Talaria Global Equity Fund Currency Hedged (Managed Fund)

Quarterly Update September 2024

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Signatory of:

Investment Insights

It is easy to say that economies and markets are cyclical, but pinpointing their exact stage and gauging their amplitude can be challenging. For instance, while there appears to be less of a debate around timing, there is still considerable discussion about the amplitude of the current economic cycle. Some believe any slowdown will be shallow, whereas others anticipate a more pronounced range from peak to trough.

We are sceptical of forecasts, and we have said before that rather than seeking a definitive answer, rather than coming down hard on one side of a debate, we are trying to construct a probabilistic framework. It is in this spirit that we share observations relating to past cycles, that we believe help with judging the odds and probabilities that investors face today.

Among other things, what we find is that certain risks are probably underestimated. For example, with absolute prices still high but inflation slowing and unemployment rising we are likely to see a period of weakening corporate earnings that is at odds with the optimism in numbers. Consensus forecasts are for S&P 500 earnings per share to be 312 in 2026, 44% higher than 2023 earnings per share.

Whilst there is no playbook to guarantee good outcomes, we also find that there are certain factors and sectors that generally do better or worse after the first cut in official interest rates. In this context, the recent change in market leadership makes sense. Although the performance picture is complicated, investors have certainly rotated towards stability - utility companies have strongly outperformed every other sector since April 2024.

Before exploring these risks further, it is also worth recapping the well-known phases of a typical cycle, beginning with phase one's economic expansion from a growth trough, usually marked by rising asset prices in anticipation of improving corporate profits and by relatively loose monetary conditions. During this phase, the market rally is broad-based with most equities moving higher driven by multiple expansion.

The second phase is marked by the economy growing and asset prices rising driven predominantly by the reality of growing corporate profits. Interest rates are typically rising in this phase.

The third phase follows when interest rate expectations and GDP growth peak. As GDP growth starts to slow, assets perceived as having structural growth become relatively more valuable. Investors are willing to pay a premium to own companies that are thought to be insulated from slowing cyclical growth. Market leadership narrows and becomes concentrated in fewer names.

The first interest rate cut typically signals the start of the fourth phase of the economic cycle, often bringing a shift in market leadership. This is also the point where growth traps are most likely to occur. While growth traps have a lower profile than value traps, they are equally valid and significant.

The concept hinges on the idea that some companies can deliver growth well above GDP and the market average, yet still have shares that disappoint. This is because the expectations embedded in their initial valuations are too high. What proves, in hindsight, to be over-optimistic expectations have been mis-calibrated due to an underestimation of the cyclicality that impacts nearly all companies.

Each market cycle is driven by a different structural growth theme that tends to be resilient. The potential danger for investors at the current point of the cycle is in continuing to chase today's theme even as the market environment changes.

The financial industry exacerbates this risk as it is heavily invested in the broadest sense of that word. It can keep pushing these structural growth trades well into the fourth stage, whether through sincere belief or from extrapolating recent performance, couching the rationale in what has seemingly become self-evident to all market participants. The industry is further incentivised by the high volumes and commissions that trades around this theme generate. Often it takes a significant drawdown or even a crisis to put an end to all this.

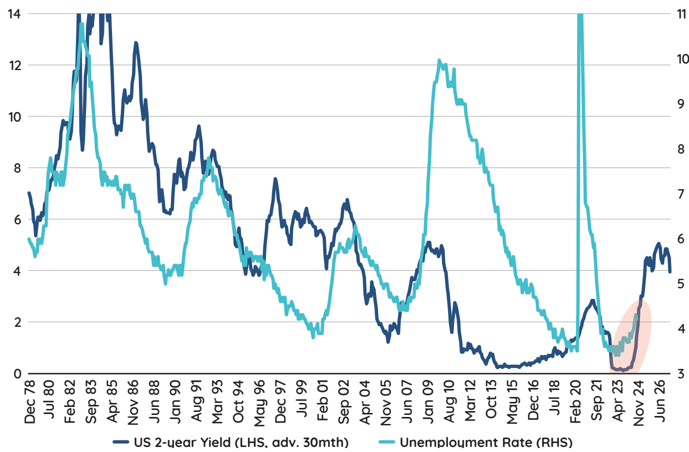
Unemployment matters

In terms of identifying the stage and likely amplitude of the current cycle, unemployment is a key indicator. More precisely and for obvious reasons, US unemployment trends are significant.

