STRATEGY OUTLOOK

August 2023

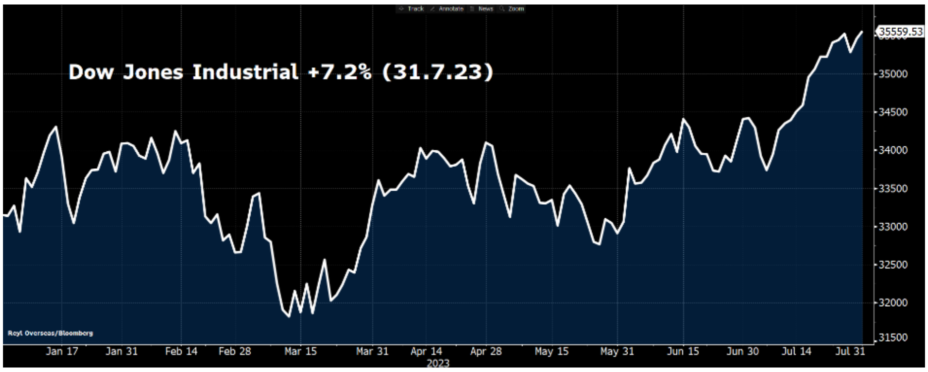
Key takeaways-

- 2Q earnings from LVMH, American, United, Lindt, Richemont….
- too much debt - still kicking the can down the road/freeway/autobahn…

July will likely be remembered for rain and mild temperatures here in Switzerland especially relative to a superb June. Some brightness came and went as the Tour de France and Wimbledon helped escape the rain but in markets it was all sunshine. The Dow Jones Industrial rallied for 13 consecutive days in July, a feat not surpassed since 1987. In 1987 what followed was a 29% rally albeit by October Black Monday had hit.

Despite central bankers' best efforts to tighten financial conditions (via interest rate hikes) markets have remained strong and conditions loose. It's true that market breadth is narrow i.e., the rally is focussed on a small number of stocks (currently called the magnificent seven), but this is very slowly expanding. Indeed, it seems that **stocks are not proving very interest rate sensitive** at all. Recession fears look either early or wrong. The investor surveys show institutional investors generally long cash, EM stocks and bonds. Overall, they look hesitant to join the rally positioned short stocks versus their benchmarks.

With such a confusingly resilient growth picture its worth looking at Q2 earnings. Meta, Microsoft, Google, and Netflix results were perhaps predictable and indeed have been the fuel to the rally so far. The magnificent seven (Google, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla) have accounted for 73% of S&P returns year to date. However, strip these names out of the index and the expensiveness of the index plummets to only 15x EPS.



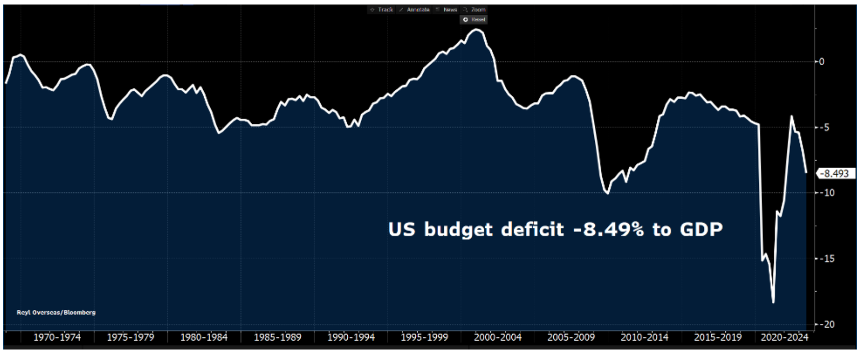
However, a particular area of interest is in **discretionary spending** where cutbacks should, in theory, come quickly if and when the consumer gets nervous.

LVMH, the French listed luxury goods group posted strong results. Organic growth was up 17% with EPS up 30%. Fashion and leather goods, which account for 49% of group revenue, had an incredible quarter led by Louis Vuitton and Dior. Operating margins remain at 40.5% with the only geographical weakness coming from the US.

Elsewhere both American Airlines and United posted better than expected earnings and raised their full year guidance**. In Switzerland**, the chocolate producer Lindt & Spruengli saw strong organic growth and margin prints. All geographies were strong, and they noted the continuing trend in global and travel retail. Richemont, the Swiss owner of Cartier reported a surprise drop in revenue from the Americas for Q2 but strong Asian sales. Sales in greater China rose 20%. Overall, the gain in sales was 19% with jewellery revenue up 24%. Interestingly, Europe saw an increase of 11% driven by resilient domestic demand and tourism.

