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Equity strategy and market outlook

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Global perspectives: Time to cut risk

- **We now question whether 2023's rally in global equities can be sustained.** The global economy has proved more resilient than expected this year, leaving labour markets proportionately tighter. An extension of the period of above-target inflation is becoming increasingly likely, in both the United States and Europe.
- **In terms of central bank policy rates,** 'Goldilocks' may have already left the building as economies run too hot, even if this overheating may be due to unseasonably warm weather. We note that in recent weeks financial conditions have tightened as the US dollar has broken its downtrend while long-term US government bond yields have been making new highs for the year.
- **Global sector performance this year has been a near-perfect mirror image of the final months of 2022.** We believe these wide swings in sector relative performance reflect investor positioning and sentiment rather than any fundamental change in the economic outlook in recent months. As such, they may be prone to reversal.
- **Geopolitical risks remain elevated.** Even as the worst-case energy outcomes in Europe have been avoided this winter, peace in Ukraine seems a distant prospect. Russia's administration continues to paint itself into a strategic corner. US/China relations, which had shown signs of thawing, seem to have re-frozen following the shooting down of a Chinese balloon over the United States earlier in February.
- **Global consensus earnings estimates for 2023 have continued on a downtrend over the past month.** It is not obvious to us at least how global equities can continue their recent uptrend in the face of earnings downgrades, rising short-term interest rates and only low single-digit earnings growth for the year.
- **We now lower our outlook on equities to neutral from positive as we have not seen the hoped-for stabilisation of earnings forecasts, even as the market has rallied**. Any improving trend in the economic data has become a double-edged sword as prospects for even higher policy interest rates later in 2023 are firmly in focus.

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Time to cut portfolio risk

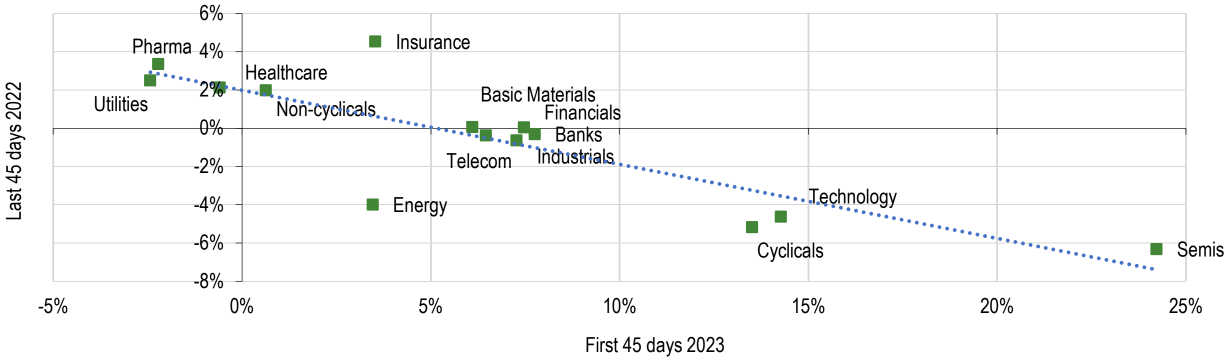
During the global equity rally of the first six weeks of 2023, which peaked in mid-February, we have observed a remarkably strong inverse correlation between sector performances leading up to and after the year-end, Exhibit 1. Defensive stocks, which outperformed towards the end of 2022, have underperformed this year, while 2023's top performers such as semiconductors and technology were previously the laggards.

We believe this reflects investor positioning and shifts in sentiment, rather than any change in the fundamental outlook, with the possible exception of the abrupt abandonment of China's zero-COVID policy. In particular, forecasts for corporate profits growth in 2023 have continued to decline during February.

The advent of disinflation in 2023 may be a welcome development for consumers, but was widely predicted by investors. Incoming economic data, as measured by economic surprise indices, have been somewhat ahead of expectations although it is difficult to disentangle how much is due to unseasonably warm weather in both the United States and Europe, rather than any underlying improvement in economic activity.

On the other hand, geopolitical risks have not receded over the winter and the position in Ukraine appears no more tractable than it was six months ago. Russia's incumbent administration is continuing to paint itself into a strategic corner, in respect of both domestic and foreign policy. Tragically for those in the theatre of war, this ongoing conflict shows no sign of resolution. Western military aid may prove decisive in the long-run, but there is little progress on the ground. Nevertheless, in our view China's long-term economic interests do not appear to be served by weighing in with military support on the Russian side.

