Economic and Market Outlook

July 2021

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International economy

Part 1: Overview

The world is in the midst of a massive global economic recovery, the extent of which has never been witnessed during the past century. This breathtaking rebound has been fuelled by two significant factors. First, the development of successful vaccines and their subsequent rollout has begun to significantly reduce infection and death rates, allowing those parts of the economies that were affected by shutdowns to reopen. Second, the unleashing of massive monetary and fiscal stimulus has underpinned this recovery - a key differentiator from what was witnessed in the aftermath of the Global Financial Crisis (GFC) where policy support was initially sluggish and inadequate.

The global reflation has been led by countries which either kept the pandemic largely under control (China, Australia) or have implemented monetary and fiscal stimulus measures on a gargantuan scale (the United States). The Euro Area recovery, on the other hand, has been stuttering at best. Public spending has been more measured, culminating in the double-dip recession in the first quarter of this year. Nevertheless, there are encouraging signs emerging. First, the vaccine rollout (whilst slow relative to its counterparts) is gaining traction. Second, industrial production continues to accelerate despite supply-side bottlenecks, raising hope that spare capacity in the labour force will eventually be reduced, lowering the bloc's unemployment rate.

Growth in emerging markets where the devastating health and financial consequences of COVID-19 have been more widespread, should also gain traction in the second half of 2021. As a result, the global recovery should become more synchronised.

One of the major risks to the ongoing recovery continues to be the steepening of the yield curve as a result of inflationary pressures. There has been much debate as to whether inflation is likely to be permanent or transitory in nature. For many years Inflation has been subdued in most advanced economies as a result of the quasi-globalisation of the workforce via outsourcing and offshoring, labour saving technological advancements, the production of goods in countries with low labour costs, and low energy prices.

In the short term however, there are several unique factors that could challenge this trend. First, COVID-19 has led to a concerted move to re-shoring operations to provide better control over supply chain disruptions. These supply chain disruptions have also increased input prices. Second, COVID-19 has disrupted the flow of migrant workers, helping to put pressure on wages in numerous service sectors. Third, President Biden's signature American Jobs Plan policy is effectively designed to curtail the offshoring of jobs, that if legislated, would put more upward pressure on wages. Fourth, Sino-US tensions and resultant protectionist policies are adding to price pressures.

Lastly and perhaps most importantly, is the impact of unconventional quantitative easing measures. Central Bank bond purchases using newly printed money don't tend to be inflationary as they are simply buying existing bonds on the secondary market, most of which is held by large institutional investors such as banks, insurance companies and super funds, who are simply exchanging one investment - bonds - for cash. In the case of buying bonds from banks, the Central Bank is effectively crediting the trading banks with reserves required to meet capital adequacy requirements.

The theory is that these excess reserves will encourage banks to lend to businesses and households to further stimulate the economy. If this lending translates into a strong rise in credit growth, then this could well ignite inflation as the extra money circulating in the real economy would be chasing the same finite supply of goods and services. This would be in stark contrast to the quantitative easing measures enacted during and after the depths of the GFC where inflation did not conflagrate because credit growth remained subdued.

The simple reason why this did not happen is that conditions simply weren't conducive to foster strong credit growth at the time. Businesses won't borrow to invest unless demand expectations are sufficiently robust to generate the required return. Similarly, households typically won't borrow unless they have confidence in their employment prospects, which in turn is largely dependent on the strength of the economy. This time could be different, however, as household lending has risen sharply, buoyed by soaring house prices. Business credit growth has also started to accelerate. Should these trends continue then a pick-up in inflation is likely.

Conclusion

The economic recovery over the past year has been remarkable, driven by the successful development of COVID-19 vaccines and stimulus of a magnitude the global economy has not seen before. Whilst inflationary risks are rising, amplified by the uneven reopening of the global economy and supply chain disruptions, these could prove to be temporary. Disinflationary pressures such as excess labour capacity and the impact of technology are key drivers that are likely to re-assert themselves over the longer term. In the interim, global economic growth is likely to remain solid and those economies which have been laggards up to this point are likely to gain momentum.

