Valvest

Investment View – 3rd Quarter 2019

Since the last quarterly report, economic factors have slightly weakened and economic growth has continued to slow down. The trade conflict between the US and China has rather established itself than inching toward a solution most people were hoping for. In Europe, political uncertainties continue to mount, and existing problems remain unsolved. At the corporate level, it is predominantly the semiconductor and automotive companies and their suppliers that have to cope with declining sales. Most firms in the other sectors continue to post good revenues and earnings growth. The increasing uncertainty, however, has a noticeable effect on the mood of corporate leaders and consumers. With the ongoing trade conflict and the resulting increased likelihood of lasting impact, companies are forced to review the entire supply chain. Some companies have already announced that they will move parts of their production to other countries or back to the US.

The big divergence

These changes lead to uncertainties with a significant impact on the stock market and interest rates. While interest rates have already been negative in Europe and have been further lowered by the European Central Bank, the US Federal Reserve in the meanwhile has also cut interest rates. At the same time, investors have increasingly sought out the safe and still positive bond market returns in the US.

The depressed and progressively negative yields on the bond markets are increasingly being compensated by investments in equities. In particular demand are companies that have stable earnings with little influence from the economic cycle. These are mainly found in defensive sectors such as food and healthcare. However, we also observe demanding valuations for high-quality cyclical companies. Due to these high valuations, part of the market offers a low earnings yield that is increasingly aligned to the low interest rates on the fixed income side.

Yet, a large part of the market is attractively valued. The smallest operational uncertainty of a company often leads to a price discount of 10-20%, even if it is a fundamentally defensive company. This shows us that the market is willing to pay a significant premium for the highest quality and thus increased security but demands a large discount for any potential uncertainties.

As a result, equities are exposed to different risks. Highly priced shares, which are being used as a substitute for bonds, are increasingly linked to the price development of bonds. However, should the earnings of one of these companies weaken, a price correction would bring the valuation back in line with the rest of the market, which is trading already at a discount due to current economic uncertainties. Should the economic slowdown be less pronounced than feared, the current price levels will offer attractive upside potential, even if earnings would remain stagnant.

Outlook

China has been an important growth driver of the global economy in recent years. Now, for the first time in a while, isolated negative news on the economic developments are surfacing. Domestic demand is becoming increasingly important as prosperity increases, but exports and foreign investment remain an important economic factor for China. Lack of investments due to increasing uncertainty and tariffs is likely to negatively impact the economy. The growing skepticism on both sides of the Atlantic could lead to globalization becoming more regional selective and diversified in the future.

We do not expect that a final agreement on the trade dispute will be reached in the near future and expect that worldwide signs of slowing economic activity will continue to show for now. Also, it is striking how the mood of the market participants has rapidly shifted to very negative. This in spite of record low interest rates and solid earnings growth of companies that continue to support the market. Should geopolitical uncertainties turn positive or even less negative, equities would benefit significantly.

In this environment, we pay particular attention to the weighting of market sectors and favor defensive, high-quality companies as well as structural beneficiaries such as technology and healthcare companies.

Zurich, September 2019