QUARTERLY INVESTMENT OUTLOOK

APRIL 2024

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EXECUTIVE SUMMARY

The first quarter of 2024 concludes with the global economy on a solid footing. Since the middle of 2022 we have argued that an economic ‘soft landing’ is most likely, and consider the current environment to align with that definition. Whilst the US remains a notable outperformer, the global economy is experiencing falling inflation, driven by rebalancing labour markets, and broader growth.

Capital markets have embraced this environment, with multiple equity indices climbing to record highs, credit spreads tightening and bond yields remaining well below last year’s recent peak. Global markets are up 7.8%[1] so far this year - the strongest first quarter of the year since 2019. Mega-cap technology stocks continue to lead equity markets, driving US strength. However, participation has spread beyond AI-related excitement, with new highs registered in sectors such as financials, industrials and healthcare, as well as France, India and Japan.

In this quarter’s Investment Outlook, we outline the broadening in economic momentum and possible next phase of the cycle in section one. In section two, we consider the market implications of the upcoming US presidential election, with particular reference to a possible second term for Donald Trump. Additionally, we summarise research that analyses whether increased market concentration presents a threat to the health of the longer-term market cycle, and how we emphasise smaller companies as a way to diversify and capture lesser-known investment opportunities.

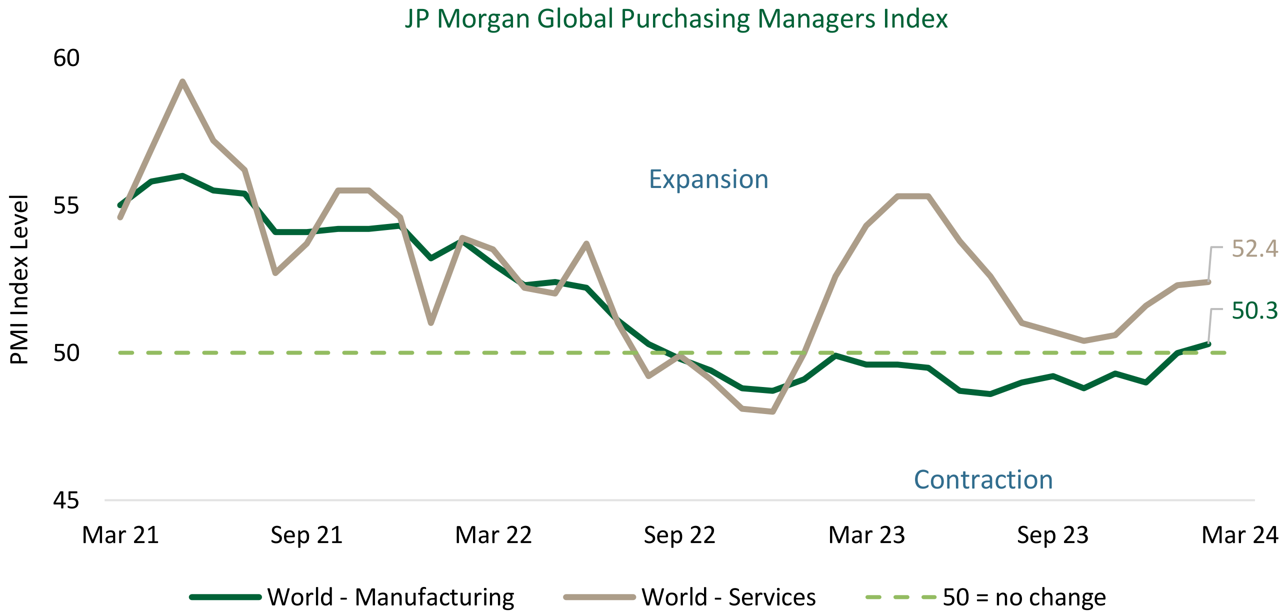
[1] *Source: Bloomberg, USD, March 2024.*

Section 1. Assessing the Global Economy

1.1 Global Economic Momentum Has Broadened

Our assessment tells us that the global economy is in reasonably good shape. As inflationary pressures continue to ease, the risk of a sustained recession is also ebbing. In fact, there are signs that global economic momentum is picking up steam. The latest reading of the JP Morgan global purchasing managers index (PMI), which aggregates business activity trends across 40 countries and c. 27,000 companies, shows broad-based acceleration across manufacturing and services, with the strongest composite reading in eight months.

