Commentary

EXPECTING THE UNEXPECTED

August is a time for reading and reflection. This year has turned out very differently from what we had expected. So much of our everyday reality has changed because of Covid-19. It has been a great challenge to adapt in our personal and professional lives and it has brought concern, adversity and distress to many. However, it is also striking how resilient our societies and economies have been in the face of the unprecedented measures taken to contain the spread of the virus and how quickly and effectively global science and technology has been able to progress towards diagnosis, treatment and protection.

The Covid-19 pandemic has accelerated many of the changes and disruptions of the past ten years, none more so than the shift from offline to online in most areas of economic and social activity. Some companies have prospered while others have faltered.

Our focus on quality and value for the long-term has allowed us to identify many of the companies whose businesses have benefitted from this acceleration of changes because of the strength and resilience of their businesses and balance sheets. That is why our World Stars Global Equity strategy is now up 8.4% for the year in US dollars.

The second quarter has borne the full impact of the measures taken to contain the pandemic on economies and companies. Corporate results over the past couple of weeks have shown how disparate the performance of companies can be. A number of our companies in two of the key areas we invest in, digital and online, health care and life sciences, have reported record results. Others in consumer products and industrials have shown resilience in absorbing the impact, adjusting their costs and using their balance sheets to take advantage of opportunities and to make acquisitions.

We discuss a number of companies in our comments below but one to highlight is Facebook, which has been subject to significant scrutiny and advertising boycotts due to its content policy. As we had expected (!), Facebook has continued to adapt its policy and is proactively enforcing the standards it has established across its global platforms. Contrary to the expectations of most brokerage analysts and journalists, second quarter results showed increases in monthly active users and engagement, along with record sales and margins. As a platform, Facebook now has more than 3 billion monthly active users, of which only 20% are in the US and in Europe. It reinforces our focus on fundamental research into companies and the long-term prospects for their businesses, avoiding distractions from short-term alarmism.

What we can expect is that the second half of the year will also contain a wide range of outcomes for consumers, companies, and investors. Much will depend on the progression of the pandemic. There are signs of increasing infection rates as measures are lifted. So far these have been modest compared to the infection rates seen earlier this year and measures like the UK quarantine period imposed on certain countries as we write seem to be motivated by politics, not science. Far more important will be if infection rates increase as the Northern Hemisphere enters the Winter season. We have made significant progress in testing and treatment of the disease but a significant increase will lead to the re-imposition of measures even if they are unlikely to be as stringent as they were before.

The only permanent solution to the situation is a vaccine. As our healthcare analyst Zhixin Shu wrote in the last month's important insight on the different vaccines being developed and tested to protect against the virus, several of the candidates have shown great promise. The mRNA vaccines developed by Pfizer/BioNTech and Moderna are in Phase 2 testing. Results are expected in the third quarter and it is possible that we will have a vaccine in the fourth quarter of this year. A vaccine in such a record time would be unexpected too and would be a tremendous positive for economies and markets.

Governments and central banks are just coming off the successful management of the global financial crisis, the biggest fiscal and monetary experiment of the post-war financial system. With the global economy growing and allowing for the stabilization and possible reduction of indebtedness as a percentage of GDP, the threat of deflation seemed to have passed and rates were rising to more 'normal' levels. Shutting down economies and incurring drops in GDP of 25% or more is unprecedented too. The fiscal and monetary impact will last for years. Given the elections in the US, the tensions in the EU, Brexit in the UK, the domestic challenges in China as well as the global uncertainty around trade and tariffs, it seems likely that governments and banks will do what it takes to stabilize economies and to withdraw measures only as gradually as possible. During the global financial crisis, the US Fed said it would be led by the evidence and we see no reason to believe it will be different now.

Corporate results have been resilient, valuations are attractive, progress in vaccine development is promising and fiscal and monetary support is likely to be ongoing. We believe the companies in our portfolios offer compelling value for the long-term and any volatility will be a buying opportunity like we had in March of this year.

We hope you are having a healthy and restful summer. Our comments and insights, including Zhixin's on Covid-19 vaccines, are posted on our website www.jsternco.com as are recent newspaper profiles, articles and statements we have made. Please read them this summer if you are so inclined.

World Stars Global Equities

Our World Stars Global Equity strategy performed strongly with the portfolio closing July up 6.7% in US dollars, bringing performance to +8.4% year to date. Our performance reflects significant outperformance compared to the MSCI World down -0.9% year to date as well as compared to other global indices.

Performance continued to be broad based. The contribution of our digital and technology holdings was led by *Amazon*, which reported a staggering 40% revenue growth during the second quarter as consumers switched to online shopping during the pandemic, with sales reaching USD 89 billion. Amazon achieved strong operating leverage, generating USD 6 billion in income (well ahead of analyst expectations) despite absorbing USD 4 billion in incremental expenses as it continued to ramp up capacity. Social media leader Facebook also delivered strong growth, with revenues up 11% during the quarter as higher user engagement and the accelerated shift to online advertising fuelled results. Importantly, the company continued to add monthly active users, up 12% during the quarter. This increase brought the number of monthly active users to more than three billion as more people used Facebook's suite of platforms to stay in touch with family and friends during the lockdown.

Within health care, leading life sciences company *ThermoFisher* benefited from its position as a key solutions provider in the fight against Covid-19. The company reported 11 revenue growth, generating USD 1.3 billion in revenues related to Covid-19 products and services, including testing kits, research laboratory products and vaccine development solutions. ThermoFisher remains a disciplined acquirer and given its increased bid for Qiagen did not meet the minimum acceptance threshold, we expect the company to seek alternative strategic opportunities continuing to take advantage of the strength of its balance sheet.

