STONEHAGE FLEMING

9 January 2023

Dear Equity Client

GLOBAL BEST IDEAS EQUITIES – 2023 Annual Letter

2022 PERFORMANCE

2022 turned out to be the worst year for global equity investors since the 2008 Financial Crisis. The MSCI World Index (including Emerging Markets and dividends) delivered a -18.4% return over the year (in US$ terms; -8.7% in UK£ terms[1]). In essence, the good returns earned the previous year have been sacrificed. Along with this, Growth investors suffered even more from the strong rotation to the Value style of investing.

Investors faced a potent combination of severe macro risk factors from early on in the year. As some of these factors faded over later months and new ones appeared throughout, investors continuously had to assess whether the overall risk from the combination of these factors was still worsening or not. The most important factors are as follows, in sequence as they appeared:

i. Global supply chain complications following the disruptions from the Pandemic
ii. Inflation rising to uncomfortable levels
iii. The Federal Reserve (Fed)'s new rate hiking process
iv. Russia invading Ukraine
v. China going into a deep economic lockdown
vi. Fears about the potential effects on US interest rates from the Fed's upcoming Quantitative Tightening (QT) process
vii. Rising fears for an upcoming US recession
viii. The US Dollar rising by 19% to its peak level
ix. Geopolitical tensions around Taiwan

This is the worst combination of risk factors investors have had to deal with in a long time and the effect on investor sentiment is logical, with inflation fears dominating risk assessment. Whilst US inflation peaked in June, the market only took some comfort after the third consecutive drop in September. Equity markets have since stabilised.

CURRENT STATE OF RISK FACTORS

Whilst some of these factors have moderated, investors continue to assess the overall risk of the combination of these factors, and which ones may be added:

1. <u>Supply Chain Complications</u>
   These have largely been resolved, with general shipping, business backlogs and delivery times almost back to normal. Whilst some sectors are still suffering from restrains (e.g. some semi-conductors), the Pandemic-inflicted supply constraints are generally no longer of material

[1] Source: Bloomberg

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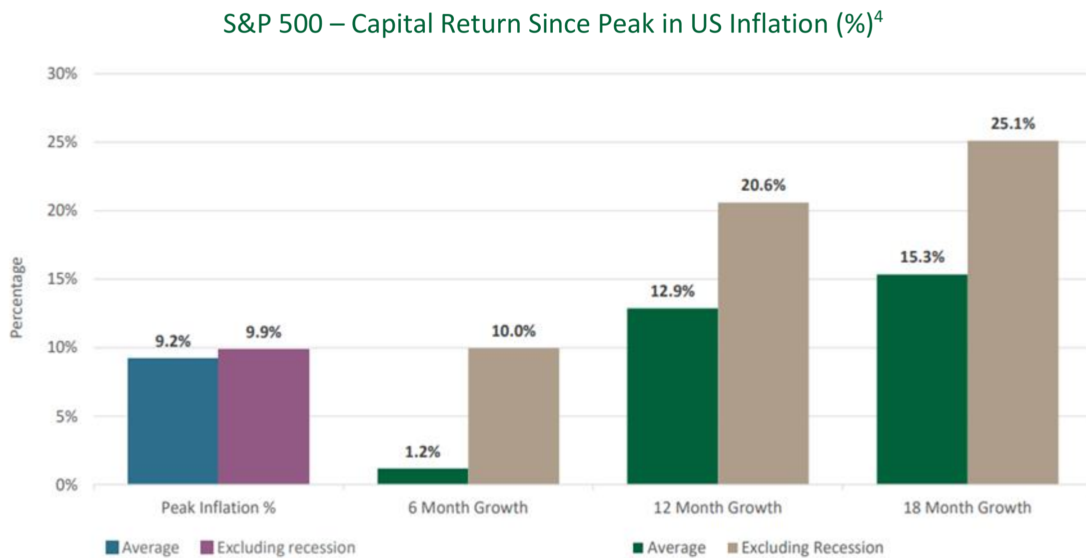
concern. The debate in some cases may rather be in the process of moving on to the issue of oversupply.

