ROBECO
The Investment Engineers

# FUNDAMENTAL EQUITY QUARTERLY - 10 | 2023


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Sustainable Investing Expertise by ROBECOSAM

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 | **Kees Verbaas,** Head of Fundamental Equities

# Vigilance required

Welcome to our renewed and expanded Fundamental Equity Quarterly. In addition to our regular outlook articles for developed markets and emerging markets, we present several new sections in this publication: where we differ from the market, Japan trip notes, sustainability highlights, a 'stunning statistic', and an interview with one of our lead portfolio managers.

Joshua Crabb, Head of Asia-Pacific Equities, opens the series. He talks about his market views and how Robeco's Asian Equity strategies developed. We hear an on-the-ground report from Japan, find out why Robeco's global team thinks some defensive sectors might be value traps in this cycle, and get a review of 2023's AGM season from our engagement team.

Going into Q4, many investors will feel like rock band Green Day's platinum hit record 'Wake Me Up When September Ends'. The S&P 500 and MSCI World indices were down well over 4% in September and sentiment was rather downbeat. Usually, after a weak September we can expect a strong Q4.

However, the foreground is not particularly bullish in our view, although the macro environment is very hard to call at the moment. Even the New York Fed and the Atlanta Fed are almost three percentage points apart in their GDP forecast. Most recession indicators are on red, the looming US debt crisis weighs on sentiment, and the two next biggest global markets, China and Europe, are affected by shrinking global trade and below-trend growth. By way of contrast, two bright spots stand out: two-thirds of companies beat earnings estimates and there is currently more than USD 5 trillion parked on the sidelines in US Treasuries. On balance, we have become more cautious in our developed markets strategies and, although keeping our foot on the gas, have shifted down a gear.

We hope you enjoy reading this Quarterly, and welcome your feedback.

DEVELOPED MARKETS OUTLOOK

**Audrey Kaplan,** Portfolio Manager

# Too good to be true?

Developed market equities are facing multiple headwinds and we have positioned accordingly in the US and Europe, with a preference for high-quality companies with steady cashflows independent of the economic outlook.

## Despite growth fears, inflation is still the #1 market risk

Entering Q4 we believe that the red-hot inflation rates that were eating into purchasing power in the US and Europe are not yet in the rearview mirror given coalescing economic risks and rising oil prices. Multiple US economic risks are making headlines. There's (a) the ongoing United Auto Workers strike; (b) a growing risk of a government shutdown; (c) the October resumption of federal student loan repayments; and (d) the impact of surging energy prices on consumption.

Higher energy prices in turn are likely to complicate the job for developed market central banks. We are therefore left mulling over whether a soft landing is only soft until it becomes a hard landing.

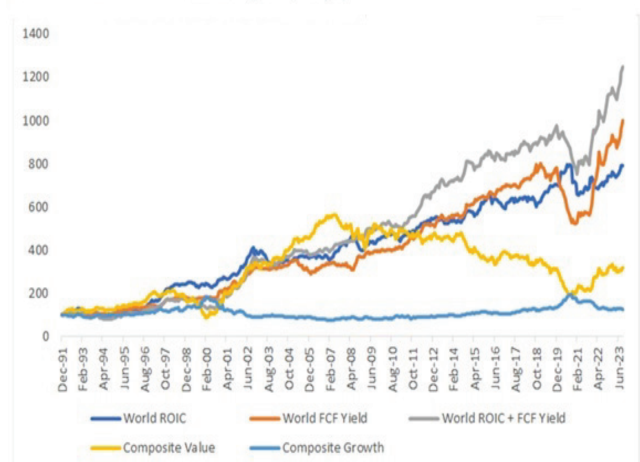
Two years ago, the median projection for the Fed funds rate was to end 2023 at 1% versus the 5.3% we achieved and held at the latest FOMC meeting. The bond market hasn't sounded recession alarms for this long in at least six decades. One signal we've been monitoring is the ten-year yield below the three-month rate – which has persisted for about 220 days (at the time of writing). This type of yield inversion has been a harbinger of contraction in the prior eight recessions.

