

Nordea View

February 2020: Bubble of everything inflates further

Our view since May 2018 has been to underweight equities in favour of long government bonds, which has been the correct decision for the period as a whole, but definitely not since late August last year. Equity markets have rallied on lower rates, perceived QE and a brighter manufacturing outlook. We have underestimated the power of TINA ("there is no alternative") and also the risk of a "green" bubble being allowed to further inflate company specific valuations. The return on long-dated bonds has at the same time been phenomenal so far in 2020. We note that the general tendency continues to be that bonds react much more to negative news than equities, which shrug it off very fast. A continued strong USD and the earnings impact from the coronavirus could mean higher volatility in the short term. Beyond that, we note that our leading GDP indicators have started to improve, inflation is likely to stay low or be lower, and we see no signs that global central banks are considering a return to rate hikes. We advocate moving to a neutral allocation between equities and bonds.

Macro strategy: Confused on a higher level

A lot has happened since our 2020 Outlook was published. The US and China have agreed to a phase 1 trade deal, leading manufacturing indicators have bottomed, the Federal Reserve has expanded its balance sheet and the coronavirus is a new threat. Equities have rallied sharply, but so have bonds. Investor positioning has moved from underweight to overweight in equities. The macro environment is complex. Manufacturing should improve after a virus setback, but earnings trends are negative. There are indications of this perhaps spilling over to higher unemployment, which would mean weaker domestic demand.

Since central banks continue to cling to a skewed reaction function, it is hard currently to see the TINA regime breaking down. We now advocate a neutral allocation between stocks and bonds. Downside earnings risks (owing to both the macro outlook and coronavirus effects), valuation and positioning are our main reasons for not advocating an equity overweight.

Equities: Rich pricing trims returns

Equity returns have been fantastic over the past year. Valuation multiples have expanded accordingly, and we believe the market must be considered richly priced, with most metrics at or above multi-decade highs. In other words, the air is thin and investors' risk appetite could suffocate. However, the market is still being fed oxygen from multiple sources. The main life support failure that we believe could pull the plug on equity returns would be sharply rising interest rates, something we do not expect in the near term. Earnings risk persists, however, reducing the expected return to 3-5% over the next six to nine months.

Equity style: Fundamental styles set for comeback

We take a balanced view on equity styles for two key reasons: we do not assume any large interest rate movements in our forecasts and our analysis indicates that the current valuation setup in the market is fair. The valuation implications of earnings growth and risk differences have increased with lower discount rates. Compounding the implications of greater importance of beta and growth differences, we deem the current valuation discrepancies in the market fair. With justifiable valuation differences and key drivers not showing any clear direction, we argue that fundamentals could increase in importance and that a balanced style exposure including reasonably priced growth and quality should serve investors well going forward.

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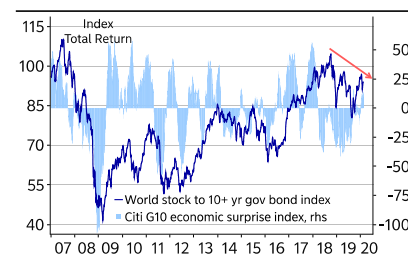
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Nordea View

Nordea
MARKETS

STOCK-TO-BOND RETURN



Source: Bloomberg, Macrobond and Nordea

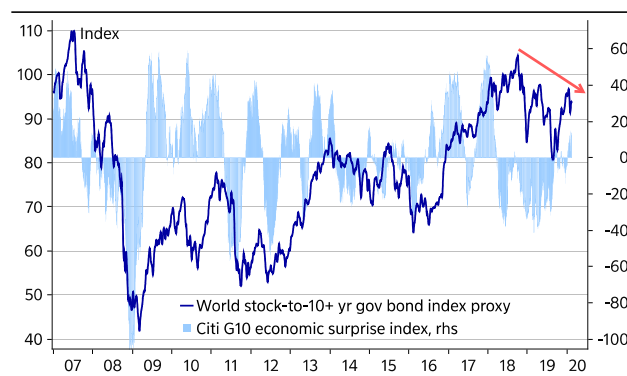
Macro strategy: Confused on a higher level

Equity markets have rallied on lower rates and a brighter manufacturing outlook. We find the macro environment more complex. Manufacturing should improve, after the coronavirus setback, but earnings trends are still negative. There are indications of this perhaps spilling over to higher unemployment, which would mean weaker domestic demand. Investor positioning has moved from underweight to overweight equities. Bonds continue to react much more to negative news than equities. We advocate a neutral allocation between stocks and bonds.

Many reasons for our old underweight equity call

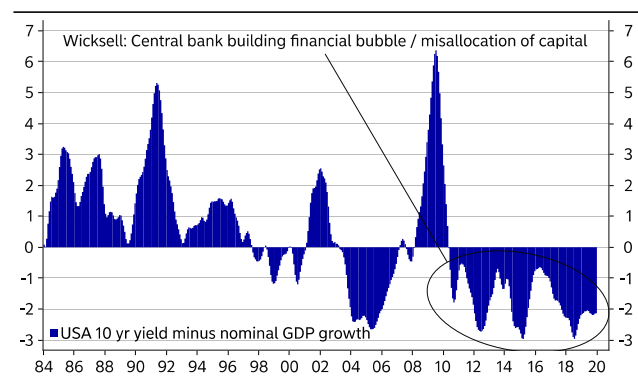
Our longstanding view since May 2018 has been to underweight equities in favour of long government bonds, which has been the correct decision for the whole period but definitely not since late August last year. The main reasons for the allocation decision have been a belief in negative global macro surprises in 2018/19, a global earnings recession in 2019/20 combined with equities at high valuation levels, and a plethora of geopolitical risks.

STOCK-TO-BOND RETURNS AND MACRO SURPRISES



Source: Bloomberg, Macrobond and Nordea

MONETARY POLICY IS TOO LOOSE



Source: Bloomberg, Macrobond and Nordea

Central banks are creating a financial bubble

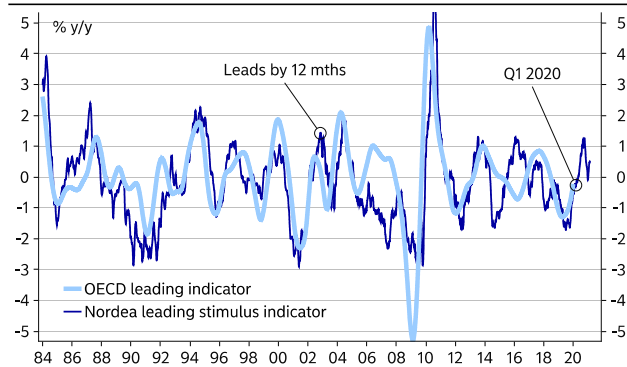
The key reason why equities have continued to be in fashion despite the troublesome global macro picture and a negative earnings trend has clearly been irresponsible central banks, jumping at every opportunity to build an ever greater financial bubble. Theory says, according to Knut Wicksell, that keeping policy rates below any reasonable estimate of the natural rate for a long period of time (and invent QE to top it up) will create financial bubbles and lead to companies surviving that would have gone bankrupt with a more correct cost of capital. This leads to a misallocation of capital, eventually leading to lower long-term growth and, at some point along the way, a crash. Central banks have forced long rates far below medium-term nominal growth. That comes with a cost, but the trigger is very hard to find today.

Both equities and bonds have rallied strongly since November

A lot has happened since our Nordea View 2020 Outlook was published in late November. The US and China have agreed to a phase 1 trade deal, leading indicators of manufacturing seem to have bottomed, the Federal Reserve has continued to expand its balance sheet and the coronavirus has emerged as a new threat. Equities have rallied strongly, but so have long-dated bonds. A general tendency continues to be that bonds react much more to negative news than equities, which shrug them off very fast. China is a case in point, where the deadly coronavirus has locked down many cities but equities (CSI 300) are almost unchanged year-to-date.

Macro surprises should swing between positive and negative in 2020

As we move further into 2020, we would argue that the macro outlook is turning more complex. We have long argued that monetary policy stimulus would mean a bottom in leading manufacturing indicators such as PMIs and ISM in late 2019. The usual pattern would then be that the manufacturing cycle leads to an overall improvement also of broader business conditions. This cycle, however, could turn out to be more out-of-sync between manufacturing and domestic demand, which is partly already a fact due to the unusual pro-cyclical fiscal stimulus in the US in 2018/19. Also, with the effects of the coronavirus still in front of us when it comes to economic data, uncertainty is high. Global macro surprises should swing between positive and negative in 2020 rather than remaining in either positive or negative territory for a long period.

STIMULUS MEANS BRIGHTER MANUFACTURING OUTLOOK

Source: Bloomberg, Macrobond and Nordea

Corona should mean a revisit of 2019 lows for global PMI

Currently, global macro surprises are in positive territory, but it would surprise us if the lingering effects of the coronavirus in a month or so do not push surprises back into negative territory. Equity and credit markets are today preoccupied with noting that the growth rate of new cases is slowing and that cases outside of China are still rather low. But other market indicators – such as metal prices, the Baltic Dry Index, the number of vessels on the world seas, cyclicals versus defensives and small caps versus large caps – warn of setbacks in macro indicators over the coming months. It is far from given that risky assets will take it as calmly as today if we get there. There is a high risk that the global manufacturing PMI will at least revisit the lows of 2019.

Coronavirus will have clear negative earnings effects in Q1, but will markets care?

Clearly, a number of global companies will see negative effects on earnings and sales at least in Q1 with Apple being the first to warn about it. Given valuation levels, this could pose a risk to equity prices. At the same time, as with the trade war, this will in all likelihood be described as a temporary problem that should not affect medium-term guidance from companies. Once again companies that would have been doing poorly even without the virus outbreak have a perfect scapegoat.

