

Investment Insight

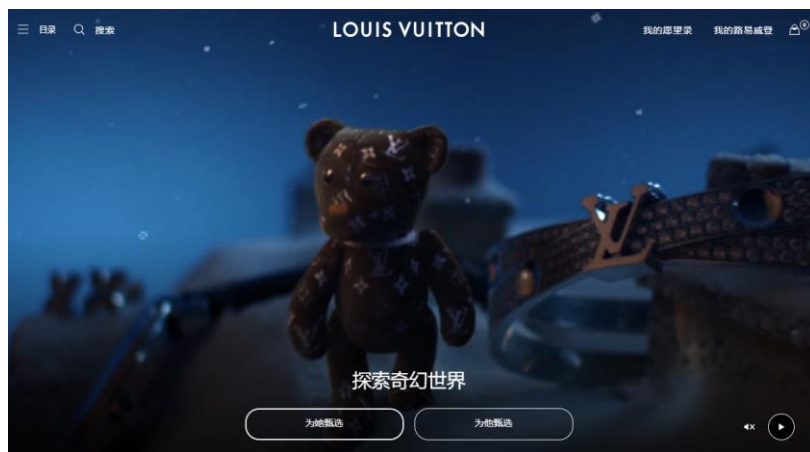
PERSPECTIVES AND OUTLOOK ON KEY SECTORS FOR 2023

Consumer companies: Near-term challenges but tailwinds from pricing power, resilient demand and reopening

Against the background of soaring inflation and unprecedented interest rate hikes, high energy costs, supply chain challenges, the Russia-Ukraine conflict and continued Covid restrictions in China, the performance of our consumer holdings has been mixed this year.

Some of our companies have benefited from re-opening trades and pent-up consumer demand while other higher multiple stocks have suffered disproportionately from de-rating in the rising interest rate environment. From a fundamental perspective, our consumer companies have been resilient in navigating through these challenges. Consumer demand for their products has been strong and they have been able to raise prices to partially offset rising costs, protect margins and enhance profitability.

Going into 2023, we see growth normalising from the high level of 2022 to pre-Covid levels, with some risk that high inflation will dampen consumer demand in the first and second quarters of the year. We are reassured that many of the consumer companies in our portfolio have strong brands, innovation and pricing power. Buyers of their goods are less sensitive to higher prices, which should allow them to generate resilient revenues and profitability.



Source: www.louisvuitton.cn

China is going through an unexpected and precipitous easing of Covid restrictions. We had anticipated a full re-opening in the spring of 2023, which could now happen even more quickly after the Chinese New Year. It adds to the uncertain outlooks for the first quarter of next year as the Chinese economy could be impacted significantly as consumers stay at home to avoid getting Covid infections. However, once the economy re-opens fully, activity is likely to surge, driven by strong corporate and consumer demand after the long period of restrictions, the resumption of international travel and likely government stimulus. It should provide direct tailwinds for several of our companies that have revenue exposures ranging from 15 to 24% to Chinese consumers.

The secondary effect of re-opening in China should further reduce local supply chain bottlenecks and shipping costs, which in turn should alleviate some of the cost pressure facing manufacturers in the US and Europe. This should ultimately ease inflationary pressures, allow for a stabilization of interest rates, and support corporate profit margins and profitability. The path for consumer-facing stocks is likely to be bumpy in 2023, but we remain optimistic that our holdings will remain resilient.

Industrials on a roll

The year has proved to be a solid one for industrial stocks despite growing concerns over possible recessions in both the US and Europe.

Our holdings, whether in aerospace, defence, electrical equipment, industrial automation or connectors and sensors have proved to be among the strongest performers. This has been underpinned by booming broad-based order activity, strong pricing power and an ability to deliver on margins despite unprecedented cost volatility.

There are clear structural reasons why this has been the case. Both Covid-19 and the Russia-Ukraine conflict have laid bare years of underinvestment in energy infrastructure, key supply chain pressure points (like ports and rail) and an overreliance on offshore sourcing. The pendulum has now started to swing back, with countries racing to re-shore key components like semiconductors, automate production to reduce reliance on scarce labour, increase energy self-sufficiency and upgrade ageing infrastructure.

At the same time, the pathway to future-proofing critical infrastructure against the effects of climate change and transitioning the global economy to net zero is still in its early innings. The recently passed US Inflation Reduction Act will provide USD 397 billion in incentives towards renewable and clean energy in addition to the USD 1.2 trillion Infrastructure Investment & Jobs Act and that will provide a slow, steady but very large additional lever to the sector.

We continue to believe the market under-appreciates the scale of the opportunity ahead. The opportunities in the space are rich but investors will have to be highly selective, differentiating long-cycle, structural beneficiaries from merely cyclical players.



Source: www.commonswikimedia.com

Water infrastructure-related companies are one example of such structural beneficiaries. Water scarcity is fast emerging as one of the most pressing environmental and social issues. Globally, more than 750 million people lack access to basic drinking water and 1.8 billion have no access to basic sanitation. The pressure is only set to increase. Per capita water supply has fallen 56% since 1962, whilst demand is set to grow 20-30% by 2050 driven by key megatrends including population growth, urbanisation and industrialisation.

