

In 2018 US GDP growth hit 4%, global company profits increased to all-time highs, US taxes were cut by \$1.5 trillion, US companies bought-back \$0.8 trillion of their own shares, unemployment fell to multi-decade lows in the US, UK, Europe and Japan... and yet stock markets struggled to make progress over the year and lurched down by 10% in Q4.

You don't have to look far for an explanation: the price of money for dollar borrowers around the world has risen meaningfully in the last year and economic growth data everywhere are now deteriorating. Policymakers have few remedies available to treat a recession or another credit crisis. Equity markets had anticipated the good 2018 data back in 2017 with blistering returns. But now, looking forward, the medium-term profits growth prospects are relatively challenging.

The flattening yield curve (long-term bond yields are normally higher than short-term yields, but are now broadly the same), suggests that it will be very hard to escape the 'secular stagnation' thesis: more retirees leaving the workforce than youngsters joining; low productivity growth; disruption from new technology and too much debt all suggest much slower growth in the future than the developed world, and its listed companies, have enjoyed in the past.

In an investment environment with stronger headwinds, the recent market reversal may not be just another trigger to 'buy on the dips' across the board. Indeed, with stagnant growth it will pay to be much more selective to avoid the bear traps. As we discuss later in this report, 'secular stagnation' means that an apparently cheap price/earnings (p/e) ratio for the market, calculated using historic earnings, may not be so cheap when the future prospects for earnings in some industries are properly considered.

Fortunately, while some of the aggregate trends look weak, there are many specific, positive trends that can beat the averages, reflected in the thematic strategy employed in the portfolio.

Thematic Strategy

Five major, long-term trend changes underlie many of the themes in the portfolio: Automation, Climate Change, Ageing (and other demographic shifts), Digitalisation and Evolving Consumption patterns. In all of these areas significant economic shifts are unfolding and we can find opportunities for secular profits growth that buck the broad trend of slower global economic growth.

These trends provide a broad spectrum of rising demand, from expanding travel to growing savings, escalating energy transition to multiplying healthcare treatments and from increasing electronic payments to advancing robotics.

Over the quarter, there were relatively strong performances in the energy transition theme, from Enel an Italian energy provider with a high share of generation from geothermal, wind, solar, hydroelectric and nuclear power, and Orsted, an offshore wind operator introduced to the portfolio earlier last year. Outperformers in the ageing theme included CSL (blood plasma), Amgen (biopharmaceuticals for rheumatoid arthritis and preventing infections) and Pfizer (oncology, cardiology).

In automation, Deere, the agricultural equipment manufacturer performed well, and in digitalisation, ServiceNow, a software-as-a-service provider, was relatively resilient given the sharp falls in many technology stocks.

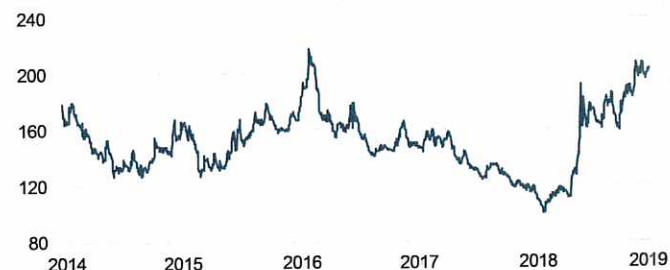
These were offset to some extent by frustratingly sharp setbacks in some of the previous best performers such as Fresenius Medical Care (dialysis equipment), Umicore (battery technology & metals recycling) and Activision Blizzard (electronic games and e-sports).

Growth & Credit Risks

Region by region the economic growth challenges have been mounting and look to be more than temporary. The US Federal Reserve has been tightening monetary policy with nine interest rate rises since 2015 and a reversal of its 'quantitative easing' (QE) bond buying programme to a 'quantitative tightening' (QT) programme, selling some of the bonds it previously bought. Other economies have been too weak to allow any interest rate rises, nonetheless, the European Central Bank has ended its QE programme.

We remain concerned that European growth is still very weak and there is little scope to boost the economy. And worries are also rising again over the vulnerability of the financial system and credit markets. It seems likely that the ECB will have to provide further direct support to banks and, with the still large weight of distressed or zombie company debt needing to be rolled-over, the cost of borrowing for companies has already risen sharply (chart 1). Slowing growth raises the risk and there are early signs of concern elsewhere in the credit markets, such as the mounting retreat from the US leveraged loan market.

Spread between Global Corporate BBB Bond Yields and Government Bond Yields



Source: Bloomberg / BAML Global Bond Indices

Heading a long list of geopolitical disorders is the US/China trade dispute. This "strategic rivalry" seems likely to last decades. In the short-term, the 90-day time-out on raising tariffs expires on 2nd March. If agreement on issues including technology transfer, intellectual property, non-tariff barriers, cybertheft and agriculture is not reached, both parties agree that the 10% tariffs will be raised to 25%. Some kind of solution does seem likely but the phoney war has already caused damage to corporate profits. In the headlines, Apple's China business fell unexpectedly by 40% in one quarter and on the other side, the US government has banned ZTE and China Jinhua from buying US technology and the Canadian government has arrested the CFO of Huawei. Behind the headlines, the damage to corporate profits is more widespread.