A weakening labour market matters because, as we have seen in the past, it can trigger a cycle of falling consumer confidence that in turn leads to lower spending, hurting corporate revenues. Lower revenues can lead to more layoffs as companies try to protect profits and so on until the economy tips into a recession. The US is at particular risk since its consumption-driven economy, where consumption accounts for about 70% of GDP, is highly sensitive to rising unemployment.

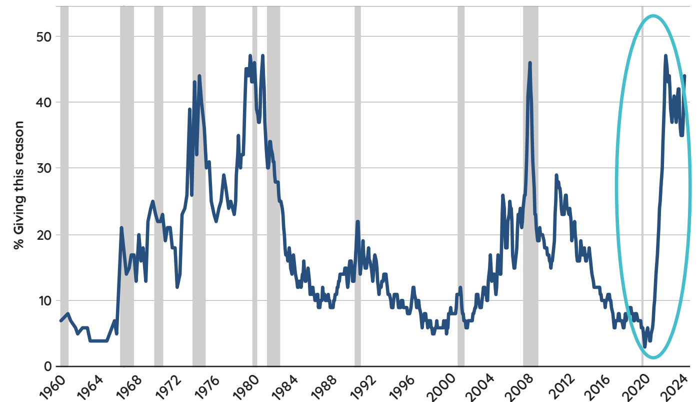
The monetary tightening initiated by the Fed in March 2022 is clearly having a negative effect on US employment today. The chart below shows the strong relationship between US two-year yields, advanced 30 months, and unemployment. If this relationship continues to hold, unemployment is likely to rise further.

Other metrics that measure the health of labour markets may also raise concerns. The quits rate has hit a new cycle low of 1.9% - people are reluctant to leave their jobs because it is hard to get another one. The Conference Board's Jobs Hard minus Jobs Easy survey has hooked up and suggests a further increase in unemployment.



Source: Federal Reserve Bank of St. Louis

Univerisity of Michigan Survey of Consumers:



Source: University of Michigan

In terms of gauging the risk, when US unemployment has increased by 0.6% from a cycle low, a recession has followed – without exception. This pattern has held true in all 12 US recessions since World War II. In the current cycle, the unemployment rate has already risen by 0.7%, reaching 4.1% in September 2024.

High prices and low inflation offer a problematic combination

Inflation, the rate of change in prices, is clearly slowing across developed markets. Core inflation in the US, which excludes volatile food and energy prices, was up just 3.2% year-on-year in August, the lowest since April of 2021.

Inflation expectations are down as well. The US 5-year breakeven inflation rate, a proxy for expected inflation, is just 1.94%, down from 3.57% at its peak in 2022. This is a whisker under the 2% Fed inflation target. Other developed economies are experiencing similar moderation in inflation expectations. This seems to be taken as purely good news, but the picture is more complex.

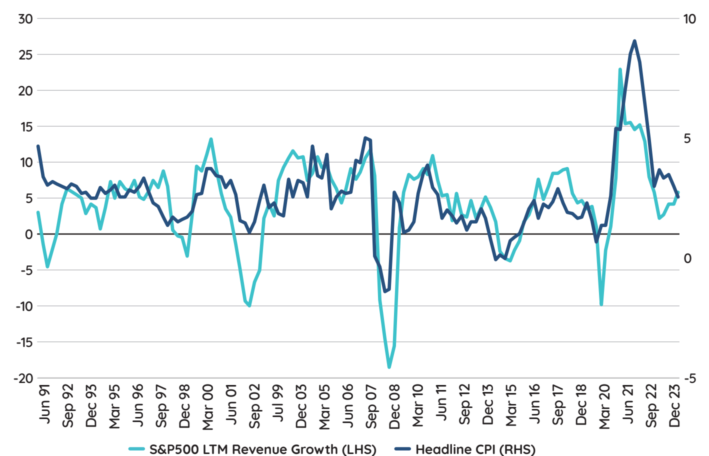
While the pace of inflation has indeed slowed, the absolute price level remains high and burdensome, especially for essential, non-discretionary purchases. Prices in the US are up over 20% in aggregate since the start of COVID.

