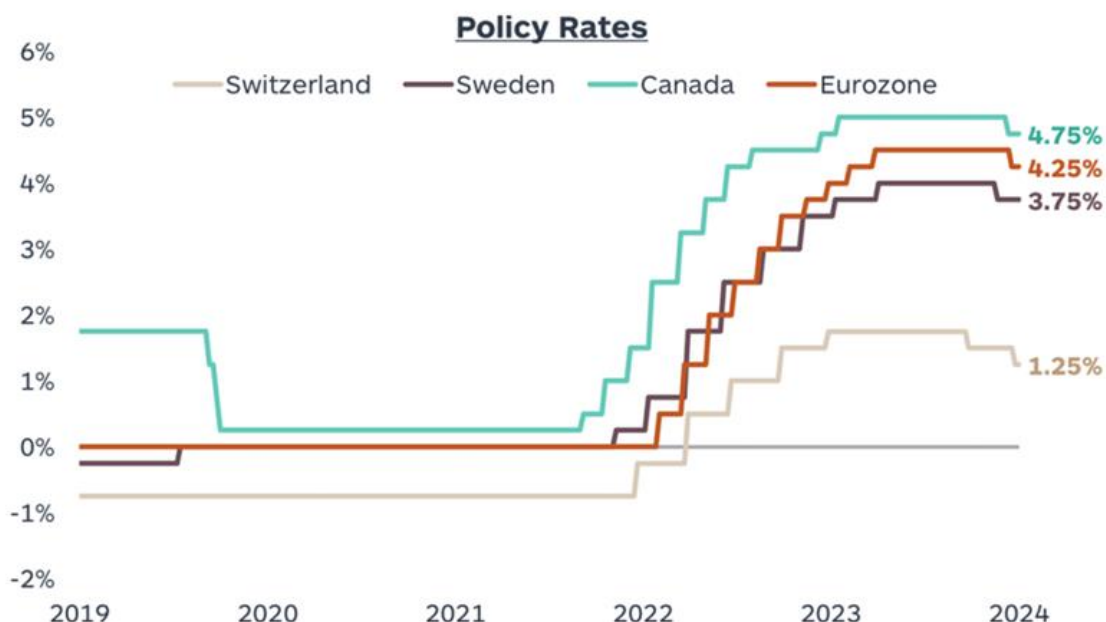


## LEARN FROM THE PAST, PLAN FOR THE FUTURE

### Introduction and Market Overview

We came into the quarter expecting major global central banks to start cutting interest rates. In the end, we had only one rate cut from the European Central Bank, Swedish Riksbank and the Bank of Canada. Switzerland also cut again, to add to their reduction during the first quarter. Resilient growth, lower disinflation and a robust labour market convinced central bankers to progress slowly in cutting rates. This dynamic supported risk assets, as it was interpreted that the reason for not cutting was generally because of good news for corporate earnings.

