ClearBridge
A Franklin Templeton Company

Global Value Improvers Strategy

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Key Takeaways

- Despite a tumultuous August, investor optimism over further interest rate cuts propelled international and value stocks higher.
- The Strategy outperformed its benchmark, led by stock selection in Japan, the U.K. and the industrials sector, which more than offset detractors in Europe and the materials sector.
- Periods of heightened volatility remind us of the importance of portfolio diversification and the benefit of having longer term investment themes less tied to the economic cycle and lend stability during extreme market movements.

Market Overview

Global markets overcame a tumultuous August, which saw an aggressive unwinding of the Yen carry trade and further pockets of slowdown in the global economy, due to investor optimism of further interest rate cuts by central banks. The MSCI World Index returned 2.64% (in U.S. Dollars), while the MSCI World Value Index continued to outpace its Growth counterpart, returning 2.83% and 2.46%, respectively. Recent outperformance has helped to narrow Growth's year-to-date outperformance, largely driven by outsized gains concentrated in AI beneficiaries, over Value.

Global markets faced increased volatility early in the month, as an interest rate hike by the Bank of Japan – from 0% to 0.25%, the highest level in 15 years – designed to stem a decline in the yen, as well as higher conviction of U.S. easing, set off a widespread unwinding of the yen carry trade. Bank Governor Kazuo Ueda cited a solid economy, accompanied by positive inflation in prices and wages, as key reasons for the decision and acknowledged that additional rate hikes may be coming later this year.

However, Japan remains the exception, as most markets rallied on the prospect of interest rate cuts from other central banks. At its August meeting, the Bank of England voted to cut rates from a 16-year high and signalled the potential for an additional rate hike this year. In the U.S., minutes from the Fed's July meeting and Fed Chair Powell's speech at the Jackson Hole summit sent strong signals that, with signs of a cooling labour market and inflation approaching its 2% target, the Fed could cut interest rates at its September meeting. Economists are also anticipating one to two additional rate cuts this year by the European Central Bank due to slowing wage growth and declining inflation across the Eurozone. Despite calls for cuts to shore up its sluggish economic growth, policymakers at the People's Bank of China stated they have no intention to lower rates but hinted at the possibility of relaxing of its required bank reserve ratio to help provide stimulus.

Economic data continued to show pockets of emerging weakness in the global economy, particularly in manufacturing and industrial sectors. The Eurozone (and particularly Germany) saw its third straight month of declining industrial output, while data showed that French manufacturing activity in August contracted at its fastest pace since January. In the U.S., the ISM Manufacturing PMI remained mired in contractionary territory with a print of 47.2, weaker than expected. Meanwhile, Chinese manufacturing declined for its fourth straight month as it continues to struggle with a real estate crisis and weaker domestic demand. However, the U.K. proved the exception, as a robust labour market and signs of manufacturing expansion helped buoy its economic outlook through the remainder of the year.

Investors continue to be spooked by outgoing President Andres Obrador's plans for an unprecedented overhaul of the Mexican judicial system. While touted by his party as corruption-busting, political opponents have said that measures requiring all the Mexican judiciary – including its Supreme Court justices – to stand for nationwide elections would make it easier for Mexican oligarchs and cartels to take advantage of politically motivated and inexperienced judges. This elevated political uncertainty has weighed on the Mexican Peso, which has lost 14% of its value versus the U.S. dollar since the June election.

Oil prices declined as concerns over weaker fuel demand from China, rising inventory levels in the U.S. and recession concerns more than offset upward pressure stemming from production disruptions in Libya and Iraq and the anticipation of further production cuts from OPEC+ members in October.

Within the benchmark, Asia Ex Japan and Europe Ex U.K. posted positive returns, while Japan saw the greatest decline. The top performing sector was the interest-rate sensitive real estate sector, while broadening market leadership weighed on IT companies and made it August's worst performing sector.

Portfolio Highlights

Against this backdrop, the ClearBridge Global Value Improvers Strategy outperformed its benchmark for the month, as strong stock selection relative to the benchmark helped bolster returns. On a regional basis, stock selection in Japan and the U.K. benefited performance. Conversely, stock selection in Europe Ex U.K. weighed on returns.

By sector, overall stock selection effects contributed to performance, with particularly strong performance coming from our industrials holdings including Hitachi (+0.55%) and Uber Technologies (+0.24%). Industrial electronics conglomerate Hitachi continues to benefit from the demand and buildout of data centre and upgrading of global electrical grids and reported strong quarterly earnings for its fiscal first quarter of 2024. Additionally, the company received further tailwinds from the announcement of its strategic partnership with telecommunications company Singtel to enhance their data centre performance and capabilities.

Rideshare platform and food delivery company Uber Technologies, one of last month's worst performers, rebounded after it beat second quarter earnings expectations and strong year-over-year growth in gross bookings, trips and food delivery. Additionally, the company announced a multi-year partnership to bring General Motor's Cruise autonomous vehicles into its fleet, helping to ease investor concerns about the impact autonomous vehicles could have on the company's business.

Conversely, stock selection in the materials sector was the biggest detractor from returns. The world's largest copper miner, Freeport-McMoRan (-0.20%), came under pressure early in the month as industrial metals prices declined to a four month low spurred by continuously worsening China housing outlook and signs of broader global economic deceleration. Despite recovering some of its losses through the rest of the month, the outsized pressure on the company made it our worst performing holding for the month.

U.S. based financials company Wells Fargo (-0.11%) also faced headwinds, declining alongside other large U.S. banks as an unexpectedly weak jobs report raised the prospects of a more aggressive interest rate cut in September. While the cut would likely benefit funding cost and investment portfolio, investors grew concerned that large banks' higher asset sensitivity to a rate cut would offset the positives.

During the month, we exited positions in Chesapeake Energy in the energy sector, Freeport-McMoRan in the materials sector and AIA Group in the financials sector. We initiated new positions in Johnson Controls International in the industrials sector, EQT in the energy sector and Teck Resources in the materials sector.

All returns are in local currency.

Positioning and Outlook

In recent months, political risk and policy uncertainty have become an increasing overhang on equity markets, and we expect this to continue until after the election. On the one hand, market valuations feel relatively full and it does not feel like we are getting paid to take outsized risk. On the other hand, volatility can present opportunities to purchase high quality businesses or unique ESG enabler candidates at significant discounts to intrinsic value. We stand ready to capitalise on these short-term technical gyrations or sentiment shifts in the market. For example, in the U.S. there is much concern around the outcome of the election and potential impact on ESG areas such as renewables and energy policy.

Our overall view is that concerns are overblown. Even in the most extreme case of a Republican sweep, a full repeal of the Inflation Reduction Act (IRA) would be difficult and unfavourable to many states where it has been a meaningful job creator. Even stress testing a full repeal scenario, many of the benefits to a company like U.S. renewable power producer AES, for example, already existed prior to IRA passage and would now just return to the situation before the bill with the biggest negative impact being the need to have those tax credits extended periodically since their first expiration in 2007.

We also remain bullish on the AI opportunities. Our positions in Vertiv and Siemens Energy both benefit from the AI driven datacentre growth but are also solutions to the environmental challenges posed by power required by such rapid growth.

Overall, periods of heightened volatility remind us of the importance of portfolio diversification and the benefit of having longer term investment themes, such as energy transition, AI revolution, and governance reform, which are less tied to the economic cycle and thus lend stability during extreme market movements.

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