Moreover, while global institutional investor recession fears have receded, growth risks are still apparent. About a third of market participants expect a European economic recession and a reduced 14% expect a global recession, according to a recent Bank of America survey.

## Valuation is its own concern

The US technology sector valuation is extremely high relative historical standards, and the rest of the US market is in the top 10% most expensive regimes. However, you can still find attractively valued high-quality companies and regions (e.g. Europe). In this context we prefer corporate idiosyncratic risk rather than leaning too much into either a value-focused or growth-focused stance. We seek high-quality companies with strong business outlooks and steady stream of cashflows independent of the pending cloudy economic outlook. There's good reason for our approach. Research from Bernstein shows that, over the long term and over the year to date, a strategy targeting return on invested capital (ROIC) and free cashflow (FCF) yield has been particularly effective as illustrated below.

**World factor Long-Short Cumulative return index**




**Source:** MSCI, FactSet, IBES, Bernstein research and Robeco.

> *"It wasn't until we saw some slightly softer data reinstating the 'peak rate' narrative that the market stabilized.*

### Good news is bad, and bad news is good

Europe earnings revisions for 2024 are more attractive than the rest of the developed world, but European equities have underperformed so far in 2023. Indeed, although some big tech companies seem to have quintessential business models, parabolic stock price rises reminiscent of the dot.com boom in the late 1990s continue to keep us wary, questioning the durability of the 2023 rally. To illustrate the point, we witnessed Adyen's fall from grace in Europe in August, and Nvidia's retrenchment off recent highs despite another giant earnings beat. Ironically, it wasn't until we saw some slightly softer data around US consumer sentiment and the labor market reinstating the possible 'peak rate' narrative that the market stabilized.

### Positioning into the year end

Technically, equity funds had the biggest weekly inflow in 18 months in mid-August according to Bank of America, on growing confidence of a soft landing. According to Deutsche Bank, the market's overall positioning appears neutral heading into the fourth quarter. By contrast, the Robeco Sustainable Global Stars Equities strategy increasingly adopted a more barbell approach to quality investing with a bucket of (i) high-growth value-creation companies at one end and (ii) defensive, high-quality companies at the other end.

| Top overweight industries | Most underweight industries |
|---|---|
| Interactive media & services | Automobiles |
| Personal care products | Healthcare equipment & supplies |
| Electrical equipment | Hotels restaurants & leisure |

This positioning should allow us to capture some upside while cushioning us from the worst of the downside risks. In the former, our largest overweight is in the interactive media & services industry – companies at the forefront of using the world's information (and data) aiming to make information more user-friendly and accessible than ever as well as companies that encourage social connectivity and online communities. In the latter, our largest overweight is in the personal care and well-being products industry, although we are cautious overall on staples companies. Still, personal care companies have standout growth and improving margins. We are focused on companies operating in the consumer healthcare space producing better everyday health products. The companies we own in this space are leading brands with attractive footprints and competitive capabilities.

EMERGING MARKETS OUTLOOK

**Wim-Hein Pals,** Head of Emerging Markets Equities

# Anticipating earnings recovery in 2024

In our view, emerging markets continue to look appealing, as macroeconomics are solid compared to developed markets. Also, we expect 18% (IBES) earnings growth in emerging markets in 2024.

## Policy easing will stimulate equity markets

Interest rate moves in many emerging markets are a driving force behind share price developments. Unsurprisingly, the countries with the largest potential interest rate cuts are preferred in Robeco's portfolio of emerging markets. Brace yourself for the central bankers who are slowly but surely taking their foot off the brake pedal.

## It's time for big interest rate cuts

Hooray, the first major rate cut in emerging markets happened in Chile on the last day of July. To the other extreme, the reduction in Chile was immediately a very large one, a cut by 100 bps, from 11.25% to 10.25%. The most recent inflation rate, the one for September, was still 5.3%. So, still a hugely positive real interest rate of about 5%. In general, marginally positive real interest rates are sufficient to curb inflation while not squeezing the economy too hard. The Chilean central bank therefore still has a considerable margin and can cut interest rates further, another 500 bps from the current inflation level. But inflation is on the decline worldwide, including in Chile. As we move further into the second half of 2023, it is likely that there will be room to reduce interest rates by a few percentage points.

