Climbing a Wall of Worry?

March 21, 2014

Given continued unrest in Ukraine, crippling winter storms and Federal Reserve “tapering” in the United States, and concerns about growth in China, you would think investors might be inclined to flee all risk assets. Despite these concerns, however, US equities have been on the rise in recent weeks, with the S&P 500® notching a new all-time high[1] in early March. One might say the market has been “climbing a wall of worry.” When those worries turn into selling pressure, Norm Boersma, chief investment officer, Templeton Global Equity Group, rolls up his sleeves and searches for bargains for his portfolios. He shares his thoughts on the volatile start to 2014, his view on equities longer term, and where in the world he’s finding equity bargains today.

One of the main questions our clients have been asking us lately revolves around worries of how strong equity markets have been over the last five years. During that period, we’ve seen markets bottoming out in February – March 2009 and basically recovering since then.[2] Given the performance of the market since the trough, it’s not surprising that people are a bit concerned right now, and the market has been quite volatile in early 2014. But when you take a look at longer time frames, ones that capture both the decline and the upturn in the equity markets—for instance a 10-year return—the numbers are below the average historical long-term return for equity markets, which is more in the 8% to 9% range for the MSCI World Index.[3]

That offers us a little more comfort that markets are not wildly overpriced. While we are optimistic about the market, I don’t think it’s prudent for investors to expect average returns akin to what we saw in the past five years to occur in the next five years. Markets appear to us today to be at what we’d call mid-cycle valuations. Many markets are no longer cheap in our view , but we are seeing a stockpicking environment where we have found individual companies to invest in that have for some reason hit a headwind and been driven down by investors in price. That's where the opportunities are arising, in our view. And, for our value-driven approach, it's an environment we like to be in.

Recently, we have seen correlations in the markets globally starting to come down, which also benefits stockpickers, that is, bottom-up investors. In some parts of the world, conditions have stabilized and recovery has taken hold. Elsewhere, there are clearly some stresses in the market. The emerging markets are certainly one area where people have been very worried, and that is creating some selective opportunities for our portfolios. Not every emerging market, not every stock, but on the margin, we're starting to see new ideas flow onto our buy list.

Exploring Opportunities in Energy, and in Europe

The energy sector is one area that looks interesting to us. Particularly in energy services stocks, we've seen a number of potential new opportunities. Companies that have the technology and know-how to help the major integrated oil companies find the oil and take it out of the ground have a lot of potential that we think the market isn't fully appreciating. We view it as a long-term growth industry and, at this point in time, these stocks look attractively valued to us.

Europe is at an interesting juncture right now. In our view, the sort of "jump up and down and get excited" time for Europe was probably in 2011/2012 when the majority of investors essentially hated Europe. Nobody wanted to buy anything there, worried that Europe was going to come apart at the seams and the euro was going to disintegrate. What we saw then was one of those big valuation opportunities, which today has definitely begun to narrow. We continue to invest in Europe, particularly in the financial sector, and additionally, a few industrials and health care stocks where in general we see names trading at a discount relative to their competitors around the world. But by and large, the valuation gaps have closed to a large extent, and they don't represent the type of bargains they did a few years ago. That said, Europe still remains a focus for us.

China: Reasons to Be Optimistic

China’s market has been through some ups and downs over the past few years. Within emerging markets overall, China’s market is probably the one most people are concerned about right now, aside from the recent political turmoil in Eastern Europe. It’s not abnormal considering China had seen growth rates in the low teens in decades past, and those growth rates have, in more recent years, started to slow into the single-digits—albeit high single digits.

When you have those kinds of lofty growth expectations, stresses start to appear in some sectors subject to what you might call “irrational exuberance.” Certainly, the banking system is one area in China that has grown very rapidly, and we’ve seen real estate overexpansion. There has also been overcapacity in a number of areas on the supply side within manufacturing in China, and one might argue there is too much debt sitting in China as well. Those are the negative issues that we think are pretty well known.

On the more positive side, China has a lot of wealth and the government has the ability to help deal with some of its problems. China’s government controls the banking sector, as well as other aspects of the overall economy. China probably has a better level of control over its economy than some other emerging markets. In China, we are starting to see the more investment-oriented and infrastructure-oriented-type companies—the companies in the materials sector and in the energy sector—starting to come under pressure because those are the areas subject to prior overinvestment. Meanwhile, some of the consumer-oriented stocks really haven’t come off that much. That’s an area where investors have been feeling that growth will likely continue to be stronger. So we are starting to see a bit of a bifurcation in the market, and we’re starting to find some opportunities in China to nibble at.

We recognize there are global uncertainties in the markets right now that will cause investors to worry at times. When those worries are enough to cause selling, as we see it, that’s where the opportunity comes in. It then becomes a question of looking carefully at the individual companies and trying to sort out which are properly valued, in our view, given the issues that we know.

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2. S&P 500 close on March 9, 2009: 676.53.

3. Source: © 2014 Morgan Stanley Capital Index (MSCI), MSCI All-Country World Index. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI. Indexes are unmanaged, and one cannot invest directly in an index. Past performance is no guarantee of future results.

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