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Opportunities Arising from Divergence and Change

2023 marked a year of divergence and change with wars, geopolitical turbulence, rapidly rising interest rates and surprisingly strong equity markets. Equity market performance was notably divergent with some areas in bear market territory, while others were surprisingly robust. Chinese equities, the green energy sector and "classic" stable growth companies were laggards, while India and the IT sector, led by the "magnificent seven", were driven strongly by the breakthroughs within AI.

Geopolitics and Wars

We are witnessing an important transition from a multi-decade period with one superpower dominating the global agenda to a multipolar world, where more countries, led by China, seek increased influence. This has profound implications and will likely create further geopolitical turbulence in the years ahead. To some extent, it can be argued that the two current, and ongoing military conflicts are rooted in this shift to a multipolar world.

Therefore, our well-established theme of 'Bigger Government' will become even more pronounced. Wars are by definition a government matter, and we will see

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Bo Knudsen
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governments exerting greater influence across the business landscape. More "Power Politics" where national interests define priorities. The green energy transition, where countries increase their level of self-sufficiency, is one example. Increasing government influence and even control of monetary policy will likely continue and become the norm. As an investor, you need to be on the right side of government priorities and policies.

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Rising rates, AI and the divergence of equity markets

Equity markets posted a strong performance in 2023 with the MSCI All Country World Index rising approximately 22% (USD). This was higher than our expectation considering the impact of rising (real) rates and our expectations of economic slowdown and potentially a recession. Even though the consensus advocates for an economic soft landing in the US, it is still too early to conclude. The truth is never uncovered by looking at coincident economic indicators as there is a tendency to underestimate the slow and lagging effect of tighter monetary policy into the real economy. Therefore, we continue to see a risk of a growth pause in the first half of 2024, which means investors should be mindful of companies' ability to sustain earnings even in a weaker growth environment.

Even though we don't spend much time on predicting short-term equity market trends, for 2024 we don't expect a straight-line continuation of the bull market of the past year. We believe that 2024 will be another year with significant divergences in global stock markets driven by a more accommodative monetary policy and a challenging economic environment.

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In 2023, interest rates and AI were the axes that separated winners and losers. Rising interest rates have been a forceful headwind for long-duration assets including some high-quality growth companies. This is exemplified by both the MSCI Minimum Volatility Index and MSCI Consumer Staples underperforming the general market by approximately 15 and 20%. An example of a "classic" well-run stable growth company is Nestlé. The share price is down about 16% from its peak in 2023 in Swiss francs (CHF) and therefore in bear market territory. This is primarily due to the valuation effect of higher interest rates. Conversely, the strengthening AI theme significantly lifted the large-cap technology companies and the so-called "magnificent seven" (Nvidia, Amazon, Tesla, Meta, Alphabet, Microsoft and Apple) more or less doubled in value as a group.

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We think this divergence creates opportunities – especially considering that the path of monetary policy is set to reverse in 2024. We also believe we have seen the peak in this interest rate policy cycle in the US. This will have important implications for the market outlook and individual stock performance in 2024. For a start, a consequence of lower rates will be to remove the headwind for long-duration assets and the performance of these assets could be a mirror image in 2024 compared to 2023. Bond yields started to fall at the end of 2023, and we think this could be a continuing theme in 2024.

The theme of AI has been well-discussed, however, what is of most interest to us is how AI affects corporate earnings as earnings fundamentally drive stock prices. A relevant historical comparison is the breakthrough of the Internet more than 20 years ago. Initially, there was a stock market boom in the IT segment, but with no corresponding lift in earnings. The positive effect on corporate earnings only happened when business models eventually evolved. It was especially from 2010 and onwards with the proliferation of social media and advertising, the so-called Internet 2.0, that earnings rose significantly, and we saw a healthier and fundamentally driven stock price appreciation.

The key question today is whether AI is comparable to the Internet 1.0 or Internet 2.0. Will we see years of no earnings impact, or will AI bring an earnings boom? We think the answer will be nuanced, where selectivity again will be key. Some companies are going to make money rather early because of AI products that will improve productivity. Here size matters, so big companies generally have an inherent edge. Microsoft, Adobe and Google (Alphabet) have made some quite important announcements. Adobe was first and then followed by Microsoft and Google with a statement to the effect that if you use our AI engine and tools to create business material, you do not need to worry about the central risk of copyright issues. If you use the product from one of these giants, they will presumably assume the legal risk. Essentially, it's very hard for smaller competitors with less financial muscle to make the same promise. Scale is important, especially in AI. Both access to data, the ability to leverage existing customer bases and risk sharing through financial strength are positive advantages. The big established companies have an opportunity to improve revenue growth with products offering immediate benefits to customers.

We recently published an article titled "Showcasing AI Portfolio Exposure" where we go into details of how our portfolio companies are positioned to exploit the opportunities of AI.

Japan and India are major beneficiaries of geopolitics

As we move into a multipolar world, geopolitics will cause uncertainty and change. However, as politics change, businesses adapt to the new environment and this change creates opportunities. One example is the focus on dual sourcing/dual supply chains and reshoring of production. This is a major shift and reshoring is going to happen.

Of course, China feels it, but there are still some great companies and opportunities in China. China wants to move upwards in the industrial value chain and has three priorities: 1) green, digital and smart production technologies, 2) expand leadership within renewable energy, high-speed trains and artificial intelligence, and 3) areas where self-sufficiency is critical e.g. manufacturing of industrial/scientific instruments, electronic components, special materials and industrial software.

In Europe and the US, we're going to see a build-out of factories, while other major beneficiaries are Mexico, Japan and India. Mexico has achieved a strong position as a manufacturing center for the US and growth in the northern and central part of the country is rather strong.

In Japan, a number of new semiconductor plants are being built in cooperation with Taiwanese and Japanese companies, especially on the southern island of Japan called Kyushu. Kyuashu is more or less the same size as Taiwan and geographically well-positioned as a dual supply alternative to Taiwan.

India is perhaps the biggest beneficiary of the dual-sourcing strategy. This comes on top of the favorable

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dynamics of a country with a huge, growing and young population steered by a government focused on far-reaching reforms while exploiting all the newest technologies. We think India warrants serious consideration by all global investors. We have liked and invested in India for many years and having just returned from a country visit, we continue to see India as one of the best country opportunities. Indeed, it is perhaps one of the best investment opportunities over the past 30 years.

Competition for capital as a guiding principle

We believe 2024 will be another year of divergence within the equity market. Two drivers of change will be a reversal of the direction of monetary policy and a more difficult economic environment. Long-duration assets like stable growth companies should have tailwinds rather than headwinds as lower rates will provide valuation support and as cyclical economic growth will be more challenged, structural growth will become more valuable. Given the impressive landmarks of AI, we think the move to a more digital society will continue in 2024 keeping in mind that size is an immediate advantage thereby benefitting the dominant IT companies. Lower rates could also provide valuation support here.

Our portfolio philosophy has a constraint of maximum 30 investments. We've kept to this limit since the launch of the firm back in 1986. It's about competition for capital. We have a constant pipeline of investment candidates that we compare and contrast with existing holdings. This constant competition for capital is done within a five, seven- or even ten-year perspective. We always think beyond a potential recession and look through the cycle to find the best risk/return risk profile. Investing is more a marathon than a sprint. A marathon runner knows it will be a long, tough journey and is prepared. This contrasts with the investment world which is a never-ending marathon populated with many investors or sprinters that seek instant gratification. Marathons require discipline and endurance, which are also helpful attributes when it comes to successfully navigating the discipline of long-term investing.

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