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Global perspectives: A temporarily high plateau

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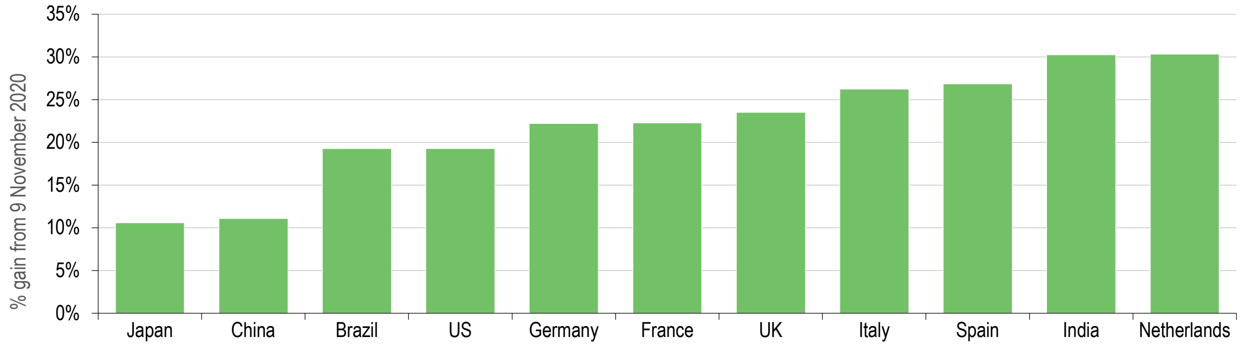
- **There has been a remarkable recovery in equity markets over the past six months.** However, investors should take care not to develop expectations of both having their cake and eating it, in our view. If COVID-19 opened the floodgates on both monetary and fiscal stimulus, then as vaccines draw the episode to a close the floodgates will also close once economic pressures and risks have ebbed.
- **We believe investors should distinguish between share price performance driven by earnings recovery and that driven by declining risk premia.** In the case of the former, which applies to the cyclical and value segments of the market, improving fundamentals are likely to offset the higher discount rates expected over the next two years.
- **Despite the depth of the COVID-19 recession, credit market spreads are now close to 20-year lows.** This is a remarkable outturn given the fact that GDP in developed markets remains so far below trend and is a testament to the extensive policy support for the corporate sector. Nevertheless, credit spreads are tightly linked to the equity risk premium and demonstrate how favourable financial market conditions are for issuers rather than investors.
- **Continuing with the value theme.** We believe investors should remain focused on sectors and companies which trade at least within sight of historical valuation norms and which stand to benefit from upgrades provided the COVID-19 recovery remains on track. In our view, growth stocks are likely to continue to suffer from weaker earnings momentum and the expectation of rising discount rates.
- **Letting air out of the bubble slowly – a temporarily high plateau rather than peak in valuations.** We expect a gradual convergence between growth and value sector valuations due to the commitment to gradualism and predictability by the world's central banks. While recent high inflation figures bear watching, they are not at present a cause for concern, in our view.
- **We remain neutral on global equities in aggregate**. The opportunities on offer within the value segment of the market remain offset by the relatively extended valuations of growth stocks. In accordance with our view that government bond yields are on a rising trajectory, and corporate debt spreads are close to 20-year lows, we remain underweight these asset classes.

A temporarily high plateau

Amid strongly bullish sentiment in asset markets, we believe investors should take care not to develop expectations of both having their cake and eating it. If COVID-19 opened the floodgates on both monetary and fiscal stimulus, then as vaccines draw the episode to a close the floodgates should also close once economic pressures and risks have ebbed. The continued progress of vaccination programmes in developed markets brings forward the advent of a return to relative normality, including a more 'normal' regime for monetary policy.

We believe investors should therefore distinguish between share price performance driven by earnings recovery and that driven by declining risk premia and temporarily low interest rates. In the case of the earnings recovery, which applies to the cyclical and value segments of the market, improving fundamentals are likely to offset the higher discount rates expected over the next two years. In the case of the latter, while macroeconomic policies are supportive for now, a faster than expected economic recovery should also give rise to expectations that over time expansionary policies will be normalised – and at least no later than previously envisaged.

