

Global Equity Observer

Between Scylla and Charybdis

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | DECEMBER 2019

As simple souls we attempt to disaggregate investing into earnings and multiples. Concerned as we are with the preservation of capital, we continue to maintain that there are only two ways to lose money in equities: if the earnings go away, or the multiple goes away. While our daily business is at the stock level, we also attempt to apply this logic to markets as a whole.

At the end of 2017, our concern was multiples, with the MSCI World Index on 17.0x forward consensus estimates.¹ This fear proved well founded, as 2018 was a down year despite double-digit earnings growth, as the market de-rated to 13.4x.¹ Given this de-rating, our concern for 2019 switched to earnings... and we were a quarter right! We say a quarter, as we were half right on earnings, which mildly disappointed being down a fraction for the year rather than the expected 7% rise, but did not foresee that the multiple would bounce back to 17.0x.¹ If we disaggregate the 2019 return of 28% for the MSCI World Index, a massive 26% came from the re-rating, -1% from earnings, and the remainder from dividends.¹ This is an extreme example of the pattern we've been seeing since 2012, where more of the market return has come from multiple expansion than from earnings growth, with only 2017 offering a strong return year driven by earnings.

AUTHORS



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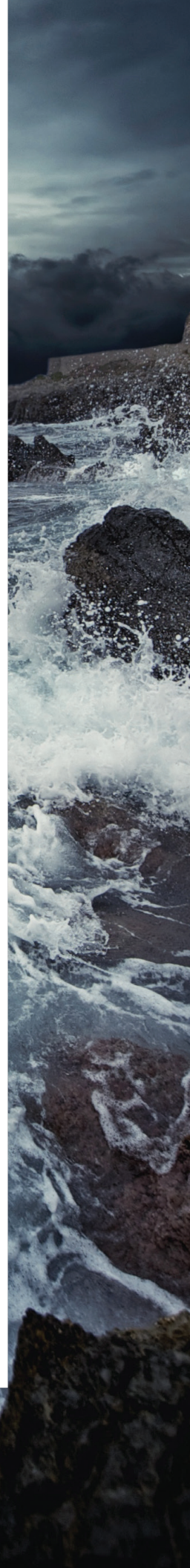
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¹ Source: FactSet, December 2019



DISPLAY 1**Disaggregation of MSCI World Returns**

	MULTIPLE EXPANSION	EPS GROWTH	DIVIDENDS	TOTAL RETURN
2012	13%	0%	3%	16%
2013	18%	5%	3%	27%
2014	5%	-2%	2%	5%
2015	2%	-4%	2%	-1%
2016	3%	2%	2%	8%
2017	5%	15%	2%	22%
2018	-21%	13%	2%	-9%
2019	26%	-1%	2%	28%
Average	6%	4%	2%	13%

Source: Factset, 31 December 2019

“2019 is an extreme example of the pattern we’ve seen since 2012, where more of the market return comes from multiple expansion than earnings growth”

This significant re-rating implies a large increase in optimism during 2019. This was clearly not driven by the actual earnings, which disappointed in 2019 and have yet to revive, but rather by hopes for the future. Monetary policy was one clear shift. The U.S. Federal Reserve’s (the Fed) rate-raising cycle, which saw four rises in 2018 amidst talk of ‘normalisation’, ended in December of that year, and 2019 saw three cuts, along with more dovish noises, and a return to a growing balance sheet as it battled the crisis in the repo market. The European Central Bank (ECB) and the People’s Bank of China have followed suit in easing monetary conditions in an attempt to boost growth. Markets were also helped by a reduction in fears about a trade war between the U.S. and China, with talk of an imminent ‘Phase 1’ deal, which would at least imply a truce.

So where does this revival of market morale leave us for 2020? Frankly, we are now nervous about both multiples and earnings. Our fear about multiples is natural enough, with the MSCI World Index back up to 17.0x, and this time without the benefit of the imminent earnings boost from the Trump tax cuts that it had in early 2018. Even putting the risk of multiple compression to one side, it is tough to see how there can be much mileage for the markets from expanding multiples—a 10% boost would require the MSCI World Index to be on close to 19x!

