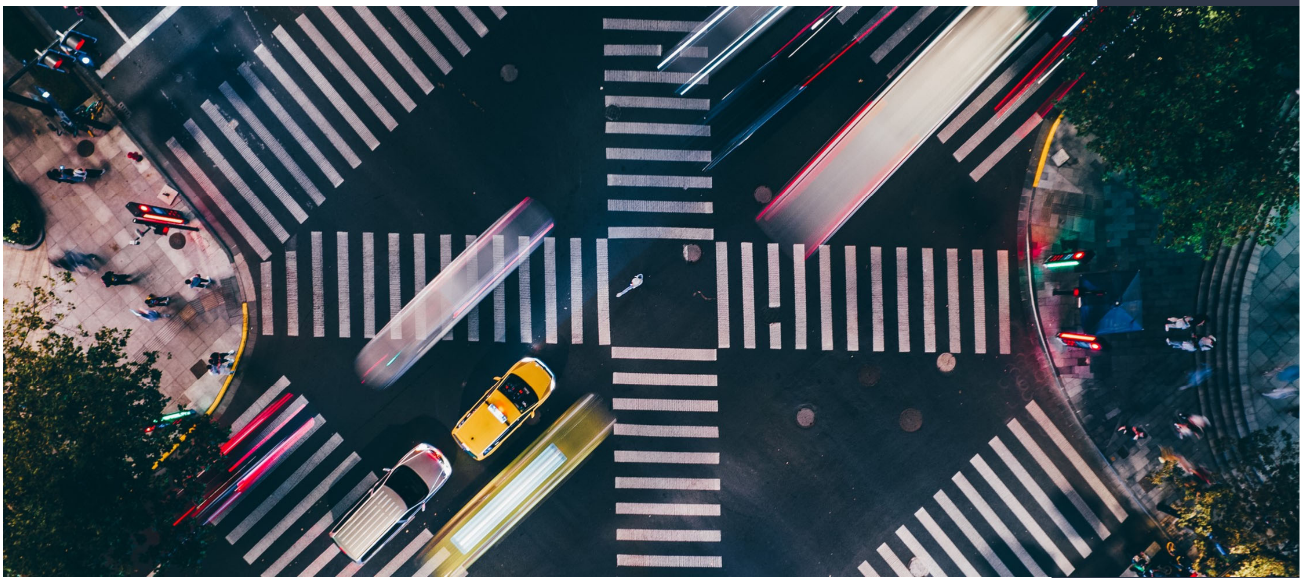
OUT OF THE ORDINARY

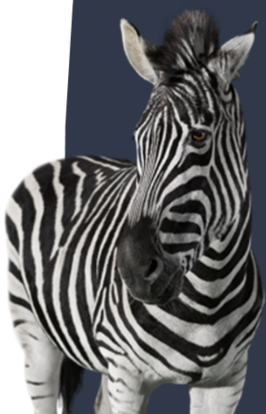
WEEKLY DIGEST | 28 November 2022

More Bumps In The Road



John Wyn-Evans
Head of Investment Strategy

The headlines at the beginning of this week have centered on China. There might have been some disquiet about the fact that Covid cases have reached a new record high in the country, but the more impactful news related to protests against President Xi and the Communist Party that broke out in a number of big cities including Beijing, Shanghai and Wuhan. The catalyst was initially the fire in an apartment building in Urumqi where the deaths of residents were



blamed, at least in part, on Covid restrictions which both stopped people leaving the building and the fire services from tackling it. Negative sentiment in the country has been exacerbated by broadcast pictures from the World Cup showing massed crowds enjoying the football without masks or other restrictions.

Nobody can be quite sure where this leads, although some commentators have suggested that it could mark the beginning of the end for Xi and the Party. But is that wishful thinking? Xi cemented his power at the recent National Party Congress and seems to be unopposed in his desire to continue to reverse the trend of previous decades when the country seemed to be becoming more "open". Anyone drawing parallels between this situation and the demise of the Soviet Union would do well to remember that the Soviet leader of the time, Mikhail Gorbachev, was instrumental in dismantling the iron curtain, or at least not standing in the way of change. It's hard to see Xi taking such a course, especially in a culture where changing one's view often represents an irredeemable "loss of face".

The growing lack of trust between China and the rest of the world was illustrated in three news stories over the weekend. In the UK, Whitehall departments are banning Chinese-made surveillance equipment on sensitive sites owing to perceived security risks. Meanwhile, in China, Tesla vehicles are reportedly being banned from military areas, and military staff and employees of certain state-owned companies are not allowed to use Teslas either. Several Chinese telecoms equipment companies have been banned by the FCC (regulator) from selling their wares in the US.

What does this mean for investment markets?

None of this bodes well in the short term for Chinese assets, nor for sectors and commodities that might be associated with a fuller reopening of China's economy. Many China-sensitive companies and commodities bounced strongly recently as the government announced first a 16-point plan to alleviate pressure in the real estate industry, and then a 20-point plan to exit its zero Covid policy.

Supply chain risks will also come back to the fore for Western companies sourcing either components or finished goods from China, with Apple, perhaps, being the one with the highest profile. A report on Bloomberg suggested a production shortfall of six million iPhone 14 Pro and Pro Max handsets, the company's most in-demand, premium offering. The company recently reduced its production forecast for this year from 90m to 87m units, and so there might yet be further downside.

Even so, we also must be mindful that any share price overreaction to short-term (and one would hope) one-off profit shortfalls can offer an attractive entry point to companies that are long-term compounders of value.

