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Equity strategy and market outlook

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Global perspectives: The cycle advances

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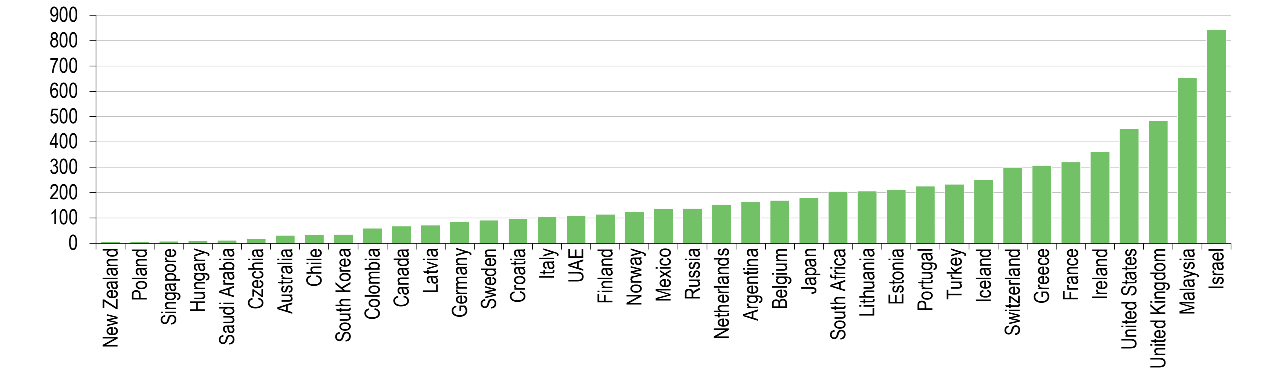
- **The impact of the positive benefits from the policy responses to COVID-19 may have peaked.** The time for tighter global monetary conditions is nearing. We believe that market volatility is likely to rise during the autumn as policymakers negotiate their first steps away from COVID-19 support towards more neutral settings, consistent with the closing of output gaps in developed market economies.
- **Investors may be focused on Fed 'tapering' but we believe the bigger risk is to economic growth.** In the very short term, the persistence of the 'delta' variant infections despite comprehensive vaccination programmes suggests that further relaxation of social restrictions is becoming less likely in developed markets. In China, purchasing managers' indices (PMIs) have peaked and bond yields are falling as growth slows, suggesting pricing of industrial commodities and energy may soften.
- **At high valuations, global equities continue to walk a tightrope.** Global equities are still trading at a 15-year high forward price/book. While this is not necessarily irrational in the context of very low yields available in other asset classes, it is suggestive of only modest returns for long-term investors.
- **We can identify two 'known' risks which may yet prove problematic.** The most obvious is that the goalposts have shifted on the 'delta' variant of COVID-19 from suppression to tolerance of endemic levels of disease. While in largely vaccinated nations infection rates have to a significant degree decoupled from economic trajectories, further social restrictions cannot be excluded during the autumn. Secondly, and arguably more importantly for markets, medium-term inflation expectations have risen sharply in the United States which may yet constrain the US Federal Reserve.
- **However, consensus earnings forecasts continue to offer support for global markets in the very near term.** 2021 earnings forecasts have continued their upward trajectory during August. While unquestionably helpful for sentiment in the short term, we do question for how long this can persist as PMI indices retrace from peak levels.
- **We maintain a neutral position on global equities, balancing valuation concerns against still strong earnings momentum. However, we suggest heightened vigilance is in order for the autumn as the prospect of tighter monetary conditions draws closer.** As developed market economies return to trend levels of activity, economic growth is likely to slow just as central bank policies take their first steps on the path to policy normalisation.

The cycle advances

The benefits from the policy responses to COVID-19 are close to peaking, in our view. The time for tighter global monetary conditions is nearing and the 'fiscal impulse' or rate of change of budget deficits will become contractionary by 2022 in much of the developed world. The narrative of a complete vaccine-led recovery is becoming increasingly challenged by stubbornly high levels of infection of the 'delta' COVID-19 variant, even if hospital admissions per infection are a fraction of previous levels.

