# Nordea View: Classic Overconfidence

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## Executive Summary

Today, we launch our new cross-asset strategy product, Nordea View, where we outline why we believe volatility is here to stay, with a negative equity market bias. We include a rather intriguing chapter on the growing number of canaries that highlights additional risks. Our analysis also strengthens our previous conclusion that valuation will matter even more for stock-pickers ahead.

### Classic overconfidence about the future

Since late January 2018, we have periodically seen the return of equity market volatility. This has happened despite a generally positive growth environment in which GDP forecasts for the major economies have been raised. **For us the volatility has to do with stretched valuations, high margin expectations for 2019 in every corner of the developed world, and overweight equity positioning – all of which need a continuous flow of positive macro surprises to survive**.

We believe that inflation risk is real in the US (see Inflation at an inflection point), which should push the US 10-year yield towards 3.5%, a level that we believe would be problematic for US stocks given that our calculations imply just north of a 6% expected return. We also see 3-6 months of a falling trend in global business surveys and a tendency for negative macro surprises. This should then be followed by a period of more balanced surprises, but we do not expect a return to the situation in 2016-17 with basically only positive surprises. Global liquidity is also a risk factor.

Thus, we see continued volatile equity markets, with a negative tilt. **What we will look for to change our defensive view are signs of stabilisation in leading indicators, lower margin expectations and reduced investor equity overweight**. It will be hard to fulfil all of those conditions, and believe two out of three might do given our view of no recession in 2019. Currently, however, the score is zero out of three.

### Too many canaries to ignore

There have been plenty of interesting events (canaries) in recent quarters, such as the popping of a cryptocurrency bubble, liquidity problems in Chinese conglomerates, US subprime auto defaults soaring, widening of the Libor-OIS spread, the blow-up of inverse volatility products (XIV), and bloodshed in select emerging market currencies. **Instead of viewing these events as idiosyncratic, we argue they reflect something more worrisome: global growth is slowing and the cost of capital is on the rise.**

### Equity valuation and margin risks are mounting

Profit-neutral valuation levels like EV/sales (Stoxx Global 1800, including all three regions) are also in uncharted territory for the median company, which leaves stocks unusually sensitive to rising interest rates, we argue. **We also see a medium-term issue in that profit margins are already at all-time highs and are expected to improve further,** with 2019 forecasts in particular looking vulnerable. With wage and input cost pressure mounting, coupled with a slowdown in growth, it suggests to us that these rather lofty forecasts are at risk.

### Equity style analysis points to value

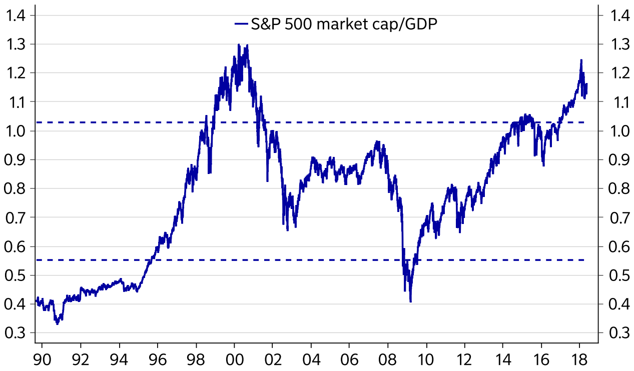
We are perplexed to see continued US value weakness; especially given that we have seen rising interest rates. In our view, rising interest rates should lead to smaller valuation differences and point to relative value strength. We maintain our belief that valuations will grow in importance in stock-picking and that investors should adopt an over-the cycle approach to valuation given the margin risks we foresee. In Europe we see some signs of a value comeback, utilising our own back-testing data, which also demonstrates that both value stocks and reasonably priced quality look ripe for a relative comeback.

# 1. Classic overconfidence about the future

Since late January 2018 we have periodically seen the return of volatility, and global equity markets have given up some of the 2016-17 gains. This has happened despite a generally positive growth environment in which GDP forecasts for the major economies have been raised. Some popular explanations for the revisions have been increased inflation risks, higher interest rates, a normal bull market correction and, most recently, trade war jitters. **Our take is slightly different and indicates that we should see continued volatile equity markets with a negative tilt.**

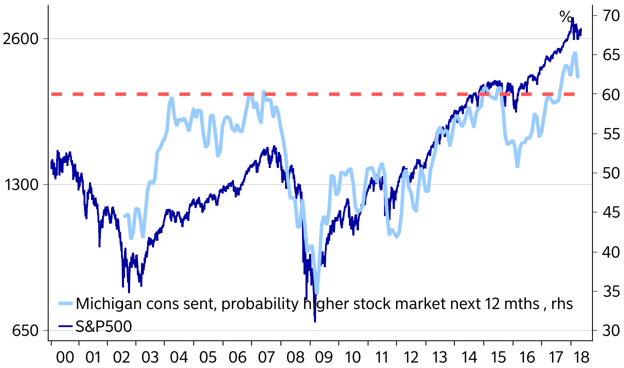
So far, markets are not really indicating increased inflation risks, in our view, even though there is an increased probability of that happening later in 2018-19. The 10-year US inflation swap trades at 2.26%, which is in line with early 2017, when it was not a problem for the equity market. Rate hikes by the Fed have gradually pushed up 10-year nominal yields, but forward rates (like the 1-year rate in 5 years) are the same as early 2017. Trade war jitters of course have not helped, but in another environment, chances would have been much higher that they would have been brushed off as political negotiation tactics.

## Figure 1. A lot of good news is priced in




Source: Nordea Markets and Macrobond

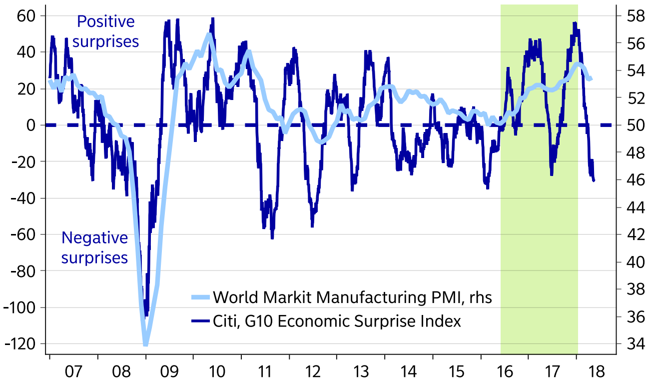
## Figure 2. US households are record bullish




Source: Nordea Markets and Macrobond

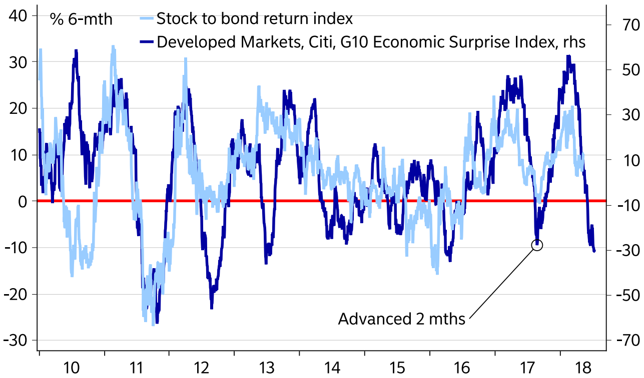
**For us the way the global equity market is trading has more to do with stretched valuations, extremely high margin expectations for 2019 and overweight equity positioning, all of which need a continuous flow of positive macro surprises to survive.** Early 2016 to end-2017 was just such a period of an unusually high number of positive surprises that led to very low volatility and pushed up profit expectations/ equity prices. It was crowned by the late 2017 ISM/PMI surge based on the tax reform that Trump was able to push through. **The period ahead will likely be different, with more negative data surprises.**

