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Equity strategy and market outlook

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Global perspectives: Fundamentally unchanged

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- **Despite the recent bounce in global equity markets there has been little change in the outlook, in our view.** Survey data in every major economic region confirms a slowing of growth since the summer while consensus earnings forecasts appear to have completed their COVID-19 related upgrade cycle.
- **High energy prices may reflect a lack of capital expenditure (capex) in recent years as much as the resurgence in demand during 2021.** We observe that capex levels within the listed global oil sector have been sharply reduced since 2016. ESG-focused investors have not rewarded energy capex with higher share prices. This lack of capex suggests that fossil fuel-based energy prices could remain elevated for some time.
- **China's US dollar high yield market under stress.** Despite the absence of a formal default by China's Evergrande to date, the market appears effectively shuttered with yields on US dollar high yield bonds issued by Chinese corporates still close to 25%. We believe investors should be watching closely for evidence of slower growth in China and any consequent effect on global materials prices.
- **Our cautious position on global equities remains in place.** Post COVID-19 normalisation along the dimensions of monetary policy, fiscal policy and economic growth in our view corresponds to a high likelihood of a period of normalising equity valuations. Globally, equity valuations remain extended on a price/book and forward P/E basis.

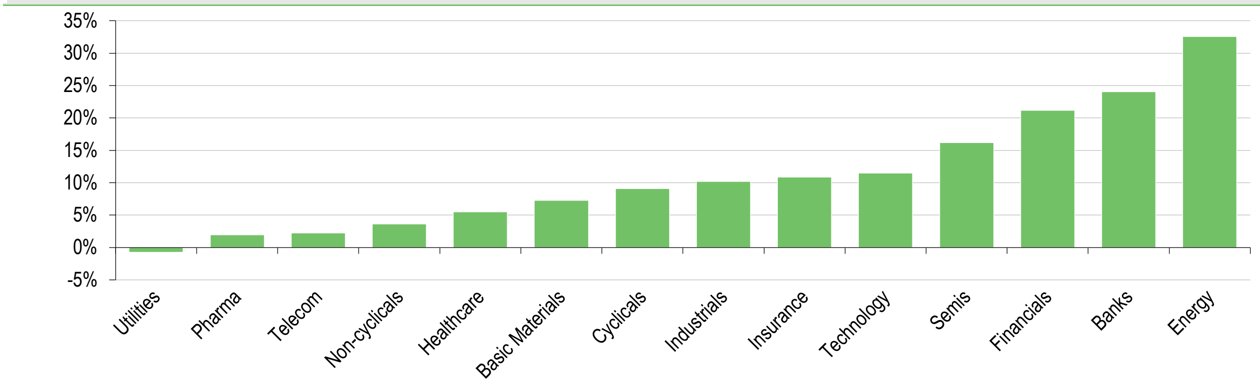
Equities rebound while fundamentals unchanged

Despite the recent bounce in global equity markets from the near-term lows of September, we cannot discern any meaningful change in the global economic outlook. Survey data continue to weaken, pointing to slower growth ahead, while inflation readings remain uncomfortably high. Central banks seem keen to prove they will act on higher inflation with higher rates, which has in recent days contributed to a flattening of the yield curve as investors start to anticipate a transient period of tighter monetary policy, only to be later unwound.

We believe it is important not to be distracted by what are still relatively modest short-term swings in market sentiment in recent weeks. The fundamental picture remains that risk premia in global equity and corporate credit markets remain very low compared to historical norms and growth is slowing from the breakneck pace earlier in the year. Global monetary policy remains on a tightening track as COVID-19 stimulus is gradually withdrawn.

During 2021, despite some high-profile individual stock performances within the technology sector traditional valuations have once again proved their relevance. Year-to-date, the strongest global equity sector performers have been previously out-of-favour fossil fuel energy companies and banks with returns of over 20% in US dollar terms – more than double the 11% return of the global technology sector.

Exhibit 1: Global sector performance year-to-date



Source: Refinitiv. Note: Price return in US$, 31 December 2020 to 27 October 2021.