Consumers are hurting. Responses to the University of Michigan's survey on "Higher Prices As Reasons For Worse Personal Finances" rose again in July to near 50%, returning to the peak levels seen when headline CPI was at 9.1% back in 2022 (see chart).

One of the reasons inflation matters is because it is positively correlated with nominal corporate revenue growth, given revenue is simply units times price.

Since inflation is in part a measure of the change in prices corporates charge, it should not come as a surprise that when inflation falls, corporate price growth also falls. At the same time, the punitive absolute price level is hurting real consumption, suppressing volume growth and further clouding the revenue outlook for US corporates.

The relationship is evident in the chart below. High inflation accelerated nominal revenue growth for S&P 500 companies in the years after COVID. Lower inflation is having the opposite effect today.



Source: Bloomberg

Corporate earnings appear set to disappoint

Against the unemployment and inflation backdrop, it may be a surprise that consensus forecasts are for S&P 500 earnings per share to be 312 in 2026. This is 44% higher than 2023 earnings per share. We can think about the likelihood of these forecasts materialising in two ways, bottom-up and top-down.

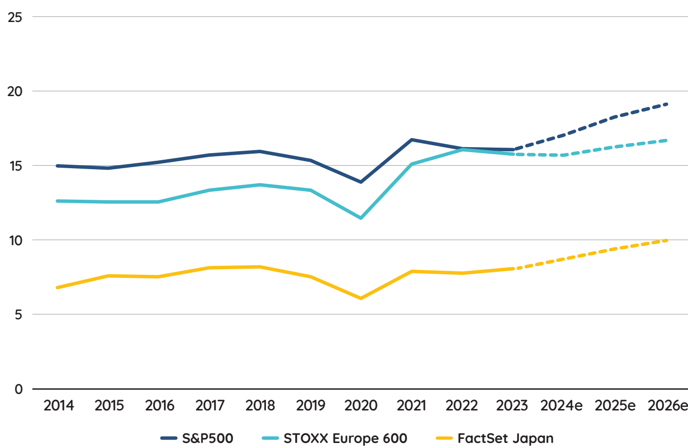
Bottom-up

Mathematically, four things drive earnings higher – revenue growth, EBIT margin expansion, lower interest expense and lower tax. It shouldn't be controversial to assume that there are neither head nor tailwinds from interest or tax, in which case 2026 earnings growth relies entirely on the remaining two drivers.

Revenues are estimated to grow 18% by 2026, or around 6% per annum. This compares to 3% growth in 2023. We have already argued that a re-acceleration in revenue growth would be difficult when inflation is trending lower and the consumer is hurting from the absolute price level.

The optimism surrounding EBIT margin expansion is even greater. Consensus forecasts are for the margin for S&P500 companies to expand from an already elevated 16.1% in 2023 to an all-time high of 19.1% in 2026, 300 basis points higher. Such expansion is estimated to contribute 22% over the three-year period to earnings growth, or 7% per annum. Because growing revenues are amplified by expanding margins, earnings per share grow even faster than the simple sum: (1+18%)*(1+22%)=(1+44%).

Optimism on margins is not isolated to the US alone. Other developed regions are seeing similar trends. In the chart below we look at EBIT margins across the US, Europe and Japan. All three finished 2023 with margins near historic highs and in all three forecasts are for margins to hit all-time highs by 2026.



Source: Factset

The optimism is not isolated to a particular sector either. In our June 2024 quarterly report, we showed that every sector except utilities is estimated to see margins expand over the next two years.

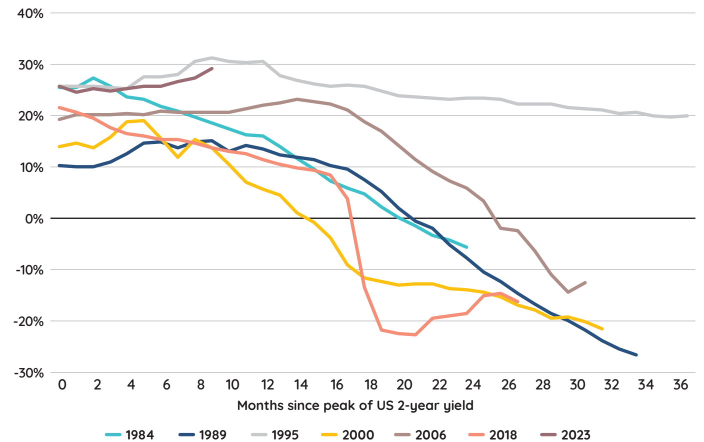
Top-down

Earnings disappointment seems odds on from a top-down perspective, too.

