

# Nordea View

## May 2019: Priced for perfection

The hunt for yield has been extreme in 2019 after central banks turned more dovish, pushing profit-neutral equity market valuations back towards multi-year highs. With indebtedness strongly on the rise we caution against solely depending on the P/E gauge. We note that other metrics like market cap/GDP and trailing free cash flow yields would rather suggest an even worse risk/reward outlook for US equities. Macro surprises have at the same time remained on the negative side, in line with our long-standing view. We still find that the risks of a marked earnings recession, from both slower growth and higher wage costs, are much greater than analysts and the equity markets seem to believe. We are also becoming increasingly concerned about the medium-term earnings growth outlook beyond this year. All in all, even though we note green shoots for 2020, we stick to our negative market view.

### Macro strategy: The great divide

Our macro view has been more or less spot on. The global slowdown has continued, macro surprises have been negative and companies are signalling growing wage cost concerns, all indicating overly high earnings expectations. There is a record divergence between macro surprises and equity performance. The trust in central banks' capabilities to avert a major slowdown has never been greater. Central banks have signalled an asymmetric reaction function, where negative surprises are more likely to trigger easier policy than positive ones are to lead to tightening. However, we still expect an earnings recession, which should challenge equity market valuations and the tight credit spreads. An earnings recession would put a dent in the market's current blind faith in the ability of central bankers.

### Equities: US richer than meets the P/E eye

We conclude that with gearing in the US having risen more than 50% since 2013 investors should not solely rely on P/E. Most other valuation gauges we have analysed suggest even worse risk/reward for US equities. One of these is the widening gap between free cash flow and earnings. Reported free cash flow yields stand just north of 3% for the median US large cap, an 18-year low, which also begs the question of the durability of the recent rally. As we see muted scope for earnings to surprise positively, rather the opposite, both in the short and medium term, the odds of further US outperformance look bleak to us.

### Equities: Medium-term earnings outlook scrutinised

Looking beyond the downward revisions that we foresee for 2019, we are becoming concerned about the medium-term outlook for earnings growth. There are a number of factors that cannot get much better, such as funding costs, corporate tax rates, buybacks, relocation of production, profit margins and depreciation costs. Furthermore, some tailwinds are set to turn into headwinds, such as those from demographics and labour costs. Productivity improvements may save the day, but if these materialise, we argue that we would first see less buyback help for EPS growth and rising depreciation costs from rising capex/sales ratios, delaying a marked earnings recovery even further.

### How to invest: Cross-asset conclusions

Risky assets are priced for perfection, which is not what we see in our crystal ball. We prefer European to US equities, a defensive sector positioning and an unusually high cash allocation. Our value bias has been wrong so far in 2019, but we are convinced that renewed uncertainty will bring problems at the expensive end of the equity market. The bond market should continue to discount the risk of a few rate cuts in the US, and we would reduce credit exposure.

#### Nordea Markets - Analysts

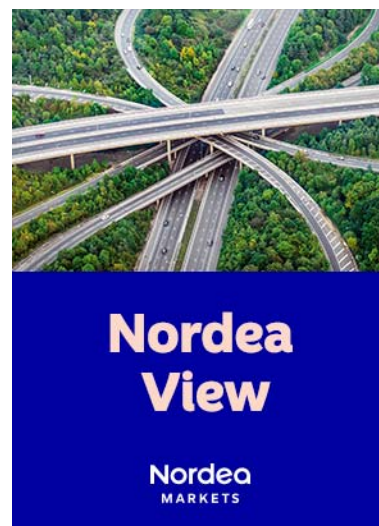
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#### GEARING APPROACHING HIGHS



Source: FactSet and Nordea

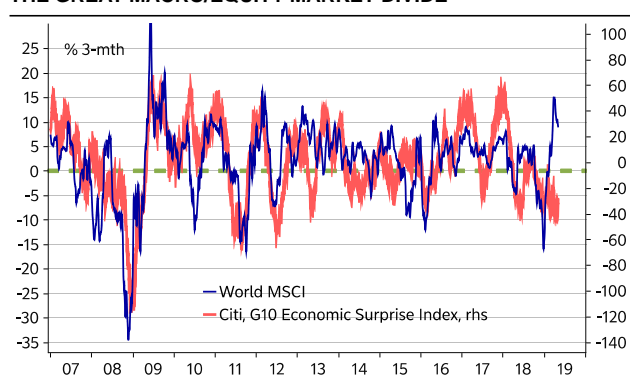
# Macro strategy: The great divide

The hunt for yield has been extreme so far in 2019, pushing profit neutral equity market valuations back towards all-time highs. Macro surprises have at the same time remained on the negative side, in line with our long-standing view. We still find that the risks for a marked earnings recession, from both slower growth and higher wage costs, are much greater than analysts and the equity markets seem to believe. So, even though we note green shoots for 2020, we stick to a defensive market view.

We are perplexed by the record divergence between macro surprises and equities

Our macro view has been more or less spot on – the global slowdown has continued, macro surprises have been overwhelmingly negative and companies have signalled a growing anxiety about wage costs, all indicating overly high profit-margin and EPS expectations. At the same time, our negative conclusion for the equity market, which was 100% correct in late 2018, has this year been totally wrong. Profit-neutral valuation measures are almost back to all-time highs. Investors seem dead-set in their search for yield – everyone wants to dance with TINA, it seems. Moreover, equity analysts have stayed firm in their belief in a V-shaped profit recovery, with Q2 2019 EPS growth for S&P 500 expected at 11% q/q, followed by a continued upward trend. The trust in central banks' and Trump's capabilities to turn a slowdown around has never been greater. This has meant a record divergence between macro surprises and equity market performance, one basically never seen before in modern times. We are honestly more than perplexed about this new market phenomenon.

THE GREAT MACRO/EQUITY MARKET DIVIDE



Source: Macrobond and Nordea

An earnings recession is still on the cards

We are still firm believers in the earnings recession scenario that we mapped out last summer, but whether that will matter for the equity market has become an even bigger question mark. From an earnings outlook, both short-term and long-term, and a risk complacency perspective, we find it to be poor risk/reward to chase this rally. Historically, equity markets have not been able to look beyond earnings recessions this early in the downgrade cycle. When downgrades to negative EPS growth have appeared in the past, there has been another leg down for the market.

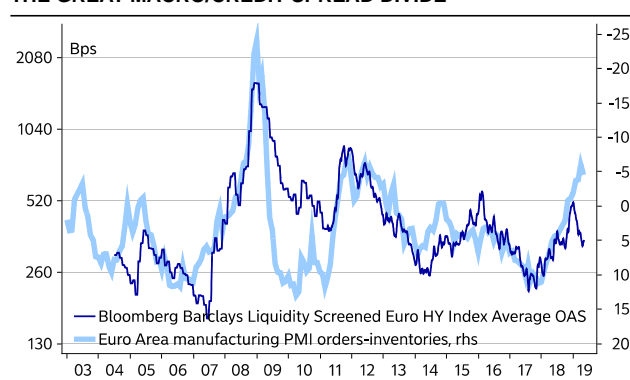
Are we underestimating the effects of central bank manipulations and buybacks?

Or, is our analysis stuck in old, obsolete truths and we are missing that the new era of central bank manipulations is buying investors' time before a more severe market meltdown at a later stage? Central bankers are not gods. They are basically as clueless as the rest of us, but they do have the money-printing power to build bubbles, and that might very well be what they will be doing. On top of that, are we underestimating the effects of another type of price insensitive QE programme, ie the huge equity buybacks taking place especially in the US? So far it seems so, but let us revisit our macro roadmap, because, at the end of the day, we firmly believe that macro will determine the market outcome.

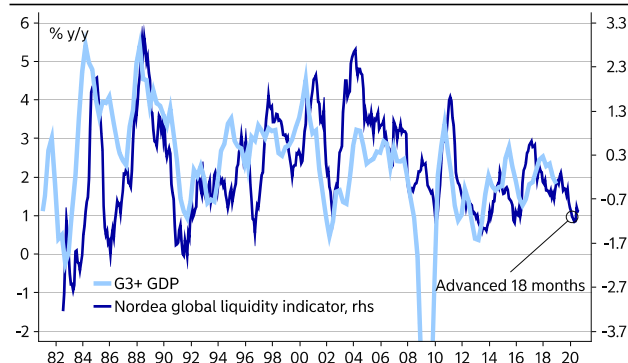
Interest rates have moved in line with the slowdown scenario

We start by noting that not all market indicators have moved against our 2019 growth slowdown scenario. Interest rates have fallen as an effect of growth worries, thereby helping to motivate P/E multiple expansions. Also, scratching the surface of the equity markets, the rally has not been confirmed by any obvious cyclicals outperformance, and small caps are still struggling. Last summer, those were both indications that the overall equity rally was running out of steam.

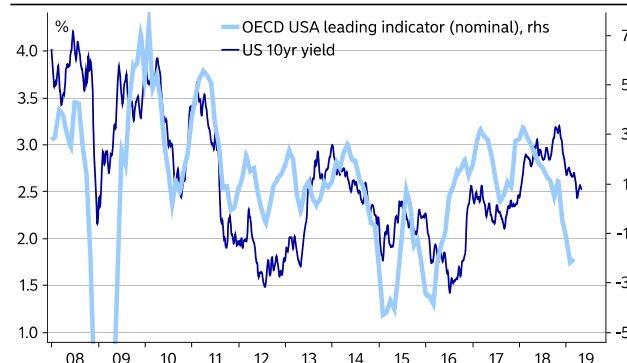
THE GREAT MACRO/CREDIT SPREAD DIVIDE



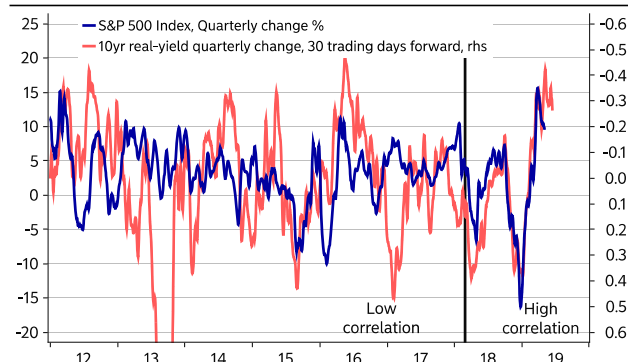
Source: Macrobond, Bloomberg and Nordea

**GLOBAL LIQUIDITY INDICATES SLOWDOWN FOR ALL OF 2019**

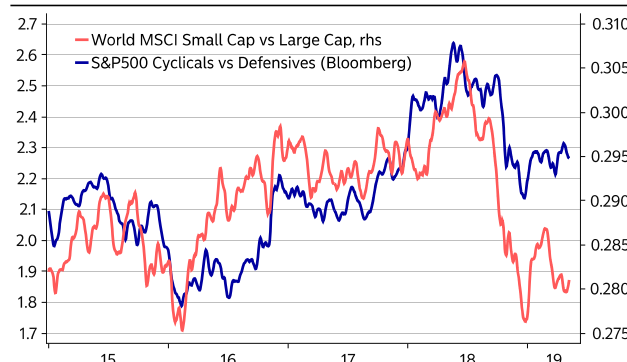
Source: Macrobond and Nordea

**INTEREST RATES HAVE REACTED TO SLOWER GROWTH**

Source: Macrobond and Nordea

**LOWER REAL RATES HAVE HELPED EQUITIES**

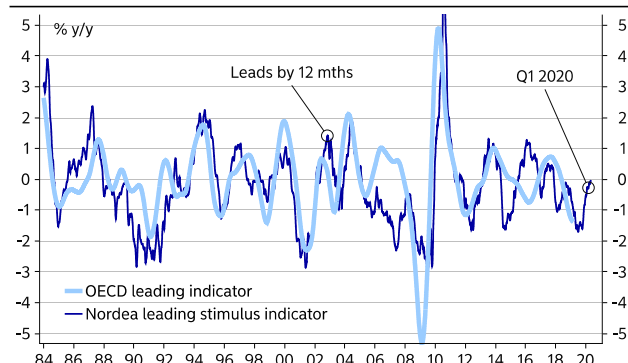
Source: Macrobond and Nordea

**SMALL CAPS / CYCLICALS NOT FULLY ON BOARD THE RALLY**

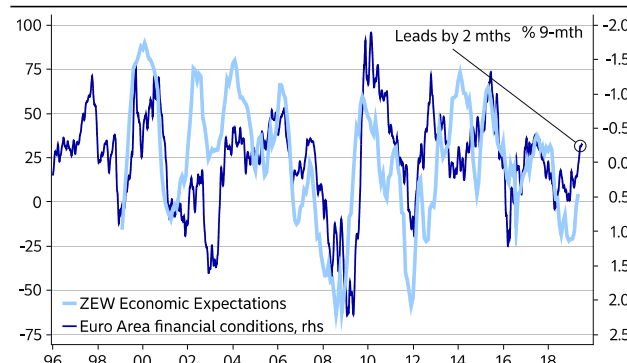
Source: Macrobond, Bloomberg and Nordea

Global manufacturing outlook should improve in 2020

There are admittedly some macro bright spots, despite the G10 economic surprise index being deep in negative territory. Long-time readers of Nordea View know that our main scenario has been that the global macro environment should improve in 2020, and we continue to see green shoots confirming this view. We find that movements in interest rates are, over time, clearly the most important stimulus force. Rising yields from mid-2016 to mid-2018 and deteriorating central bank liquidity formed the base of the global slowdown scenario that we have embraced since late 2017. Now, falling interest rates over the last eight months have resulted in an improvement in our leading stimulus indicator, pointing to a global manufacturing improvement in 2020.

