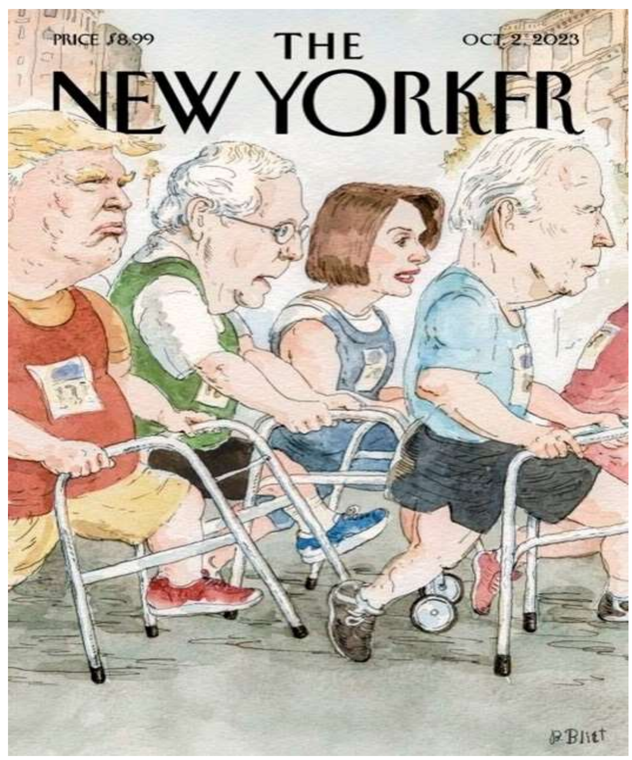
WARNER MATTHEWS
ASSET MANAGEMENT

Newsletter – Fourth Quarter 2023

Given that there are general elections in the UK and USA within the next 12 months or so I thought I'd lean on Billy Bragg, the singer songwriter, for inspiration. Billy is known for his political activism. He was a major musical influence during the 1984 miner's strike and his lyrics reflected the class divide. His song "Between the Wars" highlighted solidarity in the working classes. I wonder whether he will be as motivated to get behind Keir et al in 12 months time after 13 years of Conservative rule!

When giving thought to this quarter's newsletter, it felt as if I would be amalgamating articles from newsletters gone by. I certainly didn't think government bond yields once again reaching new highs would be at the forefront of our investment minds. Similarly, I didn't think the Ukraine conflict would continue to its 3rd anniversary and the continued tightness in oil supply would maintain inflation at elevated levels. It all feels rather groundhog day. What keeps us active is the sense that we are getting closer to the point at which central banks feel they have won the war on inflation and can plot a declining interest rate path that hopefully should be more advantageous for risk assets such as equities, especially those that are more interest rate sensitive.



The good news is that in a year's time leading discussion points are likely to be centered on US and UK elections. Will a change in the UK Government prove a threat to economic growth, taxes and investments? I suspect the next few newsletters will embrace some of these quandaries. The US election looks more surreal than ours by comparison. Trump is the current favourite, but can he run if he is incarcerated beforehand? Amazingly there is a precedent – in 1920 Eugene V Debs received a million votes while behind bars, thereby becoming the Socialist party nominee whilst serving 10 years for urging his faithful congregation to resist the WW1 draft. Legal scholars are now mulling whether Trump, if convicted, could pardon himself immediately upon taking office. What about the rest of the candidates? I've used the front cover from the well known US weekly which I think aptly depicts the election path ahead.

Downgrade to US Credit Rating

This perhaps did not get the appropriate airtime during the quarter, however one of the US ratings agencies (Fitch) downgraded US government debt a notch to AA+ (from AAA). The reasons supplied were a fiscal deterioration over the next 3 years, a high and growing government debt burden and the last-minute standoffs in debt limits. Fitch also highlighted the steady deterioration in the standards of government governance which has eroded confidence. It appears that the lack of a medium-term fix to the debt increase is a cause for concern now that is too large to ignore, especially in light of rising interest rates. It now costs the US government over $1 trillion per annum to service this debt.

