Investment Views

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BUTTERFIELD

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Concentration Conundrum

- US equity markets have become very concentrated
- Artificial Intelligence (AI) has been a strong driver
- Concentration is a reflection of success but comes with risks

Over the past year, the concentration of the US equity market is a theme that has dominated investor conversations. The weighting of the top 10 stocks in the S&P 500 has reached 35%, which is a multi-decade high and has eclipsed the 27% reached in 2000. We have written extensively about the seven stocks dubbed the “Magnificent 7”. They are not all in the official Technology sector, but technology is a strong theme across the group. The seven stocks are Alphabet (Google), Amazon, Apple, Microsoft, Meta (Facebook), Nvidia and Tesla. The group had a difficult 2022 as many were beneficiaries of the pandemic (for example work from home and e-commerce) and the cycle turned in favour of value stocks as interest rates went up.

The group then bounced back with a vengeance and outperformed significantly in 2023. This was helped in large part by AI, which has been a theme of all seven companies to varying degrees. Nvidia has

been the most direct beneficiary from selling the semiconductors enabling AI tasks. Microsoft has also been a direct beneficiary through ownership of OpenAI. Microsoft, Amazon and Google have also benefitted though their public cloud operations.

There is a great deal of excitement in the economic and investment industry around the potential of AI. Companies are also discussing AI on their earnings calls and the potential ways in which it can help drive efficiencies. The opportunities are clear and span a wide range of industries. However, financial markets have a tendency to extrapolate themes too optimistically and hype takes over, which can drive valuations to unrealistic levels. This creates a conundrum for investors. The concentrated nature of the equity market makes it very difficult to outperform without owning these stocks at least close to benchmark weight. Furthermore, with such elevated concentration, some mandates may not even be able to "overweight" these stocks due to risk management around sizing positions in portfolios.

While the concentration of the market intuitively means increased risk, there are mitigating factors. On the one hand, concentration means more exposure to company specific risk. With Microsoft, Apple and Nvidia accounting for 20.8% of the S&P 500, passive investors by definition have meaningful exposure to the corporate governance of these three companies. Fortunately, these three companies have some of the world's most impressive management teams. Corporate governance at other large cap names, such as Meta (lack of shareholder voting power) and Tesla (questions around board oversight) have been problematic, but these are smaller weights in the index. Meta has managed to navigate a changing environment well, for example pivoting focus from Metaverse to AI.

On the other hand, the concentration is arguably beneficial from a shareholder perspective. These large cap companies have significant economies of scale and almost quasi-monopoly or duopoly status in some cases. These companies are also highly profitable and can

20.8%

The percentage of Microsoft, Apple and Nvidia of the S&P 500.

borrow at cheaper rates than small businesses, allowing them to acquire smaller competitors. This has helped to limit competition, which in turn has drawn greater regulatory scrutiny.

