ISSUE 10 SUMMER 2024

INVESTOR

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WILL THE MARKETS SETTLE AFTER THE GENERAL ELECTION?

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WELCOME

As we move into the height of Summer, the dust is settling after the recent general election and we are continuing to navigate somewhat uncertain markets.

In this Summer edition of our Investor newsletter, Chief Investment Officer (CIO) Ben Conway gives his review of the last quarter and a look ahead following the election.

Senior Investment Manager Greg Sellers also takes a look at whether markets will settle following the election, in our regular 'Dear Hawksmoor' feature.

Elsewhere, Research Analyst Emily Cave introduces us to the concept of 'Swiftonomics' – a definition coined in 2023 referring to the economic influence of Taylor Swift, who has stormed stadiums across the world on her recent Eras tour.

Senior Fund Manager Daniel Lockyer discusses upcoming macro and political events and the impact they may have on positioning investments, whilst Senior Research Analyst Robert Fullerton looks at global interest rates.

I hope you are having a relaxing Summer, and that the newsletter gives you a flavour of some of the broader elements that go into the business of managing your investments. As always, if you have a question about any aspect of our service to you, please don't hesitate to contact your Investment Manager.

Sarah Soar
CEO

IN THIS ISSUE

MARKET UPDATE
TIME HORIZONS

Ben Conway, *Chief Investment Officer & Head of Fund Management*

Last quarter in these pages we admitted to an inability to forecast events with any accuracy and additionally observed that even if we could, this would not necessarily help us forecast the direction of financial asset prices. One recent event that was eminently forecastable was the election of a Labour government with a thumping majority. Betting markets had the probability of a Labour outright majority well in excess of 90%, so there was little profit in the correct forecast. We are of the view that the new government has little choice but to be pro-markets and pro-economy in the face of a heavily indebted Treasury and a populace already burdened by some of the highest taxes in the developed world. We await further policy announcements and the Autumn budget, but in the meantime, we remind readers that over the long-term, the nature of governments in developed economies have little bearing on asset prices.

Amid continued gains for all regional equity markets, the second quarter of the year saw a continuation of the leadership of stock markets by the largest companies in the world. We discussed these stocks in the last edition of this newsletter with reference to short cuts or investing by acronym and urged caution. By the end of 2nd quarter, US stocks (as represented by the S&P 500 index - the largest 500 stocks by market capitalisation) were up 14.5%. Six stocks (Nvidia, Microsoft, Apple, Alphabet (aka Google), Amazon and Meta (aka Facebook)) accounted for two-thirds of this gain, and 113% of the Q2 gain of 4% - which means that excluding these 6 stocks, US equities would have fallen in the second quarter. We call this "concentration" or "narrow leadership" in the jargon of the investment world, and it is not necessarily a healthy thing.

We also talked about biases, and we must be as wary of snobbery as we are of excessive valuations of the stocks that continue to power global equity markets. This brings me to time horizons. The valuation of an investment needs to be contextualised in relation to the likely holding period. A great company can be expensive based on the price of its shares relative to its earnings over the next few years, but cheap relative to the earnings it is expected to generate over 5 to 10 years. This is especially true of companies with high expected growth in revenues, accompanied by the belief that profit margins will be maintained. The longer one's investment time horizon, the more one can tolerate bearing the risk of remaining invested in companies that rely on continued growth long into the future. The success of Nvidia as an investment is a function not just of recent sales growth well in excess of even the most optimistic of analyst assumptions just a few months ago, nor the maintenance of a truly eye-watering profit margin, but the extrapolation of these things well into the future. To think that Nvidia can continue to be a good investment involves betting that these trends will continue even longer into the future – and this means necessarily lengthening one's time horizon and thus the risk one bears.

