

*Jacques Berghmans*

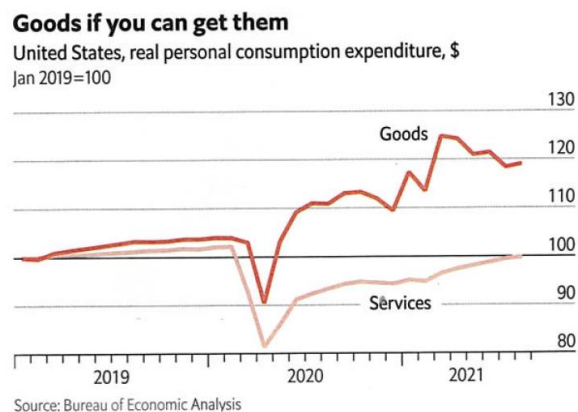
## 1. Economic and Market Environment

After an excellent start of the year, the last few months were somewhat more pedestrian for global equity markets. As I am writing, the MSCI All Countries World is up a little since September as its three major constituents, the American, European and Japanese stock markets, are slightly up, slightly down and roughly flat, respectively. One major concern for investors is the persistent high inflation in the US and Europe, which for the first time in decades is above 5% YoY.

In our second quarter newsletter, we did an analysis on what could be the causes of inflation and why investing in the global stock market is a good way for long term investors to protect their purchasing power. A lot of investors remain concerned though and wonder if it is the right time to invest. Our experience tells us that timing the market is impossible, but what is certain is **that after 10 years, cash will lose 40% of its purchasing power when inflation is running at 5% per annum.**

*"Today people who hold cash equivalents feel comfortable. They shouldn't. They have opted for a terrible long-term asset, one that pays virtually nothing and is certain to depreciate in value."* (Warren Buffett)

Initially most economists thought that the inflation pick-up was driven by supply disruptions due to the COVID-19 pandemic. There was plenty of anecdotal evidence of supply bottlenecks and experts thought at the beginning of 2021 that inflation would be temporary<sup>1</sup>. Twelve months later, the same experts are not so sure anymore and Henry Curr, editor at *The Economist*, recently wrote that we could face a new world of higher inflation. He also observed, as shown in the graph below that inflation might not only be supply driven, but that the pandemic and the resulting policies may also have created a boom in the demand for goods. Households in Europe and the US, stuck at home and unable to spend money on services, with some of them receiving a cash bonus from their respective governments, went on a spending spree. Housing, home renovation, electronics and surprisingly second-hand cars were bought and saw significant price increases.



<sup>1</sup> <https://www.economist.com/finance-and-economics/2021/01/21/supply-bottlenecks-are-pushing-up-costs-for-manufacturers>

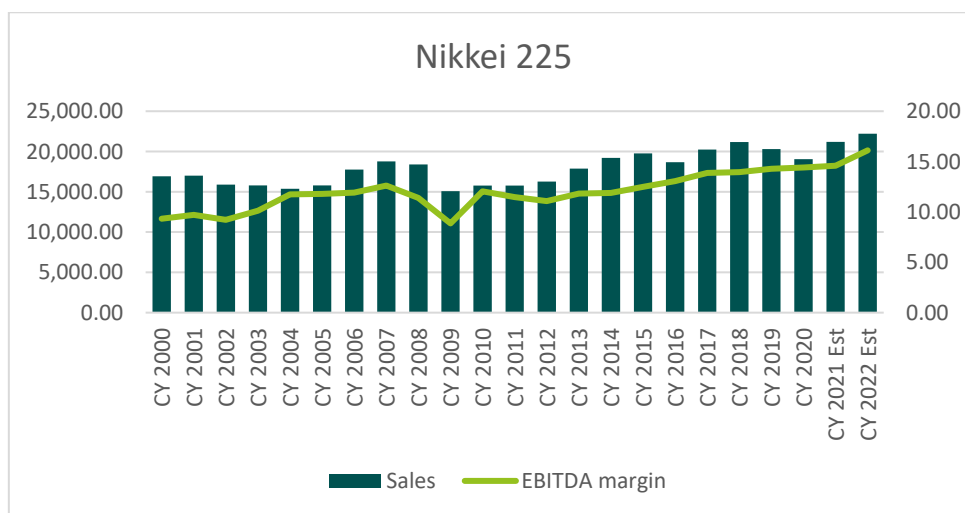
The increase in the demand of goods in the US and Europe led to a boom in Chinese exports, surging electricity demand in China and eventually higher energy prices across the world. This inflation spike could still prove temporary if supply catches up and/or there is a significant drop in aggregate demand, but this will be less and less likely as inflation tends to feed itself through higher wages and companies increasing prices. If inflation is here to stay, it is interesting to understand why **global equity markets** tend to provide decent protection for long term investors. In our 3Q21 newsletter<sup>2</sup>, we observed that a lot of the excellent performance in recent months was driven by a strong earnings recovery and not valuation multiple expansion. Over the long term, global equity valuation multiples tend to be range bound between 10x and 20x forward price to earnings. There are short periods of time when equity markets are more expensive, like during the dotcom bubble in 1999, or cheaper, such as just after the crash in 2008, but these situations usually only last one or two years. **Over longer cycles, the only driver for stock performance is earnings growth** as shareholders are legally entitled to the flow of future earnings. In simple mathematics, the link between equity returns, earnings growth and ultimately inflation can be explained by the three equations below.