Exhibit 1: High inverse correlation between sector performance +/- 45 days from year-end 2022



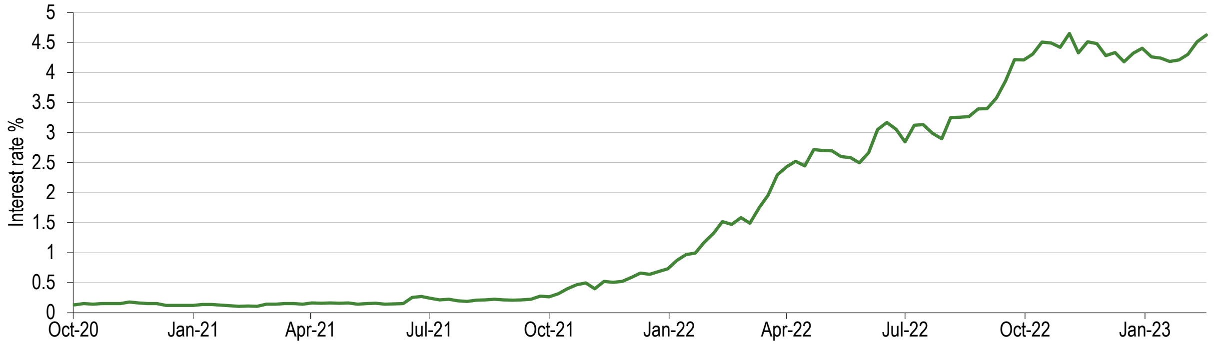
Source: Refinitiv. Note: Returns shown in US dollars.

Key to the about-turn in market sentiment at the year end was the relative stability in long- and short-term interest rates as global bond market investors welcomed the peaks seen in US and European headline inflation rates. However, since mid February both bond and interest rate markets have become increasingly sensitive to the risks of persistently higher than target inflation as economic activity surprises to the upside. A turn in purchasing managers' indices is in evidence in above-consensus readings on both sides of the Atlantic during February.

In the space of just a few weeks, investors are therefore rotating away from recession risks and back towards fearing persistently high inflation. We would concur with this recent change in market mood. US inflation remains well above target and despite a substantial tightening of monetary policy in the United States and Europe over the past 12 months, unemployment is still at decade lows, Exhibit 3.

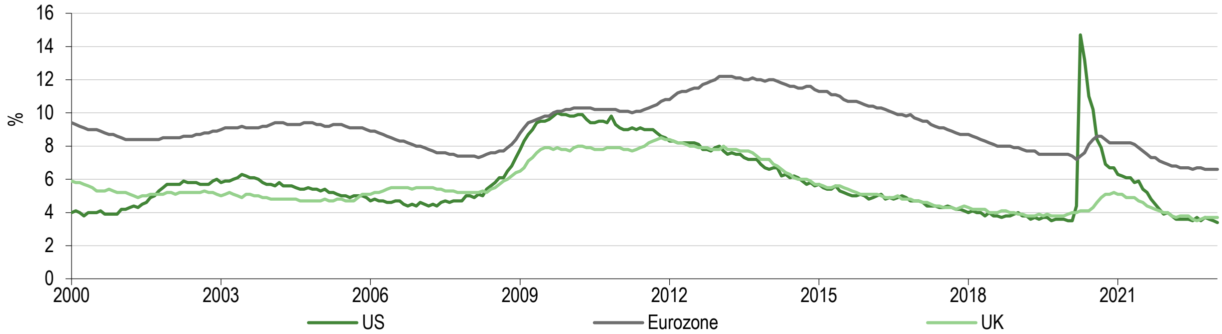
However, if monetary tightening has failed to create an output gap, underlying inflationary pressure is likely to persist. This increases the risk either of a higher peak in policy rates, or a longer period of high interest rates. In either case, we would now expect central bank rhetoric to become increasingly hawkish in coming months, especially given the extent of the recent gains in more speculative assets, such as meme stocks and cryptocurrencies.