## Figure 3. Unusually high number of macro surprises in 2016-17




Source: Nordea Markets and Macrobond

## Figure 4. Expect more negative surprises going forward

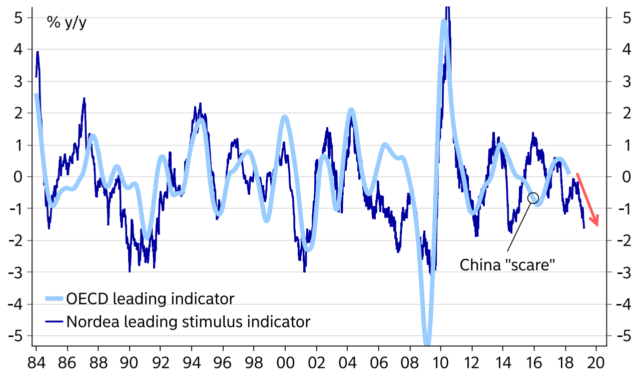



Source: Nordea Markets and Macrobond

The main factor we see behind changing macro momentum is that global stimulus effects are ebbing out, with higher interest rates and oil prices taking their toll on leading indicators such as PMIs, ISM, and IFO. This is already pushing economic surprise indices into negative territory. That trend should continue according to most of our own leading indicators (see below). Several **indicators already point to risk of industrial production in the OECD near 0% y/y**

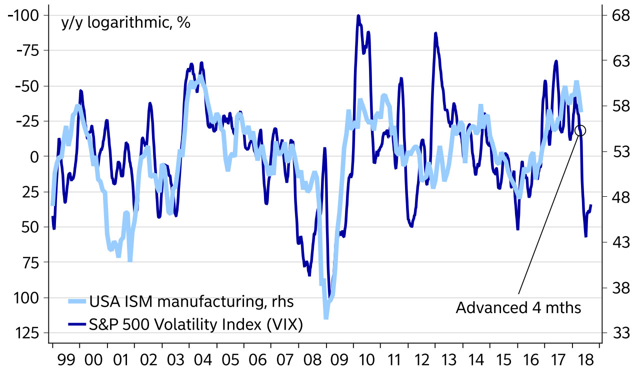
**growth late in 2018**. But should it matter to equities given that the broad GDP growth outlook is still okay? A fair question and admittedly, at the time of writing, the very short-term market ebb and flow seems to favour rising equity prices. We see this as an opportunity to take some chips off the table, since at the end of the day, momentum in leading manufacturing indicators has always mattered to equities. **Investors are not usually comfortable with having an overweight in equities when macro momentum goes the wrong way**. A case in point is the 2015-16 slowdown in activity, which was not particularly worrisome from an overall macro perspective, but over nine months still led to a 17% drop top to bottom for MSCI world.

## Figure 5. Stimulus effects are ebbing



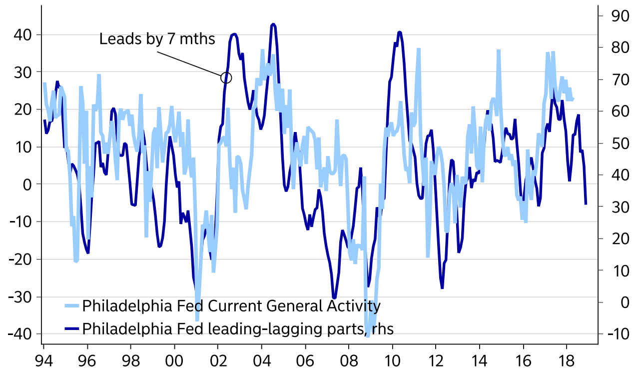

Source: Nordea Markets and Macrobond

## Figure 6. Market volatility usually means less optimism



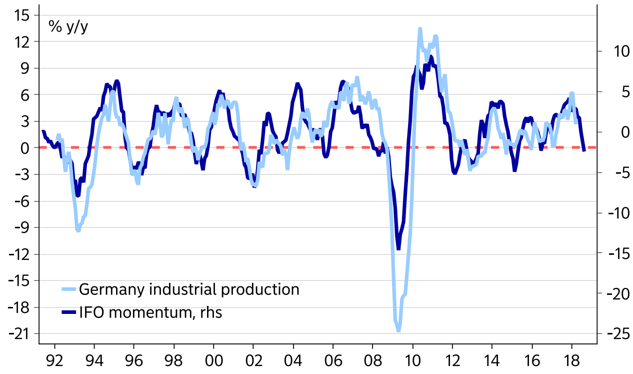

Source: Nordea Markets and Macrobond

## Figure 7. US business surveys set to fall



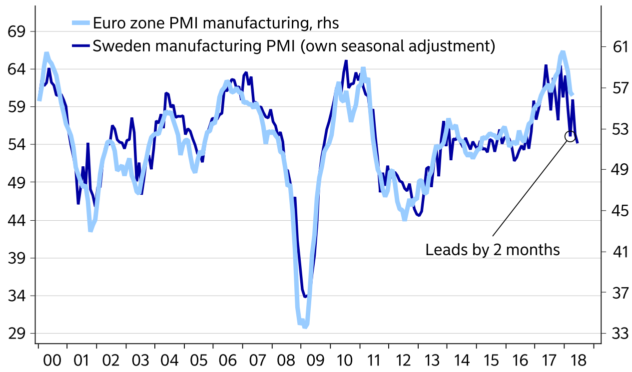

Source: Nordea Markets and Macrobond

## Figure 8. Euro area growth momentum is turning downward



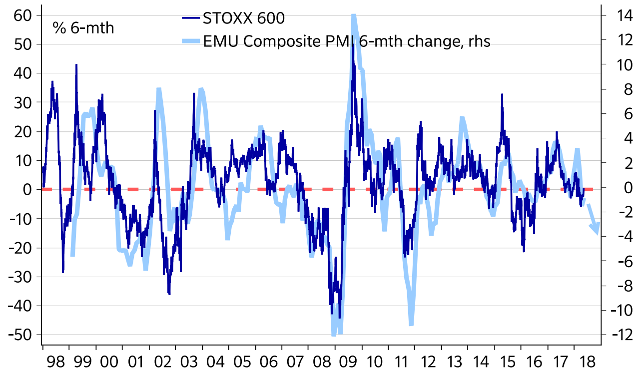

Source: Nordea Markets and Macrobond

## Figure 9. Sweden is leading Euro area down




Source: Nordea Markets and Macrobond

## Figure 10. Equity markets follow growth momentum

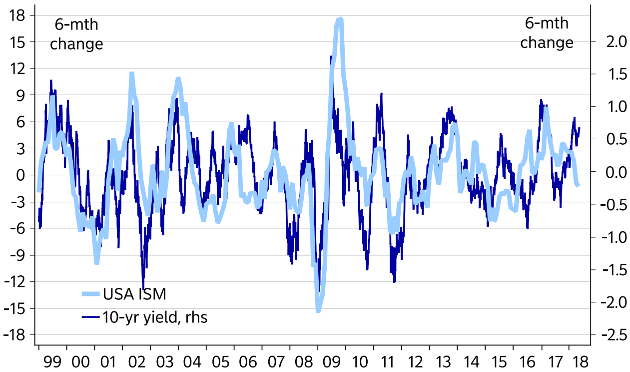



Source: Nordea Markets and Macrobond

Normally, a mean reversion in surveys should also lead to lower interest rates, which at some point would stimulate activity again. This time, however, it will **for many reasons be harder for yields to drop. The Fed seems intent on staying its course, and is not that concerned about increased equity volatility now that inflation is trending higher**. There is a growing number of signs that wage inflation is about to take off. In fact, most US inflation indicators are at their highest level in ten years, which has led us to forecast the highest core inflation since 2006 in 2019. Read more in "Inflation at an inflection point". A larger budget deficit and increased bond supply have not helped either.

