

# Favorable environment for value investing

2016 was a decent year for equity returns, and this continued in the first quarter of 2017. Developed markets rose almost 5%, with Europe slightly outperforming the US, and Japan slightly weaker. Emerging Markets led the way, partly thanks to their attractive valuations – we write more on Emerging Markets below.

But this does not mean early 2017 has been a simple extension of conditions in late 2016. There are at least a couple of themes deciding the direction of the market. On one hand, there are good signs of a continued synchronous global upswing in economic data. On the other hand, market enthusiasm has been curbed by increased uncertainty over the prospects for policy changes in the US. Both of these have implications for the market direction as well as the market rotation that started last year.

The global economic upswing story took off in Q3 last year and started a slow rotation, where cyclical sectors and low-priced value stocks started to outperform. Rising US rate expectations were part of this story. When Trump won the election, his plans for economic stimulus were fuel for this narrative of inflation and growth, and the rotation accelerated. Certain sectors and investment styles saw ‘huge’ (as Trump would say) outperformance within a very short time. What we saw in this first quarter was that the second part of the story – the Trump stimulus story – weakened, which led to some unwinding of the rotation from 2016.

After a long, steady climb, US markets seemed to pause in the middle of the quarter as investors started to question the Trump administration’s ability to deliver. This gathered pace after the failure to replace Obamacare, which means likely delays to his tax reform agenda. In addition, in March, the US Fed raised rates and signaled that there is more to come. Yet the ten year treasury yield fell back a little, most likely because of the weakened Trump reflation story – and this caused the yield curve to flatten.

*US markets seemed to pause in the middle of the quarter*

Market sentiment was also influenced by geopolitical tensions, which have boosted demand for safe-haven assets in the past weeks, and pushed up measures of implied volatility in equity markets. While Trump’s unpredictability is undeniable, the US military strike on Syria, its disagreement with Russia, and its brinkmanship with North Korea are not entirely new phenomena. Experience suggests that such geopolitical events will likely generate more short term volatility than long-term economic consequences. It is important to remember that the economic upswing that started the rotation in Q3 is still in place. It may even have grown stronger as European data seem to continue to strengthen. European stock markets also slightly outperformed the US market as we passed the obstacle of the Dutch election and concerns about the upcoming French election receded a bit. It seems that the feared break-up of the EU is not as imminent as some sceptics have been thinking and investors have been focusing more on the upbeat economic releases from the region.

*Geopolitical events will likely generate more short term volatility than long-term economic consequences*

## Rotation reversal

So, market participants witnessed some reversal of the market rotation from the second half of 2016. More specifically, the industries and the specific stocks that rallied after the surprise election result, trailed the overall market in early 2017. We witnessed a change in investor behavior, back to a focus on perceived safe stocks, where investors prefer to pay for

stability. Growth stocks outperformed value stocks. Defensive sectors like healthcare and consumer staples had underperformed in the second half of 2016, but in early 2017 were among the top performing sectors globally. Meanwhile IT was the best performing sector, fueled by high-flying Apple and Facebook. At the bottom of the table, energy stocks lost their momentum from last year, falling in tandem with oil prices as data suggested that supply is still not likely to abate in the near term.

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Another sector that suffered during the reversal was financials. This sector had finished 2016 in spectacular fashion, but trailed the market in the first quarter. We can't deny that in late 2016, valuation discounts for financials had shrunk significantly, because share prices had risen faster than earnings expectations. This multiple re-rating didn't continue in early 2017, and we think we're now in a phase where earnings expectations have to catch up with valuations. However, from a longer-term perspective, we do think current earnings expectations for financials don't fully reflect the potentially strong cocktail of rising interest rates and accelerating loan growth. With a US economy getting close to full employment, we expect wages and inflationary expectations to rise during the year, leading to higher interest rates. It might also lead to increased willingness for capital investments, and therefore a pick-up in loan growth. In other words, all the monetary stimulus measures could finally be spilling over to the real economy, leading to macro-conditions that are relatively favorable for financials. In addition, the last decade has seen other factors contribute to lagging returns for financials. There has been increased regulatory pressure and a strong need for balance sheet de-leveraging, which we expect to be less of a burden going forward. Now that banks have generally built up sufficient capital, we also see room for increased dividend payments to shareholders. Overall, we believe that financials are one of few value segments left in the market with some attractive catalysts and we therefore continue to have a relatively large exposure to this sector.

*We believe that financials are one of few value segments left in the market*

## Fund Positioning

Looking at our funds in the first quarter, the reversal of the market rotation was something of a headwind for our developed market funds. Emerging markets rebounded, partly thanks to the weaker dollar, and our funds continued to outperform – more on that below. Within Europe, returns were in line with benchmark, well supported by our European small cap exposure, where smaller, domestic-oriented companies seemed to have been preferred by foreign investors wanting exposure to the European economic recovery. Meanwhile, within the US where the reversal was stronger, we lost some ground relative to the index – this of course also hurt the overall performance of the global developed market funds.

