Global Equities Update

November 2020

This report has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Ethical Global Equiti es Fund.

Market Review

As the US election outcome in favour of Biden but with a Republican senate became clearer and several vaccine breakthroughs were announced, equity markets started to rally and MSCI World ended the month +12.8%.

Whilst all sectors were up in November, the most cyclical sectors led, with Energy +28.2%, Financials +19.2% and Industrials +15.7%. This was at the expense of Utilities +5.0%, Consumer Staples +78% and Healthcare +8.9%. Europe and the UK outperformed the US, boosted by some slowing COVID infection rates in the former and hopes a "no-deal" Brexit might be avoided for the latter. Partly an outcome of these moves and partly a distinct rotation shift was the outperformance of Value/Cyclical over Growth.

Outside of equities the main move was in Bitcoin which ended the month +42%. This was despite a ~12% daily fall towards the end of the month and a gold price that was actually down ~5.5% for the month. The US dollar was also weak, meaning our benchmark MSCI World in AUD was only +7.6%.

Perhaps, a good overview of the market's risk sentiment through the month is the movement in the CBOE VIX measure of volatility. This was down significantly, having started November at ~38 and fallen to a post COVID (Feb 2020) low of 20.5 by the end of the month.

The market rotation we saw in the month, primarily driven by short term sentiment around a successful Covid-19 vaccine, has been swift and brutal. November was textbook example of a market scenario where in our view quality stocks underperformed a rapidly rising market characterised by a rotation towards cyclical and lower quality stocks, which have been material laggards.

We saw the tailwind from not owning the FAANG-related stocks. The top 5 market cap stocks (Apple, Microsoft, Amazon, Alphabet and Facebook) all struggled to keep up with the market, which is not unexpected given their previous run and elevated valuation levels.

Whilst Energy and Banks had their day in the sun in November, we struggle to find companies in these sectors that deliver the quality mix of criteria we look for, i.e. durable industry positions, good secular growth, sustainably high returns on invested capital, strong balance sheets and top quartile ESG characteristics.

We remain of the view that the long-term investment case for the stocks we own has been unchanged through the Covid-19 crisis and impending recovery. Some have seen short term positive boosts from lockdowns (e.g. Electronic Arts, PayPal, Dollar General and Home Depot) but we see most of these tailwinds as sustainable going forward and valuations attractive as this durable uplift is underestimated by the market.

2021 Outlook

We are reasonably optimistic, as we do see a gradual economic recovery, continued ultra-low interest rates with at least the potential for further fiscal stimulus. With improving fundamentals and plenty of liquidity it is hard to see a large amount of multiple contraction next year, but after the remarkable level of multiple expansion in 2020 (driving returns this year as EPS expectations went backwards) it is unlikely to see more expansion. Thus, EPS growth needs to do the heavy lifting and the outlook for earnings growth looks good in 2021.

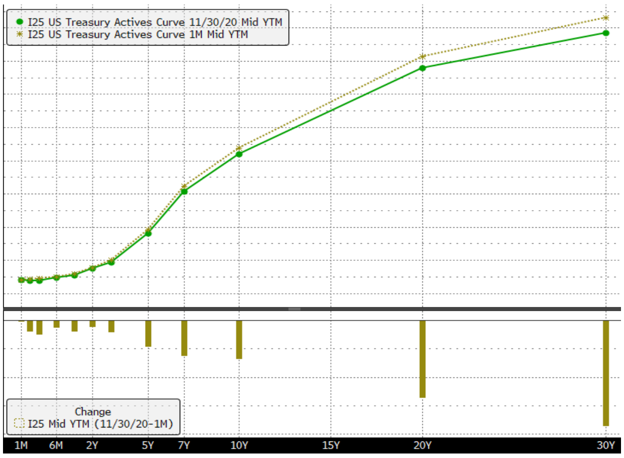
The biggest question that we ask ourselves is: how long will this rotation last and how material will it be from here onwards?

