Nordea View

July 2019: Summer update

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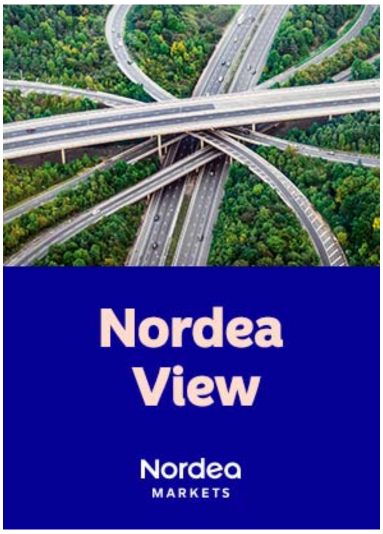
Macro data surprises have remained negative compared to consensus estimates, in line with our longstanding scenario, but equity markets have disregarded this and seem to be driven by a blind trust in central bankers' abilities to turn the trend around before a more severe earnings recession takes hold. Falling bond yields have also renewed the push for higher valuation multiples, hence profit-neutral valuations are back at multi-year highs. Falling interest rates have challenged our value bias and triggered a further valuation divergence between the expensive and cheap ends of the equity market. We still believe there will be a marked earnings recession and view analysts' V-shaped earnings expectations into 2020 as very unlikely. There is a risk, however, that central bankers could manage to create a larger asset bubble before a more severe crash takes place in some distant future, but we see too many dark clouds on the horizon in the short term to dare play that scenario.



Macro strategy: Bubble or trouble?

Our models, particularly for the US, point to much lower growth than consensus expects, as well as rising wage costs, which should trigger a marked earnings recession. How have previous Fed easing cycles played out for equities in such a scenario? In four of five cycles, equities have performed well from one month before the first cut up to one month after. In all easing cycles, the S&P 500 has at some point been higher within twelve months than the day before the first cut. In the medium term, two easing cycles have appeared hand in hand with bull markets and three have accompanied bear markets. The difference seems to depend on the presence of a marked earnings recession or not. It has not been enough that the Fed has eased to get an all-clear for equities. We still expect global manufacturing to improve in 2020, but the number of detrimental trends in the fundamentals still bothers us in risk/reward terms, and represent a warning signal in our view.

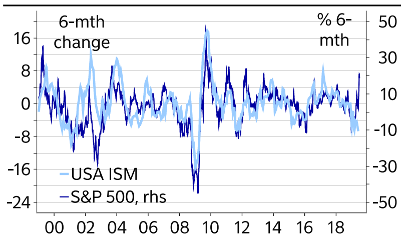
Equities: Valuation and estimate risks remain

We see a clear risk that we will enter an earnings recession and that analysts have not moderated expectations enough on top lines and profitability estimates. Long-term tailwinds for profit margins are gradually disappearing and in some areas turning to headwinds. With valuation levels on profit-neutral multiples once again approaching new highs, we doubt that the market will withstand the estimate cuts that we foresee. Given that we remain confident in our macro outlook and that believe earnings estimates will need to come down for 2019-20, we find support for our defensive positioning. Where we could go wrong could be an underestimation of market participants' willingness to push the expected return even lower (in other words, buoying valuations even higher). We are very reluctant, however, to recommend playing such a scenario.

Equity styles: Double down on value

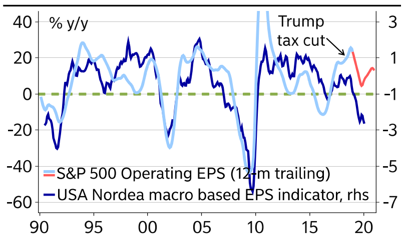
With interest rates falling and central banks turning more dovish, some wonder if we should abandon our value bias and accept that valuations do not matter in a low interest rate environment. We do not accept this view and advise doubling down on the value factor. First, the valuation discrepancy between the cheap and the expensive end of the market is unprecedented. Second, slower global growth in a low cost-of-capital environment should theoretically reduce valuation differences, not increase them. Third, we can demonstrate that 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 its abysmal relative performance of late that a much smaller capital allocation to the style is enough to turn the tide. For those not daring to take the full value plunge, we advise combining value with solid quality and cash-conversion traits.

MACRO & MARKET OUT OF SYNC



Source: Macrobond and Nordea

EARNINGS RECESSION ON THE CARDS



Source: Macrobond and Nordea

Macro strategy: Bubble or trouble?

The hunt for yield has been extreme so far in 2019, pushing profit-neutral equity market valuations back towards multi-year highs. At the same time, macro surprises have remained on the negative side, in line with our longstanding view. We still find that the risks for a marked earnings recession, from slower growth and higher wage costs, are much greater than analysts and the equity markets seem to believe. So far, investors have disregarded the earnings risks and decided that the Fed will save the day. We doubt that conclusion will be right.

The record divergence between macro data and equities has continued

In 2019, the divergence between equity markets and macro data has been the largest seen in modern history. Whether you look at global macro surprise indices that are clearly stuck in negative territory or the falling trend in ISM, it is historically unheard of that the S&P 500 would rise ~20% over a six-month period, as has been the case. The main driver for this divergence is the Federal Reserve's shift in monetary policy signals, where the market now believes in ~100 bp of rate cuts until the end of 2020. The stock markets' performance and analysts' earnings estimates indicate that the expected rate cuts are viewed as precautionary and thus will save the day. Our macro models tell a different story of an earnings recession already on the cards. Will markets look beyond an earnings recession? How have the Fed's previous easing cycles correlated with equity market performance in this respect?

Some evidence suggests that equity markets perform well around the first Fed cut

Profits decide the medium-term equity performance, not the Fed

First, in four of the past five cycles, equities have performed well from one month before to one month after the first rate cut. The recent "risk-on" sentiment, in that sense, is not entirely uncommon and could be further helped by kicking the trade war can down the road again. With time closing in on the next presidential race in the US, we believe there is also a rising probability that Trump will agree to a quite empty trade deal and then simply call it a success. Second, in all easing cycles, the S&P 500 at some point has been higher within one year than it was the day before the first rate cut – so far so good. Third, and important over the medium term, two of the past five easing cycles (1995, 1998) have gone hand in hand with bull markets, whereas three (1989, 2001, 2007) have gone hand in hand with bear markets (maximum drawdown over 15% after the first rate cut). The difference between the outcomes appears to us to be whether there has been a marked earnings recession or not. Historically it has not been enough that the Fed has started to ease to signal an "all clear" for equities.

Central bankers risk creating a large asset bubble

Given the stock market's strength during the first half of 2019, we must admit that we clearly have underestimated investors' willingness to disregard the negative macro environment in favour of an implicitly strong belief in central banks' capabilities, a TINA driven hunt for yield and a possible 2020 improvement in global manufacturing (which we have talked about for a long time). We respect all those arguments and acknowledge that the risk has increased that central bankers will manage to create a larger asset bubble before a severe crash in some distant future.

We stick to our view of a marked earnings recession in the US

At the risk of being viewed as "perma-bears", we continue to be bothered by the sheer number of detrimental trends in fundamental indicators that raise red flags in a risk/reward sense. Our leading US indicator points to much lower GDP growth than consensus expects; taken together with rising wage costs, we believe that this implies a high risk of a marked earnings recession. Accordingly, we find that analysts' V-shaped EPS expectations are more than challenging. Weak global M1, slumping semiconductor sales and South Korean exports are other risk elements. Falling interest rates have once again helped multiples to expand, and profit-neutral multiples are back near record highs. Historically, however, forward P/Es have dropped during earnings recessions. Moreover, long-term tailwinds for profit margins are gradually disappearing; in some areas (eg demographics), they are turning into headwinds.

In the first Nordea View (May 2018), we noted that we wanted to see stabilisation in leading indicators, lower margin estimates and reduced equity overweight from investors in order to change our defensive equity view. Today, we would say only the latter has changed. On leading indicators, the picture is mixed to negative, and margin expectations have just begun to moderate. We stick to a medium-term defensive view.

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

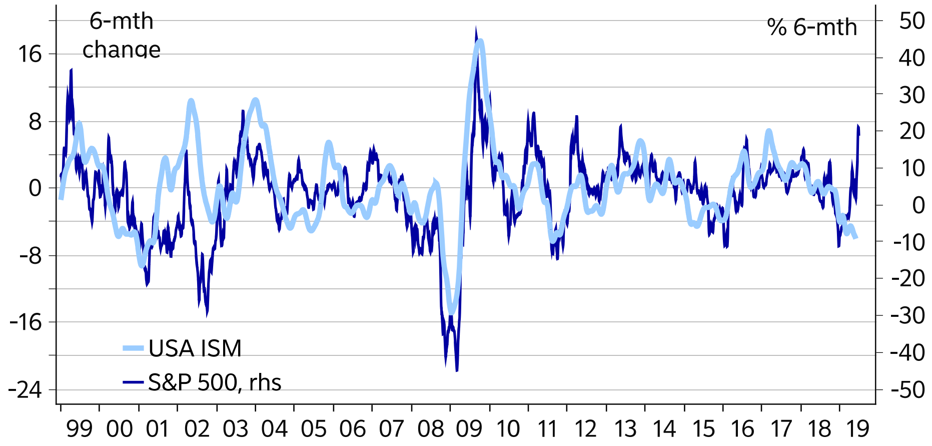
S&P 500 AND FED RATE CUTS: EARNINGS HAVE BEEN DECISIVE FOR THE MEDIUM-TERM EQUITY OUTCOME

Development until 1st Fed rate cut								12-m Fed	Development from 1st Fed rate cut						Max 12-m high	Max drawdown
-1y	-9m	-6m	-3m	-1m	-1w	1st Fed cut	P/Book	discount	+1w	+1m	+3m	+6m	+9m	+1y	vs day prior cut	vs day prior cut
27.5%	18.9%	8.4%	2.3%	3.1%	0.9%	14/12/1989		-115	-1.8%	-4.0%	-4.0%	3.4%	-9.7%	-6.9%	5.1%	-15.8%
22.1%	20.3%	18.8%	8.1%	2.2%	0.6%	06/07/1995	2.70	+10	2.5%	2.1%	6.4%	12.7%	19.8%	20.1%	24.0%	0%
10.0%	10.0%	-4.3%	-7.9%	2.1%	2.4%	29/09/1998	4.07	+11	-5.7%	1.8%	16.9%	24.9%	27.0%	22.3%	35.3%	-8.5%
-11.8%	-14.8%	-12.7%	-10.0%	-3.1%	-3.4%	03/01/2001	3.91	-133	2.3%	5.5%	-13.8%	-3.8%	-16.4%	-9.2%	7.0%	-39.5%
12.3%	4.3%	5.9%	-3.1%	2.6%	2.2%	17/09/2007	2.86	-105	2.8%	3.8%	-2.6%	-14.0%	-9.0%	-36.6%	5.5%	-54.4%
						31/07/2019?	3.43	-100								

