

# Nordea View: Summer Update

**Mikael Sarwe**

Head of Market Strategy  
[mikael.sarwe@nordea.com](mailto:mikael.sarwe@nordea.com)

**Martin Enlund**

Chief FX Strategist  
[martin.enlund@nordea.com](mailto:martin.enlund@nordea.com)

**Carl Grapenfelt**

Head of Market Research  
[carl.grapenfelt@nordea.com](mailto:carl.grapenfelt@nordea.com)

## Executive Summary

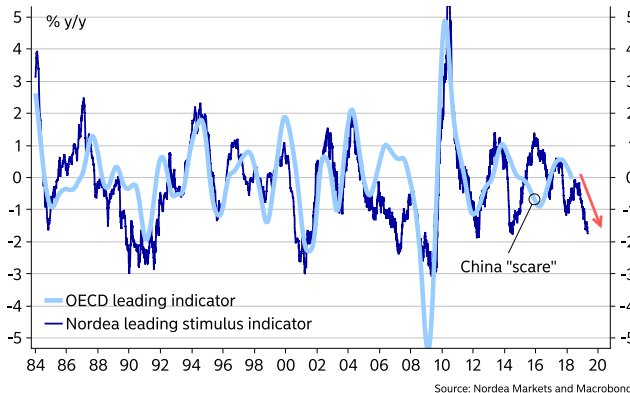
In this Summer Update we reaffirm our conclusion from [Nordea View published 16 May](#) that equity valuations are stretched, particularly given that profit margins are at all-time highs and expected to rise further despite slowing global manufacturing growth, rising input/wage costs, interest rates trending up and liquidity conditions deteriorating. **We expect a rocky road, with higher volatility, and reiterate a negative tilt for equities/risky assets in to 2019.**

## The Macro Backdrop

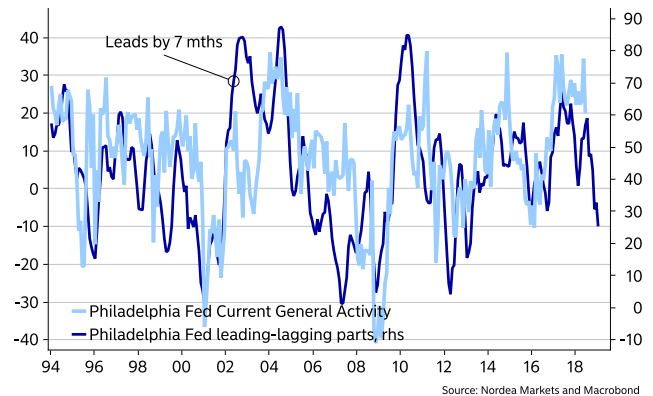
### Negative macro surprises set to continue

The world economy is booming and global profits are increasing. But global stimulus effects are ebbing out as an effect of rising interest rates and oil prices which should lead to a downturn in macro momentum. That led us in our last report to conclude that the early 2016 to early 2018 period of positive macro surprises would turn into negative ones in 2018. **Since the previous Nordea View, leading indicators of manufacturing activity has continued to drop.** So far the negative surprises have been more common in Europe and Asia/Emerging markets while the US is doing fine. Leading parts of US business surveys have, however, started to signal a slowdown there as well, and we expect ISM to approach 50 by early next year.

**Figure 1. Leading indicators are falling**

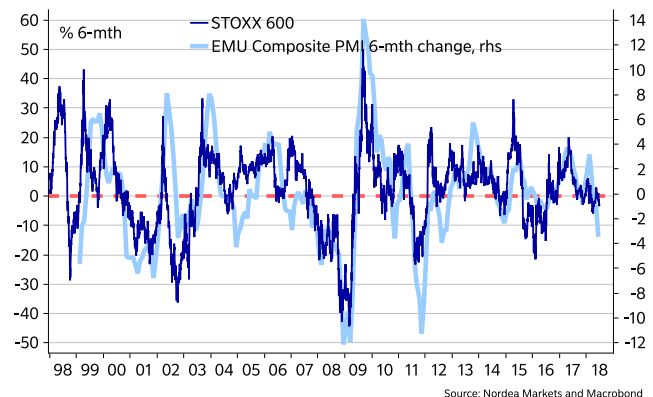


**Figure 2. Early signs of a peak in US surveys**



**Our main scenario is a grinding slowdown in global manufacturing similar to 2015/2016 when business surveys trended down, OECD industrial production fell to slightly negative y/y rates, and fearful investors reduced equity overweights to neutral, triggering a 17% drop in global equities top to bottom.** The macro situation did not dip into a recession, and we do not expect this to happen now either, since short real rates are still negative, but expectations were too high and needed to come down. There are a few positive macro risks to the scenario now, e.g. PBOC signalling possibly increased stimulus and the US tax reform, but the **negative risks compared with 2015/2016 clearly outweigh, which make us convinced that a defensive strategy is warranted.**

**Figure 3. Equity markets follow growth momentum**

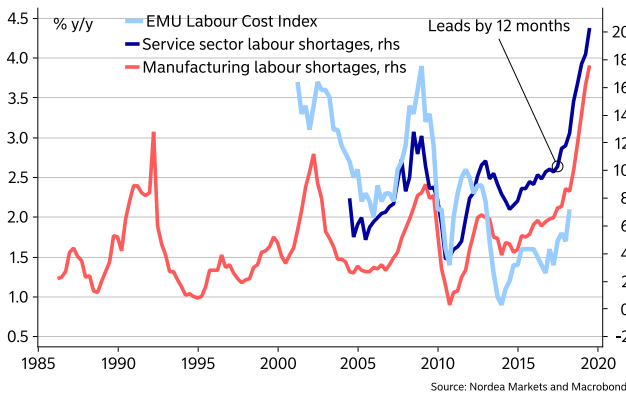


### Three very important negative risks

First, inflation was dead in 2015/2016, but currently it's not resting in peace. There are clear signs in the US that wage inflation is on the way up to levels not seen since before the financial crisis. Companies are signalling price increases and our forecast is that core inflation will surpass 2.5% in 2019. The Fed will likely stay on track with its rate hikes, which over time should push the US 10 year yield towards 3.5%, though not in straight line. **In the Euro Area, inflation risks are on the rise as well.** The share of companies screaming about difficulties in attracting labour is at a 30-year high and, as a consequence, wage growth has started to move up; a trend that should continue into 2019 and push up core inflation from today's low level. This will make it very hard for interest rates to drop markedly and help kick start the economies in the same way as in 2015/2016.

Read more about inflation risks in [Inflation at an inflection point](#).