When asked "how much risk can you bear?" in relation to your investments, you are really being asked "when do you think you might need to realise your investments?". The longer you are sure you won't need to realise any of your investments, the more risk you can take. This means you can hold the shares of companies whose valuations are expensive only if their success continues long into the future. The daily share price movements of such stocks ("volatility" in the jargon) can be excessive. Those with longer time horizons should be less tempted to watch daily valuations of their investment accounts and should thus be less bothered by this daily volatility. You might often hear investment professionals be wary of the ability for individuals to view the daily movements of their investment accounts. Human nature means that this can turn even the most patient of investors into short-term worriers, potentially driving emotional investment decisions that do more harm than good. One of the disciplines of the professional investor is to overcome these emotions and match the investment with the risk profile of the client. It is also why last quarter we made the apparently odd statement that the same investment can be suitable for one client and not for another.

The very few companies that are powering equity markets globally are, generally speaking, very good. "Very good" in this context means strong competitive positions. It may therefore be that these companies will "grow into" their valuations.

> *Thankfully, outside these stocks, we can find many opportunities that are less richly valued, and thus carry a lighter burden of expectation. These opportunities do not necessitate taking as long a time horizon to justify their current valuations and thus are arguably less risky.*

Professional investors tend to shun stocks benefiting from narrative-driven flows (e.g. acronym investing) because opportunities exist elsewhere. The UK stock market is one such area. Before the election, the Labour government even referenced the undervaluation of the UK stock market in its document outlining its vision for financial services, "Financing Growth". We therefore find ourselves optimistic that we have a confluence of factors leading to a strong investment case for UK shares: cheap valuation and a government intent on reversing capital flows out of the UK.

The last quarter saw inflation across the world dissipate. This is a necessary condition for interest rates to fall, which is generally thought to be a good thing for the prices of financial assets. The very minimum objective of any investment is to at least keep pace with inflation – something that, over the past 3 years has been very difficult: almost all financial assets have lagged consumer price inflation. We find ourselves finishing this letter observing that a combination of falling inflation and attractive valuations outside of the largest stocks in the world may mean that professional investors can be more optimistic than they have been for a while.

DEAR HAWKSMOOR...

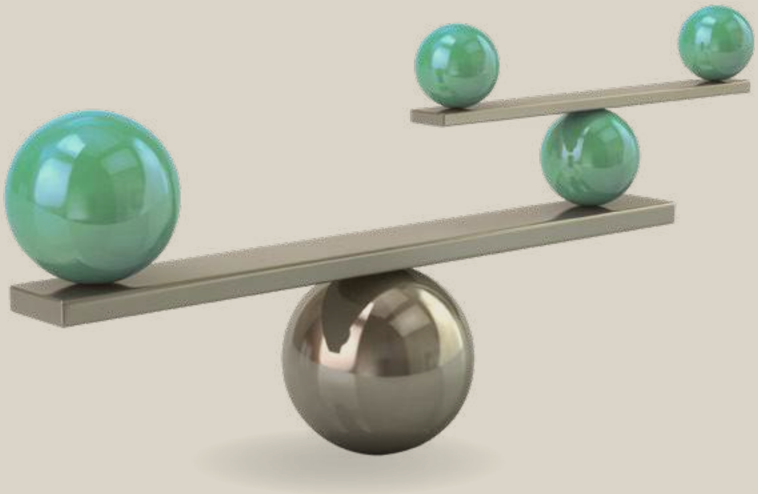
An end to market uncertainty?

As the dust settles after the recent General Election, the UK market has taken the likely political stability from such a large Labour majority in its stride. Stability is something that has been sorely lacking in recent years in the UK and its impact has been felt by the UK financial markets. As I write, it is France that is now experiencing political turmoil and the French market is down some 7% since the beginning of the year (as represented by the French CAC 40 Index). This is in stark contrast to the UK and many other western markets which are firmly in positive territory for the year (as I write).

> *Markets hate uncertainty and the UK has had plenty of that in recent years. However, is this about to change?*

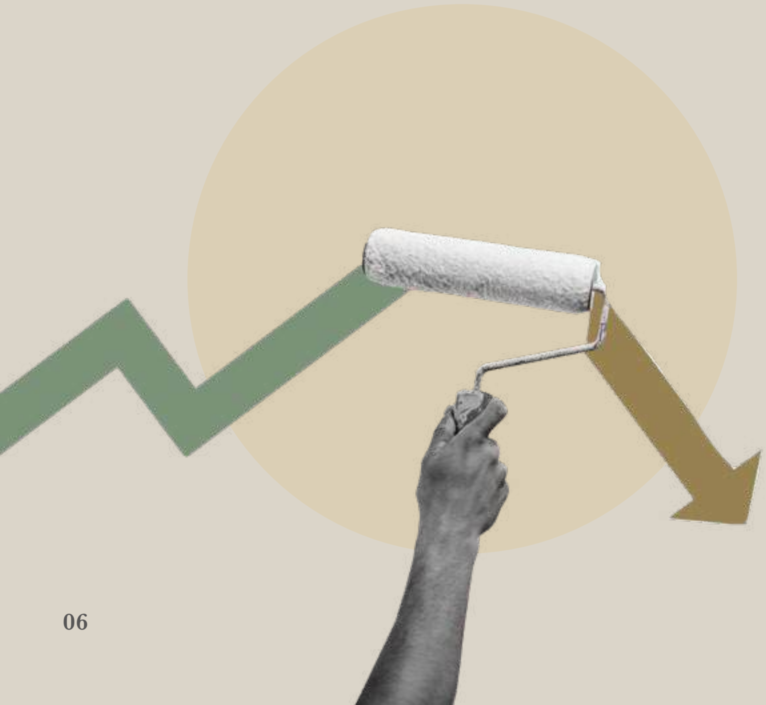
The new Labour administration has a real opportunity to improve the fortunes of the UK market after years of turmoil. The UK market is now cheap by historical standards. Without getting too technical, the average UK listed company is trading at a near 35% discount to the average global peer trading in the MSCI World Index. Mathematically, this is over two standard deviations away from the average which is statistically significant. However, you do not need a maths degree as evidence that UK companies are trading at a discount. The merger and acquisitions (M&A) market provides further proof. According to UK investment bank, Peel Hunt, in 2024, over 30 UK companies have been bid for. This is only second to the US. Clearly, international companies know a bargain when they see one. As an example, UK video game services provider, Keywords Studios, is in the process of being acquired by a Swedish private equity company who offered a near 70% premium to the value at which the company's shares were trading immediately before the offer. Likewise, US company, International Paper, has bid for UK packaging and paper group, DS Smith, at a significant premium of 48%. This will potentially end a near 40-year lifetime on the stock market for DS Smith. According to fund management group, Polar Capital, the average premium for a bidder making an offer for a UK medium-sized company has been over 40%. Over 6% of this part of the market has been bid for since the beginning of the year.

Whilst such bid premia are exciting for investors in the company being bid for, the shrinking number of companies listed on the UK stock exchange is a cause for concern. On a more positive note, it should alert international investors that the UK is worth a second look after years of tumult. I am reassured that the new Chancellor has been reaching out to the business community and seems to recognise the importance of the UK's capital markets as part of a thriving economy. Of course, it is early days and the proof will be in the pudding but as long as the new Labour administration do not do anything too calamitous, the UK market may enjoy a good relative period of outperformance if international investors start to return. The tide may have already started to turn – May 2024 saw the first inflow of monies into UK equity funds after 36 consecutive months of outflows.



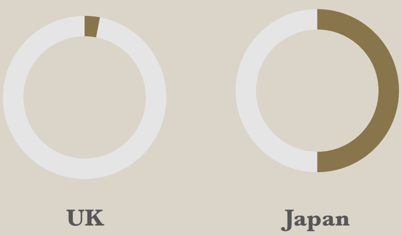
My wish list for the new Chancellor to stimulate UK capital markets is as follows:

1. Scrap stamp duty on UK share purchases (a 0.5% transaction tax on the purchase of UK listed companies).
2. Demonstrate to international investors that the UK is once again a politically and economically stable place to invest.
3. Encourage UK pension funds to support the domestic stock market.



