Nordea View

January 2019: High bull trap risk

Nordea Markets - Analysts
Mikael Sarwe
Head of Market Strategy
mikael.sarwe@nordea.com

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

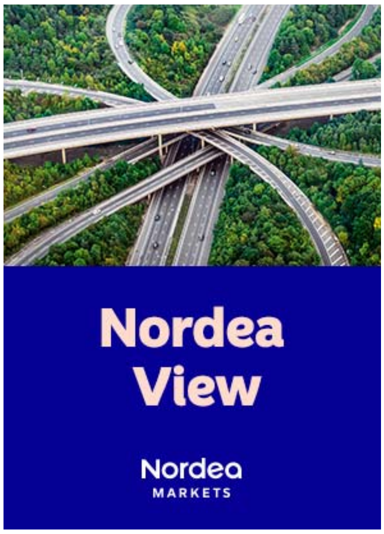
Arvid Böhm
Head of Equity Strategy, Market Strategy
arvid.bohm@nordea.com

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

Since mid-May 2018, we have held the view that the stock markets and economies would follow a roadmap similar to 2015-16. After a vicious December, global equity markets reached our initial target of a 15-20% drawdown from the peak, a drop in line with the 2015-16 experience. On the macro side, however, we find that the comparison with 2015-16 no longer fully holds true. We have already indicated in previous issues of Nordea View that there are several negative differences compared with that period, which could mean a more negative stock market scenario this time. Currently, we are even more worried about those differences; so, we are not yet willing to neutralise our underweight equity and corporate bond positions. We admit that the call is much harder to make now that markets have temporarily corrected to forward P/E levels that could be viewed as fair on a longer time horizon. However, profit-neutral multiples, such as EV/sales, are still much higher than at the market trough in 2016, and the risk of an earnings recession is, in our view, greater now. We also continue to recommend a value approach to equity investing, with an additional tilt towards GARP on the back of lower bond yields.

Macro strategy: Deteriorating macro outlook

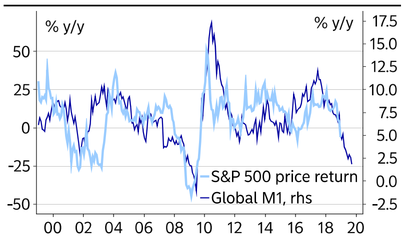
After US markets posted the worst December since 1931, global equity markets reached our initial target of a 15-20% drawdown from the peak. As such, the equity market is much more attractive than it was in 2018. At the same time though, the macro environment has deteriorated, which increases the risk of an earnings recession. Various leading growth indicators are more negative than we previously assumed, central bank liquidity trends are pointing downwards and wage costs are continuing to rise. We note, on the positive side, that the Federal Reserve appears to be signalling a pause for rate hikes and that trade talks between the US and China seem to be progressing. However, we still believe that the increasing likelihood of an earnings recession favours sticking to a defensive stance towards risky assets. Our view on the equity market rebound in early 2019 is that it is likely a bull trap.



Equities: Entering the downgrade cycle

Security analysts around the world appear to be scrambling to adjust to a new reality of slowing global growth, while cost pressures from late-cyclical wages accelerate. Forward-looking P/E multiples have retraced to levels that in a historical context could be deemed reasonable, but the problem, we argue, is that the markets have discounted a profit growth slowdown, but not an earnings recession – and our indicators suggest this is becoming more likely. Style-wise, we remain stubbornly in the value camp, given the extreme valuation differential between the expensive and the cheap ends of the market. We advise complementing this bias with underperforming quality and GARP characteristics, given the pull-back in bond yields.

M1 SIGNALS DOWNSIDE RISK



Source: Macrobond and Nordea

Equity strategy: Timing is everything – risk adjust

Today, we introduce a tool that could prove to help us in timing the market. As described earlier, major indices lost close to 20% from peak to trough. The factors behind the sluggish markets have been numerous, but in short, we explain it by overly high expectations that were challenged by deteriorating fundamentals. The core fundamental in any asset price is valuation. When valuation is extreme, be it high or low, an unexpected event is more likely to move the price. At the end of the day, the aim of marginal investors is to buy any asset cheap and sell it dear. Incorporating market risk into the equation helps. For most of 2018, our risk-adjusted valuation signalled utterly poor risk/reward. Currently this gauge is more neutral. Should it drop below 2016 levels, it could be an important stepping stone for a broad re-allocation into equities.

Macro Strategy: Deteriorating macro trend

After US markets posted their worst December since 1931, global equity markets reached our initial target of a 15-20% drawdown from the peak. As such, the equity market is much more attractive than it was in 2018. At the same time, however, the macro environment has deteriorated, which increases the risk of an earnings recession. As a consequence, we stick to our defensive stance towards risky assets, but it is a more difficult call than our original 2018 bearishness. Our view on the equity market rebound in early 2019 is that it is likely a bull trap.

High risk that the equity market is a bull trap, in our view

In late 2018, global equity markets reached our initial target of a 15-20% drawdown from the peak. That makes the equity market much more attractive than it was in 2018, but is it attractive enough? On the positive side, apart from the price corrections, the Federal Reserve appears to be signalling a pause in its rate hikes and trade talks between China and the US are progressing (if we are to believe official spokespersons). On the negative side, various leading growth indicators are more negative than we previously assumed, central bank liquidity trends are pointing downwards and wage costs are continuing to rise. Overall, we still believe that the increasing likelihood of an earnings recession favours sticking to a defensive stance towards risky assets, but it is a substantially more difficult call than our original 2018 bearishness. In other words, our view on the equity market rebound in early 2019 is that there is a high risk of it being a bull trap, which could catch investors off-guard once updated outlooks are released alongside Q4 earnings reports.

Forward P/E multiples have corrected, but are based on positive EPS growth forecasts

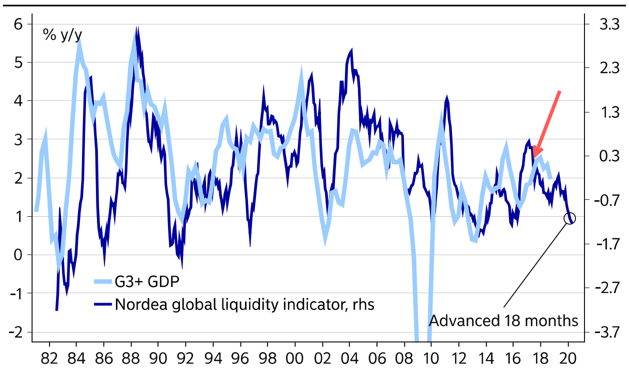
Since mid-May 2018, we have held the view that the stock market and economies would follow a roadmap similar to 2015-16. Back then, the MSCI World Index dropped almost 20% from peak to trough, as growth slowed and earnings disappointed. GDP in the US decelerated from 3.8% y/y in Q1 2015 to 1.3% by mid-2016, whereas growth in the Euro area stayed fairly healthy at 2%. The average forward P/E for the S&P 500 dropped from over 17x to 15x before markets and economies stabilised. The correction in the US stock market in 2018 resulted in the average forward P/E for the S&P 500 dropping as low as 14x, which is below the 15x longer-term average. Should that not be enough?

Macro backdrop looks worse than 2015-16

The rebound in markets in early 2019 indicates that some investors believe so. However, we find that the comparison with 2015-16 on the macro side does not hold true anymore. We have already indicated in previous issues of Nordea View that there are several negative differences compared with that period, which could mean a more negative stock market scenario this time. Currently, we are even more worried about those differences; so, from a risk/reward perspective, we are not yet willing to neutralise our underweight equity and corporate bond positions.

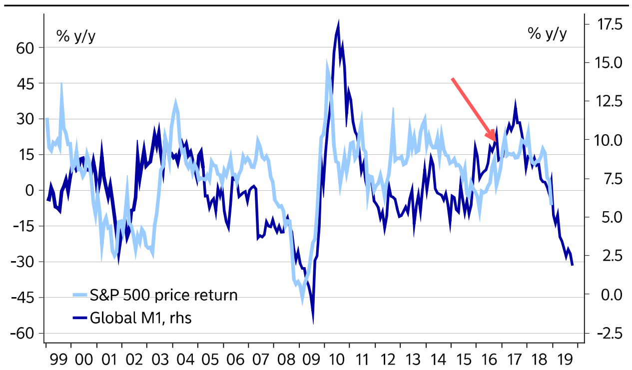
In the appendix (at the end of this section), we provide a series of charts comparing the current market situation, liquidity trends and leading macro indicators with 2015-16. The red arrows indicate where the leading indicators were pointing at the trough of the market in 2016; our conclusion is that the overall macro environment and EPS outlook appear less favourable today.

