July 2024
Issue No. 32

GLOBAL INSIGHT

Overview

- In our Investment Outlook, we consider the recent performance of equity markets in the context of our forward-looking views.
- We delve into AI's role amongst MAG7 outperformers and whether Investors should be cautious during a period of such high concentration in markets and strength in risk assets.
- We take a dive into Nvidia's recent results and their effect on the wider market, including whether there could be a concentration risk within Nvidia's top customers.
- Geopolitical risk continues to impact markets fueling the widening of the valuation gap between the EU and US to multi-decade levels, but how can this spread narrow?
- The resilience of the US economy and consumer has taken many by surprise, but recent weakness in jobs data and US housing market sees optimism emerge once again towards potential FED rate cuts.
- In our strategic piece, we put forward our house view on the positively skewed risk/reward in treasury markets, our view on high yield future returns following strong outperformance YTD, an update on our gold thesis followed by our view on equity markets and the prospect of a rate cut fueled melt up in the US.

MSCI Value vs MSCI Quality - The Jaws of Divergence Widen

Source: *LSEG Datastream*

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The Highlights

- MAG7 Concentration — Risk or Reward?
- Geopolitical Risk Hits Europe, but longer term, how will Europe fare?
- Breakdown in trend impacts the TOPIX, and wider EM bucks the China negativity even amidst a strong dollar.
- Nvidia Results and their impact on wider markets.
- What are the prospects for future returns when we are facing high starting valuations?

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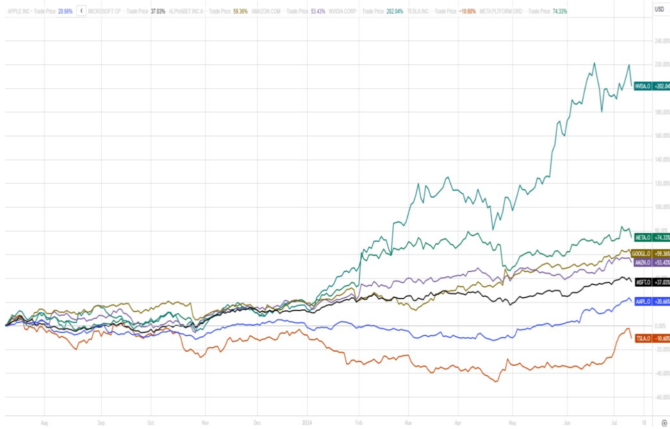
Based upon information available up to and including:

12th July 2024

Key Issues in Charts

The Mag7 Are Back Together Once Again

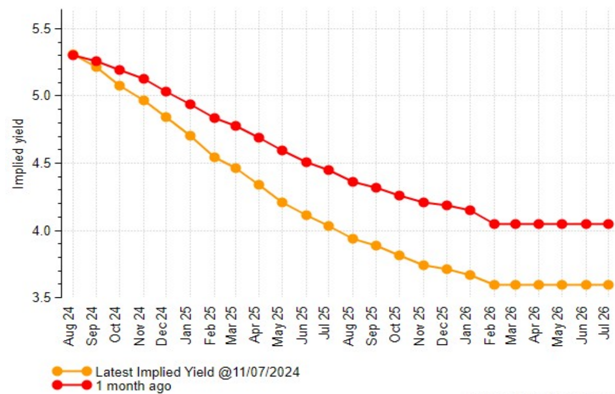


- The Magnificent Seven (Apple, Amazon, Alphabet, Microsoft, Tesla, Nvidia, Meta) are reunited once again.
- Following weak performance over the past 12-18 months for Apple and Tesla, since their trough low around April 22nd, both companies have bounced back sharply to the tune of +38% and +69% respectively.
- With the entire MAG7 back in business once more, market concentration amongst these names has crept back up again, now reaching 36.5% in the US 500 Blue Chip index.

