EQUITY

Navigating New Global Market Uncertainties

November 04, 2019

Antonio (Tony) Docal, CFA
Director of Portfolio Management
Portfolio Manager, Research Analyst
Templeton Global Equity Group

Heather Waddell, CFA
Portfolio Manager, Research Analyst
Templeton Global Equity Group

Peter Moeschter, CFA
Portfolio Manager, Research Analyst
Templeton Global Equity Group

Global equity markets continued to face uncertainties during the third quarter of this year, but by and large, they remained resilient. Templeton Global Equity Group's Tony Docal, Peter Moeschter and Heather Waddell provide an overview of events shaping markets in the third quarter and share their outlook for global equities. They explain their preference for multinational companies in the United Kingdom, why they see downside risk as limited in Europe versus the United States and why they still see a case for value investing.

Quarter in Review

In the third quarter of 2019, global equity markets were slightly positive, but markets outside the United States generally declined for a number of reasons. These included concerns about the progress of US-China trade talks, a continued lack of clarity on Brexit and an escalation of conflicts in the Middle East. On the economic front, the headlines were mostly negative, with global data that pointed to continuing economic slowdowns and, in particular, manufacturing weakness. Virtually the only positive headlines came from the global central banks that continued to cut interest rates and deliver accommodative guidance.

Volatility flared up periodically during the quarter on the back of the latest tweet or headline. Equity markets in Japan and the United States rose during the quarter, while markets elsewhere in Asia and Europe were generally weak. Because of the US strength and weight, developed markets were up 0.7% while emerging markets fell more than 4%[1] as Chinese equities suffered amid escalating trade tensions.

Two defensive sectors, consumer staples and utilities, were the strongest during the quarter, given all the geopolitical and macro uncertainties. Perhaps not surprisingly, cyclical sectors, energy and materials, were the greatest laggards.

In an environment of slowing economic growth and rising risks, investors have been willing to pay a premium for growth and safety. The safety premium is evident in the outperformance of bond proxies like staples and utilities. Cyclicals are simply the inverse of this theme; cyclicals depend on improving macro conditions, and these types of stocks have generally been out of favour this late in the economic cycle as risks are rising.

We view sector opportunities as very highly selective. In our view, the extreme crowding and positioning in bond proxy sectors (as mentioned above) increases the likelihood of a sharp and severe rotation out of defensives into cyclicals. However, sustainable longer-term cyclical performance would likely require a durable improvement in macroeconomic conditions and a de-escalation of the political risks we see today globally.

For this reason, we have adopted somewhat of a barbell type of positioning in our portfolios. On one side of the barbell, the bulk of our investments are in what we view as higher-quality, cash generative, industry-leading companies that (for whatever reasons) still trade at modest valuations. On the other side of the barbell are select special situations in cyclicals where valuations have become simply too cheap to ignore.

Looking at energy specifically, stocks in this sector came under pressure during the quarter as rising geopolitical tensions created significant volatility in the price of oil. Our energy strategy has been to remain nimble and use major price declines to increase exposure to the more cyclically geared oil services and exploration production stocks. We then rotate back toward the stable, dividend-paying large integrated energy stocks as the price of oil recovers above the marginal cost of production. Integrateds remain very cheap and unloved despite improving fundamentals that have allowed them to generate better cash flows this year than they did when oil last traded at US$100/barrel.

At the commodity level, we think the vigilance of the Organization of the Petroleum Exporting Countries (OPEC), along with rising depletion rates and enhanced geopolitical risks, all point to future supply tightness.

Meanwhile, at the corporate level, capital discipline has improved noticeably as managements prioritise value over volume. Yet, the energy sector now trades at a relative price-to-book (P/B) value of mere 0.45x, roughly half its long-term average and by far the cheapest valuation since at least 1952.[2] Being historically cheap, firmly out of favour, with corporate fundamentals improving and a healthy supply/demand backdrop, all create a compelling long-term investment opportunity in the energy sector, in our view.

Europe: Headwinds to Growth, but Downside Risk May be Limited

Economic conditions in Europe have deteriorated as the year has progressed. With the majority of data releases being downside surprises, weakness in global growth in the past 12 months can largely be attributed to Europe. Certainly, the US-China trade war hasn't helped, given that exports represent about 28% of eurozone gross domestic product (GDP) versus 12% for the United States and about 19% for China.[3] Europe is export-oriented and very vulnerable to external shocks, such as the escalating trade tensions and Brexit uncertainty. This is most visible in Germany, where real GDP contracted during the second quarter of 2019 and likely shrank again in the third quarter.

It's been a long time since investors have favoured European equities outright, but their degree of unpopularity has definitely increased significantly this year, as we've seen some large equity outflows. Sometimes expectations get so low that even the slightest positive surprise can turn things around. For example, Germany's recent manufacturing purchasing managers' index (PMI) came in at 41.1, within the lowest decile of all historical observations.[4] That's a very poor report, but we also see it as a contrarian indicator, since historical readings at this level have typically been followed by strong regional equity outperformance.

