Close Brothers
Asset Management

Investor Insights

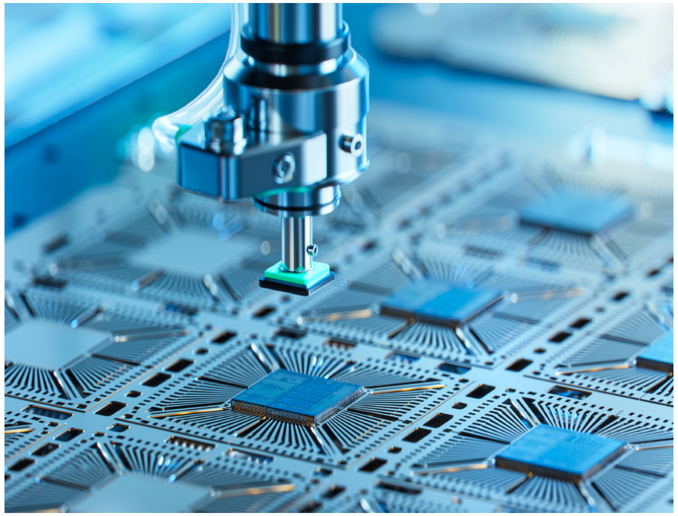
Spring 2024

A bumpy road lies ahead, but optimism prevails

In this edition of Investor Insights we cover

A strong outlook for 2024

Markets have experienced strong gains early in the year, but can this last?



US tech stocks

We explore the significance of the Magnificent 7

Risks vs opportunities

Whilst monetary policy moves in a more positive direction, the pace of growth is important

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A strong outlook for 2024

2024 is off to a strong start, with the global index up around 5% at the end of February. However, with such strong gains early in the year, can this last?

An early start

In the Autumn of 2023, investors were looking to the coming year with cautious optimism. While the global growth backdrop was not expected to be especially favourable, the hiking cycle appeared to be over and the prospect of rate cuts was coming into view, promising a more supportive backdrop for equities and bonds. Given the soft outlook for nominal growth, a result of soft real GDP growth and falling inflation, multiple expansion was likely to be a necessary driver of performance.

What investors likely did not anticipate was the alacrity with which markets would price in rate cuts after the Federal Reserve's (the Fed) pivotal December meeting. This began when Powell's comments at the press conference went further than market participants had expected, departing from the "higher for longer" message to acknowledge that "naturally, [the timing of rate cuts] begins to be the next question."

By Christmas day, more than six rate cuts were expected in 2024. This coincided with the US 10 year bond yield dipping below 4%, a rally in global equities and a softening dollar.

The fact that such considerable rate cuts were priced in before the year had begun was a concern for many. The repricing of rate expectations offered support to asset prices in December and a reversal of that repricing could withdraw that support.

Confidence in the probability of cuts has already been tested this year, by Fed minutes, comments from Federal Open Market Committee members and by the data itself. US data has been stronger than expected so far this year, making the case for a delay to rate cuts. These factors have led market expectations of rate cuts to be scaled back, with fewer than four rate cuts now expected this year.

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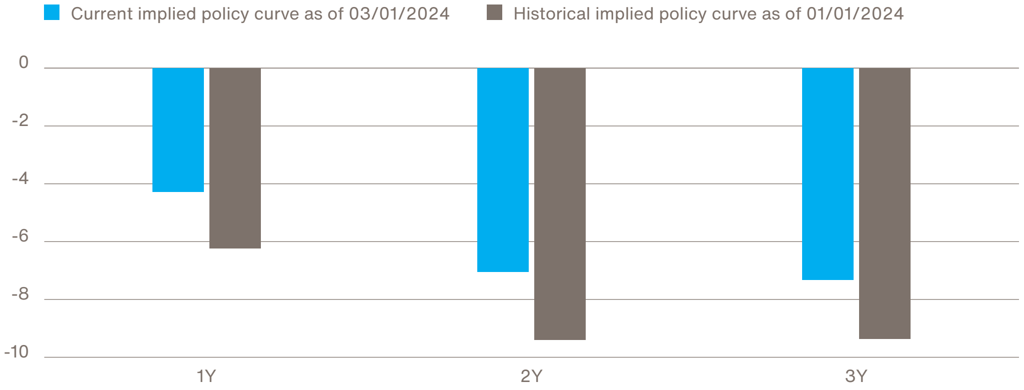
Implied number of rate cuts by the Fed 01/01/2024 vs 03/01/2024



Source: Bloomberg Finance L.P.

Tech support

Despite this reappraisal, asset values have been surprisingly resilient. While US treasuries are modestly softer year to date, equity values remain buoyant.

