Illumination: Equity strategy and market outlook

February 2021

Published by Edison Investment Research

Global perspectives: Value rotation

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- **Global markets have hesitated as yields on government bonds rise from ultra-low levels as economic recovery beckons.** It remains an unusual market environment with a number of the high-profile distortions arguably introduced by the resurgence in retail trading and ultra-low interest rates. However, we believe 'value' is poised for a recovery over recently outperforming growth stocks as lockdowns in developed markets are released.
- **The valuation excursion for the fastest growing stocks has been extraordinary**. These valuations are now at risk of mean-reverting as yields increase on long-term bonds. Relative earnings momentum is starting to favour the real economy as upgrades become concentrated in traditional sectors such as oil, mining and banks.
- **We remain neutral on equities as attention turns to a sector rotation from growth towards value**. Such a rotation is by nature offsetting and unlikely to push global equity indices significantly higher in aggregate in the short term. However, with positive earnings momentum continuing the conditions are also not in place for a large equity market drawdown.
- **We remain of the view that global bond yields are likely to face continued but steady upward pressure**. Nominal yields may have risen during February but the still ultra-low 10-year real rate on offer suggests that should the recovery broaden as we expect, then government bond markets are likely to remain under pressure and we remain underweight.

Rotating to value as COVID-19 cases decline

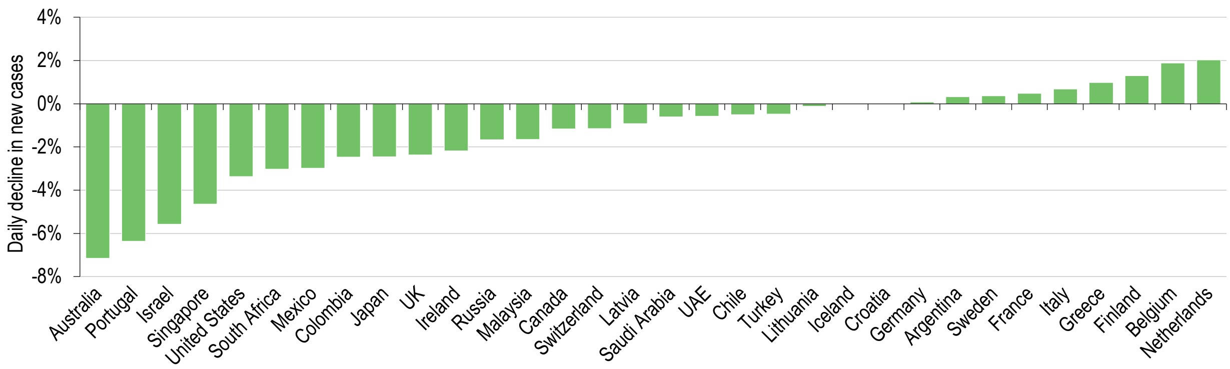
Global markets have hesitated as ultra-low yields on government bonds have risen just as economic recovery beckons. Rising yields should hardly have been a surprise to investors given the consensus assumption that the world would record a strong economic recovery in 2021. We believe there is a rotation to value sectors underway. This is in part due to a shifting pattern of earnings upgrades and in part due to a striking overshoot in valuations of the world's fastest growing companies.

Provided the trajectory is not overly steep, rising real or nominal yields are unlikely to derail the nascent economic recovery. On the contrary, the primary restraint on economic recovery is government-imposed restrictions on social activity rather than the cost or availability of credit. Social restrictions are on track to be progressively relaxed over the coming quarter as new COVID-19 infections are falling in all major economic regions.

We are encouraged by the recent data on vaccines from an economic perspective, even if the goalposts have been quietly shifted from the original aim of achieving herd immunity. In the UK, data now show vaccinated individuals have an approximately 90% reduced risk of a severe case of COVID-19. While some would have preferred the original goal of immunity rather than protection from a severe case, governments are likely to quickly ease lockdown restrictions as pressure on healthcare provision declines. From the start of the pandemic, for investors it has been the economic impact of public health measures rather than the virus itself that has held greater importance.

At this stage we have increased confidence that a progressive relaxation of developed market lockdowns may be permanent. The aim of governments is to have a sufficient percentage of the population vaccinated so that no further lockdowns are required. Some countries have already made significant progress in this endeavour while EU nations are likely to catch up in coming months. We believe this development is likely to change the sector leadership within global equity markets over the course of 2021 towards the real economy and away from the digital themes which performed so strongly in 2020.

Exhibit 1: COVID-19 cases declining in most major markets



Source: Our World in Data. Chart shows daily percentage rate of decline in new infections averaged over past seven days.

Growth stocks expensive relative to history

Despite a marked underperformance of 'value' indices in recent years, the value investment discipline should remain at the core of investors' processes in our view. The confluence of a range of factors positive for higher growth stocks have driven an extraordinary outperformance of this segment of the market in recent years. However, growth valuations now appear stretched and fundamentals are favouring more traditional sectors of the market.

