Investment Insight

A YEAR OF CHALLENGES AND RESILIENCE – REVIEW OF 2023 AND OUTLOOK FOR 2024

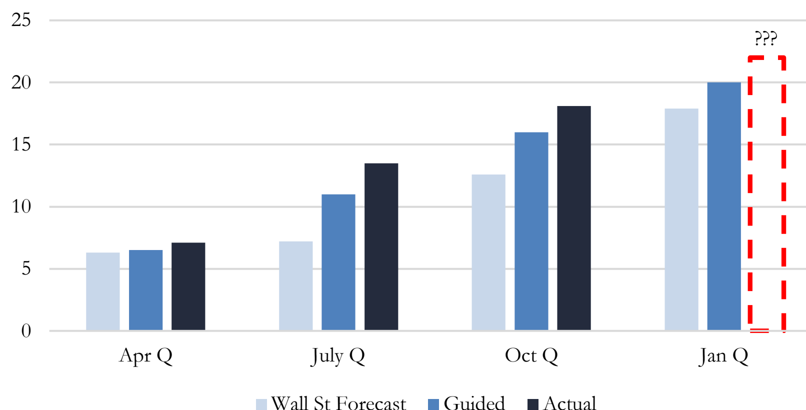
Technology: Conviction pays off

This time last year, we remained resolute in our conviction in the investment cases for the technology companies we have invested in. We highlighted that many of these companies have exceptional core businesses and strong growth prospects but had to adjust to the changing macro environment and implement cost-cutting measures after excessive hiring during the pandemic. We said that the battered share prices of companies in semiconductors, software and digital advertising offered an opportunity to own great companies at great prices, and that we were taking advantage of it by increasing our position in *Nvidia*.

Reviewing the performance of the year, these companies have been the success stories in 2023. *Salesforce* (+90%) and *Meta* (+176%) performed strongly as their core businesses remained stable, they cut costs and they delivered on operating margin expansion. *Alphabet* (+53%) *Amazon* (+75%) and *Adobe* (+80%) did well as their businesses remained resilient after the sell-off. We continue to own these companies in the portfolio and their long-term outlook remains unchanged.

Artificial intelligence is the new metaverse and our strongest performer was *Nvidia* (+225%). What it is really about is the increase in computing capacity that is enabling new technologies, software and applications that will change and disrupt how we do business and how we live our lives. Despite Nvidia's share price performance we believed that the fundamentals of Nvidia remained very strong and its valuation more than justified its share price. Quarter after quarter Nvidia regularly increased its guidance well ahead of Wall Street expectations and comfortably exceeded it when it came to report the actual results three months later. Nvidia delivered higher sequential growth through the year as its experienced management team proved that they were able to secure enough capacity to accommodate this demand.

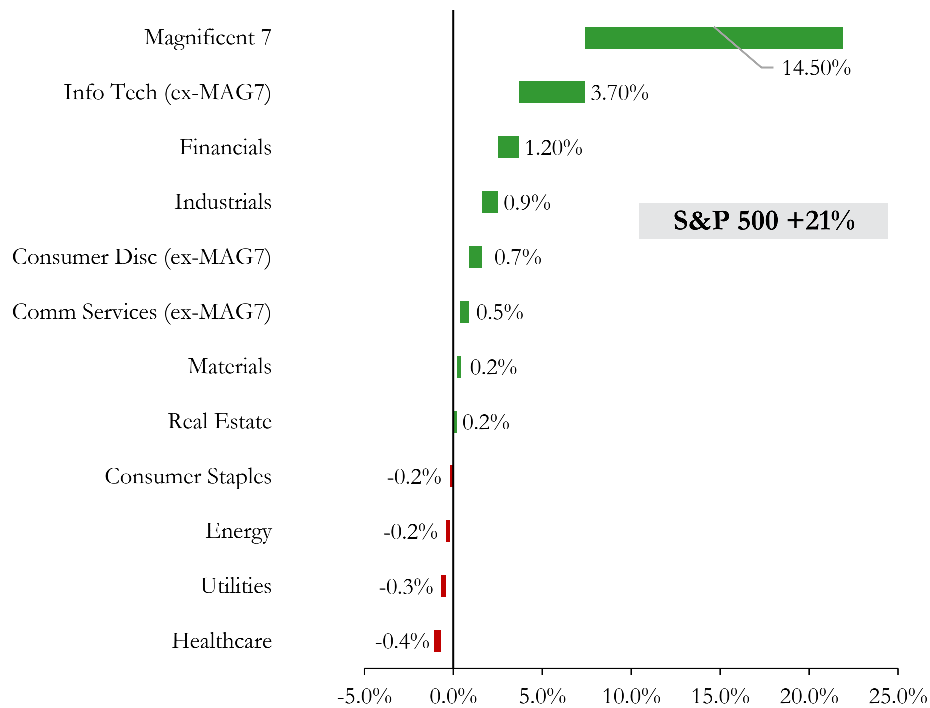
Nvidia Revenues 2023/2024 (in USD bn)



