Pitcher Partners

Economic and Market Outlook

April 2021

International economy

Part 1: Overview

The COVID-19 pandemic brought with it social and economic upheaval on a scale not witnessed for three-quarters of a century. However, as the tumultuous year drew to a close, the clouds of uncertainty appeared to part. Vaccines were shown to be effective, raising hopes that the pandemic would soon be extinguished. The United States election result also provided hope of relative geopolitical calm from a Biden presidency.

The passing of a US$900 billion relief bill in December, which concentrated on jobless benefits, aid to small businesses, stimulus cheques and money for vaccine distribution, and the recently passed US$1.9 trillion stimulus package, where the focus was on direct payments, additional jobless assistance, support for parents and funding for COVID-19 tests and vaccines, have led to the ballooning of household savings. This latest stimulus package takes the US' COVID-19 fiscal response to an eye-watering 27% of GDP. The massive monetary and fiscal response (the latter significantly upsized under the new President) was seen to provide a bridge towards a much-awaited end to the pandemic.

Yet that confidence is already being tested in 2021 as new COVID-19 variants take hold, doubts emerge about the supply, speed of rollout and efficacy of vaccines. Further, the Democrats' Senate win has stirred fears of an aggressive taxation and regulatory agenda that is unfavourable to business. Although growth outcomes around the world have been vastly better than most expected at the onset of the pandemic, the human cost has still been catastrophic. In the United States, for example, with unemployment at 6.2%, there were 9.5 million less jobs in February than there were twelve months earlier. The picture is bleaker in most other countries, with the exception of China, whose economy is expected to be 10% larger by the end of 2021 than it was at the end of 2019. Many developing economies and emerging markets could take years to return to their pre-pandemic trajectories. The common theme among these economies is that stimulus is either minimal or non-existent and the vaccine delivery timetable is certain to significantly lag that of advanced economies.

As policy-makers across the globe battle the brutal economic effects of the pandemic, many governments of advanced economies continue to borrow like there is no tomorrow. Government debt in the United States alone has more than doubled over the past decade. While interest rates remain low, the ability to service this debt remains manageable but this could easily change if and when rates start to rise over coming years. When an increasing proportion of taxpayer funds are required to service debt, either taxes will need to rise or welfare and services cut, curtailing future growth prospects.

Nevertheless, the latest economic update from the Organisation for Economic Co-operation and Development (OECD) confirms that the expansionary policies adopted by many advanced economies have provided the lifeline required, with sustained strong readings in goods, trade and industrial production. Economic growth in the United States is expected to be 6.5% in 2021, boosted by the passing of massive stimulus bills. China is forecast to grow by 7.8%, the Eurozone by 3.9% and Japan by 2.7% during 2021. Overall, global output is now projected to reach pre-pandemic levels by the middle of this year.

This strength has led to a spike in bond yields that has rattled financial markets over the past month. Rising bond yields are normal during an economic recovery as many investors shun defensive assets and gravitate towards riskier assets. What markets are really concerned about however, is a sharp rise in inflation that would cause the United States Federal Reserve (the 'Fed') to aggressively lift rates from the zero bound. In anticipation of this concern, the Fed shifted its approach to monetary policy in 2020 to "average inflation targeting", which now allows the central bank to let inflation "run hot" by looking through any near-term inflationary pressures if they prove to be transitory. The Federal Open Market Committee (FOMC) members do not expect the initial rate hike to arrive until 2024 at the earliest. The Fed has taken great pains to signal this to the market, in an effort to avoid a repeat of the 2013 "taper tantrum". Although the Fed will likely reach its 2% inflation target in the short term due to "base effects" (e.g. the oil price is much higher now than it was during the early days of the pandemic), any sustained lift in consumer price inflation appears unlikely until wage growth gains traction, which will require the elimination of excess capacity and therefore a much stronger environment for job creation than at present.

Conclusion

The economic recovery, like COVID-19 vaccines, will not be evenly distributed around the world over coming years. Economic risks remain profound, both to frontier economies facing imminent debt problems and low-income countries experiencing an alarming rise in poverty. With the pandemic far from being controlled and global debt at record levels, and policy normalisation likely to be uneven, the situation remains precarious. Nevertheless, optimism remains high that the global recovery will not be derailed, as supported by recent OECD upgrades to global growth forecasts to 5.6% in 2021 and 4.0% in 2022.

