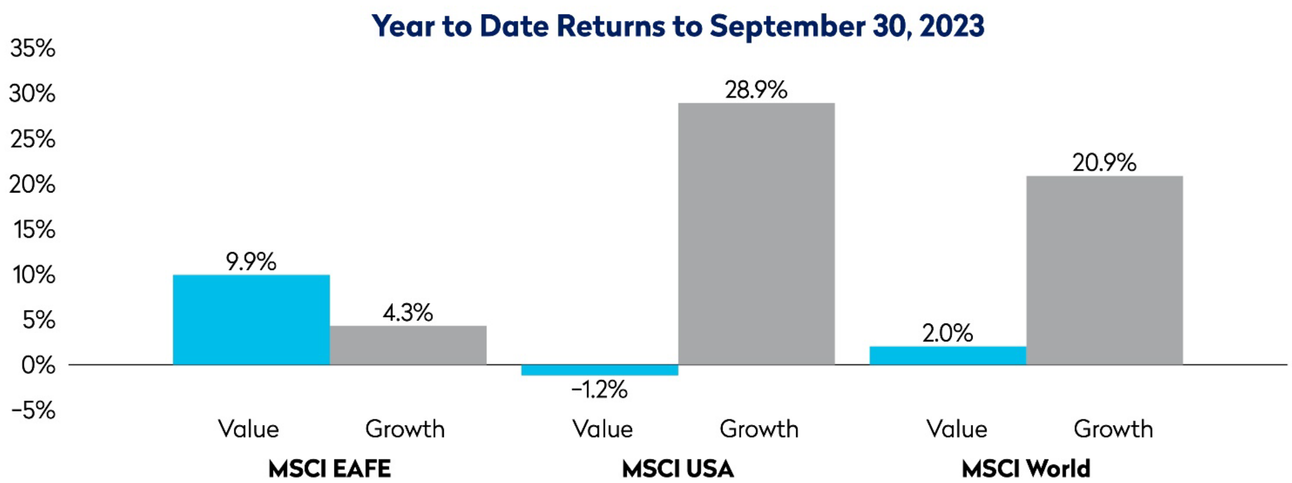
Quarter 3, 2023

Global Equity Investment Outlook

Economic uncertainty is pushing investors to try sometimes conflicting paradigms

The most recent IMF forecasts for world growth estimate 3% real GDP growth for this year and next year, with the US economy avoiding a recession. While projected global growth is low against pre-pandemic history, most investors would be relieved to escape that easily. Short-term US interest rates are 228 basis points above 12 months ago, and European rates have risen even more sharply. But inflation is still not fully under control. The US yield curve has been inverted for 15 months and remains so even though long rates have now begun to rise. The range of outcomes remains wide.