It is very normal for earnings growth estimates to be elevated at the peak of two-year US bond yields. This has been the case every single time since consensus figures came into existence in the mid-1980s.

The seven coloured lines in the chart below show the progression of consensus estimates for two-year growth in S&P500 earnings per share following the peak in two-year US bond yields, month zero. At that point, earnings were forecast to grow by between 10% and 25% in the first full forward two-year period in all seven cases.

Fast forward 30 months and reality painted a different picture. In five out of six completed instances the actual two-year growth in earnings turned out to be negative. On average, the actual two-year forward earnings per share ended 28% lower than the initial consensus forecast. The only time that two-year forward earnings did not see significant downgrades but grew in line with the initial estimates was the 1995 soft landing (see blue box for details on why the 1995 backdrop was very different to the backdrop today).



Source: Piper Sandler

The 1995 soft landing that propelled the S&P500 higher was different to today in three important ways.

First, the labour market was booming in 1994/95. Unemployment had decreased from 7% in 1993 to 5% in 1995, and was still falling. Today, unemployment has already troughed and is rising.

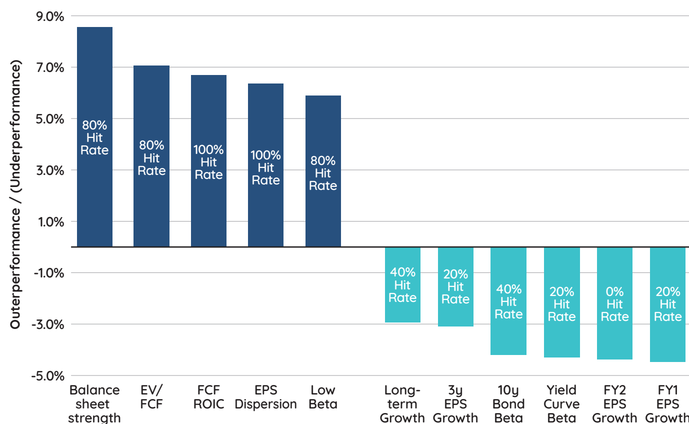
Second, monetary policy is far tighter today than it was in 1995. The yield curve never inverted back then. It has been inverted since 2022 in the current cycle.

Third, the Conference Board Leading Economic Indicators index posted precisely one month of very modestly negative year-on-year growth in January 1996. In the current cycle, the index has been in negative year-over-year territory since mid-2022.

In the past, when the Fed cuts rates, growth underperforms; stability outperforms

Whatever the earnings outcome, history suggests that what performs well after the first Fed rate cut is different from what did well before.

The chart below shows that four of the six worst performing factors in the 12 months following a rate cut are growth related. The average underperformance for these factors in the five cycles we looked at was between 3% and 4%. What is interesting is not only the absolute underperformance, but that the hit rate is very low in every instance (a hit rate of 0% means that the factor underperformed in all five instances).



Source: Talaria, Société Générale

Conversely, factors that perform best centre around stability. Since an easing monetary cycle typically coincides with a weak economy and declining corporate earnings, factors like balance sheet strength, high cash flow and low earnings variability become very important. The outperformance for such factors is typically between 6% and 8%, with a hit rate of 80%-100%.

The final piece of quantitative work we did was to look at which sectors consistently outperform in a Fed easing cycle. It should not come as a surprise, given the factors discussion, that Healthcare and Staples came on top of the list. Companies in these sectors epitomise stability. In every easing cycle since 1990, Healthcare and Staples have outperformed on average by nearly 1100 and 900 basis points, respectively.

Conclusion

As we have mentioned in this and other reports, rather than trying to predict the future, we find it more effective to apply a probabilistic framework to identify where the greatest risks to global equities lie, whether to the upside or the downside.

