PineBridge Investments

2018
EQUITIES OUTLOOK

At Long Last, Fundamentals Take the Driver's Seat

- Price correlation among stocks within sectors and markets has dropped sharply. This suggests that company fundamentals – rather than liquidity – are driving stocks.
- Expect a new wave of "smart capex" and strategic investments to create the corporate winners of 2018 and beyond.
- Through bottom-up research, we find alpha opportunities in areas including Asia, Japan, Europe, small and midcap stocks, as well as global industrials and technology-related industries.

Author:
Anik Sen
Global Head of Equities

Normalization of global markets has only just begun. Price correlation among stocks within sectors and markets has dropped sharply, suggesting that company fundamentals – rather than liquidity – are driving stocks. This is a sharp change in the market conditions that persisted after the global financial crisis. And since the second half of 2016, valuations have risen further as global growth has gained traction, inflation has remained low, and central banks have continued easy monetary policy. But this is only the beginning; there is much more to come.

What will happen next? That depends on who you ask. The traditional macroeconomic view of our current economic expansion, which looks at the length of the cycle from beginning to end, is that we are nearing the end. Since 1945, we have had only two periods of expansion that have been longer than the one we are in right now.

But there is another way to look at it. In every business cycle, there is a point when businesses increasingly begin to invest rather than return cash to shareholders through dividends and share buybacks. Yet quantitative easing (QE) has created abnormal characteristics that make this cycle more unusual: high valuations are the norm across all asset classes, interest rates in the major economies of the world are persistently low or negative, and arguably, large amounts of investors are crowding at the security level.

Crowding has been visible in equities, first through the high valuation of bond-like, "minimum volatility" stocks, and then in the high valuations for visible growth stocks, such as for some of the well-known tech names. The dispersion of returns, or the difference in the amount that stocks move, still remains low relative to long-term historical averages. This, combined with the abnormal characteristics of this cycle, suggests that we are much earlier in the cycle than many market observers believe.

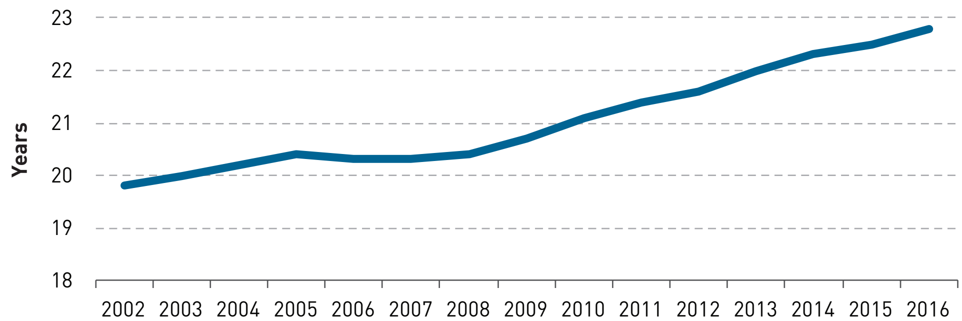
The good news for equity investors is that company fundamentals are turning up. For the first time in the last nine years, earnings expectations are solid and improving. The most notable recent improvements are in Europe, Asia, and Japan.

Businesses are turning to "smart capex"

Investment spending is the key part of the business cycle that we have yet to see, even though capital stock is aging. But things are looking up. While there is plenty of capacity

Capital stock is aging, signaling that it's time for companies to invest.

Age of US Private Fixed Assets (By Industry)



Source: Bureau of Economic Analysis. Annual data through 31 December 2016.

globally, there is little need to make traditional capital investment. For example, since the early 1990s, US manufacturing capacity utilization has been persistently under 85%, the level generally accepted as requiring new investment spending. The situation is similar in other parts of the world, especially China, which has been taking steps to consolidate excess capacity in many industries.

Operating margins for most companies are also stagnating as the relatively easy improvement through cost-cutting since 2008 is now over. While company managements were not truly rewarded for embarking on capital expenditures in the past due to the long payback periods on projects to increase capacity, there is a significant change taking place in investors' attitudes toward capex. Investors are now looking for management teams with superior skill and vision that are able to improve operating margins through investing and strategic actions. This will require investments in areas of technology such as automation and analytics, as the production philosophy shifts from one of standardization to new levels of customization where the customer demands a tailored product or service at an ever lower price point. This is "smart capex."