Does this actually matter? The US balance sheet actually looks a lot healthier than a lot of other first world economies. Take Japan as an example. Their rating is single A, meaning 4 notches below the US, but the cost to borrow for the Japanese government is much lower than in the US, a consequence of Japanese central bank intervention. Conventional wisdom states that when debt exceeds 115% of GDP then problems begin to occur; however, a lot of governments have already breached this limit, and perhaps total debt (including consumer and corporate as well as government) is more revealing. I recently attended a seminar hosted by Russell Napier (economic historian) who touched on this point. I have summarised the salient total debt (to GDP) data below which reveals how poor the situation is:

Japan 417%	France 333%	China 307%	Switzerland 304%	Sweden 275%

Contrast that with a select band of emerging economies, I think the data is quite revealing…

Indonesia 78%	Mexico 81%	Emerging Markets ex-China 154%	India 174%	Poland 110%

The case for being different:

In extreme times, the secret to making money lies in contrarianism, not conforming to what others are doing. Investors are by and large driven by their emotions and behaviour and therefore react accordingly. Investors tend to "herd" together to push prices up to unjustified levels during periods of excessive optimism and the opposite when pessimism rules the investment waves. A few pointers on how we strive to generate returns – you have to understand what the herd is doing, why it's doing it, what's wrong with it and what should be done instead and why.

With that in mind, China provides an interesting paradox…

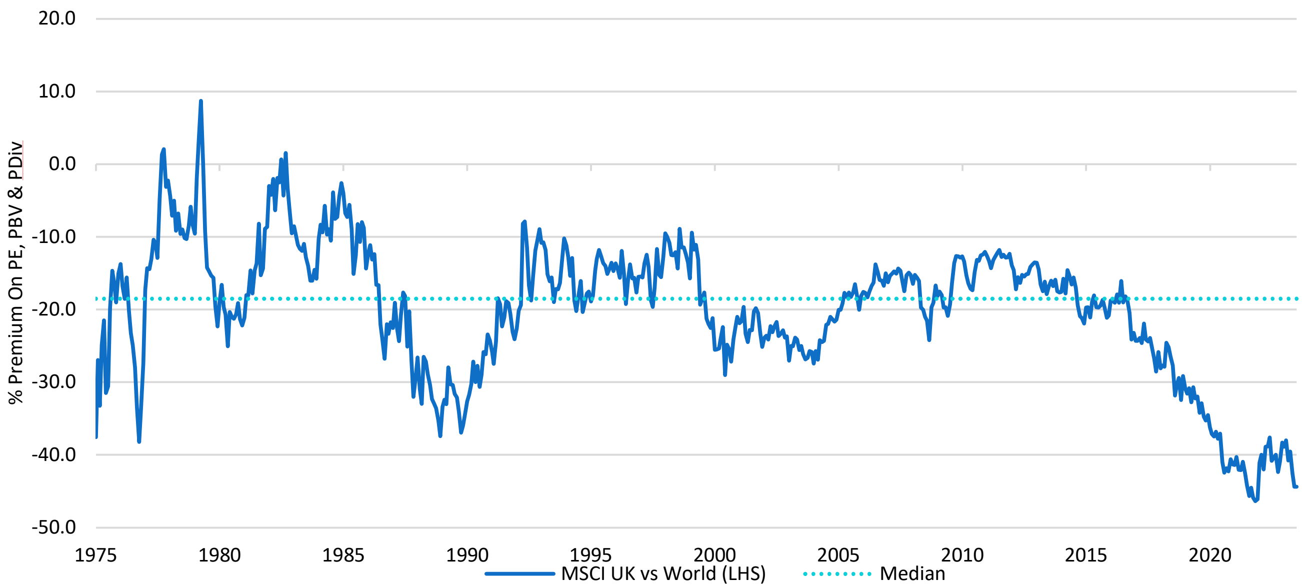
On the one hand, investors recognise that China has a lot of debt on its balance sheet, as shown above. In addition, it has a significantly over supplied housing market and an economy that was reliant upon exports and a government that pulled fiscal levers (fixed asset investment) when the economy slowed down. It has less room to manoeuvre now and the de-globalisation trend that has emerged out of Covid means less imported cheap products from China to support its foreign exchange surplus.

However, the case to be contrarian appears strong. Chinese equity valuations are undemanding against their long-term average as well as the US equity market (almost half the rating). The Chinese weighting in the global indices is now smaller than the company Apple's weighting and the index is trading close to levels not seen since the 2008-09 financial crisis.

Investing in a market that is controlled by a Communist apparatus has its risks and also rewards. Geo-politics is never far from the centre of overseas investor's minds, but we sense Xi Jinping (the Chinese leader) may have taken note of the pariah like status afforded to Putin following the invasion of the Ukraine. Operating in an authoritarian economy has its benefits. When the government decide to stimulate the economy, everyone falls into line. This ability to unleash an array of temporary measures to lift economic growth shouldn't be underestimated. The government is aware of the legacy economic model and is in the process of transitioning to a more consumer, service driven one. The contrarian in us as asset allocators makes this destination an interesting topic of discussion during our monthly investment committee meetings.

