Investment **Research**

By V. Ghotgalkar, D. Page and F. Wenzel, Research & Investment Strategy

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US equities – risks skewed to the downside

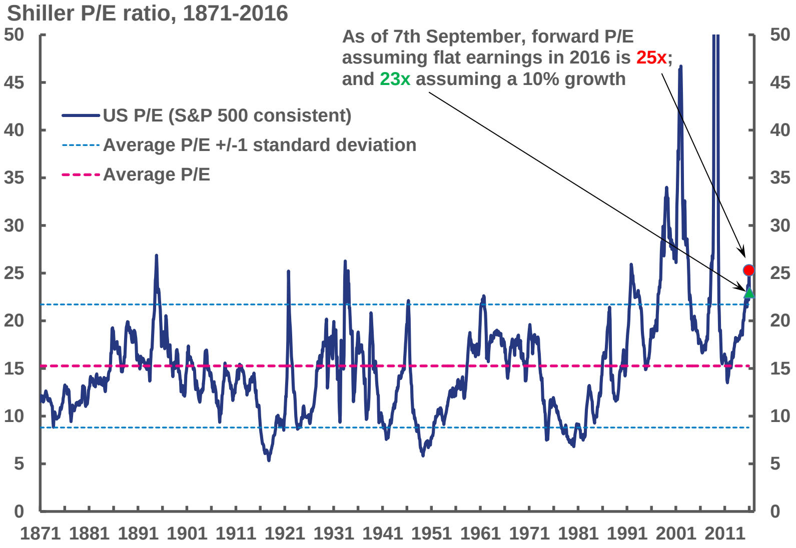
Positive sentiment versus flat earnings growth and rich valuations

Key points

- We see the recent rally as short-lived and maintain our cautious stance on equities. With negative earnings growth and expensive valuations currently contrasted by relatively positive sentiment, risks appear to be skewed to the downside for US equities and thus for global equities since the US accounts for over half the market.
- US economic activity appears to be quickening although reluctance to increase capex persists and global trade remains subdued. Political uncertainty remains elevated and equity markets seem relatively complacent about November's presidential elections.
- Valuations are rich on several metrics and the main catalysts, liquidity and earnings, have run their course. Analysts' estimates of 11% earnings growth are ambitious and downward revisions are likely. US earnings growth has now been negative for the last four quarters and the recent rise in unit labour costs does not bode well.
- Market sentiment is tilted towards optimistic while volatility is low. The long US equities trade now appears to be crowded and S&P 500 performance is diverging from quite a few indicators.
- In our asset allocation recommendations, we remain underweight on global equities. Within equities, we are neutral on the US on the back of its defensive appeal and relatively strong macro-economic position.

Exhibit 1

Valuation stretched even assuming 10% eps growth



Source: Robert J. Shiller website and AXA IM Research

Recommended asset allocation

Global allocation	Short term (3-6M)	Medium term (12-24M)
Cash	=	=
Equities	🔴	🔴
Government bonds	=	🟢
Credit	🟢	=

▲/▼ Changes of the month

Source: AXA IM Research

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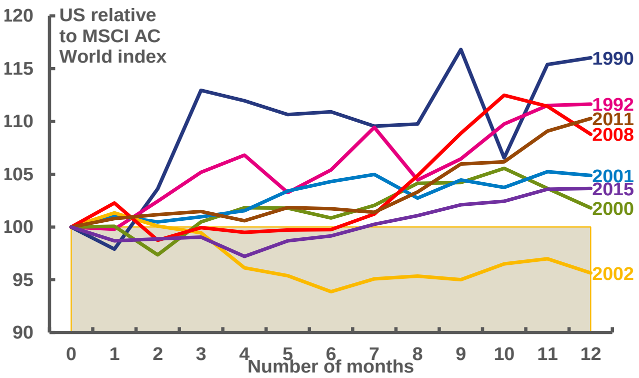
The rally since late June has been driven by upside surprises in US economic data and investors re-risking post Brexit. We take an all-round approach to evaluate the US equity markets and summarise our views on six key drivers, namely, macro-economics, politics, valuations, earnings, sentiment and technicals. All in all, we see the recent rally as short-lived and that risks appear to be skewed to the downside for US equities.