The situation is worsened by poor water governance. 'Non-revenue' water (treated water that is wasted or unremunerated because of leaks, theft or inaccurate meters) is a major financial challenge for utilities globally, especially in developing markets where non-revenue water can represent 10% to 60% or more of net water produced.

At the same time, climate change is irrevocably affecting water patterns. Infrastructure remains woefully inadequate to meet these challenges. Take the US as an example. In its 2021 *Report Card for America's Infrastructure*, the American Society of Civil Engineers gave the country's drinking water infrastructure a C- rating, its wastewater networks a D+ and its stormwater systems a D. The country's 16,000 wastewater treatment plants are functioning, on average, at 81% of their design capacity, while 15% have already reached or exceeded it.

In recent months, we have initiated a position in one of the world's leading global water technology companies serving the utilities, industrial, commercial and residential buildings sectors. Importantly, the firm's strong digital and smart infrastructure offering allows it to participate in some of the most exciting opportunities in the market, as customers seek to increase the efficiency of their water networks. Above all, the company is an example of the kind of industrial company we look to invest in: structural compounders, less vulnerable to the economic cycle, rich in intellectual property gained through persistent investments in R&D and positioned in many cases lower on the value chain where competition is less obvious and pricing power richer.

Digital platforms and technology companies: Resetting growth expectations and costs structures

The rapid interest rate hikes in 2022 have caused valuations of long-duration assets to decline. This has placed pressure on digital platforms and technology companies given that their valuations are driven by their prospects for long-term future growth and profitability.

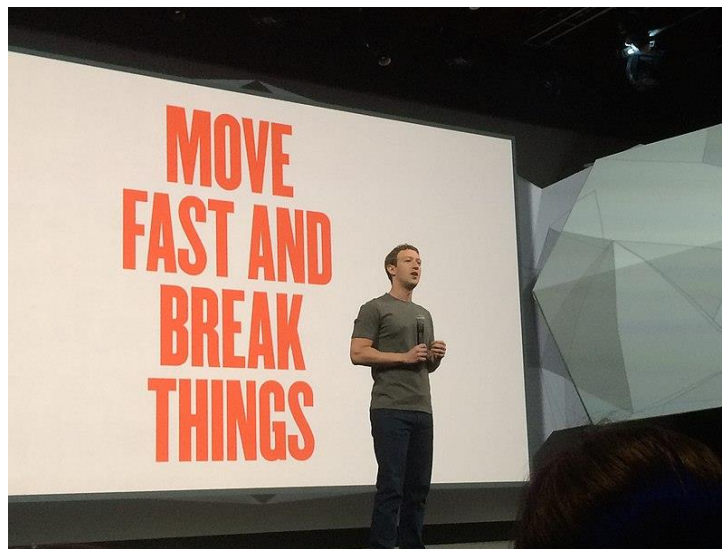
The technology-heavy NASDAQ index has declined 27% to the end of November, in marked contrast to the more industrial-weighted Dow Jones index which has dropped 5%. High growth indices have done even worse: The Philadelphia Semiconductor Index has fallen 28%, the IGV Software Index 31% and former highfliers like the ARK Innovation ETF 60% over the same period. A long list of publicly-listed companies that had been valued at over USD 100 billion, like Snap, Shopify, Sea, PayPal, Netflix, Zoom, Block, Alibaba, Meta and Pinduoduo have all declined more than 75% from their highs last year.

Private markets have been severely impacted by the change in markets after many start-ups and potential unicorns achieved dizzyingly high valuations over the last few years. Investors in high-profile private companies have had to accept lower valuations to raise money. Klarna, a European fintech payment and 'buy now, pay later' company, saw its valuation decline from USD 45.6 billion to just USD 6.7 billion within a year.

The emerging SPAC (special purpose acquisition company) market had fueled this frenzy during the Covid pandemic as these listed blank check vehicles promised faster ways to access

public markets and potential new exit routes for early investors. 90% of these SPACs trade below their initial price and several of the most recent transactions failed to be backed by their shareholders, who preferred to get their money back.

We believe that many private companies have yet to face reality and accept down rounds to receive funding. Founders, venture capital and private equity owners have been reluctant to revalue stock options downwards and lower employee morale. Taking market share and being a top-five player had been a strategy in itself, leading to a potential acquisition by a competitor fearing disruption or a public listing through a SPAC. With a tight funding environment, private companies have had to pivot their business models to prioritize profitability and cash flow over growth and market share.



