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Equity Market Outlook

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What makes growth stocks attractive?

During the last couple of quarters, we have described the key equity market drivers where the authorities' actions to contain the spread of COVID-19 have caused economic uncertainty, while the unprecedented fiscal and monetary policy responses to support economies and capital markets have created strong tailwinds. Looking solely at the restrictive measures, it may have been difficult to understand the remarkable recovery of the equity markets, while the fiscal and monetary policy measures have dominated. In reality, central banks and governments are signalling that they will not allow major plunges in the housing or equity markets because the potential consequences are too great. This skews the risk balance in favour of equities.

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The prospect of negative real interest rates for a long time to come makes investors willing to pay more for a company's future earnings. That increases the valuation of equities. The current low level of interest rates does not necessarily signal a weak growth

outlook, as it normally would, because low rates are an effect of deliberate central bank action. We are also seeing an economic dichotomy where some companies are experiencing good growth, such as the healthcare sector and tech companies, while others are clearly in decline. Relative to the growth sectors of the economy, interest rates are too low, but interest rates are not set by this segment. As a result, growth companies will be experiencing structural tailwinds for a long period of time.

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Growth outlook supported by green investments and automation

With equity markets normalising in recent quarters, the focus is now on the long-term growth and inflation outlook. As we gradually learn to live with COVID-19 without extensive lockdowns, fears of recession will gradually diminish. Most likely, 2021 will be the "year of the vaccine", meaning that equity markets will increasingly be driven by economics and the outlook for corporate profitability.

Consumer spending is the most important factor for economic growth. The willingness of politicians to conduct expansive fiscal policies combined with the policy of central banks underpinning the housing and equity markets will support growth in consumer spending. Furthermore, we see a long and global green investment cycle where Europe, the US (especially if Joe Biden wins the presidency) and China will be investing heavily in the necessary energy transformation.

Hydrogen produced from sustainable energy is increasingly seen as the missing link in the transition to a fossil-free energy system. Hydrogen can be used as a fuel, but also as a storage medium. It can also be applied in industrial processes within steel, cement, heavy-duty transport and refineries. In other words, it can be used to decarbonise industrial processes, where green power is not an option. Hydrogen is currently not competitive with fossil fuels, but we expect this will change gradually. As described in its "Hydrogen Plan", the EU will actively support such a development.

Hydrogen is essential in order to achieve the climate targets. According to organisations like The Hydrogen Council and Bloomberg New Energy Finance (BNEF), hydrogen is expected to account for 20-25% of global energy consumption by 2050. Our current solar and wind power capacity will have to increase tenfold by 2050 for these visions to materialise, and according to UBS, it will require additional investments in solar and wind power and in energy grids of USD 250 billion annually until 2050. Such a wave of investments will support a long-term growth cycle and form a base for more sustainable and ultimately more productivity-led growth.

Moreover, we believe companies will increase their capital investments to expand their value chains and increasingly anchor supply chains more locally and closer to consumers. The latter is a consequence of the US-China trade war, which along with COVID-19 has exposed the vulnerability of the current single-source supply chains. Repatriation of production to western economies will result in, among other things, strong demand for automation technologies and digitalisation of manufacturing, as we have described in our White Paper "Fragmenting Supply Chains & the Rise of the Robots".

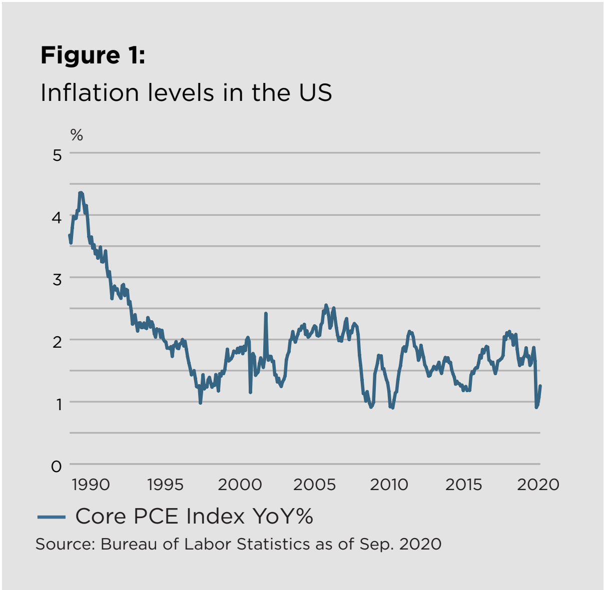
A sustained mild inflation outlook

Today, central banks have a range of monetary policy tools available. One option is "helicopter money", where large sums of new money are printed and distributed directly to the public. Another is to issue loan guarantees to banks to support lending, while a third method is for central banks to purchase bonds and other assets directly through the capital markets. The first two options involve the greatest inflationary risks and are thus the least attractive to equity investors. Central banks today mainly opt for the third option. The transmission mechanism via the capital markets has proven less inflationary and has had a positive effect on assets, such as equities and bonds.