**THE MANUFACTURING OUTLOOK FOR 2020 IS IMPROVING**

Source: Macrobond and Nordea

**EASIER FINANCIAL CONDITIONS ARE HELPING SENTIMENT**

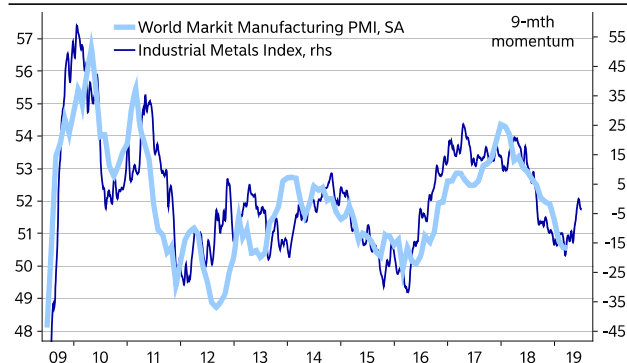
Source: Macrobond and Nordea

Growth expectations have been cut in the Euro Area

In the shorter term, easier financial conditions (rates, credit spreads, FX, equities) should also help some sentiment indicators, particularly in regions with a strong manufacturing presence. At least analysts are becoming less negative, as seen in the ZEW indicator. Industrial metal prices have been moving sideways, which could be an indication of the worst for manufacturing being over, but it could also be the effect of more technical supply reasons. We note that our leading GDP indicator for the Euro area has started to improve, although it points to weakness for the majority of 2019. Economists have also come further in revising down growth prospects for Europe than

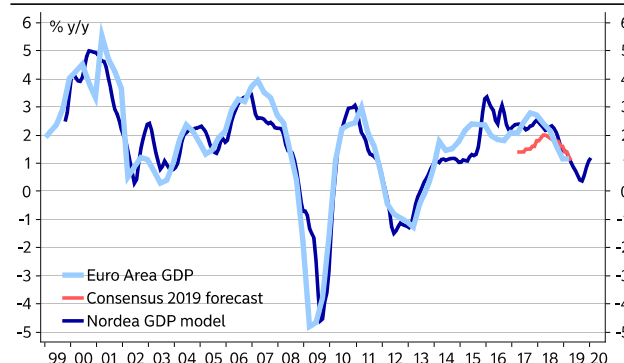
for the US, so the divergence between our GDP model and the consensus forecast is now quite small.

#### INDUSTRIAL METAL PRICES HAVE STOPPED FALLING



Source: Macrobond and Nordea

#### OUR EURO AREA LEADING INDICATOR HAS BOTTOMED



Source: Macrobond and Nordea

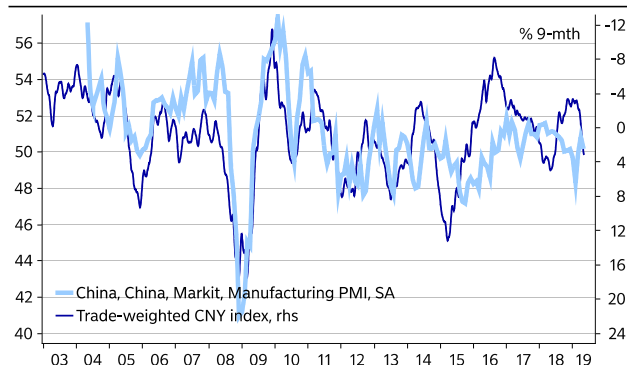
Of course, once a trade deal is in place with China, if Trump's focus shifts to aggressively targeting EU, then the "fishhooks" in European leading indicators might turn out to be a mirage – but that is a story for another day.

Will the Asian green shoots survive the new tariff threats?

The authorities in China have continued to promise to support the economy through tax cuts etc, and it seems that Chinese liquidity/credit measures are reaching the bottom, albeit from a very weak starting point. The manufacturing PMI has rebounded, especially the import component, and export numbers out of neighbouring countries show a less negative tilt. Until this week, Chinese and US representatives continued to "sweet talk" the upcoming trade deal, but with Trump's new tariff threat we will see what happens. We will also see if the financial conditions driving Asian green shoots can weather renewed trade worries.

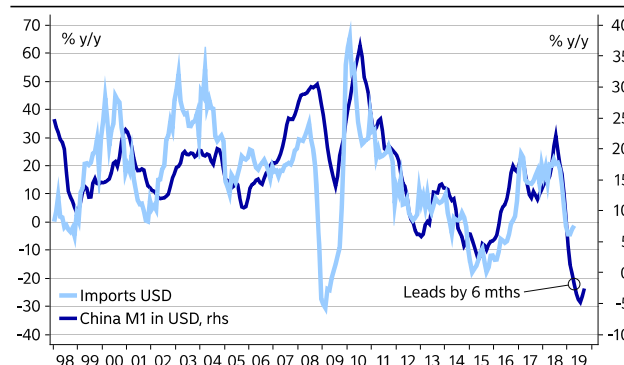
It is no surprise that risky assets have boomed when the future looks so bright that we will always need sunglasses. What then prevents us from spinning this more bullish economic story, more than in general being old and grumpy?

#### CHINESE PMI REACTING TO STIMULUS PROMISES



Source: Macrobond and Nordea

#### CHINESE M1 GROWTH REBOUNDS FROM VERY LOW LEVEL



Source: Macrobond and Nordea

Still a number of macro reasons to be cautious

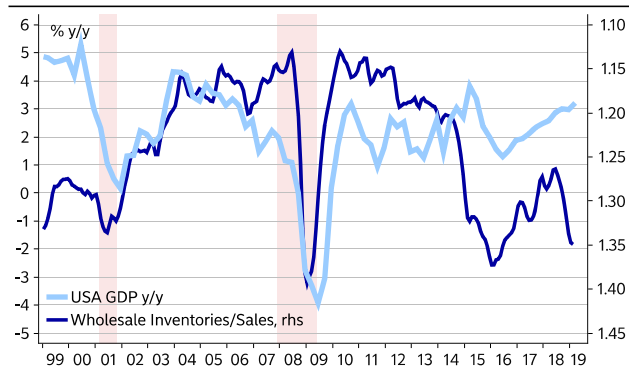
The fundamental macro reasons we see backing a slowdown are a quite large inventory overhang, our broad leading GDP indicator for the US still pointing much lower than consensus forecasts, and the historical time lags between monetary policy/credit cycles and the economy. To this we can add rising wage costs and a high risk of a marked earnings recession that currently is not in equity analyst forecasts for the remainder of 2019 or 2020. Also, we find it slightly difficult to use easier financial conditions and sunshine in early 2019 to predict continued easier financial conditions and even more sunshine for the rest of the year.

Inventories could become a serious problem

In the US, inventory-to-sales ratios have been surged over the last six months. For the past three quarters, US GDP growth has averaged 3%, but rising inventories explain a full percentage point of that growth, so demand has been weaker than meets the eye. In the Euro area, after a weak second half of 2018, industrial production increased in

early 2019. Neither business surveys nor orders justify that production increase, so it seems to us that it is ending up in inventories. That conclusion is confirmed by looking at stocks of finished goods in the PMI, which is at its highest level since the financial crisis. In the Nordics, inventory-to-sales for the 150 biggest companies were at an all-time high in 2018. Increasing inventories is fine in the earlier part of the business cycle, but late-cycle it often becomes a quite large nuisance.

#### RISING INVENTORIES A POTENTIAL US PROBLEM



Source: Macrobond and Nordea

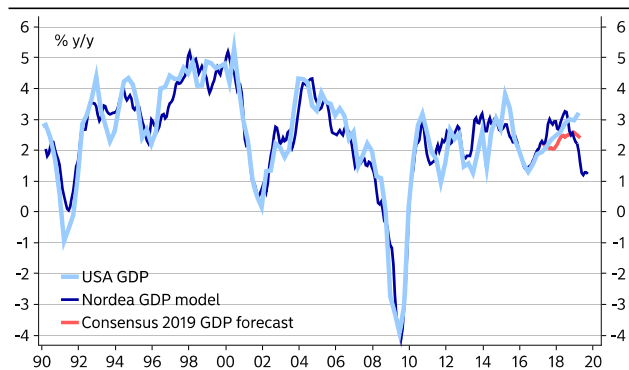
Domestic demand in the USA has already slowed

Compared with the 2015-16 oil/China-induced slowdown, the weak parts of our leading GDP indicator today are more domestic. On the surface, Q1 US GDP growth was strong, at 3.2% annualised. However, final sales to domestic purchasers was a paltry 1.4% and the two-quarter average was the weakest since 2013. The domestic slowdown we have been expecting is starting to happen, even though it currently is masked in overall GDP by inventories and strange import numbers. Consensus GDP forecasts, and thereby equity analysts' sales forecasts, for 2019-20 look way too high if we are to trust our models. Thus, we envisage a period ahead when negative growth surprises become more prominent in the US than in the Euro area.

ISM should continue to fall

We still believe that the US economy will continue to suffer from lagged effects from the rate hikes of 2017-18. The historical time lags between interest rates and the ISM indicate further downside, which we see being corroborated by a look at leading versus lagging parts of various business surveys. Order intake is slowing at the same time as inventories are high, so we expect the ISM to continue to fall to 50 or below later this year.

#### CONSENSUS US GDP FORECASTS LOOK WAY TOO HIGH

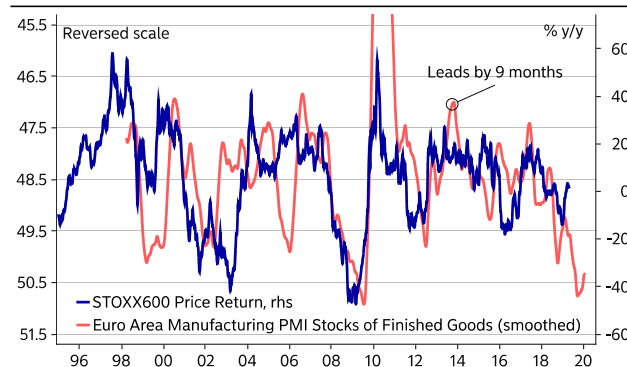


Source: Macrobond and Nordea

Long time lags between central bank measures and effects on economy

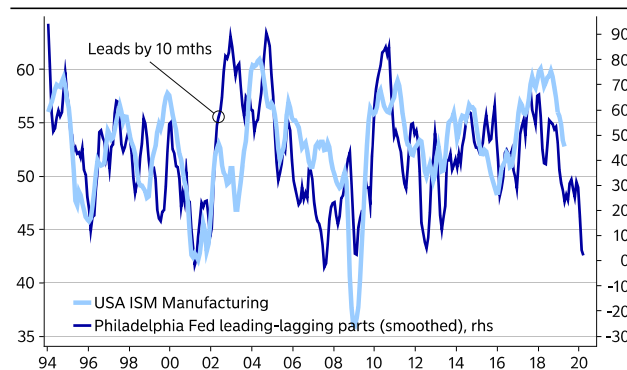
We have in previous editions of Nordea View written extensively about the rather long time lags between shifts in global monetary policy and the economy, so we will not dwell too much on it here. However, it is an important reason for our continuously defensive view on risky assets. It is clear to us that central banks have gone into pause mode, but so far the effects on the ever-important narrow money supply measures have been small and the growth rates are still at dangerously low single digits. Historically, it has taken about a year from turnarounds in money supply until equity markets have found more solid footing. That was the case at the market bottom in 2016, and we still have a long way to go before central banks are near those stimulus levels. Equity markets currently do not seem to agree with that conclusion.

#### EURO-AREA INVENTORIES HIGHEST SINCE FINANCIAL CRISIS



Source: Macrobond and Nordea

#### ISM SHOULD DROP AT LEAST TO 50

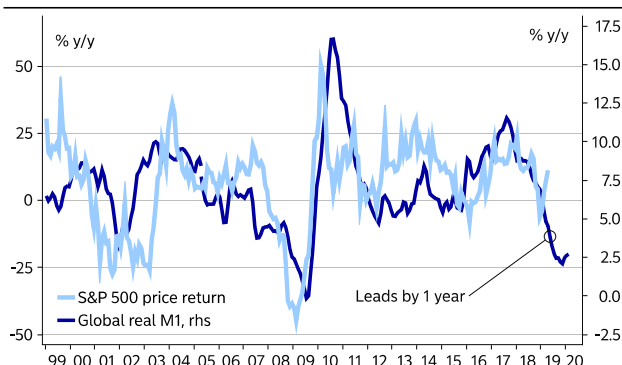


Source: Macrobond and Nordea



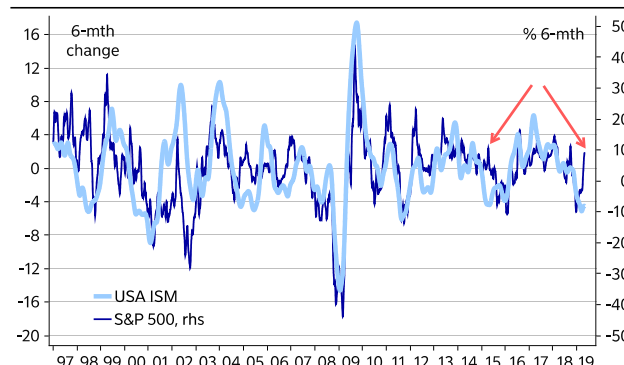
Interestingly, we had a similar divergence between macro and the equity market back in 2015, before the final leg down in 2016. The ISM and other leading indicators warned about a slowdown that the equity market disregarded until earnings revisions turned more markedly negative. That is still what we expect to happen again, in 2019.

#### MONETARY POLICY WORKS WITH A LONG LAG



Source: Macrobond and Nordea

#### WILL THE EQUITY MARKET GET DISAPPOINTED, AS IN 2016?



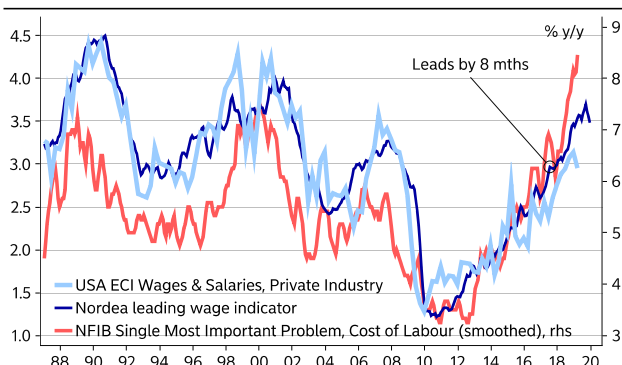
Source: Macrobond and Nordea

Slower sales and higher wage costs indicate risk of marked earnings recession

In our scenario, companies get squeezed by both slower sales growth and higher wage costs, which we think analysts currently have incorporated in EPS forecasts only to a very small extent. Companies are already complaining loudly about labour costs, and those complaints should stay intact for the rest of 2019. Unemployment is low and should stay so for a while. Our wage models point to wage growth in the US continuing higher all through this year. This should pressure profit margins and also make it harder for the Fed to cave in to market demands for rate cuts (more on central banks later in the report). In the Euro area, complaints about labour shortages have come down slightly, but are still very near all-time high levels, indicating an upward wage trend there as well. Analysts could be slow to catch on to this in their profit-margin forecasts, as we have not seen anything similar in the last 20 years.

