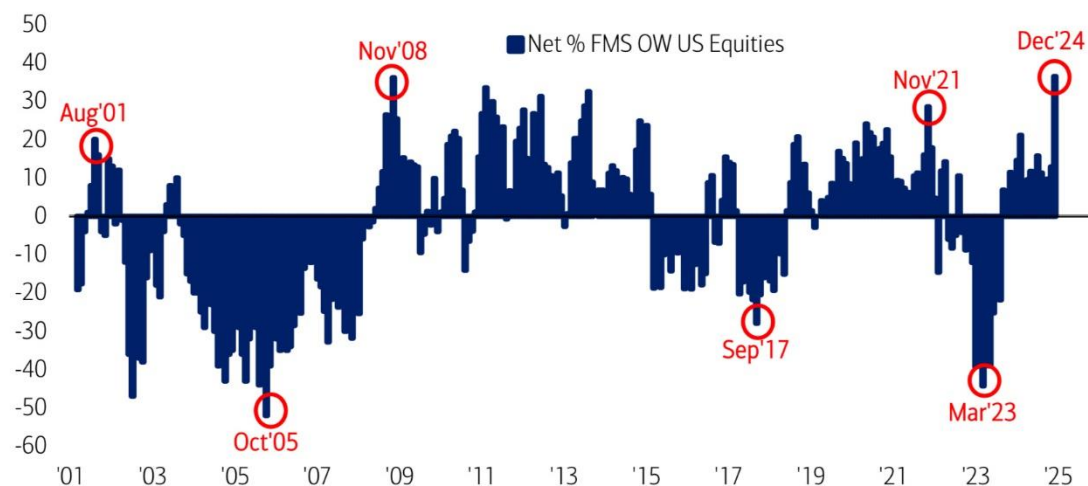


Capicraft Newsletter: Fourth Quarter 2024

In our previous newsletter, I stated that the market trend of “American exceptionalism” is becoming quite stretched and that a period of underperformance is ahead for this market. However, market movements since the convincing Republican victory in November 2024, have given this thesis a bloody nose. The Dollar index (DXY) is almost 5% stronger and the S&P500 has outperformed the rest of the world index by about 8% (in dollar terms) since the election results. The rotation into US equity funds over the last two months has been one for the record books.

Chart 15: US equity allocation surges to record high

Net % FMS OW US equities

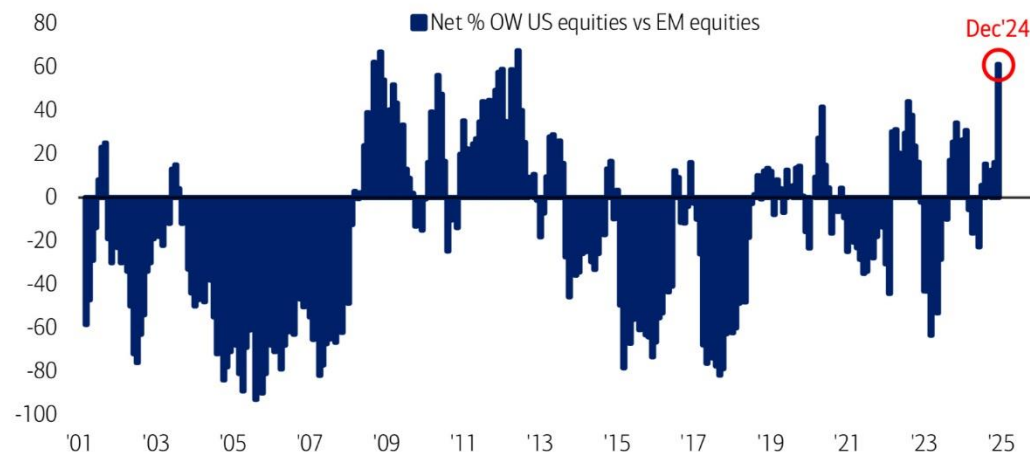


Source: BofA Global Fund Manager Survey.

