March 2024 Investment Views

BUTTERFIELD

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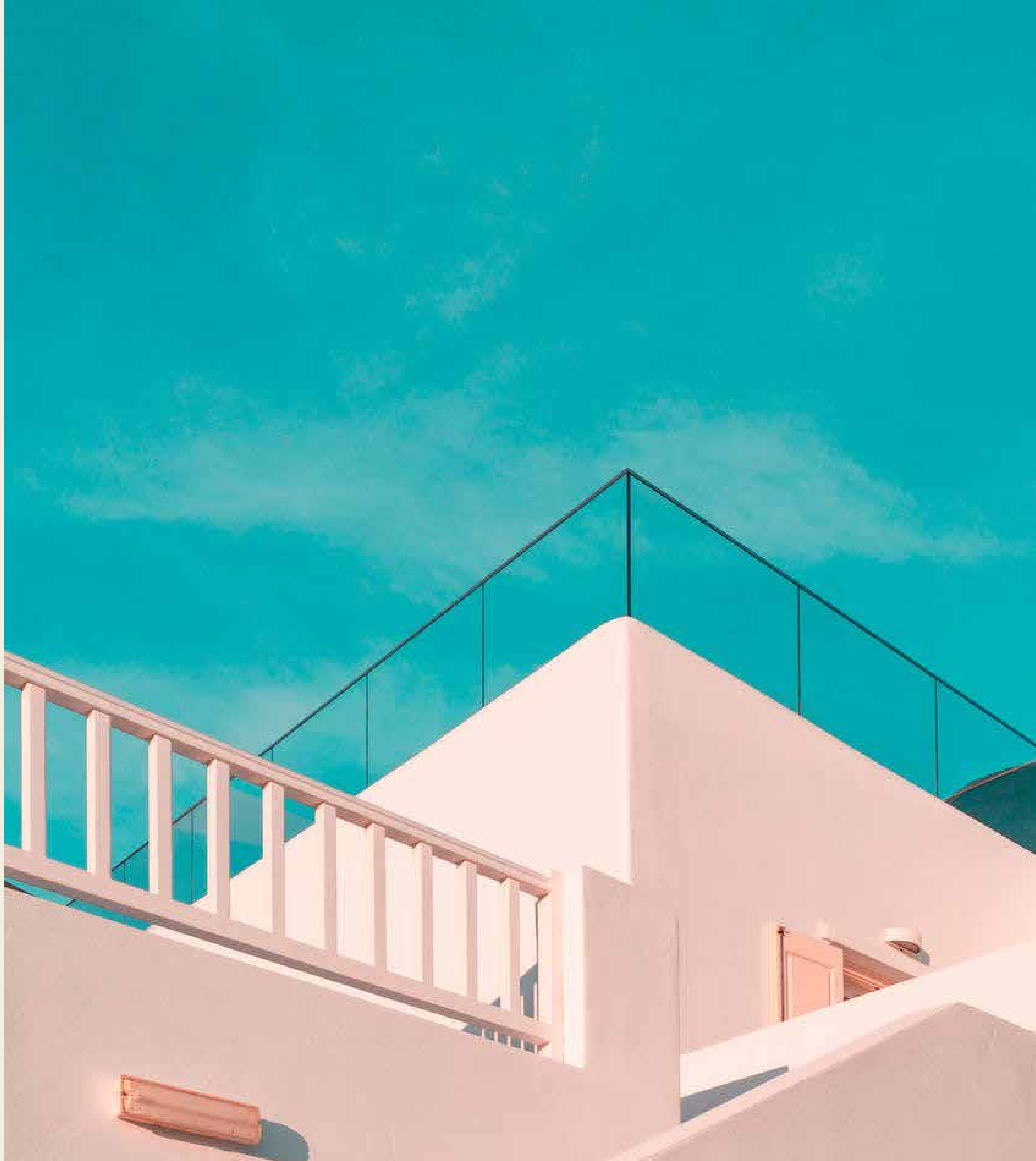
Forward to the Future

- Artificial Intelligence (AI) has been an important driver of markets
- Michael Dell describes AI as a "change or die kind of moment"
- Technology is impacting all sectors but not equally

Having first discussed the rise of Artificial Intelligence (AI) back in the July edition of Investment Views last year, AI has grown to be a powerful driver of US equity markets. New technologies like AI play an important role in financial markets, but also in advancing the standard of living in the world. As such, economists have been crunching the numbers (with the help of technology of course) to forecast its potential impact on future productivity.

