

Global Equity Views

Themes and implications from the Global Equity Investors Quarterly

2Q 2019

IN BRIEF

- While our portfolio managers are more cautious after the first quarter's gains in equity markets, we still see good reasons to stay invested.
- Emerging market equities look attractive even after a strong rebound from October's lows. UK equities, which are trading at a significant discount to the broader market, also present some interesting opportunities despite the obvious uncertainties of Brexit.
- With the value style near historical lows relative to growth and amid renewed concerns about the economic outlook, our investors are finding opportunities in higher-quality value-oriented and cyclical stocks.
- Trade and tariffs remain the biggest risks to our outlook; our investors are also watching for signs of a recession.

TAKING STOCK

After a rip-roaring recovery from the miserable end to last year, it is easy to think of reasons to take a more cautious view of the prospects for world equity markets. In particular, analysts have steadily lowered profit forecasts around the world amid sluggish growth in the major developed economies and concern over the outlook in China. The message from bond markets is to expect more of the same, with the U.S. yield curve temporarily inverting recently and the troubling sight of negative yields on government debt once again spreading across Northern Europe and Japan. Given that the U.S. economic expansion is already the second longest in history, investors are understandably anxious about the outlook for growth and profits over the next couple of years.

Our portfolio managers are also more cautious after recent gains, but we see some important reasons to stay invested. Equity market valuations still look very reasonable despite the jump in prices during the last three months; moreover, international and emerging market stocks are at an unusually wide discount to U.S. equities. Compared with the returns on offer from bond markets, stocks again look cheap around the world. And within markets, the discount for taking risk is still unusually large, with valuation spreads between low and high priced stocks wider than average. All of this suggests that investors are well aware of the near-term challenges, and sentiment toward equities remains far from exuberant. Meanwhile, amid a subdued economic outlook, we see more signs that management teams are embracing "self-help" strategies in Europe and Japan, while U.S. corporations are still buying back stock to return capital to shareholders at historically generous levels.

AUTHOR



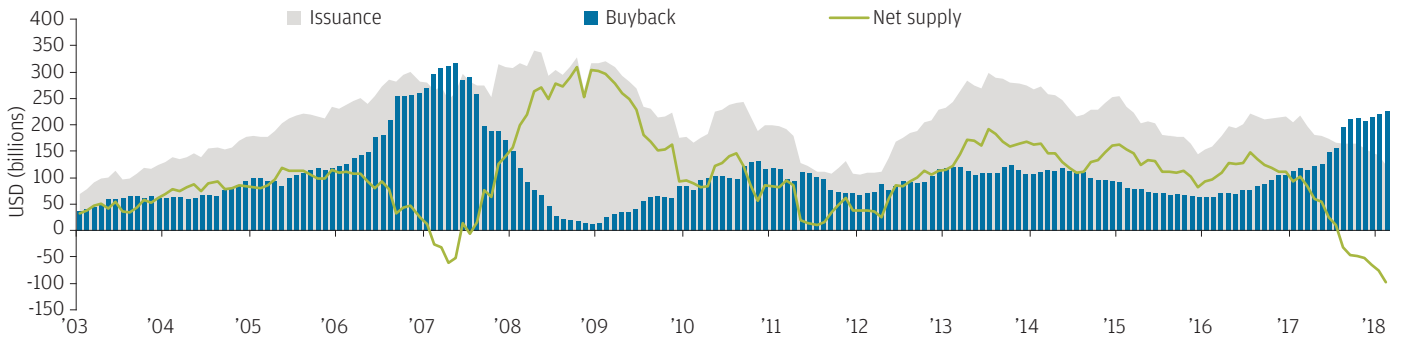
Paul Quinsee
*Managing Director and
Global Head of Equities*

TRENDS

Our earnings forecasts have continued to drift lower, as they have since mid-2018, and we see more modest growth this year. Lower commodity prices and softer growth have weighed in particular

As buybacks gradually increase, net equity issuance is now negative for the first time in a decade

EXHIBIT 1: EUROPE STOCK BUYBACKS AND EQUITY ISSUANCE, 12-MONTH ROLLING, USD BILLIONS



Source: J.P. Morgan Asset Management; data as of January 31, 2019.

on the industrial sectors, while parts of technology have also cooled down. Looking further out (which we think is the more important perspective), we still believe that profits in many more cyclical sectors are above sustainable levels, although the correction is already underway in the semiconductor space. In the emerging world, profit expectations have also fallen, but there are some tentative signs of improvement recently—a less than robust outlook, to be sure, but only modestly different from how we saw things a year ago. Of course, a U.S. recession would change that, but aside from the signals from the yield curve, we don’t see the typical warning signs yet.

A more tempered outlook for economic growth is helping encourage companies to focus on shareholders, both by returning capital and restructuring to improve profitability. In Europe, it appears that net equity issuance is now negative for the first time in a decade as buybacks gradually increase, while similar practices are slowly gaining more traction in Japan (EXHIBIT 1). However, attitudes still vary tremendously from company to company, which provides interesting opportunities

for stock selection. U.S. companies continue to enthusiastically return capital at record levels, with a growing list of activist investors quick to chase any perceived laggards.

Despite briefly performing better toward the end of 2018, value stocks have yet again been eclipsed by “growthier” names this year as investors have quickly returned to their favorite stories amid a more cautious economic outlook and mistrust of more cyclical investments. This extends a decade of underperformance for the value style, one of the longest periods that we can identify in the past century of stock market history. Unsurprisingly, the gap between the pricing of growth and value stocks is now at very wide levels, surpassed only during the first internet boom, in 1999-2000. Investors have also showed renewed enthusiasm for stable dividend payers in the last year, and the so-called bond-proxies again command an unusually large premium. Cyclical companies and financial stocks (a popular choice) have lagged even during a better trend in markets so far this year.

