Insight

INVESTMENT THEMES AND OPPORTUNITIES FOR 2020.

As we look forward to 2020 after a year of significant returns across our equity and credit investments, we find ourselves in a similar constructive frame of mind as last year.

In the following, our investment team offers our views on some of the issues we see and how they may impact our investments.

As last year, from an equity perspective, we believe there are many drivers that should lead our companies to do well, both from a cyclical and secular perspective. We think there are significant opportunities in fintech with the large digital platforms launching new products and the existing payment providers benefitting from increased usage. In luxury, LMVH, the global leader, was our best performing stock this year and is going from strength to strength. Finally, in industrials we see strong growth from structural opportunities and cyclical reacceleration, not to mention from markets if Benjamin Graham-type value stocks come back into favour.

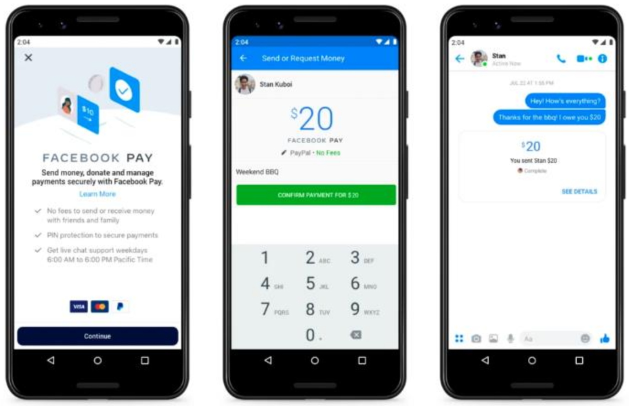
From a credit perspective, we are expecting another good year albeit constrained by credit spreads that have compressed over the past year. We hope to use the inevitable volatility in emerging markets to our advantage and remain vigilant given the number of political risks on the horizon for emerging markets in 2020.

By sticking to what we know, identifying global companies that have strong fundamentals and attractive valuations and keeping a long-term perspective, we expect our investments to be resilient and to continue to take advantage of market movements

EQUITIES

Technology: Fintech, payments, cloud computing and regulation

Earlier this year we wrote about the fintech sector and the opportunity for payments in a number of our investment insights. Performance has been strong in our holdings in technology, both in some of the great digital leaders and in payment service providers. Nonetheless, we believe that fintech will remain a key investment topic in 2020 as the banking sector faces a significant number of challenges and opportunities ahead. Digital disruption is occurring at every level in the banking industry with incumbents increasingly vulnerable to disruption.



The largest technology companies in the world are using their brand and scale to launch consumer focused financial products. For example, *Alphabet/Google* is set to release a checking account in partnership with Citi, Facebook is bringing Facebook Pay to its billions of users and *Apple* continues its credit card in partnership

J. Stern & Co
4 Carlton Gardens
London SW1Y 5AA
United Kingdom

Tel: +44 20 3478 1800
Fax: +44 20 3478 1799
info@jsternco.com
www.jsternco.com

with Goldman Sachs. The tech giants are all looking to make inroads into the lucrative banking sector as are a significant number of upstarts. Some notables such as Revolut, Monzo and Starling are all offering new digital solutions without being tied to legacy systems and processes. There has also been consolidation amongst merchant acquirers and processors in the back end, creating scale and improved technological capabilities for merchants and issuers.

A related important driver will be cloud computing, data analysis and artificial intelligence, which will continue to be areas of focus for enterprises. Data is becoming increasingly important and valuable for enterprises. With artificial intelligence, enterprises can better analyse and make sense of data. We have said that we believe that the roll out of global enterprise resource planning (ERP) systems like SAP, which allows companies to analyse and control their global capital allocation, purchasing, costs, inventories and investments, is one of the reasons corporate profits are so high in industries that allow their major participants to retain them. The role of the data scientist has evolved and it is now a highly sought-after profession. Cloud computing resources enable more efficient data storage as well as providing the necessary computer power and processing functionality.

Greater portions of enterprise budgets will move towards these areas with the large technology companies investing into their own resources and finding compelling commercial applications. In particular, Alphabet is placing great emphasis on its artificial intelligence capabilities and is positioning itself into major industries such as automotive with Waymo and healthcare with AI driven diagnostics. Alphabet is also leading the race in the quantum computing roadmap, as it seeks to determine the future of computer processing.

