Mawer Global Equity Fund, Series A

Q2 2023 | Performance Commentary

Market Overview

The MSCI ACWI posted strong gains overall in the quarter, with outsized returns in U.S. large cap technology stocks offsetting tepid results in other regions.

Providing a modicum of relief for central banks globally, inflation continued to decelerate in the quarter, though core inflation which strips out more volatile food and energy prices remained stubbornly sticky in many countries including Canada and the U.S. Despite the deceleration in price growth overall, many central banks including the Bank of England, Bank of Canada, European Central Bank, and Reserve Bank of Australia raised rates at their most recent meetings, and while the Federal Reserve paused in June, Chairman Powell continued to jawbone markets into expecting several more hikes before 2023 is through.

After a brief steepening in Canadian and U.S. yield curves in April following the U.S. regional banking crisis, yield curves reversed course and resumed inverting to end the quarter. What the markets appear to be signalling is that with every rate increase by central banks, the risk of a policy error grows. Despite this tug-of-war between central banks and market participants, it's hard to imagine central bank resolve to tame inflation abating until after there are clear, sustained real economic indicators that the fight has been won.

Corporate profits remain broadly resilient while a potential recession remains one of the most widely anticipated on record.

Regionally, European stocks took a breather with modest gains in Q1 after being leaders last quarter, while Japanese and U.S. stocks posted strong returns. Japanese stocks have been on fire this year, thanks to a confluence of factors: (1) the return of modest inflation after decades of deflation which has given Japanese companies a degree of domestic pricing power (2) the chilling of US-China relations boosting returns of Japanese defense and semiconductor related stocks and (3) a push by policymakers to encourage a greater focus on profitability and returns to shareholders for listed Japanese companies.

U.S. markets shrugged off the government debt ceiling brinksmanship to post excellent returns, though looking under the hood, the rally was concentrated in the biggest market cap technology stocks such as Apple, Microsoft and Nvidia, which are benefiting from frenzied interest in AI as a potentially burgeoning source of long-term secular growth.

China's much talked about re-opening has been more fizzle than sizzle contributing to underperformance of the emerging market complex.

Performance Commentary

The portfolio modestly underperformed the benchmark in the quarter.

Standout positive performers were concentrated in the non-bank financial and technology sectors. Brazilian broker-dealer **XP Inc.** continued to execute in a challenging capital markets environment where the Brazilian overnight rate is 13.75%. The company reported strong quarterly results thanks to a cost-cutting program that improved margins paired with a gain of 80bps in market share from incumbent banks. Insurance brokerage and consulting firms **Marsh & McLennan** and **Aon** continued their steady revenue growth and improving margins in the quarter while providing less cyclical exposure to the portfolio.

Our underweight to the technology sector detracted from relative performance though **Microsoft**, **Amazon**, and **Alphabet** were three of our top performers. These businesses benefited from a combination of bullishness around generative artificial intelligence (AI), the end of the rate hiking cycle potentially approaching, and continued execution in their core businesses. Lastly, BMW reported expanded auto margins and increased sales penetration of fully electric cars, and an announcement of another buyback program of EUR2B (equivalent to 3% of current market cap).

On the other side of the ledger, healthcare stocks Moderna and Organon continued to give back some of last year's gains. The largest U.S.-based value-added reseller of IT hardware, software, and services CDW saw sales volumes lag expectations in the quarter with the company highlighting caution from customers in anticipation of a potential recession. After a very strong Q1, FTI Consulting gave back some of their gains, though the bankruptcy and restructuring consultancy remains well-positioned to benefit from a potential acceleration in bankruptcy activity.

Looking Ahead

The combination of historically inverted yield curves, strong year-to-date gains in equity prices, benign credit spreads, and well-anchored longer-term breakeven inflation expectations are all consistent with the consensus outlook for a soft landing; put differently, that central banks will be successful in their fight against inflation without causing too much harm to the economy. The widely anticipated recession, should it ever arrive, is expected to be mild.

The risks lie on both sides of this consensus: either that the impact of recent monetary policy impairs demand more substantially than expected (a hard landing), or that inflation persists longer than projected, emboldening policymakers to hike even further than currently expected. Both would likely be negative for equities.

Yield curve inversion has historically been a reliable predictor of recessions, and the transmission mechanism is worth understanding. Inversions tend to hurt the balance sheets and business models of banks, who borrow short to lend long. Higher short-term borrowing costs result in lower bank profitability, and the banks typically adjust by cutting back on lending which has a ripple effect across the economy. We've seen some indications of these ripples—the notable regional bank failures in the U.S., UK Gilt crisis, etc.—but they haven't materialized to the extent one might have anticipated given the degree of curve inversion. It's possible that any reduction in liquidity from the banks is being offset by other sources, e.g., excess consumer pandemic savings, private credit markets, and government fiscal policy. Nevertheless, it would be very unusual by historical standards to have the degree of yield curve inversion seen in many major economies today without an associated recession.

To prepare against the risks, we've leaned into our bottom-up approach. Our investment philosophy naturally leads us to businesses with more stable demand given the criticality of the products and services they provide to their customers, and we always have an eye on our companies' balance sheets as lower debt provides resilience in times of crisis. Our forensic accounting checklist is designed to ensure that we avoid getting caught up in narrative, and instead methodically comb through financial statements for clues with respect to changes in business or management quality. In the current environment, and especially as COVID-19 supply shocks have encouraged many companies to build up their inventories, companies with excess inventory levels may face gross margin pressures in the coming quarters should demand abate from its current trend. As such, in addition to continuing to understand how companies are coping with inflation, we're looking closely at cash conversion and days of inventory, especially when coupled with valuation levels that, year-to-date, have outpaced earnings.

Yes, "boring" work. But ultimately an approach that should prepare the portfolio to be resilient for the multitude of scenarios that may play out going forward.

Global Equity Fund

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Performance Summary[1] (%)
As of June 30, 2023:

	YTD	3 Mo.	1 Yr.	3 Yrs.	5 Yrs.	10 Yrs.	Since Inception[2]
FUND	10.7	3.3	18.9	9.1	9.3	12.3	11.7
BENCHMARK	11.3	3.8	19.5	9.9	8.2	11.5	10.7

Calendar Year, as of December 31:

	2022	2021	2020	2019	2018	2017	2016	2015	2014	2013
FUND	(11.2)	21.3	9.8	20.7	4.3	17.5	(0.4)	21.5	14.5	34.3
BENCHMARK	(12.4)	17.5	14.2	20.2	(1.3)	15.8	3.1	18.9	14.4	35.2

[1]Performance figures are net of management fees and operating expenses. Periods greater than one year are annualized. Performance figures are in Canadian dollar terms.
[2]Mawer Global Equity Fund Series A Inception: October 22, 2009

Selections from Mawer's Art of Boring Blog and Podcast:

Rising Debt and its Potential Consequences: Canada's New Normal?
We need to understand where we are in the debt super cycle to inform our investment decision making.

Artificial Intelligence: The Return of The Centaurs
Recent AI breakthroughs are underscoring the power of the centaur model—humans + machines—creating something more potent than either model operating independently.

Inflation's one-two punch
It's inflation's second punch that can deliver a blow that investors may not be expecting.

Disclaimer

Opinions and Forecasts:

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Benchmarks:

FUND	BENCHMARK
Mawer Global Equity Fund	Oct: 2009: MSCI World (net) Oct 2016: MSCI ACWI (net)

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