International and Global Markets Commentary & Investment Outlook

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by Chautauqua Capital Investment Team
of Chautauqua Capital Management

Introduction

Markets grinded higher in the third quarter. Gains were exceptionally strong in July and August, though there was a modest pullback in September. Strength was broad-based amongst sectors and geographic regions. In this environment, growth stocks outperformed substantially relative to value stocks.

We were able to again outperform in the third quarter, aided by the significant repositioning we had done in portfolios amidst the sell-off in March. However, we are wary of the risks to the market rally, including elevated valuation multiples, over-reliance on central banks, an uneven or stagnant economic recovery, resurgences in coronavirus cases, unresolved trade tensions, and uncertainty in the U.S. election. As markets have climbed higher, we have grown more concerned with the disconnect between stock prices and fundamentals.

Accordingly, we made changes in portfolios this past quarter, including taking proceeds from some high valuation “winners”, redeploying to lower valuation holdings, and raising cash levels so we have more dry powder. On the margin, these changes should help mitigate some downside if markets become less hospitable, and we continue to contemplate further adjustments for a more conservative balance of growth, profitability, and valuation in the portfolios.

We thank you for entrusting us with your precious capital. This is an unprecedented market environment, and we are hard at work navigating the near-term uncertainty. Our investment process is selective and identifies durable and high-quality growth companies, which we believe can ride out and, in many cases, grow through difficult times such as this.

Market Update

The economic recovery in the U.S. has now stagnated after the initial recovery. Retail sales have lost momentum since August. Labor markets, unsurprisingly, are soft after extended unemployment benefits lapsed in July, and employers have been reluctant to add staffing in this reduced demand economy. Political stalemate over additional coronavirus relief continued, and there has been little progress on the next stimulus bill. Many state and local governments are facing budget troubles and would be hard-pressed to fill the gap.

The Federal Reserve (Fed) changed its policy framework so that it uses an average inflation target that can make up for past inflation shortfalls, provides outcome-based forward guidance, and potentially extends quantitative easing by changing the rationale of the program to stimulus from market-functioning. Overall, these changes will allow the Fed to remain accommodative for longer, and the Fed has communicated a preference to leave rates unchanged through 2023.

In Europe, the economic recovery is anything but smooth. A surge in coronavirus cases stoked fears of a second pandemic wave, as infection rates jumped back to peak levels from the spring. Full-scale lockdowns were avoided this time, but the most recent economic data suggests that the uptick in cases has weighed on economic output. Back in July, Purchasing Managers’ Index (PMI) data increased markedly, showing expansion for the first time since the pandemic. However, PMI data slowed in August and again in September, hand-in-hand with an uptick in new cases and containment measures. Data on retail sales and factory orders followed a similar pattern, softening in the latter months of summer after a strong initial rebound.

At this time, the European Central Bank (ECB) is in a wait-and-see mode. The ECB left policy settings unchanged, but it has left the door open for further stimulus. Thus far, policies have been effective in easing financial conditions from the tighter levels following the initial coronavirus shock, and another tranche of pandemic asset purchases could be announced by the end of the year. Any notion of policy tightening seems off the table, as it could put the recovery at risk. Furthermore, the Fed’s new stance would allow looser monetary policy for longer.

The Bank of Japan (BOJ) kept its monetary policy unchanged, confirming that its ultra-easy stance, which includes negative interest rates, zero yield long-term government bonds, and substantial asset purchases, backed by former Prime Minister Shinzo Abe, remains intact under his successor Yoshihide Suga.

Outlook

The headwinds are easy to identify. Fiscal policy is a critical tool to support the economy in difficult times, but political gridlock has made it difficult to muster. In the U.S., both parties are still far apart on the size and scope of a potential plan, and odds are increasing that Congress will adjourn in October without a deal. This will further stress labor markets and consumption trends that have stagnated after a honeymoon rebound. Election uncertainty remains an overhang. Not only is the outcome still uncertain, but President Trump has also refused to say whether he would honor the transition of power if he loses in November.

There is still a lot of skepticism whether the Fed can improve inflation, and the Fed's job is now harder with such a depleted policy arsenal. The Fed's balance sheet ballooned to approximately $8 trillion in June but since then has been largely stagnant. Markets sold off when the Fed did not expand the size of its asset purchase program, even though it had formalized a new longer-term framework for accommodative policy, showing the effects of addiction to accommodative monetary policy.

The initial rebound in the European economy was not necessarily a good guide to the recovery, and overall, the ECB has set expectations for economic uncertainty and unevenness going forward. Inflation in the eurozone turned negative for the first time since 2016. The euro currency has appreciated to near all-time highs, but this has happened at the same time as economic data softening and inflation turning negative. This is a concern for the ECB. The combination of a strong euro and a moderation in the economic outlook should result in a downward revision in the inflation outlook. Even with another tranche of pandemic monetary stimulus, the ECB may struggle to curtail euro gains, given underlying dollar weakness and uncertainty heading into the U.S. election.

Member countries in the European Union (EU) remain fractionated, however leaders reached a deal for a long-term fiscal budget covering 2021-2027. Importantly, the budget included a pandemic recovery fund worth €750B, comprised roughly of an equal mix of grants and low-cost loans. Fiscally conservative countries such as Germany, Netherlands, Austria, Denmark, and Sweden pushed to link distributions of the recovery fund to enhancing growth reforms. On the other hand, countries such as Italy and Spain are in a weaker fiscal position but stand to receive the largest amounts from the program. The EU has indicated that distributions from the recovery will not occur until the second half of 2021, and these will be conditional on the submission of national recovery and resilience plans that meet guidelines of the European Commission.

In Japan, the new Prime Minister Yoshihide Suga is a strong advocate for structural reforms to increase the country's economic output, such as deregulation, digitization, and encouraging consolidation within the country's low profitability banking sector. Japan has suffered relatively few coronavirus cases and deaths compared to the U.S. and Europe, but its economy is recovering slowly from a state of emergency in April and May and the decline of global trade.

In spite of the risks and weak economic fundamentals, markets have grinded higher. Equity markets are expensive relative to current earnings power. In this recessionary economy, earnings have collapsed. The rise in stock prices has been accompanied by extraordinary levels of monetary accommodation, quantitative easing, and back-stopping of financial assets by central banks. On the one hand, policy support remains accommodative. On the other hand, policy arsenals are nearing exhaustion, and there is little fundamental support to belie high valuations and the exuberant market rally.

Therefore, we have made adjustments to portfolios, including realizing profits from some high valuation "winners", redeploying to lower valuation holdings, and raising cash levels so we hold more dry powder. On the margin, these changes should help mitigate some downside if markets become less hospitable, and we continue to contemplate further adjustments for a more conservative balance of growth, profitability, and valuation in the portfolios.

Valuations are high across the market, but on a relative basis, they are still most attractive for international stocks. The pandemic has delivered a global growth shock, but in doing so, it has accelerated the timeline for several mega trends that we have been actively investing in, such as productivity enhancement (robotics, automation, and software), e-commerce, electronic payments, and rapid drug development. Furthermore, many portfolio companies have been able to continue to deliver growth even in this recessionary environment, which is an exceptional trait.

Business Update

There have been no changes to the investment team at Chautauqua Capital Management nor have there been any changes to the ownership structure of our parent company, Baird.

Respectfully submitted,

The Partners of Chautauqua Capital Management – a Division of Baird

https://chautauquacapital.com/

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