In our asset allocation, we remain underweight on global equities, neutral on government bonds and overweight on credit. Within equities, we are neutral on the US due to the 'safe haven' status it enjoys in adverse markets and its relatively healthy macro position compared to other developed economies. Given its low beta (0,95), the US tends to offer safety during weak global performance, frequently even when it is at the root of the problem. On average, US equities have generated 4.7% alpha over one year holding periods when global equities have been down. The US has outperformed in all negative years for global equities except 2002, which is attributable to idiosyncratic risks (*Exhibit 2*).

Exhibit 2

US outperforms in global equity bear market years



Source: Datastream and AXA IM Research

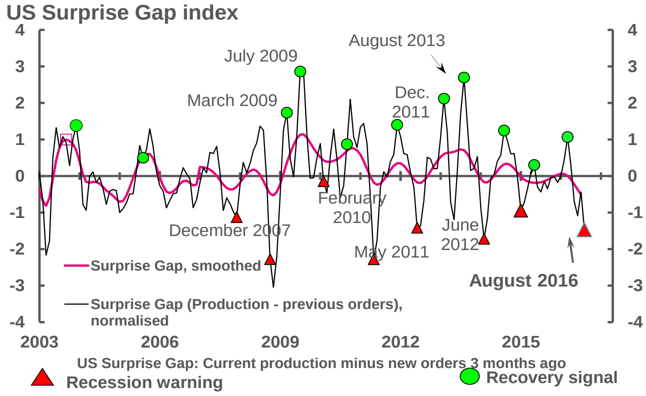
Relatively resilient macro-economic backdrop

Global growth remains fickle with no meaningful acceleration in sight for 2017. Consensus opinion is that we are in the late cycle stage globally and economic indicators are sending mixed signals. The recovery in the US has been relatively resilient, supported by the consumer. In the short-term, US economic activity appears to be quickening having suffered four subdued quarters to Q2 2016 (annual growth of 1.2%). Solid consumer spending growth and moderate employment growth should combine with an end to inventory contraction to support moderate overall growth over the coming four quarters. Regional surveys have shown improvement from the start of the year, although recent figures are more mixed. Consumer confidence indices remain robust. We forecast US growth to accelerate from 1.6% in 2016 to 2.0% in 2017. Conversely, we forecast the growth outlook to slightly deteriorate for the euro area, from 1.5% in 2016 to 1.2% in 2017.

However, the reluctance amongst US businesses' to increase capex and several recent mixed signals for growth momentum are weaknesses in the US outlook. Moreover, there is little sign of improvement in productivity – something that has particular relevance to elevated unit labour costs, despite an ongoing modest pace of wage growth. The surprise gap has also rolled over to contraction mode in recent months (*Exhibit 3*).

Exhibit 3

US surprise gap index now in the red



Source: Datastream and AXA IM Research

The Fed looks within striking distance of its mandates, with unemployment to fall below its expectation of the long-run rate over the coming years and inflation to reach its goal by 2018. With the Fed's policy objectives within sight, it appears likely that policy stimulus will be reduced. Hawkish commentary appears to be testing market resilience to a rate hike. We do not forecast a sharp tightening anytime soon and forecast a 0.25% December hike this year and only one more hike in 2017. The markets are not entirely convinced, with the probability of a rate increase by year-end around 55%. The FOMC[1] expects more tightening in 2017 and 2018 than us or the markets. Concerns about international developments, financial market uncertainty and low productivity levels continue to weigh on monetary policy normalisation.

