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Equity strategy and market outlook

MAY 2023

Published by Edison Investment Research

EDISON

# Global perspectives: In a holding pattern

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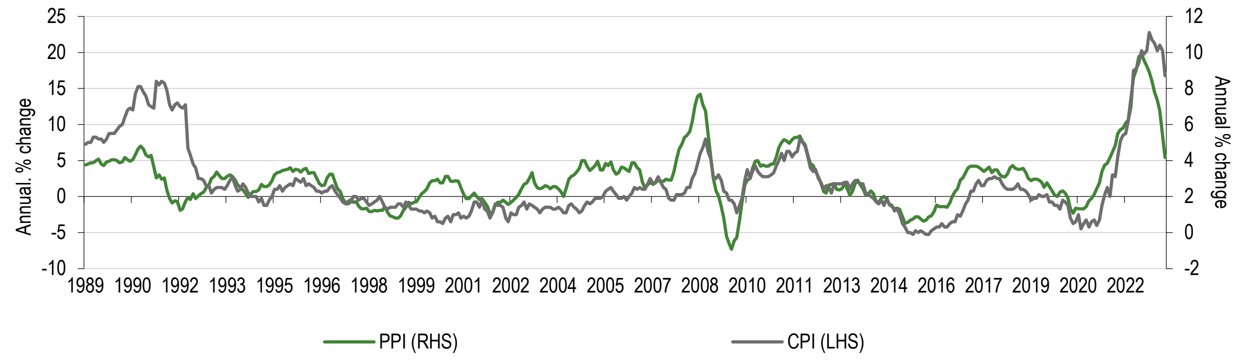
- **Global markets appear to be in a holding pattern.** Following the banking mini-crisis, investors are still appraising the ultimate impact of the long period of rising global interest rates and declining credit availability.
- **Inflationary pressure, even if on a declining trend, has proved stubbornly persistent.** The tightening of credit conditions in the US – and rapidly declining credit growth in Europe – portends a slowdown in economic activity. For now, the services sector of the economy appears to be in robust health, but surveys and commodity prices suggest fading demand in the manufacturing sector.
- **After an extended period of downgrades, global earnings forecasts for 2023 show some tentative signs of stabilisation.** A 12-month period of declining earnings forecasts has proved a challenging headwind for equity markets. If sustained, this stabilisation in the fundamentals will be a welcome development, finally aligning consensus profits forecasts with relatively muted GDP growth. Nevertheless, mid-single digit consensus earnings growth for global equities seems an insufficiently attractive foundation for a major rally, at least until 2024 is within sight.
- **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. The next six months are likely to be difficult for central banks as stubbornly high inflation readings may require them to consistently talk tough to manage inflation expectations. However, as the credit cycle has already turned there is likely to be only limited further tightening.
- **We maintain a neutral outlook on both global equities and global bonds**. Global equity valuations slightly above their long-term averages offer little directional guidance at a time of cyclically low earnings growth, leaving investors in an unsatisfying holding pattern.

## In a holding pattern

Following 18-months of rising interest rates, global markets appear to be in a holding pattern due to lingering fears of difficulties within the financial system. In recent weeks, the theatre of the periodical US debt limit negotiations has also affected global equities. Theoretically, there should be nothing for global investors to fear. US voters are unlikely to reward politicians who drive their government to default on US Treasury securities. However, partisan US politicians still have political capital to gain by taking markets hostage, if only briefly. In a month's time, the debt limit is likely to have been increased, political points scored and it will be off investors' list of concerns.

Inflationary pressure, even if now on a declining trend, has proved stubbornly persistent. In the UK core inflation is still running at 6.8% year-on-year to April, as second round effects such as wage increases feed into the services sector of the economy. Declining wholesale food and energy prices are yet to fully feed into consumer prices and there is an increasing divergence between sharply declining producer price inflation (PPI) and still sticky consumer price inflation (CPI), Exhibit 1.

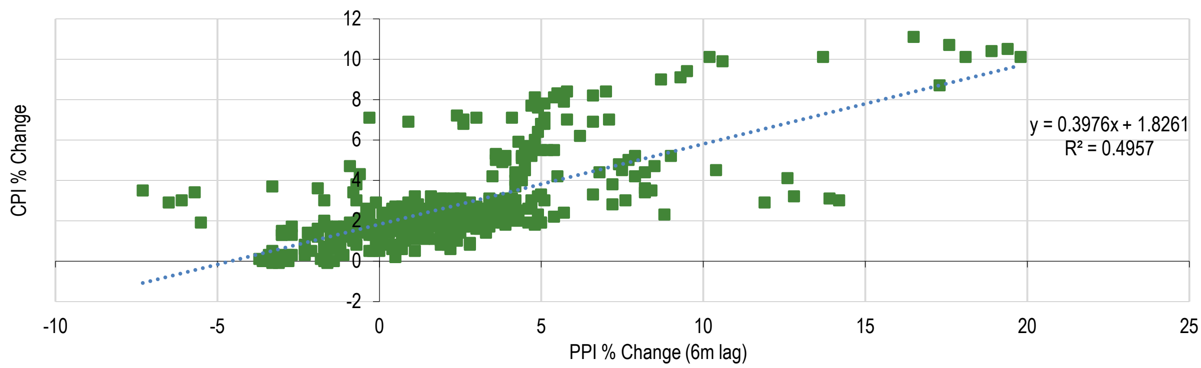
**Exhibit 1: UK CPI sticking at a high level for now, but PPI is falling fast**