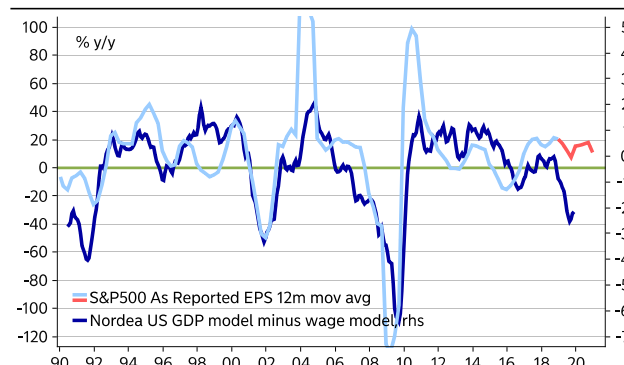
Our US earnings risk indicator (GDP model minus wage model) points to a scenario where a more pronounced earnings recession is highly likely. Historically, the equity market has run into problems during earnings recessions, whether or not central banks promise to relieve the situation. Once profits start falling for more than a single quarter or so, investors seem to start to ponder whether companies will embark on cost reduction programmes that might push the earnings recession into a more severe, outright GDP recession. Our models currently do not forecast any GDP recession, but when growth slows more markedly, we note a tendency for markets to overreact.

#### WAGE COSTS BECOMING A PROBLEM FOR COMPANIES



Source: Macrobond and Nordea

#### HIGH LIKELIHOOD OF A MARKED EARNINGS RECESSION



Source: Macrobond and Nordea

We advocate an underweight for risky assets

All in all, at current valuation levels of the equity market and with the macro risks still tilted towards an earnings recession scenario, we stay with an underweight for risky assets. At the same time, we acknowledge that the green shoots for global manufacturing 2020 are intact.

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

# Asymmetry: The rule of the game

The monetary policy backdrop has changed markedly over the past few months. The central bank "put" is very much alive, as major central banks have shifted dovishly in various ways. The shifts suggest asymmetric responses from central banks and from the fixed income market to economic or financial developments. Significant setbacks in data or a tightening of financial conditions would likely prompt central banks to deliver more easing. In contrast, stronger activity or higher inflation should not have a substantial influence – and would likely be welcomed rather than fought.

The Fed caving on QT has removed a "fear factor" from markets

## Federal Reserve – dovish in *four* different ways

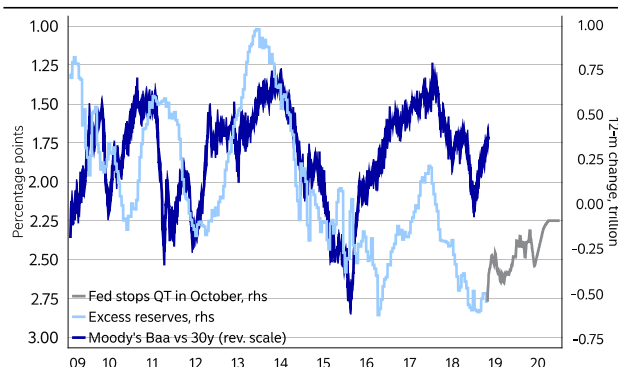
The monetary policy backdrop has changed markedly over the past few months. The most important central bank in the world, the Federal Reserve, has turned dovish in several different ways. **Formally, the Fed has signalled a pause in raising rates** and an end to quantitative tightening (QT). The former has been good news for risk sentiment in a conventional way, as the Fed backing away from rate hikes has been instrumental in dragging down Treasury yields. The second point has been good news in a more unconventional way. Market participants have been very worried about the impact on risk appetite from QT, even though the Fed has never understood why. **Nonetheless, the Fed caving in on QT has removed a "fear factor" from markets.**

FED'S PAUSE ON RATE HIKES IS DRAGGING DOWN 10Y YIELD



Source: Macrobond, Bloomberg and Nordea

CREDIT SPREADS NARROWING – DUE TO FED'S QT SHIFT?



Source: Macrobond, Bloomberg and Nordea estimates

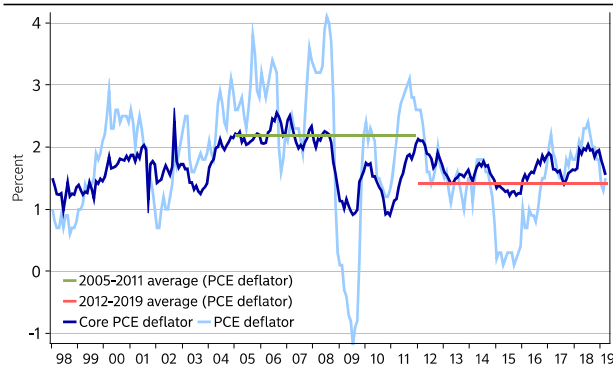
More informally, **the Fed has signalled that it may adopt an average inflation-targeting regime, implicitly allowing a substantial period of overshooting (inflation above target)**. As a consequence, the market has not needed to be as worried about accelerating inflation or wage growth, which might otherwise have forced the Fed into tightening policy or prevented it from implementing "the Fed put" for risky assets.

**Key Fed officials have also considered the idea of rate cuts to boost inflation or inflation expectations.** Inflation has averaged only 1.4% since the Fed formally adopted its inflation target in 2012. The longer inflation is below target, the greater the risk of inflation expectations becoming unanchored, which in turn would limit the efficacy of monetary policy in the next downturn, or so the thinking goes.

The Fed's precautionary rate cuts in 1998 helped build the IT bubble

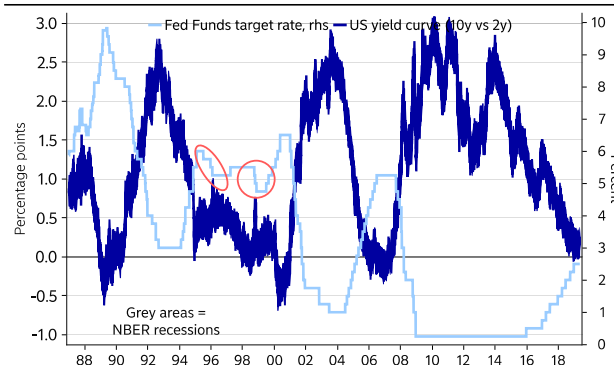
Precautionary rate cuts, as in 1995 and 1998 when the Fed lowered interest rates to defend against a weakening of the economy, have also been pondered. Interestingly, 1998 was one year when an inversion of the US yield curve did not precede an imminent recession. **Instead, the Fed's precautionary rate cuts in the wake of the Asian financial crisis at the time helped build the IT bubble that then burst two years later.**

## US INFLATION 1.4% ON AVERAGE SINCE ADOPTING TARGET



Source: Macrobond and Nordea

## THE FED CUT RATES AS A PRECAUTION IN 1995 AND 1998

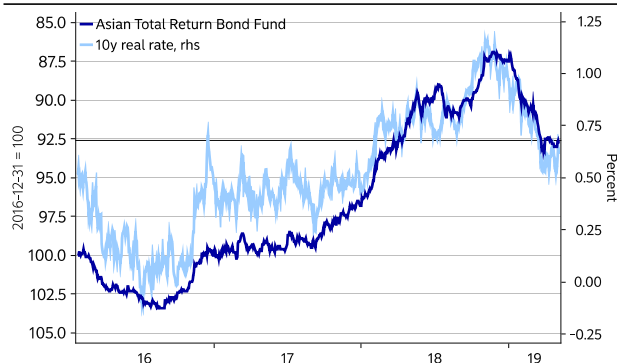


Source: Macrobond, Bloomberg and Nordea

All of the above contributed to a ~88 bp plunge in the US 10y yield. Taken together with rising oil prices, this has translated into a large (~60 bp) drop in the US 10y real rate. In turn, this has been quite helpful for risk sentiment, for inflows to EM Asia and, as a result, for financial conditions that have become easier in many parts of the world. This is a key reason why there have been green shoots in recent months.

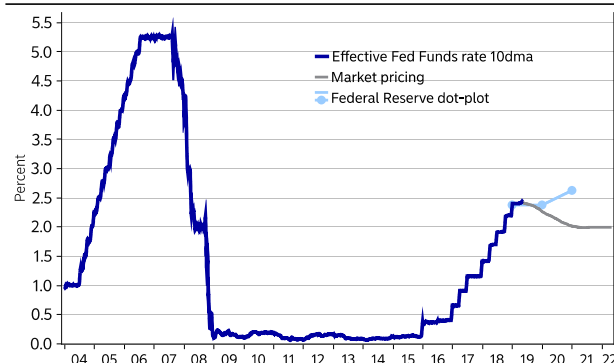
On a final US point, the increasing interest in Modern Monetary Theory (MMT) is noteworthy. It might presage a move towards more fiscal and monetary policy coordination in the coming years, after monetary policy having been the only game in town since the 1990s. **While monetary policy appears to have been at its wits' end when it comes to sustainably boosting inflation, we do not doubt that extreme fiscal policy would do the trick.** We could consequently come to expect a trend change from an eventual implementation of MMT in inflation (higher) and in real rates (likely lower). Admittedly, this is likely to be more relevant for markets in 2020 onwards than it is today.

## PLUNGE IN US REAL RATES INSTRUMENTAL FOR EM FI



Source: Macrobond, Bloomberg and Nordea

## MARKET SEES ~40 BP WORTH OF RATE CUTS



Source: Macrobond, Bloomberg and Nordea

## ECB – limited ammo but slowly doing what it can

In the Euro area, the ECB has strengthened its forward guidance on interest rates (no hikes until next year at the earliest), mulled a tiering of its interest-rate system (which could augur further rate cuts) and unveiled loans to banks (new TLTROs) that will be available this autumn (good news for EUR liquidity, although how good remains to be seen – all details are not known yet).

**ECB officials have also highlighted the symmetry of the ECB's inflation target,** sending a somewhat similar message as the one heard across the Atlantic, ie the central bank may not need to tighten rates even if core inflation starts to accelerate.

The ECB is more likely to cut rates than to hike them over the next 15 months

Accordingly, **on current market pricing, the ECB is more likely to cut rates than to hike them over the next 15 months.** The market does not expect the first 10 bp hike until April 2021 and projects the current negative rates environment to last until the end of 2022.

The ECB faces substantial hurdles that may prevent it

However, **compared with the Federal Reserve, the ECB faces substantial hurdles** that may prevent it from engaging in significant stimulus. While the Fed could easily

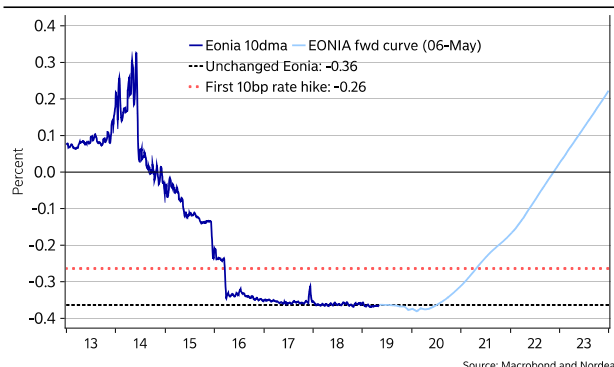


from engaging in significant stimulus

lower interest rates by more than 200 bp, such a move does not appear feasible for the ECB with its current deposit rate at -40 bp. Indeed, if the ECB were to cut rates further into negative territory, and substantially so, it would risk an international political backlash. It would not only be tricky to implement, but with a **tiered negative rates system, it would also partly short-circuit the transmission mechanism**, which means at the end of the day the ECB may only get a weaker currency – a beggar-thy-neighbour policy. The Shanghai Accord of 2016 is supposed to have stopped this "race to the bottom".

While we are definitely not there yet, a restarting of its QE programme could be on the cards if the ECB were to decide it is risking inflation expectations becoming unanchored again. However, this too could face political constraints given, for instance, the size and composition of the ECB's balance sheet. Euro-area MMT? Forget about it.

#### ECB – NEGATIVE RATES UNTIL 2022



Source: Macrobond, Bloomberg and Nordea

#### EUR 10Y SWAP RATE DOWNTREND INTACT



Source: Macrobond, Bloomberg and Nordea

Fixed income markets will likely react asymmetrically to outcomes

#### Where does this leave fixed income markets?

While one could always have an academic debate about whether the signals to allow inflation overshooting are credible or not given that central-bank rhetoric will be prone to change once they stare accelerating core inflation in the face, we judge that the central bank put(s) are very much alive.

Significant setbacks in activity data, in cost pressures, or a stock market-led tightening of financial conditions, would likely bring central banks to implement more easing. In contrast, stronger activity or higher inflation will matter little – and would likely be welcomed rather than fought by central banks. This suggests that fixed income markets will likely react asymmetrically to outcomes.

Downtrend in EUR 10y swap rates intact

**In the Euro area, we find the tiering enthusiasm somewhat overdone**, which suggests slightly higher rates in the near term. In the bigger picture, however, both the ECB as well as Euro-area macro will likely need to surprise hawkishly and positively to change recent fixed income trends. **The downtrend in EUR 10y swap rates since October remains intact**, and expectations of a dovish ECB decision in June are likely to keep it as such. In short, nothing much is likely to happen in Euro-area fixed income this year.

