OP Insights

Thoughts from Richard Oldfield

The ruby red shoes which Judy Garland wore in *The Wizard of Oz* sold last week for $28 million. This may seem a lot – but a snip when you consider that it is only four and a bit times the price of a banana, or at least the banana which crypto billionaire Justin Sun bought at Sotheby's in November and which, a week later, he ate.

The US stock market has been effortlessly climbing a yellow brick road. For the S&P index, the Shiller P.E. – a smoothed measure of long-term valuation, calculated by dividing today's share prices by the inflation adjusted average ten year earnings – is now 39. Indeed, in 150 years the ratio has surpassed 39 only once, and that was in 2000 at the height of the tech bubble. A scattergram analysis, [referred to in Christoph Ohm's *Why Valuations Are Key to Success*], reveals only a handful of instances when the Shiller PE has been above 35, and on those occasions the subsequent ten year real return has never been above zero.

All investment roads now lead to the US. In November the US stock market outperformed the rest of the world by more than in any month since 1998. The US market capitalisation is 67% of the MSCI All Country World Index, although the US economy accounts for 26% of the GDP of these markets. US households now have 48% of their financial assets in equities, a record. This compares with 30% in the boom times of the 1960s, and 15% when this particular newsletter writer was starting work in the late 70s.

While the US basks in the glow of economic resilience, technological innovation, and pre-Trumpian optimism, the rest of the world languishes. As Rana Foroohar wrote in the Financial Times on 9th December, "Europe today is like a well-dressed flaneur who is unaware he's about to be attacked in an alley by a couple of street thugs". These thugs come in the form, on the one hand, of President Trump, Elon Musk and the big tech titans, and on the other of Beijing "hollowing out Germany's car industry". As a consequence, Europe is wrestling with *dunkelflaute* – the German word for dark doldrums. The term is used [as mentioned in Harry Fraser and Sam Ziff's *The Energy Transition: A Work in Progress*] to describe those periods when the sun is not shining and the wind is not blowing. It is a term which is apt as a depiction of the continent's economic malaise.

It is difficult to get excited about economic prospects when there is a combination of strangulated bureaucracy, and severe political problems. In France, the French Prime Minister resigned after a period in office of Trussian brevity, and the German coalition is in disarray. But the compelling message of the scattergram referred to above is that it is overwhelmingly probable that over the next ten years Europe and Asia will vastly outperform the US, even if right now we cannot quite see why. When things are unsustainable they do not last, and when something else emerges the reason for its emergence becomes apparent. Relative valuations tell a powerful story. The contrast is particularly acute between growth stocks (especially tech -related) and value stocks. As GMO point out, it is in deep value – the cheapest quintile of

markets – that the valuation depression is especially evident. According to them, deep value in markets outside the US is now in the lowest percentile of its past valuation range – historically indicative of strong subsequent returns.

It is unfashionable to focus on valuation. The *Financial Times* daily commentary column, Lex, had in October a few paragraphs about Stellantis, the car company: “on about three times forward earnings… it is not clear why anyone would climb aboard its recovery trip now”. Three times forward earnings can be a reason to climb aboard. In the next column was a paragraph about OpenAI, at a valuation of $157 billion at which level investors are paying 13 times estimated revenues while the company is burning $5 billion a year through losses. Lex, though not recommending OpenAI, brushed this aside: “True, losses are common in tech.” This contrast in treatment reflects the mood of the last several years, that valuations do not matter. They do, and they will. In Japan for instance, depressed valuations have meant that the public markets are now awash with private equity firms or activist investors, with new targets still being announced every week. For so long a corporate governance desert, Japan has sprung to life. Yet even now, half the companies within the Topix still sell at less than book value.

We are committed to value philosophically as a way of investing because of the overwhelming evidence that when a value style is applied consistently over time, it results in good returns. Precisely because of trends in recent years, we are now more convinced than ever, and excited about the next decade. We feel strongly confident that the next ten years will be excellent for investors who focus on value. A change in fortunes for the style, when it happens, can be sharp, and it is important to have a portfolio which is in the right shape for the change. We are determined to be in the right place to benefit investors when the turn comes.

Richard Oldfield,
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