Global Equity Views

Themes and implications from the Global Equity Investors Quarterly

3Q 2020

IN BRIEF

- With central banks and governments piling on monetary and fiscal stimulus to an unprecedented degree to counter the economic impact of the COVID-19 shutdown, equity markets have rallied dramatically since our last update. The recovery has been very broad, but mega cap technology stocks remain as popular as ever and many have hit new highs. Casualties of the economic collapse have recovered too but remain significantly below pre-crisis levels.
- After such a rapid and comprehensive recovery, our investors are much less optimistic about future market returns than they were in late March. Valuations look reasonable to rich depending on the market and sector, and the opportunity to invest at depressed prices is largely gone. Meanwhile, the market's appetite for risk has increased significantly, and very high prices for some technology favorites and a surge in speculative activity by day traders in the U.S. are both reasons for a little caution.
- Many of our investors see a good chance of better relative returns from a wider range of stocks. The difference in valuations between perceived winners and losers remains as wide as ever in most markets, but with clear signs of a strong rebound in economic activity from very depressed levels, we think that investors should pay close attention to risk exposures and look for opportunities outside the usual suspects that have dominated returns for a decade.

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TAKING STOCK

Once again, equity markets have reversed course in dramatic fashion in the space of a few weeks. This time, we have seen the fastest recovery from a bear market in U.S. equities since the 1930s, with markets around the world following suit. Volatility remains high but well off recent peaks, and investors everywhere have recovered their nerve, with a surge in speculative activity by day traders reminiscent of the late 1990s.

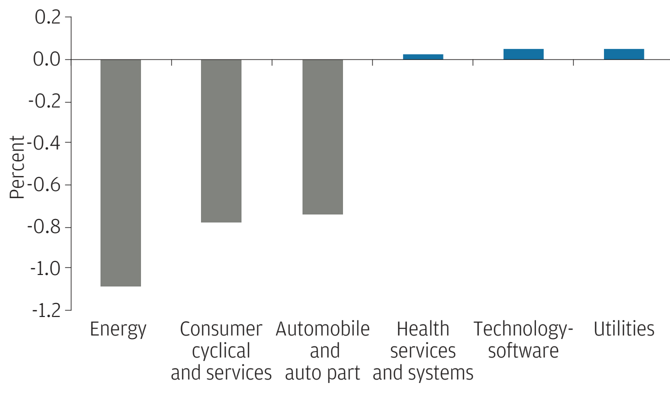
Our research team has been rapidly recalibrating near-term earnings forecasts since the onset of the shutdown, cutting over 30% from our expectations for 2020 and 20% for 2021. At this point, we think that we've captured the full scale of the disruption, and we've even seen reasons in recent weeks to increase numbers in a handful of cases. Where we have reduced forecasts since the onset of COVID-19, industry differences are far more important than regions.

The banking sector stands out once again, accounting for around 15% of the base earnings power of companies in developed markets but fully 25% of the cuts in dollar terms, with higher provisions wiping out half the sector's profits for 2020. While the banks are not the cause of the crisis this time around, and are far better capitalized than in 2008, there is no avoiding the impact of an economic shutdown on leveraged balance sheets. Energy sector profits have been

wiped out, and we've cut forecasts for automobiles by over 70%; these two groups account for another big part of the overall shortfall. Meanwhile, the giant technology and health care sectors have been relatively unscathed, with profits for this year only around 5% less than we had expected back in January (**EXHIBIT 1**).

Technology and health care have been relatively unscathed, with other sectors hard hit

EXHIBIT 1: EARNINGS REVISIONS FOR 2020, TOP 3 AND BOTTOM 3 SECTORS, JAN 2020 TO MID-JUNE 2020



Source: J.P. Morgan Asset Management. Revisions on developed markets from January 2020 to mid-June 2020

Longer term, we expect two broad impacts on corporate profitability: first, an acceleration of existing structural changes (which is now very much the consensus view), and second, a drag on profits from a more conservative approach to many issues, including supply chains and share repurchases. But the biggest impacts on our forecasts are more short term and transient in nature.

Compared with late March, equity market valuations now look less compelling to us. Emerging markets, for example, touched 1.2x price-to-book (the 2008 low) before rebounding to 1.6x, which is reasonable but no longer that remarkable. Multiples of near-term earnings look demanding in many cases and already anticipate a significant rebound in profits. The one valuation metric that stands out is the comparison between equities and government debt; based on past norms, we could see the S&P 500 trading 30% higher than today's levels if that was the only consideration. But that seems very unlikely. Overall, we expect normal, subdued returns from these levels, as we did at the start of the year (**EXHIBIT 2**).

Within markets, the extreme discounts applied to out-of-favor value stocks and the biggest losers from the economic shutdown have narrowed a little but remain very wide. And while overall market volatility has calmed down somewhat, the volatility of factors such as value, momentum and size continues to climb and has exceeded 2008 levels. This is a challenge for portfolio managers looking to control risk, and if history is a guide, it may well suggest a change in investor preferences ahead after years of dominance by mega cap technology stocks.

