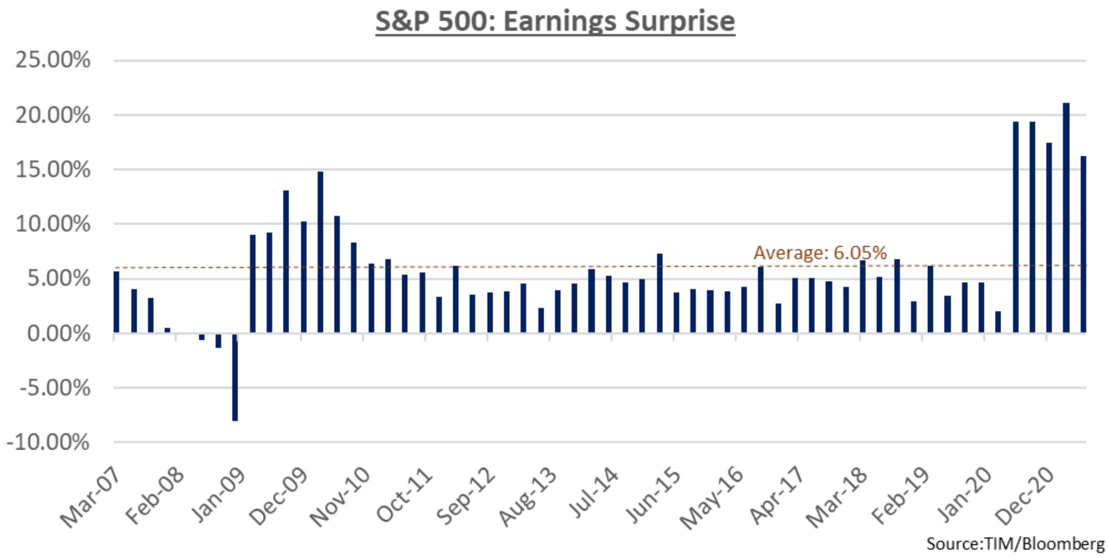
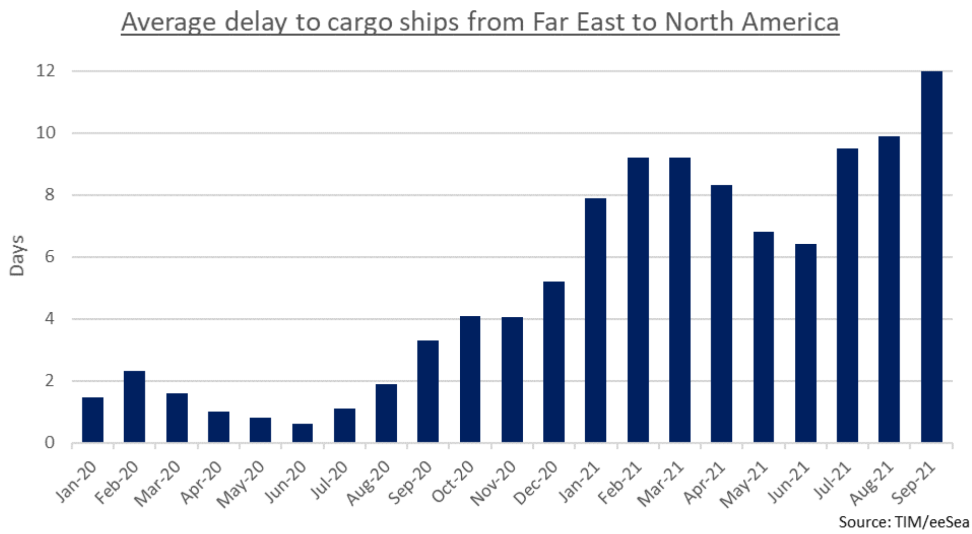
What Do You Expect?

