

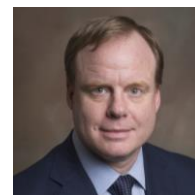


A WORLD OF SECULAR CHANGE— WHAT DOES IT MEAN FOR INVESTORS?

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David Eiswert

Portfolio Manager, Global Focused Growth Equity Strategy



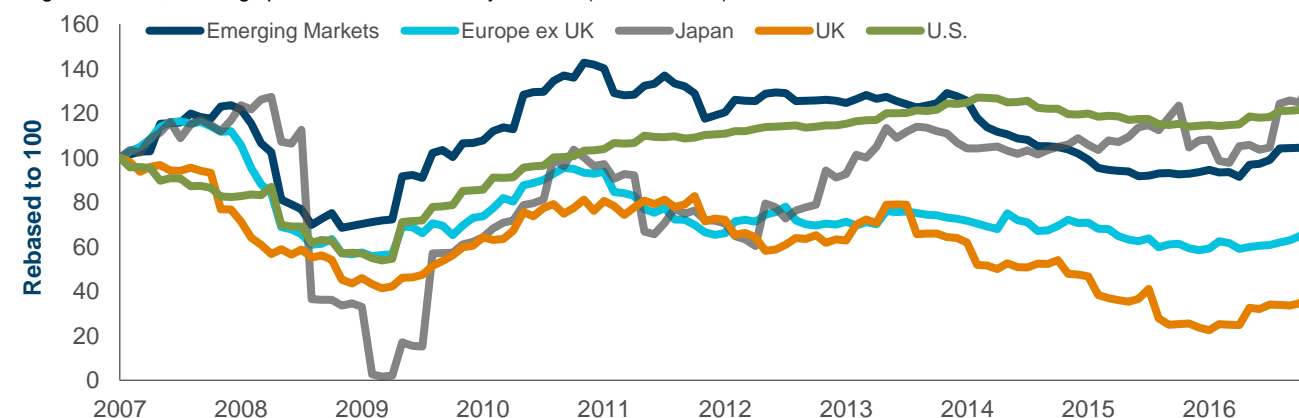
Is the collapse of the “wall of worry” in 2017 signaling renewed optimism and further gains for global equity investors? Or is this the beginning of the end for a monumentally old bull market? That is the debate abounding in global equity markets today as bearish voices have been temporarily quietened amid equity returns that have surprised even the optimists. So what has driven many equity markets to new highs this year, and is it merited?

CORPORATE PROFITS ON THE RISE

In many respects, the answer is to be found in the nondramatic descriptors of stability and gentle improvement. Global growth has been modest but trending upward, and the political backdrop (North Korea aside) has been less extreme in nature versus worst-case scenarios. Most important, corporate earnings have been trending upward and broadly so, acting as a fundamental underpin to rising investor expectations (see Figure 1). After a decade defined by the global economy lurching from crisis to crisis, the biggest concern today is perhaps the absence of a healthy level of skepticism with respect to whether this period of tranquility and optimism is set to be disrupted.

Figure 1: Corporate profits are coming back

Regional Profits, Earnings per Share Since Last Cycle Peak (October 2007)



Source: FactSet, as of August 31, 2017.

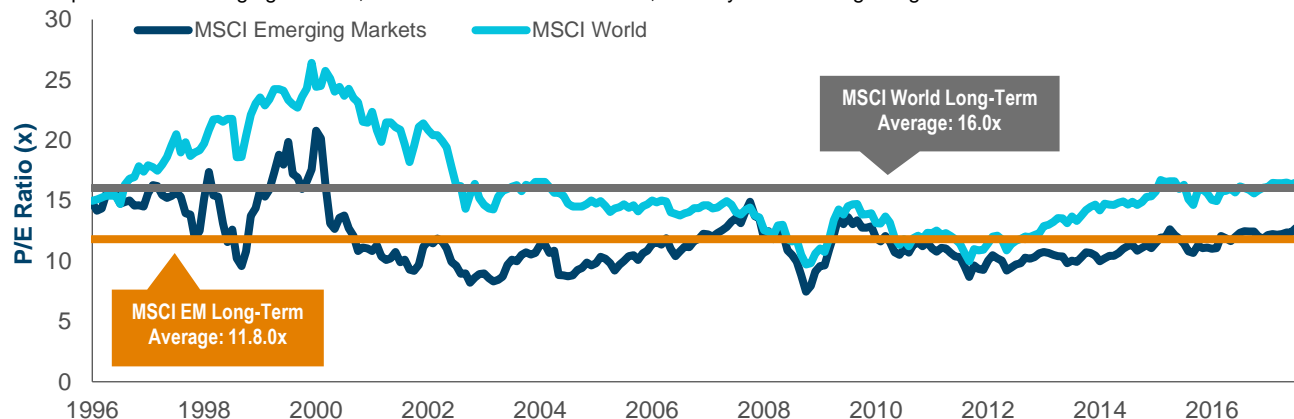
This bull market will of course end at some point. However, it is unlikely to be old age alone that causes this bull to die. Bull markets tend to end due to crisis (2007) or valuation extremes (2000), and while some segments of the market have established premium valuations, we are certainly not witnessing broad-based valuation extremes, especially as corporate earnings continue to trend higher.