OPPORTUNITIES

Although our investors see much less potential for market gains, the opportunities for stock selection still look unusually good. Quality remains a popular theme across our team, with our managers finding many attractive companies trading at depressed prices, while few are inclined to invest aggres-

Expected market returns have come down, but the opportunity for stock selection remains high

EXHIBIT 2A: EXPECTED RETURN

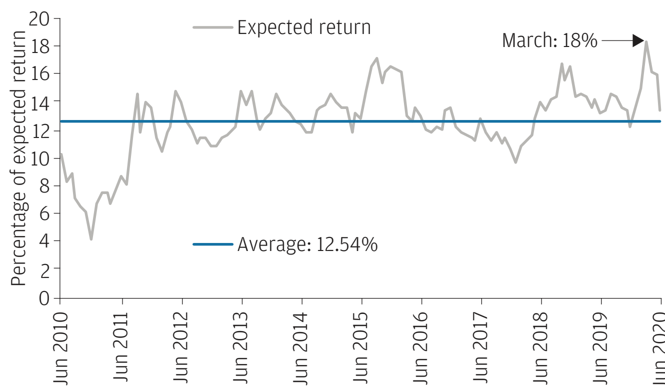
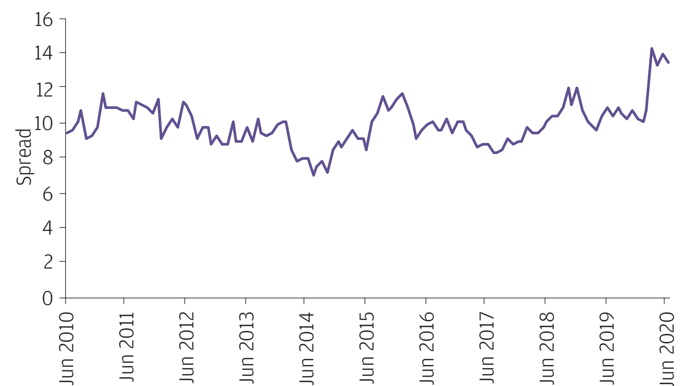


EXHIBIT 2B: Q1 MINUS Q5 EXPECTED RETURN



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

Views from our Global Equity Investors Quarterly, June 2020

EXHIBIT 3

A subset of survey results are shown for Global Equity Investors Quarterly participants taken in June 2020. These responses are taken from a quarterly survey representing 42 CIOs and portfolio managers across Global Equities.

sively in the most troubled situations. And value will matter, we think, with very large variations in pricing within every market around the world.

In U.S. equity, large cap value remains under a cloud. Our own measure of the value opportunity was higher in March than we had seen in the last 30 years, and it is still very high, higher even than 2008–09. Our value portfolio team expects the value style to outperform at least for a while, given this starting point and the rapid economic rebound now underway, during which time many beaten-down companies should have a strong recovery in profits. On many metrics, there is a wide range of opportunities to choose from, but our preferred sectors include those most leveraged to consumer income (retail and restaurants), as well as housing-oriented consumer names. Automobile sales, responding well to low interest rates and strong demand in China, are up year-over-year.

Emerging markets still offer reasonable value overall; our valuation work suggests solid rather than spectacular returns, but overall price-to-book ratios are still below average and multiples are reasonable. Within the asset class, the opportunities for stock selection still look very good. The very fastest-growing companies are expensive, but we can find many high quality investments with solid prospects at attractive prices. We don't need to pay up too much to build a high quality portfolio.

In the last few months, the banking sector has been hit hard around the world, presenting some good long-term investment opportunities. Few banks are long-term structural winners, but equally most are much more resilient than they were in previous crises. While we do worry about the risk of political pressure, and while extremely low interest rates will erode deposit businesses, we see good opportunities in banks that have already taken high and upfront credit losses, those where valuations are distressed and those where the long-term profitability profile remains intact (in India, for example).

EXHIBIT 3 presents a snapshot of our investors' views.

RISKS

Our investors focus on two main risks, at this point. The first is the risk to overall markets from a resurgence of COVID-19. Obviously, we have no real ability to predict whether that will happen, but markets have by now bought into the view that the virus is much more under control and that we are well on the path to economic recovery. Should that not be the case and further restrictions on economic activity prove necessary, then more downward revisions to earnings will be required and markets will be disappointed. This is a complex issue with significant geographic variations that we will need to watch carefully in coming months.

The other risk is to the relative returns for growth and quality investors should the stock prices of the most depressed parts of the market recover sharply while the winners take a rest. We often emphasize investments in faster-growing, better-positioned businesses, a strategy that has worked especially well in the past three years. But the valuation gap between winners and losers is extreme, and an economic recovery is underway (barring a resurgence of the virus, as discussed). In our more flexible core mandates, our portfolio managers are watching style risks closely and balancing an underinvestment in the highest risk, most troubled names with added positions in better quality cyclical and financial stocks, many of which still trade at attractive prices.

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NEXT STEPS

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