LIQUIDITY BACKDROP WORSE THAN IN 2016



Source: Macrobond and Nordea

GLOBAL M1 SIGNALS DOWNSIDE RISK FOR EQUITIES



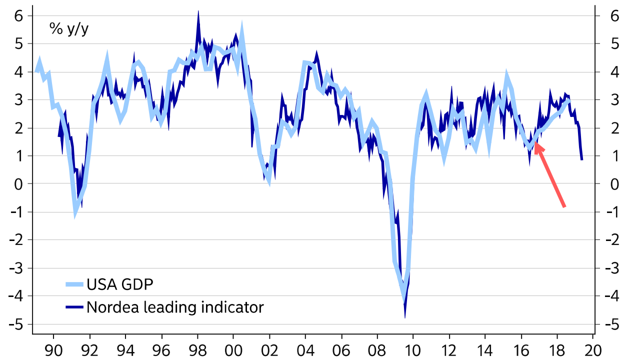
Source: Macrobond and Nordea

Liquidity trends are markedly negative

To begin, when the market hit bottom in 2016, central banks had been flooding economies and markets with liquidity since mid-2015. Currently, central bank balance sheets are still being reduced and trends in M1 money supply growth are markedly negative. Even if central banks change to a more pro-growth policy, it normally takes time for that to impact markets and economies. Money makes the world go around, so this is a major reason for our defensive stance. In the very short term, however, the upcoming debt ceiling in the US is technically leading to a surge in excess liquidity for the US banking system; in our view, this is an important reason to believe in a weaker USD (read more in our FX Weekly). It could also be that this liquidity push helps risky assets, but with our six- to nine-month investment horizon, the negative trends in M1/ central bank balance sheets should be much more important.

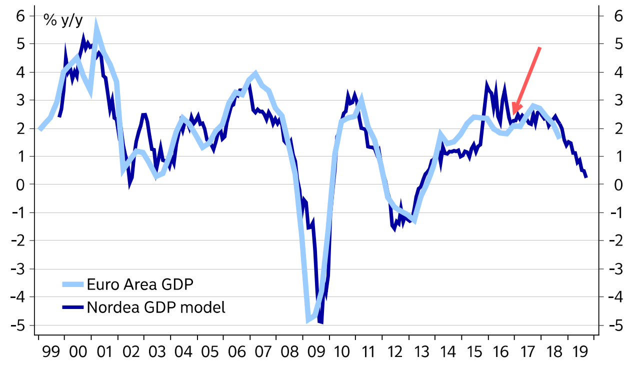
Link - https://e-markets.nordea.com/#!/article/47286

OUR US GDP MODEL WARNS FOR GROWTH BELOW 1%



Source: Macrobond and Nordea

EURO-AREA GROWTH COULD BE HEADING TOWARDS 0%

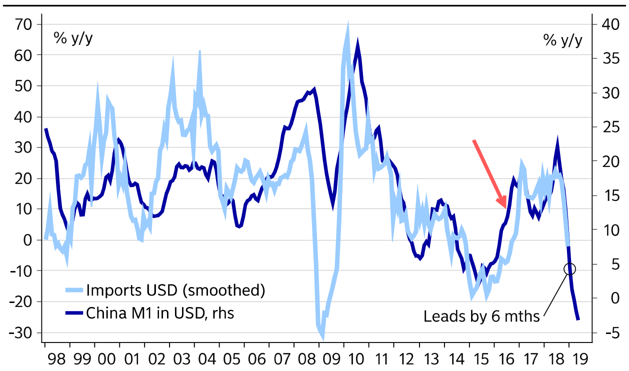


Source: Macrobond and Nordea

Our broad leading GDP indicators point to a relatively severe slowdown

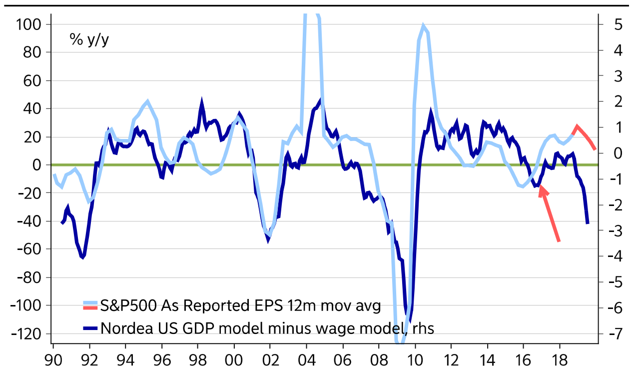
Moreover, our broad leading GDP indicators are more negative today than in 2015-16, particularly for the Euro area where our GDP indicator pointed to 2% growth in 2016 and is now warning for close to 0%. In the US, the indicator has dropped to slightly below 1%. Our previous assumption that Chinese growth should hold up better than in 2015-16 could also be challenged, both from a trade war perspective and by a doubt that current stimulus measures are as effective as the credit boost of 2016. M1 growth in China has been catastrophic for quite some time, thereby having signalled the current import slump (and even worse) well in advance. We do not expect a global recession and consequent market crash, due to low real short rates, but risks have increased. This should mean that global sales growth forecasts will be revised down.

VERY WORRYING M1 TREND IN CHINA



Source: Macrobond and Nordea

SLOWER GROWTH/RISING COSTS WARN FOR EPS RECESSION



Source: Macrobond and Nordea

Risks of an earnings recession have increased owing to slower growth and higher wage costs

On the cost side of the equation, wages are already increasing much more than in 2016 and our leading wage indicators are pointing to even higher cost increases in the future (see the appendix). Wage increases are late-cyclical phenomena, so even if growth slows, it could take up to a year for that to push wages down again markedly. Taken together, slower growth and higher costs point to a higher likelihood of an earnings recession in 2019 than 2016, which our EPS indicators are flagging. Even though earnings revisions have already turned negative, we still find profit margin and EPS forecasts too high. The S&P 500 EPS forecast for 2019 is +8% (source: Bloomberg), but it could very well end up at -8%, which also illustrates why we currently view forward P/E levels as somewhat misleading. Profit-neutral EV/sales and P/book for the US market are still much higher than at the trough in 2016.

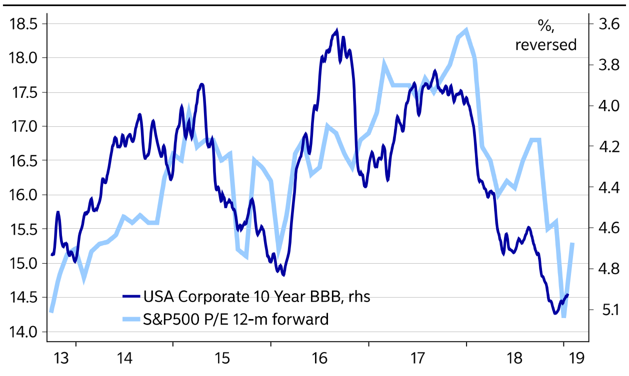
The Fed has helped the market by sounding less hawkish

Link - https://e-markets.nordea.com/#!/article/47270

On the more positive side, the recent market rebound has probably developed partly as an effect of the Federal Reserve sounding markedly less hawkish (read more about this in our Week Ahead). Several Fed governors have implied at least a pause for rate hikes, and market rates were at one point discounting almost two rate cuts by the end of 2020. Also, there have been some signals that the balance sheet reduction is no longer fully on "autopilot". Any directional change in Fed policy would, of course, be helpful for risky assets, but we find it too early to make such a call and it would be too late for the Fed to come to terms with the possible earnings recession. Recall that, from a valuation perspective, US interest rates are expected to stay much higher than was the case in 2015-16. Corporate bond yields do not justify higher forward P/E multiples, which should create a valuation problem if EPS drops in the way we anticipate.

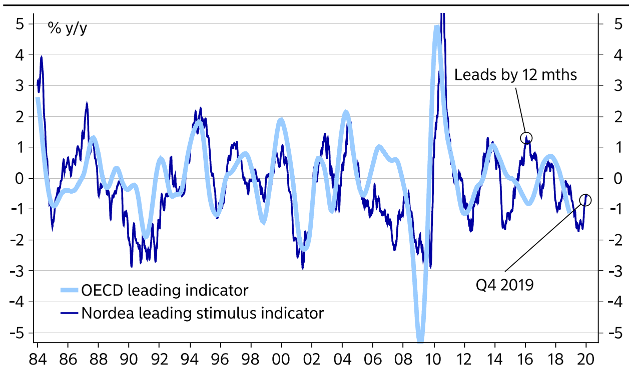
That said, falling interest rates and the drop in oil prices have already meant that our longer leading global stimulus indicator has started to rise, which is the first positive cyclical sign we have seen for quite a while. The indicator basically says that our current thinking about a possible market trough towards the middle of 2019 could still prove to be correct.

BOND YIELD DOES NOT JUSTIFY FORWARD P/E EXPANSION



Source: Macrobond and Nordea

STIMULUS INDICATOR SLIGHTLY MORE POSITIVE LATE 2019



Source: Macrobond and Nordea

Some potential for fiscal policy stimulus

The positive effects of Trump's fiscal policy stimulus are ebbing away and we do not anticipate a stimulus extension given the political situation between the Republicans and Democrats. However, there are signals from other countries, Germany for one, where fiscal policy could be loosened. China has continued to promise further tax cuts, which has occasionally made the market happy. That said, the question is: how effective is fiscal policy currently? How much of that will go to savings instead of consumption, etc?

