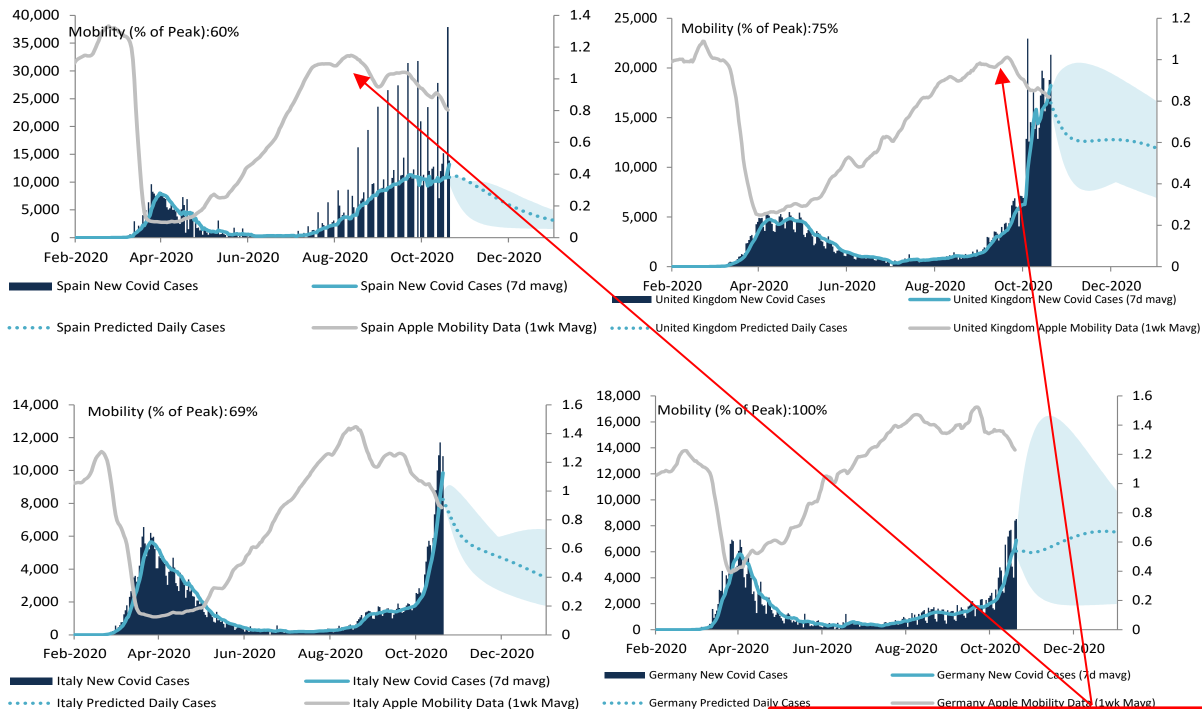
Third Quarter Review: International Equities Strategy

Economic and Capital Markets Commentary

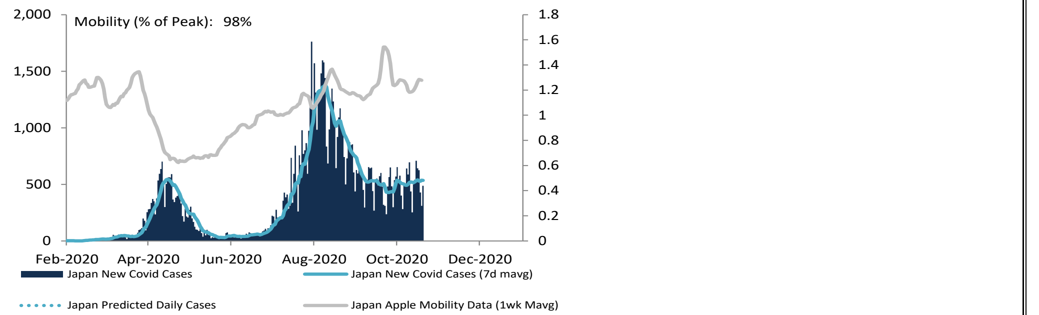
During the prior update, we provided a caveat to the nascent rebound in economic activity: a "second wave" in COVID infections. Suffice it to say, the rise in infections did portend a more vicious resurgence in cases than many expected. New cases have reached pandemic highs in some countries, including the U.K., France, and Spain. New restrictions on consumer and business activity have raised the specter of stalling recovery, though actions at this point have stopped short of the draconian lockdowns from earlier in the year.