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Chart 16: “US exceptionalism”...big FMS rotation into US equities, out of EM equities

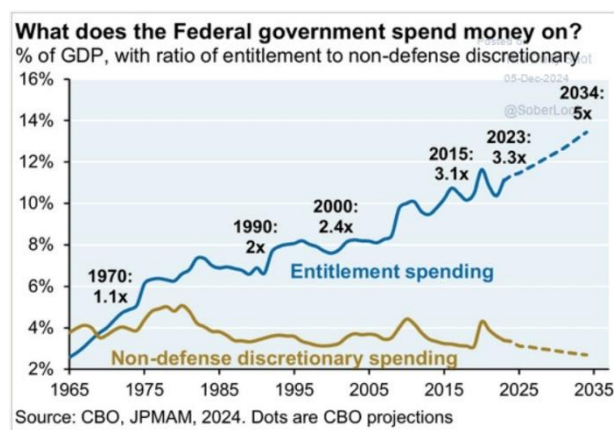
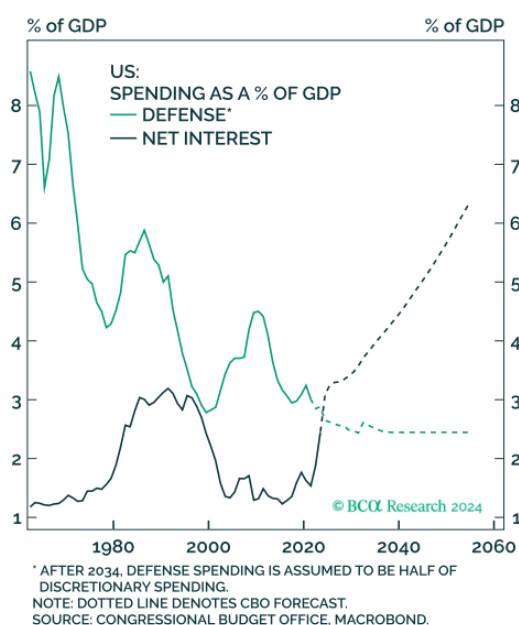
Net % US equities - net % OW EM equities



Source: BofA Global Fund Manager Survey.

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The new Trump Administration certainly has the potential to bring about real policy changes that will put American society and the economy on a much stronger foot in the long run. I hope they do. However, there are major challenges - especially when it comes to the financial markets. Deep reforms are needed, and the bureaucratic “deep state” is not going to make this easy. Many of the Administration’s policies and objectives may also counteract each other. Trump promised his voters lower inflation, but import tariffs, restrictions on immigration and tax cuts are certainly not deflationary. A weaker Dollar policy is also not going to help keep inflation in check or protect the Dollar’s position as a reserve currency. Most importantly, the US fiscal position, despite initiatives like DOGE, is not going to change significantly without causing an immediate recession. Most of the fiscus consists of “mandatory” social spending and a growing interest component in any case.

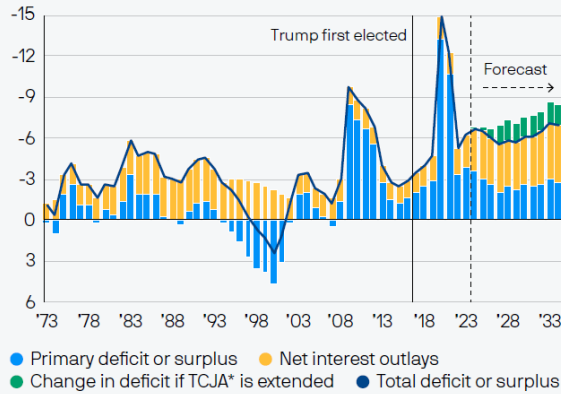


In many ways, Trump has been given a hospital pass. The back of inflation appears to have not yet been broken, a new cold war is raging, and fiscal spending is at record levels. For these reasons – inflation expectations, geopolitics, and debt – the 10-year U.S. Treasury yield has moved more than 1% higher since September, despite, or perhaps because, the Federal Reserve has begun cutting interest rates. The 10-year yield is currently 4.78%, and the stock market is struggling to process these higher rates. Rates don’t have to move much higher before something in the financial markets break. The last time rates traded near 5% was when Silicon Valley Bank collapsed and many regional banks in the U.S. had to be bailed out.