**Overall equity return**  $\cong$  (**Earnings growth** x change in valuation multiple) + dividend

**Earnings growth**  $\cong$  **Revenue growth** x margin evolution

**Revenue growth**  $\cong$  Volume growth x **Price increase (inflation)**

Empirically, we can also observe that earnings growth has been remarkably resilient across major markets over the last twenty years. Looking at the Nikkei 225, we can see that over 20 years, the listed companies have delivered slow but consistent revenue growth and expanding margins which ultimately led to good earnings growth.



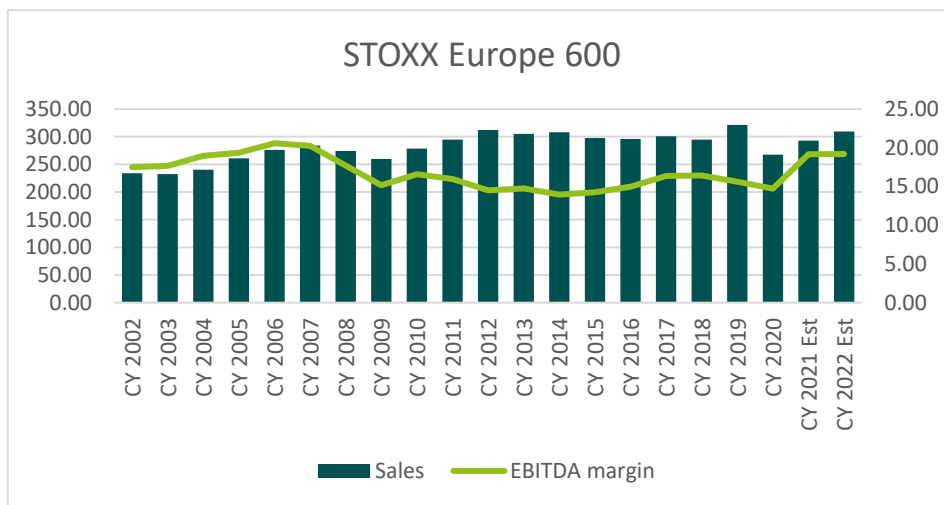
Source: Bloomberg

Interestingly in Japan, the consistent earnings growth was accompanied by a de-rating of the overall market and the Nikkei 225 currently trades on a trough price earnings ratio. We are anything but experts in Japanese stocks and we would never recommend buying a specific geography, but these low multiples give us some comfort, as Japan still represents an important part of global indexes.

<sup>2</sup> <https://treetoprivate.be/sites/default/files/2021-10/3Q21%20Lettre%20du%20Gestionnaire%20JB.pdf>

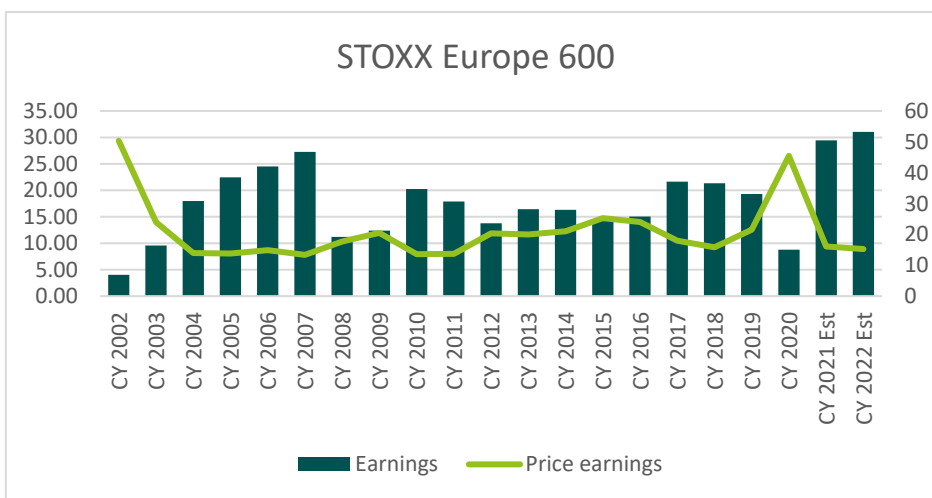


Europe unfortunately has been more problematic with low revenue growth like in Japan but also margin pressure since the financial crisis in 2008. As a result, earnings growth has been weak overall.



