Stranger Things

The aim of this article is to identify the areas and explain the reasons for the current profoundly confusing investment environment torturing markets and investors.

Why are markets dazed and confused?

The losses in 2022 were mostly in the first 6 months of that year as we've said. The result of post-pandemic inflation made raging by the Ukraine invasion. In 2023 so far markets have seen areas of very strong and very weak performance combining to effectively cancel each other out in aggregate.

A clear story

Markets go up and down over shorter periods based primarily on the headline narrative.

Markets like to anchor to an overarching theme.

But 2023 has been anything but clear and the narratives have swung from certain economic recession to soft landings and from rates coming down to staying higher for longer.

Examples of unusual things

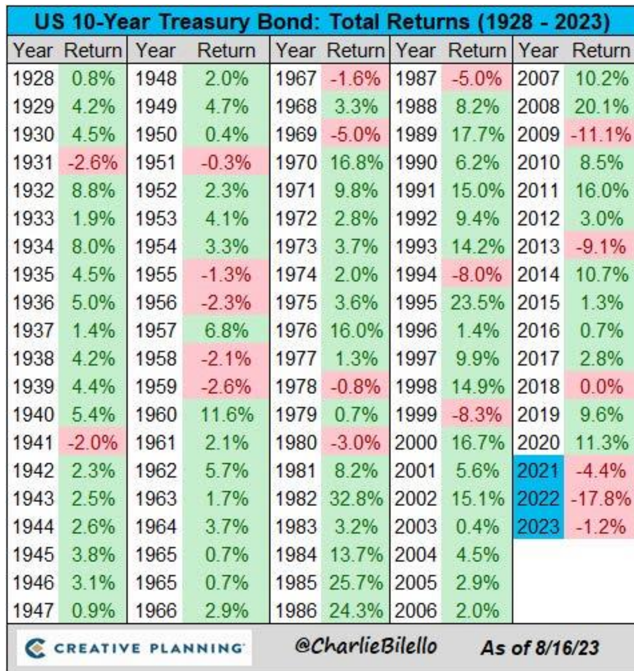
Inverted Yield Curve

When short-dated rates such as 2-year Gilts or Treasuries offer higher returns than longer dated ones of 10 years plus. This only happens historically when a recession is imminent.
An investor will in normal times want to receive a higher interest rate to lock up money for an extended duration.

It's been inverted for well over a year now. But as of yet no sign of a recession.

3 Years of Bond Losses

Bonds in the US are currently registering a loss in value 3 consecutive years, which has never happened before.



US 10-Year Treasury Bond: Total Returns (1928 - 2023)									
Year	Return	Year	Return	Year	Return	Year	Return	Year	Return
1928	0.8%	1948	2.0%	1967	-1.6%	1987	-5.0%	2007	10.2%
1929	4.2%	1949	4.7%	1968	3.3%	1988	8.2%	2008	20.1%
1930	4.5%	1950	0.4%	1969	-5.0%	1989	17.7%	2009	-11.1%
1931	-2.6%	1951	-0.3%	1970	16.8%	1990	6.2%	2010	8.5%
1932	8.8%	1952	2.3%	1971	9.8%	1991	15.0%	2011	16.0%
1933	1.9%	1953	4.1%	1972	2.8%	1992	9.4%	2012	3.0%
1934	8.0%	1954	3.3%	1973	3.7%	1993	14.2%	2013	-9.1%
1935	4.5%	1955	-1.3%	1974	2.0%	1994	-8.0%	2014	10.7%
1936	5.0%	1956	-2.3%	1975	3.6%	1995	23.5%	2015	1.3%
1937	1.4%	1957	6.8%	1976	16.0%	1996	1.4%	2016	0.7%
1938	4.2%	1958	-2.1%	1977	1.3%	1997	9.9%	2017	2.8%
1939	4.4%	1959	-2.6%	1978	-0.8%	1998	14.9%	2018	0.0%
1940	5.4%	1960	11.6%	1979	0.7%	1999	-8.3%	2019	9.6%
1941	-2.0%	1961	2.1%	1980	-3.0%	2000	16.7%	2020	11.3%
1942	2.3%	1962	5.7%	1981	8.2%	2001	5.6%	2021	-4.4%
1943	2.5%	1963	1.7%	1982	32.8%	2002	15.1%	2022	-17.8%
1944	2.6%	1964	3.7%	1983	3.2%	2003	0.4%	2023	-1.2%
1945	3.8%	1965	0.7%	1984	13.7%	2004	4.5%		
1946	3.1%	1965	0.7%	1985	25.7%	2005	2.9%		
1947	0.9%	1966	2.9%	1986	24.3%	2006	2.0%		