High energy prices associated with declining investment spend

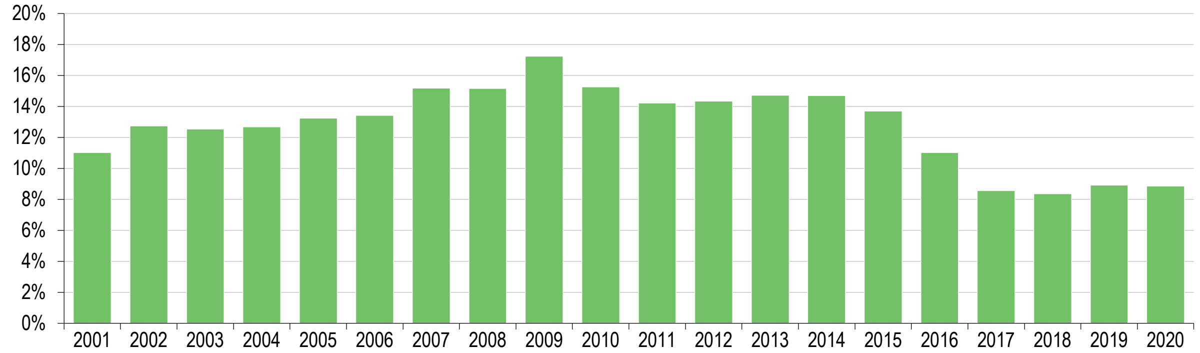
The recent strength of energy markets can in part be attributed to the sheer rapidity of the post COVID-19 recovery. However, we can also see there has been something of a collapse in capital expenditure within the listed oil sector. Measured as a percent of total assets of the largest global oil companies, industry capex has fallen to 8% of total assets compared to 14% before 2016. This is below typical depreciation rates for plant and machinery, suggesting the sector has responded both to low oil prices towards the middle of the prior decade but also to pressure from shareholders and governments to avoid investing in potentially stranded assets, even as oil prices rebounded in the 2018–2019 period.

The ESG investment theme has created a clamouring for diverting cash flows to either shareholders or green energy investments, rather than maintaining infrastructure and extending reserves. The sector could be forgiven for its failure to divine with precision the necessary balance between short-term demands for fuel and the decades-long trend towards net-zero carbon emissions, especially in the context of the economic shocks of the COVID-19 era.

However, as a supply-side factor with companies' investment criteria subject to non-monetary factors such as ESG rather than forecast oil prices, the risk is that higher energy prices may persist for longer than investors expect. Furthermore, by-products of the petrochemical industry, which include plastics and fertiliser, imply further upward price pressure on global goods supply chains.

In particular, rising input prices for farmers on a global basis suggest that agricultural commodity prices are likely to remain firm well into 2022. This is perhaps less of an issue for developed markets where food is a smaller component of overall consumer purchasing but nevertheless, these price rises could yet represent an example of market forces and supply chain disruption ultimately playing into the political domain, should food prices remain elevated.

Exhibit 2: Global energy sector capex as a percentage of total assets



Source: Refinitiv, Edison calculations

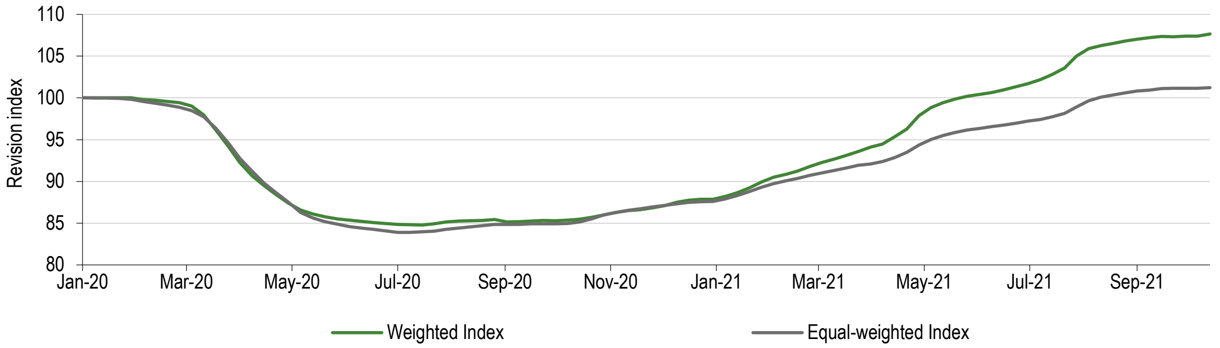
Positive economic and profits momentum fading

Purchasing managers' indices have fallen from the strong levels seen earlier in 2021 in the United States, Europe, Japan and China. With the exception of China, these indices remain in positive territory but the temporary boost to GDP growth from the re-opening of national economies post COVID-19 is clearly on the wane.

