

## Five takeaways on the potential rewards and risks facing global equity investors

Schroders

**Simon Webber, Head of Global Equities, Schroders, looks at the ways that increased market breadth and volatility against a resilient economic backdrop should create opportunities for active fund managers.**

A soft landing for the US economy remains our central scenario and we expect equity markets to be well-supported in the medium term by modest growth in corporate earnings. In Europe, inflation has remained on a clear downward path as the eurozone and UK have emerged from shallow recessions.

This has allowed the European Central Bank and Bank of England to begin cutting interest rates. Economies such as the UK and Spain have a high percentage of floating rate mortgages and a decline in interest rates will provide some immediate support to the consumer. We are also seeing higher real wage growth in Europe and the UK, which combined with excess savings, should further support consumption growth.

The August market correction saw a de-rating in equities to reflect a more uncertain outlook for the US economy, but they have quickly recovered losses, supported by good earnings growth and the outlook for easier monetary conditions. Equity markets were vulnerable to a correction after a very strong nine months, but company fundamentals are decent and heightened volatility creates opportunities for repositioning where dislocations occur.

### 1. Headline valuations continue to favour markets outside of the US

Based on commonly used metrics, the UK remains one of the most attractively valued markets globally relative to its long-term history. In global equity markets, valuations continue to favour ex-US markets, particularly the UK, Japan, and emerging markets (EM) (see table, below).

Valuation vs. 15-year median (% above or below)

Equity market	CAPE	Forward P/E	Trailing P/E	P/B	Dividend yield
US	32 (29%)	20 (19%)	25 (19%)	4.7 (60%)	1.4 (39%)
UK	15 (10%)	11 (-7%)	12 (-13%)	1.9 (5%)	3.8 (1%)
Europe ex. UK	19 (11%)	13 (-3%)	15 (-11%)	2.0 (15%)	3.2 (0%)
Japan	21 (-4%)	14 (-3%)	15 (-8%)	1.4 (7%)	2.4 (-12%)
EM	12 (-10%)	12 (0%)	15 (12%)	1.7 (6%)	2.8 (-3%)

Key:	<-25%	-25% to -15%	-15% to -5%	-5% to 0%	0% to 5%	5% to 15%	15% to 25%	>25%
	Cheap			Neutral		Expensive		

Source: LSEG Datastream, MSCI and Schroders Strategic Research Unit. Data to 7 August 2024.

Figures are shown on a rounded basis. Assessment of cheap/expensive is relative to 15-year median.

Past performance is not a guide to future performance and may not be repeated. The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested. All investments involve risks including the risk of possible loss of principal. Any reference to regions/countries/sectors/stocks/securities is for illustrative purposes only and not a recommendation to buy or sell any financial instruments or adopt a specific investment strategy. 613609

However, valuations in the US market looks less demanding when you look beyond the “Big Tech” mega-cap growth stocks, which are dragging up the overall P/E multiple of the S&P 500. The Big Tech stocks have, in aggregate, benefitted from both relevant thematic exposures and strong fundamentals. In contrast, the remainder of the market has been contending with a still tough operating environment, which has dampened top- and bottom-line growth for much of this time.

## **2. Scope for market drivers to broaden, creating opportunities for active investors**

Market breadth has remained at extremely low levels over the past year as a narrow set of stocks has accounted for the vast majority of market gains. The narrowness in markets to date has been a function of both top-down drivers – the AI thematic – and bottom-up fundamentals, represented by divergent revenue and earnings growth.

Consensus is now anticipating this gap to close somewhat, with expectations of an acceleration in earnings growth for the broader market, and a significant deceleration for the Big Tech cohort (see chart, below). The mega-cap US tech companies have demonstrated very strong earnings growth in the last 18 months, driven by renewed cost discipline and sustained revenue growth.

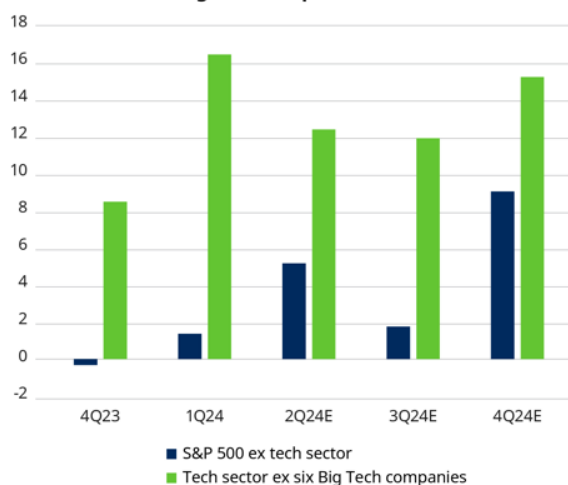
The benefits of that cost discipline are expected to wane in coming quarters though, bringing earnings growth down closer towards the rest of the market. In aggregate, these companies remain underpinned by great businesses and strong fundamentals, but they are vulnerable to downside asymmetry on revenue and earnings delivery relative to the rest of the market.