BALTIC DRY IS SENDING A WARNING

Source: Bloomberg, Macrobond and Nordea

Stock-to-bond performance is most often decided by macro surprises

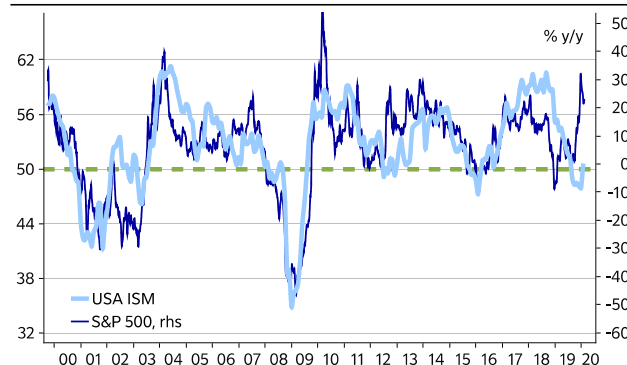
In the longer term, the virus effects should not matter in an allocation decision and, admittedly, the irresponsible central banks have meant a loss of cyclical gravity for equities during the 2019 manufacturing recession. So why bother? The reason is that even in 2019, periods with data trending into negative surprise territory meant an underperformance of equities to bonds. Positioning has also moved from underweight equities last summer to overweight, according to investor surveys, futures data and hedge fund performance. This means a case for being somewhat cautious and not to chase the risky asset bid going on.

Business surveys might have exaggerated downside growth risks

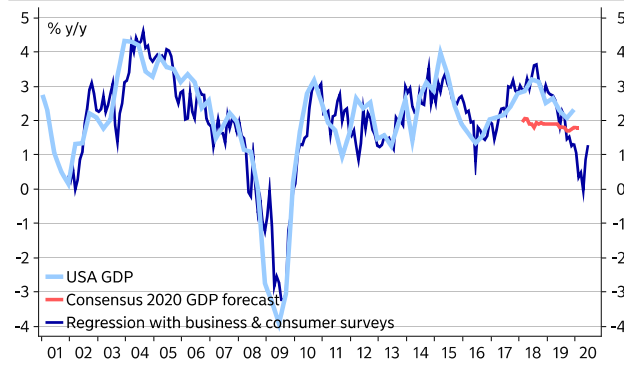
It is clearly a difficult allocation call. We have to admit that growth numbers out of the US have been stronger than our models have predicted. There could be negative revisions but it could also be that surveys have been affected too much by trade war headlines rather than actual demand trends. Surveys have been indicating a risk of 0% GDP growth in the US, but it simply has not happened. Barring the coronavirus impact, there has also been a tendency towards improving business and consumer surveys lately. Moreover, central bank policies have started to lift global liquidity indicators even though the follow-through to economies, particularly China, is far from given.

ISM REACTING TO FED RATE CUTS

Source: Bloomberg, Macrobond and Nordea

THE GREAT MACRO VERSUS EQUITY MARKET DIVIDE

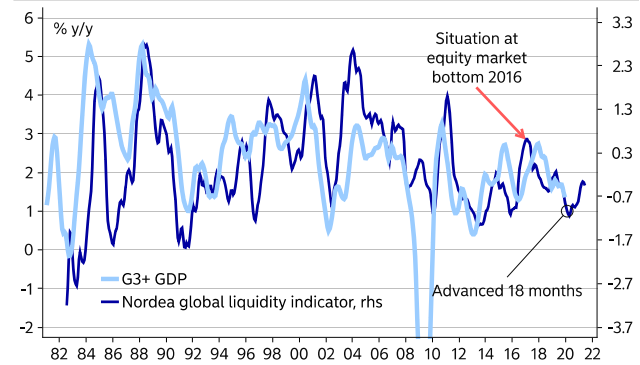
Source: Bloomberg, Macrobond and Nordea

US SURVEY INDICATORS HAVE IMPROVED RECENTLY

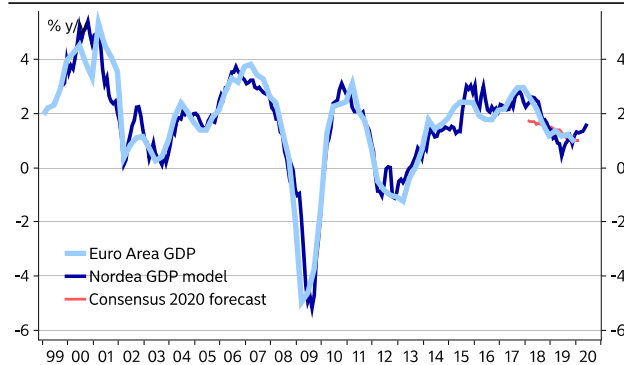
Source: Bloomberg, Macrobond and Nordea

Companies still signal uncertainty, which could hold back investments and hiring

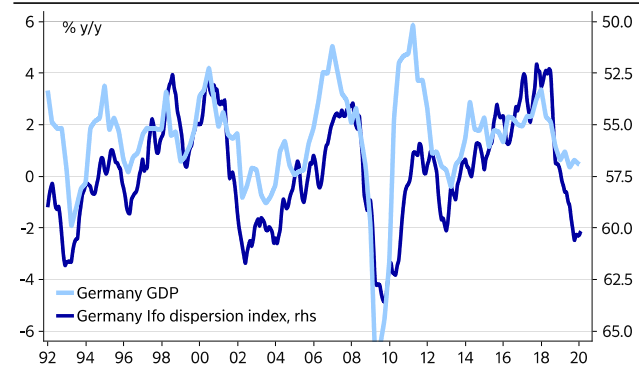
Even our Euro area leading GDP indicator is pointing to a cyclical recovery in 2020. So why are we not sounding an all-clear on the cyclical side, given that markets are right in assuming only short-term disturbances from the coronavirus? To start with, hard data such as industrial production and retail sales has remained weak in the Euro area and the upturn in our GDP indicator is so far driven almost exclusively by financial conditions. Also, whether you look at IFO's dispersion index in Germany or the US Conference Board's CEO survey, both continue to indicate a high level of uncertainty that could hold back investment and hiring decisions.

GLOBAL LIQUIDITY HAS IMPROVED SOMEWHAT

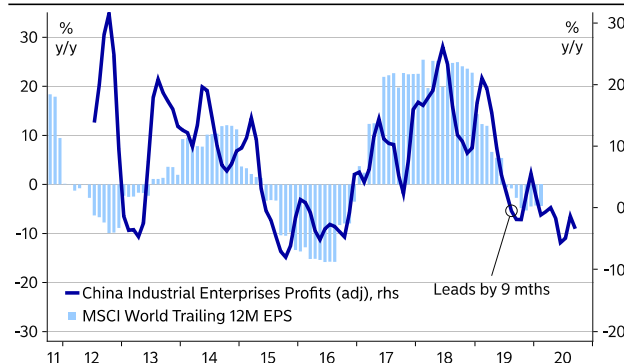
Source: Bloomberg, Macrobond and Nordea

FINANCIAL CONDITIONS LIFTING EURO AREA GDP INDICATOR

Source: Bloomberg, Macrobond and Nordea

COMPANIES STILL SIGNAL HIGH LEVEL OF UNCERTAINTY

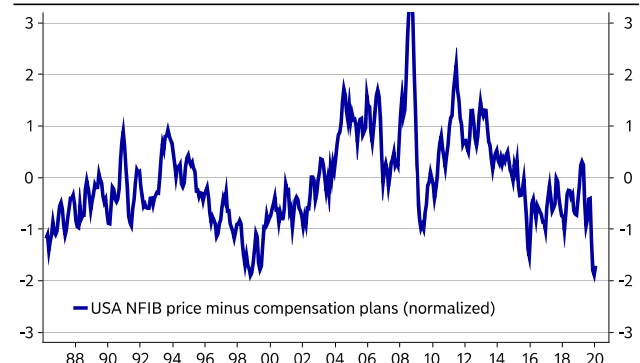
Source: Bloomberg, Macrobond and Nordea

GLOBAL EARNINGS TREND STILL NEGATIVE

Source: Bloomberg, Macrobond and Nordea

The global earnings trend is still negative

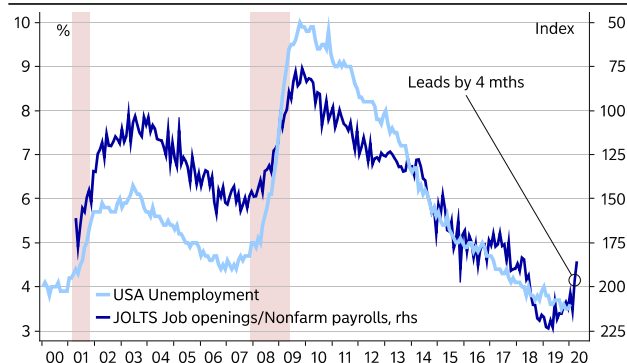
The weak global earnings trend adds to the macro complexity with Q3 profits at -4% y/y. Companies are not only pressured by slowing global sales growth, but also rising wage costs and difficulties in raising prices. In relation to this, we note a number of indicators around the world (US, Japan, Germany, France, Sweden, etc) that point to higher unemployment in 2020, which means a clear risk of gradually weaker domestic demand. Such indications are normal in earnings recessions as companies feel a need to arrest falling profit margins and they risk broadening the manufacturing recession to the rest of the economy. It could of course also be a combination of trade war worries

MARGIN PROBLEMS FROM WAGE COSTS AND PRICE PLANS

Source: Bloomberg, Macrobond and Nordea

and difficulties in finding labour that have led to an overly negative trend in job openings, but it looks troubling and rhymes with weak earnings.

JOB OPENINGS INDICATE RISING UNEMPLOYMENT 2020



Source: Bloomberg, Macrobond and Nordea

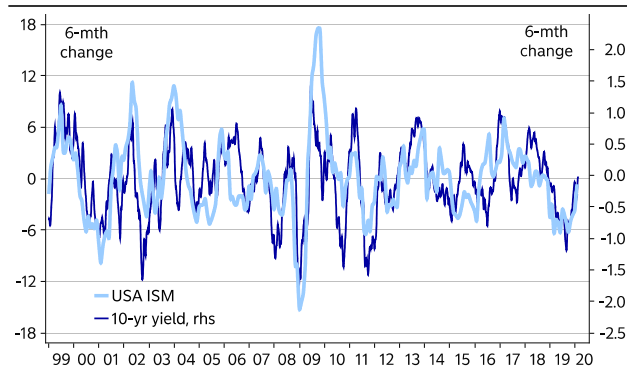
Our broader GDP indicators have started to improve

All in all, if we trust our broader GDP indicators, it seems the growth outlook is improving, albeit from weaker growth rates than currently suggested by Q4 2019 GDP numbers. However, downside risks are still plentiful and we need to see leading labour market indicators improving again before fully believing in a sustained brighter outlook. Where do all of these confusing macro signals lead us in terms of market views? The starting point is difficult as equities rallied strongly through a major profit multiple expansion in 2019, a year when profit trends and the business cycle pointed to the reverse.

