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WORLD EQUITIES: MID-YEAR SCENARIO UPDATE

WHERE NEXT FOR EQUITIES AFTER A SPARKLING FIRST HALF?

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SUMMARY

Developed-market (DM) equities

- Equities have benefited from a positive feedback loop in 2021, with stronger economic recovery increasing sales growth, improving margins and earnings set to rebound by 40% in 2021 in the US and Europe.
- The Q2 21 reporting season is set see a continuation of the recent trend of positive earnings surprises given the base effect comparison with last year will be particularly strong and bullish guidance from companies. Earnings growth in 2022 is expected to be healthy (over 10%).
- Equity valuations are rich but expected to gradually ease as equity positioning is bullish but not extreme.
- After cyclical stocks' strong outperformance versus defensives as the pandemic began to wind down, markets are becoming less polarised. As inflation fears abate, sovereign yields have fallen again, favouring growth relative to value.
- Cash returns to shareholder are expected to be key again for equity returns going forward after equities' strong price performance in H1. The Fed has already removed payout constraints on US banks and the ECB is set to follow suit in 2H.
- After the strong recovery and upgrade to our year-end targets (4375 for the S&P 500 and 465 for Stoxx Europe 600) to take into account stronger earnings than initially expected, we are keeping a neutral stance on equities overall.

Emerging-market (EM) equities

- The strong momentum that lifted EM equities at the start of the year was abruptly interrupted by the rise in US real yields and a pullback in Chinese equities.
- Latin America and EEMEA outperformed the broad MSCI EM index during H1 on the back of fast rising commodity prices and stronger post-covid catch-up potential.
- We remain cautious on the outlook for EM equities in 2H2021 despite a supportive backdrop of strong economic growth in the context of a global reopening
- The inherent inertia to China's credit normalisation, the risk of a brisk rise in US real yields and the lag in vaccination campaigns in a number of EM countries remain tangible risks for EM equities.
- We maintain our year-end target of USD1,400 for the MSCI EM (~5% upside), with a chance that the actual outcome is slightly higher.

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DM equities: tailwind from earnings recovery

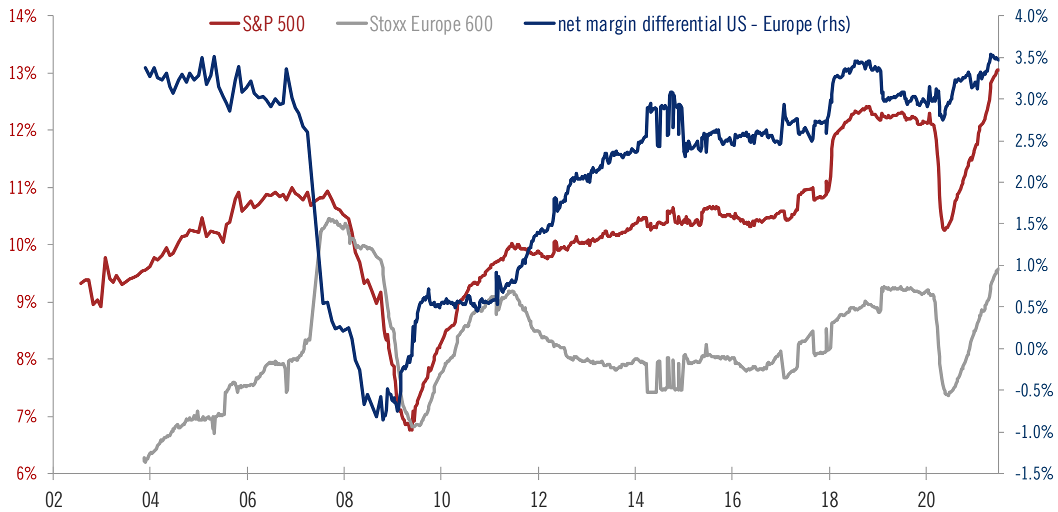
In the first half of 2021, the S&P 500 posted a stellar 15.3% return (in USD) and the Stoxx Europe 600 +15.2% (in euros), with the recovery in earnings the cornerstone of this performance. With our year-end price target having already been reached, it is time to reassess our outlook for the rest of 2021.

