Investment Commentary

GOLDILOCKS AND THE BEAR MARKET

Last week we had a chance to speak at the first London Quality Growth conference, a timely gathering of investors given the sell-off in markets and the even bigger sell-off in some of the companies we own. We highlighted our long-term approach to investing in quality and value, and our view that volatility is as much an opportunity for long-term investors as the kind of rotation from 'growth' to 'value' we have had this year.

For us, quality is a long-term concept. We look for companies that have competitive advantages and opportunities for innovation and growth of cash flows for 25 years or longer. Value is a long-term concept too, but there can be short-term opportunities for even greater returns that arise in a matter of days, weeks or months when uncertainty and fear lead to indiscriminate selling and opportunities.

Pressures on markets are increasing this year and, understandably, many investors are nervous given concerns about inflation and the ongoing effects of the Covid-19 pandemic, in particular China, and the Russia/Ukraine conflict.

We have to remember that the Covid-19 pandemic shut down much of the global economy for two years and that it only survived because of government support. We are now moving into the next phase of the transition to a post-pandemic economy, in which recovery continues and the expectation of interest rate rises is replaced by actual hikes.

As a result of strong demand hitting disrupted supply, supply constraints have deepened in most industries. We have highlighted repeatedly that these supply constraints were always likely given the lack of investment in private and public infrastructure in recent decades. The pandemic and the Ukraine crisis have simply exacerbated this already fragile situation and caused greater bottlenecks.

These supply restraints will take time to resolve but the question investors face is whether we will have a technical recession (which looks all but inevitable given the difficult comparisons to the high growth we had last year) that can be resolved in the short term, or whether it will be so severe that it will cause not just a slowdown in consumer spending and corporate demand, but a more significant downturn in the economy and a prolonged recession.

What is certain is that whatever the outcome we are entering a new economic cycle and we think it is about time we recalled some of the concepts from the last time we faced the burst of a technology bubble, major geopolitical conflict, strong recovery, inflation and interest rises in the early 2000s. We remember constant concern about economic growth and inflation being too high or too low and the Fed being too aggressive or too hesitant on rates.

We will have to remember the distinction between 'headline' and 'core' inflation. As benefits and savings run out and workers re-enter the workforce, oil and gas production increases (especially in the US), and global supply chains are realigned to face the new realities (as hopefully, the Russia/Ukraine conflict starts to abate and China reopens), there should be a significant supply-side response, which should result in headline inflation falling over time. It could take through the second half of this year, again given the difficult comparisons, but the result should be persistent core inflation but at much lower levels than today.

We must also dust off the data-driven phrase coined by Ben Bernanke in the early 2000s. The Fed has already given more than a hint that incoming data would be behind its decisions on whether to raise interest rates. As Fed chair Jerome Powell said in January a few weeks before its first interest rate hike in March: “We're going to be guided by the data. We'll try to communicate as clearly as possible, moving steadily and transparently." Expect this theme to continue as the year unfolds.

The most important concept we have to remember, however, is the 'Goldilocks' economy, after the character in *Goldilocks and the Three Bears*, who likes her porridge not too hot and not too cold, but just right.

US and European markets are now in a bear market having dropped 20% from their recent highs, and there is a risk that the consumer slowdown tips over into something worse. The key question for investors is whether we move from an expectation of extremes to a more balanced scenario where the Fed manages to deliver a Goldilocks economy, where economic growth is steady enough to prevent a prolonged recession but not aggressive enough to cause sky-high inflation. If the Fed delivers, we will see an improving environment in terms of both inflation and markets. The Fed's rate hikes this year and its strong anti-inflation stance are already slowing down economic activity, which in our view raises the prospects for a more moderate outcome.

Company fundamentals matter most to us and we will have to closely analyse the impact on the sales, earnings and cash flows of the companies we invest in. The post-pandemic transition is difficult to predict in detail and we have to be careful not to draw the wrong short-term conclusions from some of the recent profit warnings. Consumers may not be buying as many goods as they were but they are consuming services again. Let us recall that the services sector represents around two-thirds of the US economy and was largely shut down during the pandemic. A shift to services is absolutely normal at this stage, it will generate employment and income and is a reason to be positive.

