View from an optimist part 2: navigating through conflicting signals?

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As 2019 slowly comes to a close, it is time to look back at a stellar year for equities and contemplate the road ahead. We also need to consider the appropriate long-term perspective for fundamental-equity investors.

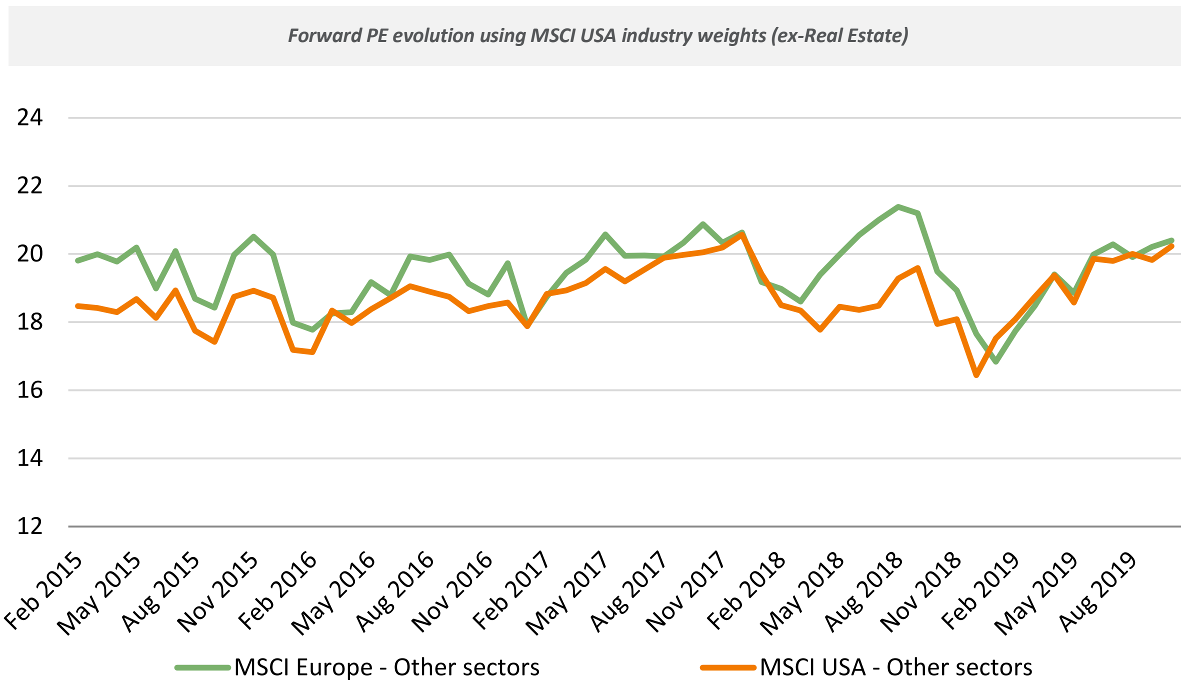
Despite recession worries, which were (mostly) due to trade war concerns at the end of 2018, the MSCI World net performed strongly (+25% at the time of writing). It more than recovered from a dismal 4Q2018. Last year, our outlook on 2019 clearly reflected this sentiment: "It is always good to invest in equities after a drop". Fortunately, the Federal Reserve's U-turn in January largely put macro-concerns to the back burner. Still, if equity investors wish to (out)perform the markets, 2019 serves as a good reminder that macro-geopolitical considerations are not the best framework on which to base one's investment decisions. Ever since 2008, the mistaken overreliance on macro has been peddled by (some) investors, who seem to live in constant fear that a new Armageddon is just around the corner. Instead, when the US yield curve inverted shortly this year and recession fears resurfaced, our **August CIO's view** emphasized a message of careful deliberation: "We would advocate to maintain perspective and default to fundamentals rather than fear and emotion […] using periods of volatility to add to long term convictions."

Obviously, we do not completely dismiss macro when it comes to managing equity portfolios. It is considered for tactical reasons, or whenever it has a material link with some of our long term convictions. The **ageing theme** and the whole debate on its affordability is a fitting example: On the one hand, it pushes us to privilege companies or sub-themes that focus on value-based healthcare solutions (such as home healthcare or selected med-tech companies). On the other hand, we have been consistently lowering the weight of consumer staples in some of our portfolios since August. We are convinced growth projections – due to easing trade worries, supportive monetary policies and the likelihood of future fiscal stimuli - will improve, and will consequently tilt long-term rates upwards. These rates tend to be negatively correlated with consumer staples. Following the August sell-off, we also added several cyclical companies to our portfolios thanks to an increase in attractive entry points.