Earnings, earnings and more earnings

The economic recovery from the pandemic has been rapid and even stronger than expected in the scenario we set out at the start of this year. This has translated into 2021 sales growth now expected to be 12.7% by consensus for the S&P 500, up from an expectation of around 8% back in December. The trend has been similar for the Stoxx Europe 600, with current expectations close to 12% compared with less than 7% six months ago.

Along with sales, there has been a synchronised rebound in margins in Europe and the US. Both operating and net margins are expected to rise above pandemic levels on both sides of the Atlantic this year. The recovery in margins has been strongest the oil & gas and cyclicals, the sectors most battered by the pandemic in 2020. The recovery has been slightly different between European and US equity indexes, given the prevalence of high-flying tech names on the latter that have been recording all-time high margins, far above the level prevailing before the pandemic. In Europe, margins this year could move above where they were in 2011, before the euro sovereign debt crisis. But further improvements in margins could prove challenging as European equities lack technology sectors with high margins.

CHART 1: 12-MONTH FORWARD NET MARGIN US AND EUROPE



Source: PWM - AA&MR Factset, 1 July 2021

Strong top-lines and record margins are sending earnings growth through the roof in 2021. Consensus expectations are for earnings growth of 43% for the Stoxx Europe 600 and of almost 39% for the S&P 500. 2021 earnings level are now expected above their 2019

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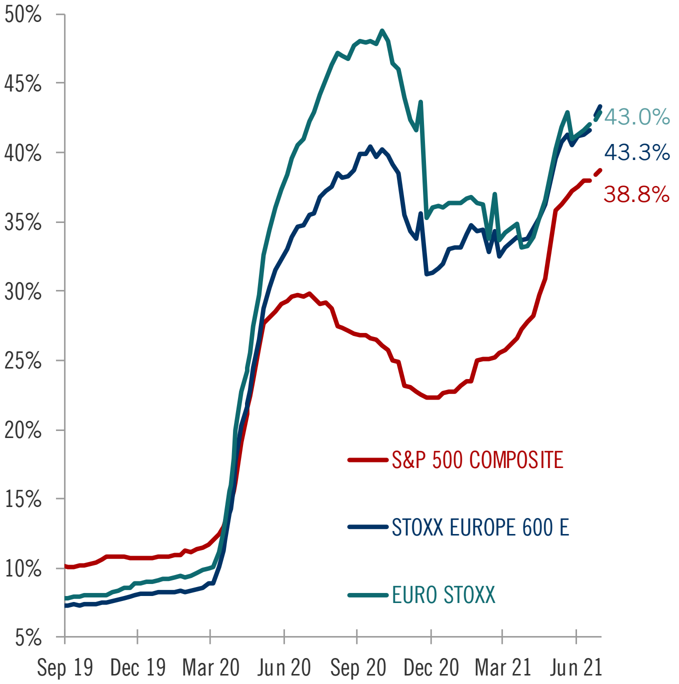
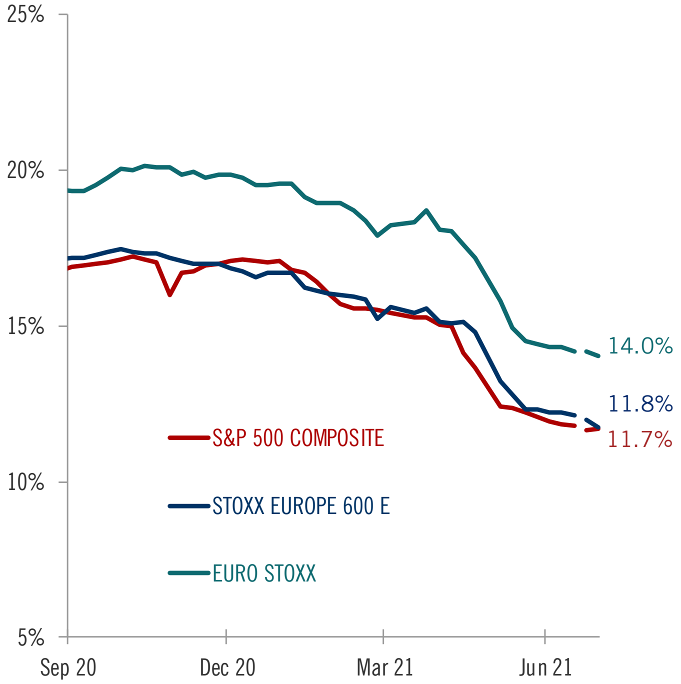
level in all major developed equity markets, ie the pandemic is looking behind us, a major achievement. In our new top-down scenario we expect that 2021 earnings growth could reach 45% in the US and 50% in Europe.

