact on the SME sector and unemployment. As a result, global equity valuations have quickly reverted to historical norms in aggregate, eliminating the 'value' opportunity briefly on offer during March and April.

This recovery in valuations is likely to cap the short-term return potential during H220. However, in the absence of a specific downside trigger we now maintain a neutral outlook on global equities. Notwithstanding the recent quarantine concerns in Europe, national economies continue to re-open and purchasing managers' survey data are on an improving trend globally. Furthermore, a vaccine programme is within sight for early 2021.

For stock market investors, it may even be time to put coronavirus to one side and assess other opportunities and risks on the horizon. We view the rapid deterioration of the US/China relationship with concern as it raises the spectre of a split in the world economy which would be highly disruptive, represents a structural break from a long period of global integration and may have major long-term implications for the direction of inflation and corporate profit margins.

We also highlight the relative performance and valuation of growth and value indices. Despite the undoubtedly attractive qualitative elements of the fastest-growing global growth stocks this is now balanced against price/book valuations that are several standard deviations above average. Current valuations appear to indicate that the merits of this segment of the stock market are now firmly embedded in current market pricing.

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