Illumination: Equity strategy and market outlook

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Global perspectives: Think in three dimensions

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- **Investors should reflect on the multidimensional nature of the recovery from COVID-19.** With the easing of lockdowns, global GDP is rebounding, but is also moving towards a rather different equilibrium compared to consensus forecasts at the start of 2020. Monetary and fiscal policy is on a completely different long-term setting. Furthermore, there is evidence of accelerated obsolescence in working practices and lifestyles.
- **While infection rates have been rising in Europe, the case fatality rate appears to be falling.** The COVID-19 pandemic also appears to be evolving into a different state, requiring a less aggressive public health response. Vaccine trials are progressing and may be reporting data by year-end. This is good news and lends weight to the idea that safe-haven assets such as gold and government bonds, in addition to the new class of 'digital defensives', may have seen their short-term high watermark.
- **2020 consensus earnings forecasts have stabilised in Europe and are rising in the US.** Despite adverse headlines in respect of quarantines and further virus control measures, incoming data have surprised to the upside in the US and Europe. Nevertheless, the most recent August purchasing managers' survey (PMI) data in Europe have been below expectations, highlighting the residual uncertainty in the outlook.
- **We maintain a neutral view on global equities given the extent of the recovery of market valuations since the lows of March but are increasingly optimistic that further national lockdowns can be avoided.** As a result, we believe it may be time to shift allocations away from the US and towards traditionally higher beta and more cyclical markets such as Europe and emerging markets.

A multidimensional recovery

Investors focused only on two-dimensional charts of the recent GDP contraction and rebound risk missing the multidimensional effects of coronavirus on economic behaviour. With the easing of lockdown, global GDP may be rebounding but is also moving towards a rather different equilibrium compared to consensus forecasts at the start of 2020. Monetary and fiscal policy is on a completely different long-term setting, while there is evidence of accelerated obsolescence in working practices and lifestyles, emphasising the shift to the digital economy. With 2020 earnings estimates now stable but market valuations up with events, we maintain a neutral outlook on global equities. However, within this view we are now more positive towards higher beta and more cyclical regions such as Europe and emerging markets, due to encouraging declines in the disease severity of the most recent wave of COVID-19 infections.

GDP data requires interpretation with care

When visualising the effect of COVID-19 on the global economy, investors should take care to look beyond two-dimensional charts of economic output against time. While the GDP rebound is clear as national lockdowns have eased, a two-dimensional analysis masks the fact that COVID-19 has driven national economies to a very different economic place compared to that originally forecast for 2020.

Foremost for asset prices, monetary policy is on a wholly different footing. Not only have short-term interest rates plunged globally but rate expectations for years ahead have remained stuck at exceptionally low levels, even after the rebound in global GDP has become evident and uncertainty has diminished. The dramatically widening output gap, as measured by unemployment and the deviation of GDP from trend gives central banks ample scope, if judged by the prior decade's reaction functions, to continue to pursue ultra-loose monetary policies.

The only constraint on policy may be the tail-risk of currency debasement, an evident fear of investors given the surge in the gold price during 2020. In the short-term however, the safe-haven bid for gold and other defensive assets may have reached its high watermark given the societal and medical progress in understanding and combating COVID-19.

The dissociation of work from its physical office location is a further step in the direction of 'virtualising' economic activities. Nevertheless, 'virtual' work, provided it is as productive, is equally valuable to the economy but may not be fully visible in national statistics. In some cases, it appears statistical quirks are quite naturally failing to capture the exceptionally rapid change in societal behaviours as a result of COVID-19. In other cases, efficiencies – such as less unnecessary commuting and use of office space are currently only evident in lower GDP. Nevertheless, higher productivity and this release of scarce resources is likely to offer scope for faster growth in future periods.

In terms of statistical quirks, if remote learning has effectively prepared students for university and the assessed examination results are a fair reflection of achievement, was there any lost output from the UK educational system as a result of COVID-19? Yet within the UK national statistics, the closure of physical school locations has been accounted as a loss of GDP and the continued employment of teachers has contributed to the surge in the GDP deflator (as costs have remained constant while the volume of output has apparently shrunk) of 7.9%.

We are not trying to argue that closing schools is an efficient way of delivering education. However, school closures certainly reduced UK GDP while remote learning (and unpaid parental support) was uncounted. In addition, there may be many more examples where the GDP contraction may have been overestimated. Increased utilisation of residential property for work purposes has not been added to GDP – while lost office rent and travel has been counted. If previously office-based workers can effectively deliver their work in a virtual environment, the expected surge in unemployment may be rather more narrowly confined to specific sectors than previously thought.

