Focus

ECP European Value strategy: outlook & positioning

November 2018

Market environment & outlook

The sell-off that occurred in October led us to postpone the publication of our quarterly market commentary in order to be able to include in our market analysis the potential results of this correction.

October was a cruel reminder of what can happen at this stage of the market cycle after 9 years of a bull market. And yes, one should not forget that European stock markets have more than doubled since the through of March 2009.

The market environment has progressively shifted in 2018; central banks are starting to tighten with, unsurprisingly the Fed being more advanced in the tightening cycle than the ECB.
As a result, interest rates are going up with 10 years US bond yields at 3.2% (05/11/18).

At company level, it is no secret that many companies are facing bigger challenges today than they did one or two years ago. The move-forward of the economic cycle is now showing itself as a cycle that is getting older but has not yet completed: economies are growing slower than they used to do, consumer spending power is good on back of wage growth and low cost of financing their homes, job markets are strong, companies have to pay more for attracting staff to work for them and commodity prices have increased.
The combination of a slower growth and higher input costs makes it difficult for companies to continue to show the same high earnings growth as they have shown in recent years.
Mr. Market has not been slow in running away from the market leaving practically all sectors with negative returns for the last 6 months. Consequently, The P/E multiples have contracted by 10%-30% across sectors with the Oil and Automotive sectors hit the hardest. Earnings forecasts have still not adjusted meaningfully. In short, a very negative economic outlook is being priced into many stocks.

As always on the stock market: when things happen too fast, mistakes happen. In practice, it means that *Mr. Market* treat all companies equally good or bad (depending on market direction) without an eye for the specifics of the underlying fundamentals of each company. This does always lead to situations where companies are valued incorrectly (from our viewpoint, of course). While we can understand and respect this nature of *Mr. Market*, it does not make much sense to us as fundamental investors having a longer term investment horizon.

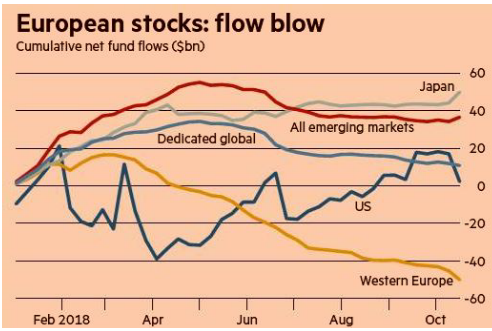
What does that mean for us as Value investors?

First of all, higher interest rates can be viewed as a proof a higher economic activity and also of stronger corporate earnings which is positive for the earnings power of the companies we are invested in.
Second, higher interest rates are putting some pressure on growth stocks which are normally long duration stocks. In other words, when interest rates go up the value of near term cash flows (Value) has higher value than far-away cash flows (Growth).
And hence as the graph below shows there is an historical correlation between higher interest rates and the outperformance of the Value style vs. Growth strategies.

However, from a European perspective, the situation appears to be much more complex.

Interest rates of the main countries like Germany have not yet really moved while, in Italy, the increased political risk related to new spending plans of the populist government led to higher spreads.

Last but not least, if economic growth has globally slowed down, we also observe a desynchronization between Europe and the US with the US economy resisting better.
As a consequence, money is still flowing out of European equities to be repatriated to the US stock market, perceived as a safe harbour.



Source: EPFR, Bernstein analysis (taken from Financial Times issue, 3-4 November 2018)

As bottom-up investors, our main focus is in analysing the fundamentals of the companies to identify those exhibiting undervalued earnings power. Nevertheless, in order not to become a victim of top-down moves affecting the operating environment of the companies we invest in, we find also important to keep an eye on the big picture, including macro- and political developments. As such, **we have currently identified 5 themes that need to be closely monitored in the following months:**

1) The comeback of value

As mentioned, there are historical evidence that the value investment style tend to outperform in periods of higher interest rates.
However, currently, despite a shift in market environment, the outperformance of value strategies in Europe is not clearly confirmed.
And, if during the recent market correction, the Value indices has been falling less than the Growth indices; many of the mid cap companies, that are usual suspects for flexible contrarian strategies like ours, have been taken to the cleaners (mainly for liquidity reasons).

