



BRILLIANT KNOWLEDGE

# ILLUMINATION

Equity strategy and market outlook

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## Global perspectives: Position defensively

- **The recent banking mini-crisis may have passed but it leaves little on which investors can build a major recovery.** Stability has returned to the banking sector, market volatility has ebbed and global equity market indices have recovered. Most investors have now realised that the global banking system is significantly more resilient than during the crisis of 2008.
- **Following the recovery in equity index levels during April, mid-single digit consensus earnings growth for global equities seems an insufficiently attractive foundation for a major rally.** A consistent trend of earnings downgrades over the last 12 months calls this modest level of growth into question. Earnings estimates for 2023 peaked last year and have been declining since.
- **Equity valuations continue to trade at above-average levels in the US and at close to long-term averages in other regions.** There is no discount on offer for the risks of an economic slowdown or geopolitical volatility. We expect the next six months to be a difficult period for central bank policymakers as stubbornly high inflation readings may leave central banks talking tough but doing relatively little tightening as the credit cycle has already turned.
- **Further geopolitical volatility lies ahead as protagonists seek to establish credible negotiating positions, ahead of any talks and resolution.** The outcomes of the expected Ukrainian counteroffensive remain uncertain, as does the shadow-boxing between the United States and China on the rules of the international order. Current equity valuations do not appear to offer compensation for these risks.
- **At the start of 2023, an overtightening of monetary policy was probably the single largest risk for global markets.** The recent banking mini-crisis has conveniently re-set policy rate expectations onto a lower trajectory. Money supply and loan survey data suggest that credit growth has slowed considerably during Q1, which should leave US interest rates on a declining trend. We believe the pain for long-term government bond holders may be over.
- **We maintain a neutral outlook on both global equities and global bonds.** As earnings estimates continue to be at risk of downgrades, we prefer defensive sectors such as utilities, telecoms, pharmaceuticals, defence and selected real estate. The food sector is also set to benefit from declining input cost pressures. Global equity valuations slightly above their long-term averages offer little directional guidance at a time of cyclically low earnings growth.

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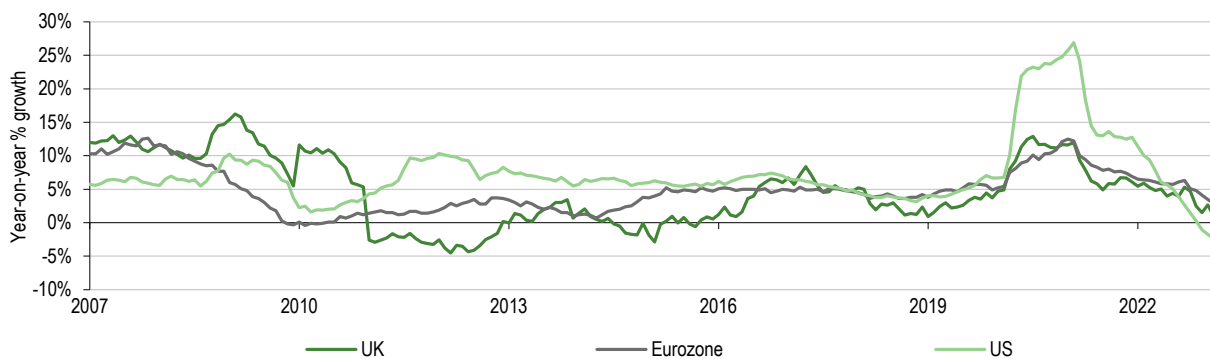
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## Position defensively

For over a year, investors have been fixated on the risks of tighter monetary policy. We now believe that we are very close to the high-water mark in terms of US interest rates and the focus is likely to turn to declining rates of economic growth and easing inflationary pressure. Credit demand has been checked by the sharp increase in interest rates seen on both sides of the Atlantic over the past 18 months. Following the banking mini-crisis of March, credit supply is likely to tighten. Broad money supply growth in Europe, which is correlated to lending growth within the real economy, has shrunk sharply over the past 12 months to the end of February, before the banking mini-crisis, Exhibit 1.

