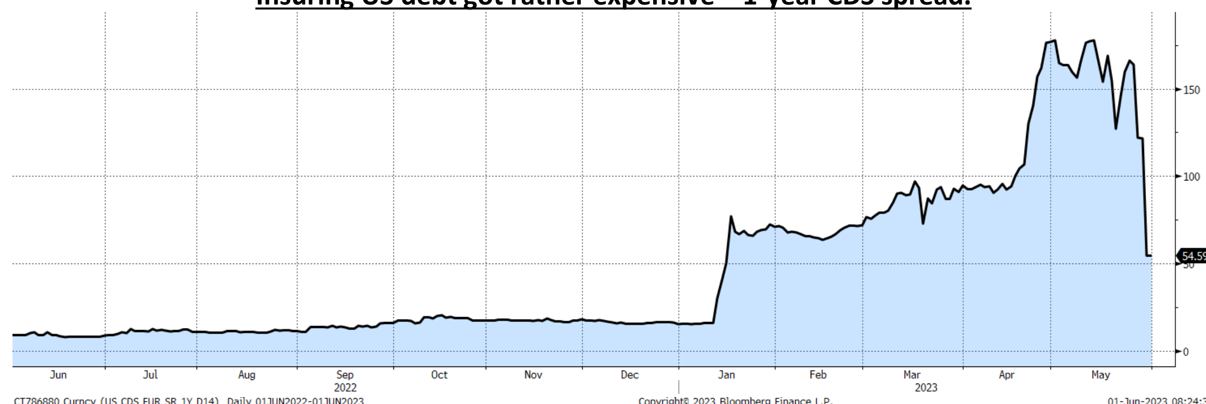
"Mediocrity knows nothing higher than itself, but talent instantly recognises genius". – Arthur Conan Doyle.

The spectre of the US debt ceiling and risk of default loomed over the month of May as Republicans and Democrats went toe-to-toe, bartering for cuts in the President's spending plans in exchange for any agreement to raise the ceiling for the 79th time since its introduction in 1960. Discussions over raising the debt limit have a habit of going to right to the line, but in the 49 times that the limit was in danger of being breaches under a Republican president, and the 29 times under a Democratic president, congressional leaders have always buckled and accepted that it is necessary to do so, rather than see the US default on its obligations.

Once again, the negotiations went to the wire but in the end, subject to it passing a vote in Congress, a two-year deal to suspend the $31.4 trillion ceiling was agreed in return for cuts in discretionary spending. The two sides disagree about the scale of these cuts, with the Democrats believing that $1 trillion will be saved over the next decade, while the Republicans see a reduction of around $2 trillion.

Insuring US debt got rather expensive – 1-year CDS spread.

