July 2022

Global Equities: Postcard from the US

Our global equities specialist partner, Northcape Capital, was last on the ground in the US 3 years ago. With borders reopening, and the US being the main country in their investment universe, it was a top priority to visit. Calvin Lim, Portfolio Manager / Analyst at Northcape spent 3 weeks travelling throughout the US recently, meeting with c100 companies across a variety of industries. Here he shares 4 big-picture takeaways and the implications for the Warakirri Ethical Global Equities Fund.

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

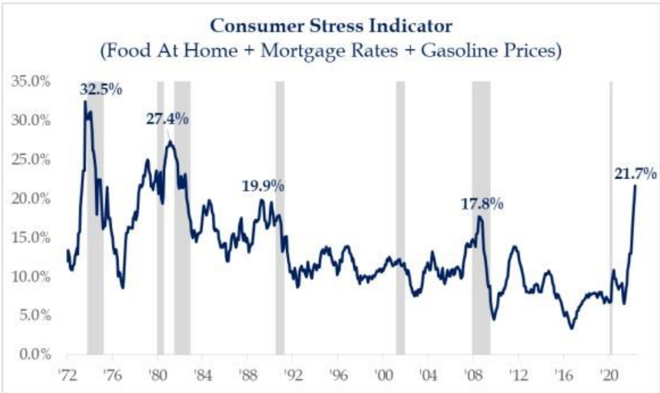
1. Inflation is Evident!

It is expensive! Inflation is the number one issue facing households, businesses and the economy. In addition to noticing this directly on my credit card, this topic was discussed in every Uber/Taxi trip, people out in the street and also by companies.

This was certainly the biggest shock from our visit 3 years ago, despite the FX rate being unchanged. For instance, a medium Big Mac meal from McDonalds cost USD11 or AUD16.20 compared to AUD12.95 in Sydney. This would have cost around USD8.60 in 2019, so the price has inflated 28% in the past 3 years, well above the Fed's targeted 2% per annum rate. It's one thing reading about inflation but being on-the-ground and living with it for 3 weeks really made it sink in just how expensive everything is and the associated impact on households.

The cost of travel also stood out with flights and hire cars costing more than double what it was in 2019, and hotel rooms also materially higher than 2019 rates.

Indeed, inflation has exceeded consensus expectations in April/May/June 2022, with the most recent June CPI at 9.1% YoY. The non-discretionary basket elements of CPI are up over 20% YoY! As the title of the chart below states, this is a strong indication of future consumer stress.



Source: Strategas

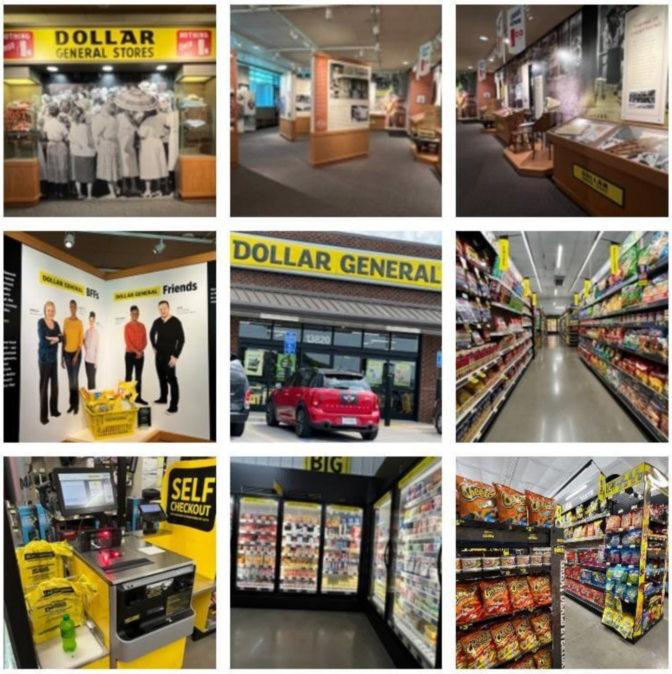
Concerns raised in our inflation analysis from our March 2021 quarterly article have largely come to fruition and continue to remain relevant as we believe there is still upward pressure on inflation from slower-moving CPI components such as rents. Feedback from meeting apartment and single-family REIT landlords confirmed this as supply/demand remains very tight, and they are seeing healthy 15%+ rent increases.