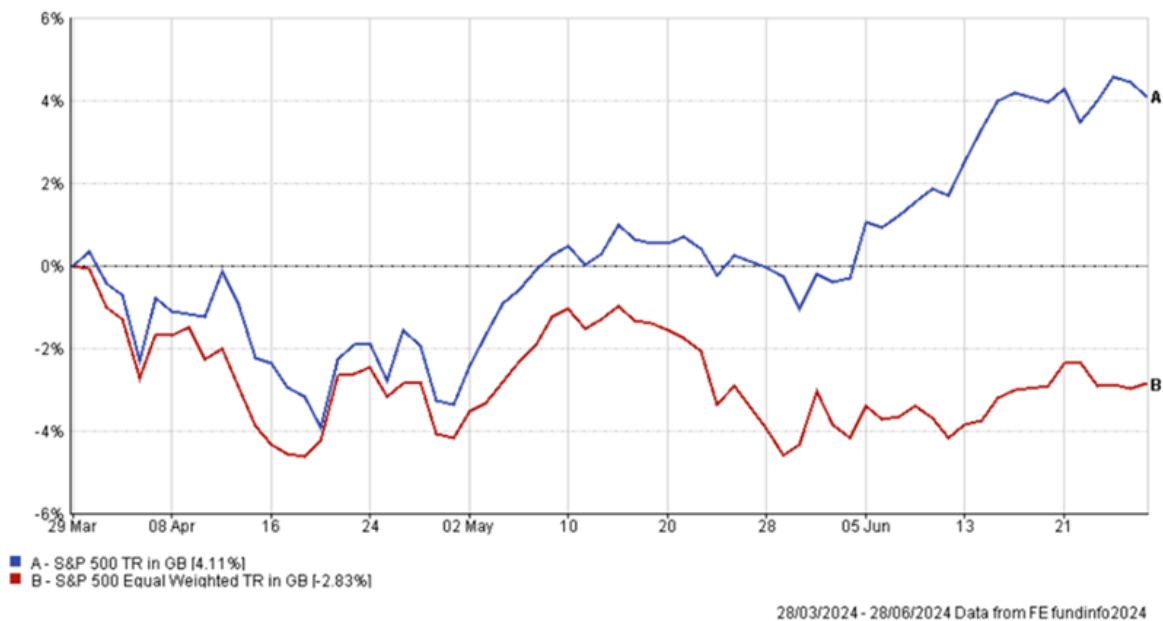


Source: Factset

The lack of significant interest rate cuts was less kind to government bond markets. Investors are also wary of the higher issuance of government bonds, particularly from the US Treasury, to fund ever-growing deficits. Corporate bond spreads, which measure the extra yield required for investors to invest in riskier bonds issued by companies over less risky government bonds, remained tight. This indicates that bond markets are not currently pricing in a deteriorating growth environment with the level of defaults picking up sharply.

The gains for equity markets during the second quarter were again driven by the technology sector, with the so-called Magnificent 7 technology stocks accounting for almost all of the quarter gains for the US S&P 500 Index. Taiwan's TSMC and ASML of the Netherlands, who are involved in semiconductors and generative AI, also enjoyed strong gains.

A further sign of the concentration within markets can be seen in the quarterly performance of the S&P 500 Index, which weighs the largest publicly traded US stocks according to the size of the company, versus the equal-weighted version of the Index. The former rose over 4% in Sterling terms over the quarter, whereas the latter fell, with the average stock slipping close to 3%.



Although stock market performance was quite concentrated over the quarter, the trend of corporate earnings growth started to broaden out beyond the mega-cap tech stocks during Q2. It was a generally positive quarterly earnings season and corporate balance sheets remain strong. This provides evidence that companies across sectors are dealing with slower economic growth and are able to increase earnings in this environment.

Within other equity markets, Japan stumbled, although this was mainly due to the weak Japanese Yen. In local currency terms, the Japanese markets broadly moved sideways. Other Asian markets outperformed, with China leading the way, helped by improving consumer sentiment with fiscal stimulus as well as attempts by authorities to address their property crisis.

It is clear that AI continues to be a dominant theme in equity investors' minds, and we expect that to continue. The issue is that there is a considerable amount of good news already baked into the "obvious" technology stock beneficiaries like the AI GPU chip maker Nvidia. As Warren Buffett once put it, "Price is what you pay, but value is what you get." The current AI trend euphoria has many similarities to the expansion of the Internet around the year 2000. During the dot com boom, investors overestimated the impact of the Internet in the short term but then underestimated its impact in the medium to long term.

Some 25 years on, life without the Internet seems unimaginable. We think that AI will follow a similar trend. With sky high valuations in the mega tech stocks potentially already overestimating AI in the short term, there is a "price you pay" risk with the obvious AI Tech stocks. We think there are much smarter ways to play this.

It is now clear that almost every major listed company has (or will shortly have) an AI strategy to adopt these new technologies into their operating model. Private small and medium size enterprises will likely follow suit. The extent and pace of wide scale productivity gains as a result of AI technologies is very hard to predict. What is much more knowable is that vast sums of money are about to be spent to build out the infrastructure required for companies to adopt their AI strategy.