Bonds have followed the business cycle more closely than equities

The divergence between the business cycle and equities was massive in 2019, but ten-year interest rates basically moved as could have been expected during a period of falling ISM and PMIs. We believed in lower government bond yields for the first half of 2020, which happened but for the wrong reason – coronavirus. But it serves as a perfect reminder of how fast negative news pushes back bond yields. US and German long government bond indices (10-plus years, ie similar duration as equities) have delivered a return of 5.0-6.5% year-to-date. From a cyclical perspective, the current US ten-year yield of 1.58% would indicate that global manufacturing PMIs should revisit the lows of 2019 again, which is quite likely given the coronavirus.

BOND YIELDS HAVE FOLLOWED THE CYCLICAL GYRATIONS

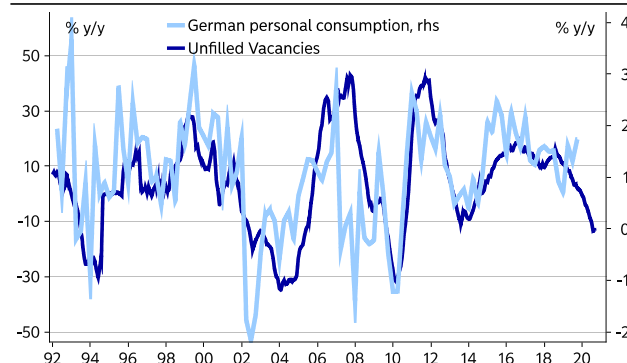


Source: Bloomberg, Macrobond and Nordea

Central banks are more prone to react to negative than positive news

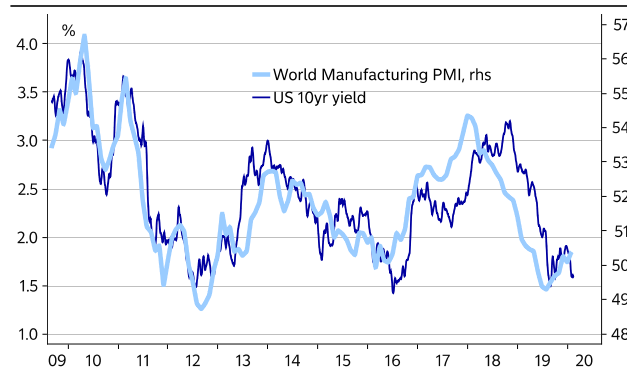
Given the currently very skewed reaction function of central banks where negative surprises to data or equities lead to reactions while positive data does not, it is hard to see markedly higher rates. Only clearly higher core inflation can change that conclusion and we do not see that happening. US core inflation should trend lower during 2020, and in the Euro area we see a relatively sideways trend. With the slump in energy prices, headline inflation will tend to drop during the spring. We would love to see central bankers change reaction function and react also to improving growth, but it does not look like it is happening. It is thus reasonable that the fixed income markets will have an easier time discounting rate cuts than rate hikes in the coming months.

DOMESTIC DEMAND COULD TAKE A HIT

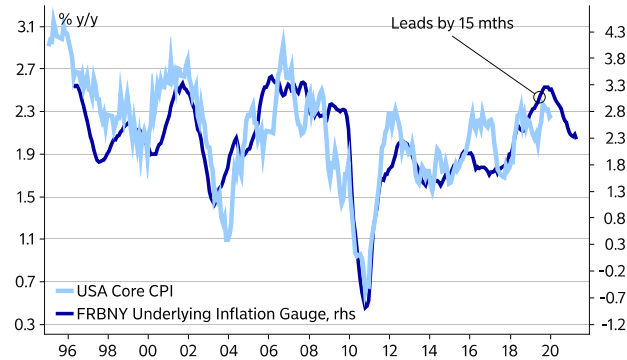


Source: Bloomberg, Macrobond and Nordea

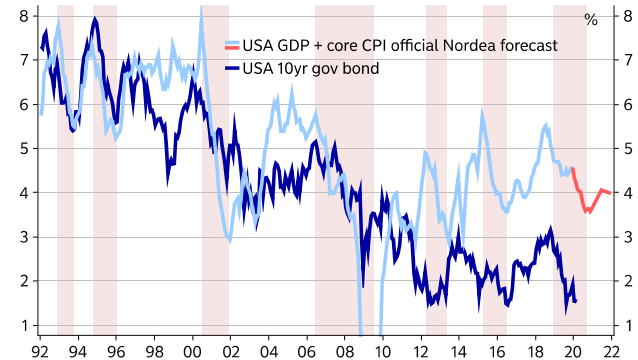
A MILD CYCLICAL CORONA EFFECT DISCOUNTED BY BONDS



Source: Bloomberg, Macrobond and Nordea

US CORE INFLATION SHOULD TURN LOWER

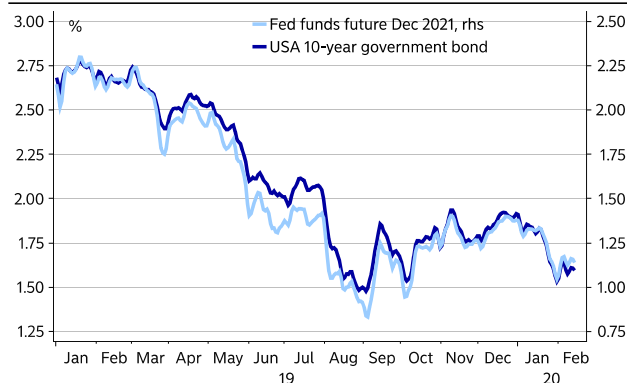
Source: Bloomberg, Macrobond and Nordea

US NOMINAL GDP OUTLOOK SPELLS LOW YIELDS

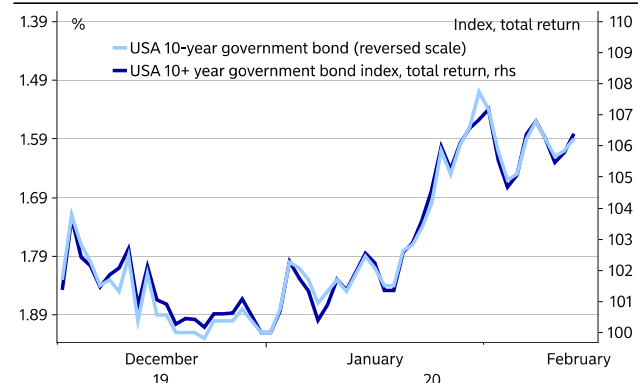
Source: Bloomberg, Macrobond and Nordea

A sideways trend in bond yields is likely

Currently the market discounts just shy of two rate cuts by the Fed until the end of 2021. Given the Fed's recent statements that they are on hold and the tight link to 10-year yields, it is hard to see much downside in longer rates today. After the short-term corona effects, we believe that manufacturing ISM and PMIs should trend higher, which would instead mean slightly higher bond yields. However, with the plethora of negative risks and the skewed reaction functions of central banks, it is more likely a second half of 2020 story. For now, we see a sideways trend in rates but also remind ourselves of how sensitive bonds are to negative surprises. A mere 15 bp drop in 10-year yields would mean a total return for a 10-plus year bond index of ~2.6%.

FED FUNDS FUTURE AND US 10-YEAR YIELD

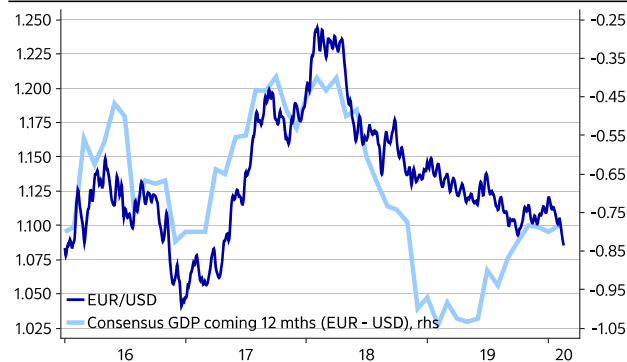
Source: Bloomberg, Macrobond and Nordea

US 10-YEAR YIELD AND BOND INDEX RETURN

Source: Bloomberg, Macrobond and Nordea

USD not yet strong enough to dent the bid in risky assets, but we could get there

The USD has remained strong and even strengthened further in early 2020. So far it has not been enough to dent the bid for risky assets, but at some point a strong USD tends to become problematic. Recent developments have strengthened our conviction that the EUR/USD could continue south a while longer, not least due to the negative corona effects likely being larger in the Euro area than in the US because of the greater reliance of exports to Asia. The perceived growth advantage of the US compared with the rest of the world is thus intact. Also, the tailwind Trump is enjoying, partly due to democratic presidential candidates in-fighting, adds to the positive USD story. That increases the risk of a renewed spike in risky asset volatility, which also could happen as an effect of corona having major earnings effects for certain companies.

USD THRIVES ON RELATIVE GROWTH ADVANTAGE

Source: Bloomberg, Macrobond and Nordea

Equity market outlook much more difficult than FX and rates

We continue to find the equity market outlook much more difficult than rates and FX. With our broad GDP indicators turning up, we would normally advocate being long equities. Given the massive multiple expansion of 2019 and the change in positioning, we however feel the air is pretty thin up here. Historically – with the current macro situation, interest rate levels, potential GDP growth, valuation and positioning – the coming years of equity returns have been much more challenging than the last five years. As we have discussed many times before, we also believe that structural profit margin tailwinds are turning into mild headwinds – demography, globalisation and labour costs being some examples.

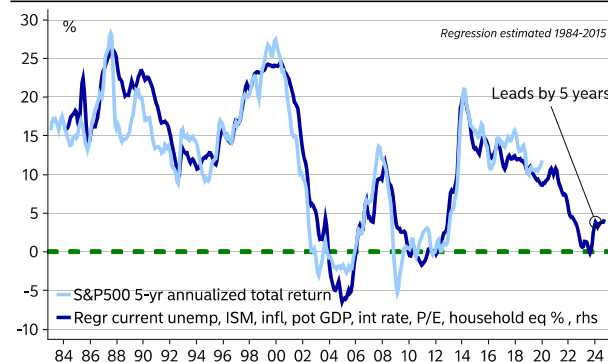
We have underestimated the force that is TINA

But maybe central banks can drive overall valuations higher. We have underestimated the powerful force of TINA ("there is no alternative") and also the risk of a "green" bubble being allowed to further inflate company-specific valuations. Our longstanding view to have the long duration of the portfolio in bonds rather than equities has been correct for the full period since May 2018, but since late August 2019, the strategy has not worked. Investors have continued to prefer equities, regardless of positive or negative news. Currently, it is hard to identify any triggers that would change this behaviour.

