

A journey through the "Valley of Sorrows"

Central banks have since the financial crisis in 2008, through low interest rates and liquidity, aggressively used the financial levers of the economy to pull the real economy forward. Now the central banks need to make a U-turn. It is about the perception of control and via the financial economy – to lower inflation and inflation expectations in the real economy. This has hit stock markets hard with a fall of almost 20 pct. (USD) so far this year. Equity markets are forward-looking and the harsher environment for equities is reflected instantly. However, the latest stock price of a company is not always the truth. When fear is the driving force, investors become short-term focused, and pessimism dominates. It can be difficult to see the end of the “Valley of Sorrows”, if it is the first time you do the walk. There are several factors in play, and with the intensification of the war in Ukraine, we are in new territory. We believe that the image of a journey through a valley is more accurate than one where we are at “the end of the world” as some permanent pessimists currently are voicing. Maintaining a long-term perspective and belief in our common future is harder and more important than ever given the current more complex investment environment.

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Bo Knudsen

Managing Director and Portfolio Manager,
C WorldWide Asset Management

Figure 1
Inflation break-out reverses structural decline



Source: U.S. Bureau of Labor Statistics, June 2022

“The central banks are on a mission to strengthen their credibility.”

The negative development in the equity markets is primarily caused by the persistently high inflation trend, which central banks had hoped would be a temporary phenomenon. At present, inflation is around 8%, while inflation excluding energy and food is around 6%. See Figure 1. Initially, rising inflation could be explained by the stop-start effects of the Covid19 lockdowns, but the war in Ukraine has sparked higher energy and commodity prices and exposed a failed Western energy policy with prolonged underinvestment in the energy sector. Therefore, the Covid19-induced inflation spike has become more persistent.

Central banks on a mission to regain credibility

Central banks have lost credibility by sticking to a very accommodative monetary policy for too long. The central banks are therefore on a mission to strengthen their credibility. They have made a U-turn and are now talking hawkishly and articulating a tight future monetary policy trajectory. Over the past decade, central banks needed to stimulate asset markets (primarily housing, bonds and equities) to spur consumer optimism, economic growth and higher inflation. Now we have the opposite situation. Central banks

Figure 2
Falling labor participation rate



Source: Federal Reserve Economic Data, May 2022

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are forced to tighten and take speculation out of asset markets to dampen the real economy and inflation expectations. This hurts being an equity investor, but more positively, labor resources may be freed-up for the real economy through an increased focus on the need for a more stable wage income. Figure 2 shows the labor force participation ratio in the US. As can be seen, the participation ratio has been declining, especially during Covid19. When equity markets and housing (and bitcoin...) were in a bull market, a part of the population could conceivably afford to live without – or at least with a reduced – wage income. This created a tendency to finance living expenses with the strong increases

in house and equity prices. This has all changed now and we would submit that the renewed need for wage income will expand the workforce once again. An expansion of the workforce will be a long-term benefit for corporations.

A relevant question is whether higher interest rates are the right tool to combat high inflation when the cause is supply problems and disruption of supply chains. It is not the right long-term solution, but central banks have no other solutions in their toolbox. While the underlying problems are partly geopolitical, they can also be alleviated through large investments in new infrastructure – including

Figure 3
30-year mortgage rate in US



Source: Federal Reserve Economic Data, June 2022

a more renewable energy structure. These crucial public and private investments can only be realized in an environment of low and preferably stable real interest rates. High interest rates are a detriment to this politically important agenda and are one of the reasons we believe that central banks will sooner or later be forced to retract on their hawkish stance.

The policy change is already having impact

The Fed has started raising interest rates – to date by 1.5%-points. The European Central Bank (ECB) is expected to follow suit in July. But the effect of the policy change is already noticeable. Ten-year government bond yields have risen approximately 1.5%-points in the US and Europe, respectively, while credit yields have risen by a similar amount or more. Chart 3 shows the development of the 30-

year mortgage rate in the US. The yield has almost doubled in six months. These increases are the strongest in more than 20 years. This will have a meaningful effect on the housing market, especially as these markets are priced at the margin. A house is the consumer’s most important asset, and a slowdown will have significant negative multiplier effects for the real economy, just as these effects worked positively during the economic upturn. Additionally, global debt is higher than ever. Government debt in the US is 130% of GDP, while in Europe it is around 100%. In the 1970s and early 80s, US debt was approx. 30%. Due to the high levels of debt, especially since the financial crisis, our thesis has always been that politicians cannot tolerate the societal consequences of high interest rates.

