PRICE**VALUE**PARTNERS

American carnage ?

"Most of the events centre on talking. But beyond lectures and panel discussions, the agenda also features more esoteric attractions. One notable event is a simulation of a refugee's experience, where Davos attendees crawl on their hands and knees and pretend to flee from advancing armies.

It is one of the most popular events every year."

- How Davos Brings the Global Elite Together, *The New York Times*, 14 January 2017.

Economists don't necessarily agree on many things, but there is almost universal acceptance that the imposition of trade tariffs worsened the Great Depression. So it is difficult to square the 'America First' language of President Trump's inauguration speech with a rosy outlook for businesses that have hitherto been the beneficiaries of globalisation. Talk is cheap, of course, but the intention seems clear:

"Every decision on trade, on taxes, on immigration, on foreign affairs will be made to benefit American workers and American families."

The very next word in the speech was 'Protection' – but it might as well have been 'Protectionism'.

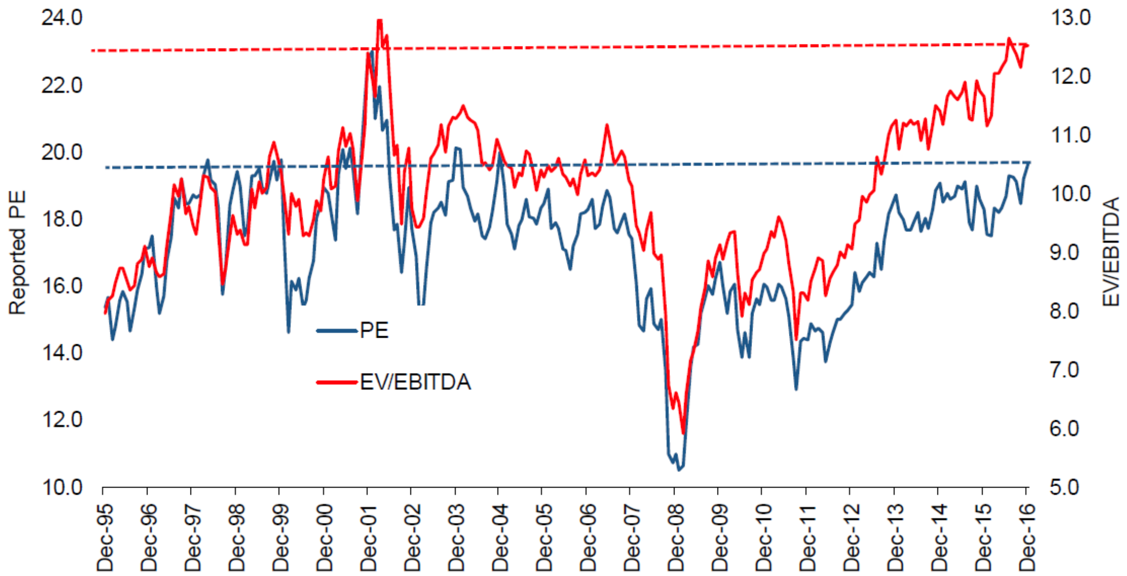
Many have made comparisons between the aspirations of the Trump administration and the economic philosophy of the Reagan presidency. But the financial market environment could hardly be more different. When Ronald Reagan was elected, the 10 year Treasury yield was over 12%. Over the following year it rose to 15.8%. When Donald Trump was elected on November 8, the 10 year Treasury yield was below 2%. It's possible that these two Presidents will have respectively overseen the all-time high and low in US interest rates.

And between 1965 and 1981 the S&P 500 index recorded no net gain in price whilst incurring a drawdown of nearly 50% in 1973 and 1974. By the time Ronald Reagan was elected, investor sentiment was extremely negative. The Reagan presidency sparked an 18 year bull market. The Trump presidency, on the other hand, begins during one of the longest stock market rallies in history, and at a period when market valuations are close to their all-time highs.

