Perspectives
Global Equities

Rosenberg Equities Client Portfolio Management Team

- **Economy and markets**: central banks supportive, but business pessimism grows
- **Factors**: factor reversal in September
- **Valuation**: the biggest valuation opportunity in 20 years
- **Earnings**: EPS growth remains muted but stable

Economy and markets

Global equities added just 0.5% over the third quarter of 2019, as measured by the benchmark MSCI World Index in dollar terms. Markets were given a boost early in the quarter when the US Federal Reserve (the Fed) cut interest rates and central banks globally maintained supportive monetary policies. A sharp escalation in US-China trade tensions saw markets give up some of their gains in August as investors flocked to safer haven assets. However, they recovered strongly in September, propped up by further stimulus from the Fed and the European Central Bank and some favourable economic data, although Asian equities suffered from the growing rift between the US and China and fears over slowing domestic growth.

Traditionally higher-yielding and defensive sectors outperformed over the period, with utilities and real estate posting the best returns, followed by consumer staples. Energy was the worst-performing sector and lagged by some margin, as concerns over global demand caused a drop in crude oil prices (notwithstanding a sharp spike in September after an attack on Saudi oil infrastructure). See Appendix for more details.

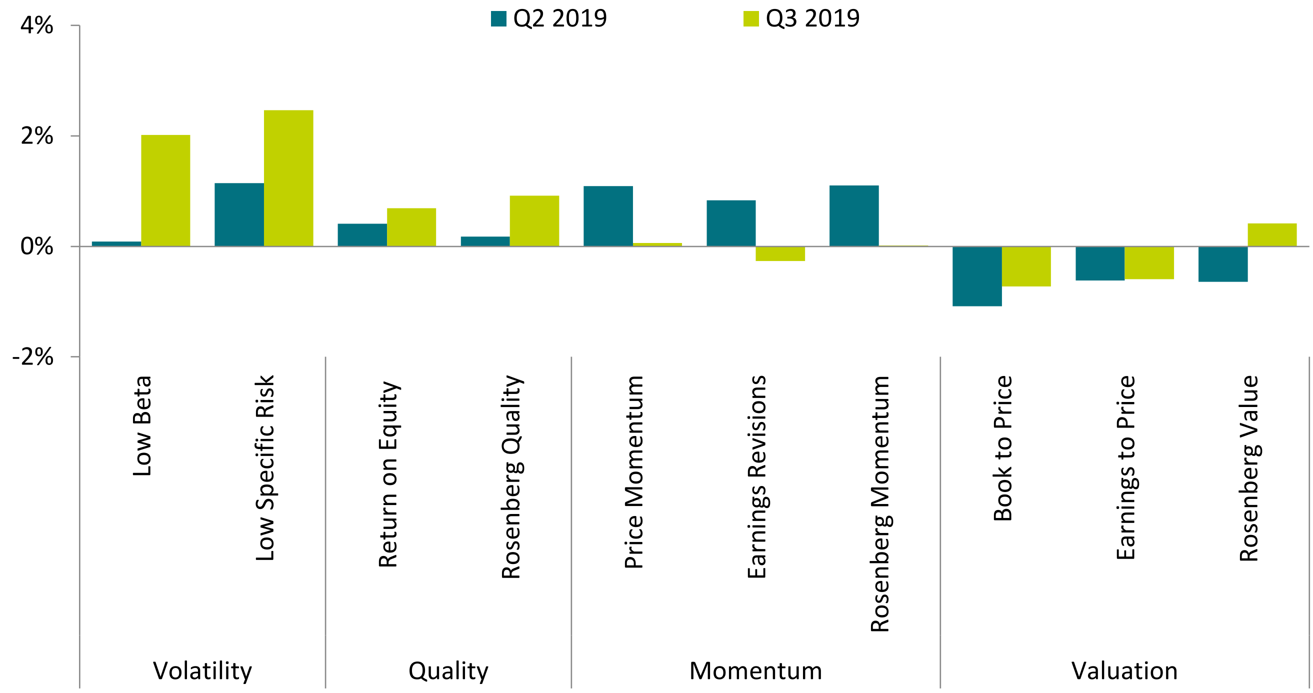
As part of our ongoing and active research agenda, we have recently developed a suite of natural language processing models (NLP), which seek to derive insight from written text. One of these NLP models uses transcript data from the regular calls between investment analysts and the management of the companies that they cover. The dataset captures some 3,500 US and international companies, and allows us to monitor the evolution in the language used by management over time as a potential indicator of their firms' near-term outlook.