To what extent is this resilience down to multiple expansion and to what degree is it supported by earnings growth? Not all sectors are geared toward the global economy, with some enjoying secular drivers. The technology sector is the obvious example of this, and for this reason tech tends to do well when global growth prospects are weaker.

The chart opposite illustrates the percentage change in Earnings Per Share (EPS) expectations for each sector of the global index. It is clear that some sectors, such as energy and materials, saw downward revisions to EPS expectations last year, while sectors such as telecommunication services and consumer discretionary sectors enjoyed upward revisions.

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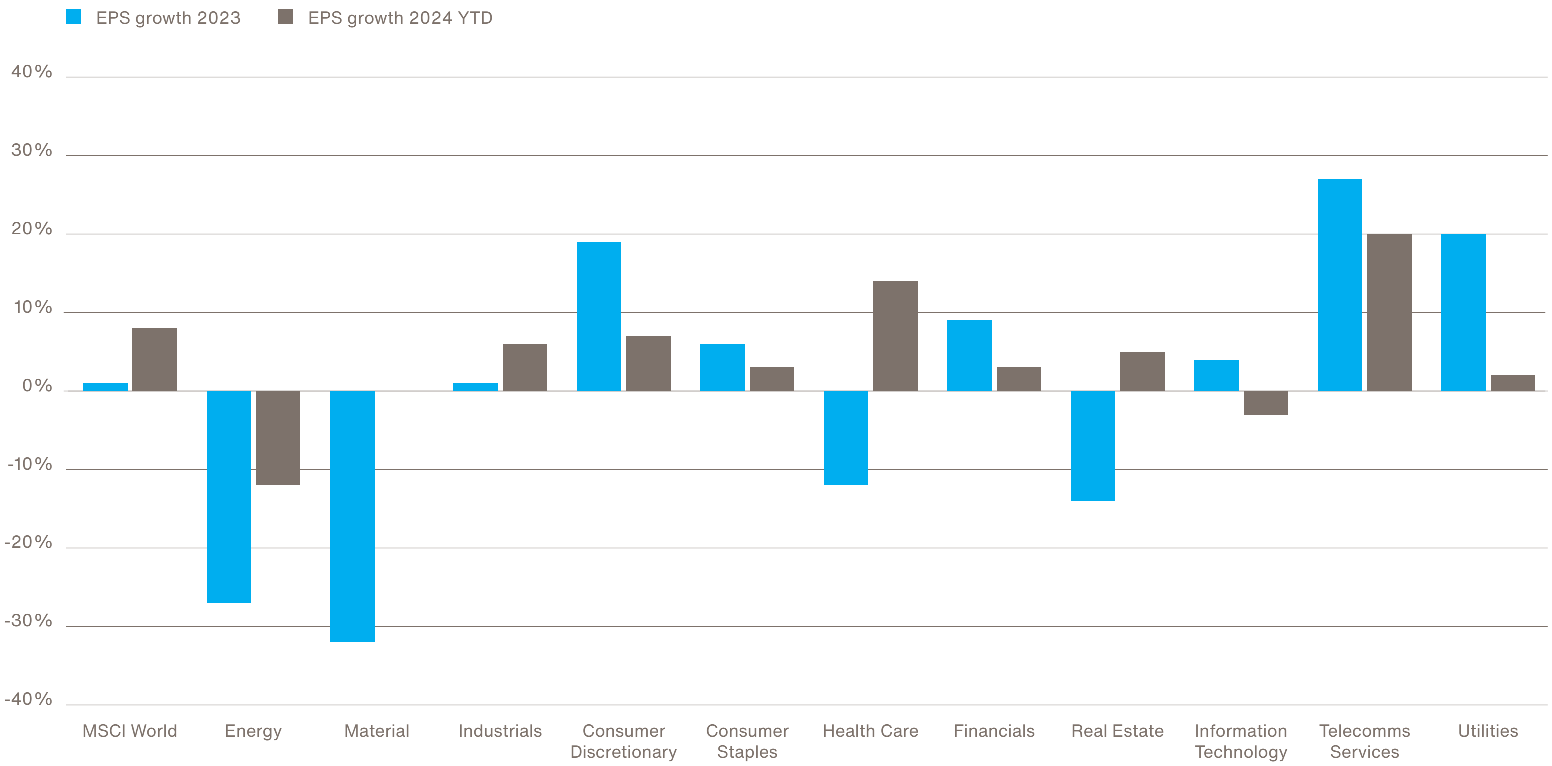
Bloomberg estimated % change in EPS expectations, 2023 and 2024 YTD



Source: Bloomberg Finance L.P.