Part 2: Key economic indicators

United States

Economic snapshot	Last reported result	Comments
Growth (GDP)[1]	4.1% (annualised) Q4'20	The United States economy grew at an annual rate of 4.1% in the fourth quarter of 2020 but contracted 3.5% over 2020, the worst contraction since 1946.
Unemployment[2]	6.2% Feb'21	The unemployment rate was unchanged at 6.2% in February as total non-farm payrolls increased 379,000, a clear signal the economic recovery is gaining traction. Most of these job gains occurred in the battered leisure and hospitality sector.
Industrial Production[3]	-2.2% m/m Feb'21 -4.2% y/y Feb'21	Industrial production fell in February, affected by severe winter weather in the central part of the country.
ISM Manufacturing[4]	60.8 Feb'21 57.5 Nov'20	February's PMI reading of 60.8 reflected an increase of 2.1 percentage points from the January reading, and continues to signal a manufacturing sector in expansion for a ninth successive month.
Retail sales[5]	-3.4% m/m Feb'21 7.1% y/y Feb'21	Retail sales fell in February due to extreme weather in parts of the country but remain solidly higher over the year, benefitting from optimism in regard to the recovery.
Credit growth[3]	-0.4% y/y Jan'21	Credit decreased by 0.4% year-on-year and stands at US$4.18 trillion.
Outlook	The US rebounded strongly in the second half of 2020 from the record contraction it suffered in the second quarter. Economic growth is expected to be strong over 2021, benefitting from massive ongoing stimulus measures, economic re-openings, a ramp-up in vaccination rollouts and stronger employment growth. The economy is likely to reach pre-pandemic levels of GDP in the first half of this year.	

[1]Source: Bureau of Economic Analysis

[2]Source: Bureau of Labour Statistics

[3]Source: United States Federal Reserve

[4]Source: Institute of Supply Management (ISM)

[5]Source: United States Census Bureau

Eurozone

Economic snapshot	Last reported result	Comments
Growth (GDP)[6]	-0.7% q/q Q4'20 -6.8% y/y Q4'20	The Eurozone economy declined in the fourth quarter of 2020, impacted by COVID-19 containment measures. In 2020 the Eurozone suffered its deepest annual contraction since the series started in 1995.
Unemployment[6]	8.1% Jan'21	The unemployment rate was unchanged in January from the level of 8.1% in December and remains higher than the level of 7.4% in January 2020. There were one million more unemployed persons in the Eurozone at the end of January compared to one year earlier.
Industrial Production[6]	-1.6% m/m Jan'21 -0.8% y/y Jan'21	Industrial production declined in January as the production of capital goods fell sharply.
Manufacturing PMI[7]	62.4 Mar'21 55.2 Dec'20	The IHS Markit Eurozone Manufacturing PMI confirmed the manufacturing sector expanded for the ninth successive month and stands at a record high.
Retail sales[6]	-5.9% m/m Jan'21 -6.4% y/y Jan'21	Retail sales declined in January as many non-essential shops were forced to close as part of nationwide lockdowns across many Eurozone member states.
Credit growth[8]	9.6% y/y Jan'21	The annual growth rate of total credit to euro area residents stood at 9.6% in January 2021, unchanged from the previous month. The annual growth rate of credit to general government increased to 22.9% in January from 22.2% in December, while the annual growth rate of credit to the private sector decreased to 5.1% in January from 5.4% in December.
Outlook	The recovery in the Eurozone is likely to continue to be rocky as issues with certain vaccines risk delaying re-openings of economies. The European Central Bank (ECB), however, has accelerated its bond buying program, in an effort to keep borrowing costs under control. This, combined with fiscal stimulus measures, should facilitate a solid rebound in growth over 2021.	

