QUARTERLY INVESTMENT LETTER

JUNE 2021

STONEHAGE FLEMING

NOW AND FOR FUTURE GENERATIONS

Executive Summary

Our constructive tilt towards equity and credit markets has generated healthy returns in 2021 so far, and it remains a key aspect of our strategy.

At the halfway point of 2021 the global economy continues to reopen creating both risks and opportunities for investors. The Delta variant has now led to a rapid increase in infections for parts of Europe and is likely to spread further over coming months. Following a 12.3% rise for global equities in 2021 so far, a more volatile period over the summer would not surprise us (see Global Equities chart on page 2).

However there are reasons to be optimistic where the pandemic and the recovery is concerned. Even though the rate of growth may wane once further reopening takes place, there remains considerable capacity for employment gains, consumer spending and manufacturing activity.

The 'relief rally' of the past year is expected to transition into a more typical 'mid-cycle' phase, and continued earnings growth will be needed to propel markets higher. Corporate earnings need to do the heavy lifting in the next 12 months, but there is every likelihood that they will deliver.

ESG[1] factors have emerged as key drivers of corporate performance, as a result of balance sheet implications, structural growth trends and investor engagement. Consumer patterns are changing, and this is creating a wave of opportunities for skilful managers.

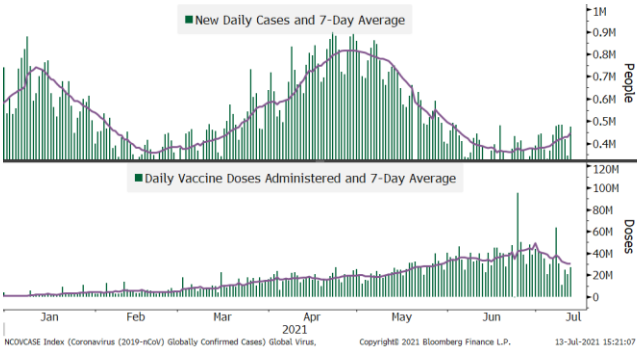
We introduced two non-conventional forms of fixed income to some of our mandates this quarter, China government bonds and Catastrophe bonds. Both exhibit uncorrelated risk and return characteristics that are highly sought after against a backdrop of ultra-low bond yields.

[1] Environmental, Social and Governance.

Introduction

At the halfway point of 2021 the global economy continues to reopen, creating both risks and opportunities for investors. Despite a significant vaccination effort over the past six months the pandemic remains a looming threat, with many densely populated nations without meaningful inoculation. This poses the risk of virus mutations developing where prevalence is high, as we have witnessed in India in the past few months.

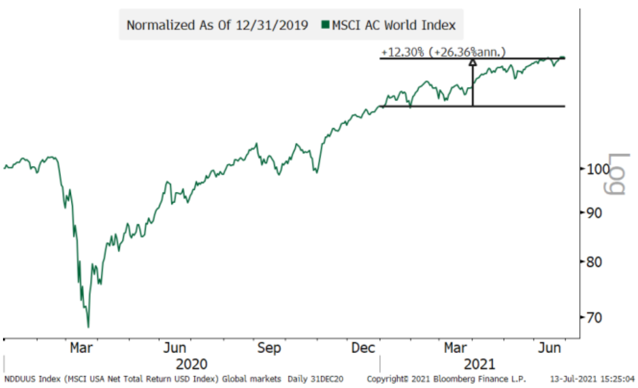
Vaccines vs Virus



Source: Bloomberg, 30 June 2021.

The Delta variant has now led to a rapid increase in infections for parts of Europe and is likely to spread further over coming months. Another 'wave' of infections later in the year has the potential to shake investors' risk appetite. Following a 12.3% rise for global equities in 2021, a more volatile period over the summer would not surprise us (see chart below).

Global Equities

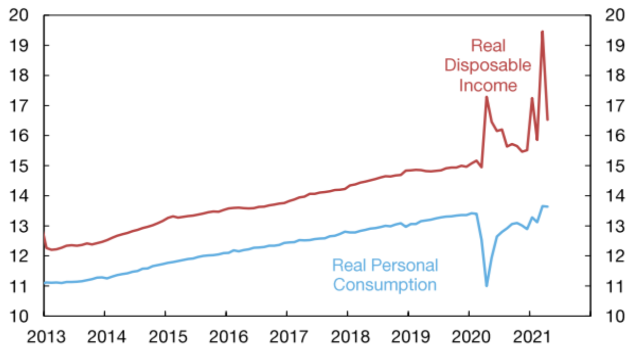


Source: Bloomberg, 30 June 2021. Total returns in USD.
Past performance is not a guide to future returns. If the information is not displayed in your base currency, then the return may increase or decrease due to currency fluctuations.

However there are reasons to be optimistic when considering the coming 12-18 months. Where the pandemic is concerned, the good news is that current vaccinations are significantly reducing the incidence of serious illness, including recent mutations.

For several nations, particularly the UK and the US, this is supporting the lifting of almost all restrictions. Income support throughout the past 15 months has provided consumers with financial ability to take advantage of leisure activities, which are soon to be readily available once again. The below chart shows the strong recovery in US personal consumption, as disposable income has surged higher (a consequence of substantial government outlays).