Looking at multiples, we see that there was some multiple expansion last year across most sectors but this is particularly true of the technology sector, and is a trend that has continued this year.

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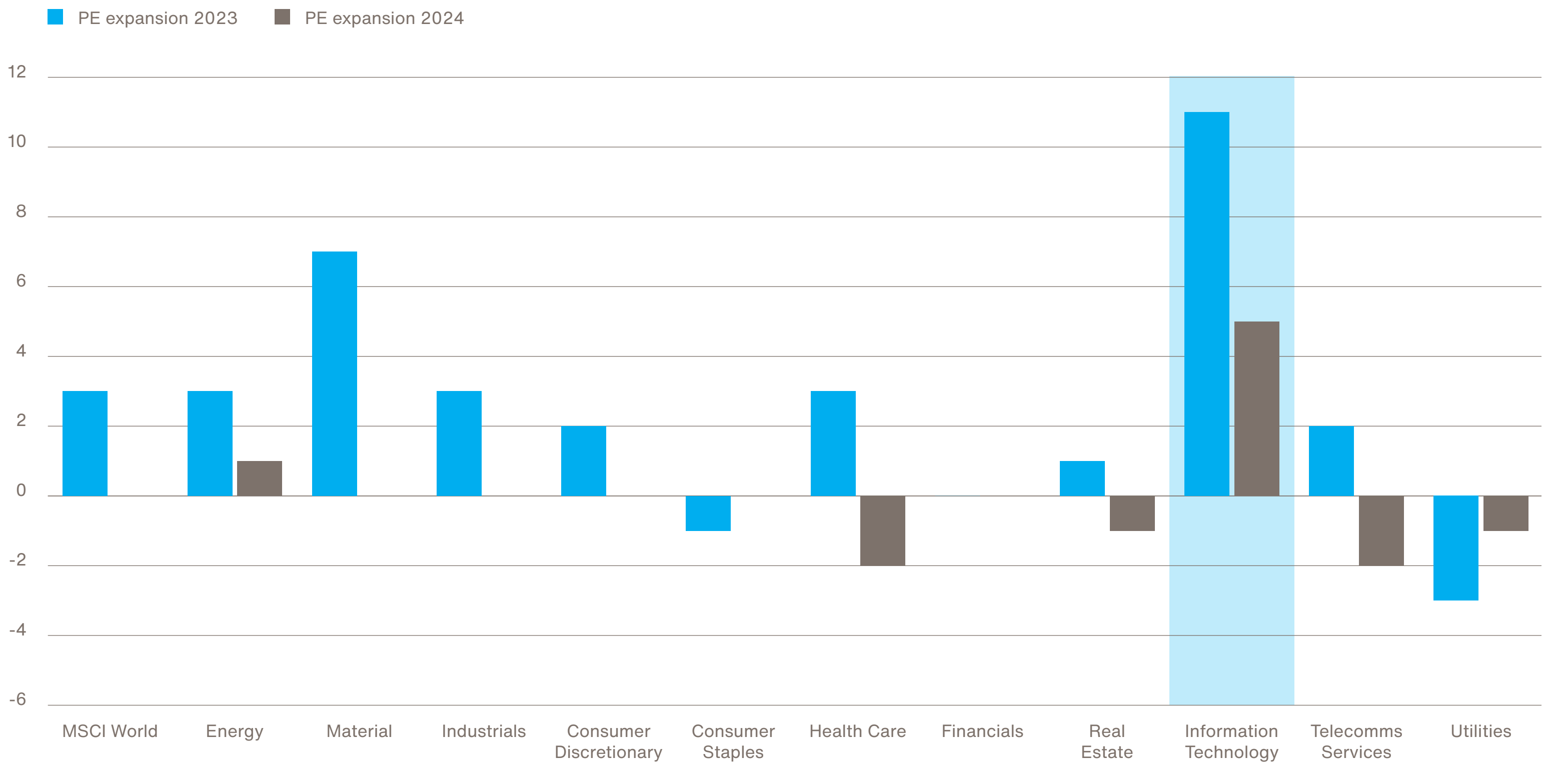
Bloomberg estimated change in Price-to-Earnings (PE) multiple 2023 and 2024 YTD



Source: Bloomberg Finance L.P.

It is certainly true that the performance of the global equity index has been greatly helped by the strength of the tech sector, especially those stocks known as the 'Magnificent 7': Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla. Year to date these stocks are up 14%, compared to the MSCI World Index which is up 5%.

