Insight Commentary

EXPECTING THE UNEXPECTED

How will we look back at this year of challenges and surprises? We invest in companies, not markets or economies but we do have broader views. At the beginning of the year, we expected that 2022 would be the year in which we would finally put the pandemic behind us. The global economy would resume where it was last at the beginning of 2020, with the prospects of strong economic growth driven by globalisation, digitalisation and capital investment. We thought that the reopening of the global economy would exacerbate some of the constraints we had seen during the pandemic. Growth would lead to increased demand for goods, services and resources, inflation would increase and we would have a gradual normalization of interest rates. Our fundamental view was that this period could last a year or two and that our companies would do well because their quality, and value would persist even if the market was volatile.

Instead, the unexpected has happened. Russia's invasion of Ukraine has had a devastating human impact. It has added surging energy price inflation and supply concerns to the constraints caused by the pandemic. Inflation has soared. The Fed has decided to accelerate increasing the Fed Funds Rate from just above 0 to 4.25 - 4.5% compressing our expected normalisation of interest rate into nine months of 75 basis point increases.

Another unexpected issue this year has been China's zero Covid policy, which has delayed our expected transition from the pandemic and left the country isolated as the last major economy not to have reopened. We thought that China would lift Covid restrictions gradually until the National People's Congress in March and reopen fully throughout the year.

As if to prove that we cannot expect the unexpected, China has this month decided to stop testing and tracing for Covid infections, perhaps due to popular unrest, and to let it take its course. Data is scarce but as we write it appears that a significant portion of the population is catching the virus and we have to hope that vaccinations will mean that most people will get over it and that hospitals will not be overwhelmed. Economic activity will be significantly impacted. We will have to brace ourselves for potentially poor economic data for the fourth quarter of this year and the first quarter of next year before there will be a massive resurgence in economic activity driven by reopening and government stimulus.

We must be clear that while we are in a period of geopolitical tensions and macroeconomic uncertainty we are not in a crisis. There are always tensions and we must hope that Russia does not choose to escalate the Russia-Ukraine conflict or that the reasons why China should hold off from invading Taiwan will hold.

Instead, we believe that we are at a macro-economic turning point where we have every reason to look forward to a period of sustained growth, with normal inflation and normal interest rates and that a world of 2-4% inflation and 4-5% interest rates is something to look forward to and not to fear.

We know this because consumer demand, full employment and inflation driven by bottlenecks – investment, capacity, labour supply, all of which appear likely to be rolling over or to improve – point to underlying strength and growth. Headline inflation should ease because energy prices would not just have to stay high but increase strongly from this year's highs to have a further impact on inflation.

4 Carlton Gardens
London SW1Y 5AA
United Kingdom
+44 20 3478 1800

Gartenstrasse 10
8002 Zürich
Switzerland
+41 44 552 80 70

2 Sir Augustus Bartolo Street
Ta' Xbiex XBX1091
Malta
+356 2034 5006

www.jsternco.com
info@jsternco.com

Markets, however, have a difficult time dealing with these moments of transition where there are sudden changes in macro indicators and difficult comparisons for economies and companies. We have discussed some of these throughout the year. None has been more dramatic than the decline in the growth of digital advertising, which slowed significantly after the 40% boom it has in 2021 in a way that was unexpected even for Mark Zuckerberg. Even he has had to listen to his share price if not to his shareholders and has changed course. Of course, digital advertising is not going away and the largest platforms still offer the highest utility and return on investment.

May we, therefore, be the first to point out that if the Chinese economy declines strongly in Q1 of 2023 because of the rapid rise of Covid infections, then Q1 of 2024 will have an exceptionally strong recovery from the previous year and Q1 of 2025 will be a time when markets will worry about a significant slowdown or even decline in growth, 'China in recession' because of the high growth of the previous year.

