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Post-coronavirus: the outlook for global equities

By Peter Rutter – Head of Equities

"In the short run the market is a voting machine, but in the long run it is a weighing machine."
Benjamin Graham

During a period of significant market turbulence, such as the last two months, this observation by Benjamin Graham, the noted American academic and investor, often comes to mind. Our investment approach is focused on 'weighing' stocks for the long term. We also believe that there is a disproportionate amount of commentary and news flow discussing and speculating on near-term factors – that is to say, 'voting'.

Indeed part of our philosophy is to find market inefficiencies in this shorter-term voting, sentiment-driven behaviour and structural dislocations (e.g. quant funds selling due to short-term risk model breaches), and this has made for an active and busy eight weeks as an investment team. Consistent with our philosophy, we think it most useful to focus here on longer-term factors. However, before we do that, a few words on the nearer-term outlook.

The near term

Near-term 'voting' will likely continue to be dominated by: changing expectations and sentiment on the outlook for coronavirus epidemiology; the pathway and timings around ending lockdowns; the complicated first order impacts of various monetary and fiscal stimulus efforts; sensitivity to bond yields; and the emergence of structural changes in consumer, corporate and economic behaviour.

We remain focused on identifying superior shareholder wealth creators with attractive valuations and an investment margin of safety, combined in a diversified high-stock-specific-risk portfolio to navigate what will likely be volatile markets. Given the volatility, we believe there will likely be some more interesting long-term opportunities for investors, both at the stock-specific and thematic levels.

The longer term

We have four main observations about the long term:

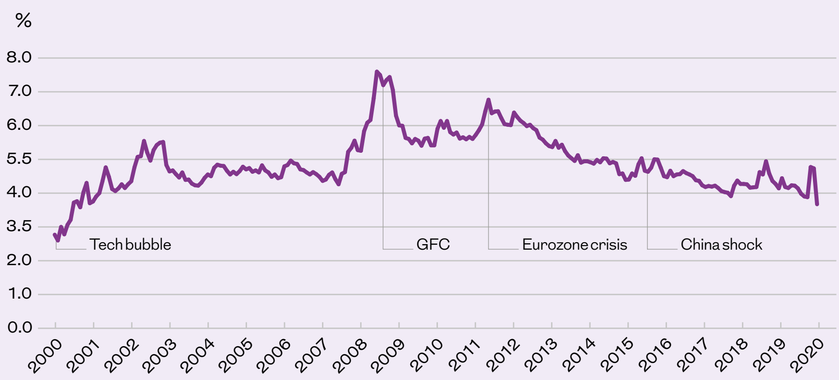
Observation one: Equities do not look particularly attractively valued relative to history, but remain attractively valued (possibly very attractively valued) relative to other asset classes, which provides significant support for equity markets.

Implication: equities remain an attractive long-term asset in the current monetary paradigm.

Looking to the longer term and the 'weighing', our market valuation framework suggests that a reasonable base case for the implied real total return from the MSCI World Index over the next decade will be around 4-6% per year (chart 1).

This is notably low compared to historical norms (the post-war period), but remains well in excess of the real yield available or

Chart 1: Global equity discount rate (implied future returns)



Valuation – value has significantly underperformed growth.

Margin of safety – discount rates have fallen sharply since their spike in Q4 2018.

Past performance is not a reliable indicator of future results.

Source: CS Holt as at 31 March 2020.

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implied in many other asset classes. As such, should bond yields and interest rates remain low and/or anchored to current long-term expectations, we remain optimistic about the future total returns from equity markets.

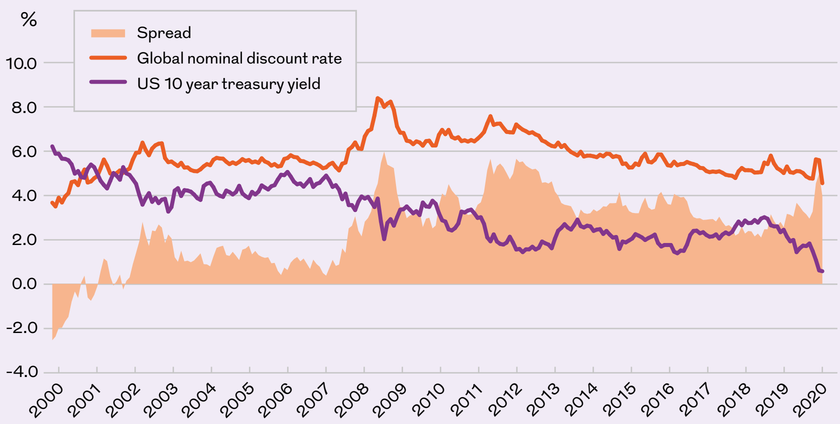
Another way to look at this is the implied shareholder cash flow yield on equities versus 10-year treasuries. By this measure, on a relative basis equities appear to be as attractively valued as they have been at nearly any point in the last 20 years (chart 2).

Observation two: Currently, market movements appear to be dominated by long-term bond yield, interest rate and discount rate expectations. We live in a monetary world – financial markets are captured by monetary policy (and arguably vice versa). We think this will remain the case for now.

Implication: portfolio construction to manage discount rate risk is of paramount importance and duration differences between sectors/stocks could dominate performance differentials within the market and between managers.

When looking for indicators for nearer-term volatility and risks, we consider stock and market valuations through our 'pricing puzzle' (chart 3).