Source: Nvidia, Citi, J. Stern & Co. estimates. Nvidia's FY2024 ends 31/01/2024

The 'Magnificent Seven' (*Alphabet*, *Amazon*, Apple, *Meta*, Microsoft, *Nvidia* and Tesla) have been significant contributors to overall stock market returns. We expect that performance

will broaden to other sectors in 2024 but it will still require careful stock picking. Within the technology sector, there will be those that benefit from AI and those that are disrupted. Selecting the right companies to own will matter more than ever.



Source: Bloomberg, UBS in USD

We believe that AI will remain at the forefront of the technology sector. We are still in the very early stages of this next technological wave and it will require an enormous infrastructure build-out. It is this need for investment that propelled Nvidia to be the best-performing company in the S&P 500 in 2023 and to a USD 1.2 trillion market cap, and we believe that it will continue to benefit from this demand.

ChatGPT was the first consumer application to show the capabilities of Generative Artificial Intelligence. We believe that the next generation of AI will be more enterprise use case focused. Many companies are developing AI models, but it will be those companies that have established user bases and own the data that will likely be most successful in developing compelling AI solutions. For example, Adobe has created Firefly, which has seen an enormous uptake in usage with the generative fill feature the most popular in Photoshop. Given the significant costs involved in developing AI, it will be important for companies to identify monetisation opportunities quickly. The speed at which enterprises can achieve this monetisation will determine the AI progress next year.

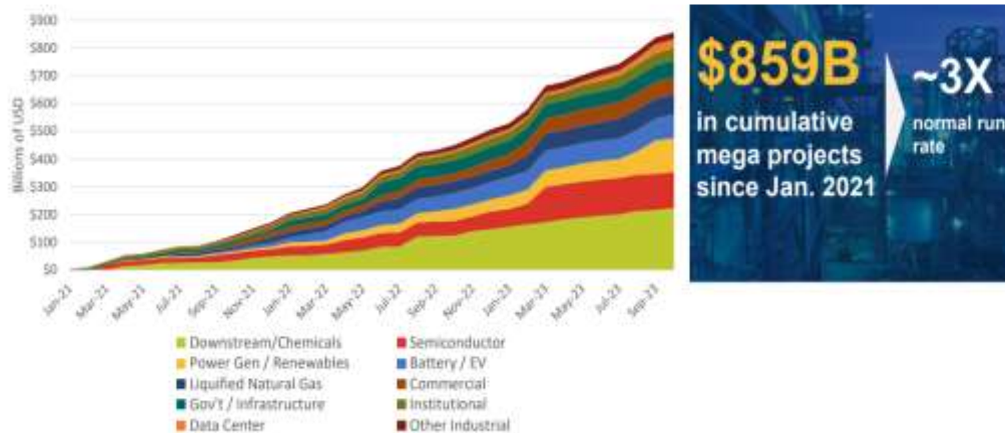
Industrials: At the beginning of a multi-decade investment cycle

It proved a mixed year for our industrial holding. Companies participating in key structural themes, including reshoring, the transition to net zero and accelerated investments in data centres continued to post strong returns, whilst others saw a strong inflexion in performance only in the last months of the year as short term headwinds receded.

Eaton, the global leader in power management solutions, is a great example of a beneficiary from increased investment, up 50% year to date. The company is forecasting to finish the year with 11-12% organic growth, fuelled by its electrical Americas and global divisions.