Implied Yield Drops on 30d Fed Futures Curve

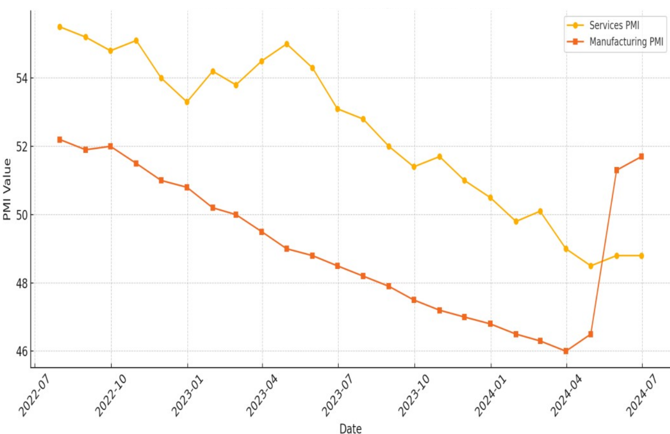
- The chart compares the latest implied yield as of July 2024 with the implied yield from one month earlier, showing how expectations for future interest rates have changed
- Both curves show a downward trend in implied yield over time, indicating that market participants expect the Federal Reserve to lower interest rates in the future.
- The past month has seen expectation for lower rates emerge once again following supportive data on inflation and weakening in jobs numbers.

Implied Yield for CBoT 30-Day Fed Funds Futures Curves



Source: LSEG Datastream

US PMI's Services vs Manufacturing



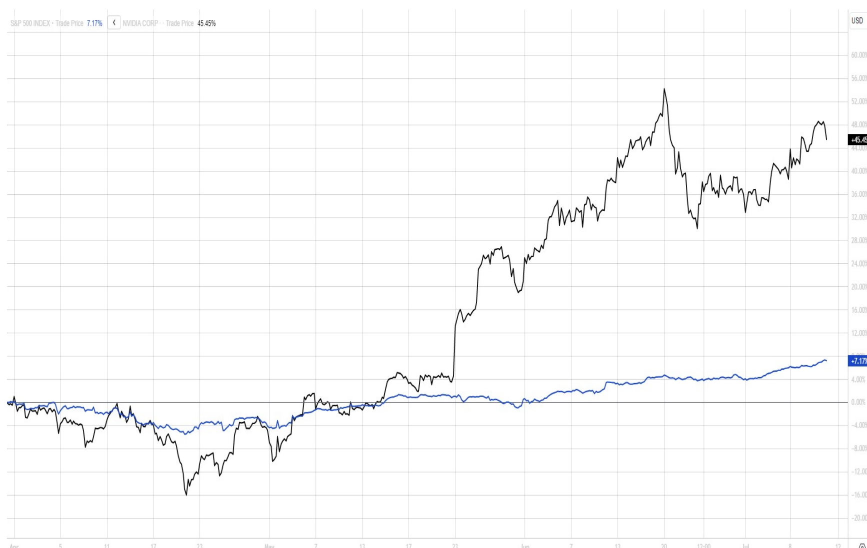
- In June 2024, the Services PMI dropped to 48.8, marking a contraction, while the Manufacturing PMI rose to 51.7, indicating growth in the manufacturing sector.
- The Services PMI shows a more volatile pattern with noticeable fluctuations, including dips below the 50 mark, indicating periods of contraction, whereas the Manufacturing PMI demonstrates a more gradual decline with recent recovery.
- Following the pandemic, the services sector provided significant relief to the US economy, proving to be a solid area of strength. However, in recent reporting periods, this trend has reversed, with manufacturing now positioned more positively than services.

Markets Review

The strength in risk assets broadly continued during the 2nd quarter with global equities returning 3.3% in dollar terms as the rally that started towards the end of 2023 showed little sign of weakening. The leading driver behind recent performance remains the US equity markets or more specifically investor perception of the change that Artificial Intelligence (AI) will make to the world and the companies that are set to benefit the most namely Nvidia, Microsoft, Alphabet, Meta Platforms, Amazon.com, and Apple. These six stocks are the only S&P500 constituents with a market capitalisation of over $1trillion and with a total size of approximately $18trillion represent 36.5% of the index's total market capitalisation of $49 trillion[i]. The dominance of such a small number of stocks in the US market is almost unprecedented and should be a concern to investors. During June "The Magnificent 7" which includes Tesla returned 9% while the other 493 constituents returned 1%[ii] meaning that investors need to have an investment view on these six powerful mega-tech stocks even if they do not own them, or indeed as is the case with most investors, do not hold them to market weight in their portfolios because of their influence on returns. The use of passive investment vehicles to gain exposure to equity markets will also maintain the positions of the largest constituents, providing support for valuations.

