

Focal Point

Equities: stay positive with a value-cyclical tilt

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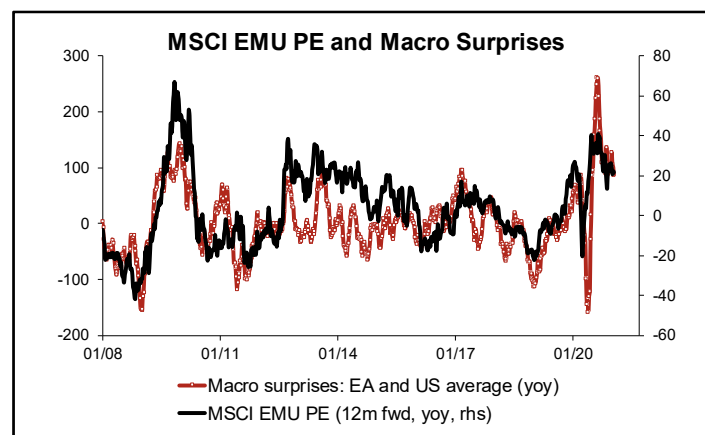
- Following a monster rally in stocks last autumn, multiples are well above historical averages, but equity investors can count on lingering low yields, tighter credit spreads and increasing central banks' balance sheets which in turn maintain low the cost of equity and the discount rate of future cash flows.
- The equity risk premia fell due to the sharp decrease in policy uncertainty and poor Fixed Income returns should keep them tight. Our positive 2021 equity view relies on earnings upturn and not on any equity multiple expansion.
- Earnings should increase appreciably in the next two years: for the euro area (EA) we forecast profits to grow by more than 40% in 2021 and some +14% in 2022 (back to 2019 levels by H2 2022), with risks on the upside.
- Value and cyclicals have outperformed last autumn and will continue to do so over the coming months. We favour Japan, UK and EMs and prefer EMU vs US over 12 months.

Stocks have rallied further since last autumn and market multiples have gone well beyond historical average. Yet, circumstances which backed such extremes are exceptional as well: first, the policy support is without precedent in history in scope and magnitude within a short period of time. Also, earnings are set to recover from the very low point reached by earnings which on the surface render higher price/earnings ratios (PEs). Finally, the perspectives of a plurality of vaccines boost sentiment. In this note, we provide an equity outlook and argue that despite the recovery already seen, there is still value in equities in this cycle, especially in lagging segments like value style and cyclicals - both at sector and market levels.

Higher valuations due to lower discount rate

Since March 23rd, equities were able to post an exceptional rally which now puts in question the sustainability of current historically high market multiples. In our view they are currently sustainable and expected to fall slightly in the mid-term mainly due to earnings rebound. Indeed, sustainable PEs are also a function of the discount rate: decreasing 10-year rates (even more real ones) and credit spreads bring the discount rate of future cash flows lower, thus enhancing the current value (i.e. the "P") and consequently the PE. For every yield drop by 50 bps, the S&P 500's fair value is on average enhanced by 7-9%. Real yields on US 10-year Treasuries declined by more than 100 bps since the start of 2020. We are also just passing the cyclical low of earnings trend in which PEs usually reach the top of the cycle as investors start discounting the earnings recovery. Furthermore, the exceptional fiscal stimulus we are experiencing in the euro area (EA) and the US is adding to lower yields.

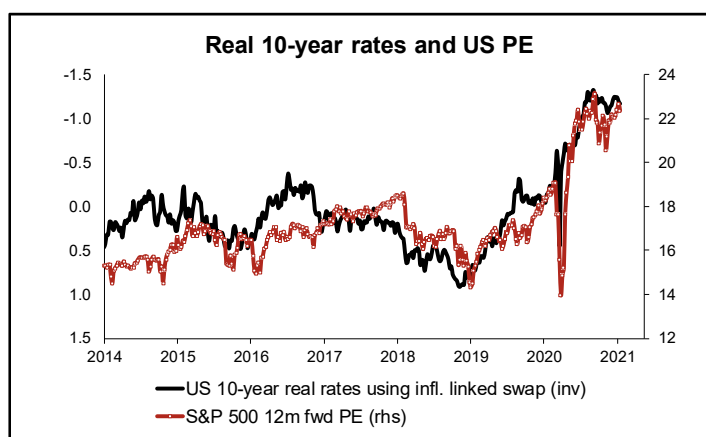
Central banks' asset expansion (25% and 22% of GDP for the EA and the US) and public deficits (38% and 18% of GDP. Source: BofA, Bloomberg) are well correlated with market multiples and account for their current high levels. Moreover, the big jump in macro surprise indices, firms' confidence and financial conditions experienced since May 2020 well justify the nearly 40% yearly PE expansion experienced in the last year. Such multiple expansion is coherent with past experience in 1994, 2002, 2008, and 2018.



