



INTERNATIONAL SELECT



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Our thoughts on the coronavirus and the market correction

- The Fund outperformed the index in February, a month dominated by the coronavirus-driven market correction.
- Our relative outperformance was mainly because the primary market trends have remained intact despite the sell-off ('growth' over 'value', 'quality' over 'cyclicals').
- We are keeping our powder dry whilst actively looking for 'early Christmas presents' in new growth areas like 'clean & green'.

February performance review – reasonable relative performance

The Fund outperformed the index in February, a month dominated by the coronavirus-driven market correction. Our performance was mainly because the primary market trends have remained intact despite the sell-off ('growth over 'value', 'quality' over 'cyclicals'), so our relative performance has been reasonable. This suggests this is not the beginning of the end of current market trends. However, we remain eyes wide open for a sustainable change in market leadership and will move quickly if and when necessary. (Please ask for our presentation "Thoughts on winning the next decade" if you are interested in more details on this topic.)

Given the extent of the market sell-off, here are our evolving real-time thoughts, observations and plans. We are clearly not expert doctors, nor are we economists, but, as evidence based, probability-adjusted investors, we do know the following:

- The global economic impact will be much greater than SARS (2003), because China's economy is so much larger and more globally integrated today - the month before COVID-19 began, China had 10x as many outbound tourists and consumed/produced 5-10x the amount of commodities and products than the month before SARS broke out. This is both a global demand and supply shock.
- The COVID-19 spread is geometric not linear. The rate of growth is slowing down in China, Singapore and Thailand, where strict measures have been put in place, but accelerating elsewhere where strict measures have yet to be fully put in place.

Markets historically bottom out when the rate of growth slows. This suggests we still have some more downside outside of China, which is now showing some signs of stability, both economically and physically. A big unknown is whether can we trust the Chinese numbers, and will COVID-19 reaccelerate again in China as all the workers return to their factories?

Japan has been hard hit both economically and physically; we are short-term cautious but long-term optimistic that if the worst is avoided then the leading Japanese shares will recover fast given the summer Olympics (if they go ahead) and the country's economic ties to China (if it recovers).

Korean and Taiwanese semiconductor shares (which we started buying too early!) have been hit hard. However, we think they will ultimately recover to new highs. Unlike travel-related companies, this is a case of demand postponement (5G), not demand destruction.

A chain is only as strong as its weakest link. The weakest link globally is Europe, specifically Italy. We remain extremely cautious here, both short and long term, except for Europe's world-leading 'clean & green' companies that we already own or want to buy next on this dip. We remain zero-weighted European banks, as the evidence continues to suggest they will remain value traps until the macro radically improves or management seriously implements massive ROIC or EVA shrink-to-grow strategies – but turkeys don't vote for Thanksgiving or Christmas, as one of my mentors taught me.

Indiscriminate selling makes for opportunity

According to Deutsche Bank, the correction we have seen in the last six trading days is the fastest ever 10% decline in the S&P 500 from a record high. This reinforces our point that Modern Portfolio Theory does not really work when you most need it and that sell-offs are indiscriminately accelerated now that markets are run more by machines than humans. This should soon give us new investment opportunities due to the indiscriminate and accelerated selling.

When and what to buy?

COVID-19 is accelerating several global trends that were already in place, so we will look to buy the dips in these areas soon:

- 1 Factory automation – especially in China and other emerging markets.
- 2 Diversification of supply chains – most Western companies were already talking about ‘China plus one’ given the trade wars, now they will rush to implement a more diversified supply chain.
- 3 Working more from home – Nudgem and I have been doing that for over a decade.
- 4 Video conferencing – less flying/driving to meetings is also good ESG.
- 5 Digital education – my brother is a headmaster, and he says it was the teachers and parents that previously slowed down this transition.
- 6 ‘Clean and green’ growth is better than filthy and unhealthy growth – ‘green collar’ jobs look attractive in a world of factory automation replacing blue collar jobs and software replacing white collar jobs.
- 7 Software, semiconductors and data are the new oil, steel and cement – capitalism with less capital.
- 8 Rethinking emerging markets as they approach the middle income trap – healthcare, food safety, services, etc.
- 9 ‘Lower for longer’ monetary policy – if the cost of capital keeps trending towards zero, then the valuation of long duration growth keeps trending towards infinity.
- 10 Fiscal stimulus – ‘helicopter money’ has already started in Hong Kong. Where next?

Points 9 and 10 probably mean that the ultimate peak for this bull market is both postponed and much, much higher than we previously thought. If you have not read the book “The Moneymaker,” by Janet Gleeson, we would highly recommend it.

Our latest probability-based scenario analysis

In conclusion, our evidence-based, probability adjusted scenario analysis is currently:

Scenario 1: 60% probability – the virus is ultimately contained and more of the same ‘growth’ factor leadership is most likely to continue (e.g. the old growth leadership of technology and US stocks, with the new growth leadership theme of ‘clean & green’).

Scenario 2: 10% probability – new sustained leadership by the ‘value’ factor is the least likely outcome until a sustained economic recovery (before then oil is probably heading towards US\$25 per barrel and financials will continue to struggle to generate profits in a flat or inverted yield curve).

Scenario 3: 30% probability – markets keep falling further as the virus is not contained (so we are currently keeping our powder dry whilst actively looking for new investment opportunities).

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