Transcript
The Ideas Exchange - Episode 45

Investment themes in today's global markets

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Rory Cunningham (00:01):
Welcome to The Ideas Exchange by ASX, connecting you with investment experts, market updates and ideas. I'm Rory Cunningham, senior manager of investment products at ASX, and this is our regular podcast, covering everything from investment trends through to different ways to invest using a variety of products.

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Rory Cunningham (00:46):
Welcome to The Ideas Exchange. I'm your host, Rory Cunningham, from ASX. Today we welcome Catriona Burns, who is the lead portfolio manager of WAM Global, a listed investment company that listed on ASX in 2018. Catriona, welcome to the podcast.

Catriona Burns (01:03):
Thanks for having me.

Rory Cunningham (01:04):
So today, we're going to be talking about global markets, and we're going to be covering a lot of ground in this episode from the current state of markets to US elections, interest rates, geopolitics and big investment themes. So Catriona, to get us started, can you give us a high-level overview of where global markets stands right now?

Catriona Burns (01:26):
Sure. So I mean, global equity markets have been, on the surface, remarkably resilient despite what is a really very dynamic economic backdrop. I mean, we've had huge inflation met with interest rate rises and now, the start of cuts and a large amount of geopolitical tension in the background, but yet, markets are basically at highs, so you'd never know anything was happening in the

background. And look, that really fundamentally comes down to earnings growth amongst particular companies has been very strong and kind of holding the market up, but when you look under the surface, because it is more divergent, you've got some of those, say, large-cap tech names that have been very strong. Whilst if you look at, say, small mid-cap companies, they're trading at 20-year valuation discounts.

(02:18):
So whilst on the surface, it looks quite one-dimensional and just all-time highs in markets like the US, there is more to it below the surface. And even when you look at the different markets around the world, the US has been exceptionally strong. Europe has kind of muddled along. Probably growth has been slower than places like the US. Japan has been more volatile but generally, relatively strong. And then China had been incredibly weak but of late has been skyrocketing on the back of stimulus that is to be announced, and we'll hear more on that tomorrow. So yeah, look, it's an interesting place be in terms of working global equity markets, but yeah, a lot more than perhaps is just at the surface level.

Rory Cunningham (03:05):
Yeah, great. We'll get into some of those things that you touched on there. As I was doing research for this podcast, I came across that your investment strategy focuses on four key themes, I suppose I'd classify them as. First is digital enterprise, then electronic marketplaces, innovative health and critical assets. So how do these things fit into the global market picture?

Catriona Burns (03:31):
Yeah, sure. So these thematics probably account for about two-thirds of the portfolio, stocks that fit within them. And we think they're as relevant today as ever. And the reasons we like these thematics is that they really drive multi-year structural tailwinds for the businesses that we are invested in, and that's regardless of short-term noise around economic cycles or geopolitical tensions. And we think they stand the test of time in terms of those multi-year tailwinds. And individually going through them, I can go into as much detail as you like, but we think, even with the noise and lots of commentary around AI, these themes are even more relevant today than they have been possibly in the past.

Rory Cunningham (04:19):
Okay. No, thanks for setting that scene there. We'll definitely dive deeper into each of those themes in a little bit. First, I wanted to touch on the US election and the implications for markets. So the US election is on everyone's mind. I suppose, how do you think a Trump administration would impact markets, particularly sectors related to your investment themes?

Catriona Burns (04:40):
Yes, we're closing in on the election. Lots of noise and media around the upcoming election and we think Trump specifically would be a bit of a double-

edged sword. You've got him talking about continuing with the tax cuts that he put in last time, a potential further tax cuts, which would be broadly beneficial to US corporates. Whilst on the other hand, the tariffs and additional tariffs on imported goods coming from places like China would punish certain companies. So those that are importing a lot of items from places like Asia would face additional cost pressure. So for our portfolio specifically, we think actually our companies will perform very well through a Trump presidency given we're not really materially exposed to areas that would be hurt, and at the same time, we would benefit. Our companies would benefit from the lower corporate tax rates.

(05:41):
Interestingly though, since the last Trump presidency, a lot has been done by companies to try and diversify their supply chains and reduce their general reliance on China. And every company that we talk to is trying to, as much as possible, do China for China, so manufacture in China only what they need to sell into China. I mean, obviously, whether it's a toy company or particular auto parts goods and so forth or electronic goods, it's not altogether possible to completely diversify away from China. But our portfolio, per se, we're not worried about at what the additional tariffs would do. In terms of other areas, so taxes, borders and trade are probably some of the key areas that we think they really do differ on. And the borders one for us as well wouldn't be an issue for the companies in our portfolio.

