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Reflections and Insights*

"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of light, it was the season of darkness, it was the spring of hope, it was the winter of despair."

– CHARLES DICKENS, A TALE OF TWO CITIES

Quite. The decision as to whether you take an optimistic view or its opposite is what financial types call 'multi-factorial'. Where you live, your politics, your personality – all of these will help determine how you view the world.

You may also veer from one view to the other. The winds, though, seem today to be blowing you to one extreme or the other. This is the result of political polarization and the fragmentation of the world order which most of us have lived through, all magnified through the prism of social media. As regular readers know, this review tends to be somewhat stuck in the middle, and with any luck, becalmed. You may argue that this is a cowardly position – surely, we have to get off the fence. After all, sitting astride a fence is hardly the most comfortable position – wouldn't we feel better in one tribe or the other?

This is a false premise which looks to simplify what are very complex issues. The reality is that, as ever, there are good and bad things going on at the same time.

Today, the global market, which, for all intents and purposes, is primarily the U.S., is dealing with rising government bond yields, which are generally bad for equity markets, and sharply rising corporate profits, which are usually good for those assets. On any given day, one or other of these influences will dominate and determine the

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movement of prices. Take one step back, though, and the two things are not as separate as they look.

The extraordinary spending by Artificial Intelligence (AI) hyperscalers is adding to growth, adding to inflation, and, because the companies involved are borrowing huge sums from the debt markets, is also contributing to higher interest rates. This is because the U.S. government, and governments everywhere in the developed world, are running large budget deficits and also need to borrow very large sums, are now forced to compete with the AI promoters debt issuance. This so-called crowding-out effect is not the only reason interest rates are higher, but it doesn't help. Inflation is sticky, partly because of geopolitics (Iran, Russia) and also partly because the hyperscaler spending on data centres and power generation is also pushing up the prices of everything from labour to construction materials. Further, the U.S. Treasury Secretary is doing his best to manipulate the long end of the bond market to contain rates, but, given the scale of borrowing needs, this may simply lead to more issuance at the short end. In any event, monetary policy is still supportive of growth as bond yields sit below nominal GDP[1] and banks are easing lending standards.

Spending by the Magnificent 7[2] alone is forecast to be up 78% this year and 18% next year, and will represent 6% of all spending in 2026. This boom far outweighs any previous infrastructure spending in history. AI-related stocks now represent about half the market capitalization of the S&P 500 Index[3] and are responsible for generating two-thirds of the return this year.

RARELY SEEN OPTIMISM

A conventional interpretation of all this would suggest that markets might be having a hard time. They are not. The reason is earnings. This review has rarely seen such optimism about the earnings outlook, both for the balance of this year and next. As a result of this, valuations, which should perhaps have caused a headwind in recent years, are now back to historically normal territory.

As has often been discussed in these reviews, valuation is a guide not a trigger. Expensive markets don't become cheap because they are expensive and vice versa. The relative cheapness or expensiveness will weigh on the magnitude of returns but will not usually, of itself, signal a change of direction. It is notable that equities may not be expensive in absolute terms, but have not been more expensive relative to bonds in over two decades.

STATE OF EQUILIBRIUM

So, markets are in a state of equilibrium between two extremes: high interest rates on one hand and exceptional earnings growth on the other. Should either of these disappoint (higher rates still or earnings disappointment), things could unravel quickly. It is also true that the market is increasingly dependent on AI delivering, and on that delivery being profitable. Delivering what, you may ask? We can see how it may improve productivity, but maybe at the cost of deskilling human capital. Will it be profitable? This review has no idea, neither does anybody else, including those making the investments. The current market also depends on the hyperscaler model of walled gardens[4] being the optimal use case for AI. It is not clear that this is the case, with cheaper, smaller models being shown to be as effective as the behemoths in many cases. The point is that the real-world jury is out, but the markets seem to have given a verdict, which is that AI will be miraculous. Further, this commentary ignores the social implications of hugely successful AI, a separate topic altogether.

Most of the action in the U.S. economy is in AI or AI-adjacent activity. The rest of the economy is OK, but there are signs of strain beginning to show by the fact that the spread between low-quality bonds over investment-grade bonds has blown out to levels which suggest distress. In other words, higher interest rates are beginning to hurt. By the same token, housing costs are becalmed by high mortgage rates. The fact that mortgage terms in

the U.S. tend to be fixed to long-term rates means that the impact on consumers is small, but new construction has been weak.

