Market Musings

April 2019

"When in doubt, do no harm."

Hippocrates, 460-370BC

Veritas Investment Management

REAL RETURN INVESTING

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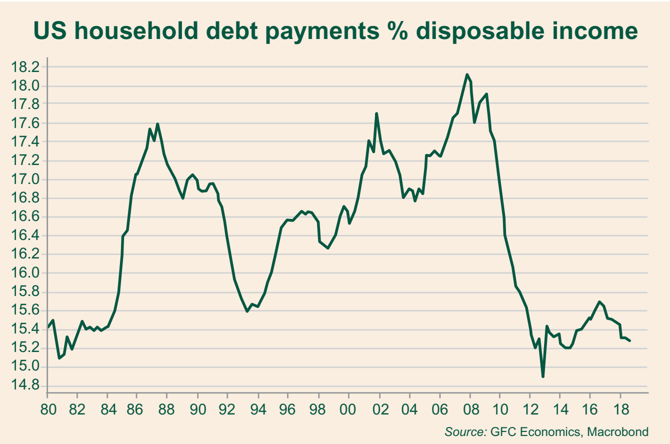
In July this year, the expansion of the US economy will become the longest on record since World War II.

There are signs of a slowdown. The Institute for Supply Management's service industries index fell in March. The number of borrowers who are more than 90 days behind in car loan repayments is at a record high. The Federal Reserve ('the Fed') has downgraded growth estimates for 2019 from 2.3% last December to 2.1% in March.

However, this may just reflect the sugar rush of Trump's tax cuts a year ago washing through, as well as the fall-out from the trade spat with China. The labour market is tightening and wages rose by a healthy but not excessive 3.2% p.a. in March, helping to sustain consumer spending. Household finances are not stretched.



The Fed's favourite inflation indicator, the Core Personal Consumption Expenditures price index, slipped back a little to 1.9% in December, reflecting downward pressure on pricing in a number of service sectors – airfares, hospital services, cable TV, tuition fees. The disinflation of technology continues and it is this that will enable the expansion to run on.

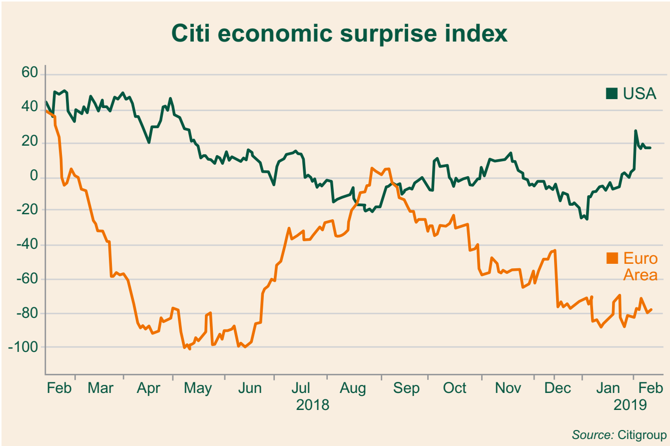
The Fed is no longer expected to raise rates further in 2019. It has even announced that 'quantitative tightening' ('QT'), the run-down of bonds totalling $4.3 trillion on its balance sheet bought in the aftermath of the credit crisis, will end in September. President Trump is seeking to appoint two loyalists to the Fed's Board, who may be expected to push for rate cuts to help Trump's re-election chances in 2020.

QT has not long been underway. It started in October 2017 with a gentle $10 billion a month shrinkage, rising to $50 billion last October. However, the extreme volatility in markets in 2018 is substantially attributed to QT, and the fact that Jerome Powell, Fed Chair, feels the need to end it prematurely is disturbing. It sends the message that the Fed has accepted an unofficial new objective, namely, financial stability, and suggests that the Fed finds itself in a policy labyrinth from which it may be impossible to escape.

Central banks around the world are grappling with the tectonic trends in politics and economics that are challenging politicians, viz. technology on the supply side containing inflation and ageing populations on the demand side restraining consumption. Add in that public sector debt levels are at historic highs, and it is clear that interest rates will remain structurally low, rendering traditional central bank policy tools impotent. The key monetary policy tool is no longer interest rates but liquidity – to fund the excess reserves that banks need to meet more stringent capital requirements post the credit crisis as well as to encourage banks to lend. This constrains central banks from de-risking their balance sheets and imposes a long term bias to easing.

Dichotomies

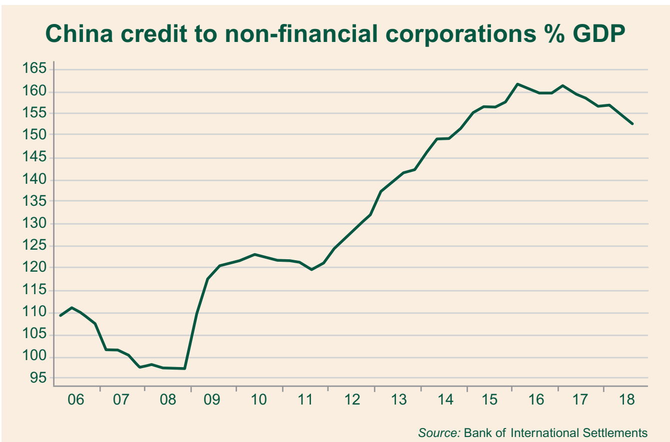
While the US economy might be getting by, across the pond the €urozone is more challenged.