Rory Cunningham (06:39):
Yeah, okay. How does that compare or contrast to a Harris-led government?

Catriona Burns (06:44):
So we think Harris will differ from Trump in her support for energy transition. That's one area. And more involvement potentially of government in industry. So she's talking about potentially increasing taxes, there's commentary around unrealized tax penalties, et cetera. But we think that the likelihood is that she won't get a clean sweep of Congress, so that would make it hard for many of these things to actually get put into action. We think in terms of the portfolio, we have a number of companies that actually really benefit from the energy transition, names like Quanta Services, which maintain and upgrade the grid. We own various exchanges such as Intercontinental Exchange or ICE, which is benefiting from trading of environmental futures.

(07:38):
Biden put in the IRA, the Inflation Reduction Act, CHIPS Act, et cetera, and these have been incredibly supportive of increased onshoring of manufacturing, chips manufacturing onshore as well, renewable infrastructure. So there'll be a number of companies there that we think we have that will benefit, but yet, more government getting into businesses and getting them so involved in industry isn't necessarily a positive. But our view would be that it's likely that it's not a sweep so that some of these things would actually be, in practice, hard to implement.

Rory Cunningham (08:17):
Okay, understood. Just for backgrounds, historically, how have election outcomes impacted market volatility, and should investors be bracing for more of the same?

Catriona Burns (08:26):
Yeah, look, it really does depend a bit on the geopolitical and economic backdrop at the time. But yes, historically, there has been some short-term volatility in the lead up to election days. We would see any volatility though if it's just because there is uncertainty around outcomes as potentially a buying opportunity. These tend to be events that are opportunities rather than a reason, per se, to turn bearish, unless it's particular names we think would be very much negatively affected from the government getting too involved in a particular industry if there was a sweep from the Democrats, et cetera. We think it's the health of the economy and the backdrop of monetary policy at the time that's a more important driver of short-term stock market returns. And that ultimately though, what drives share prices longer term is earnings, growth and cash flow generation.

Rory Cunningham (09:22):
Sticking with kind of macro themes, we can't talk about global equities without unfortunately talking about geopolitics and what's going on around the world. So geopolitical tensions are creating uncertainty in markets globally. How do these tensions affect the investment thematics that you were focused on?

Catriona Burns (09:42):
Look, we think obviously the geopolitical tension is creating uncertainty. And whether it's been the Ukraine issues, Middle East issues, potential for China to get more involved in Taiwan, there's lots of things to discuss on the geopolitical front. But I think what we love about the thematics that we're exposed to is that they are just so structural in nature, and we actually think they become potentially even more critical. And we say critical assets or critical infrastructure is one of our key thematics, and in an environment of geopolitical tension, that becomes more important. One area we have got some investments outside of those thematics is in a few defence beneficiaries. So we own some names, say, in Europe that will benefit because Europe is under-invested in defence for decades, and we think those holdings will benefit as Europe potentially increases defence bids. So we think there are some beneficiaries as well as those key thematics that we invest in, which we think are only enhanced by geopolitical tension, not detracted from.

Rory Cunningham (10:59):
At the beginning of the podcast, you mentioned interest rates and particular markets around the world are showing signs of stabilizing or even declining interest rates in some parts of the world. How does that shape your investment outlook, particularly with reference to small-cap stocks?

Catriona Burns (11:17):
Yeah, so we tend to love investing in small, mid-cap stocks, but they've been massive laggards of large caps globally. Actually, ever since we started the fund. And the valuations right now are at those sort of 20-year valuation discounts. We think a number of factors have caused this discrepancy, whether it's been uncertainty around... Given we had had interest rate increases, we had recession fears, we have had that geopolitical uncertainty and the flow of just passive money into really liquid names.

(11:51):
With interest rates now starting to be cut, we do think that that will be a really nice tailwind for small/mids going forward. We do have to get through the uncertainty around recession still. And I mean, the US jobs data last week was extremely strong, and the economy itself continues to be extremely resilient. But we think as rates do continue to come down, that should be a tailwind to small caps, which as I said, had headwinds over the last few years. The concentration of returns across MSCI World or the S&P 500 is exceptional right now. So we think as interest rates come down, we should expect to see that concentration come out of the market, and we see much more wider returns from other parts of the market.

Rory Cunningham (12:46):
You mentioned there being positive tailwinds for certain sectors in relation to geopolitical tensions or interest rates, but what regions or sectors might experience headwinds from those external pressures?

