

QUARTERLY INVESTMENT REVIEW

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"The market is still dominated by investors that either will not (index funds), cannot (untrained novice investors) or chose to not (valuation indifferent prof. investors) have valuation as a cornerstone of their investment process." David Einhorn

After the turbulence in the Spring when several banks collapsed, including Credit Suisse, equity markets recovered steadily helped by easier liquidity conditions, resilient economic data, a perceived peak in inflation and reasonable profit growth. By the end of September, the S&P500 was up 11% and the MSCI World Index was up 9.6%. However, these returns are misleading. The strong performance has been generated almost entirely by seven stocks (Apple, Microsoft, Alphabet, Amazon, Tesla, Meta and Nvidia). These stocks are up on average 91% and excluding them the indices are only modestly positive. The size of these companies is astonishing. Collectively their market cap equals about 40% of US GDP or 10% of global GDP. Apple and Microsoft's market cap would place them in the top ten of the world's largest countries by GDP. For example, Apple's market cap reached \$3 trillion, comparable to the GDP of India, the UK or France. Nonetheless with the market recovering so strongly since the Spring risk assets are now more sensitive to downside surprises and more caution is warranted. In particular, if the view that inflation is settling back down to pre-Covid levels is undermined, then both bond and equity markets would react poorly. Inflation has fallen due to lower commodity prices and supply chains stabilising, but a further fall is more likely to be caused by lower demand thus eroding company profits. At the end of the quarter the oil price started rising, and along with some large wage increase settlements, inflation may stay higher for longer. If this continues there is likely to be more pressure on the highly valued areas in the market, including the mega cap stocks.

Since early 2022 the world has undergone one of the sharpest interest rate rises in history. Following a long period of near zero rates, they have risen, in the case of the US, by 5.25% since March last year. Higher rates raise several concerns. The lagged effects of significant interest rate rises will burden the economy because of the higher financing costs. Many mortgage holders, businesses and investment funds took advantage of the cheap financing available when interest rates were low, and are now facing the reality of much higher rates as their loans are renewed. More expensive and less available credit will stress the system and reveal those who are ill prepared. A mortgage holder on a two-year deal who has been enjoying a 1% rate will now be resetting at 6.5%. This will affect consumer sentiment. Governments will also feel the impact. The gargantuan fiscal stimulus packages that western governments launched during the Covid crisis and its aftermath have left these countries with high debt levels. For twenty years any crisis has been met with a bazooka of government spending. This was possible when interest rates were so low as the interest payments were relatively small, but with today's much higher rates the bond markets are curbing this profligacy. Last year a poorly communicated budget in the UK led to the collapse of the UK bond market on concerns that it would result in excessive borrowing. Many countries now have debt levels equal to their annual GDP. If interest rates stay at 5% that means that governments have to spend 5% of the country's income on debt servicing. This is happening at a time when most governments are operating structural deficits which are further increasing their overall debt. The US has an

annual budget deficit of about 6% of GDP. This is unusual outside a recession and begs the question of what will happen in a slowdown. Governments have always found it hard to cut expenditure, and in a world where the demand for spending on climate change, military upgrades, and an ageing population, controlling these deficits will be all the harder. To persuade buyers to purchase debt issuers of all descriptions will likely have to pay a much higher rate than they have been used to. With the issuance of debt showing no sign of falling the risk is that there is another non-linear event along the lines suffered by the UK government a year ago. The competition for capital is intensifying and that is likely to keep the pressure on rates higher for longer. Of course, what could alleviate this situation would be if growth rates improved, but if anything growth rates seem to be declining around the world. The two main engines of growth in the last twenty years have been the US and China, while Europe has been sluggish. It is therefore of particular concern that China's growth has been stalling. China's fixed-asset, high debt economic model produced average annual real GDP growth of over 9% for over four decades. However, since 2008 Chinese banking assets have risen from \$8.6 trillion to \$54.5 trillion, on an economy of \$18 trillion. For comparison the US banking assets are \$23 trillion on an economy of \$25 trillion. Debt is good if it is financing high return investments, but China's economy, particularly the property market, looks bloated. With the debt fueled party coming to an end the country is left with huge outstanding debt and a stagnating economy. This situation is exacerbated by the deterioration of relations with the US, worsening demographics, and industrial deflation. China's growth has been the most powerful contributor to global growth since 2008, and its absence will be felt widely. Globally many economies and companies are having to adjust to two big changes – a substantial change in the interest rate structure, and the diminishment of what has been the largest producer of demand growth.

Against this bleak backdrop what should investors do? Over the last decade or so the market has paid up for growth because growth was scarce. The companies that have performed best have also been those that offered the security of dominant market share, or dominant brands, backed by long term histories of consistent growth, and high returns on capital. Conditions suited these exceptional companies over this pessimistic decade, but it has left them selling on exceptionally high ratings. Their high PE ratios are harder to sustain with bond yields rising higher, and they are vulnerable if they fail to meet the market's high profit expectations. The giant institutional funds are overweight these stocks, not least because they don't have much choice, as these stocks have the trading liquidity that they need. However, when everyone is herded into the same area that area becomes dangerous. The better opportunities lie in areas where there are new economic demands caused by re-shoring supply chains closer to home, defence, and decarbonisation projects caused by climate change. This will require investment in commodities required to produce the critical raw materials, and in upgrading infrastructure such as the world's electrical grids. It will take years of substantial investment to reinvigorate this infrastructure that has been ignored for so long. Between 1985 and 2021 investment in tangible capital fell from 12.5% to 8.5% of GDP in the US, while intangible investment rose from 11.5% to 16.75% as the digital economy was created. Environmental pressures have been another hindrance to the old economy industries.

Outside of remote parts of Australia, Canada and the US opening a new mine has been almost impossible. To produce the necessary materials will require a reversal of the nimbyist mindset characterized as BANANAS – Build Absolutely Nothing Anywhere Near Anything. The hope of some of the green lobby that the energy transition can be achieved without involving fossil fuels and large-scale investment in heavy industry is a pipe dream. In the battle between platitudes and physics, physics always wins. The irony is that to achieve a clean economy it is necessary to use some of the 'dirtiest' industries. Many of the relevant companies have been starved of capital. As a result, there is less competition and they have been forced to streamline their businesses leaving them lean and well placed to profit from any growth. It is notable that two stock markets heavily exposed to these themes that have been performing better recently, namely Japan and the UK. The UK, for example, has outperformed the S&P (and even Nasdaq) since the start of last year.

High interest rates and high energy prices are a bad combination for markets as they tighten liquidity. The longer this tightness endures the harder it will be for markets to perform, particularly the indices which are dominated by the high priced megacaps. The yield now available from a US Government bond is a high hurdle, and companies will have to show a compelling profit outlook to attract investors. It will also not be surprising if these tight liquidity conditions lead to more bankruptcies, but the removal of weaker companies will make a better operating environment for those who remain. Thus, the benefit of this higher interest rate environment is that it provides much better opportunities for the active stock picker. This opportunity is more volatile than that provided by the steady growing companies that have dominated the last fifteen years, but the long term upside is considerable.

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