LOMBARD ODIER
INVESTMENT MANAGERS

1798 TerreNeuve Strategy

2019 Outlook

Alternatives • Equities 2019

Dear Investor,

2018 proved to be a challenging year for financial markets but we enter 2019 with unwavering optimism about the opportunity set for our strategy and excitement about the task ahead. Over the past six weeks we have been asked a lot about our market views, what is on our mind, how we have structured the portfolio going into 2019, etc. We thus thought it might be helpful to go beyond what we usually provide in our monthly newsletters and produce a standalone letter where we offer a general overview of the themes underpinning our stock selection, discuss relevant macro and other salient top-down inputs and share a few thoughts on technical aspects of the market.

KEY THEMES

The TerreNeuve strategy is a stock picking, bottom-up driven strategy but we have always been passionate about thematic analysis.[1] Unearthing, researching and eventually exploiting the next big themes that may drive value creation/destruction within our sectors is at the heart of our idea generation engine.

We have been discussing in our monthly newsletters a large number of themes, and, as you would expect most, if not all of them, remain extremely relevant to the extent we expect them to play a material role in driving the top line, earnings and multiples of many stocks within our focus sectors. In the sections below we discuss a number of themes which we think offer particularly rich investment opportunities for our strategy. All these themes are complex in nature and would certainly deserve more than a few paragraphs but our objective here is to provide an overview, not to write a PhD thesis.

Plastic and the Future of Packaging

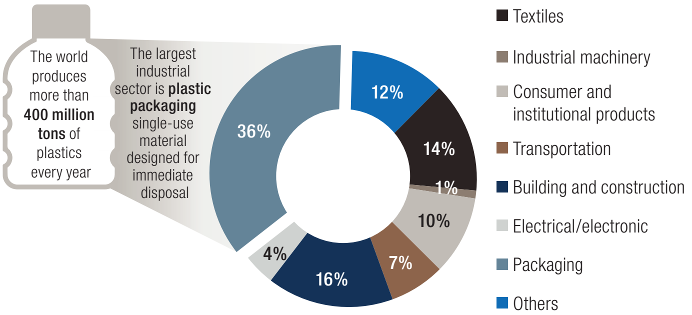
We first discussed the theme of plastics and disclosed a number of positions in our May and September 2018 newsletters.

Plastic production has increased by a factor of >40x since 1960 to reach 322m tons in 2015[2] – this compares to cement production expanding 12x and steel 3.5x. Plastic has become a ubiquitous material thanks to its amazing properties – lightweight in nature, high strength-to-weight ratio, water resistant, thermally/electrically insulating, cheap and easy to mass manufacture. Plastic has revolutionized packaging (36% of the demand) and food/beverage preservation and will continue to play a key role in construction, automotive and electronics applications going forward. Unfortunately there are two major issues with plastic. First, the production of plastic is largely reliant on fossil hydrocarbons which are non-renewable resources. Second, unlike other materials, such as metals or paper, plastic recycling remains marginal (<15%). In fact a recent study estimates that 79% of the plastic waste ever produced now sits in landfills, dumps or in the environment, while about 12% has been incinerated and only 9% has been recycled. It is widely thought to have a detrimental impact on both the environment and health and governments/regulators are starting to take action.

At the end of May 2018 the EU announced a proposal to ban a number of single-use plastic products (e.g. cutlery, straws, etc.) and for EU countries to collect 90% of single-use plastic bottles by 2025. Producers are also being asked to help cover costs of waste management and the clean-up process. In May 2018, the American Chemistry Council's Plastic Division announced plans for 100% of plastic packaging to be re-used, recycled, or recovered by 2040, which aligns with PlasticsEurope's 2040 commitment. In 2017, as part of a wide array of environmental measures China banned the import of plastic scraps – a measure that may lead to higher virgin plastic production in the short-term but certainly looks like the first rather than the last step to contain plastic growth. In October, the UK government proposed a tax on the production or importing of plastic packaging that is not made up of at least 30% recycled material. After decades of a laissez-faire attitude towards plastic it is on its way to become a genuinely regulated material.[3]

1 https://www.unepfi.org/fileadmin/documents/materiality2/obesity_jpmorgan_2006.pdf
2 https://www.plasticseurope.org/application/files/5715/1717/4180/Plastics_the_facts_2017_FINAL_for_website_one_page.pdf
3 http://www.ncsl.org/research/environment-and-natural-resources/plastic-bag-legislation.aspx
https://www.nationalgeographic.com/environment/2018/07/ocean-plastic-pollution-solutions/

GLOBAL PLASTIC PRODUCTION BY INDUSTRIAL SECTOR, 2015



Source: UN, adapted from Geyer, Jambeck, and Law, 2017.

