Illumination: Equity strategy and market outlook

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Global perspectives: Valuation-led downgrade

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- **Global equity and credit markets now offer relatively little risk premium for bumps on the road towards a post COVID-19 recovery.** It is remarkable at a time when much of the developed world continues to face a significant degree of COVID-19 disruption and is operating well below trend GDP that forward US price/book (P/B) multiples are at a 12-year record high and the risk premium for corporate credit risk is at cyclical low.
- **Evidence of speculative excess in pockets of the equity market.** A bumper period for equity issuance highlights the current demand for risk by investors. A surge in valuations for more speculative companies also lends weight to the idea of a bubble forming in certain sectors. We believe it is time for investors to stick to a value-based discipline as valuations for the world's fastest growing stocks have surged.
- **Vaccines offer hope but no guarantee of a return to 'normal' in the short or medium term.** The emergence of new and more contagious strains of COVID-19 highlights the new reality that despite vaccine programmes, social restrictions may be in place for rather longer than expected as recently as December. Outside developed markets vaccination has been negligible which highlights the medium-term challenges facing the travel industry.
- **Continued K-shape recovery.** COVID-19 has resulted in a step-change in the nature of economic activity. Digital economic interactions have grown and the shift towards the 21st century economic objectives of new energy and environmental protection have accelerated. These sectoral shifts should be reflected in portfolio asset allocations in our view as they are likely to persist even after the acute phase of the pandemic.
- **Global equity markets have risen since December even as the likely duration of pandemic disruption has increased.** While we started the year with a positive outlook on equities, the risk/reward balance is tilted back towards neutral. We now favour relatively COVID-secure and less cyclical sectors, preferring to accept lower expected returns for greater predictability. We remain of the view that bond yields will face upward pressure. Inflation expectations may have increased but real rates remain at record lows.

Valuations drive equity downgrade

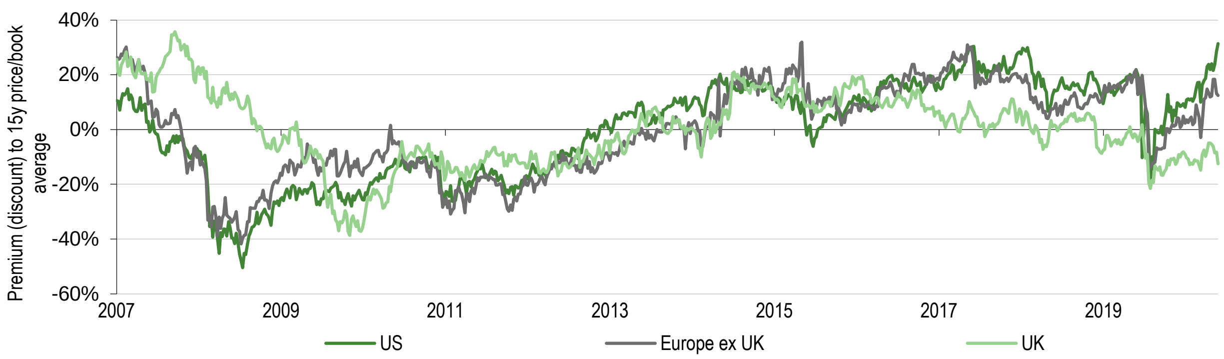
Since the turn of the year, the race between the deployment of effective vaccines and the evolution of new, more contagious variants of COVID-19 has tightened considerably. Across the US and Europe there has been a steady drift towards longer lockdown restrictions as case numbers and hospital admissions have remained stubbornly high. For the listed corporate sector there is still a significant degree of cushioning provided by fiscal support for demand and the ability of larger companies to continue to operate under COVID-secure protocols compared to the SME sector. This cushioning has contributed to the resilience of 2021 consensus earnings forecasts despite the extended lockdowns now in place.

Due to the recent resilience of corporate earnings, in our view the risk is growing of a mis-placed confidence that the second wave of COVID-19 will represent the end of the affair. A more likely scenario at this time is that social restrictions will be removed only slowly across developed markets during 2021. Furthermore, international travel will remain significantly impeded by requirements for quarantine, regardless of vaccination or test status. Outside developed markets, vaccination programmes are moving only slowly. While it is easy to state that on the projected vaccination programme delivery much of the developed world will have received immunity by late 2021, this does not mean that social restrictions can be fully lifted.

For example, the extent to which vaccination prevents asymptomatic transmission is not well understood as confidence intervals in existing trials are large and further studies are necessary. The enhanced reproduction rates for new variants of COVID-19 point to very demanding levels of vaccination of 80% or more before social restrictions could be fully removed. Given the transmissibility of new variants, COVID-19 appears unlikely to be eradicated at this stage. The prospect of new variants in unvaccinated populations in developing nations may require an ongoing annual vaccination programme, similar to that of influenza.