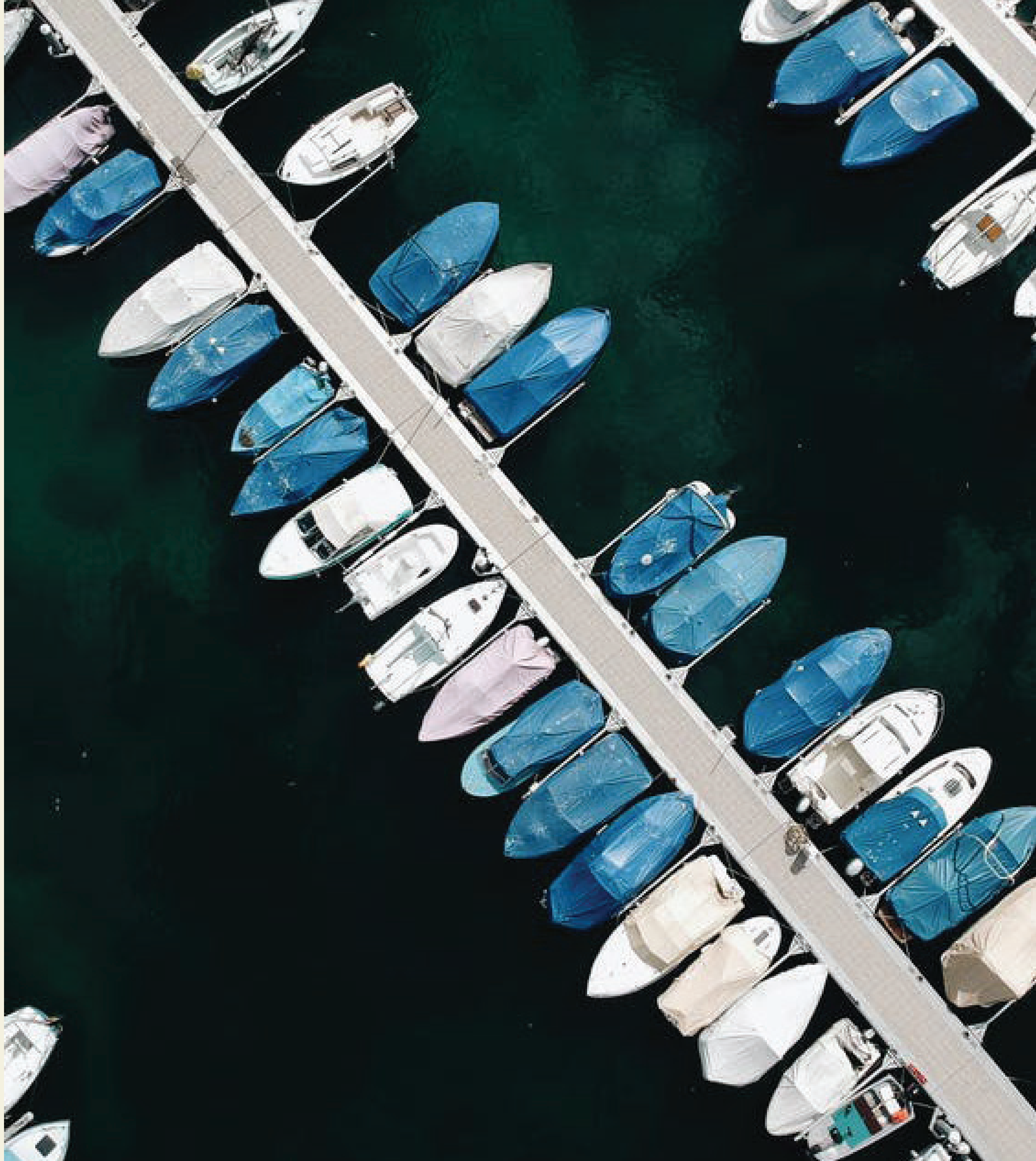
The market concentration is somewhat concerning from a top-down perspective. Valuations have climbed and themes tend to be cyclical, which suggests that caution is warranted. From a bottom-up perspective, these are great companies and investors need to own them. While the top 10 stocks accounts for 35% of the S&P, they also account for a significant 27% of earnings. Our exposure varies based on the mandate, but overall, these stocks are well represented in portfolios which has been a driver of performance.

Resilient Markets Amidst Diverging Economic Data

- Credit spreads rise suggesting caution
- Mixed macro data: US weak, Europe and UK stronger
- Bond yields diverged; cautious on US rates, favourable for the Euro

The month of May proved to be rewarding for risk assets as equities rallied. However, this did not translate into broad gains in credit spreads, with US high yield spreads rising 8 basis points (bps) on average. This is a potential cause for concern in terms of the sustainability of further outsized moves. Global macroeconomic data continued to prove resilient, although, weakness is visible in most regions apart from Europe and the UK, with data especially in the UK positively surprising expectations.

Canadian and US government bond yields fell, with US five-year Treasuries declining 21bps to 4.51%. The Bank of Canada is expected to lower base rates in June and US economic data



showed signs of weakness. Weak non-farm payroll, unemployment claims, ISM manufacturing and sentiment data add to growing evidence that the US employment market may have reached a turning point. However, sticky inflation and still buoyant services spending are injecting a large amount of uncertainty into the base rate outlook over the next 12 months. The market is currently priced for 46bps of US base rate cuts. Although the Bank of Canada is expected to be dovish, the stronger than expected unemployment rate adds a degree of caution which for now is offset by weaker than expected Q1 GDP and retail sales data.

Outside of North America, with economic data improving and progress on inflation slowing, European and UK government bond yields diverged and underperformed their US counterparts. This helped to strengthen the euro and sterling, mitigating some of the impact from a total return perspective. Election risks remain a factor to consider with a UK general election on 4 July and European elections also taking place. That said, the positive re-rating of the economic outlook has been the dominant factor for bond and currency investors, especially relative to the US and the expectation that the ECB will lower base rates next month, has not dampened demand for exposure to the euro – rate cuts are deemed supportive for growth with inflation much more contained than in the US.

Although broad commodity markets edged upwards, there has been significant divergence with lumber and oil falling, large rises in US natural gas prices, and copper and gold prices have been flat. As a result, few clues can be gained this month from commodities as to the path of global growth. The good news is that with the imminent start of base rate cutting cycles across the major economic regions, the global outlook is likely to improve and is favourable to further gains in risk assets. Unfortunately, the Federal Reserve is likely to be late to the party and refrain from lowering base rates until September at the earliest. With US employment data at a crucial juncture and inflation still sticky, the dual mandate will be thoroughly tested over the coming months.