Some contract tracing studies have shown that 10% of infected people have been responsible for 90% of the new infections, which could build a case for renewed government restrictions on activity. But, policymakers now recognize the unsustainable economic, social, and health costs of broad based restrictions, emphasizing targeted action. Striking the appropriate balance of the cost-benefit for a population in the face of attempting to control the "super spreader" cohort and venues will continue to prompt divergent responses by various nations. Fortunately, the World Health Organization has recently come out with commentary cautioning against widespread lockdowns as an appropriate response, noting the disproportionate impact by "making poor people an awful lot poorer" and potentially "doubling world poverty by next year."

Regardless of the actions taken by government, a self-preservation instinct will temper economic recovery as case counts rise in a population. Responsible individuals will alter their personal behavior in the face of the increased risks. With case counts surging, sequential economic data may stall until new cases trend down, an effective treatment is available, or a vaccine is widely available.



Clear declines in mobility data as citizens altered behavior in the face of rising new cases (and ahead of many of the newest restrictions)



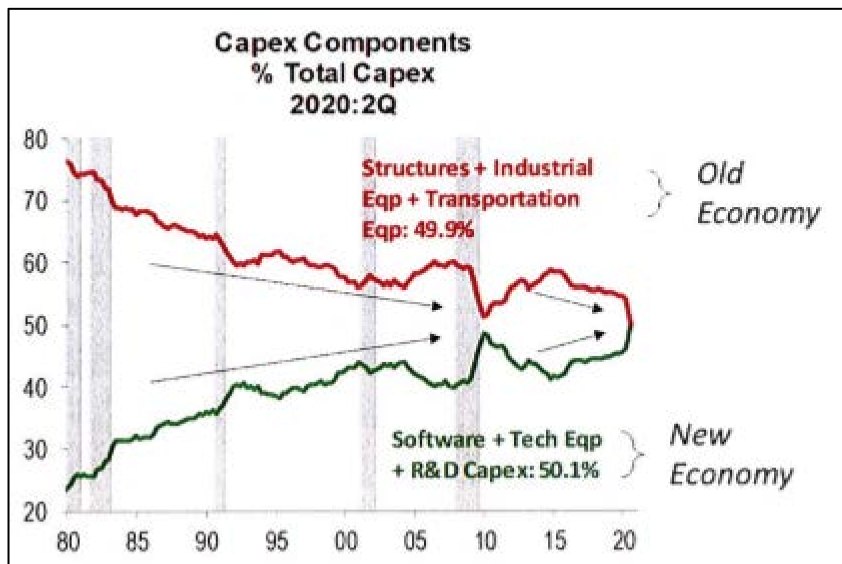
Source: Evercore ISI

The persistence of the pandemic and its impact on our global economy has served as a catalyst to accelerate "creative destruction," a theory first advanced in Joseph Schumpeter's *Capitalism, Socialism and Democracy*. Analysis by Bank of America research notes that the penetration of e-commerce has doubled over the past few months, as consumers alter behavior in the face of government and self-imposed restrictions. The consequence has been a flood of bankruptcies of traditional, bricks-and-mortar retail. Many online and omni-channel retailers have seen sales actually increase over the last two quarters, as they have taken market share from those unwilling or unable to embrace change.

While the wave of retail bankruptcies has exhibited the most obvious casualties, the ripple effect on related markets and services makes the impact much broader. The closures of store fronts will have lasting impacts on real estate vacancies for retail. Online payment platforms have seen surges in activity, with PayPal noting revenue from online transactions surging 28% during the second quarter from the prior year's quarter. In banking and finance, the importance of internet and mobile banking has increased as consumers have abruptly limited trips to traditional branches. Consistent with on premise retail, restaurants have also had to respond with an increase in food delivery versus dine-in. Just Eat Takeaway.com has seen activity surge in their food delivery platform, as more restaurants fight for survival with capacity restrictions and consumers increase the usage of home delivery.

Remote work is another phenomenon that has surged as a result of restrictions. While risks to company culture and individual productivity can be debated, the forced introduction of remote work has prompted a critical assessment of the workplace. The frequency of virtual meetings and conferences has exploded, allowing a more efficient and cost effective manner to interface with coworkers, suppliers, and customers. One personal anecdote was a recent attendance of two overlapping conferences – one in Munich and one in Little Rock – without leaving Dallas, Texas. The proliferation and acceptability of these platforms, while less likely six months ago, could last beyond the resumption of a [new] "normal." The persistence of these platforms would likely lead to a recalibration of resources allocated to travel and accommodations, weighing on the recovery timeline for some of these industries.

