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Equity strategy and market outlook

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Global perspectives: Maintaining course

- **The roll-out of the COVID-19 vaccination programmes continues in developed markets.** Where vaccination programmes have been implemented swiftly, COVID-19 cases have been falling sharply. In only a few months, other regions in Europe will have caught up with the UK and cases should start to drop even as lockdowns are eased. In the absence of an 'escape' variant, COVID-19 should have a much lower impact on developed markets by the end the year, even if it appears likely to persist as a healthcare issue for rather longer.
- **Equity market volatility has fallen as the evolution of the pandemic becomes clearer.** With increased certainty, the full effects of the fiscal and monetary stimulus measures are now on offer. The benefits are likely to be felt most strongly in the real, physical economy which coincides with where we believe the value in financial markets currently lies.
- **2021 and 2022 are likely to deliver well above trend GDP growth in developed markets, provided COVID-19 remains contained.** Furthermore, consensus earnings forecasts indicate significant growth in corporate profits lies ahead. With monetary policy likely to remain accommodative until later in 2022, the fundamental outlook for the value segment of the market remains strong.
- **We remain neutral on global equities in aggregate but favour the value segment of the market**. Valuations for the fastest growing segment of the market remain significantly in excess of their long-term averages, which suggests future returns may disappoint. In contrast, while valuations for the value segment of the market are no longer at bargain levels they continue to be supported by an extended period of fiscal and monetary stimulus, GDP and profits recovery.

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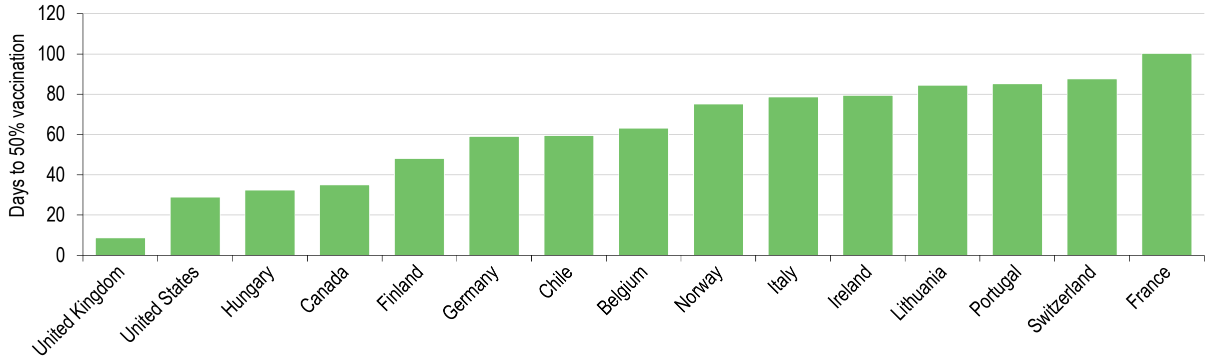
Maintaining course and focusing on value

We believe investors positioned for the COVID recovery should maintain course and remain focused on the value segment of the equity market. The encouraging decline in COVID-19 cases and easing of lockdown restrictions where vaccination programmes have been pushed aggressively demonstrates that it is now possible to look towards a post-pandemic world. We would also highlight that in many developed markets while the initial vaccination roll-out stuttered, progress is now much faster, with many nations expected to reach 50% vaccination rate within the next 100 days, Exhibit 1. If the experience of Israel and the UK is a guide this should be associated with a significant decline in infections and hospitalisations.