With the third quarter earnings season opening this week amidst many supply shortages, bottlenecks, inflation concerns and lingering COVID constraints, we debate whether the extraordinary earnings surprises seen for the past five quarters can be maintained, and thus whether the meteoric rise in global markets since March 2010 is set to abate.



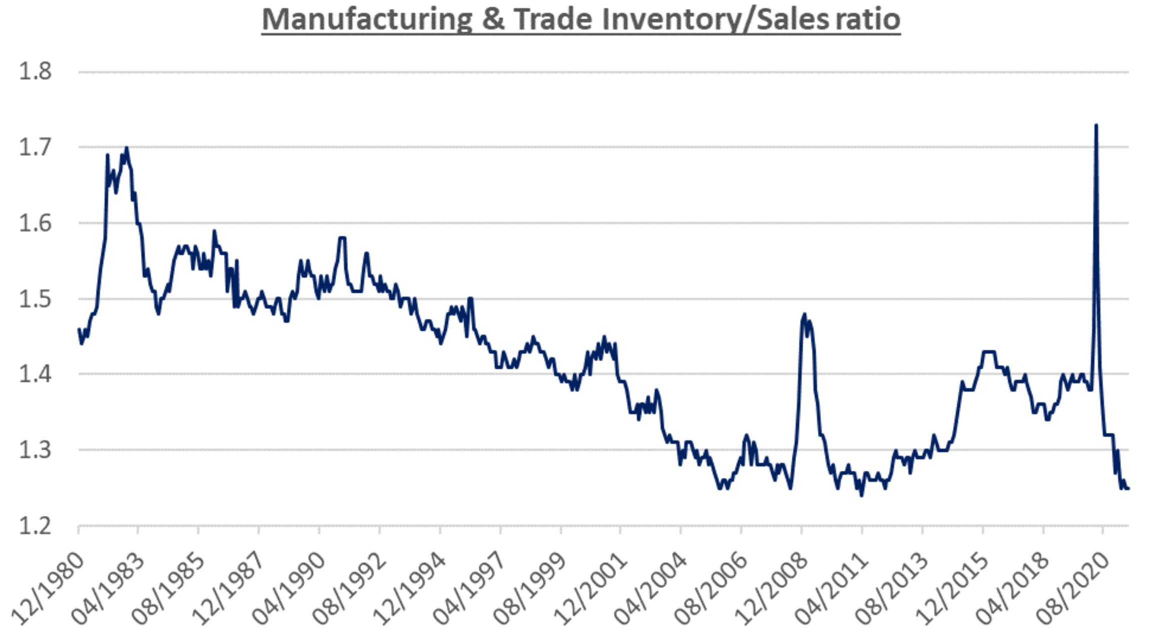
Obviously, earnings surprises can be manipulated by companies guiding the analyst community to lower earnings than they are currently experiencing, however the scale of the outperformance by global corporates since the pandemic brought global economies to a standstill has been extraordinary.

Over the summer months markets have whipsawed between re-opening trades, cyclical recovery companies and quality growth stocks, in no particular order, suggesting that the Mr Market is still undecided in what to expect in the coming quarters. The continued backlog of shipping of the western seaboard and driver shortages in Europe have come to a head in recent months, compounded by oil and energy prices increasing exponentially.



The ‘just in time’ nature of supply chains over the past decade mean that any delay in component parts or finished products can have serious ramifications on production numbers, sales and thus profitability. As Nike recently reported, the combination of cargo bottlenecks in the US, driver shortages in Europe and closures in their Vietnam factories had created a perfect storm and thus they were unable to fulfil the record levels of demand for their products. The paint and coating manufacturer, Sherwin Williams, saw the need to warn the market twice in the space of 20 days that supply shortages caused by Hurricane Ida meant that they too could not meet the demand for their products, compounding the lag in pricing between the rapidly increasing commodity prices and their list prices.