The tone of both questions and answers in Q3 suggests that analysts and management have become more pessimistic about the business environment. The number of references to positive indicators (words such as high, strong, rising) has fallen sharply in recent quarters, and negative indicators (falling, weaker, low etc.) have risen. This is particularly evident in the calls with industrials and technology firms in the US, and industrials, consumer discretionary and materials firms internationally. Given this pessimistic mood, there was much less talk about inflation, references to which fell some 150%.

Factors

Our factor monitor, Exhibit 1 below, plots factor returns in Q2 and Q3 2019. The monitor is grouped by the four factor families – Low Volatility, Quality, Momentum and Valuation – and shows both simple common factors as well as Rosenberg Equities' proprietary factors.

Exhibit 1: Rosenberg Equities Factor Monitor



Source: Rosenberg Equities. Factor returns to 30 September 2019. The charts show univariate factor returns based on the MSCI World Index universe and are square root of market cap weighted and net of market returns. Factors shown are simple risk factors and Rosenberg Equities' proprietary factors - see Important Information section for additional information on Rosenberg proprietary measures. Rosenberg proprietary factors are not individually available as investment strategies and the factor returns shown should not be used to extrapolate the performance of Rosenberg Equities' strategies. Past performance is not a guide to future performance.

Factor performance measured over Q3 as a whole was similar in pattern to the prior quarter and indeed the trends we have seen over the last three years, namely strength in Quality and Low Volatility and weakness in Valuation. As we have stated before, it's not unusual for Quality to do well late in the cycle as investors seek sources of reliable earnings growth. Given worries about global economic growth and falling interest rates, it's also unsurprising for Low Volatility to do well (as it has over the past quarter and year).

However, overall Q3 returns mask a significant reversal in some of these long-established factor trends in September. We show this in Exhibit 2, below, where we compare September factor returns with those in July and August. This shows a sharp rotation into Value factors, and out of low beta, during the quarter. Momentum factors, which had aligned with Quality and Low Volatility, also reversed sharply.

Exhibit 2: Rosenberg Equities Factor Monitor – Q3 2019 in detail

Source: Rosenberg Equities. Factor returns to 30 September 2019. The charts show univariate factor returns based on the MSCI World Index universe and are square root of market cap weighted and net of market returns. Factors shown are simple risk factors and Rosenberg Equities' proprietary factors - see Important Information section for additional information on Rosenberg proprietary measures. Rosenberg proprietary factors are not individually available as investment strategies and the factor returns shown should not be used to extrapolate the performance of Rosenberg Equities' strategies. Past performance is not a guide to future performance.

The factor reversal in September, in our view, can be best explained as an unwinding of 'excessive pessimism' that had built up over the summer period, especially in August. This pessimism was sparked by a slew of weak economic data, and further fuelled by escalating US-China trade tensions.

As we moved into September, US-China trade tensions eased, there were some upside surprises in economic data and bond yields stopped falling. Put simply, the pessimism of investors in July and August appeared overdone, triggering the sharp September factor reversal in pro-cyclical stocks and boosting Value.

