GENERALI INVESTMENTS

Focal Point

Higher equity valuations increase short-term risk

November 28, 2017

Authors: Michele Morganti / Vladimir Oleinikov

- This year global equities returned +20% with the euro area (EA) slightly underperforming the US. Systemic risks diminished and global growth accelerated while, due to weak inflation expectations, central banks remained supportive.
- Notwithstanding strong global earnings growth (13%), market multiples expanded to stretched levels, especially in the US and in some Emerging Markets (EMs), while remaining slightly above average in the EA and Japan.
- Short term we are less bullish on equities as higher valuations and investors' complacency are challenged by less dovish central banks, possibly higher geopolitical risks, toppish macro surprises and stronger focus on Chinese risks.
- For the next year, however, we expect decent total returns in the EA and Japan (+6%), due to their contained overvaluation, good earnings growth and limited pressure from only slightly higher yields. The US index should, on the other hand, underperform due to very expensive valuations and rising unit labor costs.

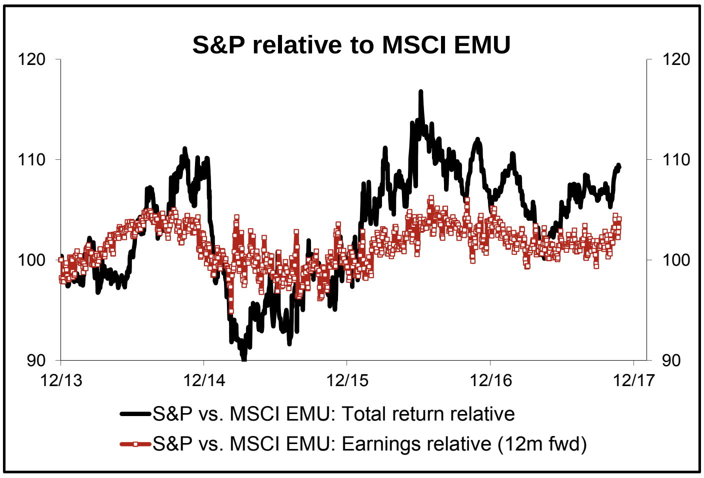
Year-to date (YTD), the MSCI World index posted a total return (TR) of 20% and the EA underperformed the US. Positive triggers were increasing global GDP growth estimates and recovering business confidence, together with declining global political uncertainty and dovish central banks. The latter surged towards cyclical highs while, at the same time, unit labor costs (ULC) came out stable or even declined slightly. This created conditions for a "goldilocks" scenario, via increasing margins and continuing muted cost of debt. On top of this, US and global financial conditions improved substantially, approaching pre-crisis levels, mostly due to continuing low volatility, falling credit spreads and surging markets. The MSCI EM index showed a spectacular performance of 36%, benefiting also from the recovery in global trade.

As a result of the strong market performance, the global 12-month forward Price/Earnings ratio (PE) increased from 16.3 to 16.9. With the current note, we assess how much current valuations are posing risks to future market performance, distinguishing between the short and the 12-month horizons.

Euro area versus US performance

The MSCI EMU showed a somewhat weaker YTD total return (13.8%) compared to the S&P500 index (18.3%), notwithstanding the former having cheaper market valuations (PE of 14.7 vs 18.2 for the US) and a higher sensitivity to the business cycle. The main reasons for the EA underperformance were a stronger trade-weighted (TW) euro, muted global inflation and stable global 10-year yields.

Investors were indeed concerned about the appreciation of



the TW euro (+5% YTD). Should current levels last, the exchange rate could have a potential negative impact on EA profits of around 4% by mid-2018. In the last two reporting seasons, such potential negative pressure on EA was overall limited. That said, YTD, the EA 12-month forward earnings increase (nearly 10%) was comparable to the one for the US, notwithstanding the higher sensitivity of EA firms to the global economic cycle. In addition to this, investors' sentiment was positively influenced by the expectation of President Trump's tax reform, which could add 5 pp to US profits growth in 2018. Furthermore, global yields remained stable this year, inducing the "secure growth" sectors, such as IT, biotech and health care services to outperform. These three sectors have a higher weight in the US index (30% in total) than in the EA one

(10.7%). EA equities, however, underperformed as continuing low yields do not bode well for financials which have a higher weight in the MSCI EMU index (20.4% vs 14.2%).