The single most important characteristic of any investment is its starting valuation when you purchase it. The starting valuation of the US stock market today can be expressed in one word: expensive. SocGen highlight not just elevated p/e multiples but a stretched ratio of Enterprise Value / Earnings:

THE US IS DRIVING THIS OVERVALUATION

Whilst PE multiples are expensive it is EV/EBITDA that is the real problem

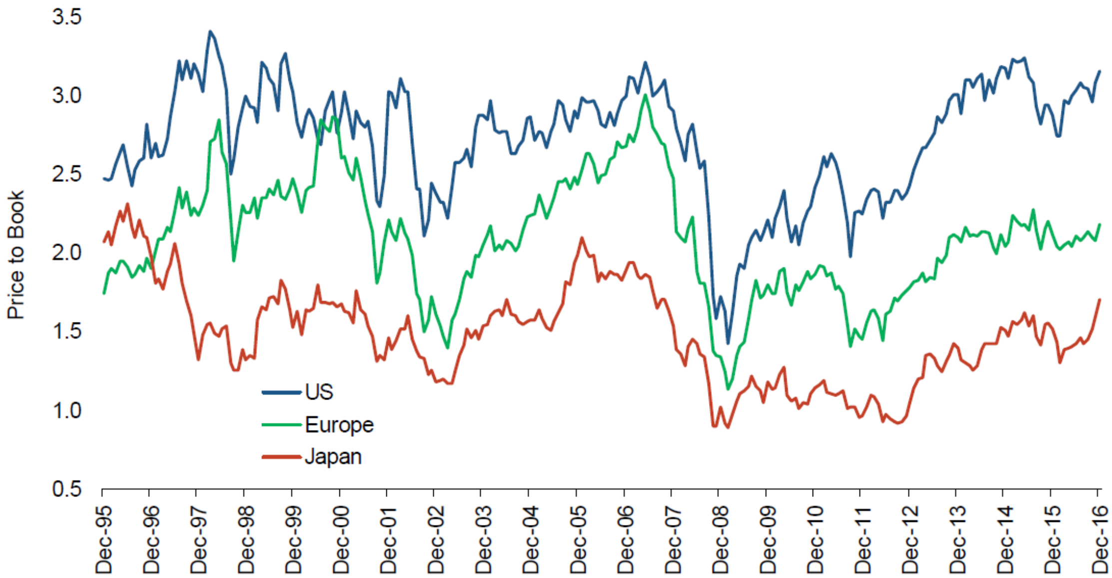


Source: SG Cross Asset Research/Equity Quant, Factset

They also point out the significant divergence between price / book ratios across the US, Europe and Japan:

THE RESULT IS SIGNIFICANT VALUATION DIVERGENCES

Median price to book valuation ratios by region



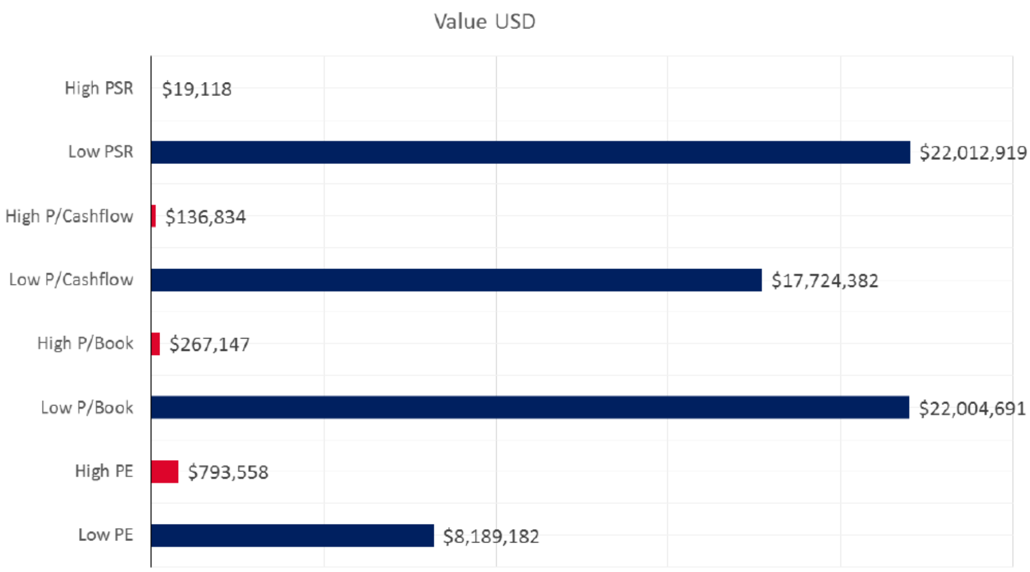
Source: SG Cross Asset Research/Equity Quant, Factset

Price / book is a particularly instructive ratio. When James O'Shaughnessy conducted an analysis of the investment strategies that were ***least*** successful in the US stock market for a period of over 50 years, paying a high price / book ratio for the market was one of them.

