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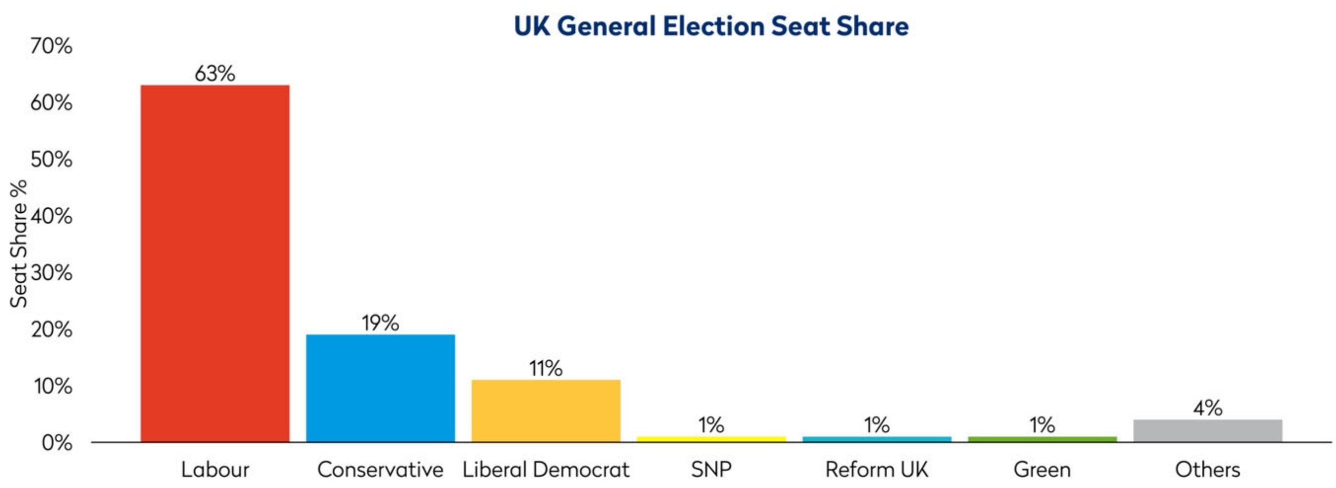
Global Equity Investment Outlook

Election results in Europe offer stability and reasons for optimism, despite some lingering uncertainty

In this year of ongoing, worldwide elections, the beginning of July gave us the results of two somewhat unexpected European votes. The UK parliamentary election, confirmed at the end of May, arrived about four months earlier than had been expected. The snap French parliamentary election, called by President Macron, was a surprise response to the strong performance of Rassemblement National (RN), led by the far-right leader, Marine Le Pen, in June's European Union parliamentary elections (the EU parliament is a less powerful but still politically significant body). Neither result is likely to be disruptive in the near or mid-term. The UK result was generally expected and was received positively by markets. While the French result was ultimately a relief to markets, it has left some lingering uncertainty.

The center-left Labour Party won the 4th July UK general election with a landslide majority of 174 seats, despite securing only 34% of the popular vote. The make-up of the opposition parties is now fragmented. Labour ousted a center-right Conservative party that had been in power in some form since 2010 but imploded under the cumulative effects of a painful and protracted Brexit process, struggling public services, flagrant breaches of self-imposed pandemic rules and a disastrous "mini budget" in October 2022, packed with unfunded spending commitments. As leader of the Labour Party, Sir Keir Starmer successfully pivoted Labour away from the "tax and spend" policies of his predecessor, Jeremy Corbyn, back towards a more market-friendly position that has proved attractive for voters. Starmer's Labour presents itself as fiscally responsible and pro-business. Funding commitments appear to be effectively costed. New UK Chancellor of the Exchequer Rachel Reeves is an Oxford-educated economist and an ex-employee of the Bank of England and the financial services company HBOS. She appears to be more pragmatic and less ideological in her approach to balancing the books than some of her predecessors. The demise of the short-lived Truss administration two years ago showed the market's distaste for large unfunded tax cuts and fiscal largesse. This warning has clearly been heeded by Labour.

We expect this Labour government to be pro-growth and generally pro-business, with a strong mandate to govern. This combination has been well received by the market with MSCI UK outperforming MSCI EAFE by more than 3% over the last three months. The irony for outgoing Prime Minister Rishi Sunak is that the macro-economic backdrop for the UK has markedly improved over the 18 months of his premiership, with rising real wages, inflation down from 11% to 2%, a Q1 GDP growth rate that topped the G7, and interest rates likely to fall in the second half of the year.