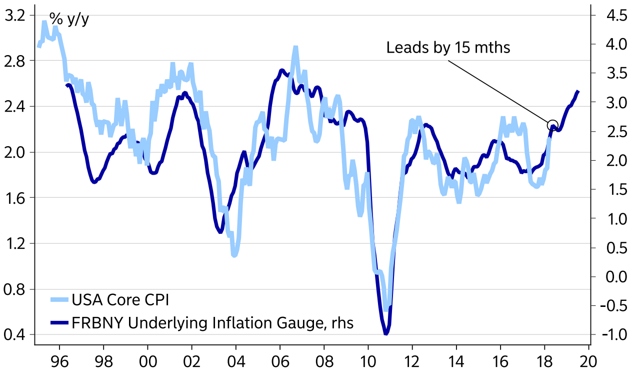
Moreover, an increased USD hedging cost has meant that FX-hedged bond yields are actually higher in Europe than the US. Foreign investors have therefore had a hard time motivating long positions in US bonds. It has thus been hard for the US 10-year yield to drop despite weakness in the equity market. The ECB at the same time sees the end of the QE purchases moving closer and that opens up a discussion about the next step being a rate hike, although relatively distant. **Our medium-term yield forecasts are for higher global yields, which would once again highlight difficult valuation levels, with 3.5% yields for risk-free US government 10-year bonds in reach when the equity market offers just above 6% expected return.**

## Figure 11. Interest rates usually follow growth momentum…



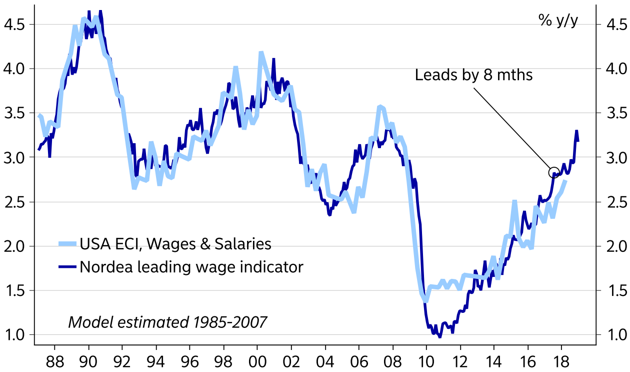

Source: Nordea Markets and Macrobond

## Figure 12. …but not when inflation risks are increasing



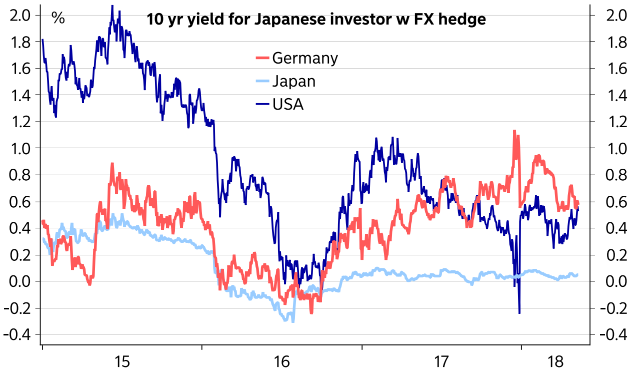

Source: Nordea Markets and Macrobond

## Figure 13. US wages on the rise




Source: Nordea Markets and Macrobond

## Figure 14. US bonds less attractive for foreign investors due to FX hedging cost

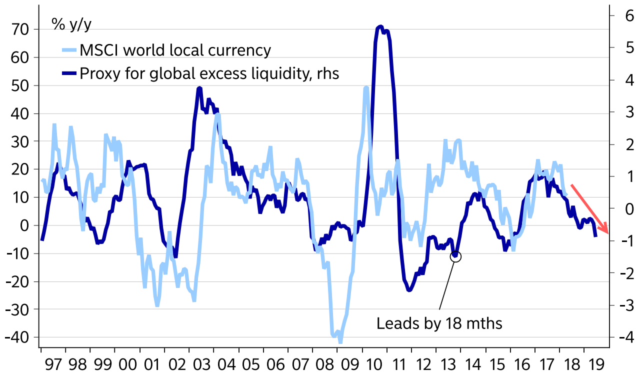



Source: Nordea Markets and Macrobond

If that was not enough, we also have the difficult area of central bank liquidity effects to figure out. **What will the impact on markets and the economies be when central bank balance sheets are reduced?** Not an easy question, but a very important one for markets.

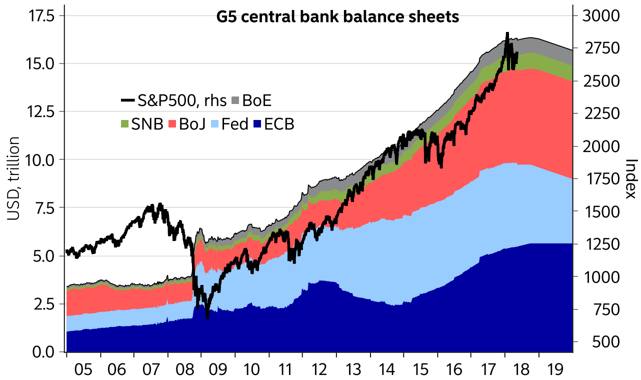
Our proxy for global excess liquidity (basically what is left of money printing to drive financial markets after the real economy has used up what it needs) has already dropped, which with a lag historically has meant higher volatility and weaker risky assets. This is before the central banks have started to reduce their balance sheets, which will suck up even more available liquidity. **Most agree that the central bank balance sheet expansion has played a role in driving risky assets higher; our assumption would then be that there will at least be some negative effects when liquidity is drained.** Equity markets, credit spreads and emerging markets assets in general are the usual victims in that category.

## Figure 15. Global excess liquidity is already falling




Source: Nordea Markets and Macrobond

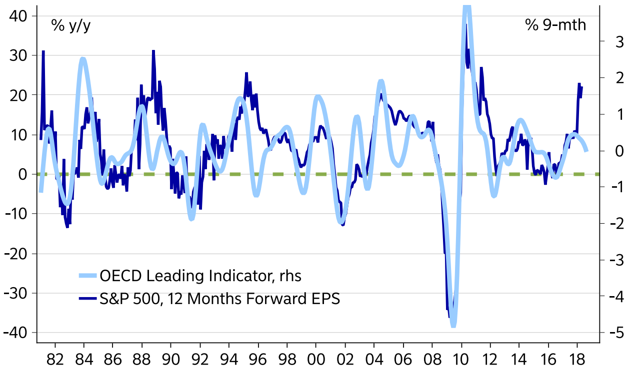
## Figure 16. How will contracting CB balance sheets matter?




Source: Nordea Markets and Macrobond

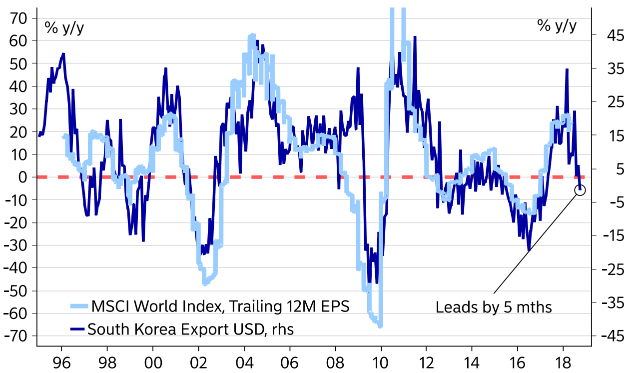
This could become an issue as the macro picture is changing. The strong macro momentum during 2016-17 and Trump's tax reform have pushed global EPS estimates higher. But that good news is now behind us. Looking ahead, the more negative macro momentum we expect should make it hard for the strong EPS trend to continue. Indeed, the classic "canary in the coalmine" **South Korean export is already at a negative y/y rate, which historically has meant negative global EPS growth down the line.**