2. High Inflation

US headline inflation has dropped every month from its peak of 9.1% in June to 7.1% in November[2]. There are promising signs for further drops in coming months – the UN Food price, the Oil price and the CRB Commodity price are flat compared to a year ago, the ISM Manufacturing Cost index is in contraction territory, US wage growth has receded from a recent peak of +5.6% to the current +4.6%, Composite Container prices have dropped -77% against a year ago, etc.[3] Cost pressures and reliefs, though, take time to work their way through, and while these are good indications, core inflation may remain sticky for a while. US accommodation rent is a particular issue (following the sharp rise in mortgage rates).

We believe US inflation is now in a slow structural decline, and while it may take time to reach the Fed's 2% target, the direction of travel is more important. Critically, investor inflation expectations (considering breakeven rates) for both two- and ten-year periods are below 2.5%.

S&P 500 – Capital Return Since Peak in US Inflation (%)[4]



The above chart reflects the S&P 500 returns following the respective timings of peak inflation since 1940. On this basis, investors can look forward to attractive returns after a year or so.

3. Fed Rate Hiking Process

Investors currently face one of the most aggressive Fed rate hiking cycles ever. The total of +4.25% hikes was equalled (not exceeded) only once, and then it took 25 months against the nine months this time[5]. This aggression has taken its toll on the capital markets.

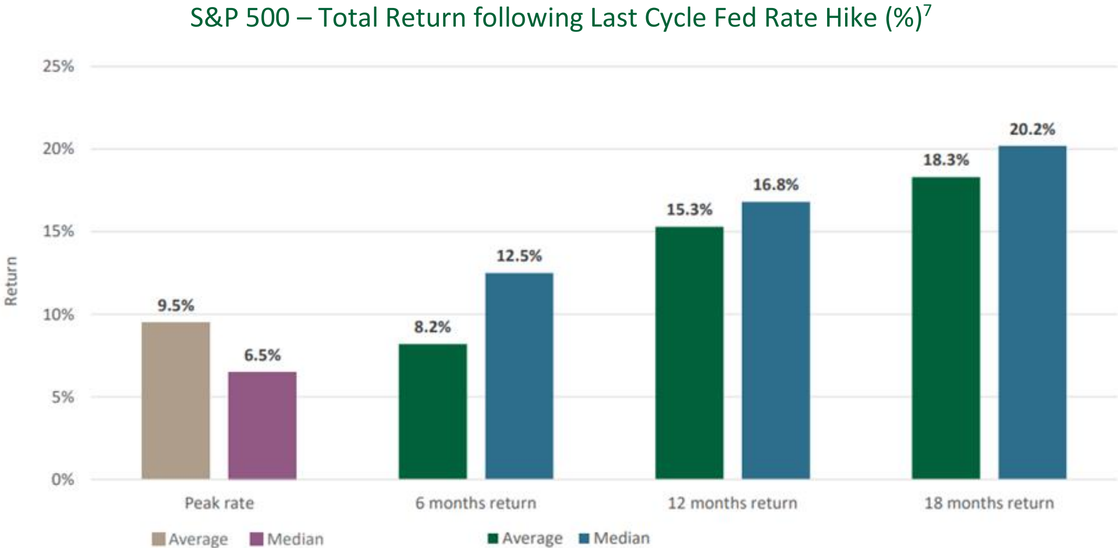
The Fed remains hawkish with strong indications of further hikes (to finally break the back of inflation and seemingly because of stubbornly low unemployment). It is, though, striking that they have tempered the most recent hike to +0.5% from +0.75%. This is an indication that the hiking process is starting to mature.

[2] Source: Bloomberg
[3] Source: Bloomberg
[4] Source: Bloomberg; Stonehage Fleming Investment Management
[5] Source: Bloomberg

Past performance is not an indicator of future returns

In this context, the December 2023 FedFund futures prices show little yield upside from current levels. Further to this, the FedFund target rate (4.5%) now exceeds the 2-year Treasury yield (4.2%)[6]. Further to this, historically, the Fed has stopped hiking rates when this discrepancy occurred. We would not make this case now, but do believe small hikes only (+0.25%) are now potentially on the cards.

S&P 500 – Total Return following Last Cycle Fed Rate Hike (%)[7]



As reflected in the above chart, since 1970 equity investors have enjoyed attractive returns following the last rate hike. Further to this, another exercise has shown that investors should actually not wait for the last rate hike – on average, those who invested six months before the last hike earned double digit twelve-month returns subsequently.