Exhibit 1: Market performance since first results of the Pfizer COVID-19 vaccine trial



Source: Refinitiv. Note: Returns in USD 9 November 2020 to 25 May 2021

While there are still significant restrictions on international movement of travellers from an economic perspective an end appears to be in sight in the war on COVID-19. The virus may remain endemic within the global population, but the advent of effective vaccination programmes, in those developed nations fortunate enough to have them, has enabled the release of lockdowns. Many developed nations will soon follow the lead of the UK and Israel in having a large proportion of the adult population vaccinated. The ending of lockdowns allows the full impact of previously announced fiscal and monetary stimulus programmes to be delivered. Provided unemployment fears are minimised, there is additional economic support from the release of accumulated savings among consumers.

However, even as developed market economies appear set for a recovery to previous GDP trends over the next 18 months, we are becoming increasingly mindful of the relatively narrow opportunity set for long-term investors. At the lower end of the risk spectrum to the highest, expected returns appear compressed by central bank policy and the return to bullish investor sentiment.

Short-term interest rates remain close to record low levels. We expect this to remain the case until at least 2023 in the United States and eurozone. Furthermore, long-term bond yields still offer scant reward for the prospect of higher inflation in future years, let alone inflation risk. There may be a debate about the degree of extra inflation risk at present, but the switch to synchronised fiscal easing and average inflation targeting in the United States means the upside risk to inflation in the medium term is clearly higher than it was prior to COVID-19.

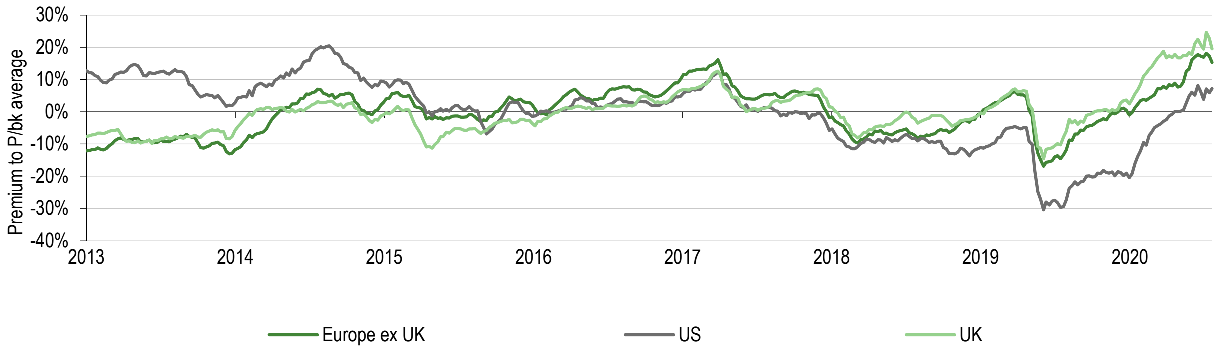
The extra yield available for taking on corporate credit risk has narrowed to lows not seen since pre COVID-19, leaving slim pickings for credit investors at this time. This would not normally be the case so close to such a deep recession, demonstrating again the impact of perceived and actual central bank support. Similarly, in aggregate global equity markets are now trading above long-term valuation norms following the rally from the lows of March 2020.

Exhibit 2: Corporate credit spreads now at 20-year lows

Source: Refinitiv, Edison Investment Research calculations

Therefore, following a spectacular rally in both equities and credit it is becoming increasingly difficult to see the pace of gains in equity markets continuing. Markets exist to discount and anticipate future developments and by the end of the summer, we believe attention will turn to the inconvenient truth that a normalising economy should be synonymous with progress towards normalising monetary and fiscal policy settings.

Exhibit 3: US and European forward price/book close to peak levels



Source: Refinitiv, Edison Investment Research calculations. Note: Median premium to seven-year average FY2 price/book.

