



Illumination: Equity strategy and market outlook

November 2020

Global perspectives: Back to life

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- **We look towards 2021 with a positive view on equities.** We expect 2021 will be a year of recovery and repair with a substantial rebound in global GDP as a vaccine for COVID-19 becomes widely available by Q121. Investors now have rational expectations, rather than hope, that the worst impacts of the pandemic will soon be over.
- **Relief at the end of the Trump era.** Political populism appears to have peaked with the unseating of US President Trump in favour of a more conventional president-elect Biden. Biden will not be able to pursue a radical agenda in the absence of a 'blue wave'. Investors have welcomed the prospect of a gridlocked US political system.
- **Brexit negotiations seem to be converging on a minimal deal.** This should enable the flow of goods over the UK/EU border with relatively modest disruption. The deal will not be what had been hoped for by idealistic Brexiteers, but if a deal can be reached any uncertainty will be eliminated, which would benefit UK equities.
- **Central banks should remain accommodative.** Central banks were the earliest to respond aggressively to the COVID-19 market volatility and have been clear that they expect to retain a central role in the economic recovery. Despite the vaccine news, we expect a sustained period of low interest rates and balance sheet expansion. Talk of monetary policy renormalisation is likely to be a H221 story at the earliest.
- **Upward pressure on bond yields likely to persist.** In view of the expected economic recovery, dramatically increased issuance, and a decline in demand for safe-haven assets, we expect bond yields to rise during 2021. We also note that the US Fed has shifted to an average inflation-targeting regime and the ECB may soon follow; if credibly implemented this would also imply higher nominal yields for long-term bonds.
- **The key risk for investors is that there is no identifiable risk at present.** For 2020, the risk turned out to be a novel coronavirus which no-one could have predicted in advance. Investors have been swift to mark-up equity benchmark indices as successful vaccine trials have been announced and political risks have diminished. As a result, valuations for many popular sectors remain higher than long-term averages. Therefore, while looking forward with a positive outlook, we recognise this is a consensus view and we expect equity gains over the year to be relatively measured.

Outlook: Back to life, back to reality in 2021

Investors must look forward. We can briefly commiserate with those positioned too aggressively at the start of 2020, those who panic-sold during March, those who were underweight highly valued technology stocks or those who missed out on the vaccine-led rally during Q4. Few investors will have been sufficiently skilled to take advantage of or avoid each one of 2020's turns. However, all this is now history.

There was also history that did not get written – the eurozone did not collapse under the weight of COVID-19 stress, nor did housing markets plunge or widespread unemployment create a self-fulfilling downward spiral in the economy. Bank loan losses did not create systemic risks to the financial system, nor did bond yields surge as investors feared sovereign bankruptcy. Equity investors have not fled, fearing massive rises in corporate taxes to pay for national rebuilding. In other words, markets, societies and political systems faced a serious shock but were not found wanting.

2021 promises to be a year of recovery and repair. Economically, we expect a substantial rebound in global GDP as the world has learnt to live with COVID-19. The prospect of a vaccine becoming widely available by Q121 means that investors can now have rational expectations – rather than hope – that virus-related disruption will be largely over by H221.

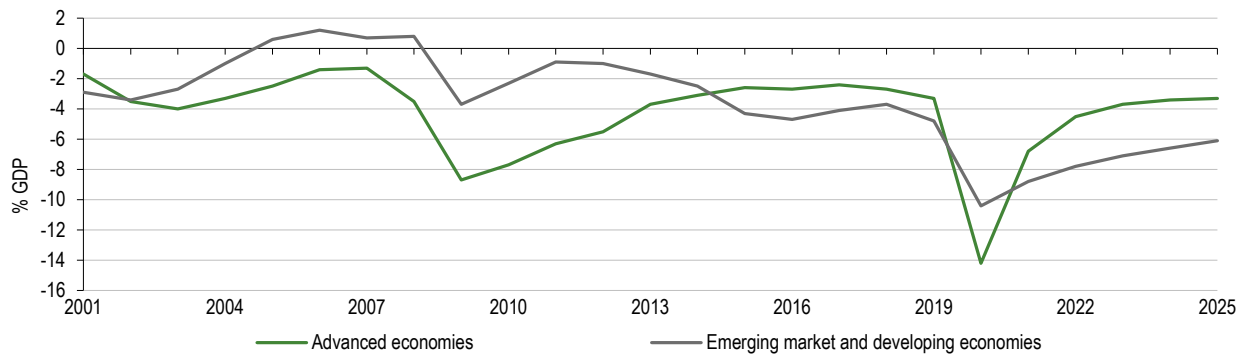
Politically, populism appears to have peaked with the unseating of single-term US President Trump in favour of a conventional if not conservative president-elect Biden. Biden will not be able to pursue a radical agenda in the absence of a 'blue wave' and investors have welcomed a gridlocked US political system.

