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Global perspectives: A predictable derating?

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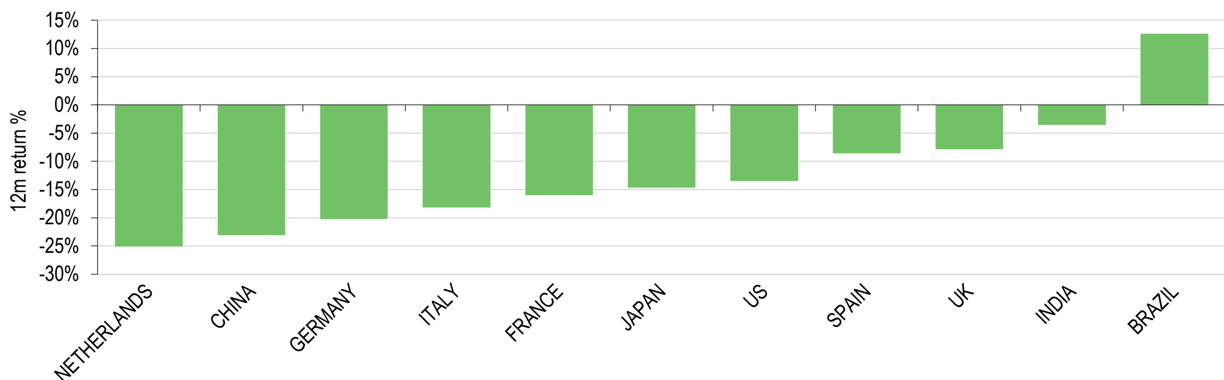
- **Year to date, 2022 has disappointed bullish investors.** While the day-to-day narrative has been shifting between the war in Ukraine, a cost of living ‘crisis’ and China’s COVID-19 lockdowns, these are the crashing waves obscuring the movement of the tide. Monetary policy is being rapidly normalised and as a result abnormally high valuations are being progressively reset lower. We believe this process has further to run.
- **On the other hand, bond markets have moved swiftly to account for a significant proportion of all but the most extreme scenarios for US Federal Reserve (US Fed) policy** over the coming three years. With US 10-year bond yields now close to 3%, we believe the market is now finely balanced between currently hawkish central bank rhetoric and a slowdown in economic activity in coming quarters. We move to a neutral rather than underweight outlook.
- **We remain with a neutral outlook on global equities but believe investors have to be increasingly selective and seek exposure to sectors that benefit from higher interest rates and also represent less cyclical earnings streams.** In an environment of normalising equity valuations we maintain the same strategy, which is to focus on traditional sectors such as energy, pharma, banks, insurance and defence, which have historically offered a degree of inflation protection while avoiding more overvalued segments of the global equity market, either by region or sector.

A predictable derating?

Global markets seem to have struggled at each turn so far in 2022. Year-to-date, many of the major national stock market indices are down more than 10%, Exhibit 1. Each time there is a lurch lower in index values the move is typically attributed to a single specific narrative such as the invasion of Ukraine, inflationary pressure, or more recently, the renewed COVID-19 outbreak in China. However, in our view there is a broader theme at work.

Inflated asset values are being gradually unwound as the reality of the surge in inflation and correspondingly tighter monetary policy slowly sinks into investors' consciousness. Monetary policy, which is sufficiently tight to impact inflation, implies both slower economic growth and lower equity valuations as real yields rise. Given the shrinkage of output gaps and the drumbeat of supply chain issues over the past 12 months, we believe these dynamics can hardly have caught professional investors off-guard, unlike Putin's incomprehensible decision to invade Ukraine during February.