Catriona Burns (13:02):
I think in terms of whether it's the geopolitical concerns are the areas that would be under pressure is things like global shipping, ocean, air freight, logistics. We don't own a lot of those companies. We think the oil price is another risk that, I mean, generally, if you have that as a big input cost for your business as geopolitical tensions or those external pressures potentially heat up, the oil price could continue to rise. So yeah, we think there are sectors that will suffer, and yeah, we just try to steer away from them and find areas that we think will benefit.

Rory Cunningham (13:42):
Okay. Let's switch tack to tech stocks. The Magnificent Seven have grown to dominate the S&P 500. How sustainable do you think that level of concentration is over the long term?

Catriona Burns (13:55):
Yes, you're right, there is a very high concentration of the S&P 500 right now in the Mag Seven. And look, these companies, depending on which one you're looking at, in many of the cases are very high quality and advantaged businesses, but they do massively differ between them in terms of the business

model, even the sector, like you say, tech broadly. But Tesla is a very different company to Apple to Nvidia to Amazon. So we think in terms of when you go through the individual valuations, you really have to pick within the individual stocks to say whether they're highly overvalued and valuations are egregious or whether they're actually okay. But the concentration is very high.

(14:43):
And even when you look at the top 10 stocks in the S&P more generally, it's over 30% of the S&P in 10 names largely driven by those Mag Seven stocks. So we think in terms of your question of how sustainable is it, you can never call the top exactly right on these things, but we do think that the market should broaden out going forward, given as interest rates come down and as those just overriding fears of recession and uncertainty, which have driven people really to just stick with liquid names and even just purely AI-related names, et cetera. We think it will broaden out going forward, but calling exactly when that happens, I won't claim I can do that.

Rory Cunningham (15:35):
Okay. Let's pick on one of those stocks for a second though. Let's talk about Nvidia. That's seen incredible valuations recently. How do you see the digital enterprise sector evolving as AI continues to drive innovation, and do you have any commentary or reflections on Nvidia?

Catriona Burns (15:53):
Yeah, look, it's been a phenomenal stock, and it actually has had phenomenal earnings growth driven by just massive spend by corporates and by the cloud providers ahead of AI rollout. And so we think that when you look at big technological shifts, often, these shifts start with benefiting that hardware layer, which is where Nvidia sits, before moving up towards the application layer. And it happened with the internet and Cisco. It's happening here with AI and Nvidia. We think that it has been a phenomenal stock. The earnings growth has been terrific. Our caution, I guess, going forward is just does that massive investment that's occurring continue, and do they continue to evolve to benefit?

(16:47):
And look, we think it's a fantastic company. In terms of forecasting the earnings growth going forward, we find that difficult. We'd prefer to position where we see businesses that we think have natural advantages and are clear AI beneficiaries for the next leg of growth. So we own companies like SAP, which is the leading global ERP player. We own Intuit, which has the tax software and just incredible data. We own Booz Allen Hamilton, which is doing all the government AI implementation and tech transformation. So we think these businesses really have unique capabilities and unique data and will benefit from this next leg of growth and benefit as we go forward from AI.

Rory Cunningham (17:35):
Okay. How do you think about things such as tech bubbles? I mean, when you see the valuations of some of those big names in the Mag Seven, investors usually ask, "Is there another tech bubble coming?" Do you think we're in the early stages in some parts of the sub-sectors of technology that were in an early stage of a tech bubble? Or do you happen to think there's still room for growth in some of these sectors?

Catriona Burns (18:02):
I think parts of AI are frothy, and even OpenAI getting 150-bill valuation when you've got Meta offering open-source large language models of potentially equal quality looks pretty aggressive. Look, but that's up to those investors willing to put money in there. We think this time around though... It is interesting. With the 2021 froth in the market and then the subsequent fall for '22, there was a lot of companies, unprofitable tech companies, that really got blown out of the water. And we think, sure, there's definitely pockets of frothiness, but it's actually a lot of those valuations for those companies haven't come back. They're still trading at valuations well off the highs. So it's nothing like that everything bubble of 2021. We think when you go through even the Mag Seven, you've got to go through them individually, and some of them actually aren't insanely... Google is not insanely valued, Meta is not insanely valued, and they're highly profitable and cash flow-generative, whereas, I wouldn't necessarily be interested in Tesla at this price, et cetera.

(19:14):
So I think, yeah, we're not in a blow-off tech bubble point in the cycle, but definitely, there's frothiness in different areas. And it's interesting, it wasn't so long ago that every company was jumping to mention AI in their conference calls and getting an immediate pop in their share price. I think some of that froth has come out, and down the track, there's a realization that there's an enormous amount of CapEx that has to be spent, which is why all these Mag Seven businesses are actually... Many of them are becoming much more capital-intensive than they have been in the past, so we're yet to see the returns they generate from that. So yeah, look, we think it's a really interesting time in markets. There's definitely always pockets of froth but not an all out tech bubble right now.