Chart 1[2]: Broader global growth implies lower recession risks

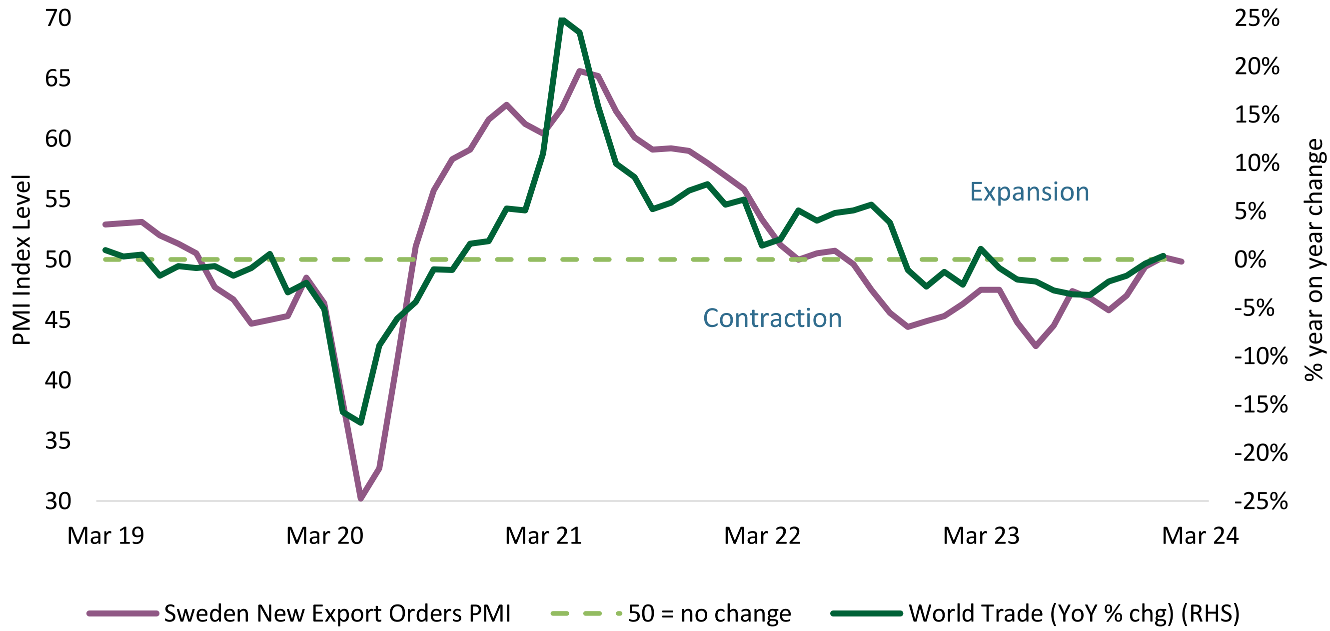


An important development is that the manufacturing sector is moving out of recession. Global manufacturing has been under pressure for the past two years, facing headwinds of rising interest rates and slowing global demand, particularly from Asia. With China's economic woes stabilising, following an erratic exit from zero-covid policies last year, the outlook for manufacturing looks brighter. Sweden is a useful gauge of manufacturing momentum, as a small, open and highly trade-driven economy. Export orders have been improving for approximately nine months, consistent with broader measures of world trade, which have turned higher recently.

> The combination of manufacturing moving out of a two-year recession, and a further strengthening in the services sector, means the risk of an imminent global recession remains relatively low.

[2] *Source: Bloomberg, S&P Global / JP Morgan, February 2024.*

Chart 2[3]: Manufacturing is no longer a burden to the global economy



1.2 Economic overheating or global recession?

The question that follows is what comes next for the global economic cycle? With growth broadening, could we see an economic over-heating that reignites inflation and motivates an aggressive second instalment of interest rate hikes? This concern is most relevant for the US, where growth has been consistently resilient. In 2023, when the consensus forecast was for a marked slowdown, the US economy grew at 2.5% - a level which exceeds most estimates of the economy's 'potential growth[4]'.

