Why we're repositioning to reflect a gloomy equity market outlook

The year so far has been a tough one for economic forecasters, with the ‘black swan’ event of Russia’s invasion of Ukraine combining with an acceleration in inflation – and central bankers’ efforts to fight it – to swiftly usurp the prior narrative of economic recovery from Covid-19 lockdowns.

Luckily for us, our investment process doesn’t require us to forecast any macroeconomic variables or company financials. Instead, it is built around the forensic analysis of company cash flows, investor behaviour and market valuations. It is through this prism that we have observed the market’s reaction to Russia’s invasion of Ukraine and rate rises from key central banks.

Since the historically brutal sell-off in markets that accompanied the outbreak of Covid-19, our investment indicators have been steering us towards ‘value’ style equities. However, the value rally has evolved significantly over the last two years and its path has been volatile. This has required us to continuously reappraise the nature of the rally.

Our key market indicators now suggest that while value stocks still look a lot more attractive than companies with high forecast growth, some repositioning is required in order to reflect a fairly gloomy outlook for equity markets.

Stocks are now more uniformly expensive than they were last year, while they have now entered a downtrend from a technical perspective. Whereas expensive valuations are no impediment to us taking a constructive view on markets whilst an uptrend is in place, we need to be a lot more circumspect in our investments once this momentum breaks down.

Investor anxiety is another consideration when we rate the investment environment. For the first time since we developed our proprietary measure ten years ago, our reading of investor anxiety spiked to very high levels at the start of the Covid-19 pandemic. Having then abated, it has risen again somewhat in the aftermath of Russia’s invasion of Ukraine.

However, while in early 2020 the spike in investor anxiety acted as a leading indicator of contrarian value opportunities, this is not the case on this occasion. This is because valuation dispersion hasn’t risen sufficiently. When investor anxiety manifests itself in very high dispersion, it usually means there are lots of deeply discounted stocks to invest it, including stocks that we would classify as contrarian value – those experiencing tough trading conditions and very sceptical investors.

Unlike last time, the recent bout of investor anxiety hasn’t led to large pockets of cash-generative companies on low valuations. Instead, we have seen good opportunities in value stocks with momentum, recovery or cash return characteristics. Recent investments in these brackets include steel producer Arcelor Mittal, food distribution specialist Jerónimo Martins, and tobacco company Swedish Match.

We’ve also found selective opportunities to pick up inexpensive quality or defensive stocks.

One key market development guiding us towards this more defensive strategy has been the surge in corporate optimism (as measured by companies’ investment of cash flows in operating assets), which we see as a contrarian market indicator.

Aggressive corporate expenditure often signals that company managers are being over-optimistic about future growth and backing this with significant investment. These investments then prove costly if growth subsequently disappoints.

We've therefore designed our corporate aggression measure to highlight when managers are becoming particularly aggressive with their investment. When this measure is high, we've found the best returns to be among defensive stocks.

Our proprietary measure of corporate aggression now sits at around one standard deviation above average in Europe, while the US is closer to two standard deviations. From a statistical standpoint, when this measure breaches one standard deviation above average, it sits in the top 15% of historical measurements; when it exceeds two standard deviations, it is in the top 2% .

Of late, we have invested in Ipsen and Roche, healthcare sector stocks offering cheap defensive quality characteristics, and Dassault Aviation, the aerospace & defence stock with good momentum and cheap quality qualities.

Key Risks

Past performance is not a guide to future performance. The value of an investment and the income generated from it can fall as well as rise and is not guaranteed. You may get back less than you originally invested.

The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term. Investment in the Fund involves foreign currencies and may be subject to fluctuations in value due to movements in exchange rates. The Fund may invest in emerging markets/soft currencies which may have the effect of increasing volatility. The Fund may invest in derivatives. The use of derivatives may create leverage or gearing. A relatively small movement in the value of a derivative's underlying investment may have a larger impact, positive or negative, on the value of a fund than if the underlying investment was held instead.

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