Commentary

TAKING A STEP BACK

"Economies are not delivering for most citizens because of weak competition, feeble productivity growth and tax loopholes. The answer needs to start with acknowledgement of the fact that something has gone very wrong"

Martin Wolf, *Financial Times,* September 2019

As if to rebut our argument last month that there has been spectacular progress in every single measure of human wellbeing and that almost no one knows about it, as Steven Pinker argues compellingly in his book Enlightenment Now, Martin Wolf, the chief economics commentator of the *Financial Times*, has written a strongly worded indictment of current capitalism. It is well worth reading. Of course, we agree that there are inefficiencies, regulatory issues and market failures, but to take such a pessimistic view strikes us as just the type of negativity that should be countered by the facts of the progress achieved.

It is a fact of a market economy that people, companies and economies must be competitive in order to foster, and one of the key roles of governments and states is to create the stability, legal certainty, education, healthcare and social security that allows them to do so. Different economies have different models that have had varying degrees of success, but there are plenty of examples that show how it can be achieved.

Rather than take issue with the outcome and seek to increase taxes on companies, profits and incomes, or increase regulatory burdens in ways that may be necessary but must be offset against the risk of raising barriers to entry for newcomers, stifling competition and favouring the incumbents who have the scale and resources to comply (as is already the case with the European MIFID II financial regulation and GDPR privacy regulation), it seems to us that the focus should be on opportunities and education, and on increased investment by people, companies and governments in areas where there is a lack of facilities that allow people to get the qualifications and experience they need to do well. After all, the US and many parts of Europe are faced with shortages of qualified people in many sectors of the economy, in industrial, engineering, computer science and healthcare among many others, and economic growth globally means immigration is falling not rising, as people find opportunities in the places they live.

Of course, this will lead among other things to increasing wage pressure in the US and Europe, but the uncertainty of future prospects and the failure of real incomes to rise as much as other parts of the economy is one of the most important causes for the discontent so strongly prevalent in public discourse (and diagnosed by economists like Wolf). Of course, companies have to innovate to provide products and services that people want and that will allow them to be competitive, grow and create value. And it is those kinds of companies we look to invest in for the long-term. But taking a step back it is important to keep sight of the long record of progress, the opportunities it creates and the need to improve opportunity and access that has proven to deliver prosperity in the past and is likely to do so in the future as well.

Meanwhile, the economic news flow provided more evidence of global economic slowdown. Volatile data from the US economy showed the job market slowing down and some weakness was confirmed in Europe with Germany and Italy both probably in technical recession this quarter.

The continued uncertainty from the trade war between the US and China - coupled with geopolitical tensions (US-Iran) - have so far been offset from a market performance stand point by the ever-increased expectations of supportive moves by central banks.

We continue to see no signs of overheating although we do think that policy makers and in particular President Trump, will have to be careful to balance the demand for addressing trade imbalances with the impact the tariffs and uncertainty have on the US, European and global economies.

Although it has clearly contributed to the slowdown we are witnessing, so far the impact has been moderate. The US government has postponed implementation and exempted important categories for example. However, companies are postponing investment decisions, as in the example of a German Mittelstand company, family owned and a global leader in its field, who have decided to delay construction of a new plant in Alabama that was intended to increase capacity both for the US and Asian markets expected to be accessed more easily from the US. That is not good news for the US economy or the German company as it has had to delay its plans for growth and investment given the uncertainty.

It continues to be our view that it is in everyone's interest for the trade issues to be resolved and would expect to see progress before the current issues push the US economy from muted growth into stagnation or recession, not least in view of the upcoming presidential elections and the importance of the US economy and the stock market for President Trump's prospects of re-election.

This short-term, more political reasoning complements our fundamental position and is why our view of the market remains unaffected, focusing more than ever on the underlying fundamentals and taking a long term view. We still expect volatility to increase during the course of the next few months but our portfolio continues to be well protected by the quality of the companies we invest in, and in particular their strong cash flow generation and solid balance sheets that should allow them to weather any kind of adversity and take advantage of opportunities as they arise.

In this month's investment insight Giles Tulloch has written about the accelerating pace of innovation and disruption in the global payments system, which was initially driven by the industry leaders of Mastercard and Visa and is now being developed by many competitors including Monzo, Revolut, Apple and Facebook. These businesses have a long runway of growth ahead as they disrupt the traditional banks, the global monetary system and even the central banks. It is a classic example of new technology generating significant growth for shareholders in a large global addressable market; and an area in which we are actively invested.

