BLACKFINCH
GROUP

CIO Outlook - Q2 2024

Key Investment Themes for Q2 and Beyond

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Inflation and interest rates continued to impact financial markets during the first quarter. In the UK, the decline in the Consumer Price Index largely met expectations, with economists now expecting overall inflation for the second quarter to be 1.8%. This would represent an undershoot of the Bank of England’s 2% inflation target, something that I’m sure would be hugely welcomed given the elevated inflation we’ve all been experiencing. Provided these forecasts turn out to be accurate, markets now expect the Bank of England to cut interest rates in August, perhaps as soon as June.

These factors will still be hugely influential for markets through the remainder of 2024. But macroeconomic data aside, there are other investment themes worth discussing for this quarter and beyond.

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AI and the US Stock Market

There has been no getting away from the hype surrounding artificial intelligence (AI), both within markets and the broader economy. I say hype, and there has been some, but I do believe AI has the potential to revolutionise how we work and live.

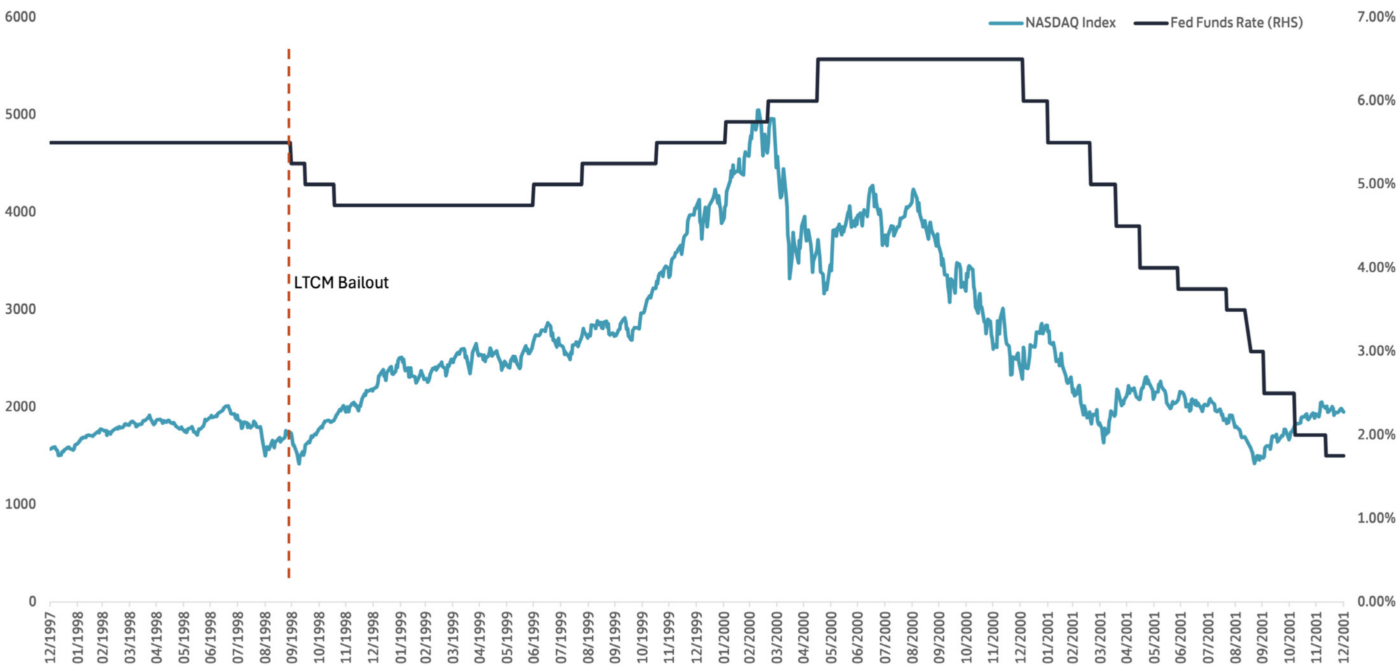
Themes such as AI are not new. If we go back to the late 1990s, markets priced what turned out to be the dotcom bubble, as the internet was to revolutionise the world. And it did in many ways; e-commerce, modern mobile devices and hybrid working, to name a few, wouldn’t be possible without the internet.