4. Ukraine War
   The Russian invasion has further polarised the global geopolitical environment and clearly further boosts the on- or re-shoring of industrial capacity. Along with the costs of the war, this can be inflationary, but it also creates new investment opportunities (e.g. Keyence in automation). With the war bringing food security in the spotlight, we also consider opportunities in this context.

5. China Lockdown
   The rolling Chinese lockdowns have clearly had a huge impact on the Chinese economy, their society and world trade. Their recent moves to end the zero-policy is generally a positive development, but it remains unclear how smooth this re-opening process will be and how their health system will be able to cope with sharply rising and large infection numbers. Much for global investors depends on China's growth path, and a degree of a stop-start economic recovery remains a possibility.

   It is important for global capital markets that the world's second largest economy gets its act together. Whilst we believe the change in the Chinese authorities' stance on their policy is a net positive for capital markets, we think the investor risk premium for that market will remain high.

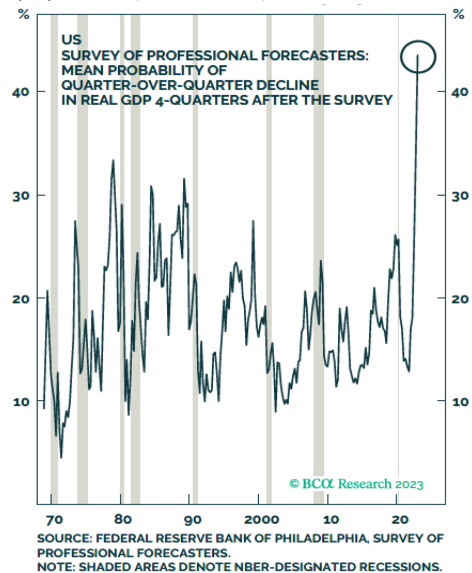
[6] Source: Bloomberg
[7] Source: Bloomberg; Stonehage Fleming Investment Management
Past performance is not an indicator of future returns

6. Quantitative Tightening (QT)
   An analysis of the necessary pathway for the Fed to reduce its balance sheet to its target provides an interesting result. They have committed to reduce their bond holdings by $95bn per month. Because of the relatively short duration of their total book and large maturities in the initial months, it seems they have to sell relatively small amounts only – in essence, less than three months' commitment over all of this year, and only five months' next year[8]. On this basis, we do not reckon QT will have any material effect on interest rates.

7. Potential US Recession
   Many leading economic indicators warn of the potential for an imminent recession. A 2023 recession has become the consensus view.

   We have a few important points to make in this context:

   - Should a recession occur, it may be a relatively mild one. The US consumer's financial position (total net worth about the same as a year ago, debt service ratio at 10%) and overall employment remain relatively strong, with consumption and retail sales currently continuing to grow[9]. Consumer confidence indices have turned for the better. There is neither a glut of homes (as in 2008) nor of capital equipment (as in 2000).
   - It will be the most anticipated recession in a generation. A survey of professional forecasters shows that 45% of them expect negative real GDP growth within a year, materially exceeding the previous record of 33% (in 1979). A Bloomberg poll of economists' views in December showed a 70% probability of a recession in 2023. Management teams, analysts, and investors should well prepared.



   - The Yield Curve and the Conference Board Leading Economic Index (both trusted leading indicators) have triggered their warning signs. A historic analysis of their respective inflection points actually indicate positive stock market returns a year after these warning signs have been triggered.
   - The S&P 500 has not previously experienced a bear market (in excess of -20%) prior to a recession (also not with the oil crisis), and has traditionally bottomed roughly just over halfway through a recession[10]. This time it has experienced a bear market before the recession and the crucial question is whether it has bottomed this time before the recession.
   - We currently have unique economic circumstances of recovering from economic lockdowns, supply chain complications and a continuing war. Whilst it is not a clear pathway for smooth growth, these disruptions may also imply an unconventional economic cycle and its own pathway.
   - The strength of the labour market is an important part of the Fed's Achilles' heel to dampen inflation, but not damage the economy too much. This is clearly a fine balance, but the slowly dropping wage increases (both in manufacturing and overall) are a promising sign.