Higher borrowing costs are also causing households to rent longer, thus putting further upward pressure on rents. This is an important indicator of inflation as shelter cost is ~33% of the CPI basket. The resulting implication is the Fed needs to continue to tighten apace, with a further +75bps base case hike expected for the upcoming meeting later this month. Whilst inflation will come down eventually, we do not think it will revert back to the Fed's targeted 2% average inflation level without a moderate to severe recession and higher unemployment to bring demand back in-line or below current supply levels.

The trip reaffirmed our high conviction in Dollar General which remains one of our top 3 positions. As the leading low-cost operator, it provides a great value proposition to existing customers and those looking to trade down. In addition, having 75% of the US population living within 5 miles of its stores makes it well placed in the current environment of elevated petrol prices leading customers to shop closer to home.

I travelled to Nashville, Tennessee specifically to meet with Dollar General and conduct numerous store visits. I was impressed by the strategic initiatives which were evident, such as cooler door expansion, self-checkouts and the new store format enabling a broader merchandise range. These help the company expand their total addressable market and continue to grow, even in a macroeconomic downturn.

Dollar General museum and store visits:



Source: Northcape Capital

2. US consumers continue to shift consumption away from goods towards services

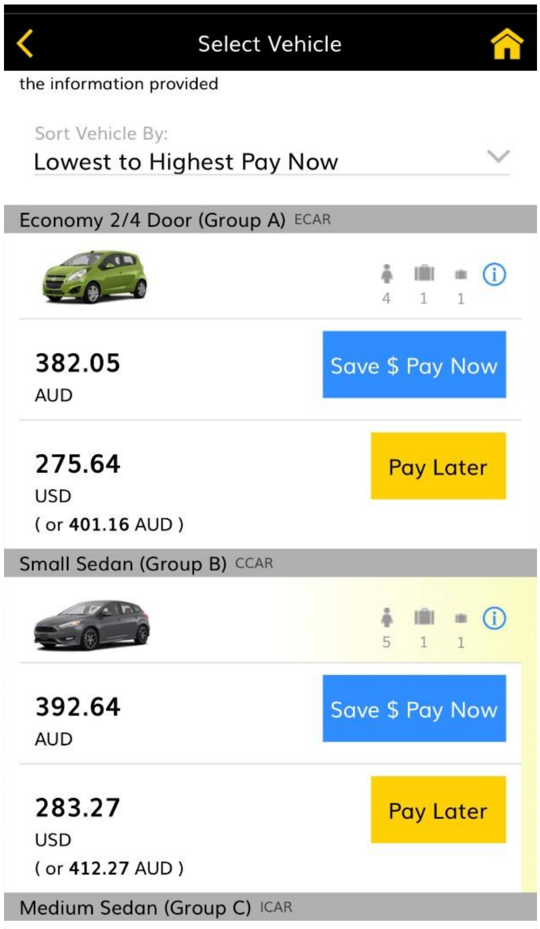
That said, we are cautious that the current US summer season could represent peak spending levels towards services which are highly discretionary in nature and can be easily cut back when household budgets are stretched.

Recently Target had a profit warning, driven in large part from having excess inventory which needed to be right-sized. During a store visit at the off-price retailer TJ Maxx, which sources its inventory from major retailers looking to clear excess inventory, I did notice that the shelves were full of stock and discounts/prices were indeed attractive. Even when accounting for the stronger USD vs AUD, I found the quality of merchandise to be good and recent along with being attractively priced and I walked out with a few shopping bags.

Having met several large hotel chains, there was consistent feedback on the strong bookings environment, especially from leisure travel, which has recovered beyond 2019 peak levels. Whilst business travel is still recovering, currently around 70-80% of 2019 levels, hotel management highlighted a pronounced shift to more leisure stays extending to the beginning and end of weekdays as consumers have more flexibility with work- from-home arrangements.