Source: Macrobond and Nordea

The great divide between macro data and the equity market has continued

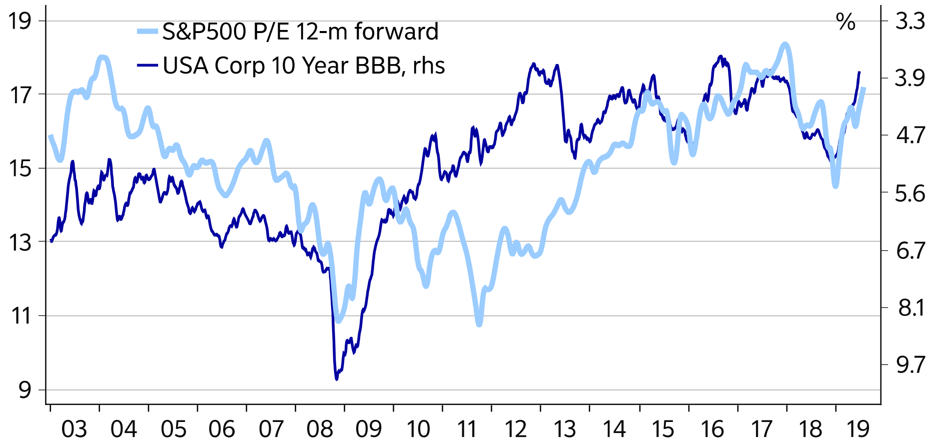
ISM AND S&P 500



Source: Macrobond and Nordea

Falling bond yields have triggered a renewed push higher for P/Es

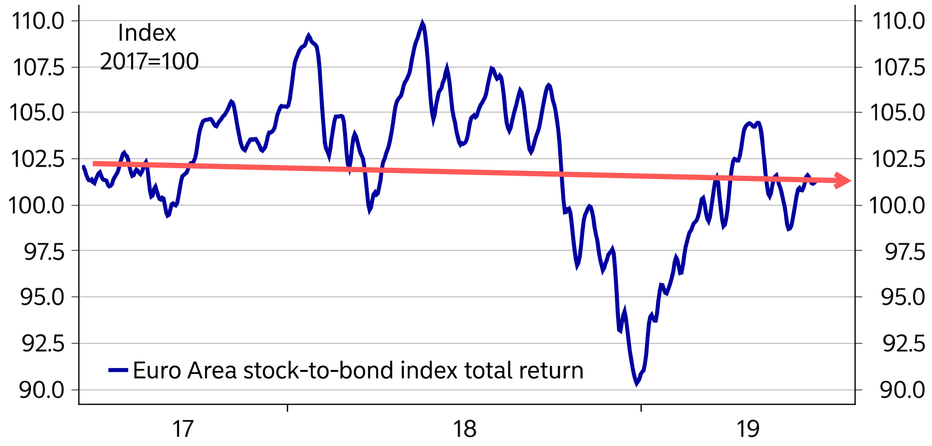
CORPORATE BOND YIELD AND P/E



Source: Macrobond and Nordea

In Europe, investors have not been paid for taking on the extra risk in equities versus government bonds since mid-2017

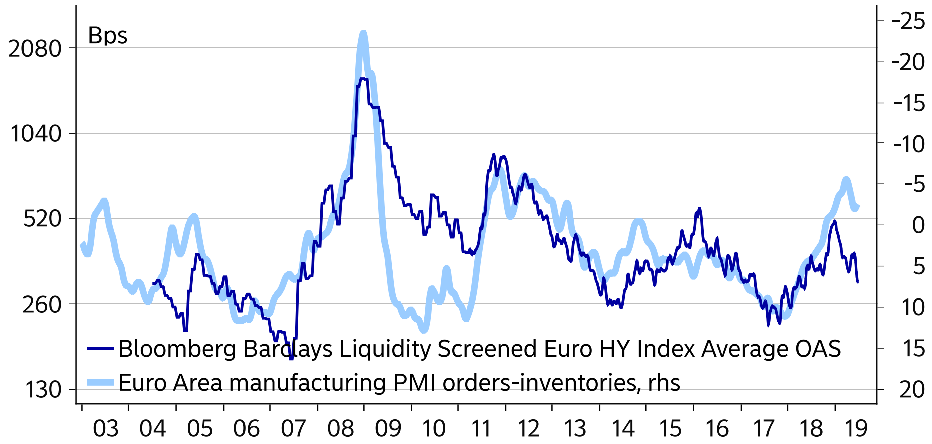
EURO AREA EQUITIES VERSUS GOVERNMENT BOND PERFORMANCE



Source: Macrobond and Nordea

Despite a marked cyclical slowdown, bond investors have chased credits, owing to slumping government bond yields

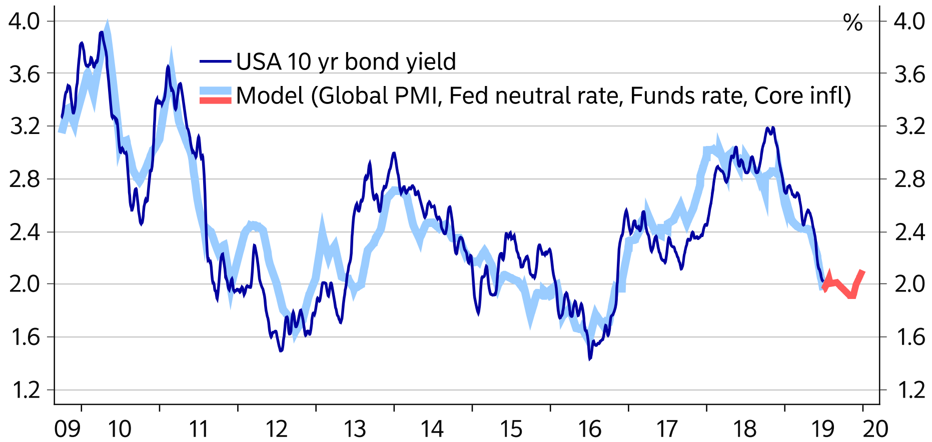
CREDIT SPREAD AND BUSINESS CYCLE



Source: Macrobond and Nordea

US government bond yields could drop somewhat more given our macro and Fed scenarios

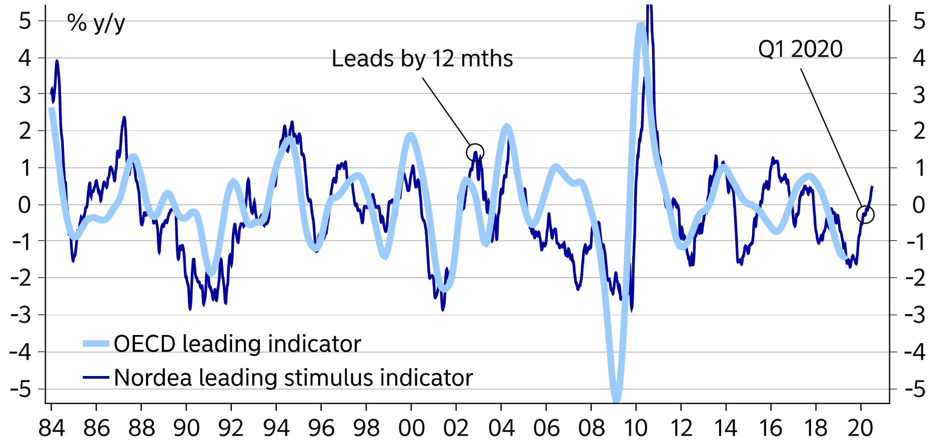
US 10-YEAR GOVERNMENT BOND MODEL



Source: Macrobond and Nordea

We stick to our longstanding view of a 2020 improvement in the global manufacturing cycle

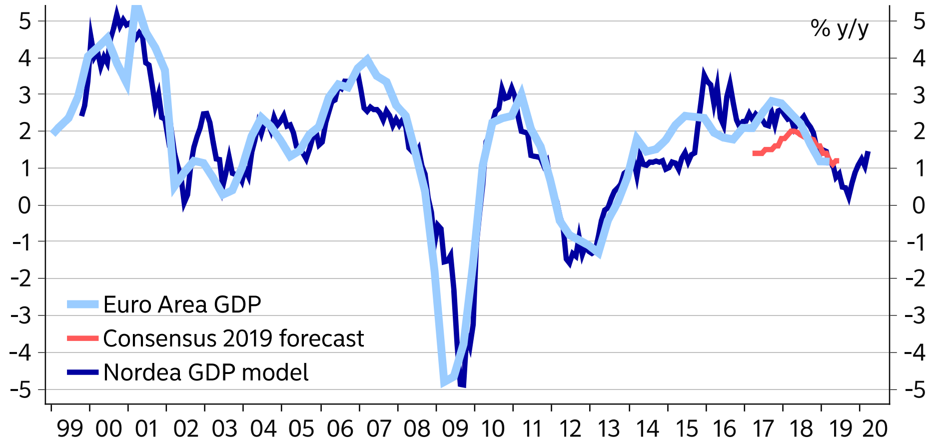
STIMULUS AND OECD LEADING INDICATOR



Source: Macrobond and Nordea

Our proprietary leading indicator for Euro Area GDP shows short-term weakness, but a slightly better 2020

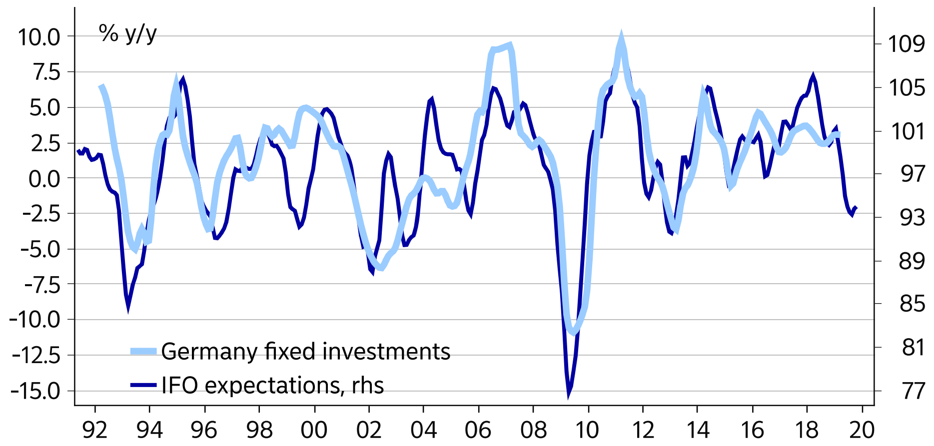
NORDEA'S LEADING EURO AREA GDP INDICATOR



Source: Macrobond and Nordea

The IFO suggests that investments will be weak in the coming quarters

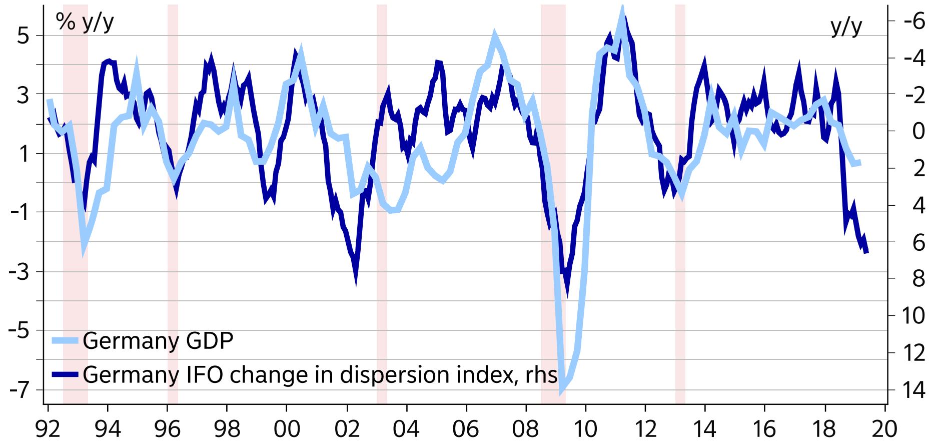
IFO AND INVESTMENTS



Source: Macrobond and Nordea

IFO DISPERSION INDEX AND RECESSIONS

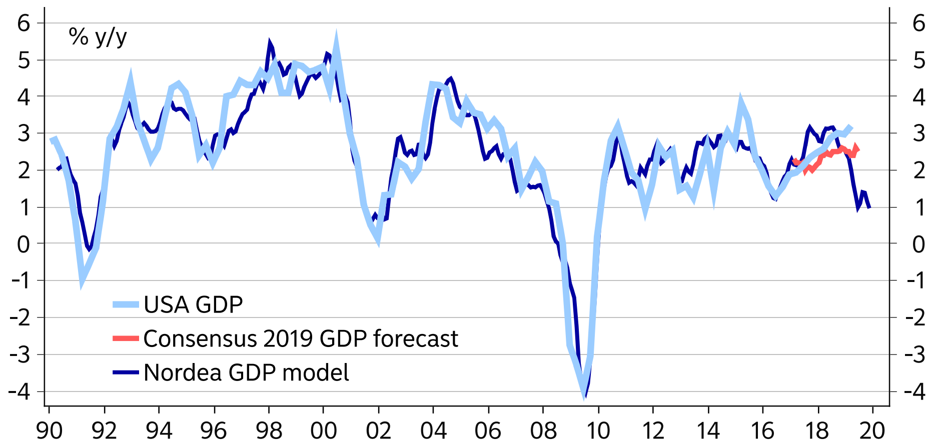
The increase in dispersion of answers in the IFO survey has historically not been seen outside of German recessions



