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Silver Linings

Equity investing is not just about managing risk but also understanding the dynamics of opportunity.

Twelve months ago, an extreme peak in the monetary cycle coincided with a peak in asset markets. Then came change. And with change comes ripple effects. Like the famous rock being thrown into the water creating ripples and waves. At the same time, negative sentiment is also being sensationalized by media, and to such a degree, whereby the positive dynamic effects – namely the silver linings - are hidden and underestimated. Two big rocks were thrown into the water in 2022, resulting in significant ripple effects, and affecting the investment environment both short and long term.

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The Rocks over Ukraine

Putin started throwing "rocks" over Ukraine on February 2022, causing heartbreak and significant ripple waves. It was a watershed moment for the geopolitical and global security situa-

Bo Knudsen
CEO and Portfolio Manager
C WorldWide Asset Management

tion, with Sweden and Finland now also seeking to join a reborn NATO. Germany's and the EU's energy policies got a massive injection of realism, and an immediate energy divorce from Russia became a reality. This led to a less naïve and a more realistic take on the energy transition, also exemplified by significant revisions of massive related EU regulation. Waking up to the threat of a cold winter has led to a mobilization of resources and an acceleration of the energy transition with an increased focus not just on alternative energy, but also, importantly on energy efficiency and the significance of natural carbon sinks.

The link between energy policy and security policy highlights the complexity of the next phase of globalization. Old friends and allies move closer together and new alliances will be formed in a more complex web with increased levels of localisation but with trade across borders continuing. Networked challenges require networked responses.

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The physical and the virtual world need energy to thrive. We can be sure of a silver lining of massive investments in new energy infrastructures, new technologies, and the best opportunities ever for energy efficiency products and services. These will be themes that drive top-line growth for certain companies for the rest of this decade and beyond. But Big Government is watching. Investors need to be acutely aware of this because there could be limits to how much of the growth and earnings that can flow to and benefit shareholders. It is not as simple as buying a passive Energy Transition ETF with all companies. As an example, despite very strong top-line growth in solar and wind energy, companies have had a hard time generating shareholder value. The energy transition is an area where stock picking and selectivity are more important than ever and where key parts of the analysis are hard to put into a spreadsheet or an AI (quantitative) tool. For example, we have exposure to the industrial gas space, where we see an opportunity to use existing fuels more efficiently with the help of technologies from industrial gas products and services.

The Blow From the Fed

The other big rock thrown in 2022 was from the hands of the US Fed Chairman Powell. It was late and necessary - but can the world handle the very accelerated pace of rate hikes? The ripple effects on capital markets have been significant and most of the economic impact and the dynamic effect from asset markets have yet to be fully felt in debt-loaded western economies.

Real Rates Hitting Valuations

The swift and violent spike in short-term rates and bond yields has created an unusual

correlation among asset classes with price drops in gold, metals, bonds, equities, and the housing market. Over the past 10 years, asset markets have benefitted from a fall in real interest rates from the long-term historical average of 2% to a range between -1% and +1% (US) as seen in figure 1 on the next page. The central bank's current fight against inflation has lifted real interest rates to around 1.5%, measured by the market expectations for the 10-year inflation outlook (US TIPS). The effect on equity markets has been a drop of approx. 5 multiple points (p/e) to a current market valuation of 14x on 2023 EPS. As earnings actually grew in 2022, all of the market declines in 2022 can be attributed to the valuation compression effect.

An investor in the US 30-year government bond lost more than 30% (USD) in 2022. This had ripple effects on long durations assets including high-quality growth companies. For example, the performance differential between MSCI Quality and Value Index was a staggering 16%-points. This created a headwind for quality-focused investments.

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Powell is trying to pull off the bandaid as quickly as possible to get back to a more balanced monetary policy approach and to steer towards zero real rates as a long-term target. Low rates are what the world needs in a world of record-high government debt and record-high asset markets to GDP. Low rates are also needed to secure the massive investments required for a new energy infrastructure and increased energy efficiency. Investing more in physical infrastructure (atoms) and maybe a little less in bits and bytes.

The housing markets do not work well with high real interest rates, and housing drives the consumers that control the direction in the two biggest economies and growth drivers in the world, China and the US.

Based on the aggressive tightening path from the Fed, 2023 could deliver both a recession in the US economy and a recovery in stock markets, albeit

Figure 1

Real Interest Rates in the US

Source: FactSet and Bloomberg as of December 2022

with high market volatility. Signs are emerging that inflation is cooling which makes the case for a peak in the interest rate cycle sometime later this year. Predicting within the framework of the calendar year is always delicate, but this is the silver lining. A cooling of interest rates could dampen the cyclical headwind and pave the way for the structural tailwind behind quality companies to regain dominance. However, the damage to risk appetite and a scarcer environment for capital could affect high-risk assets such as overvalued equities, profitless startups/tech companies, and crypto for many years to come as we saw post the tech crash in the year 2000. Unicorn investing has suddenly become harder with more competition for capital. How many delivery apps do we actually need?

As central banks pause their hawkish stance, real rates (TIPS) are likely to gravitate back towards zero - the past decade's trend, although with high volatility. This should have positive market implications supporting higher market multiples, albeit likely lower than the levels seen in the past 5 years. The challenge in 2023 will be corporate earnings as an economic slowdown and a possible recession seems inevitable. However, earnings risk should be lower among structural growth companies supported by positive market trends compared to purely cyclical companies. For us, it is about getting the trend in earnings right.

“Investing beyond calendar years is key for us. We invest in companies that fundamentally grow bigger over time – the recipe behind compounding is simple yet powerful.”

Covid

Already at the beginning of 2020, a rock in the shape of Covid was thrown into the water, and from March it caused significant ripple effects – both lasting and temporary. Fortunately, this rock has sunk, and most countries around the world are back to a more normal, pre-pandemic state.

However, there are exceptions. In China, for example, although anti-epidemic measures are being adjusted, the societal, commercial, and travel environment is not back to normal. Yet the same can be said for Japan. On a recent corporate trip, we witnessed firsthand the ongoing domestic restrictions prevalent in all aspects of Japanese society. In most meetings, we were not only wearing masks, but also separated by plexiglass when having conversations with Japanese companies. Japan continues to be demographically challenged, but is a global force of power in the future productive and digital society with robot technologies, global MedTech champions, and providers of high-tech com-ponents and materials. I am a fan.

Conclusion

Investing beyond calendar years is key for us. We invest in companies that fundamentally grow bigger over time – the recipe behind compounding is simple yet powerful. It is always humbling to see that missing only one or two of the biggest stock performance days during a year removes the effects of long-term compounding. And who knows about the exact big days in advance? Intraday and intra year timing are not lucrative nor rewarding in my view. Compound thinking wins marathons. Understanding structural trends is key. However, it will not always be the winning strategy in sprints and shorter-term distances. That is part of the price of winning marathons – focusing on winning consistently over a rolling five-year time horizon.

We are facing a tougher investment environment in the coming decade with near-zero and volatile real interest rates. But if you can find companies that grow in real terms, you will see stock markets rewarding these companies with solid valuation multiples.

Back to rocks and water; a river cuts through rock, not by short-term raw power, but by long-term patience and persistence. That is a mentally tough but rewarding path to follow.

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C WORLDWIDE ASSET MANAGEMENT FONDSMAEGLERSELSKAB A/S

Dampfaergevej 26 · DK-2100 Copenhagen

Tel: +45 35 46 35 00 · Fax: +45 35 46 36 00 · VAT 78 42 05 10 · cworldwide.com

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