Elgin asset management

investment commentary monthly

Monthly Commentary 6th of August 2024

It was a bumpy ride for global stocks in July. Stock markets across the globe tumbled before the end of the month on fears over the future of AI. Some of the Magnificent 7 stocks saw their shares dropping double digit during the month, as investors questioned the high earnings expectations and expensive valuations. Overall, the month closed relatively flat for most global stock indices. On the other hand, bonds have been gaining positive momentum over the past couple of months as investors continue to believe that central banks are getting closer to rate cuts. UK, US and EU bonds were up more or less 2% for the month. In commodities gold's 5% gain in July was a solo performance. Silver, oil, and in general, commodities as measured by the CRY Index all ended with losses of -4%. The dollar index was down 1.67% while bitcoin was up 4.29%.

Tech's "rout" – breaking news

As we write this commentary the Japanese equity market had a horrible session, falling 12.2%, driven mostly by financials and technology. This has taken the drop from its July all-time high to more than 24% (15% in USD terms). The Taiwanese market, home to TSMC, the world's largest semiconductor manufacturer) had its worst drop in 57 years and fell almost 9%. Nasdaq futures (a tech proxy) is currently down 4.5%, for a drop 16% from its July high. This is all scary stuff. How much do we need to worry that this is the beginning of a new bear market? Below are our thoughts. We consider all of the above a healthy correction and not the beginning of a bear market.

What has caused these sudden falls in equities, and tech in particular?

If we had to choose three reasons, they would be:

1. A rise in US unemployment from 4.1% to 4.3%, coupled with a less-than-expected rise of "only" 114,000 new jobs created.
2. A further contraction in US manufacturing.
3. Berkshire Hathaway's announcement that they sold (a massive) $75B of Apple shares in the second quarter while big tech earnings for the likes of Microsoft, Alphabet and Amazon "disappointed".

Let us look at each reason.

1. A rise in US unemployment from 4.1% to 4.3%, coupled with a less-than-expected rise of "only" 114,000 new jobs created.

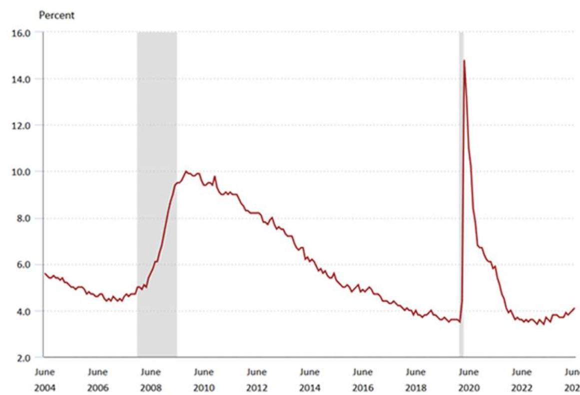
This was a surprise and created a growth scare for the US economy, with many economists increasing the probability of a recession, rather than a soft landing. Now, "rear-view mirror" pundits are saying that the US Central Bank should have cut rates last week to prevent a recession.

We are of the opinion that the markets have over-reacted to the downside and do not think the probability of a recession is very high.

The reasons:

- So called “high frequency” data (airline passengers, restaurant bookings, bank lending, tax withholding, bankruptcy filings, card spending, retail sales) are showing a solid economy.
- The private sector’s finances are in rude health with much less leverage than in the past, and as such, more disposable income. Households’ debt servicing ability has grown.
- Earnings growth is the highest since 2021. Revenue growth is solid. Margins are strong. This is a sign of a healthy economy.
- Q2 productivity rose more than expected, by 2.3% quarter-on-quarter annualized. Versus last year, productivity was up a strong 2.7% year-over-year.
- Goldman Sach’s economists raised their recession probability from 15% to 25%. That’s still a 75% chance of no recession.

As for unemployment it is still exceedingly low as the chart below of the last 20 years shows:



US UNEMPLOYMENT RATE 20 YEARS

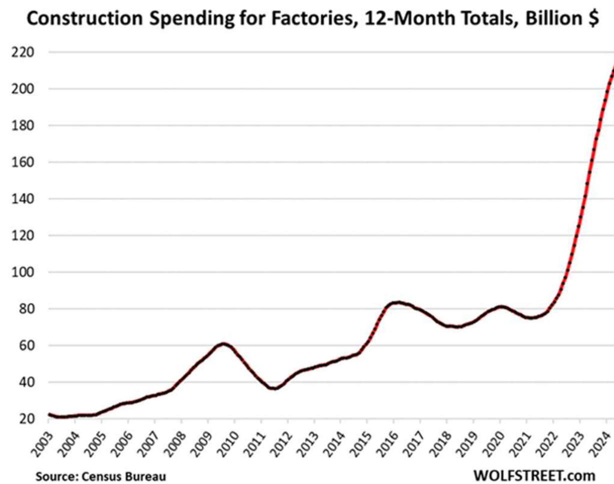
So, the growth outlook has weakened, and the probability of a recession in the medium term looks a bit higher. But there are many measures that look just fine.