We have demonstrated that the balance of probabilities indicates earnings estimates in the US are overly optimistic. Historically, this phase of the cycle, characterized by falling interest rates and rising unemployment, tends to coincide with weakening corporate profits. Moreover, lower inflation often translates into reduced revenue growth for companies. Amongst other things, this increases the likelihood of growth traps.

Given this backdrop, we have also analysed which factors tend to perform better or worse after the initial rate cut. Thinking in terms of odds and probabilities means accepting that anything can happen. Nevertheless, our work suggests that risk management and rotation towards stability remain key considerations for investors.

September 2024 Quarterly Performance

The third quarter was a busy one for global equities. Most regional indices ended near all-time highs with a considerable increase in volatility. The macro environment continued to worsen in most regions, but markets were buoyed by a rate cut in the US and fiscal stimulus plans in China. Market leadership shifted away from big tech while market breadth widened. Small cap outperformed.

Against a complex backdrop there was a notable spike in market volatility. US unemployment hit a cycle high in July and remained elevated at the end of the quarter. Inflation softened, paving the way for the first Fed rate cut this cycle. We also saw two assassination attempts on former President Trump and escalating tensions in the Middle East. The "yen carry-trade" selloff in Japan and the "deflationary spiral fear" selloff in China were followed by sharp rebounds. Despite the turmoil, equity markets showed resilience and mostly rose.

The US equity market was again amongst the best performing globally but with a notable shift in leadership. Mega-cap tech underperformed (the tech-heavy NASDAQ was up just 2.6%) while small-caps outperformed (the S&P 600 small-cap index popped 9.6%). The broad-based and large-cap S&P500 ended somewhere in between, up 5.5%. European indices made relatively small gains despite signs of worsening economic prospects. The pan-European Stoxx 600 was up 2.2%, led by the German DAX, up 6% while the French CAC was up 2.1%.

In China, the Shanghai composite surged 12.4% in the quarter, reversing an earlier slump, helped by freshly announced fiscal and monetary stimulus. Japan was the only major equity market in the red, with the Nikkei down -4.2%. The index was weighed down by a very strong yen that rallied 12% versus the US dollar.

Against this backdrop the Fund delivered a return of 6.35% for the quarter.

Distributions: The Fund paid a September 2024 quarterly distribution of 5.30 cents per unit taking its 12-month income return to 10.42%.

The change in market leadership was also evident across sectors. Utilities was the best performing sector this quarter by some margin, up 16.9%, offering relative safety amidst rising uncertainty, and helped by falling interest rates. Big tech underperformed relative to the rest of the market with Tech (NVDA, AAPL, MSFT) and Communication Services (Google, Meta) up only a modest 1.4% and 2.6%, respectively. Energy was the only sector to decline, down -3.2% on the back of lower oil prices.

The long anticipated first Fed rate cut finally happened in September. The US 10-year yield fell by 62 basis points to 3.78% at the end of the quarter. Volatility rose significantly from a low of 12.4 points at the end of June to 16.7 in September. The US dollar weakened against all major currencies while the yen was particularly strong, up 12% versus the US dollar as the Bank of Japan started tightening policy. The price of oil dropped a significant -16.4% because of a change in Saudi Arabia's production strategy that meant the country will boost its production.

The top contributors to portfolio performance this quarter were pharmaceutical majors Gilead and Sanofi. Apart from better-than-expected quarterly earnings, both companies saw positive news from successful drug development trials. Another top contributor to performance was Bunzl, a global distributor headquartered in the UK. A strong earnings report and an upgrade to forward guidance boosted the shares.

The largest detractor to performance in the quarter was Pluxee, a French employee benefits provider. Concerns over more stringent regulations have seen its shares meaningfully de-rate in recent months. The stock is trading on very attractive headline multiples (~11x FY25e EPS) while the business continues to grow at a reasonable clip (Q3 24 operating revenue +11%) and remains highly cash generative. Another detractor was Subaru, a Japanese automaker. A stronger yen and weakening demand for cars globally have contributed to the decline.

This quarter the Fund initiated a new position in Randstad, a global staffing business. The shares offer an attractive risk/reward skew given its depressed valuation despite potential cyclical risks. The business has a very flexible cost base and a strong track record of managing costs. A solid balance sheet also means the business can keep funding shareholder returns (buybacks and special dividends) should P&L weakness persist. The Fund exited two positions in the quarter: NN, a Dutch insurance business, and Henry Schein, a US dental supplies distributor, both on valuation grounds.