Government policies alone may take time to materially impact supply/demand dynamics for plastics but when combined with an evolution of consumer purchasing behaviour and corporates' actions to curb plastic usage (for cost or brand building purposes) we think the single-use plastic value chain is starting to face serious challenges and demand headwinds. For the avoidance of doubt, we remain very bullish on prospects for high value-added plastics and fibres which play a key role in many industrial applications (including lightweighting).

As an investment research team our work has been focused on I) analysing risks/opportunities for the single use plastic value chain from petrochemicals manufacturers to plastic packaging/products manufacturers, consumer product companies and plastic recyclers; and II) identifying alternative value chains and business/economic models.

We cannot share in this newsletter every single investment decision we have made on the basis of our work but we have articulated over the past quarters a number of long/short trades in the portfolio underpinned by our work. We highlight below the key drivers of our investment decisions:

- Plastic "disruption" is definitely gaining traction as an investment theme: sell-side analysts are asking questions on conference calls, reports are being published, brokers are organizing conferences and quite importantly relevant stocks have started to move. We think this is just the beginning.
- Petrochemicals companies, in particular the ethylene-based value chain operators (leading to poly-ethylene/styrene and PET), will have to revise down their long-term growth assumptions in our view. For now, management teams of sector leaders, such as LyondellBasell or DowDuPont, continue to assume and plan capex for 3-4% demand volume growth p.a.[4] We think this is wrong and believe that cracker margins, which started to deteriorate in 2018, are unlikely to bounce as much as consensus believes post 2019.
- We think plastic packaging producers such as Amcor, Berry Global and Huhtamaki are going to face growing demand headwinds.
- We believe the pulp and paper packaging industry is well positioned to benefit from a gradual transition out of plastics, especially pulp producers which also control forestry assets.
- Plastic will not go away but virgin plastics should come under considerable pressure as the principle of circular economy gains traction and recycling increases. We have identified and invested in leaders in the space.
- Bio-plastic (i.e. plastic made from renewable feedstock) is now a reality. We view PLA (polylactic acid) as the only viable bioplastic solution in the coming years while Bio-PET or FDCA bioplastics will take 5-10 years before they are commercially viable (witness the delays suffered by Avantium/BASF). It is a small sector at this point but we see the potential for exponential growth. We have taken a position in the emerging industry leader.
- Within consumer staples we haven't implemented any trades on the basis of the plastics theme yet. Our thinking is that global brand owners will have to demonstrate stewardship on this matter if they don't want to lose consumers. The soft drinks industry, which has been at the forefront of the single-use plastic revolution, will once again be an easy target for regulators around the globe. Having had to absorb sugar taxes (somewhat passed on to the consumer) we think PET taxes will soon emerge on the agenda of policy makers. We think reinstating the re-usable glass model, which remains prevalent in Germany or Brazil, is the way forward.

Air Pollution

Tedros Adhanom, the head of the World Health Organization, has warned that air pollution is the "new tobacco," i.e., the new priority. In October 2018 the WHO launched a new global campaign to push governments and stakeholders around the world to take action against air pollution. The problem is not exactly new but it is reaching alarming levels: there are 4.2 million deaths every year as a result of exposure to ambient air pollution, 91% of the world's population lives in places where air quality falls below WHO guideline limits. In Europe the cost of air pollution was estimated at USD 1.6 trillion p.a. due to early deaths and disease.[5]

But, what is air pollution? Air pollution refers to unhealthy levels of pollutants in the air including I) particulate matter i.e. solid/liquid droplets arising from fuel combustion and road traffic; II) nitrogen dioxide from road traffic or indoor gas cookers; III) sulphur dioxide from burning fossil fuels; and IV) ozone at ground level, caused by the reaction of sunlight with pollutants from vehicle emissions.