In fact, following Nvidia's first quarter results the company has become the focal point for market returns and the ongoing leadership of mega-tech. Nvidia shares were up 36.7% over the quarter bringing the rise so far this year to 149.5%. Charles Cara of Absolute Strategy Research (ASR) quotes Semianalysis in his recent publication reporting that Microsoft, Meta, Amazon, and Google represent 40% of Nvidia's sales[iii]. Furthermore, analysts are forecasting Nvidia's earnings to be $120bn in this financial year rising, to $188bn by January 2027, and margins to rise from 53% to 56% over the same period. The majority of this revenue growth is expected from GPUs (Graphics Processing Units) used in data centres and Nvidia reports that its largest customer represents 13% of sales.

Nvidia vs S&P 500 Q2 to date



Source: *LSEG Datastream*

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Microsoft, Meta, Amazon, and Google represent 40% of Nvidia's sales.

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Charles Cara points out, however, that the additional $120bn in revenue forecasted to be generated by Nvidia from increased data centre capacity is significantly more than the $75bn of increased capital expenditure expected from the major technology companies. We believe that AI will have a major influence on life and the global economy over the next decade and investors are betting that the existing six megacap tech companies in the US are set to be the major benefactors. However, there currently seems to be a disconnect in the forecasts between the near monopolistic provider and its major customers. Time will tell if the optimism being generated by investors proves accurate or whether valuations have run too far, Either way megacap tech looks priced for perfection in its domination of global markets.

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Elsewhere, geopolitical risk continues to influence markets no more so than in Europe where the European elections have seen an increase in the populist right vote with particular consequences in France. The strong showing of Marine Le Pen's National Rally and the poor performance of the centrist Ensemble alliance prompted President Macron to call an unexpected snap election. The investment focus on France seemed to highlight the level of government, corporate, and households' indebtedness in France causing the yield spread between French OATs and German Bunds to widen to levels not seen in a decade. The stock market was also shocked by the move falling 7.5% in June dragging European equities down 2% to finish the quarter -3.9%. We calculate that the valuation gap between US and European equities now stands at multi-decade levels and with the ECB already cutting rates we would expect to see this gap gradually close especially if the interest rate differential weakens the Euro in favour of European exporters. The biggest headwind for Europe is the sluggish state of the Chinese economy, its largest trading partner, and the potential widening of Chinese trade restrictions to include Europe.

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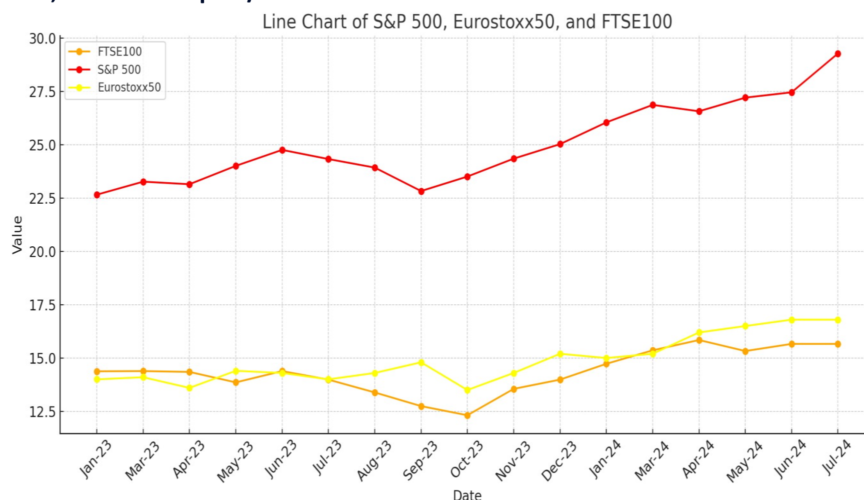
Election fever also took hold in the UK after Prime Minister Sunak surprisingly called an early General Election for July 4th, 2024, with polls predicting a major landslide victory for the Labour Party. Electioneering in the build up to the vote saw all parties steer clear of Brexit topic which has had a major impact on the UK economy since the UK's departure where the economy has been slow to recover since the pandemic compared to its developed market peers. UK equities lost ground in June, down 1.4% but finished the quarter up 2.6%.

