EQUITIES

German Equities Present Opportunities to Combat Headwinds

BARINGS CONVERSATIONS

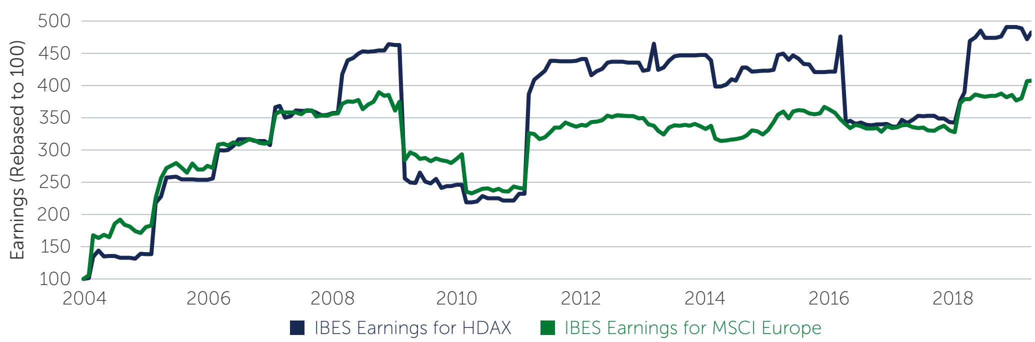
In this Q&A, Rob Smith, Manager of the Barings German Growth strategy, shares his thoughts on how German equities are positioned to combat various headwinds, and which sectors the team expects future growth to come from.

Concerns are increasing about whether the global economy may be approaching a recession. Do you share such sentiment, and how do you think the German economy is positioned?

There have been plenty of dramatic headlines regarding the growth prospects of the global economy, but there are reasons to remain positive. The latest manufacturing data from China indicated expansion, beating forecasts.[1] The U.S. PMI numbers have also been higher than expected as the U.S. government shutdown effects disappear and sentiment continues to be supported by the Federal Reserve's accommodative monetary policy. In our view, recent economic lows are merely reflective of a mid-cycle adjustment, rather than heralding a protracted global economic downturn.

Specifically for the German economy, it's important to stress that the second half of 2018 was impacted by some significant one-time events which are estimated to have reduced German GDP by around 0.5%.[2] Auto production was reduced due to delays in passing vehicles through the new Worldwide Harmonised Light Vehicle Test Procedure (WLTP) emissions testing regulation, and water levels in the Rhine River fell to such low levels that shipping products in and out of the chemical and steel plants became impossible—this was unprecedented. Both of these events are highly unlikely to be repeated in 2019, so just going back to a normal level of production should generate some useful year-on-year growth.

FIGURE 1: German Equities Typically Have Greater Earnings Growth Compared to European Peers



SOURCE: Thomson Reuters Datastream. As of March 31, 2019. Institutional Brokers' Estimate System (IBES) is a database that gathers and compiles the different estimates made by stock analysts.

Keeping on the topic of headwinds, the issue of Brexit remains prominent. How do you see the various scenarios impacting the German economy?

If an agreement is made that allows the exchange of goods with no hard border with Europe, there will be no change at all, in theory, so soft Brexit would mean a limited impact. With a hard Brexit, it all depends on whether the U.K. would start imposing tariffs to protect its own companies from competition. The current rhetoric seems to endorse free trade, in which case the country should remain fairly tariff free. Delays at the borders may necessitate an increase in working capital for companies on both sides (this is currently taking place as companies build up stocks), meaning increasing costs, however the impact should be contained if tariffs are not applied. The crucial thing to look for in commentary is the terms of future trade agreements.

We have not seen a significant impact of the ongoing Brexit negotiations on German companies, apart from the fact that many investment decisions are being put on hold until there is clarity one way or the other. That said, we continue to monitor for developments in this area, particularly as a "no-deal" Brexit could have a small negative impact due to the potential trade barriers it would present.

1. Source: National Bureau of Statistics of China. As of March 2019.
2. Source: IHS Markit. As of November 20, 2018.

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Which sector in the German equity market has experienced the strongest growth recently, and how have you positioned the Barings German Growth strategy for this?

Technology stocks have seen significant growth over the past few years. The German technology sector is home to a diverse and vibrant set of companies with idiosyncratic growth opportunities which we believe have the potential to drive long-term, structural growth. Many tech companies also seek to disrupt industries through continual innovation, and leverage their technological advantages to drive this structural growth.

Having said that, it is also important to be mindful of valuations as we believe many technology companies have become very expensive. For example, we sold our position in Wirecard, a financial technology company, toward the beginning of 2018 as the valuation stretched to a price-to-earnings ratio in excess of 40 times. While we continue to believe Wirecard will benefit from the disruptive trend of payments moving from cash to card, and from the ongoing growth in e-commerce, we took the view that other attractive investment opportunities were available at a much more reasonable price. One such company is S&T, a small-cap IT consultancy and solutions company, trading at a price of around 30 times earnings. We believe this company has compelling growth potential as it moves away from being a traditional low-margin hardware manufacturer to a full-service player with a focus on connected devices. Healthcare and specialty chemicals also contain a number of companies with high growth opportunities, in our view, and companies that are focused on the future of electric mobility seen in the automotive and engineering sectors should also offer growth potential.