[6]Source: Eurostat

[7]Source: IHS Markit

[8]Source: European Central Bank

China

Economic snapshot	Last reported result	Comments
Growth (GDP)[9]	6.5% q/q Q4'20 2.3% y/y Q4'20	China's economy was the only major economy to expand during 2020 as global demand for its goods surged during the second half of the year.
Unemployment [9]	5.5% Feb'21	The unemployment rate of 5.5% masks the extremely high youth unemployment rate of 13.1%.
Industrial Production [9]	35.1% y/y Jan-Feb'21 7.0% y/y Nov'20	Industrial production rose strongly, albeit off a very low base, in the first two months of 2021.
Manufacturing PMI[10]	50.6 Feb'21 52.1 Nov'20	The latest reading of 50.6 was lower than the January reading of 51.3 but continues to indicate an expansion of the manufacturing sector.
Retail sales[9]	33.8% y/y Jan-Feb'21 5.0% y/y Nov'20	Retail sales surged in the first two months of 2021, albeit off an extremely low base. E-commerce sales now account for nearly half of all retail sales.
Fixed asset (urban) investment [9]	35.0% y/y Jan-Feb'21	Fixed asset investment (FAI) boomed in the first two months of 2021, albeit off an exceptionally low base.
Outlook	China's economy continues to recover from the biggest contraction on record in the first half of 2020. This can be attributed to its success in controlling the spread of COVID-19, as well as deployment of massive amounts of fiscal and monetary stimulus. China's economic growth in 2021 is likely to continue to outperform those of other developed economies as demand for its exports is likely to remain strong. Whilst China's Authorities have stated they would like to avoid any "sharp turns" in policy, they appear likely to taper current monetary and fiscal stimulus measures should the recovery continue to gather momentum.	

Japan

Economic snapshot	Last reported result	Comments
Growth (GDP)[11]	12.7% (annualised) Q4'20 22.9% (annualised) Q3'20	The Japanese economy continued to recover from the steep contraction in the first half of 2020, supported by strong exports, offsetting weakness in domestic demand.
Unemployment[12]	2.9% Jan'21	The unemployment rate declined in January, supported by a recovery in the healthcare and manufacturing sectors.
Industrial Production[13]	4.2% m/m Jan'21 -5.3% y/y Jan'21	Industrial production benefitted from a pickup in global demand, which led to strong rises in production of electronic parts and general-purpose machinery.
Manufacturing PMI[14]	51.4 Feb'21 49.0 Nov'20	The latest reading of 51.4 marks the strongest growth in the manufacturing sector in over two years.
Retail sales[13]	-0.5% m/m Jan'21 -2.4% y/y Jan'21	Retail sales declined for a second successive month as consumption was affected by extended state of emergency measures.
Outlook	The Japanese economy will likely contract in the first quarter of 2021 as renewed restrictions in Tokyo and some prefectures curb business activities and household spending. As the vaccine rollout gathers momentum, we would expect growth to accelerate over the remainder of the year, aided by strong export demand and ongoing stimulus measures.	

[9]Source: National Bureau of Statistics

[10]Source: The Manufacturing PMI data is compiled by the China Federation of Logistics & Purchasing (CFLP) and the China Logistics Information Centre (CLIC), based on data collected by the National Bureau of Statistics (NBS). The Manufacturing PMI data is NOT the Caixin Manufacturing PMI.

[11]Source: Cabinets Office

[12]Source: Statistics Bureau of Japan

[13]Source: Ministry of Economy, Trade and Industry

[14]Source: Jibun Bank and IHS Markit

Australian economy

Part 1: Overview

Australia's economy has been very resilient during the health crisis. GDP rose a strong 3.1% in the December quarter of 2020. The recession, though sharp, was short-lived. Whilst annual GDP growth remains below its "pre-COVID-19" level, strong quarterly growth rates over the second half of 2020 have almost erased the 7% economic contraction suffered in the second quarter. The rebound in growth can be attributed to increases in consumer confidence as restrictions eased and outbreaks successfully contained, resulting in low rates of hospitalisations and very few deaths. Increases in the aggregate demand for goods and services, largely driven by a timely fiscal policy response, was well targeted to support household and business incomes. Finally, expansionary monetary policy via significant reductions in the cash rate to 0.10%, and alternative measures in the form of Quantitative Easing has ensured credit markets remain liquid, placed downward pressure on an appreciating Australian dollar, solidified consumer sentiment and encouraged long term business investment. In fact, from the second half of 2020 the collective fiscal and monetary response resulted in strong economic readings across measures such as GDP, unemployment, retail sales, capital expenditure, construction, payrolls and consumer sentiment.