Lion's share of effect on multiples from dovish repricing likely behind us

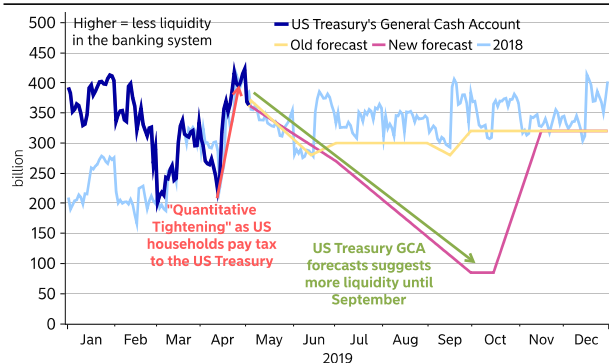
The US money market is pricing in slightly more than one rate cut from the Fed over the next 12 months. **Two rate cuts would indicate a US 10y yield at 2.25-2.30%, and more than this seems highly unlikely barring a major, negative shock**. Accordingly, the lion's share of the effect on multiples from the dovish repricing of the Fed are likely behind us.

The US Treasury to add almost USD 300bn of electronic dollars to the banking system

More interesting is the outlook for US excess liquidity. Relating to the now-binding debt ceiling, the US Treasury forecasts a drawdown of its General Cash Account (GCA) in the coming months. **The process will add almost USD 300bn of bank reserves (electronic dollars) to the banking system until the end of September**. The USD ~300bn amount is roughly three times as much as the Fed's quantitative tightening until the end of September, and this can be seen as a form of **temporary and stealthy quantitative easing**. Around a similar shift in the GCA in early 2017, Libor-OIS compressed markedly.

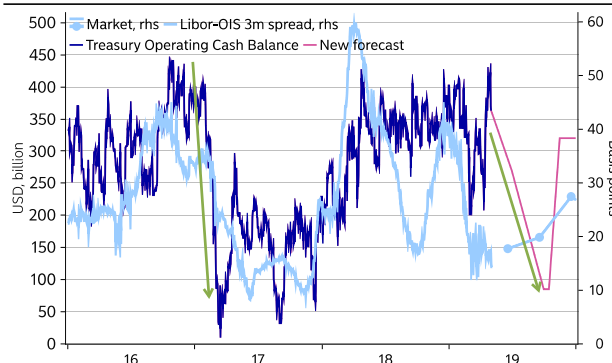
At the end of the day, we expect broadly range-bound US rates and yields with a modest upward tilt, but not enough to dent risk sentiment on its own.

#### US TREASURY'S PLANS WILL BOOST US EXCESS LIQUIDITY



Source: Macrobond, Bloomberg and Nordea estimates

#### COULD TREASURY COMPRESS LIBOR-OIS FURTHER?



Source: Macrobond, Bloomberg and Nordea estimates

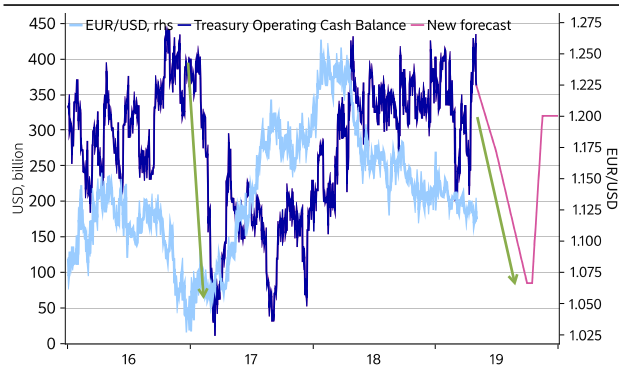
#### And how about the dollar?

The drawdown of the US Treasury's account will be a dollar-negative driver until the end of September, and is one reason behind our call of a somewhat weaker dollar in coming quarters.

When the Treasury's GCA account plunged in early 2017, it augured a trend change in EUR/USD at a time when positioning in the USD, as well as the psychology thereof, had become very optimistic – not too dissimilar to today. EUR/USD rose by 17% in the first three quarters of 2017.

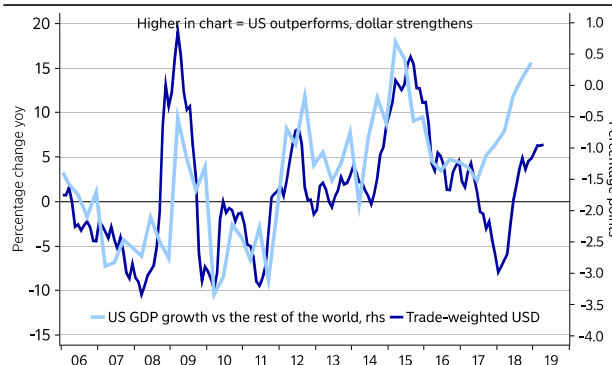
Such an outsized move seems highly unlikely in 2019. To boost EUR/USD materially, we need more signs that growth is picking up in the rest of the world, and especially in the Euro area. As those signs are scarce, our call is for a modest weakening of the dollar versus the euro.

#### TREASURY GCA DRAWDOWN BAD NEWS FOR THE DOLLAR



Source: Macrobond, Bloomberg and Nordea estimates

#### ROW NEEDS TO PICK UP TO DENT DOLLAR MATERIALLY



Source: Macrobond and Nordea

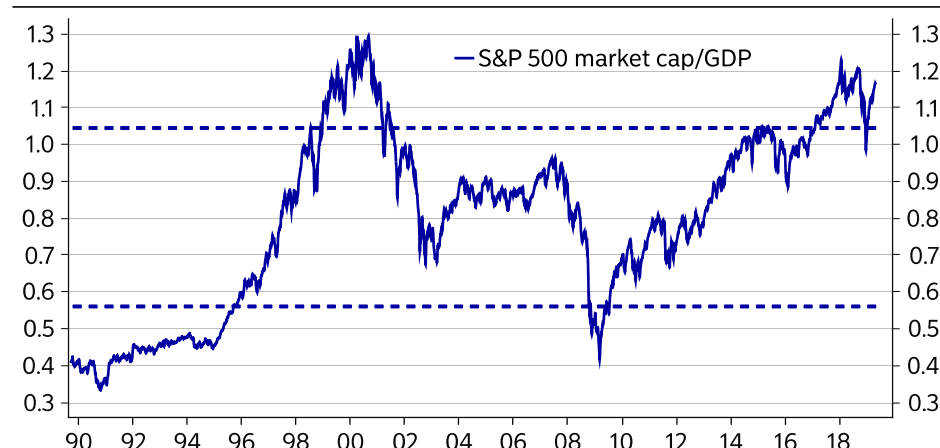
This section has been produced by Nordea Research's Non-Independent Research unit

# Equities: US richer than meets the P/E eye

We conclude that with gearing in the US having risen more than 50% since 2013 investors should not solely rely on price/earnings. Most other valuation gauges we have analysed suggest even worse risk/reward for US equities. One of these is the widening gap between free cash flow and earnings. Reported free cash flow yields stand just north of 3% for the median US large cap, an 18-year low, which also begs the question of the durability of the recent rally. As we see muted scope for earnings to surprise positively, rather the opposite, both in the short and medium term, the odds of further US outperformance look bleak to us. Lastly, given the strength of the US dollar, we would rather play Europe than EM as a relatively safe haven compared with the US.

In our valuation analysis, we employ both earnings and profit-neutral valuation methods. Currently, we get somewhat mixed signals if we focus on more macro-based gauges (such as market cap/GDP), or profit-neutral valuation multiples (such as EV/sales or the Shiller cyclically adjusted P/E), or if we look at traditional forward-looking P/E. Therefore, we take a deep dive into why these differ. Profit margins for the median company globally have been on an upward-sloping trajectory for the past 15-20 years. Mean reversion of profitability levels could obviously bring about material normalisation of these differences, but we believe it is not the entire story.

MARKET CAP / GDP FOR S&P 500



Source: Macrobond and Nordea

THE SHILLER CYCLICALLY ADJUSTED P/E



Source: <http://www.econ.yale.edu/~shiller/data.htm> and Nordea

The macro gauge would suggest it is time to run for the hills

Of course, we acknowledge that US companies are much more "global" today than 20 years ago

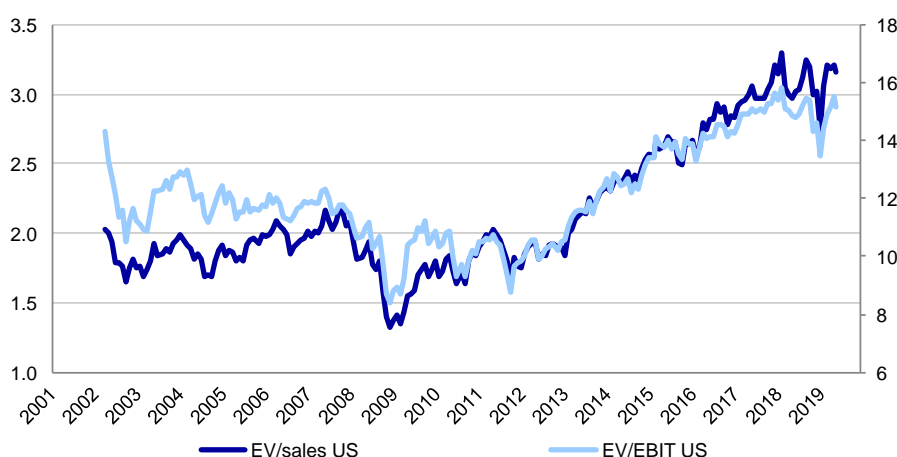
At least partially, the Shiller P/E tends to corroborate that view...

### AGGREGATED 12-MONTH FORWARD P/E FOR S&P 500



Source: FactSet

### MEDIAN EV-BASED VALUATION FOR US LARGE CAPS



Source: FactSet and Nordea

### Don't rely solely on Price-to-earnings

Price-to-earnings is one of the most often cited valuation measures, utilised both for single securities and when asset allocators compare regions and sectors. We argue that it should be complemented with other metrics. Given the recent surge in capital distributions, which have been greater than free cash flow in recent years, we would caution investors against relying solely on price-to-earnings.

EV-based valuation multiples, on the other hand, adjust for changes in indebtedness. It is interesting that the differential between EV/EBIT and P/E multiples has compressed to levels not seen before. However, we should remember that lower corporate tax rates and lower interest rates have also reduced the differential. The 2018 corporate tax cut alone lowered the differential by close to 10 pp. Even with this in mind, the trend since 2005 is intriguing. It is worth stressing that EV-based multiples should, therefore, be somewhat higher than their historical averages.

...whereas a forward-looking P/E gauge would suggest lower above-average pricing, which is not as concerning when considering today's lower interest rates, barring a margin mean reversion scenario

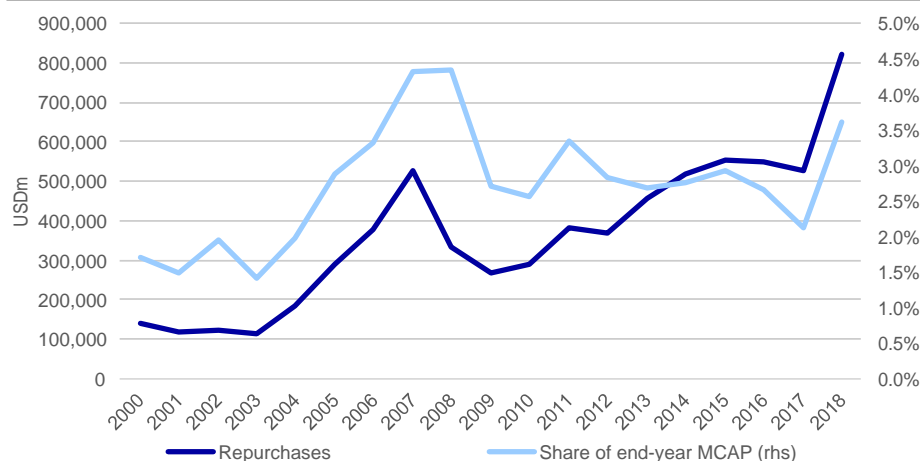
EV-based metrics are, on the other hand, more supportive to our macro gauge suggesting poor risk/reward

We argue that the buyback frenzy has distorted the use of the traditional P/E gauge

Buybacks are at unprecedented levels...

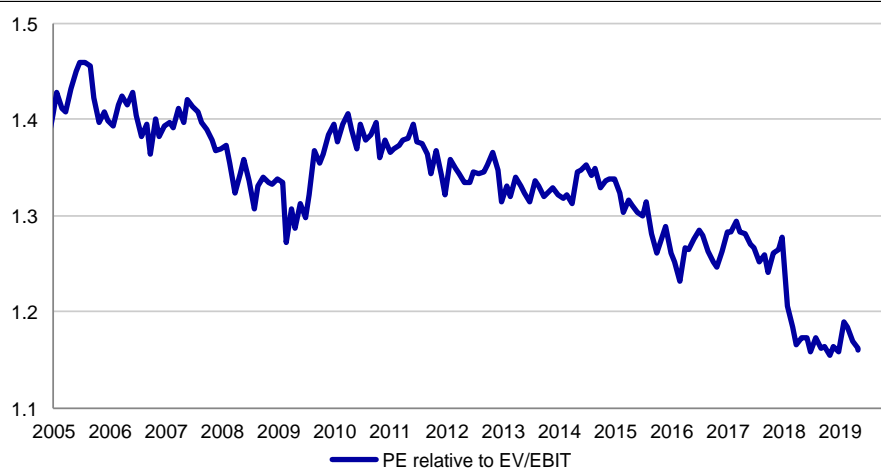
...and are approaching historical peaks versus market caps, although the latest surge in equities brings the current buyback yield towards 3%

#### BUYBACKS AND SHARE OF BUYBACKS FOR THE S&P 500 (CURRENT COMPOSITION), USDm



Source: FactSet and Nordea

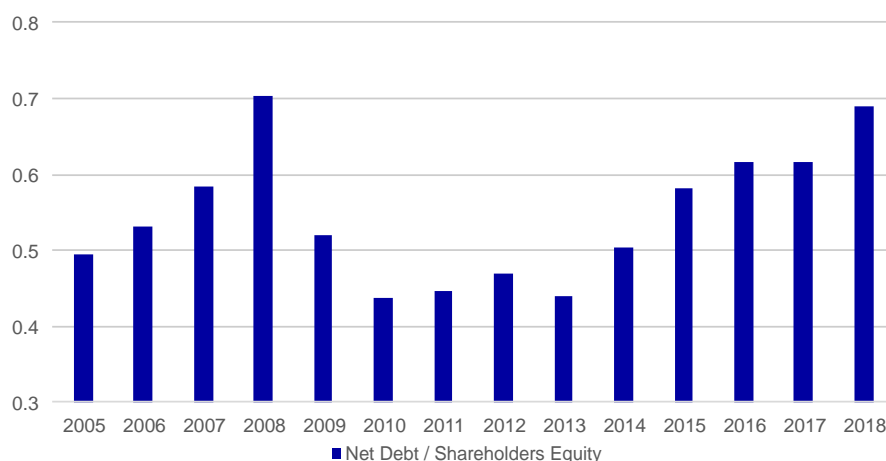
#### VALUATION DIFFERENTIAL BETWEEN P/E AND EV/EBIT



Source: FactSet and Nordea

Indebtedness relative to equity has risen a staggering 56% in the US since 2013, and 40% versus 2005. Given that we are within touching distance of multi-year highs in indebtedness, comparing today's P/E with its historical average could be somewhat misleading, as you would normally not want to pay the same P/E multiple for a company that has increased its gearing substantially. This is why we argue that the analysis should be complemented utilising other metrics.

