Multi-Asset Solutions Weekly Strategy Report

Global markets and multi-asset portfolios

July 27, 2020

IN BRIEF

• Markets are forward-looking, and equity investors have moved well ahead of the real economy to price in an expected sharp recovery in corporate profits. This at least partly explains valuations that look elevated when comparing stock prices to today’s depressed earnings levels.

• A turning point in the earnings cycle is already visible in the incipient divergence between forward and trailing earnings. Backward looking earnings are still falling, while 12-month forward expected earnings have begun to pick up.

• Analysts currently estimate U.S. quarterly profits will hit new highs in around two years. That is likely too optimistic, but we could well see a faster-than-usual earnings recovery.

• We have a modestly positive tilt on risk assets in our multi-asset portfolios. Believing the economy to be in a globally synchronized early-cycle recovery, we favor cyclically geared markets such as the euro area and emerging equities, while maintaining exposure to the mega cap tech sector via large cap U.S. equities.

A TURNING POINT IN THE EARNINGS CYCLE?

What explains the seeming divergence between risky assets – equities in particular – and the economy? After global equity markets (MSCI ACWI) fell by 34% from February to March, stocks recovered nearly all that ground and now trade less than 5% below their all-time highs. In contrast, economies, though improved, are still far from full recovery.

One key reason for this divergence: markets are forward looking. Investors have thus been able to move well ahead of the real economy to price in an expected sharp recovery in corporate profits, leading to equity valuations that are optically high when compared with today’s depressed earnings base. Valuations don’t look nearly as rich when compared with 2021 or 2022 earnings expectations. At some point, however, hard earnings data needs to catch up and justify investors’ bright hopes for the future.

That juncture may be close at hand as the second quarter reporting season now underway looks likely to signal the turning point in the global profit down-cycle caused by the COVID-19 pandemic. While there is some debate about the depth of the second quarter losses, both top-down and bottom-up analysts agree that a fairly rapid recovery
is set to follow as economies begin to re-open. Indeed, a turning point is already visible in the incipient divergence between forward and trailing earnings (Exhibit 1); backward looking earnings are still falling, while 12-month forward expected earnings have begun to pick up.

Certainly the composition of stock markets around the world should help the earnings rebound outpace the economic recovery. Details vary across regions, but the basic message is consistent for most markets: manufacturing is overrepresented in equity markets relative to the economy, while services are underrepresented. For instance, in the U.S., manufacturing accounts for over a third of stock market capitalization, but only around 10% of U.S. GDP and employment. In contrast, services are much more important in the economy than in the stock market. Many service businesses hit hard by the pandemic (including restaurants and hair salons) are very small and simply absent from public markets. Historically this difference between markets and economies has mostly been to markets’ detriment during recessions, as downturns generally hit manufacturing harder than services. However, the unusual nature of this recession means that manufacturing is now suffering less than services.

The shape of the earnings recovery

Consensus bottom-up forecasts show a decline and rebound in profits that may be sharp enough to be called V-shaped. After an already weak first quarter, analysts forecast that U.S. second quarter earnings will plunge by just over 40% year-on-year, while the more cyclically geared markets in Europe and Japan are expected to see falls of 55%-60%. To put these estimates into context, during the worst quarter of the 2008 global financial crisis (amid the most severe U.S. recession since the Great Depression), U.S. equity market profits dropped by 65%, driven by huge losses in the financial sector. The declines in current earnings projections are unsurprisingly led by cyclical sectors, with energy hit particularly hard, followed by materials, industrials, consumer discretionary and financials.

Expecting an economic recovery in the second half of this year, analysts project that U.S. earnings will grow nearly 60% in H2, finishing 2020 just 13% below their-pre-pandemic level. On a quarterly basis, U.S. earnings are expected to reach new record highs by Q4 2021. In other words, analysts currently expect U.S. quarterly profits will surge from COVID-driven collapse in Q1 to new highs in around two years. On an annual basis, these numbers

EXHIBIT 1: S&P 500 12-MONTH FORWARD VS. 12-MONTH TRAILING EPS

Earnings for S&P 500 companies plunged in Q1 and while 12-month rolling reported trailing earnings are still falling, the much-watched 12-month forward estimate of earnings has just begun to rise. This suggests that we have very likely seen the bottom of this down cycle in earnings.

Source: Refinitiv Datastream, J.P. Morgan Asset Management Multi-Asset Solutions; data as of July 20, 2020. For illustrative purposes only.
imply an EPS drop of 20% in 2020 (from USD163 to around USD125 in S&P 500 terms) followed by around 30% growth in 2021. This would leave 2021 earnings roughly back where they started. Such a move would be fast relative to history, but not outlandishly so, and it would be fairly close to the length of the post-financial crisis earnings recovery. At the global level (MSCI ACWI), annual growth figures look practically identical to those of the U.S. There is some regional variation, with regions such as Europe and Canada expecting both a sharper drop and rebound, while much of Asia sees a flatter trajectory given its different COVID-19 experience.

How should investors weigh these seemingly rosy earnings expectations? On the one hand, history shows that analyst consensus forecasts for the year ahead are almost always overly optimistic and end up cut back over time. Expecting a full earnings recovery by late next year may turn out to be a bit optimistic, and indeed we have been somewhat more cautious in our own forecasts. On the other hand, when one considers the unprecedented monetary and fiscal stimulus that has been thrown at this crisis, coupled with equity markets’ favorable sector skew, we may well see a faster-than-usual earnings recovery. In the near term if investors can see a bottom in earnings and evidence of recovery – ideally confirmed by commentary during the earnings season - it should be enough to support markets.

ASSET CLASS IMPLICATIONS

We have a modestly positive tilt on risk assets in our multi-asset portfolios, including overweight positions in high yield credit and equities. In the context of our view that the global economy has moved out of recession and is now in a globally synchronized early-cycle recovery phase, we favor cyclically geared markets such as the euro area as well as emerging equities, while for now also keeping exposure to the mega cap tech sector via U.S. large cap equities. Our least preferred markets are the UK and Canada, due to their defensive nature.
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