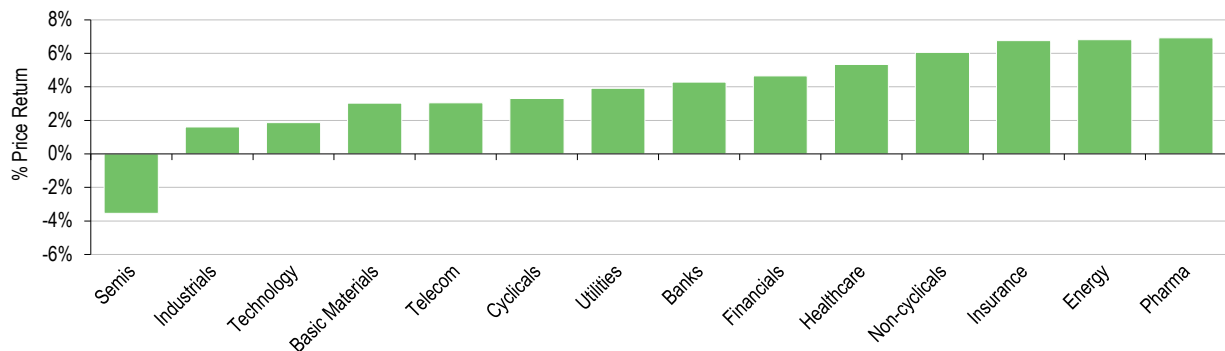
**Exhibit 1: Money supply growth has diminished since the end of the COVID-19 pandemic**



Source: Refinitiv

Despite stubbornly high wage growth and core inflation at present, we therefore believe the worst is over for government bonds. The peak in US policy rates appears to be close at hand, following which US short-term interest rates are likely to decline as economic activity slows.

**Exhibit 2: Rebound in global sector indices post resolution of Silicon Valley Bank (SVB) and Credit Suisse**



Source: Refinitiv, sector returns 20 March 2023 to 26 March 2023

While the European Central Bank has some further tightening ahead, it is also likely to be on hold by mid-2023. In the UK, the market-implied path of interest rates indicates a peak in May but then declines over the following 18 months. With inflation still well-above target but falling, this will be a period when central bank policymakers are likely to focus on talking tough on inflation but doing relatively little, in acknowledgment of the significant lag between policy actions and their impact on the real economy.

## Low earnings growth suggests modest progress after rebound

There has been a rapid rebound in global equity markets as investors shifted away from the idea that events at SVB and Credit Suisse were the harbingers of another major crisis in the banking system, Exhibit 2. Nevertheless, from here mid-single digit 2023 consensus earnings growth seems insufficient to underpin a major rally, in our view. A consistent trend of earnings downgrades over the last 12 months even calls this modest level of growth into question. Earnings estimates for 2023 have declined at an accelerated rate since mid-2022.

**Exhibit 3: 2023 consensus global earnings growth – mid-single digit and on a declining trend**



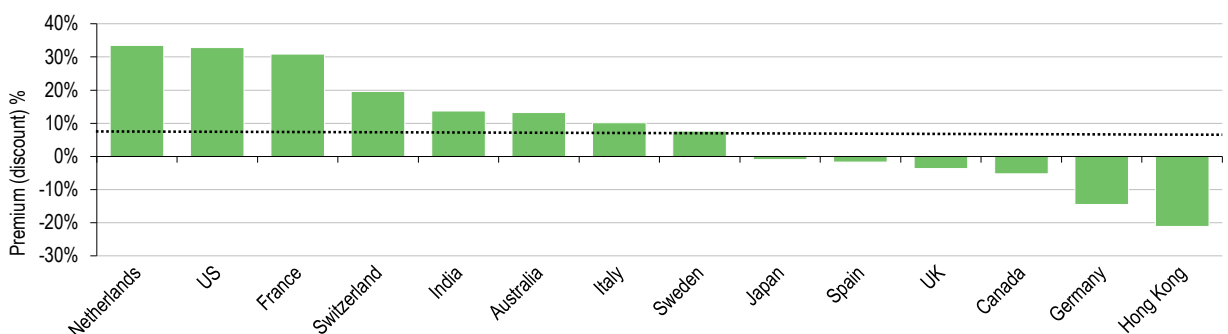
Source: Refinitiv

We believe it is counterintuitive to expect a major market rally in an environment of relatively weak earnings growth, a persistent trend of downgrades and global equity price/book valuations above long-term averages. In time, there is likely to be a case for investing on the basis of improving growth prospects for 2024, but this will be contingent on a less challenging valuation backdrop and conviction that the trough in economic activity is at least imminent.

## Equity valuations too high given risks

Despite one of the most significant periods of monetary policy tightening of the last quarter-century – and a banking mini-crisis within the last month – we estimate global equity valuations remain 8% above long-term average levels on a price/book basis.

**Exhibit 4: Equity markets still trade at an average 8% premium on a price/book basis**



Source: Refinitiv, Edison calculations. Note: Price/book versus 15-year average.

