Antipodes

Quarterly Outlook June 2024

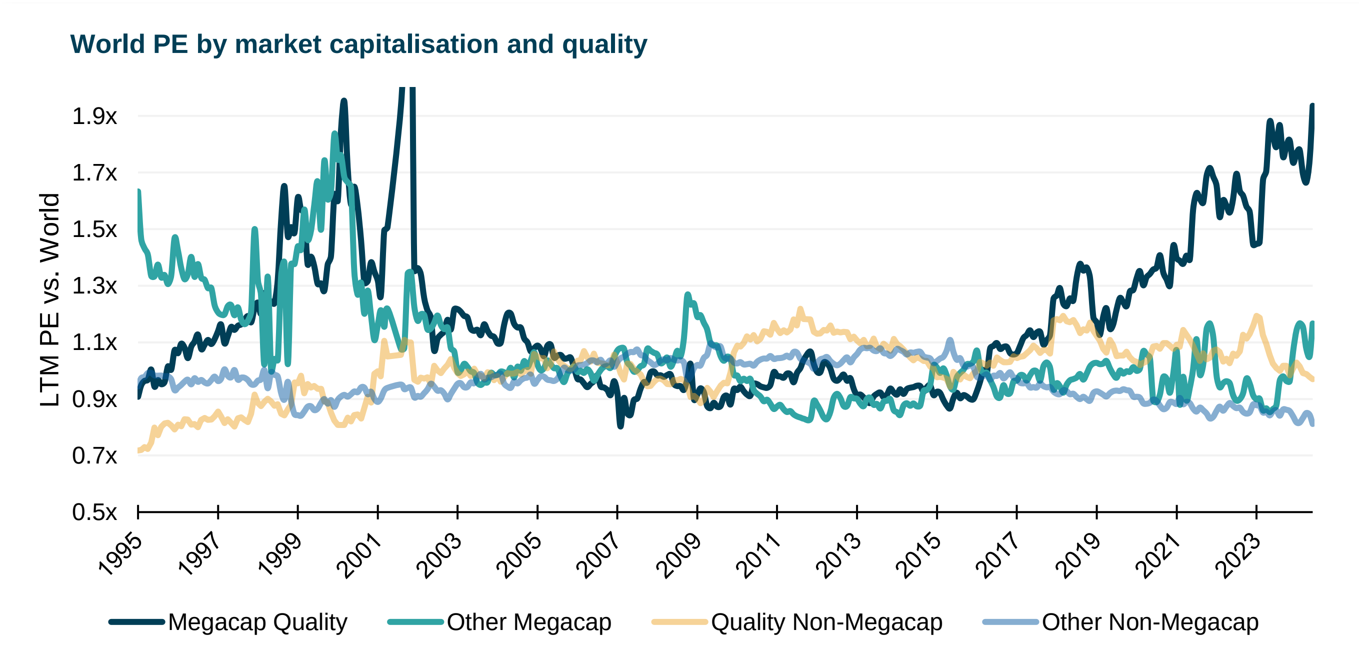
As we head into the second half of the year the equity market remains fixated on the AI investment cycle, and almost singularly focused on Nvidia. The MSCI ACWI rose almost 12% (in USD) in the first half of the year with Nvidia alone accounting for almost one-quarter of this move. Add the other Fab Five (Microsoft, Apple, Google, Amazon and Meta) and these six stocks accounted for 50% of the MSCI ACWI's first half gains. The performance of this group, however, is becoming inextricably linked, reinforcing market concentration and the narrowness of returns.

Comparisons to the dot-com bubble abound, and while there are nuances between now and then (on most measures Nvidia's valuation is not as stretched as Cisco and co in 1999/2000), parallels exist. For example, Cisco, a networking business, produces the plumbing for the internet. In the dot-com era the business was considered unassailable; barriers to entry were high, the Internet was expected to change our lives, the company's growth and profitability were forecast to get stronger. In retrospect these arguments still hold true, but ultimately the extent of this non-linear change played out over a much longer period than expected. Likewise, AI will change our lives in ways we cannot predict and today Nvidia's GPUs are facilitating this change. But it is not correct to assume – or price – that Nvidia will, over the long term, maintain its monopoly status and a gross profit margin of over 70%. In a market-based economy, large profit pools come under attack. We would also argue that the range of outcomes in the early phase of a disruption cycle are wide and, arguably that is not reflected in NVDA's current market value. Going deeper, whilst the company's Cuda software ecosystem represents an effective lock on LLM training GPU deployments, we're not sure the same applies for inference deployments where both AMD and custom silicon will have far greater opportunity to compete.