Source: Refinitiv, UK ONS

We would observe that historically there is a tight link between PPI and CPI six months later, Exhibit 2. A simple regression model would indicate that based on current readings for PPI, UK CPI is likely to fall to 3.4% by the end of 2023. Similarly, the US PPI reading of just 2.3% in April suggests that CPI is on track to be as low as 2.5% by the end of the year, which is close to target and in-line with current US Federal Reserve projections.

**Exhibit 2: PPI strongly correlated to CPI six months ahead**

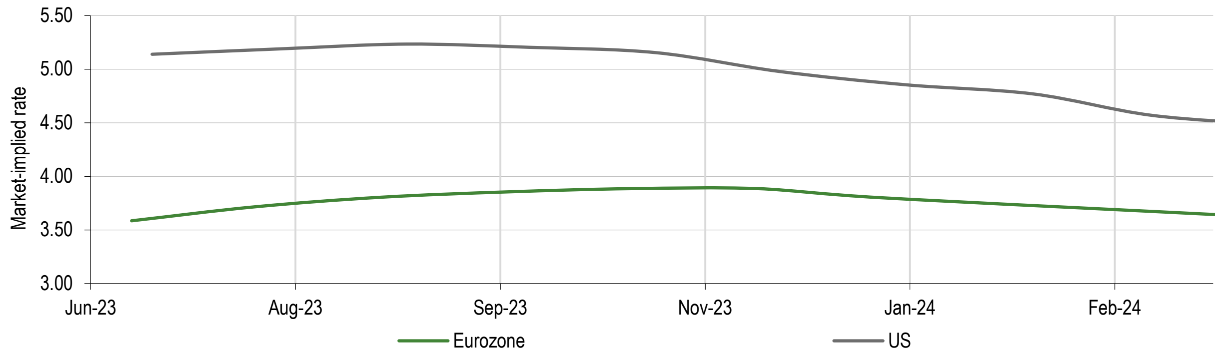



Source: Refinitiv, UK ONS, Edison calculations

The battle against inflation is therefore likely already won in our view, but given the time lag discussed above, CPI data are likely to remain challenging for some months. Central banks will also be motivated to talk tough to keep pressure on any self-reinforcing inflationary expectations within the services sector, but we believe investors should look through this rhetoric.

In this respect we note that in recent weeks global interest rate markets have shifted and are no longer expecting any policy rate cuts for the remainder of 2023 in Europe or the US, Exhibit 3. There has been significant volatility in the outlook for short-term interest rates as expectations have been jostled by the US banking mini-crisis, resilience in the services sector of the global economy yet declines in food, energy and industrial metal prices.

**Exhibit 3: Market-implied interest rate levels imply no rate cuts in 2023 in the US and Eurozone**




Source: Refinitiv

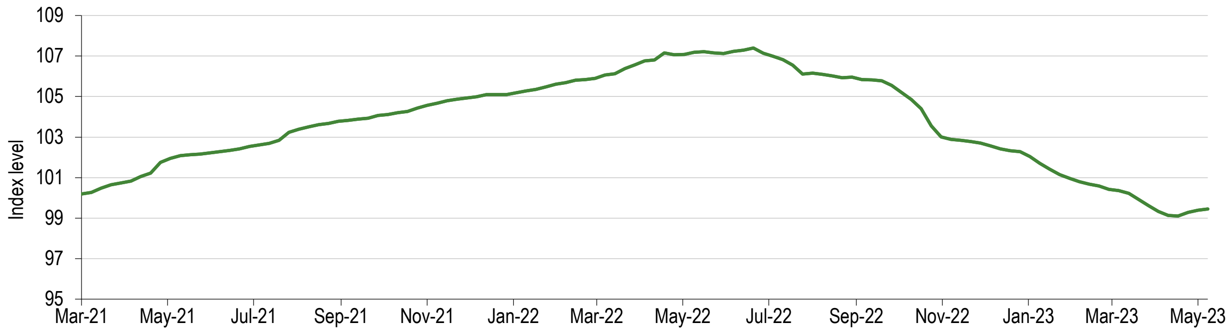
The risk of accelerating or out of control inflation appears much more modest compared to early 2022, when inflation pressure was extraordinarily high and rising, but interest rates were at record low levels. As inflation continues to moderate over the coming quarters, we believe forward rate expectations are likely to ease and as a result, the yield curve should flatten from its current inversion.