Source: Macrobond and Nordea

NORDEA'S LEADING GDP MODEL FOR THE US

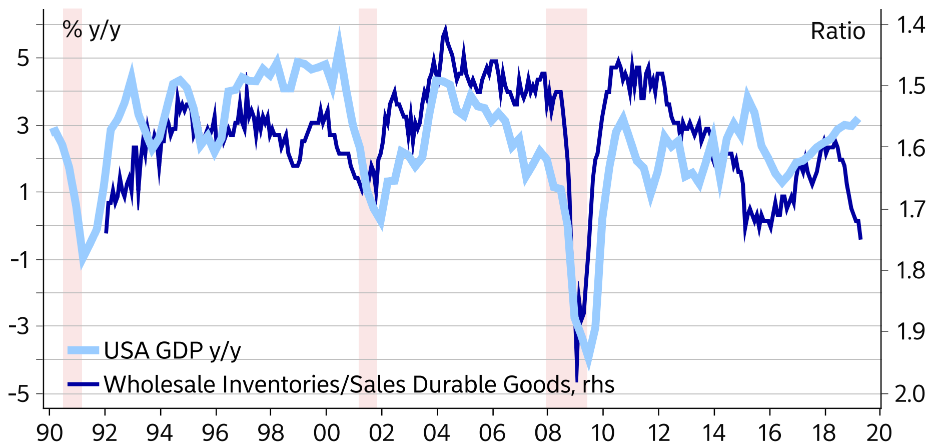
Our GDP model points to 1% growth, which indicates that negative macro surprises should move to the US



Source: Macrobond and Nordea

US: INVENTORY-TO-SALES AND GDP

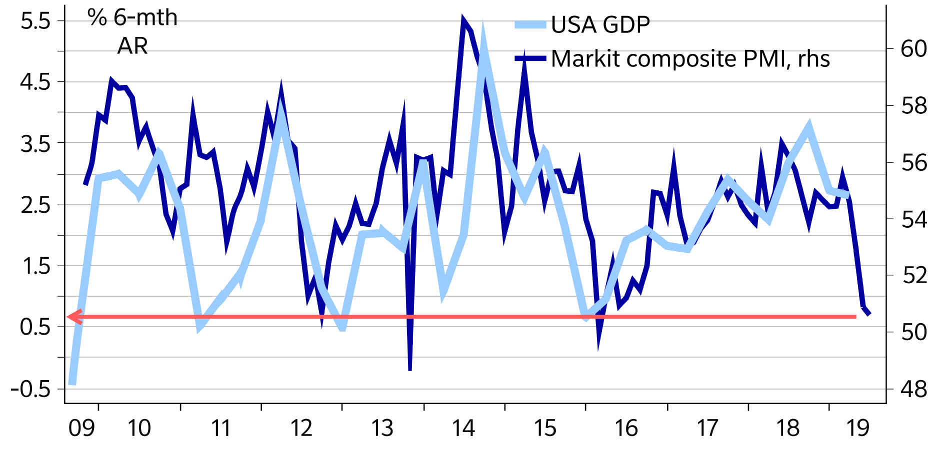
We continue to see rising inventory levels as a potential problem for both growth and earnings



Source: Macrobond and Nordea

Some business surveys already point to a severe slowdown in the USA

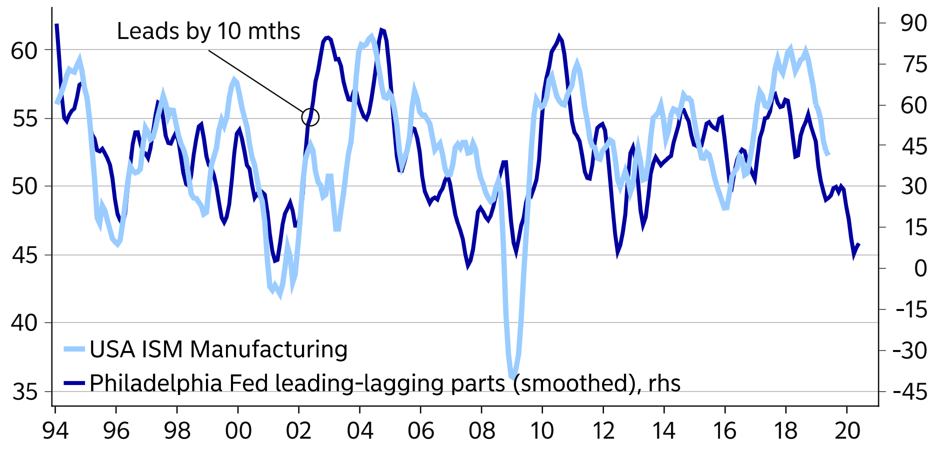
US: GDP AND MARKIT PMI



Source: Macrobond and Nordea

Our models warn that ISM should be heading for sub-50 levels over the coming six to nine months

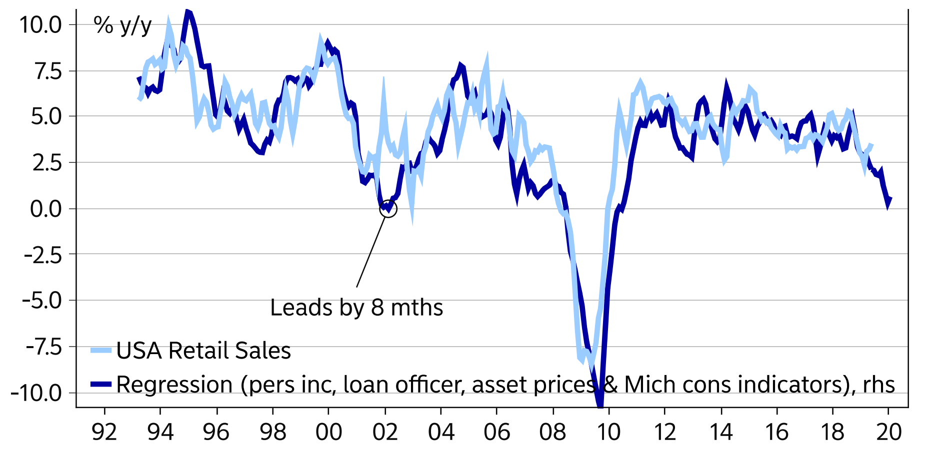
ISM AND LEADING/LAGGING PARTS OF PHILADELPHIA FED SURVEY



Source: Macrobond and Nordea

Indicators of the domestic US economy, such as housing and retail sales, are markedly weaker than during the 2015-16 slowdown

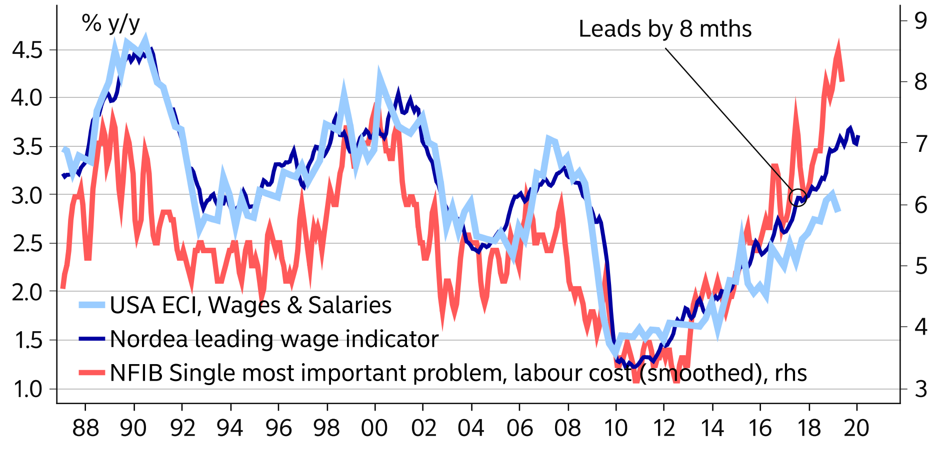
NORDEA'S US RETAIL SALES MODEL



Source: Macrobond and Nordea

Wage cost increases should rise further in the US, and companies are already complaining about it

US WAGE COSTS

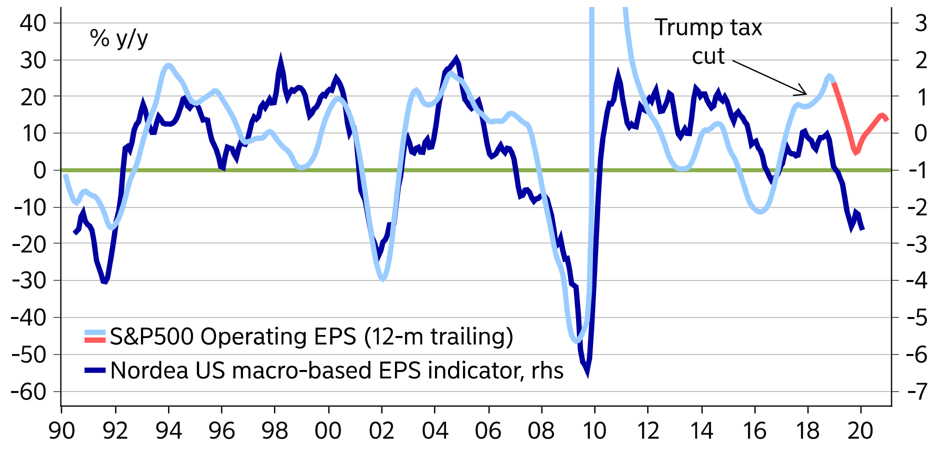


Source: Macrobond and Nordea

Rising wage costs and weaker growth should trigger a marked earnings recession, according to our model

It looks much more like the Fed easing cycles in 1989/2001/2007 than in 1995/1998

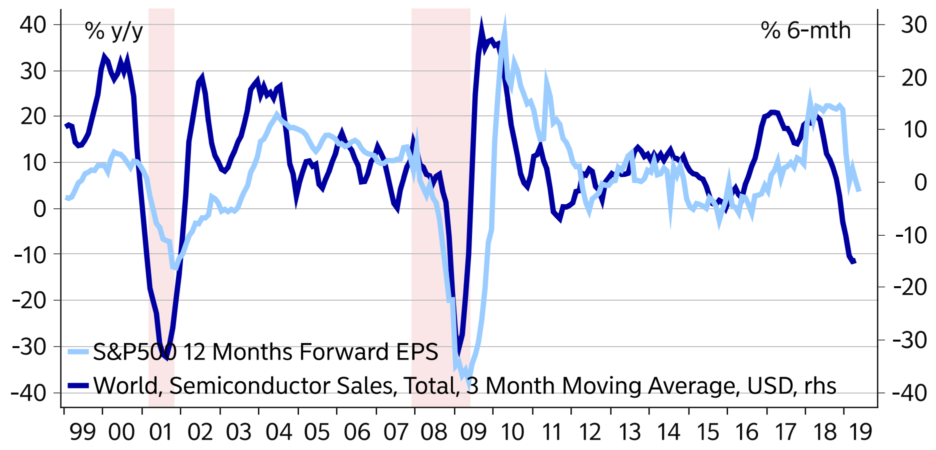
US MACRO-BASED EARNINGS INDICATOR



Source: Macrobond and Nordea

Semiconductor sales are falling in a way that in modern times has correlated with earnings recessions

