

Nordea View

October 2019: The hunt for Red October

We believe the equity market is underestimating the risk of a marked earnings recession and thus stay underweight in risky assets. Surveys have taken a turn for the worse during the autumn and some imply an outright GDP recession. While falling interest rates at some stage should help stabilise the macro outlook, we fear this point has been pushed further out. Historically, earnings recessions have gone hand in hand with falling equity markets and we thus advise a defensive stance in asset allocation. We expect a rather poor Q3 reporting season, prompting analysts to adjust their V-shaped earnings expectations. Recently, there has also been quite large equity style moves; momentum strategies have taken a beating while value has risen from the ashes. We also discuss from a structural standpoint what could go wrong in our negative equity call, but do not find enough evidence for a more bullish stance.

Macro strategy

The global slowdown we called in late 2017 has continued. Now we find that there are several more negative indicators than positive ones, and, in particular, leading surveys in the US have deteriorated. Moreover, macro and geopolitical risks are way above average, which makes a risk/reward equation worse. Uncertainty is becoming a major obstacle to growth. Although we still believe a GDP recession will be averted, recession risks have increased. Companies will be squeezed by slower sales and higher wage costs, which should lead to an earnings recession. We update our dollar-o-meter and find that four out of five factors continue to speak for a stronger USD. At the same time, the ECB's renewed QE purchases have seen EUR credits outperform USD ones.

Theme: Profit recessions under scrutiny

Having analysed 27 profit recessions in the US equity market, we affirm our cautious stance on equities. Although the range varies considerably, the median and average suggest that profit recession (peak to trough) and share price declines could be ~20%. There have been instances where share prices have proved resilient, but each of these has been associated with low valuation. The fact that trailing and Shiller P/E multiples have only been higher twice ahead of a profit recession (1997 and 2000) suggests poor risk/reward today, as our indicators point to a high likelihood of a marked earnings recession.

Equities: It's adjustment time for V-shaped earnings forecasts

We expect that seasonal third-quarter downward adjustments are likely to be compounded by fears of an earnings recession as analysts and investors prepare for earnings season. If the profit recession we forecast hits, we doubt that today's valuation levels can withstand the estimate pressure. We also believe the growing gap between reported and operational earnings is evidence that valuation in the US is more expensive than operational P/E would suggest. We find it unlikely that the US will continue to outperform the rest of the world from a relative earnings perspective and we thus maintain our underweight.

Equity styles: Sticking to fundamentals as uncertainty rises

Late August/early September gave us a hint of how fast a winning strategy can become a losing one, with momentum strategies cracking and investors seemingly rotating into value. In this report, we present five potential triggers for a sustained value revival: rising rates, a comeback for European banks, positioning, M&A, and absolute valuation levels. We also demonstrate that there is a clear valuation limit to how big a premium investors should pay for bond proxies. For those investors reluctant to take the full value plunge, we would advise combining value with quality and cash conversion traits.

Nordea Markets - Analysts

Mikael Sarwe
Head of Market Strategy
mikael.sarwe@nordea.com

Carl Grapenfelt
Head of Market Research
carl.grapenfelt@nordea.com

Arvid Böhm
Head of Equity Strategy,
arvid.bohm@nordea.com

Martin Enlund
Chief FX Strategist
martin.enlund@nordea.com

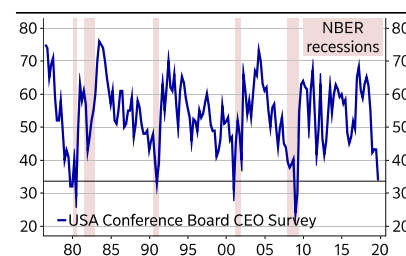
Lars Mouland
Chief FI Strategist
lars.mouland@nordea.com



Nordea View

Nordea
MARKETS

INCREASING RECESSION RISK



Source: Macrobond and Nordea

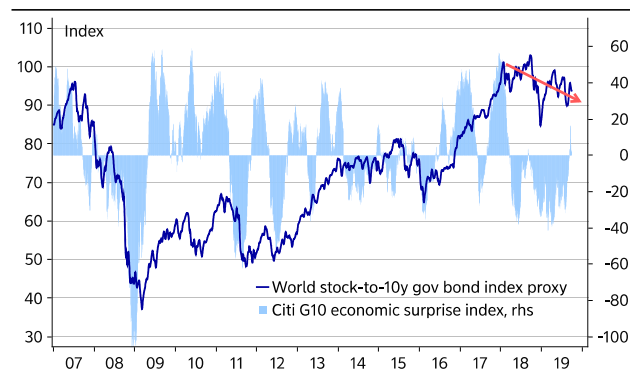
Macro strategy: Caution warranted

We believe that the equity market is underestimating the risk of a marked earnings recession and remain underweight in stocks. Surveys have taken a turn for the worse during the autumn, and some even imply an outright economic recession. Even though falling interest rates should at some stage help stabilise the macro outlook, we fear that this point in time has been pushed further out. Historically, earnings recessions have gone hand in hand with falling equity markets, and we thereby advise a defensive stance in asset allocation.

Overweight in bonds and underweight in equities has been warranted

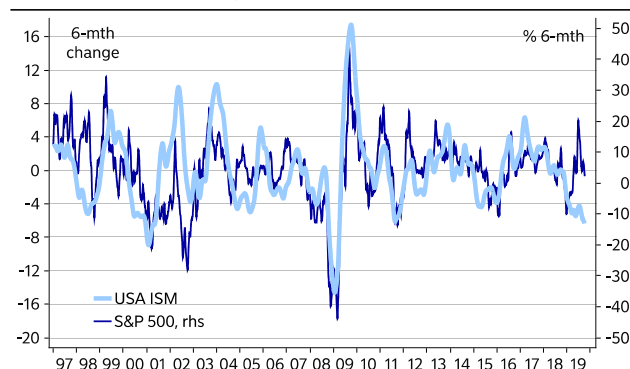
We have been advocating underweighting equities and thereby overweighting bonds since May 2018, which has been correct so far from an allocation perspective. That said, we would have expected both equities and bonds to have performed worse.

STOCK TO BOND RETURNS AND ECONOMIC SURPRISES



Source: Bloomberg, Macrobond and Nordea

THE GREAT MACRO/EQUITY MARKET DIVIDE



Source: Bloomberg, Macrobond and Nordea

The global slowdown has continued

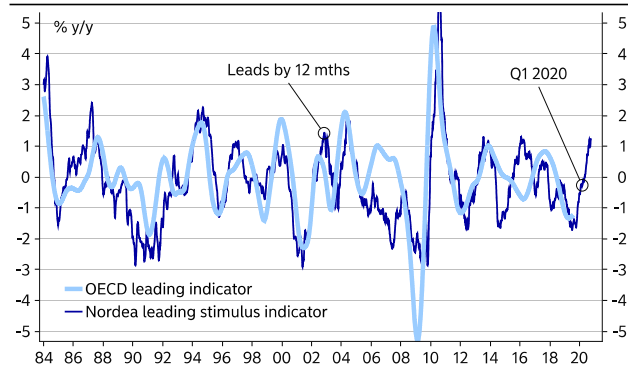
The global slowdown we have been discussing since late-2017 has continued. Germany is likely already in recession, Chinese GDP is increasing at its slowest pace in modern history, Swedish unemployment has risen dramatically, and there are now growing signs that the US is also slowing materially. September was a veritable disaster when it comes to various business surveys in the Western world. Despite this, analysts' earnings expectations continue to form a V-shaped curve, and equity markets, although basically range-bound, are trying to find reasons to break out to the upside; most recently on hopes for a trade deal between China and the US. We continue to be perplexed about this macro/equity market divide.

Poor risk/reward equation for equities

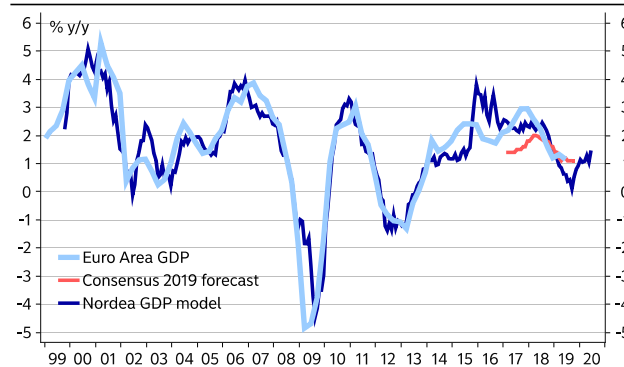
It is not that we do not see the potential positive twists. They are there. But we continue to find that risk/reward still favours a defensive view, particularly given valuation levels, our prediction of a marked earnings recession and historical equity price movements during similar periods. Also, as we have pointed out previously, the number of macro and geopolitical risks is clearly way above average, which makes the risk/reward equation even worse.

Stimulus from falling interest rates could help manufacturing in 2020

There is a chapter in this report that covers where we could be structurally wrong in regards to our negative equity view, but there are also some positive cyclical factors we should yet again point out. As we wrote in the August edition of Nordea View, we had expected to become more positive towards equities in mid-2019, since we believed that added stimulus from lower rates and more dovish central banks should create a base for an improving manufacturing cycle in 2020. Our stimulus indicator points to such a possibility, and overall financial conditions have helped our leading Euro-area GDP indicator to bottom and turn upwards. Also, the G10 economic surprise index has briefly been in positive territory for the first time since early-2018 and the Chinese Caixin PMI has bounced to relatively upbeat levels. On top of this, some investors clearly believe there is a high likelihood of fiscal policy coming to the rescue both in Europe and on the other side of the Atlantic.

RATES-BASED STIMULUS INDICATOR

Source: Bloomberg, Macrobond and Nordea

EURO-AREA GDP INDICATOR

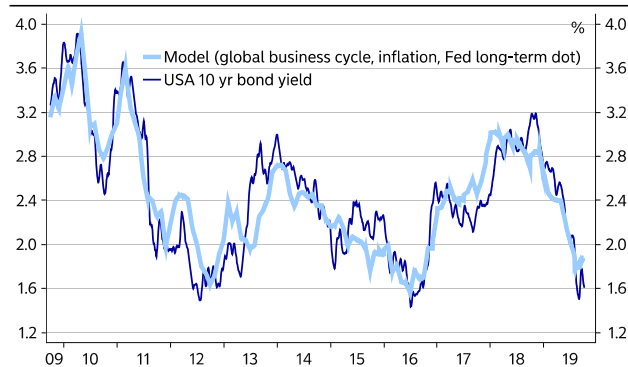
Source: Bloomberg, Macrobond and Nordea

Recession risks have increased since spring

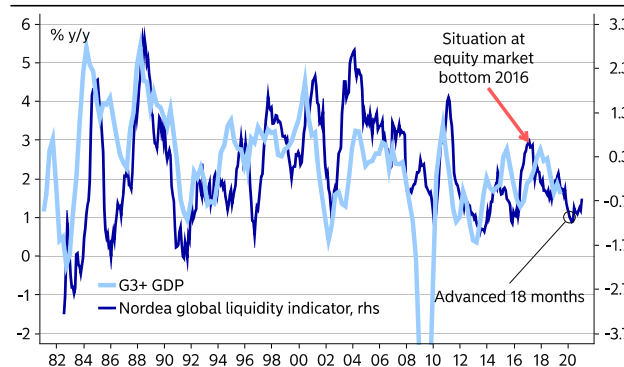
Still, we once again find counter-arguments for why there is a high risk that the cyclical bottom lies further in the future, and that recession risks, if anything, have actually increased since the spring.

Liquidity indicators are still downbeat

On the monetary policy side, we note that interest rates are in line with cyclical models and could probably not drop more than marginally unless things evolve into a recession scenario. We thus do not see much more stimulus or help for equity valuation from monetary policy. So far, our liquidity indicators have not shown much inclination to react, and we thus suspect that stimulus effects from falling yields will take longer to bite, similar to the outcome back in 2015-16. Our broad global liquidity indicator basically warns that the cyclical slowdown could continue throughout 2020, and it is nowhere near as positive as it was when the equity market bottomed in 2016. The effectiveness of monetary policy with rates this low could also be questioned. There is, however, a high probability that the Fed needs to increase the amount of bank reserves for operational reasons, which wouldn't be a "true" QE programme but could be perceived as such by the market and be interpreted positively for a while.

USA 10-YEAR BOND MODEL

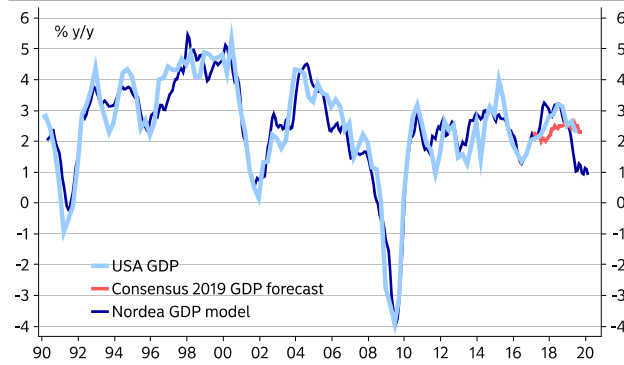
Source: Bloomberg, Macrobond and Nordea

LIQUIDITY WARNS OF SLOWDOWN THROUGHOUT 2020

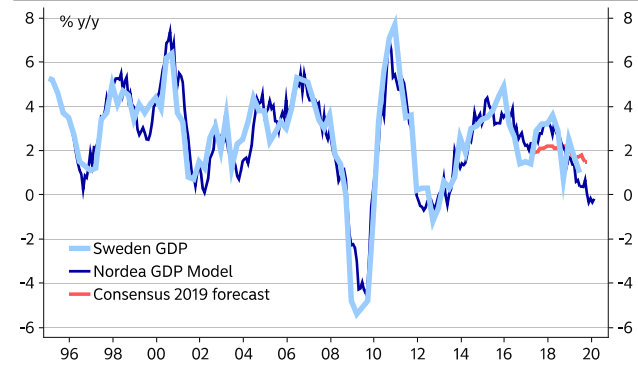
Source: Bloomberg, Macrobond and Nordea

The slowdown in the Euro area seems to be moving to the service sector

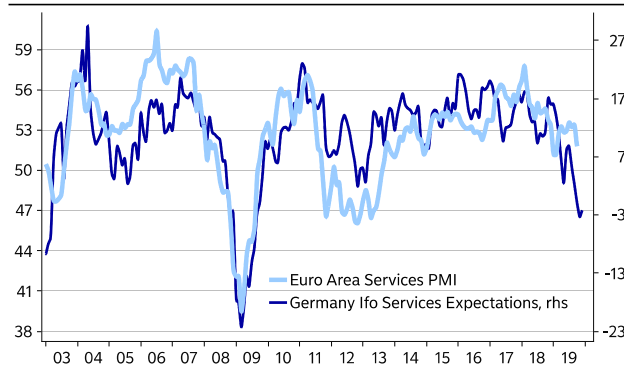
We doubt that the G10 surprise index will stay in positive territory for very long, since most of our leading GDP indicators are clearly below economists' consensus. In the Euro area, where our GDP indicator is more in line with consensus, the development in surveys such as Sentix and ZEW warns of a recession. Also, the German Ifo survey indicates that the slowdown is spreading to the employment-heavy service sector which has so far been sheltered. Trump's promise that Europe is next in the trade war seems to be prolonging the pain, and uncertainty, measured as the Ifo dispersion index, is rising in a way previously only seen in recessions. Uncertainty is starting to become a major obstacle for the outlook in Europe.

US GDP MODEL POINTS TO 1% GROWTH

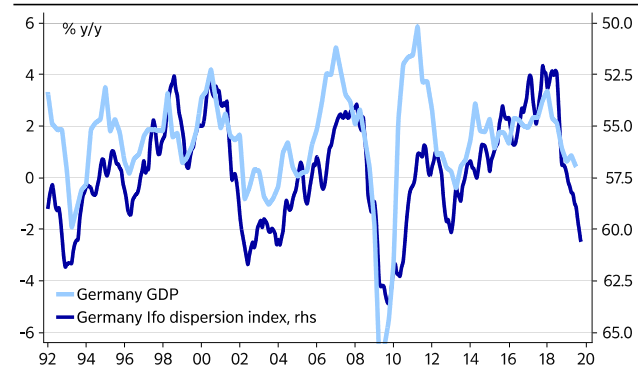
Source: Bloomberg, Macrobond and Nordea

SWEDISH GDP MODEL WARNS OF MILD RECESSION

Source: Bloomberg, Macrobond and Nordea

EURO-AREA SLOWDOWN SPREADING TO SERVICES

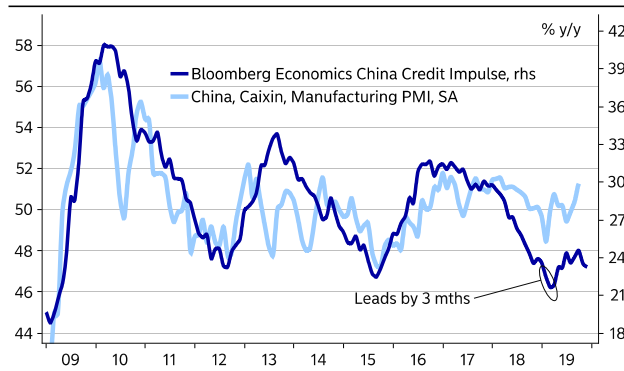
Source: Bloomberg, Macrobond and Nordea

UNCERTAINTY INCREASES EURO-AREA RECESSION RISK

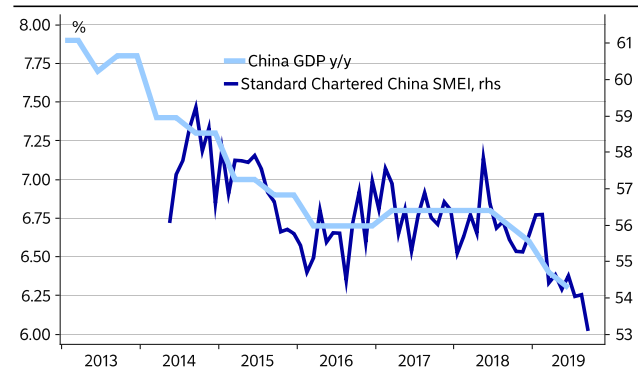
Source: Bloomberg, Macrobond and Nordea

Chinese PMI should fall back again

The jump in Chinese PMI is not corroborated by other indicators, and we deem it likely that there has been political pressure on the large companies to show optimism, owing to China's 70-year anniversary and the trade war. The Chinese credit impulse is negative, South Korean exports are still falling considerably, industrial commodity prices are not rising, and small and mid-sized companies are more pessimistic than for a long time. We thus believe that PMIs will fall back again towards the end of 2019. We do not believe that China and the US will solve their trade issues, and a continued trade war is our primary view. Knowing Trump's previous decisions, it is even possible that he will introduce more tariffs in such a scenario. Admittedly, a trade deal should lead to a more positive short-term scenario, but it is obviously very hard to call the outcome. However, we think that, even in this scenario, the signs of a more material slowdown in the US scenario are here to stay in a slightly longer time horizon.

