WALTER SCOTT

QUARTERLY COMMENTARY

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COMMENTARY

The year started with the promise of stability. Inflation looked to be easing, markets seemed upbeat and central banks suggested a more predictable path ahead. But that calm did not last.

Donald Trump's return to the White House reignited trade tensions, with new tariffs disrupting supply chains and rattling investor confidence. Global equities, which started the year on a strong footing, stumbled as renewed geopolitical risks and the new administration's policy shifts sparked market volatility. Where once 'US exceptionalism' looked to be a constant feature of global equity markets, investors' attention has been captured elsewhere, notably Europe and China. For now.

The only certainty this quarter has been uncertainty. Trump's announcement of a universal 10% baseline tariff on goods coming into the US plus 60 country-specific "reciprocal" rates at the start of April has given us some clarity, but uncertainty still abounds. For companies around the world, a lot of the all-important detail remains largely absent.

Given how rapidly rhetoric has escalated, and ebbed, during the quarter, it is important to avoid any knee-jerk reactions. As long-term investors, we have been through similar periods of tariff threats before. The import tax announcements should not have come as a surprise.

Post pandemic, there has been a general move towards US onshoring, and given Trump's long-held 'America First' attitude, international companies have long been preparing themselves for the possibility of more stringent trade restrictions, reducing their exposure to China and increasing production in the US.

The three countries at the sharp end of Trump's tariffs have been China, Canada and Mexico. Whilst much has been made of companies domiciled in the two neighbouring nations, there are US businesses with production facilities across both borders too.

A number of these are medical technology device manufacturers including Intuitive Surgical and Stryker. Mexico is where 90% of Intuitive's instruments and accessories are made. It is where Stryker has one of its 40 facilities (with another one in Canada). Both are currently evaluating the implications for their operations.

Shifting production Stateside

Others, domiciled beyond the shores of the Americas, have been building up their production capabilities in the US. Luxury group LVMH, which is so fiercely proud of its European heritage, has opened a number of workshops in the US since 2011. One of these, in Texas, was during Trump's first presidency.

On a recent earnings call, CEO Bernard Arnault said he was "seriously considering" increasing the group's facilities in the US. This is undoubtedly partly in response to the current US administration's attitude. It is also a not-so-subtle dig at the current French government which has increased corporation tax.

At the start of March, Taiwan Semiconductor (TSMC) announced a $100bn investment in the US. This is on top of the $65bn already pledged to build two fabrication plants in Phoenix, Arizona that are well under way. Whilst the majority of TSMC's chips are still produced in Taiwan, this investment in the US, plus a handful of other international locations, represents a notable shift in the company's strategy.

Inflationary implications
For most companies, it is more likely to be the second-order effects that pose a challenge. Tariffs on imports are very likely to push up costs for businesses and consumers. The topic has come up regularly on earnings calls and in our recent meetings with management teams. For most, they acknowledge that it is almost impossible to comprehend the impact at this stage, a refreshingly honest response in an ever-changing environment. That is not to say they are complacent.

As a high-street fashion retailer, an industry where traditionally much of the production is in China, Inditex may be expected to be hit by the associated tariffs. However, management has been keen to highlight the company's geographical diversification in terms of sourcing and sales.

Roughly 50% of its clothes are currently made in "proximity" markets (Spain, Portugal, Morocco and Turkey) with the remainder in Asia, not all in China. Inditex's flexible business model, with its proximity to sourcing, allows it to adapt at speed where necessary.

There are some which can be more sanguine about the possible inflationary environment. Take Compass Group, where 85-90% of its purchasing is domestic. US tariffs are less important. Should inflation kick in, the catering group is confident that it can pass costs on to its customers. Given Compass's huge scale gives it unrivalled purchasing power and thus the ability to be more competitive than its rivals.

From serving hot food to selling auto parts, O'Reilly's management remains similarly confident in its ability to succeed in a changing environment. They put forward the case that, during the last period of significant tariffs, in 2018 and 2019, the US auto parts industry behaved very rationally in response to increased costs. O'Reilly fully expects this dynamic to continue and anticipates the industry will have both the ability and the resolve to pass on any increased tariff costs.

TJX Companies has a strong track record in tougher economic times as people look to shop more price-consciously. The world's leading off-price apparel retailer also has a very flexible business model, without the rigidity of the traditional seasonal schedule. This allows TJX's buyers to be opportunistic, continuously scouring the marketplace for the best value.

With weakening consumer confidence, branded stores are closing, creating more opportunities for the buyers. With regards tariffs, any direct imports from China are a very small percentage of the business, which could increase costs over the short term. But, over the medium and long term, TJX's flexibility allows the company's buyers to shop elsewhere.