NO VALUATION BUBBLE (YET)

Price/earnings (P/E) ratios are trending around 10% to 15% above 2007 highs (the last cycle peak) but only around 20-year averages. In fact, most markets look to be slightly cheap when compared with long-term averages on cash-based valuation measures (Figure 2), while even the premium valuation of the S&P 500 looks consistent with periods in history when the U.S. economy was growing with modest, positive inflation. This “average-to-slight premium” reality is materially different when compared with valuation extremes in history, including Japan in the late 1980s and broad-based global equities in the latter stages of the late-1990s technology rally.

Figure 2: Long-term history suggests there is still value to be found

Developed Versus Emerging Markets, 12 Months Forward P/E Ratio, January 1996 Through August 2017



Sources: MSCI and FactSet.

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Indeed, it is how we've managed to get so deep into this bull market without valuation extremes forming is perhaps worth considering when evaluating what may be in store for equity investors.

The depth of the global financial crisis is partly the cause, with very cheap valuations providing an anchor to the majority of returns to date, while also extending the overall duration of what has been a very pessimistic bull market on average. It is also the global financial crisis and the subsequent length and breadth of monetary policy response to it that continues to stoke equity market returns so deep into the cycle. Expensive alternatives to equities, led by government bonds, combined with QE assisting a period of improvement for the global economy (employment has been rising on a coordinated global basis) have left equities still looking attractive on both a fundamental momentum basis and relative to alternatives. Absent an inherently unpredictable “crisis,” the fundamental backdrop is therefore still solid when considering the potential for global equities to hold their ground or deliver more, albeit more modest, returns.

WILL RISING INTEREST RATES END THE GLOBAL EQUITY CYCLE?

There is much talk about whether the end of QE and a tighter monetary policy regime will be the catalyst that kills this bull market. In some respects, a sharp tightening of monetary policy via a meaningful increase in interest rates could very well create challenges for the global economy and global equity markets. Leverage has increased steadily in many segments of the global economy, and it's unlikely that all debt holders are ready for a sharp tightening of policy. However, just as many strategists have dusted off their late-cycle playbooks to position for a rate hike cycle and bears have cried “credit crisis II,” it seems as though the inflation trends of late 2016 and early 2017 have stalled. This is a positive for the bulls given it may defer and downplay credit issues related to imprudent borrowing, but it has left many (including the Fed) scratching their collective heads as to the root cause of anemic inflation.

