PM Perspectives

Testing the narrative for opportunities and risks

Global Select Equity Strategy

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> **One of the lessons of the financial crisis that led to the Great Recession is that there are periods in which competition, among experts and among organisations, creates powerful forces that favour a collective blindness to risk and uncertainty.**
>
> D. Kahneman

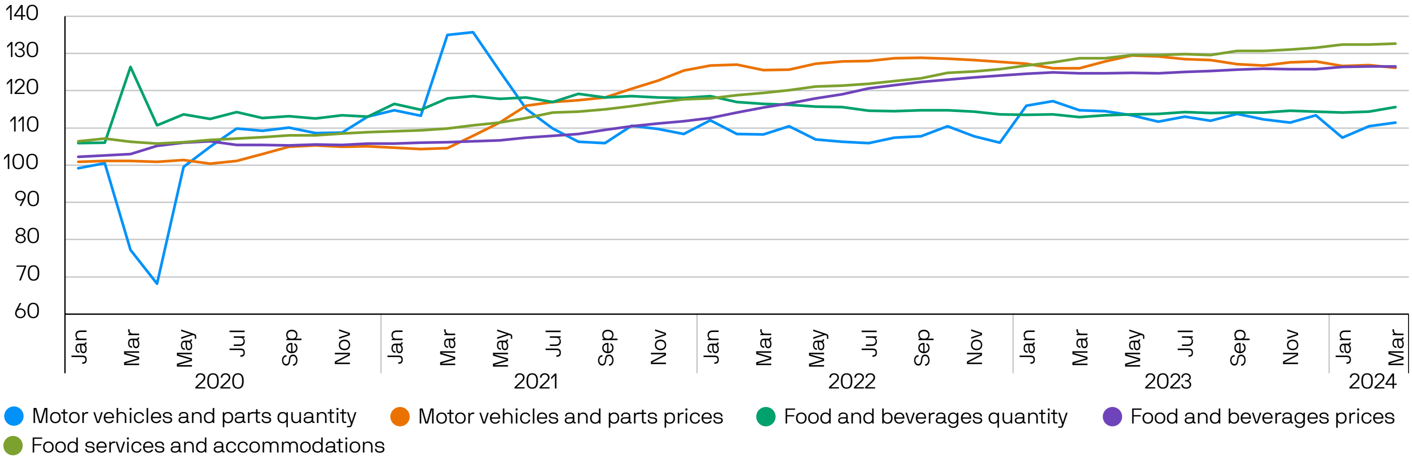
If the wisdom of the late Nobel Laureate Daniel Kahneman has taught us anything, it's that a coherent narrative can be more powerful than the quality of the evidence. The narrative that resonated most with investors in the first quarter of 2024 was the Goldilocks scenario of disinflation, stable economic growth, lower interest rates and accelerating corporate earnings growth – which was good for bonds, good for equities and good for the consumer. While the narrative is clear, what about the quality of the evidence?

To help answer this question, we are fortunate to have a long-term valuation process that allows us to keep at least one eye open to risk, uncertainty and opportunity in markets. The measure we are most concerned about at the moment is corporate earnings growth, which can be broadly broken down into two drivers: sales growth (price x volume); and margins (cost control and operating leverage).

Pricing pressures are starting to impact volumes

With regards to pricing, the evidence suggests consumer goods inflation is gradually returning to pre-Covid levels, while services inflation has remained higher. As the chart from the US Bureau of Economic Analysis shows, the consumer staples and automotive industries have exemplified the excess pricing power of the last few years. However, the last six quarters have seen a meaningful decline in consumer goods volumes as higher prices start to bite.

