International Market Outlook—What's Trending for 2022?

DIAMOND HILL CAPITAL MANAGEMENT

Portfolio managers Grady Burkett, CFA, and Krishna Mohanraj, CFA, discuss inflation, supply chain disruptions and other issues markets are facing as we head into 2022.

Grady Burkett, CFA
Portfolio Manager

Krishna Mohanraj, CFA
Portfolio Manager

Whether inflation is transitory or the beginning of a longer-term trend, how are global companies positioned to deal with rising costs?

Grady Burkett: Transitory or not, we are definitely seeing higher inflation globally, though currently it's higher in the US than in Europe or Asia Pacific. Given how dramatically and quickly global supply and demand have changed over the past 18 months, it's not surprising we are seeing some manageable challenges for some companies. A few companies we're invested in have experienced a small amount of margin compression, most of which we believe is short-term in nature. We've also seen a few situations where companies have had minor delays in supply or reductions in inventories, but again we believe these are temporary.

Overall, the majority of our portfolio companies are managing input costs well. We haven't seen widespread margin pressure or challenges in delivering supply to fulfill demand. In some cases, we've even seen margins expanding because revenue is still recovering, so operating leverage is taking hold. Also, many of the businesses in which we're invested have pricing power, allowing them to pass through higher input costs over time.

As we move into 2022, the other consideration is how interest rates respond to rising inflation. Currently, real yields are negative throughout the world, and central bank policy rates are well below inflation rates. If short-term rates rise sharply, we could see some earnings benefits to our companies with large net cash positions. Companies like Check Point, Meta (Facebook), Swatch and Nintendo, for example, could benefit at the margin.

On the other hand, a sharp rise in developed market interest rates could pressure some emerging markets and create headwinds for our multinationals that have a lot of emerging markets revenue. For example, Ashmore, a UK-based emerging markets bond manager, could experience some outflows if investors lower their emerging markets exposure. However, I believe that scenario is partly priced into Ashmore's current market price, as we believe its shares are trading at a significant discount to the company's intrinsic value.

Overall, we believe our international portfolio will be resilient to different economic conditions. Some businesses could be impacted by higher inflation above what's already expected, while others may benefit.

Supply disruptions are expected to potentially ramp up as we close out the year, but it's unclear whether these issues will persist next year. What is the outlook for 2022?

Krishna Mohanraj: Supply chains have been a hot topic this year. In looking at where we are today and what might be coming in 2022, I will frame it in two parts—what's happening today vs. what could be more permanent secular change. Let's start with the current situation.

In our portfolio, companies across industries have dealt with some supply chain constraints in 2021. This year has been a double whammy because the pandemic impacted both supply and demand. From a demand perspective, how products were consumed changed a lot throughout the crisis. Take beer consumption—when the crisis hit, consumers went from drinking beer in restaurants and bars to drinking at home. We saw consumers stock up their personal home inventories, often from volume stores such as Costco.

As the pandemic progressed and vaccines became available, consumers weren't stocking up at home as much. While retail food outlets were still largely closed, consumers were buying smaller quantities from their local grocery stores. A few months later as restaurants and bars began to reopen, the demand picture changed again. Of course, these shifts varied from country to country depending on the pace of vaccine rollouts. Now imagine overseeing a global supply chain during this time. On the demand side, buying packing material, glass bottles or aluminum cans. Throw in the supply chain constraints—aluminum shortages, labor shortages, shipping container shortages—these were some of the worst conditions businesses could imagine.

Given all that, we were pleasantly surprised by how well the businesses we're invested in managed. One thing that we were reminded of was the extent of redundancies some global companies have built into their supply chains. Unilever, for example, couldn't source some chemicals from China when the crisis first hit. But it was able to quickly shift to India. Then when the crisis hit India hard, Unilever was able to shift to Latin America and then back to China. Being global and having these supply chain networks and redundancies meant Unilever had very good on-shelf availability throughout the crisis.

Now, looking to the future is even more interesting. Given everything the global economy has been through, we need to start thinking about the future of supply chains. A big part of that future is ESG, which is changing the dynamics in a big way. It's causing global companies to really think about supply chains. Nearly every company we're invested in wants to take on more control of the supply chain, and many companies have signed the net zero emissions pledge.

For a company like Nestle, for example, two thirds of its greenhouse gas emissions are in the agricultural supply chain. Therefore, Nestle needs to be intimately involved in that supply chain and consider things such as regenerative agriculture. Over time, we believe this secular change will benefit the A players over the B or C players, especially in fragmented markets. Leading companies with scale and credibility will come out ahead. One example is Bunzl, a leading distributor of consumer products to corporate customers. Bunzl supplies things like shopping bags, containers, labels and cleaning supplies to grocery stores such as UK-based Tesco. Most of Bunzl's competitors are tiny players. When Tesco starts looking at its supply chain with an ESG lens, Bunzl is one of the few players who can provide its customers with the analytics and options to help manage and track ESG impacts.

What global trends are going to shape and drive growth as we look out into 2022 and beyond?