Only the hype of the internet got ahead of itself in the early 2000s. The Nasdaq Index – containing many of the large technology stocks in the US – rose over 87% from October 1999 to its peak in March 2000, clearly an unsustainable rise in such a short space of time. Stocks such as Cisco Systems rallied even further, with its shares rising over 140% across those few months.

Cisco is usually the case in point when discussing the dotcom bubble. Its networking infrastructure provided the 'plumbing' necessary for the internet to operate. This was a reasonable investment thesis for Cisco, supported by the acceleration in quarterly revenues which increased from $2.8bn at the start of 1999 to $6.7bn in the first quarter of 2001. However, the biggest issue for Cisco's stock was a matter of valuation. On a price-to-sales (P/S) basis, Cisco shares were valued at 63 times its annual revenue in March 2000, an increase from the 15 times at the start of 1999. To this day, the stock price has never regained its peak set in 2000, even after a steady rise in quarterly revenue that surpassed $15.2bn in the third quarter of 2023.

Alongside the internet euphoria in the late 1990s, Long-Term Capital Management (LTCM), a highly leveraged hedge fund at the time, suffered billions in losses as the Asian and Russian financial crises developed. Without expanding on the details here, a bailout of LTCM ensued, brokered by the Federal Reserve (Fed), to prevent contagion into the wider market. The Fed also cut interest rates three times over the following couple of months, from 5.5% to 4.75% (Figure 1) to help support financial markets.

Figure 1: The Nasdaq Index leading into the dotcom bubble and its subsequent bursting in 2000 (Blue). The Federal Reserve cut interest rates three times in the year before the dotcom bubble developed.



Source: Bloomberg, Blackfinch Asset Management

There is a well-known aphorism in financial markets, “History doesn’t repeat itself, but it rhymes.” And in today’s markets, there is a lot of rhyming with the late 1990s.

“AI is to revolutionise the world, just like the internet did. Nvidia is the AI story-stock of the present, as its advanced chips are powerful enough to run complex AI algorithms (remembering Cisco was to connect the internet). In addition, the Fed is expected to cut interest rates three times in 2024, from 5.5% to 4.75%, only this time due to falling inflation and not to reduce systemic financial risk. Hence the question keeps being asked: are we witnessing a stock market bubble that parallels the dotcom era?”

Focusing on Nvidia for a moment, its P/S ratio rose from 10 in the fourth quarter of 2022, to a peak of over 45 in 2023. It has since eased to 36, although many would agree this is still a high valuation. In comparison to Cisco’s valuation in the lead-up to the dotcom peak, Nvidia’s P/S trajectory is similar, but, of course, is yet to reach the heights of over 60. However, I should add that Nvidia has grown at a far quicker pace than Cisco did in the late 1990s, and is expected to increase revenues by over 80% again this financial year (though down from a 126% growth rate last year).

In terms of the broader US stock market, the S&P 500 Index currently trades on a price-to-earnings (P/E) ratio of 21.5, coincidentally about the low it reached on the eve of the LTCM bailout. After the Fed cut rates and the dotcom bubble really inflated, the P/E ratio peaked at 29.6. Therefore, using the simple P/E ratio as a barometer of market bubbles, we’re not at peak dotcom bubble just yet.

Finally, there is the Fed and its interest rate policy. Since its December meeting, there has been a rally in risk assets based on expectations that interest rates are heading lower. All else being equal, lower interest rates should translate into higher asset valuations, a dynamic we’ve seen recently in pockets of equity markets. If we do begin to see interest rate cuts from the Fed, it may act as a further catalyst for stock markets to rise, again rhyming with the three cuts actioned by the Fed in 1998.

Having spoken to numerous company management and fund management teams over the last quarter, AI does look to be potentially revolutionary. Broadly speaking, productivity across most business sectors should rise as Generative AI – or Gen AI – becomes ubiquitous. We’re still in the nascent stages of this theme, although ChatGPT has caught collective imagination and shown how useful Gen AI chatbots can be.

“Yet, when it comes to markets, collective euphoria over new themes always tends to end with burst bubbles. I don’t think we’re at this stage when it comes to AI. Nvidia has shown spectacular growth, and most indicators suggest this can continue for a while longer. However, extrapolating high growth rates indefinitely has repeatedly proven to be a risk when it comes to stock pricing. We only need to look back a few years at Zoom’s share price rise and fall during the pandemic to show what happens in these circumstances. Or Cisco’s during the dotcom era.

