JOHCM Funds

November 2021

Global Value and Income Dispatch

Stewarding capital through regime transitions

Portfolio Executive Summary

Central Bank policy normalization will be tricky and could prompt renewed market volatility. Investors may need to find ports in the storm from which to deploy when opportunities arise, but depending on the normalization path, traditional defensives may not work.

1. **Recent bond volatility should be a reminder of the "Liquidity Illusion"**

   - Markets may seem healthy, but when volatility spikes, algorithms pull bids and prices may have to gap widely to balance flows

   - The late September yield spike in US bonds markets (arguably the world's deepest) is a case in point

2. **Did the Covid-19 recovery disappear or was it merely delayed?**

   - The summer primacy of growth, falling bond yields and cyclical suggest the former, …

   - …however, the possible fading of Delta Variant, healing supply chains and re-normalizing labor markets give grounds for optimism

3. **With this in mind, we remain pro-cyclically positioned and continue to be wary of duration**

   - Reaccelerating economic growth could push real rates higher favoring financials and some cyclicals while hurting valuations for high growth technology shares

   - In contrast to some smaller countries, US and EU central banks remain pro-cyclical, but we watch for signs this may change

Current positioning and the competition for capital

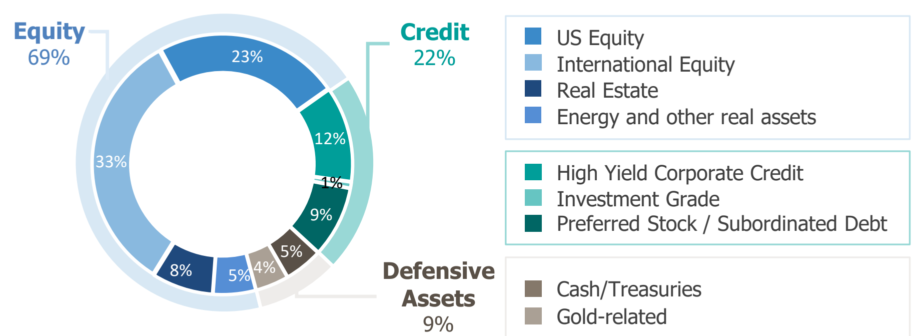
Life was very different a few short years ago when one could earn mid to high single digits lending money to solidly solvent enterprises.

It is not the case today. Indeed, lending, especially at longer durations, entails significant risk of capital loss and so our playbook and asset allocation remain very different from where they were in the early days of Chairman Powell's tenure - before the Powell Pivot.

We are of the view that risk is everywhere, so we might as well get paid for it! Even "risk free" assets such as cash and US Treasuries can be undermined by inflation and rising rates, in the case of bonds.

Current Allocation (as of 09/30/2021)

Subject to change without notice.



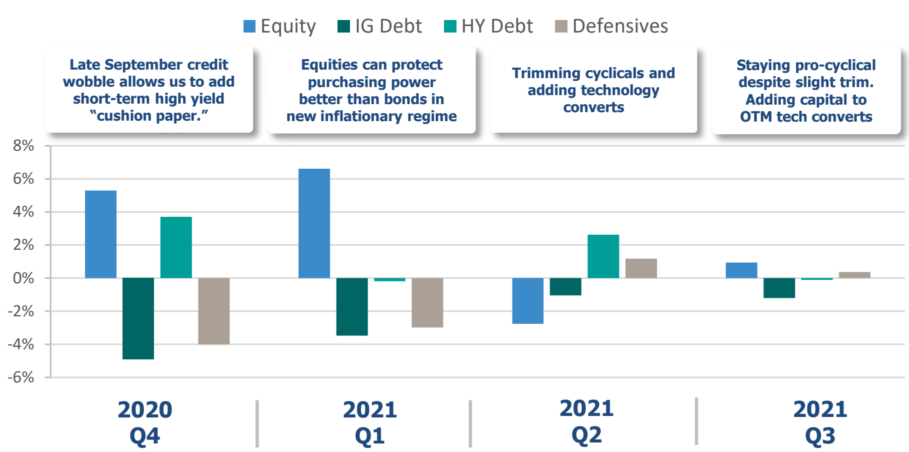
Source: JOHCM, Bloomberg as of September 30, 2021

As our asset allocation above suggests, we continue to find better compensation for risk in equities than in fixed income. The fixed income we do hold is more short duration and event-driven and often involves cheap optionality.

Allocation Shifts

Allocation shifts in the most recent quarter were modest. On the margin, we deployed a bit of capital into Asian technology and Hong Kong listed shares to take advantage of stress in those markets, and we continued to dribble capital into "out of the money" convertible bonds – an example of relatively free optionality in fixed income.

The strategy's capital deployment in the past year



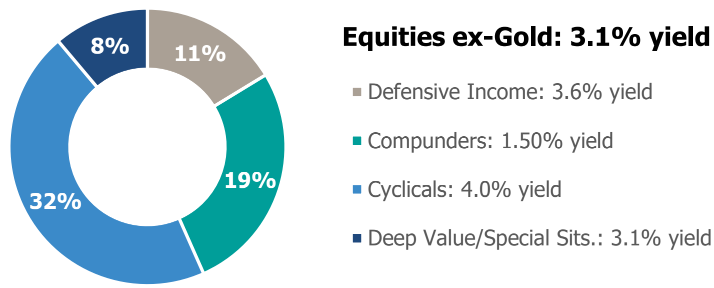
Source: JOHCM, Bloomberg as of September 30, 2021

Stylistic Positioning

Within equities we continue to favor cyclicals over traditional defensives, while at the same time featuring a relatively sizeable allocation to what we consider to be compounders. Growth became cheap during the initial bond yield spike in the spring and so we leaned in to some of our secularly growing holdings.

