Quarterly Market Update - February 2025

Recent Performance

We have recently seen strong relative outperformance for portfolios. This outperformance is most notable over the past 3 months and can be seen versus benchmarks, our peers and passive strategies. The driver of this recent outperformance has been our stock picking and more diversified technology exposure, outside of the largest mega-cap technology companies. Pleasingly, a strong contribution to this performance came from protecting capital (falling less) in December when markets were down, whilst also outperforming on the upside when markets rallied in January.

Investment Trusts we own within portfolios have also performed well of late. A good example is JPMorgan Global Core Real Assets, which is up 21% in just two months following a vote to wind the trust up (we voted in favour of this), with further upside as the proceeds get paid out. There are still plenty of examples in the portfolio where this value is yet to come through. Ultimately, we think it is really a much more positive environment for our strategy, and it is pleasing that this is starting to show through, both in absolute terms and relative to peers/benchmarks.

Summary

As we look back on the final quarter of 2024, to say stock market returns were not uniform would be somewhat of an understatement. US equity markets delivered strong high single digit to double digit returns during the quarter with technology, communications and banking stocks fairing the best. However, elsewhere European, Asian and UK stock markets were negative over the period, albeit only slightly so in the UK. Bond markets were weak, while the gold price was strong. What underlies this divergence within and between asset classes during the quarter - in no small way - was the election of Donald Trump for a second time as President of the United States of America – the world's largest economy.

A Trump administration, particularly several of his policy pledges, could have significant implications for currency, equity, commodity and bond markets. Whilst the prospect of deregulation and tax cuts were well received by the US equity markets, these policies have the potential to fuel inflation which would be an unwelcome development. Trade tariffs and a tightening of US labour supply from immigration controls could also be inflationary and impact the global economy, already reflected in weak bond markets and European (major exporters to the US) equity markets. The extent to which President Trump manages to implement these policies remains to be seen, but at a time when central banks are still battling with sticky inflation whilst trying to deliver interest rate cuts, markets will be preoccupied by, and react to, news flow.

For portfolios, we keep these diversified across regions, sectors and businesses. This allows us to protect portfolio values on the downside, whilst still participating well on the upside through stock selection. For example, in December the S&P 500 was down around -2.5%, but many of stocks held in portfolios were up - with the likes of Alphabet (+14%), Diageo (+8%) and Amazon (+7%) performing well. We are also diversified away from some of the largest companies in the US, which are likely to be volatile.

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Outlook for 2025

Looking forward, markets will remain focussed on political events and announcements in the first quarter of 2025. President Trump will continue to sign executive orders with the aim of moving more manufacturing back into the US. In Europe, Germany will go to the polls in February with a very low likelihood of a clear government majority, whilst the latest French Prime Minister Francois Bayrou will attempt to agree and announce the country's budget. With government debt levels currently in focus and France having some of the highest debt levels in Europe, there will undoubtedly be turbulence as the bond market digests the French spending and taxation plans.

In the UK we will continue to deal with changing priorities in the current government, who may need to drastically amend their spending and taxation plans should the bond market refuse to buffer the country's borrowing costs. However, we are one of the few major European countries with a government majority, which means that countermeasures can be put in place quicker and without a huge amount of opposition. The government is taking the need for legislative reform more seriously, to stimulate the growth needed to improve our economy and reassure the bond market of our ability to repay debts. Recently, there has been genuine debate over reforms to land, financial, pension & energy regulation.

President Trump's trade policies, ongoing geopolitical uncertainty and the higher level of government borrowing costs places the global economy on a weaker footing. Inflation will remain higher in the short term and central banks will need to wait until the economy is sufficiently weakened to reduce interest rates. When you consider that stock markets are forward looking, it appears that many equity markets are already pricing in a high likelihood of a recession.

The current outlier is the US equity market, which continues to trade on a premium to its long-term valuation and is therefore vulnerable to an (unforeseen) economic contraction. This premium has been exacerbated by the increased interest, excitement and developments in Artificial Intelligence, given the US stock markets heavy exposure to the technology sector. The dominance of the largest companies in the US has also meant that the market has become very concentrated, with just 10 companies now accounting for 40% of the whole US market.

Whilst we have seen a huge increase in sales related to artificial intelligence, share prices have increased to a greater extent which leaves little room for disappointment. This came into focus when the Chinese company DeepSeek released its latest artificial intelligence model which was able to match the capability of the very best that the US has been able to create. It was believed that the Chinese would take many years to match the performance of the US AI models considering the restrictions placed on Chinese companies from accessing the very best components needed. Remarkably, this AI model was just 6% of the cost of the US equivalents. It has called into question whether the vast amount of expense into computer power is necessary, and whether both the US and the largest technology companies in the world could maintain their competitive advantage long term.

We believe the mega cap technology companies such as Google, Amazon and Microsoft will sit at the centre of this technology revolution, however the opportunities will spread beyond a handful companies. It is likely that investors will look back at areas of the stock market that have been ignored over the past few years, which as a result offer excellent value for money. We remain highly selective and well allocated to these outcomes; we do not expect Nvidia to contribute over 20% of the entire US stock market return for a third year in a row.

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Portfolio Positioning

Our philosophy regarding portfolio construction remains unchanged as we enter 2025. We continue to believe a diversified approach, focussing on business resilience and underlying valuation will prevail over the medium to long term. The equity market performance of 2023 and 2024 has called this long-standing investment principle into question, with investment capital flowing indiscriminately into single companies and sectors that are now heavily represented in global stock market indices. As investors realise the limitations and risks of this, capital allocation will expand across more areas of the global stock market, and we would expect to see a good outperformance of the portfolio.

We remain tactically positioned in certain sectors that are exposed to the opportunity in Artificial Intelligence, such as cloud computing, cyber security, healthcare and big data and we continue to offset and diversify these investments with our holdings in traditional economies and sectors with differentiated returns and revenue profiles. We also believe that income as an investment strategy is once again becoming necessary for both absolute performance and portfolio diversification. We will continue to identify and invest in areas with high and reliable income returns.

Considering the fragile political and economic environment, we continue to prefer government bonds over corporate bonds, given their ability to withstand an economic downturn. Whilst there has been considerable debate in the press over the past few weeks regarding government debt levels and breaching borrowing limits, we believe this can be incorrectly interpreted as an impending default in Western governments. Whilst you can never rule out a government default, the reduction we saw in government bond prices (and subsequent increase in bond yields) is a symptom of the bond market placing a higher rate of interest on the governments *future* borrowing. Given the current level of interest rates we believe that government debt provides an attractive real return and remains well funded in the UK. Importantly, we believe government debt, alongside the exposure we have to gold in portfolios, should also provide some protection should there be an economic shock.

In summary, we enter a period where careful stock selection will be more important than ever as we navigate global markets as trusted custodians of your assets. We believe this is a time when active management can add real value.

The Winchester Team | RBC Brewin Dolphin