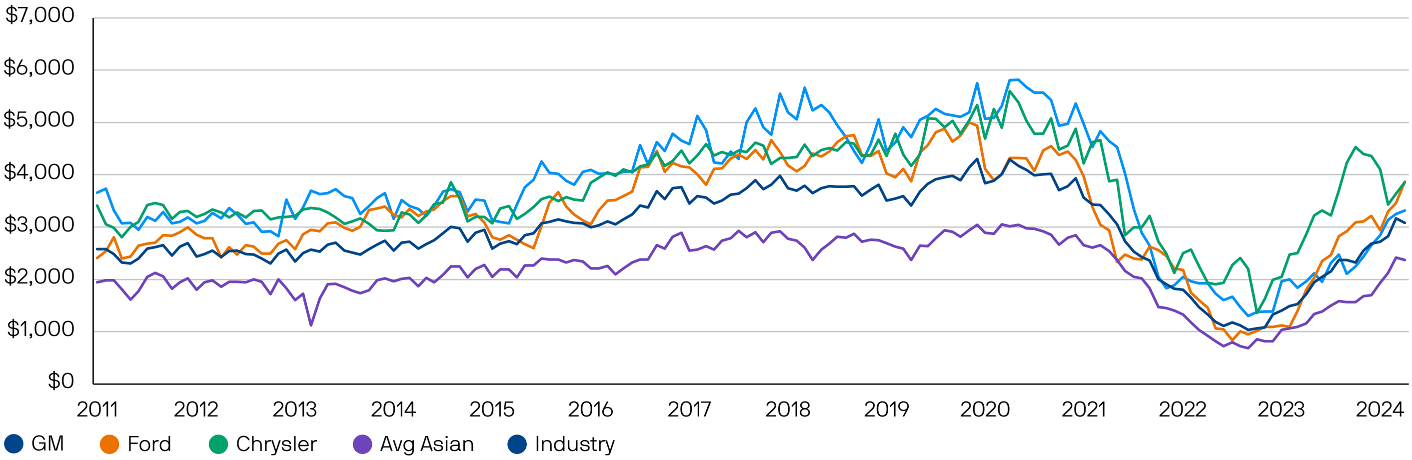
Pricing and volumes in the US food and beverages, and motor vehicles and parts sectors



Source: BEA data. As at March 2024.

From the discussions I have with our analysts, it's clear that fewer consumer goods companies have been talking about continuing with big price increases into 2024. However, many of the pricing decisions taken last year are still to be implemented so the volume recovery may be pushed out a little further in many areas. Also, while automotive volumes have not come down, anecdotally companies are talking about a shift away from the high end and demand for fewer options packages. We're also seeing the return of higher dealer incentives in the North American market, with our autos team highlighting a deteriorating mix and weaker margins throughout the current reporting period.

Total dealer incentives by US automaker



Source: MotorIntelligence. As at March 2024.

These pricing trends are also confirmed by the volume data that our analysts are tracking for some of the larger US food companies, where the post-Covid normalisation is very evident and we are slowly getting back towards trend, supported by comments from Walmart that inventories have been right-sized.

