

The commentary below applies to the TB Evenlode Global Income portfolio. Market data is from FactSet and FE Analytics.

The summer holidays are accompanied by the half year corporate reporting season, ensuring that analysts and executives have to keep their thoughts from the beach for at least some of the mid-year break. At the start of the year, we set the scene for 2023ⁱ, highlighting supply chain disruptions, cost inflation, and what we thought might be a temporary setback in corporate cash generation. We wondered about global demand in an era of rising rates, and the outlook for corporate spending which had seemed to worry the market particularly when it came to information technology companies. Where IT is concerned, we certainly didn't predict that the global market's imagination would be captured so much by the promise of artificial intelligence, and sector concerns have done a volte face toward optimism. We'll return to that subject when we look at fund performance below. First, we'll pick out some themes from the results, thinking about the context of the recent past.

Economic and operational themes

Inventories and input costs

Throughout 2022, supply chain disruption resulted in increasing input costs and rising inventories as companies attempted to secure input supply reserves. The broad takeaway from recent results is that these challenges are easing. Excess inventories are now being sold down, reducing working capital and generating additional cash flow. Companies such as L'Oréal and Nestlé in consumer goods, and Cisco and Hexagon in information technology, have reported this dynamic. Other companies had been affected by the amount of their product that had built up at their distributors. Sportswear firm adidas and bicycle components manufacturer Shimano both reported that this 'channel inventory' build-up has started to ease.

Another effect of easing supply chains has been to ease the pressure on input costs, where inflation has at least moderated, if not reversed. The price of raw commodities and energy has fallen, helped by stabilisation following the initial disruptions caused by the war in Ukraine, though some volatility in energy prices remains. This has led to profit margins recovering as many companies have increased prices to their customers, helping to grow revenues without associated increases in costs.

Pricing and demand

One input cost that continues to rise is wages. Information services company Wolters Kluwer and consumer giant Procter & Gamble both highlighted this trend. A common interpretation is that this wage pressure is being driven by consumers responding to increased product prices (as mentioned above) by demanding additional wage increases. This is often referred to as the driving force behind the "wage-price spiral". The future for this trend is a matter of speculation, but with some of the bottlenecks and cost pressures easing for business there could be a commensurate easing on price rises and wage demands.



Central bankers have been trying to get a handle on these pressures by raising interest rates, which should lower production and consumption (the interest-rate transmission mechanism), and there are some signs that demand is indeed starting to cool.

Microsoft reported a slowing in its commercial business. Advertising agencies Omnicom and Publicis expect their growth to slow in the second half of the year, particularly from their customers in the information technology and telecommunications sectors, reflecting Microsoft's experience.

Looking back at our musings from the start of the year things have progressed broadly as might have been expected. Revenue growth has eased, increasing by +4% on average year-on-yearⁱⁱ, compared to +9% for 2022 over 2021. The figure for the first half of 2023 is brought down a little by the impact of revenues of some companies which were boosted by the coronavirus pandemic receding into the past. Medical testing company Quest Diagnostics and health care firm Roche saw covid testing revenues decline, although their 'base' businesses of non-covid testing services and technology are performing well.

Fund performance

It's fair to say that the overall market reaction to this steady-not-spectacular corporate performance within the portfolio has been muted. This has meant that the fund's relative performance has drifted after a strong start in the first four months of 2023. This doesn't overly concern us, as we view performance over longer timescales. It is worth mentioning however, particularly as the market performance is being driven once again by sectors that the fund has no exposure to. Rising energy prices have meant that there has been strength in energy-related businesses, and the financial services sector has been recovering from its wobbles of early 2023. However, compared to the comparator benchmark, the MSCI World Index, the biggest negative in terms of relative performance has been the information technology sector. Here the fund does have exposure, making up around 15% of the portfolio. The IT sector had been a strong performer for the fund but spectacular for the market, helped along by the artificial intelligence boom and expected semiconductor investment.

The flip side of muted market performance is that valuations in the portfolio continue to look incrementally more attractive. The forward cash flow yield for the fund now stands comfortably above 5%, a significant premium to the fund's comparator benchmark, the MSCI World Index. This not only provides portfolio companies with enough cash to comfortably cover dividends but gives us confidence that they can continue to invest to drive future cash flows. We see this as key to compounding and long-term value creation for shareholders.

Looking ahead

On the point of dividends, we had seen some strong dividend growth coming out of 2022. Despite the subsequent improved cash flow performance from companies, we suspect that boards and management teams may reflect the slowing revenue growth in future dividend increases. This is something to look out for once the full year figures are reported in early 2024. However, we may be proved wrong if revenues hold up and the cost picture continues to improve, so we will continue to monitor these trends in the second half of the year.



Evenlode Global Income Investment View

August 2023 – Thoughts following results season



We will also continue to be on the lookout for additional valuation-related opportunities. For example, we recently initiated a position in global drinks business Diageo after its share price declined. We had made some space in the portfolio's consumer goods exposure by reducing some of positions that had performed relatively well such as P&G and PepsiCo, although these remain holdings. The market and economic environment continue to be particularly dynamic, and although portfolio activity has reduced from the days of the pandemic, we remain ready to take opportunities such as Diageo if they are presented.

Ben, Bethan, Chris, Rob and the Evenlode team

30 August 2023

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ⁱ<https://evenlodeinvestment.com/news/scene-setting>

ⁱⁱ Around 70% of the portfolio by weight having provided a half year update.