Finally, in last year's outlook we wrote that regulation and privacy will be important issues for the technology sector. Despite all the attention that it received in 2019, we believe that it will continue into 2020. These issues are important and as the technology sector evolves, so will the responsibilities of the large players. Facebook has made progress in terms of their settlement with the FTC regarding data privacy, but more will need to be done in 2020. Both the DOJ and FTC are leading investigations into the large tech companies, and with bipartisan support across the US House of Representatives and especially in an election year, we expect that there will be further significant developments. The political uncertainty will persist.

However, we still do not see what advantage a break-up of the US tech giants would achieve. We think that the ability of US tech companies to compete globally, in particular against Alibaba, Tencent and the other Chinese companies that benefit from China's large and closed internet economy, is a major competitive advantage for the United States that it would do well to weigh against the real and perceived competitive threats and privacy issues they cause. And finally, we believe that government and politicians should proceed cautiously to increase regulation because of the obvious but nonetheless 'unintended' consequence of increasing barriers to entry for competition since—like in any industry—the incumbents are best placed to deal with increased regulatory burdens because of their scale and resources, whereas disruptors or smaller players cannot afford it and are driven out of business. During our recent field trip to meet companies on the West Coast of the US we spoke to the managements of many leading technology companies for who it is an important issue and who are working on providing solutions to address the legitimate issues they are facing.

Giles Tulloch

Luxury Goods: The winner takes it all

Source: www.uk:louisvuitton.com

We had high expectations but nonetheless, 2019 turned out to be as we had expected at the beginning of the year. The trade war between the US and China slowed Chinese GDP growth but had a minimal impact on the consumption pattern of luxury goods of Chinese consumers, who now make up about one third of global luxury goods demand and drive much of the sector's growth. What we had not expected at the beginning of the year was the disruption in retail districts in Hong Kong since July. The student demonstrations and riots on the streets reduced tourist traffic to the territory and store opening days, both of which have had negative effects on luxury goods sales in Hong Kong. However, the sector was able to offset a part of these lost revenues from increasing sales elsewhere, most noticeably in Mainland China.

We purchased LVMH for the World Star portfolio in January this year taking advantage of the low valuation after a 30-35% de-rating, negative market sentiment and the extreme bearish outlook towards the luxury goods sector at that time. The stock has since re-rated and generated close to 60% total shareholder return since our purchase.

Source: www.bulgari.com

The luxury goods sector is increasingly polarised. With a few notable exceptions, the great conglomerates are outperforming mono-brand companies and soft luxury is doing better than hard luxury. The rise of importance of Chinese and millennial consumers is shifting the demand for luxury goods from traditional mid-aged clienteles to much younger demographics. These consumers, aided by social media, are demanding ever more innovation from luxury companies. The implication of this trend for the industry is that all companies must invest more and more on product innovation, brand equity as well as digital platforms. Larger companies with better financial resources are faring better than smaller mono-brand companies as they can leverage the scale to spread the cost across the entire company infrastructure without the detrimental profit margin re-set.

LVMH is the leader in the luxury goods sector. With its broad portfolio offerings and geographic reach, LVMH continued to innovate and invest for future. It has outperformed the market in the recent years and gained market share.

Source: www.tiffany.co.uk

In November this year, LVMH reached an agreement to buy Tiffany & Co, an iconic luxury jewellery brand with the unique American heritage. The brand's elegance, innovative design and fine craftmanship are exemplified by Truman Capote's Breakfast at Tiffany's and the iconic film starring Audrey Hepburn. The acquisition strengthens LVMH's presence in jewellery where it is subscale before the acquisition. For Tiffany, being a member of much larger LVMH family means that the brand can focus on its strategy without the market pressure of balancing between investing in the business for the long term and meeting analyst expectations at the quarterly reporting in the short term.

The global 'trade war' has particular relevance for luxury goods industry and LVMH, as much of the demand comes from China and its Asian neighbours, and many brands and their aura depend on products manufactured in France and Italy. As we enter 2020, the uncertainty of the trade-war continues to linger. The talks about 'phase one' deal between the US and China are on going. Depending on the outcome, whether it is rolling back some of the tariffs already in place as it appears from the latest news, a cease-fire, or further tariff implementation, we believe the Chinese government will respond accordingly with both monetary (interest rate and RRR cut) and fiscal policies (infrastructure spending) to stabilise the economy. In the longer term, the government is rebalancing towards a consumption led economy through structural reforms. Provided the labour market is not hit hard by the trade war, we believe the income growth can be sustained at 5-6% in the next few years which, in turn, provides a solid ground for consumer spending and demand for luxury goods.