We believe a Labour majority is unlikely to see any large policy swings due to limited fiscal flexibility, and financial markets may be buoyed by the possibility of a more stable government. UK equities trade on a forward price-to-earnings multiple of approximately 11.7x compared to mid-twenties for example in the US and Japan, and outflows of investors' assets from UK equities to international markets since Brexit has seen the weighting of the UK as a constituent of world indices fall below 4% from an average of nearer 10% during the 1990's[iv]. With a dividend yield of 3.7% UK equities are not only on cheap multiples but also offering an attractive income. The question is whether this is enough to lure back investors who are hooked on the growth in technology which only has a sector weight of approximately 1% in the UK compared to 23% in World indices and 30% in the US.

The resilience of the US consumer and the wider US economy has surprised many this year leading bond markets to reprice the potential for a rate cut cycle by the Fed this year and next. After pricing out as many as six cuts to no

UK, US and Europe P/Es



Source: Data: *LSEG Datastream / Charting: Python Generated*

more than two recent signs that the economy is slowing has seen rate cut speculation come back to the forefront. Core inflation remains sticky as data surrounding corporate margins has shown support for pricing power, and as ASR point out also support a rise in capital expenditure (capex)[ii]. However, the jobs market and the housing market have shown signs of weakness leading to increased market expectation for a cut in rates in September, and another during the 4th quarter. This has seen the yield on the 10-year US Treasury fall from 4.7% to 4.4% during the quarter and the correlation between stocks and bonds remains positive.

Economic resilience has also seen the US credit default rates remain low at 1.3% compared to an average of 1.6% since 2000 and 4.6% during periods when earnings contract[v]. We believe this helps explain the strong absolute performance of credit markets even though yield spreads to government bonds remain extremely low offering little value on a risk-adjusted basis.

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The main reason for interest rates to remain higher for longer is the strength in the economy which has created an environment that favours risk assets; however, the performance of low-yielding growth stocks has seen the dividend yield on US equities fall to 1.6% which is historically low compared to the yield of say 4.4% on 10-year Treasuries. As the Fed looks to reduce its influence on the Treasury market, fiscal deficits also seem to be in the minds of investors in the US where US public debt looks set to continue to rise steadily[ii]. This leaves the Treasury market and new issuance back in the hands of more traditional price-sensitive investors which may increase volatility in bond markets especially when liquidity is tight. The back-up in yields over the past two years of central bank tightening has been a tough environment for bond investors but if rates have now plateaued in most developed countries so that the next move whenever it happens is lower, then we would argue that bonds can offer a different exposure in portfolios to equities.

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With the Dollar Index 1.4% stronger over the quarter and the US Federal Reserve on pause it may be surprising to see Emerging Marker (EM) equities up 4.1% during the quarter. Despite a slowing China still being affected by the

The outlook for EM bonds is still attractive as rates are still expected to come down as developed economies also start their easing cycles, US higher-for-longer seems to have provided a headwind over the course of the quarter.

property sector and a lack of stimulus from the authorities, the rest of EM is forecast to see steady growth on the back of robust global growth. The number of elections taking place this year certainly increases geopolitical risk with surprises in India, South Africa, Mexico, and Argentina. With the US elections still to come in November, this could have a material effect on how the US trades with its partners including many EM countries. The outlook for EM bonds is still attractive as rates are still expected to come down as developed economies commence their easing cycles, US higher-for-longer seems to have provided a headwind over the course of the quarter.

Japanese Yen has weakened substantially against the Dollar since 2021 giving momentum to the rally in Japanese equity markets.

However, they have fallen 1.9% over the quarter as the negative correlation between the Yen and the TOPIX index seems to have broken down as earnings momentum turns negative.

The most recently favoured foreign exchange carry trade has involved borrowing in the low-yielding Japanese Yen and depositing the funds into Mexican Peso to make a return on the interest rate differential. However, the election results disrupted this trade as FX rates became more volatile exacerbated by traders reversing some of their carry trades. However, the Japanese Yen has weakened substantially against the Dollar since 2021 giving momentum to the rally in Japanese equity markets that have substantially rerated gaining 18.3% over the first half of the year. However, they have fallen 1.9% over the quarter as the negative correlation between the Yen and the TOPIX index seems to have broken down as earnings momentum turns negative. Nick Nelson at ASR states that since dollar / Yen has crossed 145 the TOPIX has not been strong enough to offset the weakness now that Japanese equities are again at their long-term average valuations compared to World equities[vi].