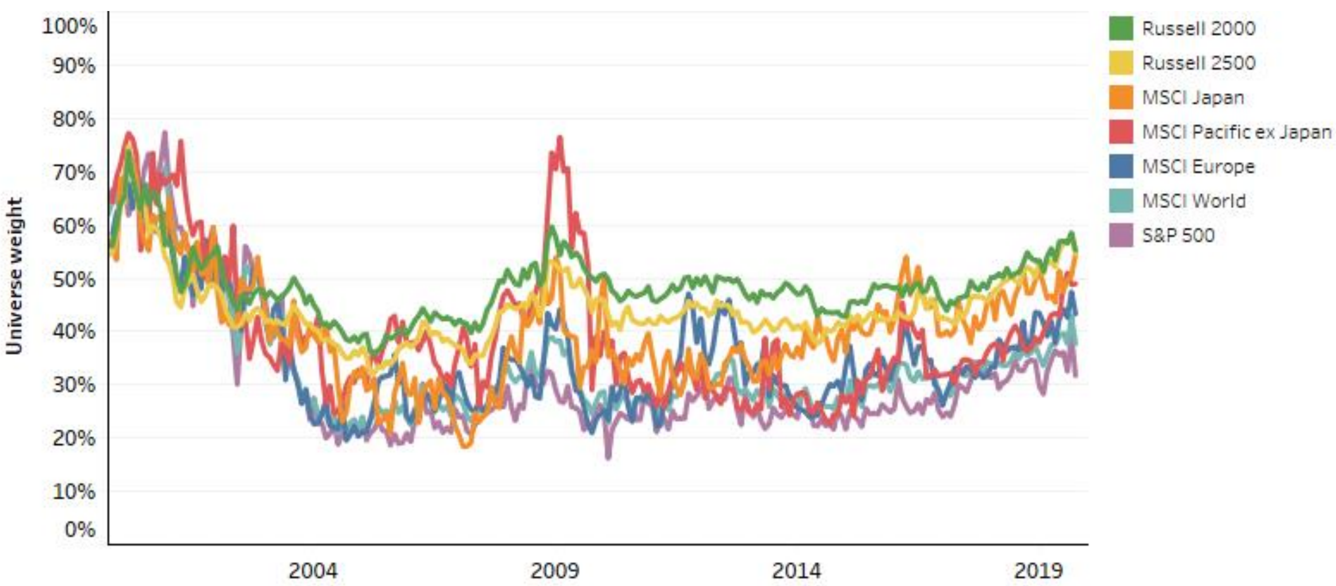
It's hard to argue, however, that September heralds the start of a clear change of direction for factors because the macroeconomic backdrop remains one of slower growth and low interest rates, which recently has favoured Quality and Low Volatility. However, the speed and magnitude of the Value rally in September is indicative of the potential opportunity offered by this long-unloved factor, which could be more supportive for Value in the near term. We delve deeper into this latent value opportunity in the next section.

Valuation

In recent quarters, we have reviewed what Rosenberg Equities' valuation model has told us about the degree of mispricing in global equity markets after a multi-year bull market for growth stocks. The best-known examples of this bull run are US technology-related firms, often grouped under various acronyms developed by investors struggling with these stocks' aversion to mean reversion. However, despite their pre-eminence in the media and public narrative, our model shows that the growing rift between prices and fundamental fair values has been much more broadly-based.

The degree of mispricing has risen across markets, sectors and capitalisation segments. Before the recent growth stock bull market began, around 25% of the MSCI World Index traded more than 25% away from Rosenberg Equities' estimate of fair value; at the end of September, this figure had risen to almost 40%. More than 50% of its small cap equivalent was this mispriced – including more than 250 companies trading more than 100% from fair value. As the chart below shows, several other indices are also approaching levels of mispricing last seen in the early 2000s.

Exhibit 3: Index weight in stocks trading at least 25% above or below Rosenberg Equities' estimated fair value, 1999–2019



Source: Rosenberg Equities, Russell, MSCI and S&P data as of 30 September 2019. Degree of mispricing is based on Rosenberg Equities' fair value calculations for the stocks in the indices referenced above. Rosenberg Equities may not value all of the stocks in each index at all points in time. Information provided is not with respect to any actual portfolio or strategy. No representation is made that the estimated mispricing is accurate or will be recognised by the market. The fair value estimates were calculated in real-time during the time-frame shown.

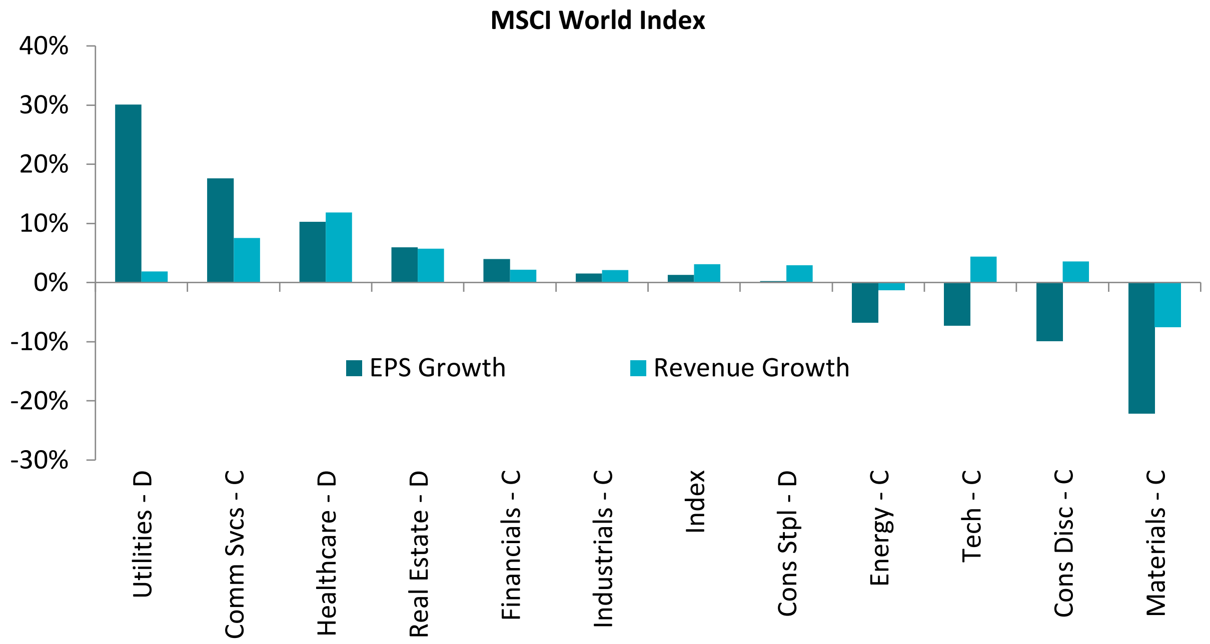
Although the mispricings we see today are not at the same levels as in the late nineties tech bubble, we believe they nonetheless represent the biggest valuation opportunity in 20 years. While the sharp shift in favour of value in September – by some measures, the strongest such shift in 30 years – was attributed to growing confidence about the outlook for US-China trade negotiations, it is possible that something more enduring may have also been driving the rotation; investors acknowledging, and beginning to address, unsustainable levels of mispricing. The magnitude and duration of growth stocks' recent dominance and the size of the reward to the Value factor in September gives us a glimpse of the pent-up performance opportunity should the rotation away from growth stocks continue.

