# Equities in the Age of the 3D Reset

## The mega-themes reshaping the world economy may provide opportunities and risks for investors in equities.

Beneath the surface of some respectable returns for global equities in 2023, with the MSCI World Index[1] so far up 22.15% through mid-December in US dollar (USD) terms, the picture is anything but benign.

A confluence of factors, associated with what we've called the 3D reset, is driving a regime shift of major proportions. Structural challenges that were already apparent before the pandemic are becoming acute.

In 2024, uncertainties may persist and equity markets may remain volatile. As always, however, the old adage that "there is always a bull market somewhere" may prove accurate. In fact, we think there are a number of areas that may prove highly profitable for global equity investors in 2024.

### The 3D Reset and the End of the Free Money Era

Perhaps the most striking feature of financial markets in the last decade was the steady decline in the cost of risk. With post-Global Financial Crisis (GFC) central-bank policy driving interest rates down to zero, the effect on asset prices was dramatic; they went up a lot. Then came the pandemic, closely followed by the war in Ukraine—events which served to crystallize pressures that had been building for some time.

There are many different factors at play, but we think they can be usefully grouped into three categories, namely 1) demographic constraints; 2) decarbonization imperatives; and 3) deglobalization initiatives. Together, they form what we call the 3D reset.

Combined with high sovereign debt levels, these factors have created supply bottlenecks, driven up wage costs, boosted general price inflation, and underpinned populist politics. Central banks have been forced to act decisively. Interest rates have risen dramatically and look set to stay elevated for some time. No wonder financial markets are jittery.

### Time To Consider Doing the Opposite?

Hindsight is always 20/20. Looking back over the 10-year period ending in 2021, there were only a few things that investors needed to have done: buy equities; invest in growth (especially technology); invest mainly in the US; not worry about valuations; and lever up (finance with debt).

Anyone following this approach would have done superbly well, and many investors did.

But the 3D reset is now ongoing, and the implications for investors could be substantial across most asset classes. Most obviously, cash is no longer trash: Money in the bank can get you respectable returns.

Equity investors many need to change their mindset. This involves considering the following strategies:

- Diversification across regions (less US, more of the rest of the world),
- Focus on the implications of structural change, and
- Renewed attention to valuation, quality, and risk.

**Insight from sub-adviser Schroders Investment Management**

**Alex Tedder,**
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### Key Points

- A confluence of factors, associated with what we've called the 3D reset, is driving a regime shift of major proportions.
- Automation is a long-standing trend that has rapidly expanded from narrow industrial processes to whole swathes of the service sector. Generative AI raises the stakes materially.
- Whereas the last decade was all about growth, the next decade may be more about finding companies that offer genuine value.

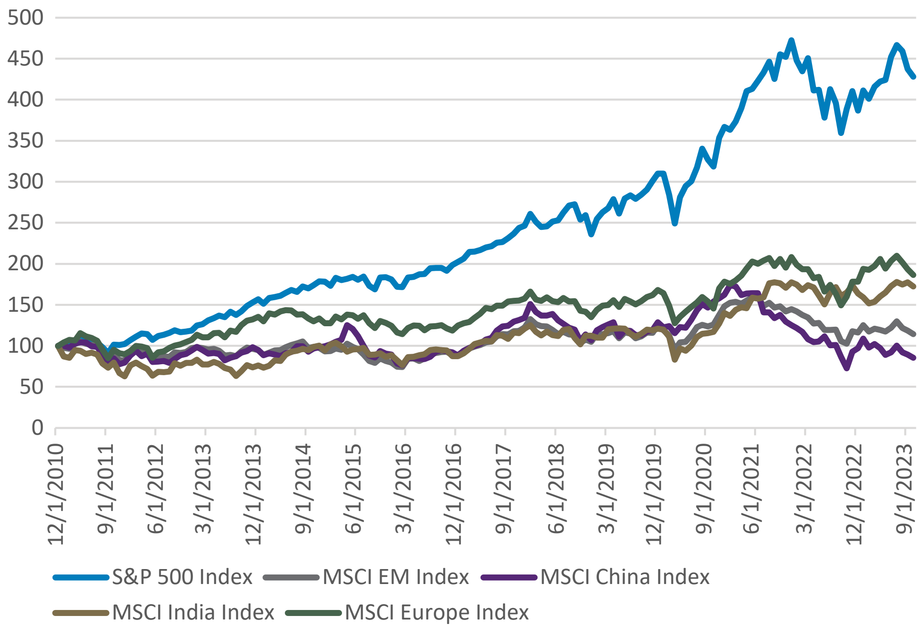
## Consider Looking Beyond the US, Particularly to Unloved Markets Such as Japan and the UK

As Warren Buffett regularly reminds us, it's tough to bet against the S&P 500 Index.[2] Since the end of 2010 the S&P 500 Index has delivered, in USD terms, a cumulative return of 340% compared to 95% for European equities and just 20% from emerging markets. China has delivered a negative return over that period.

