

BLACKWOOD QUARTERLY COMMENTARY

In the prior commentary pieces, we said that the direction of stock markets has depended on two questions:

Whither the Magnificent Seven (or Fab Five)?

Have markets fully absorbed that the period of declining and/or ultra low interest rates are behind us?

Repetitious as it may be, but these two questions persist.

The share price of Nvidia peaked on 18th June at \$135 a share. This represented a 174% increase in the share price since the start of the year. As a result, Nvidia alone represented around one third of the entire increase in the S&P 500 since the start of the year (5.3% of the 15.8% increase). All of this made it the world's most valuable publicly listed company, leapfrogging Apple and Microsoft (source of data: Bloomberg). Since then Nvidia's share price has fallen 13% (handing the crown back to Microsoft). It will continue to fluctuate.

Market direction is currently extraordinarily concentrated not just by sector (technology) but within that sector to just a few companies. The surge in profitability at Nvidia has been quite extraordinary. In Q1 2021 it posted earnings of \$2.2bn. Q1 2022 earnings were the same. Q1 2023 earnings had risen to \$2.5bn. An upward trend of modest proportions. One year later its Q1 earnings were \$17.3bn.

It is hard to know how sustainable this surge in AI driven chip demand is. 40% of Nvidia's revenue comes from sales to fellow Magnificent Seven members: Amazon, Meta (Facebook), Microsoft and Alphabet (Google). [source Motley Fool]. It is possible that these sales are justified by the extraordinary promise and value generation potential of AI. It is also possible this demand has components of panic and herd buying and may not be sustainable. Which CEO would like to announce that they can see no value to their business from AI? Pretty much every pitch deck for any technology company looking to raise money has used the words AI or machine learning for over a decade. It has a perfect blend of being futuristic, full of potential and somewhat nebulous that are

components of the narrative behind speculative investment bubbles.

It is the role of investment managers to view the world in probabilistic terms rather than binary, however through that perspective it is hard to love Nvidia's valuation. It is highly reminiscent of Cisco. In 2000 Cisco was going to dominate the "picks and shovels" of the internet and was the most valuable company in the world. Cisco did go on to fulfil this promise and its earnings have quadrupled in the intervening years. However its share price is 40% lower now than it was in 2000 during a period in which the S&P 500 (a measure of US equities) also quadrupled in value. Since 2000 Cisco has been an excellent company but a terrible investment. If we were to attach a 30% probability of this outcome to Nvidia then the current share price appears clearly unsustainable. It is currently valued at 62x EBITDA (a measure of profitability) and even with strong forecast growth this only falls to 28x EBITDA in two years time. That's a hell of a valuation. And it creates a dilemma; do we accept the market's opinion and believe it rationally encompasses the attractiveness of the company and its prospects or do we want to hedge our bets in the face of what looks like frothy speculation? We favour the latter. It is possible that Nvidia and AI surpass even today's expectations and that no competitive threat emerges (unlikely), so we do not believe a definitive "no" is justified. But we have sufficient experience and data to suggest that a blind "yes" is also imprudent.

This is why within client portfolios, we have ensured a higher degree of diversification than that expressed by the S&P 500. We have done this by taking exposure to an equal weighted version of the S&P 500. The S&P 500 is a market capitalisation weighted benchmark; the companies in it are represented by their value - the biggest companies have the most influence. This is a rational calculation methodology (the FTSE 100 is calculated in the same way) but it means that investors buy the highest exposure to its most highly valued companies. In strange times this can lead to undesirable outcomes. In 2000 if you bought UK shares in line with the FTSE100 you would have invested nearly 25% of your portfolio into Vodafone. In the intervening years you would have lost 85% of your investment.

An equal weighted benchmark means that you invest the same proportion in each of the companies. It is an expression of the investment proposition that "we believe the US stock market represents good value considering the macro economic growth potential, but there is some unjustifiable speculation around a few well known (and strongly performing) companies".

The solution of this proposition is investing into US equities more broadly than the benchmark and also increasing our exposure to US smaller companies. Our strong contention is that smaller companies, having underperformed for many years, will have their moment in the sun over the next

three years - they look exceptional value.

One area of interest for investors so far this year has been gold. The price of gold is up 13% since the start of the year and is up over 20% over the last year. It peaked in May at a new all time high of \$2,427 a troy ounce (source: Bloomberg).

Gold is considered a safe haven asset and has proven to be an excellent hedge against inflation in client portfolios; much as we would expect from its historic track record. What has been an interesting feature of the gold market has been the level of central bank purchases. There is a clear desire by emerging markets, and China in particular, to reduce its reliance on US dollars. This trend was amplified by the financial sanctions imposed on Russia as a consequence of its invasion of Ukraine.

As a consequence, it is estimated that central banks have added around 1,000 tonnes of gold to their holdings in 2022 and 2023 (source: WGC). China alone bought 225 tonnes in 2023. More recently, the central banks of advanced economies seem to have followed suit.

At current levels, we consider gold to be fully priced. Adjusting for inflation, gold is around 28% more expensive than its 10 year average price (source: Bloomberg). In the short term, we would expect central bank demand to continue to be supportive of gold price as it remains an attractive safe haven in a world with heightened geopolitical risks.

However, we are beginning to see opportunities for investment elsewhere. Property markets, for example, have a lagged response to interest rate movements. They have been slowly readjusting to a world of 5% interest rates and have seen share prices falling. Our analysis suggests that prices are more rationally adjusted now to this environment and that the negative sentiment may be overdone. Our exit from property exposure was well timed, but we are increasingly examining opportunities in the space. There are also opportunities in the alternative investment space and other commodity assets.

As such, we would expect the direction of travel in client portfolios to be a rotation away from gold and towards other asset classes in the coming months. Gold will continue to be an important holding within client portfolios but it will likely be reduced from its current overweight position.

Overall it has been a period of modest progression for investors and we would expect this to persist.

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