

## Focal Point

### Equities in 2022: higher volatility but still good returns ahead

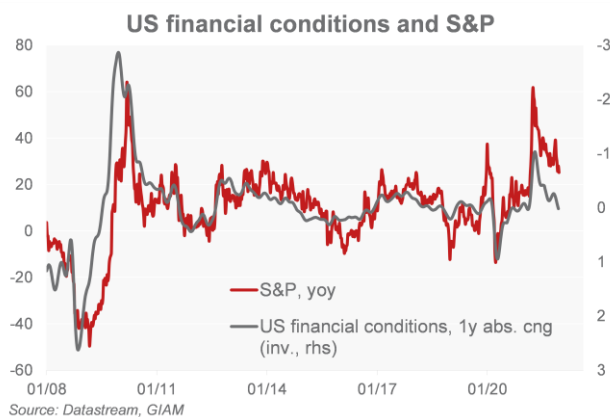
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December 21, 2021



#### Our Focal Point series explores topical issues on macro, markets and investment

- The current environment still looks beneficial for equities in 2022. Fundamentals remain robust as global and EA GDP growth will stay above potential (above 4%) and real yields contained. Solid pricing power and growth should keep margins relatively safe.
- Thus, equities will be supported by continued solid earnings growth which we cautiously estimate at +10% (EA and US). This considers higher wage growth and lower momentum in capacity utilization.
- All in, we forecast a positive total return of around 7% over the next 12 months, assuming some further PE compression and a drag from a diminishing policy support.
- That said, sticky high inflation triggers a higher uncertainty regarding the monetary response to future macro data. Furthermore, the risk premium usually gets more volatile in periods of higher inflation and eroding confidence indicators (e.g., PMIs). Finally, bond volatility has increased, which historically has fanned the risk of lower equity risk-adjusted returns vs bonds and spikes in equity volatility.
- Thus, we maintain a cautious OW in equities, recommending a slight OW in EMU vs. US and a style and sector barbell strategy: OW Value and defensive growth. We see a neutral stance on EMs warranted in the short term.



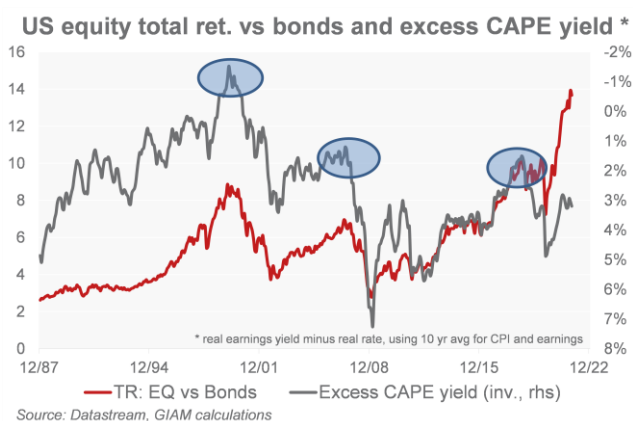
**Equities have risen much in 2021. Is there still juice? We see positive returns ahead but be aware of higher volatility.** Equities still have legs in our base scenario as fundamentals stay rather solid. [GDP growing above potential](#) and lingering low yields are certainly two good starting points. We see attractive returns in 2022 despite a modest PE contraction. Tactical indicators are neutral and both corporate cash and increasing buybacks (contributing to net 1% cash yield to shareholders in the US) ensure against abrupt and prolonged drawdowns. That said, the difficult aspect of the 2022 stock market assessment is represented by an increased uncertainty, lower financial conditions and consequently possible higher volatility. Let's see why.

## Good fundamentals reflected in positive total returns

**Earnings growth and low real yields.** In our base scenario of Omicron representing a non-disruptive event, the year 2022 will be positive for equities due to a sustained nominal GDP growth supporting an ongoing positive momentum in earnings. Real growth will stay at about 4% in 2022, and, coherently to our proprietary models, we expect earnings to grow at around 10%. As a rule of thumb, please note that the earnings multiplier for a given real GDP growth has been historically around 3X. Our estimate incorporates the assumption of slightly decreasing margins in the next quarters. They are expected to remain solid, coherently to both high CPI/ULC ratio and upbeat companies' statement. Indeed, firms have recently affirmed seeing reasonable pricing power due to strong demand and are using workarounds and tech investments to enhance productivity to offset cost increases. Earnings are buoyed by high pricing power of firms (contrasting the GFC aftermath) because of the strong demand and high excess savings of consumers. To estimate earnings, we use our macro forecasts as inputs in our models (e.g., GDP, inflation, yields, unit-labour costs, etc.). They see US NIPA profits (all US firms' profits contained in the GDP) at around +8% in 2022 after +20% in 2021. Margins (NIPA/GDP) should remain relatively stable in the period. Such figure corresponds to a S&P500 IBES forecast of +12.5% in 2022, which is similar to our IBES model results: +10%-14%. The same is true for EMU earnings, albeit they seem to have a potential to grow faster by nearly 1%.