On the monetary side, we believe the debate will start in earnest in Q3 in the United States. We continue to expect a steady tapering of QE over the course of 2022 from the current level of US$120bn per month, with a ‘lift-off’ in US rates shortly thereafter. If we are correct, US yields may already be on a rising track. In Europe, the timing may be delayed relative to the United States, as recently confirmed by comments made by European Central Bank Governing Council member Villeroy, but the direction of travel is the same. Inflation in the UK is somewhat higher and given the recent pace of expansion interest rates may start to rise by Q122.

For fiscal policy, there is by necessity a significantly greater degree of uncertainty in modelling the timing of what are essentially political decisions, rather than the technocratic monetary mandates adhered to by central banks.

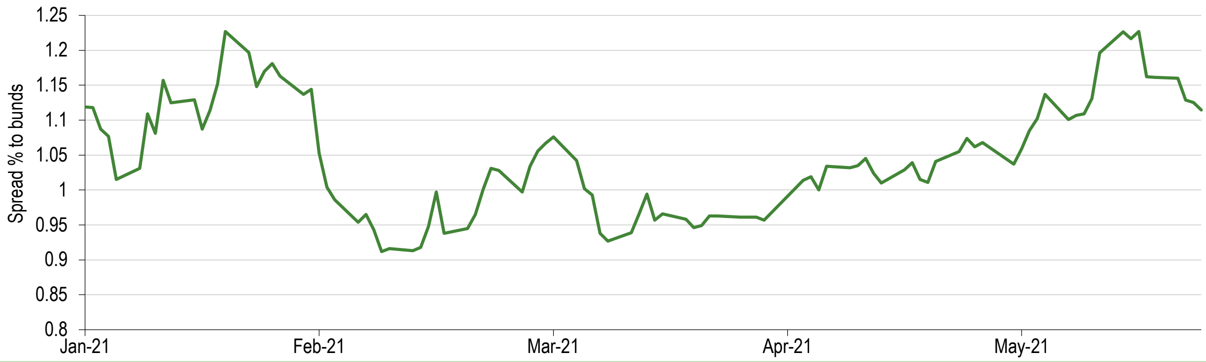
Nevertheless, we note the discussions between G7 nations on a global minimum corporate tax rate of 15%. This now appears to be linked to the recognition that digital transactions are taxed closer to where consumers reside rather than where the supplying corporation is tax resident. This would address a key fiscal policy objective for European governments which have in many cases benefited very little in terms of tax revenue from the growth of US e-commerce giants.

The Biden administration and the UK's Chancellor have also been clear that US and UK corporation tax rates will be increasing in coming years, breaking a multi-decade trend in ever-lower corporate tax rates. This obviously has a direct impact on net earnings per share and P/E multiples.

However, combined with a minimum tax rate, the greatest impact may be on international corporations with carefully optimised tax planning. Outside the corporate sector, although governments will be looking to repair the damage to balance sheets from COVID-19, over time we believe a policy of gradualism will be adopted. A sudden and unforced turn towards austerity seems unlikely now that governments have crossed the fiscal Rubicon towards expansionary policy.

One tail risk that we believe remains 'live' is the incomplete nature of the fiscal and monetary union within the eurozone. This may yet cause further ructions as we note the spread between Italian and German government bonds has been on a rising trend during the past three months, although not to levels indicating any kind of panic at this stage. We believe investors should however maintain a careful watch for any evolving stress within the eurozone as now that the acute phase of the COVID-19 crisis has passed the political will for European solidarity may be weakening, even as southern European states remain hard-hit by the restrictions on travel within the bloc.

