



Preparing for a Post-COVID World

Growth and value both present opportunities amid the pandemic.

August 2020

KEY INSIGHTS

- Developed market equity valuations generally appear reasonable given extremely low interest rates but vary widely among sectors and regions.
- The gap between growth and value stocks is almost without precedent, and the rotation back to value—although difficult to time—is likely to be forceful.
- Likewise, the global economy's reliance on unparalleled fiscal and monetary stimulus means tail risks have become elevated.



Raymond Mills
Portfolio Manager, Overseas Stock Fund

Q: Are markets reflecting too optimistic an outlook for the rest of 2020?

As of early August, the MSCI EAFE Index was trading around 18.5 times estimated earnings over the next 12 months—a modestly elevated level that can be justified in the context of very low interest rates. The market also seems to be rational in pricing in a further reopening of the global economy over the next 12 to 18 months. Even as we await a vaccine, treatment protocols for the coronavirus are improving, and a level of herd immunity seems likely to emerge. It also appears inevitable that people will allow themselves to engage in more risky behavior—for good or ill—as they grow fatigued with the shutdowns. Finally, valuations reasonably reflect the massive fiscal and monetary stimulus that has been directed at reviving the global economy.

Q: What permanent marks do you see COVID-19 leaving on the global economy?

Physical retail seems likely to be permanently impaired, and it is telling that e-commerce continues to grow in Europe even as shops reopen. Business travel will also bear lasting scars, but I expect it will come back to around 80% to 90% of its previous levels once the pandemic is over. People are social animals, and I expect that leisure travel and restaurants will eventually come back very strongly—especially as a wave of pent-up demand is released following the end of the pandemic. We should also see steady growth and progress in the health care sector, which is of course getting a lot of attention right now. We're interested not only in pharmaceutical firms, but also in companies involved in medical services and diagnostics.

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Q: What factors would need to come into play for a sustained value rally?

The performance gap early in the pandemic between growth and value in international markets was only matched briefly during the financial crisis, and the current differential remains extreme. It is very hard to identify a catalyst for value to rebound, however, partly because technical factors are at play. For example, Japan’s central bank is buying exchange-traded funds, which tends to favor stocks that have done relatively well and are heavily weighted in the indexes.

Rising interest rates and inflation could spark a market rotation, but that is not our base case; more likely, it is the continued reopening of the global economy that will eventually favor value. History does suggest that the reversal may be forceful when it comes—which is to say that there’s not going to be plenty of time to shift your portfolio. Accordingly, we think it’s important to consider having some exposure to value now.

Q: Has the massive monetary and fiscal stimulus in response to the pandemic changed how you think about valuation?

Certainly, risk-free interest rates below zero in many regions make future earnings much more valuable. In that light, it’s understandable that investors are bidding up the stocks of companies with healthy and reliable cash flows, such as e-commerce and medical technology firms. What I find more interesting—and a source of opportunity—is that the market is not applying the same discount model to industrial companies, for example, that have more volatility in their cash flows but are still growing at a healthy pace over the long term. In theory, very low rates mean investors should also be favoring stocks with healthy dividend yields, but that is also not the case. This makes some sense, as dividend cuts have been occurring as companies seek to preserve liquidity. That’s why we’re less interested in stocks with a high dividend yield—often

a sign of distress—than in companies that are able to grow their dividends.

Q: Where are you seeing opportunities from a regional or sectoral perspective?

The U.S. market is expensive relative to the rest of the world, which can be justified given its higher weighting in technology stocks and higher return on equity. But the valuation gap seems extreme, with stocks much pricier in the U.S. on sales and book value, in particular. Valuation differentials across sectors are still somewhat extreme—as, for example, with consumer staples versus financials. And, finally, there is the substantial gap between growth and value names within sectors. This is particularly true in health care, where we’re seeing opportunities in stocks that have been left behind in the momentum-driven rally.

Q: How are U.S.-China tensions affecting your outlook?

The tensions with China are based on real issues surrounding technology and international competition, and you can make an argument that they might even increase under a Biden administration. We limit our direct exposure to China, partly because we are primarily focused on developed markets. We are also being careful to avoid companies involved in sensitive activities, such as technologies that enable surveillance.

At the same time, China is a huge market that offers real potential for investors, and we are invested in some leading internet companies as well as a couple of insurance firms. Recently, the prospect of Chinese companies being delisted from U.S. stock exchanges has gathered some attention, but that doesn’t really concern us. I expect they’ll just move instead to Hong Kong, which should not result in any substantial value destruction for investors. It’s also notable that emerging trade barriers with China are creating some opportunities for

Global Equity Valuations

(Fig. 1) Non-U.S. stocks are cheaper relative to history

	Price/Earnings		Price/Book		Return on Equity		Dividend Yield	
	Current	Median	Current	Median	Current	Median	Current	Median
S&P 500 Index	21.7	14.4	3.5	2.7	15.6%	15.2%	1.9%	1.9%
MSCI EAFE Index	17.1	13.6	1.5	1.6	9.7%	10.1%	2.8%	3.1%

As of June 30, 2020

For illustrative purposes only and not indicative of any specific investment. Valuation and metrics are subject to change.

Median data points are for the trailing 15 years.

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outside firms—as with European firms poised to seize 5G telecom equipment markets away from Chinese giant Huawei.

Q: What are the main risks you see for the market?

Investors do not seem to appreciate the global economy's reliance on fiscal and monetary stimulus. Global central banks poured USD 4 trillion into the global financial system in March and

have added more since. The U.S. alone is expected to run a deficit this year that is roughly equivalent to one-fifth of gross domestic product. While this extreme level of support may have been necessary, it's clearly not sustainable. How and when the withdrawal of this underpinning will play out is highly uncertain, and history can offer a lot of different scenarios. But it's clear that we've moved further out on the limb, so to speak.

Huawei was not held in the Overseas Stock Fund as of 6/30/20.

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