# GLOBAL EQUITY INVESTMENT OUTLOOK

SARASIN & PARTNERS

- **AFTER V COMES W?**
- **A CASCADE OF DOMINOES**
- **A PREMIUM PRICE FOR REASONABLE GROWTH**

This report considers the outlook for investing in global equities at a time of severe human, social and economic stress. Whilst the market rebound in Q2 and the progress of the virus are of note, the two main issues we consider are first, the variety of new trends now evolving and secondly, the thematic strategy employed in the portfolio.

From the low on 23rd March, stock markets had a blistering rally in Q2, taking the world equity index in sterling terms back to where it started the year. The portfolio performed roughly in line, which was a solid result given the variance and style swings in the market. Such exuberance in prices may create a sense that the problem of the pandemic is past and the global economy is also recovering rapidly to pre-pandemic levels; but sadly the economy is struggling and the major cause of asset price rises is the trillions of dollars of monetary and fiscal spending by governments and central banks. Ironically, the scale of the intervention highlights how bad the authorities see the medium-term demand destruction and economic risks. Evidence of a true return to normality and a sustained upturn in inflation would likely see a withdrawal of financial support and cause yields to rise and asset prices to fall back.

Should the economic news start to deteriorate, for instance unemployment staying more elevated than expected or deflation risks becoming evident, central banks will take more extreme policy action. Either way, the risk of a policy mistake is high and uncertainty over the ongoing impact of the virus and when to end furloughing and other support payments complicate the picture. Whether it is a first or second wave, a V or a W, the World Health Organization (WHO) is still reporting an acceleration in the spread of the virus in Africa, Asia and North and South America, as well as flare-ups in countries that successfully lowered infection rates but have since relaxed restrictions. Support payments are likely to be extended but there is ultimately a limit to government largesse and "whatever it takes" money printing, even at zero interest rates.

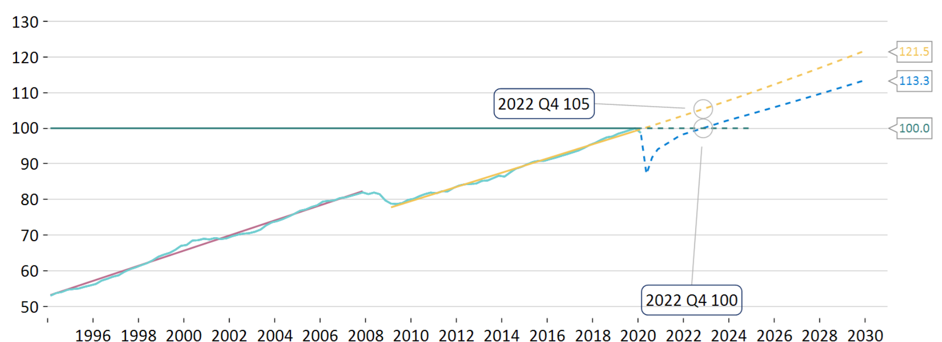
We don't expect the US economy to recover fully to pre-lockdown levels of activity until at least the end of 2022, and later in most other economies. The real issue for investors is the economic 'scarring' that will affect the medium to long-term growth rate (a lower growth trajectory, shown on figure 1) and the extent of the exceptionally strong policy stimulus needed.

These are linked as the lasting impact of the virus and the recession fall hardest on the weakest in society – the poorest countries, the lowest paid, many minority groups, the elderly and the small and medium sized businesses that typically provide the majority of employment in most countries. Monetary and fiscal policies are likely to continue to be directed at supporting recovery where incomes are worst hit, ignoring for the time being the unavoidable 'moral hazard' that such a vast financial inducement has on the equity and bond prices of the large stock market listed companies relatively unaffected by the crisis.