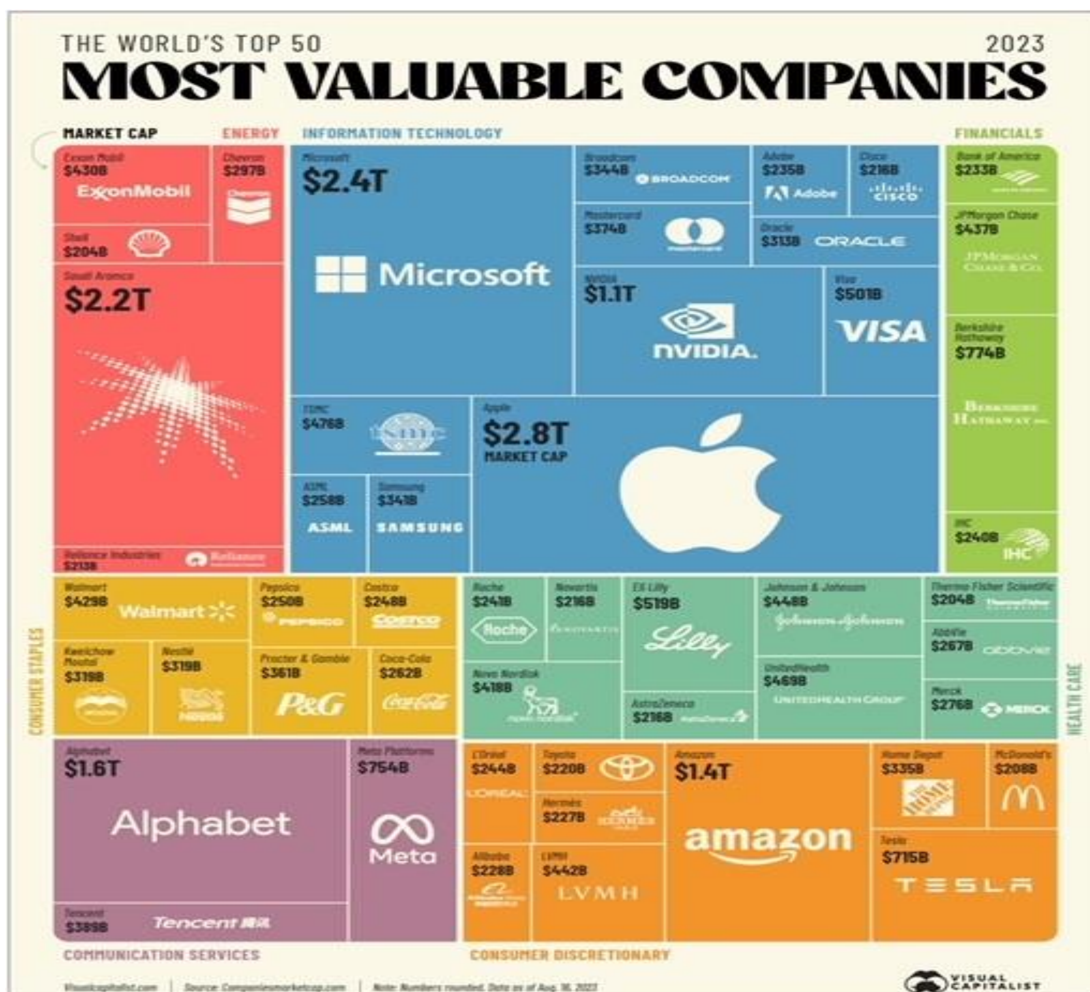
CREATIVE PLANNING @CharlieBilello As of 8/16/23

<u>S&P 500 (75% of 16%)</u>

The main US stock index the S&P 500 was up 16% to the end of July 2023 (it has fallen since). Of the 500 company stocks in the index, 75% of this total return came from only 7.

The Magnificent 7

APPLE
AMAZON
NVIDIA
TESLA
GOOGLE
MICROSOFT
META



The distortion in the Nasdaq Technology index became so extreme that they had to reduce the weightings of these companies in July as they had risen to over 50% of the total.

Why The Outperformance?

They are the easiest way to invest in the AI revolution which gripped investors' imagination in the second quarter to the exclusion of pretty much everything else.

What Isn't Going Up

If we look at 2 top performing funds we can see that outside of areas such as large US tech, markets are still depressed. The Smithson fund is the small and mid-cap version of the stellar performing Fundsmith Fund.

It was launched in 2018 to invest in high quality companies all of whom are highly profitable and have rock solid balance sheets. The best of the best. So not profitless tech and not burning cash.

