St.Gotthard wealth

HOUSE VIEW

JULY 2024

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THE "NEVERCESSION"

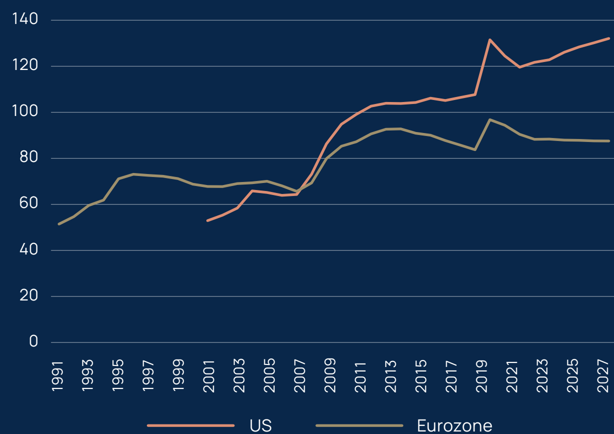
Despite the restrictive monetary policy of many central banks, among them the US Fed and the ECB, the major economies in the West do not appear to be weakening in any meaningful way, considering still positive economic growth in the US and an uptick in growth in Europe. The doomsayers look like they were proven wrong, giving rise to hope that recessions can be avoided, and that the world might enjoy a period of calm and prosperity for many years to come.

In reality however, the economic situation, although displaying more strength than was foreseen, is still fragile. From an aggregate perspective, the world economy's drive is the US, but also the EU, as both are being supported by material government support stemming from so-called "infrastructure investment": Both the "inflation reduction act" by the Biden administration in the US (amounting to USD 1.6tn) and the NextGenerationEU pact by the EU commission (EUR 800bn), were designed to support the respective economies – and have been a success, at least when looked at from the outside. The economies are growing still, after all, and this despite the monetary headwinds in the form of much higher short-term rates.

BORROWING FROM THE FUTURE

Under the disguise of "helping the economy", governments worldwide, and in particular in the West, are tapping into funds that will haunt several generations to come. Government debt in the G3 has reached levels exceeding annual economic production for more than a decade now. The spike during the pandemic was partially offset by strong economic growth in its aftermath, however the current situation remains dire. What is more, the US is splurging during a time of rather strong economic growth, while in the Eurozone, it is Germany's official debt brake keeping overall deficits in check – that is, below 4% of gdp for the currency area. However, other major EU countries such as France (6.0% in 2023) or Italy (12%) are in violation of the (still officially valid) Maastricht Treaty. With the radical left having gained significantly in France's surprise parliament elections, the prospect of balancing the budget in due time is minuscule, as is the case with Giorgia Meloni's government in Italy – but so is any credible punishment by their fellow European governments for violating the deficit rules.

GOVERNMENT DEBT AS % OF GDP



BOND MARKET TANTRUM TO FOLLOW?

The dire outlook for government finances appears to shock not too many market participants, as longer-term government bond yields have remained in check in the past 9 months. The drop in yields in late 2023 was connected to an expected economic slowdown in the US which did not materialize and hence yields rose this year again somewhat. After an intermediate high in late April around 4.7% for 10-year Treasuries, they have slightly eased to the midpoint of the last 18 months' range.

We are, however, far from any crisis in bond markets. This in part may have been helped by US Treasury Secretary Yellen's focus on funding the government primarily on the short end of the spectrum, driving down the average duration of outstanding Treasuries. The motive behind this to us is not to overload the supply of longer-term bonds that would be triggering further yield rises.

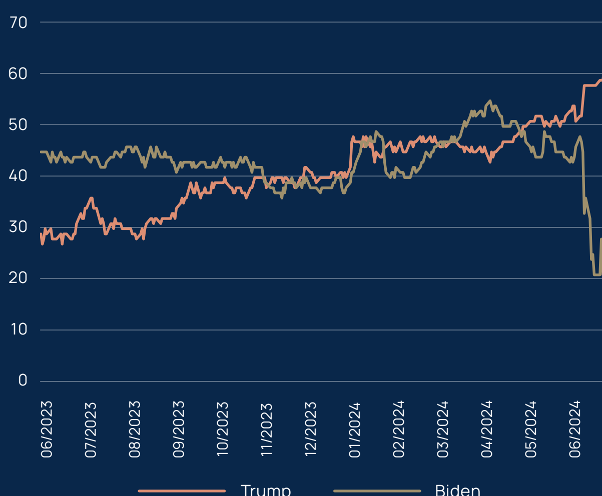
US TREASURIES AVERAGE YIELD AND MODIFIED DURATION

