EQUITY

A Value Investor View of Market Dynamics and Potential Dislocations

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Alan Bartlett
President
Chief Investment Officer
Templeton Global Equity Group

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

Equities saw strong 2019 performances across the globe, so the big question for investors is whether the bullish momentum can continue. Templeton Global Equity Group's Alan Bartlett and Tony Docal provide a look at what drove the positive performances around the globe in late 2019, and how they are poised to take advantage of any potential dislocations in the year ahead.

Shifting Market Leadership

Over the course of 2019, we saw a pretty significant shift in leadership, from the continued outperformance of growth stocks in the first part of the year to cyclical outperformance in the latter part.

The main drivers include the improving global economic outlook, decline in interest rates and accommodative central bank policy posture. In the first half of the year, investors focused on growth and quality, with bond proxy stocks (those investors look to for income and stability) outperforming. That all changed once the US Federal Reserve pivoted to a dovish stance and bond yields bottomed in the second half of the year.

In September, the bond proxies sold off sharply and value stocks and cyclicals rallied as renewed central-bank intervention raised expectations that the economic cycle would be extended, lifting interest rates. With the valuation and performance spread between cyclicals and defensives perhaps having reached their limits, this policy pivot and reflationary expectations were the catalyst needed for mean reversion. Yet, once again it was short-lived; in the fourth quarter of 2019, growth and quality again outperformed value.

In our Templeton portfolios, we have been working to diversify among different types of value and different economic exposures. This has included some higher quality but still attractively valued investments on the one hand, as well as cheap cyclical stocks with greater operating leverage on the other.

Recent examples of opportunities include conglomerates, which compound value over time, defensive exposures in industries like precious metals, utilities and telecommunications, and also opportunistic bargains in the volatile Hong Kong market.

On the cyclical side, we added to our European banks and energy holdings as opportunities arose throughout the year, and also found some bargain opportunities with predictable value catalysts in Japan.

We have not found many opportunities in the high-flying parts of the market, including the information technology sector and the quality factor, which have seen valuations rise to extremes. But, we are ready to react if these rich multiples see a significant fall.

Let's take a more detailed look at regional developments and opportunities we see.

A Look at Brexit Developments—and UK Equity Implications

In the United Kingdom, the Conservative Party won a landslide 80-seat majority in the December 2019 election—the biggest majority since Margaret Thatcher's win in 1987. Before the election, the Conservative Party operated a minority government, meaning it needed the support of other parties, or at least ministers from other parties, to pass legislation. The precarious nature of the minority government had even caused disaffected conservative members of parliament to vote against their own party—a reason for a Brexit stalemate prior to the election.

The scale of the election victory in December gave the new Conservative government a very clear mandate to get Brexit done. Now, UK Prime Minister Boris Johnson doesn't need the support of other parties to pass legislation, and he has firm control over his own party as well. So, the Withdrawal Agreement Bill passed through the House of Commons successfully on the 9th of January and moved to the House of Lords for review.

While Brexit is set to occur on 31 January, in many ways the United Kingdom doesn't really leave the EU on that date, as there is a transition period of 11 months during which the United Kingdom and the EU will try to negotiate a comprehensive trade agreement. During this period, the United Kingdom will follow EU rules and regulations. It will remain in the single market, the customs union, and the free movement of people across Europe will continue.

The Withdrawal Agreement Bill actually prohibits any extensions at this transition period beyond the end of 2020. We think it is very unlikely a comprehensive trade deal can be agreed upon in such a short space of time, so we expect the Brexit debacle rumble on well into 2021, unfortunately.

In terms of UK equities, it's certainly possible to argue a value case from a top-down, macro perspective. The UK market has lagged equities globally and still trades at a discount on a number of measures. That said, we are cautious about domestically oriented companies where the valuations don't discount an earnings downturn. For example, the companies we favour for our portfolios have actually tended to be more export-oriented and not really part of a Brexit theme. It's going to be interesting to see how news flow around trade negotiations progresses in 2020, which we think could present us with more opportunities in the future.