"Air pollution" is not a new investment theme for us and it is fair to say that investors are broadly aware of the issue given the recurring newsflow. However, we do not think business risks/opportunities and the ramifications of the matter are necessarily well understood or properly priced-in, therefore giving us numerous opportunities to deploy capital.

[4] Source: Bloomberg, February 2019.
[5] https://www.theguardian.com/environment/2015/apr/28/air-pollution-costs-europe-16tn-a-year-in-early-deaths-and-disease-say-who

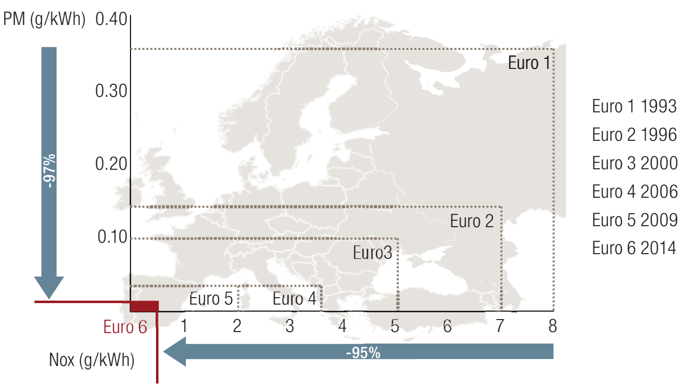
Our general view is that air pollution is likely to get worse before it gets better on a global basis. However, governments of the most advanced nations including China and beyond have already put in place considerable regulation and substantial measures aimed at curbing toxic emissions. These have already had and will continue to have a massive impact on a large number of sectors and companies.

Through our research we have identified the three pillars of regulation which we think we will have the most substantial impact on global business: I) Emission control legislation for light and heavy duty vehicles, II) IMO 2020 – the International Maritime Organization efforts to reduce sulphur emission, III) The Blue Sky China policy.

Emission control legislation for light/heavy duty vehicles

The EU has been leading the world (together with the California Air Resources Board) in terms of emission standards for light and heavy duty vehicles and while one may aspire to see further reduction in emission it's clear that since 1993 we have come a long way – the chart below shows that Euro 6 emission regulation for heavy-duty vehicles, now into force, has driven a 95% reduction in Nitrogen oxides (NOx) and Particulate Matter since the introduction of the first Euro 1 standard in 1993. Most nations around the globe have communicated a clear legislation roadmap which will result in a clear tightening of emission standards in the years ahead.

EU EMISSION REGULATION – 1993 TO DATE



Source: Paccar, 2014.

From an investment perspective we remain primarily focused on the auto/truck catalysts industry, which is extremely consolidated, and likely to continue to benefit from a major tightening of global regulation in the years ahead. We have disclosed in past newsletters the fact we hold both Johnson Matthey, the global leader in the industry, and Umicore in the strategy and continue to see the stocks as attractive. There is a major debate on Johnson Matthey though with investors questioning the long-term growth algorithm in a world where diesel cars are losing share to gasoline cars (catalysts content of diesel cars being 2x) and electric vehicles. It is fair but on our estimates, at 9.2x EV/EBITDA the market is attributing close to zero value to the European light-duty diesel business and ignoring much of the hidden value offered by the R&D-driven fuel cell and cathode material operations.

In the auto supplier space we see Faurecia as one of the major beneficiaries of tightening standards, having developed market leading solutions for NOx reduction. In the chemicals sector, we note that Yara, a major fertilizer producer, has developed a leading position in fuel additives to reduce Suplhur Oxides (SOx) and NOx but this is still a tiny business relative to their core operations.

