WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT

QUARTERLY COMMENTARY

GLOBAL

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COMMENTARY

Rigour, time and patience

It was a solid quarter for most global equity markets, although US dollar returns in some bourses were flattered by the weakness of the 'greenback'. The Federal Reserve cut interest rates by a sizeable 50 basis points and flagged the likelihood of further reductions. The Fed's view is that the economy is largely in reasonable shape, but with inflation now near the 2% target, an interest rate cut is timely in view of an easing of labour market tightness, mixed personal spending trends, and ongoing torpor in the manufacturing economy. The European Central Bank also obliged investors with an interest rate cut in September, continuing the monetary easing path that it started in June, in view of receding inflation and the region's tepid growth outlook. The quarter was not without volatility, however, as the Bank of Japan's modest interest rate hike temporarily upset the equity market apple cart, with investors pondering the demise of the yen carry trade.

However, there was a change in the complexion of market returns this quarter. Market concentration has been a well-documented feature in recent years. From September 30, 2021 to September 30 this year, the Magnificent Seven in total contributed to 39% of the MSCI World USD return, with Nvidia and Apple alone accounting for 26%. However, some of the famed technology members of the Magnificent Seven were noticeable by their absence this quarter. Some of this was likely due to the short-lived vortex brought about by an unwinding of fast, carry-trade money.

But their lacklustre share price performance was also perhaps reflective of previous strong share price gains, with investors arguably awaiting further tangible evidence as to how the AI theme will be monetised in the long run. Accompanying Alphabet's recent healthy quarterly results was CEO Sundar Pichai's reminder that AI infrastructure will take a lot of time and effort to build, which perhaps speaks to the market's now more-considered view on what will be a long, evolving, and broadening AI story.

AFFAIRS OF THE HEART

There was notable share price weakness amongst a few healthcare companies over the quarter. Amongst them, Edwards Lifesciences, a pioneer in the field of aortic stenosis (AS) treatment. AS is a serious heart condition that affects millions of people worldwide. For decades, the only treatment available was the manual replacement of the aortic valve through dangerous open-heart surgery. However, the potential complications and side effects of surgery limits the addressable market. Edwards has since pioneered the development of transcatheter aortic valve replacement (TAVR) therapy, a revolutionary approach to treating AS in a minimally invasive manner.

Having navigated the fall-out from the Covid era, the recent quarterly results showed a deceleration in TAVR sales. This resulted in the company cutting 2024 TAVR sales guidance from a range of 8-10% to 5-7% year-on-year growth.

"The company believes it is a transitory issue"

We spoke with the CEO and CFO during the quarter and visited the company as part of a US MedTech road trip. Management attributed the slowdown to the impact of the introduction of new structural heart therapies (including Edwards' own EVOQUE tricuspid valve replacement system) on the capacity of surgeons to carry out TAVR procedures. This sudden deterioration raised questions about the long-term structural growth trajectory of the TAVR market, hence the adverse share price reaction. The company believes it is a transitory issue, albeit one that will take several quarters to rectify as heart teams hire more staff and improve the efficiency of their workflows.

The CEO emphasised that there are two important catalysts that should help accelerate growth of the TAVR market. Firstly, asymptomatic approval, which is expected at the end of this year, and secondly, approval for moderate AS sufferers, which is expected in 2026. Roughly one-third of patients with severe AS have no symptoms, whilst there are at least twice as many moderate sufferers compared to the severe cohort. Currently, none of these patients are receiving TAVR. The CEO also stressed that the company is in a transition period. TAVR has been the linchpin of the business, but that will gradually change over the long term as Edwards builds out its embryonic transcatheter mitral and tricuspid therapies (TMTT). This part of the business is now growing rapidly, and the CEO believes that over time the opportunity set could rival that of TAVR. In the long run, Edwards will focus on four key areas - TAVR, TMTT, aortic regurgitation and heart failure.

"We always take the long view"

Earnings progression is seldom linear in any business. Over the lifespan of any company, there will be challenges to navigate, which in addition to the ebbs and flows of market themes or cycles, may periodically impact share price performance. However, we always take the long view. We analyse and debate ideas and views from the perspective of how events and developments will shape the returns of a business over time, rather than focus on near-term headwinds. Our investment approach is founded on our belief that seeking out leading companies with attractive growth runways, and with time and patience allowing compounding to work, represents the best way of achieving good long-term returns.

A CHINA BOOST

A fillip to markets was China's decision to deploy greater fiscal and monetary stimulus in an economy which has been beset by the travails of the property market and relatively frail consumer sentiment. The apparent policy heft now being applied by the Chinese government to foster more growth suggests concern in Beijing about the near-term economic direction, and the need to revive both the property market and personal spending.
While the jury is out on the real impact of the new stimulus, with some of the specifics of the fiscal measures yet to be announced, it was enough to rekindle investor enthusiasm in various global equity sectors such as luxury.

LVMH staged a rebound from its recent lows, after a period where there have been concerns about the near-term outlook for high-end consumer spending. Pan-Asian insurer AIA Group has been off the investor radar for a prolonged spell, but renewed optimism about China has arguably cast a spotlight on the ongoing operating recovery the company has been witnessing for well over a year. Our recent podcast on China[1] discusses our on-the-ground findings by members of the Research team after an intensive two-week trip to Mainland cities and Hong Kong.

A FOCUS ON FUNDAMENTALS

Recently, equity markets have been reflecting a benign monetary environment, amidst a 'muddling through' picture of global growth. While this may continue, risks remain in the form of the cumulative effects of inflation, which may crimp the spending power of consumers. Investors have also paid little attention to global politics, largely due to the stability of energy markets. However, the forthcoming election in the US may raise the prospect of tariffs and a reset in the economic relations between the US and its trading partners, while strife in the Middle East and Ukraine may yet be a source of volatility. Whatever the backdrop, we will stick to our approach as we have done through a multitude of cycles. We will monitor events, but our strategy is to seek out leading, financially strong companies that are often veterans of navigating economic or political ebbs and flows, while remaining well positioned to deliver robust growth over the long term.

1 https://www.walterscott.com/talking-research-challenging-thinking-on-china/

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