CP COURTVILLE PARTNERS

Courtville Partners – Investment Outlook, July 2024

Summary of the key points in this quarter's Investment Outlook

- Emerging Markets have started to perk up at last.
- For the most part politicians and Wall Street would have the rest of us believe that inflation has been vanquished. We disagree.
- Does the continued strength of gold portend either a "Minsky moment" or a devaluation of the US dollar – or both?
- Politics and politicians are best ignored by investors. The crowd-sourced wisdom of markets is supremely efficient at discounting political developments.

Anyone who writes about financial markets each quarter does well not to start by rehearsing what has happened over the previous three months. Boring, boring, boring. Having said this – and you can guess what comes next – we see some noteworthy features among the 2Q24 performance data and so must risk boring you, our readers.

In general terms, the decision last time to hold both our nerve and our noses has paid off. Equities have continued to outpace bonds, albeit at a more subdued rate: the MSCI All World Index rose another 3% in the second quarter, while the Barclays Global Bond Index fell 1%. What we find interesting is that Emerging Market equities hit the front of the pack for the first time in ages, chalking up a gain of 8.4%. "Magnificent 7" or not, the S&P 500 was left trailing (up just 4.3%). This EM surge is all the more impressive given that Chinese equities remain stuck in standby mode. Does the EM revival have something to do with the strong dollar, rising commodity prices and relative energy costs? Perhaps a little of each. And here's another apparent anomaly: gold rose almost 5% in 2Q24, taking its year-to-date gain to 13%. What intrigues us is not so much gold's outperformance versus most other asset classes, but the fact that it has defied both a strong dollar and relatively high real interest rates, both of which the consensus sees as hostile influences on the gold price. Are we looking at a canary in the coalmine of monetary policy?

Our financial worldview continues to rest on our conviction that inflation remains the biggest threat to investors' wealth (though UK savers will soon be able to add a Labour government to the threat list). Headline inflation data are still falling in most economies, above all the US (June's PCE fell from 2.8% to 2.6% YoY). But nothing has undermined our bedrock hawkishness. Quite the opposite, in fact. For example, in April's Outlook we laid out at some length the Congressional Budget Office's worries about ultra-loose US fiscal policy – arguably the biggest single inflationary force on the planet. Well, the CBO isn't getting any less nervous and in mid-June lifted its estimate of the 2024 budget deficit from \$1.5trn to \$1.9trn. Nobody blinked, of course. But then not everyone believes that the Fed is serious about getting inflation back down to 2%. The political class continues to make the claim, as do most Wall Street investment banks. But we don't buy it – and would cite several other factors to support our scepticism: huge new tariff barriers, the wealth-effect of the extended rally in almost all asset prices, soaring insurance costs and shipping rates (Baltic Dry Index +80% in a year)... And so on. As an aside, we'd contend that inflation is the most regressive of all macroeconomic policies. (The poor have few or no assets to inflate and often little wage-bargaining power.) Anyone in search of a one-factor explanation for the rise of political populism in the West need look no further.

Against this fundamentally inflationary backdrop, we cannot repeat often enough our strong preference for real over nominal assets, i.e. equities over bonds. We have also counselled against fretting excessively over central banks' interest rate policies. You are probably old enough to remember when the consensus expected five rate cuts in the US this year. Even three months ago it was still going to be a hat trick of cuts. Now there will be one – if we're lucky. How have stock markets coped with the rate-cutting wind being taken out of their sails? They've barely noticed. But what about the pesky gold price...? Could it be the monetary equivalent of Matthew McConaughey's character in *Interstellar* trying to send a warning from the future to his daughter by pushing books off the shelf? (If you don't pick up on this film reference, give yourself a treat and watch it.)