CHART 2: 2021 EARNINGS GROWTH



Source: PWM - AA&MR, Factset, 1 July 2021

CHART 3: 2022 EARNINGS GROWTH



Source: PWM - AA&MR, Factset, 1 July 2021

Further earnings upside

Consensus expectations for earnings growth in Q1 are exceptionally high— 60% on the S&P 500 and over 100% for Stoxx Europe 600. Despite such high expectations, two factors could contribute to positive surprises: base effects and guidance. First, the collapse in earnings by around a third in the US and by half in Europe at the height of the pandemic in Q2 2020 mean the base effect is very strong. Second, bullish earnings guidance points to positive earnings surprises. Historically, an average of two-thirds of S&P 500 companies have issued negative guidance before earnings announcements. Since H2 2020, 2/3 of companies have issued positive guidance (see chart 5), fuelling strong positive earnings surprises since then. Pandemic-related uncertainties meant few companies were willing to provide guidance, but the numbers have picked up over the past four quarters. So far, 103 S&P 500 companies have provided guidance for Q2 2021, within the historical range of 100-120, meaning that Q2 21 guidance is significant. With the noticeable exceptions of energy and financials, where few pointers have been provided, positive guidance is well distributed across sectors, with materials, IT, communication services, industrials and healthcare providing the best.

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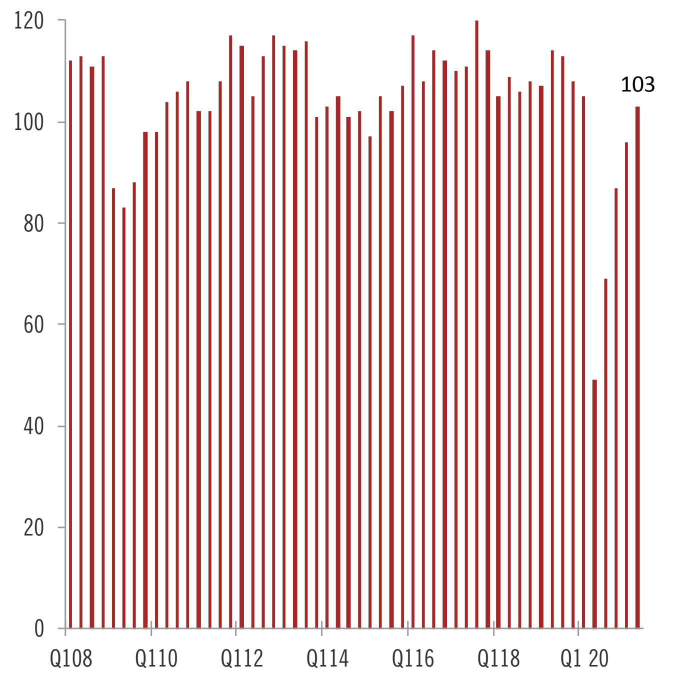
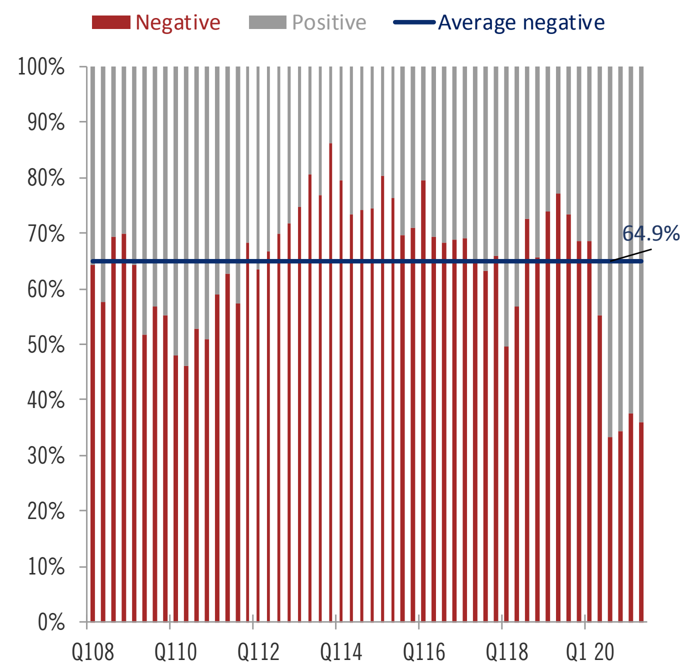
CHART 4: NUMBER OF S&P 500 COMPANIES ISSUING QUARTERLY GUIDANCE



