Quarterly report

VALUE EQUITY

# Big stock market return differences

On the surface, third quarter felt like a good one for global equities. Markets extended their gains from the second quarter, and the broad MSCI World index rose 5.53 percent. However, under the surface there were large dispersions. For instance, when comparing regions, it was indeed a great quarter for U.S. equities, an average quarter for European and Japanese equities - and a very weak one for emerging markets.

U.S. markets were fuelled by a strong U.S. economy and a convincing earnings season, and they ended the quarter with a gain of 7.9 percent, way ahead of the rest of the world's stock markets. Japanese equities were up 4.2 percent on relatively strong corporate profits and improved political visibility, after Prime Minister Shinzo Abe won an internal vote to continue as leader of the ruling Liberal Democratic Party.

In Europe, the economic environment was weaker, and headline risk was higher, with UK and Italy attracting most attention. Given the high level of uncertainty related to the outcome of the ongoing Brexit negotiations, and the fact that the deadline for a deal was getting closer it was probably no surprise that UK equities weighed on European markets. The Italian debt situation also caused European worries and on the last day of the quarter the coalition government presented a wider than expected budget deficit goal. This caused widespread selling of European equities, which ended the quarter with gains of 1.3 percent. Global emerging markets continued to be the laggard with another negative quarter losing 0.6 percent – so in this letter we have devoted a fair bit of space to emerging markets, and trade tensions.

While regional differences were somewhat obvious and perhaps not difficult to understand, there were other underlying sector and style dispersions during the quarter. Health care was the best performing industry sector, perhaps due to its defensive tilt, but also partly on the back of encouraging fundamentals and M&A activity. In terms of style factors, value stocks continued to underperform growth stocks and small caps saw relative losses of about 3.0 percent in all regions globally. This made it another difficult investment climate for our funds. While European strategies were in line with the MSCI Europe index, our global developed market and global emerging market funds slightly lagged their respective benchmarks.

It is always difficult to say exactly what drives different parts of the financial markets, but we can learn a lot from looking at the returns. For instance, when defensive stocks outperform, it normally suggests that uncertainty is increasing or that economic growth is slowing. Therefore, as the cycle continues to age, it is perhaps no large surprise that the stronger capability of defensive stocks to withstand macro headwinds cause them to outperform cyclicals. This fits well with the fact that an increasing number of people have been warning about an imminent stock market correction. Some point to decelerating macro conditions, while others focus more specifically on the dynamics of interest rate hikes or excessive leverage, trade tensions, peak corporate earnings or political issues around the world.

In October, markets entered into large declines. Perhaps it started due to a rapid increase in U.S. bond yields, but judging from the market rotations beneath the surface, the sell-off seemed to be an acceleration of the worries about the impact of trade tensions on global growth. Investors continued to favour defensive stocks over cyclicals, which suggests broad anticipation for economic trouble brewing.

## Headwind in emerging markets

Emerging market equities are having a tough year. As we write, developed markets (as measured by the MSCI World in euros) have risen 5.0 percent so far in 2018, while emerging markets (MSCI EM) are down 10 percent. This is in stark contrast to 2017, when developed markets rose only 8.0 percent compared to nearly 21 percent for emerging markets.

So, what caused this shift? In many ways, the tone was set in April and May, so we will focus a little on those months. In January to March, global growth momentum had slowed a little, the U.S. dollar had weakened somewhat, and oil prices had risen. Emerging markets outperformed, continuing the trend from 2017. This soon changed. On 23 March, the Trump government released plans to slap 25 percent tariffs on USD 50bn of Chinese imports. Chinese equities fell, and with hindsight, this was the start of emerging market underperformance in 2018. In early April, the U.S. confirmed those tariffs, and China retaliated immediately.

We discuss the trade tensions in more depth below, but they are not the only explanation for weak emerging markets this year. Early April also brought new U.S. sanctions on Russian officials and tycoons considered allies of President Putin. This was the U.S. expressing its unhappiness with Russia over Crimea, Ukraine and Syria, and the alleged election interference in 2016.

