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Global equities – A fragile rally

Peter Szopo

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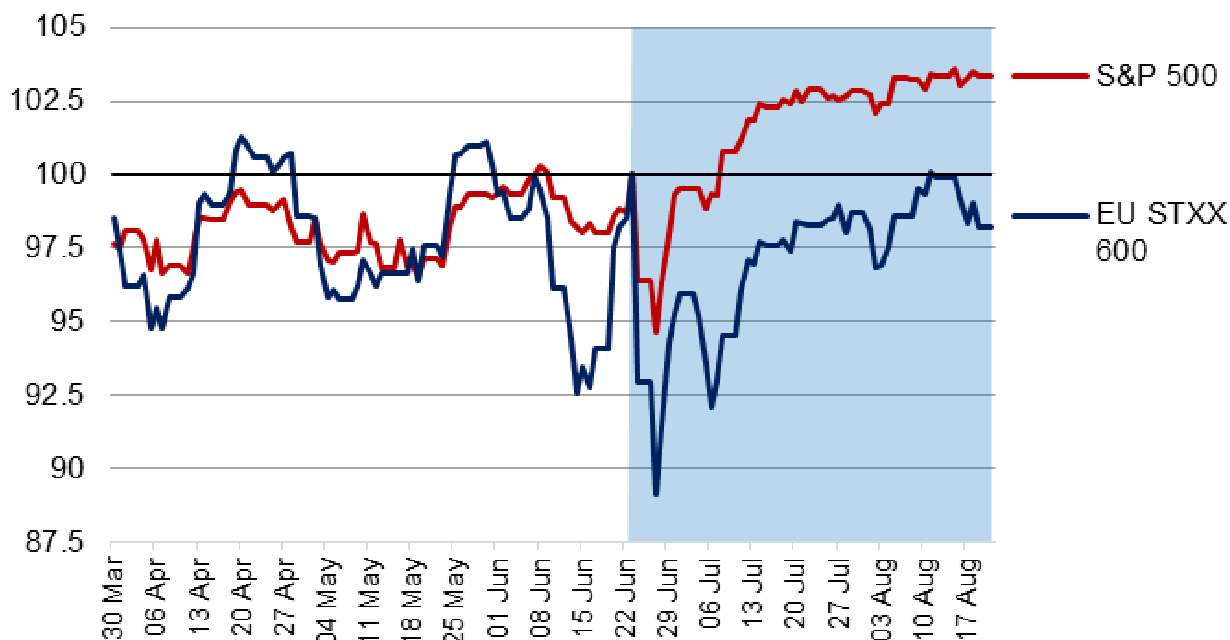
The Brexit-vote was a non-event, it seems. At least, that is what global equity markets are telling us. Since June 24 – the day after the referendum – US, European and Japanese indices all have gained around 10% in local currencies (up to August 19). Emerging Markets, on average, made a similar move as well. Whether the rally will continue depends on a number of factors, pointing in opposing directions. While the fundamental backdrop suggests remaining cautious and also valuation is not supportive, low bond yields and economic policy will likely continue to provide tailwinds for global equity markets.

Index Performance (Jun 23, 2016=100)