Source: Bloomberg

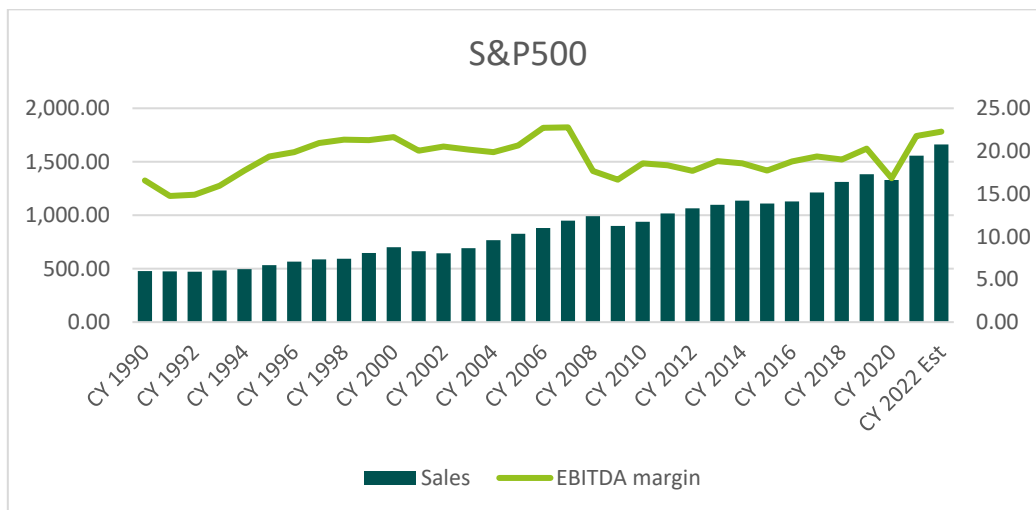
Analysts expect earnings for the STOXX Europe 600 to overtake its 2007 level for the first time in 2022, 13 years after the financial crisis! While earnings growth and overall market performance hasn't been attractive in Europe, at least the market is trading at trough valuation multiples and 2021 will hopefully mark the end of the earnings drought in Europe.



Source: Bloomberg

Lastly and most importantly, given its weight in global indexes, the US market has delivered excellent performance this year in continuation of the positive trend since the financial crisis in 2009. As we can see on the graph below, both EBITDA margins and revenue growth have been steady over the last two decades and while 2020 was a difficult year,

due to the pandemic and various lockdowns, 2021 will be a very good year for US listed stocks. For long term investors, it is important to notice that EBITDA margins in the US market are only expected to go back to the level of the mid-nineties and we cannot really speak of US companies over-earning massively even after the recent uptick.



Source: Bloomberg

As we can see on the graph below, the US-market has actually de-rated this year and is cheaper than at the end of 2020. Valuation multiples are higher than in the decade following the financial crisis in 2009 but are not excessively high when looking at the last thirty years.

