

Quarterly Outlook March 2024



Rewinding the clock 12 months, the first quarter of 2023 saw Silicon Valley Bank unravel in a matter of days and Credit Suisse taken over by its frenemy UBS. We were in the sharpest rate hiking cycle in decades with a question mark over the impact to the real economy and a ballooning fiscal deficit. Tensions were building over potential vulnerabilities in the US financial system as unrealised losses from government bonds were threatening to meaningfully hit capital positions. It was arguably the most uncertain time in global equity markets since the collapse of Bear Stearns and the global financial crisis.

Yet today, the S&P 500 and European equities are at or near all-time highs, and even the Nikkei has finally broken through its previous 1989 peak. Very few market commentators (if any) were expecting global equities to return 23% in USD terms (26.5% in AUD)¹ over the year to March 2024. The Fed reacted quickly by expanding its balance sheet and the Treasury issued short-dated Bills which contained stress in the financial system. The consensus US recession – also the Antipodes base case – did not occur. We underestimated the combined power of renewed fiscal stimulus and COVID related excess savings to support US consumption, the economy's broad ability to tolerate rising rates, and the liquidity environment also remained more buoyant. In addition, we expected China to take a more pragmatic approach to policy in the face of slowing global demand for goods and a domestic property crunch.

Over the last year, the Antipodes Global Long strategy returned 16% in AUD terms (13% in USD)². The portfolio generated alpha in Europe (including UniCredit, TotalEnergies, Saint Gobain, Daimler Trucks) and Latin America (including Itau Unibanco and Fomento Economic Mexicano), with some good stock selection in North America (including Meta, Oracle, Merck, Capital One Financial). The regional underweight to North America and overweight to China, and the portfolio's broader underweight to the Quality factor (stocks with a high degree of profitability), however, proved costly relative to MSCI ACWI returns. The short book was an additional headwind to the Global Long-Short strategy (returned 9% in AUD, 6% in USD). We needed to be even more dynamic with our net equity exposure in a strong upward moving market as the US economy remained resilient.

Taking stock

As we look ahead, the trajectory for inflation is down but there are risks inflation in the US could be stickier than the market expects driven by core services, and risk to the upside via energy prices. We retain the view that the Fed's target of 2% core inflation will be difficult to achieve and as such rates can remain higher for longer. The market is also starting to lean this way; over the last three months expectations have fallen from six rate cuts over 2024 to just one.

After a prolonged industrial production downcycle, the global manufacturing economy is recovering from its post COVID normalisation with restocking and tentative recovery in end demand, and while the services economy continues to grow, it has been slowing. This dynamic needs to be monitored closely as the services economy accounts for 70% of US GDP while manufacturing is only 30%³.

Employment indicators continue to moderate. While we are still in a labour deficit, the data suggests we are moving to a more normal labour environment e.g. job openings per unemployed person continue to trend down and initial and continuing unemployment claims have inflected higher off very low levels. In this sense, the direction of the fiscal and credit impulse (Figure 1) is important. A significant proportion of the US government's \$5t in COVID stimulus was not immediately spent, rather it was saved and spent over time

¹ Source: MSCI.

