

Global Equity Observer

2018: Eyes Wide Open

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | DECEMBER 2017

Our central concern at the start of 2017 was a backdrop of generally high valuations coinciding with some significant macro/political concerns for the then forthcoming year, including China, the risk of U.S. and European politics going wrong, and the vulnerability of the financial system to shocks due to the sharp increase in debt and general stagnation. We observed that if some of these major concerns went wrong, there was little margin of safety generally and probably quite a lot of downside given the nature of some of the potential risks. As bottom-up stock pickers, we found little margin of safety in stocks more or less across the board. 2017 ended with most major country indices up 20-25+% (in U.S. dollar terms)¹ making such concerns look at best premature, at worst just plain wrong. However, enthused U.S. dollar-based investors getting excited about markets in 2017 may have forgotten that markets went up a lot in something that went down a lot (i.e., the dollar).

As we start 2018, we are more concerned about valuation and on balance less concerned about macro, although there is still plenty that could go wrong. In a nutshell, the market has re-rated on the basis that 2017's expected earnings increase of 15% for the MSCI World Index actually delivered for the first time in five years, as growth for once did not disappoint. Although there is growing evidence of gross domestic product growth across the board, should these proverbial green shoots fail to bloom, in our view the market could de-rate multiples on lower actual earnings, the proverbial double hit.²

¹ Source: FactSet, 31 December 2017.

² Forecast/estimates are based on current market conditions, subject to change and may not necessarily come to pass.

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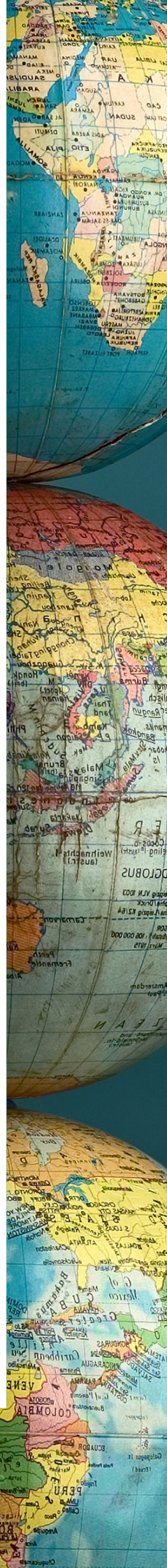
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In the U.S., despite the sturm und drang and the flying of a lot of liberal feathers, the market has broadly seen the benefits of Trump (tax reform being the biggest win) without any of the major risks eventuating as yet (an unholy cocktail of awfulness ranging from a trade war with China to nuclear war with North Korea). To the credit of Congress, it has passed, after much drama, the single measure we thought would have the biggest long-term positive impact on the U.S. economy, namely tax reform. Although its impact on overall U.S. corporations may be muted in the short term (few major U.S. companies pay a full U.S. tax charge unless they are purely domestic), the big long-term question is whether the combination of the tax reform and short-term capital expenditure (capex) and cash repatriation packages will be enough to get a capex cycle going, leading to a pick-up in productivity from current lows. In recent years, U.S. corporates have generally chosen to buy back shares rather than increase capex, so productivity has generally suffered as a result. A bull would say the combination of tax reform and opportunities provided by the Internet of things (IoT) and Artificial Intelligence (AI) will kick off a long cycle of investment to drive waste out of many sectors, with massive potential cost savings, a good chunk of which will come through in margins, which will be propelled to permanent new highs. A bear would respond that there may be some positive impact, but U.S. corporations will just continue to buy back shares and margins may normalize as labour seeks to get its hands on a larger share of corporate profits from a still historically low starting point, leaving aside the risks from the ageing U.S. economic cycle.

Add to this that the U.S. market is anticipating a repeat of the 12% earnings growth in the S&P 500 it saw in 2017, it is hardly a surprise that the market has not been over-concerned with valuation. A bull (no shortage of those) would say that at 18.2x, the NTM (next 12 months) P/E ratio of the S&P 500 is only about 14% above the long term mean of 16.0x from 1997 to 2017, so why the fuss? A bear (count us as one)

would point out that even leaving aside quality of earnings (given the largest ever cycle of U.S. earnings manipulation), corporate debt after a buyback binge is near record highs, as are margins, which means that the debt adjusted price to sales (EV/Sales) at 2.44 for the S&P 500 is getting close to the 2000 peak of 2.98, which is a clear amber light, even leaving aside outdated notions of earnings reversion to the mean or the risk of a downturn in the U.S. economy.

If one takes a longer-term view of valuations as per the Schiller P/E, the U.S. market has gone from expensive on 27.9x at the start of 2017 to very expensive on 32.4x at the end of 2017. Unless the visionary tech bulls are right that a heady cocktail of AI, IoT, e-commerce et al will propel already peak margins ever higher, leading to a ton of earnings growth, this is also a dark amber light for valuation, with a lot of expectations baked into prices. We believe no bull market ever bursts purely from valuation alone, but when markets do focus on valuation once more, it matters.