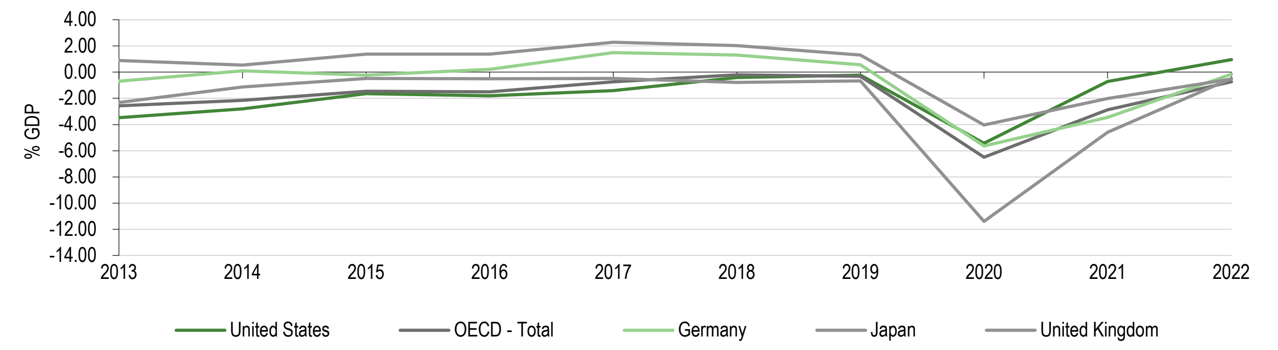
Exhibit 1: Is the 'delta' variant defeating the first generation of vaccines?



Source: Our world in data, Edison Investment Research calculations. Note: Chart shows daily new cases per million of population.

The shifting of the goalposts in terms of the benefits of vaccines away from the gold standard of herd immunity to moderating hospital admissions has been accompanied by a similar shift in thinking among investors in terms of the impact of COVID-19 on the economy and financial markets. The stubbornly high level of infections in the UK and the fourth wave of infections in Israel, both populations with high vaccination rates, has not been associated with any meaningful increase in equity market volatility in recent weeks. Investors believe the trajectory of the economy has to a large degree decoupled from the evolution of the pandemic, for as long as the most intrusive social restrictions can be avoided.

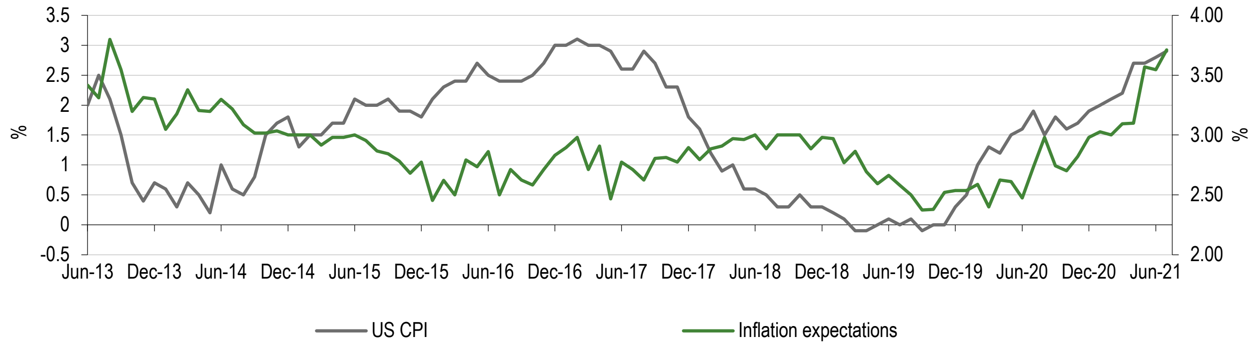
Exhibit 2: Narrowing output gaps close the window for extraordinary policies



