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3 Opportunities in a Crowded World

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Trades seem to be getting more and more crowded, and some investors are concerned that a bubble is being or already has been created. They are wondering whether focus should be shifted away from areas that have seen unusually large appreciations in the recent few quarters and toward less crowded exposures.

To start, we believe the talk of bubbles is premature. Central banks are helping backstop the markets and they probably aren't finished yet. Generally speaking, when people start talking about bubbles, it's a while before the bubble bursts. Bubbles are usually predicted far in advance.

What we are seeing, however, is that policy actions related to COVID-19 are boosting asset prices, and this is both good and bad.

The insidious element under the hood is that many of these recent policy actions are actually impacting the longer-term fundamental values of certain markets and market segments via their effects on human capital. Kids aren't going to school, factories aren't being used, and restaurants have been closed (and are even going out of business over time). These reductions of capital are ultimately also reductions of value—part of our analysis now is to assess the permanence of these impacts.

But this creates opportunities, many of which lie outside the United States. The United States has been one of the more aggressive major world economies in providing immediate stimulus (cash in hand) instead of deferred stimulus (such as tax breaks), loans, and grants. And immediate stimulus has the greatest immediate effect on asset prices. Deferred stimulus also has an impact, but it is typically delayed, while loans and grants generally don't affect asset prices at all. The nature of this kind of stimulus has dampened the influence of fundamentals in places such as the United States.

The situation is similar elsewhere: central bank manipulation of asset prices has swamped fundamentals, and it will probably continue to swamp fundamentals for the foreseeable future.

Fundamental value can be thought of as a kind of gravitational pull on price. It's sometimes slow, but it's inexorable. Often, investors don't even notice it is happening, but over time, prices do eventually revert to value. However, if this gravitational pull is weaker and slower than is typical because of stimulative impacts, how should investors adapt?

Some investors adapt by mining recent data to figure out what's been working and invest in a similar fashion. And that causes shifts in performance—growth may outperform value, for example, or one sector (such as information technology) might materially outperform another (such as energy).

We saw it in the 1980s before the Black Monday crash; in the 1990s before the tech bubble burst; and in the 2000s going into the global financial crisis. And today we have perhaps the most extreme situation that I can think of in the history of human civilization. The Federal Reserve (Fed) and other global central banks were already manipulating asset prices, and COVID-19 has only served to further accelerate this behavior.

For example, COVID-19 has accelerated digitization, and the tech-oriented markets such as China, Taiwan, Korea, the United States, and the Netherlands have been supported by policy actions. Equities in some of those markets (especially the United States) are particularly expensive on a purely fundamental basis, so where should investors look for value?

We believe Asia-Pacific (APAC) is one place to look for value, because the world is shifting from the concept of nation-state to the concept of civilization. Countries used to compete; now groups of countries compete.

The United States and Western countries are one core civilization; China is another. Other civilizations exist, but they will have to ultimately align themselves with one of those two poles.

Asia will likely align itself with China, which should remain an engine of growth. And that growth should also occur not just within China, but throughout the region, thanks to the network effects.

Within APAC, we find Singapore, Australia, Philippines, Indonesia, and Malaysia to be the most attractive on a fundamental basis. Importantly, the region as a whole should benefit from China's growth.

We believe there is also an opportunity in emerging markets relative to developed markets, generally speaking, thanks to their diverging situations.

Developed markets benefited for 60-plus years from a demographic dividend and the relative stability of the Cold War. While the era of mutually assured destruction was in many ways a scary one in which to live, it turns out that it is the most stable game theory structure that exists.

Now, the developed world has to address very significant social welfare commitments, and at the same time demographics and productivity aren't there to provide support. So, where does the support come from? We believe it will come from emerging markets, via increasing migration, trade of goods and services, and capital flows. These things have been set back a bit recently, but should resume over time.

The last opportunity is a bit of an unsung hero: currency. It is commonly said that currencies can't be managed based on fundamentals. But for the past 30 years, we have actively managed currencies in just such a manner.

When valuing asset markets, one has to forecast cash flows, come up with a discount rate, and discount the cash flows. While value can be calculated from these inputs, if the estimates aren't arrived at in a robust and thoughtful manner, the value might very well be inaccurate.

Now think about valuing currencies. We believe that relative purchasing power parity determines real equilibrium exchange rates. That is, the price of a basket of goods should remain constant across two currencies, after adjusting for the relative inflation differences in the two countries. When a real exchange rate deviates significantly from equilibrium, economic forces will be exploited and push the exchange rate back toward equilibrium.

Here's a simple example: a resident of El Paso, Texas, has a choice to buy a car in the United States for $50,000 or drive across the border and buy it in Mexico for an equivalent $25,000. That resident is most likely going to buy the car in Mexico. This involves buying Mexican pesos and selling U.S. dollars.

Now imagine this being done on a much larger scale across dozens and dozens of currencies on a global basis.

The point is that there's not typically a lot of uncertainty associated with currency value. It's fundamentally driven and is less affected than asset prices by the type of policy actions that are occurring today.

So, where are we seeking value in a crowded world? We are focusing on Asia, we're focusing on emerging markets, and we're focusing on currencies.

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