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Econote No. 93: Valuing equities with unknown unknowns 17/6/2020

Summary	**Investment Conclusions**
The start of earnings recovery justifying high equity values will depend on the elimination of CV-19.Economic and social activities will return to normal when CV-19 stops killing thus removing the need for lock-downs and massive restrictions on human mobility. While we learn how to kill the capacity of CV19 to kill people, it is next to impossible to forecast when economic and social activities will go back to normal. The buoyancy of the stock market is based on the expectation that CV19 is fully under control, which it is not. **A typical case of "forecasting" unknown unknowns**.	At this stage the most important macro guidance in the major economies (US, EU) will be the speed of the recovery of the labor markets and of the permanent loss of jobs. This will be an indication of the underlying strength of the economies, of sentiment and of consumer spending. We use here a sample of 10 important equity markets and apply standard metrics to reconfirm that absence of optimism on equities is justified. The trillions of state aid, and especially tax and rate cuts, do not help directly the unemployed or SMEs both of which will rely on the drip-down, slow effects.

Relying on known, known metrics

Sample of equity markets: Four developed: US, EU, Japan and UK using their standard indices, and seven Asian developing spread over big and smaller ones: PRC, Hong Kong, Taiwan, S.Korea, Singapore, India and Thailand. There was no specific reason why these markets were chosen but the emphasis on Asia reflected the importance of China and our own regional focus. **Time period**: Two periods 2007-2020 and 2019-2020 in order to capture longer and shorter term trends. All data to 15-16/6/2020. **Metrics:** Best PE ratios, 50 days moving averages where applicable and Relative Strength Indicators, all based on Bloomberg data and calculations covering the above periods.

We start here with the performance of the **PEs** as an indicator of the expensiveness of markets versus historic and recent performance. In Figures 1 (developed) and Fig. 2 (developing) markets there is a common and obvious trend.

Following the stock market crash in March all indices rose at the back of expectations of recovery driving all PEs sharply upwards. Individual markets performed individually, but all shares became more expensive.Given the continuing grim macro forecasts, the expectations about earnings were either irrelevant or wildly optimistic.The Shiller CAPE index for the S&P 500 is currently (16/6) at 28.7 or 67.5% higher than its historic mean of 17.1.The PE of S&P stands 24.3 but the comparison to CAPE is not relevant.

Fig 1: Best PE for main indices, US (red), EU (bl), Jap (yel), UK (br) 2019-20

Adding and refining on what the metrics tell us

The position of the **50 days moving average** of each of the stock indices gives a mixed picture, subject always to the limitation of this measure as an indication of a trend unless taken with a number of other indices-as we do here.In six markets, EU, Japan,EU, Singapore, Taiwan and Thailand the index stood above the 50D MOA, in four, UK,Hong Kong,S.Korea and India index and average were coinciding while for S&P500 the average was above the index.No real conclusions can be drawn except that for a majority of markest the index stood above the average on the 16/6 /2020.

More challenging results were drawn from the **Relative Strength Index (RSI)** .The four developed markets ranged from 47.5 to 51.7, while the developing, bar Taiwan, ranged from 47.3 to 57.6.Taiwan stood at 60.8.Clearly the majority of the markets fell near enough the 50.0 mark neither over nor undersold.

Drawing all these results we can point to three conclusions based purely on metrics

First, the markets are not oversold and the trends do not necessarily point to a further acceleration.

Second if we were to use the RSI only, the markets are not oversold and this goes against the arguments that now is the opportunity of a lifetime to buy the markets "cheap" as some are still below their peak values in early 2020.

Third, it is difficult to justify the current levels of PEs making shares comparatively expensive in the space of 2020 when there is absence of earnings guidance in view of the crisis, or macro data supporting buoyant expectations. In term of purely technical information, one would find it hard to advise for adding positions on equities at this period.

FACTBOX: Disentangling Rumsfeld, equities forecasting and CV19

"Reports that say that something hasn't happened are always interesting to me, because as we know, there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns—the ones we don't know we don't know. And if one looks throughout the history of our country and other free countries, it is the latter category that tend to be the difficult ones." Yes, hopefully this makes it clear why CV19 –equities is so hard to forecast!

Fig.2 Best PE for main indices, PRC (red),HK(gr),Taw (or),S.Kor (blu), India(bl), Thai(mauve) (bl),Sing (yel), 2019-20.

Source: Bloomberg

Conclusions: No evidence justifying growing equity positions

Recent macro data from the US on retail sales, and especially jobs creations, may have given a optimistic impression of the longer term underlying weakness of the economy, this is especially true on the crucial area of net new job creations as opposed of partial return to existing but "inactive" jobs. The Fed's current position with expectations of next- to- zero rates till 2022 is eloquent enough. However consider the following:

If the lock-down loosening in major economies, including China, continues for at least three months with no major or any secondary infection flashes and

If labor statistics in the US and EU/UK point to strong recovery, say 75% plus, on the jobs lost "temporarily"

Then this could be the inflection point to become bullish on equities again.

Econotes has always been a critical of US-centric obsessions as this ignores the fact that a lot of economies are independent enough to drive their own trajectories. However, here the trigger of a bull run on Asian markets would depend to a great extent on what happens in the US. Hence Asian investors could add to the two "ifs" above an extra bullet point on how these two "ifs" affect Asia.Some sectoral considerations could also be added, to the extent that China's recovery will be domestically driven as the economy was never, despite blind faith to the contrary, exports driven. Here a commodities boost could take place and could add support to Australia, and even Brazil, but not necessarily to oil unless Saudi-Russian manipulations turn a different page.

Andrew Freris (writing concluded on 17/6/2020)