In Europe, the trade dispute took a turn for the worse in the fourth quarter after France passed a new law to impose 3% tax on revenues of digital services providers. The US responded with a proposal to implement a tit-for-tat tariff of 100% on French goods, most noticeably luxury goods such as handbags, cosmetics, and wines. In our view, pricing power of many luxury brands as well as a shift in demand from the domestic US to other international markets (as we have seen in Hong Kong this year) could, in part, mitigate the impact of tariffs if they are implemented.

The acquisition of Tiffany by LVMH could also trigger a wave of consolidation in the luxury goods sector in the coming years. In fact, the latest news is that Kering and Moncler have already held initial exploratory discussions to create an Italian luxury powerhouse according to press articles. In today's volatile environment, where significant investments in brands, product innovation and digital platforms are essential to compete successfully, size does matter. We believe that LVMH with its phenomenal global presence, will continue to capture a disproptionate share of the premium growth in the luxury sector.

Zhixin Shu

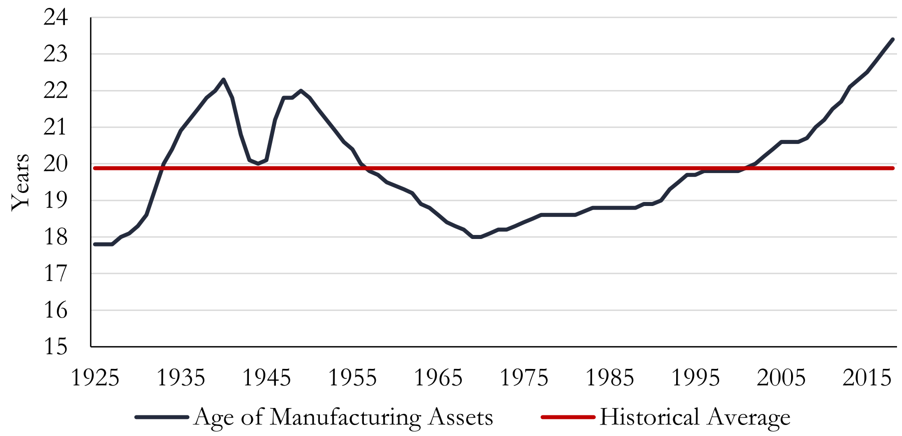
Industrials: Structural opportunities and cyclical tailwinds

2019 was a year characterised by volatile newsflow, with the ongoing trade war affecting global supply chains and tempering demand for capital spending as managements were unwilling to commit to large investment projects amidst the uncertainty. At the same time disruptive forces have seeped into the industrial arena, most notably in verticals like automotive and energy as the market tries to quantify the pace of transition into a lower carbon economy and identify the winners and losers emerging as a result. Against this background, end market exposure and the ability to steer through these disruptive forces whilst managing effectively the shorter-term effects of the trade war have been the distinguishing factors driving performance within the sector. Most if not all of our companies have not only managed successfully this balancing act but have actually prospered in this environment. United Technologies, Eaton and Honeywell have all ranked amidst our top performing holdings given their significant intellectual properties, dynamic portfolio transformations and proven operational execution track records.

Looking forward into 2020, we continue to see headwinds but believe that we are approaching a resolution in key issues. The Conservative majority arising from the recent UK election paves the way for the country's managed exit from the EU, whilst the upcoming US presidential election is acting as a pressure point for a resolution in the ongoing trade dispute, although the US/ China battle for influence will likely continue to play out for many years to come. Central banks are likely to continue to be accommodative whilst fiscal policy remains an available lever both within China as well as Europe. In short, with global trade headwinds receding, ongoing strength in the domestic US economy and China maintaining its target ~6% growth rate, the global backdrop is paving the way for a positive outlook for industrial demand.

Importantly, the structural need for capital investment has been building after years of below trend spend levels. Within the US for example, private sector assets are now aged over 23 years on average, making the country's industrial base the oldest it has been since the 1950s. With tight labour markets and pent up demand the stage is set for the industrial sector surprising on the upside in 2020. At the same time, the sector more broadly remains relatively under-owned meaning that stocks with solid fundamental stories and still undemanding valuations are well placed for outperformance in the year ahead.

