State Street Global Equity Fund

Why We're Going Positive on Semiconductor Manufacturers in Emerging Markets

STATE STREET GLOBAL ADVISORS

- Semiconductor manufacturers continue to be undervalued, even as earnings fundamentals improved over the third quarter.
- In the shorter term, semiconductors stand to benefit from rising consumer demand for devices, which is likely to be further fueled by the arrival of 5G technology.
- Over the longer term, demand for artificial intelligence-enabled applications will likely create a strong tailwind for the industry.

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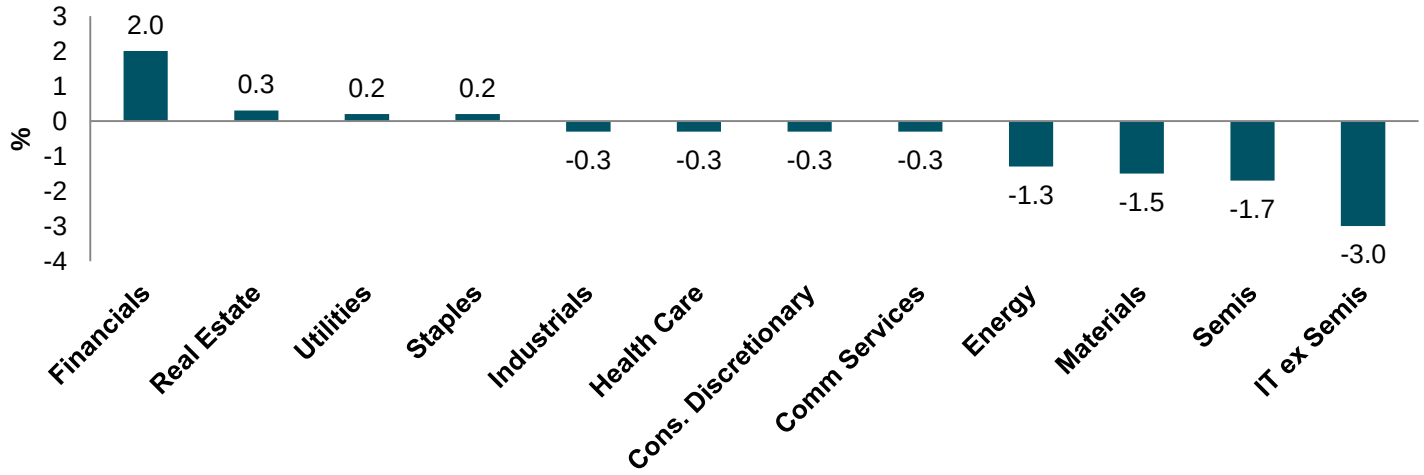
2019 has been a pretty tough year for corporate earnings in emerging markets. Many sectors managed to eke out a positive profit story, but in aggregate this year's earnings are likely to be down 2% to 7%.

Semiconductors and other tech hardware firms have been a big part of the decline (see Figure 1).

Figure 1. **Global Semiconductor Earnings Have Declined During 2019**

Global EPS Forecasts for the 2019 Calendar Year, by Industry (%)



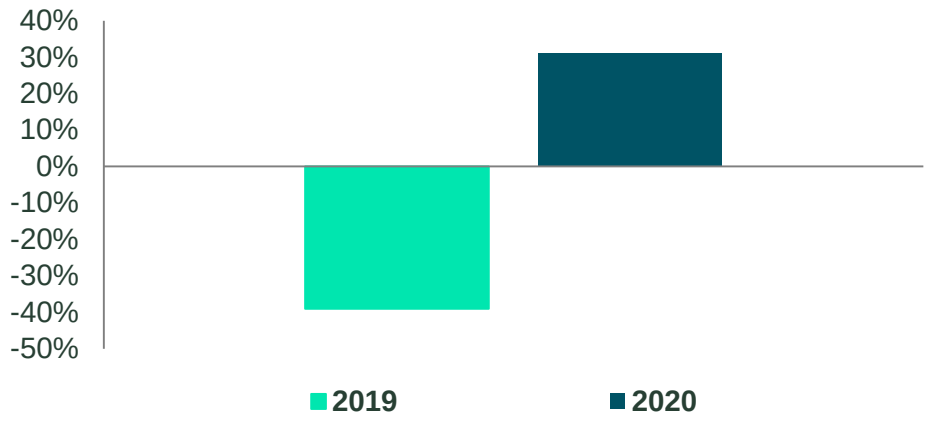
Source: JP Morgan, MSCI, Bloomberg Finance L.P., as of November 2019. Projected characteristics are based upon estimates and reflect subjective judgments and assumptions. There can be no assurance that developments will transpire as forecasted and that the estimates are accurate.

