GENERALI INVESTMENTS

Focal Point

Equities: positive returns ahead despite challenges

September 21, 2020

Authors: Michele Morganti / Vladimir Oleinikov

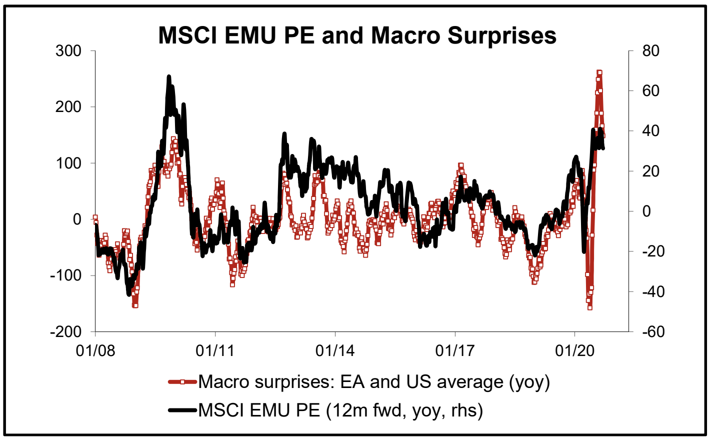
- Equity markets have rebounded from a historical slump in Q1, with US markets even posting fresh record highs.
- We acknowledge the risen risks of setbacks amid loftier valuations, elevated political risks (US elections, Brexit and US-China frictions) and Covid uncertainties into autumn.
- Overall, however, we see some further moderate upside. Higher valuations are compensated by recovering economic growth and corporate earnings amid strongly expanding monetary and fiscal policies.
- Central banks' commitments to persistently low yields and continued asset purchases justify structurally higher market multiples. Investors' positioning is still not stretched.
- We maintain a slight tilt towards cyclicals and EMs, which have been lagging the rally.

In the first month following the Covid-19 outbreak stock markets plummeted and experienced drawdowns of 30% comparable only to those of the Lehman crisis in 2008. Since the end of March markets rebounded appreciably due to a bold policy action. More recently, markets' volatility has risen up (especially the NASDAQ) mostly due to the increase in new Covid cases, geopolitical risks, US elections' uncertainty, and surging US FAANG's volatility (Facebook, Amazon, Apple, Netflix and Google) after their huge rally posted YTD (+37% on average).

In this note, we provide an equity outlook, arguing that despite the recovery already seen, there is still value in equities in this cycle, especially in lagging segments like cyclicals and EMs.

Rising risks for the short term

As a result of bold policy stimulus and consequent significant reversal in equity performance, markets' multiples are now above historical average: +35%, +17%, and +11% for the S&P, MSCI EMU and MSCI EM, respectively. At current levels, markets discount already – albeit not fully - a respectable earnings growth in 2021. Furthermore, as valuations stay high, equities are more exposed to possible negative news flow and the above-mentioned risks concerning US elections: a reverse of Trump's tax cuts, higher minimum wages in a Democratic sweep scenario, and the negative effects from delays in mail-in vote count. As for the Covid issue, while the winter flue should represent a headwind, we have become less worried in the last weeks, seeing a declining mortality rate. Besides hospitals have better protocols and there is some progress on the development of vaccine and new cures.



