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INVEST WITH CONFIDENCE

TAKING ADVANTAGE OF THE FEAR AND UNCERTAINTY

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Global markets are certainly showing plenty of fear and uncertainty right now, as the raging bull narrative has turned back to one of an aging and fading bull. One primary reason relates to concerns over inflation and the end of monetary stimulus. We are skeptical on the "return of inflation" narrative, despite the year-on-year rise in price data and the markets' elevated concern. Indeed, volatility around the direction of inflation and general macro concerns in markets have been offering us a chance to upgrade and improve our holdings, which is a positive by-product of this more risk-off environment.

SHOULD WE BE WORRIED ABOUT INFLATION?

Last year inflation remained unusually muted versus expectations, allowing central bank monetary policy to remain loose. This helped dial down volatility and ramp up animal spirits for the first time in almost a decade. This year, however, we have seen inflation move from a strategist by-line to a cycle-ending scenario, if you choose to believe the bears. Indeed, louder and more confident voices are articulating that wages, prices and politics (more on this later), will drive up inflation, interest rates and finally end this equity cycle.

For us, given inflation is important for sentiment and market fundamentals, we are closely analyzing not just the magnitude of inflation, but also the constituent parts of its origins. Cyclical inflation is showing itself for the first time in a while (Figure 1), but the secular debate is a crucial one in our opinion, because so many of the secular forces we see today actually sit outside the traditional economic frameworks that economists like to use.

WHY DO WE DIFFER?

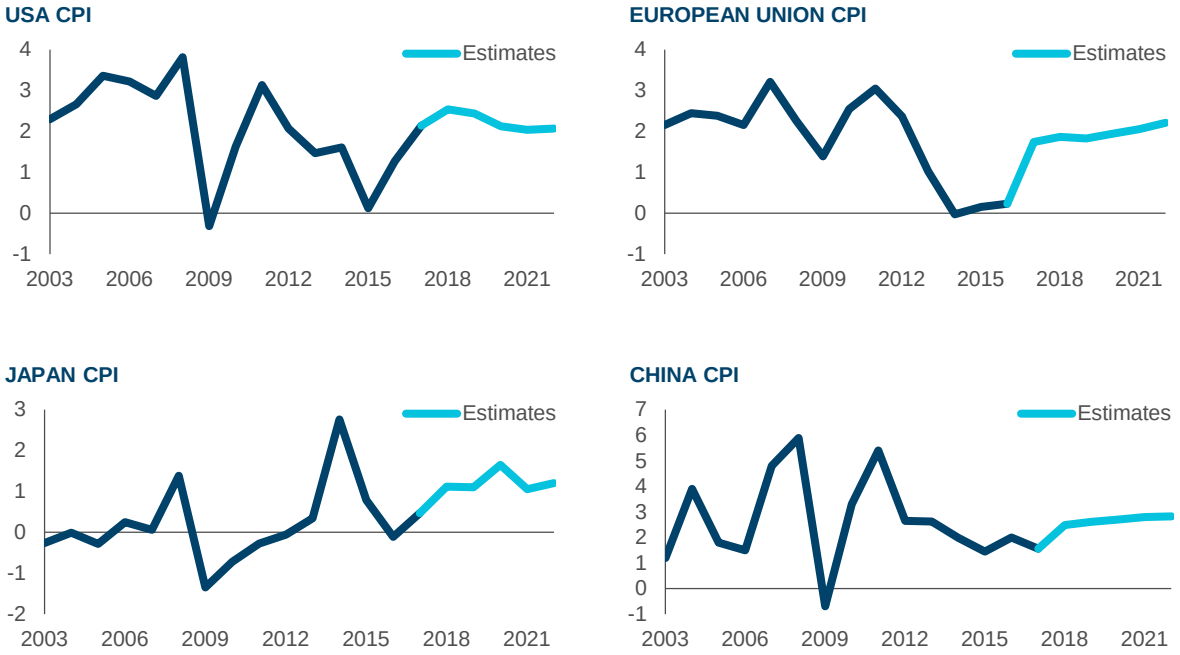
On the cyclical front, while U.S. wage growth exceeding expectations might be perceived by some as a sign that economic growth is maturing and broadening, the market's reaction to accelerating wage inflation actually tells you of investors' dislike of regime change (higher inflation and what that might imply) (Figure 2). It also implies a dislike for the prospect of higher disposable incomes, higher consumption and broader wealth creation. Unfortunately, these cyclical forces are likely to keep playing out in the near term, so volatility is likely to remain with us in the coming months for as long as the market keeps perceiving inflation as "bad."