Real GDP growth	2021	2022
World	5.6%	4.3%
United States	6.8%	4.2%
Euro Area	4.2%	4.4%
China	8.5%	5.4%

Source: World Bank, *Global Economic Prospects*, World Bank, Washington, DC, June 2021.

Part 2: Key economic indicators

United States

Economic snapshot	Last reported result	Comments
Growth (GDP)[1]	6.4% (annualised) Q1'21	The strong growth recorded in the first quarter was underpinned by increases in Personal Consumption Expenditures (PCE), fixed investment and spending by government at all levels, dwarfing decreases in private inventory investment and exports, and an increase in imports.
Unemployment[2]	5.8% May'21	The unemployment rate declined by 0.3% in May to 5.8%, with significant job gains in leisure and hospitality, public and private education, and healthcare and social assistance.
Industrial Production[3]	0.8% m/m May'21 16.3% y/y May'21	Industrial production rose for the third successive month, but persistent disruptions to supply chains continue to restrain growth in industrial output.
ISM Manufacturing[4]	61.2 May'21 60.8 Feb'21	May's PMI reading of 61.2 reflected an increase of 0.5 percentage points from the April reading, and continues to signal a manufacturing sector in expansion for a twelfth successive month.
Retail sales[5]	-1.3% m/m May'21 28.1% y/y May'21	Retail turnover fell in May as sales rotated from goods to services as the vaccine rollout gathered pace, allowing Americans to travel and otherwise engage in activities that were, until recently, restricted by the pandemic. The yearly reading remains very strong, albeit off a very low COVID-19 induced base.
Credit growth[3]	5.3% y/y Apr'21	Credit increased by 5.3% year-on-year and stands at $4.24 trillion.
Outlook	The strong economic recovery in the United States appears likely to continue, as the Federal Reserve keeps interest rates lower for longer and both consumer and business confidence continues to improve as greater parts of the economy emerge from lockdown.	

[1]Source: United States Bureau of Economic Analysis

[2]Source: United States Bureau of Labour Statistics

[3]Source: United States Federal Reserve

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

[5]Source: United States Census Bureau

Euro Area

Economic snapshot	Last reported result	Comments
Growth (GDP)[6]	-0.3% q/q Q1'21 -1.3% y/y Q1'21	The Euro Area entered a double-dip recession during the March quarter as a new wave of COVID-19 hit Europe. Growth in the French economy was more than offset by the decline in Germany.
Unemployment[6]	8.0% April'21	The unemployment rate declined slightly in April and continues to remain higher than the level of 7.4% in January 2020. This shows the economy continues to be heavily scarred.
Industrial Production[6]	0.8% m/m Apr'21 39.3% y/y Apr'21	Industrial production increased in April as the production of durable consumer goods and energy increased solidly.
Manufacturing PMI[7]	63.1 May'21 57.9 Feb'21	The IHS Markit Euro Area Manufacturing PMI confirmed the manufacturing sector expanded for the eleventh successive month and stands at a record high.
Retail Sales[6]	-3.1% m/m Apr'21 23.9% y/y Apr'21	Retail sales declined in April as sales of non-food products were significantly lower (-5.1%) during the month but remains significantly higher over the past year.
Credit Growth[8]	7.7% y/y Apr'21	The annual growth rate of total credit to Euro Area residents decreased to 7.7% in April, from a level of 9.1% in March. The annual growth rate of credit to general government decreased to 18.0% in April from 21.9% in March, while the annual growth rate of credit to the private sector decreased to 4.0% in April from 4.6% in March.
Outlook	The recovery in the Euro Area has once again stalled, dragging the economy back into recession in the March quarter. With vaccination rates significantly increasing, containment measures easing and the European Central Bank (ECB) pledging to accelerate its bond buying programme, the Euro Area economy is likely to grow solidly in the second half of the year.	