Compared to 18 months ago, long-term US government bond yields appear to be at much more attractive levels, and we note press reports that bond funds are now attracting significant inflows as a legitimate income-producing alternative to equities at current yields. In our view, US government bonds have resumed their traditional role as diversifiers within a portfolio, offering a 1.5–2.0% return above medium-term inflation expectations, with yield compression potential in the event of an economic slowdown. We maintain a neutral view on this asset class.

## 2023 earnings estimates stabilise

After an extended period of downgrades, global earnings forecasts for 2023 are showing some tentative signs of stabilisation, Exhibit 4. A 12-month period of declining earnings forecasts has proved a challenging headwind for equity markets. However, if sustained, the recent stabilisation in profits forecasts should be welcomed by investors.

**Exhibit 4: 2023 consensus global earnings growth – mid-single digit and on a declining trend**




Source: Refinitiv

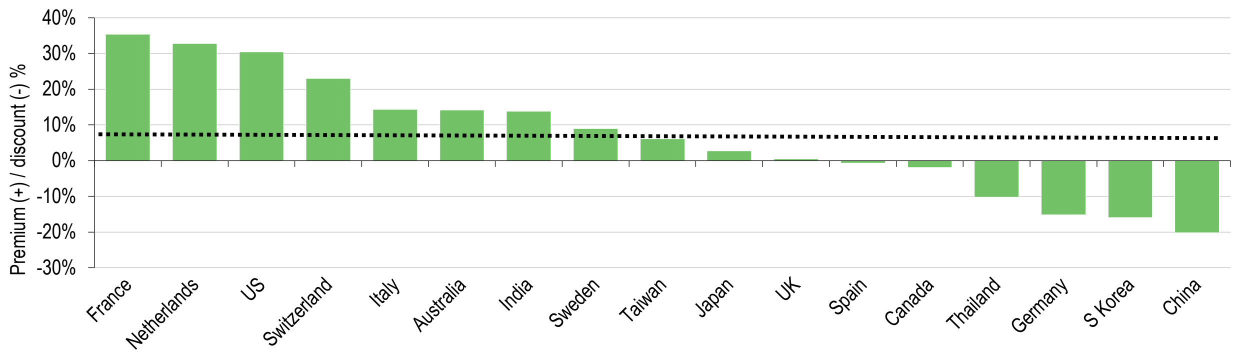
Nevertheless, we continue to believe it is counterintuitive to expect a major market rally in an environment of relatively weak earnings growth and with global equity price/book valuations above long-term averages.

We note that the listed corporate sector has a bias towards large, capital-intensive industries such as manufacturing and resources, rather than the services sector of the economy. At present, the dynamics of the post COVID-19 recovery clearly favour services over manufacturing. According to recent purchasing managers' survey data, manufacturing activity is contracting at an accelerating rate, in contrast to labour intensive services, which continue to expand in developed markets. This recent strength of the services sector is in our view responsible for the surprising resilience of the overall global economy and strong demand for labour, maintaining interest rate expectations at a higher level than would otherwise be expected given soft manufacturing data and declining credit growth.

## Equity valuations offer little directional guidance

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

**Exhibit 5: 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.

In our view this premium provides precious little cushion against any further volatility, whether related to the US debt limit negotiations, the significant uncertainty in terms of the extent of any slowdown during 2023, or geopolitical events.

## Conclusion

Following a relatively weak recovery from the banking mini-crisis, investors have moved on to fretting over the current impasse in the US debt ceiling negotiations. We believe the risk of a US default is actually remote. Such an extraordinary act of economic self-destruction would be in no domestic parties' interest. Nevertheless, the political dynamics suggest that only once markets have been spooked will politicians face the pressure to agree a deal. In this event, any volatility is likely to be short-lived and may represent a short-term buying opportunity.

We note the stubbornly slow declines in CPI inflation, which have pushed markets to expect no interest rate cuts until 2024. However, given the strong correlation of CPI with earlier moves in PPI, we expect CPI inflation to fall relatively rapidly to levels consistent with current central bank forecasts by the end of 2023, assuming energy prices do not rise later in the year as the European winter approaches.

While investors will welcome the recent stabilisation in earnings forecasts for 2023, mere mid-single digit consensus earnings growth for global equities seems an insufficiently attractive foundation for a major rally. Equity valuations continue to trade at above-average levels in the US and at close to long-term averages in other regions.

We maintain a neutral outlook on both global equities and global bonds. Global equity valuations modestly above their long-term averages offer little directional guidance at a time of cyclically low earnings growth, at least until prospects for 2024 come into view.

## United Kingdom

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