ClearBridge Investments

International Value Outlook: The Real Economy Matters Again

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Key Takeaways

- For the first time since the Great Depression, 89% of all markets fell in value last year, conditions conducive for a secular change in the underlying valuation of assets.
- We believe it is critical for investors to be well positioned for the coming reconnection of financial assets with company fundamentals and to focus upon businesses tied to the real economy.
- Low valuations and fundamental catalysts are aligning for a powerful recovery in the laggards of the past long cycle. We find emerging markets, China, Asia, Europe and the UK most compelling, and favor cyclical companies in those regions.

"There can be few fields of human endeavor in which history counts for so little as in the world of finance." – John Kenneth Galbraith

The Great Distortion Starting to Evolve

In prior notes we have discussed our belief that the investment environment of the past two decades, which we call the Great Distortion, was coming to an end. Given the duration and depth of the divergences and excesses that have built up during this period, the potential shift in the economic landscape is generational. As a result, investment success for at least the next decade likely will require a materially different asset mix. Our focus in this letter is to step back and view the present challenges and opportunities from a longer-term perspective.

At its foundation, the Great Distortion has been a massive subsidy to the owners of capital driven by the overarching goal of eliminating solvency risk. Beginning with the bailout of a Nobel Laureate–managed investment fund in 1998, central bankers and policymakers have acted to limit the downside of poor economic decisions by inflating asset prices with ever-increasing amounts of debt.

The underlying negative impact on resource allocation has remained largely overshadowed by the historic rise in asset prices and the seemingly magic power of increasing leverage. But beginning with the housing bubble and global financial crisis of 2008, many of the socially and economically regressive effects became more apparent, such as inequality, stagnation, low productivity growth, wage repression and limited capital investment, or what is now characterized as the "winner take all" economy. To ward off any normal correction in asset prices, the real cost of capital was pushed to the lowest levels in recorded history, which incentivized financial engineering and the funding of otherwise unsustainable business models and created a rising number of zombie companies. The average worker became trapped between the beneficiaries of this distorted capitalism and the growing transfer payments needed to help those most harmed by a stagnating real economy.

During the past two years, the citizens caught in the middle began to voice their anger and dissatisfaction by electing a number of leaders from outside the status quo. Voters in the United States, Germany, Brazil, Mexico, France, Scandinavia, Holland, Italy and Greece have looked to both the political left and right to oust representatives they considered to be out of touch. Political instability is likely to continue or even worsen in 2019 as faith in democracy, civil discourse and the rule of law has decreased. The behavior of asset prices has also changed. For the first time since the Great Depression, 89% of all markets fell in value last year. Add in the likelihood that the 35-year bond bull market ended back in the summer of 2016 and we have the conditions for a secular change in the underlying valuation of assets.

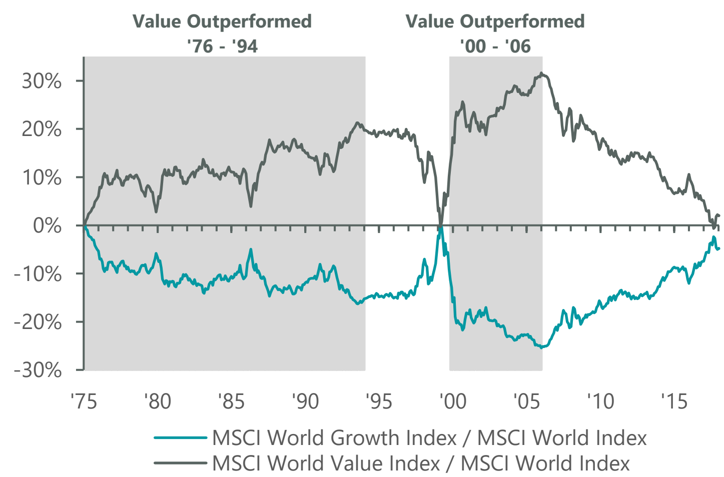
As noted by Morgan Housel in a recent piece for the Collaborative Fund, "there is often a lag between big events and coming to terms with big events." He adds that we are typically distracted by pessimism and "despite the awareness of how powerfully things have changed in the past, it's easy to underestimate their ability to change in the future. Pessimism reigns because it is easy to underestimate how those crazy states will ever adapt or revert to the mean." Howard Marks, in his newest book on understanding market cycles, makes the point that the "average investor sees the environment primarily in terms of isolated events rather than taking note of recurring patterns and the reasons behind them. The superior investor is attentive to cycles." In the current unsettled investment environment, it is particularly important to consider these cogent observations and focus upon the tendency of things to eventually return to normal. But what is normal?