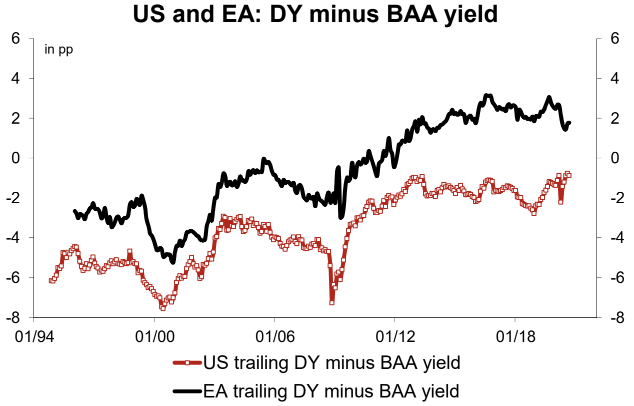
Turning to the recovery momentum, we see possible negative second-round effects coming from fading unemployment benefits, impaired balance sheets and low capacity utilization representing a drag on capex and consumer spending. This would vindicate the view of a "swoosh" (i.e. a stretched U) or even a W-shaped recovery with developed markets' GDP not returning to pre-crisis level before the end of 2021. Furthermore, sluggish demand and the cited negative secondary effects will keep the earnings expectations at risk. After an initial surge in momentum, earnings progress could lose some traction in the next months. Acknowledging the risks mentioned we show in the next sections why we see further upside potential in equities.

Earnings revisions finally stabilizing and helpful

The Q2 reporting season showed positive surprises of +22%-33% for the S&P500, the MSCI EMU and Topix. Q2 yearly earnings growth is fully in negative territory but might represent the bottom in this cycle: -7% yoy for the US and -30% for the euro area (EA). Previous bottom for the MSCI EMU was at -40% yoy during the GFC. Fundamentally we can still afford a limited further negative revision (-3% to -5%) without having to reduce our 12-month total return targets (cautiously near +5% for Europe and Japan). Such revisions should be limited as Q2 numbers were already gloomy while macro indicators have improved. Resuming activity will trigger a rebound in Q3 macro data. This will sustain 12-month earnings revisions which were already in positive territory in the last weeks also due to a rolling effect (12-month forward earnings: +2.3% for EA and US and +2.7% for EMs). Furthermore, annual earnings growth will likely turn positive again in Q1 2021, thus continuing to support markets.

Our earnings projections are almost aligned to consensus, showing for the S&P 500 a yoy growth of -22%, +32%, +9%, respectively in 2020, 2021 and 2022. In particular, past recession experience and our earnings models imply a noticeable profit rebound in 2021. Such a sharp recovery is also suggested by the past response of US NIPA profits to GDP (a proxy for corporate margins) which is highly correlated to the deficit spending.

US and EA: DY minus BAA yield

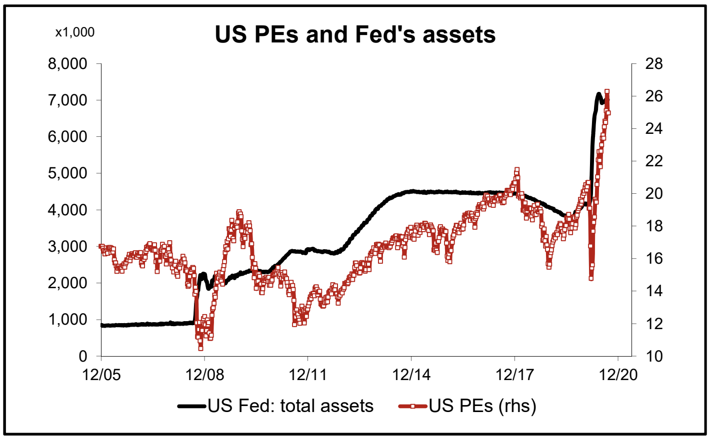


Positive total returns in 12 months

We remain constructive on equities. To begin with, the unprecedented policy response (both fiscal and monetary) was mainly responsible for the reversal of equity performance, inflating market multiples, with the S&P 500 returning a positive 6% year-to-date (YTD). Furthermore, during the summer, G10 and euro area macro surprises expanded, with the US leading the way. The Q2 reporting season showed significant positive surprises, too. The described multiple expansion was mainly caused by a sharp decline in 10-year rates and credit spreads, which ultimately decreased the future cash flow discount rate along with the cost of capital for firms. Such a phenomenon of higher multiples is also coherent to the visible positive momentum of macro surprises which has induced a turnaround of major economies from Q2 troughs (see chart). High multiples can linger for a while like H2 2009 experience shows: PEs usually tend to increase at the bottom of the cycle and with superior magnitude after deep recession-induced collapses. Then, they tend to decrease as earnings start showing positive revisions. This is already occurring in the US, while revisions for the MSCI EMU and other relevant indices are only stabilizing, i.e. becoming less negative.