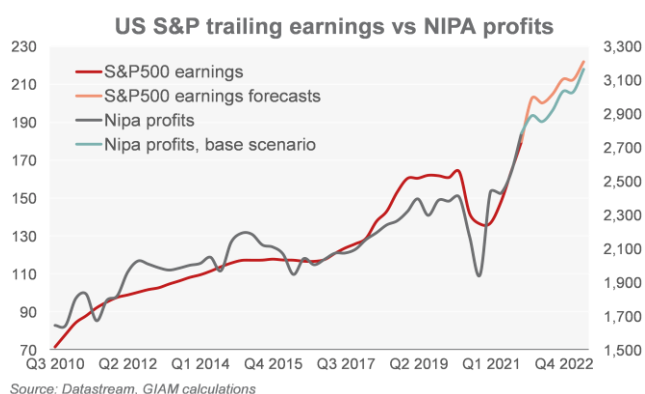
been slightly negative since the Q3 season started. For 2023, we forecast a 4% growth (our long-term earnings growth assessment) which turns out to be 4% below consensus.

Concerning yield levels, we dive into cross-asset returns through the cycle, looking at the yield curve, nominal and real rate "levels": equity returns adjusted for risk (Sharpe ratios of quarterly returns) should outperform fixed income in 2022, given current and targeted 10-year yield levels (2% for 10y US Treasury in 12 months). Indeed, the CAPE yield gap versus 10-year real yield remains quite high when compared to past pre-crisis levels: nearly +3%, vs. +1.5% in 2018 and 2007 and -1.5% in 2000.



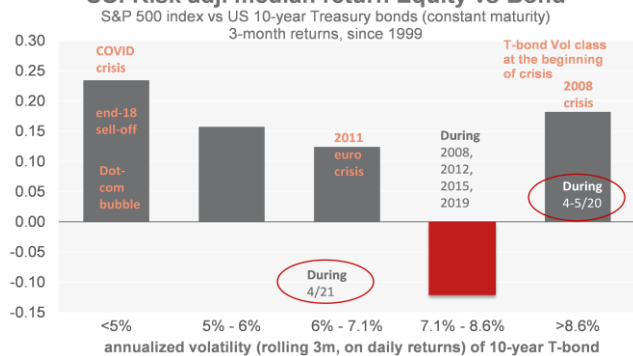
## The problem is the increased volatility of future returns

To begin with, a higher volatility of fair value is due to the less predictable response of monetary policy to high-for-longer inflation. Secondly, confidence indicators have peaked, adding to the uncertainty caused by a lower fiscal and monetary support. The result is already visible: financial conditions and excess liquidity are normalising, pointing south from a cyclical peak, while PEs most probably will continue to shrink next year (we estimate by -4%), after -10% already achieved year-to-date (average of EMU and US). Volatility should also drift higher. Indeed, during a higher headline inflation range (2.5%-3.5% vs 1.5%-2.5% in the previous regime, where 3-3.5% is our estimate for Q4 2022) the average risk premium demanded by investors didn't change significantly in the last decades. But the standard deviation of the same risk premium did, increasing by nearly 40 bps which corresponds to a  $\pm 5\%$  in fair value. Lastly, and most importantly, recently surged bond volatility has reached a level at which historically [equity return vs. bonds starts suffering](#), also increasing the risk of spikes in drawdowns.



Having said this, we see increasing pressure by less strong momentum in capacity utilization, high-for-longer input costs, wage lifts and lower deficit spending vs 2021. For this reason, we prefer not to exploit all the potential (+12%-15%) from high nominal GDP growth and stay with a forecast of 10%, similar to consensus. Indeed, US Q/Q growth ex-energy has been already -1% in Q3 and Q4 revisions have

## US: Risk adj. median return Equity vs Bond



Source: Datastream, GIAM calculations

All in all, we see 1-year total returns in the range of +7%. To assess the fair value for the US market, we use very long-term Shiller data to calibrate the targeted risk premium coherently to the new inflation regime. We find that the S&P500 fair value lies between 4,700-5,250 in 12 months, assuming 10-year yields at 1.5%-2.0% and earnings per share of 219USD and 228USD, respectively for 2022 and 2023.