Household spending has ground to a halt in France, beset by the *gilets jaunes* protesters. Manufacturing in Germany is crumbling: the Purchasing Managers' Index tumbled to 44.7 in February, the third month of contraction, hit both by trade tensions with China and the fall-out from the emissions scandal in the all-important auto sector. To compound their difficulties, German car manufacturers have been slow to recognise and adopt the rise of mobility services in displacing car ownership. Unusually, Spain has been the biggest single contributor to €urozone growth, with employment growth of 3% p.a. for four years spurring consumption and investment.

The €uropean Central Bank has downgraded its 2019 growth forecast by a hefty 0.6% to 1.1% and re-started its crisis-era stimulus programme.

China seems to be having rather more policy success than the West. Despite the headwinds of the trade war with the US, Beijing is staying the course on its deleveraging drive – successfully so: corporate sector debt as a share of GDP is falling.

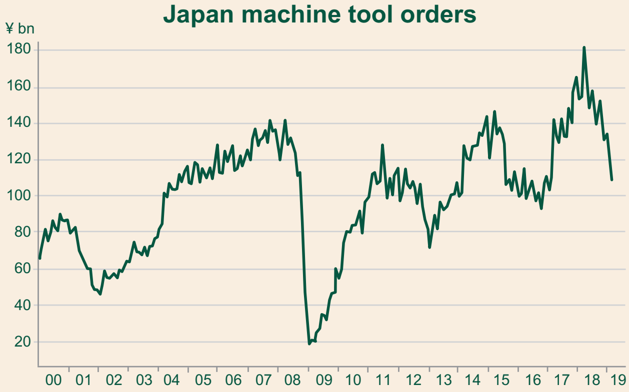


The government's GDP forecasts have been trimmed to 6.0% for 2019 from growth of 6.5% in 2018, not helped by the trade dispute or the deleveraging drive, but reflecting as much as anything else the law of large numbers.

Despite the deceleration, evidence of the country's growing wealth abounds. During the Cultural Revolution, keeping animals that could not be put to work was regarded as a bourgeois indulgence. Today there is a pet boom, fuelled by city dwelling millennials who spend lavishly at the puppy grooming parlours, animal hotels and dog day care centres that have sprung up across the country.

Japan, like the US, has a tight labour market, driven in part by the shrinking workforce, but also by tech-related service sectors. The latter are more than making up for the pullback in exports on the back of the rise in competition from China in machinery and components, traditionally Japan's stronghold.

Japan machine tool orders



Source: GFC Economics, Macrobond

In the round therefore, the services sector is taking up the slack in manufacturing in many countries. Wages are growing yet inflation is contained. Central banks are attempting the Hippocratic oath of "when in doubt, do no harm".

Healthy returns

At Veritas, our quest for our clients is for real returns, ahead of inflation, both protecting and growing the purchasing power of their capital on a rolling five year view.

March saw the 10th anniversary of the start of the current bull market. The return of constructive monetary policy will be helpful to markets. However, we remain firmly wedded to our philosophy of *not* trying to time markets. Few do it well consistently.

Over time, a company's share price will always reflect the underlying progress in earnings and free cash flows. We therefore strive to ferret out companies that are growing predictably and sustainably, established businesses run by proven management, financially sound with robust cash flows, a moat against competitors, all at a sensible price. We run focused portfolios, investing in some 25-40 equities.

We approach stock selection by identifying tectonic structural shifts. These trends form the basis of our global growth themes, in turn a funnel to narrow the investable universe and focus on attractive sectors and stocks that are likely beneficiaries.

Our current high conviction themes are:

- online life
- demographic dynamics
- regulation, and
- all change: wire & re-wire.

A longstanding 'demographic dynamics' sub-theme is healthcare. Originally it arose out of ageing populations, but

SPOTLIGHT

"Diversity – the art of thinking independently together": Malcolm Forbes

Diversity is a fashionable topic: it (or more often, the lack of it) was rarely out of the headlines last year. For us, diversity of thought has however long been a crucial part of our long-term investment philosophy, both as a factor to consider for our own team structure and during our investment research process.

Successful investment management over the long term is about good judgement, skills and experience. We believe the judgement of a team is greatly improved when diverse perspectives are combined with a culture of openness which promotes debate and welcomes new ideas.

Our aim is to encourage diversity of thought at all levels of our business, from investment research and portfolio management through to governance. Over half of our staff are female and ages span six decades. Team members have a wealth of experience from across the career spectrum, including roles in healthcare, teaching and the public sector, bringing invaluable expertise to our investment thinking and client services. By combining our experiences, both inside and outside investment management, with curiosity and open minds, we can challenge the status quo and continuously improve services for our clients.