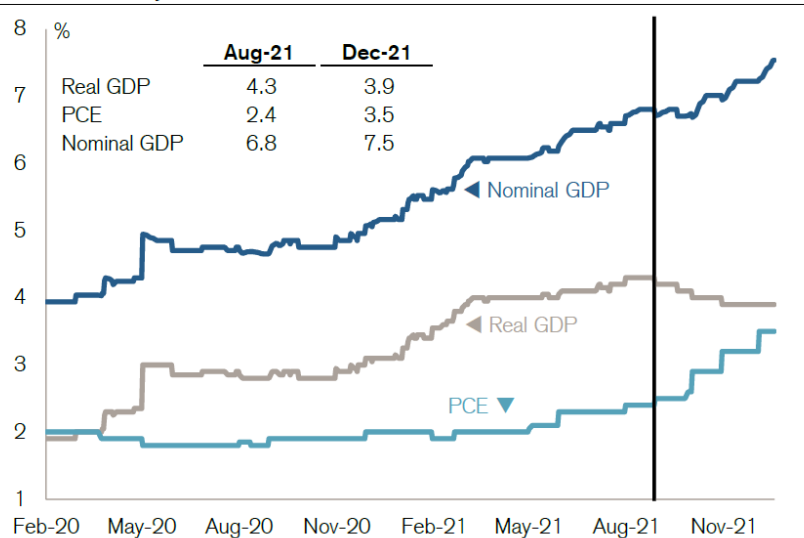


Source: Bloomberg

The investment bank Credit Suisse in a recent report<sup>3</sup> upgraded its guidance for the S&P500 to low teens returns for 2022. While these kinds of forecasts need to be taken with a heavy pinch of salt, as they rarely pass the test of time, the methodology behind these forecasts can be informative. The rationale used by the Credit Suisse analysts is that consensus has been upgrading its growth forecasts for the US economy over the last twelve months, first as the economic recovery post COVID was much faster than expected, and then as inflation accelerated and pushed nominal growth higher. While we are sceptical of short-term forecasts for equity markets, we think the methodology is valid over a longer time horizon.

<sup>3</sup> U.S Equity Strategy Navigator, January 2022

## Consensus Projections for 2022 Real and Nominal GDP and PCE



2022 nominal GDP is projected to expand 7.5% (3.9% real and 3.5% inflation)

Real GDP forecasts have fallen over the past 4 months

Source: BEA, the BLOOMBERG PROFESSIONAL™ service, Credit Suisse

In conclusion, the excellent performance of global equity markets over the last 18 months<sup>4</sup> does not mean that we have necessarily reached a peak. A significant part of this performance was driven by a strong economic and earnings recovery following the onslaught of the COVID-19 pandemic, which means that global equity markets are not that expensive especially compared to other asset classes like bonds. Going forward, we are seeing signs of continuous strong activity like the significant demand acceleration for goods, which could drive the economy and company earnings to the next level<sup>5</sup>. For long term investors, global equity markets also act as an inflation hedge, crucial in these times of increasing prices.

Please feel free to contact us if you have any questions on our investment strategy. We wish you a happy new year and fruitful investments.

## 2. Our convictions

After a very strong start of the year, the last few months were more disappointing for our strategy as some of our investments reversed some of their gains like **CHINASOFT INTERNATIONAL**, **FUFENG** and **INDIABULLS HOUSING FINANCE**. Some of our historic investments like **ASSTEAD** and **ALIMENTATION COUCHE-TARD** performed better but didn't compensate enough for the poor performing stocks. While disappointing, these businesses continue to have strong fundamentals and trade on reasonable valuation multiples.

One major change we made in recent months is to replace some of our investments (mainly companies which were acquired, like **ZOOPLUS** and **NORWEGIAN FINANS HOLDING**) with members of the 'Dogs of the Dow'. The 'Dogs of the Dow' is an index-like strategy, where once a year the 10 highest dividend paying stocks from the Dow Jones Industrial Average index are selected to form an investment portfolio. Our rationale in adopting this strategy for part of the portfolio is severalfold. First, the strategy has a good long-term track-record, outperforming most of the markets in recent years and over the longer term. Secondly, our strategy, as well the ones of my colleagues Andrew Dalrymple and Sharon Bentley Hamlyn, tends to heavily overweight growth and small & mid-market capitalizations. We each have our own predilection, myself for Asian growth businesses, Andrew for American tech and medtech stocks and Sharon for European growth companies, but none of us focuses on large American value stocks. Given the market evolution in recent years, even global indexes tend to overweight high flying American growth stocks. The Dogs of the

<sup>4</sup> Past market behaviours do not prejudge future behaviours

<sup>5</sup> No guarantee of results or performance

Dow on the contrary is exclusively made of large cap value names. While not as sexy as some growth stocks, we think the strategy will provide a good counterbalance to the overall offer of TreeTop.

Third, the Dogs of the Dow, by focusing on large companies with high dividends, should hopefully deliver a more consistent performance if economic performance deteriorates. The ten 2022 components of the strategy listed in the table below are mostly household names like **COCA-COLA** and **IBM**. Most stocks trade with a price to earnings ratio below 15x, with the exception of **COCA-COLA**, which trades on 26x PE and **3M** which trades on 18x PE. Every stock also has a dividend yield above 2%.

