Lincoln Private Investment Office
London

30 September 2021

Investment Report – Q3 2021

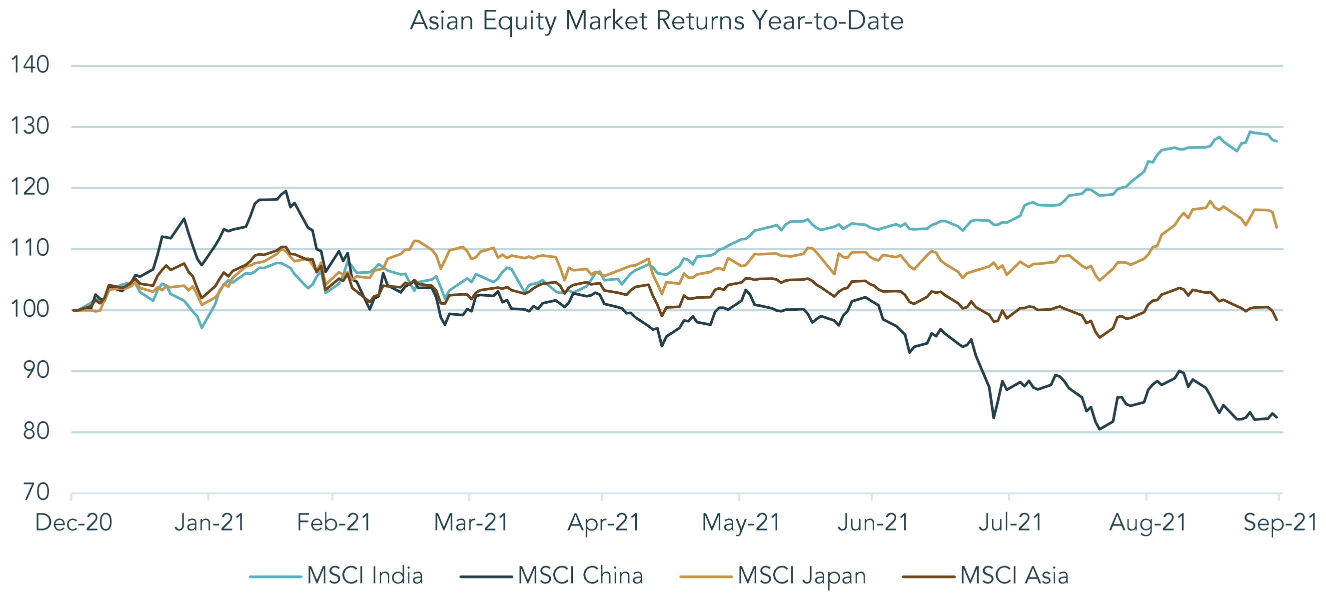
"Green mountains are gold mountains. To protect the environment is to protect productivity, and to improve the environment is to boost productivity — the truth is as simple as that." Xi Jinping, President of the People's Republic of China, 2021

A flick back over the quarter's headlines paints a picture that is quite incongruous with the positive investment performance in our portfolios. The disconnect is all the starker when considering that political developments in China, an equity market in which we have a tactically overweight position, seemed to make the news for all the wrong reasons. We will go on to explain this disparity as we discuss recent developments across Asia, a region which continues to excite us from an investment perspective.

Much of the recent volatility in equity markets has emanated from China, where journalists would have investors believe that the prospect of generating attractive investment returns there is a thing of the past. Having spoken to fund managers and business executives on the ground, we have a more sanguine view of recent events. The raft of regulatory measures announced by the Chinese Communist Party must be viewed in the context of China's maturing economy. State officials have been forthright about their objective of population growth for some time, with the legacy of the so-called 'one-child policy' of the late 20th century leaving them with the problem of an ageing population. Young people are the driving force behind economic growth, whilst ageing populations are expensive to look after, so China is taking steps to try and address its demographic imbalance. For example, it has targeted high property prices and high tuition costs which are seen as barriers to having more children. Consequently, it has been advisable to avoid equity market sectors that are exposed to these dynamics, and indeed our active managers in the region have done so.

Beijing's social agenda is nuanced, but well understood by those living and working in China. Among the social interventions announced over the summer was a crackdown on the amount of time Chinese teenagers (under 18) can spend playing video games, limiting them to 3 hours per week. This is one of many measures designed to protect consumers, with addictive products and services such as tobacco, gambling and unhealthy gaming having been subject to regulatory scrutiny for some time now. In the corporate sphere, Chinese lawmakers are focused on tackling the cost of doing business for small companies, showing hostility towards monopolies in certain sectors. It is hoped that by encouraging fair competition and promoting innovation among smaller businesses, economic growth will be stronger and distributed more fairly. China has also publicly committed to reducing its carbon footprint, with Xi Jinping having pledged to make the country carbon neutral by 2060. It is clear that the government wants a certain type of economic growth, and investors that position tactically to benefit from China's next economic phase should be well rewarded in the long run.