Large drop in equity market has increased probability of a trade deal

The outcome of the trade discussions between the US and China is, of course, difficult to predict. The large drop in the equity market in late 2018 might make a slightly positive outcome in those negations more likely. Politically, both parties want to declare any upcoming potential deal a success, regardless of the actual content of the agreement, which could sway the markets to the positive side. However, our view is that a deal will probably not include a final solution to all of the rather far-reaching demands of President Trump.

We stick to a defensive view on risky assets

All in all, even though our original market targets have been met, we remain underweight in risky assets. Positioning globally is likely still overweight risky assets. As such, we view the current stock market rebound as most likely to be a bull trap. For our strategy, we stick to the name of our December Nordea View: Sell on strength. We admit that the call is much harder to make now that markets have corrected to forward P/E levels that could be viewed as fair on a longer time horizon. Moreover, one could argue that there are now a number of single company names that more or less discount a recession, but we find that the risk/reward for the overall market is not yet there to advocate for a less defensive position.

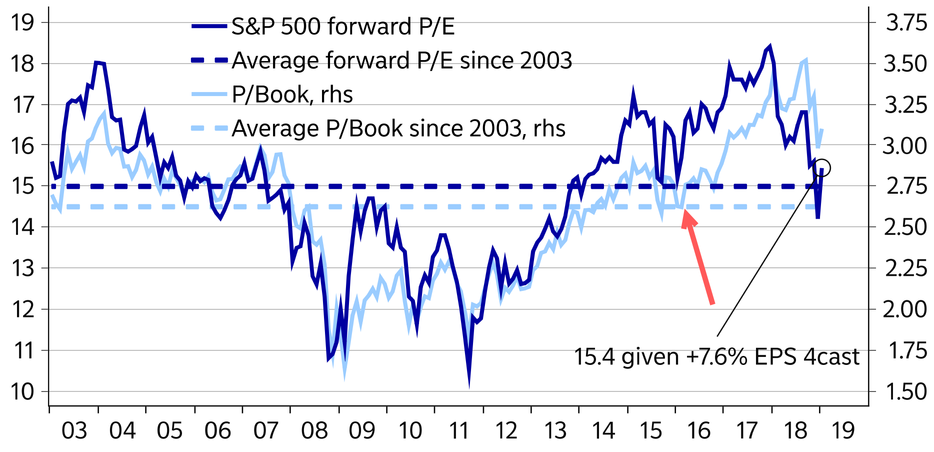
This section has been produced by Nordea Research's Non-Independent Research unit.

Macro Strategy chart appendix

Forward P/E has dropped, but is based on increasing EPS

Profit-neutral multiples are still much higher than at the 2016 market trough

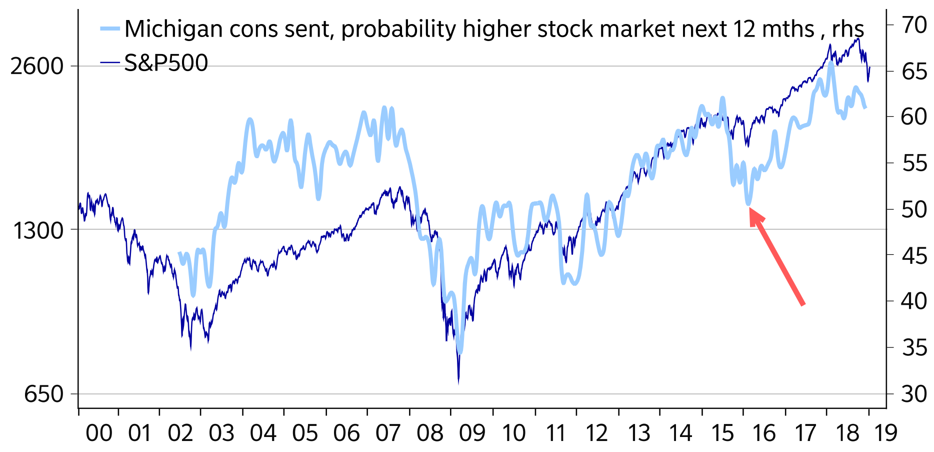
S&P 500 FORWARD P/E AND P/B



Source: Bloomberg, Macrobond and Nordea

US households are still very bullish towards equities, potentially a contrarian indicator

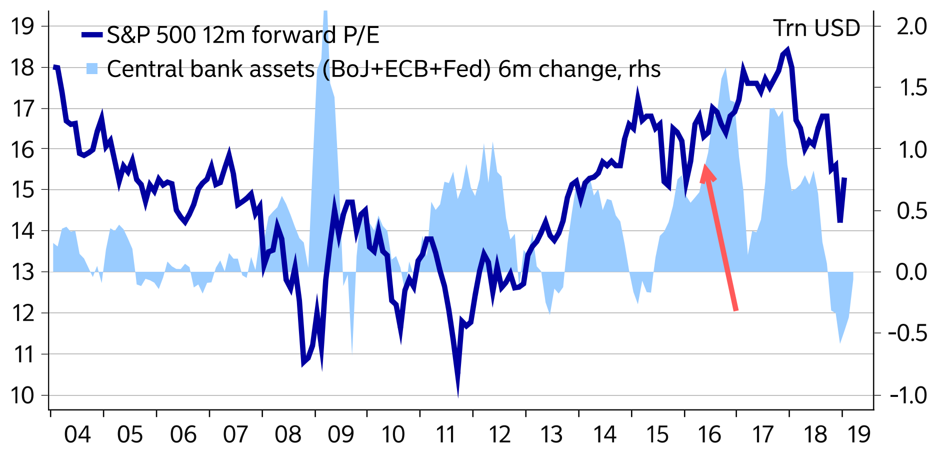
US HOUSEHOLD VIEW ON THE STOCK MARKET



Source: Macrobond and Nordea

At the bottom of the market in 2016, central banks had been flooding the markets with massive liquidity injections since mid-2015 – that is definitely not the case today

CENTRAL BANKS' BALANCE SHEETS AND P/E

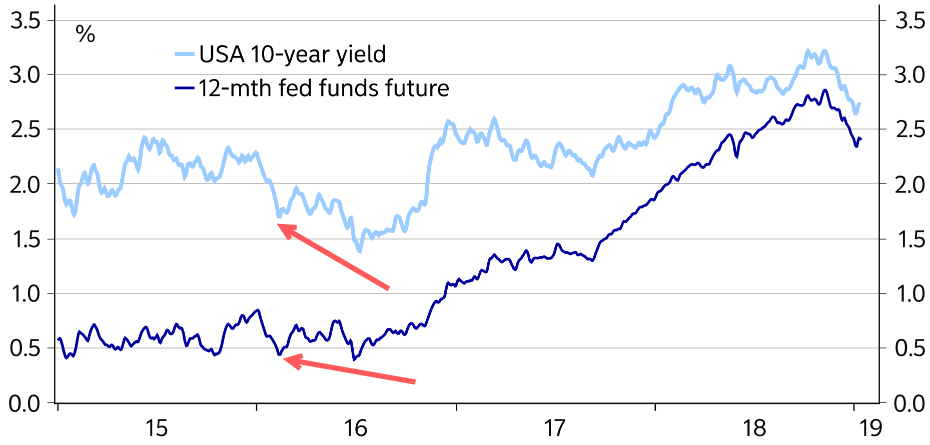


Source: Macrobond and Nordea

Macro Strategy chart appendix (continued)

Even though the Fed outlook has been challenged, interest rate levels should remain much higher than in 2016

