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# Amity International Fund – Q4 2019 Commentary

Quarter to end December 2019

## Performance

| | 3 Months | 6 Months | 1 Year | 3 Years | 5 Years | 10 Years |
|---|---|---|---|---|---|---|
| Fund Performance (B share class) | 2.18% | 4.03% | 19.10% | 22.84% | 48.86% | 110.93% |
| FTSE World TR GBP | 1.39% | 5.22% | 22.81% | 34.89% | 82.39% | 204.26% |
| IA Global | 1.95% | 4.39% | 22.01% | 31.00% | 66.86% | 149.80% |
| Quartile | 2 | 3 | 3 | 4 | 4 | 4 |

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

## Review

The last quarter of 2019 played out in stark contrast to the volatility experienced 12 months prior, largely driven by supportive central banks and diminishing geopolitical risks, leading to a positive quarter for risk assets. The primary geopolitical factor impacting market sentiment has been the US-China trade negotiations. Threats of further escalation and additional tariffs appear to have dissipated, with Phase One of a trade deal expected to be signed by mid-January. US monetary policy continued to ease during the quarter, whilst domestically a conclusive win for the UK Conservative Party in the December General Election was received favourably by both UK markets and Sterling. Overall, global equities delivered a total return of 1.4% in sterling terms over the fourth quarter, topping off a positive year for investors in which equity markets produced a total return of 22.8%, materially better than expectations.

The UK political environment dominated the quarter, with Boris Johnson's Conservative Party triumphing in December's General Election. While pollsters had correctly predicted a victory for the Conservatives, most had not anticipated the Party would win the largest majority since Margaret Thatcher's victory in 1987. The removal of uncertainty was positive for UK equity markets, with those companies facing potential nationalisation threat experiencing a particularly strong relief rally. The FTSE 250 Mid-Caps and the FTSE Small Caps Index delivered 10.4% and 9.7% quarterly returns respectively, eclipsing the more internationally-exposed FTSE 100 Index which gained 2.7% in the quarter (all measured on a total return basis). In FX markets, Sterling rose strongly against all major currencies appreciating by 5.6% on a trade-weighted basis over the course of the quarter. The new Government's first priority will be to take the UK out of the European Union (EU) by 31 January 2020, and the announcement there would be no extension to the Brexit transition period post end 2020 provided a timely reality check.

In the US, economic growth remained solid, as data confirmed that the economy expanded by 2.1% (on an annualised basis) in the third quarter of the year. This was better than anticipated and stronger than in Q2. While we await for the growth data for the fourth quarter, the unemployment data released in early December showed that joblessness declined to 3.5%, its lowest point since 1969. Forward-looking data such as the purchasing managers' indices, which survey the manufacturing and services sectors, continues to indicate modest expansion in the US economy. Despite the solid footing, the Federal Reserve cut interest rates once in the quarter to provide insurance against a growth slowdown, before indicating that "the current stance of monetary policy is appropriate." Buoyed by these developments as well as fading geopolitical uncertainty following the aforementioned Phase One trade deal announcement, US equities discounted the ongoing developments surrounding the impeachment of President Trump and delivered robust gains.

The Eurozone economy showed some signs of stabilisation, with the composite purchasing managers' index (PMI) coming in unchanged at 50.6 in December, marginally above the threshold 50 level that indicates weak that separates expansion from contraction. The open economies of the region should be beneficiaries of any thawing in the US-China trade negotiations, with the exporting component of Germany's economy likely to rebound. This may be short-lived should the US Trade Representative Lighthizer turn his attention from China to Transatlantic trade. Headwinds arising from such discussions would be untimely, and further underlines Mario Draghi's calls for increased fiscal spending. For his successor Christine Lagarde, navigating these challenges is likely to need more than the regurgitated QE, with fiscal stimulus a key feature in Lagarde's inaugural speech.