Source: PWM - AA&MR Factset, 1 July 2021

CHART 5: SPLIT BETWEEN S&P 500 COMPANIES PROVIDING NEGATIVE AND POSITIVE GUIDANCE



Source: PWM - AA&MR Factset, 1 July 2021

Usually, the tendency is for analysts to start out with over-optimistic earnings expectations and then to revise them downwards as results come in. The opposite tends to hold true during economic recoveries, and the 2020 pandemic is no exception. Since summer 2020 in the US and January 2021 in Europe, both 2021 and 2022 earnings have been steadily upgraded by analysts. Yet earnings strength for 2021 have been pushing down 2022 earnings growth expectations – around 12% for the S&P 500 and Stoxx Europe 600. In 2022, apart from the US travel & leisure sector, the base effects boosting earnings growth this year will have vanished. Structural growers are expected to lead the pack n earnings again some time in 2022 as the cyclical recovery fades. Important risks to corporate earnings are an increase of corporate tax rate in the US and the implementation of a 15% global minimum tax rate in the OECD.

Positioning and valuation

With 12-month forward earnings ratios of 21.6x for the S&P 500 and 16.7x for the Stoxx Europe 600, equity valuations remain rich, having only marginally eased from 22.8x and 17.4x, respectively, at the end of last year. While the European discount tends to shrink dramatically when sector differences are taken into account, a sector-adjusted analysis shows that European stocks are still cheaper than their US peers. Cyclical sectors in the US and Europe still generally carry valuations far above the levels prevailing before the coronavirus outbreak. The US technology complex is still being paid at a 12-month forward price-earnings (PE) ratio of 24.5X, a premium to the overall market.