The other major geo-political risk facing the world at the start of 2017 (aside from Trump) was the risk of political disruption in Europe, possibly leading to a scenario of a breakup of the Eurozone if the politics went wrong. After a few awkward moments, the market shrugged off such concerns following the Dutch and (in particular) the French elections and, even after nasty surprises in the German election, continued to concentrate on the growing evidence of a Eurozone economic recovery. So far, the market has been right, with some entirely unexpected positive results such as a big majority in Parliament for President Macron in France, which (miracle of miracles) means that reform (particularly labour market reform) has actually progressed in France and looks set to continue. Our concerns that Brexit could inspire a cascade of falling Euro-dominos have been hitherto wrong: the only domino to fall flat on its face has been the U.K. itself, after doing what Michael Bloomberg memorably described as “the single stupidest thing any country has

ever done.” In fact, the only wobble of the dominos to date has been a positive impact – the U.K.’s self-immolation probably inspired France to rally round Macron to avoid the fate of its much loved European partner. However, our concerns for the European elections were not that there was a high probability of things going horribly wrong in France or Germany; rather that the risk was Italy, which managed not to have its general election in 2017. Italy has been the big loser of the euro, with its economy not growing for 20 years due to an inability to reform itself and (mostly) to it losing its historic ability to depreciate its currency (the lira) to keep its competitive plates spinning. Furthermore, Italy has the strongest euro-sceptic forces of the major European countries going into their electoral cycle. The risk, now, is that Italy with its election in March 2018, elects a government that decides to do something about the euro – if so, political risk will be back in Europe in spades.

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Looking forward to 2018, there does seem to be a synchronized global expansion. However, in our opinion it isn't that large, has quite a lot of risk and seems to be priced in by markets. We see that few of the major structural problems in the world (debt, the unknowns of a quantitative easing (QE) unwind, political uncertainty, China et al) have gone away. In simple terms, a “Goldilocks” scenario has been priced in but there remain elevated risks and no apparent margin of safety in valuations. Such growth as there is looks unlikely

to drive a sharp pick-up in inflation. Even though the U.S. is pressing the reflation button of tax cuts, this does not guarantee that the U.S. will reflate, especially given its starting point of one of the longest economic expansions in recent memory and already record high margins. One might also point out that giving the wrong people (corporates and the wealthy) tax cuts does not in itself amount to a conventional hitting of the reflation button via fiscal policy. General use of fiscal policy to reflate Europe also looks questionable, given the Germans have to agree to it, which looks far from a foregone conclusion with a weakened Chancellor Merkel in discussions with the (socialist) SPD for a renewed Grand Coalition. However, even if there is very little probability of systematic German-led reflation in Europe, we believe that at least European fiscal policy as a whole no longer looks like a future drag, and could be mildly expansionary.

Despite its many problems (debt, demographics, QE ad nauseam), we believe Japan does not face the same political risk as the West, given that Abe has just been re-elected with a large majority. Furthermore, the Japanese

cabinet approved a draft tax measure to incentivize companies to increase wages and raise capex in December 2017, potentially lowering Japanese corporate tax rates from the current 30% to 20%. There is even some evidence that Japanese companies are at last taking measures to run themselves better, although this is very much on a stock by stock basis and generally their number is few. Japan just may have the ability to surprise on the upside from reflation, particularly as there is growing evidence of labour shortages driving up wages. However, as always in Japan, there are a frustratingly small number of investible companies that can benefit from this.

As bottom-up stock pickers, the substantial general rally in markets in 2017 aggravates the problem we have faced over the last few years of generally not having a sufficient margin of safety in the form of price to compensate us for potential risks, be they cyclical, macro or the threat of disruptive change. Certainly the market does not see a margin of safety as a principal concern, with the VIX trading near all-time lows.³

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This means it has generally been difficult to find new names for all portfolios and there have been no obvious sectors which have been dramatically mispriced, so 2017 has been about company-specific factors. To us, the risks look skewed more to the downside than upside. If widespread hopes of a continuation of the current synchronized pick-up in world growth fail to materialize, the current backdrop of high valuation and low concern for risk make preservation of capital the key concern. To us, high-quality companies that should still be better able to grow sales and profits in a downturn look the best relative bet, even if they may seem unexciting in absolute terms.

RISK CONSIDERATIONS

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect **global franchise companies** and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. Stocks of **small-capitalization companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market** countries

are greater than risks associated with investments in foreign developed markets. **Non-diversified portfolios** often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **Option writing strategy.** Writing call options involves the risk that the Portfolio may be required to sell the underlying security or instrument (or settle in cash an amount of equal value) at a disadvantageous price or below the market price of such underlying security or instrument, at the time the option is exercised. As the writer of a call option, the Portfolio forgoes, during the option's life, the opportunity to profit from increases in the market value of the underlying security or instrument covering the option above the sum of the premium and the exercise price, but retains the risk of loss should the price of the underlying security or instrument decline. Additionally, the Portfolio's call option writing strategy may not fully protect it against declines in the value of the market. There are special risks associated with uncovered option writing which expose the Portfolio to potentially significant loss.

³ Source: Chicago Board Options Exchange Market Volatility Index, 31 December 2017.

INDEX INFORMATION

The **MSCI World Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

DEFINITIONS

Capital expenditure, or **Capex**, are funds used by a company to acquire, upgrade, and maintain physical assets such as property, industrial buildings, or equipment. Capex is often used to undertake new projects or investments by the firm. This type of financial outlay is also made by companies to maintain or increase the scope of their operations. **Downside** is the negative movement in the price of a security, sector or market. Downside can also refer to economic conditions and it describes periods when an economy has either stopped growing or is shrinking. **Gross Domestic Product** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. It includes all private and public consumption, government outlays, investments and net exports. **Price-Earnings (P/E)** is the price of a stock divided by its earnings per share for the past 12 months. Sometimes called the multiple, P/E gives investors an idea of how much they are paying for a company's earning power. The higher the P/E, the more investors are paying, and therefore the more earnings growth they are expecting.

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