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Equity strategy and market outlook

July 2021

Global perspectives: Valuations in the ointment

- **Volatility rises as investors balk at high equity valuations.** Global equities are now trading at a 15-year high forward price/book, suggesting that only modest returns are on offer for long-term investors. This is not necessarily irrational in the context of very low yields available in other asset classes. However, the recent market sensitivity to above-consensus inflation data and slowing US survey data suggests that markets may struggle to make further progress until investors have more visibility on 2021 profits growth.
- **Consensus earnings forecasts continue to offer support for global markets in the near-term.** 2021 earnings forecasts have resumed their upward trajectory during July. We note that while sectors exposed to rising input prices may now be under margin pressure, commodity and energy sectors are still benefiting from upgrades.
- **The UK may have brought 'delta' under control after a worrying period of escalation.** Initial fears of an explosion of cases of the highly infectious COVID-19 variant have given way to relief as case numbers have fallen to one-half of peak levels while hospital admissions remain low. This may be a helpful precedent for other regions.
- **We remain neutral on equities.** The outlook is balanced between a degree of overvaluation for developed markets in aggregate against the prospect of another year of very low interest rates and ongoing positive earnings momentum. However, we believe that investors should take the opportunity to realise profits in currently overvalued sectors, while investor sentiment remains strong.

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Valuations in the ointment

Despite the arrival of 'freedom day' in the UK and the strength of other developed market economic recoveries, global equity market progress has been relatively muted in recent months. During July volatility has been rising while global government bond yields have fallen. With global equities now trading at historically elevated valuations investors seem to have become shy of chasing equities ever higher, absent actual delivery of promised profits growth for 2021 and beyond.

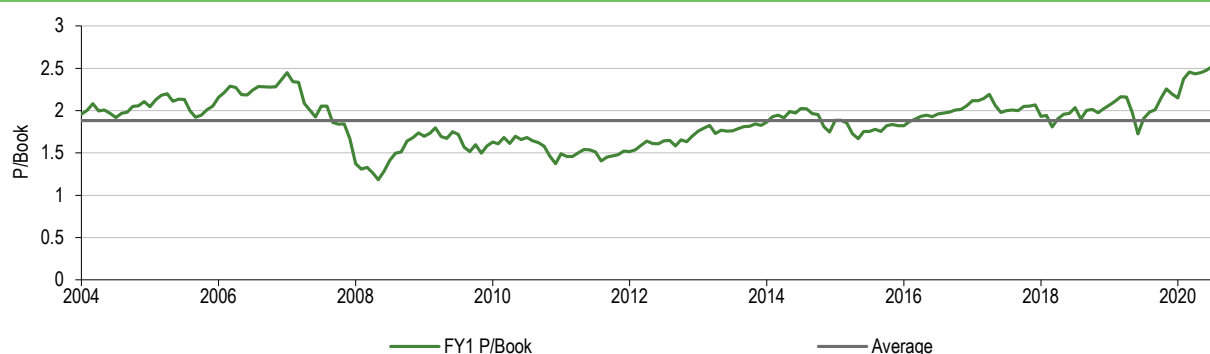
We believe investors are aware of their limited investment choices at present however and it is not an era which could be defined as one of extreme bullishness. Low bond yields, low corporate credit spreads and the anticipation of an extended period of accommodative monetary policy into 2022 are in our view the drivers of relatively high equity valuations – and it is not necessarily irrational.

In the event 2021 profits match current expectations, we would expect markets to tread water as earnings catch up and push valuations closer to long-term averages over time. In fact, the expectation of a continued period of low interest rates and rapid profits growth has been the basis for our neutral view on equities for much of 2021.

On the other hand, the risk of a correction in equity prices is clearly present given that global equities are trading close to a 15-year record forward price/book multiple, Exhibit 1. It is generally difficult to identify the trigger for a correction ahead of time. We would highlight instead that the distribution of returns may have an unusually negative skew as positive surprises are likely to lead to a more muted market reaction compared to negative surprises.

Furthermore, the apparent overvaluation of the market is not an artefact of a few large-cap companies skewing the aggregate. On an equal-weighted basis forward price/book multiples are also at a 15-year record, according to our calculations. Based on historical evidence, currently high valuations suggest a relatively modest rate of return for global equities over the longer term.

