Global Equity Views

Themes and implications from the *Global Equity Investors Quarterly*

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In brief

2022 was a very rough year for investors, despite a rebound in global equity markets during the fourth quarter. However, our portfolio managers are becoming more optimistic. Profit forecasts are getting more realistic, so far earnings have held up well, and valuations look much more attractive than they did a year ago.

We see average returns from world equity markets and a good chance that markets that have lagged for a long time in Europe, Japan and the emerging world will be much more competitive this year with the U.S. market.

Despite dramatic swings over the past year, many of our investors think the value style still has the advantage over growth, and we still take a very cautious approach to investing in many formerly high flying "pre-profit" companies. In an environment that is still full of uncertainty, quality matters even more than usual to us in stock selection.

Taking stock

2022 was a year that most investors will be keen to forget, with global stock markets falling 20% (MSCI All Country World Index, ACWI).

As economic growth slowed and rates rose, the speculative bubbles that had built up over the past few years began to deflate, in some cases dramatically. Value and income stocks held up much better, however, and the trends that had dominated the equity world for the last decade began to reverse. Energy stocks delivered again, while the all-important technology sector fell from favor.

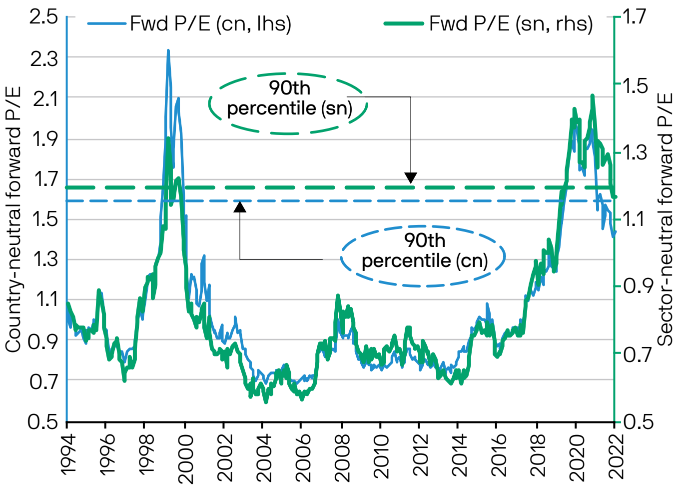
Our portfolio managers believe profit forecasts overall are still too optimistic, and many think that the unwinding of the speculative bubble in growth stocks is not yet complete. But we also see reasons for optimism. Profits are resilient so far, and valuations in most markets are still below average despite good gains in the last quarter (**Exhibit 1**). After a dreadful year, the outlook for Chinese equities appears to be improving, at least in the near term.

This is a time to be patient and accumulate positions during market weakness. Investors should be at least balanced between the value and growth styles, but many are not. Relying on the winners of the previous decade is not a good idea, in our view, but many investors still seem to be overallocated to these growth stocks and underinvested in the former market laggards.

Given an unusually uncertain economic outlook, we have a strong bias toward quality in many of our strategies; we look for proven management

Valuation spreads are still wide

Exhibit 1: Median price to earnings, highest value quintile and the lowest value quintile



Source: FactSet, J.P. Morgan Asset Management. This exhibit shows the log of ratio between the medians of a valuation metric in the highest value quintile and the lowest value quintile from December 31, 1994, to December 30, 2022. Valuation metrics are defined as forward P/E NTM (next 12 months) on a country-neutral and industry group-neutral basis.

teams, strong and profitable businesses, and conservative balance sheets. As some of the obvious places to hide in a recession (consumer staple stocks, utilities) have become very expensive, high quality companies in the industrial, technology and even energy sectors seem better choices, despite some near-term earnings risks.

Health care remains a big theme in many of our strategies, too. Several portfolio managers have also added a little to beaten-down high growth companies, but we have very little interest in more speculative names that have yet to become profitable, even after dramatic declines in these stocks over the last year.

Earnings and the surprising resilience of European profits

Our investors have been expecting a reset of profit expectations after the extraordinary economic boom spurred by the monetary and fiscal measures aimed at mitigating the impact of the COVID-19 pandemic. We cut back our own forecasts in recent months, as we anticipate a tougher environment in 2023.

In particular, we expect more pressure on profit margins, which remain exceptionally high in the U.S. We think overall profits will drop by 3% this year, after a likely gain of 7% in 2022 (and over 50% in 2021). Industrials and technology look most vulnerable to profit declines, while banking sector profits will be at risk if the gloomier economic forecasts prove correct.