Source: Bloomberg, Erste Asset Management

Sluggish economic growth

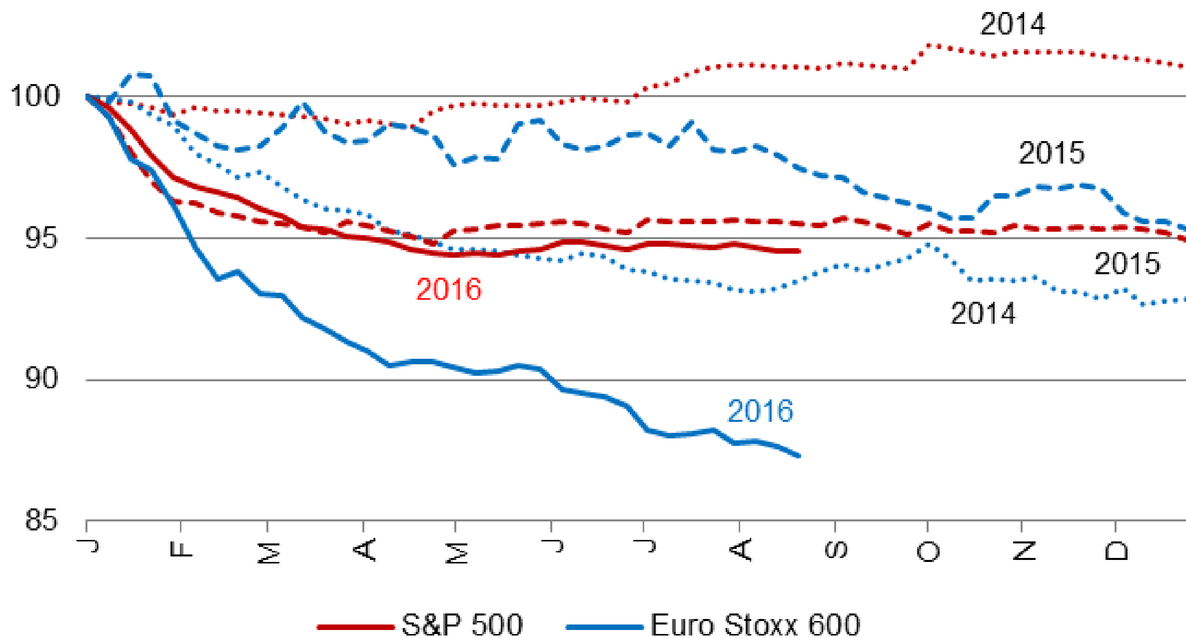
The global growth outlook continues weakening. After the Brexit vote, consensus forecasts for 2017 GDP growth in the UK, the Eurozone and the US have been cut by 1.5, 0.4 and 0.1 percentage points respectively. Also the IMF in its recent update of the World Economic Outlook revised its growth projections again down by 0.1 percentage points to 3.1% and 3.4% for 2016 and 2017. The acceleration in 2017 is only due to faster growth in emerging economies.

The view that the developed world is entering a period of secular stagnation either because of a structural lack of demand (the Keynesian view) or a slowdown in productivity growth combined with demographic trends (the supply side version of the story) is increasingly gaining popularity. The bottom line for investors is that neither the near-term nor the longer-term outlook suggest that economic growth will be the main source of higher stock prices – at least in the developed world.

Lackluster earnings performance

In line with the macro-economic backdrop, earnings have been a drag on equity performance in recent quarters. In the US, the second quarter 2016 was the 7th quarter in a row with falling earnings, in Europe – which has had a lackluster earnings performance for the past five years – it will be the 4th.

Earnings revisions 2014-2016



Source: Bloomberg, Erste Asset Management

This is also reflected in analysts' earnings revisions in recent months. Both in the US and in Europe, earnings estimates have drifted lower since the beginning of the year. Particularly in Europe the earnings outlook deteriorated significantly, with estimated EPS cut by more than 12% since January.

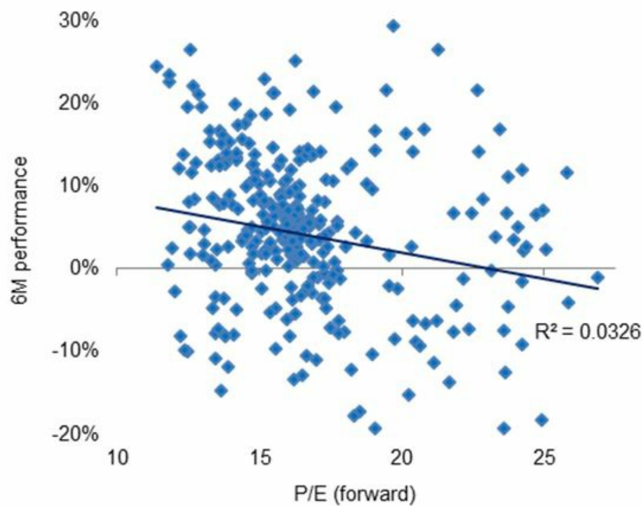
That said, the current earnings season was better than expected. On both sides of the Atlantic, positive earnings surprises outnumbered disappointments by a significant margin, fueling expectations that the next quarter could bring an end to the earnings recession.

