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Resilient US equity market reluctant to pass the baton

Our weekly view on Asset Allocation

26 April 2021

US equity market remains resilient

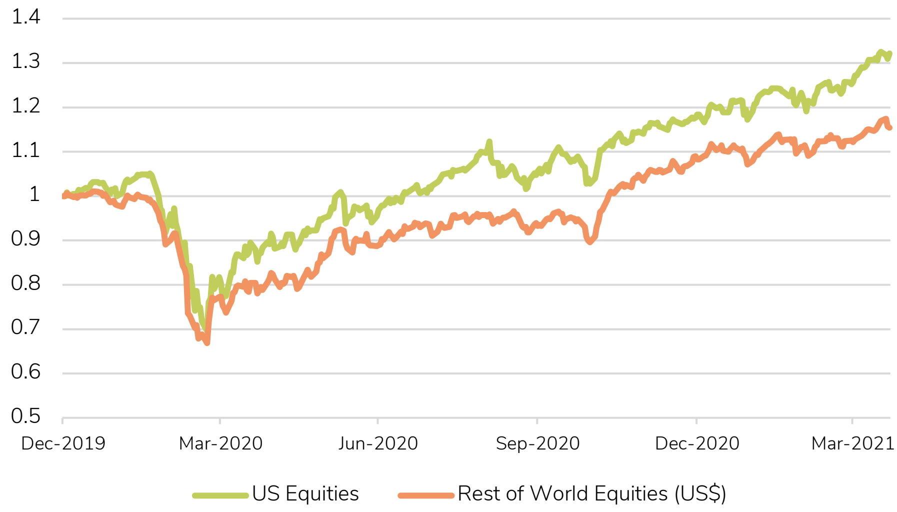
The US equity market continues to surprise many market pundits with its almost uninterrupted ascent. Global equities have enjoyed a very strong rebound over the last 12 months, and the US market has, for the most part, led the way.

With vaccine driven recovery hopes buoying equities over the last 6 months the more cyclical/value markets in the "rest of world" have enjoyed a degree of relative outperformance versus the US. We see this as likely to be the dominant trend of the coming year. However, the US has regained leadership recently as bond yields have retreated from their March highs helping the long duration US tech sector catch a fresh bid. This leadership switch is likely to be temporary, but the resilience of the US market and the US tech sector specifically is encouraging for the sustainability of the global equity rally.

Australia has underperformed the US significantly over the last 12 months in local currency terms (49% to 35% total returns before currency adjustments). Still, when the appreciation of the A$ is considered (20% appreciation over 12 months), Australia is ahead of the US market in common currency performance terms.

We still see at least some moderate upside to the A$ as global growth improves and expect Australia can outperform the US in common currency terms over the next 6 to 12 months. However, we see Australia as likely to be a market performer versus the rest of the world.

Exhibit 1: US and rest of world equity market performance



Source: Refinitiv, Wilsons.

Exhibit 2: US outperformance peaked last October but has revived recently

Source: Refinitiv, Wilsons.

US equity valuations are peaking but holding

Despite ongoing concerns around over-valuation, US market valuations have shown a high degree of resilience even in the face of rising bond yields and the Biden Administration's stated intention to raise the US corporate tax rate.

The PE multiple for the US market (and indeed all markets) looks to have peaked, but at just over 22x the valuation of the US market has barely budged from its highs.

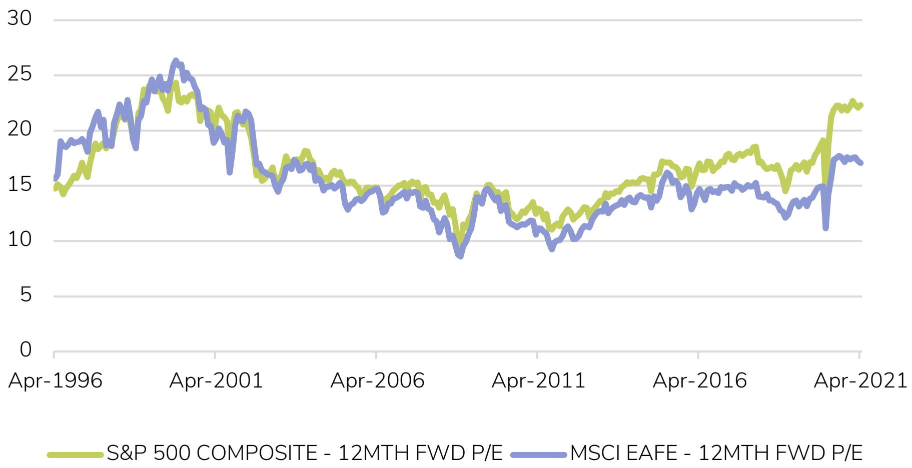
The US market's ability to hold its premium multiple is likely a function of the huge additional fiscal stimulus being injected into the US economy at present, alongside tangible re-opening optimism as the US vaccine rollout gathers pace. The recent moderate reversal in the ascent of the US 10-year bond has also given the US market fresh impetus in recent weeks.