Yet for all the positive developments in the Australian economy, there remain significant headwinds which must be carefully navigated over 2021. First, the JobKeeper wage subsidy scheme that shielded many workers from joblessness in 2020 has recently ended. Whilst there is clear momentum in the Australian labour market, there is the risk that unemployment may rise in the sectors worst affected by social distancing and travel restrictions (i.e. tourism and hospitality). Second, the migration pause remains a demand-side headwind when one considers that more than half the country's population growth this century has been from overseas migration. Third, international travel bans have been detrimental to the tourism and foreign student education services industries.

The fourth headwind to a continued economic recovery involves the long-running tensions in the Australia-China trade relationship. The geopolitical tensions have escalated and further damaged the relationship between the two nations, at least over the short term. The economic effects of the souring of relations has been masked somewhat by China's insatiable demand for Australia's iron ore. However, should the dispute become protracted, returning iron-ore capacity in South America, coupled with new capacity from Africa, could seriously damage Australia's net export position and crank up pressure on Australian exporters to find new markets.

Nevertheless, there are a number of tailwinds that are likely to continue to support growth outcomes over the short term. First, the labour market rebound from lows reached in April and May was genuinely extraordinary. Though the unemployment rate remains higher than its pre-COVID-19 level, it has been reduced to a level lower than even the most optimistic forecasts this time last year, when the unemployment rate peaked at 7.5%.

Second, expansionary fiscal and monetary policy since the outset of the crisis have been by far the most accommodative ever witnessed in Australia. The RBA has re-affirmed its cash rate target of 0.1% until at least 2024. The RBA has also extended its current Quantitative Easing (QE) program, and a further $100 billion of government bonds will be purchased after the current $100 billion program is completed, with the RBA leaving open the possibility of a third round of QE. This program will help drive employment growth by maintaining interest rates at low levels across the yield curve and provide a price ceiling for the Australian Dollar.

Third, household balance sheets have remained strong throughout the crisis as the government unleashed unprecedented stimulus which has seen $140 billion in direct COVID-response stimulus since the crisis started, in addition to another $30 billion in increased social security stimulus in 2021 alone. This has resulted in household savings rates increasing from 4% to 19% as households have accumulated around $120 billion over the past year.

The fourth tailwind for the Australian economy is the ramping up of the vaccine rollout. The decision by the Australian government to manufacture the Astra Zeneca vaccine in partnership with CSL Limited at their facility in Melbourne, has meant the hording of vaccines by the Eurozone and other countries will likely have minimal impact on the vaccine rollout domestically. The sooner a robust level of immunity across Australia is reached, the earlier business and consumer confidence can be fully restored.

The fifth tailwind is the surge in housing and property markets, which have seen record levels of residential building and renovations, as well as loan approvals. In the short term, at least, this will likely create a positive wealth effect as rising asset prices will encourage households to feel more confident about the future and their propensity to spend.

Conclusion

Australia has often been euphemistically described as the lucky country due to its vast abundance of natural resources that have helped sustain economic growth for over a quarter of a century. That luck looked like it was about to run out at the start of the pandemic but a combination of good fortune (being an island) and good management (adherence to health advice, robust quarantine and social distance measures, coupled with unprecedented fiscal and monetary stimulus) have helped the economy rapidly rebound from the worst quarterly (June 2020) economic contraction in history. We expect this momentum to continue through 2021 as the vaccine is progressively distributed, global trade accelerates and other sectors of the economy gradually reopen.