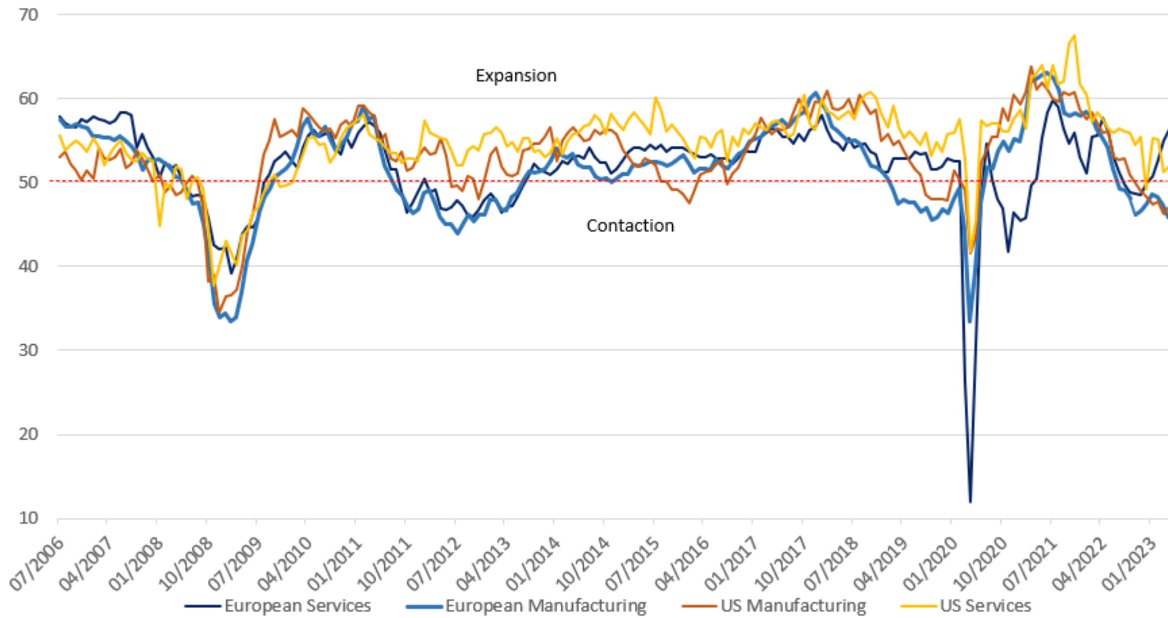


Source: Bloomberg

The economic backdrop remains opaque, with many of the different leading indicators painting very different pictures of the outlook for the developed economies. This month we have seen the first signs of weakness in consumer spending, which up to now has been surprisingly robust. Inflation is starting to come down, but in many areas at a slower rate than the market expects, and central banks are stating to turn less hawkish. We expect that inflation will remain above the top end of the central banks' arbitrary target bands for much longer than their estimates currently suggest, but they will have to start the rate cutting cycle before that time. The market currently is pricing in a pause by the US Federal Reserve in July with the first cut coming in September and 50bp but the year end, which we believe is plausible, but the 150bp cut by this time next year may be too optimistic and investors should get used to more a normal interest rate environment, unlike what we have experienced over the last decade; in this situation sensible balance sheet management should finally be rewarded.

On area where the current differences in economic environment have become very apparent is shown by the Purchasing Managers' Indices, where the supply part of both Europe and the US continues to grow at an acceptable rate, while the manufacturing side shows little sign of improving and in fact the most recent data shows that it is declining at a faster rate.

Bifurcating economies.