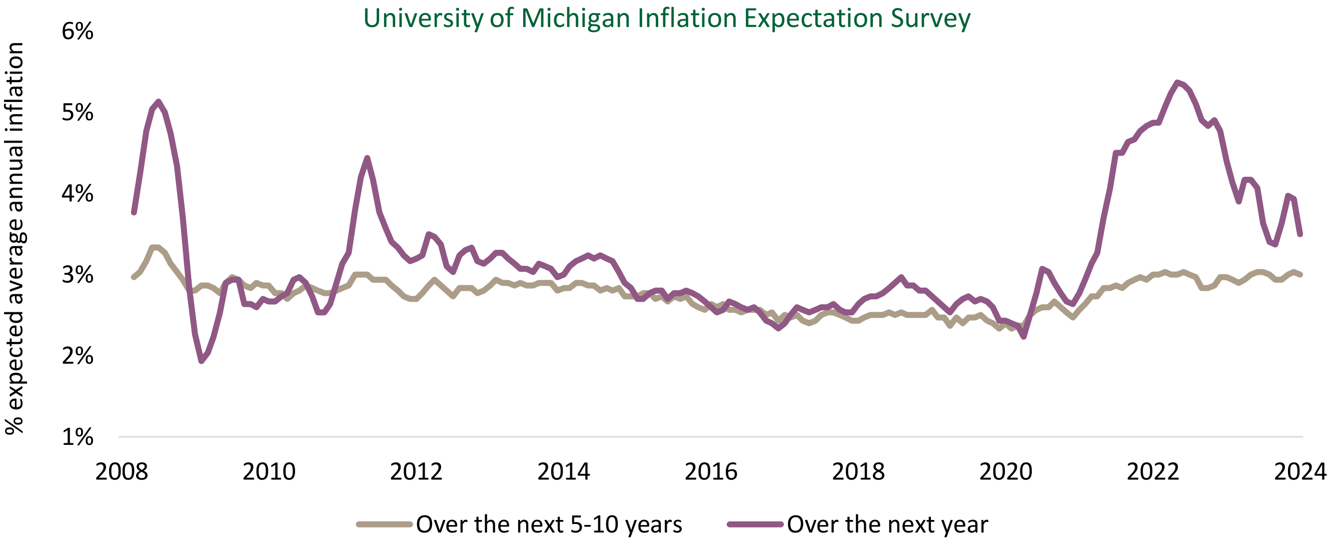
The case for an economic overheating is not to be dismissed. As equity, bond and real estate markets have rallied in recent months, financial conditions have eased, acting as a tailwind to consumer confidence and spending. Recent inflation readings have been higher than expected, challenging the assumed gradual disinflationary trend.

Whilst monthly indicators can be volatile, economic first principles ensure we are focused on what matters most. The strongest pass-through to sustained price inflation comes from accelerating inflation expectations, which in turn feeds wage growth. Currently, inflation expectations are well-anchored at levels consistent with the 2010-15 period, having spent 2015-20 in a low growth, low inflation environment.

> In the absence of an exogenous shock that disrupts global demand and supply, sustained inflation would require consumers to anticipate accelerating prices, driving up wages. There is little sign of this today.

[3] *Source: Bloomberg, CPB World Trade Volume Index, Swedbank Purchasing Managers Index (3 month moving average), February 2024.*
[4] *Potential growth is defined as the rate of growth that an economy can sustain over the medium term without generating excess inflation.*