Notwithstanding these opportunities, recent regulatory news has been detrimental to the performance of Chinese market indices. Sentiment around China was damaged further when The Evergrande Group, China's second largest property developer, announced that it would default on its mountainous debt pile. For many skilled fund managers, Evergrande has been a ticking time bomb best avoided. However, as a substantial company, it accounts for a large proportion of the indices tracked by passive investment vehicles, such as the MSCI China Index shown below. In our view, this underscores the need for active management when investing in the region.



Source: Bloomberg LLP, 2021

Our Emerging Market and Asian equity positions are diversified not just by sector but also by region. This allowed our portfolios to benefit from exposure to India which has been among this year's best performing equity markets. The MSCI India Index returned 12.5% over the quarter, driven by strong momentum in company earnings as well as the liquidity injected into financial markets by the Reserve Bank of India during the pandemic. This performance is reflective of an improving economic picture in India, with the government's fiscal position in relatively good shape compared with other economies. Encouragingly, politicians are taking pragmatic measures to reduce bureaucracy and gradually privatise large state-owned companies. Given the relatively steady footing of the national finances, President Modi's proposed $1.5tn National Infrastructure Pipeline stands a better chance of being delivered, with significant economic benefits if it does. Furthermore, we believe that India's increasingly wealthy, relatively young 1.4 billion consumers offer a compelling investment prospect for many years to come.

Against the backdrop of Beijing's regulatory posturing, Japan's major political event struggled for space on the front pages. However, the resignation of Prime Minister Yoshihide Suga in early September on account of his poor handling of the Covid-19 pandemic has potentially significant ramifications for the world's second largest equity market. His replacement, Fumio Kishida, is seen as a continuity candidate with a centrist view on key political issues. He intends to deliver a significant fiscal stimulus package in October which will put cash in consumers' and companies' pockets, boosting the economy and Japanese businesses. Investors certainly seemed to buy into this narrative, with the Japanese equity market rallying strongly in early September. Kishida has called a general election for 31st October which will determine his ability to deliver this agenda. We will monitor the lead-up to election day with interest.

As mentioned in our last letter, the Federal Reserve's intentions at the Jackson Hole Symposium were well telegraphed ahead of the event, so much so that the headline act, Jerome Powell's address on 27th August, produced very few discernible moves in financial markets on the day. Later in the quarter, however, we saw bond yields climb as comments from central bankers, including the Bank of England, brought forward expectations of interest rate hikes to keep inflation under control. These inflationary concerns were compounded by rising energy prices towards the end of September and, importantly, rising wages in the US. Investors shunned fixed income securities in response, with the benchmark US 10-year Treasury yield rising from its low of 1.17% in August to 1.49% at the end of the quarter, resulting in material capital losses for holders of conventional government debt. We feel the trajectory of these benchmark yields is likely to be higher from current levels, giving us continued comfort in our unconventional stance in developed market fixed income.

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These interest rate dynamics are one of the reasons we have a constructive view of the UK equity market which has lagged the returns of other developed markets over the last decade. The FTSE 100 index contains a relatively large proportion of sectors that should benefit in an environment of higher inflation and interest rates, such as mining companies and banks. Moreover, UK equities currently trade on attractive valuations compared with other developed markets, giving a margin of safety to investors. These attractive valuations are being capitalised on by global private equity groups, with a flurry of mergers and takeovers so far this year despite some reported disruption in domestic supply chains. On average, these deals have been done at a 47% premium to the prevailing share price, demonstrating the good value for money on offer in many UK shares. With $1tn of unspent money sitting in private equity 'buy-out' funds globally, we expect to see more UK companies snapped up at a premium to their share prices over the coming months.

As inflationary pressures cause a headache for investors in traditional balanced portfolios, we are less troubled by the current narrative driving financial markets. Given our alternative security selection in fixed income, our portfolios are likely to weather the headwind that inflation poses to holders of traditional fixed income assets relatively well. Elsewhere in our portfolios, we have positions in equity market sectors which should benefit from a moderately inflationary environment, as well as exposure to a diverse range of commodities. This is not to say that we are making a concentrated bet on the idea of inflation, but if we are entering an extended period of higher inflation, we feel well prepared.

Fred Hervey

Fred Hervey
Chief Investment Officer