

## Time for some high quality defence?



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At the end of June, we expressed our concern that the markets were at high multiples of high earnings, as they were “dominated by the twin beliefs in the invulnerability of the U.S. economy and the massive impact of GenAI”. At the time the MSCI World Index was on 18.5x forward earnings, and those earnings were expected to surge at 13% in 2025 and 10% in 2026.<sup>1</sup>

Two months on, after a burst of volatility, we are roughly back to where we were. The market is slightly higher, as the forward multiple has inched up to 18.7x, with double-digit earnings growth still expected. However, the July-August squall did provide us some comfort about the defensive nature of our global portfolios in the downturn.

There were a few weeks during the third quarter when the market seemed to share our worries. The second quarter results season triggered questions about the returns on capital that the “hyperscalers” were earning on their fast-accelerating generative artificial intelligence (GenAI) capital expenditure, causing some air to escape the GenAI balloon during July. There was also a general growth scare in early August, given weak U.S. job numbers and the Services PMI (purchasing managers’ index) joining the Manufacturing PMI in contraction territory. On top of this, a 12% single-day collapse in the Japanese market on the back of an unwind of the yen carry trade and a violent spike in the VIX Index<sup>2</sup> to an intra-day peak of 60 added to the general sense of malaise. According to the New York Times, Google searches for the word “recession” rose to levels comparable to the Global Financial Crisis. At the trough on 5 August, the MSCI World Index was down 7% from its July peak, with the mighty Nvidia off by over a quarter, though the hysteria would have suggested that the fall was much worse.<sup>1</sup>

Calm has returned over the last few weeks. The MSCI World Index has bounced back to all-time highs, and the VIX Index has dropped back to normal calm levels at 15.<sup>3</sup> Even the bruised Japanese market has recovered close to its level at the start of August. Admittedly the “tech-y” sectors have not bounced back quite as far; for instance, Nvidia has recovered “only”

<sup>1</sup> Source: FactSet.

<sup>2</sup> Source: Bloomberg L.P. The VIX Index, often known as the Fear Index, measures the market’s anxiety level, or rather its expectation of volatility.

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around 60% of its recent fall, leaving it up a “mere” 140% in 2024 so far.<sup>1</sup>

This recovery means that the concerns we expressed at the end of June remain. As mentioned earlier, the market remains expensive, at a high multiple of forward earnings, with the S&P 500® Index looking particularly stretched at over 21x, and the assumed double-digit growth in those earnings requires margins to improve further from what are already record levels.<sup>1</sup> While an imminent recession looks unlikely, economies worldwide are facing negative economic surprises, according to the Bloomberg indices.<sup>3</sup> It is also far from clear that the recent spurt of optimism about interest rate cuts, with nine or 10 pencilled in by the end of 2025, is fully supported by the inflation and wage data, or is compatible with the kind of economy which will drive double-digit earnings growth. Overall, the benign scenario is priced in again as though the scare never happened.

In addition, despite the mild underperformance of the “Magnificent Seven” so far this quarter, the market still remains extremely concentrated, with 27% of the S&P 500® Index accounted for by just five companies, while the U.S. makes up more than 70% of the global index.<sup>1</sup> Owning the index does not offer the diversification that many think it does. The situation has reached the point that FTSE Russell and S&P Dow Jones, two of the main index providers, are contemplating capping the weights

of individual stocks in the index, which would effectively make them active managers by default.

The good news is that our global portfolios behaved as they should have during this sell-off, appearing resilient in the face of fears around both GenAI and the overall economy. Looking at the period from 10 July—where the tech names peaked—to 5 August—the trough amid the Japan carry trade panic—the MSCI World Index fell 7%. During this period, our global portfolios were actually UP by around 1%, demonstrating their ability to provide reduced downside participation.

Much of the portfolio’s outperformance was “given back” as the market bounced back over the rest of August, though the portfolios are still ahead of the index for the quarter so far. Looking forward, if the bulls are right, with a continuation of the AI boom and the bumper earnings growth seemingly assumed by the market, then the portfolio’s relative performance is likely to be mediocre. However, if there is either a cooling of GenAI frenzy or a failure to deliver fast earnings growth for the market, both of which are distinctly possible, then a portfolio delivering resilient earnings at a reasonable valuation may well offer some high quality defence, as it did during the recent squall. There are only two ways of losing money in equities, if the earnings go away or the multiple goes away. Right now, both risks look elevated for the market, but less so for our defence portfolios.

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<sup>3</sup> Source: Bloomberg L.P.

## Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect global franchise companies and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. **Stocks of small- and mid-capitalisation companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed markets. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). Non-diversified portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **ESG strategies** that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance.

### DEFINITIONS

**Earnings per share (EPS)** is the portion of a company's profit allocated to each outstanding share of common stock.

**Return On Capital (ROC)** is a measure of a company's efficiency at allocating the capital under its control to profitable investments, calculated by dividing operating income by total capital.

**Forward to price earnings (P/E)** is a measure of the price-to-earnings ratio (P/E) using forecasted earnings for the P/E calculation

The **MSCI World Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

The **S&P 500® Index** measures the performance of the large cap segment of the U.S. equities market, covering approximately 75% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy.

The **Volatility Index (VIX)** is the ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 index options. It represents one measure of the market's expectation of stock market volatility over the next 30-day period. The VIX is quoted in percentage points and translates, roughly, to the expected movement in the S&P 500 index over the next 30-day period, which is then annualized.

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