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Reflections & Insights

“I have a foreboding of an America in my children’s or grandchildren’s time -- when the United States is a service and information economy.

When nearly all the manufacturing industries have slipped away to other countries. when awesome technological powers are in the hands of a very few, and no one representing the public interest can even grasp the issues; when the people have lost the ability to set their own agendas or knowledgeably question those in authority; when, clutching our crystals and nervously consulting our horoscopes, our critical faculties in decline, unable to distinguish between what feels good and what’s true, we slide, almost without noticing, back into superstition and darkness...”

– CARL SAGAN

Politics don’t matter. At least that’s what you might have concluded from last quarter’s review which avoided any mention of the US election, the political turmoil in France or Germany, the mess in the Middle East or Ukraine. And it is true that, usually, even political upheaval has little effect on markets unless there is a proximate (usually local) reason.

2024 was almost a carbon copy of 2023, at least in US equity markets, which have, once again, proven truly exceptional. Even though a pale shadow of their US brethren, European equity markets rose a tad, overcoming both the weak underlying economy, horrible structural problems and the previously mentioned political spats. For the record, the US market rose by 25% while global markets notched up 18%, the bulk of which is accounted for by the US. Without the US, the rest of the world rose less than 5%.

So, two great years for US equity investors, back-to-back, as long as they weren’t in value or small-cap names. Focusing on the US market, which now represents something like 70% of the global opportunity set, the returns came from an increase in the valuation level – in other words, the price/earnings (P/E) ratio went up. This accounted for about 40% of the overall return. Dividends accounted for 4% of the return, while earnings accounted for the balance. Earnings growth can be further broken down into two main components – increases in sales and increases in margins. Last year, sales growth accounted for about 20% of the total return, while the balance came from an increase in margins.

In other words, pretty much everything that could go right did go right. The US Federal Reserve began to loosen monetary policy as inflation showed signs of behaving itself, companies pushed through price increases over and above that rate of inflation and the market became more expensive, partly as a result of these two factors. Even the election of Trump was deemed a positive force, most sceptical commentators turning mysteriously positive overnight as his combination of fiscal expansion and tariffs became a talisman for growth.

WHERE DOES THAT LEAVE THINGS?

When we cast around for factors which will influence returns in 2025, we can start with dividends. They likely won't change much and will be a positive factor. Turning to earnings, it is unlikely that corporate America will be able to push through further price increases ahead of inflation – signs of consumer resistance are present. Sales could also be affected by the weakness of economies elsewhere and the uncertainty surrounding tariffs, which may or may not happen, and if they do, may or may not invite retaliation. Margins are also at record highs, partly as a result of the mix of weights in the S&P 500 Index, which is much more exposed to higher margin technology businesses than in previous cycles, but, even so, profitability is pushing at the boundaries of what is possible without denting other parts of the economy. Valuation may go up or may go down. This factor used to be correlated with interest rates, but more recently, the P/E confounded investment logic by going up even as real interest rates reached decade-long highs. It then carried on going up as rates began to fall.

All this is to say that things are unpredictable and showing signs of true excess. Much has been made of the concentration of the S&P 500 in the so-called Magnificent Seven, now 40% of the US market and therefore about 28% of the world's stock markets. This degree of concentration in a series of monopolistic companies, that are also generating profits and cash at a barely imaginable rate is unprecedented. Looking back at previous episodes of what Alan Greenspan called 'irrational exuberance', the returns clocked up by these businesses have no analogue in post-war history. The difference between these behemoths and previous eras of belief is the profitability. In the dot com bubble, for example, most companies were not cash flow positive. This time, the four largest companies have cash balances of US\$500 billion and plan to spend US\$200 billion next year on capital expenditure. Such sums make these businesses as economically relevant as most G7 countries.

Signs of excess are not confined to these companies. Other businesses have seen large boosts to market value when they unveil artificial-intelligence (AI)-related strategic moves. Cryptocurrency (crypto) assets are booming on the back of the crypto lobby having bankrolled the Trump campaign and now looking forward to the promise of light regulation as Crypto-evangelists land in positions of financial influence. Gold too had a good year, albeit a much less volatile one than Bitcoin .

We have speculated before in these reviews about what might cause some of this exuberance to unwind. The most likely culprit is that the scale of investment currently underway fails to generate a decent return on capital employed; that certain applications of AI are just plain silly (Exhibit 1 - a self-driving baby buggy); and that the productivity gains touted for AI are exaggerated.

DO YOU WANT TO MISS THE PARTY?