In Asia, the key development was again the progress in US-China trade negotiations. From a trade and tariff perspective, Phase One is expected to see a halving of the tariffs placed in September on $120 billion of Chinese goods, although the 25% tariffs on $250 billion of Chinese goods is expected to remain in place until future phases. Asia and emerging markets were also supported from a weaker US dollar. Taiwan was a key outperformer, rising 11% in local terms, due to the high technology weighting, supported by positive earnings updates. In contrast, Hong Kong continues to experience fallout from the ongoing political demonstrations with tourist arrivals falling 56% year on year, approaching the 60% decline experienced during the SARS crisis in Apr-May 2003.

In Japan, equity markets posted an 8.6% total return in local terms as investor sentiment towards trade improved and the Yen, the risk-off proxy, weakened. The much delayed consumption tax hike (from 8% to 10%) took place on 1st October, easing Government funding ahead of a significantly large fiscal budget for 2020. Despite hosting world-class exporters, Japan had mirrored other domestic economies with divergence between a resilient service sector offsetting an ailing manufacturing sector. However, while December Manufacturing PMI remained weak at 48.4, Services PMI fell to 49.4 from 50.6, the lowest reading since 2016. The ¥100+ trillion budget, certainly needs to achieve "both economic regeneration and fiscal consolidation" as a matter of priority.

## Performance & Activity

The Amity International Fund returned 2.2% in Sterling terms, outperforming the FTSE World return of 1.4% and finishing second quartile for the period. Unlike the previous quarter, style reverted to the long-run trend with value stocks underperforming growth by 2.15%, taking the full year underperformance of value to 11.1% in GBP terms. As highlighted previously, over longer time frames, growth equities have delivered a total return of 352% compared to their value peers of 226% since the end of 2008 and Global Financial Crisis, a reflection of prolonged unconventional monetary policy and an uncertain economic growth trajectory.

The fund mitigated this headwind through positive regional allocation and stock selection. Over the quarter, the strongest region was the UK, rising 2.8%, where the removal of nationalisation threat drove our utility and telecom holdings significantly higher, contributing to an 8.5% return from our UK holdings. Asia ex Japan, another undervalued region, was the second best performing region, rising 2.7%, with our holdings outperforming by 1%. The political unrest in Hong Kong was the primary headwind for Dah Sing Bank which fell around 7% over the quarter. The bank appears very attractively valued, well capitalised, and liquid with a highly prudent loan book. Japan continued to provide the fund with outperformance, with our holdings rising 4% against the benchmark's 0.25%. The outperformance was driven by similar holdings to prior quarter, with Sony and Horiba, the global leader in emission testing and environmental solutions, continuing to perform well, rising 16.6% and 17.5% respectively over the quarter. The underweight allocation to the US was largely neutral from a return perspective, as the US performed in line with the broader global index, however adjusting for the weaker dollar, the currency effect was a material positive contributing 1.1% at fund level. Finally, the overweight allocation to Europe remained a detrimental factor in Q4 with Europe underperforming by c.1% in Sterling terms, as a weaker Euro acted as a drag. From an overall currency perspective, the drag experienced in Q3 reversed resulting in a positive contribution for the half.

In terms of sector allocation, the top performers were two of the fund's core overweight allocations. Technology and Healthcare rose over 6%. Meanwhile, our long-standing underweight allocations to consumer services, consumer goods and zero-exposure oil & gas were positive, with these industries registering negative total returns during the quarter. Stock selection within both consumer sectors was significantly positive, while the fund's largest overweight sector allocation, to industrials, benefited from superior stock selection. There was minimal negative contribution from adverse sector allocation over the period, with the primary source of detraction coming from stock selection in Technology, Healthcare and Materials.

In terms of individual stocks, the strongest positive contributor was Bingo, the Australian waste recycling leader, which rallied c.25% after reporting a strong outlook for 2020, driven by improved operating performance spurred by the acquisition of DADI. The update reflects impressive strategic execution, driving the stock up over 130% since we materially added to our holding following February's unexpected macro-influenced warning and resulting 40% correction. Tarena, the China based vocational educator, rebounded 81% over the quarter as signs that the management team have had some success addressing their recent operational challenges. Other key contributors included Vaisala, the Finnish meteorological testing company, which rose 21%, following strong earnings. Asia-orientated holdings were key contributors over the quarter with TSMC (+18%), Prudential (+14%), and Hi-P (+30%) stand outs. In terms of negative stock contribution, Nokia was the largest single detractor, as the company announced significant investment into next generation 5G to improve their proposition, prompting a significant correction in the share price. French Telco, Orange, fell 11%, following a disappointing investor day guiding to below consensus EBITDA growth over the medium term. Completing the network and telephony weakness over the quarter was Cisco, with the company cutting guidance on the basis of slower demand caused by the myriad of political uncertainties globally.

