The Broadening of Market Leadership

October 24, 2023

Market leadership began to broaden throughout the third quarter relative to the narrowly led performance we experienced in the first half of the year. As discussed in previous quarters, we believe that we are now in a different inflation and interest-rate environment—one that we have not seen in a long time—and we expect the broadening of market leadership to continue.

Broadening Leadership

Beginning in June, following stronger-than-expected economic data, the market began to acknowledge that monetary policy was not likely to shift from tightening to easing anytime soon, thus coalescing around a view that rates are likely to remain higher for longer.

This sentiment pressured the valuations of longer-duration cash flows, and we subsequently experienced a shift in style performance to favor value over growth. This was evident during the quarter as the MSCI All Country World Index (ACWI) Value outperformed its growth counterpart by 3.11%.

Relative outperformance was driven by inexpensive and cyclical sectors such as energy, autos, financials, and consumer discretionary retail. We have also seen a broadening in regional performance. Italy, Spain, and Japan outperformed in developed markets, while Brazil, India, and Turkey had strong returns in emerging markets.

Economic Expectations

The global economy remains on an expansionary course, although the pace is slow.

Disinflation has been the primary story over the course of the year. In the United States, inflation has averaged 2% to 2.5% since June, but more recently higher energy prices drove inflation toward 3%. Shelter also remains a primary driver of the year-over-year change in the Consumer Price Index (CPI), but shelter prices are sequentially decelerating on a monthly basis. While the monthly data may be volatile, we expect that U.S. inflation will likely remain in the 2.5% to 3% range for the remainder of the year. We have seen a similar trend in Europe.

Importantly, disinflation's ability to buoy real incomes and consumer spending growth is improving, particularly in developed markets. It has contributed to positive real wage growth in both the United States and Europe. This is contributing to better purchasing power and stronger consumption, which we expect to support gross domestic product (GDP) growth. It also suggests that a soft landing is likely.

We continue to closely monitor energy prices. Although natural gas prices have come down across the board, it is important to note that European gas prices are still twice as high as they were before the Russia-Ukraine war. In particular, Germany has seen a significant hit to its energy-intensive industrial production, primarily due to these higher prices.

Earnings Growth Expectations

How does this all equate into expectations for corporate earnings growth?

There appears to be a significant amount of mispricing between what we expect in aggregate economic growth and what has been observed in consensus estimates, and we note some interesting divergences.

U.S. companies are expected to deliver double-digit earnings per share (EPS) growth next year; however, we believe these estimates could be overly optimistic. Developed Europe, meanwhile, is likely to be one of the weakest regions for corporate earnings growth for the remainder of the year. These markets contrast with Japan, which has experienced strong and broad earnings growth this year, while estimates for next year appear quite modest. We believe developed Europe and Japan are likely to have the most potential upside relative to expectations in 2024.

Emerging markets, led by China, have been the weakest performers this year. Perhaps not surprisingly, estimates are pointing to a rebound in earnings in 2024. While economic activity in China has decelerated throughout the year, recent macro data suggests that the economy is near or at trough levels. Signs of stabilization in the purchasing managers' index (PMI), acceleration in retail sales growth, and easing of deflationary pressures are encouraging.

Where to From Here?

While the prospect for higher-for-longer rates has seemingly surprised the market, as we have communicated in previous quarters, we believe we are now in an economic regime that is quite different from the decade following the Global Financial Crisis.

That period was anomalous, with low inflation and extraordinarily accommodative monetary policy. We merely expect low inflation and extraordinary accommodative monetary policy to revert to the very long-term averages of previous decades.

Thus, we continue to position our portfolios toward beneficiaries of an environment featuring slightly higher inflation and interest rates. This means exploring beyond the few industries that have dominated growth and market performance over the last several years, while also focusing on companies with nearer-term growth and margin improvement versus maximizing long-term growth potential. Breadth and diversification of types and levels of growth will be keys going forward.

Insights Into Japan

Japan has been a focal point for many investors this year as relative performance has been a standout among developed markets. Notably, compared to Europe and the United States, Japan has seen significant breadth of strong corporate earnings growth, spanning across sectors.

While economic and corporate profit growth have lagged major developed markets over the past several years, there have been recent signs of improvement, and we have directed our research to determine if the underlying drivers are sustainable.

The most powerful force would be a shift from deflation to (modest) inflation, and we believe that may be underway, driven primarily by the end of the corporate deleveraging cycle that had been going on for almost two decades. Anecdotally, society in general is also showing signs of accepting price increases, reversing the cultural pressure that had been prevalent.

During the deleveraging period, corporates were less able to invest for innovation and growth, making Japan Inc. less competitive. More recently, as debt has been worked down, cash balances have risen, leading to inefficient capital allocation. These influences have led to lower sales, profitability, and returns compared with global competitors. Thus, it has also resulted in lower equity valuations.

Importantly, the government, society, and corporates have aligned around the unsustainability of these developments, and many initiatives have been undertaken to increase growth and improve corporate performance. For example, the Tokyo Stock Exchange has been leading reforms by incenting all companies trading below their book value to devise a plan to improve capital efficiency.

Recently, members of the global equity team traveled to Japan to meet with several dozen corporate management teams, policymakers, and local investors to further our insights on Japan's economic potential. The conclusions supported signs that a shift in deflation and corporate reforms are gaining traction. As a result, we are actively researching our Japanese investment universe, as we believe that these structural growth tailwinds could support improved corporate growth and equity performance going forward. We will discuss this in more detail in future blog posts.

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