Investment Commentary

A WIN, WIN OPPORTUNITY

Stock markets have rebounded somewhat from the lows they reached in June. We continue to be at a turning point. As the global economy recovers from the pandemic, underinvestment in public and private infrastructure and disruptions and bottlenecks from the pandemic have led to a surge in inflation. Central banks, led by the US Federal Reserve, have tightened policy and raised interest rates in response. Will they lose control of inflation, get it right and adjust their policies in time, or will they overshoot?

Renowned economist Nouriel Roubini has just said it is delusional to think we can avoid a severe recession and a severe debt and financial crisis. The market has gone for boom and bust at the same time: it has sold off 'growth' stocks over 'value' stocks because of rising interest rates and stocks in general because of a fear of recession and collapse. We do not think we are delusional but we did say earlier this year that we were lunatics because we believe everything may be OK in the words of one of our favourite *Matt* cartoons. We cannot all be right.

The post-pandemic transition is difficult to predict and we have to be careful not to draw the wrong short-term conclusions. To us, company fundamentals matter most. We invest in companies that have quality and value for the long-term, and we look closely at what is happening to sales, earnings and cash flows of the companies we invest in.

Companies are reporting results for the second quarter and their outlook for the rest of the year. They matter because they offer the first real indication of how central bank policies are affecting consumer confidence. So far the results of our companies have been alright and we remain positive. We expect companies to signal that they are seeing a slowdown in demand but not a collapse; that consumer demand is slowing and that there is a shift from products to services; that corporate demand is holding up and that they are raising prices to offset increases in their costs; and that they are cautious in their outlook but will continue to innovate and invest in their businesses. A short-term sell-off may provide the opportunity to buy them at good prices but great companies create value from quarter to quarter. That is why we have to take a long-term perspective.

Currencies offer a lesson on that as well. It was almost exactly 20 years to the day when the US dollar/euro exchange rate reached parity this month for the first time since July 15, 2002. Currency exchange rates are driven by purchasing power parity and interest rate differentials. They have their ups and down but data shows that they do not matter over periods of three years or more unless there are specific events that make a difference. We invest in global leading companies because we think they are best placed to manage currency risks. They can align their sales, costs and balance sheets and they have the scale and knowledge to hedge their commodity and other exposures. It is one less thing to worry about for us.

Our focus on the fundamentals of the global economy and of the companies we invest in leads us to believe that it is not lunatic to think that a Goldilocks economy is more likely than not. It is certainly what governments and central banks are trying to achieve. The market sell-off this year and the low valuations of the companies we invest in, lead us to think that investors face a win/win opportunity.

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If the lunatics are right and things turn out OK, you want to own quality companies that will do well because they have strong and sustained growth and are at low valuations today. If Nouriel Roubini is right and the lunatics are delusional, then the last thing you want to own is low-quality companies that are cyclical, have high fixed costs, are capital intensive or have other problems. Instead, you want to own quality companies that will do better than most because they have strong and sustained growth and are at low valuations today. We believe that in both scenarios, quality companies that offer resilience, pricing power and long-term growth prospects will offer the best chance of generating value over time.

It is summer in the US and Europe and so our Investment Insight this month is about the strong recovery in global travel and its implications for the companies we invest in. Everyone wants a Roman holiday! Hotels in Europe are full, restaurants are booked, luxury stores have long lines outside, and good luck trying to book a scooter like Gregory Peck and Audrey Hepburn did in the 1950s movie classic. The pandemic has changed many things but it has not changed our basic desire to live our lives and to experience new things. That is why travel is another example of things that turned out OK.

The rebound this summer is a boon for many businesses. Yet it is also leading to all sorts of problems and bottlenecks. Prices are increasing because of this demand and China has not even lifted its restrictions. So, may we be the first to point out that next year will be a tough year for travel because this year is so good? But can we skip the dire predictions of a recession in global travel when it happens to focus on the long-term fundamentals?

Our focus is on the great opportunities for the companies we invest in, their attractive valuation today and their prospects for long-term value generation. You can read our Investment Insight by following this link or clicking on the attachment.

World Stars Global Equity

Our World Stars Global Equity strategy faced another challenging month with the strategy down 7.3% for the month and 24.4% year to date, both in US dollar terms. You can find the USD factsheet for our World Stars UCITS fund here.

The rotation out of higher multiple stocks, especially digital and technology companies, continued unabated with *Nvidia* and *Adobe* among our hardest-hit holdings. This is despite our companies actually delivering solid earnings. For example, Nvidia entered June having reported its results for the first quarter of 2022 a few days beforehand, posting 46% revenue growth fuelled by ongoing momentum in the key data centre and gaming businesses.

However, the sell-off was not confined to digital and technology companies. *Sika*, the Swiss materials technology leader, was also down sharply for the month, as fears of a slowdown in economic activity gained hold. This is despite Sika's exposure to the less cyclical refurbishment market and the significant self-help the company has at its disposal, including the expected CHF 160-180 million in synergies from the recently announced MBCC acquisition.

On the positive side, *Salesforce*, the leading software as a service provider, provided a good example of the underlining earnings resilience of our digital and technology companies. The company reported strong results, with 24% revenue growth, and a positive outlook, with

management saying that it had not seen any deceleration in demand. The stock defied the market sell-off and closed up 3% for the month.