As US interest rates hit the 5% level we expect they should, we think that the factor rotation that has hit our portfolio and stocks has now run its course. Fundamentally our companies are doing well and even if the first two quarters of the year are challenging because of the delayed impact of inflation, rate rises and uncertainty on corporate and consumer spending, we think that a probabilistic view of the outcomes is ultimately positive.

What do we do to expect the unexpected? We fall back on our core conviction of investing in quality and value for the long term. We invest in strong and sustainable globally leading companies based on our own investment and ESG research. These companies have the innovation and resources to drive growth and the pricing power to offset inflation.

We still believe that equities are the asset class in this environment of higher inflation and interest rates that people can use to invest and that there will continue to be inflows. Most importantly, the quality of stocks matters most in a crisis. In March 2020, when we did not know how long it would take to overcome the pandemic, they outperformed by 10-15%. The same is true on a back-tested basis during the global financial crisis. Liquidity, leverage and structural risks do not matter until they do.

If we are right and we have a moderate economic scenario with growth and easier comparators, then our stocks should do well in absolute terms and may outperform as factor rotation reverses. However, if we are wrong and the unexpected happens again, externalities take place, inflation is much higher and the Fed has to raise rates to much higher levels, then the US economy is likely to roll over then all the cyclical financial, material, resource and utility stocks that have done well this year will tank.

Whatever the outcome, expected or unexpected, we take a long-term view and believe that our portfolio is well-positioned and that our stocks should be poised to perform.

World Stars Global Equity

Our World Stars strategy recovered strongly to close the month up 7.8% terms and, bringing performance year to date to -21.8%, both in US dollar terms.

Performance was led by a strong resurgence in some of the hardest hit areas year to date, as the market started to look past the recent volatility and towards their medium and long-term earnings potential.

Advanced semiconductor manufacturer, *Nvidia*, closed the month up 26% on the back of strong quarterly earnings especially within the company's datacentre business despite lingering short-term macroeconomic concerns. The company has a strong line-up of new products, with its Ada Lovelace gaming graphics card selling out immediately upon launch. At the same time, increased customer spending in next-generation technologies including the metaverse, AI and autonomous vehicles is set to fuel an accelerated growth pathway in the years ahead. Social media platform, *Meta*, also recovered and was up 27%. Investors were encouraged by the higher cost discipline of the company, as it announced its intention to reduce its workforce by 13% and listen to investor feedback on capital allocation.

Our holdings linked to Chinese consumers were buoyed by the continued re-opening of the local economy, which has accelerated significantly this month with the government's decision to stop testing and tracking for the virus. For example, luxury goods provider, *LVMH* and hair care and cosmetics leader, *L'Oréal*, were among our top five performers this month. We believe both companies will continue to do well next year given the resilience of demand for high-end and personal care goods irrespective of the macroeconomic environment. Pent-up demand from Chinese consumers will act as an additional trigger. On a similar note, our portfolio holdings in the spirits industry, high-end eyewear and payments networks continue to demonstrate robust performance on strong ongoing leisure and travel activity, and resilient category spending trends.

Our industrial holdings also powered ahead. Structural trends related to the transition to net-zero and broader energy, reshoring, green and smart infrastructure, in addition to increased defence spending, have positioned the sector for a multi-decade 'golden age' of growth. We continue to find attractive investments, adding a position to one of the leading global providers of water equipment and digital infrastructure. We believe that we are at the early innings of this investment cycle as developed nations seek to upgrade their woefully out-of-date water networks and as emerging nations build out water and wastewater treatment systems that can meet the increased demands of population growth, industrialisation and climate change.

Finally, we added to our positions in *Nvidia* and *Disney* taking advantage of the stocks' depressed valuation levels despite their unique positioning within their respective industries and their earnings growth trajectory going forward. We financed these purchases by selling our holding in *Medtronic*. The medical device company retains an exceptionally strong franchise but recent negative news related to its pipeline, and in particular, its hypertension treatment device, placed a cap on its medium and long-term prospects. We decided to exit our position and invest in stocks that we believe offer greater upside potential.

