Global Equity Views

Themes and implications from the Global Equity Investors Quarterly

4Q 2020

IN BRIEF

- Despite the persistence of the COVID-19 pandemic, markets have been driven higher by expectations of a quick recovery and easy monetary policy. The rebound in equities has been impressive, but it is still uneven, with enthusiasm for large cap technology winners only intensifying.
- Our investors think the best of that market recovery is now behind us, and few see supercharged returns from here. But with highly supportive monetary policy, and hopes and expectations of a medical solution to COVID-19, it is hard for us to be too cautious. For our team, the big debate is about stock selection rather than market direction.
- Valuations vary enormously within the markets, and we see a good chance of better returns from a wider range of stocks. As the perceived winners have gotten expensive, though still supported by strong growth, we think investors should balance their portfolios and look for opportunities elsewhere in less expensive companies poised to benefit from a rebound in economic activity.

TAKING STOCK

The struggle against the COVID-19 virus is far from over, but investors are reassured by the beginnings of a rebound in economic activity, supported by exceptionally low interest rates. Markets have continued to rally as profit forecasts have stabilized. After slashing 30% from our expectations for global profits for this year, our research team has stopped cutting near-term profit forecasts and has even made a few upgrades of late. Overall, our 2021 forecasts fall roughly in line with the 2019 pre-pandemic numbers, but our long-term “normalized” forecast (a key element of our investment process) comes in around 10% below pre-crisis levels. We see some regional nuances to the recovery, but differences among industries remain far more significant and indeed extreme.

Energy stands out as the industry with the biggest decline in expectations; our long-term numbers are more than 40% lower than in January, and near-term profitability has essentially disappeared. Energy companies face enormous challenges, which have hardly escaped the market’s attention (the sector has delivered the worst returns over all the time periods we reviewed). The near-term profitability of the financial sector has also fallen sharply, accounting for almost a quarter of all of our cuts for this year across the globe. Meanwhile, technology companies, drug companies and many consumer staples businesses are sailing through the year with little or no impact from the violent cyclical downturn, and with long-term structural drivers of profitability as powerful as ever.

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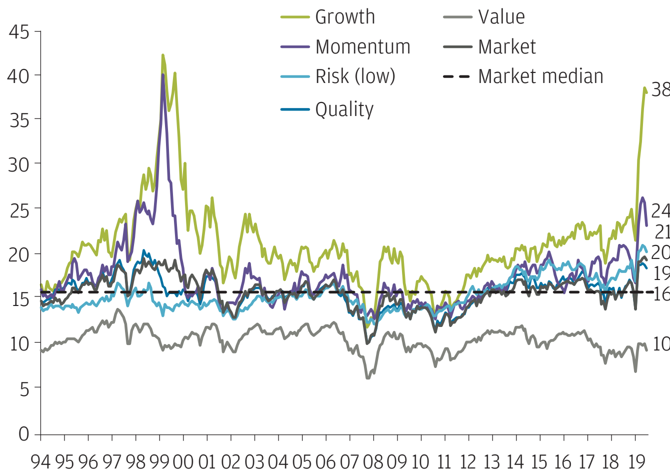
Equity market valuations already anticipate a significant rebound in profits and naturally look less compelling to us than they did in March, but they still do not seem especially demanding. Comparisons between equities and fixed income still flatter our market. Overall, we expect average rather than spectacular returns from current levels.

Within markets, the picture is more complex. The premium for owning the best growth companies is as high as ever, while the discounts applied to out-of-favor value stocks remain stubbornly wide. On any metric we can find, this has been a historically challenging year for value stocks. Meanwhile, the median forward P/E of the fastest-growing quintile of companies globally now is 38x, a level last seen in early 2000 (**EXHIBIT 1**). The fastest-growing companies then and now were growing at similar rates, but they operated in very different interest rate environments. The 10-year U.S. Treasury yields around 80 basis points (bps) today vs. 6%-plus at the turn of the century. For high multiple stocks with a long duration, that really matters. Are investors mesmerized by the growth narrative heading for a similar fate as in 2000–01, when the Nasdaq index lost 80%? Or are the structural forces at play powerful enough to support growth stock performance for years to come? It's a subject of spirited debate.

One example illustrates the controversy: a comparison of Tesla with the six largest traditional auto manufacturers (Toyota, Volkswagen, BMW, Daimler, General Motors and Ford, as ranked by market capitalization). After a fivefold increase this year, Tesla has roughly the same market value as the big six combined (**EXHIBIT 2**), which this year will collectively produce 90x more cars and 45x the revenue, and will invest 40x more in research and development. Which is the better investment? Valuation metrics based on the current business suggest that expectations for Tesla are very demanding, to say the least. Yet many point to the extreme success of disruptors in other industries and the enormous long-term potential for Tesla to take market share (not to mention the big six's struggles to create any shareholder value in recent years). We see merits to both sides of the argument and good reason to keep a balanced approach to growth and value investments.