Stock in focus: Ambev

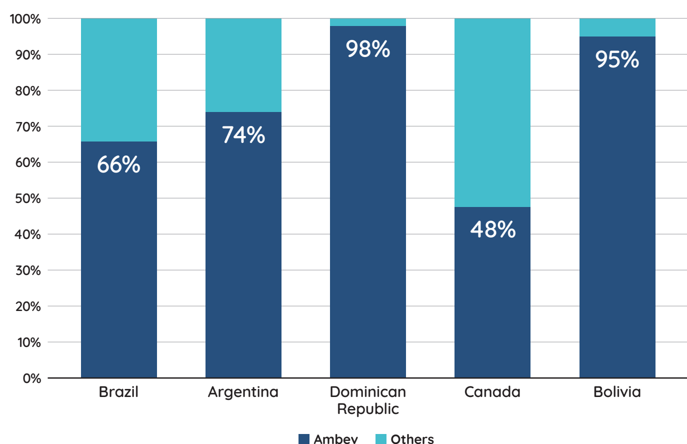
Ambev is one of the largest beer producers worldwide. It is a market leader in a highly concentrated market with attractive organic growth prospects and high levels of return on capital. The company has a safe balance sheet, generates strong cashflows, offers a high dividend yield, and is very attractively valued with a substantial upside to its current price.

Ambev is Latin America's biggest brewer. It produces and sells some of the world's most recognisable beer brands including Budweiser, Corona and Brahma. The company is headquartered in Brazil and is majority owned by Anheuser-Busch InBev (ABI).

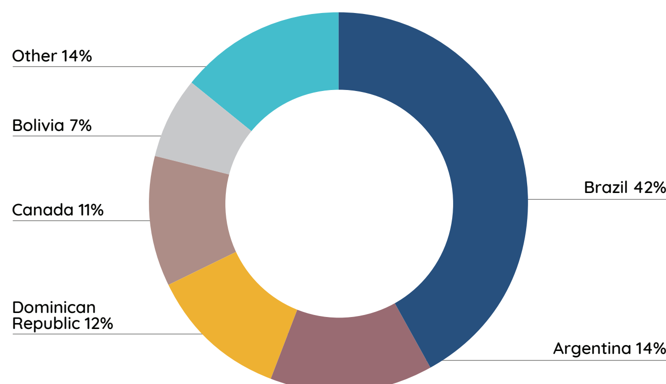
Business overview

Ambev commands a dominant market position in the five most important countries it operates in (see chart). These five collectively represent around 85% of group EBIT.

The Brazilian beer market (~42% of group EBIT) is effectively a duopoly, with Ambev controlling around 66% and Heineken 26%. In the Dominican Republic and Bolivia Ambev has close to a monopoly over beer production while it controls three quarters of Argentina's and half of Canada's.

