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Global Research Unlocked

Global Wave inflects, that often means swell outcomes for EM, cyclicals, equities

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Macro
United States

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Key takeaways

- BofA Global Research analysts join the podcast to discuss emerging risks, opportunities, and growth themes in global markets.
- After peaking over two years ago, the Global Wave troughed in Jan, suggesting investors can position for a sustained upturn.
- Nigel Tupper says it's typical for the US to perform best in downturns, for cyclicals and EM to perform in the upturn.

Global Wave should start to buoy Emerging Markets

The Global Quant Strategy team's macro indicator, the Global Wave, has inflected and is now rising. This positive signal follows the longest downturn on record (25 months). And while US markets have been rallying for over a year, US outperformance during Global Wave downturns is typical. History shows that in the year after previous Wave troughs, global equities rallied and emerging markets modestly outperformed the US. Consistent with this improvement in riskier regions, cyclicals also tend to outperform defensives in the year after the trough. Nigel does note there are 3 risks to the upturn, (1) if inflation is sticky and monetary policy remains tighter, (2) if China's recovery is delayed or muted, this could lead to a drag on the global economy and (3) if we see an earnings downturn, perhaps because of higher rates. *Global Research Unlocked can now be found on public podcast platforms, including Spotify, Apple Podcasts, Google Podcasts, and Amazon Music. These podcasts are first released to clients and then to the platforms.*

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Full Podcast Transcript

T.J. Thornton, Head of Product Marketing: Hello and welcome to Global Research Unlocked, where we discuss what's rising from growth industries to rising risks and opportunities in global markets. I'm T.J. Thornton, Head of Product Marketing at BofA Global Research, and we're recording this episode on Wednesday, January 31, 2024.

The most recent trough signal from the Global Wave was in earlier this month, January 24. On average after trough signals in the Global Wave, global equities have averaged better than average returns in the subsequent year. Equities tend to perform better when the Global Wave is rising. On average, every market across the world globally has posted a positive return in the 12 months after the Global Wave started to improve.

- Nigel Tupper

The US markets in particular have been rallying for well over a year now, despite weak consumer confidence and generally lackluster reads on the industrial economy, which of course begs the question as to whether markets are rightly anticipating improvement in the macro or if they're reacting to inflation rolling over and will soon be disappointed as growth rolls over too. Nigel Tupper, our Australia based Chief Global Quant Strategist, has developed a product called the Global Wave. This has nothing to do with conditions at various surf spots in Nigel's country of residence and everything to do with conditions in the global economy, in mid-January, the wave trough, and today we're talking to Nigel about what that means for markets in the US and elsewhere. It is positive with markets typically performing well after a trough, but there's a lot more to it than that. Thanks Nigel for joining us today.

Nigel Tupper, Chief Global Quantitative Strategist: Thanks very much for having me.

T.J. Thornton: So Nigel, let's start with the basic question. What are the key inputs into this global wave?

Nigel Tupper: The aim at the Global Wave is to identify multi-year trends in economic data in order to help investors know how to appropriately position investment portfolios at any point in time. The type of stocks that tend to outperform in economic upturns is usually quite different from the type of stocks that perform in downturns. When we created the Global Wave back in 2008, we tested an enormous amount of macro data around the world to determine what generally helps predict rotation within equity markets. There are seven components in the Global Wave, each of which is a global indicator that we've created based on data from the largest 50 countries. Four of the seven components are sensitive at turning points, including industrial confidence, consumer confidence, credit spreads, and trends in earnings expectations, which we call the earnings revision ratio. The other three components of the Global Wave are real economy indicators, which help identify long-term economic trends, including capacity utilization, unemployment, and producer prices. Now the Global Wave places more emphasis on the largest countries globally, and we place equal importance on each of these seven components. So in aggregate with seven components across 50 countries, there are about 350 data points in the Global Wave calculation each month. And by updating the Global Wave on a monthly basis, we can identify multi-year economic trends and also turning points when data changes direction.

T.J. Thornton: Okay. Nigel, equities have tended to perform well after the Global Wave troughs, but the S&P's been performing well for over a year now, even though other markets haven't been so fortunate. And there is a great debate about whether that continues, or whether we see broader strength in markets with other markets outside of the US participating. Is the Global Wave suggestive of that sort of broader strength across regions?

