PICTET WEALTH MANAGEMENT

Global Equities - Taking stock after the shock

Awaiting better entry point amid scope for continued near-term turbulence

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FLASH NOTE

SUMMARY

- The correction in equity markets over the last couple of weeks is not particularly unusual, although events feel more dramatic given the prior period of low volatility. Equity corrections can start for a variety of reasons, but they rarely end until a 'growth scare' comes with some degree of investor capitulation (not seen yet).
- Our economists do not expect the current growth scare to be followed by a recession, the most likely catalyst for turning a tactical correction in stocks into a longer-term decline. However, while the longer-term outlook for equities appears benign, we expect the current period of elevated uncertainty and volatility to persist for a while longer and see a better entry point later this summer.
- While the S&P 500 is down 8% from its high on 16 July, our performance and valuation framework suggests that risk-reward remains skewed to the downside. We would feel more comfortable adding exposure when the index is back close to its 12-month average level (4900) and valuation is closer to its 10-year average of 17.9x based on forward 12-month earnings rather than the 19.4x level we see today.
- Post a 23% fall from its peak, the risk-reward profile for Japanese equities has improved significantly, with valuations falling to their lowest post-covid level at Monday's close (with the index's forward 12-month price-earnings ratio at 11.8x).

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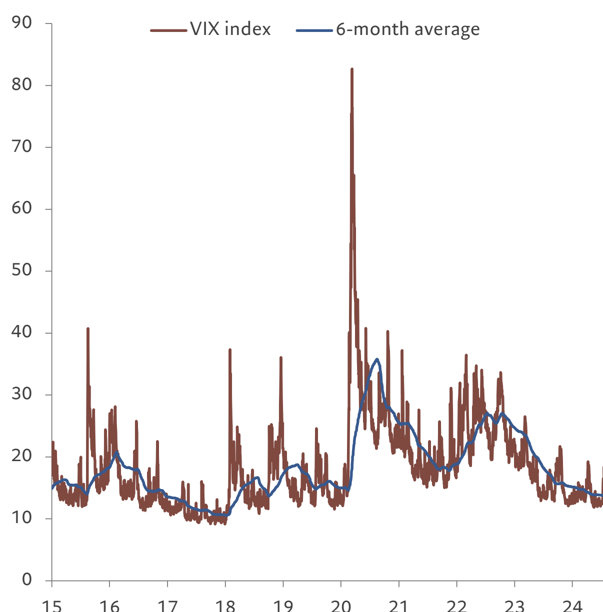
TOUGHER TIMES

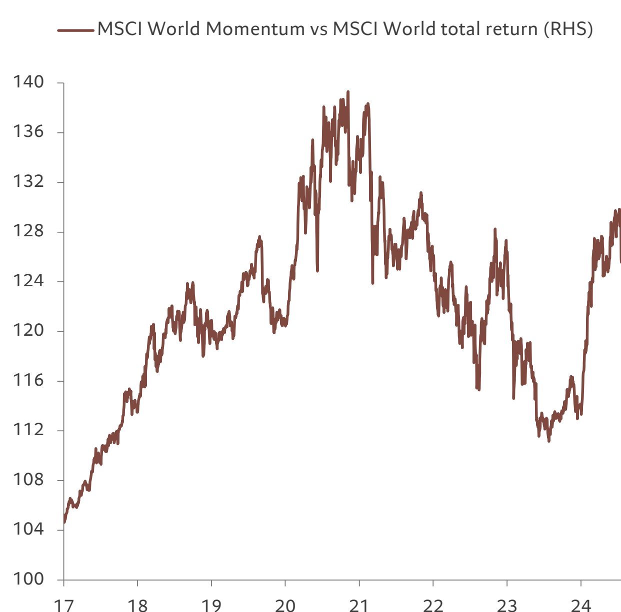
After a period of exceptionally low volatility, performance trends have shifted significantly over the last few weeks, raising broader macro concerns and producing one of the biggest trend reversals in recent years, as illustrated by a sharp downturn in the momentum factor *(chart 2).*

Chart 1: Volatility has jumped sharply from its prior 5-year low



Source: Pictet Wealth Management, FactSet, as of 05.08.2024

Chart 2: Significant unwinding of performance of MSCI World Momentum Index



Source: Pictet Wealth Management, FactSet, as of 05.08.2024

From our perspective, the outlook for risk assets had been deteriorating for the last couple of months. This contributed to the GIC's decision to reduce equity exposure at the end of June based on a number of factors, including:

1) Weaker macro news flow. Bloomberg's economic surprise indices turned negative during 2Q. Yet headline equity indices held up until early July, possibly reflecting stable credit markets and hopes for lower interest rates through 2H. However, a renewed dip in leading indicators in late July, coupled with signs of a deterioration in the US labour market, has raised recession fears.

