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FOR PROFESSIONAL INVESTORS ONLY

J O Hambro Capital Management Group

Under the Bonnet

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Investment background

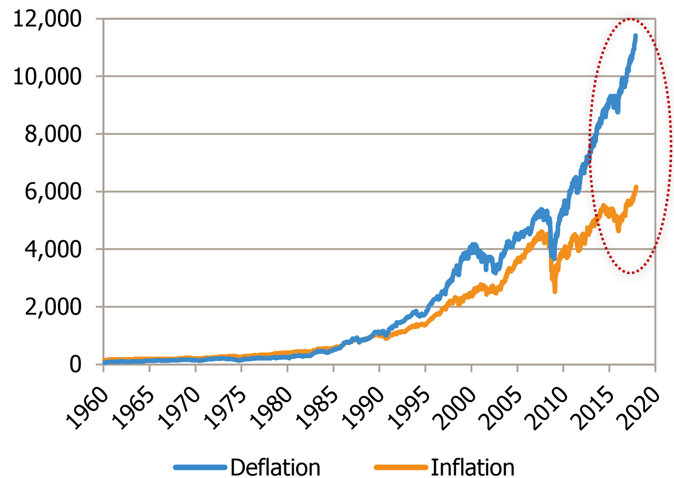
A raft of strong economic updates in January ensured that last year's theme of synchronised global growth continued into 2018. This in turn triggered one of the most volatile starts to the year in two decades as markets began to compute the inflationary implications. The FTSE All World Total Return index rose 4.1% in local currency terms whilst in the bond markets the US 10-year treasury price fell 1.99%. According to J P Morgan, only once in the past 20 years have global equities rallied as much in a January (2001) or bonds sold off as much (2009).[1]

In the eurozone, economic growth, already at multi-year highs, strengthened further, with December's manufacturing PMI recording its best level since surveys began in mid-1997. Likewise, the service sector PMI showed the steepest increase in activity for over six-and-a-half years, and the subsequent flash estimate revised this up to the highest level since August 2007. In Japan, the manufacturing PMI reached a 46-month high in operating conditions, whilst the China Caixin composite output index registered the fastest rate of activity growth in a year. In all cases, economic growth led to rising backlogs of work, forcing firms to use inventories of finished goods to ease production line burdens and take on further payroll, meaning inflationary pressures remained elevated. Citi reports that analysts' global earnings per share (EPS) growth expectations for 2018 are now 14% compared to just 11% in mid-December.[2]

Bond prices fell across the globe in January, with the US 10-year generic government bond yield nearing a four-year high (2.72% vs 2.80% in March 2014) whilst the UK 10-year gilt yield rose from 1.19% to 1.51%, more than offsetting the compression it had experienced after the EU referendum. Rising concerns about inflation were compounded by the Bank of Japan's decision to trim its purchases of long-dated debt. This comes at a time when the European Central Bank is halving its monthly bond-buying and the US Federal Reserve is on a clear path to tighter monetary conditions. Analysis from Bank of America Merrill Lynch (BAML)[3] shows that US$102bn flowed into equities in January, making the pace of rotation from government and high yield bonds the fastest on record. As we re-iterated last month, it is clear that a new narrative is beginning play out in the market. This is likely to have multi-year implications for sector performance, as illustrated in the below analysis from BAML.

[1]JP Morgan Global Data Watch – 2 February, 2018
[2]Citi Global Equity Strategist: EPS forecast melt-up – 2 February, 2018
[3]Bank of America Meryll Lynch – The Flow Show – February, 2018

Inflation vs. deflation assets (total returns)



Source: BofA Merrill Lynch Global Investment Strategy, Global Financial Data, Bloomberg; note: Inflation assets: Commodities, TIPS, EAFE, US Banks, Value and Cash; Deflation assets = Govt bonds, US IG, S&P 500, US Cons. Disc, Growth and US HY.

Despite the US leading global EPS revisions following the impact of the recent corporation tax rate changes – Citi reports that analysts now expect US EPS growth of 17% vs 12% in mid-December – the US trade-weighted dollar resumed its decline. The greenback fell 3.25% to reach a three-year low as investors began to focus on the likelihood of central bank rate rises globally, not solely by the Federal Reserve. This devaluation further fuelled the bull market in US equities, with the S&P 500 rising 5.7% (on a total return basis), the Dow Jones Industrial average gaining 5.9% and the Nasdaq 100 surging 8.7%.

