IN BRIEF

• It has been a grand old first half of the year for equity investors, despite soft economic and earnings data, and a deterioration in the news around international trade discussions. Our team is a little cautious on the outlook but we don’t see any reason to move aggressively away from equity exposure.

• Once again this year, investors have had a clear preference for both perceived long-term structural winners and defensive stocks, coupled with an aversion to companies seen as more economically sensitive or vulnerable to disruption from technological change.

• These trends, which have only accelerated in recent weeks, are now manifested in very wide valuation spreads. While absolute returns in value stocks are robust, the gap relative to growth stocks hasn’t been this wide since the late 1990s. Our investors are finding parts of value they like (including high quality financials and disrupted consumer companies that should fare better than feared) and those that they don’t.

• Geographically, preferences are not especially strong. Europe and the UK are the most out of favor and attracting some contrarian interest, emerging markets equities are somewhere between fairly valued and cheap, and U.S. equities look more highly priced (understandable given U.S. companies’ superior growth prospects).

TAKING STOCK

Since our last Investors Quarterly, in March, the positive trend in world stock markets has continued, albeit at a slower pace than in the early months of the year, and for the first half world equities (as measured by the MSCI All Country World Index) recorded their best returns in more than 20 years. These gains, from a depressed starting point, of course, come against a backdrop of sliding economic growth, especially in the manufacturing sector, and sliding profit forecasts as well.

Most of our portfolio managers remain fairly conservative in their view of equity markets, with the dichotomy between rising prices and falling profit expectations the main reason for caution. But within markets there seems to be ample opportunity for stock selection. For our value-oriented teams, the ever-growing gap in valuations between the haves and the have-nots is a recurring theme, especially as this gap is now at a level that has in the past suggested healthy outperformance from lower priced stocks. Our growth investors still see plenty of companies offering tremendous secular opportunities, with software a particularly strong focus (although valuations here do look rich in the short term). Of particular interest to the growth team are smaller companies that are poised to benefit from digital transformations across industries and are not subject to the regulatory scrutiny faced by some of the mega cap tech firms.

Overall, we can find many reasons to recommend staying invested. As we have said before, the fundamentals for the leading growth stocks remain exceptionally strong, but bargain hunting for
relative value in the less richly priced value areas, smaller cap stocks and international markets is a good use of fresh money. **EXHIBIT 1** presents a snapshot of our outlook.

**TRENDS**

While 2019 may be shaping up as a strong year for market returns, the profit picture is still very pedestrian, with low growth expected in developed markets and flat profits across the emerging world. The erosion in near-term profit forecasts that began a year ago has continued, although at a moderated pace. Negative revisions have been most apparent in cyclical sectors such as basic industries, industrials and automobile manufacturers as trade fears have intensified in recent weeks. Interestingly, technology sector profitability is also soft following a decline in the volatile semiconductor group, but markets have already looked through this.

Even while pretty much everything has gained in price this year, the winners have a very familiar look: large cap growth stocks (especially concentrated in the U.S. market) and the equity of companies considered relatively immune to a downturn in the world economy. More economically sensitive investments have continued to lag. These trends have been in place for many years now; a look at the winners of the past 10 years shows the dominance of the U.S. market by geography and growth by investment style (**EXHIBIT 2**). The technology sector has delivered exceptional performance and the U.S. is home to 75% of the world’s tech companies by market value. Overall, the equity market’s gains have come against a backdrop of general investor pessimism about the future: Equity funds (passive and active) are experiencing outflows while the appetite for bonds appears to be insatiable.

Clients may be cautious in equities, but corporate management seems a little more confident, with merger activity picking up. And stock repurchases remain very much in vogue. U.S. buyback activity is at record levels, and there are signs the trend is slowly spreading elsewhere.

A look at the winners and losers over the past 10 years shows the dominance of the U.S. and technology

**EXHIBIT 2: INDEX RETURNS: TOP AND BOTTOM INDICES, 10 YEARS**

![Index Returns Chart]

Source: Morningstar; as of June 30, 2019. Index returns are annualized and in USD.
OPPORTUNITIES

Once again at our Investors Quarterly we assessed the opportunities in the out-of-favor value space. The underperformance of value has been a pronounced feature of global markets for a decade now, and the trend has accelerated in recent months. Our work shows that the difference in valuations between high priced and low priced stocks is wide and getting wider. As our value investors pointed out, however, any disappointment in performance from value investing is only a relative disappointment. In the U.S., for example, value funds have typically returned 14%-15% annualized net of fees over the past decade, and even if one had invested at both the absolute peak of the last cycle and the peak of value’s previous outperformance—the summer of 2007—then the returns would have been around 6% annualized, which hardly ranks as one of the worst investment mistakes ever made. But, of course, growth stocks have done even better, delivering an additional 2%-3% a year over the same period. Our investors see two challenges in buying value: the cyclical risk to profits after a long economic expansion, and the secular challenges to many older businesses from the explosive growth of technology-driven disrupters. We think cyclical risks are well known and heavily discounted, while the secular challenges are in some cases exaggerated. Incumbents with good balance sheets and astute management teams will put up a tougher fight than many expect. And as some of our global investors noted, parts of the health care sector—often thought of as part of growth—present some attractive value opportunities these days, with controversy raging in the space.

By geography, UK equities remain hugely out of favor, with political uncertainties an easy reason to stay away. Yet the market looks underpriced and the profitability of many leading companies is not dependent on the domestic market. In aggregate, emerging market equities appear somewhere between fairly valued and cheap, but not conclusively attractive. The effects of the row over trade are now showing up in China, with measures of industrial activity quite weak, but by our reckoning, Chinese equities don’t yet offer compelling value. Signs of near-term cyclical risks to the Chinese economy have also led our global team to pare some exposure there—for example, in the formerly fast-growing Chinese cosmetics space. Pockets of real value do exist elsewhere, with Korean equities significantly out of favor and looking quite interesting. Overall emerging market equities look somewhere between fairly valued and attractive.

RISKS

Trade tariffs and barriers have risen to the top of the list of issues that worry our team, for obvious reasons. The economic impact of higher tariffs may be fairly modest, at least in the short term, but we are very wary of the impact on profits after so many companies have spent decades building global supply chains predicated on a low tariff, free trade world. The issue is no longer new, and some of the pain is already discounted, but the risks to profits and stock prices from a further escalation are still considerable.

While we debate growth and value, most of our portfolio managers think that many defensive stocks—the areas of the stock market most closely linked to the fixed income markets—are very richly priced on any relative basis and often have unattractive growth prospects as well (EXHIBIT 3). With long-term bond yields already at historically extreme lows, the risk-reward equation for these now very popular investments looks most unappealing.

Many defensive stocks are very richly priced

EXHIBIT 3: RELATIVE ATTRACTIVENESS OF BOND-LIKE STOCKS VS. THE BROADER EQUITY MARKET

Source: Factset, FirstCall, J.P. Morgan Asset Management; data as of June 20, 2019. Bond proxies consist of stocks in the Russell 1000 Index with top decile bond proxy composite scores with the exclusion of mortgage REITs and extreme high dividend yield stocks. The bond proxy composite includes low volatility, low market and interest rate beta, high dividend yield and payout ratio, as well as large market capitalization. Valuation spread of bond proxies is measured by the weighted average valuation of bond proxies divided by the weighted average valuation of an S&P 500 portfolio, logged. The spread is measured in a z-score relative to its history.
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