## Figure 17. Upbeat US EPS forecast driven by tax reform




Source: Nordea Markets and Macrobond

## Figure 18. Global EPS growth at the peak!

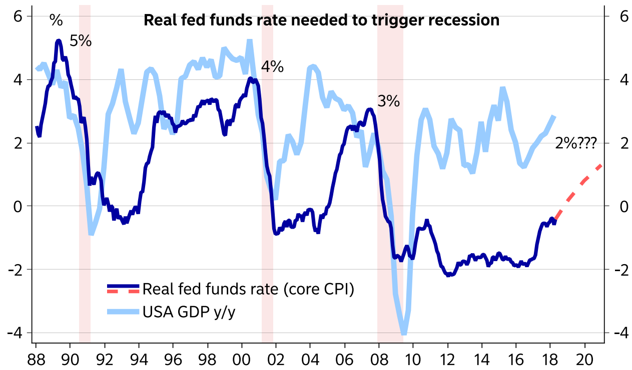



Source: Nordea Markets and Macrobond

Not everything is pitch black, however. **Even though the overconfidence in the future needs to be scaled back, we currently do not see a recession scenario playing out.** The main reason for this is that no central bank has really put its foot on the brakes yet. **Real interest rates are too low to trigger a recession at this point**, in our view; the real Fed funds rate is still negative.

The last three US recessions have been triggered at a 5%, 4% and 3% short real rate, respectively. Even though that level might have fallen further due to high debt levels, the Fed's own forecast does not even reach 2% at the end of 2020. As long as we believe there is no recession around the corner, then the equity market rout cannot continue forever, so there will likely be a buying opportunity at some point.

## Figure 19. Real yields too low to trigger a recession




Source: Nordea Markets and Macrobond

In other words, we see 3-6 months with a falling trend in global business surveys and a tendency for negative macro surprises. It should then be followed by a period with more balanced surprises, but we do not expect a return to the 2016-17 experience of basically only positive surprises. **Equity markets should feel the pain of a more negative macro momentum and interest rates grinding higher.** Global liquidity is moreover a risk factor that is obviously known but has largely unknown consequences.

**What we will look for to change our defensive view are signs of stabilisation in leading indicators, lower margin expectations and reduced investor equity overweight. It will be hard to fulfil all of those conditions so two out of three might do, given our view of no recession. Currently, however, the score is zero out of three.**

*This section has been produced by the Nordea Markets Non-Independent Research unit*

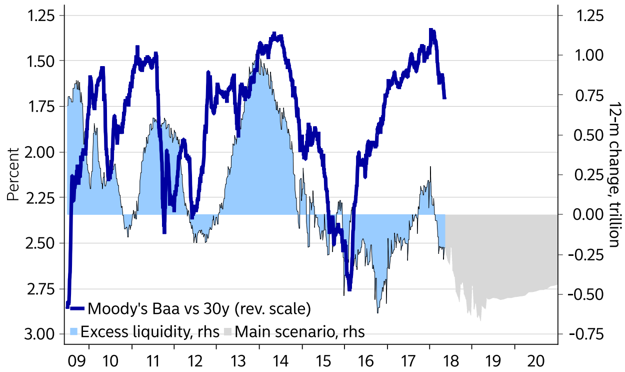
# 2. The clutch of canaries continues to expand

## See the forest for the trees

**There have been plenty of interesting risk events in recent quarters**, all of which seem to be explainable in one way or another, such as the apparent popping of a cryptocurrency bubble, liquidity problems in Chinese conglomerates, US subprime auto defaults soaring, widening of the Libor-OIS spread in the US money market, the blow-up of inverse volatility products (eg the XIV ETN), earlier carnage in the tech equity space, a bond blow-out in a famous auto manufacturer, credit spreads widening, weaker-than-expected activity and inflation in the Euro area, bloodshed in the EM space with Indonesia shelving plans to issue debt, emergency rate hikes from Argentina's central bank, or Turkey getting closer to emergency rate hikes in order to shore up confidence in its currency.

While there are idiosyncratic explanations for each and every one of these events, for instance ECB chief economist Praet has blamed influenza for the European growth slowdown, focusing on the individual events poses a risk of not seeing the forest for all the trees.

### Figure 20. Credit spreads started to widen as Fed started to "unprint" money




Source: Nordea Markets and Macrobond

**Instead of seeing such events as idiosyncratic, we argue they may form a larger pattern. Indeed, the recent era of "cheap money" may be coming to an end just as global growth is slowing.** The Federal Reserve is intent on tightening monetary policy further, even as the 10-year yield has breached 3%. The Fed has accelerated its unprinting of money, which might bring unanticipated tightening of global financial conditions on top of the Fed's signalled hiking pace.

### Figure 21. Euro-area growth expectations set to start falling


Source: Nordea Markets and Macrobond

Other central banks may be less hawkishly inclined, but aside from delaying rate hikes, they offer little support in the form of monetary easing, or in the form of central bank liquidity. As for global growth, this year the G10 economic surprise index has plunged to its lowest level since the start of 2016, with the corresponding Euro area index collapsing to its lowest level since 2011. European growth expectations are furthermore likely to start falling within months, in light of recent weakness in forward-looking indicators such as PMI.

## USD has been gaining for the wrong reasons

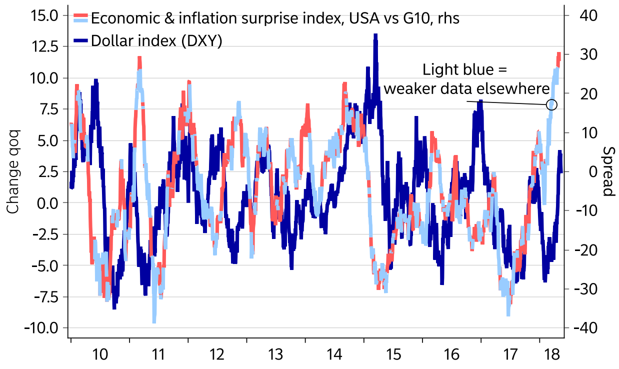
Global growth momentum has been fading, but the US economy has yet to show any really significant disappointments. As a consequence, the US economy has suddenly been outperforming the rest of the world – but primarily due to disappointments elsewhere rather than positive surprises in the US. **The USD has thus, at least partly, been gaining for the wrong reasons.** One lesson from 2014 is that the rise of the dollar can hurt risk-taking in other parts of the world, via financial spillovers, so it is not a coincidence that emerging market currencies have not been doing so well.

**The recent gains of the dollar have impacted emerging markets negatively, but not yet affected the outlook for monetary policy in the US.** If anything, recent statements from the FOMC have been on the somewhat hawkish side, as for instance Fed

Chair Powell has toned down the impact from US monetary policy on the rest of the world.

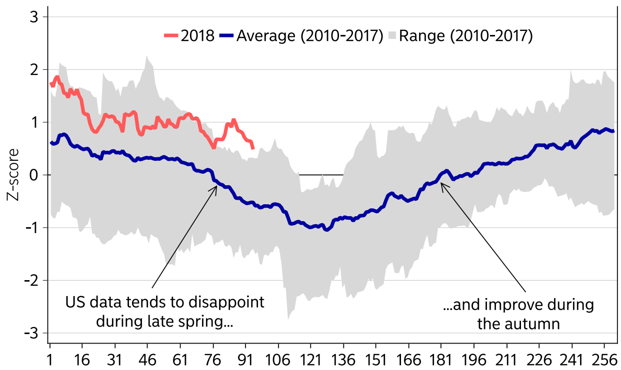
**The USD has also seen tailwinds due to lower political risk premiums**. For a long time, the White House was viewed as likely to put doves in charge of the central bank, but President Trump's appointments and subsequent FOMC rhetoric have put a nail in that coffin. Moreover, President Trump's approval rating rising and the improved likelihood that the Republican Party will keep control of the House of Representatives in the election this year have also been helpful for the greenback.

