

Investment Insights

Hiding in plain sight...

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Stephanie Butcher and Oliver Collin
European Equities Team,
Henley Investment Centre

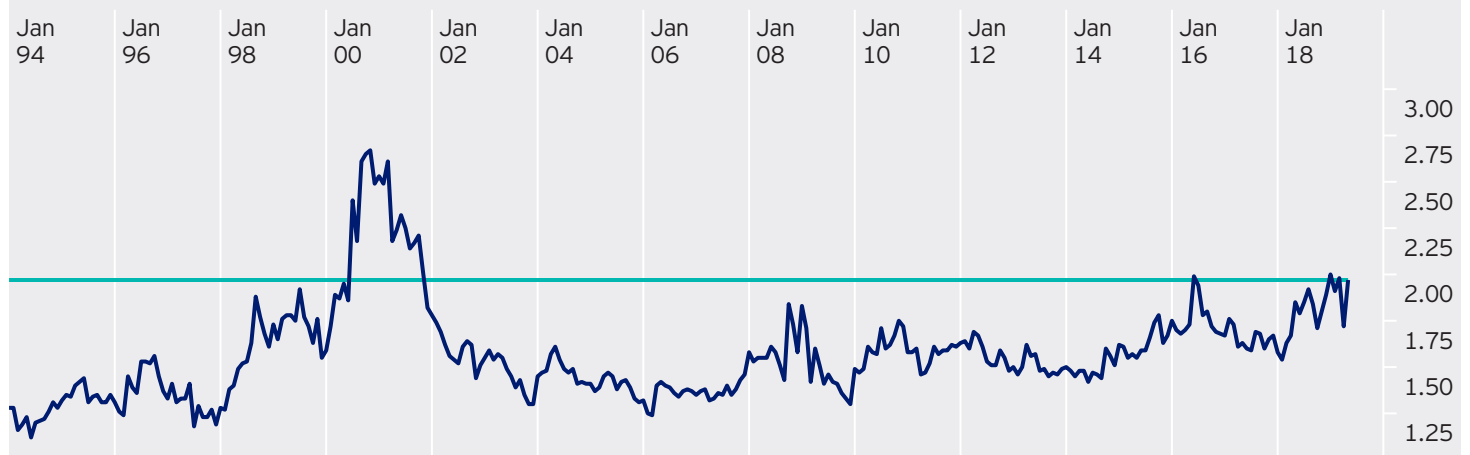
We have been flagging the widening disparity of valuation within the market for some time. Whilst we are less worried about overall market valuations, we believe aggregate multiples are masking a huge skew within the market itself and that skew is itself a risk. David Bowers, ASR's strategist recently wrote;

"It is not the risky calls that damage portfolios the most - if you know something is risky you can plan accordingly. What causes the greatest damage is something you assume to be safe that turns out to be nothing of the sort."

Some market commentators highlight that when one looks at the Quality/Value factor valuation gap measured by PE it is nowhere near as extended as 1999/2000.

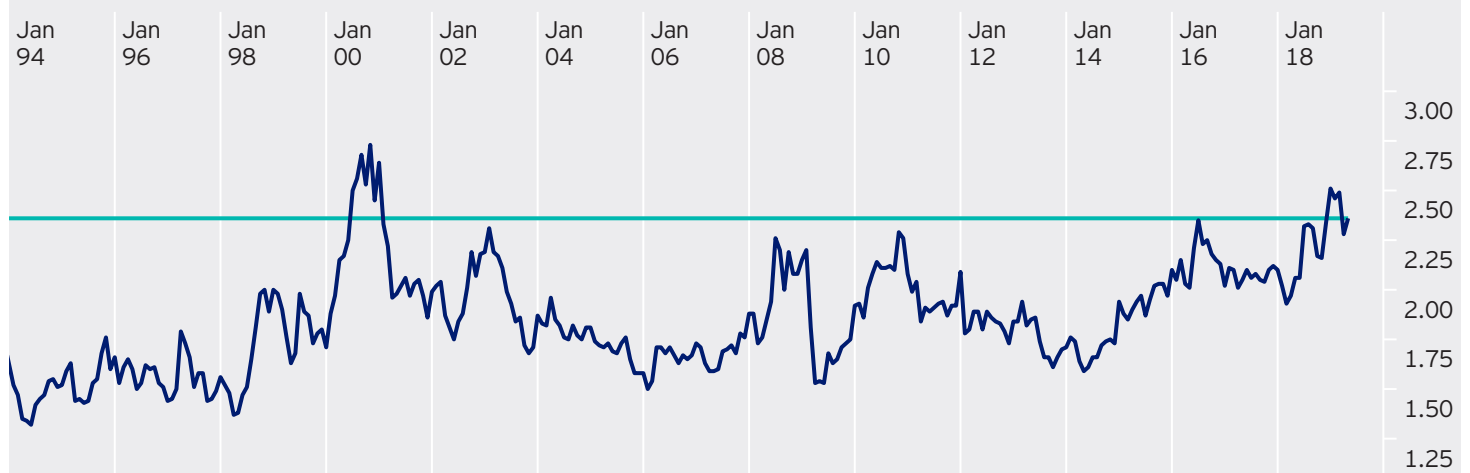
Whilst on a pure PE basis valuations do not look as extended, we note, there is a meaningful difference between now and the last market valuation bubble (seen in the late 1990s); leadership today encompasses companies with earnings, versus companies trading in clicks and eyeballs. This makes just looking at earnings for a valuation anchor too simplistic. When one looks at a wider range of comparable measures such as P/BV, or Cashflow, or dividend, then a very different pattern emerges - one which suggests that we are in very extended territory indeed.