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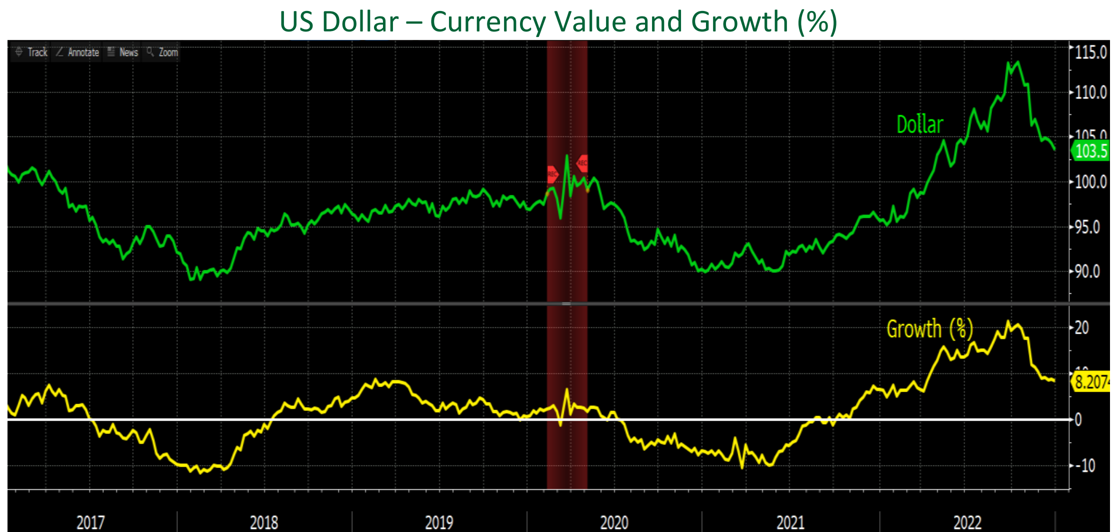
[8] Source: Bloomberg; Stonehage Fleming Investment Management
[9] Source: Bloomberg
[10] Source: Bloomberg; Stonehage Fleming Investment Management

8. Strong Dollar
   Many US operators struggled with a very strong Dollar through 2022, which, at a stage, had appreciated over +20% against the level a year ago:

US Dollar – Currency Value and Growth (%)



   The currency's strength was a major headwind for many global operators and suppressed S&P 500 earnings to a major extent. We believe it is overvalued, but since the Fed became less hawkish, has started to depreciate. This new trend can turn from a headwind into a tailwind for those earnings, encourage US exports and support other economies. This can especially favour global US operators and Emerging Markets saddled with Dollar denominated debt. Potential US inflationary issues from imports may materialise later on.

9. Taiwan
   We have over time learned to be alert but to be careful in taking a firm investment stance on geopolitical issues before such a potential major event. That said, it is our impression that the Russian/Ukraine war may act as a deterrent in the context of Taiwan. We are nevertheless careful to invest in Taiwan, also seeing the abundance of alternative investment opportunities at lower risk.

10. Other Risk Factors

   Interest Rates
   The basis-point increase in Treasury yields last year has been the sharpest (+2.5%) since the 1980's. There is some risk for further increases in rates, which may have a further detrimental effect on equity valuations. The inflation outlook clearly is part of these considerations.

   We are, though, conscious that the Treasury market has stabilised and that yields are currently over half a percent lower than their peak level in October 2022. With this being the most liquid market in the world, we take cognisance of this stability. Further to that, historically, yield increases of that order have in two-thirds of the cases been followed by lower rates a year later[11]. Odds therefore seem to favour a continuing stable Treasury market.

   Earnings
   A big challenge for 2023 may be the high base of corporate earnings and profitability. Overall S&P 500 Index operating margins have already dropped from recent peak levels. As mentioned,

[11] Source: LPL Research

the Dollar may turn into a tailwind in this context, but generally analysts and investors have already adjusted their expectations and should not be caught off-guard.

Political
The US midterm election delivered a deadlock in Congress. That said, since WWII, the US stock market has delivered positive returns in the year following these midterm elections, and apart from three occasions, also with congress deadlocks[12]. History is currently on investors' side in this context.