Company		2021		Company Description
Tickers	Name	PE	Dividend Y	
<b>DOW US</b>	<b>Dow Inc</b>	<b>6.5</b>	<b>4.8</b>	Dow Inc. produces and distributes chemical products. The Company manufactures and supplies chemicals for liquid injection molding, architecture fabrication, leather, textiles, automobiles, rubber consumer goods, and food industries. Dow serves customers worldwide.
<b>VZ US</b>	<b>Verizon Communications Inc</b>	<b>10.0</b>	<b>4.7</b>	Verizon Communications Inc. is an integrated telecommunications company that provides wire line voice and data services, wireless services, Internet services, and published directory information. The Company also provides network services for the federal government including business phone lines, data services, telecommunications equipment, and payphones.
<b>IBM US</b>	<b>International Business Machi</b>	<b>13.7</b>	<b>4.8</b>	International Business Machines Corporation (IBM) provides computer solutions. The Company offers application, technology consulting and support, process design and operations, cloud, digital workplace, and network services, as well as business resiliency, strategy, and design solutions. IBM serves clients worldwide.
<b>CVX US</b>	<b>Chevron Corp</b>	<b>14.4</b>	<b>4.4</b>	Chevron Corporation is an integrated energy company with operations in countries located around the world. The Company produces and transports crude oil and natural gas. Chevron also refines, markets, and distributes fuels, as well as is involved in chemical and mining operations, power generation, and energy services.
<b>WBA US</b>	<b>Walgreens Boots Alliance Inc</b>	<b>10.8</b>	<b>3.6</b>	Walgreens Boots Alliance, Inc., operates retail drugstores that offer a wide variety of prescription and non-prescription drugs as well as general goods. The Company also offers health services, including primary and acute care, wellness, pharmacy and disease management services, and health and fitness. Walgreens Boots Alliance serves customers in the United States.
<b>MRK US</b>	<b>Merck &amp; Co Inc</b>	<b>13.3</b>	<b>3.4</b>	Merck & Co., Inc. is a global health care company that delivers health solutions through its prescription medicines, vaccines, biologic therapies, animal health, and consumer care products, which it markets directly and through its joint ventures. The Company has operations in pharmaceutical, animal health, and consumer care.
<b>AMGN US</b>	<b>Amgen Inc</b>	<b>13.5</b>	<b>3.1</b>	Amgen Inc. is an independent biotechnology medicines company that discovers, develops, manufactures, and markets medicines for grievous illnesses. The Company focuses on human therapeutics and concentrates on innovating novel medicines based on cellular and molecular biology.
<b>MMM US</b>	<b>3M Co</b>	<b>18.3</b>	<b>3.3</b>	3M Company conducts operations in electronics, telecommunications, industrial, consumer and office, health care, safety, and other markets. The Company businesses share technologies, manufacturing operations, marketing channels, and other resources. 3M serves customers worldwide.
<b>KO US</b>	<b>Coca-Cola Co/The</b>	<b>26.3</b>	<b>2.8</b>	The Coca-Cola Company manufactures, markets, and distributes soft drink concentrates and syrups. The Company also distributes and markets juice and juice-drink products. Coca-Cola distributes its products to retailers and wholesalers in the United States and internationally.
<b>INTC US</b>	<b>Intel Corp</b>	<b>10.1</b>	<b>2.6</b>	Intel Corporation designs, manufactures, and sells computer components and related products. The Company major products include microprocessors, chipsets, embedded processors and microcontrollers, flash memory, graphic, network and communication, systems management software, conferencing, and digital imaging products.

Other than the Dogs of the Dow, we will continue to look for exciting businesses across the world and manage our existing positions. We continue to work with the management of **FUFENG** to improve value for external shareholders. **FUFENG** has been a long held position of ours and its successful consolidation of the amino acid industry in China hasn't translated yet into satisfactory returns for shareholders. One positive move by the management team though is its significant increase in the dividend payout and its consistent focus on delivering excellent operational results. As with other positions which were initially disappointing like **ZOPLUS**, we hope that patience will eventually pay off. Similarly, **INDIABULLS HOUSING FINANCE**, a leading real estate finance company in India, suffered tremendously from first a real estate crisis in India, then a banking crisis and finally COVID. Most managers would not survive such an onslaught of bad luck and indeed a number of Indian competitors did go bankrupt. Having straightened the ship during

a hurricane force five, we think that the management of **INDIABULLS HOUSING FINANCE** has a good shot at redemption.

We also continue to hold large positions in our historical winners like **UPLL**, an Indian herbicide & pesticide business with a worldwide presence, **ASHTeAD** and **UNITED RENTALS**, two leading equipment rental businesses in North America with incredible operational and financial track-records. To paraphrase the legendary investor Warren Buffett “*Why sell a stock if the business is still good and there is still value on the table.*”

With these wise words from the Sage of Omaha, we conclude 2021 and hope that 2022 will bring us health most importantly! And a lot of exciting investments.

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