Volume growth for US food companies

North America divisions: Quarterly Volume for key food players	Q1 20	Q2 20	Q3 20	Q4 20	Q1 21	Q2 21	Q3 21	Q4 21	Q1 22	Q2 22	Q3 22	Q4 22	Q1 23	Q2 23	Q3 23	Q4 23	Q1 24
Nestle	9.2%	2.3%	2.5%	3.0%	3.0%	5.1%	4.6%	3.8%	1.4%	(1.9%)	0.7%	(4.9%)	(0.8%)	(1.2%)	(0.7%)	1.3%	(5.8%)
Mondelez	12.2%	7.4%	4.2%	2.4%	(2.8%)	(0.5%)	(2.1%)	(1.2%)	0.2%	(1.0%)	(0.6%)	4.2%	2.3%	2.0%	4.6%	(5.5%)	(2.1%)
Hershey	(1.7%)	(3.8%)	2.2%	7.9%	11.0%	11.8%	1.3%	(0.8%)	3.8%	3.4%	3.4%	1.7%	2.1%	(3.2%)	1.3%	(7.2%)	4.1%
General Mills: NA Retail	0.0%	35.0%	16.5%	10.0%	9.0%	(19.0%)	(7.0%)	(6.0%)	(8.0%)	(3.0%)	(5.0%)	(7.0%)	0.0%	(6.0%)	(4.0%)	(5.0%)	(2.0%)
Kraft Heinz	4.4%	5.6%	2.6%	1.6%	1.2%	(4.1%)	(0.3%)	(0.7%)	(2.4%)	(3.3%)	(4.4%)	(5.0%)	(6.5%)	(8.1%)	(5.9%)	(5.5%)	(3.7%)
Danone					0.9%	5.0%	4.0%	3.9%	1.3%	2.0%	1.0%	(2.2%)	0.8%	(2.7%)	(0.2%)	2.8%	1.5%
Kellogg	5.0%	13.0%	2.2%	(1.2%)	(1.9%)	(11.9%)	(4.5%)	(4.7%)	(8.3%)	1.7%	1.5%	1.7%	(0.6%)	(10.7%)	(10.2%)	(6.5%)	(4.7%)
Conagra: Grocery and snacks	(1.7%)	38.0%	17.2%	13.6%	9.4%	(19.8%)	(3.3%)	(5.3%)	(1.8%)	(7.2%)	(6.1%)	(11.6%)	(10.0%)	(5.5%)	(4.4%)	(3.7%)	(0.8%)
Conagra: Refridgerated and Frozen	(0.4%)	17.8%	12.8%	6.4%	7.8%	(8.9%)	(3.8%)	(4.7%)	(4.5%)	(8.1%)	(2.5%)	(5.5%)	(9.8%)	(11.5%)	(10.5%)	(3.3%)	(3.3%)
JM Smucker: US Retail Consumer Foods	21.0%	19.0%	7.0%	10.0%	(3.0%)	0.0%	6.0%	(2.4%)	2.0%	(20.0%)	(2.6%)	3.0%	2.0%	27.5%	0.0%	(2.0%)	0.0%
Campbell Soup	16.6%	12.3%	6.7%	4.2%	(12.0%)	(4.9%)	(5.7%)	(8.5%)	(2.7%)	(4.4%)	(1.4%)	(1.5%)	(7.2%)	(4.7%)	(5.0%)	(2.0%)	0.2%
Average	6.5%	14.7%	7.4%	5.8%	2.0%	(4.3%)	(1.0%)	(2.4%)	(1.7%)	(3.8%)	(1.5%)	(2.5%)	(2.5%)	(2.2%)	(3.2%)	(3.3%)	(1.5%)

Source: Company data as reported, Bloomberg consensus estimated for companies that have not yet reported for Q124.

The outlook for costs is a bit more nuanced by industry and country. Energy costs are coming down in Europe, which will help margins and improve consumer confidence, while freight and logistics expenses have eased since the end of the pandemic, even with the extra tension in the Gulf and the Baltimore bridge incident.

In contrast, I'm seeing companies spend more on advertising and promotional activities in order to drive up volume growth for the second half, as evidenced by the strong increase in advertising revenues reported by the likes of Google, SNAP and Facebook in the first quarter.

However, this trend does not appear to be reflected in forecasts for S&P 500 margins, where the cost savings from lower materials or logistics costs are expected to drop straight through to the bottom line, driving up forecasts in 2025 and beyond. It is in this area, therefore, where I'm focusing on risks to sales.

The companies above are shown for illustrative purposes only. Their inclusion should not be interpreted as a recommendation to buy or sell.

Portfolio positioning: A more defensive stance

Against this backdrop, since the end of last year we've gradually taken a more defensive stance in the Global Select Equity Strategy, raising the quality profile of the portfolio and looking for defensive business models in industries and sectors with structural growth drivers.