Markets also need catalysts to move suddenly in either direction. If we do see interest rate cuts from the Fed this year, and economies and markets remain robust, that could be the catalyst that the US stock market needs to rally higher. Based on already-rich valuations, interest rate cuts leading to even higher valuations may be a bubble in waiting.”

Timing the Market

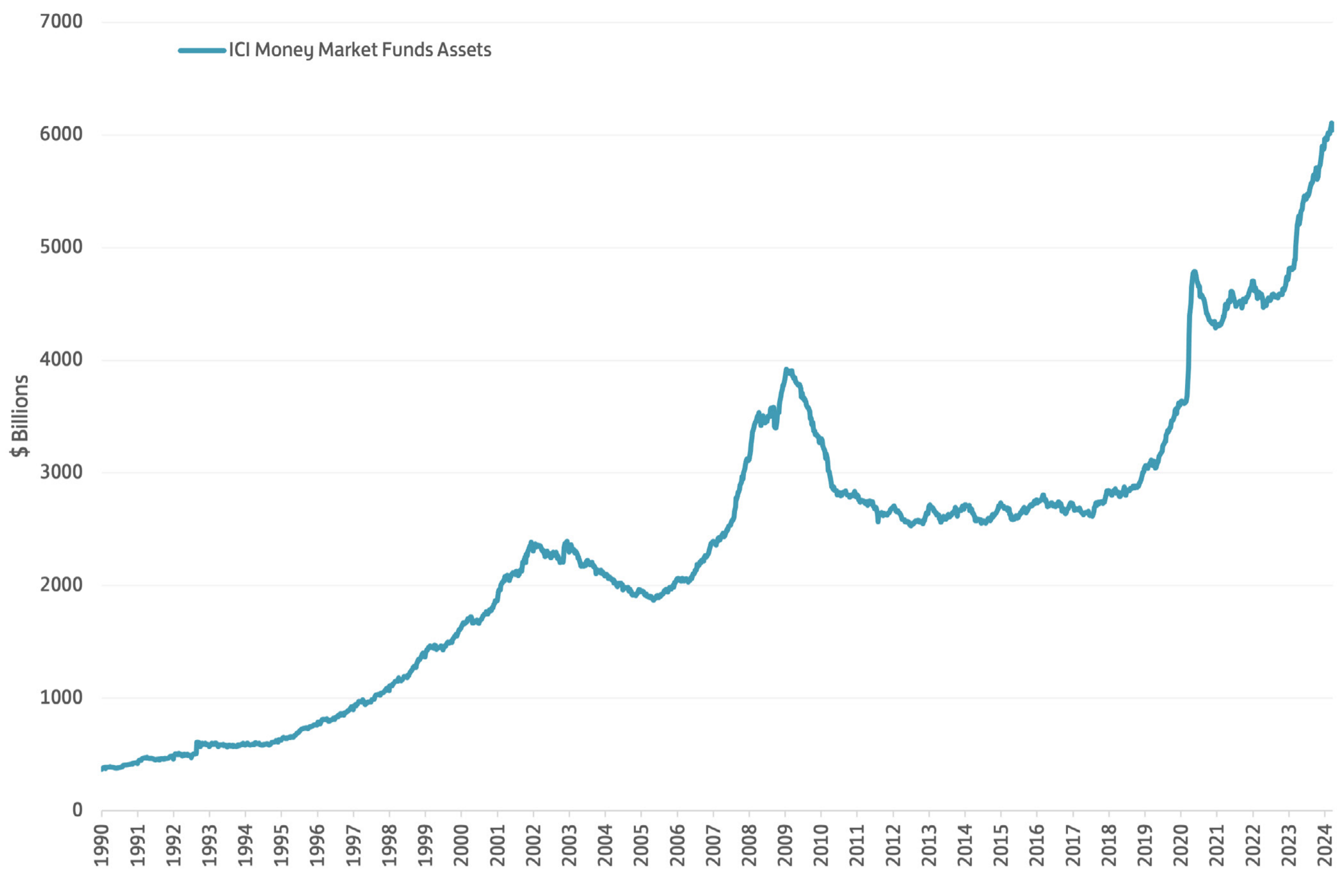
Should investors ever time the market? It’s a debate that often arises, and I’ll admit I’m not going to answer conclusively either way here. However, I do want to discuss this topic considering the significant fund flows we’ve seen over recent years into cash and cash-like securities. Very simply, as interest rates have risen to levels not seen in decades, investors were finally able to generate a bit of a return on their cash, and hence the increased flows.