Smithson Performance
2019. +33%
2020. + 31%
2021. + 19%

2022 - 28%

Top 10 holdings

- Recordati
- Moncler
- Fever-Tree Drinks
- Verisign
- Fortinet
- Temenos
- Verisk Analytics
- Diploma
- Rightmove
- MSCI

The interesting thing from an investment perspective is the fund until 2022 always traded above NAV. This means new investors paid a price higher than the value of the fund's assets to get in. It currently trades at a 12% discount which means new investors pay 88p for £1 of assets.

Nothing about the fund has changed apart from the sentiment being highly depressed for small and mid-cap companies generally. This will correct in time and presents an excellent buying opportunity.

Scottish Mortgage

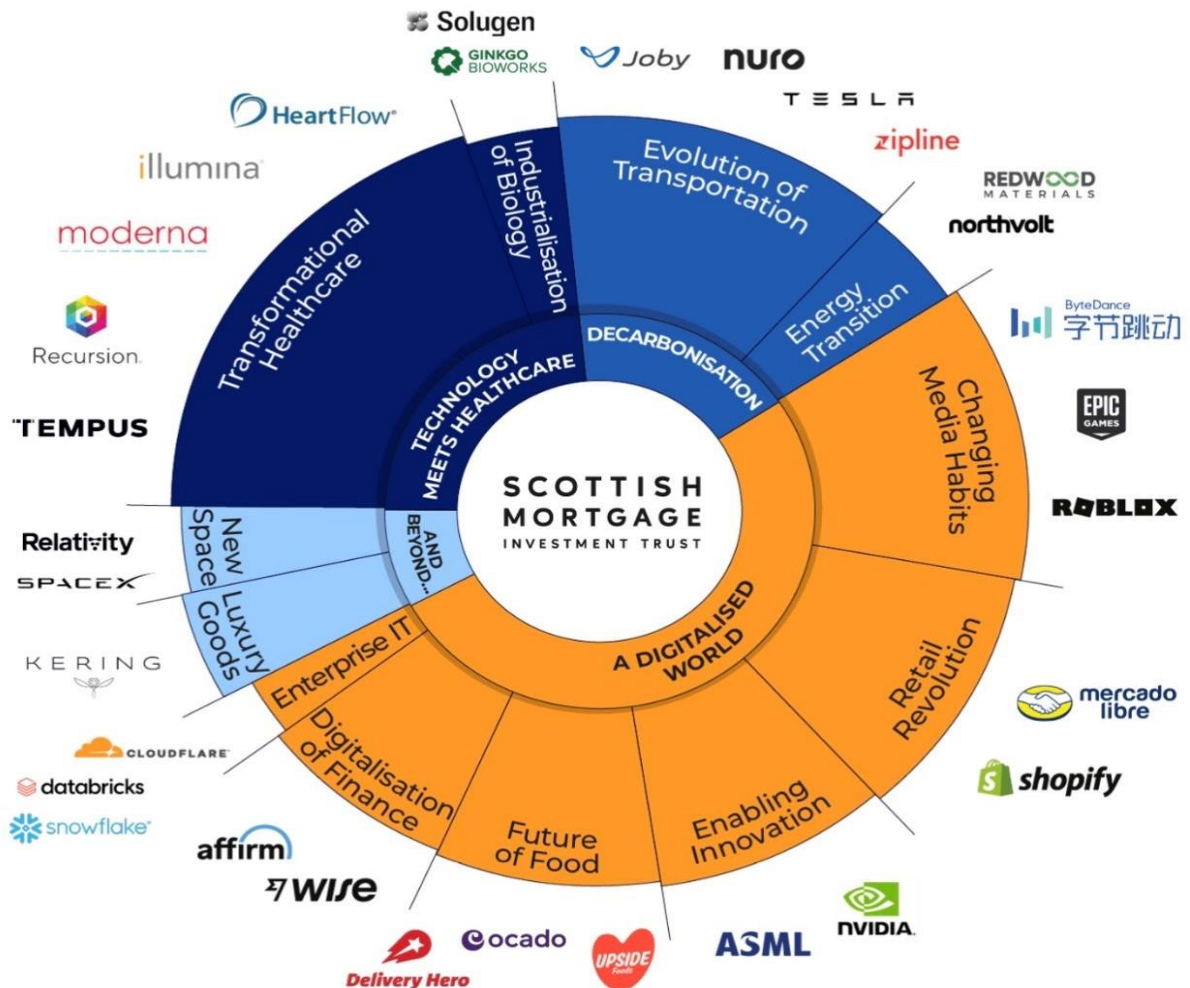
Another previously stellar performer whose share price traded above NAV until recently. The fund has a terrific set of companies and is well represented in those at the cutting edge of Ai.