Exhibit 4: 10-year Italian government bond spread to German bunds

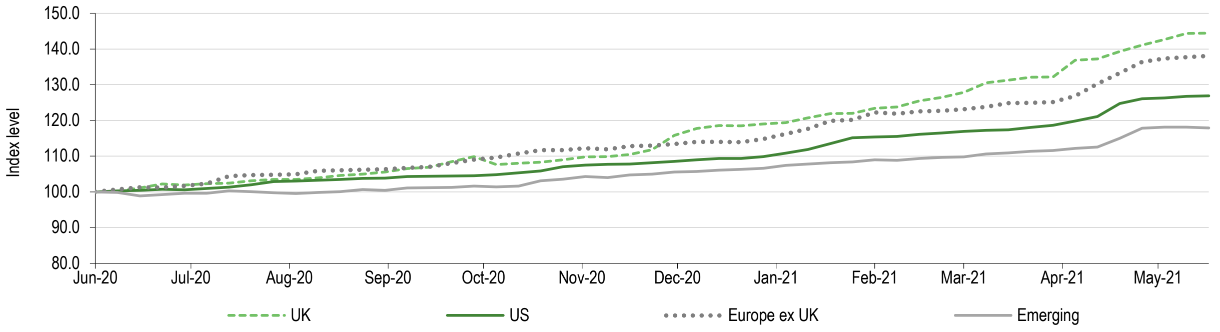


Source: Refinitiv

Strong short-term data pushes 2021 earnings forecasts higher

In the short term, bullish investor sentiment is consistent with the immediate risks to the global economy being balanced to the upside. Purchasing managers' indices remain in expansionary territory; in Europe new order inflows have surged at their fastest rate for 15 years during May while in the UK, the PMI survey indicates the private sector is delivering the fastest output growth for more than 20 years. UK PMI indices for both manufacturing and services were over 60 in May. At 66.1 the UK's manufacturing index is at the highest since the early 1990s. In the US, the composite flash PMI index has just made a new record of 68.1 supported by record levels for both services and manufacturing.

Exhibit 5: 2021 consensus profits forecasts for global markets march higher



Source: Refinitiv, Edison Investment Research calculations

Consensus earnings forecasts for 2021 have maintained their positive momentum in all the markets we follow. The more cyclical sector weighting of the UK is evident in the fact that despite including Brexit the UK has offered the strongest total upgrade over the past 12 months of over 40%. Refinitiv consensus now calls for earnings growth of over 75% for the UK in 2021. Europe ex-UK has also benefited from an improving outlook and a similar level of earnings growth expected for 2021. However, on a relative basis the United States has lagged, with a larger weighting towards the less cyclical technology sector.

We would highlight that the UK market still trades at only a modest premium to historic valuation norms, unlike continental European and US markets which are at significant premiums. As the relatively better recent earnings momentum shows, the UK's more traditional energy, mining and financials sector weighting is ideally positioned for the COVID recovery trade. Despite this, the FTSE 100 is still well below its pre COVID-19 high.

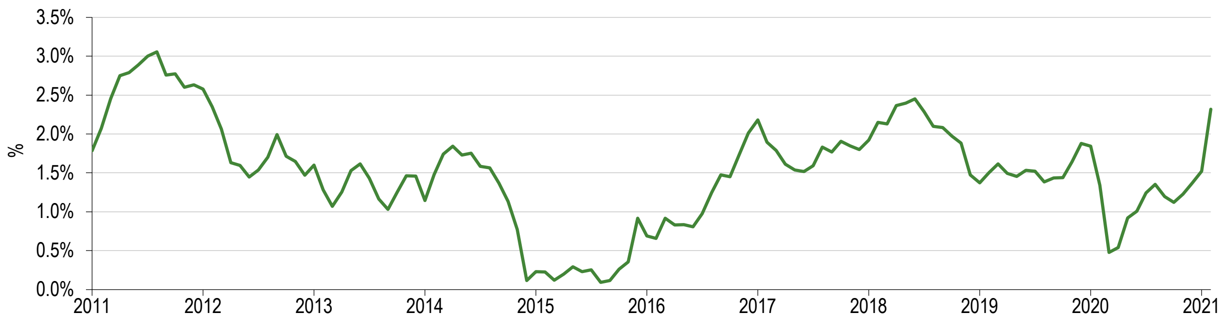
Rising inflation yet to impinge on the outlook for monetary policy

Recent weeks have seen investors almost develop an obsession with a narrative whereby inflation concerns might impinge on the current outlook for monetary policy. There is no doubt that price inflation for a variety of hard, soft and industrial commodities has surged following the initial stages of recovery from COVID-19. There have also been specific issues of product availability in certain segments such as automotive semiconductors. Commentators have raised concerns that monetary policy may have to be tightened sooner rather than later.