Just as we value diversity in our own business, it is an increasingly important issue in our investment decision-making process. While company statistics on diversity are often misleading, board composition can send a clear message about the long-term predictability and sustainability of the businesses in which we invest. For example, we were pleased to see that board directors at Avery Dennison, a recent addition to portfolios, have experience from numerous industries including consumer goods, retail, healthcare and technology.

Of course, without being able to spy on board meetings, we will never see the full extent to which differing views are encouraged and embraced. But diverse boards, with a wide range of views and skills, at least have a chance of producing constructive debates, fully understanding the variety of risks businesses face today (including environmental, regulatory and cyber risks), being innovative, forward-thinking and willing to challenge pre-existing ideas.

Philippa Bliss, Assistant Investment Manager

increasingly it is driven by all four of our themes, making it even more robust. Technology has upended many industries, but it is only now disrupting healthcare which is not sustainable in its current form. Doctors, pharmaceutical companies, regulators and consumers are looking to Silicon Valley in their quest to bring healthcare costs down, and that has started.

In the US, the Food & Drug Administration's approval of medical artificial intelligence ('AI') algorithms has expanded dramatically from two in all of 2017 to one or two a month in 2018. By recognising patterns in behaviour or creating their own logic, machine learning algorithms are set to transform a number of aspects of healthcare.

Ophthalmology is expected to be the first speciality of medicine that is fundamentally transformed by AI, diagnosing complex eye diseases in real time. *DeepMind,* owned by Google's parent Alphabet, working with Moorfields Eye Hospital, has built a working prototype of a device that can diagnose complex eye diseases. Algorithms in Google Cloud analysed a retinal scan and produced an urgency score and detailed diagnosis, all in only 30 seconds! The system can detect a range of eye diseases, including glaucoma, diabetic retinopathy and age-related macular degeneration with the same level of accuracy as leading specialists – in less time. And a clinician is not required to interpret the results, making it usable by medics not normally involved in eye care.

Pharmacogenomics is the study of how genes affect a person's response to particular drugs. This relatively new field combines pharmacology (the science of drugs) and genomics (the study of genes and their functions) to develop effective medications. Some drugs simply do not work on patients due to their genetic make-up. Some even have an adverse impact: the Center for Disease Control in the USA reports that almost 7% of hospitalisations are related to adverse drug reactions. Genetic screening to cut these numbers would generate huge cost savings.

Applying AI algorithms to genetic sequencing can also tailor doses in medication to variations in a person's genes, resulting in more effective treatment – and significant cost savings.

Another area of focus for companies such as Cerner is the re-wiring of health records into electronic format, enabling up-to-date information at the touch of a button that is currently siloed in the systems of hospitals, doctors and insurers. Linking these in a central database, including test results, scans, prescriptions and allergies, will reduce duplication and improve the accuracy of diagnoses. Booking appointments and paying medical bills online will eliminate countless administrative hours.

At present doctors must type up notes on an appointment with a patient. *Suki* is a start-up that listens to the conversation between the doctor and a patient, and automatically updates the patient's medical records.

Healthcare is in the foothills of tectonic upheavals that stand to transform both the effective treatment of patients, as well as the costs of doing so.

Connecting to the future

Amphenol is a new addition into portfolios (where appropriate to the mandate), bought in the wake of the December downdraft in markets that brought the share price of this high quality company within our valuation parameters.

Amphenol is another play on the explosion in technology. It manufactures connectors, sensors and antennae, small electronic components that go in anything electric. (Connectors are used to join electrical circuits so that power and data can be transmitted.)

With a presence in more than 50% of the world's mobile devices produced each year, it is very likely that every time you pick up a mobile phone, tablet or wearable device, an Amphenol product is embedded somewhere in the device. For example, the hinges in a Microsoft Surface Pro tablet are made by Amphenol.

In order to support the latest automotive electronic systems (GPS, Bluetooth, mobile phones, assisted-driving, entertainment and safety systems), the modern car has close to 700 feet of wiring threaded through its body - compared to about 300 feet of cabling in the average home! Amphenol has been working closely with global car manufacturers on solutions for hybrid-electric vehicles.

Amphenol is a technology leader in the manufacturing of connectors for industrial applications, such as medical equipment, factory automation and alternative energy. The group offers a broad range of coaxial cable products to service the growing broadband market.

Amphenol's revenues have outgrown underlying markets. This is attributed in part to its decentralised business model which enables fast and local decision making as well as healthy competition between the business units. Growth by acquisition has been almost as important: in a highly fragmented market, Amphenol is the acquirer of choice due to its leading technology, global footprint, company structure and culture.

Amphenol's long term mission is "to be the enabler of the electronics revolution". This stock is a pure play on the shift to a more connected world. The company has grown organically at nearly double GDP for 15 years, yet we are only at the start of connecting the physical world. We have every confidence it will deliver the real returns over time that are our objective for clients.

Meg Woods
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