Analysis by Capital Economics suggests countries that successfully adopt AI could see their productivity growth lifted by as much as 1.5% a year in the decade following widespread adoption. Considering the low level of productivity seen over the last 15 years, this would be a significant boost to growth. Even if this turns out to be too optimistic, it does not change the underlying point about the importance of the technology in boosting growth. Analysts at



Bloomberg estimate that spending on Generative AI could rise to $1.3 trillion in 2032, which would be a rise of 43% on an annualised basis. This would take Generative AI spending from the current level of 1% of technology spending to 10-12%.

When thinking about new technology, it is always important to distinguish between hype and reality. Technology is particularly prone to boom-bust cycles because of the nature of the sector. Technology can experience exponential change, such as computing power, the internet or mobile connectivity. The potential for significant upside through transformational new technological innovation can mean that traditional short-term valuation metrics are of little use as they struggle to price upside optionality. Furthermore, narratives around technology can become extreme and the potential can often be bounded only by the extent of imagination. This can lead to excesses which can unwind aggressively, as we saw with the dot-com bubble in 2000.

In a recent interview, JP Morgan CEO Jamie Dimon said of AI: "This is not hype. This is real… when we had the internet bubble the first time around … that was hype. This is not hype, it's real". Dimon then continued to provide concrete examples of how the largest bank in the US is already using AI: "The way to think about it for us is every single process, so errors, trading, hedging, research, every app, every database, you can be applying AI. So, it might be as a co-pilot, it might be to replace humans".

In a blog post last year, JP Morgan described how they have been using the underlying AI-powered large language models for payment validation screening for more than two years. This has sped up processing by reducing false positives, enabled better queue management, reduced fraud and cut account validation rejection rates by 15-20%.

While the release of ChatGPT thrust AI into the spotlight, the reality is that AI is not new. The term artificial intelligence was

43%

The annualised percentage Bloomberg estimates spending on Generative AI could rise by 2032