While we don't profess to have the exact answer, we do note the following key risk factors:

Stock Markets are above pre Covid-19 levels but the vaccine roll out and earnings recovery is still uncertain: While the recent vaccine news is optimistic from an efficacy point of view, it does not alter the timelines and complexities of rolling out the vaccine and subsequent reopening of economies. Despite this, the market has priced in a fairly V-shaped recovery since May/June already, especially in the US, with many stocks back to pre Covid-19 levels despite structural damage caused and a number of questions remaining (think about logistics, willingness to get vaccinated and the duration of virus immunity). Our central case remains that we will see a gradual, time-consuming roll-out and a subsequent partial 'back to normal' scenario for next year. In all likelihood this would translate into EPS numbers not getting back to 2019 levels from at least 2022. Given the obvious fact that companies will be comping tougher numbers from 2H21 onwards, it remains to be seen whether inflated valuation levels are warranted and whether we will see a 'pause' in the recovery trade.

The Bond market reflects a different outlook: What we do know is that this is not a normal economic cycle and as such the equity and bond markets have reacted very differently to it. Where the equity market is backing a full-blown V-shaped recovery and has priced that in, the bond markets haven't moved recently (as shown in the lack of change in the US Yield Curve last month), whereas in any normal cyclical up-market there would have been a steepening of the curve.

2021 Outlook (contd.)



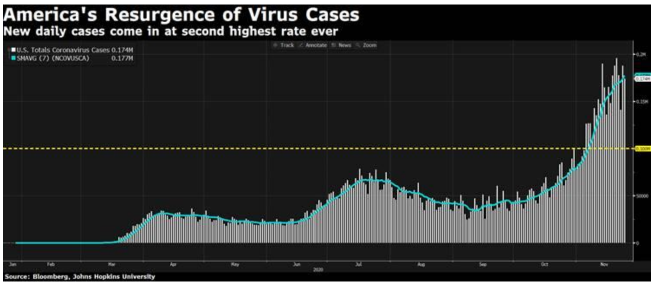
Monetary policy at extreme lows and risks to fiscal stimulus: The other two friends of the equity markets, monetary and fiscal stimulus, will likely continue to dominate headlines and equity sentiment. Monetary stimulus is a near certainty, as the Fed and ECB have admitted that they need to continue to do so for at least the next 3 years, but we do wonder how effective it will be with interest rates at near zero levels. We are also suspect of a short-term steepening of the yield curve (around the developed world) as central banks will do everything in their power to avoid this. This will continue to support (inflated) valuation levels but will likely have little impact on Main Street.

What will be crucial to keep markets happy is another material round of fiscal stimulus in the US and Europe. In Europe we see little hurdles, given the continued dire economic situation and the political willingness to go ‘all in’. The US is a very different story however. With newly appointed Janet Yellen as Treasury Secretary, there won’t be a lack of Democratic willingness, as she is fully aware of the necessity of further stimulus. The relationship with the Republican party however has been so poisoned over the last decades that it is hard to see a constructive debate possible and as we know the gap between the proposed numbers is in the trillions of dollars.

It will be crucial to watch the outcome of the Georgia senate election (January 5th 2021), as this will determine either a 50-50 split (with VP Harris as final veto) or a 52-48 majority for the Republican party which gives them the power to block any material legislation (and Congress has the final say over most non-budget neutral proposals).

FX uncertainty: A consequence of continued US monetary stimulus could potentially be more pressure on the USD, which seems to be the consensus view. While we see this as a likely outcome, we would caution to jump to performance headwind conclusions for AUD-based investors. First of all, it seems unlikely that the US will be alone in the monetary race to the bottom and we might end up with the default ‘flight to safety’ trade that actually favours the USD. Second, given the global nature of the US domiciled companies in our portfolio we will see a lot of benefits on operational profit level from a weaker dollar which translates into higher EPS and cashflows.

Rising cases and near term Covid-19 headwinds: Whilst not our base case, in the very near term, rapidly rising Covid-19 cases in US and Europe along with a second round of lockdowns/movement restrictions does raise the possibility of a double dip recession in early 2021.



The Warakirri Global Equities Fund is long only, low turnover, concentrated and benchmark unaware. As such it will typically hold up to 40 stocks. These stocks will come from a concentrated Approved List based on Northcape’s research of around 60-75 selected stocks from global developed markets which comprise of resilient companies with enduring quality characteristics that are typically within attractive industries.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au