Focal Point

Equities: Tactically slight UW. Short-term risks prevail

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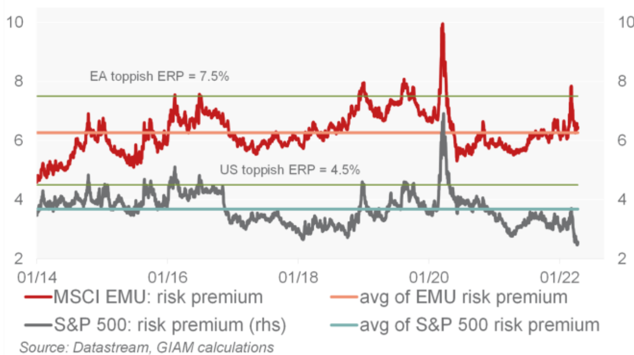
Our Focal Point series explores topical issues on macro, markets and investment

- Despite the recent risk rebound, headwinds are likely to prevail short term: lingering risks of a war escalation and sanctions are augmented by tougher central banks and increased signs of slowdown. Thus, we decreased the equity exposure to slight underweight (UW), reducing Value and sector cyclicality vs. more defensive Growth names.
- Short term, we prefer US and UK vs. EMU despite higher US valuations. EMU is more cyclical, exposed to the Ukraine crisis and more dependent on energy imports. Longer term, a scope remains to be diversified into US equities.
- Our base scenario of a slowdown – not a global recession – induces us to refrain from endorsing a strong UW on equities. Indeed, even with flat earnings growth in 2022 and lower-than-average PEs, equities may render mid-digit positive returns over 12 months (+5%).
- Furthermore, the current adjusted earnings yield gap vs. real yields is attractive, and so is the huge gap in cash flow vs Capex. Historically equity returns, while reduced, also tend to outperform bonds in periods of high inflation.



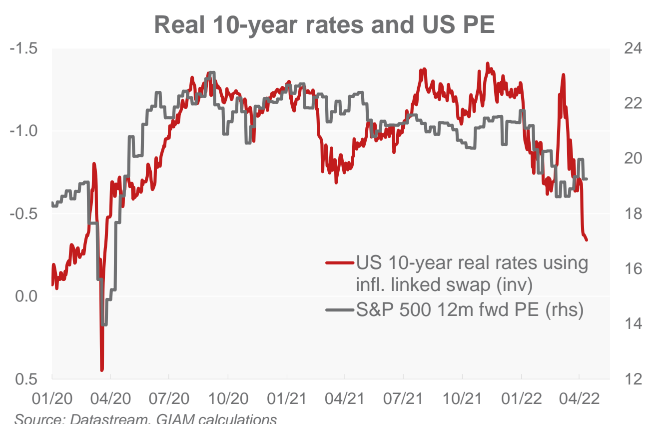
Source: Datastream, GIAM calculations

Equities are on average lower by 8% year-to-date (YTD), triggered by increased central banks' hawkish stance, higher bond volatility and credit spreads plus higher real yields. The war magnified such headwinds, bringing PEs further down from lofty levels (-18% YTD). In particular, The MSCI EMU index has been subject to elevated levels of realised volatility, (30-day volatility at 32% vs. the historical average of 18%). In this note, we provide an equity outlook while distinguishing between still a cautious view after the rebound and potential positive medium-term total returns (TR). Overall, we suggest a more defensive – and less cyclical – allocation.

Short-term risks prevail

Despite talks between Russia and Ukraine, it won't be an easy game for equities in the short term. Indeed, lingering war perils, escalating sanctions on Russia, and more hawkish central banks (CB) are hurting both households and firms' confidence, especially in the euro area (EA). This is inducing a notable downward revision in GDP growth. Such an environment represents headwinds to earnings growth, too, notwithstanding an expected decent Q1 reporting season. Analysts still have to revise down their +9% 2022 growth for EMU: we forecast it to be a more limited 1%. Due to sticky high inflation, CBs will remain on the hawkish side for some time, inducing further higher, albeit limited, 10-year yields and credit spreads. As a result, financial conditions for firms would continue to deteriorate, triggering even lower PEs and higher risk premia (ERP). Geopolitical risks will also stay particularly high (US vs. Russia and China) in the short term.

