OPINION / COLUMNISTS

SHANE WATKINS: Upside abounds in the great rotation from growth to value

Joe Biden's victory in the US and coronavirus vaccine prospects are reversing powerful trends towards developed markets

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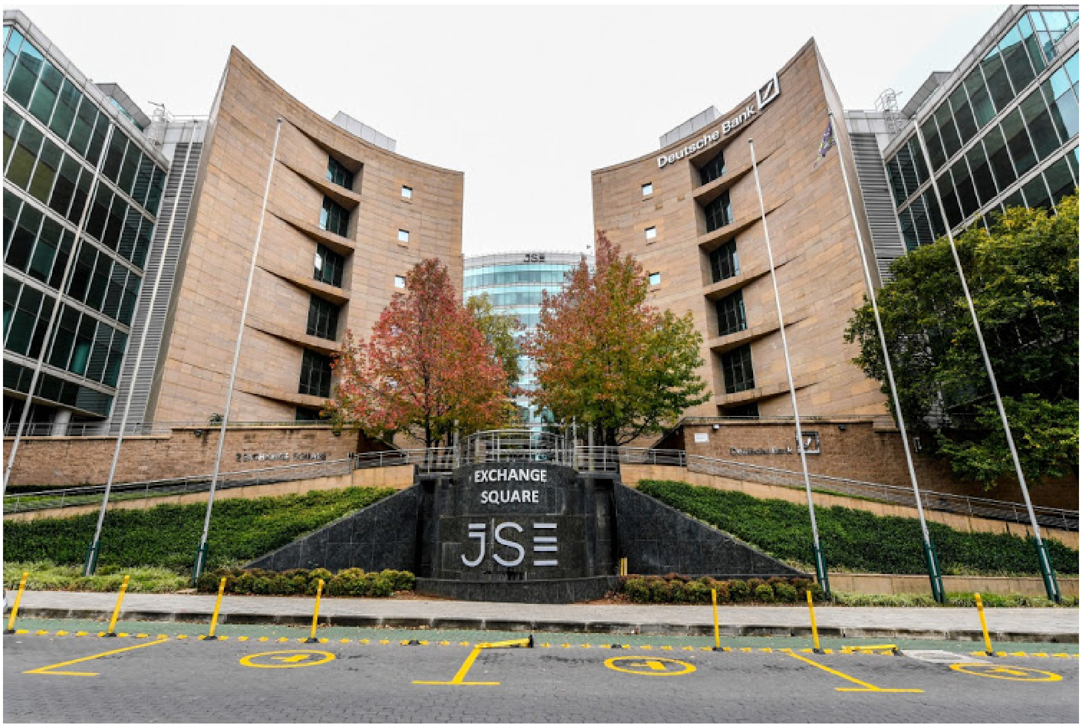

CHARLES SAVAGE_ED_218724

Charles Savage

Image: Freddy Mavunda

Returns on the JSE have been abysmal. Over the past five years less than 25% of the companies listed on the JSE have generated positive returns. Contributing factors have been a poor SA economy, outright corporate fraud and lesser corporate malfeasance. Management missteps in offshore expansions have been value destructive.

But there was another reason, unrelated to SA and SA company management: a global move out of emerging markets and into the developed markets, mainly the US. A big driver of this flow has been swopping value stocks for growth stocks. The JSE, of course, is an emerging market, populated largely with value-type companies.

The powerful trends that have held sway for more than a decade now appear to be reversing. We are suddenly experiencing emerging market inflows and value is outperforming growth. The proximate causes of the change can be identified in two recent events: the win of Joe Biden in the US presidential election and the virtually simultaneous announcement by Pfizer of a coronavirus vaccine that is more than 90% effective.

A Biden presidency is likely to produce US tax hikes and higher government debt, making US businesses less attractive and weakening the US dollar. A vaccine will result in a move back to less tech-intensive countries and companies as the global economy reopens over time.

The reversal of the growth over value trade has resulted in epic moves on the JSE in November. Banks are up about 30%, life insurers are up 25% and the property sector has rallied 20%. But even after these moves, the sectors are still down 24%, 25% and 46% year to date respectively. Banks valuations remain about 1 times book value vs a long-term average of 1.5 times book value.

Life insurers are similarly well below their long-term valuation averages. Staggeringly, even after its 33% bounce, Old Mutual still trades at an almost 50% discount to embedded value. Bidvest trades on 11.7 times forward earnings vs the five-year average of 13.6 times. Under a bullish scenario there is still upside potential to our domestic names.

However, two additional factors must be considered — SA political reform and potential corporate activity. Under a growth to value switch, emerging markets will outperform developed markets. US equities now make up 59% of the MSCI All World index. This compares to its 24% of world GDP. US technology is the most crowded trade in history, according to the BofA Global Fund Manager Survey.

For SA to outperform emerging markets, we need evidence of political reform. The recent announcement of an arrest warrant for a senior ANC politician is a helpful step in tackling a decade of rampant corruption. Potential corporate activity is another area where value could be unlocked. Many share prices are still down significantly (attractive valuations), interest rates are about 3% lower (cheaper funding) and the rand is weaker (favouring foreign buyers).

We are already seeing an uptick in corporate activity. Vivendi has bought a stake in Multichoice and Linde made an offer for the Afrox minorities. We believe there is opportunity for further deals.

It is possible that Aton will make another bid for Murray & Roberts. Standard Bank may look to buy out the Liberty Holdings minorities and Remgro, having stated that it does not want listed subsidiaries, may buy out RCL minorities. Other potential transactions are Bidvest buying out Adcock and even Walmart acquiring 100% of Massmart.

If you overlay cheap valuations, emerging market inflows, value regaining favour, possible corporate activity and returning confidence in SA, then there could be upside on the JSE.