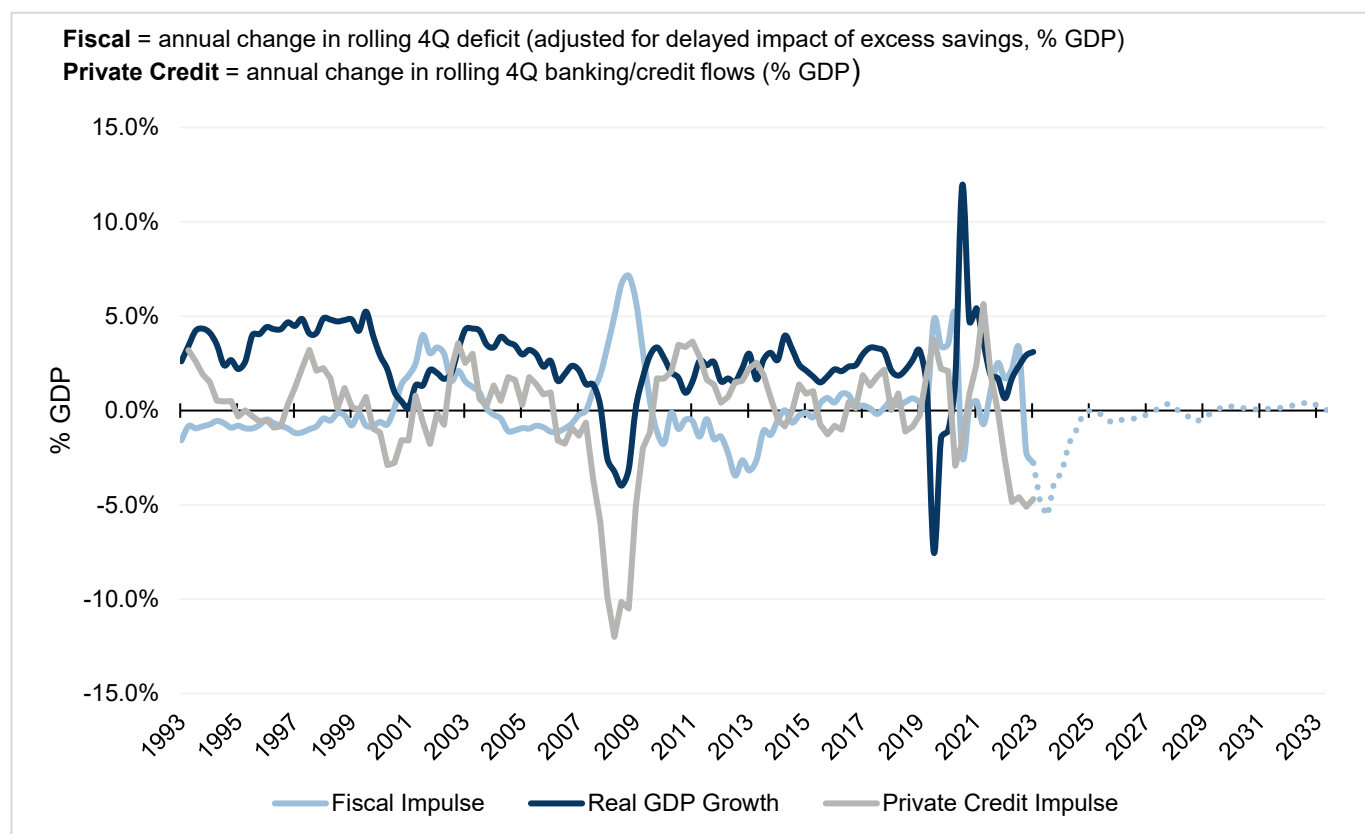
² Source: Antipodes. Past performance is not a reliable indicator of future performance.

³ Source: Antipodes estimates.

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which led to a stronger and longer fiscal impulse. We are reaching the point where this excess savings has been virtually exhausted across all income cohorts which will see the fiscal impulse dramatically weakened. At the same time the credit impulse has been weak due to higher rates and a cautious approach to lending by banks which will likely ultimately result in weaker economic activity and corporate earnings.

Figure 1: Fiscal and Credit Impulses



Source: Congressional Budget Office, US Treasury, Bureau of Economic Analysis, Federal Reserve

The positive potential offsets to this slow-down include:

- 1) Ongoing spending on various programmes e.g. Chips Act, energy transition, onshoring accelerates, supporting economic activity.
- 2) A cyclical economic rebound in Europe and China activity offsets weakness in the US. The European economy is more sensitive to rates than the US, and European central banks are turning more dovish as disinflation is unfolding as expected. They should lead the US in loosening. If China stimulates more aggressively, this would also feed through to global demand and be supportive of looser monetary/liquidity conditions globally.