Multi-Asset Income

November was another strong month with our portfolio up 5.8% in US dollars terms (now down 14.9% since the start of the year) with macroeconomic news providing most of the support. With the consensus that inflation has peaked in most developed economies, markets are discounting the probability of the US Federal Reserve fast-ending its monetary tightening policy with the distinct possibility of interest rate cuts to come.

All asset classes benefited greatly from this new state of mind with equities the strongest performers, up 7.7% for the month (down 21.1% year to date), followed by our fixed income portfolio up 6.5% (now down 8.1% since the start of the year). Alternative funds were also positive but by a smaller margin of 1.2% (down 12.4% for the year).

In our equity portfolio, *Estée Lauder* (up 17.6%) was a strong performer benefiting from the hope that China's Covid-zero restrictions could be lifted earlier than expected. *Siemens Healthineers* announced positive, albeit late, results with the stock becoming the target of bargain hunting (up 13.3%) by investors.

Our fixed-income portfolio saw positive news flow from our Ukrainian holdings and from earnings releases (see our Emerging Market Bonds commentary).

Alternative funds were more mixed but at one end saw a relief rally from some companies threatened by possible windfall taxation in the UK (*Sequoia* +8.5% and *Greencoat* +8.3%). Meanwhile, *Hipgnosis*, the music royalty fund came under pressure ahead of the half-year results this month (-3.6%).

Macroeconomic data will carry on driving volatility with the possibility of disappointing earnings globally to weigh on risk assets. Subsequently, we have made some adjustments to our portfolio reducing our exposure to equities by taking profits in some specific companies (*Schlumberger*) and adding to some of our industrial companies (*Eaton* and *Honeywell*). We have also increased the weight of our fixed-income portfolio to reflect some of the opportunities (*UPL* and *AES Andes*) to extract more income and reduce the volatility of the strategy.

Emerging Market Bonds

Our Emerging Market Bond strategy was up +5.4% for the month in US dollar terms, with all sectors and geographies contributing positively. Overall risk sentiment improved as economic data moderated previous macro concerns about US interest rates and tightening liquidity. As the market expectations for peak rates declined, credit spreads tightened 75 basis points during the month to 370 basis points and now trade 15 basis points wide to the last 20-year average.

In addition to macro tailwinds, performance was also backed by the conclusion of a robust corporate earnings season which emphasised the strength of underlying fundamentals. Highlights include *YPF* (Argentina, energy) which reported strong operating growth driven by higher production and better-realised prices. This led the company to its tenth consecutive quarter of positive free cash flow and net leverage declining to its lowest level since 2015.

Elsewhere, our Ukrainian corporates were some of the top performers despite the ongoing military conflict. *MHP*'s (agro-industrial) showed again a high degree of resilience with poultry production volumes and most exports continuing despite war-related logistical challenges. The company also restarted bond coupon payments during November and reiterated its expectations to make deferred spring coupons in full in the coming months. Meanwhile, *Kernel* (agro-commodities) released a quarterly operational update which saw a 5.8x sequential improvement in grain exports 3.1x improvement in edible oils sales 3.1x following resumption in exports from Black Sea ports.

Going forward, performance will continue to be driven by macro conditions. There are signs focus is shifting from inflation and monetary tightening to concerns about an economic slowdown, albeit volatility is likely to remain elevated. Credit fundamentals are strong and many companies have been proactive in terming out their debt maturities at low fixed rates, partially insulating them from the higher interest rate environment.

Such a setting is a great opportunity for long-term investors to lock in attractive yields by buying and holding bonds to maturity. Our Emerging Market Bond strategy offers an 11.5% per annum yield to maturity (in US dollar terms) with a relatively short duration of four years. This comprises a 7.5% per annum income yield and 4.0% per annum capital appreciation potential, given the average bond price is 84 cents on the dollar.

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