

The risk of outperforming this market

On face value the US market is up this year so it's certainly a victory for the optimists but ask any portfolio manager about this market and they will tell you it's not been this confusing for a very long time.

The S&P 500 is now up 15% in 2023 and, on face value, on the cusp of another bull market from its lows back in Q4 2023. Fantastic, but why? Well, certainly 2023 started with the expectation that the number of interest rate hikes in 2022 were going to quickly tip the global economy into a 2023 recession. This simply has not happened and instead tech stocks under the banner of a torrid 2022, a very hot artificial intelligence (AI) rally and expectations of interest rate cuts coming soon have brought us to where we are today, on the cusp of a bull market. It's safe to say a lot of very informed and experienced investors have been caught offside.

However, under this headline gain of 15% in the S&P 500, which is the top 500 largest companies in the US, 493 of the companies in the index are hovering around small gains or outright losses in 2023. Just think about that for a second, that's 98% of the US's biggest companies trading flat to a loss this year, yet add in those additional 7 stocks (Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla, Meta) and the index

of those same top 500 companies is miraculously up 15%!

If you want a date when this last happened, it was in the 1970s when the market was driven this high by such a small level of stocks and as we approach the half year mark this has been one of the best half year performances in the last 20 years… from 7 stocks. Apple is now worth more than the entire FTSE 100 which I still can't quite get my head around.

That's an absurd level of strength and concentration coming from very few stocks and certainly raises the risk that we are in bubble territory for some of these stocks. On a headline level, this market is a great example of the risks of blithely buying into a passive ETF because you are essentially just buying the market, which in the case of US ETFs, is dominated by those 7 stocks. Investors in US passive ETFs are essentially confirming they agree that Apple being worth more than the entire FTSE 100 is not only justifiable but cheap enough to warrant investing further into. "Gulp".

It's also a reasonably good explanation of why a lot of active fund managers running global funds are underperforming their benchmarks this year because they are, by design, actively looking for the best companies from across the global market of 1,500 stocks when this year the headline gains are coming from just 7 stocks. Yes, Meta and Nvidia are storming this year, but they halved in value in 2022 so one can't say those investors, whilst having their time in the sun, haven't completely forgotten the volatility of the last 18 months, leaving them with somewhat of a bittersweet experience.

Right now, the lay of the land is firmly dominated by inflation and recession. Yes, it's the most widely flagged economic slowdown in history but no one knows 100% if it's coming, when it's coming, how deep it's going to be or how long it's going to be and everything in between. This is causing all sorts of different views from investors which is creating some of the wider dispersions in investors' portfolios as different investment teams invest into different signals.

At TAM, we liken the global economy, with the US at its core, like an oil tanker. Did you know that after one powers down an oil tanker it takes over 8 kilometers for it to eventually stop? I think we are in a similar situation with the economy, we are slowing but the speed and heat created from the money pumped into it from COVID-19 has led to a massive level of strength which needs to eke out of the economy before the numbers start to flash red. The US Federal Reserve has raised rates 10 times in 10 sessions to 5.25% in a little over a year. That's a heck of a lot of interest raises in a very short time and the idea that it's not going to cause an economic drag of some degree is certainly something we contest and are investing for a market which does, eventually price in a slowdown.

The 30,000ft view right now is that the equity market's storming start is tantamount to saying there isn't going to be a recession, and even if there is a recession it's going to be a light and short one as inflation is going to get back to 2% very soon and the central banks can start cutting rates again. This is confirmed with investors putting massive amounts of money to work in mega cap tech which they believe will outperform in this scenario.

The bond market on the other side is not sharing the same enthusiasm, with government bonds this year being in negative territory with an inverted yield curve (the most reliable indicator of every historical

recession) on the view that inflation isn't going to come down in the way the equity market thinks it is and as such, central banks are going to have to keep rates higher for longer which, along with tightening lending standards from regional banks, spells a much higher chance of a deeper recession.

Sadly, both can't be right, one is going to correct towards the other as the year unfolds. Either the bond market will see inflation isn't going to stay worryingly high and react positively towards the equity market highs as interest rate cuts start to get priced in. Conversely, the equity market is going to realise inflation isn't going away and its "no recession" narrative is a little ambitious and sequentially come off its highs. Under that second scenario it's a good bet that investors will sell their equities and buy government bonds as a cheap and effective safe haven ahead of a recession.

From here it's critical for clients to realise how important it is to spread investments over different scenarios, outcomes, and opportunities. Yes, that type of wide portfolio will be underperforming the equity market at present but it's key to appreciate that's no bad thing and certainly doesn't indicate the portfolio you own is not of good quality. Remember – this market is broadly up on just 7 stocks out of 1,500 to choose from.

This market is not one TAM's portfolio is designed to beat, it's too hot and too narrow. However, we have had some fantastic victories this year from the likes of European value and Japanese equities, along with high quality corporate fixed income in areas other investors have overlooked. Likewise, some out of the money investments are starting to get to work in the portfolio after a tough time this year. We remain risk averse and firmly in the mode of keeping the protective and diversifying investments for which we are renowned firmly in place should we see volatility.

I will leave you with an analogy which sums up the performance dispersion of managers in today's world and how clients should try and frame the challenges ahead. If the 2023 market was a racetrack that you knew could intermittently and without announcement switch from smooth tarmac to off-road, which type of vehicle would you choose to get you to the finish line in one piece, an F1 car or a 4x4 Jeep? In this analogy the F1 car is the portfolio full of high-flying mega cap and AI tech, and the 4x4 Jeep is the diversified portfolio spreading its risk and staying invested into protective assets for its clients. Right now, the F1 car is out in front at 200mph but what happens should the track switch to off-road? I will let you decide which one you would prefer to be in.