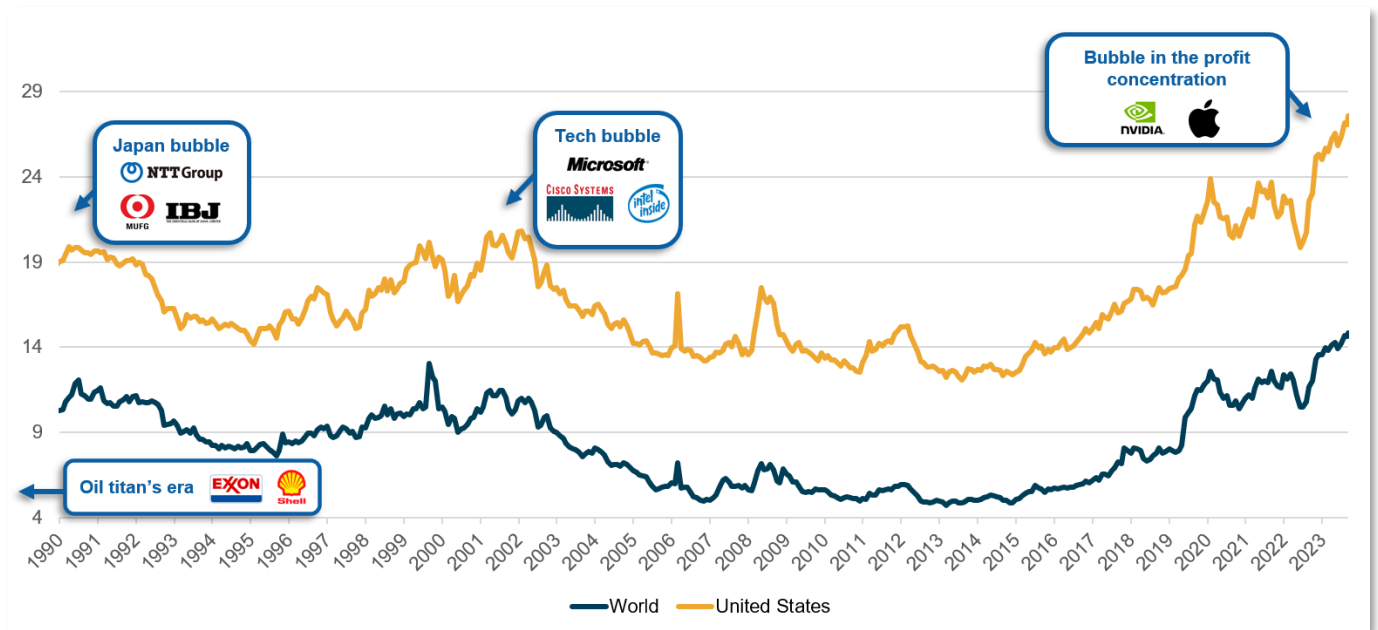
It's also been widely reported that the performance of the market has been incredibly narrow and Quality has been the winning trade over the last 18 months, but we are now at very extreme levels. While March showed some broadening in performance the Super Six⁴ still account for 28% of the S&P market cap and 20% of earnings⁵ (Tesla is no longer considered Magnificent having fallen over 30% this year). We are at multi-decade high levels of market concentration and narrowness of returns (Figure 2).