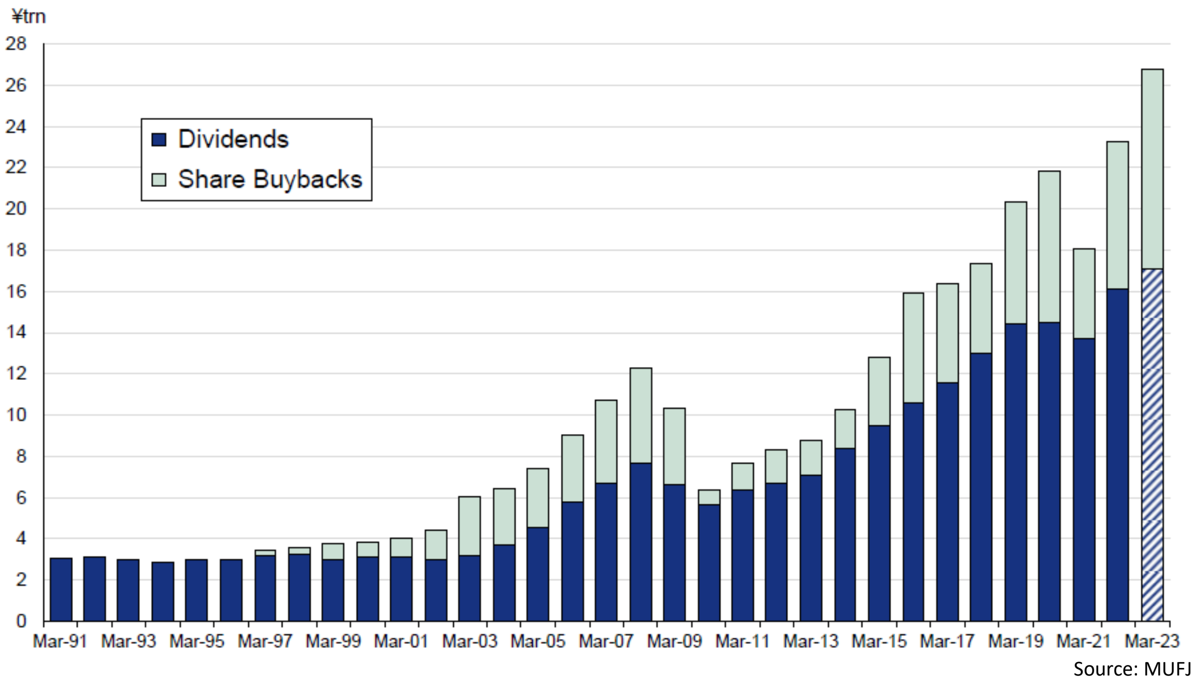


Source: TIM/ Institute for Supply Management/ S&P Global

The Japanese stock market has had many a false dawn, but the recent rally has seen the Nikkei 225 hit the highest level since 1990 in Yen terms, however in Sterling, Dollar or relative to the MSCI index it remains a long way off hitting new highs.

Source: TIM/ Bloomberg

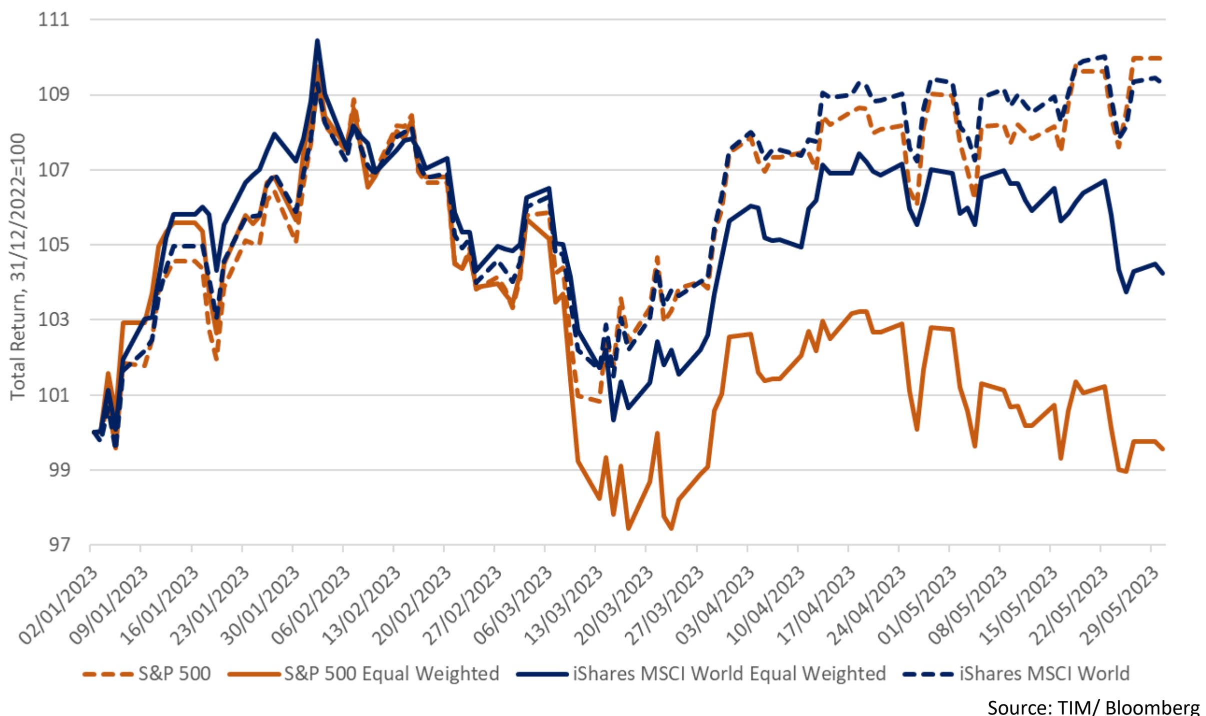
The decision whether to hedge the Yen, or not, has always been a key decision for investors who have sought to make a profit from investing in Japanese equities in the past, but there are signs that there are more fundamental changes afoot in the land of the rising sun that may lead to opportunities in whichever currency one chooses. Over the last decade corporate governance has improved, cross shareholdings have decreased, and management teams have started to return cash to shareholders, rather than sit of large net-cash balance sheets. Many companies are buying back large amounts of their own shares, agreeing with the beliefs of the Tokyo Stock Exchange that hundreds of companies trade well below book value; Citizen Watch recently grabbed the headlines with announcement that it is to buyback 25% of its outstanding stock.