## Figure 22. US outperforming due to weakness elsewhere




Source: Nordea Markets and Macrobond

## Figure 23. US economic surprise index set to weaken




Source: Nordea Markets and Macrobond

In the Euro area, both activity and price data have been disappointing, adding to the recent downdraft of the EUR/USD. **Here it is crucial that activity and inflation rebound if the ECB's 2018 forecasts are to materialise**. What will indeed be important for the dollar in coming months is to what extent US economic outperformance will persist, or whether the rest of the world is set to close the gap with the US in terms of economic surprises. This would dampen the upside pressure for the USD but could be offset by EUR-negative positioning adjustments in the wake of falling Euro-area growth expectations.

**We see the balance of risks skewed to the downside for the EUR/USD in the near term, but believe that such a move will offer long-term opportunities to put on longer-dated hedges against USD weakness**. The USD is, after all, getting increasingly overvalued once again, and this soft patch will, in the end, be a modest one, meaning that long-term ECB normalisation bets will be looming just underneath the market's horizon.

*This section has been produced by the Nordea Markets Non-Independent Research unit*

# 3. Equities: Valuation and margin expectation concerns

## Valuation becoming an obstacle

**As we are believers in over-the-cycle valuation metrics, we do not agree with general remarks that the valuation levels are close to normal**, often citing forward-looking P/E. The major risk with just looking at the forward P/E is the margin assumption it is based upon, ie valuation based on P/E of 16x at historically poor earnings is super attractive in our view, whereas today's 16x "best margins on record" is not.

Based on profit-neutral multiples like EV/sales we have just reversed after hitting multi-year highs. Also when observing median company valuation we are also just off historically observed highs. The most extreme market from this perspective is the US, where the recent rise in bond yields should bring back a renewed discussion of valuation levels for market participants. **The fact is that when the US market peaked in January it had not been that strained from a valuation perspective since the dot-com bubble burst (EV/S, Shiller P/E, P/S, trailing P/E, GDP vs stock markets etc.)**.

**We contend that the sensitivity to higher rates is much greater than commonly argued given the lofty valuations**. The choice for an asset allocator when he can achieve above the dividend yield on a two-year note or can get 3% guaranteed for 10-years should start to become a conundrum when equities in the US are only offering just north of 6%.

During the journey south for bond yields, the lower required return for equities has led to multiple expansion and greater valuation differences. **Unless the earnings recovery is far beyond our expectations, a move north in interest rates should, if history repeats itself, lead to multiple contraction and compression** (greater valuation contraction for the more expensive names), due to the exponential relationship between growth and the cost of capital.

The relative appeal versus other asset classes for equities still exists, but as we see limited opportunities for the implicit cost of capital to fall further it is hard to argue that equities should offer more than 6-7% total return in the years to come. **We would therefore argue for keeping some extra firepower on the side-lines in order to get better odds.**

## Margin forecasts a real concern

**There is also a potentially longer term problem with regards to profits, which from a margin expectation point of view look really lofty**. If the latest reporting seasons is anything to go by then input price pressure and less leverage seems to have had a negative impact. This cements our view that 2019 forecasts could become a key obstacle for the stock market. Shorter term the US tax cuts have acted as a buffer and have made the earnings momentum look very good in the US and for global aggregates, but underneath the surface we note signs of margins coming under some pressure.

**We also want to flag that the median company is already supposed to post all-time high margins in all regions** (based on 12-month forecasts). As previously stated we are not fans of paying high multiples for great earnings. Inflationary pressure is also building with potential wage pressure, commodities having rallied (oil approaching USD 80) and a weak USD driving as key components. In Europe, Eastern European workers moving back could help reignite the inflation discussion although the strong EUR will likely counteract this.

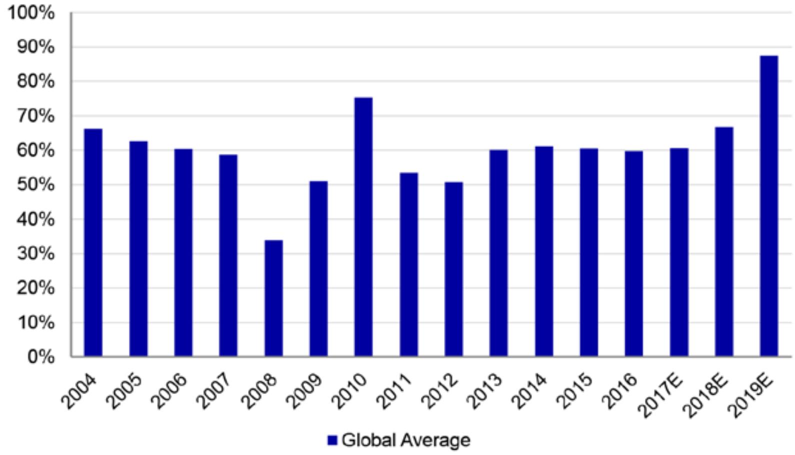
Corporate profits will likely be under pressure due to the currency in Europe. **The real scare point is if we are embarking on a journey where corporates will need to transfer some of the wealth to workers and capital owners**. If this materialises even to a lesser extent, today's lofty margin forecasts will not be met. The ray of sunshine comes from sales momentum, where the outlook remains pretty strong and aggregated forecasts could be achievable, in our view.

That said, the strong macro momentum during 2016-17 and Trump's tax reform have pushed global EPS and sales estimates higher; but that good news is now behind us. Looking ahead, the more negative macro momentum we expect should make it difficult for these strong EPS/sales trends to continue.

*This section has been produced by the Nordea Markets Independent Research unit*

Analysts globally see close to 90% of companies set to improve profitability in 2019 versus 2018

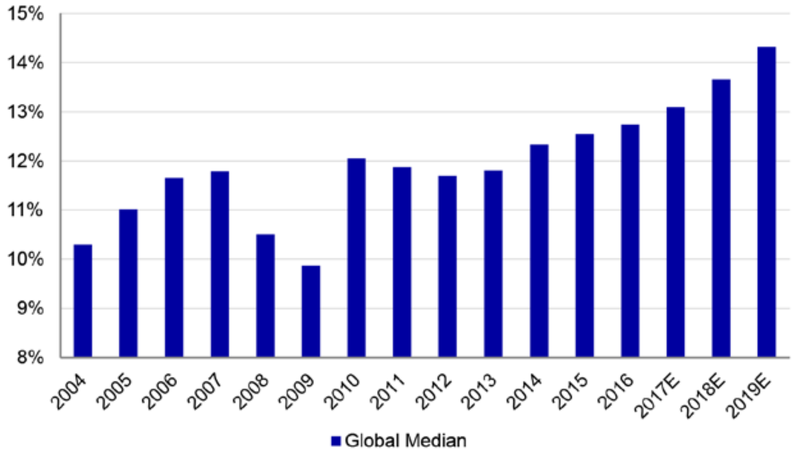
## Figure 24. Share of STOXX 1800 companies forecast to improve margins




*Source: FactSet and Nordea estimates*

2017 was already a peak year from a profitability perspective; we doubt that 2019 will overshoot this peak by more than 100 bp