Despite this scenario of an enduring impact from COVID-19, the global appetite for risk assets has only strengthened. In our view this tilts the overall equity risk/reward balance back to neutral from the positive outlook we expressed at the turn of the year. We note that market P/B valuations in the US are now at 12-year highs while continental European valuations have seen a full recovery from the sharp declines at the early stages of the pandemic, Exhibit 1. We note that UK markets still languish some way below their 15-year price/book average due in part to the years of uncertainty created by Brexit.

Exhibit 1: Forward P/B for developed markets



Source: Refinitiv, Edison calculations

Within corporate credit markets the impact of central bank policy and the fiscal support for the economy has been clearly felt. Policies designed to prevent a credit freeze have resulted in credit risk premia, as represented by the difference in yield between risky and risk-free bonds, narrowing back to 15-year lows. This is a remarkable feat at a time of such economic uncertainty, especially given the increasing levels of leverage within the corporate sector in recent years.

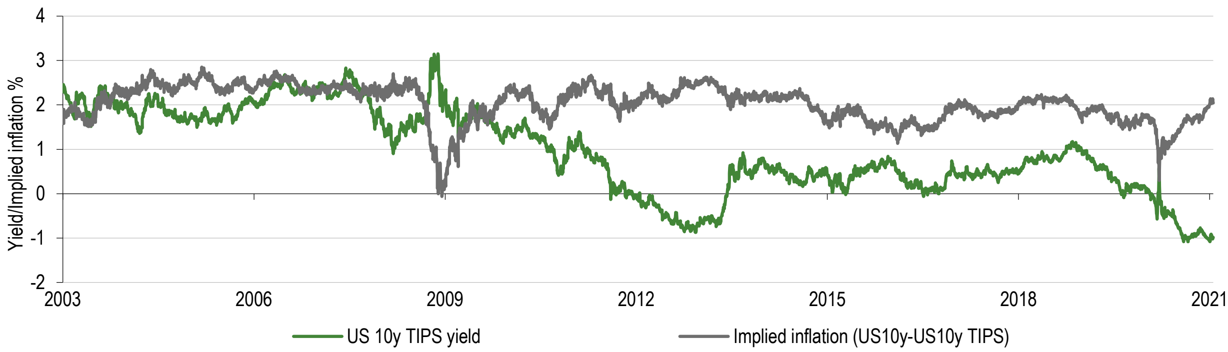
Exhibit 2: Investment-grade corporate credit spreads remain close to cycle lows

Source: Refinitiv

Recent evidence of speculative activity in markets, such as outsize gains for early stage or unprofitable US technology companies, highlights the turn in sentiment since the investor panic of Q120. For years during the long US bull market, investors have been comforted by the relative absence of retail investors as a sign that markets had not yet peaked. Since the pandemic there has been something of an explosion in retail trading, as evidenced by the number of small lots being traded in US markets, and the surprising performance of more speculative securities.

With both equity and credit markets buoyant, if not effervescent at times, further stimulus from central banks remains unlikely in the short term. We note that commodity prices have been rising sharply and inflation expectations have also rebounded sharply over the past six months. Without wishing to naively interpret central banks' mandates, policies put in place over the past year could, on the face of it, represent a wholly successful monetary intervention in respect of maintaining inflation expectations and nothing further would be required.

Exhibit 3: US 10-year real rates remain low as market-implied inflation expectations increase



Source: Refinitiv. Note: TIPS = Treasury Inflation Protected Securities.

Therefore, we are not expecting further monetary fireworks at this point. In contrast, attention is likely to turn to the spill-over effects in asset prices. We note China's interbank rates rose from 2.5% to 2.8% this week as an adviser to the PBOC gave a public warning of the risk of asset bubbles if monetary policy is not tightened during 2021. Furthermore, fiscal policy responses are old news in Europe and US President Biden's headline $1.9trn stimulus package is likely to be watered down before being approved. While the willingness of governments to spend has been crucial to maintaining market sentiment to date, we also therefore see little further upside from fiscal policy in the short term.

Equity valuations: Overvaluation concentrated in fastest growing sectors

The recent warnings given by a number of prominent investors on extended equity valuations would carry greater weight were it not for the fact that since 2009 bearish equity investors have been repeatedly stymied by never-ending reductions in global interest rates and the ensuing prolongations of the economic cycle. It has been described as the most unloved bull market, in part because even pre COVID-19 it was happening for the 'wrong' reasons.

Revenue growth rates for the global markets in aggregate have been sluggish while EPS growth has at times been driven as much by financial engineering in the form of share buybacks as it has from growth in net income. Market performance has also been skewed towards a relatively narrow segment of the overall stock market, to the detriment of the generalist active manager.