### Shiller-based approach to valuation

| US CAPE-based valuation (adj. for inflation)                     | 10Y  | CPI  | Real 10Y Rate | EPS   | Current (e/p - 10y real) |
|--|------|------|---------------|-------|--------------------------|
| Scenario 1 (current input with consensus CPI & 12m fwd earnings) | 1.44 | 6.24 | -4.81         | 218.0 | 4.52                     |
| Scenario 2 (consensus 12m forward in 1 year)                     | 2.00 | 3.70 | -1.70         | 239.0 | 4.96                     |
| Scenario 3 (GI 12m fwd in 1 year)                                | 2.00 | 3.20 | -1.20         | 228.4 | 4.74                     |
| Scenario 4 (downside macro scenario)                             | 1.00 | 1.60 | -0.60         | 158.5 | 3.29                     |
| Scenario 5 (upside macro scenario)                               | 2.50 | 3.50 | -1.00         | 251.0 | 5.21                     |

| using 20% of risk (SD)   | Scen. 1 | Scen. 2 | Scen. 3 | Scen. 4 | Scen. 5 |
|--------------------------|---------|---------|---------|---------|---------|
| Implied PE Trailing IBES | 22.5    | 24.7    | 23.6    | 16.4    | 25.8    |
| Avg S&P500 valuation     | 4,468   | 4,897   | 4,684   | 3,249   | 5,119   |
|                          | -2.4%   | 7.0%    | 2.3%    | -29.0%  | 11.8%   |

Note: Base risk scenario: using 20% of risk premium's stand. deviation (SD=2.9%) adds around 60 bps to the average risk premium calculated since 1872 (4.1% + 60 bps = 4.7%). Target ERP (4.1) is calculated assuming CPI in the range b/w 2.0% and 3.2%.

| Scenario 3 (GIe) with lower ERP (yield at 1.5%) | Scen. 1 | Scen. 2 | Scen. 3 | Scen. 4 | Scen. 5 |
|---|---------|---------|---------|---------|---------|
| Implied PE Trailing IBES                        | 22.5    | 24.7    | 26.5    | 16.4    | 25.8    |
| Avg S&P500 valuation                            | 4,468   | 4,897   | 5,261   | 3,249   | 5,119   |
|   | -2.4%   | 7.0%    | 14.9%   | -29.0%  | 11.8%   |

Note: We take lower ERP by 50 bps in scenario 3

Source: Datastream, GIAM calculations

Of course, the projected positive total returns are sustainable (especially for the US) - in presence of high multiple versus history - only because of the described good earnings growth and low discount rate. For example, in the euro area (EA), the spread of GDP growth minus 10-year yield (proxy for earnings growth and discount rate, respectively) is around +5%, which compares to zero in 2018 and -2% in 2007 as well as in 2000. As a result, current PEs can stay higher than history. The same applies to the US. Our fair value indicators (a cautious approach to valuation based on 12-month forward earnings divided by the 10-year yield adjusted for a constant risk-growth factor) show EA market "currently" at a small discount (+5%), while the US is overvalued by 10%. In a year's time, earnings growth and buybacks will limit the downside in the US and the Shiller approach for the US remains our favoured approach.

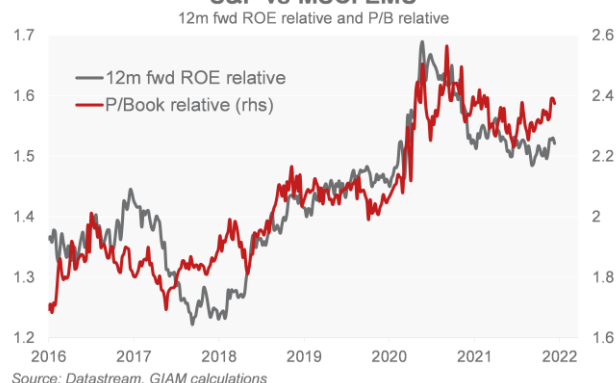
Finally, in terms of tactical indicators (composite indicators

which consider valuation, positioning, risk measures etc.) equity look neutral now. Cash yield to shareholders (dividend + buyback), cash in the balance sheet (+30% vs 2019) and aggregated cash flow minus capex, all show favourable conditions for equities. US buybacks could represent a net 1% yield or nearly 700bn USD in volume in 2022, very concentrated in Tech, financials and communication sectors.