For the majority of large listed companies, underlying trading has been disrupted by the lockdown, although as we discuss below, some have benefited from an acceleration in their growth trends. Dividends have been cut across many sectors, with financials and energy

**FIGURE 1** US REAL GDP GROWTH - GAP DOWN AND TREND SET TO SLOW

*Source: Macrobond, June 2020*

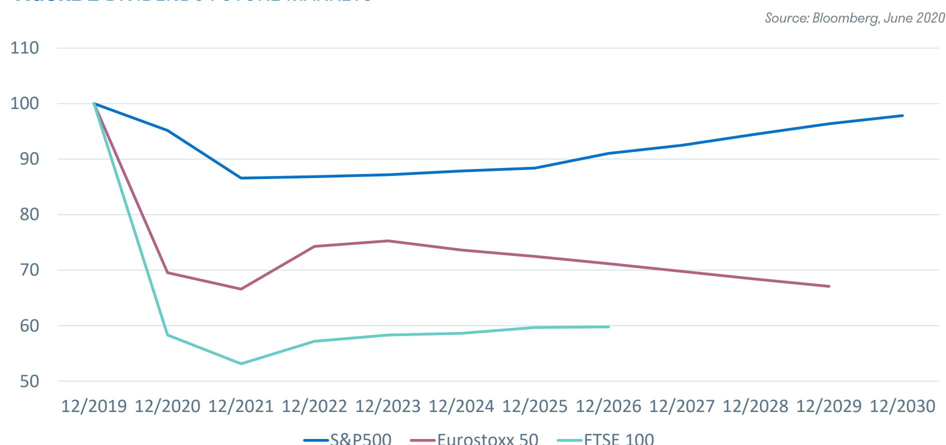


worst hit, and the market expects many not to recover, as figure 2 shows.

The sector mix in each index has made a significant difference: prior to the crisis half the UK FTSE 100 index weight comprised financials and resources, resulting in the worst dividend cut of the three indices shown.

So while parts of the stock market have executed a V, the virus is following a W and the economy and corporate profits more of a half-hearted 'tick'. This suggests continued strong policy action, supporting asset prices, albeit with a risk if virus and economic news flow are surprisingly better or much worse.

**FIGURE 2** DIVIDENDS FUTURE MARKETS




## TIPPING POINTS

The inevitable focus of attention on the pandemic and the recovery distract from the wider thematic picture: the second quarter of 2020 may also be remembered for a cascade of dominoes as multiple long-standing precedents passed a tipping point – technological, behavioural, climate change, environmental, demographic, economic, political, fiscal policy and competition norms and assumptions have been disrupted, triggering or accelerating long-term change.

We're all Zoomers now... but rapid implementation of new technology during the lockdown has not just been a consumer trend: businesses are developing entirely new IT plans and are accelerating spend on multiple aspects of their digital infrastructure. Previous caution about cloud, AI and data security has been cast aside and capex is shifting even faster from physical real estate to digital.

For some industries the implications are profound – for example, as consumers opt for home delivery of groceries, UK supermarkets have seen the digital channel jump from a market share of 7% to 13% in three months, limited only by hitting maximum capacity on delivery slots. Similar patterns are reported around the world. As delivery capacity and the digital market share expands, the writing is on the wall for capital intensive, operationally geared, low margin physical supermarket stores. And the balance of power will shift rapidly for suppliers as well: for the food retailers the software on their app or platform grants them greater power to control the customer experience and the large branded food producers will find they have to pay more to the retailers to retain sales.

For consumers the behavioural shifts extend beyond shopping and working from home (35% of the US workforce is working from home compared with 8.2% pre-crisis according to the Dallas Fed). Less public transport and more bicycle journeys are likely a permanent shift (the portfolio holds shares in Shimano). Significant tracts of real estate will need to be completely re-engineered, not just in retail but in offices. The loss of rents and drop in property values is beginning to ricochet into banking systems, albeit softened for the time being by government support packages and central bank intervention in credit markets.