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Central banks are expected to continue down the tightening path until something gives in. This may be a clear sign that inflation is declining because of falling demand and lower consumer confidence. Another option is troubled credit markets. The central banks cannot ignore this. The ECB will be concerned about the effects of large yield increases in southern Europe. We believe these conditions limit how long central banks can continue with their existing tight monetary policy stance.

Economic indicators are deteriorating

There is intense debate over whether a recession is imminent or not and as usual, we will only detect the recession and get confirmatory data in hindsight – approximately a couple of months after it has occurred. We do not have access to a crystal ball but we are confident that we are facing a slowdown because of rising bond yields, rising inflation which erodes consumers’ real disposable income, the prospect of a weaker housing market and the declines in equity markets. Whether this will cause a recession this year is probably too early to call, but the direction is clear.

Not what we had anticipated

We had not foreseen the current situation. We had expected market turbulence when the central banks, as expected, would raise interest rates in the first half of the year. But we did not foresee the Russian aggression in Ukraine and the subsequent effects on inflation.

Generally, we believe it is a difficult exercise to time equity markets. Among other things, we have written about this in our Insight: [Global Equities – Buy, Sell Or Hold?](#) It is not the end of the world that awaits equity investors, but rather a challenging



journey. If we get a more severe recession, equity markets face more risk as companies will start to downgrade earnings forecasts. Until now, the decline has primarily been driven by rising interest rates which have compressed valuations. In addition, the increased market volatility has led more speculative market participants to reduce leverage and thus risk exposure. This reinforces the downward pressure on equity markets.

Current market prices are a snapshot influenced by many short-term factors. A war on Europe’s doorstep naturally narrows investors’ time horizon. As always, we recommend a longer time horizon as we believe the patient investor will be rewarded. We foresee a period where economic indicators will be negative, but the sentiment will change. Negative



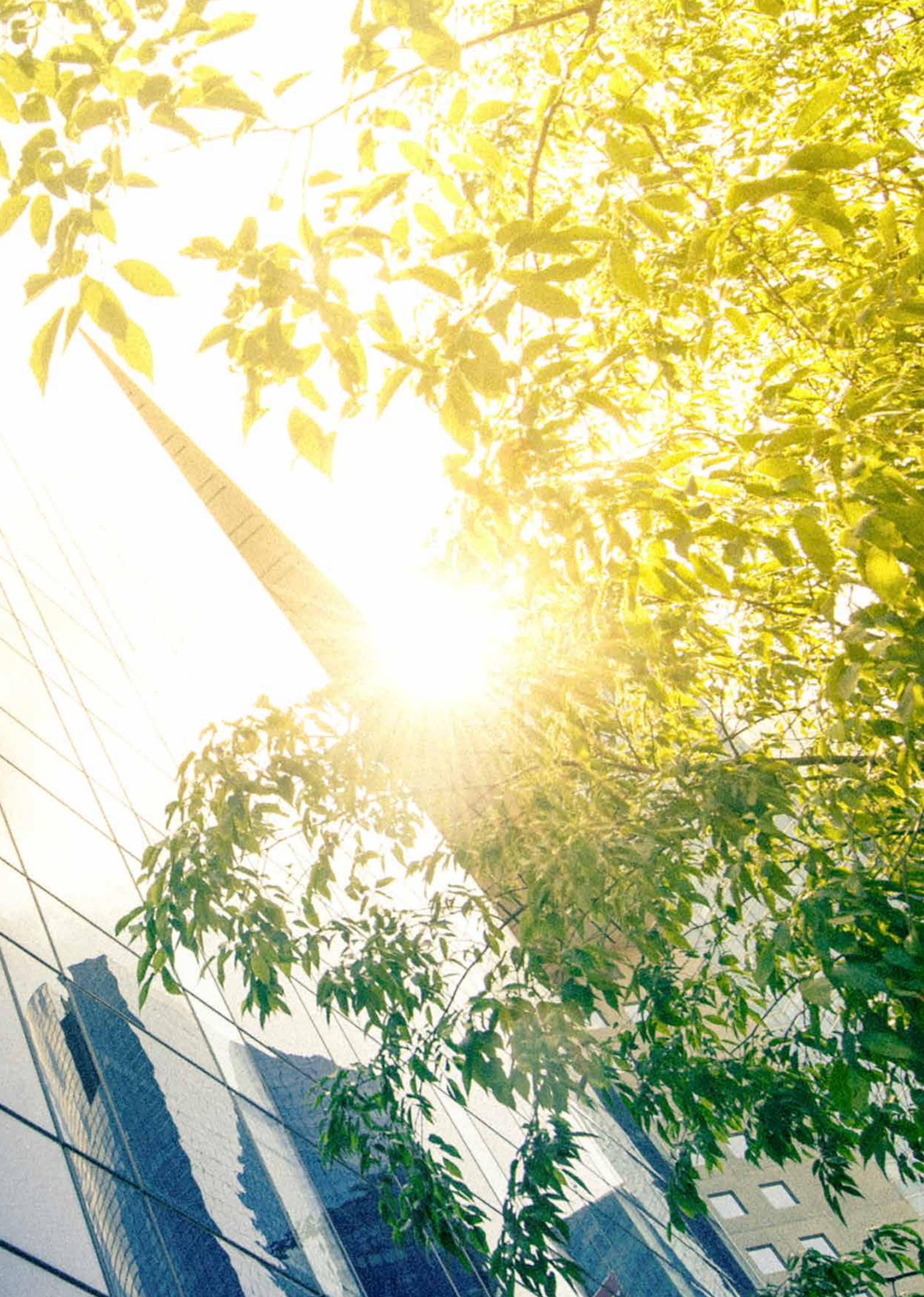
“We are facing a period where the economic indicators will be negative, but the mood around this will change. Negative numbers will be interpreted positively”