So far, however, corporate profits have held up pretty well. Most companies have adjusted to the more difficult economic environment. We see this most vividly in Europe. Despite near-recession conditions and the shocking rise in energy prices that followed the Russian invasion of Ukraine, European profits actually rose more than 20% last year. A weaker euro and energy sector profits explain some of those gains, but the strong performance also reflects broad-based tenacity in a tough environment. With European stocks still trading at discount valuations, profit resilience is an interesting trend to watch.

On the other hand, emerging market profits fell 15% last year. We see a much better outcome in 2023, led by a rebound in China, which recently lifted stringent restrictions on activity that had been put in place to counter the pandemic. Emerging market equities, which look very reasonably priced, would benefit handsomely if the U.S. dollar continues to weaken.

Growth and “pre-profitability” companies

Last year was very difficult for investors in growth companies. Higher interest rates played a role, of course, but as the year progressed and the highly unusual economic dynamics of the COVID-19 era faded quickly, it became increasingly clear that estimates of revenue and profit growth were in many cases wildly optimistic.

As this drama unfolded, “pre-profit” companies were especially hard hit; by our estimates, in 2022 this group underperformed a weak market by more than 40%, on top of 33% underperformance in 2021. Despite these declines, our investors take a very cautious and selective approach to investing in these stocks. Achieving profitability will be much more difficult in the next few years as growth slows. And historical evidence suggests that these stocks as a group usually underperform over the longer term, with a few extreme exceptions to the rule.

So far, returns in this bear market for pre-profit stocks have matched almost exactly those seen in the bursting of the 1999–2000 dot-com bubble. That precedent is not encouraging; after that episode, they lagged broader markets in 12 of the next 15 years. More broadly, although established growth companies are much less overpriced, they are still not cheap, even as fundamentals weaken. Several of our investors have been adding a little to the best names, but many think the value style will probably have the upper hand again this year. Energy, once the ultimate value play, is still not expensive, and companies remain very disciplined in terms of capital spending. That's a challenge for oil consumers but a gift for shareholders.

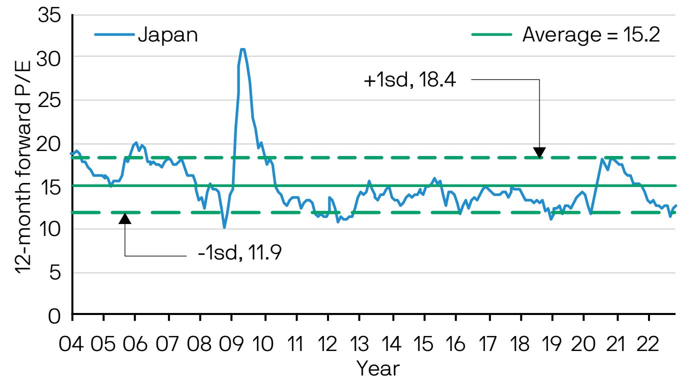
Japan: Strong profits and balance sheets, cheap stocks

This author remembers when Japan was, by a wide margin, the largest equity market in the world, powered by tremendous speculation in the domestic real estate market. Those days are long gone. Japan's banking sector, which was at the heart of the late 1980s boom, has lost over 90% of its market cap since the market peaked in late 1989. In short, that bubble is well and truly deflated.

Today, our team in Tokyo sees many reasons to take a positive view. Profits are surprisingly robust, balance sheets are strong, companies are becoming better governed (promoted by government influence), and the economy is opening up quickly from a prolonged pandemic shutdown. At 12x earnings, the stock market is cheap (**Exhibit 2**), as is the currency. At only 6% of the MSCI ACWI (less than Apple and Microsoft combined), Japan is out of favor, and we see much better returns ahead. For U.S. investors, Japan presents one more reason not to give up now on international exposure, despite a long period of disappointment.

Japanese stocks are cheap relative to recent history

Exhibit 2: 12-month forward P/E ratio



Source: CLSA, FactSet, MSCI.

Exhibit 3 shows the views of our team members around the world. They emphasize quality and cash flows in this uncertain environment, but most of our investors are now cautious on the most expensive defensive names. Energy has both supporters and detractors, and speculative growth stocks find little support.

Views from our *Global Equity Investors Quarterly*, January 2023

Exhibit 3

Source: A subset of results is shown from a January 2023 survey of *Global Equity Investors Quarterly* participants. These responses are taken from a quarterly survey representing 30 CIOs and portfolio managers across global equities.

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