Part 2: Key economic indicators

Economic snapshot	Last reported result	Comments
Growth (GDP)[15]	3.1% q/q Q4'20 -1.1% y/y Q4'20	The Australian economy recorded a second successive quarter of strong economic growth in Q4 of 2020. GDP output is expected to return to pre-pandemic levels by the end of Q1 2021.
	12 month outlook	The economy should grow solidly in 2021 as the pandemic and its related restrictions subside.
Retail trade[15]	0.5% m/m Jan'21	Retail trade increased slightly in January but remains 10.6% higher than January 2020 as stimulus measures feed through to the consumer.
	12 month outlook	Retail sales appear likely to continue to rise in line with consumer sentiment as economic conditions improve.
Manufacturing PMI [16]	58.8 Feb'21 52.1 Nov'20	The Australian Industry Group (AIG) stated that the Performance of Manufacturing Index (PMI) rose 3.5 points over the month and has reached its highest level since March 2018.
	12 month outlook	We continue to expect a solid expansion in manufacturing as economic conditions improve.
Business investment (private new capital expenditure)[15]	3.0% q/q Q4'20 -7.5% y/y Q4'20	Private new capital expenditure rose over the quarter as spending on equipment, plant and machinery increased sharply.
	12 month outlook	Business investment is likely to be solid as a result of the strong pipeline of infrastructure projects.
Unemployment[15]	5.8% Feb'21 6.8% Nov'20	The unemployment rate decreased 0.5% in February as employment increased by 89,000, whilst there were 70,000 less unemployed persons.
	12 month outlook	The pace in the decline of the unemployment rate seen of late is expected to slow in the near term as the Federal Government's 'Job Keeper' program comes to end. Unemployment may temporarily spike in the June quarter, however the downward trajectory will likely resume over the second half of the calendar year as business activity increases and general labour market conditions improve.
Inflation and interest rates[17]	**Inflation:** 0.9% q/q Q4'20 0.9% y/y Q4'20	The Consumer Price Index (CPI) rose solidly in the December quarter due, in part, to the reversal of some COVID-related price reductions.
	Interest rate: 0.10% Cash Rate Mar'21	The RBA left the cash interest rate unchanged in March at a record low of 0.10%.
	12 month outlook	The RBA has reached its lower bound for the cash rate of 0.10% and is unlikely to lower this rate further.
Australian dollar	AU$1 = US$0.76	The AUD has weakened slightly over the quarter but remains supported by the expansion in the RBA's bond purchasing program (Quantitative Easing).
	12 month outlook	The upward pressure on the AUD caused by the global recovery and strong demand for Australian exports is projected to continue well into late 2021. However, the RBA remains committed to ensuring the AUD remains at an internationally competitive rate through use of alternative monetary policy tools, such as Quantitative Easing. Equally, the US dollar should strengthen as the US economy recovers.

[15]Source: Australian Bureau of Statistics

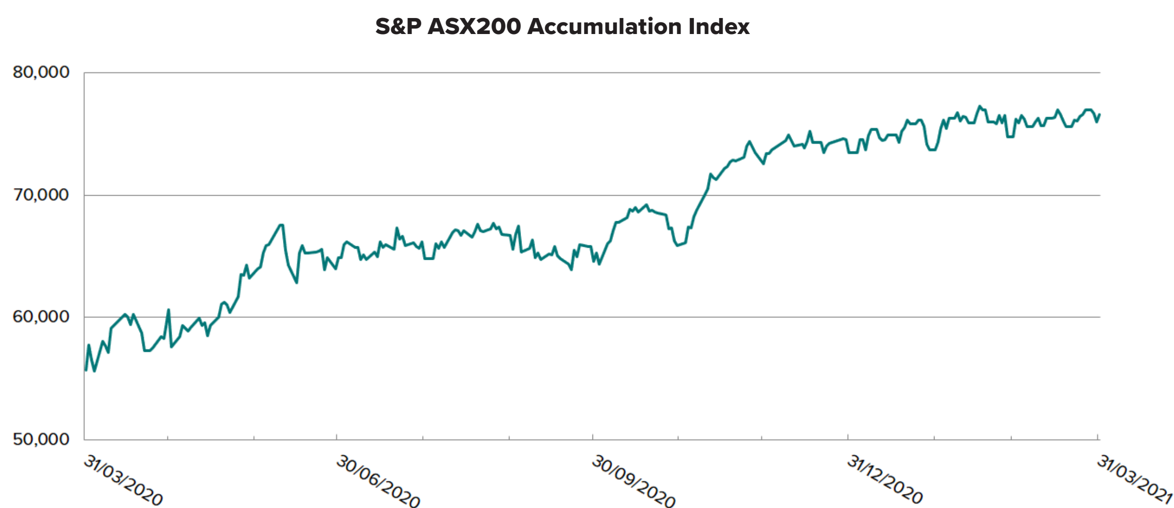
[16]Source: Australian Industry Group

[17]Source: Reserve Bank of Australia

Australian equities

Overview

The S&P/ASX 200 Total Return Index returned 4.3% over the three months and 18.0% over the nine months to 31 March 2021.



