What can '*Peristance of Memory*' teach us about market fragility and real risks?

By Kunal Desai, CFA

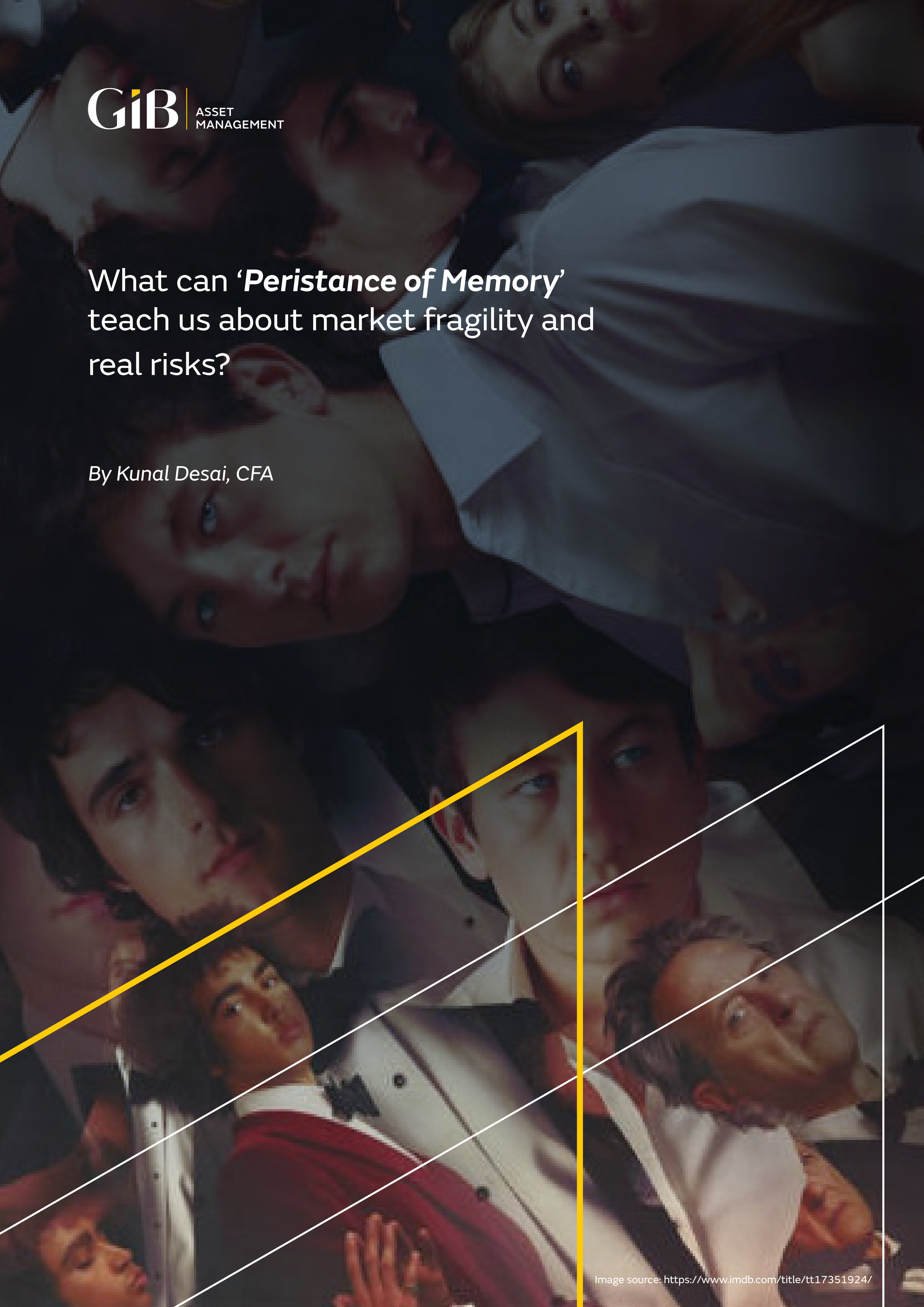


Image source: https://www.imdb.com/title/tt17351924/

What can 'Persistence of Memory' teach us about market fragility and real risks?

