Evenlode Income Investment View

October 2024 – The US Election – A bottom-up perspective

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October was a busy month for the UK stock market. It was characterised by global uncertainty ahead of the US election, domestic uncertainty ahead of the UK's autumn statement, geopolitical tensions in the Middle East, a weak Chinese economy, a busy third quarter reporting season, and rising bond yields - catalysed both by US economic data remaining robust, and markets beginning to price in a higher probability of a Trump presidency.

Performance

Evenlode Income continues to lag the FTSE All-Share during the current year. As discussed in recent investment views, the underperformance occurred in the March-April period. Though performance has been a bit ahead of the FTSE All-Share since the end of April, as I write Evenlode Income has risen +3.4% since the start of January, compared to +8.2% for the IA UK All Companies Sector and +8.7% for the FTSE All-Share[i].

We would rather be reporting more positive performance this year, but we continue to plough our usual, steady, cash compounding approach. We also view the current combination of quality and valuation appeal in the portfolio as very compelling. The portfolio's free cash flow yield[ii] is 5.3% and forecast to be 5.9% next year, providing healthy cover on the 2.8% dividend yield[iii]. Looking ahead over coming years, we think the prospects for free cash flow and dividend growth are attractive, thanks to the competitive advantages, attractive economics and growth opportunities of underlying holdings.

Evenlode Income passed its fifteenth anniversary on 19 October. Over this decade-and-a-half period, the fund has returned +337.1% versus +187.4% for the FTSE All-Share and +175.2% for the IA UK All Companies sector. This represents an annualised return of +10.3% after fees, compared to +7.3% for the FTSE All-Share and +7.0% for the IA UK All Companies sector[iv].

US election – The aftermath

In this month's investment view, I will focus on the US election result and its implications. I'm writing this on the day after the election, at which point it is clear that Trump has won the presidency, and that the Republican party has won control of the Senate. The race for the House of Representatives may not be known for several days, though it looks likely that the Republicans will win the house as well, giving the party a 'clean sweep'.

Global financial asset markets had begun to price in a Trump victory over the last six weeks, with bond yields rising and the dollar strengthening. Within the global stock market 'Trump trades' such as banking shares and US-listed shares (particularly technology, banks and more domestically-exposed businesses) have been performing strongly. Conversely, non-US equities (particularly companies more exposed to tariff risk and China) have been underperforming. These trends continued today, in the aftermath of the election.

It is worth noting that prior to the US election, the valuation of the US stock market index was already looking elevated, relative to both its long-term history and the current valuation of other non-US stock markets. On most long-term valuation yardsticks (such as market capitalisation as a share of GDP, price-to-sales ratio and cyclically adjusted price-to-earnings ratio[v]) the S&P 500 is close to or above the peak it reached back in the 1999-2000 period. Though global investors are strong buyers of the

US index today – as they have been with increasing urgency over the last two years – it is worth reflecting on the more limited margin of safety that such valuation multiples provide from here.

Evenlode Income – Implications for holdings

What are the main implications of the US election result for the companies held within the portfolio? The rest of this investment view contains a brief overview.

The prospects of a more protectionist US trade policy – particularly with China - is an important topic to discuss, and I will come back to this. First, though, I will rattle through some headline points.

A clear result

Prior to the election there was considerable nervousness that a clear result might not be forthcoming for weeks or months, both in the investment and the corporate world. Though Trump's victory is not without some unpredictability, the world now knows who the winner is, and the risk of a contested election has been removed from the list of potential outcomes.

Dollar strength

Many of the Evenlode Income holdings are UK-listed global market leaders. The portfolio's underlying revenues are therefore geographically diversified, with about 40% generated from the North American economy. The recent move in the dollar relative to the pound (+4% since the end of September) will provide a tailwind to the reported value of the portfolio's earnings and free cash flow, when translated back into sterling terms.

US corporation tax

On the fiscal policy front, the Trump administration's aim will be to reduce US corporation tax from 21% to 15%. The degree to which this is possible will rely on the final result of the race for the House. If Congress is split, the possibility of material changes to fiscal policy are likely to be limited. If Republicans take the House, tax reductions are likely. Any reduction in US corporation tax would – all other things being equal – provide a tailwind to the earnings and free cash flow generated from US listed holdings (Microsoft and CME Group) and US subsidiaries of the other Evenlode Income holdings.