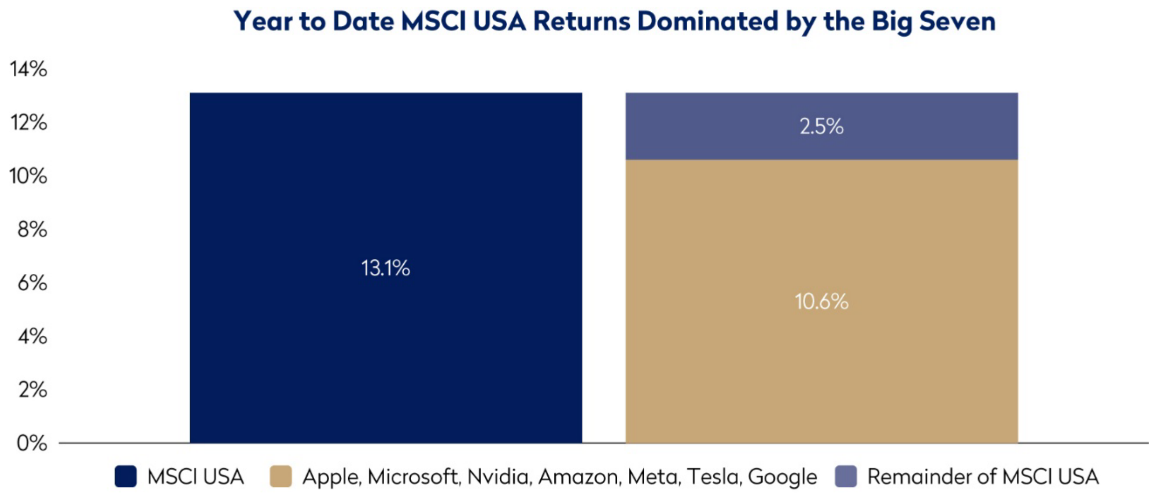
Against this backdrop, 2023 has seen some extraordinary movements in equity markets. Global equities rose strongly in the first half of the year (despite a volatile March triggered by the US regional banking crisis) as surprisingly strong macroeconomic data increased investor confidence that the Fed might be able to increase interest rates without pushing the economy into recession. This, coupled with the exuberant optimism around artificial intelligence (AI) caused the significant outperformance of growth-oriented companies in the first half of 2023. While the growth segment of the US market continued to be strong in the third quarter, we saw a sharp reversal in international equity markets as the energy sector rose strongly following OPEC's decision to cut its production. As a result, the EAFE Value sub-index is now ahead of the growth sub-sector year to date. This is in sharp contrast to the return composition for the US equity market.



Source: FactSet, MSCI

The formidable 'seven' in the US equity market explains Growth's dominance

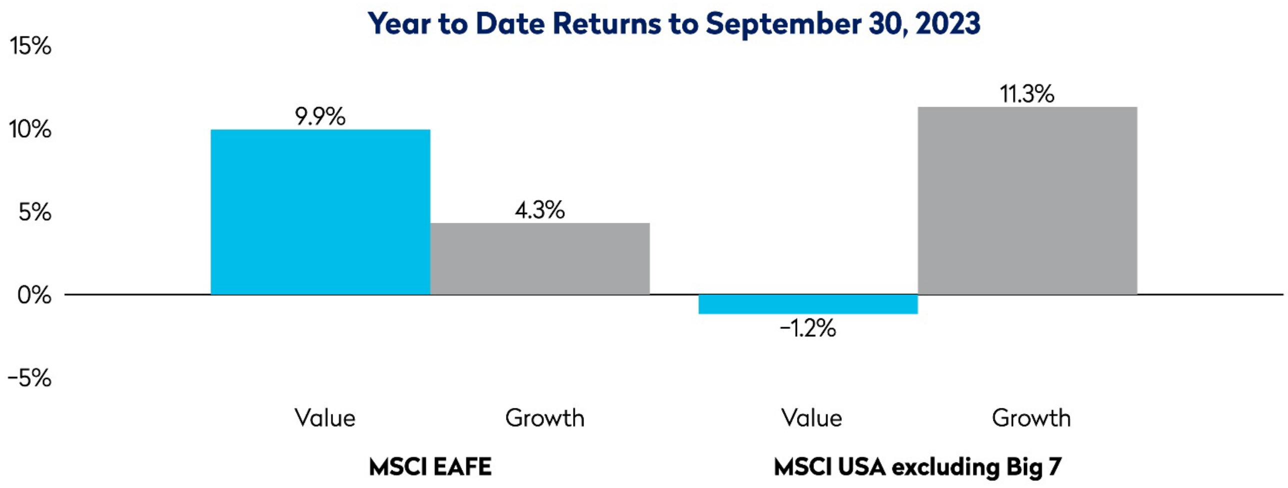
Much has been written in the market about the narrowness of the strength of the US market – the so-called 'Magnificent 7' stocks in the US which drove most of the strength in global equity markets this year: Apple, Microsoft, Nvidia, Amazon, Meta, Tesla and Google. The chart below shows that the biggest seven names in the US market drove over 75% of the strength in the US market year to date.