Nigel Tupper: We can go back and look at the 12 previous Global Wave trough signals over the last 30 years, of which six were based on back testing, and six have occurred since we started publishing this monthly update to the Global Wave back in 2008. The most recent trough signal from the Global Wave was in earlier this month, January 24. The Global Wave had been falling for 25 months and that was the longest downturn on record. And it was a period during which central banks in developed markets were raising short-term rates to address inflation. In downturns in the Global Wave, it's typical for equity market returns to be quite muted, for the United States equity markets to perform relatively well and for defensive stocks to outperform. And over the last two years when the Global Wave was falling that's exactly what happened across the world. During that period, the US was one of the best performing equity markets. Emerging markets underperformed. Now, more specifically, the US equity market outperformed the China market by 40% over that 25-month period. So now that the Global Wave has troughed, it's interesting to go back and look at the lessons from its history, as how equity markets usually perform in upturns. On average after trough signals in the Global Wave, global equities have averaged better than average returns in the subsequent year. Equities tend to perform better when the Global Wave is rising. On average, every market across the world globally has posted a positive return in the 12 months after the Global Wave started to improve. As you may suspect, the markets which have the most exposure to cyclical stocks tend to perform best in economic upturns. Obviously past returns are no guaranteed future results, but in answer to your question, yeah, a much broader range of equity markets tend to perform well in an economic upturn.

T.J. Thornton: Nigel, how long did these upcycles in the Global Wave last? It was a long down cycle, as you point out, the longest we've seen - 25 months. For how long should we expect this upcycle to continue?

Nigel Tupper: Based on our analysis of global cycles over the last 30 years, upturns in the Global Wave have averaged two years. Now there are different influences in each cycle, which will determine the profile of performance in the upturn, but the average equity market performance in the last 12 upturns has been quite consistent on a quarterly basis over the next year or two. Investors are often cautious about adding exposure to a market that's already performed well, but history suggests equity markets generally move with the economic cycle, so equity markets rally in a persistent upturn. The general rule is the longer the economic upturn, the longer that equity market rally can last.

T.J. Thornton: Okay, got it. And back to the question about breadth. There's a lot of debate about Magnificent 7 and for how much longer those stocks can continue to lead markets and whether those are the stocks to own or whether it's more cyclical names. And just last night actually a couple of those Mag 7 stocks reported in the stocks have traded a bit poorly in the wake of that. I assume that the message from the wave would be that this broader group of stocks in the US and globally is probably better positioned, is that right?

Nigel Tupper: The quick answer to that is definitely. Market breadth generally rises in an economic upturn when the Global Wave's going up. A market breadth narrows in downturns when there's a limited number of very large earnings stable stocks with diversified earnings streams that are outperforming, that's your flight to safety, flight to quality. In contrast, smaller stocks often perform better in market upturns because they may be more sensitive to increased demand and an economic upturn and various other factors, so a broad range of stocks often perform better in an upturn. Now, one caveat this time around is that breadth may be a function of globalization. Over the last two decades, some companies have been able to access new markets for customers and have built a truly global audience. If globalization remains in place, some extremely large companies may continue to benefit and continue to dominate market cap weighted index returns. Now it's possible a broader range of stocks outperforming in the economic upturn that appears to have just begun, but breadth may not return to the lofty highs before globalization took hold.

T.J. Thornton: Got it. All of this is great, if we continue to see the Global Wave trend up. But I assume there's a possibility that the trend upward could last just a short period of time and we could roll over again. What are the risks that you're focused on that would lead to another peak and then roll over in the wave?

Nigel Tupper: Yeah, indeed. There's always a risk that the global economic, upturn doesn't last very long. Exogenous events such as a war or even a global pandemic have the potential to abruptly change the course of the global cycle, but these events tend to be difficult or impossible to predict. There are three risks that seem a bit more obvious. The first is inflation. Central banks in developed markets are expected to reduce short-term interest rates this year as inflation moderates, and has contributed to the recent positive signal from the Global Wave. But if inflation surprises on the upside and monetary policy remains tighter than expected, then the components of the Global Wave may weaken. A second risk is China. China's the second largest economy by GDP (Gross Domestic Product), so if a recovery in China is delayed or muted or non-existent, this could drag on the global economy. And a third risk is earnings. Some market commentators suggest that earnings must deteriorate because the US Fed and other central banks have raised rates so significantly in the last couple of years. Fortunately, so far the global earnings cycle has remained surprisingly resilient in the light of this tighter policy, so an earnings downturn appears to have been averted at this stage. Now if these risks do start to eventuate, then they should become more evident in the monthly updates of our Global Wave Report.

