5 Equity markets: watch out for the swinging doors!

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The end of the first half of the year calls for an initial observation: the MSCI world gained about ten percent, thereby largely fulfilling its pledge. Everything seems for the best in the best of all possible worlds. What are the limits to this good mood of the markets? What should we expect for the second part of the year?

First signal of a deterioration in margins in the United States, but we can put it into perspective for the moment

Corporate margins measured at macroeconomic level (see graph 1), are showing the first sign of weakness (a second peak appeared in Q3 2016). This indicator interests us since on average since the Second World War, a recession appears 6 quarters after the margin peak. The oil counter-shock encouraged a rebound in margins whereas they had already reached an initial peak in Q3 2014 (oil shock). The same pattern had occurred at the end of the 1980s, also during an oil counter-shock, and the recession appeared 7 quarters after the second peak. Using this simple observation and given that on average the markets anticipate cycle peaks only one quarter in advance, the second part of 2017 should therefore still be immune.

Three other factors support this initial observation:

- corporate profits rebounded in Q1 on all continents (+28% in Japan, +23% in Europe and +14% in the United States)[1] and could continue to benefit from a favourable comparison until Q3 this year, even though it may be necessary to wait for the next earnings season (July) in order to gain a more precise idea,
- after a disappointing Q1 in the United States in terms of economic growth (GDP up by only +1.2% year-on-year), Q2 is expected to show an improvement, if only because of the weaker dollar in recent months. Historically low economic surprise indices could therefore rebound; over the last 10 years, Citigroup's index was lower only in 2008 and 2011,
- neither should hopes of tax reforms be abandoned. The approach of mid-term elections in the United States (November 2018) could ultimately facilitate the adoption of a few measures, even though they are likely to be less powerful than initially hoped and somewhat belated.

Nevertheless, let's not forget that in 1987, the market did not wait for the 7 quarters to which we refer in order to fall sharply. However, as long as US long yields move gently between 2% and 3%, this risk, which we highlighted in this publication in March[2], remains contained.

Equity markets are vulnerable to a sudden upward or downward movement in long yields

At first sight, the equity and fixed income markets do not appear to see things in the same way (decline in yields and increase in equities). And yet, US equities have also priced in the appearance of doubts with regard to tax reforms. This can be seen for example (see graph 2) in the underperformance of US small caps (+4% vs. +9% since the beginning of the year), which are more domestic and therefore potentially helped to a greater extent by any promised tax cuts.

In fact, the consolidation of long yields since the beginning of the year has helped US growth stocks, notably GAFAM[3] stocks which have broken records (+25%

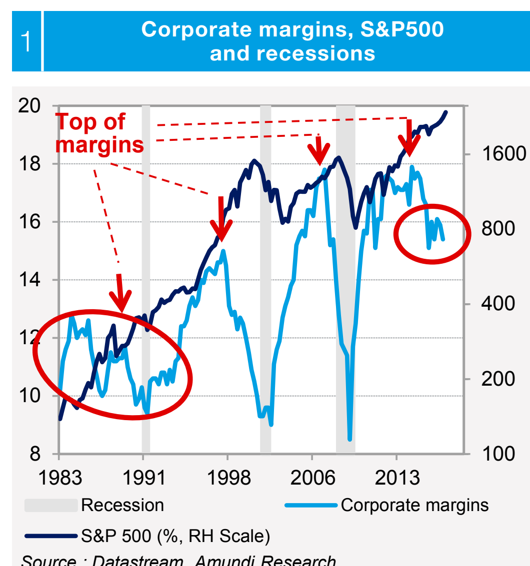
The essential

The signal launched by the deterioration in US companies' margins can for the moment be put into perspective. As long as US 10-year yields remain contained between 2% and 3% and corporate profits improve, which should be the case at least until the autumn given the favourable base effects, the equities cycle can continue.

But this is not without danger. Historically, towards the end of a cycle, there can be sudden movements between «Growth» and «Value» factors. At this stage, between monitoring the rise in US technology stocks, already very expensive growth stocks, or remaining overweight on eurozone equities, which are likely to benefit from a moderate rise in bond yields, our choice is made; we prefer the second option.

> "Margins that are topping out in the United States"

1 Corporate margins, S&P500 and recessions



Source : Datastream, Amundi Research

[1] See the June 2017 Cross Asset publication: "Lessons learned from the Q1 2017 earnings season"

[2] See the March 2017 Cross Asset publication: "France or the United States: where does the real danger lie for equity markets?"

[3] GAFAM: Google, Apple, Facebook, Amazon, Microsoft. These 5 stocks account for 12.5% of the S&P500 index's capitalisation

since the beginning of the year), come back into favour. Admittedly, bond yields are not the only factors responsible for the very sharp rise in GAFAM stocks; their profits also being very healthy (an average +20% increase is expected for these five stocks over the next 12 months and +13% excluding Amazon, vs. +10% for the S&P500)[4]. The good performance of these stocks has therefore contributed to the rise in the S&P500, which has reassured investors and helped maintain volatility at a very low level.

However, the rise in US stocks is not uniform. This mechanism is therefore vulnerable if bond yields were to rebound; growth stocks being very sensitive to them. However, 5-year inflation expectations have already returned to the level of current underlying inflation (around 1.7%), which militates in favour of considering that bond yields tend to be at the bottom end of their fluctuation range (see our bond yield scenario). Moreover, GAFAM stocks are already very expensive with regard to their PER (50x on average on the profits of the last 12 months and 26x excluding Amazon).