⁴ NVIDIA, Alphabet, Meta Platforms, Microsoft, Amazon, Apple

⁵ Source: S&P, Antipodes

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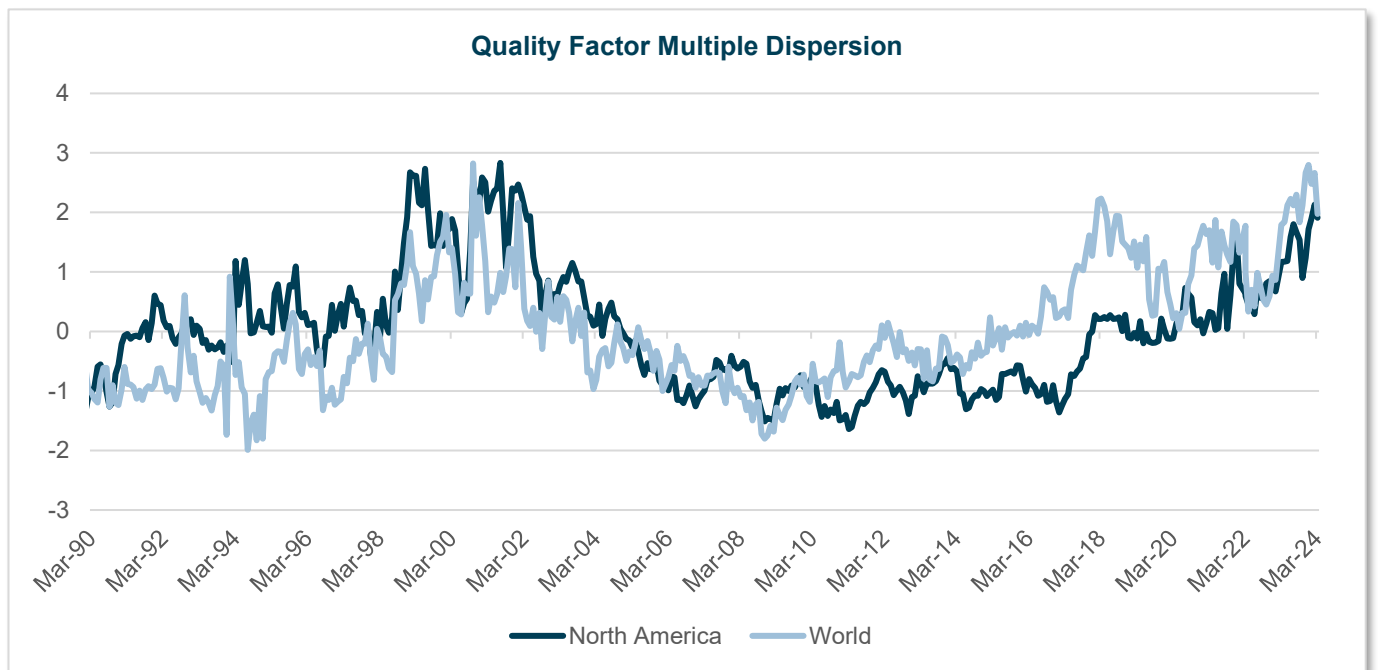
Figure 2: Largest 10 stocks share of total market cap



Source: Factset, Antipodes

Similarly, Quality stocks globally are priced at all time high relative valuations and approaching dot com bubble extremes in the US (Figure 3).

Figure 3: Valuation of the Quality factor relative to history



Source: Factset, Antipodes

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Looking ahead

In assessing where to from here, the potential outcomes range from Hard Landing to Higher for Longer, but bear in mind these are not permanent states. Policy makers respond to the backdrop which ultimately leads to the beginning of the next regime.

Table 1: Range of outcomes

Regime	Characteristics	Market outcome*	Response and next regime
Hard Landing	Financial conditions remain too tight and economic growth collapses	Value has historically outperformed Quality e.g. defensive value and low multiple cyclicals that benefit from structural thematics	The Fed responds by cutting rates aggressively and potentially stimulating to support economic activity, with the goal of transitioning to a Soft Landing
Soft Landing	Economy remains resilient, inflation continues to fall and the Fed can cut rates	Quality has historically outperformed Value. Cyclicals will participate as economic activity remains resilient	Goal would be to maintain the Goldilocks state, however resilient economic activity may require the Fed to lift rates potentially transitioning to Higher for Longer.
Higher for Longer	Stickier inflation prevents the Fed from cutting rates	Value has historically outperformed Quality	As fiscal support is also fading, the risk of prolonged tight policy/Higher for Longer scenario is transitioning to a Hard Landing

*Note we are referring to the Value factor which represents low multiple stocks versus the Quality factor which represents stocks with high profitability and typically high multiples.

Our analysis suggests the market is placing a very high probability on the Soft Landing scenario and potentially leaning towards Higher for Longer, but pricing a negligible risk of a Hard Landing. While expectations around rate cuts have been tempered, credit spreads remain relatively tight and the valuation of US equities remains full on a forward PE basis at 23x.

We roughly equal weight the Soft Landing and Higher for Longer scenarios with a lower weight on the Hard Landing. The Soft Landing scenario is highly dependent on inflation falling to 2.5% allowing the Fed to cut the policy rates to circa. 3.5%, restoring US government bond term premia and an upward sloping yield curve all of which will reduce funding pressures for the US government and high risk corporate borrowers. If inflation gets stuck above 3% and significant rate cuts are delayed, the risk of Higher for Longer transitioning to Hard Landing increases significantly due to the linkage between interest rates and employment.