We can also see in consensus earnings forecasts that economic momentum is fading during Q321. With central banks now focused on uncomfortably high inflation readings and national governments more focused on sovereign balance sheet repair rather than COVID-19 stimulus, it is not immediately clear which policy levers might be pulled to reverse this trend.

The narrowing of output gaps during 2021 to date gives good reason to believe that developed market economic growth from this juncture is likely to be significantly slower than in the prior three quarters. For the corporate sector, rising input prices and supply chain bottlenecks have become a consistent feature of corporate earnings reports, which serves to highlight the supply-led nature of the slowdown in growth.

Exhibit 3: Positive trend in global earnings revisions has stalled during Q321

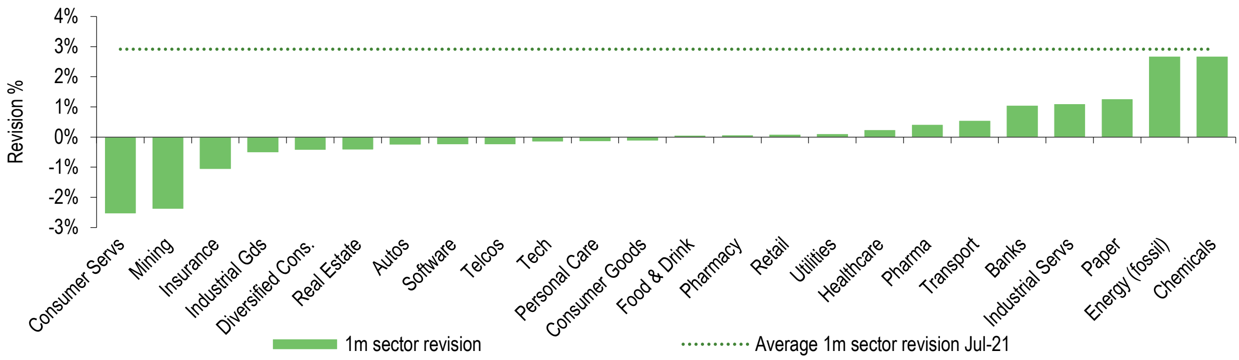


Source: Refinitiv, Edison calculations

We can see rather starkly from an analysis of sector revisions in Exhibit 4 the extent of the decline in earnings momentum since the end of Q221. As recently as July, the average monthly sector revision was +3% for FY21, an abnormally large figure, which demonstrates that both analysts and corporate guidance were still playing catch-up to the re-opening of the economy.

Since mid-September however, revisions have slowed to levels more typical of a normal year, with a mix of upgrades and downgrades with most sectors recording effectively unchanged earnings expectations over the month. The data support the idea there is relatively little benefit now in positioning portfolios for COVID-19 specific dynamics, as the 're-opening of trade' appears to be complete.

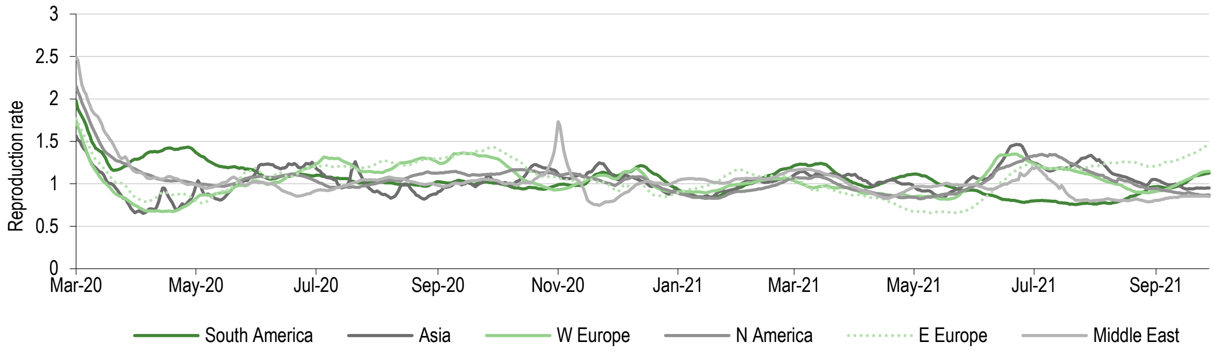
Exhibit 4: Declining momentum in global sector profits forecasts since July 2021



Source: Refinitiv, Edison calculations. Note: Chart shows one-month 2021 consensus profits revision compared to July average.