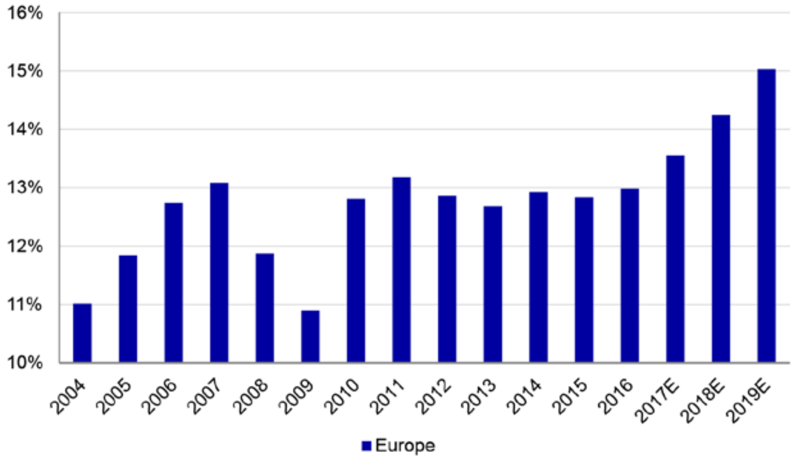
## Figure 25. STOXX 1800 median company EBIT margin




*Source: FactSet and Nordea estimates*

2017 already at great levels, but 2019 supposed to be amazing, which we doubt

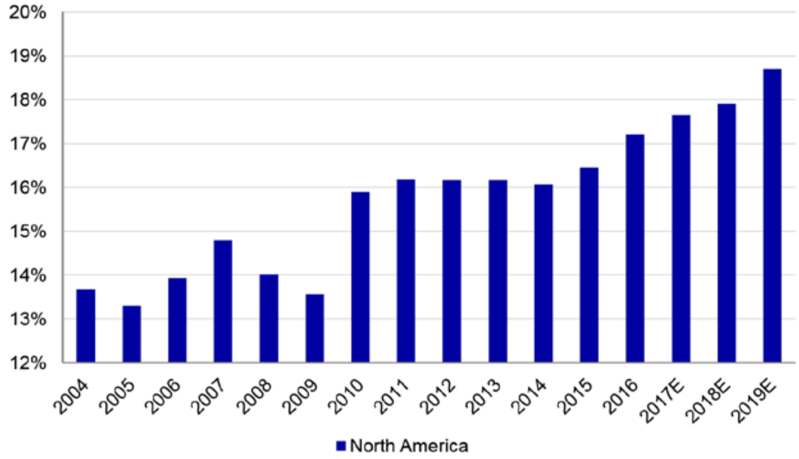
## Figure 26. STOXX Europe 600 median company EBIT margin




*Source: FactSet and Nordea estimates*

US margins have never been higher, but why not add another 100 bp on top of the 2017 level?

## Figure 27. STOXX North America 600 median company EBIT margin




*Source: FactSet and Nordea estimates*

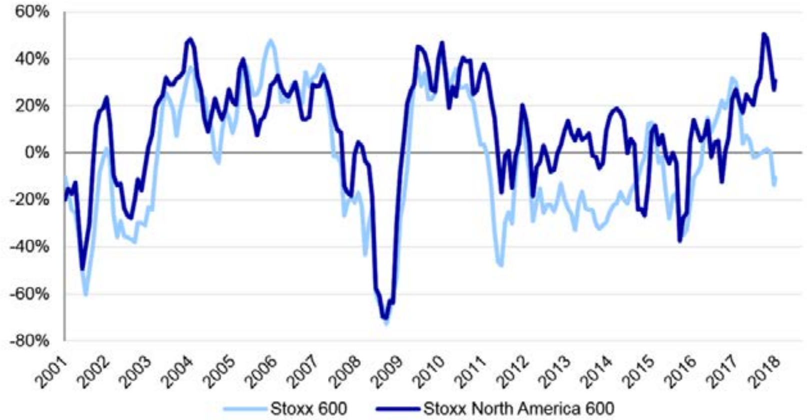
Our revision indicator is showing slowing momentum (net % of companies seeing upgrades)

## Figure 28. Our EPS revision indicator – STOXX global 1800


*Source: FactSet and Nordea estimates*

North America faring better than Europe, which is in negative territory

## Figure 29. Our EPS revision indicator – Europe and US




*Source: FactSet and Nordea estimates*

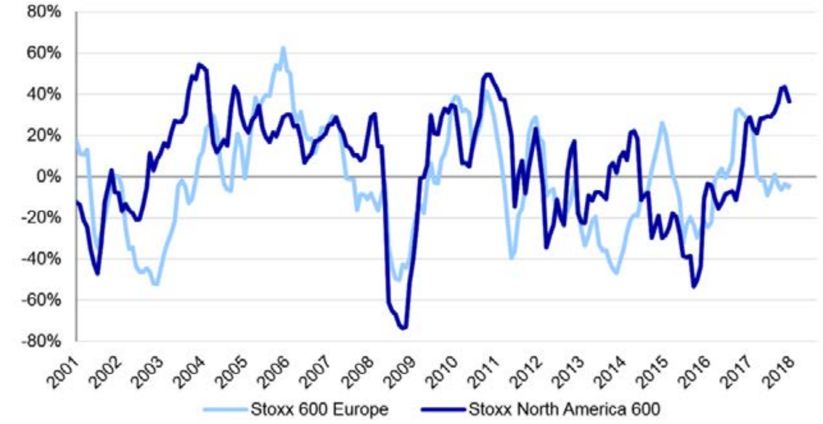
Sales momentum positive, but also waning

## Figure 30. Sales revisions – STOXX global 1800


*Source: FactSet and Nordea estimates*

US stronger than Europe here as well

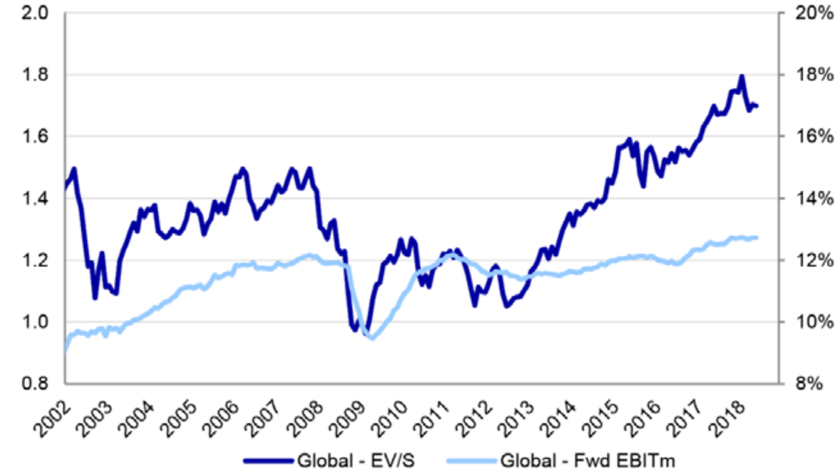
## Figure 31. Sales revisions – Europe and US




*Source: FactSet and Nordea estimates*

EV/sales very sensitive to margin mean reversion

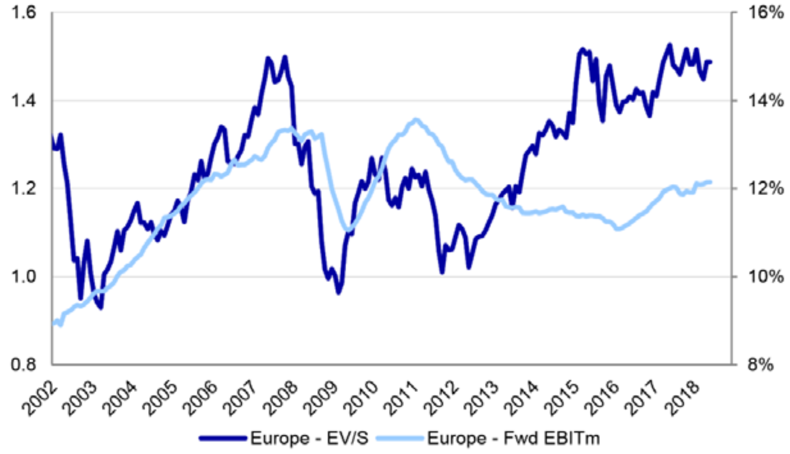
## Figure 32. EV/sales vs margins (aggregated) – STOXX global 1800




