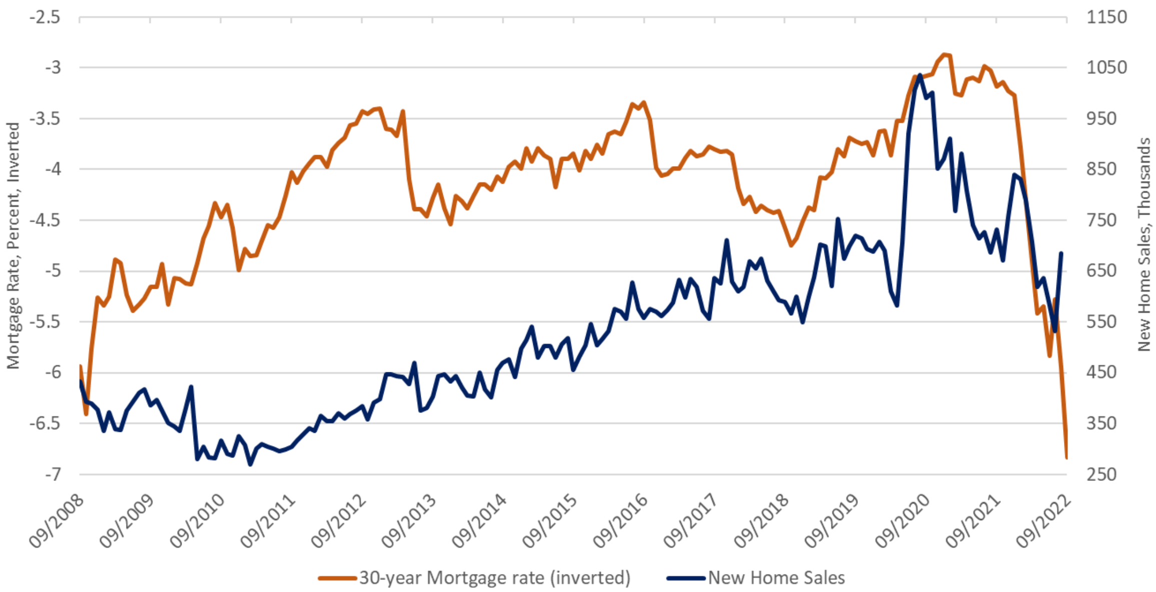
"You don't write because you want to say something, you write because you have something to say"- F. Scott Fitzgerald.

The month was marked by the global central banks engaging the overdrive switch in their attempts to tame inflation. Global currencies ebbed and flowed as rate rise announcements came forth, except for the US Dollar, which continued its march forward, extending its gains against most other currencies as it reinforced its perception as the safe haven currency.

With the economic uncertainty and rising interest rates, bond yields have risen significantly, with the ramifications being felt in the housing sector. In the aftermath of UK mini budget, which was anything but mini, the volatility of currency and bond yields led to many banks and building societies pulling their mortgage products to new customers as they sought to find new levels at which to offer money to prospective buyers. In a similar vein, the increase in mortgage rates in the US, where 30-yr fixed is the standard tenure, the increase has led to a drop in demand for new homes from not only new buyers but those moving house. We expect that August's uptick was only a caused by a rush by buyers to complete before the expected further increase in rates this month and again later in the year.