Exhibit 2: US two-year rates recently moving higher with positive economic data



Source: Refinitiv

Exhibit 3: US, eurozone and UK unemployment rates remain close to decade lows

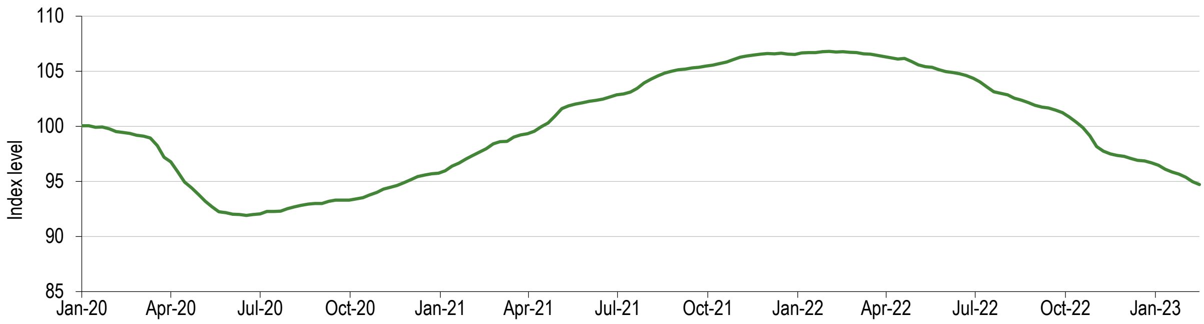


Source: Refinitiv

Earnings estimates still on a downward track

2023 earnings forecasts remain on a downward track, Exhibit 4, despite the recent optimism expressed through improving sentiment in global equity markets. The declines are evident at a global level and are widely spread across sectors, Exhibit 5. Given the extent of the positive turn in market sentiment, we are becoming increasingly concerned that the fundamental earnings rug is being pulled from under investors' feet.

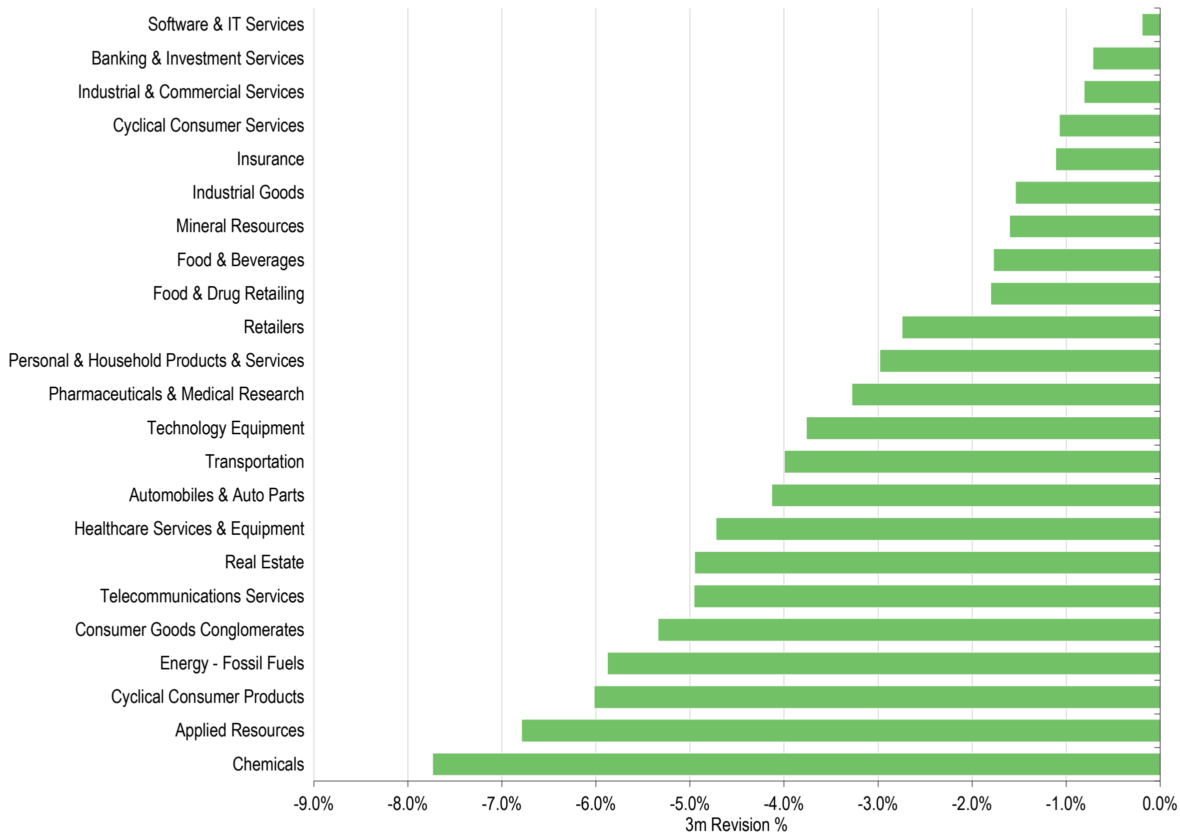
Exhibit 4: Global earnings forecasts continue to be revised lower



