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Illumination: Equity strategy and market outlook

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Global perspectives: Halting (but) progress

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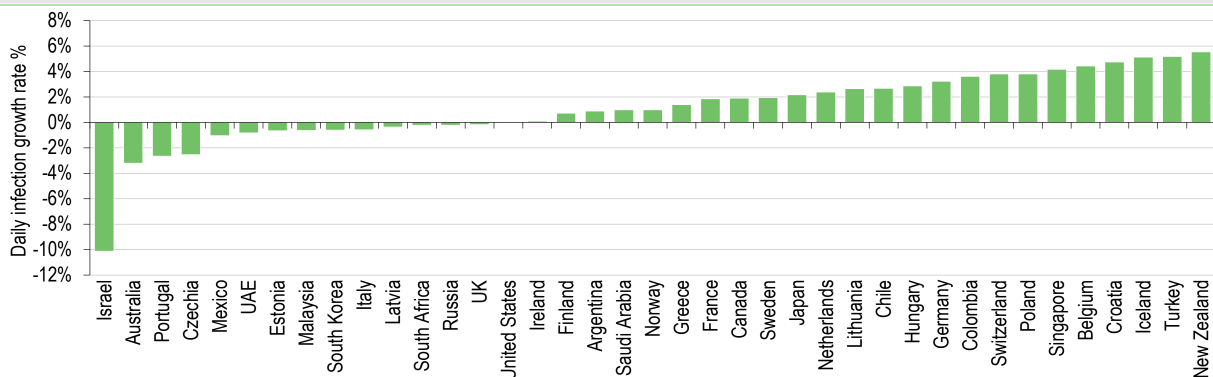
- **The prospect of further lockdowns in continental Europe has put the equity 're-opening trade' on pause.** With such a slow pace of vaccination, the region was increasingly vulnerable to a third wave as new more infectious variants gained traction. A third wave would postpone the final recovery from COVID-19 and could have a notable impact on international travel and tourism over the summer.
- **In contrast, where nations such as the UK have pushed ahead aggressively with vaccination programmes, they are reaping the benefits.** While we expect the decline in UK case numbers to moderate as lockdown restrictions are released, a third surge in cases is much less likely. The UK has vaccinated over 40% of the population and a significant additional percentage have antibodies from naturally acquired infection.
- **Rising yields on US government bonds have caused angst in recent weeks but should not unduly worry the value investor.** Increases in US bond yields are a corollary of recovery. The US Fed has only recently made it clear that hikes in US interest rates are unlikely until the beginning of 2023 and asset purchases will remain at current levels perhaps until 2022. These accommodative financial conditions are likely to maintain lower than usual risk premia on equities. Furthermore, consensus earnings forecasts remain on an upward trend on a global basis.
- **We remain neutral on global equities as the ongoing earnings recovery is balanced by relatively high market valuations**. We continue to believe that value sectors are likely to outperform this year, despite the recent bump in the road. The EU vaccination delays are unfortunate but temporary and there is clear potential for a catch-up to US and UK inoculation levels in only a matter of months.

Halting (but) progress

The prospect of further lockdowns in continental Europe has put the equity 're-opening trade' on pause, at least for the short term. With such a slow pace of vaccination, the region was increasingly vulnerable to a third wave as new, more infectious variants gained traction. This will postpone the final recovery from COVID-19 in Europe with a notable impact on international travel and tourism over the summer.

However, we believe that these developments represent a temporary bump in the road. They are also a reminder of the outstanding uncertainties in the evolution of the global pandemic. The headlines may be dominated by vaccine diplomacy, or the lack of it, at present but supply issues are highly likely to be resolved over coming months. Furthermore, the resurgence in infections in continental Europe may press home the importance of vaccination where there has been a greater degree of local resistance to the programmes. For longer-term investors, we believe the re-opening of trade, which overlaps to a large degree with an overweight position in value sectors, remains the correct positioning.

Exhibit 1: Case numbers re-accelerating in Europe



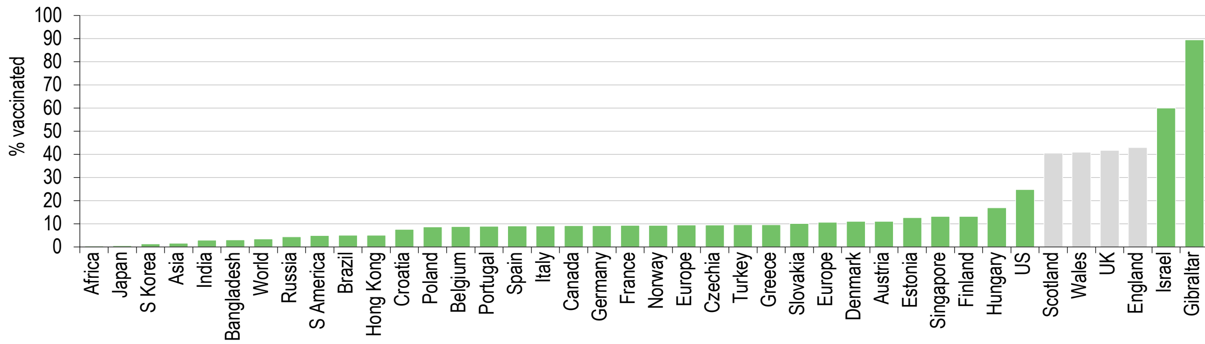
Source: Our World In Data, government statistics. Note: 10-day average case number growth as of 25 March 2021.

UK: The value of vaccination

The UK economy has faced a perfect storm over the past 18 months as the political distraction of Brexit overlapped a very serious COVID-19 crisis. Following a poorly informed initial response, the UK government has pushed ahead with a world-leading vaccination programme and looks set to emerge from the pandemic towards the head of the pack. We believe that as social distancing and lockdowns give way to social spending, the domestic leisure, entertainment and travel sectors are set for an earnings-based recovery.

The announcements for England in February provided a timetable for the easing of restrictions out of the pandemic which the other devolved nations are likely to follow. Infection rates continue to fall in the UK and encouraging vaccination data suggest a high degree of protection from hospitalisation with COVID-19. The UK has been one of the quickest nations to vaccinate with over 40% of the population having received at least one jab, Exhibit 2. While not at the levels required to ensure herd immunity, with a further 15% of the population having naturally acquired antibodies there is some scope for the current lockdown to be the last if the relaxation schedule is properly managed.

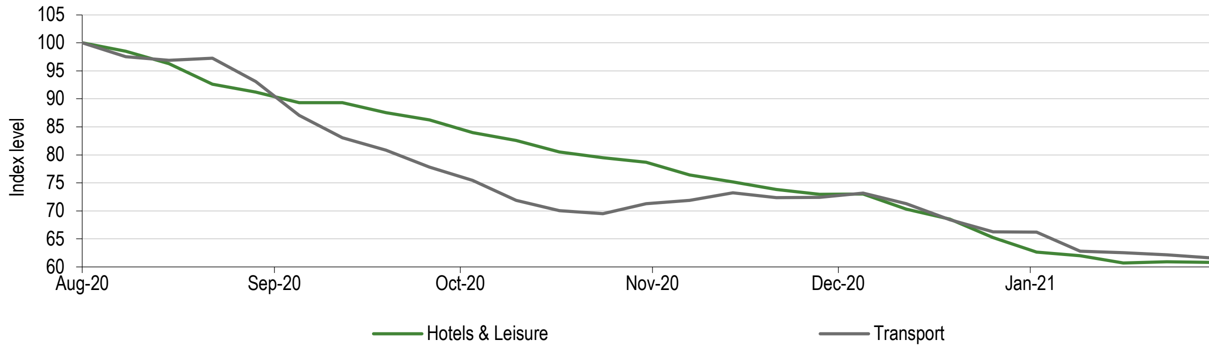
Exhibit 2: UK towards the head of the pack in vaccinations



Source: Our World In Data, government statistics

In the UK, schools have re-opened during March while non-essential retail is expected to re-open in April. Pubs, bars and restaurants are likely to re-open in May, albeit with social distancing measures remaining in place. Restrictions on the tourism sector may be lifted in June. International travel remains uncertain for the summer, depending on the development of vaccination certificates and also significant further progress in vaccination rates in continental Europe, which has lagged the UK markedly. By the end of this year, we expect the advent of the second generation of vaccines, which provide protection against a wide variety of variants of COVID-19, which could bring into prospect a progressive return to normality for international travel.

Exhibit 3: Second lockdown drove 2021 consensus estimates lower for UK transport and leisure