## Caution over China

We'll leave aside the ongoing rate cuts in China for a moment, because that's where the first rate cuts actually took place during the current global interest rate cycle. China's interest rate moves are desperately needed in frantic efforts to revive the sputtering economy. The Chinese central bank is traditionally very cautious about changing interest rates and the cuts are again extremely small at 10 or 15 bps.

## Brazil's monetary policy success contrasts developed markets

Brazil is the second country where interest rates have been lowered after a long time. Interest rates were cut from 13.75% to 12.75%, with 50 bps reductions in both August and September. In Brazil too, interest rates will continue to be in double digits for a few months. The absolute levels are even higher than the ones in Chile with an inflation rate of just over 4% so a real interest rate of just under 9%. Brazil still can't shake off the label of a "high inflation" country despite performance that many central bankers would be envious of. Over the past decade, Brazilian inflation has only briefly exceeded 10%, and its highest level was just 12% in April of last year.

**Emerging markets valuation discount to MSCI World is still at record levels**

**Source:** MSCI, Robeco – September 2023

> *“Interest rate moves in many emerging markets are a driving force behind share price developments.*

Recently, the *Banco Central do Brazil* has had a much better track record than the traditional central bankers of the US, the EU and Japan. In those "rich" markets, interest rates have remained far too low for far too long. We are still reaping the sour fruits of this, with rapidly rising interest rates in both the US and the EU.

### Asia to follow

Asia will also join the party. Several emerging countries will join Brazil and Chile during the remaining part of 2023. Indonesia might be the first to cut in Asia ex-China. The country has a moderate inflation rate of about 3%, a relatively high economic growth rate of just above 5% and a positive real interest rate. So there is room for lower interest rates than the current 5.75%.

### Earnings growth will recover in 2024

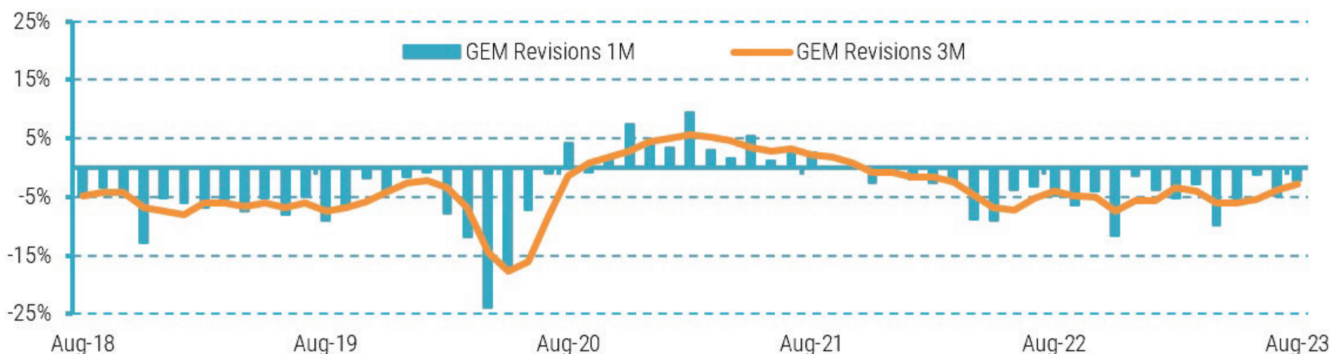
Coming back to the earnings growth foreseen for 2024, i.e. around 18% growth, this may sound like a high absolute number. However, the declining interest rates will come with lower interest bills for corporate emerging markets, which is supportive for the earnings picture.

Furthermore, the 18% growth rate is coming from a low base, i.e. after a bad earnings year 2023. The consensus earnings in Latin America will drop by almost 19% in 2023. Moreover, earnings in Taiwan and Korea are to drop 23% and 36%, respectively. So, overall consensus earnings in emerging markets are going to decline by low- to mid-single digit in 2023. Thus, after the current disappointing earnings year, calendar 2024 is going to be much better, at least from an earnings perspective.

