International Share Update

November 2023

WATERSHED
Funds Management

A Mega Quarter for Mega Caps:

<u>Key Points:</u>

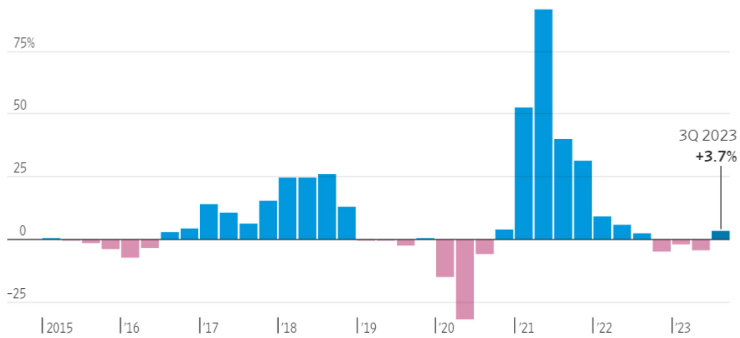
- **Earnings Rebound:** The US economy has seen a positive turnaround in earnings growth, marking the strongest quarter in a year. This follows three consecutive quarters of declining earnings, reflecting the resilience of the US consumer base, with consumer confidence and spending remaining strong despite higher interest rates.
- **Mega Cap Tech Dominance:** Mega-cap technology companies, particularly Microsoft and Apple, are playing a pivotal role in driving market performance. These companies are heavily investing in artificial intelligence (AI) and have optimistic outlooks, with Microsoft leading the way with impressive results, showcasing substantial revenue growth and profitability.
- **Portfolio poised to deploy high cash position:** The International Share Portfolio maintains a significant cash position of approximately 20%. This strategic cash holding provides flexibility during market selloffs, highlighted by our recent move to add to our existing position in JPMorgan. Despite the cash exposure, we remain confident in the underlying strength of the portfolio's core holdings.

<u>Market Observations:</u>

Earnings Growth Rebound in the Latest Quarter:

In a promising development, companies in the US S&P 500 reported overall earnings growth of 3.7% for the September quarter, marking the best performance in a year. This reversal breaks the trend of declining earnings seen over the previous three quarters. This resurgence underscores underlying consumer resilience, even in the face of relatively high interest rates, with consumers supported by the still-low unemployment rate of about 3.9%.

S&P 500 quarterly earnings, change from a year earlier:

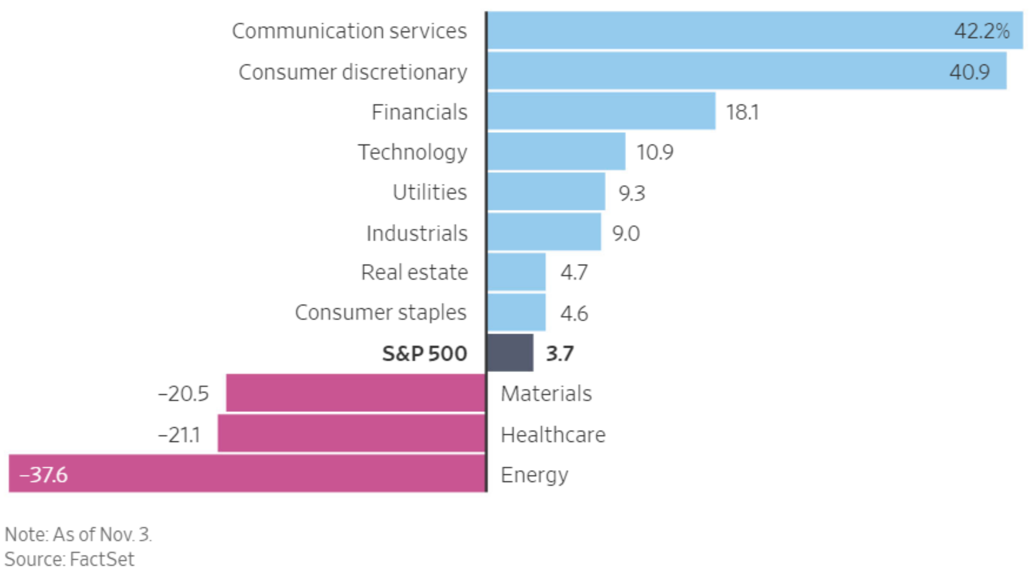


Note: The change for the third quarter of 2023 is as of Nov. 3 and based on a blend of actual results and estimates.
Source: FactSet

2. Divergence in Sector Performance:

A notable feature of the recent reporting season has been the striking divergence in sector performance. While certain sectors have thrived, others have encountered significant challenges. Communication services and consumer discretionary sectors have particularly excelled, powered by giants like Google, Facebook (now Meta), Amazon, and McDonald's. Conversely, sectors such as energy, materials, and healthcare have grappled with lower oil prices, declining commodity prices, and uncertainties surrounding the impact of new obesity treatments.

S&P 500 quarterly earnings, change from a year earlier, by sector:



3. Mega Caps Continue to Drive Market Performance:

Microsoft and Apple now jointly possess a market capitalsation approaching $3 trillion and exert significant influence within the S&P 500 index. These companies have heavily invested in artificial intelligence (AI) and maintain an optimistic outlook. Despite lingering concerns about overvaluation, these mega-caps have consistently delivered robust results, and retain strong underlying fundamentals.