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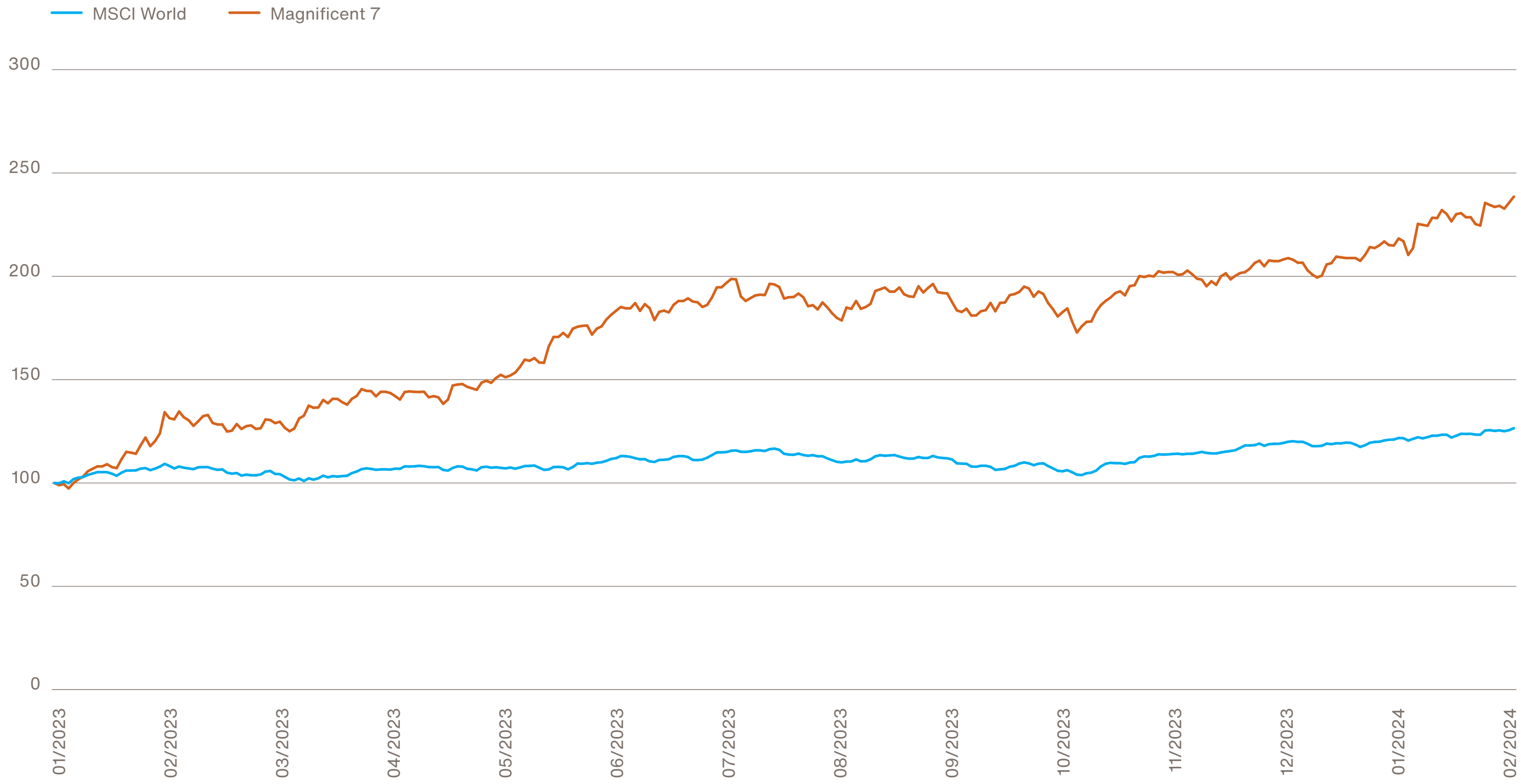