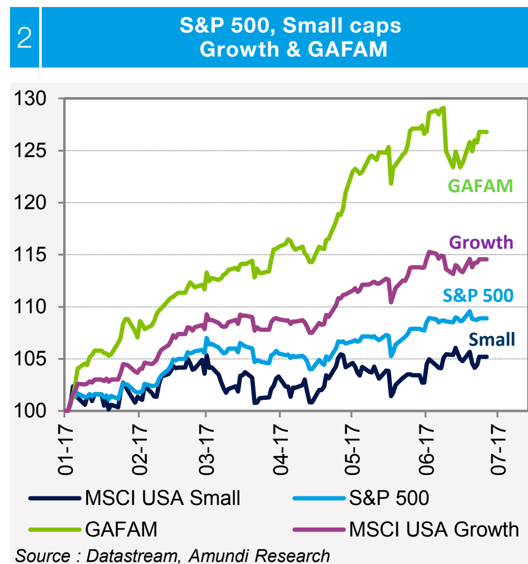
As the US market is expensive (the PER of the S&P500 is close to 20x the profits of the last 12 months), the other markets are benefiting from this situation and performing well. Our preference for eurozone equities has therefore been rewarded (see graph 3). This region is recovering from the political doubts (Brexit referendum, referendum in Italy, elections in the Netherlands and then in France). The argument is twofold: 1) a powerful operational effect on profits (+22% expected according to Ibes in the eurozone in 2017 vs.+10% in the United States), 2) a substantial valuation difference in favour of this region vs. the United States (adjusted PER for the cycle of 17x vs. 26.4x). We still consider these arguments to be pertinent, but they also have their limits. If, this time, bond yields were to fall again on a long-term basis, in parallel with a resurgence of deflation fears, the eurozone, with its abundant financial stocks, would be particularly affected. Here also, our forecasts in terms of bond yields tend to be reassuring (+0.6-0.8% on the Bund over the next 12 months) and therefore militate again in favour of this region's continued outperformance.

In light of this ambivalence between the outperformance of US technology stocks and European stocks, our global analysis of the «Growth» and «Value» styles provides an interesting clarification (see graph 4). It is worth remembering that when cycles that favour growth stocks occur (which is also the case this time), they always end in a three-phased exaggeration in favour of growth stocks. We are in the second exaggeration phase, which is propelling GAFAM stocks upwards… Following this movement as from now is therefore starting to present an asymmetrical risk/reward profile if our interpretation of the cycles of styles and our bond yield forecasts are correct; in other words, the «swinging door» risk is increasing.

However, a rebound in long yields towards the top of their range (compatible with an upturn in terms of economic surprises) would be compatible both with a moderate consolidation of the US market and renewed favour for the eurozone, driven by the rekindling of the «Value» theme, notably with regard to financial stocks. We therefore reiterate our regional preference for this region.

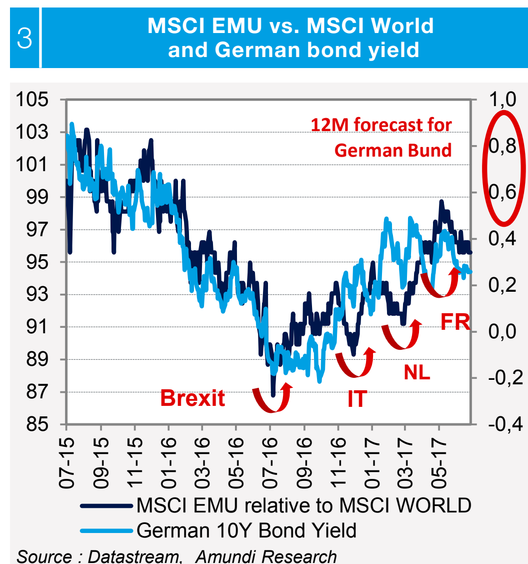
Conclusion

As long as US 10-year yields remain contained between 2% and 3% and corporate profits improve, which should be the case at least until the autumn given the favourable base effects, the equities cycle can continue. But this is not without danger. Historically, towards the end of a cycle, there can be sudden movements between «Growth» and «Value» factors. At this stage, between monitoring the rise in US technology stocks, already very expensive growth stocks, or remaining overweight on eurozone equities, which are likely to benefit from a moderate rise in bond yields, our choice is made; we prefer the second option.



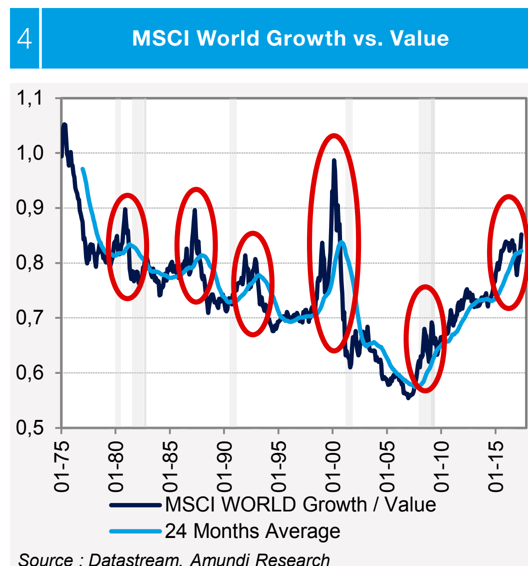
2 S&P 500, Small caps Growth & GAFAM

Source : Datastream, Amundi Research



3 MSCI EMU vs. MSCI World and German bond yield

Source : Datastream, Amundi Research



4 MSCI World Growth vs. Value

Source : Datastream, Amundi Research

[4] *12-month estimated profits according to Ibes: Google: +9%, Apple: +16%, Facebook: +19%, Amazon: 56%, Microsoft: +10%*

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