Frontier MFG Global Equity Fund
Institutional Class (FMGEX)
Sub-advised by MFG Asset Management – Sydney, AU

FRONTIER FUNDS

Quarterly Commentary, December 31, 2023

The quarter ending December 31st saw strong global equities returns driven by lower bond yields. The Information Technology sector led these gains (up 16.9%), followed by Industrials (11.4%) and Financials (11.2%) with these sectors sensitive to interest rate movements and the economic outlook. The Energy sector declined 5.5% as oil prices fell in the quarter.

The main driver of equity returns in the quarter was a large fall in bond yields. U.S. 10-year Treasury yields fell 70bp to 3.9%, German 10-year Bunds declined 80bp to 2.0% and Japanese 10-year JGBs declined 10bp to 0.6%. These were a response to easing inflationary pressures, with annualised U.S. core inflation in the three months ending November 30th running at 2% compared with 5.5% just six months earlier. Notably, this development led the Federal Reserve to suggest in December that its policy rate may be "at or near its peak". The tailwind to equity returns from lower interest rates was reinforced by a slightly improved profit outlook, with the gradual slowdown in global growth not hurting profit growth as much as many had feared earlier in the year.

The Chinese growth outlook remains challenged as the country digests its real estate bubble. Poor consumer, business and investor confidence are stiff headwinds to growth and will take time to improve in the absence of economic stimulus. While the Chinese government appears so far to be more focused on internal security rather than growth, there have been some signs of minor pro-growth policies. These growth headwinds are reducing geopolitical risk in East Asia as the Chinese government focuses more on domestic issues.

For the quarter, the largest contributors were the holdings in Microsoft, Amazon, Chipotle Mexican Grill, ASML and Intuit, which all rose 19% or more in the quarter. The moves reflect both bullish expectations for many of these as AI opportunities are considered and a weak period of growth ends, and a shift in sentiment around higher growth investments as policy interest rates are seen to be at peak (and falling in 2024). Microsoft delivered a strong fiscal Q1 result driven by commercial cloud momentum, unexpected Windows growth in a stabilising PC environment, gross margin expansion, and operating leverage. Azure performance provided encouraging early evidence of Microsoft's ability to monetise the AI opportunity despite cloud spending headwinds. Amazon benefited from the broad rally in longer duration growth companies and also reported a strong 3Q23 result. AWS growth stabilised in 3Q23 vs the prior quarter and management indicated growth would inflect in 4Q23/F24 as optimisation efforts reduce and digital transformation programs resumed. ASML rose with semiconductor peers and while its Q3 result was within guidance, it outperformed consensus earnings on stronger gross margin.

Detractors were limited to Nestlé and Diageo, which both fell just over 5% over the quarter. We have high long-term conviction in Nestlé as its ability to deliver steady compound growth in cash flows and earnings remains robust and we anticipate good results in February. Short-term digestion of some supply constraints and related capacity additions has weighed on near-term growth. Diageo is cycling exceptional growth, particularly in the U.S. and its tequila franchises, in the past two years while recent weakness reflected inventory excesses in Latin America which it is working to clear, but which will weigh on near term profits.

2023 ended with a bang as markets almost everywhere (OK, not China) rallied. Breadth expanded beyond the few stocks that led 2023 strength and financials caught some interest as a benign U.S. economic backdrop became a more consensus view. We are seeing recessions in Europe, clear weakness in China and still some small risk of a brief period of economic weakness in the U.S. even though in late 2023 U.S. growth accelerated.

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Without a notable slowdown in its economy, accompanied by deteriorating employment conditions, or a concern that deflation could be ahead, we doubt the U.S. Federal Reserve will feel compelled to cut its policy rates too quickly. We expect U.S. 10-year Treasuries at around 4% for a while yet and quantitative tightening to continue even as inflation further comes back to levels seen as acceptable to central banks around the world. However, this is no longer a major headwind for equity markets and indeed we believe it will likely become a tailwind sometime during 2024. September Federal Reserve projections (rates, GDP growth, unemployment) were all revised to reflect a sustainably stronger economic outlook, and nothing thus far has contradicted this.

In many respects the world looks to be in good shape economically. Measures of Consumer Sentiment show gloominess amongst Americans, but this seems somewhat at odds with prospects and perhaps is a function of social media's negative lens. We continue to see remarkable progress in many areas and numerous opportunities within markets and we encourage a longer-term and disciplined approach by investors.

Areas of consternation largely reflect some level of dysfunction politically and geopolitically – migrant crises, Israel/Hamas, income inequality and high government debt and we can add to that regular weather calamities. Yet in the U.S. economic growth (real) has accelerated and is likely to be close to 3% in 4Q23 vs 0.7% a year ago. Unemployment has been below 4% for the longest period since the 1960s and the participation rate amongst 18- to 64-year-olds is the best it's been since 2009. With falling inflation, real wages are up and wealth drivers of housing and share markets mean household net worth is up strongly. While a myopically short-term and rubbery tool (yet quoted by many), the one-year forward price earnings multiple for U.S. stocks is lower today than a year ago.

Prospects for corporate earnings and cash flows mean an exciting backdrop for long-term investors. New projects are being undertaken as the trends of decarbonisation, digitisation and deglobalisation gain momentum. U.S. non-residential construction spend is strong and has one of the highest growth multipliers (estimated at 3x) of any industry. Even if interest rates do not fall materially, we believe opportunities outweigh the risks within equity markets.

Stepping to the portfolio positioning, we are clearly positive on the opportunity to deliver wealth creation in global equities. We believe there are boundless opportunities in front of us for our well managed companies with strong competitive advantages to deliver exceptional earnings and cash flow growth in coming years. There may be some share price bumps along the way as bond yields fluctuate and sector rotations within markets affect prices through flows, but we are confident in valuation upside for the portfolio. Strong earnings mitigate rate volatility risk over a longer time horizon and so the portfolio is tilted towards those companies we believe can keep delivering better-than-expected results through time and are yielding high cash flows from their operations even today.

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We expect that some volatility in markets may accompany us over the next few months as share prices continue to adapt to the evolving interest rate environment and reshaping of economic growth. Volatility isn't inherently risky. We work diligently to assess the real risks that face our portfolio companies and will continue to hold the line on our absolute return objective. We thank you for the trust you place in us.

Index movements and stock contributors/detractors are based in local currency terms unless stated otherwise. U.S. GDP statistics come from the U.S. Department of Commerce, while U.S. employment and inflation statistics are published by the U.S. Department of Labour. EU economic statistics come from Eurostat. UK statistics are released by the Office for National Statistics.