



January 2024

Reflections and Insights

"When everyone thinks alike, everyone is likely to be wrong." And, "Don't confuse brains with a bull market."

– BOTH ATTRIBUTED TO HUMPHREY NEILL

You can never erase your digital footprint. With that in mind, we thought it might be worth revisiting the prognostications of this review at the beginning of 2023. Here is the last paragraph:

'There is an old Wall Street saying which goes 'bull markets climb walls of worry'. What this means is that when everything is rosy, you can be sure that all the good news is in prices – witness the end of 2021. When all you can see is woe, then there is almost no good news discounted. Clearly, we have plenty to worry about today, but as explained, prices are lower, valuations are lower, expectations for economic activity and inflation are quite bleak and investors are on the sidelines. These are the preconditions for better markets, although the catalyst is as yet hidden.'

It is a cause of regret that, while broadly correct, we were not banging the drum for risky assets. That would have been the right call, as most equity and bond markets had a very good 2023. Therein lies the forecaster's dilemma. Taking a position that sits on the fence is uncomfortable and produces content that nobody reads, but it does reflect the reality of what most investors can do. You could have owned tech stocks in 2021, energy stocks (but not tech) in 2022, then tech stocks (but not energy) in 2023. That would presuppose you had nothing better to do and, even more, that you got these calls right and didn't panic when they looked wrong. Sadly, most investors, professional or otherwise, don't try to do this because it is all but impossible. Nevertheless, the financial world is full of experts who don't sit on the fence and dispense advice of this ilk. Those who get it wrong (probably about half of them) forget what they said. Those who get it right (the other half) tell you.

2023 was a very peculiar year that saw such widespread positive returns. Looking at the US market, 72% of the 500 stocks in the S&P 500 Index underperformed the market. Normally, in a rising market, you would expect that number to be between 30 and 40%. By sector, the contrast was even more marked. In Consumer Staples (food and things like that), 97% of the stocks underperformed. In Information Technology (the best-performing sector in 2023), 39% were laggards, itself a higher number than you might expect. The reason for this was that the biggest tech names (colloquially known as the Magnificent Seven) represented nearly 30% of the overall index, which itself is 57% of the global market. That means that over 17% of global equity markets are made up of seven companies, all within the same

sector. It also reflects, incidentally, the outperformance by the US market of everything else. At the start of the 2020's the US market was 49% of the global market.

Hiccups ahead

Investors reacted to this by getting closer to the benchmark while still largely underperforming, as very few investors can hold only seven stocks. This unusual set of circumstances reflects universal excitement about the prospects for artificial intelligence (AI). It is well beyond the scope of this review to speculate on the developmental path of generative AI or to predict its effects on productivity, but it is also beyond the knowledge of most of the investors in the stocks. At current price levels, there is a mountain of expectation that the transition to a high-productivity AI-driven economy will be quick, straightforward and free of political interference. In practice, all of these hiccups lie ahead, even if AI lives up to its promise. At the end of the 1960 film 'The Magnificent Seven,' four of the seven gunslingers die, and the village elder tells the survivors they are "like the wind, blowing over the land and passing on." This is not a counsel of despair but a reminder to be cautious when everybody else is not

Looking back again, at the end of 2022, investors had begun to search for the point at which interest rates would start to fall. This became known as the 'Fed pivot.' As it turned out, they spent the whole of 2023 searching for it too, because it only came right at the end of the year. The expectation, though, was enough to keep momentum in markets for most of the year, even if it was a very strange-looking bull market.

