EQUITY

Is it Time for Small-Cap Stocks to Shine?

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As global markets increasingly ponder how long US economic growth can continue, Franklin Equity Group's Ed Lugo says he's looking for potential investment opportunities outside the United States. He explains why he sees opportunities in Europe and Asia, despite concerns about Brexit negotiations and a slowing Chinese economy.

US Economic Growth Faces Headwinds

The US economy is now entering its 10th year of economic expansion. The probability of continued economic expansion over the next five years, in our view, is pretty low.

There are several reasons why we think this is the case. Tariffs and rising interest rates may in time slow down the US economy. Although rates might flatten out a bit in the short term, the United States is at full employment and there's upward pressure on wages, which will likely cause inflation and push rates up in the longer term.

Higher rates have significant implications for US stock prices, in our assessment. For one, the present value of future US corporate cash flows will be discounted at a higher rate. This would suggest to us that stock prices will likely need to come down for those companies where earnings growth isn't sufficiently fast.

In our view, US small-cap stocks are currently among the most expensive in the world, especially in the technology and health care sectors. With valuations looking expensive to us in the United States amid rising interest rates, we are finding more compelling opportunities in Europe and Asia outside of Japan.

Political Uncertainty Weighs on European Stocks

Despite continued political uncertainty related to Brexit and the growing influence of populism in Europe, we believe select European small-cap equities look attractive if you take a longer-term view.

Many companies in the region's less cyclical industries have fallen out of favour as the market has seemed more interested in health care and technology stocks. While some of these less cyclical companies can be found in a number of sectors, they generally have stable revenue growth and reasonable valuations, among other things, in common.

Companies providing corporate services are particularly attractive to us. For example, we've identified potential opportunity in a French company that provides contract catering. We think it could potentially benefit as more companies in Europe outsource their cafeteria services.

We are also finding value in select glass and plastic consumer packaging companies. UK waste management services providers in the United Kingdom are also on our radar. Garbage needs to be collected regardless of Brexit or whether the economy is up or down.

Economic Concerns in China Create Opportunities Across Asia

In the Asia-Pacific region, we see value opportunities in Hong Kong, Korea, Thailand and China. In our view, valuations for many Chinese stocks are attractive to us currently. The country's been hit hard on a number of fronts and that is weighing on stocks in many industries. First, the Chinese government has cracked down on corruption, hurting consumer sales, particularly of luxury goods. On top of that, a sharp rise in real estate prices has led to government tightening.

In addition, US-China trade tensions have been more impactful to China, which relies more on US exports than the United States relies on exports to China. That means Chinese economic growth could grow at a slower rate than in recent years due to ongoing trade tensions.

This concern about slower Chinese economic growth is also leading to attractive valuations in places like Singapore and South Korea. China is the biggest economy in the region by far. When its economy weakens, the surrounding economies are affected.

Unlike in Europe, where we see value in some of the less cyclical sectors of the market, we are finding economically sensitive sectors, such as real estate companies in Hong Kong, more attractive in Asia.

According to our analysis, the stocks of some real estate companies are trading at a discount to what their property holdings are worth. Their stock prices have fallen in anticipation of a downturn in the Chinese real estate market that hasn't materialised. In our view, these companies are likely to be less impacted by a slowing Chinese economy compared to other stocks, such as banks in the region.

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What Are the Risks?

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