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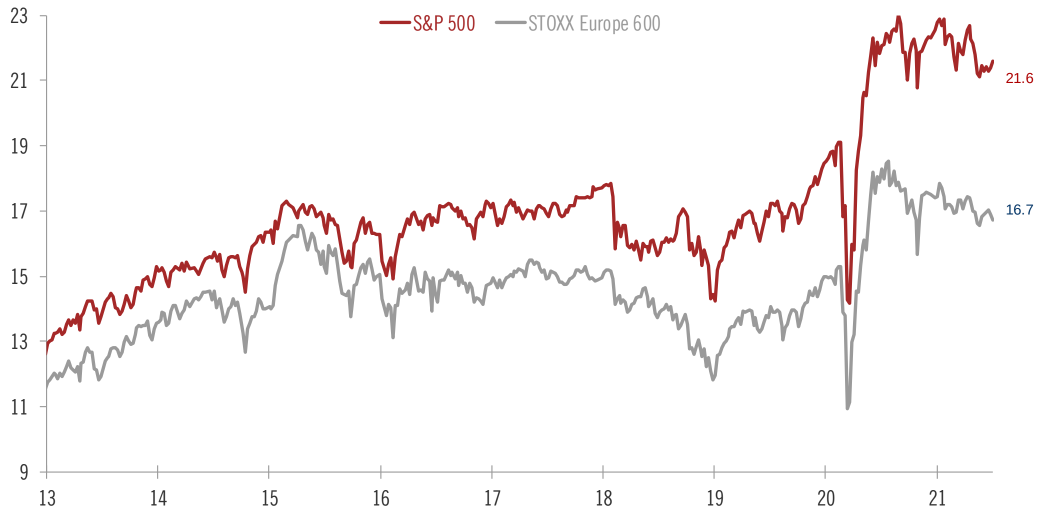
CHART 6: 12-MONTH FORWARD PE



Source: PWM - AA&MR , Factset, 1 July 2021

Equities also look expensive relative to sovereign yields, despite the recent increase in the equity-risk premium (ERP), the difference between the 12-month forward price-earnings yield and 10-year government bonds. At 3.2% for the S&P 500, the ERP is around the level that prevailed for most of 2018 but is still below the 4.25% average of the past decade. This suggests there is potential for further compression in equity valuations in the second half of 2021 in line with our initial 2021 scenario with around 10% derating. Our year- end PE target stands at 20.1x in the US and 14.9x in Europe.

We do not forecast a massive equity valuation derating as earnings momentum remains supportive and equity positioning, while bullish, is not extreme. Inside systematic strategies, hedge funds exhibit a fairly high beta to equity, especially CTA strategies. At the same time, risk-parity strategies' exposure to equities has remained fairly low since March 2021. We estimate a basic risk-parity strategy focused on the S&P 500 and 10-year US Treasuries has an average exposure of 26% to the former, below the 35% long-term average. Volatility trends also suggest that investors are not overly optimistic. Since its March 2020 peak, volatility, as measured by the CBOE VIX index, has declined massively and now stands at 15x, at the lower bound of our standard volatility regime that ranges between 15x and 25x. While low, volatility is still above the level that prevailed in 2017, when the VIX index stood at around 10x for a few months. Skew, the volatility differential between options whose strike price is 10% above or below the spot price, remains quite high on the S&P 500 and above the early-March 2020 level. This suggests that while investors are bullish, they have put protection in place. For this reason, we are not overly pessimistic about equities and equity valuations.

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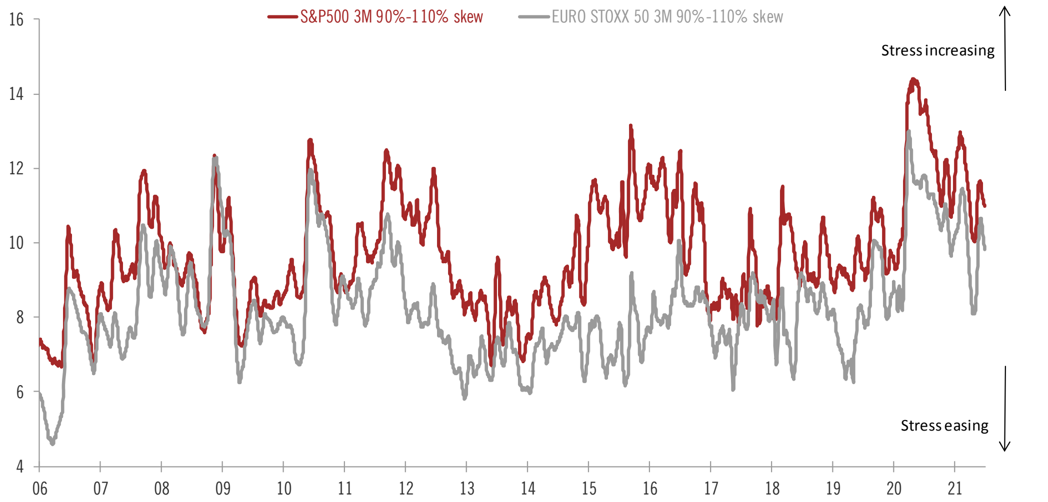
CHART 7: S&P 500 AND EURO STOXX 50 SKEW