Source: OECD, National statistics

However, we believe that market volatility is likely to rise during the autumn as the Fed and other monetary policymakers negotiate their first steps away from COVID-19 support towards more neutral policy settings, consistent with the closing of output gaps in developed market economies. While investors should in our view keep an open mind on the transience or otherwise of the factors behind the recent increase in inflation, it is a fact that US inflation has exceeded policymakers' initial forecasts during 2021 and increasingly risks boxing in US monetary policy at a time when the risks from COVID-19 have not gone away. Consumer surveys of medium-term US inflation expectations are elevated, Exhibit 3, and the fact that long-term bond yields are yet to respond is a testament to investors' conviction in the Fed's control of the long end of the yield curve, which may yet be tested.

Exhibit 3: Rising US inflation and survey-based inflation expectations not yet reflected in US bond yields



Source: Refinitiv, Federal Reserve Bank of New York

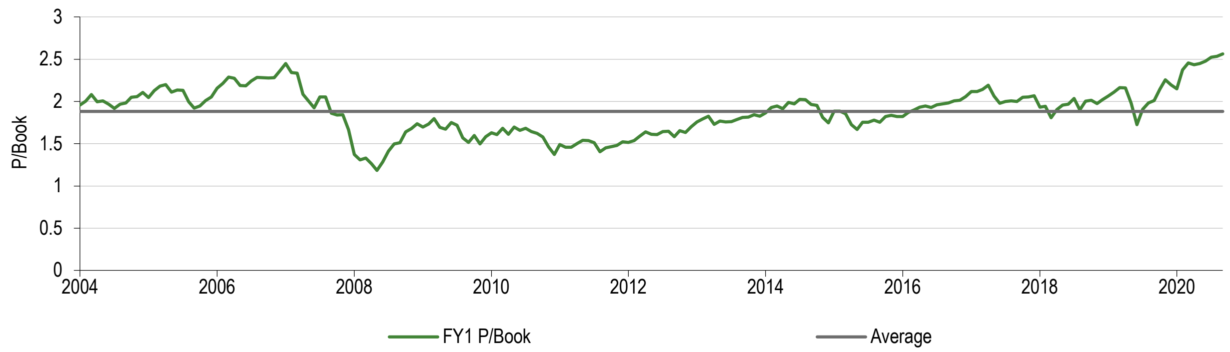
For equity investors, forward price/book multiples remain at a 15-year high, according to our calculations. Based on historical evidence, currently high valuations suggest a relatively modest rate of return for global equities over the longer term. We believe experienced investors are under no illusions but are currently faced with few compelling liquid alternatives to equities. In addition to low term premiums for government bonds, corporate credit spreads remain close to record lows.

Furthermore, the trend in consensus earnings forecasts remains positive, leading to the sense of needing to do something as portfolios generate significant gains in 2021, but perhaps not right now. We believe the optimal strategy is to maintain discipline and take profits where sector valuations are fully up with the recovery while recognising that for as long as earnings forecasts continue rising a major market correction remains relatively unlikely.

Nevertheless, the breadth of the argument for maintaining equity weightings has shrunk considerably compared to as recently as Q320. At that time, the bull case could draw on supportive valuations, the prospect of a strong COVID-19 recovery and accommodative policy settings, in addition to positive earnings momentum. Bullish arguments based on the single factor of recent positive earnings momentum should carry less weight in our view.

The US manufacturing PMI peaked in July while the Euro-area PMI index has also fallen from the record levels of earlier in the summer, with respondents highlighting supply chain issues and input price inflation as negative factors. While developed market PMIs are still at levels indicating a relatively fast expansion, we also note that in China the Caixin manufacturing PMI is close to 50, having declined steadily since the start of the year.