In the UK, sterling rallied against the US dollar to levels last seen prior to the EU referendum 18 months ago, hurting overseas-earning stocks and leading the FTSE All-Share Total Return index to fall 1.99%. This move masked what should be a positive development for UK domestic-centric stocks, as, if sustained, a stronger pound will increase UK household disposable income by reversing a large part of the foreign exchange-related cost inflation experienced in petrol, energy and food. There were already signs that inflation may have peaked, with the Consumer Prices Index including owner occupiers' housing costs (CPIH) 12-month inflation rate falling to 2.7% in December 2017, down from 2.8% in November. While consumer data remained weak in January – the BRC-Springboard data showed December footfall down by 3.5%, the largest year-on-year fall since March 2013, and BRC-Nielsen's Shop Price Inflation (SPI) data recorded a 57th month of decline – there were signs that consumers' downbeat mood may be improving, with January's GfK consumer confidence measure showing an

improvement from -13 to -9. There were also signs that average regular weekly earnings are starting to improve, with year-on-year nominal growth of 2.4% November compared to 2.3% in October.

Strategy update

The Fund returned -0.54% in January, net of fees, representing outperformance of 36bps against its benchmark, the FTSE All-Share Total Return index (12pm adjusted), which returned -0.89%.

JOHCM UK Dynamic Fund
5 year discrete performance (%)

	JOHCM UK Dynamic	Benchmark	Relative return
1 year to 31 Jan 2018	13.87	11.12	2.48
1 year to 31 Jan 2017	29.30	22.46	5.59
1 year to 31 Jan 2016	-6.96	-6.33	-0.68
1 year to 31 Jan 2015	6.63	8.50	-1.72
1 year to 31 Jan 2014	21.39	9.02	11.35

Source: JOHCM/Bloomberg/FTSE International. NAV of share class A in GBP, net income reinvested, net of fees, as 31 January 2018. Inception date: 16 June 2008. Note: Performance data for the period 16 June 2008 to 22 October 2009 is for Ryder Court UK Dynamic Fund. From 23 October 2009 onwards, the Fund converted to JOHCM UK Dynamic Fund. All fund performance is shown against the FTSE All-Share TR Index (12pm adjusted). Performance of other share classes may vary and is available upon request.

Despite being a busy month for the portfolio, with broadly positive updates from more than a third of holdings, outperformance was predominantly driven by sector allocation. Rising bond yields meant the Fund benefited from its underweight positions in consumer goods and utilities, which are highly correlated to bond prices. Elsewhere, the Fund's overweight holding in **Anglo American** was the greatest individual contributor to performance. The basic materials sector continued to rally in response to the falling US dollar and rising global growth, while South African assets continued to re-rate following the removal of Jacob Zuma as leader of the ruling African National Congress (ANC) party.

Shares in **Stock Spirits** rose 13% after a pre-close trading statement that upgraded full-year expectations. This upgrade was due to good performance in the company's key markets of Poland and Czech Republic, where growth in both volume and value terms continued. This follows on from upgrades made at the interims ('Under the Bonnet' – September 2017), as new management's actions began to take effect with market share regained through an improved go-to-market strategy. Market share gains have been especially notable in Poland. Here historically stiff competition is weakening following the market leader, Roust, entering Chapter 11 last year and the number three operator, Marie Brizard, disbanding its traditional trade sales force to cut costs.

There were a number of Christmas trading updates from the Fund's consumer services holdings. All of these, despite the perceived economic headwinds, met or beat analysts' expectations. In most cases, though, this was not enough to prevent their share prices from underperforming as the market continued to put downward pressure on UK-centric stocks. Given sterling's strength against the US dollar in the period, these share price performances are particularly remarkable. For example, **Morrisons**, which has a 10% short interest and currently trades on a four-year low EV/EBITDA multiple of 6.8x, reported like-for-like (LfL) Christmas sales growth of 2.8% versus consensus expectations of 1.7% and had its debt upgraded from Baa3 to Baa2 by Moody's, yet its share price rose less than 1% over the month. Likewise, **Marks & Spencer**, which also has 10% short interest and currently trades on a near six-year EV/EBITDA low of 5.3x with a dividend yield of 6.5% twice covered by free cash flow, reported LfLs slightly ahead of expectations and reiterated full-year guidance. Nonetheless, its share price fell by more than 4%.