All the hotels we stayed at were at >90% occupancy levels with some fully booked for several weeks. All my domestic flights were full and rental cars were priced at a material premium (shortage of cars no doubt a contributing factor). The cheapest 1-day rental car quote in San Francisco was $382 AUD (USD275)! Looking back to 2019, a one day hire rate for Chicago cost USD46.66!

Hertz 1 day rental quote in San Francisco in June 2022 compared to the price I paid for a 1-day rental in Chicago back in 2019:



INITIAL CHARGES

RENT RT	$ 56.46	/ DAY	@ 1 / DAYS		$	56.46
SUBTOTAL 1					$	56.46
DISCOUNT -	R 20 %				$	11.29
SUBTOTAL LESS DISCOUNT					$	45.17

CHARGES ADDED DURING RENTAL

LDW	INCLUDED IN	AUADAU	RATE
LIS	INCLUDED IN	AUADAU	RATE
PAI, PEC			
PREM RD SVC	DECLINED		

* ADDITIONAL CHARGES

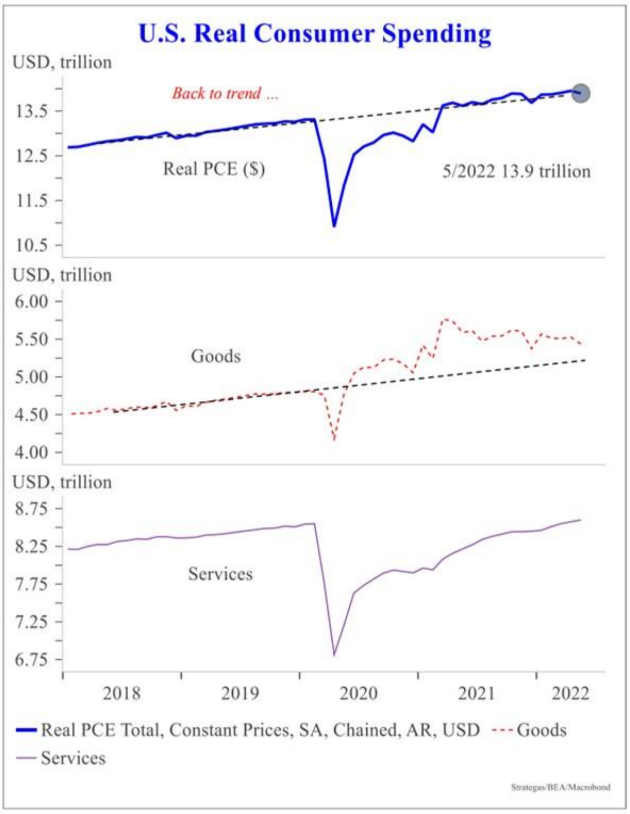
SERVICE CHARGES/TAXES

				$	1.49
TAX	21.000 %	ON TAXABLE TTL OF $	.00		
TOTAL AMOUNT DUE				$	46.66

Source: Northcape Capital, Hertz

The shift in spending towards discretionary service areas like hotels, travel, entertainment, and restaurants makes sense given the pent-up demand due to COVID restrictions in recent years, which have now been largely removed. Whilst it remains uncertain how enduring this shift will be in an economic downturn, we have been reducing the portfolio's exposure to discretionary consumer goods companies, exiting Nike and Home Depot, which were beneficiaries of the higher goods spending that occurred through the pandemic and are now at risk of earnings downgrades.

US real consumer spending has recovered back to trend levels, though with a material disparity between goods and services which is in the process of mean reverting:



Source: Strategas

3. Shortages are everywhere across both labour and supply chains across a wide variety of industries

In my meetings with various corporates, it appears that supply chain disruptions are still present and likely to persist for a while longer, although easing from 1-2 years ago. Labour shortages was a common theme discussed, which was also evidenced by the number of job advertisements in retail, hospitality and transport. Labour shortages seem most acute for lower skilled roles, though we note a recent change in tone from the tech sector recently with a number of companies instituting hiring freezes or layoffs.

