EQUITY

Value Update: Where Is the Next Pocket of Opportunity?

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A year ago, Templeton Global Equity Group’s Norm Boersma, Cindy Sweeting and Heather Arnold penned an article for Beyond Bulls & Bears discussing the signs of a revival in value stocks. With the nascent rally in global value stocks underway, the trio return along with their colleague Tucker Scott to outline where they now see the next pockets of overlooked potential opportunities for patient bargain hunters.

Over the last 18 months we’ve seen the beginning of a rally in value stocks, which have rebounded from 2015’s 20-year lows. In 2016, value stocks outperformed growth stocks by the widest margin in well over a decade.[1] We explored some of the reasons for that rally a year ago in this article for Beyond Bulls & Bears.

Now, with the value rally underway, the question we’ve posed to ourselves is: where is the next pocket of long-term potential opportunity for global investors?

We believe equities outside the United States look exceedingly attractive in the current environment relative to US stocks.[2] The argument for non-US stocks today in many ways resembles the case for value stocks that we’ve been making over the past 18 months.

Non-US stocks appear undervalued, have underperformed US stocks and possess potential catalysts that could help spur a turnaround.[3]

There’s also a strong historical relationship between value and non-US equities. Over the past two decades, non-US stocks have tended to outperform US stocks when value starts to work.

There are several possible explanations for this relationship. These include a typically higher representation of cyclical sectors in markets outside the United States and ta generally higher level of operating leverage in these markets attributable to higher fixed costs and less flexible labor. Additionally, we believe the recent valuation discount applied to “riskier” non-US equities creates greater scope for re-rating.

While the value resurgence represents a potentially strong tailwind for non-US equities, there are a number of fundamental pillars of support for the non-US investment case as well.

Valuations: “Cheaper” Outside the United States

The outperformance of US stocks compared with non-US stocks over this past cycle has been historic. Our experience suggests that US stocks generally look expensive and offer limited long-term return prospects from current levels when measured against their own long history.

The cycle-adjusted price-to-earnings (CAPE) in the US stock market currently stands at 25. CAPE is an important measure because it is theoretically robust and has historically demonstrated a statistically significant correlation with future returns. Today’s US equity market CAPE ratio implies a 10-year total real return (including dividends and inflation) of about 5% annualized. Now compare that with non-US equities. With a CAPE of 11–12, both European and emerging markets have been recently trading at levels historically consistent with double-digit real annualized gains over the following 10 years.[4]

As ever, when market cycles mature, long-term value often emerges among the most unloved and overlooked stocks. Thus, we intend to look outside the United Sates for the strongest potential opportunities.

Catalysts: Four Compelling Drivers for the Future

The current case for non-US versus US equities supposes an eventual mean reversion in historically divergent performance and valuation trends. But what could be the catalysts for such a move? Encouragingly, we see a number of potential positives coming increasingly into focus. They include fundamental economic catalysts, corporate catalysts, policy catalysts and political catalysts.

1. Economic Fundamentals

The US economic cycle looks vulnerable as post-election reflation euphoria fades. The current US recovery, which is now tied for the third-longest on record, has also been the weakest economic expansion since World War II, with an average annual growth rate of just 2% over an 8-year period.[5] It may not take much to derail such tepid growth, particularly in light of continued high expectations.

On the other hand, European growth has accelerated while expectations remain depressed. In fact, gross domestic product growth in Europe has now matched or exceeded growth in the United States for five of the last six quarters.

2. Corporate Fundamentals

We think an improving global economy should help bolster corporate fundamentals outside the United States. Indeed, profit growth for companies in the MSCI All Country World ex-US Index is expected to far outpace profit growth in the S&P 500 Index over the next 12 months.[6] This is coming off of a low base.

The share of global corporate earnings attributable to non-US companies is at a 13-year low of 43%.[7] Not since the aftermath of the ill-fated technology, media and telecommunications (TMT) bubble has the United States commanded such an overwhelming share of global corporate profits. The contrast between corporate earnings in the United States and Europe appears especially stark.

Such conditions usually don’t last forever, and there are already some signs that relative earnings conditions are normalizing.

3. Policy Conditions

The US policy response to the global financial crisis was early and aggressive, which is at least partially why its economy bounced back so much more quickly than other major developed markets.