*Our inherent value bias makes our funds thrive when political and geopolitical uncertainties abate*

We are not overly concerned by the first quarter developments. Our inherent value bias makes our funds thrive when political and geopolitical uncertainties abate, GDP growth improves, and inflation expectations rise. Generally speaking, we believe the global economy remains in a gradually strengthening mode, leading to improving earnings in companies with higher operational gearing, typically including value companies.

In past years, we've had some concern that valuations in some of the more defensive sectors had become stretched, as they were treated almost like bond proxies. In late 2016, defensives fell back on a relative basis, leaving their valuations slightly more tempting - but their strength in early 2017 means we again have some doubts over the valuation levels. Looking at the major regions in the world, Europe and emerging markets stand out with the most attractive valuations, followed by Japan and finally US. Europe has been through a tough decade since 2007, including Euro-crises vol. 1 (2011) and vol. 2 in (2014), and a general lack of earnings growth in most companies, leading people to invest only in the 'bond proxies' if investing Europe at all. That means that when investors do add money to Europe – as happened in recent months – it's other areas of the market, like small caps, that can benefit.

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We continue to look for opportunities across the board. In our developed market funds, we still have an overweight in companies in more economically-sensitive sectors, but mostly these are strong businesses currently experiencing an acceleration in earnings, no matter the success of Trump's policies or the direction of bond yields. Consequently, in spite of recent headwinds, there are still uplifting stories to be told.

## Hochtief sold

In our global developed market and European funds, we recently sold Hochtief, one of our long-term holdings. We first invested in the German construction conglomerate in 2004 at around €18 per share, as we saw a substantial discount to its sum of the parts valuation. At the time of our investment, Hochtief had a strong net cash position, diversified global construction operations and a growing order backlog. Although its construction business had low profitability, we were attracted by its financial stakes in several airports, and its 50% stake in an Australian construction company, Leighton. Leighton was separately listed, so we could easily see that the stock market was hardly attaching any value to the core businesses of Hochtief, which we thought was shortsighted. In the first years after our investment, Hochtief's share price performed strongly, driven by Leighton's growth in the Asia Pacific region. The Australian subsidiary benefitted strongly from China entering the WTO, high commodity prices driving capital investments in Australia and a construction boom in the Middle East. Although Leighton was doing very well, Hochtief's rising share price remained below its sum of the parts. As a result, Hochtief was often mentioned as a potential takeover candidate.

Unfortunately, the global financial crisis happened before a takeover actually materialized and Hochtief's share price fell from the high €90s to the low €20s, before recovering to around €60 at the end of 2009. A year later Spanish construction company ACS stepped in and acquired a majority stake in Hochtief. We decided not to sell our shares, as our analysis suggested the sum of the parts value was well above the price that ACS offered. Soon after ACS got majority control of Hochtief, it replaced management, simplified the business structure and decided to focus on improving the profitability of the core construction businesses. As time progressed this resulted in increased cash flow generation and monetization of the financial assets of Hochtief. Over the last 3-4 years Hochtief's earnings power and earnings volatility have substantially improved as well as the capital returns to shareholders. This has led to a strong share price development to around €150 now - well above pre-financial crisis highs. Although we have seen lots of volatility along the way, the annualized total returns (including dividends) since our

initial investment has been well over 20% against 8% for the MSCI world.

## Emerging Markets

Emerging Market equities have been stand out performers so far in 2017. From January to end-March, developed markets – the MSCI World index – rose 4.9% in Euros, but the MSCI EM index rose 9.9%. Meanwhile our emerging market funds both outperformed the benchmark.

### *Emerging market equities have been stand out performers so far in 2017*

Such strong performance was not the general expectation a few months ago. Remember that during most of 2016, emerging markets had strongly outperformed developed markets, but then suffered something of a setback towards year-end, particularly on Donald Trump's election. There were a couple of obvious country-specific impacts. Russia rallied strongly, on expectations of improved US-Russia relations under Trump. Meanwhile, Mexico suffered. During the US election campaign, the Mexican Peso and stock market had acted as barometers for the election: when Clinton gained ground, so did the Mexican currency, and when Trump rose in the polls, the peso weakened. So, after Trump's victory there was a sharp decline. From election to mid-January, the Mexican peso fell around 16% against the US dollar.

But concerns were not just focused on Mexico. Trump's anti-trade rhetoric was seen as posing risks to various emerging economies that rely on either direct or indirect exports to the US, including China. Additionally, US economic improvements, Fed actions and rising US yields had already led to concerns about a strong USD before Trump won, and those concerns only increased on his election.

Our view was cautiously optimistic. Generally speaking, we found it too early to gauge whether Trump's more extreme campaign promises would actually turn into policy. Regarding US dollar strength, we have noted before that Emerging Markets are not one homogenous market, but a diverse group of economies. In general, they seem far better placed to handle US dollar strength than they were at the time of the 2013 'Taper Tantrum'. Typically, the most vulnerable countries would be those which have high levels of foreign-denominated debt, high current account deficits, and high levels of commodity exports – because commodity prices generally fall when the US dollar rises. We think levels of foreign debt and current account deficits have broadly improved. Meanwhile, in 2013 commodity prices were coming off high levels, but the context has now changed: after years of depressed

prices, there seem to be some fundamental supply and demand drivers behind a modest recovery in commodity prices, perhaps leaving them slightly less vulnerable to a strong dollar.