The market capitalization of the Magnificent 7 is now greater than that of the UK, France, China, and Japan combined.

FIGURE 1

**Is it Time to Think About Non-US Markets Again?**



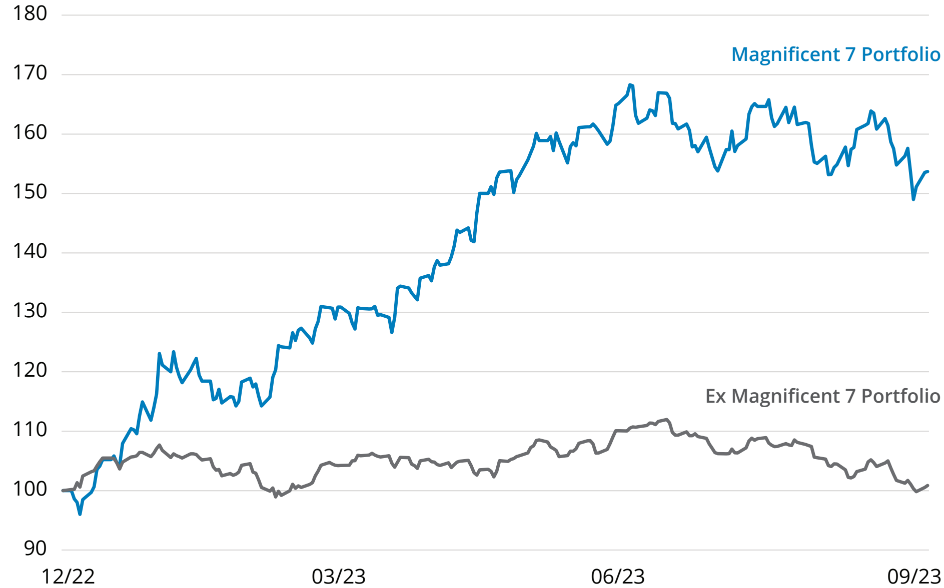

As of 10/31/23. **Past performance does not guarantee future results.** Indices are unmanaged and not available for direct investment. Please see index definitions on page 6. Data source: Schroders and EIKON.

The US corporate sector remains, in aggregate, better managed and more innovative than nearly any other. It has a unique composition. High-growth areas such as technology, communications, or healthcare account for a far higher proportion of the Index than in other regions. The IT sector, for example, now accounts for 28% of the S&P 500 Index compared to just 6% in Europe.

In light of these facts, the S&P 500 Index could continue to trade at a premium to other markets. However, it's notable that the valuation gap between the US and the rest of the world is now at extreme levels. To put this into context, the market capitalization[3] of the Magnificent 7 (responsible for most of the return from global equities this year) is now greater than that of the UK, France, China, and Japan combined. While such polarization has often persisted for long periods, the gap has eventually closed in the past.

FIGURE 2

**The Magnificent 7 Are Up Over 50% This Year, the Rest of the World Is Flat**




As of 10/31/23. **Past performance does not guarantee future results**. The Magnificent 7 portfolio consists of Apple, Microsoft, Alphabet (Google), Amazon, Nvidia, Tesla, and Meta (Facebook). Ex Magnificent-7 is a portfolio of the remaining constituents of the MSCI ACWI Index. MSCI ACWI is a free float-adjusted market capitalization index that measures equity market performance in the global developed and emerging markets, consisting of developed and emerging market country indices. MSCI index performance is shown net of dividend withholding tax. Data Sources: LSEG DataStream and Schroders.

To be clear, we aren't negative on the US market. If you were to strip out the Magnificent 7 and other high-growth names, the S&P 500 Index is trading only slightly above its long-term average. Indeed, small- and mid-cap US stocks look compellingly valued in many cases.