Expect total returns of +5-9% over 12 months

Our models (target PE, dividend discount models (DDM), 3-stage earnings growth model, Fed model) see high multiples (i.e. PE) to linger and indicate 5-9% total returns (bigger for EM, EMU and UK vs the US) for 2021 thanks to strong earnings recovery that we discuss later. As a reality check we use the very long [Shiller series of risk premium](#) for the US in periods of low inflation, which indicates a fair

value for the S&P500 at nearly 4,100 for this year (see GI's scenario 3 in the table below). Our target includes the net benefit of a Democrats' majority in the senate (second fiscal stimulus looming): additional 1.6% GDP growth and +6% earnings growth in 2021, even after taking into account the drawback from the +15 bps rise in the 10-year UST rate.



Furthermore, we note that the cyclically-adjusted PEs (CAPEs) for non-US countries range from being near to historical average (Europe) or at a discount (in particular for the UK FTSE 100 but also for EMs and Japan). For the US, the high CAPE (or the low earnings yield) would theoretically justify an absolute total return of 2% for the next 10 years. That said, as also Prof. Shiller stated recently in a broker's interview (see also his [statement](#) on higher relative attractiveness of equities vs bonds), the long-term real equity return over bonds is statistically more reliable. The latter would still be near +4 pp for the next decade, thus making equities very attractive vs government bonds. Finally, as said before, the low earnings yield in this cycle should be related to unusually low bond yields, which make the outlook of future equity returns less gloomy compared to history. These were also the conclusion from our [recent paper](#). Lastly, the dividend yield spread over BAA yield (a measure of risk premium) is at its historical highs in the US and only slightly below in the EA. Overall, the upside potential for EMU is higher. It would probably depend on the speed of EU progress towards greater integration and the success of the recovery fund.

US CAPE-based valuation (adj. for inflation)	10Y	CPI	Real 10Y Rate	EPS	Current (e/p - 10y real)
Scenario 1 (current input with consensus CPI & 12m fwd earnings)	1.13	1.16	-0.03	164.7	4.26
Scenario 2 (consensus 12m forward in 1 year)	1.21	2.00	-0.79	192.6	4.98
Scenario 3 (GI 12m fwd in 1 year)	1.35	2.20	-0.85	196.1	5.08
Scenario 4 (downside macro scenario)	0.70	1.00	-0.70	115.0	2.98
Scenario 5 (upside macro scenario)	1.95	1.50	-0.35	210.6	5.45

using 20% of risk (SD)	Scen. 1	Scen. 2	Scen. 3	Scen. 4	Scen. 5
Implied PE Trailing IBES	26.0	30.4	30.9	18.1	28.8
Avg S&P500 valuation	3,493	4,083	4,155	2,438	3,869
	-4.8%	11.3%	13.3%	-33.5%	5.5%

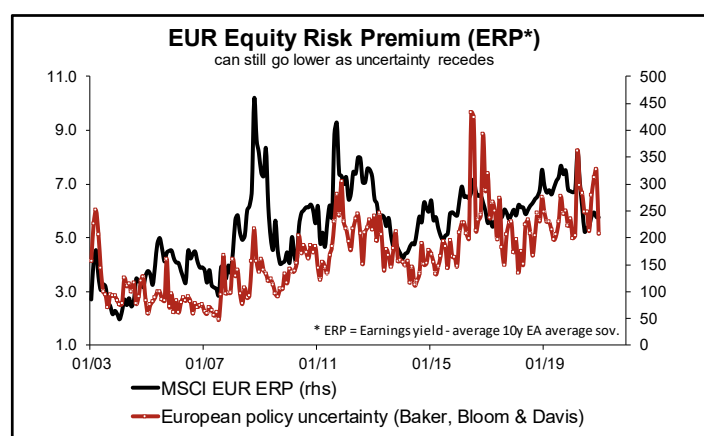
Note: **Base risk** scenario: using 20% of risk premium's stand. deviation (SD).

