Today’s Investment Environment

Q1 2019

The love-hate relationship between the markets and the Fed continued into 2019 as equities staged a strong recovery following a particularly severe period in the capital markets. Just as the Q4 market collapse had a lot to do with Fed hawkishness at a time of slowing growth, the big reversal came after the Fed abruptly changed their stance on inflation to one of “patience” and more of a “whites of their eyes” approach.

The first quarter was also a good period for real assets and various credit markets. It was a time of some significant divergences as well, including U.S. equities outperforming foreign markets and growth stocks again handily outperforming value stocks. The latter has become an enigma that we will discuss shortly.

Investing (through our managers and otherwise) on the basis of deep fundamental analysis and where we believe we have identified an edge has always been our most important engine of return. Our focus, moreover, is opportunistic and bottom up with a keen eye on maintaining diverse sources of value add. These are the principles that gave us and our managers the conviction to stay the course in Q4, and we see them as even more important now that markets are again at or near all-time highs.

Despite the market rebound, we remain in a world of increased global fragility. The United States economically is in a bit of a Goldilocks environment where inflation is tame, long-term bond yields are roughly 50-60 basis points lower than before the Q4 meltdown, and underlying growth remains strong. But conditions in foreign markets are not as sanguine. Germany and Japan have stagnant economies and their ten-year bond yields have declined back to zero. In addition, China is struggling to maintain the high level of growth needed to meet its social promise and the world’s number two economy is appearing to be quite vulnerable to U.S. trade pressures.

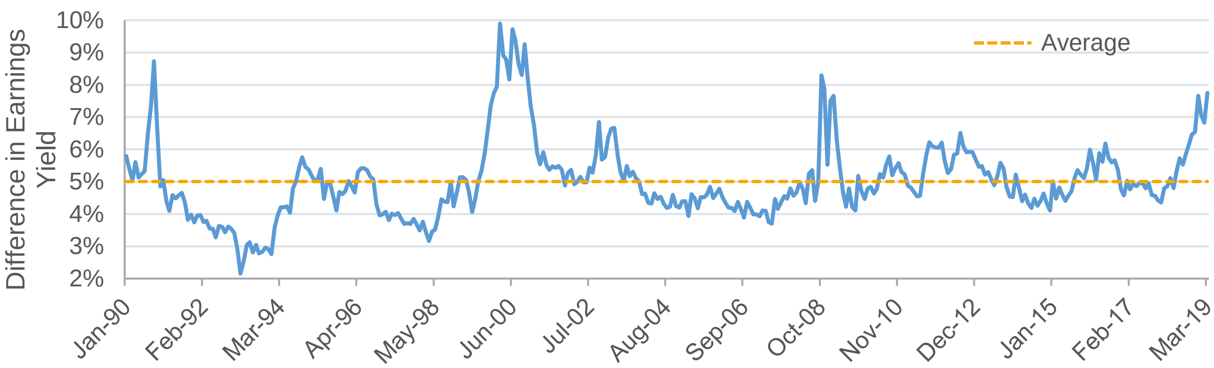
The markets appear to have recognized these conditions as evidenced in P/E multiples remaining much higher in U.S. than foreign equities (**Exhibit 1**). We believe that the difference in valuations is largely justified on the grounds that there is a higher quality and lower risk to the earnings of U.S. firms even though their near-term earnings outlook is not that much better than for non-U.S. firms.

Exhibit 1: Earnings Growth, Forward P/E Ratios & Forward Earnings Yields (as of March 31, 2019)[1]

	U.S. Equities	Non-U.S. Developed Equities	Emerging Market Equities
2019 estimated EPS growth (FY 2019 versus FY 2018)	2%	1%	-1%
P/E on estimated 2019 earnings	17.2x	13.6x	12.6x
Earnings yield (based on estimated 2019 EPS)	5.8%	7.3%	7.9%
U.S. bond yield (10 Year)		2.4%	

Within equity markets, the valuation differences are starker. The valuation gap, as measured by differentials in earnings yields, is now close to the prior extremes reached in 1990, 2000, and 2007 (**Exhibit 2**). The chart shows that the shares of cheap (high earnings yield) companies are now sporting an 8% advantage over expensive (low earnings yield) firms—versus a normal relationship of around 5%. This, moreover, is something of a global phenomenon.

Exhibit 2: The Valuation Gap between Cheap and Expensive U.S. Equities[2]



The valuation gap by itself would make sense if the expensive companies genuinely had growth rates worth paying up for and if the cheap companies had poor outlooks, but we think there's a lot more there:

1. The stocks that are cheap are primarily of cyclical businesses such as financials, energy and autos, sectors whose prices today are so low that they are seemingly being priced for a recessionary outcome. The companies in these sectors look particularly inexpensive given that many have been deliberately extracting efficiencies and investing in their futures.
2. As the incidence of highly priced stocks has increased, there are also more firms in this category with mediocre growth characteristics. We see this as being indicative of a much-improved opportunity set for short selling.
3. Some of the expensive stocks are in areas where there are big/high growth/secular themes well worthy of the loftier multiples—and absolutely worth being owned by investors skilled in those areas.

We see these conditions as auguring especially well for investing on the basis of careful fundamental analysis—short as well as long. We believe it to be a richer opportunity set today, one that underscores the basis of our strategy, the choices we make in managers and their skill sets, and the high confidence we have in how they are seeking to invest.

[1] Source: Bloomberg
[2] Source: Morgan Stanley US Equity Universe

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