LIGHT DUTY EMISSION CONTROL LEGISLATION ROADMAP

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Europe	EU 6b		EU 6c/Euro 6d temp				Euro 6d final/95g/km CO_2			EU 7?	
North America EPA	Tier 2		Tier 3 Phase 3 In: NMOG + NOx, PM Tightening								
North America CARB	LEV III Phase In: NMOG + NOx, PM Tightening						LEV III Further Tightening				
Japan	JP09			JP 18							
South Korea (Gasoline)	K-ULEV	K-ULEV 70					LEV III/97g/km CO_2				
South Korea (Diesel)	EU 6b				EU 6c/Euro 6d temp		Euro 6d final/97g/km CO_2			EU 7?	
China (Beijing)	BJ5 (EU 5)		China 6a			China 6b			China 6b/RDE		
China (Nationwide)	China 4 (EU 4)			China 5 (EU 5)		China 6a			China 6b/RDE		
India	BS3 (EU 3)		BS4 (EU 4)			BS6 (EU 6)			BS6/RDE		
Indonesia (Gasoline)	EU 2				EU 4						
Indonesia (Diesel)	EU 2						EU 4				
Thailand	EU 4								EU 5		

Source: Johnson Matthey, July 2018.

IMO 2020 – The most disruptive global legislation EVER!

Hold your breath. The International Maritime Organization (IMO), a UN agency, which has regulatory powers, decided in 2008 (yes, in 2008) that the sulphur content of ships' fuel should be reduced from 3.5% to 0.5% from 01 January 2020 onwards. You would think that the world has had time to prepare and everybody understands the far reaching implications of these new standards but this would be far from the truth.

A few figures to contextualize the regulation:

- The shipping industry accounts for c.7% of transport oil demand.
- The shipping industry accounts for 90% of Sulphur dioxide (SO2) emissions.
- 15 of the biggest ships emit more SO2 and NOx than all the world's cars combined.
- One million cars emit as much particulate as one cruise ship produces in one day.

Our conversations with experts suggest that compliance will be very high and in such a scenario there are implications across a large number of sectors with relatively clear investment implications – many of which have yet to play out yet.

- Our strategy has practically no exposure to the energy space but our research suggests IMO 2020 will be a game changer for refiners. Shipping companies are most likely to switch from High Sulphur Fuel Oil (HSFO) to diesel which will lead to lower HSFO prices and lead to a squeeze in diesel prices, given limited production capacity available. Complex refiners who can handle the switch and have ample diesel capacity should benefit. Note that by implication the heavy oil discount to light oil should widen.

- The shipping industry is likely to experience a substantial increase in operating cost – which will have to be passed on to customers, with some implications for commodity costs. In addition, the jet fuel market is likely to tighten too with negative implications for the airline sector, where cost pass-through is less mechanical.
- Industrial gas companies, such as Air Liquide or Air Products, are likely to benefit from a surge in demand for hydrogen, which is used in the desulphurisation units of refiners.
- Ship owners may choose to install scrubbers, i.e. exhaust gas cleaning devices, in order to continue to use HSFO rather than switch to diesel (the payback is around four years). Alfa Laval and Wärtsilä are the global leaders in the sector and their orders book are very full – the market is well aware of this though.
- Less understood, we think, is the fact that TIC (Testing, Inspection, Certification) companies with a presence in the maritime sector are likely to get increasingly busy. We favour Bureau Veritas, which is the market leader in the space.

China – Blue Sky Plan

In July 2018 China's State Council released its 2018-20 Blue Sky plan expanding pollution control to 82 cities across China, representing about 37% of population and c40% of China's GDP. This far reaching plan builds on a number of measures which started being implemented throughout 2017 within a number of industries and cities. Just a few highlights:

- The new plan introduced a national pricing system for carbon emission and the contamination of water, among other measures.
- Favourable electricity pricing for energy-intensive industries has been revoked.
- An import ban of plastic, paper, cinder and textile waste has been implemented since the end of 2017.
- The development of a green transport system is another key feature.

From an investment perspective the short/mid-term implications are subtle. Some measures had a temporarily positive effect on a number of verticals within the global chemicals sector but all things being equal, with more compliant production now back on stream, we have seen brutal pricing adjustments (e.g. PET). There have been surprising developments in the urea market where China's export capacity had been written off but suddenly resurfaced when global prices started to firm up – challenging sell-side assumptions for a number of key names such as OCI or CF Industries. Demand for some products such as MTBE (Huntsman is a key player in this space) will not come back.