US listed corporates have broadly lower levels of debt leverage, longer debt and lower variable rate mix, relative to the unlisted sector. In terms of relative size, we estimated the US workforce is split 25% employed

by listed companies, 60% unlisted and 15% government⁶. Further, roughly 10%⁷ of the US workforce is employed by private equity backed firms and those firms carry very high leverage funded by a combination of leveraged loans and private credit which are non-amortising loans that typically carry a variable rate of interest.

Hence, risks really lie in the US private equity/non-listed sector due to⁸:

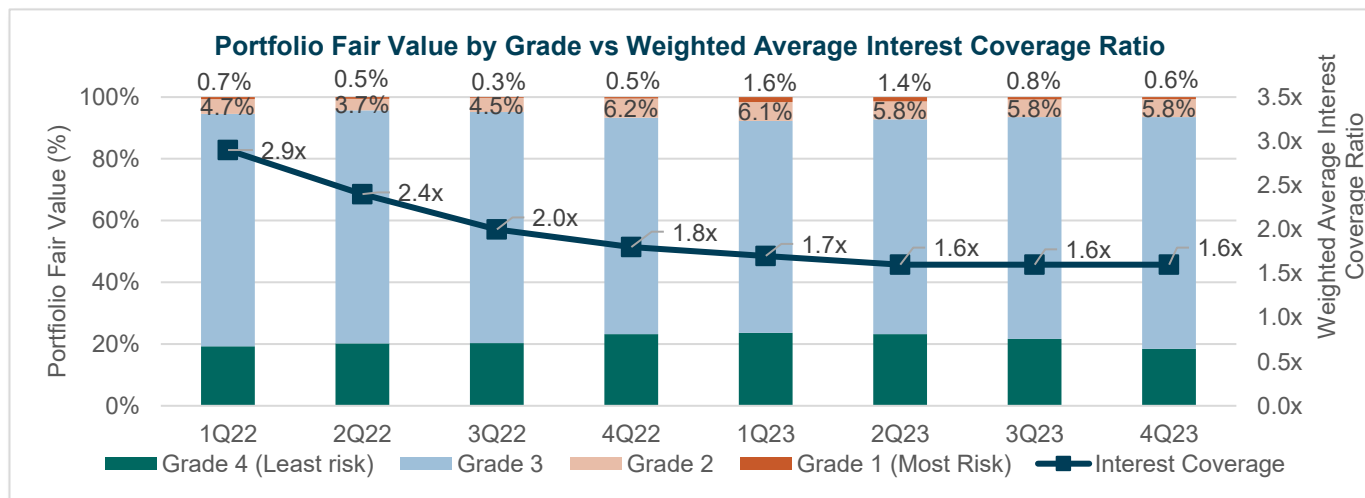
- Size: PE-backed companies comprise 36% of outstanding leveraged & high yield loans, a c.\$2.7trillion market or 5% non-financial business borrowing
- Leverage: Servicing cost is now 10%, up from 4% in 2021 with median interest consuming 43% of EBITDA (7% for S&P500)
- Refinancing wall: Vast majority of high yield debt and leveraged loans are to be refinanced in the next 5 years (vs. a third of US listed corporate debt)

However, the linkages to listed markets are very real:

- Listed companies are also going through a refinancing cycle, but with a larger component of fixed rate debt and lower leverage, this is having a slower and lower impact on profits
- Any issue in Private Equity or Credit will rapidly become a public market issue via:
 - o Direct exposures such as listed Private Equity and Private Credit managers.
 - o Listed closed-end Private Credit funds, otherwise known as Business Development Corporations (BDC).
 - o Listed companies with weaker balance sheets that rely on similar credit markets to remain open for survival.
 - o Ironically, given the illiquid nature of Private Equity and Private Credit, investors need for liquidity may mean they need to sell their liquid listed assets first.

The data from Ares Capital Corporation (ARCC), one of the largest listed BDCs which provides credit to small and medium sized businesses in the US, presents a window into an otherwise opaque asset class (Figure 4). As interest rates have risen, the interest coverage ratio of the companies that ARCC lends to on a portfolio weighted basis has fallen from 2.9x EBITDA to 1.6x. Despite this dramatic decline, ARCC assesses that the risk in its portfolio remains relatively unchanged – this would appear surprising to an outside observer.