Another aspect of the current environment is that demand at the higher end has remained robust. Travel is resurging and comments from European luxury goods companies as recently as this week are reporting higher numbers of tourists in major cities, in particular US and South-East Asian tourists, lines outside their stores and strong demand for their products. Companies like LVMH continue to invest in their products and innovate; they are pushing the edge with new technologies. Our investment insight this month highlights the emerging market for luxury NFTs, some of which have sold for prices in excess of the goods they represent. The crypto market is in turmoil but it seems to us that NFTs and the metaverse will drive continued interest, especially with younger generations of consumers. You can read the insight here or by clicking on the attachment.

This does not mean we underestimate the challenges that lie ahead. We expect the performance of equities to continue to be volatile this year. However, valuations are now highly attractive and despite the increasing pressures we continue to believe that if a company can show it has the pricing power to offset inflation and innovation to grow volumes, then it will be well-positioned for whatever comes next.

There is another concept from the 2000s, markets 'climbing a wall of worry'. The story of Goldilocks and the bear market did not end well for the bear market and investors who kept their conviction in companies that offered quality and value, many of which we are still invested in today, were richly rewarded for their decisions, even though the global financial crisis that followed. That is why the current weakness is as much an opportunity for us as it is for any long-term investor.

World Stars Global Equity

Our World Stars Global Equity strategy continued to be affected by the overall market volatility during May, closing the month down 2.0% and is now down 18.5% year to date, both in US dollar terms. Despite this volatility, the earnings releases from the large majority of our companies remained solid, supported by robust underlying long-term structural trends. You can read the factsheet for our World Stars Global Equity fund by following the link here.

For example, life sciences company *Becton Dickinson* was up 3.5% during the month, as the company reported its first results post the spin-off of *Embecta*, posting a 3.9% organic revenue growth (this was 9.6% excluding the lapping effect of prior year Covid-19 testing revenues). Importantly, the company also reiterated its long-term strategic roadmap of 5.5% growth and 400 basis points of margin expansion by 2025, providing assurance of the prospects for the restructured business. Its peer, *ThermoFisher Scientific*, was up 2.6%. The world's largest life sciences product and services provider held its annual investor day when it reiterated its long-term growth guidance of 7% to 9% revenue growth, whilst increasing the synergy target for the recently acquired PPD clinical research franchise from USD 50 million to USD 175 million. The company continued to highlight its enhanced position as a partner of choice within the industry. This was illustrated by its 15-year collaboration, announced in February this year, with Moderna to manufacture both Covid-19 and other investigational mRNA vaccines.

Several of our holdings within the broader digital sector recovered after the recent sell-off. *American Tower*, the mobile tower operator, was up 6.3% as the market digested the impact of upcoming interest rate rises on the valuation of the name, with the effect now broadly seen as priced in. We have seen a similar pattern with other holdings in the area in recent weeks as stock multiples have come back to levels that fail to reflect either the long-term growth prospects of the companies or the depth of their competitive moat.

On the weaker side during the month were several of our consumer-related holdings. The current elevated inflationary pressures we are seeing globally have started to affect consumer spending in key markets, with the largest US retailer, Wal-Mart, suggesting that it is seeing a shift away from discretionary spending into more essential goods, especially among lower-income consumers. The company said that it would work with vendors to limit inflationary pressures on the consumer, which could limit the ability of consumer goods companies to pass on higher costs.

We are monitoring these developments closely and believe that our consumer companies are positioned in categories that are inherently more resilient, including coffee, infant nutrition, spirits and skin care. These are all categories with strong brand recognition and limited exposure to private labels. At the same time, the global nature of our consumer companies makes them less susceptible to the actions of any one retailer compared to their more US-centric peers. In a more uncertain economic environment, these are precisely the type of companies that provide the highest earnings visibility and we remain confident that the stocks will continue to deliver growth and value over time.