CHINESE CREDIT IMPULSE AND PMI

Source: Bloomberg, Macrobond and Nordea

PESSIMISTIC CHINESE SMALL/MID-SIZED COMPANIES

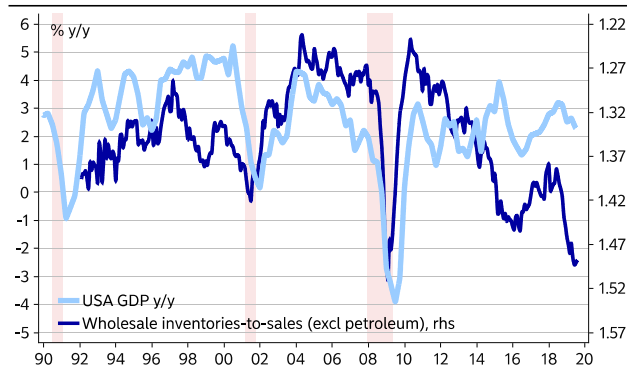
Source: Bloomberg, Macrobond and Nordea

A growing number of indicators signal a marked slowdown in the US

Although hard data, including retail sales, housing and unemployment, has remained relatively upbeat in the US, there are a number of leading indicators that are signalling upcoming problems in Q4 and onwards. Wholesale inventories to sales are at their highest level since the financial crisis, when they became a huge problem as demand faltered. Our broad survey-based GDP model is pointing to 0% growth in early-2020.

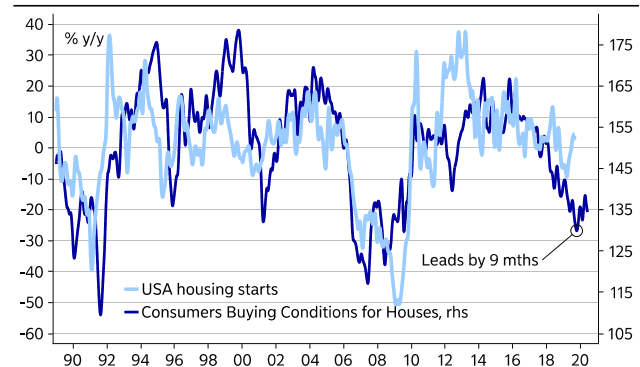
Despite massively falling interest rates and improved affordability, households are still not signalling any improvement in plans to buy homes. Leading labour market indicators, such as overtime hours, NFIB and the ISM employment indices, signal a more pronounced drop in non-farm payrolls than at any time since the financial crisis.

US INVENTORIES ARE WORRYINGLY HIGH



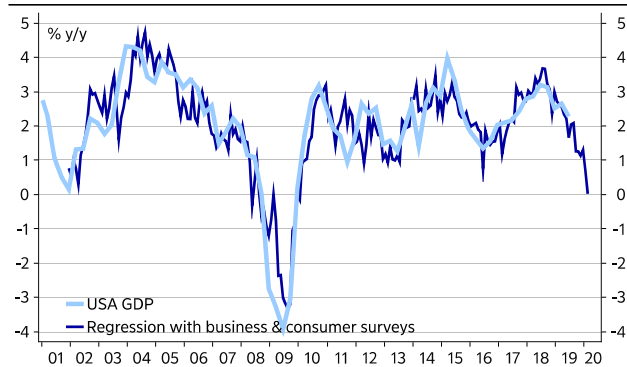
Source: Company data and Nordea estimates

HOUSEHOLDS STILL DOWNBEAT ON BUYING HOMES



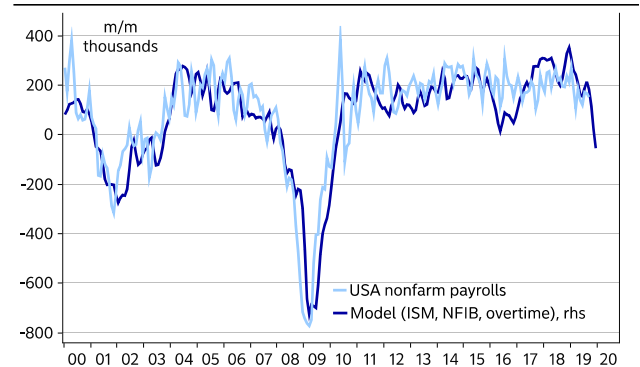
Source: Bloomberg, Macrobond and Nordea

SURVEYS INDICATE RISK OF 0% US GDP GROWTH



Source: Bloomberg, Macrobond and Nordea

EMPLOYMENT GROWTH POSSIBLY NEGATIVE IN EARLY 2020

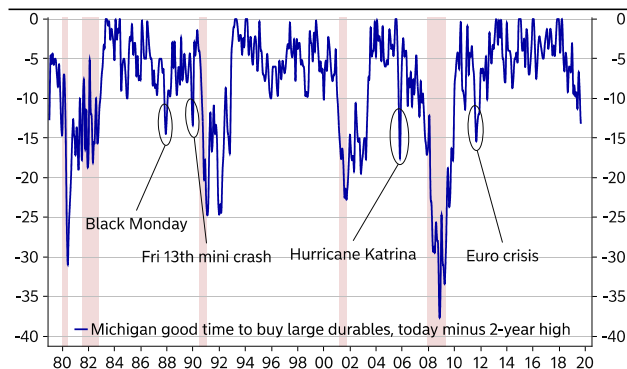


Source: Bloomberg, Macrobond and Nordea

Some surveys already indicate that the US is in recession

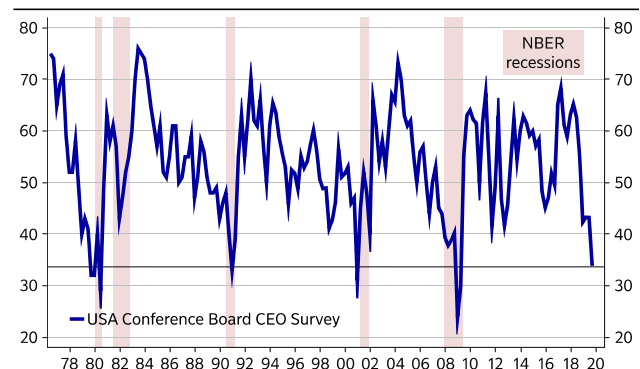
There are also some lesser-known indicators that are already signalling a recession. Besides in recessions, households' intentions to buy large capital goods rarely fall as much as they have done recently. Conference Board's CEO survey has dropped to a level that has always meant a recession in the past, and the survey has had a perfect track record since its inception way back in the late 1970s. So even though our broad leading GDP indicator is still around 1%, which is clearly below consensus, there is a growing probability that growth will slow even further. Once again, in risk/reward terms, the global economy seems to be only one setback away from an uglier scenario.

US HOUSEHOLDS LESS WILLING TO SPEND



Source: Bloomberg, Macrobond and Nordea

US CEOS ARE PREDICTING A RECESSION



Source: Bloomberg, Macrobond and Nordea

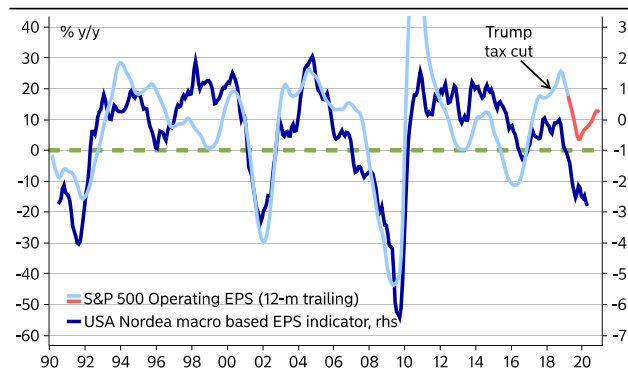
High risk of marked earnings recession

Even if a US GDP recession is averted, which is our main scenario, we stick to our long-standing prediction of a marked earnings recession starting late in 2019. This scenario is nowhere to be seen in analysts' V-shaped forecasts. Companies are being squeezed not only by slower sales but also by wage costs rising the most since before the

financial crisis. The share of small companies that see wage costs as their biggest problem is at the highest level in over 30 years. Recently, our macro-based earnings indicator (leading GDP minus wage model) has fallen even further into negative territory.

Many investors believe that the equity market should be able to withstand an earnings recession, partly because of the strong TINA regime and partly due to central banks or fiscal policy saving the day. We, however, do not believe that the Democrats will let Trump get any fiscal stimulus through Congress in a year of presidential election. In Europe, we argue that no marked fiscal efforts will be pushed through until it is too late, ie only if the economy is already in some type of free fall.

A MARKED EARNINGS RECESSION IS ON THE CARDS

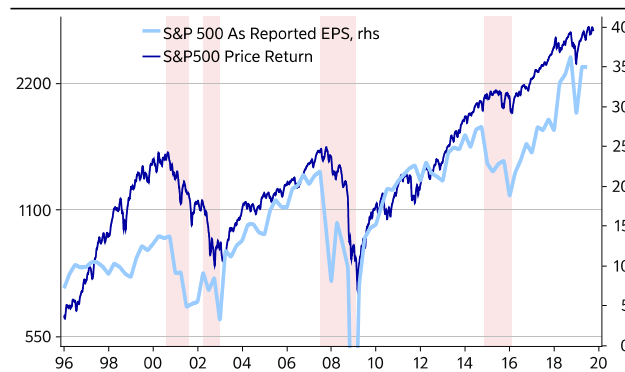


Source: Bloomberg, Macrobond and Nordea

Equity prices normally fall throughout earnings recessions

We stay underweight in equities and overweight in bonds

S&P 500 AND EARNINGS RECESSIONS



Source: Bloomberg, Macrobond and Nordea

Also, in another chapter of this report, we look at US earnings recessions since 1900 and what the equity market has done. In short, equity prices have dropped practically every time, and particularly if valuation levels have been high as now. If we look at the three most recent earnings recessions, we can see that the stock market has started falling every time profits have peaked and have continued falling until earnings have bottomed. In other words, the equity market has not been as forward-looking as one might think. With such a historically strong correlation between falling equity prices and earnings, we are not willing to put our money in the “it’s different this time” camp, even though we can understand why some do.

All in all, we still think the risk/reward regarding the economy, valuation and earnings favour defensive positioning, and we continue underweighting equities and overweighting bonds. We also note that there has been a clear pattern over the last ten years, in which Q4 has brought market turbulence and volatility spikes. The hunt for Red October is on.

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

Dollar-o-meter: Keeping firm

The dollar is at its strongest level since the spring of 2017. We update our dollar-o-meter framework, this time also incorporating the dollar smile theory into our analysis. Despite growing headwinds, we argue that relative growth, inflation, central banking policy, politics as well as the dollar smile theory still favour the USD, and that the greenback will consequently remain firm.

A year ago, consensus expected EUR/USD to trade around 1.20-1.25 by now

The USD has put the consensus on a wrong footing again this year. A year ago, consensus expected EUR/USD to trade around 1.20-1.25 by now, but instead the USD is trading at its strongest level since the spring of 2017 – versus the EUR and versus a broader basket of currencies. To see what the future may hold, we revisit our dollar-o-meter framework, which examines the following factors: relative growth, relative inflation, relative central banking policy, and politics. In this update, we also incorporate the dollar smile theory into our analysis.

We find that relative growth, relative inflation, relative central banking policy, and the dollar smile theory all favour the USD. The political outlook appears more neutral. We consequently stick to our view that the USD will remain firm this side of 2020.

Growth

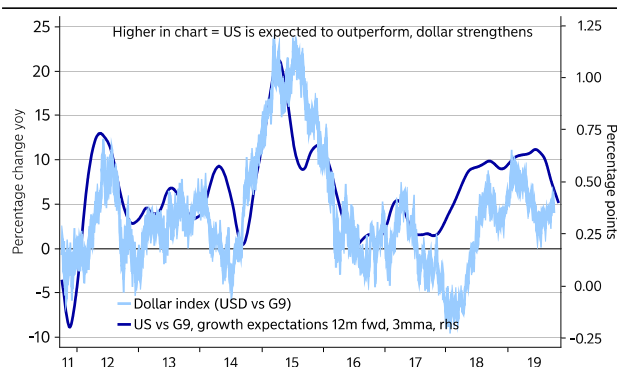
US growth expectations need to converge with the rest of the world before any significant weakening occurs

US growth expectations have been falling in relative terms since the start of the summer. If this trend continues, it could weaken the USD at some point. Looking at empirical evidence, however, we argue that US growth expectations need to converge with the rest of the world before any significant weakening occurs – right now, relative growth expectations are still consistent with a USD that will strengthen 5% on an annualised basis.

It is also striking how Euro-area (EA) data has generally kept disappointing. A weaker EUR, record-low bond yields and accelerating monetary growth have so far failed to stabilise activity growth. Instead, the most recent PMI for manufacturing was the weakest since 2012, and there are sadly more and more signs that weakness in the manufacturing sector has started to spill over into the more employment-heavy service sector.

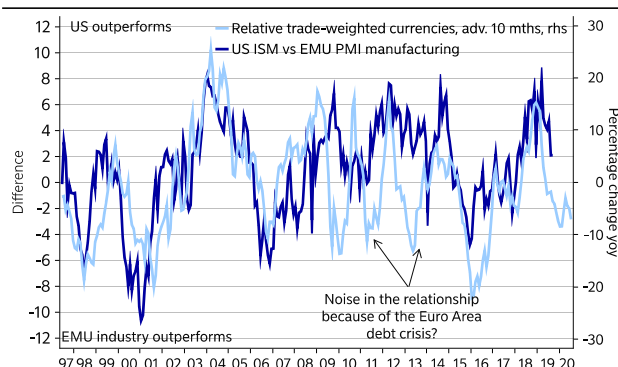
Even as US growth estimates are lowered, we argue that the country is still outperforming well enough to keep the USD firm.

RELATIVE GROWTH STILL SUPPORTIVE OF THE USD



Source: Macrobond, Bloomberg and Nordea

NO SIGNS OF STABILISATION IN EA DESPITE WEAKER EUR



Source: Macrobond and Nordea

Inflation

US core inflation has recently topped expectations three times in a row

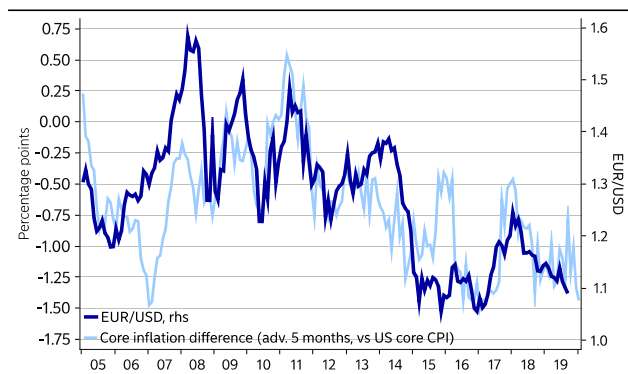
While inflation is generally considered a negative driver for currencies, higher inflation can, counterintuitively, have a positive impact on the currency – if it pushes a central bank in a hawkish direction. Indeed, over the past decade, relative core inflation developments have helped predict the direction of the EUR/USD (after some delay). US core inflation has most recently topped expectations three times in a row. This is positive news for the USD, especially since our models suggest that a further

acceleration in US core inflation may be on the cards.

The same cannot be said about Euro-area inflation. The ECB's new chief economist, Philip Lane, has said "the pass-through of higher wages to domestic price pressures remains muted" and "pass-through remains limited", which has "yet to be fully explained". In other words, Euro-area inflation pressures remain mysteriously low and the ECB cannot explain why.

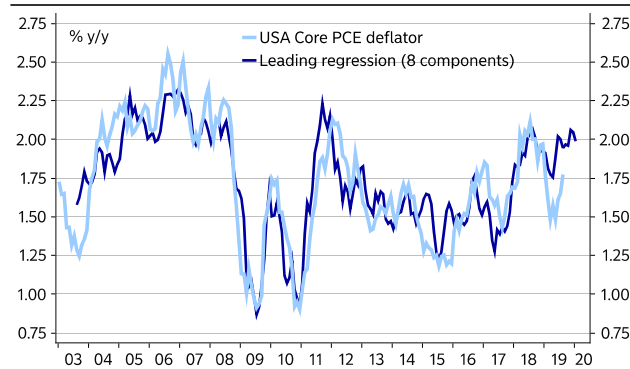
Recent US core inflation outcomes and the outlook for relative inflation suggest that the USD will continue trading on the strong side versus the EUR.