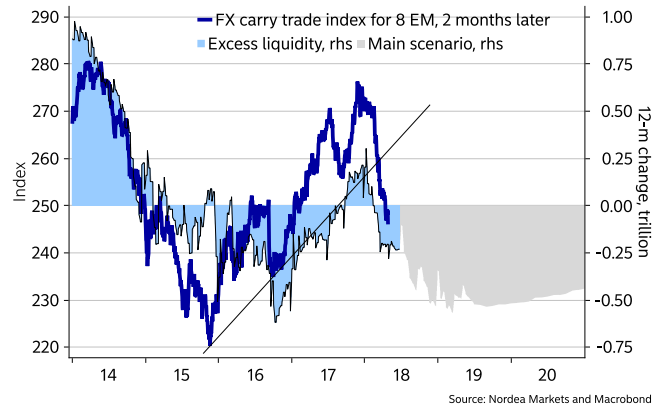
### Figure 4. Euro Area wages heading higher



Second, central banks were supplying massive amounts of liquidity in 2015-17 which helped stabilise markets and push up valuations in risky assets. That is not the case today. In 2017, central bank balance sheets increased by ~2 trillion USD, while the current plan is that they will decrease by ~0.8 trillion USD in 2019; a potentially huge difference for markets. **The drying up of liquidity has already started in the US and a growing number of canaries are dying in the process.** Since the last Nordea View, we can add the canaries: EM currencies and stock markets under severe pressure, credit spreads widening, and huge daily movements in Italian bonds on relatively known political risks. **These are in our mind early signs of slower global growth, higher cost of capital and deteriorating liquidity conditions.**

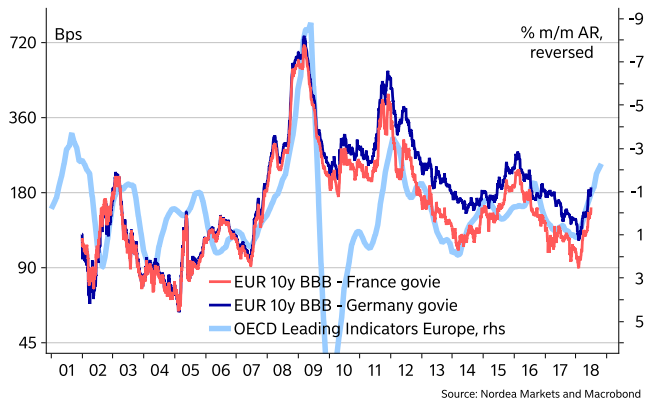
Read more about the liquidity outlook in [Central Bank Liquidity: Into the desert](#).

### Figure 5. Liquidity & EM pressures



Third, the upswing in the capex cycle has been a positive force in 2017 and 2018, and is one reason why we believe that a recession is not on the cards. **The increasing trade war noise is, however, becoming a risk. It is likely a relatively easy decision for companies to pause investment plans when the uncertainties about trade tariffs are increasing.** This is something that could expedite our grinding slowdown scenario and, if worse comes to worse, lead to a more pronounced recession risk.

### Figure 6. Macro outlook favours slightly negative stance on risky assets



**So, even though things look great on the surface today, and our main scenario is not a global recession, both the macro momentum and the increasing number of risks make us believe that risk/reward favours a continued negative stance towards risky assets.**

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.

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

## Equities: Estimates & Style

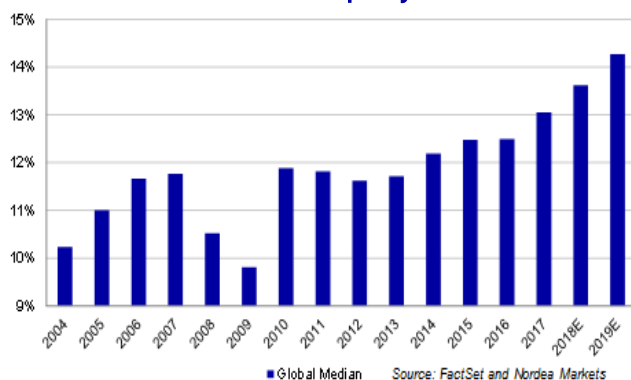
### The dollar should trigger lower S&P500 earnings forecasts

Despite the worst G10 economic surprise index since the summer of 2012, EPS estimates have continued to be revised higher as a result of the tax reform and positive outlook statements by corporates. This has been underpinning equity indices. However, we argue the broader analyst collective will be forced to nudge down global EPS estimates during the coming weeks.

We note that the general practice among sell-side analysts is to incorporate spot rates in medium-term forecasts. Since mid-April, the USD (DXY) has strengthened by roughly 5%. As 40-50% of S&P500 revenues stem from abroad, the unhedged translation effect on 2019-20 forecasts should be in the range of a negative 2-2.5%. We are therefore reasonably certain that our US revision indicator, which has been mostly positive since the spring of 2016 should turn negative ahead of or during the second quarter reporting season, i.e. in the coming weeks. Even though FX-implied estimate revisions are generally considered of lesser importance, this may still create some additional volatility. For Europe, we expect a slight tailwind, albeit the effect is counter-balanced by EM currency weakness and recent softening of business surveys.

We also reiterate our concern with regard to margin expectations for 2019, which we doubt will materialise on the back of slowing global growth, rising wage and other input costs. As we outlined in our May report, this concern is not isolated to a specific region, but rather includes North America, Europe and developed Asia. If we are proven right, this may also push up earnings uncertainty, which could be detrimental for the earnings momentum style as revisions around a more uncertain consensus should matter less for share price performance.

**Figure 7. High profit margin expectations – STOXX1800 median company**



## Mounting small cap risks

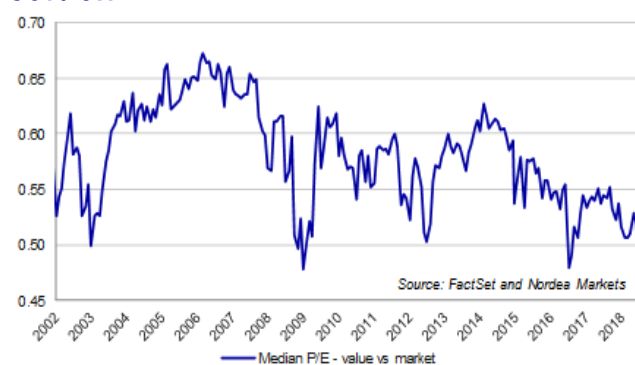
Despite our clear belief that the best absolute and relative ideas are found in the small cap space, we voice some concerns about small caps. This apprehension stems from our view of slowing global growth, rising cost pressure and worsening liquidity conditions (central banks), all while estimate and valuation risks are elevated.