ECHO, ECHO, ECHO…

We acknowledge that there is an echo effect playing out in inflation terms, but inflation is of course a point in time comparison that depends on the base level of a year ago. That base level was unusually low in Q1 2017 as a muted global economy and uncertainty over U.S. politics, and specifically the rules of engagement for companies, reined in spending and investment. A year on, the picture is very different as synchronized global growth, strong profits growth and clarity over taxes (lower for nearly all) have lifted sentiment and the willingness of corporates to imagine an economic outlook that implies more investment in labor and growth capital expenditure.

Figure 1: **Inflation Is Boring, Why Does It Matter?**

As of April 30, 2018

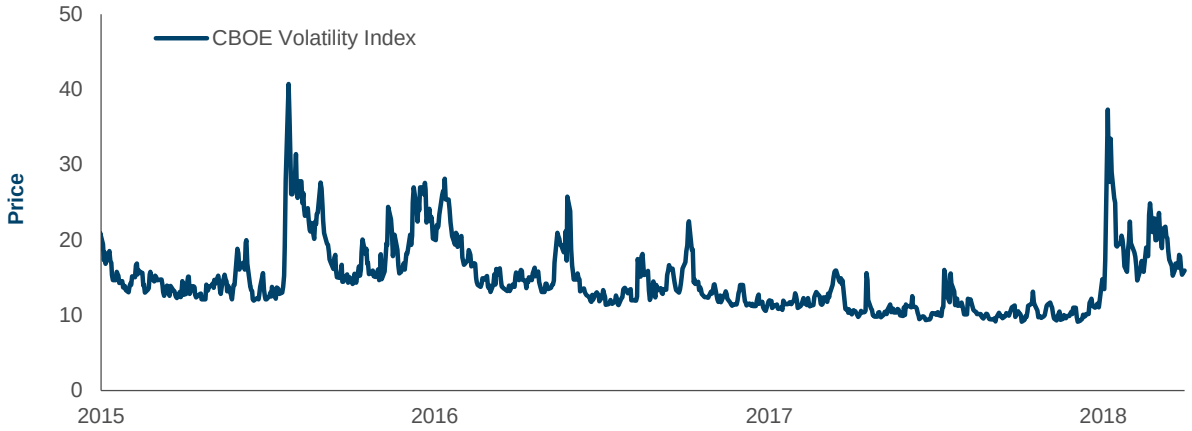


Sources: IMF World Economic Outlook and FactSet Research.

Figure 2: **Volatility and Regime Change**

Volatility returns in 2018. CBOE volatility index 2015–2018.

As of April 30, 2018



Source: FactSet.

DOES AN INFLATION ECHO TURN INTO A CRESCENDO?

As stated, the outcome of the inflation fight that will play out this year is much more complex than an economics text book would imply. Economic text books speak of the Phillips curve and how a certain level of unemployment leads to a certain level of wage inflation. While the unemployment-wage growth relationship remains cyclically

important, we see some very strong structural forces vying for superiority which are influencing inflation both negatively and positively.

Think of it this way in boxing analogy terms. Structural disinflation stands in one corner, being driven by technology (think of Amazon's impact on retail prices, Spotify's on music prices, the adoption of automation/robotics and the impact for manufacturing jobs and wages), demographics and globalization. We would also argue that the shift away from manufacturing (most notably in the United States), as well as a shift away from commodity consumption (most notably in China), should be factored into lower inflation expectations.

Meanwhile, over in the opposite corner, we have in tandem with the cyclical recovery in the U.S., economic policy which once again looks very inflationary on the surface. Tax cuts for corporates and individuals—tick, cancellation of the Iran nuclear deal pushing up oil prices—tick, trade war with China/everyone—tick. Although, we continue to believe the risk of a full blown trade war is low, it is a risk we are monitoring given this would inject "bad" inflation into the global economy.

We all know politics and politicians have become more unpredictable, while at the same time wealth inequalities have grown (primarily down to the wage cycle being so anaemic over the past decade). However, our base case remains that the potential tipping point for inflation of a full blown trade war remains in no-one's interests.

While wages are rising and unemployment is low, the prospect of a broad break out to the upside is also not our central scenario. Our view remains that inflation is likely to peak in the middle of 2018 and leave an uglier version of Goldilocks behind—stability and solid growth, but absent the positive surprise factors of 2017 and with more volatility attached. That, however, is an environment we can work with as equity investors. In particular, as growth investors, uncertainty and volatility allows us to be active and nimble (Figure 3).

