ROTHKO
MONDRIAN INVESTMENT PARTNERS LIMITED

AI's Rich Pickings and the QE Ratchet

Quarter 2, 2019

Opportunities became abundant in Q2, as markets gyrated, dislocating valuations. In this piece, we investigate some of the opportunities found by Rothko, especially for our EM Small Cap strategy. We also focus on ECB policy errors to discuss why central banks are locked into providing a QE "put" for the foreseeable future *(which we have long forecast)*; a good reason to increase EM allocations we believe.

Discovering Dislocated Valuations

- **Rothko finds opportunity in the turbulent markets of May and June**
- **Materials, across the cap spectrum, offer compelling valuations**
- **... While value has ebbed away from Consumer Discretionary**
- **Rothko models propose a portfolio realignment for our EM Small Cap Equity Strategy**

Rothko's AI tirelessly searches for income-oriented value opportunities. Q2 presented such an opportunity, with our models finding EM Consumer Discretionary stocks a poorer prospect than the oft maligned Materials sector.

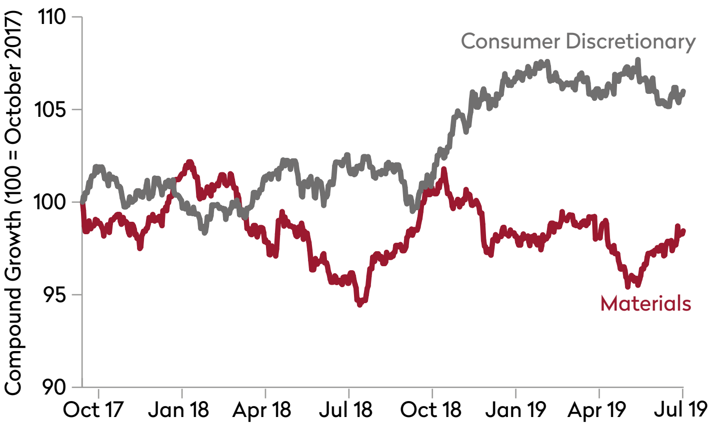
Rothko AI's Tireless Search for Opportunity

Rothko's AI continually pours over the fundamentals and valuations of the thousands of stocks in the international equities universe, looking for opportunities. The system operates like a fundamental analyst in that when it sees improving fundamentals, better shareholder value or smoother growth of US$ earnings, it infers a higher probability of improving future US$ dividend payments. The difference is, Rothko doesn't have behavioural biases and it doesn't take coffee breaks.

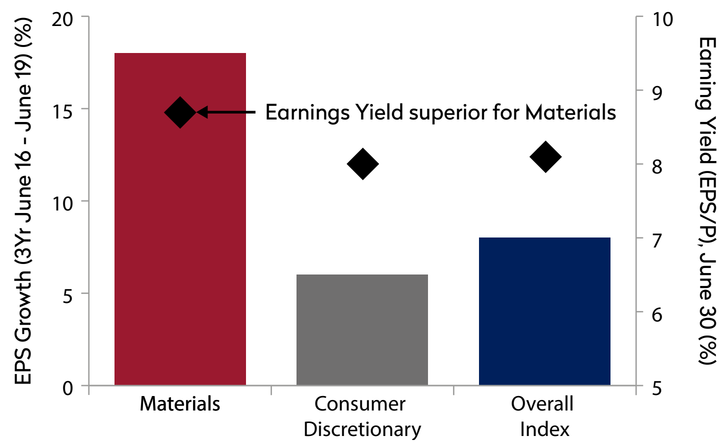
Rothko recently identified an opportunity in EM Small Cap Materials names, that have seen improving earnings coupled with increasingly attractive valuations. That isn't supposed to happen in an efficient market, but in the real world of International and EM equities we believe these opportunities remain persistent for objective fundamental investors and most specifically, Rothko. Rothko is trained to locate stocks that present these opportunities, a situation that appeared to be abundant in Q2. While Materials stocks looked attractive, the flip side was EM Small Cap Consumer Discretionary names, which had fundamentally deteriorated while prices had improved. Recognizing these shifts at the end of Q2, Rothko proposed a portfolio realignment in July for our EM Small Cap Equity strategy, improving fundamentals and valuations in the process; a very typical observation we find Rothko makes in international equity markets.

Figure 1: Materials: Improving Valuations, Improving Fundamentals

Relative Performance of Materials and Consumer Discretionary in EM Small Cap



Relative Earnings Profile (US$ EPS Growth Over 3 Years (left); Diamonds: Earnings Yield (right))



Source: Rothko, FactSet.

Figure 1 shows the story as it evolved over the past year. Prices diverged between Small Cap Materials and Consumer Discretionary starting in September 2018. The Q1 2019 reporting season revealed a change in fundamentals that contradicted this change in valuation. Income statement health was the focus of this contradiction, with US$ based EPS growth continuing at a stronger clip for Materials than for Consumer Discretionary. However, an opportunity to take advantage of this developed in July for the Rothko EM Small Cap Equity strategy after May saw a sharp fall in markets (MSCI EM Index fell -7.3%) followed by a bounce in June (+6.2%). This additional distraction for traditional investors caused greater dislocations between fundamentals and pricing, something we see Rothko is consistently good at exploiting. It allowed us to move out of Consumer Discretionary stocks, at what Rothko saw as rich valuations, and into Materials to improve overall fundamentals and to improve value characteristics at the same time for the EM Small Cap Equity strategy. A classic Rothko move.