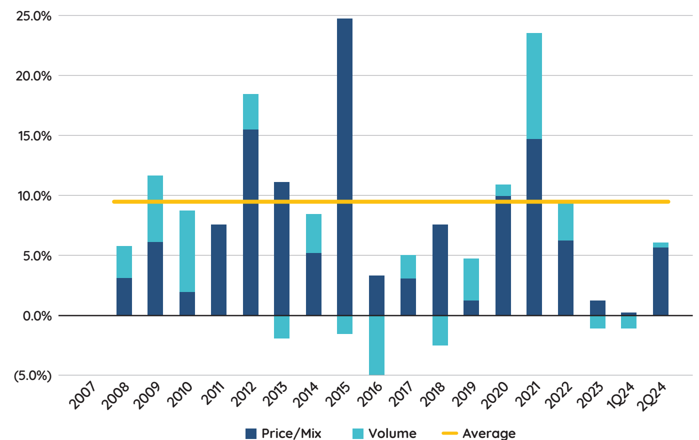


Source: Company, Bernstein



Source: Company, Bernstein

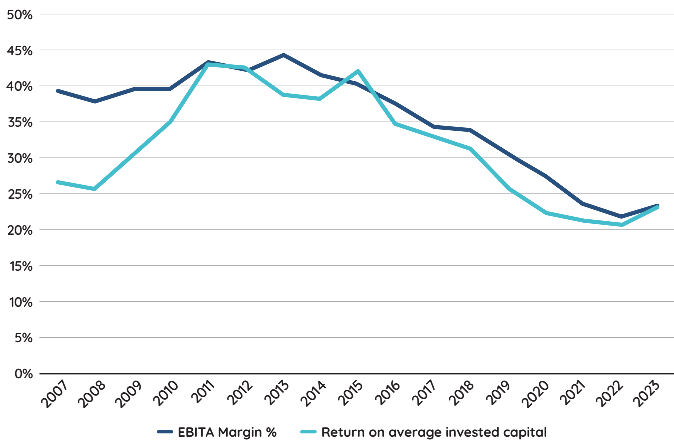
Ambev has grown its top line by an average of 9.4% since 2008. This has been predominantly driven by mix (selling a higher proportion of premium beers) and higher overall prices (~7.5% to total growth) but also by solid volumes (~2%). A recent cyclical slowdown in 2023 has bottomed out in 1Q24 and we are already seeing a rebound in growth from 2Q24 (see chart).



Source: Company

Ambev's dominant market position has historically been reflected in a very attractive operating margin and a high return on capital. The average operating margin in the 15 years prior to the COVID pandemic averaged 39% and was as high as 30% in 2019, while ROIC has averaged between 30% and 40% and was as high as 26% in 2019.

However, commodity headwinds and Brazilian currency weakness have led to a significant drop in margins and returns, particularly since 2019. The operating margin hit an all time low of 21.7% in 2022 while ROIC dropped to 20.7%. Both metrics have been improving since.



Source: Company reports

Ambev also has a very solid balance sheet and has historically generated strong cash flows. The company currently sits on a net cash position of 10.7bn reais (~ 5% of market cap) with a significant balance sheet optionality.

The business generated over 12bn reais of Free Cash Flow in 2023 (6% FCF yield) with a close to 100% cash conversion rate since 2014. Close to 90% of FCF are returned to shareholders via a dividend (current yield of ~5.5%).

Investment case in a nutshell

We estimate the fair value of Ambev shares to be around $3.6 per share by 2027, whilst being paid a healthy dividend along the way. This offers a significant upside on the price at the time of writing of $2.50. Our normalised valuation scenario is based on four main assumptions.

Firstly, we assume an organic top line growth of 4.3% over the coming 4 years. This is roughly half of the long-run average and incorporates cyclical issues in Argentina and Canada.

Secondly, we assume the operating margin will expand slightly to 24.6%, 140 bps higher than the 2023 margin. This is still significantly lower than the 30% pre-COVID margin and offers further upside should Ambev achieve efficiency gains.

Thirdly, our assumptions translate into a ROIC of 27% by 2027 and continued strong cash generation.

Finally, we assume an exit EV to IC of 3.5x translating into an equivalent EV/EBIT multiple of 13x, below both peer averages of 14x and the company long-term average of 14x.

All four components are achievable; they are in line or below historical averages and yet they imply a significant valuation upside from here.

Risks and a stress scenario

All in, we estimate a stress case valuation of $2.05 that implies Argentina is wiped out, Brazil grows at a much lower rate of 2% organic (vs 6% in our base case) and the margin in all divisions outside of Argentina falls to the 2021-22 lows, equivalent to a group margin of 19.6% and a ROIC of 20.6%. We assume an EV to IC of 2.1x that corresponds to an exit multiple of 10x EV/EBIT.

A weaker Brazilian currency is perhaps the biggest risk that is beyond the company's control. Around 50% of profits are generated in Brazilian Reals while the shares we own in the fund on behalf of our investors are the ADRs, priced in USD. However, we believe that a strong balance sheet and a very attractive valuation skew more than compensates for this risk.

