Buy the Cyclicals, the Unpopular, and the Neglected

Causeway Market Commentary, January 2019

2018 ended with investors shedding equities and portfolio risk. All markets have enjoyed the support of "cheap" money. By late 2018, global net asset purchases by central banks turned negative, led by the United States. For the first time since 2007, US cash yielded more than US stocks and the US yield curve continued to flatten. Other signs of investor nervousness included the widening of credit spreads and a significant increase in global stock markets volatility from prior years.

Risk aversion has become most acute in non-US developed markets. Stocks in industries such as utilities, real estate, food & staples retailing, household & personal products, telecommunications and pharmaceuticals typically outperformed overall markets in most regions in the fourth quarter of 2018. For Europe and the United Kingdom, in particular, the combination of tapering quantitative easing, concerns over a potential disorderly Brexit, Italian political risks, and European corporate earnings sensitivity to global trade likely unnerved investors. This may explain why European equities have "de-rated" back to five- year price-to-earnings ("P/E") lows and dividend yields have risen nearly to Euro Crisis levels. UK stocks de-rated severely in 2018, and are currently trading at the cheapest levels in the past 25 years (except during the global financial crisis "GFC" in 2008-9) on a dividend yield basis. Measured by the earnings yield/bond yield premium, *the UK stock market has only been cheaper twice in the past 100 years* (during World War I and World War II)[1].

Exhibit 1 illustrates the defensive valuation premia across the major geographies at year-end 2018. *EAFE markets contain the highest valuation gap between defensives/cyclicals, not only relative to the other geographies but even on a self-relative basis*; the current defensive premium is nearly at the level that occurred during the height of the GFC. At year-end 2018, for example, UK beverages traded at all-time high valuations (typical P/E ratios of over 20x) while UK banks languished at discounts to book value and at single digit P/E multiples.

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[1] Citi Research, January 3, 2019, "Global Equity Road Ahead"

Exhibit 1: Defensive Stocks Traded at a Sizeable Premium to Cyclicals
Defensive Premium % by Region, from December 1999-December 2018

Note: The "Forward P/E" of a stock is its price divided by the consensus EPS estimate for the next twelve months. "Defensive Premium %" is the median forward P/E ratio of the most defensive quintile divided by the median forward P/E ratio of the most cyclical quintile, less 100%. The cyclicality of a stock is calculated as its 60-month beta to the monthly performance spread between the Russell Global Dynamic and Russell Global Defensive indices. Universe consists of the constituents of the MSCI USA, EAFE, and Emerging Markets Indices. Source: FactSet, MSCI, Russell Investment Indices

The P/E of EAFE cyclicals (Exhibit 2) is now cheaper than it was during the Euro Crisis in 2011 and approaching the GFC nadir. *Cyclical and financial stocks (banks and insurance) have become irresistibly undervalued, especially relative to their defensive peers.*

Exhibit 2: Cyclical Stock Valuations are at Multi-Year Lows
Forward P/E Ratios by Region, from December 1999-December 2018

Note: The "Forward P/E" of a stock is its price divided by the consensus EPS estimate for the next twelve months. The cyclicality of a stock is calculated as its 60-month beta to the monthly performance spread between the Russell Global Dynamic and Russell Global Defensive indices. Universe consists of the constituents of the MSCI USA, EAFE, and Emerging Markets Indices. Source: FactSet, MSCI, Russell Investment Indices

From an overall global market view, value looks inexpensive relative to growth – perhaps acutely inexpensive in the more worrisome regions of the developed world.

Exhibit 3 shows the earnings yield spread between the cheapest 20% of stocks (measured using a blend of valuation metrics) in the MSCI EAFE universe versus the most expensive 20%. As of 12/31/18, the 8% spread equates to the 97th percentile using data points starting in 1999.

Exhibit 3: Spread Between "Cheap" and "Expensive" Stocks At Extreme Levels
As of 12/31/2018, the MSCI EAFE Forward Earnings Yield Spread was in the 97th Percentile vs. History
MSCI EAFE Index, December 1999-December 2008

Earnings Yield Spread
80th Percentile
90th Percentile

Forward Earnings Yield Spread ("Cheap" - "Expensive" Quintiles)

12%
11%
10%
9%
8%
7%
6%
5%
4%
3%
2%

Dec-99 Dec-00 Dec-01 Dec-02 Dec-03 Dec-04 Dec-05 Dec-06 Dec-07 Dec-08 Dec-09 Dec-10 Dec-11 Dec-12 Dec-13 Dec-14 Dec-15 Dec-16 Dec-17 Dec-18

Note: Earnings yield spread represents the median forward earnings yield (forward EPS estimate divided by price) of "cheap" stocks minus the median forward earnings yield of "expensive" stocks. "Cheap" ("Expensive") stocks represent the top (bottom) quintile of stocks in the MSCI EAFE Index sorted by an equal-weighted composite of valuation factors (forward earnings to price, LTM earnings to price, book to price, dividend yield, and cash earnings to price). Percentile cutoff values are calculated using monthly earnings yield data from December 1999 – December 2018.
Source: Causeway Analytics, MSCI

How long will this underperformance of cheap stocks persist?

Exhibit 4 shows the relative return of the cheapest quintile versus the most expensive quintile over the following year. Using history since 1999 as a guide, at points in the past when this gap in earnings yield reached the 97th percentile, the cheap quintile outperformed the most expensive quintile by 32% over the next twelve months. Although timing cannot be predicted, *we suspect that history will repeat itself, as it often does.*

Exhibit 4: "Cheap" Stocks Have Significantly Outperformed At Similar Spreads

The 97th percentile corresponds to 32% subsequent 1-year outperformance of "Cheap" stocks over "Expensive"

MSCI EAFE Index, December 1999-December 2018

1-year Forward Return Spread (Cheapest Quintile - Most Expensive Quintile)

35%
30%
25%
20%
15%
10%
5%
0%

97th Percentile as of 12/31/2018

0% 10% 20% 30% 40% 50% 60% 70% 80% 90% 100%

Percentile of Earnings Yield Spread (Cheapest Quintile - Most Expensive Quintile)

Note: Earnings yield spread represents the median forward earnings yield (forward EPS estimate divided by price) of "cheap" stocks minus the median forward earnings yield of "expensive" stocks. "Cheap" ("Expensive") stocks represent the top (bottom) quintile of stocks in the MSCI EAFE Index sorted by an equal-weighted composite of valuation factors (forward earnings to price, LTM earnings to price, book to price, dividend yield, and cash earnings to price). Forward return spread calculated as the median 1-year forward total USD return of stocks in the "cheap" quintile of the MSCI EAFE Index minus the median 1-year forward total return of stocks in the "expensive" quintile of the MSCI EAFE Index. Percentile cutoff values are calculated using monthly earnings yield and returns data from December 1999 – December 2018.
Source: Causeway Analytics

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