ALTA CAPITAL MANAGEMENT
A member of Guardian Capital Group Limited

April 2024

Reflections & Insights*

"Pessimists sound smart. Optimists make money."

– PATRICK COLLISON

This quotation has turned out to be prophetic, at least over the past quarter. There wasn't any point agonizing about geopolitics or how expensive markets were; it was futile worrying about the path of interest rates or inflation. All you had to do was buy stocks exposed to artificial intelligence (AI) and weight loss drugs; this was a policy which took you to the US and (to a lesser extent) to Denmark. The Magnificent Seven (M7[1]) stocks had a couple of members decline, but its AI bellwether, NVIDIA, rose by more than 80% in the first quarter of the year alone.

The optimism leaked a little into the broader market towards the end of the period, driving a 10% return for the US market, and 5% for the world as a whole (in US dollar terms). The biggest contributor to these returns was the expansion of price to earnings (P/E) multiples, which generated more than seven percentage points of the overall outcome. In the US, corporate earnings added another 3% or so, while in the rest of the world, earnings subtracted 2.5%.

Even more striking was the fact that the earnings of the M7 rose last year by 31%, whereas the rest of the market saw earnings decline by 4%. Maybe optimism wasn't the point – maybe it was just about the profits. For this year, the consensus forecast is for M7 earnings to rise 25%, while the rest of the market goes up by 8%. The number for the aggregate is almost certain to be revised down, as it is in almost every year,

[1] Alphabet, Apple, Amazon, Meta, Microsoft, NVIDIA and Tesla

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as the most inveterate optimists are forecasters. The consensus expectation for M7 is that profit growth will fade during the year but still look robust going into 2025. Further, the parts of M7 where the glitter is wearing thin are Tesla and Apple, for good old-fashioned stock-specific reasons.

Most people would look at all this and conclude that the opportunity in AI is both massive and that all the benefits will accrue to companies who are already the largest on the planet. AI, however, doesn't happen in a vacuum. It needs data centres, which will take time and cost hundreds of billions of dollars; it needs engineers, whose salaries are being bid up aggressively; it consumes huge amounts of electricity and the capacity to deliver that is questionable; and it needs consumers and regulators to see it as a force for good, hardly a given. The quest for the 'picks and shovels' of AI (for example, semiconductor companies) is in full swing, and industries that will see productivity gains from its use are also attracting investors.

The reality is that while AI could be a general-purpose technology, which changes everything, it might turn out to be less spectacular than it looks today, or the winners may be companies that develop the tools through which it can be embedded in processes. You don't need to be a pessimist to think that there is a lot of hope and hype on the AI bandwagon. For now, though, it rolls on.

What about the rest of the economy?

What is truly remarkable about the last quarter is that the optimism that interest rates would fall sharply during 2024 has waned, as the economy has demonstrated greater resilience than expected. In January, the market expectation for 2024 was that, in the US, interest rates would fall by 160 basis points. Now, that number is 60 basis points. Inflation has been well-behaved, but there are signs that it is somewhat sticky in the face of economic strength. Market expectations at the outset of the year were very different, and the new news might have been expected to unsettle things. In fact, the opposite has been true. The enthusiasm in markets has, itself, contributed to economic strength and consumers at the upper-income levels have continued to spend, buoyed by the wealth effect of rising asset prices.

The level of optimism is reaching extreme levels. Many advisers are recommending clients go 'all in' on equity markets, and that record low levels of cash should be held. Recession odds are at very subdued levels and sentiment indicators[2] are at levels last seen in 2009/10 when the world was recovering in a coordinated fashion from the Great Financial Crisis.

It is not clear what might upset this consensus. It is possible to argue that while the economy is strong, momentum is fading, the yield curve is sharply inverted and lower-end consumers are tightening their belts. The average time between the start of a monetary tightening cycle and the onset of a recession is ten quarters. We are currently in Quarter 8 of this cycle.

Ignoring history

What went wrong in the forecasting? First, economists underestimated the reflationary effects of the pandemic and other fiscal stimulus, which is only now running out of steam. Second, expectations that monetary policy would work quickly were misplaced. Some of this was ignoring history, but some of it was that rises in interest rates only begin to bite when fixed-rate mortgages run off and have to be refinanced. This process has barely begun.

All in all, the risk of disappointing growth in the US is likely to rise as the year progresses. For now, though, the equity market doesn't want to hear the pessimistic case.

It is worth remembering that the US consumer represents an economic weight larger than China and is roughly the same size as the economies of Germany, Japan, India, the UK, and France combined. For investors, America has been a truly exceptional place, and its capital markets have come to dominate global finance so totally that it is easy to forget that the rest of the world exists.

Elsewhere, economic activity is weaker, and inflation is coming under control.

2 Organisation for Economic Development OECD data, Consumer Confidence Index (CCI) https://data.oecd.org/leadind/consum-er-con idence-index-cci.htm

This suggests that interest rates will fall sooner and faster in the Eurozone, Japan, and Emerging Markets than seems probable in the US.

Momentum developing?

In Europe, the markets do look to have reasonable value and, with interest rates likely to fall over the next 18 months, maybe some momentum will develop in the comparatively subdued equity and bond markets. The UK faces an election later this year and although its market is cheap, ideas about how to put the country on a sustainable growth path are thin on the ground, particularly as a substantive rapprochement with the EU seems off the cards. It is now widely recognized that BREXIT has been a disaster, but the willingness to pick the scab is absent.

In Japan, very low interest rates have kept the country somewhat disconnected from the global cycle. A confluence of positives is visible. The ending of deflation, better corporate governance, cheap valuations, aggressive stock buybacks, and the fact that both domestic and international investors are very underweight, all point to sunnier climes ahead.

China is dealing with a range of domestic problems. Slowing growth, combined with high leverage, particularly but not exclusively in the real estate sector, act as brakes on the economy. The stimulus measures announced last year have underwhelmed the markets and the hangovers from political interference and trade dislocation have left international investors cold. The markets are at very reasonable valuations, but valuation alone is not a basis on which either to buy or sell an equity market.

A year of elections

We have written in these reviews about 2024 being a year of elections. The first of these saw the major shock of Vladimir Putin being re-elected. Who could have predicted that? Unfortunately, it entrenches the regime in its Ukrainian war and has heightened tensions in several former Soviet nations who fear they may be next. The elections to the European Parliament, in the UK and the US are all punctuation marks at which Russia will aim to disrupt the status quo using propaganda. And, of course, we also face the prospect of a US presidential election between two gerontocratic candidates. It is hard to comprehend how such a poor choice can be offered to the US public. In the Middle East, the risk of escalation is real and the plight of people there is heartbreaking. We live in very uncertain times, although investors can seem callous in their indifference.

One asset category that suggests that 'all is not well' is gold. The price of this insurance policy has risen sharply in the first quarter. Who knows whether that reflects concerns over geopolitics or the likelihood of even more profligate fiscal policies, but it does highlight some of the risks that more conventional asset markets are ignoring. There is a lot of debt in the world and it will weigh heavily on growth.

Trying to bring this back to an investment level is an impossible task. If a commentator calls for a pause in the upward march of AI, they might be lucky and get it right, but the truth is, nobody knows. That is why we believe the only sensible investment approach is to remain diversified. As the US dominates global markets to an ever-deeper extent, so the search for more diverse sources of potential return becomes more important. That search should be truly global and across asset classes. 2024 has started well. The balance of the year is unlikely to see prices rise at the same rate, and we may also see a greater divergence of returns by market.Caution is warranted.

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Published: April 2024
18033372-UFD-04152024