#### NET DEBT TO EQUITY FOR S&P 500 EX FINANCIALS



Source: FactSet and Nordea

Gearing has risen a whopping 56% since 2013, now closely matching 2008 peak levels



Free cash flow and earnings differ the most since 2000

The latest data point in the chart (2018 adj), which incorporates the rally year-to-date, would suggest just north of 3% FCF

Earnings and cash flow have spread apart to the greatest degree since the IT bubble burst

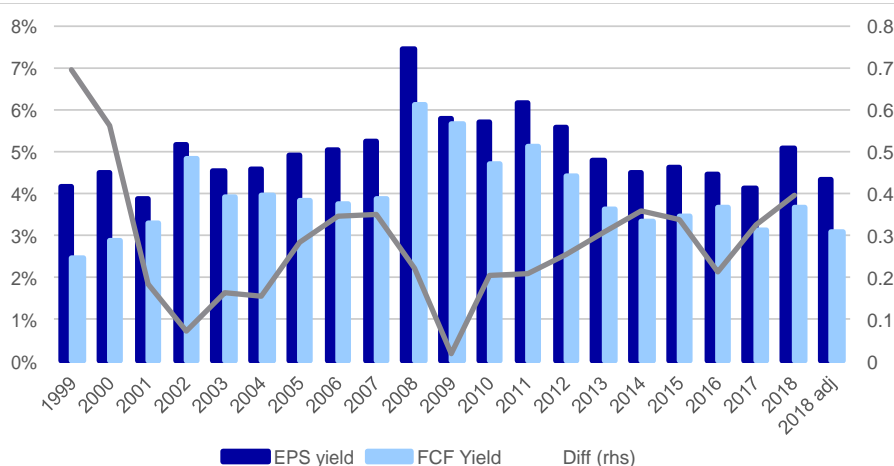
A mere 3% (18-year low) median company trailing FCF yield surely suggests poor risk/reward for US stocks

### Difference between free cash flow and earnings spread apart

While we argue that rising indebtedness potentially complicates the use of P/E, we can also illustrate that we are currently witnessing the greatest differential between reported free cash flow and reported earnings since the IT bubble burst. It is not uncommon that cash flow and earnings drift apart late in the cycle, as we saw in 2007, and in 1999 and 2000.

With such strong sales growth during 2018, it is not that strange to see working capital rising. Having said that, we would still want to point out that with trailing free cash flow yields for the median company at just north of 3%, valuation is the richest it has been for the past 18 years, clearly putting a question mark on the durability of the rally. It therefore also more closely matches our EV-based observations and macro gauge.

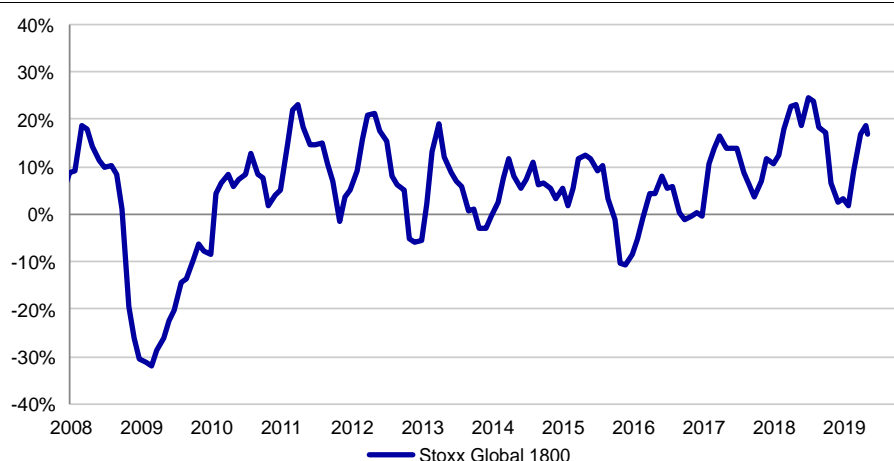
#### EARNINGS YIELD VERSUS CASH FLOW YIELD (REPORTED MEDIAN)



Source: FactSet and Nordea

Even though there could be some help from reduced working capital ahead, we should maybe not expect help from lower capex given that our revision indicators are improving, and capex-to-sales remain historically depressed. Coupled with our rather muted earnings outlook, it is hard to see greatly improved cash flows saving the day. Like our analysis on indebtedness above, this points to the fact that simply looking at the prevailing forward-looking P/E gauge is likely not enough.

#### CAPEX REVISIONS INDICATOR – STOXX GLOBAL 1800



Source: FactSet and Nordea

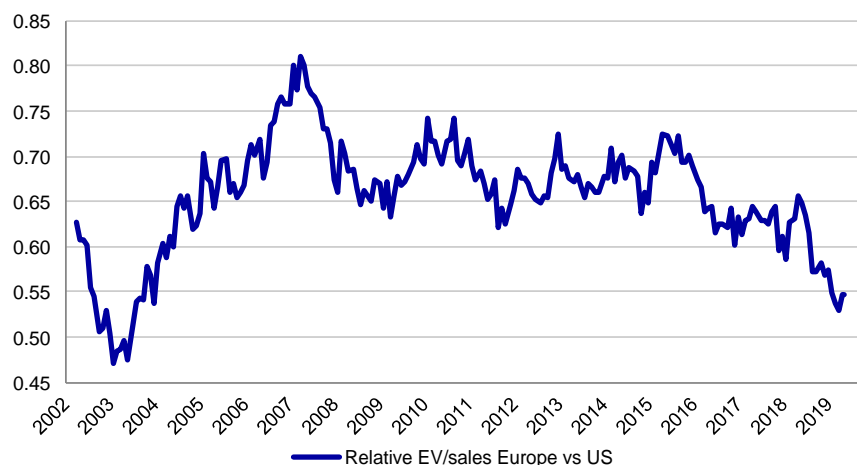
Capex revisions turning positive once more, potentially capping some of the cash flow comeback from working capital releases

In our view, that leaves a further reduction in the cost of capital as the only valuation-based upside risk to equities. Given the recent softness of inflation data and central bank rhetoric, we do not find it completely unlikely that investors will accept equities returning below 6% per annum – the problem is that when utilising our profit-neutral or EV-based valuation metrics, we are there already. Therefore, we would caution strongly against playing such an overshooting scenario.

In conclusion, we are even more convinced that the US market should be underweighted in favour of especially Europe, where macro revisions have come the furthest. Relative valuation is approaching multi-year extremes, which, when coupled with clear risk of relative earnings disappointments, suggests good odds in underweighting US equities. Even though we note a compelling valuation argument for emerging markets as well, we are increasingly concerned that the strength of the US dollar could reignite the 2018 worries.

#### RELATIVE EV/SALES STILL SUGGESTS UNDERWEIGHTING THE US IN FAVOUR OF EUROPE

We also believe that the US will not outperform Europe from an earnings revision standpoint either, suggesting good odds for underweighting the US



Source: FactSet and Nordea

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

# Equities: Medium-term growth scrutinised

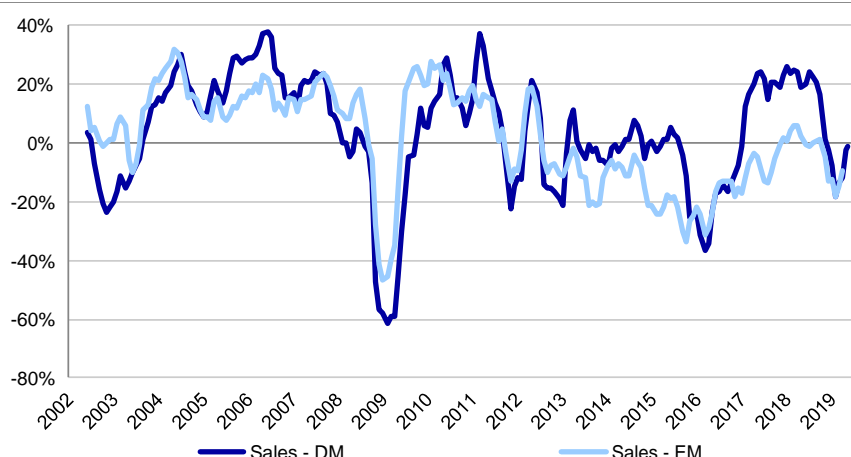
Looking beyond the downward revisions we foresee for 2019, we are becoming increasingly concerned about the medium-term outlook for earnings growth. This is because there are a number of factors that can't get much better, such as funding costs, corporate tax rates, buybacks, relocation of production, profit margins, and depreciation costs, while some tailwinds are set to turn into headwinds, such as for demographics and labour costs. Productivity improvements may save the day, but if these materialise, we argue that we would first see lower buyback help for EPS growth and rising depreciation costs (from rising capex/sales ratios), delaying a marked earnings recovery even further.

Our revision indicators have improved somewhat during the Q1 reporting season. Our sales indicator in particular has clawed its way back towards a neutral reading, whereas our EPS indicator remains negative. We remain convinced that we have at least another leg to go in the downgrade cycle. In previous issues, we have written quite extensively about why we believe estimates are too lofty, but as a reminder we base this upon the factors mentioned below:

- Our macro indicators suggest further downward revisions to sales forecasts
- Wage cost pressure shows little sign of abating
- Historically, downgrade cycles have seen a greater magnitude of estimate cuts
- Inventory levels could prove problematic for earnings if the slowdown continues

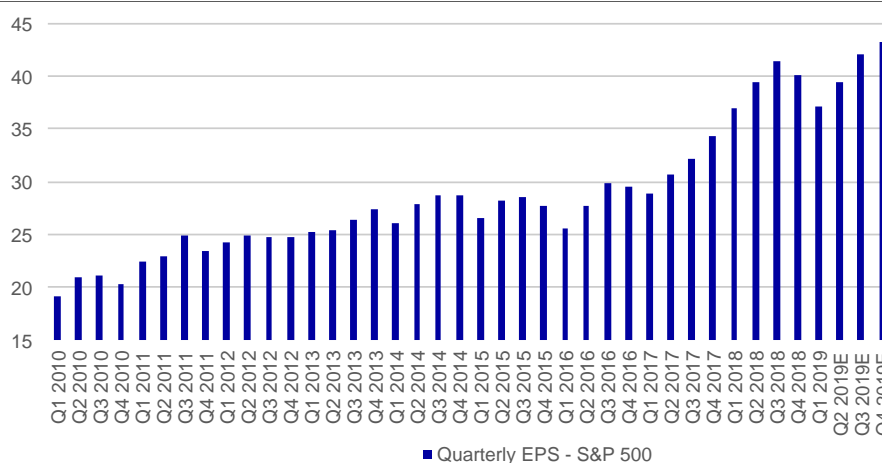
Our sales indicator has moved back towards the neutral mark, but we think that it's a false signal, as our macro indicators suggest more downside

EPS AND SALES REVISION INDICATORS - STOXX GLOBAL 1800



Source: FactSet and Nordea

S&P 500 QUARTERLY EPS DEVELOPMENT

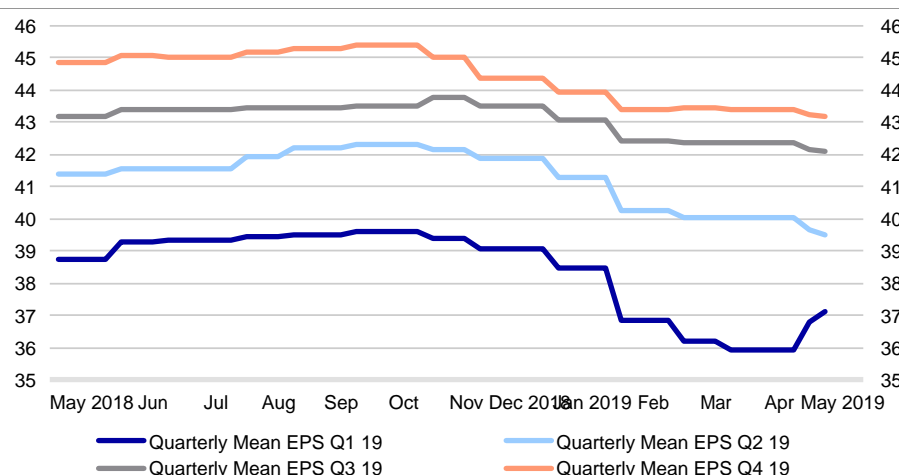


Source: FactSet and Nordea

We doubt that earnings will match these V-shaped recovery expectations

We expect Q3 and Q4 estimates to come down further

#### S&P 500: 2019 QUARTERLY REVISIONS TREND



Source: FactSet and Nordea

We believe earnings growth in the coming years will struggle to match the levels seen during the past couple of decades

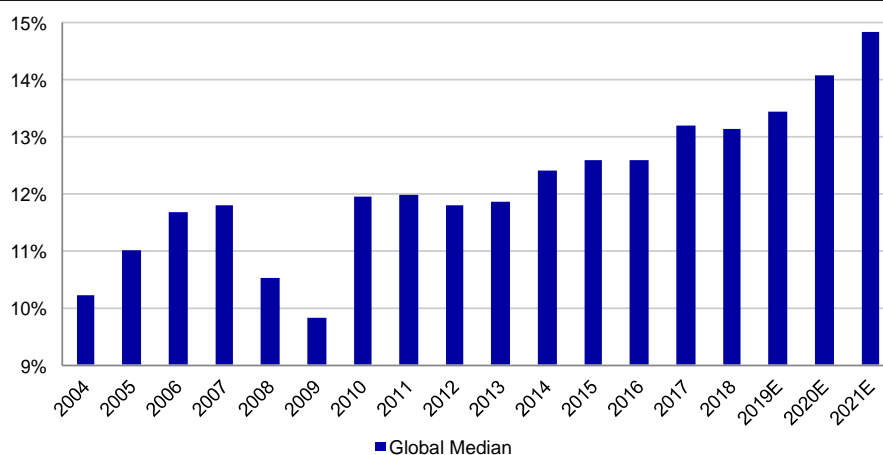
In this report, we take a deeper look at the earnings growth outlook beyond 2019. Although we far from exhaust every angle, we are fairly confident that drivers for earnings growth are worse for the coming years than in recent history. Below, we list our core arguments, which are then explained in more detail below.