Our analysis suggests that mid/small caps have a higher share of wage costs to total costs than larger caps, which points to a greater sensitivity to the rising wage pressure we foresee. We also argue that small caps are the most risky from a liquidity perspective and we would therefore raise the possibility that investors could reduce risks (small cap positions) as the Fed continues to shrink its balance sheet.

## Style conclusions

Despite continued value weakness we reiterate our belief that valuation should start to matter more for stock-pickers. We base this on our belief in interest rates grinding higher (higher discount factor should lead to multiple contraction and bring smaller valuation differences) and the relative appeal of our (“proprietary”) European mid cap value basket. This group of companies is now offering (median company) a 50% discount to the overall market. Historically, when our value basket has touched or fallen below half price versus the overall market (2003, 2009, summer of 2012 and 2016) investors have been richly awarded by employing a value bias in their stock-picking.

**Figure 8. European value basket on sale – 50% off**



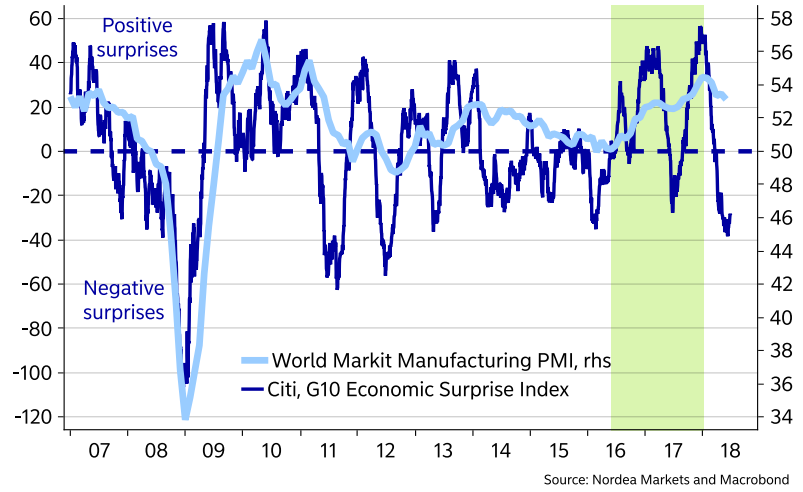
Unlike 2016, we also note that our value/quality hybrid (reasonably priced quality) is also trading close to record lows (~30% discount). We therefore argue that investors can play the potential value recovery either through outright buying cheap stocks or through screening for reasonably priced quality business.

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

# Chart Appendix

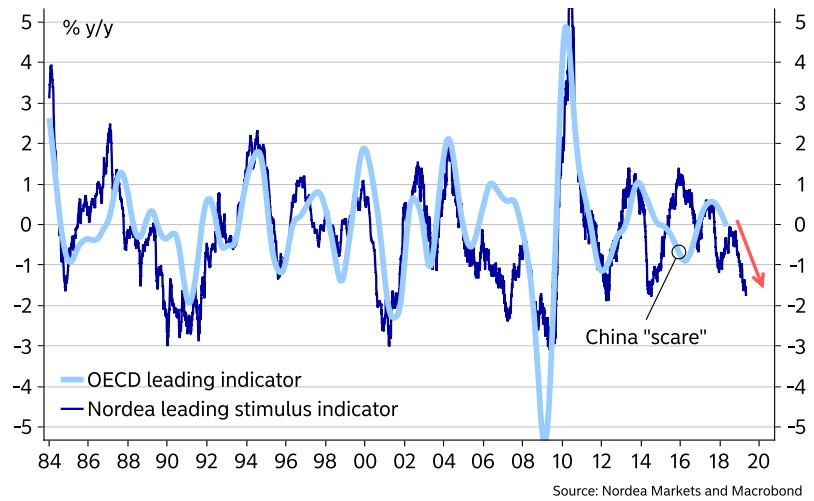
## The Macro Backdrop

**Figure 9. Global macro surprises turning negative**



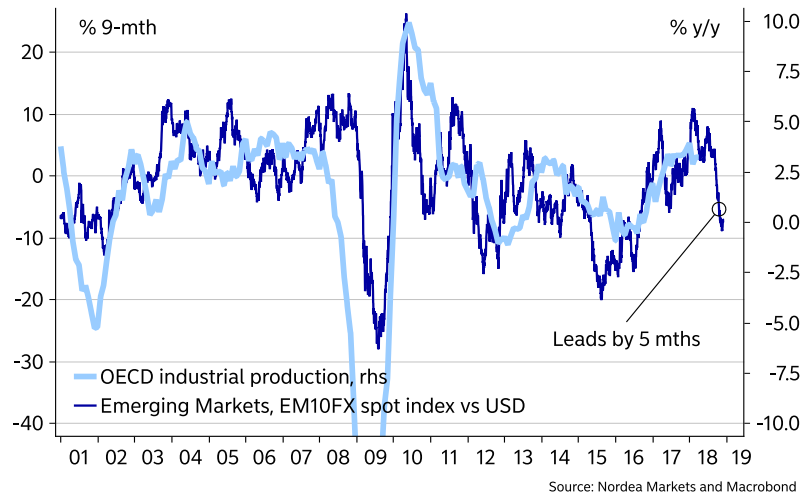
Macro surprises have turned negative and we expect that to continue into 2019, similar to the late 2014 to early 2016 period

**Figure 10. Stimulus effects are ebbing out**



Rising interest rates and oil prices have started to take their toll on leading indicators; that trend should continue at least all 2018

**Figure 11. EM currencies send slowdown signal**



Stress within emerging markets often is an early sign of a global manufacturing slowdown

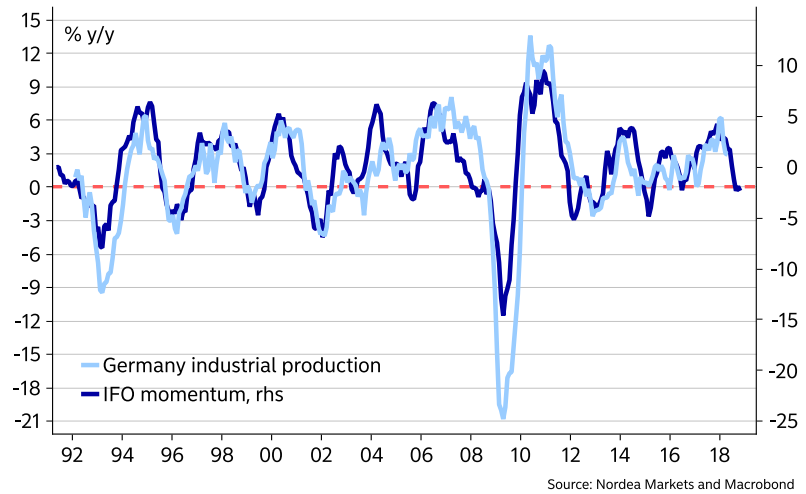
**Figure 12. Sweden is a leading indicator for Euro Area**