The Brexit process is nearly complete with a minimal deal to enable the flow of goods over the UK/EU border with relatively modest disruption in sight, but not at this point agreed. Any deal would not be what had been hoped for by idealistic Brexiteers, but if even this minimal deal can be signed off, the uncertainty will have been eliminated. Larger listed companies have had ample time to prepare for Brexit and we expect few issues in this segment of the market.

In the event of a deal, the absence of uncertainty is likely to draw investors back to the UK, potentially reversing a long period of underperformance, especially when combined with the cyclical/value weighting of the UK market. Valuations are relatively attractive within a well-managed, transparent and shareholder-friendly corporate sector. There is also an increasingly brisk trade in UK equities by overseas corporate buyers during the autumn.

Within the EU, COVID-19 represents a crisis which has been put to good use. There has been meaningful progress on the thorny issue of debt mutualisation (perhaps with the German populists silenced by the immediacy of the necessary fiscal support), which from an economic perspective will smooth over with a thick plaster the remaining cracks in the fragmented eurozone economy. The alternative would have been to let the periphery perish for the second time in a decade, given the uneven impact of COVID-19. The risk of a rupture in the EU in the circumstances were simply too high.

From a fiscal perspective, the exogenous nature of the COVID-19 shock has also facilitated rapid and extensive fiscal support across the globe. Unlike the financial crisis of 2009, there was no perception of bailing out a rogue sector, which de-politicised the debate and allowed a rapid fiscal response to government-ordered lockdowns and ensuing GDP contractions. It remains the case that the lion's share of the financial costs of COVID-19 have been borne by national governments and the corporate sector has emerged relatively unscathed, placing it in a good position for the coming recovery.

Exhibit 1: Pandemic pushes governments into a large-scale fiscal stimulus as deficits widen worldwide


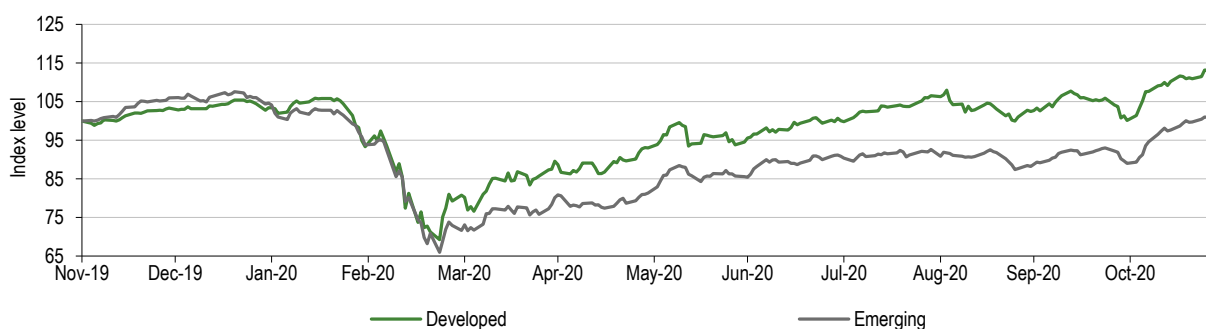
Source: IMF data and forecasts

The fiscal support will also endure during 2021. COVID-19 spending will need to be financed but there is little public or political appetite in developed markets for rapidly narrowing the current fiscal deficits through austerity measures at this time which is one less short-term risk for investors. Assuming demand for long-term government paper remains high, we expect the emphasis will instead be on issuing long-term government bonds to spread the cost of the pandemic far into the future.