US Consumer: Income vs Consumption



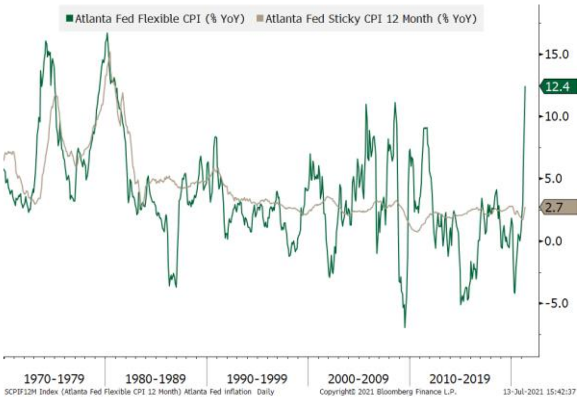
Source: New York Federal Reserve, 30 June 2021.

Inflation – sticky or flexible?

We wrote last quarter about the threat of inflation, and its inevitable rise in the first half of this year. Inflation is a completely backward looking measure, comparing prices last year with prices today. As this annual change compares a near complete shutdown last year with a rapid recovery this year, the recent inflation spike has come as no surprise. Sharply higher commodity prices are the main culprits. As the below chart shows, the most volatile components of US inflation readings, such as petrol and food, (the 'flexible' CPI measure) have jumped sharply. However the 'slower to adjust' components, such as insurance and maintenance costs, (the 'sticky' CPI measure), remain at comfortable levels.

> It is the 1970s scenario, when both measures rise to very high levels that policymakers are closely watching for.

US Inflation

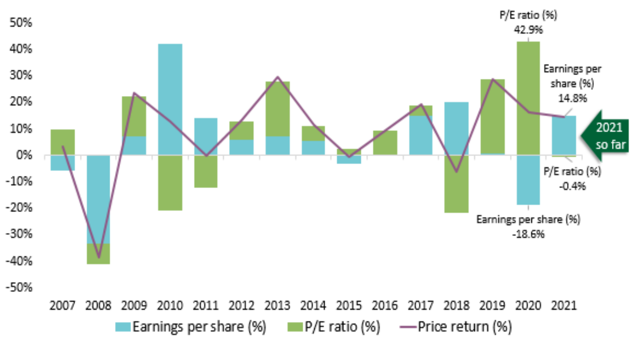


Source: Bloomberg, Atlanta Federal Reserve, 30 June 2021.

From relief rally to mid-cycle

As the 'relief rally' of the past year transitions into a more typical 'mid-cycle' phase, equity returns are likely to be accompanied by higher volatility. Global equities are up 91.5% since the 23rd March 2020 low, however much of this has been delivered by multiple expansion. The valuation of global equities has re-rated from 13.5 times earnings per share at the low to c. 27 times today – a historically elevated level. As shown in the below, which charts the annual change of the S&P 500 along with earnings and valuation components, 2021 has seen a healthy recovery in earnings so far but valuations remain substantially higher than pre-pandemic.

US Equity Returns: Earnings and Valuation % Change



Source: Bloomberg, 30 June 2021. Price returns in USD.
Past performance is not a guide to future returns. If the information is not displayed in your base currency, then the return may increase or decrease due to currency fluctuations.

The implication is that returns will now be harder to come by. Earnings will need to continue to grow to propel markets higher, with valuations unlikely to push higher as economic momentum starts to fade later this year. The good news is that it will be fading from a very high level**.**

> Even though the rate of growth may wane once further reopening takes place, there remains considerable capacity for employment gains, consumer spending and manufacturing activity. Corporate earnings need to do the heavily lifting in the next 12 months, but there is every likelihood that they will deliver.

The further implication of elevated valuations is that, as asset allocators, we need to look further afield for differentiating opportunities.

We identified two rotations of equity capital last quarter, from large cap US to the UK and Asia. With an advanced vaccination campaign supporting a strong consumer recovery, the UK market typifies the recovery theme. In addition, it benefits from lower valuation multiples and a high representation of energy, financials and industrial stocks. After years of being in the doldrums, these areas of the market may be entering a period with the wind at their backs, driven by higher commodity prices, rising bond yields and strong global growth. The Asian opportunity is also long term, linked to compelling growth areas – the digitisation of the economy, a theme accelerated by the pandemic, sustainability, accelerated by net-zero carbon emission targets, and the evolving consumer market in China.

These rotations remain key elements of our equity strategy. In the more recent period, we have sought out differentiating opportunities outside of equity, deploying cash into assets with uncorrelated return properties.

The fixed income space is plagued by low yields and historically tight spreads. In this case, our strategy is to tilt our allocations increasingly towards 'alternative fixed income', where there remains the prospect for real income generation and diversification.