2) Rising earnings uncertainty. The 2Q reporting season provided the usual level of earnings "beats" in both the US and Europe, but this is predominantly a backward-looking indicator and hence of limited comfort to markets. Looking forward, consensus forecasts for a healthy increase in earnings in 2H24 now appears to be challenged by weaker macro sentiment and a number of high-profile profit warnings (particularly relating to the consumer), which could signal weaker profit margins ahead. We expect earnings downgrades to accelerate from here (which would be consistent with the normal seasonal pattern for August-September).

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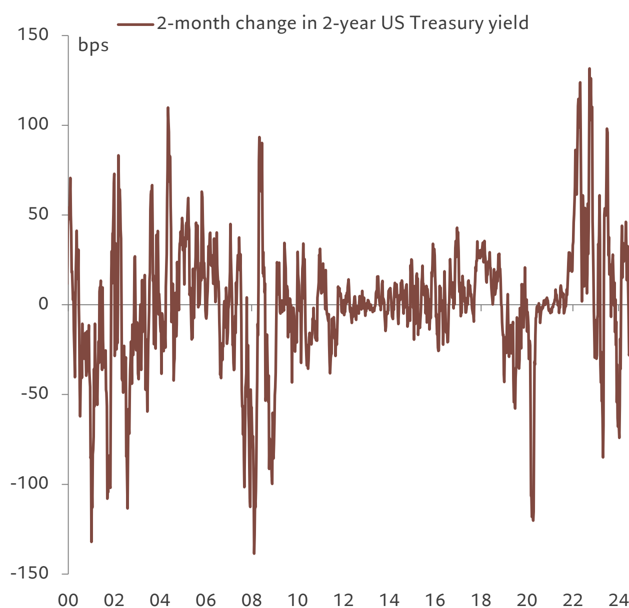
3) Geopolitical risk. The August-October period is often the most volatile (and least rewarding) for risk markets. This year has the added complication of the US election in early November and the risk of further escalation in the Middle East. Given the maxim that risk markets dislike uncertainty more than anything else, the current seasonal plus geopolitical backdrop constitute a considerable hurdle for investors looking to re-engage.

4) The yen. Although the yen only really started to appreciate strongly a week or so ago, it actually troughed versus the USD on 3 July, two weeks before the MSCI World peaked. The lack of visibility around carry trades in general is an incremental source of unease for investors trying to model upside/downside risk profiles.

EQUITY CORRECTION → GROWTH SCARE → CAPITULATION

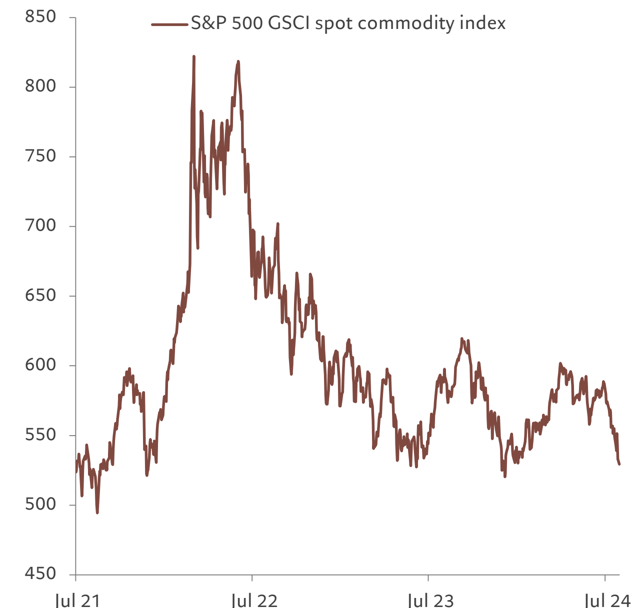
Experience tells us that it is hard both to time market peaks and identify the exact trigger that prompts equities to start falling. However, once the correction starts it often unfolds in three stages. First, a correction is initially viewed as a "market event". Second, this narrative then changes into concerns of a broader macro "growth scare". Third, this is followed by some degree of market capitulation as investors de-risk. At this time, we are most likely in stage two, as suggested by the sharp drop in interest rate expectations *(chart 3)* and commodity prices that are approaching three-year lows *(chart 4).*

