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EQUITIES

Our Time Traveling Reporter Sees International Opportunities amid Regime Change

By: Christopher M. Dyer, CFA | & Ian Kirwan | October 11, 2022

London - Active investing requires a forward-looking approach to selecting stocks and positioning portfolios for the market conditions we anticipate will emerge in the coming quarters and years. This is an especially challenging mandate in times of elevated volatility and uncertainty, as investors focus too much attention on current news and fears, and not enough on how the world will look and feel in the future. Our investment team's consistent focus on the sustainability of business models aims to provide resilience in periods of disruption and opportunity in the aftermath.

A core aspect of our investment process is seeking to minimize behavioral biases, such as short-termism, in our decision-making. As one of our more than 50 proprietary portfolio exercises, we recently asked each member of our investment team to imagine they are a Time Traveling Reporter, tasked with sharing a dispatch on what the world looks like for investors and financial markets one year from now. Will we be in the middle of a multi-year bear market or has the market improved? What main themes drove the equity market over the last year, and how did those impact sector and geographical performance?

Three key takeaways from our time traveling reporter

- Current fear is setting the stage for opportunity
- Higher discount rates mean valuation matters
- Higher inflation is here to stay

Fear creates opportunity

Rampant inflation, consistently rising interest rates, mounting energy costs, Putin's invasion of Ukraine, ongoing pandemic-related disruptions, monetary policy, and corporate earnings all dominate headlines. The latest AAI Sentiment reading revealed that investor bearishness is at its highest level since the global financial crisis in March 2009.

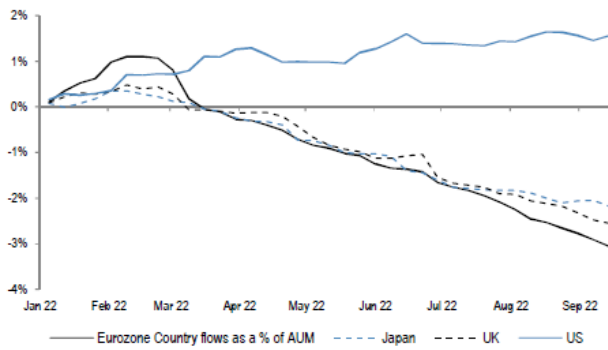
AAII Sentiment Survey: Pessimism stays above 60%



Source: American Association of Individual Investors (AAII), September 29, 2022.

Interestingly, even amid turmoil in global markets, U.S. equities have experienced consistent inflows year-to-date while Europe and Japan have seen persistent outflows.

Cumulative fund flows into regional funds as a % of AUM



Source: JP Morgan Global Equity Strategy, September 20, 2022; EPFR as of September 14, 2022. Japan includes Non-ETF purchases only.

Myriad factors suggest a bearish approach to European markets, but our investment team sees sources of opportunity. Being selective is essential, and current circumstances underscore the need for active management and our focus on sustainable business models that can outperform through cycles.

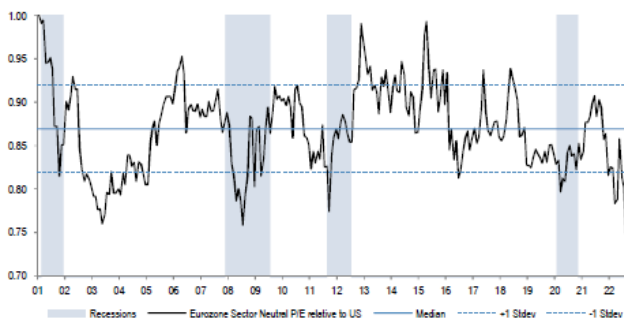
As reflected in the Time Traveling Reporter exercise, our investment team believes some current sources of fear will abate in the coming quarters. Even if inflation stays higher for longer, our Time Traveling Reporter believes we are near the peak rate of inflation. While short-term interest rates may spike higher to combat inflation, we see yield curve inversion in many markets. It's debatable how much higher 10-year rates will climb, particularly given the rise in short rates is not supportive of demand or GDP.

We use exercises like Time Traveling Reporter to ensure we are forward-thinking and not paralyzed by short-term noise and uncertainty. We adjust portfolio positioning if appropriate, and compile a list of companies to watch over the next year. When valuations are attractive, we view it as a great time to pivot to these names.

Higher discount rates will constrain high multiple stocks

The era of rewarding high multiple or no earnings stocks is over. Materially higher risk-free rates imply materially higher discount rates. Investors must adjust the way they value companies. Our team has been talking about bubble dynamics in certain areas of the financial markets for some time now (cryptocurrency's volatility, the drastic imbalance of large tech names in the S&P 500 Index), and these dynamics are currently subject to extreme vulnerability.

MSCI Eurozone sector neutral P/E relative to U.S.



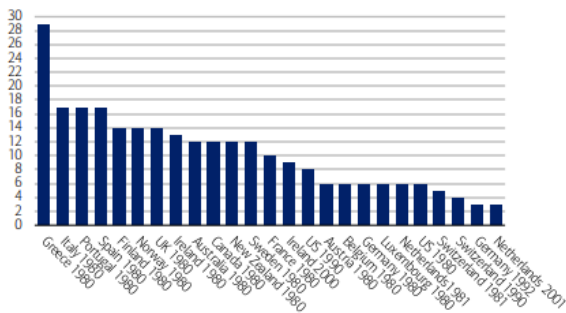
Source: JP Morgan Global Equity Strategy, September 20, 2022; Datastream.

While equity inflows have been steady in the U.S., the outflows from Europe in 2022 have placed further pressure on European equity valuations, which are now at multi-decade lows relative to the U.S. We believe the U.S. dollar is susceptible to mean reversion, while international equity could experience the double benefit of a relative re-rating of its equity valuation and its currencies.

Higher inflation is here to stay

Pricing power is a vital element in our assessment of a sustainable business model. We believe the final shoe to drop in the next 12 months is earnings. As inflation continues to soar, pricing power becomes more important. History has shown that whenever inflation reached current levels, it remained elevated for many years. In most prior slowdowns, interest rates would have already rolled over and would be much lower than they are today, given the weakness in the global economy. The persistent tightening suggests the current global growth slowdown may be longer and deeper, and sustainable business models can offer greater earnings resilience.

Cases of inflation above 5% in advanced economies 1980-2020, years to decline to 2%



Source: IMF and BofA Global Research, September 21, 2022.

Once inflation is above 5% in advanced economies, it takes on average 10 years to drop to 2%.

Our team sees the opportunity to add risk in the coming quarters, but it is important to remember that adding risk does not mean buying bad businesses. A focus on sustainable business models enables sifting through to find winning businesses, regardless of the market regime of the broader economy.

Bottom line: Investors must quell worries over current market conditions and examine how those factors create opportunity. The current landscape underscores the need for active management and our focus on sustainable business models through cycles. We believe we are near the peak of inflation, but we expect inflation to remain elevated for several more years. Pricing power gains steam as inflation continues to spike. Persistent inflows into U.S. equity and outflows from Europe have exacerbated the relative valuation discount of international equity. Higher interest rates and discount rates are likely to constrain the returns of high multiple stocks, including many highly valued U.S. companies. It's time for investors to turn their attention to international equities as a source of diversification and undervalued opportunity.

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