Figure 4: Ares Capital Corporation: nothing to see here?



Source: Ares Capital Corporation corporate filings

⁶ Bureau of Labour Statistics

⁷ Antipodes estimates.

⁸ EY Private Equity Pulse, Antipodes Calculations

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As every month of 10% funding costs goes by, underlying Private Credit stress is likely to increase and the corporate imperative to cut cost to remain both liquid and solvent could lead to job losses. In aggregate High Yield Bond, Leverage Loans and Private Credit have become a circa. US\$3Tr⁹ source of funding for US businesses. If flows into the asset class slow, and or the economy weakens, the vulnerable nature of the underlying borrowers, either due to an inability to pay interest or roll-debt, will be revealed. This is a much larger, and potentially more systemic issue than the current credit stress apparent in parts of the commercial property market.

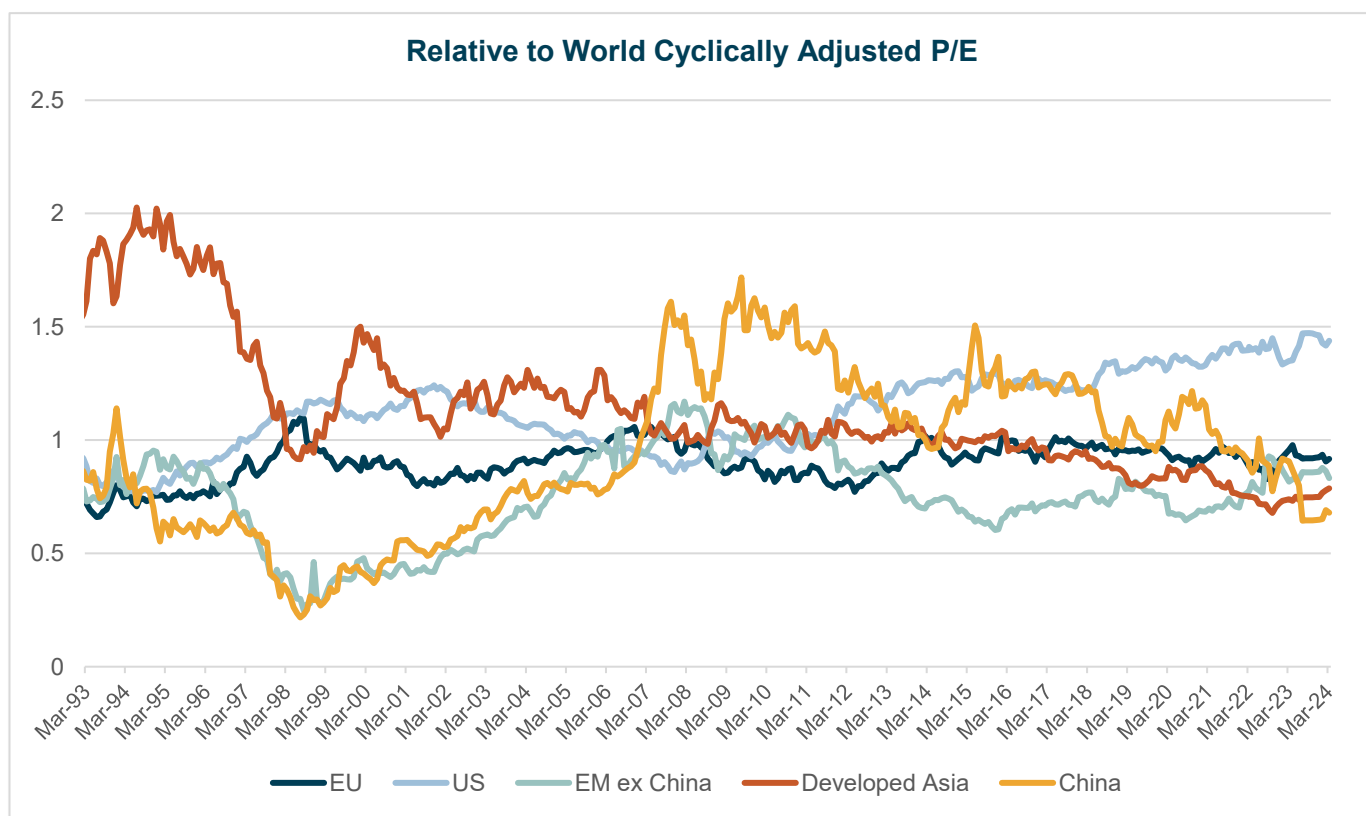
It's also worth noting that every prior rate hiking cycle of similar magnitude has ultimately culminated in recession.