The final wish is worth expanding on. According to figures from the Office for National Statistics, the pension market is worth an estimated £2 trillion. That's a lot of money that potentially could be invested in the UK. However, the average UK pension fund only holds 3% of its assets in the UK market, even though the UK market comprises 4% of the global market. This is in stark contrast to say, Japan where the average Japanese pension fund invests nearly half in its domestic market, despite Japanese equities having a far lower allocation in the global index. The same is also true of the US, France, Italy and Australia to name a few.

Pension Funds:
Allocation of Assets in Domestic Markets



The opportunity for the new government to reinvigorate the UK market is sizeable. It will, however, take some bold policy decisions and patience. We shall see…

Article by Greg Sellers
Senior Investment Manager

FICKLE FRIENDS

Robert Fullerton, *Senior Research Analyst*

JD Vance was previously only known to me as the author of a book called Hillbilly Elegy, which later became a Netflix film. It's an autobiographical story about his working-class origins in the Appalachian mountains and how he overcame a difficult childhood to go to Yale. While promoting the book in 2016, he said "I'm a never Trump guy". Now apparently he might end up as Trump's Vice President.

Donald Trump and JD both believe one of the key problems facing the US is a strong dollar. JD has even quizzed Jerome Powell on the subject in a Senate committee hearing and appears to believe the strong dollar is at least partly driven by the dollar's status as the world's reserve currency, which he would like to end. I have news for JD about this, but that will have to be a different Investor article. Let's see if he can get himself elected first.

Why do they think this? The dollar became the world reserve currency as part of Bretton Woods towards the end of World War Two. This created global demand for dollars. The stronger dollar encourages imports and makes exports from the US more expensive. The US runs a trade deficit with most obviously China, who then reinvests its surplus back into the US – both into equities and US Treasuries.

This is one reason the US equity market is so strong, but it is also one reason the US has significantly de-industrialised. Trump and JD want the US to start making things and exporting them again, and a weaker dollar would help.

In November last year I wrote about the Japanese yen and how cheap it looked vs the strong dollar. It was Y149 at the time – historically low. Despite several interventions by the Japanese central bank, including raising interest rates for the first time since 2006. It has continued to fall and is Y157 as I write, having been over Y160 earlier this month. Rhetoric from Trump and Vance is one reason it has been rising from its lows (or more specifically the dollar has been falling). The US election hasn't happened yet.

As for me being completely wrong about the direction of the yen, all I would say is one feature of markets this year has been momentum. All these trades which looked stretched at the end of last year – credit spreads, growth vs value, the rest of the world vs the US, small cap vs large cap valuations – have all essentially carried on becoming more stretched. The US small cap index has had a huge rally in July but is still lagging behind large caps year to date.

It is important to look at the make up of the rally in Japan. Japan has historically been a significantly export led economy running a trade surplus with the rest of the world. More recently it has fluctuated between a surplus and a deficit. A weak yen has historically tended to help the equity market and especially exporters, but they have not been part of this rally.

A key sector leading the Japanese market at the moment is banks. They have benefitted from rising rates and reasonable economic growth globally. The weak yen does benefit them, for example with loans to foreign borrowers but they should be less sensitive to this than a goods exporter. Japanese banks are particularly diversified. As well as savings and loans, they do wealth management, advisory services, leasing and other services, which has helped them grow profits even in Japan's difficult economic climate. They are generally well funded.

Japanese interest rates are likely to continue rising, even if the numbers are still small and this will help bank earnings even further. Rising rates transfer wealth from borrowers to lenders – in Japan's case this means from the government to the banks.

The point about all this is that Japan's weak yen isn't just their problem anymore. Trump has decided it is a problem for the US as well.

