Portfolio performance

The Swell Global Portfolio fell by 40.73% in the six months to June 2022 as continued volatility shook global stock markets throughout the half, with the technology sector particularly impacted. We sold two companies in the half year, holding 12 stocks and 7.9% cash on June 30.

Market conditions

The highly infectious COVID-19 omicron variants which emerged late in 2021 and early in 2022 continued to disrupt businesses operations with stretched supply chains pushing inflation higher. As expected, central banks responded by aggressively raising interest rates in most countries throughout the first half of 2022.

Portfolio Investments

During the half we sold Intel and PayPal.

We sold Intel due to a thesis change and because we saw better opportunities with less risk. Our thesis rested on the success of Intel’s IDM 2.0 strategy and the demand by European countries and the US for sovereign chip manufacturing capacity to counter the dominance of TSMC and Samsung. However, we believe we underestimated the cost of executing IDM 2.0. The increased CAPEX and production costs on top of lost margin from outsourcing production to TSMC will reduce gross margins from management guidance over the next 5 years and still do not guarantee “unquestioned leadership” in manufacturing.

Similarly we sold PayPal because we believe its moat is shrinking while its competitors’ moats are expanding. PayPal has failed to innovate at the same pace as its competitors and despite its large user base of both consumers and merchants, convenience is pushing users to newer platforms offering a superior user experience.

Our top three investments in the half were Deere & Co, Booking Holding and S&P Global. We discuss each company below.

Deere & Co

John Deere continued its run of strong performance early in the half, building on success in the precision agriculture sector as well as higher soft commodity prices which point to likely improvements in farmer profitability. Deere’s investments in precision ag and automation have increased the size of its moat in the agricultural machinery market, and these investments are starting to pay-off through increased interest from farmers seeking efficiency gains driving higher revenues as well as providing higher long-term margins for the core business.

In March the share price mirrored the spike in agricultural commodity prices which peaked after the imposition of global sanctions on Russian exports. Deere’s share price is positively correlated to certain soft commodity prices such as grains and dairy as they are leading indicators of farmer profitability and therefore capacity to upgrade farm machinery.

Second quarter earnings rose 17% from Q221 to $2.1 billion and the company forecast full year earnings to reach $7.0 - $7.4 billion. Despite supply chain pressures, production improved in the quarter to meet increased delivery demands. At its investor day in late May, Deere revealed its integrated technology strategy for precision agriculture could open an incremental addressable market worth $150 billion.

CEO John May told investors the $150 billion “includes every drop of herbicide or pound of fertiliser that our machines save through precision application. Every extra bushel our customers get from achieving uniform emergence in their crop, and every dollar saved on a job site due to less rework from smart grade technology”.

Deere's smart industrial strategy, announced at its last investor day in 2020, was designed to realise more value per unit sold, rather than driving higher unit sales. The strategy has driven a business reorganisation which includes centralising technology development.

Momentum for the strategy is coming from robotics, AI and machine learning built into Deere's equipment. At the investor day VP Automation and Autonomy, Jorge Heraud, described a custom camera which the company manufactures. Its high dynamic range enables it to see images in sunlight and shadows, a sensing element measures the best wavelength to use for maximum clarity and it is rugged enough to withstand all weather and terrain conditions. A customised graphic interface captures the ultra high resolution images which feed into the robotics, AI and machine learning to provide real time analysis of growing conditions.

Deere's proprietary agricultural technology delivers value by enabling farmers to make decisions at the level of the plant, rather than the field or the farm. It is currently collecting data from more than 300,000 connected agricultural machines and this is expected to triple by 2026. Similar technology supports Deere's Earthmoving Productivity System which provides real time load data and is also being developed for construction equipment.

Booking Holdings

Booking Holdings' financial results for fourth quarter and full year 2021 were impacted by the delta and omicron COVID-19 variants, with room nights declining in the December quarter. However, by February when the 2021 results were reported, room nights had returned to pre-pandemic levels and northern summer bookings were ahead of 2019. Gross bookings for 2021 were 116% ahead of 2020, at $76.6 billion while total year revenue increased 61% from 2020, to $11 billion

CEO Glenn Fogel told investors the company was continuing to prioritise its connected trip vision and focus on driving benefits for travellers and industry partners. The strategy seeks to provide a single platform to book travel, accommodation, restaurants and events, drawing on predictive technologies to offer users personalised recommendations.