We refer to concentration in profits and narrowness of stock market performance, but the extent of re-rating in a specific cohort – Megacap Quality – should not be overlooked. Megacap Quality (megacaps with a high degree of profitability) are priced at 2x the world PE, which is extreme relative to this group's own history and, perhaps more surprisingly, relative to other Megacaps and other Quality stocks (Figure 1). That is to say, not all Megacaps and not all Quality stocks are equal.

Further, the valuation differential between Quality Megacaps and Non-Megacaps is at dot-com era extremes.

Figure 1: Not all megacaps are equal



Source: Antipodes, FactSet

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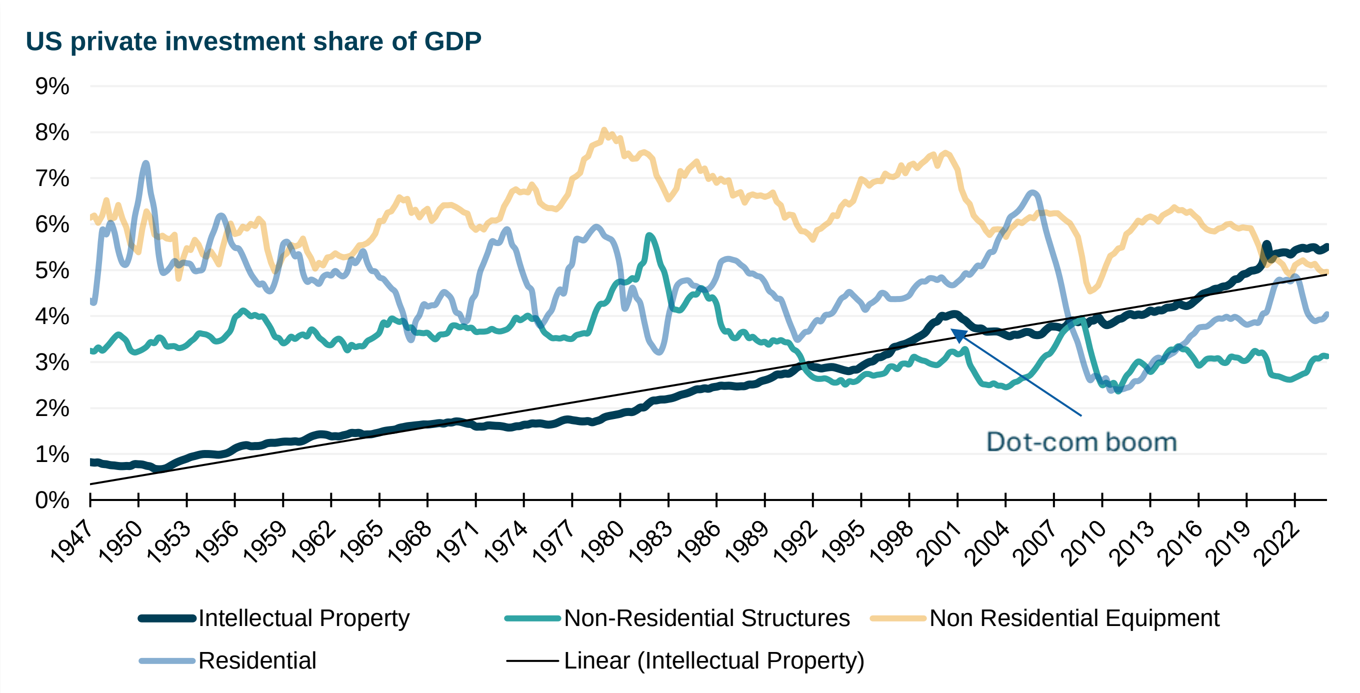
While “Quality Megacaps” include an assortment of stocks such as Eli Lilly, Visa, Procter & Gamble, Hermes, Coca-Cola & Home Depot to name a few, the complex is dominated by semiconductors and software. This is a function of the acceleration in investment in software, which has been running above trend for several years (Figure 2). It’s now the largest component of US private sector investment and its growth has helped offset the slowdown in residential and non-residential investment. This outsized software capex cycle, along with strong US household consumption, has helped power the US economy.

