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QUARTERLY THINKING

**FRENCH CHEESE,  
GUNSLINGERS,  
AND REASONS TO  
BE CHEERFUL**

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*“How can anyone govern a nation  
that has 246 different kinds of cheese?”*

**PRESIDENT CHARLES DE GAULLE (ALLEGEDLY)**

This year’s upward march in equity markets has not been without its wrinkles. In this article, Roy Leckie, Executive Director – Investment and Client Service, highlights some of the events and developments that might influence markets over the coming months, while retaining an optimistic view on the prospects for leading companies that can weather near-term challenges and seize long-term opportunities.



**ROY LECKIE**  
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At the start of the year, we commented about the wide range of possible equity market outcomes that lay ahead in view of an array of economic, monetary policy and political uncertainties. Six months on, many of these uncertainties have not evaporated, but equities have continued to plough higher, albeit market concentration has been a dominant feature.

Expectations of a series of interest rates cuts have given way to the realisation that the Federal Reserve is not quite ready to be the market's friend, and although the European Central Bank (ECB) offered up a modest rate cut in June, it is currently sticking to its wait-and-see stance. The 'muddling through' global growth narrative is still a broadly consensus view, although the picture remains uneven.

The US economy continues to be reasonably robust, although there are signs that it may be losing some of its lustre. Consumer spending continues to edge up, but at a more modest pace, and a number of retail companies have noted more price sensitivity amongst customers. Unemployment has risen slightly to 4.1%, but in the grand scheme of things, this is still below historical norms. It is a tribute to the resilience of Main Street (and credit cards) that consumption has defied the corrosive effects of high inflation and costlier money. The Core PCE (Personal Consumption Expenditure) Index, the Federal Reserve's preferred measure of inflation which excludes food and energy, eased to 2.6% in May, but Chairman Powell wants to see more data before opening the monetary taps. Likely the fact the economy is doing better than expected compared to the bleaker forecasts of a year ago, will shape some of the Fed's thinking on monetary policy. Why the urgency for interest rate cuts when the economy is doing OK?

### *“It is premature to write an obituary on what has been a robust post-Covid period of recovery”*

But, as we've noted in our conversations with some industrial companies, the manufacturing sector has continued to be in the relative doldrums. The Institute of Supply Management Purchasing Managers' Index, having poked its head above the key 50 'expansion/contraction' level earlier in the year, has been sitting below that level for the last three months. Overall, the net result is that there is a general consensus that US growth is slowing, but it is premature to write an obituary on what has been a robust post-Covid period of recovery.

Against a backdrop of mixed economic signals at home and abroad, the Magnificent Seven rode into prominence during the quarter. Highlighting the scale of market concentration, in index terms, the whole of the group drove MSCI World Index performance, with the rest of the world collectively being a performance detractor. However, the principal gunslingers in the posse in the second quarter were Nvidia, Apple and Alphabet, the parent company of Google, reflecting investor pursuit of all things AI related.

### *“The evolving AI journey will be a long one”*

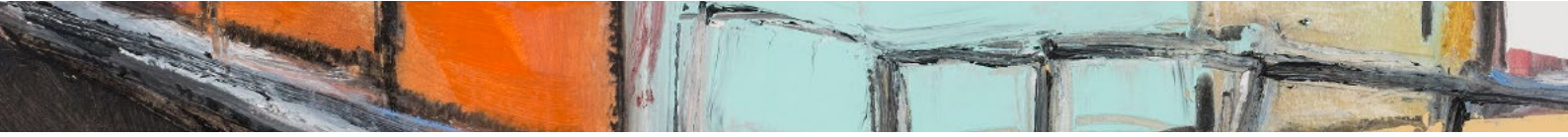
While the market focus has been on these immediate AI beneficiaries in this build-out phase of infrastructure, the evolving AI journey will be a long one, and the gaze of the market will broaden. This investment in this technology is occurring because companies across the board are experimenting to see how the ongoing development of AI can

benefit their businesses. There is money in 'them thar hills' in terms of the pick axes the likes of Nvidia are providing to dig for AI gold, but the long-term focus of our fundamental analysis will also be on how companies are employing AI to reach customers, more efficiently and more profitably, with better products and services.

Interest in AI has not been confined to US names with a number of Taiwanese and European enablers capturing the market's attention, although Europe was latterly distracted by politics. The euro-zone economy has been improving in fits and starts, but growth remains lacklustre, with preliminary estimates suggesting that GDP rose 0.4% year on year in the first quarter. Falling inflation and tight labour markets have helped consumption and there have been nascent signs of a bottoming out in manufacturing activity. However, market bonhomie was disturbed by President Macron's call for a snap election for the French National Assembly.

