Global Equity Views

Themes and implications from the *Global Equity Investors Quarterly*

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In brief

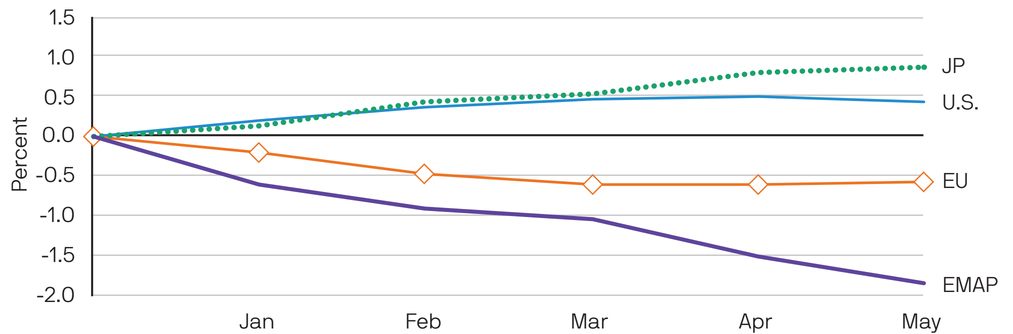
- Before the setback in markets over the last week, higher valuations and a narrow market in the U.S. had made our investors more cautious on the outlook.
- Profits remain healthy and are rising this year in most regions, although momentum is slowing and forecasts for further gains in 2025 look aggressive.
- Our investors now favor more defensive stocks, higher quality names and value. Some think that enthusiasm for the artificial intelligence (AI) theme is in dangerous territory, at least in the short term.

Taking stock

After a dull couple of years for profits, this year continues to offer double digit earnings growth for companies around the world. That's the view of our research team, which sees American companies at the forefront of the move, with 13% earnings growth expected. The outlook for profits is also healthy in Japan, India and many other parts of Asia, and looks to be improving in Europe, but trends in China remain very weak (**Exhibit 1**).

We continue to upgrade forecasts in Japan and America, but emerging markets remain weak.

Exhibit 1: J.P. Morgan Asset Management expected return revisions in 2024



Source: FactSet; data as of May 31, 2024.

Our earnings expectations ticked higher after Q1 results were reported, but the 2Q reporting season looks a little weaker so far. The long-awaited broadening of profits growth from a handful of giant technology companies to the rest of the market is slow, and there are creeping signs of weakness in parts of the consumer and industrial sectors.

Two concerns weigh on our investors and lead us to expect somewhat subdued returns over the next 18–24 months. First, profit forecasts beyond 2024 look aggressive to many of our investors, especially given recent trends. Second, valuations have risen, especially for the best companies in the U.S. market. Momentum has been the driving force in the U.S. market, and the characteristics of the stocks with the best momentum have become increasingly risky.

Across the rest of the world's equity markets the pattern has been quite different, with value stocks performing very well, especially in Asia. Still, the extreme level of enthusiasm in the market for mega cap technology stocks does give some investors pause for thought.

Overall, our choices have taken on a more defensive cast of late. Many portfolio managers have added to good quality stocks that have lagged the market but still offer protection should the U.S. economic environment become more difficult. This may or may not happen, but the protection on offer isn't expensive and is attractive as we take profits in technology winners.

Value themes such as financials and health care also feature on our investors' latest list of "best opportunities." Conversely, enthusiasm for the AI theme has now reached worrying levels for many in our team. Most of our investors have a positive long-term view of AI's potential, but delays and disappointments are always possible, and they wouldn't sit well with current valuations. The high prices of many Indian equities also give us cause for concern, despite good fundamentals.

Our research views: Profits rising steadily, and the best growth stocks fully priced

As we've noted, our research team still sees solid profit growth in 2024, led by the U.S. The long-awaited broadening of U.S. profits growth appears to be slowly under way, although Q2 earnings reports tell us that many companies are incrementally more cautious again about the rest of this year. China is a particularly weak spot. Meanwhile our expected return signals (driven by our research work) are now tilted toward value, with the largest stocks looking more expensive as a group.

Globally the picture is similar. In Europe, the best companies are fully priced. In Japan, we see signs that companies are increasing share buybacks in response to growing pressure from shareholders across many different industry groups. Our profit forecasts are moving higher as well, despite the risks posed by a potential recovery in the yen.

When we consider how stocks are priced relative to our five-year earnings forecasts, the lowest growth cohort is now priced as cheaply as we have ever seen. That seems broadly correct to our research team. Most of the companies in industries such as auto manufacturing will struggle to generate decent returns on capital, let alone grow. It will be fascinating to see if management teams across these struggling businesses can do anything to improve this outlook, but unless they can, the prospects for sustained outperformance look dim.

On the other hand, as discussed, the premium awarded to the best growth companies is again very high (as it was in early 2022). Should any of these favored names show signs of dimming growth prospects, then the risks to their stock prices will be significant. As always, detailed analysis company by company will guide our decisions, but we will need to be mindful of the opportunities and risks created by the strong consensus in the market on the best growth opportunities.

Does recent price action signal a change in market leadership?

