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Are current equity valuations sustainable?

As the global pandemic continues to exert its stranglehold on the global economy, it seems absurd that equity and fixed income markets are still finding new highs. We're unlikely to be wealthier given the devastating economic impact of Covid-19, so what is really going on, and how will it impact investors?

Thanks to emergency monetary stimulus, there are 30% more US Dollars in the world than a year ago, and a large proportion of those Dollars have helped to bid up the price of US equities and bonds. So rising equity prices are not really a sign of a burgeoning economy. Rather, they are a product of freshly-printed money seeking a home that offers the best possible return.

The fact that interest rates are so low is also helping. Companies can borrow at will, which helps to drive growth and future returns as well as prevent bad companies from going under. At the same time, the US Federal Reserve has said it will allow inflation to run above its 2% target before increasing interest rates, and inflation is unlikely to rise significantly in the immediate future since people are buying fewer and cheaper goods and services thanks to the pandemic.

As investors, the Manager surely can't complain about such positive conditions. But as equity prices ride high and bond yields remain close to zero, investors are forced to take more risk in search of return. We must also ask whether businesses are able to live up to current valuations in terms of future growth and earnings, and what risk that brings to portfolios.

"Equities are expensive but remain the asset class with the highest long-term return potential. A lack of alternatives, combined with fiscal and monetary support, means they continue to earn their place in portfolios, albeit in a low-growth environment that will produce few winners while many will struggle."

Philip Smeaton
Chief Investment Officer

30%

The increase in the supply of US Dollars within the monetary system last year.

Source: Bloomberg

The Sanlam view

The good news is that there are still pockets of opportunity. As discussed in more detail in 'Investment View', much of last year's equity growth was driven by the US as investors flocked to the relative safety of the American economy. Within that, technology stocks soared since they were net benefactors of the Covid-19 crisis. As a result, the UK, Europe and Japan struggled to rebound to pre-Covid levels. And while Emerging Markets fared better, that's largely because their valuations were low in the first place.

For that reason, the Manager will exercise caution and consideration when investing in US-based companies while looking for opportunities in other regions. A strengthening global economy will give good companies around the world the opportunity to outperform their current valuations. That said, the Manager expects longer-term economic growth and, therefore, returns to be muted. Government policy is likely to divert resources to servicing debt and funding political programmes such as the green agenda rather than helping businesses prosper. And while economic conditions will improve, there are significant wounds to heal, which won't happen overnight.

Although current equity valuations could be sustainable in the absence of other opportunities, the Manager will remain cautious in its stock picking to avoid taking unnecessary risk.

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Investment view: Why it is important to look beyond the Index?

By the end of last year, the MSCI World Index had returned 12.3%, and the losses of the stock market crash in March were nothing but a distant memory. But do such remarkable headline numbers tell the whole story?

While a high-level view of global equity performance in 2020 paints a picture of rising prices and impressive returns, but when the Manager digs beneath the surface, it finds that those headline figures were not a global story at all.

In fact, as you can see from the table below, what happened last year was that investors flocked to the relative safety of US stocks and, in particular, technology stocks, at the expense of other countries and sectors.

GBP Total Return by Region (%)	
US	**17.3**
UK	-13.0
Europe	2.4
Japan	11.2
Emerging Markets	14.9

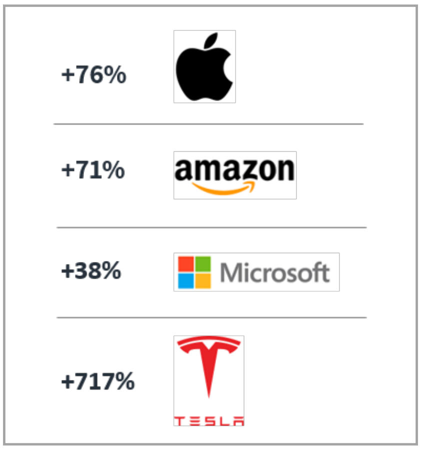
GBP Total Return by Sector (%)	
Information Technology	**39.7**
Consumer Discretionary	**32.4**
Health Care	10.3
Financials	-5.6
Industrials	8.5
Consumer Staples	4.7
Energy	-33.4

All of the above show MSCI Total Return Index. Source: Bloomberg, MSCI.

Dig a little deeper, and the Manager finds that just four stocks dominated the global picture: Apple and Microsoft (Information Technology), and Tesla and Amazon (Consumer Discretionary). While those companies only make up 10% of the total global stocks within the Index, they contributed 45% of the return.

This shows why stock picking is so important. If you had held just those four stocks, you would have achieved an overall return of 55% last year. But if you had invested in the MSCI World Index without those four stocks, you would have returned 7.5%.

Of course, there's not a portfolio manager in the land who would have ploughed all their client assets into just four companies. The risk would have been unpalatable. But it does illustrate that there are always winners and losers within an Index that performs well. The narrow nature of 2020's seemingly fantastic recovery highlights the fact that failing to hold this tiny corner of the market made it extremely difficult for investors to keep pace with the Index.



Apple, Amazon, Microsoft and Tesla contributed an incredible 45% of the total return of the MSCI World Index in 2020.
Source: Bloomberg

To learn more about VAM Funds, please contact us at sales@vam-funds.com or on +230 465 6860.

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Source: Sanlam Private Wealth.

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