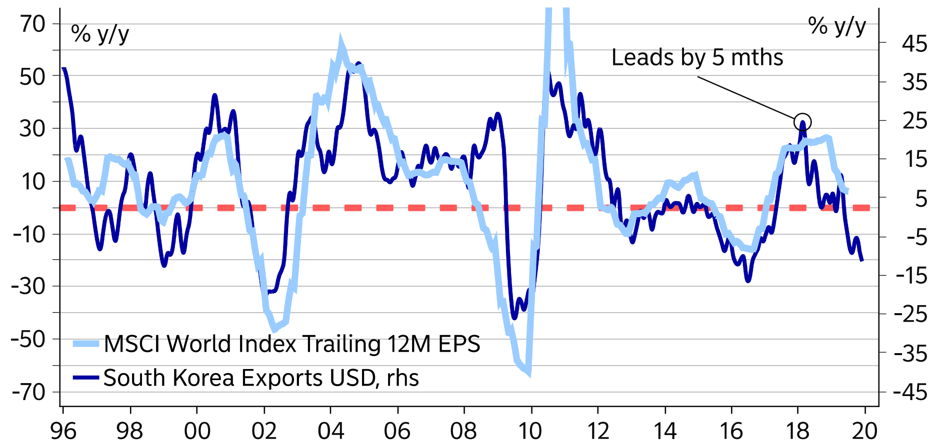
SEMICONDUCTOR SALES AND FORWARD EPS



Source: Macrobond and Nordea

Falling South Korean exports have historically meant a global earnings recession

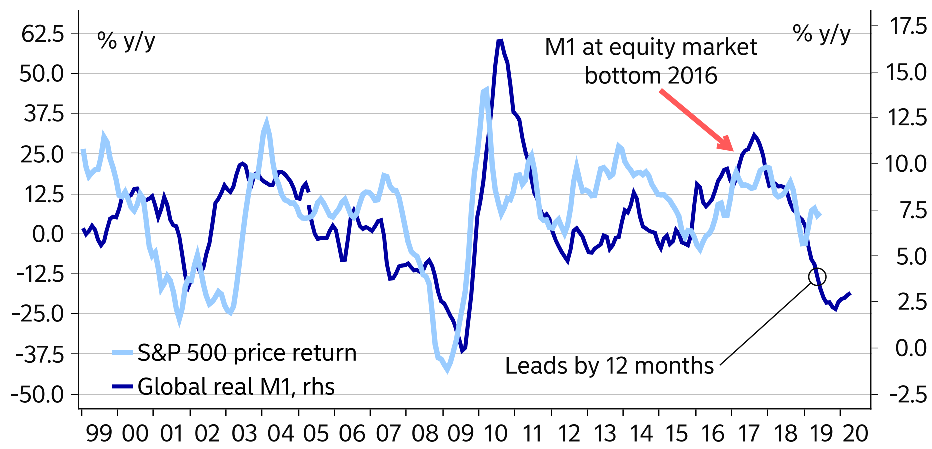
SOUTH KOREAN EXPORTS AND GLOBAL EARNINGS



Source: Macrobond and Nordea

Global monetary policy is massively less accommodative than it was at the equity market bottom in 2016

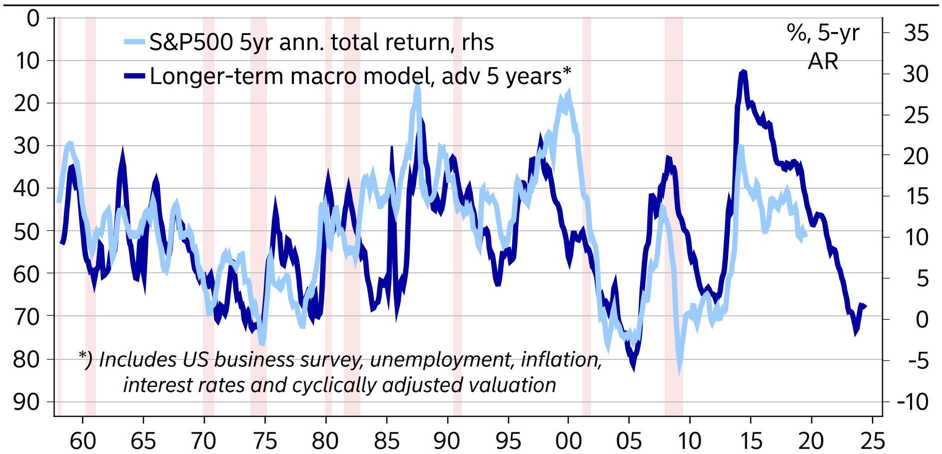
GLOBAL MONEY SUPPLY AND S&P 500



Source: Macrobond and Nordea

Our longer-term macro model warns about quite bleak equity market returns over the coming five years

LONGER-TERM EQUITY MODEL



Source: Macrobond and Nordea

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

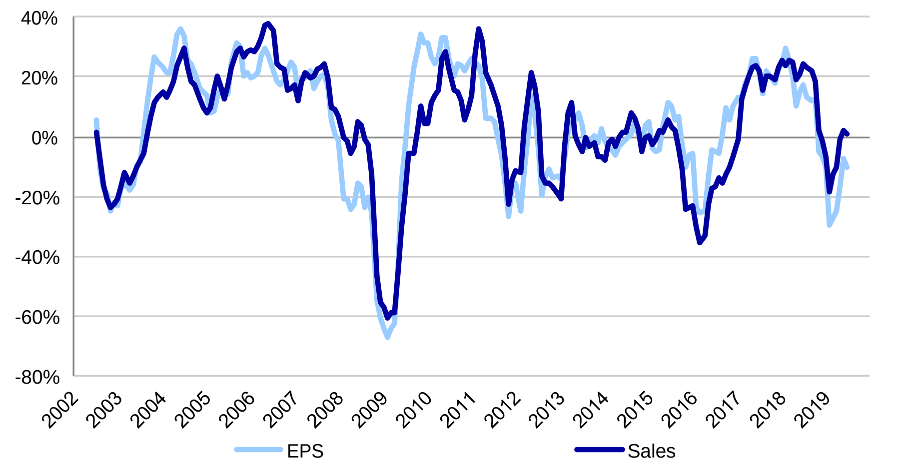
Equities: Valuation and estimate risk remain

We still see a clear risk that we will enter an earnings recession and that the analyst collective has not moderated expectations enough when it comes to the top line and profitability. Moreover, we believe that long-term tailwinds for profit margins are likely going to diminish gradually, and possibly even become headwinds in the case of demographics, labour costs and depreciation (see Nordea View May 2019). This could leave earnings growth materially lower in the coming years than during the past 20-year period. With valuation levels on profit-neutral multiples once again approaching multi-year highs, we doubt that the market will withstand the estimate cuts that we foresee. Given that we remain confident in our macro outlook and our expectation that earnings estimates will need to drop for 2019-20, we find support for our defensive positioning. It is possible that we have underestimated market participants' willingness to push the expected return even lower (in other words, buoying valuations even higher), but we are very reluctant to recommend playing such a scenario.

Our sales and EPS indicators have shifted back towards the neutral mark...

...but we think that it is a false signal, as our macro indicators suggest more downside

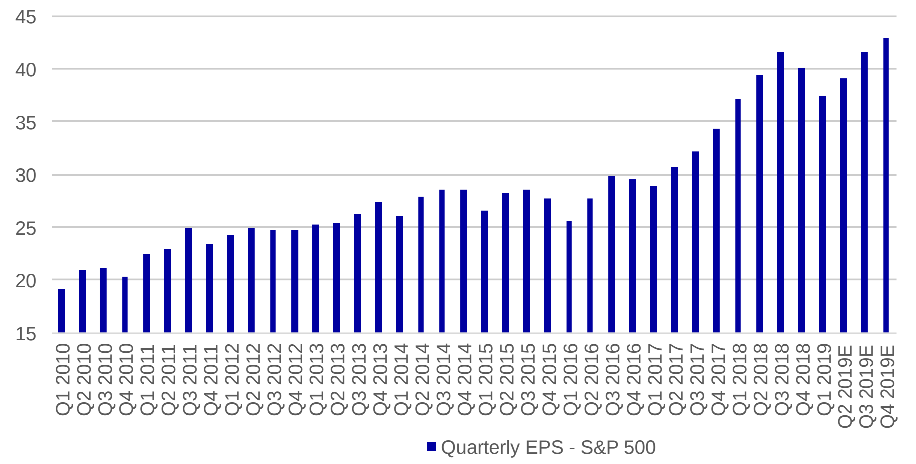
EPS AND SALES REVISION INDICATORS – STOXX GLOBAL 1800



Source: FactSet and Nordea

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

S&P 500 QUARTERLY EPS TREND

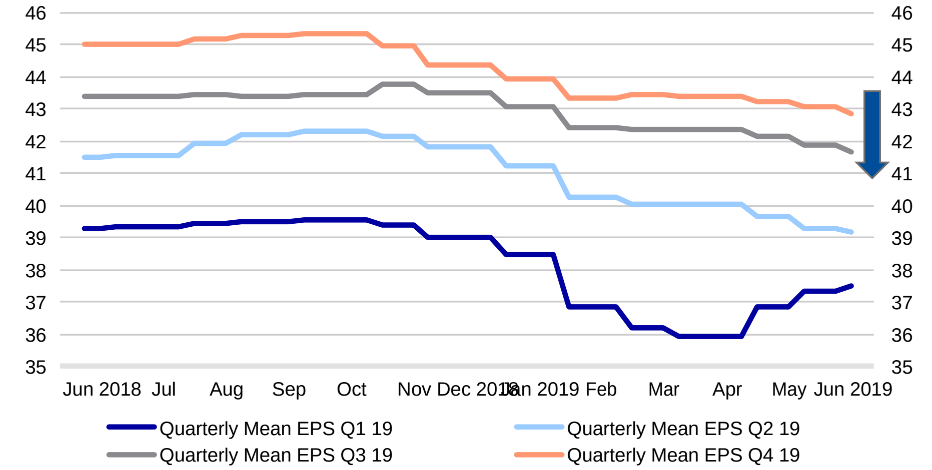


Source: FactSet and Nordea

We cannot square the sequential acceleration in Q3-Q4 versus Q1-Q2, especially as our macro indicators remain bleak

Hence, we believe that estimates need to drop further

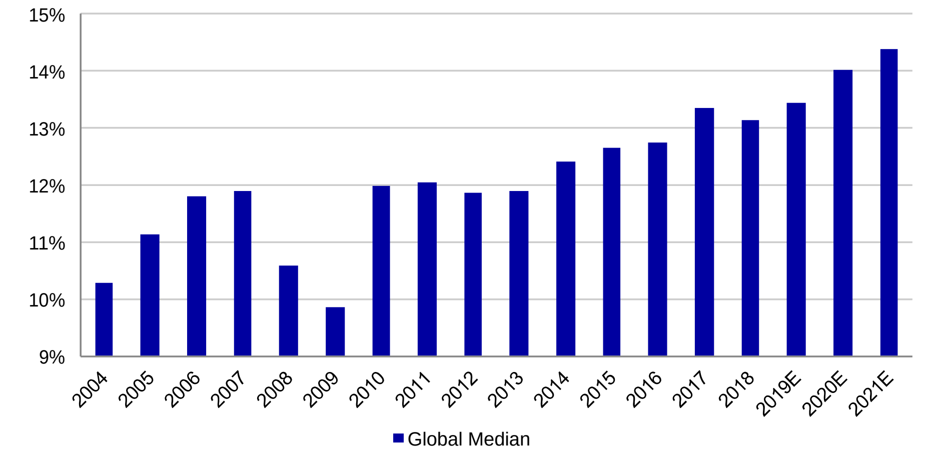
S&P 500: 2019 QUARTERLY REVISIONS TREND



Source: FactSet and Nordea

We struggle to see how profitability can improve this much in the coming years, having already reached a multi-year high in 2017

MEDIAN EBIT MARGIN FOR STOXX GLOBAL 1800

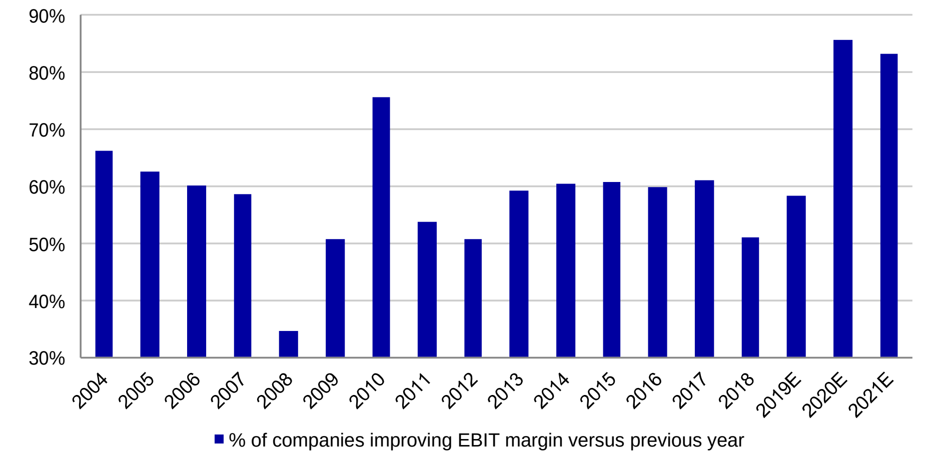


Source: FactSet and Nordea

The consensus among analysts is that 85% of global companies are set to improve margins in 2020...