In the renewable space we have seen a clear bid from China for all type of green technologies – note Weichai Power's investment in fuel cell system specialist Ballard Power Systems, a leading fuel cell operator, and one of the strategy's holdings.

Mid/long-term Western observers should have no doubt China will lead in the renewable and green technologies space. China is already the world's largest market for what it refers to as NEVs (new energy vehicles – plug-in hybrids, battery electric vehicles, fuel cell electric vehicles) with the ambitious penetration target of 12% by 2020.[6]

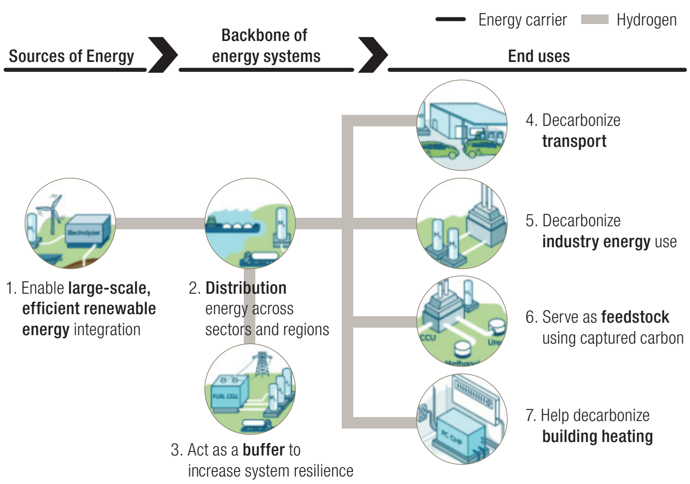
Hydrogen

As most of our regular readers know we have been talking about the theme of hydrogen for quite some time now and we remain extremely excited by the potential of the hydrogen economy for future mobility and energy storage.

Hydrogen is currently used in several industrial processes and generates cUSD 130 billion in sales globally but, according to the Hydrogen Council, the hydrogen economy could generate USD 2.5 trillion in sales and increase hydrogen demand by 10x by 2050.

While hydrogen is currently produced primarily out of methane it is possible to produce "green" hydrogen via water electrolysis using renewable energy sources (e.g. photovoltaic or wind energy) or bio-methane. Hydrogen has a high energy density and can be easily transported and could thus play a major role in i) decarbonizing/reducing emissions in transport, industrial processes and building heating, ii) energy storage, enabling large-scale, efficient renewable energy integration and improving grid efficiency/resilience.

HYDROGEN – ROLES IN DECARBONIZING THE ECONOMY



Source: Hydrogen Council, 2017.

While green hydrogen today is uneconomical, price parity could be achieved by 2030 according to a number of studies. That said, for hydrogen to really take off government support and incentives are going to be needed - infrastructure will need to be built, incentives will need to be put in place to favour grid access, etc. The good news is that in the past twelve months we have seen a massive increase in the number of:

Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document.

[6] China State Council – Blue Sky Plan, July 2018.

i) Government-sponsored hydrogen-related projects around the globe (Germany, China, California).
ii) Legislation supporting hydrogen for mobility and storage applications (California).
iii) Corporate initiatives (commercial vehicles).
iv) Substantial M&A activity (e.g. Air Liquide acquired a c19% stake in Hydrogenics in January 2019).

From an equity market perspective it is fair to say that the theme is just starting to emerge but we believe we are close to the stage we were at three years ago when the market "discovered" lithium – and stocks like Albemarle or FMC. We have done a full mapping of the hydrogen investment universe and analysed all key operators within the value chain and we believe that the largest beneficiaries of the boom in hydrogen will be the industrial gas companies. We have written regularly in our newsletters about Air Liquide which is at the forefront of the green hydrogen revolution and remains one of the core positions within the strategy. Importantly, our view on Air Liquide does not rest solely on the hydrogen theme but on the fact we expect the company to continue to deliver an acceleration in organic sales and profit growth in the quarters ahead, benefiting from its late cycle attributes and an acceleration in start-ups, at a time when many industrial/chemicals companies are going to show a steep decline in their rate of growth. In addition to Air Liquide we have taken small positions in several stocks involved in the hydrogen supply chain, which we think have the potential to double or triple in the years ahead.

