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CADIZ ASSET MANAGEMENT INVESTMENT UPDATE

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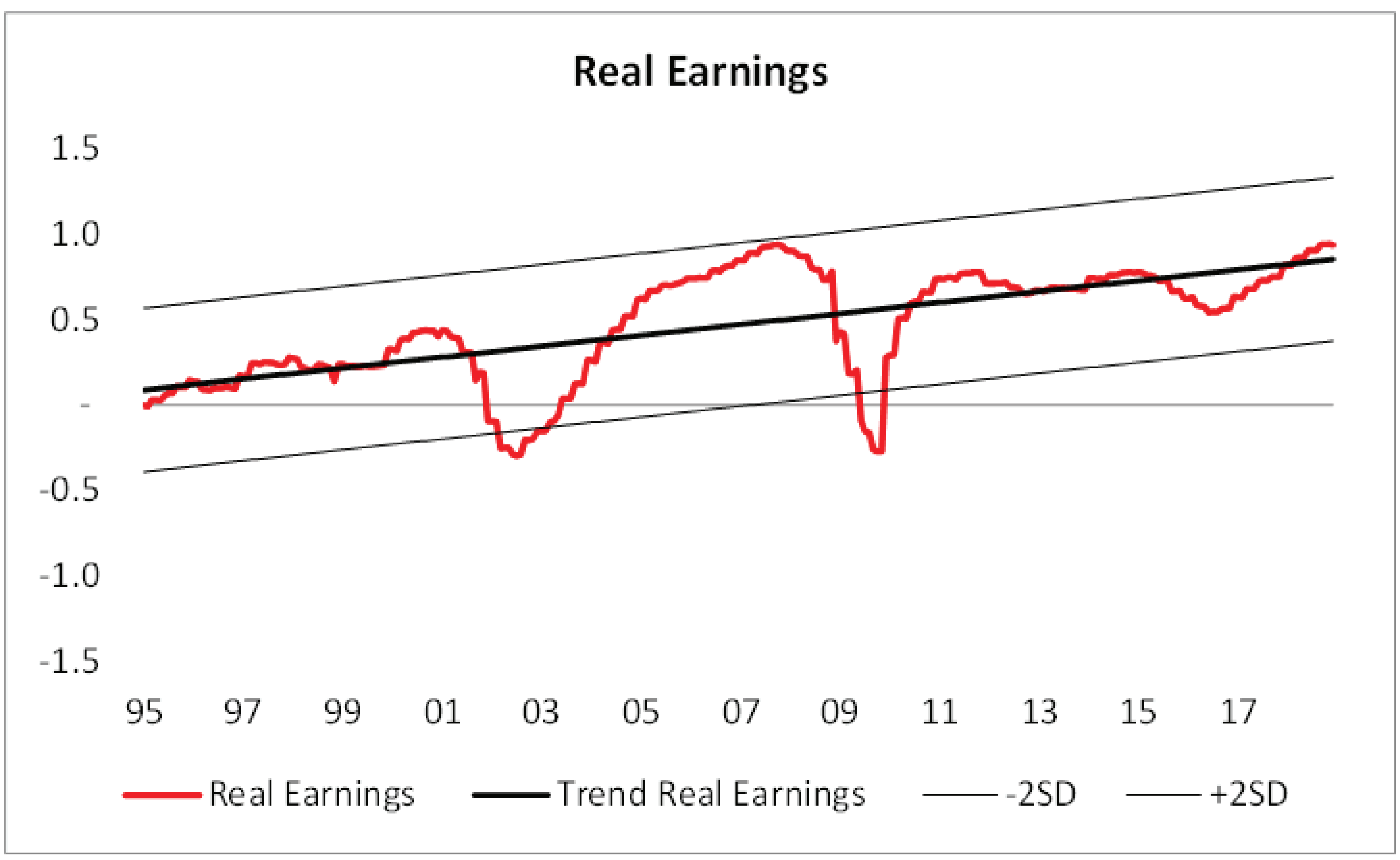
Global Earnings Outlook – Headwinds are Building