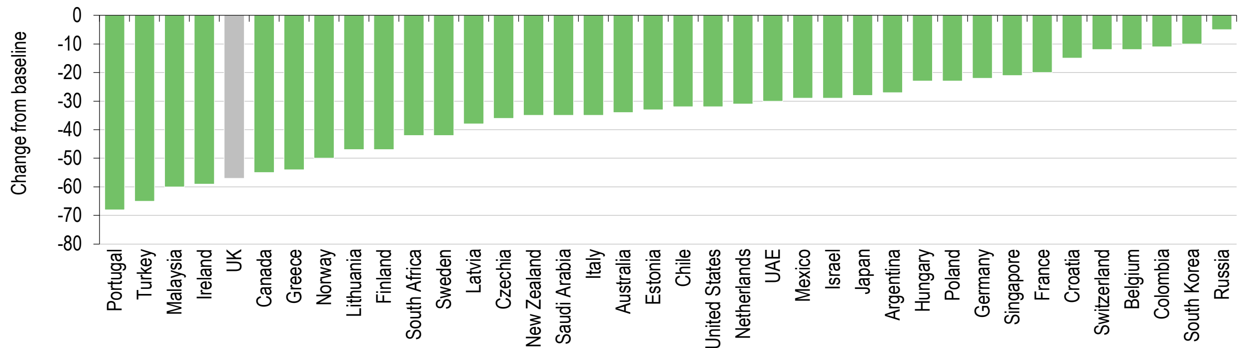


Source: Refinitiv, Edison Investment Research calculations

Despite the prospect of a domestic recovery during the second half of 2021, the second wave of lockdowns has hit UK consensus earnings forecasts in the most exposed sectors hard. In the transport, hotels and leisure sectors earnings forecasts have fallen by more than one-third since September to date. Only in recent weeks have earnings forecasts stabilised, Exhibit 3.

Google mobility data, Exhibit 4, shows that until very recently the UK was under one of the more draconian lockdown regimes on a global basis. Transport hubs are operating at a small fraction of normal levels, in sharp contrast to many other nations similarly dealing with COVID-19. Retail and recreation usage is also highly depressed on an international comparison, suggesting the scope for a large bounce-back in profitability once restrictions have been lifted.

Exhibit 4: UK mobility has been highly restricted in an international context

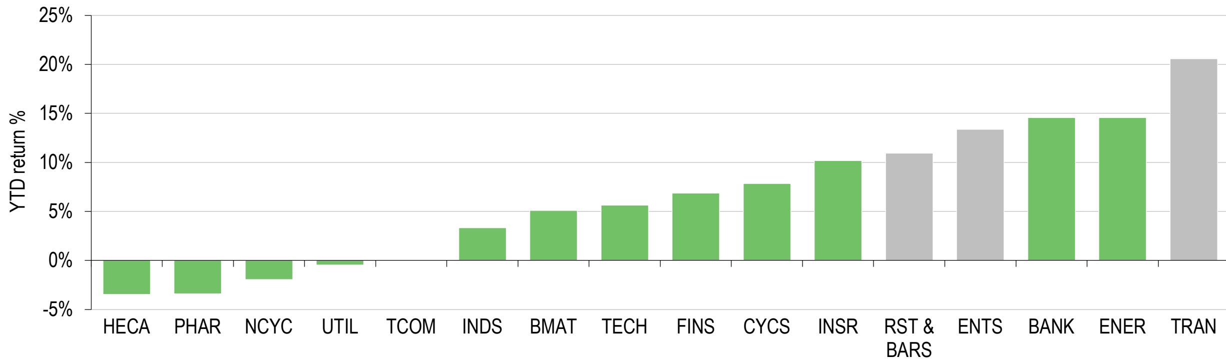


Source: Google LLC 'Google COVID-19 Community Mobility Reports', 1 March 2021

Therefore, since the start of 2021, investors appear to have looked through these downgrades and poor, near-term trading. Year-to-date, the UK's domestic leisure and travel sectors have delivered some of the strongest price performances, Exhibit 5. Defensive sectors have lagged in comparison. There is clearly some risk in this combination of rising prices and earnings downgrades, which represents a substantial vote of confidence in a rebound in earnings beyond 2021.

However, the fact that the UK has pushed ahead with its vaccination programme provides significant comfort for investors that rather than going out on a limb they are instead getting ahead of a substantial improvement in operating performance later in the year.