Perhaps the best indicator of the opportunity ahead is the level of projects in the US of over USD 1 billion in value announced since January 2021.

Reindustrialisation – momentum continues with mega project announcements
Cumulative U.S./Canada Mega Project ($1B+) Announcements



Source: Eaton

At the end of this year's third quarter, these mega projects stood at USD 859 billion, having grown from the USD 600 billion level at the beginning of 2022. Activity levels are running at three times the historical rate, reflecting heightened activity across a wide range of markets, including semiconductors, batteries, electric vehicles and renewable power generation. Eaton is at the beginning of a multi-year runway of investments in its key markets. 80% of these announced projects have yet to start and when they do, lead time to orders averages around two years. At the same time, AI is fuelling investments in the industrial sector, a connection that is often overlooked. Eaton's data centre vertical is seeing a significant acceleration in demand, with power management requirements being 3x higher for data centres that serve AI-related applications than traditional ones. Against this background, it is of little surprise that its backlog stands at a record level of USD 12.4 billion, three times the USD 4.2 billion at the end of 2019, setting the stage for another record year in 2024.

Other companies in the portfolio, including industrial software producer *Honeywell*, experienced weaker performance, as shorter cycle end markets experienced destocking and as businesses like logistics automation paused their spending after years of Covid-related record demand. Ultimately, with a record backlog of USD 31.5 billion and USD 24-27 billion in capital deployment, the company is primed for stronger performance into 2024 as these headwinds recede, fuelled by the growing themes of sustainability, automation and next-generation aviation.

Ultimately, the drivers of performance for the industrial sector are profound and supported by multi-decade requirements to invest in order to address key structural challenges: the need to enhance economic resilience, decarbonise the global economy, reduce the dependency on scarce labour through automation, futureproof critical infrastructure, manage risks associated

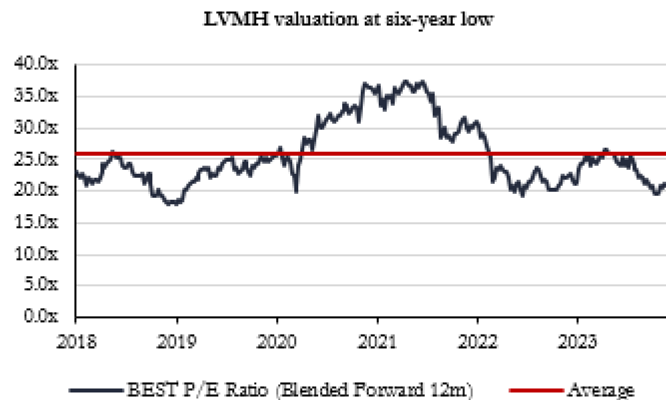
with global supply chain vulnerabilities, strengthen national security and make more efficient use of scarce natural resources.

As we have highlighted in the past, governments are spending to make this happen. In the US, for example, the CHIPS and Science Act, the Inflation Reduction Act and the Infrastructure Investment and Inflation Reduction Act will see trillions of dollars invested to address many of these needs. This is underpinning increased project activity and we believe, will power our investments in the years ahead.

Consumer: Demand slows as rates and inflation rise

The luxury sector delivered remarkable growth during the pandemic years as demand accelerated to above-trend double-digit growth. By the middle of 2022, the recovery from the pandemic was in full swing and the luxury sector began to normalise. Consumers started to shift spending priorities from goods to services, hospitality and travel which had been restricted during the pandemic years. At the same time, consumer demand started to slow because of rising interest rates and higher inflation.

Following the sudden re-opening of China in December last year, our expectation was that a strong recovery in luxury demand by Chinese consumers would offset potential weakness in consumption in the US and in Europe. Demand in the US and Europe held up, leading to a to a strong rally in the luxury sector at the beginning of 2023. However, by May this year, it became clear that the Chinese economic recovery is being held back by concerns about the construction sector and other issues. At the same time, demand from the US started to show cracks. Shares subsequently underperformed leading to a significant de-rating. For example, at the time of writing *LVMH* is trading at a 12 month forward PE of 21.9x versus a six-year average of 25.8x. This valuation is close to a six-year low. We believe the sector has hit the bottom and is poised for a recovery.