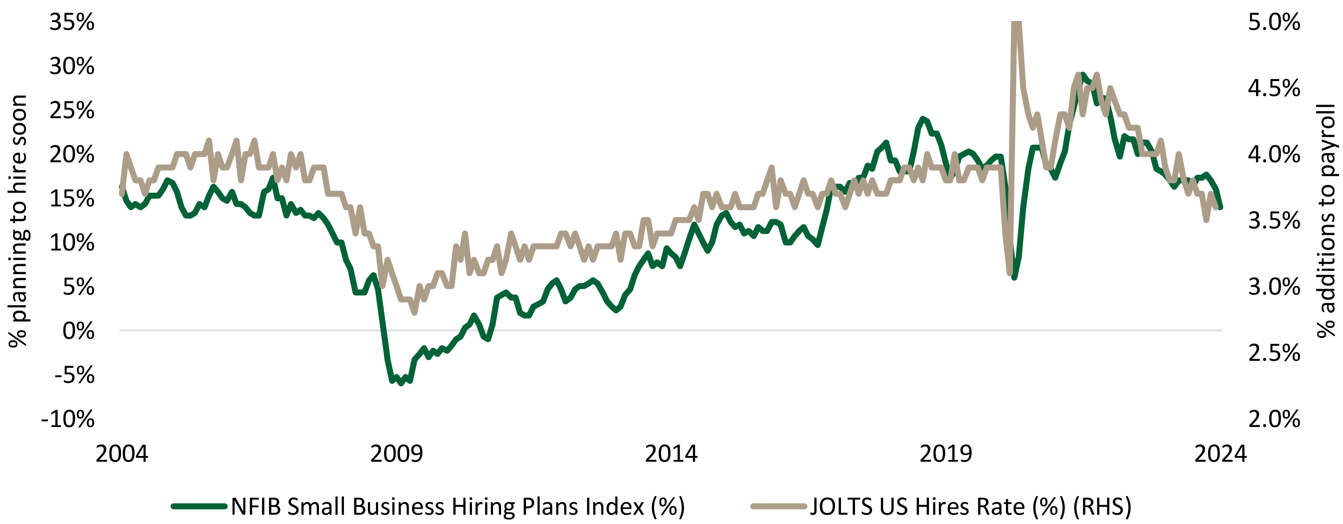
Chart 3[5]: Well contained inflation expectations underpin the soft landing scenario



An equally strong case can be made for a gradual slowing of economic growth that tips into a global recession, either later this year or in 2025. Growth in Europe and the UK was a paltry 0.5%[6] for 2023, and the region continues to face tight monetary and fiscal policy that weighs on economic momentum. The Economist newspaper recently outlined '*the triple shock facing Europe's economy*[7]', which having just dealt with an energy shock, now faces notable threats to businesses from cheap Chinese imports and a possible second Trump presidency.

US resilience is also not to be taken for granted. Evidence that the labour market is softening is currently welcomed as a sign of post-pandemic normalisation and lower inflation. Yet, the cycle of fewer job vacancies, reduced hiring, increased consumer savings and rising unemployment is well supported by economic history, explaining why unemployment cannot stay low indefinitely.

Chart 4[8]: Declining US hiring intentions signals softer employment growth to come



[5] *Source: Bloomberg, CPB World Trade Volume Index, Swedbank Purchasing Managers Index (3 month moving average), February 2024.*
[6] *Source: IMF Economic Outlook, January 2024.*
[7] *Source: The Economist, 28 March 2024.*
[8] *Source: Bloomberg, Bureau of Labor Statistics, NFIB. The JOLTs Hires Rate has been capped at 5% (actual peak was 6.1% in May 2020).*

With global recessions painful for equity investors, their warning signs warrant close attention and ongoing monitoring. Segments of the US economy are softening, however from a global perspective the weight of evidence does not indicate an uncomfortably high risk of near-term collapse. Two other developments are noteworthy.

Firstly, central banks are collectively shifting to a more accommodative stance. Whilst the Bank of Japan recently caught the headlines by raising rates for the first time in 17 years, they do so from a negative rate, and have retained very easy policy. The Federal Reserve, Bank of England and European Central Bank have all recently signalled they are likely to start reducing interest rates later this year, citing continued progress bringing inflation down. The Swiss National Bank began their cutting cycle in March. Importantly, central bankers now seem more sensitive to a growth disappointment than an inflation overshoot, and are unlikely to retain restrictive interest rate policy for much longer.

Secondly, China's economy has stabilised, with signs that industrial production, investment and exports are improving. Celebration would be premature, however, with real estate deleveraging stifling consumer demand and underpinning a longer-term deflationary slowdown. Nevertheless, sequential and modest growth in the world's second largest economy suggests limited global recession risks this year.

> As the economic soft landing becomes a reality, we are acutely aware of what could come next. The risks of economic overheating or recession are not to be dismissed, but as inflation moderates and global growth shows signs of broadening, they remain well contained in the near term. In which case, equity market engagement is well supported.

Section 2. Multi Asset Investment Strategy

2.1 The US Presidential Election – Market Implications

In addition to the next phase of the economic cycle, the upcoming US election represents a source of uncertainty for capital market investors this year. As we wrote last quarter, the state of the US economy will be critical in determining the chances of a second term for President Biden. The incumbent is re-elected approximately two-thirds of the time, and in c. 80% of non-recession election years.