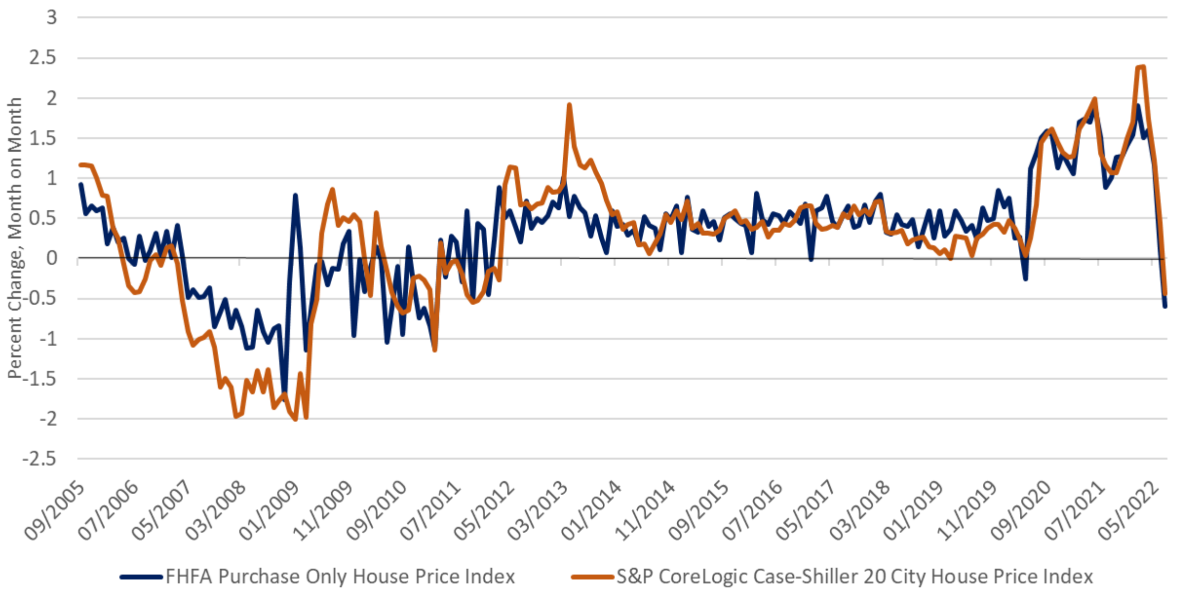
Will housing demand withstand the increased mortgage cost?



Source: TIM/ US Census Bureau/ Bankrate.com

After September's FOMC meeting, Jerome Powell the Chair of the Federal Reserve, stated that the goal of the Fed was to achieve maximum employment while also hinting that a correction in house prices would be a good thing. While house prices falling to more affordable levels would be good for first time buyers, it has serious ramifications for consumer confidence of existing homeowners, and the increase in the mortgage rate offsets much of the benefit of lower prices for those looking to purchase a new home. The July readings for the S&P CoreLogic Case-Shiller US House Price index and the Federal Housing Finance Agency US House Price Index, released this month, posted the first negative monthly readings since 2011, and given these are already two months old, the correction is likely well underway. As consumer demand accounts for over 70% of US GDP, falling house prices are usually a precursor to the economy entering a recession, which we believe the US is already in.