### Strategic implications

We are entering the quarter with a positive view, in particular on countries such as South Korea, Indonesia, Vietnam in Asia, and on Brazil and Mexico in Latin America. From a top down angle, we also like the United Arab Emirates, Greece and Hungary. We foresee the strongest earnings resilience in those countries in combination with attractive valuation parameters. From a sector perspective, we continue to actively overweight information technology and consumer discretionary.

**Earnings revisions trend has bottomed out**




**Source:** MSCI, Robeco – September 2023

INTERVIEW

Joshua Crabb, Head of Asia-Pacific Equities

# "This part of the world is driving global change.

Joshua Crabb has been working as an investor in Asia since 2001, and joined Robeco in 2018. The Australian is Head of Asia-Pacific equities and shares with us his investment philosophy and what he likes in the markets at the moment.

### What originally got you into investing?

My initial interest in investing was sparked by a family friend who was working in the industry when I was young. Embarrassingly enough, the original Wall Street movie also played a role in drawing me to investing.

### Why did you choose Robeco?

I was drawn to the firm because of its long-term fundamental approach. Additionally, I was impressed by the long tenure of many of its employees, which makes sense for a house committed to long-term investing based on research.

### Did Robeco's reputation in sustainable investment play a role?

Sustainability expertise wasn't the core reason for my decision and, even as recently as five years ago, it was still seen as a peripheral issue by many investors in Asia. Since then I've come to rely on that SI expertise and methodology as part of our investment process, and I believe it helps us generate alpha. Sustainable investment in Asia has moved fast and change is occurring now, with regulation impacting operations and hence also share prices. Asia's population and current state of development means the biggest near-term impact of SI will be made here. That's why we have built a local SI team. Clients are interested in both affecting change and enhancing performance – not just excluding – so this is absolutely key to our Asia strategies. Moreover, the metals and mineral inputs and important manufacturing clusters for EV batteries and solar energy are produced here. This part of the world is driving global change.

### What's a good example of how you apply that SI lens?

If you take the auto sector for example, whether it's the industry giants or the new entrants like BYD and Vinfast, assessing the credibility of a carmaker's sustainability roadmap and whether it's consistent with their stated commercial strategy, and their manufacturing and supply chain competencies – that is now absolutely central to picking winners. Product differentiation in terms of traditional metrics like speed or comfort is getting harder and harder in the auto industry so it's innovation at the engineering stage that matters. We are really looking at how a carmaker optimizes its resource footprint, and builds a competitive vehicle more accurately and efficiently. The sustainability methodology Robeco has developed is instrumental to that process.

### Is that process what you enjoy about equity investing?

Absolutely. Equity investing is captivating because there's always something new to learn every day with so many global industries in transition, and it provides exposure to a multitude of interesting sectors and people. Additionally, the unpredictable nature of the market is a humbling experience, constantly reminding you that there's always more to learn. It also gives one the opportunity to help allocate capital in ways that can benefit a vast number of investors.

### What makes a good stock?

A great stock emerges when the real value of a company doesn't align with market perceptions. It's the delicate balance between identifying strong companies and profitable investments. There are always opportunities that the market has mispriced or that are off the beaten track and just not under consideration by most investors. Some stocks in Vietnam have been in that category. You also have to look at how the regulatory and governance framework is changing. Japan has had great companies in the past three decades with world-leading products, but that inherent value has only recently started to reward investors, partly due to governance reform.

**Josh Crabb,** Head of Asia-Pacific equities

# "*With Asia at the same valuations as after past financial crises, there's a real secular growth opportunity here.*

### What's your biggest lesson learned over the years?

Over the years, I've learned the importance of relying on facts instead of bending them to fit a preconceived narrative. It's crucial to understand your unique edge and leverage it to maximize performance. It's also essential to remain authentic and true to label in how you manage the strategy.

### What's your view on China right now?

China's really, really cheap and people are really, really negative. China has some structural headwinds going forward, whether it's demographics or geopolitics. We talk about 'value with a future', and you can buy companies in China at the moment that are actually beating expectations because however bad it is, the expectations are even lower. So, from a stock specific perspective, that's very interesting. But Asia is a lot more than just China.