Exhibit 4: Global equities close to 15-year record price/book

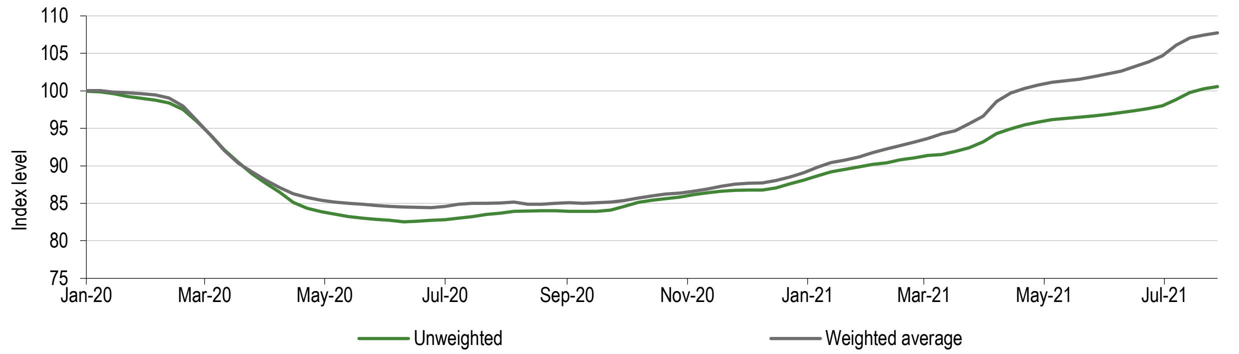


Source: Refinitiv, Edison Investment Research calculations as of 30 July 2021

Earnings momentum still positive for now

Global consensus earnings estimates have continued their upward trajectory, representing another bullish impulse in the tug of war between high valuations on the one hand and strong profits momentum on the other.