### *“It's a case of plus ça change with regard to French politics”*

The spectre of a potential right-wing Rassemblement National (RN) administration stoked memories of the impact on bond and equity markets of former UK Prime Minister Liz Truss's foiled ploy to woo the electorate with unfunded tax cuts. However, currently, there are attempts to forge a centre-left alliance, although the leftward-leaning policies of some of the potential members of the coalition members prompted a warning from France's Cour de Comptes, the country's supreme audit institution, regarding the perils of fiscal indiscipline. The political situation is messy, but as President de



Gaullé's cheese observation alluded to, it's a case of plus ça change with regard to French politics. In the UK, the Labour Party won the UK General Election and enjoys a huge majority in Parliament. Consequently, there are expectations of fiscal profligacy, despite the new government's claims to the contrary. It is the case, however, that over recent years, and accelerated by Covid stimulus, all governments have gone 'big'.

These proceedings have put a spotlight on bloated budget deficits, although so far, bond markets have been well behaved. High borrowing, either at the sovereign or corporate level, was not an issue for markets in the lengthy post-GFC period of very cheap money, but risks are rising as monetary policy, despite expected rate cuts, reverts back to a normal range.

*“Election outcomes seldom alter the long-term fundamentals of high-quality companies”*

In the US too, politics may start to gain more prominence in markets in the coming months, with tariff threats, potential fiscal giveaways and a possible reset in the security relationships the US enjoys with its allies on the agenda. This may be a source of equity market volatility globally, and we are monitoring events, assessing their impact on

sectors and businesses. However, election outcomes seldom alter the long-term fundamentals of high-quality companies, many of which are leading, global-facing businesses well-versed in navigating political schisms or economic cycles, both in their domestic markets and abroad.

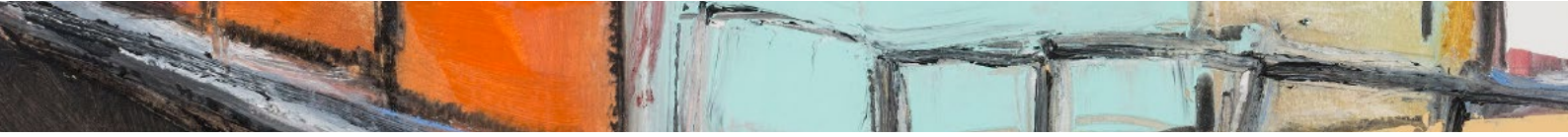
US political reverberations and tense Sino-Western relations continue to haunt China-related equities, dampening sentiment despite improving fundamentals of a variety of businesses that are benefitting from a modestly growing (by Chinese standards) economy. The 'China +1' corporate re-shoring strategy has become more prevalent, but the country remains an integral part of global supply chains, and as the world's second largest economy, it still represents a significant export market for many global companies.

In Japan, a longstanding policy goal was to foster inflation in an economy which had suffered a lengthy period of chronic deflation. Unfortunately, the post-Covid awakening of inflation has been of the cost-push rather than demand-led variety. While a weak yen has been good for the country's competitiveness and earnings translation gains, it has exacerbated inflation, inhibiting real wage growth and domestic consumption. This was evident in the 2.9% slump in GDP in the first quarter, although the Bank of Japan is still expecting the economy to eke out a 0.8% gain this year. However, the appeal of Japan for us has never

been based on hopes of economic resurgence, but on the fundamental merits of the country's corporate champions in a variety of fields such as technology or the industrial sector. Some of these businesses are in the process of managing their way through stiff macro headwinds, but remain beneficiaries of long-term growth trends in semiconductors, AI, and automation.

*“Investors will display heightened sensitivity towards earnings delivery and valuations”*

Connecting the dots on all these events and developments creates a picture of middling growth with the prospect of a mild alteration of monetary policy – potentially a benign environment for equities but pockmarked by periods of politics-induced volatility. It is likely too, that with a number of markets and sectors having run hard from pandemic lows, investors will display heightened sensitivity towards earnings delivery and valuations, wary of hype and bloated balance sheets. However, our optimism on equity returns is not based on divining economic or market cycles, but on the prospects for many of the world's leading, financially strong companies that can adapt, innovate, and weather 'macro' headwinds. There remain many long-term growth trends that will outlast the vagaries of economic or political cycles.



## **IMPORTANT INFORMATION**

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## **STOCK EXAMPLES**

The information provided in this article relating to stock examples should not be considered a recommendation to buy or sell any particular security. Any examples discussed are given in the context of the theme being explored.

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