Central banks were the earliest to respond aggressively to the COVID-19 market volatility, in some cases while political leaders appeared to be in denial. Central banks have also been clear that they expect to retain a central role in the economic recovery with a sustained period of low interest rates and balance sheet expansion to ensure easy financial conditions, economic recovery and the green agenda. We expect that any tightening of monetary policy in response to vaccination programmes will be a H221 story at the earliest, as a variety of central bank officials have recently stated.

While investors in recent weeks have rather lunged at the prospect, the very low cash and long-term interest rates provide the backdrop to an earnings recovery during 2021, supporting equity markets during H121, a period when profits will remain under pressure from continuing social distancing measures.

Value investing is likely to stage a partial recovery, not least because the narrowness of the global technology index leadership means that 'value' is starting to imply everything else. We expect emerging markets to benefit from a more intelligent approach to US foreign policy (and a less corporate-friendly US administration with corporate tax cuts firmly off the agenda). European markets will be supported by accommodative ECB policy, fiscal support and the resolution of the Brexit question.

Exhibit 2: Investors grasp at the prospect of a vaccine during Q420 as developed markets reach 12-month high


Source: Refinitiv. Note: Price index shown in US dollars.

The road to recovery during 2021 will not be paved with technology but a resurgence in real rather than virtual social-related spending, in our view. With valuations for the highest growth and technology stocks still several standard deviations above their long-term averages it may be time to tactically turn to more cyclical sectors as at least some of 2020's relative outperformance is at risk of reversal in our view.

Economic trajectory likely to lag market direction

While financial markets continue to rebound aggressively it should not be overlooked that the world is still suffering some of the largest numbers of daily COVID-19 infections to date. Much of Europe is currently under lockdown restrictions. Furthermore, the pre-Christmas lockdowns have not delivered the rapid decline in infections initially forecast, leaving political leaders with little option but to continue social restrictions of varying degrees over the Christmas period and into 2021.

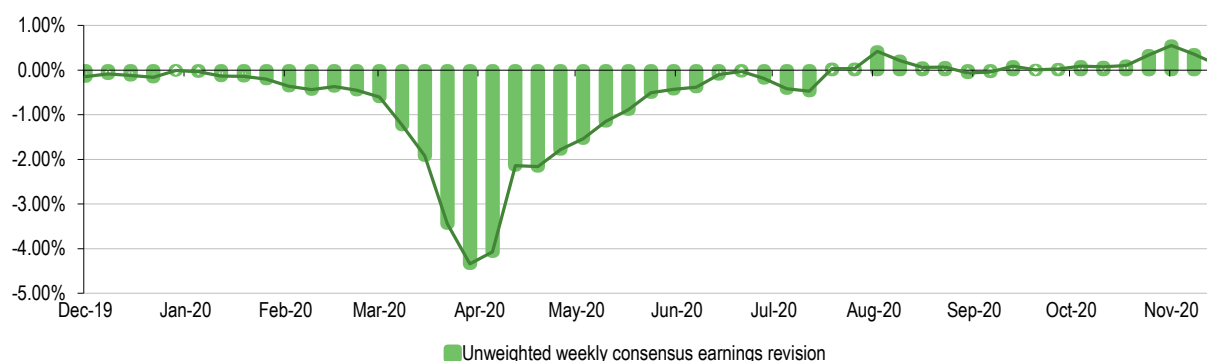
Nevertheless, due to the invention of an effective vaccine investors are now able to look through the current public health crisis and are rationally able to anticipate earnings upgrades for 2021 and beyond. The key to investing this year has been an insight into the timing, depth and duration of disruption to the global economy. In theory, and especially in an ultra-low interest rate environment, artificially depressed current year earnings should have relatively little impact on company valuation, provided the adverse conditions can reasonably be expected to be temporary. The development of an efficacious vaccine has confirmed the hoped-for roadmap out of the crisis during 2021.

While we fully expect that both Q420 and Q121 GDP in Europe will be significantly affected by Lockdown 2.0, this will not in our view have a corresponding negative impact on markets. Furthermore, while not necessarily such good news for the environment, real-time air pollution data for Europe suggest that industry has for the most part remained open, in contrast to the original lockdowns of Q220.