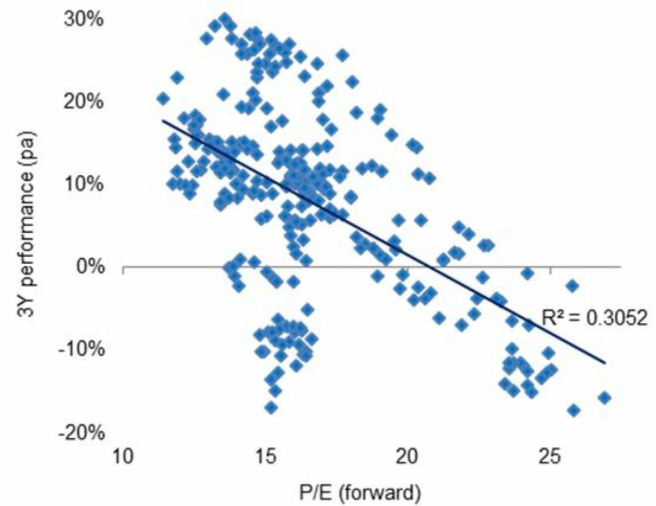
Valuation rich by historical standards …

In the US, Europe and emerging markets, current PEs are about 20% above their five year average and also significantly above long-term levels. Only Japan does not appear to be overvalued by historical standards. That said, valuation is not a reliable indicator for the near-term performance of markets. For the US (which offers longer stock-price series than any other market) the regression between the market's price-earnings ratio (P/E) and its subsequent six-month performance shows only a modest negative relationship, and the explanatory power is weak (R2 of just 3%).

Over the longer-term, the negative link between valuation and index performance is more pronounced. But even starting from an elevated earnings multiple of 18.6x (current level), regression results imply a three-year return of c.4% per annum based on data since 1990 – which is not thrilling, but clearly not a disaster scenario.

Valuation and index performance (S&P 500)





Source: Bloomberg; Erste Asset Management.

… but attractive relative to fixed income

While equity valuation may not be particularly enticing relative to its own history, relative to fixed income stocks appear highly attractive. Calling the peak of the bond market has turned out to be a fool's game, but, for example, with German and Japanese ten-year rates below zero, there is little further upside. Holding European stocks is equivalent to holding 10 year German or Japanese sovereign bonds to maturity, even if dividends are cut by 50% by tomorrow and the Euro Stoxx 600 drops 20% over the next ten years. Nothing is impossible, as we learnt in recent years, but this looks like a comfortable margin of safety.

Fiscal policy support?

On top of valuation relative to fixed income, the recent strength in equity markets could be driven by shifting investor's expectations with regard to economic policy. In the US as well as in Europe, fiscal policy will likely turn more expansionary, mostly driven by the rise of political populism – in Europe fueled by the Brexit vote and migration-related issues on the Continent, in the US related to the presidential race. In addition, Japan will likely rely increasingly on fiscal easing, because of Prime Minister Abe's famous "three arrows" so far only the monetary policy-arrow has been shot. A turn toward a more expansionary fiscal policy in all three main developed regions would result in stronger demand and (nominal) growth, which – at moderate levels of inflation – is generally beneficial for equities. After years of solely relying on central banks, markets see a second ray of hope.

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