The Russian Ruble plunged in response to the sanctions, but there was some broader weakness among emerging currencies. This accelerated in late April and May, as the U.S. dollar strengthened. Some emerging markets are perceived as being more vulnerable to a stronger U.S. dollar: typically those with significant twin deficits (both a fiscal deficit and a current account deficit), such as Brazil, India, Indonesia, Mexico, Peru, South Africa, Turkey, Argentina and Colombia. (We do not have investments in those last two). The fear is that as the U.S. dollar strengthens, it can trigger a negative spiral in which weaker domestic currency leads to higher inflation, which leads to monetary tightening, which leads to lower economic growth, which leads to fiscal tightening. The trade tensions may also contribute to inflationary pressures. Meanwhile we have also seen a significantly higher oil price this year - despite the U.S. dollar strength - which has hurt.

Political concerns can also play a role. In Turkey, where President Erdogan retains a tight political grip, the Lira fell around 10 percent in May, leading to a sharp emergency rate hike – and the currency has dropped over 30 percent against the U.S. dollar so far this year. South Africa also faced challenges, partly because sentiment from Turkey spilled over, but also because the country turned back to recession, the honeymoon period afforded to President Ramaphosa after succeeding Jacob Zuma is now over, and while some governance reforms have come, there has also been debate about land reform which has concerned investors.

Brazil saw considerable volatility in the run up to the October presidential election, which ultimately seemed to come down to a choice between two dramatically different candidates. On one hand was Jair Bolsonaro, a right wing politician from the Social Liberal Party, and Fernando Haddad, a left wing former Sao Paulo mayor. From April to mid-September, the Brazilian Real fell over 20 percent against the U.S. dollar, with equity markets equally weak. However, in the final weeks before the first round election on October 7th, as a win for Bolsonaro looked increasingly likely, Brazil rallied strongly – and did so again when his first round victory was confirmed. While Bolsonaro's record of comments on social issues has come in for heavy criticism, he is also associated with liberal economic policy and structural reform. The second round election comes on October 28th.

So, against this background, many emerging market currencies have been weak. How worried should we be? Certainly, if there is a relentless continuation of U.S. dollar strength (and rising U.S. yields) that is typically negative for many emerging markets. However, many economies are far more robust now than during the taper tantrum of 2013, and better able to withstand challenging conditions such as a stronger U.S. dollar. Meanwhile, a stronger dollar and higher U.S. yields are not always so negative: if gradual and driven by benign economic conditions, they can be positive for many of the higher beta markets in the world, such as emerging markets and indeed Japan and Europe, as they benefit from trade with the U.S. Of course, this linkage feels somewhat under threat this year, due to the Trump administration's protectionist leanings.

## The trade war affects everyone

We are now 10 months into a year, where President Trump has engaged in aggressive trade rhetoric against China, backed up by actual tariffs.

As we write, Chinese stocks are down 16 percent this year, while U.S. stocks are up 10 percent (MSCI indexes in euros). No doubt, Trump would present this as America becoming great again, and winning like never before. But it would be wrong to assume this stock market divergence in 2018 is a fair reflection of the impact of tariffs. Yes, Chinese stock markets have been more sensitive to tariff developments this year, but partly because it coincided with some weakening of underlying economic data in China – which leaves any market more vulnerable to negative sentiment. Looking at the actual economic impact of the tariffs, neither country is free from pain.

The latest World Economic Outlook from the IMF carries a scenario analysis on global trade tensions. This uses five increasingly painful scenarios. The first scenario looks simply at trade measures already being implemented. In the near term (say, 2019), this is estimated to affect GDP by only around -0.2 percent in the U.S., but -0.5 percent in China. However, in the long run, the impact is around -0.3 percent for both countries.

The second assumes that the U.S. slaps a 25 percent tariff on USD 267bn more Chinese imports, and China retaliates so that all USD 130bn of goods imports from the U.S. face 25 percent tariffs. Here again, the impact is significantly greater on China in the short term, but in the long run, both countries see GDP hurt by around 0.5 to 0.6 percent. Under this scenario, some countries actually benefit in the short term: for example, the USA's NAFTA trading partners and the Euro area would likely get a short-term boost as the U.S. and China seek alternative sources for some of their pricier imports.

