QV UPDATE

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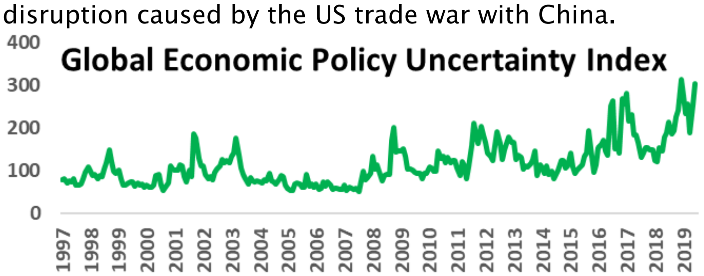
The Price of Certainty

If lower interest rates drive asset prices higher, why does the Japanese stock market trade at only 13x earnings despite the Japanese 10-year bond currently yielding -0.11%?

The simple answer is that low interest rates don't affect asset prices uniformly. Low rates are symptomatic of wide scale central bank asset purchases, but also weak economic growth and inflation expectations in what has been a very uncertain global economy. Investors tend to buy government bonds for the certainty of their return. When government bonds no longer generate a reasonable return, investors logically look to the next most certain asset class for better returns. This drives up the valuations of assets with highly certain returns (bond proxies) as well as those whose intrinsic values are more sensitive to low interest rates (growth stocks). Conversely, assets that are more dependent on economic growth and inflation languish when expectations for both are less certain.

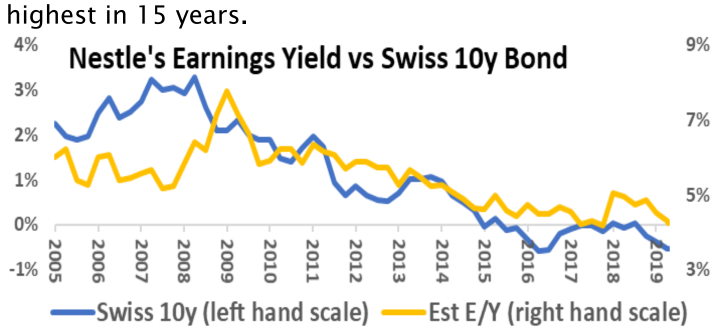
By many accounts, the world is more uncertain today than it has been in a long time. The poles of geo-political power are shifting, trends in globalization have peaked, and policy uncertainty is the highest on record. For businesses exposed to such uncertainty, it is a challenging period. For example, BASF SE, the world's largest chemical company and a recent addition to the QV Global Equity Strategy, reduced its 2019 operating income guidance by 30% last week, partially in response to disruption caused by the US trade war with China.



Source: Economic Policy Uncertainty

From an asset price perspective, a wedge of unprecedented proportion has been driven between the valuations of bond proxies and growth stocks compared to assets whose earnings are less certain (economically sensitive stocks). As noted in our quarterly update, so called low-volatility stocks trade at a price-to-earnings premium of >10x vs value stocks, which is more than double the long-term average since the 1980's. In other words, the price of certainty is very high today.

QV Global Equity Strategy holding Nestlé S.A. is a perfect example of this phenomenon. Nestlé operates in 189 countries around the world, has consistently increased prices while improving operating margins and its earnings are minimally affected by recessions because of the nature of the everyday products it sells. These extraordinary traits exemplify why the global strategy has owned this business since 2009, but they also explain Nestlé's current valuation and why it is only a less than 2% weight in the strategy today. Because Nestlé is so bond-like, as government bond yields have fallen in response to rising uncertainty, Nestle's valuation has moved in lockstep. Today, the price of Nestlé's certainty is the highest in 15 years.



Contrast this with AT&T Inc, the largest holding in the QV Global Equity Strategy. Despite also having stable cashflows over time, its valuation is compressed as investors expect growth to be very low in the future. Today it trades at only 9.5x earnings vs a long-term average of 13.5x. Even if Nestlé grows its earnings at 8.5% for the next five years and AT&T only grows at 1%, AT&T would generate a return that is ~75% higher than Nestlé, assuming both stocks revert to their historical average valuations over time. BASF is further out on the uncertainty spectrum. Although the global economy can't function without its products, demand is cyclical, meaning its earnings are often uncertain in the near-term even if they should be more predictable over a longer horizon. Today, BASF trades at the lowest valuation since 2009, reflecting concerns over the global economy (for this reason the stock was little changed after last week's earnings announcement). Certainty is an important component of value, but today it looks quite expensive compared to the price of some incremental uncertainty.