The Great Reversion Gaining Momentum

As value investors we tend to think of ourselves as experts in mean reversion. Most importantly, we understand the challenges of gauging the potential for change against some kind of historical average. Means tend to be unstable and trends can remain in place for long periods of time. It is impossible to determine precisely the level of deviation from the mean that will lead to a reversal. Things that have never happened before happen every cycle, which can be disruptive and render a seemingly cheap stock a "value trap." Consequently, we select investments based upon a combination of fundamentals, probabilities and also a sense of the underlying state of the cycle from a financial and behavioral perspective. We are not macroeconomic forecasters or market timers but believe our investment performance can benefit from what Howard Marks calls an understanding of the "tendencies" for cycles to display recurring patterns.

The environment of the Great Distortion has acted to suppress adaptation, competition and failure while amplifying imitation and conflict. In the stock markets, this has led to returns of price momentum that are historically anomalistic in both magnitude and duration over the past 20 years. The gaps in relative price between leading and lagging assets are at 20- to 50-year highs. The divergences are especially significant in equity markets between value and growth (Exhibit 1), U.S. and international, emerging and developing, Europe/UK and the world along with real assets versus financial assets and commodities relative to bonds. In sum, the odds for a shift from trend following to mean reversion and the potential returns are the highest in a generation.

Exhibit 1: Is Third Time the Charm for a Value Comeback?



As of Dec. 31, 2018. Source: Bloomberg.

We are observing changes in corporate, policy, political and social behavior that signal the beginning of a powerful transition. This is similar to the profound change in the investment landscape after the 1965– 1982 range-bound market. Policies were focused upon the wars on poverty and communism. By the time President Reagan was elected the negative consequences of funding these initiatives were viewed as increasingly unacceptable. At the same time, the Federal Reserve acted aggressively to break the inflationary cycle and tax cuts poured money into the private sector. It took more than a decade for investors to abandon the fear of reflation, sell their inflation hedges and fully embrace the new consumer-stock-led bull market.

Now, we are shifting from a war on insolvency to policies that can be broadly defined as a war on inequality or a bit more positively termed an emphasis on inclusion. The financial economy has prospered but now the focus is on the real economy. On a global basis, reducing deficits and inflating asset prices with the printed money of quantitative easing is being replaced with tax cuts, home buying subsidies and increased government spending on infrastructure and transfer payments. Regulations are being rolled back to help the formation of small businesses and the hiring of employees. Wages are rising due to both market forces and legislated increases. Fiscal policy expansion funded by increasing deficits during a well-established economic recovery is somewhat unusual, but it highlights the focus on making sure the benefits are felt by the wider population.

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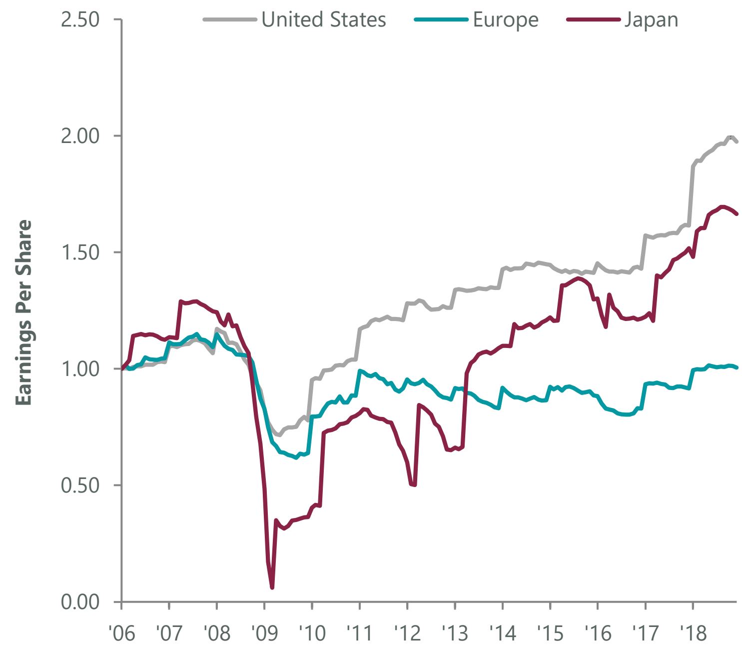
Central banks are also reacting to recent signs of a modest loss of momentum in the global economy by cutting rates or slowing the pace of balance sheet reduction. In fact, the rate of quantitative tightening is likely to peak later this year. On a rolling 12-month basis, the rate of change in global central bank asset holdings topped out at a positive $1.7 trillion in 2017 and then fell to a negative $250 billion last year. We believe this was a key driver of the fall in asset prices in 2018, especially in those regions and sectors most sensitive to changes in global liquidity such as emerging markets, commodities and cyclical companies.