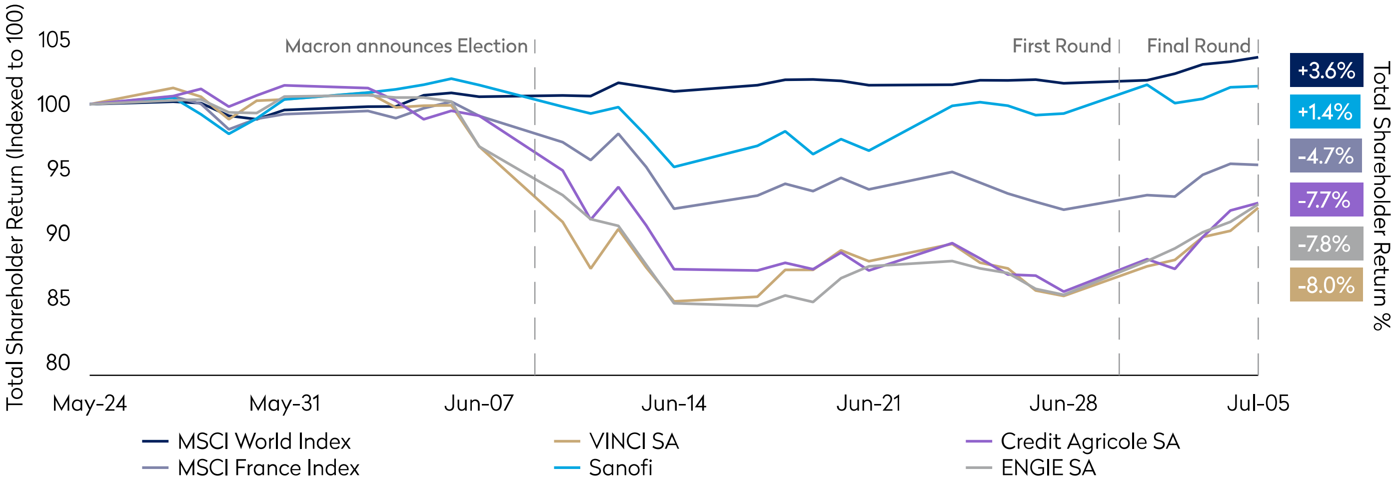


Source: UK Parliament House of Commons Library

In France, lower house elections have returned a hung parliament, with the New Popular Front – an alliance of parties on the left – emerging with the largest number of seats, albeit far short of the number required for an absolute majority. Precisely what follows now is uncertain, but a state of political paralysis is the likely outcome: Macron remains in-post as an influential and potentially moderating force, and the scale and manner of the New Popular Front's partial victory weakens their ability and to some extent their legitimacy to govern (having been flattered by political maneuverings designed to shut-out the far-right Rassemblement National in a process known as the "cordon sanitaire"). Under one potential scenario, a technical/caretaker government may be appointed until new elections can be held.

Whilst we do not expect a materially adverse outcome from this election, the political situation can be viewed as creating incremental uncertainty for the French economy: ultimately, the left-wing alliance is now a more powerful political force, so we may see some backsliding in terms of supply-side reform and overdue fiscal retrenchment (the fiscal deficit is c.5% and government debt-to-GDP is c.110%), with interest rates remaining moderately higher than they otherwise would have been. Set against this, French equities have already been under pressure: whilst the market has lagged MSCI World, and only modestly lagged MSCI EAFE, more domestically-oriented stocks have typically been weaker. Most of the damage was sustained in the first half of June, shortly after Macron announced the snap elections.