O'Shaughnessy scoured the entire market and selected the most expensive 50 stocks by price / book. He then reweighted that 50 stock portfolio each year to ensure that it remained expensive over time. Starting with $10,000 the high price / book portfolio ended, after 52 years, being worth $267,147.

Which sounds like a respectable outcome, until you see how much you could have earned by selecting a portfolio of the lowest price / book stocks instead – one of the ***most*** successful strategies. There, a starting valuation of $10,000 would have ended, after 52 years, being worth over $22,000,000. O'Shaughnessy's original data are shown below. Paying over the odds by way of p/e is similarly damaging to performance over the long run, just as favouring low p/e stocks is tremendously profitable.

Value of $10,000 invested in various strategies for the 52 years ending in December 2003



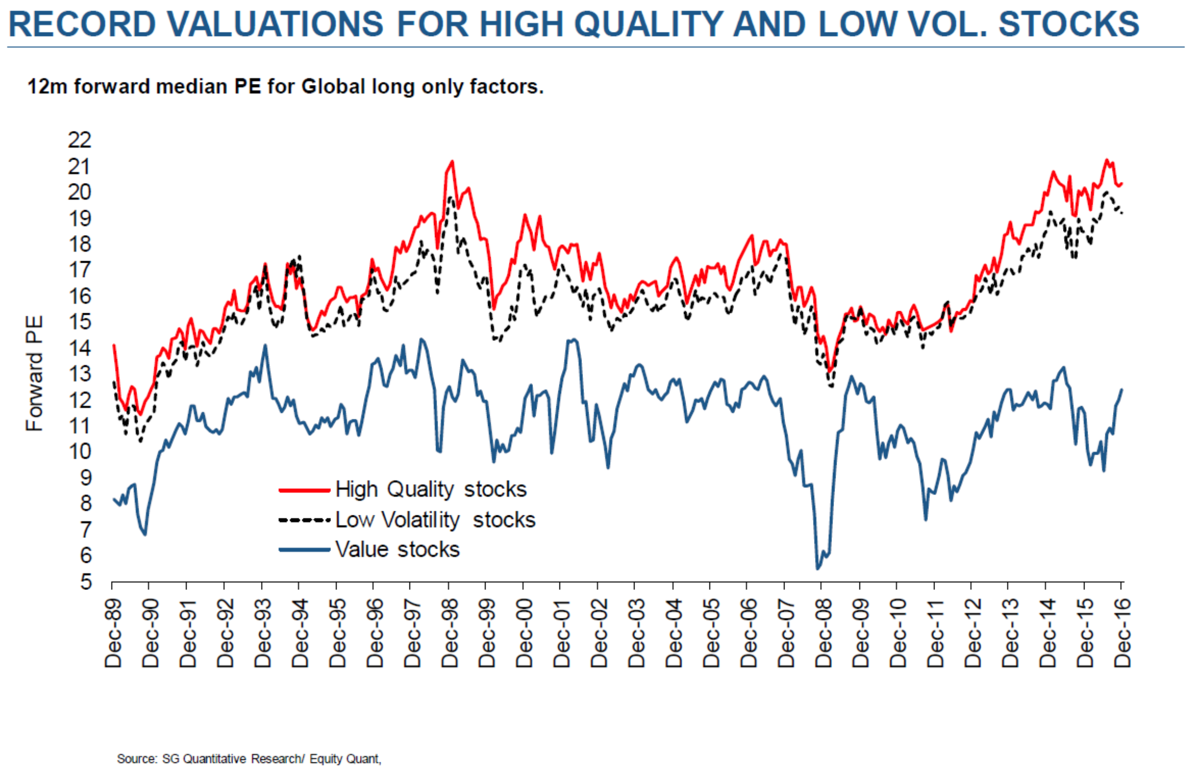
Source: What Works on Wall Street by James P. O'Shaughnessy

52 years is clearly a long time, but the point still holds: over the long run, value strategies beat just about everything. The problem is that most investors don't have the patience to withstand the inevitable periods of sub-par performance.

This is not to say that the entire US market is overvalued; there are still pockets of value in North America, but their numbers are thinning as a band of bold investors increasingly herd into an ever-smaller universe of mega-cap global growth stocks with strong price momentum. But those companies may be precisely the ones most vulnerable to protectionism and trade wars.