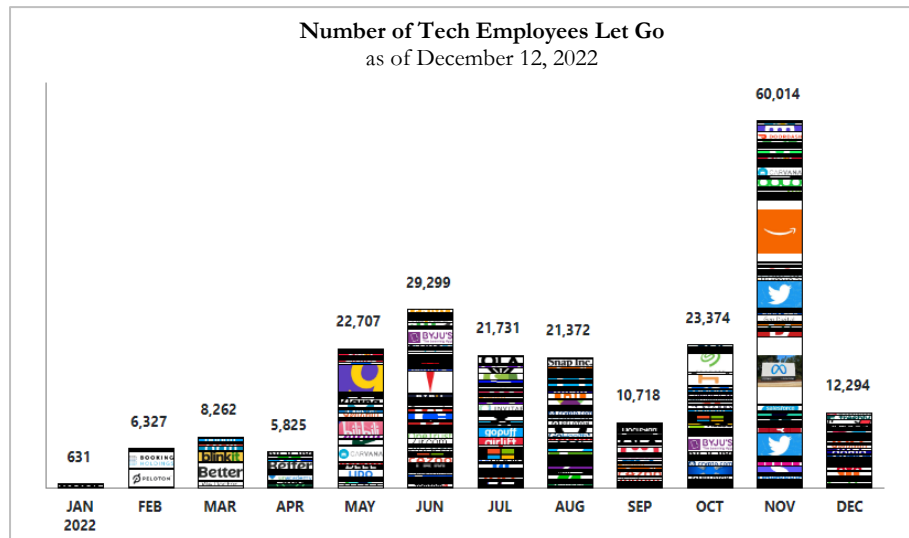
Source: www.commonswikimedia.org

One of the principles for Silicon Valley tech companies has been to ‘move fast and break things’. They needed to be fast at making decisions and creating new prototypes and business lines, to disrupt or be disrupted. As the US and European economies shifted from offline to online during the pandemic, many companies increased headcounts and other costs substantially to grow their core businesses and expand into ancillary business lines.

However, other forces have been at work this year. Higher inflation, increasing rates, surging energy prices, continued supply chain disruption and concerns about corporate and consumer demand have meant that demand for technology has slowed. Digital advertising has slowed after soaring in 2021 because of difficult comparisons, higher penetration, a shift back from consumption of online goods and services to offline hospitality and travel, and regulatory and privacy pressures. Uncertainty around the broader economy has been putting further pressure on advertising growth. Pressure on budgets has meant that many corporates have paused digital transformation projects with greater scrutiny being placed on costs that can be deferred until the outlook is clear.

This year, large and mega-cap tech companies, and in particular the digital platforms, have been too slow to recognize the business slowdown, adjust their expectations and cut costs. Companies have now taken action with highly publicised headcount reductions and

profitability targets, and as we look into next year, we think there are great opportunities despite the challenges.



Source: <https://www.trueup.io/layoffs>

We believe that next year the initial focus is likely to be on those companies that have stable core businesses and can generate reliable profits and cashflows. As the economic outlook stabilizes, we expect attention to shift to companies whose business is tied to investment and infrastructure, notably semiconductor manufacturers and suppliers. We also expect software demand and digital advertising growth to improve throughout the year.

One of the medium-term benefits of the rout in technology valuations has been that there is less capital available to privately-owned companies so large and mega-cap tech companies have better opportunities to buy companies that can enhance their offerings, accelerate innovation, reduce required capital investment or avoid the risk of disruption.

Medical technology: Overcoming current headwinds

Recovery in medical technology has turned out to be slower than expected in 2022. Although hospital procedure volumes have greatly improved since the re-opening of the US and European economies, the pace of recovery has been affected by Covid outbreaks, continued staff shortages (especially nurses) in hospitals, supply chain and component challenges and overall cost inflation, and has led to a mixed performance in 2022.

Overall, growth has remained below pre-Covid levels with no clear benefit from the significant backlog of patients. The strong US dollar also has had a sizeable impact on reported earnings for US companies, which has caused earnings to be revised down. Higher valued stocks have also suffered disproportionately from de-rating as the central banks have raised interest rates aggressively to combat rising inflation.

Looking ahead, we anticipate procedural volume to improve on both the supply and demand sides. We also expect supply chain challenges and staff shortages to gradually improve as the healthcare system further normalises in the aftermath of the pandemic. For the first time in many years, instead of price erosion by a few percentage points each year, we are beginning to see modest price increases in the sector. As purchase contracts in many categories tend

to last for two-to-three years, we expect further gains in pricing in the new year. This should offset, in part, cost inflation and margin pressures.

We expect a continued robust pipeline and healthy innovation cycles. Strong balance sheets should provide capital for re-investment and value-creating M&A to supplement growth. Several of our companies have had a sizeable Covid-testing business that generated a significant cash flow during the pandemic. This could make 2023 a year of tough comparisons. However, we believe the market will focus on the performance of ongoing base businesses instead. In China, we see the rapid re-opening providing tailwinds for procedure volume as well as new quotas for capital equipment, offset by continued pressure for price concessions from the VBP (value-based purchasing) programme as it did in 2022.

Overall, we think that 2023 should be a better year than 2022 as both pricing and volume improve, supply chain challenges ease and a weakening US dollar provide tailwinds for US-reported earnings.

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December 2022*

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