The question of when a degree of caution reveals itself is elusive, however, and in the meantime do you want to miss the party? It is hard nowadays to find anybody in the investing world who does not have exposure to Nvidia, and Crypto is becoming increasingly mainstream. The writer of this review learnt (painfully) early in his investing career never to buy anything he didn't understand. Crypto falls into this category for him, so don't expect a coherent view.

Trying to guess whether the P/E of the market will go up or down is one definition of madness. The only message that valuation sends is that when it is super high, as it is today, the likelihood of high positive returns in the following decade is small, and the higher the valuation, the smaller the likely return. It tells you nothing about what might happen in the year ahead. Given that the past two years have been so good, it is not unreasonable to expect the positive factors which underpinned those returns may be neutral or even negative. It may be that in the year ahead, sales growth is more moderate, and margins don't expand. It pays to remember that the long-term returns for the US equity market (1926-2023) are roughly 10% per annum, a number which remains remarkably constant over long slices of time within that 97-year range. Two years of 20% plus returns are anomalous and falsely suggest the emergence of new economic factors, in that the potential growth rate of the US economy has not changed very much, driven as it is by demographics as much as policy.

There's not much to add to the broad view of the economy. As we said last time, the US is motoring along quite happily, while the rest of the world is

variously suffering. This is largely the result of fiscal stimulus under Bidenomics and the ability of the US government to issue debt much as it sees fit – the privilege of having the reserve currency.

POLITICS. DOES IT MATTER?

This brings us back to politics and whether it matters. Having lived through Trump One, it is hard to know whether Trump Two will be more of the same or if a coherent plan might emerge. There is a contradiction at the heart of the policy pronouncements we have seen – tariffs and deportations coupled with deregulation and tax cuts. On balance, this policy mix is likely to increase the fiscal deficit; the question for investors is whether the bond market takes fright. Certainly there is a high degree of optimism baked into bond markets, with spreads against Treasuries at almost record lows. Returns in longer-dated bonds in 2024 were poor, with falls of 5% or so. Bond investors are resetting prices from which positive returns can be earned. Long-term returns from the bond market (over the 1926-2023 period) have been +5% per annum, or thereabouts.

As more policies (and those charged with implementing them) become clear, the market has scaled back its expectation of rate cuts during 2025. It now believes inflation will be sticky and that Trumpian policies won't help. The propensity for grandstanding and deal-making is inherently destabilising. As to the role of Elon Musk, in the US and elsewhere? No comment. [Refer to his exchanges with Steve Bannon.]

The reality is that we are in a period of uncertainty in the way in which politics interacts with capital markets. It is a cliché to say that markets don't like uncertainty and that the world is increasingly uncertain. This is likely to weigh on returns in the year ahead, but the exuberance we see and the boosterism of the new administration could keep the plates spinning for a while longer yet. What usually bursts a bubble is increasing rates. While one can see the pace of cutting being moderated, the likelihood of short-term rate increases is remote, but in longer-dated areas, the bond vigilantes may decide that Trumpian largesse to the plutocracy has destabilised the long-term health of the economy – in UK terms, a Liz Truss moment.

Meanwhile, the litany of problems in Europe would fill another review. Suffice to say that they are bad and may have political consequences, pushing large countries in the populist direction. Add in the US dimension – tariffs, defence spending, Ukraine and the next five years are likely to be an unpleasant time to be a European politician.

The EU prides itself on being the superpower of regulation, just as the tide of history washes in the other direction, and its very essence as a legal construct is to legislate rather than to repeal. The UK is in a mess of its own making, but at least it has a trade deficit with the US, which should make any upcoming tariff discussion interesting. Nevertheless, if the promised solution to Ukraine emerges and the Middle East settles down somewhat, these clouds could lift quickly.

JAPAN FACES PROBLEMS

Japan faces problems of its own and the geopolitical situation in East Asia is another point of concern. The Chinese economy, which is going through a painful deflationary crisis, is likely to be hit with high tariffs, but the evidence from Chinese EV sales in Europe suggests that price cuts and devaluation are likely to have a large role in helping to meet policy objectives. In the meantime, the economy has slowed and triggered a slew of stimulative policy responses. Uncertainty, again.

Going back to the root question: we have had two good years, so are we due for a lean one? The answer is, not necessarily, but things are more ominous than a year ago, when we could look forward to monetary easing and reasonable earnings growth. Today, there are no pessimists left in the US. It is all about belief and American exceptionalism. The pessimists are all in Europe, where markets are cheap, and it all looks pretty bleak. It may be time to cut back on the Trump trade, and the AI mania and go back to investing in quality businesses across the globe in a sensible diversified manner

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