The Restaurant Group also has 10% short interest and trades on less than 6x EV/EBITDA. It saw its shares fall more than 15% in January despite reporting a post close 2017 update in line with market expectations, albeit management lowered analyst 2018 LfL expectations from 1% to 0% in order to continue to invest in price in response to the highly competitive UK leisure market. As we have outlined previously ('Under the Bonnet' – October 2017), we are under no illusion that the leisure brands part of this business will be easy to turn around. However, further price investment at a time when competitors (Prezzo, Byron and Jamie's Italian) are increasingly closing sites is commercially logical, as it will speed up capacity exit from this market. This, in turn, should rebuild the potential for higher returns over time. At the current share price, the valuation we are being asked to ascribe to the leisure estate turnaround is increasingly becoming minimal in a sum-of-the-parts calculation. As per the maths we previously outlined in October, there is the potential for these c. 370 sites to make £70-100m of EBITDA if run properly, whilst the market capitalisation ascribed to them is now just £211m (assuming the valuation for the pubs and concessions has not changed), implying a lowly EV/EBITDA range of 2.1-3.0x.

The Fund continued to build its position in **Tesco**. This was partially in response to our growing conviction over the achievability of the 3.5-4% 2020 margin target and, in part, a reaction to the sharp (-4.5% in day) but short-lived (four days) sell-off in the stock following the Q3 trading statement (+1.9% LfL sales growth for the six-week Christmas trading period was slightly weaker than market expectations of +2.8%). It is remarkable to think the market ascribed a c.£0.75bn change in value to the nuances of a six-week trading period in this multi-year turnaround, especially as CEO Dave Lewis re-iterated he is "really comfortable and confident" with the margin target.

McBride provided a 31bp headwind to performance in the month. It was forced to downgrade profit expectations for FY18 because of increasing losses in its personal care and aerosols division (PCA) and significant new business wins coming in at very low margins. Whilst it is disappointing that management failed to control the level of losses in PCA, albeit this is in part due to being unable to dispose of the aerosols business as first hoped, we understand that the low margin business wins represent strategic actions taken by management rather than competitive pressures in the market. The new contracts are with leading European value retailers and were won after the number three player in the European market entered bankruptcy. Not only do these contracts represent new customer relationships

for McBride, but, as the current European market leader, keeping margins low ensures that production capacity will exit the market, thereby building the potential for higher returns over time. Whilst this may have all the hallmarks of a "jam tomorrow" strategy, this also comes from a management team with a proven track record in asset and cash optimisation, as per the successful repair phase of their turnaround strategy, and who have recently gained sole supplier status for private-label household by Tesco. We continue to back management.

Other updates included **Chemring**, where full-year results were modestly ahead of estimates, and **ITE Group**, which reported Q1 LfL revenues up by 5%.

Finally, **Britvic's** Q1 statement showed a more subdued start to the year, with a strong performance in GB Carbs offset by a weaker-than-expected showing in GB Stills and Brazil. The performance in GB Stills was particularly surprising given management's confidence over trading at the post-results roadshow in December. However, it must be noted that Q1 represents the least significant trading period for the group, and we understand that trading may have been affected by de-stocking ahead of the release of Britvic's new stills range.

Source: JOHCM/Bloomberg unless otherwise stated. Issued by J O Hambro Capital Management Limited authorised and regulated by the Financial Conduct Authority. Past performance is no guarantee of future performance. The value of investments and the income from them may go down as well as up and you may not get back your original investment. The information contained herein including any expression of opinion is for information purposes only and is given on the understanding that it is not a recommendation. The Funds investment include shares in small-cap companies and these tend to be traded less frequently and in lower volumes than larger companies making them potentially less liquid and more volatile. Source: JOHCM/Bloomberg/FTSE International. Note for return history: NAV of share class A in GBP, net income reinvested. Benchmark: FTSE All-Share TR Index. Performance of other share classes may vary and is available on request. FTSE International Limited ("FTSE") © FTSE 2017. The Industry Classification Benchmark ("ICB") and all rights in it are owned by and vest in FTSE and/or its licensors. "FTSE" ® is a trademark of the London Stock Exchange Group companies and is used by FTSE International Limited under licence. Neither FTSE or its licensors accept any liability for errors or omissions in the ICV. No further distribution of ICB is permitted without FTSE's express written consent. JOHCM® is a registered trademark of J O Hambro Capital Management Ltd. J O Hambro® is a registered trademark of Barnham Broom Holdings Ltd. Registered in England and Wales under No: 2176004. Registered address: Ground Floor, Ryder Court, 14 Ryder Street, London SW1Y 6QB.