Ultimately, we believe PE multiples will trend lower (as rates move higher). However, global equity markets can still deliver solid returns given the prospect of strong earnings growth over both calendar 2021 and 2022. While earnings growth estimates are already strong, we think the risk is that estimates are actually upgraded further over this year as the global economy gathers momentum.

While US earnings have upside risk, particularly in the near term, we ultimately see more earnings growth and more upside risk to current earnings estimates in the rest of the world versus the US, over the next 12 to 18 months (alongside lower starting valuation multiples). Equity markets in UK/Europe and Asia tend to be more cyclical than the US. This drives our 6 to 12-month preference for the rest of the world, notwithstanding the superior structural growth credentials of the tech laden US equity market.

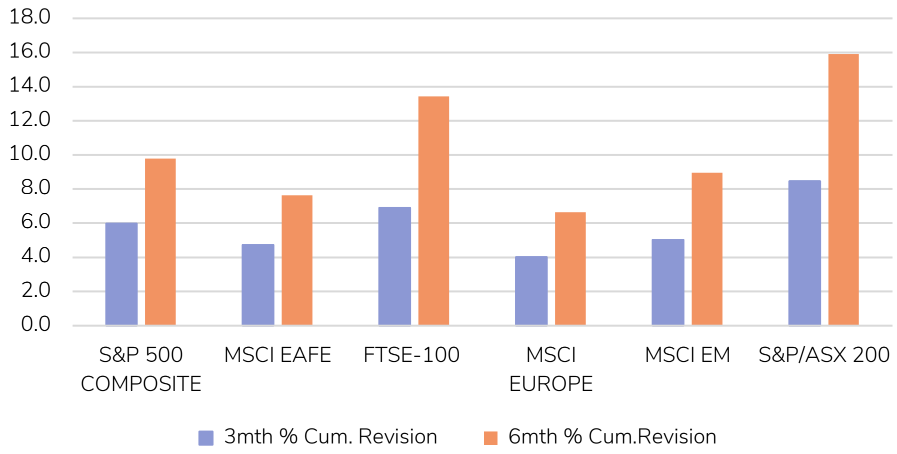
Aligned with this view is the prospect of an ongoing revival in the value style, which should favour the "rest of world" versus the US. Growth has been the dominant investment style of the last decade. Yet, value has outperformed growth over the previous 6 months as optimism over future economic prospects build and higher bond yields place some degree of pressure on "growth stock" valuations.

Exhibit 3: Valuation re-rate looks to have peaked but multiples proving resilient



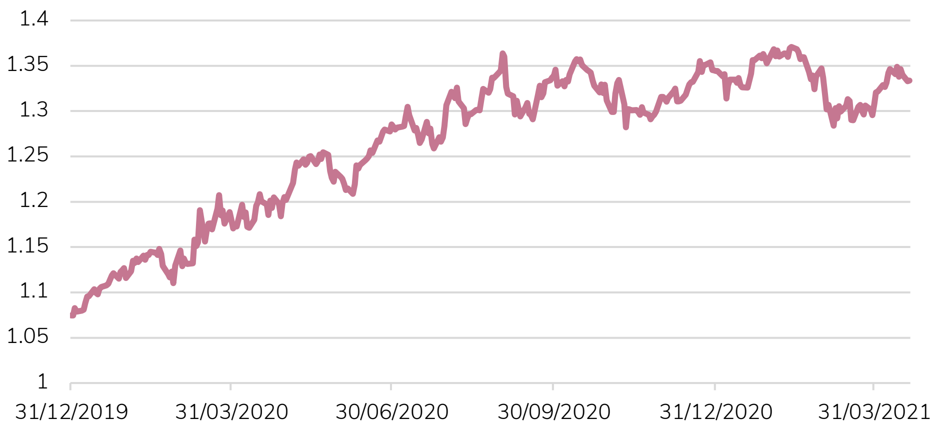
Source: Refinitiv, Wilsons.

Exhibit 4: US EPS revisions still stronger than R of W but Australia and UK strongest



Source: Refinitiv, Wilsons.

Exhibit 5: Global IT sector performance relative to global equities (from outperformance to market performance)



Source: Refinitiv, Wilsons.