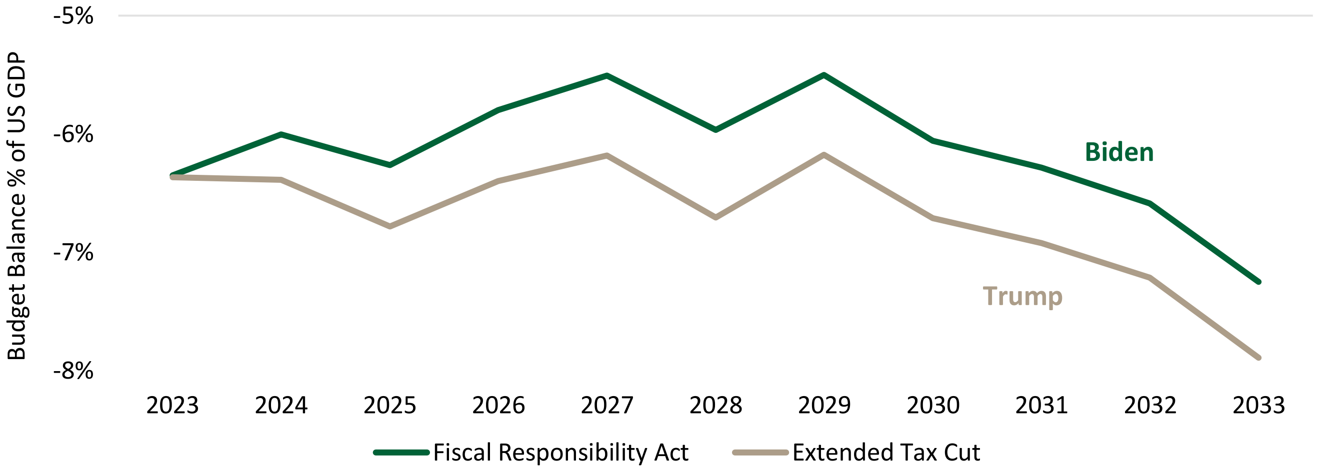
Of course, 2024 might be different. President Biden's approval rating has not benefited from recent US economic strength, leaving him vulnerable to adverse growth or inflation surprises. With former president Donald Trump the presumptive Republican candidate, a close re-match awaits. Unusually, both candidates are vying for a second term. Voters may be comparing their own financial situation in the past four years to Mr Trump's first term, when interest rates, inflation and geopolitics were more stable. This boosts Mr Trump's chances, however, his popularity is also relatively low, considering his track record of erratic policy making and the 91 felony charges he is facing.

Whilst it is too early to form any longer-term conclusions that might inform investment strategy, we are regularly asked what the market implications of a second Trump presidency might be. Policy uncertainty is considerable, but there are a few areas that are likely to be in focus; these are highlighted below, along with our assessment of the market implications.

Expansionary Fiscal Policy

Mr Trump has made clear his intention to pursue pro-work tax policies, keeping corporate and individual taxes low or reducing them further. The budget deficit is unlikely to fall under either candidate, but Republican control of the White House and Congress would be particularly expansionary.

