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# Market Update: 4th February 2021

## Share Prices Reflect Improving Company and Economic Fundamentals

Despite the near-term uncertainty surrounding the global economic recovery, equity markets continued to reflect improving investor optimism towards the end of 2020 as key risks abated and the outlook brightened. At the turn of the year, equity markets rallied as vaccine rollouts gathered pace and the Georgia Senate runoff led to greater expectations for economic stimulus from the US. In recent weeks, this upward momentum has waned, as a mixture of valuation concerns, profit taking, depressed analyst forecasts and a retail trading frenzy added to uncertainty.

After concerns that the uncertainty may continue to weigh on risk assets in the short term, investors breathed a sigh of relief this week, as markets found support owing to improving corporate earnings expectations while the Reddit fuelled trading cooled and positive vaccine data hit the headlines once again.

### *Stock Market Detractors*

Upon the conclusion of the Senate runoff, investor concern surrounding overvalued equity prices weighed on markets. In comparison to historical values, key global indexes were trading at multiples significantly above their long run average, with the US' top 500 companies trading at a forward P/E of around 22.7 in mid-January, the highest level since the 2000 dot com bubble. Tesla has played a key role in contributing to the high valuations, having witnessed its share price increase over 700% in 2020, giving it a forward P/E multiple of 170.

Alongside these elevated multiples, company fundamentals remained relatively weak in the majority of sectors, and analyst expectations ahead of the earnings season had been muted. As analysts factored in rising virus cases and renewed lockdown restrictions for much of the fourth quarter, they predicted that these negative factors would feed into company financials, with lower consumer demand reducing revenue expectations.

Finally, the short squeezes that were focused on firms like GameStop had begun to cause worry across markets. As retail investors collaborated through Reddit message boards, GameStop's share price had increased 16x since the beginning of the year to its January high of $469, while analysts forecasted the firm's fundamentals to earn it a maximum value of $60 per share. Although these trades had only directly affected a handful of companies like GameStop, the wider market worry arising from the market inefficiency and stretched valuations led to investors behaving more cautiously. This can be explicitly seen in the value of the Cboe Volatility Index (VIX) below, which spiked to 37.21 towards the end of January, the highest since the runup to the presidential election in November.


*VIX, Google, 3rd February 2021.*

***What's Changed?***

A key driver for equity prices over the last week has been improving corporate earnings expectations. A significant proportion of firms have reported their results in the latter half of January that have turned out to be above expectations, which is believed to be down to analysts being slow to make adjustments to earnings, despite a gradual uptick in economic data. Up until the 29th January, 37% of the top 500 companies in the US had reported their Q4 results, with 82% reporting earnings per share figures above estimates, 8 percentage points above the 5-year average. According to Factset, if 82% is the final percentage for the quarter, it will be the second highest percentage of the top 500 US companies reporting a positive earnings per share surprise since Factset began tracking the data in 2008. A similar trend is evident in Europe, too, with Q4 earnings surprising 13% to the upside so far, the highest positive surprise since the global financial crisis. After a month of falling equity prices across industries, the latest earnings surprises could be equally important to investors who seek to justify the elevated share prices that have been present for months, and the uptick in share prices over the last few days suggests that investors are increasing their confidence in the global stock market recovery.

Additionally, it appears the Reddit retail traders have turned away from the stocks they aimed to short squeeze, with GameStop currently trading around $90. Market confidence has returned somewhat, for a number of related reasons. Firstly, it appears that we are unlikely to see another short squeeze to the same extent from retail traders, with the recent share price changes appearing more as a one-off event, rather than a trend that will continue going forward. This is supported by the limited capital behind retail traders when compared to institutions, and the euphoria experienced will be unlikely to continue for many retail traders. Secondly, markets became increasingly worried about the potential downfall of financial institutions such as hedge funds, which would pose a greater risk to the stability of financial services. Although several hedge funds did realise significant losses, the limited number of hedge funds experiencing losses and the fact that losses did not escalate further for each institution has prevented any real damage. As the situation has cooled, investors will also likely welcome the permanent changes that may come to the financial system as a result, for both institutions and retail investors.

Since key indices in the UK, Europe and US bottomed on Friday January 29th, they have all increased between 1.65% to 3.11% up to February 3rd. The unravelling of the events above has been key contributors to investor confidence of an improving outlook returning, and the waning of potential threats to the financial system. That being said, it is important to also note the ongoing developments with the vaccine distribution and the expected stimulus plans within the US, with news flows being both contributors and detractors to the share price performance towards the end of January.

***Our View***

Despite continued short term weakness in economic and company fundamentals, investors have continued to look through short term weakness and towards an improving medium to long term outlook in recent months. Valuations have undoubtedly become elevated in certain regions and sectors, however at the same time, economic fundamentals have been improving. Additionally, although there have been mixed news flows regarding vaccines and the global pandemic, nations had begun to set expectations as to when they expect a significant proportion of the population to have been vaccinated, which allows businesses to set their expectations accordingly. With the improving outlook in mind, despite short-term uncertainty, economic and company fundamentals now appear to be moving in the right direction, providing investors with greater confidence during this period of short-term weakness. Overall, our medium to long-term outlook remains positive, and we continue to search for new opportunities for our OBI portfolios as the global economy recovers.