*Source: FactSet and Nordea estimates*

Europe "only" at the 2007 peak

## Figure 33. EV/sales vs margins (aggregated) – STOXX Europe 600




*Source: FactSet and Nordea estimates*

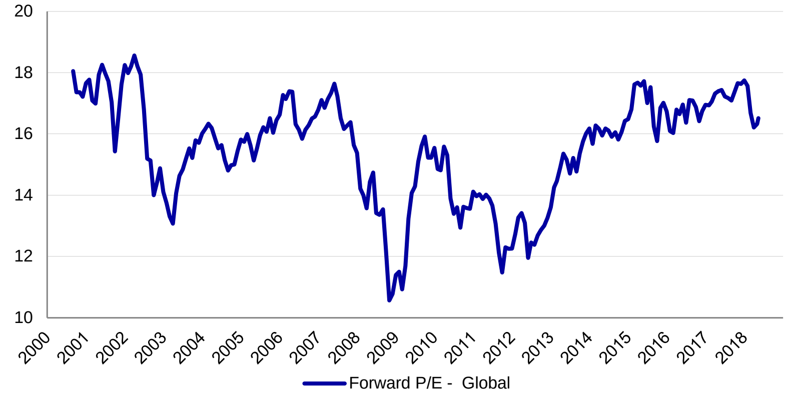
Long way down to reach 2004-08 levels

## Figure 34. EV/sales vs margins (aggregated) – STOXX USA 600


*Source: FactSet and Nordea estimates*

Median P/E at 16x based on great earnings

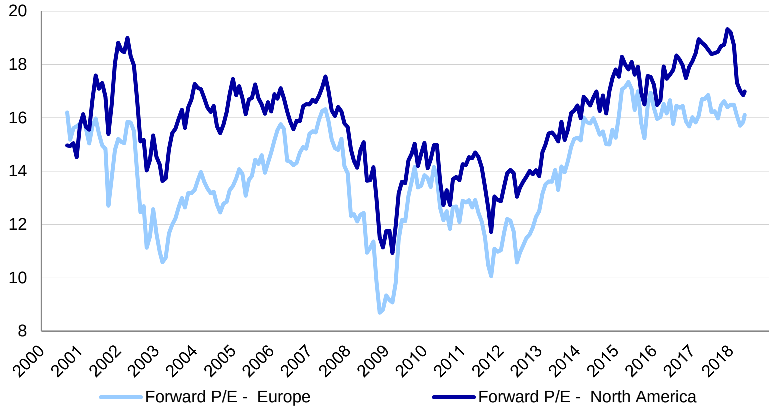
## Figure 35. Median P/E – STOXX global 1800




*Source: FactSet and Nordea Markets*

Same goes for Europe but the US is a touch higher at 17x

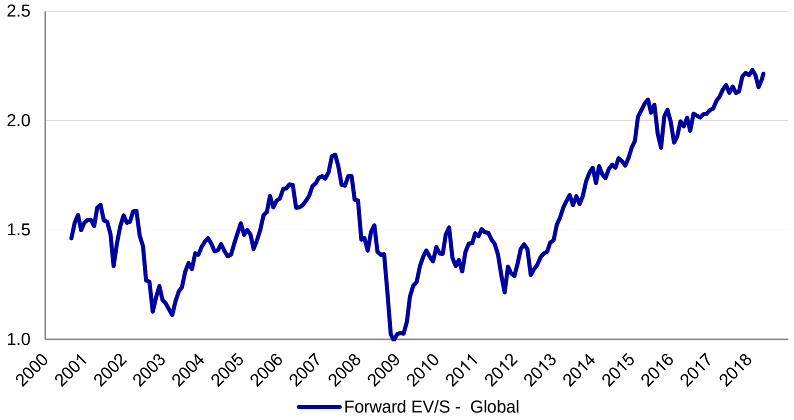
## Figure 36. Median P/E – Europe and USA




*Source: FactSet and Nordea Markets*

EV/sales close to all/time highs

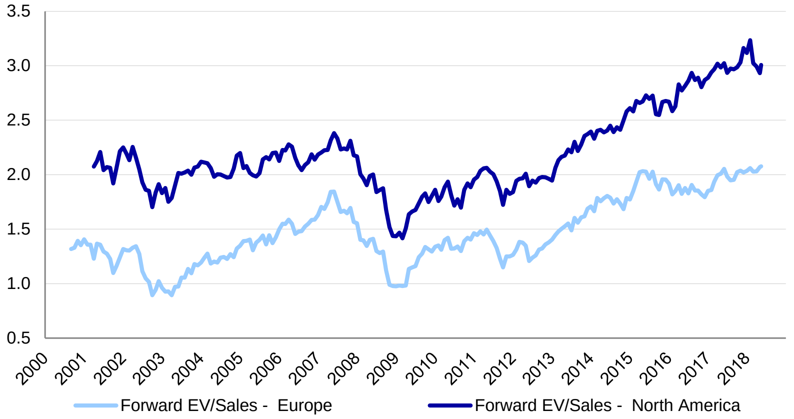
## Figure 37. Median EV/Sales – STOXX global 1800




*Source: FactSet and Nordea Markets*

EV/sales has never been higher in Europe, while US's upward journey has been halted, but still a long way south to the previous peak in 2007

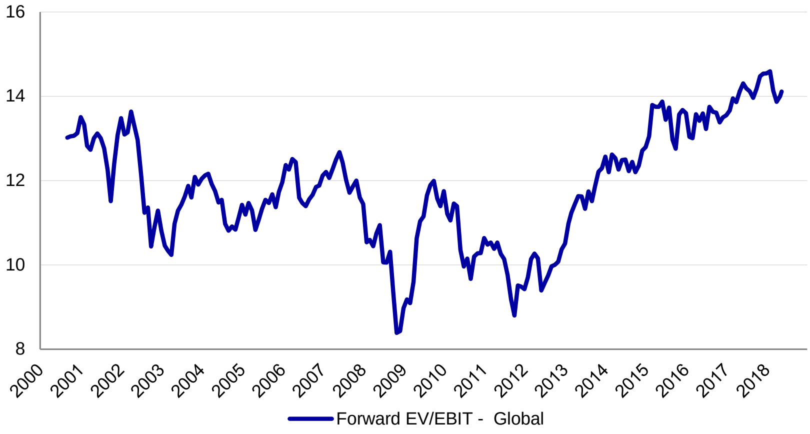
## Figure 38. Median EV/Sales – Europe and USA




*Source: FactSet and Nordea Markets*

For us it's dangerous to get excited about 14x EBIT on great margins

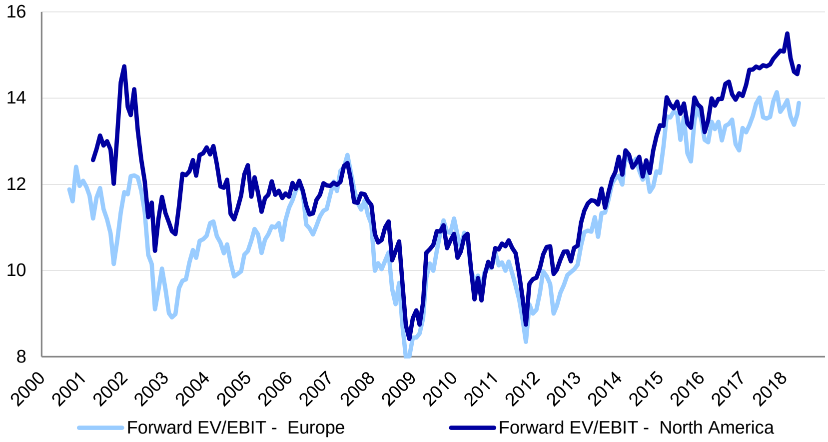
## Figure 39. Median EV/EBIT – STOXX global 1800