Chart 5[9]: Little sign of fiscal consolidation in the years to come

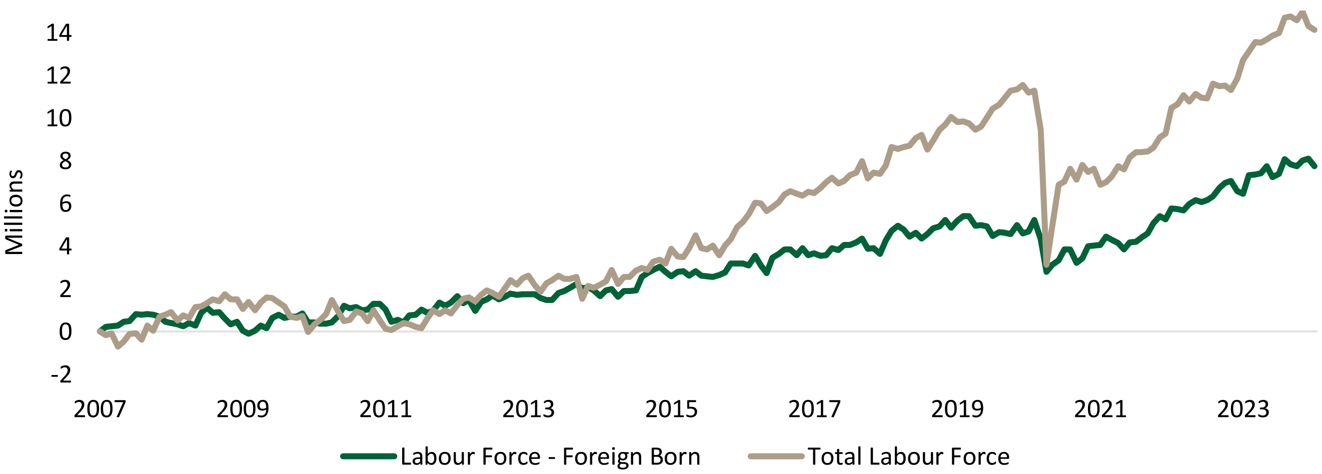


In the short term, equity markets may respond with a similar sentiment boost as in 2016/17, with earnings per share estimates being revised higher. However, there is a longer-term consideration around the sustainability of the US fiscal position. Bond markets may require higher 'term premium', pushing up long term Treasury yields, to the detriment of equity market valuations.

Slowing Labour Supply Growth

A notable feature of the US labour market's current strength is post-pandemic growth in immigration, addressing major labour shortages in the services and construction sector. Strict immigration controls proposed by Mr Trump are likely to limit labour supply growth and, particularly in the absence of a recession, act as a tailwind to wage growth and ultimately price inflation.

Chart 6[9]: Tighter labour supply controls could drive inflationary pressures



Strict immigration controls would increase the probability of the 'economic overheating' scenario described in section one, where inflation expectations become de-anchored and interest rates rise anew. Should this come to pass, bond yields will rise, and equity market valuations are likely to reset to lower levels.

[9] *Source: BCA Research, March 2024.*

Trade

Protectionism was central to Mr Trump's first term, and recent threats of a blanket 10% tariff on all imports, and a "more than 60%" tariff on Chinese imports, makes clear it is a policy priority for his second. This would be particularly problematic for the global economy, weighing on the manufacturing sector still in the early stages of recovery, and exacerbating China's long-term growth slowdown.

The European economy would also be threatened, with c. $540billion of exported sales in the US last year. A recent study by the German Economic Institute[10] estimated that world GDP could be approximately 1% smaller by 2028, assuming such threats are carried out and are responded to in kind. Germany would take a particular hit, as an export-oriented economy, with their main export partners suffering a 5.5% decline in demand relative to the status quo.

Overall, whilst a case can be made for a short-term boost to US profitability that emboldens the market cycle, the medium-long term impact of a second Donald Trump presidency presents notable investment risks. In particular, the combination of increased tariffs, strict US immigration controls and a ballooning fiscal deficit could be a recipe for volatile market conditions.

Of course, this analysis is based on assumptions made with considerable uncertainty and variability. A lot can change in the coming eight months, not to mention Mr Trump's willingness and ability to follow through on these policies, even if he is successful in November. Nevertheless, we will keep these critical developments under close attention.

2.2 A Concentrated Equity Market – Does it matter?

As equity markets soar to record new highs, one question is commonly asked: does market concentration represent a concern?

A recent study by Goldman Sachs[11] analysed this question in detail, with the global equity market experiencing increased concentration by country, sector and underlying companies over recent years. The US has risen as a share of the global market, and is now 62.5%[12] of the MSCI All Country World Index. Technology constitutes almost 25% of global equity, and the top stocks have surged in relative size. In the US, the Magnificent 7[13] now represent 29% of the S&P 500 Index. In Europe, the GRANOLAS[14], a new acronym which captures 11 dominant growth companies across industries, have risen to 20.5% of the European equity market[15].

