GLOBAL EQUITIES OUTLOOK:

UPSIDE POTENTIAL REMAINS IN 2022 – UP TO A POINT

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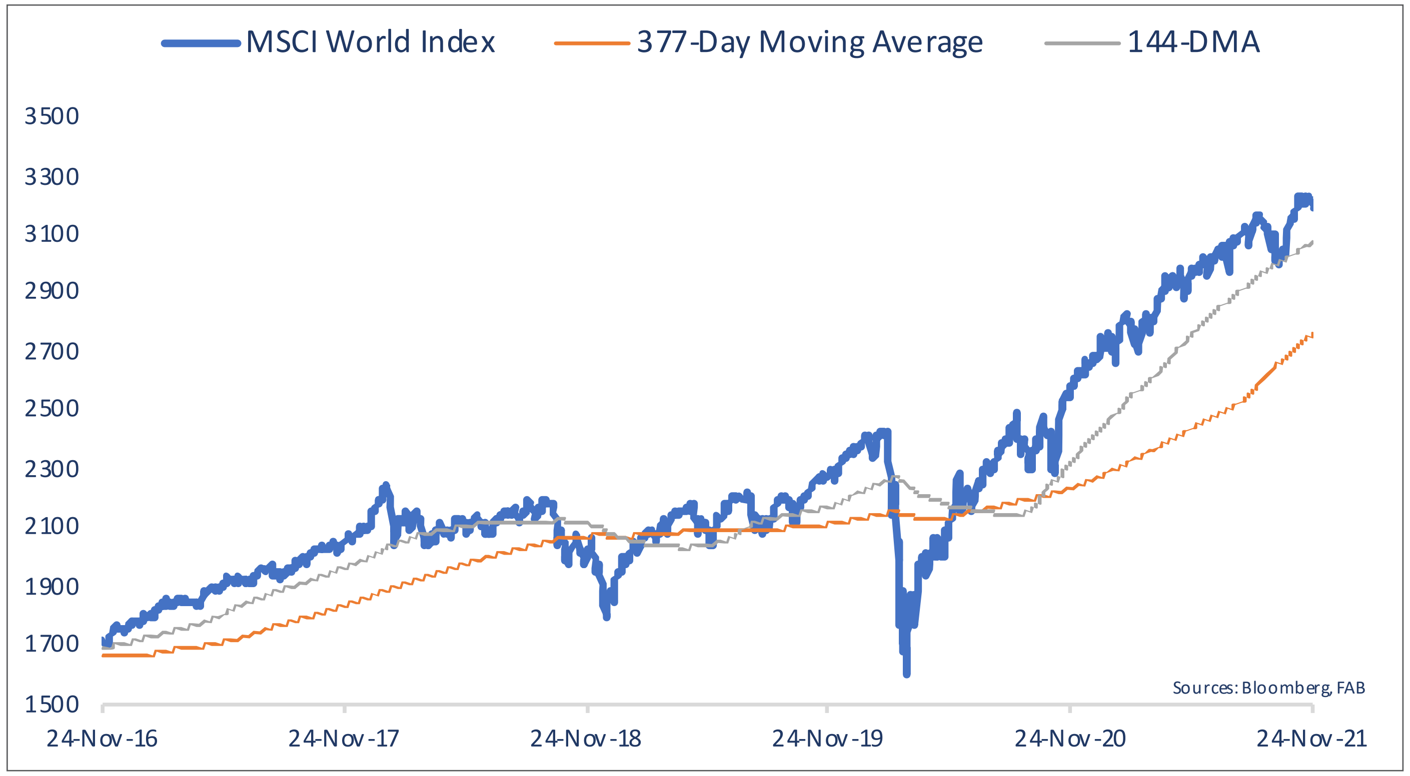
Last year's FAB Global Investment Outlook stated that "the stars are aligned for good gains in developed world equities in 2021, with potential appreciation of up to 20% from current levels". At the end of November, the MSCI World Index, which excludes emerging markets, was ahead by 20.14% for the year.

The FAB Global Investment Outlook for 2021 also indicated the S&P 500 could go to about 4,400 for a return of 18%, compared to the 'safe' Wall Street consensus of 9% at the time. By November 25th, the S&P 500 was still above 4,500 for a year-to-date return of more than 25%. It had climbed a proverbial 'wall of worry', facilitated by accommodative global monetary conditions. The massive tide of quantitative easing plus the quicker-than-expected progress on the vaccine front ensured that the 'flash' recession of 2020/21 was just that, and that it did not become a depression.