There is also a case for a broadening of equity market returns regionally. European economies will be more sensitive to interest rate cuts than the US economy, and in Japan real wages have turned positive after many months of contraction. Europe and the UK for example both saw a return to positive GDP growth earlier this year following a period of weaker growth and a more protracted earnings slowdown.

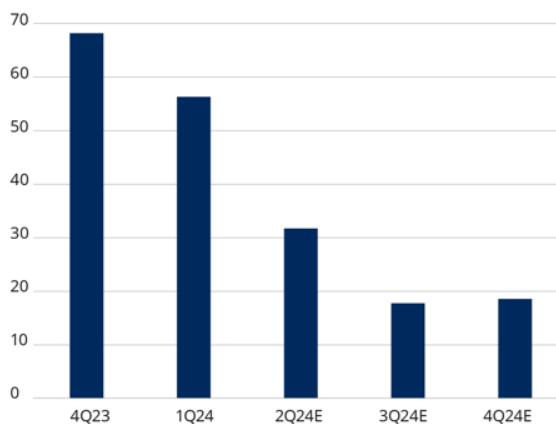
These regions should be further supported by interest rate cuts. European consumers in particular have higher exposure to variable interest rate mortgages (relative to the US) and companies are more dependent on bank lending. In contrast, the narrative in the US has shifted from bringing inflation under control to avoiding a recession. While a US recession isn't our base case, there is the potential for catch-up in some regions.

### Earnings per share growth beginning to accelerate for the rest of market... ...as Big Tech EPS momentum is expected to decelerate

EPS growth S&P 500 ex tech sector and tech sector ex six Big Tech companies



EPS growth of six Big Tech companies



Source: Standard & Poor's, Refinitiv, FactSet, UBS, as at 19 August 2024.  
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### 3. Japanese companies remain well positioned to return cash to shareholders

We continue to see an underappreciated earnings improvement story underway that should continue to support Japanese equities. Three decades of deflation has led to corporations and individuals stock-piling their cash.

We are now seeing ongoing reforms, led by the Tokyo Stock Exchange and various government institutions, aimed at improving governance and capital efficiency. These reforms are being introduced alongside incentives such as the NISA tax free investment scheme for individuals. Such initiatives should help to put excess cash to work and raise what are exceptionally low rates of equity ownership relative to other developed markets.

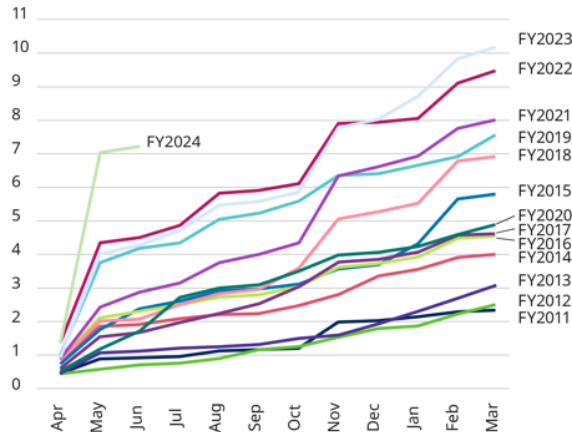
As a result, we are seeing greater focus on shareholder returns as well as increased investment and capital spending. This renewed focus on productivity and profitability is further supported by a more normal inflationary backdrop that is leading to the Bank of Japan's pivot away from yield curve control at a time when most central banks are biased towards easing.

We believe that this should provide greater support for the currency, which has eroded the returns of foreign investors for most of the last decade. As a consequence, we should see an increased number of attractive opportunities in domestically focused businesses.

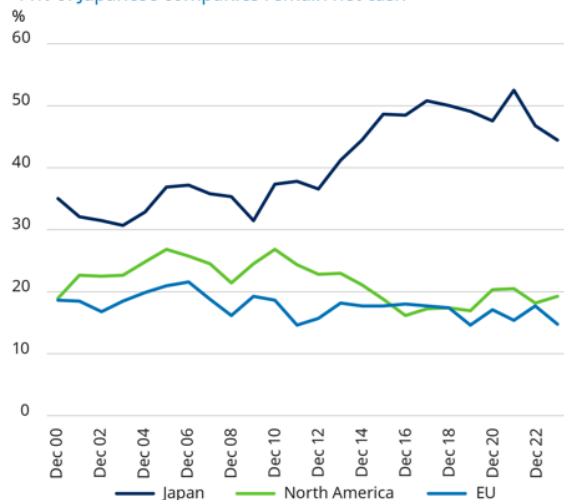
## Japanese companies remain well-positioned to return cash to shareholders

Value of share buybacks announced in Apr-Jun up 1.7x YoY to ¥7.3tn

Total value of announced share buybacks by fiscal year (Ytn)



Percentage of net cash companies (excluding financials) – 44% of Japanese companies remain net cash



LHS source: Mizuho Securities Equity Research, based on Nikkei and TSE as at 27 June 2024 for FY2024. RHS source: SMBC Nikko, MSCI, Schroders, as at 31 December 2023. Past performance is not a guide to future performance and may not be repeated. The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested. All investments involve risks including the risk of possible loss of principal. Any reference to regions/countries/sectors/stocks/securities is for illustrative purposes only and not a recommendation to buy or sell any financial instruments or adopt a specific investment strategy. 613609

## 4. US election: potential for increased volatility but fundamentals take precedence

The political calendar has been particularly busy in 2024. More than 40 countries representing three quarters of the global investable universe have held, or are scheduled to hold, national elections. The US election in November remains one of the most closely anticipated, with an outcome that has the potential to significantly impact geopolitical relationships.

