INTERNATIONAL EQUITY

Andrew Smith, CFA, Associate Portfolio Manager and Senior Equity Analyst

We have highlighted in the past (third quarter 2019) how, largely due to sector compositional effects, European equities typically exhibit the strongest style sensitivity of any region to US Treasury yields and inflation expectations. In general, this element of the equity environment landscape has been in a persistent one-way trend over the past fifteen years, both prior to and in the extensive aftermath of the financial crisis.

However, as economies emerge from the upheavals of the past several quarters and the extreme policy responses that we have witnessed necessarily attenuate, long dormant measures of inflation have again commanded some attention. The likelihood is that many of the inflationary impulses that have manifested themselves in recent month will not become rampant or self-reinforcing in nature. Disrupted supply chain shortages, bottlenecks in labor markets and energy have had a cost-push impact but are expected to be largely resolved in the second half of the year.

Hence, the majority of institutional investors surveyed by Merrill Lynch currently believe that inflation pressures are transitory (72%) rather than permanent (28%). This is reflected in aggregate outlook and positioning stances, with a virtual dead-heat in assessing the primary tail-risk to markets (30% each for inflation versus a "taper tantrum" over policy unwinding and normalization). Likewise, investors are adopting a barbell approach. On a medium-term horizon, both Value stocks and Tech names remain in favor to an equal degree; on a twelve-month basis, the balance of opinion is that Value will outperform Growth but also that High Quality earners will on average beat Low Quality peers.

Looking at updated correlation data helps to put the portfolio risks at the regional level in context and square the circle of ostensibly self-contradictory expectations.

EXHIBIT 1: CORRELATION OF RETURNS WITH US 10 YEAR REAL YIELD

	MSCI Europe	MSCI USA
Value	0.44	0.62
Quality	-0.24	-0.63
Growth	-0.44	-0.21
Cyclical	0.08	-0.38
Defensive	-0.12	0.07

Source: Exane BNP June 2021, calculated using 3 year lookback period.

While the longstanding relationship of Value and Growth to fluctuations in real rates holds true in both Europe and the US, it is worth noting that the headwinds to Quality are far less pronounced in Europe. In addition the relative impacts on Cyclicals versus Defensives is flatter in Europe and, in fact, directionally different to the US.

This is instructive in explaining how we, as bottom-up and company-specific investors integrate or hedge a specific top-down or macroeconomic risk factor (inflation expectations) in our portfolio. Much of the answer lies in the emphasis that we attach to analyzing sector context and idiosyncratic competitive dynamics within industry niches and value chains. Within our key investable markets of Europe and Japan, where growth characteristics are scarcer and declining capital return profiles more prevalent, inherent pricing power – regardless of cyclical dynamics and sensitivities – is a recurring feature of many well-managed and structurally compounding companies. End market structures – the degree of concentration, technological or scale barriers to entry, customer interaction and retention trends – often provide the opportunity for firms to steadily and successfully solve the cost-price "inflation equation". To fully seize that opportunity, companies should develop a sustainable edge in innovation, brand power or product criticality. Those firms that can provide and, importantly, prove the value of their offering – in terms of productivity, consumer perception or economic payoff – are best able to flex their pricing power muscles. Aside from lower revenue-vulnerability to swings in volume, the cash generative drop-through of healthy pricing offers abundant self-financing firepower for further R&D, M&A or ESG investments.

Portfolio companies that fulfill many of these criteria include industrial players such as Atlas Copco and Schneider Electric. The former is dominant in air compressors and vacuum-based technologies with a large and growing aftermarket service business that lowers the total cost of ownership for customers. The latter's ability to deliver energy efficient solutions via an increasingly convergent portfolio of low/mid voltage and automation systems is a key ingredient in its steadily increasing margins over recent cycles.