Many of the drivers of last year may be different this year. Global economic growth is decelerating, and the IMF is likely to revise its forecast GDP growth of 4.5% for advanced economies in 2022 (compared to 5.2% in 2021) and 5.1% in developing economies after expansion of 6.4% last year. However, the JP Morgan Global Composite Purchasing Managers Index stood at 54.5 in November after a low of 52.5 in August, so although global growth has slowed, the global economy is nonetheless expanding and reasonably healthy.



At the beginning of 2021, equity analysts were far too cautious in their forecasts, and the reversal of that position provided confidence and enabled investors to justify paying higher prices for stocks. However, the earnings 'beats' are now becoming far less numerous and it looks as though analysts have largely caught up. Major upside potential in earnings has fallen, although this is to be expected after an operationally-geared earnings recovery of such magnitude and as equity markets head into more normal times.

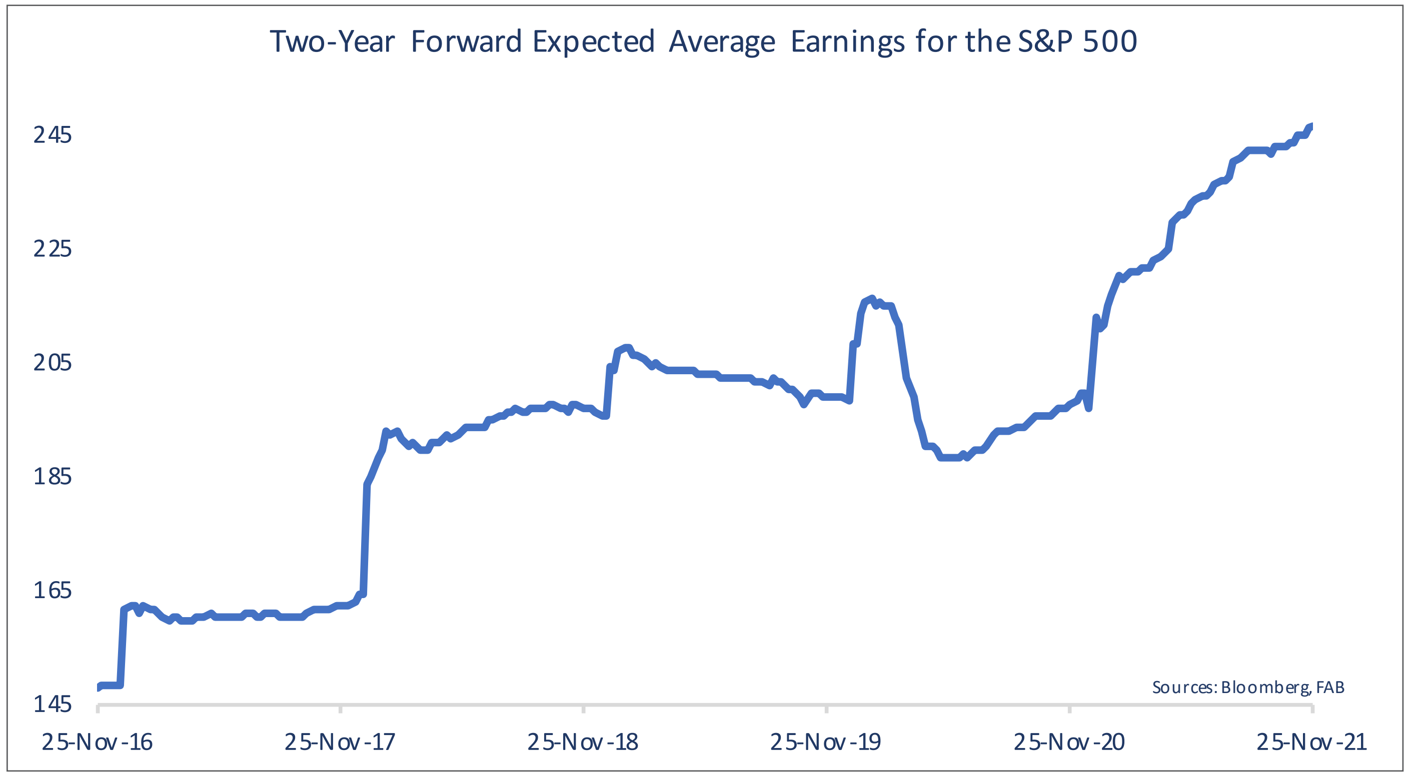
There are also the 'known' risks, which include recurrent COVID mutations, Taiwan, and the difficulties of understanding 'Common Prosperity' in China among others. On the face of it though, much is going right for global equity investors. US listed companies have taken inflation above 6% in their stride, essentially because their pricing power was much greater than expected. Meanwhile, supply chain disruptions are ebbing, and the next cyclical recession is probably more than a few years away.