Exhibit 1: Global equities close to 15-year record price/book



Source: Refinitiv, Edison calculations as of 30 June 2021

Near term, the risks to the outlook have grown modestly. Economic growth has slowed and US inflation has risen above expectations. Equities trading close to their 15-year record forward price/book levels are offering a limited cushion for any unforeseen risks which we believe contributed to the uptick in market volatility in recent weeks.

We observe that on a sector basis equity overvaluation is also relatively widespread, Exhibit 2. Global sector valuations are almost universally above average except insurance, banking and telecoms, possibly interesting sectors to look for specific company opportunities, given their current status as consensus underperformers.

Nearly one-half of global sectors are more than 40% above their long-run forward price/book multiple at present. On a country perspective, US markets are significantly above their long-run average while European markets are only modestly above fair value on this measure.

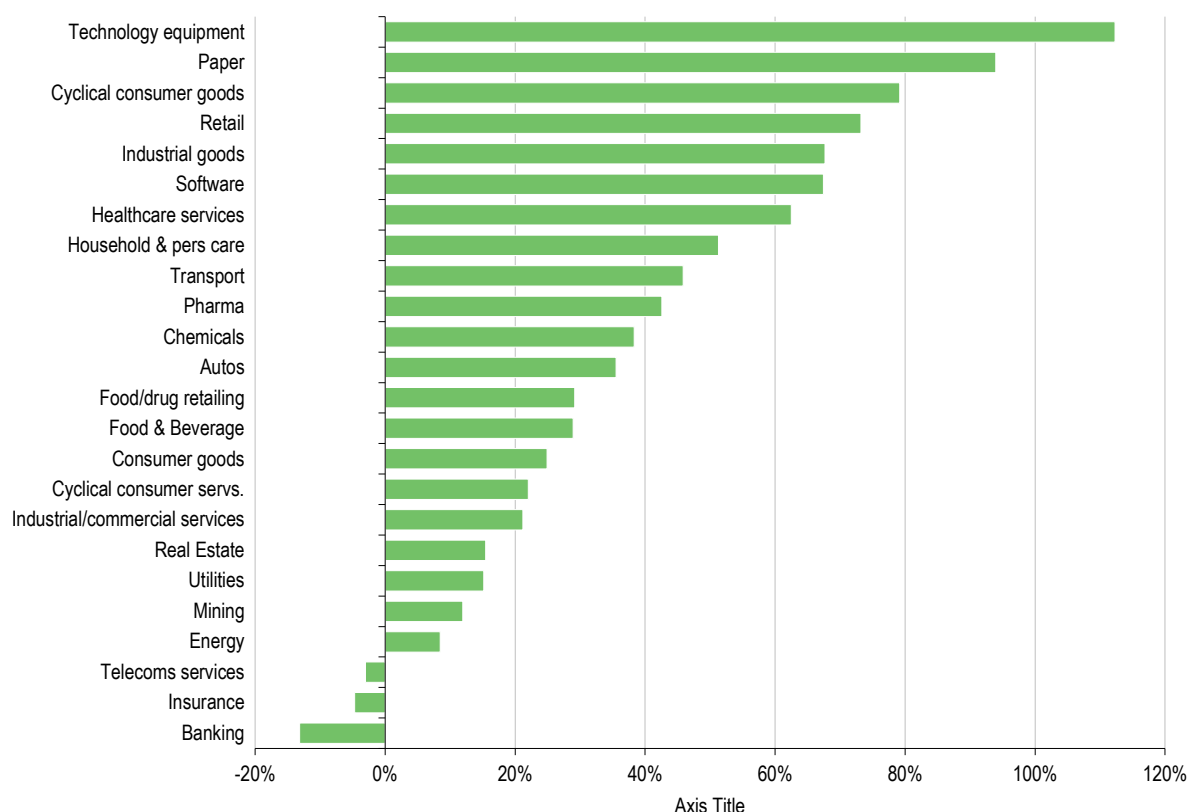
In terms of the portfolio response to this data, when markets decline even relatively low valuations provide very little protection from capital losses in the short term. Unloved sectors struggling to attract the marginal investment dollar are even less likely to do so at a time when investors are seeking to reduce portfolio risk rather than add to it.

