Global Equities Views

Themes and implications from the Global Equities Investors Quarterly

2Q 2017

IN BRIEF

- The outlook for the corporate sector is improving, and near-term growth expectations are trending higher as markets price in a gentle move toward global reflation.
- Our equity analysts forecast synchronized double-digit earnings growth globally in 2017 and 2018 after two flat years in 2015 and 2016. In Europe, a six-year drought in profit growth is now coming to an end.
- Much of this expected improvement is already reflected in stock prices after strong gains since early 2016, but there is still room for stocks to move higher. After many years of outperformance by U.S. equities, we are finding the most promising opportunities in emerging markets (EM) and Europe.
- Value investing has worked well in most markets over the past six months, leaving a diminished opportunity set, but we still find many attractive prospects in value stocks, especially financials.
- Among the potential risks we are monitoring: a slowdown in China, a “melt-up” in the U.S. dollar and, of course, politics.

TAKING STOCK

What a difference a year makes! In the first quarter of 2016, investors feared that weak conditions in many emerging markets, commodities and global manufacturing would deteriorate into a full-blown recession across the developed world and China. As stock markets struggled, equity investors overwhelmingly preferred defensive stocks and gave an unusually generous discount to companies vulnerable to weak economic activity and low interest rates.

But the recession never arrived. Reduced fiscal austerity and continued easy monetary policy, coupled with greater confidence in the industrial sector and increased bank lending, have reignited global growth. Commodity prices have rallied, and the outlook for corporate profits now appears better than it has in several years. Though equity markets have moved quickly to price in the welcomed shift, we still see opportunities, especially outside the U.S., after many years of substantial returns for the S&P 500.

In the following pages—the inaugural edition of our quarterly *Global Equities Views*—we review our investment outlook, examine market trends, identify opportunities and assess potential risks.

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TRENDS

Earnings and valuations

After two disappointing years, the near-term outlook for corporate profits is brightening. Across global equity markets, we see rising bottom-up earnings expectations and positive estimate revisions. Stronger growth, recovering commodity prices and a gradual trend toward higher interest rates are all contributing to a better outlook. We now forecast earnings increasing at low double-digit rates in the U.S., Europe and emerging markets in 2017 and 2018. In Japan, we expect double-digit profit growth this year, followed by single-digit growth in 2018.

U.S. earnings began to strengthen in 4Q16, and we look to a recovery in the energy and financials sectors to propel further gains, against a backdrop of steady growth from the rest of the corporate sector. Although the cycle is already lengthy, we see very few indicators of recession on the horizon. In Europe, earnings are growing for the first time in six years as companies harness high operating leverage and an increase in nominal GDP growth that should bring the growth rate to about 3%. In Japan, too, strong operating leverage has kicked in, reflecting better nominal GDP growth in both domestic and export markets. Across many emerging markets, a broadening profits recovery is evident in revised earnings forecasts.

Of course, some of this improvement has already been reflected in strong gains since early 2016. But our equity investors see room for further progress, especially in international markets. At almost 18x forward earnings, U.S. equity valuations are above their long-term average, but stocks are still attractively priced relative to bonds. The earnings yield on the S&P 500 is higher than the Moody's Baa bond yield, for example, which historically has not been the case. This provides continued support for both asset allocation shifts into equity and debt-financed stock buybacks, a key driver of the U.S. market in recent years. Non-U.S. markets haven't performed nearly as well in the past five years and may offer better value: European stocks are trading at 15x earnings, and the EM price/book (P/B) ratio (our preferred metric) is still very reasonable by past standards. International diversification may well reward investors from here. The key will be the delivery of the long-awaited growth in profits, particularly in Europe.

OPPORTUNITIES

Emerging markets

The MSCI Emerging Markets index bottomed in January of last year, almost 40% below the levels of late 2014. Prices now have recovered most of those losses, but with profits improving and valuations still very reasonable, we see further gains ahead. Many emerging market currencies also look attractively priced, and with the asset class still well below the all-time high set in late 2007, we recommend adding to exposure.

Within emerging markets, we have believed for a long time that strong earnings growth translates into strong equity returns. Our investment process, which focuses on quality and growth, identifies stocks that have the ability to compound earnings growth at a superior rate. Companies we classify as "premium" and "quality" have delivered superior earnings growth; today these firms are mostly based in India, Brazil and South Africa—markets we overweight. Near term, lower quality stocks also still hold some appeal as the economic cycle improves; we continue to see some opportunity in financials, but many of the major commodity-related companies look fully valued.