Slower moving, but a much larger crisis requiring even greater individual and government action, climate change is forcing its way back to the top of the headlines: globally, so far 2020 is again the hottest year on record and Siberia has seen average temperatures 10oC above normal and three million acres of forest fires are now out of control. Most alarming is the melting of permafrost over swamps, releasing trapped CO2 and methane from below the ice into the atmosphere and creating a climate change feedback loop that scientists have long feared. The next intergovernmental COP meeting on Climate Change has been postponed until November 2021, but much more significant action on decarbonisation will have to be agreed, including carbon taxes and accelerated shifts to renewable energy and energy efficiency.

In the past, stock markets have been rightly sceptical on meaningful government policy action on climate and the environment. But public support for action continues to grow: in a global survey in April, Ipsos MORI found that 70% of the public feel that climate change is as serious as Covid 19 and that their government will be failing them if it doesn't act on climate change now. With a desperate need to bolster government finances, 'Green New Deals' seem like one of the least unpopular ways of raising taxes. Through the lens of our Climate Change theme and work on 'Extended Producer Responsibility', we continue to see opportunities (and threats) as the pace of energy transition and the repricing of other uncosted negative environmental externalities remain underestimated in financial markets.

Looking more specifically at US fiscal policy, a risk to aspects of the recent equity rally might well be fuelled by rising fears of at least a partial reversal of the 2017 Trump tax cuts: corporations and richer individuals will have to carry a higher share of the tax burden and again, this does not yet appear to be fully priced-in.



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If there was ever any confusion about priorities before the pandemic, it is now very clear that we rely on social bonds more than anything else – our families, friends and health are what matter. This realisation is helping reset moral compasses and the outpouring of sympathy for the Black Lives Matter movement has rightly forced fundamental action against discrimination and sharpens political focus on addressing under-regulated 'harms'. Our detailed ESG analysis highlights too many ways in which companies cause social or environmental harm in the generation of their profits. Toleration of exploitation in any form is passing a tipping point.

Space limits discussion of dozens more tipping points but the bottom line is that the level of disruption to many historic business models and profit streams is accelerating.

## PORTFOLIO STRATEGY FOR H2 2020

We expect more large short-term fluctuations in sector performances in the second half of 2020 as investors try to seek out value among recovering companies. Talk of a successful vaccine or a V-shaped recovery will trigger a pivot into cyclical stocks such as financials, autos, energy and basic materials. The experience when China saw Covid cases all but disappear was a sharp rally in banks, outperforming technology by as much as 35% in four weeks, but the rotation subsequently faded and completely unwound. There may well be valuation anomalies to pick up but the 'new normal' slower trend economic growth and heightened disruption outlined above will leave the medium to long-term potential in many of these stocks constrained at best. Our focus is not on short-term 'bottom-fishing' but on finding positive, long-term, compounding returns.

Digitalisation, which is one of our five core themes, has likely accelerated significantly as a result of Covid-19. Increased processing power, software design and the advent of 'Cloud' systems in recent years allow companies to 'dematerialise', massively expanding potential capabilities while often reducing costs.

An evolving component of digitalisation is artificial intelligence (AI) that allows machines to sense, comprehend, act and learn. The way work is done will change as human intelligence and machine intelligence are better integrated, reinforcing and enhancing the role of people in driving business growth. Analytics Insight reports that the AI Market world-wide will grow from $43 billion in 2019 to $153 billion in 2023. One of the ways that the fund invests in AI is through its holding in Accenture, a global leader in providing strategy and consulting advice to companies on how to deploy AI. After outperformance, we realised some of the profit on Accenture during the quarter.

As almost every organisation becomes increasingly digitalised, their IT teams have to manage huge amounts of data, devices and complexity. There is a need to maintain security, solve problems and spot opportunities by using the data effectively, and increasingly this needs specialist help. Step forward Splunk, a specialist software company that supports companies in searching, monitoring, and analysing machine-generated big data to

provide intelligence for their business operations. The portfolio also holds shares in Mastercard for the inexorable growth in internet payments - and those transactions are handled in data centres operated by Equinix. Of course, in every electronic device are processors and memory chips, many manufactured by TSMC using advanced lithography machines made by ASML.