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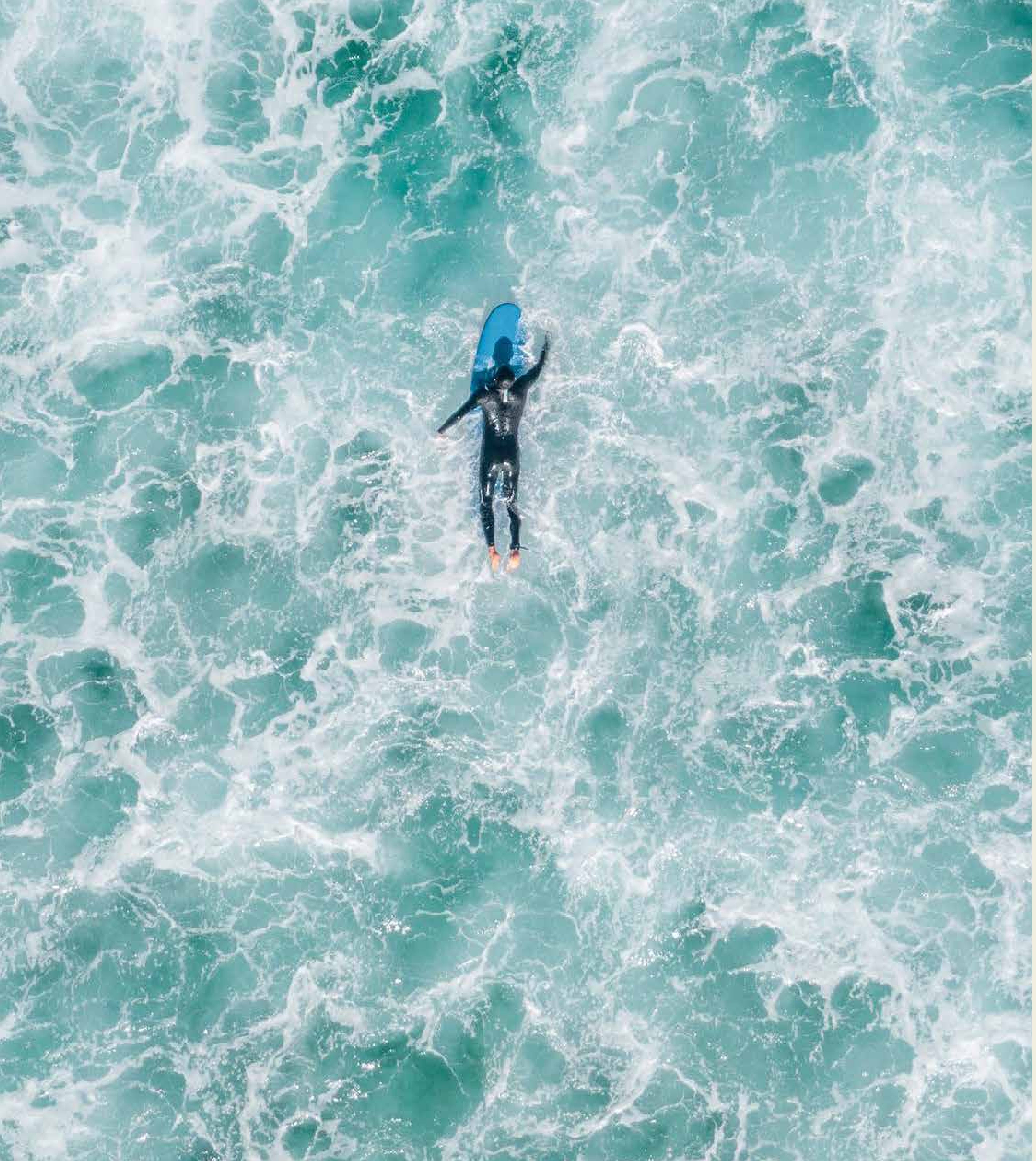
- JP Morgan CEO **Jamie Dimon**



coined back in 1956 at Dartmouth College, six years after Alan Turing developed the Turing Test to help measure the intelligence of machines. In 1997, IBM's AI machine managed to beat then World Chess Champion Garry Kasparov and in 2014 Google acquired DeepMind to improve their AI capabilities. Recent use cases have included virtual assistants such as Amazon's Alexa, and Apple's Siri, autonomous vehicles, recommendation/prediction algorithms and virtual chat helpdesks.

The primary beneficiaries of AI have so far been semiconductor firms, led by Nvidia. Large providers of cloud computing technology, such as Microsoft and Amazon, have also benefited in addition to data centres, software companies and power generation firms. The main constraint in the AI revolution has been computing power and people with the skillset required to develop and deploy the models. Companies have been mentioning AI regularly on earnings calls, but it is going to take time for management teams to consider how the technology can be utilised across different market sectors.

Technology is something that touches every business in one way or another. In addition to the applications in finance, the health care sector is also well placed to benefit. Technology can be used to analyse medical images and, with the help of doctors, learn to improve their ability to read scans over time. Content creation is another area where AI is very powerful. The ability of AI to generate images and write copy is very impressive and has the potential to drive productivity in a broad range of sectors. In a recent interview, Michael Dell described AI as a "change or die kind of moment… for many organisations and industries".

