Global Equities Update

March 2021

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

Market Review

March was a very strong market environment for global equities. The MSCI World index finished the month up 5%, recovering from the volatility we saw in February. Market sentiment continued to be driven by a further steepening of the US yield curve with the strengthening economy and various supply chain shortages (see below) driving up input prices and as a result inflation expectations.

Despite this, the Fed during the month confirmed their original stance which is to ignore any short-term spike in inflation and look at longer trends before raising rates. It is also happy to stay on the sidelines for now before interfering with the long end of the curve, for example by new policy instruments like Yield Curve Control or other unconventional monetary measures.

The other significant driver during the month was the break-down of various supply chains, which culminated in the almost farcical accident in the Suez Canal where one container ship paralyzed the global economy for weeks. One of the most obvious examples of this pressure is in the semiconductor value chain, where supply shortages have caused delays in end markets like Automotive and Handsets due to lack of components. A lack of investments in previous years, lean inventory channels and a strong comeback in some markets, especially Automotive which came to a standstill in 1H of 2020, are the main drivers. The long lead times of semiconductor equipment and the time to get new semiconductor fabs online are major hurdles for a short-term solution of these shortages.

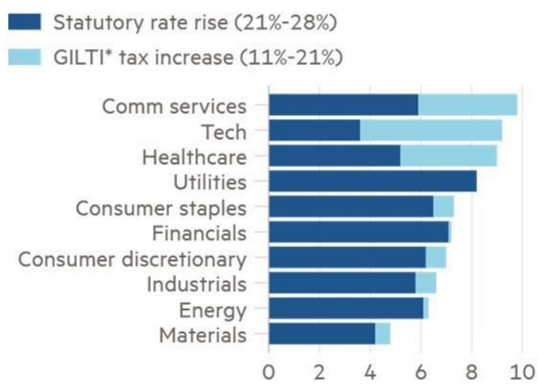
The market outlook in general remains optimistic, due to combination of lower Covid infection rates, accelerated vaccination rates (outside of Australia) and strong GDP and earnings growth expectations based on weak 2020 comps. This has been reflected in strong earning upgrades in the last 2 quarters. Especially in the US, we have seen a shift in the primary market driver away from multiple expansion (the big driver in 2019 and early 2020) towards EPS upgrades. The chart below breaks the S&P 500 performance since mid-2020 into these two variables: EPS expectations for the next twelve months (NTM EPS) and the multiple that the market is willing to pay for these expectations (NTM P/E). As a result, the forward-looking P/E multiple in the US remains high at 22x, but it has not expanded since June 2020 despite the strong rise in the market. We have seen similar movements in the other regions as well, albeit that multiples are significantly lower and earnings upgrades have been less pronounced than in the US.

Source: Credit Suisse

A big driver of this EPS momentum in the US is the very material fiscal stimulus packages that have been announced. On top of the early Covid-stimulus package in 2020, President Biden has rushed through another round of US$1.9 trillion consumer stimulus plus an upcoming round of up to US$4 trillion of infrastructure spending (if approved). This additional liquidity has driven US GDP expectations for 2021 upwards to around 6.5% and is making its way through earnings expectations in a range of industries that are positively exposed to this stimulus.

The market has however kicked one can further down the road: the question of funding. While the current climate in the US seems accepting of growing deficits and higher Debt/GDP ratios, the sheer amount of this stimulus needs a response. It is therefore not surprising to see a range of tax hikes being announced, from corporate to individual, to bring in at least some revenue to pay for it. One of the results is a proposed move upward again in the US corporate tax rate (from 21% to 28%) and proposed higher rates on globally sourced earnings (the so-called GILTI tax), which will have a material impact on future earnings.

The chart below shows the impact on various sectors.



Source: Credit Suisse

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During March we saw the partial undoing of some of the market rotation we had seen so far this year. The earlier rotation saw a significant outperformance of typically lower quality sectors, like Banks and Oil, driven by a gradual reopening of the global economy. The speed and severity of this rotation in Jan/Feb was an outlier from a historic cyclicality perspective and hence it was not that surprising that we saw a counter reaction to it in the last two weeks of March.

The portfolio remains well positioned for most economic scenarios in 2021. We still see a continued global reopening and an ultra- accommodative monetary and fiscal environment as supportive for equity markets. Whilst it could be spooked by further steepening of the yield curve, the coalition of central banks are watching any increased volatility closely with every intention to keep interest rates under control.

While the abundance of earnings growth in 2021 might favour some of the more cyclical parts of the market, we do believe that a lot of that has been priced in already in earlier months. Our long-term positioning remains unchanged and is still focused on those select quality companies that can continue to grow at high returns with low volatility around the outcome.

*The **Warakirri Ethical 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