RELATIVE INFLATION POINTING SOUTH FOR EUR/USD



Source: Macrobond and Nordea

UPSIDE RISKS TO US CORE INFLATION



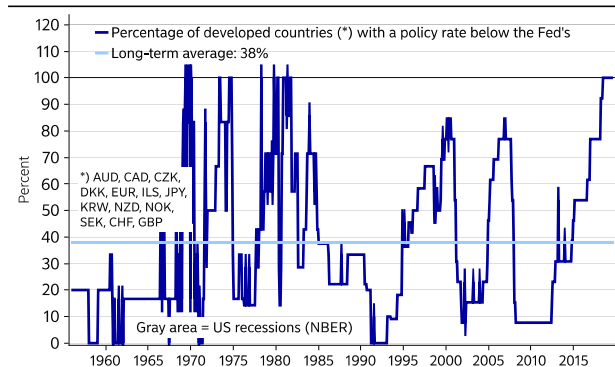
Source: Macrobond and Nordea estimates

Central banking policy

The Fed would need to lower rates by 280 bp to bring the USD 3m hedging cost for EUR/USD down to zero

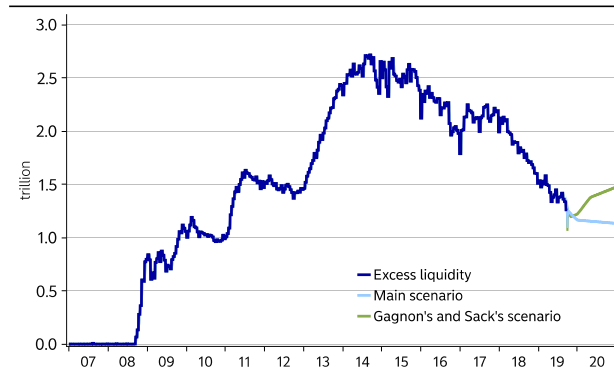
The US Fed has lowered its target interval for the federal funds rate twice this year. Together with administrative IOER rate cuts, the effective fed funds rate is now down to 1.85% from 2.45%. While this should have been negative news for the USD, the greenback seems largely unaffected. The US policy rate is still, after all, the highest in the G10, meaning that USD selling remains costly, especially versus currencies where negative rates reign, eg the CHF, DKK, EUR, JPY and SEK. The Fed would need to lower rates by 280 bp to bring the USD 3m hedging cost for EUR/USD down to zero. US monetary policy may also still be "too tight" for much of the world – leaving the USD in a benign spot. In short, even if the Fed lowers rates twice more, we argue that the rate change is unlikely to undermine the USD significantly.

US MONETARY POLICY MAY BE TOO TIGHT FOR RoW



Source: Macrobond and Nordea estimates

FED COULD ADD LIQUIDITY, WHICH COULD DENT THE USD



Source: Macrobond and Nordea estimates

The liquidity outlook is more interesting. The Fed was recently caught off-guard by volatility in the money market. Formally, there is still almost USD 1,300bn in "excess liquidity" available, but changes to the market structure mean that these may no longer truly be excess dollars. Instead, recent money market strains suggest there may be too few dollars around.

If the Fed decides to flood the banking system with more liquidity, it could undermine the dollar

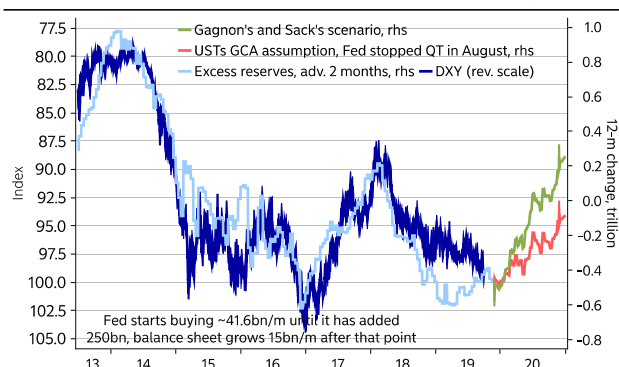
Two former Fed officials – Sack and Gagnon – recently suggested the Fed should add USD ~250bn over a six-month period, ie a "soft" quantitative easing (QE). An illustration of their scenario is shown in the table above on the right. If the Fed decides to flood the banking system with more liquidity, it could undermine the dollar temporarily. We think

it is too early to make that call, and we suspect that adding liquidity when the policy rate is close to 2% would have a different (ie less powerful) effect than adding liquidity when the rate is close to zero. For now, we do not think increased liquidity would be a game-changer for the USD.

No one knows exactly how the ECB's new tiering system will impact short rates – and the market has been using a lot of guesswork, trying to price in the new EUR rates curve that starts on 30 October. It is possible that the market is pricing the changes too hawkishly. What's more, the ECB's open-ended "hard" QE of EUR 20bn per month starts on 1 November. This will likely cause EUR-negative flows – and it is possible that these flows have yet to be fully discounted. Euro-area PMIs are down, which usually triggers more easing from the ECB – and which will likely keep the EUR on its heels.

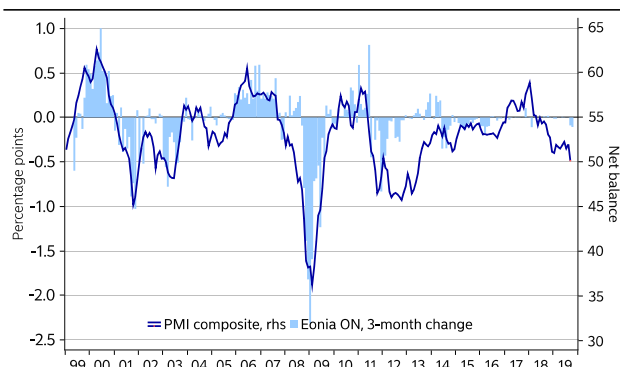
Overall, we believe that the US Fed will cut rates and add liquidity (temporarily), but the outlook for relative rates and liquidity suggests that these changes will not be drastic enough to significantly dent the greenback.

2020 COULD BE DIFFERENT IF FED ADDS ENOUGH LIQUIDITY



Source: Macrobond and Nordea estimates

EA PMI COMPOSITE NOW DEEP IN ECB EASING TERRITORY



Source: Macrobond and Nordea estimates

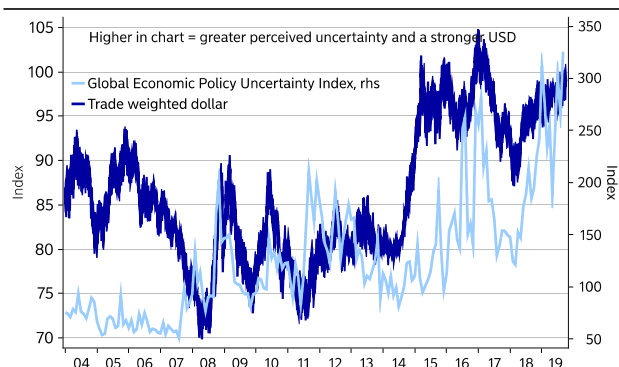
Politics

On the political front, the WTO has recently given the US a green light to implement tariffs against the EU, in retaliation for the EU's Airbus subsidies. While this is not a surprise, it is nonetheless bad news for Euro-area growth. The EU has filed similar complaints against Boeing; the ruling is expected two months from now, after which the EU will likely retaliate. While the sums involved are paltry in relation to the combined economies of the EU and US (USD 40tn), the conflict does heighten the political uncertainty.

While most analysts refer to the "trade war", a more apt moniker may be "Cold War 2.0"

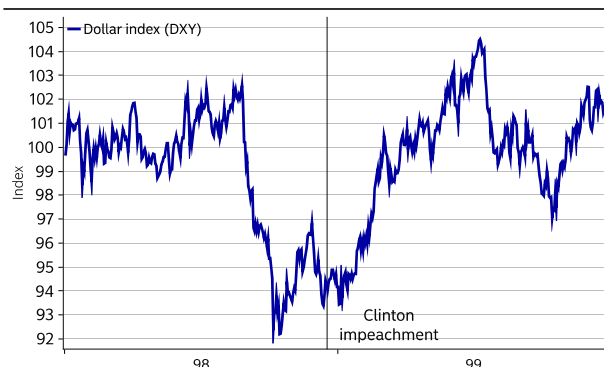
That applies doubly to the US/China trade talks. While most analysts refer to the "trade war", a more apt moniker may be "Cold War 2.0". The US is considering the placement of medium-range missiles in the Asia-Pacific region (similar to the Soviets placing missiles in Cuba back in the 1960s), and the White House is reportedly discussing ways to restrict US capital flows into China (somewhat similar to what the US did to Japan before Pearl Harbour). Elevated global economic policy uncertainty, however, is typically good news for the USD – especially on a trade-weighted basis.

ELEVATED UNCERTAINTY GOOD FOR THE USD



Source: Macrobond and Nordea

USD SOARED AFTER THE IMPEACHMENT OF CLINTON



Source: Macrobond and Nordea

The impeachment of President Clinton in 1998 did not do much to derail the USD

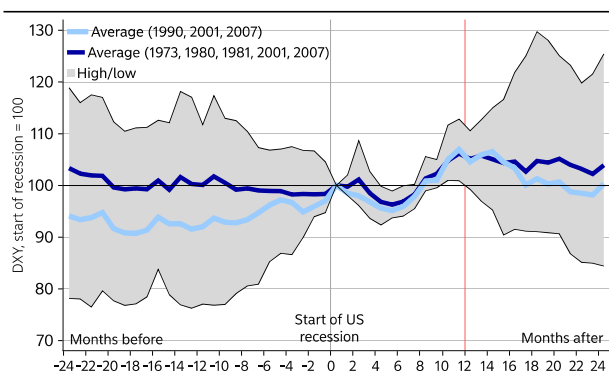
In the US, the debate surrounding an impeachment of the sitting President has intensified – the likelihood of an impeachment before Trump's term ends has jumped to ~70%, according to betting markets. As far as we can tell, however, the current crop of allegations are no more serious than anything else that has been thrown at him over the course over the past three years, so at this time we would not make much of it. Furthermore, the impeachment of President Clinton in 1998 did not do much to derail the USD.

A hard Brexit scenario would weigh significantly on European currencies

On the European side of the Atlantic, the main political risks stem from Brexit. A hard Brexit scenario would weigh significantly on European currencies versus the USD. The ECB is also facing a growing revolt against its policies, from economists and former central bankers, especially in northern countries. If this revolt causes a larger split within the ECB, it could further delay monetary policy easing under Mrs Lagarde, who will take over after Draghi in November. This would be positive for the EUR. At this current juncture, we do not expect the revolt to impact the ECB's policies.

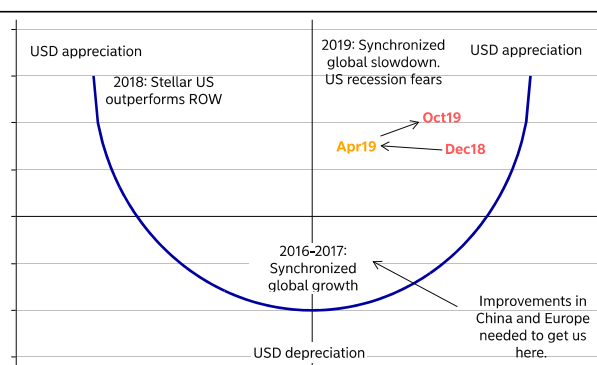
Global economic and political uncertainty is likely good news for safe-haven currencies, of which the USD is the most important. We hence argue that the USD will remain firm on a trade-weighted basis. Transatlantic risks related to the Brexit process may be slightly positive for the USD, but we judge them as roughly neutral in our subjective scoring.

USD GAINS 5% ON AVERAGE DURING US RECESSIONS



Source: Macrobond and Nordea

A SYNCHRONISED SLOWDOWN IS GOOD FOR THE USD



Source: Macrobond and Nordea

The USD does well when the US economy outperforms significantly *and* during a synchronised global slowdown

Rounding up with the dollar smile theory

In an adverse economic scenario such as a US recession, the USD usually gains an average of 5% versus other major currencies over the following 12 months. This has led to the formulation of the dollar smile theory, which posits that the USD does well when the US economy outperforms significantly *and* during a synchronised global slowdown – as has been the case in 2019. According to this theory, the USD only weakens significantly in a scenario with synchronised global growth. The central bank stimulus being enacted in 2019 should pave the way for a recovery in growth, but we assume that will be a story for another year.

To sum up our findings, we argue that relative growth, relative inflation, relative central banking policy – and the dollar smile theory – overall still favour the USD. The political outlook appears more neutral. Consequently, we stick to our view that the USD will remain firm in the near to medium term.

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

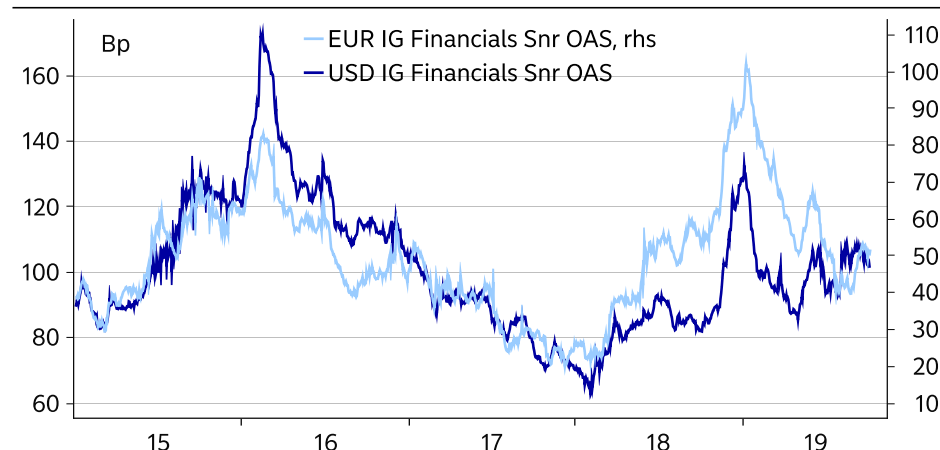
Credit: Hunt for yield in focus again

Investors have been eager to buy up European credit paper before the ECB and as a result credit spreads in Europe have become much tighter than in the US in 2019. However, we also see signs of a hunt-for-yield mentality emerging in the US as a reaction to the large fall in rates this summer. As more American issuers take advantage of the low European credit spreads, it becomes more expensive for Scandinavian issuers to raise money in Europe. This will also impact credit spreads in the domestic markets.

Expectations of new QE the most important event for the EUR market in 2019

The expectation of a restart of QE by the ECB has had a major impact on European spreads. Investors remember how hard it was to get a hold of bonds when the ECB was a big net buyer, and this time they have been eager to invest before the central bank enters the market. On a relative basis, the difference between US and EUR credit spreads are now back to where they were in 2015-17, when EUR credits traded with a 50% beta to the US. As the previous ECB QE programme was unwound in 2018, European spreads were repriced and eventually traded more in line with the USD market. However, as expectations for more ECB QE gradually built up over 2019, European spreads have tightened massively.

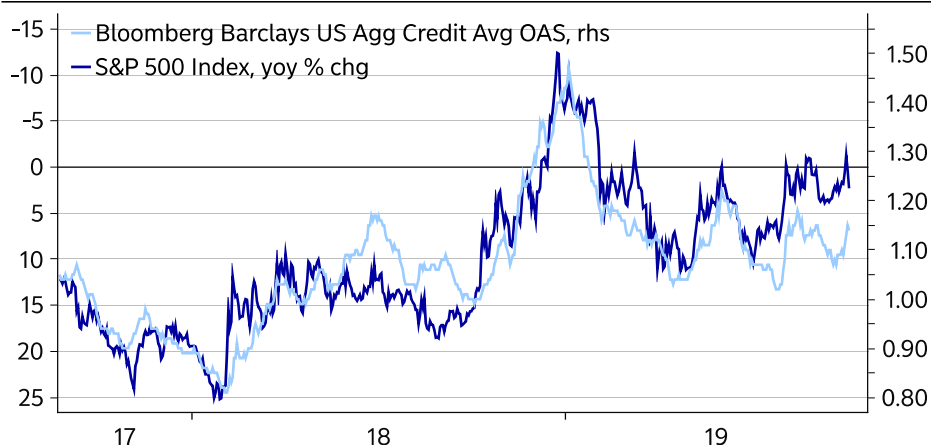
EUROPEAN CREDITS ARE BACK TO QE-PRICING



Source: Bloomberg, Macrobond and Nordea

Tentative signs of hunt for yield in US markets

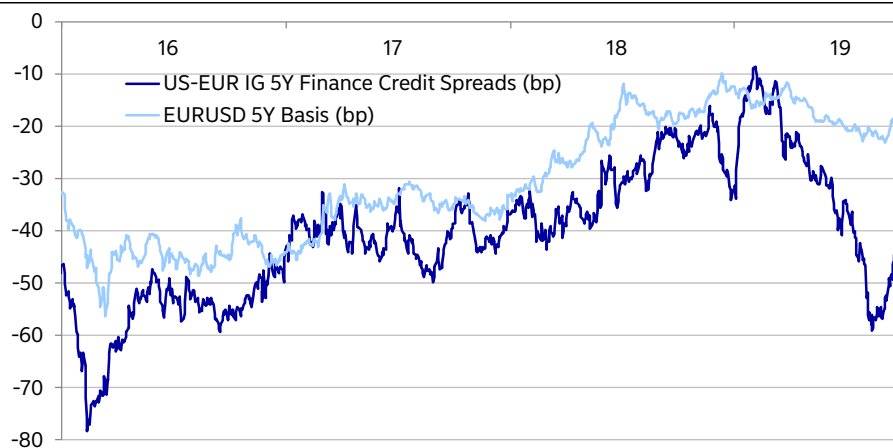
US credit spreads have closely tracked returns in the equity market since 2017, but since mid-August spreads have tightened more than this relationship would imply. This coincides with the massive drop in rates and leads us to believe that investors are now more willing to go out of the risk curve in order to reach their yield target. This is a story we know very well from watching the European market and if US rates continue to fall, US credits could continue to tighten, even in a struggling equity market.

US CREDIT SPREADS ON THE TIGHT SIDE COMPARED TO EQUITIES SINCE AUGUST

Source: Bloomberg, Macrobond and Nordea

Low European credit spreads also impact the US market

Lower European spreads mean it is now very attractive for US companies to issue bonds in Europe. As a result, we have seen an increased amount of this so-called Reverse Yankee issuance, which could also help explain why spreads in the US have tightened as the need for US companies to raise money in the US has decreased.