Source: MUFJ

Foreign investors, enthused by Warren Buffet's recent promotion of Japanese equities, have started to invest once more in the region with a net $44 billion of flow heading into the market since the start of April. Whether this belief in a new era for Japanese equity investing will last, or prove to be another false dawn, may well rest on the actions of the new governor of the Bank of Japan, and whether he looks to abandon the ultra-loose monetary policy of the old guard. According to the last data, the monetary easing policy resulted in the Bank of Japan owing 63% of all the assets invested in Japanese ETFs, making it the largest holder of Japanese equity market, surpassing the Government Pension Investment Fund for the first time. Thus far Governor Ueda has continued to adopt a dovish stance despite the rise in inflation.

The Narrowness of the Market.



Source: TIM/ Bloomberg

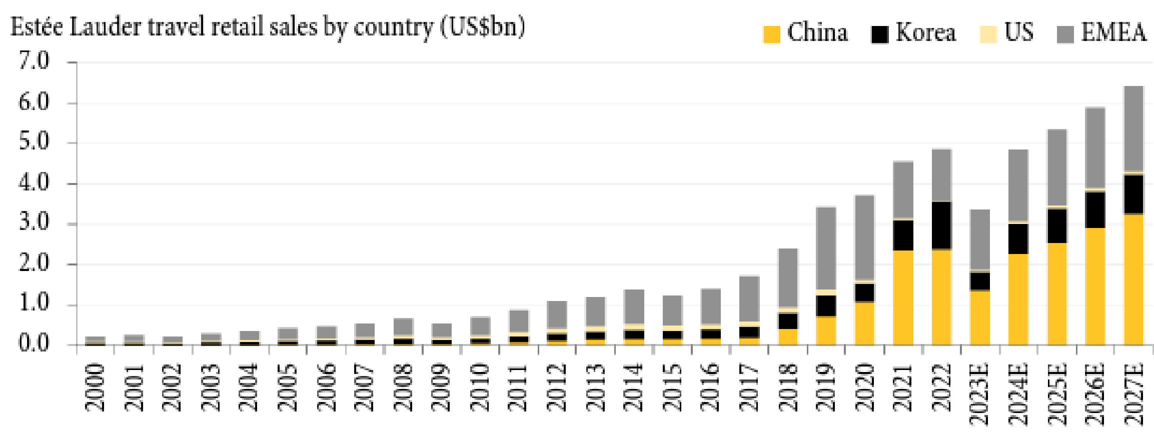
The Narrow nature of global markets has been a headwind for Fund so far this year, as the Fund has a high active share and therefore has composition markedly different to the top 10 weighted stocks of the global index. At the end of April, the top 10 weighted stocks had a combined weighting of 17.9% of the total index, more than that of all of the companies of Japan, the UK, France and Canada together. As shown in the chart above, the US the concentration is even more marked as the equal weighted S&P 500 has negative returns so far this year, while the market-cap weighted version is up by almost 10% and the NYSE FANG+ index (Amazon, Alphabet, Netflix, Apple, Meta, Microsoft, Advanced Micro Devices, NVIDIA, Tesla & Snowflake) is up 62% so far this year. Although the concentration has been a factor for most of the year, the race to the perceived safety of the large caps has accelerated in the month, exacerbated by the AI offerings launched by most of these companies.