Consensus earnings forecasts robust during Lockdown 2.0

Remarkably, given the experience earlier in the year, consensus earnings expectations appear to have been immune to the second wave of infections seen in the US and Europe during the autumn. In part this will have been due to an excess of caution earlier in the year in terms of corporate earnings guidance. European forecasts are still down more than 25% compared to pre-COVID expectations. Nevertheless, the data show how the evolution of infections does not map 1:1 in terms of the impact on the corporate sector.

Exhibit 3: Global consensus earnings forecasts robust in the face of Lockdown 2.0



Source: Refinitiv, Edison calculations

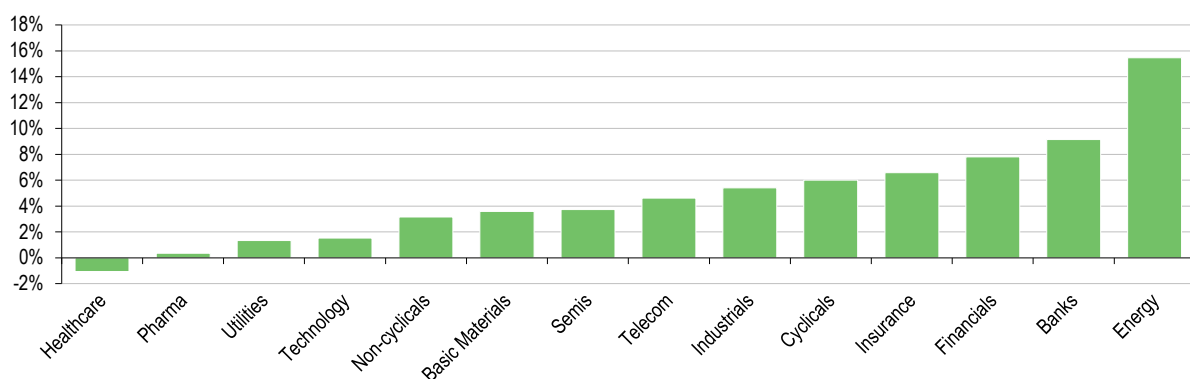
We believe the recent robustness of earnings estimates is due to the privileged position of the largest listed companies and the adaptability of large business. The travel, leisure and hospitality sector makes up a relatively small share (less than 3%) of global market caps. Outside this sector,

listed companies have adapted well to COVID-normal, with office workers able to deliver projects from home while the surge in e-commerce and deliveries has largely come at the expense of the smaller bricks and mortar-based retailers. This consolidation of final distribution has played into the hands of the largest players.

Qualitative narrative clearly favours equities over bonds

So far, we have described a favourable narrative for equity markets. Political risk is diminishing as populism retreats, notably with the exit of US President Donald Trump. This trend is also evident in Europe with the diminishing influence of the fringes of the political spectrum during the pandemic. Meanwhile, fiscal policy has loosened significantly across the globe and monetary policy is also expected to remain accommodative until the recovery is well underway.

Exhibit 4: Value sectors have led post-vaccine recovery



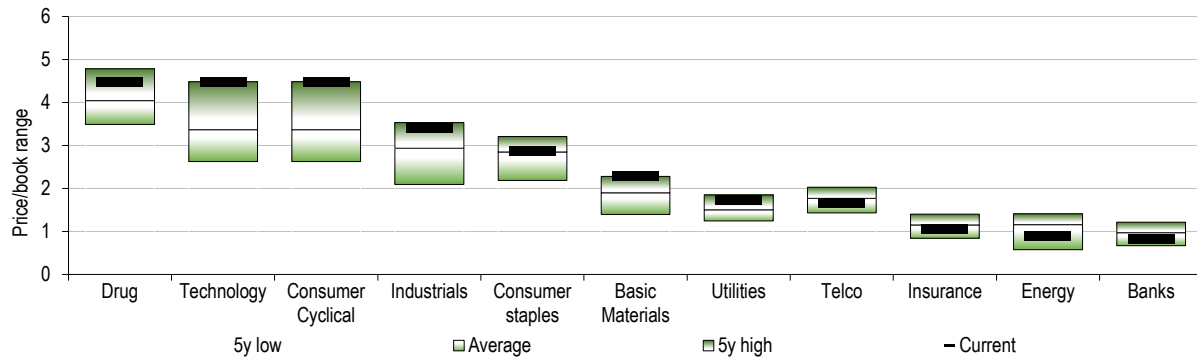
Source: Refinitiv, Edison calculations. Note: Global sector price returns in USD between 8 November 2020 and 25 November 2020.