Figure 2: US private investment share of GDP; software substantially above trend



Source: Antipodes, MacroBond

Cross-currents in the US

Data released over the recent quarter continues to suggest policy tightening lag in action and that the US consumer is normalising. COVID related excess savings are almost exhausted across all income cohorts, the fiscal impulse is weakening, the credit impulse is negative, retail sales continue to decelerate towards long-term trend growth rates led by a slowdown in goods, and the employment balance is returning to pre COVID levels. The abundance of jobs relative to unemployed people is evaporating and any further decrease in job openings will have a more significant impact on unemployment and wage growth.

There is also evidence of stress in the credit sensitive parts of the market. Private credit today represents around $1.6t in total lending and has grown rapidly in recent years, competing with the high yield bond and leveraged loan market, traditionally described as junk borrowing in terms of credit quality. This cohort today accounts for 32% of total corporate debt, and the share of private credit has grown substantially since the 2008 financial crisis. It’s also been instrumental in the growth of the highly leveraged playbook of private equity.

Higher rates has led to rising delinquencies and deteriorating interest coverage across all debt profiles, but assessing the extent of risk building in private direct lending is incredibly challenging since it’s very opaque. Ares Capital Corporation, one of the largest listed Business Development Corporations which provides credit to small and medium sized businesses in the US, reported that interest coverage has halved to 1.6x for the

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average corporate borrower within their structure as servicing costs have increased to over 10%. This structure itself is also geared at 1:1 debt to equity supported by banks and public markets. Peer comparisons suggest similarly worrying statistics. Zooming out, companies and structures that employ a high degree of leverage, including private credit, support businesses across technology, retail, healthcare and services which we estimate together account for more than 20% of employment in the US. It's not difficult to see that if policy remains tight there can be much broader implications for the real economy.

The Fed's ability to achieve a Soft Landing is contingent upon core inflation falling fast enough to avoid the Higher for Longer scenario. While services is dis-inflating, goods inflation is already at a 50-year low. Leading indicators such as US import prices and China PPI[1] have been inflecting for many months which suggests goods could re-inflate and arrest some, or all, of the disinflation in services. This is not appreciated by the market. Our view remains that the equity market is over-pricing a Soft Landing (dovish rate cuts) and under-pricing the probability of Higher for Longer and the risk this transitions to a Hard Landing (recessionary rate cuts) via a credit event.

There are cyclical risks building in the US economy - but it's not all bad news.

We are at the beginning of a policy-led energy transition and onshoring investment cycle.

The US government has announced direct, incremental spending of ~$185b each year for the next five years across the Infrastructure Investment and Jobs Act, the Inflation Reduction Act and the CHIPs Act. The focus of these programmes is climate and infrastructure, and this investment is substantial in the context of total government investment c. $1t in 2023. This is before any potential additional investment from the private sector, which has historically invested $5 for every dollar of government spending. The question is whether this government-led investment cycle, along with tech investment, can offset the cyclical slowdown in the US economy.

What does this mean for equities?

We don't doubt that there is a long-term trend where innovation is becoming a bigger part of the US economy, but around that trend there will be cycles. What Figures 1 and 2 show is that the software cycle is not priced for mean reversion, which does not align with the range of outcomes:

- Higher for Longer: policy remains tight which will affect the availability of capital

- Soft Landing: dovish rate cuts will sustain an investment cycle, but a new government-led energy transition investment cycle designed to encourage private investment via tax credits. Does this lead to greater competition for capital and a higher a neutral rate?

- Hard Landing: unemployment will rise and private investment will slow which will likely feed earnings disappointments across both consumer and corporate facing Megacap Quality stocks.

On the other hand, a stronger, tangible - or property, plant and equipment – led investment cycle is not priced to develop. Further, the beneficiaries of investment in climate and infrastructure are listed globally, they aren't disproportionately US-listed businesses like Megacap Quality technology stocks.

A pivot in the investment cycle can be the catalyst that drives rotation in equity markets, and shrink the premium embedded in US equities relative to the rest of the world.

1 PPI (Producer Price Index) measures the change in prices producers receive for their inputs, which feeds into the price of final goods.