In terms of fund activity, we switched our exposure within the global packaging sector, initiating two investments in Greatview Aseptic and DS Smith, funded by the sale of Smurfit Kappa. Based in China, Greatview Aseptic is the world's third largest supplier of aseptic packaging, seeking to make liquid foods safe for consumption over extended periods. Valuation appears attractive trading on 11x FY19 earnings with a dividend yield of c.7.5%. DS Smith, is developing innovative sustainable packaging solutions, in order to reduce plastic waste through smarter design incorporating greater circularity. Examples include their recent "dropbox" initiative with Costa, aiming to reduce the one billion disposable cups used in the UK. Over the quarter, we added to our position in smart-irrigation leader Valmont Industries. Elsewhere, we reduced our exposure to German reinsurer Talanx, and exited our holding in the Japanese engineering collective, Technopro, at the end of the year due to an extended valuation.

## Outlook

The wall of worry that was built over trade war concerns, Brexit and other broader geopolitical risks led to substantial total returns, in excess of 20%, as markets priced out these tail risks. 2020 expectations dictate more muted gains in equity markets, with a continued preference for risk assets over bonds given the anaemic yields on offer coupled with expectations that global economy remains resilient.

The US-China trade war remains the key short-term variable, with positive sentiment towards an initial resolution tempered by the specifics of the Phase One deal. Future negotiations are likely to be harder to secure, given the enforcement challenges around issues such forced tech transfers and intellectual property protection. One potential scenario is that the US Trade Representative turns attention towards Transatlantic trade, as a defensive measure to counter a European digital tax on US tech leaders. Timing and nature of tariffs on European goods needs to be monitored given the fragile nature of European economy. Overall, policy action from the US may end up being relatively muted given the election year. Expectations for fiscal stimulus should be deferred until post November, while the Fed is expected to have a more muted role setting a high bar for any future interest rate hike, despite signs US economic data looks to be improving.

Domestically, focus in the short-term is Brexit and the ability to negotiate palatable terms within a very finite time period. Any meaningful probability that the UK trades with the EU on WTO rules in January 2021 would impact Sterling and UK growth. That said the UK's risk-reward looks skewed to the upside given the substantial valuation discount relative to global equities, the extent of under-weighting in a global context, and undervalued currency on a long-run PPP basis. The mini post-election rally was testimony to how markets struggle to price uncertainty. In Europe, the change in leadership at the ECB yielded a consistent message, with Lagarde's first speech reiterating the need for fiscal stimulus from member states, reflecting the limitations of unconventional monetary policy. However, fiscal stimulus has a high bar given the over-arching EU budgetary constraints and lack of willingness from leading economies namely Germany.

For Asian economies, the headwinds of 2019 look to be abating. Despite a slowing quantum, China is unlikely to reverse the deleveraging trend in favour of repeating the large-scale stimulus of the past. Targeted stimulus coupled with ongoing supply-side structural reforms should be viewed positively. The key risks to the China outlook remain persistent tariffs, a co-ordinated global manufacturing contraction and the reversal of globalisation. The deterioration in the services PMI in Japan is concerning given the recent consumption tax introduction. With both PMIs indicating contraction, the outlook remains cautious in the short-term. We continue to adhere to our bottom-up, stock-picking process, searching for sustainable and responsible companies with strong cash flows, robust balance sheets and healthy long-term growth outlooks, which have temporarily fallen out of favour with markets and are therefore trading on attractive relative valuations.

## Further Information

To obtain further information please speak to your normal EdenTree representative, visitor call our support team on 0800 011 3821.

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