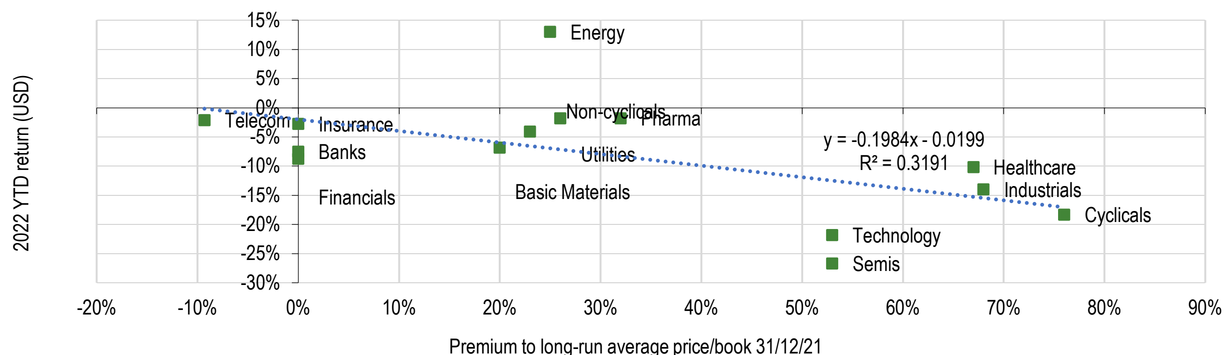
Exhibit 1: Disappointing returns in global equity indices during 2022



Source: Refinitiv. Note: Price return in US dollars year to 26 April 2022.

There remains a clear relationship between year-to-date sector performance and the initial price/book premium for each sector at the start of the year, Exhibit 2. This may be a refreshing change for investors with more than one decade of experience. The surge in global liquidity from central bank policies designed to backstop the economy during the COVID-19 pandemic made traditional valuations close to irrelevant for a time. As monetary policy is tightened, financial excesses are being punished. In fact, the only significant outlier from the regression trend in Exhibit 2 is the energy sector, which has outperformed as the oil price increased by more than 50% following Russia's invasion of Ukraine.

Exhibit 2: Still-strong relationship between starting valuation premium and performance



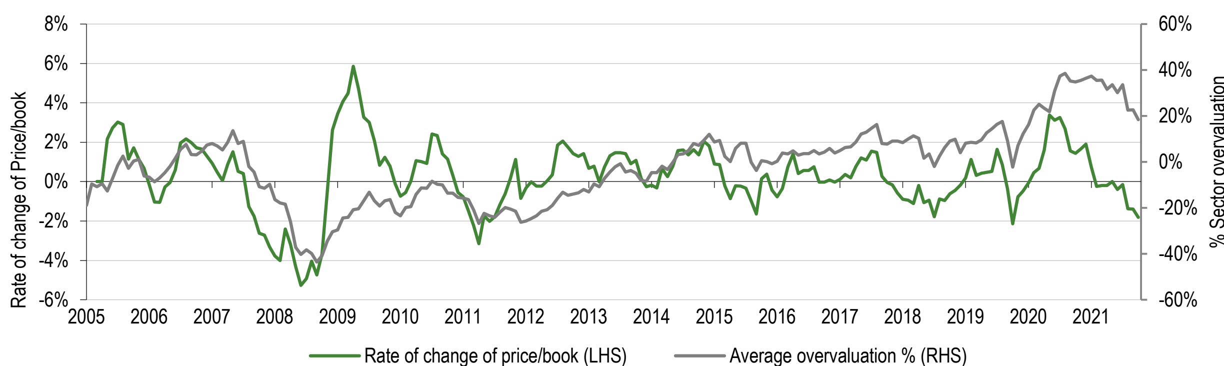
Source: Refinitiv. Note: Price return in US dollars year to 26 April 2022.

A period of contracting valuations for listed equities is now underway. We believe this is a logical development, the risks of which we have highlighted in earlier notes.

Exhibit 3 shows the rate of change of the forward price/book multiple for global equities, calculated from the simple average of the global sectors shown in Exhibit 2. Following a truly remarkable period of COVID-19 related multiple expansion which peaked in December 2020, market valuation exuberance has steadily declined during 2021 and has since turned negative this year to date.

