Investment Commentary

REASONS FOR OPTIMISM

Over the past two months, the mood has lifted across markets. As we expected, our companies rebounded strongly in July with a broadening out of macro-economic concerns and a second quarter results season which has shown that many parts of the global economy remain in robust shape.

Micro is what we do, macro is what we put up with, and this year has been all about macro. Macro can be as much a source of opportunity for long-term investors as volatility and market rotation. We believe that there are reasons for optimism and that there is much more to come.

Although the US economy entered a technical recession with its 0.9% second consecutive fall in quarterly GDP, this compared with Covid-recovery growth of 6.5% in the first half of 2021. After the strong market declines this year, investors appear to have been reassured by the US Federal Reserve's policy of monetary tightening, interest rate increases and data-driven approach going forward, as if its determination to deliver a positive outcome was ever in doubt. As we write today, from the low point in mid-June, the S&P 500 index has risen 15% and the 10-year Treasury yield has fallen from 3.5% to c. 2.8%.

The outlook remains challenging and delivering a 'Goldilocks' economy, in which economic growth, inflation and interest rates are balanced, will not be straightforward. However, there are more positive indicators entering the frame. For example, core consumer price inflation (CPI) in the US in July was unchanged at 5.9% and has remained consistently below the peak of 6.5% in March. Inflation in services and wages is expected to persist in the coming months but energy and goods prices are already coming off.

Services account for 70% of the US economy and demand continues to be strong. As employment opportunities increase, savings rates decline and Covid relief checks are spent, labour supply should increase as people go back to work. Energy and goods prices have been impacted by the long-term lack of investment in production and transport capacity, Covid bottlenecks, in particular in China, and the Russia/Ukraine conflict.

Supply responses for energy and commodities will take time but a realignment of global supply chains and capacity increases are taking place. In the US, all-important gasoline prices are back to $4 per gallon in many places from over $5 in mid-June. The Russia/Ukraine conflict is a primary concern and looks likely to persist, but there are signs that some of its impact on the global economy will abate. Europe, and Germany in particular, is exposed to supply shortages and price increases in Russian gas but is working hard to replace it.

The upcoming winter heating period will be difficult but we believe that there are good reasons why Europe will get through it. To the extent Russia will want to maintain leverage on Europe, it cannot be interested in a complete replacement of supply and so it may be that intermittent reductions in supply are more likely than a complete shutdown. In commodities, the limited resumption of grain exports from Ukraine has to be taken as a sign of strategic engagement or leverage as well.

At the same time as European measures to replace energy sources and protect industries and consumers are put in place, price increases in the autumn should lower demand. The

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

amounts involved in subsidising energy supply chains and consumers are staggering but in many ways just another example of government intervention after the global financial crisis and the Covid pandemic. Consumers may have to turn down their heating by a couple of degrees this winter and we have to realise that governments have no incentive to make positive statements at this point that would encourage people to increase not decrease their energy demand.

If these supply responses in labour, goods and supply chains take place, it seems likely that a material fall in inflation will occur in 2023 as the current high numbers annualise. The easing of inflationary pressures, a reduced need for tough monetary action and a resumption of GDP growth after technical recessions should provide a more constructive backdrop for markets that could occur faster than investors expect.

We invest in companies, not markets, micro not macro, and what matters most to us is that our companies have been doing well. As we note below in our World Stars Global Equity commentary, the second quarter trading results and outlook statements from the large majority of our companies have been robust and resilient.

Our focus on high-quality global leaders with enduring competitive advantages in good industries with long-term secular growth drivers has delivered continued progress in sales earnings and cash flows. Demand for most continues to be strong, and they are taking steps to increase prices and lower costs to offset the input cost pressures they face. The strong US dollar, which is 13% higher on an indexed basis year-on-year, is leading to some downward adjustments to reported earnings, but on a constant currency basis, the strong underlying momentum is clear.

It is a stock picker's market and we remain focused on investing in the companies and industries that we believe offer quality and value for the long term.

Our global leaders in digital and technology, consumer products, health care and life sciences and industrials benefit from strong demand for their goods and services and the need for investment in public and private infrastructure. The macro picture remains challenging but our expectation of a post-Covid secular recovery is unchanged and is well-justified by recent corporate results, economic data and policy actions.

At current valuations, our investments are strongly supported by their underlying growth drivers and business performance and offer great opportunities for long-term value creation.

World Stars Global Equity

The World Stars Global Equity strategy performed strongly in July, closing the month up 8.7% in US dollar terms. The strong performance allowed it to regain some of the losses realised during the recent market selloff leaving it down -17.8% year to date in US dollar terms. You can find the USD factsheet for our World Stars UCITS fund here.

Most of our companies reported strong results during the second-quarter reporting period, providing evidence of the strength of their structural growth drivers and operational flexibility.

Performance this month was driven by the strong recovery of stocks in the digital sector, led by our long-term position in *Amazon*. Amazon continues to benefit from robust consumer spending online, with its Prime membership scheme driving customer engagement. Given its industry-leading inventory management capabilities, the company has been well placed to manage the recent shift in consumer spending and the move away from categories that benefited through the pandemic, avoiding the inventory buildup issues we have seen with other retailers like Walmart or Target

Enterprise software and semiconductor companies also rebounded strongly. Although the most recent numbers show some of the challenges, investors have been shifting focus towards the long-term earnings power of these companies following the re-adjustment of their valuation multiples in the light of a higher interest rate environment and short-term uncertainties.