In the short term, mayhem is averted, but at the cost of further pushing up the government's debt servicing costs (as currently, T-Bills yield up to 1 percentage point more than for instance 10-year issues), which in turn drives the deficit up further. There are more factors that should keep investors alert to an impending US debt crisis, for instance the famous "Trump tax cuts" of 2017 that expire next year and would need to be renewed. According to the bipartisan Congressional Budget Office (CBO), the cost estimate of extending the expiring portions of Trump's 2017 tax cuts amounts to USD 4.6tn over ten years. Spread evenly, that's 70% of last year's net interest outlays by the government, which are rising quickly, too. According to the CBO, government funding costs will rise by 35% in 2024 alone to USD 892bn, a whopping 18% of federal revenues, and relentlessly rise further.

TRUMP OR BIDEN?

Following the candidates' debate in late June, observers including ourselves were dismayed by President Biden's performance and it is only due to the made-up minds of a huge part of the electorate that poll figures for the 80+ years old president didn't plunge materially in the aftermath of the debate. However, betting markets adjusted strongly. We take the view that another Trump presidency – in the absence of a team change on the side of Democrats – has become much likelier.

BETTING MARKETS PROBALITIES: TRUMP VS BIDEN



Markets could take this as a positive, considering the first Trump presidency brought about tax cuts for corporates that drove up earnings, and also reduced red tape in the energy sector, leading to growing US domestic oil production during his presidency. While oil prices could suffer consequently, we do not think lower energy prices are a given in the case of Trump winning the presidency as there are multiple other factors driving energy markets.

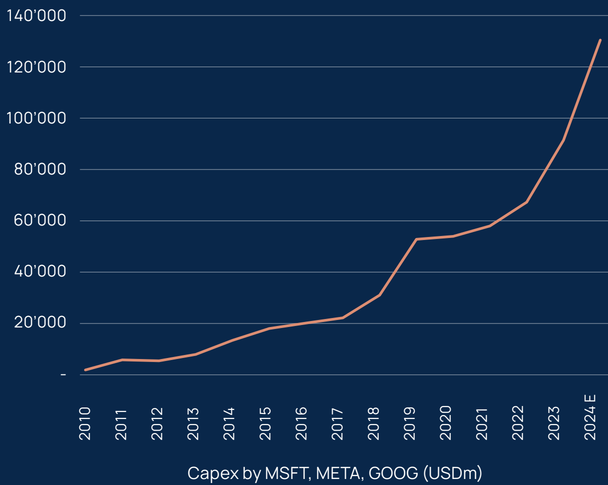
Following the debate, Treasury yields leaped upwards for several days. Market participants hence expect the deficit to further rise under a Trump presidency, exerting pressure on bond prices. We would also expect a new Trump administration, as was already announced by the former president himself, to bring on a new round of tariffs on all imports in the order of 10%, which would also stoke inflation. Higher inflation rates for longer rattles bond investors and therefore bond prices could become under pressure, should a Trump presidency gain further in likelihood.

THE AI BOOM

Stock markets globally have profited from the fascination around ChatGPT and its AI cousins which are putting on display staggering capabilities when it comes to generating text, software programs and even pictures and videos. Despite their hallucinations, i.e. the AI engines simply making up new content, many industries are already feeling an impact from this technology, that in effect was presented to the public only a good one and a half years ago. Personal experience with AI-supported hotlines has quite often led to disappointment, however from an economic standpoint AI's potential is enormous and we all shall experience a breathtaking level of change in many aspects.

Whether the explosion in the market cap of the world's number one AI-related semiconductor producer (Nvidia) will continue, is another question, however. True, the growth rates of both the top- and bottom line are staggering, however, owing to its growing size, marginal growth is diminishing, with the latest quarterly growth rate at "only" 17.8% (down from 87.8% three quarters ago) – which still translates into an annualized growth rate (if quarterly growth rates stay the same) of 93%. However, the valuation has almost equally skyrocketed; the price-to-sales ratio back in 2022 stood at an already demanding 8 times, now, the stock trades at 23 times estimated sales (which themselves doubled over the past 12 months). To us, it appears that the stock is "priced to perfection", so if any bump comes along, the downside is significant. Also, will this company retain its competitive advantage over the coming 10 years?

