Dear Client,

Equity markets sailed through rough seas last month. US markets are back to square one, notwithstanding decent gains till last summer, while European markets are clearly in negative territory.

Every day financial media provide new reasons why equity markets are diving: the trade war between China and the US, higher rates in the US, Italy's budgetary issues, the Brexit, considerable currency selloffs in certain emerging countries, the fear for a worldwide slowdown of economic growth, fear of peak earnings in the US, and recently tensions with Saudi Arabia.

Let it be clear, the wall of worries seems to rise further every day.

The recent **negative market sentiment** has translated in several sector rotations. For the industries considered cyclical, like technology or industrials, severe punishments followed, while more defensive industries like healthcare and telecom were able to hold the line. The semiconductor sector saw share prices fall in just a few months' time. After two favorable years, rising fears are the industry will correct substantially in 2019. Worries about inventories, combined with slowing growth perspectives and a few profit warnings resulted in panic among investors, selling en masse the semiconductor shares. Same goes for the automotive and industrial sectors.

Companies that report only a whiff of disappointment have been immediately sanctioned. Amazon and Alphabet both reported solid Q3 figures, with topline growth of 29% and 22% respectively, which showed a solid growth rate. These results were however slightly below expectations and resulted in a downright selloff for the industry. Their investments in future growth have not been acknowledged by the market, which is usually the case. Similarly, Intel reported its best quarter ever with +19% topline growth, so good it cannot keep up production. It was completely ignored by the market.

Looking at **our stock selection**, more than half shows a negative implied growth rate, meaning financial markets expect growth of earnings and cash flows to be negative on a long term perspective. Some stock prices reflect the potential for a global recession in the coming years. Lower economic growth for the US economy in the near future appears reasonable to us given the strong economic growth witnessed in the last decade. But the gap between slowing growth and an outright recession is quite significant, leading us to the conclusion that several companies have been oversold.

Winston Churchill stated: "A pessimist sees the difficulty in every opportunity, an optimist sees the opportunity in every difficulty." The timing of economic cycles is by definition uncertain, but we know for sure that an **investor with a long term time horizon will come across great opportunities**. As experienced the previous quarter, the incoming Q3 reports are robust and do not support the pessimism in the financial markets. Companies like United Technologies, LVMH, Intel, Comcast, Kion, Vinci, Schneider Electric, Alliance Data and Bureau Veritas all reported better than expected results, in some cases accompanied by raised guidance.

Of course, like every quarter, some companies came in below, like AB InBev, WPP or Ingenico. In every case with it was due to company specific issues.

Were valuations then simply too high?

We tend to disagree. The price/earnings ratio for the US equity markets quoted at 16,8x times earnings at the end of September right before the selloff, slightly above the past 25 year average of 16,1x. Europe quoted at 13,5x earnings, below the 25 year average of 14,5x. Europe looks especially inexpensive as rates hardly moved and remain at low levels. With the German 10 year Bund quotes at 0,35%, the risk premium remain significant over the current European earnings yield, or earnings/price of 7,5%. In the US the risk premium is significantly lower as the 10 year rates are at 3,10%. It is however accompanied by higher structural growth. This is confirmed in our own analyses that exhibit very decent free cash flow yields.

Does this mean there are no issues on sight? Or that financial markets will quickly recover?

Not exactly. Markets are driven by two main forces, the economic and company-specific fundamentals and the general sentiment, which can remain negative for quite some time. In the fundamentals area, an escalation of the trade war between the US and China appears to be the greatest risk at the moment as both geographies are of utmost importance to the global economic growth. However, we tend to believe that sooner or later a solution will come, whereby both countries and by extension the world economy will come out stronger. We actually witnessed this scenario recently with the trade tensions opposing the US, and Europe, Canada and Mexico.

Conclusion:

The one thing that is for sure is that uncertainties will always remain. What you can count on is that we are continuously on the lookout for value and that should earnings and cash flows be sustained, value will sooner or later translate in investment returns.

Do not hesitate to contact us if you have any questions.

Kind Regards,

The Management of CapitalatWork Foyer Group