We advocate a neutral allocation between equities and bonds

Our equity analysis (see next section) implies possible upside of 3-5% in the next six to nine months. In volatility-adjusted terms, it is possible that bonds can return something similar, but not given. Leading indicators are improving. We therefore advocate a neutral allocation between equities and bonds. Downside earnings risks (owing to both the macro outlook and coronavirus effects), valuation and positioning are the main reason for not advocating an equity overweight.

This section has been produced by Nordea Research's Non-Independent Research unit.

EQUITIES: MORE TINA OR STOLEN FROM FUTURE RETURNS?

Source: Bloomberg, Macrobond and Nordea

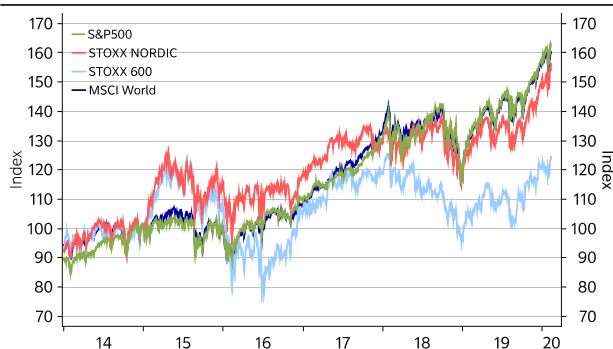
Equities – rich pricing trims returns

Equity returns have been fantastic over the past year. Valuation multiples have expanded in tandem with this, leaving most metrics at or above multi-decade highs, and we believe the market must be considered richly priced. In other words, the air is thin and investors' appetite for risk could suffocate. However, the market is still being fed oxygen from multiple sources. The main life support failure that we believe could pull the plug on equity returns would be sharply rising interest rates, something we do not expect in the near term. Earnings risk still remains, however, which reduces expected return to the range of 3-5% over the coming six to nine months.

After multiple years of solid returns, 2020 is off to a good start - too good?

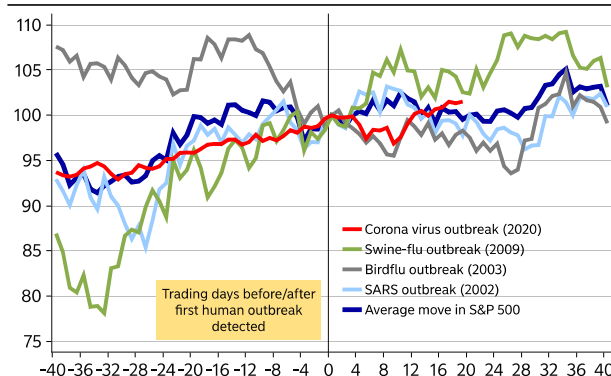
In 2019 alone, global stocks (MSCI World) returned 28%. Certainly, we could argue that the starting point was very favourable, and it was not until October 2019 that the market broke through the index peak from January 2018 – and kept going. The favourable trend continued at the start of this year, with the world index around 5% higher in the new year. Not even the outbreak of Covid-19 (coronavirus) did more than send temporary jitters through the market, as interest rates and liquidity injections came to the rescue with little delay.

WORLD EQUITY RETURNS



Source: Macrobond and Nordea

VIRUS OUTBREAKS AND THE EQUITY MARKET



Source: Macrobond and Nordea

Significant multiple expansion

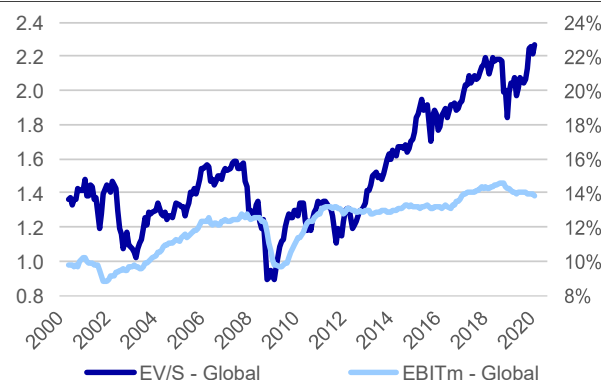
This strong performance has not gone unnoticed in terms of valuation. Stocks are priced very richly, to say the least – global P/E (12-month forward) is zooming in on 18x, only a whisker below historical peaks after 22% multiple expansion since the start of 2019. Setting the earnings cycle somewhat aside, an EV/sales ratio above 2.2x is a 20-year high. This comes at the same time that the corporate sector has been seeing profitability headwinds; the global median EBIT margin has contracted by 100 bp since the beginning of last year.

GLOBAL P/E NTM AT HISTORICAL PEAK



Source: FactSet and Nordea

GLOBAL EV/SALES AND EBIT MARGIN SEND A WARNING

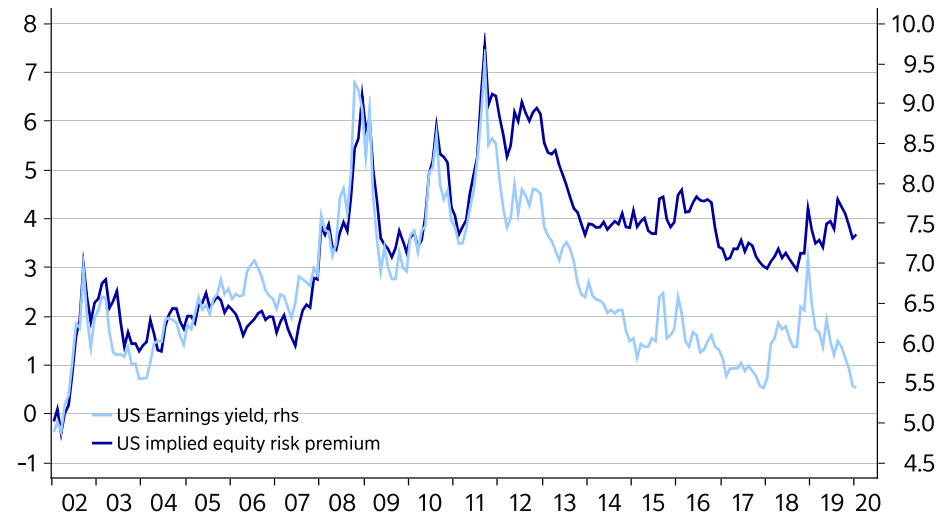


Source: FactSet and Nordea

Market's earnings yield down to 5.5%, a market slump of 20% would lift it back to the historical average – Is it needed though?

The market earnings yield has contracted as well. Using the S&P 500 index forward-looking P/E (18.4x), the implied earnings yield is 5.4%, a contraction versus the last two decades' average of 6.6%. Under more 'normal' circumstances, this would suggest sub-trend returns with poor risk/reward, as a mean reversion (all else equal) would imply the market index slumping close to 20% lower. However, pricing gravity does not need to come into play for the time being, as the compensation for the equity risk is higher than the historical average. Using the US 10-year bond yield as a proxy for risk free return, the implied risk premium is 3.8 pp, which is 60 bp higher than the historical average. The implication of this is that the expected return pickup between equity risk and the risk-free investment is currently around 240% $(=(5.4/1.6-1))$ versus the historical average of about 100% $(=(6.6/3.1-1))$.

US EARNINGS YIELD AND RISK PREMIUM

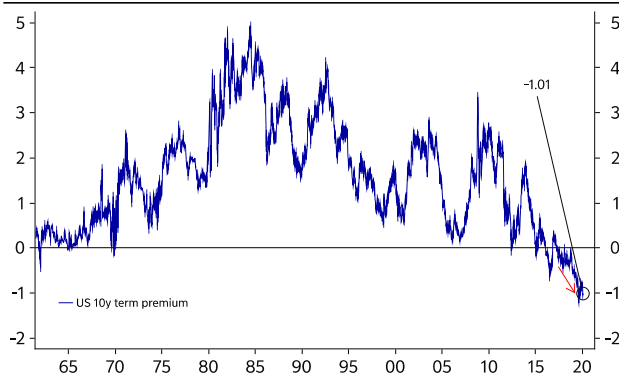


Source: Macrobond and Nordea

The real conundrum rests on the shoulders of the bond market

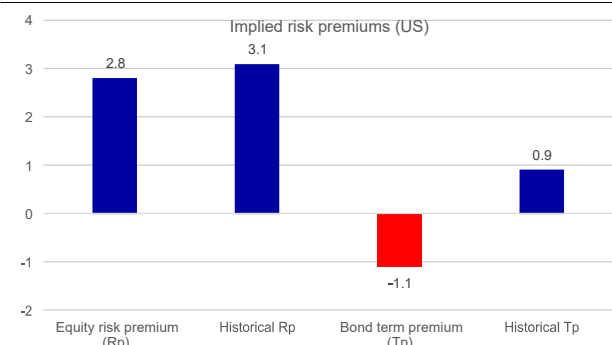
Furthermore, and this could prove to be vital to understanding last year's sharp multiple expansion, when adding the term premium to the equation the attractiveness of equities from the standpoint of long-term duration risk may well have increased significantly. The term premium refers to the extra compensation investors demand to hold longer-term bonds rather than short-term paper. That is, the implied risk premium for long bond duration. Although it might seem straightforward, there are quite a few considerations to be made to fully comprehend the accuracy in estimating term premiums. For the interested, we warmly recommend "BIS Term premia: model and stylised facts", 23 September 2018. In the charts below, we use calculations made by the New York Federal Reserve. During 2019, an already compressed US 10y term premium fell into negative territory and accelerated to some -100 bp. Not since the 1960s (as far back as the data is available) has the market experienced this.