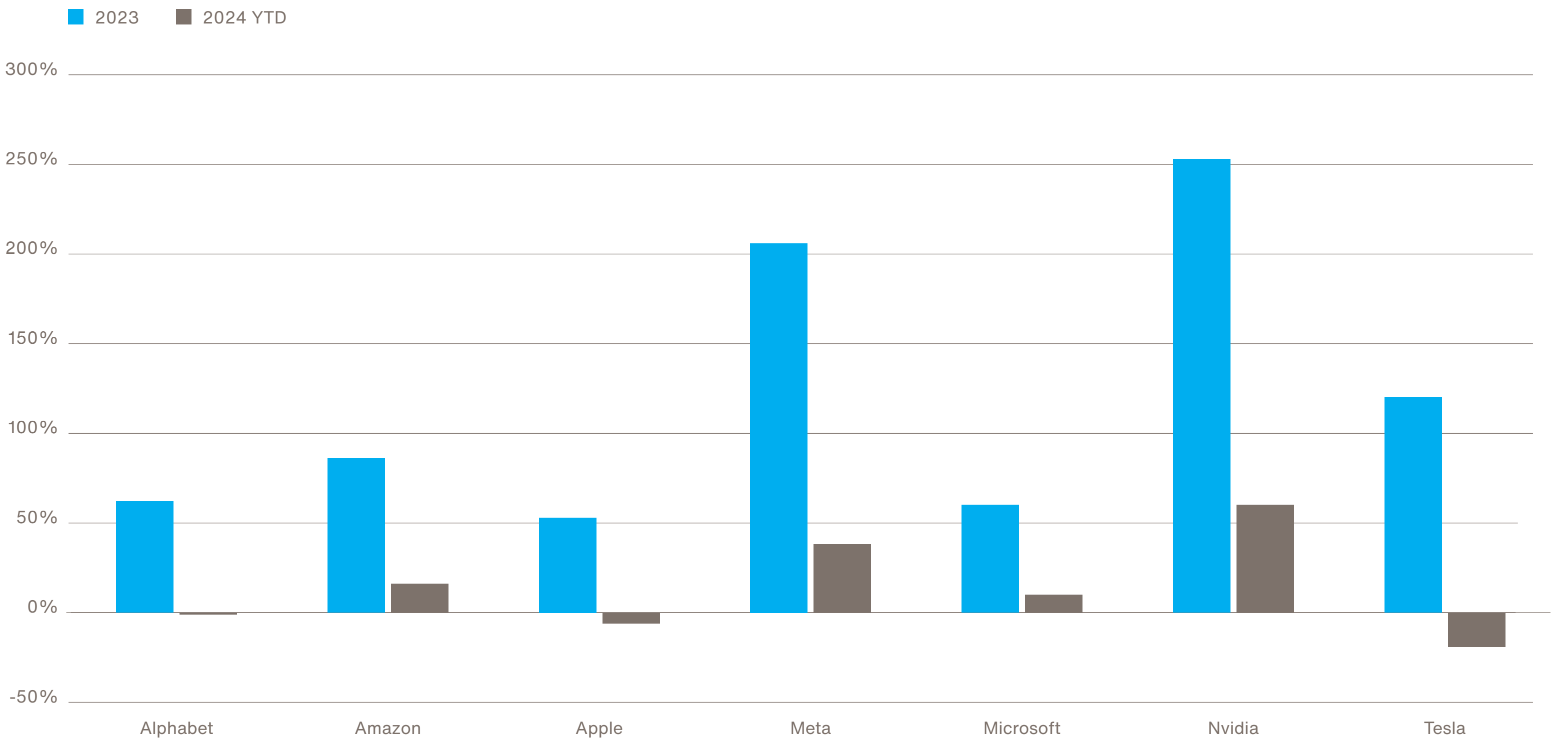
Performance of MSCI World vs Bloomberg Magnificent 7 composite