Source: Bloomberg

Looking forward to 2024, we see a year of two halves. We believe that the normalisation of the sector growth will continue into the early part of the year. As inflation subsides and interest rates begin to stabilise and perhaps even come down, consumer sentiment should improve. We believe that combined with greater numbers of international tourists from China in the second half of the year and cheap valuations, we should see improved performance as market sentiment turns. Over the long term, we remain convinced of the strong fundamental growth drivers of luxury consumption. We recently took advantage of the lower share prices to increase our position in LVMH.

The performance of the spirits sector mirrored the luxury sector. A period of close to double-digit supernormal growth led to strong performance during the early part of the pandemic

years. The trend started to reverse in the second half of 2022 and through 2023, led by the market normalisation and the sector-specific factor of destocking.

This year there has been an inventory adjustment in the aftermath of increased stock during the pandemic years as retailers and wholesalers built up inventory to combat supply shortages. The unwinding of stocks has been particularly acute in US markets, and most recently, in Latin America where *Diageo* issued a profit warning. The combination of market normalisation and inventory adjustment led to the sector's de-rating and underperformance in 2023, especially in the second half of the year.

Next year the US destocking should be largely behind us. The spirits market is gradually returning to the long-term trend of mid-single-digit growth. We expect fewer pricing increases as inflation pressures subside, while innovation will be the key revenue driver. As with the luxury sector, we expect consumer sentiment to improve as inflation moderates and interest stabilize or decline during 2024. With cheap valuations, the sector is ripe for a re-rating. Our conviction is reflected in our recent decision to increase our holding in *Pernod Ricard*, based on the end of the destocking cycle and potentially improved demand in travel retail and China.

Healthcare: Innovators will be the winners

Having benefited from Covid testing and treatment revenues during the pandemic years, 2023 saw a sharp decline in these revenues. Although the underlying growth of our companies remained strong, challenging comparison (from Covid-related sales) to the prior year led to reported results being somewhat lacklustre in 2023.

In the second half of 2023, the medical technology sector suffered selling pressure because of investor fears of a reduction in the total addressable market as a new class of weight-loss drugs, known as GLP-1, entered the health care mainstream. Created to treat diabetes they have demonstrated significant metabolic improvements on multiple medical conditions such as cardiovascular disease, sleep apnea, progression in diabetes and kidney disease to name just some.

Whilst we agree on the benefit of the GLP-1 class of drugs, we also believe the innovative medical technology sector can co-exist with GLP-1. In fact, in some subsectors of medical technology, we see a synergistic benefit of a combined use of devices and GLP-1. For example, real-world data from both *Abbott* and *Dexcom*, the two leading providers of continuous glucose monitoring (CGM) devices, point to an increased usage (not less) of CGM amongst GLP-1 users. This marriage makes perfect sense to keep patients compliant with the GLP-1 class of drugs. In addition, not all medical conditions are caused by obesity and an ageing population will continue to be a key growth driver for healthcare.

We expect the drag from Covid-related revenues to fade heading into the spring as the underlying strength of companies in the sector becomes ever more evident. As investors continue to digest data from GLP-1, they will become more selective on which companies will benefit from its presence.

Over the medium term, the medical technology sector will innovate and come up with devices that address new and unmet medical needs. As an example, statins have been prescribed not just to lower bad cholesterol levels but also to reduce the risk of heart attack and stroke. Today, more than 200 million people globally are on statins since the first statin was approved

by the FDA in 1986. Cardiovascular devices like structural heart, leadless pacemakers and implantable cardioverter defibrillators (ICDs) are still one of the fastest-growing areas of medical technology.

Whilst the benefits of the GLP-1 class of drugs are plenty, they also present some undesirable side effects. Substantial lean muscle loss from weight loss could be problematic, especially for the elderly where regaining muscle mass is more difficult. This challenge presents a new opportunity for innovation. Companies including *Roche* have already started to look into how to preserve muscle mass by combining GLP-1 drug with its own anti-myostatin muscle antibody following the recent announcement of the acquisition of Carmot.

With 2024 an election year in the US, we anticipate some volatility as politicians ratchet up pressure on the bulging cost of healthcare and drug pricing. That said, given the low valuation of the pharma sector, this is mostly discounted already and we remain positive on healthcare, and especially medical technology, in 2024.

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December 2023

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