FIXED INCOME

Portfolio positioning continues to remain neutral short dated US duration as we await evidence that the US economy has peaked. This continues to be elusive despite spiking consumer delinquency rates across almost all types of borrowing. Longer-term bond exposure is vulnerable to rising term premiums, although lower fixed income volatility has helped to supress this recently. Weaker US bond auctions as well as rising European and Japanese bond yields add another layer of risk and place a floor below yields for now. Within multi-currency mandates, exposure to the euro, sterling and Swiss franc has been increased at the expense of the US dollar. We also remain underweight the Japanese yen despite action from the Bank of Japan given disappointing macro data. Corporate credit spreads look set to remain tight for some time as global growth remains stable, but there will likely be better opportunities to add exposure here in the future so we continue to avoid risk with sectors and companies that are susceptible to a US recession.

Nvidia, Utilities, and the Broadening AI Trade

- Markets recover from April weakness
- Utilities benefit from AI enthusiasm
- Nvidia well ahead in winner-takes-all market

The MSCI World delivered the best monthly performance since December last year, returning 4.5% in May. However, this was on the heels of a 3.7% sell off in April, leaving us relatively unchanged for the second quarter.

Most sectors performed as you would expect in a “risk on” environment, except for the Utilities sector which was one of the best performing sectors in the month. Looking at quarter-to-date returns gives us a clearer picture of recent trends. The best performing sector over the last two months has been the Utilities sector which returned 8.7% and outperformed the MSCI World Index by 8.1%. Utilities have outperformed lately as the “generative AI is energy intensive” narrative gained traction. A large amount of power is required to run and train AI models with both mutual

funds and hedge funds buying into this narrative and increasing exposure to the sector. The Real Estate sector, which is normally fairly correlated with Utilities due to its sensitivity to interest rates, was one of the worse performing sectors over this period, indicating that the Utilities sector is currently being driven by the broadening AI trade rather than the change in yields.

The worst performing sector this quarter was the Consumer Discretionary sector as cracks continue to appear in consumer spending. Consumption patterns vary depending on income levels. Low to middle income consumers are being squeezed by inflation, whereas middle to high income consumers continue to spend. That said, consumers are increasingly making value-driven decisions and choosing to trade down to price-competitive retailers. As a result, discount and off-price retailers have seen an increase in traffic and are better positioned in this economic environment.

The equal weight S&P 500 lagged the S&P 500 quarter to date as some of the largest S&P 500 stocks, notably Apple and Nvidia, performed strongly. Apple announced better than feared Greater China revenue on the back of iPhone growth and boosted its dividends and share buybacks program. Investors are getting excited about the company's next iPhone cycle as Apple prepares to release an iPhone with AI functionality.

Nvidia powered through $1,000 after releasing another set of strong numbers which were better than expected. The share price closed up 9% on the day returning 27% in May. Nvidia's continued success suggests that semiconductors are a winner-takes-all market. AMD, which is the runner up, has had little impact on the former's success. In 2023 Nvidia returned 239% while AMD returned 128%. Year to date Nvidia is up 160% while AMD is up only 9%. Despite these moves, Nvidia and AMD trade on relatively similar Price to Earnings multiples and Nvidia is rolling out new chips at a blistering pace, protecting their first to market moat.

160%

The percentage that Nvidia is up Year to date.

Nvidia's meteoric rise is incredible. A few years ago, it was a mid-sized company designing graphics cards, whereas today the market capitalisation of Nvidia is among the top three largest companies in the world. Nvidia recently announced a 10-for-1 stock split to increase liquidity for retail investors and its employees. Historical data suggests that the share price of companies that announce stock splits outperform in the week of the announcement but show no real pattern on the date of the stock split and subsequent weeks. In terms of liquidity, in most cases, apart from the increase in trading volumes around the announcement date, the long-term liquidity benefits are questionable.

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Tel +(441) 299 3817
www.butterfieldgroup.com/Investments

Butterfield Bank (Cayman) Limited is licensed to conduct securities investment business by the Cayman Islands Monetary Authority. Registered Office Address: Butterfield Place, 12 Albert Panton Street, George Town, Grand Cayman KY1-1107, Cayman Islands.

Tel +(345) 949 7055
www.butterfieldgroup.com

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Tel +44 (0)1481 711521 Fax +44 (0)1481 714533
www.butterfieldgroup.com

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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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