Global Markets Overview

Special Report: Equity

25 June 2020

Equity bull or bear?

1. Assessing equity attractiveness

At the time of writing, the S&P 500 and MSCI World equity benchmark indices have recovered significantly from their lows three or so months ago. What caused the recent upswing to reverse the large drawdown in large cap US equity prices that we saw in February and March? The US jobs report shows unemployment in the US was 13% in May.

The COVID-19 equity market crash was the fastest ever bear market, when looking at the Dow Jones Industrial Average index. The current US equity rally has been the fastest since 1933. Are equities completely detached from the fundamental outlook? Or is pricing reflecting that the global economy is out of the woods with the trough in economic data at the end of April?

Is now the time to increase exposure? Or to reduce?

The recent equity market sell-off beginning in February coincided with a dramatic sliding in fundamental indicators of the real economy. Some of this is temporary, caused by enforced short-term cessations of economic activity ("lockdowns"). With the stringency of economic lockdowns easing in most major economies, it is the shape of recovery that is key to the outlook from here.

In this report, we summarise our recommendations and set out bull and bear cases for equities to help highlight the wide range of possible outcomes and their drivers.

2. Recommendations

Considering the full balance of risks, we have the following recommendations:

- Reduce exposure to equities, where investors are either unable to withstand near-term downside risks or have less portfolio diversification. Drawdown risks are elevated for the rest of 2020 compared to an 'average' year. Protracted earnings and market risks also remain elevated (the left tail of outcomes from here is worse than usual);
- Potential outcomes are far wider than usual – retain both upside optionality and downside protection to equity exposure where possible;
- We expect high divergence in equity returns between countries, industries, and companies to continue. Likely future return dispersion is an ideal time for skilled active management;
- Maximise the amount of portfolio diversity and continue to be dynamic where possible.

3. Bear case

Equity markets are priced to perfection when considering the near-term outlook for fundamentals.

US equity prices have rallied significantly since March lows. Valuations have increased around 20% since the recent market bottom and risk premia have reduced. What is driving this? Q1 showed a record quarter in retail brokerage activity as "stay at home" policies spurred a record quarter for retail brokerage sales. Market structure analysis from some of our preferred hedge funds suggests much of the rally is retail driven.

Institutional investor equity positioning remains light. However, consensus forward earnings (a measure of institutional analyst expectations) also depict a "V shape" earnings recovery, with US earnings reverting to near prior levels by 2021. This mirrors bottom-up analyst discourse that prior earnings are increasingly relied upon to forecast the future, given the current situation of an unprecedented number of companies forgoing earnings guidance given the high levels of uncertainty.

Implicit in a "V shape" recovery narrative is an environment of no further "lockdowns", a swift recovery in employment (supportive of corporate earnings) and a high level of government and central bank policy success. Given the level of monetary and fiscal support, a reversion to similar earnings at the aggregate index level is a plausible outcome consistent with our optimistic outcome in our scenario framework – though does not reflect the full range of high probability outcomes from here.

As economies open, more lasting unemployment will replace temporary furlough schemes – many buy-side, sell-side and central bank estimates forecast double digit unemployment in advanced economies at the end of 2020; alongside a second wave of bankruptcies in the second half of the year. This is as at least as high as US unemployment in the Global Financial Crisis. From an equity market perspective, these represent headwinds to corporate profits and are consistent with lower spending and earnings within the economy – this is a scenario which is not priced in.

Current expectations and valuations, therefore, leave markets very vulnerable to re-pricing, if the narrative behind these valuations (that future earnings will quickly look like past earnings) changes.

Looking to history - following a structural equity bear market, a second drawdown is more common than not, historically retesting the prior lows if the economy is in a recession. This is consistent with analysts and investors updating to new negative information – if estimates of more lasting job losses and hits to earnings become apparent.

4. Bull case

US forward guidance is for "unlimited" further monetary and fiscal support from here, consistent with economic support to increase the speed of an economic recovery.

The extent of monetary policies is consistent with a significant regime change (upwards) for the valuations of equities in the "next normal". Over 2020, the Federal Reserve will print half the total of new US dollars that it printed between 2009 and 2018, to support asset purchases of Treasuries and corporate bonds. Record corporate debt issuance is underway with $1 trillion of issuance in the US so far. The extent of this global stimulus is goliath – the USD money supply is likely to double this year to allow the government and central bank to support the economy (and therefore asset prices).

