August 27, 2020

How far have markets run ahead of themselves?

While we are optimistic about 2021, valuations look to have raced too far ahead and are vulnerable to short-term disappointment.

“Of course, markets always anticipate the economy to some extent. However, we believe they are doing so now in an extremely optimistic way. A lot can happen before companies earn what their current high valuations suggest they should.”

Stefan Kreuzkamp
Chief Investment Officer

Rarely have we expected financial markets to offer so little return potential over a 12-month period as we do now. And not because our economic forecasts are particularly pessimistic. On Covid-19 our assessment of the future course of the virus is neither exceptionally optimistic nor gloomy. In fact, we have largely been able to stick to our virus model from the spring. But we see many reasons to be cautious. The most dynamic part of the economic recovery – the bounce back from lockdown – should already be behind us. Now the somewhat more arduous phase is beginning, in which incremental improvements will most probably be smaller. Some of the repercussions of the pandemic might only become apparent now, as the various types of short-time work expire. There could also be a wave of bankruptcies among smaller companies. And so there will be setbacks, even though the overall direction of the economy should remain upward – provided there is no second, large-scale lockdown. While companies and societies will continue to strive to improve their coexistence with the virus, not all sectors will benefit equally.

It is valuations that are the reason for our low return forecasts. Many stock indices are again trading near or above their pre-coronavirus highs. Risk premiums on corporate bonds have also narrowed almost entirely back to pre-crisis levels. It's almost as though Covid-19 never happened.

And yet this is all quite understandable. In addition to record fiscal aid packages, very benevolent central banks have contributed to the positive sentiment. Given low nominal and real interest rates, there is again no real alternative to equities. Additionally, many institutional investors have not yet raised their equity quotas to pre-crisis levels, and many first-time investors are flooding the market.[1] The demand for investments is there. The problem this causes is that valuations are back to the levels seen at the turn of the millennium. That is why we are becoming wary. Despite central-bank interventions, equities remain risk investments with a strongly fluctuating earnings profile. The equity risk premium does not disappear, even in a time of low interest rates. And, as the example of Japan shows, central-bank largesse and ultra-low interest rates do not guarantee rising share prices. At some point earnings would have to follow suit. With earnings, as is the case for share prices, the market dichotomy has widened as a result of the Covid-19 crisis. A number of U.S. technology companies were able to increase profits even during the crisis and are constantly achieving new record valuations. In the short term, this sector, in a similar way to healthcare, may well continue to outperform the market. But in the longer term the air will become thinner. Even the frontrunners may struggle for breath.

[1] https://www.cnbc.com/2020/05/12/young-investors-pile-into-stocks-seeing-generational-buying-moment-instead-of-risk.html

We expect government-bond yields to move sideways. We do not believe that inflation will become a major concern for investors over the next 12 months. Corporate bonds from developed countries should continue to be supported by central-bank purchases but most of the spread tightening is likely already to have happened. As for the dollar, we expect a slight recovery from current levels.

In this environment, we believe alternative investments are worth looking at. Given low real yields and rising global debt, gold should retain its appeal as a hedging instrument. Private-equity investors might also be in for a promising vintage. Real estate, on the other hand, is more inconsistent than ever. Although some segments are seeing significantly higher yields, retail and office real estate are likely to remain under pressure for some time to come as people shop less in high streets and more online, and work from home more, too. The situation is clearer when it comes to sustainable investment and ESG rankings, which now extend across all asset classes. This year, sectors with high exposure to climate transition risk, such as energy, automotive and materials, have clearly underperformed.

In short, as exciting as the next twelve months will be, we expect little market upside while corrections in the market certainly cannot be ruled out. Risks that are already on the horizon could easily provoke them. The escalation in the U.S.-Chinese technology dispute, setbacks in the fight against Covid-19, the failure to reach an agreement on the U.S. stimulus package, or manoeuvers in the run up to or aftermath of a bitter U.S. election could easily lead to something not at all surprising: another hot autumn for the markets.

Look at our forecasts to see our 12-month outlook in numbers.

GLOSSARY

A corporate bond is a bond issued by a corporation in order finance their business.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

A hedge is an investment to reduce the risk of adverse price movements in an asset.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling

In economics, a nominal value is not adjusted for inflation; a real value is.

Private equity is a direct or indirect investment by a financial investor in a substantial part of a company's equity. Usually the company invested in is not listed.

The real interest rate is the nominal interest rate adjusted for inflation as measured by the GDP deflator.

The risk premium is the expected return on an investment minus the return that would be earned on a risk-free investment.

The spread is the difference between the quoted rates of return on two different investments, usually of different credit quality.

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