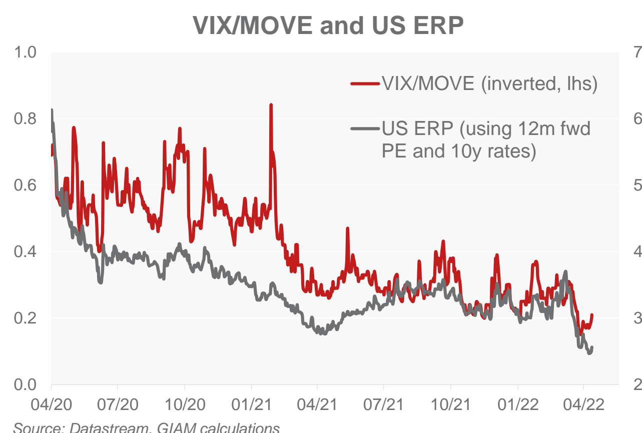
Furthermore, due to recently rocketing bond volatility, US equity volatility vs. bonds' one decreased substantially, pushing the US equity risk premium to its 14-year lows (and the EMU back to the historical norm): it is not so comfortable when CBs show their teeth and growth declines. Lastly, positioning, when measured by equity inflows year-to-date, remains elevated. Moreover, our quant models (Machine Learning approach) still see equity returns as disadvantaged vs. bonds' ones. For these reasons, we are tactically slightly UW on equities.



Source: Datastream, GIAM calculations

Allocation: reduced cyclicality, more defensive growth

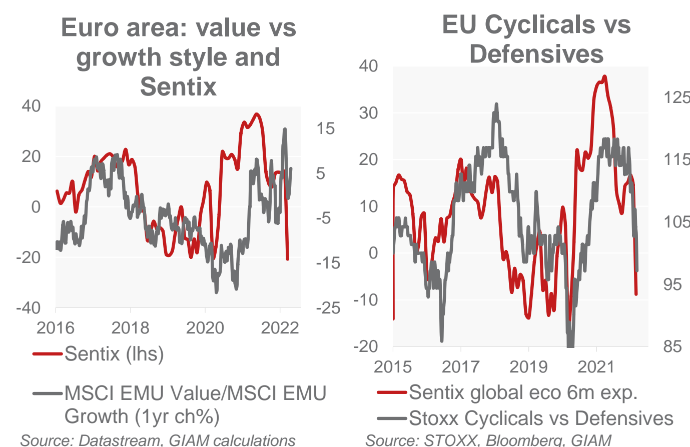
Regionally, we slightly OW US and UK vs. the more cyclical and riskier EA, notwithstanding some hopes of a ceasefire deal. To be clear, EMU is cheaper than the US: premium of 8% on market multiples vs history vs. 33% for the S&P 500. The PEG (PE/exp. EPS growth) adjusted for beta and ROE is 1.2X for EMU and 1.5X for the SPX. The same is true for the current CAPE level (i.e., PE adjusted for the cycle) gap vs history, which shows EA at premium of 6% vs. 40% of the US. The EA has also started to use fiscal policy in an anti-cyclical way, representing a put for markets in future severe slowdowns. Progress towards greater EU cohesion represents an additional plus. That said, the EA is more cyclical, confidence indicators are plunging (IFO and Sentix), and it has more to lose from the Ukraine and energy crisis, being far less energy independent than the US.



Source: Datastream, GIAM calculations

Furthermore, risks arising from the French elections could jeopardise the EU reform process while keeping the relative risk premium high. The US also deserves other advantages, which render structural diversification still worthy. We refer to the doing business conditions, Tech governance rank, spending on Innovation and R&D, other than population growth, rank in competitiveness, and trend in productivity growth. Indeed, when we look for global sectors with the lowest correlation to the EU but higher sharper ratios, 15 out of 40 sectors are from the US.

Finally, US volatility is structurally lower and our 5-year TR forecasts not too different for the two indices.



Source: Datastream, GIAM calculations

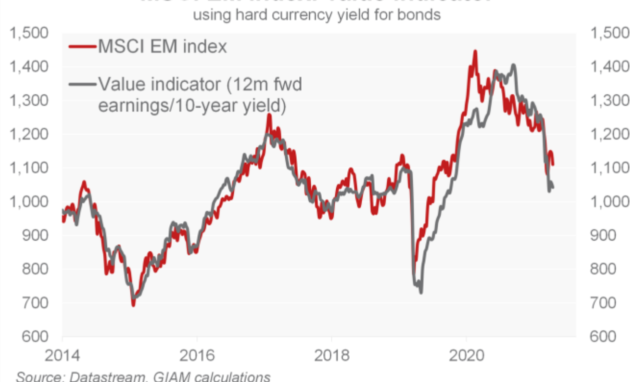
Source: STOXX, Bloomberg, GIAM

We continue to OW UK FTSE 100. Its valuation is still relatively appealing vs. EMU: by 5% based on our Value indicator (12m fwd earnings/10y rates), 8% judging from market multiples and even more when we consider the PEG

ratio (PE divided by the expected long-term earnings growth), adjusted for the level of COE (cost of equity) and ROE. Furthermore, the UK is more energy independent than EMU, with its sector composition being more defensive and tilted vs. commodity firms (energy plus materials is 23% vs 11% for EMU; while defensives' weight is 41% for the UK vs. 27% for EMU).