Having said all of that, it seems inconceivable that China will remain locked down in perpetuity. It's not as if they don't know what they need to do in terms of vaccinating the population. The biggest risks remain with the older cohorts, with a third of over-60s (amounting to around 90 million people) still not having received the crucial third dose. But national pride over having to use a foreign-made mRNA vaccine seems to be getting in the way of pragmatism. Optimistically, a wider-reaching vaccination programme could begin to be rolled out within weeks, even though it would not be early enough to prevent restrictions during the winter. But at least then investors could anticipate more normal activities resuming by the spring/summer of 2023.

What other issues are front of mind for investors?

Uncertainties in China add to our list of market influences that are expected to keep us on a bumpy path for the next few months. While the UK is most probably already in a recession, and Europe is odds-on to follow it, the biggest questions still hang over the United States, and it is the direction of that economy that will end up defining the wider investment outlook through 2023.

At the latest meeting of our Global Investment Strategy Group, the majority (and almost unanimous) opinion was that the US will enter recession within the next 12 months. That being the case, we still expect company earnings to come under pressure as we enter the New Year – the long-awaited "next shoe to drop". And although the US market has already suffered a big de-rating this year, we continue to believe that this is largely a function of rising interest rates. Our long-term dividend discount model for US equities suggests no change in the underlying valuation since the beginning of the year. We still believe that we will be offered more timely opportunities to increase equity risk in portfolios.

Do interest rates affect company valuations?

Readers may have seen a recent article in the press suggesting that rising interest rates should have no bearing on company valuations. The writer asserted that a rising discount rate (which mathematically reduces the net present value of future cash flows) is offset by the higher revenues implied by rising bond yields and the need to raise rates. I would beg to differ, at least in the current environment.

Investors had already priced in a booming revenue environment before the Federal Reserve even contemplated raising rates. If anything, we are now seeing a combination of the discount rate effect and a reassessment of growth prospects to lower levels. And while revenues might benefit from the inflationary effects on prices (and that's before we consider the risk to volumes), the other side of the equation has not been taken into account – namely the influence of rising costs on margins.

I spotted a research note on a UK-listed company in the Leisure sector where flat year-on-year revenues in 2023 (price rises offset weaker volumes), translated into a 16% reduction in EBITDA (earnings before interest, tax, depreciation and amortization – a measure of underlying cash flow generation) and an extraordinary 71% downgrade to earnings per share. Higher wages, interest costs and product input costs all come to bear at the earnings line, as does the UK-specific factor of higher Corporation Tax rates next year. While this is not an egregiously leveraged entity (forecast net debt/EBITDA of 2.5x), it does give an illustration of the negative effects of operating and financial leverage, and it gets worse the more leveraged you are. Thus, our desire to stick with companies with robust margins and stronger balance sheets.

While I accept the point that equities can prosper when rates are rising (as they did in the 1950s and 1960s), it all depends on the current context. We are now in a much more inflationary time and rates are the weapon being used to combat inflation. The risk to margins and earnings remains too high.

Nevertheless, there is some positivity on the horizon. Some adjustment to valuations and expectations has already been made and sentiment and positioning remain weak. The ultimate effect of a successful central bank campaign to take the froth out of prices will be to set up the base for a new bull market. We expect that base to be formed some time next year. If we are wrong, and we have already seen the lows, then at least our “cautious, not fearful” approach means that we will not be entirely left behind.

Economic Commentary

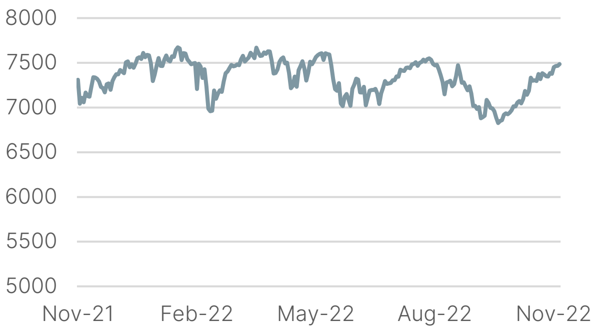
FTSE 100 weekly winners

Rolls-Royce Holdings plc	6.3%
Abrdn plc	5.8%
Glencore plc	5.5%
ITV PLC	5.2%
Entain PLC	5.0%
Whitbread PLC	4.8%
BAE Systems plc	4.8%

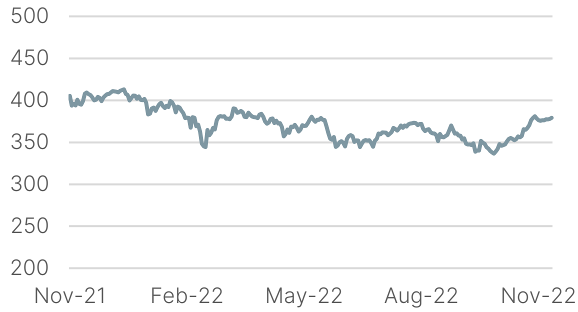
FTSE 100 weekly losers

Vodafone Group Plc	-4.5%
Ocado Group PLC	-4.2%
International Distributions Services plc	-3.8%
Prudential plc	-3.6%
Scottish Mortgage Investment Trust Plc	-2.8%
M&G Plc	-1.8%
Just Eat Takeaway.com N.V.	-1.3%

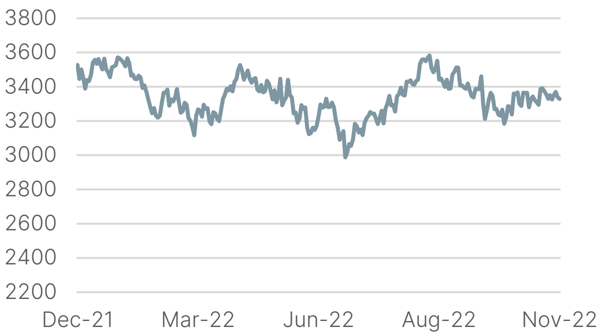
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



All data shown in GBP.

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