Naturally, these remain considerations to monitor. But in early 2017, the market reality has been very different. Far from being weak, most emerging market currencies have gained against the USD. The Mexican peso has rallied sharply since mid-January – up around 17% against the US dollar, back around pre-election levels. The Taiwanese Dollar, Korean Won and Russian Ruble all have high single-digit gains. Equity markets are performing well. Trump is spooking emerging markets much less than expected. So far, he has not really made any major protectionist moves. In recent weeks he has distanced himself from Russia, and despite previous tough talk on China now seems to be warming up, stating that it is not a currency manipulator. On Mexico, there has been less tough rhetoric, and there are signs that some republicans would oppose a border exemption tax.

It is significant that he has had difficulties with both his health care agenda, and his executive orders on immigration. One never knows where Trump's policy – or twitter feed – will go next, but so far he does not seem as threatening to emerging markets as many had worried.

So, we are cautiously optimistic on emerging markets. It appears that inflation continues to abate in various emerging markets – such as Brazil - giving central banks scope to reduce rates. There are signs that emerging market earnings growth is improving across an increasingly broad base. This is typically a condition that leads to emerging markets equity outperformance.

## Upcoming events

That said, Emerging Markets do have challenges, particularly on the political front. Some have positive momentum – such as Indian PM Modi's strong showing in recent state elections. Brazil and South Korea are working to move forward from their major corruption issues. But in South Africa, President Zuma has raised eyebrows again by dismissing many of his cabinet, including the well regarded finance minister. In Turkey, President Erdogan is in an increasingly dominant position, while in Hungary there are some questions about the direction being taken by PM Orbán.

But political risk is clearly not just an emerging market issue. Developed markets have their fair share. So far we've had Brexit, Trump's election, and the Dutch and the first round of the French presidential election. There is no doubt that politics will remain being a market driver in the next few quarters,

as investors debate how much of Trump's political agenda is already priced in. There is continued uncertainty regarding legislative changes, with the potential tax cut being one of great importance, because it is so directly tied to further earnings growth in US companies. As the year progresses, there are several events that can add volatility to the market. With upcoming elections in core European countries involving very EU-sceptic parties, the polls and the final results of these elections are expected to set the direction for the market, and we can expect volatility to rise up to the events.

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The French election is the next hurdle to pass, and although polls currently predict pro-EU Emmanuel Macron to beat Le Pen in the second round of the presidential election, the fate of the EU is at stake, and this does make investors nervous. Shortly after triggering Article 50 of the Lisbon Treaty, and formally announcing its intention to exit the EU, the UK now faces a general election as well. This comes after Prime Minister Theresa May called for surprise early elections, supposedly to strengthen her hand in the upcoming Brexit negotiations. This event also attracts a lot of attention, but no matter the outcome, the main focus in the UK is what happens over the two years of Brexit negotiations – so the upcoming election probably has less potential for market impact than the French election.

Some of these events have the potential to develop in ways that benefit equity markets, but overall the high level of geopolitical uncertainty around the world has increased the risk of sudden market corrections - and it does curb the optimism for broader market returns. As always, we will monitor these developments and the impacts they have on markets, both looking to protect our portfolios, and potentially exploit opportunities.

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## Outlook

In spite of the political and geopolitical noise, investors have good reason to embrace the economic development and equities seem to be well supported, assuming that GDP growth translates into higher corporate profits. However, it is important to highlight an associated risk for equities in general.

There is a real risk that increasing bond yields will lead to lower equity valuations, and with markets up already 5% in the first quarter, we warn against being too optimistic regarding future returns. Against that backdrop, the value investment style presents an attractive opportunity. Value stocks as a category have outperformed the broader market when looking at longer time series, but they have underperformed the market during the past 10 years. We saw a sector and style rotation start last year, which benefitted value, and we remain optimistic that this can continue. As always, we refrain from making specific macro forecasts, but higher bond yields going forward seem more likely than not. For a long time, we have argued that higher bond yields will lead to outperformance for value stocks and when combined with the valuation gap, we think we are still in a favorable environment for value investing.

*We think we are still in a favorable environment for value investing*

However, we do not invest in value stocks on the back of a narrative. We are value investors because we believe that investing in attractively priced stocks generates above average returns. In that context, we have seen stock-to-stock correlations fall lately, meaning that stocks started to move more because of their individual qualities, and less because they belong to a specific industry or have certain characteristics. For bottom-up stock pickers like us, such market conditions often provide solid support for excess returns. We believe our diversified portfolios of discounted stocks provide you as investors with a strong risk/reward profile, and we are confident that we can deliver good results even in the challenging markets described above.

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