CAPITAL EXPENDITURES BY MAJOR CLOUD PROVIDERS



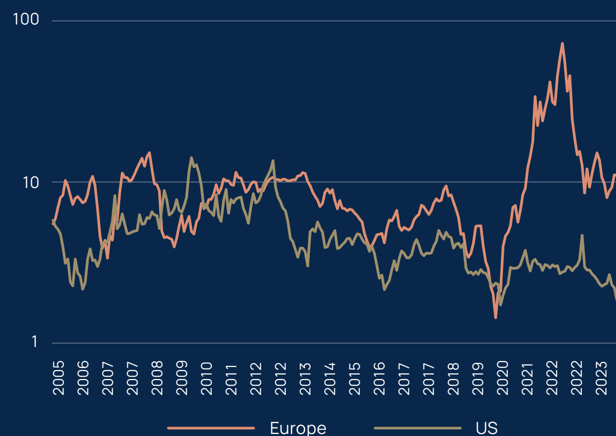
Another factor that appears to be ignored during these current times of enthusiasm are said company's customers. The large tech firms are seeing their capital expenditure (capex) budgets explode. Compared to only three years ago, capex budgets have more than doubled at the big three spenders, Alphabet (Google), Microsoft, and Meta (Facebook), mostly driven by additional AI-related expenditures. While this for itself is not a negative (considering the large potential for these investments), the fact that today's investments at one point will need to be depreciated could weigh on margins for a long time to come. This aspect will not suddenly turn markets but should not be forgotten as earnings multiples have risen strongly in expectation of further strong profit growth. In case the latter starts to stagnate, the bubble will deflate meaningfully. At current valuations, we are very cautious when it comes to "magnificent" stocks, to put it differently.

THE HUNGER FOR ELECTRICITY

The explosion of computing power in the service for large language models that appear to revolutionize many industries – whether the term "intelligence" is being applied correctly in this context, may be another question – has led national and international energy agencies to increase their electricity consumption projections meaningfully. According to the International Energy Agency (IEA), global electricity demand is set to grow by 3.4% annually in the period 2024-26, more than a full percentage point above the respective figures in 2022 and 2023. Not all this growth is due to data centers employing AI-related tasks, as there are plenty of other drivers of strong demand growth, be it electric vehicles (EV) or the general trend of replacing fossil fuels in heating, in short: the electrification of many aspects in our daily life. This rather Western view is complemented by the fact that in industrializing countries, demand for energy is growing significantly stronger: increasing life standards towards Western levels means a multiplication of electricity demand in the coming decades.

While the IEA proudly states that clean sources of electricity (renewables and nuclear) will meet all additional demand for electricity out to 2026, the fact remains that more than 60% of global electricity production in 2022 came from fossil fuels, a figure that the IEA expects to fall to 54% in 2026. In India and Southeast Asia respectively, coal-based electricity production should grow by 2.5% p.a. and 4% in the three years to 2026 – partly offsetting a reduction of coal's use for electricity production by other countries which on a global aggregate still accounted for 36% of all electricity production, expected to drop to 33% in 2026.

NAT GAS PRICES IN THE US VS EUROPE (LOG SCALE)

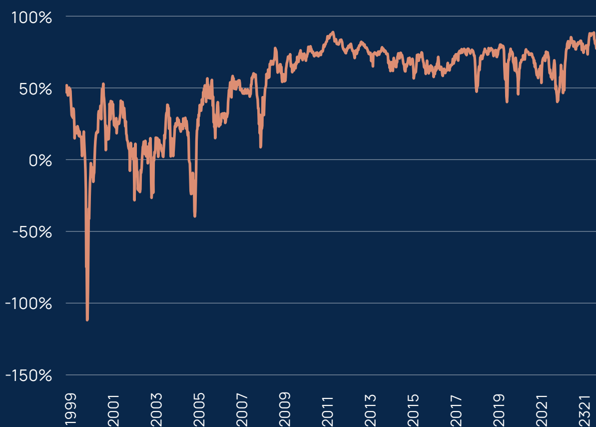


POTENTIAL FOR NATURAL GAS

Natural gas' share of global electricity production has stayed at around the same level for more than a decade at around 22%. Switching from coal to natural gas would result in about 50% lower CO2 levels per unit of electricity produced, so there is strong case for substitution. However, the supply of natural gas is not unlimited and there are signs that the shale oil fields that also produce copious amounts of natural gas are starting to deplete, according to industry observers. They note that once half of the recoverable reserves have been produced, shale gas basins' production peaked and started to decline – as did the Barnett and Fayetteville basins that were developed in the mid-2000s.