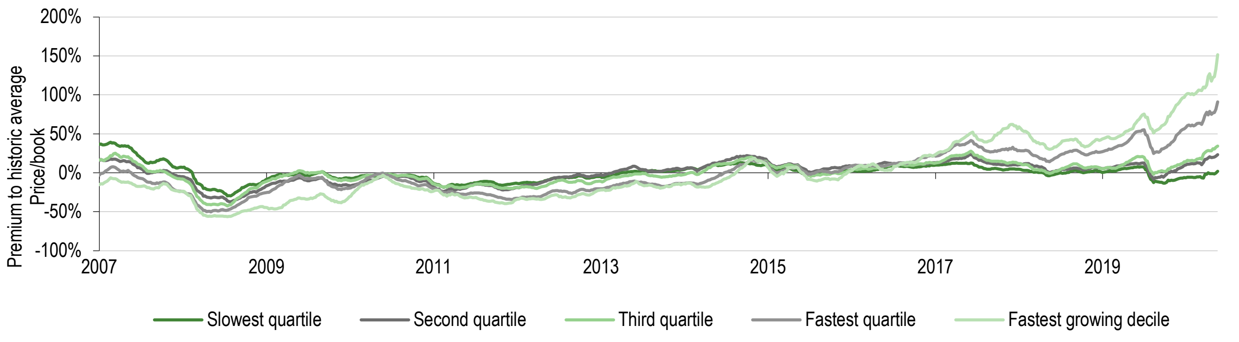
The emotional discipline and diligence required in value investing has been rewarded in practice, but only over the much longer term as historically a bias to owning securities at lower valuation multiples has resulted in stronger returns. The most prominent example of this is the US, where we see that since the 1880s investing in the S&P 500 has been significantly more profitable if shares are bought at the lowest valuation decile on a cyclically adjusted P/E basis. Currently the S&P 500 cyclically adjusted P/E is 34x, as high as at any time outside the original dot-com boom.

Resistance to the value investing style has grown following the recent long period of outperformance of growth versus value indices, discrediting the approach in the eyes of at least some investors. The outperformance of growth is also a key factor behind the relative underperformance of UK markets since 2017. The UK might have faced Brexit uncertainty but it also has a value-heavy sector weighting in its largest indices. The global underperformance of value following the Brexit referendum has therefore cast a further shadow onto the UK market relative to developed market peers.

Growth stock outperformance has been driven by several factors over the past year. COVID-19 created a perfect tailwind for e-commerce but by its nature is a one-off and hopefully unlikely to be repeated in the foreseeable future. Nevertheless, 'value' investors must accept the very recent outperformance of growth has some fundamental support from a relatively better earnings performance of digital and technology sectors during the pandemic. COVID-19 induced an accelerated transition to the digital economy.

COVID-19 has also triggered a quite extraordinary yet temporary surge in monetary and fiscal support for the economy. This has driven real interest rates to record lows, reducing discount rates for profits expected a long way into the future.

Exhibit 2: Growth stock valuations have surged post 2018



Source: Refinitiv, Edison calculations

In combination, these two factors have led to an extraordinary surge in growth stock valuations, which based on the history of stock market bubbles we expect to revert to more normal levels over time, Exhibit 2. We note that the fastest growing quartile of the world's listed equities are trading close to a 100% premium to longer-run average multiples of forward price/book.

Therefore, while for much of the past decade it was the delivery of profits that drove the performance of growth stocks, a significant re-rating relative to value has occurred since 2019 and is the focus of our concern. Until this point, the differentials between the valuations for each segment of the market had been comparatively stable.

Return to normality favours physical over digital

As vaccines bring the developed world into a post COVID-19 mode by H221 and as economies continue to recover, real interest rates are likely to continue to rise steadily from their recent record low levels. We do not expect this process to be disruptive to markets as central banks will be keen to reinforce their message that there is no hurry to step back from accommodative policies until the recovery has broadened sufficiently.

We acknowledge there is for now a modest risk, given the rapid rise in commodity prices during the past six months, that inflation numbers will change the direction of monetary policy sooner. However, we believe based on the recent behaviour of the US Fed and European Central Bank (ECB) that this uptick will be dismissed as only a transient pick-up in prices.