Improved Fundamentals, Improved Valuations?

We have noted in the past that fundamental investor inertia tends to result in fairly long run periods where Rothko is able to identify bottom-up opportunities to both improve fundamentals and value characteristics. It is a hallmark of the Rothko approach. At the same time, factor-quants find it very difficult to identify these opportunities at the stock level because they are driven to achieve top-down factor exposures. Fundamentals at this level of granularity tend not to show up in factor loadings. Rothko is focused on the bottom-up profile of a company, allowing the system to draw, what we see as deeper and more powerful inferences. We believe Rothko's performance speaks for itself on this.

QE's Ratchet Kicks In; There's No Going Back

- **QE "put", a back stop for EM assets**
- **Reversal of QE unthinkable, maybe impossible:**
- **... ECB U-turn: Eurozone printing press cranks up again**
- **... Fed U-turn: Fed's rapid rate hikes to be reversed**
- **While monetary repression hits new lows....**
- **... Europe: Value of negative yielding debt hits record €12.5tn (including in emerging Europe)**
- **... Japan: BoJ balance sheet now exceeds Japan's GDP**

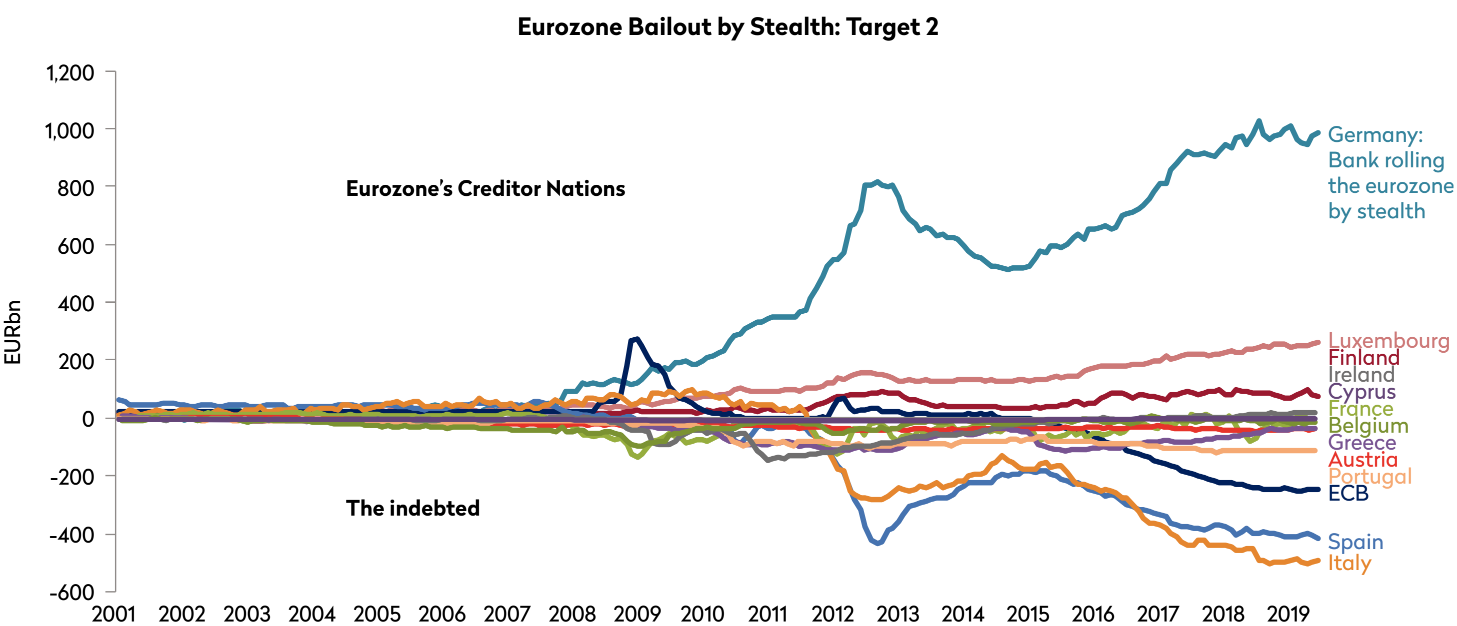
QE reversal is unthinkable, if not impossible, as the BoJ discovered some time ago; massive asset purchases come with a ratchet. They are difficult to reverse. The ECB has only just figured this out (the Fed did last year) and that means the "QE put" is in place for the foreseeable future. All else equal, EM assets will remain supported by looser monetary conditions. We discuss some important, hidden aspects.