If we dig a little further into this year's performance, some noteworthy items stand out:

- **The continued outperformance of US markets**.
- **The stellar performance of the semiconductor stocks**, despite negative earnings revisions of 10%.
- **The lacklustre performance of the energy sector**, held hostage by range-bound oil prices and lingering ESG concerns.

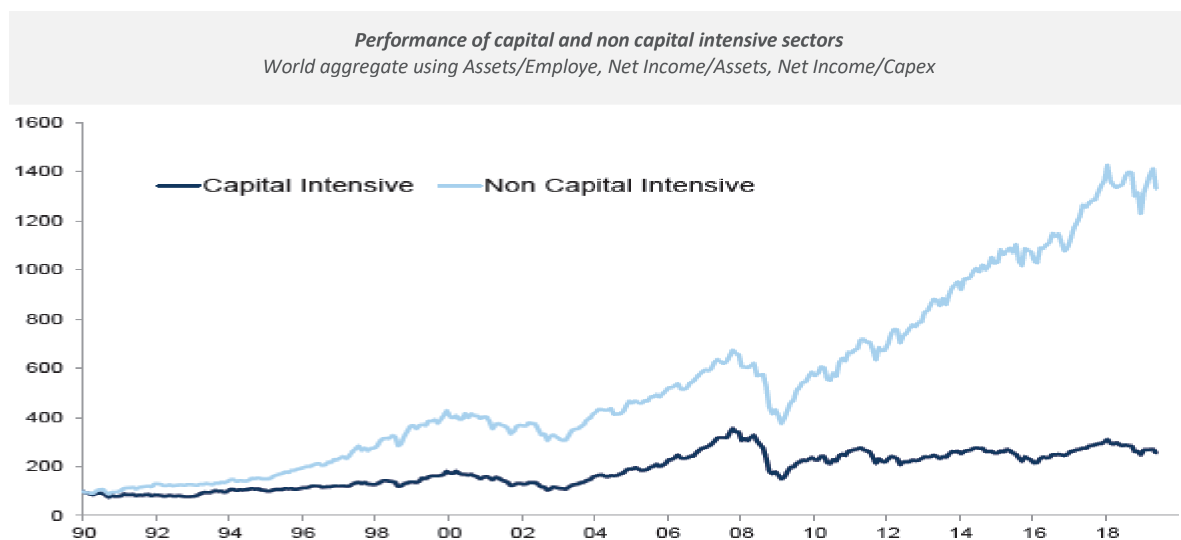
The outperformance of US indices has been the one defining trend in equity markets this past decade. 2019 has been no exception. The S&P500 has a starkly different index composition than MSCI Europe. This difference explains most, if not all, of the p/e-multiple discrepancy. A closer look under the hood of both indices reveals that the impact of disruption – both negative and positive – is also vastly different. After a deep dive into each GICS1 sector, we reckon that approximately 30% of the US index is disrupted, or at risk of being disrupted. However, in the EU that figure surpasses 40%. More importantly, the US also has a substantially larger share of **disruptive companies** than the EU in the remaining non-disrupted index weight. When plotting these non-disrupted sectors ('other sectors' in the graph below) against each other, one notices that valuation in terms of p/e are similar between the US and Europe.



Forward PE evolution using MSCI USA industry weights (ex-Real Estate)

Source: MSCI, Bloomberg, DPAM

Note that looking at valuation through a p/e multiple lens is far from perfect. It overlooks the capital intensity of a business or sector, as well as its ensuing capacity to generate free cash flows and reinvest these into its business. **We prefer to conduct long-term investments in capital-light businesses** (see graph below). Here again, the US dwarfs Europe: Approximately 44% of US businesses are capital-light, in Europe, the figure is closer to 33%.