Age of U.S. Manufacturing Assets (1925-2018)



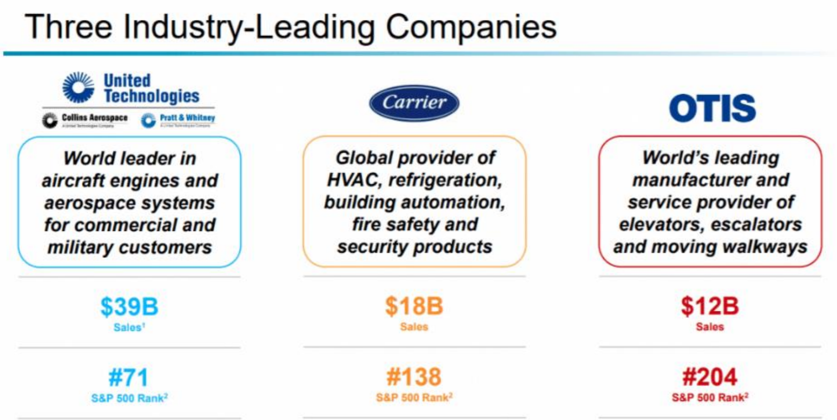
Source: U.S. Bureau of Economic Analysis

Longer term, the sector is in the process of digesting fundamental disruptive changes, creating both threats and opportunities for players in the industry. The digitalisation of manufacturing, automation and Industry 4.0 are a prime example of such a technological transition. At the same time, requirements for increased energy efficiency, the emergence of intelligent and interconnected systems and investments in renewable resources that require connection to the utility grid are acting as structural drivers for electric infrastructure spend. Within aerospace, the opportunity to utilise artificial intelligence to enhance maintenance, communications and traffic management are all opening the door to transformative changes within the space. More broadly, the emergence of ESG (environmental, social and governance) as an additional investment consideration coupled with higher climate awareness are unlocking interesting opportunities in green aviation, smart infrastructure, green buildings, electric transportation, environmental protection and clean energy.

Against this combined backdrop of receding short-term headwinds and long-term structural transformation our holdings are likely to see another year of positive momentum.

Honeywell, the leading industrial technology player, has been amongst the earlier players to identify the opportunities that the digitalisation of manufacturing has to offer, transitioning to a more software centric offering, leveraging its installed base and domain expertise, across the aerospace, commercial building, manufacturing and logistics industries. Examples include the company's flagship GoDirect and JetWave connected aircraft offerings that offer enhanced passenger entertainment solutions as well as flight support (eg weather, turbulence and traffic predictive capabilities) and maintenance services. A similar such example is the recently acquired Intelligrated franchise, which offers warehouse automation solutions, capitalising on the structural growth in e-commerce and the increasing automation of the supply chain. At the same time, the company maintains its commitment to actively managing its asset portfolio, with the 2018 spin-offs of its transportation systems and home controls and distribution businesses pivoting the portfolio away from more cyclical areas, and focusing it further around software, automation and sustainability.

Similarly, the investment case for our holding in United Technologies remains robust. The upcoming spin-offs of the Otis (escalators & elevators) and Carrier (HVAC and fire & security) franchises should unlock significant shareholder value in this leading industrial player, concluding the portfolio transformation process of recent years.



At the same time, the merger of the core aerospace business with Raytheon, expected to close shortly after the company's breakup, will create an unrivalled pure aerospace provider, offering significant technological synergies in terms of advanced analytics, ISR (intelligence & reconnaissance) material technologies and hypersonics at a time when the aerospace industry is pushing against the limits of physics and engineering in its quest for next generation technological solutions. In the meantime, the core business continues to enjoy solid momentum with commercial aerospace and military spend seeing good trends, the ramp-up of the GTF engine supporting the Pratt & Whitney franchise and the Rockwell

Collins business acquired last year reaping already delivering meaningful cost and revenue synergies.

Katerina Kosmopoulou

MULTI-ASSET INCOME AND CREDIT

Multi-Asset Income Strategy

With two weeks to go until the end of the year and reflecting on the markets in 2019 and our asset allocation over the same period, the adjustments made early in the year worked well. Entering this past year when the equity markets had corrected almost 20% at the end of 2018 due to the combination of a China growth scare and expectations of further interest rate rises by the US Federal Reserve, our central scenario was that although slowing, global economic growth would be resilient, especially in the US, and our equity portfolio's earnings would again see good growth.

What made 2019 a particularly good year was the combination of attractive valuations for both equities and credit (especially in emerging markets, more on this below) and the sharp reversal in global monetary policies. Investors' reluctance to get involved due to recession fears, meant that risk aversion became a positive support for risk assets due to high cash balances set aside to be invested, further pushing prices higher. This was the case for US equities and emerging markets debt, which both saw high levels of inflows during the year.