- The interest rate market suggests growth will be sluggish
- Demography is a headwind rather than a tailwind
- Profit margins are already at multi-year highs
- Credit spreads are fairly tight, while interest rates are close to being at multi-year lows, implying that corporate funding costs can't get much lower
- Corporate tax rates have been lowered substantially in developed markets
- Capex/sales is at multi-year lows – rising capex/sales tends to lead to margin pressure before productivity gains kick in
- Labour cost increases are the highest they have been for almost two decades
- It is hard to see expansion of buybacks driving improving (vs history) EPS growth

In previous reports, we have illustrated that profitability for the average listed global company is at unprecedented levels. In our view, however, some of the tailwinds that have made this possible are changing. Firstly, the past 20 years have enjoyed the enormous influx of cheap labour with China joining the WTO in 2001. In Europe, the EU enlargement has also contributed to companies benefiting from cheap labour and being able to move production to low-cost countries.

We struggle to see how profitability can improve this much, having already reached a multi-year high in 2018

#### MEDIAN EBIT MARGIN FOR STOXX GLOBAL 1800

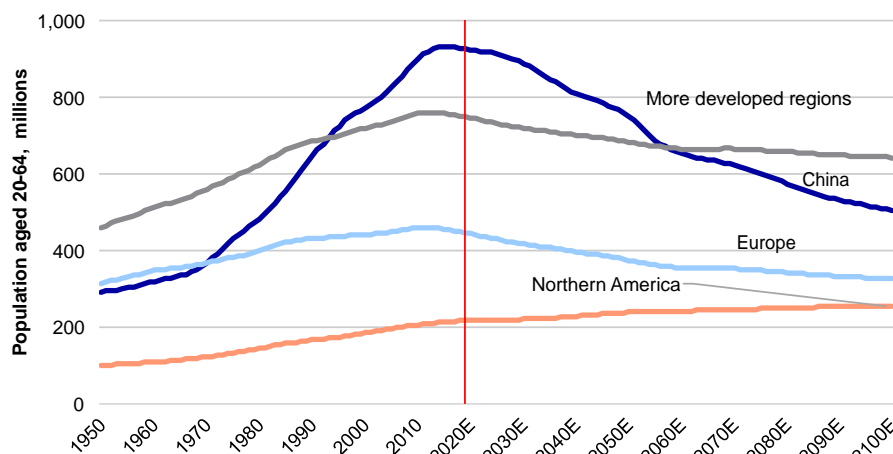


Source: FactSet and Nordea

The tide is now turning, with the working population shrinking in both Europe and China. Emerging market wages are rising sharply and US, Japanese and European wages are increasing at the fastest pace for at least ten years. Altogether, this means that companies are most likely facing the greatest wage cost headwind for 20 years. We continue to believe that sell-side analysts are underestimating this. Supporting this view is the fact that the average analyst believes that 85% of the global equity universe is set to improve profitability in 2020 and then close to 80% again in 2021. In our view, this simply won't happen.

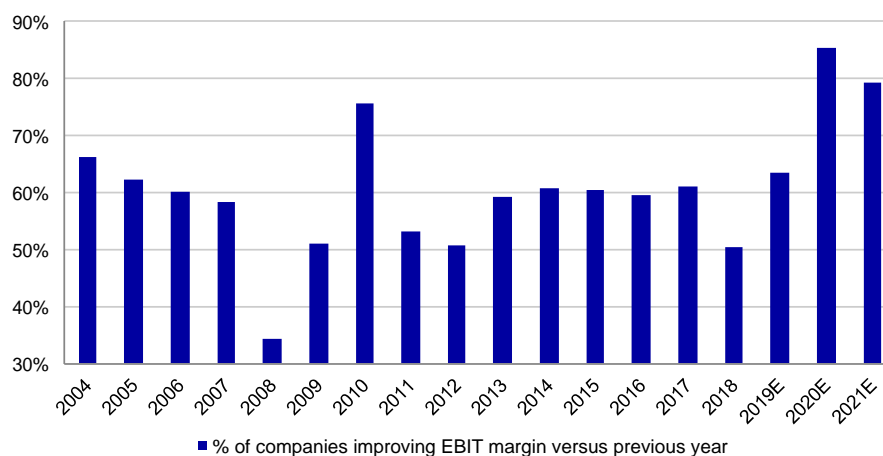
Trade war concerns, a tight labour market and a shrinking developed region global workforce are all behind the wage cost pressure currently being seen

#### WORKING AGE POPULATION SINCE 1950 BY REGION - WE ARE PAST THE PEAK



Source: United Nations

#### SHARE OF STOXX 1800 COMPANIES EXPECTED TO IMPROVE EBIT MARGINS



Source: FactSet and Nordea

Funding costs and corporate tax rates are unlikely to produce a significant earnings delta

There are, of course, other factors that can help earnings growth, but we doubt that credit spreads will tighten much further and, conversely, that corporations will be able to lower their funding costs much further. Additionally, considering the global fiscal debt piles, we doubt there is anything equivalent to the US tax reform that could boost global EPS imminently. In 1980, corporate tax rates around the world averaged 47% and 39% when weighted by GDP. In 2018, these have been cut to 26% and 23%, respectively. Hence, declines have been seen in every major region of the world, including the largest economies. The recent tax reform in the US took the statutory corporate income tax rate from among the highest in the world closer to the middle. Today, most countries have corporate tax rates below 30%. In the OECD, the average corporate tax rate is 23.9% and in the EU it is 21.9%.

Productivity could be the game changer, but we believe a capex wave, hurting short-term profitability, is needed

The game changer that could surprise us could be a technologically driven productivity boost. This is obviously extremely hard to predict, but we would still argue that for that to happen, we should see rising capex to sales ratios. Obviously, rising capex will also increase costs in the short-term, as depreciation costs will rise. In addition, rising capex in the short term is also often associated with a short-term loss of productivity. We are therefore somewhat sceptical about productivity improvements saving the day in 2020.

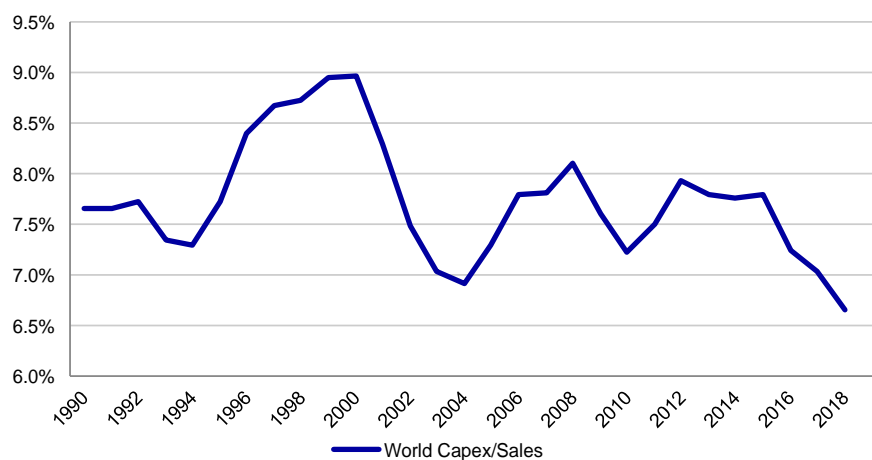


We could, of course, be underestimating the potential productivity gains from technology advances like cloud, AI and big data.

#### CAPEX TO SALES - STOXX GLOBAL 1800

Capex to sales at multi-year lows, while buybacks are at record highs

In our view, this suggests sluggish growth prospects



Source: FactSet and Nordea

As described in the first chapter, we believe interest rate markets have not only reacted to softer central bank posturing but have also responded to the growth outlook deteriorating. Again, demographic tailwinds are turning into headwinds, and we subscribe to the premise of a moderation of economic growth in the coming years. Multi-year lows for capex/sales and record buybacks would support such an outlook for sluggish growth.

Reduced buybacks for capex investments mean lower EPS growth, at least for the coming years

The final piece of the puzzle in terms of the consequences of rising capex could be reduced buybacks, which would dampen the EPS effect buybacks have had. The surge in buybacks could also be interpreted as global corporations having had a rather muted outlook for growth. There has also been commentary recently about buybacks with regards to inequality (executive versus workers' pay), and we would hence not be surprised if buybacks were to feature in the Democratic presidential candidacy. In any event, we struggle to see any scope for increasing buybacks further. If we are proven wrong, the lack of investment opportunities for capex will thus eventually drag down the growth prospects.

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

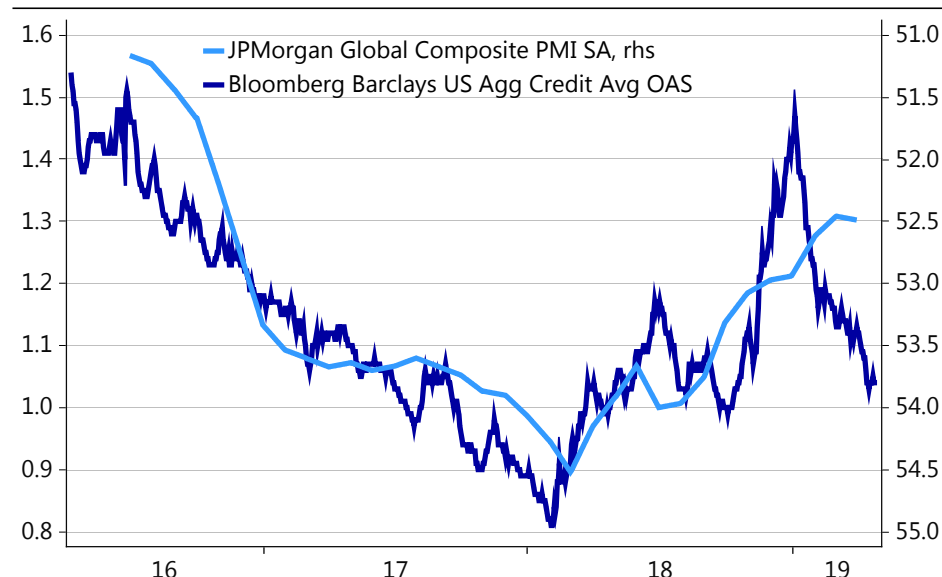
# Credit: The hunt for yield lives on

The credit market has failed to price in the weaker growth outlook and has instead moved in sync with the equity market. Our take is that accommodative central banks are making investors less risk averse and lower rates are forcing investors out the risk curve. This might seem like a good combination for risky assets in the short run, but the longer-term implications of investors investing because they have to and not because they want to sounds like trouble.

Credit spreads out of sync with PMIs

We see that credit spreads bottomed out at about the same time that the global macro indicators were at their best, at the start of 2018. Since then, credit spreads have widened as global PMIs have worsened, but the relationship has been far less stable than in 2016 and 2017. On a level-based comparison, US credit spreads should have been some 25 bp wider given global composite PMIs. If not the economy, what has been the driver of credit spreads lately?

**CREDIT SPREADS AND PMIS HAVE BEEN OUT OF SYNC LATELY**

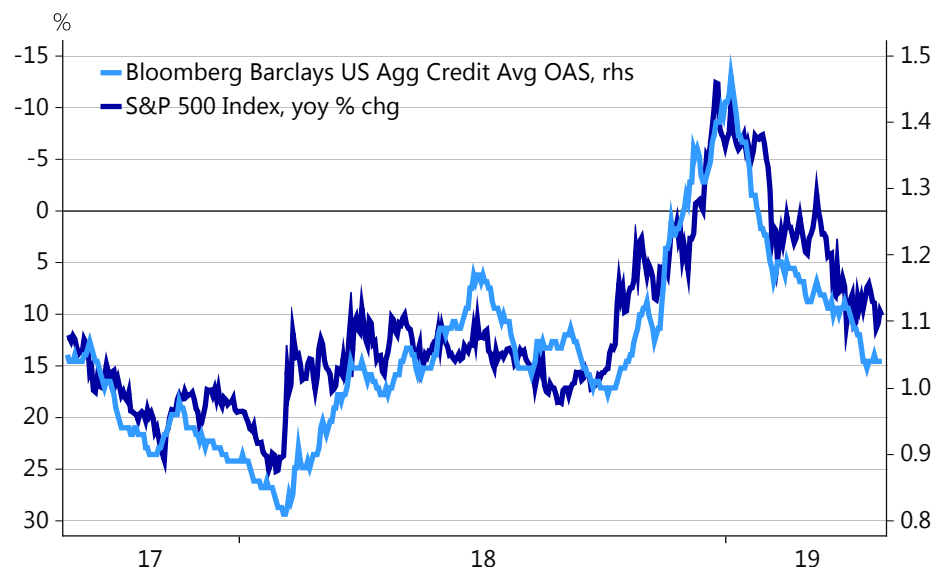


Source: Macrobond

High correlation to equities

If we compare US spreads to the equity market, correlations have held up remarkably well over the last year. This suggests to us that there are forces at play other than just the global growth outlook. Our prime suspect is the central banks. A softer stance from the FED, cancelling future rate hikes and being more concerned about lower inflation than the economy overheating have provided a big cushion for lower growth and made investors more willing to take on new risk in both the equity and credit markets. The ECB has also gone soft in the light of slower European growth, replacing talk of interest rate hikes with discussion about new easing measures. We believe softer central banks will continue to support the market, but that slower earning growth will make it harder for the equity markets to grind ever higher. Current spread levels correspond to approximately 15% annualised returns in S&P 500, something we find very unlikely.