AI is an arms race and there is huge appetite to spend money to gain a first mover advantage. We think it likely that companies and industries that are involved in the AI buildout of data centre, power and IT infrastructure are likely to have a substantial increase in their earnings over the coming years. As the chart below shows, projections of potential electricity consumption by US data centres are expected to continue rising sharply over the coming years. According to data from Bloomberg, altogether data centres already use more electric than all but the 16 most power-hungry nations in the world.

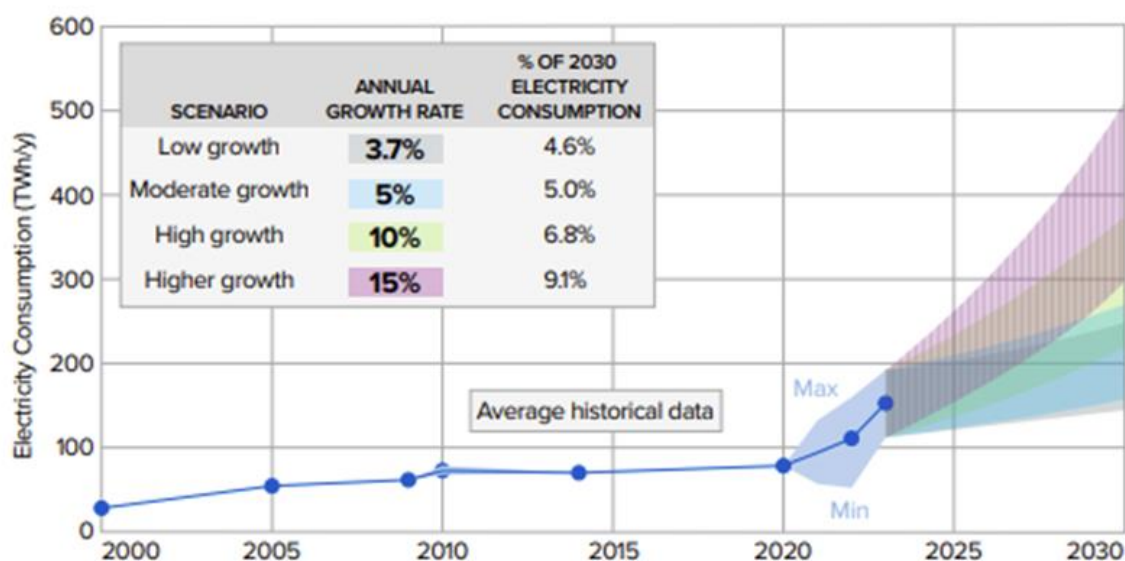


Figure ES-1. Projections of potential electricity consumption by U.S. data centers: 2023–2030 . % of 2030 electricity consumption projections assume that all other (non-data center) load increases at 1% annually.

It remains to be seen what impact AI will have on productivity but for the time being, global growth is picking up in most regions despite monetary policy remaining quite restrictive. We received data during the quarter, which showed that the UK exited the technical recession it entered in the second half of last year. US growth exceptionalism continued over the quarter but showed some signs of slowing.