Earnings

With Q3 earnings season kicking off and global growth stalling, investors are rightfully focused on company earnings and revenue growth. Company profitability has remained relatively stable but has come under increased pressure as wage growth and tariff costs weigh on bottom line growth. Global earnings growth was weaker in Q2 as cyclical companies underperformed, while defensive companies' earnings per share (EPS) held up better. Though increased recession risk and the 'rush to safety' were key reasons for defensive sector outperformance, revenue growth improvements also helped. Investors have been counting on continued growth in earnings as a fundamental support for equity markets. Trailing EPS growth remains muted but stable, as the much-feared earnings recession has failed to materialise.

We continue to see companies surprise on the upside for Q2, but as we move into Q3 earnings season downgrade concerns remain elevated. As leading indicators and global growth slow, how earnings evolve and which sectors benefit will continue to be a key focus for investors.

Exhibit 4: Global EPS and revenue growth by sector, Q2 2019



Source: Rosenberg Equities, MSCI and Bloomberg as at 30 September 2019. GICS sector classifications. C = cyclical sector, D = defensive sector.

Outlook

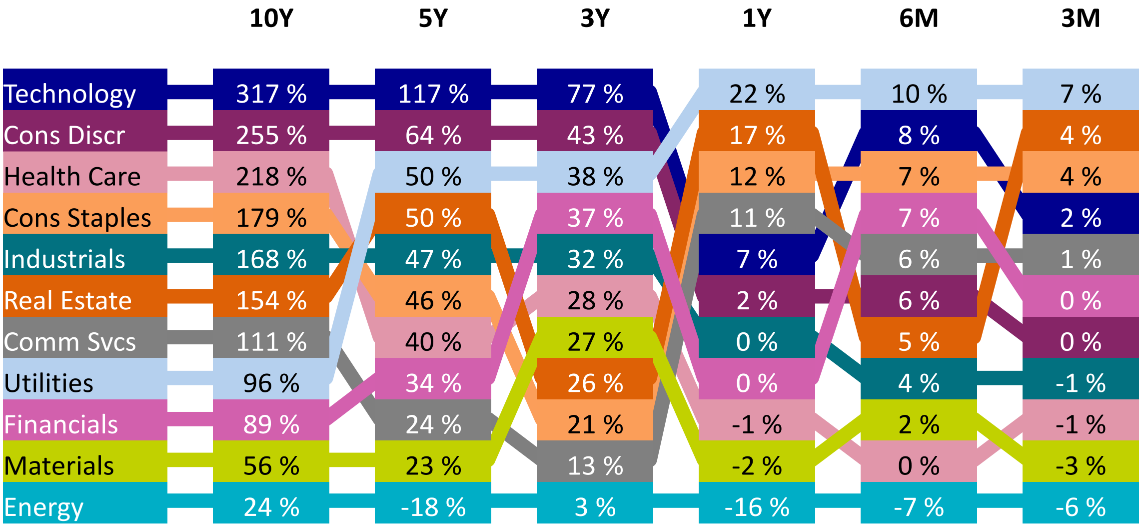
Global growth has been decelerating. The US has seen weaker manufacturing data but services remain solid for now. Elsewhere, macroeconomic data has been disappointing, with the Eurozone, UK and China all showing signs of slowdown.

