BBGI GROUP Global Investments

Economic Research

WEEKLY ANALYSIS

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Volatility in equity markets offers attractive opportunities

General decrease in valuation levels. Positive fundamentals. Strong likelihood of year-end rally. Re-establish positions in equity markets and tech stocks.

Key points

Equity markets correction provides new opportunities

Welcome adjustment in valuations: outlook once again positive in the US

Renewed interest in tech stocks and in GAFA stocks in particular

European equities likely to outperform US stocks

Upswing of the Nikkei and Japanese stocks

Decline in risk and attractive valuations for emerging equities

Seize opportunities in Switzerland: outperformance of small and mid caps

Equity markets correction provides new opportunities

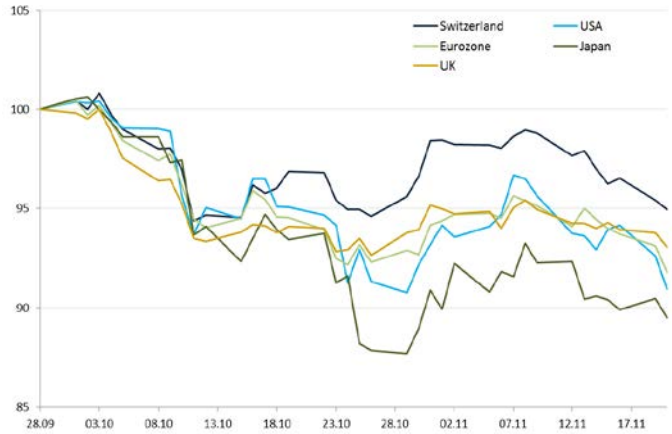
After the rise in US equity prices in Q3, we recommend caution regarding the relative prospects of US stock market indices. The risks of disappointment for 2018 are probably limited, but just a few weeks away from the end of the year, the outlook for 2019 seems less bright, both in the absolute and from a relative point of view. While the market overall does not seem to be on the cusp of a major correction, recent developments suggest growing investor vulnerability and complacency with regard to tech stocks and to the GAFA set in particular, which bodes ill for the medium term. In this context, we had noted that the US market was not free of risks.

S&P500 corporate earnings growth had, as would be expected, boosted the index; however, as tariff increases were being implemented by various parties, it was important to realise that US corporate earnings would not be immune to the risks generated by this wrestling match.

We recommended paying more attention to the risks of disappointment related to corporate earnings announcements and to the impact of the introduction of tariffs on the earnings outlook for 2019.

A few weeks later, equity markets very abruptly plunged unto a new phase of share price corrections and profit taking, only a few weeks from the end of the year. It is hard to pinpoint a single specific factor that changed investors' risk perception, but it must be noted that the correction started mostly in the US tech sector before spreading to other sectors and markets more broadly.

Evolution of the markets 30.09 to 20.11.2018



Sources: Bloomberg, BBGI Group SA

The month of October is known statistically to be one of the worst months in terms of stock market performance. The -6.94% drop in the S&P500 index this October was the worst monthly performance since the -7.18% drop in September 2011. On the statistics front, note that the latter was more than fully made up for in October 2011 thanks to a rapid surge of +10.77%. At time of writing, the market is still in free fall, and while the S&P500 is posting a drop of -9.08%, the Nasdaq, which had posted one of the largest increases, is now down -14.26%. Elsewhere, the declines are for the most part less significant (Nikkei -10.52%, Euro Stoxx 50 -8.2%, MSCI Emerging Markets -7.08%, FTSE100 -6.49%, Shangai Shenzen CSI 300 -6.37%), while Switzerland has proved particularly resilient, giving up only -3.51% (SMI).

Volatility thus made a significant comeback in October, as confirmed by the increase in the VIX index from 11 to 25, although the index is not yet indicating major stress compared with when it exceeded 40 in February 2018 and August 2015.

Should we thus be concerned about this development, which would likely be synonymous with a continuation of the current phase of consolidation?

Or on the contrary may we consider that equities' current valuation levels are more in tune with the economic outlook for 2019?