The fund's top 10 holdings include:

1) ASML - the only company manufacturing the most cutting-edge computer chip manufacturing machines.
2) Nvidia - the only company creating cutting edge GPU chips required for Ai
3) Tesla - The leader in autonomous driving which is essentially Ai
4) Moderna - trials are proving messenger RNA tech works on cancer amongst other things. Over 40 trials for new therapies in progress. Hugely assisted by Ai in terms of speed of process and collation and analysis of data (see Quantum Computing below)

5) Amazon - Delivery is going to be revolutionised by Ai and autonomous vehicles.

The Scottish Mortgage Portfolio



It currently trades at a 20% discount to NAV! This means if the value of the investments go up say 10% and the discount disappears which it will when sentiment improves, then that's a return of 35%.

<u>Inflation</u>

In Western economies inflation rates are falling fast and likely in most countries at or close to 2% by early 2024. The lagging nature of some very large components, most importantly shelter means the current deflation in rents is still yet to register in the overall inflation numbers.

So, if inflation is no longer a problem why are markets still unsure about the levels of interest rates going forward and when they may start to reduce?

The Time Lag Of Fixed Rates

Economists are essentially financial historians. They look at what happened in the past and the accepted explanation of why and then they say, “well obviously the same things will happen next”

But in reality there’s absolutely no historic comparator to what’s playing out now.

Fixed Rate Borrowing

In the 1970s inflation was created in part by demographics (the coming of age of the boomer generation) and consequent huge increases in consumer debt, all of which was floating rate (went up as soon as rates rose). A central bank has really one tool to squash inflation:

Hike interest rates to make the cost of servicing debts go up (if it’s not fixed which it wasn’t)

This reduces the remaining money an individual or company has to spend.

So slows economic activity.
Company profits fall as production reduces.
They lay off workers.
Wage increases fall as labour market becomes weak so no bargaining power.
Recession begins.
Inflation falls.
Central banks then start cutting rates

So, what’s different in 2023?

The debts of individuals and companies are mostly fixed for a term.
This means the rate increases are only affecting those whose loans are coming off a fixed rate.
This is estimated at about 15-20% per annum of total debts.

There has been no sharp reduction in economic growth and spending as economists predicted because the rate rises are not affecting the majority of companies or individuals yet.

It will keep getting progressively more restricted over time like a tightening noose, as the effects are cumulative.

Employment Staying Strong

This again has been a surprise to many but is logical up to now if the following is considered.

There is no immediate pressure to lay off workers as economies have not yet weakened (as most thought they would). Employers don’t want to lose employees if they think it will be hard to replace

them as it has been post-pandemic. But as economies start to slow this will reverse which is already starting to happen.

<u>What Are Markets Watching</u>

1) Inflation
2) Employment strength (unemployment above or below 4%)
3) ISM numbers which show global economic activity (below 50 is a retraction)

But it's crucial to keep reminding ourselves that the above factors messing with the moods in markets are transitory and will dissipate. We likely won't be talking about inflation and tight labour markets anything like as much in 2024.

<u>Quantum computers (something we will be talking about)</u>

There are already functioning quantum computers.

The implications for their uses are staggering and harnessing the technology is the new arms race for big governments as the stakes are huge.

This is an odd intro to the subject but please bear with.

The most recent Ant Man Marvel film featured the "quantum realm" which is where matter is subatomic meaning smaller than an atom. It's things like photons and electrons that are in an atom. In the film the key understanding is that the physics of our world don't apply in the Quantum realm. The rules are completely different, and this is scientifically exactly right.

This is where it gets freaky but it's real.

A regular supercomputer has enormous computational power using bits. These are essentially either a 1 or 0. It crunches data in a linear progression.

The difference with a Quantum computer is that if electrons are used as bits (then called a qubit) they can because of the different rules of subatomic physics be both a 1 and 0 simultaneously.