US domestic investment

As well as aiming for loose fiscal policy, Trump's administration is keen to pursue an American First economic policy. At heart, the plan is to encourage both US and non-US companies to invest in the domestic US economy, utilising both carrots (such as generous investment credits, tax reductions and reduced regulation) and sticks (such as tariffs on imports and geopolitical threats). In many ways, this approach represents an amped-up version of the US industrial policy pursued by the Biden administration. The Republicans might, for instance, look to tweak the implementation of the Inflation Reduction Act if they take the House, but it is very likely that the overall act will be retained. The general thrust of the legislation is aligned with an America First policy, and it is already creating a large number of jobs, many of which are in Republican leaning counties and states.

As mentioned above, around 40% of Evenlode Income's revenues come from the US economy. More specifically, we think companies such as Smiths Group, Rotork, Diploma, Spectris, Halma and Spirax are well-placed to participate in the structural growth opportunities that long-term industrial investment and renewal will present (in the US, but also globally).

China tariffs

Now to tariffs. Trump has suggested that he is considering tariffs of up to 60% on all imported goods into the US from China. Many US/China tariffs are already in place, but a step-up in protectionism of this magnitude would clearly present risks to the Chinese, American and global economies. Balanced against these high headline levels, however, it is worth noting that there is a difference between saying and doing. Recent interviews with senior advisers to Trump suggest that the floated pre-election tariff level represent a maximalist stance (i.e. an opening gambit for negotiations). Given Trump's highly transactional approach, it is even possible that negotiations end with no tariffs, and a new trade deal between the US and China.

In terms of the impact on individual companies, if further US/China tariffs were implemented, it is worth making some more detailed comments. The themes of both tariff and supply chain complexity are ones that we have regularly discussed with companies over the last few years. We also ran an extensive project in 2022 on Chinese supply-chain exposure across the Evenlode portfolios, from which the company quotes used below are sourced.

1. US/China tariffs have limited relevance for many holdings. Some don't operate in the US at all. Others do operate in the US, but they sell services rather than 'stuff'. Falling into this category, for instance, would be RELX, Experian, Sage, Wolters Kluwer, Informa, LSE Group and Compass.
    - **Informa**: "*We don't have a China supply chain as such.*"
    - **Compass**: *"China is completely immaterial in terms of revenue and profit. I don't know exactly what percentage we source exactly but it's tiny – we mainly source food within country."*
    - **Sage**: *"our procurement spend in China is negligible."*
2. Where there is a potential impact from US/China tariffs, it tends to be related to supplier arrangements rather than the company's own manufacturing footprint. Most multinationals utilise a 'local-to-local' manufacturing model in both the US and in other regions. Products that are sold in the US tend to be made in the US. When they are not, it will tend to be for a specific reason, which doesn't typically involve manufacturing in China (e.g. Scotch Whisky is made in Scotland).
3. In terms of most company's sourcing footprint, US imports from China are small and have shrunk over the last few years. US/China tariffs have now been in place for over five years, and after their introduction during the first Trump administration, they were subsequently increased during the Biden administration. As a result, companies have been deliberately managing down China supply-chain risk for several years. This process accelerated during the post-Covid input cost inflation spike, and then again after Russia's invasion of Ukraine, as supply-chain disruption and geopolitical risk rose to the forefront of company management minds.
    - **Bunzl:** Its US business sources more than 90% of the not-for-resale products that it distributes in the US from the US - safety goggles, cleaning products, paper straws and similar items. Of

the remaining 10%, only a portion comes from China, and this could be substituted by supply from the US or other countries, if more onerous US/China tariffs were applied.

- **Spectris:** had one of the highest Chinese supply chain footprints that we have come across before Covid, at between 25%-30% of its cost-of-goods-sold. It has, though, reduced this exposure to less than 10% today. Of this c.10% figure, half of these purchases are made for China-for-China manufacturing. The rest could be quickly dual-sourced from elsewhere, if necessary.

4. Any tariff hikes on Chinese sourced inputs would be applied to the cost-of-goods sold value, rather than the final selling price. If it came to it, companies with high gross margins and pricing power would be in a strong position to protect their profitability from any price increases, as they were during the post-Covid input-cost inflationary spike. The average gross margin in the Evenlode Income portfolio is approximately 50%.