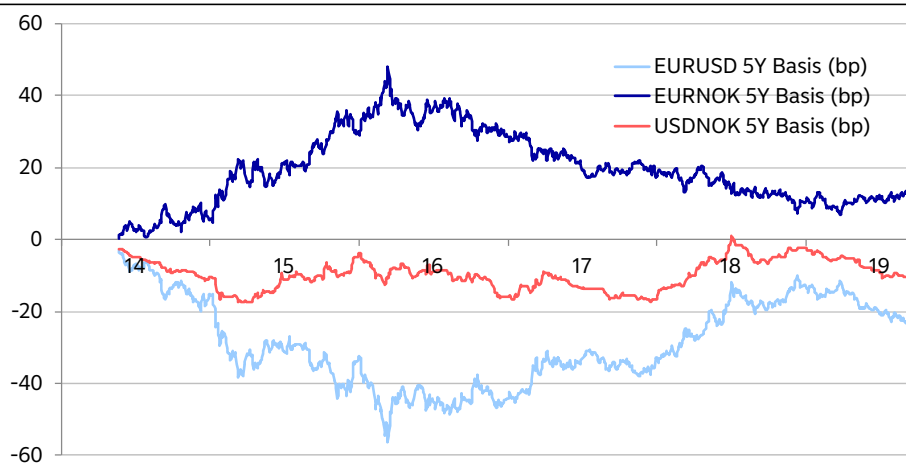
DIVERGENCE BETWEEN US/EUR CREDIT SPREADS AND EURUSD BASIS MAKES IT ATTRACTIVE FOR US COMPANIES TO ISSUE BONDS IN EUROPE

Source: Bloomberg and Nordea

As it is still attractive for US issuers to come to Europe, we expect to see more Reverse Yankee issuance going forward. As US companies issue bonds in Europe, they usually swap the proceeds back home to USD pulling the EURUSD basis lower. As the EURUSD cross-currency basis sinks, the EURNOK and EURSEK basis is pushed higher. A higher basis means the all-in cost for Scandinavian issuers that fund themselves in the EUR market will go up. Hence, more Reverse Yankee issuance could also have an impact on domestic Scandinavian credit spreads as domestic issuers are more inclined to raise more money at home.

LOWER EURUSD BASIS WILL PUSH EURNOK BASIS HIGHER AND LIFTS THE BAR FOR NORWEGIAN CREDIT SPREADS

Same logic applies to Swedish credit spreads as well



Source: Bloomberg and Nordea

This section has been produced by Nordea Research's non-independent research unit

Theme: Profit recessions under scrutiny

Having analysed 27 profit recessions in the US equity market, we affirm our cautious stance on equities. Even though the range of profit recessions varies considerably, the median and average suggest that a profit recession (peak to trough) and share price declines could be ~20%. There have indeed been instances where share prices have proven to be resilient, but each of these instances has been associated with low market valuation. The fact that trailing and Shiller P/E multiples have only been higher twice (in 1997 and 2000) in our dataset suggests poor risk/reward today, as our indicators point to a high likelihood of a marked earnings recession.

We have previously warned of the likelihood that we are embarking on a marked earnings recession. All five of our indicators – semiconductor sales, South Korean exports, the FedEx share price development, the conference board CEO survey and our own macro-based EPS indicator – point to such a risk currently. The latter utilises our US GDP model less our wage cost indicator as a gauge for sales minus cost. Although we tend to use these indicators as a guide for the general direction of earnings, we do note that three out of the five suggest an earnings recession of -15% to -20%. The fourth and fifth indicators (CEO survey and FedEx) point to an even more pronounced earnings recession.

Semiconductor sales suggest that 12-month forward earnings growth forecasts should turn negative to the tune of 10%

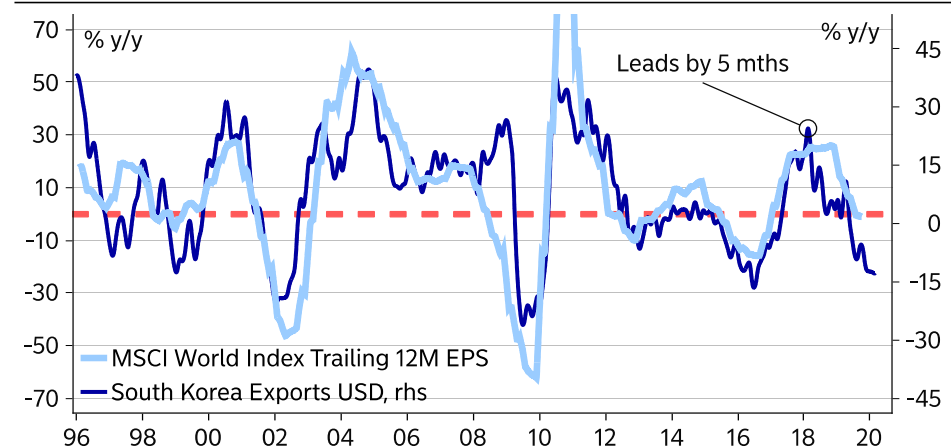
SEMICONDUCTOR SALES AND FORECAST EARNINGS



Source: Bloomberg, Macrobond and Nordea

South Korean exports suggest that trailing EPS should turn markedly negative over the coming couple of quarters

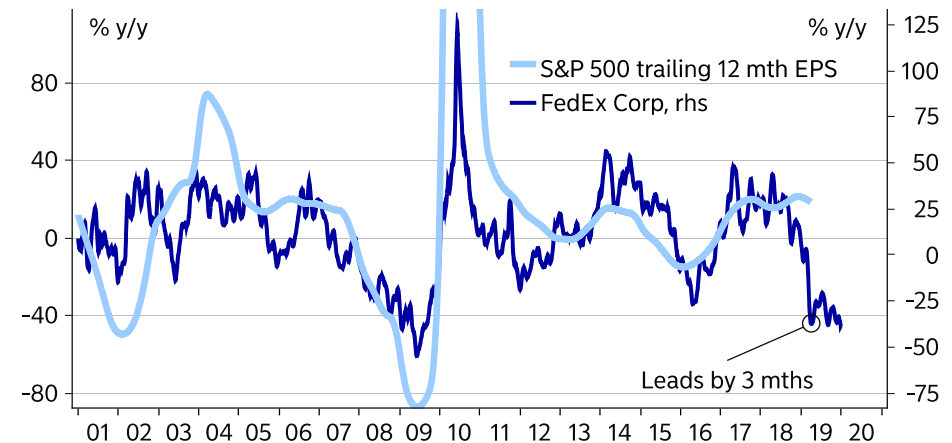
SOUTH KOREAN EXPORTS AND TRAILING GLOBAL EARNINGS



Source: Bloomberg, Macrobond and Nordea

FEDEX AND TRAILING EARNINGS

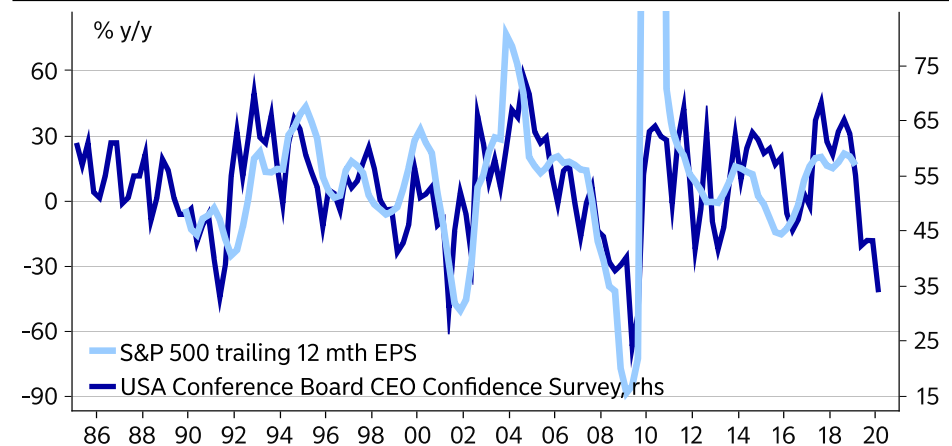
Although FedEx has its share of company-specific issues, its share price development has historically trended with US earnings



Source: Bloomberg, Macrobond and Nordea

USA CEO SURVEY AND TRAILING EARNINGS

When CEO's have been this uncertain, they have implicitly signalled that an earnings recessions is about to hit



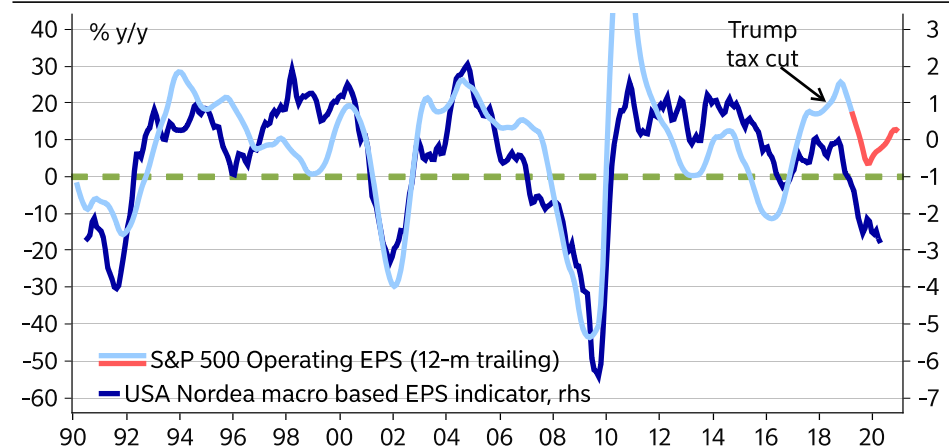
Source: Bloomberg, Macrobond and Nordea

NORDEA'S MACRO-BASED EARNINGS MODEL

Our macro-based model consists of our GDP model less our wage growth model

This macro-based model also signals a marked earnings recession

Although we use these indicators primarily for direction, we note that our models suggest a 15-20% earnings recession



Source: Bloomberg, Macrobond and Nordea

US profit recessions – methodology and biases

120-year data set reveals 27 profit recessions. Our models suggest we are about to embark on number 28

To investigate the impact on stocks in previous earnings recessions, we have looked at a long dataset that Robert Shiller has made available. Since 1900, there have been 27 earnings recessions, defined as at least -5% negative earnings development (peak to trough). We have identified the start of an earnings recession by calculating the six-month change in profits. To gauge the peak-to trough share price impact, we have looked at the peak in the S&P 500 24 months prior to the first negative earnings figure and the share price trough 24 months after the same date. We have made two

exceptions to this methodology, as share prices peaked after the profit recessions starting in 1997-98 and 2014-15. Utilising the same methodology, we have also derived the trough in trailing and cyclically adjusted price earnings, inclusive of the two exceptions. The table below also illustrates the valuation as we enter a profit recession ("@date" in below table).

Beware of biases when looking at an historical comparison like this

Such an analysis obviously has some assumptions that carry biases, like a perfect foresight bias, ie we treat the data as if we knew the exact first datapoint of the earnings recession. Secondly, since the year 2000, Shiller's dataset utilises average monthly prices, which makes the price action in the 2015-16 profit recession look less pronounced than it actually was. Also, it is fair to assume that the price decline during profit recessions is likely a bit steeper, as neither the intra-month peak nor the intra-month trough is captured, only the closing price for that month. Nevertheless, it gives us a decent indication of the peak/trough drawdown. Thirdly, it should be noted that Shiller's earnings series are on a reported earnings basis, rather than operating EPS, which several databases makes available.

The findings

More than half of the historical profit recessions range between 10% and 25% and lows in multiples have on average been around 12-13x on trailing and Shiller P/E

More than half of these 27 profit recessions have ranged between 10% and 25%. This corresponds reasonably well with the median profit recession of ~19%, with similar peak-to-trough price declines (median price decline of -17%). Given the intra-month peak/trough discussion above, it is fair to assume that on average share prices have declined in line with profits. There are five instances with very minor price corrections, which prior to 1997-98 all had low multiples in common. The median reported and Shiller P/E following a profit recession appears to have been around 12-13x historically. Recent history, however, suggests a greater tolerance for somewhat higher trough multiples. We also note that it is not unusual that share prices start correcting when the profit recession hits, although the average over our dataset suggests that share prices peak six months before a profit recession.

Having analysed the data, we arrive at the following conclusions:

- It is rare that profit recessions are less than -10%
- Markets appear more resilient to profit recessions if the starting valuation is low
- The average number of months that the S&P 500 has been in profit recession is 18
- Share prices peak on average six months prior to profit recessions
- Share prices tend to at least follow the magnitude of a profit recession
- Lower-than-average interest rates in the 1930-50s did not help to protect the downside in those profit recessions

The best outcome would be a minor correction in stocks, but be aware that history suggests pushing the inevitable hit two to three years forward

Unless we are completely wrong in our profit recession risk scenario, the best outcome investors should hope for is a mild drawdown in stocks (~10%), but as the declines in the profit recessions in 1997-98, 1927, 1943, 1980 and 1985 suggest, this would only defer the inevitable and cause an even greater problem to deal with in the not-too-distant future. Our dataset suggests that such a time frame could be two to three years out.

Although this is just one piece of the puzzle, it resonates with our cautious stance on equities

It is always dangerous to draw inferences straight from a historical dataset like this one, as each occurrence tends to have something different behind it. Sector compositions also vary, for example. However, applying the conclusions above to the current situation, we note that valuations have only been higher twice ahead of any profit recession in our sample. Both instances were in the build-up to the dotcom bubble bursting. A reasonable expectation following this analysis would be to at least expect a profit recession (based on reported earnings) of the magnitude of 15-20%. Despite lower interest rates, we struggle to square a scenario where share prices do not at least follow earnings, given the elevated starting point in valuations, and we therefore maintain our cautious stance on equities.

US PROFIT RECESSIONS - S&P 500

	Profit	# of months	Peak versus trough		Trailing P/E	Shiller P/E		10-year	
	recession	Length	Price peak	Price Earnings	@ date	Low	@ date	Low	yield
We have analysed 27 profit recessions	30/04/1903	22	-7	-29%	-22%	13.0	11.5	19.0	15.0
	30/04/1907	23	-7	-38%	-24%	11.5	9.4	14.7	9.4
	30/06/1910	22	-6	-16%	-22%	12.2	11.6	13.0	11.6
	30/04/1913	22	-7	-25%	-26%	13.0	12.2	12.4	12.2
A share price and reported profit decline of ~20% would constitute some kind of normal occurrence	31/05/1917	59	-6	-33%	-36%	6.2	5.3	9.1	5.3
	31/01/1927	13	-1	-1%	-11%	10.9	10.9	13.2	10.9
	31/03/1930	39	-6	-74%	-63%	16.5	13.8	24.6	13.8
	31/12/1937	14	-10	-45%	-49%	9.8	9.8	13.0	9.8
Share prices hardly corrected in the 1927, 1943, 1951, 1980, 1985 profit recessions...	28/02/1942	9	-22	-36%	-21%	8.0	7.7	9.7	7.7
	31/10/1943	13	-3	-8%	-18%	11.5	11.5	11.2	11.5
	30/11/1945	11	0	-16%	-16%	17.6	9.7	14.8	9.7
	31/05/1951	17	-3	-2%	-18%	8.0	7.9	11.9	7.9
...The trailing and Shiller P/E on average in these instances was below 10x at the trough	30/06/1956	11	-2	-16%	-17%	12.9	11.9	18.2	11.9
	31/12/1957	13	-17	-17%	-17%	12.0	12.0	13.7	12.0
	31/01/1960	21	-6	-10%	-12%	17.1	16.2	18.3	16.2
	31/12/1969	17	-12	-29%	-13%	15.8	13.7	17.3	13.7
Note that the earnings decline is on a reported basis	31/01/1975	11	-23	-36%	-15%	8.3	8.3	8.9	8.3
	31/07/1980	8	0	-9%	-6%	8.1	7.5	8.9	7.5
	28/02/1982	16	-15	-19%	-19%	7.6	7.5	7.2	7.5
	31/03/1985	15	-1	-1%	-13%	10.9	10.9	10.4	10.9
The average length of a profit recession is around 18 months (six quarters)	31/08/1989	13	0	-11%	-23%	14.3	14.2	17.7	14.2
	31/01/1991	16	-7	-10%	-27%	15.4	15.4	15.6	15.4
	30/11/1997*	16	8	-12%	-7%	23.5	26.8	32.3	33.5
	30/11/2000	18	-3	-42%	-54%	26.9	26.1	38.8	26.1
In only two out of 27 instances has a profit recession lasted less than ten months	31/08/2007	24	-1	-50%	-92%	18.0	18.0	26.1	18.0
	31/12/2014*	18	5	-10%	-18%	20.1	21.4	26.8	24.0
	04/10/2019	?		?	?	22.0		29.6	
Average		18.5	-5.8	-23%	-25%	13.4	12.7	16.4	13.2
Median		16.0	-6.0	-17%	-19%	12.5	11.6	14.2	11.7

* Share price peak occurred after start of profit recession

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

Equities: It's adjustment time

We expect a rather messy Q3 reporting season, with analysts likely to adjust their V-shaped profit recovery. We expect that seasonal downward adjustments are likely going to be compounded by fears of an earnings recession. If the profit recession we forecast hits, we doubt that today's valuation levels can withstand the estimate pressure we foresee. We also believe the growing gap between reported and operational earnings is evidence that valuation is more expensive than operational P/E would suggest. The US continues to stand out the most in a negative way (from a valuation perspective). As we find it unlikely that the US will continue to outperform on relative earnings, we believe the market could start to question the safe haven status of US equities.

After dissecting our estimate indicators, we are starting to see clearer evidence of increased breadth in sales forecast downgrades globally. As detailed in the previous section, we continue to see a clear risk of an earnings recession, which analysts appear to have captured in the upcoming quarter only.

We, however, expect to see the sharpest adjustments during this reporting season to Q4 2019 and H1 2020 estimates. This is also the time of year when the sell-side focuses more on quarterly estimates for the coming year. We therefore expect to see a combination of earnings recession fears and seasonal adjustments.

We see material downside risk to sales and margin forecasts

Drawing on the conclusion from our profit recession theme, we struggle to see the V-shaped recovery that the analyst community is pencilling in. If projections hold, it would not even count in our definition of a profit recession. The shortest profit recessions on record in our sample have lasted around three quarters, whereas our study calls for around six quarters in duration on average. We therefore fail to see any compelling arguments for margin improvement given our muted macro outlook, which stands in stark contrast to expectations of more than 80% of global companies improving margins in 2020.