Exhibit 5: Global consensus earnings estimates re-accelerate to the upside

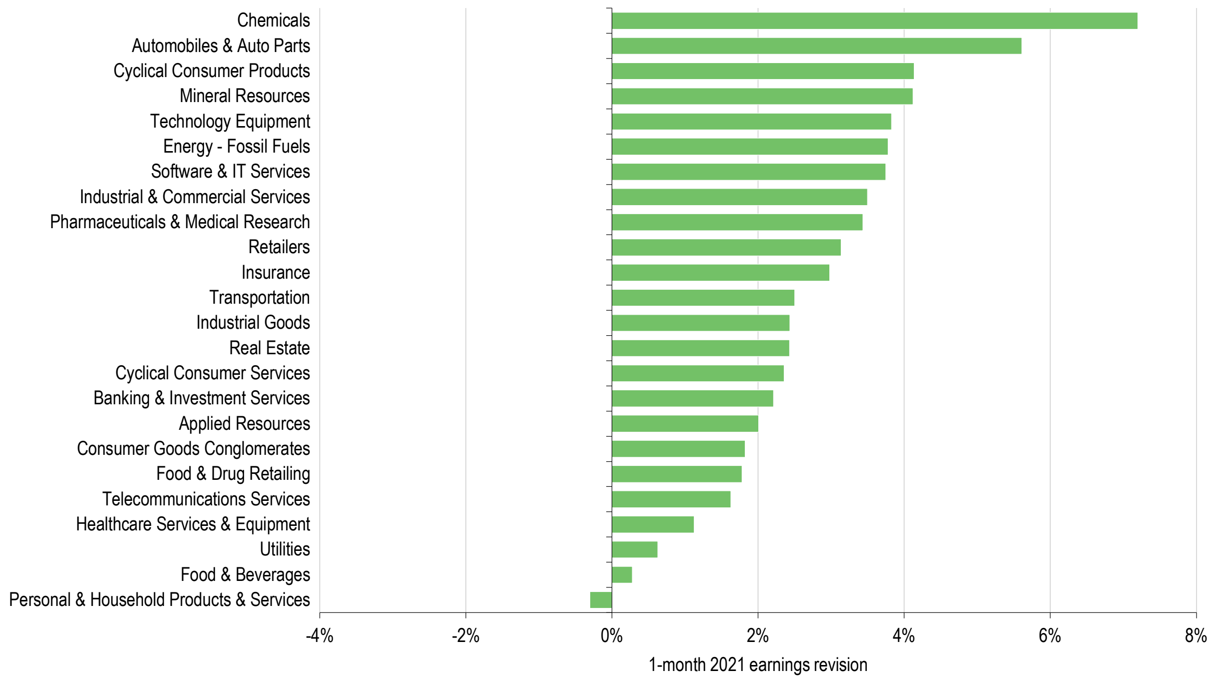


Source: Refinitiv, Edison Investment Research calculations as of 24 August 2021

Despite our worries of a loss of economic momentum, the strong corporate performance being demonstrated in the recent earnings season has once again pushed consensus forecasts for 2021 to a new high. On a weighted basis we estimate that global profits forecasts are now 5% higher than the pre COVID-19 levels of January 2020.

On an equal-weighted basis global profits forecasts are close to par with pre COVID-19 levels. The stronger growth for the weighted index reflects the unanticipated surge in profits for the large-cap technology sector during 2020 which has 'stuck' as working practices have changed, followed by the 2021 recovery in expectations for the mining and energy sectors.

Exhibit 6: 2021 global sector one-month consensus earnings revisions



Source: Refinitiv, Edison Investment Research calculations as of 24 August 2021

Even given some high-profile earnings misses in the personal and household goods sector, in aggregate there appears to have been relatively little impact to date on corporate profits from exceptionally strong input cost inflation over the past year. All but one of the 25 largest global sectors benefited from upgrades during the past month.

We believe the corporate sector is in something of a sweet spot with stimulus packages put in place to counter COVID-19 restrictions still supporting activity, while all but the most trivial of public health restrictions to counter the spread of COVID-19 have been removed. We also note that travel restrictions and costly requirements for pre- and post-travel testing and quarantine are being progressively dismantled across Europe.

However, unlike earlier in the year this benign picture from consensus earnings revisions is increasingly at odds with the declining momentum in PMI survey data and a modest softening of energy and industrial metals prices in recent months. Investors may have become accustomed to corporate earnings upgrades over the past 12 months, but they are the exception rather than the rule as it is more typical for earnings forecasts to modestly decline over the course of a year.

Looking further forward, we believe there is a risk that earnings momentum will ebb over the remainder of the year as the positive effects from the re-opening of the economy fade and the negative effects in terms of supply chain issues and input cost inflation gain in prominence.

Conclusion

We believe that we no longer need to look towards 'unknowns' to argue for a considered approach to portfolio risk at present. Globally, equity valuations remain extended on a price/book basis with many sectors well above long-term averages on this measure. An autumn resurgence in 'delta' COVID-19 infections would hardly be a big surprise given the waning efficacy of the current generation of vaccines over time. Furthermore, survey data point to slowing global growth rates while Fed policymakers have much to ponder on rising US inflation expectations and the risks of any delays to the tapering of the US QE programme.

It remains the case in our view that given current valuations, the risk/reward appears unusually asymmetric to the downside for many sectors and markets. While we remain neutral on global equities, the tailwind from COVID-19 stimulus measures is diminishing and the hard questions of higher inflation, tighter monetary policy and slower growth lie ahead. Earnings momentum may remain positive for now but as the key swing factor for corporate profits expectations is energy and commodity demand, we are now calling time on this period of ever-rising earnings forecasts, which are already above pre COVID-19 levels.

We maintain a neutral position on global equities for now, balancing valuation concerns against still strong earnings momentum but suggest heightened vigilance is in order for the autumn as the prospect of tighter monetary conditions draws closer. As developed market economies return to trend levels of activity, economic growth is likely to slow just as central bank policies take their first steps on the path to policy normalisation.

We remain underweight on global bonds as current yields do not appear to reflect rising inflation or inflation uncertainty, nor the Fed's new-found determination to ensure an average rate of inflation close to target in the medium term. These factors suggest that at current yields global bonds could offer limited or even no protection for portfolios, should the growth rate of the global economy slow during the autumn.

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