The natural endpoint of this process as real interest rates move higher would be when valuations are no higher than average. On our estimates the average global sector was 18% overvalued at the start of April. The gap has closed as markets have fallen sharply during the month. However, global equities are still not trading at bargain levels and investors are increasingly likely to face a period of weaker trends in corporate earnings forecasts over coming quarters.

Exhibit 3: Global equities – rate of change of forward price/book peaked in December 2020 and is now negative



Source: Refinitiv, Edison calculations. Note: RHS shows average global sector overvaluation.

In an environment of normalising equity valuations we maintain the same strategy which is to focus on traditional sectors, which have historically offered a degree of inflation protection, while avoiding more overvalued segments of the global equity market, either by region or sector. We are also favouring sectors such as banks, which stand to benefit from a period of higher interest rates, provided asset quality is maintained. While global purchasing managers' indices are still indicating expansion, the implied rate of growth has steadily fallen over the past six months and a more defensive sector positioning is now in order in our view.

In this context, we are not surprised to see the UK outperforming in 2022. The UK stock market is both relatively inexpensive in a global context and has significant energy exposure. The weighting towards currently overvalued technology is low at 2% versus a 37% weight in the US. While there is a relatively high exposure to basic materials at 12%, the strong weighting towards financials and healthcare plays both into the rising interest rate theme and a defensive strategy. After a long period of underperformance, the UK market has proved resilient during the recent market declines.

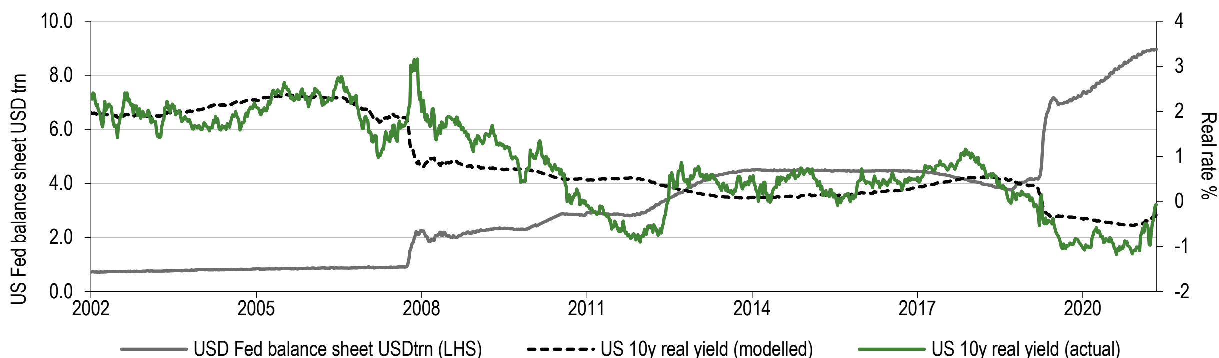
Moving to neutral on US bonds as yields approach 3%

We believe the COVID-19 pandemic may have represented the low point for global bond yields following several decades of trending lower. The extent of the fiscal packages required to support incomes during periods of mandatory lockdowns placed a similar amount of spending power at the gates of a supply-constrained global economy.

In consequence, we have to date consistently maintained a negative view on US government bonds in the post COVID-19 era, in view of the likely inflation risks associated with significantly increased government fiscal deficits at a time when supply was effectively constrained by service sector disruption. Real and nominal yields were also artificially depressed by the asset purchase programmes of both the European Central Bank and the US Fed.

As goods prices have surged over the past 12 months this leaves central banks trying to put the inflation genie back into the bottle – and after denying it ever escaped. Nevertheless, the recent bout of volatility and extraordinarily large upward shift in global interest rate expectations also raises the question of when and where the peak in global bond yields lies in this cycle.

Exhibit 4:US real yields have been rising as US QT* comes into focus



Source: Refinitiv, Edison calculations. Note: RHS shows average global sector overvaluation. QT – quantitative tightening.

