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Amity International Fund – Q3 2019 Commentary

Quarter to end September 2019

Performance

	3 Months	6 Months	1 Year	3 Years	5 Years	10 Years
Fund Performance (B Class)	1.81%	9.87%	3.14%	25.57%	44.22%	121.93%
FTSE World TR GBP	3.78%	10.56%	7.93%	42.22%	88.10%	210.56%
IA Global	2.36%	8.96%	5.84%	35.72%	69.53%	154.55%
Sector Quartile	3	2	3	4	4	4

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

Review

Global equity markets were particularly mixed in the third quarter of 2019, with modest gains overall, effectively consolidating what has already been a strong year for risk assets. Following on from weakening second quarter trends, economic data continued to indicate a downside. The two rapidly priced-in US rate cuts were implemented by the Federal Reserve in July and September due to "uncertainties regarding the path of the economy". Manufacturing and industrial data continues to disappoint with consensus attributing the US – China trade dispute as an additive factor to an already deteriorating outlook.

Against this backdrop of negative calibration, markets performed relatively well, supported by the usual cast of central bankers, led by the Federal Reserve (Fed) and European Central Bank (ECB). In addition to the aforementioned Fed easing policy, the ECB cut interest rates further into negative territory, with Draghi announcing the restarting of quantitative easing in the form of asset purchases until inflation reaches target. Increasing comment from the ECB around the need for fiscal stimulus from member states illustrates the limitations and efficacy of such unconventional monetary policy. Economic data and leading indicators during the quarter illustrate the challenges as Eurozone activity expanded only 0.2% in Q2, with the traditional engine of growth, Germany, suffering particularly given its open, trade orientated export economy.

US equities significantly outperformed all regions except Japan, rising just under 5% in GBP terms, despite growth concerns and a mixed message from the Fed regarding a mid-cycle adjustment, rather than the beginning of an easing cycle. August saw an inverted yield curve (2yr-10yr), sparking debate regarding the merit of its recessionary signalling power. The political environment remained turbulent with increasing speculation the Democrats would begin impeachment proceedings for President Trump in the run up to the 2020 election. Economic data signalled a growth slowdown rather than any sign of recession although consumer confidence, seen as the key leg of support for the US economy, showed signs of weakness.

Japan was the top performing region rising 6.6% in GBP terms against a backdrop of relatively stable $/Yen. While the Upper House elections in July were won comfortably by Prime Minister Abe's party, the Liberal Democratic Party fell short of the two-thirds majority required to push through the constitutional reform agenda. The much delayed consumption tax hike from 8% to 10% was confirmed for 1st October.

In the rest of Asia, markets recorded negative returns in aggregate, driven by Hong Kong as ongoing demonstrations continued to impact the economy through lower mainland visitation and substantially weaker retail sales. China remains a mixed picture, with trade tariffs continuing to dominate sentiment, with the US announcing new tariffs on $300 billion of goods, effective from September. Taiwan was the key outlier in the region rising 8.8% in GBP terms, with strong tech bellwether stocks such as TSMC leading the index higher.

The UK was the second worst performing region, rising 1% in GBP terms, reflecting the uncertainty which as usual plays out in currency weakness. Ongoing political uncertainty is evident in underlying economic growth with second quarter GDP contracting 0.2%, paving the way for a technical recession to follow this quarter. The range of scenarios ahead of October 31st remain varied despite an increasing likelihood of a more volatile outcome.

Performance & Activity

The Amity International Fund returned 1.81% in Sterling terms, underperforming the FTSE World return of 3.78% and finishing third quartile for the period. In a quarter where value stocks saw the biggest positive short-term rotation

since the Global Financial crisis, value ended the quarter with almost identical returns to those of growth. So far in 2019, growth equities continue to dominate their value counterparts, outperforming by 8.25% in GBP terms. Over longer time frames, growth equities have delivered a total return of 330% compared to their value peers of 224% since the end of 2008 and Global Financial Crisis, a reflection of prolonged unconventional monetary policy and an uncertain economic growth trajectory.

In terms of regional attribution, Japan was the strongest region over the quarter rising 6.6%, while the fund's holdings delivered 8.3% driven by Sony, which rose 15.9% and Horiba, the global leader in emission testing and environmental solutions. The United States was the second best performing region up 4.9% with the fund's holdings outperforming modestly, returning 5.3%. While our underweighting to the US has moderated over the last twelve months from around 30% underweight to 23% underweight, the lack of allocation offset the outperformance resulting in around a 1% headwind. The fund's overweight allocation to Europe was also a detrimental factor, with Europe returning only 1.7% during the quarter. A similar experience was felt in the UK, however the impact on us was less than 0.25% due to our lower allocation. At an aggregate portfolio level, currency moves effectively accounted for around 75% of the underperformance, mostly attributable to depreciation of sterling versus US dollar.

