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Equity strategy and market outlook

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Global perspectives: Staying the course

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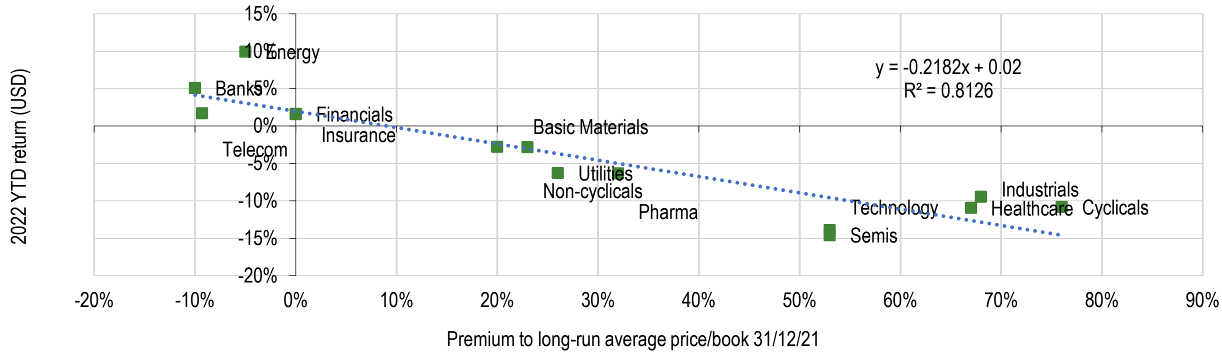
- **There has been little change in the investment outlook over the past month.** Overvalued equity markets, such as the US, are progressively digesting the removal of accommodative monetary policy expected during 2022. The appropriate valuation level for global equities in a rising interest rate environment remains the dominant question for investors.
- **Real interest rates have been rising while inflation expectations remain stable.** Stable inflation expectations, even as current inflation remains well above central banks' targets, suggest we are observing policy normalisation, rather than any fears of out-of-control inflation. It is a signal that despite high current inflation readings, central bank credibility in the eyes of the market remains intact.
- **Russia has now embarked on a full-scale invasion of Ukraine.** Investors should position portfolios to avoid the direct impact of potentially long-lived sanctions on Russian markets, despite discounted valuations. Russia's foreign policy remains on a collision course with the international community and severe and potentially long-term economic sanctions are on the agenda.
- **A spike in energy prices raises the spectre of further upward pressure on headline inflation.** In such a scenario, the predicament for monetary policy will be an ever-increasing divergence between current inflationary pressure and the increased likelihood of an economic slowdown. We believe this tension is already in evidence in the bond market, with long-term market-implied inflation expectations declining in recent weeks, even as nominal bond yields have risen.
- **European and 'old economy' sectors still appear better hunting grounds for returns in 2022.** We continue to see the potential for European markets to outperform the US on valuation grounds. We expect energy sector profits to be supported by strong oil prices while financials should continue to benefit from rising interest rates. While non-US equities are not 'cheap' in absolute terms, many sectors are trading only a little above historical valuation norms and are priced to offer returns well above domestic bond yields. We maintain a neutral outlook on global equities for 2022 and expect the year-to-date sector and regional rotation in relative performance to continue, albeit perhaps at a slower pace, during the year.

Staying the course

The key investment theme for 2022 of post-pandemic monetary policy normalisation remains dominant in our view and portfolios should require relatively little adjustment at this time, despite clearly increased geopolitical tensions.

Year-to-date, over 80% of relative sector performance on a global basis can be attributable to the sector valuation premium prevailing at the start of the year, Exhibit 1. We believe this is an abnormally high proportion of sector returns attributable to a single factor. However, it also corresponds to our earlier views on the importance of valuation parameters at a time of rising real interest rates, as excess liquidity is drained from global financial markets.

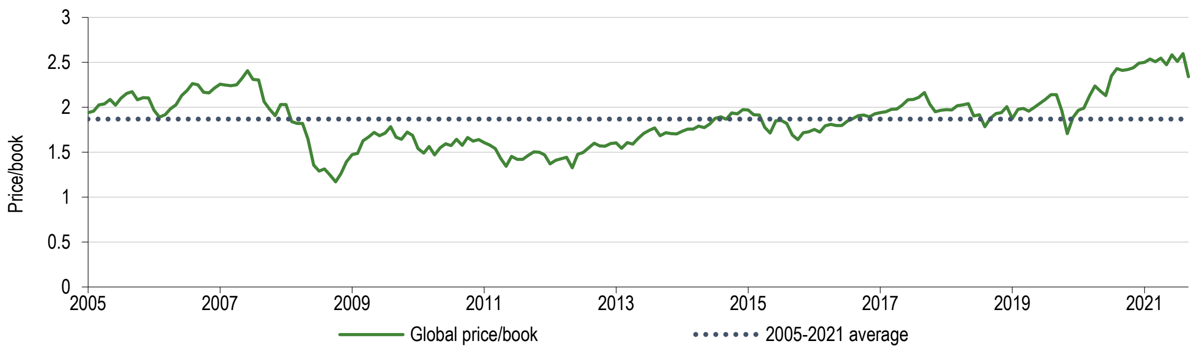
Exhibit 1: 'Cheapest' sectors continue to outperform during 2022



Source: Refinitiv, Edison Investment Research calculations. Note: Returns between 31 December 2021 and 22 February 2022.

