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QUARTERLY INVESTEMENT REVIEW

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2023 has proved an awkward environment for investors. At the start of the year it was hoped that inflation would roll over, but strong employment has stymied that. Then the banking crisis in US regional banks sent interest rate expectations into reverse. Since then the continued strength of the economy, stubborn inflation pressures, and a brief panic over the US debt ceiling, have forced interest rates back up. After the brutal losses in bonds last year the result at mid-year is only a small recovery. This uncertainty left equity markets drained of confidence, leading to an extreme divergence of performance between the mega cap technology stocks and everything else. This divergence is best demonstrated in the US where the Dow has recorded a year to date performance of 3.8%, while the large cap tech index, the Nasdaq 100, gained 38.7%. The performance of the S&P500 of 15.9% was accounted for almost entirely by just seven stocks – Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta and Facebook. Most of these stocks are beneficiaries of AI (Artificial Intelligence), and the rest of the market has barely moved. So, the tale of the year has been that jittery investors, unsure of the direction of inflation, interest rates and growth, have herded into the one area that has offered certainty pushing these companies' share prices to a level that looks extended. It has been a difficult environment for a diversified strategy.

This tension in markets has been triggered by inflation and the accompanying rise in interest rates. Following more than a decade of near zero interest rates, when the Federal Reserve raised them by 500 basis points in fourteen months, there were bound to be some casualties. The most speculative companies, that require frequent capital raisings to keep going, are in serious trouble. But the tightening of liquidity is putting strain on much larger borrowers. The Turkish lira has fallen 40% this year due to concerns on its government's economic policies, and the UK bond market has weakened as it has been less successful in containing inflation. The regional banking crisis in the US is another example. Despite a mountain of legislation intended to prevent financial problems the US has suffered 3 of the 4 largest bank failures in its history. This raises the question of whether the level of interest rates needed to bring inflation under control is higher than the financial architecture of the US and other profligate countries can withstand. The Federal Reserve has said that it is determined to bring inflation down to its target of 2%, but this may prove too painful. If too many things break, they may be forced to let inflation run at a higher level. The ongoing banking crisis, the downturn in commercial real estate, and continued recession worries make the Fed's decisions all the more difficult.

Interest in Artificial Intelligence (AI) has dominated stock market news this year. AI is using powerful computers to analyse and predict data in an efficient way, and it is reaching a level where it can match humans' ability in some areas. AI machines are now able to pass the US bar exam, and to write code for software engineers. More alarmingly an experienced US military pilot lost a simulated dogfight to an AI controlled competitor, while on a more upbeat note it is helping develop medicines to solve diseases such as Alzheimers. Everything about the economy, healthcare and warfare can be affected by AI. Computers may be able to detect cancers years before tumours form, and help address poverty issues and global warming. Equally they will be able to break all forms of encryption, revealing all military and civilian secrets. Short-term the best application of AI may be its ability to reduce error in the economy. Retailers can use AI combined with RFIDs (a wireless tag) to manage their inventory with pinpoint accuracy. By knowing exactly where their stock is, and exactly when it sells, they can operate their supply chains and inventory more efficiently. Avery Dennison have said that these efficiencies can cut labour costs by as much as 50% in the food retail supply chain. The same process can be applied to areas such as auto parts, parcels and post, general merchandise, apparel, personal care products, and airline baggage etc. The sudden omnipresence of AI has taken governments by surprise, and regulation will need to catch up. Currently there is less regulation on AI than making a sandwich in a café. However, as AI is starting to threaten white collar jobs, because this cohort has more political clout than blue collar workers, the pushback will be fierce.

Despite the outperformance of technology this year, the rotation from technology and growth stocks to asset intensive and cyclical stocks is likely to continue. Quality stocks have enjoyed a spectacular decade of performance, but a large part of the reason for this is that they started at low valuations. In 2010 free cash flow yields on a typical quality growth stock was about 6-7%, now it is nearer 3%. Their earnings growth during the period has been steady but, in most cases, not spectacular. Some examples illustrate the point. Oriental Land, the Japanese company that operates the Disney franchise there, has had almost no earnings growth over the past five years, yet its PE ratio has doubled to over 100 times. Amazon earnings have doubled over the last five years, but its PE ratio has soared to 130 times. Nvidia, which is at the centre of the AI excitement and does enjoy strong earnings growth is on 200 times its earnings and has a market valuation of 25 times sales. For a mature company anything above 10 times sales usually indicates that the company is entering extremely overvalued territory. What this shows is that despite their excellent fundamental businesses many widely owned stocks are very expensive, even relative to their own history. There are also reasons to think that the profitability of IT companies may be lower going forward. The last decade has seen a huge investment in innovation and technology, leaving the world awash with online games, video streaming services and food delivery apps. This investment was possible due to low inflation and a low cost of capital. Now the priority for investment is in asset heavy industries such as defence, renewable energy and relocating supply chains back to western domestic markets. The Covid pandemic and the war in Ukraine revealed the fragility of depending on strategic rivals for vital supplies, and as a result, supply chain security will be prioritised over the cost of production. This will give a demand boost to industries that have suffered a dearth of investment for years. The companies in these industries have low ratings and decent growth prospects, and if their earnings start to pick up investors should start to rotate back into them. This rotation may include reducing US exposure. The US stock market has been by far the best performing one over the last fifteen years based on America's greater GDP growth, higher interest rates, and better stock market performance. With the exception of the AI mania it is less obvious that the US is exceptional in these now, and it has a banking crisis. The Rest of the World is closing the gap. As the US is 70% of the World Index, if investors reallocated 5% elsewhere that would involve trillions of dollars going into other markets.

Given the low starting values in some sectors the rerating could be dramatic. Energy and commodity stocks have had poor performance over the past twelve months. Oil demand has been rising as China reopens, while supply has been tightened by OPEC, and production may be peaking in the US, and inventories have fallen to low levels. If demand remains firm then there will upward pressure on the oil price over the second half of the year. The outlook for other commodities is strong due to the transition to green energy requiring vast amounts of critical materials such as copper and lithium. Likewise, the healthcare sector has a strong outlook based on ageing demographics worldwide and strong innovation in new drugs. The Japanese market is performing well, encouraged by multiple initiatives from the government and stock exchange. This has engendered a change in corporate behaviour, and there is strong pressure on companies to raise returns. On top of this the highest inflation in Japan for forty years is giving Japanese companies pricing power in the domestic market. The cost cutting that companies undertook to survive deflation means that revenues growth will translate directly into earnings growth. Emerging Markets have endured a desultory decade of performance. Selectively there is great value, particularly in Hong Kong and the Asean markets where many companies can be found trading with dividend yields higher than their PE ratios – the definition of value.

Inflation, recession, and China's reopening have wrong footed investors this year. In reaction to these uncertainties, investors have crowded into a handful of stocks, which are superb businesses, but now exhibit very rich valuations. Absent a crunching recession there is clearly better value in other parts of the market. It may take some time for this value to be realised, but investors should start to look beyond the very narrow field in which they are huddled.