Figure 1
Forward PE of 'High' Quality relative to 'Cheap' Value (x)



Source: Morgan Stanley as at 31 May 2019. Non-sector neutral Composite Value as calculated by Morgan Stanley: A composite score is generated from the equal weighted average of the 12-M Fwd P/E, Price-to-Book and the Total Yield (Dividend yield plus Net Buyback Yield) for all companies in the MSCI Europe. These scores are then grouped into quintiles - Q1 is the cheapest and Q5 the most expensive. Non-sector neutral Composite Quality as calculated by Morgan Stanley: A composite score is generated from the equal weighted average of the return on equity, EBITDA margin, debt to equity, Tax to Pre-tax Income and change in number of employees. These scores are then grouped into quintiles - Q1 is the highest quality and Q5 the lowest quality. In the chart above the forward P/E of the high-quality bucket (Q1) is compared to the forward P/E of cheap value bucket (Q1). Universe is MSCI Europe. The portfolios are rebalanced quarterly, and returns are equal weighted.

Figure 2
Valuation (using equal weighted Price to FCF, Price to Dividend & Price to Book) of 'High' Quality relative to 'Cheap' Value (x)



Source: Morgan Stanley as at 31 May 2019. Non-sector neutral Composite Value as calculated by Morgan Stanley: A composite score is generated from the equal weighted average of the 12-M Fwd P/E, Price-to-Book and the Total Yield (Dividend yield plus Net Buyback Yield) for all companies in the MSCI Europe. These scores are then grouped into quintiles - Q1 is the cheapest and Q5 the most expensive. Non-sector neutral Composite Quality as calculated by Morgan Stanley: A composite score is generated from the equal weighted average of the return on equity, EBITDA margin, debt to equity, Tax to Pre-tax Income and change in number of employees. These scores are then grouped into quintiles - Q1 is the highest quality and Q5 the lowest quality. In the chart above the Price to FCF, Price to Dividend and Price to Book - on an equal weighted basis - of the high-quality bucket (Q1) is compared to cheap value bucket (Q1). Universe is MSCI Europe. The portfolios are rebalanced quarterly, and returns are equal weighted.

In addition, the effect is accompanied by crowding - momentum strategies can inform as to whether there is a strong pattern to where the incremental dollar is being invested. It is clear that trend followers seem very certain that the winners can keep winning.

It is a road well-travelled to refer to the veteran investor, John Templeton, who suggested that the four most dangerous words in investment were, 'It's different this time'. There is, however, a growing chorus of those who are proposing exactly that - that we are in a different growth, pricing, and policy regime which renders past relationships with regard to valuation obsolete.

In this article, we look to explain why the market has got to such valuation extremes and to examine the likelihood that the conditions that gave rise to it stay in place for the foreseeable investable future. We are minded, however, to refer to another great man, Mark Twain, who reminded us that, 'History doesn't repeat itself, but it does rhyme'. When valuations become this extreme, something tends to shift within the environment to close those extremes.

What got us here?