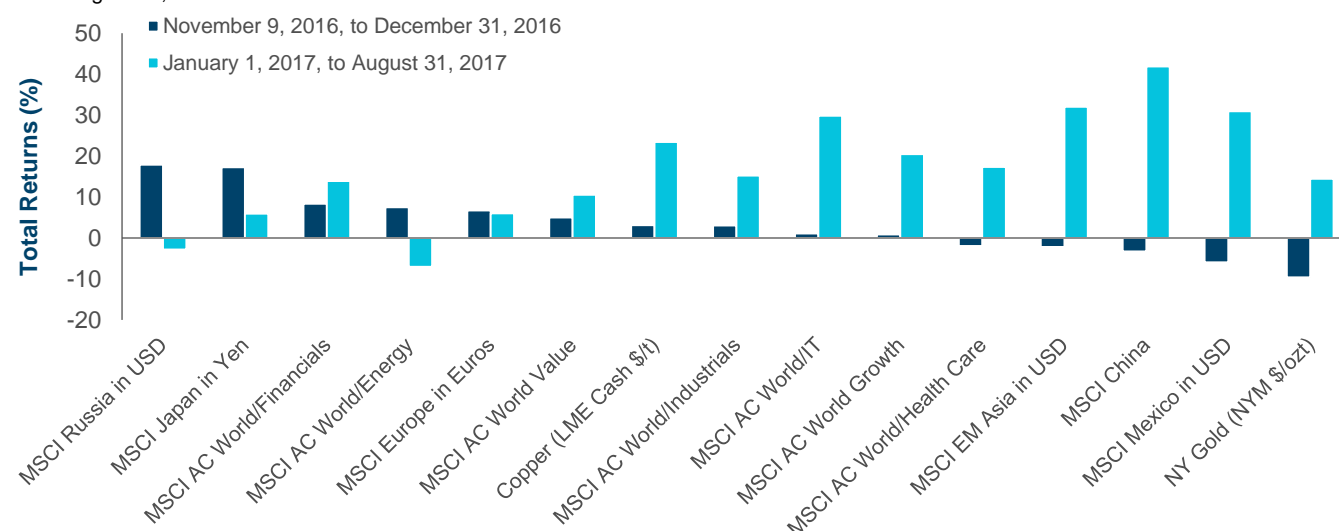
We believe the reasons why inflation is likely to remain subdued are broad-based, secular in nature, and have potentially wide-ranging consequences for investors (please refer to the section titled *Secular Disinflation and Deflationary Progress*). While there are material long-term implications if we are right, near term, the impact has been to adjust expectations around when interest rates may rise and by how much, with the consequence of adding more gentle fuel to the equity embers.

THE FADE OF THE TRUMP TRADE

While seemingly in contrast to the low-volatility environment of 2017 (although it hasn't felt like a low-volatility environment), we have seen tremendous rotation in markets as the Trump rally of late 2016 has faded, and with it, market leadership has switched from value and cyclicals (deemed to have the most exposure to late-stage economic expansion, inflation, and interest rate sensitivity), toward growth and anything on the wrong side of Donald Trump's Twitter account (Figure 3). Go China and Mexico!

Figure 3: The changing nature of the Trump rally

As of August 31, 2017



Past performance is not a reliable indicator of future performance.

Sources: MSCI and FactSet.

This has been helpful from an active return perspective, given our ongoing skepticism toward commodity-oriented sectors and caution on valuations within the industrials sector. In general, we are being very selective within deep cyclicals as a whole, given our view on the fundamental earnings prospects of many stocks. Our growth-oriented strategies have also benefited from renewed tailwinds behind some of our key stock positions within the IT sector, especially those in Asia, where weakness was pronounced in late 2016.

SECULAR DISINFLATION AND DEFLATIONARY PROGRESS

So why the rotation, and why the fading of inflationary pressures so late in the economic cycle when employment markets are tightening? We believe that we are facing an era of structurally lower inflation driven by:

- Technology and deflationary progress
- Demographics and aging populations
- Globalization
- Excess supply of natural resources combined with excess debt of sovereigns

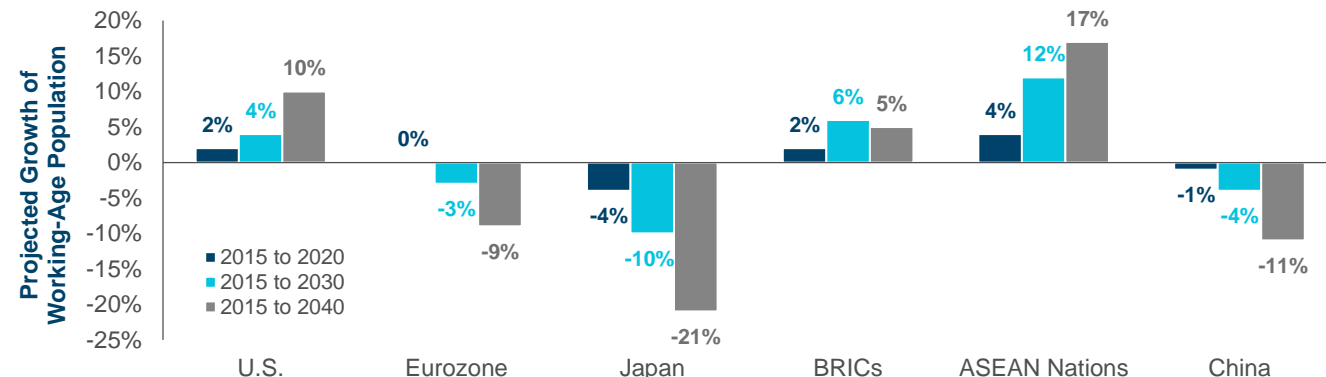
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Take the issue of technology and its impact on our society and the global economy. Whether it's Amazon's retail or IT services offerings, Spotify's music service, Fanuc's automation capabilities, or Apple Pay's contactless payment system, we are seeing disruptive technologies bring not only efficiency and choice, but also lower prices. These technological shifts create benefits for users and have driven phenomenal market share gains for the companies at the heart of successful disruption. More importantly, they have also unlocked capacity (arguably a deflationary force if resources, including human capital, are not allocated elsewhere), which has had consequences for the companies that are being disrupted (e.g., Dell, Blackberry, Nokia—the list goes on). One certainty is that this technological progress has fundamentally disrupted the traditional corporate capex cycle, given the relatively asset-light nature of many of these disruptors compared with older economy peers that have pared back investment in the face of declining market share prospects.

