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QUARTERLY INVESTEMENT REVIEW

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"The Middle East region is quieter today than it has been for two decades." James Sullivan, US National Secretary Adviser, 29.9.2023

"The Western World faces the greatest number and most complex array of threats since the end of the Cold War." General Petraeus, 21.10.23

"The stock market is a device for transferring money from the impatient to the patient." Warren Buffett

2023 was a year in which investors were continually wrong footed. Surging inflation and sharply rising interest rates meant that the banking crisis in March caught them unawares, as bond prices plunged. The reassertion of higher rates as economic growth continued to be strong, despite interest rates reaching a twenty year high, caught them off guard again. In equity markets performance was dominated by a handful of immensely powerful US technology companies benefiting from an explosion of interest in Artificial Intelligence. Apart from these companies, the stock market's performance was muted. By year end the performance of US 10-year bonds was flat ex the coupon payment, registering a third consecutive disappointing year. The S&P 500 was up 24.2%, though much of this rise was accounted for by the mega tech companies' stellar performance. The equal weighted S&P index was up 11%.

After a forty-year bull market bonds have been struggling. When interest rates reached all-time lows, the temptation for any type of borrower to take on debt led to an orgy of debt issuance. Yet despite higher borrowing costs debt has continued to accumulate. In 2023 the US Government issued its second largest amount ever. Incredibly this borrowing occurred during a year of reasonable growth, which begs the question of what borrowing would reach if the economy fell into recession and required government support. The annual rate of US Government borrowing is now running at approximately $2 trillion, piling on top of a total of about $33 trillion. The annual interest bill is now close to $1 trillion per year and rising. The $2 trillion of new debt, together with $7.6 trillion that matures in 2024 that will need to be rolled over, is now incurring an interest rate of over 4%, compared to the current average of 2.78%. The market seems to be floundering as it digests these giant flows. The further complication is that large-scale buyers such as the wealthy Middle East oil nations and China have become less willing to buy American debt, leaving the market rate being set by more price sensitive investors such as fund managers. The other major support was the Federal Reserve which owns $5 trillion of Government debt but is now shrinking its holdings by $80 billion a month putting more pressure on the market. The combination of Treasury issuance and Fed sales requires the market to find about $10 billion of buyers of Government debt each trading day, against a background of a gridlocked Congress where the Democrats refuse to cut spending and the Republicans block tax rises. There is no sign of this impasse ending, and with 2024 being a Presidential election year there is little chance that spending will be reined in before that election is over. The situation in Europe is no better. Taking the UK as an example, the value of UK Government debt has risen from £300 billion in 2003 to £2.4 trillion today. The annual borrowing rate of £240 billion would constitute the second largest department in the UK

Government measured by spending. This bulging debt burden is due to an ageing population, health costs, and social welfare spending, exacerbated by the 2008 financial crisis and the Covid pandemic. In addition, there are strong pressures to increase spending to meet energy transition targets, and to ramp up defence spending. Since 2011 when the UK Office for Budget Responsibility stated that the current trajectory was unsustainable, the budget has expanded every year. Much of the problem stems from the unwillingness of politicians to cut spending, and thereby damage their electoral performance. This leads to a population conditioned to live beyond its means, and reluctant to having benefits taken away. As the debt costs explode, it becomes ever harder to keep the debt under control. Even legal frameworks have struggled to contain it. The US introduced a debt ceiling in 1939 to try and curb the problem. Since 1960 it has been raised 78 times. In Europe the Maastricht Treaty set down that any member must keep their debt below 60% of GDP. The average rate is now 84% and several countries exceed 100%, most notably Italy with about 140% of GDP. The strains in the system are clear, and are reaching the point where, historically, something breaks. The most likely outcome is there will be a controlled inflation whereby the debt is worked off via interest rates being kept below inflation, so the debt is slowly inflated away. In general, this would be good for equities, gold, and real assets, and negative for cash and bonds.

With inflation running at higher levels the structural decline in interest rates appears to be over. During the long period of yields declining from the early 1980's, the build-up of debt never mattered because it could always be refinanced at ever-lower rates, but if interest rates are on a structurally upward path, then this game is over. This means that investors need to be wary of any entity laden with debt, because these borrowers are not used to the problems it can cause. The abrupt collapse of Silicon Valley Bank in March was an example of this. But there will also be an impact on strong companies. Apple was able to launch a €1 billion bond in 2019 which paid no interest. When this bond renews in 2025 there will be a cost. However, this change will have a slow impact. Many consumer borrowers and corporates took advantage of the period of low rates to lock them in. Most US mortgages are set for 30 years so the holders of these are unaffected when rates rise. Equally many companies extended their debt schedules to a decade away, so are also insulated from the worst of the trouble. Moreover, higher rates are beneficial for savers. The $5.8 trillion invested in US Money Market funds are now earning an estimated $300 billion of income for savers. In the third quarter Alphabet (the parent of Google) earned over one billion dollars from its cash alone. Higher rates are forcing companies and consumers to think harder before they take on debt to invest or consume which creates a healthier environment. Nevertheless, the challenge will become greater if high interest rates persist. A lot of refinancing is due in 2025 and 2026, particularly in private equity.