US TERM PREMIUM SINCE 1961



Source: NY Federal Reserve, Macrobond and Nordea

LONG DURATION RISK PREMIUMS IN COMPARISON



Source: Macrobond and Nordea

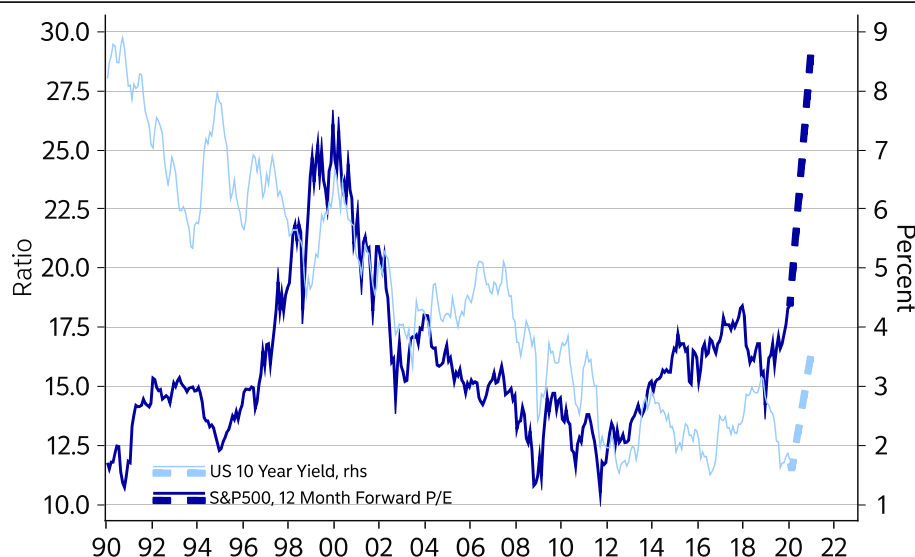
Any compensation for risk is always better than none

The implications of this are significant, we argue. Instead of narrowing the analysis to whether the current equity earnings yield is too low, the focus should instead be on an equity risk premium that is positive and in line with its own historical average, while for the alternative long durational asset, bonds, it is well below its historical level and possibly (at least according to the NY Fed calculations) also clearly negative. For these calculations, we have used the risk-neutral 10-year yield, calculated by the NY Fed. A negative compensation for the risk your savings is exposed to suggests the most rational course of action would be to move it elsewhere. In this current market, long risk duration continues to favour equities over bonds for global portfolios.

Implied equilibrium suggests P/E 29x

Let us assume that equities and bonds find equilibrium, not in terms of relative returns but in the relation of risk compensation. Please try to ignore the fact the term premium currently is negative. Over the past 30 years, the equity risk premium has been 200 bp higher than the term premium. Today it is close to 400 bp higher. Should this imbalance be neutralized and we keep all else equal, it would need either for the US 10y bond yield to rise to 3.5% or for the US earnings yield to contract to 3.5% (P/E 29x). Please note that, keeping all else equal, we assume the risk-neutral rate remains unchanged at the current 2.6%.

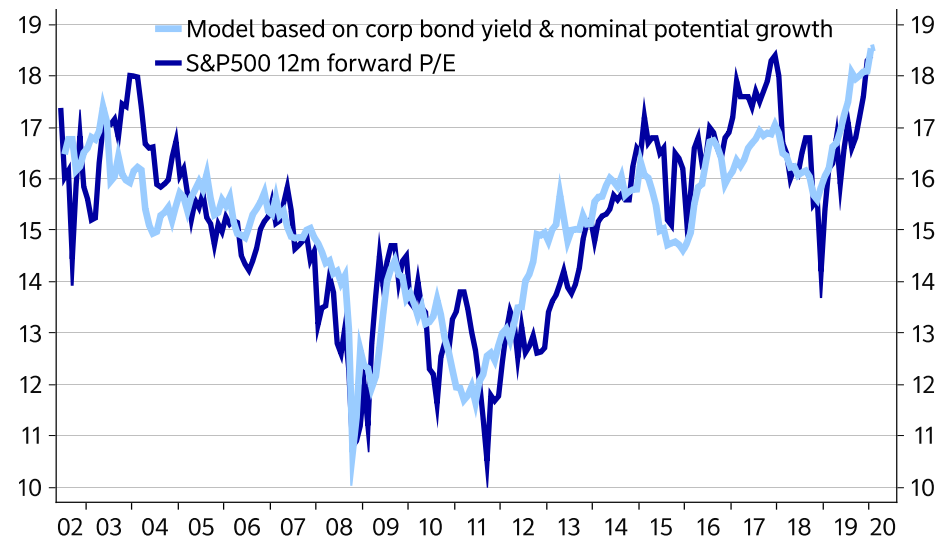
US P/E NTM REACHING 29X AND UST 10Y RISING TO 3.5%



Source: Macrobond and Nordea

A Gordon approach suggests equilibrium has been reached

In addition, setting the risk compensation aside, the recent interest rate changes could put the market into equilibrium. Using the Gordon growth model approach and using the (US) long corporate bond yield as a proxy for "r" and (nominal) potential GDP growth for "g", we have made a P/E model through regression. In the chart below we show the model, together with the consensus-based P/E metric. In clear contrast to the situation back in 2017, when we last witnessed equally high P/E valuations, the market is now in balance, based on this approach.

GORDON BASED MODEL P/E AND ACTUAL P/E

Source: Macrobond and Nordea

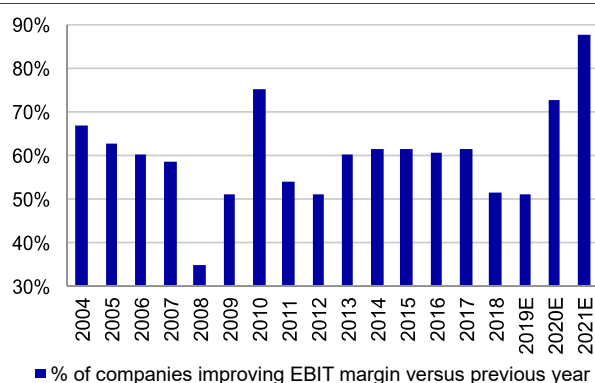
The earnings cycle still poses a risk we argue...

In this situation, one could argue that the short-term risk is symmetric, ie new information that has bearing on future earnings expectations has the equal risk of lifting or pushing the market down. One important concern we have been carrying for most of the past year, and which is still with us, regards the earnings cycle. The strong earnings cycle, which received an extended leg for US corporations in the wake of Trumponomics in 2018, came to an end in Q4 2018. Since then, we note that global profit growth (y/y) has been negative. In Q3 2019, profits fell by 4%. The trend of low single-digit negative growth rates is expected by consensus (FactSet) to continue till Q2 2020, and subsequently to recover by 6-8% in H2 2020. This represents an earnings cycle profile that does not necessarily need to be wrong, but which, in our view, is probably far too smooth.

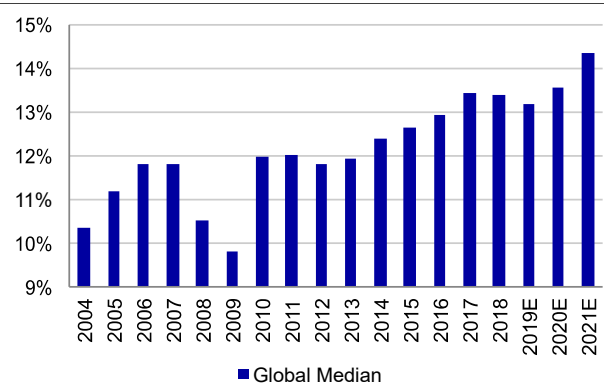
For the US market, at the end of 2018 profits in 2019 were expected to grow by close to 7%. Currently, the FactSet estimate for the full-year 2019 (still some companies left to file Q4 earnings statements) is now at around 0%. For 2020, FactSet consensus expects once again close to a 7% profit rise. This positive bias in estimates is, however, not isolated to the US market.

...but markets could show further resilience

Reviewing expectations regarding the core sub-component to profits, the profitability, we see cause for concern. Based on the STOXX Global 1800 index, around 75% of all companies included are expected to improve the EBIT margin in 2020 compared to last year. Furthermore, the median EBIT margin would rise to a record level of 13.5%. Additionally, in 2021 close to 90% of all businesses are expected to improve the margin to a median of nearly 14.5%. A level that is depicted as all-time-high feels like an understatement.

EXPECTED SHARE HIGHER EBIT MARGIN, STOXX 1800

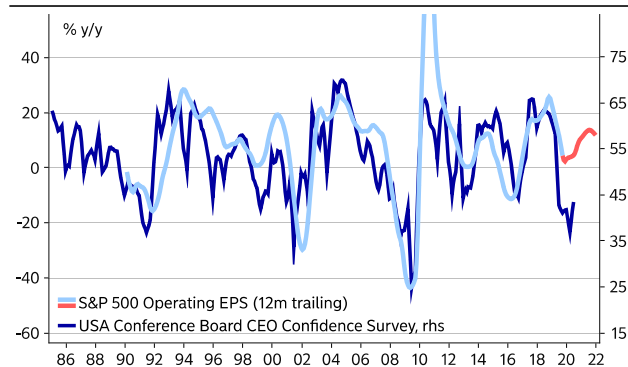
Source: FactSet and Nordea

MEDIAN EBIT MARGIN, STOXX 1800

Source: FactSet and Nordea

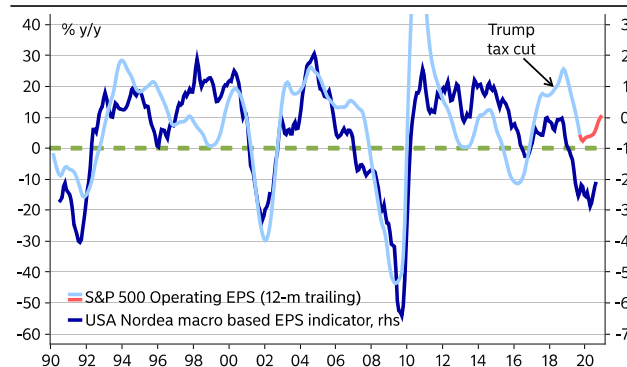
There is a valid argument that the market consensus has always had a structural bias towards overly optimistic profit expectations, and that the investor base has taken this into consideration. Hence, market expectations are implicitly lower than consensus expectations. The challenge now, however, is somewhat different. We are in the middle of an earnings recession that is seemingly expected to be mild, to end shortly and to turn into a fairly strong recovery. This follows a period of significant multiple expansion. A couple of macro models, shown below, suggest that profits could drop much further.