In tandem with the disinflationary force of technology, we are also now at a tipping point for demographics, with many nations facing working-age population shrinkage over the next 10 or 20 years (Figure 4). This shrinkage is likely to end the “demographic dividend” of the past 50 years when growing populations and improving productivity combined to stimulate economic growth.

Figure 4: Where are all the workers going?

As of June 30, 2017



Source: FactSet. Working-age population = all citizens age 15 to 64.

Put together with globalization—which has helped to grow global trade in total but has also remapped the share of individual countries' contribution and compressed production prices—both of these forces are undoubtedly disinflationary. In past cycles, most notably in 2007, the influence of these was muted through an increase in sovereign borrowing and spending and tight, inflationary conditions in natural resource production, which spurred a frenzy of old-fashioned capex. With sovereigns unable or unwilling to increase debt, and with China's demand for natural resources waning, we are perhaps now facing the true steady state level of inflation for the global economy—and it is likely lower.

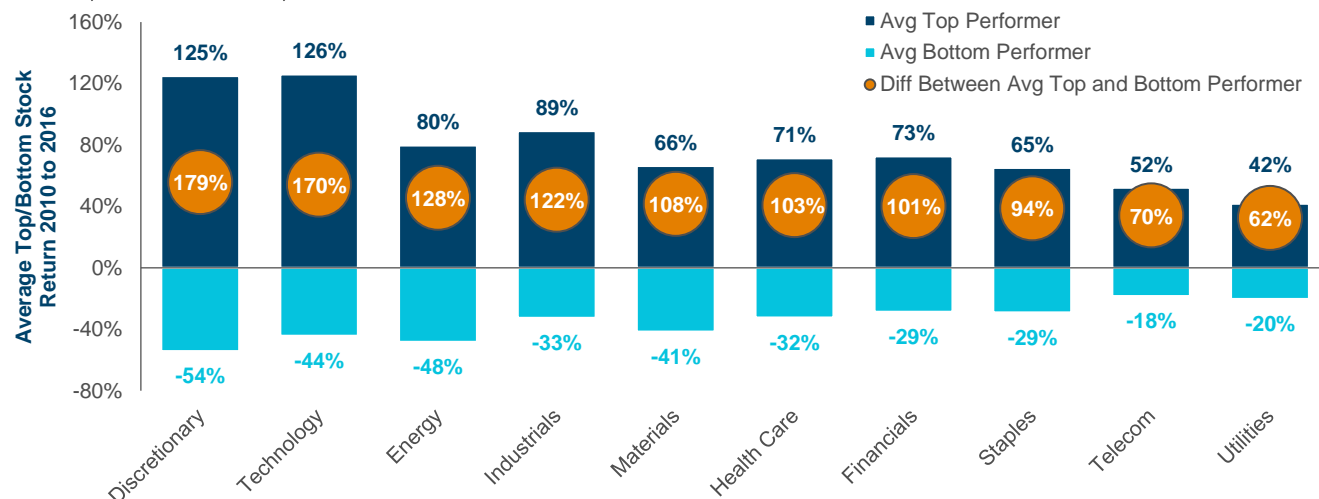
What does this mean for global equity investors? One natural conclusion is to own those stocks on the right side of the changes we are seeing today, the disruptors taking market share from rivals. This has been a profitable exercise in recent years and, at the right price, will continue to be a source of opportunity for forward-looking investors. Conveniently, segments defined by change and disruption (especially consumer discretionary and technology) also lend themselves to active management, with the benefits to winners over losers dramatically more pronounced than in segments of the market where change is less dramatic (e.g., consumer staples, utilities, and telecommunications) (Figure 5).