Now, the surge in digital growth stocks in the most recent 12 months places another question mark over the actual value added by active value managers. The top-performing fund managers today are those who have continued to ride technology stocks to ever higher multiples or even invested in alternative digital assets such as Bitcoin. Ironically, coal miners may be out of favour from an environmental, social and governance (ESG) perspective, but highly energy consumptive Bitcoin miners appear to be exempt from such considerations.

For experienced investors who can remember periods of euphoria such as the stock market bubble of 2000 or the mortgage finance bubble of 2007, valuation alarm bells are ringing. The Nasdaq index was up over 40% in both 1999 and 2020 – and arguably for similar reasons. Central banks, which were in the process of removing the punch bowl as recently as 2019, have quickly reversed course and added a stronger brew in response to COVID-19. The bogeyman may be different – it was the millennium bug in 2000 – but the result has been the same. Loose monetary policy applied to the broad economy at the same time as a surge in spending on technology services has seen technology stocks rocket.

Historically, value has mattered. Periods in which US share prices were at a relatively low multiple of book value or alternatively 10-year trailing average earnings have been followed by the strongest 10-year returns. The quartile return ranking from the Shiller 10-year P/E for US equities is well known and accords with the intuitive result that investing at low valuations offers better returns than investing at high valuations. With the current Shiller P/E for US equities firmly in the top quartile, the measure currently indicates a relatively sluggish period for US equities in the decade ahead.

Collectively, this fact is both known and understood by institutional investors. However, institutional fund managers are also presented with few attractive alternatives at present. 10-year government bonds are priced to lock-in losses in real terms, if central banks can make good on their inflation targets. There is also a risk that the Rubicon of fiscal sustainability has been decisively crossed as there has been no substantive political opposition to a worldwide deficit spending spree in response to COVID-19. This fiscal determination to support the economy may have rescued equities and corporate credit, yet current government bond yields still offer a derisory risk premium for any unanticipated uptick in inflation in coming years.

The question of over-valuation should also not be over-simplified. Splitting the largest 2,000 global companies into revenue growth quartiles confirms that the surge in P/B valuations over the past year is concentrated in the highest growth segments of the market, Exhibit 4. We also find that valuations for these faster growing companies have been expanding since 2014, lending credence to the idea that a degree of complacency could now be setting in. Valuations for faster growing companies have not mattered for over six years. Furthermore, we can see a notable further increase in P/B valuations for the very fastest growing 10% of global equities (D10).

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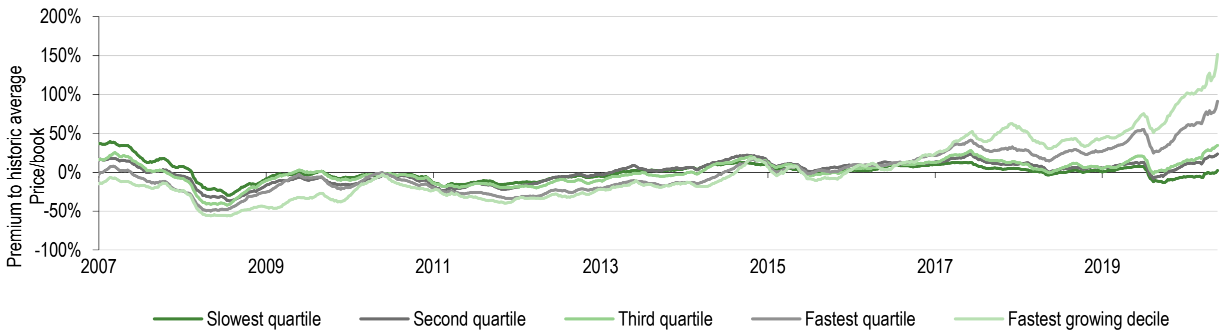
Exhibit 4: Valuations for faster growing companies have surged



Source: Refinitiv, Edison calculations. Note: Chart shows forward P/B premium by growth quartile for world's largest 2000 companies

Outside these segments we observe that slower growing companies may be trading above their 10-year P/B multiple, but not excessively so. With corporate profits underwritten by fiscal policies and markets supported by ample liquidity, it is quite possible to argue this is precisely what should be expected at this stage in the pandemic and as vaccination programmes get underway. Therefore, framing the question of valuation in binary terms, such as all-in versus sell everything, may make for good headlines and stimulate trading activity but in our view, it provides the wrong context for long-term decision making.

The data suggest to us that outside the fastest growing segments of the market, long-term investors are balancing the low yields available on risk-free securities with genuine inflation uncertainty and the timing of the likely exit from COVID-19 social restrictions.

Current modestly higher than average valuations for 'normal' rather than 'super-normal' companies point to investors consciously accepting lower than average return expectations for equities at present. If so, this is a recipe for an equity market to move sideways rather than face any dramatic reversal, provided central banks do not remove the punch bowl too soon. In addition, new strains of coronavirus must not challenge the consensus that the economic impact of the pandemic will fade by mid-2021.