[6]Source: Eurostat

[7]Source: IHS Markit

[8]Source: European Central Bank

China

Economic snapshot	Last reported result	Comments
Growth (GDP)[9]	0.6% q/q Q1'21 18.3% y/y Q1'21	China's growth rate was subdued in the first quarter of 2021 from the record levels achieved in the second half of 2020.
Unemployment[10]	5.0% May'21	The unemployment rate of 5.0% masks the extremely high youth unemployment rate of 13.8%.
Industrial Production[9]	8.8% y/y May'21 35.1% y/y Jan-Feb'21	Industrial production has grown at more normal levels in May, supported by strong levels of production of electricity, thermal energy, gas and water production.
Manufacturing PMI[9]*	51.0 May'21 50.6 Feb'21	The latest reading of 51.0 was lower than the April reading but continues to indicate an expansion of the manufacturing sector.
Retail Sales[9]	12.4% y/y May'21 33.8% y/y Jan-Feb'21	Retail sales continues to be strong, compared to May 2020 as the Chinese economy moved out of lockdown earlier than peers.
Fixed Asset (Urban) Investment[9]	15.4% y/y Jan-May'21	Fixed Asset Investment (FAI) continues to be solid, supported by strong investment in the private sector.
Outlook	China's success in containing COVID, coupled with massive amounts of fiscal and monetary stimulus, has seen the country achieve pre-pandemic levels of GDP much earlier than peers. Growth is forecast to be strong at 8.6% over 2021, but we expect the rate to gradually moderate over the year as pent up demand starts to taper off and monetary support is wound back, causing both industrial production and retail sales to grow at a slower pace.	

Japan

Economic snapshot	Last reported result	Comments
Growth (GDP)[11]	-3.9% (annualised) Q1'21	The Japanese economy contracted in the first quarter of 2021, affected by a surge in imports and continued weak domestic demand as continued lockdowns impact the economy.
Unemployment[12]	2.8% Apr'21	The unemployment rate increased in April as COVID-related restrictions were reimposed, primarily impacting the services sector.
Industrial Production[13]	2.5% m/m Apr'21 15.4% y/y Apr'21	Industrial production continues to recover and now stands at a level not seen since the beginning of the COVID crisis.
Manufacturing PMI[14]	53.0 May'21 51.4 Feb'21	The latest reading of 53.0 marks the fourth straight month of expansion in the manufacturing sector.
Retail sales[13]	-4.5% m/m Apr'21 12.0% y/y Apr'21	April's annual growth figure for retail sales was strong, albeit off a low base. On a monthly basis, sales declined due to COVID-19 restrictions being reintroduced.
Outlook	Japan's economy is likely to have contracted again in the June quarter following further lockdowns and semi-conductor chip supply shortages that have impacted car exports. As the vaccine rollout gathers momentum, growth over the second half of the year is expected to accelerate due to local business re-openings and relatively strong global demand.	

[9]Source: National Bureau of Statistics, China

*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.

[10]Source: National Bureau of Statistics, China

[11]Source: Cabinets Office, Japan

[12]Source: Statistics Bureau, Ministry of Internal Affairs and Communications

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

[14]Source: Jibun Bank and IHS Markit

Australian economy

Part 1: Overview

The Australian economic recovery from the ruins of the pandemic-induced damage has been nothing short of spectacular. Fears of a long-lasting recession never eventuated. Instead, the unleashing of massive amounts of monetary and fiscal stimulus has helped the economy grow by more than 1% over the year to March, a feat few developed economies have matched.

Notwithstanding the winding back of certain stimulus measures, there are many reasons why the economy is expected to expand further. First, the continued easing of restrictions and eventual reopening of international borders will expedite the return to normalcy. Second, the RBA has continued to signal that supportive monetary settings will be in place for an extended period of time. Whilst the RBA will commence to taper some of its Quantitative Easing (QE) measures from July, it continues to be of the view that interest rates will remain on hold until at least 2024.