Yet, with inflation picking up and policymakers increasingly worried about the distortive effect of multiple years of extraordinarily accommodative monetary policy, the US Federal Reserve (Fed) now seems determined to keep raising interest rates.

President Trump’s intended fiscal stimulus could help offset US monetary tightening, but it still needs to be devised, approved, funded and implemented, all of which takes time.

Meanwhile, Europe is entering a rare period of coordinated fiscal and monetary relaxation. Looking more broadly, while the United States continues to tighten, monetary policy conditions globally remain quite loose.

The bottom line is that tightening US policy conditions may represent a headwind for a maturing US bull market, while accommodative conditions outside of the United States could help a fledgling recovery gain pace in other regions.

4. Political Conditions

Political uncertainty in markets outside the United States has long unnerved risk-averse investors, and we believe such fears are now excessive in today's environment. Europe has rolled from one crisis to the next, with the UK vote to leave the European Union in June 2016 shocking the pro-euro establishment and raising concerns about a domino effect.

Yet the United Kingdom—with its separate language, independent central bank, sovereign currency and physical separation from the continent—has always maintained a healthy dose of euroskepticism.

The rise of anti-euro nationalist politicians in a number of countries in the region does represent a threat to ongoing unity. However, it's worth noting that the majority in most European countries approve of the euro and want to see it survive.

Recent election results in Austria, the Netherlands and France all suggest continued majority support for the European experiment. Yet even in the event of a crisis, institutional safeguards in Europe are stronger than ever before. These include a €500 billion European Financial Stability Fund, which we think should be sufficient to support the banking system if needed.

Meanwhile in China, the world's second-largest economy, President Xi Jinping has every incentive to maintain stability ahead of this fall's Party Congress, where he hopes to use a raft of leadership transitions at the top of the Communist Party to consolidate political power.

In Japan, Prime Minister Shinzo Abe recently proposed two new governors at the Bank of Japan. If elected, they would consolidate his influence over central bank policy and likely ensure fidelity to his stimulative policy agenda.

In summary, depressed share prices seem to have exaggerated political risk in non-US markets. Meanwhile, US stocks have been regularly charting new highs and appear to be fundamentally underpricing the risks associated with one of the most uncertain and divisive political climates of our lifetime.

Conclusion: Compelling Value in Markets Outside the United States

As the anticipated value rally gains steam, we think non-US stocks should begin to benefit. Like the value universe a year ago, non-US equities today look to us to be undervalued, under-owned and exposed to positive catalysts, including improving corporate fundamentals, economic tailwinds, and political and policy support.

Meanwhile, various US economic indicators have been stalling and monetary policy is tightening. While we continue to find select value in the United States, we are particularly cautious about the expensive sectors, regions and stocks that have fared so well over this protracted bull market, and we currently favor potential opportunities elsewhere.

What Are the Risks?

All investments involve risks, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Value securities may not increase in price as anticipated, or may decline further in value. To the extent a portfolio focuses on particular countries, regions, industries, sectors or types of investment from time to time, it may be subject to greater risks of adverse developments in such areas of focus than a portfolio that invests in a wider variety of countries, regions, industries, sectors or investments. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments; investments in emerging markets involve heightened risks related to the same factors.

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1. US value stocks represented by MSCI World Value Index. US growth stocks represented by MSCI World Growth Index. See www.franklintempletondatasources.com for additional data provider information. Past performance is not an indicator or a guarantee of performance. Indexes are unmanaged and one cannot directly invest in them. They do not include any fees, expenses or sales charges.

2. Non-US stocks represented by MSCI All Country World ex-US Index. US stocks represented by MSCI USA Index. See www.franklintempletondatasources.com for additional data provider information. Past performance is not an indicator or a guarantee of performance. Indexes are unmanaged and one cannot directly invest in them. They do not include any fees, expenses or sales charges.

3. Ibid.

4. Europe represented by MSCI Europe Index. Emerging markets represented by MSCI Emerging Markets Index. See www.franklintempletondatasources.com for additional data provider information. Indexes are unmanaged, and one cannot directly invest in them.

5. Source: US Bureau of Economic Analysis.

6. Source: Bloomberg. The MSCI All Country World Index captures large- and mid-cap representation across 23 developed and 23 emerging market countries. Please see www.franklintempletondatasources.com for additional data provider information. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. There is no assurance that any estimate, forecast or projection will be realized.

7. Source: Thomson Reuters.