Source: Bloomberg Finance L.P.

While this sobriquet has certainly captured the attention of the media, looking within this group of companies we see some quite different dynamics. While companies such as Nvidia and Meta have enjoyed strong performance year to date, based on strong earnings guidance, other names, such as Apple and Microsoft, have not performed as well. What this illustrates is that some technology names are being supported by fundamentals, making prices less sensitive to downgrades to rate forecasts.

Price performance of Magnificent 7



Source: Bloomberg Finance L.P.

US tech stocks
The ‘Magnificent 7’

Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla comprise the group coined the ‘Magnificent 7’. The performance of this group of large, tech oriented US stocks has been a major theme for markets in recent years.

Our Senior Investment Specialist, James Tulloch met with Valeria Moore, Deputy Head of Equity Research to explore the significance of this group of stocks on markets, and what exactly makes them so magnificent.

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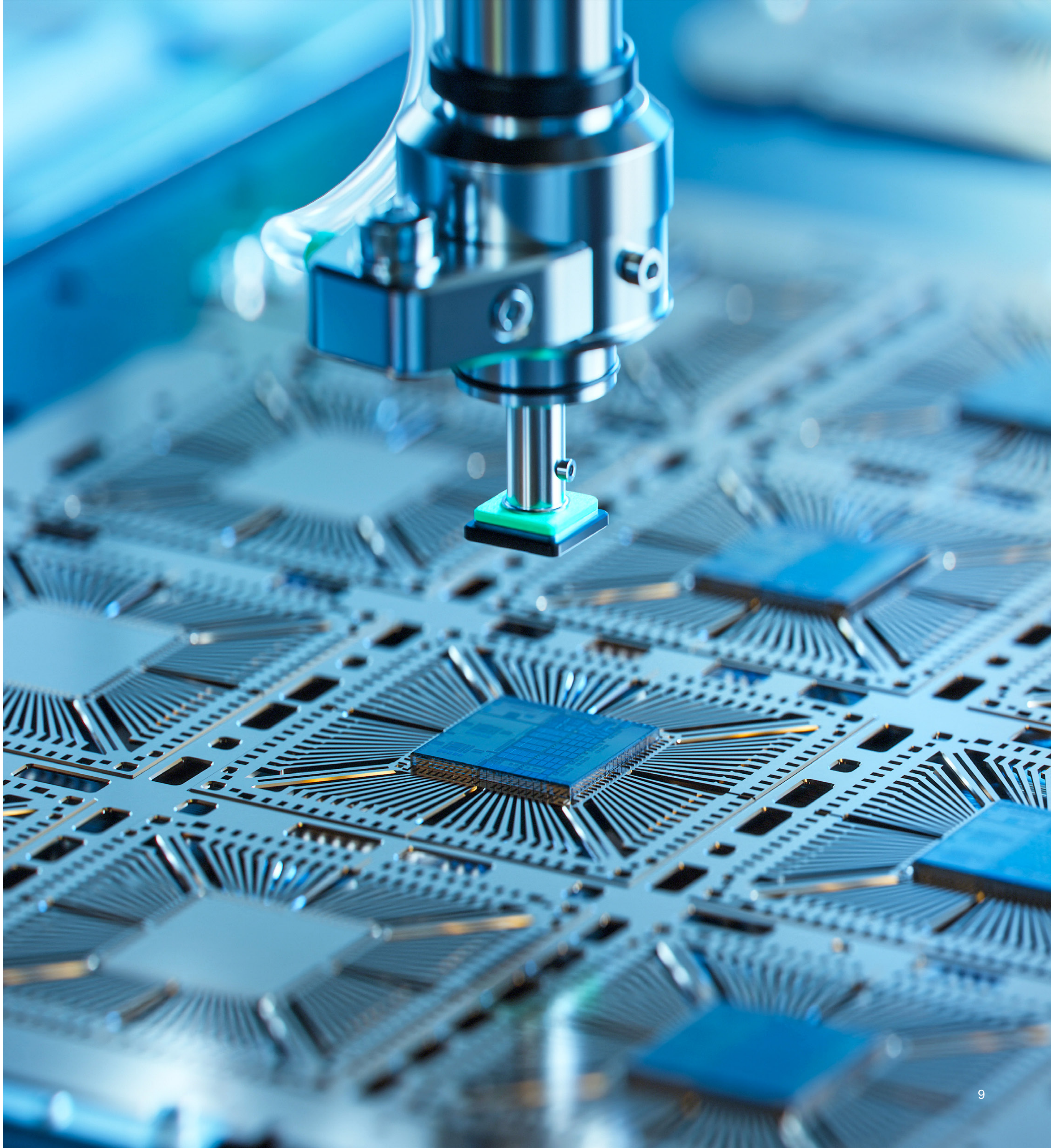