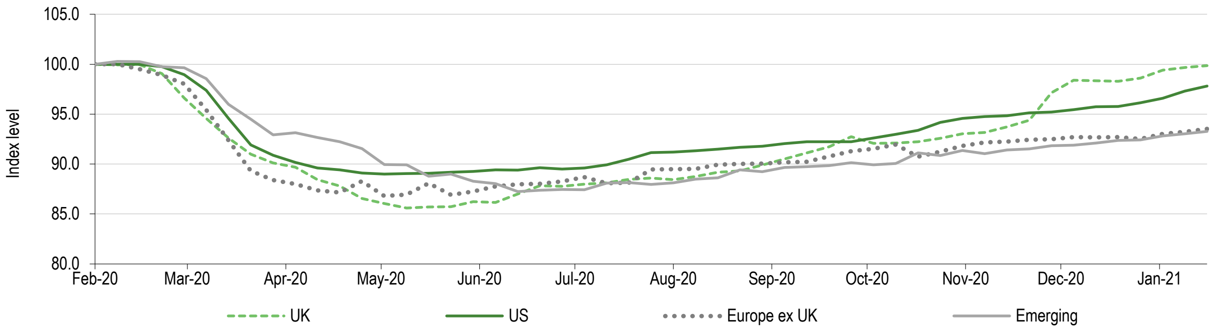
An additional strategic overlay that investors now must contend with is the K-shape recovery. The digital economy has on an earnings basis dramatically outperformed the remainder of the stock market during the pandemic and this is likely to continue during 2021, should social restrictions continue as we expect. This is the upper arm of the 'K' while the lower leg, such as traditional retail, travel, leisure and entertainment may continue to struggle.

While we are not expecting a major reversal in sentiment, valuations for the world's fastest growing companies are at 10-year highs, relative to the other 75% of the market. We believe investors should now carefully review their holdings in this segment of the market with a view to taking profits. Nevertheless, for the remainder of the market the data suggest the argument for running for the hills with bond yields at such low levels has less merit. Instead, investors should carefully consider which leg of the 'K' their investments fall under as the economy slowly emerges from the pandemic.

Profits forecast still robust as COVID-19 rages

While we are shifting from a positive to neutral outlook on global equities, this should not distract investors from the resilience of corporate sector profitability. Despite the re-introduction or extended duration of significant social and travel restrictions, consensus profits forecasts for 2021 have remained robust even as we note the recent softening of PMI indices in Europe. There may be concerns about valuations in certain sectors, given the remarkable central bank-driven rally during 2020, but for now corporate fundamentals in aggregate remain strong.

Exhibit 5: Global earnings estimates for 2021 close to pre COVID-19 levels



Source: Refinitiv, Edison calculations. Note: Weighted data to 26 January 2021.

In view of the recent rise in infections, we have continued to track earnings estimates on a global basis as the collapse in 2020 profits forecasts during Q120 was the key driver for the stock market declines in that period. During this second wave, consensus earnings forecasts have been surprisingly resilient. Global profits estimates for 2021 are now close to pre COVID-19 levels and this optimism has not dimmed even where significant restrictions have been re-imposed, such as in the EU and the UK.

Outside certain sectors such as leisure and entertainment, it seems corporate profits have proved increasingly COVID-secure. Last year's question over where the costs of coronavirus will fall appear to have been decided – and that is not at the feet of large companies but instead in the SME sector and on government balance sheets. Nevertheless, given the stubbornness of the second COVID-19 wave it appears there are still significant challenges to a return to business as usual, leaving us to wonder if investors are a little ahead of the actual evolution of events on the ground in the hotel and travel sectors.

Conclusion

We believe the risk/reward for global equities now only justifies a neutral position on valuation grounds. It is remarkable in many respects that we would downgrade equities on a valuation basis at a time when much of the developed world continues to face a significant degree of COVID-19 disruption and is operating well below trend GDP. Nevertheless, since our last outlook global equity indices have risen while at the same time new, more transmissible variants of COVID-19 have been discovered and the probability of a long period of disruptive social restrictions extending well into 2021 has increased.

With the fastest-growing companies trading at record-high valuations, investors should in our view focus on companies that meet traditional valuation criteria but are also on the right arm of the 'K' shaped recovery. This includes companies that may be slower growing but as importantly, are not struggling. We understand this may narrow the universe of potential investments, but it is in our view important to remain focused on growth, where it can be obtained at a reasonable price.

In terms of government bonds, the still ultra-low real rate on offer highlights that the bond market has still not bought into the recovery while inflation expectations have risen. We expect further upward pressure on yields during 2021 and would remain underweight.

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