GLOBAL MARKETS UPDATE

Revisiting our forecasts for equities

- With monetary policy likely to remain loose for a long time and the world's largest economies gradually re-opening, our view remains that equity markets will continue to make ground over the coming years.

- Back in March, when global equities were down by over 30% from their peak in mid-February, we argued that stock markets would rally once there were signs that the virus was brought under control in much of the world and containment measures could start to be lifted. Although the scale and speed of the recovery has surprised us, so far that is how things have panned out. (See Chart 1.)

- We think that there are at least two reasons why global equities will make further gains over the coming years, despite the size of the economic shock and the risk of secondary waves of infection.

  - First, as lockdowns are gradually lifted over the next few months, we think that corporate earnings will bounce back. While the hit to EPS from the coronavirus crisis is likely to be much bigger than in previous downturns, the recovery is also likely to be much faster. During the Global Financial Crisis, for example, earnings fell by ~40% between Q2 2008 and Q1 2009. They only started to recover in 2010, two years after the crisis had begun. The timely economic data are already improving, suggesting that EPS could start to recover much quicker this time around. And our economic forecasts, which are underpinned by fairly conservative assumptions about the progress of the virus, point to a big rebound. (See Chart 2.)

  - Second, in our view monetary policy will continue to support equity valuations. For a start, we expect interest rates to be kept at rock-bottom level for a long time, reducing the risk-free component of the discount rate used to value equities. And on top of that, some central, most notably the Fed, have also gone further than ever before to ensure that the pandemic doesn’t trigger another financial crisis by providing direct support to competitive risky asset classes, like corporate bonds.

- Admittedly, the valuation of the MSCI All Country World Index (ACWI), as measured by the ratio of prices over expected earnings over the next year, has shot up during the rebound to a level which is very high by the standards of the past twenty years. (See Chart 3.) However, a lot of that probably reflects the fact that expectations for earnings have not been updated adequately to reflect the brighter economic outlook, just like they were not downgraded rapidly initially to reflect the deterioration of the economic outlook at the beginning of the coronavirus crisis.

- Meanwhile, the VIX Index is still above its average of the past decade, suggesting that the sharp rebound in the S&P 500 recently has not left it looking “frothy”. (See Chart 4.) Credit spreads are also still higher than prior to the coronavirus crisis. (See Chart 5.) The upshot is that support from monetary authorities and comparatively appealing valuations will, in our view, continue to underpin demand for risky assets once the dust settles after coronavirus.

- Of course, a lot of this is already discounted in the prices of the main equity indices, given how far they have rallied already. But that is why, even after the latest revisions, we are forecasting only relatively modest gains in equity prices, particularly when compared to end-2019 levels. (See Chart 6.) (You can find our latest projections here on our website.)

- Within developed markets, we continue to think that the MSCI ex USA Index will outperform the MSCI USA Index. This is because the former has higher weights in sectors like consumer discretionary, energy, materials and financials. These sectors have started to outperform over the past few weeks after a prolonged period of underperformance, including during the early stages of the coronavirus crisis. We think that this outperformance will continue. (See Chart 7.)

- In emerging markets, we think that the MSCI Latam Index and the MSCI EMEA Index will continue to do better than the MSCI EM Asia Index, even if the economic hit from the virus may be larger in EMs outside of Asia. This is because the MSCI Latam Index and the MSCI EMEA Index have a large weighting of firms in the energy and materials sectors, and of economies that depend on commodity exports. So, they should benefit more than the MSCI EM Asia Index from a rebound in commodity prices. In addition, equities in Latin America and EMEA are less vulnerable to a rise in tensions between the US and China. (See Chart 8.)
Global Markets

Chart 1: MSCI ACWI
(Rebased at 100 = 12th February 2020)

Number of coronavirus cases outside of China rises sharply

Chart 2: MSCI ACWI's EPS & World Trade
(12m/12m %, US$)

Chart 3: MSCI ACWI's Price Estimated Earnings Ratio

Chart 4: US Equity Volatility (S&P 500, %)

Chart 5: Option-Adjusted Spreads Of ICE BofA ML IG Corporate Bonds (bp)

Chart 6: Changes In MSCI Indices Implied By CE's Revised End-2021 Forecasts (%), LC

Chart 7: Combined Weight In Selected Sectors & Projected Change In MSCI Indices Until End-2021

Combined Weight of Energy, Materials, Financials & Consumer Discretionary (%)

Chart 8: Correlations Of MSCI EM Equity Indices With China & USA Indices (Monthly Changes, Since 2016)

Sources: Refinitiv, Bloomberg, Capital Economics
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