On the Minds of Investors

November 2020

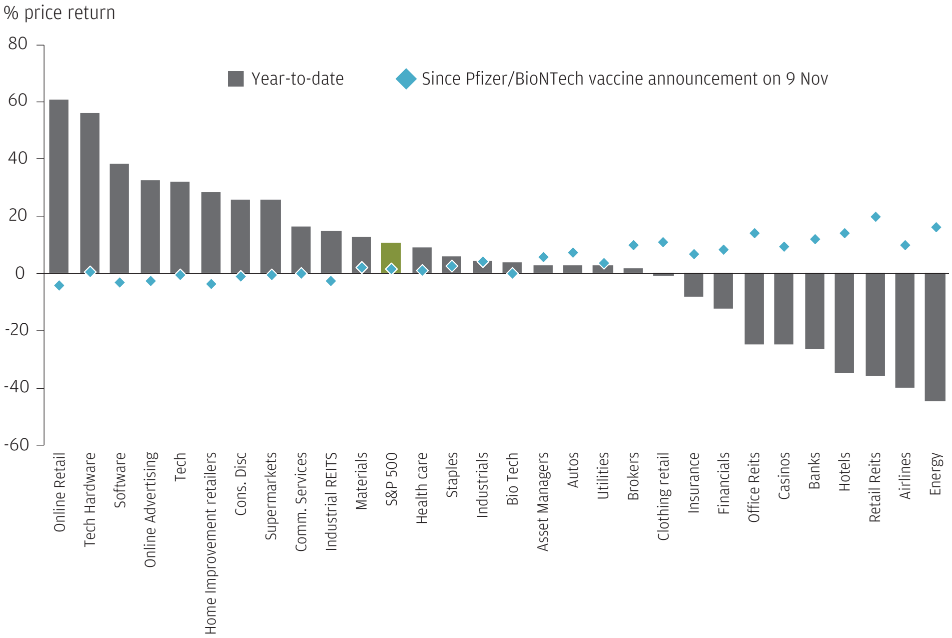
Where still offers value and could continue to benefit if a vaccine is approved?

The recession triggered by Covid-19 has been unusual in many ways. For investors, perhaps the most striking feature of this recession has been the degree to which it has created winners and losers.

The technology stocks that have provided the hardware and software to enable vast swathes of the population to work from home have been key beneficiaries. As have those companies that help to facilitate life while staying at home, such as online retailers (see **EXHIBIT 1**). The combination of increased earnings and very low discount rates (thanks to the central banks) has helped boost the returns of these perceived winners.

In contrast, many companies and sectors that rely on people going out continue to languish. Weak demand has depressed the price of oil and, in turn, has pushed energy stocks lower, while the hit to the economy and labour market—along with the prospect of a lengthy period of zero interest rates—has been an unpleasant mix for financials.

EXHIBIT 1: S&P 500 PERFORMANCE IN DETAIL



Source: Refinitiv Datastream, Standard & Poor's, J.P. Morgan Asset Management. Data as of 11 November 2020.

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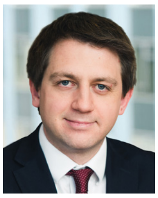