With traditional business cycle analysis struggling in this unique post-covid cycle, it is increasingly important to focus on what is happening with the fundamentals in individual industries and companies. Understanding technical innovation and tilting investments towards the beneficiaries in a risk-controlled way is an increasingly important part of our investment philosophy.

Bond Markets Shift as Global Growth Gains Pace

- Global economic growth accelerates but inflation rises
- A sharp rise in US bond yields as market adjusts rate cut expectations
- The US dollar strengthens; cautious stance on credit risk

During February, we witnessed continued acceleration in global economic growth. This is happening across the three main growth blocs in the world; the US, Europe, and China. In addition, inflation data was hotter than expected in Japan, Europe and the US. Looking at macro-economic data, it is unlikely that US base rates are lowered in the immediate term and bond markets have now started to reflect this view, pricing in 90bps of cuts this year versus 175bps back in mid-January. This has led to a sharp move upwards in US bond yields, with 5-year US Treasury yields rising by 41bps to 4.25%.

With this most recent move in bond yields, the market is now almost in line with the latest projections from the Federal

Reserve. Therefore, we are slightly more comfortable adding to duration although the buoyancy of the US economy and stickiness of inflation leaves us cautious. The elevated US fiscal deficit at 6% and negative term premiums (additional yield that investors demand to hold onto longer-duration securities) suggest another move higher in longer-dated bond yields cannot be ruled out.

46bps

Indicates the rise of the 2-year US Inflation Breakevens.

Unlike in the fourth quarter, better news on the economic front has also been met by rising inflation expectations. 2-year US Inflation Breakevens (a measure of expected inflation) rose by 46bps to 2.79%. Our US inflation protected securities have therefore helped to reduce mark-to-market losses in bonds during the month. Rising inflation also raises the odds that interest rate cuts are likely to be pushed out into the future, which could mean risk assets will need to take a breather in the months ahead. Currently, the first rate cut in the US is expected in June. The European Central Bank and Bank of England will likely wait for the US to start cutting interest rates before they can ease pressure on consumers in their own regions.

In currency markets, the US dollar strengthened, especially versus the Swiss franc, Japanese yen, and Australian dollar, with the Euro flat over the month. Given recent correlations, the Japanese yen and Swiss franc look set to benefit from any risk asset volatility, while the US dollar may benefit from high real rates and buoyant growth.

Chinese, Japanese and Swiss 10-year government bond yields fell in February, bucking the global trend of higher yields. Inflation is not an issue in China and Switzerland. Therefore, policymakers have the luxury of cutting interest rates earlier than other regions. In Japan, rumours swirl over the end of their negative interest rate policy, with the bond market now pricing in 40bps of rate hikes in 2024; a large move for the Bank of Japan. However, it remains to be seen whether domestically generated price pressures are sustainable. In any case, a stronger yen, which may follow the first

hike, reduces the odds that the Bank of Japan aggressively hikes in subsequent months. In addition, the strength of the yen continues to reman contingent on the yield spread differential with US Treasuries.

With the rally in equity markets also triggering a 32bps fall in high yield spreads (the yield premium on corporate credit versus government bonds) to just 312bps over US Treasuries, we continue to favour an underweight to credit risk. Spreads at these levels leave little room to absorb any dislocations in risk assets in the months ahead. With odds rising that the path for lower US base rates will be more gradual in the months ahead, fixed income portfolios look set to capture carry for much longer than in previous economic cycles.

In addition, a case could be made that the Federal Reserve's longer-term base rate (neutral rate) forecast could be raised, as the current level of interest rates is clearly failing to restrict the economy or risk sentiment. This could lead to a rise in fixed income volatility and higher longer-dated yields, which may be the catalyst for risk assets to enter a healthy correction. However, economic data is still prone to large revisions and seasonal adjustments, so a degree of caution is warranted by policy makers.