World Stars Global Equity portfolio

During August, our World Stars strategy consolidated its past gains, closing the month up 0.4% in US dollar terms, showing resilience against volatile markets. It is up 19.7% year to date.

Once again positive earnings newsflow from across our holdings supported performance. Mobile tower operator *American Tower* reported solid earnings trends on the back of the ongoing structural growth in mobile data consumption. At the same time, the company's stable recurring revenue business model makes it a safe haven in periods of elevated market uncertainty, something which benefited the stock during the month.

Meanwhile, spirits producer *Pernod-Ricard* also reported solid earnings fuelled by consumer demand in China and India. Within healthcare, *EssilorLuxotica* continued its upward trajectory on the back of the strength of its operating results reported in late July, as well as receding governance concerns following the battle for control among its leadership team earlier this year. Leading online travel platform *Booking Holdings* posted a 12% growth in room nights booked, dampening concerns over any slowdown in global travel affecting demand. Finally of note, within the food & beverage industry *Nestlé* continued to gain momentum as the market increasingly recognises the company's more focused strategic approach under CEO Mark Schneider.

On the weaker side, within the energy space, *Schlumberger* retreated during August as market concerns around the ongoing trade war and its implications for the global economy dominated the headlines. We believe, nonetheless, that the company is a high quality asset with an attractive dividend yield of over 5.7% that stands to benefit as the oil market normalises from the downturn of recent years, and as geopolitical risks to supply are re-evaluated. Indeed, we have seen signs of this already in September.

In summary, we are encouraged to see the ongoing positive business momentum across our holdings, underpinned by the attractive structural characteristics of their end markets, the strength of their competitive moats, and their managements' focus on steering the businesses for the long term, irrespective of any macroeconomic or geopolitical volatility that arises.

Multi-Asset Income portfolio

August was characterised by increased volatility in our fixed income portfolio, down -4.3% for the month but up 3% since the start of the year, triggered by renewed concerns about the deteriorating situation in Argentina (more on the Emerging Markets bond portfolio below) and a weaker oil price, which has subsequently reversed in September. However, performances from equities and non-correlated funds, up 0.6% and 0.4% respectively (and now up 23.7% and 3% year-to-date), provided some downside protection. Overall our portfolio fell 1.5% in the month but is up 7.8% year to date in dollars.

Despite our limited exposure to Argentina (4.25% of the total portfolio) our fixed income allocation suffered because the price movements were quite violent (*YPF* -33%, *Clisa* -19%), whilst *Chesapeake Energy* (-11.5%) was affected by the lower oil price and market concerns regarding the group's business model. Our strategy remains to hold to maturity unless there is evidence that the fundamental drivers of the investment case are no longerintact. In all these cases we still feel comfortable with the fundamentals and have bought shorter duration bonds for YPF (2021) and Chesapeake (2022) to benefit from the opportunity.

The portfolio cash generation so far this year has been 3.1% and on this front we expect to finish the year on a strong note.

Emerging Markets bond portfolio

August was the first negative monthly performance in 2019 for the Emerging Market Bond portfolio which was down -1.8%, bringing the year-to-date performance to 7.9%, net of fees.

Our Argentina allocation was the main reason for this poor performance. Following the results of the primary elections in Argentina which showed the Peronist candidate's inevitable victory in October over the incumbent President, the market subsequently priced a default for Argentinian bonds across the board. In response, our *YPF* holding was down 31.4% and *CLISA* down 18.9%. The sell-off was aggravated because most investors were long Argentinean risk and liquidity is thinner during the summer months. We remain confident in our position in YPF, given that the Oil & Gas sector will remain a priority for the Government and this cannot be developed without external capital.

Our position in *Pemex* was the outlier, up +4.9%, having underperformed earlier in the summer. Bond investors came back to the company in anticipation of the announcement of a support plan by the Government in the form of a capital injection, and the opening of the capital to private companies.

Coming back to the global macro environment, the potential trade war between China and the US and its potential impact on global growth triggered a flight to quality - and a subsequent flattening of the US benchmark curve - with the 5-year US Treasury yield dropping by 30bps to 1.39%.

The combination of the decline in global yields and overall low credit spreads creates favourable conditions for new issues. However, in view of the limited differentiation between ratings and quality, we continue to remain highly selective for our bond universe and focus our analysis on solid credits, which we define as a company with good visibility of earnings, predictable cash flow generation and a record of capital preservation.

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