Chart 3: Rare drop of over 100 bps in two-year US Treasury yields in space of two months



Source: Pictet Wealth Management, FactSet, as of 05.08.2024

Chart 4: S&P GSCI Commodity Index close to three-year low



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While the fall in Japanese stocks and the rise in the VIX may tempt one to assume that we have already seen some capitulation-like behaviour, we are sceptical of this point and note that the S&P 500 Equal-Weight Index is down less than 6% from its peak so far. It is also worth noting that investor inflows into equities were very healthy in July (despite the deteriorating backdrop described above) and CFTC data suggests that asset manager positioning in S&P futures was very elevated going into last week.

AWAITING BETTER RISK-REWARD PROFILES FOR STOCKS

We view the current turbulence in risk assets as more of a near-term tactical event than something that will derail the longer-term outlook for stocks. The most likely reason to change that assessment would be a larger-than-expected economic slowdown in the US (for example, if labour market weakness tips the economy into recession), which would open the door to lower equity valuations and earnings. As our economists discuss here, while a slowdown to below-trend US growth in 2H is on the cards, a recession is not.

Absent a recession, the longer-term outlook for stocks still looks good to us, although we believe the recent weakness in equity markets is likely to persist for a while longer and hence are in no rush to increase exposure at this time. While we think it is still too early to position strongly today, below are three catalysts that could stabilise equity markets:

i) An improvement in economic growth sentiment. In particular, this could involve an uptick in economic leading indicators or signs that the US labour market is not deteriorating significantly.

ii) Market capitulation. As discussed above, we don't believe this has happened yet and think it would only be triggered by considerably lower index levels than we currently see.

iii) Lower valuations. While non-US equity valuations are already reasonable, global stocks will continue to take their lead from the US where valuations remain more elevated (see below). Hence, our third catalyst is also only likely to kick in at index levels lower than at present.

BENCHMARKING THE CORRECTION

Periods such as this are always difficult for investors. This may sound obvious given the potential for capital loss, but markets are usually volatile on the upside as well as the downside. This two-way volatility challenges investors to keep a level head and avoid getting whipsawed by very short-term market behaviour. In this context, we believe it is important to maintain an appropriate performance and valuation framework to help balance the overall risk-reward outlook and to assess potential entry points ahead.

With this in mind, you can find some of our preferred charts for the main equity indices below.

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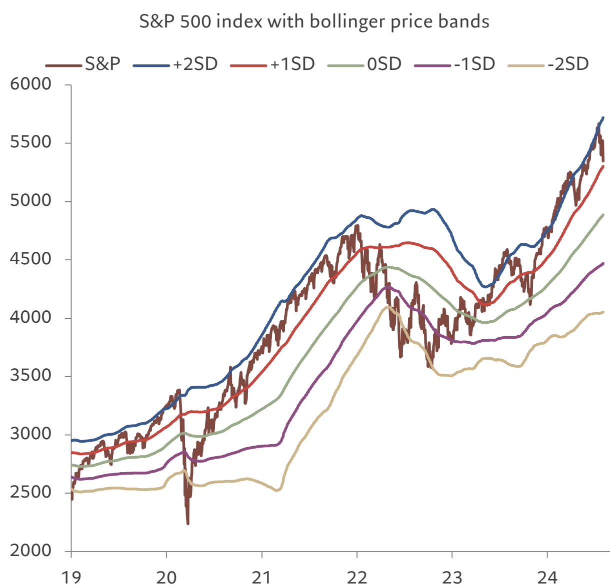
S&P 500 – Valuation still elevated, risk-reward looks better at 4900

Chart 7 plots the price performance of the S&P 500 alongside Bollinger bands that express the spot level in terms of standard deviations (SD) away from the 12-month average (also known as z-scores). For much of the last year we have been following a typical bull market pattern whereby performance regularly hugged the +1 to +2 SD thresholds. Given the headwinds discussed above we think this is unlikely to persist, but we do not see a bear market pattern emerging where the S&P 500 trends down towards the -2 SD level as in 2022 when very high inflation derailed all asset markets.