In Europe, the long-term pivot away from Russian sources of natural gas translates in strong demand from other sources. US-based Liquefied Natural Gas (LNG) has mainly filled the gap, however demand growth in Europe is set to continue and hence are imports of LNG. The Biden administration halted the commissioning of more US-based LNG export terminals in January of this year, citing America's energy security and prices. In early July, a judge ruled against the moratorium on new licenses for exporting LNG. This by itself will not lead to new terminals, but the tone is set. Medium-term, we would expect a resumption of the growth in LNG exports from the US, leading to a tighter domestic market. The price difference between US and European natural gas prices therefore should shrink.

DISCOUNT OF NAT GAS PRICE RELATIVE TO OIL (ENERGY EQUIVALENT BASIS)

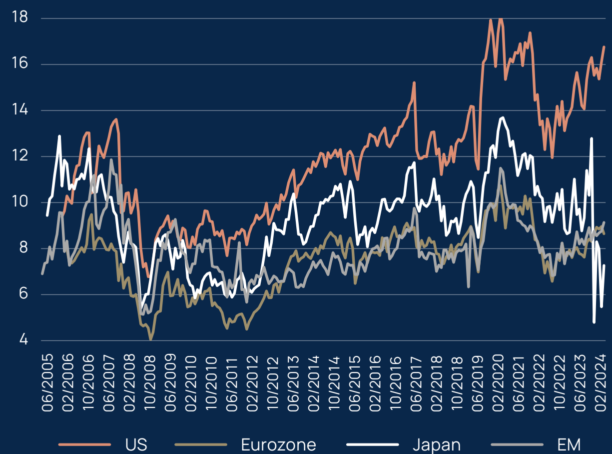


Considering the steep discount of natural gas prices vs oil prices on an energy equivalent basis has reached extremes again in Q2 of this year, we see very high potential for gas prices to recover and therefore are closely looking at US natural gas producers as their share price valuations – contrary to other segments of the market – are very undemanding at current gas prices, let alone at recovered price levels.

STOCK MARKET VALUATIONS

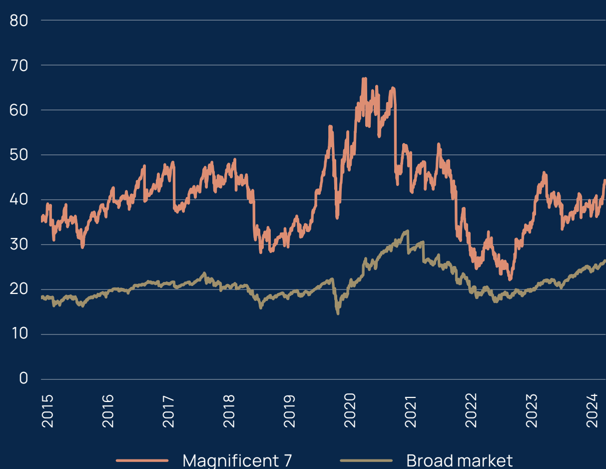
The divergence among regional equity markets when it comes to valuations has risen strongly over the past years. Japanese equities for instance have seen cash flow multiples drop to levels unseen in 12 years, while US equities are close to new 14-year highs. Price-to-earnings multiples in the US are close to the level reached during the pandemic recovery in 2020/21 and during the late phase of the dotcom bubble at the turn of the millennium.

REGIONAL EQUITY MARKETS' P/CF



The high valuations of US equities are the product of the "magnificent seven", the biggest tech stocks that dominate the market. Semiconductor producer Nvidia is among them, but also Alphabet, Amazon, Apple, Meta, Microsoft and Tesla. While a case can be made for these companies to be on the avenue to generate huge profits, we would not think such a scenario is guaranteed, as competition will drive down profits over the longer term. What is more, we consider rates to stay at current levels or even higher for years to come, which will act as a severe headwind to valuations going forward. We therefore question a projection of ever rising earnings multiples and wonder whether the profit outlook is as flawless as some may think today.