In all cases, central banks will struggle to communicate any pre-emptive tightening of monetary policy if official statistics continue to indicate a very weak outturn for GDP.

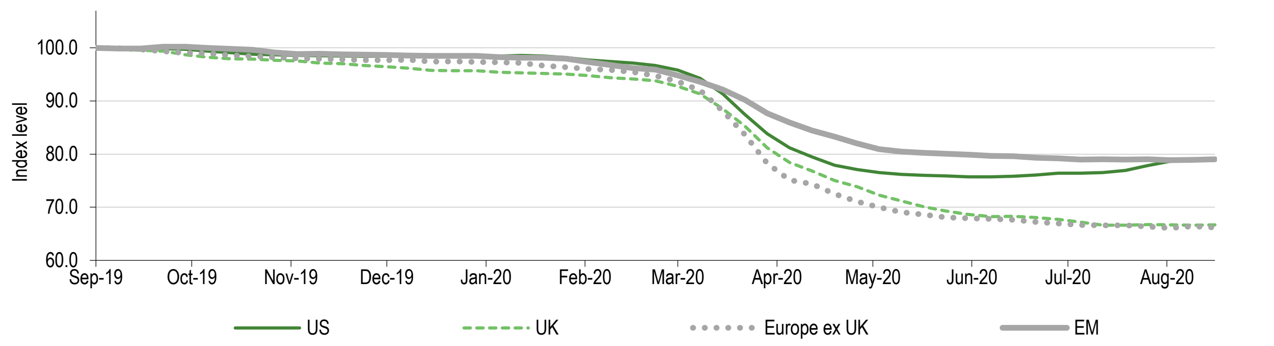
Consensus forecasts stable in Europe and rising in the US

The adverse calculation effects in terms of national accounts data also suggest that corporate profits may be more robust than would otherwise be expected, given the dramatic downturn in GDP.

We note for example that US consensus earnings forecasts have been rising since June, despite close to 40,000 new US COVID-19 cases per day and continued restrictions on social activity.

In Europe and the UK, estimates have been stable over the same period. The logic that the control measures rather than the virus itself represents the greater risk to corporate profits continues to hold true. While cases are rising, the reluctance of national governments to reimpose broad lockdowns has given markets confidence that even if there is a second wave of cases there will not necessarily be a second suppression of GDP as severe as that seen during Q220.

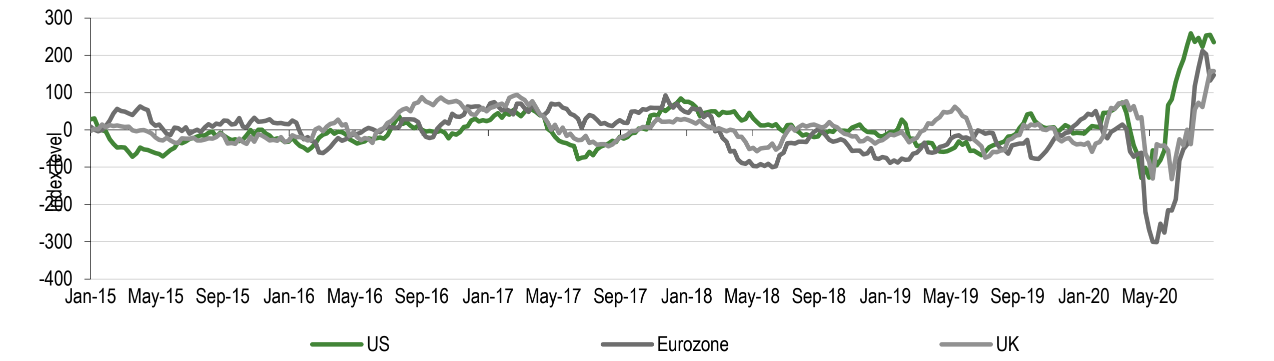
Exhibit 1: 2020 consensus forecasts stable in Europe, rising in the US



Source: Refinitiv, Edison calculations

We note that economic surprise indices, which measure the difference between incoming data and consensus expectations, have been strongly positive in recent weeks. This positive economic momentum in an environment where case rates in many developed nations remain relatively high has been a welcome development for equity investors and represents confirmation of an interim economic recovery, even as COVID-19 is yet to be clinically beaten.

