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QUARTERLY INVESTEMENT REVIEW

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"The EU was formed in order to screw the United States'"
President Donald Trump 26 February 2025

The first quarter saw the inauguration of President Trump and almost immediately this led to a series of dramatic changes in the political climate. Final detail on many policies hasn't always been clear but among the more significant policies that have been indicated has been the proposal to raise tariffs on various goods, a decline in the importance of the climate change narrative, the abandonment of Ukraine and corresponding greater accommodation of Russia, a fracturing of the NATO alliance, and the suggestion that Canada, Greenland and Panama come under US control. These pivots in American policy signal the end of the post 1945 Settlement and led directly to Germany's government voting through a €1 trillion bill to increase spending on defence and infrastructure, casting aside their fiscal and military restraints, a major reversal. An equal impact on markets was the announcement in January by a Chinese firm called Deepseek that its semiconductor chips could perform as well as some of those of the American giants at a fraction of the cost, thereby challenging American leadership in AI, which has become the most important trend in the stock market in the last few years and was the embodiment of US exceptionalism. These events generated a mass of noise and commentary. Yet at the end of the quarter most markets were affected much less than might be thought. The S&P fell 4.6%, The MSCI World index fell 2.7%, the US 10- year bond market rose 5.5%, and the US dollar fell 4%. Gold rose 19%.

The levels of debt and deficits in the Western world mean that Governments have started to face significant issues as global bond markets question the sustainability of this vast debt load being supported by flimsy growth. Nonetheless it is impossible to predict what level of debt creates extreme stress. Japan has shown that fiscal stress is not guaranteed even where the government debt has been ballooning for decades. The most important market is the US, where Government expenditure is running at a rate of 6% above receipts. Worryingly this is during a period when the economy is reasonably strong, which begs the question of what would happen if a recession arrived. The US needs to refinance $7.6 trillion of maturing debt in 2025, in addition to issuing new bonds to meet any budget deficit, and as interest rates rise the interest bill rises commensurately. US interest payments are now the second highest item in the US Government budget (greater than the defence budget), and the stock of Government debt is increasing by $1 trillion every 100 days. Elon Musk is attempting to make inroads on Federal spending, but even the Trump Administration has said that its target by 2028 is to lower the fiscal deficit from 6% to 3%. Deficit spending is entrenched, and this at a time when both tariffs and reshoring of industry will keep upward pressure on inflation and interest rates. One solution to reduce the debt is to raise taxes. US taxes are low relative to National Income which is one reason that stock market profits have been so high. However, Trump looks unlikely to take this path having been elected on a low tax agenda. Europe's debt problems are even more acute because the tax burden is already high. Europe's expansion of the welfare state has crowded out other priorities which has led to the confrontation with Trump who has insisted that they bear more of their defence expenditure. With no appetite for austerity most European Governments are having to confront tough choices. These decisions are all the harder given that despite the spending binge of the last decade few of the citizenry in western nations feel satisfied.

Until the release of Deepseek the US market was driven by just a handful of share prices. The so-called Magnificent 7 (Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta and Tesla) represented 34% of the total market cap of the S&P500 index, and 44% of the Nasdaq index. At one point the top ten US stocks had a greater market cap than all non-US stocks in total, and the Mag 7 performance in 2023 and 2024 equalled the entire performance of the S&P. They had a combined market cap of $17.6 trillion. This compared to the total market cap of the Japanese market of $6.3 trillion, or the top three largest market caps in Europe (Novo Nordisk, LVMH, SAP) of $1.1 trillion. The Mag 7 are all technology companies and were largely propelled by investor enthusiasm for AI. As the Mag 7 performed so strongly momentum funds poured ever more funds into them at the expense of everything else. Such index investing is a momentum strategy and ultimately causes problems in capital allocation because the money is mechanistically allocated without consideration for fundamentals. The release of Deepseek halted this momentum trade and the Mag 7 suffered a setback. Tesla, for example, halved from its peak.