House Price Inflation started turned negative in July



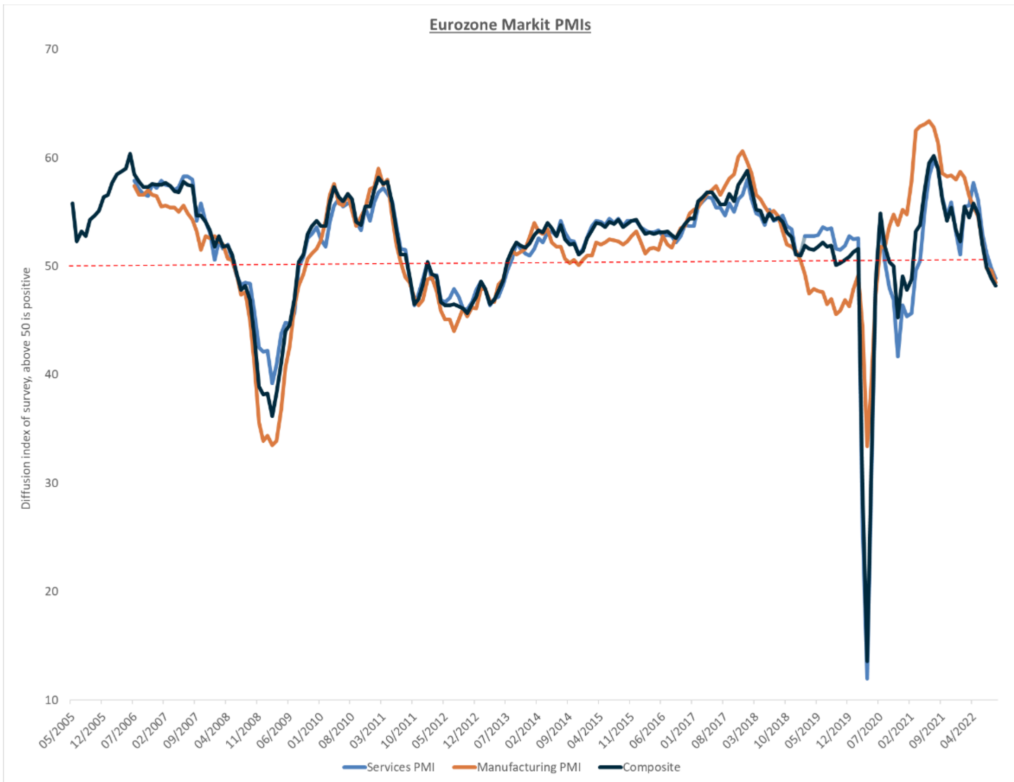
Source:TIM/ Bloomberg

While it is difficult to call the market bottom, it is useful to remember that the market turns on average four months prior to the end of any recession, and the largest gains are normally made in this intervening period. One notable change in the economic data is that seen in the University of Michigan consumer sentiment index, which having reached the lowest level on record has started to report low but significantly better numbers, suggesting that perhaps there is a growing belief that the US economy is past the nadir and that the Federal Reserve's action will only cause a mild recession.

It is now two months since the low, are things on the turn?

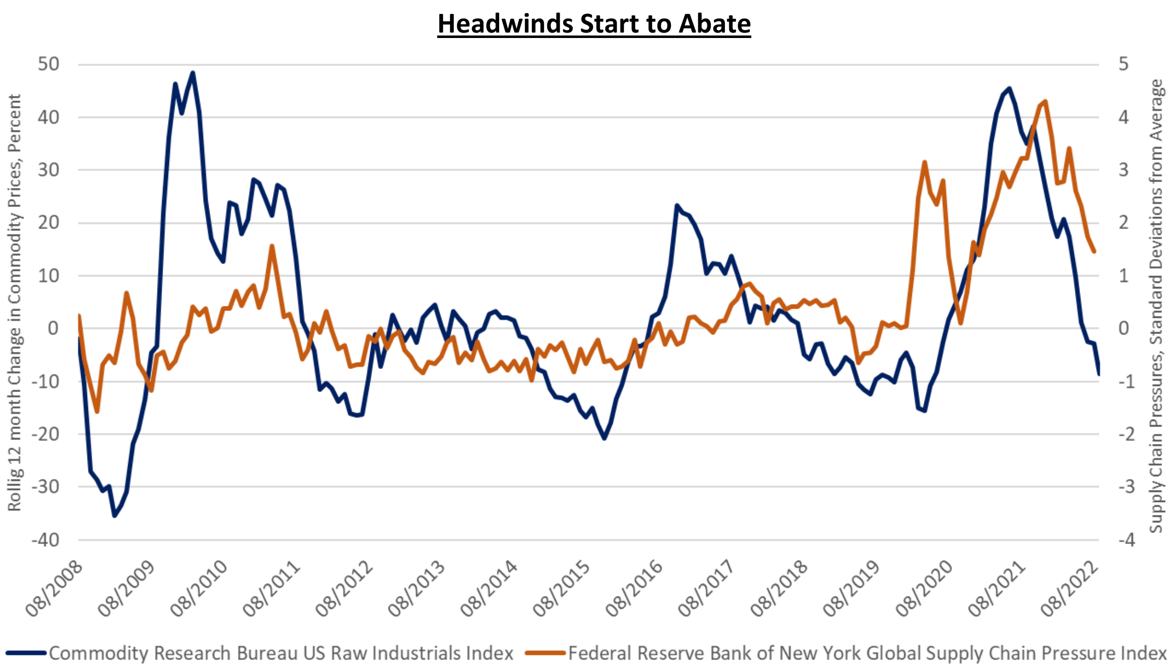
Source: TIM/ University of Michigan

The economic malaise in Europe, however, seems more entrenched, as the higher rates of inflation and problems as it weans itself off Russian commodities have resulted in a significant slowdown in manufacturing activity. The latest Purchasing Managers' Index readings for Germany turned negative in both manufacturing and services, while France managed to eke out a little growth in services it too saw a further decline in manufacturing, and we expect similar negative pictures in Spain and Italy when their numbers are released next month. The UK has not been immune, despite having weathered the malaise better than their Eurozone partners earlier in the year, and here too both readings point to negative GDP growth.