So why has the gold price been so perky? Its historically inverse correlation with real interest rates seems to have broken down. It is one thing to own gold when interest rates are nugatory. But investors are now happy to hold this zero-yielding, yet incorruptible, asset even when government bonds offer plausible real and risk-free returns. On one level, there is little mystery. Almost all buying of physical gold originates in Asia – and much of that comes from central banks, led by China. Why do Asian central banks feel the need to stockpile gold? For much the same reasons that we have always advised holding gold in most portfolios: as an insurance policy against serious policy failure in the West, whether of the fiscal, monetary or geopolitical variety. In addition, Asian central banks (and others) took the hint when the US froze Russia's foreign exchange reserves in early 2022: fall foul of Uncle Sam and he can put your dollar-denominated assets where you can't touch them. Gold, among other assets, may not be such a bad place to store all those earned dollars that are the flipside of America's giant twin deficits – a better place than US treasuries, anyway. And, as an asset, gold is terrifically liquid, turning over almost $150bn a day (i.e. on a par with the S&P 500).

By contrast, most investors in the West couldn't care less about gold. The big gold ETFs have been withering steadily; and it is unusual to see gold (or other precious metals) within the asset allocations of institutions of any kind. Such a state of affairs entitles gold bugs to speculate what might happen to the gold price if Western investors ever did develop an appetite for the metal. Who would be the natural seller(s)? Not obvious, is it? (Where is Gordon Brown when you need him?)

Gold is not the only commodity price on the rise. Several other commodities, hard and soft, seem to be on an up-trend. Research firm Gavekal have wondered aloud whether higher commodity prices betray investors' suspicion that a modern-day Plaza (or Louvre) Accord may be on its way, i.e. a coordinated international agreement to drive down the value of the dollar. Commodities were among the best-performing assets in the wake of the 1985 Plaza Accord (while the dollar's trade-weighted value had almost halved by 1988). After all, almost everyone is in favour of a lower dollar, including both US presidential candidates. Putting up massive tariff barriers against Chinese goods (above all EVs) will not be enough to build a successful or competitive domestic industry (as the solar panel example of a decade ago showed). No, the US Government's determination to reindustrialise across the board – not least as a means to maintain its military hegemony – is almost certain to require a weaker currency too. (Did we mention that all of this is likely to be inflationary too?)

Meanwhile, back in stock markets... The so-called Magnificent 7 has a new outsight leader in the form of Nvidia. The specialist chipmaker's market capitalisation touched $3.3trn in June – up almost 10 times since the start of 2023. (As an aside, it is worth contemplating that Nvidia, Apple and Microsoft together have a market cap greater than that of Europe.) Concentration risk in markets is nothing new; it comes and it goes; and it was at least as pronounced in the US in the early 20th century as it is now (and again in the 1930s and the early 1960s). After all, new industries or technologies tend to generate super-normal returns thanks to innovation, pricing power and surging demand. In due course, those sky-high returns attract more capital, which shifts the supply/demand balance and drives down prices and returns. This is a familiar story.

Nvidia's near-monopoly in graphics processing units (or GPUs) for AI applications explains its net profit margin of more than 50%. But roughly 40% of Nvidia's sales are to just four customers (Microsoft, Meta, Amazon and Google) – which *inter alia* indicates concentration risk within concentration risk. This raises an important question: are the capital expenditure forecasts for Nvidia's biggest customers consistent with forecasts for Nvidia's own revenues? Spoiler alert: no, they are not, according to analysis by Absolute Strategy Research. Forecasts for Big Tech's capex *are* rising, just not enough to match consensus estimates for Nvidia's GPU sales. Such analysis is admittedly a classic example of "the difference between two very large numbers"; and it is made up of many moving parts. Nevertheless, consensus expectations for Nvidia may have run ahead of themselves. Alternatively, it could be a sign that investors are under-estimating the extent to which capex (datacentres in particular) could dent Big Tech's famously strong cash flows. At the very least more capex may mean fewer (or smaller) share buybacks.