Despite being income-oriented and having a value bias, we are not fixated on price-to-earnings and price-to-book multiples, as today much investment takes place in the income statement and needs to be adjusted as such. Some profitless companies have very strong unit economics and are losing money only because they generate 5-to-1 returns from every new customer they acquire!

Equity holdings and LTM yield grouped by style



Source: JOHCM, Bloomberg as of September 30, 2021

Inflation, deflation, both or neither?

Our top-down aware process is mindful of the economic regime as this affects discounts rates and the cost of capital and can also be an important driver of unit economics for cyclicals and financials.

Our best guess is that we remain in a reflationary regime, although we have seen both disinflationary and stagflationary pulses!

After the vaccine-fueled recovery from Covid-19 lows, we saw a deflationary pulse over the summer. Inflation expectations fell 30 basis points from their highs and real interest rates dropped back below negative 1%. Economic growth slowed due to (i) the Delta Variant, (ii) supply chain tightness and (iii) labor market shortages.

As we write, inflation expectations have surged back with 5-year 5-year forwards rising to new recent highs in the early days of Q3. This seems to have prompted various smaller central banks to act and the dovish Fed and ECB chairs to focus a bit more on inflation.

Inflation Expectations
5-Year, 5-Year Forwards

Source: JOHCM, Bloomberg as of September 30, 2021

Some commentators are suggesting that these tightening measures could be a policy mistake. The Neo-Fisherite perspective, which has increasingly begun making the rounds, suggests that if capacity is scarce, then the last thing one should do is raise interest rates. Why crush demand, when the real problem is supply?

Beware creeping oligopolization: too much of a good thing?

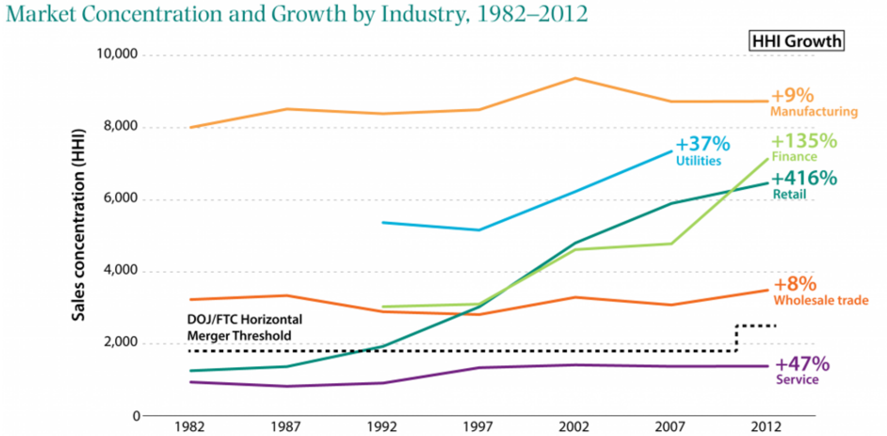
One additional factor complicating supply increases is the impact of market consolidation at the macro level. As shareholders, we are generally happy when industries consolidate and companies become more rational in their capital decisions.

We have seen such increasingly shareholder friendly behavior across numerous industries, including even commodity industries such as mining and energy which have been undisciplined in the past.

The chart below (from the Hamilton Project and Brookings) shows the increase in consolidation in recent decades across various industries.

In order to solve the current wave supply chain shortages, some capacity will need to be added. Oligopolization might render this more difficult. This could increase the risk of inflation overshoots which might prompt the Fed and ECB to abandon their accommodative stances and undermine the Neo-Fisherite narrative.

Market Concentration and Growth by Industry, 1982–2012



Source: Autor et al. 2017.
Note: Market concentration refers to the Herfindahl-Hirschman Index (HHI; sales). After defining the boundaries of a market and calculating each firm's share (e.g., of total sales), HHI is calculated by summing the squared market shares of all firms, then multiplying the sum by 10,000. HHI growth is for the date range available (1982–2012 for all series except Utilities and Finance, which show 1992–2007 and 1992–2012, respectively). The dashed line indicates the threshold market concentration established by the U.S. Department of Justice (DOJ) and Federal Trade Commission's (FTC's) Horizontal Merger Guidelines above which a proposed merger would trigger enhanced scrutiny.

Conclusion

There is no shortage of risk factors at present. Slowing growth, rising inflation and the imminent tapering of unprecedented money printing (to name a few) could all reek havoc on asset prices in different ways. Yesterdays defensives may not be tomorrows havens.

In this potentially rapidly changing environment, we stand ready to reposition as needed and are on the lookout for any opportunities the may arise in what could be bumpy path to normalization.

Sources:

1. " The state of competition and dynamism: Facts about concentration, start-ups, and related policies", Brookings. https://www.brookings.edu/research/the-state-of-competition-and-dynamism-facts-about-concentration-start-ups-and-related-policies/