Over the past 20 years there has been a relatively strong link between the US Fed's balance sheet, short-term interest rates and the level of US 10-year real yields which we show in Exhibit 4. We observe that each step-change in the Fed's balance sheet was accompanied by a persistent shift in the long-term real interest rate. As the Fed's' balance sheet reduction programme approaches with significant further rate increases forecast over the next 12 months, we consider how real yields will respond.

In the most recent Fed minutes of March 2022, policymakers hinted at an upper limit of US$95bn of monthly balance sheet run-off, also known as quantitative tightening or QT. This level of QT would represent a shrinkage of a little over US$1trn pa or US$3trn over the next three years.

This would imply a total balance sheet size of approximately US$6trn and Fed projections call for a policy interest rate of 2.8% at the end of this three-year period. If this historical relationship between Fed monetary policy settings and 10-year real rates is a guide, we would expect US real interest rates to be around 0.2% at the end of this period. This is very close to current levels following the surge from abnormally low levels of -1% in evidence as recently as Q421. Provided long-term inflation expectations remain anchored around 2%, this implies nominal 10-year yields in the region of 2.5–3.0%, or close to current levels.

Only a much more significant balance sheet run-off would be associated with the 2% real yields that prevailed prior to the global financial crisis of 2008. The relationship between balance sheet size and real interest rates is not linear and suffers from diminishing returns on size. The 2009–2014 balance sheet expansion appears to have had the greatest impact on market real yields. Therefore, the initial declines in the balance sheet may have less impact on real yields than investors currently fear.

The global financial crisis of 2008 triggered the first recent expansion in the size of the Fed's balance sheet as the Fed employed several quantitative easing stimulus packages in the years that followed. However, there have been difficulties experienced by markets when the Fed has removed market liquidity by reducing the size of its balance sheet, even after ample policy signalling such as in the 2017–18 period. We therefore believe this proposed rate of balance sheet reduction of US$95bn per month is unlikely to be exceeded – and could even be tempered in the event of market volatility.

For the US at least, bond markets have therefore largely digested the likely impact of both the coming increases in the Fed's policy rate and the reduction in the size of the Fed's balance sheet.

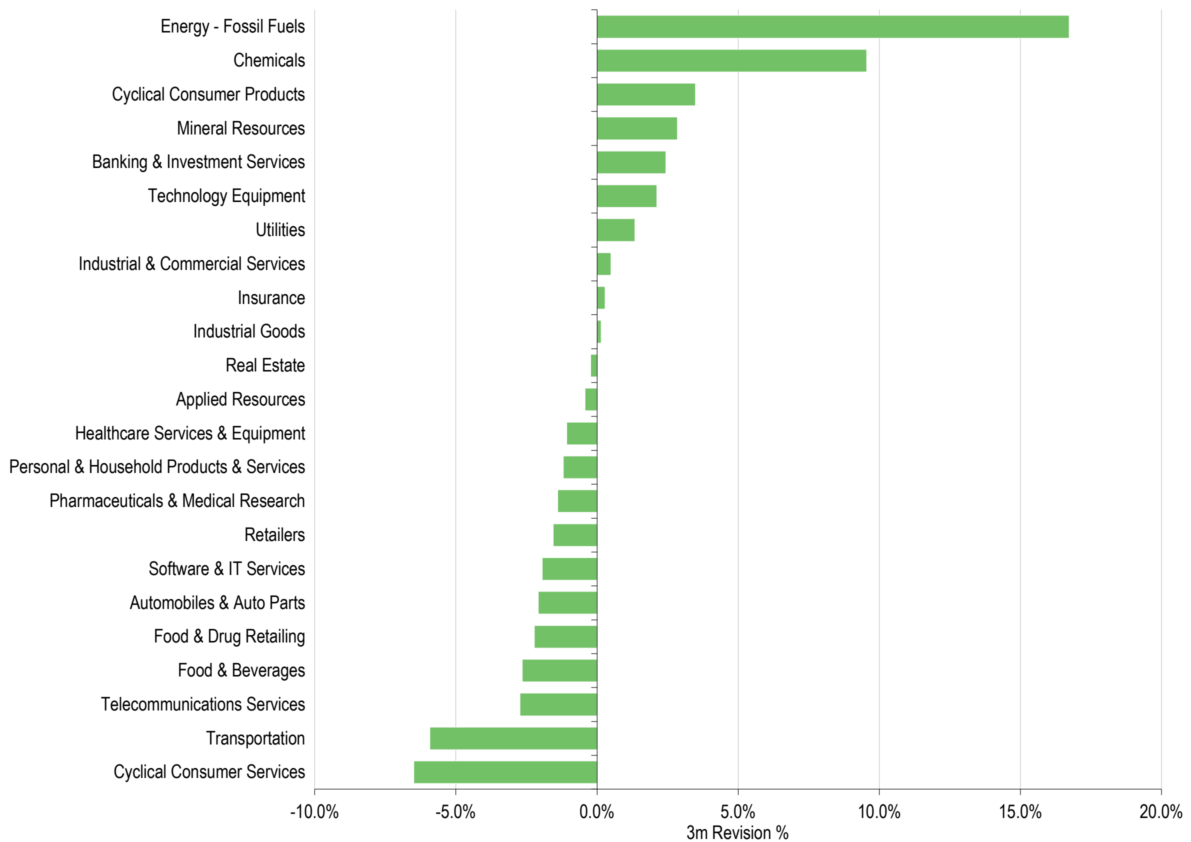
We believe US long-term government bond yields are close to fair value and move to a neutral outlook.