The Mag 7 have been the stars of the global stock markets show for several years; and the seemingly inevitable rise and rise of large-cap US equities has helped create an impression that nothing much can go wrong. The Fed's monetary policy has long played a similar role, persuading investors that the Fed will cut rates and/or print money if asset prices take a tumble. (This approach has removed at source the creative destruction on which capitalism depends – but that's a discussion for another day.) There is a catch, though: by definition, the resulting stability of markets – especially the stock market – makes a reckoning inevitable sooner or later. The popular term for this is a "Minsky moment", named after the economist Hyman Minsky. His essential observation was that stability breeds instability. In other words, the longer a market exhibits stability, the more probable a sudden moment of instability. The Global Financial Crisis of 2007-08 was perhaps the most egregious example of this phenomenon.

Are we overdue another Minsky moment? We can never know, of course – but we can say that the VIX Index (the most common measure of stock market volatility) sits below 13, compared with a 20-year mean of 20. And US stocks haven't seen a drawdown greater than 5% so far this year. Yet there is no shortage of potential catalysts for a spike in volatility – from elections to geopolitics to deficits to valuation, to name just a few. Or could private equity (and credit and real estate) be the trigger? Private investments in the US have ballooned from $2trn to $12trn in about 15 years, boosted by the magic of zero interest rates and gearing. But does the model still work with interest rates at 5%? If there was a crunch, would the authorities force investors to take the pain – or would they ride to the rescue again? If it's the latter, would this lead to dollar devaluation? Quite possibly.

Are we eccentric to make no mention of politics given events in the US, the UK and France, among other countries? Whether we are or not, we're not tempted to second-guess financial markets, which are supremely efficient discounters of political developments. Everything that is known about the US presidential election, the UK's incoming Labour government and Macron's mega-gamble is factored into the prices of equities and bonds (and currencies) at every minute of every trading day. This is truly the wisdom of crowds (as distinct from electorates).

Asset Classes	Courtville Partners Asset Allocation (%)	FTSE PI Balanced Index (%)
UK Equities	10	14.4
International Equities	52	46.9
Fixed Income	16	26.3
Alternatives	15	7.3
Commercial Property	1	0.1
Cash	6	5.0
Total	**100**	**100.0**

Courtville Partners Model Portfolio	ETF	Weight (%)	Changes this quarter	Weighted OMC (%)
UK Equities		**10**	**0**	
UK	VUKE LN	8	0	0.09
UK	VMID LN	2	0	0.10
International Equities		**52**	**0**	
Global	IWQU LN	5	0	0.30
US	VUSA LN	16	0	0.07
	XDPG LN	9	0	0.09
	IUVD LN	3	0	0.20
Euro	VERX LN	2	0	0.12
	EGRG LN	2	0	0.29
Japan	VJPN LN	4	0	0.19
Asia ex-Japan	VAPX LN	4	0	0.22
Emerging Markets	VFEM LN	5	0	0.25
Emerging Markets ex-China	EXCS LN	2	0	0.18
Fixed Income		**16**	**0**	
Government Bonds				
UK Inflation Linked	INXG LN	2	0	0.25
UK	IGLT LN	2	0	0.07
US	IDTM LN	5	0	0.17
EM	SEML LN	3	0	0.50
China	CNYB NA	2	0	0.35
Corporate Bonds				
US	CORP LN	2	0	0.20
Alternatives		**15**	**0**	
Gold	PHAU LN	5	0	0.39
Oil	WEL5 GY	2	0	0.18
Infrastructure	INFR LN	2	0	0.65
Uranium	NUCG LN	2	0	0.55
Water	IH20 LN	2	0	0.65
Carbon Allowances	CARB LN	2	0	0.35
Commercial Property		**1**	**0**	
Global	IWDP LN	1	0	0.59
Cash	XSTR LN	**6**	**0**	0.15
Total		**100**		**0.21%**

Courtville Partners	Model Portfolio	FTSE PI Balanced Index	Relative performance
2024 YTD	7.1%	6.6%	0.5%
Since inception(1/1/2015)	100.2%	91.1%	9.1%
CAGR	7.6%	7.1%	0.5%

The value of your investments can fall as well as rise. You may not get back all the money you invested