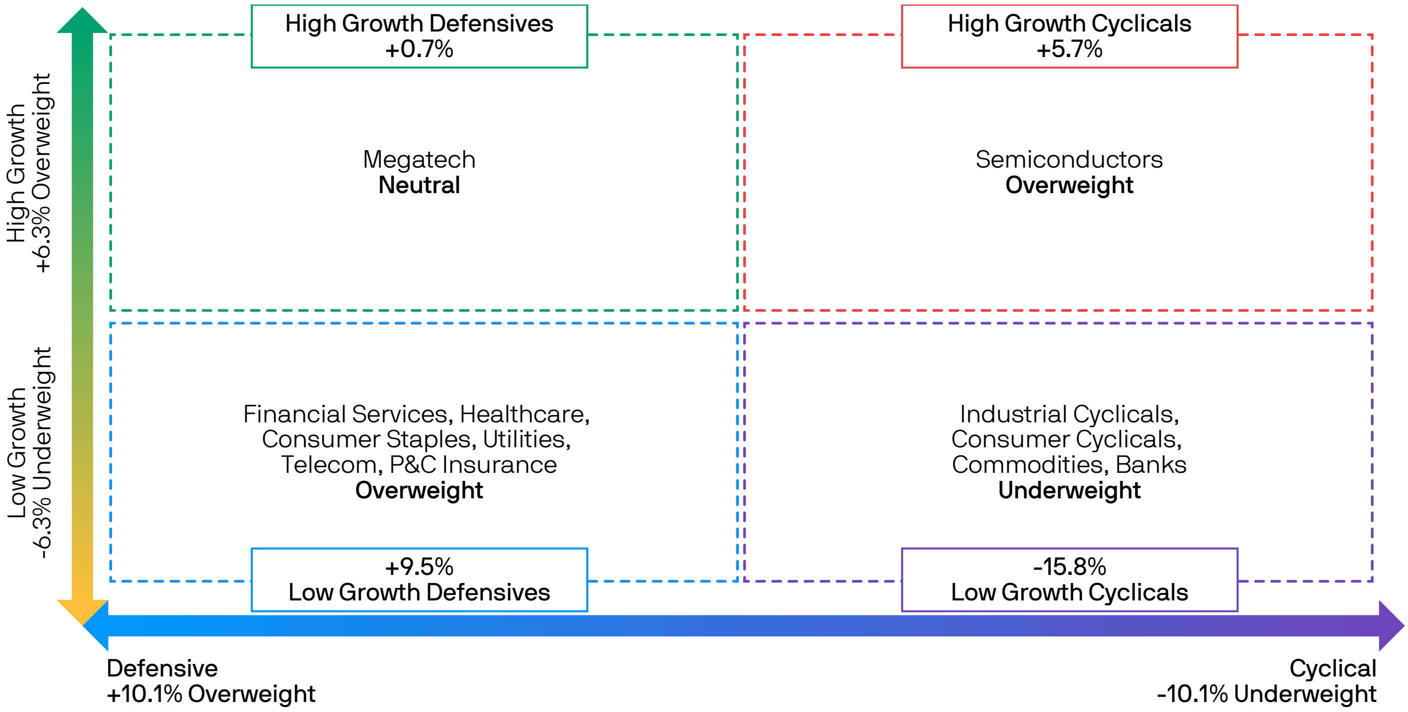
For example, we've added to more defensive consumer-driven names, such as AutoZone and O Reilly Automotive in the retail sector, although we have reduced our position in McDonalds due to its weaker value proposition relative to its fast food peers. We're also finding opportunities in utilities now that the headwind from rising interest rates has eased, allowing fundamentals to come back into focus. Here we prefer the US market, where companies have not seen their earnings distorted by the energy price rise that accompanied the Russian-Ukraine conflict , unlike in Europe, where the energy price boost is now fading.

US utilities are also benefiting from a uniquely positive fundamental backdrop, with several states seeing positive demand growth for the first time in years, thanks to some population migration into lower tax jurisdictions and also growing demand from artificial intelligence data centres. At the same time, the regulatory backdrop in these states is very supportive for investment.

We've broadly avoided defensive sectors where valuations are less appealing or where earnings risks are elevated, such as telecoms, where there is a need for large investments and where competition is affecting pricing power. Consumer staples and pharmaceuticals have also been underweight, although more recently we have started closing the underweight in consumer staples as valuations return to more reasonable levels and companies finally recover from the pandemic shock to demand and inventories. We've added names such as Nestle, Diageo, Heineken and Mondelez and now have a more neutral weighting towards consumer staples.

The other notable change in the portfolio has been a reduction in our banks weighting on the expectation that net interest margins have peaked, while we're also seeing a slowdown in loan growth and a deterioration in asset quality at the margin. In the sector, we've sold holdings in TD Bank and US Bancorp.

Global Select Positioning: Leaning into defensives



Source: J. P. Morgan Asset Management. Positions are as of 30 April 2024 for a representative account of the Global Select Equity strategy. Cyclicality is measured using a long term market beta. Growth is calculated using revenue and earnings growth. Provided to for illustratively purposes only. Opinions, estimates, forecasts, projections and statements of financial market trends are based on market conditions at the date of the publication, constitute our judgment and are subject to change without notice.

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