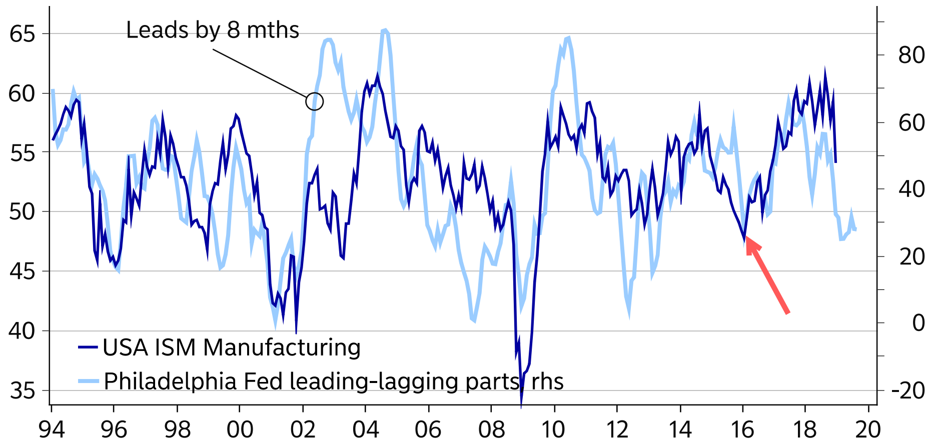
US INTEREST RATE LEVELS



Source: Bloomberg, Macrobond and Nordea

We believe the ISM will fall further

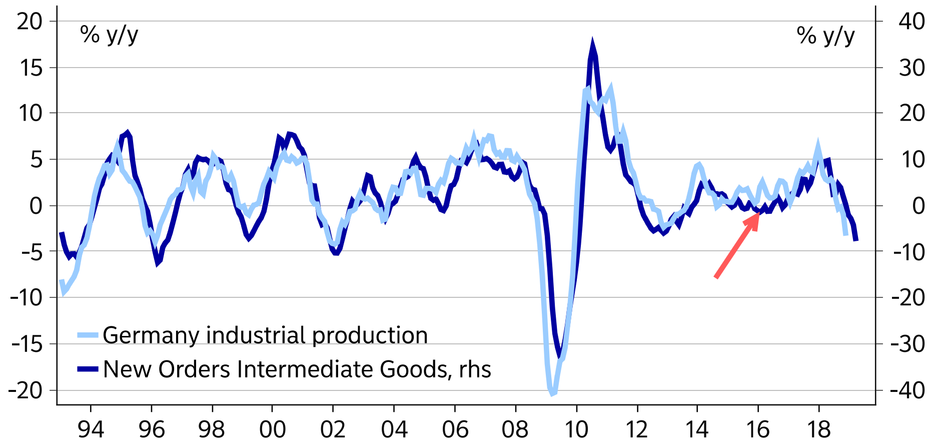
ISM AND LEADING INDICATOR



Source: Macrobond and Nordea

Manufacturing indicators in the Euro area are markedly weaker than during 2016

GERMAN INDUSTRIAL PRODUCTION AND ORDERS

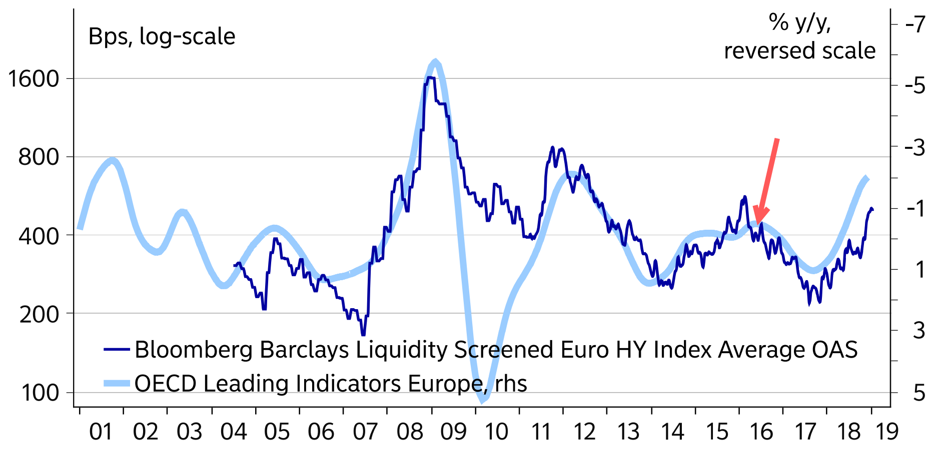


Source: Macrobond and Nordea

Macro Strategy chart appendix (continued)

Leading Euro-area indicators look more like 2011-12 than 2015-16 and so there is a risk that credit spreads could widen further

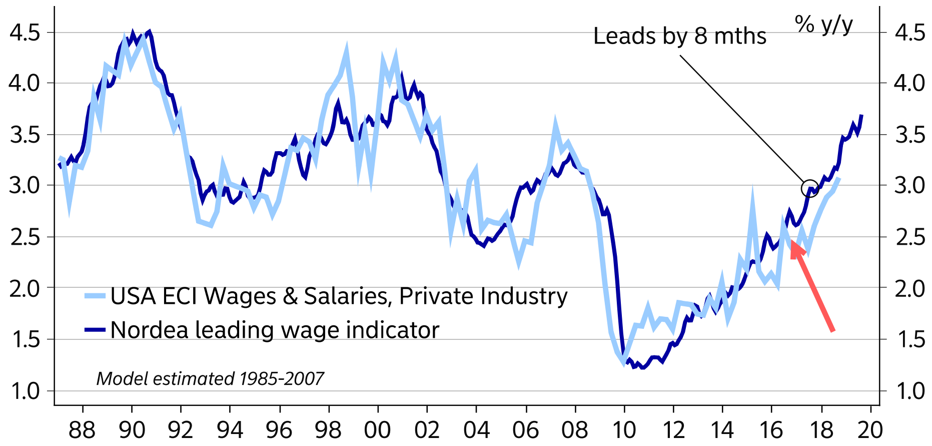
LEADING EURO-AREA INDICATOR AND HIGH YIELD SPREAD



Source: Bloomberg, Macrobond and Nordea

Our leading US wage indicator points to even higher cost increases in 2019 than 2018

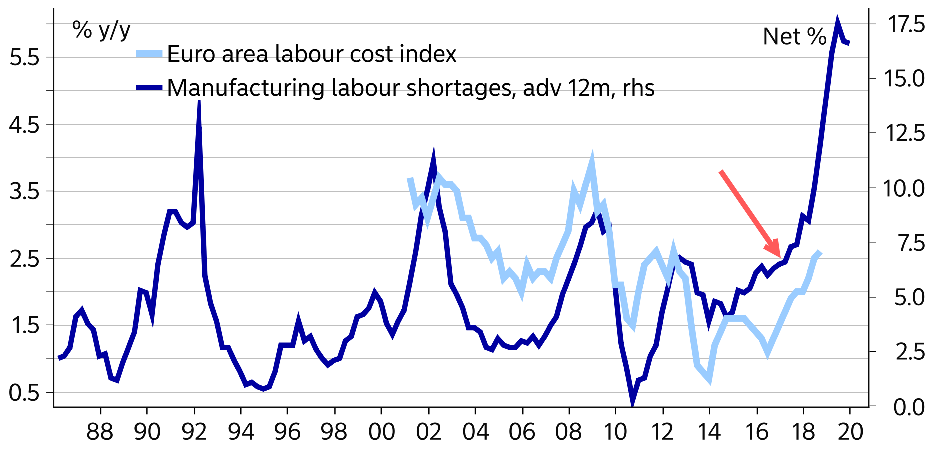
US WAGE GROWTH AND LEADING INDICATOR



Source: Macrobond and Nordea

The conclusion about higher wage cost increases also seems true for the Euro area

EURO-AREA LABOUR SHORTAGES AND WAGE GROWTH



Source: Macrobond and Nordea

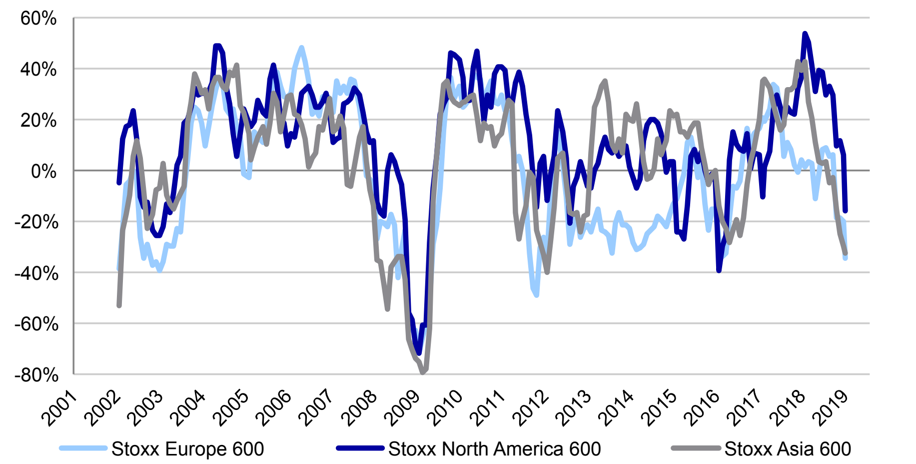
Equities: Entering the downgrade cycle

Security analysts around the world appear to be scrambling to adjust to a new reality of slowing global growth, while cost pressure from late-cyclical wages is accelerating. Forward-looking P/E multiples have retraced to levels that in a historical context could be deemed reasonable, but the problem, we argue, is that the market has discounted a profit growth slowdown, but not an earnings recession. And our indicators suggest this is becoming more likely. Style-wise, we remain stubbornly in the value camp, given the extreme valuation differential between the expensive and the cheap ends of the market. We advise complementing this bias with underperforming quality and GARP characteristics, given the pull-back in bond yields.

Given further signs that economic activity is weakening, security analysts are in downward adjustment mode. Our revision indicators (net number of companies being upgraded minus downgraded by total companies), which broadly turned negative following the Q3 reporting season, have continued to slide deep into negative territory. The same is true for both developed and emerging markets as for cyclicals and defensives. The broad scope of the downgrades (in a historical context) suggests that markets will be in downgrade mode for at least the coming six to nine months. The severity of the revision indicators implies a tough economic slowdown, and when they have been this negative in the past, we have witnessed an earnings recession (negative earnings growth) on most occasions.