“Many of the levers for earnings growth have been pulled hard already, particularly in the U.S.”

This leaves earnings as the main potential driver of any significant upside for markets, and here we are sceptical for the broad market in the medium term. It may well be that an industrial recovery can drive progress in 2020, but our structural concerns remain. Our anxiety is based on the fact that most of the levers for earnings growth have been pulled hard already, particularly in the U.S., leaving limited opportunity for them to help further and skewing the risk to the downside. Margins are high, as corporates have been advantaged relative to labour, given globalisation and the political move to the right over the last few decades, and also relative to consumers, given the falling role of anti-trust. Profits have also been boosted by low interest rates and increased leverage, decreasing interest payments and allowing earnings per share-boosting buy-backs. On top of all this, the gap between the ‘adjusted’ numbers, used for consensus and paying management, and the actual profit at the bottom of the income statement has ballooned, reaching \$600 billion over the last three years in the U.S. alone.² These were all tail-winds for earnings over the last few years that are unlikely to be repeated, and may turn into head-winds if they go into reverse.

This may not matter in 2020. It is quite possible that the U.S. can continue to steer between the Scylla of recession and the Charybdis of inflation, delivering economic and earnings growth without the Fed having to tighten and end the party. With the MSCI U.S. Index earnings multiple now at 18.7x, and double-digit earnings growth forecast for 2020 after the slight fall in 2019,³ success seems to be what the market is expecting. Europe looks distinctly cheaper, in relative terms at least, at a ‘mere’ 14.6x,³ as there is far less optimism about growth. Part of

² Source: FactSet, Morgan Stanley Investment Management, December 2019

³ Source: FactSet, December 2019

this is down to the relative shortage of fast growing technology companies, but it is also down to the continent as a whole being mired in very slow growth. Here, there could be a positive story if there is a move towards fiscal reflation in 2020. The block, as ever, is Germany, given its balanced budget requirement. But if this is eased, perhaps using the need for infrastructure to deal with the climate emergency as an excuse to issue green bonds, then this could drive faster growth, or at the very least the hope of faster growth, which may be all that is needed to drive a rally. The ECB under Christine Lagarde is likely to remain helpful. By contrast, it is probably fruitless to expect structural change in Japan, which at $14.3x^3$ is marginally cheaper than Europe. However, having suffered a double-digit earnings fall in 2019, as industrial production struggled, it may well be a beneficiary of any industrial bounce-back.

“It is possible the U.S. can steer between the Scylla of recession and the Charybdis of inflation, delivering economic and earnings growth”

Alongside the U.S. premium to the rest of the developed world, growth is thriving relative to value, trading at a relative multiple not seen since the tech-media-telecom (TMT) bubble at the start of the millennium. We are agnostic on the growth versus value debate, since we are wary of both of them! The valuations for fast growing companies make us nervous, and we have moved around 1,000 bps of our global portfolios over the last two years from the faster growing companies, with estimated sales growth of 6% or higher, to the ‘duller’ side of the portfolio with 3-5% top-line growth,⁴ where valuations are more reasonable. As for value, it is the companies’ prospects that often look relatively dim, with several of the struggling sectors facing genuine threats, be it trapped assets for energy, the rise of electric vehicles for autos and low interest rates for financials.

DISPLAY 2 Relative Multiple: MSCI World Growth Index versus MSCI World Value Index



Source: FactSet, 31 December 2019

“One of the pluses quality companies offer is resilience in tough times”

As ever, we advocate the case for quality. We look for companies with the intangible assets to give them the combination of recurring revenue and pricing power, along with the ability to sustain high returns on operating capital. One of the pluses they offer is resilience in tough times: the recurring revenue protects sales and the pricing power protects margins. 2019 was yet another time that the portfolio’s companies displayed this economic resilience, with the earnings continuing to compound steadily all year while the market as a whole failed to deliver any earnings growth at all. At a time of raised multiples and high uncertainty (uncertainty that is arguably not properly reflected in the markets), we would argue that it makes sense to go with the relative safety and durability of high-quality compounders.

⁴ Morgan Stanley Investment Management, December 2019

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-capitalisation 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.

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