Given demographic and labour cost headwinds, we foresee lower earnings growth in the coming years than has been seen over the past 15-20 years

As we have argued in recent reports, long-term tailwinds for profit margins are gradually disappearing, and in some areas even turning into potential headwinds ([see our Nordea View published May 2019](#)). This could very well leave earnings growth in the coming years materially lower than it has been in the past 15-20-years. Having said that, we do not believe net margins will fully mean revert to the 20-year average given the very low interest rates (debt service costs) and the markedly reduced corporate tax rates in the OECD countries.

Valuation analysis boils down to estimate risk versus the risk (opportunity) of market participants accepting even lower expected returns

The US remains in a valuation league of its own

Valuation analysis, in our view, continues to boil down to whether lower bond yields will protect against the earnings recession we foresee. History is on our bearish side, assuming we are right on the earnings recession call, as the starting point for valuation has only been higher twice in the past (1997/98, 2000) ahead of an earnings recession. Given our conviction in the macro backdrop and our view that estimates remain too elevated, we advocate for defensive positioning from a risk/reward perspective.

The most likely point on which we could be wrong is market participants' willingness to push the expected return even lower (read pushing valuations even higher), which we may have underestimated. However, following our earnings recession study, we are even more reluctant to play such a scenario from a risk/reward perspective.

Rising difference between operating and reported earnings also illustrates the risk in relying too much on forward P/E

We also remain adamant that the greatest valuation risk lies in the US market, where profit-neutral gauges like market cap/GDP and EV/sales remain at levels that we deem to be very sensitive to the prospects of an earnings recession. Given that reported and operating earnings have continued to drift apart, we also question if investors should rely solely on operating numbers. Reoccurring adjustments, which are also rising, may not be something investors want to adjust for, we argue.

On single stocks, it could on occasion make sense to look at adjusted numbers, but when aggregating all non-recurring items on an annualised basis, we argue that collectively they are actually re-occurring. Otherwise the number would not be this big on an annualised basis; we are also rather concerned that they are rising.

The difference on a 12-month rolling basis is currently ~15% (close to a ten-year high), which is like comparing ~22x reported earnings with <19x operating earnings. It therefore makes quite a big difference which multiple you base your conclusion on, and we believe investors may be placing too much faith in operating multiples.

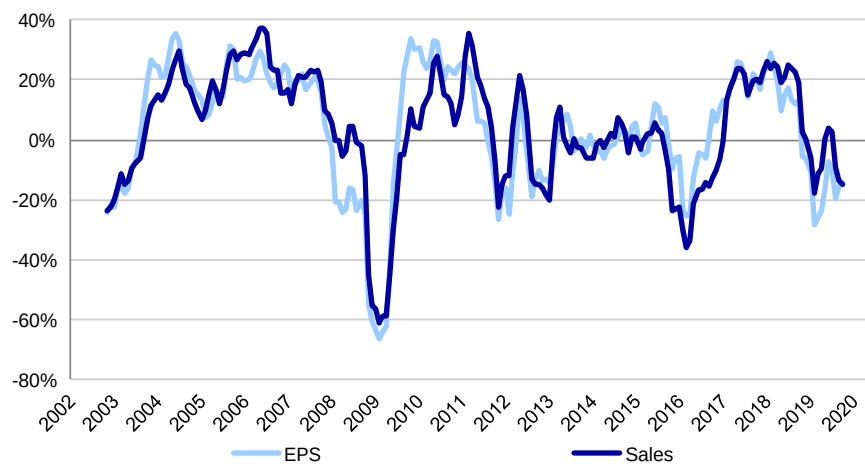
US valuation is in a stratosphere of its own, which could be challenged as relative revision momentum wanes

Supported by relative currency moves (USD strength), we also struggle to see US earnings revision momentum continuing to outpace the rest of the world. Albeit tentative, we are starting to see signs that US outperformance versus Europe is starting to abate. We also gain some support for this view from our macro indicators, which suggest that the consensus macro forecast risk is also somewhat greater in the US. We therefore see decent odds that the safe haven status of the US should start to be challenged.

Our sales indicator has deteriorated ahead of the Q3 reporting season

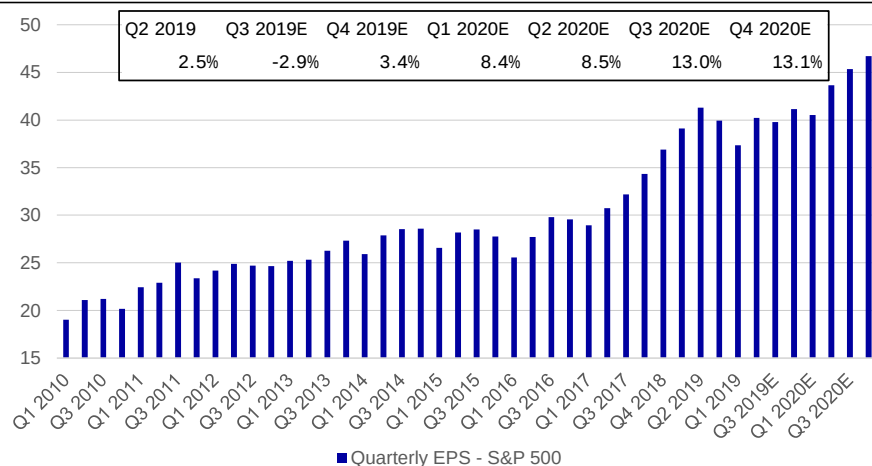
We expect these indicators to be even more negative after the upcoming reporting season

EPS AND SALES REVISION INDICATORS – STOXX GLOBAL 1800



Source: FactSet and Nordea

S&P 500 QUARTERLY EPS AND YEAR-ON-YEAR QUARTERLY GROWTH FORECASTS

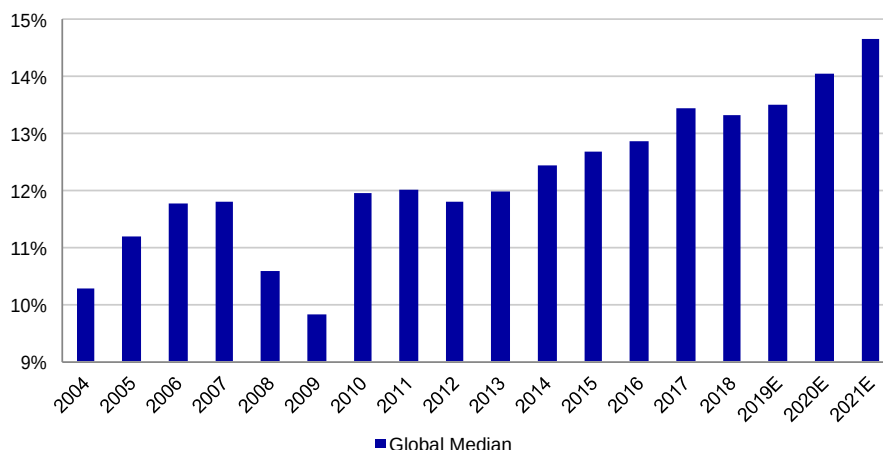


Source: FactSet and Nordea

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

MEDIAN EBIT MARGIN FOR STOXX GLOBAL 1800

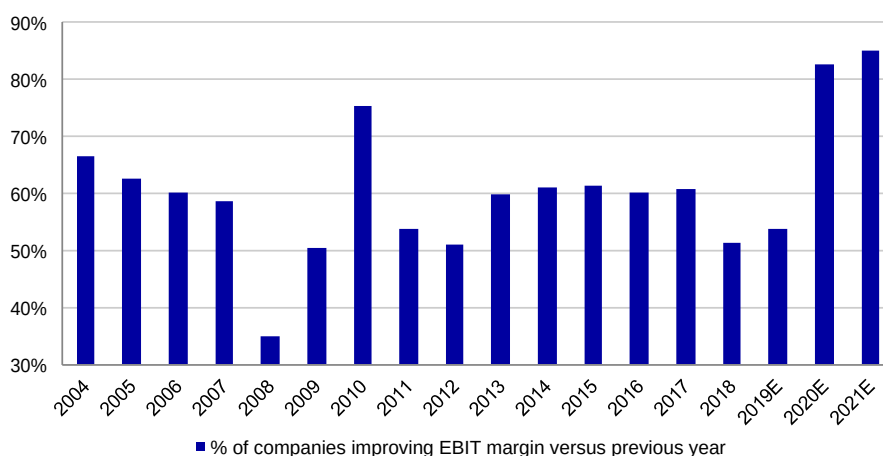
We struggle to see how profitability can improve this much in 2020 and 2021 for the median company



Source: FactSet and Nordea

SHARE OF STOXX 1800 COMPANIES EXPECTED TO IMPROVE EBIT MARGINS

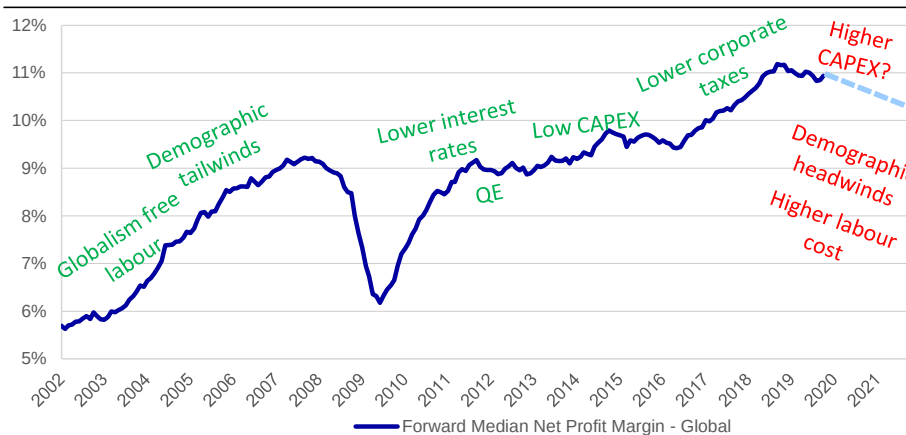
Amazingly, consensus among analysts is that >80% of global companies are set to improve margins in 2020 – this will not happen, according to our scenario



Source: FactSet and Nordea

MEDIAN NEXT 12 MONTHS NET MARGIN DEVELOPMENT – STOXX GLOBAL

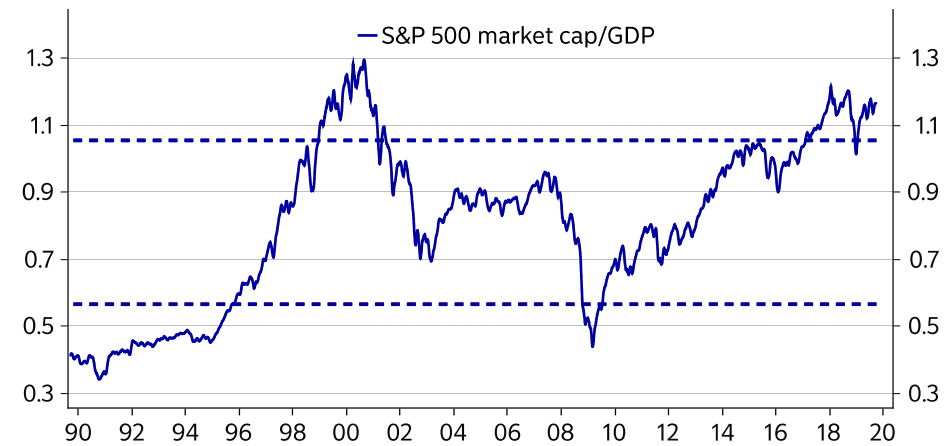
Tailwinds turning into mild headwinds, suggesting it will be harder to grow earnings as fast as investors and analysts have gotten used to



Source: FactSet and Nordea

MARKET CAP / GDP FOR S&P 500

The macro gauge suggests very poor risk/reward



Source: Macrobond and Nordea

THE SHILLER CYCLICALLY ADJUSTED P/E

Other profit-neutral metrics like the CAPE gauge remain elevated



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

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

This stands in stark contrast to P/E multiples having been range bound since 2014

However, be aware that debt levels and the difference between reported and operating earnings have risen



Source: FactSet

OPERATING AND REPORTED EARNINGS DRIFTING FURTHER APART

Extraordinary items on an aggregated basis have been rising

This chart would suggest that these special items are re-occurring

Maybe investors should base their valuation analysis on a reported rather than adjusted basis

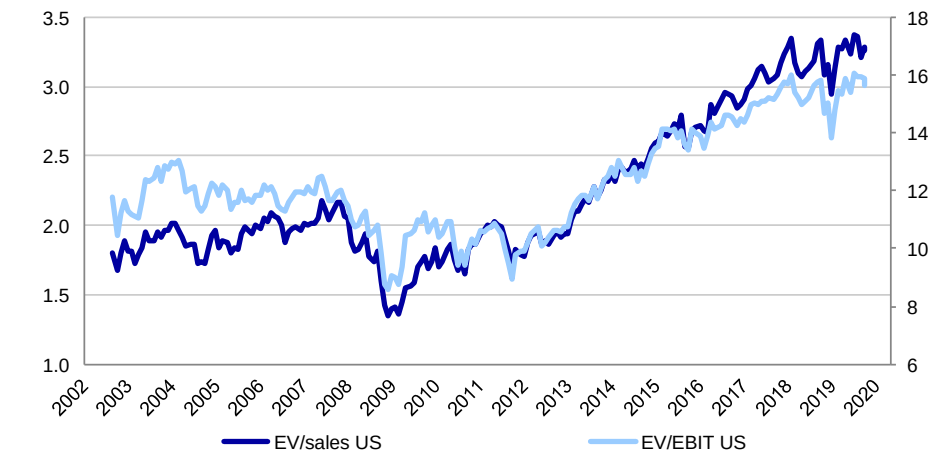


Source: Macrobond and Nordea

MEDIAN EV-BASED VALUATION FOR US LARGE CAPS

EV-based valuation in the US remains at unprecedented levels

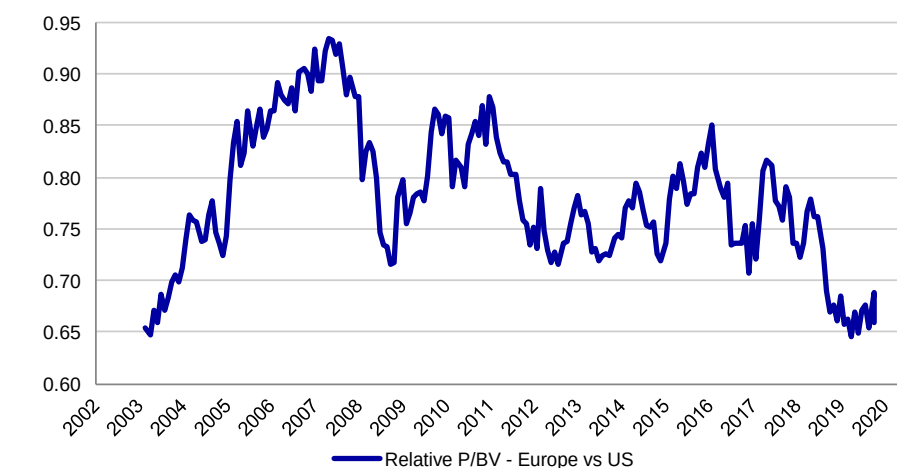
We doubt these valuation levels can withstand the earnings recession we foresee



Source: FactSet and Nordea

RELATIVE P/BV (MEDIAN COMPANY) IN THE VICINITY OF THE 2003 TROUGH

We are within reach of the relative valuation trough between the US and Europe on P/BV



Source: FactSet and Nordea

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

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



Source: FactSet and Nordea

RELATIVE EPS MOMENTUM HAS SUPPORTED US OUTPERFORMANCE

Given currency headwinds, we doubt that the US can sustain its EPS momentum supremacy

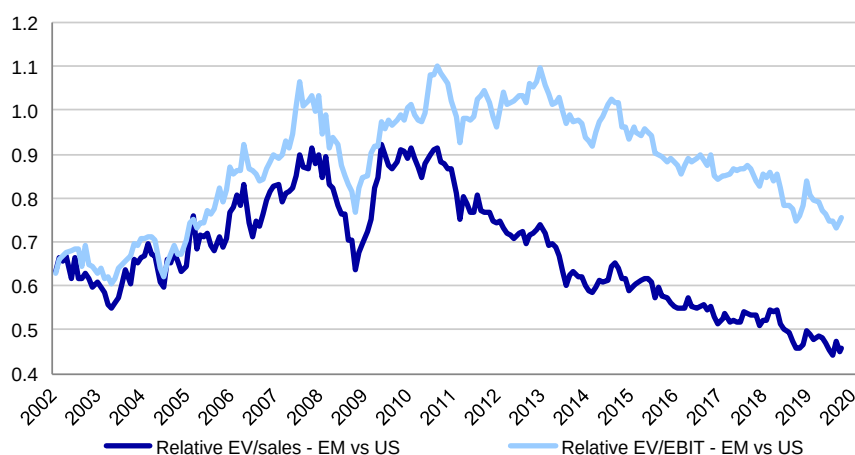


Source: FactSet and Nordea

EMERGING MARKETS ALSO AT A STEEP DISCOUNT TO THE US

Relative EV/sales in EM versus US is in uncharted territory

The relative EV/EBIT chart resembles the European relative chart



Source: FactSet and Nordea

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

Equity styles: Sticking to fundamentals

Late August/early September gave us a hint of how fast a winning strategy can become a losing one, with momentum strategies cracking and investors seemingly rotating into value. In this report we present five potential triggers for a sustained value revival: rising rates (stabilisation may be enough), a comeback for European banks, positioning, M&A, and absolute valuation levels. We also demonstrate that there is a clear valuation limit to how big a premium investors should pay for bond proxies. For those investors reluctant to take the full value plunge, we would advise combining value with solid quality and cash conversion traits.