Taking another step back, it seems we may be entering an era of higher, more volatile interest rates. For those of us who have been around a long time, this is a reversion to a normal state of affairs. For those whose frame of reference is the last twenty years, this is something different. The period of globalization triggered by the collapse of communism (and, no, Democrats are not communists – they're not even socialists, for the most part) and China's entry into the World Trade Organisation[5] led to a huge supply shock. Supply chains were integrated, and workers were in surplus. There were economies of scale, and the whole structure allowed growth with falling inflation.

RESILIENT VS. LOW-COST PRODUCTION

A lot of this is now reversing. The call now is for resilient production as opposed to low-cost production. Labour supply is slowing everywhere because of demographic pressure; the need for resilience fragments economies of scale; capital requirements are rising; and the geopolitical backdrop is less benign, with calls to increase defence spending even as the nature of conflict shifts. All of this suggests that labour, over time, will be in a stronger position. Politicians who tout an industrial revival have not accounted for the fact that most industrial production can be fully automated and that new jobs will be in the service sectors, which are impossible to offshore and difficult to automate. Combined with labour shortages, this likely means higher and more volatile inflation, which itself leads to higher, more volatile interest rates. None of this will happen overnight, but it points to a more conventional relationship between bonds and equities, where higher rates are bad for stock markets and vice versa.

It would be easy to spend the whole of this review covering geopolitics, but that is another area where the unpredictability of U.S. policy (in particular) makes it difficult to say anything sensible. At the time of writing, though, the U.S. suspension of Russian sanctions to allow the export of Russian diesel is an astonishing alignment of U.S. policy with Putin's agenda and, at the same time, is unlikely to offer any relief in pump prices ahead of the mid-term elections (assuming that was its purpose). It is, of course, impossible to know how the election will turn out or how the Administration will react if the outcome is bad, as the polls suggest.

EUROPEAN DILEMMA

In any case, U.S. policy toward Russia is further evidence of the dilemma in which Europe finds itself. It is now clear that the U.S. is not a supporter of Ukraine, which brings into question the value of NATO[6] and pushes to the top of the agenda the need for a workable European defence policy.

To that end, some movement in the UK to a recognition that BREXIT has been a disaster is welcome, but this is offset by political developments in Germany ((Alternative for Germany (AfD) winning regional elections) and France, the latter facing the consequences of its unsustainable political path. France faces a real danger of triggering another Euro crisis, but on a scale to make the Club Med[7] issue of the 2010's look like a picnic. On top of that, the leading contender to replace France's President, Macron, in next spring's election is Marine Le Pen, whose populist right-wing policies are at odds with the EU and are not fiscally conservative at all.

While these reviews focus on markets in Europe and North America, China is an increasingly important influence on economics and markets. The country continues to develop soft power and is taking a lot of the notional space abandoned by the U.S. At the same time, its economy is slowing to a more realistic level. The problem for investors remains the political influence over corporations and the pursuit of a nationalist agenda. This leaves

portfolios vulnerable to rapid about-turns in policy, although the leadership positions that country has in many sectors cannot be ignored.

The advice of this review is, as ever, to stay diversified.

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Endnotes

1 Gross Domestic Product (GDP) is the total monetary value of all final goods and services produced within a country's borders during a specific period, such as a quarter or a year.
2 The Magnificent Seven (Mag 7) are Apple, Microsoft, Amazon, Alphabet, Meta, Nvidia, and Tesla.
3 The S&P 500 is an index of 500 stocks designed to reflect the risk/return characteristics of the large-cap U.S. equity universe.
4 A "walled garden" approach is a closed platform or ecosystem (e.g., Amazon, Apple, Facebook) wherein the platform provider controls the content, applications, and/or media and restricts access at its discretion.
5 The World Trade Organization (WTO) deals with the global rules of trade between members. Its main function is to ensure that trade flows as smoothly, predictably and freely as possible.
6 The North Atlantic Treaty Organization is an intergovernmental military alliance between 32 member states.
7 The economies of Southern Europe—primarily Greece, Italy, Spain, and Portugal (and occasionally France).

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