EXHIBIT 2 presents a snapshot of our outlook.

Views from our Global Equity Investors Quarterly, March 2019

EXHIBIT 2



A subset of survey results is shown for Global Equity Investors Quarterly participants polled in March 2019. These responses are taken from a quarterly survey, representing 35 CIOs and senior portfolio managers across global equities.

OPPORTUNITIES

By region, emerging markets still look relatively attractive to us, with valuations no longer extremely cheap but still sensible despite a 15% rebound from last October’s low. Within this group, we see further potential for recovery in the all-important Chinese stock market, with sentiment recovering from a severe sell-off during 2018.

Elsewhere, we note the very significant discount now applied to UK equities; this seems to offer generous protection against the obvious uncertainties of Brexit. Our investors point out that the revenues and profits of the major British companies are very international. Moreover, UK equities offer a dividend yield in excess of 5% vs. around 3% for the global average, and with UK stocks trading at a 30% discount to the MSCI World—near 30-year lows—there are some interesting opportunities (EXHIBIT 3).

Cyclical stocks were also battered last year, and very low multiples of current profits in sectors such as automobiles and airlines show that investors remain very skeptical that these profits are sustainable. In many cases we agree, but we’ve added to selected transportation, energy, industrial and financial stocks in a number of strategies. We’ve noted before that after a decade of underperformance from value stocks, this group looks unusually attractive from a long-term viewpoint, and that remains the case. Worries over global economic growth and low interest rates have hurt both the financial and cyclical stocks that tend to dominate value portfolios. But with the discount for value well into the top decile over the past 30 years, investors should be paying attention to this group. As a result, many of our portfolio managers are looking for higher quality cyclical stocks.

In the U.S. market, our growth investors remain focused on the tremendous long-term opportunity for software-driven businesses to take market share across a broad range of industries, even as some of the classic “FAANG” growth stocks become less

appealing. Many software-driven names have run up strongly recently and appear more fully priced again. But the team is enthusiastic about the longer-term prospects for many of these companies, which are poised to benefit from the need for increased productivity as workforces age and from additional demand as small and mid-size businesses increasingly adopt software systems. As renowned entrepreneur and venture capitalist Marc Andreessen’s prediction that “software is eating the world” plays out, we find attractive software-driven business models across the technology, financial and consumer sectors. As much as two thirds of our growth portfolios are now invested in this key theme.

RISKS

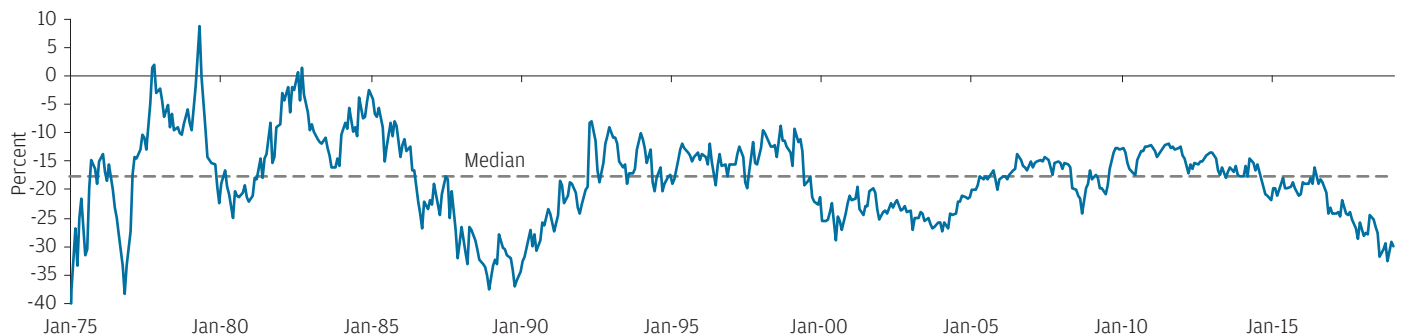
Although markets have become less anxious on the topic of trade tariffs and barriers, we are carefully monitoring developments on this front and are concerned about the potential for major disruption to supply chains and relationships built up over three decades of globalization. As we have previously noted, the tariff issue is more significant for companies than for the overall economy, with profits heavily skewed toward the industries that have benefited most from the ability to reduce costs, source new markets and pay less in taxes.

In the past, we’ve worried that tighter monetary policy from the Federal Reserve could present another major threat to the long bull market. That risk seems diminished, which markets have been quick to reflect. A recession is higher on the list of risks, although not an obvious near-term threat despite the gloomy message from the bond markets.

Meanwhile, the risk premium for defensive stocks—those that are less sensitive to economic conditions—is high again across regions, indicating that these names appear expensive relative to their more cyclical counterparts.

UK equities’ 30% discount to the broader market is near a 30-year high

EXHIBIT 3: MSCI UK VS. MSCI WORLD, 1975–2019



Source: J.P. Morgan Asset Management, using data from MSCI, I/B/E/S, Morgan Stanley Research; data from January 31, 1975, to January 31, 2019. Based on P/E (price to earnings), PBV (price to book value) and PD (price to dividend). Average relative valuations use 12-month forward data where available (forward P/E data starts in 1987) and trailing data where forward P/E data is not available. Past performance is not a reliable indicator of current and future results.

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NEXT STEPS

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