Total Shareholder Return vs MSCI World Index Over The French Election Period



Source: MSCI, FactSet

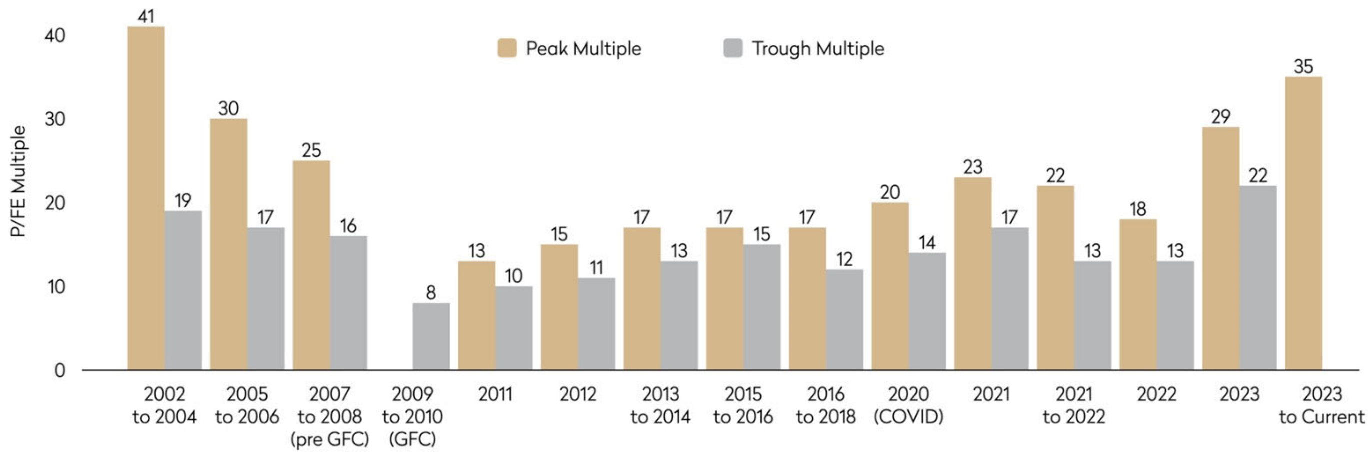
The contrast that has been made between the two elections – with the UK supposedly casting off populism while French voters elected a parliament with the biggest presence of the hard right ever seen – has been largely overdone. Despite Labour winning a convincing majority of seats in the UK parliament, the UK results were not a clear repudiation of the populist right: Nigel Farage's Reform party received more than 4mn votes, securing approximately 14% of the popular vote, splintering the right-wing vote and undermining support for the center-right Conservative Party. The 'first past the post' system in the UK means that this has only translated into five seats for Reform, but it severely wounded the Conservatives, resulting in a humiliating defeat and a paltry 121 seats. Although the populist right is far from power in the UK, it does continue to influence the political discourse. In France, right-wing populism made a leap, with the RN nearly doubling its vote and seat share from 2022. This result echoed the strong performance of the far-right parties in Germany, the Netherlands and Italy in the recent European parliamentary elections.

While there is much to be positive about in terms of the overall results in both the UK and in France, these elections are a reminder that politics are likely to be a continued source of equity market volatility, with populism having moved firmly into the mainstream for reasons that are part-cyclical and part-structural.

AI euphoria continues

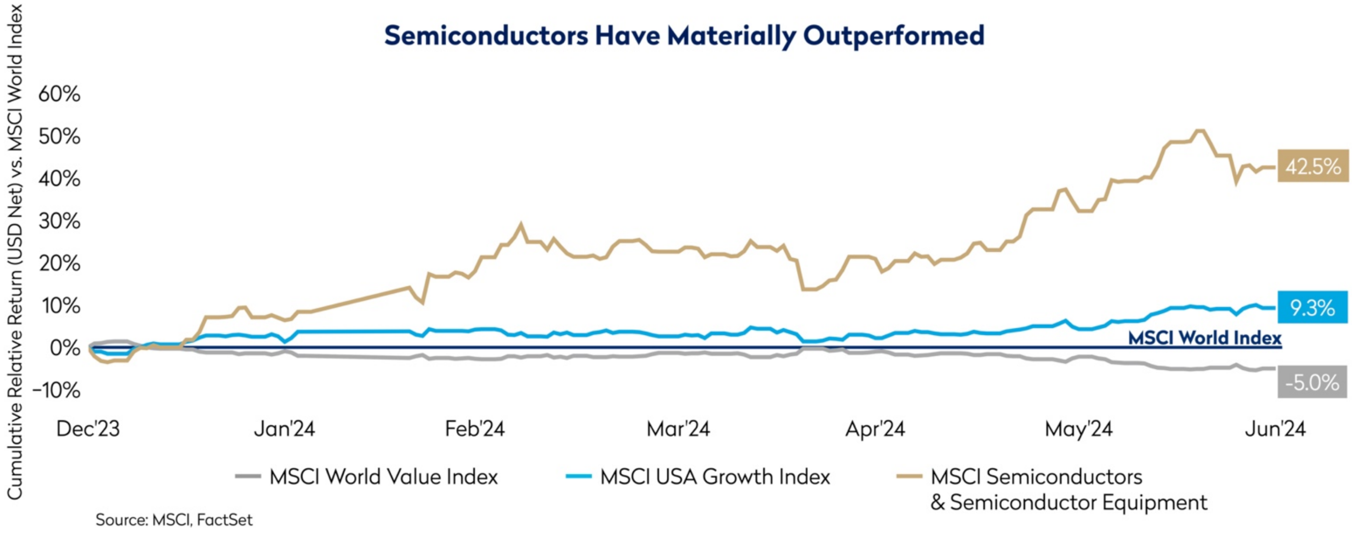
While the politicians have been hogging the airwaves, the market returned to its current favorite subject: Artificial Intelligence (AI). Technological innovation and financial capital are intrinsically linked, with advancements in technology attracting financial investments, which in turn fuel further innovation. The success of ChatGPT at the end of 2022 sparked a new wave of investment in AI with venture capitalists and major corporations pouring billions into startups and research budgets to explore the transformative potential of this nascent technology. Public market investors have embraced semiconductors as the "picks and shovels" of the AI rush. Using our disciplined valuation methodology, Mondrian portfolios have benefitted from exposure to semiconductors, depending on mandate, to companies such as TSMC, Shin-Etsu, Samsung Electronics and Micron Technologies, all stocks that we purchased on much lower multiples than they trade at today. While we remain positive on the long-term potential for AI and also accept that forecasting the trajectory of AI stocks is impossible, we believe, for reasons explained below, at this juncture the skew for market valuations is increasingly negative.