TOPIX index vs USD/JPY 2021 to date

Source: *LSEG Datastream*

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The currency has gone on to again test the 160 level versus the Dollar as the interest rate differential between the two is not being helped by the higher-for-longer stance of the US Fed and the Bank of Japan currently leaving rates unchanged at zero despite stepping up quantitative tightening.

Finally, general commodity prices have also benefitted from signs of a pick-up in global growth and the remaining strength in the US economy, rising 2.7% over the quarter to be up 4.1% year to date. Oil has been stronger towards the end of the quarter following the OPEC+ meeting which reported that members

would taper their supply cuts while the gold price gained 4.2% over the quarter as continued central bank buying presented a significant tailwind. In summary, there are many risks to financial markets, most notably continuing geopolitical risk not least the US Presidential Election, and rising trade tensions between China, the US and the EU.

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The concentration risk in US equities also requires our attention as the broadening out of returns that started in April were reversed in May and June as the leadership of US mega-tech continued.

In summary, we expect equities to lead returns in the medium term, although we would like to see the concentration risk reduce significantly - and non-Mag7 holdings do 'heavier lifting', as the excitement over the effects of AI risks investors collectively losing sight of valuations.

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[i] Based on Refinitiv Workstation data
[ii] Ward-Murphy Zara _ Absolute strategy Research _ ASR Investment Committee Briefing _ July 1, 2024
[iii] Cara Charles _ Absolute Strategy Research _ Capex Forecasts and Nvidia's Revenues _ June 20, 2024
[iv] Rajadhyaksha Ajay _ Barclays FICC Research _ Global Outlook _ Calm on the Surface _ June 20, 2024
[v] Ward Karen et al _ J.P. Morgan Assert Management _ Mid-Year Investment Outlook 2024 _ June 13, 2024
[vi] Nelson Nick _ ASR Equity Strategy _ Upgrade Eurozone, Downgrade Japan_ May 23, 2024

Investment Outlook

Having reviewed the key macro developments and market movements in the prior quarter, we turn our attention to current valuations and the prospects for future returns, both of which influence our asset class views and positioning as we navigate the remainder of 2024.

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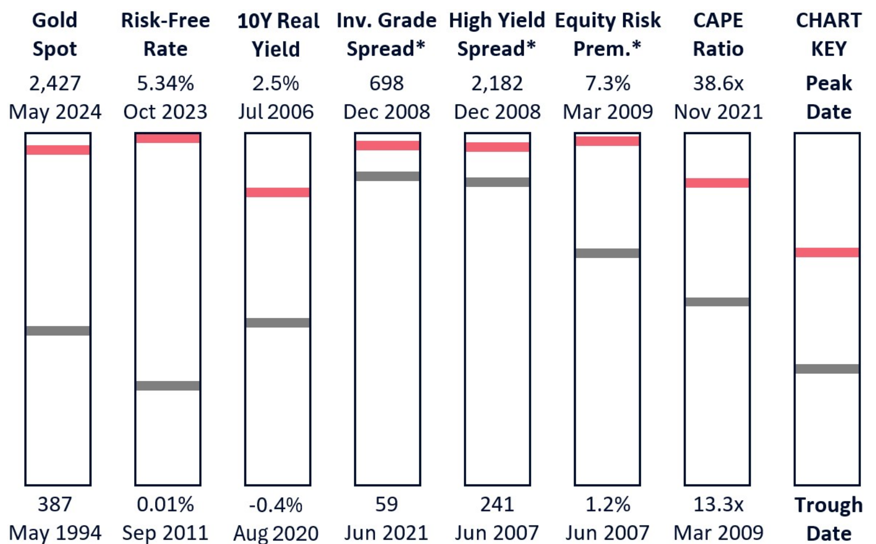
Global Barometer:
Current (coral) and 20-Year Average (grey) measures (* = inverted)