Medical devices and diagnostics leader *Abbott Laboratories* also posted better than expected results, with the company generating over USD 600 million in revenues from its own Covid-19 testing products. Although Abbott's medical devices business suffered as operations were postponed globally, we expect this demand to come back strongly as health care systems start to return to normality.

Lastly within the health care sector, medical devices and life sciences leader *Becton Dickinson* rebounded from its prior month weakness. As we highlighted last month, the company's capital increase in May was a pre-emptive move to take advantage of strategic opportunities which are arising in the pandemic, rather than a reflection of financial stress. The market has now backed up this view and any weakness due to short-term results or the capital increase are an opportunity.

Within the industrials sector, leading elevator company *Otis* posted better than expected results, demonstrating the resilience of its service business. At the same time the company is starting to reap the results of its prior investments in digitalisation and increasing labour density, translating to higher levels of profitability. As a recently independent company following its spin-off from United Technologies, the results demonstrated the attractiveness of Otis as a standalone entity, further consolidating its shareholder base and pushing the share price to new highs.

Materials technology provider *Sika* also posted better than expected results, despite lockdowns affecting construction activity globally. Importantly, the company has been seeing a normalisation of activity in the US, Europe and parts of Asia since June and is anticipating a further acceleration during the second half of the year given the resilience in refurbishment activity and supported by infrastructure related projects.

On the weaker side during the month, leading aerospace company *Raytheon Technologies* continued to be volatile reflecting uncertainty around the timing and pace of the recovery of commercial passenger traffic. Nonetheless the company's cash flow is shielded by the resilience of the defence business, accounting for over 55% of revenues, which continues to post mid-single digit growth.

Also on the weaker side was global luxury goods leader *LVMH*, which was hit by shutdowns in retailing outlets globally. However, demand by the critical Chinese consumer has already bounced back towards more normalised levels and we expect other regions to follow suit as lockdowns ease progressively. Long-term the company remains one of the strongest players within the luxury goods space, a position that will only be strengthened by the imminent takeover of Tiffany's.

Multi-Asset Income

Risk asset benefitted from a relatively benign environment during the month of July, buoyed by further signs of economic recovery globally. Our Multi-Asset Income strategy had a strong performance for the month, up 3.9% in (and now positive up 2.2% for the year). Equities were up 6.4%, and are now 12.1% ahead since the start of the year. Fixed income carried on its recovery with a 3.9% positive return for the month (still down 11.5% year to date) and non-correlated funds also contributed positively, up 1.5% (now up 1.5% for the year). All performance is in US dollars.

Financial markets were supported in July by positive economic news and positive news flow on the Covid-19 vaccine front, as well as by news of an agreement between EU countries for the launch of the EU recovery fund and the expectation of additional US fiscal stimulus.

Our fixed income portfolio saw some of the lagging performers in European high yield catching up with recovering emerging market bonds. Bonds including *Douglas*, *Schenk* and *AA* all had strong performances during month.

The strong performance of equities led us to further adjust our asset allocation, taking profits in equities and increasing the allocation to bonds to benefit from prices that have in some cases not yet fully recovered from the correction and have attractive yields. Our purchases included *HTA* (Helios Towers) a leading independent telecom towers operator in Africa, *Koc Holding* and *MHP*. The credit portfolio after the recent recovery still offers investors a current yield of close to 7.5% per year for a very short duration.

Our 12-month view of the global economy and financial markets remains constructive thanks to the continued support from central banks and additional fiscal stimulus by governments. However, markets may be volatile as they are faced with the uncertainty of economic recovery, the difficulty of managing the trade-off between reopening the economies and controlling Covid-19 infection rates, and the tremors of the US election campaign. It is also worth noticing that the US high grade sector is now trading at a 100 year low yield.

The fundamentals of our underlying investments are still very healthy, with strong earnings and cash flow, and we view any volatility as an opportunity to optimise our portfolio and expected returns for our clients.

The strategy has so far generated 2% cash yield and with the recent bond purchases will be on target for a strong income delivery for the full year.

Emerging Market Bonds

July was another positive month for our Emerging Market Bond strategy, returning 1.6% in US dollars during the month. The support provided by the Fed and the ECB continued to be a tailwind to credit markets globally. In addition to this monetary stimulus, the US dollar had its worst month in a decade as US Treasury yields fell to record lows, providing a positive backdrop for emerging markets as foreign investors searched for higher bond yields and faster economic growth.

Performance was once again led by *YPF*, which returned 11.3% in the month. The company managed to successfully execute an exchange offer with bondholders in July for its bonds maturing in 2021, thereby extending its maturity profile and ensuring sufficient liquidity in the short term, whilst also reducing refinancing risk. *Marfrig*, one of Brazil's largest meat packers also had a strong month, returning 8.2% as the business continued to benefit from both strong demand and pricing across its markets.

Earnings reporting for the second quarter is underway will provide greater visibility of the current and prospective operational and financial impact of Covid-19 on geographies, sectors and companies. Our exposure to challenged sectors like energy is low and we feel our portfolio continues to be well positioned going forward. Volatility around the US elections as well as geopolitical risks are among our main concerns for the rest of the year, in particular due to the fraying relationship between the US and China and the potential consequences this will have on the global economy and investors' risk sentiment.

July 2020