Style developments have been unusually intriguing of late following the reversal of fortunes for momentum strategies in late August, and even value investing seems to have yielded a small amount of alpha (~4% in the past five weeks). Although momentum has regained some of its lost ground, these kinds of style reversals may be something we may have to get used to, as positioning has seemingly become too one-sided. Given the snapback in the great valuation divide, it seems that valuation played a rather crucial role in this style reversal. Interestingly it is more evident in the 75th versus the 25th percentile, suggesting that valuation is broadly growing in importance. Having said that, the recent reversal constitutes a mere blip in the great valuation divide charts we present towards the end of this section. In this report we scout for triggers for a more sustained value comeback and illustrate that there should be a clear ceiling to the premium investors should pay for bond proxies.

MSCI GLOBAL: VALUE RELATIVE TO GROWTH

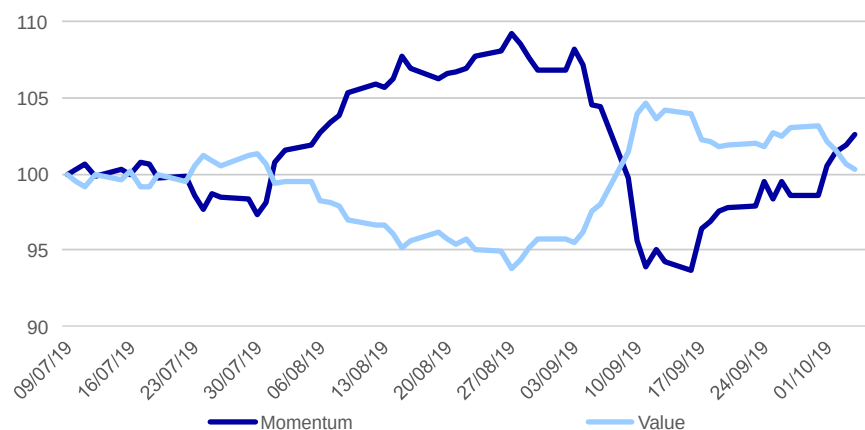
Small fish hook for value stocks relative to growth in the past five weeks (4% outperformance)



Source: FactSet and Nordea

3-MONTH PERFORMANCE CHART: DOW JONES THEMATIC MARKET NEUTRAL INDICES

Early September witnessed a significant style reversal



Source: Bloomberg and Nordea

Lower required rate of return on equities suggests greater valuation premium for bond proxies

In our August report, we offered a framework with regards to the premium investors should be willing to pay for perpetually faster growing companies. Extending this study to stocks exhibiting lower risk and greater (historical) predictability in profitability, we can demonstrate that falling bond yields have favoured high-quality and low-risk traits. The argument for this relationship being strong could originate from the fact that investors accept a lower expected return from stocks that exhibit lower risk. In a low interest rate environment, ie lower discount factor, moving cost of equity (CoE) 50-100 bp further down has meaningful effects on the valuation premium investors should be prepared to pay.

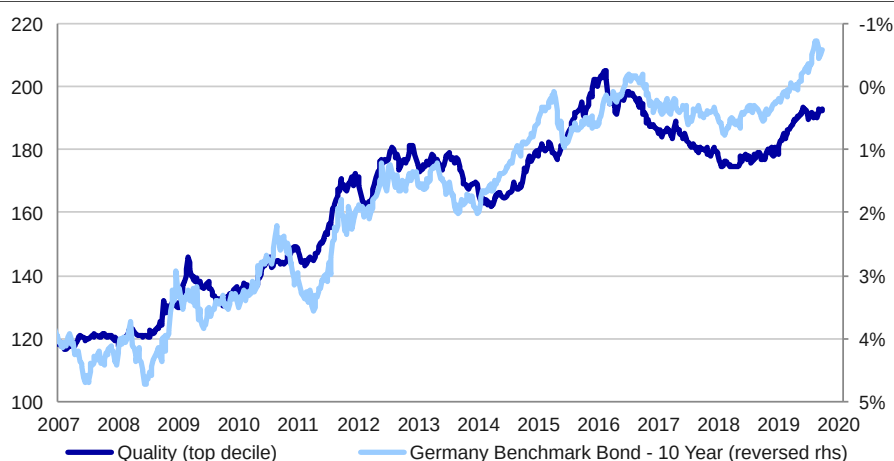
There is, however, a distinct ceiling to how far the valuation premium should go

We can hence utilise our Gordon dividend growth inspired P/E matrix to gauge what premium investors should be willing to pay for stability and low-risk traits. We conclude that in a low CoE environment (6%) the premium warranted for lower risk traits is around twice as high as a more (historically) normal CoE of ~8%. We hence gain a greater understanding of why bond proxies have been chased to such a degree, but the charts below also remind us that there is a clear limit to what premium investors should pay for lower risk traits even in a lower-for-longer cost of capital world. In other words, we are growing in confidence that the great valuation divide has been pushed too far.

This and the next chart utilise our proprietary European mid-small cap data set

High-quality relative performance (vs the market) and bond yields have been closely linked for the past 12 years

RELATIVE PERF. OF HIGH-QUALITY STOCKS IN EUROPE VERSUS 10-YEAR BOND YIELD

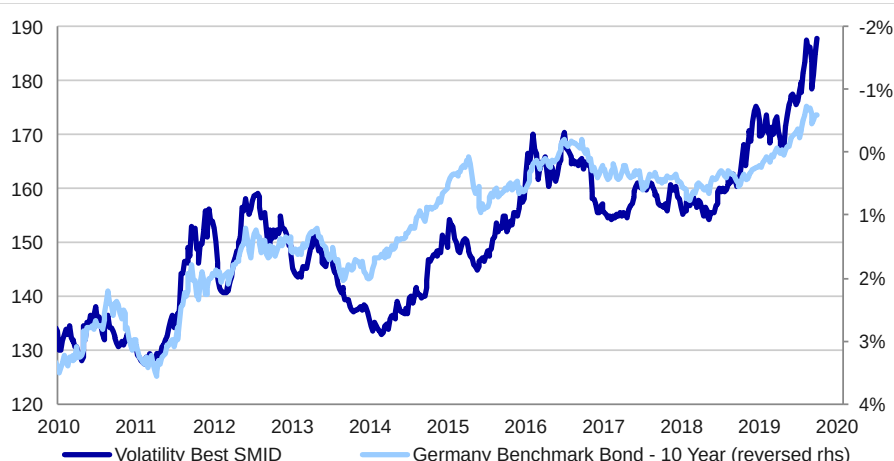


Source: FactSet and Nordea

Falling rates appear to go hand in hand with low-risk stocks outperforming

The logical explanation could be market participants' acceptance to put lower implicit cost of capital requirements for stocks with lower risk profiles

LOW-RISK (LOW STOCK VOLATILITY) STOCKS ALSO CORRELATE WELL WITH BOND YIELDS



Source: FactSet and Nordea

Assumptions:

$P/E = D / (k - g)$

k = cost of equity (CoE)

g = long-term market growth

Payout (D) = 75%

P/E of 15x represents CoE of 8% and market growth of 3%

NORDEA'S GORDON GROWTH MODEL IMPLIED TRAILING P/E MATRIX

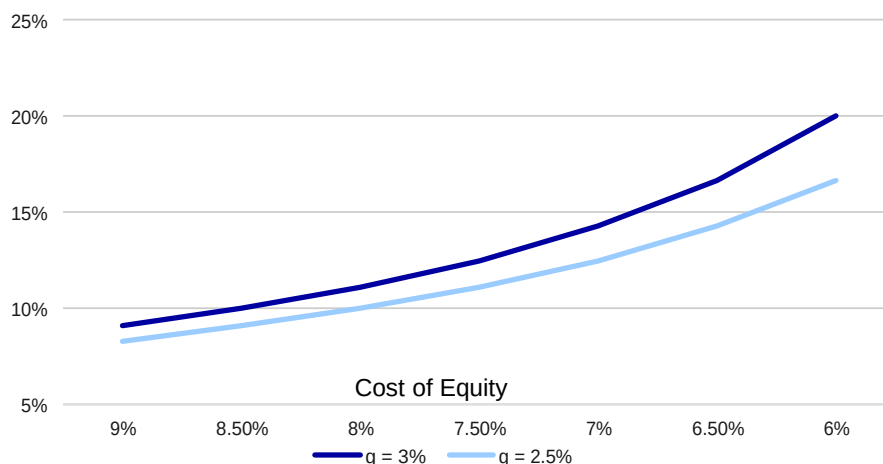
		Discount Factor (Cost of equity)							
		8.5%	8.0%	7.5%	7.0%	6.5%	6.0%	5.5%	5.0%
Growth (g)	3.5%	15.0	16.7	18.8	21.4	25.0	30.0	37.5	50.0
	3.0%	13.6	15.0	16.7	18.8	21.4	25.0	30.0	37.5
	2.5%	12.5	13.6	15.0	16.7	18.8	21.4	25.0	30.0
	2.0%	11.5	12.5	13.6	15.0	16.7	18.8	21.4	25.0
	1.5%	10.7	11.5	12.5	13.6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

Source: FactSet and Nordea

The premium investors should be willing to pay for earnings predictability and low-risk traits increases as cost of capital falls

This premise relies on investors being willing to accept lower expected return for lower risks

WARRANTED VALUATION PREMIUM VERSUS THE MARKET FOR 0.5 PP LOWER COE

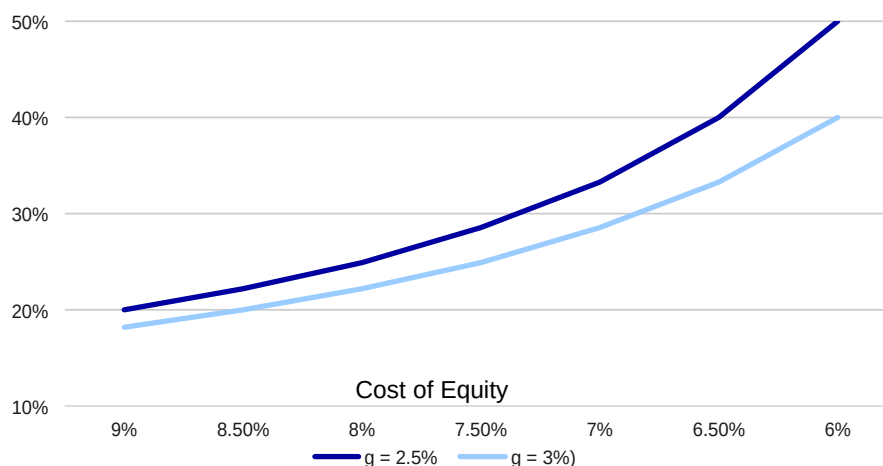


Source: Nordea Research

This chart helps us understand why bond proxies have been in high demand

Although the warranted premium rises more at lower CoE, this does not mean that investors should be prepared to pay whatever to get their hands on low-risk exposure

WARRANTED VALUATION PREMIUM VERSUS THE MARKET FOR 1 PP LOWER COE



Source: Nordea Research

Scouting for triggers for a sustained value recovery

Potential value triggers include:

When scouting for triggers beyond relative valuation we have come up with five possible triggers for a reversal of fortunes for value investors:

Rising rates...

Sharply rising interest rates or a sudden inflationary shock would be very welcome for value-biased investors, but this potential trigger seems far-fetched as central banks and bond investors chase into negative yielding territory. A mere stabilisation of interest rates, like we witnessed in August, gave us signs that it could trigger a snapback. We are, however, doubtful that it has the merits for the start of the great rotation.

...a comeback for European Banks...

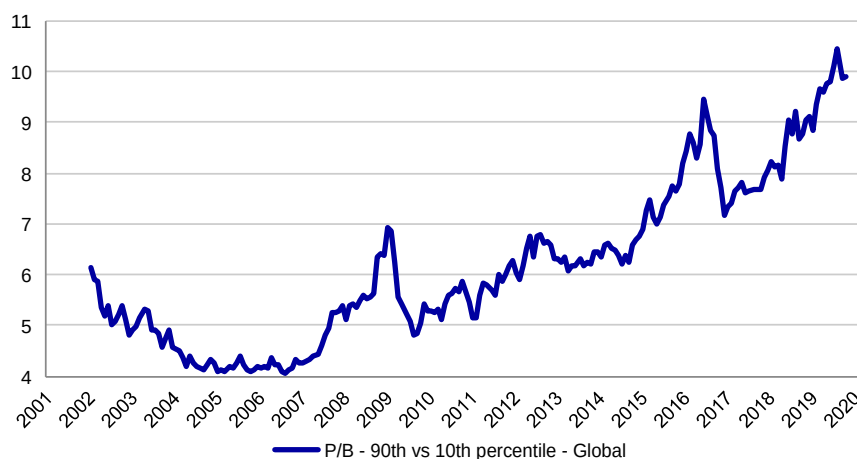
Other triggers could involve European banks attracting shareholder capital. The abysmal run coming to a relative end could re-ignite hope for the value style. The problem again is that such a reversal of fortunes is likely linked to interest rates.

...shrinking relative market cap...	In our summer update we illustrated that the much-reduced relative size of the value camp could be argument enough for a reversal of fortunes, as a lower capital allocation to this style is needed to turn the tide.
....M&A...	Maybe the most intriguing trigger, and one which we are even more enthusiastic about, is M&A. Surely when there is a low P/E basket of 100 stocks in Europe, which on average are trading at ~6x earnings, private equity funds should be looking to pounce. And given ample firepower in combination with exceptionally low interest rates, the ability to gear these businesses should be both relatively easy and relatively cheap.
...and absolute valuation levels	Finally, we are also compelled by the absolute return prospects of the value camp, which is zooming in on multi-year absolute lows. Surely when investors now go hunting for yield when bond returns look so bleak, they should also be intrigued by value stocks from a relative return standpoint.
Four reasons investors should not abandon valuation as a key alpha factor	We believe valuation still has an important role to play in stock-picking We see four reasons why investors should not abandon valuation as a key alpha factor. Firstly, the valuation discrepancy between the cheap and expensive ends of the market remains staggering. Secondly, slower global growth in a low-cost-of-capital environment should reduce valuation differences, not increase them further. Thirdly, expensive stocks tend to struggle as uncertainty rises (eg the VIX index). Finally, the cheap end of the equity market has become so much smaller, given the abysmal relative performance lately, that much less capital allocation to the style is enough to turn the tide. For those investors reluctant to take the full value plunge, we would advise combining value with solid quality, cash conversion and growth traits.
Earnings uncertainty decoupled completely from company management responses in the IFO survey	With the IFO dispersion index (respondents answers in the survey) widening further, we remain perplexed that earnings uncertainty, measured by analysts' dispersion around the consensus mean for the median company, remains very tight. We still find it likely that analysts will eventually start disagreeing and because of that we would caution against relying too much on revision momentum. The rationale stems from the logic that revisions around a more uncertain consensus should mean less for share prices. In our view, this means that investors should focus more on fundamental factors such as valuation and earnings quality. Over the past 12 years, all four market corrections (>10%) have been accompanied by value weakness, and hence the common feeling among investors is that valuation cannot protect downside in turbulent markets. Prior to this period, the answer to that question was quite supportive of the premise that being valuation-focused protects downside during market corrections.
Valuation may yet prove to offer defensive attributes	Twice during the 1980s, value outperformed growth when the market corrected. The recession in the early 1990s was more mixed, and value protected the downside early on, whereas we witnessed relative weakness versus growth in the second leg of the correction. After the bursting of the IT bubble, value stocks protected the downside and outperformed strongly. During the final leg of the correction in H2 2002, value gave back some of the relative gains. What we hence continue to argue is that the starting point in relative valuation (expensive versus cheap) is now much more like the bursting of the IT bubble rather than 2007-08, when the difference in valuation was unusually small.

