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QUARTERLY INVESTMENT REVIEW

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FOR PROFESSIONAL INVESTORS ONLY

NSPGROUP.COM

"We're not investing approximately $200 billion in capex in 2026 on a hunch."

Andy Jassy, CEO of Amazon

"For the first time since the Medici were bankers to François I, yields on 10-year French government bonds now stand above the yields on Italian, Spanish, Greek or Portuguese bonds."

Louis Gave

Markets contended with several conflicting forces during the third quarter. Bond yields rose, the oil price spiked, and the political backdrop was unsettled as the US approaches the midterm elections in November, with an increasing expectation that President Trump may lose his majority in Congress. In July a $45 billion AI focused hedge fund blew up when the S&P500 was down just 3%, due to excessive leverage. Nonetheless corporate earnings were strong, and some announcements spectacularly so. Moderna declared a successful trial result in July, and its stock price recorded the largest ever one day move for an S&P500 share with a 177% jump. During the quarter the US 10-year bond yield rose from 4.47% to 5.29%. The S&P500 rose by 2.3%. The Brent crude oil price rose by 29.5%, and gold rose 3.7%.

Longer dated government bond yields have been breaking important levels. The 30-year bond in the US is at 5.63% (its highest level since 2002), in Japan they have broken above 4% (a level never seen since the country issues at 30 years), and in France and the UK they are 5.47% and 5.95%. The US 10-year yields 5.29%, also the highest level since 2002. The size of government debt is far greater than it was when yields were previously at these levels, so these higher yields are much more painful than they were then. The US budget deficit continues to deteriorate. The deficit in July was $432bn, far worse than the expected $300bn, and a significant deterioration from the $291bn the previous July, and worse than any single month outside the Covid crisis. For the US, and other western countries, the arithmetic of this debt is becoming unforgiving. $8 trillion of US Government debt will roll over in the next 12 months at interest rates 1% higher than their current coupons, adding $80bn in extra annual interest payments. This is before the $2 trillion annual deficit is funded. Each refinancing deepens the deficit and adds more debt. It is probably because of these runaway budget deficits that western bond yields are rising as markets start to question the sustainability of this enormous debt issuance. There is also the inflationary pressure from higher commodity prices. The day before the US bombed Iran the 10-year Treasury yield was at 3.95%, now it is at 5.29%. While oil prices have risen the impact has been cushioned by drawing down reserves. However there has been a much more dramatic rise in oil products, such as diesel where supply has been constrained by refineries being shut down in the Gulf, and the destruction of capacity in Russia. Higher prices for diesel and other oil derivative products feed quickly into higher transportation costs, and puts pressure on labour costs, all of which is inflationary and adds

further pressure to bond yields. What is most worrying is that these deficits and spiralling costs are occurring during a relatively benign economic period. How much worse would the figures look if the economy slipped into recession. Nonetheless if US Treasury yields go much higher then US pension funds would start to be natural buyers. Their target return tends to be 6-8%. If yields approach 6% then it makes sense for them to buy that return in a product guaranteed by the government.

Structural forces make changing policy difficult for governments. For forty years interest rates fell, and for the decade and a half following the financial crisis of 2008 raising debt was almost cost free. Spoilt by these conditions' governments expanded their spending plans, largely on welfare. A vast expansion of social spending ensued. Perhaps the height of this lax attitude to spending was President Trump's promise to give every adult American a $5000 cheque if the Republicans retain control of both houses of Congress. If delivered this would see borrowed money offered to voters by a government already heavily overindebted. Now an ageing population requires more pension and healthcare payments, while globalisation introduced a far more competitive labour force leading to an entrenched unemployment class. Social welfare payments are ballooning. Any threat to remove the benefits for these groups has proved electoral suicide, so necessary economic decisions have become politically impossible. The only way to curb profligate governments and control entitlement spending is for bond yields to rise to the point that threatens or produces a crisis which forces the government to take hard decisions. Bond markets appear to be doing just this. Governments are also facing competition from the private sector for the first time in many years. The slow recovery since 2008, particularly of the banking sector, has meant that the private sector has not sought major financing. The AI revolution has changed this. The largest technology companies which were self-financing up to now, have been conducting enormous spending on projects to develop their AI projects, which has required them to use the debt markets. So, governments are demanding mountains of money for their welfare plans while the tech giants are demanding mountains of money for productive infrastructure like the grid, power, and datacenters. Money goes where it is treated best so governments need to compete for this capital with some of the most efficient and successful companies of all time. This is healthy. Nevertheless, rising rates are always uncomfortable for financial assets, because equity market corrections are nearly always caused by a recession or monetary tightening. The current rise on rates raises the potential for a setback.