US CEO AND S&P500 EPS GROWTH



Source: Macrobond and Nordea

NORDEA MACRO EPS MODEL AND S&P500 EPS GROWTH



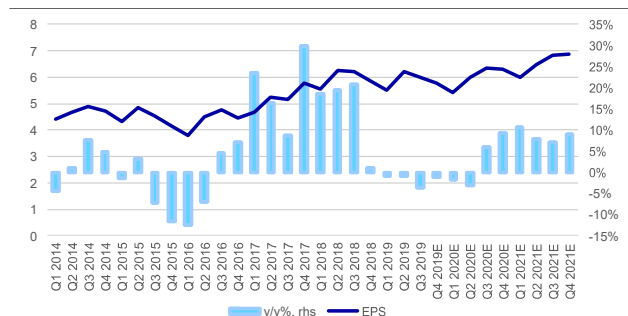
Source: Macrobond and Nordea

The coronavirus could be made a scapegoat

A number of global companies have recently started to wave the warning flag to investors, raising the spectre of near-term earnings disruptions due to the virus outbreak. Little to no explicit estimates on the impact have been provided, and some companies will likely use this as a scapegoat to conceal poor performance.

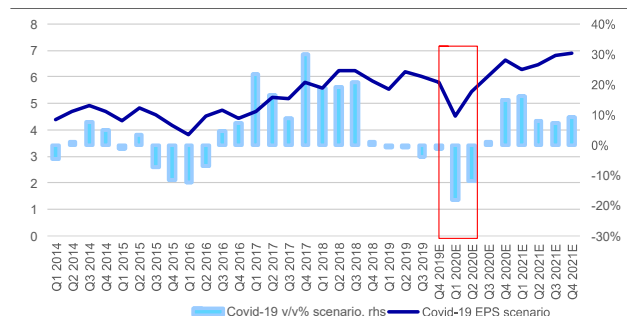
Current FactSet consensus for Stoxx 1800 suggests a six quarter smooth earnings "recession". It implies that profits will slip by 2% y/y in Q1 2020 and another 3% in Q2. In our alternative scenario, we impute a rough 20% profit level reduction from current consensus (equal to the Chinese economy's share of the global GDP in 2018) in Q1 2020. We then trim consensus by 10% for Q2, and 5% in Q3. Hence, we assume a fairly short lived shock but also a somewhat drawn out recovery phase before lost ground has been fully recovered.

CONSENSUS SEES SMOOTH SAILING THROUGH CORONA



Source: FactSet and Nordea

ALTERNATIVE FULL IMPACT Q1 SCENARIO



Source: FactSet and Nordea estimates

Full impact of our alternative scenario could make global profits drop 18% in Q1

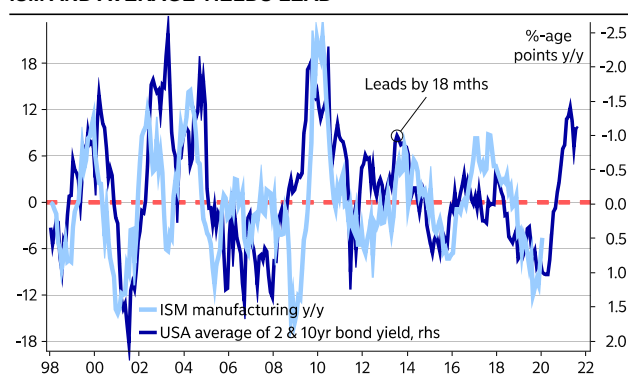
The scenario above would imply that we risk witnessing a sharp profit recession near term. In Q1 2020 the y/y EPS growth would fall by 18% in this scenario, instead of by the currently expected -2% and an additional -12% in Q2 before the growth rate stabilises and embarks on a full recovery. For 2020, the profit growth over 2019 would, instead of the current +2.6% estimate, fall by 3.5%. Calculating the weakest period, Q3 2019 to Q2 2020 relative to the preceding four quarters (Q3 2018 to Q2 2019) the profit slump would be close to 9%. Not too far from levels indicated by our macro models above.

High valuation on trough earnings would be nothing new

We would like to reiterate parts of what has been discussed above. Although the current business cycle (including the coronavirus outbreak and its impact on corporate profits) might not be different from normal cycles, the market reaction could be. With the real conundrum in the market, ie the negative term premium, in play, the market's resilience to profit estimate downgrades could prove to be much higher than normal.

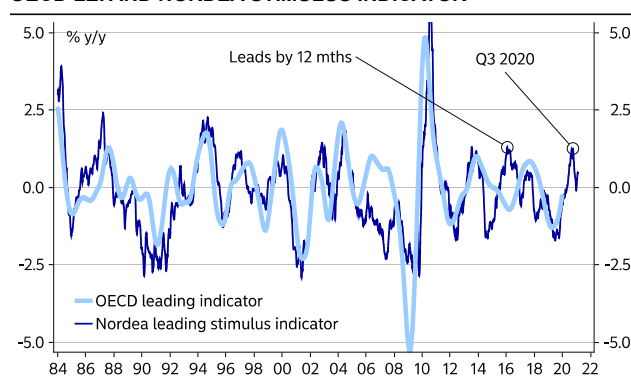
Applying this to the US market, where consensus expects profits to rise by 7% this year, and imputing the macro models' implied downside risks to profit, a 15% fall, the current 12-month forward P/E of 18.4x is actually 23x, with an implied earnings yield of 4.4%. Keeping interest rates unchanged, the implied risk premium is thus 2.8 pp, only 30 bp below the 30-year average – and at trough earnings. Admittedly, using the risk-neutral yield and hence benchmarking the implied risk premium against the term premium, the equity risk premium would drop to 1.9 pp in the event of a marked earnings collapse. However, this would still be positive and still close to 1 pp above the long-term relative mean. The macro section of this report has also provided multiple macro gauges suggesting that the sluggish business cycle is likely to trough and turn in 2020, paving the way for a recovery scenario in 2021, and taking this into consideration we find fundamental support for the market being able to absorb further (strong) earnings headwinds through multiple absorption.

ISM AND AVERAGE YIELDS LEAD



Source: Macrobond and Nordea

OECD LEI AND NORDEA STIMULUS INDICATOR



Source: Macrobond and Nordea

A 3-5% return next six to 12 months could be expected

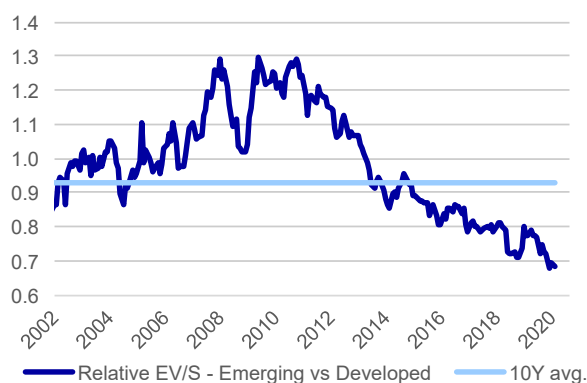
Should assume a new valuation equilibrium has been reached prove to be correct, incorporating the overly lofty short-term (2020 outlook) earnings estimates, as well the scope for further multiple expansion on trough earnings, we could expect another 3-5% return over the coming six to 12 months. Earnings growth is key, we argue. If profits were to fall 15% instead of the current consensus (FactSet) estimate of 7% growth, the NTM P/E would reached a +1 standard deviation above the implied new mean, and hence any positive returns would need to incorporate an excessive valuation overshoot.

Emerging markets are starting to look interesting from a relative valuation standpoint

Geographical split – reduce underweight in emerging markets

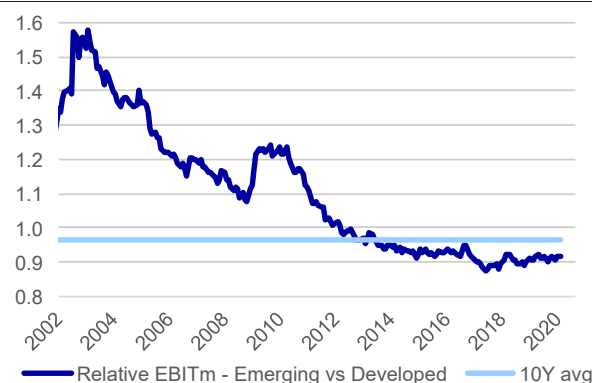
However, there are regional differences that should not be neglected, we argue. We find the continued underperformance of emerging markets relative to developed markets to be intriguing. The relative valuation in this context speaks in favour of increasing emerging market exposure, as the spread is the largest it has been since at least the financial crisis. The relative profitability (EBIT margin) has not seen the same development, though, indicating that the emerging markets have not experienced the same multiple expansion that we have seen in developed markets.

RELATIVE EV/SALES (MEDIAN) – EMERGING/DEVELOPED



Source: FactSet and Nordea

RELATIVE EBIT MARGIN (MEDIAN) – EMERGING/DEVELOPED



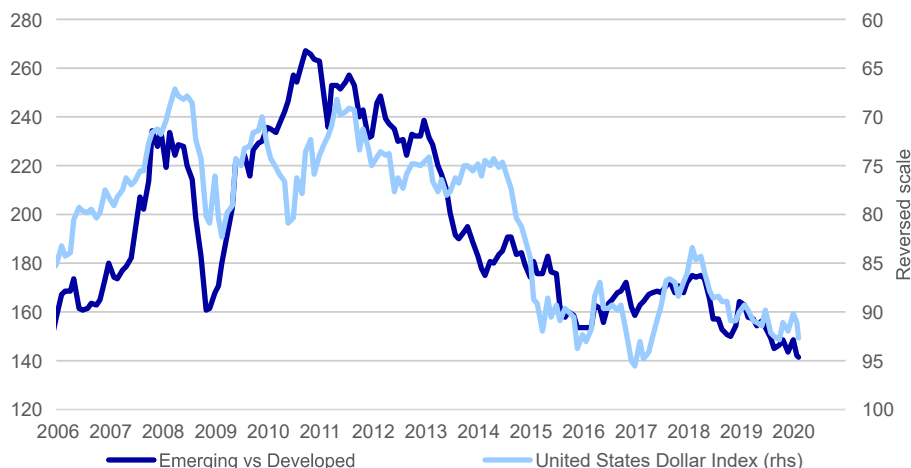
Source: FactSet and Nordea

However, the performance of emerging markets is usually closely associated with USD strength, and our view is that there will be continued USD strength in 2020. Coupled

with the coronavirus, which is so far disproportionately affecting emerging markets, and the continuation of loose monetary (US, EU and Japan) and fiscal policy (US and Japan) in developed markets, we believe it is too early to go overweight in emerging markets, but to start reducing the underweight would be a prudent move, to our mind.