Source: FactSet, MSCI, Mondrian

But excluding the biggest seven names, growth strategies still outperformed value in the US

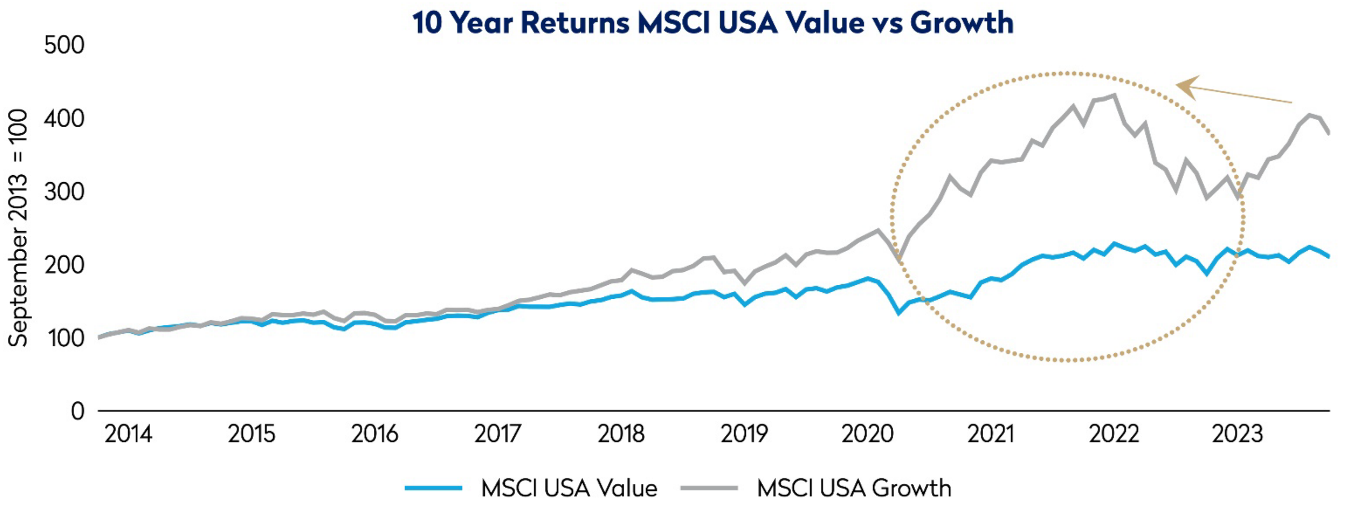
Given the significant divergence in returns between the value and growth sub-segments in the US and international markets, it would be natural to presuppose that the outperformance of the growth sub-sector in the US market was mostly driven by the strength of these seven companies alone. To test this hypothesis, we reconstructed the returns of the US market, excluding the biggest seven names in the universe: growth securities still outperformed their value peers by more than 12%. The divergence in returns between value and growth sub-indices was even more broad-based than we had expected.



Source: FactSet, MSCI, Mondrian

Value-growth divergence is approaching the pandemic levels in the US

During the depths of COVID, the growth style outperformed the market significantly as interest rates were floored to save global economies, while a radical upheaval in traditional working and leisure practices benefited innovative tech companies, supporting the earnings of more typically growth companies. Markets seemed complacent, we wrote, as investors attached a high probability to the best-case scenario in some segments of the market. Post-COVID, as the Fed started raising rates and COVID-related earnings were proven to be unsustainable, we saw some spectacular collapses in the more growth-oriented companies in 2022, with the likes of Netflix and Salesforce in the United States, and ASML and Infineon in Europe, giving up their earlier gains.