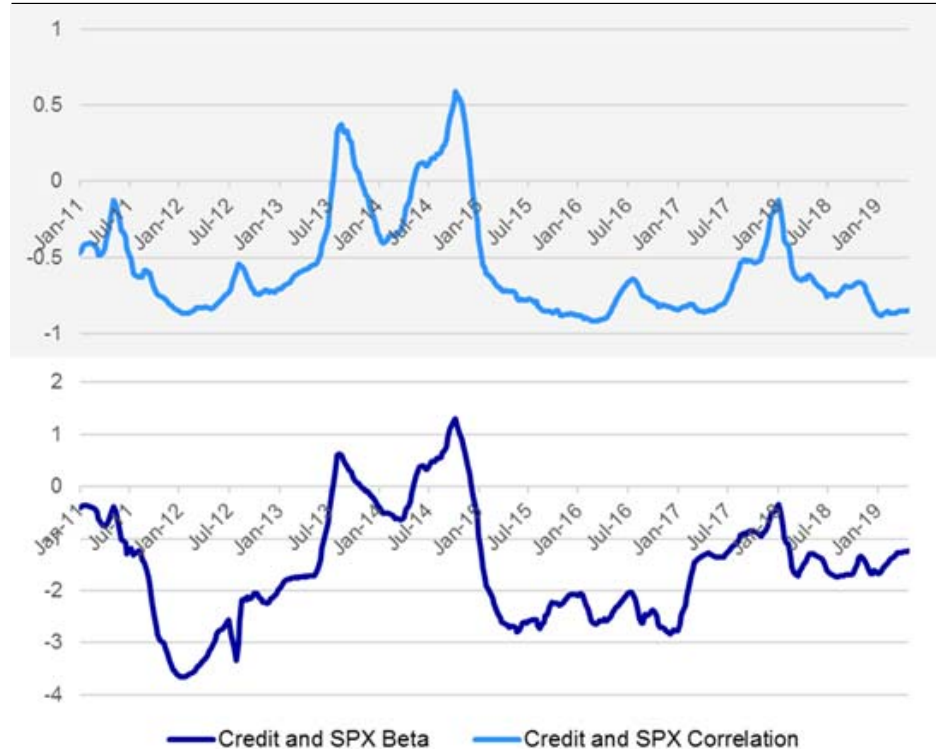
### CREDIT SPREADS AND EQUITIES HAVE BEEN CLOSE FRIENDS THE PAST COUPLE OF YEARS



Source: Macrobond

It is not unusual to see a tight connection between equities and credit spreads. Since 2011, the 12-month running correlation has been below -0.5 roughly three quarters of the time. The beta from equity returns to credit spreads is more modal, however. From mid-2015 to the end of 2016 it held at -2.5. Since the spring of 2018, the beta has been -1.5, meaning that 10% lower annual returns in S&P 500 have translated into 15 bp higher credit spreads for the broad US credit market.

### CREDITS AND EQUITIES ARE NEGATIVELY CORRELATED MOST OF THE TIME

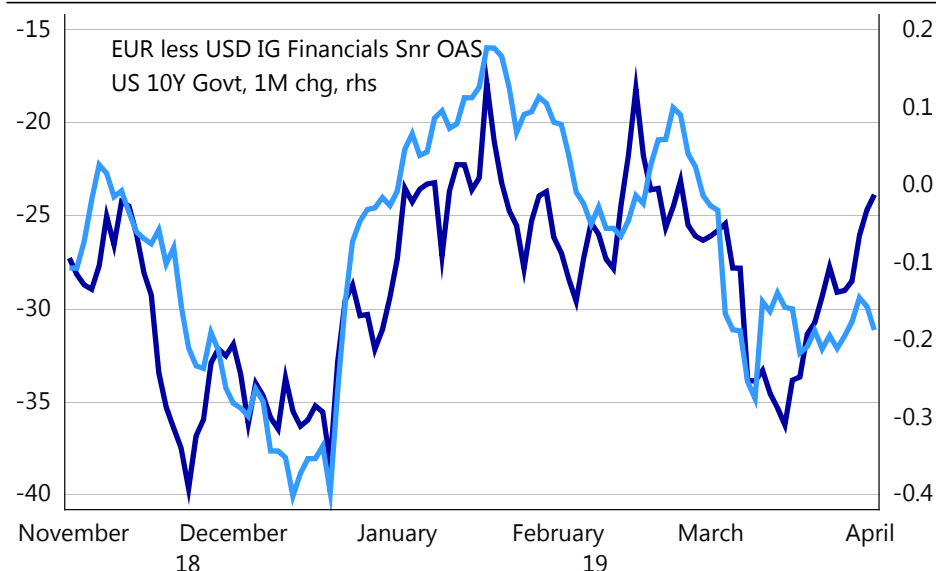


Source: Bloomberg and Nordea calculations

Lower rate levels force investors more easily out the risk curve

One noteworthy difference between the 2015/16 and the 2018/19 periods is that interest rates on average have been some 90 bp higher in the latter period. Interestingly, when we look at the impact on credit spreads from interest rates lately, we also find a higher beta in markets with lower interest rates. When rates fall, credit spreads contract more in the Euro market than in the US, and vice versa. One viable explanation we see is that yield-starved investors in low yielding markets are more inclined (or forced) to move out the risk curve to meet their yield targets. From a risk perspective, you could argue that the opposite should happen. Lower rates imply lower growth and more risk for company finances, hence credit spreads ought to be higher. However, evidence points the other way.

#### FALLING RATES MEANS EUROPEAN CREDIT SPREADS CONTRACT MORE THAN IN THE US



Source: Macrobond

As rates have come down quite a bit since the top, perhaps we should expect higher betas in US credits from both equities and bond rates going forward? A higher beta for equities would mean that it would take even more than 15% annualised equity returns for spreads to stay where they are, but higher betas for interest rates would mean it would require less of a fall in rates to support the credit market. Perhaps these two factors could outweigh each other as central banks still stay on the supportive side of the equation. However, we still believe the more challenging outlook for equities will win out, forcing investors to take a more cautious approach to the credit market.

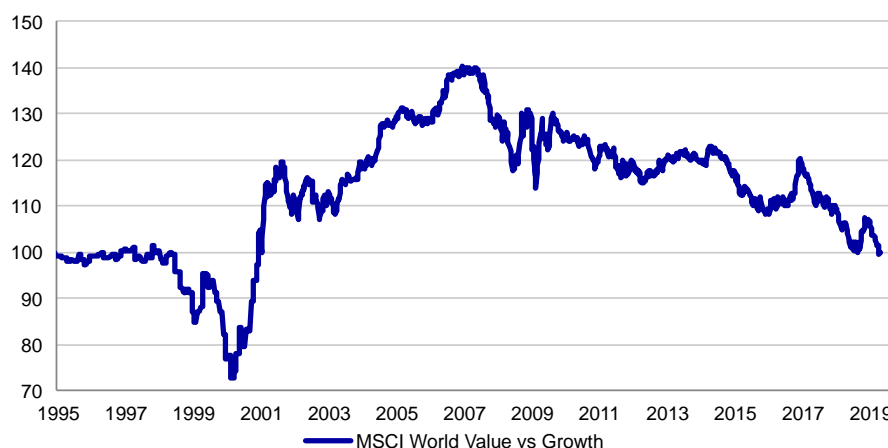
*This section has been produced by Nordea Research's Non-Independent Research unit*

## Equity styles: We remain value contrarian

While we acknowledge that we have underestimated the effects lower bond yields have had on the value style, we maintain our value bias. This bias is underpinned by the huge difference in relative valuation between the cheap and expensive ends of the market. We also steadfastly argue that a slowdown in global growth also implies that such valuation differences should decline, something Mr. Market currently disagrees with. Furthermore we can demonstrate that expensive stocks tend to underperform when uncertainty rises (VIX spikes), which we believe is likely to materialise in the coming months. Finally, with revision momentum style expected to remain lacklustre from an alpha point of view, we find it likely that investors will combine value, quality and growth traits in the search for GARP.

Growth has continued to outperform value as investors appear to have fallen back into old habits: chasing growth at any price as central banks soften and long-dated bond yields fall. Our proprietary models in Europe confirm this. We also notice that style moves have been rather calm of late. Quality has edged higher and value traits remain lacklustre, while revision momentum is once again struggling. The latter is of particular interest, as we have been arguing that a much more uncertain economic near-term future should bring problems to the style. Although earnings uncertainty (measured as dispersion around the consensus for the median company) has only just started edging higher, we note that other indicators, such as the dispersion within the answers of the IFO survey, suggest rising earnings uncertainty in the months to come.

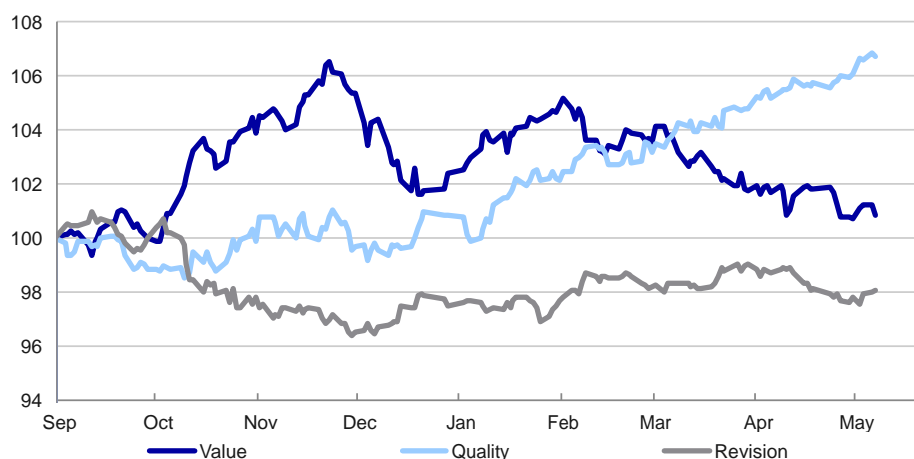
### MSCI GLOBAL - VALUE RELATIVE TO GROWTH



Source: FactSet and Nordea

Growth once again the dominant style as the entire relative value gain of H2 2018 evaporates

### VALUE, QUALITY AND REVISION – 1 YEAR PERFORMANCE (EUROPEAN MID CAPS)



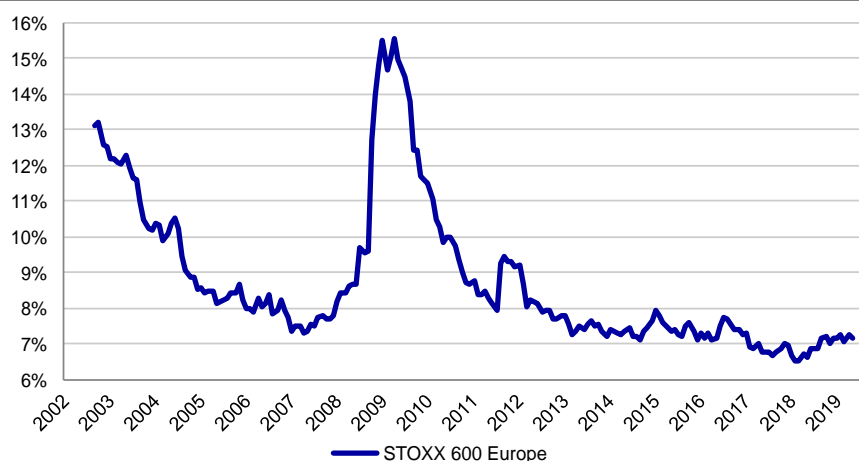
Source: FactSet and Nordea

Quality, like growth marched on, but earnings revision momentum has continued to struggle in Europe



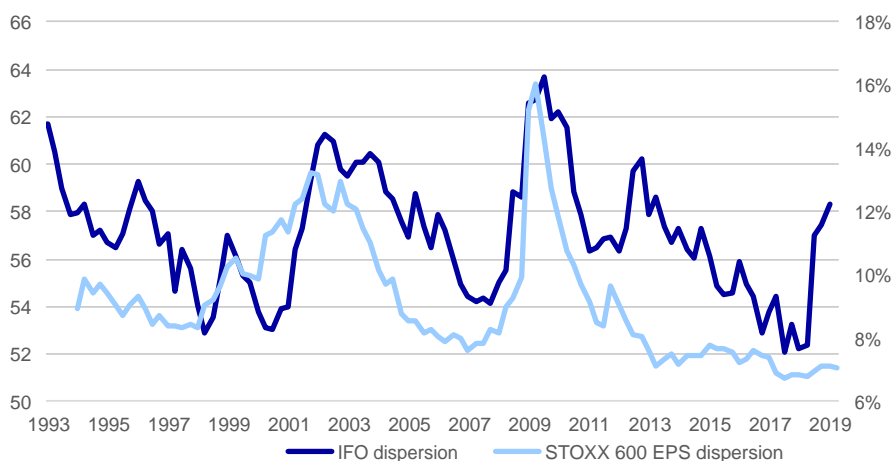
### EUROPEAN ESTIMATE UNCERTAINTY SLOWLY ON THE RISE

The sluggishness of the revision style materialises as EPS uncertainty slowly rises