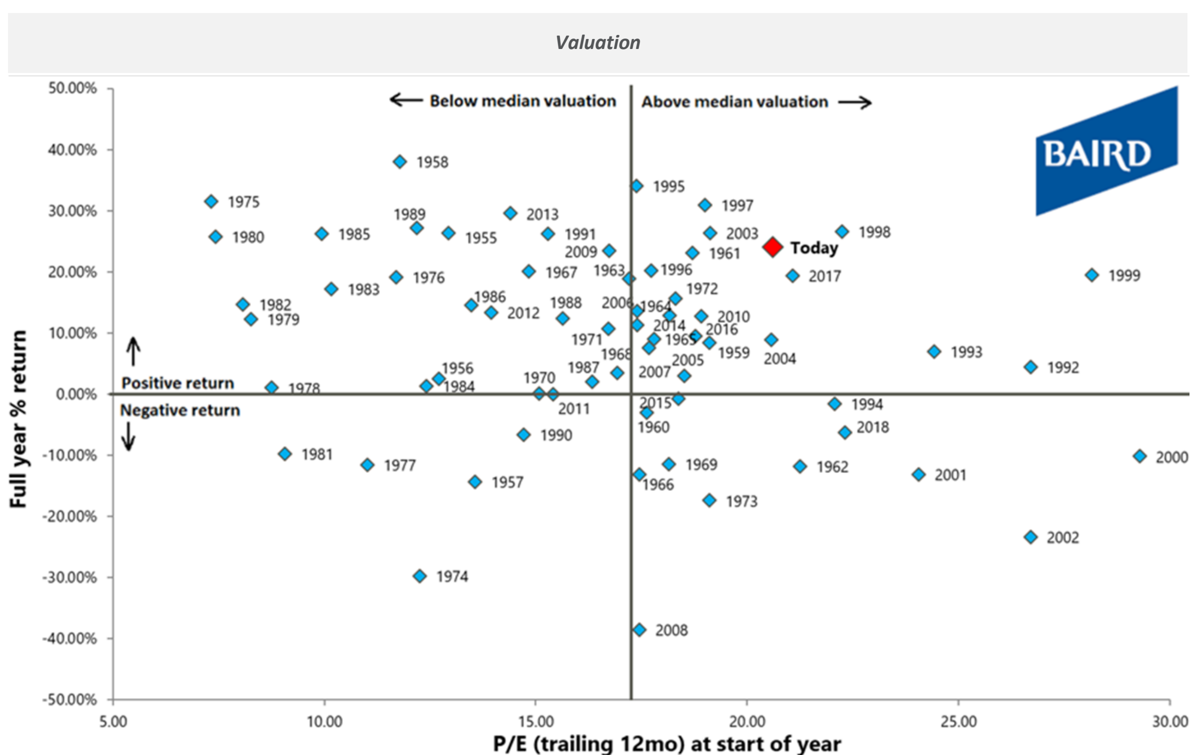
Performance of capital and non capital intensive sectors
World aggregate using Assets/Employe, Net Income/Assets, Net Income/Capex

Source: Datastream, Worldscope, Goldman Sachs Global Investment Research

Capital Intensive Sectors: Forestry & Paper, Industrial Metals & Mining, Automobiles & Parts, Leisure Goods, Construction & Materials, Oil Equipment & Services, Fixed Line Telecommunications, Electricity, Gas, Water & Multiutilities. Non Capital Intensive Sectors: Beverages, Food Producers, Household Goods & Home Construction, Personal Goods, Tobacco, General Retailers, Health Care Equipment & Services, Pharmaceuticals & Biotechnology, Software & Computer Services, Technology Hardware & Equipment

Does the above lead us to advocate a continued US-outperformance in 2020? Although we refrain from investing on such short-term horizons (i.e. we generally hold positions in our funds for 3-5 years), **we actually expect EU markets to outperform the US in 2020**. Indeed, the former is more likely to react actively to an improving trade rhetoric and the dissipation of Brexit fears. Germany in particular will profit disproportionally from these two factors. Moreover, new winds are blowing at the top of the EC and ECB, which could result in stronger-than-expected fiscal measures. Meanwhile, we do not expect any US fiscal stimuli, due to the looming US elections and the on-going impeachment process. Contrary to 2019, **2020 will need to show some earnings growth**, though average p/e multiples remain relatively attractive. However, the illustration bellow clearly indicates that **one should not necessarily base the prospective performance of equities one year from now on p/e multiples**. The upper-right and bottom-left quadrants fails to show any correlation between the p/e multiple (of the S&P500) at the beginning of the year and its performance in the following 12 months.

Valuation



Source: Baird

Barring a catastrophic outcome of the “phase-1” US-China trade discussions, **we anticipate mutedly positive performances for equities**. In addition, we also expect an outperformance of European markets, helped by the revival of net inflows in equities during 2020, which were largely absent in 2019. We also repeat our August message for long-term investors:

We continue to favour investments in quality companies that are able to grow their top line through the cycle, with competitive advantages, relatively low leverage, less prone to disruptive forces and ideally being able to capitalize on the so-called sustainable development goals.

5 Key messages for 2020

- Equity markets should have muted positive performance with EU outperforming
- Short-term snap-back in value, continue to watch out for disruption
- Not only negative impacts from the trade war
- Think thematic & long term
- ESG integration will become more important, qualitative analysis is key

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