> *The BoJ has been finding out the hard way that you can't always get your currency to go up just because you want it to, but literally anyone can make it go down.*

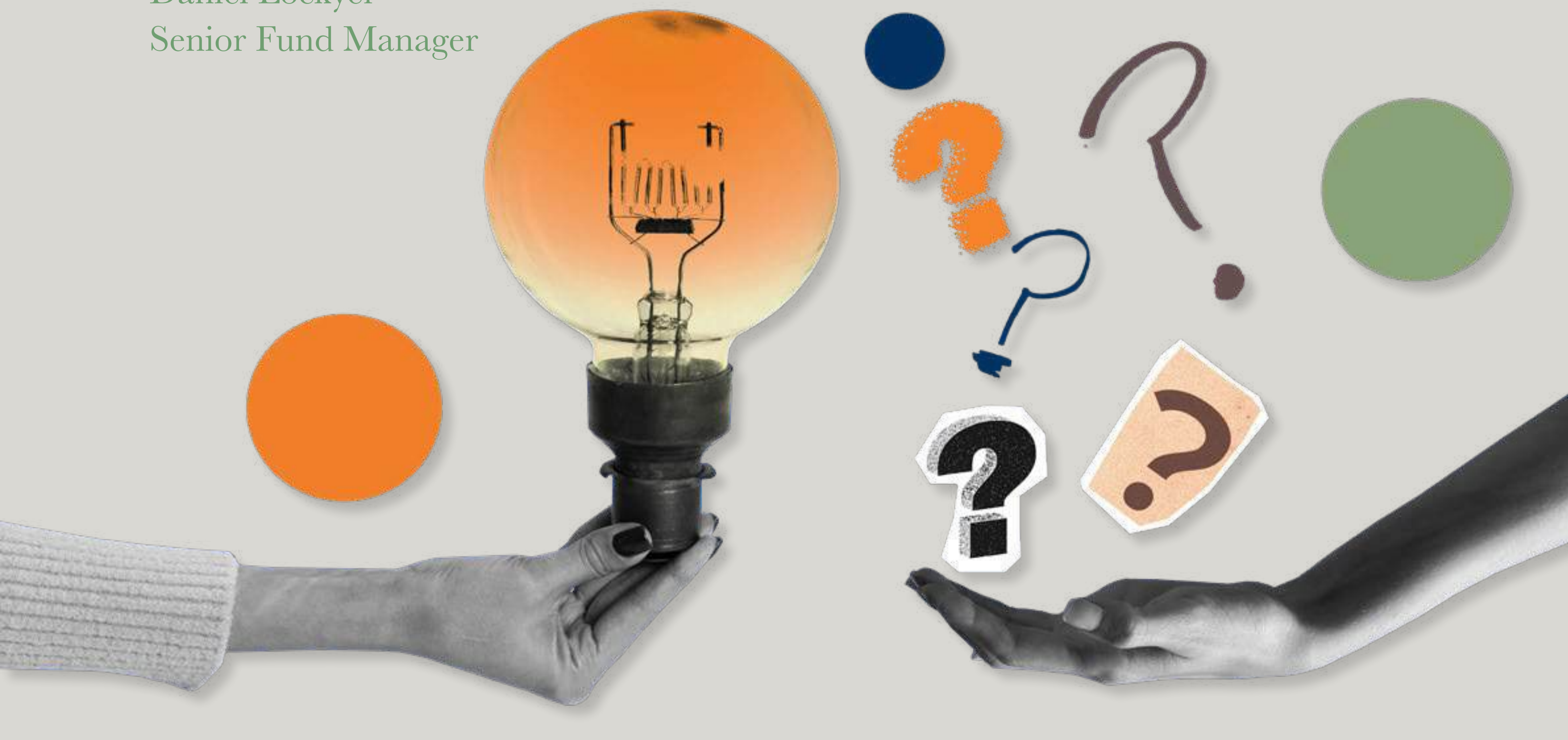
One obvious way to get the dollar down is to reduce interest rates and Trump is already putting pressure on the Fed.