We believe this pattern of returns where 'value' sectors of the market outperform has further to run. Despite a 10% decline in US equities in recent weeks, on a global basis equity valuations remain significantly higher than long-term averages, Exhibit 2, while the pockets of under- or in-line valuations tend to be in unpopular traditional sectors such as energy, banks, telecoms and insurance or regions such as Europe.

Exhibit 2: Global equity markets remain expensive on a price/book basis (x)



Source: Refinitiv, Edison Investment Research calculations. Note: Current price/book versus 16-year average.

Interest rates: Real rates rising, inflation expectations stable

With current inflation well above target in the US, UK and eurozone investors have reset expectations for the trajectory of monetary policy. The rapid rise in inflation has led to perceptions that central banks are well behind the curve in removing policy accommodation, leading to fears of runaway inflation. We believe such fears are overdone at this time for several reasons. The first is that the long-term indicator of investors' inflation expectations, which is the spread between traditional (nominal) and index-linked (real) market interest rates, has remained within historical ranges, Exhibit 3, and has even been declining in recent weeks. This is hardly a signal that central banks do not have inflation in hand.

On the contrary, the recent flattening of the yield curve highlights the growing risk we expect will come to the fore in H222, which is how to avoid compounding tighter financial market conditions with tighter official policies to the point that the economy slows sufficiently quickly to cause another reversal in the direction of monetary policy.

Exhibit 3: 10-year market-implied inflation expectations higher but still within historical range

Source: Refinitiv

A recent surge in broad money growth may have inflation hawks worried, but should not be a surprise due to the determined use of fiscal policy to maintain incomes during the COVID-19 pandemic. However, these stimulus packages have been, or are in the process of, being wound down and are unlikely to be repeated even if there are further surges in infections as governments encourage citizens to 'live with' endemic transmission of the virus. For example, the EU will shortly request national governments to withdraw pandemic support by 2023.

As a result, broad money growth is likely to decline significantly during 2022. Furthermore, the easing of COVID restrictions on a global basis is set to significantly improve service sector productivity and ease the pressure on goods sector demand as consumers are redirected towards out-of-home spending. We therefore concur with central banks' expectations for materially reduced inflationary pressure by the second half of 2022, even if there are likely to be some uncomfortably high inflation readings in coming months.

Following the remarkably rapid reset in market expectations this year, we believe the outlook for interest rates is now balanced. Central banks have had to adapt rhetoric to the reality of a more rapid than expected rebound in inflation and economic growth. Yet the tightening of current financial conditions will start to weigh on growth by the second half of 2022. We expect central banks to talk tough but note also that long-term interest rates are moving at a fraction of the rate of the short-end of the curve, leading to a significant flattening of global yield curves, Exhibit 4.

That it is the real component of interest rates that is rising at the long end of the yield curve is encouraging for central banks focused on maintaining inflation fighting credibility. However, we also note that despite having risen, US real interest rates are still some way below their pre COVID-19 levels even if market-implied US inflation expectations are close to the 2% target.

As a result, investors looking for diversification from bond investments may be disappointed during 2022 as there remains a further period of normalisation of real rates ahead as central bank asset purchase programmes are wound down. In terms of global bond yields, this is likely to offset the benefit of easing inflation concerns as economic growth slows in the second half of the year.

Exhibit 4: The US yield curve has flattened suggesting bond markets fear a slowdown

Source: Refinitiv. Note: Chart shows spread between US 10-year and US two-year yields.

The continuing normalisation of real interest rates and slowing growth during 2022 suggests to us that investors may start to reappraise the risks from cyclical equity portfolio exposures at this point in the cycle. We view our traditional sector recommendations as optimal for a slowing economy, consistent with the valuation signals, and also defensively positioned given rising geopolitical risks.

Ukraine: Investment implications of Russian invasion

Over the course of the past month and despite the diplomatic efforts of numerous nations seeking a peaceful demobilisation of Russian forces assembled around the borders of Ukraine, Russia has moved to de facto annexe not only parts of eastern Ukraine in which it previously exercised control, but it has attacked installations across the entirety of Ukraine and is in the process of a full military invasion.

Russia's objective at this time appears to be to obtain control of Ukraine through military means, having been unable to obtain effective control through international agreement over the heads of the Ukrainian government and people. That the very high cost of pursuing this objective seems to outweigh the moot strategic benefits is at this stage irrelevant. The past six weeks has demonstrated that there is limited appetite in the international community for offering concessions to Russia, either in terms of applying political pressure on the government of Ukraine to accept a role as a vassal state, nor compromising Ukraine's sovereignty over its foreign policy.