The good news is that smart capex has a very rapid payback period of three to four years and a high return on cash invested, so that the operating margin improvement is within the forecastable horizon of a potential investment. This is a far cry from the past, when the return on investment had long payback periods and was often below the cost of capital.

It is little wonder, then, that investors have been reluctant to reward capex in the past. And this early in the capex cycle, sell-side analysts' estimates still do not reflect the substantial improvement potential in operating margins. Many management teams will struggle to embrace the technological changes needed in virtually every industry. As a result, the gap between the winning management teams and the rest – as well as the dispersion in returns – will be wide in the coming years.

All eyes on new technology

We expect this cycle to be all about the deployment of new technology. Indeed, we see several disruptors on the horizon, and the pace of change in the tech industry today is unprecedented. These changes are not limited to the tech sector itself; this revolution affects businesses beyond Silicon Valley, especially ourselves as consumers.

Take electric vehicles. They have the power to change our mode of transportation, but they can also have far reaching effects on the global economy. Major auto manufacturers are promising that, within the next couple of years, there will no longer be a combustion-engine-only car. This transformation is about the creation of an entirely new ecosystem of industries and not just about a change from one technology to another. It will have far-reaching effects on other industries, such as energy and mining (from the electrification of cars), insurance, real estate (from owning cars to sharing and renting them), and entertainment (from the time freed-up from driving). For the wider economy, a lower cash outlay on car ownership frees up more cash available for other consumption. In short, there will be investment opportunities in many industries.

All this change will affect markets with a broad stroke. There will be more winners and more losers – big ones. We didn't see much of this over the past nine years because companies were mostly focused on cost cutting and the major central banks were busy providing the largest liquidity safety net ever seen. But now that global economic growth is synchronized, a new wave of "smart capex" and strategic investments will create the winners of tomorrow and beyond.

Who will these winners be? Very simply, the companies that have unique businesses and strong management teams. These are powerful filters that we believe will separate the vast majority of companies in the investment universe and leave the select few at the top. By unique businesses we mean those with hard-to-replicate competitive advantages and financial flexibility that operate in attractive industries. Strong management teams are those with proven track records, strategic vision, and financial conservatism. These companies have the ability to embrace technology to revolutionize their processes and to raise their competitive barriers even higher.

Large, slow-moving companies will likely look to smaller, more nimble companies for innovation in a wave of bolt-on mergers and acquisitions over the coming years. Finding these winning companies and owning them at the right valuation is the goal for active managers, as these are the opportunities that will provide investors with attractive returns when markets are richly valued.

Opportunities will be driven by selection

Finding investment opportunities is no longer about markets at the index level but what is happening within them. For instance, underlying fundamentals have been improving in India, but that does not warrant a blanket approach. Our local team has classified some equity securities as bizarrely overvalued, trading at levels that appear very difficult to justify. Yet there are many opportunities that are attractively valued in that market. This is true of virtually all equity markets around the world where valuations are at their highs versus history but the dispersion of valuations – or the difference between richly valued and reasonably valued stocks – is also at its highest point.

This speaks to the high payoff for correctly identifying the winning companies and positioning for when their valuations converge with fundamentals over time. The opposite is also true, where many companies are set to disappoint investors due to their high valuations when the correspondingly high expectations that are built into their stock prices fail to materialize.

That is why the next several years will be a different investing period compared with the last nine. The environment will be particularly attractive for active management, rather than the top-down, style-based investing that has characterized investment flows for some time. Through bottom-up research, we are finding alpha opportunities in areas including Asia, Japan, Europe, small and midcaps, as well as global industrials and technology-related industries.

Minding the risks when markets appear "just right"

We must always mind the risks, but many of them have softened. Europe presented the most uncertainty on the political front, but outcomes there were nowhere near as alarming as they could have been. Geopolitical risks will be here to stay, but synchronized growth has put the world on stronger footing.

For the first time in this cycle it feels like we have a solid environment for equities: Europe, Asia, Japan, and the US are all showing synchronized growth. Order books are generally healthy and earnings expectations, on average, are being revised up. At the same time, central banks remain very supportive of markets. Companies are early in their investment cycle as they look to increase productivity and raise their competitive advantages through bolt-on deals. To us, all this points to increasing opportunities for active, bottom-up investors.

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