Eleon Capital Management Ltd.

- MARKET OUTLOOK -

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In a recent Goldman Sachs research article, "The Concentration Conundrum", they noted how the equity markets were becoming much more concentrated at a country, sector, and stock level. Specifically, the US equity market is increasingly dominating global equity indices; the IT sector is dominant at the sector level; and the "Magnificent Seven" is becoming ever more commanding at the stock level.

The US's dominance at all three levels has largely been justified primarily because of above average: earnings growth; reinvestment rates and returns on invested capital. In addition, the authors note that generally, the growth factor has outpaced the value factor as interest rates have fallen since the Great Financial Crisis pushing up the valuation of longer-duration growth assets compared to their value counterparts. However, they note: "…that said while fundamentals have driven the ascent of the US, its equity market has also become increasingly expensive relative to the rest of the world even taking into account differences in sector weights …. nevertheless, the premium remains justified by superior rates of return on capital and profitability."

In Jeremy Grantham's article "The Great Paradox of the US Market", he highlights that the US equity market is trading at a Shiller P/E multiple of 34 which is in the top 1% of history. He notes: "As for the U.S. market in general, there has never been a sustained rally starting from a 34 Shiller P/E … Separately, there has also never been a sustained rally starting from full employment … Remember, if margins and multiples are both at record levels at the same time, it really is double counting and double jeopardy … Prices reflect near perfection yet today's world is particularly imperfect and dangerous." In addition, Aswath Damodaran notes in an interview "The Secret to Profiting from Market Volatility", that there has never been an overvalued stock in history that has remained overvalued over its life.

Generally, any investor that did not have exposure to IT-related assets and more specifically the Magnificent Seven and the AI hype that has driven their performance to date, would have had a torrid time from a relative performance perspective even if the underlying fundamentals of their investments remained sound albeit temporarily weakened by the macro-economic environment i.e. higher inflation and interest rates, waning consumer demand.

In Howard Marks' "Mastering the Market Cycle", he noted that when investor risk aversion is low, risk appetite high, liquidity high with weak underwriting standards, and valuations unjustified by fundamentals, investors should proceed with extreme caution since these are strong indicators that the market is in the high end of its cycle.

Although we are not macroeconomic investors and do not base our investment decisions on such factors, we feel that extreme caution is warranted given that what markets are expecting seems to be at odds with the situation on Main Street. Specifically, there is a higher probability that inflation may remain stickier than anticipated and that interest rates may have to remain higher for longer than what is priced in the markets.

Quality assets i.e. high returns on invested capital, reasonable long-term growth prospects, sustainable competitive advantages, reasonable debt levels, and high cash conversion bought at reasonable prices will compound adequately over time and offer protection in the event of unfavourable macroeconomic scenarios.

The increasing concentration in the equity markets is becoming a real concern. Nevertheless, it is imperative to focus on investing in quality assets bought at reasonable prices. In light of the possibility of inflation remaining higher than anticipated and interest rates staying elevated for longer, caution is critical, and investors should prepare for unfavourable macroeconomic scenarios. By investing in assets with high returns on invested capital, reasonable growth prospects, sustainable competitive advantages, reasonable debt levels, and high cash conversion, investors can safeguard their portfolios while also achieving long-term growth objectives.

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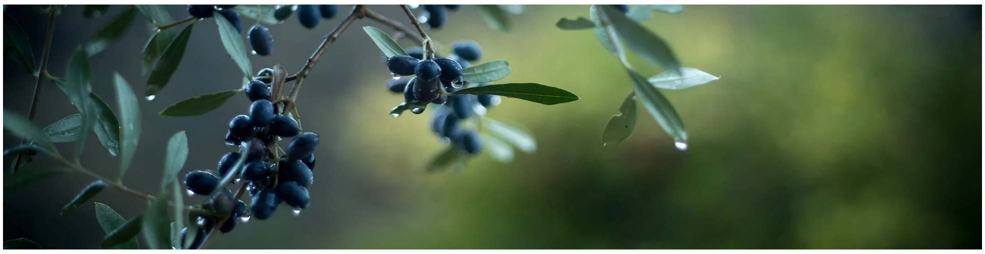

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Strong Roots, Sustainable Growth

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