While these are only a few of the disruptive surges in the market as a result of an epidemiological catalyst, they exhibit a step change in trends already set in motion during the prior decades. Software, Technology Equipment and R&D capital expenditures have grown to now represent over 50% of total capex. The most recent inflection only confirms a trend, as technology capex has increased its share from a mere 23% of total capex in 1980. Interestingly, they appear to surge, then recede relative to capex in more fixed asset investments as economic expansion resumes.



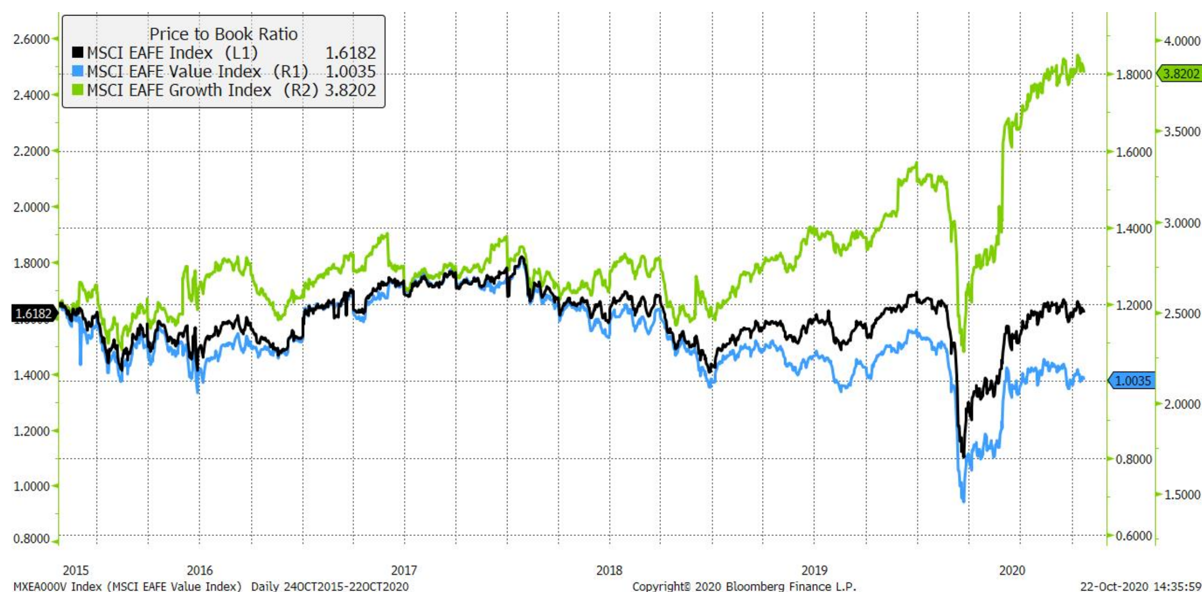
Source: Cornerstone Macro

This "Drivers versus Dinosaurs" dynamic, as so eloquently expressed by Cornerstone Macro, has resulted in some interim winners and losers during the pandemic. Market participants have been overzealous in their capital allocation towards sustainable business models and growth industries, creating a bifurcated market. In the international markets, the German market, as measured by the Deutsche Boerse Index, is currently down only 3% versus the Spanish market, as measured by the IBEX Index, down 29% year to date. Germany is widely recognized to have a more innovative market with greater penetration of information technology and industrial automation. Valuation metrics have rebounded to pre-COVID levels on a price-to-book value ratio for Germany, while Spain remains 20% below January multiples.

This divergence is apparent in the price performance of growth indexes. When comparing the MSCI EAFE Growth and Value Indexes, the dispersion of returns is quite stark. The growth index is *up* 5% whereas the value index is *down* 19%. The price-to-book multiples for the growth index is now 17% above the start of the year, as investors assign a greater premium to future earnings potential in a low risk-free rate environment. The greater mix of value in the broader MSCI EAFE Index has resulted in anemic performance for 2020 thus far when compared to the S&P 500 Index.

<ins>Relative Performance of MSCI EAFE, MSCI EAFE Value, and MSCI EAFE Growth Indexes</ins>

Historic Price-to-Book Value for MSCI EAFE, MSCI EAFE Value, and MSCI EAFE Growth Indexes



Source: Bloomberg L.P.