ECB: The Stealth Bailout (that Came with a Ratchet)

The ECB and the Fed have finally figured out that QE came with a ratchet. It is difficult to reverse, and that means the "QE put" is in place, to a large extent, for the foreseeable future. This is good for EM asset prices but at what cost to developed markets? We look into the financial plumbing of the eurozone which has been responsible for transmitting effective monetization across the global financial system.

In March, the ECB sent the shocking, associated message to markets that the €850bn in stealth bailout capital supplied to Italy and Spain, will never be fully paid back. They didn't quite put it like that but that's what they meant. Corrective fiscal policy has been politically impossible in Europe and turning the eurozone into a transfer union between Germany and the South, is an unbroachable subject. The ECB stepped into this political vacuum to proxy both aims by stealth back in 2015. It's an economic reality that seems to remain hidden from Northern European voters in the depths of the eurozone's financial plumbing; evident in the Target 2 balances (see Figure 2).

Figure 2: Bailout by Stealth; Where there isn't a Political Will, there's a Monetary Way

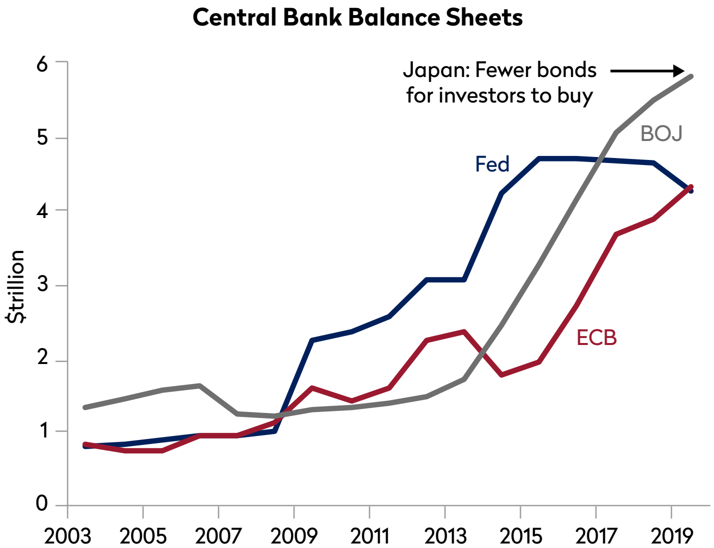


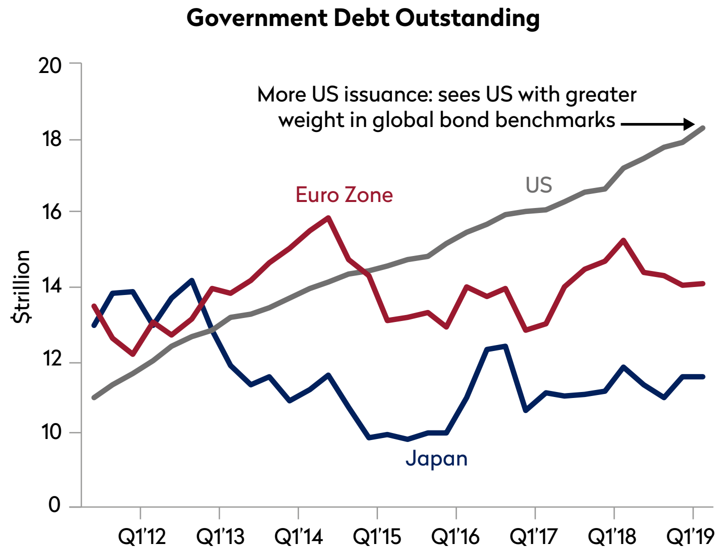
Source: ECB.

We note one perverse outcome of the ECB's QE program has been the significant portion of that capital that has been diverted, not into Southern Europe, but into the US Treasury market. This, in turn, has transmitted the effect to EM monetary conditions. It is possible that since 2015, when the ECB launched its asset purchase program (APP), around $2 trillion of domestic eurozone investment has been diverted into foreign bonds, mainly US treasuries[1].

Figure 3 shows the rate at which central banks have been buying their own bonds, pulling down their weights in bond benchmarks, and when considered against the rising bond issuance in the US, the effect of indexed assets alone gives an impression of why the US should have benefitted from these capital flows. Given the ratchet on the APP, and QE more broadly, the money tide is unlikely to ebb anytime soon.

Figure 3: Buy US Treasuries! Unintended Results of Eurozone and Japanese QE





Source: Federal Reserve, Bank of Japan and Statistical Office of the European Communities.

Rothko: Opportunity from Inertia

Rothko's AI continually pours over the fundamentals of the thousands of stocks in the international equities universe, looking for opportunities across emerging markets, developed markets and the market capitalization spectrum. We see the QE "put" as only a tactical opportunity to increase EM equities allocations while the strategic opportunity is to profit from the inertia of fundamental investors and factor investors' chronic lack of a bottom-up focus. We believe asset allocators and owners that are slow to move from traditional investment approaches will ensure this opportunity will be available to Rothko for many years to come.

[1] www.ecb.europa.eu/press/key/date/2018/html/ecb.sp181026_1.en.html

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