NEW PROVIDENCE

International Series
July 2020

Frank Brochin

Investing Internationally in the Post-Coronavirus Era

Summary

Assuming that the Coronavirus crisis eventually subsides and the world returns to normality, how should investors outside of the United States adapt their investment strategy in the post-crisis era?

In this paper, we argue that investors should continue to favor secular growth opportunities in the Asia (ex-Japan) region, where the next normal will be the old normal and the fundamental investment thesis will remain in place.

In contrast, Europe and Japan will become less attractive, as their political, fiscal and monetary response to the crisis will further challenge their economies. In an environment of low economic growth and interest rates, investors in these markets should favor selected growth-oriented investments.

Asia (ex-Japan)

For the most part, governments in Asia (ex-Japan) have chosen not to "monetize the Coronavirus crisis". Unlike the United States, Europe and Japan, which have merged their fiscal and monetary policies and massively inflated their money supplies, other countries in Asia have mostly followed relatively orthodox, conservative policies. Interest rates remain comparatively high: China's 10-year bonds yield 2.8%, India's 5.9%, and Indonesia's 7.2%.[1]

When the health crisis eventually subsides, in contrast with developed markets, Asia (ex-Japan) will return to its pre-crisis state and **the next normal will be the old normal.** The drivers of the investment opportunity will remain, and the investment thesis described in our paper "Why Invest in Developing Asia?" will still be valid.

Fundamental investment principles will continue to apply in a normalized economic environment. Investors will be able to structure portfolios around economic developments, with the main drivers of growth still in place and attractive stock returns potentially available in various sectors, even prosaic ones. In fact, Asia's attractiveness as an investment destination will increase because global investors will seek in Asia the secular growth that they cannot easily find in their home markets.

Thus, investors outside of the United States should seek managers with the skills and experience to underwrite growth in Asia (ex-Japan):

- Such growth should be easy to find given the secular socio-economic trends taking place around the region. The ability to understand its drivers and appreciate its duration will be key.

- They should invest in the growth of New Asia rather than seek value opportunities in Old Asia. Pure value-oriented strategies, however well executed, are often not as successful in Asia because the mechanisms used to close the value gap in Western markets do not always exist or are not culturally acceptable.

Developed International Markets

Developed economies have engaged in massive money printing to limit the economic impact of the Coronavirus crisis. In turn, **for Europe and Japan, the next normal will not be normal:**

- Interest rates were close to zero or negative before the crisis, and given the unprecedented amount of stimulus, it will be hard to normalize monetary policy. While low rates may keep governments solvent, they have negative effects on the economy, banks and businesses:

- They are bad for banks, which will find it difficult to make money. It is hard for a region to build a healthy economy with unhealthy banks.

- They are bad for industry and business. Low rates allow industrial projects with low potential growth and low marginal returns to get financed, they allow zombie companies to survive and ruin margins for other players. Capitalism does not work well without a hurdle rate for investments.

- They are bad for investments and productivity. Low rates induce companies to practice financial engineering, and buy existing assets rather than invest in new, productive ones

- With social pressures increasing following the crisis, governments have started to become more involved in the economy, via increased regulations, price controls or direct ownership of nationalized assets. One should expect government spending to increase, along with taxes and social policies. This will slow down business growth.

[1] Source: Bloomberg, June 30, 2020.

What is rare becomes more valuable. Thus, as earnings growth becomes harder to find, it should become more valuable. In turn, the valuations of growth companies should continue to increase, as they already have done in the recent past. If rates remain "lower for longer", growth stocks may become extremely valuable because lower rates will increase the discounted value of their future earnings.

So how should investors approach Europe and Japan?

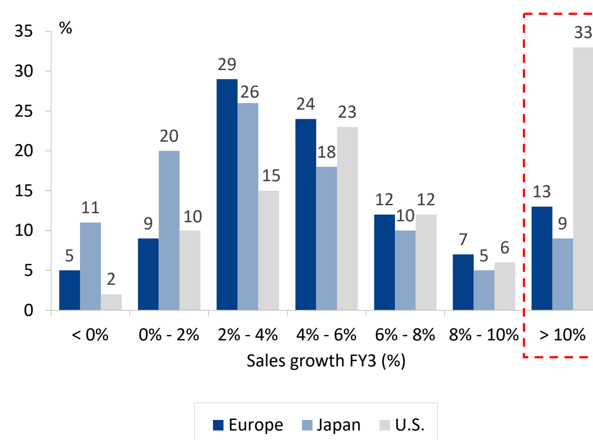
- They should seek managers able to find growth in a challenging economic context. As opportunities will remain rare, they should favor managers with broad geographic mandates and the ability to focus on niche, underappreciated growth sectors.

- As fast-growing companies become harder to find, concentration will be key. Investors should avoid mechanical factor strategies leading to very diversified portfolios.

- Careful stock selection will become even more important given that the overall trends will not be favorable. Thus, investors should continue to focus on managers with a very deep understanding of what they own and why they own it.

Investors outside of the United States should keep in mind that growth was already hard to find in Europe and Japan before the crisis. As shown in Chart 1 below, there is a substantial difference in the number of growth companies in the United States, and Europe and Japan. For example, companies accounting for just 13% of STOXX 600 market cap are expected to grow sales by 10% or more in FY3 on consensus forecasts while the S&P 500 has almost three times as many such stocks.[2]

Chart 1: % of Market Cap by Sales Growth Expected in FY3[2]



Non-Asian Emerging Markets

For a variety of reasons, and considering all the damage caused by the Coronavirus crisis, we believe that other emerging markets in Latin America, Eastern Europe, Africa and the Middle-East remain purely speculative at this time, regardless of how much these markets may have declined.

[2] Source: Goldman Sachs, May 2020.