Regarding EU sectors, high geopolitical risks plus spiking inflation and a weaker economy ahead represent headwinds for Value-Cyclicals. We still favour a barbell strategy: Value is reduced and in part, also cyclicals, vs. more defensive Growth names (food and healthcare). After having cut its overweight (OW) progressively in the last weeks, banks are neutral due to higher credit spreads and lower GDP growth, notwithstanding our expectation of mildly higher 10-year yields, which continue to represent a tailwind for financials. We also turn neutral on Insurance after a good performance and less appealing relative earnings while also downgrading Durables due to lower consumptions ahead. The OW on Healthcare Equipment and Energy is instead increased, whereas we lower the UW on Media and Telecoms. Our OWs: Energy, Food, Healthcare, Materials. The UWs are in Diversified Financials, Capital Goods, Media, Telecoms, Real Estate, Technology Hardware and Utilities.

EM Equities: neutral stance is recommended. After the extreme underperformance, EM PE (12-month forward) looks attractive vs the MSCI World, but EM Value indicator remains on a declining trend short term (earnings/10-year yields) due to weaker earnings and higher 10-year government bond yields. Chinese stocks are preferred to the MSCI EM due to attractive valuation (both in terms of market multiples, the value indicator, and the internal country score) and higher chances of policy support, notwithstanding lockdowns and technology supply bottlenecks. We also OW Korea.

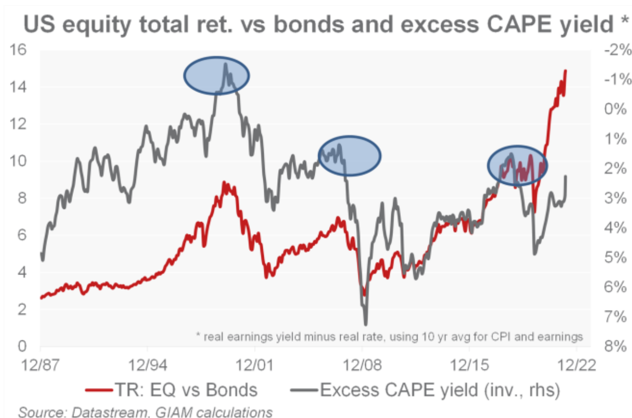


Source: Datastream, GIAM calculations

Medium-term case for equities. Remain constructive

As said, our current UW is a limited one. Indeed, equities still offer value in the medium term. In our base scenario, with risks still tilted to the downside, comparatively high growth rates will be achieved even in the EA (2.2%). This is due to the statistical overhang (this does not exclude negative quarterly growth rates in 2022). After the war-related slowdown, the economy is expected to temporarily regain some momentum by the end of 2022.

Furthermore, the US economy should remain in a decent shape in the following months, and Chinese authorities are using both the monetary and fiscal levers to offset in part, the current weaker growth momentum. This would ultimately benefit global growth, too. Lastly, even using a lower PE target (13.2X vs 14.2 of hist. norm for EMU), 12-month TR is seen at +6% for EU (4% for the US), should recession be avoided in 2022, as we expect (no deep negative earnings growth). Our 12-month TR forecast factors in a lower EA GDP estimate by 1.7 pp (to 2.2%) and zero earnings growth for 2022 from our previous 6%. Overall, we remain below earnings consensus by 5% and 8% in '22 and '23. Furthermore, currently high free cash flow (CF minus capex) and earnings yield gap (CAPE yield) vs real yields add to the historical evidence that US equity returns in periods of high inflation, while being lower, tend to outperform bonds.



Source: Datastream, GIAM calculations

Our long-term view remains constructive as well. In our base scenario, notwithstanding a possible meager 2-3% TR in 2023 in anticipation of a late-cycle slowdown to happen in the turn of 2023-24, we see mid-single-digit CAGR TRs for equities in the next years. They are below the historical average but relatively appealing compared to FI assets. Indeed, even considering a lower cyclically adjusted price-to-earnings ratio (CAPE) target in 4 years (especially in the EA) and lower earnings growth vs. norm, the rising yield levels are unlikely to be sufficient to derail equity returns. In this scenario, characterized by higher yields and still decent nominal growth (the latter averaging +3.5% for EMU and 4.5% for the US), the cheaper EA would deserve a slightly higher return vs. the US: by nearly 1% per year in 2023-2026.

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