Rory Cunningham (20:05):
Okay, thank you. Let's dive deeper into your investment themes. And starting with digital enterprise, what kinds of companies are you focusing on here, and what opportunities do you see for growth?

Catriona Burns (20:17):
Yeah, sure. So when we look at digital enterprise, we think, look, really... And this was highlighted more than ever during Covid. To remain relevant and competitive and to be able to reach your customer base, it's becoming more and more important for any business to transition to being digitally native, to

upgrade your tech, to migrate to the cloud and adopt software application. This spend is clearly high priority in the minds of chief technology officers across every size business, and there are real efficiencies and cost benefits, productivity benefits that you can get from investing and digitizing your enterprise. We own a number of businesses that we think will benefit from that, whether that's Intuit and SAP and Adobe. I mean, SAP is a great example. As I said, global leader in an ERP software and listed in Germany but a global leader.

(21:20):
And what's become apparent with AI is that if you are not cloud native, it's very hard to implement AI. And so they've got an enormous amount of business underway migrating... First, you've got to go from on-prem to in the cloud, and then you've got to go big cloud, able to use the cloud to adopt AI technology. And the revenue opportunity for SAP in that transition is significant, two to three times higher, and then you're layering in the AI capabilities and tools that they have. So we think that really sets up for very strong revenue growth and profitability as you look forward. So that would be an example of a business we own in the digital enterprise thematic, but as I said, we own a number of them including that, Intuit, Adobe, et cetera.

Rory Cunningham (22:13):
Okay. Switching to electronic marketplaces, they've become a dominant force in the global economy. How do you see this theme evolving over the next few years, especially with that backdrop of geopolitical and economic uncertainty?

Catriona Burns (22:28):
So these are the types of businesses that we love. I mean, you've got a business transferring from analog to electronic processes, and this can be across so many different asset classes. And we own lots of different examples of them, whether they're in fixed income, mortgages, real estate, events and ticketing. And what these businesses benefit from early is network effects, which means that the more people that use the product or the service, the greater its value becomes. And so really whether it's geopolitical or economic uncertainty, we think the value creation continues and won't stop, be stopped by that and actually potentially increase. So you've got a business, say, in the fixed income space, we own Tradeweb, which is digitizing fixed income markets. So unlike equities, which as you know are very much on exchange, the fixed income markets are many years behind. And so TradeWeb's a leading player there. They've got an incredible opportunity to electronify fixed income markets.

(23:37):
And that transition is going on. We can see mid-teens earnings growth, per share growth over the next few years, and it's multi-year in terms of that transition. And as you get uncertainty and geopolitical tension, it's easier to have a marketplace where you can go and see pricing, visible pricing. So we think that the business case for transitioning from analog to electronic is even greater in times of uncertainty. I mean, other examples would be we own in Sweden the

equivalent of REA Group, which is called Hemnet. Over 90% of eyeballs go there first for when they're looking for real estate, and it's just an incredible platform that is very early days in terms of monetizing. And so we think that tailwind, regardless of economic or geopolitical backdrop, continues and won't be slowed.

Rory Cunningham (24:39):
Innovative health is another area that you're focused on, and it's a rapidly growing area. What innovations in healthcare technology are you most excited about, and how are they also impacting markets?

Catriona Burns (24:53):
It's a really exciting time in the health space. I mean, even last week, I was reading about world first therapy success around donor cells to send autoimmune diseases into remission. The amount of developments going on at the moment, whether it's cell and gene therapy, biopharma, et cetera, it's pretty phenomenal. We think you've got, not only just huge amount of innovation, you've got that demographic tailwind, so aging populations around the world, emerging middle classes in places like China and India. And then you've got generative AI, which can assist pharma and biopharma researchers in developing drugs faster and at a lower cost. So it's a really super interesting time in the healthcare space.

(25:46):
Where we tend to love to hunt for ideas and exposure here though is really the picks and shovel plays. So not necessarily picking which therapy or which drug, per se, will be successful, more the picks and shovels providers of products and services, materials, consumables, instrumentation to the industry. And we've owned, for a very long time, Thermo Fisher Scientific, which is a great example of one of those players. As I said, agnostic to which drug or therapy is approved but really a key supplier to large and small pharma. And buy those smaller biotechs as well run by an outstanding CEO, Marc Casper. We also own Avantor, which is a similar player in the space, more undiscovered and yet to prove themselves like Thermo Fisher has, but we think are really interesting. Another play. Yeah, so we've got various plays on that innovative health thematic.