A shift to a policy environment that supports a stronger real economy could also have a material impact on the leading asset classes of the Great Distortion and the intertwined and highly crowded passive, growth, low volatility, momentum trade. Much of these investor flows have been centered on the U.S., with $10 trillion of foreign capital coming into domestic markets since 2008. A reversion in the performance of the large U.S. technology and consumer companies along with the resumption of dollar weakness might cause the U.S. to lag foreign markets. This appeared to be the case in the final quarter of 2018 when emerging markets significantly outperformed U.S. small and large cap shares. Indeed, earnings per share in all international markets have trailed the U.S. since the financial crisis (Exhibit 2). Overall, we believe it is critical for investors to be well positioned for the coming reconnection of financial assets with company fundamentals and to focus upon businesses tied to the real economy.

Exhibit 2: Earnings Outside the U.S. Have Ground to Make Up



As of Dec. 31, 2018. Source: Bloomberg.

Key Risks and Bull Traps

During the final months of 2018, both the FAANGs and semiconductor companies began to show they are not immune to the axiom that no great idea can survive too much capital and linear thinking. Revenue growth unexpectedly slowed, and margins fell. The story of never-ending shortages of memory chips turned into order cancellations and price cuts to clear out excess inventory. The strategists at 13D research summed the situation up well: "Whether Apple, Google, Facebook, Amazon or Netflix, tech-giant business models were always destined to cycle and mature. Global macro factors shift. Innovations age and competitors catch up."

In the short term, the oversold "tech" stocks are poised to rebound a bit given the spin likely to be placed on upcoming results by the universally buy-rated analyst community. But underlying fundamentals remain challenging. Incumbent cable and satellite providers, facing a steady loss of subscribers, are locked in a "content war" with the streaming companies including Netflix. As a result, Netflix reported the largest negative free cash flow in its history last year while competition from Disney, Facebook and Apple promised to only increase. Amazon is planning to spend billions building out physical stores under the Amazon Go and Whole Foods banners and ironically may look to some of the vacated Sears locations. Facebook's global social media market share continues to drop, with the U.S. falling from

76% to 52%. Investment spending at both Google and Facebook now rivals that of Exxon Mobil, challenging margins, free cash flows and the notion of a capital light business model. European governments are taking the lead in implementing digital taxes to capture lost revenues and level the playing field for traditional media and retailing firms. Amid this negative overall environment, some Chinese social media and technology stocks stand out as better positioned fundamentally with stronger cash flows and a less hostile competitive landscape.