Market rally induced higher multiples

YTD, a sustained growth in 12-month forward corporate earnings (+13.1%) added to the market multiples' expansion (+3.8%) for the good price performance (+17.4%) and dividend return (2.7%) of the MSCI World index (see table). As said, higher synchronized GDP growth and muted ULC triggered higher corporate margins and healthy earnings growth globally. The Q3 reporting season confirmed this trend: 7-8% yearly realized earnings growth for the US and the EA, 18% for Japan and 20% for EMs. US NIPA profits – which represent profits from all US corporates and tend to anticipate the S&P500 and MSCI EMU earnings by 3 to 6 months – rebounded to 7.8% yoy in Q2 2017 after having reached -8% in Q2 2016.

Concerning the expansion in the 12-month forward PE, the S&P500 and the MSCI EM experienced sizeable increases: +6.5% and +8.5%, respectively, with the MSCI China at +22.9%. On the contrary, EA and Japanese PEs remained almost unchanged. As a result, current global market multiples (PE, PBV, DY and PCF) are higher than historical average by 14.5% but the S&P 500 stands out with a premium of 20.5%. The multiples for the EA, Japan and EMs are higher by 14.8%, 3.5% and 2.2%, respectively. The MSCI China's premium is 15.9%, after having shown a YTD total return of 57%.

Index	DY	%Price	%Earnings	%PE
MSCI World	2.70	17.4	13.1	3.8
S&P 500	2.13	16.2	9.1	6.5
MSCI EMU	3.11	10.7	9.2	1.4
TOPIX	2.31	17.0	16.6	0.3
FTSE100	4.03	3.4	6.4	-2.8
SMI	3.72	12.7	8.6	3.8
FTSE MIB	3.72	15.3	17.2	-1.6
MSCI EM	2.97	32.7	22.3	8.5
MSCI Brazil	2.51	20.4	11.9	7.6
MSCI Russia	4.96	0.7	-3.3	4.1
MSCI India	1.77	26.0	9.3	15.3
MSCI China	3.25	53.5	24.9	22.9

* changes are YTD

Getting more cautious on equities short term

As markets rallied appreciably, we have turned more cautious, favoring a more balanced allocation between EA and US equities and a tilt towards more defensive sectors. Higher valuations and investors' exuberant sentiment could be challenged going forward by less dovish central banks, possibly higher geopolitical risks, toppish macro surprises and stronger focus on credit and Chinese risks. We consequently favor a less pronounced overweight position on equities, compared with the past quarters.

Starting with valuations, our "value momentum" (based on consensus 12-month forward earnings estimates and 10-year yields) and our quant models show that most markets are fairly valued but the US is very expensive. In our view, so far investors have ignored risks related to US valuations mainly due to: improving US GDP and corporate margin momentum, weak USD, better financial conditions, low real rates and bullish expectations on US tax reform. In Europe, the ratio of PEs between cyclical and defensive sectors has reached a cyclical high and EA confidence indicators look toppish, too (see chart next page).

Furthermore, market implied volatility has reached new historical lows. Investors show a strong confidence that central banks remain slow and cautious for longer in reducing the monetary stimulus. As a consequence, financial conditions stay particularly supportive, favoring business sentiment and risk taking. Yet, we forecast inflation to continue to slowly increase as output gaps have been reducing and labor markets continue to improve. Thus, we believe that central banks can surprise investors with a more hawkish communication stance in the next few months.

Concerning sentiment, in recent surveys, global fund managers declared a higher appetite for risk, lowering their cash position to a level which corresponds to a neutral signal for riskier assets and no longer a contrarian-buy one. Investors expressed also a higher degree of confidence on a goldilocks scenario (high growth, low inflation), reaching a level which occurred only three times since 2008. Lastly, the risks emanating from the next Italian elections and the political impasse in Germany could delay the EU integration talks, further limiting the equity upside.

It is important to note the recent pressure on high yield (HY) bonds, given the high correlation between them and equity markets. The pressure derives from the telecommunication sector repricing, less benign momentum of the debt-to-EBITDA ratio in the US and expectations for the tax reform to lower the deductibility of interest expenses. HY bonds are potentially vulnerable as spreads are quite tight, reflecting very low market volatility. Given the high correlation with equity markets, the S&P 500 and EM performance, in particular, could come under pressure.

