EQUITY MANAGER REPORT JULY 2023

REPORT ANALYSIS

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July 2023 Equity Market Outlook: Positive sentiment emerges as inflation slows

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- **Q2 2023 was a more favourable environment for Emerging Markets, Europe, Australia, and Real Assets managers.**
- **There was no single style factor that dominated returns across markets, with country and sector positioning being more relevant.**
- **Managers are optimistic about the decline in inflation across the globe but still expect a mild recession.**

As inflation continues to subside, is investor sentiment turning more positive?

Investors have been encouraged by the ongoing deceleration in inflation rates around the globe, as well as by expectations that policy rates are near peak levels. In addition, the agreement on raising the U.S. debt ceiling, retreating concerns related to systemic risks in the wake of the collapse of Silicon Valley Bank (SVB) and Credit Suisse, and continued excitement around artificial intelligence (AI) are adding to the positive momentum.

However, with a mild recession still expected, managers have a preference for companies with resilient balance sheets and strong business models that can weather the current challenging environment, where cost pressures are impacting margins and investments. Managers also remain cautious on China, due to slowing growth and weak consumer confidence.

On balance, the second quarter of 2023 proved to be a more favourable environment for active managers in Emerging Markets, Europe, Australia, and Real Assets equities, while being more challenging for U.S. Large-Cap, U.S. Small-Cap, Long/Short, Global, Global ex-U.S., Japan, UK, and Canada managers.

Contrary to previous quarters, there was no single style factor that dominated returns across markets, with country and sector positioning being more relevant. However, the growth and quality factors continued to be rewarded in the U.S., while the value factor outperformed in Emerging Markets, Japan, and Europe.

Information technology was again the best-performing sector across most regions, while energy, materials, real estate, and consumer staples generally underperformed. Financials typically also fared well, with the exception being in the U.S.

Drawing on our unique relationship with underlying managers, we've compiled the latest insights from specialists across the manager universe into an easy-to-read report. Listed below are the chief tactical observations from key equity and geographic regions around the globe during the second quarter of 2023.

Australian equities

Same, same

- For the third consecutive quarter, managers largely kept portfolios unchanged.
- Since the second half of 2022, managers have increasingly focused on higher-quality companies with stronger balance sheets that can maintain margins and revenues in a challenging economic environment.

Less enthusiasm on China demand

- Managers were expecting that the reopening of China post-COVID would increase demand for Australian exports. Outside of education, this has not occurred. Managers are now less optimistic on demand from China.
- Few managers are overweight iron ore miners, believing steel production is unlikely to accelerate. Battery minerals are preferred.
- Demographic shifts in China make productivity and GDP (gross domestic product) growth more challenging in the future. Declining birth rates mean China's population could halve by 2090.

Canadian equities

High-quality opportunities in energy

- Investors are more optimistic about opportunities within the energy sector, as many companies have transformed their business models to become more focused on cash flow generation versus production and revenue growth. As such, they have better balance sheets and the ability to withstand commodity price fluctuations.
- Canadian natural gas producers are well positioned within the industry, with a very favourable supply/demand situation. Increasing Asian demand is expected to benefit Canadian natural gas producers. With better logistics for Canadian producers versus their U.S. counterparts, they have a cost advantage to meet demand outside of North America.

Favourable environment for strategic acquisitions

- Despite rising interest rates and a higher cost of borrowing, managers are optimistic about the M&A (mergers and acquisitions) environment for high quality strategic corporate buyers. The high borrowing costs are reducing competition for deals from private equity, providing more opportunities for conservatively managed corporate buyers with strong balance sheets that have more flexible financing options.

Managers are selective within transports

- While not attractively valued based on current P/E (price-to-earnings) multiples, managers view the rail companies as compelling long-term compounders with great earnings visibility. Rail volumes continue to remain strong, supporting pricing power and durable earnings.
- Managers are cautious on trucking companies, which are challenged by higher input costs and less stable demand.

Emerging markets equities

Is China oversold?

- Despite negative sentiment and weaker consumer/macroeconomic confidence, managers are not capitulating on exposures.
- Valuations are increasingly attractive, which is supportive as managers look to add to oversold opportunities.
- Expectations are that targeted government stimulus will continue and earnings will improve.
- Current high level of short positions on Hong Kong stocks are short-term and can quickly unwind on positive news.

Lower inflation expectations see Latin America buoy on ideas

- Managers have continued to add to their exposure in Latin America, particularly in Brazil, as expectations of policy easing remain on the horizon due to quicker actions taken to tame inflation.
- Nearshoring remains an active theme among investors as they look to take advantage of opportunities arising as a result.

EM looking increasingly attractive

- Growth differentials relative to developed markets are reaching attractive levels, having narrowed over the last few years.
- The U.S. dollar (USD) is expected to continue weakening, which is also supportive for the asset class.