Life for the largest US 'ultra-cap' technology firms like Apple, Alphabet, Amazon, Facebook and Microsoft may become more challenging in the coming months with the advent of new regulation and taxation systems. This

could cause a pause in their share price rises, but will not stop the deployment of capital and subsequent growth for these businesses. The EU Competition Commissioner, Margarete Vestager, seems unlikely to be successful in convincing the Trump administration to combat anti-competitive behaviour in Digital markets. We expect a steady drip of fines and targeted behavioural remedies such as "stop undercutting third party sellers on the Amazon Marketplace" or "share customer data with marketplace/platform users where that use has been consented". Structural separation is eminently possible but unlikely; dismembering Google (Alphabet) would either be a brilliant act of precision corporate surgery or an appalling example of the patient dying on the operating table. So, after some disruption, we expect the majors to live-on.

As mentioned above, climate change risk to stock market listed investments is rising rapidly. Making sufficient cuts in emissions each year will require further radical change – in particular the closure of many more coal, oil and gas-fired power stations and replacement with wind or solar arrays. The global leader in constructing and operating offshore wind farms is the Danish company Orsted and, as efficiency of turbines rises and prices fall, year by year they exceed estimates of the scale of the build out of new capacity. The wind turbines are getting much larger - the latest 12MW offshore turbines stand 260 metres tall and each can generate 67 gigawatt hours of electricity a year, or enough energy to run 16,000 average European households.

As well as cleaner energy, we need to be much more efficient and flexible in our energy use. Governments are seeking to 'build back better' in their economic recovery programmes. For example, the European Commission has set aside 25% of its €750mn recovery package for climate investment, with a focus on renovation of buildings and infrastructure, rolling out renewable energy projects, smarter power and cleaner transport and logistics. 'Smarter power' means controlling demand and supply by digitalising and automating the management of electricity and Schneider Electric is a leading supplier of the equipment to do this.

Covid has directed much attention to vaccines and associated medical treatments. But the consistent and largest scale trend in health vulnerability and healthcare spending is ageing. Lifespans have doubled over the last 100 years, to an average of 72 years-of-age globally. An acknowledged goal for the future is to improve not so much longevity but the quality of life, particularly in later years when health can be poor. As the baby boomers retire, the number of over 65-year olds globally is set to more than double by 2050, from 730 million today to 1,550 million, and with this ageing population will be a rising need to provide better treatments.

The treatment options are being revolutionised by tools like gene science to unravel the complexities of disease and understand better the fundamentals of human biology. Diseases for which there have been limited treatment options are seeing new medicines developed by Amgen, including cancer which is also a major area of research for Merck, along with diabetes, and Shionogi. Shionogi also works on new antibiotics, a crucial area for the future as misuse of antibiotics has led to antimicrobial resistance, meaning that our primary treatment of many bacterial infections may become useless. CSL is a world leader in influenza vaccines and also immunoglobulins used in the treatment of immunological disorders and wound healing, for example for recovery from surgery. The number of surgical operations continues to rise every year as an ageing population needs more hip replacements, heart surgery etc but also as treatment becomes more affordable across emerging markets. Medtronic develops and manufactures pacemakers and other devices and therapies to treat chronic diseases.

## CONCLUSION

What the Bank for International Settlements in its latest annual report, calls a "global sudden stop" will not see an equivalent "sudden re-start". The economic scarring in the form of unemployment, consumer caution and demand loss will be long-lasting and the accelerating forces of disruption will have profound impacts on historic patterns of corporate profits. Many dividends have been cut and share buybacks reduced; balance sheets are damaged, requiring gradual repair.

However, change is a two-sided coin and many of the long-term opportunities across our five core themes have become relatively even more attractive: Digitalisation and Automation trends are accelerating; governments have the opportunity to tax environmental 'negative externalities' and hasten action on climate change; many consumption patterns are evolving more rapidly while ageing continues on its inexorable path. The portfolio is diversified across a wide variety of investments with clear opportunities for growth.



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