Nevertheless, the idea of 2021 as a year of recovery economically is hardly a radical departure from consensus. There should however be no psychological objection to go with the crowd if it is headed in the right direction, provided market pricing remains sufficiently attractive. We suspect that many investors have a good idea of what they wish to do but portfolios remain tilted towards risk-aversion, rather than fully participating in the recovery. Even as we move to a positive view on global equities for H121, we believe investors must also recognise the extent of the recovery to date and that short-term gains are likely to be more measured over coming months, compared to recent weeks.

Developed markets are already trading at their all-time high, reflecting the optimism surrounding a vaccine. Value investors searching for above-market returns must now be prepared to invest in the least-favoured sectors such as energy and banks, at least if they wish to invest at a discounted price/book compared to historical averages.

We believe that despite the evident attractions of the global technology sector it is overbought at present. 'Digital defensives' may therefore underperform more cyclical sectors as the recovery in earnings during H121 continues and investors shift away from overweight allocations to COVID-secure ideas. In addition to technology, after the initial enthusiasm for pharma during 2020, the sector remains towards the higher end of its historical valuation range and it no longer has its prior safe-haven appeal during what was at times an open-ended COVID-19 pandemic.

We have previously highlighted the global industrials sector as the sweet spot of perhaps lower-profile intellectual property based businesses which were also relatively COVID-defensive. However, we note that strong recent price performance means this sector is also now trading close to the top of its valuation range on a global basis.

Exhibit 5: Global sector price/book versus long-term averages


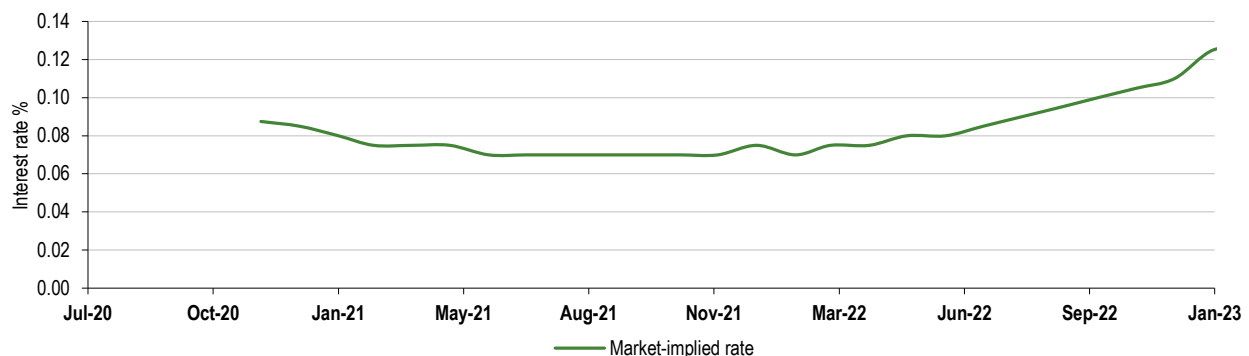
Source: Refinitiv, Edison calculations

Energy is a sector deeply out of favour as it runs counter to the prevailing clean-economy narrative, but we note that the sector is now close to the lows of its prior valuation ranges. Many large-cap hydrocarbon-based energy companies are now trading with close to double-digit dividend yields and have unfortunately disrupted their shareholder base as they 'come clean' with the realities of phasing out investments in oilfields for renewable energy projects, but at lower projected returns on capital. At times, it has felt that Big Oil's portfolio of assets and business strategy has alienated both new and old economy investors, an effect magnified by the COVID-19 related plunge in the usage of transportation fuels this year.

While the oil industry is in decline and for the right reasons, we believe investors may be overlooking the cash-generative nature of these franchises. In some respects, we are reminded that the end of big tobacco was called before the sector delivered some of the highest global sector returns for a 10-year period ending at the mid-point of the prior decade.