The VT Tyndall Global Select Fund B Acc (GBP) fell by 2.92% as its consumer spending related stocks (Nike and Estée Lauder) and healthcare holdings ex Roche, Novo Nordisk and AstraZeneca weighed on performance (see later). The Fund has risen by 2.68% in the year-to-date.

Fund Activity and News

Our holding in Estée Lauder held back performance this month after making significant cuts to its outlook for the year as travel retail sales in China have failed to materialise leading to excessive inventories in the channel.

Travel retail has grown in importance for Estée Lauder over recent years, especially in the Asian world. The total market size in this category is estimated to be $87 billion, of which 43.7% is spent on perfumes and cosmetics; in China the share of cosmetics as a percentage of travel retail sales is in excess of 65%. Over the past five years the duty free has been a tremendous source of growth for the company and now accounts for 27% of total sales, having been only 12% in 2016.



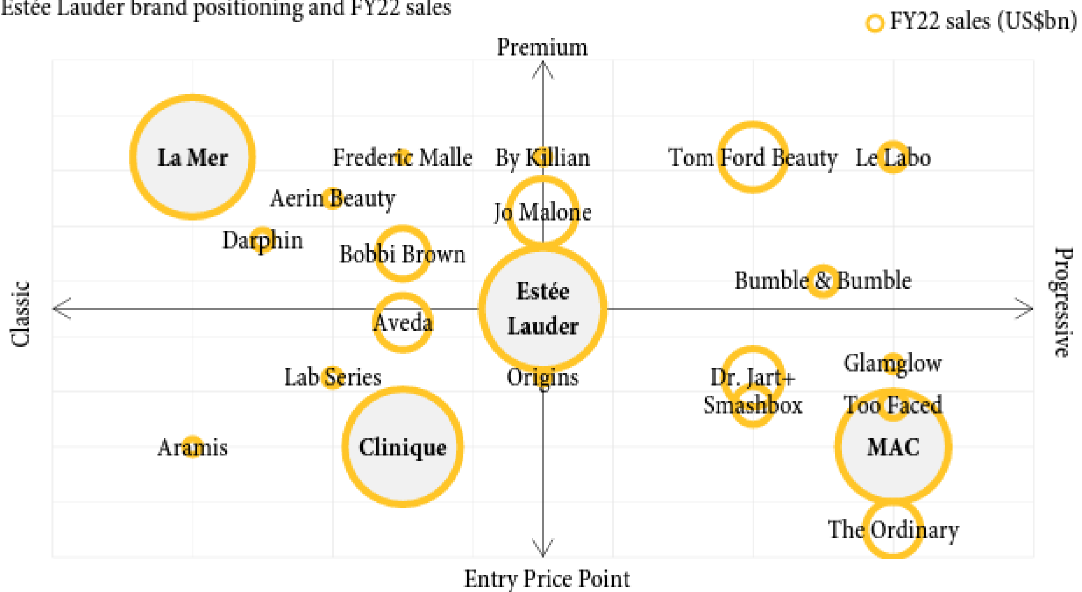
Lead times for orders and the lockdown in China have combined to create a large speed bump in the trajectory of growth in Asia. The CEO pointed out that in Asia customers must place their orders several months in advance, and thus came into Estéé before China went into full lockdown last August. The lockdown led to inventory sitting on retailers' shelves until China reopened to travel, and thus, subsequent orders will have to wait until these excess inventories normalise. Recent data shows that post the initial surge in sales in the immediate aftermath the reopening, which included Chinese New Year, customer conversion rates have fallen significantly, suggesting that it may take a few quarters for these backlogs to work through. We do not think that low conversion rates is an Estée specific issue as their brands remain amongst the top in the most desirable lists.