However, following the vaccine-led recovery of the past eight months we believe prudent investors should now be looking to take profits in sectors that have outperformed and are currently richly valued, whether in technology franchises or in value names that have performed well this year.

Until recently, for most of 2021 investors have enjoyed relatively low volatility as the benefits from previously announced monetary and fiscal policy have flowed into financial markets and later into corporate profitability. The less attractive investment features of the recovery from COVID-19, such as the inevitable H221 growth slowdown from the heady rates of H121, the surge in global inflation and the possibility of more transmissible COVID-19 variants have now come to the fore.

While we remain neutral on global equities, from the preceding comments we are clearly closer to cautious than overweight on valuation grounds. We believe long-term investors should remain focused on sectors and geographies which are not so clearly overvalued and are likely to offer better returns over the medium-term.

Exhibit 2: Premium to average price/book by sector



Source: Refinitiv, Edison calculations

Growth wobble unnerves markets – but UK keeps delta in check

Last month the fear was excessively high inflation but during July growth fears have returned. A weaker than expected non-manufacturing PMI in the United States has triggered a sharp decline in global government bond yields. The US 10-year government bond yield has now fallen to 1.26%, down from 1.71% in April. We believe equity investors should have expected a slowdown in the rapid pace of economic growth as comparisons lap the Q120 lockdown period. Globally, consensus earnings estimates for 2021 are now above those prevailing pre COVID-19.

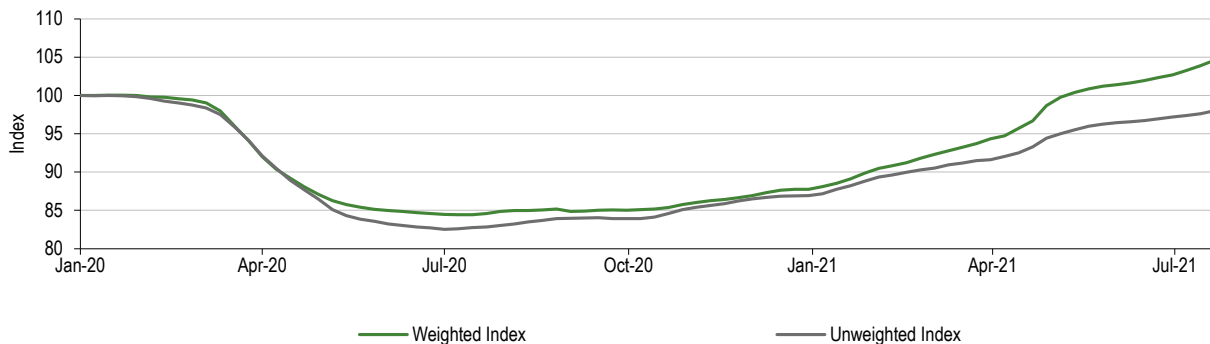
Exhibit 3: US 10-year TIPS (real) government bond yield close to lows despite economic recovery



Source: Refinitiv

Nevertheless, despite the signals from the bond market where US real yields are close to record lows at -1.05%, Exhibit 3, consensus earnings forecasts continue to rise during July. Although a number of companies exposed to margin pressure from rapidly inflating input costs have delivered disappointing Q2 results, for many cyclical names rising commodity prices are a boon and the mining and energy sectors continue to benefit from upgrades.