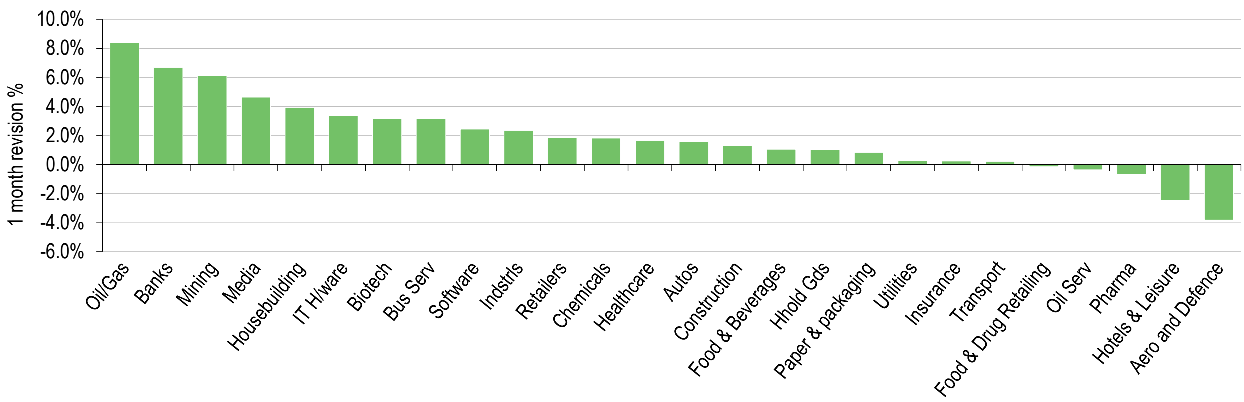
A period of rising long-term rates should favour value over growth indices as near-term cashflow becomes worth proportionately more. Furthermore, value-driven markets such as the UK would be expected to outperform in this scenario.

Separately to monetary conditions, a further boost for physical businesses is that there has been a savings boom among consumers in the UK and US. As both incumbent governments have indicated they are unlikely to swing back to austerity and will at least maintain current levels of spending until the recovery is well underway, a significant fraction of these savings may find their way back into consumer spending.

Therefore, while the growth of the digital economy is unlikely to be fully reversed, later this year the consumer may switch back to the physical economy, catching up on discretionary spending which involves face-to-face social interaction whether eating out, entertainment or holiday travel.

A pause in the digitisation trend and some challenging comparables could therefore mean relative earnings momentum could even favour value over growth for the remainder of 2021. The long recovery in consensus earnings expectations has continued during February and we note that from a sector perspective the largest US upgrades have been in the traditional sectors of oil, banks, mining and media during the past month, Exhibit 3.

Exhibit 3: Value sectors now driving US upgrades to 2021 forecasts

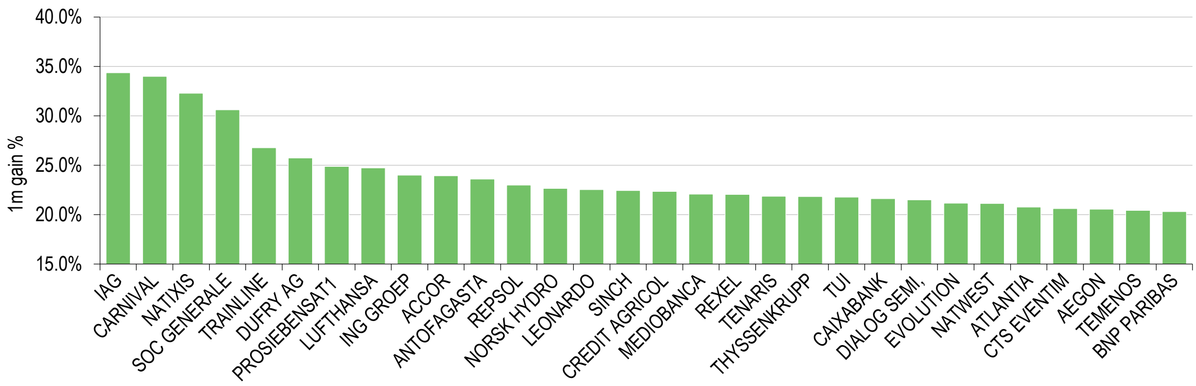


Source: Refinitiv, Edison calculations

US earnings forecasts for 2021 have now recovered all of their COVID-19 related declines while 2021 forecasts for Europe and the UK are within 5% of their pre COVID-19 levels. This is testament to the continued support provided by governments during the pandemic and more recently the recovery in energy and commodity markets has provided a further lift to forecasts.

Investors are now catching onto this trend of value over growth; we note that over the past month the list of the top performing European equities is populated with travel, leisure and bank stocks, which are benefiting from the prospect of a relaxation of COVID-19 restrictions and a normalisation of interest rates.

Exhibit 4: One-month STOXX 600 leaders dominated by travel, leisure and banks



Source: Refinitiv to 23 February 2021

Conclusion

We remain neutral on equities as attention turns to a sector rotation from growth towards value as the possibly final COVID-19 lockdowns are progressively relaxed and vaccination becomes the first choice for managing the pandemic. The offsetting nature of this rotation may have relatively limited impact on global equity indices in aggregate.

We believe growth stock valuations are now a concern as relative earnings momentum shifts back towards more traditional sectors. In this still unusual market environment, we think investors are better off focused on companies that have a future but also meet normal investment criteria for valuation and shareholder returns.

We remain of the view that government bond yields will continue to face upward pressure, although volatile surges are likely to face central bank jawboning to keep interest rate expectations in check, as seen in recent days from the US Fed and ECB. Real yields may have risen modestly during February but the still ultra-low real rate on offer suggests that as the recovery gains traction, the bond market is likely to remain under pressure and we remain underweight.

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