Sweden is a small, open export-dependent economy that picks up on global demand shifts faster than the Euro Area



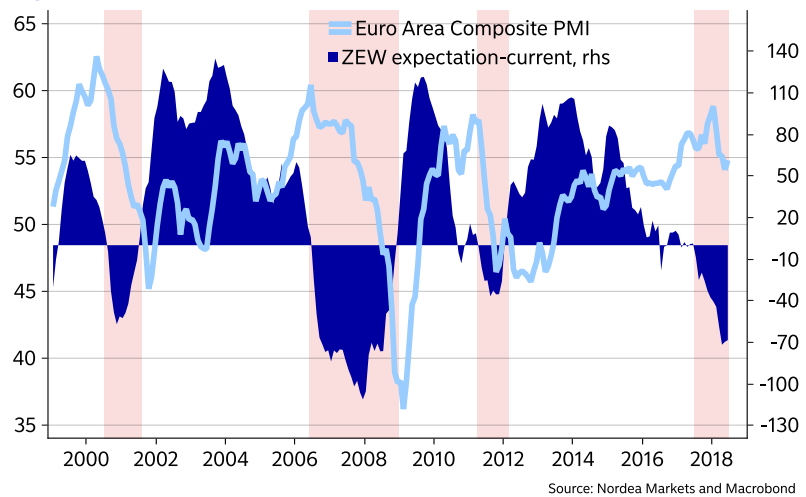
**Figure 13. Industrial production heading for 0% growth**

Momentum in many Euro Area leading indicators has already turned negative; the IFO survey momentum points to 0% growth for industrial production



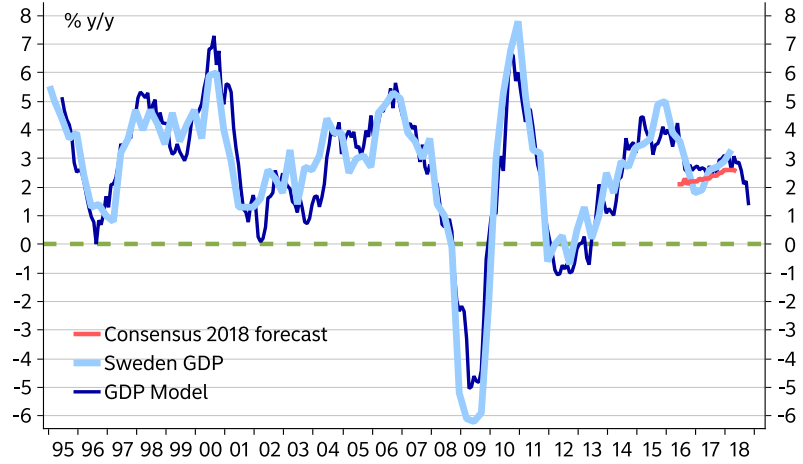
**Figure 14. Expect further drop in Euro Area business surveys**

The expectation components in various surveys are undershooting current conditions - usually a warning flag



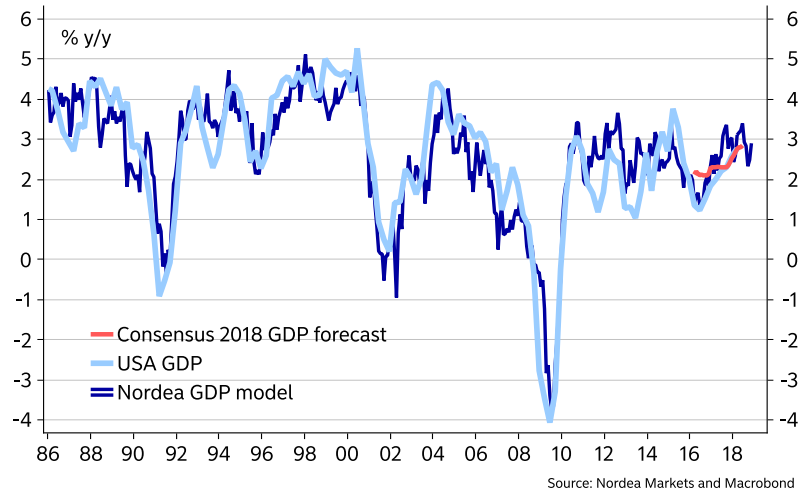
**Figure 15. Swedish growth slowing**

Our leading Swedish GDP indicator points to a slowdown during the fall.



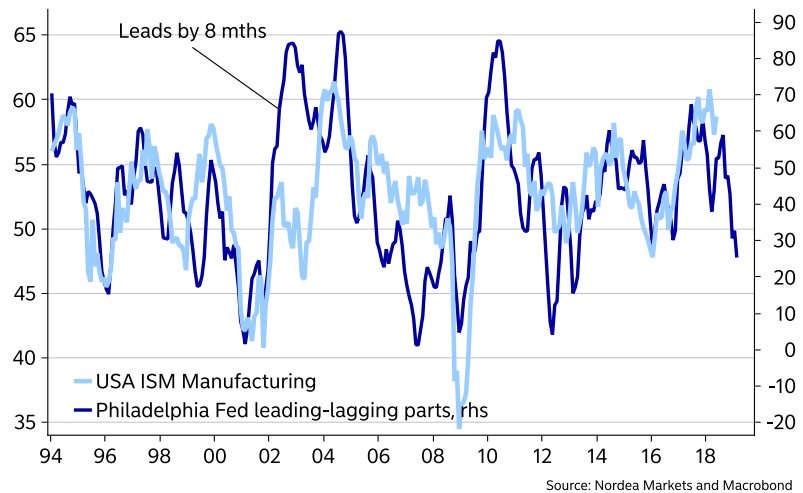
**Figure 16. Tax cuts helping US growth**

The Trump tax reform makes the US look better than Europe currently, and growth in Q2 looks strong