- Real risks have an uncanny ability to masquerade as innocuous until they unmask their true nature in the theatre of hindsight
- Investors should take heed, as warning lights are beginning to flash
- However, for those seeing the bigger picture, opportunity can present elsewhere, particularly if driven by underappreciated pockets of secular growth

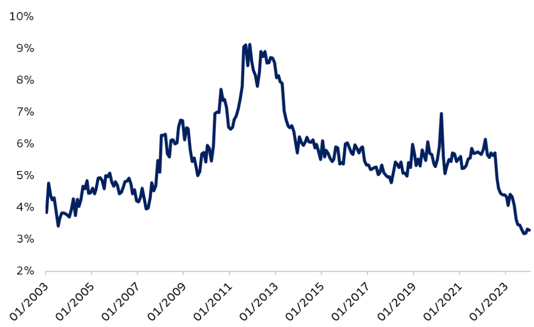
What do Salvatore Dali's '***Persistence of Memory***', ***The Talented Mr. Ripley*** and ***Saltburn*** have in common? Rave cultural reviews aside, all three explore the fluidity of time. In particular, how risks and consequences may only become apparent when viewed through the lens of memory and reflection. The understanding of risk is a nuanced endeavour, often only revealing its intricacies in hindsight. Experience from film, art and indeed, life, have a consistent rhythm in this respect - it seems the most unpredictable and profound risks are the ones we never saw coming. It is in the afterglow of consequences that the once subtle risks become glaring beacons of oversight.

Beyond Hollywood studios and gleaming galleries, we are often confronted with the misappreciation of real risks. Financial markets are in many ways the truest test of shifting narratives. It is within this backdrop, that the current set-up is particularly combustible. Important pockets of the market are crowded, overvalued, and deeply bifurcated. History points to deep drawdowns and sharp rotations in such instances. This brings opportunity though - we see increasingly underappreciated pockets of secular growth and believe these should be explored.

The dominance of US equity markets over the last decade has been well documented. So called American 'Exceptionalism' has powered markets to all-time highs, with relative valuation multiples peaking against most other indicators of value. Much of this is well justified. America's remarkably durable corporate earnings resilience, a deep and integrated domestic market, high monetary sovereignty, and geopolitical assertiveness are key ingredients in explaining premium valuations. Within emerging markets, India shares a similar podium position for many of the same reasons. Both markets, within global and emerging markets portfolios, are viewed as sources of enduring strength with characteristics of quality to withstand most periods of volatility. However, warning lights are beginning to flash.

1. US equity risk premia have fallen to the lowest levels in 20 years. American 'Exceptionalism' notwithstanding, implied expectations are at the highest levels in a generation with margins of safety conversely extremely low.

Chart 1: US equity risk premia have fallen to 20-year lows[1]



2. US market breadth is collapsing. Market leadership is becoming increasingly unhealthy through record concentration in the US equity market (Magnificent 7, AI, GLP-1). We have moved beyond the point of the dotcom bubble (and we know how that ended).

Chart 2: Peak market concentration in over 50 years [2]

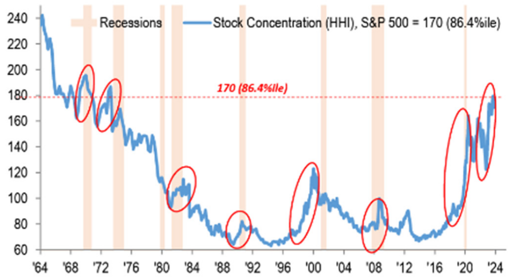
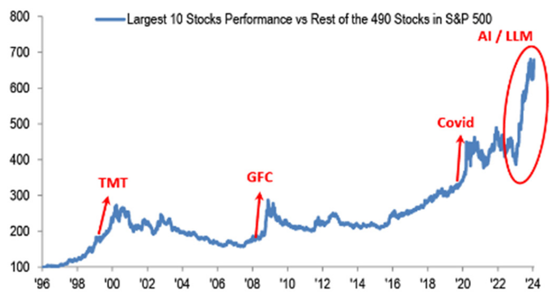


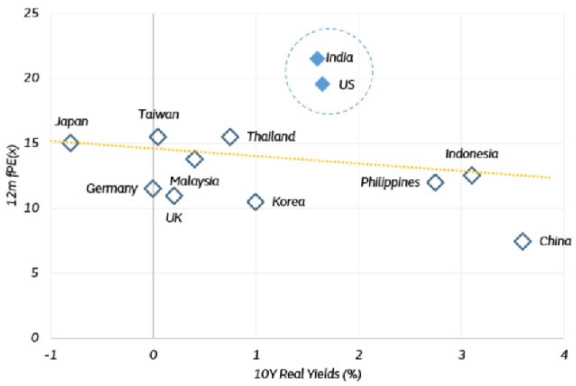
Chart 3: Performance of the largest 10 stocks vs. Rest of S&P 500[3]



[1] Bloomberg (2024)
[2] JPM (2024)
[3] Bloomberg, JPM (2024)

3. Relative valuations in the context of market yields are unbalanced. Both 'Exceptional' markets are outliers in the battle between valuations and market yields. As disinflation continues and interest rates topple, falling global market yields can re-rate other pockets of value where relative sensitivity is higher.