Source: TIM/S&P Global

The Irony of all this negative economic news is that when speaking to companies on the ground, their management teams are surprisingly upbeat, and although analyst earnings estimates are coming down, they are relatively upbeat about profit margins, especially as commodity prices continue to decline and supply chain pressures ease. As highlighted earlier the only fly in the ointment is how to manage the FX impact on cash flows that many multinational companies are experiencing as the Dollar continues to appreciate.



Source: TIM/ Bloomberg

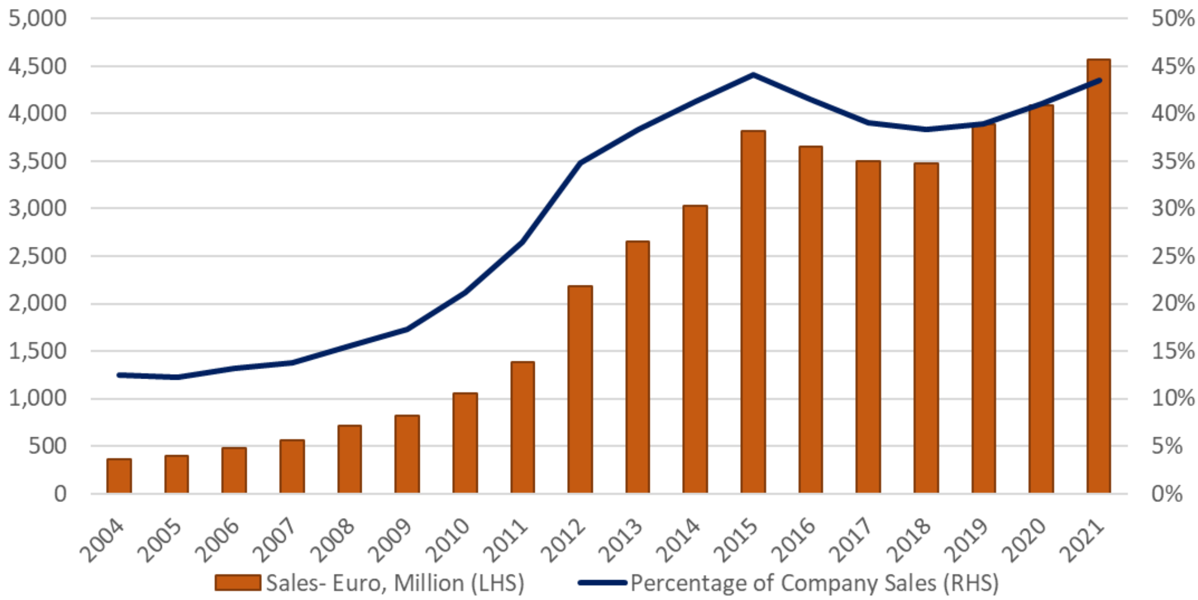
The Fund fell by 4.17% during what was a volatile month not only equities, but currencies and bonds as well. As a result, the VT Tyndall Global Select Fund B Acc (GBP) loss for 2022 thus far was 15.87%.

Fund Activity and News

During the month we sold our long-standing position in the Finnish lift operator, Kone. The Fund still holds a position in its US competitor, Otis, which it has held since buying United Technologies in 2008 and as a standalone entity post its spin-out in 2020. Although they both operate globally the geographical exposures and unit density differ, with Kone being the market leader in the Asia Pacific region and Otis in the Americas.

Our decision to sell Kone was predicated on our outlook for the Chinese property market. COVID lockdown aside, which are currently suppressing conditions further, the property sector is facing severe liquidity problems that will only be resolved by a major overhaul of the sector by the state. All the Escalator and Elevator (E&E) companies have surfed on the wave on growth in China over the past thirty years, with new cities emerging and old cities turning into mega cities and housing turning from single level apartments and blocks with only stair access to multi-storey complexes with state-of-the-art access to all floors. Kone made the most progress, capturing this growth earlier than the other western players, growing out a large cohort of representatives and service professionals; as of the end of June the company employed 31,924 people in the Asia-Pacific region (over 23,000 in China alone), over half of the company's total workforce. At the end of 2021 China accounted for around 35% of the company's overall revenues.