Tariffs with other countries

Trump has also floated – in quite a vague way – the possibility that he might impose tariffs of up to 10%-20% on imports from other countries. Pronouncements along these lines are, and may continue to, create uncertainty; Europe has made it clear that any tariffs from the US would be matched. Ultimately, any sweeping tariff policy to the rest of the world seems highly unlikely to materialise. One in every three items sold in the US is imported, so the inflationary impact on the US economy of anything broad-brush would be extremely uncomfortable for the new president – particularly as he found his way to the White House on an inflation-reducing ticket. It is likely, though, that selected tariffs are threatened and potentially applied on certain non-Chinese imports. For instance, the threat of tariffs on Mexican imports may be used as a negotiating point for discussions around bilateral trade and immigration. Or certain types of imports into the US, such as Scotch Whisky could be targeted. Scotch, for instance, was targeted before by the US, with tariffs levied between 2019 and 2021 as a result of a broader trade dispute with the EU.

In such targeted situations, if it came to it, most of the points made above, relating to China tariffs, would again be relevant.

The wider geopolitical backdrop

The other main question that Trump's victory raises is the implication for the global geopolitical backdrop. I have already touched on the US and China's competitive relationship - this will clearly remain an important part of the global mood music. For reference, we estimate that Evenlode Income's underlying revenue exposure to China is a little under 5%. We view this exposure to China as a risk to manage, but also as a source of opportunity. With the Chinese economy weakening this year, and recent worries over a Trump election win, several global companies with exposure towards China (Burberry and LVMH, for instance) are looking particularly interesting from a valuation perspective at present. China's government is likely to announce further stimulus measures over the next few days and weeks, with the timing of the National People's Congress deliberately coinciding with the aftermath of the US election.

Another factor to consider is Russia's occupation of Ukraine. It may be that the US will look to explore a negotiated ceasefire. This would come with risks, but it might also lead to an improvement in European economic sentiment – a region in which the backdrop has been very tough, but where interest rates are beginning to fall and there are early signs of economic green shoots.

Elections aren't everything and business fundamentals and valuations still matter

As the above discussion implies, the geopolitical backdrop is complex, and the US election has not simplified it. But two points are worth finishing on.

First, there is more to the economic backdrop than the US election cycle. In the aftermath of Trump's first election in 2016, for instance, high inflation was expected, bond yields spiked, and oil shares led the market higher. But in the end, over the duration of Trump's four-year term, inflation and bond yields fell, and the energy sector ended up as the weakest performing sector. Looking ahead to coming weeks, investors thoughts will turn to the potential Federal Reserve and Bank of England rate cuts this week, China stimulus, and the underlying performance of the global economy.

Second, company performance matters over the longer-term. We continue to believe in the compounding power of competitively advantaged companies. They possess qualities that allow adaptation and resilience in a wide range of circumstances. Many are also out of fashion at present and are therefore trading on unusually depressed valuations.

Hugh, Chris M., Ben P., Charlotte, Leon and the Evenlode team
6 November 2024

Evenlode has developed a Glossary to assist investors to better understand commonly used terms.

i IFSL Evenlode Income B Acc (GBP). Source: Evenlode, Financial Express, total return. Pre-swing-price NAV Performance from 31 December 2023 to 6 November 2024. Performance based on published (swung) prices is 2.8%.

ii Free Cash Flow (FCF) is a measure of how much cash a company can generate over and above normal operating expenses and capital expenditure. The more FCF a company has, the more it can allocate to dividend payments and growth opportunities. Free Cash Flow Yield is calculated as FCF per share divided by the current share price. A higher Free Cash Flow Yield implies a company is generating more cash that could be paid out as dividends and to reinvest into growth of the business.

iii Yield is a measure of income from an investment over a period of time. A dividend yield is calculated by dividing the dividend per share by the current share price. Source: Financial Express, Bloomberg, total return. Figures in GBP terms 31 October 2024.

iv IFSL Evenlode Income B Acc (GBP). Source: Evenlode, Financial Express, total return. From 19 October 2009 to 19 October 2024.

v Source: Rosenberg Research.