Exhibit 4: 2021 global consensus earnings continue to march higher



Source: Refinitiv, Edison calculations

Early data from UK delta wave are encouraging as a global precedent

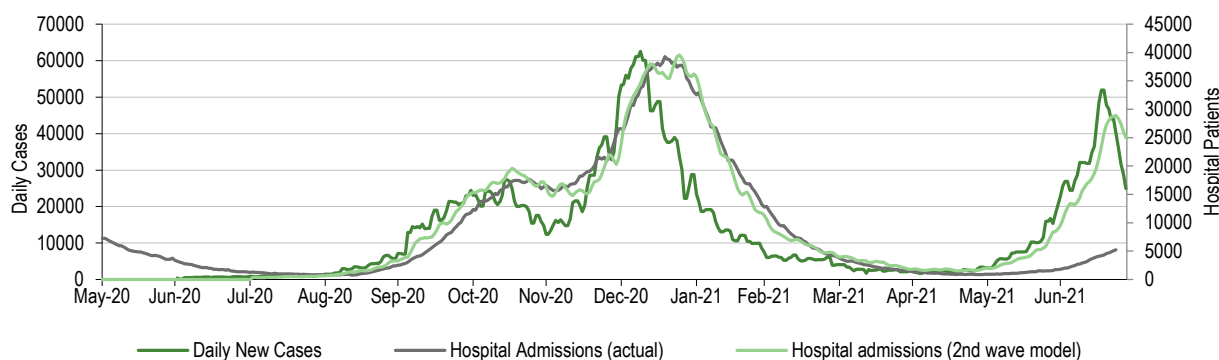
In terms of the risks from COVID-19, the UK government appears to have been vindicated in its determination to proceed with the removal of COVID restrictions as case numbers have halved since peaking at 50,000 per day earlier in July. The UK government came under significant criticism from international scientists for opening up the economy and removing COVID-19 restrictions.

However, while this unusual intervention may have been high profile, we note the focus of the scientific criticism was on mask wearing and adequate ventilation rather than any prescription for a more severe lockdown. We suspect many in England will not alter their mask-wearing behaviour significantly until cases have declined considerably, out of personal self-interest.

The delta COVID-19 variant has spread rapidly in the UK, accounting for almost all the increase in case numbers. However, the economic impact may be different this time. According to our preliminary estimates the UK's vaccination programme may have cut COVID-19 related hospital admissions by a factor of five, which means the surge in cases seems less likely to translate into an economy-wide lockdown in the autumn.

The UK's COVID-19 policy is clearly on the aggressive end of the COVID-19 policy spectrum, compared to nations such as Australia. Nevertheless, the early data from the delta variant wave of infections offers hope that hospitalisations will be well below earlier rates due to the effectiveness of the UK's vaccination programme.

Exhibit 5: COVID-19 hospitalisations per infection tracking at 20% of second wave



Source: UK government statistics, Edison calculations

The key question economically speaking is whether the anticipated increase in case numbers will pressure the health service, which in the past has been the critical factor in triggering national lockdowns. We have therefore modelled hospitalisation rates from the second wave using an autoregressive method. This simple model provides an excellent fit to the actual hospitalisation data, which lags case numbers by several weeks.

As the second wave occurred when vaccination rates were much lower, we can apply this model to more recent data to assess the relative efficacy of the vaccination programme in preventing serious disease. Our preliminary estimates suggest a five-fold reduction in hospital patients in the 'delta' wave. We would attribute this result not only to vaccination but also to the changing demographics of the pandemic, towards younger unvaccinated patients who are less likely to suffer serious infections.

It remains too early to be sure, and the relaxation of social restrictions is certainly not without risk, but the data to date is therefore suggestive that as case numbers are now falling rapidly, an uncontrollable surge in hospital admissions appears to be an increasingly pessimistic scenario.

Conclusion

Global equity markets on a valuation basis appear fully up with events as consensus earnings forecasts are higher than pre COVID-19 levels and P/E multiples have expanded. The recent weaker than expected US Institute for Supply Management (ISM) data suggest that we have passed the peak in growth momentum in the United States.

However, in the absence of any known trigger for a reversal in market sentiment, and still very low government bond yields, we believe we believe markets are likely to remain in a trading range over the summer. With relatively tight credit market spreads providing private equity with the ammunition to explore deals, further debt-financed M&A activity is also likely to support equity investor sentiment.

For now, the UK's vaccination programme appears to be effective in dramatically lowering hospital admissions, but it is preliminary data and investors should be on guard for further mutations of the virus.

We remain neutral on equities, balancing a degree of overvaluation for developed markets in aggregate against the prospect of another year of very low interest rates and ongoing positive earnings momentum.

However, on balance risks to the outlook are increasing. Investors are having to digest higher than expected inflation and slowing economic growth, even if consensus forecasts are still rising modestly. Furthermore, we expect the drumbeat of monetary tightening will continue to grow in intensity during the autumn. During the summer, investors would appear to have an opportunity to consider realising profits in currently overvalued sectors, while investor sentiment remains strong.

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