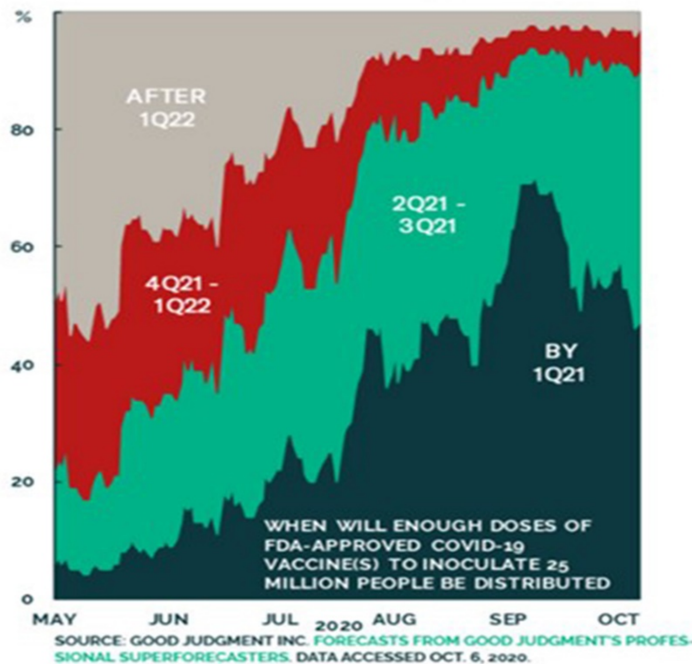
Our popular index for domestic markets in the U.S. further exemplify these trends of greater price appreciation of growth-oriented names. The top 5 constituents in the S&P 500 (Apple, Microsoft, Amazon, Alphabet, and Facebook) represent ~23% of the capitalization weighted index, and all five have technology "drivers" to growth. This historically large weighting of top constituents has pulled the S&P 500 Index price higher by ~6%, excluding dividends, whereas the S&P 500 Equal Weighted Index price remains 3% *below* the price at the start of the year. Some fear that this concentration in the United States may have introduced idiosyncratic risk into the benchmark. The concentration could also limit further price appreciation of the index in the event of a rotation, despite it being broader based.

The MSCI EAFE Index is less concentrated, despite the same growth/value dynamics at play. The top five constituents by weight only represent 8% of the index, and only the fifth constituent has direct exposure to information technology (ASML). The other top names are in the Consumer Staples, Consumer Discretionary and Healthcare sectors. So irrespective of divergent economic outlooks for non-U.S., developed markets, this index more accurately exhibits the lack of breadth that has raised some concern in our domestic market.

The uncertainty in the outlook for cash flows in cyclicals has weighed heavily on the enterprise value for this segment of the market. The actions taken by central bankers in all major markets to reduce the risk free rate resulted from the strict lockdown earlier in the year, which devastated most economic activity. These, often asset intensive, industries must manage uncertain operating cash flows with ongoing demands from maintenance capital expenditures. Similarly, banks face decreasing interest revenue – and thus organic capital generation – while facing potential capital losses due to a credit cycle. These risks will remain for the short to medium term, which decreases visibility in relatively low growth industries. A low discount rate does little to the present value of the business under these scenarios, since terminal values must also contemplate uncertainty, growth, and returns. Alternatively, the platforms that leverage fewer fixed assets into growth at high incremental margins have a decided advantage on the rate impact on present value in a discounted cash flow model, but unfortunately, are highly dependent upon strong growth assumptions tied to a terminal value at - often - lofty multiples.