Kone's growth in the Asia-Pacific region

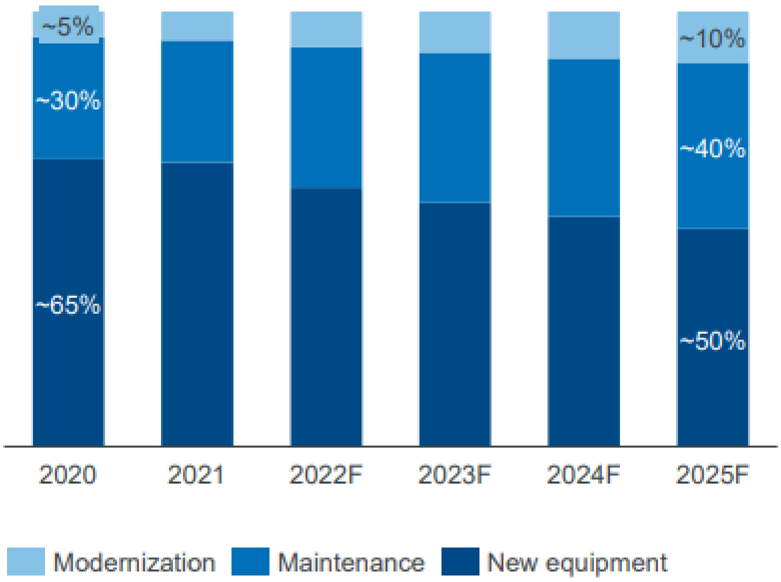


Source: TIM/ Company Data

One of the drawbacks of such a large exposure to what was such a fast-growing region in the economics of the E&E industry. Margins are typically low on new installations, better on modernisation, but the swing factor is the very cash generative and lucrative servicing of their products. While competition is fierce in the servicing sector, with many independent players vying for contacts, the large E&E players have invested in digitalisation of their products over the years, tying in warranties, and no fee periods, in the hope that the building owners choose them as a full-service provider. The fly in the ointment is the conversion rate in the Asia-Pacific, which is significantly lower that typically experienced in the Western world and is shown out in the relative margins of Otis and

Kone, where Otis' margins are typically 2% higher than those of Kone. In 2017 Kone reported that the conversion rate in China was around 50%, however this has been increasing over time, but still only accounts for 10% of the company's Chinese sales.

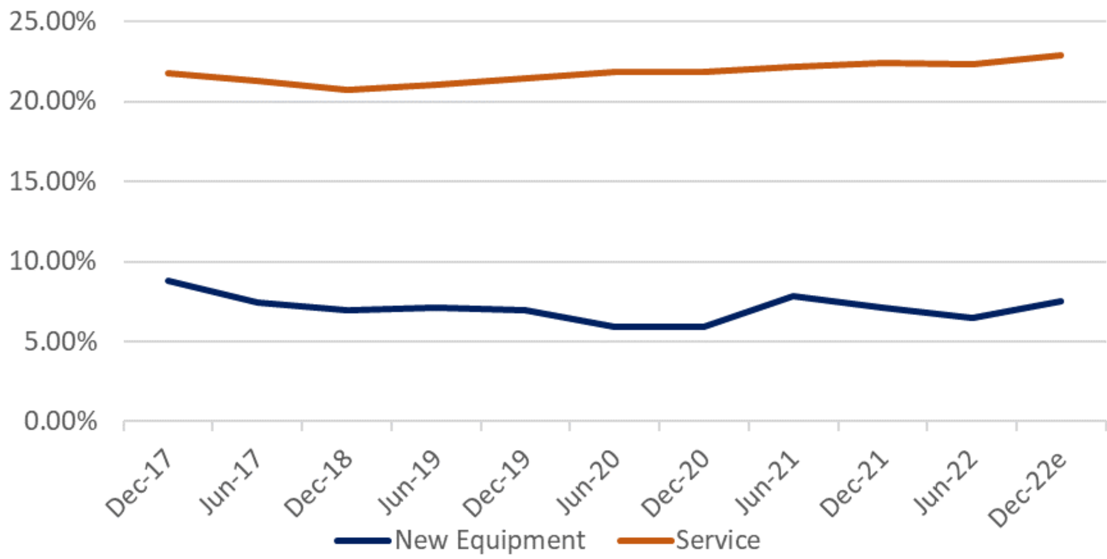
China E&E market composition by monetary value