The premium for owning the best growth companies is as high as ever

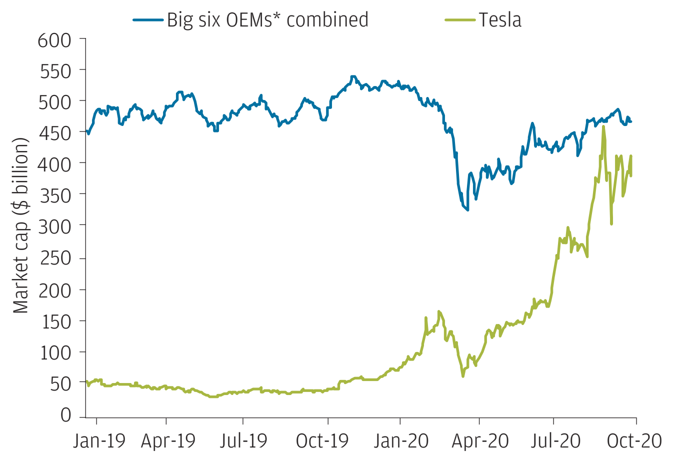
EXHIBIT 1: FORWARD PRICE-TO-EARNINGS RATIOS BY FACTOR



Source: Factset, IBES, J.P. Morgan Asset Management. Chart shows the median forward price-to-earnings ratio of the top quintile for each factor. The price-to-earnings multiples are equal weighted and based on next 12 month IBES earnings per share estimates. The Value factor is based on earnings and free cash flow yields; the Quality factor is based on profitability, capital discipline and earnings quality; the Growth factor is based on forecasted earnings growth on a next 12 month and FY3/FY2 basis using IBES consensus estimates; the Risk factor is based on volatility and beta and the Market factor is the median P/E of the investible universe. The overall universe is the Behavioral Finance Global All-Cap investible universe of developed market and emerging market equities, and consists of approximately 4,000 companies. Data is shown from Dec. 31, 1994-Sept. 30,2020. The dotted line is the overall market median since 1994. Past performance is not a reliable indicator of current and future results. Data as of September 30, 2020.

Tesla has roughly the same market value as the big six automakers combined

EXHIBIT 2: TESLA MARKET CAP VS. OTHER OEMs*



Source: Bloomberg, J.P. Morgan Asset Management; data from December 31, 2018 to October 2, 2020. The securities above are shown for illustrative purposes only. Their inclusion should not be interpreted as a recommendation to buy or sell.

*Original equipment manufacturers: BMW, Daimler, Ford, General Motors, Toyota and Volkswagen

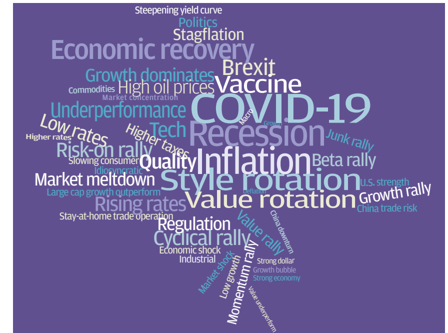
Views from our Global Equity Investors Quarterly, October 2020

EXHIBIT 3

BEST OPPORTUNITY GLOBALLY?

WORST OPPORTUNITY GLOBALLY?

BIGGEST RISK GLOBALLY?



A subset of results is shown for an October 2020 survey of Global Equity Investors Quarterly participants. These responses are taken from a quarterly survey representing 41 CIOs and portfolio managers across Global Equities.

OPPORTUNITIES

Although our investors see less potential for market gains, the opportunities for stock selection still look good. Many of our U.S. investors find opportunities in depressed consumer cyclical companies that are likely to benefit from a recovery in demand over the next year. For example, global auto production declined by 20%, inventory levels are now very low, and our analysts expect a meaningful production recovery. We are investing in auto suppliers, semiconductor manufacturers and materials companies with exposure to an auto recovery. Housing is another theme in our portfolios. The sector benefits from both cyclical trends (economic recovery) and secular trends (home purchases by millennials), along with low inventory and very low mortgage rates.

Outside the U.S., we can still uncover attractive investments in areas of long-term growth, although they too have posted some very strong equity market gains. Within Europe, our team finds renewable energy companies particularly attractive as environmental legislation spurs investment and dramatically lower prices for solar and wind power generate more demand. Strong returns in this space over the last few years have made some investors skeptical about the sustainability of outperformance in the near term. But we believe that these companies can still generate robust returns over the long term. In China too, solar power and electric vehicles are becoming more economically viable as government subsidies lower costs and stimulate demand. A newly consolidated industry should continue to drive equity returns.

Lastly, we see Japanese equities as a generally undervalued and often overlooked opportunity. Dividends quadrupled over the last two decades, reflecting a shift in corporate focus toward shareholder returns. Healthier balance sheets and profit margins, which have converged with European equities over the last decade, provide a margin of safety that should continue pushing dividends higher as payouts rise steadily. All in all, they position Japanese equities as an attractive source of income for investors.

EXHIBIT 3 presents an overview of our outlook.

RISKS

Unsurprisingly, our investors continue to view COVID-19 as the biggest risk and greatest source of uncertainty for both economic activity and equity markets around the world. Society may be better equipped to handle an uptick in cases compared with earlier this year, and markets have clearly begun pricing in a pathway to recovery. However, a severe enough uptick in cases may lead to further restrictions on economic activity and, by extension, weigh on equity markets, which are once again more demandingly priced.

For many of our investors, the biggest challenge to outperforming the markets would come from a sharp rotation into the most cyclically depressed companies. Investing in faster-growing, higher quality businesses has worked very well over a multi-year period and especially in the past 12 months. But we are mindful that valuation spreads between the cheapest and most expensive companies are now extreme by any past standards. Greater confidence in an economic recovery would likely encourage at least a temporary revival in more beaten-up sectors, and many of our portfolio managers are taking a balanced approach to allocating capital, aware of the chances of a rebound in value stocks.

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NEXT STEPS

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