ARE EQUITY MARKETS OVERVALUED?

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Global equities are only a tad below the February record high

The MSCI AC World Index is currently merely 2% below the peak reached in February this year before the Covid-19 crisis. There was a consolidation in June but it continued its rally in July. Many investors have started to worry about whether valuations have become stretched and stock markets are vulnerable. Here we try to address some frequently asked questions regarding the stock markets.

Potential upside surprise from the vaccine development?

Out of over 250 vaccine candidates globally, 25 of them have entered human clinical trials and 5 of them with promising results in Phase I and II trials have announced timelines for potential emergency use from September to December this year, according to a research report from McKinsey. **Experts agreed that COVID-19 vaccines is likely to be available for use in specific populations between 4Q 2020 and 1Q 2021.** Thanks to unprecedented access to funding and more advanced technology platforms, the robust vaccine pipeline reveals accelerated development efforts (historically it took at least 4 years to develop a vaccine). Historical attrition rates would also suggest that such a pipeline could yield more than 7 approved products in the next few years. Vaccine manufacturers have announced cumulative capacity that could produce as many as 1 billion doses by end-2020 and 9 billion doses by end-2021 (sufficient for the whole world with 7.8 billion population).

When there are more signs of a potential success in a COVID vaccine, analysts are likely to revise up further their economic growth and corporate earnings forecasts. **With hopes and expectations of COVID vaccines in coming months, equity market could remain resilient and we may not see a meaningful correction until this good news is realized** (i.e. vaccine is successfully developed – "buy the rumors, sell the news").

A tech bubble *déjà vu*?

The Big 5 (Apple, Microsoft, Amazon, Alphabet, Facebook*) in the S&P 500 (by index weighting) gained 58% versus only 1% return for the rest of the S&P 500 over the past 12 months. No doubt stock concentration of the Big 5 has driven up the index's overall forward PE valuation to 22x, almost reaching the peak of 25x in March 2000 before the burst of the tech bubble. Are high valuations justified? Shall we concern about a tech bubble *déjà vu*?

Compared to the top 5 companies during the tech bubble in 2000 (forward PE 47x), the Big 5 today, which are currently trading on 34x, are not overly stretched. Net margin of Big 5 is 18%, higher than the top 5 companies' 11% in 2000. Also, the Big 5 are in net cash position, versus the top 5 companies' 2% net debt-to-EBITDA during the period of tech bubble.

The Big 5 today in comparison with the rest of S&P 500 are superior in different (trailing 12-month) financial metrics as shown in the table. The gap of sales growth between Big 5 and the broader market is large by historical standards. They also have healthy balance sheets with positive net cash positions (negative net debt-to-EBITDA).

Trailing 12-month (%)	Big 5	S&P 500 ex-Big 5
Sales growth	11.2	0.1
Earnings growth	6.1	-13.1
Net debt-to-EBITDA	-0.6	2.3
Net margins	17.5	10.2

Source: S&P's, Factset, Thomson Financial, Credit Suisse, BNP Paribas WM, as of 1 Aug 2020

For 2Q, earnings per share (EPS) for the Big 5 grew 19% vs -34% for the broad index. The mega caps have shown their capacity to deliver robust earnings growth at a time when the rest of the market is reeling from the negative impact of COVID-19. In terms of return on equity, US tech in general stands close to 30%, which is significantly higher than other regions in the world (23%).

The robust fundamentals explain US mega-cap tech stocks' superior returns and higher multiples. The performance and valuation gap could widen further as they are among the major beneficiaries from a low yield environment with secular growth trend from a number of accelerating themes such as 5G, AI and Cloud usage. Nevertheless, the results of US election could affect their performance, especially a Democratic sweep would see risks of tax increase and technology regulation.

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Abundant liquidity supports elevated valuations?

The ultra-loose monetary policy and vast excess liquidity do support higher valuations, but they also need to be justified by good earnings in the longer term. For 2Q's earnings results, US and European companies exceeded consensus EPS forecasts by +22.3% and +7.4% respectively. Hence, 2020 earnings estimates have been adjusted higher in most sectors in the US with forecasts having improved the most in the discretionary and health care sectors. Further opening of economies, continued dovish monetary policy, additional fiscal stimulus and more potential positive newsflows on COVID vaccines could see earnings forecasts for 2020 and 2021 revised up further, and potentially more reasonable PE multiples (with earnings - the denominator of P/E ratio - going up).

Can the stock market momentum sustain after a 48% rally in 5 months? The table shows the 1-month, 3-month, 6-month and 12-month performance of S&P 500 historically after the index had its largest 50-day rally. The results seem to suggest that past big rallies have led to continued strength in the US equity market.

S&P 500's largest 50-day rally (> 20%)		Subsequent S&P 500 returns after the 50-day rally			
Date of the end of 50-day rally	50-day change (%)	1-month	3-month	6-month	12-month
6-Mar-75	26.9	-4.0	10.8	3.0	18.2
22-Oct-82	35.6	-3.3	3.6	15.6	20.3
26-Mar-91	20.8	0.8	-1.5	3.0	8.7
24-Jun-97	20.5	4.9	6.2	6.4	26.4
18-Dec-98	23.8	4.0	6.2	12.4	19.4
19-May-09	34.2	1.1	9.0	22.2	22.8
16-Sep-09	21.3	2.6	3.7	9.1	5.2
3-Jun-20	39.6	0.2	?	?	?
	Average	0.8	5.4	10.2	17.3
% of positive returns		75.0	85.7	100.0	100.0

Source: LPL Research, Factset, BNP Paribas WM, as of 31 July 2020

With growing evidence on COVID vaccine development and the rebound in economic activity, we could see a rotation from the expensive growth stocks to value stocks. Value stocks outperformed in 2003 and 2009 during the recovery from their respective recessions. Rotation into value could see the rally to last longer.

To conclude, vaccine development, robust liquidity and improving earnings are the positive catalysts for the equity market. However, at the same time, COVID, US elections, geopolitical tensions remain the key risks that investors can't simply ignore. Hence, we continue to recommend a "barbell" strategy – to stay invested with exposure to risk assets and buy on dips on one hand, and to hedge with defensive strategies such as gold, dividend stocks and quality corporate bonds on the other hand.

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