A cultural shift within the European Central Bank (ECB) could also aid the recovery of the sluggish European economy. New ECB President Christine Lagarde has indicated a dovish bias by discussing the policy tools at her disposal and her willingness to use them. And perhaps even more indicative, Wolfgang Schäuble, the ultra-hawkish former German finance minister, recently admitted the traditional German policy model of being fiscally conservative was not dynamic enough given current challenges.

In our view, austerity measures will likely continue to fade away and increased fiscal stimulus may complement open-ended quantitative easing. To this end, we have noticed an intensifying political and business-led backlash against the very rigid budget rules and austerity of the past. And the fact that investors are willing to pay eurozone governments for the opportunity to lend them money (given bonds with negative interest rates) suggests ample fiscal space to stimulate the economy with increased government spending and tax cuts.

It's worth noting also that European equities actually held up pretty well during the volatility that engulfed the markets back in the fourth quarter of 2018, which we think is a function of already weak sentiment and already low valuations.

So in short, we think the depressed conditions in Europe should limit the downside risk considerably, relative to regions like the United States that are pricing in far more optimistic scenarios.

Brexit: A Healthy Degree of Caution

Brexit certainly is a fluid situation. We continue to leverage the collective knowledge of our investment team and our boots on the ground in the United Kingdom and Europe to evaluate developments as they unfold. We are navigating bouts of Brexit resolution optimism and pessimism with a healthy degree of caution.

At present, we are finding value chiefly in UK multinationals, where earnings stem from foreign markets, amid the uncertainty. However, we may find more value in domestically focused corporates going forward, as we stand ready to take advantage of potential market volatility.

The Brexit deadline has been further delayed through the end of January and—at the moment—the United Kingdom looks set to go to the polls in mid-December, when Prime Minister Boris Johnson will be looking for a fresh mandate to push through his Brexit plans. On the other hand, a Johnson loss at the election would result in a less market-friendly Labour government with Jeremy Corbyn at the helm pushing for a new Brexit referendum.

The concerns mentioned above are only somewhat priced into the market, as more disruptive scenarios could further weigh on equities. The market has priced in some economic weakness, but it is not the same as pricing in a hard Brexit-driven recession or a less market-friendly Labour government.

It’s true that UK equities have experienced a steady and significant de-rating versus developed market peers since the 2016 Brexit referendum. The MSCI UK Index trades at a 34% discount to the MSCI World Index on a blend of price to earnings (P/E), P/B and dividend yield.[5] But as noted, there are adverse outcomes not fully priced into stocks. We could see a further downdraft in the British pound and would need to consider how this would impact individual companies, either negatively or favourably, and to what degree.

We thoroughly evaluate the long-term fundamentals of companies in the United Kingdom and search for undervalued opportunities, as we do in all geographies. But there are certainly added complexities due to Brexit, which lead us to view the UK macro backdrop and currency with considerable caution.

United States: Equities Priced for Near Perfection

The US equity market has been a perceived haven for many investors seeking a stronger economic backdrop than the rest of the world, and they have been willing to pay up accordingly. But in absolute terms, US conditions don’t look that great. Headline GDP growth is anemic, the housing market is slow and wage growth is tepid.

Earnings are at or near peak levels, and political risks appear to be rising. That said, the United States has been managing to eke out about 2% GDP growth this year, and interest rates are at least still positive. Over the long term, the United States also has an extremely dynamic corporate sector, with service- and knowledge-based businesses operating at the high end of the global value chain.

In our view, valuation remains a key concern. US equities are priced for near perfection when fundamentals look vulnerable, setting the stage for potential disappointment should economic conditions deteriorate.

The latest stretch of US equity market outperformance is one of the longest on record, at a time when the US economic expansion is also the longest in history and US equity valuations are near their highest levels ever. At the end of the third quarter, valuation measures ranging from cyclically adjusted P/E, market cap-to-GDP (and a host of others) show US stocks at the 95th to 99th percentile of their historical valuation range.[6]

Setting aside valuation, US earnings growth appears unsustainable to us. For example, since 2009, US companies’ reported earnings have risen by 360%, while revenue growth has barely exceeded 50% and corporate profit margins and consensus earnings per share estimates are both near record levels.[7]

Based on our analysis, many other geographies offer more attractive valuations.

The last point we would make is that market dominance typically changes every decade. There are multiple examples of countries or market segments falling out of favour, such as Japanese equities in 1990, technology stocks in 2000 and commodities in 2010. Over the past 50 years, on average, only two out of the world's 10 largest companies have successfully maintained leadership from one decade to the next.[8]

Yet it seems like history is repeating; we are in an extended market cycle and many market participants are extrapolating this cycle's narrative of winners and laggards into perpetuity. Of the 10 largest companies in the world today by market capitalisation, the majority are tech companies, and eight of the top 10 hail from the United States.[9] We would ask: What are the chances these will be to stocks to own for the next decade? We think the month of September offered a glimpse into possible market rotation, should the popular narrative of this cycle began to falter.

That all said, we do still find values in the United States, but they are highly selective.