...we do not believe this happen, even in a more optimistic scenario

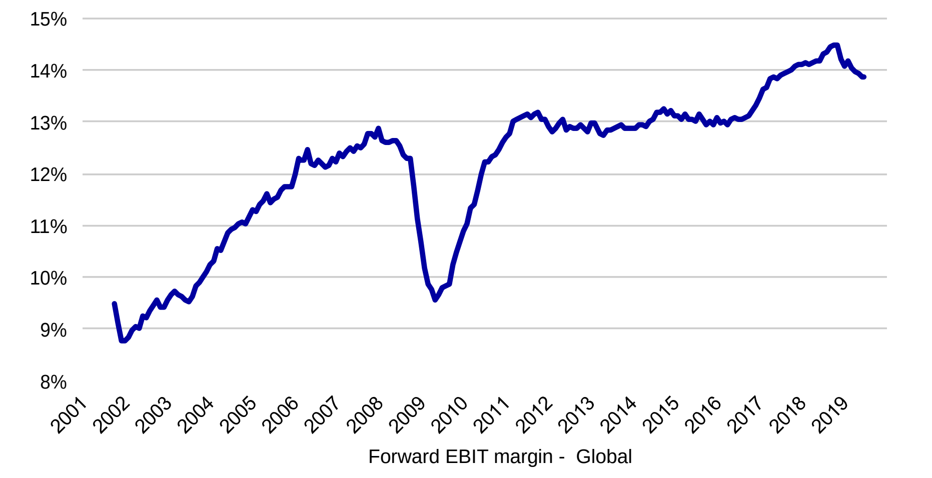
SHARE OF STOXX 1800 COMPANIES EXPECTED TO IMPROVE EBIT MARGINS



Source: FactSet and Nordea

Global EBIT margin forecasts heading south; we expect this trend to continue for a while longer

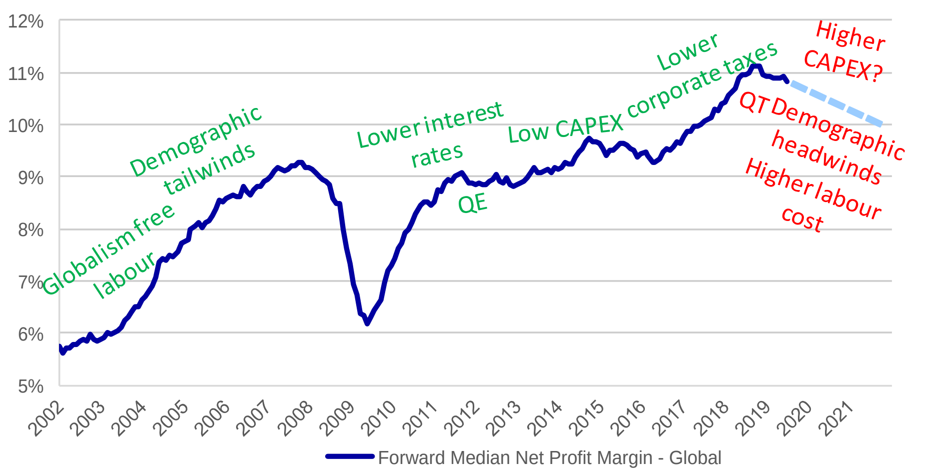
MEDIAN EBIT MARGIN FORECAST (+12-MONTH) – STOXX GLOBAL



Source: FactSet and Nordea

Tailwinds for profit margins cannot get much better, and we believe some of these tailwinds are turning into headwinds (eg demographics, labour costs and potentially rising depreciation)

MEDIAN FORECASTED (+12-MONTH) NET MARGIN – STOXX GLOBAL 1800

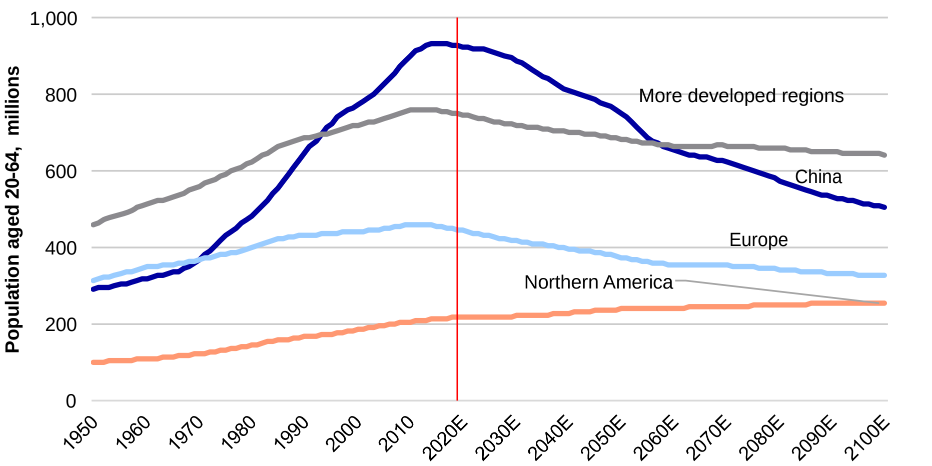


Source: FactSet and Nordea

Trade war concerns, a tight labour market and a shrinking work force in developed regions are all behind the current margin pressure

Just like the falling interest rates, this suggests sluggish growth if productivity does not save the day

WORKING AGE POPULATION SINCE 1950 BY REGION – WE HAVE PASSED THE PEAK

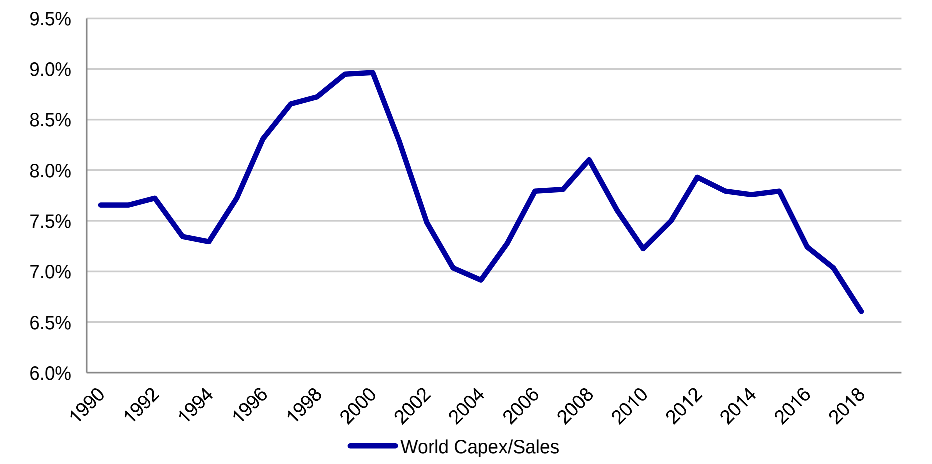


Source: United Nations

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

In our view, this also suggests sluggish growth prospects

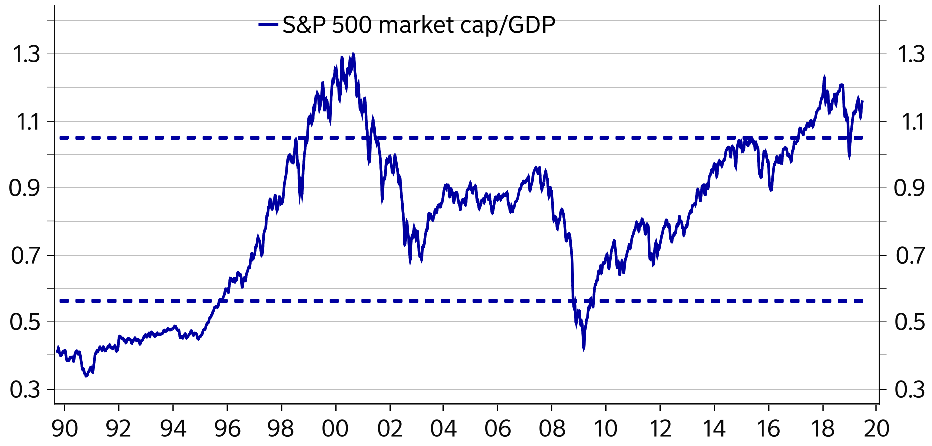
CAPEX-TO-SALES – STOXX GLOBAL 1800



Source: FactSet and Nordea

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

MARKET CAP / GDP FOR S&P 500



Source: Macrobond and Nordea

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

THE SHILLER CYCLICALLY ADJUSTED P/E

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

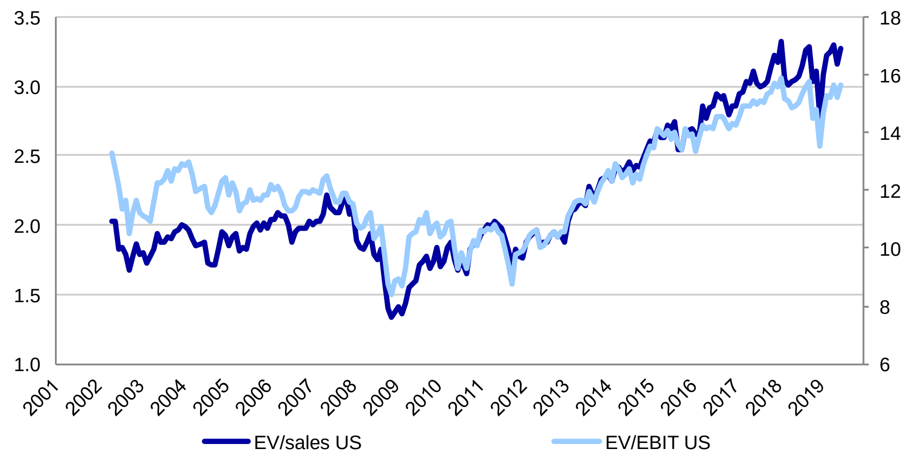
...whereas a forward-looking P/E gauge would suggest lower above-average pricing, which is not as worrisome when considering today's lower interest rates, barring a margin mean reversion scenario

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

Source: FactSet

EV-based metrics are, on the other hand, more supportive to our macro gauge, suggesting very poor risk/reward and a distinct sensitivity to reacceleration of estimate downgrades

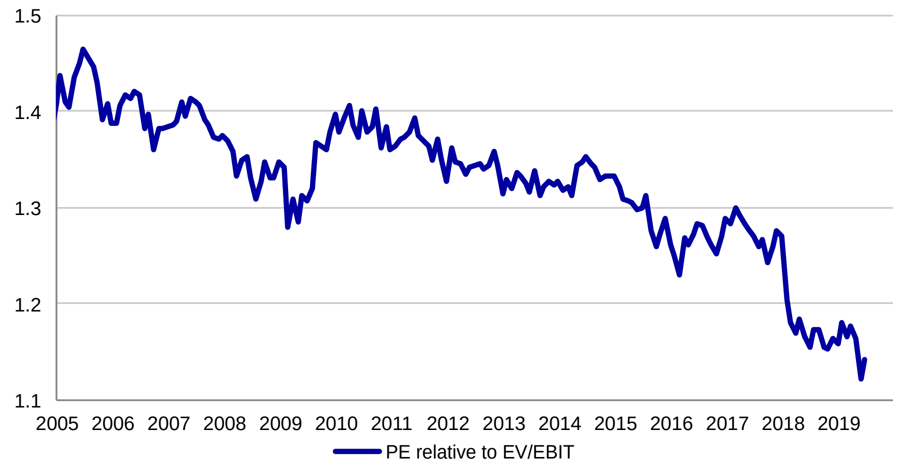
MEDIAN EV-BASED VALUATION FOR US LARGE CAPS



Source: FactSet and Nordea

Rising gearing, lower funding costs and lower corporate tax rates driving the difference south

