March 2020 Boston Partners Market & Portfolio Update

With the emergence of COVID-19 disrupting personal and business activity, we wanted to share our assessment of things as it relates to the global equity markets. Starting with a view of the economic picture, things are going to slow. US GDP will likely show solid growth in Q1, followed by significant negative GDP growth in Q2 and breakeven to negative growth in 3Q with a solid pickup in economic activity in 4Q. In all, Q2 will feel like a recession and if we dip into negative growth in Q3 this slowdown will be classified as a recession.

We anticipate an aggressive policy response with both monetary and fiscal stimulus over the coming months. The Fed recently reduced the Fed Funds Rate to close to zero and fiscal measures such as interest free small business loans, employee sick-time payments and payroll tax relief are being considered. These actions should provide relief and accelerate a return to normalcy.

Market sentiment has been decidedly negative during the last month. We will continue to monitor a myriad of economic statistics such as oil, copper, and gold prices, 10-year bond yields, the yield curve, credit spreads, company guidance, weekly jobless claims and current active cases of COVID-19 worldwide. As a reminder, the Chinese equity market has stabilized as represented by the MSCI China Index after the number of active cases peaked around the end of January. Perhaps a similar peaking in cases in developed countries will act as a catalyst for a global equity market rebound.

Over the second and third quarters we expect slower global growth (potentially an official recession in the US) and significant downward earnings revisions. Current consensus 2020 earnings growth is about 7% and we believe a decline of 10% plus is likely more realistic. We expect the most significant earnings reduction will occur in Q2 and Q3. Inflation will likely remain subdued and fears of deflationary spirals may creep into market sentiment. When the virus appears contained (sometime in Q2?), we believe the Federal Reserve will be reluctant to increases interest rates in order to maintain ample liquidity in the system. Fiscal stimulus will also supplement the Fed policy mix to help with a recovery.

Within our US portfolios, we are focusing on taking advantage of relative valuation discrepancies and mis-pricings caused by market volatility. First, equity valuation spreads (the difference in valuation between the most and least attractive stocks as ranked by our models) are the widest (largest price discrepancies) we have seen since the 2008 financial crisis. This serves as a reminder that one wants to maintain attractive valuation characteristics throughout the cycle and that this has historically been a good entry point for value-oriented portfolios. Second, portfolio composition has changed as a result of recent market events such as a reduced exposure to energy as the combination of falling demand and increased Saudi supply has created a cash flow shortfall across the industry. Transportation related holdings have also been reduced as travel restrictions and supply chain disruptions have significantly reduced our earnings expectations. We have trimmed some bank holdings as the shift down in the yield curve will pressure net interest margins. However, this group appears inexpensive and we may get an opportunity to add to positions at lower prices after future rate cuts by the Fed. Lastly, we are using the significant market downturn as an attractive entry point to buy businesses with high quality balance sheets and predictable cash flows; examples include: high quality pharmaceutical companies, defense contractors, consumer stocks and property and casualty insurance companies with strong balance sheets.

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For markets outside the US, we are seeing more attractive relative valuations. Additionally, Asia seems to have a better handle on managing the COVID-19 outbreak and is further along in the cycle. As a result, we are actively looking for opportunities in Asia. As the market downturn has accelerated, we are witnessing some opportunities created from the dislocations. Holdings with defensive characteristics have held price to an extent; but are down disproportionately to underlying fundamentals. Gold miners for example, have traded down with the market by 20-30% despite the price of gold up 10%. We believe that these differences will converge as conditions normalize. Food companies and high-quality insurance names also provide ballast to the portfolio. In terms of new opportunities, we see opportunity arising from the downturn in high quality technology companies that are now trading at 15x earnings down from 25x earnings. We are also seeing attractive values in European banks, industrials, and cyclical technology.

Lastly, we are seeing opportunities in our long/short portfolios as the goldilocks economy of low growth, low inflation, low rates, and steadiness has given way to a more perilous economic landscape. We believe that this sets up well for portfolios that seek to find alpha in both overvalued and undervalued positions. As our long portfolios participate in many of the areas described above, we will focus on the short portfolio.

Short portfolios are positioned with low quality cyclicals with balance sheet risk and declining earnings. This includes regional banks that are trading at 1.5 to 2.0x book value, commodity chemicals businesses, and energy companies with weak balance sheets that require $50-60 oil prices. Profitless prosperity stocks also populate the short portfolio as software-as-a-service companies are valued beyond their fundamentals as are high flying health care companies. Recently, we shorted an expensive aircraft engine manufacturer with their major customer exposure heavily tied to international air travel.

Boston Partners was founded in 1995 and we have been through many turbulent market events together as a team including the Tech Bubble of the late 90s and the ensuing recession, the Global Financial Crisis and the Brexit era. Our time-tested three-circle process has served us well historically during times of extreme market dislocations. Today we are navigating more market turbulence and are looking at this as an opportunity to utilize our approach to effectively guide our client portfolios through the volatility.

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