Risk Factor Summary
The potent combination of risk factors investors faced last year has, largely, run a major part of their courses. We are not yet out of the proverbial woods, but there now seems to be good reason to be more constructive on equities as an asset class.

INVESTMENT STRATEGY

We believe the following are pertinent issues for the coming year:

A. Forecasts
Whilst we do thorough investment research and project our individual companies' results three years forward, we refrain from depending on brave macro-economic and market forecasts and rather consider current facts and trends as a guide.

B. Resilience
We expect business and earnings resilience to be a major factor this year. Whilst this plays directly into our philosophy, we are particularly alert to businesses that may have overextended themselves in recent times and took on too many costs. Our expected earnings growth for our portfolio for this year is +11%.

C. Balance
We invest for sustainable, above average organic growth. We, though, believe a balance of stable and higher growth is appropriate and responsible, rather than simply owning particularly high growth operators.

D. Investor Reactions
We have had a major sell-off and derating in most markets. We are conscious that investors often overreact under such circumstances, following herds and index weights, and that bear markets are usually followed by good recoveries. Following such corrections, we are more guided by the quality of the business and its valuation than stock trading volumes and index weights.

Alphabet is an example in this context. It has a cash balance well in excess of $100bn, a cash resource level of almost a fifth of its market valuation, continues to grow organically and generates double-digit ROIC numbers, but trades on a forward earnings multiple of 15 and free cash flow yield of over 6%[13].

The share has suffered from negative sentiment and an overall divestment from technology despite its consensus upside of 45%[14].

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[12] Source: Factset; Carson Investment Research; Stonehage Fleming Investment Management
[13] Source: Bloomberg
[14] Source: Bloomberg

We believe 2023 enjoys good investment opportunities from the 2022 sell-off.

E. Strong Franchises

True to our mandate, we only invest in strong sustainable growth franchises. We are particularly focussed on strong management and cost controls. The overall metrics of our portfolio have the following characteristics[15]:

- Operating margin : 30%
- ROIC : 19%
- Net Debt / EBITDA : 0.8
- 3-year expected earnings growth : +12% p.a.

F. Growth Theme

Whilst 2022 had experienced a sharp rotation from Growth to Value, a bleaker economic outlook may lead to a stabilisation and later reversal of this trend. The current stable Bond market is a positive signal in this context.

G. Specific Opportunities

We believe the following offer specific opportunities this year:

- Health Care following the sector sell-off, structurally growing demand and high quality franchises (**Becton Dickinson, Edwards Lifesciences, Stryker, Thermo Fisher**).
- De-globalisation/on-/re-shoring and automation (**ASML, Keyence**).
- High recurring revenue (**Adobe, Cadence Design Systems, Microsoft, S&P Global, Verisk).**
- China consumer exposure (**AIA, Estée Lauder, L'Oreal, LVMH, Nike**).
- Franchise fee based business model / low operational cost (**McDonald's**).
- Large net cash balance sheets – earning growing interest (**Accenture, Alphabet, Edwards Lifesciences, Keyence, Microsoft**).

RESPONSIBLE INVESTING

Environmental, Social and Governance (ESG) considerations have been integral to our investment process all along, in support of our investment philosophy of sustainable long-term growth. Our additional research work in this context fully incorporates these fundamental issues, considering also inputs from external ESG specialists. We vote on all the holdings in our Global Best Ideas Equity Fund, prioritising sustainability and best-in-class governance in all our voting decisions.

We often engage (and re-engage) with numerous businesses on important stewardship issues (for both our portfolio holdings and other candidates). Details of our votes and engagements are published on our Fund's website.

Stonehage Fleming is a signatory to the United Nations' Principles for Responsible Investment and the UK Stewardship Code.

[15] Source: Bloomberg; Stonehage Fleming Investment Management

IN SUMMARY

2022 has been a particularly challenging year for quality growth mandates. That said, our mandate has continued to provide excess performance against its comparative index (MSCI AC TR) since inception. Our strategic approach to investing remains intact. The volatile market conditions provided opportunities to refine the portfolio and switch two holdings for exceptional businesses that we had previously considered to be overvalued. We are considering further new opportunities and will continue to rebalance the portfolio for even better franchises at attractive valuations.

We are grateful for all your support.

With kind regards

Gerrit Smit
Partner – Head of Global Equity Management

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