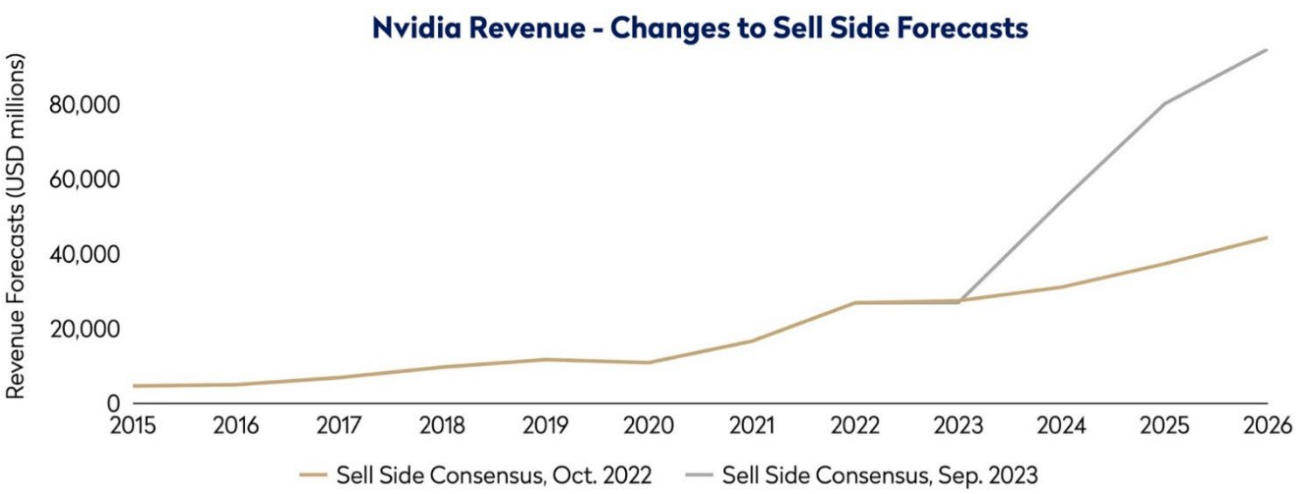
Source: FactSet, MSCI, Mondrian

Interest rates have risen steadily since early 2022. However, despite that, the extreme bifurcation in the valuation of the value and growth styles has returned to pandemic levels this year, with a select group of more growth-oriented companies enjoying significant multiple expansion.

Extreme optimism in Artificial Intelligence (AI) opportunities

The release of Chat GPT in November last year created mainstream accessibility to prototype artificial intelligence (AI) tools. The enthusiasm around AI has since fuelled some of the extreme share price movements in markets this year. The potential for AI is immense, with the technology offering tremendous economic promise but it is worth noting the technology has gone through a number of hype cycles in the past, with the first so-called “AI Winter”, that is a period of reduced funding and interest in the technology, dating way back to the 1970s. The relationship between technological revolutions and financial capital has always been highly cyclical with excitement typically driving the over-investment that ultimately lays the foundations for the next leg of growth. For example, today’s dominant internet companies all benefited from the over-investment in internet infrastructure during the tech & telecom boom of the early noughties.

One of the clear beneficiaries of the investments in AI thus far is Nvidia, as its H100 chip enjoys a dominant position within AI training servers. Such is the criticality of the GPU chip in training and operating artificial intelligence programs that the market has started referring to companies as “GPU rich” or “GPU poor”. The chart below shows you the dramatic change in revenue expectation for Nvidia this year, with consensus now expecting almost $100bn in revenue by 2025. While this forecast is an entirely plausible scenario, a few questions come to mind, including: What is the business use case that is going to fund this level of investment? And how likely is Nvidia to maintain its competitive position? It is worth noting that many of Nvidia’s biggest customers have sizeable R&D budgets themselves.