Exhibit 2: Global economic surprise indices strongly positive for now



Source: Refinitiv

Nevertheless, disappointing European PMI data for August highlight the problems with predictions for a smooth recovery out of the COVID-19 crisis. In real-time, it is difficult to be sure whether recently improved activity will prove durable or, on the other hand, whether growing new orders represents one-off inventory rebuilding. Investors should in the circumstances continue to expect significant volatility in the incoming data given the leads and lags in various sectors of the economy. We also note that the reintroduction of quarantine and local lockdown measures will have been unhelpful for sentiment in recent weeks. Historically, PMI survey respondents can overreact to near-term and transient newsflow.

The US data on the other hand are more positive. Not only have PMI data come in well ahead of expectations for both the service and manufacturing sectors of the economy, but earnings forecasts are on a rising trend following the earnings season. The US infection rate also appears to have stabilised.

For equities, the backdrop of progressively improving economic data and at least stable earnings forecasts is a clear positive. However, we retain a neutral view on global equity markets for the near term as these improving fundamental factors are balanced by the sheer extent of the market recovery to date, while in Europe the second wave of infections requires careful monitoring.

The recent re-imposition of quarantine requirements within Europe demonstrates that governments are still feeling their way towards a set of minimally invasive social restrictions that will keep the COVID-19 infection rate at bay during the upcoming winter. While significant progress has been made towards a vaccine, it still appears unlikely this will become widely available prior to Q1 21. Although we view further national lockdowns as unlikely given the economic costs, European governments are likely to maintain or even extend social restrictions, given rising case rates in recent weeks.

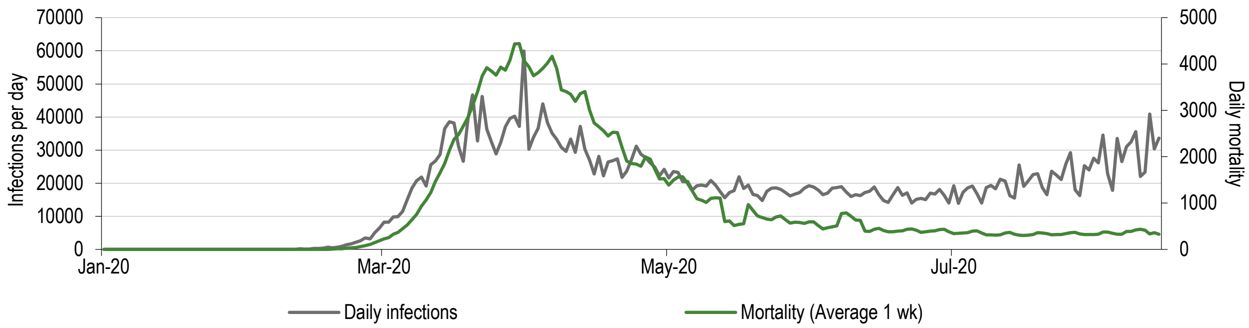
Nevertheless, given the encouraging absence of a corresponding rise in mortality following the second wave of cases, sentiment towards the hardest-hit sectors such as transport, leisure and hospitality may start to improve even if profitability is likely to remain depressed for at least the remainder of 2020.

Get back to school, back to work and muddle through

The recent rise in European COVID-19 infection rates has raised fears of a harmful second wave in the region. Quarantine restrictions have been re-introduced across Europe while regional lockdowns have been re-imposed.

However, this second wave of infections is quite different from the first. Most importantly, hospital admissions and death rates have not surged in the days and weeks following the rise in detected infections.

Exhibit 3: COVID-19 mortality has not surged with infection rates in second wave



Source: Refinitiv aggregation of European government data

We believe that this is a result of two factors. First, infections are focused on a much younger demographic compared to earlier. Second, the rapid increase in testing rates has meant the proportion of infections detected in the hospital setting, which would be expected to be severe cases, has dropped sharply. It is perhaps too early to speculate that mutations in the virus has reduced its severity. The recent rise in infections is therefore arguably not suggestive of the need to re-impose further severe national restrictions as there is insufficient threat to public health – and this is consistent with the response of national governments over the summer.

Investors should therefore take care to continue to discriminate between data which is indicative of a new public health crisis and infection rates which have relatively little consequence for the evolution of the economic recovery. A month ago it was too early to determine if the rise in new infections would lead to a similar surge in death rates but given the lag in the first infection wave was only a matter of weeks, this second wave now appears far less deadly than the first, and as a result should not give rise to a need to shut down national economies – or interrupt education systems. It is still the case that it is not the spread of the virus which is important for investors but the economic impact of public health control measures to contain it.