Increasing political uncertainty

Attention is turning to November's elections and global policy uncertainty is elevated (*Exhibit 4*). To date, equity markets have seemed relatively complacent. Assessing the post-election outlook is difficult because: we don't know who the next President will be; the full extent of proposals; nor how much either President would be able to pass through Congress, with the possibility of a political logjam. While we believe the timing of the elections is likely to impose only a marginal influence on Fed decisions over the coming months, we think the outcome of the election could be material for the outlook for monetary policy and potentially the composition of the FOMC. In two previous publications, we reviewed the outlook for the US presidential elections and considered the economic and financial market ramifications of the possible outcomes[2]. Increased uncertainty caused by Brexit concerns is likely to persist for a while and is

[1] Federal Open Market Committee

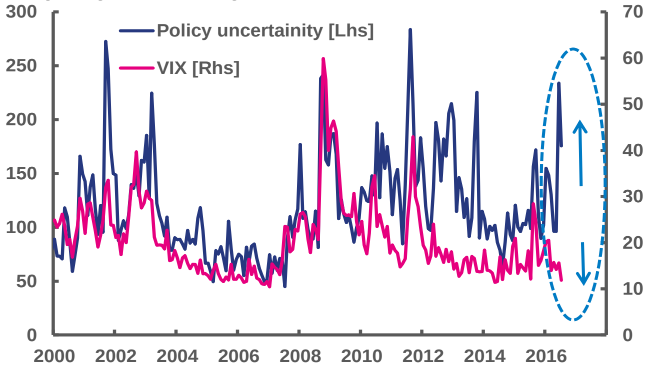
[2] (1) Page, D., "US elections: a post-primary primer - Part 1", AXA IM Research, 3 August 2016; (2) Page, D., Ghotgalkar, V. and Venizelos, G., "US elections: a post-primary primer - Part 2", AXA IM Research, 8 August 2016.

compounded by the Italian referenda. Policy uncertainty in the euro area is at an all-time high.

Exhibit 4

Divergence in rising policy uncertainty and volatility

US policy uncertainity and VIX indices



Source: Baker, Bloom & Davis, Bloomberg and AXA IM Research

Stretched valuation multiples

The US stock market is at all-time highs with valuations rich on several classical metrics. The Shiller price-earnings ratio (P/E), which looks at the latest earnings and prices (S&P 500) currently trades at around a 25x multiple assuming zero earnings growth in 2016. The last time we observed such elevated valuations in a rising market was in early 1992 and then in the late 1990s/early 2000s when the technology euphoria overextended valuations (*Exhibit 1*). In both cases, future market performance followed the path of earnings growth.

The main catalysts for equity markets, namely liquidity and earnings, have mostly run their course and even turned negative in momentum. The consensus growth hypothesis of 10% (next 12 months) brings forward multiples down to 23x, which is still stretched. To bring valuations back within the one standard deviation band, earnings growth needs to be more than 15%, which looks ambitious in the current economic environment.

Earnings growth is however just one element and we need to account for interest rates when valuing financial assets. As we all know, valuations and interest rates typically have an inverse relationship; lower interest rates imply higher valuations and vice versa. Although, historically this relationship has changed somewhere around 3% in real yield terms (*Exhibit 5*). Typically, beyond this threshold lower real yields do not drive multiple re-rating, but rather de-rating because of the growth scare and the diminishing effectiveness of monetary stimulus. Data from the mid-1950s, with the exception of 2008, would argue for a lower P/E multiple.