Sustained Value Rotation Difficult to Pinpoint

Lastly, as value investors, we noted with interest the rotation into value stocks that took place during the third quarter was driven chiefly by stretched valuations. Some market observers highlighted other factors, including better-than-expected economic data, accommodative policy messaging, easing trade tensions and stabilisation in yields. This all came at a time when growth and momentum were at extremes versus value in terms of relative performance and valuation—and this wasn't a gentle adjustment. These conditions set the stage for the dramatic rotation we experienced during the quarter, culminating in one of the largest three-day momentum value rotations in over 30 years.

We expect that this rotation could continue in the near term, but the path and timing of a sustained rotation back to value remains difficult to pinpoint. We have discussed the extreme undervaluation of value versus growth and momentum styles for some time. Historically, mean reversion has exploited these disconnects. We believe markets will ultimately rotate back to value, particularly if we see catalysts such as a steepening yield curve and the relative improvement of earnings in key value sectors.

There are some skeptics who suggest the proliferation of new technologies may be widening the competitive moat that is protecting incumbent winners. This, in turn, would support more investor money flowing into some of the same market leaders at lofty evaluations. To this, we would reiterate that today's market leaders rarely persist into tomorrow, and note that even if technology allows certain companies to corner markets and stifle competition, we would expect antitrust regulation eventually could help level the playing field.

Timing of market rotations may be tough to pinpoint precisely, but for a multitude of reasons, we are constructive on the resurgence of value.

What Are the Risks?

All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments; investments in emerging markets involve heightened risks related to the same factors. To the extent a strategy focuses on particular countries, regions, industries, sectors or types of investment from time to time, it may be subject to greater risks of adverse developments in such areas of focus than a strategy that invests in a wider variety of countries, regions, industries, sectors or investments.

Important Legal Information

Portfolio holdings information, opinions and other market or economic information and data provided are as of the date of the commentary, unless another date is expressly indicated, and may change without notice. Statements of fact cited by the manager have been obtained from sources considered reliable but no representation is made as to the completeness or accuracy. The manager's assessment of a particular industry, security, sector or investment is intended solely to provide insight into the manager's investment process and is not a recommendation to buy or sell any security, nor investment advice. This commentary is not a complete analysis of every material fact regarding any market, industry, security or portfolio. The views expressed in this commentary are those of the portfolio managers of the Templeton Global Equity Group only and may vary from the views expressed by portfolio managers representing other investment platforms or strategies within Franklin Templeton. The way we implement our main investment strategies and the resulting portfolio holdings may change depending on factors such as market and economic conditions.

References to particular securities are only for the limited purpose of illustrating general market or economic conditions and are not recommendations to buy or sell a security or an indication of the authors' or any managed account's holdings. Such securities may or may not be in one or more Templeton–managed portfolios from time to time. References to and discussions about portfolio holdings apply only to those portfolios managed by the Templeton Global Equity Group. Individual portfolios within the strategies may differ due to a number of factors including but not limited to portfolio size, specific investment guidelines and restrictions and inception dates of individual portfolios.

All investments involve risks, including possible loss of principal.

Data from third party sources may have been used in the preparation of this material and Franklin Templeton Investments ("FTI") has not independently verified, validated or audited such data. FTI accepts no liability whatsoever for any loss arising from use of this information and reliance upon the comments opinions and analyses in the material is at the sole discretion of the user.

Products, services and information may not be available in all jurisdictions and are offered outside the US by other FTI affiliates and/or their distributors as local laws and regulation permits. Please consult your own professional adviser or Franklin Templeton institutional contact for further information on availability of products and services in your jurisdiction.

CFA® and Chartered Financial Analyst® are trademarks owned by CFA Institute.

---

1. Sources: Bloomberg, FactSet. Developed markets are represented by MSCI World Index, which captures large- and mid-cap representation across 23 developed market countries; emerging markets are represented by MSCI Emerging Markets Index, which captures large- and mid-cap representation across 26 emerging market countries. Indices are unmanaged and one cannot directly invest in an index. They do not include fees, expenses or sales charges. Past performance is not an indicator or guarantee of future results.

2. Source: Empirical Research Partners, as at 30 September 2019. Price-to-book value is a valuation metric that compares a company's current market price to its "book value", or net asset value of a company.

3. Source: Gavekal Research.

4. Source: IHS/Markit research, as at September 2019.

5. Sources: MSCI, IBES, Morgan Stanley Research, as at October 2019. Indices are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.

6. Sources: Bloomberg, Yale/Robert Shiller, Federal Reserve Econ Data, US Bureau of Econ Analysis, John Hussman, Crescat Capital, as at September 2019.

7. Source: Lance Roberts, Real Investment Advice. "Peak Buybacks? Has Corporate Indulgence Hit Its Limits?" 26 September 2019.

8. Source: Louis-Vincent Grave, “An Investment Thesis for the 2020s,” Gavekal, 2 August 2019.

9. Source: Owuor Otieno, Sophy. “The Largest Companies in the World by Market Cap.” WorldAtlas, 8 July 2019.

© 2018. Franklin Templeton Investments. All rights reserved.