

Global Equity Observer

(Trade) War – What is it good for?

– EDWIN STARR

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At the time of writing (31 October 2018), the MSCI World Index experienced its first more than 10% correction since early 2016. Market commentators attribute the correction to a range of factors, including rising interest rates, rising energy costs due to supply constraints and environmental regulation, political upheavals in Italy, and the escalation of trade tensions between the U.S. and China. As usual, we have no edge in determining whether or not this is the start of a more persistent market slowdown or just a temporary blip.

However, it may be helpful to lay out in a bit more detail why we believe our portfolios are positioned to better navigate these challenges, using the trade tensions as an example:

How to assess the impact of rising protectionism

Most analyses we see on the trade tensions attempt to estimate the impact of import barriers on gross domestic product (GDP). There seems to be no consensus on the extent of the impact, but the European Central Bank estimates a -0.75% direct and indirect impact on global GDP relative to baseline for the first year.

GDP can be a useful tool in forecasting demand for individual products but, in this specific case, it may actually be quite misleading. Trade wars have a direct impact on GDP through two channels: On the one hand, higher import tariffs reduce the purchasing power of households, resulting in lower consumption. This negative impact on GDP is partially offset by higher prices for imported goods inducing consumers and firms to switch to domestically produced goods, which in turn

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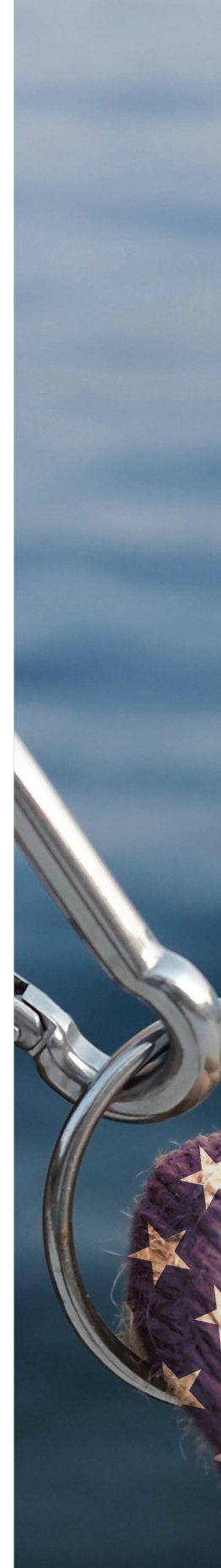
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“How this affects the bottom line depends on the degree of pricing power a company has”



increases domestic demand and reduces exports. To put it simply, applying an import tariff on, say, cars may reduce the demand for foreign-produced cars, but that negative effect is partially offset by an increase in demand for domestically produced cars. So, the GDP impact is partially mitigated.

For global companies that make up the bulk of the indices, this mitigation does not happen. First, they see a fall in absolute demand for their products as prices rise in line with the import tariffs. Furthermore, if customers then shift to domestically produced items, these companies have to move production from more efficient locations to less efficient, often smaller domestic facilities. So, they get hit on both volume and margin, plus have to wear the capex expense of the relocation.

The severity of the margin impact depends on the degree of pricing power, share of recurring revenues and depth of the supply chain

This example assumes a simplified, fully vertically integrated production model. In reality, the world has become deeply integrated over the last 30 years and parts are produced and assembled wherever this can be done in the most efficient way. Apple, for instance, has over 200 suppliers spread all over the world, but mostly in Asia, which deliver their goods to the major manufacturing base in China. Only 46% of the value added of electrical and optical equipment exported from China is actually generated in China. If this supply chain gets disrupted and production has to be split across multiple locations, effects of scale and scope across the value chain are lost.

The question of whether this loss of efficiencies affects the company bottom line very much depends on the degree of pricing power and the share of recurring revenues. In most industries, companies do not have the pricing power to push higher cost through to customers and experience sharp falls in revenues as demand drops.

Some companies are better than others

Our bottom-up investment approach focuses on pricing power and recurring revenues as a key component of the quality assessment. Additionally, our approach to risk focuses on, among other things, potential challenges to the underlying franchise of the company, which includes the supply chain. As a result, our portfolios tend to be weighted towards consumer staples, software & services, and health care, which we believe to be more resilient in a trade-war scenario than other sectors.

Consumer staples companies tend to have relatively short supply chains, as a lot of their products do not travel well. More importantly, staples' revenues are usually recurring revenues, i.e., purchases are made regularly and are more difficult to postpone.

Consumers can delay the purchase of a new dishwasher/car/mobile phone by another year, but they need to buy their soap, washing tabs, baby food or bin bags every week or month. Furthermore, these items tend to be sold for modest individual amounts. Hence, price increases to compensate for import taxes or lower production efficiency could be passed on to the customers more easily and quickly than in other sectors. Within the sector, we find some companies have stronger brands and market positions than others, making them even more capable of improving economics through price/product mix.

“Our portfolios tend to be weighted towards sectors we believe to be more resilient in a trade war scenario.”

Software & services companies are generally less affected by traditional import taxes, since they do not have supply chains in the traditional sense. To the extent tariffs are applied to

their products, strong pricing power allows them to pass these on to the customer base in full. For example, where products have already moved to an ongoing subscription model via the cloud, providers have an effective means to get customers to participate in the shift of economics. However, one area of concern is where we have seen restrictions on people movement, for example, with reduced availability of short-term work visas. Whilst these kinds of restrictions can have negative repercussions, in this case they have been beneficial for consulting companies operating on a cost-plus basis that already have a large part of their workforce in high-cost locations.

Health care is also an industry with fairly short supply chains. Most of the value lies in research and development and/or highly sophisticated production capabilities. Given these products are patent protected or hard to replicate, of truly vital importance, and that governments tend to foot most of the health care bill, import tariffs on health care products are fairly rare. Even if they were to be applied, health care providers have the pricing power to pass these through to their end customers.

Sectors where we would expect trade wars to have a more severe direct impact on volumes and margins are industrials, materials and information technology hardware manufacturers, driven by their limited ability to pass through higher costs to customers as well as, in some cases, the dependency on deep and complex supply chains built over the last decade.

Our portfolios continue to be heavily skewed towards the three sectors we regard as more robust – consumer staples, software & services, and health care – since we focus on high, recurring returns and pricing power. We remain cautious on industrials, materials and financials despite some improvement in valuations.

RISK CONSIDERATIONS

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect **global franchise companies** and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. Stocks of **small-capitalization companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing

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DEFINITIONS

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

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