Exhibit 1: Additional stimulus will push the US fiscal deficit to extraordinary levels

Composition of the US federal deficit

% of GDP

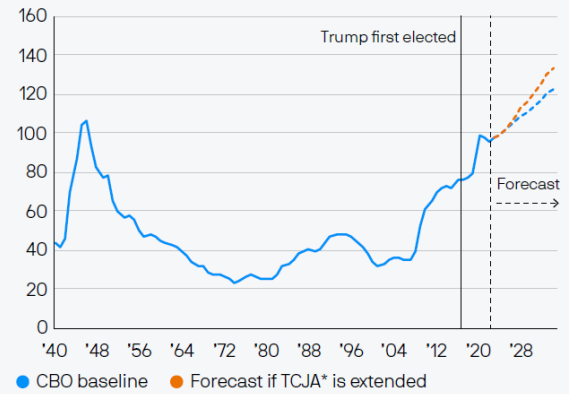


Source: (All charts) BEA, CBO, US Treasury, J.P. Morgan Asset Management. Forecasts are based on the Congressional Budget Office's (CBO's) latest budget and economic outlooks and internal J.P. Morgan Asset Management estimates. *TCJA refers to the Tax Cuts and Jobs Act of 2017, parts of which will expire on 31 December 2025 unless extended. Years shown are fiscal years. Data as of 12 November 2024.

Exhibit 2: Ever-rising government debt could unsettle the bond market

US federal debt

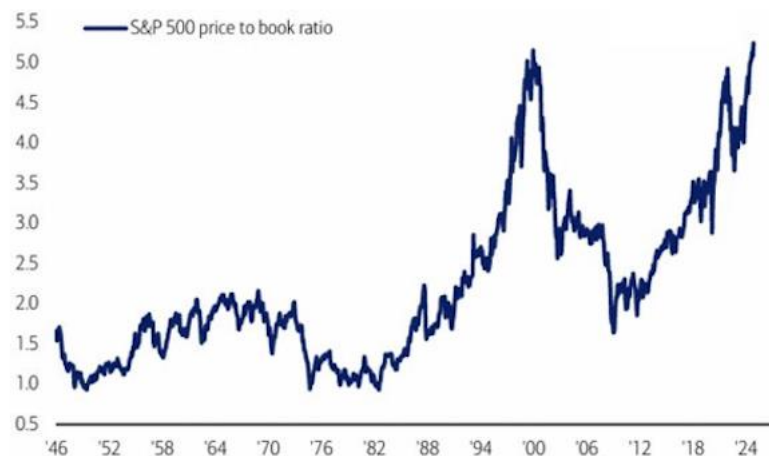
% of GDP



It's possible that the US economy could grow at a very good nominal rate thanks to an "America First" policy. Industrial revival (onshoring), tax cuts and deregulation are all good for business confidence, but the growth will not benefit stocks proportionally and evenly. A large part of Trump's voter base is the lower and lower-middle class of the US "flyover states," and policies will be aimed at them at the expense of multinationals and technology companies in blue cities. We foresee a policy environment that tolerates slightly higher inflation, as long as wage inflation outperforms the general inflation rate. Not a great environment for corporate margins that are sitting at record levels. Nominal growth will therefore also contain a larger component of inflation and so bond rates will have to stay higher for longer. Higher bond rates are not good for stocks that are sitting at record valuation levels.