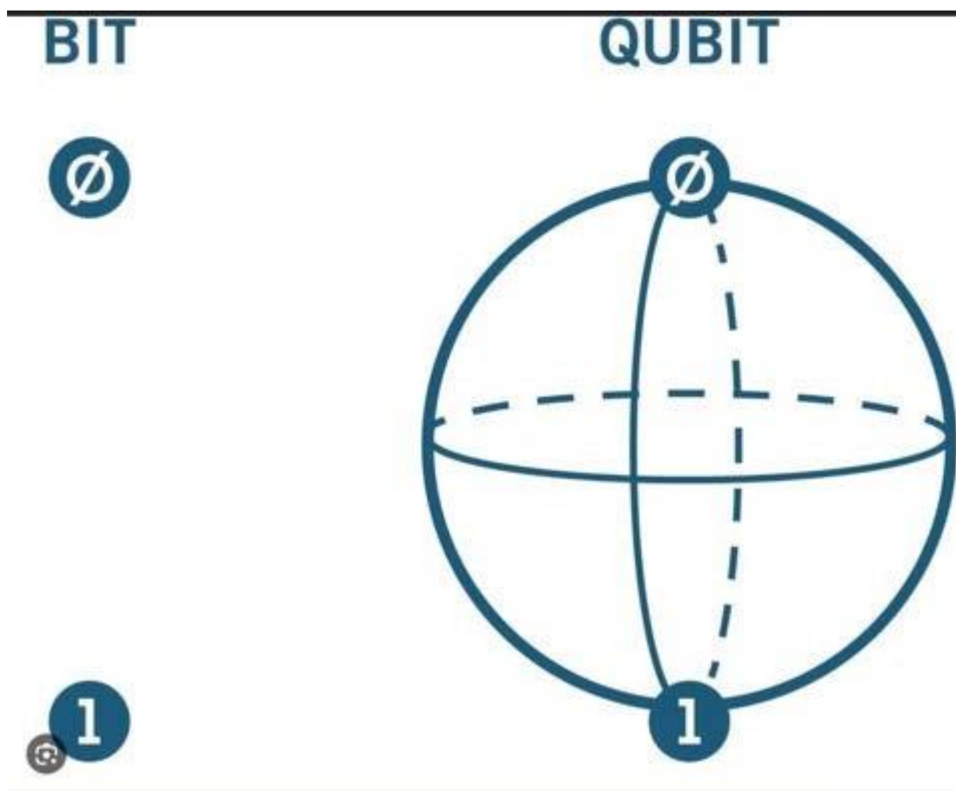
At a subatomic level something can be both a particle and a wave so be in different places at the same time 🤯 🤯 🤯 as different things.

The key difference to what these computers can do therefore is the same as why Ai and large language models are also transformatory.

Computing using Qubits allows for quantum computers to see everything pretty much all at once to identify patterns and markers in huge data sets in minutes or hours which would take supercomputers months, years or even decades.

Regular computers process data in a linear progression so like reading words.

Quantum sees it all as a single picture at the same time in essence.



To unlock new discoveries requires analysis of experimentation and results. This can with Quantum be modelled out almost instantaneously to an exponential degree. All data can be analysed, and new simulations run from it at speeds and quantities unimaginable until now.

This will be revolutionary for so many areas including:

10 QUANTUM COMPUTING APPLICATIONS TO KNOW

- Artificial intelligence
- Better batteries
- Cleaner fertilization
- Cybersecurity
- Drug development
- Electronic materials discovery
- Financial modelling
- Solar capture
- Traffic optimization
- Weather forecasting and climate change

The one that Governments are most stressed about is that no current encryption model will prevent a Quantum computer from cracking it

<u>All we need to focus on</u>

That stock markets on average will return a growth of around 7-9% per annum. Some years are plus 15-20% and a few are minus 20% but it will all average out to around 7-9% over the cycle.

Why?

Because of the growth in company profits.

2.5% from inflation
3% average rise in real net profits
2.5% dividend

Total averages around 8% pa

Remember the above figures are averages (see Super 7 above)

Why invest in stocks and bonds at all?

Simply because cash accounts like a Building Society loses you money after inflation is factored in. The purchasing power of £1 even with interest added goes down over time as the interest is lower than inflation. So, to have your money grow in purchasing power you need to go up the volatility curve.

Volatility curve

This is just a way of expressing the idea of how much that the value of an investment can fluctuate. Cash in a savings ACC does not fall in capital value ever but does lose value against inflation over time.

Investments in equities and bonds will fluctuate in capital value but they give positive returns above inflation over time.

It's about averages

So, if we know the average return is around 8% for a whole index of stocks and we'd like to outperform this then what element should we focus on?

The answer if you refer back to the 3 elements that make up the 8% is the variable one, the growth rate of real profits.

If these are growing not at 3% but at 10 or even 20% pa and importantly can be predicted to keep doing so for the foreseeable future then returns from those companies' stocks will be far better than average.

Conclusion

Markets will fixate on short term moves in interest rates or inflation, but these don't really matter.

What matters is:

1) Invest in quality assets

2) Don't worry about short term fluctuations.
3) Equity valuations over time follow profit growth.
4) For above average returns over time invest where the growth will be consistently better.

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