Since the Global Financial Crisis (GFC) of 2008, the Central Banks of the major Developed countries across the globe have pursued an extreme monetary policy. With debt levels so extended post crisis, there was no capacity to implement fiscal tools - indeed a program of austerity was embarked upon on a widespread basis - leaving Central Banks as the main agents of the financial rescue package. The extent, both in terms of size and duration, has gone well beyond that which the protagonists would have envisaged when it was first put in place.

At the same time, policy makers and regulators have sought to ensure that nothing like the GFC happens again. To that end, capital requirements for the biggest sinners of the previous cycle, the banks, have been ratcheted up in the pursuit of an assurance that never again will tax payers be required to pay for the sins of the 'Masters of the Universe'.

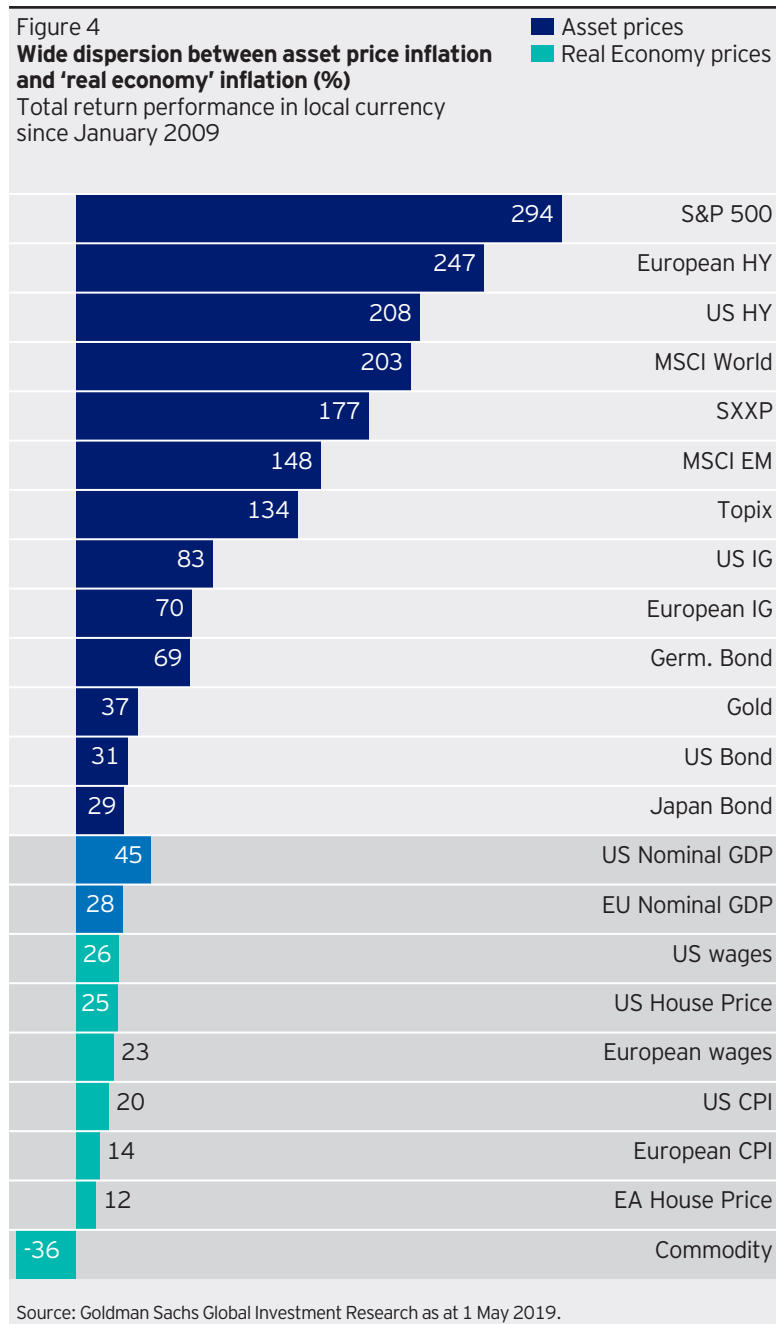
On a holistic basis, the 'success' of these strategies is obvious. Despite the profound fears of the time, Western economies did not disappear into a black hole; growth has recovered, stock markets have prospered and, despite (largely German) hyper-inflationary fears at the time, inflation has remained contained. The banking system sits on a much firmer capital footing, with ample liquidity, lower leverage, and balanced sources of funding. So far, so good. Policy implementation of this magnitude, however, inevitably has consequences on a wider basis.