Source: PWM - AA&MR, SG, 1 July 2021

Rotation inside equities

The second part of 2020 and the beginning of 2021 witnessed a sharp sector rotation, with the incipient economic recovery pushing investors to favour cyclical sectors over defensive ones. Stripping out oil & gas, financials and TMT (technology, media and telecoms), our analysis shows that defensive sector massively outperformed cyclical ones before and at the height of the virus outbreak, but gave back more than their outperformance since then. Since mid-March 2021, defensives' underperformance has vanished, but defensive outperformance has been small and bound within a tight range, with investors still feeling that earnings figures may be too good to be true going forward.

The other popular way to look at equity rotation is to look at trends in 'value' and 'growth' stocks. Such analysis takes into account the sectors that we left aside in our previous cyclical / defensive analysis. Value / growth definition is not straightforward: there are as many definitions as index providers and index rebalancing can lead to massive shift of companies from one group to another (as happened in September 2020 and again in March 2021). Besides, the rate environment can impact the performance of growth versus value. Historically, the value versus growth trade tends to be more volatile and to perform better when interest rates are rising. Since mid-May 2021, growth has been outperforming value again as a result of a pause in the rise in sovereign yields.

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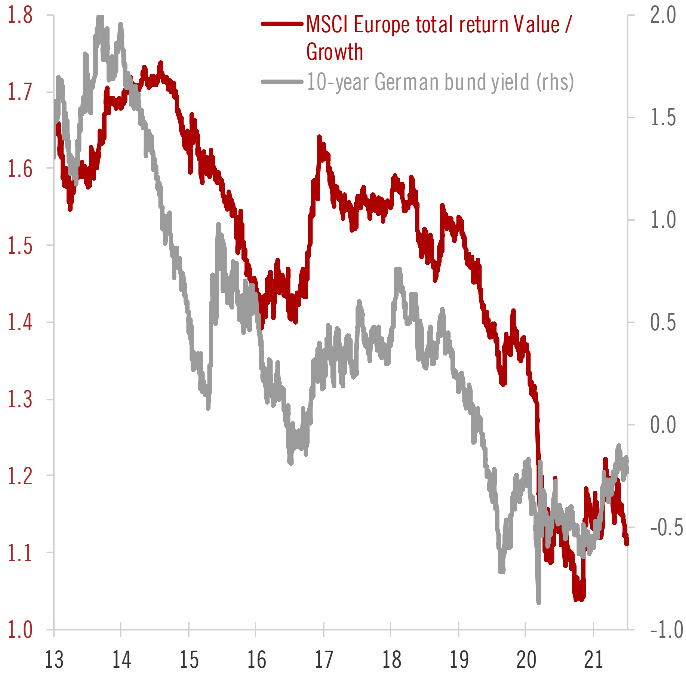
CHART 8: RELATIVE RETURNS OF DEFENSIVE/CYCLICAL SECTORS

Source: PWM - AA&MR Factset, 1 July 2021

CHART 9: RELATIVE RETURNS OF EUROPEAN VALUE VS. GROWTH STOCKS AND 10-YEAR BUND YIELD



Source: PWM - AA&MR Factset, 1 July 2021

Cash returns to become important

After the strong post covid-19 rally, the potential for further increases in equity indexes looks reduced. Indeed, the S&P 500 returned 38% from end-June 2020 to end-June 2021, compared with a long-term annual average of below 9%. Limited price performance may mean cash returns play a greater role in shareholder returns from now on.