Furthermore, recent reports on the progress of the Oxford vaccine trial indicate that 20,000 patients have so far been recruited with the hope of sufficient data possibly being made available to regulators before the end of the year. Unsurprisingly in an election year, the current US administration appears to be exploring an emergency use authorisation for this vaccine, although the mooted timing of October still appears somewhat aggressive.

Nevertheless, the pattern of mitigation (or muddle through) with the minimum necessary restrictions on social activity followed by the relatively rapid availability of a vaccine is a scenario which should be carefully assessed by investors. If it proves increasingly likely, then a further sector rotation is likely away from technology, gold and government bonds and towards leisure, hospitality and travel where valuations remain significantly depressed.

This would also place European markets, due to the lower weighting of technology compared to the US, at something of a relative performance advantage over the remainder of 2020.

Accelerated obsolescence – but at what price?

In some respects, COVID-19 has driven an accelerated obsolescence of 20th century working practices, and most notably the presumed necessity of office-based work. In terms of consumer behaviour post-lockdown, offline retail has suffered from accelerated online spend and the reaction of major retailers to accelerate investment in online suggests this shift is expected to be permanent.

The ubiquity and continuity of digital social activity as physical social events and contact has been interrupted directly benefits the world's largest technology and media companies. These trends have also intersected with 21st century environmental concerns. Energy consumption and urban pollution levels have fallen while critical transport infrastructure is no longer full to capacity or beyond, even if urban centres have suffered a significant loss of revenue as commuter numbers have diminished.

A re-tooling in respect of hardware and software services, in order to allow working and living from home, has represented a mini-investment cycle. As a result, the global technology sector has benefited from the strongest relative earnings momentum since lockdown.

Furthermore, the rapid fall in the long-term discount rate for future earnings has disproportionately benefited a technology sector perceived by many investors to have quasi-monopoly characteristics in a number of key global markets. The resulting performance of technology this year has been remarkable and currently extended valuations do raise significant questions over the investment returns which should be rationally expected over coming years.

Much has been written over the years about the perceived over-valuation of the US equity market which has continued to outperform and defy the critics. Yet in many cases, 'value' and/or retail investors have been caught completely off-guard by the encroachment of Web 2.0 franchises into the profitability of old economy stocks, particularly those appearing to trade at a discount, with traditional retail the prime example.

Digital disruption has become a commonplace if not critical investment risk. A rising share of global profits growth has been won by US technology companies, leading to a shifting national share of the global profits pool. It may be unfortunate as it is quite arguably the result of a disciplined focus on business success, but it has had an effect sufficiently large to catch the eye of governments. Countries are now grappling with the problem of a shrinking corporate tax base as the profits of digital competitors often arise at a distance from the original, disintermediated, economic activity.

This fundamental success in profitability followed initial investor scepticism, as seasoned investors were still mindful of the outcome of the original dotcom bubble. This contributed to a technology sector outperformance which has been significant and of a long duration. Over this period, 'Web 2.0' has already become a quaint moniker for a sector which in many respects has morphed into the key driver of the US and global markets.

There remains the possibility however that what the wise person does in the beginning, the retail investor does in the end. Before COVID-19 struck, an argument could be made that the global market rally was likely to continue despite the ageing of the US economic expansion, at least until a peak in the participation of retail investors. The moment, if retail participation is a factor at all, appears to have arrived. A combination of stock market volatility, a reduction in sports betting opportunities and furlough schemes appear to have contributed to record levels of new account openings at both new and conventional brokerage firms on both sides of the Atlantic.

The performance of the US technology stocks this year is also remarkable as earnings have not rebounded significantly post COVID-19, despite the positive qualitative narrative. It may be sobering to note that the weighted average consensus earnings forecast for the NASDAQ 100 index is still 2% below its level at the start of the year while the index itself is up 34% year to date. Nor are all technology companies equal – the median consensus forecast remains down 13% since the start of the year.

The market value of the world's seven largest US digital franchises now accounts for $8trn, which is close to 10% of world GDP. For these highly valued large cap companies, an average forward P/E ratio of over 30x embeds very high expectations for at least the next five years of profits growth.

This is in a world where developed markets will record negative GDP growth this year and are likely to have failed to grow at all in the 2019–2021 period. Furthermore, as the recent spat between Epic Games and Apple has shown, the highly lucrative 30% profit margins charged by digital platforms such as Apple and Google to third-party software developers are at greater risk of shrinking rather than growing.