Chart 2: Spread between global equity discount rates and bond yields



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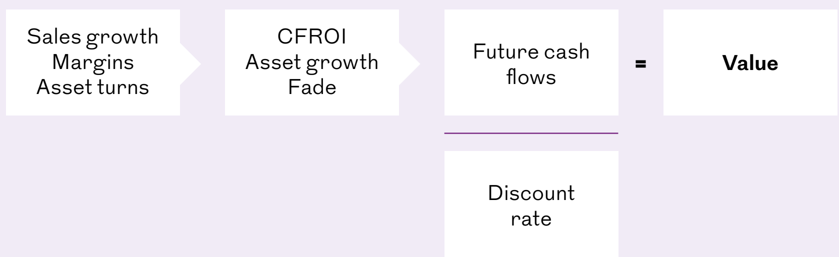
Source: CS Holt as at 31 March 2020.

Chart 3: Pricing puzzle

Fundamental value = Discounted net cash receipts to shareholders



Source: RLAM, for illustrative purposes only.

We would note that as discount rates have approached ever lower levels, and the duration of the aggregate market has increased (growth outperforming value), equity market valuations are currently very sensitive to changes in expectations for discount rates (bond yields, interest rates, opportunity costs of capital). We can observe this in equity market behaviour over the last five years, including the recovery from the recent crisis. Although markets tend to rally before the trough of the recession, the size and nature of the recent rally (bond proxy stocks, defensive growth and quality growth driving the recovery) clearly point to the impact of the falling discount rate, bond yields, etc. rather than outsized expectations of economic recovery.

Observation three: Within equity markets, sector and style factors have dominated relative performance for the last 5-8 years and these are built on some themes and concepts that are very well established. While these themes may well continue for some time, much is now implied in sector/stock valuations to that end.

Implication: the importance of portfolio construction, long-term valuation discipline and differentiated stock picking on a forward-looking basis is likely increased. Consensual themes have on numerous occasions historically been the source of significant market inefficiency, but changes in paradigm are hard to time. Thoughtful long-term valuation assessments can be a guide.

The differentials in the valuation and implied outlook of different sectors, styles and stocks are at a magnitude we haven't seen since the dotcom boom. For example, we can observe some commodity related sub-sectors are valued at c.50% of their previous cyclical lows (global financial crisis) on a price-to-book basis, while other sub-sectors trade at 300% premiums to crisis lows and are at all-time highs in terms of price-to-book and some other long-term metrics.

The market may well be correct in applying these differentials (e.g. technology revolution, earnings growth at a premium, areas of permanently impaired capital in commodities/industrials/banks, sustainability/ESG factor flows, permanently low bond yields, etc.), but there is much less room for error in what may be fairly consensual expectations.

We know from history that there are capital cycles at the sector/stock level and this is very clear in our Corporate Life Cycle framework. We also know that economically the world can move through changing paradigms. For example, it's not so long ago that it was relatively consensual that we were running out of cheap oil. Or contrast UK mortgage rates of 30 years ago to those of today.

Observation four: The coronavirus pandemic could lead to: structural changes in the corporate economy or in the relationship between governments, societies and corporates; and potential paradigm shifts in the fiscal/monetary landscape. These could have far more important long-term investment implications than the near-term cyclicality of earnings on stocks and markets.

Implication: understanding these structural topics in light of recent changes is a primary focus of our investment work in order to inform individual stock analysis and portfolio risk management.

The final element of our market outlook, which impacts the second and third observations (above), is the longer-term implications of the coronavirus pandemic on the rate and manner of recovery in economic activity from the near-term recession, the structural changes the pandemic causes in the corporate and real economy (e.g. logistics networks, de-globalisation) and, perhaps most importantly, the impact of fiscal and monetary policy on global bond markets and the financial system e.g. massive fiscal deficits and the monetisation of government debt by central banks. We are currently focused on understanding these issues and how they impact the second and third observations.

Portfolio positioning

In relation to the four observations above:

1. We remain fully invested in line with our relatively optimistic view on equity prices, so as to minimise cash drag;
2. We maintain our philosophy of investing across the Corporate Life Cycle as a methodology to manage duration and discount rate risk in global equities. This is especially important as our valuation philosophy typically leads to a lower duration equities portfolio and a tendency to do better in periods when discount rates and bond yields are stable or gently rising;
3. Our focus on identifying long-term shareholder-wealth-creating businesses, with attractive valuations and an investment margin of safety in the analysis/valuation, is leading us towards pockets of the market where we may well be unearthing very attractive long-term opportunities. The key for us is heavily stress-testing these ideas for where we might be wrong and also insisting on strong balance sheets in case it is some time before that longer-term value and potential is realised. We believe Anglo American, Steel Dynamics and Micron are examples of these kinds of businesses. We continue to ensure a very high level of stock-specific risk within the portfolio;
4. The challenges associated with the fourth observation highlight the need for being highly cognisant of and managing systematic risks in our portfolio construction in order that stock-specific risk is the main driver of relative investment returns for our clients.

In terms of performance drivers given the outlook, we expect those to remain relatively consistent with our historic guidance (table 1).

Table 1: Performance environments due to portfolio positioning, style and philosophy

	Relative performance: Better	Relative performance: Worse	
Stock selection	Strong	Weak	**70%-80% of risk**
Discount rate	Rising	Falling	**20%-30% of risk**
Smaller cap	Outperforming	Underperforming	
Valuation/value	Market focus	Not market focus	
Corporate credit spreads	Rising	Falling	

Idiosyncratic stock risk dominates – in line with competitive advantages. Consistent systematic risk tilts inherent in the process.

Past performance is not a reliable indicator of future results.

Source: RLAM for illustrative purposes only.

Contact us

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