After more than two years in upgrade mode, security analysts are scrambling to adjust to a new reality of late; our revision indicators have turned sharply lower

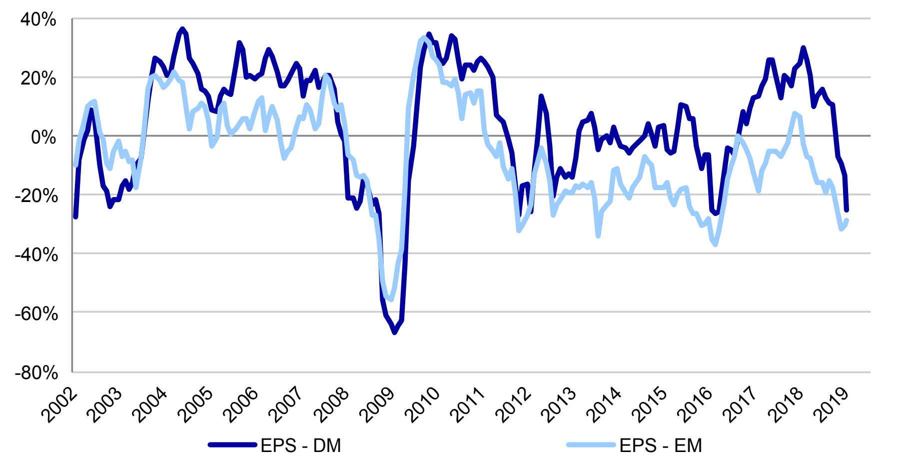
OUR EPS REVISION INDICATORS FOR EUROPE, NORTH AMERICA AND ASIA



Source: FactSet and Nordea

The speed of downgrades is a plausible sign of an ominous earnings recession

EPS REVISON INDICATORS FOR DEVELOPED VERSUS EMERGING MARKETS



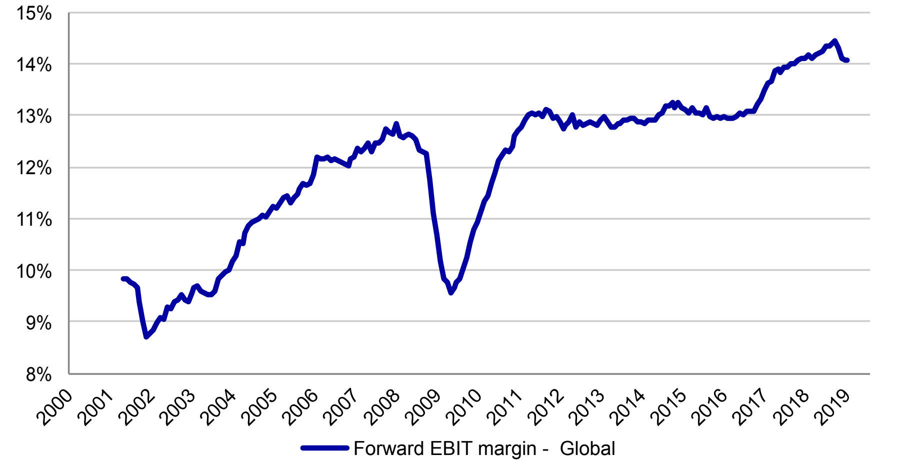
Source: FactSet and Nordea

Despite having been adjusted downwards, margin expectations remain too elevated in our view, suggesting that investors should expect further downgrades. In addition, given the estimate risk we foresee we advise caution against focusing too much on forward-looking multiples.

Margin adjustments have started...

Given slowing sales momentum and persistent wage cost pressure, we would expect further adjustments over the coming quarters

MEDIAN EBIT MARGIN FOR STOXX GLOBAL 1800

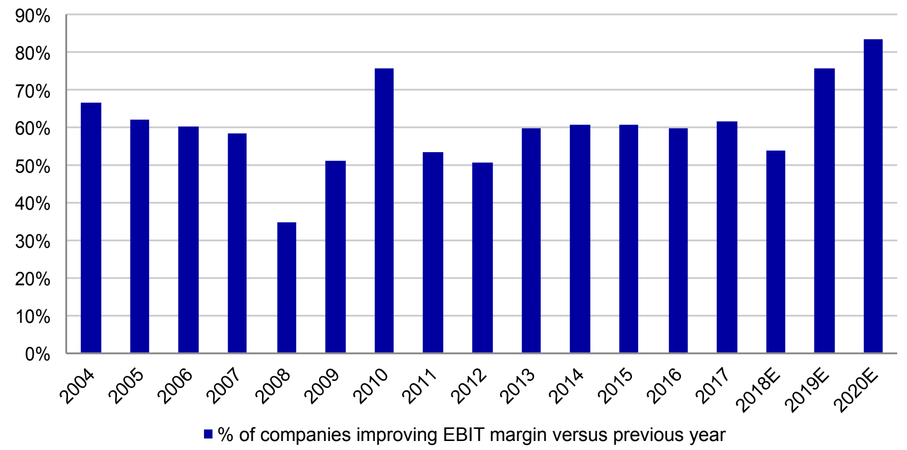


Source: FactSet and Nordea

Analyst adjustments are also visible when depicting the proportion of companies expected to post margin improvements

There is further to go in 2019 though, and a repeat of 2018 would constitute a positive scenario, in our view

SHARE OF STOXX 1800 COMPANIES EXPECTED TO IMPROVE EBIT MARGINS



Source: FactSet and Nordea

An analysis of Q4 estimates' current run-rate versus 2019 forecasts strengthens our belief that forecasts will continue south

We have analysed the current Q4 run-rate in the US, taking into account historical seasonality. This analysis shows that if US companies maintain their current run-rate, estimates would need to come down by 6% on sales and 11% on net income for the median company. Even though this is a simplified analysis, it does further support our view that consensus estimates have downside risk. This then adds an additional dimension to our view that the stronger US dollar has not been fully incorporated into estimates, in addition to our GDP indicators having softened markedly, while cost pressure remains.

The equivalent analysis in Europe signals similar estimate risk on net income. In Asia, analysts appear to have pencilled in a more cautious top-line scenario, while the earnings risk is greater. It is worth highlighting that the number of contributors to quarterly estimates is much better in the US even though far from perfect, suggesting we should apply some caution to European and developed Asia figures.

IMPLIED 2019 BY Q4 2018 RUN RATE VS 2019 MEDIAN CONSENSUS ESTIMATE

Region	Sales	EBITDA	EBIT	Net Income
Global	-4.1%	-7.0%	-8.1%	-13.8%
Europe	-3.2%	-5.4%	-6.7%	-12.4%
North America	-5.8%	-7.9%	-8.0%	-13.0%
Asia	-1.4%	-6.8%	-9.0%	-17.1%

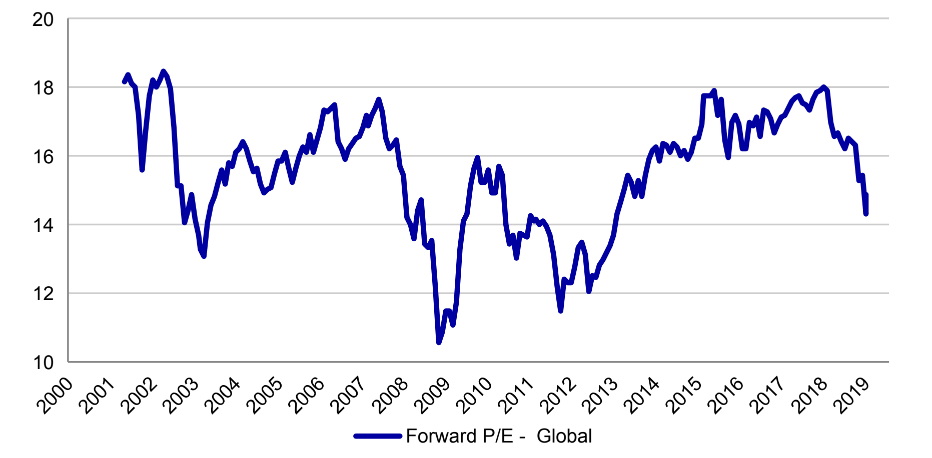
Source: FactSet and Nordea

What's priced in?

The markets have, of course, already reacted and the question we need to answer is what is discounted. Forward-looking P/E multiples have contracted materially, falling 3-4 units from the peak, and with interest rates moderating, this could suggest an improved outlook for equities. The problem, we argue, is that profit-neutral multiples such as EV/sales remain above historical averages, with the US standing out the most negatively in this comparison.

