Strategy & Outlook MARKET UPDATE

31st December 2019

Outlook

The aggressive change in sentiment and market positioning over the last 6-8 weeks of 2020 has been driven by a number of factors such as the immense provision of liquidity by the Federal Reserve, hopes that the trade truce will lead to a significant pick-up in global growth and earnings and the removal of the short-term risk of a no-deal Brexit. However, despite some pockets of strength in US data (employment for example), it is difficult to see a rebound in economic activity that would justify current market pricing. The announcement that Boeing would suspend production of its 737-MAX aircraft from January, for example, is alone expected to shave 0.8% from Q1 US GDP. Additionally, it seems inevitable that there was some front-running ahead of the possible increase in tariffs, which should dampen the expected rebound in growth in the short term.

If economic growth does not improve substantially, the consensus outlook for a rapid rebound in earnings, with growth of approximately 10% expected for 2020, looks too optimistic. Even if this growth in earnings is realised global equities look expensive, with a forward P/E of 16.4x. The US trades on 18.7x, Europe on 15.3x, Japan on 14.2x and China on 12.3x. These are close to the highs of the last decade. In absolute terms, earnings have declined this year, leaving the entire gain in equities in 2019 down to multiple expansion.

As noted above, one of the drivers of the most recent leg of the rally in equities was the provision of liquidity by the Federal Reserve. However, this liquidity splurge was designed to be short-lived, i.e. a year end liquidity provision. How markets react to the potential removal of much of this liquidity will be key – but if the extraordinary provision of liquidity continues, the valuation of high-quality companies can remain elevated relative to what might otherwise be considered fair value.

It is worth pointing out that the year is ending much the opposite of how it began. At the beginning of 2019, global equities were oversold, put-call ratios suggested extreme caution amongst market participants, economic expectations looked overly pessimistic and markets were at very attractive entry levels from a technical and a valuation perspective. As we end 2019 however, global equities look overbought, put-call ratios suggest extremes of complacency, economic growth expectations look overly optimistic and market valuations look expensive.

Positioning

We therefore remain underweight equities, with a defensive bias. Markets are pricing in a significant recovery in economic growth and earnings, which seems optimistic to us, at a time when complacency amongst market participants seems high.

Within our equity exposure, we added some European financials. Despite the negative backdrop they face in terms of persistently low yields the sector, which has offered value for a while is beginning to see earnings upgrades ahead of the market. We also added some US financials. The liquidity provision by the Federal Reserve, coupled with earnings upgrades and a steeper yield curve should continue to support the sector. We for now feel, despite not participating in the rally of the 6-8 weeks as much as we would have liked, that it is best to maintain a defensive positioning given our ongoing concern about economic data and valuations. We continue to own high quality equities which in spite of the malign economic backdrop are still able to grow their earnings.

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