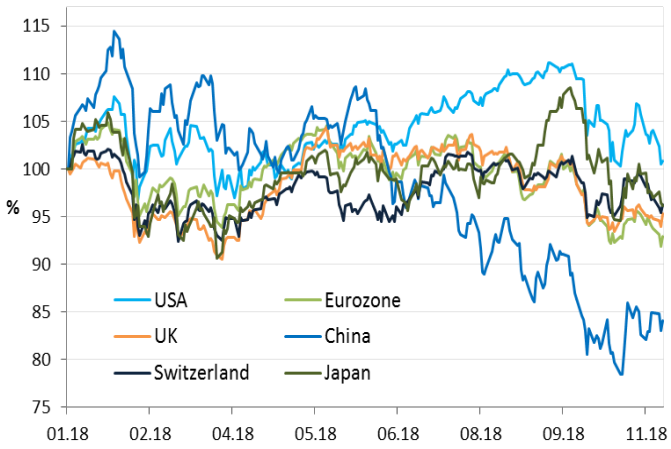
Welcome adjustment in valuations: outlook once again positive in the US

At the time when we were advocating caution with regard to US equities due to their somewhat generous valuation levels for 2019, the S&P500's PE ratio was approximately 18x. At 16x earnings, current valuation levels already seem more reasonable, allowing us to contemplate more serenely the risks of a decrease in US corporate earnings in the event of a large-scale trade war with China as of January 2019. We estimate that a 25% increase in tariffs on Chinese products could have a -7% impact on US corporate earnings, which consequently could lead to adjusted net earnings growth close to zero in 2019. We had mentioned this scenario as an equity market risk that had certainly not been incorporated into share prices but that does now seem to be partly taken into account with the recent fall.

The latter is now consistent with the risk of correction that we had anticipated several months back. At the time, we had estimated that, with interest rates trending up, PE ratios would tend to contract and that a drop of only 10%, namely from 18x to 16.2x, could produce a drop in the index of over -10%.

Since our Q1 recommendation to seize the opportunity to reinvest in equity markets after the -10% drop in US share prices, the US market has surged by approximately +20% for the NASDAQ and over +10% for the S&P500. As we mentioned in previous analyses, one of the main risks with regards to the US market is that corporate earnings growth really has to deliver in order to justify the rather generous valuation levels. This factor will likely remain favourable in 2018, but organic earnings growth will likely slow in 2019, or even drop significantly in the extreme scenario wherein the US president's threats of increased tariffs are fully implemented. In a context of rate hikes and expected long-term rate increases to over 3% and perhaps even close to 3.5%, PE ratios' expansion phase will likely reverse and become another negative factor hampering the stock market. After the rise in US equity prices in Q3, we recommend caution regarding the relative prospects of US stock market indices.

Evolution of the markets in 2018 (YTD)



Sources: Bloomberg, BBGI Group SA

However, at current levels, we recommend re-establishing positions in the US market, buying low. After the tumble in tech stocks, we believe valuations are now attractive and also more reasonable with regard to the GAFA stocks in particular.

European equities likely to outperform US stocks

In the recent context of high volatility, European shares fared just slightly better than US stocks. European equity valuations thus continue to remain lower than US valuations, without, for now, resulting in arbitrage or share price increases.

Still today, the European market's overall PE (13.8x 2019) remains very attractive compared to the US's (18x 2019). This 25% valuation differential is considerable, and we are thus trying to determine how much longer the US market may benefit from this premium, having posted an outperformance of around +17% to date in 2018. European shares retain a valuation and yield (3.6% against 1.9%) advantage; while investors should thus be returning, Euro shares also present several drawbacks.

US corporate earnings growth is benefiting from supportive fiscal policies, whose impact is being felt mainly in 2018, and which doubled growth prospects (+23%) compared with 2017 (+12%). Eurozone earnings growth had been higher in 2017 (+15%) without resulting in net arbitrage. The growth differential is clear in 2018 (Eurozone growth below +10%) but should even out in 2019 and 2020, as forecasts for both markets are similar (+10%). This factor likely worked in favour of US equities. The prospects for emerging markets and the latter's sometimes chaotic stock market performance have been stronger sources of uncertainty and risk in Europe.

