WALTER SCOTT

QUARTERLY THINKING

THE GOLDEN AGE

ROY LECKIE, EXECUTIVE DIRECTOR – INVESTMENT & CLIENT SERVICE
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KEY TAKEAWAYS

- The US economy is broadly in good shape, but the complexion of the equity market may change
- For a “museum”, Europe has some great companies, while Japan still offers opportunities amidst economic uncertainty
- We don’t share the overly pessimistic consensus view on China

At his recent inauguration, President Trump forecast a golden age of prosperity for America, founded on smaller government, tax cuts, and the promise of trade and security policies squarely aimed at putting the interests of the nation first. This bullish vision perhaps contrasts with the cautious global view of some of the great and the good that descended on Davos for the World Economic Forum, although conspicuous by their absence were the heads of state of China, India and Brazil.

The consequences of a more assertive America were a key topic at the event. Indeed, what to expect from Trump 2.0 has been a focus of attention for global investors over the last few quarters as they mull the prospect of a reset in US security and trade relations amongst its allies, trading partners and ‘frenemies’ alike. Wall Street has welcomed the growth-positive aspects of fiscal laxity and a looser regulatory grip.

GOOD..WITH A FEW BLEMISHES

Not that the US economy has been performing poorly. GDP rose at an annualised 3.1% rate in the third quarter, with Main Street continuing to open its wallet, albeit selectively. Several US retailers are continuing to report price sensitivity amongst their customers, as the lingering effect of inflation weighs on certain areas of spending.

Additionally, as noted in our discussions with a number of industrial companies, and as indicated by the ISM Purchasing Managers' Index, manufacturing activity remains in contraction territory. That said, the rate at which it is declining has moderated. However, notwithstanding the uncertainty over the impact of tariffs on US inflation and supply chains, President Trump's fiscal adrenalin shot may assist the long-awaited turn in the industrial cycle as well as underpin personal spending. Consumer penny pinching indeed seems selective, with recent trends showing rising demand for luxury goods, which has offset some of the overly negative sentiment towards the sector's prospects in China.

In light of US economic vigour, and with a nod to the potential inflationary effect of tariffs, the Federal Reserve's new-found caution over the pace and scale of interest rate cuts makes sense. Why cut rates aggressively if the economy is reasonably robust? Countering that, President Trump is exerting pressure on the Fed to reduce rates forthwith.

THE MARKET'S BROADENING GAZE

Although the market is now musing over the Fed's next monetary steps, the shift towards cheaper money has helped provide a solid backdrop for equities over the last two years, although market performance has been skewed by the narrowness of returns. In 2024, the Magnificent Seven accounted for 47% of the MSCI World Index return. To a large extent, this reflects the market's pursuit of the AI theme, but over time we would expect this interest in AI to broaden. Investors will look further beyond the enablers of AI and focus on how companies across many sectors are monetising the opportunities afforded by the technology in terms of providing better products, better service and improved profitability.

Notwithstanding any policy-induced volatility as the president pursues his economic agenda, the near-term tailwinds for US equities are likely to persist. However, after the prolonged run in the market, albeit with gains distorted by the pre-eminence of the Magnificent Seven, investors may pay closer attention to valuations. With the forthcoming results season looming large, companies that fail to match earnings expectations will be given short shrift by investors.

A MUSEUM??

Amongst the crop of Davos dignitaries were the doom merchants regarding Europe. "It's at risk of becoming a museum", stated Ana Botin, the chair of Santander Bank. This was a clarion call for the region to give itself a shake economically and politically in view of external and internal challenges. The European Commission downgraded its forecast for 2025 in November, now expecting the region's GDP to grow a modest 1.3% year on year. Lower inflation and further European Central Bank interest rate cuts are expected to bolster personal spending, but industrial production across most of the region remains sluggish.

This is particularly the case in Germany, where energy costs, slow demand, and competition from China has blighted the industrial environment. Not that this has inhibited the equity market, with the Dax index rising 19% in local currency terms in 2024. Perhaps not quite a case of "Die glorreichen Sieben", (the Magnificent Seven) but a select number of leading companies led the charge, including enterprise software giant SAP.

"There is a cost to be paid for fiscal abandon"

Political leadership in Europe, or lack of it, has periodically caused some market jitters. The fracas in France over how to contain the burgeoning budget deficit has continued, dampening the stock market last quarter and inducing a temporary spike in bond yields. This is perhaps indicative of the fact that investors have not forgotten that even in the face of lower interest rates, there is a cost to be paid for fiscal abandon in the form of higher bond yields and, consequently, the cost of credit. The US enjoys the privilege of being the world's reserve currency and so *far* has been able to run huge deficits without bond vigilantes making a disruptive appearance.