We believe the risk-reward profile becomes compelling if the S&P 500 falls back towards its 12-month average level of just below 4900 (representing neither a bull nor bear market regime). For investors wanting to frame bigger downside risks (which could range from recession to a geopolitical event or a bigger unwind of the carry trade) we would reference the -1 SD threshold just below 4500.

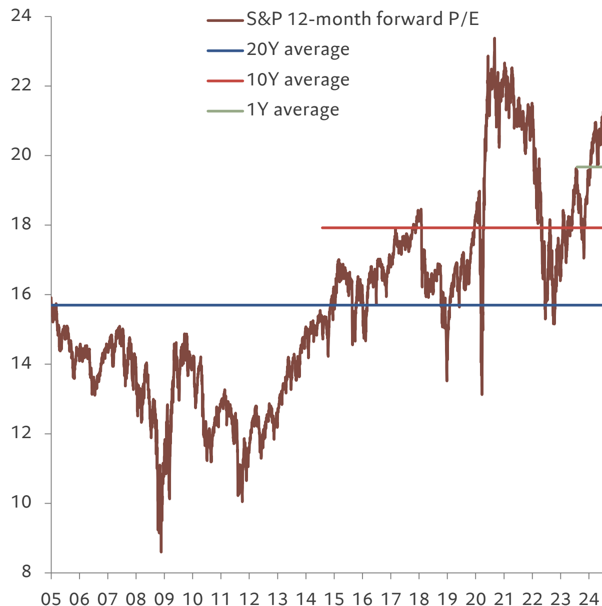
The S&P currently trades on a a forward 12-month price-earnings ratio (N12M PE) of 19.8 which is high in an historical context, as per chart 8. For investors assessing downside risks we think a move back to the 10-year average of 17.9 is a good reference point and would represent a further 10% fall in the S&P 500 from its current level to c.4700.

Chart 7: S&P 500 remains vulnerable at +1SD above its 12-month average



Source: Pictet Wealth Management, FactSet, as of 05.08.2024

Chart 8: S&P 500 valuations still high in historical context



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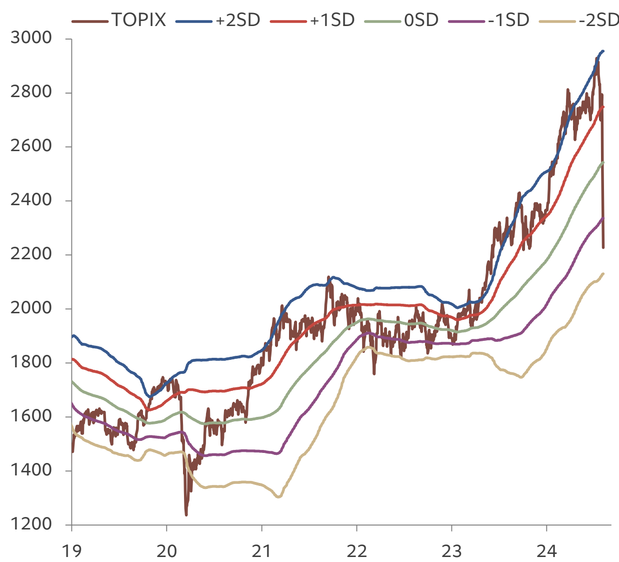
Japanese equities – oversold + attractive valuations

There has been a much larger correction in Japanese stocks in recent days than in the S&P 500, with the TOPIX index trading -1.5 SD below its 12-month average at Monday's close. While it is not uncommon for equity indices to overshoot the -2 SD threshold that we classify as 'oversold', any such moves tend to be very short and hard to time.

The 24% fall in the TOPIX from its peak in early July has, unsurprisingly, also had a big impact on Japanese equity valuations, with the TOPIX's N12M PE falling to 11.8x at Monday's close. This is below longer-run averages and its lowest level since the height of covid in Q1 20. Valuation is rarely a good tactical indicator but it is useful for indicating longer-term opportunities, and while a return to the 10-year average price-earnings ratio implies 10% downside for the S&P 500, the same analysis for Japan suggests 22% upside from here.