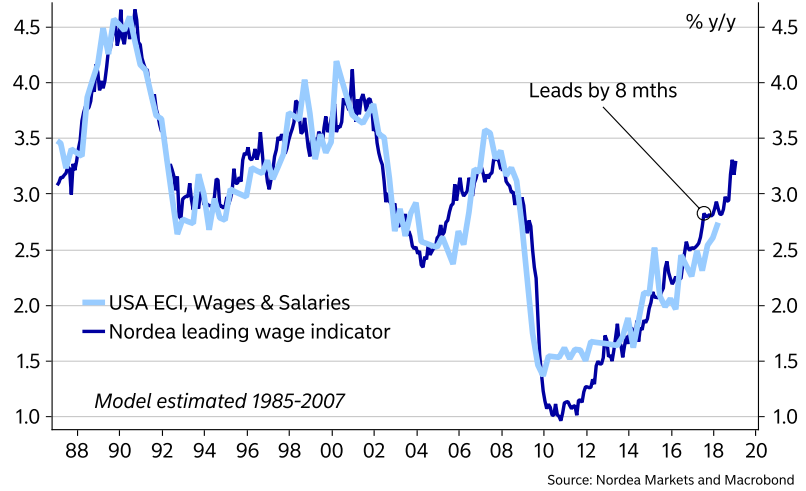
**Figure 17. Leading parts of US surveys pointing down**

ISM should start to trend down during the late summer/autumn; leading parts are pointing to ISM close to 50 by early 2019



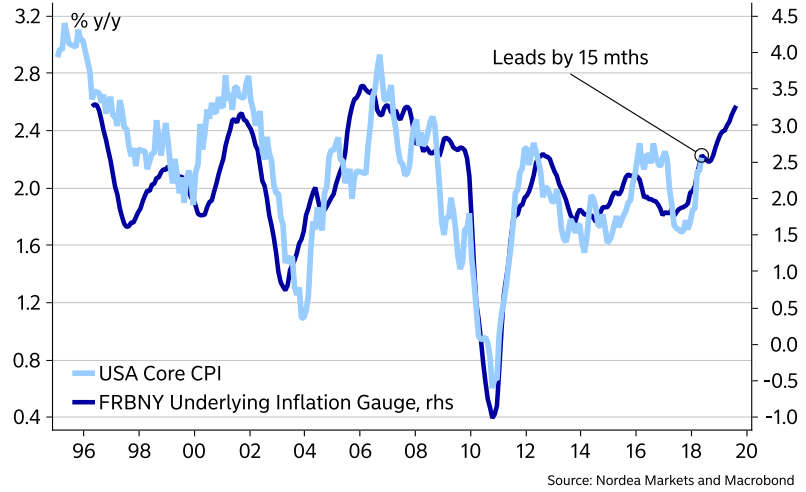
US wage increases should be back at more normal levels in 2019; labour shortages are increasing

**Figure 18. US wage increase to rise further**



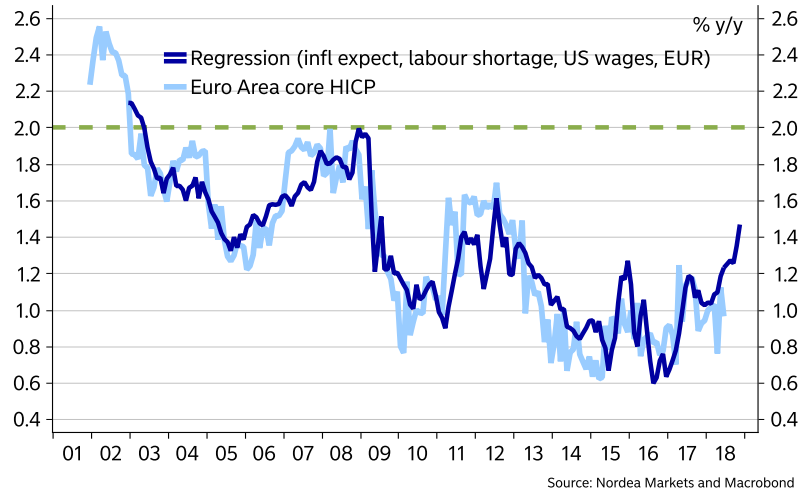
Inflation indicators in the US are broadly at a point we haven't seen in 10 years - Fed will likely continue to hike

**Figure 19. US core inflation heading above 2.5% 2019**



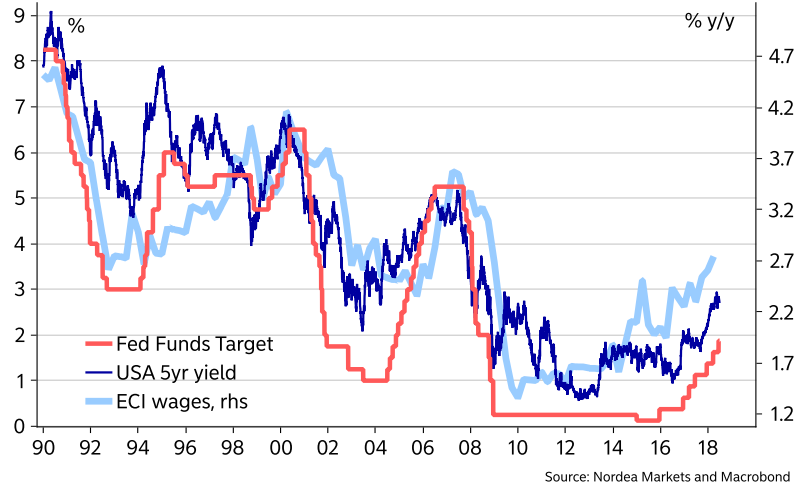
The inflation trend is turning up also in Euro Area, but from a lower level; core inflation should reach at least 1.5% in 2019

**Figure 20. Euro Area core inflation will also rise**



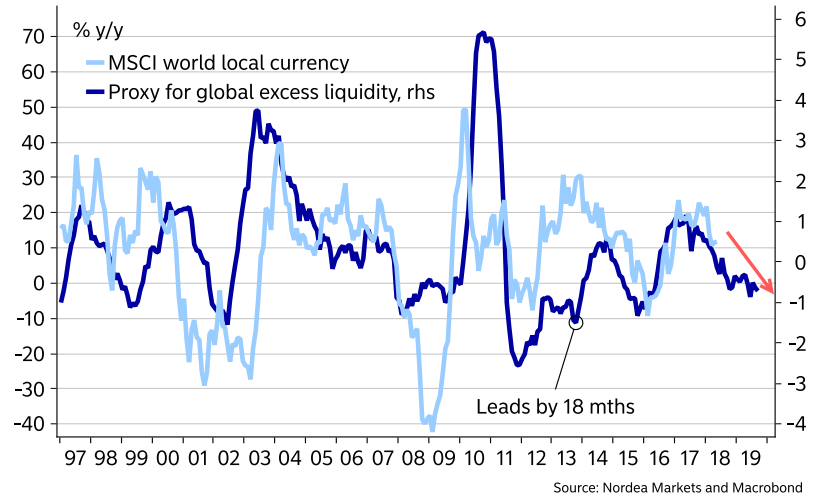
**Figure 21. Inflation and interest rates move up together**