Exhibit 5: UK transport, leisure and entertainment have outperformed ytd

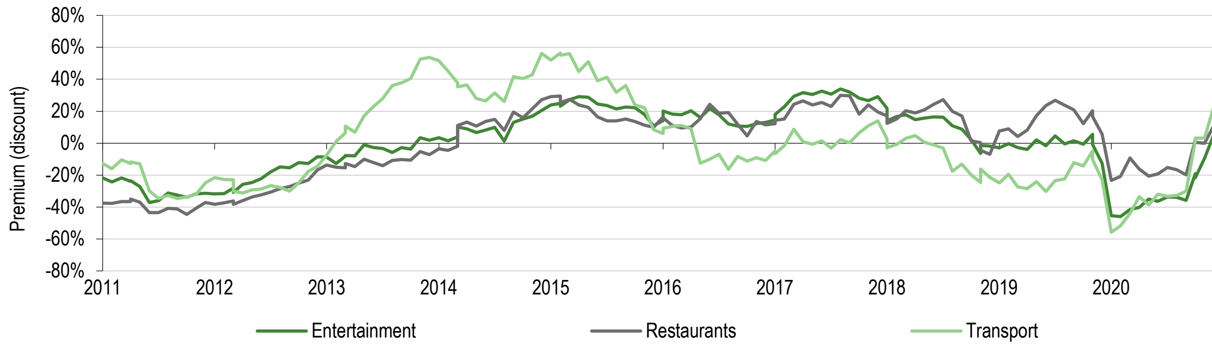


Source: Refinitiv. Note: Returns shown in GBP as of 24 March 2021. NCYC/CYCS = non-cyclical/cyclical sectors.

With the end of lockdown in sight, the focus is shifting away from questioning the strength of company balance sheets and instead looking towards the earnings recovery in 2022. However, funding remains an important risk given the ongoing uncertainty over the timing of the reopening of the hospitality industry – just as recent events in continental Europe have demonstrated.

For any investment in the equity 're-opening trade', in our view balance sheets must be sufficiently robust to bear the costs of a further six months of weak trading with a contingency for further delays. On the other hand, the larger listed leisure companies are comparatively well placed to not only recover lost profitability but also gain access to opportunities where weaker and smaller competitors have failed during the pandemic.

Exhibit 6: UK price/book valuations have rebounded from 10-year lows



Source: Refinitiv, Edison Investment Research calculations

In terms of valuations, investors have been swift to recognise the potential for recovery as forward price/book valuations for the UK transport and entertainment sectors are at, or in the case of transport even above, long-term averages. Nevertheless, there are currently relatively few segments of the global stock market which trade close to long-term fair value and meet traditional value investment criteria, yet still have very strong earnings growth ahead.

Therefore, as it is no longer the case that valuations are highly discounted, instead the theme must be that of ongoing positive earnings momentum. We believe investors will be continuing to add exposure to this earnings recovery on any retracement. The companies with the strongest performance are likely to be those that can take advantage of the new trading environment, putting themselves in an improved competitive position compared to before the pandemic.

Rising US bond yields? Value investors have little to fear

We have maintained our underweight view on US government bonds since yields fell during the onset of the COVID-19 pandemic. From our perspective, it seemed relatively clear the monetary policy response to the pandemic and depression in US GDP would be large but ultimately transitory.

Consequently, it would have been counterintuitive not to expect a rebound to higher rates of interest on risk-free government bonds as the global economy recovered. Yet even as we see US rates making an orderly retracement away from record lows, we are struck by the angst this is causing in global markets. In our view, rising interest rates should not of themselves be a cause for alarm.

Exhibit 7: 10-year US government bond yields back to pre-COVID levels

Source: Refinitiv

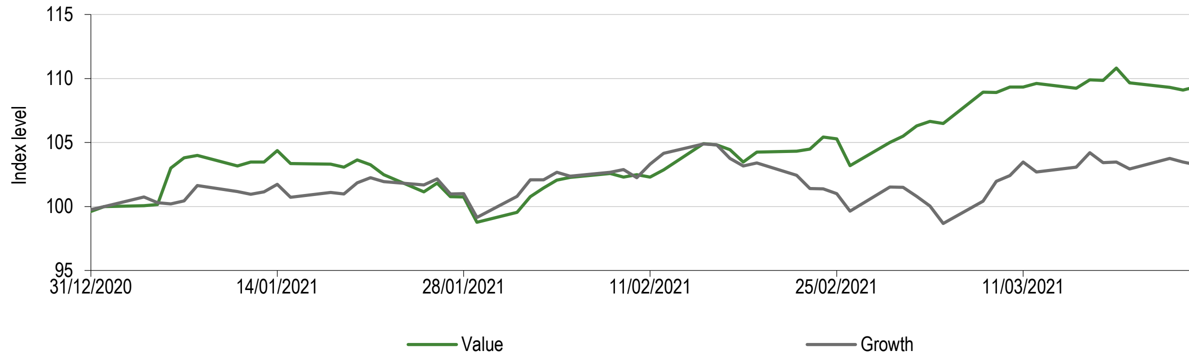
Value investors should have little to fear from rising rates

For equity investors, and especially those investing in value sectors of the market, rising interest rates should instead be viewed as a welcome sign of bond investors' confidence in the recovery.

They have been accompanied by significant US earnings upgrades in recent months, which more than offset the impact of rising discount rates.