Market strength and dividend cuts (mainly in Europe) mean that dividend yields have declined over the past few months. Currently, the 12-month forward dividend yield stands at 3% on the Stoxx Europe 600 and slightly below 1.5% on the S&P 500. Overall, US companies preserved dividends during the pandemic, whereas lower earnings and regulatory constraints pushed European companies to slash dividend payouts. The Fed's decision to lift restrictions on US banks paying out dividends and buying back their shares should provide an additional boost to the sector. In Europe, dividend expectations are still below their pre-pandemic levels, Things should improve after the result of stress tests on euro area banks are known at the end of July. A return to the pay-out ratio to the pre-pandemic level of around 50%(from the current maximum of around 15%) could translate into Stoxx Europe 600 banks paying out EUR37 bn in dividends in 2022.

Buybacks are the other way for companies to reward shareholders. Historically, they have been more important in the US than in Europe. With the exception of tech-related names (IT and communication services), buybacks collapsed in the US in 2020. The strong rebound in Q1 2021 (from USD105 bn in Q4 20 to USD191 bn in Q1 21) was largely driven by the financial sector. We expect buyback figures to improve further as US banks restart buying back shares in H2 21, keeping in mind that US banks paid out as much as IT in

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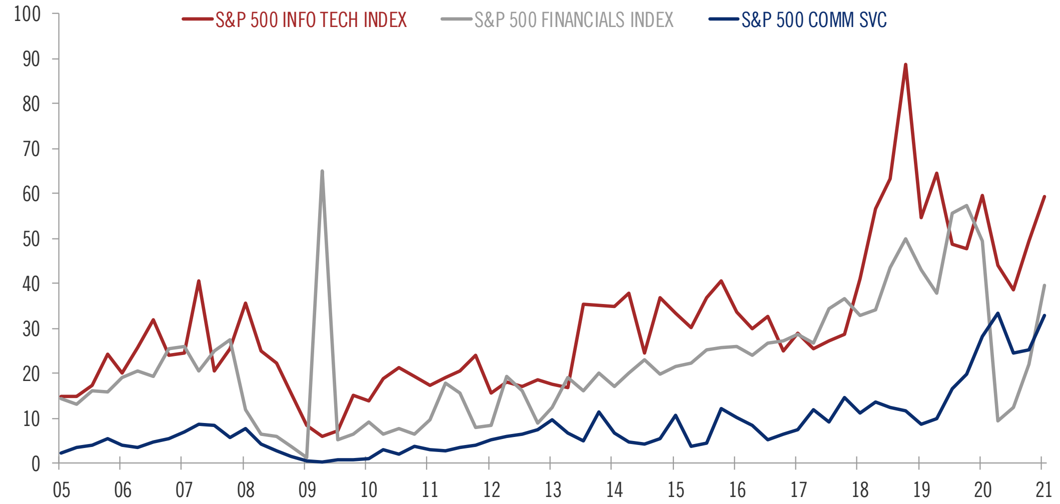
2019. Financials, and especially banks, are also key to European dividends and buybacks and are expected to become more substantial in the coming months.

CHART 10: S&P 500 BUYBACKS (IN USD BN)



Source: PWM - AA&MR Bloomberg, 20 June 2021

Revising up our 2021 year-end target

Owing to mild valuation compression and stronger earnings than we expected at the start of this year, we are revising up our year-end price target for 2021 for all major equity indices. Our new target is 4,375 for the S&P 500 and 465 for the Stoxx Europe 600. This compares to levels of 4358 for the S&P 500 and 460 for the Stoxx Europe on 6 July, indicating that we expect both indexes to make only modest extra gains over the remainder of 2021. Our neutral stance on equities balances the prospect of strong earnings with risks regarding corporate tax, bullish (but not extreme) equity positioning and rich equity valuations.

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EM equities: muddling through H2

A whirlwind start to the year

Coinciding with the US elections and very promising clinical results for mRNA-based covid-19 vaccines, EM equities had the wind at their back at the end of last year, but experienced difficulties again in February due to a combination of internal and external factors. The two main ones were the rise in US real rates and macroeconomic developments in China.