Source: Refinitiv, Edison calculations, equal-weighted global revisions index

Aside from our concerns on the persistence of earnings downgrades, the current consensus forecast for earnings growth in 2023 is very modest, at less than 5% for each of the US, UK and eurozone, consistent with the below-trend level of developed market GDP growth expected by central bank policymakers. A negligible rate of earnings growth offers precious little scope for forward P/E multiple compression from expanding earnings over the course of the year.

Exhibit 5: Consistent pattern of 2023 earnings downgrades across global sectors



Source: Refinitiv, Edison calculations, equal-weighted sector revisions index

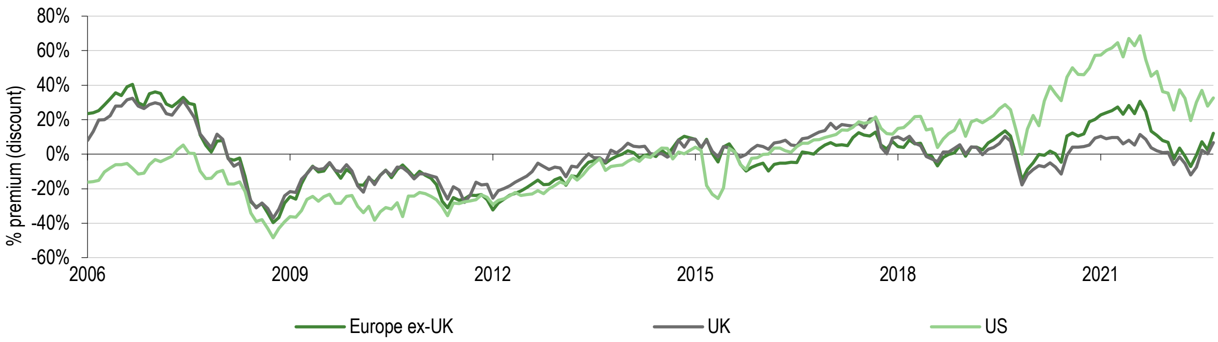
Furthermore, we have been relatively patient in waiting for a turn in earnings forecasts to catch up with market sentiment. Somewhat paradoxically, the peak in 2023 earnings expectations, driven by the COVID-19 recovery in developed markets, was seen well before the upward turn in market sentiment in Q422. In our view, it is now time to follow the data and acknowledge that during a period of downgrades investors should not expect a strong short-term equity market performance.

Valuations: US equities once again extended, Europe neutral

Following the substantial recovery of global markets from the lows of Q422, valuations are no longer as supportive of a positive equity outlook as they were in November. US equities once again appear expensive while European equities are in line with long-term averages, notwithstanding the significant outstanding risks in terms of the evolution of the war in Ukraine and its impact on the regional energy market.

In an environment of modest forward earnings growth and negative earnings momentum, we see little reason for valuations to move materially higher from current levels in coming months. It is also much too early in the year to look towards 2024 and our base case for equities is now a period of treading water, at least until there is confidence that the inflation ogre has been defeated, rather than merely sleeping.

Exhibit 6: US, UK and Europe ex-UK price/book valuations



Source: Refinitiv, Edison calculations. Note: Chart shows current FY1 price/book premium versus 15-year average.

Conclusion

An environment of renewed upward pressure on both US short-term interest rates and the US dollar is not conducive to a strong equity market performance in the short term. We believe investors have been prepared to hope for the best early in 2023 but there is a risk of a reality check as the fundamental factors of growth, inflation, corporate profitability and geopolitics appear to be stubbornly little changed from three months ago. Improved economic sentiment does not appear to be reflected in improved earnings forecast trends, possibly as tight labour markets shift the benefits to workers.

As consensus earnings forecasts have failed to stabilise and continue to suffer downgrades, we now believe the 2023 equity market rally is at risk of stalling and we therefore reduce our equity outlook to neutral from positive. Global equity valuations at a little above their long-term averages offer little directional guidance in an environment of rising short-term interest rates and cyclically low earnings growth. Furthermore, geopolitical risks only appear to have increased in recent weeks as early signs of a rapprochement between the United States and China have been snuffed out by accusations of aeriel espionage..

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