Source: S&P

Outlook

Our outlook for some of the major sectors of the S&P/ASX 200 is as follows:

Banks

Recommendation: Retain neutral.

The banking sector has rebounded strongly over the last six months given its leverage to an improving domestic economy. Continued policy support by the RBA, elevated commodity prices and resilient consumer demand has resulted in exceptionally strong asset prices in the housing and equity markets and are likely to underpin strong economic growth in the short term, which augers well for the sector.

Rising long bond yields and a steepening yield curve (higher yields on longer dated bonds than shorter dated ones) are normally a clear positive for bank margins, which have been squeezed by historically low interest rates and a flat yield curve. Higher margins are a direct consequence of a steepening yield curve as banks normally borrow in the short term money market and lend at the (very) long end. Therefore, banks provide a hedge against what is a headwind for many other sectors.

The housing market has responded to economic policy initiatives and low borrowing rates, and an improving economic outlook by recording solid credit growth. Fears of a systemic increase in Bad and Doubtful Debts (BDD's) have dissipated as initial expectations around unemployment have proven to be overly pessimistic.

Deferrals have continued to decline, with more than 90% of customers exiting deferrals now able to meet loan repayments. The writing back of previous loan impairment provisions have significantly improved their Common Equity Tier-1 (CET1) ratios. Further, the planned removal of the Responsible Lending Obligations (RLO's) is a positive step in freeing up additional credit for housing, boosting housing credit growth.

The cycle of banks reducing dividends to preserve their CET1 ratios is being unwound and dividends are likely to return to sustainable levels over the next year. Noting the strong share price performance within the banking sector since November, we retain a neutral recommendation on the sector.

Resources

Recommendation: Move from slight overweight to overweight.

The resources sector continues to strengthen as economic growth ramps up across the globe. Forecasted global growth of 5.6% in 2021, with China and the United States leading other developed economies, is likely to underpin a continued rise in commodity prices. Industrial commodities, in particular, are attractive as they are benefitting from both improving global growth and rising inflation concerns.

The reflation of the world economy is expected to gather pace in 2021 as a result of continued stimulus and the accommodative interest rate environment.

Shareholders in mining companies (notably the large iron ore producers) are benefitting from the uptick in the mining cycle, allowing management to focus on paying out large fully-franked dividends. This trend is likely to continue throughout 2021 as debt amongst the major producers is low and profits can be largely paid out as dividends.

Continued diplomatic tensions between Australia and China remains a significant risk to commodity prices over the short term. However, we note that Australia is a significant producer of several highly sought-after commodities (notably iron ore) and so any action in regard to tariffs on such commodities would appear to be futile as China would have difficulty sourcing significant quantities elsewhere.

Retail

Recommendation: Retain neutral.

The retail sector has rebounded strongly over recent quarters as an improving economy has seen consumer confidence return to levels last seen in 2019. This has translated into increased demand for goods and services and proven to be a bonanza for numerous listed retailers, especially those with a strong online presence. Much of this demand has been provided by unprecedented stimulus packages from the Federal Government such as JobKeeper and JobSeeker. As these packages have now been withdrawn, it is likely that the unemployment rate will temporarily rise in coming months as many workers are displaced from affected industries like travel, tourism and hospitality, which is likely to be a drag on retail sales. Over the medium term however, we would expect that the vaccine rollout and ongoing recovery will be supportive of the sector.

Australian Real Estate Investment Trusts (AREITs)

Recommendation: Maintain neutral.

AREITs continue to recover from the brutal sell-off inflicted in the early stages of the COVID-19 pandemic. Rent collections have re-started and occupancy levels have not significantly declined (as much as previously forecasted) during the pandemic.