But if Europe is a museum, it contains more than a few active and enterprising exhibits. Despite the macro headwinds, it remains a repository for leading, globally competitive companies with high barriers to entry in fields such as healthcare, specialised information technology, key industrial processes, and luxury. We have never defined an investment opportunity by the macro vagaries of its place of listing. This holds true of Japan, which has endured its fair share of economic false dawns in the forty years we have been investing in the country.

FOCUSING ON COMPANIES

Japanese equities were robust last year, with the market reflecting the competitive benefits of the weak yen and signs of better corporate governance However, the extent of the fall in the currency not only undermined market returns in US dollar terms, but also sustained unwanted cost-push inflation. Demand-led inflation has long been a goal of the Bank of Japan (BoJ).

The bank still hopes that real wage growth will pick up and invigorate personal spending, and it has a cautiously optimistic view of the economic outlook, albeit some of that is based on expectations of improving overseas trade. Interest rates look set to increase, but the BoJ will tread carefully given the still-fragile state of the economy. We remain broadly agnostic on the 'macro' prospects for Japan. Rather, we are more encouraged by the opportunities afforded some of its leading companies. These include areas such as technology, where many are lynchpins in key processes, or in factory automation, where global and indeed domestic demographic trends offer long growth runways.

THE MIDDLE KINGDOM

Investor and media sentiment towards China has remained broadly negative in view of the 'economic slowdown' and the lengthy downturn in parts of the property market. Compounding this has been the prospect of a further round of tariffs on Chinese export goods at a time when the Xi administration is promoting the development of a value-added, globally competitive industrial sector.

> *"We don't share the consensus pessimism about China"*

However, whilst we don't underestimate these challenges, as regular visitors to the country we don't share the consensus pessimism about China.

The trend of global companies moving production in China to other countries is ongoing, but there are limitations. China remains an integral part of both the global economy and hard-to-unravel supply chains. There may be inflationary consequences for the US if further tariffs are imposed on China. It also still represents a vast market opportunity for companies across the world.

The days of extremely rapid economic growth may be behind it, but the Chinese economy is still growing faster than the majority of developed markets. The Middle Kingdom is moving up the value chain and taking advantage of powerful growth trends in emerging markets. China's penetration into the electric vehicle market, highlighted by the problems facing Volkswagen, and its growing dominance in solar energy, speak to success in its industrial evolution and the emergence of globally competitive corporate champions.

For a country on the wrong end of the de-globalisation trend, China recorded a record trade surplus in 2024, although that also reflects tepid import growth. While the jury is out regarding the efficacy of Beijing's latest fiscal and monetary stimulus measures, the economy is nonetheless estimated to have reached its 5% GDP growth target for the full year. Recent retail sales were better than expected, while industrial production has continued to expand.

> *"Tariffs are not new"*

The immediate fixation of global markets in coming months will be on tariffs. Tariffs are not new. Global trade has had a more protectionist bent for nearly a decade, stretching back to President Trump's first term in office. Many of the tariffs imposed at that time were retained by his successor Joe Biden, with some levies on Chinese goods actually increasing during his tenure. Companies have therefore had several years to adapt to a more protectionist world and to implement strategies to mitigate its impact, through diversifying supply chains or relocating manufacturing. We can expect them to be similarly proactive in the event of a new wave of tariffs.

LONG-TERM OPTIMISM AMIDST UNCERTAINTY

A golden age ahead? As bottom-up stock pickers with a multi-year investment horizon, we have a resolutely positive view of the future. Core to our long-held investment philosophy is the belief that it is company fundamentals, not political or macroeconomic factors, that ultimately determine investment returns over time. Many of the world's market-leading, globally diverse businesses are well versed in navigating changes in political and economic landscapes, while retaining the ability to take advantage of growth trends that will outlast near-term headwinds.

ROY LECKIE

Roy is Executive Director, Investment & Client Service at Walter Scott. Since joining the firm in 1995, he has held a range of investment, management, client service and governance responsibilities. Roy was integral to the development of the firm's emerging market capabilities, and he has played a central role in the stewardship of Walter Scott's global and international strategies since 2007. Roy joined the firm's Board in 2008 and is Co-Chair of the Investment Management Committee. He holds a BSc (Hons) in Statistics from the University of Glasgow.

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STOCK EXAMPLES

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WALTER SCOTT & PARTNERS LIMITED, ONE CHARLOTTE SQUARE, EDINBURGH EH2 4DR
TEL: +44 (0)131 225 1357 · FAX: +44 (0)131 225 7997
WWW.WALTERSCOTT.COM

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FCA Head Office: 12 Endeavour Square, London E20 1JN · www.fca.org.uk

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