Magellan Global Quarterly Update

April 2024

Jack Mann:

Hello, and welcome to the quarterly Magellan Global Update. My name is Jack Mann, and I'm a key account manager here at Magellan. Today I've got with me two portfolio managers, Nikki Thomas and Arvid Streimann. Welcome.

Nikki Thomas:

Thanks, Jack. Good to see you.

Arvid Streimann:

Great to be here, Jack.

Jack Mann:

Arvid, last year, the focus was all about interest rate rises. This year, people have been talking about rate cuts. Can you give us your view and how you think it might impact portfolios?

Arvid Streimann:

Sure thing, Jack. So last year, it was all about the rate hikes, I agree, and one thing that I would say about the economic cycle, I would say even over the past four years or so, is that things have taken longer than expected to unfold. So, remember when we were thinking about inflation, I would say that there was that transitory debate, but it actually took a lot longer for inflation to actually slow down than what people thought. And then when you think about what's happening right now, the US consumer's being a lot more resilient than what people have expected, so again, that slowdown has taken a lot longer than what people had thought. But we're in this happy environment where inflation is actually slowing, so I think rate cuts are actually on the table, and in fact the Fed more or less said so themselves.

So, let's think about what that impact on the markets might be. Now, there's around three or so rate cuts expected by the end of this year, and that's probably about right, and if that is the case, then I wouldn't expect there to be, all else equal, much impact on the markets because by definition, things are panning out pretty much as markets had expected. But if inflation continues to slow, then I would expect the markets to continue to grind higher because that's actually a very positive outcome for markets, okay? Very positive environment. But if inflation was to rise from here, then I think the markets may hit a bit of a rocky patch. And by the way, commodity prices are up 20% this year, so I would say that this is not our base case, but it is a scenario that is rising in probability or likelihood.

But if we stand back and say, "Well, what actually drives market over the long term?" it's not interest rates. The primary driver of equity returns and stock market returns at the market level but also importantly at this stock or company level is the earnings outlook, okay? So, we've been through, I would call it, a fairly unusual period where the driver's being dominated by interest rates. I think we're more likely to go to a more normal period, where it's driven by earnings outlooks, and this is where I think it's really important to think about what those structural thematics are. AI is one. I think there's a lot of talk about AI. I would say the shift to the cloud, which is a similar type of thematic, is another one. And I would also say the energy transition is another one. So, there's always some structural thematical that is a tailwind for markets, and that can be felt at the stock level as well as the market level.

Jack Mann:

Yeah. So, you mentioned AI, and I think the big driver or what we've seen really impacting markets over the last little bit has been the Magnificent Seven, and with inside the Magnificent Seven, it's been Nvidia. So, Nikki, we obviously don't have it in our portfolio. Can you talk about why we don't have it in our portfolio and maybe some other businesses that we have in the portfolio in that sector?

Nikki Thomas:

Yeah, absolutely. Don't we love a good phrase? Bricks, FANGs, Mag Seven. So, Mag Seven was termed back in April '23, and at that point, it was about 88% of market performance came from those seven stocks. So, it was back at 45% by January, and to be honest, Mag Seven's dead, and the performance across those seven is very divergent, but absolutely, the best one in the Magnificent Seven has been Nvidia, and it remains very strong. We run a process here where we are trying to make sure we can deliver very good returns while managing a portfolio that runs with lower risk than the market. Nvidia comes with big risk, and so it just is very hard for us to allocate it in the way we run the process without having to sit on a whole lot of cash, and I don't want to sit on a whole lot of cash. We're pretty optimistic about where markets can go.

So, we have had several of the Magnificent Seven in the portfolio, and obviously been good contributors to our performance. We haven't had Tesla or Nvidia. One's been great, one's been not-so-great, so that is what it is. And really, for us, it's always just about the earnings cases, what are these businesses going to deliver as we look forward, and have we priced that correctly, and we still see a lot of upside for some of those businesses, and there's more consternation uncertainty for some of the others. So instead of a Nvidia, I would say in that semiconductor space, we've obviously had a nice allocation to ASML. It's been a great performer, it's got an extraordinarily good story, and it's a business we really like and we continue to hold. So, we often play it differently, but we're looking at our risk budgeting and we're thinking about portfolio construction.

Our two biggest positions in the portfolio are two Mag Seven stocks, which is Microsoft and Amazon, and then we have got exposure to a couple of the others in the portfolio, where we think there's still a really, really compelling opportunity over the next few years for these businesses, somewhat related to AI but often just around the way they monetize and the opportunity that sits in front of them as economies regather steam, and they're superbly positioned against that.

Jack Mann:

So global travel's back. Arvid, you've just been to Washington. Can you give us a bit of a rundown on what you're hearing on the ground there? And maybe the big topic, I think, at the moment is the US election, so anything you've heard around the election? And then tie that back to what you think that might do with portfolios.