Throughout the year and after a very strong performance for emerging market corporate bonds, we decided to diversify the credit portfolio and invest more into both US and European high yield bonds, which presented attractive yields and still fairly wide spreads. We bought bonds including *Fage* (2026) and *Mauser (*2025) bonds. However, the portfolio suffered from a somewhat prematurely timed purchase of *Chesapeake Group* (2026 and 2022) bonds just as oil prices came under pressure due to slower global economic growth.

We see 2020 benefiting from a similar investment back drop, with interest rates remaining low as central bankers will be reluctant to take their foot off the accelerator. Significant progress and eventual resolution of the trade dispute between the US and China, and possible resulting increases in corporate investments, may alter the investment environment although we do not expect a significant impact until the following year at the earliest. The reflation trade is likely here to stay.

As a result, we expect 2020 to provide another year of reasonably positive returns for risk assets. In a low to negative interest rate environment, the case for yield is ever more present across the investment community and we would expect more cash to be put to work.

In this context and assuming continued upward price pressure for risk assets, we would expect to increase our allocation to non-correlated funds. The latter have been a key theme of our strategy generating consistent returns since inception (5.5% pa since January 2015) with minimal volatility.

During the course of 2019 we extended our coverage of such investment opportunities adding two more trade finance funds with returns ranging from 6.5% to 9% annualised and also adding another royalty fund (this time in the music space). Beside bringing visibility to the returns of the overall strategy and reducing volatility, they also represent good sources of recurring income cash generation and provide diversification away from the traditional ways of corporate funding. As the disintermediation of funding by banks follows its course globally there are increasing opportunities with attractive rates of return in differentiated credit markets remains relatively strong despite the sharp fall in interest rates worldwide and the record amount of debt now yielding negative returns.

We approach 2020 with a number of exciting opportunities in our pipeline which will provide the strategy with further diversification, visibility and stability.

Jean-Yves Chereau

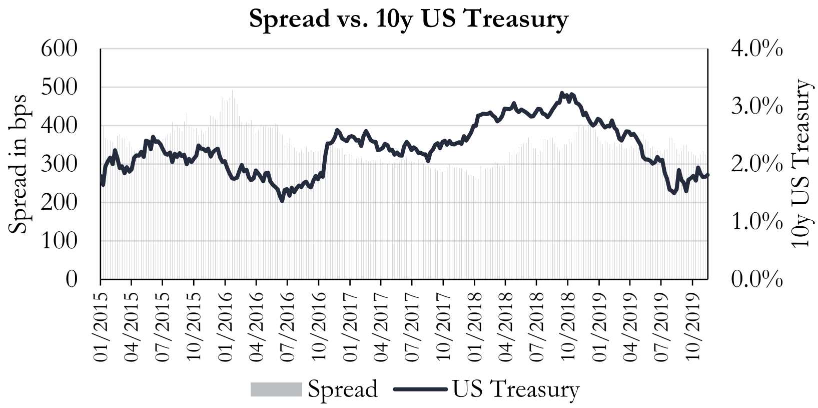
Emerging Markets Bonds

A year ago, we were advocating the attractiveness of emerging market bonds with an average yield to maturity of 9% in our Emerging Market Bonds portfolio. Not surprisingly, our portfolio rose 5.3% in Q1 supported by the Fed shifting to a dovish tone, signalling that they will not respond to stronger growth unless they see inflation risks. Furthermore, the US economy showed resiliency and progress in the US – China trade discussions were factors supporting risky assets in general and emerging market assets more specifically across 2019. A resumption of optimism coincided with robust inflows into the asset class pushed prices up and spreads tighter. This happened in the context of a compression and dis-inversion of the US Treasury yield curve, which saw the five-year US Treasury yields falling to 1.60% from 2.5% at the beginning of the year.

Given our view that central banks will keep rates low, growth will remain positive and there will be only moderate inflationary pressure in 2020, the backdrop for emerging market debt is positive, although it will be difficult to replicate the strong performance of 2019. At this stage, US rates will be more of a headwind to EM than a tailwind as happened in 2019.

Whilst most baseline forecasters are apathetic about fixed income as an asset class given the low level of base rates and tight spreads, we advocate a distinction for emerging market bonds, which in our view should remain resilient because investors who do not usually buy emerging market bonds will have to allocate to the asset class given the insufficient level of income provided by investment grade bonds.

As the chart below shows, the overall level of spreads in emerging market bonds is historically still generous. However, what is more striking is the sharp decline in benchmark rates resulting in overall compressed yields. That said, the universe is very disparate offering the possibility to combine strong quality, liquid names with less researched, smaller but robust companies.



Catherine Blanc-Adams
December 2019