Looking ahead we expect:

- Central banks to continue to ease monetary policy which should, in the absence of further negative shocks, help to counter a deeper global macroeconomic slowdown in 2020.
- Equities to deliver low single-digit earnings growth on the back of soft top line growth and ongoing margin pressure.
- Volatility to rise on the back of growth concerns, elevated political risks and trade uncertainty.

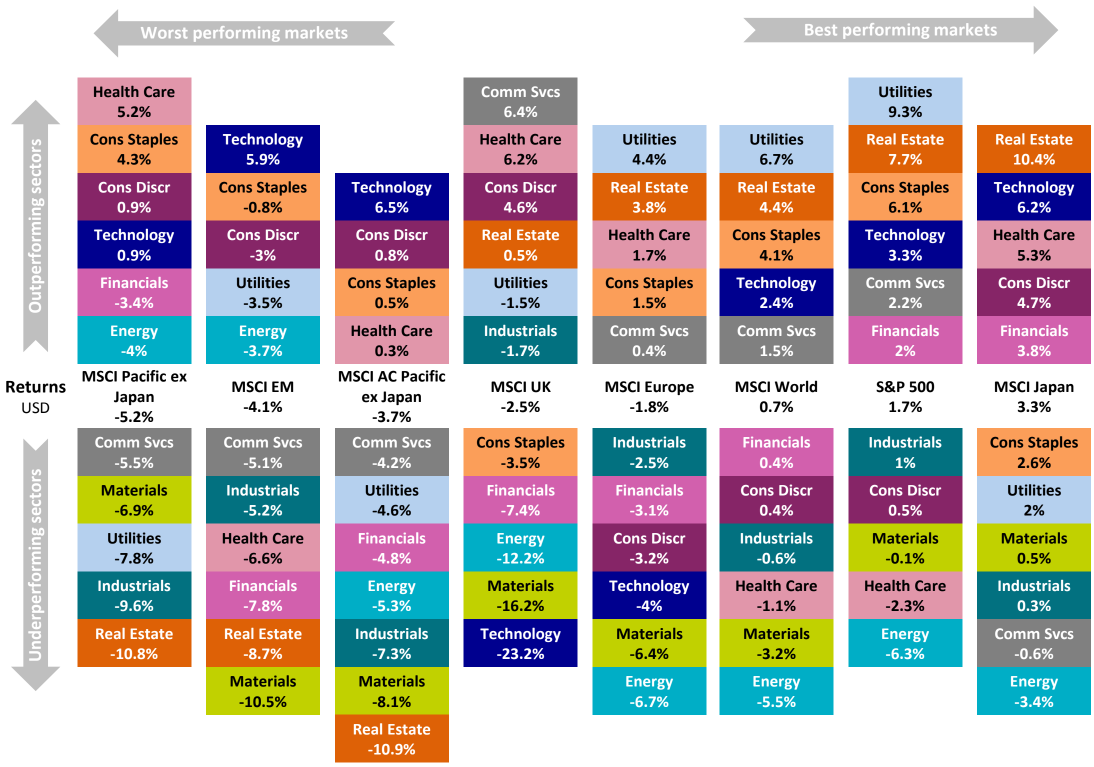
Appendix

Global sector returns (MSCI World Index), all periods as at 30 September 2019



Source: Rosenberg Equities, MSCI. Exhibit shows cumulative return of each sector in USD over the period shown to 30 September 2019. Sector returns are based on GICS classifications, calculated with gross dividends re-invested in USD terms.

Regional sector returns, Q3 2019



Source: Rosenberg Equities, Thomson Reuters DataStream, I/B/E/S, S&P, MSCI as of 30 September 2019. Past performance is not a guide to future performance. It is not possible to invest in an index. Index returns are calculated with gross dividends re-invested in local currency terms. Sector returns are based on GICS classifications.

Important Information

Additional information on Rosenberg proprietary factor measures: 'Rosenberg Quality' combines proprietary measures of Earnings Sustainability and forecasted change in Earnings Sustainability; 'Rosenberg Value' combines proprietary valuation and earnings forecast models as well as a machine learning 'value trap' model; 'Rosenberg Momentum' combines price momentum with analyst revisions and a natural language processing news sentiment measure.

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