Arvid Streimann:

Sure thing. So, let's talk about AI first because I think it's interesting. As investors, we always listen to what the companies have to say, but when you're in Washington, you get to speak to and have access to people who are informing and influencing industrial policy. So, whether that's the government or it's the regulators, these are a different set of people who can give you insight into what's happening in the market.

And I would also put another set of people there that you can double-check or fact-check what you're thinking with regards to AI, and they are people who work in the defense industry or defense establishment and people who work in the intelligence community, because these types of people are singularly focused on figuring out whether America has an AI advantage over other countries, so they would have some view on what's coming down the AI pipeline, and there, I would say that the feedback was very positive, not just on what's going to happen with the innovation cycle, because we have all seen what's been innovated and the really interesting things which have come out which AI has enabled, but also on the adoption cycle, because it's one thing to innovate, but you actually have to adopt that technology into everyday use for it to really have an impact and for companies to really make money out of it. So, I walked away from Washington much more confident about what Nikki's just talked about and AI in general, okay? That'd be the first thing.

The second thing would be around the risk of a US-China confrontation over Taiwan. Now, we've always thought this is a fairly low probability, but I have a higher level of conviction this is the case? Now, let's think about why the US may defend Taiwan. It's not to defend so much the chip factories in Taiwan. I would say it's a couple of things. Firstly, it's about American prestige, and they want to be the big country on the block, so to speak, and so to say that they're going to defend Taiwan and not do it, that would hurt their national prestige. Also, if they weren't to defend Taiwan, then there would be question marks around some of their defense treaties, in particular NATO, so it's very important for them.

The second thing I would say here is that the US military forces and posture within the East Asia region has increased in its intensity and its scope, and so that just makes it harder for China to do anything. So, let's call that the deterrence value has increased.

And the third thing I would say here, and I think we kind of all know it, China's economy is not really that strong, and so that means that if Xi Jinping's really interested in trying to take the island of Taiwan, it's going to be very difficult because if he fails, then the local population in China will say, "Well, you've just dented our national prestige in this overseas folly, but also our economy is doing quite weak." So, I think there's reasons there to be confident this is not going to happen on a 10-year or so view.

You mentioned the election. I would say that Donald Trump is the slight favorite right now, but look, it's quite a long way away. But I think that if Donald Trump was to win, and remember, Joe Biden, he's going for his second term, Donald Trump would be a new president, so to speak. If he was going to do that, I think it was probably a net positive for markets, because if you remember back to his first presidency, he was constantly talking up the markets and how much it had gone up. I think that's important to him, and the optics are important, but it's not going to be the same for all companies. I would say companies that may be caught in the middle of a US-China trade war, that maybe they have a bit of a rocky time. Companies that are considered to be woke, West Coast companies, may have a bit of a rocky time. But companies that benefit from deregulation and a pro-growth agenda, which Donald Trump probably has, would, in our minds, probably be the largest beneficiaries.

Jack Mann:

Yeah, so you mentioned China a few times there, and Nikki, I believe you're planning a trip to China at some point in the near future. So, we don't have any holdings in the portfolio that any of the Chinese businesses, so what are you planning on getting out of this trip?

Nikki Thomas:

Look, China is the second-largest economy in the world. We would've said 12 months or 18 months ago, we thought this was a derating asset. It's not meant to be a smarty-pants comment. We didn't expect it to derate as rapidly as it has, and obviously, the performance of China as an investment has been very difficult over the last 12 months. But you can't write off such a large economy as irrelevant to the globe, and so that's the key piece for us. We are looking at global companies, we're thinking about cost competitiveness of industries, and China's reshaping certain industries. It really goes back to their Made in 2025 strategy that they put in place back in 2015 and the progress they've made around the industrial complex in particular.

So, China now is a dominant player in solar batteries, in wind power, in lots of renewables, in electric vehicles, in batteries, and that's going to be really important for the globe as we look forward. We've had people who've been on the ground up there tell us that the vehicle production capacity of China today, so all vehicles, is 50 million. Let's contextualize that. You need about 90 million cars to fulfill all global demand for new cars in any one year. So, there are over 50% of productive capacity today that is over capacity, they don't require high returns on capital in that economy, and so you should expect some of those cars to start appearing outside of China, anywhere they can export them. That will be good for their economic growth story, because I've got an export story happening, along with batteries and some other things, but it's going to be tricky to navigate for them because of tariffs, and it's going to have implications, we think, for places like Europe because of that cost competitiveness issue, as they produce things very cheaply and other economies, countries, and companies are going to find that challenging.

So, it's really important that we keep an open mind to the whole world, how each country can impact others and how that will influence our businesses, whether they operate from inside China or are competing against China in certain places.

Jack Mann:

Yeah, it's really interesting. Thanks so much for your time today, Nikki and Arvid, and thank you very much for listening today. Please feel free to share this with any of your clients.