Multi-Asset Income

May saw the continuation of the negative momentum we have witnessed so far this year. All asset classes contributed negatively to an overall return of -1.2% in US dollar terms over the month (down 10.9% since the start of the year). You can read the factsheet for our Star Multi-Asset Income fund by following the link here.

Although equities saw further weakness down 0.75% for the month (down 17.6% since the start of the year), May was a month of two halves marked by some clear bargain hunting in its last week as some share prices fell to attractive levels.

The credit portfolio declined a further 1.8% for the month (now down 6.6% since the start of the year) driven by weakness across our Turkish holdings and some concerns around the Russia/Ukraine conflict that affected the bond price of *Trans-Oil*. Despite this, our recent purchases of higher credit quality bonds (*Braskem*, *Marfrig*) started to contribute positively to the performance.

The non-correlated funds were also down 1.4% for the month, mainly as a result of the announcement by the UK Government of a possible windfall tax on power generators, which put pressure on our *Greencoat UK Wind* holding.

Market volatility was essentially macro-driven with higher- and broader-than-expected US inflation data and some mixed corporate results highlighting the impact of the strengthening US dollar on companies' growth. But within our portfolio, the large majority of reported results were robust with some, such as Nvidia (Q1 sales +43%), very strong indeed.

The US Federal Reserve has confirmed its key objective of bringing down inflation, but it seems that both global economic growth and inflation are showing signs of peaking already. With market sentiment at a multi-decade low and China reopening, we believe that the worst might be behind us and as such we have started to slightly increase our equity asset allocation.

Even if partially discounted, a full-blown recession and resulting negative earnings revisions are certainly not currently priced in the markets. It is still too early to form a strong view on this especially as the path to a soft landing is fairly narrow. However, as long-term fundamental investors, we will look to take advantage of such opportunities.

Our "all-weather" fixed income portfolio, which is now yielding approximately 8% with a yield to worst of 11.5% for less than four years duration, is in a strong position to deliver outstanding returns. We are gradually building the equity portfolio to equally generate superior returns over the mid-long term.

Emerging Market Bonds

Our Emerging Market Bond strategy was down 1.3% for the month in US dollar terms, following another volatile month for risk assets globally driven by macro headwinds. Initially, there was a steep sell-off driven by US inflationary concerns, which saw the 10-year Treasury Note touch 3.1% before increased fears of global slowdown caused markets to price in less aggressive Fed policy tightening. Subsequently, the 10-year Note settled lower at 2.9%, similar to where it started the month. Meanwhile, emerging market credit spreads widened 25 basis points and are now in line with the average levels seen since 2010.

Aside from the broader market volatility, our Turkish companies, which have been relatively robust so far this year, were the primary detractor from performance in May. Bonds came under pressure as the Turkish lira experienced a further round of weakening driven by the country's inflationary issues and balance of payment concerns after posting a widening current deficit and drop in FX reserves. Despite such a macro backdrop, the underlying fundamental strength of our company holdings was evident from the latest earnings releases. For example, *Koc*, Turkey's largest conglomerate, saw strong operating performance across all business units – benefiting from significant export revenues. Meanwhile, *Turkcell*, the leading telco provider, continued to add subscribers and successfully execute its pricing strategy to pass on inflationary pressures.

Going forward, rising rates and tighter financial conditions could weigh on company fundamentals, albeit we believe that emerging market companies are starting from a strong position given low leverage, higher interest cover and comfortable debt maturity profiles. This is supported by the current default rate which stands at just 0.5% year-to-date (excluding idiosyncratic situations: Russia/Ukraine and Chinese property) – in line with current US high yield levels. As such, we believe it is an opportune time to take advantage of the market weakness and selectively lock in attractive bond yields. Today, our emerging markets portfolio offers a 9% yield to worst and a 7% current yield (both in US dollar terms) with a relatively short duration of four years.

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