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2019 MARKET OUTLOOK

AN INTERVIEW WITH KEVIN GIBSON

Kevin Gibson, Chief Investment Officer for Value Equities, is approaching 2019 optimistically; 2018's falling markets have exposed good value in over-discounted stocks from a bottom-up perspective.

Q How are you approaching 2019?

Optimistically. Not only are the conditions that led to a decade of momentum-led investment easing, (which is encouraging news for bottom-up, value investors) but also (and more significant from our point of view) value dispersion remains high.

This dispersion narrowed in late 2018 as the markets sold off. Nevertheless, significant valuation disparities remain not only across, but also within, the Emerging, Asian and Japanese equity markets and world markets per se.

It is relatively easy to identify good value at the stock level in non-tech China, Japan, Korea and across-the-board cyclicals.

Q But this valuation dispersion has existed for several years.

Yes, that is correct. It was largely a consequence of the high liquidity that resulted from central bank quantitative easing over the past decade. That high liquidity encouraged investors to pay ever higher prices for stocks perceived to have characteristics such as 'quality' and 'momentum'. We were on the opposite side of that trade.

The liquidity 'pattern' was manifest both across markets (e.g. Developed vs. Emerging) and within sectors (e.g. 'New' economy such as IT vs. 'Old' economy such as the banks). The latter grouping, we hasten to add, is somewhat of a misnomer; we view stocks as being either 'Expensive' or 'Cheap'. Whether the 'New' or 'Old' economy stocks fall into these two categories is largely a matter of timing.

Q What makes 2019 'different'?

What is 'different' is that the liquidity driver is losing strength as central banks retreat from their quantitative easing. But more significant, in our view, is that this shift is occurring as the relative gap between the price-to-book valuations for the Developed and Emerging Markets is historically wide.

It is true, however, that on an absolute basis, the Emerging Market price-to-book ratio still has room to fall; it remains above its 2002/2009/2016 lows. Could there be more downside? Absolutely. But is good value present? Absolutely.

On balance, after a year of volatile performance, the risk/reward pendulum seems to be swinging in favour of 'Reward'.

Asia has historically had significant upside from today's low valuation[1]

Asia (ex Japan)[2]	% of observations	Average rolling returns over:		
		1 Year	3 Years	5 Years
Less than 1.5x	24	37	45	91
1.5x to 1.75x	37	8	37	52
1.75x to 2x	19	11	28	43
2x to 2.25x	13	5	-3	23
2.25x to 2.5x	5	-6	10	18
More than 2.5x	2	- 39	-7	-3

Q Given these still large uncertainties, what stance are you taking?

At this juncture, it is critical to look through the business cycle. Put another way, investors are now confronted with a 'Time Arbitrage' balancing the short-term risks that rattled investors in late 2018 against the longer term reward as today's attractive valuations are priced out.

It may not look like it today, while volatility is high, but when volatility dies down and investors begin to reflect on opportunity rather than risk, they will likely recognise the great potential opportunities 'out there'.

Q While you leave the door open to more potential downside, the implication is that a lot of the perceived 2019 downside risks have been discounted or even over-discounted.

Yes. There are many instances where one can make the case that fears have been over-discounted. A strong dollar, for example, is generally perceived as being unambiguously bad for both Asia and the Emerging Markets. The reality is rather better.

The aggregate ability, for example, of Emerging Market companies to service their dollar debts is significantly better than it was 10 years ago. Furthermore, when we focus on a company's balance sheet, we try to ascertain whether we are being paid to take the implicit currency volatility risk.

For the companies we buy, we believe this to be the case.

Having said that, the dollar has strengthened a lot, yet the stocks we own have outperformed (albeit in a falling market). Incidentally, we could apply similar arguments to President Trump's trade war fears.

Q You were strategically underweight the IT sector in 2018. Yet this sector was still a major contributor to overall performance. Will IT remain on your 2019 radar?

This apparent 'contradiction' illustrates many of the points made above. We were underweight the IT sector because we had no exposures to the high profile, expensive larger stocks that many investors were chasing. We did find value, however, in some of the lessor known names that lay in the 'Old' IT sectors (i.e. those sectors outside the 'New' sector of IT services), particularly in Taiwan.

We remain underweight but less so as the major IT 'names' slide on falling profit forecasts. If any of these names slide further than justified (thus repeating the over-discounting pattern alluded to above), we would consider adding.

Q You have been overweight the financial sector, particularly the banks. Will 2019's forecast rising interest rates be sufficient to boost performance?

When we apply our valuation models, the Financials appear repeatedly attractive. A lot of bad news has been priced in. Our decision once again, is that 'Time Arbitrage' in which we trade off risk against the potential reward.

For us, the risk of credit losses in China needs to be closely monitored. And while not to the forefront of our thinking, we do see as threats both Thai bank revenue risk (via regulation) and funding pressure on India's non-bank financial companies. One must also bear in mind that some of Asia's more successful financials are already trading at high multiples.

Having applied the above caveats, many of Asia's banks are approaching the credit cycle with stout capital ratios and provisioning policies.

So, while we remain overweight, we hold the story lightly and are continually retesting our convictions to ensure our exposures are appropriate.

Q Japan's equities look attractive amongst the Developed Markets, yet many investors have shunned the market, claiming it lacks a 'catalyst'. What would be your rejoinder?

We do not look for 'catalysts' per se but rather exploit the opportunities engendered by such reluctance.

While a lot of good things have already happened at the corporate level, a missing piece to the puzzle may be appearing – and that is rising capital expenditure.

Moreover, inflationary pressures could be building; although it is early days, there is little slack in the economy and labour market conditions are tighter. A 'beating-deflation' vindication for 'Abenomics' would likely be viewed positively by investors.

In the meantime, with dividends and share buy-backs nearing record highs, and attractive valuations based on profits that regularly beat forecasts, we are quite happy availing ourselves of the opportunities this investor reticence is presenting.

Sources: [1]The historic price to book ratio was 1.43X as at 31 October, 2018. [2]MSCI Asia exc. Japan Index.

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