FROM A GROWTH TO A VALUE BUBBLE?

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Hans Ulrich Jost
Lead Manager
DIVAS Asset Management AG

"Conventional wisdom has it that old economy Eurozone will never grow again and that interest rates will stay at zero forever."

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In the following paragraphs we would like to address the various preconceptions the market has established over the course of the past 10 years encompassing two systemic crises (Subprime/Eurozone), a major commodity implosion in early 2016, pulling most yield curves into negative territory, accompanied by various side-shows like Russia/Ukraine, Brexit, Turkey, Italy, WLTP and finally the US trade war. The fallout of these occurrences was exacerbated by exceptionally easy money, the creation of USD2.5 trillion new products, all buying the same sensitivities (momentum) and a set of perceived disruptors like shale eats it all, Amazon eats it all, Tesla eats it all and Fintech eats the lunch of the structurally challenged banks.

This finally culminated in the value implosion seen early 2019, which comfortably beat the one seen in early 2016 (-1162 basis points versus growth, compared to -632 basis points) completing the most extended (thirteen years) and pronounced (underperforming by some 90 percentage points) period of underperformance of value versus growth in history.

The new normal

Unintended consequence of this distorted ten-year period was that the market bred a whole new generation across the entire value chain (Sell- and buy-side analysts, fund analysts, portfolio and fund managers, client advisors and CIOs), which controls global flows and is convinced that what was probably the biggest aberration in financial history since the great depression (the last 10 years) is the new normal and will last forever. Conventional wisdom has it that old economy Eurozone will never grow again and that interest rates will stay at zero forever. Below we try to illustrate why this is probably one of the biggest misconceptions of our time and how it is likely to unravel.

The dog chasing its own tail with USD2.5 trillion

The ultimate amplifier of this momentum trade of the century is the fact that since 2009 the market has created some USD2.5 trillion worth of new products (ETFs, absolute return equity funds, smart beta ETFs and trend following strategies or Artificial Intelligence) factually chasing the exact same sensitivities, the very proxies for low volatility, growth or yield. As it is with such forceful flow driven momentum trends, they eventually become self-fulfilling, taking the positioning of the market from one extreme to the next. Since the machine (high frequency trading, trend following strategies etc.) today drives some 90% of daily flows and all machines are based on the same back-testing logic, they are factually all programmed to buy the same sensitivities.

The ultimate driver of all asset categories - the 10-year Bund yield

Looking at the sensitivities for the various asset categories, there is evidence that in recent months the machines have all converged to directionally strongly correlate with the 10-year Bund yield. This seems to be the last reliable safe haven trade available. Any yield curve normalisation, overdue since 2016, would push the machines to aggressively buy value in general and financials in particular.

Priced for recession

Eurozone leading indicators peaked in January 2018, moving into a classical mid-cycle slow-down. This in itself would not have attracted much attention, had it not been compounded by the introduction of the Worldwide Harmonised Light Vehicle Test Procedure WLTP (laboratory test used to measure fuel consumption and CO2 emissions), which temporarily depressed car sales and wiped out some 1.25% worth of GDP (The entire global auto value chain accounts for some 13% of global industrial production), Brexit and the US trade war. Just to put this into context, an outright trade war between US and China would reduce GDP by some 0.5% and 1% respectively. The impact of tariffs implemented to date on Eurozone GDP of some 0.1% is neglectable. Were the trade war to escalate to include auto tariffs, the cost would rise to some 0.3%. Annoying but not a disaster.

Uncertainty about the outcome of Brexit and the potential fallout of the US trade war held back investment decisions, driving capex to sales to a 30-year low. Any clarity on Brexit or the US trade war would strongly improve sentiment. This combined with Eurozone capacity utilisation close to its record high of 84% reached in March 2018, consumer confidence across Europe at elevated levels (supported by a very high savings rate of some 12%), destocking coming to an end and the WLTP drag falling away, should have eurozone GDP gradually trending back towards 2% growth.

Taking from the prevailing incredibly depressed earnings multiples of value stocks, it seems however that the market is priced for recession, since current earnings multiples are priced for earnings to halve. Our holdings are currently valued on 7.9x earnings, 0.85x book and pay us a generous 4% dividend yield. Put another way, in order for our holdings to trade at fair value, prices of all our positions would either have to double or the earnings thereof would have to implode by 50% (a scenario that is not possible, since many of our business models, even in a full-blown recession, would never lose 50% of their earnings power).

Priced for deflation

Early July 2016, the peak of the Brexit panic, when European yield curves had reached their most extreme negative levels in history and headline inflation stood at 0%, forward inflation expectations troughed at 1.25%. This compares to 1.24% at the end of March 2019, with headline inflation running at 1.7% and core inflation at 1.3%. We can see from these numbers that current inflation expectations are in stark contrast to actual inflation, i.e. the market does not only expect inflation to never move higher over the next five years, but even to move considerably lower. Hardly a realistic scenario, but that is what the 10-year Bund yield and financials, a proxy thereof, have fully priced in. Since forward inflation expectations are a key driver of relative performance for value, a normalisation thereof would trigger a major rotation back into value.

Flows

The 12 months to March 2019 saw a record USD120bn net outflow from European equities, compared to USD95bn into February 2016. Over the last 7 weeks another USD20bn deserted European equites, bringing the grand total over the last three years to an incredible USD200bn. This very much smacks of capitulation.

A dying species - the last man standing

In 2013 I was presenting at a client conference in Ascot. My opening remark was that we value investors were a dying species and that on day, I would be the last man standing. Early 2016 I had lost my last two true value competitors, as they had capitulated and become inconsistent to their own approach. There are many funds in existence today that still carry the word value in their name, but all have long ago converted to growth or a derivative thereof. To me, the strongest signal yet of capitulation was, when an investor, who throughout his 30-year professional life had preached the virtues of value investing, had admitted mid-May to having exited all his value strategies. [1]

A return to valuation-driven stock pricing?

If there is anything, I have learned over the past thirty years, it is that history does repeat itself and that the law of central gravity and therefore convergence to the mean still exists. Recent cracks in momentum-based strategies are heralding a return to valuation-based stock pricing, through which fundamental dislocations, built over the course of the last ten years, would have to be corrected. While it is possible to extract alpha from value stocks even in a pro-growth environment, the good news is that the rotation back into value, which should highlight the true worth of stock picking, has not even started. To the contrary, since the low point in February 2016, eurozone value has even underperformed growth by another 1100 basis points. Should this dam eventually break, some USD2.5 trillion of liquidity will try to exit the same tranche of overbought strategies at the same time. This will be a nightmare for the wider market, but a feast for true value investors who are likely to be on the receiving end of this flow.

[1] In addition please read the following article on Citywire

Contact

DIVAS Asset Management UG

Reichenaustrasse 11 a-c

78467 Konstanz, Germany

www.divas-am.com

hansueli.jost@derivativesolution.com