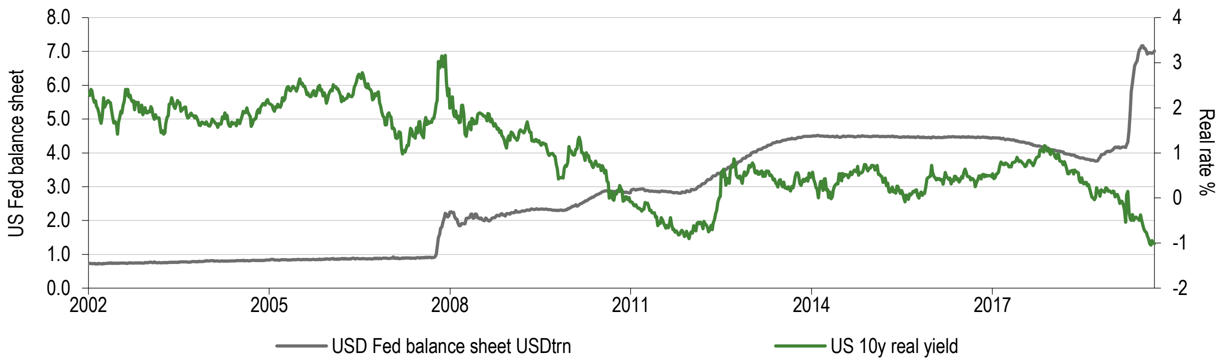
In recent years we have dispassionately viewed the rise of the technology behemoths and the relatively laissez-faire approach to antitrust regulation (in comparison to the 1990s period) on a global basis. This policy has contributed to the highly consolidated markets in key digital service segments. Despite strong share price performance, the exceptional and scale profitability of these franchises has in the past justified maintaining positions, even if to do so required projecting excess returns on capital uncomfortably far into the future at times.

At this point however, we believe the US technology sector will struggle over the medium term to grow into the very high expectations for profits growth currently implied by market valuations, which have effectively doubled in a little over one year while profit forecasts have fallen over the same period. Given the weight of this sector in US indices, this also drives our view that investors should now look towards European and emerging markets where valuations are less demanding, even if growth rates are somewhat lower.

Real rates at 25-year low and set for rebound as recovery broadens

The driver of the rapid recovery in asset prices during 2020 has been central bank intervention. In many respects the economic costs of COVID-19 have been towards the higher end of expectations in terms of their duration, impact on global GDP and corporate profits. We note that US 10-year real rates are now at 25-year lows at -1.0%. This downward trend curiously started some time before the advent of coronavirus, around October 2018, Exhibit 4, and has more recently been accentuated by the loosening of US monetary policy and the surge in central bank asset purchases earlier this year.

Exhibit 4: Real rates still close to 25-year lows – set to rise on COVID-19 recovery?



Source: Refinitiv

Central banks on both sides of the Atlantic have adamantly insisted that low interest rates will remain in place until the recovery in employment has been well established, following the impact of COVID-19. However, it is difficult to see why investors will wait quite as long to re-price long-term interest rate markets if further national lockdowns can be avoided at the same time as fiscal and monetary stimulus continues apace.

While central banks will take care to ensure that any adjustment in policy is relatively smooth rather than abrupt, a steady rise in real interest rates from current levels is in our view a natural consequence of any recovery from the COVID-19 crisis and may allow an implicit tightening of monetary conditions, thus warding off risks to financial stability (the preferred central bank code word for an asset price bubble) without an explicit change in policy.

In turn, any increase in real rates may have an impact on the pricing of sectors perceived as defensive such as bond proxies, in addition to the new class of large-cap 'digital defensives' into which investors have crowded in recent months. We continue to believe that intellectual property and quality business franchises are not attributes exclusive to the headline large-cap technology sector. Investors may in coming quarters become increasingly likely to consider the more cyclical industrials sector as COVID-19 effects diminish, where forward price/book valuations are much closer to long-term averages.

Conclusion

While infection rates have been rising in Europe, the case fatality rate appears to be falling. The COVID-19 pandemic also appears to be evolving into a different state, requiring a less aggressive public health response. Vaccine trials are progressing and may be reporting data as soon as year-end. This is good news and lends weight to the idea that safe-haven assets such as gold and government bonds, in addition to the new class of ‘digital defensives’, have likely seen their short-term high watermark.

We maintain a neutral view on global equities given the extent of the recovery of market valuations since the lows of March but are increasingly optimistic that further lockdowns can be avoided. As a result, we believe it may be time to shift allocations away from the US and towards traditionally higher beta and more cyclical markets such as Europe and emerging markets.

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