STONEHAGE FLEMING

7 October 2023

Dear Equity Client

GLOBAL EQUITIES – 3rd Quarter 2023

Performance

Equity investors experienced a weaker quarter, as often happens during the summer season. The MSCI World Index (including Emerging Markets and dividends) shrank by -3.2% (in US$ terms, +0.6% in UK£ terms). This brings the year-to-date Index performance to +10.1% (in US$ terms, +9.1% in UK£ terms). A +3.2% strengthening of the Dollar over the quarter (against a basket of trading currencies) further dampened Dollar returns.

Macro Backdrop

The US economy has remained resilient, with continued strong employment. US headline inflation edged higher during the quarter from 3.0% to 3.7%, predominantly driven by the higher oil price, itself in turn driven by tightened Middle-East supply. Whilst the Federal Reserve (Fed) held its target rate at their September meeting, they surprised markets with a firm message that they plan another hike this year and emphasised that rates will be kept higher for longer. This became evident with the median FOMC[1] dot-plot rate projections for end 2024 and 2025 both being 0.5% higher compared to their previous meeting.

All this ignited US interest rates, with the 10-year US Treasury yield rising sharply over the quarter from 3.8% to a 16-year record level of 4.6%. This accelerating bear bond market directly affected equity risk appetite and increased stock market volatility. Despite the sharp drop in September, the market succeeded in technically maintaining its constructive course.

Portfolio Comments

The higher interest rate environment makes us focus even more on our individual businesses' valuations. Whilst we project a solid +14% p.a. earnings growth[2] for the portfolio over the next three years, we are scrutinising the immediate outlook carefully. Given their strong balance sheets, our businesses are sheltered from higher interest rates from a cost perspective – in fact, many benefit.

We have implemented a number of material changes within the portfolio. A holding in Linde has been built to its target weight. Linde is the world's largest global industrial gas business following a re-merger of Praxair with Linde AG a few years ago. This consolidation follows a mega-industry swapping of strategic assets a decade ago, which has benefitted end consumers and shareholders alike. Linde is also capitalising on the Biden Bipartisan Infrastructure Law and Inflation Reduction Act by installing subsidised capacity in green energy. In due course, this can further support the portfolio's ESG orientation.

Along with holding Verisk Analytics, we have further increased our exposure to the casualty insurance sector. AJ Gallagher has a strong cash generation business model, in essence earning an annuity broking commission on insurance coverage in the mid-category corporate market. As with Verisk, it does not take any underwriting risk itself. Climate change and cyber security issues ensure continued good organic growth.

We have furthermore introduced MasterCard to the portfolio as both a quality business and as a partial counter against potential volatility in our longstanding Visa holding. Visa retained 20% of its shares held by sponsor banks as security against potential litigation following its IPO in 2008. It is now planning to unlock these shares.

[1] FOMC = Federal Open Market Committee

[2] Calculated using a weighted average of Stonehage Fleming Investment Management Limited's earnings' projections.

Whilst the Artificial Intelligence (AI) excitement has settled down to some extent, we believe that we are well positioned to benefit from it. Accenture has highlighted over 300 early phase client projects they are working on. As AI activity picks up, it can re-accelerate slowing growth in cloud activity, with Alphabet, Microsoft and Amazon (to a lesser extent) benefitting directly. We remain alert to regulatory threats against these technology leaders.

Lastly, but importantly, developments around the potential effects from the new diabetes drugs (Ozempic and Wegovy) can have a 'Richter scale' effect on investor sentiment in some other sectors (especially Health Care and Food & Beverages) and have to be taken seriously. There is risk of a possible overreaction on both the positive and negative sides. Aside from the positive benefits of losing fat, it is unclear what the long-term health effects might be of also continuing to lose muscle. Health care businesses may not see any slowing demand for some time and investor sentiment may have prematurely turned against the sector. As our Health Care exposure is more equipment related, we may well be presented with further buying opportunities in existing holdings. Whilst we tread cautiously in this industry shift, UnitedHealth may well benefit from potentially lower claims.

Furthermore, investors may become averse to any businesses that promote products with high *calorie* or *alcohol* content. These companies will have to introduce new or alternative products. Walmart has access to good information on both the pharmaceutical and food retail sides. John Furner, its US CEO, commented last week that they already see an impact on shopping demand – 'Just less units, slightly less calories in the basket'. As these Staples type of businesses are also often the higher yielding stocks, they face further investor sentiment headwind in a higher interest rate environment. Against this backdrop, we have trimmed our exposure to Staples.

<u>Summary</u>

The Fed actions justified a weak third quarter, having thoroughly dampened risk appetite. With higher interest rates, equity investors rely even more on solid operational and earnings performance. Our portfolio reflects this. We remain focused on these companies, but also continue to look for good opportunities in this uncertain environment.

We are grateful for all your support.

With best wishes.

Gerrit Smit
Partner – Head of Global Equity Management

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