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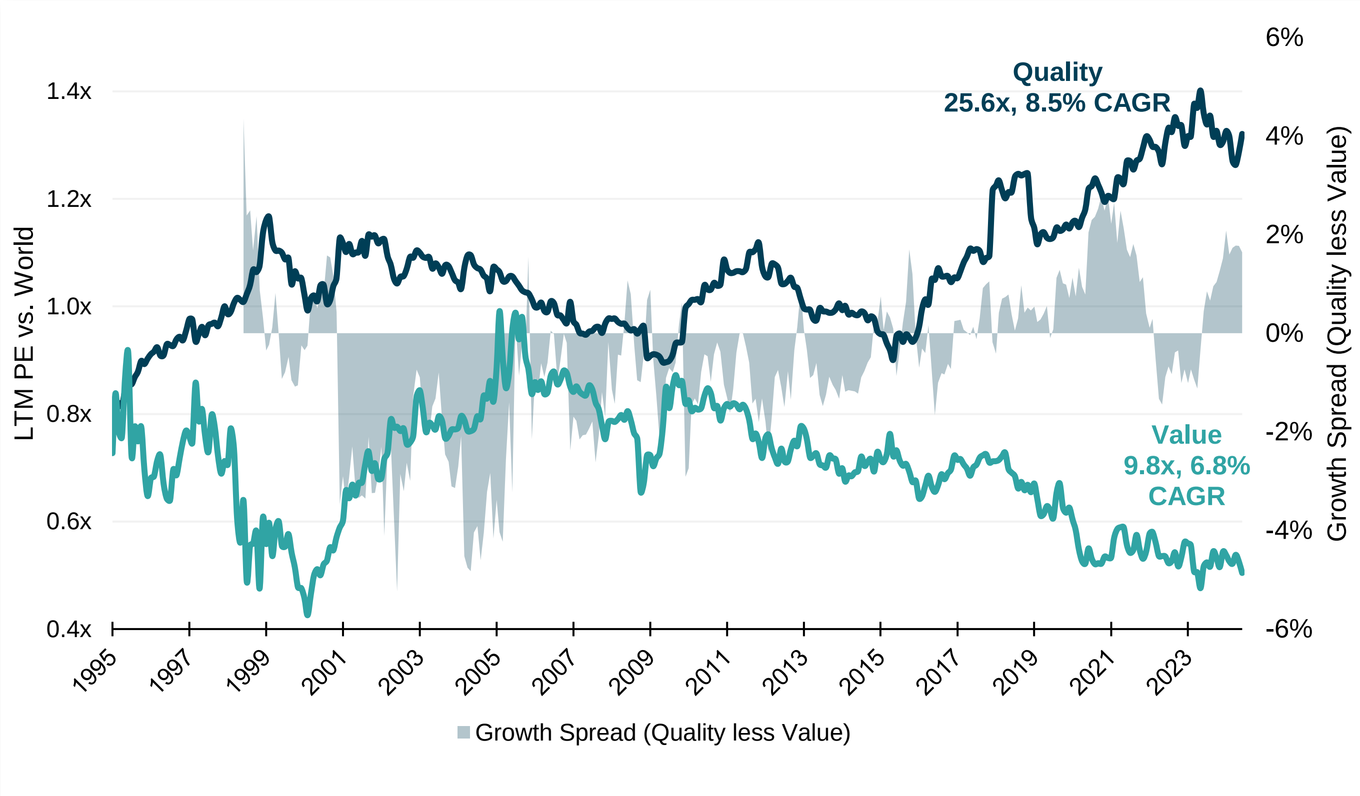
The final anomaly worth highlighting is the price investors are prepared to pay for growth in Value stocks versus Quality stocks.

Value stocks are priced at a large discount to the benchmark multiple versus Quality stocks at a premium (globally and on a regional basis) – this is not new news, but it is worth noting that the relative discount and premium is the largest in 30 years (Figure 3). Today, investors are prepared to pay 26x earnings for Quality stocks that are compounding earnings at 8.5% p.a. **2** but only 10x for Value stocks growing earnings c. 7% p.a. The Quality cohort is growing its earnings faster than the Value cohort, but is the growth differential sufficient enough to justify the very meaningful valuation premium? Our view remains that opportunities are available at very attractive valuations for investors prepared to look beyond today's main acts.

Figure 3. Value vs. Quality



Quality (Value) represents top quintile of global profitability (low multiple). Growth measured as 7Y historic + 3Y forward EPS growth. Growth spread highlights difference between Quality and Value growth profiles.