[1] CFA® is a trademark of the CFA Institute

The trade trauma and the spat over Huawei have been headwinds this year, but the good news is that the bad news now seems to be mostly in the past. 2020 appears to be setting up for a nice earnings recovery for both emerging markets (EM) semiconductors and for EM equities in general. Next-twelve-month consensus estimates anticipate earnings-per-share (EPS) improvement of 31% for semiconductors (see Figure 2) and a 14% uptick in EPS for EM equities as a whole.[2] Making the right call on semiconductors will be important for investors next year, as they consider individual stocks and as they look at the asset class more broadly.

Figure 2. **Emerging Markets Semiconductor Earnings Are Expected to Grow in 2020**

EPS Growth Forecasts for EM Semiconductors, 2019 versus 2020



Source: UBS, MSCI, Bloomberg Finance L.P., as of November 2019. Projected characteristics are based upon estimates and reflect subjective judgments and assumptions. There can be no assurance that developments will transpire as forecasted and that the estimates are accurate.

Earnings on the Rise

Our investment process is rooted in finding stocks that are attractively priced and show improving fundamentals. Semiconductors fit that bill for us at the moment.

Within our model, semiconductor stocks have historically scored well on valuation metrics. Compared to the large EM internet stocks that tend to offer more glamorous stories for retail investors, chipmakers have consistently offered investors superior cash flows and dividend yields, at a significantly lower cost. Semiconductors continue to be undervalued, but earnings fundamentals started to improve substantially in the third quarter. As a result, one of our largest overweights by industry is in semiconductors.

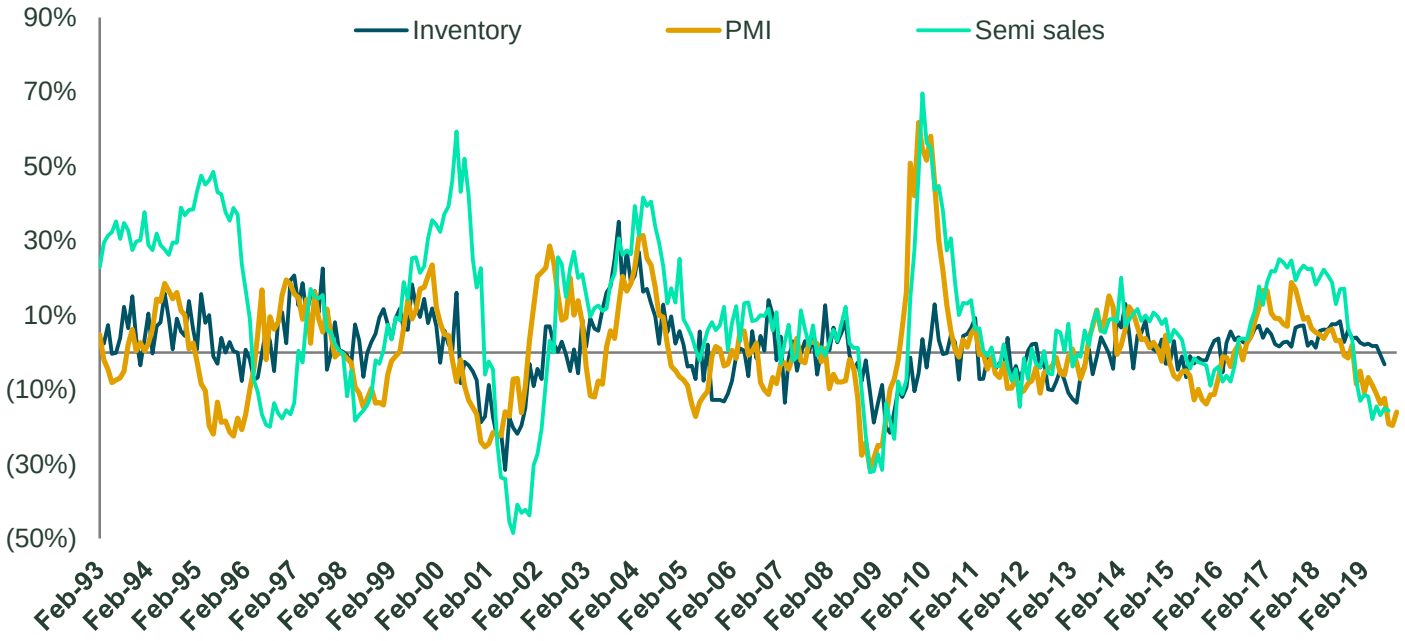
Sentiment Measures Pick Up On Improving Fundamentals

EM semiconductor companies are clearly linked to demand in developed markets; therefore, a supportive global economy is a precursor to any sustainable improvement in earnings. To this end, there is reason for optimism coming from US Purchasing Manager's Index (PMI) figures, which reached post-GFC lows in September. These figures began to increase in October, an encouraging sign to some analysts, as positive PMI movements have historically led global semiconductor sales by three to five months.