There were signs in the first quarter that the US market was broadening as the other companies started to perform better. Technology valuations reflect a strong future which make them vulnerable to any disappointing announcement. They need to justify the current hype and show that they can make a return on the gigantic investment they have made in AI. The news of Deepseek threatens to undermine this. America has dominated technology for the last forty years but there is nothing to guarantee that this will continue. China is making rapid progress, and it is notable that many of the leading American companies in AI are run by American Chinese such as Nvidia, AMD, and Broadcom. The reason that the Mag 7 outperformed was that they were extraordinarily profitable, when they used to run capital light business models. However, the huge investments that they have made in AI, running at several hundred billion dollars a year, makes generating exceptional returns much harder. They have become more capital intensive, and building semiconductor plants and data centres is much expensive than building steel works and shipyards, sectors that have suffered in the stock market because of their capital intensity, and the cyclicality of their returns. On top of this, as technology matures, competition is increasing and the mega tech companies have started cannibalising each other's businesses. A graphic illustration of this shift in the perception of the market is that over the last three years classic old economy stocks like Caterpillar and Cummins have risen about 50% while, Apple and Microsoft are up only about 20-25%. President Trump's policy of trying to force manufacturing back to the US is helpful to these infrastructure stocks as it is an enormous task to relocate so much capacity. It will also be positive for material and commodity products which will be necessary in this construction. However, the main bottleneck on this project is that the US workforce has lost the skills in many areas to accomplish it. For example, when TSMC tried to build semi-conductor plants in the US they had to bring their own engineers from Taiwan because of the unavailability in US of a trained workforce. It will take many years for the US to train their workforce with the necessary skills needed to operate the industries they want to bring home, after several decades of hollowing out the skillset in these businesses.

As far as stock markets are concerned there is more opportunity underneath the index leaders, particularly outside the US. The starting point for these companies is much more attractive. In the fourth quarter of 2024 European stock markets had their worst return relative to the US since 1976. This was driven by political perception as investors flooded into the US on the perceived pro-business dynamism of the Trump Administration versus the apparent paralysis of Europe. Ironically the Trump's attacks on Europe have done more to galvanise various European countries and achieved breakthroughs that have seemed remote for years. Germany for example has overturned decades of fiscal conservativism to allow borrowing to increase by one trillion euros on military and infrastructure projects. As Europe's largest country this has obvious significance and allows the shackles to be loosened in other countries. Europe's markets have lagged those of the US dramatically but there are signs that this is changing. European markets performed much better in the first quarter. Investors have shunned Europe in favour of pursuing American technology companies, but many European industries and businesses have been transformed and even with low volumes are delivering record margins. If volumes normalise, and fiscal boosts like Germany's will help achieve that, then there is a substantial opportunity. Trump's challenge may be exactly what Europe needs to become more market friendly and encourage an environment that is less statist in approach, and that innovates rather than regulates. An end to the Ukrainian war would help as well. China has also unveiled a fiscal package and measures to encourage more consumer spending, which the market has responded to positively. In the past Asia was viewed as attractive because of the high growth rates available. It may start to be viewed more as a low-risk investment destination given the strong balance sheets and high savings rates in the region, in contrast to the indebted West.

Global markets ended the quarter in a state of uncertainty as President Trump has engendered radical change and uncertainty. Even the final form of the proposed tariffs is unclear. This uncertainty has been exacerbated by the arrival of Deepseek which may undermine the business model on which the most successful part of the US stock market has been built. The likelihood is that political events will continue to be disruptive for the next several months at least. Upheaval in bond markets remains the major risk. This is a new situation historically because the 'risk free' asset being the source of risk upends orthodox investment theory. With cash and bonds vulnerable to inflation, investors should be best served by a diverse portfolio of good operating companies, particularly those companies whose share prices already have the uncertainty priced in.

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