T.J. Thornton: Okay. And earnings revisions are one of the inputs into the Global Wave, but you also publish on them separately. And as many people know, stocks do tend to follow earnings, so it's a really important thing to discuss. Are earnings revisions now consistent with the weakness we've seen in many markets since the post-COVID highs, where you got really positive revisions and then they sort of petered out? And are those revisions starting to improve?

Nigel Tupper: Yes and yes, so equity market performance typically reflects the earnings of companies through time, as you suggested. But stock markets often are very forward looking too, therefore changing earnings expectations are one of the key drivers of equity market performance. An analysis of consensus earnings expectations of stocks globally shows that an earnings recession has been averted. Earnings expectations did moderate as monetary policy was tightened in recent years, but the good news is that in recent months, the global aggregate of earnings estimates appears to be rising in tandem with the Global Wave. In fact, over the last 35 years, for which we have data globally, the global earning cycle has had a high correlation with the Global Wave, so the recent improvement in the global earning cycle is right on cue. While equity performance in the last year was largely driven by a valuation re-rating, market performance has the potential to be earnings led in 2024 as the global earnings cycle recovers.

T.J. Thornton: Okay, Nigel, last question for you. In your role as Chief Global Quant Strategist at BofA Global Research, you've built many models to help investors understand investing in equity markets. Whether it’s sectors or macro inputs like inflation, are these models telling you anything that you think might surprise investors?

Nigel Tupper: My team's so very fortunate to have had the scope to be creative over many years when analyzing global equity markets from either a top down or a bottom up perspective. If we look at our 300 or so global stock selection models that we've developed, there are a few that always surprise investors. The biggest surprise is usually how useful news can be in the stock selection process. These days it's possible to use natural language processing algorithms to quantify millions of articles every day. Most investors assume that if something's mentioned in the news, then it must already be reflected in the price, but our analysis shows otherwise. Some of our most effective stock selection models combine trends in news sentiment with other more traditional investment techniques. A second surprise relates to unintended exposures. Investors are often surprised by the relative performance of their portfolios, which can be impacted by exposure to things like interest rates or currency moves or geographic revenue exposure or the direction of the cycle or how other investors are positioned. For example, many stock market investors were shocked by the negative impact of rising interest rates and that impact on growth stocks in recent years. Understanding as many drivers of stock prices as possible can minimize the chance of a nasty performance surprise. And finally, many investors seem surprised by the opportunity to use style rotation to add to portfolio performance. Investors often have a very static approach to investing, miss the opportunity to adjust portfolio exposures through time and are then surprised by the performance of the stocks they own. The opportunity is to tilt towards stocks with the aggressive style characteristics in an economic upturn and tilt towards stocks with more defensive characteristics in a downturn. Our analysis shows it's possible to quantify the direction of the global cycle, and it's also possible to quantify which stocks have the optimal characteristics at each stage in the cycle. And I suppose that's where the Global Wave becomes useful. This is a macro indicator of the global cycle, which is designed to help investors take advantage of that significant rotation that occurs within equity markets through time.

T.J. Thornton: Nigel, thank you very much for your insights. I appreciate you joining us today.

Nigel Tupper: Absolute pleasure. Thank you for having me.

T.J. Thornton: The Global Wave was complicated to build, but the output is quite simple. It indicates whether the global economy is in an upcycle or a downturn, and as of earlier this month, the wave is in an upturn. Sure, some markets have already rallied, but whether you're looking at regions, sectors or stocks, that rally has generally been pretty narrow. The trough and the wave though suggests that the rally will broaden. And other strategists at BofA Global Research have expressed similar views for 2024, in terms of improving breadth, even as they have their own ways for coming up with those conclusions. And though there's always a risk, the rising wave could be short-lived, these upturns tend to last two years, meaning there's still time and probably lots of bouts of volatility that'll enable investors to get more exposure to equities. Thanks for joining.

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