### So how do you see global markets at the moment?

The current market landscape is more complex than in the past with the unpredictability of geopolitics, and the fact that cash as a benchmark can return around 5%. While the US market has until very recently reflected a very optimistic outlook, the EU appears undervalued, with geopolitical challenges and structurally weak growth prospects impacting valuations of even great companies. In comparison, Asia and emerging markets are undervalued despite their inherent growth potential. With the US nearing peak valuations and Asia at the same valuations as after past financial crises, there's a real secular growth opportunity here. Sentiment over China is clouding that at the moment, but as we all know opportunities arise when expectations are at their lowest. In addition, Asia didn't do all the pump priming in the economy, so this part of the world has the ability to cut rates and stimulate.

### Which trends and opportunities are most prominently reflected in your portfolio?

Robeco's Asia-Pacific equities strategy prominently reflects the end of Japan's deflationary period and the ongoing shareholder-friendly restructuring in the region. It also showcases the effects of supply chain diversification and foreign direct investments, particularly in ASEAN countries like Indonesia, Vietnam, and the Philippines. ASEAN economies with their 600 million-plus population are already benefiting massively as global supply chains diversify away from China. The multiplier effects of capital investment in countries like Indonesia and the Philippines where infrastructure investment is suddenly accelerating makes the promise of emerging markets in Asia-Pacific more compelling than in past cycles.

### How as an active investor do you avoid the noise and the over-information you're exposed to?

Avoiding information overload is challenging in today's digital age. Over the past decade, the influx of data and the rise of algorithms that reinforce your bias have made it even tougher. To navigate this, I prioritize viewing different perspectives and studying history to better understand current events within a broader context. Focusing on facts, rather than opinions, is the only way to cut through the noise.

### What's been your best investment ever?

There have been a few that fit a certain narrative. Smaller companies with great management and industry structures that are overlooked by others and compound earnings over long periods of time to drive performance rather than re-rating. FPT in Vietnam fits into that category.

### If you could meet any historical figure (dead or alive) who had a significant impact on the financial world, who would it be, and what investment question would you ask them?

Nathan Mayer Rothschild, and I'd ask him what he thinks is the best long term investment strategy in an uncertain world.

JAPAN TRIP NOTES

**Kelvin Leung,** Portfolio Manager

# Investors should broaden their Japan exposure

You can feel the buzz on the shopping streets of Tokyo. Most investors are concentrating on (you guessed it!) tech, following the same AI-playbook as across the Pacific, but based on our recent visit to 4 cities, where we had 48 company meetings, we found many other interesting ideas.

## It's happening

After visiting Japan in September, it's clear that the country's current phase of economic growth and structural transformation is real and ongoing. Inflation can be seen in action at vending machines, with Suntory's ice coffee now JPY 140 instead of JPY 100 not long ago. We also noted that Japan's labor shortages are evident in these service sectors with more than 50% of convenience store employees now foreign workers in some metro areas.

## Narrow focus on familiar names

During our conversations we learned that overseas investors are primarily focused on Japan technology and industrial automation names, thereby neglecting other interesting sectors. Value stocks often get bypassed, despite the broader, multi-year, corporate governance reform opportunity. From our perspective, the tech trade in Japan is now very crowded, following the AI-driven US trend with any earnings surprise on the downside likely to be scary. Industrial automation is in the same category with China-related downside risk growing in our view. The consumer sector is also a focus for foreign investors but here we are more positive. Domestic department store sales are high and we saw how busy they are. There are good reasons to think this reopening trend could persist with Chinese tourists returning and with the weaker Japanese yen, tourists are also spending more.

## Investors need more convincing on autos and real estate

We have been constructive on the auto sector but were surprised that it's currently a popular short. The Japanese OEMs themselves seem confident based on the conversations we had, with North America sales recovering strongly since the Covid supply chain issues.

Japan real estate is underappreciated in our view. In Tokyo, rents for offices, hotels, retail, logistics and residential assets are all rising which is very positive, and this sector is not a crowded trade. Investors are also ignoring real estate's decade low valuation and strong correlation with higher domestic inflation.

