Growth and Quality Assets Are Most Likely to Deliver on Earnings

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Buoyed by unprecedented monetary and fiscal intervention, global equities markets demonstrated their resilience in 2020. As we look forward to 2021, pandemic-induced uncertainty continues to be a dominant theme. A rising tide of COVID-19 infections, on the one hand, will pose challenges to markets, while signs of progress toward a medical resolution to the crisis will spark rallies.

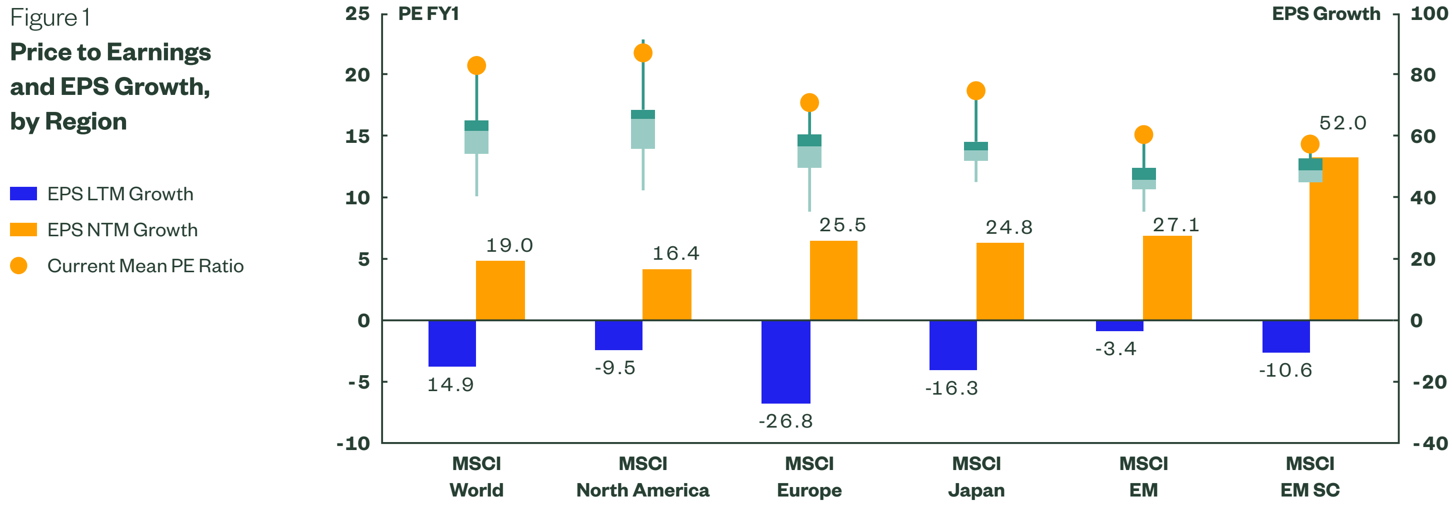
In general, we favor equities compared with other asset classes because they continue to offer relatively attractive excess returns. The equity risk premium (ERP) for developed equity markets stands at 5.5% as of October 31, 2020 — 46 basis points higher compared with the same time last year. The ERP for US equities exceeds that in Europe, largely due to comparatively greater compression of US bond yields. (Earnings prospects for US companies also appear more promising than for European companies.) The equity risk premium for global emerging markets (EM), while slightly below last year, has come back in line with long-term averages.

That said, fundamentals continue to be thoroughly disconnected from equity price movements. This is the second straight year that equity returns have been driven primarily by stimulus-fueled multiple expansion — not by earnings. For equity markets to continue to perform, the pressure is on earnings to come through. Although governments could manage to deliver larger-than-expected stimulus packages, we see limited room for additional stimulus. Quantitative easing measures will not be enough.

On the earnings front, after lagging market developments for months, earnings expectations are beginning to reflect the reality of COVID-19's impact. Compared with other regions, we believe earnings in North America are least likely to disappoint (see Figure 1).

Figure 1

Price to Earnings and EPS Growth, by Region



Source: State Street Global Advisors, Bloomberg, as of November 19, 2020. EPS = earnings per share; PE = price to earnings ratio; FY1 = one year forward; LTM = last twelve months; NTM = next twelve months; EM = emerging markets; SC = small cap. The box plots represent the mean price-to-earnings ratios for MSCI constituents in each category over the 10-year period ending November 19, 2020. The whiskers represent the 10-year minimum and maximum values for mean PE ratios; the median value is represented by a horizontal line, and the box represents the 25th through 75th percentiles for the 10-year period.

Focusing closely on earnings potential provides a few key points for equity investors to consider in 2021:

We are most confident that growth and quality assets will deliver on earnings in 2021. Growth companies' contribution to profits has been disproportionately higher than their overall market capitalization, and earnings growth is coming through to justify their valuations.

We believe that individual consumption will bounce back in 2021; investors should pay close attention to this theme. Consumer spending globally has already shown a sharp recovery since its low point in April. Despite recent job losses, stimulus efforts have supported household incomes, while increased savings have bolstered household assets. Although some areas have reimplemented mobility restrictions in response to rising COVID-19 rates, these have mostly stopped short of the blanket lockdowns that took shape in the spring of 2020. As economic activity resumes, and demand for goods and services revives, we believe the consumption theme is on track to outperform in 2021.

With all of this in mind, we expect earnings growth in China to be especially resilient, supported by a resumption of growth and consumption. Digitization and consumption trends will warrant a reconsideration of EM equity exposures in general. In that context, we favor Chinese consumer and growth stocks.

As we compose this equity market outlook, we're keenly aware of key points of uncertainty that pose risks to our base case. The days following Election Day in the United States saw a steepening of the yield curve and a rise in the MOVE index after a period of dormancy, indicating rising inflation expectations. If the Senate ends up in Democratic control following runoff elections in January, US fiscal expansion could exceed current expectations, and inflationary pressures could step up further, triggering trade in reflationary assets.

For now, although we're keeping a close eye on the potential for a nearer-term uptick in inflation, we believe this is more likely to materialize beyond 2021. This year, we favor growth and quality equities, and encourage investors to consider their equity exposures in the two markets that we believe are most likely to deliver on earnings: North America and China.

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