Target ERP (4.6) is calculated assuming CPI in the range b/w 1.3% and 2.3%.

Falling uncertainty to support lower risk premium

Since March 2020, the relative equity volatility versus bonds collapsed, due to lower yields, credit spreads and continuing policy support. In line, the dispersion of analysts' earnings forecasts (a measure of risk aversion) decreased appreciably, being also supported by stabilizing macro

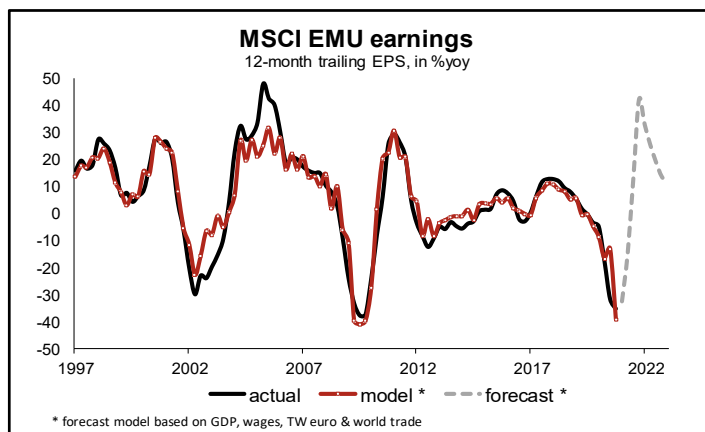
surprises. As a result, the implied equity risk premium (12-month forward earnings forecast/price minus 10-year rates) fell, too, producing higher market prices. Volatility – VIX – after falling from March highs, spiked up again in August reaching a top at nearly 40 just prior to the US election day. Like in past elections, volatility collapsed immediately after November 2nd as policy uncertainty decreased. The US presidential election reduced uncertainty as it improved the chances of smoother international relations and a return to multilateralism. Arguably, the US-China cold war will continue, but the US will probably maintain more predictable relations with its traditional partners, including Europe. As monetary support will stay, and vaccines campaign progresses along with lower political risks (resolved Brexit uncertainty, Biden's victory declaration), we think volatility has scope to decline further midterm after the new spike in contagion abates again. As for the EA, the ECB composite [indicator](#) of systemic stress (CISS) is extending its fall together with the Policy uncertainty index, backing further compression in the equity risk premium in the following months. This together with the low yield environment and recovering inflation expectations back the extension of the equity overperformance vs bonds.



Strong earnings rebound to do the job in 2021-22

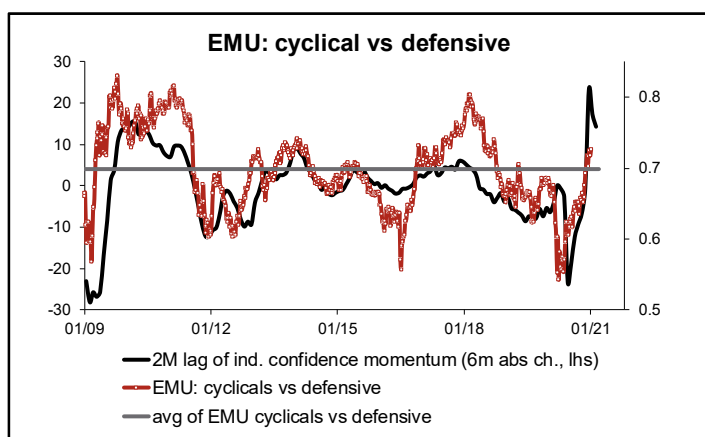
Our macro-based models back an earnings growth of +42% for EMU in 2021 and +17% for the US. Earnings in EMU should recover to 2019 levels in H2 2022 (24 months would be the norm according to past recoveries after recessions but this time the policy support makes the difference), and by the end of 2021 in the US. 2022 should see an earnings growth of around +10% for both. A lower US weight in energy and financials and a higher one in tech explains a faster recovery in US earnings than in the EA. Our estimates have upside risks as world earnings revisions linger at the top of the cycle and Biden's victory can provide higher GDP growth in 2021. Such earnings development can generate total returns of 5-8% in 12 months and somewhat more for EMs (9%). Currently, markets are fairly valued or only slightly overvalued (US) when we take into account current yields and earnings estimates. But, as said, the latter are expected to rise significantly, rendering positive returns in 12 months. US domestic NIPA earnings have already picked up (+10% yoy) and typically lead trailing earnings for the S&P 500 and the MSCI World with a lag of 1 or 2 quarters. US corporate margins (proxied by NIPA/GDP) are well correlated to the deficit spending whose surge should promote a jump for the former at least in the next few quarters. The fall observed in real unit labour costs