<u>Positioning of International Share Portfolio – Cash Remains the Largest Exposure:</u>

The International Share Portfolio continues to maintain a substantial cash position, at approximately 20%. This strategic allocation of cash provides the flexibility to capitalize on market fluctuations, which may persist as a recurring theme over the coming months. Most recently, we added to our position in JPMorgan (JPM), signaling the portfolio's readiness to seize opportunities during market selloffs.

Microsoft Remains Our Highest Conviction Holding:

The performance of Microsoft during this reporting season deserves special mention. The tech giant showcased impressive figures, including a 13% increase in revenue, a 25% boost in operating income, and a remarkable 27% surge in net income. The forthcoming outlook for Microsoft is equally promising, projecting an EPS growth of 25%.

In our assessment, Microsoft is just embarking on its journey to monetize Artificial Intelligence (AI), with early successes such as offering 'Co-Pilot' with Office 365, which has already witnessed significant adoption. Currently, in the US, they charge about US$36 per user for Office 365, and adding 'Co-Pilot' incurs an additional US$30 charge—a near doubling of revenue from Microsoft's core Office customer base. This type of revenue growth is not yet fully reflected in Microsoft's financials. Therefore, we maintain a highly positive view of Microsoft. In summary, the company boasts a very strong balance sheet, substantial free cash flow generation, and a solid outlook.

Financial Summary	**3 Months ended 30 Sep**			
US$ Millions	**2023**	**2022**	**Change**	
Income Statement				
Revenue	56,517	50,122	13%	↑
Operating Income	26,895	21,518	25%	↑
Net Income	22,291	17,556	27%	↑
EPS	$2.99	$2.35	27%	↑
DPS	$0.68	$0.62	10%	↑

JPMorgan – Expanding Net Interest Margin:

JP Morgan is another holding that enjoyed a strong quarter, achieving revenue growth of 13% and an impressive 39% increase in earnings per share. Rising interest rates in the US have allowed the bank to expand its net interest margins. Additionally, its acquisition of First Republic, secured under attractive terms during the regional banking crisis, has already yielded dividends, contributing $1.1 billion to the total net income of $13.2 billion. The bank maintains one of the strongest balance sheets in the banking sector, featuring a CET1 capital ratio of 14.3%.

Financial Summary	**3 Months ended 30 Sep**			
US$ millions	**2023**	**2022**	**Change**	
Income Statement				
Noninterest Revenue	17,148	15,198	13%	↑
Net interest income	22,726	17,518	30%	↑
Net Revenue	39,874	32,716	22%	↑
Operating expenses	(21,757)	(19,178)	13%	↑
Operating Profit	18,117	13,538	34%	↑
Provision for credit impairment	(1,384)	(1,537)	(10%)	↓
Income tax expense	(3,582)	(2,264)	58%	↑
Net Income after Tax	13,151	9,737	35%	↑
Earnings per Share	$4.33	$3.12	39%	↑
Dividends per Share	$1.05	$1.00	5%	↑

Apple – A Cash Flow Generation Machine:

Apple's performance in the recent quarter presented mixed results. While the company reported an overall decline in sales, it maintained profitability with increased gross profits, evident in the robust 13% growth in earnings per share (EPS). With the recent launch of the iPhone 15 and a promising outlook for India, Apple continues to be a positive long-term holding in the portfolio.

Financial Summary	**3 months ended 30 Sep**			
US$ millions	**2023**	**2022**	**Change**	
Income Statement				
Net Sales	89,498	90,146	(1%)	↓
Products	67,184	70,958	(5%)	↓
Services	22,314	19,188	16%	↑
Gross Profit	40,427	38,095	6%	↑
Products	24,598	24,571	0%	↔
Services	15,829	13,524	17%	↑
Operating Income	26,969	24,894	8%	↑
Net Income	22,956	20,721	11%	↑
Diluted EPS	$1.46	$1.29	13%	↑
DPS	$0.240	$0.230	4%	↑

Amazon – A Profit Resurgence:

Amazon navigated the challenges posed by the COVID-19 pandemic by making substantial investments in its logistics and distribution centers to meet the surge in online orders. While these investments initially impacted profitability, the past quarter marked a significant turning point for Amazon. The international operations shifted from a $2.5 billion loss to breaking even, while Amazon Web Services (AWS), the cloud computing division, reported a remarkable 29% increase in profit, well ahead of its sales growth of 8-12%.

Financial Summary	**3 Months ended 30 Sep**			
US$ Millions	**2023**	**2022**	**Change**	
Income Statement				
Net sales	143,083	127,101	13%	↑
North America	87,887	78,843	11%	↑
International	32,137	27,720	16%	↑
AWS	23,059	20,538	12%	↑
Operating Income	11,188	2,525	343%	↑
North America	4,307	(412)	Large	↑
International	(95)	(2,466)	(96%)	↓
AWS	6,976	5,403	29%	↑
Other Income	1,031	759	36%	↑
Net Income	9,879	2,872	244%	↑
Diluted EPS	$0.94	$0.28	236%	↑

Conclusion:

In conclusion, the recent US reporting season underlines the strength of earnings within the International Share Portfolio's holdings. This strength is bolstered by a resilient US economy and ongoing structural growth opportunities, particularly through increased investment in artificial intelligence.

Despite prevailing market uncertainty, the portfolio's substantial cash exposure positions it well to capitalise on market volatility and add to existing positions.