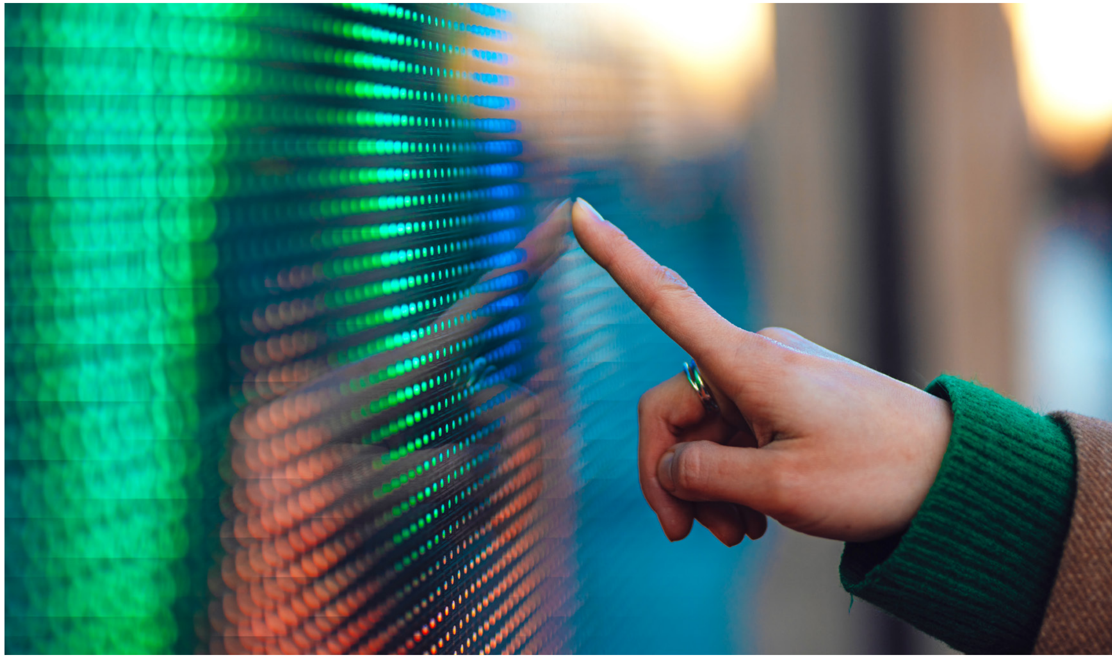

James Tulloch (JT): What do these companies have in common and why have they been grouped together by market commentators as the Magnificent 7?

Valeria Moore (VM): The stocks have been grouped due to their large market capitalisation, strong market positions and global reach within their respective industries. Their dominance is evident in various ways, and individually each has had a significant impact on technology, business and consumer markets globally. The companies all have massive user bases through social media platforms, operating systems, online market places and mobile devices, which materially translates to a large global reach. These companies continue to be leaders in innovation. The fast pace of this innovation is arguably the most fascinating and transformative attribute the Magnificent 7 have in common.

JT: So far this year there has been quite a large dispersion in share price amongst these stocks, with Nvidia's share price continuing to rise quite substantially and Tesla's seeing a notable decline. How can we discern between the companies in this group, are they all as magnificent as each other?

VM: All seven companies are certainly unique and they differ in various areas, such as by end market and growth drivers. For example, Tesla is driven by trends in Electric Vehicles (EV) and the company has benefited from EV adoption quadrupling over the last three years. However, there are various short term challenges for Tesla, including pricing trends as mass market penetration increases.

On the other hand, Nvidia is experiencing earnings' momentum due to strong demand of its graphic processing units (GPU) used by clients such Alphabet and Meta. This is a unique, advanced and complex solution and is based on hardware, software and connectivity that supports generative artificial intelligence (Gen AI) as large language models (LLM) are adopted, trained and later modified by Alphabet, Meta and other clients, including enterprises and governments.

JT: On the theme of volatility, is the performance of the Magnificent 7 in any way reminiscent of the dot.com bubble?

VM: The performance can be seen as reminiscent, but is a completely different market environment today than the dot.com era of the late 90s, early 2000s, when valuations reached the top of the 'bubble' and then declined causing significant investor losses. At that time, most internet companies were at an immature stage of development, some were not profitable and the structure of the market was very immature and highly competitive. Valuations were then very high, and at times based on arbitrary parameters such as clicks, which we know now are not viable. So although at present we have high but reasonable valuations, it is within a more mature market structure.

JT: Should we be concerned about history repeating?

VM: In contrast to the companies involved when the dot.com bubble burst, the Magnificent 7 companies are more mature, with a strong competitive advantage that has been built over decades. They have solid market positions and financial strength, so overall they are much more robust than those in the dot.com era.

JT: These stocks have seen their share prices rise very significantly over a prolonged period. How do you go about discovering whether or not that can continue?

VM: As an equity analyst, I am guided by different market variables which can affect the companies and I keep a close eye on performance on a daily basis. I consider valuations based on numerous metrics, and also earnings expectations for the next 12 months or more in order to support earnings' visibility. I meet with management and consider the balance between supply and demand and I also look at clients' demand as capital expenditure intentions that back order decisions.

Ultimately, semiconductor stocks can be volatile and macro related pauses in orders' demand can take place unexpectedly, so it is imperative to watch these stocks closely.

JT: One stock which isn't as familiar a household name as the other companies is Nvidia. Why has this company become so significant?

VM: We are in the early stages of a new era, seeing the initial experimentation phase of artificial intelligence (AI) and Nvidia is significant because it excels with new product launches in this area. The group offers a full and unique architecture, giving it a strong competitive advantage. At this stage, market penetration is very low still and likely to expand which is advantageous for the group. AI is a revolution which can bring productivity and other advantages, critical for the likes of Meta and Google and also for enterprises and governments. Nvidia is at the forefront of this innovation and provided generative AI is used ethically, I see this as a medium term growth driver.

JT: Are there any stocks within the Magnificent 7 which you are paying particularly close attention to?

VM: I am watching Microsoft with particular interest due to its exposure to the cloud, and the fact that the group has been able to innovate and adopt generative artificial intelligent based solutions to further support cloud expansion. These solutions support enterprise clients as they continue to increase their efficiency and productivity.