China: Clever vs. Wise

Placing the current China-U.S. relationship in the context of the history of a reigning power being challenged by a rising one, as Graham Allison does in his excellent 2017 book, Destined for War, 12 of the 16 instances identified ended in war. While these are pessimistic odds, Allison does not believe a military conflict is inevitable. The best hope, he contends, is a path similar to the "Great Rapprochement" of the UK and the U.S. in the late 18th and early 19th centuries. Wider cultural differences with China might prevent such an alliance, but in the short term we believe Chinese leaders will focus on accommodation to preserve the long-term goal of becoming a middle income, developed nation over the next 20 years. China will buy more commodity products from the U.S. while also buying fewer of our bonds. They will increase the openness and transparency of their economy and work to protect intellectual property, which supports the goal of steadily improving the value add captured by local producers. The outward signs of China's rise such as the "China 2025" and "Belt and Road" initiatives will be toned down so as not to be overly boastful or antagonistic. In short, Chinese leaders will cut a deal to restore order and stability. At the same time, they will embark on a "charm offensive" with Europe, Japan, the UK and ASEAN nations to provide a contrast against the rising U.S. unilateralism and weaponization of trade. China has signed 16 free trade agreements covering 24 nations over the past year.

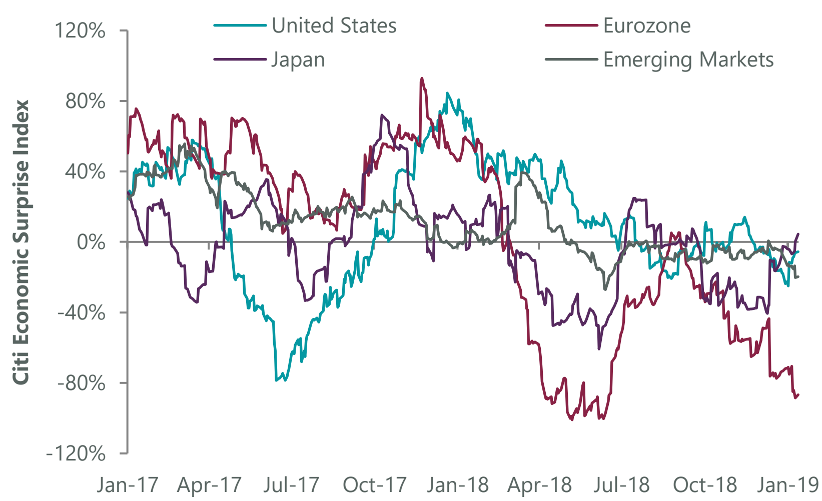
In the near term, China will continue to evolve internally and in relation to the global economy. This is both positive and necessary as the Middle Kingdom is no longer a poor, small nation but on many measures the largest economy in the world and the biggest consumer of nearly every commodity. They are clearly easing monetary and fiscal policy to offset the dual headwinds of domestic reforms (environmental, social and financial) and the impact of recent trade disputes. Growth will continue to slow in line with the historic experience of developing Asian economies, which settle into a 5% expansion rate as per capita incomes continue to rise. China permabears remain focused on the quantity of growth and miss the steady improvement in the quality of growth. The current uncertainty and pessimism has Chinese stocks trading at a significant discount to global markets while remaining materially underrepresented in most benchmarks.

Europe and the UK Muddle Along

Over the past year, European stocks have dramatically underperformed due to a loss of momentum in the domestic recovery and a large dependence on exports, especially to emerging markets and China. Shares on the Continent are trading at the lowest relative level on record. Eight of the 10 main markets are at or below their 1999 peaks and returns for the past 18 years have a range from zero to negative. European banks have never been cheaper relative to U.S. peers. But unlike in 2011–12, the risks to the economy appear to be well contained even in Italy and the peripheral countries. Domestic demand is well supported with low interest rates, solid credit growth and an improving labor market. Also, most countries now have current account surpluses and room to expand fiscal stimulus. Yet, judging by the Citi Economic Surprise Index (Exhibit 3), the EU economy appears to be rolling over.

European parliamentary elections in May of 2019 promise a shift to more expansionary policies and actions to address the banking systems' remaining structural weaknesses.

Exhibit 3: Pessimism Reigns in the Eurozone



As of Dec. 31, 2018. Source: Bloomberg.