Mixed picture for earnings estimates outside energy sector

We continue to see a mixed picture for consensus earnings revisions. The energy sector has seen significant upgrades due to the soaring price of oil, but this is highly unlikely to be repeated in our view. It remains to be seen if oil prices can be maintained so far above marginal costs as economic growth forecasts are cut, reflecting the surge in living costs and the impact on consumers' budgets. Futures markets for oil have barely moved for longer-dated maturities since the invasion of Ukraine.

Nevertheless, while we anticipate that the risk of downgrades is increasing, in aggregate global earnings forecasts remain stable for now. This is likely to limit the downside for global equities in the short term. We note however the recent downgrades to the transport and consumer services sectors, which as expected are suffering disproportionately from rising input costs.

Exhibit 5: Three-month earnings revisions continue to show mixed picture



Source: Refinitiv, Edison calculations

Conclusion

Investors should be clear about where the uncertainty lies in portfolios. The most highly valued segments of the global equity market continue to be at risk from the ongoing normalisation of global monetary policy, a trend that has only gathered pace during April. Precisely how far this valuation correction will extend remains an open question. However, any floor in asset valuations is likely to be contingent on the perception of a ceiling for policy interest rates.

In this respect, we believe bond markets have moved swiftly to account for a significant proportion of all but the most extreme scenarios for US Fed policy over the coming three years. With US

government 10-year bond yields now close to 3%, we believe the US bond market is now finely balanced between currently hawkish central bank rhetoric and a slowdown in economic activity in coming quarters and move to a neutral rather than underweight outlook.

On the other hand, the ultimate economic outcome from the war in Ukraine remains highly uncertain as Russia becomes increasingly boxed in militarily and economically by international aid for Ukraine and sanctions on Russia. A sudden twist, such as Russia's decision to concentrate forces in the south following the remarkable Ukrainian defence of Kyiv or a further escalation cannot be ruled out. For example, the recent halting of gas supplies to Poland and Bulgaria represents a notable economic escalation by Russia in recent days.

We maintain a neutral outlook on global equities while acknowledging the return to a more normal monetary policy setting could continue to challenge investors in the more highly valued segments and regions of the global equity market. We continue to observe an ebbing of earnings momentum outside the obvious beneficiaries of the enormous gains in energy prices. In combination with weakening purchasing managers' survey data, this reinforces our belief that economic growth is waning.

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