This would have the happy effect of steepening the yield curve – already being known as the "Trump trade". Not only is the market apparently confident about the result, they have given it a name and made a start. Now it turns out we don't even know exactly who is going to be on the ballot.

FUNDS IN FOCUS

THE FINAL PIECE OF THE JIGSAW

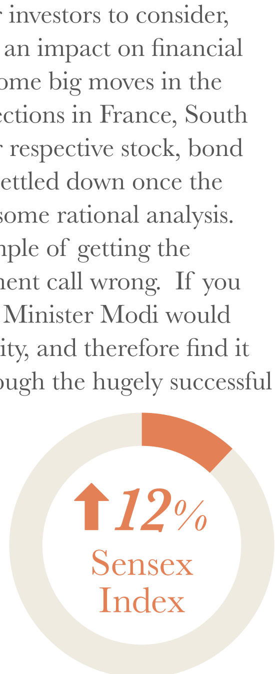
Daniel Lockyer
Senior Fund Manager



We are often asked for our views on upcoming macro or political events and how we are positioning our funds accordingly. For example, at the start of the year, the market was pricing in six interest rate cuts by the Federal Reserve in the US. If you had correctly guessed there would be none by this point in the year, you might have reflected that view by shorting the high growth Nasdaq index. This would have cost you dearly with the index up over 20% so far!

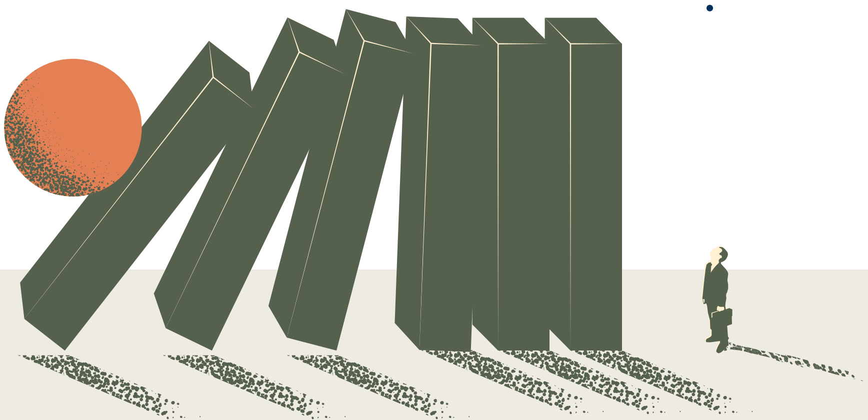
> *"The answer is always that we don't have any edge in forecasting such events so don't try, but crucially even if we did get the prediction right, making the correct consequential investment call is often even harder.*

This year has been well flagged as a huge election year with more than half the world's population going to the polls. This has naturally created plenty of news headlines and has given lots for investors to consider, but has it really made much of an impact on financial markets? While we have seen some big moves in the immediate aftermath of the elections in France, South Africa, Mexico and India, their respective stock, bond and currency markets quickly settled down once the certainty of the result allowed some rational analysis. India's election is another example of getting the prediction right but the investment call wrong. If you had forecast that India's Prime Minister Modi would fail to secure an outright majority, and therefore find it harder to continue to push through the hugely successful reforms, you might choose to sell your Indian equity exposure. That would have been the correct call for 24 hours when the market sharply fell on the news, but ***the Sensex Index is up 12% since then (4th June 2024 to 31st July 2024).***