Monetary and fiscal policies have proven highly effective in supporting corporate earnings and fundamentals for listed assets since their inception in March. The impact of huge stimulus packages on equity pricing is twofold:

- A support to earnings, particularly large corporates with easy access to capital markets. US companies are particularly adept at productively using cheap resources to grow earnings. This has an additional knock on impact of increasing valuations, to reflect higher future earnings growth;
- A distortion in risk premia, inflating prices relative to fundamentals as investors are pushed along the risk spectrum. As Treasury yields decline and markets price lower credit risk to corporate bond markets supported by Central Banks, the relative attractiveness of assets with higher upside potential to cashflows increases.

Central bankers moved very rapidly to reduce interest rates and longer-term yield costs to combat the impact of the pandemic, e.g., the US policy rate was cut by 1% to effectively 0%. As a very approx. rule of thumb, if we assume constant risk premia and growth expectations, a 1% reduction in long-term rates leads to a 25% increase in equity fair value. We now have record low yields in the US and across global central

Equity bull or bear?

Assessing equity attractiveness

banks. Forward guidance is for a continuation of this cheap-money regime for a protracted period of time, to reduce the cost of borrowing on record high levels of global debt. The duration of the global economy has effectively increased materially.

Once we leave the current crisis (and assuming economies evade the worst of the left tail risks – which we still assign a roughly 10% probability to), we can expect higher price tags attached to the same equity cashflows, when compared to the last era (structurally higher valuations). A caveat to this is the potential for changes to taxation and regulatory environments for large corporations.

5. Conclusions

The cessation of economic activity we have seen in 2020 is new; policies of this scale and speed to provide direct support to households and businesses are also new; therefore, some of the impacts are unknowable. We are currently in the "aftershock" phase of the initial economic impact of the Coronavirus economic cessation. This increases the range of probable outcomes from here: there has never been a more important time for exposure to diverse risk drivers.

Uncertainty is high – sell-side bottom-up analysts are "flying blind" and anchoring to prior earnings in an environment of a record number of companies forgoing earnings guidance. As we continue to assess the corporate earnings environment, more dynamism than usual is warranted for investors able to be nimble.

On the other side of this crisis, our central expectation is for a significant change higher in valuation regime. New money printing and quantitative easing have the potential to materially distort market pricing compared to recent history.

On the balance of risks, an environment with such large economic shocks is an environment in which diversification and capital preservation are key. A retesting of a recent market drawdown has to date happened 100% of the time that the US equity market has fallen 30% or more when the economy is in a recession. We recommend a portfolio approach that maximises diversity, and considers left-tail hedges and contingent upside exposure, reflecting elevated downside and upside tail risks.

Asset Research Team

Disclaimer

Disclaimer

Willis Towers Watson has prepared this material for general information purposes only and it should not be considered a substitute for specific professional advice. In particular, its contents are not intended by Willis Towers Watson to be construed as the provision of investment, legal, accounting, tax or other professional advice or recommendations of any kind, or to form the basis of any decision to do or to refrain from doing anything. As such, this material should not be relied upon for investment or other financial decisions and no such decisions should be taken on the basis of its contents without seeking specific advice.

This material is based on information available to Willis Towers Watson at the date of this document and takes no account of subsequent developments after that date. In preparing this material we have relied upon data supplied to us by third parties. Whilst reasonable care has been taken to gauge the reliability of this data, we provide no guarantee as to the accuracy or completeness of this data and Willis Towers Watson and its affiliates and their respective directors, officers and employees accept no responsibility and will not be liable for any errors or misrepresentations in the data made by any third party.

This material may not be reproduced or distributed to any other party, whether in whole or in part, without Willis Towers Watson's prior written permission, except as may be required by law. In the absence of our express written agreement to the contrary, Willis Towers Watson and its affiliates and their respective directors, officers and employees accept no responsibility and will not be liable for any consequences howsoever arising from any use of or reliance on this material or the opinions we have expressed.

Towers Watson Limited (trading as Willis Towers Watson) is authorised and regulated by the Financial Conduct Authority in the UK.

About Willis Towers Watson

Willis Towers Watson (NASDAQ: WLTW) is a leading global advisory, broking and solutions company that helps clients around the world turn risk into a path for growth. With roots dating to 1828, Willis Towers Watson has 40,000 employees in more than 140 countries. We design and deliver solutions that manage risk, optimise benefits, cultivate talent, and expand the power of capital to protect and strengthen institutions and individuals. Our unique perspective allows us to see the critical intersections between talent, assets and ideas — the dynamic formula that drives business performance. Together, we unlock potential. Learn more at willistowerswatson.com.

Towers Watson Limited is a limited liability company registered in England and Wales under registered number 5379716.
Registered address: Watson House, London Road, Reigate, Surrey, RH2 9PQ, United Kingdom

Willis Towers Watson