Chart 6: S&P500 price-to-book ratio now exceeds March 2000 high

S&P500 index price-to-book ratio



Source: BofA Global Investment Strategy, Bloomberg, Global Financial Data

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Of course, not all stocks are expensive, there is a lot of value outside the heavyweights in the S&P500 and even more so outside the US. Many commentators will refer to the so-called “Magnificent 7” and how expensive they are. Parallels are sometimes drawn with the IT bubble of the early 2000s. However, this phenomenon compares much better with the so-called “Nifty Fifty” of the early 70s. The stocks that enjoy higher valuations today are not necessarily growth companies (as with the IT bubble). Apple’s revenue has been stagnant for three years, yet the stock trades at a 37 price-earnings multiple. Similarly, Costco, not even close to a technology company, trades at a 55 earnings multiple. Both traded at half these multiples a few years ago when bond prices made it much more attractive to close your eyes and just hit the buy button. There are more examples, but what most have in common is that “quality” is a factor and price is not. All are listed in the US. Exceptional companies in an exceptional market. Similarly, the “Nifty Fifty” included companies such as Johnson & Johnson, Coca-Cola and Walt Disney. Despite these companies showing good profit and revenue growth over the following decades, the high levels of buying and a changing macro environment produced very disappointing returns for their investors. A lost decade for the current “exceptionals” are also a strong possibility.

Then there is the talk of a productivity boom thanks to artificial intelligence (AI). As with most technology cycles, however, most of the benefits will only be experienced later. Currently, the AI infrastructure is being built and experimented with. Similarly, the infrastructure for the internet was built in the late 90s, but the winners such as Amazon, Google and Netflix were only obvious more than a decade later. The AI Hyperscalers (those who build the infrastructure such as cyber cloud services, data centres and “Large language models”) are already pricing in very high expectations. At the same time, their business models are becoming increasingly capital-intensive and more commoditized. This means thinner margins and lower returns on capital than they currently enjoy. Therefore valuations should come down as well.

The next opportunity is in the AI developers. These are the companies that will write or improve their software on the back of the Hyperscalers’ infrastructure. Harder to predict, but we took small positions in Docusign and Zoom during 2024 at very low valuations. We also mentioned in a previous newsletter that we don’t necessarily want to supply the “picks and shovels” or “hardware”. These are Nvidia or ASML and TSMC, for example. This sector is particularly cyclical, already very highly priced and a trade war (or physical war) poses significant risks for them.

Under the radar are those companies that provide critical services to the hyperscalers. Think water to a gold miner in the desert. That’s why we made a case that energy suppliers will be a big indirect winner from the AI explosion.

However, we are taking it a step further with a recent investment we made in Landbridge. This company owns 273,000 acres in the Delaware Basin, which is in the western Permian Basin of Texas. The company is operated as a royalty company, similar to Texas Pacific Land (check out what TPL's share price has done over the past few decades). While they are cashing in on royalties on oil and gas production, water transportation and water processing have become a large part of the business. Hydraulic fracturing requires large amounts of water and also produces large amounts of wastewater that needs to be processed. This activity has produced enough profit to justify an acquisition in Landbridge, but the opportunity lies in data centres.

West Texas is sparsely populated, land is cheap, the air is dry, there is a friendly regulatory environment and a lot of fibre optic infrastructure runs through West Texas. Then energy in the form of wind, solar and gas is cheap and nearby. This makes it ideal for a hyperscaler to operate a data centre there. All that is needed is water to cool the data centre. The water, land and energy can all be provided by Landbridge's ecosystem, of course. Landbridge recently signed its first lease agreement for such a data centre, which will take up about 2000 acres. Landbridge's share price is up 110% since our purchase earlier in 2024. However, if the full potential of Landbridge were to be realized, the company could be worth 10x the current share price.

We believe the risks for 2025 lie where you least expect them. The opportunities, elsewhere. Outside the heavyweights, outside the hyperscalers, outside quality, outside the US.

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