Subsidiary KAYAK launched KAYAK for Business in 2019, a free solution enabling small and medium businesses to manage corporate travel. In January 2022 it announced Southwest Airlines, the world's largest low cost airline, had been added to the platform. The integration further improves the booking experience and expands access to more travel options for business travellers.

Booking reported its highest quarter of gross bookings in the first quarter of 2022, reaching $27.3 billion. Earnings per share was $3.90, well ahead of analyst estimates of $0.90. Comparing results with the first quarter of 2019, prior to the pandemic, Booking noted room night bookings were down 6%, although they improved in April 2022 to be up 10% on April 2019. During April the company repurchased approximately $325 million of its common stock, having repurchased 486,112 shares in the previous three months.

Chewy CEO Sumit Singh joined the board of Booking Holdings in June, replacing Robert van Dijk who retired at the June meeting. Mr Singh has extensive ecommerce experience, and was included in the 2020 Bloomberg 50 annual list of innovators, entrepreneurs and leaders who have changed the global business landscape over the past year.

S&P Global

S&P global completed its IHS Markit merger in March, following an 18 month delay due to regulator scrutiny of the deal. In an investor call following the merger conclusion, the company gave updated guidance of 13-15% earnings growth for the next three years, revenue synergies of $350 million and cost synergies of $600 million by 2024. The company also announced an accelerated share repurchase program to buyback $12 billion worth of common stock in coming months.

First quarter revenue, reported in April, rose 1.7% from Q121 to $3.1 billion, with growth in five of the company's six business divisions. Revenue in the Ratings division declined 15% due to the global slowing in debt issuance while Market Intelligence rose 7%, Commodity Insights rose 14%, Mobility rose 10%, S&P Dow Jones Indices rose 14% and Engineering Solutions rose 7%.

Announcing the first quarter results, management reduced expectations for global GDP growth by around 1% and increased their outlook for inflation from 3.9% to 5.8%. Revenue guidance was reduced from a mid to low single digit increase and diluted EPS came back from $13.30 - $13.50 to $13.00 - $13.25. However, guidance for the remainder of the year was suspended on June 1 due to "extraordinarily weak market conditions for its ratings business". New guidance will not be issued until the next earnings call which is scheduled for the end of July.

S&P confirmed debt issuance levels have been extremely weak this year and are not expected to improve in the second half. However, the impact has been diminished because ratings is no longer the company's dominant revenue source. In the last quarter ratings contributed around 28% of total revenue, compared to almost 50% in 2017. Expansion of the market intelligence business together with the acquisition of IHS Markit increased recurring revenue to more than 70% of the total.

H2 2022 Outlook

We expect June quarter results and September guidance to be significantly impacted by lower consumer confidence in the US. Earnings estimates for companies in the Portfolio remain unchanged, but the broad fear in the market that a deep recession is inevitable has reduced confidence in their value. In early July the Atlanta Fed estimated that US GDP in Q2 shrank by 2.1%, indicating it may already be in a recession.

If a recession is confirmed, it will represent a significant compression of the typical business cycle, which is the time from one economic peak to the next, or one recessive trough to the next. The US National Bureau of Economic Research has identified eleven such cycles between 1945 and 2009, with the average cycle lasting a little more than 5.5 years. The current cycle is around 2 years.

The anomaly with the current conditions is that household balance sheets remain strong, aided by record fiscal stimulus during the pandemic and strong employment growth post pandemic as economies reopened. It is because of these two factors that our base case for the short term remains a shallow recession. Employment remains robust, with the US Bureau of Labor Statistics announcing 372,000 new jobs were added in June, holding the unemployment rate steady at 3.6%, although participation continues to be a problem.

We expect share markets to recover over the remainder of 2022 as investors adjust to a slowing economy. We remain exposed to companies with long term structural growth drivers like e-commerce, digital advertising and the cloud which will drive higher earnings in a slowing economy.