Stock markets still continue to be dominated by the AI theme, which in turn is dominated by a handful of companies, particularly the so-called Magnificent 7 and semiconductor companies. July saw a sharp correction in these names, which wiped out the Situational Awareness fund. However, the most damage occurred in the Far East and particularly Korea, where speculative hysteria reached extreme levels. When the correction arrived 3.4% of the adult Korean population received a margin call, and there were stories of speculators selling their blood plasma to cover their losses. Importantly though this correction was caused by financial over extension not fundamental earnings. The companies involved continued to post stellar earnings results. Nonetheless bond markets have started to question the gargantuan spending by the companies building the AI

infrastructure and as with government debt the yields of the debt of US big technology companies have risen; and for example, in July the debt of Oracle was downgraded. The scale of the AI build out is enormous. The cumulative capital expenditure for the next few years is estimated at about $11 trillion which is far larger than previous large capital projects such as the internet build out in 2000 or housing boom that led to the bubble in 2008. A lot of the cashflow from this expenditure goes to the semiconductor companies whose chips power everything, but the average life of these chips is far shorter than the railway tracks or fibre optic cables that were overexpanded during previous bubbles, so it is a valid question to ask what depreciation rate and what the return on capital of these investments will be? A considerable amount of the economic growth in the US has been due to the vast spending of Open AI and Anthropic, the leading developers of AI software, but this could slow down. Both companies have highlighted risk concerns of the dangers of unbridled AI, and as the advantage gap has narrowed between them and their competitors, including Chinese models, it isn't obvious why consumers will continue to pay several times more for the cleverest application when the other models perform adequately the task most users require. If this sector slows down, then that would have significant implications for both US GDP growth and the stock market.

With all these concerns why has the stock market held up so well? The principal reason is that earnings have been exceptionally strong, and this is partly due to AI starting to boost profits of companies beyond the technology sector by improving efficiency. Global earnings have been growing at a rate of mid-teens to twenty percent, which is well above anything experienced in post war history, other than in a recovery from a cyclical economic low point. The effect is twofold. AI can be used to improve productivity and to lower costs. It is particularly effective in companies that use a lot of data which it can digest and organise in seconds. Banking is one example and it is remarkable that while the technology companies have gone from being cash generative to debt hungry, banks have done the reverse going from being dependent on government bail outs to being in a position where they are returning significant amounts of excess cash to their shareholders.

This year is seeing further evidence of a reduction of American exceptionalism in terms of stock market performance. Since Trump was sworn in most other regions have outperformed the US, and in the case of the Emerging Markets and Japan by a handsome margin. This reflects better starting valuation levels of share prices outside the US, but also an improved economic environment. Many Emerging Markets, for example, have followed far more orthodox economic policies than their Developed Market peers. With strong trade surpluses and far stronger fiscal balances than the West their currencies should appreciate offering extra potential for return. In terms of sectors the energy and mining sectors have been strong. Higher energy prices make oil stocks an obvious beneficiary of the troubles in the Middle East. It is an anomaly that they represent only 3.5% of the index yet are estimated to account for over 8% of the earnings. The longer the oil price remains high the more glaring this anomaly will be. Mining companies have an equally strong outlook as they benefit from both government expenditure, due to the need to renovate old public infrastructure, and the AI boom, because datacentres and

the electrification of the grid is commodity intensive. Gold should also perform well. History suggests that governments facing high debt burdens rarely overcome them through austerity. Especially in democratic systems they maintain nominal interest rates below the rate of inflation, which results in currency debasement and even financial repression. This environment is supportive of gold as investors seek to protect their wealth and purchasing power. Moreover, for longer term investors an opportunity has been opened up by the crowding into the AI theme by most investors. Currently trading is dominated by computing program driven funds, passive flows, and pod shops that are chasing quarterly returns. They tend to herd into the same names and sell everything else. This creates an opportunity for investors with longer time frames that can buy companies with good fundamentals that have been sold to cheap levels, though the caveat to this is that there is no certainty on when they will be rerated.

The Hormuz situation presents the world with more uncertainty than one and two quarters ago. Elevated and rising oil prices have a history of causing financial upheaval because of their effects on increasing prices and wages. When oil prices rise enough they have often tipped the economy into recession. Bond yields are reflecting this, but they also reflect strong growth, and this growth is producing strong corporate earnings. If the energy situation is resolved both bond and equity markets are likely to improve. The opportunities are in select areas, but investors are likely to have to withstand more volatility than in the past few years.

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