The Next Agricultural Revolution

We have referenced the agriculture sector in many of our past newsletters and we think the broad sector offers exciting investment opportunities both on the long and the short side in 2019 and beyond. The main opportunity from our standpoint arises from what we think is a relatively widespread lack of understanding of the challenges faced by the sector in terms of its existing practices and the forthcoming disruption from new regulation and technologies – what we call the next agricultural revolution.

We have been following the agriculture sector for nearly 25 years and like many investors we have been served the same arguments over and over again: alarming population growth (1.65 billion in 1900, 7.8 billion in 2018 going to 10.2 billion by 2060) in the face of limited arable land growth potential (1.6 billion ha currently) calls for continuing productivity gains in agriculture which can only be achieved by using more/better seeds, more fertilizers and more crop protection products, i.e. more of what we've been doing since the end of the Second World War. While we don't disagree with the input to that reasoning, albeit many forecasts are based on a debateable extrapolation of consumption trends in the western world to the rest of the world, and arable land potential is traditionally underestimated, we are not convinced there is only one conclusion and solution.

We think most equity investors have yet to recognize the many structural issues faced by the agriculture chemical and seed industry in the years ahead. The market is missing three factors in particular:

- The growing burden of proof required by regulators from ag chemicals manufacturers that the environmental impact and safety profile of their products can meet increasingly high standards (not only for new products but also for old products which have to be re-registered on a regular basis) has negative implications in terms of the industry's capacity to innovate, obtain pricing power and meet margins. The August 2018 verdict by a Californian court to pay USD 289 million in damages to a man who claimed Monsanto herbicides containing glyphosate had caused his cancer was a watershed moment for the industry in our view.
- The advent of precision agriculture as a technology enabling a lower usage of ag chemical products (crop protection and fertilizing products) will have negative implications in terms of volume growth for the industry.
- The gradual loss of pricing power in seeds due to growing pushback from various stakeholders and diminishing yield progress. In that respect, note the January 2018 ruling by Brazil's patent office that Monsanto's Intacta RR2 Pro patent for GMO soybean seed should be declared void based on Monsanto's failure to prove it brings de facto technological innovation. As a result USD 204 millio of annual royalties, based on the 2017/18 season, will not be paid to Monsanto – while sell-side analysts continue to assume they will.

As a result, it shouldn't be a surprise we remain bearish on Bayer (see our August 2018 newsletter). But we also hold a cautious view on a number of large names in the sector.

Quoting the FAO (Food and Agriculture Organization of the United Nations) the fact is "a transition is needed to more sustainable food systems – food systems that produce more, with more socio-economic benefits and with less environmental consequences. In many countries agriculture has been seen as an enemy of the environment, but there is increasing recognition that a regenerative, productive farming sector can provide environmental benefits and services while creating rural employment and sustaining livelihoods." In that respect serious progress should be made to rethink farming practices, whether it be around the concept of integrated farming (a whole organic farm management system) or agroecology, which is based on applying ecological concepts and principles to optimize interactions between plants, animals, humans and the environment while taking into consideration social aspects. It may sound utopian but the fact is integrated farming and agroecology are gaining traction on the basis of agronomic science which has led to a dramatic improvement in our understanding of soil and ecosystems – and along the way requires much less (or zero) external input in terms of fertilizer and herbicide/pesticide.

Science and technology are leading a quiet revolution which will have a profound effect on farming practices and techniques. For example, understanding and exploiting microbes (beneficial bacteria and fungi) for farming is a rapidly developing part of agricultural biotechnology. Novozymes – one of the strategy's holdings – is at the forefront of that revolution through its BioAg division, which is seeing strong commercial success based on selecting/developing microbes that helps reduce the need for fertilizer or insecticide (e.g. a microbe can fix nitrogen from the air into soluble nitrates acting as natural fertilizer). We also like innovations in the bio-ag chemical sector led by companies like Croda – another strategy holding. Precision agriculture, is another area where the strategy is active and we are increasingly focused on ag data management which offers promising investment opportunities.