We will continue to monitor developments closely. With possible retaliatory tariffs anticipated, these are issues that are not going away. An integral aspect of our research is meeting with the companies, their competitors, suppliers and customers. It provides insights that no amount of desk-based analysis ever can.

During the quarter, there were trips to the US, Indonesia and South Korea. In the US, two members of the team spent a fortnight quizzing 25 companies across a range of sectors. Two of the standout meetings were with very different businesses, operating in very different industries but with equally impressive levels of innovation.

On-the-ground insights

In Minnesota, we attended Fastenal's capital markets day, its first since 2018. A lot has changed since then, with the company transforming itself from a retailer to becoming a strategic global supply chain partner to its customers. As part of this transformation, the company has halved its branch network, while expanding its focus on larger accounts ($50,000+ spend per month).

We visited one branch that, since Covid-19, has been converted from a retail shop serving lots of small customers to a warehouse supporting large customers' onsite operations with Fastenal's own logistics network. Interestingly, CFO Holden Lewis noted that more than 90% of deliveries today use Fastenal's own delivery fleet and that this vertical integration gives the company at least three points of operating margin advantage versus their peers.

Another factor behind the company's increasing market share in this still highly fragmented industry is its specialised salesforce. These individuals are trained to address customers at every level, from the factory floor management teams all the way up to C-suite executives. There is also a team of experts analysing all aspects of potential cost savings for customers.

Another key focus area of Fastenal's business transformation has been an increased investment in technology. This has included acquisitions related to software and hardware capabilities for inventory management. The company is also looking into how generative AI can make its employees more productive. CEO Dan Florness believes these efforts should allow Fastenal to return to a double-digit revenue growth as the US industrial landscape normalises.

Continuing the AI theme, we had a fascinating discussion with Moody's Corp in New York about its first generative AI offering. Moody's Analytics, which is the division that accounts for 52% of overall sales, released its Research Assistant in December 2023. So far, it has been adopted by more than 100 companies, saving them 30-40% of their time spent finding and analysing information.

Given that these customers are familiar with Moody's interface, the company has seen broader adoption of its generative AI tool across its clients, with increased customer stickiness. It is also being constantly enhanced with the most recent update being a workflow automation of, for example, credit analysis which typically involves more than 20 steps pulling information from different sources.

Taking into consideration the highly regulated nature of Moody's Ratings (the other 48% of the business), it will need to navigate various hurdles to convince regulators of the credibility of its AI-generated outcomes, but this process is currently under way.

It is unsurprising that AI is a common thread running through most of our company interactions, regardless of the sector. So much of last year's market enthusiasm was for all things AI and there continue to be ongoing developments, including the surprise announcement around DeepSeek's generative AI model in January. The Chinese start-up unveiled a highly capable generative AI model, reportedly developed with fewer critical GPU chips and at a fraction of the cost of comparable models.

Adobe is one company which has borne the brunt of investors' disappointment around the speed of AI monetisation. In March, we had a call with the company's CEO as well as (virtually) attending its analyst day. Both were encouraging exchanges. On the monetisation of its generative AI Firefly franchise, management suggested that much of the heavy lifting has been done to position the company for its next leg of growth.

The business is still in investment mode, but the focus is very much shifting to monetisation. Firefly's annual recurring revenue is expected to go from zero to $250m in two years, by the end of 2025. For the latest quarter, this figure was already $125m. Adobe also revealed it has approximately $3.5bn in AI-influenced revenues, which includes higher-priced tiers across various products that are being used in tandem with Firefly or Acrobat AI Assistant premium tiers, helping drive better customer retention and reduce churn.

Further uncertainty ahead
The outlook for equity markets remains clouded by uncertainty. Companies face not only the unpredictability of tariffs and AI developments but also the volatile market reactions. The Federal Reserve's upcoming interest rate decisions and weakening US consumer sentiment add to the complexity.

At the start of January, few could have predicted a challenge to 'US exceptionalism,' expecting the US economy to outpace global counterparts under the new administration. However, the market trajectory has shifted dramatically in just three months. Europe and China have shown improvement in sentiment although this hasn't yet been reflected in consistent economic data. Optimism around still-to-be-implemented policies has partly driven the rise in share prices there.

US market uncertainty is unlikely to resolve itself soon, as investors navigate the implications of the government's radical trade and foreign policies. More tariff-induced volatility is anticipated. Given this environment, investors may shift focus to non-US markets, potentially reducing the valuation premium of US assets. Nonetheless, as long-term investors, our priority remains resolute on businesses with the capability to generate wealth, regardless of the macroeconomic and geopolitical landscape.

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