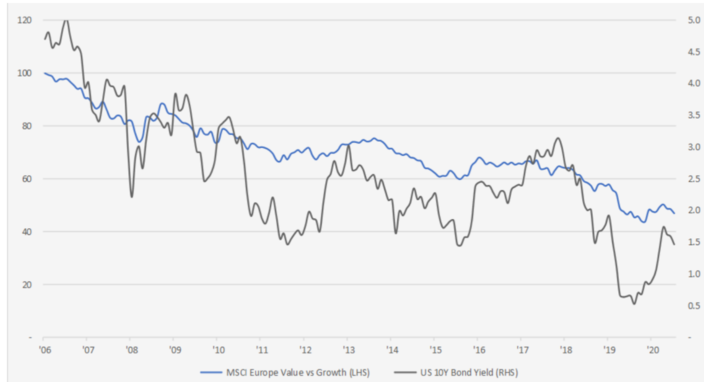
Digitization mega-trends offer pricing benefits beyond the industrial landscape. Many leading consumer companies have been able to optimize and stratify their brand value as a result of the enhanced point of sale and consumer behavior data now available. Spirits company Pernod Ricard is a good example of this across geographic end markets – their adoption of "connected bottles" within the Internet of Things (IoT) is a commercial reality not a vanity project. Elsewhere within discretionary or higher-end consumption the inherent cachet and brand power at companies such as luxury powerhouse LVMH or eyewear specialist EssilorLuxottica is difficult to replicate. Even building material company James Hardie is reaping the benefits of investing in its brand presence and relevance in the key US residential market.

Another category of companies that tend to exhibit stealthy degrees of pricing power is those that are able to differentiate themselves from their peers by better handling complexity or problem-solving for customers. Examples include specialty distribution channels such as chemicals (Brenntag) and construction (Ferguson) where product safety requirements, regulations and relatively small total cost contributions provide incumbent advantages. Within Real Estate, Australian-based industrial developer Goodman Group focuses on opportunities in Tier 1 markets for warehouses and logistic centers. These projects within global hubs and densely populated cities may require greater expertise and the take longer to complete but the investments and risks are more than compensated for by the resultant leasing rates (often longer-term and pre-booked) that are realized at completion.

Finally, it must be acknowledged that some geographies are naturally less fertile breeding grounds for pricing power. The deflationary mindset that has become endemic in Japan over the course of a generation means very few domestically oriented companies are able to escape the gravitational pull of negligible or negative price traction. The few exceptions tend to be found among export driven and innovation rich industries, with prime examples being medtech/imaging specialist Hoya and industrial automation leader Keyence. The challenge in these instances is not so much correctly identifying as accurately evaluating the growth opportunities that present themselves.

This relative valuation conundrum, or the premium that is warranted by best-in-class profit engines and all-weather names, applies, of course, to the full range of high Quality characteristics. However, empirical evidence and our own experience suggest that pricing power, in all its various guises, is one such characteristic whose duration is more underappreciated than others.

EXHIBIT 2: VALUE VERSUS GROWTH AND US BOND YIELDS



Source: DuPont Capital, FactSet, June 2021

Based on the data in Exhibit 2, maintaining a solid footing within the Quality cohort in Europe appears to be a lower risk portfolio exposure than in the US. We contend that selectively anchoring that Quality exposure among high margin companies provides a more efficient hedge against inflation tail risks – both unexpectedly real or imagined.

About our firm:

DuPont Capital Management is an SEC registered investment advisor based in Wilmington, Delaware. Since the firm's establishment in 1993, we've had a long history of developing global investment opportunities in both traditional and alternative strategies across equity, fixed income and alternative investments. Our investment team structure gives us the ability to be flexible and adapt to changing market conditions. DuPont Capital's focus is delivering consistent investment management results for our clients. Our history of institutional asset management is rooted back to 1942 when our former parent company, DuPont, established a pension plan for its employees. Corteva Inc. succeeded DuPont as sponsor of the DuPont Pension Plan in 2019. DuPont Capital is a wholly owned subsidiary of Corteva and continues to manage the legacy DuPont Pension Plan.

DuPont Capital's President and CEO, Valerie Sill believes in education and diversity of experience as represented in our investment teams which are comprised of PhDs, engineers, medical doctors, and scientists. We believe their global expertise creates a portfolio implementation edge that benefits our clients.

For additional information, please contact:

Mr. William Smith
Managing Director
Business Development and Client Service
(302) 477-6204
Bill.Smith@dupontcapital.com

Important Disclosures: