Antipodes

# **Quarterly Outlook** September 2024

At the tail end of the quarter, two of the world's most influential economies surprised the market. The US Federal Reserve cut policy rates by 50 basis points – the first cut in four years, and larger than anticipated. Not long after, China unveiled its most comprehensive stimulus package this economic cycle, marked by both its scale and urgency, with assurances more fiscal measures are to come. In response, Chinese equities surged nearly 25% in the week following the announcement. We anticipate the price action in China will remain volatile until clearer details around these policies emerge.

### Is China's new stimulus enough?

As China's post-COVID economic backdrop continued to deteriorate and investors all but lost patience, the calls for more stimulus were deafening. The Fed's recent loosening gave China the scope to announce more aggressive stimulus without placing the Chinese Yuan at risk. The Chinese Communist Party (CCP) responded with a more comprehensive plan including the promise of more fiscal stimulus, funded from ultra long-term and special sovereign bonds. The out-of-cycle policy meeting, typically reserved for exceptional circumstances, underscores the significance of the announcement. The last time was in March 2020, at the peak of the COVID crisis. While the full scale and direction of fiscal stimulus is still unclear, the tone of the CCP represents a shift in direction, which is encouraging.

The most significant policy so far is the near-$120b in stock market support. Institutional investors can borrow against existing assets to purchase equities and the People's Bank of China (PBoC) will provide subsidised funds for listed companies and controlling shareholders to buy back stock. Additionally, mortgage rates and down-payments have been lowered with the goal of stabilising the property market, and liquidity in the banking system has been increased to encourage lending and flows into growth/risk assets.

These recent announcements are positive, but they may not be enough to pull China's domestic economy out of its funk. The CCP needs to do more to repair household and business confidence to stimulate broader economic growth, not just an equity market rebound/sugar rush.

At the peak, property activity broadly accounted for 25% of GDP, and an enormous amount of household wealth is tied to property (we estimate c. 60%, similar to Australia). With household wealth depreciating, it's unlikely consumers will boost spending or invest in the stock market. Likewise, while confidence remains weak, the primary constraint on credit growth isn't liquidity it's lack of demand.

Lower mortgage rates and down-payments are helpful but need to be complemented with policies that provide financing for property developers to deliver existing presales and/or more support for State Owned Enterprises (SOEs) to purchase unsold inventory and repurpose as social or rental housing as progress here has been disappointing (e.g. improving the funding mechanism or lowering the cost of funding to encourage SOEs to step up purchases). Weak transaction volumes in the primary market and weak property prices in the secondary market are a key overhang on household confidence.

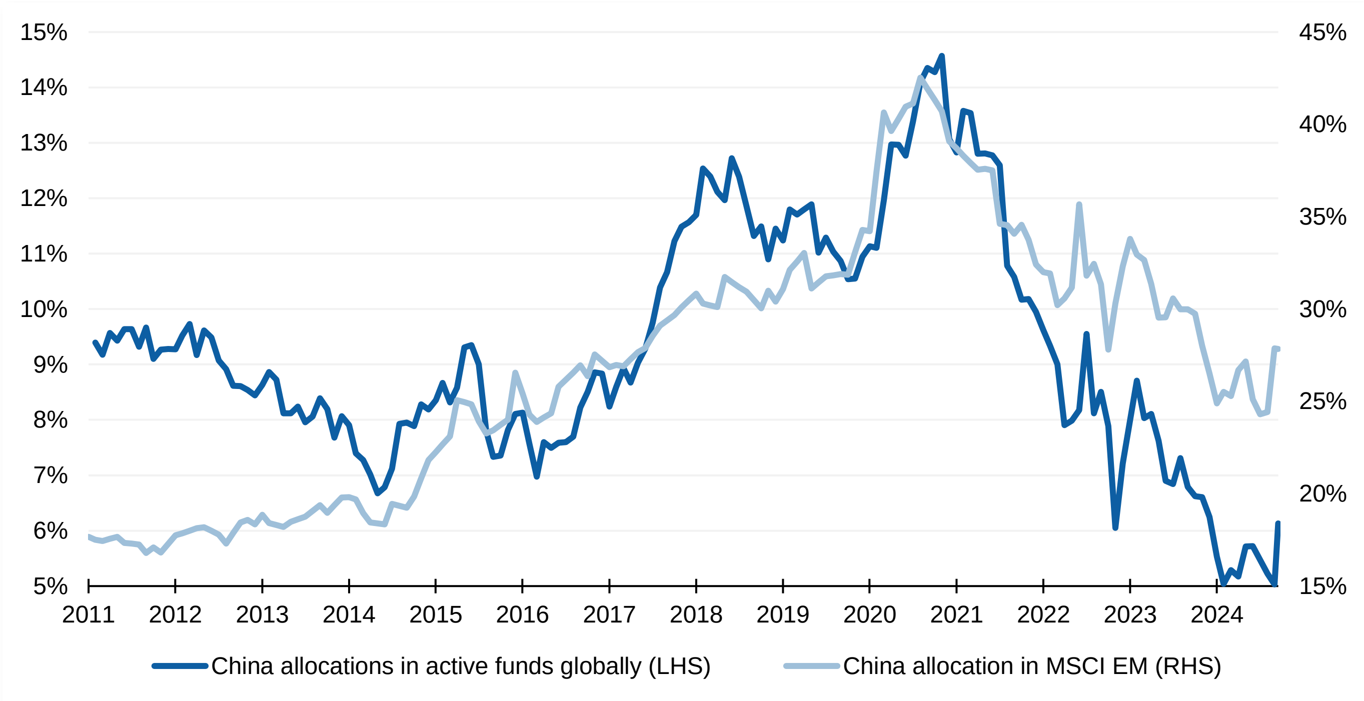
Historically the CCP has channelled fiscal support into infrastructure and more recently industrial development (e.g. EVs, renewables, technology) but we need to see Western-style direct to consumer fiscal stimulus to drive consumption. The CCP has been resistant to drive growth via hand-outs, but more consumption subsidies could ensure spending rather than saving. At the time of writing there are rumours of RMB2t (USD 285b) in stimulus, with potentially half directed at the household and the other half towards repairing local government balance sheets. A potential RMB1t in household stimulus still only equates to 0.8% of China's GDP. For context, US fiscal stimulus directed at the household during COVID was closer to 3.5% of GDP .

We also need to see more support for entrepreneurs and private enterprise, and to restore local officials' confidence to make investment decisions without risk of investigation.

As investors, the question must always come back to what is in the price.

Despite the recent surge in Chinese equities, the MSCI China benchmark remains priced at 11x calendar year 2024 earnings, indicating just how under-owned Chinese equities are, with significant scope for Chinese and Western households to increase their allocation. Today, Chinese households invest roughly 10% of their financial assets in equities, with the corresponding figures in the US and Japan being c. 40% and c. 13% respectively. A mere 1% increase in their allocation could equate to almost $350b of incremental equity flows. Though less material, Figure 1 offers a sense of how low global equity allocations to China are relative to their peaks. A 1% increase in global ETF and active fund allocations to China would equate to a further $105b of incremental buying.

**Figure 1: Allocation to Chinese equities in active and passive funds well below peaks**




Source: EPFR, MSCI, FactSet, Goldman Sachs Global Investment Research as at 30 September 2024 (where the data point for Sept 24 is based on early reporting from 35%+ of funds in the EPFR universe)[1].

It's true that the Chinese economy will grow at a slower pace than it has historically and the geopolitical backdrop is more fraught – but this is arguably in the price. With an urban population of over 900b people, China is an incredibly large single area of demand. This is a unique and interesting opportunity.

**1** Per Goldman Sachs, China allocations in active funds globally includes GEM, AEJ, Global & Global ex-US funds. AUM = USD$1.1t.

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The range of outcomes are converging towards larger stimulus to engineer a cyclical recovery, or at the least address the issue of deflation. Given the current positioning in Chinese equities, any formalisation of household fiscal support or additional property policies can build confidence in China's economic growth trajectory and extend the rally.

Against this backdrop, we continue to see three broad areas of opportunity:

- Platform businesses such as Alibaba and KE Holdings, the largest property portal in China with a disproportionate share of secondary transactions.
- Consumer exposures such as Li Ning, a market leader in domestic sportswear, and Tsingtao Brewery, the second largest beer company operating in a consolidated market.
- Structural growth opportunities focused on localisation and decarbonisation e.g. Nari Technology, whose modern grid equipment and technology solutions will be in high demand as renewables and the complementary build-out in ultra-high voltage infrastructure occurs.

### The Fed moves and the ECB's dilemma

Fed Chair Powell emphasised the larger than expected 50bp rate cut was a proactive move, rather than a response to recession fears. From the Fed's perspective inflation is no longer a concern and the focus has shifted to the labour market. Fed forecasts suggest another 50bp in rate cuts over the remainder of 2024 and another 100bp in 2025, which will take the Fed Funds Rate to around 3.5%.

The market has priced a normalisation of inflation to the 2% target and a deceleration in economic growth back to trend levels. Tightening credit spreads imply a sharp fall in defaults (i.e. a reduction in risk), and the rate cutting cycle is predicted to be as aggressive as what we saw in the 2008 financial crisis.

The inconsistency is that the market isn't translating slower economic growth into consensus earnings forecasts; the S&P500 ex the Magnificent 7 is still expected to report an acceleration in earnings per share (eps) growth. In short, the market is pricing a feather soft landing.

While the US services sector continues to grow modestly, manufacturing data continues to weaken. Even though services accounts for two-thirds of the economy, weak manufacturing can often serve as a leading indicator of a broader downturn. The employment data also bears close watching given the consequences for wages and consumption. The labour market continues to normalise, with softening demand met with lower vacancies as opposed to outright layoffs. Recent statistics still see 1.1 job openings per unemployed person.

The Fed's ability to achieve a Soft Landing is contingent upon inflation falling fast enough to avoid the Higher for Longer scenario. The risk is that inflation may be structurally higher due to the shift to net zero, the de-globalisation trend and populist policies e.g. tariffs, increasing government spending which has implications for the pace of the rate cutting cycle. It's likely the neutral interest rate – the real interest rate where monetary policy is neither stimulating nor constraining growth – is rising. The risk is the market is wedding to a return to the 0 – 1.5% range consistent with the post 2008 financial crisis and pre-COVID period. A higher neutral rate is relevant for the pricing of all risk assets.

We remain roughly equal weight the Soft Landing and Higher for Longer scenarios. In our assessment the equity market is overpricing a Soft Landing 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).

In Europe, a divergence between the core and the periphery is building. Eurozone data suggests a similarly modestly growing services sector alongside a persistently weak (and weakening) manufacturing

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sector. This masks notable weakness in key economies like Germany and France, while periphery nations like Spain, Italy and Greece are experiencing above trend growth.

The European Central Bank (ECB) once again faces the challenge of running a single monetary policy to suit different underlying economies, with an outcome that may see rates that are too low for the periphery.

Adding to the complexity, the ECB is expected to backstop decarbonisation, manufacturing re-localisation and an increase in defence spending. France has breached the European Union's fiscal limit of 3% of GDP (and has announced a delay in meeting this limit) and Germany is getting close at 2.5%. For the first time since the 2008 financial crisis, France and Spain's sovereign debt has the same yield.

The opportunity for Europe, however, is a resurgence in China given the strong export linkages between these two regions.

At 13x earnings we remain comfortable with our allocation to Europe/UK. We have exposure to resilient domestic and multinational companies (those that generate revenue and earnings globally) that are market leaders with a low risk of disruption, that are priced at a material discount relative to similar peers listed elsewhere in the world.

On the domestic front examples include Tesco at 13x forward earnings v Walmart at 33x, and our European/UK financials at an average 6x forward earnings and US banks on 10x earnings. On the multinational front, TotalEnergies is priced at 8x forward earnings v Exxon at 15x and Siemens at 16x forward earnings v Rockwell at 28x. European multinationals also provide exposure to the Soft Landing scenario in the US, at more attractive prices.

## Trump v Harris ambivalence

With less than a month until the US heads to the polls, there's remarkably little focus on the US election. At risk of oversimplifying, Harris is focusing on middle income earners, while Trump emphasises lower taxes, foreign policy and tariffs, where his proposal could see the highest blended tariff rate since the 1930s. A recent episode of the Good Value Podcast covers the US election with Absolute Strategy Research Head of Global Strategy, Nick Nelson.

Both candidates are adopting a populist approach, with Trump leaning more inflationary and potentially adding more to the budget deficit with unfunded tax cuts. Corporate taxes could fall as low as 15% under Trump but may rise to 28% under Harris.

Trump may find it difficult, but not impossible, to repeal Biden's Inflation Reduction Act (IRA). The Republicans would need to control both the House and Senate, and Democrats have more Senate seats to defend in this election. Given 80% of IRA investments have gone to Republican states, full repeal is complicated. Trump might instead target Biden's executive orders, such as tailpipe emissions or drilling permits.

That said, it's likely the Fed's decisions will be more meaningful for markets than the outcome of the election. Just as the forces driving inflation are becoming more structural so too are the forces driving the US fiscal deficit with increased spending on climate and an ageing population (healthcare, social security). Government debt is rising. Interest payments alone are forecast to reach almost 20% of this year's government revenue[2].

**2** Congressional Budget Office

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### The case for Value is growing

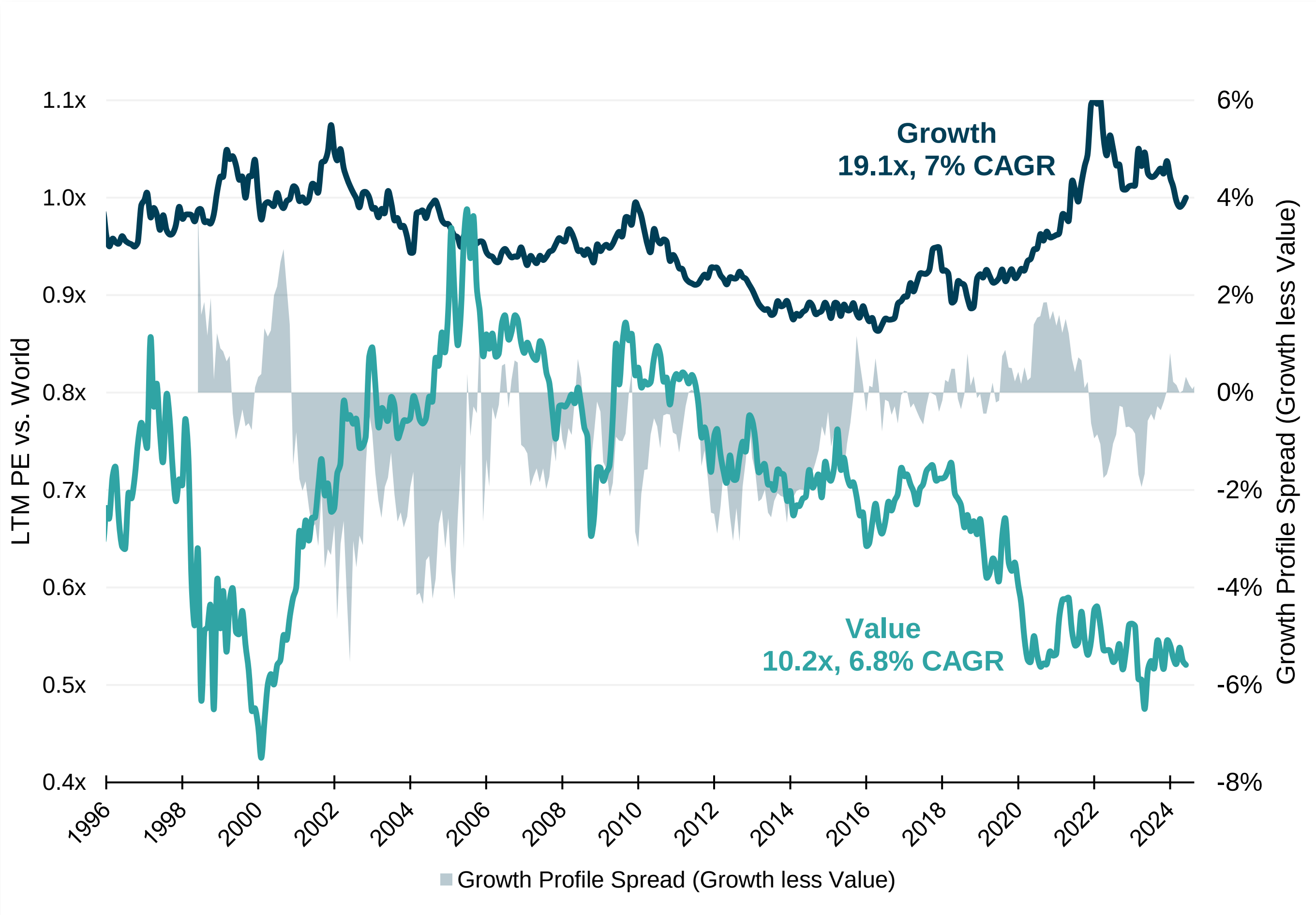
Given the extreme market concentration and narrowness of returns we highlighted the multiple dispersion between Quality and Value stocks in last quarter's report. It's worth widening the discussion to include Growth stocks.

We know that Value is cheap versus Growth (and Quality), but as Figure 3 shows, the valuation of Growth is at the top of its 30-year range, while the Value cohort is priced near its largest relative discount.

Even more interesting is that investors are prepared to pay 19x earnings for Growth stocks that are compounding earnings at 7% p.a. but only 10x earnings for Value stocks that are growing at 6.8% p.a. A 9-turn valuation premium is remarkable given there is no difference in the growth profile of each cohort.

On top of this, the last time multiples diverged to this degree, the growth spread was significantly higher.

### Figure 2: Value vs. Growth




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

Source: Antipodes, FactSet as at 18 September 2024

Six stocks – Nvidia, Apple, Microsoft, Amazon, Alphabet and Meta – have a combined share of c. 35% of the MSCI AC Growth Index. History tells us this degree of index (or market) concentration does not persist.

The case for owning Growth (and Quality) today is increasingly dependent on the performance of just a handful of companies whose own futures are becoming inextricably linked to each other. It's worth remembering that the range of outcomes in the early phase of a disruption cycle are wide, and in a market-based economy large profit pools come under attack. Such narrow concentration and returns is a vulnerability, not a strength.

We've started to see more signs of a broadening out in market performance over recent months, but Figure 2 shows the case for a more fundamental shift to Value investing.

## Portfolio positioning

Our broader portfolio exposure to Mature/Cyclical businesses (consumer, financials, energy and industrials), Structural Investment trends (cloud/AI monetisation, the energy transition), and Defensives (consumer staples, healthcare, gold) remain relatively unchanged over the quarter, though there was some rotation within these categories:

In our Mature/Cyclical exposures we increased our allocation to Developed Market (DM) financials and reduced our exposure to Emerging Market (EM) financials. Notably, we added to CapitalOne Financial, the leading US digital retail consumer bank and the third largest credit card issuer and auto lender. Unlike many of its peers, CapitalOne has the scope to protect net interest margins in a rate cutting cycle via lowering deposit rates. The proposed acquisition of Discover Financial will see the combined entity become the largest credit card player in the US by outstanding card balance, all while priced at a significant discount to peers (7x earnings). See our recent CapitalOne video for more detail on our investment case.

In EM financials we exited KB Financial (Korea) and Itau Unibanco (Brazil), both of which have meaningfully outperformed regional indices, making their relative valuations less attractive.

We continue to remain overweight European and underweight US Financials. As discussed last quarter, European and UK banks can see net interest revenue grow even as policy rates fall as a large proportion of assets (primarily mortgages) roll off onto higher yields relative to where they were fixed several years ago. This exposure is anchored by French-listed Societe Generale and UK-listed NatWest.

The price divergence between mega cap tech and the software sector created an opportunity to add to our Cloud/AI monetisation exposure via Workday, which complements our existing holding in Oracle. Workday has evolved from leading HR software provider to a broader enterprise resource planning (ERP) software platform via the development of its financial management software. ERP is the last major cloud transition opportunity, with penetration still only c. 35% and where a cloud (or subscription) based customer generates 2-3x the revenue of an on-premise customer over the life of the contract as infrastructure is also provided to the client. AI is adding impetus to shift ERP software to the cloud to take advantage of this technology.