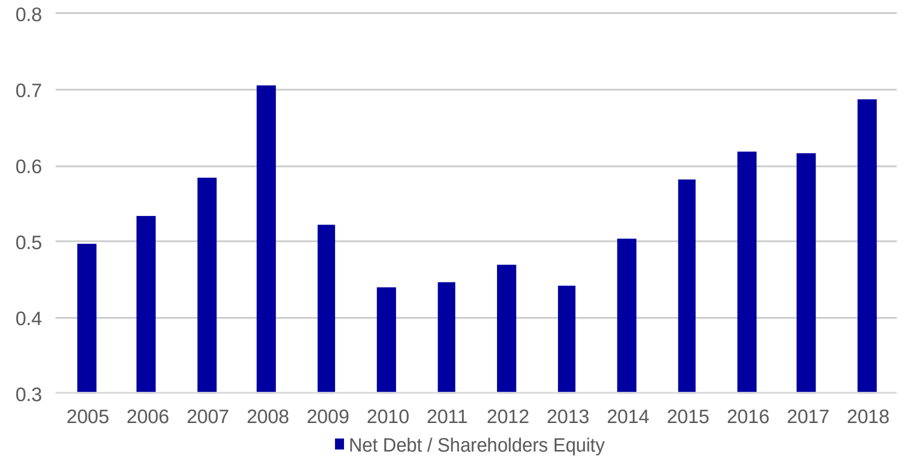
VALUATION DIFFERENTIAL BETWEEN P/E AND EV/EBIT



Source: FactSet and Nordea

Gearing has risen a whopping 55% since 2013, now closely matching 2008 peak levels, suggesting that relying solely on P/Es could prove dangerous

NET DEBT-TO-EQUITY FOR S&P 500 EXCLUDING FINANCIALS

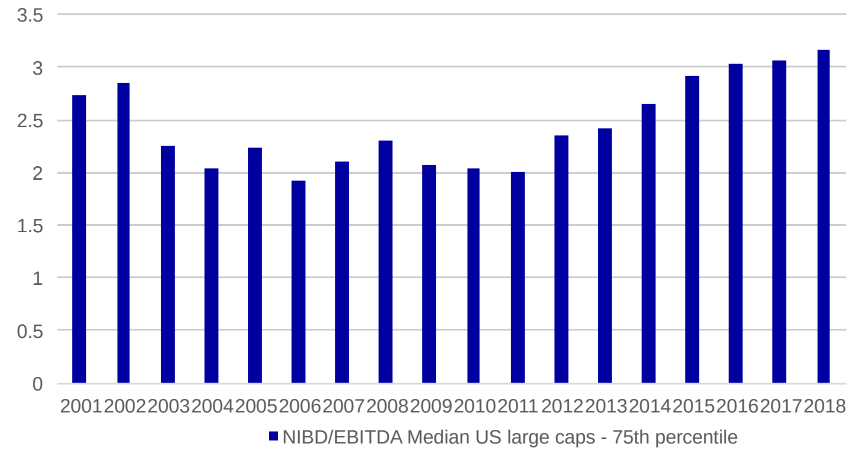


Source: FactSet and Nordea

The highly leveraged US companies are quite highly leveraged from a historical standpoint…

….if EBITDA were to start to contract, several companies could be forced to stop buybacks

INDEBTEDNESS IS UNUSUALLY HIGH FOR THE HIGHLY GEARED (75TH PERCENTILE)



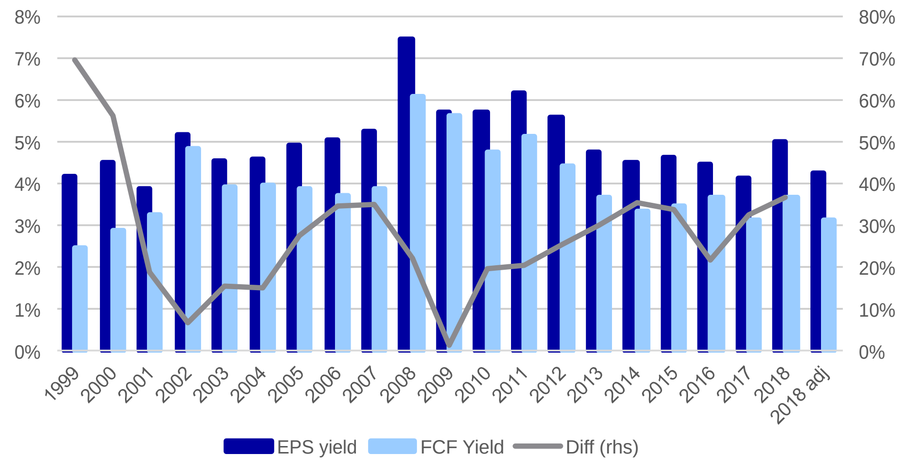
Source: FactSet

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

The last datapoint (2018 adj) incorporates the share gains year-to-date

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

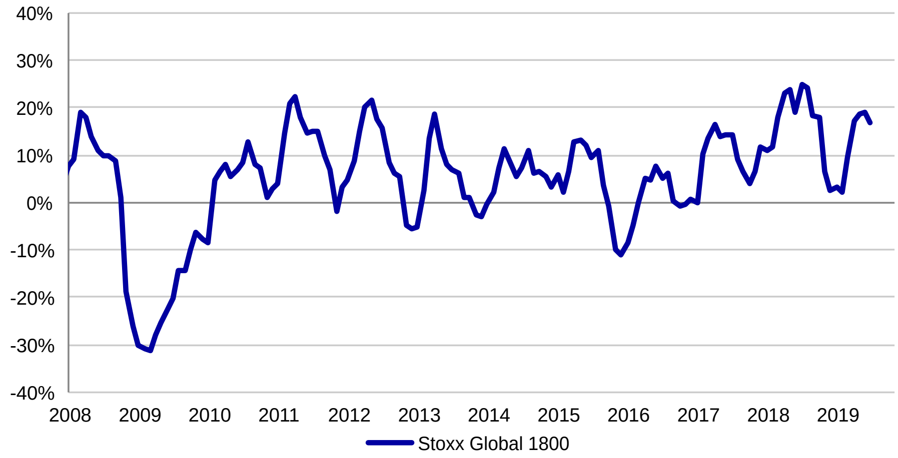
EARNINGS YIELD VERSUS CASH FLOW YIELD (REPORTED MEDIAN)



Source: FactSet and Nordea

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

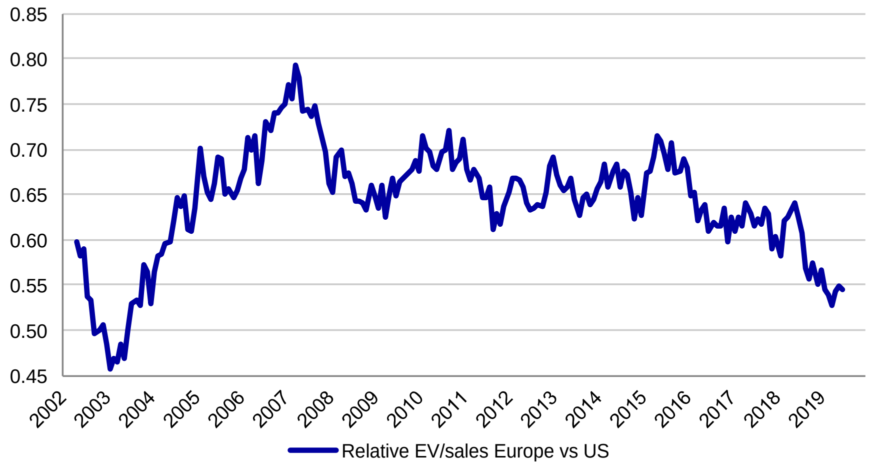
CAPEX REVISIONS INDICATOR – STOXX GLOBAL 1800



Source: FactSet and Nordea

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

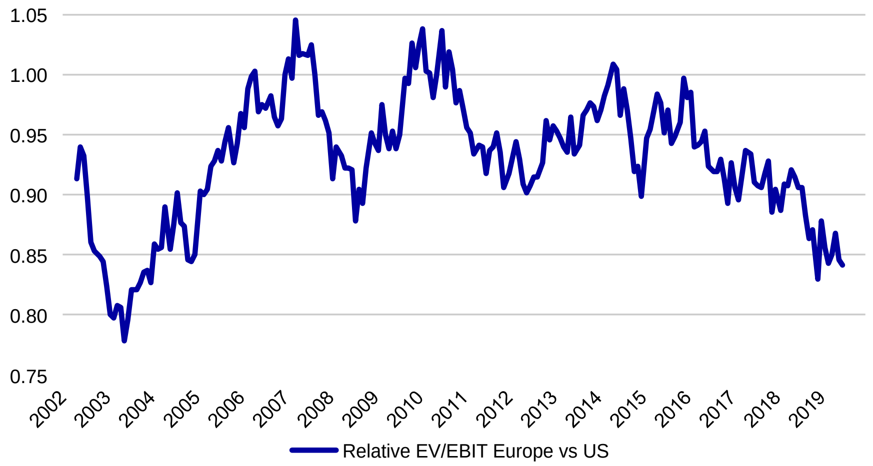
RELATIVE EV/SALES STILL SUGGESTS UNDERWEIGHTING THE US IN FAVOUR OF EUROPE



Source: FactSet and Nordea

Relative EV/EBIT is also approaching historical levels, where it has proved advantageous to switch some capital from US to European equities

RELATIVE EV/EBIT SUGGESTS THAT EUROPE COULD RECOVER SOME OF ITS LOST GROUND



Source: FactSet and Nordea

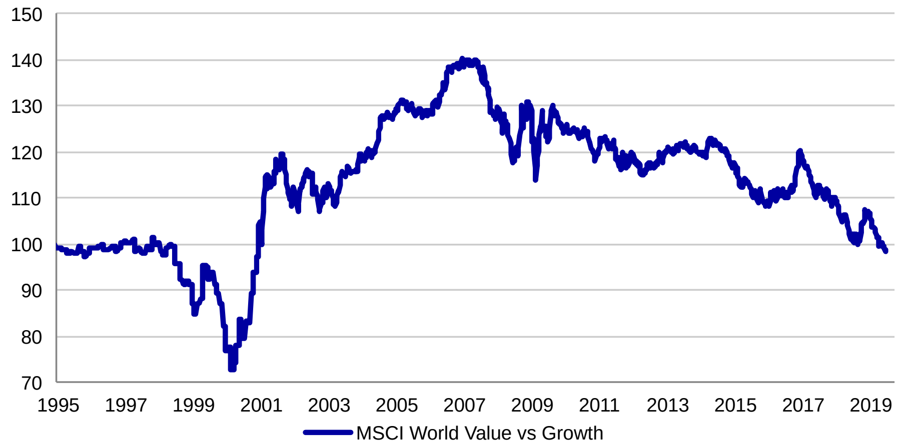
This section has been produced by the Nordea Markets' Independent Research unit.

Equity styles: Double down on value

With interest rates falling and central banks turning even more dovish, the question is whether we should abandon our value bias and accept that valuations simply do not matter in a low interest rate environment. We think not, but instead advise doubling down on the value factor, based on four arguments. First, the valuation discrepancy between the cheap and the expensive ends of the market is at unprecedented levels. Second, slower global growth in a low cost-of-capital environment should theoretically reduce valuation differences, not increase them further. Third, we can demonstrate that 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 not daring to take the full value plunge, we advise combining value with solid quality and cash-conversion traits.