The contentious debate around the Brexit agreement is somewhat surprising for the nation that basically invented civil compromise and "the middle way." The chaos in the UK highlights the large gap between populism and pragmatism. Britain needs to both find a way to work with its largest trading partners while also increasing its sovereignty. In the current highly polarized environment there appears to be no agreement that satisfies the dogmatic needs of the hard and soft Brexit camps. The situation is quite fluid and unpredictable. The odds of not reaching a deal before the March 29 deadline are put at 70% currently in the UK betting markets. PM May failed to get her existing deal through Parliament in January but survived a no-confidence vote, making an extension of the Article 50 deadline likely. There is an outside chance that a new government is formed or that a delay gives rise to a second referendum. Anticipating a failure to pass the current Brexit agreement, one member of Parliament has put forth a "Plan C" that involves rejecting the deal with the EU but ruling out a no-deal exit from the EU. In short, our best guess is a delay, eventual compromise and then a Norway-like agreement that keeps goods and people flowing while not subjecting the UK directly to EU laws.

We believe the risks and uncertainty surrounding Brexit are real but well known. Companies have been preparing for potential dislocations surrounding leaving the common market for over two years. Fears that trade shuts down on March 29, leading to shortages of food and medicine like the panic leading up to Y2K, seem unfounded. Clearly, uncertainty is harming economic activity, but once a decision is made, businesses and people will adapt, and the UK can move forward with its new-found freedom to expand trade and reduce onerous business regulations.

Emerging Markets Showing Resilience

Emerging markets have historically been highly sensitive to shifts in global liquidity, commodity prices and prone to political instability. While this remains true for a few nations such as Argentina, Turkey, Russia and South Africa, most countries have proven themselves remarkably resilient in the face of a challenging macroeconomic environment over the past year. Having learned hard lessons in the past decades related to dependence on foreign capital and external demand, most countries have improved their current account balances and acted to materially improve domestic demand. Overall growth has slowed somewhat with the rest of the world but remains solid at an average of a bit more than 4%. Sound fundamentals have not prevented investors from fleeing emerging market stocks, which traded back down to the relative lows experienced just after the global financial crisis. More recently, though, developing country shares have been outperforming. The related currencies and corporate bond prices have also been rising. The favorable demographic and income growth dynamics of the emerging markets remain in place: the middle class in Vietnam alone now rivals the entire population of Canada. As with shares in Europe, valuations are pricing in a typical global economic downturn and a plunge in corporate profits.

Outlook and Opportunities

Investors are understandably guided by the memory of the global financial crisis in their reaction to the uncertainty surrounding tightening monetary policy, political turmoil, a potential trade war and modest signs of a global economic slowdown. No one ever again wants to be late in recognizing the solvency risks inherent in a debt-laden world with inflated asset prices. But we believe that a powerful paradox at the company level and foundational shifts in policy objectives are being overshadowed by the current pessimism. Quite simply, the firms most harmed from the 2008 downturn in the global economy are now the best prepared for a decline in business activity. Mining companies, homebuilders, banks, automakers and energy producers are all focused on free cash flow, debt sustainability, capital discipline and lowering breakeven levels. At the policy level, central banks need to maintain strong nominal growth and have a stated goal of increasing inflation. With any minor hint of a slowdown, they stand ready to pump liquidity into the system. Based on recent statements from European, Chinese and U.S. central bankers, we may even be on the cusp of another easing cycle. Politicians are also not going to permit another crisis on their watch and want to respond to demands for broader sharing of global prosperity. This is leading to a level of fiscal stimulus that is highly unusual outside of recessionary conditions.

Consequently, both low valuations and fundamental catalysts are aligning for a powerful recovery in the long-suffering investments of the past long cycle. Specifically, we find emerging markets, China, Asia, Europe and the UK most compelling. From a sector standpoint, we favor cyclicals such as materials, industrials and consumer discretionary companies. Global financials are also poised to benefit from reflation, continued economic growth and a normalization of the yield curve. Given the real risks in the global economy, we also think it makes sense to emphasize quality and yield within these undervalued investments. While paying up a bit for quality is usually rewarded, we find the high valuation premium demanded for most defensive stocks unattractive. This leads to a relatively low weighting in utilities, communication services, real estate and consumer staples. Finally, we are cautious and patient in exploring new investments in the technology-related sectors as growth expectations and sentiment remain overly optimistic.

We cannot precisely identify how the Great Distortion will give way to the Great Reversion. But we can understand the fundamental and behavioral dynamics driving the shift in the global economy and investment environment. Combined with objective and time-tested stock selection tools and experienced judgement, we can prepare to benefit from the coming generational changes.