Global markets initially reacted negatively to this week's movement of Russian armour into eastern Ukraine. Both the move of armour and the decree recognising the region as two independent states were a quite predictable continuation of a narrative of 'protecting' Russians living in other nations. However, markets recovered quickly as the Western sanctions announced fell well short of those feared by investors and notably did not target the flow of energy into Europe. Following the announcement of invasion, we note Russian equities have fallen by up to 40% pending the announcement of economic sanctions, which may yet isolate Russia from the global financial system.

It was a surprise that Germany suspended approval of the gas pipeline Nord Stream 2, an enormously controversial multi-decade project which emphasised the reliance of Europe on Russian hydrocarbon resources. Potentially for the first time in a decade, Germany has been prepared to confront Russia even at the cost to its own consumers and industry lobby. Nevertheless, it was clearly insufficient to deter Russia from continuing with its invasion plans.

With the window of diplomacy effectively shut and no resolution on the critical issue of Ukraine's self-determination, the military situation has descended into war as invasion represented Russia's only remaining means of achieving its objective of a Russia-dependent Ukraine.

Following the invasion, investors should not assume the current round of sanctions will be the last, nor that a real conflict between technologically advanced forces has been avoided.

Outside Russia, the primary impact for investors to date has been in global energy markets as investors discount potential interruptions to Russian oil and gas supplies. This is in the context of a rapid increase in oil demand as the transportation industry rebounds as COVID-19 restrictions are eased on a global basis.

In our view the extent of the global sell-off is likely to be relatively modest provided the military conflict remains wholly within Ukrainian borders. Coldly rational markets are likely to be a poor measure of any loss of human life in Eastern Europe. Nevertheless, Russian asset prices are likely to remain under significant selling pressure as investors anticipate an extended period of economic sanctions. Given the extent of the declines, institutional investors seem to be fearing forced disposals to comply with incoming sanctions.

At this stage, we believe Russia's invasion of Ukraine is unlikely to herald the advent of military hostilities between the major powers, which would represent a significant additional risk premium for markets to bear. The appetite for arming Ukraine, let alone supplying troops, seems to be relatively limited in Europe and the United States, leaving Ukraine standing alone militarily against more numerous and better-equipped Russian forces.

Outnumbered by the estimated 190,000 Russian troops stationed on the border, and under threat from Russia's clear air superiority and a substantially larger array of heavy weapons, Ukraine may only be able to slow any determined invasion. Nevertheless, provided there is the will to fight, losses on both sides may well prove significant even as the military power appears one-sided.

Should Russia annexe Ukraine or install a puppet government we believe the policy response will be rather different to the muted reaction to the annexation of Crimea, which arguably has emboldened the Russian leadership to embark on its current course.

Given Russia's apparent determination to pursue its goal at effectively any cost, the possibility of a new 'Iron Curtain' cannot be excluded over the medium-term. A significant increase in geopolitical tension across the region – precisely what Russia claims to fear – could be the inevitable response to Russia's political and military aggression towards its neighbours.

Aside from representing a new form of Cold War, economically this would represent a further step towards deglobalisation and a reversal of the trends towards the trade liberalisation in recent decades which has supported corporate profitability.

Combined with the more restrictive approach towards China, this ultimately could lead to a bifurcation between liberal and authoritarian economic blocs, with the resulting inefficiencies impinging upon global economic growth. Significant economic inefficiencies would result as entire supply chains from intellectual property through to basic materials would need to be duplicated for inherently smaller markets, increasing the costs of traded goods.

Energy benefiting from geopolitics and demand recovery

However, for the short term, we believe investors should now focus on the impact of higher energy prices and the resultant drag on the economy and pressure on consumer budgets. The oil price has already risen by 68% over the past 12 months and we believe investors are currently well-served to focus on less discretionary sectors of the economy at present on both valuation and cyclical grounds.

The spike in energy prices to over US$100 a barrel raises the spectre of further upward pressure on headline inflation which is currently expected by central banks to fall back during the second half of 2022. In such a scenario, the predicament for monetary policy will be an ever-increasing divergence between current inflationary pressure and the increased likelihood of an economic slowdown.

We believe this tension is already in evidence in the bond market with long-term market-implied inflation expectations declining in recent weeks, even as nominal bond yields have risen.

Conclusion

We maintain a neutral view on equities as we recognise that within a global equity market that appears overvalued in aggregate, there remains a long tail of sectors outside the United States that are set to benefit from a continued economic and corporate profits expansion, and which currently trade only a little above long-term valuation averages. We note consensus earnings expectations have continued their positive trend during February.

The correlation between valuation and relative returns has been unusually strong this year as real interest rates rise as excess liquidity is drained from the financial system and monetary policy normalised. Nevertheless, we note that long-term inflation expectations remain well contained and central banks may yet face a rather different set of economic parameters later in the year with both economic momentum and inflationary pressure easing. We believe the 'interest rate shock' of 2022 is already in the rear-view mirror as market expectations have shifted very rapidly in any historical context.

We expect continuing market volatility arising from Russia's military intervention in Ukraine and are primarily concerned that a short-term spike in the oil price may postpone the peak in headline inflation and act to crimp economic activity in oil-consuming nations. It may be time to consider reducing cyclical risks within equity portfolios. The situation appears set to deteriorate further in the short term rather than improve and a discount for Russian assets is likely to persist.

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