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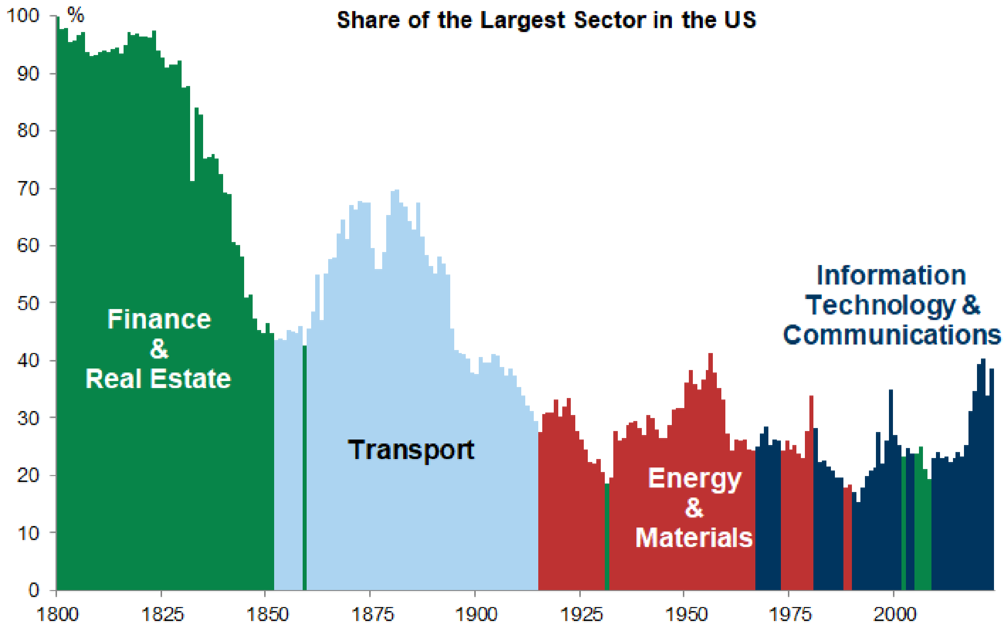
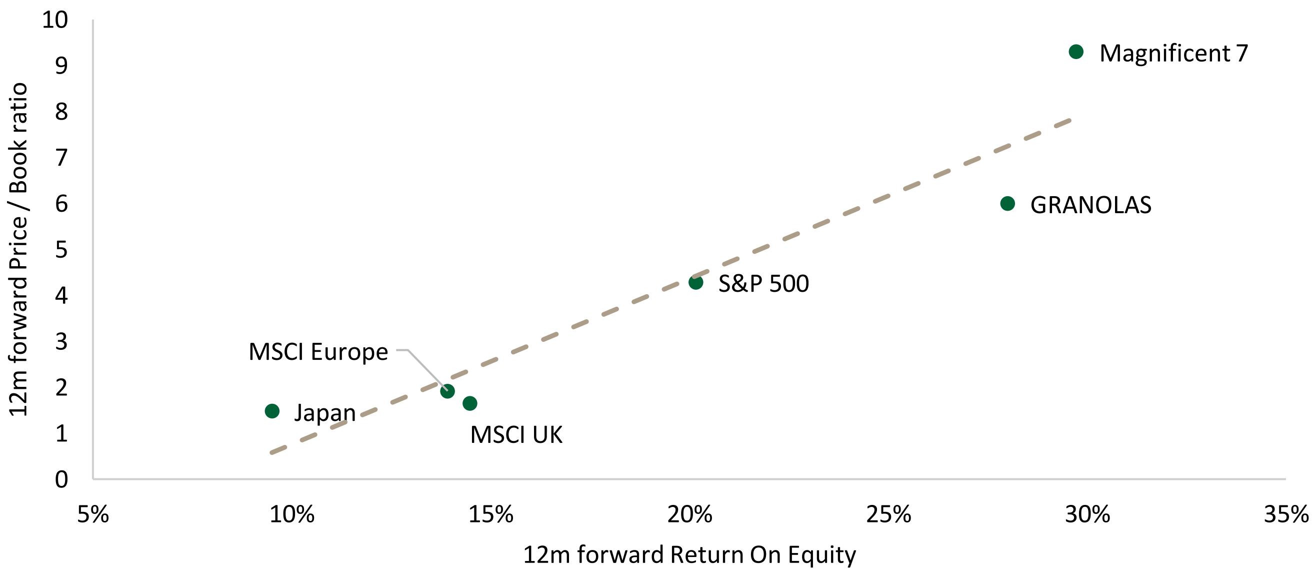
[10] Source: "What if Trump is re-elected?", German Economic Institute, March 2024.
[11] Source: "The Concentration Conundrum: What to do about market dominance", Goldman Sachs Global Strategy Paper, March 2024.
[12] Source: Bloomberg, 02 April 2024.
[13] The Magnificent 7 are Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia, Tesla.
[14] The GRANOLAS are GSK, Roche, ASML, Nestle, Novartis, Novo Nordisk, L'Oreal, LVMH, AstraZeneca, SAP and Sanofi.
[15] Source: Bloomberg, March 2024. Based on the EuroStoxx 600 Index.