Figure 3
Momentum correlation with value and quality



The broader (unintended) effects

- Vast Central Bank purchases of risk-free assets have crowded out the natural buyers and pushed them instead to look for others which replicate the characteristics of the bonds they can no longer buy.
- Banks have been unable to grow as the capital requirements associated with that growth have become more and more onerous - excess liquidity QE created was absorbed by regulatory tightening. Meanwhile demand was lacklustre as households, corporates and governments de-levered.
- Low interest rates have made it rational for corporates to run themselves for cash, including taking on debt to buy-back shares rather than invest in their businesses i.e. become more bond-like.
- In an environment where capital is freely available, the market attributes almost no value to tangible assets as the cost of replacing them is so low. Instead value is ascribed to the resources which are regarded as truly scarce - intellectual capital and brand measured by clicks, followers, net promoter scores (NPS) and total addressable market (TAM).
- Beneficiaries of policy have been extremely polarised - asset prices have soared whilst those exposed to the real economy, in particular, labour, have seen barely any improvement at all; Baby Boomers are the 'haves', Millennials and Generation Z the 'have-nots'.



The consequences

- The financial world has witnessed the formation of enormous skews of differential performance within the markets; US outperforming ROW, long duration outperforming short duration, Growth/Quality outperforming Value, capital light outperforming capital intensive.
- On Mainstreet the differential in policy benefit accrual is being noticed and populist politicians are thriving on the back of it. The benefits of a solution designed to save the world from the mistakes of the financial world have largely benefitted exactly that same group. Salvini, Trump, Corbyn et al are symptoms, not causes, of the policy decisions that have been made post the GFC.
- Capitalism itself is being questioned. Theory dictates that there should be efficient allocation of capital with excess returns being competed away over time and with proportionate returns to capital and labour. Outside returns to quasi-monopoly entities and owners of capital with labour seeing little or no part of the benefits accrued breaks that social contract. Capitalism today is skewed heavily towards short-term shareholder returns (as witnessed by debt-driven buy-backs) and is ignoring the importance of returns to all stakeholders.
- Regulation has become unbalanced. It has sought to protect consumers from past mistakes (the banks), to drive down pricing (telecom) or prevent national or regional monopolies (rejection of the Siemens/Alstom deal) whilst ignoring the rising geopolitical competitive threat of the Chinese super-power or the supra-national nature of the tech behemoths. The latter combined with the impact of ultra-low interest rates has allowed new near monopolies to be created which, whilst they might provide services consumers want, have had a detrimental effect in terms of allocation of wealth in the wider stakeholder economy.
- Risk Management has struggled to adapt. Asset volatility is a crucial measure of perceived risk, but with a centrally mandated buyer of vast tracts of the bond market, and large proportions of the equity market replicating those assets' qualities, volatility is almost certainly artificially low in areas of the market which have dominated performance and ownership.

With this in mind we must ask whether it is likely that the current patterns hold. Is it likely that the policy regime that has been in place since the GFC remains the same moving forwards? There is certainly the chance that this could continue to be the case near term, but we are increasingly of the view that it is unsustainable over any meaningful period of time; no politician could now be elected on a platform of austerity. Populism is a genie that is not easily put back in a bottle.

“Throughout centuries what we’ve seen when the masses think the elites have too much, one of two things happen: legislation to redistribute the wealth... or revolution to redistribute poverty.”

Alan Schwartz
 Guggenheim Partners

What might change looking forwards?