Source: Antipodes, FactSet

Growing probability of cyclical recovery in Europe and China

During the quarter the European Central Bank (ECB) cut rates for the first time in five years – and this is the first time the ECB has cut rates before the Fed. Unlike the Fed, the ECB has cut ahead of the sticky elements of inflation turning and the risk is policy isn't loosened as aggressively as the equity market would like. The European economy has been much more sensitive to the hiking cycle than the US; economic growth has been flat and credit growth has been negative. In a similar vein we expect Europe to be relatively more sensitive to the loosening cycle.

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On a longer-term view, the picture isn't as straightforward. Europe remains vulnerable to a stagflation scenario as an increasingly politicised ECB is expected to backstop decarbonisation, manufacturing re-localisation, and increase defence spending across the EU. This is against a backdrop of populist fiscal policy at a country level, which appears to be intensifying. For now, however, a few rate cuts can breathe life into the European economy at a time when disposable income is rising.

The quarter also saw policy makers in China take a more proactive approach towards managing – or clearing – excess inventory in the property sector. "Destocking" has been used in government communications for the first time since 2016. Initiatives have been announced that will see local governments, state owned enterprises (SOEs) and others buy inventory to convert to rental, social housing or even offer discounts to get buyers to return.

Since these announcements monthly secondary sales volumes have meaningfully picked up (following a strong 2023 that saw secondary volumes grow 30% yoy) and monthly primary sales volumes have also improved, although not to the same extent. While this is a move in the right direction, more still needs to be done to restore household and investor confidence e.g. clarity around funding from the central government and proof of commitment by SOEs and local councils to act.

We continue to forecast new sales will stabilise at around 8m units a year in in 2025, compared to 16m at the peak in 2019/20. Recent policy action can also put a floor under house prices, which are currently down 20 – 40% depending on the city, and would negate the deflation spiral argument which has weighed significantly on consumer confidence. We estimate that around 60% of household wealth is tied up in property (similar to Australia) and any improvement in property prices will not only stabilise the sector but also support consumption and household credit growth.

Political upheaval takes centre stage

2024 will see a record number of voters go to the polls and while elections were well and truly underway in 1Q24 some of the more recent results noted in our Portfolio Commentary have dominated headlines. The results of some of these key elections, whether in Developed or Emerging markets, show the political pendulum is swinging. At the top of voters' minds is rising cost of living/housing, growing inequality and a backlash against immigration.

And the Biden – Trump rematch in November only adds to the tension.

Biden and Trump are both adopting a populist, loose fiscal stance – though Trump is tilting marginally more inflationary. More will come to light in the coming weeks and months but both candidates have policies around protecting domestic industries (e.g. rebuilding manufacturing), Biden is expected to lean further into investment in renewables and the grid and increase corporate and high-income tax rates, while Trump is expected to extend tax cuts, introduce more aggressive tariffs and take a tougher stance on immigration. Regardless of which candidate succeeds, the fiscal deficit will come under greater scrutiny.

Portfolio positioning

Given the backdrop of economic and political volatility, we have been adding to attractively priced defensive assets, and where we have added to cyclical exposure the focus has been beneficiaries of structural investment trends like AI, the energy transition and supply chain re-localisation.

Healthcare remains a key cornerstone of our long book, anchored by Merck (where key therapies continue to deliver e.g. immuno-oncology drug Keytruda which generates sales of c. $28b and is expected to grow c.

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14% this year along with HPV cancer vaccine Gardasil which is growing c. 6%) and Sanofi (which has begun the process of unlocking the value in its leading consumer health business). In addition, portfolio holding Alnylam reported a best-case scenario Phase 3 trial result which saw the share price increase 60% over the quarter.

We continue to add to our Infrastructure exposure via Ameren, a regulated utility in Midwest America with almost 85% of its asset base in electric transmission, distribution and generation. The company will be a key beneficiary of the Inflation Reduction Act, with investment in renewables and long-distance transmission to meaningfully increase in Ameren territory, and it complements our existing holding in American Electric Power.

The impact of AI on the power equation is also very real. The International Energy Agency suggests that datacentres will increase from 4% of electricity demand to 6% by 2026, driven by AI workloads. Today, an AI query requires 10x more energy than a Google search. Running AI workloads will undoubtedly become more energy efficient over time, but AI prompts are still only running at a fraction of daily Google searches. The point is the ongoing investment cycle in electricity production and grid efficiency is supported by the shift to renewables *and* AI.