Europe

In Europe—perhaps the most out-of-favor region of all global equity markets—corporate profits are growing for the first time in six years. European stocks are plainly cheap relative to U.S. equities and very cheap when compared with local bonds. Meanwhile, global investors seem to have largely lost interest in the region, deterred by poor profitability and the seemingly endless political uncertainty over the future of the European Union. Here we see opportunity; despite the politics, European economic growth is improving, and the region's companies will also benefit as the global economy reflates. Additionally, financial stocks are still undervalued, with prices not yet reflecting improving returns, a recovery in loan demand and the likelihood, in some instances, of substantial return of capital to shareholders.

Value

Value has worked very well in most markets over the last six months, which leaves investors with a diminished opportunity set. But we continue to see some potential. European and EM value stocks look especially interesting. Inter-sector valuation spreads remain high in international developed markets—large-cap staples are very expensive, for example, when compared with cyclicals. Interestingly, our U.S. investors also see opportunities in the fastest-growing companies after weak returns last year. The opportunity is to take risk, either in the value or growth space, and avoid the defensive stocks that still seem overpriced in many instances.

RISKS

China slowdown

Both real estate and "old economy" industrial companies have struggled with weaker revenues/profits as government spending, the main driver of their expansion, has slowed. Historically high debt levels have made it difficult for Beijing to stimulate the economy. We could see weaker GDP growth in coming quarters, which would act as a headwind for both global growth and emerging market equities.

U.S. dollar

Renewed strength of the U.S. dollar presents a challenge to emerging markets, particularly for unhedged U.S. investors. U.S. fiscal stimulus and regulatory reform, coupled with Federal Reserve policy normalization, should support the U.S. currency over the near term, but we think the multi-year U.S. dollar rally is now in its final phase.

CONCLUSION

In equity investing, this is a time for both risk-taking and diversification (EXHIBIT). The outlook for corporate profits has improved considerably, but a fair amount of that improvement has been recognized by investors in recent months. We see further gains ahead and suggest staying invested through the inevitable bouts of volatility and uncertainty. Safer, more predictable stocks still look richly priced in many regions. Our investors continue to find opportunities in value stocks, especially in the financial sector, while growth names also look attractive in the U.S. Diversification should start to bolster returns for global investors; after several years of outperformance from U.S. stocks, equities in both the emerging world and Europe offer both better value and (finally) rising profits as well.

		U.S. EQUITY	EUROPEAN EQUITY	EMERGING MARKETS EQUITY
Trends	*Earnings*	• Synchronized global recovery with double-digit earnings growth in 2017 and 2018 after two flat years		
		• U.S. earnings are already showing evidence of growth in 4Q2016 revenue and earnings reports • Expect continued growth to be driven by energy and financials	• Forecast positive growth for the first time in six years • European companies have high operating leverage and benefit from higher GDP growth, increased oil/commodity prices and better growth in EM/U.S.	• Profits recovery is broadening out and increasingly evident in forecast revisions • Still see some opportunity in financials, but commodities are looking more stretched
	Valuation	• Above-average valuation based on P/E (currently 0.3 standard deviations above 25-year average) but attractive on a relative basis (S&P 500 earnings yield is 5.9% vs. Moody's Baa bond yield at 4.7%)	• Reasonable valuation based on P/E (currently 14.9x vs. 25-year average of 14.6x) and attractive 3.5% dividend yield	• Attractive valuation based on P/B (currently 1.6x vs. 25-year average of 1.8x)
Opportunities		• Value/momentum • Cyclicals • True growth	• Value/momentum • Cyclicals • Financials	• Value/momentum • Financials
Risks		• Political uncertainty regarding promised reforms • Tighter financial conditions • Complacency	• Political uncertainty regarding elections • Brexit/UK inflation	• Renewed slowdown in Chinese economy • U.S. dollar melt-up

Source: J.P. Morgan Asset Management. Views are as of March 16, 2017.

Opinions, estimates, forecasts, projections and statements of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice. There can be no guarantee they will be met.

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- Partner with one of the world's leading equity managers and benefit from our ***long history of innovation*** and success.

NEXT STEPS

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II-GEV-2Q17 | 0903c02a81d3120a

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