Global equities

A decade after the global financial crisis, a mixed bag of growth

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Key takeaways

- The overvaluation of structural growth stocks, such as technology stocks, is unsustainable, in our view.
- For markets used to easy money, the transition to a more 'normal' period for central banks is likely to pose a challenge.
- The European market looks a lot more attractively valued than the US, especially those stocks more sensitive to the direction of the economy, such as banks.

The outlook for global growth has become more mixed. While the synchronised economic expansion that I discussed in this piece last year is less widespread today, it should still be sufficient for corporate earnings to grow. Amid continued regime change – quantitative easing has given way to quantitative tightening, and interest rates are rising – the US continues to press ahead, while there is less momentum elsewhere.

In the 10 years since the global financial crisis, what does this mean for global growth? We see the US continue to be propelled by fiscal stimulus and still-supportive domestic financial conditions. Europe and Japan are following at a still-healthy but clearly decelerated pace. In the meantime, China's economy is losing steam and it is unclear how successful attempts to reinvigorate activity through renewed credit and fiscal stimulus can be against the backdrop of leveraged balance sheets and trade tensions with the US. The uncertainties over global trade, combined with the tightening of dollar liquidity, are weighing on emerging market economies across regions, even if to different degrees.

We're clearly in a phase of transition now that we are entering a more 'normal' period for central banks globally. For markets used to easy money, it's unlikely to be an easy transition. Expect bouts of volatility along the way. Even the two-day rally at the close of October 2018 couldn't rescue global stock markets from a dismal reality: It was their worst month in more than six years (since May 2012). Discouraging earnings forecasts from some of the world's largest technology groups had triggered a wider sell-off, reigniting fears that the longest bull market in history had come to a halt.

Overall, it's a positive story for most equity markets, and third quarter corporate earnings on both sides of the Atlantic have offered some reassurance. However, financial markets have been beset by worries for some time over rising interest rates and a slowing global economy. At the top of the list are concerns that the US/China trade relationship is likely to continue to worsen into year's end; that US tariffs on Chinese goods are set to move higher in a few months; and that trade talks have broken down.

The transition could be all the more stark for the US equity market given that it was supported in 2018 by a one-time repatriation of earnings held abroad by US corporates, with much of the money used to buy back stock or increase dividends. As we go into 2019, however, it is unlikely that the US equity market will remain as well-supported on this measure as in the previous year.

Anticipating the end of the business cycle

The US equity market is clearly anticipating the peak of the business cycle and, consequently, it fears that a recession may come soon. That has influenced recent flows into the more favoured structural growth stocks, such as technology. We still see this sector as overvalued. In our view, the real investment opportunities lie outside of the US as we look to exploit the valuation disparities between the US and the rest of the world.

The US equity market has never been more expensive compared to other regions, skewed by technology stocks. The so-called FAANMG stocks (Facebook, Amazon, Apple, Netflix, Microsoft and Google's parent company Alphabet) have dominated market performance this year, seeming to promise relentless growth based on society's digital revolution. Tech company growth rates have been considered relatively resilient to escalating trade tensions as well. The market has continued to narrow with its focus on growth, while paying little regard to valuations. These six technology-related stocks have contributed around two-thirds of global equity returns so far this year. In my view that isn't sustainable.

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I remain focused on valuations and the potential for markets to generate sustainable returns over the long-term. As such, I am more constructive on the prospects for European, UK, and Asian markets over the next few years in regard to their ability to generate returns. Europe, for example, currently offers some of the best investment opportunities, in my view. On the whole, the European market looks a lot more attractively valued than the US, especially those stocks more sensitive to the direction of the economy, such as banks.

We are seeing strong companies trading at significant discounts to their intrinsic worth. With the era of easy money coming to an end and interest rates rising, the pendulum could swing in favour of cheaper sectors such as financial services stocks, which tend to benefit from rising interest rates. Given the concerns around Brexit, the UK stock market looks incredibly undervalued. A lot of UK-domiciled stocks are trading at very low valuations relative to their global peers, suggesting that much of the 'bad news' has already been priced in.

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Meanwhile, there are signs that a rotation could be underway from growth to value stocks given the recent downturn. Major revenue shortfalls reported by both Amazon and Alphabet triggered their largest share price falls in years, creating a gap for other sectors to perform, such as energy and health care.

While the US macro picture has not worsened since early October, there has been a steady drip of disappointing news from elsewhere. At the time of writing, Brexit negotiations are still ongoing, and there remains the risk that the UK Parliament could vote down any eventually agreed-upon deal, in which case there might not be enough time (or willingness on the part of the EU) to negotiate a new one before next April. The Italian government's face-off with European authorities has not been resolved, and China and the eurozone have slowed more than expected this year.

Amid a slower period of economic growth than in 2017, we can assume that markets will continue to worry about the end of the cycle going into next year. However, we believe that over the medium term economic growth will be sufficient for most equity markets to deliver decent returns.

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