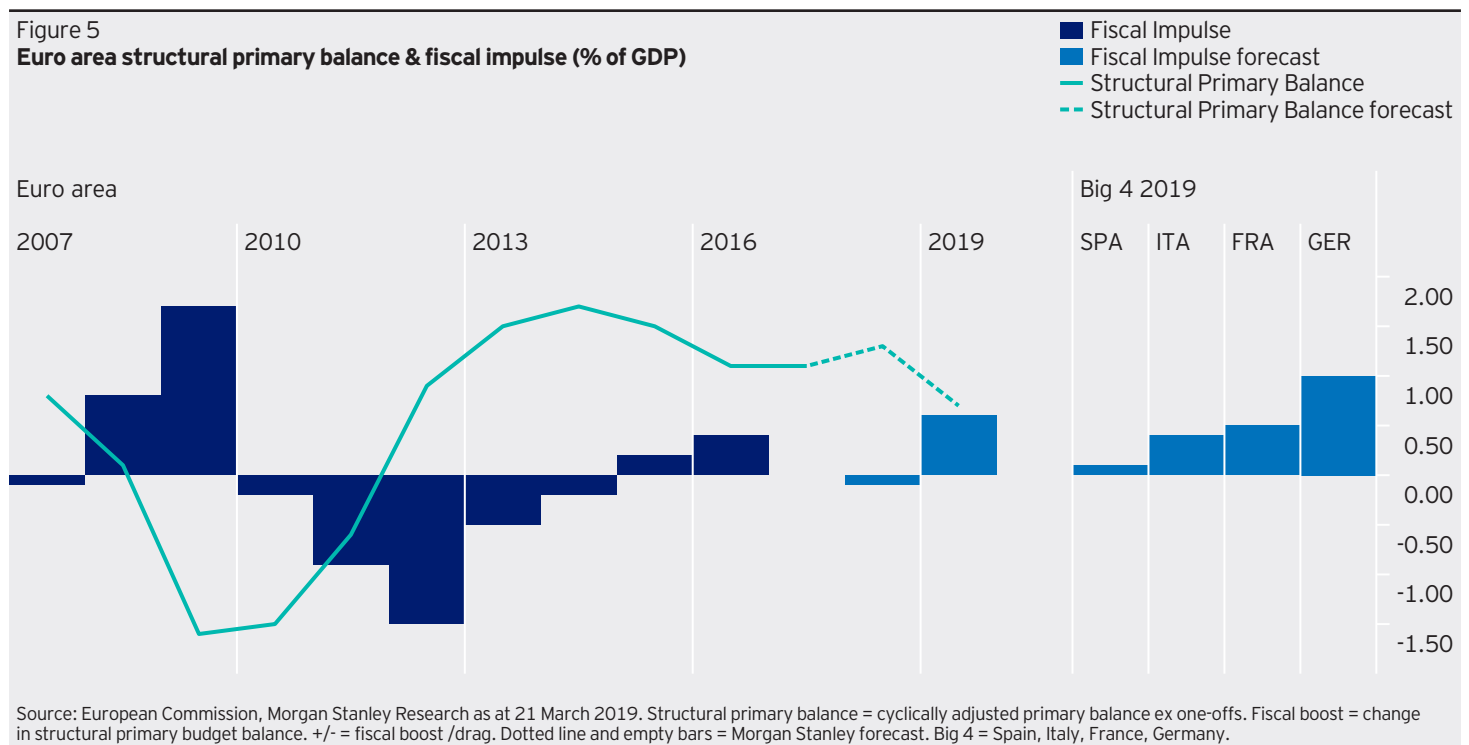
- **Rates** - 'Lower for longer' is now almost entirely consensual, which we doubt is 100% certain as inflation risk is, we believe, mispriced (see section on fiscal policy below). However, the more relevant point is that incremental cuts to interest rates from current levels is mathematically difficult. In Europe, deposit rates are -40bps. Unless the policy intention is to tax savers through charging consumers for holding cash in their bank accounts then further cuts will only hurt the banking system.

As the banks are the main monetary transfer mechanism in Europe, damaging them does not seem an obvious policy goal to us. It's not just us that doubts the sense of it. A number of ECB policy makers have publicly debated the impact negative rates are having on banks, whilst Draghi himself suggested that any further rate cuts, if required, would likely include deposit tiering to stop the banking pain. We believe it is important to underline - rates not being a constant declining force would itself be a radical change versus the past decade.

- **Fiscal policy** - As already highlighted the policy tool-kit has relied almost entirely on monetarism. With the emphasis on reducing budget deficits, expansionary fiscal policy was regarded as impossible. Relatively recently, however, the Trump Administration has cleared that psychological hurdle. The emphasis has been on lower taxes but is starting to shift towards infrastructure.

The debate now shifts elsewhere, particularly in Europe, with the core member Germany, so recently committed to a 'black zero' budget policy now providing the biggest delta in an uptick in Fiscal spending in 2019. President Macron, elected on a mandate of reform and budget control, has shifted with alacrity to a fiscal expansionary mode in the face of public demonstrations of anger by the 'gilets jaunes'. The EU's frustration with Italy's expansionary budget was less to do with the notion of fiscal spend itself but more in the methodology of simple wealth transfer from the wealthy North to the unproductive South.

