



Comfortable Being Uncomfortable

Where we are hunting amid the market confusion.

August 2019

Successful investors are a strange bunch. They can simultaneously hold in their minds multiple competing ideas. It is unusual to find a vivid imagination, nestled in steely analytics, set alongside a deep curiosity for human psychology.

There is nature and nurture to the foundation of investment success. Over time, two factors work to develop it—experience and apprenticeship.

A skilled T. Rowe Price portfolio manager once wondered aloud, “How do you deal with the stress of markets?

If you seek ‘comfort,’ you are in trouble. You have to learn to be comfortable being uncomfortable.”

In a sense, comfort and safety are your enemy when seeking idiosyncratic alpha. If you find yourself in a room where everyone agrees that they all know the answer, you want to identify the exits and stand close to them.

The current market environment is one of confusion. We have had a long bull market, which has often done its best to defy the presumed rules of a “cycle.” Despite its length, interest rates and inflation are low and falling, in part because disruption is so prevalent. Demographics, automation, and excess energy have led us from a world of scarcity to a world of abundance.



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Technology is unlocking capacity in every industry.

I thought that I would enjoy a world of abundance, but it turns out that it causes all sorts of problems. The key problem being that this flavor of abundance is driven by intellectual property in the form of technology, making the winners concentrated and the losers broad. Median incomes are not rising fast enough, and democracies are rightfully upset at the median worker being left behind.

Markets Are Leaning Toward Low Earnings Volatility

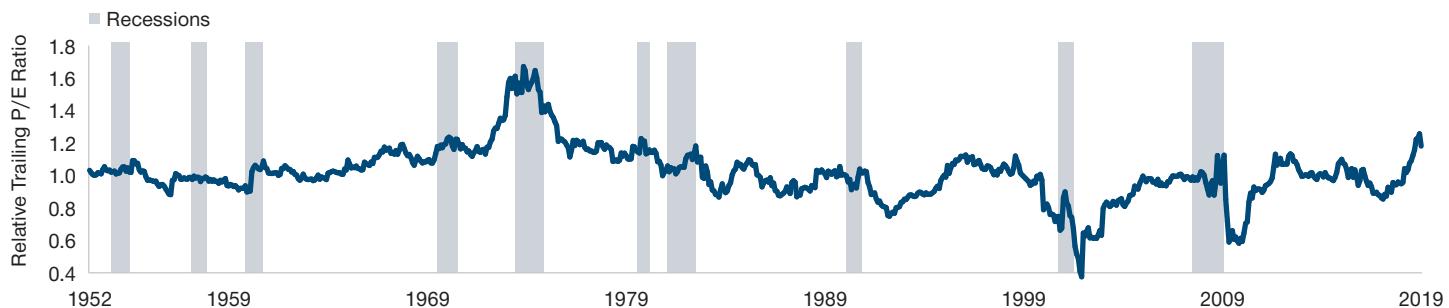
How have global equity markets reacted to our conundrum? In the wake of the sugar high of the “Trump stimulus,” markets are being shaped by the low-growth and low-inflation environment. Despite the best efforts of policymakers, it turns out that increasing deficits and debt levels do not change structural growth rates—at least not in the form of fiscal stimulus from tax cuts.

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(Fig. 1) Stable Stocks Appear Expensive

Relative Trailing P/E Ratio for Top Quintile of Fundamental Stability Score, U.S. Large-Cap Stocks¹

January 1952 Through June 2019



Sources: National Bureau of Economic Research and Empirical Research Partners.

¹Equally weighted data for the 750 largest U.S. stocks by market capitalization.

One reaction has been the rotation of global investors toward stocks with low earnings volatility (Figure 1). While it's understandable that investors want stable and consistent growth, especially in uncertain times, valuations always matter and the rerating of many companies perceived as stable is causing us concern. Therefore, selectivity is ever more critical. Being able to identify future, stock-specific drivers of change is the source for any comfort we may feel in this segment of the market, not the factor characteristics that might describe a stock's past and present.

In contrast to the perceived safe havens, many cyclical "value" stocks have suffered, and rightly so (Figure 2). The issue with cyclical value centers on the fact that underlying stock prices are driven by tightening capacity and a pricing power improvement cycle. However, if technology keeps unlocking capacity, which in turn suppresses prices and the improvement cycle, you never get a value cycle. The early recognition of this insight has been critical, with oil and banks prime examples of sectors that are on the wrong side of deflationary change. Don't get me wrong: There is a trade to be had when no one owns one asset and everyone owns another. Eventually, you get a short and wicked reversal. But without industry consolidation and strengthening pricing power, this is a tougher way to

make money in today's world of constant technological disruption.

The Case for Growth Cyclicals

Growth cyclicals are another story, however. Here's where the details matter. For example, while oil and semiconductors may move together and "look the same" amid short-term volatility, their vastly different industry structures and long-term supply/demand trends will ultimately drive stock prices. Near term, as the U.S. stimulus has faded and trade fears have ramped up, cyclical growth sectors, including semiconductors and industrial automation, have been hammered. At these times, insights about positive change are even more valuable. Today, we can find cyclical growth stocks with tremendous long-term runways for value creation priced for a crisis. This underlies our current interest in building positions in cyclical growth stocks, based on the company-specific earnings acceleration characteristics we believe we will see in 2020 onward.