Chart 4: American and Indian 'Exceptionalism' – but what next for the rest of EM[4]



4. Blue sky expectations meet a dose of realism. We expect the period of higher interest rate regime to bite with a delay; the depletion of excess household savings; continued volatility from data dependent central banks; US elections and consequent policy eccentricity.

So where to next? With more and more eyes pointing towards last decade's winners, pockets of ignored value are emerging in areas backed by secular tailwinds. Despite the doom and gloom surrounding emerging markets, EM ex China is already seeing much improved momentum. In 2023, EM ex China returned +16.9% (all USD) which outperformed DM ex US (+14.8%). The wider DM/EM Index return composition can seemingly be contaminated by the impact of its largest constituents. The strengthening structural stories of Indonesia, Vietnam, Saudi Arabia, Brazil, Vietnam and Poland require more attention. Meanwhile the multi-decade investment opportunity in the semiconductor value chain – with market leading companies in Korea and Taiwan – offers investors a long runway of compounding growth.

With the prospect of peaking inflation and interest rates, an outlook of a weaker USD is a real prospect. This traditionally helps emerging markets on account of easier liquidity, their risk on nature and balance sheet balm. EM central banks are ahead of the curve and continue to lead global central banks in a pro-growth rate cutting cycle. Meanwhile EM ex China corporate ROEs are inflecting at the fastest pace relative to the developed peers at the fastest pace in more than a decade. Looking at relative growth differentials versus the US (Chart 5), EM ex China is trading cheap against fair value. We believe this to be an attractive mispricing which offers a compelling opportunity for superior risk adjusted returns. Rotations can be sharp with significant price momentum developing in these pockets of mispriced value. Data from Chinese flows points to a potential turn in its fortunes (Chart 6).

Chart 5: EM ex China growth differentials underappreciated by relative valuation multiples[5]

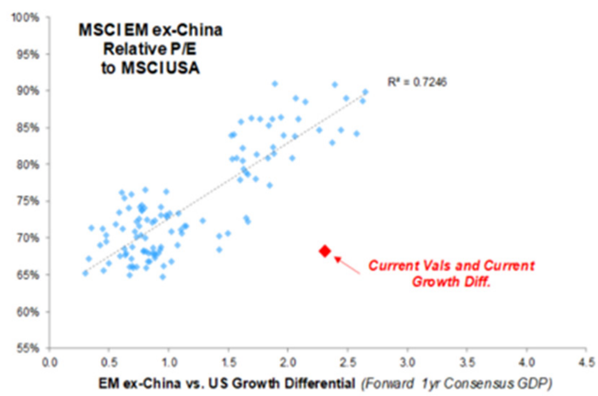
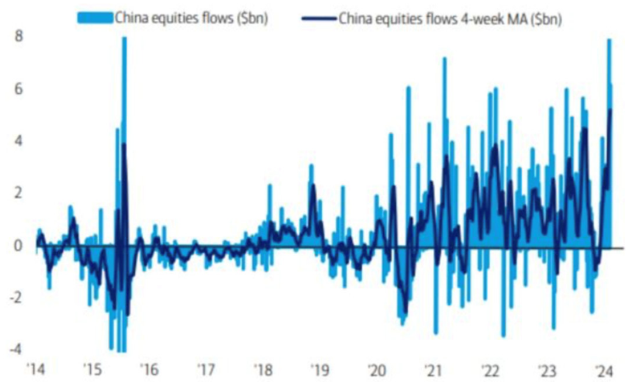


Chart 6: The largest ever 4-week inflow into Chinese equities[6]



Real risks have an uncanny ability to masquerade as innocuous until they unmask their true nature in the theatre of hindsight. We learnt this the hard way in ***Saltburn*** & ***The Talented Mr Ripley.*** Troublesome ends for the wealthy asset owners, ultimately undone by overappreciated sources of strength that proved to be anything but.

Take heed!

[4] GIB AM, Bloomberg (2024)
[5] BAML, Bloomberg, EFPR (2024)
[6] BAML, Bloomberg, EFPR (2024)

Image source: https://www.imdb.com/title/tt17351924/

Contact

info@gibam.com

T: +44 (0) 20 7259 3456

Follow us: in