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

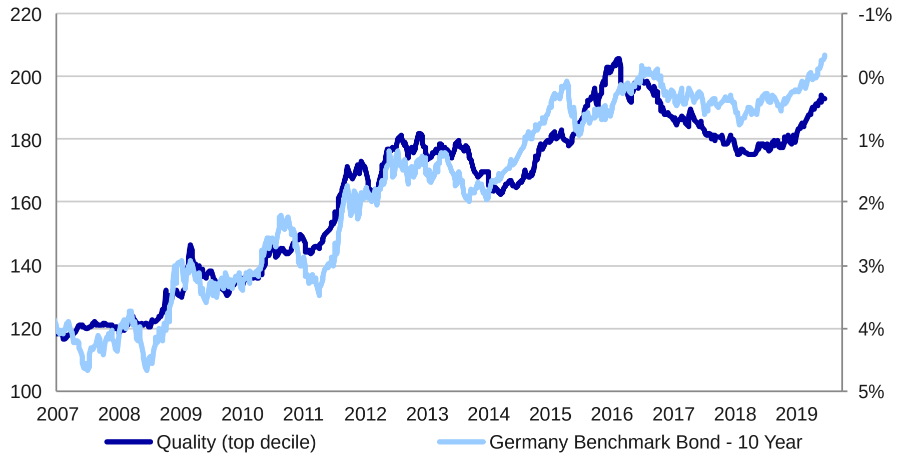
MSCI GLOBAL: VALUE RELATIVE TO GROWTH



Source: FactSet and Nordea

Falling interest rates and high quality outperformance continue to go hand in hand

RELATIVE PERFORMANCE OF HIGH QUALITY AND BOND YIELDS (EUROPEAN MID CAPS)



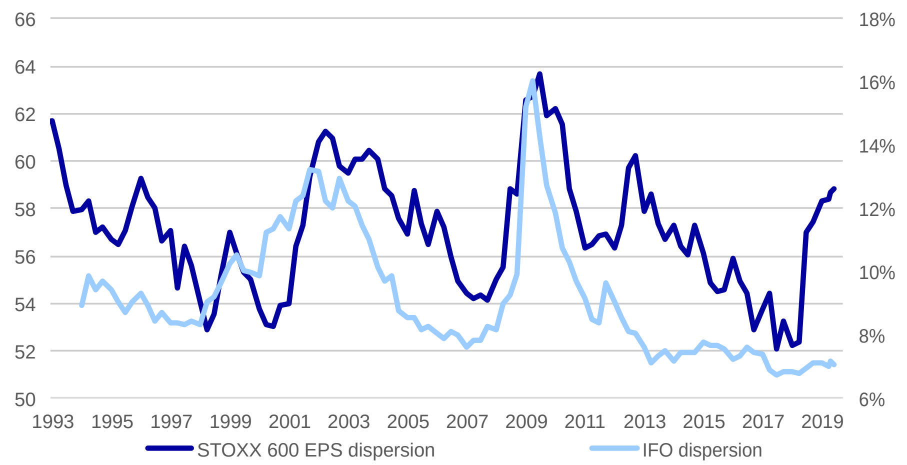
Source: FactSet and Nordea

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

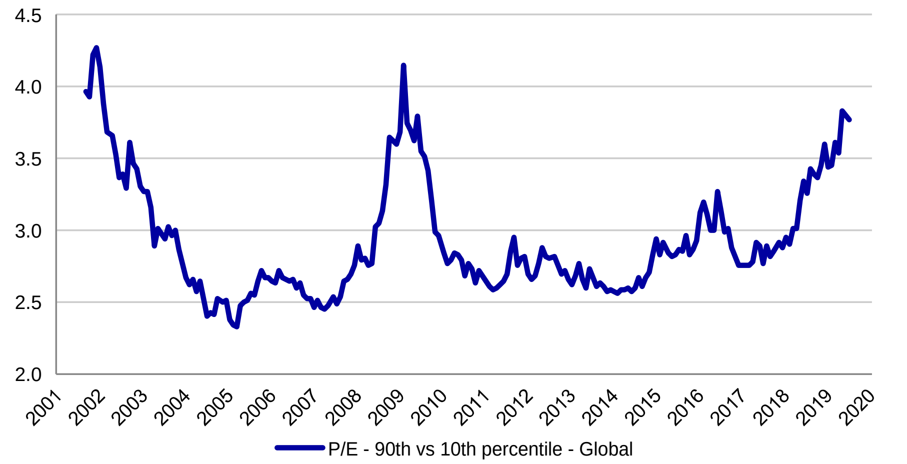
IFO SURVEY DISPERSION VS CONSENSUS EPS DISPERSION



Source: FactSet and Nordea

The gulf between the expensive and cheap ends of the global equity market is approaching previous market extremes (IT bubble bursting and financial crises)

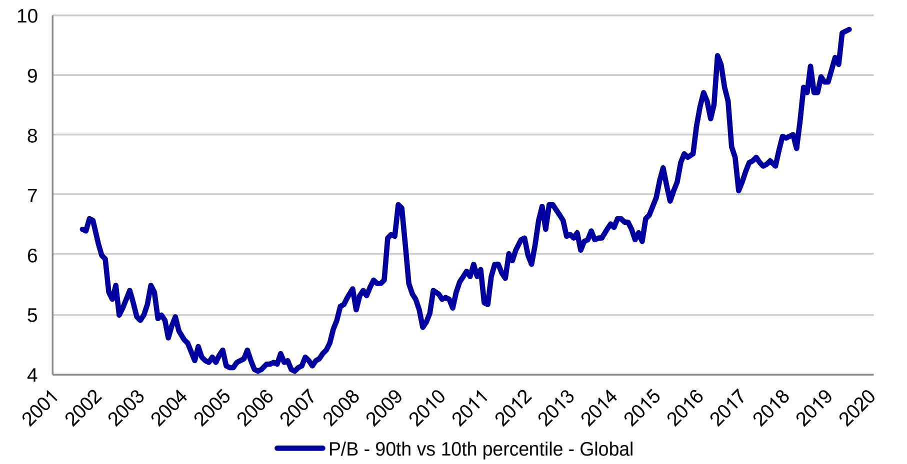
MEDIAN RELATIVE P/E FOR THE 90TH VS 10TH PERCENTILE IN STOXX GLOBAL 1800



Source: FactSet and Nordea

The relative P/BV multiple is in uncharted territory

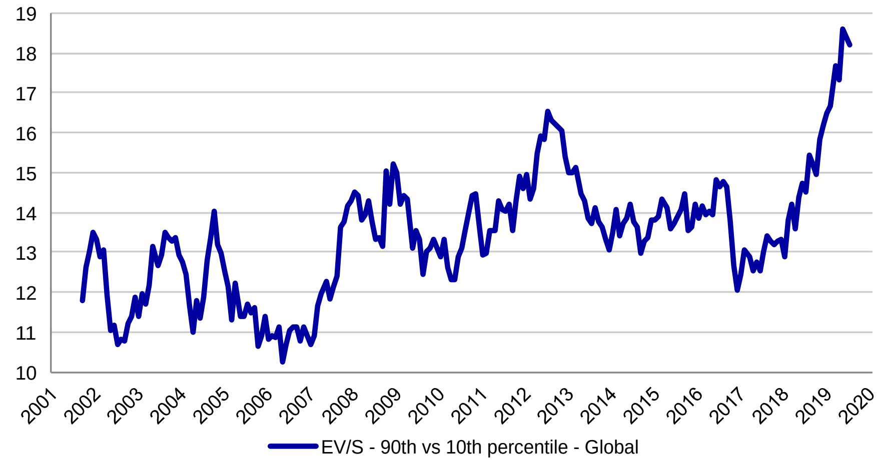
MEDIAN RELATIVE P/B FOR THE 90TH VS 10TH PERCENTILE IN STOXX GLOBAL 1800



Source: FactSet and Nordea

The relative EV/S ratio has gone hyperbolic; surely valuations will matter at some stage

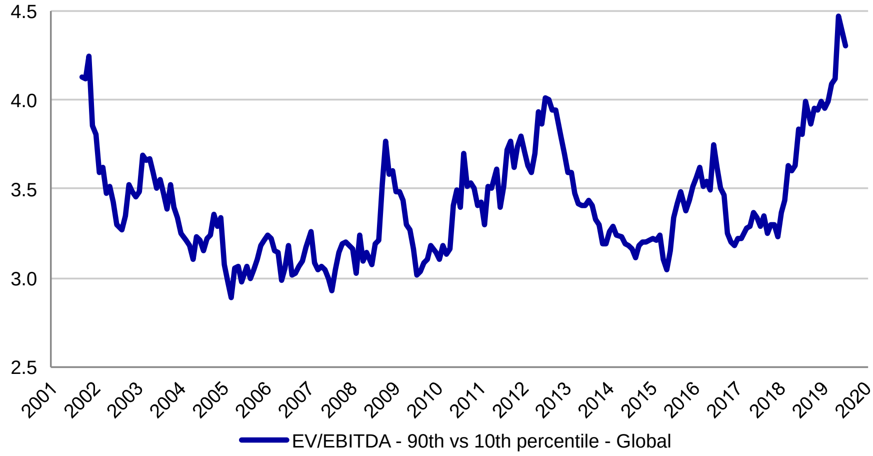
MEDIAN RELATIVE EV/S FOR THE 90TH VS 10TH PERCENTILE IN STOXX GLOBAL 1800



Source: FactSet and Nordea

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

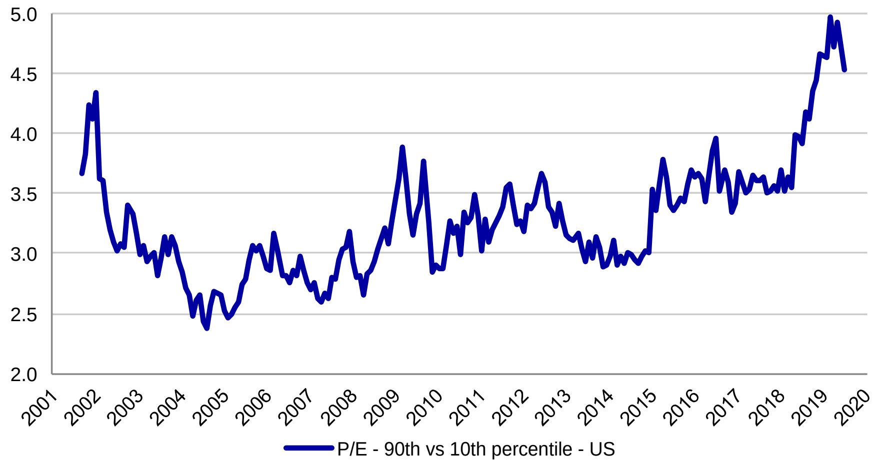
MEDIAN RELATIVE EV/EBITDA FOR THE 90TH VS 10TH PERCENTILE IN STOXX GLOBAL 1800



Source: FactSet and Nordea

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

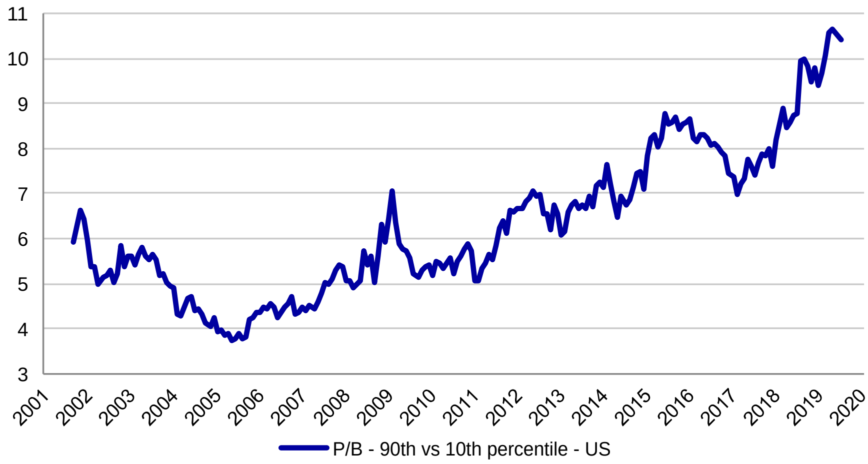
MEDIAN RELATIVE P/E FOR THE 90TH VS 10TH PERCENTILE - STOXX NORTH AMERICA 600



Source: FactSet and Nordea

Is there no stopping the relative P/BV ratio or will investors realise that it is time to be contrarian and that valuations will eventually win?