2. A further contraction in US manufacturing.

The so-called ISM manufacturing PMI (Purchasing Managers Index) has weakened further in June, and came in quite a bit below expectations.

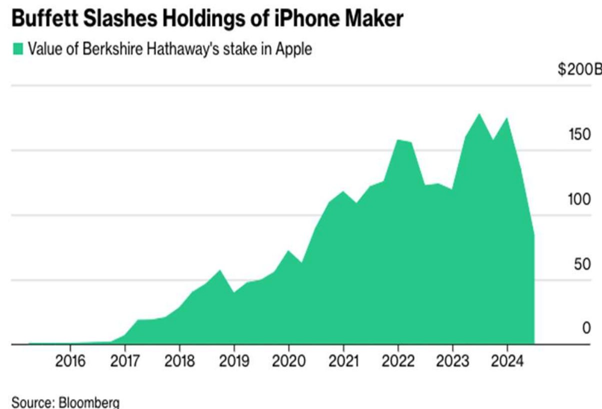
Yet, we have to keep in mind that manufacturing is not a large part of the US economy. Services are much bigger and they are still growing.

There is also a huge increase in new factories being built in the US, which bodes well for manufacturing. The chart below does not lie as “reshoring” is picking up steam. The figure is huge.



3. Berkshire Hathaway’s announcement that they sold (a massive) $75B of Apple shares in the second quarter while big tech earnings for the likes of Microsoft, Alphabet and Amazon “disappointed”

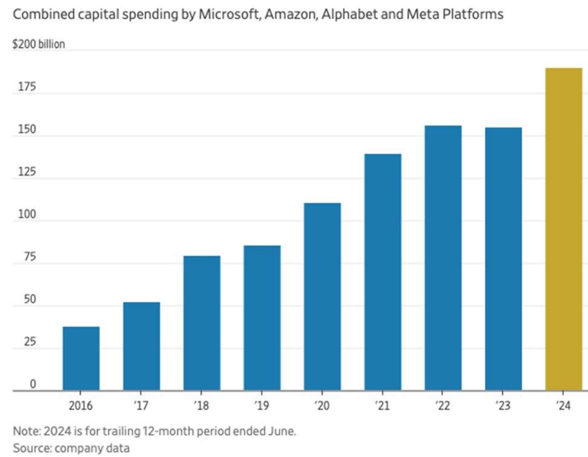
Buffett was one of Apple’s largest investors, and since he first started investing in 2016 the stock is up almost 900%. It is not surprising that he has taken profit. Berkshire still own $80B worth of Apple, and it is still their biggest holding. It’s also not the first time Berkshire has cut its stake in Apple. At its annual meeting in May, the firm revealed that it had reduced its position during the first quarter of the year.



We like Apple for the following reasons:

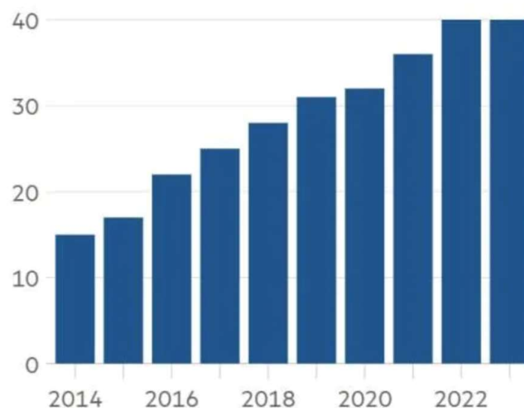
- It has a solid balance sheet and expected to grow earnings faster than the market.
- It has amazing brand loyalty.
- It is on the cusp of a major upgrade cycle in 2025 and 2026. This is on the back of AI.