Indeed, the relative exposure of US and European shares to this risk indicates that European firms are more invested and exposed than their American counterparts. Overall, Eurozone firms could be more affected by a slowing global economic cycle. The risk of contagion from emerging market crises to peripheral Eurozone countries and to the European banking sector as well as the risks related to the Italian crisis are also factors that have weighed on the risk outlook. However, the most crucial factor remains, in our view, the uncertainty related to the US's protectionist threats, which is probably the largest contributor to the widening of the European equity risk premium. European equities will likely benefit from a decrease in international tensions and from investor arbitrage related to their rather comfortable risk premium.

European equities YTD

Sources: Bloomberg, BBGI Group SA

Upswing of the Nikkei and Japanese stocks

Japanese corporates will likely benefit from the favourable macroeconomic context as well as from the depreciation of the yen. However, the Bank of Japan's latest Tankan survey actually indicated a decrease in the confidence of large manufacturing firms, although average exchange rate forecasts for the end of the year (107.4 yen per dollar) were well below current levels (114 yen). This gap, if it should persist as we believe it will, should lead to upward revisions in Japanese corporate earnings.

The +17.9% increase in yoy profits announced at the end of June, after a particularly anaemic first quarter (+0.2%) will thus likely continue. Japanese corporate earnings growth may accelerate in a context of continued global economic expansion, provided that the risks of a trade war do not intensify and in particular that the yen remains weak. The fall in equity share prices and valuations to 15x earnings offers an attractive opportunity for repositioning. For the current fiscal, Japanese blue chips are valuing revenues and profits using an exchange rate estimate of approximately 107 yen. As we have seen, the yen is now trading at close to 115 yen to the US dollar.

We anticipate a stabilisation of the exchange rate by the end of the year at between 110 and 120 yen, which would thus ultimately significantly boost year-end corporate results. The current decline of the yen is thus no stranger to the improvement in investor sentiment and to investor interest in Japanese shares. A continued decline of the yen will thus likely drive further increases in the Nikkei, as long as the investment climate remains positive.

Japanese equities YTD

Sources: Bloomberg, BBGI Group SA

Decline in risk and attractive valuations for emerging equities

Emerging markets have largely borne the brunt of the intensifying tensions between the US and China since the end of January. After a barely positive first quarter (+1%), the shock was brutal in Q2 (-8.6%), and the downward spiral continued in Q3, although less dramatically, with a -2% correction. It is true that China and emerging markets were the primary beneficiaries of the liberalisation of global trade and the decrease in customs barriers. The risks of an all-out trade war have thus naturally been the key factor of uncertainty and correction in emerging markets.

However, emerging economies' fundamentals remain relatively solid from our point of view. It is not clear either that the worse-case scenario will come to pass with regard to emerging markets' economic future, as the US finally came to an agreement with Mexico and Canada and emerging currencies' volatility has significantly decreased. The rise in dollar rates was also a key stress factor for emerging markets and in particular for countries with a significant current account deficit. The situation in Turkey and Argentina is unlikely to spread to other emerging markets.

The economic growth outlook for China and India is thus not affected. These countries will contribute significantly to global growth, and earnings growth will likely also deliver in other emerging countries more generally. With regard to valuations, most of these markets are now offering much more attractive levels than those that prevailed at the end of 2017 and even at the end of the 3rd quarter. Uncertainty persists, but an improving investment climate will benefit emerging markets. As we see it, the risks of an all-out trade will abate, and we thus recommend a positive view of exposure to diversified emerging equities.

Emerging equities YTD

Sources: Bloomberg, BBGI Group SA

Seize opportunities in Switzerland: outperformance of small and mid-caps

SMI stocks withstood the increase in volatility particularly well, but there are opportunities to seize in the small and mid-cap segment in Switzerland, which is again likely to broadly outperform the SMI index.

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