Marching Higher

- Another strong month for Large Cap Technology
- Industrials are benefitting from stronger growth
- Consumer Staples are under pressure

The MSCI World Index rallied 4.2% in February, as positive sentiment and momentum drove the markets higher. This is the fourth consecutive positive month since the 2.9% selloff in October. The best performing sectors were Consumer Discretionary, driven by Amazon and Tesla, Information Technology and Industrials. The Industrials sector has outperformed the broader benchmark in three of the past four months, suggesting investors are becoming more comfortable with the state of the broader economy. The worst performing sectors were Utilities and Consumer Staples, with some names in the Consumer Staples sector, such as Nestle and Reckitt Benckiser, releasing results that underwhelmed.

The US was the best performing country followed by Japan, which continued to do well after a strong January. Interestingly, Emerging Markets rebounded as Chinese equities recovered and was the second-best performing region this month after a very weak start to the year. Asia Pacific ex Japan lagged again and is the worst performing region year-to-date.

The MSCI World Growth Index beat the Value index by a meaningful margin but the difference between the S&P 500 and the equal weight S&P 500 was less pronounced, pointing to a broadening rally. Small caps rebounded strongly after lagging by 4% in January.

The fourth quarter earnings season is now over. Aggregate sales beat analyst expectations by 7.2%, the third best beat over the last two years. Aggregate earnings-per-share (EPS) beat analyst expectations by 1.2%, the second lowest beat over the last two years. The largest beats were in Consumer Discretionary and Healthcare and the largest misses were in Utilities and Real Estate. Earnings revisions have been stable and given the strong start to the year in the equity markets, valuation multiples have expanded. The S&P 500 now trades at c.21x blended forward earnings, which is a 15% premium to its 10-year average.

Three of the "Magnificent Seven" (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, Tesla) posted very strong returns in February. Nvidia rallied 29% after publishing results that beat fourth quarter estimates and also beat on guidance, confirming that the AI story is still on track. The stock closed up 16% the following day, and posted the best monthly gain since May 2023. Meta closed the month up 26% after reporting robust results, initiating a dividend and boosting share buybacks. The stock popped 20% the following day, nearly as much as the 23% gain seen when they reported fourth quarter results last year. Amazon finished the month up 14%, the best monthly return since May 2023, after reporting better than expected operating income. This, coupled with the announcement that the company is to replace Walgreens Boots Alliance in the Dow Jones Industrial Average, more than offset news that Jeff Bezos is selling shares. Tesla rebounded 8% in February but is still down 19% year-to-date.