And looking ahead, what sectors is growth likely to come from over the next 12 months, and in the medium and longer term?

It’s difficult to say which sector will outperform in Germany this year. While growth sectors should continue to grow, cyclical stocks are also likely to bounce back from the problems of last year. Naturally, growth is much easier to come by for smaller companies than their larger counterparts, and for this year, given the ramp-up in production of new electric vehicle models, it’s likely that the fastest growth will come from those small-caps focused predominantly in this niche.

It’s also difficult to pinpoint the best performing individual company share prices over the near term because the highest growth companies are often accompanied with the higher valuations. If we have an announcement of a U.S./China trade deal by the middle of this year, I suspect some of the smaller cyclical companies like Deutz (a compact engine provider) will end up with the biggest share price gains. Being more correlated with the economic cycle than growth stocks, such companies are more likely to benefit from a sudden boost for positive global economic growth. In terms of sectors, it’s difficult to say with conviction which are best placed over a short time frame, however we are less bullish on defensive sectors such as telecoms, utilities and consumer staples, so we are underweight in these areas.

Over the medium term, those same niche players should still enjoy strong growth rates, though as the base becomes larger the rates will likely slow. Digitalization of the manufacturing base will probably maintain its current strong rate of growth benefitting many IT services companies, as well as the likes of S&T mentioned before. Personalized healthcare will also probably see rates of growth even faster than the level for the general healthcare sector.

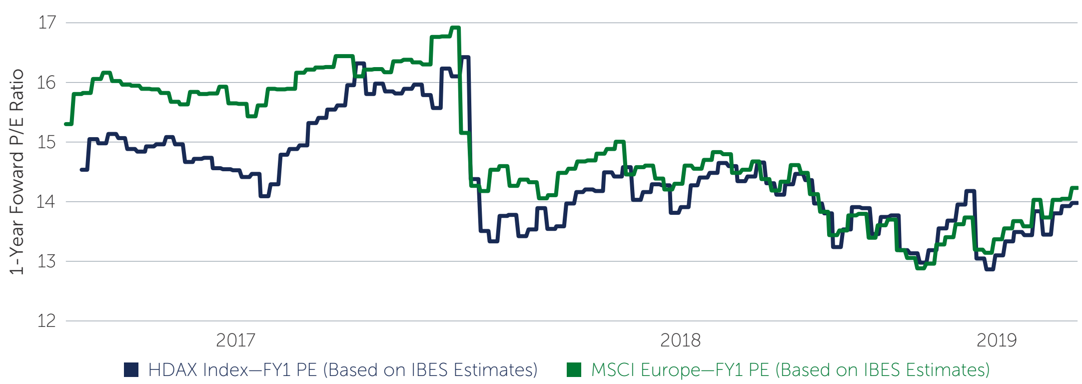
On a 5-year time horizon, there will likely be another business cycle and so cyclical stocks should also have strong growth rates at some point. More broadly, we continue to believe in the positive stock selection opportunities among German companies. We absolutely believe that Germany will continue to be a global leader in the small/medium enterprise space. No other country has as many "hidden champions" as Germany, especially in the fields of electrical engineering and industrial products. These are often global industry leaders in their specific niche sectors, which tend to be overlooked by analysts. These medium-sized, or 'Mittelstand', companies are often at the forefront of innovation: they find and define a niche, and then sell on an international level.

With about 1,500 such companies operating in Germany, these hidden champions are one of the key pillars of the German economy and we believe they will continue to drive growth in the long run.

Any final thoughts?

The German equity market offers a rich source of companies operating in sectors that stand to benefit from cyclical as well as structural growth over both the short and longer term. This is particularly true of companies at the small-to-middle part of the market capitalization range, especially those developing economic engineering and industrial products. In our view, Germany's best-in-class manufacturing industry, world-leading auto sector, and its status as one of the world's most significant net exporters, means it is well positioned to benefit from positive global growth trends and a potential trade deal between the U.S. and China. This doesn't mean to say the other markets don't have great companies to invest in, but typically the German market has traded at a discount to other equity markets because of its association with large cyclical companies. However, earnings growth is as good if not even better than many other equity markets over the longer term.

FIGURE 2: German Equities Trade at a Discount to the Wider European Stock Market



SOURCE: Thomson Reuters Datastream. As of March 31, 2019.

Rob Smith

Manager, Barings German Growth Trust & Barings German Growth Fund

Robert joined Barings in 1998 and is lead manager for the Barings German Growth Trust and the Irish-domiciled Barings German Growth Fund. Robert transferred to the Pan European Equity Team in 2008, having previously worked in both the UK & Europe Equity Team and the Pan Euro Small and Mid Cap Team. Robert was appointed Divisional Director in 2005. Before joining Barings, Robert worked with HSBC Asset Management and Dresdner RCM Global Investors. Robert is a member of the Society of Technical Analysts and has passed the Securities Institute Diploma. He received the Investment Management Certificate in 1995 and was awarded the SFA Registered Representative in 1991.

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