Third, the twin tailwinds of a sharp rise in commodity prices and strong demand for Australian exports as the global recovery broadens is likely to lead to strong export growth. Whilst China has successfully managed to send the price of iron ore lower in recent weeks, it faces a very difficult task to achieve lower prices for longer. Paradoxically, it is the Australian iron ore producers which will benefit from China's decarbonisation plan which aims to double carbon capture by 2025 and also reach peak carbon emissions around the same time. Australia's iron ore has the least impurities of any ore around the globe, with the exception of Brazil. Demand for this grade of ore will increase in line with China's (and other economies) push to reduce carbon emissions, helping to underpin robust export revenue over the medium term.

Fourth, consumer spending remains strong underpinned by robust business conditions and improved prosperity from booming share and house prices. This is evident in the 25% rise in retail sales over the past year, albeit off a low base.

Fifth, private investment is strengthening and likely to underpin growth outcomes in the next year. Dwelling investment continues to benefit from the surge in building approvals and housing construction. Business investment increased at its highest pace in over a decade during the quarter as businesses took advantage of tax breaks to purchase plant and machinery. Private investment, underpinned by a 6.4% increase in dwelling investment and an 11.6% rise in business investment, grew by 5.3%, contributing half of the economy's first quarter growth.

The main risks to the outlook remain mutations that prove vaccine resistant, potentially causing ongoing rolling lockdowns or the possibility that the RBA may well have to lift interest rates much earlier than forecast. The temporary halt on immigration and border closures have led to labour and skills shortages across the services industry. The resultant wage cost pressures could well prove to be inflationary.

Conclusion

We expect the Australian economy to continue to expand at a solid pace over the next 18 months as reinforced by the latest RBA growth forecasts for 2021 and 2022 of 4.75% and 3.5%. This will be underpinned by ongoing stimulus measures, the broadening of the global recovery and strong commodity demand. Furthermore, strong asset price growth has helped restore consumer confidence, which in turn has driven a strong recovery in consumer spending, jobs growth and a long-awaited improvement in business investment.

Part 2: Key economic indicators

Economic snapshot	Last reported result	Comments
***Growth (GDP)*[15]**	1.8% q/q Q1'21 1.1% y/y Q1'21	The Australian economy grew strongly in the first quarter of 2021 to erase all the decline suffered as a result of COVID-19. Private investment (namely investment in machinery and equipment) and household spending were keys drivers of the quarterly reading.
	12 month outlook	The economy should grow solidly in 2021 as the vaccine rollout gathers pace and restrictions ease.
***Retail trade*[15]**	1.1% m/m Apr'21 25.0% y/y Apr'21	Retail trade increased solidly in April and is now 25% higher than the same month in 2020. The monthly reading was underpinned by spending at restaurants and cafés, and household spending.
	12 month outlook	Retail sales are expected to rise further as economic conditions improve but the rate of growth will likely ameliorate.
***Manufacturing PMI*[16]**	61.8 May'21 58.8 Feb'21	The Australian Industry Group (AIG) stated that the Performance of Manufacturing Index (PMI) rose 0.1 points over the month and has reached its highest level since March 2018.
	12 month outlook	The manufacturing sector should continue to grow in line with an improving economy.
***Business investment (Private New Capital Expenditure)*[15]**	6.3% q/q Q1'21 0.8% y/y Q1'21	Private new capital expenditure rose over the quarter as spending on equipment, plant and machinery continues to increase solidly.
	12 month outlook	Business investment is expected to remain robust, supported by a solid infrastructure pipeline.
***Unemployment*[15]**	5.1% May'21	The unemployment rate decreased 0.4% in May for the seventh consecutive monthly decline. The number of unemployed people has fallen by around 303,000 since the peak of 1 million unemployed people in July 2020.
	12 month outlook	The unemployment level is expected to stabilise further as the economy continues to strengthen.
***Inflation*[15] *and interest rates*[17]**	**Inflation:** 0.6% q/q Q1'21 1.1% y/y Q1'21	The Consumer Price Index (CPI) rose strongly for the second successive quarter, due mainly to higher fuel prices which continue to rise significantly from a low base during the COVID-19 crisis.
	Interest rate: 0.10% Cash Rate Jun'21	The RBA left the cash interest rate unchanged in June at a record low of 0.10%.
	12 month outlook	The RBA is likely to maintain the cash rate at the lower bound of 0.10% as a key driver for raising the cash rate – significant wage growth – is unlikely over the next year.
Australian dollar	AU$1 = US$0.77	The Australian Dollar continues to be rangebound, notwithstanding the global economy continuing to improve.
	12 month outlook	The Australian Dollar is expected to trade around current levels, supported by an improving global economy which continues to underpin a strong outlook for commodities.