Due to lingering bold monetary policy - reaffirmed by Fed's strategy overhaul at Jackson Hole - financial conditions have eased off quickly inducing a collapse in equity volatility vs bonds and a lower dispersion of earnings' forecasts by analysts (a measure of uncertainty/risk). This prompted a steep decline in the equity risk premium (to 4% and 6% in the US and the EA, respectively), back to post-Lehman average but still high on a longer term horizon and so attractive vs bond yields.

But most importantly for the mid-term horizon, spiking Fed's assets support structurally higher US PEs as the story since 2005 shows (see chart below). The Fed also remains dovish and fully flexible for the midterm as the inflation target will now be specified in terms of average around the business cycle, while seeking to minimise the shortfall from maximum employment and concepts like equilibrium interest and employment rate have been further downplayed, as well as the very Taylor rule.



Our mix of valuation tools (targeted PE, DDM, 3-stage earnings growth model, Fed model) suggests the mid-single digit total return in 12 months cited above (around 5%). This is driven by multiples remaining higher than in history (justified by lingering low yields) and by a bold earnings rebound in 2021. Applying a reality check and using the one century long Prof. Shiller series of risk premium and CAPE for the US (in periods of low inflation), we come up with a fair value for the S&P500 of around 3,550 for the next quarters (see the table below).

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)	0.70	1.24	-0.54	142.5	3.90
Scenario 2 (consensus 12m forward in 1 year)	1.14	1.25	-0.11	173.4	4.74
Scenario 3 (GI 12m fwd in 1 year)	0.90	1.40	-0.50	176.3	4.82
Scenario 4 (downside macro scenario)	0.50	1.00	-0.50	130.0	3.56
Scenario 5 (upside macro scenario)	1.50	1.50	0.00	190.3	5.21
Scenario 6 (lower recent ERP average)	3.25	2.30	0.95	166.3	4.49

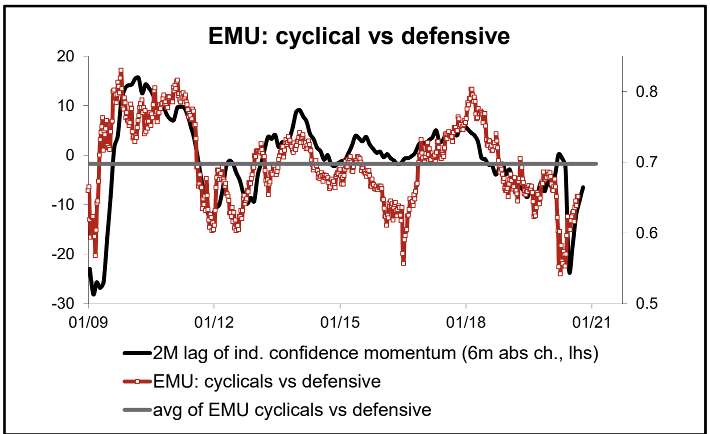
	Scen. 1	Scen. 2	Scen. 3	Scen. 4	Scen. 5
Implied PE Trailing IBES	20.3	24.6	25.1	18.5	27.0
Avg S&P500 valuation	2,864	3,483	3,543	2,612	3,822
	-17.5%	0.4%	2.1%	-24.7%	10.1%

Note: Target ERP (4.7) is calculated assuming CPI in the range b/w 1.0% and 2.0%. We used 25% of risk premium's stand. deviation (SD). Possible range for scenario 3: 3,540 - 3,700.