Chart 7[16]: A high but not unprecedented level of US market concentration



Market concentration is not without precedent. In December 1989, Japan constituted 37% of global equities, compared to less than 10% today[17]. This does not however imply that current US dominance should reverse; concentration in itself does not represent a threat to investors if it is supported by investment fundamentals. The US economy has demonstrated greater resilience in recent years, with deeper market liquidity, stronger earnings growth and a higher reinvestment rate. This has encouraged US-listings of international companies, supporting the trend of US leadership. Whilst valuations are higher in the US, when adjusted for higher profitability, there is little evidence of excess.

Chart 8[16]: US profitability-adjusted valuations are not extreme



[16] *Source: Goldman Sachs, March 2024.*
[17] *Source: Bloomberg, February 2024*

US outperformance is widely accepted, but the eye-watering share price gains of some technology giants in recent years is surely a dangerous sign? Nvidia, for example, has leapt 225%[1] in the past 12 months alone, as investors repeatedly upgrade the company's earnings potential on exponential AI-driven semiconductor demand. Comparisons with the late 1990's 'Dot-Com bubble' are common, with even higher levels of stock concentration today. The below table compares the top US companies today and at the peak of the late 1990's period of excess, with relevant financial metrics.

Chart 9[16]: Market concentration does not equate to unjustified euphoria

	Valuation	Fundamentals	
	24m fwd Price / Earnings ratio	Return on Equity (%)	Net Income Margin (%)
Magnificent 7 (2024)			
Microsoft	27.2	29%	36%
Apple	22.8	133%	26%
Nvidia	31.1	69%	52%
Amazon	31.1	16%	7%
Alphabet	16.7	24%	25%
Meta Platforms	21.4	25%	33%
Tesla	40.3	14%	10%
Magnificent 7 - Aggregate	**25.1**	**44%**	**27%**
Tech Leaders (2000)			
Microsoft	53.2	35%	39%
Cisco Systems	101.7	22%	17%
Intel	42.1	26%	25%
Oracle	84.6	39%	15%
IBM	23.5	39%	9%
Lucent	37.9	36%	9%
Nortel Networks	86.4	-1%	-1%
Tech Leaders (2000) - Aggregate	**52.0**	**28%**	**16%**

> The largest companies in the US market today have, on aggregate, higher profitability, lower valuations and stronger balance sheets than those in the late 1990's. The argument for disinvestment from these high growth leaders due to euphoric share price gains is not well supported by fundamental analysis.

Whilst we do not see evidence of unjustified market euphoria that warrants a defensive approach, we do seek to mitigate market concentration through an active and diversified global strategy. Approximately half of our typical US allocation is through active managers and specialist strategies, capturing underlying companies outside of or at differing weight to the market.

In particular, one area of the US market we favour is the medium and smaller company sector, which offers the opportunity to capture high growth leaders that are earlier in their lifecycle. Furthermore, these stocks typically have lower analyst coverage than their larger peers, and have endured several years of diminishing investor enthusiasm, a consequence of mega-cap dominance. This can present compelling long-term opportunities.

Super Micro Computer is one example held by our favoured US small cap manager. As a provider of servers and storage systems for enterprises data centres, Super Micro remained a small cap company until mid-2022. Since then, the stock has returned c. 2,400%[18] and been promoted to the S&P 500 Index. Whilst the magnitude of their success is atypical, it demonstrates the hidden opportunities in the small cap technology space, and the need to allocate beyond the dominant market leaders, using experienced active managers, to capture them.

CONCLUSION

The coming six months will be critical for the next phase of the economic and market cycle, as central banks pivot their policy to reflect incoming growth and inflation trends, and the US presidential race enters the final stretch. Equity markets are currently well supported by broadening economic momentum, and market concentration is not perceived as an imminent threat to the health of the market. Nevertheless, periods of shorter-term volatility will not surprise us as investors react to ongoing developments and adjust their expectations. Our focus will remain disciplined, with a focus on longer term developments that drive our strategy. Our portfolios are well-diversified across assets and market segments, reflecting today’s economic, political and geopolitical shifting sands.

SFIM Chief Investment Officer Group
April 2024

[18] *Source: Bloomberg, March 2024, in US Dollars, since June 2022.*

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