In general, policies and policy differences of the Democrat and Republican candidates are still lacking in key areas, while greater clarity could perhaps serve to increase short-term volatility rather than reduce it. That said, where differences are apparent – trade tariffs, energy policy, deregulation of banks, drug pricing – we think the implications are clear. In either scenario, we expect to see trade policies that realign US relations away from rivals and prioritise advancing US leadership in high-tech industries.

History has shown that positioning portfolios around who you think is going to win an election is almost always a losing strategy, and it is always important to have a diversification of risk. Of course, this is not to say that we ignore the potential policy risks, but we believe it is more important to remain focused on the outlook for the economy, the direction of interest rates, the forecast for earnings growth and the relative attractiveness of valuations.

Within our portfolios we prefer to find companies that are in control of their own destiny. To this end we have tried as best we can to minimise our exposure to some of the sharp edges that are firmly in the crosshairs of policy risk.

## 5. Increased scrutiny around AI monetisation

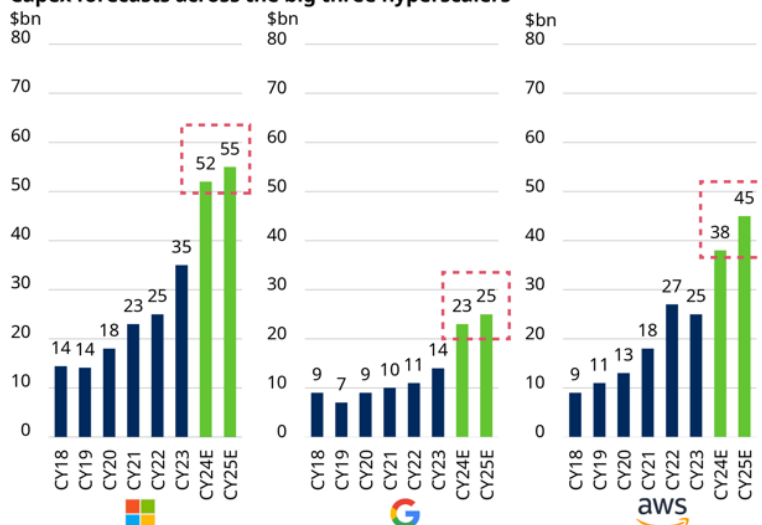
The euphoria around generative AI has been a major driver of share price growth in markets over the past year. Investors have flocked to some of the clear beneficiaries in the semiconductor and data centre segments of technology.

However, revenue from AI is running near a level that is estimated at 10x less than the amount of capital expenditure currently being spent. As a result, there are questions about whether there is enough near-term future revenue to justify the current level of infrastructure buildout. These uncertainties contributed to the Big Tech stocks bearing the brunt of the de-rating in the US equity market during the August market correction. The ability of these tech companies to monetise their AI spending will remain an important theme.

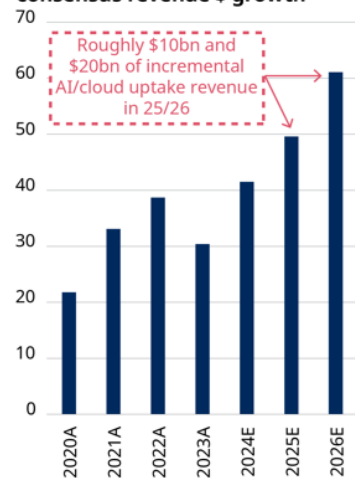
We are fully aware that generative AI remains early in its innings and that the development of this technology holds huge potential to transform businesses and productivity. However, it is now facing greater scrutiny around the level of power consumption, supply constraints and the pace of revenue growth. There are also questions around whether we are seeing an overbuild that will require a consolidation phase for AI infrastructure related stocks.

#### AI: can future revenue justify current capex expenditure quickly enough?

Capex forecasts across the big three hyperscalers



Big three hyperscaler incremental consensus revenue \$ growth



LHS source: Goldman Sachs, company data as of 15 July 2024. Hyperscalers include Amazon, Microsoft, Google. Amazon capex is GSe specific to only AWS, Google capex is GSe of server and network equipment and Microsoft capex is on a consolidated basis.

RHS source: Barclays Research, Bloomberg consensus, company documents as of 25 June 2024.

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