Interest rates likely to be on a medium term rising trend since inflation is moving higher



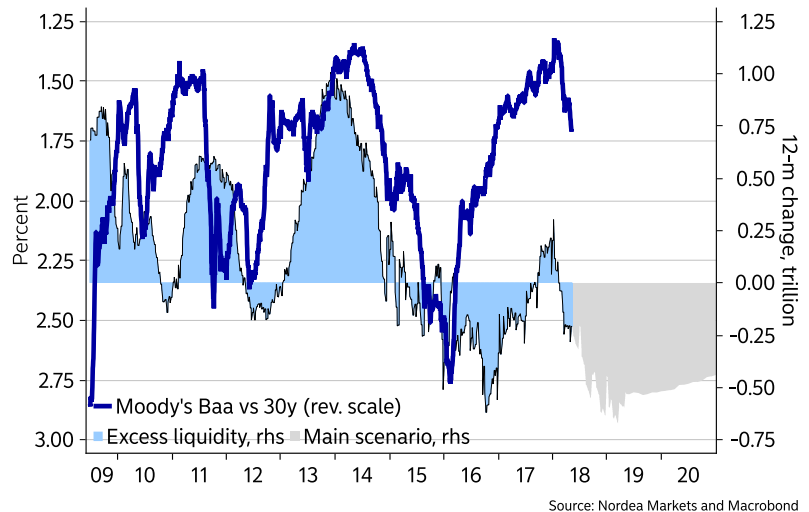
**Figure 22. Liquidity conditions are deteriorating**

Central banks are not printing as much money as before; soon balance sheets will be reduced  
Tightening liquidity conditions usually are detrimental to risky assets



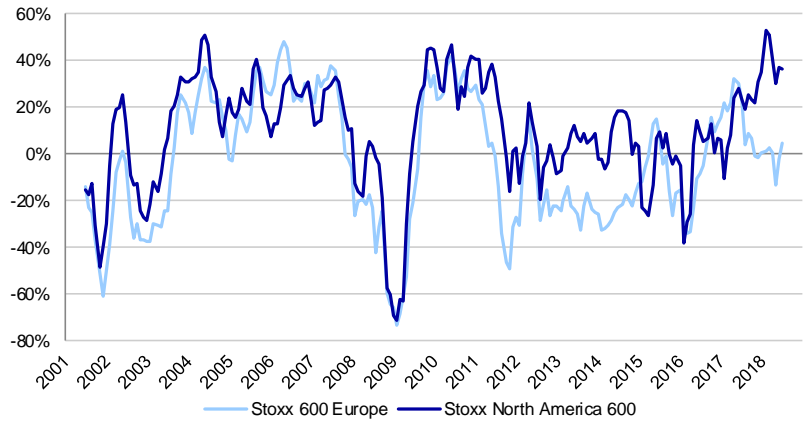
**Figure 23. Credit spreads widen as liquidity is drained**

EM problems, credit spreads widening, crypto currency crash and higher volatility have all coincided with the Fed starting to un-print money.



## Equities: Estimates, Small Caps & Style

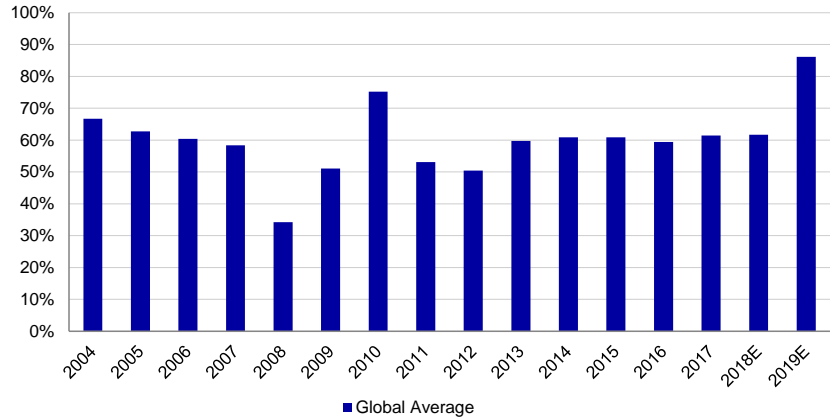
Figure 24. Our EPS revision indicators



Source: FactSet and Nordea estimates

We expect to see our US revision indicator fall as analysts pencil the USD strength into their forecasts

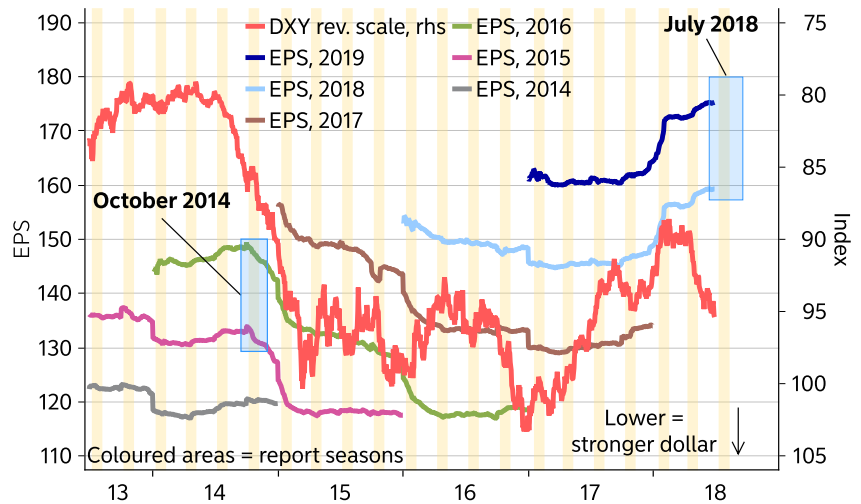
Figure 25. Share of STOXX 1800 companies forecast to improve margins



Source: FactSet and Nordea estimates

We cannot envisage a scenario where 87% of STOXX 1800 would improve margins in 2019 (vs 2018E), especially given our belief in slowing growth and rising cost pressure