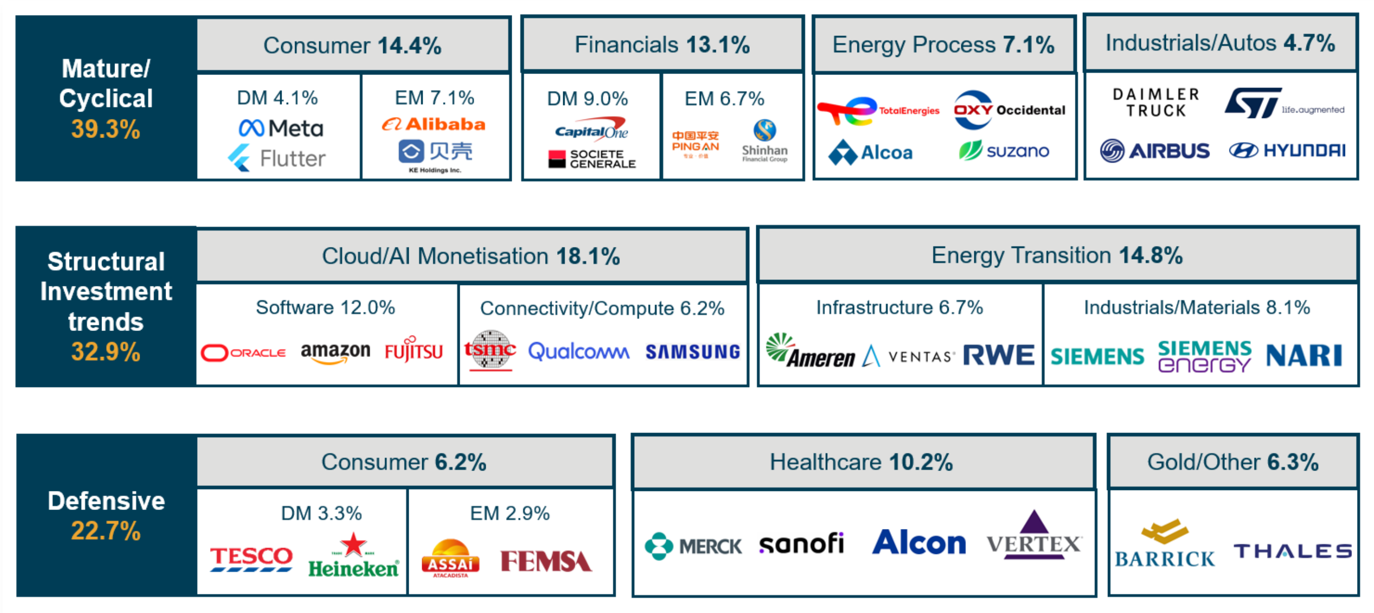
Exposure to Structural Investment trends remains anchored by Amazon (where AWS continues to take a leading share of growth in cloud infrastructure, and the company is winning share of retail sales globally), TSMC (the undisputed leader of leading-edge chips to semiconductor companies globally), and Siemens Energy (a key enabler of the energy transition via wind turbines, utility scale gas turbines and grid transmission equipment).

Finally, in Defensive assets we reduced our Healthcare exposure via reducing/exiting drug distributor Cencora which has reached its price target, and increasing our exposure to Gold, notably via Barrick Gold. We see Barrick's costs falling following a recovery in volumes which can prompt an inflection in earnings, and the stock is priced at just 8x at today's gold price. Even though the gold price is at 20-year highs, it has been driven by central bank buying. Gold can be a winner in both the Higher for

Longer/Hard Landing scenario, where we would expect retail demand to increase, as well as the Soft Landing scenario, as demand from geopolitical flows should remain sticky.

Gold – and energy - can also be cheap insurance against further escalation in the Middle East. Isreal now has a clear advantage having seemingly compromised Iran and its proxies from an intelligence perspective, and Iran is now more vulnerable than expected. The range of outcomes around escalation pathways has widened, and we are monitoring this closely.

### Figure 3: Global Long strategy exposure




Source: Antipodes, September 2024

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