*Source: FactSet and Nordea Markets*

US is 1 EBIT unit higher

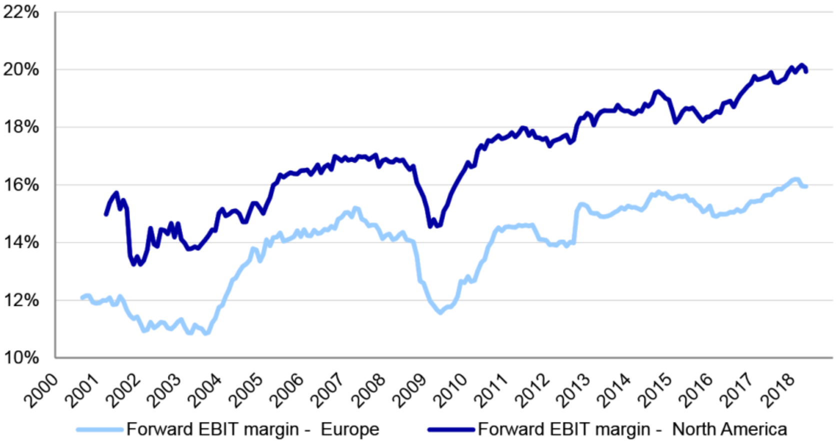
## Figure 40. Median EV/EBIT – Europe and USA




*Source: FactSet and Nordea Markets*

Signs of margins rolling over in Europe, with the same tendency in the US

## Figure 41. Median EBIT margin – Europe and US



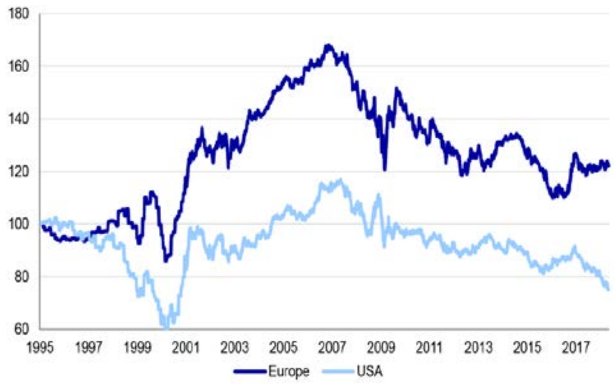

*Source: FactSet and Nordea estimates*

# 4. Equities: Style analysis points to value

Utilising MSCI's definitions of value and growth we can show that value stocks have continued to struggle in the US. We are perplexed to see continued value weakness, especially given that we have seen rising interest rates. **In our view rising interest rates should lead to smaller valuation differences and hence should point to value strength**. We have long argued that the fall in interest rates, and consequently in cost of capital, has exponentially benefitted growth stocks. In our view this has materialised due to the exponential relationship between cost of capital and growth.

**The relationship is obviously reversed when cost of capital is on the rise, and we are therefore quite confident that we will see both valuation contraction and compression**. Given our belief of the US 10-year yield approaching 3.5% by year-end we would voice some serious concern for the expensive end of the market. We would not be surprised if we see a repeat of 2000-01, when valuation actually protected the downside.

### Figure 42. Relative performance (TSR) of MSCI Value vs Growth




*Source: FactSet and Nordea Markets*

Europe does not show a value sell-off equivalent to what we have witnessed in the US over the past year.

## Proprietary analysis highlights value importance

Our proprietary series for mid-cap Europe (back-tests) shows some signs of a value comeback in recent months, which adds some support to our thesis. With cheap stocks (top 10%) in Europe (mid/small caps) trading at around a 50% discount to the market, we strongly argue for increased valuation focus on stock-picking. **We are perplexed that the cheapest names have become relatively cheaper during the latest rise in bond yields.**

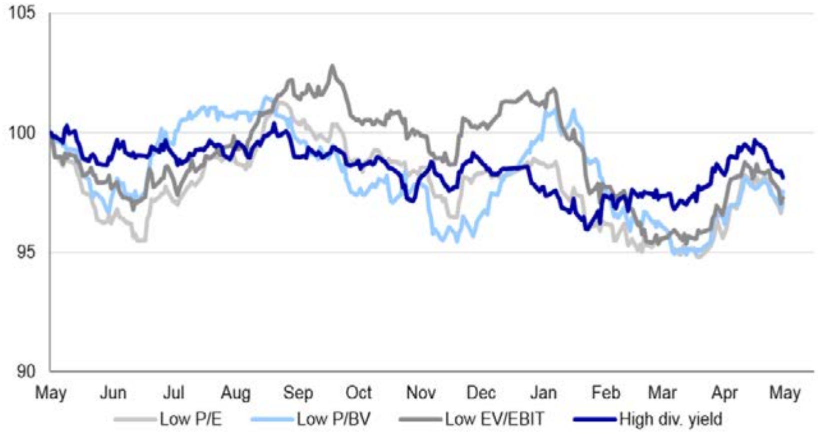
With expensive stocks (top 20%) in Europe (mid/small caps) trading at 30x forward earnings based on virtually peak margins, we strongly argue for profit-taking among the most expensive names to reduce the valuation risk. We are also puzzled by the expensive names getting relatively more expensive during the latest rise in bond yields. The recent hiccup in the FAANG cluster could be early signs that our thesis will become more widely adopted.

**Our analysis finds that the Greenblatt style (reasonably priced quality) outperforms after periods with simultaneous value and quality underperformance such as what we have seen over the past nine months**. Interestingly revision momentum strategies have struggled following such periods and we would thus be very mindful paying too high a multiple for earnings upgrades give the rather lofty earnings forecasts. We therefore reiterate our belief that fundamentals should return to the fray.

*This section has been produced by the Nordea Markets Independent Research unit*

Value stocks recovered in April, but have given back some gains in May

## Figure 43. Some signs of value comeback (European mid/small cap (back tests)




*Source: FactSet and Nordea Markets*

Our rule of thumb suggests that investors should always overweight value traits when value offers a 50% discount to the overall market

Historically, investors have been richly rewarded by adopting a value bias - 2003, 2009, 2012 and 2016 proved to be amazing value years

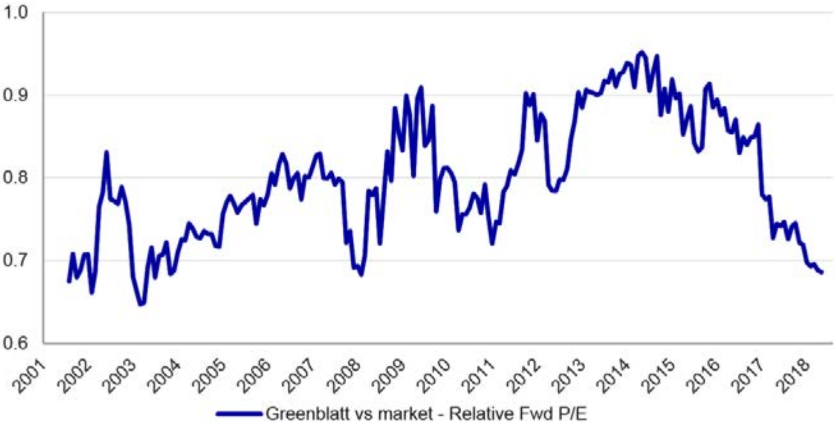
## Figure 44. Value at half price versus market (top 10% of universe)


*Source: FactSet and Nordea Markets*

Our value/quality hybrid is at levels where investors have historically received good odds to buy reasonably priced quality stocks

Interestingly, in 2008 we observed the same set-up as today, with 30% Greenblatt discount following value and quality underperformance

## Figure 45. Reasonably priced quality (top 10%) close to record discount versus market




*Source: FactSet and Nordea Markets*