[2] Source: UBS, JP Morgan, as of November 2019.

Figure 3. **Developed Market Sentiment Measures Typically Lead Semiconductor Sales Improvement; US PMI Reached Post-GFC Lows in September**

US PMI, Global Semiconductor Sales and Global Semiconductor Inventory, 1993-2019 (% change, year over year)



Source: CLSA as of 31 October 2019.

Apple's October 30 2019 earnings report, which registered record earnings per share (EPS) for the previous quarter,[3] should help the improvement in PMI figures to endure. Apple's Q3 2019 earnings call anticipated strong holiday sales in Q4 2019, signs of a recovery in their sales figures in China, and a stronger iPhone growth cycle in 2020. In addition to rising demand from consumer giants, semiconductor firms are set to benefit from the massive computing power needs of the AI industry, which is likely to be a big driver in the years to come.

Our proprietary sentiment measures pick up on these fundamental trends by systematically analysing earnings and sales forecasts, as well as other metrics such as levels of short interest in EM semiconductors. Better prospects lead to better stock prices, all else being equal. Attractive valuation is the icing on the cake.

Ahead of the Curve on ESG

While our strategy is not bound by ESG considerations, we use a range of proprietary metrics to form an ESG-related view of every company in our investment universe. As part of our quality assessment, this ESG-related view helps us to evaluate whether companies are managed effectively and responsibly, with an eye to long-term shareholder and stakeholder returns. Firms that show relatively strong ESG characteristics are more likely to outperform, because they are generally less susceptible to future scandals or other improprieties. Our research has provided solid empirical evidence to support this belief. EM semiconductors tend to screen well on our ESG metrics. This suggests that EM semiconductors are ahead of the curve relative to other stocks in the EM universe on metrics such as carbon emissions, use of renewable energy, and to some extent improving board diversity.

5G technology creates a tailwind

As we look forward, it's reasonable to ask whether the turnaround we anticipate in semiconductors' growth prospects will be sustainable. We believe it will be.

One strong tailwind for EM semiconductor companies is the arrival and adoption of 5G technology. Apple and

[3] Source: "Apple Reports Fourth Quarter Results" (October 30, 2019; https://www.apple.com/newsroom/2019/10/apple-reports-fourth-quarter-results/).

Huawei are pushing aggressively to include 5G compatibility on their new 2020 devices. This is very likely to trigger demand for replacement devices as consumers look to benefit from improved streaming capabilities. The longer-term implications for the semiconductor industry are even more encouraging; 5G technology promises to help spread the use of artificial intelligence across a multitude of devices, beyond mobile phones.

Risks to the call

Broad industry calls always include some idiosyncratic elements, but certain industry-wide risks merit particular consideration. A deepening of global trade wars (either between the US and China, or between Japan and South Korea) would create additional earnings pressures. This would cause any anticipated 2020 economic recovery to be pushed out potentially to 2021, further delaying recovery in EM equity markets.

At an industry level, semiconductors constantly are vulnerable to commoditisation. One critical aspect of semiconductor manufacturing over the past 50 years has been the ability of the industry to consistently shrink components. As the size of components shrinks, it is becoming increasingly more expensive and technically difficult to stay ahead of low-cost producers.

The bottom line

Companies in the semiconductor industry currently warrant particular consideration because we believe the industry as a whole is relatively undervalued, even as earnings fundamentals improve. Rising demand for 5G-compatible and AI-enabled technology is likely to further fuel semiconductors' performance. Risks to watch include the potential for intensification in global trade tensions.

Portfolio positioning and performance[4]

Global equity markets continued its rally in October, led by developed Asia (including Japan) and US equities. US president Donald Trump announced that China and the US had reached a tentative trade agreement. The US agreed to suspend tariffs scheduled for October 15, while China agreed to buy up to $50bn in US farm products and accept more American financial services. However, announcements by Chinese officials at the time did not confirm a trade deal had been reached. Economic data was soft in the US and Europe, but showed signs of recovery in China. Sector-wise, Health Care and IT led gains while Utilities, Energy and Consumer Staples underperformed.

The State Street Global Equity Fund underperformed its benchmark during the month. Having a lower exposure to Energy added value, but was more than offset by negative stock selection within IT (not holding Apple and O/W IBM) and Staples (Kimberly-Clark and Colgate-Palmolive). The fund underperformed over the past 12 months; having a lower exposure to IT (not holding Microsoft) was a key detractor while good stock picking within Financials (Munich Reinsurance, Alfac Inc and Sun Life Financial) contributed positively.

[4] Bloomberg Finance, L.P. SSGA as at 31 October 2019. Past performance is not a reliable indicator of future performance. This information should not be considered a recommendation to buy or sell any security or sector shown. It is not known whether the securities or sectors shown will be profitable in the future. Characteristics are as of the date indicated, subject to change, and should not be relied upon as current thereafter.

Disclosure

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