MARKETS AND ECONOMY

Capitalizing on Opportunity in International Equity Markets

By: Christopher M. Dyer, CFA | & Ian Kirwan | July 25, 2022

London - With news of record-high inflation and growing investor concerns over economic growth, uncertainties in international equity markets continue to abound. There are increasing signs that the consumer is feeling inflationary pain and trading down, and we expect this to get worse before it gets better. While the COVID honeymoon in financial markets is definitively over, we believe the outlook for international equity investors is not entirely bleak.

Markets Draped in Uncertainty

China's COVID policy is exacerbating the global supply chain bottlenecks that kicked off this inflation cycle. Even with the lockdown in Shanghai now easing, the transportation infrastructure remains very congested. This, of course, feeds back into the inflation loop, and pushes central bankers to move faster and harder on monetary policy. Higher bond yields means growth stocks are de-rating meaningfully. The June Bank of America "Global Fund Manager Survey" revealed that optimism on global growth has hit an all-time low since the survey began in 1994. The S&P 500 is now officially in a bear market — the 20th in the last 140 years.

Optimism On Global Growth Falls To New Low

Fund Manager Survey: Percentage Expecting Stronger Economy

Despite many central banks having shifted their language toward aggressive interest-rate increases, we have seen bond yields ease back in recent weeks. This reflects the bond market's view that the central bank action on rates will crack demand and inflation will ease. The result, of course, would be some kind of economic slowdown or recession. Many commodity prices, such as copper and oil, have begun to move lower too.

A Focus on Long-Term Drivers of Profitability

In markets like these, we think it's important for long-term investors to focus on company fundamentals and prospects over time, and not get caught up in the deafening day-to-day noise. A focus on securities that feature secular growth and high levels of profitability and returns on capital — typically viewed as drivers of compounding — can help position a portfolio to navigate vacillating macro conditions. In addition, the tactical inclusion of some sustainable cyclical companies allows for better navigation of different market environments, and to seize opportunities created by valuation dislocations. We also think it's critical to assess environmental, social and governance (ESG) issues that are financially material to the sustainability of a company's business model.

Team-Based Decision-Making

Within the global equity team, we have created a culture that encourages diverse opinions and professional development, emphasizes dynamic debate, and embraces a multifaceted approach to counteracting common investment biases. To that end, we have developed over 40 unique portfolio exercises to address common behavioral biases (e.g., over-confidence, recency, herd mentality, risk aversion, etc.). These exercises are essential to generate ideas, acknowledge mistakes, stimulate debate, avoid complacency, and focus on long-term value creation.

In line with our focus to not get caught up in recency bias, our team performed a portfolio exercise at the end of March called "500 basis points for Capital Preservation." Given all the risks to the global equity markets at the time, the exercise asked portfolio managers and analysts to assume global equity markets would fall another 20% in 2022, and consider what stocks would be most resilient. It asked individuals to assume they had 500 basis points to allocate, with the object of preserving capital. Exercises like these help ensure we are deploying capital to the best opportunities and avoiding complacency.

Thoughts on Future Directions

In this environment, we are keeping a close eye on the industrial and commodities areas of the economy as well as on Chinese government policy. Despite the building trend to re-shore manufacturing away from countries like China, it remains the so-called "Factory of the World."

China's impact on manufacturing and supply chains will likely affect global GDP trends in 2022. Another area we are watching closely is inflation; particularly its stickier elements such as wages and housing rental rates.

A few months back, our team had begun to take a more defensive posture; recently, however, we have begun to recycle some capital from our defensive winners back into names that have de-rated this year. More generally, given current valuations that have come down sharply since 2021, we see market opportunities to begin adding back to positions. As investor fears build, we look for opportunity. The panic that is driving fund managers to hold cash and defensive stocks will increasingly create the opportunity to move against consensus.

Bottom line: Although a number of challenges exist in the current market, we believe international stocks offer significant areas for potential investment, particularly in view of depressed valuations. Our approach is to take advantage of near-term imbalances, moving against consensus where we see opportunity.

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