However, something interesting happens in the more severe scenarios. The third assumes that the U.S. implements its threat to place a 25 percent tariff on all imported cars and car parts (USD 350bn), and that affected trading partners retaliate. The fourth and fifth layers factor in the potential impact of falling confidence on investment plans, and the impact of tightening financial conditions on corporates. Under all three of these, the U.S. - and its NAFTA trading partners - start to see a much more significant impact on near term GDP, but most notably, the long-term impact on U.S. GDP is estimated at around -0.9 percent – compared with only -0.6 percent for China. The increased impact on the U.S. is because of the large volume of imports to which the tariffs would apply, and because car parts (intermediate inputs) make up almost half of them.

Obviously, these scenarios are just that: scenarios. However, they do appear to confirm the common sense point, that trade wars rarely benefit either party. Were President Trump to follow through on most of his trade threats, and were trading partners to respond in kind, in the long run the U.S. economy is likely to be among the worst hit. In a sense, this may be comforting: once mid-term elections are done, might Trump himself be motivated to dial back the rhetoric, or at least, not follow through on it? Perhaps, although you will not catch us trying to predict what Donald Trump will do next. If the trade war does escalate, it is clearly a negative for global growth, and periods of weakened global growth are not typically supportive of emerging market equities. However, given the relative performance of Chinese and U.S. equities lately, and given their relative valuations, the markets may need to adjust to price in the long-term impact of trade tensions.

## Attractive Emerging Market valuations

Although our emerging market funds have had a strong relative rebound in the month of October so far, overall this year has been tough relative to the MSCI EM index. This is partly because they have a fair exposure to small and mid-cap stocks, which have generally been weak this year. However, periods of small cap underperformance are to be expected, and we believe they continue to offer decent potential for long-term returns. Our funds have relatively little exposure to energy, which was the strongest sector so far this year on the back of stronger oil prices. Finally, we have seen some relatively weak performance from a few individual positions, which led to somewhat negative selection returns so far this year. Looking at our long-term returns, we note that selection of individual stocks remains a significantly positive driver for us. It is worth noting that in a year of negative sentiment in emerging markets generally, it is often common to see overreactions to negative stock specific news. As always, when individual positions underperform, we focus on analysing why, and confirming whether the long-term investment case remains solid. When it does, we will sometimes use the share price weakness as an opportunity to build the position for the long-term. A good example of this – from our developed market strategy – is BlueScope Steel, which follows just below.

Given the higher U.S. rates, some weaker GDP readings, and reduced confidence due to the political environment, earnings expectations for emerging market companies have come down over recent months. However, the fall in share prices has exceeded this, meaning that that both the broad emerging market universe, and our holdings, have become significantly cheaper during the year. Looking at the simple ratio of share price to estimated earnings two years from now, the MSCI EM index has seen its price-to-earnings ratio fall from 12.9x in January to 10.7x in September. The asset class of emerging market equities has become significantly cheaper, both in absolute terms, and relative to developed market equities. It is worth remembering that this remains an asset class with significant earnings growth potential in the medium to long-term, and even in 2018 and 2019 growth of around 12 percent is still expected. Meanwhile, for Sparinvest Ethical Emerging Markets Value the same price-earnings ratio declined from 10.5x to 8.3x, suggesting that our fund's relative discount to the wider universe has expanded. As value investors, we find this reassuring about the potential in the overall asset class - and in our funds.

## BlueScope Steel benefits from trade war

For most companies involved in international trade and manufacturing the uncertainty of the trade tensions creates additional challenges. However, for one holding in our global developed market funds, the introduction of tariffs on U.S. steel imports was clearly beneficial. BlueScope Steel had been a successful investment for us already, having delivered returns well in excess of other global steel companies in recent years

– so the additional strong performance in 2018 was the icing on the cake.

BlueScope Steel owns steel assets in Australia, the U.S., New Zealand, and Asia. We first acquired shares in 2011. The share price had declined significantly since the global financial crisis and the outlook was not particularly rosy. The company was under pressure from low steel prices and a strong Australian dollar that limited its ability to export. However, it was trading at about half its replacement value. In fact, our sum-of-the-parts analysis suggested that the share price only reflected the value of the international assets, meaning we could effectively get the Australian business almost for free – and we were confident that BlueScope Steel's Australian operations would eventually benefit from a reversal in steel prices.