On the topic of AI, we continue to look for Pragmatic Value exposures to this investment cycle, recently adding Samsung Electronics to complement existing hardware exposures TSMC and Qualcomm. The memory market is recovering from a deep downcycle driven by weak demand from servers and personal electronics. With demand recovering the industry has generally worked down its excess memory inventory – and one of the strongest drivers of demand is AI. AI servers require a special type of DRAM called High Bandwidth Memory (HBM) which is used inside AI chips as well as greater system DRAM. The result is AI servers have 6 – 8x more DRAM content than a regular server, and similarly AI enabled smartphones and PCs require up to 2x more DRAM to run AI features locally. Given the oligopoly structure of the memory industry, Samsung will be a key beneficiary of the AI investment cycle. At c. 1.4x book, the company is priced at a discount relative to its own history and peers.

We have rotated our exposure in Industrials/Materials, favouring global cyclicals that will benefit from the energy transition capex cycle. Over the quarter we added aluminium to the portfolio to complement our long-held exposure to copper. A reduction in competitive bauxite supply in China has reinforced a policy of Chinese smelter capex discipline (which has moved from net exporter to importer), the closure of capacity in the West and low levels of inventory can keep the supply/demand equation tight - a positive for the aluminium price. We see upside to aluminium's growth profile from decarbonisation via light-weighting and green supply chain goals due to aluminium's recyclable properties. Alcoa is the only substantial aluminium producer in the US which could see the company become a beneficiary of geopolitical tensions should aluminium receive strategic metal status.

We continue to remain overweight European financials and underweight US financials. Even as the ECB (and potentially the Bank of England) cut rates, European and UK banks can cut deposit rates and still see net interest revenue grow as a large proportion of assets (primarily mortgages) roll off onto higher yields relative to where they were fixed several years ago. This is particularly true for our core holdings Société Générale, as France experienced the fastest pace of deposit rate increases in the Eurozone, as well as NatWest in the UK. Our European financials are generally over-capitalised with opportunities to increase payout ratios and buybacks, and we see our collection of holdings achieving mid-to-high teen total shareholder return yields over the next one to two years. This is a very attractive valuation compared to US financials, where capital ratios are lower and requirements are increasing, limiting the scope to meaningfully increase total shareholder return yields to high single digits.

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While the Chinese economy remains under pressure the policy direction is improving, and we see three broad buckets of opportunity covered in more detail in our recent Good Value Podcast:

- Attractively priced cyclicals that have consumer and property exposure e.g. Alibaba and KE Holdings (the largest property portal in China, with a disproportionate share of secondary transactions).
- Defensive businesses e.g. Tsingtao Brewery (second largest beer company operating in a consolidated market, priced at 6x earnings ex cash).
- Structural growth opportunities around advertising and AI adoption, decarbonisation (e.g. investment in China's grid) and localisation (e.g. Kingdee, a local enterprise resource planning software business which can grow at the expense of global players like SAP and Oracle as China focuses on developing domestic champions).

Beyond China, LATAM has had a tumultuous quarter as concerns around political and fiscal sustainability and higher for longer rates in the US weighed on their domestic markets. Claudia Sheinbaum's landslide victory in Mexico led to concerns around the power of independent bodies, but the appointment of respected technocrats to key cabinet positions reduces the risk of governance issues and a blowout to the fiscal deficit. We have trimmed our holding in leading convenience store operator Fomento Economico Mexicano (FEMSA), though we continue to see growth opportunities for the company, including via consolidation, and it appears costs (notably wage expenses) will be held in check.

In Brazil, the revision of the fiscal deficit target to accommodate more spending saw fear ripple through the market. Emphasis on reducing expenses and a pause in the rate cutting cycle to re-anchor inflation expectations provides some assurances, though valuations broadly continue to price in a poor macro outcome. There has been no change to our two key positions: Itau Unibanco is seeing loan growth re-accelerate with scope for provisions to come down, and a higher for longer rate scenario can be a positive tailwind for net interest margins; cash and carry operator Sendas Distribuidora continues to gain market share and is now the largest grocery retailer in Brazil with scope for profitability to increase as new stores mature, and we see no risk with the company's ability to service its debt in a tighter policy environment.

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Fund summaries

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