Significant Multiple Expansion Drives Semiconductor Stocks' Performance



Source: Alliance Bernstein

Semiconductor stocks have hit new all-time highs on the back of recent AI investments and the sub-sector has been responsible for much of the market's strength this year. However, for these investments to be maintained two critical uncertainties need to be addressed. The first is the shape of the AI adoption curve. After launching in November 2022, ChatGPT broke the record for the fastest application to reach 100 million active users (in January 2023). But the application has still not reported 200 million active users. The lack of widespread adoption leads us to believe that while this technology is very exciting, it is not yet sufficiently useful to warrant wholesale changes to the way we work and live. The second uncertainty is how these AI tools will be monetized. While the promise of AI-driven revenue streams is enticing, several factors complicate their realization. Identifying and developing viable commercial applications that provide demonstrable value can be challenging, particularly in new and uncharted markets. Addressing these two unknowns will be essential for sustaining the current level of investment in the semiconductor sector, something we do not believe is being discounted in current market valuations.

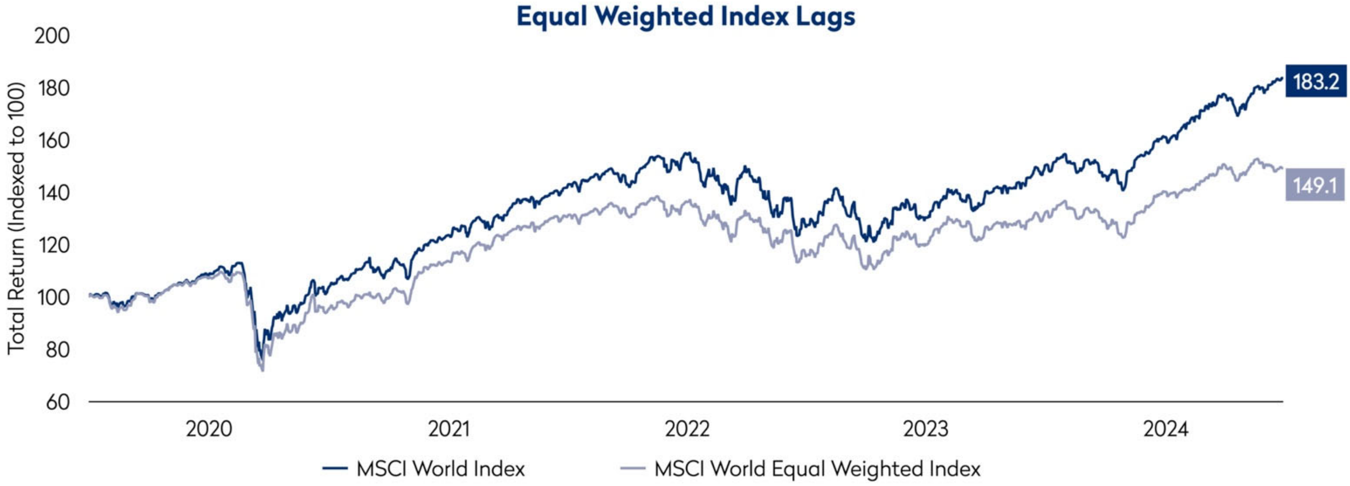


When evaluating the future of AI another key unknown is the pace of technological advancement. The next step up in intelligence may be just around the corner but we believe the industry faces significant scaling challenges in the near-term. Advancements in AI are partially dependent on scaling data and some analysts estimate that we will fully utilize the stock of human-generated data as soon as 2026. Major information sources like the New York Times and Reddit are now restricting access to their data, further increasing the cost to train these models, and potentially stalling the pace of innovation. The future of large language model (LLM) development hinges on finding new ways to access or generate high-quality data, as the era of abundant, freely available data appears to be coming to an end.

Much of today's excitement around AI stems from the possibility of achieving Artificial General Intelligence (AGI), which holds the promise of machines that can perform any intellectual task that a human can, potentially transforming countless industries and solving complex global challenges. However, today's investments are focused on LLMs and there is a broadening consensus that these statistical-based systems may not be capable of delivering AGI. We believe the market is currently pricing in a best-case scenario for AI. There needs to be a significant breakthrough in AGI, or a substantial advancement in LLMs, to justify current market valuations.

Opportunities for active managers increasing

Increasing concentration has become a well-known phenomenon in the US market. While the impact is somewhat smaller, it has affected international markets as well. As a result, a significant divergence has opened between the returns of the MSCI World (market cap weighted) index and the equivalent equally weighted index. The first half of 2024 saw a narrow rally in markets, with returns boosted by investor frenzy over the potential for generative artificial intelligence to fuel leaps in productivity and growth. The performance of AI beneficiaries has masked weaker performance among many of the index's other constituents. After a record first half to the year for markets, there is a question over how much longer the performance of AI winners can continue to lead the way.