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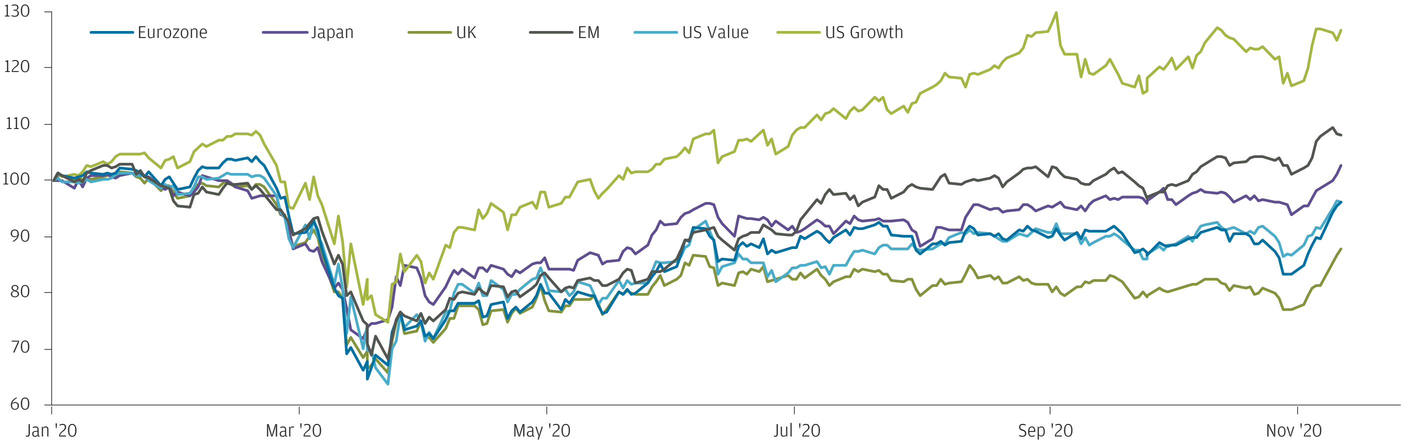
Global Market Strategist

EXHIBIT 2: EQUITY MARKETS YEAR-TO-DATE

Total return index level, rebased to 100 at the start of the year



Source: FTSE, IBES, MSCI, Refinitiv Datastream, Standard & Poor's, TOPIX, J.P. Morgan Asset Management. Indices used are; Emerging Markets: MSCI Emerging Markets; eurozone: MSCI EMU; Japan: TOPIX; UK: FTSE 100; US growth: S&P 500 Growth; US value: S&P 500 Value. Past performance is not a reliable indicator of current and future results. Data as of 11 November 2020.

The winning trade through Covid-19 has therefore been to overweight tech and underweight energy and financials, or overweight growth stocks and underweight value. The US stock market's large weighting to technology, online retail and online advertising stocks has seen it outperform other markets this year (see market performance year to date, **EXHIBIT 2**).

But the recent positive news on progress towards a vaccine being approved could mean life is able to return to normal at some point next year and has led to some of the beaten up sectors rallying. In what follows, we highlight three areas that still offer value, despite the recent rally, and that could continue to benefit if a vaccine is approved.

US value stocks

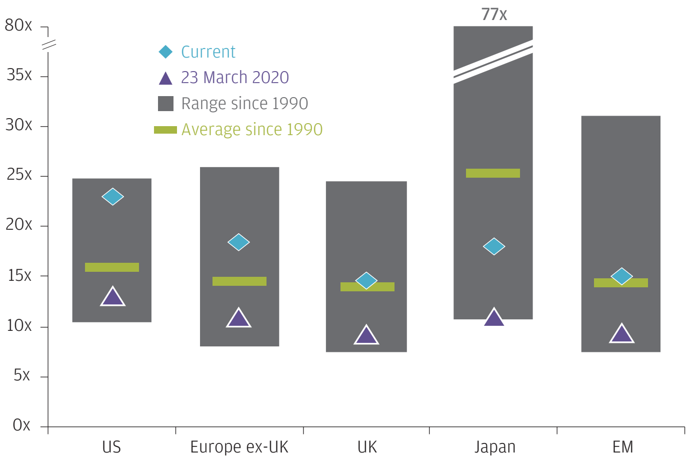
While the US market as a whole looks rather expensive by historical standards, trading on a price-to-earnings (P/E) ratio of 22x 12-month forward earnings (see **EXHIBIT 3**), this valuation is distorted by growth stocks, which are up about 25% this year and are trading on a P/E of 30x. While not all growth stocks are overvalued, some of the cheaper stocks in the market could have more upside if a vaccine is approved and the economy recovers, compared to those that have already performed very well this year.