The retail sub-sector continues to improve as the vaccine rollout gathers momentum. Consumer sentiment has risen steadily as the unemployment rate improves. Significant stimulus packages have managed to support businesses and households during the worst of the downturn, with households accumulating significant savings. These factors have led to strong retail sales with many retailers posting record profits, which are likely to continue to grow solidly in line with an improving economic landscape. The eventual reopening of borders will provide a further tailwind for sales, as will the easing of restrictions domestically, allowing more workers to return to their workplaces on a regular basis (predominantly in CBD's) and consumers to frequent bars and restaurants more easily.

The office sub-sector has been the worst affected by the crisis. The ability to work from home during the crisis has made many businesses rethink their need for such footprints in a post-COVID world. A headwind for this sub-sector involves the renegotiation of leases as they expire. These leases are either less likely to be renewed or, if renewed, will be done so on less favourable terms. Therefore, the difficult conditions within the office sub-sector are likely to continue into the medium term.

The residential sub-sector has strengthened considerably, with strong rises in mortgage pre-approvals and borrowers being able to comfortably resume mortgage repayments as mortgage deferrals come to an end. House prices have moved up strongly, benefitting from the record low interest rate environment and a move away from other assets, namely defensive assets where returns are minimal and growth assets such as shares, where valuations are increasingly perceived to be stretched. The sub-sector will receive a solid boost when international borders finally re-open.

The industrial sub-sector continues to benefit from strong investor demand, to the extent that in Sydney, at least, prime industrial capitalisation rates are now lower than those for office and retail assets. The industrial sub-sector is likely to continue to benefit from strong e-commerce growth and higher inventories as businesses position themselves to avoid disruptions in their supply chains.

We maintain our neutral recommendation on the AREIT sector. The moderate gearing levels of companies across the sector, as well as an improving economic climate, continue to provide support.

Conclusion

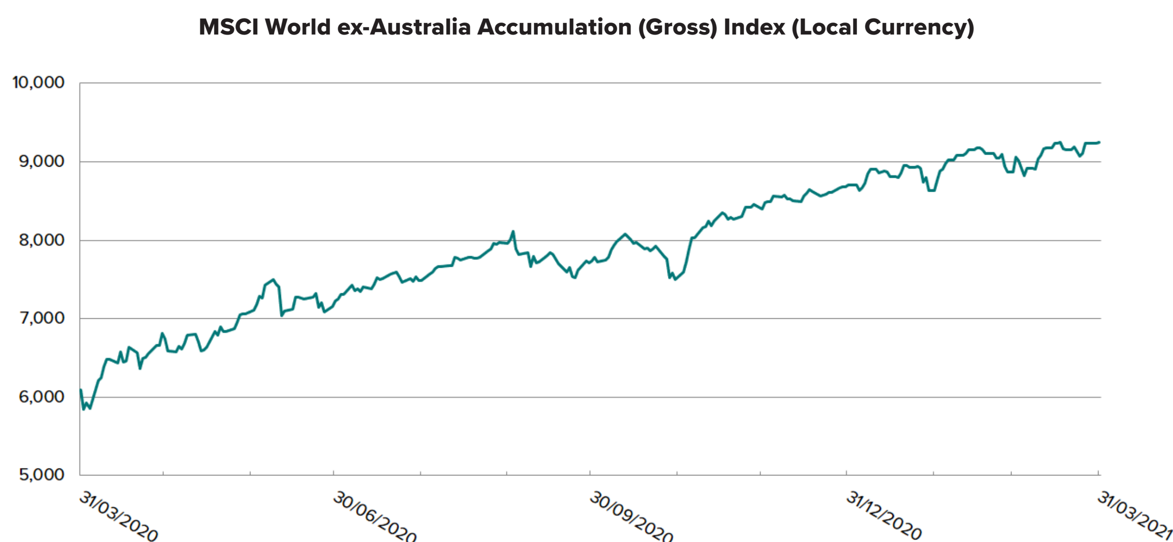
Recommendation: Retain neutral.

After the strong rebound in share prices over the last twelve months, valuations have become stretched when compared to historical averages. Nevertheless, the outlook for listed Australian companies continues to look constructive, supported by a recovery in corporate earnings and increased dividends. For these reasons we expect further gains over the remainder of 2021 and recommend a neutral exposure to this asset class.