Last year, the MSCI World Index was led by Energy (up 44.6% for the year to late November), Financials (31.6%), and Information Technology (27.8%), with Staples (9.4%) and Utilities (4.0%) as the laggards. Small-Cap Value outperformed (24.12%), and Mid-Cap Growth lagged (16.43%), although not by much, with major indices showing increasing breadth in their advances.

And, after a period early last year when value was leading, growth recovered to be slightly ahead of value (with gains for the year of 22.85% compared to 20.11%) at the end of November. This year, quality financials, healthcare, and selected technology names could outperform while consumer staples and utilities seem poised to continue to underperform.

Bull markets rarely end quietly, and usually go higher than expected. Despite last year's gains, a 'melt-up' is still possible as 'fear of missing out' takes hold. This, however, could die of exhaustion if the Fed's punch bowl is really removed, even if that of the ECB and BoJ are not. Extreme negative real rates have been a major bonus for equities and should moderate in 2022.

In mid-November, the S&P 500 Index was just above 4,700, trading on a consensus prospective P/E ratio of 20.97x for 2022 and 19.16x for 2023 based on earnings growth estimates of 7.45% and 9.44% respectively. The Bloomberg consensus is for average earnings of US$224.18 on the S&P 500 for 2022 and US$245.30 in 2023. Analysts have been revising earnings upwards although normalisation is likely to become apparent this year.



Going into the second half of 2022, investors will increasingly be using prospective 2023 earnings for their P/E calculations, the estimate for which could edge ahead (to perhaps US$250 for growth of about 11.5%) for a 2023 P/E of 18.8x, equivalent to an earnings yield of 5.32%.

Using FAB's Chief Economist Simon Ballard's forecast of a US 10-year Treasury yield of 2% or less for most of this year, and comparing that to the assumed earnings yield of 5.32%, the basic equity risk premium should be close to 3.32%. In recent years, equities have usually looked cheap versus Treasuries when their risk premium approaches 4.5% and expensive when it falls towards 2.5%.

Conclusions

- During the next 12 months, US corporate earnings are unlikely to do significantly better than what might have been expected in a 'normal' year, although that could now mean earnings growth of 10%-11% rather than the historical 9% annualised rate after the house-cleaning and extra technological innovation that resulted from the pandemic.
- US consumers are coping with the pricing power being exerted by many listed companies and they want to spend, although such abandon cannot continue indefinitely.
- If the likelihood of 'technologically-enhanced' earnings growth (i.e. 10%-11% vs. circa 9% compound historically) proves right, a 2023 P/E of about 21x can be justified, or slightly higher than the forward average.
- The above would equate to about 5,250 on the S&P 500 by the year's end, or 11%-12% above late November levels – potentially via a 'melt-up' sometime in 2022.
- The final third or so of most bull markets do end in this way, clearly without the next cyclical recession ever being in sight, because trees do not grow to the sky.

- A 'greed-induced' run to 5,250 on the S&P could weather a rise in the 10-year Treasury yield to 2%, but probably not much more. In reality, equity valuations would probably be hurt by a rise above 2.5% in the 10-year Treasury yield.
- Globally, investors should emphasise careful stock selection focused on quality. Europe and Japan have some excellent quoted companies, but the return on equity for the STOXX Europe 600 Index tends to be only about half that of the US S&P 500 (and similarly for Japan, which probably continues to be a long-term 'value-trap').
- There are usually good reasons for individual stocks or markets appearing cheap. For instance, UK equities as a class may look tempting, but the country is suffering from Brexit-related disruptions while the Labour Party is now beating Boris Johnson's Conservatives in recent polls, adding to the political uncertainty surrounding this market.

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