However, there is a niche of the market that may be exposed to this relatively predictable normalisation of financial conditions. Portfolios exposed to faster-growing sectors of the stock market, where valuations remain well in excess of long-term averages, are at risk of lagging the market in 2021, in our view. In recent weeks there has been an unsurprising albeit modest reversion towards valuation norms and this has driven the underperformance of 'growth' indices relative to 'value'.

Exhibit 8: US value outperforming growth in 2021



Source: Refinitiv

Runaway inflation remains only a tail risk

For inflation, it is not for example immediately clear why there should be an uncontrolled surge in wages at a time when advanced economies are still running well below full capacity. The global fiscal stimulus now underway is a temporary affair and will be followed by fiscal consolidation to repair government balance sheets out to 2030, a development expected to slow growth and weigh on inflation.

The bigger risks to inflation do not in our view lie in the realms of economics, but instead in trade and geopolitical tensions, notably between the US and China but also in the Brexit process. Trade tariffs and a partial reversal of specialisation as national strategic factors become increasingly important represent an unwind of globalisation. Taken together with the fading one-off deflationary impact of China's accession into the World Trade Organisation, these might be better reasons to suggest proportionately higher inflation and slower real growth may lie ahead, rather than the pandemic and its policy responses.

Recent FOMC meeting emphasised continuity of monetary policy

Fed policymakers have only recently shifted to an average inflation-targeting regime. This offers significant room for manoeuvre in respect of higher than target near-term inflation readings. If counter-cyclical monetary policy allowed for long deviations from neutral levels of interest rates in the past, average inflation targeting significantly extends the duration of this approach.

Furthermore, US monetary policy thinking has evolved through experience over the past 15 years. In particular, the experience of large-scale market interventions such as asset purchase programmes has demonstrated to policymakers that the impact on asset prices is rather higher than that on actual inflation and the real economy. As Fed policymakers believe they can always offer asset prices a smooth off-ramp from central bank purchases over time, financial stability risks tend not to be a focus for monetary policy.

Higher priority is given to keeping monetary stimulus in place for longer, rather than risk prematurely tightening policy and initiating a loss of market confidence which would drive GDP

further below trend, exacerbating government sector deficits and long-term economic scarring from the pandemic.

Unsurprisingly therefore, at the most recent FOMC meeting the Fed delivered a confirmation of prior policy settings. The revised Fed ‘dot-plot’ charts of individual policymakers’ expectations for the trajectory of interest rates indicates no US interest rate increases for nearly two years, close to pre-meeting market expectations.

It may have been helpful for Fed policymakers that the nascent bubble in certain growth segments of the US stock market, which could have been a constraint on doveish policy signalling, has at least stopped expanding in 2021. While we expect asset purchases to slow during 2022 (and this to be flagged well ahead of time) there was no talk of it for now. Fed Chair Powell’s press conference also represented continuity of policy, even as the proposed $1.9trn fiscal stimulus has now been signed off.

In the light of the direction of US Fed policy we believe that much of the increase in bond yields is behind us. US 10-year yields are already trading at pre-pandemic levels. The Fed has been resolute in holding interest rates down despite the improving economic picture, as vaccinations enable a re-opening of the economy while the $1.9trn stimulus programme pushes near-term growth prospects even higher.

Looking further out, we would expect the US 10-year to end the year around 2%, factoring in the likely slowing of quantitative easing (QE) in 2022 and the prospect of Fed interest rate increases late in 2022 or early 2023. This assumes of course that vaccinations will be effective in preventing an economically damaging third wave of infections in the US. Both policymakers and bond investors are likely to look through any temporarily high inflation readings in the meantime.

While there might have been a minority of liquidity driven investors or short-term traders hoping for further monetary largesse, the inflection point of accommodative monetary policy was reached some months ago. Instead, long-term investors should welcome this monetary policy stability in combination with a very strong rebound in US growth in 2021 which should support earnings estimates and the traditional ‘value’ sectors of the market.

Conclusion

We remain neutral on equities, balancing a modest level of overvaluation against the prospect of several years of very low interest rates and the post-pandemic recovery. While acknowledging the recent hesitation in global markets as COVID-19 case numbers accelerate again in the EU, we believe the issues surrounding the supply and distribution of vaccines will be resolved in a matter of months and do not justify giving up on the ‘re-opening’ or value trades at this time.

In terms of US government bonds, a significant proportion of the move higher in yields is already in the rear-view mirror. US 10-year yields are already trading at pre-pandemic levels. Nevertheless, we remain underweight government bonds. US 10-year rates are in our view likely to drift slowly higher as of the pace of QE slows in 2022 and the prospect of Fed interest rate increases becomes visible on the investment horizon.

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