STOXX GLOBAL 1800 VS STOXX EMERGING 1500 AND USD INDEX (REVERSED SCALE)

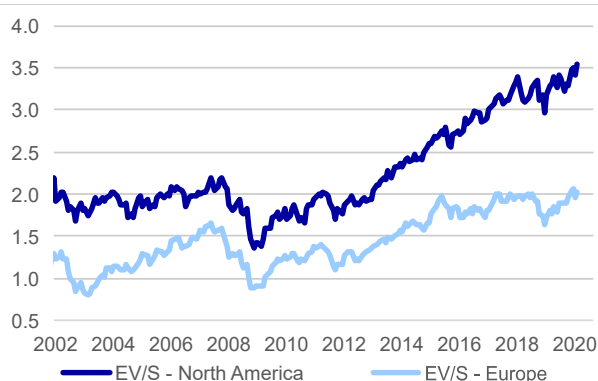
A USD that trades stronger still suggests remaining underweight in emerging markets for some time still



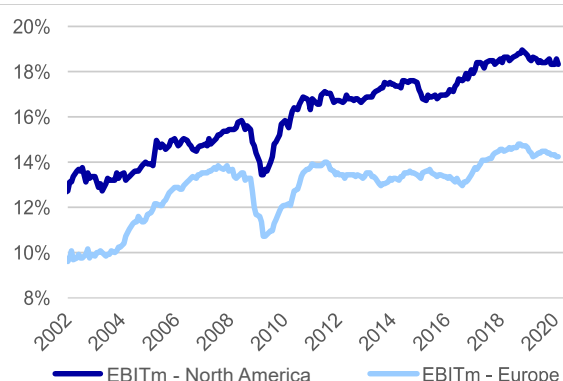
The relative valuation spread between the US and Europe keeps widening but is not unreasonable given the margin differential

Within developed markets, the relative valuation between the US and the European equity markets has continued to diverge, with the US market median EV/sales multiple climbing to a new high of 3.5x. Although the European EV/sales multiple is also at year-high levels, it has mostly moved sideways since 2015. The EV/sales spread between the US and Europe has consequently expanded, but considering the margin differential, which has also widened, this is to some extent justified. While we are not entirely comfortable with the US valuation levels, we do not currently see an obvious rotation in favour of Europe. US elections (a topic we will get back to as we get closer to November) are usually associated with stronger US markets, and the cyclical turnaround, with Europe more exposed to the business cycle, is still in its infancy.

US AND EUROPE: EV/SALES (MEDIAN)



US AND EUROPE: EBIT MARGIN (MEDIAN)



Value or growth?

We present our analysis on value and growth stocks separately in the following section.

This section has been produced by Nordea Markets' Independent Research unit.

Fundamental styles set for a comeback

We take a balanced view on equity styles for two key reasons: we do not assume any large interest rate movements in our forecasts and our analysis indicates that the current valuation setup in the market is fair. The valuation implications of earnings growth and risk differences have increased with lower discount rates. Compounding the implications of greater importance of beta and growth differences, we deem the current valuation discrepancies in the market fair. With justifiable valuation differences and key drivers not showing any clear direction, we argue fundamentals could increase in importance and that a balanced style exposure including reasonably priced growth and quality should serve investors well going forward.

Market dynamics have changed as falling interest rates have caused lower discount rates

Falling interest rates over the past decades have without a doubt had a profound impact on equity markets in general and arguably the value factor in particular. Markets have seen valuation levels rise to very high levels and valuation differences between the expensive and cheap stocks have reached stratospheric levels. We seek to grasp the full extent of the recent developments' implications for market valuation, valuation differences and the outlook for the value factor, and have identified two key drivers:

Lower discount rates have increased valuation of growth and equity beta

- Falling discount rates cause valuation differences between companies growing at different growth rates to widen
- The market risk premium as part of the total risk premium has increased, causing equity beta to grow in importance in company valuations, amplifying the level of justifiable valuation differences

Current CoE composition along with growth and beta differences between cheap and expensive companies explain prevailing valuation differences

Each of the items points towards a larger justifiable valuation gap in the market. The questions hence become: are the valuation differences currently being seen in the market at justifiable levels, too low, or has the trade been overextended? We use a DCF simulation to compound the two separate key drivers and reach the conclusion that current valuation differences are not unreasonable, and maybe even justifiable.

No large changes in interest levels in our forecast bode for a comeback of fundamental styles

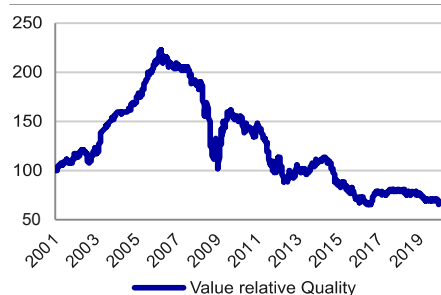
In our view, this does not mean one should disregard valuation as a consideration in investment decisions – on the contrary. With no major interest rate movements in sight in our forecasts, one could argue that fundamentals, including but not limited to, value should return to the fray. In conclusion, we believe combining value with growth and quality could serve investors well amid the current market conditions.

Value exposure should remain an important part of the style mix but we foresee no normalisation of relative valuation levels without a shock from rising interest rates

If interest rates were to start rising, we would expect a reversal of past trends: valuations should come down in general, valuation differences should shrink and betas should become less important. All in all, the value factor should see a revival. Without a marked interest rate increase in our forecasts, this is not our base-case scenario, but we acknowledge that the outcome distribution of the future interest rate development is most likely skewed towards a greater likelihood of higher interest rates. Including valuation in the overall factor exposure should be beneficial if we are right that fundamentals could become more important, but should also serve as material downside protection if interest rates start to rise.

High quality has outperformed value significantly since the market peaked prior to the financial crisis

VALUE REL. QUALITY - TOTAL RETURN



Source: FactSet and Nordea

VALUE REL. QUALITY - TOTAL RETURN



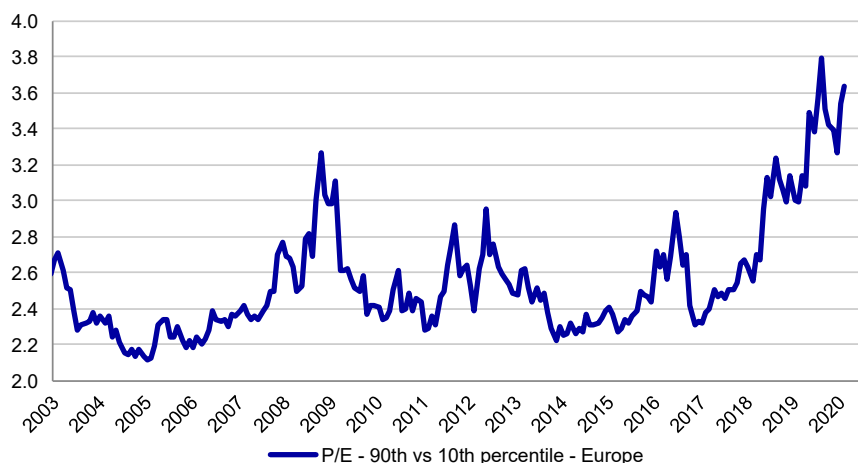
Source: FactSet and Nordea

Growing valuation differences between expensive and cheap companies have played a vital role in value underperformance

Our analysis indicates that this is not completely out of sync with reality

As long as interest rates do not start to move upwards, we do not foresee a normalisation of valuation of styles – however performance of styles could become more balanced around this new normal

RELATIVE VALUATION BETWEEN CHEAPEST AND MOST EXPENSIVE EUROPEAN COMPANIES



Source: FactSet and Nordea

Falling cost of equity amplifies the importance of growth

Cost of equity has reached new trough levels

Cost of equity has come down markedly over the last decade and has now reached the lowest level since the turn of the millennium at around 5.5%. Using a Gordon growth model, we have previously illustrated that valuation differences between companies able to grow at different rates in perpetuity should increase when discount rates fall.

The drawback with using a valuation model such as the Gordon growth model stems from its simplicity; the fact that it is not possible to fade growth rates over time forces the user to have an opinion on differences in perpetual growth, which we argue is very hard to estimate accurately. Additionally, the model's output becomes very sensitive to input differences when the difference between the discount rate and growth narrows. To allow additional flexibility, we transition into using a DCF model to probe how growth differences between cheap and expensive companies should theoretically impact valuation.

History show that expensive companies tend to grow at a higher rate in future periods than cheap companies...

...these growth differences have grown in importance as discount rates have fallen

Our analysis shows that European companies that belonged among the most expensive 10% of companies 15 years ago have grown their profits by as much as 7.7% annually, while the cheapest 10% have only grown their profits by 2.6%. However, it is unreasonable to assume that a growth difference of ~5 pp between expensive and cheap companies will remain constant in perpetuity. Instead, we use history as a guide and model excess growth for a 15-year period and thereafter assume market growth. However, we lower market growth to 2.5% compared to the observed 4.2%. Our DCF modelling shows that the companies growing 3.5 pp faster than the market should trade approximately 90% higher than a company growing 1.6 pp slower than the market. (We have assumed that excess growth is constant for 15 years and thereafter fades to the market growth rate during a ten-year period.)

The analysis shows that growth rate differences have a larger implication for valuation today than ever during the past 20 years, but it fails to fully explain the valuation differences currently being observed in the market.