Exhibit 1: Days to 50% vaccination



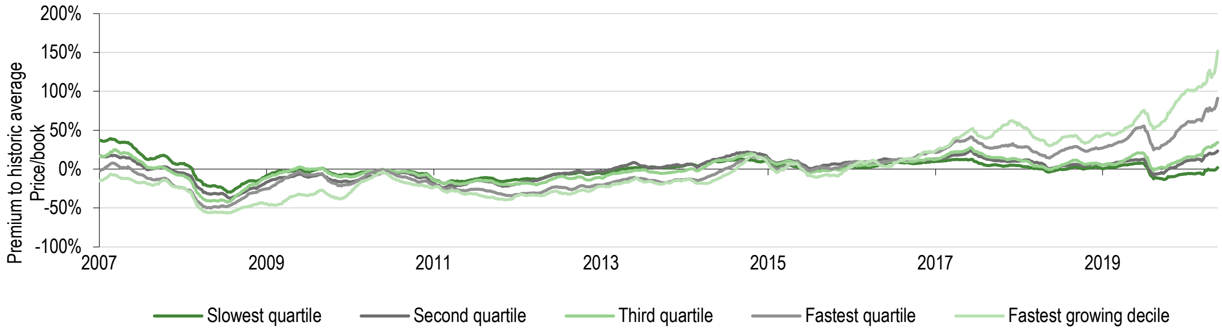
Source: Our world in data, government statistics, Edison calculations based on current vaccination rates

This is of course provided that new COVID variants do not evade the protection afforded by vaccination, and at least before shots can be adjusted to combat them. We also acknowledge that emerging markets will unfortunately take longer to reach the vaccination threshold required to see a progressive decline in cases.

The market recovery since the lows of 2020 has been impressive. From a valuation perspective, at first sight this presents investors with something of a dilemma. Cash returns, long-term bond yields and equity expected returns all low compared to history. The US S&P 500 is now trading on a 10-year trailing P/E of over 32x which has in the past been followed by annualised returns over the next 10 years of less than 1%. This is even lower than the current yield on US 10-year government bonds of 1.65%.

However, a significant proportion of this P/E multiple expansion has been driven by the growth segment of the market. There continues to be a significant valuation premium for the world's fastest growing companies, Exhibit 2. The fastest growing 20% of global companies are still trading at a 100% premium to their longer-run price/book average while the fastest growing 10% of companies are trading at a 150% premium, Exhibit 2.

Exhibit 2: Global growth companies remain on a 'valuation excursion'



Source: Refinitiv, Edison calculations

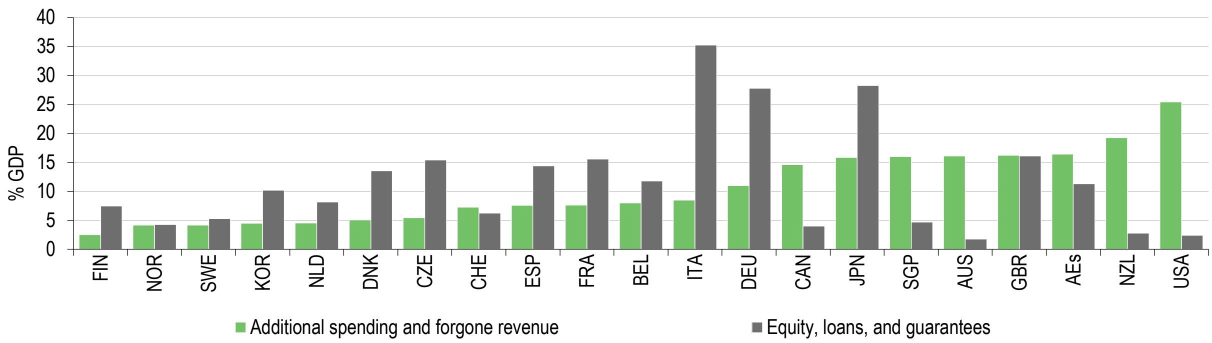
The outperformance of growth indices and their ensuing popularity over the past decade has not been uniform but is comprised of several distinct phases. For much of the period, value and growth indices delivered very similar returns, up to 2015. In the subsequent four years global growth stocks reportedly outperformed by c 30%, a meaningful percentage but also one which appeared warranted by the consolidation of many digital industries into the hands of just a few key players.