Figure 26. US earnings revisions and USD

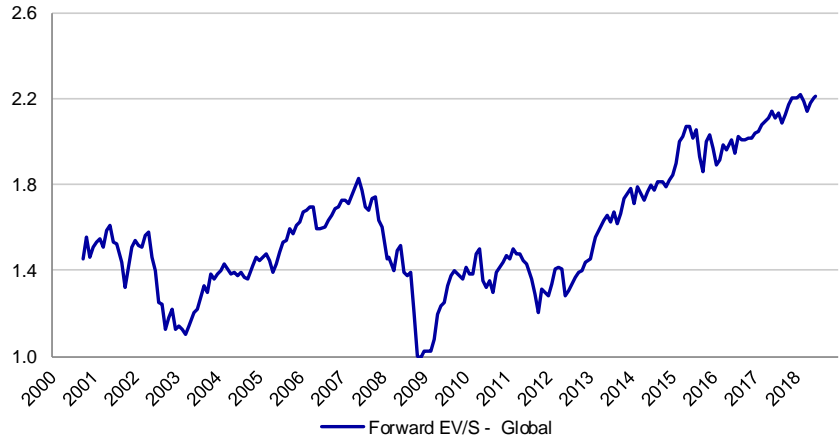


Source: Nordea Markets and Macrobond

The USD has strengthened 5% since mid-April; which should lead to negative estimate revisions in Q2

EV/sales in uncharted territory and thus sensitive to margin disappointments

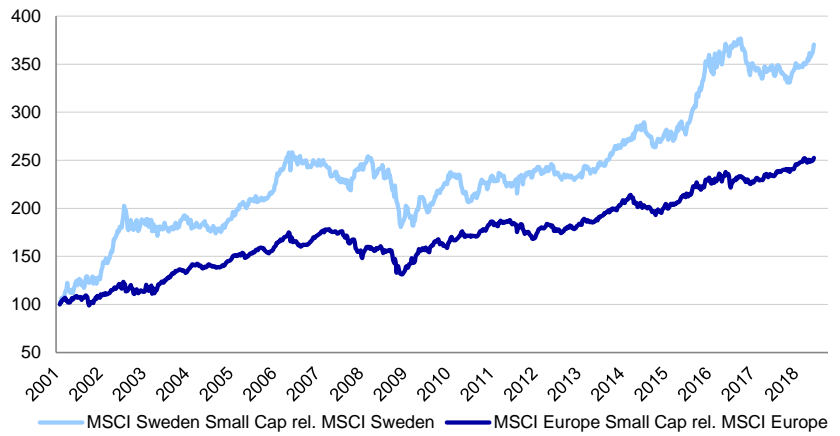
**Figure 27. Median EV/Sales – STOXX global 1800**



Source: FactSet and Nordea estimates

Small cap outperformance has been amazing: beware of liquidity risks and greater sensitivity to rising wage costs

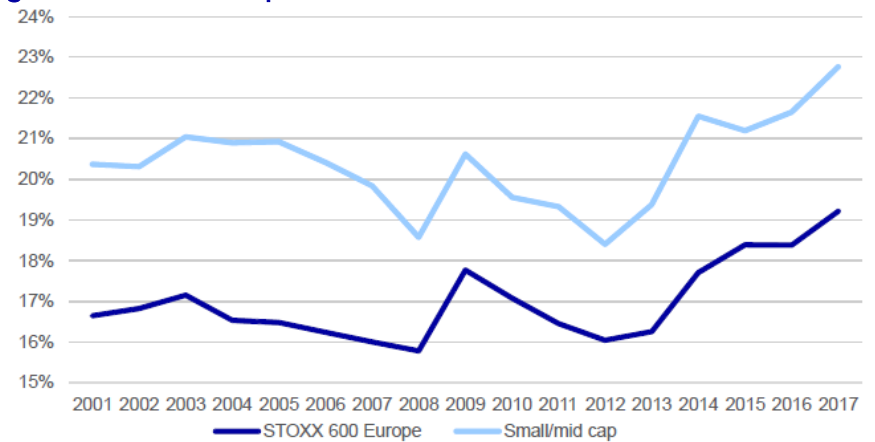
**Figure 28. Small Caps performance – Sweden & Europe**



Source: FactSet and Nordea estimates

In Europe small caps have higher share of wage costs as a proportion of total costs

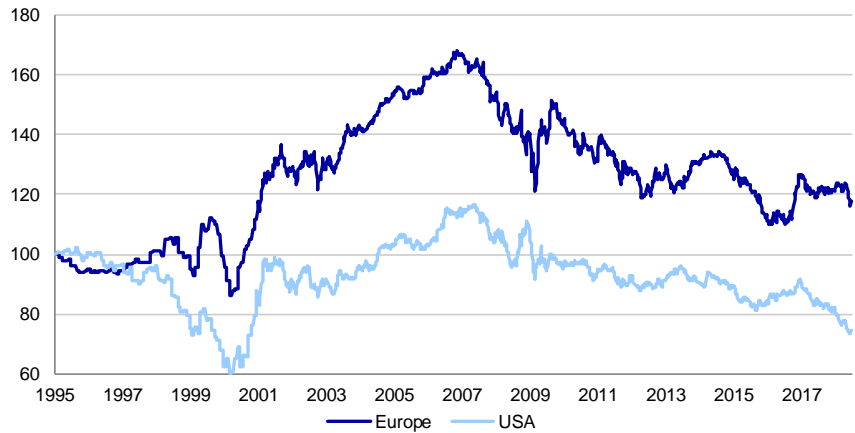
**Figure 29. Labour expenses to total costs**