MEDIAN RELATIVE P/B FOR THE 90TH VS 10TH PERCENTILE – STOXX GLOBAL 1800

The great valuation divide can be summarised by this chart

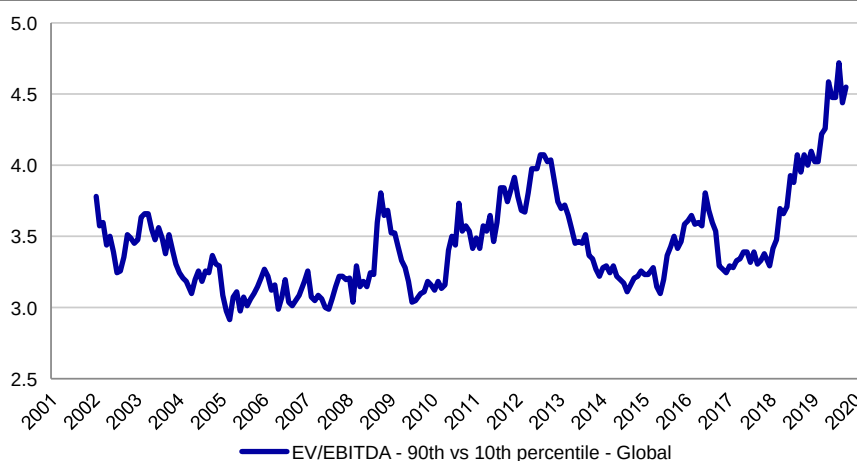
The relative P/BV multiple recently corrected from levels never seen before



Source: FactSet and Nordea

MEDIAN RELATIVE EV/EBITDA FOR THE 90TH VS 10TH PERCENTILE – STOXX GLOBAL 1800

The relative EV/EBITDA ratio is also beyond levels witnessed over the past 20 years



Source: FactSet and Nordea

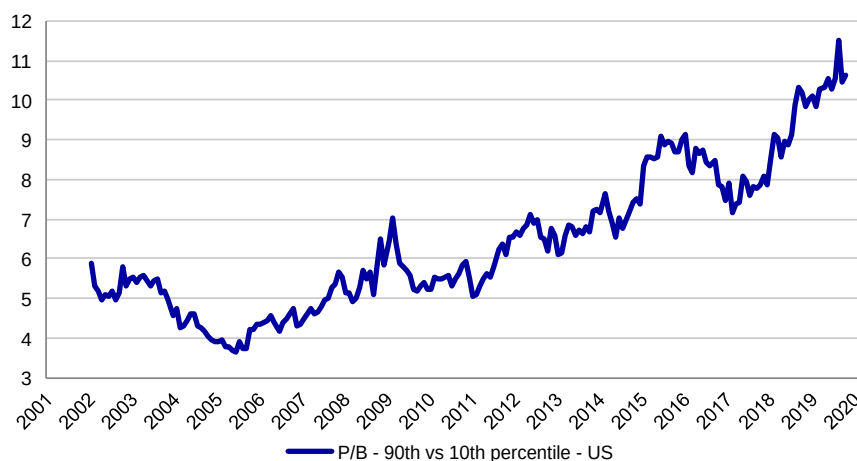
MEDIAN RELATIVE P/E FOR THE 75TH VS 25TH PERCENTILE – STOXX NORTH AMERICA 600

In the US (North America), the relative P/E ratio has now passed the IT bubble peak by a considerable margin

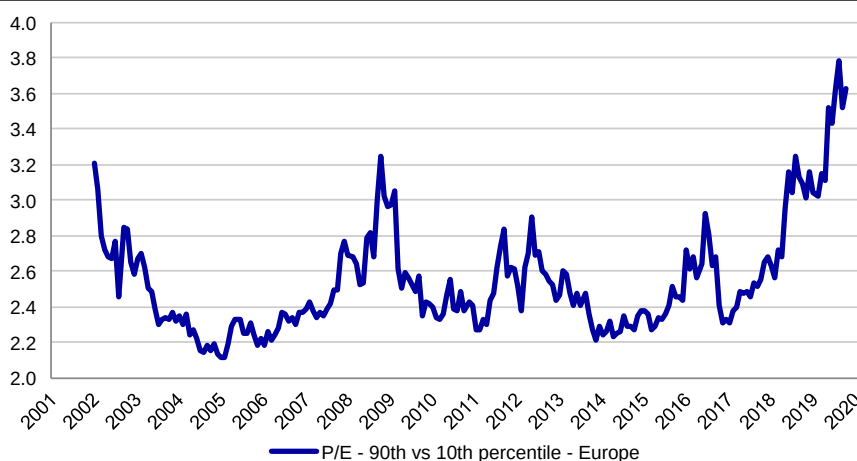
This chart contrasts the valuation premium between the 75th and 25th percentiles



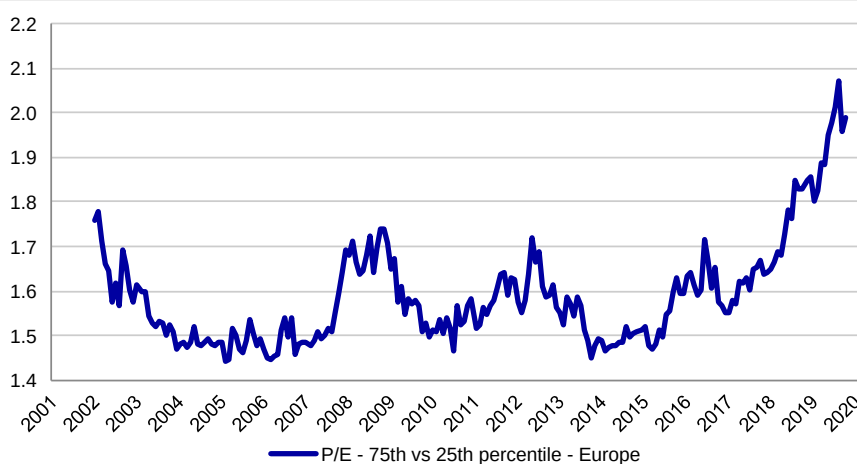
Source: FactSet and Nordea

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

Source: FactSet and Nordea

MEDIAN RELATIVE P/E FOR THE 90TH VS 10TH PERCENTILE – STOXX EUROPE 600

Source: Company data and Nordea estimates

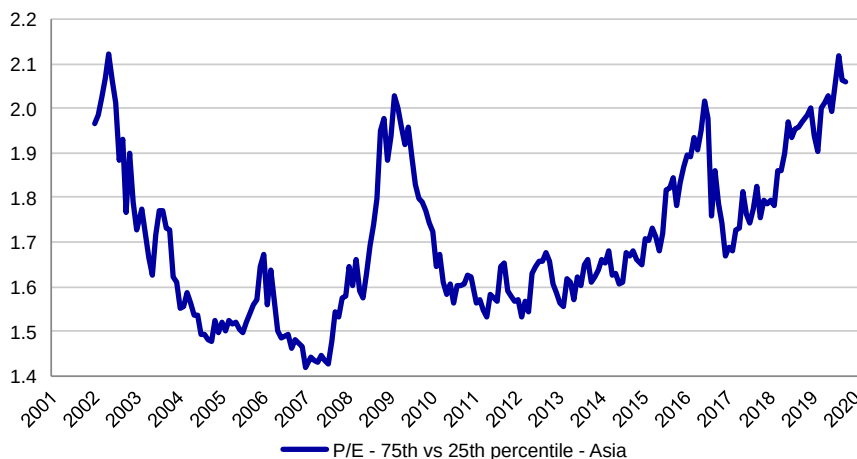
MEDIAN RELATIVE P/E FOR THE 75TH VS 25TH PERCENTILE – STOXX EUROPE 600

Source: FactSet and Nordea

MEDIAN RELATIVE P/E FOR THE 75TH VS 25TH PERCENTILE – STOXX ASIA 600

Being value-focused in the early years of this century, in 2009 and 2016, paid great dividends

This chart suggests that the odds are good for the value factor making a comeback



Source: FactSet and Nordea

MEDIAN 12-MONTH FORWARD P/E FOR THE 25TH PERCENTILE – STOXX GLOBAL 1800

Absolute valuation at lower end of historical range for cheaper end of equity universe



Source: FactSet and Nordea

MEDIAN 12-MONTH FORWARD EV/EBITDA FOR THE 75TH PERCENTILE – STOXX GLOBAL 1800

The more expensive end of the equity market however is at levels not even seen during the dot-com era



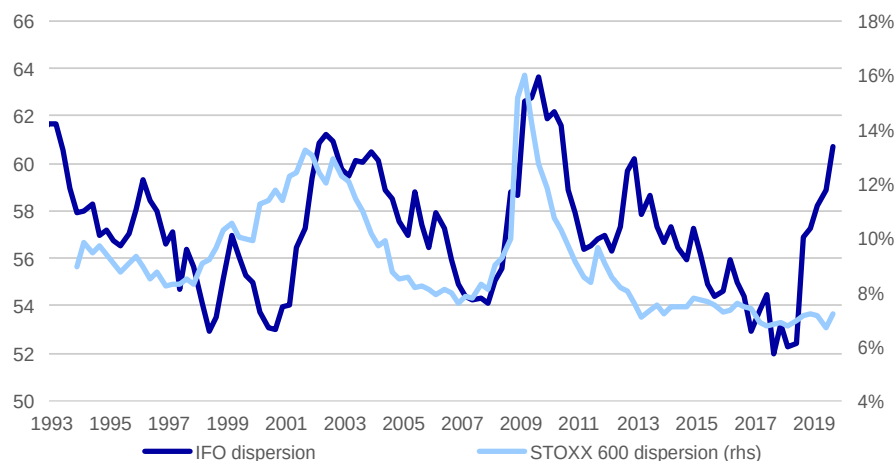
Source: FactSet and Nordea

The IFO dispersion index suggests a very uncertain earnings outlook, but the analyst community appears very certain

Rising estimate dispersion has historically been detrimental to a revision-based momentum strategy

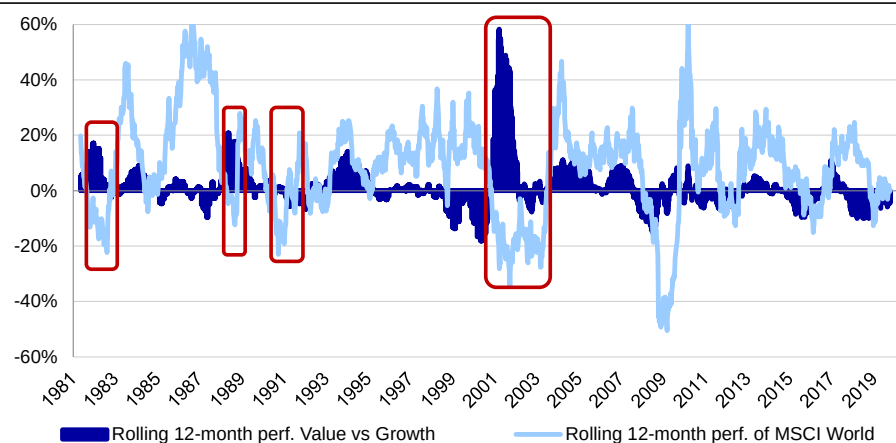
This is why we caution against relying on revision momentum too much

IFO SURVEY DISPERSION VERSUS CONSENSUS EPS DISPERSION



Source: FactSet and Nordea

ROLLING 12-MONTH RELATIVE PERF. OF VALUE RELATIVE TO GROWTH VERSUS MSCI WORLD

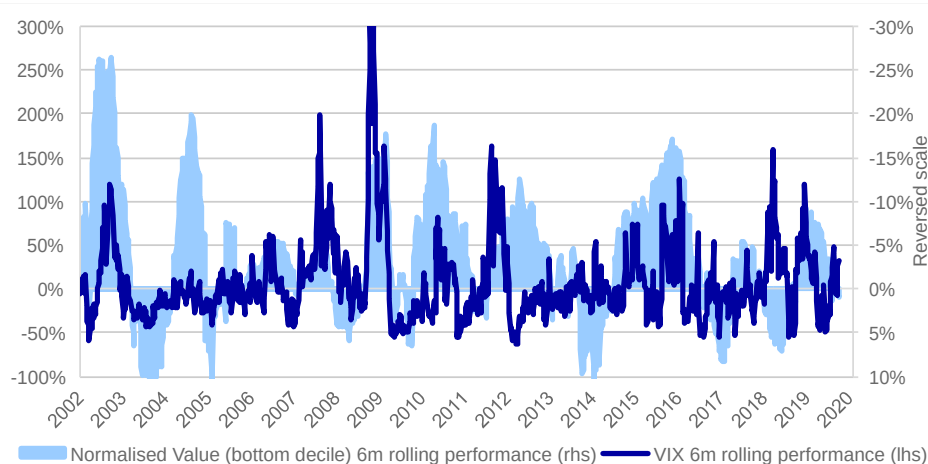


Source: FactSet and Nordea

In recent times (past 12 years), market corrections have been associated with value weakness

Before that, value traits actually offered defensive attributes during market corrections

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



Source: FactSet and Nordea

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

Given our belief that we are embarking on a profit recession, this could be a trigger for the style rotation we expect

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

Where could we go wrong?

There are multiple factors that combine to form our cautious market view, and while they are all interlinked, they are not necessarily fully correlated. Below, we discuss these factors and the risk that we are wrong. We address this issue by splitting the factors into four areas where we see that possible structural shifts could make historical data less reliable: underestimated efficiency improvements; changes to the composition of the economy; changes to market risk premiums; and implications of interest rates. We conclude that should the market sharply reduce its required rate of return, the repercussions we are expecting from a marked earnings recession could turn out to be exaggerated.

Multiple factors suggest a marked earnings recession is looming

As we have described in this report, we see evidence that supports our outlook of high risk for a marked earnings recession in the market. The historical correlations between leading gauges such as semiconductors, the FedEx share price performance, and more core macro-oriented leads such as growth and wages all point in the same direction.

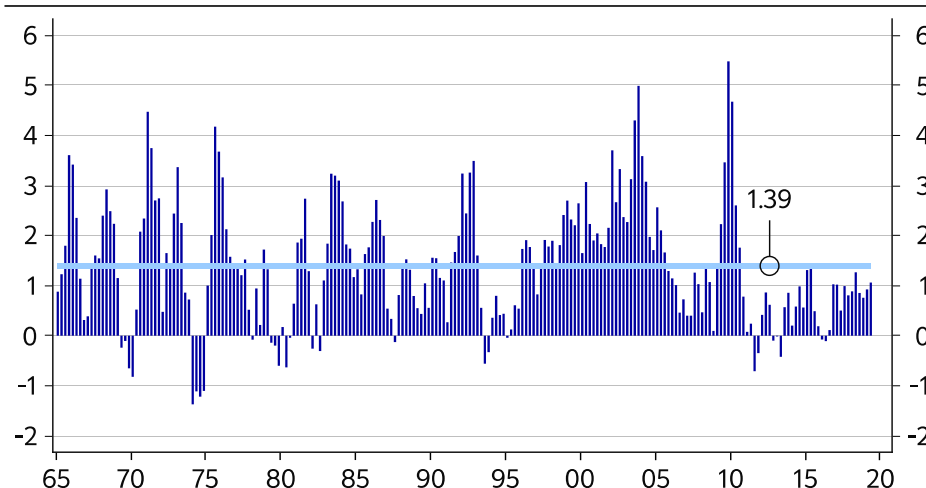
Tailwinds are easing

Additionally, we have frequently addressed the outlook for margins. After decades of margin tailwinds stemming from demography, globalisation (economy of scale), the sharp increase of the labour force (reduced wage costs), falling interest rates and sluggish capex (lower debt service burden) as well as the reduction in corporate tax rates, the tailwinds are at the very least easing.

Could productivity gains be a surprise?

Hence, the squeeze on record-high margins seems set to continue. What is hard to predict, however, is the potential effects of a sudden and sharp increase in productivity. Our models, which are based on history, could easily underestimate the impact of years of IT investments and the leverage from IoT and AI.

US PRODUCTIVITY GROWTH (%)



Source: Macrobond and Nordea

No evidence a rise in productivity is lurking around the corner

We note, however, that there is no evidence that a surge in productivity is ongoing. On the contrary, US productivity growth has averaged 1.4% over the last 50 years or so and since 2011, productivity has been below the long-term average.

Therefore, if efficiency gains are currently being underestimated, it would most likely be a steady rise over years to come and not a sudden explosion. So far, we see no path for a recovery in productivity. Furthermore, productivity also typically correlates well with the business cycle, suggesting that should underlying improvements be underestimated, it would not likely reverse the normal business cycle impact.

Cyclical headwinds normally overtake productivity gains – this balance is changed when the cycle recovers

If anything, productivity gains should pave the way for a stronger earnings recovery once the cycle turns more positive. Anecdotally, we hear that businesses are better prepared to protect profitability in a cyclical downturn today. Lessons have been learned from the last great recession, it is said. Whether this is true for a selected few or for the majority of the equity universe is hard to determine. It would probably require a full cycle to find out. One would expect these preparations to already have resulted in higher efficiency (ie higher productivity), which we do not see happening.

Macroeconomic backdrop rests on historical correlation – could structural changes make it different this time?

Our macro outlook has for some time suggested a business cycle downturn. Since the peak in the real cycle in Q4 2017, leading indicators have headed south and the real economy has followed suit. Trump's fiscal expansion in 2018, Japan's volatile national accounts, China's clouded statistics, Brexit, the trade war and low interest rates have all challenged this outlook, but at the end of the day change its course. We are currently monitoring how the lagging effect on the labour market is starting to take its toll on employment numbers.

Private versus public sector

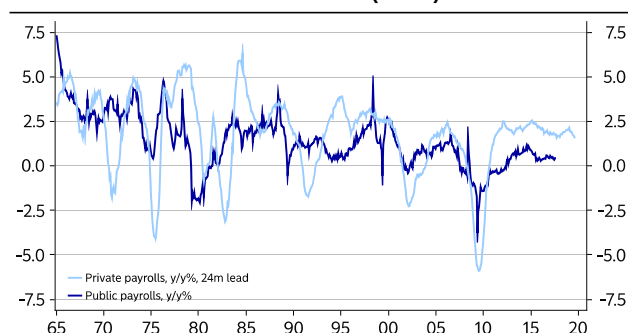
In regards to the macroeconomic backdrop, one potential risk is the possible increasing deviation between the public and the private sector, and possibly between listed and unlisted (mostly smaller) companies. This would then imply that the private sector in general, and listed companies in particular, would do much better than current aggregated data suggests.

The structural decline in public employment makes it too small to make a major difference

To examine this, we have reviewed payroll statistics. Private payrolls in the US have been doing clearly better than the public payrolls in recent years. Looking longer term, deviations between private and public payrolls are frequent. Private payrolls have unsurprisingly also shown higher volatility. As the labour market recovered after the great financial crisis, private payrolls have improved more quickly, by an average growth rate of around 2% y/y.

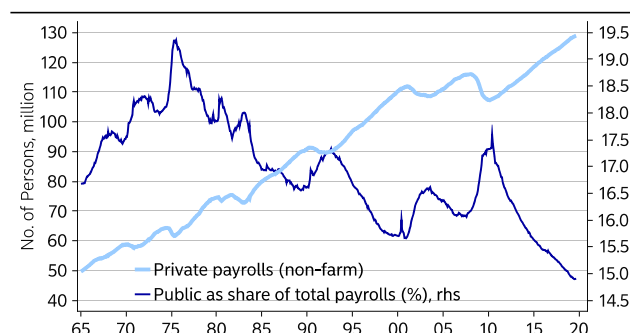
For the public sector, the improvement has been much more sluggish, as payrolls have been close to unchanged. This indicates a possible shift, suggesting a split in the economy. However, there are two important factors to consider. First, the private payrolls normally have up to two-year leads on the public sector. Second, non-private payrolls are less than 15% of total payrolls. Hence, the macro signals received on a more challenging earnings outlook cannot exclude the private sector of the economy.

US PRIVATE AND PUBLIC PAYROLLS (Y/Y %)



Source: Macrobond and Nordea

US PUBLIC PAYROLLS – SHARE OF TOTAL PAYROLLS



Source: Macrobond and Nordea

Differences in earnings growth between listed and unlisted US companies prove to be only temporary

In order to evaluate whether earnings trends differ between the listed and the unlisted US corporates, we have reviewed quarterly profit growth since 2010. Although they can deviate in strength, data suggests that they normally do not deviate in trend. There has been one clear change to this pattern recently, however.