P/E levels quickly approaching more appealing levels

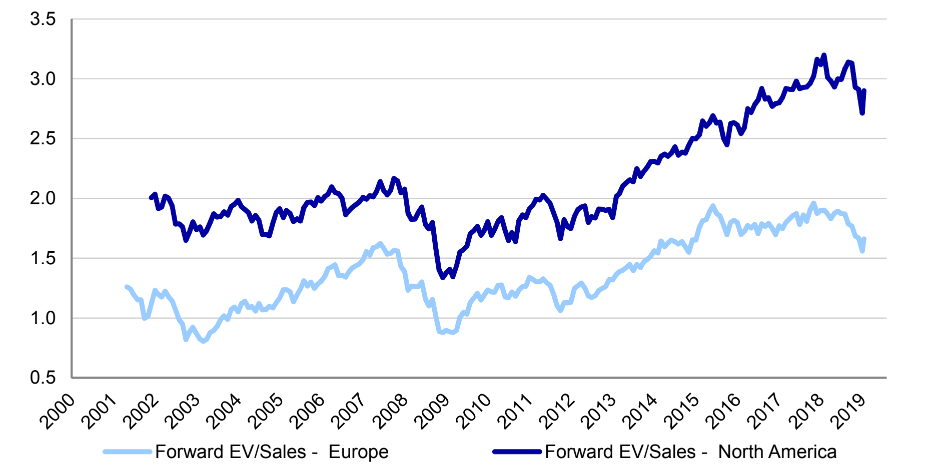
MEDIAN P/E FOR STOXX GLOBAL 1800



Source: FactSet and Nordea

EV/sales multiples, however, have much further to fall to reach historical averages, suggesting further downside as uncertainty grows with regards to the estimate outlook

MEDIAN EV/SALES FOR STOXX EUROPE 600 AND STOXX NORTH AMERICA 600



Source: FactSet and Nordea

Even though the recent falls in equities signal an earnings slowdown, we think an earnings recession is not discounted yet

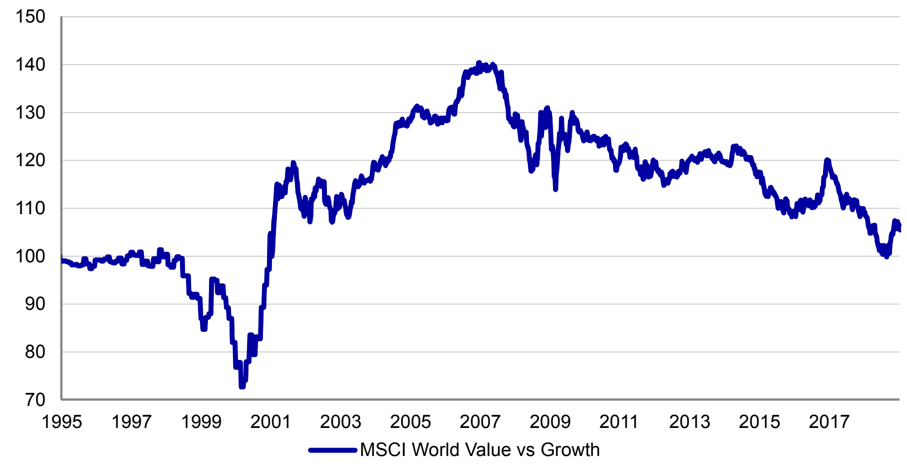
In conclusion we argue that an earnings growth slowdown has been discounted, but we do not think the overall market has priced in a mild earnings recession. Given that both our macro indicators and revision indicators suggest an increasing likelihood of such a scenario, we remain cautious. Finally, as we are in unchartered profitability territory, there is also a risk that we have only seen the beginning of a medium-term profit margin adjustment period. Adding that risk to our main scenario of a mild earnings recession, we suggest that the recent comeback in stocks should be utilised to reduce equity positions further.

Style analysis still points towards a value bias

We have seen rather small value/growth moves lately, suggesting a pause in the value recovery we witnessed during the autumn. Our European data-based proprietary quant models suggest that low-risk strategies have fared the best, whereas classic underweight strategies (expensive, low quality and downgrades) still deliver sizeable underweight alpha. This suggests that investors remain focused on what not to own. In our minds, this opens up opportunities for being a bit more constructive with the opportunity to create alpha on the long side.

Value recovery slightly halted of late, but we deem it likely a pause rather than a trend shift

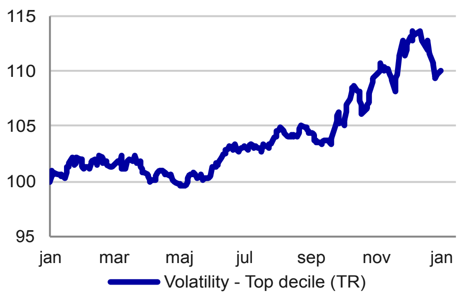
MSCI WORLD VALUE VS GROWTH



Source: FactSet and Nordea

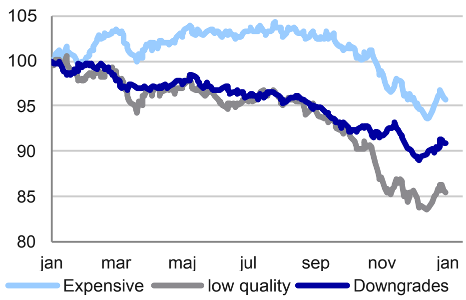
Low-risk stocks have proven a safe haven, while classic underweight traits have been avoided like the plague in Europe

LOW VOLATILITY OUTPERFORMS



Source: FactSet and Nordea

UNDERWEIGHT TRAITS STRUGGLE



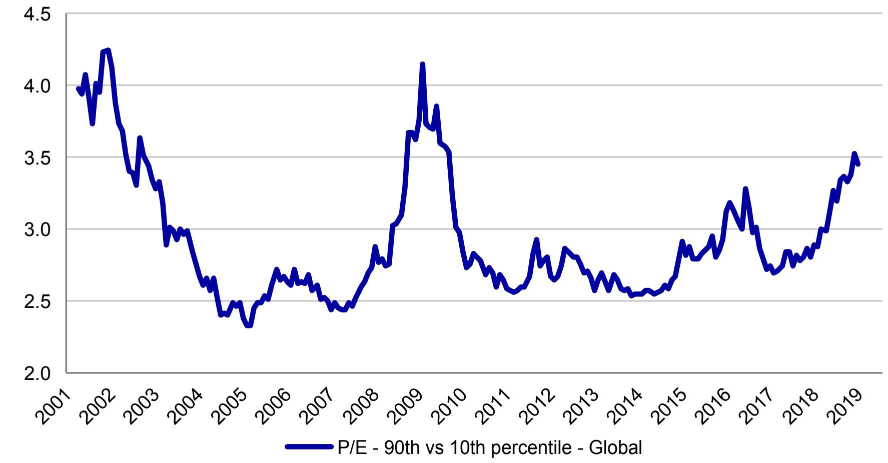
Source: FactSet and Nordea

We remain convinced that valuation will continue to grow in importance and that a value bias should be complemented with underperforming quality and GARP characteristics

The valuation differential between the cheap and the expensive ends of the global equity universe remains extreme, suggesting goods odds to stay valuation focused, as similar historical extremes have yielded solid alpha in coming periods, having employed a value bias in allocations and stock picking. We therefore remain value-biased in our approach, but given the bond yield developments, we would argue in favour of complementing this bias with both underperforming quality and GARP characteristics. Given growing uncertainty in earnings, which the latest dispersion reading also suggests, we remain convinced that estimate revisions will play a less dominant role, especially with regards to finding longs.

Expensive stocks (90th percentile) at 3.5x higher P/Es versus cheap (10th percentile suggest an opportunity to be contrarian by focusing on valuation

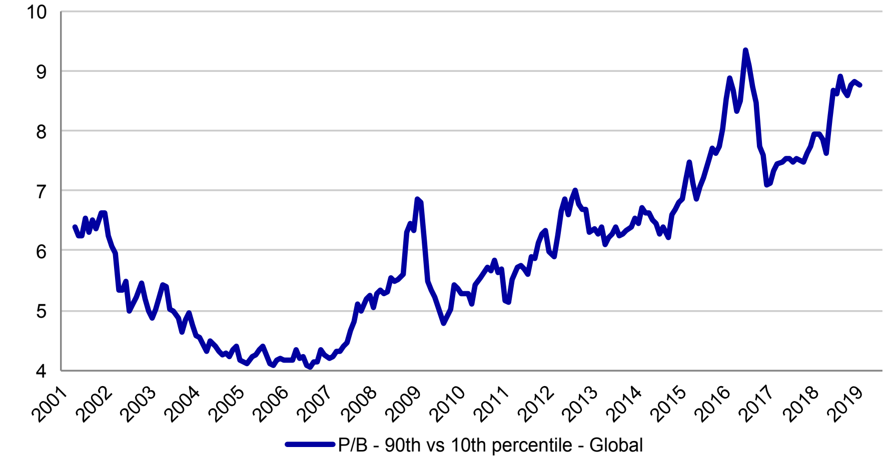
MEDIAN RELATIVE P/E FOR 90TH VS 10TH PERCENTILE IN STOXX GLOBAL 1800



Source: FactSet and Nordea

The equivalent P/BV differential between the expensive and the cheap end is a whopping 9x

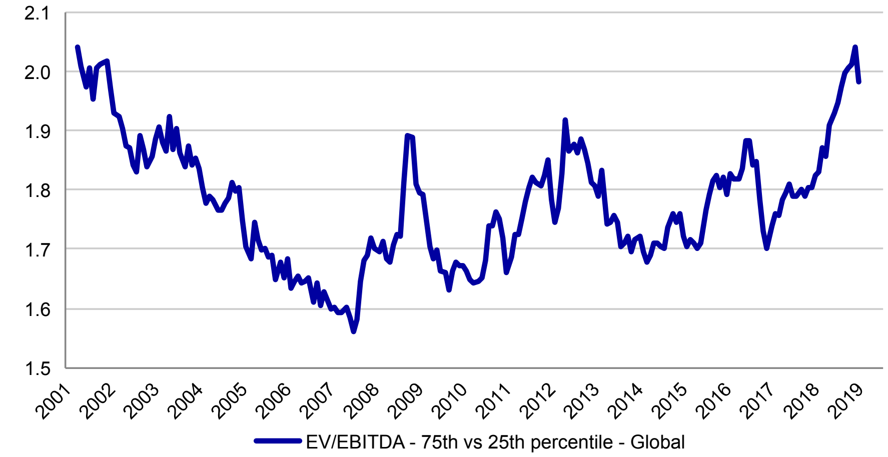
MEDIAN RELATIVE P/BV FOR 90TH VS 10TH PERCENTILE



Source: FactSet and Nordea

We have to go back 18 years to find such a differential between the cheap and the expensive ends of the global equity universe