Europe and UK equities

The UK at the crossroads

- Having struggled to forecast the path of inflation, which was stickier than expected in the first half of the year, UK investors are understandably cautious in predicting change as the year goes on.
- However, initial signs of cooling goods inflation, the impact of energy price capping and signs of food retailers competing on price are giving some managers hope of a positive inflation surprise. This is leading to a greater willingness to increase UK domestic exposure, particularly toward the consumer discretionary sector.

Finally, Europe's time to shine?

- While Europe has been cheap relative to the U.S. for a considerable time, valuation spread is now at an all-time high.
- Historically, this has been somewhat justified by sector composition and greater EPS (earnings per share) growth out of the U.S. However, the situation is changing, and European 12-month-forward EPS growth is now outstripping the U.S.

Interest rate shock

- Curing a system addicted to cheap borrowing is no easy task and it can have extreme consequences for illiquid or highly leveraged businesses. Unlike 2008, pockets of risk remain in the market despite the average European corporate being well-capitalised.
- The SVB debacle in March was a first warning, but worries are now engulfing other companies and sectors. Most notably, the real estate sector – where most companies

have been strong benefactors of low interest rates – is now struggling to adjust to higher borrowing costs in addition to declining deal volumes and property prices.

Global equities

Embracing AI, but not the euphoria

- AI is a technological breakthrough that will alter the productivity landscape. Growth managers believe that semiconductor companies, along with large-scale cloud providers, are the most direct way to participate in the AI theme.
- Cross application has opened innovation opportunities outside of tech – for instance, material composites and biotech drug design.
- That said, the significant rally in AI-related mega-cap tech names have managers taking profits on peak valuations.

No consensus over China

- Sentiment has turned bearish given China's slow-paced recovery and underwhelming policy stimulus. Some managers anticipate lower structural growth with an ageing population, deglobalisation and weaknesses in the housing market.
- Growth managers, however, view these as near-term concerns that are priced in, particularly in innovation sectors such as internet and technology on the back of easing regulatory pressure.
- Managers also believe that only modest monetary policy will suffice to incentivise consumption and allow consumer discretionary stocks to partake in more of the post-COVID recovery trajectory.

Europe remains a valuation story

- Value managers remain attracted to Europe – particularly to financials, where attractive dividends offer a buffer against the rising inflationary environment.

Investors appreciate defensive business models

- Although there remain pockets of opportunity within cyclical sectors, there is growing caution among active managers, irrespective of their investment style. Investors are increasingly willing to pay up for the quality premium in more defensive businesses with resilient revenues and pricing power.

Japan equities

Interest gradually shifting into laggards

- Large cap exporters, particularly semiconductor-related companies, rallied strongly in Q2. This was driven by expectations of the cycle bottoming, the yen's depreciation, and a large inflow from overseas investors. Overseas investors who underweight Japan tend to buy large-cap stocks at the initial stage.
- A majority of active managers believe the demand for semiconductors will structurally grow as a result of an expansion of applications using generative AI, supply-chain reorganisation associated with geopolitical risk and structural-demand growth backed by an increase in data traffic. At the same time, many have been trimming these positions due to expensive valuations and possible weak near-term earnings, shifting into laggards in the sector.

Maintaining a positive view of Japan’s relative earnings

- Managers believe Japan’s economic outlook remains relatively attractive thanks to the Bank of Japan (BOJ)’s easing policy, corporate governance improvement, and the recovery of inbound tourism and production shifts to Japan, backed by global supply chain reorganisation.
- **BOJ policy:** The consensus view is that the BoJ will not change its policy much until Japan’s inflation rate consistently exceeds 2%. This has led some to increase bank exposures due to the rising potential of future inflation and/or auto exposures due to a weaker yen.
- **Corporate governance:** Management teams are under strong pressure to improve capital efficiency, particularly for those which trade on price-to-book (PBR) below 1x. As a result, there is an increased focus on identifying low PBR stocks which have opportunities to improve capital efficiencies.
- **Production shift /recovery of inbound tourism:** Managers are increasingly focused on the beneficiaries of this. Domestic demand-oriented stocks having specific growth stories are preferred.

Long/short equity

Hedge funds aren’t chasing upside

- Equity long/short hedge funds are displaying a lack of appetite to buy into the recent rally.
- De-grossing resumed, especially in the U.S. and China, as managers covered crowded shorts and trimmed crowded longs (especially mega-cap tech).

Shifting tides: Decreasing China exposure in light of economic and geopolitical worries

- The increase in investments in China – observed from late 2022 to early 2023 – has quickly reversed, with fund managers significantly reducing their exposure to the country.
- Concerns about the Chinese economy, along with rising geopolitical tensions, have driven the decreased beta exposure, with managers more focused on select idiosyncratic ideas.