**Historical Economic Growth Rates Over the Last 5 Years**



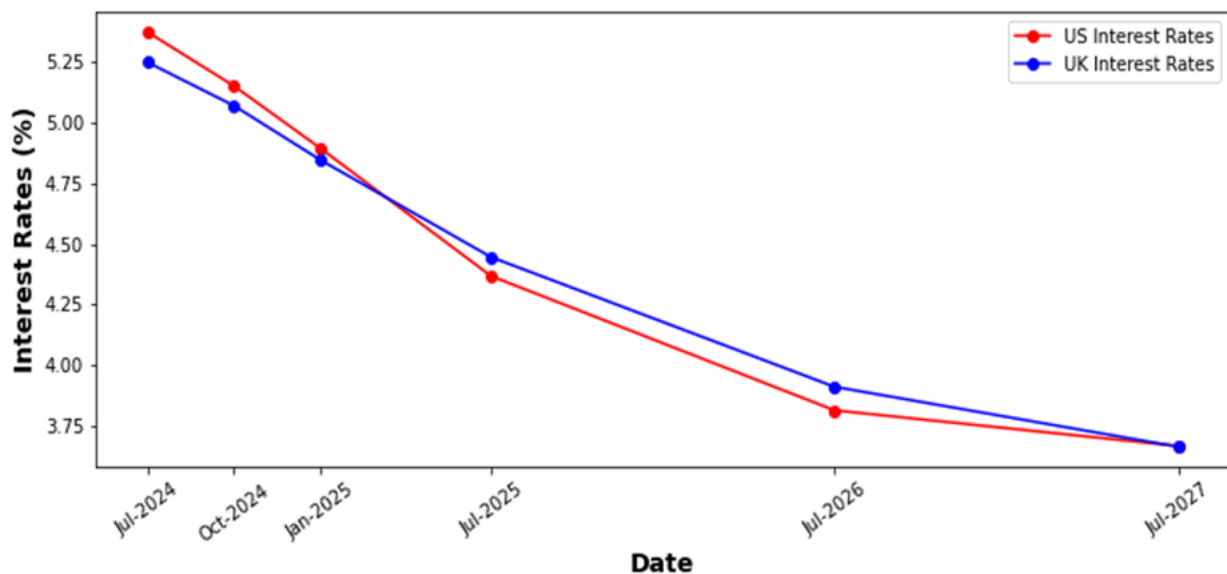
Source: Bloomberg

Elsewhere, oil prices fell, which helped contain inflationary pressures. Commodity prices were broadly strong. The price of copper is seen as a leading indicator of the global economy’s health, so it is a good sign that its price jumped sharply during the quarter. Silver is another metal that is an essential component in many industries, and its price rose even more sharply than copper.

During the quarter, PM Rishi Sunak called a surprise early election, which took place shortly after the quarter end. The result was that the UK public voted to bring the Labour Party back into power for the first time in 14 years. Interestingly, in the lead-up to this outcome, financial markets showed little reaction despite the expectations of a new majority government. Even during the week of the election, UK stocks, gilts and Sterling remained relatively unmoved by events. It seems the response by investors is turning out to be one of hope that Starmer’s centre-left platform will draw a line under a tumultuous period in British politics, especially at a time when political volatility is growing in neighbouring France and across the pond in the US.

As we move into the third quarter, there are several things that we are paying particularly close attention to. The outlook for interest rates will be important for growth assets. As long as disinflation trends reassert, it should give central banks the freedom to cut rates, although we expect rates to remain higher than pre-pandemic levels. National elections and their impact on industrial policy will also continue to play an important role in markets.

### Market Implied Interest Rates



Source: Bloomberg

Personal consumption expenditures represented nearly 68% of US GDP during the first quarter, making it an important component of growth for the world's largest economy. The US consumer has remained strong against the headwind of higher interest rates as their mortgages are fixed for long terms at lower rates, but the cost of unsecured lending is starting to bite. This is critical for whether the US can engineer an economic soft landing, so is something we are watching closely.

With policy easing on the horizon in many economies, fiscal policy remaining supportive and consumer spending maintained by an employed and productive labour force, we anticipate global growth to remain relatively resilient in the second half of 2024. The economic slowdown is so far looking like the “soft landing” that investors were hoping for as interest rates peaked at the back end of last year. We believe the chances of a “Liquidity Event” and a sharp move down in markets due to the Fed’s over-tightening of monetary policy looks to be greatly reduced, which we view as a clear positive for growth markets like equities going forward.

We retain the view that the strong performance of large technology stocks in recent years, which exceeds the growth of their fundamentals such as earnings, has left them overvalued. We believe that investors need to look beyond recent winners as the changing economic backdrop supports a broadening out beyond the mega-cap tech stocks. The underperformance of global value stocks, including emerging markets, Europe and smaller caps - has produced some potentially compelling opportunities.

The current environment of modest growth and inflation continuing to ease, should be a positive backdrop for equity markets, in our view.