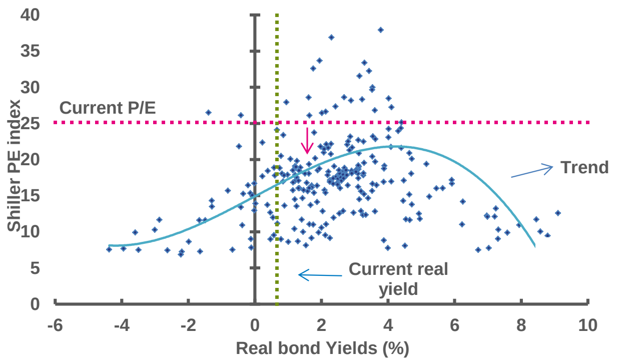
This time has been different, with unconventional monetary policy (i.e. quantitative easing) supporting markets despite weak earnings. Liquidity has been at the heart of the rally since 2011. Although still ample, the impulse of (US) liquidity is fading. Excess liquidity (the gap between real narrow money supply and production growth) appears to have peaked and off late has had a diminishing impact on multiple expansions. We therefore see little scope for any meaningful re-rating in US equities.

Another approach would be to compare the inverse P/E to a (real) bond yield. The current gap implies a risk premium just shy of 4%, suggesting current levels are expensive compared to trend and at best neutral based on a long term average; nonetheless it does not make a compelling argument to buy US equities.

Exhibit 5

Real yields currently suggest lower valuation multiples

US real yields & P/E



Source: Robert Shiller website, Datastream and AXA IM Research

Optimistic consensus earnings estimates

Consensus expects 12-month forward earnings growth of 11% and 13% for 2017. We think downward revisions are likely and expect 2016 US earnings to remain close to flat and edge up in 2017. The market rebound has been helped by improving expectations, although reported earnings remain weak. Elevated cash pay-out ratios (cumulative dividends and buybacks) indicate low management confidence in growth prospects and imply lower sustainable growth rates.

Exhibit 6

Earnings error contains a large cyclical element

USA: ISM & earnings error

Source: Datastream, AXA IM Research

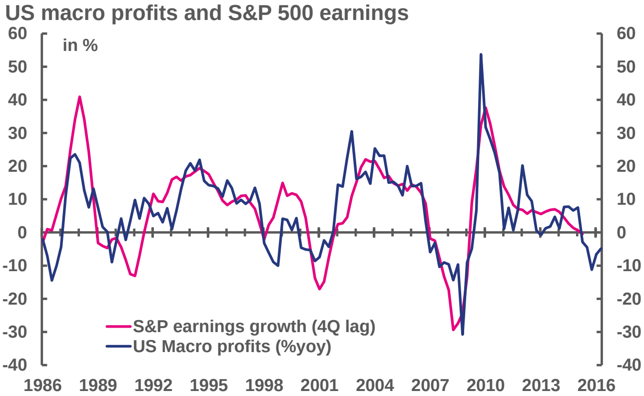
US earnings contracted by 4%yoy in Q2 2016 and 8% in Q1. Earnings growth has been negative now for the last four quarters. Weak numbers have been ignored by investors as they beat consensus estimates. However, the positive earnings surprises have been negligible (less than 5%) and can be attributed to the steep downward revision from earlier this year. Any meaningful earnings surprises are unlikely in the near term without a pickup in macro-economic activity due to the large cyclical element in the earnings error (ratio of reported earnings and consensus forecasts for the period) (*Exhibit 6*).

Margins have peaked with our leading margin proxy signalling some further contraction. Unit labour costs have gradually risen for the past five years and should build cost pressures. The stronger dollar will continue to weigh on corporate America and feeble top lines should persist amid weak global nominal growth. US IP, a near proxy for volumes, has steadily declined for almost 12 months. Macro profits contracted by 6.5% in Q1 and 4.7% in Q2 2016. S&P 500 earnings typically lag macro profits by three to four quarters (*Exhibit 7*). Factory orders and capex remain weak, signalling low confidence in earnings prospects. Global trade remains subdued and OECD[3] industrial production shows limited signs of retracement.