## The big restructuring picture is intact

A lot of the hidden value in Japan is still to be revealed in our view, with cross-ownership structures yet to be unwound and potential to go beyond the 1x price-to-book benchmark that's been set. The Japanese market is offering many appealing opportunities and we remain significantly overweight going into the new quarter.

# Defensive sceptics

One area where our positioning differs from the market is in the so-called defensive sectors – those companies which traditionally have been safe havens for investors in tough times. In particular, we're cautious about consumer staples businesses, where fundamentals are weakening.

### Consumer staples fundamentals wilt

The staples sector is a segment whose defensive qualities are questionable right now, and we therefore do not consider it to be particularly interesting. Our concern is that many of these companies have raised prices too far over the past two years to make up for input cost inflation. In particular, the staples businesses that are exposed to tier two brands will likely experience a substantial decline in volumes, as consumers continue to trade down to non-branded consumer goods in supermarkets.

On the positive side, we consider the defensive qualities in many pharmaceutical stocks to be intact. We like healthcare a lot better than staples overall, in that pharmaceutical companies look cheap, and will not face the same input cost and consumer spending pressure that staples businesses are dealing with.

### Policy-induced pressure on the consumer

We think that US interest rates may remain higher for longer, as we continue to see upward pressure on energy and food prices. As a consequence, we do not think that core inflation in the US will fall back to 2% very quickly.

This will keep the US Fed on their toes, which means we may see higher rates for longer. We only expect the Fed to start lowering rates closer to normal levels around the middle of 2024. We expect the same for Europe, where we also see stickier inflation, and therefore expect that the ECB may keep rates higher for longer, thereby hurting the economy.

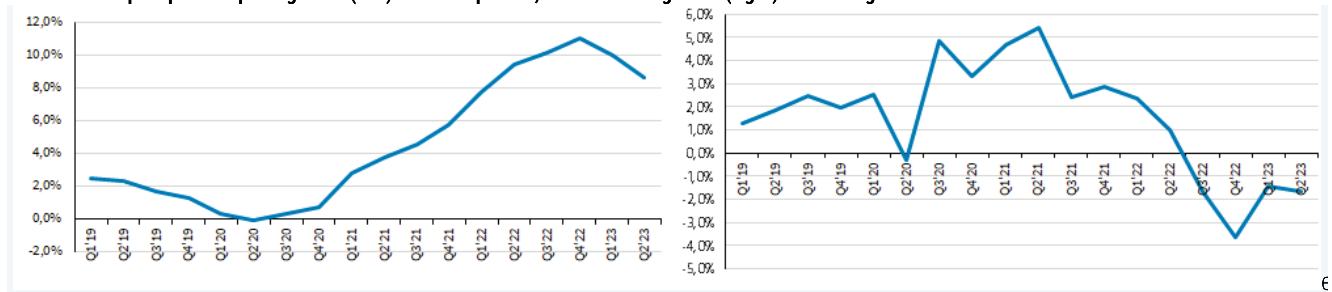
It all means that many of the buffers and support that consumers had in the wake of Covid have now gone, which we believe will eat into consumer spending. And this time, it means that many stocks which are typically considered defensive may be lackluster performers.

### Utilities as value traps

In the case of utilities companies, we're concerned about poor cash flow generation, as most governments will likely keep a lid on the pricing of utilities services to consumers.

Additionally, these companies are generally heavily indebted. In some countries (like the UK, for instance) the utilities' debt is inflation linked, which makes for a toxic cocktail. There is hope for a change in the outlook for the sector, but our view is that only once rates have peaked will utilities become more interesting.

**Consumer Staples product price growth (left) was exceptional, while volume growth (right) turned negative**




Source: Company Reports, Barclays, Robeco.

# Rocky US AGM season but Japan moving forward

Active ownership is a key pillar of sustainable investment and influences policies that can ultimately enhance corporate performance, but 2023's AGM season wasn't entirely smooth.

