

QUARTERLY INVESTMENT REVIEW

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"Americans prefer strong and wrong to weak and right." Bill Clinton

The second quarter was an unsettled one. The bond market rose modestly. In April the technology sector fell sharply before rallying strongly over the rest of the quarter. Most of the rest of the market did the exact opposite. In a year full of elections, the Indian result surprised with Prime Minister Modi experiencing a setback. In the European parliamentary elections, the parties with more nationalist tendencies did well, and in France this triggered a further election to take place in early July. As we enter the third quarter the US Presidential elections in November will start to dominate headlines in what looks a close race between two ageing and uninspiring candidates. Political uncertainty looks set to continue.

Election years tend to witness heavy spending because democratically elected Governments choose fiscal misbehaviour over unpopularity every time. There has been a relentless deterioration in western Government finances. US Federal spending increased 22% year over year to May and is up 55% since 2019 while the population has grown only 2%. The Federal debt has risen from 30% of GDP to 120% since the late 1970's. As interest rates rise the government is being hurt as much as anyone. US Government debt now stands at \$34.7 trillion and is increasing at a rate of \$1 trillion every 100 days. If it had to pay 4.5% (the current two-year rate) on all of that, then that implies \$1.56 trillion of interest payments annually. This sum is equivalent to the GDP of countries like Australia or South Korea. US economic growth has been exceptional over the last five years, adding approximately \$6 trillion of GDP, but how much of this growth is due to fiscal spending? The quantities are gargantuan. The last week of April saw the US issue debt of \$213 billion, a sum greater than the federal deficit of 2007 which was \$160bn. In the twelve months to the end of May the US has issued additional debt of \$4 trillion. The unchecked public borrowing seems impossible to contain as a politician suggesting restraint on entitlement spending is committing electoral suicide. Politically it has become unacceptable for Governments to cut spending. As Government debt balloons it leaves investors in the uncomfortable position that the riskiest asset may be Government debt, normally supposed to be the one asset that is risk free. The UK, France and others show similar irresponsibility, and it is hard to believe that there are no consequences to this incontinent money printing. The danger is that like Viagra it works until you have a heart attack. The Liz Truss budget in the UK in November 2022 came perilously close to this. The steady deterioration of finances since then makes a repeat of such an event more likely. The energy transition, electric grid upgrade required by AI, the reshoring of industry to home markets, and increased military spending all add to the pressure. As a result of its unexpected election the current focus is on France which has not run a budget surplus since 1974. Their debt has grown from 20% of GDP to 112%, even while the tax receipts have risen from about a third of GDP to over half. There may be limits to governments' ability to tax populations. In the UK many retire early or work part time, seemingly for tax related reasons. In Canada a huge increase in capital gains tax led to lower tax receipts. In the US there is a steady migration from high tax states to low tax ones. Other than in the UK there has been no serious panic over a fiscal crisis in a Developed Market, but governments are starting to be constrained by how they proceed with tax rises which

may be counterproductive. However, if concern on this issue rises interest rates will rise further and overleveraged entities will be in trouble. It is always borrowers who are on the margin who get into trouble, and rising interest rates reveal the hidden weaknesses and the borrowers who can't pay. Property is by far the largest asset class in the world, and it contains a lot of debt. Private equity and private debt require a healthy bond market so they could also struggle. As regulation has pushed a lot of capital into these unregulated areas they have boomed, and it may be that there are more problems here than in the tightly regulated banking sector and public markets. Governments themselves will always find a way to fund themselves, but as the debt rises to record levels the temptation will be to inflate it away. When the promises exceed the tax raising ability inflation is needed to square the circle.