A more stable or slightly stronger USD, together with future higher US yields could also represent a temporary cap for EM spreads and equities. Here we need to differentiate across countries. Indian valuations, while relatively high are still justified: We see reforms to start paying off as acknowledged recently by the rating upgrade by Moody's. On the other hand, the high MSCI China's valuations appear more problematic (the Shanghai index looks cheaper). The strong tailwinds behind China's recovery since early 2016 are likely to wane in the coming months. In addition to this, Chinese 10-year rates moved higher recently mostly due to concern of PBoC limiting leverage and excesses in wealth and asset management industry. Negative spillovers could also affect the real estate market. Likewise, the Brazilian index should be priced with a discount, rather than the current small premium, due to a still gloomy fiscal position, ongoing political uncertainty (next elections in October) and comparatively lower profitability.

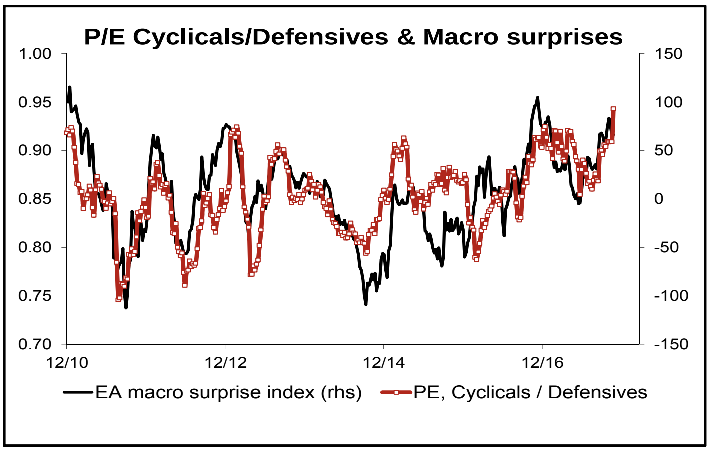
Markets	Price / Earnings *		Price / Book *		Price/ Cash Flow *		Dividend Yield *		Avg.
	current	hist. avg.	current	hist. avg.	current	hist. avg.	current	hist. avg.	Discount, %
WORLD	16.9	16.0	2.2	1.9	10.9	8.6	2.5	2.7	14.5
USA	18.2	15.3	3.0	2.3	12.4	9.8	2.0	2.2	20.5
JAPAN	14.7	15.7	1.3	1.3	8.5	7.0	2.0	1.9	3.5
UK	14.1	13.8	1.8	1.8	8.9	7.9	4.3	4.0	1.5
SWITZERLAND	16.7	15.4	2.4	2.2	12.3	11.2	3.5	3.3	5.0
EMU	14.7	14.2	1.6	1.5	8.4	6.4	3.3	3.9	14.8
FRANCE	15.0	14.3	1.6	1.5	9.0	6.8	3.3	3.8	13.6
GERMANY	13.8	15.1	1.7	1.5	8.9	6.6	3.0	3.4	12.9
GREECE	13.2	12.8	1.5	1.6	6.8	5.9	3.7	3.9	5.6
ITALY	12.9	15.3	1.2	1.2	5.6	4.6	4.3	4.7	3.7
PORTUGAL	17.3	12.6	1.8	1.7	6.8	5.9	4.4	4.5	15.5
SPAIN	12.8	13.0	1.3	1.6	5.2	5.1	4.1	5.1	0.2
EURO STOXX 50	14.1	13.2	1.6	1.5	8.1	6.1	3.6	4.3	15.3
STOXX SMALL	16.2	14.3	1.9	1.7	10.5	8.2	2.9	3.2	15.6
EM, $	12.8	14.6	1.6	1.6	7.9	7.7	2.6	3.1	2.2
BRAZIL	12.2	8.9	1.6	1.7	7.6	14.2	3.4	4.3	1.7
RUSSIA	6.6	7.1	0.7	0.9	3.8	4.6	5.6	3.5	-28.0
INDIA	18.6	14.3	2.8	2.7	12.7	11.5	1.5	1.6	12.4
CHINA	14.0	13.0	1.8	1.7	8.7	7.5	2.0	3.0	15.9

Note: The first four markets (ex. World) are based on the main local indices, the rest on the corresponding MSCI indices.
Multiples are based on 12m forward estimates; PEs are since 1987, the rest is since 2003.
Discount in % to historical average: blue and negative numbers = undervaluation. Red and positive numbers = overvaluation.
Source: Thomson Reuters Datastream, IBES estimates.