Fiscal and monetary stimulus key to recovery

Both fiscal and monetary policymakers are willing and able to go beyond the normal boundaries for policy to support the economy and markets during the COVID-19 pandemic. During 2020 central bank balance sheets have expanded by US\$7trn¹ and interest rates are now expected to remain at current lows at least for the duration of 2021, Exhibit 6.

Exhibit 6: US interest rate futures markets forecast no rate increases through to end-2021


Source: Refinitiv

1 Source: ECB, BOJ, US Fed, PBOC published data, Edison calculations.

This forceful action headed off the risk of a health crisis becoming a financial crisis as markets stabilised. Within credit markets, corporate bond yields have returned to normal levels and there has simply been no crisis, such as that seen during 2009. Furthermore, bank funding costs have also remained well-behaved, not least in part due to the extensive efforts to ensure a more robust capitalisation of the global banking system over the past decade.

The willingness of governments to support the economy by absorbing the costs of lockdowns and other social restrictions has been key to the relative resilience of the listed corporate sector. Larger listed corporates have in many cases suffered less from social restrictions, compared to SMEs. Continuing fiscal support for the global economy is expected in 2021 which will underpin expectations for corporate profits.

The figures are material. For developed markets, the IMF projects government spending will return to its pre-COVID-19 trajectory by 2022 and this group of nations will run fiscal deficits of 7% of GDP during 2021 on average. The household and corporate sectors of the economy will have little incentive other than to be dragged along by this anchor of government spending.

Furthermore, the willingness within Europe to allow the EU to borrow to fund fiscal support packages where needed on the periphery is a significant step to reshaping the relationship between EU member states and the attitudes towards fiscal consolidation within the eurozone. There has been no repeat of the eurozone debt crisis during 2020.

With the risk of austerity off the table, investors will also have to acknowledge that these deficits will need to be financed through debt issuance and higher taxes in future years. We expect that while rates remain low, the focus will be on issuing long-term debt to fund recovery packages while fiscal revenue-raising measures will be largely targeted at the household sector in terms of increases to income taxes. Provided fears over fiscal sustainability remain as low as currently, this is in our view a political problem which will be routinely kicked into the future.

A regime of high fiscal deficits funded at least in part by central bank asset purchase programmes while possibly innocuous in the short run does in our view raise questions over the merits of investing in government bonds at such low yields. Bond yields that are already close to zero are unlikely to offer the same level of diversification benefit to investors' portfolios as in the past. Looking out further into the future, developed market debt/GDP has taken another large increment when if COVID-19 had not happened, investors might have expected nations to move to repaying debt as the economic cycle matured.

In the short run, bond yields are likely to move higher as the 2021 recovery takes hold and risk moving even faster later in the year as central banks trial new inflation-averaging policies and overtly delay responding to rising inflation pressure. These policies allow inflation to run 'hot' early in a recovery, in order to ensure that the targeted level of inflation is reached over the full cycle.

In line with our views on economic recovery we have a negative outlook for government bonds in 2021. Furthermore, while rising inflation pressure and low real yields would normally be supportive of the gold price, gold may struggle to progress significantly above the highs of 2020 as investors become less risk averse as the end of the COVID-19 pandemic comes into view.

Conclusion

We view 2021 as a year of economic recovery and repair as social restrictions give way to vaccination as the primary means of controlling the spread of COVID-19. This view is to a significant degree embedded in consensus expectations and global equity markets, but it does not make sense to us to be contrarian at this stage as investors continue to reposition portfolios for recovery.



Instead, we have a positive outlook on global equities, but with expectations for steady progress rather than sharp gains from current levels. COVID-secure or digital defensive investing was the theme for much of 2020 and valuations at the upper end of historical ranges for these sectors suggest a more muted outturn for performance in 2021. For the more adventurous investor, stronger gains may still be possible in the still-discounted energy and banks sectors.

We maintain an underweight view on government bonds as yields are likely to rise as the recovery becomes more firmly entrenched. Furthermore, there is a risk that under an average inflation targeting regime, central banks could be perceived as ignoring rising inflation signals leading to the possibility of a more rapid rise in long-term yields later in 2021. The US Fed has changed to average inflation targeting over the summer and the results of the ECB's strategy review are due shortly; we believe investors should adjust expectations for monetary policy accordingly.

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