Reflecting on the last 12 months, we were clearly positioned for tighter conditions too early, but the risks have not disappeared, and the range of outcomes arguably widen the longer monetary policy remains tight. The market's pricing of these risks, however, has materially diminished over the last 12 months. Today, we believe the market is *over-pricing* a Soft Landing and *under-pricing* the probability of Higher for Longer and a Hard Landing.

The Higher for Longer and Hard Landing scenarios represent a greater chance of a market drawdown, where Value - or low multiple stocks - is typically the best performing factor. Yet today, the valuation of Quality relative to Value stocks is at extreme levels (Figure 5).

The key to avoiding this and achieving the Soft Landing is a benign pathway to a lower level of inflation which allows the Fed to cut in a dovish manner, i.e., not in response to rising unemployment and recessionary risk.

Figure 5. Overcrowding driving up US valuations



Source: Antipodes, FactSet

⁹ Antipodes estimates.

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On a headline basis the S&P 500 is trading at a next 12-month PE ratio of 21.6x but excluding the Magnificent 7, this drops to 19.8x versus 13.5 for MSCI Europe and 8.3x for China – if we adjust for historical valuation discounts, these multiples imply that Western Europe and EM/China are trading at a discount of 8% and 32% to trend valuation. Hence, the Hard Landing scenario is arguably priced attractively in some of the cyclical parts of the global stock market (including in the US) and broadly in ex-US markets. On this basis we have added to our global industrials and auto exposures, especially those that have a decent exposure to the US. Given how cheap these stocks are, we should win in all three scenarios. To be clear, there are interesting opportunities in the US market. We are identifying companies that may be mispriced relative to their business resilience and their growth profile, and 35% of our long book is invested in the US, and based on where the underlying companies generate their revenues this rises to roughly 48%.

However, the key message remains Europe and China may not be priced for any good news, even though manufacturing and services activity has positively inflected in both economies.

Incremental improvement in China

At 8.3x forward earnings Chinese equities are as cheap in both an absolute and relative basis for reasons that are well known, yet this quarter has seen a noticeable change in policy makers' stance towards supporting activity and the equity market, and the data is incrementally improving.

Property sales in the primary market are yet to stabilise but we are seeing positive signs in the secondary market. Sales volumes across 36 cities rose 35% in 2023 versus the prior year. Demand for property exists where there's no developer completion risk, and early data readings suggest secondary sales will return to growth in 2Q24. Government actions to create a 'white list' of developments (where policy makers guarantee funding and delivery) can help restore household confidence in completion, and measures to remove purchase restrictions and lower mortgage rates can help stimulate demand. The property sector may continue to be a drag on GDP in 2024, but we expect stabilisation next year as unsold inventory is worked down.

We are encouraged by the actions of the People's Bank of China (PBoC) to pump more liquidity into the banking system which can translate into activity through lending to priority industries. More is required, even if we are seeing incremental improvement outside of the property industry. For example, the manufacturing economy reported its first expansionary reading in over six months and services have been steadily strengthening. Domestic travel and per capita spending over the recent holiday periods exceeded 2019 for the first time. Meaningful savings can be deployed as confidence returns; we estimate households have \$3.5t (c. 20% of GDP) in excess savings¹⁰.

Policy makers have also followed the lead from Japan and Korea to drive asset prices higher. Just as the Tokyo Stock Exchange nudged companies with low ROEs and valuation to increase returns and shareholder value via distributions, and Korea recently followed suit with its 'Value Up' program, Chinese regulators are encouraging SOEs (State Owned Enterprises) to put cash to work via dividends, buybacks and investments with similar goals in mind. Given these are state owned entities the government's directive is followed more quickly than would otherwise be the case. As the market has responded, privately owned enterprises are following suit. Dividends and buybacks noticeably increased in the recent reporting season.