And in the case of the Magnificent 7, although they may not have as far to run as before, they remain unique franchises with powerful and highly profitable business models. They aren't going away anytime soon.

Incrementally though, after years of disappointing returns, now is probably a good time to look at unloved markets such as Japan and the UK.

Japan's market has been a laggard since its asset price bubble burst in 1992 with catastrophic consequences for the economy. After two decades without inflation and a currency that has depreciated 50% against the USD, the Japanese economy is now highly competitive. What's more, authorities there have woken up to the fact that more than half of companies on the stock market trade on less than the value of their assets (that is, have a book value[4] of less than 1), as of the end of May 2023.

In late 2022, a directive was issued to encourage Japanese companies to return cash to shareholders, either via buybacks or higher dividend pay-outs. There has already been a startingly strong response from the corporate sector, and we expect this to continue.

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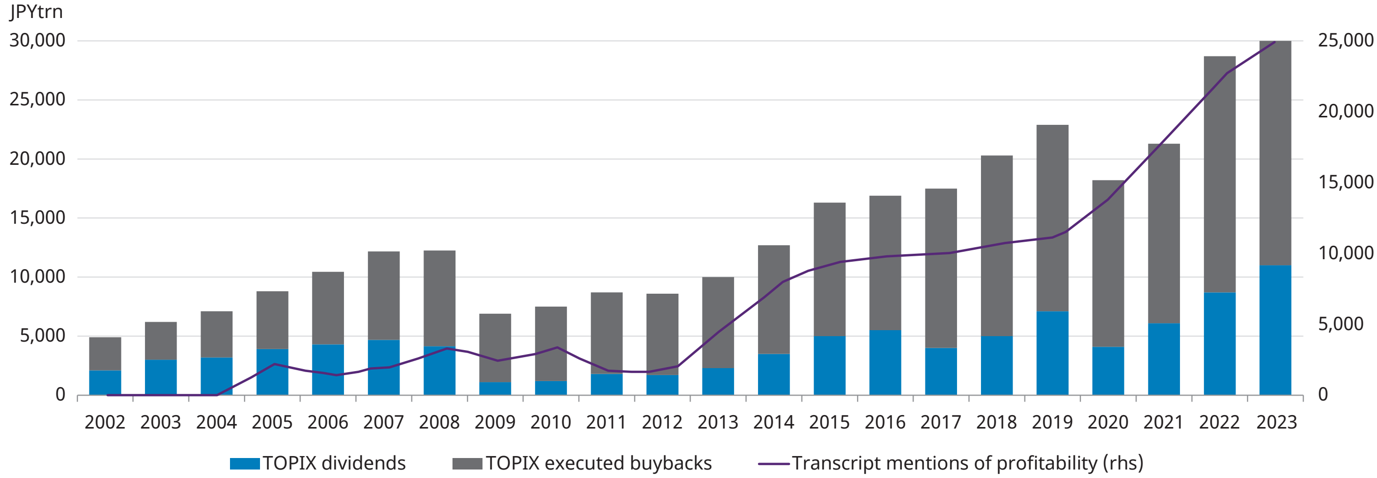
FIGURE 3

**A Resurgence of Profitability and Productivity in Japan**




As of 5/24/23. 2023 data has been annualized. The Tokyo Price Index, known as TOPIX, is a Japanese stock market index that tracks domestic companies in the exchange's first section, which represents Japan's largest firms by market capitalization. Data Sources: TSE, Nikkei NEEDS, AlphaSense, and Morgan Stanley Research.

Long perceived as a "legacy" stock market due to the relatively high concentration of traditional industries such as energy, mining, consumer staples, and banking, the UK has steadily under-performed the MSCI World Index over the last 20 years. Regulation, government apathy, and Brexit haven't helped. Yet scratch the surface and the UK may have much to offer.

Governance and accounting transparency are generally best-in-class. Companies in the Financial Times Stock Exchange Group (FTSE) are mostly global businesses with broad exposure to growth markets. And there around 1,800 other listed companies, many of which are over looked and under-researched. Most significantly, the UK market trades at a material discount, both to the rest of the world and to its own history. With the FTSE All-Share Index[5] valued at just 10 times next year's earnings and with a dividend yield[6] over 4%, the market looks compelling.[7]

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## Think About Long-Term, Structural Themes

It's striking that so far in 2023 the MSCI Global Alternative Energy Index[8] is down 40%.[9] Investor sentiment has been hit by a combination of poor results (not helped by extended valuations in some cases) and a political backlash against environmental initiatives.