In terms of the COVID-19 pandemic itself, there has also been some concern in the UK for example that infection rates could lead to the need to re-impose social restrictions during the winter. Furthermore, in eastern Europe COVID-19 is spreading relatively quickly as a number of eastern European nations have both relatively high levels of current infection and reproduction rates well above one.

Exhibit 5: COVID-19 reproduction rates by region



Source: Our World in Data, government statistics and Edison calculations

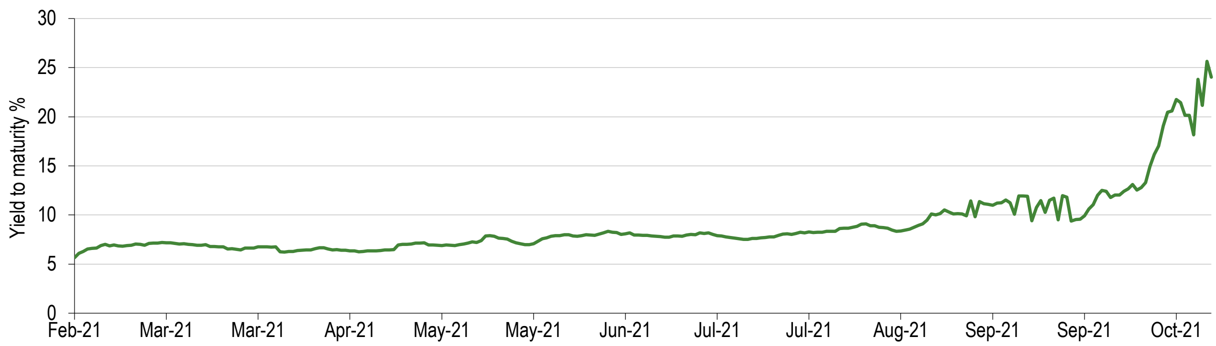
However, viral reproduction rates outside eastern Europe have on a global basis remained relatively contained at close to 1.0, even as social restrictions have been lifted and more infectious strains of the virus have become dominant. This is encouraging in respect of the durability of the recovery as it implies a relatively steady rather than rapidly increasing burden on healthcare provision and in our view should place renewed lockdown risks for portfolios below those of tighter monetary policy and high equity valuations.

China: Real estate trouble still brewing

The slowing of China's economy has brought property developer risks into sharp relief with the yield on internationally issued high yield Chinese corporate bonds surging to as much as 25% since the end of August.

Despite Evergrande's recent payment on a US dollar bond coupon which had previously been missed, this market remains in effect shuttered to new issuance, adding to the corporate distress in the sector. While not a systemic issue on a global basis as China's internal banking system is largely separated from the rest of the world, we believe China's response to this recent round of property sector volatility warrants close attention given the potential consequences for global growth and the outlook for the materials sector.

Exhibit 6: Average yield on China domiciled and US dollar-denominated high yield corporate debt



Source: Refinitiv, Edison calculations

Conclusion

The recent rebound in global markets represents in our view a swing in sentiment rather than any change in the fundamentals. This should not therefore distract investors from the challenges of normalisation ahead. Normalisation along the dimensions of monetary policy, fiscal policy and growth in our view corresponds to a higher likelihood of a period of normalising valuations. This could either be abrupt, an outcome that monetary policymakers will be keen to avoid, or more gradual, which would represent a longer period of sub-par equity returns in overvalued markets.

We believe investors should be maintaining a cautious approach to equities at present, especially in those sectors and markets which are trading well above long-term valuation averages. Globally, equity valuations remain extended on a price/book and forward P/E basis. We would also highlight that year-to-date the best performing sectors have been the lowly valued and out of favour banks and energy.

We remain underweight on global bonds despite the recent increase in yields and continue to believe, given the very low yields on investment grade corporate credit, that the optimal shift in portfolios may be towards a tactical allocation to cash and other lower risk assets.

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