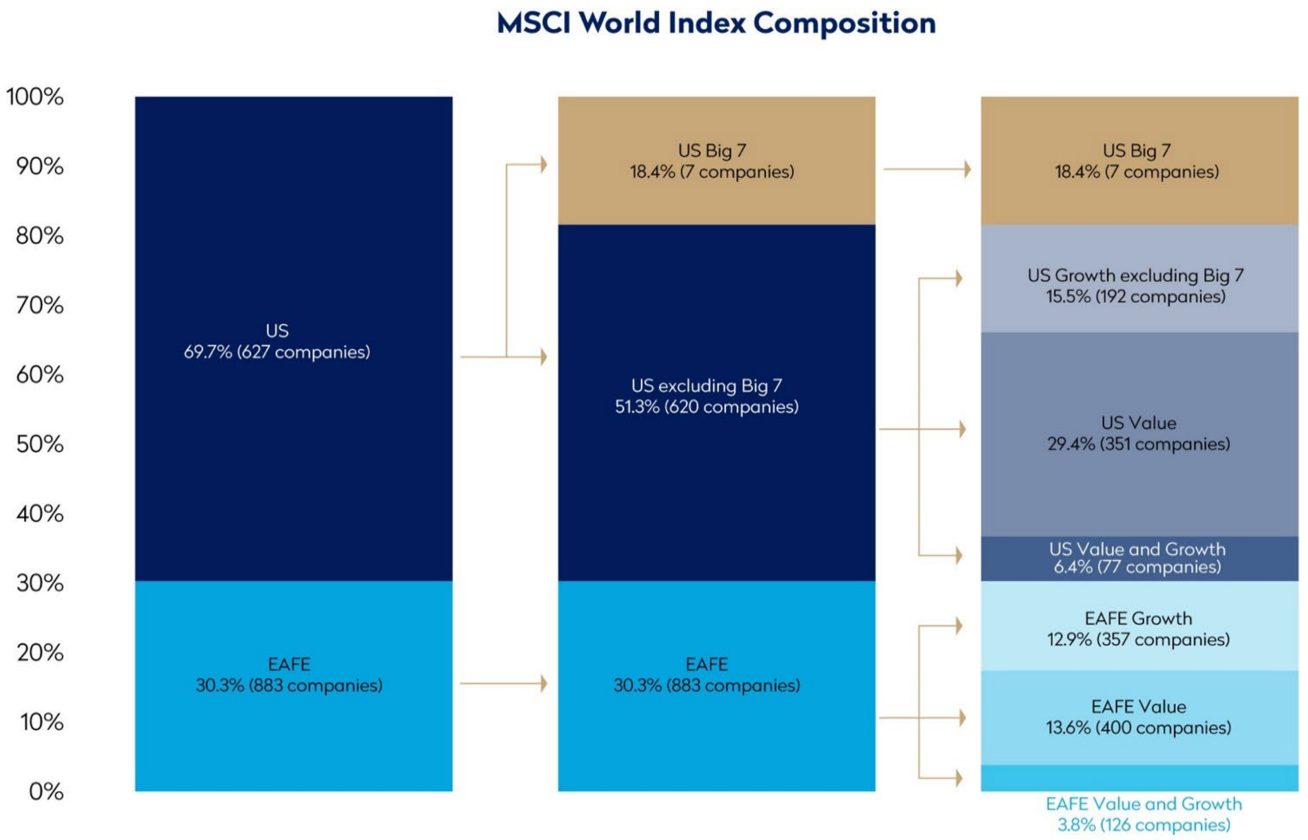


Source: FactSet

We share the market's excitement about what the prospects of AI could mean for global economies and are closely monitoring developments here. The challenge for us is the price that we have to pay to access the growth *potential* of these companies. The range of outcomes is still very wide and current valuations are capitalizing a lot of the potential benefit upfront. Nevertheless, we have managed to identify attractive investments in companies that could benefit from this exciting growth opportunity that AI offers (even if the hype around AI fades) across our Global and International equities products. Among these opportunities are developed market equities such as Meta, Dell and Sony, and emerging market equities such as Samsung and TSMC. In parallel, we are also looking at the broader portfolio to understand how AI may offer opportunity or disruption to existing businesses.