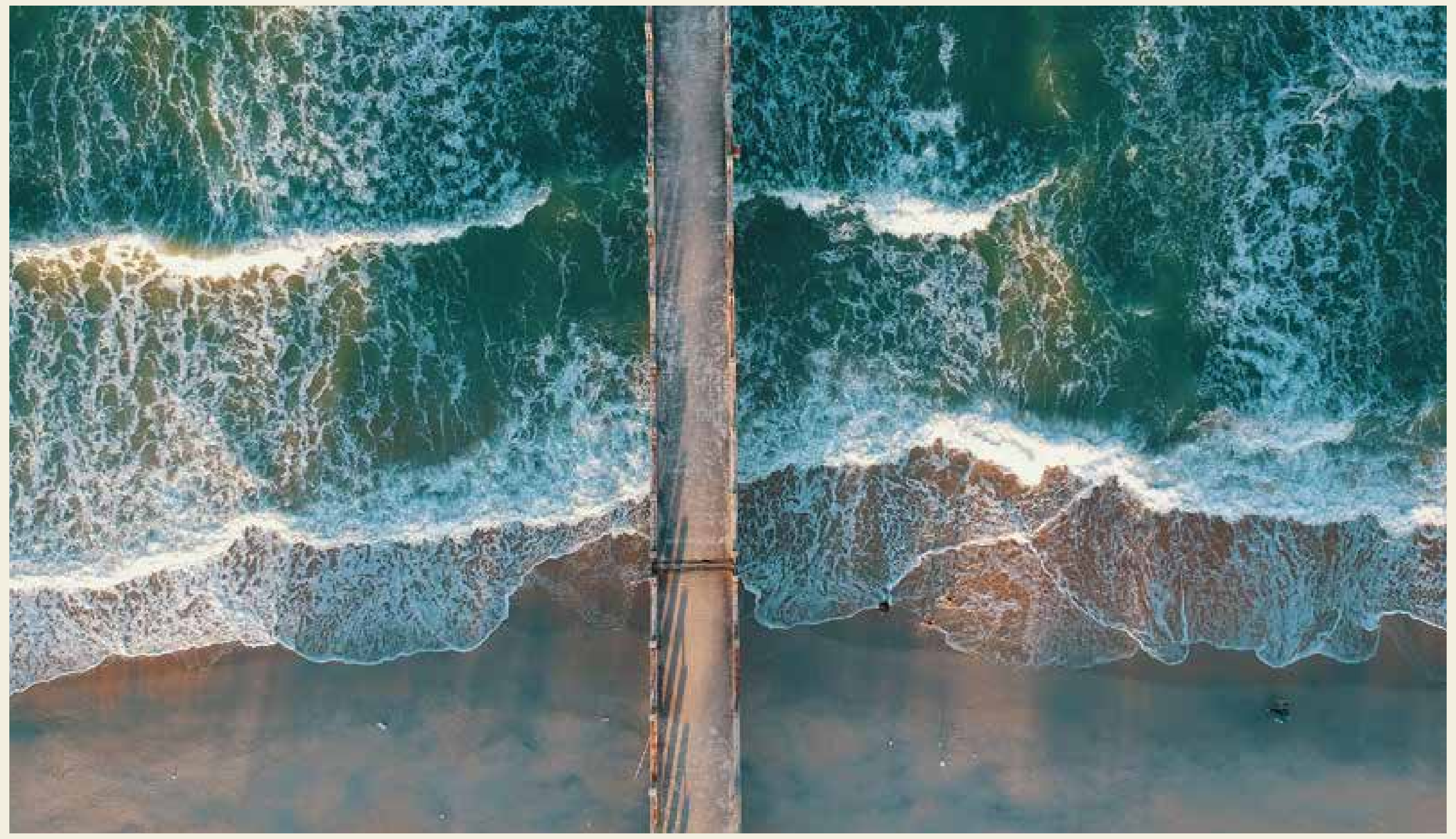
7.2%

The percentage that aggregate sales beat analyst expectations.

7.1%

The percentage the S&P 500 is up at the end of February.

Interestingly, recent data from mutual funds and hedge funds shows that institutional investors have been reducing their exposure to the Magnificent Seven in the fourth quarter. The average mutual fund is now underweight these stocks in aggregate by around 7%. This reflects expectations that returns for this year in these seven stocks will not match those of last year. Mutual funds and hedge funds have been increasing equity exposure in line with the market rally, however mutual funds have been rotating into defensives while hedge funds have been rotating into cyclicals. The S&P 500 is up 7.1% as at the end of February. Earnings growth for the calendar year is expected to be 8.8%. For additional returns this year, earnings expectations would need to be revised upwards or valuation multiples would need to expand, which is hard to see given the 21x blended forward P/E. That said, the S&P 500 has traded as high as 23x earnings over the last 10 years, which would result in an additional 10% return from current levels.



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Global Asset Allocation

The chart below details our 6-12 month tactical investment strategy

	UNDERWEIGHT -	+ OVERWEIGHT
Asset Allocation	EQUITIES (MODEST UNDERWEIGHT)	CASH (MODEST OVERWEIGHT) NON-TRADITIONAL ASSET CLASSES (MODEST OVERWEIGHT)
Fixed Income		EMERGING MARKET DEBT INFLATION PROTECTION
Equities Regional		JAPAN EMERGING MARKETS EX CHINA
Equities Sector	CONSUMER DISCRETIONARY UTILITIES	ENERGY HEALTHCARE

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