numbers will start to be interpreted positively. This will be a sign that the central banks have reached their goals, and the journey through the Valley of Sorrows is nearing the end.

It is a typically difficult period for growth stocks when investors’ time horizon narrows, and bond yields rise sharply. This has been the case this year and is the reason for our weaker return relative to the market. However, except for a few instances, the companies in our global portfolio have met our expectations this year. We remain confident that the fundamental value and competitive position of our portfolio companies are intact. We have seen this trend before, and weaker economic growth or a recession usually reverses the relative trend in favor of growth stocks.

Energy and commodity prices are key risk factors

It is relevant to mention commodity and especially energy prices as a risk factor. A worsening supply situation, especially in relation to the war between Ukraine and Russia, could mean higher commodity prices, which will make it more difficult to contain rising inflation. This would pressure central banks further thereby magnifying the dilemma between tighter monetary policy and the corresponding negative consequences for economies and asset markets.





C WorldWide Global Equities Ex Tobacco

Quarterly comment

In the quarter, the strategy returned -7.5% (AUD), slightly above the MSCI AC World Index, which fell 7.9%. The second quarter marked the end of the worst first half-year for global equity markets since the launch of the MSCI World Index in 1986 and a period full of negative events, such as the war in Ukraine, the draconian lockdowns in China, continued supply chain disruptions, rising inflation, and an aggressive hiking cycle by the Fed supplemented by quantitative tightening. As a small positive, there are some signs that inflation is peaking, and US 10-year rates have fallen close to 50bps from the high in mid-June. Furthermore, many commodity prices have fallen substantially from their highs, copper for instance by 25% since March, signaling the anticipation of a weaker economy and raising hopes that the Fed may become more dovish towards the end-of-the-year, a development that should support the heavily de-rated growth stocks. There are also some tentative signs that the lockdowns in China are becoming less restrictive.

The top contributors for the quarter were Novo Nordisk, AIA and American Tower. After a long period of transforming its agency network in China from a mass-market salesforce to more modern distribution channels, AIA has seen an increase in numbers of agents promoting its insurance products. The top three detractors were Amazon, Alphabet and ASML. Equity prices of technology companies with exposure to the digital ad market, such as Alphabet and Amazon suffered after competitor Snap preannounced negative results and pointed to broad-based weakness in digital ads across regions and verticals. There are some reasons to believe that this could mostly be an issue for Snap as consumers are shifting spending away from buying merchandise to travel where Snap has minimal exposure.

Investment strategy and portfolio changes

We sold our investment in **Unilever** and added the industrial gas company **Linde**. Linde forms part of the oligopoly in the western industrial gas industry. The company is highly integrated with its customers and as industrial gas contracts are long-term in nature, the revenue stream is highly predictable. Unilever has a disputable track record in value creation, especially from expensive bolt-on acquisitions in recent years. In addition, the more recent debacle around the GSK Consumer Health bid has reduced our faith in the management team's strategy on capital allocation.