[15]Source: Australian Bureau of Statistics

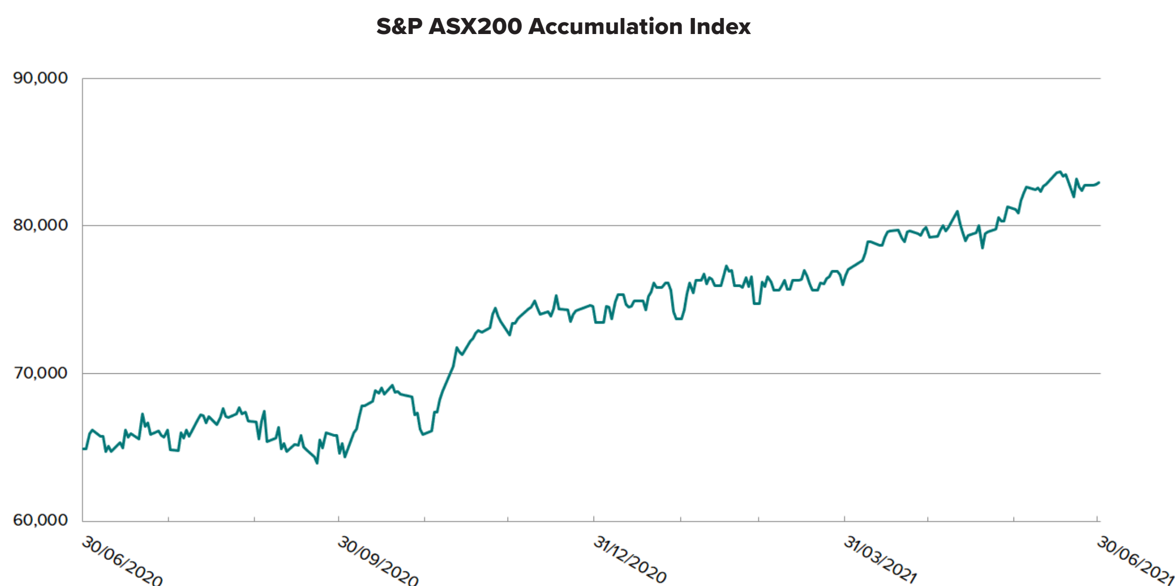
[16]Source: Australian Industry Group

[17]Source: Reserve Bank of Australia

Australian equities

Overview

The S&P/ASX 200 Total Return Index returned 12.9% over the six months and 27.8% over the twelve months to 30 June 2021.



Source: S&P

Outlook

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

Banks

The banking sector has recovered sharply from the share price lows plumbed in mid-2020, benefitting from Australia's recovering economy. As Australia's employment figures have steadily improved, the banks have moderated their loan loss provisions from the billions flagged during the depths of the crisis, so their profits have rebounded accordingly.

Whilst the recent H1FY21 results were characterised by strong capital positions, low bad debts and improving loan growth, a key theme of the recent reporting season has been the importance of managing expenses, which have been impacted by a significant increase in compliance and related spending, a higher level of amortisation and expensing of projects as well as remediation activity and fines. There is a delicate balance between reducing the cost base and continuing to invest in technology, cyber security and compliance.

Due to the capital ratios of the banks exceeding minimum regulatory levels by a significant margin, banks are now in the enviable position of being able to return excess capital to shareholders by way of share buybacks or increased dividends.