by Brian Munro, Head of Multi Assets

In the last quarter of 2018, risk assets (including both local and international equities, property and commodities) had a torrid time as investor concerns around a possible global recession and other global risks were heightened. Fortunately, calm has returned to markets resulting in these same risk assets rebounding at the start of this year. After enjoying nine years of strong earnings growth from a very low base after the Global Financial Crisis in 2008, and more recently experiencing strong growth since 2016 there seems to be an inflection point in the business cycle where we expect earnings growth to slow to trend-growth. Tailwinds that have supported earnings growth are beginning to fade. As a result we don't expect earnings to experience the strong growth it enjoyed between 2004 and 2007 as seen in Figure 1.

Understanding where we are in the earnings cycle and the risks to earnings is crucial, because in the long run, stock prices tend to follow earnings. Understanding the risks to earnings growth at the stock level, industry level as well as the market level, is helpful in assessing where possible risks may lie.

Figure 1: MSCI World Real Earnings 1995 to 2018 (Log scale)



Source: Cadiz Asset Management, Bloomberg

Global earnings growth expected to slow to trend-growth as tailwinds become headwinds

Tailwinds that have supported the strong earnings cycle have included historically low interest rates, low oil prices, low wage growth (since employment levels were low), and more recently, tax cuts. This has allowed profit margins to reach historically high levels in the US. These tailwinds are fading and likely to become headwinds over the next two-to-three years.

Looking at these drivers more closely:

- Wage pressures are building. With low unemployment levels, skilled labour is becoming scarce, thus allowing employees to demand higher wages. Wage inflation in the US (currently 3%) has been rising slowly and is expected to accelerate further. Price inflation for goods and services is currently 2%. If wages continue to grow faster than prices of goods and services, it will start to impact profit margins, which are at historically high levels.
- Fuel costs are expected to increase as oil prices have risen from a low of $25 per barrel of Brent Crude oil to above $60 per barrel.
- Debt servicing costs are expected to increase as interest rates rise. On aggregate, corporates have increased their debt levels, taking advantage of cheap debt and extending the maturity dates when this debt needs to be repaid. This has weakened corporate balance sheets, which could become a major risk in the medium-term if borrowing rates are raised significantly higher.
- Last year, the US government cut personal and corporate taxes. This encouraged increased consumption, resulting in revenue growth for companies as customers bought more of their products. At the same time corporates paid less tax, boosting earnings growth by 7%. This is unlikely to be repeated.

Global trade, increased tariffs and tensions between US and China are further risks to earnings

Concerns around global trade have created considerable uncertainty for companies as the rules of engagement are being redefined. The US is in the process of renegotiating a number of trade agreements with China and other countries. Additionally, the BREXIT outcome is also likely to affect trade. An uncertain economic environment does not encourage businesses to invest or expand their businesses. Increased investment is one way for companies to improve efficiencies, reduce costs and grow profits. We expect investment growth to be subdued until there is more clarity and stability on trade policy.

A more direct impact to earnings has been the increased tariffs imposed by the US on various imported goods from China and other countries. These increased import tariffs have affected certain industries more than others and have caused various input costs to increase meaningfully, thereby placing pressure on profit margins. Companies do have scope to source goods elsewhere, but this has implications for their regional and global supply chains, which are being disrupted. We expect tensions between the US and China to be ongoing and will be a major risk to global growth and company earnings going forward.

Faced with these headwinds, we expect earnings growth to slow and grow in-line with trend-growth. However, risks to this view have certainly increased.

In this environment we continue to favour quality businesses that have a competitive advantage; high barriers to entry; are able to maintain their pricing power; have economies of scale and/or excellent distribution networks. These quality companies are more likely to navigate the risks mentioned above and have proven track records of generating higher returns on capital for shareholders. This enables them to grow their earnings, and the value of their companies over time.

At Cadiz, we focus on buying these quality businesses at attractive prices, when we believe there is a sufficient margin-of-safety to limit the potential for losing your capital. We continue to remain disciplined in allocating capital to both local and offshore opportunities to achieve the fund's investment objective of compounding your wealth, overtime while limiting any permanent loss to your capital.