Apart from valuations, we note that positioning remains overall not stretched yet and tactical indicators we follow are in only neutral territory – not overbought, with a persistent search for yield by investors. As long as there are no new macro shocks and volatility keeps declining, systematic strategies will mechanically re-leverage and discretionary investors who may have stayed out of equities so far should become more comfortable participating, thus providing support for the market.

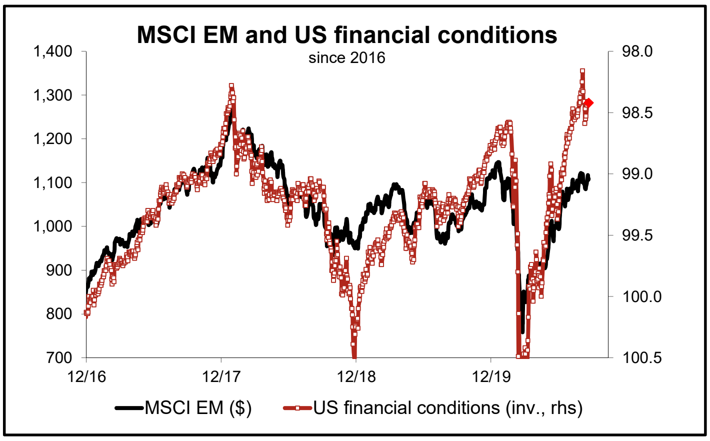
Maintain a cyclical tilt vs sectors and countries

As described before, the global economy is recovering. Yields have probably exhausted their downward momentum and look more stable now with some yield curve steepening ahead, especially in the EA (the EUR 10yr30yr spread). Such "recovery" phases tend to favour cyclical assets and value ones. As for European sectors, we reshuffle our allocation as some of the previous preferred styles (Growth and Defensive ones) became stretched but we are ready to jump in again in the mid-term as they still deserve superior growth ahead: pharma, utilities, and IT. Our analysis includes results from quant models, relative earnings revisions, positioning and relative valuations, which are aggregated into a single score, representing the basis for our recommended sector allocation: We overweight insurance, div. financials, capital goods and semiconductors. Underweights are durables, transportation, and comm. & prof. services. As said, we favour some rotation into cyclical values (IFO and other confidence indicators gained momentum) but avoid adding too much risk in the portfolio (only cautiously optimistic on banks and energy, for example). In general, Value per se is not a clear buy to us as yields are going to stay low and our quant models do not offer a clear direction at this time.



As for country allocation, we recommend a balanced portfolio (US aligned with EMU) with a marginal tilt to EMs and to EA vs Europe-ex EA. Mid-term, the cyclical recovery, more stable yields and improved sentiment due to the recovery fund approval could ignite an overperformance of EMU vs US that we estimate to be in the region of 5-7pp (via a reduced risk premium gap of 50 bps). Of course, a stronger EURUSD could at some point represent a headwind for the EA. For the time being, the EMU risk premium has already come down appreciably vs the US one. Less attractive are also the ECB assets momentum vs US (which affects relative PEs: both in 6m %changes), the EMU PEG ratio (PE divided by the expected long-term earnings growth) and our internal composite valuation score: we remain neutral EMU vs US. UK and Switzerland scores are similar to EMU ones (neutral) but UK can continue to suffer due to its defensive nature and Brexit uncertainty despite a weaker pound and lower valuations. The Topix index (a cyclical Value) scores very well in relative terms but we want to see first the policy of the future prime minister and let the market digest the strong yen: we recommend a neutral position.

At a time when developed market equities are near their all-time highs, EM equities are significantly lagging. This situation might be changing. In the Covid aftermaths, EM equities have proven resilient, which resulted from China quickly emerging from the COVID crisis. Positive for EMs is the ongoing growth improvement, which is seen in a relatively stronger rebound of EM manufacturing PMI. As a result, EMs' earnings have been revised up, with the revision ratio showing a better momentum versus that of developed markets. Improved macro surprises and eased Fed's financial conditions are supporting the EMs as well (see chart above). In term of multiples, EMs are trading at a discount to US (24%) while the risk premia on EM hard currency bonds remain attractive relative to US HY. Our proprietary country score indicator (based on expected total return, average PEG ratio, Shiller PE discount, market multiples discount and positioning) confirms the most relevant EM indices being at the top of the world index list. Midterm, a weakening US dollar and relatively low valuations will provide tailwinds: we see total return in 12 months of nearly 6% in USD. We favour Korea, Taiwan and Poland, thanks to a better Covid contagion trend, supporting M1 momentum, and high internal score ratings.