Source: FactSet and Nordea

### IFO SURVEY DISPERSION VERSUS CONSENSUS EPS DISPERSION

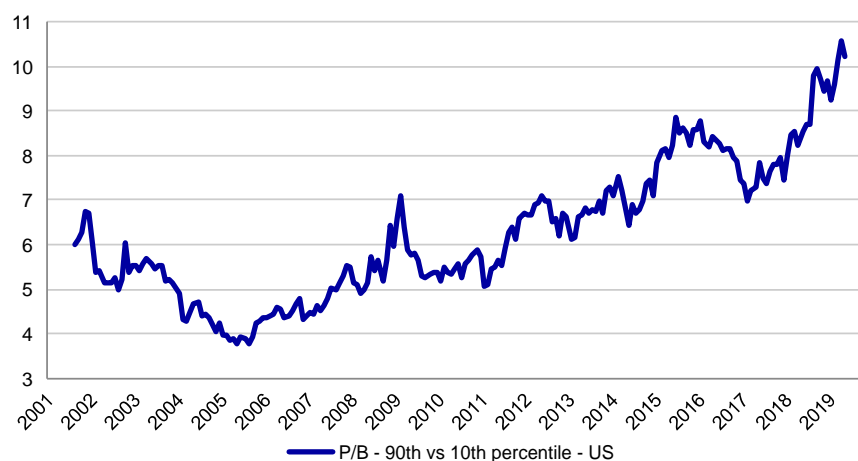


Source: FactSet and Nordea

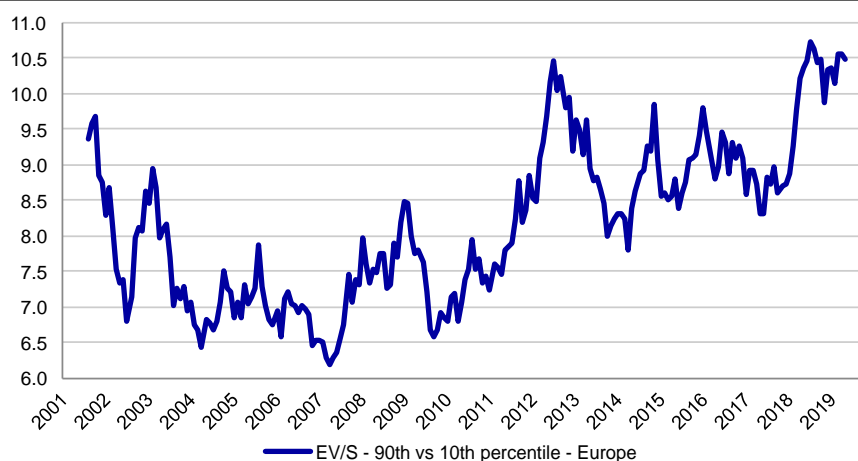
The differential between the expensive (implicit high growth) and the cheap ends of the equity market remains and has in several instances reached new multi-year highs. This is the case regardless whether you compare the 90th vs 10th or 75 versus 25th percentiles, or if you look at specific regions or sectors, or if you look at profit-neutral or earnings-based multiples. There are a couple of sector outliers, with Energy being the most prominent. We struggle to see scope for further widening of the difference in valuation between the expensive and cheap ends of the equity market, even if interest rates remain low for longer.

**MEDIAN RELATIVE P/E FOR THE 90TH VS 10TH PERCENTILE IN STOXX GLOBAL 1800**


Source: FactSet and Nordea

**MEDIAN RELATIVE P/B FOR THE 90TH VS 10TH PERCENTILE IN STOXX NORTH AMERICA 600**


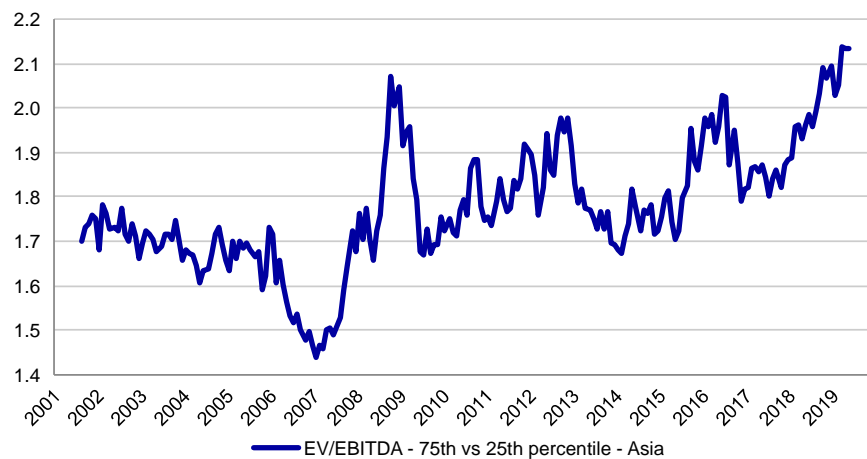
Source: FactSet and Nordea

**MEDIAN RELATIVE EV/S FOR THE 90TH VS 10TH PERCENTILE IN STOXX EUROPE 600**


Source: FactSet and Nordea

It does not matter if we look at Asia or compare the 75th to the 25th percentile; the conclusion remains

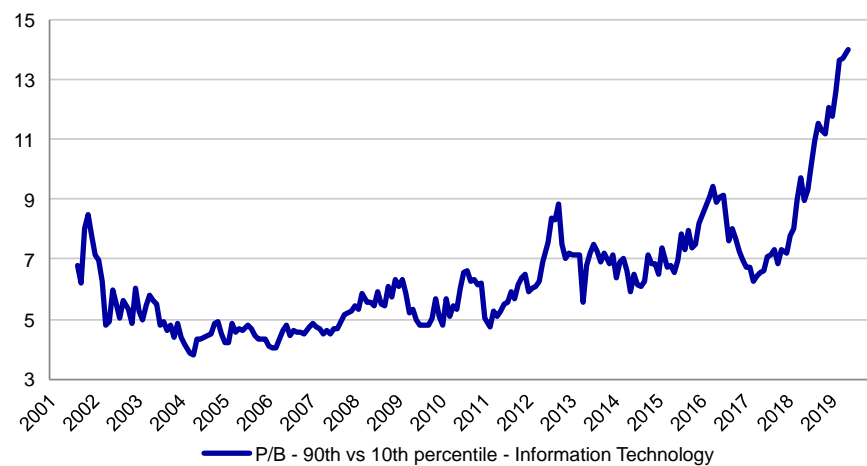
#### MEDIAN RELATIVE EV/EBITDA FOR THE 75TH VS 25TH PERCENTILE IN STOXX ASIA 600



Source: FactSet and Nordea

The global IT sector illustrates this cheap versus expensive phenomenon the most clearly

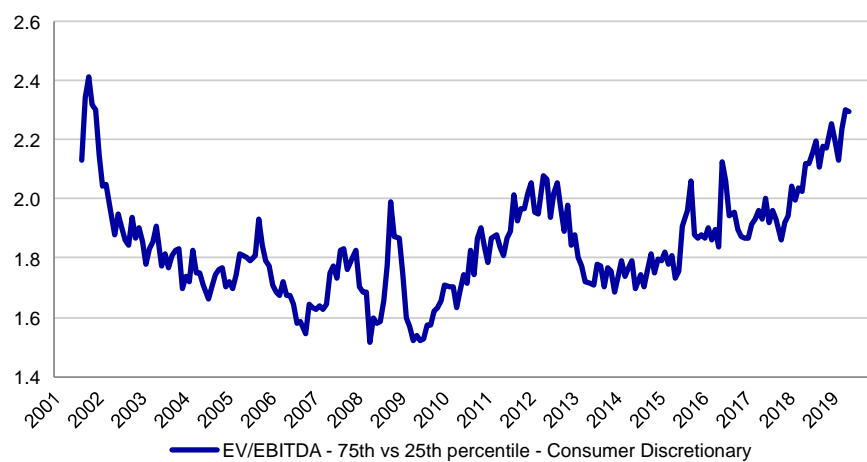
#### MEDIAN RELATIVE P/B FOR THE 90TH VS 10TH PERCENTILE - STOXX GLOBAL 1800 - IT



Source: FactSet and Nordea

Consumer Discretionary sector also illustrates the expanding gap even if we compare the 75th versus the 25th percentile

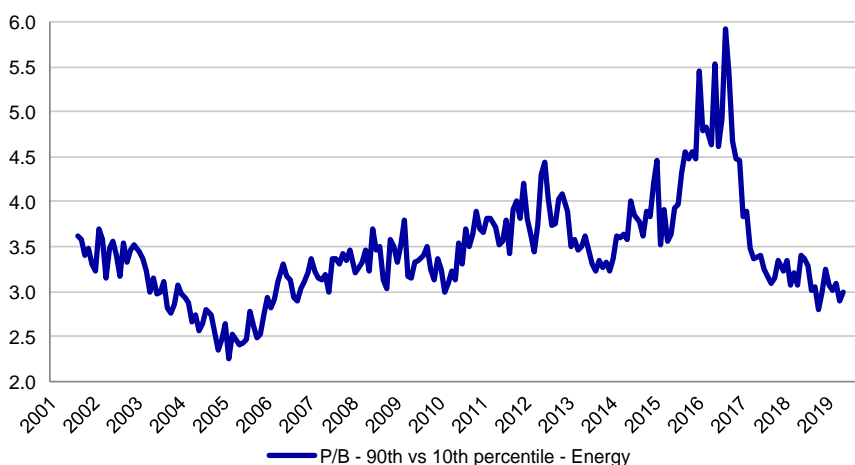
#### MEDIAN RELATIVE EV/EBITDA FOR THE 75TH VS 25TH PERCENTILE - CONS DISCRETIONARY



Source: Company data and Nordea estimates

**MEDIAN RELATIVE EV/SALES FOR THE 90TH PERCENTILE - INDUSTRIALS**

Source: FactSet and Nordea

**MEDIAN RELATIVE P/BV FOR THE 90TH VS 10TH PERCENTILE - ENERGY**

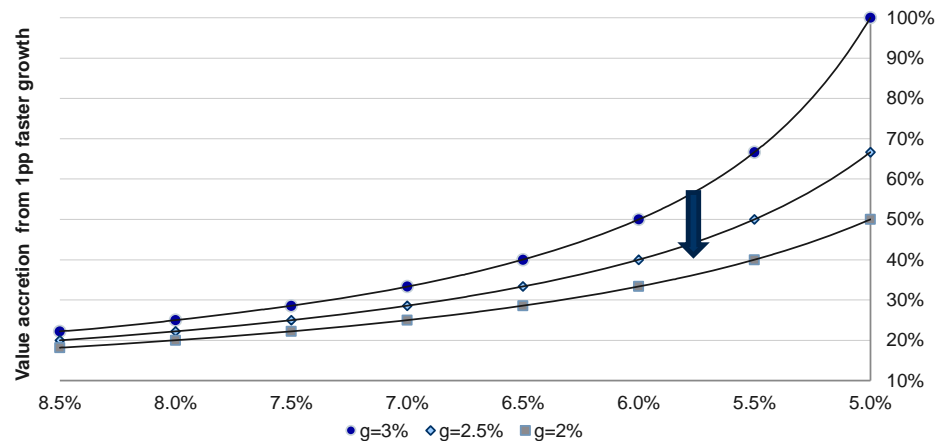
Source: FactSet and Nordea

What we continue to argue that the market participants are struggling to incorporate is the slower growth outlook. In our view a slowing global economy also implies smaller valuation differences, just like higher interest rates do. We are therefore confident that our value bias will eventually bear fruit. The biggest problem with our call is that it is contingent on changing investor behaviour. Having said that, we remain convinced that enough investors will dare to place some chips in the seemingly untouchable value camp, just because the margin of safety looks so compelling. One potential near-term trigger we see is increased uncertainty, ie a volatility spike, which historically has led to expensive stocks underperforming.

At  $g = 2-2.5\%$ , the premium paid for companies expected to post superior growth falls materially (compared to  $g=3\%$ ). This is particularly the case in a low interest rate environment

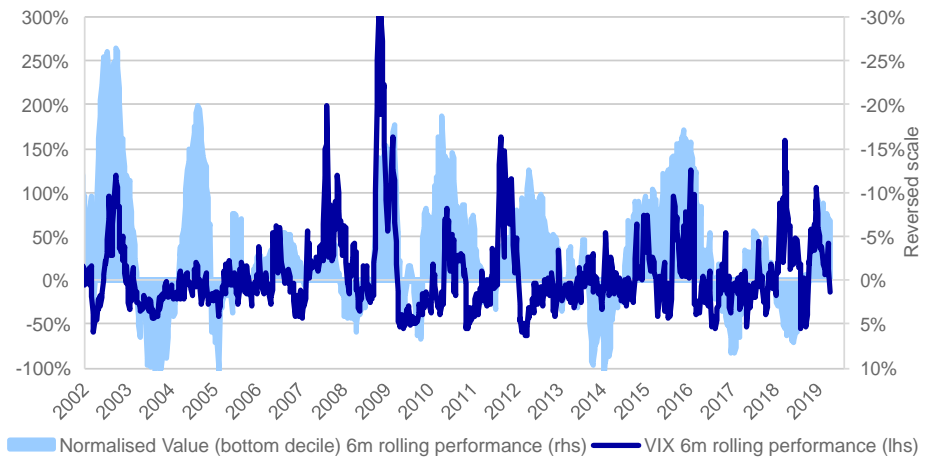
This is one of our core arguments why we remain so adamant that valuation should grow in importance

#### WARRANTED PREMIUM FOR EXCESS GROWTH AT VARIOUS COE AND GROWTH RATES



Source: FactSet and Nordea

#### SIX-MONTH ROLLING PERFORMANCE OF VIX AND OUR EXPENSIVE BASKET



Source: FactSet and Nordea

Spikes in the VIX are generally associated with poor performance of expensive companies

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

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