The pivot was really a statement that the Federal Reserve (Fed) thought the cycle of rising rates had run its course because inflation had fallen further and more quickly than expected. This does not mean that interest rates will fall imminently, but the market has now priced in a number of cuts during 2024. The corollary of this optimism is that the economy is not set for a giant leap forward. Indeed, many leading indicators point to a more sluggish environment. Without going too much into the gory details, high levels of inventory, tighter lending standards, decelerating wage gains, weakness in capital spending, and many more such data, point to a slowdown. Whether this is the soft landing of the optimists or a hard landing in the form of a recession is largely academic, even if a lot of ink has been spilled in the debate. These are conditions, though, which mean that real corporate revenues and profits are likely to struggle more than in the last couple of years. The consensus is that there will be a soft landing (i.e., no recession), and profits will be up 11-12% in each of the next two years. These two views are internally

inconsistent. At least one (and possibly both) are off the mark.

The Fed will also be very wary of two factors. The first would be a further wave of inflation, which could delay or limit any fall in rates. The second has to do with fiscal stimulus in the shape of federal spending, which is always a risk in an election year, even with paralysis in Washington.

When you put all this together, it is hard to bracket equity markets together. As discussed, there are many sectors and types of stocks which have not participated in the risk rally of 2023. Many of these are in sectors (like Consumer Staples) that will benefit from a quieter economy or even a recession, where the stability of earnings and the strength of balance sheets are protective. On the other hand, some equities trade at prices that render them vulnerable to a dimming of risk appetite. The risk-reward ratio in aggregate looks at least as attractive in other markets like bonds and even cash. It is worth noting that inflows into cash funds during 2023 were ten times larger than flows into any other asset class.

Voted with their feet

While the US has become the indispensable equity market, the rest of the world continues to decouple. In China, a botched exit from COVID restrictions, a crisis in the real estate sector and some heavy-handed political intervention in corporate life have all led to poor markets. Although these trade at low valuations, many investors have voted with their feet and are staying away until the weather clears.

In Europe, the combination of the effects of a hot war on the doorstep, significant interest rate rises, and structural economic problems against a difficult political backdrop has pushed the EU economy into recession, albeit a relatively shallow one. As in the US, interest rates in the EU will begin to fall during 2024, as a weaker economy and falling inflation create the space for a change in the monetary weather.

The UK economy remains troubled, and the likelihood of economic decisions being influenced by politics is a near certainty ahead of elections towards the end of the year. These are likely to play to populism rather than sound finances. The UK remains a country struggling to cope with its reduced relevance on the global stage, and its stock market holds a mirror to that, with many new listings opting for New York rather than London.

Japan remains reasonably stable, and the emerging world, in general, is moving into a downward cycle for interest rates. Combined with a weaker dollar, which may evolve as a response to interest rate falls

in the US, this is likely to be positive for emerging economies, although selectively so.

All this means that economies are less coordinated than they have been in recent years and could become even less so if the trend toward greater protectionism continues.

Important year for politics

2024 will be an important year in politics. More people than ever before in a single year are being asked to vote in democratic elections – even if this supposedly includes Russia. It is difficult to point to many conclusions, but the trend towards what Viktor Orban calls ‘illiberal democracy’ could strengthen in Europe. India will head in a similar direction under Modi, while the wild card is in the US. The re-election of Donald Trump would have profound effects on the world order and would almost certainly send the US in a more introspective direction. For those in the crosshairs of China or Russia, this would be a moment of real risk. Whether a Pacific alliance or the EU is able to stand up to the expansionary autocrats is open to question. This is without mentioning the Middle East where the risk of a wider conflict is not trivial.

Nevertheless, markets are only infrequently derailed by geopolitics, and even when they are, they quickly get back on track. Translating all this to the mundanity of a portfolio is, of course, a matter of annual angst. For us, a more balanced approach to portfolio construction is warranted. Fixed income securities have a reasonable risk-reward trade-off for the first time in a while. As far as equity markets go,

we all know the US market is probably overvalued to a point where it offers relatively low returns over the next five years, but it is not universally so. While most professional investors, for understandable reasons, have chosen to hide in bushes near the benchmark, this may be a time when stock selection comes to the fore. There are attractive valuations all over the world, the flip side of even the occasional punter wanting exposure to AI and weight loss drugs. This is normal herd-like behaviour but may be an opportunity for those prepared to look for new pastures.

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