We believe this inflation narrative is convenient but represents an example of the easiest explanation for some limited market volatility or noise in recent weeks, rather than the correct one. The stop-start in global supply chains was bound to cause significant disruption in the acute phases of both the slowdown and the recovery.

A year ago, short-dated oil futures briefly traded at negative prices, reflecting fears of over-supply and full-to-capacity storage facilities. In hindsight, this was an overshoot with an element of panic selling by investors. Similarly, the recent increases in commodity prices contain both elements of an underlying shortage of demand and short-term supply disruptions, which could easily prove that in hindsight the recent surge in measured inflation may also be an overshoot. For now, the US Fed's policymakers appear to share a benign interpretation of the recent US inflation data as recent comments re-affirmed the view that short-term supply chain issues were at the root of the recent move higher in US inflation.

Exhibit 6: US inflation rising but still consistent with US Fed projections



Source: Refinitiv, US personal consumption expenditures year-on-year change

US CPI inflation reached 4.2% year-on-year during April although energy costs contributed significantly to the rise in the headline index, up 25% year-on-year. For us, the question is not rising inflation, which is clearly not a surprise as the world gets back to work post COVID-19, but the impact on policy. For the US, the Fed's March 2021 Statement of Economic Projections disclosed that it expects inflation to average 2.4% during 2021, before falling closer to target at 2.2% in 2022.

If we adjust for the base effects from last year and assume the current high monthly rate of inflation continues unchanged from the April data, then we estimate US inflation would average 2.6% this year. This is not so different from the Fed's projections in March. We believe that unless current inflation trends accelerate to the upside, they are unlikely to materially change the current outlook for Fed policy. We believe investors will be (or at least should be) aware that the 'peak' in developed market monetary stimulus was last year and in effect central banks are effectively on a long pause in the first part of 2021, waiting for the economic recovery to broaden before carefully signalling a slow and gradual tightening of policy from the beginning of 2022.

Therefore, provided the economic recovery continues to progress, outside liquidity-driven names, where valuations have been pushed well above historic norms, the recovery in earnings forecasts is likely to continue to support equity prices despite the modest increases expected in discount rates over the next 12 months. Value-oriented sectors should have little to fear – US inflation at current rates should not materially change the outlook for Fed monetary policy. Investors should instead be firmly focused on the robustness or otherwise of earnings forecasts – and for now, vaccines are delivering on their promise of enabling the relaxation of lockdowns.

Conclusion

We remain neutral on equities, balancing a degree of overvaluation for developed markets in aggregate against the prospect of several years of very low interest rates and ongoing strong earnings momentum which should be expected in the post-pandemic recovery. As each month elapses however, the normalisation of monetary policy draws closer.

The underperformance of growth versus value indices since the first vaccines became available late last year highlights that the liquidity floodgates are already on the turn. Yet for many investors, it is often too difficult to act on valuations alone as the reasons for their historical tendency towards mean-reversion tend to be more obvious in hindsight.

This time however, the theme of a concentration of upward earnings revisions in cyclical sectors, together with the prospect of steadily tighter monetary policy, are relatively clear and evident in the most recent data. We continue to expect value sectors to outperform growth with the primary risk to this view not being any temporary rise in inflation but any re-introduction of social restrictions if

COVID-19 case numbers pass critical thresholds in nations where the majority of the population has been vaccinated.

In accordance with our view that government bond yields are on a rising trajectory and corporate debt spreads are close to 20-year lows, we remain underweight government bonds and corporate credit.

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