Looking at our own country, how have the UK markets responded to Labour's landslide victory in the recent election? As everyone already knew that Labour were odds on favourites to win with a large majority, it was no surprise that markets were relatively calm the next day. Any ripples would only have occurred if a result other than a Labour majority had transpired. However, the removal of that uncertainty regardless of how likely the result, has definitely improved sentiment towards UK assets – not difficult considering sentiment was rock bottom after years of political shambles! Without going into the whole set of policies, a commitment to growing the UK economy, but without the reckless borrowing suggested by Truss/Kwarteng, should benefit UK domestic orientated companies which tend to reside in the small and mid cap indices. We have been heavily invested in UK smaller companies funds for at least 18 months, a decision not predicated on the outcome of a future election, but on the valuation case where single digit multiples and high dividend yields were commonplace and indicated a huge margin of safety even if a recession occurred or further political turmoil ensued. But it wasn't just small caps that were outstanding value a year ago, Artemis UK Select's mostly large cap portfolio was trading on an 8.7x PE as recently as February this year, and is still just 9.3x despite returning 14% this year. For context, the UK market as a whole trades on 11.5x forward earnings today (10 year average 13.1x), which compares to the US market's 21.4x (10 year average 17.9x). (Source JPM Guide to Markets.)

These depressed valuations do not hang around for long, as trade buyers, private equity, or the companies themselves will buy the shares. The amount of company buybacks is significant with around half the UK index buying back their own shares at a rate of around £1bn per week. This is helping to offset the relentless selling by pension funds and national wealth managers, with the current running total at £22bn redeemed from IA UK equity funds over the past 3 years – we understand that is a run of 37 consecutive months of outflows!



Today, PE ratios are still below long term averages, balance sheets are strong, dividend yields are high, company share buybacks are rife, inflation seems to be under control, interest rates have probably peaked, the economy seems on a steady footing and we have a settled government now the election is out the way. The missing ingredient is the inflows to the sector which we believe is mostly caused by the low weight of the UK equity market in the global indices tracked by so many passive investors.

> *At just 3.7%, the entire UK equity market is a smaller weight than either Nvidia, Apple or Microsoft, each representing more than 4% individually in the MSCI World Index.*

Further, the UK is the only country in the G7 whose pension funds are underweight in their domestic equity markets – all the rest are materially overweight relative to the weighting of each region in the MSCI World Index. Given the significant tax breaks enjoyed by pension funds, it wouldn't be a surprise if Labour is aggressive in going after this and mandating more investment in UK companies from pension funds. It feels as though inflows are the final piece of the jigsaw for a rerating to occur.

Unless you are very good or very lucky at market timing, being early in investments is crucial both in terms of buying and selling. It can be incredibly uncomfortable to be owning more UK small caps than US tech stocks, but while we have missed the end of the US equity bull market, we won't be there when it has its inevitable setback, and at least we captured all the small cap recovery.

There is never one reason why a stock market rises or falls so an election on its own is not a reason to panic or get too excited. Hence our reluctance to offer opinions on such events.

SWIFTONOMICS

Emily Cave, *Research Analyst*

Swiftonomics is a definition which was coined in 2023, and refers to the economic influence of Taylor Swift. Last year both Taylor Swift's Eras tour and Beyonce's Renaissance tour caused a few global economies to have a surge in inflation. They weren't the only reason, but they certainly added to it. For instance, Taylor Swift, Beyonce, and Barbenheimer added $8.5bn to the US GDP last year according to Bloomberg. And when Beyonce brought her tour to Sweden's capital city it caused a surge in accommodation and restaurant costs by 3.3% compared to the month before her concert – this similarly happened in Paris.

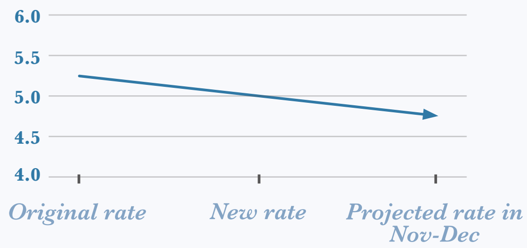
Now you may or may not know that Taylor Swift is currently on the European leg of her world tour. In June she played in Wembley to almost 90,000 people per night (she played there three nights and will play another five nights at Wembley in August). The tour has become the largest grossing tour of all time, even beating Elton John's Farewell Yellow Brick Road tour and Coldplay's Spheres World tour, who claim the second and third spots respectively. Her concerts are some of the most highly attended concerts of all time, she played Murrayfield in Edinburgh to nearly 73,000 people per night and it made history by being the most people to attend a concert in Scotland.