Tesla saw its shares fall as despite a whopping 47% y/y increase in revenue free cash flow and gross margins contracted. Additionally, the company have chosen to cut prices to drive volume growth albeit their communication has been confusing. Their solar installation and backup battery business rose 74% y/y.

Bank of America released credit card spending data which points to below-trend, but not recessionary, economic activity. Amazon's Prime day, which took place July 11 & 12th also showed appetite for goods was up 25% from last year. To what extent this was 25% more discounting than last year is unknown! **Caterpillar, a good proxy for global construction spending** saw the company post 2Q earnings that easily beat sales, volume, and margin estimates. Starbucks released a good set of earnings too. Its sales in China rose 46% with even North America growing 7%. Margins grew more than expectations and sit today at 17%. The brand added 588 new stores to total 37,222, 51% of which are company owned.



After years of **kicking the can down the road** in terms of the fiscal situation the evidence remains that central banks will be forced to keep markets liquid and volatility down. In short this means liquidity and QE will continue to be a source of support to markets over the medium term. The near collapse of the UK defined benefit pensions in September last year or the bankruptcies in the US banking sector in March this year continue to support the theory that the market will not be allowed to find its own equilibrium. In March free markets could have seen unsecured depositors >$250,000 lose all their money. Corporations and funds would have lost billions with the subsequent requirement to cut payroll, future investments, or contracts to survive and raise cash flow. US bonds could have become illiquid, US stocks would have likely seen a wave of sellers looking to escape and raise cash (foreigners own 70% of US GDP in US assets than US investors own of foreign assets). Contagion too probably wouldn't have been US centric. Financial stability is therefore just as important as monetary policy for authorities.

US deficits are increasing (as highlighted in the graph) and **within the next two years approximately 40% of this debt needs to be rolled** (commercial real estate will also see the need to roll over $2trn, many of these assets may now have a negative NPV). There is only one possible buyer – the Federal Reserve. Foreigners have been reducing their exposure to US debt for decades. The US too with the Russian invasion of Ukraine, rightly or wrongly, seized Russian assets without legal recourse and threw them out of the SWIFT banking system. That was a clear signal to any other nation to at least have a plan B, and not, have all your asset in the US system. Hence the **rise of the BRICS and central bank buying of gold**.

Add in a US election in 2024 and there is little chance of the free markets being allowed to find their equilibrium. Risky assets should, in that environment, outperform bonds.

"The budget should be balanced, the treasury refilled, public debt reduced, the arrogance of officialdom tempered and controlled, and the assistance to foreign lands curtailed, lest Rome becomes bankrupt." Marcus Tullius Cicero

Fiscal issues don't matter until they matter and for long amounts of time the market doesn't care. These are structural issues that may have no impact on markets for years to come. Indeed, a few days ago Fitch downgraded US Government debt to AA+. As a comparison the Swiss Government, Microsoft and J&J are AAA.

'The Met Office says summers will be 40C in 2060. The weather tomorrow, however, remains a mystery to them'

Alongside too much debt **demographics is an area of influence** in the long term but of little interest to markets given their differing time horizons. Baby boomers, born 1945 to 1964, control over $100 trillion in assets (by comparison the US GDP is $22trn). It's estimated that this generation will add 10m people to Florida's already 23m population over the next ten years as they move south. What that means for healthcare, eldercare and deathcare on top of specific real estate needs in Florida could be sizeable. Compare this to Japan. **Japan has over 10 million homes free because there are no families to live in them**. Fertility and the birth rate have fallen so far that there are more Japanese dying than being born. By 2035 there won't be enough taxpayers left. China too with their infamous one child policy now has a huge labour deficit under 40 years which will likely see manufacturing continue to shift to places like Mexico.

Markets have performed strongly so far this year and are very unlikely to continue going up in a straight line. There seems to be a lot of resiliency in the market versus an investor base that is sceptical. We added stock market exposure in early July as we believe its likely stocks will outperform bonds and cash. Exposure to oil services was added and for more conservative mandates we added dividend exposure.

The Fed have and are pushing interest rates higher at the fastest pace in 40 years. Indeed, with the strength in stocks, continual high growth rates and super tight labour markets there is a case that the Fed may still need to do a lot more. Yet tighter bank lending, manufacturing inventory overhand and slowing construction are headwinds. Ultimately **liquidity is key** we suspect a degree of stealth QE from the Fed has been occurring since the UK pension issues of September last year. **The gains of the first half of the year are unlikely to be simply repeated into Christmas but the bears still seem to outnumber the bulls**. Whether we have a recession or a soft landing and to what extent the global economy is really interest rate sensitive remain important questions. **Perhaps most importantly however is to figure out to what extent global liquidity i.e., the pool of cash and credit sloshing around financial markets will be positive or negative. If there is money sloshing about the system, then asset prices are going up.**

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