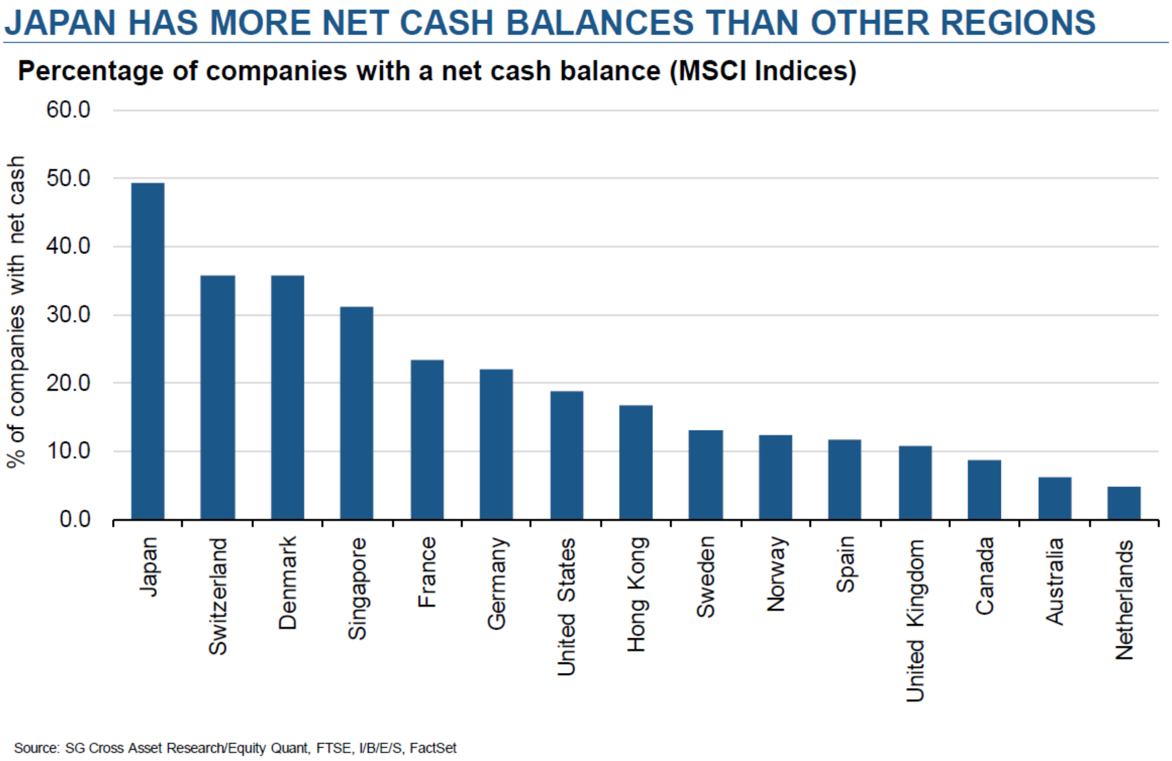
Valuation is not the only problem facing US stocks. A strong dollar will also hurt those US businesses with a sizeable international foot-print. So far the Trump administration, which has only just begun, is sending out mixed messages with regard to the dollar. But given prevailing valuations – and the power of mean reversion – it requires some fairly heroic expectations of future revenue growth to warrant current market prices for larger US common stocks. Any margin of safety is wafer thin.

As SocGen point out, 'high quality' (and 'low volatility') stocks are now trading at close to record levels:



Investors may not appreciate the extent to which high price invalidates the investment case for supposedly 'defensive' stocks – Big Pharma springs to mind, not least because they seem set to be another of President Trump's corporate whipping boys. Disappointment at the performance of 'expensive defensives' may be widely shared in 2017.

If North America stands out by way of high valuations, Japan stands out by way of low and attractive ones. A third of the entire Japanese stock market has a cash flow yield (Enterprise Value / Cash From Operations) of over 15%. No other developed market comes close. And as SocGen point out, Japanese companies also have more net cash than listed businesses in any other country:



So although the Japanese payout ratio, at around 25% to 30%, is lower than the FTSE's 65%, for example, it is likely to rise. Japanese companies are being actively encouraged to improve their capital allocation, which means a combination of higher dividends and share buybacks. Whereas the balance sheets of US companies are groaning with years of accumulated debt, Japanese balance sheets are the healthiest in the world, and they have the cash at hand to distribute. SocGen's Andrew Lapthorne jokes that having spent 25 years derating and deleveraging, Japan is now, incredibly, an equity income play. We agree. This holds regardless of what President Trump may end up doing to his own economy, and stock market.

Tim Price is co-manager of the [VT Price Value Portfolio] and author of 'Investing through the Looking Glass: a rational guide to irrational financial markets'.

www.pricevaluepartners.com