If correct, the late stages of the equity cycle may also take on a different dimension in terms of market leadership if we don't see the typical late cycle drivers of earnings growth and inflation evolve as history might predict. A measure of selectivity around late cycle stocks is therefore going to be important, as opposed to a top-down cyclical approach to buying interest rate sensitive companies.

More broadly, a period of dramatic secular change where economic share is being redistributed and historical patterns impaired implies that the index may be a poor indicator of opportunity and future economic relevance. Being active, being nimble, and being open to change will be important if disruption continues or if the disruptors become a bubble in themselves.

Figure 5: The opportunity for outsized returns for the disruptors

S&P 500, as of December 31, 2016



Past performance is not a reliable indicator of future performance.

Source: IMF World Economic Outlook.

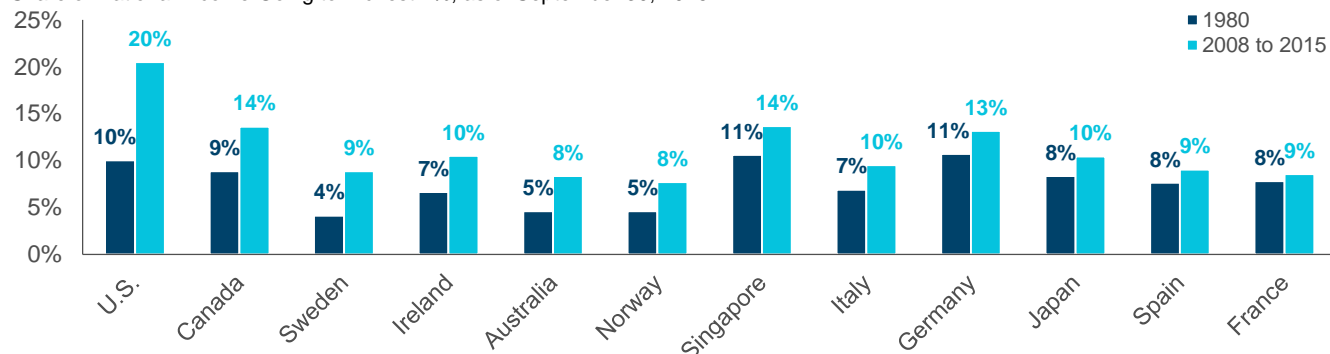
POLITICS AND THE PROTEST VOTE

While inherently hard to predict, it is also likely the case that the rising incidence of protest votes and the shift in voting preferences away from established norms is likely to continue. In the absence of broad-based inflation, wage inflation has been unusually weak, even this deep into the economic cycle when global labor markets are tight. When taken together with the gains to asset owners that have stemmed from QE boosting capital markets, the wage inflation cycle has led to a growing wealth gap in society.

In the case of Brexit or the election of Donald Trump, both campaigns relied heavily on the need to create a better outcome for domestic employment and living standards via wage growth (Figure 6). This is not easy in practice and is unlikely to be derived by dialing back the globalization trend that has helped the global economy over the past three decades. Regardless, as established norms are changed and if political pressure grows to redistribute wealth, this will require active risk control and decision making in the next stage of the economic cycle.

Figure 6: Inequality continues to grow

Share of National Income Going to Richest 1%, as of September 30, 2016



Source: World Wealth and Income Database.

STAY ALERT AND ACTIVE TO ACHIEVE THE BEST RETURNS

Overall, we remain gently optimistic on the prospects for global equity markets, especially given the alternative uses of capital. While we believe we are witnessing a period of powerful secular change with broad consequences for investors, as with any phase of the market cycle, it is important to focus on fundamental, bottom-up research to unearth the best and most promising stocks. Complacency in any environment is risky, especially as valuations rise, so we are constantly evaluating our opinions and the risk/reward profile of our holdings. We will remain active, alert, and prudent, but will also not adhere to the index to guide our bets. Rather, we will continue to actively search for durable companies where we see the best opportunities for growth and improving returns. Encouragingly, we continue to see many opportunities in today's market, even despite the gains equity investors have enjoyed so far in what has been one of the longest equity bull markets in history.

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