We can use the Investment Company Institute’s measure of money market fund assets to demonstrate how much cash has been chasing higher interest rates (Figure 2). Money market funds being those that invest in various short-term debt instruments, typically from governments and high-quality corporations, and cash deposits that generate interest.

As Figure 2 shows, since the pandemic unfolded, cash in money market funds has approximately doubled, from $3trn to now over $6trn. Given the response to the pandemic from fiscal and monetary authorities was to flush economies with cash, I'm not at all surprised to see this steep rise. Moreover, this increase in assets came in two broad spikes; one at the outset of the pandemic in 2020, and another starting in 2022 when interest rates began to rise.

Focusing on the second spike beginning in 2022, a rotation into cash during the bear market in stocks and bonds that year was a sensible tactical move. Timing the market was key, because if investors reduced their allocations to these riskier assets and increased weightings to money market funds at the start of 2022, their portfolio losses would have been lower.

Figure 2: The Investment Company Institute Money Market Fund Assets from 1990 to the present day, shown in billions of dollars.



Source: Bloomberg, Blackfinch Asset Management

But what about in 2023? The Federal Funds Rate had already risen to 4.5% by the end of 2022, and money market assets rose an additional $1.2trn across 2023, far more than the $30bn rise during 2022. Yet, as the table of broad market returns shows below, investors would have done better to stay invested in stocks in 2023, compared to generating circa 5% in interest in money market funds. Again, timing was everything, although it seems $1.2trn of inflows got this timing wrong.

Index	Total Return in 2023 (GBP)
S&P 500	19.7%
UK 100 Large Caps	7.8%
Stoxx 600	14.2%

“As the conversation from central bankers now turns to interest rate cuts, there remains a significant amount of cash in money market funds. This highlights the difficulty of market timing. Most of the money market inflows occurred in 2023 at a time when markets were recovering from the steep losses from the prior year. Now, investors run the risk of remaining in money market funds as interest rates begin to fall.”

Tying this together with the theme of AI and the potential for a US stock market bubble, there is clearly a lot of cash that could find its way into stocks, which in turn may increase valuations further. Looking ahead to this quarter and beyond, we remain cognisant of these themes and potential risks, but still view AI as having significant potential to revolutionise broad sectors of the economy over the long term.

Final thoughts

This quarter’s outlook has primarily focused on the US stock market. The US acts as the technology capital of the world, stemming from Silicon Valley and leading all the way up to the mega-cap stocks dominating the Nasdaq. Therefore, AI has developed as an investment theme first in the US stock market. In this regard, Nvidia is leading the way with its cutting-edge graphics processing units (GPUs) that enable AI as a technology. Furthermore, on the prospect of interest rate cuts, the Fed is by far the world’s most influential central bank.

However, it would be remiss of me not to end this quarter’s outlook on the UK, given recent developments to support our own stock market. Indeed, losing ARM’s initial public offering – a homegrown leading technology company that Nvidia tried to acquire – to the US is a symptom of how our own stock exchange isn’t working as well as it could.

The recent proposal for a British Individual Savings Account (ISA), announced in the March Budget, is a very small step in the right direction, but it doesn't go far enough. And, without clarity on how this will operate alongside the standard ISA, it's difficult to understand how it will work in practice for Alternative Investment Market (AIM) discretionary portfolio services. Further initiatives should address the high Stamp Duty paid on trading UK shares, and the wide bid-ask spreads paid on our small and mid-cap stocks.

There is a vast ecosystem of private market capital in the UK directed towards the venture capital space. In fact, outside of the US and China, the UK is often ranked next in terms of venture capital investment. The Enterprise Investment Scheme (EIS) has worked brilliantly to channel investment flow into our exciting start-up space. We should encourage these companies to list on our public equity markets by reducing burdensome regulation and audit costs to do so, extending the Mansion House Compact of allocating to 'unlisted equities' to include AIM, and further promote the role of public equity markets and their critical function within an economy.

Only then will we be able to compete with the US and its dominant technology sector.

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