Banks however are likely to adopt lower dividend payout ratios, so dividends will be better than last year but below pre-pandemic levels.

As the performance of the banking sector is heavily correlated with the economy, banks are expected to perform well as the outlook strengthens. Credit growth has been particularly strong in the low interest rate environment as investors have returned to the market along with first home buyers who have been enticed with additional government incentives. Regulators have not yet signalled any intention for macroprudential intervention to tighten lending standards, so this trend is likely to continue in the short term.

Business credit has been strong in recent quarters and with confidence increasing, is expected to continue. To provide a further fillip for the banks, eventual interest rate rises will increase their historically low Net Interest Margins (NIM's), ultimately feeding through to their bottom-line performance. NIM's across the sector are also expected to improve as the banks have both been a recipient of the RBA's $209 billion term funding facility (which has allowed banks to price fixed-rate mortgages at ultra-low interest rates) as well as having access to the mountain of bank deposits that have built up since the start of the pandemic.

Resources

Commodities continue to benefit from massive infrastructure packages across the globe. 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. The World Bank, in its latest projection, forecasts global growth to be 5.6% in 2021, before moderating to 4.3% in 2022. Since growth in the United States is projected to be 6.2% and China and India are forecast to grow at 8.5% and 12.5% respectively in 2021, the outlook for commodities is expected to remain strong.

As urbanisation rates rise in developing economies, demand for steel is likely to increase. As a result, the iron ore price and coal price are expected to remain well supported. Demand for copper, the bellwether commodity for the state of the global economy, is also expected to remain solid. As many economies across the globe begin the transition towards a lower carbon footprint, producers of more pure grades of commodities will likely benefit. Pure grades need less refining, which in turn will lead to lower carbon emissions and boost productivity.

Although listed ASX companies face the risk of escalating diplomatic tensions between Australia and China, supply side constraints and strong global demand should ensure that the near-term impacts are limited.

Retail

The Australian retail sector has been buoyed (until recently) by the successful management of the pandemic and the massive stimulus packages. Consumer confidence levels remain high, which has translated into increased demand for goods and services. This has proven to be a bonanza for numerous listed retailers, especially those with a strong online presence. There were concerns that the termination of JobKeeper at the end of March could impact sales, but the withdrawal has had no discernible impact thus far. Indeed, the outlook has only strengthened, as strong jobs growth will remain supportive of consumer spending. As restrictions are eased further with the vaccine rollout, sales in hard-hit sectors like travel, tourism and hospitality are also likely to recover.

Australian Real Estate Investment Trusts (AREITs)

AREITs continue to recover strongly in line with a rebounding economy.

The retail sub-sector continues to perform well despite ongoing COVID outbreaks and snap restrictions. CBD retailers are more susceptible to these COVID-19 flare-ups, benefitting suburban malls at the expense of city locations. As the vaccine rollout improves and restrictions no longer apply, retailers in and around CBD's are likely to see more normalised sales patterns. Tailwinds in the form of rising consumer sentiment, an unemployment rate not seen since before the crisis, and high savings rates are likely to remain supportive. Retailers with bricks and mortar operations that have had to compete against online retailers will be beneficiaries of an eventual lifting of restrictions, though many of these operators may seek to have a lower footprint upon lease renewal. This could ultimately lead to lower rents across the sector.

The office sub-sector remains hamstrung by the effects of the pandemic. Businesses that successfully managed the work from home transition, are likely to reduce their floor space requirements as leases progressively expire, putting downward pressure on rents and valuations.

REITs with residential property exposure continue to benefit from the ultra-low interest rate environment that has caused demand to surge and prices to boom. Lead indicators including mortgage pre-approvals and building approvals bode well for further growth. Fears of a sharp uplift in mortgage defaults at the end of JobKeeper that threatened to dampen prices have failed to materialise and the sector may well receive a further boost when international borders eventually re-open.