MEDIAN EV/EBITDA FOR 75TH VS 25TH PERCENTILE



Source: FactSet and Nordea

Moving downwards on growth also shifts multiples down and valuation multiples tend to compress when comparing a market or a company delivering excess growth

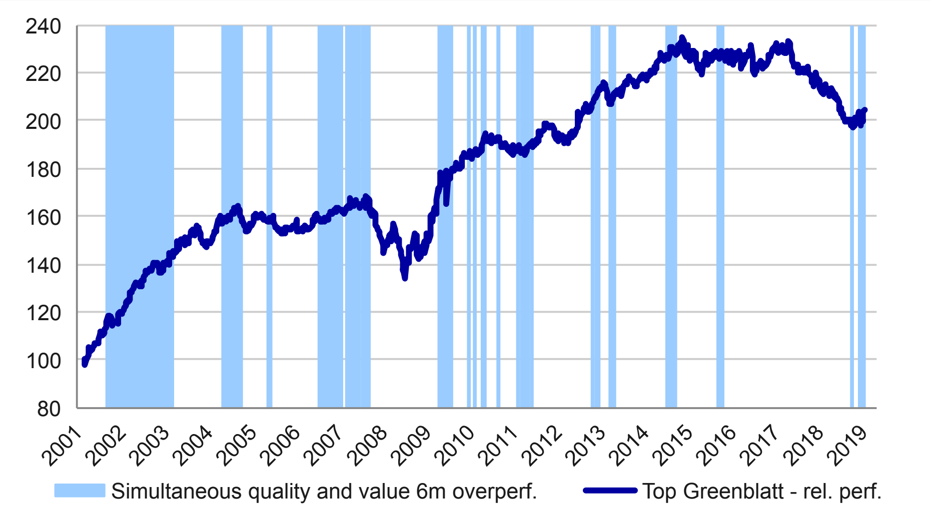
VALUATION, COE AND GROWTH IMPACT ON VALUATION ACCORDING TO GORDON

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

Source: Nordea

We see solid potential that market participants revert to focusing on fundamentals as earnings uncertainty rises

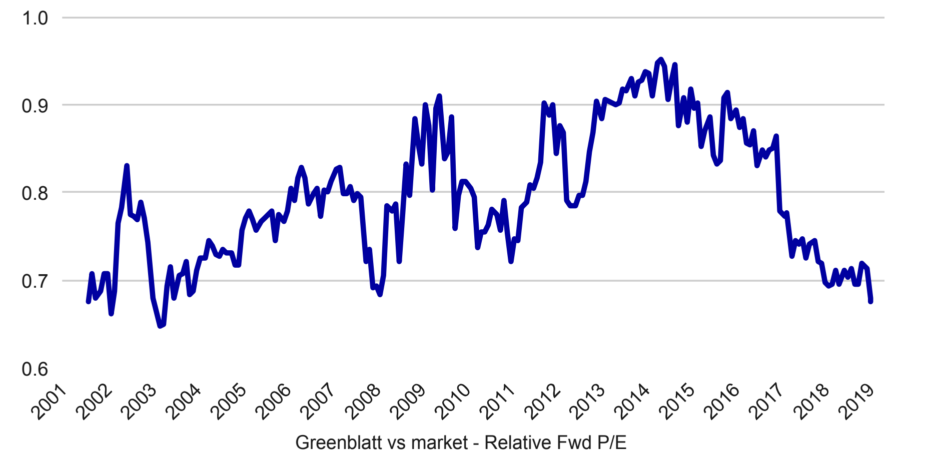
QUALITY AND VALUE TRAITS SHOULD COME BACK IN VOGUE



Source: FactSet and Nordea

Reasonably priced quality stocks have rarely looked this cheap relative to the market in Europe

GREENBLATT-STYLE DISCOUNT CLOSE TO ALL-TIME HIGH

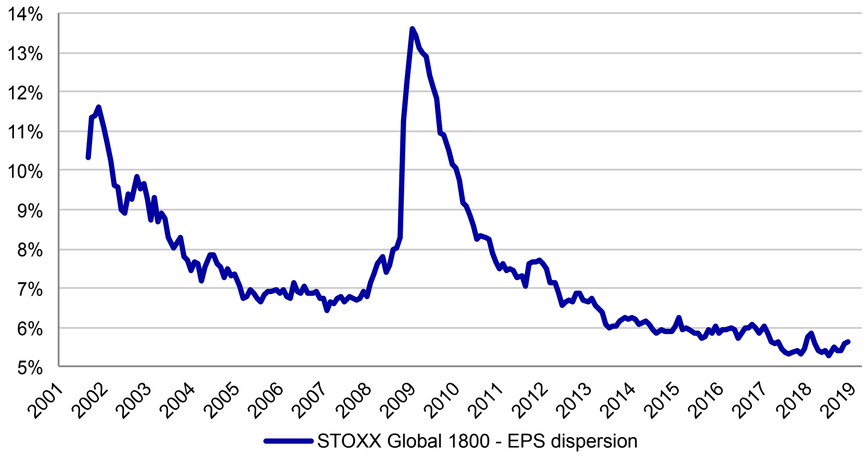


Source: FactSet and Nordea

Recent estimate downgrade pressure remains pretty uniform, but there are small signs that dispersion is rising

We would expect dispersion to pick up further, adding a further question mark on playing the earnings momentum strategies

EPS DISPERSION STILL AT HISTORICAL LOWS BUT HAS STARTED TO RISE



Source: FactSet and Nordea

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

Timing is everything – risk adjust

Today we introduce a tool that could help us in timing the market. As described earlier, major indices lost close to 20% from peak to trough. There are plenty of factors behind the sluggish markets, but in short, we believe overly high expectations were challenged by deteriorating fundamentals. The core fundamental in any asset price is valuation. When valuation is extreme, be it high or low, an unexpected event is more likely to move the price. At the end of the day, the aim for marginal investors is to buy any asset cheap and sell it dear. As easy as this might sound, difficulty arises when deciding at any given time whether to invest in or divest an asset. Here we explain why incorporating market risk into the equation helps.

The risk of not knowing must be discounted

A multivariable function forms the valuation assessment of an asset. Many of these variables are based on forecasts and are hence unknown. These forecasts will vary over time as new information is gathered, as will the price of the asset. Therefore, the quality of any valuation can only be evaluated by knowing the strength of the underlying expectations. An asset class being priced at a long-term average could prove either attractive or the opposite if marginal investors have low or high expectations about the times ahead. The model we show below seeks to incorporate not only valuation but also the market perceived risk. Using this model, we conclude that the market has moved from very poor risk/reward over the past year to a more normal (neutral) risk/reward.

Isolating the earnings cycle reduces unwarranted volatility

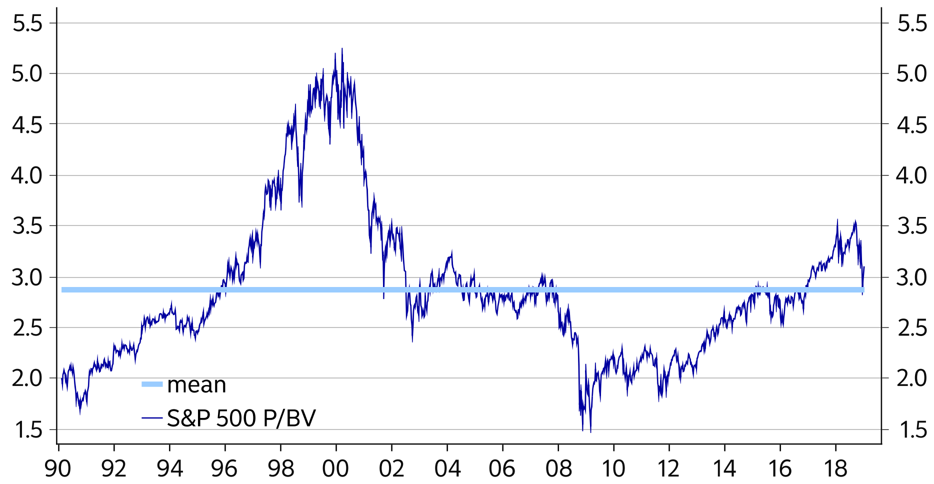
The concept of risk-adjusting the valuation of equities could be used on most metrics, including forward earnings-based metrics. However, we find that nature of the earnings cycle brings unwarranted volatility into the function. It is better then, we argue, to seek earnings-neutral valuation metrics. In this study we focus on P/BV.