During her time in Edinburgh (three nights) she brought £100million to the Scottish economy. And it is estimated by the time she completes her UK dates she will have brought around £1bn to the UK economy. This comes from not just ticket costs, but hotel fees, merchandise, cost of food and drink whilst in the host city, car rentals, shopping, transport to the host city, and more unexpectedly outfits to wear to the concert. The average ticket holder for the Eras tour will spend £848 per head on tickets, travel, accommodation and outfits. For reference, I spent just under £400 total on my Eras tour experience, but I had accommodation covered (i.e. I stayed at my family home for free), and I walked to and from Murrayfield from said family home. But I can easily understand how that figure can be reached.

> *The June weekend at Wembley was expected to bring over £300million to London alone, and Liverpool expected a 115% increase in hotel prices during the nights she played at Anfield.*

I am a Taylor Swift fan, and I do have a financial point to all this. It's been proposed that her August Wembley dates clash with a key inflation index day, meaning it might influence the Bank of England interest rate discussions.

We know that the Bank of England cut rates at the beginning of the month to bring interest rates from 5.25% to 5%, but will we see a spike in inflation numbers during August when she plays Wembley again, this time for 5 nights? Current consensus is there will be a further rate cut in November or December to 4.75%.



Again, this is merely a potential factor to be considered, there is still the issue of sticky service price inflation. Currently wage and service inflation remains at 5.7%.

But it got me thinking about the influence events of even one tour can have on entire cities and country's economy. And events which the market has never fully accounted for before. We are all aware of the financial cost and benefits of hosting large sporting events like the Olympics or the Euros. For example, it was estimated that Germany will see a €3.8 billion boost to its hotel and retail sectors during the Euros.

> *The Paris Olympics have been expected to generate between €6.7-€11.1 billion in net economic benefits to the Paris region.*

And it is estimated around €2.6 billion will be spent by tourists during their visits to Paris whilst the games have been happening. But that is mainly one country or region benefiting, now look at the Taylor Swift tour and its impact on almost every country and city she plays in happening simultaneously. An important note being that hosting a large event, like the Olympics, has a cost for the host country. Around €10 billion has been spent on hosting the Paris Olympics, with over €3 billion of that coming from French taxpayers. The Taylor Swift economy boost is all profit as no city is building a new arena for her to play in.

I think we all knew the increasing power celebrities have, from influencing brands, even getting people to register to vote, and even impacting share prices on single stocks. Look at some of Tesla's share price moves when Elon Musk has tweeted, or when Kylie Jenner said she didn't use Snapchat anymore and its share price fell by $1.3bn. But now add in the potential to influence financial markets by impacting inflation numbers…it has definitely reached new territory.

It's not just economic benefits Taylor Swift is bringing to each city she visits, she has donated heavily to food banks in every UK city she has visited on her tour. In Liverpool, one of the food banks said her donation will help them get through the next year, and in Cardiff the food bank said the donation is equivalent to 10,800 meals which can now be provided. She has also done the same in a number of US cities during her US leg of the tour.

On top of this, her concert in Edinburgh generated significant seismic readings due to the dancing, and yes, applauding whilst she was playing. The British Geological Survey posted a seismograph on the Friday evening and pinpointed three times during the concert which produced significant frequency readings, meaning she caused seismic activity. This was during her songs "Cruel Summer", "…Ready For It?", and "champagne problems". At the end of champagne problems there is a 4-minute applaud which caused the reading. I couldn't believe it myself but I guess that's the Taylor Swift effect…

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