Grady Burkett: There are several long-term trends that are driving growth in economies across the globe. Based on the bottom-up research our team does on non-US companies, and those businesses we've invested in, there are five that stand out to us. Those include the adoption of 5G, increased regulation of big tech, the continuation of wealth creation and growing interest in ESG.

If we look at 5G adoption, this trend is going to enable all types of innovations that we don't have available to us today. 5G, as most people know, is the latest wireless networking standard, which is being rolled out by wireless operators throughout developed countries. It's another step in the wireless evolution that enables faster data speeds, more capacity and more thorough coverage. Wireless operators tend to talk about it in iterative steps, e.g., 3G, 4G, 5G, but it's really a continuous process of upgrading wireless networks.

In our portfolio, we prefer the telecom operators that have strong fixed-line networks and strong wireless networks because an operator needs both physical assets to deliver a competitive 5G service well into the future. We own two telecom operators—Rogers Communications in Canada and BT Group, which is based in the UK. Both companies are large players with durable competitive advantages that we believe will be generating a lot of cash 20 years from now. Currently, both are trading at attractive discounts to our estimates of intrinsic value.

Some other innovations that will evolve from this technology include autonomous cars, simpler access to health and education services, immersive reality games—the list goes on. Life in 20 years will look completely different than it does today, just like today looks vastly different than it did 20 years ago.

We own shares of Meta (Facebook), which owns some of the most lucrative mobile apps in the world, including Facebook, Instagram and WhatsApp. The company is investing billions of dollars every year into virtual reality products, which will continue to improve as mobile networks improve. We also own Chinese technology companies Alibaba and Tencent. Similarly, we believe their businesses will continue to improve as mobile networks improve, especially given the fact that they are making big investments into some of the same areas that Meta is.

Finally, our chip makers—Taiwan Semiconductor and Samsung—stand to benefit substantially from advancements in 5G, because memory and computer processors are key building blocks to all of the services that I mentioned.

Can you tell us more about the secular trend of wealth creation and what businesses are capitalizing on this trend?

Krishna Mohanraj: Global wealth creation is a well-known trend that has been evolving for some time now. Look at the last two decades—enormous amounts of wealth have been created, especially in emerging economies such as China and India. It's a decades-long trend, but what is fascinating is what occurred in 2020. Last year during the pandemic, roughly $29 trillion was added to global wealth. The global economy was in shatters, but household wealth grew 7%. In fact, countries that got hit by the pandemic the worst grew wealth the most.

The reasons are obvious. In hindsight, we know governments took preemptive action: they pumped money into economies, both directly to people and businesses and indirectly through quantitative easing. People didn't have a way to spend money during the pandemic, resulting in higher savings. Asset prices also boomed. Putting that all together, 1% of the world's population can now call themselves dollar millionaires. That's astounding.

Wealth creation effectively got a big boost in 2020 and the trend is expected to continue. Nearly every one of our consumer companies is talking about the impacts of wealth creation. From Diageo to Nestle to Richemont, they're all focused on one key trend—premiumization. Premiumization is a fancy word that means consumers want to move away from wherever they are on the consumption ladder to one step higher. They want to consume less quantity but more quality. So instead of drinking a six-pack of cheap beer, they'd rather have one fancy cocktail or a high-end single malt Scotch, for example. We are seeing premiumization occurring across the globe, even in emerging markets.

Now, who benefits from this? The premium luxury players, of course—companies like Louis Vuitton and Richemont, which owns Cartier and other high-end jewelry brands. In fact, Richemont recently reported earnings with higher-than-expected sales—up 20% over even pre-pandemic levels. We are seeing these spending trends at several luxury brands, but also with regular consumer products companies.

Household goods and food product companies are seeing strong growth in the premium end of their businesses. For example, Nestle's Nespresso coffee brand and Purina pet food are both doing well in terms of sales. Unilever, another global consumer products company, has experienced significant growth in its high-end beauty products.

Another interesting example is Diageo, the British spirits company. Diageo has invested aggressively and seems to be benefiting from this trend. Tequila is a good example. Over the last few years, as people have upgraded their lifestyles, tequilas have gone from cheap rocket fuel that young adults consume during spring break to a premium, high-end sipping drink. That change is indicative of what's happening across the world. Case in point, Diageo paid roughly $1 billion dollars for Casamigos, the tequila brand from George Clooney. In just two years, Casamigos' growth has been staggering—roughly 80% volume growth in 2020 and 125% in 2021. By making a shrewd investment, despite opinions that the cost was exorbitant, Diageo went from basically zero market shares in the tequila world to being a serious player with Casamigos and Don Julio.

As of October 31, 2021, Diamond Hill owned shares of Alibaba Group Holding Ltd., Ashmore Group PLC, BT Group PLC, Bunzl PLC, Check Point Software Technologies Ltd., Compagnie Financiere Richemont S.A., Diageo PLC, Facebook, Inc., LVMH Moet Hennessy Louis Vuitton SE, Nestlé S.A., Nintendo Co. Ltd., Rogers Communications, Inc., Samsung Electronics Co. Ltd., Swatch Group Ltd., Taiwan Semiconductor Manufacturing Co. Ltd., Tencent Holdings Ltd., Tesco PLC and Unilever PLC.