Tilting towards alternative fixed income

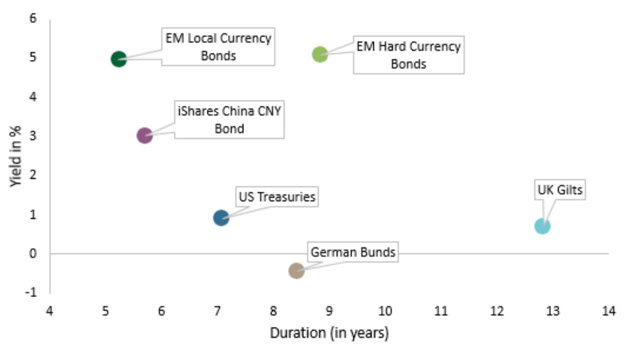
This quarter we introduced two non-conventional forms of fixed income to mandates that historically would have held more meaningful allocations to corporate bonds. Firstly, China government bonds. This is a sub-set of the global bond universe we have been monitoring closely in recent years, and believe it represents a compelling opportunity.

The Chinese onshore bond market is the second largest bond market in the world (behind the US market) and continues to grow at a strong pace. Foreign ownership has been steadily growing, as its proportion of global bond indices also increases. In addition, Chinese policymakers have an interest in opening up their local markets, fostering competition and deepening capital markets.

> For foreign investors, the opportunity is clear. In addition to lower interest rate sensitivity and correlation to global equities, China government bonds offer higher yields compared to traditional counterparts.

The China 10 year yield is currently 2.9%, compared to 1.3% for the US 10 year yield, and below zero in Europe[2]. The below chart offers a broad comparison of the yields available in the fixed income space, along with their respective interest rate sensitivity (duration).

Fixed Income: Yields vs Duration



Source: Bloomberg. As at 13 July 2021.

The second allocation we made last quarter was to Catastrophe Bonds. 'Cat Bonds' are a form of risk transfer from insurance companies to capital market investors. The insurance contracts that underlie these instruments have clearly defined triggers for what they pay out on, often insuring entities against wind risk (hurricane, tornado, etc.), earthquakes, storms and floods. By transferring risk from their balance sheets, insurers can underwrite more business, while giving capital markets investors an opportunity to generate a return. Of particular interest to us is the differentiated nature of this return – it is derived from the risk of natural events, and is unlike the economic risk taken through equity allocations.

> Our analysis of Catastrophe Bonds has been rigorous, and we believe it has become attractive on both a valuation and a diversification perspective.

Of course, this investment is not without risk. Indeed, a particularly damaging natural catastrophe could lead to meaningful losses, as the market re-prices with wider spreads. However, given that its underlying risks are not correlated to those faced in financial markets, and the c. 4% yield available, we believe that the compensation for exposure to these risks is adequate.

ESG permeates the post-pandemic landscape

The next phase of the market cycle will require continued earnings growth, and ESG factors have emerged as important drivers for corporate performance. We highlight three main reasons.

Firstly, environmental standards are now a balance sheet issue, not just a public relations exercise. The European Union is leading the way in creating a blueprint for how the decarbonisation transition could work. It has begun to issue penalties and taxes to bad actors, for example, based on carbon emissions and non-recyclable packaging. Plans for EU-wide carbon taxes have rapidly become credible. Regardless of investor preferences, financial analysts must become savvy to which financial models will be under more ESG pressure.

Secondly, ESG initiatives are now globally coordinated, such as net zero emission targets. This is creating structural opportunities for companies whose business aligns with such objectives. A number of our managers are finding ideas in clean energy

[2] Source Bloomberg. As at 13 July 2021.

production, energy storage, the solar supply chain, sustainable packaging, insulation, sustainable farming technologies, waste management, electric transport, and many more.

> Consumer patterns are changing, and this is creating a wave of investment opportunities for skilful managers.

Finally, the power of engagement, which is an integral part of our due diligence process. All of our active managers are signatories (or due shortly to become signatories) of the UN Principles for Responsible Investment. A key tenet of this is engaging with companies in order to reduce negative externalities and improve stakeholder outcomes regardless of whether a strategy is explicitly ESG. Whilst we believe in responsible investing, academic evidence proves that engagement embedded into the investment case can improve returns or is, at worst, neutral. The majority of engagement focuses on governance, which in turn creates an enhanced platform to improve environmental and social outcomes. Markets are responding to signals across the environmental, social and governance spectrum as companies improving their rankings are rewarded.

Summary

Our constructive tilt towards equity and credit markets has generated healthy returns in 2021 so far, and it remains a key aspect of our strategy. With economic growth expected to be impressive and policy still accommodative, we expect further gains yet in 2021. However, the dynamics of the market are evolving, from initial relief rally to mid-cycle grind. The next phase will require earnings to do the hard work, and this raises the likelihood of shorter term disappointment or volatility. Indeed, the backdrop remains an unpredictable pandemic, with vaccine-resistant mutations a looming concern.

Our focus in the most recent period has been on deploying cash in specialist asset classes which offer differentiating return profiles. In an era of unsavoury bond yields, sub-sets of the fixed income market such as catastrophe bonds and China government bonds are important additions to our overall portfolio. Like all underlying allocations they are under close inspection for market or manager related developments that change our thesis.

SFIM Investment Committee
July 2021

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