Generative AI: Early innings but promising, despite concerns

- Although hedge funds are unclear on their long-term impact, many see ample long and short opportunities in the near term from AI.
- Hedge funds are also using ChatGPT to improve workflow processes at the firm level.
- The main concerns of many hedge funds are those surrounding security, and particularly, its accuracy. Many hedge funds are cautiously approaching using ChatGPT for material investment use cases due to its tendency to provide inaccurate information. This calls for the need for ChatGPT to be trained on better, more accurate data sets.
- ChatGPT was able to pass Bridgewater’s investment associate test, stating that its power is like having ‘millions of junior staffers working all at once.’
- Bridgewater, among others, is experimenting with machine-learning AI in its trading strategies.

Real assets equities

Inflation outlook remains a risk

- Across both infrastructure and real estate, the future path of interest rates and inflation are significantly important. Managers believe elevated inflation is likely to persist. Historical evidence highlights the difficulty of controlling inflation even after initial containment. In the U.S., there have been two periods of high unexpected inflation—one in the post-WWII era and the other in the early 1970s. Those periods experienced a subsequent resurgence in inflation following initial containment, indicating the potential challenges in controlling inflation.

Several infrastructure sectors have linkages to inflation

- Regulated utilities have periodic rate cases that reflect inflationary cost impacts. They also have inelastic demand with low fluctuation.
- Airports and toll roads have CPI+ (consumer price index plus) toll or fee increases permitted via concession agreements.

Inflation moving past peak levels would be a favourable environment for REITs

- Supply growth should remain muted due to increased financing costs and uncertainty. Also, higher construction costs may slow real estate supply growth.
- Balance sheets are strong as leverage levels remain low, which should allow REITs (real estate investment trusts) to play offence this cycle.
- Cash flow growth for REITs remains strong, though estimated changes reflect slowing growth.

U.S. large-cap equities

Trends in artificial intelligence

- The introduction and rapid development of AI models is seen by managers as an era-defining technology breakthrough.
- Growth managers believe the incumbent cloud providers and their suppliers – particularly in semis – will be the primary initial beneficiaries of AI and are responding by adding to their holdings in large-cap technology names.
- Value managers are more focused on the potential disruptive impact of AI and are stress-testing existing holdings while also bargain-hunting in select areas like technology consulting.

Market breadth and valuation expansion

- Index returns year-to-date continue to be dominated by the handful of AI-related mega-cap technology companies noted above, with stock valuations expanding in anticipation of secular growth.
- Growth, value and market-oriented (MO) managers all expect market breadth to widen over the course of the rest of the year. Growth and MO managers are looking for second-order beneficiaries of the AI trend trading at lower valuations, while value managers are (continuing) to position portfolios more defensively in healthcare and consumer staples, given elevated valuations elsewhere.

Healthcare policy

- Managers believe innovation and growth within U.S. healthcare are undervalued in the current market, but most are hesitant to meaningfully add to holdings given uncertainties around policy.
- With 2024 a federal election year, politicians across the political spectrum are likely to talk about plans for lowering healthcare (especially drug) pricing over the coming year-plus. In addition, unexpected decisions by the FTC (Federal Trade Commission) in recent months to block mergers within pharma represent a second, less predictable headwind, giving managers pause.

U.S. small cap equities

Growth managers find AI-related opportunities in small/mid-caps

- Small-cap growth managers believe AI-related opportunities are not just in large caps, but also in small caps. These are more focused on the picks and shovels part of value chains – such as data centers construction, power back-up, data centers cooling, and those providing connectivity between servers and data centers.
- Managers believe the fundamentals of such companies have a long runway for growth and that valuations are not stretched either.

Value managers see opportunities in energy, banks, and consumer discretionary stocks

- Energy stocks have attractive relative valuations, favourable supply/demand characteristics, and strong free cash flow generation with improved capital allocation.
- While banks' earnings are likely to be weak in Q3 and Q4, the stocks are now approaching tangible book value, which is typically an attractive entry point.
- Consumer discretionary stocks have struggled recently with inventory destocking, but that is now closer to the end.

Market-oriented managers find opportunities in consumer discretionary stocks

- Managers believe recession concerns are now lower and the valuations in the sector are attractive, which provides a good cushion for increasing exposure.
- There's an increased focus on opportunities in travel and restaurant stocks, which benefit from pent-up demand and until recently were ignored by the market because of recession concerns. Restaurant suppliers are also looking attractive, as are casino/gaming supplier companies.

The bottom line

The slowdown in global inflation and optimism that policy rates are nearing their peak for the cycle has led to an uptick in positive sentiment for equity managers. However, there is a risk that the current drop in inflation could lose steam, which would result in consumer prices stabilising at higher-than-expected levels. This, in turn, would likely cause central banks to hold rates higher for longer. In addition, the deceleration in Chinese economic growth after a strong first-quarter impulse is a potentially concerning development that warrants close attention. In such an uncertain environment, we believe the views of specialist managers will be critical to identifying and exploiting both risks and opportunities. We look forward to continuing to share these insights with you as the second half of the year unfolds.

QUESTIONS?

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