Markets offer opportunities for active value investing

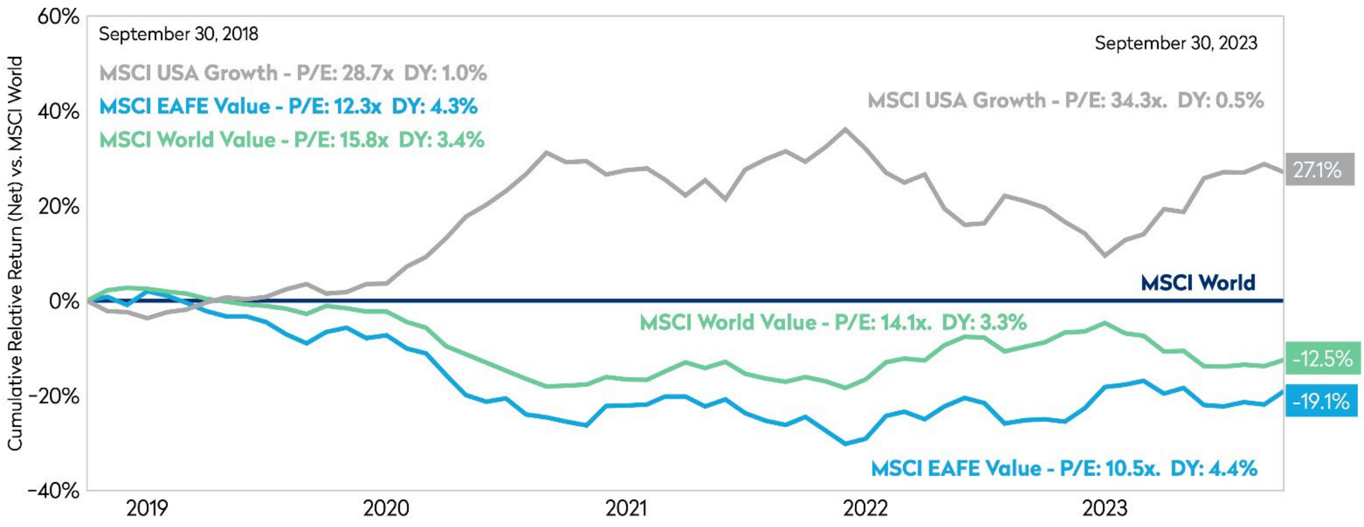
Given the extreme concentration levels of markets and the significant divergence between value and growth returns, there are now significantly fewer growth stocks in the US Growth index vs the rest of the world. While we do not invest in securities solely on the basis of MSCI classifications, we believe the wide breadth of potentially cheap companies presents attractive stock picking opportunities for value-oriented investors like Mondrian. There are now double the number of investment opportunities in the US Value sub-index than there are in its growth counterpart as shown in the following chart.



Source: FactSet, MSCI, Mondrian

We continue to find attractively valued securities globally and, in particular, outside the US. To put this in context, Japan, now a classic value market, makes up 7% of the MSCI World index and has approximately 235 stock opportunities while the US market, representing a staggering 70% of MSCI World today, has just over 625 listed securities.

Notwithstanding the recent short outperformance of the value segment of international markets, so-called value stocks have not really closed the return gap with their growth-oriented peers and they still continue to trade at very compressed earnings multiples in absolute terms. The following chart shows a history of price-to-earnings ratios for MSCI World Value, MSCI EAFE Value and MSCI USA Growth. While the MSCI USA Growth sub-index has experienced multiple expansion, the international value sub-sector has seen material multiple contraction over the same time period.



Source, FactSet, MSCI, Mondrian

Conclusion

A higher cost of capital and an uncertain economic backdrop have meant that investors, grasping for certainty, have focused on a narrow range of securities whether it's the "magnificent seven" in the US, or Novo Nordisk in Europe, where they can feel some optimism. While these securities have offered a great ride, such a narrow focus concentrates risk and obscures numerous potentially great investments that a more clear valuation-oriented approach could unearth. It was just a year ago where we witnessed a sharp reversal in performance between value and growth in global equity markets as the earnings of the COVID beneficiaries (typically growth equities) were proven to be unsustainable. International markets, despite their challenges, remain cheap against the US market and the valuation gap between growth and value that has developed in recent years has not materially closed. As a benchmark-agnostic, value-oriented investor, we can look through concentrations within regional benchmarks to identify the best risk-adjusted opportunities across the globe. The key for us is to identify mispriced securities through application of a consistent DDM methodology within structured scenario analysis in order to produce strong alpha and defensive characteristics. We believe that the skew of outcomes will be in our favour in the coming decade.

Disclosures