Eaton Vance Management

Timely insights from portfolio managers and industry experts on key financial, economic and political issues.

JULY 16, 2021

Equities

Mid-year outlook bright for international equities amid shifting paradigms

Ian Kirwan
Global Equity Analyst
Eaton Vance Advisers International Ltd.

London - On balance, our outlook for international equities is optimistic for the rest of the year. Europe is now catching up on the vaccination front and the U.K. is preparing to lift all COVID-19 restrictions over the next few weeks. Japan, which has been a notable vaccination laggard, is aggressively ramping up its efforts to control spread of the virus, most recently closing the summer Olympics to spectators.

As restrictions ease, consumers and businesses will be increasingly free to spend again. The playbook we have seen in China and the U.S. bodes well for Europe and, in time, Japan.

Strong earnings and cash-rich consumers

In Europe, the monthly corporate earnings figure for May showed the greatest year-over-year momentum since 1988. Although year-over-year earnings momentum has likely peaked, we believe the current trajectory of corporate earnings, coupled with vaccinated, cash-rich consumers, creates a fertile environment for continued earnings surprises. According to analysis from UBS, operating leverage for European equities, defined as operating profit growth to revenue growth, is running near a 20-year high.

"Although year-over-year earnings momentum has likely peaked, we believe the current trajectory of corporate earnings, coupled with vaccinated, cash-rich consumers, creates a fertile environment for continued earnings surprises."

Consequently, we do not believe now is the time to aggressively adopt a more defensive posture, although, as we noted earlier in the year, we do think the outperformance of high-beta, low-quality stocks has passed its peak.

Will inflation derail optimism?

Last quarter, we wrote that inflation was set to be the big topic during earnings results season. This certainly seems to be the case. A study by Deutsche Bank found that Google searches for the word "inflation" are now running higher than at any period since 2010, potentially pointing to concerns around purchasing power and investment returns. We believe pricing power increasingly matters for businesses. It is, in fact, one of the key performance indicators we use when assessing business model strength — and we think it bears close watching in the current market environment.

Over the last six months, we have seen significant movement in the U.S. 10-year Treasury yield. We believe this choppiness will likely persist and continue to drive volatility between longer-duration sectors, such as technology, and rising-yield beneficiaries, like banks. When coupled with ongoing disruptions to global supply chains, the macroeconomic noise is likely to remain loud in the coming months. This should lead to lively debates — and interesting outcomes —

as we watch the evolving direction of interest rates, inflation and sector leadership.

A potential change in policy status quo

Looking further out, we think the enormity of both government and central bank policy responses to the COVID-19 crisis means that the status quo that drove equities from 2009 to 2019 will likely change. Interest rates, taxes and costs (i.e., inflation) could all be heading higher, and this will have an impact on corporate profitability and sector leadership.

Accordingly, we believe portfolio decisions over the next year will not be based on the same assumptions that drove the last decade of impressive earnings growth. The unlimited policy support, excess liquidity and permanently low interest rates we have experienced may all change over the coming years.

For the international equity strategies we manage, our focus, first and foremost, is on business model sustainability and bottom-up stock picking, rather than on the macro environment. We look for stocks that we believe have the potential to perform well regardless of whether interest rates and inflation are headed up or down. In our view, that is a key mantra for successful long-term wealth creation, and we try to ensure our strategies reflect interesting ideas from both shorter-term cyclical and longer-term secular perspectives.

Bottom line: Many trends — opening economies, strong earnings, attractive valuations and cash-rich consumers — bode well for international equities for the balance of the year and, we think, beyond. Although macroeconomic challenges exist, we believe our focus on sustainable business models and pricing power position our international equity strategies well for long-term success.

The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the U.S. and global markets. The value of equity securities is sensitive to stock market volatility. Investments in foreign instruments or currencies can involve greater risk and volatility than U.S. investments because of adverse market, economic, political, regulatory, geopolitical, currency exchange rates or other conditions. Investing primarily in responsible investments carries the risk that, under certain market conditions, a strategy may underperform those that do not utilize a responsible investment strategy.