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Courtville Partners – Investment Outlook, January 2025

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

- Sooner or later the exceptionalism of the US stock market becomes just another bubble. It's not as if we haven't seen this movie before.
- We think it's time to take some evasive action by reducing "Magnificent 7" concentration risk and increasing the allocation to cash.
- Highly plausible analysis argues that US equity returns, nominal and real, are likely to be lower over the next decade – thanks mainly to today's stretched valuations and market concentration.
- Many central banks are reluctant to administer the *coup de grâce* to inflation. Fixed income, already beleaguered as an asset class, remains largely off-limits as a result.
- Demography is destiny – no ifs, no buts. The influence of anaemic birth-rates across the developed world will increasingly be felt on everything.

Our conviction that portfolio investment is a marathon, not a series of sprints, sits uneasily with our profession's traditional end-of-year stock-taking. What's so special about 1st January anyway? Not much. Instead, we prefer to be alert, while sitting quietly in a room (as Pascal advised); to stay invested (mostly); and to let the power of compounding work its magic as the years roll by. All the same, we think it worthwhile pointing out 2024's more portentous developments, especially since many are likely to influence capital markets this year and beyond.

- In effect, the Federal Reserve abandoned 40-plus years of rigorous inflation-targeting. Whatever Powell says, cutting interest rates while the core PCE deflator is still running at 2.8% YoY implies that 2% is no longer a target, but a floor. Big difference. We now live in a world of looser monetary policy and higher inflation – and we'd better get used to it.
- US short-term interest rates and 10-year US treasury bond yields have gone in opposite directions (down and up 100bp, respectively, in 4Q24) to a degree never seen before. Is this an omen?
- Cryptocurrencies properly took off. Their aggregate value more than doubled to $3.5trn (from just $200bn in 2019). But can they become of use to wider society? Can they live up to the "currency" part of their name? If not, they remain no more than nerve-shreddingly volatile stores of value.
- Investors' worries about the valuation of US equities, whether relative or absolute, seemed to disappear from view – as if super-stretched valuations should somehow be taken as read. Are we all momentum junkies now?
- The issue of rock-bottom birth rates went mainstream (sort of). Almost every country outside sub-Saharan Africa is affected. Demography really is destiny; but few governments so far are facing up to the social and economic consequences, let alone floating possible solutions. (Whatever challenges the world faces, too many people is not one of them.)
- The euthanasia of European manufacturing industry accelerated, fuelled (excuse the pun) by ideological energy policies and anti-capitalist regulation. China has taken an astonishing lead in EVs (both cost and design). More seriously, it has achieved technological superiority in almost *all* major industrial sectors (aerospace and pharmaceuticals being two glaring exceptions – for now). This is not widely appreciated in the West.
- China issued $2bn of dollar-denominated bonds in Saudi Arabia at 1bp over US treasuries. The issue was 20 times oversubscribed. No one had this on their bingo card. With an annual trade surplus of $1trn, China certainly doesn't need the money. Was it a shot across the bows of US dollar imperialism?

Stock market bubbles are another awkward fit with our preference for low-turnover investing. Even assuming we can identify a bubble before it bursts, only dumb luck would enable us to get out of the way in time while not forfeiting gains from the bubble's continued expansion. Nevertheless, the time has come to face up to US stock market exceptionalism – its unprecedented scale, its influence on global indices, its sustainability and the possible fall-out if the bubble bursts.

In synthetic terms, the US represents 65% of the MSCI All World Index despite accounting for only 25% of global GDP and 4% of the world's population. Even if it has been the case for several years already, it is no exaggeration to say that global asset allocation nowadays hangs on one decision: whether to over- or underweight US large-cap stocks (and the so-called "Magnificent 7" in particular). The fact that 93% of active large-cap US managers have underperformed the S&P 500 over 20 years suggests how the question has mostly been answered.

We have seen this movie before, of course. The dotcom bubble of 1999/2000 and, before that, the mid-80s Tokyo supernova spring to mind. In both cases, the crazier the valuations became, the more imaginative the metrics to justify them (who remembers "EV per eyeball"?). In fairness, investors can point to a raft of structural forces that underpin the American exceptionalism of the present era: the rise and rise of Big Tech since 2008's financial crisis; energy self-sufficiency courtesy of shale; a uniquely large domestic market for America Inc.'s products and services; the dollar's unchallenged position as the world's reserve currency – and more recently the advent of AI. America's star burns even more brightly when set against the political, fiscal and industrial agonies of Europe or China's protracted balance-sheet recession. By now, however, there are plenty of visible threats to the continued exceptional performance, absolute and relative, of the US stock market.

- First, aggregate valuations stand at all-time highs on most yardsticks – and that's before worrying about the newly stretched relationship between US treasury yields and equities (as measured by the dividend or earnings yields).
- Second, the incoming Trump administration's proposals to impose tariffs on China and others pose obvious risks, including higher inflation and disrupted supply chains.
- Third, AI may have propelled Nvidia and certain other stocks into orbit, reflecting enormous capital spending by Big Tech. But what if Google, Meta et al. decide that prospective returns on their AI investments just aren't attractive enough – and rein in their spending?
- Fourth, Trump's choice for Treasury Secretary, Scott Bessent, has made it clear he would like "some kind of grand global economic reordering" – a euphemism (we assume) for a weaker dollar and a stronger renminbi, *inter alia*. If he gets his way, what might be the effect on asset values of a 2025 version of 1985's Plaza Accord?