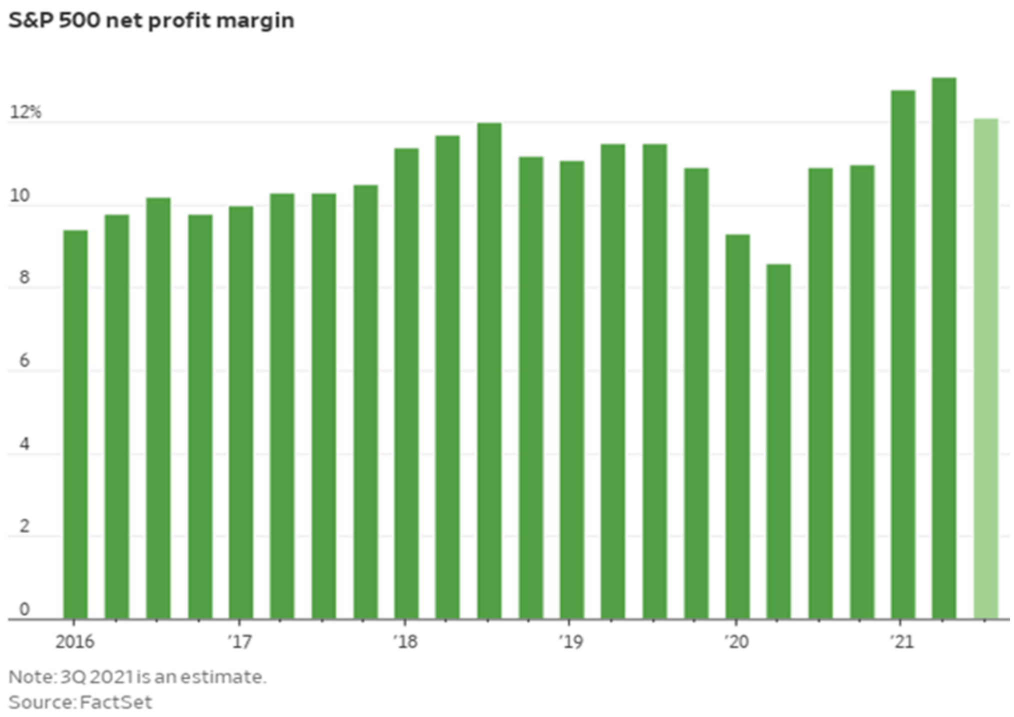
In usual times, companies would be able to weather these factors if they were short to medium term in nature from their existing inventories, but in order to save costs during the pandemic many companies underinvested and are now running on abnormally low levels of inventory, meaning that if they do not have the power to pass through costs, they are likely to result in significant margin compression and sales shortfalls.



Source: TIM/ US Census Bureau

The use of Michael Porter’s 5 forces to analyse which companies have the market positioning and power is an integral part of the VT Tyndall Global Select Fund’s process, however this alone is not enough to determine which companies will ride through the current headwinds unscathed. Quality of management is another determining factor, as companies must have a strong focus on customer outcomes if they are to flourish in the long-term, and therefore there is a fine balancing act between squeezing supplies, passing costs through to end customers and maximising profits, that only the best managements will be able to finesse.

Turning our attention to where how the market sees the headwinds impacting companies in the current quarter, the data from FactSet shows that the consensus expects a slight drop in Net Profit Margins, but for them to remain at elevated levels. Given that oil has increased to over $80 dollars/ barrel from $40 dollars/barrel this time last year, and many other input costs have increased, these expectations may still be too high for the scale of earnings surprise to be anything of the order of those seen since March 2010. We find it surprising that expectations are not lower at this point, but we prefer to focus on our underlying companies’ fundamentals than where the wider market sits.



Richard Scrope, Fund Manager, VT Global Select Fund, 15th October 2021
Data source (unless otherwise stated): Bloomberg

Contact Details:

Fund Manager – rscrope@tyndallim.co.ukbracket
Sales Director - hnolan@tyndallim.co.uk

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Investment Manager: 5-8 The Sanctuary, London, SW1P 3JP.