Figure 3: **What Does Deflationary Progress Imply for Investors?**

Source: T. Rowe Price.

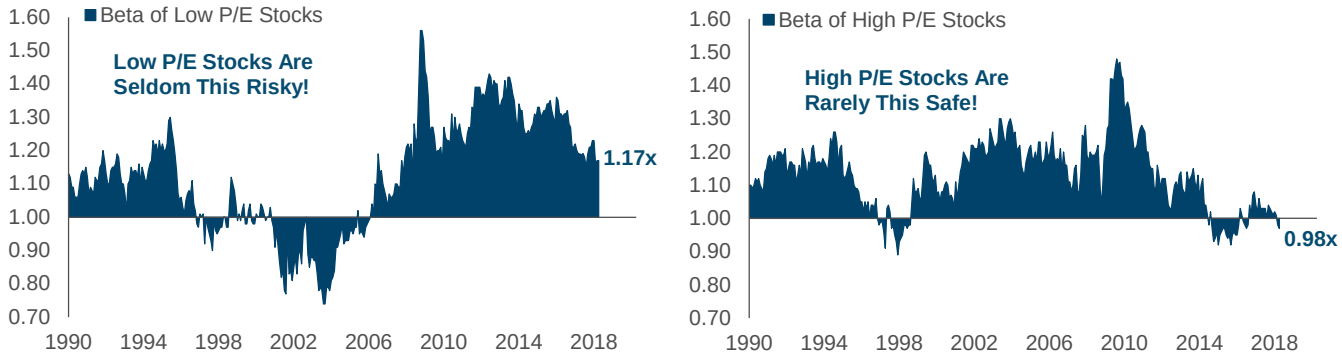
SECULAR CHANGE AND THE VALUE-GROWTH QUESTION

One notable impact of this era of secular change for equity investors is that in a world of lower economic growth, growth companies have outperformed significantly and assumed a more favorable reputation with many investors. This is intuitive, given the nature of a scarce commodity (growth) and the price investors are willing to pay for companies which can create positive shareholder returns in a more growth-challenged world.

However, it is also notable that growth stocks have been changing from an absolute and relative volatility perspective. Figure 4 demonstrates this point and shows that while higher P/E stocks have taken on lower beta characteristics versus history, lower P/E stocks have seen their beta characteristics rise significantly since the GFC. We believe this is in part because of the increasingly cyclical nature of "value," especially in market segments such as financials, energy and materials. Leverage adds to this volatility shift, with many successful growth innovators amassing large positive cash balances, while debt has increased in the value complex, in an era of cheap and available financing.

Figure 4: **Now That is New!**

As of April 2018



Source: Cornerstone.

This evolution is certainly worth noting from a risk-return perspective, with growth assuming better and more defensive drawdown characteristics in recent years when compared to value. Time will tell whether this is due to transitory investor behavior, but our perspectives on structural change inform us that there is also real change occurring, which is shifting the nature of markets and stocks.

SO, WHAT'S THE STORY?...LONG TERM GLORY?

We remain focused on being on the right side of change, investing in companies that can grow in what we believe will be a lower growth world. We have re-iterated this point many times, but a low growth world does not imply a lack of change or progress. In many senses, the pace of change still feels furious to us as industries grow, with the winners winning big and the losers facing an uncertain future.

What we are doing, is taking a more balanced approach as many of the cyclical areas that were structurally depressed (financials and industrials), have rebounded in response to rising global growth expectations. Meanwhile, information technology and other areas that have been clear market beneficiaries have become a much more crowded space, which poses a challenge to certain segments of the market.

So we are therefore being very specific about the stocks we own, and remain committed to our investment framework that focuses on identifying and investing in high-quality companies where we have insights about their improving economic returns for the future. What volatility has allowed is a refreshing upgrade to our holdings, where macro fears have shifted stock prices unnecessarily.

Looking at the big picture, we remain confident in the long term outlook for companies that are on the right side of change. Are we being watchful for risks however, and are we open to changing our mind? Absolutely.

Key Risks

Transactions in securities of foreign currencies may be subject to fluctuations of exchange rates which may affect the value of an investment. The strategy is subject to the volatility inherent in equity investing, and its value may fluctuate more than a strategy investing in income-oriented securities. The strategy may include investments in the securities of companies listed on the stock exchanges of developing countries.
