

Investment Views

MARCH 2024

Rational exuberance?

Equities have started the year strongly with US and European indices hitting new highs, India's Sensex extending its multi-year boom and Japanese stocks finally surpassing their 1989 peak. Cries that markets are in an unsustainable "bubble" have surfaced from a vocal minority, although many commentators profess valuations are still reasonable and the best gains are yet to come. Which camp is likely to be right?

Headline stock markets have certainly been performing well. In the US, the S&P 500 has posted four consecutive months of gains, rising over 20% since the end of October and more than 40% since late 2022.

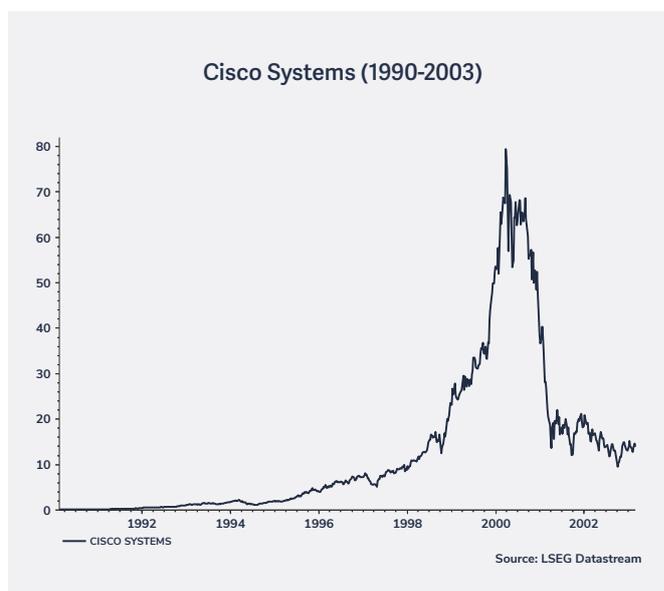
This momentum actually bodes well for the near-term. As the Financial Times notes, historically once this flagship index has recorded a new high it typically rallies further over the subsequent 12 months, going on to produce positive annual returns more than 70% of the time with an average gain of 14%. Where new highs are reached in both January and February (as has been the case this year) those numbers increase to almost 90% and 16%, respectively. So far, so good for those with a bullish bias.

What has been driving the gains? For US equities, optimism around artificial intelligence (AI) has been the dominant factor with the "Magnificent 7" tech stocks gaining more than 80% over the past year. Without these stellar returns, large-cap US and global indices would have stagnated, suggesting "bubble" talk is only relevant to a handful of tech firms. In turn, this begs the question, are we witnessing a repeat of the late 1990s dotcom boom and subsequent bust?

Undeniably, price action is eerily similar. In 1999, just before the bubble burst, the Nasdaq index enjoyed a staggering 86% advance and gained a further 24% during a final 3 month "melt-up" as the new millennium began. The index hit a peak in March 2000 before shedding over 80% in a brutal bear market that lasted almost 3 years. This time around, whilst the direction of travel is the same, the numbers are somewhat different. The Nasdaq bottomed in late 2022 and has so far rallied by 59%; an impressive move but, significantly, one that only brings it back to its late 2021 peak.

More importantly, the valuation backdrop is markedly different with multiples, so far, largely under control. Comparing the "poster child" stock from each bull market helps to illustrate this point.

Around the turn of the century, few stocks were as popular as Cisco, which listed in 1990 and saw its stock price increase by a staggering 123,600% in the following 10 year (chart below). At its peak, in March 2000, its forward price-to-earnings ratio hit over 100x, meaning investors were willing to pay up for more than a century's worth of annual profits. For context, since 1985 the S&P 500's forward P/E ratio has traded around a more realistic 17x and extreme valuations, like Cisco's at its peak, seldom end well. Indeed, its share price tumbled by almost 90% during the subsequent bear market and currently trades around half of that 2000 high.



Fast forward to today and most eyes are on Nvidia, the semiconductor giant which dominates the supply of graphic processing unit (GPU) chips that cater to the machine-learning boom. Last month, the company added U\$276bn of market capitalisation (equivalent to the entire value of oil major Chevron) in a single day when it announced much better than expected Q4 results with revenue growth of 22% over the quarter and 265% compared to Q4 the previous year. This has helped extend a run of form that has seen its share price rise almost 700% since its 2022 low.

Critically, however, with earnings growing faster than its share price, Nvidia's forward price-earnings ratio stands around an elevated, but not excessive, 30-35x. This leaves slim margin for error should future revenue and profits news disappoint, but its valuation is nowhere near as precarious as those seen at the dotcom peak. The same holds true for the "Magnificent 7" as a whole, whose earnings have kept pace with the significant rise in share prices over the past year.

It is also encouraging to see market leadership broaden out beyond the US mega caps. Indeed, after strong recent gains, a handful of European defensive stocks are generating 3- year returns in line with the "Magnificent 7". In turn, Goldman Sachs has inevitably christened a basket of the eleven best performers, which stem from the healthcare, tech and luxury consumer goods sectors, with another acronym; the "Granolas". Collectively they account for 25% of Europe's Stoxx 600 index and have driven half of its past year's gain; a level of concentration comparable to the distorted US market.

One outlier remains the UK. A valuation anomaly in UK stocks first emerged around the Brexit vote in 2016 and has generally seen them trade more cheaply than their international peers ever since. There are several reasons behind this trend but the UK's declining weight in global indices and domestic pension funds diverting more capital to both overseas markets and private assets have been influential forces.

On the plus side, there were prolonged periods during the 2000s, and even the 2010s, when the UK traded at a premium to global equities, so there is precedent for the market to outperform. With UK indices trading at

the bottom of their 30-year valuation range it will take a meaningful catalyst for such a positive trend to re-emerge, but it is interesting (and welcome) to see bargain hunters now taking advantage of depressed multiples and the weaker pound.

Corporate activity is on the rise with Direct Line Insurance, Currys and Wincanton just some of the higher profile UK names generating interest from acquirers in recent months. This means the tide may finally be turning for UK equities with the mid and small-cap markets looking ripe for a significant re-rating. Higher up the cap scale, the larger listings are also cheap, trading around half the valuation of their US counterparts and providing an attractive 4%+ dividend yield. In short, we believe UK stocks are looking increasingly attractive for investors growing wary about the sustainability of US tech outperformance.

Even where price momentum is much stronger, we struggle to buy into the idea equities are in bubble territory, the odd AI-related stock aside. Valuation metrics are generally half as expensive as they were during the latter stages of the late 1990s boom and, more significantly, the current crop of tech firms are mostly producing sizeable profits and returning cash to investors via buybacks and dividends; something the dotcom stocks failed to achieve.

Furthermore, investor sentiment is relatively contained with the latest American Association of Individual Investors survey showing a bullish reading of just 47%. It was above 60% in March 2000. And beyond the big US tech names, fund flows into the broader equity market are relatively subdued, arguing against investors being in the sort of euphoric state that typically precedes a crash.

On balance, the stage is set for headline stockmarkets to produce reasonable gains for a second consecutive year. However, the past decade's returns have exceeded their long-term average and it would be prudent to assume equity investing becomes more of a grind from here. Increasing tax burdens, a fraught geopolitical landscape and the delayed effect of higher borrowing costs all render it likely that headline returns will be less pronounced going forward. Unless, of course, AI really does live up to the hype and deliver the productivity miracle it is promising.