The Evolution of Consumer Diets

The large food and beverage companies have been reporting disappointing sales growth figures for most of the past ten years now. Management teams have spent a lot time over that period blaming GDP, currencies, commodities, inflation (or lack of) and retailers but we have seen very little in the form of a self-assessment of why the packaged food and beverage industry is struggling. We think there are a number of fundamental issues at work here. Firstly, barriers to entry in the industry have fallen dramatically over the past few years and historical industry behemoths are now truly challenged by small and agile businesses who are taking significant share. Secondly, years of complacency and underinvestment in marketing and R&D capabilities have left many industry leaders struggling. Lastly, we think many operators have failed to address powerful social trends related to the desire of the consumer to live a healthier life and who is therefore buying more natural, organic, clean label products, etc.

Another trend to watch is the fact that in "rich" countries the number of vegetarians, vegans and flexitarians is growing rapidly. In the UK, a recent study by IGD in October 2018 revealed that more than half of British consumers are either following or are interested in a flexitarian diet, which emphasises plant-based foods. The trend is even more marked amongst younger people, with 68 per cent of 18-24-year-olds drawn to a vegan, vegetarian or flexitarian diet. Consumers are turning flexitarians for three main reasons: their own health, the environment and animal welfare. The UK may well be ahead of the pack on that theme but the underlying drivers of consumers' decisions should resonate with others – at least the younger generations.

These themes continue to feed our bottom-up stock picking process and in that context we feel better than ever about two stocks we have discussed in detail in a number of newsletters in 2018: Wessanen, the European leader in organic food (and has a large vegan/vegetarian offering) and Danone, which is not only a leader in fresh dairy products but also in plant-based nutrition. We have no exposure to the "protein" sector (long or short) as stars have not aligned for us to press the trigger here yet.

MACRO INPUTS

The TerreNeuve strategy is a bottom-up driven stock picking strategy not a macro strategy, to the extent that we do not structure trades based on macro views but we are undoubtedly macro-aware. Macro inputs are key to our company modelling and risk management. We are not going to go through every single macro factor but we thought it would be useful for our investors to understand what we are looking at.

Gavekal, one of the research boutiques we source economic research from, tends to say that it's all about three factors: the US dollar, the US 10-year yield and oil prices. We don't disagree but will need to be a more granular in the context of our strategy.

FX

Top of mind in the context of our strategy at this point time are Emerging Market currencies and sterling.

- Many of the companies we cover tend to be very dependent on emerging markets for their growth and, to the extent that currencies reflect economic fundamentals, we tend to closely watch developments in the EM FX world. Here, we note that after a steep correction EM FX did trough in September 2018 and so far in 2019 the trend has been positive. Given the USD is at 12 month high versus other developed market currencies (DXY) it seems that EM FX strength may reflect a better outlook for EM growth rather than USD weakness. Consumer staples stocks tend to have the broadest exposure to emerging markets and we model their exposure with a great deal of attention. In other sectors EMs do matter but it's more about China than anything else.
- With the end of March deadline approaching soon, Brexit newsflow has become the single biggest driver of GBP (and GBP/EUR). In turn GBP has become the single biggest driver of stocks in the UK with domestic names bouncing on strength while so-called exporters are inversely correlated. We'll make two observations: i) from a risk management perspective we have decided to keep the portfolio extremely tight in terms of exposure (neutral positioning on exporters and domestic) as long as we don't have clarity on the situation, ii) UK domestic names have performed strongly so far in 2019 (after a shocking end to 2018) but valuations remain attractive and we think there could be substantial upside in a "soft" Brexit scenario. Conversely so-called exporters are trading at all time high multiples and we think many of them are extremely vulnerable if GBP strengthens. Finally, we think that in the event of a hard Brexit some of the exporters may actually derate sharply (despite FX benefit) to the extent that their activities may be truly affected by trade disruptions (e.g. Diageo – a large exporter of Scotch whiskey).