We choose to focus on P/BV

Ahead of the market slump in 2018, the US market traded briefly at a P/BV 3.5x. This was a very high level indeed, only exceeded by the dot.com bubble close to 20 years ago. Now, the P/BV ratio has backed down to below 3.2x, after landing just below 3x at year-end. Overall, a clear reversion towards the mean has taken place. One possible conclusion would be that any long-term investors should rebalance their allocations back to normal because, over time, average returns should be expected.

US P/BV has reverted back towards mean

S&P 500 P/BV INCLUDING MEAN SINCE 1990

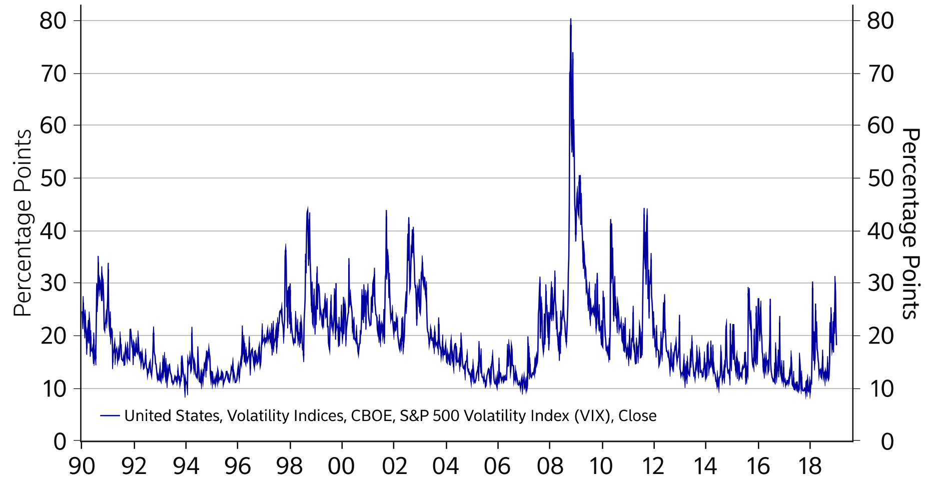


Source: Bloomberg and Nordea

VIX a good gauge on discounted risk

If assumed risk is also in balance with forthcoming events, the conclusion above gains further traction. In gauging the market's discounted risk level, we turn to the Chicago board options exchange SPX volatility index (VIX). The VIX can be used as a benchmark of market participants' general view on how secure they feel about the future. The sentiment has shifted sharply over the past year.

S&P 500 VOLATILITY INDEX (VIX)

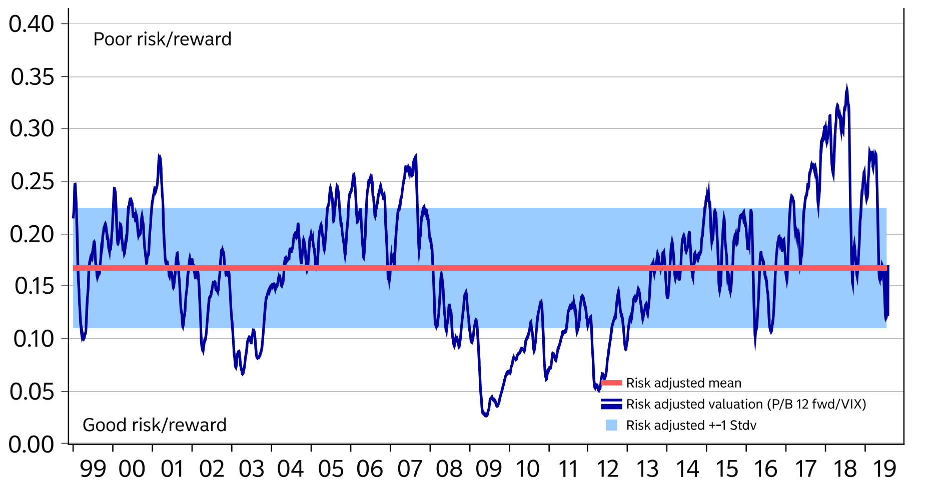


Source: Macrobond and Nordea

Adjusting valuation to market risk sentiment

A combination of any forward-looking valuation metric and a risk gauge would then guide an investor not only on core fundamentals, but also in the context of market confidence. In the chart below, we have deflated the P/BV metric above, using the VIX index as the deflator. This creates a risk-adjusted P/BV valuation metric for the market. Somewhat disregarding the absolute level of the P/BV metric, this provides us with information on the risk/reward composition of the market. We have added a one standard deviation range to the chart, as a guide for when the market seems to be trading in extreme situations regarding risk/reward.

RISK-ADJUSTED P/BV VALUATION, S&P 500

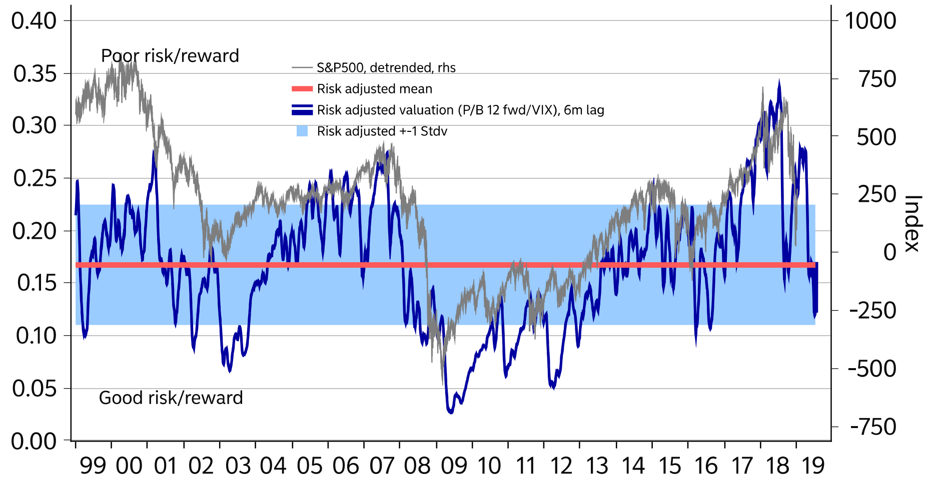


Source: Bloomberg, Macrobond and Nordea

Our risk-adjusted metrics show a good correlation with the market, especially at the turning points

When we add the market price index, we find a strong correlation. As the P/BV and the VIX index are stationary variables, we have detrended the S&P 500 index in the chart. The risk-adjusted P/BV metric is shown with a six-month lead over the stock market index. Hence, not only do our calculations suggest that our metric can signal a risk of change in market direction when the risk/reward balance is far from mean, but it also moves in tandem with more normal conditions. Furthermore, the gauge appears also to be a bit numb in timing from a short-term trading perspective, in the sense that it can suggest clearly poor or good risk/reward for some time without the market reacting. Therefore, this should be viewed from an investment perspective rather than used as a trading tool.

RISK-ADJUSTED P/BV AND S&P 500 INDEX



Source: Bloomberg, Macrobond and Nordea

The risk/reward was very poor ahead of the market drop

From the perspective of a long-term investor, the market's risk/reward has improved after a large part of 2018 signalled poor risk/reward. The risk-adjusted P/BV has fallen to long-term mean levels, currently suggesting a neutral risk/reward.

Our model suggests a market lead of up to 6-months

Adding our model's suggested six-month lead, the market (S&P 500) could certainly see further downside before the investor community starts appreciating a more balanced risk/reward. A probably too-narrow reading of the model implies a 6% drop for market index, to a line with the current level of our risk-adjusted valuation metric.

A tool to gauge the risk/reward for the long-term investor

This said, history also highlights that the one standard deviation range is no backstop. The spike in 1999 was ignored by the market, and in 2001 the "buy" signal proved to be false, as it revisited new lows before the market turned higher again. Also, the dip below -1 standard deviation in 2008 was premature. These points do not disqualify the tool's validity, but rather offer guidance on how to use it. It surely should help offer a starting point on determining when the risk/reward is right for moving large pools from one asset to another, and when to sit tight despite the market moving extensively in a favourable direction, as in 2001-03 and 2009-14.

Calculating risk-adjusted metrics for single stocks the next step

Furthermore, and although the market seems to have reverted to the mean in the concept of risk-adjusted valuation, this is an average of all constituents of the market. Therefore, when applying this method on single stocks one should be able to identify those offering good relative to those offering poor risk/reward. In our Equity Strategy report released today, we present our findings as the stocks in our Nordic universe when screened on risk/reward.

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

Disclaimer

Completion date: 17 January 2019, 21:20 CET

Nordea Bank Abp

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 Bank Abp, filial i Sverige

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 Danmark, Filial af Nordea Bank Abp, Finland

Nordea Markets Division, Research

Visiting address:
Grønjordsvej 10
DK-2300 Copenhagen S
Denmark

Tel: +45 3333 3333
Fax: +45 3333 1520

Nordea Bank Abp, filial i Norge

Nordea Markets Division, Research

Visiting address:
Essendropsgate 7
N-0107 Oslo
Norway

Tel: +47 2248 5000
Fax: +47 2256 8650

Nordea