MAGNIFICENT 7 VS. US EQUITY MARKET P/E



Therefore, we would remain cautious when it comes to adding exposure towards the equities asset class, as economic growth may hit a bump soon which would result in stuttering earnings growth at a time of stretched long-term equity valuation measures such as the cyclically-adjusted price-to-earnings multiple, also known

as the Shiller-P/E, that has reached a level only surpassed in 1929, 2000, and in the post-Covid recovery of 2020/21. While markets have been extending their highs over the past 9 months, we are convinced that the end of the flagpole will soon be reached, with the potential triggers being a government debt crisis in the US (due to already high deficits spiraling up thanks to further tax cuts or more spending increases), a geopolitical shock driving up energy prices or cutting international economic ties, or some unknown unknown, as we may call factors that from today's perspective are completely underestimated to derail markets.

CORPORATE BOND SPREADS REMAIN TIGHT

On the fixed income side, corporate bond yields have reached levels unseen in 15 years, thanks to a rise in government bond yields. However, credit spreads, i.e. the additional yield on top of government bond yields owing to credit risk, have reached levels close to the lows of the past 15 years. In the 12 months following those local spread lows in 2017 and 2021, spreads widened starkly, translating into losses for bond holders, especially at lower credit quality bonds. We therefore remain rather cautious in this segment and suggest keeping a low average time to maturity in order to profit from the heightened yields without incurring too much downside in case the mood darkens. We would keep the powder dry for the time being, focusing on Treasury bills at the moment and waiting for spread to widen and add exposure then.

GLOBAL CORPORATE BONDS: CREDIT SPREAD AND YIELD TO MATURITY

All data presented in the charts is sourced from Bloomberg.

CONCLUSION

- Thanks to strong fiscal support, the US economy has defied gravity in the sense that higher interest rates have not (yet) brought demand to its knees which would mean a recession. However, the signals are increasing that lower consumer segments are very much struggling.

- Sentiment on financial markets is buoyed by the boom in artificial intelligence (AI) and more generally technology-related stocks. The top 7 stocks now make up more than a third of large-cap stocks in terms of market capitalization. Close to being priced to perfection we wonder if such a degree of market concentration is sustainable.

- AI is indeed changing the corporate world at a breathtaking speed. The electricity consumption however is often overlooked, and it is here where we make out interesting long-term investment opportunities. While renewables account for a growing share of electricity production, there are still plenty of fossil fuels being burned to generate electric power, and demand for fossil fuels will continue to remain significant for decades to come.

- We see a lot of potential for cleaner fossil fuels such as natural gas. Demand will grow strongly for years to come, and supply is not expected to keep up. Also, the difference in natural gas prices in different regions worldwide should severely shrink, so the case for significantly higher nat gas prices in the US is strong.

- Regional equity valuations display a high degree of dispersion, with US equities that are dominated by skyrocketing tech stocks on the very expensive side, while other regions such as emerging markets or Europe look a lot less demanding. We consider the downside risk to be highest with US equities and would gradually take down risk exposure.

- On the bond side, yields continue to be high compared to the past two decades, however the yield charge-up ("spreads") over government bonds is close to 17-year lows. Therefore, we are very cautious when it comes to adding long-duration bonds and suggest to wait for spreads to widen again before adding exposure to government bonds.

- Digital assets and especially bitcoin have seen a very strong first quarter of 2024 and since have traded sideways to down, with an unsuccessful attempt to new all-time highs above 72K in the case of Bitcoin. Many market participants had expected an extension to the upside after the halving in mid-April, as it had happened in the previous three cycles. However, this further bull run did not materialize, for a number of reasons. We consider the current sideways phase as an opportunity to add in case the weakness persists as we continue believe in the enormous potential of digital assets. The market cap for the asset class amounts to about USD 2tn; this compares to the total value of gold ever mined in the order of USD 15tn. We can see further potential for gold (which has gained 15% this year in USD terms) and in the medium term see a distinct reduction of the valuation gap between digital assets and gold.

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