Principal Global Equities

Principal

Quarterly commentary

Diversified International Equity

2019 third quarter

Market review

The third quarter of 2019 was highlighted by volatility and dispersion in returns but despite all the consternation and tug of war in geopolitical events, returns were relatively muted overall helped by strong advancements in the final month of September. Much like the second quarter, slowing global growth and escalating trade tensions between the United States and China weighed on investor sentiment during much of the quarter. The political brinksmanship in the United Kingdom regarding Brexit, mixed messages from the U.S. Federal Reserve (Fed), the lingering protest movement in Hong Kong and the formal initiation of a U.S. presidential impeachment inquiry all added to the apprehension. Despite all these uncertainties, sentiment swiftly turned positive towards the end of the quarter led by more productive talks between U.S. and Chinese deputy negotiators. Adding to the shift were various further stimulus measures being implemented by central banks across the globe to moderate growth concerns.

Many long-standing themes persisted in the quarter, but some notable shifts emerged during early September. Overall, sector leadership favored higher yielding less economic-sensitive groups like real estate, utilities, and consumer staples but the final month told a very different story. A modest rise in bond yields and moderating recession fears unleashed a resurgence of value, particularly among financials and small cap shares during September, contrasting the longstanding dominance of growth, quality, and low volatility segments of the market. U.S. markets also extended their relative dominance in comparison to most international markets. The more accommodating stance of the Fed contributed to the advancement while a healthy consumer and housing backdrop were able to offset cracks in the manufacturing data.

The upswing in September wasn't enough to help emerging markets finish with positive returns for the quarter, particularly among the greater China variety. A host of economic releases emphasized further slowing in the region prompting the Peoples Bank of China to step in with additional liquidity measures, notably allowing the yuan to breach the symbolic 7-to-1 threshold versus the U.S. dollar. Positively, trade talks between the U.S. and China did progress in the latter part of the quarter with another planned meeting to take place in October. We remain far from any sort of "grand deal" but the U.S. is delaying some of the Chinese tariffs and Beijing responded by increasing imports of American farm products setting the stage for further advancements.

Growth contraction dynamics also hampered European markets as contagion effects from slowing global trade hit export-oriented countries particularly hard, especially Germany. Growth is slowing, inflation is non-existent. All the while, Brexit continues to devolve without any semblance of a resolution ahead of the October 31 scheduled withdrawal date. Markets were once again rattled as Prime Minister Boris Johnson sought to suspend Parliament for an extended period ahead of the exit date. That attempt was swiftly reversed, leading some to speculate Johnson must compromise or be forced from office. Even if a surprise compromise is somehow achieved, it's not a forgone conclusion that the European Union will be willing to oblige. Perhaps its little surprise that some measures of relative valuation are at multi-decade lows for UK listed stocks compared to other developed markets. That presents opportunities among some leading global companies, that are being shunned merely as a result of their headquarters location and listing domicile, but selectivity is clearly warranted.

The quarter wasn't kind to industrial commodity prices, and even tougher on the shares of commodity producers. Global oil prices (Brent), slumped 9% during the quarter despite spiking to US$70 in September on the news of the Saudi oil field drone attack. An investigation into the matter has all signs pointing to Iran being at the heart of the attack, further straining U.S. and Iranian relations. The gains in oil prices quickly dissipated as the Saudis noted they'd be able to get operations back online sooner than expected. Conversely, precious metals advanced amid the low rate environment and heightened geopolitical risks.

The fixed income markets continue to do their part in making stocks comparatively attractive. As widely expected, the Fed lowered overnight rates by a quarter of a percent to a target range of 1.75% to 2.00%. Meanwhile the yield on the 10-year Treasury briefly fell below 1.5% nearly matching its all-time low in 2016, before rising slightly to finish the quarter at 1.68%. This compares to 3.1% a year ago. The closely watched spread between 2-year and 10-year Treasury notes briefly inverted in August, before risking slightly to close the quarter at a mere 0.05% (5 basis points). In other words, the yield "curve" is basically as flat as a pancake. Indeed, the yield on the ultralong 30-year bond briefly fell below 2%, and below the dividend yield of the S&P 500 for the first time on record. The yield advantage on stocks remains even more pronounced in Europe and Japan, where an estimated US$17 trillion in sovereign bonds trade at negative nominal rates. Credit spreads finished the quarter largely unchanged, while nominal effective rates for both investment grade and high yield corporates remain near all-time lows. Corporate CFOs remain incentivized to sell bonds (issue dept) and buy stocks (share repurchases), accommodating the somewhat counter intuitive propensity for many investors to do the opposite.