Source: Kone

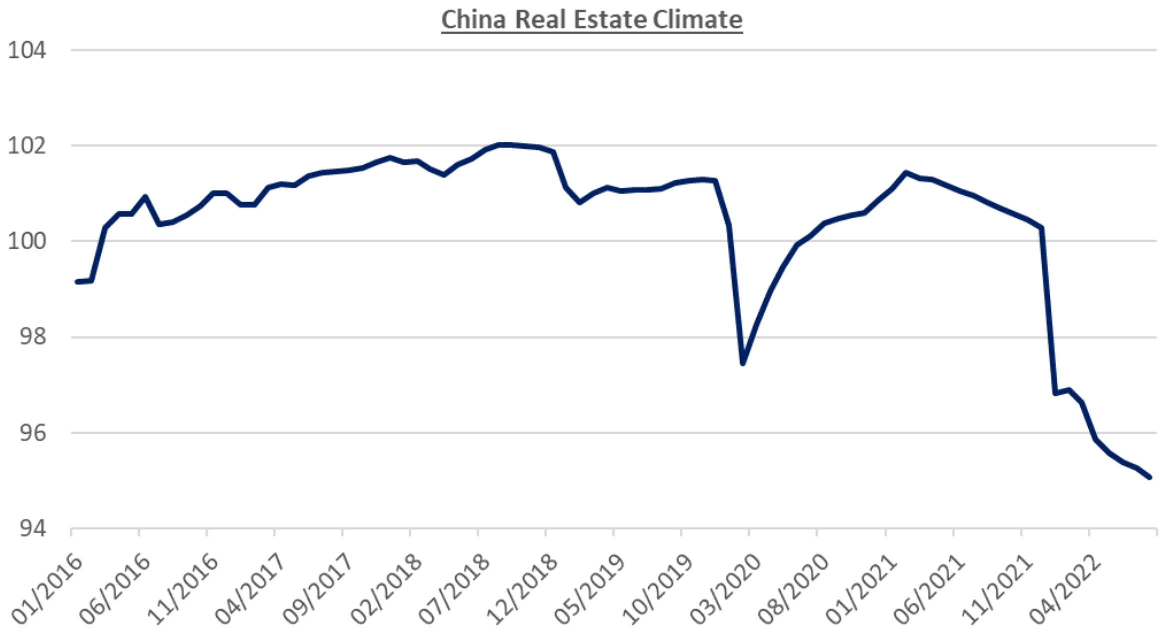
Although both companies disclose sales by new equipment, maintenance, and modernisation, Kone does not each segment by margin and Otis discloses maintenance and modernisation as a blended margin and their Swiss competitor is even more opaque with its disclosures. At its latest investor day, Otis disclosed that it has a conversion rate of 62%, the largest service share worldwide with $6.5bn of sales and a 94% retention rate.

Otis' operating margin by segment



Source: TIM/Otis

Switching to our concerns about the outlook for the Chinese property market, where all the E&E companies have significant exposure, we do not see the current downtrend as a short-term issue. More than two-thirds of household's wealth is invested in property and the industry accounts for one-fifth of GDP, but now people are refusing to pay-off mortgage debts, buyers are dropping out of the market altogether, developers are seeing available liquidity dry up and no help appears to be forthcoming from the government despite the impending Communist Party Congress.



