

Global Equity Views

Themes and implications from the Global Equity Investors Quarterly

2Q 2020

IN BRIEF

- As investors scrambled to assess the economic impact of the tragic coronavirus crisis, global equities plunged and volatility surged with record speed in March, with no markets or sectors spared around the world.
- No one can yet accurately predict the depth or duration of the economic downturn and with volatility still high, investors should be braced for further near-term declines in stock markets. But almost all of our portfolio managers think that this combination of highly negative sentiment and attractive valuations presents a solid longer-term buying opportunity. Valuations look low, especially in Europe and the emerging markets, while value stocks trade at huge discounts—but everything is on sale.
- There are obvious near-term risks of the economic shutdown to company profits and balance sheets. But a more lasting impact on consumer spending, restrictions on dividends and share buybacks, and the potential tax consequences of the higher fiscal deficits that will result from coronavirus-related stimulus spending all pose longer-term risks that investors should be mindful of.

TAKING STOCK

Our investors have lived through plenty of periods of turmoil in equity markets over many decades, but we have never seen such a sudden and dramatic change in the outlook as we experienced in the last four weeks. The bear market that has erupted is the fastest on record, and markets around the world have been locked together in a dizzying collapse in which volatility has surged from historically low readings to record levels in just a handful of trading sessions.

Any assumptions about the economy and corporate earnings that investors were making earlier this year are now irrelevant as the near-term outlook has changed with bewildering speed. As the impact of the COVID-19 crisis is beginning to appear in high-frequency economic data, it is clear that we are entering a shutdown, not a slowdown, in business conditions around the world during the second quarter, and gauging the depth and duration of this shutdown is still a big challenge. Consumer spending had been a source of strength in a rather subdued economy before March, but that picture is now entirely different. At this stage it appears that the rapid and aggressive measures taken by the Federal Reserve and other central banks have been successful in providing liquidity to the most stressed areas of the fixed income and money markets, which should avert an even more serious financial crisis. But the worst of the economic and profit data is still ahead of us, even with the vast fiscal spending programs also announced with impressive speed during March.

Equity market valuations are much lower now and our measures of near-term market sentiment, which we tend to regard as contrarian indicators, have moved from suggesting complacency as

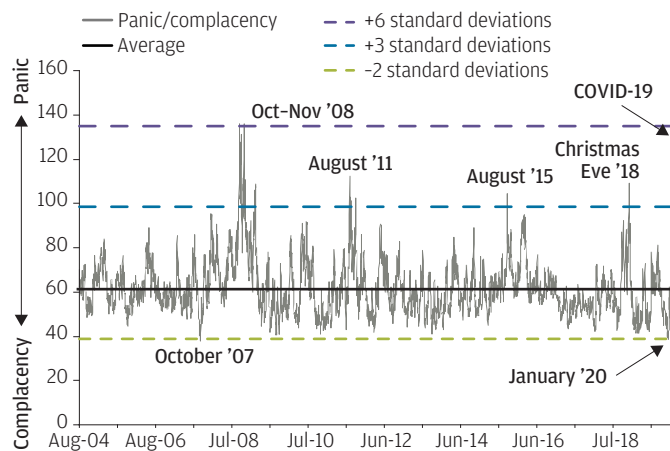
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Equity markets have reached panic levels

EXHIBIT 1A: PANIC/COMPLACENCY INDICATOR



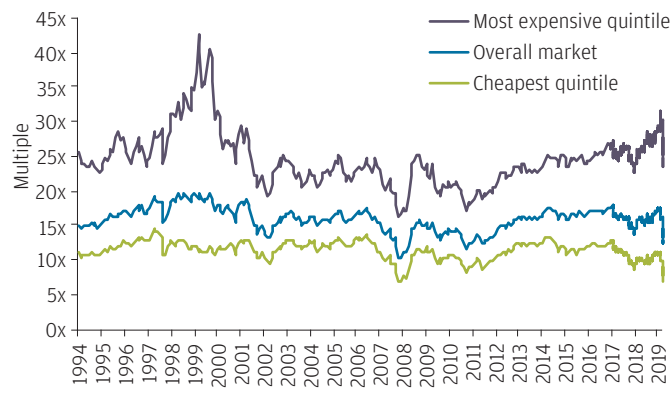
Source: J.P. Morgan Asset Management; data as of March 2020.

recently as mid-February to full-blown crisis and panic mode (**EXHIBIT 1**). This level of uncertainty is as dramatic as anything we saw in the 2008-09 period.

Within markets, the gap in valuations between high- and low-priced stocks has been widening steadily over the past three years, and that process greatly accelerated in the past month. Value stocks sold off sharply, wiping out all the gains of the last five years. This leaves many companies in the industries that make up the bulk of value indices (industrials, consumer cyclicals, energy and financials) trading at enormous discounts to the overall market. In fact the gap between low- and high-priced stocks has reached record levels, as the latter have proved relatively resilient in the last few weeks. (**EXHIBIT 2**)

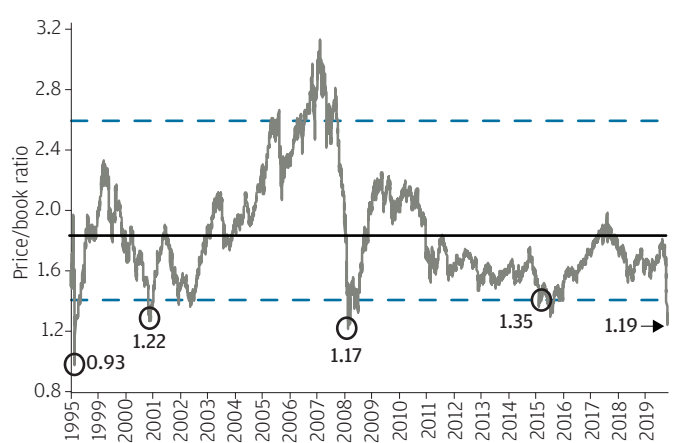
The market's cheapest stocks are now trading at lower valuations than they did in the depths of the 2008 financial crisis

EXHIBIT 2: AVERAGE FORWARD P/E MULTIPLES



Source: J.P. Morgan Asset Management; data as of March 2020.