Strategy review

The portfolio underperformed the index over the quarter.

Top contributors

Stock selection in Germany contributed to outperformance, led by not holding SAP SE. SAP is a multinational software company, developing business software, consulting, and providing training services. Valuation had healthy growth priced in from a revenue perspective (3.5% to 8.0% going forward) as well as margin expansion expectations (to 23.5% to 26.0%). Our overvalued viewpoint led us not to hold this company, which proved positive for the portfolio as the company underperformed during the period under review. The weakness stemmed from poor 2Q 2019 results that saw organic growth missing expectations led by the licensing segment as uncertainty surrounding the U.S.-China trade relations is beginning to have a negative impact.

Stock selection in China contributed to outperformance, led by an overweight position in ANTA Sports Products Ltd. Anta Sports Products Ltd is a China-based branded sportswear producer, engaging in the designing, manufacturing, and distributing of sports products under the brands ANTA and FILA. In April, the company acquired Amer, another sportswear manufacturer/distributor, which we expect to contribute positively to the company's full year earnings. During the period, Anta also reported Fila brand sales grew 70% year-over-year, with the average discount level narrowed by 3% driving its share price higher. Moving forward, earnings upside will be driven by an improved portfolio mix as well as margin expansion led the Fila brand.

Stock selection in the consumer discretionary sector also contributed positively to performance, led by an overweight position in Li Ning Company Limited. Li Ning Company is a local sportswear brand in China, with sales through wholesale, direct retail, and online sales. Li Ning has restructured its distribution channels, brand portfolios, product categories, management team, and supply chain strategy, leading to improved business

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fundamentals. During the period, Li Ning reported core net profit 10% above consensus expectations, supported by higher operating cash flow & further improvement in receivables. The company also announced the hiring of a new joint CEO and executive director, who brings extensive experience in supply chain, products, and merchandising management to the company. We believe this joint CEO structure helps to smooth the CEO position transition with low execution risk.

Stock selection in South Africa also contributed positively to performance, led by not holding Sasol Limited. Sasol is South Africa's largest integrated Energy and Chemicals Company. Its core business is adding value to low-cost coal and gas feedstock through its proprietary technology, Fischer-Tropsch, for the production of fuel and chemical feedstock. The company has witnessed continued weakness stemming from the delays of its LCCP project driving downward guidance to earnings before interest, taxes, depreciation, and amortization. The portfolio will continue to not hold given downside risks to earnings and dividends.

Stock selection in the industrials also contributed positively to performance, led by an overweight position in Itochu Corporation. Itochu is one of the five major Japanese trading companies, with diverse business exposure including textiles, food, retail, ICT, and machinery. During the period, the company reported net profit 10% ahead of consensus, achieving 30% of full-year guidance within the first quarter driving returns higher. Strong underlying trends in core businesses, such as textiles and food, paired with strong cash generation, are expected to grow profits over the next two years. The company is being the most proactive of the Japanese trading companies in terms of enhancing shareholder returns, announcing multiple buybacks in the past two years and cancelling treasury shares.

Top detractors

Stock selection in the UK detracted from performance, led by an overweight position in Prudential plc. Prudential is a UK-based, global life insurance company with leading operations in Asia, the US, and the UK. Much of the company's relative weakness as of late reflects an increasingly challenging macro backdrop, namely Brexit, but the company did report strong operating profits during the period. Prudential's Asian Life business is one of the most attractive insurance franchises in the world, with high returns, steady growth and strong cash generation. The company has chosen to focus on South East Asian countries, for they have a young, growing population, very low state provision of a safety net, and very low (but growing) insurance penetration.

Stock selection in the Netherlands detracted from performance, led by not holding ASML Holding NV. ASML Holding engages in the development, production, and servicing of advanced semiconductor equipment, consisting of lithography related systems. It mainly caters the makers of memory chips and logic chips. The company has an EUV backlog extending in to 2021 by customers such as TSMC, Global Foundries, Samsung and Intel, in which they will have 100% of the extreme ultraviolet lithography (EUV) market segment. The growth and progress in the EUV segment drove its share price higher though we continue to not own given concerns surrounding supply and pricing in the semiconductor industry.