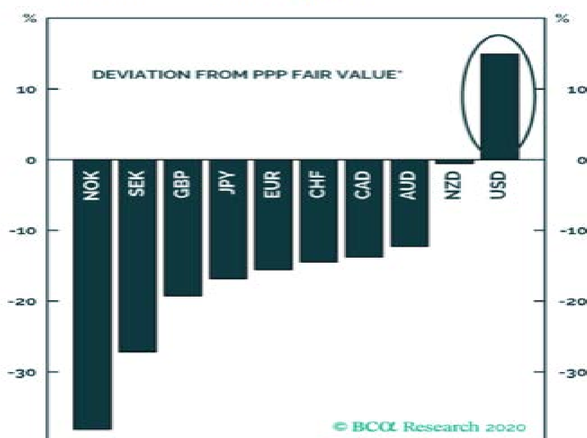
Source: Evercore ISI

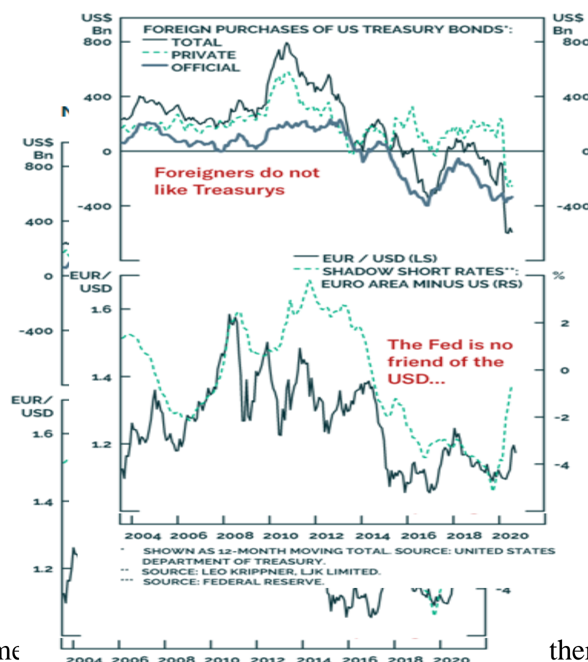
As we move towards treatments and vaccines for the coronavirus, a clearer path towards cyclical recovery becomes visible, presuming appropriate, accommodative policy. As uncertainty fades, there should be a capital rotation from growth to value. The impact on cash flows and prospective discount rates would alter the value proposition. Unfortunately, there is no crystal ball to determine when (and if) this rotation will occur, and these business models tend to be less attractive, given our investment discipline. Value has attempted multiple breakouts during the past quarter, but these proved short lived. We manage our portfolios with an eye towards the proper mosaic of sectors, regions, and factors, including both growth and value. We prefer to maintain a growth tilt on our core mandate for long term value creation but recognize that lower quality vehicles could see a reversion at some point in a recovery.



Source: BCA Research

The U.S. Dollar weakened during the summer months, as the flight to quality gave way to a collapse in interest rate differentials between markets. Prior to the re-introduction of accommodative monetary policy, the spread between the U.S. and German 10 year government bonds were tracking at 180-200bps, whereas this spread fell to 110bps at its lowest point in August. Since June, the trade weighted USD has declined by 2%, as this compression reduced the incentive to buy US Treasuries. While there could be some support for the USD as the relationship reverses course, further increase in US rates would likely be a result of an improved economic outlook, which typically precipitates a move towards more economically sensitive currencies. Additionally, the USD still sits comfortably above its fair value, as measured by purchasing power parity. As we move through this pandemic-induced recession towards recovery, there could be further downside risk to the U.S. Dollar over the next few quarters.





Source: BCA Research

Though the resurgence of new cases poses the most imme ... ther risks could potentially undermine its shape and sustainability. ... iew cases and increased restrictions on activity, recent developments have increased the likelihood of a "no deal" Brexit. Instability resulting from a hard exit from the European Union would impair a recovery and likely trim their potential growth rate for long term GDP. Hopefully, they can resume trade discussions and prevent exacting costs on both economies. In the U.S., we have our own uncertainties with the potential for a less accommodative regulatory and tax regime. The current Biden tax proposal would be the largest tax increase since 1968, which contributed to a recession… there are many things that seem eerily familiar from that period when considering our current situation. If policies swing to the extreme, there will be significant changes in the ways that savings and investments are allocated. One would expect growth rates in per capita capital stock to stumble in the aftermath. These are two risks worth highlighting, as both will experience developments during the current quarter and could have impacts on long term potential rates of growth.

The leadership in the markets continues to lie squarely in the growth and momentum camp. Though there were multiple failed attempts during the quarter for value constituents to break from their malaise, market participants await better visibility of a sustainable economic recovery. This recovery will be contingent upon a combination of both fiscal and monetary stimuli to bridge the economic gap, as well as the introduction of better treatment and vaccines for the coronavirus. Until this time, volatility in near term cash flows for many cyclical industries will continue to weigh on the present value of the enterprise. The disruption in "normal" activity has led to an inflection of some trends which were already in place prior to the pandemic. While there may be a stepdown in this growth rate for some companies as we resume a "new normal," many of these secular shifts will persist. Epidemiological and policy risks remain, but we continue to remain constructive on the outlook for EPS growth

broadening into 2021, despite a potential near term pause in economic activity for some markets due to spikes in new cases.

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October 22, 2020

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