Figure 5
Euro area structural primary balance & fiscal impulse (% of GDP)



Source: European Commission, Morgan Stanley Research as at 21 March 2019. Structural primary balance = cyclically adjusted primary balance ex one-offs. Fiscal boost = change in structural primary budget balance. +/- = fiscal boost / drag. Dotted line and empty bars = Morgan Stanley forecast. Big 4 = Spain, Italy, France, Germany.

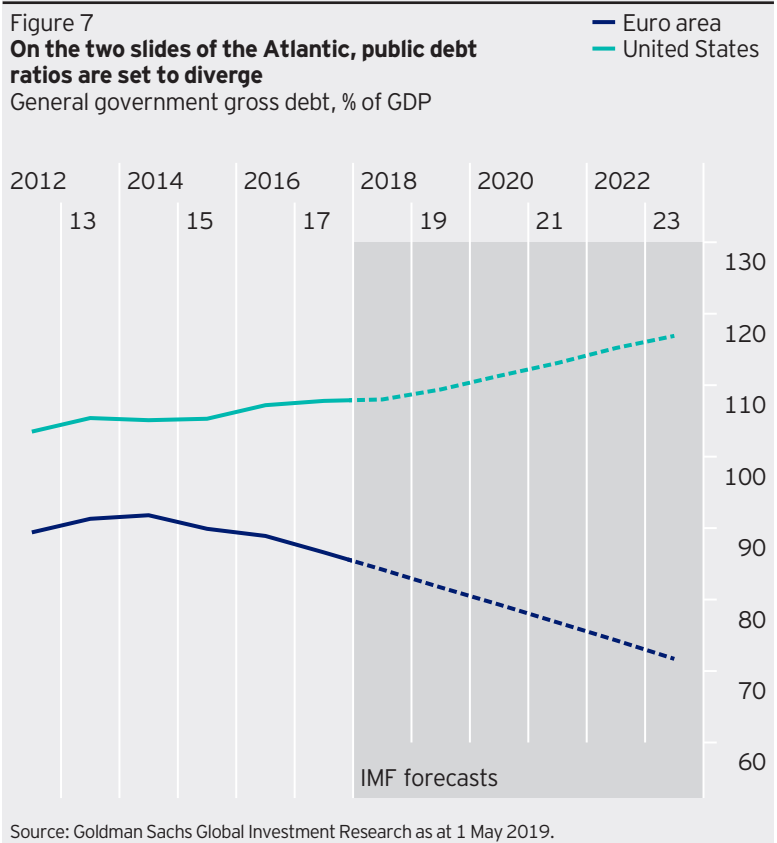
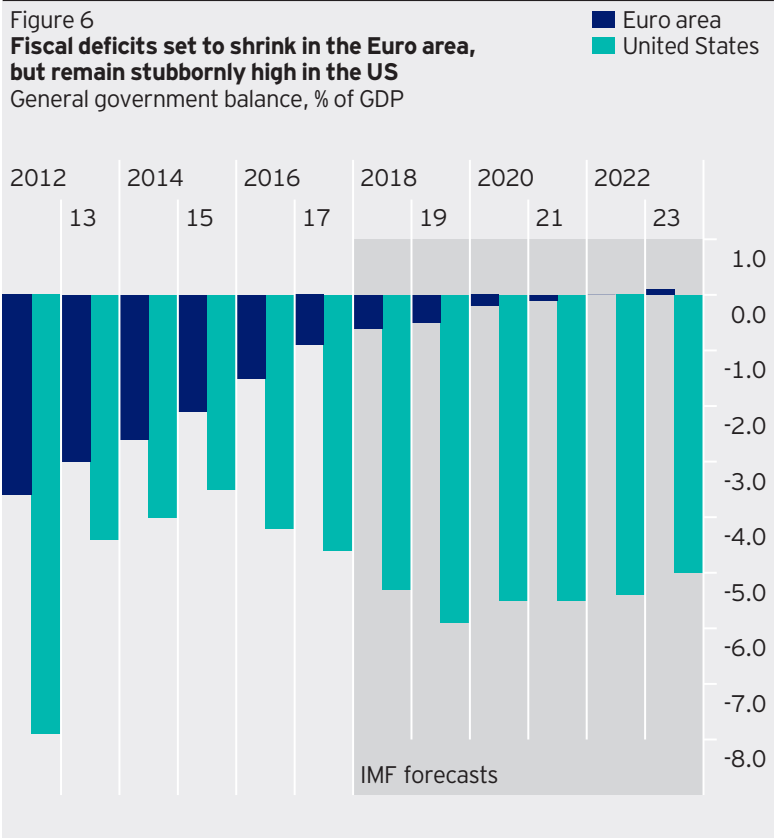
There are plenty of areas ripe for investment and the environmental agenda appears to be an increasing area of focus for potential infrastructure plans - aided by the rising political power of the Green Party in Germany (with a significant voter base within the 'have-not' Millennial generation). Fiscal policy is likely to be able to get inflation back into the system. As we know, prices go up when there is more demand than the available supply - so by increasing the demand for real assets and labour, the effect on inflation should be evident. Importantly, Europe in aggregate has plenty of room to flex its fiscal muscles more forcefully than it has to date.