represents an additional positive. In the EA, the firms' capacity utilization is starting to bounce, and the firms' ROE has chance to follow, increasing significantly from here. The cyclical sectors – like industrials or financials – should benefit from high global macro surprises. In the US, higher oil prices and a weaker USD should represent an additional positive which is less true for the EA due to the stronger euro.



Value and cyclicals still have potential to rise

As said, equities are set to rise further and we think the rotation towards value and cyclical styles (at sector and market levels) can continue due to the cited policy support, the vaccine development and the GDP recovery in the next two years. The Biden policy will be more “reflationary” than Trump’s one (even more after winning the majority at the senate), inducing slightly higher US rates by year end and a steeper yield curve. This will not represent a net negative, as we forecast strong earnings growth ahead, but would rather promote a style rotation into cyclicals and value (shorter duration assets outperforming longer duration ones).



The impact from the EU recovery fund will be positive for Europe together with the good Chinese macro momentum, which supports global export activity. In sum, the rotation into cyclicals and value countries (EA, UK, Japan and EM) and sectors (industrials, financials, materials, energy) can continue at the expense of growth ones. After the rally, we are slightly more tilted to value (the real laggard in this recovery: around -20pp vs Growth since Jan. 2020 and -33pp since 2019). Looking to the value sectors, we see relatively strong earnings momentum vs the market. This is the case for financials, energy and materials, in particular; less so for

industrials. Our quant models still see a huge undervaluation for value but not so much for cyclicals, such as capital goods or commercial & professional services. For this reason, we lowered capital goods from overweight (OW) to neutral (N) going slightly OW on banks. The latter looks particularly vigorous in terms of relative earnings momentum, so we decided to go beyond the neutral position, trying not to raise further our risk exposure after the rally. We overweight energy, financials, food retail, materials, semis and software.

EM equities to outperform their developed peers

EM equities are showing a faster earnings recovery, supported by the ongoing rebound in growth following the global Covid outbreak. Despite this relative earnings strength, EM equities have only slightly outperformed the MSCI World (+22% vs 17%) over the last year. They look attractive, using different measures of valuation: market multiples, internal country scoring and Shiller PE (almost one standard deviation below average). Improved macro surprises, the perspective of a sustained global recovery next year and more favourable global financial conditions are also supportive for EM stocks. For the mid-term, the expected steepening of the US yield curve, a weakening US dollar and higher commodity prices should also benefit EMs. We favour Korea, India, Poland and Taiwan.

Risks

The major risk is represented by extended Covid-19 infections requiring much broader and prolonged shutdowns than expected. We also see a continuing US-China confrontation, Tech regulatory tightening to eventually hit the leading sector in the US, the increased investors' positioning in equities and surprising higher 10-year rates/inflation. These could trigger temporary setbacks short term. That said, net equity demand should increase this year (+1TN USD) thanks to sovereign wealth funds (SWFs) and risk parity funds. A declining VIX (thanks to bold monetary policy) will help in this regard. As buybacks and leveraged buy-outs (LBO) normalize, the net equity supply should decline, too, adding to the positive market technicals.

Conclusions

In this report we argued in favour of the sustainability of high market multiples due to a change in paradigm (refer to our Outlook 2021 "[Repair and Despair](#)"). This sees a huge and extended use of unorthodox tools of monetary policy (QE, average inflation targeting etc.), extraordinary fiscal intervention – unprecedented in the EA – and an unexpected global effort on vaccine development. The by-product is lingering low yields – keeping cost of capital low, i.e. the discount rate for future cash flow – which sustain high PEs for longer. But the real work will be done by a significant recovery of earnings – especially in Europe (+40% in 2021) – and declining uncertainty and volatility. This in turn will favour equity total returns of 5-9% this year, definitely higher than for fixed income ones (particularly in the US case) with investors induced not to abandon risky assets anytime soon.

Imprint

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