IMPLIED COST OF EQUITY HAS DECLINED TO MULTI-DECADE LOWS

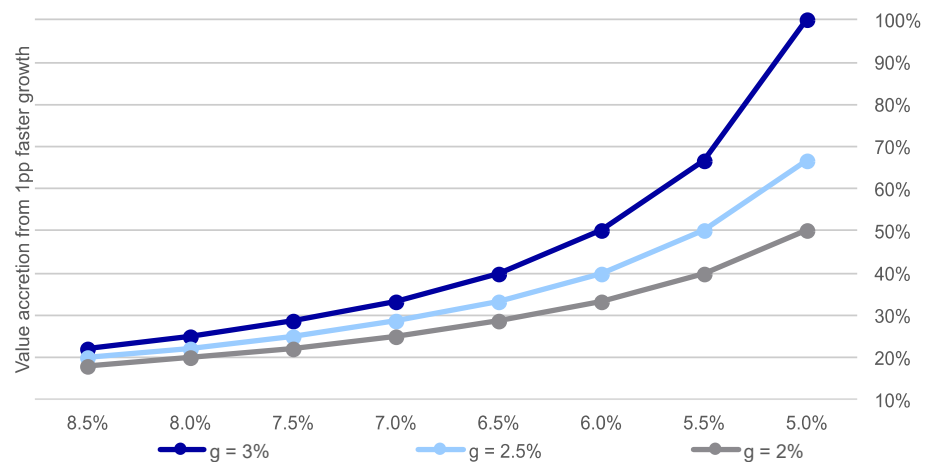
Implied cost of equity has reached multi-decade lows



Source: FactSet and Nordea

JUSTIFIED VALUATION PREMIUM FOR 1 PP EXCESS GROWTH AT VARIOUS DISCOUNTS AND PERPETUAL GROWTH RATES

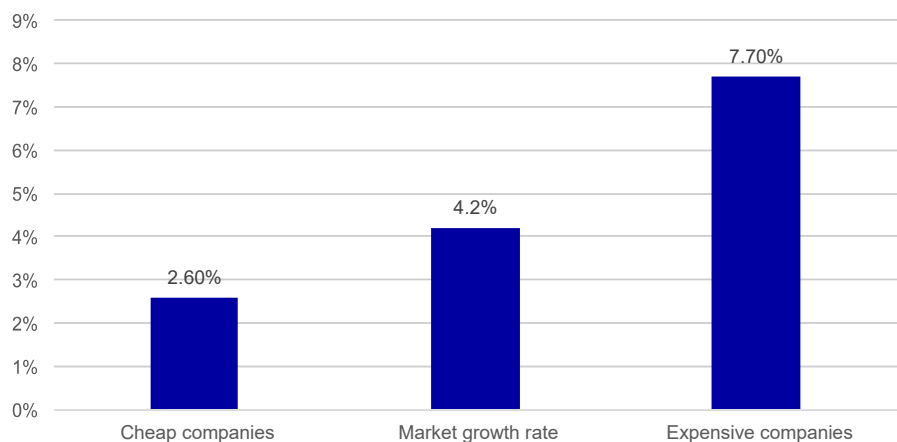
Valuation differences between companies growing at different rates increase exponentially as discount rates fall



Source: Nordea

15-YEAR EBIT CAGR IN TOP AND BOTTOM VALUE NAMES 15 YEARS AGO

The most expensive companies back in 2005 outgrew the cheapest companies by ~5% per annum up until 2018 on EBIT



Source: FactSet and Nordea

Equity beta has become more important in valuation

A consequence of falling cost of equity driven by declining interest rates is that the market risk premium has become a large portion of the total cost of equity. The result is that differences in beta values will create larger swings in discount rates.

Market risk premium is a significantly larger part of CoE than on average

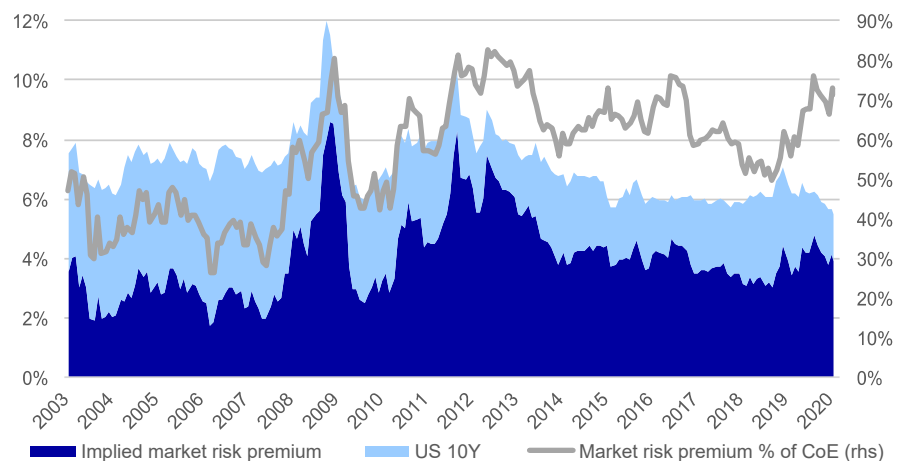
Today, approximately 70% of the cost of equity stems from the market risk premium compared to around 40% in the years preceding the financial crisis. Given that we currently observe an equity beta of around 1.2 in the cheapest companies and 0.8 in the most expensive companies, the discount rates between the two groups differ by as much as 35% compared to ~15% in 2005. The difference in discount rates has historically peaked during the financial crisis, the euro debt crisis, in 2015-16 and in the period from late 2019 to today, and these occurrences all coincide with peaks in valuation difference in the market.

Compounding the impact from larger importance of beta and growth helps understand prevailing valuation differences in the market

Our DCF simulation indicates that the valuation difference between a beta of 0.8 and a beta of 1.2 should amount to approximately 55% using the current market risk premium and risk-free rate, but only 25% using inputs from, for example, 2005, when the composition of the cost of equity was vastly different. Combining the growing importance of growth with the unusually large impact from beta differences, we are able to theoretically justify a valuation difference of ~315%. If we account for differences in cash conversion between the most expensive and the cheapest companies (37% versus 19%, respectively, on average over the last 15 years), we arrive at a valuation spread of close to four times, in line with the valuation difference observed in the market.

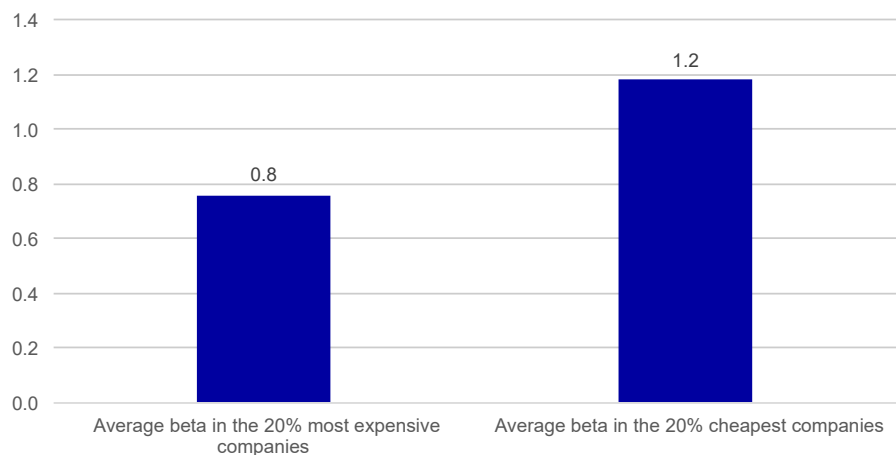
Falling interest rates have caused implied market risk premium to be 70% of total CoE for a beta 1 company

MARKET RISK PREMIUM IS NOW AN UNUSUALLY LARGE SHARE OF TOTAL COST OF EQUITY



Source: FactSet and Nordea

DIFFERENCES IN BETA BETWEEN EXPENSIVE AND CHEAP COMPANIES

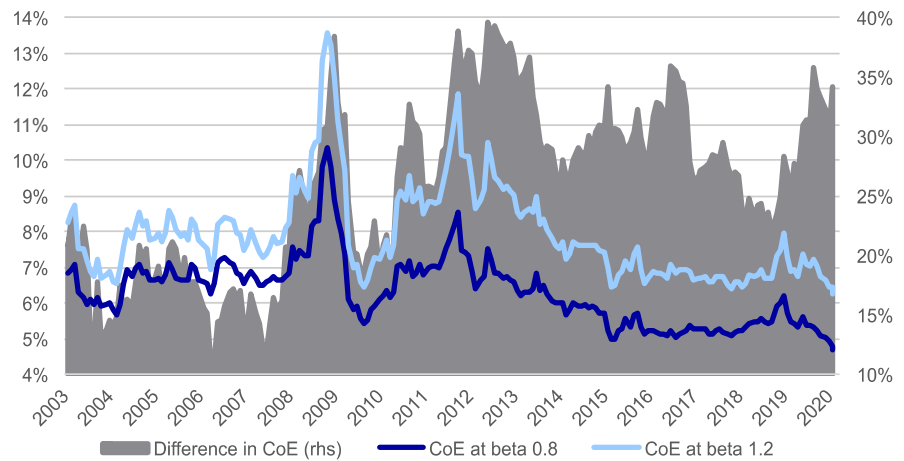


Source: FactSet and Nordea

Beta in the cheapest and most expensive European companies currently is 0.8 and 1.2 respectively

COE DIFFERENCES HAVE INCREASED BETWEEN BETA 0.8 AND BETA 1.2 COMPANIES

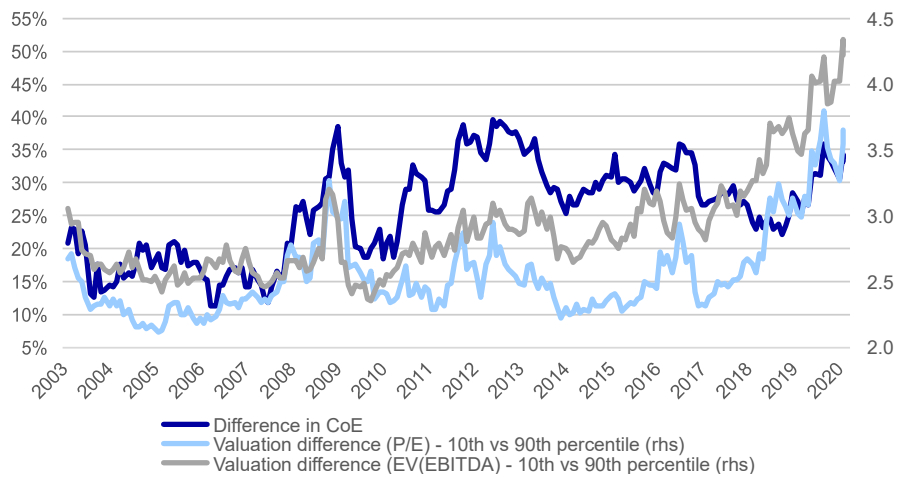
CoE differences between a beta of 0.8 and 1.2 have grown recently as market risk premium has become a larger part of CoE



Source: FactSet and Nordea

COE DIFFERENCES AT DIFFERENT BETA EXPLAIN VALUATION DIFFERENCES IN THE MARKET

Differences in CoE help understand movements in relative valuation between the cheapest and most expensive companies



Source: FactSet and Nordea

This section has been produced by Nordea Markets' Independent Research unit.

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