It's important to filter out those value stocks that could continue to struggle even after a vaccine is available. But there are quality, cyclically-exposed businesses available at reasonable valuations that would benefit from the economic recovery a vaccine would enable.

Some stocks in the financial sector, for example, trade on relatively cheap valuations and would be exposed to any improvement in the economic outlook. And while steeper curves would help financials, not all financials rely on higher interest rates to increase profits, with asset and wealth managers being a good example.

EXHIBIT 3: GLOBAL FORWARD PRICE-TO-EARNINGS RATIOS

x, multiple



Source: IBES, MSCI, Refinitiv Datastream, Standard & Poor's, J.P. Morgan Asset Management. MSCI indices are used for all regions/countries (due to data availability), except for the US, which is represented by the S&P 500. Past performance is not a reliable indicator of current and future results. Data as of 11 November 2020.

UK valuations look reasonable on low earnings expectations

On this side of the pond, the FTSE 100 trades broadly in line with its long-run average on a P/E of around 15x next year's expected earnings, but those earnings expectations are down at the same level they were at in 2009 (see **EXHIBIT 4**).

The FTSE has struggled because it doesn't have the large tech names that the US does. Instead, the UK market has a large weighting to banks, which are down 36% year to date, and about 7% weighting in oil and gas stocks, which are still down 48%.

EXHIBIT 4: FTSE 100 12-MONTH FORWARD EARNINGS PER SHARE

GBP, next 12 months' earnings per share estimates

Source: FTSE, IBES, Refinitiv Datastream, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 11 November 2020.

Approval of a vaccine would give investors greater clarity on the likely size of the bad loans that the banking system will have to absorb. It would also improve the outlook for the labour market and should lead to a higher oil price as activity recovers further.

Clearly, the possibility of a hard Brexit remains a risk. Were that to happen, sterling would likely fall sharply. In that scenario, given 77% of FTSE 100 revenues come from abroad, large-cap stocks would probably prove more resilient than the more domestically-focused mid and small cap stocks.

Given the ongoing uncertainty, investors looking to increase exposure to the UK equity market in anticipation of a vaccine driven recovery might therefore want to take a relatively size-neutral approach to UK equities until the domestic outlook is clearer. Perhaps the time to add to UK mid and small caps will come once the clouds of Brexit uncertainty clear.

Long-term growth at a reasonable price in emerging markets

Emerging market equities trade on a forward P/E of around 15x, with the MSCI China Index also on about 15x earnings despite its strong recovery this year. The long-term growth opportunity in emerging markets is well documented. In short, incomes tend to rise as continued urbanisation and investment drive rising productivity, and greater demand for products and services that were previously unaffordable. This story is not new, but the difference is that back in 2007, the MSCI Emerging Markets Index was on a price to book ratio of 3 compared with only 1.8 at the end of October. The Covid-19 recession may therefore provide an opportunity to gain exposure to the long-term growth story available in some emerging markets at a reasonable valuation.

Of course, while China has contained the virus relatively well, many other emerging markets have really struggled with the virus and may take longer to receive and roll out a vaccine than developed economies. However, equity markets are forward looking and could price in an economic recovery long before a vaccine is fully available, assuming one is approved.

As always when it comes to the emerging markets, some economies, markets and companies are likely to thrive or struggle more than others. Therefore, a selective approach is probably wise. Parts of Asia, and China in particular, may be a good place for investors to start increasing their exposure if other areas such as Latin America still seem too risky. Trade tensions remain a risk but the US election result could help to diminish the risk somewhat.

Summary

While some stocks are already pricing in a lot of good news, there are still opportunities, even after the recent rally, for investors with a long-term investment horizon who are confident that a vaccine will be approved. Those investors may want to reduce their exposure to more expensive assets, such as government bonds and certain US equities, and rebalance into cheaper stocks, both within the US and in cheaper areas such as the UK and emerging markets.

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