Source: FactSet and Nordea Markets

**Figure 30. Relative performance (TSR) of MSCI Value vs Growth**

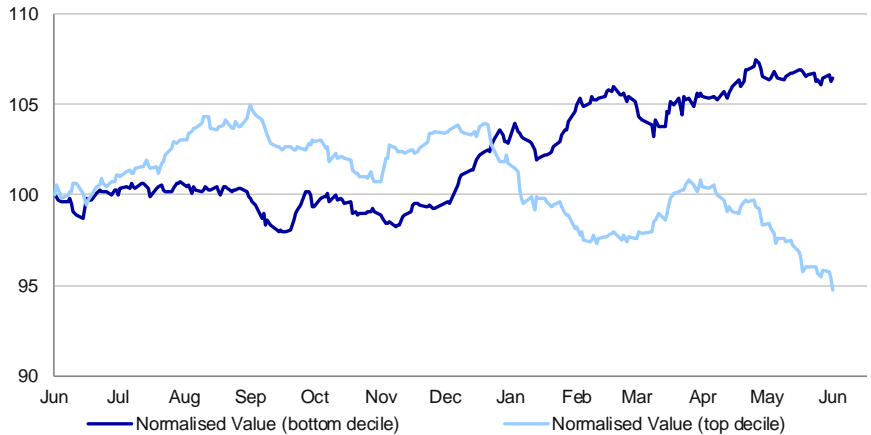
Value stocks have continued to slide



Source: FactSet and Nordea Markets

**Figure 31. Expensive versus cheap stocks**

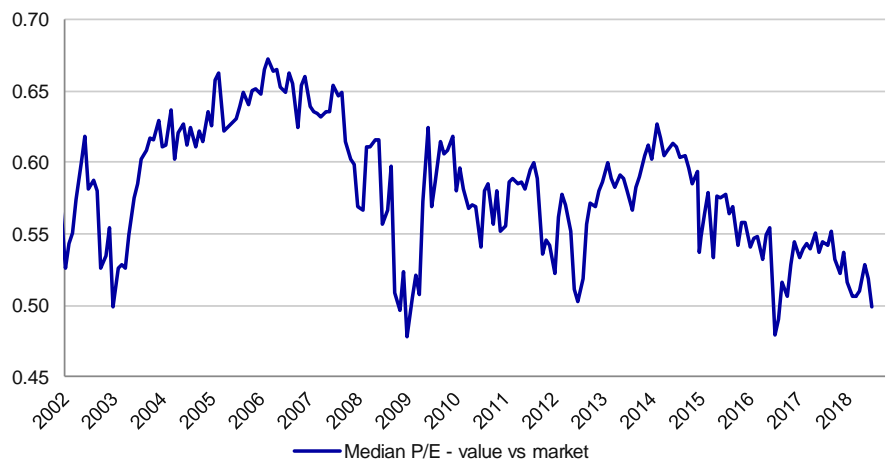
Since December we can demonstrate that expensive stocks have outperformed cheap stocks to the tune of 15%



Source: FactSet and Nordea Markets

**Figure 32. European value basket on sale – 50% off**

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



Source: FactSet and Nordea Markets

This P/E Matrix illustrates that greater valuation differences are warranted when you apply a lower cost of capital

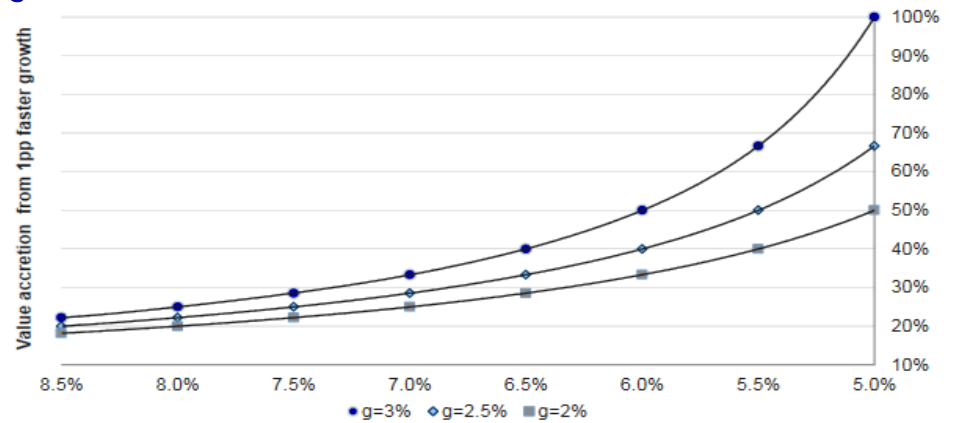
**Figure 33. Valuation, CoE and growth according to Gordon**

(B) (ppm)g	Discount Factor (Cost of equity)								
	9.0%	8.5%	8.0%	7.5%	7.0%	6.5%	6.0%	5.5%	5.0%
3.5%	13.6	15.0	16.7	18.8	21.4	25.0	30.0	37.5	50.0
3.0%	12.5	13.6	15.0	16.7	18.8	21.4	25.0	30.0	37.5
2.5%	11.5	12.5	13.6	15.0	16.7	18.8	21.4	25.0	30.0
2.0%	10.7	11.5	12.5	13.6	15.0	16.7	18.8	21.4	25.0
1.5%	10.0	10.7	11.5	12.5	13.6	15.0	16.7	18.8	21.4

Source: FactSet and Nordea Markets

Rising cost of capital (following higher interest rates) should, in theory, bring about multiple contraction and compression (smaller valuation differences between value and growth stocks)

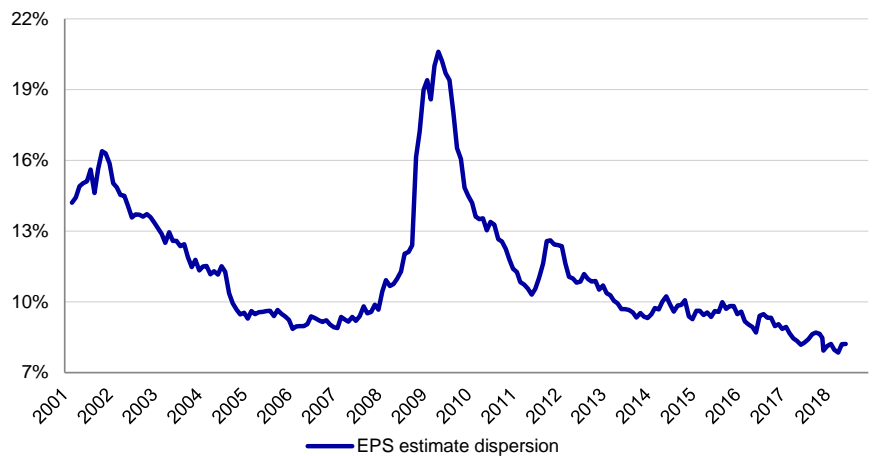
**Figure 34. The lower discount rate the higher premium for growth**



Source: FactSet and Nordea Markets

The analyst collective is unusually certain about EPS development for the coming 12 months; rising dispersion has historically been detrimental to a revision-based momentum strategy (while falling dispersion has been positive)

**Figure 35. Analyst earnings estimate dispersion**



Source: FactSet and Nordea Markets

#### DISCLAIMER

Nordea Markets is the commercial name for Nordea's international capital markets operation.

The information provided herein is intended for background information only and for the sole use of the intended recipient. The views and other information provided herein are the current views of Nordea Markets as of the date of this document and are subject to change without notice. This notice is not an exhaustive description of the described product or the risks related to it, and it should not be relied on as such, nor is it a substitute for the judgement of the recipient.

This report should be considered marketing material as the macro and FX sections not have been produced in accordance with the regulations designed to promote the independence of investment research and it is not subject to any legal prohibition on dealing ahead of the dissemination of the report.

The information provided herein is not intended to constitute and does not constitute investment advice nor is the information intended as an offer or solicitation for the purchase or sale of any financial instrument. The information contained herein has no regard to the specific investment objectives, the financial situation or particular needs of any particular recipient. Relevant and specific professional advice should always be obtained before making any investment or credit decision. It is important to note that past performance is not indicative of future results.