EXHIBIT 1B: MSCI EMERGING MARKETS INDEX, PRICE/BOOK RATIO



OPPORTUNITIES

During our Equity Quarterly discussions last week, almost all of our portfolio managers expected attractive returns over the next few years from this starting point. Despite the magnitude of the downturn that is just beginning, the combination of highly negative sentiment and attractive valuations makes this a rewarding time to invest for the long run, in our view. After the rapid sell-off, equity markets look very reasonably valued to us—and, in many cases, downright cheap. Our favored emerging markets measure in time of stress—the price/book ratio—has fallen to levels consistent with those reached in the depths of most previous crises, if not quite matching the lows of 1998. European and Japanese stocks are trading at the lowest multiples seen in a long time. And large cap U.S. stocks are much less fully priced now, if still at a premium to other markets (which we think is well deserved). All in all, our portfolio managers around the world do believe that patient investors should find this to be a good entry point for equity investment.

Earnings and cash flows will undoubtedly fall in the months ahead, but the comparisons of value with other investments are also striking. In Europe, for example, we think stocks currently have a cash flow yield close to 7%, compared with 2% on offer from corporate bonds and negative yields on much of the region's government debt. In U.S. equities, more than 70% of the companies in the S&P 500 index carry a dividend yield higher than 10-year U.S. Treasury debt, a historical high. Yes, there will be dividend cuts, but dividends these days are sourced from a very broad array of companies, with technology the biggest single contributor by sector, so the comparison is still valid, in our view. There is plenty of income as well as value to be found in today's equity markets.

We have had many discussions about the opportunity in value stocks. The compensation for taking risk here seems very generous; in our work the spread between high and low priced stocks is as wide as at the peak of the New Economy bubble in early 2000. But this is a very different situation. Back then, the perceived winners were very, very expensive. Now, faster-growing stocks look reasonably priced in absolute terms, but the lowest price stocks are very low priced indeed. Many companies in this cohort of the market will face a very difficult time in the quarters ahead. Balance sheets across large parts of the classic value sectors are more stressed than in the last crisis, with the notable exception of financials, where capital reserves are much stronger. A large number of fundamentally weak companies in this cohort have borrowed heavily in recent years when interest rates were low and liquidity ample. One lesson of 2008-09 was that financial strength matters a great deal in adverse economic conditions, and companies with weak balance sheets and impaired cash flows are likely to find the next few months especially difficult to navigate without lasting damage to the value of their equity. Industry- and company-level research is thus critical in determining where and when to take risk, and portfolio position sizing matters a lot too. For example, the energy sector's problems seem deeper and longer lasting, and bargain hunters here need to be very careful indeed. In the broader industrial space, we can find good companies with operating leverage but reasonable balance sheets; they tend not to be the very cheapest stocks but may well make better investments with so much of the downturn still ahead of us. Many of our portfolio managers also see opportunities to invest in better quality companies at more favorable prices after recent declines, with every area of the markets more attractively priced now. **EXHIBIT 3** presents a snapshot of our investors' views.

RISKS

At this stage, predictions of both the duration of the COVID-19 tragedy and the likely economic consequences are still very difficult to make with any conviction. Stocks rallied hard and fast during the last week of March, there is plenty of bad news to come, and market volatility remains very high, so we cannot be confident that we have seen the equity market lows for this downturn.

While we don't know the trajectory of the economic recovery, anecdotal evidence from Asia is encouraging, with factories and stores already reopening across China even as other governments grapple with the worst of the crisis. But consumers may well take time to recover confidence, rebuild their savings and return to previous spending habits. Many companies will need to fix balance sheets and in many cases carry more cash and less debt than in the past, and it may take years for the worst-affected companies to repair the damage to their balance sheets of an extended shutdown. Plenty of companies will also need to spend more on technology infrastructure to address the operational risks highlighted by recent events.

We also have to be thoughtful about the longer-run consequences to equity investors posed by the dramatic level of government support for the economy. There is already much discussion about the wisdom of stock buybacks, and broader political restrictions here may be one consequence for companies needing that support. We can expect more restrictions on payrolls and employment too. And, of course, at some point the exploding fiscal deficits around the world will become a focus, as higher taxes may be required to help improve government balance sheets once the crisis has passed.

Views from our Global Equity Investors Quarterly, March 2020

EXHIBIT 3

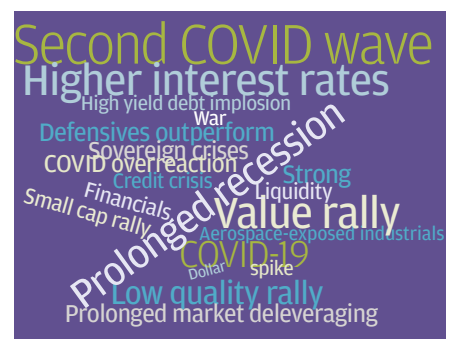
BEST OPPORTUNITY GLOBALLY?



WORST OPPORTUNITY GLOBALLY?



BIGGEST RISK GLOBALLY?



A subset of survey results is shown for Global Equity Investors Quarterly participants taken in March 2020. These responses are taken from a quarterly survey, representing 28 CIOs and portfolio managers across Global Equities.

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