Sources: *Federal Reserve Bank of St. Louis, LSEG Datastream, Robert Shiller via Yale Department of Economics. Investment grade spread: ICE BofA 3-5 Year US Corporate Index Option-Adjusted Spread. High Yield Spread: ICE BofA US High Yield Index Option-Adjusted Spread. Equity Risk Premium: CAPE earnings yield less real 10-year interest rate. CAPE: Cyclically Adjusted Price-To-Earnings Ratio: Real price index divided by 10-year trailing earnings.*

The figure above reflects that the policy rate is close to a 20-year high, representing an elevated risk-free hurdle for returns from other asset classes to surpass (albeit embodying reinvestment risk, given expectations of upcoming interest rate cuts). Simultaneously, credit spreads and the equity risk premium (the additional compensation that investors receive for enduring the additional risk that non treasury bonds and equities, respectively, embody over relevant risk-free rates) are all at, or very near to, 20-year lows. The interest rate cycle has historically had significant implications for the prospective performance of the major liquid capital markets.

Simultaneously, credit spreads and the equity risk premium (the additional compensation that investors receive for enduring the additional risk that non treasury bonds and equities, respectively, embody over relevant risk-free rates) are all at, or very near to, 20-year lows.

Firstly, the yield on the ten-year treasury – traditionally the 'safe haven asset', benefitting from 'flight-to-safety' flows during times of market stress - historically peaks during the rate hike cycle and prior to the peak rates that precipitate interest rate cuts. Policy rates have remained unchanged for 11 months, since August 2023. If the current rate proves to be the peak of the current cycle, then the cyclical 'top' for 10-year yields may already be in, auguring well for prospective medium-term returns. Indeed, given elevated current yields and the 10y duration profile, the risk / reward is appealing: for a 100 bps upward / downward shift in the yield curve, the price return would be -3.5% / +12.5%, i.e. a gain 3.6x the loss for an equivalent yield curve shift. The price

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change for two-year notes in either scenario would be positive, +6.6% / +2.8% for a 100bps fall / rise. We continue to exploit attractive nominal rates at the short end of the curve and target some duration for the favourable risk / reward available.

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Secondly, amidst elevated nominal interest rates that have been significantly discounted by high inflation, investment grade and high yield credit spreads have tightened as investors have been compelled by high nominal yields and motivated to chase eroding real yields. Positively, the maturity schedule supports credit valuations, especially within high yield, when just c.13% of the index is due to refinance during the next 3 years (2024-2026), in sum equivalent to the quantum in 2027 alone, before more significant proportions are due refinancing thereafter. Further, the composition of the high yield index has improved over time: now ~55% comprised of BB-or-better-rated issues (compared to less than 40% at the end of 2007). Alongside low default rates and falling refinancing costs, these factors have led high yield credit to outperform investment grade, in turn outperforming treasuries, year to date. Unfortunately, current valuations offer little by way of prospects for future returns: the starting yield of 5% for the Barclays Global Aggregate Index anticipates, via a regression model with significant explanatory power, nominal prospective five-year annualised returns of 5.2%.

Thirdly, turning to the equity markets, valuations are elevated relative to history, although alone are a largely irrelevant tool for timing participation in the short term: over the past 25 years, for the S&P 500, the current starting forward earnings multiple of 21.2x has predated a broad range of return outcomes for the ensuing 12 months, ranging from less than -20% to more than +40%. In the short term, investor sentiment - as reflected by changes in equity multiples - dominates returns and volatility therein contributes to the wide range of returns over the prospective 12-month period. Over the longer term, however, investor sentiment moderates and fundamentals evolve to have a more significant influence – earnings growth contributes the majority of returns. As such, over a prospective ten-year period from this starting multiple the range of annualised returns is far narrower, and not compelling: 0% to 5%. We would also caution against pinning hopes for further equity index appreciation on anticipation of interest rate cuts, which have tended to occur alongside earnings recessions and escalating default cycles as policymakers respond to economic weakness. We don't rule out the possibility of a rate-cut-driven-melt-up scenario, but the arithmetic – at least at the index level – is challenging and underpins our ongoing conviction in targeting positions in individual companies to exploit not momentum and 'greater fool' theory, but fundamental merit.