Europe Catches Value Tailwind

Looking across Europe, and more specifically the eurozone, the region has seen modest improvements since early 2019. Germany and the United Kingdom avoided recessions, and leading economic indicators more recently appear to be turning slightly more positive. As we are value investors, we also would note that value as an investment style rallied strongly in September 2019. Europe—which is highly leveraged to value and cyclicals—was a key beneficiary of the value rebound.

Within Europe, we are finding opportunities in France and Germany in particular. On an industry basis, we favour European banks, pharmaceuticals, telecommunications and energy stocks. Despite the rebound in Europe, valuations remain cheap relative to the rest of the world and especially to the United States.

Even on a sector-adjusted basis, the eurozone continues to look cheap to us. While challenges remain, we believe once global investors take note of the improving European fundamentals and the very low equity valuations, they might allocate away from the United States and other markets and increase their European weightings.

We have found that inexpensive stocks can remain that way for long periods, and often need a catalyst to unlock value. We saw that in European banks in late 2019, for example. Many global investors have been underweight European financials for some time, but a modest rise in interest rates and improvement in regional economic and political conditions toward the end of the year renewed investors' focus on low valuations and improving fundamentals in the sector. The general theme of depressed interest rates and elevated macro risks will likely continue to pressure the financials sector, but much of that is discounted in very depressed valuations, and, as we saw towards the end of last year, low expectations create scope for positive surprises.

It’s important to point out that European banks aren’t just sitting idly in this low interest-rate environment. They are cutting costs as aggressively as possible and are focusing on growth segments and/or areas that require less risk-adjusted capital, which includes wealth management and other fee-generating businesses.

And, after a decade of tougher bank regulations, we think the pendulum may be swinging the other way. Investors seem optimistic that the European Central Bank may adopt a softer regulatory stance. The European legislative process around Basel IV will begin mid-year, and a pivot to less severe regulations could further boost investor sentiment for financials stocks.

We also think energy and telecommunications stand out as two other sectors with unsustainably low valuations that would likely benefit from any event that refocuses the market’s attention on these overlooked areas.

Trade Uncertainties Dominate Asian Equities, but Japan Worth Watching

The biggest factor holding back the Asian markets in 2019 was the trade-war skirmishes between the United States and China and then between South Korea and Japan. Yet, the absolute return of Asian markets in aggregate was remarkably strong despite this uncertain environment.

We think there are opportunities in areas that trade-war fears have disproportionately impacted. South Korea is an interesting market that suffered in 2019 because it’s seen as dependent on global trade. Tensions with the United States hit Chinese technology companies, but in general they haven’t really reached levels that we think are compelling.

Meanwhile, political unrest in Hong Kong has caused a number of stocks to sell off to levels that have rarely been seen historically. While the issues in Hong Kong have dragged on for longer than many would have predicted, we are willing to be patient if prices are attractive enough.

We also think it’s going to be fascinating to see how the Japanese stock market develops over the coming years. It’s been a very long time since it hurt global equity managers to ignore Japan. That’s because when Japan has performed well for any meaningful period over the last 20 years or so, it’s largely been whenever the US market has been performing strongly or when the Japanese yen has been weakening.

Japan’s weight in the global and international equity benchmark indices has fallen significantly, which also makes it easier to ignore for index-relative investors. Japan has a huge national debt and significant demographic issues, with one of the fastest-aging populations in the world. As we all know, tax revenues in Japan really need to rise, but increasing tax rates tends to reduce economic growth, and so it can be counterproductive.

Indeed, economic growth has been anemic in Japan for decades. After the bursting of the bubble in the late 1980s, it took many years for corporations to repair their balance sheets. Stability and the maintenance of full employment were regarded as more important to society than profitability and shareholder returns. The resulting deflationary environment meant companies had to cut costs every year just to tread water and real growth domestically was incredibly hard to achieve.

From a global perspective, being underweight Japan just hasn’t hurt relative performance for long enough to make investors pay attention. But that could change.

One reason is that the social contract between government corporations and individuals seems to be evolving in Japan. In simple terms, the government is encouraging corporations to focus more on making profits for shareholders. This is because the government now sees growing corporate profits as the key to broader economic growth, and economic growth as the roots of balancing the books.

It’s important to understand that Japan is a collectivist society, which foreign investors often misunderstand. The collective nature of Japanese society can mean change is slow to gain traction, but it also means that once momentum builds, it’s very powerful.