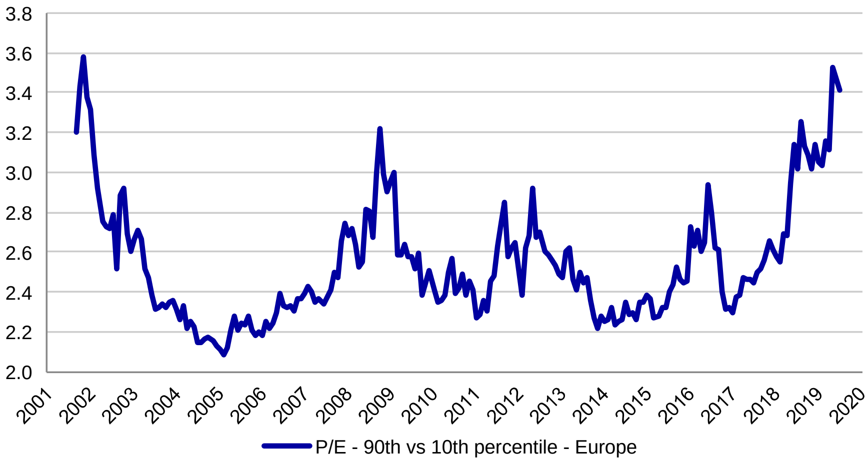
MEDIAN RELATIVE P/B FOR THE 90TH VS 10TH PERCENTILE - STOXX NORTH AMERICA 600



Source: FactSet and Nordea

Europe is not far behind the US with the relative P/E ratio matching 2001 levels

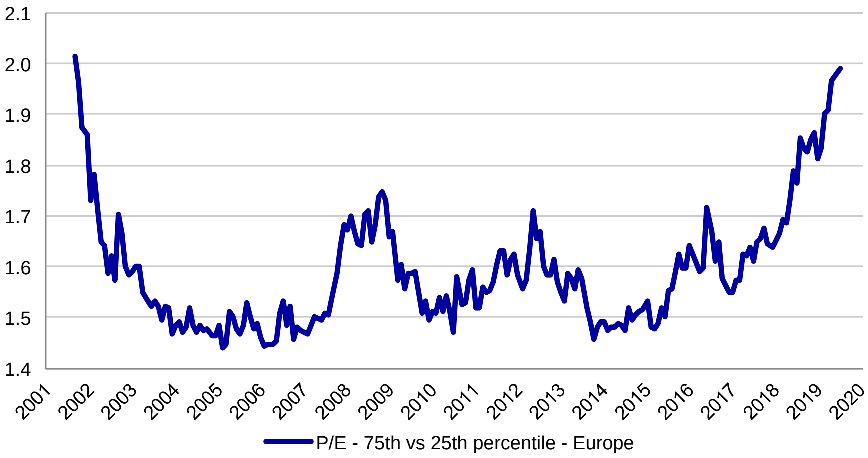
MEDIAN RELATIVE P/E FOR THE 90TH VS 10TH PERCENTILE - STOXX EUROPE 600



Source: Company data and Nordea estimates

Even if we narrow in, utilising the 75th versus the 25th percentile, we can illustrate this extreme valuation differential

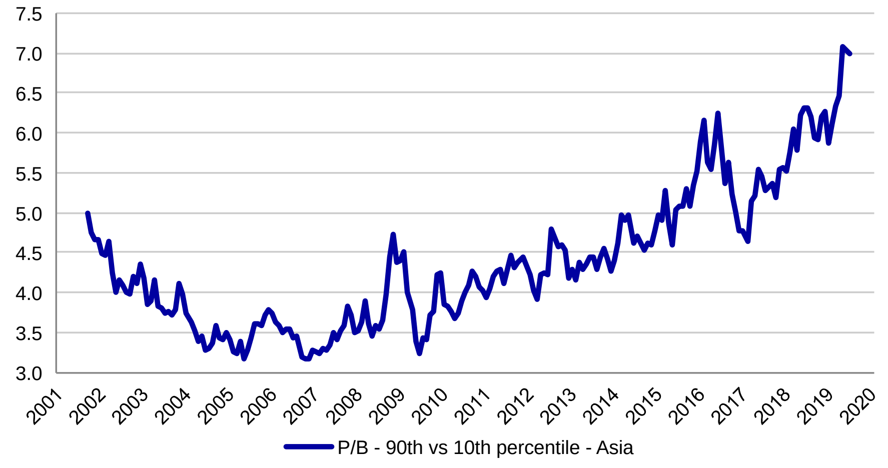
MEDIAN RELATIVE P/E FOR THE 75TH VS 25TH PERCENTILE - STOXX EUROPE 600



Source: FactSet and Nordea

Asia's relative P/BV is no different; it is also in uncharted territory

MEDIAN RELATIVE P/BV FOR THE 90TH VS 10TH PERCENTILE - STOXX ASIA 600

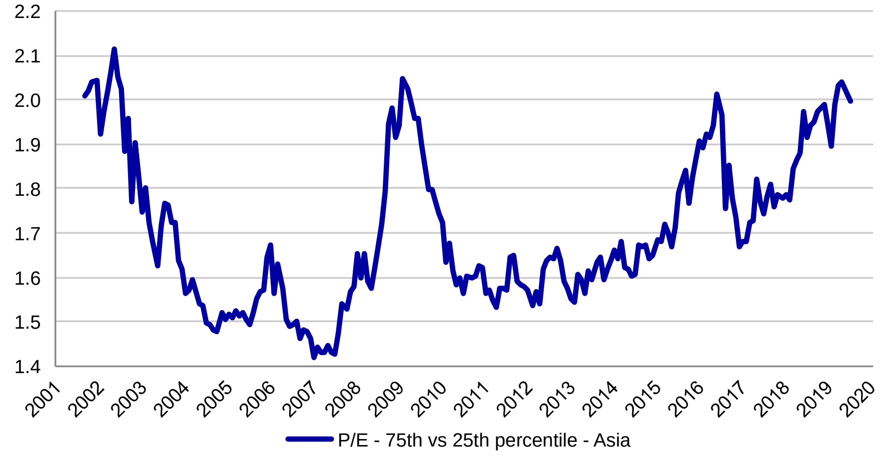


Source: FactSet and Nordea

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

This chart suggests that the value factor has good odds of making a comeback

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

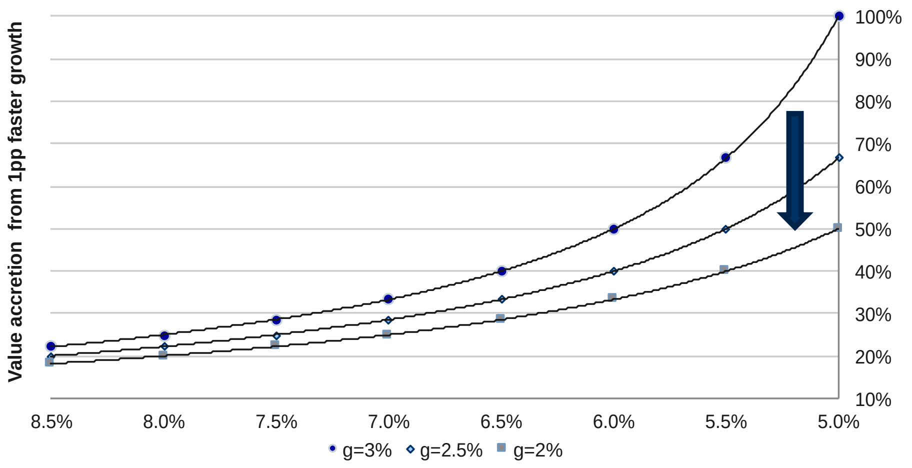


Source: FactSet and Nordea

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

This is one of the core reasons we remain so adamant that valuation should grow in importance

WARRANTED PREMIUM FOR EXCESS GROWTH AT VARIOUS COE AND GROWTH RATES

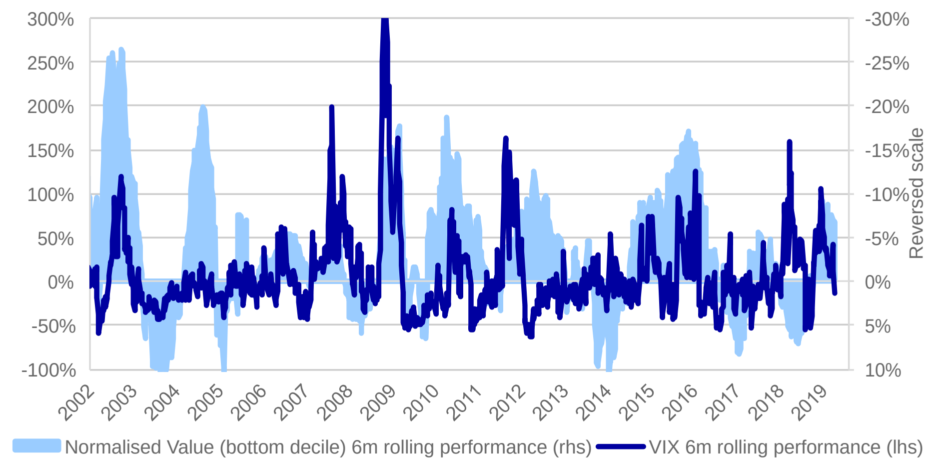


Source: FactSet and Nordea

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

Given our bearish view, this could be a trigger for the style rotation we expect

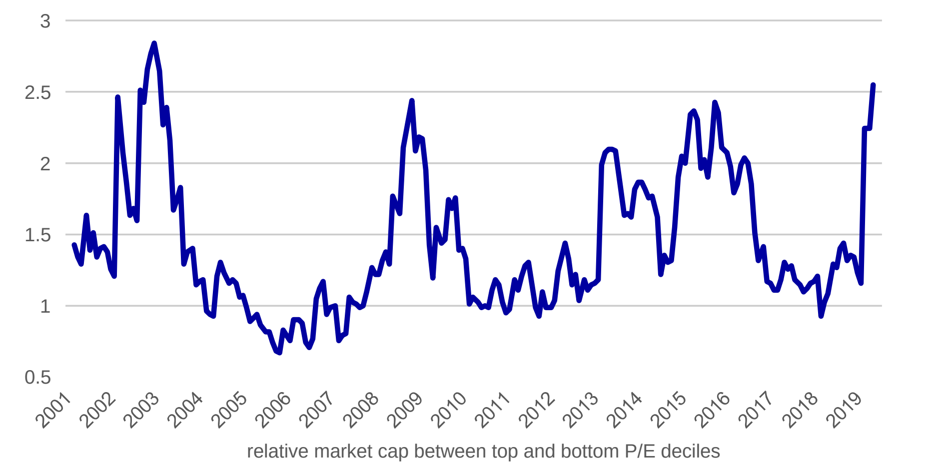
SIX-MONTH ROLLING PERFORMANCE OF VIX AND OUR EXPENSIVE BASKET



Source: FactSet and Nordea

Utilising our back-testing portfolios, we can demonstrate that the relative market cap between the expensive and cheap ends of the European mid/small caps is extreme

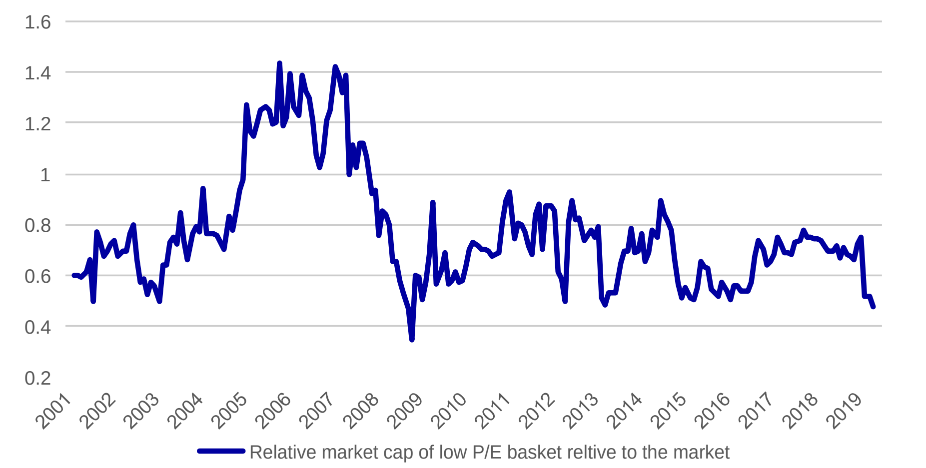
RELATIVE MARKET CAP BETWEEN EXPENSIVE AND CHEAP STOCKS – EUROPE SMID



Source: FactSet and Nordea

Cheap stocks have an unusually low market cap relative to the market, suggesting very little capital is needed to turn the tide

RELATIVE MARKET CAP OF LOW P/E BASKET VERSUS THE MARKET (MEDIAN COMPANY)



Source: FactSet and Nordea

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