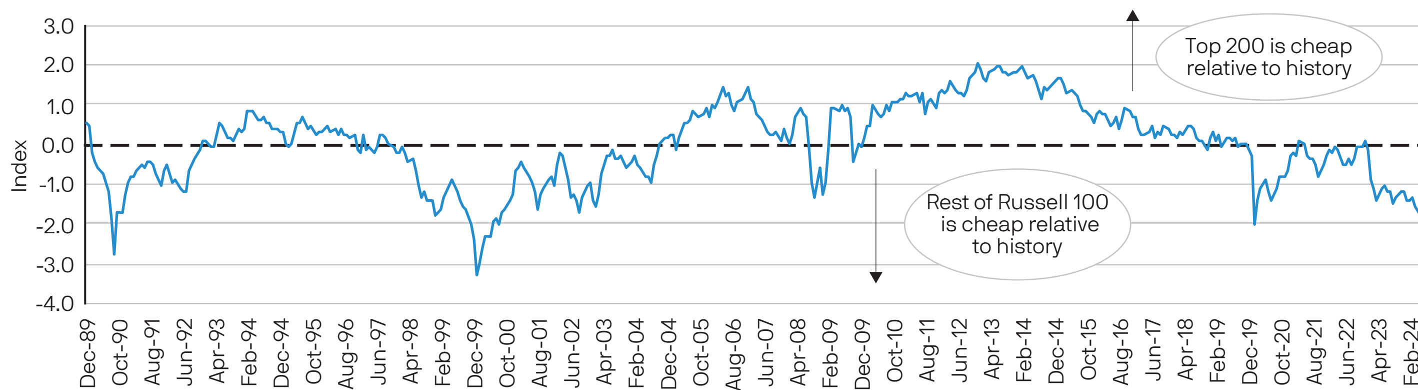
All investors are asking the same question: Can mega cap stocks continue to dominate returns? Certainly, their outperformance has been remarkable for quite a long time. From a research perspective, the valuations of the largest stocks look historically expensive, not just in the U.S. but across the developed markets and so our expected return signals now increasingly favor the smaller market capitalization cohorts (**Exhibit 2**).

That being said, mega cap fundamentals remain outstanding: the big companies have much higher profitability, less debt and better earnings momentum. For those investors worried about a slowdown in the economy, making the shift into mid/small caps is difficult.

On the other hand, those who see AI enthusiasm as entering the speculative phase (as many of our portfolio managers do) will find it easier to sell the winners. Overall, we think the case for building mid/small cap exposure is reasonable but not compelling. But we do think investors should at least rebalance to offset the drift toward mega caps created by price moves over the last few years.

Are smaller cap stocks coming back into favor?

Exhibit 2: Value spreads for top 200 names in Russell 1000 relative to the other 800 names over the last 25 years



Source: FactSet; data as of July 11, 2024.

One complicating factor in the recent rotation has been the strong outperformance of lower quality small cap stocks. That presents a significant challenge to many of our investors' long-term preference for higher quality, more profitable companies. We don't see any reason to change those preferences now. Depressed, heavily shorted names can of course rally for a while but eventually fundamentals will matter again.

UK: A second look at the long-unloved market

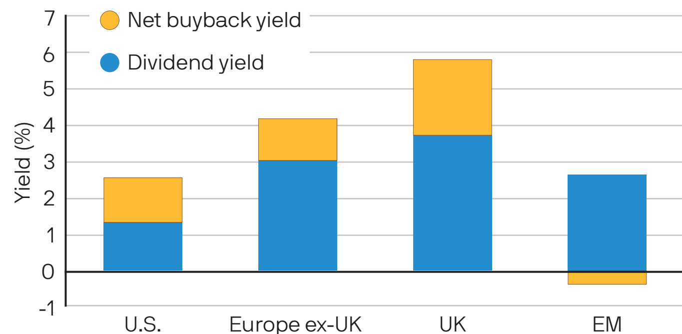
For many years, Japan was seen as the most unloved major market. But with the TOPIX index now up 40% over the last two years, driven by a powerful earnings recovery and growing enthusiasm for shareholder-friendly management initiatives, investor sentiment has shifted. Investors must look elsewhere for a truly contrarian idea.

Enter the UK equity market. It has languished for years in relative terms and despite a recent rally still trades only 20% above levels first reached a quarter of a century ago. UK institutional investors have almost abandoned their local market over the past decade in favor of global portfolio, bonds and alternatives.

Does the UK equity market offer new opportunity or familiar disappointment? Our UK equity team makes three arguments in favor of the optimist's perspective. First, the market is attractively valued, with the FTSE All Share index at around 11x forward earnings and a shareholder yield (dividends plus stock buybacks) of almost 6%. Second, we see signs of some improvement in corporate profits and the local economy. And third, M&A activity is on the rise principally as private equity investors look to snap up bargains among mid and small cap stocks (**Exhibit 3**).

A relatively high shareholder yield is coupled with attractive valuations

Exhibit 3: UK stock buyback and dividend yield relative to rest of the world



Source: Bloomberg, FTSE, LSEG Datastream, MSCI, S&P Global, J.P. Morgan Asset Management. U.S.: S&P 500; Europe ex-UK: MSCI Europe ex-UK; UK: FTSE 100; EM: MSCI EM. Chart shows yields for the last quarter in which buyback data is fully available. Net buyback yield adjusts for share issuance. Past performance is not a reliable indicator of current and future results.

As fundamental investors, we make bottom-up decisions, driven by our assessment of individual companies, not markets. Several UK-listed stocks in the energy, health care and banking sectors are now attracting the attention of our more value-minded global investors.

Exhibit 4 shows the views of our team members. Overall, they are a little more defensive, prefer quality and question the levels of AI enthusiasm.

Views from our *Global Equity Investors Quarterly*, July 2024

Exhibit 4

A subset of survey results are shown for Global Equity Investors Quarterly participants taken in July 2024. These responses are taken from a quarterly survey representing 49 CIOs and portfolio managers across Global Equities.

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