The changes that we are seeing in corporate Japan have been building for over a decade now, and we believe we're past the tipping point.

Historically, corporate governance in Japan has simply not been aligned with best practices in the United States and Europe, and it's fair to say that Japan is still a long way behind. But, governance is improving steadily. With strong support domestically from the government, trade bodies, the Government Pension Investment Fund—which is the largest pension fund in Japan and the world—there has been a dramatic improvement in return on equity in Japan in recent years. Share buybacks have increased markedly, and the dividend payout ratios have increased as well. Many companies can go further and they're under increasing pressure to do so.

One of the really interesting things about corporate Japan to us is the high level of tangible assets held inefficiently on corporate balance sheets. Many companies have high levels of cash or significant shareholdings in other companies; some hold large amounts of redundant property assets. Attitudes change slowly, but as companies continue to focus on improving shareholder returns, we expect to see some of this value on balance sheets be released. For example, we see an increasing trend for companies to absorb their listed subsidiaries, and a broadening of the trend toward increased dividend payout ratios.

US Bull Market Ageing

In terms of the United States, it's tough to predict whether the decade-long outperformance of US equities will continue. We have been expecting outperformance of non-US markets for some time, based on the wide valuation discounts on offer. However, the US economy remained in a "Goldilocks" scenario through most of last year, experiencing both low inflation and record low unemployment. Fiscal policy has also been supportive. Liquidity has been abundant, and growth was higher than elsewhere in the developed world, translating into strong corporate earnings.

The US economic expansion became the longest in the postwar period during the second quarter of 2019, so we are now in uncharted territory, both in terms of the US market and the economy. We can't predict the future, but we do know that in aggregate the United States looks like a riskier place to invest at these levels, which a number of indicators are flashing as overvalued.

"Bubble" might not be the best word to describe what's happening in the US market—a better word may be malinvestment. Too much liquidity and too little growth have resulted in too much capital chasing too few opportunities. Inevitably, this capital flows disproportionately toward the punchy growth rates achieved historically in the technology sector. Low interest rates also structurally support technology multiples, and it's not just the public equity markets, private equity has also bid up the valuations of unlisted technology companies.