From Q4 2017 to Q4 2018, listed US corporates (S&P500) saw profits rising strongly while for the whole economy, profits dropped. This correlates well with Trump's tax reform. As the base effects were reduced, the S&P500 profit growth has reverted back to the general mean. Hence, our profit models risk being wrong should a new policy scheme be introduced. If not, then a structural (ie long-lasting) deviation in profit trends is not on the cards.

US CORPORATE EARNINGS GROWTH (Y/Y%)



Source: Macrobond and Nordea estimates

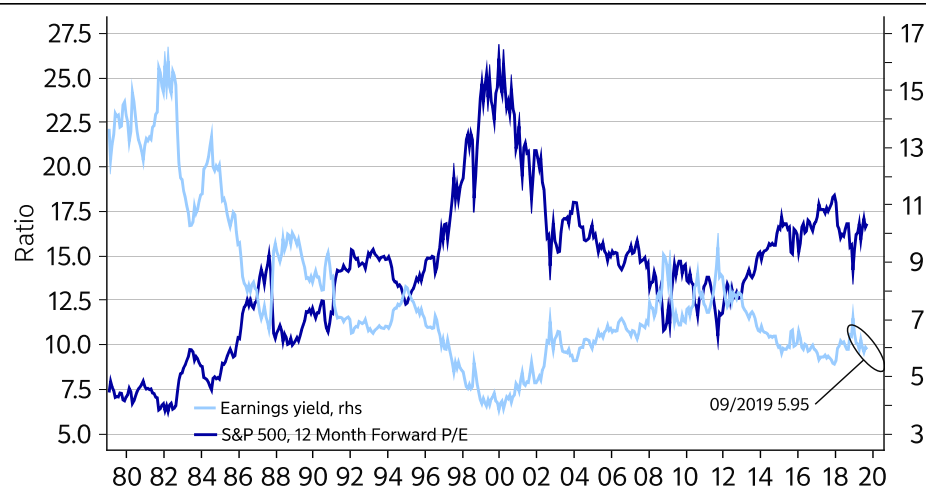
Market risk premiums could alter the picture

Based on current consensus estimates, S&P500 currently trades at a P/E of 16.6x expected earnings. This implies an earnings yield of 6%. On the back of [our recent analysis on the market's required rate of return](#) (12 June 2019), we can conclude that current valuation is at the level of long-term equilibrium. This stems from a derived risk-free rate of 2.5% and a market risk premium of 3.5 pp. If we assume that the marginal investor shares our analysis, a change in "E" would force the same change in "P" for the market to remain in equilibrium.

Rule of thumb: 50 bp equals a ~10% change in valuation

The assumption regarding the risk premium is essential, however. Should the marginal investor differ on our derived assumption by +/-1 pp, the implied market equilibrium would range from -14% to +20% from the current level. Hence, all else being equal, for each 50 bp drop in the market risk premium, the market could absorb a cut in estimated earnings via a multiple expansion (ie higher P/E) of approximately 10% and remain in long-term equilibrium.

S&P500 EARNINGS YIELD AND P/E, 12-MONTH FORWARD-LOOKING



Source: Macrobond and Nordea

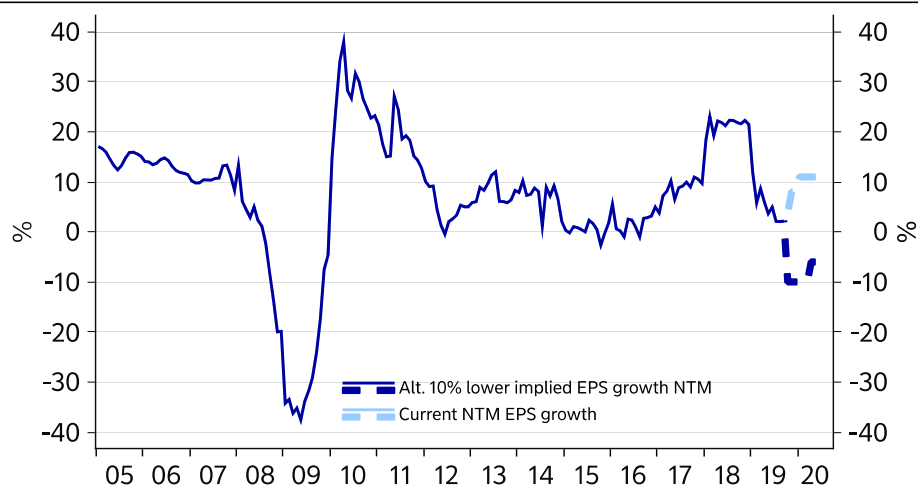
If earnings fall 10% over the next 12 months, estimates are roughly 20% wrong

An earnings slump of 10% for the coming year would imply a 12-month forward-looking P/E ratio of 19.4x, which would be the highest forward-looking P/E ratio for two decades (ie since the dotcom bubble burst). For this to arguably be balanced, the risk premium would need to be cut by 1 pp. Although this might not seem impossible for some readers, there is one important factor to consider. Should one expect the marginal investor to lower the required rate of return by cutting the risk premium as an earnings recession begins?

Should we impose a 10% drop in earnings for the coming year, and recalculate the implied quarterly EPS growth, the currently expected soft patch in earnings growth is

replaced with a clear earnings recession scenario.

S&P500 EPS GROWTH, 12-MONTH FORWARD-LOOKING



Source: Macrobond and Nordea estimates

If we look behind the numbers forming the 12-month rolling earnings growth outlook shown in the chart above, the quarterly year-over-year numbers are very different in the two scenarios. Consensus currently expects EPS to have slipped 3% in Q3 over the last year. Thereafter, consensus expects profits to recover and grow (y/y) by 4% as soon as in Q4, by some 8% in H1 2020 and 13% in H2 2020.

S&P500 QUARTERLY PROFIT GROWTH, Y/Y

	Q1 2019	Q2 2019	Q3 2019E	Q4 2019E	Q1 2020E	Q2 2020E	Q3 2020E	Q4 2020E
Consensus (y/y)	1%	2%	-3%	4%	8%	9%	13%	13%
Alt. scenario (y/y)	1%	2%	-3%	-9%	-15%	-13%	-5%	8%

Source: FactSet and Nordea estimates

An alternative in line with historical earnings recessions

Would investors be inclined to cut the risk premium in the wake of an earnings recession?

Our alternative scenario with 10% lower earnings over the next five quarters (including in Q3 2019), where we assume a normal distribution from Q4 2019 to Q4 2020, implies that annual profit growth will slip from -3% in Q3 2019 to -15% in Q1 2020. This is not a forecast; it is one scenario in our evaluation of where we could go wrong in respect of market risk premium.

However, it could be important to reflect on whether the market would behave in line with long-term equilibrium assumptions in the event that it is surprised by a notable earnings recession, which we forecast. Additionally, a risk to the above scenario is that we (in line with market consensus) are reviewing this based on operating profits and on forward-looking multiples rather than on reported and trailing earnings. Furthermore, we do not consider changes in corporate debt levels, which have risen in recent years.

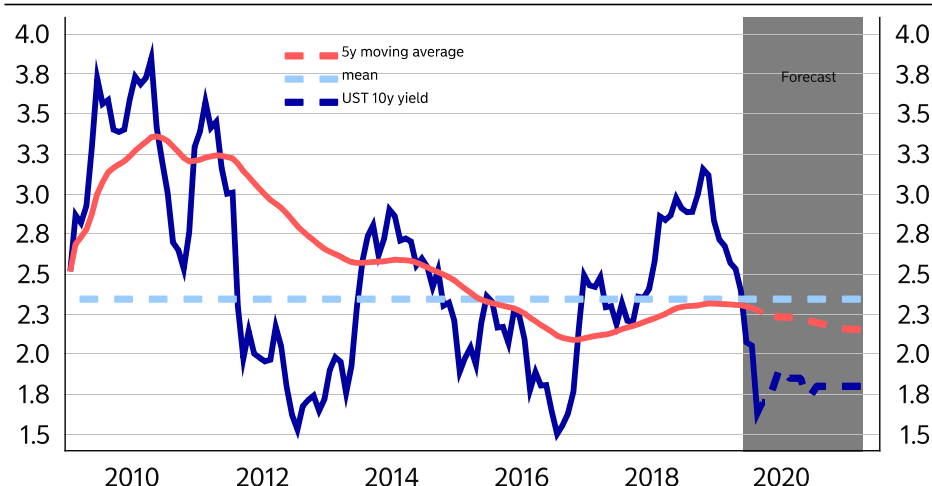
Interest rate implications cannot be neglected

The other factor in the market's required rate of return is the risk-free rate. Again, we can refer to [our analysis on the subject from earlier this year](#). We have set the risk-free rate at 2.5%. The benchmark for this is the US ten-year government bond yield. The basis for the 2.5% is the assumed long-term average yield of the bond. We reiterate our risk-free rate assumption. However, it could be worth noting that as recently as six months ago, this assumption was supported both by recent events and by Nordea's medium-term outlook, but the latter has now changed.

Sharply revised outlook just over the last six months

The revised medium-term outlook for the US ten-year benchmark bond yield implies that the ten-year average has notched lower to 2.3% (from 2.5% previously) and that the five-year rolling average is sliding, and looks set to reach 2.2% by mid-2021. Currently, the benchmark yield is 1.7% and is forecast to see only a minor lift over the coming two years.

GAUGING RISK-FREE RATE, US 10Y GOVERNMENT BOND YIELD



Source: Macrobond and Nordea

The market clearly seems reluctant to fully incorporate the recent bond yield contraction

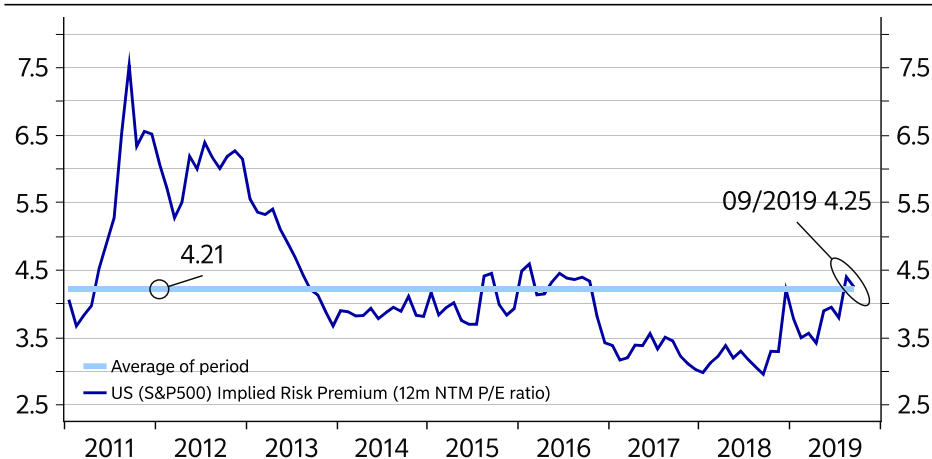
Similar to the discussion above regarding the risk premium, and keeping all else equal, the implications of changes to the risk-free rate assumption are significant. If we were to impute a 50-100 bp lower risk-free rate, the market would seek new equilibrium in the range of 10-20% higher and hence implicitly be able to absorb similar earnings cuts without trading lower.

Reflecting on the above, one natural question is why this has not to some extent already happened, as earnings multiples (P/E) have come down from the recent peak in December 2017 by some 10%.

Equity market risk premiums have been taken higher

In deriving the implied market risk premium, the market has "chosen" to increase the risk premium over the last year. The rise equals 130 bp, up from 3 pp to currently 4.3 pp – a significant rise indeed. Keeping all else equal, one could argue that the market has gone from seeing low to higher earnings risk. Hence, it has prepared itself for a much harsher earnings environment than consensus estimates currently suggest.

US EQUITY IMPLIED RISK PREMIUM



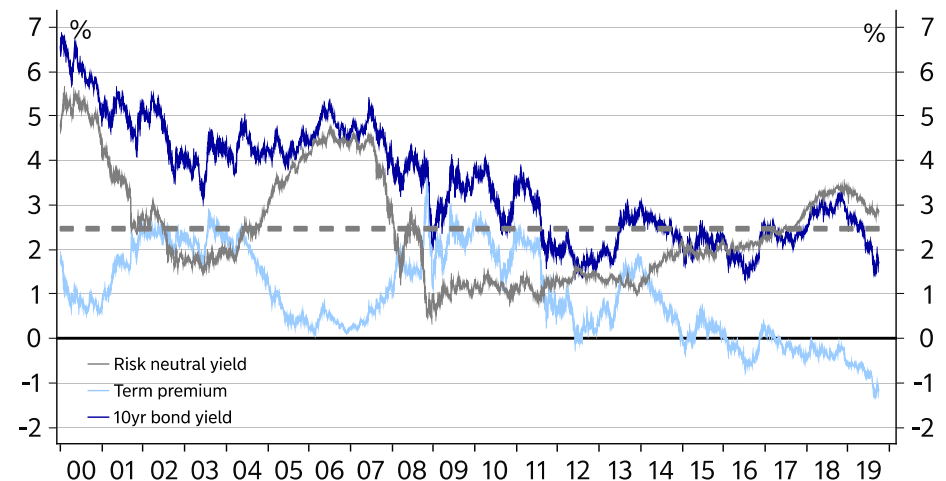
Source: Nordea Markets and Macrobond

Source: Macrobond and Nordea

NY Fed suggests a risk-free rate of 2.8%

Another explanation could be that the market does not assume that the current low interest rate level will be stable over the long term. Hence, it has increased the risk premium today to better absorb rising interest rates ahead. Support for this can be found from the NY Federal Reserve's calculation of the "natural rate". According to its calculations, most of the recent bond yield contraction can be explained by the fact that the term premium has been falling sharply into negative territory. The "risk-neutral yield" is currently 2.8%.

FEDERAL RESERVE NEW YORK CALCULATED RISK-NEUTRAL YIELD AND TERM PREMIUM



Source: Macrobond and Nordea

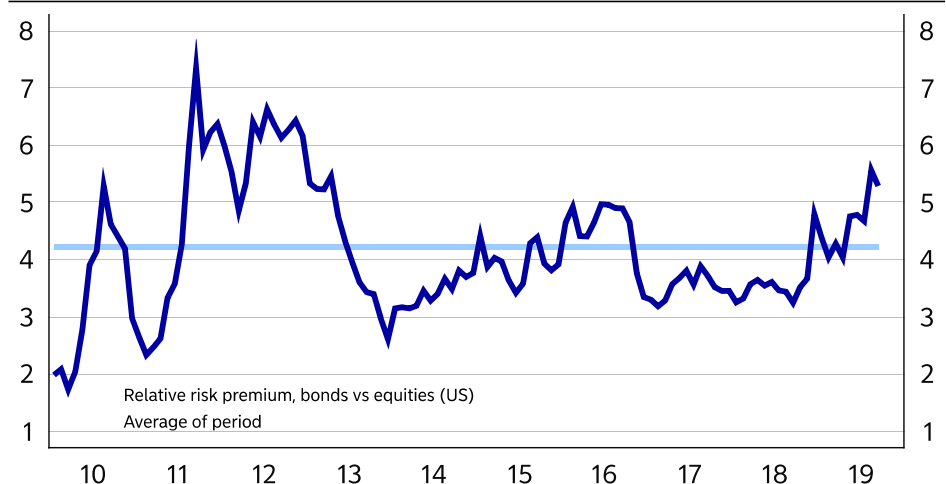
Our long-term assumptions find good support

Hence, we find little evidence that we are wrong in assuming a long-term market risk premium of 3.5 pp – if anything, the market suggests that at least currently it should probably be higher. Furthermore, the NY Federal Reserve calculation of the risk-neutral yield does not suggest that our assumed risk-free rate of 2.5% is too high – in fact, we see support for our 2.5% being a bit higher. However, there is one profound point of asymmetry in the market currently. With a term premium of -1 pp and an equity risk premium of 4.3 pp, the compensation for capital being exposed to equity risk rather than fixed income is high.

The real conundrum, however, is the negative term premium

Is the implied risk premium spread perhaps too high to absorb the risk of an earnings recession? Possibly the spread is of less importance today relative to the fact that the other asset class (bonds) trades with a negative risk premium. As long as this is the reality, any setback in equity performance could merely offer a better entry point. This would then rhyme well with the last few years' market behaviour, as the marginal investor fails to see any true alternative.

RELATIVE RISK PREMIUM BONDS VS EQUITIES (US)



Source: Macrobond and Nordea

Could a negative term premium suddenly and sharply cut RRR?

This condition is, however, yet to be tested in a marked earnings recession. Nevertheless, it would, if true, imply a sharp decline in the equity market's required risk of return (RRR). In essence, a 100 bp drop in RRR would counterbalance the drop in earnings that we foresee. Should this be the next step incorporated by the market, we clearly could be exaggerating the risks stemming from a marked earnings recession.

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 have not 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.

In the United States, to the extent that this publication or report includes an analysis of the price or market for any derivative and is not otherwise exempt from the applicable U.S. Commodity Futures Trading Commission (CFTC) regulations, it is approved for distribution in the United States to US persons that are eligible contract participants from a CFTC perspective. Nordea Bank Abp is a provisionally registered swap dealer with the CFTC. Any derivatives transactions with US persons must be effected in accordance with the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Completion date: 7 October 2019, 16:35 CET

Nordea Bank Abp	Nordea Bank Abp, filial i Sverige	Nordea Danmark, Filial af Nordea Bank Abp, Finland	Nordea Bank Abp, filial i Norge
Nordea Markets Division, Research Visiting address: Aleksis Kiven katu 7, Helsinki FI-00020 Nordea Finland Tel: +358 9 1651 Fax: +358 9 165 59710 Reg. no.: 2858394-9 Satamaradankatu 5 Helsinki	Nordea Markets Division, Research Visiting address: Smålandsgatan 17 SE-105 71 Stockholm Sweden Tel: +46 8 614 7000 Fax: +46 8 534 911 60	Nordea Markets Division, Research Visiting address: Grønlandsvej 10 DK-2300 Copenhagen S Denmark Tel: +45 3333 3333 Fax: +45 3333 1520	Nordea Markets Division, Research Visiting address: Essendropsgate 7 N-0107 Oslo Norway Tel: +47 2248 5000 Fax: +47 2256 8650



Confidential