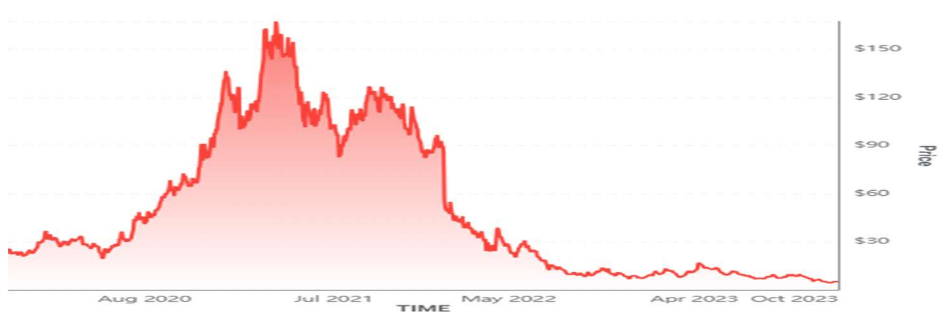
And what about the UK stock market – are investors too bearish?

During the quarter an interesting economic data release caught our eye. The Office for National Statistics revised its GDP growth rate higher than pre-Covid levels, much to the dismay of certain sections of the media. In fact, the UK now sits comfortably mid table in G-7 countries in terms of economic recovery. Would it be too fanciful to suggest that those negative commentators get less gloomy, and the discount applied to UK based assets starts to unwind?



What worked during Covid is unlikely to work in the new investment backdrop

Looking at falling angels in the stock market is something of a guilty pleasure. Another Covid winner appears to have bitten the dust. During lockdown several friends imparted their glee at having a Peloton in the living room, allowing them to better fill their working from home calendars! Peloton, for those that haven't come across them, make stationary fitness bikes which are internet connected to allow you to join others in an instructor led class (that's a spin class Ed…). The Peloton model was based on the razor and blades concept adopted by the likes of Gillette – to lose money on the equipment and make it back on subscriptions. However, in reality, the company has lost money every year since it listed in 2019. Indeed, its latest filings highlight the company lost over $1.25bn on $2.8bn of revenues last year – quite an achievement. The share price paints an interesting picture – from the top of its Covid peak, the shares have fallen 97% at which point its market capitalisation reached almost $50bn.



The company has been blighted by product recalls, senior management departures and legal settlements to name a few. However, what is clear is that the days of easy money and with them easy gains are over and we are now swimming in different waters.

Speaking of bubbles, a Vietnamese electric vehicle (EV) manufacturer listed in the US via a merger in August, received a valuation of $23bn. Vinfast was founded in 2017, sold petrol cars until 2022 when it shifted to EVs. It is now attempting to sell EVs in the US. By July this year it had sold 140 units. On the first day of trading as a new entity the share price tripled. By the end of the second week of trading, its market cap had exceeded $159bn. Given that it took Tesla over 10 years before it became profitable, I suspect this company is going to run out of available cash pretty quickly. I wonder whether this will become another Peloton, the share price driven up by initial exuberance only for reality to eventually prevail.

Diomede Islands

I recall being told that the distance between the USA and Russia is but 3 miles. I never gave it a second thought but then came across an article that highlighted this fact. Between Russia and Alaska, in the middle of the Bering Straits lie two islands, Little Diomede (USA controlled) and Big Diomede (Russian controlled) which are 3 miles apart from each other. Given the inhospitable climate in these parts, an ice bridge forms between the two islands during the long winter months. That then makes it possible to walk from Russia to USA and back, albeit illegally. As US-Russian relations are at an all-time low as the Ukraine conflict nears its 3rd anniversary, these two nuclear powers have the ability to conduct land-based attacks without even the need for warships. Any thawing of this Ice Curtain looks more remote by the day.

For all your quiz experts, Russia is therefore the nearest country to the US without sharing a border..

These islands are often referred to as Yesterday and Tomorrow islands. There is a quirk that means that the international date line passes between the two islands meaning that there is a 21-hour time difference between the two. So, depending on which way you are travelling, you can either gain a day if you are moving westward, or lose a day if travelling eastwards. So, when you look at Big Diomede islands from the Little One, it is possible to look into the future!

This report is for informational purposes only and should not constitute investment advice. Past performance is not a guide to future performance. No investment is suitable in all cases and if you are in doubt you should contact us. Market and exchange rate movements can cause the value of an investment to fall as well as rise, and you may get back less than originally invested. The views expressed are based on information believed to be accurate at the time of writing but no assurances are given.