Hosking Partners®

Hosking Post

Plunging share prices and soaring ‘known unknowns’

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PLUNGING SHARE PRICES AND SOARING ‘KNOWN UNKNOWNS’

There are two common fund management responses to an unexpected negative external event. The first is to dash for 20% liquidity (or some other proportion), and the second is to take no action. While some might say this latter is the “rabbit in the headlights” response, it is just as much an admission that better decision making is possible once more of the germane facts are known and that the cone of uncertainty has narrowed appreciably. At the time of writing the response of Hosking Partners lies firmly in the inaction camp. We are not rabbits but are taking an alternative view of assessing probabilities implied by market prices and are evaluating where to bet with the market and where to bet against it.

Moreover, the dash for cash at times of market turmoil is not a strategy, historically at least, that has played out well. Investors inevitably get caught out by recovery and end up buying in at higher levels. Not two hours after this note was penned, US President Donald Trump announced he was pausing reciprocal tariffs for most countries for 90 days, sending markets temporarily soaring again.

Inaction is not a statement by us that tariffs are bullish. Partly the tariffs are ideological (the 10% blanket import tariff for example): but partly they are opportunistic (“escalate to de-escalate” as Scott Bessent has memorably described it). If the opportunistic side of Trump’s great gamble was to pay off, and market access improved dramatically in consequence, this would be a clear positive for free trade and the world economy. Although prices have fallen sharply this is not a topic (i.e., for or against tariffs) that justifies a bet. There are more fertile areas than that.

For several years we have advocated that stock markets were imbalanced and that the collective investor focus on stock picking, growth companies, momentum, US index weight, concentrated holdings, and passive indexation had all run to unsustainable levels. Tariff-gate greatly increases our confidence in that unpopular viewpoint. To the extent that the new US government is upending the economic orthodoxies of the last 50 years, it would be surprising if stock market trends were not equally disturbed relative to the staggering persistency of the last 20 years. Further, to the extent that the new environment focuses disproportionally relative to history on traded goods, the biggest disruption will be in manufacturers rather than natural resources or cheaply manufactured goods, and especially so if they are made in China. The high technology industry seems acutely vulnerable in this regard. Declining returns on assets are long overdue in this sector, from profit margins effected by the supply chain, to say nothing of the US$320bn current year investment in AI-related activities!

Shorter term, the extraordinary correlation in share price declines is also counter intuitive. The new regime, whatever it turns out to be will surely have its own dispersion of relative out and under performers. No doubt this covariance phenomenon has many causes such as programme trades and short-termism, as well as the aforesaid dash for cash. It is likely to be unsustainable, however.

A value bias, such as the one embedded in our clients' portfolios, incorporates a substantial cyclical bias. The kneejerk response to tariff-gate is to sell down cyclical businesses. No doubt this is appropriate in some instances. However, after a couple of decades of underperformance and consequential valuation compression, many cyclical firms sell at recession valuations. Thus, even if the chances of recession are now 60%, we are not necessarily minded to sell these businesses. If they can endure hardship without equity dilution, as we believe, then long-term intrinsic value per share is unaffected and share price weakness effectively temporary. In many cases they can create substantial equity upside by slashing capital expenditures. Airlines, we are looking at you!

Of course, portfolio construction is not just about stock picking, despite fashionable views to the contrary. Our confidence in the US underweight is increased, as is our confidence that non-index countries like Sri Lanka offer favourable risk: return characteristics. However, it is our largest "big" country weight, Japan, that seems likely to garner more attention from global investors. The investment case here is that managements continue to take steps to boost corporate returns, in terms of return on assets and return on equity, with their ability to do so entirely unaffected by macro-economics in Japan, let alone by the increased uncertainty in America. Valuations, on an enterprise value basis, are at rock bottom levels. Remember too, investors believe that a materially higher yen exchange rate is high on the US president's wish list!

Duration is the last factor in our stance of inactivity. The events of the last 10 days may indeed have been traumatic, but it is not clear that they say much about stock market conditions over the long term, let alone in 2035, which is the appropriate terminal date for clients with a ten-year investment timeframe. For ten years at least our long-term lodestar has been to build in ever increasing levels of contrarianism. In our opinions, the probability of ultimate success is greatly increased by the tumultuous beginning of the Trump presidency.

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