Equally resilient during the month was *Raytheon Technologies* (see our latest investment insight) which continues to stand firm on the back of robust travel demand fuelling its commercial aerospace business and with the Russia/Ukraine conflict leading to structurally higher levels of US and European defence spending for the years ahead. Similarly, among consumer companies, our holdings in the cosmetics and skincare segment as well as in luxury goods remained unaffected by the market turbulence given their historically resilient nature even in recessionary periods.

It has clearly been a difficult first half for our strategy. As we look forward, second-quarter results will be a key guide for the direction of the global economy and the extent to which inflationary pressures, rising interest rates and geopolitical concerns weigh on demand. We will monitor management commentary and outlook especially closely. It is clear, however, that the depth of the market sell-off is creating compelling opportunities to buy best-in-class companies at highly attractive valuations and we will look to take advantage of the opportunities that arise.

Multi-Asset Income

Performance for the month was driven by macro news flow. Our Multi-Asset Income strategy closed down 6.4% for the month and down 16.6% year to date, both in US dollar terms. All asset classes were affected but equities were the worst performers down 8.4% for the month and down 24.5% year to date. However, the rout spread to our fixed income portfolio, down 5.3% in June and down 11.5% year to date, and the alternative investment funds were down 4.4% for the month and down 7.3% year to date. The performance represents a proper market correction. You can find the latest factsheet for our Multi-Asset RAIF fund here.

However, we saw a shift in the reasons for the negative performance in this last period. Whereas share prices have been impacted so far by the expectation of rising interest rates and higher yields, mostly affecting the longer duration and high-valued securities, June's movements were a reflection of investors' worries about economic growth and the possibility of a global recession triggered by the central banks' aggressive actions to target inflation. Many economic indicators reached historic record low levels, apart from labour markets which remain strong globally because of staff shortages.

There was profit-taking in some of our economically sensitive names. *Schlumberger*, our best performer so far this year (up 20%) was down 22% during the month although the oil price stayed strong overall. There was as well further rotation out of some technology names like *Nvidia* despite the strong underlying performance of the business.

Our fixed income portfolio, which so far this year had resisted the rout, succumbed to the pressure with several longer duration and energy-related names suffering the most (*Pemex, YPF*). Besides, there were renewed concerns about the Russia/Ukraine conflict and the possibility of a protracted war, which put pressure on our local exposure (*Kernel, MHP*). By and large, the increased volatility in US 10-year treasury yields over the month proved to be less of a detractor than investors' concerns about a potential higher default rate.

As we approach the second quarter results, investors' focus is very much on the possible impact of the current environment on corporate earnings. This could trigger a further market correction.

However, even if it has slowed, corporate activity has remained reasonably sustained. Following the correction, our equity portfolio and especially our fixed-income portfolio are now presenting investors with a very attractive entry point. It is impossible to predict whether this is the best entry point but it is clear that with a three- and half-year duration, a current yield of around 7-8% and a yield to maturity of 12-14%, the fixed income proposal is very attractive.

We expect volatility to stay with us for a while, but we are confident that our long-term approach will yield rewards.

Emerging Market Bonds

Our Emerging Market Bond strategy was down 4.8% for the month in US dollar terms as risk sentiment weakened further on macro headwinds. This resulted in widespread losses across all risk assets and capped a challenging first half of the year. Markets initially focused on US inflation concerns (6.3% PCE print) which saw US 10-year treasury yields rise from 2.9% to 3.5% before increased fears of global economic slowdown caused markets to price in a less hawkish Fed down the line. US 10-year treasury yields settled at similar levels to where they started the month. Meanwhile, emerging market credit spreads widened 50 basis points on the month and now trade wide to the average levels seen since 2010. You can find the latest factsheet here.

There were few places to hide in such an environment, although the credit spread widening in the higher-yielding companies was particularly pronounced. Our African companies were some of the larger detractors of performance, despite the focus on the defensive industrial sector and the energy sector which still benefits from elevated oil prices. Putting the broad macro-driven market volatility aside, there were several positive underlying corporate events.

First, *Tullow Oil* (African E&P) announced a proposed merger with Capricorn Energy that would strengthen the company's balance sheet and increase cash flow generation, whilst diversifying the production and geographical footprint. Second, *DP World* (Dubai-based logistics) announced the long-awaited monetisation of domestic assets to deleverage below management's commitment made back in 2020. Last, *MHP* (Ukrainian agro-industrial) provided an operational update highlighting strong monthly momentum in poultry volumes and confirming the Spring sowing campaign has been completed despite the Russia/Ukraine conflict.

The inflation narrative is likely to dominate the market focus near term and could provide further volatility until there are concrete signs that it has peaked. The lower secondary market liquidity during the summer months is likely to amplify bond price volatility. However, such an environment will continue to create attractive value for long-term investors, as the market eventually shifts its focus to recessionary risks and accompanying accommodative financial conditions. Today, our Emerging Market Bond strategy offers an 11% yield to worst (in US dollar terms) with a relatively short duration of four years. The portfolio has an 8% current yield, and the average bond price is 82 cents on the dollar, which provides room for capital uplift.

We hope you are having a good summer and look forward to your questions and comments as always.

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