The case for cyclical industrial automation is certainly compelling. Imagine the future: Will there be more or less robots, lasers, and computers (artificial intelligence and machine learning) running factory or machine-driven processes? Are the companies with key intellectual property (IP) in these areas

(Fig. 2) Value Versus Fundamental Stability

Ratio of Forward P/E for Bottom Valuation Quintile to Forward P/E for Top Fundamental Stability Quintile, U.S. Large-Cap Stocks¹
January 1977 Through June 2019



Sources: National Bureau of Economic Research and Empirical Research Partners.

¹Equally weighted data for the 750 largest U.S. stocks by market capitalization.

likely to be more or less valuable? The good news is that given the current backdrop of confusion and fear, we can buy these stocks today at large discounts to what we believe is their future earnings potential. This enables us to be comfortable amid the confusion.

The case for semiconductors is similar, but nuanced. The semiconductor industry can be broken down into analog/mixed signal and digital. Analog/mixed signal involves taking real-world measurements of temperature, light, and pressure and connecting those measurements to a computing platform. We will only see more of this. The industry has consolidated, and, as a result, fierce competition no longer prevails, helping the dominant survivors. There is significant room for long-term value creation.

Digital semiconductors are the memory and logic of all devices and of the cloud. Dynamic random access memory (DRAM) was once mainly used in PCs and then in smartphones. Now it is the “brain memory” for artificial intelligence and machine learning. Ten years ago, there were more than eight independent DRAM makers globally. Today, three companies dominate while keeping up with the technological demands of manufacturing. DRAM has become difficult, creating new and bigger barriers to entry. The result

is a consolidated industry with strong structural demand trends trading at historically low valuations.

The Sources of the Market's Discomfort

Stepping back, we think global equity markets face two key challenges in the short term.

First, global growth is slow and inflation is low. While the change is linked to the fading of the U.S. stimulus of 2017 and 2018, it is very significant in sentiment terms, especially as slow U.S. earnings growth removes a comforting blanket of safety. Chinese stimulus also peaked in 2016, leading to a slower and lower growth profile. This has pulled European growth rates down in tandem, given the underlying export ties.

Second, the Trump administration is focused on obtaining significant trade concessions from China heading into the 2020 election year. The case for trade reform between the U.S. and China is strong. The two countries mutually benefited from China's economic development. To boost corporate profitability, the U.S. traded off low-skilled manufacturing industries for IP rents in technology, machinery, manufacturing, and health care. The trading relationship

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and the underlying incentives since have evolved, however. China is now on the verge of developing its own IP strongholds, but in many ways it is still operating from a trade perspective as though it were a disadvantaged partner.

Given the recent news flow, the rebalancing of the U.S.-China trade relationship is creating understandable discomfort. We observe that there are three elements to President Trump's China trade war:

- First, the long-term/structural trade policy rebalancing of power, which is a logical and, I believe, sound policy.
- Second, get reelected because nothing else matters if you are not. Trump needs to run against something, and running against China is a strong position for many U.S. voters and especially his own core voter base. However, incumbent U.S. presidents win elections when the stock market is up in the trailing 12 months preceding an election. This is a balancing act.
- Third, get reelected because (as above). Given that the executive branch of the U.S. government controls trade, we think Trump sees trade as his lever over asset prices. In contrast, Trump faces a split Congress and has little hope of implementing stimulus via fiscal policy into the 2020 election, given it would help his cause. As an alternative to fighting policy through Congress and his Democrat opponents, he can use tweets about China to scare markets and pressure the U.S. Federal Reserve to cut rates. We are effectively living in a world where Twitter is a medium for driving short-term global asset prices.

While Trump has formed his actions around his desired reelection objective, one big unknown remains China's thinking about its own best moves in the game. Clearly, the U.S. election creates the potential for a change in U.S. leadership, one that might benefit China.

While many of the headlines are centered on Trump and his bargaining strategy, the uncertainty is very real as to whether China will want to dance with the Trump administration or play for new leadership. This is a complicated calculation with many competing interests.

The bottom line on U.S.-China trade and the markets is that we have lots of room for fear and rhetoric in 2019, but also a high probability of "progress" on trade in 2020 to drive Trump's reelection campaign. If we are in a deep trade war with China in 2020, Trump's chances of winning reelection will be significantly lower, in our view. Therefore, we expect the trade war will soften going into the election, with positive implications for asset prices. Survival comes first, policy second.

The World Is Not in Crisis

Back to "being comfortable being uncomfortable." Global investors are afraid and have crowded into stocks with low earnings volatility. High-quality, long-term growth assets with cyclical and perceived "risky" characteristics are priced for fear. Yet to us the world still looks much more like a "slow growth" and "low inflation" environment than a global crisis. If rates stay low while modestly positive growth persists, stocks should trade at higher multiples based on the equity risk premium—it is just math.

From a distinct headwind, China trade tensions should turn to a positive for market sentiment in 2020, based on the North Star of politics. Therefore, we expect to hunt for cyclical growth stocks where fear is embedded, while fading our positions in stocks where investors feel safe. As always, we will be carefully contrarian and balance our portfolio, always using insights about improving stock fundamentals as our guide. However, we believe that amid today's confusion and discomfort, now is the time to think about the opportunities that lie in 2020 and beyond.

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