It is the COVID-19 era that appears more speculative to us, as growth continued to outperform value by a further 40% in 2020. This was a result of short- and long-term interest rates falling at the same time as one-off boost to growth stock earnings. Lockdowns clearly favoured the digital economy over forcibly shuttered real activities. The peak in growth performance coincides almost perfectly with the successful trial results of the first COVID-19 vaccine in November last year, from which point value has started to outperform.

Fundamentals continue to favour value over growth stocks

We believe that economic fundamentals are likely to remain supportive for the value sectors of the equity market compared to growth over the remainder of 2021. There has been a quite enormous fiscal response to COVID-19 in developed markets which is likely to continue to support economic activity for the next two years, Exhibit 3.

Exhibit 3: Estimated size of fiscal response to COVID-19



Source: International Monetary Fund

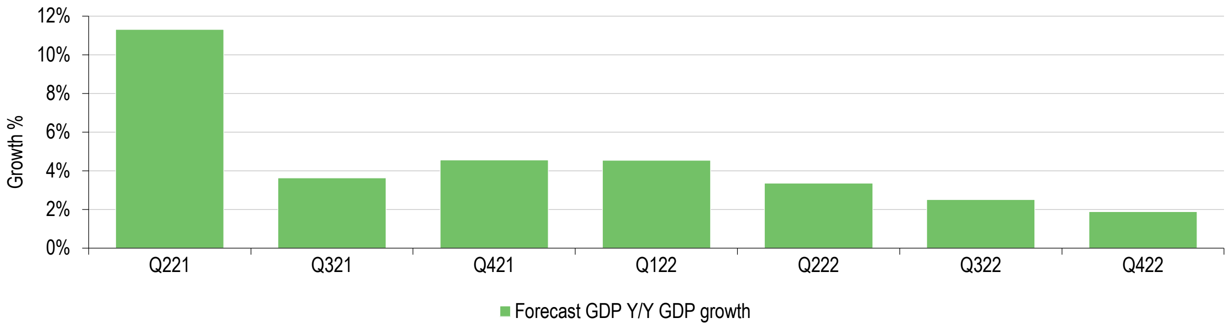
Notably, in the United States the total stimulus amounts to close to 25% of GDP compared to a stimulus of less than 5% of GDP in response to the financial crisis of 2008. Unlike then, the absence of moral hazard concerns has contributed to the absence of opposition among lawmakers for similarly expansive fiscal programmes across developed markets.

In addition to the fiscal support for the economy, monetary policy has been highly accommodative and will remain so for some time, based on central banks' stated determination for low rates to stay in place until the recovery is well underway. The reintroduction of QE has been timely and forceful with a balance sheet expansion of $2.8trn and €3.6trn in the United States and eurozone respectively. We do not expect talk of tapering US QE until the end of 2021 and the first US interest rate increase only becomes likely by the end of 2022.

While there may be some fears in the market of an uptick in inflation, we believe both investors and US policymakers will look through this data due to its noisy nature until the base effects of the initial COVID-19 wave fall out of year-on-year comparisons. The US Fed has considerable room for manoeuvre given its new policy of average inflation targeting in any case. In the eurozone, the European Central Bank (ECB) is likely to keep rates lower for even longer, as the COVID-19 recovery is likely to be several quarters later than in the United States and the UK, due to a slower pace of vaccinations.

The combined effect of fiscal and monetary stimulus with vaccination programmes is an extended period of rapid growth in GDP. IMF forecasts suggest that developing market GDP growth will be approximately double the long-run average over the coming 12 months before declining back towards trend levels by the end of 2022, Exhibit 4. We view the combination of high GDP growth and a sharp rebound in profitability as a favourable backdrop for a much broader range of sectors than the narrow list that dominated 2020's market performance.