In terms of sectors, Financials reversed their second quarter performance, producing the second worst sector returns for the fund in Q3 as the reality of slowing economic growth implied further monetary policy induced earnings pressure would be coming. The fund's reduced exposure to banking helped offset some of the headwinds experienced, particularly in Asia. Our Basic Materials holdings performed worst during the third quarter reflecting deteriorating global cyclical outlook. The fund's modest exposure to bond proxies, namely Utilities and Consumer staples was a headwind, with the Utilities sector delivering a return of 8.5%, while Household goods and food & drug retailers returned 12% and 10% respectively, as investors sought safe havens and reflected the increasingly negative yielding bond market.

In terms of individual stocks, the strongest positive contributor was US cardiac and diabetes device maker, Medtronic, which rose 16.4% over the period following strong results and new product launches. Overall, we view the medical technology as offering efficiency solutions for globally under-pressure health budgeting, and less at risk ahead of 2020 US elections. Another strong US performer, rising 27%, was recently added Federal Signal, which provides emergency communication systems, environmental cleaning equipment and safe digging solutions for municipal infrastructure market. Other key contributors in US included water infrastructure provider Mueller Water Products (+19%), Alphabet (+17%) and NXP Semiconductors (+16%). In terms of negative contributors, local lender Dah Sing Bank, and Prudential, fell 22% and 13% respectively, as markets reflected the disruption from demonstrations and social unrest in Hong Kong. In Sweden, smart packaging solutions provider BillerudKorsnäs fell 15% due to slower ramp-up of their highly efficient KM7 board machine in Gruvon.

In terms of fund activity, following ongoing company engagement we established a new holding in Valmont Industries, the market leader in efficient agriculture irrigation solutions, coatings and power distribution structures. Additionally in the US we invested in medical device maker Zimmer Biomet on signs of improving operational execution following prolonged underperformance. We trimmed our holding in peer Medtronic, following strong performance. Earlier in the quarter, we reduced our exposure to Asian banks, specifically in Singapore following resilient performance, in addition to divesting from HSBC due to diminishing conviction in the investment case. More recent fund activity has focussed in Japan and Europe where we reduced both Sony and Horiba following strong performance. In Europe, similar profit taking took place in Talanx and Autoliv, with the proceeds reinvested in Swedish smart packaging solutions provider BillerudKorsnäs given the transient nature of their ramp-up delay.

Outlook

The final quarter of 2019 sees event risk centred on the nature of the UK's exit from the European Union at the end of October. Additional scenarios resulting in further delays would be predicated on an immediate parliamentary election, acting almost as a confirmatory proxy of the outcome in 2016. Expectations remain for Sterling to be the initial buffer for markets, to reflect a no-deal or a more managed scenario. Overall, we remain overweight UK equities, which continue to look undervalued and subject to significant under-weighting by global asset allocators. With Sterling trading significantly below long-run purchasing power parity, UK equities long-term appear to offer a positive asymmetric risk/reward, notwithstanding the short-term event risk.

Outside of the domestic agenda, in the US there is increasing pressure from Republicans for the Trump Administration to reach a compromise with China around trade, sufficiently far enough ahead of the November 2020 Presidential elections to reverse the trend of deteriorating economic data. A stop-gap solution looks the most likely short term option, with both parties significantly away from an agreement on intellectual property and forced technology transfers. China's additional distraction comes from ongoing demonstrations in Hong Kong, which have

persisted longer than expected, with potentially permanent impairment to the economy's status as a financial centre and luxury shopping destination.

Closer to home in Europe, the increasing rhetoric from the ECB around the need for fiscal stimulus from member states illustrates the limitations of such unconventional monetary policy. More broadly, we remain concerned regarding the underlying efficacy of negative interest rate policies. An over-reliance on central bank policy remains unhealthy in the long-term, given the resulting inequality permeates to capital allocators and asset owners, with a continued lack of participation within the broader economy. A co-ordinated pivot to more productive stimulus with a greater multiplier effect remains elusive. For central banks, there remains an acute challenge to assess the impact of inconsistently variable trade policy and set an appropriate monetary response. Corporate earnings season will be a key barometer of how much trade tensions are impacting, particularly given many companies have maintained full year guidance predicated on a stronger second half. As ever, we continue to invest responsibly in well-managed companies with robust fundamentals at attractive valuations, capable of weathering the ongoing volatile environment.

Further Information

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