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Amity International Fund – Q2 2018 Commentary

Quarter to end June 2018

Performance

	3 Months	6 Months	1 Year	3 Years	5 Years	10 Years
Fund Performance (B share class)	3.83	0.17	6.10	37.66	50.57	139.60
FTSE World TR GBP	7.16	2.41	9.35	54.01	86.13	185.43
IA Global	7.83	2.67	9.39	45.02	70.54	130.77
Sector Quartile	4	3	3	4	4	3

Source: Morningstar. Figures compared on a Bid to Bid basis with Net Income Reinvested.

Review

The second quarter of 2018 saw global markets recover from a challenging start to the year, despite the continued escalation in global trade tensions, persistent geopolitical uncertainty and pockets of weak economic data. A robust corporate earnings season in the United States (US) was the primary driver, although it is clearly too early to expect any meaningful impact of trade tensions. The US Administration continues to prioritise the renegotiation of existing trade agreements with its major trading partners. Efforts to address the trade deficit and improve the US' international competitiveness centred on trade with China. What began with an introduction of a 25% tariff on $34bn of goods was quickly reciprocated by the Chinese, targeting goods in President Trump's political strongholds. Subsequently, this has escalated rapidly into plans for additional 10% tariffs on $200bn of Chinese imports, plus an additional $350bn worth of tariffs targeted on auto imports from the European Union. Rising protectionism remains a political priority in the US, yet if tariffs of this magnitude are imposed it is likely to create inflation for consumers in the US, in addition to hurting trade flow globally. As ever, it is important to contextualise the size and importance of these measures, while assessing the longer term impact that such policy uncertainty can produce.

Overall, the second quarter economic data outside of the US has been broadly softer than expected, casting doubt over how synchronised the global growth outlook is. Signs of a slowdown in Europe were compounded by the political uncertainty in Italy, as anti-establishment and far-right coalitions were vetoed, and fears increased over Italy's commitment to the euro and desire for a significant fiscal expansion. Guidance from the European Central Bank (ECB) indicated that it was unlikely to raise rates until mid-2019, effectively when current Governor Mario Draghi steps down, coupled with a reduction to Eurozone growth forecasts from 2.4% to 2.1%. Cumulatively this rhetoric hurt European markets and led the euro to depreciate against the dollar, as the Federal Reserve raised rates by 25bps in June, forecasting a further two hikes in 2018. The strengthening US dollar, withdrawal of cheap liquidity, and rising global trade tensions hurt emerging markets.

Performance & Activity

The global index recovered the losses of the first quarter, to post a marginal gain of 2.1% (in sterling terms) for the first half of the year, however this masks significant disparity at a regional level - US markets rising 10% compared to Asia ex Japan's gain of 2.3% and European equity markets gain of 3.6%. In sterling terms, the Amity International portfolio faced headwinds relating to this disparity, rising 3.3% vs the benchmark's gain of 6.9% in the second quarter. Year to date, due to regional and style headwinds, the Amity International Fund erased the outperformance of the first quarter, rising 0.4% and underperforming the global equity benchmark by 1.66%.

Given the prospect of slower economic growth and no rate rises, markets rotated further towards global growth stocks with the style significantly outperforming, led by FANGs and the NASDAQ index. Specifically, the MSCI World Growth total return index (+7%) has outperformed MSCI World Value (-0.6%) by close to 8% year-to-date, taking the total performance differential to c.20% (US dollar terms) since the beginning of 2017. Given the fund's long-standing value stance, this has been a significant performance headwind, not just over the last two years, but effectively since the Global Financial Crisis, with value underperforming growth by 73% since start of 2009. The disparity of value vs. growth and between US equity market returns and the rest of the world share an element of commonality here, with the technology heavy Nasdaq index rising 13% over the first half, led by the FANGs which gained over 32% in first half[1] - not holding Amazon or Netflix detracted 0.65% alone in 2018. Europe's lack of technology representation was exacerbated by a sell-off in the cyclical sectors, specifically Financials and Industrials, given the deteriorating growth outlook highlighted above. After Technology, the second best performing sector in first half was Oil & Gas, up c. 9%. The ongoing geopolitical tension in the Middle East, US-led sanctions on Iran and supply disruption in Venezuela and Libya pushed oil prices up mid-single digits, which detracted given the Amity Fund's structural underweight to the sector.

In terms of stock selection, Japan was the stand-out region with the fund's holdings rising 7.6% vs. the market's 0.5% gain. Zojirushi, which gained 46%, and TechnoPro (+23%) have subsequently been sold, while new holding Horiba (+16%) also had a strong start. Amada was the only noticeable underperformer falling 26% on global growth concerns. The fund's largest holding, Sony, gained 16.4% yet remains attractively valued. Elsewhere in Asia, there was a degree of mean reversal following strong performance with Hi-P (Singaporean precision moulding), Hop Fung (paper, Hong Kong), Minth (lightweight auto parts, China), and Tarena International (education & training, China) all falling over 25%. The fund's holding in Hi-P and Minth had been significantly reduced given the extent of outperformance, while we have recently added to Tarena following a call with management detailing the attractive expansion plan. In Europe, ING Group fell on ECB rate guidance.

In terms of portfolio activity, two new positions were established in the US: Mohawk Industries, a global leader in flooring products for residential and commercial applications, and the repurchase of NXP Semiconductors as the price fell close to our original purchase price, reflecting the low likelihood the Qualcomm bid would succeed due to US – China trade tensions. This was funded by the sale of two positions, Victrex and Zojirushi**,** which having performed strongly, traded at unjustifiably stretched valuations. The fund's holding in Smurfit Kappa was also scaled back following significant outperformance post the International Paper bid, and reinvested into a new position in Swedish niche packaging peer BillerudKorsnäs.

Outlook

Prospects for the rest of 2018 are significantly more balanced than the euphoria that characterised the start of the year. Escalating trade protectionism, prolonged fallout from Chinese deleveraging, higher oil prices and the uncertainty of November mid-term elections in the US are now appearing on the risk register. The potential direct and indirect impacts from escalating trade tensions remain as difficult to assess. Equity markets appear to be discounting a relatively benign short-lived outcome, however the bond market appears increasingly concerned with the growth outlook. Specifically in the US, the 2s-10s spread continues to tighten (sub 30bps), with the long-end struggling to remain over 3%. The narrative that the Federal Reserve will gravitate to a lower neutral rate than previous cycles would suggest that continued US dollar strength is not guaranteed. Given investor positioning and relative valuation, signs of recovery in the Eurozone would be well received, particularly within depressed cyclicals such as Industrials and Financials. In the US, the economy continues to benefit from significant late cycle fiscal stimulus, however this is expected to fade into 2019, posing a challenging comparative. China's economy remains a focus, and while there is significant room to add stimulus should growth fall below the official 6.5% target rate, the priority remains quality over quantity.

Further Information

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[1] Based on the NYFANG Index, both measures in GBP terms