Talaria Global Equity Fund - Currency Hedged (Managed Fund)

Top 10 Holdings*

Company name	% weight
Roche	5.7%
Johnson & Johnson	5.6%
Sanofi	5.5%
Wec Energy	5.0%
Gilead	5.0%
Alibaba	3.8%
Secom	3.7%
Nestle	3.6%
Henkel	3.6%
Medtronic	3.6%

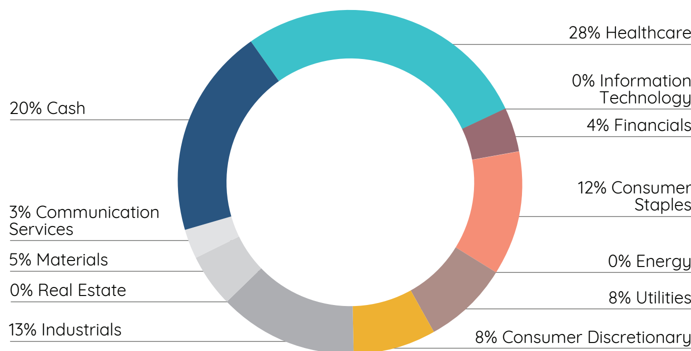
* Weightings include option positions held and cash backing put options. It assumes that put options will be exercised.

Performance at 30 September 2024

Period	Total Return	Average Market Exposure
1 month	0.04%	64%
3 months	6.35%	65%
6 months	4.98%	63%
1 year	9.28%	60%
3 years p.a.	9.39%	57%
5 years p.a.	8.55%	57%
7 years p.a.	7.45%	58%
10 years p.a.	6.66%	59%
Since Inception p.a.	7.82%	59%

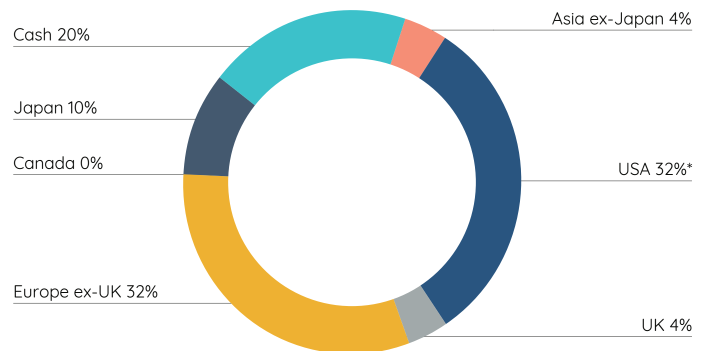
1 Fund Returns are calculated after fees and expenses and assume the reinvestment of distributions
2 Inception date for performance calculations is 31 December 2012
3 Past performance is not a reliable indicator of future performance
4 Average Market Exposure based on delta-adjusted exposure of underlying portfolio

Sector Allocation



* Weightings include option positions held and cash backing put options. It assumes that put options will be exercised.

Regional Allocation



* USA includes American Depositary Receipts (ADRs) listings.

Quarterly distribution

Period	Cents per Units	Reinvestment price
September 2024	5.300	$5.6435
June 2024	33.938	$5.6822
March 2024	8.500	$5.7704
December 2023	8.570	$5.7594
June 2023	16.8078	$5.6610
June 2022	26.444	$5.2023
March 2022	8.100	$5.5794
June 2021	33.783	$5.2060
March 2021	8.500	$5.3360

Asset allocation

Asset allocation	% weight
Global equity	65.0%
Cash – put option cover	16.0%
Cash	20.0%
Total	**100.0%**

Portfolio contributors	Portfolio detractors
Gilead	Pluxee
Alibaba	Subaru
Sanofi	Nestle
Roche	Femsa

1 Portfolio contributors and detractors are based on absolute quarterly contributions to return, including option positions

Talaria Global Equity Fund - Currency Hedged (Managed Fund)

Fund snapshot

APIR Code	WFS0547AU	**Inception Date**	31 December 2012
Management Fee	1.20% p.a. of the net asset value of the Fund plus Recoverable Expenses	**Liquidity**	Daily
Recoverable Expenses	Estimated to be 0.12% of net asset value of the Fund each Financial Year	**Exit Price**	$5.68230 (30 Sep 2024)
		Buy / Sell Spread	0.25% / 0.25%
Platform Availability	Asgard, Ausmaq, BT Wrap, BT Panorama, CFS FirstWrap, Hub24, IOOF, Linear, Macquarie, Mason Stevens, MLC Wrap, MLC Navigator, Netwealth, Powerwrap, Praemium, Grow Wrap/Voyager	**Distributions**	Quarterly
		Minimum Investment	$5,000

Important Information

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