Connector and sensor manufacturer *Amphenol* posted an impressive 18% organic growth, fuelled by ongoing momentum in its industrial, IT and datacom, automotive and commercial aerospace sectors. Amphenol is uniquely placed to take advantage of the electrification and digitalisation of the global industrial base, and the unabated demand for data and enhanced communication capabilities. Performance in the sector was further supported by our holdings in electrical engineering and industrial automation companies, where the transition to Net Zero, the need for Industry 4.0 solutions amidst labour shortages and infrastructure-stimuli programmes that are powering that part of the global economy.

Our consumer holdings benefited from their exposure to resilient categories and higher-end consumers. Luxury goods company, *LVMH*, posted 19% organic growth in revenues, despite the headwinds faced in the Chinese market due to ongoing lockdowns. Similarly, our holdings in personal care and spirits also posted strong numbers given their economic resilience and the post-pandemic return to normal of the hospitality and travel industries.

The overall message from the reporting period has been positive. The large majority of our companies have navigated the current uncertain macroeconomic and geopolitical environment exceptionally well, testing and validating our approach of focusing on quality and value for the long term. They have benefited from their exposure to accelerating structural trends and resilient product categories. They have also highlighted their operational adaptability, with managements able to address supply chain pressures and highly volatile costs to deliver on profitability targets. With valuations in many industries now compressed, many of our companies are looking to deploy their strong balance sheets to take advantage of M&A opportunities.

Multi-Asset Income

July saw a positive return of 2.9% in US dollar terms, the first positive month since March this year. The strategy is now down 14.2% year to date in US dollar terms. In contrast to June, when negative macro data drove asset prices down, in July "bad news was good news". The increasing probability of a global economic recession had a positive impact on US 10-year Treasury yields, which combined with not as bad as expected corporate earnings to support the equity rally.

Equities were the main contributor to the performance last month bouncing back strongly by 9% in US dollar terms and now down 17.7% year to date. Positive guidance by most managements supported our equity investments with performance being led by digital and technology companies including *Amazon* and *Nvidia*, which suffered the most from the rotation to 'value' equities and benefited from lower US yields.

By contrast, the fixed income portfolio witnessed some weakness, down 0.8% for the month and now down 11.7% year to date, lagging the general recovery in prices. Our Ukrainian exposure was impacted by renewed negative news flow on the conflict despite an agreement to help its exports of grains. Retreating oil prices put pressure on our energy-related names. Turkish bonds also came under pressure as a result of poor economic news flow.

With the second quarter reporting period soon behind us, risk assets markets are likely to be mostly macro-data-driven and volatility could increase due to the low volume summer months. Although we are confident in our investments delivering operationally, markets will continue to be concerned about the prospects for lower earnings due to the economic slowdown.

Our focus remains on cash income generation of 4-5% gross and our portfolio is in a very good position to achieve the target this year.

Emerging Market Bonds

The Emerging Market Bonds strategy was up 0.2% for the month in US dollar terms. After a prolonged period of market turmoil, risk assets saw signs of a recovery in July on interpretations of a more dovish Fed. The market focused on Federal Reserve Chairman Jerome Powell's statement that the 75 basis points hike in July placed the US Fed funds rate closer to the neutral level and that recent indicators of spending and production had softened. The US economy posted negative growth for the second consecutive quarter signalling a technical recession and helping drive the 10-year US Treasury yield down from 3.0% to a low point of 2.6% in early August. Emerging market credit partly benefited from the recovery in US Treasuries although credit spreads widened marginally and continued to trade at wider than average levels seen since 2010. You can find the latest factsheet here.

Over recent months, we have been cautiously extending the duration and increasing exposure to higher-quality companies that have been most affected by the interest rate volatility. With this, some of the defensive companies such as *Millicom* (communications), *Braskem* (basic materials) and *Marfrig* (non-cyclical consumer) in Latin America were amongst the top performers during the month, benefiting from the tightening of US Treasuries.

The ongoing Russia/Ukraine conflict and the Ukrainian government launching a consent solicitation to defer Eurobond payments weighed on corporate bond prices. which were already impacted by the lack of market liquidity during the summer period. However, two of our Ukrainian holdings had positive headlines. *Kernel* (agricultural commodities) did better after a deal was brokered by the UN to allow grain shipments to resume from the country. Meanwhile, *MHP* (agro-industrial) confirmed it will resume interest payments on its bonds going forward, having been granted a reprieve after the Russian invasion in February.

Performance will continue to be driven by macro conditions and volatility is likely to continue with the Fed abandoning any form of indicative forward guidance with a move to data-dependent mode. We are likely to see the market continue to shift its attention between concerns about the persistence of inflation and deep recession.

Lower secondary market liquidity during the summer months could amplify bond price action and new primary issuance could see some further pressure in September. This environment should continue to create attractive value opportunities for long-term investors focused on strong underlying corporate fundamentals. Today, our Emerging Market Bonds 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.

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