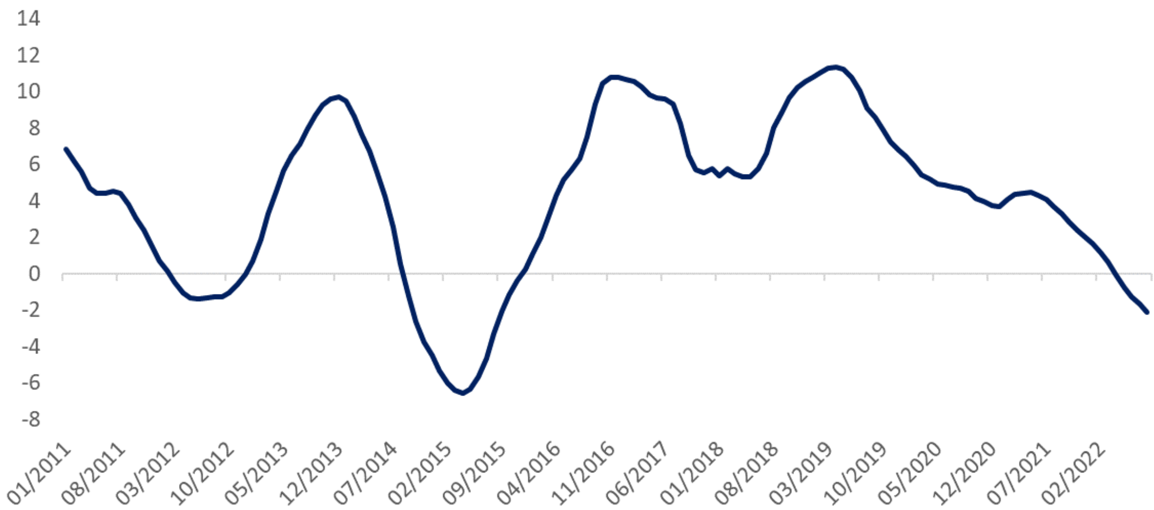
2012:100, Moderate levels: 95-105
Source: TIM/National Bureau of Statistics of China

The real estate market has been under pressure ever since President Xi warned developers and potential buyers that "Housing is for living in, not for speculation" while simultaneously imposing limits on borrowing to cool down property price inflation. The subsequent issues and eventual default by Evergrande, the largest property developer in China, served to increase concerns in the market, and has left many other developers facing a liquidity crunch as delays to completing projects has led to weaker sales and thus less ability to invest in new building projects.

Source TIM/Bloomberg Intelligence

The government has tried multiple times to patch over the issues only to find that their plaster has not been sticky enough. Cutting interest rates, easing of restrictions surrounding purchasing as well as encouraging local authorities to conduct bailouts of unfinished projects in their areas have all come to no avail and attention has now turned to whether the state will undertake a larger scale bail-out of the sector. Aside from the cash-flow issues, the problem, however, may turn out to be a simple imbalance of supply and demand, reminiscent of the period in 2009, when stories of ghost cities, such as Kangbashi, where a city designed for one million people had only 20,000 residents, started to circulate. In 2021 Business Insider reported that China had around 65 million empty homes and it has been reported that currently there are at least 50 municipalities, often labelled as ‘development areas’, ‘new areas’ or ‘eco-cities’ that are fully completed or suspended mid-construction with occupancy rates are equally low.

China Newly Built Residential buildings



Source: TIM/ National Bureau of Statistics of China

Without an unprecedented level of government support we believe that the boom in growth of the Chinese property sector has passed its peak and therefore Kone and the other E&E companies will be looking to the refurbishment and replacement cycle to kick in to capture new orders, however as this has a normal 10–15-year delay, peak sales may have already passed. Fortuitously for Otis, the underinvestment that happened during its time as a part of United Technologies means that they are underexposed to China relative to Schindler and Kone and therefore should be better positioned to weather the impeding storm.

Kone produces a market outlook every quarter and this backs up the conclusion that modernisation and maintenance is where the opportunities in China lie, however, with developers struggling with their cash flows, both these pockets may also turn out to be slower in growth than previously expected.

Operating environment by region

	New equipment market in units		Maintenance market in units		Modernization market in monetary value	
	4–6/2022	1–6/2022	4–6/2022	1–6/2022	4–6/2022	1–6/2022
Total market	---	--	+	+	+++	+++
EMEA	+	+	+	+	++	++
Central and North Europe	-	Stable	+	+	+	++
South Europe	+	+	+	+	+++	+++
Middle East	++	+	+	+	+++	+++
North America	++	+++	+	+	+++	+++
Asia-Pacific	---	---	++	++	+++	+++
China	---	---	++	++	+++	+++
Rest of Asia-Pacific	+++	++	++	++	++	++

The table represents the development of the operating environment compared to the corresponding period last year.

– – – Significant decline (>10%), – – Clear decline (5–10%), – Slight decline (<5%), Stable,
+ Slight growth (<5%), ++ Clear growth (5–10%), +++ Significant growth (>10%)

Source: Kone

Richard Scrope, Fund Manager, VT Global Select Fund, 30th September 2022

Data source (unless otherwise stated): Bloomberg.

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