The industrial sub-sector remains the preferred exposure within the AREIT sector. Industrial properties in or near many capital cities, Sydney and Melbourne in particular and Brisbane of late, continue to be highly sought after, to the extent that capitalisation rates are now lower than those for retail and office properties. Industrial property continues to benefit from strong e-commerce growth (which has fuelled demand for logistics space) and stockpiling of inventories as businesses proactively deal with the risk of potential disruptions to their supply chains.

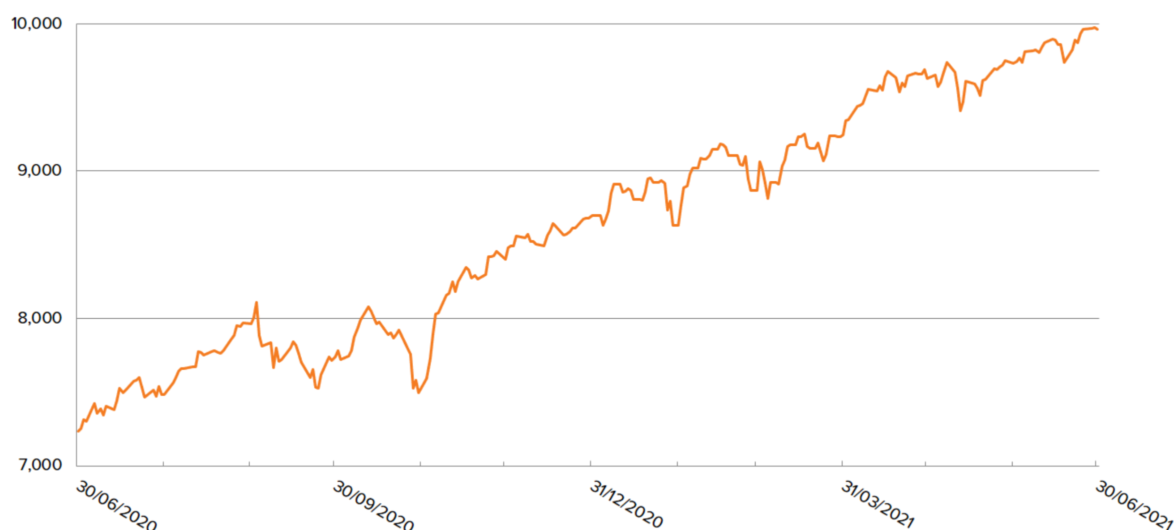
Conclusion

Even though valuations are stretched when compared to historical averages, there are several reasons why domestic equities should continue to perform well over the next six months. First, the upswing in global and domestic growth that is expected in the second half of the year should drive demand and revenues. Second, the low interest rate environment will reduce borrowing costs and interest expense. Third, many companies have experienced cost reductions over the year due to either rent reductions, temporary wage freezes or lower travel and marketing expenses. The combination of these factors should help underpin further earnings growth and sharemarket gains. The main risk remains any rise in inflationary expectations that could push interest rates higher. Although the RBA is relaxed about this prospect for now, we believe pressures are already rising, which may well force the bank to lift rates much earlier than their timetable suggests.

International equities

Overview

The MSCI World (ex-Australia) Accumulation Index (local currency) returned 14.5% over the six months and 37.7% over the twelve months to 30 June 2021.



Source: MSCI

Outlook

Global markets have continued to be the beneficiary of unprecedented government spending initiatives as well as conventional and unconventional policy measures of central banks that have helped create an environment of ultra-low interest rates. In the absence of any real income return from cash and bonds, investors have flocked into equities seeking both higher income and growth opportunities. This flood of money has helped sharemarkets rapidly recover, with many soaring to new highs.

With central banks retaining their commitment to keep interest rates low for the foreseeable future, and as the global economy continues to benefit from business re-openings and pent-up demand, the tail winds for equities appear to remain largely intact. There are, however, a number of warning signs that have begun to emerge that could jeopardise this outlook.