Rates

Bond yields have been on a downward trajectory since October and while the 10 year US Treasury yield tends to get all the attention we note that German rates have come in at an even faster and somewhat worrying pace year to date. Bond yields have broad-based implications for financial markets, across asset classes, but we would like to make two simple observations pertaining to risk management and portfolio construction. Bond yields have a substantial impact on the value and leverage factors and we are acutely aware of that. Nevertheless, as fundamental investors we care deeply about the value of assets and the quality of a company's balance sheet. These two core attributes, which tend to be somewhat diluted in a world where Central Banks remain under pressure to pursue accommodative policies, ultimately contribute to success and outperformance.

Commodities and Trade

Global commodity prices, not just oil, have been under pressure since the summer of 2018 owing to macro concerns, ample supply, trade concerns and a strong dollar. This has come as a surprise to many investors who had bought into the late cyclical argument to own commodities – and positioning may well explain some of the brutal downward moves, notably in oil. While oil prices matter to us, we care even more about chemical product spreads based on complex value chains, pulp & paper prices, precious metal prices and soft commodities in the context of our granular modelling of companies under our coverage. Our updated work on commodities lead us to the following conclusions:

- Commodities have bounced so far this year in line with other risk assets but there is the potential for a stronger rally. A resolution of trade skirmishes and a softer dollar may hold the key to a potential synchronized recovery. Our research suggests inventories throughout value chains are low and in the soft commodity sector, stocks-to-use ratios are already very high. In the meantime, the 4Q18 reporting season has been characterized by most companies reporting continuing inflationary pressure – driven by commodities/energy and labour- and mentioning more price action to preserve margins. Strangely this does not really reconcile with the latest inflation prints in the US or Europe.
- From an equity market perspective the playbook at this point would suggest i) to buy companies which have suffered from higher input costs throughout 2018 and are in the process of recovering margin through prices and ii) to sell upstream operators involved in the production of commodity chemicals, pulp or soft commodities. The problem is that the playbook has largely played out throughout the second half of 2018 and the trade is effectively very consensual at this point (not to say crowded). We think there may be opportunities to be somewhat contrarian here.

COMMODITY PRICES CLOSE TO THE BOTTOM OF THE RANGE… POISED TO RALLY?

Source: S&P GSCI Index Spot CME, Bloomberg, February 2019.

Increasingly important is going to be the price of CO2 in Europe (already up from 5/ton in 2017 to 20 at the time of writing) to the extent it effectively represents another cost of doing business in Europe. It will not matter so much for luxury goods companies but it is going to be extremely relevant and material in a number of sectors we cover such as chemicals and construction materials. In that context we find the recent announcements by Solvay to reduce absolute greenhouse gas emissions by 1 million tonnes by 2025 or BASF's commitment to CO2- neutral growth until 2030 as particularly encouraging.[7] This is about environmental stewardship, cost containment and risk management. Conversely we find the cement industry, which has a bigger relative footprint than the chemicals sector, to be somewhat complacent on this matter – leaving room for proper engagement. With recent reports suggesting CO2 prices could trade as high as 50/ton in the winter of 2021 and 2022[8] the earnings impact for large emitters could be substantial on our estimates.

CO2 PRICES IN EUROPE (EUR/TON) – A FUTURE EPS HEADWIND IN A NUMBER OF SECTORS

Source: ICE ECX Emission, Bloomberg – CO2 European Emission Allowances, February 2019.

[7] Source: https://www.solvay.com/en/sustainability/acting-environment, https://www.basf.com/global/en/media/news-releases/2018/11/p-18-374.html, November 2018).

[8] Source: http://www.agefi.fr/sites/agefi.fr/files/fichiers/2018/08/carbon_tracker_initiative_carbon_countdown_cp_21_08.pdf, August 2018).

CONCLUSION

We could have covered many more themes and discussed at length many other macro, micro and technical factors which play a key role in our research and investment process but we hope this condensed analysis will give our investors a good sense of some of the things that matter in the 1798TerreNeuve Strategy for 2019 and beyond. Hopefully what should come out from this piece is that there are investment opportunities abound in our sectors for whoever dares to think and look beyond the next quarter. We are committed to ESG/sustainability integration into our investment process, not because we are forced to, but because we believe it gives us an information edge. The good news for our investors, we think, is that the monetization process of that information edge is accelerating in the context of growing market efficiency and a growing attention of investors to sustainability matters.

Sincerely,
Arnaud Langlois

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