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Fourthly, considering liquid alternatives exposure via our diversified basket of hedge funds, their collective performance has been challenged by the enduring and prevailing 'risk-on / short-volatility' environment and its concave return profile, during which equities and credit have performed well, and protection has been deprioritised and devalued. Should an adverse scenario manifest, characterised by 'risk-off / long-volatility' positioning, hedge funds, with their collectively decorrelated return streams and convexity credentials (preserving capital, or at least drastically reducing downside participation, in times of market stress) are poised to demonstrate their value once again – alongside, inci-

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dentally, the ten-year treasury and other ‘flight-to-safety’ assets, of which there are few that can consistently be relied upon, hence their outsize performance when such conditions manifest.

Finally, examining gold: performance is mixed in risk-on / risk-off regimes, but gold remains a hedge against fiat (‘paper’) currency debasement, extreme economic instability and, most relevantly recently, geopolitical risk. Over the circa 50 years since President Nixon abolished gold exchangeability for the Dollar in 1971, above ground stocks of gold have grown by 2.4x, or c.1.7% annually (source: World Gold Council), which is pedestrian compared to the proliferation of Dollars, as measured by the M2 money supply: up over 30-fold, or almost 7% annually (source: St. Louis Federal Reserve). With M2 money stock of $21tr, and the US Treasury’s gold holdings of 8.1 metric tons worth $681bn, assuring convertibility of the former to the latter today would mathematically imply a gold price 31x higher (or $73k per ounce, compared to $2.4k currently). On the demand side, central bank purchases (6% 10-year CAGR) have accounted for almost all net purchases. Since 1Q22, when the US confiscated sanctioned Russian state assets, quarterly central bank purchases as a proportion of total gold demand have risen from 7% to 26%, averaging 25% (more than 10% above the 10-year average). Despite the prevailing high real rates that traditionally represent gold’s opportunity cost, in the form of foregone yield as a non-yielding investment, we maintain our gold allocation.

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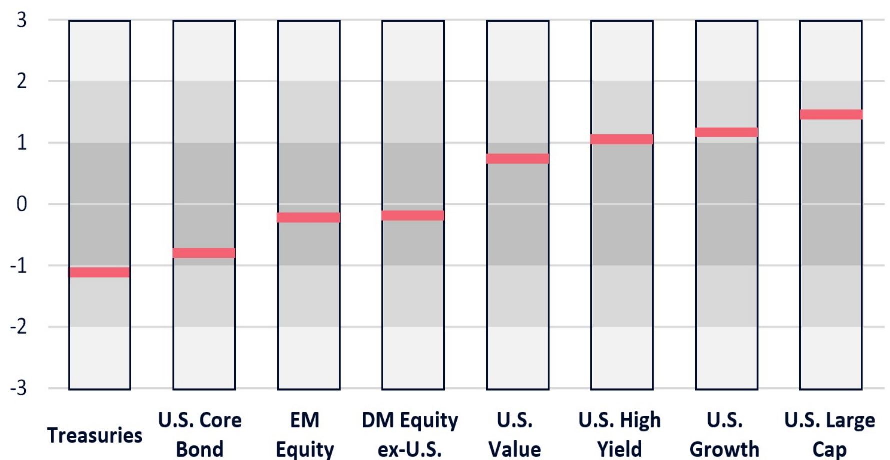
Global Valuations Monitor:

Z-scores based on 25-year average valuation measures*



Sources: *J.P. Morgan Asset Management, Bloomberg, BLS, CME, FactSet, MSCI, Russell, Standard & Poor’s.*

*Valuation measures are yield-to-worst for Treasuries, and U.S. Core Bond, spread-to-worst for U.S. High Yield, P/B for EM Equity and Fwd. P/E for all other equity indices. A standard deviation of zero corresponds to the 25 year valuation average, while -3 and +3 correspond to extreme low and high valuations, respectively. Readings above (below) zero represent a premium (discount) to the long term average.

Although credit and equity valuations are rich compared to respective 25-year histories (see chart above) we believe that the underlying economic environment continues to favour risk assets. Simultaneously, we remain overweight cash and government bonds given favourable risk / reward potential and as diversifiers set to preserve capital in the event of a disruption to currently optimistic expectations of a benign investment environment. We retain our positions in liquid alternative trading strategies and gold, while largely avoiding credit, for similar reasons.

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