## Overweight EA vs US, Value and defensive Growth

For the reasons mentioned above, we recommend a cautious OW in equities. Regionally, we see an increasing number of arguments in favour of the EA vs the US. The EA is significantly undervalued vs the US in terms of PBV-ROE and conventional PE (Z-score of -2.2). This remains valid even after having modified the PE with the expected long-term growth (PEG), beta and ROE. This adjusted PEG ratio is unusually lower for the MSCI EMU than that for the US. Furthermore, the trade-weighted EA seems beneficial for EA earnings, even after considering the difference in the real GDP growth rates between the two regions. Finally, the lower EA macro surprise index looks well discounted.

### S&P vs MSCI EMU

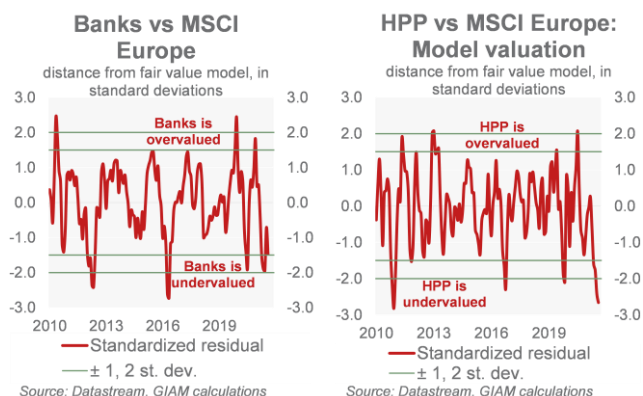


Source: Datastream, GIAM calculations

As for EU sectors, we favour a barbell strategy (Value + defensive growth). Financials and energy benefit from higher yields and inflation, decent GDP growth and undervaluation. We also OW defensive growth sectors as confidence is peaking and policy support declining. They deserve structurally higher total return adjusted for risk – Sharpe ratio. OW: banks, insurance, cons. durables, energy, food, Households (HPP), and pharma. UW: RE, div. financials, telecom and utilities. Our OWs all score well in terms of cycle phase, quant model results, valuation and revision trends. The HPP's revisions are bottoming out, while market multiples are about average. Furthermore, Households, representing a global, defensive growth, performs well in the environment of increasing uncertainty/volatility. The sectors put on underweight, on the other hand, are negatively correlated with inflation, have average relative valuation and earnings revisions but weaker EBITDA margin revisions YTD

(RE and Telecoms). Diversified finance and utilities are overvalued based on quant models. And while utilities have good revisions similarly to banks, the sector has the highest negative correlation with inflation.

OW together with secure global growth like staples, Durables and Pharma.



### EM equities: neutral stance warranted in the short term

EM macro surprises seem to have bottomed out and should be supportive for EMs in the short term. Additionally, there is a positive gap between EM performance and US financial conditions. That said, we continue to see weaker earnings and further headwinds that are represented by a slowdown in China and high real interest rates. On the positive side we see extreme underperformance vs. the MSCI World (Z-score of -1.85), low relative valuation (0.9 stdev below average) and better future domestic growth plus higher policy support. Increasing Korean export growth and China's RRR cut bode well for Korea and Chinese A-shares (both OW, good country score). We stay neutral on MSCI China.

### Conclusions

In this report we highlighted good equity fundamentals which we expect to continue in 2022. Global GDP growth above potential will trigger earnings growth of nearly 10%, thus offsetting further declining market multiples and backing total returns of around +7%. Sustainability of high market multiples will be guaranteed by low-for-longer yield, especially in real terms (albeit higher from current levels). That said, we described the factors causing higher uncertainty and volatility next year. It is not only the lower monetary and fiscal support, and consequently lower financial conditions, but also the ramifications from a sticky high inflation. First, monetary response gets less predictable. Second, the range of risk premium oscillations usually widens when inflation trend increases and, thirdly, bonds volatility has reached a level which makes the risk of equity setbacks more probable. All this translates into a cautious OW on equities, with a small preference for EMU vs. US, and a sector barbell where Value (Financials and Energy) are

## IMPRINT

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