Exhibit 4: IMF GDP growth forecasts 2021–22

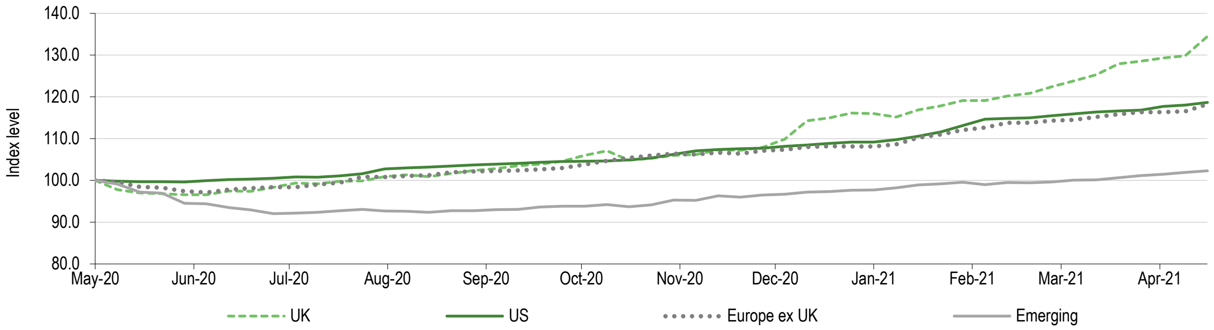


Source: International Monetary Fund

Further support for consumer spending comes from the very high level of personal savings recorded across the United States, UK and eurozone during the pandemic. Personal savings as a percentage of GDP doubled during 2020 in each of these regions. We expect this phenomenon carried both a precautionary and forced element as the economy was shut down during lockdown. Provided the pump-priming by fiscal and monetary policy is effective, as the private sector becomes more comfortable with releasing savings built up during the pandemic, this may offer scope for a secondary phase of growth.

Given these circumstances of stimulus and the promise of broad vaccination programmes we are not surprised to observe that Refinitiv I/B/E/S consensus earnings estimates have continued to trend higher since the start of the year and currently point to 40% profits growth for 2021 in Europe (including UK) and 30% growth in the United States. As lockdowns are progressively released, further upgrades should be expected, supporting the case for the value segments of the market.

Exhibit 5: 2021 Consensus estimates remain on an upward trend



Source: Refinitiv, Edison calculations. Note: Index rebased to 100.

Fed remains on hold in April, as expected

There was no change, as expected, to policy settings in the FOMC statement of 28 April. Nevertheless, the new reference to the progress of vaccinations and deletion of the word 'considerable' in respect of risks to the economic outlook may represent the Fed's first tentative and small step back from the very accommodative policy settings put in place to counter the pandemic. However, during the press conference, Fed Chair Powell was at pains to emphasise the gradualist nature of policy changes and the transient nature of currently high inflation readings due to last year's base effects. The timing of US QE tapering still does not appear to be on the Fed's agenda.

We remain underweight government bonds as the economic recovery broadens and commodity prices move higher indicating some further challenging if transient inflation readings ahead. However, we are not expecting a sudden shift higher in bond yields which would be seen as an undesirable tightening of financial conditions by the Fed and other central banks at this stage.

Instead, progressive shifts higher in yields should be expected in our view as policy gradually moves back to normal settings over the course of the next 18 months. In this regard, beyond 2022 a looser longer-term fiscal policy position in developed markets may indicate a somewhat higher long-term bond yield and tighter monetary policy than investors have become accustomed to in the decade after the 2008 financial crisis.

Conclusion

We remain neutral on equities, balancing a modest level of overvaluation for developed markets in aggregate against the prospect of several years of very low interest rates and the strong earnings growth which should be expected in the post-pandemic recovery. It may be tempting to take profits now, but we believe the value segment of the market has fundamental support and the inevitable frustration of doing relatively little should be preferred to changing course. The known risk factors for a relapse in economic activity – a peak in the cycle or a tightening of monetary or fiscal policy – remain unusually modest at present.

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