Value of investments can fall as well as rise and you may not get back the amount you have invested

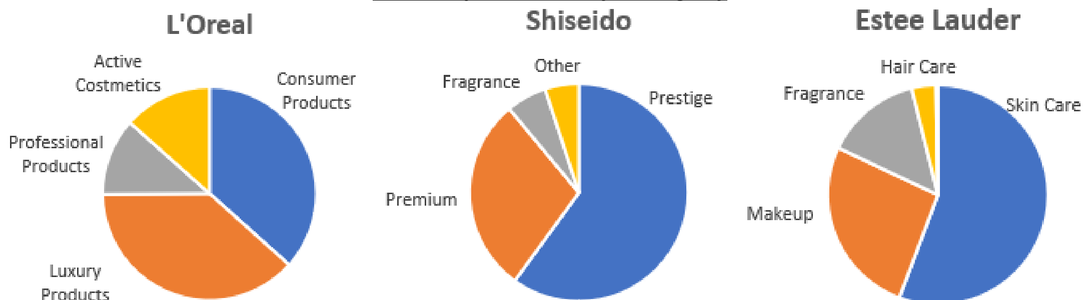
Hainan visitors are returning but not spending.

Source: TIM/ Hainan Tourist Administration

The positioning of Estée Lauder is distinctively different from that of Shiseido or L'Oréal, being heavily skewed towards premium, making it more reliant on affluent customer spending patterns, albeit that we believe the beauty product market is fairly price inelastic as customers are traditionally unwilling to trade down when they find a brand or product that they like.



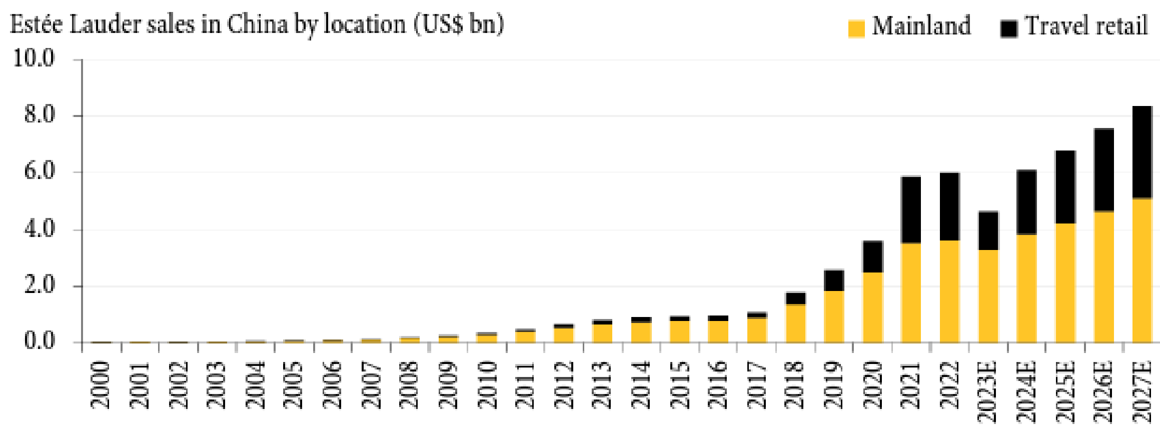
The Major Three by Category



Source: TIM/Company Reports, Redburn

Geographically all three have seem growth in Asia outpace that from their Western markets and Asia Pacific accounts for 37.3% of L'Oréal's sales, 68% of Shiseido's (45.7% ex Japan) and 30.7% of Estée Lauder's sales. Despite its relative late entry to China, L'Oréal entered the country 27 years ago, the high exposure to prestige has led to a rapid acceleration of growth in Asian sales, both in travel retail as well as mainland sales.

Estée Lauder's big bet on China



Source: Redburn, company

While it may take time for Estée to regain their growth trajectory, we believe that following the price correction after reporting its their-quarter results, where it reset its guidance and laid out the issues in travel retail, now reflects the short-term headwinds. We still see luxury consumer goods as a core growth sector with limited cyclicality and strong cash flow characteristics, and as such we continue to hold our position in the company.

Richard Scrope, Fund Manager, VT Global Select Fund, 31st May 2023
Data source (unless otherwise stated): Bloomberg.

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