The MSCI World index has risen 50% since October 2022. This remarkable performance is even more unusual given that the performance has been achieved by relatively few stocks, mainly technology related, and in particular Nvidia which has risen ten times over that period, driven by the AI boom. It is a market cap driven market which is getting ever narrower. The S&P500 is up 14.5% this year, but nearly all the return has been generated by Nvidia. The average stock in the index is up 4%. Nvidia alone has increased in value by \$2.8 trillion since late 2022. To put that increase in context during the dotcom bubble from early 1999 to mid-2000 the entire global tech industry added \$3.5 trillion in value. Nvidia is in a wonderful spot at the heart of the AI boom but at 40 times trailing sales (anything above 10 times usually signals a dangerous over valuation) any bad news makes it vulnerable. China could be one source of such negative news. It has made making high grade semiconductor chips a matter of national security. With unlimited financial and human resources to deploy, China can undermine the extraordinary profitability Nvidia enjoys. More generally the so-called Magnificent Seven that have driven the index have the problem that they have become so enormous, that continued growth at the current rate becomes harder to achieve. Each of Apple, Microsoft and Nvidia now have market capitalisations equivalent to the GDP of the entire African continent. As their businesses mature, they become more like utilities, and therefore subject to regulation. They have extremely high margins but if Jeff Bezos's dictum is followed – 'your margin is my opportunity' – then these margins may start to be commoditised. Nor does their growth come for free, this year they are investing \$200 billion, on which they will need to show a return. The Magnificent Seven are all superb companies but valuation matters. More and more stock prices are driven by the ascendancy of index funds. As these increase their dominance fewer people understand what they own, and indexing only works on an up escalator, so any decline could trigger chaotic selling. Outside the top tier, stock valuations look more reasonable and as the next stage of the AI revolution diffuses into the general economy more stocks should see the benefit. For example, AI is stunningly good at translation. As it becomes pervasive AI will help discover new drugs, manage traffic flows, optimise shipping routes, aid building designs, manage electric grids and water systems more efficiently, run retail warehouses, detect fraud, improve agricultural productivity, and much else. Used correctly, it should make companies more efficient by preventing poor capital expenditure. Banks and insurers should benefit considerably because it is particularly good at dealing with

complex data. A huge amount of savings should be able to be taken out of the sales, general and administration lines in most companies. So long as demand stays strong many companies can enjoy a profit boom. Meanwhile growth in Emerging Markets continues, and the uplift of EM consumers from low income to medium income can be as strong a story as AI over the next five to ten years. Sixty-nine of the world's largest hundred cities are within a four and a half hour flight radius from Hong Kong. Many of the consumers in these markets are at a level where their purchasing power is going beyond basic goods and rising up the value chain creating an enormous opportunity in consumer goods and services. Development is still at an early stage in the region. For example, there is still no direct flight between Delhi and Beijing. Establishing more routes such as this will allow trade and commerce to flourish even more.

Both the AI revolution and the energy transition are commodity intensive. A single high processing chip from Nvidia consumes more than the average American home. This voracious power demand will require investment in power generation at scale. Following decades of underinvestment infrastructure and the electric grid will need to be upgraded and expanded requiring copper, nickel etc. These commodities face the best outlook since the 2000's when they benefited from China's construction boom. Commodity producer equity valuations have been battered by environmental concerns, but these companies are necessary to accomplish the progress the environmentalists are looking for. Investors can buy these stocks at reasonable valuations, and with their good yields they may be better income generating assets than bonds, because they also offer inflation protection. Gold has also performed well, which is notable given that a strong dollar and positive real rate environment is usually negative for gold. Probably it is benefiting from concerns about fiscal sustainability, proving its long-term store of value quality. In the strange period since 2009 following the financial crisis, gold has held its purchasing power when measured by the dominant product of this era the iPhone. In 2009 the iPhone cost \$900, and today it is \$1500, but it costs 15% less gold to purchase it. Investors' problem has been that to perform they have been forced to buy stocks that appear highly valued by historical standards. If they don't own this small group of stocks, then performance is likely to have been poor. Some rotation from the highly valued stocks to the rest of the market is likely, and investors should look at the better values on offer outside the US. Selectivity remains crucial. There are superb companies available, but overindebted ones or those negatively affected by AI will suffer. The main risk is a major dislocation if the bond market buckles. This could be caused by the return of inflation, or bond investors being overwhelmed by the torrent of supply from the bond market leading to a buyers' strike. The outlook for gold and commodities remains attractive.

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