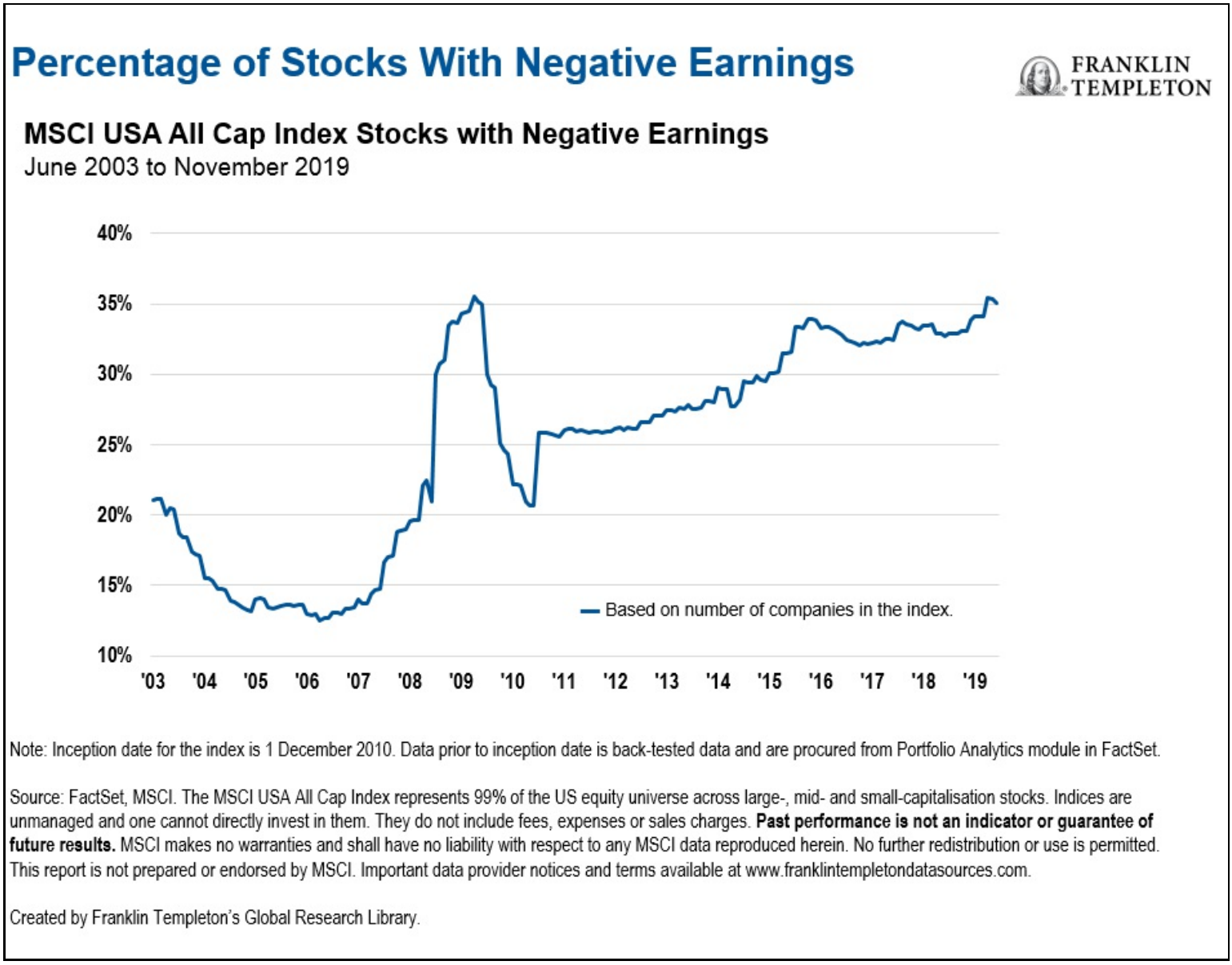
Yet, many of these companies saw their growth rates decline as 2019 progressed and the likelihood of achieving profitability remains low for many years into the future. Meanwhile, consensus expectations call for a significant acceleration of technology earnings this year, setting up a situation where earnings growth assumptions could be severely tested by decelerating growth at a time when valuations are extremely high.

The consensus-assumed fundamental improvement may or may not come to fruition, but the market's pricing this in as if it's a certainty. As such, we think the balance of risks in such a scenario skews to the downside and any disappointment from high expectations could reveal a big air pocket between these expectations, fundamental reality and valuations.

Of course, there are some great US tech companies with a real competitive advantage, formidable moats and long-term growth optionality, but elsewhere there are certainly some warning signs.

Last year, the United States saw the largest number of unprofitable initial public offerings (IPOs) since the tech bubble peak in the 1990s. In fact, 83% of companies that listed last year were unprofitable, higher than in 2000—right before the bubble burst.[1] Of the listed companies in the United States, roughly 35% were unprofitable, again the most since the tech bubble.[2]

Furthermore, net debt among Russell 2000 companies has tripled since the global financial crisis. This should all be cause for concern, especially considering the real cost of capital in 2019 was arguably the lowest in a hundred years.



Not Reliant on Value to Outperform

Recent years have no doubt been very difficult for value investors. We aren't necessarily predicting a renaissance for the global value factor in 2020. That would certainly help our strategies, but we don't think we need that in order to add value for clients. What we do need are dislocations.

We need pockets of opportunities caused by specific issues in individual countries, in industries or with individual companies themselves. We need opportunities where fundamental research and patience matter. As this cycle rumbles onwards, we do see more potential sources of dislocations, and we've been working very hard on the research side to be ready to take advantage of them.

For example, while we aren't predicting the return of inflation in 2020, we also don't think the risk of inflation is priced into many of the stocks that have done very well in recent years. In September of last year, we saw how aggressively markets are likely to react to any suggestion that interest rates might rise, but we also saw how determined policymakers are to avoid an end to this cycle. So, structuring a portfolio today is a delicate balance.

For the time being, it seems that sentiment is the dominant factor for investors, but ultimately, we know that fundamentals matter and we feel strongly that they are on our side.

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1. Sources: Bloomberg, Jay Ritter, University of Florida, CNBC.

2. Sources: Societe Generale Cross Asset Research/Equity Quant.

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