Before the trade dispute escalated, China's growth was already slowing as the government imposed reforms on the financial sector. It may well need to boost the economy again later in the

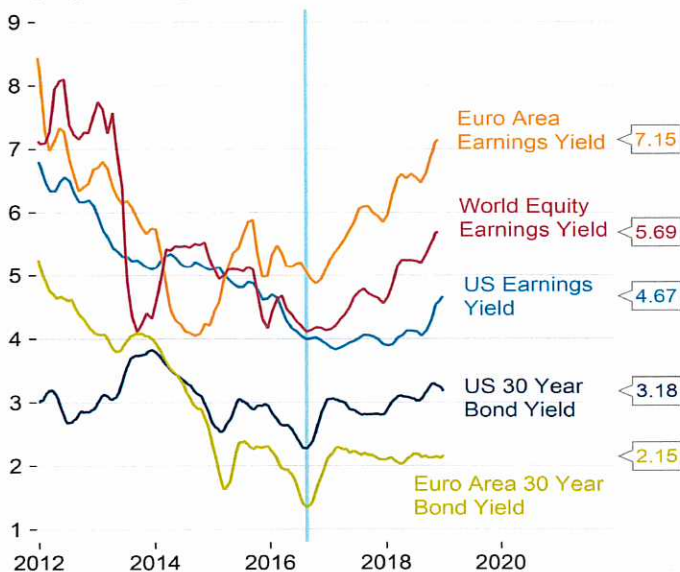
year with new tax cuts - this should favour consumer stocks. There is a risk that military confrontation may be used as a distraction from slower growth, either in the South China Sea or Taiwan.

Set against these concerns, lower oil prices and lower inflation will help consumers and keep interest rates low. The prospects of not only an end to Fed tightening but also an end to US-dollar strength could provide a significant boost to many emerging market economies.

Valuation

The long-term decline in bond yields, equity earnings yields and property yields came to an end in 2016 (see chart 2). Since then there has been remarkably strong global equity earnings growth, boosted by corporate tax cuts in the US, which has lifted the world equity earnings yield from 4.2% to 5.7% with only a small price correction.

Equity Earnings Yields & 30 Year Bond Yields



Source: Macrobond

Even if bond yields look still too low to meet most investors' goals, earnings yields on world equity indices could now be described as attractive relative to the very subdued long-term inflation rates implied in bond markets (1.9% in US and 1.6% in Eurozone).

So far so good. On the face of it there is an underpinning for long-term equity ownership. However, the blot on the landscape is that in each asset class there is real devil in the detail - significant price distortions stem from the scramble for yield over the last decade and also from the challenge in pricing the true impact of future technological, demographic and environmental disruption that will undermine many previously lucrative business models. And this is without taking account of the impact of any cyclical downturn, something that always catches-out financially and operationally geared businesses.

Clues to the mistrust being shown in future equity returns can be found in the very high premium of European equity earnings yields over the bond yields (a 5% premium, shown in chart 1). But if you delve inside the European equity indices, you find that the apparent value lies in the large weighting to industries facing

long-term challenges: for example, at 20%, financials is the largest European sector, including many troubled banks and insurers. In Germany and France, consumer discretionary stocks make up 18% of the indices, heavily weighted to car manufacturers and automotive component companies challenged by industry oversupply, trade disputes and the transition to electric vehicles. Across the EU, with government budgets constrained (except Germany) and the working age population declining by 0.5% p.a., many companies are struggling to grow their top line.

"I can't go back to yesterday - because I was a different person then." Alice in Wonderland's acknowledgement that she had been fundamentally altered by her experiences rings true for the pace of change the world is encountering today. Further advances in digital technologies will ratchet-up business disruptions. Cyber risks and data privacy add to operational and reputational pressures. And the transition to a low-carbon economy and repricing of 'uncosted negative externalities' could also put pressure on profits.

There has been a consistent pattern of sector underperformance in each global region: over the last decade, financials, energy, materials, utilities and real estate have all underperformed in the US, Europe, UK, Japan and Asia Pacific. These industries all seem exposed to ongoing disruption. Markets with a heavy bias to these sectors (the UK has 50% in resources and financials) have good reason to look relatively cheap.

It is now a real challenge to decide whether the 'known unknowns' and the risks of earnings declines are fully discounted and whether there is deep value in those industries where the market is expressing real scepticism. But for value hunters, there continue to be regular examples of sharp share price falls when expectations anchored in past performance start to unravel, as recently with the US industrial giant GE: it has seen a share price collapse of 80% in the last two years. Poor capital allocation decisions, to bulk-up GE Capital and purchase Alstom (making turbines for fossil fuel power stations...), contributed to the problem but there appears to be a deeper seated secular decline too. It slashed the dividend in October and its once triple-A credit rating is now five tiers lower at A2, but trading at Baa prices, one notch above junk.

This 'curate's egg' (good in parts) nature of equity markets isn't helpful for asset allocators using broad indices as a proxy for equities. It is adventurous to assume that all of the fears implanted in the cheapest sectors are overdone, although some may be. However, it is very hard to sort the sheep from the goats. For an active, thematic investor looking to avoid the challenged areas and make sound, long-term investments, one relevant issue is timing. Recent declines have provided a better entry point.

In conclusion, the portfolio is focused on investments in companies with strong underlying themes that can buck the challenging headline economic growth trends. Valuations need very careful consideration and we will continue to avoid the 'traps' where apparent value is reflecting poor longer-term prospects.