2) Brexit

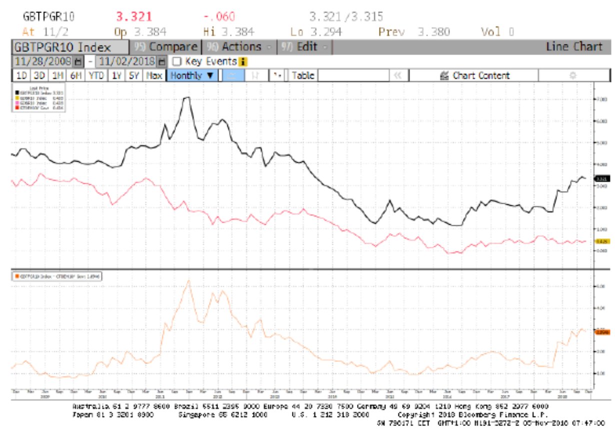
Brexit is a painful process with a still uncertain outcome. We believe that, at the end, business reason will prevail on political insanity on both sides of the Channel but in the meantime, uncertainty remains and continues to weigh on the market sentiment in Europe

On a short-term period, the GBP has strengthen both against the USD and the EUR but, on a long-term basis, it remains at very low level.

3) Italy

Alongside Brexit, Italy is probably the main political risk in Europe. The new Italian government wishes to increase public spending with the aim of boosting economic growth without taking into consideration the European framework in which each national budgets should normally fit.

The market cannot ignore the situation which has led to an increase of spreads (see graph below) as well as to an increased investors' mistrust in the Italian financial and banking sector.



Source: Bloomberg

4) World Trade

Trade tensions between the US and its main trading partners have regularly made the headlines in recent months; the battle that rage with China being the main concern.

Recently, overall perception is that some negotiations will soon take place between the two economic giants that should bring some relief to the trade war concerns. China having already mentioned that they should be more open to an increase of importations.

The rebound of Chinese stocks in the last week of the month of October is probably a consequence of this more positive perception.

5) Oil

Globally, commodity prices have increased in the recent months with some relevant impact on companies input costs.

However, during the month of October, the oil price has shifted downwards in the wake of pressure put on Saudi Arabia to increase production (which it did to satisfy counterparts still very focused on the murder in Turkey of a journalist). Inventories are now at a high level but the new US sanctions on Iran that recently came into force will probably have an impact and might lead to a rebound.

Portfolio positioning

In 2017 and earlier in 2018, *Mr. Market* priced many companies for perfection and blue skies forever. We used that opportunity to sell out of several companies. We particularly reduced our exposure to the Automotive segment that is now under the highest pressure on the stock market. We slowly reinvested the money into more conservative business models which, at that time, were considered "out of fashion" by *Mr. Market*. That gave us a good entry point in companies like *ISS*, *G4S*, *Jeronimo Martins* and *Shire Pharmaceuticals* (which was taken over just a few days after we invested). Now *Mr. Market* has changed his mood and priced in a very pessimistic scenario (on almost everything) and we can again make several investments that we believe will give our investors very healthy returns that are not entirely dependent on the economic cycle. We build our positions slowly to reduce the entry point risk.

We often take a different view than the market overall. This has for 20 years generated healthy long-term returns for our strategies. The flip side is that being contrarian always involves the risk of looking foolish, sometimes even for an extended period of time. This is just something we have to live with.

This shift in market environment, however painful it is for us in the short-term, creates investment opportunities. Indeed, we are convinced that, in the recent weeks, many babies have been thrown with the bath water which led to a situation where several companies are now priced as if they have no future. This goes both for companies that we own already and companies that we do not own.
In those cases, we always start by asking ourselves two very basic questions: First, does the company sell a product or a service that will also be needed in future? Second, does the company have sufficient strength to weather a potential storm? If both questions are answered with a solid "YES" we move on in our research process on the company. Provided that the company makes it through our research process and the valuation is attractive enough, we are ready to invest and start to build our position slowly. In the big scheme of things, more than 10 companies have left our portfolio this year than 10 companies have entered the portfolio. More than half of our new companies have entered the portfolio after the summer. Those new positions have an overall more defensive business profile and a lower valuation than those leaving the portfolio.

As a conclusion

Market environment remains challenging for long-term investors like us. It's now more than ever crucial to stick to our guns and continue to focus on our investment principles with the aim to invest in quality companies benefiting from a strong undervalued earnings power.

European equities remains currently a hated asset class despite the fact that valuations are still low (both on an absolute and relative basis) while the companies in which we are invested are still exhibiting strong earnings power.

With the cycle entering a new phase, consensus estimates in terms of companies' earnings are not so demanding so we believe the risk of deception is lower than it was last quarter.

This is, from our point of view, a good starting point in a context that should, if history is any guide, ends up in favour of Value strategies.

We need to remember that **we are now laying down the foundations of our performance for the next 4 to 5 years**. So, we go searching for companies that are fundamentally and significantly mispriced in relation to what we believe is the earnings power of the company in a normal year. It has always been and still is the start of our journey.