And yet, even the most hardened eco-skeptic would struggle to deny that extreme climate effects are becoming ever more apparent. The case for decarbonization is overwhelming. Given that many post-pandemic cost pressures and over-capacity in parts of the renewable energy space have now been worked through, now would seem to be an excellent time for investors to consider the energy transition theme.

It seems clear that technology is key to addressing many of the structural challenges we currently face. For example, solar and carbon capture are central to the energy transition theme. In a similar vein, the challenge of demographics is one that could largely be met by medical discovery, automation, and artificial intelligence (AI).

AI has captured the imagination of investors and, of course, there's a substantial risk of it getting over-hyped. Nevertheless, the logic behind the market's excitement is irrefutable. Automation is a long-standing trend that has rapidly expanded from narrow industrial processes to whole swathes of the service sector. Generative AI, based on language models, raises the stakes materially.

Globally, there are more than one billion knowledge workers—workers applying theoretical or analytical knowledge to specific tasks. Augmenting, enhancing, and perhaps replacing a portion of this work could result in immense changes and may create significant opportunities for investors not just in the technology sector but in almost every part of the economy. PwC put the potential economic value of AI at $17 trillion annually by 2030. Compared to current global GDP of around $110 trillion, that's an extraordinary sum and the opportunities in the automation space could prove immense.

AI advancement could result in immense changes and may create significant opportunities for investors in almost every part of the economy.

## Price Is What You Pay, Value Is What You Get

In a higher interest-rate environment, valuations matter much more than when interest rates are close to zero. Equities have been wonderful long-term investments, with the S&P 500 Index delivering a real return (after inflation) of more than 7% per annum over the last 150 years, compared to just 2% from US Treasuries. And yet equities are also highly volatile. There have been drawdowns of more than 10% in 29 of the past 50 years. Equity markets are fickle and can be quite unforgiving.

All the more reason, in our view, to focus on valuations. Or more precisely, on value for money. Whereas the last decade was all about growth (especially revenue growth), the next decade may be more about finding companies that offer genuine value.

By this we don't simply mean companies that are cheap. Cheap stocks are usually cheap for a reason. Companies in traditional sectors such as energy, financials, or industrials are not only highly cyclical, but also face major disruption from the transition to new technologies. In contrast, a company that trades expensively based on current metrics may turn out to be attractive, but only if it delivers sustained growth and cashflows in the future.

We think investors could benefit from focusing on the longer term, identifying areas with structural, under-appreciated growth, and committing strongly to those companies with sustained competitive advantages. Like anything, the price you pay for a security is the price you pay. Value is what you get. We think there's plenty of value in global equity markets, especially for the patient investor.

**Talk to your financial professional to learn more about positioning your equity portfolio.**

[1] MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets.

[2] S&P 500 Index is a market capitalization-weighted price index composed of 500 widely held common stocks.

[3] Market capitalization refers to the total dollar market value of a company's outstanding shares of stock.

[4] Book value is the sum of the amounts of all the line items in the shareholders' equity section on a company's balance sheet.

[5] The FTSE All-Share Index represents the performance of all eligible companies listed on the London Stock Exchange's main market, which pass screening for size and liquidity. The index captures 98% of the UK's market capitalization.

[6] The dividend yield, expressed as a percentage, is a financial ratio (dividend/price) that shows how much a company pays out in dividends each year relative to its stock price.

[7] As of 10/23. Data source: Bloomberg.

[8] The MSCI Global Alternative Energy Index includes developed and emerging market large, mid and small cap companies that derive 50% or more of their revenues from products and services in Alternative energy.

[9] As of 10/31/23. Data source: Bloomberg.

MSCI China Index is a free-float adjusted market-capitalization index that is designed to measure equity market performance in China.

MSCI Emerging Markets Index is a free float-adjusted market capitalization-weighted index that is designed to measure equity market performance in the global emerging markets. MSCI index performance is shown net of dividend withholding tax.

MSCI Europe Index is a free-float adjusted market-capitalization-weighted index designed to measure the equity market performance of the developed markets in Europe.

MSCI India Index is a free-float adjusted market-capitalization index that is designed to measure equity market performance in India.

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