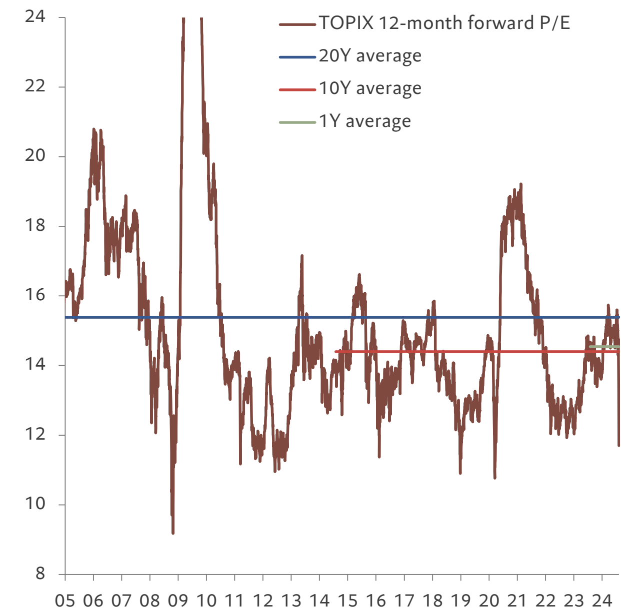
It is worth noting that marking-to-market Tuesday's 9% rebound in the TOPIX would produce a -0.6 SD reading for Chart 9 and a N12M PE back up to 12.9, with the latter still 10% below its 10-year average.

Chart 9: Monday's 12% drop was sufficient to push Japanese stocks close to oversold territory



Source: Pictet Wealth Management, FactSet, as of 05.08.2024

Chart 10: Topix trading at its lowest level since Q1 2020 based on 12-month forward P/E



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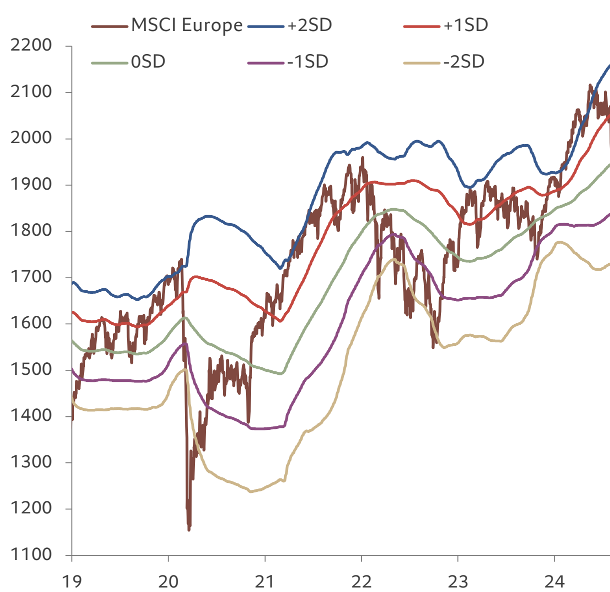
Europe looks neutral on our framework

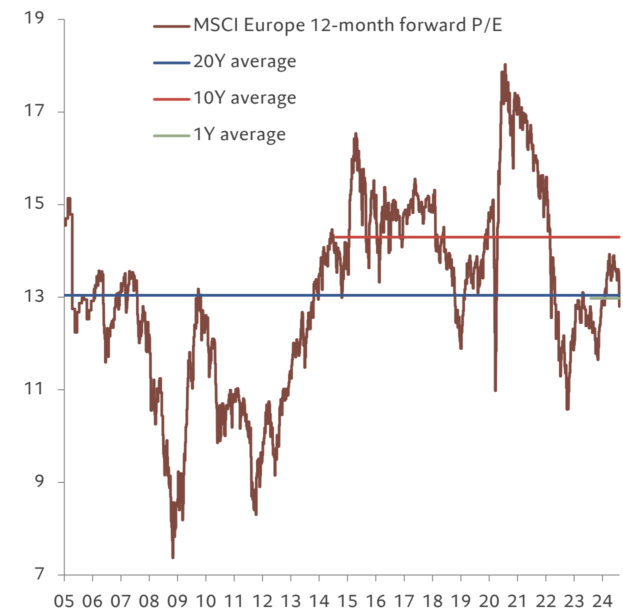
Our framework is not giving us such a strong view on European equities right now, with MSCI Europe back to its 12-month average in price terms (ie., the index seems neither overbought nor oversold). On a N12M E of 12.8x, valuations are close to their 20-year average but below their 10-year average of 14.3x.

Chart 11: MSCI Europe is back to its 12-month average



Source: Pictet Wealth Management, FactSet., as of 05.08.2024

Chart 12: MSCI Europe 12-month forward P/E stands just below its long-run average



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