Conclusions

Equity markets prolonged their rebound in the summer with macro surprises going into the expansionary territory and the Q2 reporting season showing significant positive surprises.

Bold policy action is set to keep equities lingering at higher-than-history market multiples but with rising risks for the short term. These are related to geopolitical and Covid issues plus the uncertainty surrounding the US elections. Possible negative second-round effects from high unemployment, impaired balance sheets and low capacity utilization could represent a drag on GDP, possibly slowing earnings recovery.

Having said this, in our base scenario we see 12-month total return targets around +6% in USD for EMs, +5% for Europe and Japan and 3-4% for the US. Targets are driven by multiples remaining higher than history – due to lingering low yields and increasing central banks' assets - and by a strong earnings rebound in 2021. While low in absolute terms vs history, such returns are still attractive vs bond ones. We keep a slight overweight position in equities and maintain a cyclical tilt in sectors and regions.

Imprint

Issued by:	**Generali Insurance Asset Management S.p.A. SGR, Research Department**
Head of Research:	Vincent Chaigneau (vincent.chaigneau@generali-invest.com)
Head of Macro & Market Research:	Dr. Thomas Hempell, CFA (thomas.hempell@generali-invest.com)
Team:	Elisabeth Assmuth (elisabeth.assmuth@generali-invest.com) Elisa Belgacem (elisa.belgacem@generali-invest.com) Radomír Jáč (radomir.jac@generali.com) Jakub Krátký (jakub.kratky@generali.com) Michele Morganti (michele.morganti@generali-invest.com) Vladimir Oleinikov, CFA (vladimir.oleinikov@generali-invest.com) Dr. Martin Pohl (martin.pohl@generali.com) Dr. Thorsten Runde (thorsten.runde@generali-invest.com) Dr. Christoph Siepmann (christoph.siepmann@generali-invest.com) Dr. Florian Späte, CIIA (florian.spaete@generali-invest.com) Guillaume Tresca (guillaume.tresca@generali-invest.com) Dr. Martin Wolburg, CIIA (martin.wolburg@generali-invest.com) Paolo Zanghieri, PhD (paolo.zanghieri@generali.com)
Head of Insurance and AM Research:	Michele Morganti (michele.morganti@generali-invest.com)
Team:	Raffaella Bagata (raffaella.bagata@generali.com) Alberto Cybo-Ottone, PhD (alberto.cybo@generali.com) Mattia Mammarella (mattia.mammarella@generali-invest.com) Roberto Menegato (roberto.menegato@generali.com) Giovanni Millo, PhD (giovanni.millo@generali.com) Antonio Salera, PhD (antonio.salera@generali.com) Cristiana Settimo (cristiana.settimo@generali.com) Federica Tartara, CFA (federica.tartara@generali.com)
Sources for charts and tables:	Thomson Reuters Datastream, Bloomberg, own calculations Version completed: see front page

In Italy:
Generali Insurance Asset Management
S.p.A Società di gestione del risparmio

Piazza Tre Torri
20145 Milano MI, Italy

Via Niccolò Machiavelli, 4
34132 Trieste TS, Italy

In France:
Generali Insurance Asset Management
S.p.A Società di gestione del risparmio

2, Rue Pillet-Will
75009 Paris Cedex 09, France

In Germany:
Generali Insurance Asset Management
S.p.A. Società di gestione del risparmio

Tunisstraße 19-23
50667 Cologne, Germany

www.generali-investments.com