Thus far the European moves have been tentative, but the policy debate is becoming far more widespread. The fact that rather extreme solutions such as Modern Monetary Theory (MMT) or People's QE are being actively discussed is telling. We have no strong belief that any such action will take place, but we do think it is significant that such radical policy is being openly debated. To be fair, many mainstream economists push back against the idea rather forcefully - but equally we would note that ahead of QE the idea that the ECB would increase its balance sheet by €4.7 trillion (as of Dec 2018) through the buying of government debt and corporate bonds would have seemed fanciful in 2012.

- **Regulation** - There is increasing unease in Europe as to the damage that ever-increasing capital requirements on the banks may be having on their ability to drive the European economy forward. It is not yet clear where the debate will end, but it seems highly unlikely to us that nothing changes. In contrast, the technology sector, which has one of the lightest regulatory burdens is coming under increasing scrutiny. The impact of the 'Gig' economy on wages, quality of life and social cohesion is being widely discussed.

All that is good in capitalism has allowed the ideas of brilliant men to thrive, but the inability of the current version of capitalism to restrict monopoly-like market positions, super-normal profitability, extreme executive pay, and societal domination is at risk of undermining confidence in capitalism itself. Pressures are beginning to mount with Commissioner Vestager taxing revenues in Europe, data regulations increasing fixed capital requirements and early stage monopoly investigations - including in the US.

The ramifications of changes in monetary, fiscal and regulatory direction are potentially significant. Crucially, the shift does not need to be violent to see those impacts become apparent. This is not about no QE, extreme MMT and regulating Big Tech out of existence. Instead, it is a recognition that the era of unchallenged monetary policy supremacy at some point requires the balance of redistribution in order to prevent malign effects. The warning shots of populism have been fired, and we sense that policy makers are beginning to recognise that fact. We do not foresee revolution, but we do predict policy evolution.



Source: Goldman Sachs Global Investment Research as at 1 May 2019.

Where are we placed?

We have talked at length in the past about our investment philosophy. We do not seek to be exposed to a specific country, sector, factor or stock from an ideological point of view - our portfolio allocations are driven by a valuation framework and within that a bottom-up exploration of what drivers within the individual company can unlock that valuation gap. At present, that valuation discipline is tilting us heavily towards the Value factor, but whilst that means we are underweight Quality, it does not mean that we own 'bad' businesses; because the skew is so extended we can buy excellent companies at cheap prices.

Quality in a factor sense has become narrowly defined as those businesses which have a high ROE today. We own a heavy sprinkling of cyclicals, financials, telecom and energy businesses but all are market leaders with strong balance sheets, strong cashflows and well-covered dividends. Perhaps where we differ most greatly from our peers is that our valuation discipline has increasingly taken us towards companies which are inversely correlated to the bond market - offering a natural hedge for diversified portfolios at a time where positive correlations amongst most other assets have rarely been higher.

If nothing in the policy environment changes, then the market skew may well continue but to do so requires ongoing extreme monetary policy, no regulatory change, no political reaction to income inequality, no use of fiscal policy tools and ultimately no inflation. We think this seems highly unlikely. We do not profess to know exactly what lies ahead, but we are convinced it is different to where we have come from. Equally, we feel very comfortable owning the companies that we hold.

Whilst it is not easy to predict what happens next, we believe the right answer is to hide in plain sight by owning under-valued, well-run assets and not over-valued low volatility bond-proxy equities. At current valuation extremes the optionality of policy movement looks to be wildly mispriced.

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