Stock selection in the communication services sector detracted from performance, led by an overweight position in SoftBank Group Corp. Softbank is one of Japan's largest mobile telecom companies, operating in mobile telecom and broadband areas in Japan and as the owner of mobile operator Sprint in the United States. Poor reception of the WeWork listing during the previous month has casted a negative shadow on SoftBank, as the company holds a 29% stake in WeWork along with its investments in Uber Technologies that has underperformed since going public this year. Expectation is for Softbank to benefit from improving operational trends, and to continue to invest their cashflow into new companies in the tech/telecom space which will drive earnings growth.

Stock selection in the real estate sector also detracted from performance, led by an overweight position in Wharf Real Estate Investment Co. Wharf Real Estate Investment Co. engages in the investment in strategic and substantial retail, office and hotel operations, with 75% to 80% of its business in Hong Kong. The company's prime asset, Harbour City, accounts for over half of its net asset value. Hong Kong protests and investor concerns on potential slowdown in high-end tourist spending led weakness in the quarter. However, the company's strong execution has helped its aggregate tenant sales growth to continue to outperform that of the overall market, while its direct access to giant and quality retail assets in Hong Kong should drive relative outperformance.

Stock selection in Sweden detracted from performance, led by an overweight position in Telefonaktiebolaget LM Ericsson. Ericsson develops and manufactures network equipment and software, as well as services for network and business operations. The Company's portfolio also includes products for the enterprise, cable, mobile platform, and power module markets. During the period, Ericsson reported their digital services operating profit was down SEK -1.3 billion, worse than consensus estimates. However, segment profitability continues to show progress toward the break-even point. Ericsson continues to emerge from a 2-year turnaround effort spearheaded by CEO Borje Ekholm, who assumed the role in January 2017. The company's turnaround efforts have centered on "stabilizing and simplifying" the business.

Outlook & strategy

Market consternation brought on by volatile Sino-American trade relations, a rash of geopolitical events including the U.S. impeachment inquiry as well mixed messages from the Fed has led to abrupt shifts in investor sentiment and swift dispersion in style and sectoral performance.

By extension, global manufacturing is decelerating as various company managements deal with the number of uncertainties and their investment plans. This coupled with renewed strength in the U.S. dollar has brought stagnation in earnings following periods of high-single to double-digit growth. Negative global revisions have ensued broadly. With that said, the consumer has been unwavering despite the unnerving amount of geopolitical uncertainty. As tax deduction credits expire, the question now turns to if consumer spending will remain on solid footing. This along with a favorable housing backdrop is providing support to near-term earnings.

As Sino-American trade relations eb and flow between escalation and de-escalation and economic data comes in mixed at best, central banks have turned to easing monetary measures to help stave off any near-term recession fears and help act as a safety net. Emerging economies have been at the heart of this including the People's Bank of China and the latest being India and their announced corporate tax cuts. Expectation is now for European Central Bank to implement more proactive measures as the region's growth is having negative effects from slowing in China with Germany at the heart of it. Lastly, the Fed has moved from a split committee to majority dovish evidenced by the recent interest rate cut. We're seemingly reverting back to a loosening environment with so much uncertainty across the globe.

Global yields have moved in a synchronized fashion lower, although found modest reprieve in September, with select European 10-years and Japanese government bonds posting negative returns. Notably, the German bund hit an all-time low of -0.7%. The U.S. 10-year shot below 1.5% before bouncing higher as it remains in a tug of war of its next directional pull. As the globe remains in a period of lower for longer rates, U.S. stocks now offer more yield than the 30-year U.S. Treasury bond, a move not seen since March of 2009, which should make stocks more attractive.

While uncertainty remains, it cannot be discounted that the comparisons of earnings and cash flow yields on equites remain quite attractive relative to government and corporate bond yields. The gravitational pull of low and negative yields abroad is consistent with our longstanding view that long horizon accumulation and liability funding objectives still have minimal opportunities to be met without meaningful equity exposure. Selectivity is key.

Regardless of the region, sector, or general market conditions, our bottom-up focus on sustainable earnings trends and valuations relative to expectations remains a constant across the portfolio and helps rise above the fray of short-term "risk on/risk off" tendencies of many investors during bouts of volatility. As always, our analysts' search for underappreciated fundamental change at attractive valuations continues and, despite the macro noise, is highlighting profitable investment opportunities across sectors and regions.

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