Looking at the balance sheet, there were concerns regarding covenants on BlueScope Steel's debt. However, after discussions with management we concluded that there were various options to address these concerns either by debt renegotiation, an asset sale, cost cutting or some form of refinancing. Soon after our first investment, BlueScope Steel announced a comprehensive strategy overhaul and refinancing package. We decided to participate in the equity offering in November 2011, significantly increasing our position - and this has had a very positive impact on our total returns from our investment in BlueScope Steel.

A key decision in the restructuring was to close one blast furnace in Australia, to improve BlueScope Steel's cost competitiveness and reduce its excess capacity to restore prices. In the following years, Australian earnings started to improve, benefitting from a lower break-even point, and the improving cash flows were used to buy out its partner in the U.S. in 2015. This doubled its potential earnings power in the U.S. The timing of this transaction could not have been much better as steel prices started to recover soon afterwards. BlueScope Steel's core earnings roughly quadrupled between this transaction and the end of 2017. Its shares outperformed the sector and the MSCI World by a wide margin.

The next phase came early in 2018, when the Trump administration announced tariffs on steel imports to the U.S., but exempted pig iron, which is a key input cost for steel makers, from import duties. As a result, U.S steel prices increased by about 40 percent since the beginning of the year, while European and Chinese prices were fairly flat. Meanwhile, input costs remained relatively stable. This meant that BlueScope Steel saw its expected earnings improve rather dramatically, and its shares continued to outperform.

However, steel prices are now well above the long-term average and as BlueScope Steel's share price approached our estimate of the company's intrinsic value, we divested our position. From our initial buy to final sale the shares gave returns roughly on par with MSCI World; however, we increased the position significantly via the capital raising in late 2011, and since then, the shares have increased around 550 percent compared to MSCI World's 150 percent.

As we divested this position, we reallocated the capital elsewhere. For example, we bought shares in Alcoa and Western Digital during the quarter. Alcoa is a fully integrated Aluminium producer with one of the best competitive costs positions globally, while Western Digital is a company that we have held before and know well. It is the world's largest maker of hard disks for data storage and the second largest maker of NAND memory chips.

## We maintain a long-term investment horizon

There is no doubt that investors are nervous, and after a decade-long bull market resulting in richer valuation of equities in general, we also question whether the bull market can continue - but this does not change the way we invest. As always, we spend time reviewing our existing holdings, ensuring that their medium- to long-term investment cases remain intact, but we also use this market volatility to look for new ideas.

We continue to buy companies trading at significant discounts to their underlying values. No matter the macro economic outlook or stock market momentum, our approach rests on having a long-term investment horizon. We carefully consider the economic outlook, but our aim is not to constantly rotate our portfolios in an attempt to position ourselves ahead of short-term trends. Instead, we do our best to understand our sensitivities, and make sure that each company in the portfolios is fundamentally strong enough to endure future headwinds. On average, our investments have robust balance sheets, which should make them less risky when it comes to an interest rate or credit market shock, and it gives them strength to withstand a period of declining revenues.

Many of our portfolio holdings are already in some sort of a cyclical downturn, some of these sub-industries, which are currently depressed, may not necessarily be hit as hard in a broader downturn, and they have plenty of potential for reversion in both profits and valuations. Furthermore, we always look for company specific catalysts that are not closely correlated to broader stock market moves. Given the increased uncertainty and low visibility, we think this is more important than ever, since it can generate performance even in a flat or negative market.

So, while we refrain from guessing too much about next quarter's or next year's performance, we do share some of the concerns mentioned above – there are wider economic and valuation risks in today's markets and they can surely weigh on the performance of both markets and our funds in the quarters to come. Meanwhile as noted above, since we invest in a portfolio of companies which have been selected for their company specific fundamental merits and their attractive pricing, our stock specific returns tend to deviate from broader industry level or stock market returns. This may not be reflected in outperformance every quarter or every year, but our long-term commitment to value investing has shown to be rewarding over the last two decades, and we are convinced that it will continue to be rewarding in the years to come.

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