Global Equity Views
Themes and implications from the Global Equity Investors Quarterly
4Q 2019

IN BRIEF

• Amid a somewhat challenging backdrop for profit growth, our investors have a more balanced outlook on the equity markets, but there are still good opportunities to be found in equities, especially in relation to other asset classes.

• Broadly speaking, equity valuations remain reasonable relative to history, and our work indicates that investors are still compensated in real terms for owning stocks.

• We are finding value across diverse parts of the market, from China to Europe, and are seeing opportunities among higher growth companies with sustainable profits and cash generation.

• Trade tensions remain the biggest risk to our outlook, as disruptions in global trade have the potential to weigh on corporate profits and stock prices.

TAKING STOCK

Equity market returns look strong year-to-date, but this is simply a reversal of a very weak end to last year, and stock prices have been trending broadly sideways in the U.S. and lower in Europe and Asia since early 2018. Profit growth has slowed, and trade tensions have come into sharper focus. Equity fund flows have been consistently weak around the world. And while investors’ support for fast growers and defensive stocks has proved very enduring, more cyclical investments remain quite out of favor.

In this environment, our portfolio managers remain somewhat more cautious than usual. At the company level, corporate profits are growing, but at a slower pace than last year. We also expect more downward revisions in earnings expectations, particularly in more economically exposed sectors, as global economic growth appears below trend, the manufacturing economy is weak, and persistent U.S.-China trade tensions pose an ongoing risk for markets and firms. Still, all is not bleak for equity investors. The best growth companies are continuing to deliver remarkable profitability and cash flow, while prospects for value-oriented stock pickers, as measured by the divergence between cheap and expensive stocks, look very interesting. And unlike in some other asset classes, valuations for equities are mostly well within historical norms and investors are still compensated in real terms for holding stocks. In sum, we find many reasons to recommend staying invested.

EXHIBIT 1 presents a snapshot of our outlook.

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TRENDS

Underlying the range-bound equity markets since the start of 2018 has been a rather dull earnings picture. Our developed markets (DM) research analysts forecast earnings growth in the low single digits this year, with the outlook for 2020 not much better. Profits in cyclical sectors such as industrials and technology have been above trend, and we expect downward pressure on earnings as these revert to more normalized levels. Similarly, in emerging markets profit expectations for 2019 have been revised lower as the year has progressed. The trend has been led by the semiconductors sector, which has been a drag on earnings growth as inventories have been de-stocked. And while our emerging markets (EM) analysts expect a rebound in profit growth next year, this is helped by easy year-over-year comparisons in cyclical sectors that have seen earnings decline this year. But valuations look sensible and incorporate a subdued near-term outlook. For EM equities as a whole, our RIGOUR framework’s five-year expected return (underpinned by earnings growth) stands at a respectable, if middle-of-the-road, 14%.

Absent a few days in September when value-oriented equities dramatically outperformed high growth names, value stocks once again found themselves overtaken by consistent growers, extending the run of more than a decade of underperformance for the value style. But as our U.S. Value team reminds us, when thinking about growth vs. value it’s important to recognize that the stock market is ultimately a collection of companies, not style factors. For market leadership to come from value stocks, we would need an environment where economic growth is on the upswing, interest rates are rising and there is some modest inflationary pressure. We’re not there yet, but as investors have become more cautious, the opportunity is building.

OPPORTUNITIES

Even if the absolute case for equities as an asset class may not be as compelling as it was a few years ago, the relative attractiveness of stocks remains clear. As our International Behavioral Finance team notes, investors are still well compensated in real terms for owning stocks. By our reckoning, equities offer a healthy risk premium across regions in real terms, ranging from 4% in the U.S. to 7% in Europe and Japan, all very respectable by past standards (EXHIBIT 2). At a time when fixed income assets are offering incredibly low yields and asset markets more generally have seen significant distortions from monetary policy, this is encouraging news for equity holders.

Against this backdrop, our investors are finding value across diverse parts of the market. China is looking more attractive these days, as the China onshore market has treaded water for four years amid slowing growth and now trade uncertainty. Our Greater China team highlights wide valuation spreads in the China A-share market, which, if history is a guide, suggest that Chinese equities could be primed for a strong run ahead.

Meanwhile, Europe remains out of favor, given uncertainty in realms political (Brexit), economic (trade, industrial slowdown) and structural (demographics, regulation). Our investors see several bright spots, though. Net equity supply has turned negative as Europe’s companies have finally started to increase share buybacks, providing a support for stock prices that has been so important in the U.S. market over the past decade. And European firms still have levers to pull to boost returns as they catch up with their U.S. peers in areas such as corporate governance and management compensation. For example, less than 50% of European company CEOs are paid based on some metric of shareholder return, vs. an average of 80% in the U.S.
UK equities look especially cheap—their discount vs. the broader world equity market average is near historical lows. The political and economic risks are obvious, but worries may be overdone, as the profitability of many leading British companies does not heavily depend on the domestic UK market. And, of course, any hopeful signs that the outcome of Brexit may not be as bad as feared should be a boon for UK stocks.

After tremendous performance from growth stocks in both U.S. and international markets, some of our investors are concerned that the group may be overextended. We see some issues, and our U.S. Growth team highlights the recent divergence in performance between high growth companies generating profits and cash and those generating neither. Growers with high margins (or at least a clear path to profitability) and positive free cash flow have proven to be excellent investments while their money-losing counterparts have not. These “good growth” companies are particularly prevalent within the software space, but our team is also finding them across other sectors, including consumer discretionary and health care. And our Europe growth investors noted that while European companies with high sales and earnings growth command a hefty premium, measures of quality and profitability do not look so expensive. This implies that Europe’s equity market is not differentiating between companies that generate high returns and those that do not, creating ample opportunities for long-term investors. As a result, selectivity will be key within the growth sectors of the market. Among the high profile IPOs this year that have either disappointed or been shelved, capital-intensive and unprofitable companies have been overrepresented. As the market has become more discerning among “good growth” and “bad growth” stocks, differentiating among these names is more important than ever.

RISKS

There is no change to the big issue on our minds: U.S.-China (and U.S. and the rest of the world) trade tensions remain an abiding risk to our outlook. While both countries have struck a truce for now, the view of our local team in Asia is that China has shown unexpected resilience in its ability to withstand U.S. tariffs, making major concessions to the U.S. unlikely. The equity markets have worried about this issue for a while now, but still, any escalation in the U.S.-China trade war would pose a risk to corporate profits and stock prices.

More broadly, the possibility of an economic recession presents another threat to our outlook. Labor markets are resilient, and the U.S. consumer appears to be in good health. But weaker corporate profits and rumblings of layoffs among some industrial companies, weak manufacturing data and, of course, the inversion in the yield curve are potentially worrying signs. Finally, every recession is different and brings different risks. The 2008-09 recession was clearly brought on by excesses in the housing market and financial leverage. This time around, we think equity investors would be wise to consider the potential impacts from the growth of private credit markets and the tremendous amounts of investment flowing into private, unicorn-type companies.
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