C WorldWide Global Equities Ex Tobacco Composite

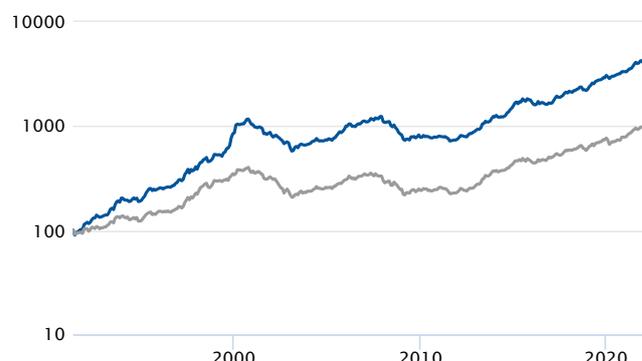
GROSS OF FEES IN AUD AS OF 30 JUNE 2022

INVESTMENT PHILOSOPHY

Name	C WorldWide Global Equities Ex Tobacco
Launch date	31 May 1991
Benchmark	MSCI All Country World incl. net dividends
Read more	www.cworldwide.com

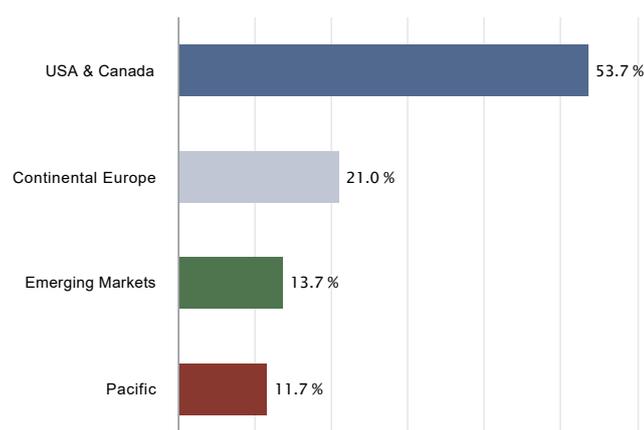
The strategy aims to achieve long-term capital growth exceeding the return of the market with a moderate risk profile as measured by standard deviation. The portfolio consists of 25-30 high conviction global large cap stock picks that ensure a sufficiently high-risk diversification. There are no geographic or sector restrictions in the strategy. This fact sheet has been prepared by C WorldWide Asset Management Fondsmæglersekskab A/S and is for information purposes only.

INVESTMENT RETURNS



Portfolio 3,299.5 % Benchmark 731.0 %

GEOGRAPHIC DIVERSIFICATION



RETURN & RISK

	Q2	YTD	1 Y	3 Y	5 Y	10 Y	Lifetime
Portfolio (gross) (%)	-7.5	-20.2	-8.6	8.2	12.4	15.7	12.0
Benchmark (%)	-7.9	-15.6	-8.0	6.9	9.4	13.2	7.0
Relative performance (%)	0.4	-4.6	-0.5	1.3	3.0	2.5	5.0

	3 Y	5 Y	10 Y	Lifetime
Std. dev. p.a. portfolio (%)	10.8	10.6	11.1	13.7
Std. dev. p.a. benchmark (%)	11.3	10.9	10.3	12.0
Beta	0.8	0.9	1.0	1.0

Periods longer than 1 year are shown annualized

TOP 10 HOLDINGS

	Share in %
Alphabet	6.8
HDFC	6.4
Novo Nordisk	6.3
Thermo Fisher Scientific	6.3
Microsoft	6.0
Visa	5.1
The Home Depot	4.8
Nestle	4.2
Sony Group	3.9
Amazon.com	3.8

CONTRIBUTION (3 MONTHS ROLLING)

Top/Bottom 5	Contribution (%)	Return (%)
▲ Novo Nordisk	0.4	7.8
▲ AIA Group	0.4	13.9
▲ American Tower	0.3	12.1
▲ Procter & Gamble	0.1	3.2
▲ Thermo Fisher Scientific	0.0	0.4
▼ Amazon.com	-1.4	-28.9
▼ Alphabet	-1.1	-14.5
▼ ASML	-0.8	-22.9
▼ Sony Group	-0.6	-15.0
▼ Siemens	-0.6	-20.6

All figures are based on past performance. Past performance is not a reliable indicator of future performance. The currency is AUD. The return may increase or decrease as a result of currency fluctuations. The figures are based on a composite. The figures are gross of investment management fee and performance fee, if any. Other fees, incurred by the investor, such as custodian fee and transaction costs, are not included.

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BNP PARIBAS ASSET MANAGEMENT AUSTRALIA LIMITED

60 Castlereagh Street, Sydney NSW 2000

Tel: 1800 267 726 (Australia) or +61 2 9619 6041 · Email: AMAU.ClientService@bnpparibas.com
www.bnpparibas-am.com.au

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The gross figures are gross of investment management fee and performance fee, if any.

Other fees, incurred by the investor, such as custodian fee and transaction costs, are not included in the gross figures. The net figures are based on the actual performance including costs of all portfolios.

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C WORLDWIDE ASSET MANAGEMENT FONDSMAEGLERSELSKAB A/S

Dampfaergevej 26 · DK-2100 Copenhagen · Tel: +45 35 46 35 00 · cworldwide.com · info@cworldwide.com