First, the dividend yield on the S&P 500 is now lower than the corresponding US 10-year Treasury bond yield. US investors can no longer rely on higher dividends from the sharemarket which will reduce the relative attractiveness of the asset class (especially if growth disappoints). Second, valuations on global sharemarkets, and in particular in the United States, are now trading at levels well above long-term averages.

Third, there is an expectation that interest rates will stay low and that earnings will continue to improve as the global economy gathers more momentum. Rising inflationary pressures, however, could challenge that assumption. In the United States, for example, core inflation surprised to the upside in the year through to May, rising to 3.8%. Yet markets are currently assuming that the recent spike in inflation will be transitory. Even the Federal Reserve acknowledge this view could be wrong. FOMC Chair Jerome Powell recently stated "as the reopening continues, shifts in demand can be large and rapid and bottlenecks, hiring difficulties and other constraints could continue to limit how quickly supply can adjust, raising the possibility that inflation could turn out to be higher and more persistent than we expect". Should inflationary expectations continue to build then interest rates may well rise earlier than expected, inevitably resulting in a correction on sharemarkets.

Valuations

In the United States, operating earnings for S&P 500 companies are currently expected to rise by 53% in 2021 and 13% in 2022. Using these forecasts (and assuming a 10% growth rate in 2023) and conventional long-term multiples, we estimate that the United States sharemarket (as measured by the S&P500) is overvalued by between 31% in the near term and 14% over the medium term.

2021 calendar year forecast	EPS earnings estimates	S&P 500 Fair Value estimate	Over/(Undervalued) S&P 500 = 4,298
Consensus	$187	2,980	(31)%
If 10% below	$168	2,687	(37)%
If 10% above	$205	3,285	(24)%
2022 calendar year forecast	**EPS earnings estimates**	**S&P 500 Fair Value estimate**	**Over/(undervalued) S&P 500 = 4,298**
Consensus	$210	3,363	(22)%
If 10% below	$189	3,027	(30)%
If 10% above	$231	3,699	(14)%
2023 calendar year forecast	**EPS earnings estimates**	**S&P 500 Fair Value estimate**	**Over/(undervalued) S&P 500 = 4,298**
Consensus	$231	3,696	(14)%
If 10% below	$208	3,328	(23)%
If 10% above	$254	4,064	(5)%

Source: S&P consensus estimates for 2021 and 2022 as at 10 June; 2023 is an assumption.

In contrast, forward Price-to-Earnings (P/E) multiples remain broadly above longer-term averages in other major markets, but less extreme, as follows:

Region	MSCI Forward PE[1]
All Country World (ex-US)	15.7
Emerging Markets	14.2
United Kingdom	13.1
Japan	16.1
Euro Area	17.0
China	16.1

There is an argument that valuations based on a historical multiple of earnings should be adjusted in this low interest rate environment. Yet when assessed against arguably Warren Buffett's favourite long-term value indicator, the ratio of total stock market value to GDP, we find that the outcomes are altogether not dissimilar.

Aggregate US Market Cap	US$52.7 Trillion
GDP[2]	US$22.1 Trillion
Buffett Indicator (a/b)	233%

[1] Forward PE = price divided by 12-month forward consensus expected operating EPS

[2] Federal Reserve Economic Data (FRED), https://fred.stlouisfed.org/, Denominator - Q1 GDP.

Source: E. Yardeni, J. Abbott and M. Quintana, *Global Index Briefing: MSCI Forward P/Es*, Yardeni Research, Inc., New York, 2021.

Conclusion

Market theory has been predicated on minimal government intervention so it is ironic that markets are testing new highs while being artificially stimulated by government and central bank policy interventions. It follows that the current exuberance in global markets, driven by debt fuelled policies, is unsustainable. Markets aren't necessarily ignorant to this reality but are currently betting on the ability of policy makers to withdraw stimulus at just the right time, and at just the right magnitude, to barely cause a ripple through asset prices. We think this is giving policy makers way too much credit. As we are in unchartered waters, untested strategies inevitably increase the potential for error. Given the increasing risks and expensive valuations, we recommend investors start to take some profits and gradually reduce exposure to global equities to underweight positions.

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