Another way of looking at the US equities dilemma is to try to quantify prospective returns from today's starting point. The logic is simple: if equities are highly valued now, but long-run returns are broadly stable, there must be less value left to accrue to investors buying today. Our eye was caught by a recent – and decidedly non-consensus – paper from Goldman Sachs (outright bulls of US equities for the last few years). Their portfolio strategy group ran exactly this analysis using a model with five main variables: starting absolute valuation, stock market concentration, recession frequency, corporate profitability and interest rates. Short version: Goldmans estimates *nominal* returns from the S&P 500 over the next decade of just 3% p.a. (versus 13% over the last 10 years), but highlights that modelled returns would be 4% higher (i.e. 7% p.a.) if market concentration was ignored. The US stock market is more concentrated today than at any time in the last 100 years. This puts a double constraint on future returns – via currently high valuations, but also via growth (super-sized companies find it harder to maintain rapid growth rates).

Although predicting when a bubble will deflate is a mug's game, we do know from history and experience that, if asset allocators are making decisions based on the fear of losing their jobs (instead of assessing information dispassionately, as they should), then the moment of balloon-bursting isn't far away. Having already exchanged some of our model portfolio's capitalisation-weighted US equity exposure for an equal-weighted ETF, we think it makes sense to do more of the same. We are also boosting the cash weighting (from 6% to 9%). As an aside, UK higher-rate taxpayers should still consider low-coupon, but short-dated, gilts as alternatives to cash given the tax-free capital gains on offer.

We have barely mentioned the incoming President of the United States. Investors mostly greeted his election with enthusiasm, above all the crypto brigade. But Trump inherits a truly dire fiscal position – hence Bessent's plan to cut the annual deficit to 3% of GDP (from the peacetime record 6-7% under Biden). No one knows whether DOGE will have an impact. But realistically much of the federal budget looks fairly immovable (Medicare/Medicaid, welfare and debt interest). On the other hand, US government spending (federal and state) accounts for only 35% of GDP, which looked positively slimline compared with 46% in the UK and a scarcely believable 58% in France. The US is still a friendlier place for investors' savings than Europe.

Poor old Europe. Mario Draghi's September report to the European Commission on how to improve European competitiveness was little more than a list of things to spend taxpayers' money on, plus a dollop of unintended black humour ("decarbonising is an opportunity", apparently, casting Draghi as Nero to Europe's burning car industry). More generally, the report is emblematic of a growing trend for governments, hemmed in by budget deficits and sky-high debt, to hijack private citizens' savings for their pet projects, which are often related to the fatal mirage of Net Zero. Market strategist Russell Napier offers a term for this phenomenon – "national capitalism" – but admits that he borrowed it from Lenin. Whatever we call it, this is something to keep an eye on. Gold, value stocks and minimal exposure to bonds are all likely to play roles in protecting investors' wealth against state-sponsored assault.

Trump also inherits a Federal Reserve under Jerome Powell that has already kicked off a new rate-cutting cycle. Never mind that inflation remains stubbornly above its longstanding 2% target. December's cut felt uncomfortably political – an attempt to rebut the charge that September's cut favoured the Democrats. With most US economic indicators still quite lively, the clear risk is that lower interest rates will exacerbate underlying inflationary pressures. We tip our hats to Vincent Deluard for pointing out that the US inflation rate for haircuts (sic) stood at 4.8% in November. He promotes this measure as an excellent gauge of wage pressures – because a haircut is essentially the same service everywhere, delivered using the same equipment as 100 years ago (i.e. haircuts are almost immune to productivity gains). Even before Trump imposes tariffs or deports illegal immigrant labour, inflation in the US still looks to us far from beaten. As we said, investors should get used to it.

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Asset Classes	Courtville Partners Asset Allocation (%)	FTSE PI Balanced Index (%)
UK Equities	10	13.9
International Equities	53	48.4
Fixed Income	13	25.7
Alternatives	14	7.7
Commercial Property	1	0.1
Cash	9	4.2
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		**53**	**-1**	
Global	IWQU LN	4	-1	0.30
US	VUSA LN	10	-1	0.07
	XDPG LN	7	-2	0.09
	EWSP LN	8	3	0.20
	IUVD LN	3	0	0.20
Euro	VERX LN	3	0	0.12
Japan	VJPN LN	4	-1	0.19
Asia ex-Japan	VAPX LN	5	0	0.22
Emerging Markets	VFEM LN	7	1	0.25
Emerging Markets ex-China	EXCS LN	2	0	0.18
Fixed Income		**13**	**-1**	
Government Bonds				
UK Inflation Linked	INXG LN	2	0	0.25
UK	IGLT LN	2	0	0.07
US	IDTM LN	3	0	0.17
EM	SEML LN	2	-1	0.50
China	CNYB NA	2	0	0.35
Corporate Bonds				
US	CORP LN	2	0	0.20
Alternatives		**14**	**-1**	
Gold	PHAU LN	4	0	0.39
Oil	WEL5 GY	2	-1	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	**9**	**3**	0.15
Total		**100**		**0.21%**

Courtville Partners	Model Portfolio	FTSE PI Balanced Index	Relative performance
2024 YTD	11.2%	11.4%	-0.2%
Since inception(1/1/2015)	107.5%	99.7%	7.8%
CAGR	7.6%	7.2%	0.4%

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