While we are aware of the macro risks, the consensus "sell China" represents a unique valuation opportunity. We have maintained our exposure at c. 13% but have rotated some of this into leading domestic businesses including dairy and beer which are priced on lower than market multiples, but with low-teens earnings growth rates and more resilient business models.

¹⁰ Antipodes estimates.

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Portfolio Positioning

Despite the challenges over the last year and the uncertainty that prevails our goal remains the same; to find companies that are mispriced relative to their business resilience and growth profile, and to build a portfolio with a capital preservation mindset. If we buy weak businesses because they appear cheap, or if we sacrifice margin of safety (the valuation we pay) to own momentum, we risk capital destruction.

AI and the cloud are tomorrow's megatrends, and we have exposure where valuations make sense e.g. Oracle, Meta, Taiwan Semiconductor Manufacturing, and we continue to look for ways to take Pragmatic Value exposure to these structural changes. For example, we added Qualcomm over the quarter, a leading provider of low power computing and connectivity chips. Qualcomm benefits from rising demand for connectivity and lower latency with certain AI functionality running locally on devices, or at the "edge". Qualcomm is leveraging its extensive IP across low power computing and connectivity to bring AI from the cloud to our handsets yet remains priced on a mid-teens earnings multiple.

Nvidia has had a phenomenal run given its near monopoly over AI chips and its pricing power. Building and operating AI models is both power and hardware (more GPUs) intensive. As companies look to scale their AI models the spotlight is squarely shifting to reducing total cost of compute. This could see Nvidia caught in the crosshairs.

As with any non-linear change, the landscape will shift over time. Competition in hardware is building from Nvidia's traditional semiconductor rivals as well as the cloud giants designing their own chips to reduce dependence on Nvidia. New algorithms will be developed which will improve the way AI models are trained and run, which can result in a more efficient use of chips. There will also be companies in the traditional parts of the economy that will be big winners from adopting AI either via driving revenue or significantly reducing costs. The point is there is highly likely to be more than one winner from this cycle of innovation despite how the market is behaving today.

We also can't ignore that many cyclicals have meaningfully de-rated over the last 12 months along with the weakness in the industrial production cycle. There are pockets that can, for idiosyncratic reasons, see a more resilient demand/supply environment, yet remain priced for recession. Over the last six months we have been selectively building out this exposure, for example:

- Autos including Daimler Truck, Hyundai Motor, Stellantis where structural concerns are overdone and a supply-driven consumption deferral (thanks to COVID supply chain constraints) can support demand. These companies are successfully making the transition to electric while maintaining profitability and capex discipline.
- Materials including Nutrien, where we see potash demand inflecting globally to support farm yields in a weak supply environment, and Suzano, a low-cost pulp and paper producer with favourable supply/demand dynamics on account of low prices, underinvestment, land shortages and regulatory barriers.
- Energy including Occidental Petroleum, with its access to low-cost oil and a leader in carbon capture technology which is critical to achieving net zero.
- Energy transition beneficiaries including RWE, the largest electricity producer in Germany which is exiting coal-based power generation by 2030 and transitioning to climate neutral sources, and Siemens Energy, a global leader in wind turbines, utility scale gas turbines and transmission

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equipment essential for connecting renewables to the grid, where performance issues relating to offshore wind turbines have been resolved.

Taking a more wholistic view, the Antipodes global portfolios give clients exposure to:

- Mature/Cyclical businesses: companies that will see their growth profile linked to economic activity but are market leaders and not under a threat of disruption, yet remain attractively priced.
- Structural investment trends: companies that will benefit from investment cycles that will dominate over the next decade and beyond including AI and Cloud monetisation, the energy transition and supply chain onshoring.
- Defensive assets: companies that are cheap relative to their growth profile and peers, and are less dependent on the economic cycle for growth.
- The Long-Short strategy has additional emphasis on downside protection via single stock shorts (where we see a disconnect between a company's valuation and business resilience and/or growth profile) and tail risk protection, to protect against risks such as market concentration, a harder landing, geopolitics/energy security, highly-levered economies and private assets.



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