Rory Cunningham (26:48):
And to finish it off, critical assets, probably more important than ever in such a volatile world. Can you explain what critical assets mean for investors in today's context, and why they're a key investment theme?

Catriona Burns (27:02):
Sure. So you're absolutely right. With growing geopolitical tension and rising power demands from technology, increased cyber risk, we think governments and companies alike are really realizing the importance of having critical infrastructure onshore and well invested in. And look, you've seen this, for example, from the US government, which the IRA is, and the CHIPS Act, a great

evidence that they realize that they need to upgrade their infrastructure, reduce the cost and increase the reliability of energy because AI and data centres are certainly driving increased power demand. They're trying to drive reshoring of manufacturing, whether it's to secure semiconductor chips... And so you've got all these increasing demands on the infrastructure at the same time as you really haven't invested properly for potentially decades, you could say. So we think that's a really interesting space, and one that, as you then layer in the geopolitical tension and all of that, is even more enhanced.

(28:16):
And so for example, a company that we've owned for the last few years is Quanta Services. So they do the upgrading and maintenance of the transmission and electricity grid across the US. And look, they're the biggest and the best at what they do. Again, Duke Austin, fantastic CEO. They're really transforming their business into instead of having recurring business they need to win, they're becoming a systems provider to the utilities because many of the utilities actually outsource their labour forces after the GFC. Lots of them were riddled with debt, et cetera. They can't do the work internally, so they rely on players like Quanta to upgrade and maintain the grid.

(29:05):
And it's interesting, for the first time, you're seeing actually rising electricity demand, and then you're layering in a lack of investment. So these guys are exceptionally well-positioned to benefit within that critical assets thematic. And look, there's a number of other businesses that we've invested in there. Teledyne Technologies, which provides really interesting sense of technology. We had a Spanish business Applus+, which was maintaining the energy and infrastructure and regulated testing and inspection work. It actually got taken out by private equity. So I mean, we think we're not the only one realizing the uniqueness of some of these assets and the critical role that some of these companies will provide as we continually need to invest in infrastructure and maintaining those critical assets going forward.

Rory Cunningham (29:55):
Great. I said at the outset we'd covered a lot of ground, and I feel like we have covered a lot of grounds. So Catriona, if you may, just in conclusion, taking a bit of a step back for investors that are listening to this podcast, what's the one piece of advice you'd offer to them when they're trying to navigate today's markets?

Catriona Burns (30:14):
I think just stick to your process, stay disciplined. It's easy when you're seeing the market breaking through all-time highs to confuse the stock prices with fundamental value. So we try to overlay valuation with earnings growth prospects for the businesses that we invest in. We're very focused also on getting to know the management teams of the companies that run these businesses and then just understanding what you're investing in. So yeah, stick

to your process, stay disciplined, and eventually, valuation, et cetera matters. So that would be the advice I'd give.

Rory Cunningham (30:56):
Okay. And then looking forward over the next 6 to 12 months, what are the key things on the horizon that investors should be watching out for?

Catriona Burns (31:06):
We think one of the key things that the Fed is looking at and we're looking at is really what happens in labour markets. I mean, we've got interest rates starting to come down. Unemployment had been very low. We'd had a very tight employment situation in particular in the US, so that's a key area we're just looking as an indicator for the health of the economy and how... Because when people lose their jobs, that's when countries like the US, which is 70% of GDP is led by consumption, that's when that comes to the fore. If you don't have a job, you're not going to spend. So that's just a short-term data point that we're watching. We look at all the economic indicators, PMIs, retail sales, et cetera, but ultimately... So that's what we're looking at near term. I think longer-term, it's just having very strong awareness and views around what's the earnings growth potential for the businesses that we own. That's what we kind of think about on a longer-term basis. But yeah, on those shorter-term things, we're watching unemployment stats very carefully. And then what monetary policy changes occur from here?

Rory Cunningham (32:18):
Excellent. Catriona, thank you so much for joining us today.

Catriona Burns (32:21):
Thanks so much for your time.

Rory Cunningham (32:23):
And if you'd like to know more about WAM Global, please head to their website where you'll find a lot of education material. And thank you to all of our listeners for joining today, and we look forward to you tuning in next month on The Ideas Exchange.

Speaker 2 (32:36):
Visit the ASX website, ASX.com.au and register for the next Investor Day, our premier education event providing timely market insights and ideas from a range of industry experts.