Decent 12-month returns in the EA and Japan

All in all, we remain constructive on equities on a 12-month horizon. Using a long-term approach to valuations (discount models, risk premium assessment, market multiples etc.) and comparing equity yields to our expectations for bond yields (both government and corporate), we can expect total returns of 5-6% from both the EA and the Japanese markets, and a subdued one (1%) for the US. Such returns are definitively appealing if compared with fixed income's ones and are consistent with a decline of trailing PEs in the next years: for EA from 16X in 2017 to 15X in 2018 (with earnings growth anticipated at 8% in 2018). Higher core yields in 12 months (+50 bps) should contribute to an outperformance of EA equities, unless the EU political risk escalates. EMs should experience a slightly higher total return than the EA, in local currency, but this will be offset by high hedging costs of around 4%.

Our earnings projections, derived from proprietary quant models, are at the basis of our total return forecasts. We expect an earnings growth of 8% on average in 2018 (consensus: 11.3% for the US and 9.5% for the EA). Such growth will keep the current dividend yield sustainable at more than 3% in the EA. The US market, though, clearly shows signs of valuation exuberance, pointing to weak-to-negative returns ahead. We come to the same conclusion using a cyclically-adjusted risk premium over the last century. The exception would be a scenario in which a positive surprise on the economic momentum is coupled by stable real yields. In this case the US index could post even a total return of 8%. On the contrary, we project bond yields to rise going forward, so US equity performance looks increasingly at risk in the mid-term.



Conclusions

After this year's rally, there are good reasons for investors' bullishness to be mitigated in the short term, favoring a balanced allocation between EA and US equities and a more defensive sector tilt. Fundamental conditions are still very healthy but higher valuations have left scarce upside from here to the next 1-3 months. Valuations apart, all-time-low volatility and significantly improved financial conditions have contributed to build high market sentiment, while investors discount a too gradual pace of monetary normalization by central banks. Our conviction is that inflation will continue to slowly increase and investors could start repricing expectations on central banks. For the longer run (12-months), valuations are sustainable in the EA and Japan. A still decent earnings growth could help produce a 5-6% total return in both countries and somewhat higher in the EM space in local currency (gross of high hedging costs, though). The US case is different. There are reasons which explain why investors have tolerated very high valuations so far. That said, over the next quarters, higher real yields and ULC should finally induce weak-to-negative returns.

US CAPE-based valuation (adj. for inflation)	10Y	CPI	Real 10Y Rate	EPS	Current (e/p - 10y real)
Scenario 1 (current input with our 2017	2.45	2.00	0.45	127.0	4.22
Scenario 2 (base 2018)	2.80	2.20	0.60	138.0	4.47
Scenario 3 (downside 2018)	1.90	1.70	0.20	114.0	3.99
Scenario 4 (upside 2018)	3.20	2.50	0.70	147.0	4.70
Scenario 5 (goldilocks)	2.45	2.20	0.25	147.0	5.15

	Scen. 1	Scen. 2	Scen. 3	Scen. 4	Scen. 5
Implied PE Trailing IBES	18.1	19.1	17.0	19.9	21.8
Avg S&P500 valuation	2,324	2,455	2,192	2,567	2,799
	-10.0%	-4.9%	-15.1%	-0.6%	8.4%

Note: Target ERP (4.7) is calculated assuming CPI in the range b/w 1% and 4%.

Imprint

Head of Research	Vincent Chaigneau (vincent.chaigneau@generali-invest.com)
Deputy Head of Macro & Market Research:	Dr. Thomas Hempell, CFA (thomas.hempell@generali-invest.com)
Team:	Luca Colussa, CFA (luca.colussa@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) Frank Ruppel (frank.ruppel@generali-invest.com) Dr. Christoph Siepmann (christoph.siepmann@generali-invest.com) Dr. Florian Späte, CIIA (florian.spaete@generali-invest.com) Dr. Martin Wolburg, CIIA (martin.wolburg@generali-invest.com) Paolo Zanghieri (paolo.zanghieri@generali.com)

Issued by:	Generali Investments Europe Research Department Cologne, Germany · Trieste, Italy Tunisstraße 19-23, D-50667 Cologne
Sources for charts and tables:	Thomson Reuters Datastream, Bloomberg, own calculations

In Italy:
Generali Investments Europe
S.p.A Società di gestione del risparmio

Corso Italia, 6
20122 Milano MI, Italy

Via Niccolò Machiavelli, 4
34132 Trieste TS, Italy

In France:
Generali Investments Europe
S.p.A Società di gestione del risparmio

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

In Germany:
Generali Investments Europe
S.p.A. Società di gestione del risparmio

Tunisstraße 19-23
50667 Cologne, Germany

www.generali-invest.com