International equities

Overview

The MSCI World (ex-Australia) Accumulation Index (local currency) returned 6.3% over the three months and 27.9% over the nine months to 31 March 2021.



Source: MSCI

Outlook

Against the backdrop of a pandemic that did not discriminate on the basis of race, religion or wealth, destroying the lives and livelihoods of many in its path, has been the remarkable story of human ingenuity. It is this ingenuity that enabled the development and production of highly complex, yet effective, vaccines in record time. These vaccines together with unprecedented fiscal and monetary support have provided the hope of a sustained recovery that has manifested itself in soaring asset prices that seemingly know no bounds. Through to the end of January the S&P 500 had rallied almost 70% from its intra-day low of 2192 in March 2020.

Optimism in the face of adversity is a defining hallmark of the human spirit but sometimes optimism morphs into greed and breeds sheer madness, as witnessed by dizzying gains in a large range of heavily overvalued tech stocks and of course, Game Stop. Fundamentals which usually support asset prices such as future earnings were abandoned and instead supplanted by baseless and random tweets pumping up prices as irrational exuberance held sway. Speculative crypto coins that have no intrinsic value and will never produce an income stream also soared to stupendous heights. The meteoric rise has only emboldened their advocates and encouraged more speculators, many of which can ill afford to lose their hard-earned savings.

Yet those who thought fundamentals didn't matter received a rude awakening in early February as a rise in inflationary expectations caused a steep rise in bond yields that resulted in a sharp correction of some of the most over hyped assets, including stocks such as Tesla among others.

The path from here is likely to be less certain. As the recovery gathers more momentum earnings are likely to continue to rise which will be supportive for equities. Such a recovery, however, is also likely to spur a future rise in bond yields that are coming off ultra-low levels. If low interest rates have been a boon for equity markets, the opposite must also be true. Further rises will act as a drag on equities given that the present value of future cash flows will reduce.

Valuations

In the United States, operating earnings for S&P 500 companies are currently expected to rise by 24% in 2021, 16% in 2022 and 12% in 2023. Using these forecasts and conventional long term multiples, we estimate that the United States sharemarket (as measured by the S&P500) is overvalued by between 42% in the near term and 10% over the medium term.

2021 calendar year forecast	EPS earnings estimates	S&P 500 Fair Value estimate	Over/(Undervalued) S&P 500 = 3,911
Consensus	$172	2,759	42%
If 10% below	$155	2,483	58%
If 10% above	$190	3,035	29%
2022 calendar year forecast	**EPS earnings estimates**	**S&P 500 Fair Value estimate**	**Over/(undervalued) S&P 500 = 3,911**
Consensus	$200	3,197	22%
If 10% below	$180	2,877	36%
If 10% above	$220	3,516	11%
2023 calendar year forecast	**EPS earnings estimates**	**S&P 500 Fair Value estimate**	**Over/(undervalued) S&P 500 = 3,911**
Consensus	$222	3,552	10%
If 10% below	$200	3,200	22%
If 10% above	$244	3,904	0%

Source: S&P, Bloomberg, Refinitiv

By contrast, forward Price-to-Earnings (P/E) multiples for the Europe MSCI Index are at elevated levels (16.5 times) relative to the past two decades, but they are by no means extreme and can be considered acceptable in the face of low bond yields and accommodative money policy.

Conclusion

Recommendation: Retain slight underweight.

The formative stages of any global recovery have historically been overwhelmingly positive for equity markets. As demand for goods and services rise off a low base, companies that had cut costs during the downturn reap the benefits as higher sales and lower costs lead to increased profitability. As profits rise, share prices generally follow. Renewed confidence typically leads to an upgrade in earnings expectations and an expansion in the P/E ratio of the market, further enhancing the sharemarket rally. The challenge for markets this time round however is that the P/E ratio of the market has already expanded well beyond earnings estimates expected over the next few years. For this pattern to hold, interest rates will need to stay suppressed by further central bank intervention and the economic recovery will need to play out as the market currently expects. Any blip could lead to significant downside shocks.

On balance, we believe the absence of value in alternative asset classes together with stronger earnings may well lead to further gains on global sharemarkets over the next 12 months but equally believe that it is prudent to be more cautious at these frothy valuations and hence recommend maintaining a slight underweight exposure.

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