Risks vs opportunities

Falling nominal growth

While we continue to expect monetary policy to move in a more accommodative direction, growth will be important. It is the pace of growth that will ultimately determine the path of monetary policy and the pace of earnings growth.

At a global level, GDP growth is expected to be more subdued in 2024, owing to weaker activity in China and a slower US. However, in some regions economic activity is expected to accelerate, including the UK, as the drag from high inflation on activity diminishes. However, with real GDP growth offering mixed levels of support to earnings growth, slowing inflation is expected to weigh on nominal earnings growth.

US no-cession continues

The US economy was far stronger in 2023 than economists expected, with year on year growth of 3.1% in the final quarter of 2023, despite significant tightening of monetary policy. This matters for the global economy because of the size of the US economy and its role in driving growth elsewhere in the world – a US recession is bad news for growth worldwide.

While the US is expected to avoid recession, growth is likely to be softer in 2024, especially in the second and third quarters. To some extent, this is necessary if the Fed is to have confidence that US inflation will return sustainably to target, though the pace of slowing appears uneven.

Over recent months, labour demand has shown signs of easing and wage growth cooling, all reassuring signs for the Fed, despite the fact that unemployment remains close to historical lows. However, recent labour data has shown unexpected strength, a concern for policy makers. Similarly, inflation has been on a downward path in recent months, but has been stronger than expected in recent months, given resilient accommodation costs.

Other factors will play out this year - excess pandemic-era savings are likely to have been exhausted by now, and fiscal policy is likely to offer less support this year, all contributing to a softer growth dynamic.

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A weaker China

China's post pandemic recovery continues to disappoint. Consumption has been constrained by weak consumer confidence, exacerbated by an ailing real estate market, which is a sizable share of household wealth for many families. The property sector itself is a large share of GDP, and so soft demand here has directly weighted on growth.

While policy makers pledged to support the economic recovery, they seem less willing to bolster growth by turning on the spending taps than in previous cycles. Efforts to support the property market have included rate cuts to bring down mortgage costs and boost demand, an easing of restrictions on second homes, and efforts to improve the availability of funding for developers struggling to finance the completion of outstanding projects. Beijing has also enacted measures to help local government funding, refinancing local government debt with central government bond issuance but large-scale infrastructure spending, a 'big bazooka', has so far been elusive.

Beijing's latest announcement is a consumer goods replacement scheme, designed to support consumption spending. While such schemes may boost growth in the near term, Beijing must invest on improving China's social safety net, in order to boost consumer confidence and allow households to lower the precautionary saving rate.

With the National People's Congress due to take place, further policy announcements are likely but, without 'big bazooka' infrastructure spending, growth is likely to be softer still in 2024, perhaps close to 4.5%.

Looking beyond this year, China's growth rate is likely to be increasingly impacted by trade regulations limiting access to high-tech components and skills. As the cutting edge of technology advances, so the gap between the most advanced industries and what is available to Chinese firms will enlarge.

Geopolitical uncertainty

Recent years have seen the reemergence of geopolitical risks and this has not abated. Russia continues its war in Ukraine and, though markets have borne this with increasing equanimity, this continues to be a potential flashpoint. Similarly, Israel's war with Hamas continues, but so far geopolitical spillover has been modest, with the most economically significant event, Houthi attacks in the Red Sea, now apparently digested by markets. The November US election is likely to provide a new source of political uncertainty, with Donald Trump likely to win a second term.

AI and productivity

The surge in labour costs seen in recent years has no doubt forced many businesses to review their wage bill. This rise coincides with the broader adoption of automation and AI within the corporate landscape. This has the potential to bring about meaningful productivity gains, allowing businesses to maintain margins and accommodate higher wages. However, the adoption of these technologies will take time, making this a long-term theme.

Investment implications

When considering which assets are likely to perform in 2024, the prospect of interest rate cuts is offering relief to asset prices across equities and bonds.

Overall, we have taken a more constructive view on equities, moving allocations to overweight from neutral. However, now is a time to be discerning: soft economic growth and falling inflation are not a supportive combination for nominal corporate earnings.

For this reason, we remain vigilant of valuation on the broader equity market, favouring stocks with a strong earnings driver. While tech stocks are trading on rich valuations, we consider that in some instances this is justified, given the growth opportunities available. Consumer staples also offer attractive valuations currently.

For bonds, a shift away from further monetary tightening has been supportive, but valuations are already looking richer.

In addition, investors need to be judicious on credit quality, given the outlook for growth, and duration, given expected volatility.

In the alternatives space, diversification has become even more critical, and we continue to identify those assets that we believe offer effective diversification away from bond and equity investments.

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