Exhibit 7

S&P 500 earnings lag macro profits by one year

US macro profits and S&P 500 earnings



Source: Datastream, Bloomberg and AXA IM Research

Market sentiment and technicals

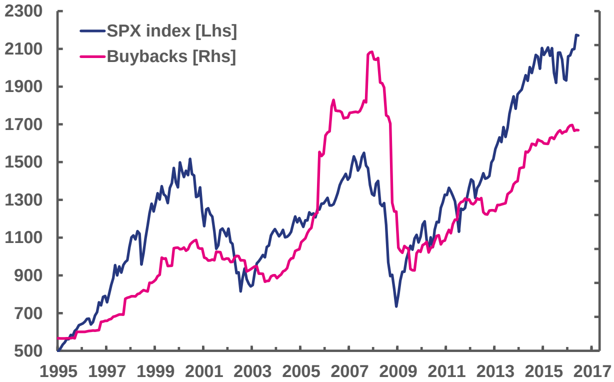
Buybacks have been the biggest driver of the markets but are losing steam (*Exhibit 8*). Corporate purchases are slowing down as there are naturally limits to capital structure optimisation. Debt is cheaper than equity only till a tipping point, beyond which further leverage increases aggregate cost of capital. Mergers & acquisitions' activity is also down 12% year to date relative to the same period last year and declined 22%qoq in Q2. More recently, markets seem to demonstrate an anchoring bias, welcoming good news and over-looking bad news due to the highly pessimistic expectations in place.

Sentiment indicators mostly suggest the mood is tilted towards optimistic. The bull-bear deviation from trend is elevated while fear indicators, although cooled off post Brexit, remain close to five year highs. Our risk appetite barometer is neutral and signalling elevated systemic risk appetite. Pair wise correlation is low and credit spreads continue their decline. The VIX[4] is near all-time lows, trading in the vicinity of 13%. Hedge fund betas are elevated and surveys suggest that they are net long US equities, with the highest exposures in a year. US equities now appear to be a crowded trade with CFTC[5] net speculative positioning fairly elevated and overweight positions at the maximum in a year, close to its upper standard deviation band while short interest is estimated to be at three year lows. Alternatively, the Ted Spread (three month Libor and T-bill gap) is closer to post global finance crisis highs. Dispersion within analyst estimates is rising and cash holdings are relatively high compared to history.

Exhibit 8

Buybacks the biggest market driver are cooling off

S&P 500 price and buybacks indices



Source: Bloomberg, AXA IM Research

The recent rally is contrasted by redemptions from equity funds and was helped by the defensive positioning going into Brexit. Demand for equities stemmed from short covering, futures purchases and buybacks. US equities have seen net outflows from almost all major foreign investors this year. A drop in primary market activity has also favoured the supply mechanics.

All in all, we appear to be in risk on mode with positive sentiment and low volatility. Given recent performance, momentum remains buoyant. The S&P 500, back to pre-Brexit levels and around all-time highs, does appear toppish, overbought and at the upper bound of its trading envelope. US market cap to GDP is now at 135% and the S&P 500 is diverging from several indicators, hitting new highs despite a strengthening dollar and falling oil prices. Similar divergences took place in the run-up to August/December 2015 before sharp corrections.

Conclusion

The risks challenging equities currently outweigh the reward and we maintain our cautious stance. Negative earnings growth and rich valuations are contrasted by positive sentiment. However, investor sentiment tends to be impulsive, unstable and typically elevated around market peaks. The heightened political uncertainty only strengthens the case to be vigilant.

We see several upside risks for US equity markets. The first stems from inflows caused by a rotation into equities by investors desperately chasing returns in the prevailing ultra-low yield setting; the second more fundamental support for equity markets in the medium term would be a rebound in earnings growth, itself possibly underpinned by an acceleration in productivity growth. Lastly, large fiscal stimulus as discussed by both presidential candidates also provides upside risk to US equities.

[3] Organisation for Economic Cooperation and Development
[4] Chicago Board of Opinions Exchange's volatility index
[5] US Commodity Futures Trading Commission

Our Research is available on line: **http://www.axa-im.com/en/research**

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