### Platform for protests

This was the first year that physical attendance was possible for most AGMs after the Covid pandemic. However, it turned out that 'normality' had not fully returned.

"AGM attendance has shifted in tone and nature," says Michiel van Esch, Head of Voting at Robeco.

"In some cases, these meetings become a platform for protest, either on climate change, social issues, or other frustrations with companies that often face conflicting expectations from stakeholders. The AGM as a platform will need some work in the future, making sure that it can remain an effective platform to exchange thoughts and information, potentially for a wider set of stakeholders."

The Robeco team cast at least one vote opposing some aspect of the company's activities at 65.4% of all the 5,176 shareholder meetings voted on behalf of clients between January and June 2023. Voting took place on 59,911 proposals – including 863 sustainability related resolutions – in 71 countries where Robeco owns shares. Many different topics, ranging from board composition, remuneration structures and sustainability topics, were covered.

### Hidden agendas complicate US voting

In the US, there was an increase in the number of shareholder proposals filed, but lower average support. One worrying trend was a significant increase in deceptively-worded proposals, where the requested change appears supportable, but has anti-ESG motives behind it. Due to this emerging strategy of masking the proposal's intentions, there was concern that shareholders would not be able to adequately discern the anti-ESG proposals from the rest. However, these type of proposals have not gained significant levels of support to date.

### Japan's governance transformation

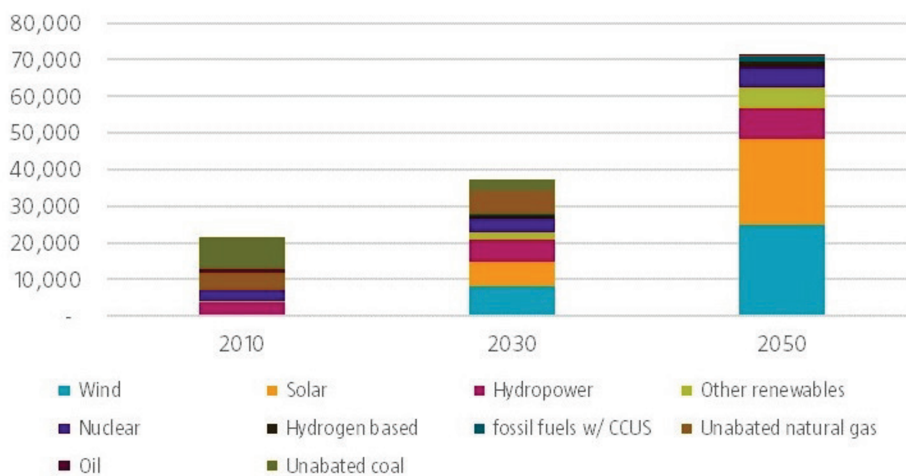
However, in Japan this year's proxy voting season has emerged as a pivotal time for shareholders to influence corporate governance and advocate for change. Several notable trends have emerged, highlighting a shifting landscape that demands stronger shareholder rights and accountability. In line with global trends, shareholders are placing increased emphasis on ESG considerations in many Japanese companies. This was reflected in a record number of proposals within Japan this season.

### Financials under climate scrutiny

During the 2023 proxy season, financial institutions met a significant number of shareholder proposals requesting additional action and disclosures on their climate impacts. Investors are increasingly demanding financial institutions to show how they are supporting the transition to net zero, and one of the most frequent requests from shareholders has been the introduction of an annual management proposal outlining the company's climate strategy. This will allow shareholders to hold companies accountable for their transition plans, and incentivize them to incorporate climate change risks and opportunities into their decision-making.

# Renewable energy, sooner than you think

Driven by technological progress, public demand and government support, the world is on track to add as much renewable energy capacity in the next five years as it did in the preceding 20, according to the International Energy Agency (IEA). Although solar and wind power accounted for only 9% of global electricity production in 2020, this is set to increase to 40% by 2030 and to 70% by 2050, says the IEA. Notably, in 2025, solar and wind power combined should overtake coal as the largest global source of electricity. The energy transition appears on track to arrive sooner than anticipated.




**Source:** IEA, Robeco Thematic Equities team

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