While long-term rates in the US had been rising since August 2020, the rise was driven by inflation expectations, whereas real rates remained stable. This changed in February 2021when the 10-year TIPS yield rose 50bps in the space of a couple of weeks (incidentally supporting a swift appreciation of the US dollar). Both the rise in global financing costs and in the US dollar put pressure on EM equities in general.

CHART 11: MSCI EM – TOTAL RETURN RELATIVE TO MSCI WORLD INDEX (REBASED ON 01.01.2021)

Source: PWM - AA&MR, Factset 7 July 2021

But the lag in EM equities' performance since February has also been largely driven by China, where equities' underperformance year-to-date has been due to two main factors.

First, there has been an exceptional drive to tighten the regulatory landscape in China in recent months. This has affected many sectors from consumer finance (e.g. Ant Financial) to internet platforms (e.g. Alibaba, Meituan) and after-school tutoring (e.g. TAL Education, New Oriental Education). While many thought regulatory zeal might weaken, we felt that more action could come after the Communist Party's centenary celebrations at the start of July. Indeed, last weekend regulators moved on several tech platforms, including the freshly listed Didi Chuxing ride-hailing app.

Second, Total Social Financing (TSF), a key indicator representing the aggregate amount of financing provided to the domestic Chinese economy, started decelerating in February. Fading stimulus is a significant headwind for Chinese earnings (as well as for EM earnings in general given the central role of the Chinese economy). The fact that China's was the first large economy to emerge from the pandemic—and therefore the first to see recovery momentum flag—may also affect earnings growth prospects.

While the picture has been looking unattractive at an aggregate level, EM equities exhibited significant internal rotation, with Latin America and Eastern Europe, Middle East and African (EEMEA) outperforming, notably thanks to red hot commodity prices. ASEAN countries, on the other hand, have been struggling to reopen their economies due to repeated covid-19 outbreaks and lagging vaccination campaigns. Year-to-date EEMEA is up +19%, Latin America +5% and EM Asia +4% (with the ASEAN subsegment down by -6%).

Clearer skies in H2? Not so fast

While the global macroeconomic backdrop of strong real GDP growth and relatively elevated inflation (we expect 6% and 3.8% respectively at the global level in 2021) coupled with accommodative fiscal and monetary policies are undoubtedly supportive of EM equities, it remains unclear at this stage whether the latter can outperform in 2H.

On the plus side, EM countries' growth advantage is set to widen in the second half of 2021, reaching a peak in 3Q21. A widening growth differential is known to drive the performance of EM equities relative to their DM peers--albeit with a significant lag. A more direct positive impact on EM equities could come from the 4% decline in the USD against other major currencies that we expect by the end of the year.

Nonetheless, there are still clouds on the horizon. First, a renewed rise in real US yields is a significant risk. We expect US 10-year TIPS yields to rise to -0.1% by the end of the year from -0.94% at the time of writing. This would be an even bigger move than the one we saw in February. While emerging markets are much less vulnerable than they were in 2013 during the so-called 'taper tantrum', EM equities would likely struggle in such a scenario.

Second, credit tightening cycles in China typically take about a year, based on past episodes in 2010, 2013 and 2018. This means a significant engine of earnings growth for EM equities could be missing at least until the end of the year. Meanwhile, the momentum observed on EM ex-China earnings could also fade should commodity prices – which tend to correlate with Chinese demand – stabilise.

Finally, covid-19 vaccination campaigns in EM (particularly in South East Asia and South Africa) have been lagging those in developed markets. The risk we see more lockdown measures to deal with further outbreaks (as is currently the case in Malaysia or Indonesia) remains a major risk as new variants of the coronavirus emerge.

We are maintaining our year-end target of USD 1,400 for the MSCI EM (compared with 1'347 on 6 July). Our upside scenario envisages the MSCI EM reaching USD1,500 should we see a stronger-than-expected depreciation of the US dollar, an unexpected acceleration of growth in China, or the emergence of a commodities 'supercycle'.

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