Where does this leave equity markets? On the surface the outlook appears quite bleak. The economy is anaemic, and the boosts that Central Banks gave in 2021 are fading. Higher interest rates are making life harder for those with debt. Inflation is higher as wages increase, and there are strikes across the economy from public sector workers to Hollywood writers. Energy costs are also high, and energy plays a role in almost every area of a modern economy. However, for many companies the outlook may be better than

this suggests. Most companies are in excellent shape, having taken advantage of the years of low interest rates, and strengthened their balance sheets. In particular, the difficulties of the last decade have led to the surviving companies being in much stronger competitive positions. Growth sectors, such as technology, have been flooded with capital leading to significant overinvestment in areas like food delivery and online shopping, such that many of these companies are struggling to be profitable. Meanwhile capital has been sparse for less fashionable areas, forcing them to run lean operations, and often removing weaker players, so the survivors' competitive position has improved considerably as their competitors have been winnowed out. In the stock market companies in less glamourous industries such as energy, banking, packaging, hotels and other cyclicals have been crowded out by the strength of the mega cap technology stocks. This has left many of these companies on attractive valuations. In effect they have a strong moat around them, because the unavailability of capital for these businesses makes it almost impossible for new competition to come in, leaving them in prime position for the next investment cycle. While many of these companies are not immune to higher rates and cost inflation they are in a far better position to deal with them. They are perceived as lower quality when in fact they are performing exceptionally well, and many are returning significant amounts of capital to shareholders via dividends and share buybacks. For example, the UK bank Natwest, which in the form of Royal Bank of Scotland was a poster child of the 2008 banking crisis, has returned 54% of its current market cap to shareholders in the last two years. These companies are more cyclical than the growth companies that have seized investors' attention over the last decade, so today's generation of fund managers are less comfortable with their more volatile earnings stream than the smoother growth of the big multi nationals. However, the opportunity is in the exceptional valuation discrepancy, their strengthened competitive outlook, and their under-appreciated growth. It is not hard to put together a portfolio of these unloved companies with an earnings yield of 10%, which is double that available in the bond market. In contrast the bigger risk may lie in the most favoured areas. The last decade has witnessed a huge swing into US assets. All institutional investors are massively invested in US stocks, particularly US technology stocks. They are also overweight the US dollar. If a financial crisis emerges you can only sell what you own, and everyone owns America. The better opportunities therefore lie elsewhere. Midcap stocks have endured their worst year relative to large cap stocks in 30 years, and they have underperformed in eight of the last ten years. This poor run won't continue forever. Emerging Markets have also become very cheap on lack of interest. Yet most of the countries in Emerging Markets have run far more orthodox financial policies than the West. They have little inflation, strong balance sheets and growth. The market is obsessed by China's problems but there are plenty of other EM markets which look attractive. However, it will probably require the dollar to fall before money flows to them. The caveats to the above are twofold. First, the geopolitical risk highlighted by the quotes at the head of this outlook. Few predicted the Russian invasion of Ukraine last year, or the outbreak of the Israel/Hamas conflict this year. Both can destabilise commodity markets, particularly oil, and both situations have the potential to deteriorate and spread to other areas. Second, is the emergence of AI which can radically alter the economic and competitive landscape. In so far as AI improves

efficiency, it reduces GNP by removing bad GNP. That reduces overall activity which threatens many companies' top lines.

There are plenty of uncertainties to worry about as we head into 2024, but uncertainty is the oxygen of opportunity. AI will create benefits as well as unleashing destruction. China may finally gain traction in its post Covid recovery and ignite an EM boom. Global trade patterns are likely to shift to try and avoid the risks incurred by a handful of Houthis blocking a vital sea lane, which will further boost the reshoring of supply chains back West. The US election is likely to hang over all markets during the year, and depending on the effect this has on US bond markets and the dollar, this may lead to 'risk free assets' becoming the greatest source of risk. Nonetheless with the 80% of the world's market cap, 60% of world GDP, and 40% of the world's population entering an election year the fiscal stimulus is unlikely to be turned down. The bulk of interest rate rises appear to be over for the time being, and rates may even be cut. If this were to happen, especially if accompanied by a weaker dollar, then equities beyond the US tech megacap should do well.

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