The US is leading the global earning recovery but more upside for rest of world from here

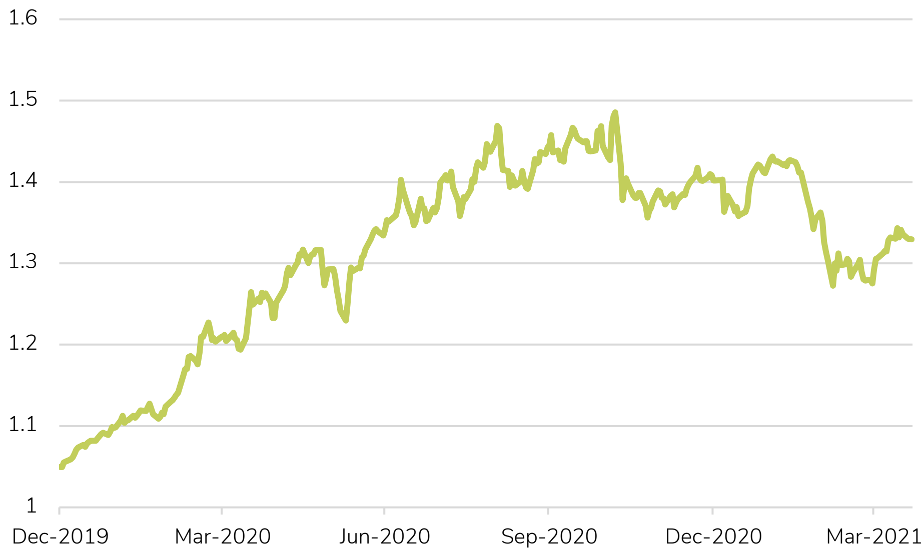
Consensus EPS upgrade momentum has been broad-based, with all major countries and regions seeing upgrades over the last 6 months. The US has shown the longest, most consistent upgrade trend (8 consecutive months of upgrades). We expect the current US March quarter reporting season to be supportive given the improving US GDP growth backdrop, however, we believe upgrade momentum will progressively shift in favour of other regions as the world re-opens.

Interestingly, even Europe, which has been in rolling lockdowns for some time, has delivered consistent upgrades in recent months. The ability to deliver upgrades against a backdrop of a Covid constrained economy suggests there is still significant upgrade potential in UK/Europe as economies re-open.

Resources and banks driving strong earnings upgrade trends in Australia

Australia has seen the strongest upgrade momentum of any major market over the past 3 and 6 months, led by big upgrades to the resources and banking sectors, and we believe there is more upside. The risk to bank sector estimates is still likely to the upside as the economy continues to surprise (lowering bad debt provisions), while the rebound in the iron ore price suggests resource estimates will once again prove too low.

Exhibit 6: Growth style outperformance versus value style looks to have peaked for now



Source: MSCI

Emerging Markets (GEM) have had a strong rebound over the past year, helped by China's superior economic performance due mainly to superior virus control. However, GEM has experienced some underperformance this calendar year.

This is likely due to a combination of transient factors:

1. the revival in the US$ (which seems to be fading),
2. concerns around China policy tightening, and
3. the skirmish between big tech in China and local regulators.

We are still attracted to the medium-term prospects for EM with strong earnings growth potential and reasonable valuations. We don't think China's tightening will be as aggressive in this cycle as Chinas stimulus last year was actually quite measured compared to the West.

This contrasts to previous global downturns where China employed massive levels of stimulus followed by fairly aggressive tightening to control speculative excesses. China's tech heavyweights are currently being reigned in terms of their dominance, but we believe China will still look to encourage national champions, so we don't think the operating landscape is set to become too draconian.

More broadly, the Emerging Market complex normally responds well to periods of synchronised global growth (and a weaker US$), so we still think the coming 12 months for EM should be constructive.

Returns to moderate but 12-month outlook for global equities remains positive

Overall, we remain constructive on global equities due to the supportive backdrop of low interest rates and a recovering economic/earnings cycle.

US resilience impressive but rest of world offers more upside over the coming year

The impressive resilience of the US stock-market is encouraging, though we continue to believe there is more upside in the rest of the world (DM and EM) on a 12-month view given less expensive valuations and more earnings leverage to a re-opening global economy.

The lack of any correction of note in global stock-markets since March 2020 is perhaps cautionary but not enough in itself to take a negative 12-month view. We would be buyers of any dip in global equities, assuming our view of a durable global recovery balanced by a moderate inflation and interest rate pick up remains intact.

Exhibit 7: Global equities - consensus valuation and earnings growth outlook

	PE (12 Mth expected EPS)	CY20 EPS growth	CY21 EPS growth	CY22 EPS growth
World	20.4	-12	30	14
US	22.3	-9	25	15
Europe	16.7	-26	32	15
UK	13.8	-41	57	14
GEM	14.7	-7	36	16
Japan	17.5	-29	18	18
Australia	18.6	-20	23	10

Source: Refinitiv. UBS.

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures

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