This provides precious little cushion against any further volatility, whether related to the banking sector, the significant uncertainty in terms of the extent of any slowdown during 2023 or geopolitical events.



## **Geopolitical risk is rising, long-dated and difficult to price**

The rest of the world can be grateful that the conflict in Ukraine has been largely contained within the borders of the country, but it is much too early in our view to assume that economic impacts have been eliminated. A cold winter in Europe could once again create considerable pain for consumers later in the year. Furthermore, events in Sudan show that the tentacles of Russian activities are widespread.

It is clearly challenging for portfolio managers to incorporate the qualitative narratives of Russian aggression and the increasingly powerful role China seeks in world affairs into portfolios. The BRICS (Brazil, Russia, India, China, South Africa) acronym is no longer an investment concept, but the leading geopolitical rival to the 'Group of Seven' leading industrialised countries. After decades of relative stability, we expect an uncomfortable and extended period of power projection, whether in respect of Ukraine, Taiwan or influence in Africa.

China and Russia have sensed that established power structures and dispute resolution mechanisms, such as the world's post-World War II (WW2) multilateral institutions, are ripe for challenge. In response, the United States and its allies, which have dominated international affairs in the post WW2 era, are having to invest significantly to protect the status quo, whether phrased in terms of protecting democracy and the right of self-determination, human rights or respect for existing borders. This is occurring through increasingly strident diplomacy and trade sanctions and more recently, in weaponry and military capability. One side's 'rules-based international order' is another's 'Cold War mentality'. Even the phrase 'a nuclear war must never be fought' has two alternative implications.

In theory, this daily drumbeat of power projection should not necessarily lead to a major conflict, but instead represent the establishment of credible opening positions for negotiations in future years. There are echoes of the nuclear arms race of the previous century.

However, while fears of a hot war between the major powers may prove misplaced, the impact on global economic growth is likely to be real and negative. Global trade barriers will become increasingly restricted if each side tries to demonstrate that it can do without the other. Trade barriers have been rising since the Trump era.

In developed economies, there has been a belated realisation that unfettered trade has arguably been an enabler in the rise of authoritarianism in developing nations, rather than creating the conditions for democratic change and a convergence of social values. In this respect, while national security implications should always have been the priority, the recent US emphasis on 'friend-shoring' and US restrictions on technology transfers into China are only likely to increase economic frictions and cut economic growth.

The economic peace dividend at the end of the Cold War was globalisation, which was enormously beneficial to global corporate profitability. This new period of geopolitical negotiation is likely to reverse at least some of these benefits over time. Geopolitical negotiation is a long-dated, large and uncertain factor similar to climate change, the kind of risk markets are notorious for failing to discount ahead of time. There are few obvious beneficiaries, apart from the defence sector. Over the next 10 years, ongoing geopolitical competition means the risks are that economic growth will be slower and valuations lower, compared to the prior decade.

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## **Conclusion**

The recovery from the banking mini-crisis is welcome and will give comfort that the weakest links in the financial chain have been dealt with. That there has not been a cascade of collapsing institutions is a testament to the improvements in banking sector regulation since 2008.

Following the recovery in equity index levels during April, mere mid-single digit consensus earnings growth for global equities seems an insufficiently attractive foundation for a major rally. A consistent trend of earnings downgrades over the last 12 months even calls this modest level of growth into question.

Equity valuations continue to trade at above-average levels in the US and at close to long-term averages in other regions. There appears to be no discount on offer for the risks of a slowdown or further geopolitical volatility.

Further geopolitical volatility lies ahead as protagonists seek to establish credible negotiating positions, ahead of any talks and resolution. The outcomes of the expected Ukrainian counteroffensive remain uncertain, as does the shadow-boxing between the United States and China on the rules of the international order. This is a long-dated, uncertain dynamic, involving unravelling aspects of globalisation, and is likely to impinge on potential economic growth over time.

At the start of 2023, an overtightening of monetary policy was probably the single largest risk for global markets. The recent banking mini-crisis has conveniently re-set policy rate expectations onto a lower trajectory. Money supply and loan survey data suggest that credit growth has slowed considerably during Q1, which should leave US interest rates on a declining trend.

We believe the pain for long-term government bond holders may be over, and in an environment where estimates continue to be at risk of downgrades, we prefer defensive equities such as utilities, telecoms, pharmaceuticals, defence and selected real estate. The food sector is also set to benefit from declining input cost pressures.

We maintain a neutral outlook on both global equities and global bonds. Global equity valuations at a little above their long-term averages offer little directional guidance at a time of cyclically low earnings growth.

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