Source: MSCI, FactSet

The widening gap between the fortunes of the market-cap-weighted and equal-weighted indices is not without precedent and is not necessarily a cause for concern. Certainly, the AI fervor currently powering the stock market shows little sign of cooling down. Still, market risks often increase when an investment thesis seems unassailable. And the valuation difference between these two indices is historically wide, with the reversals from such gaps having, in the past, been severe and rapid.

AI-related securities have offered a great ride and Mondrian portfolios have benefited from this exciting growth opportunity. The challenge for us remains the price that we have to pay to access the growth potential of many of these companies, whose range of outcomes is still very wide. We believe that the market's narrow focus concentrates risk and obscures numerous potentially more attractive investments that a clearer valuation-oriented approach can uncover. Rather than chasing hype, Mondrian continues to focus on the large universe of companies we have identified in more attractively valued segments of both the US and international markets, opportunities that we believe offer good long-term return potential.

Markets continue to offer a wide range of outcomes: the case for a disciplined value approach remains

Investor reaction to elections in France and the UK has been justifiably sanguine. France stepped back from the brink of a far-right government. The disruption of a far more radical government has been averted – at least for now. The UK has elected a steady, seemingly centrist government with an unassailable majority. But the outcomes of both elections were primarily the result of a rejection – of RN in France, and of the Conservatives in the UK – rather than real enthusiasm for an alternative. In both countries, we have seen a continuing fragmentation of the party system and greater volatility in voter allegiances. Loyalties in these countries appear more fragile. And this at a time when the international challenges faced by both the UK and France are only likely to intensify, with deadlock in Ukraine, and with the potential for a second Trump presidency, and the challenges that might present to the Nato alliance, steadily increasing.

Significant uncertainty remains in markets, be it in relation to the nature of the AI revolution or the political outlook in Europe. And in 2024, the biggest year for elections in history, the range of outcomes has the potential to widen further, with Americans going to the polls in November. Our objective is to maximize risk-adjusted returns for our clients, and we believe that our structured and detailed scenario analysis framework should prove to be particularly helpful at a time when policy risks are high, with a substantial divergence in opportunities in markets. We remain faithful as ever to our investment process and consistent in our application of the long-term dividend discount methodology. In an environment where the range of long-term outlooks is wide, we believe our focus on underlying valuation supports the portfolio.

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