As we have described in previous articles, history shows that pandemics have had significant deflationary impacts. This has primarily been the result of excess capacity due to a pandemic and more cautious consumer behaviour. The disinflationary effects of the digital transformation will furthermore help to limit the inflation risk due to the expansive fiscal and monetary policies.

As shown in figure 1 below, which depicts inflation trends in the US, inflation has not exceeded 2.5% since the early 1990s. This illustrates the power of the current deflationary forces and explains why the market continues to price-in US inflation to remain at around 1.6% per annum over the next 10 years.

Figure 1:
Inflation levels in the US



Source: Bureau of Labor Statistics as of Sep. 2020

This average-inflation-targeting approach will enable the Fed to allow inflation to move slightly higher before tightening its monetary policy. In other words, interest rates will remain low for longer, and that is the script for having positive equity markets.

On the other hand, it is now a long-term political goal to raise inflation, because this is the only acceptable way today to manage the current high levels of debt. This is also the background for the Federal Reserve's recent change of approach to inflation targeting. The target will now be to maintain inflation at an average of 2%, instead of as an absolute target.

This average-inflation-targeting (AIT) approach will enable the Fed to allow inflation to move slightly higher before tightening its monetary policy. In other words, interest rates will remain low for longer, and that is the script for having positive equity markets. Low interest rates support valuation, and companies with pricing power, i.e. the ability to raise prices without reducing demand, will see their earnings improve. It follows that equities can act as insurance against slightly rising inflation, unlike bonds, where the owners will see the nominal value erode.

We are facing a period of global, green investments in which Europe, the USA and China will be investing heavily in the necessary energy transformation.

Growth or value?

The growing divergence of returns between growth and value stocks has spurred a broad debate about the two asset classes. The price differentials have grown larger this year with some tech stocks appreciating by more than 30%, whereas some stocks in sectors such as banking, energy and transport have lost in excess of 30%. This polarisation is the result of an acceleration in the underlying trends, where COVID-19 accelerates the digitalisation trend, while the prospects of interest rates reaining low and yield curves staying flat are worsening the outlook for the banking sector, for example.

As a fundamental investor, we believe that equity valuation reflects a company's ability to generate earnings and the ability of its management to allocate capital in a disciplined manner. The concept of value stocks is basically about whether stocks are valued lower than the value an investor attributes to the company. However, the notion of value is often associated with companies that have low growth prospects and low ROE. We prefer stocks with sustainable and predictable growth that also produce a strong return on capital.

In an environment of marginally rising inflation, it is essential to be able to invest in companies with pricing power, and that is a typical characteristic of market-leaders with differentiated products.

From our perspective, many stable growth companies can today be termed value stocks. One example is the global food company Nestlé, which has good growth prospects and a high ROE. Assuming the company can grow earnings by about 5% annually over the next five years and that it will pay an annual dividend of about 2.5%, the annual return to shareholders could be 7-8% expressed in CHF. By comparison, investors in Swiss

government bonds will have to make do with a negative return of about 0.5%.

Short-term market noise vs the value of sustainable growth

The upcoming US presidential election will undoubtedly dominate the headlines in the fourth quarter and cause noise in the equity markets over the short-term. However, when we analyse historical developments, it turns-out that the political party affiliation of the sitting president rarely has had a lasting influence on the equity markets or the performance of specific sectors.

We therefore spend more time on understanding the long-term trends. There are numerous indications for believing that we can expect a new, positive investment-driven growth period. The central banks' choice of asset purchases as their policy method is positive for equities. Inflation may increase slightly over time, in line with political preferences. In an environment of marginally rising inflation, it is essential to be able to invest in companies with pricing power, and that is a typical characteristic of market-leaders with differentiated products. In a low interest rate environment, companies meeting the market's growth expectations will be in high demand. The challenge is to identify those companies. Compounding is dead in large parts of the capital markets. That means, compounding through growth companies being able to deliver will be more valuable than ever.

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