As for big tech, some have likened the bubble-like rise in their stock prices to the telecom companies before the dotcom crash. They cite massive spending, and at a $200B annual clip for 4 companies, it is:



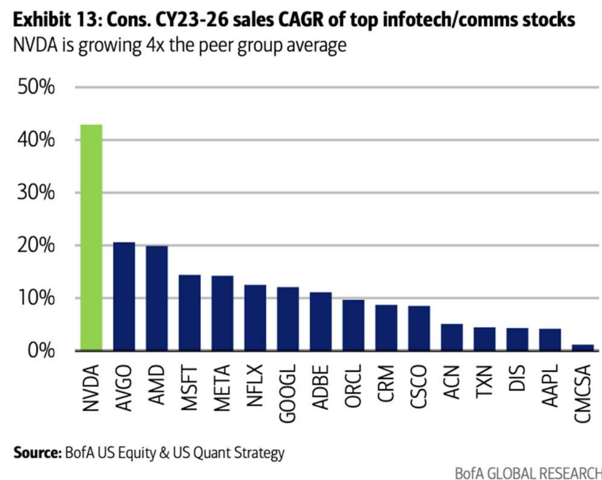
We do not believe that they are in a bubble about to burst in a big way. A big difference is that the current big-tech companies have very solid balance sheets and various drivers of growth. They are better managed, and the top five (Microsoft, Apple, Nvidia, Alphabet, Amazon and Meta) have $400 billion in free cash flow. The reason that they are spending big today and for the next few years is that they see massive potential in AI. They have strong management and would not throw money away just to keep up. They obviously see a huge opportunity. In fact, Microsoft announced in its recent earnings report that they do not have the capacity to meet demand.

They also spend big on Research and Development, which becomes a perpetual cycle of enduring growth. See below from the FT. With 40% of the total R&D spending of the S&P 500, they are well positioned to maintain a leading edge over competitors.



As Robert Armstrong from the FT puts it: “With regards to capital allocation, what is special about Big Tech companies is they achieve high Returns on Equity (ROEs) while having an absolutely enormous amount of equity in their businesses. Google has an ROE of more than 25 per cent on equity of $300bn. That is mad, and suggests immense capacity to increase investment further, as needed. What these companies cannot be accused of is maximising short-term profits at the cost of investment”.

Below are the expected annual sales growth expectations for 2023-2026 from Bank of America.



There are six companies that are in our Best Ideas portfolio that are expected to grow their revenues double digit over the next two years.

The forward guidance of many large tech companies like TSMC, ASML, META and ServiceNow has been very strong.

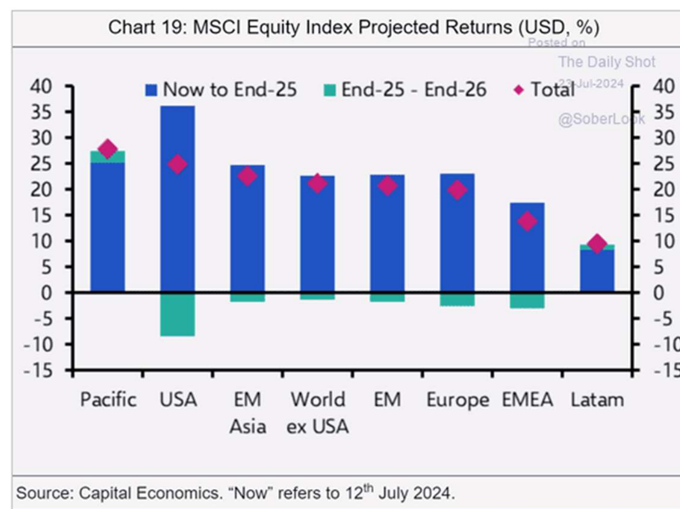
For example, TSMC announced recently: “*Over the past three months, we observed strong AI and high-end smartphone-related demand from our customers, as compared to three months ago… Thus, we continue to expect 2024 to be a strong growth year for TSMC. We are raising our full-year guidance and now expect revenue to increase slightly above mid-20s % in USD terms…*”.

ASML, the biggest high-end semiconductor equipment manufacturer said: “*We currently see strong developments in AI driving most of the industry recovery and growth ahead of other end market segments. We still expect a stronger second half relative to the first half of the year*.”

Finally, we should add that investors got spoiled with the massive equity returns of tech companies in the last 20 months or so. Valuations are still expensive as they deserve a premium to the market. They are certainly less expensive now. Despite the immense promise of AI and other innovative tech applications, the market seems to have moved ahead of itself. Since the end of 2022 the Nasdaq has appreciated at an annual rate of 32%. This is not natural, and it needed to exhale.

So where are markets headed?

Capital Economics, a well-respected firm of economists created the below forecasts on July 11th, the day after the recent market peak:



Source: Capital Economics

As you can see, they expect 25% return in the US market until the end of 2026. And that's before the 8% drop since the chart was published. The odds are good… **So, if anything, it is a good time to put cash to work. I.e. When markets are panicking.**

Despite the uncomfortable feelings we all experience when we see markets going down fast, if you stick to quality, the future is bright!

We leave you with a much-used quote, but still most relevant:

It's not about timing the market, it's about ***time in the market.***

The Elgin Analysts Team

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