One of the reasons provided for low flight availability is that an airline pilot shortage is resulting in over 400 planes grounded! It wasn't just labour that had shortages, many apartment and single-family-home landlords mentioned a shortage of housing stock which has driven vacancy to record low levels. At one Starbucks we saw notification of a coin shortage!

In San Francisco I walked into a Japanese ramen restaurant and to my surprise they mentioned they aren't serving any ramen dishes. I then asked if there was a ramen shortage causing this, but alas it was again due to the supply chain, with the extractor/ventilation fan equipment in the kitchen broken and they have been waiting for replacement parts for weeks now, which is only expected to arrive in 2-3 weeks. While a small anecdote, such issues as this are being experienced in the wider economy.

We have been mindful in our stock selection to mitigate supply chain risks and focus on resilient businesses in the portfolio that are managing the elevated risk environment well. For example, Dollar General, by virtue of being a top 3 customer of its suppliers, can command more than its fair share of inventory. Also, suppliers prefer to support growing retail formats like the discount stores. Separately, Visa is in essence a computer network that is not overly reliant on a complex physical supply chain for its business. Finally, Marsh & McLennan as an insurance broker and professional services firm relies on human capital and being the largest and most reputable in its industry globally is able to attract the required talent. Marsh was also strategic in hiring talent over the past few years while its key competitors were distracted during a complex merger process (AON and Willis Towers Watson) which was eventually terminated.

Hiring signs were prevalent everywhere

Source: Northcape Capital

I noticed a few were advertising hourly rates. Such is the acute labour shortage that businesses are resorting to this! Needless to say, the base hourly rate excluding tips for restaurants has increased by several times in the past 3 years.

This one made me laugh – coin shortages at a Starbucks store – positive for continued adoption of digital payments!

Source: Northcape Capital

One small example here, but we think is illustrative of shortages in the broader economy we discussed.

4. Private market asset prices are just starting to correct, lagging public markets.

Meetings with real estate investment trusts, private equity companies such as Blackstone and investment banks like Morgan Stanley consistently pointed towards declining prices in a variety of private market asset classes. Commercial real estate prices, according to Jones Lang LaSalle for example, have only just started to correct by 10-15% in the past 1-2 months. The increasing US 10-year government bond yield and rising cost of debt is putting upward pressure on cap rates and a lot of transactions have been put on the sidelines while price discovery takes place. Furthermore, the M&A deal pipeline is slowing materially due to elevated macro uncertainty, slowing growth and rising funding costs.

Residential property prices remain the last major asset class that has not declined materially this year. Given 72% of US mortgages are long-term (20-30 year) fixed rate, US residential asset prices are not as sensitive to the increasing Fed funds rate compared to countries where mortgages are mainly variable like in Australia. Whilst this is helpful for consumers who stay put in their current properties, we think the tailwind of material price gains since COVID began is highly unlikely to be repeated in the coming years.

We are concerned that business models where revenues are materially linked to asset prices and/or transaction activity will have greater downgrade risk. As a result, we have been trimming our holding in CBRE as a Commercial Real Estate services business with brokerage revenue. For similar reasons, we are happy to continue avoiding banks and asset managers.

Conclusion

As a result of our observations, we have increased conviction in a US recession occurring within the next 12-18 months and even possibly already. That said, the Warakirri Ethical Global Equities fund should be well placed in a slowing growth/recession scenario. The correction in stock prices this year has been virtually all earnings multiple compression driven and EPS forecasts remain too high in our view.

As a result, we have been rotating into the more quality defensive stocks, placing a greater focus on earnings certainty while reducing exposure to the more cyclical stocks where we believe earnings risk remains.

Overall, we continue to maintain a portfolio of high-quality businesses across a variety of sectors and exposures to manage risk in what we think continues to be a volatile market and cautious macroeconomic outlook.

Market decline YTD all driven by multiples compression. Earnings and guidance likely the next penny to drop:

Source: Strategas

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