

TRANSCRIPT: EPISODE 409

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[INTRODUCTION]

Staci West (SW): Welcome back to the Investing on the go podcast brought to you by FundCalibre. I'm Staci West and today I'm joined by Darius McDermott and Juliet Schooling Latter for our quarterly market insights. So, thank you both for joining me, yet again.

Darius McDermott (DM): Pleasure to be here Staci.

Juliet Schooling Latter (JSL): Hi Staci.

[INTERVIEW]

SW: Now, I really want to just start with some good news because I feel like every time that we sit down to record one of these podcasts, I start by just asking you about war and inflation and oil shock and some other impending disaster. So I want to break the cycle and let's start with something positive. What has actually gone right for investors in the past three months, and what has maybe pleasantly surprised you about markets?

JSL: Well, the first half of the year saw tech as the top-performing sector, but the past three months, tech was ousted from the top spot and replaced by commodities, which are up almost 8% in those three months. But although that was partly related to the AI trade as well as demand for sort of electrification and data centers increases. But the second-best performer over the past three months. Drum roll, please.

DM: UK smaller companies?

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JSL: UK Smaller. Yes. Well done, Darius. Gold star. UK smaller companies, finally. So that definitely counts as my pleasant surprise, having championed UK smaller companies on this podcast for what feels like forever. Although also actually UK All Companies and UK Equity Income made it into the top quartile too in the past three months.

DM: In preparation for another podcast I'm on on Tuesday, I was looking at the best and worst performing funds within the VT Chelsea Managed range that we manage. And one of the best performing things is the Raynar UK Smaller Companies fund, which is Elite Rated by FundCalibre. It's also in Chelsea's core buy list. So it's sort of nice when not only do you have the right asset class, but you have a good fund pick within it. So that's sort of up 9.5% in the last quarter. So that's very positive.

To Jules' point on commodities, I mean, when I look at what's worked and what's not worked in our funds, the energy has been a very strong contributor in the last quarter. Not touching on the negative, but the conflict in the Middle East still goes on, that's kept oil price high. And those energy securities have been very strong returners over that quarter, which I suppose you would naturally expect. The other fact about energy equities is they generally perform well in inflationary environments, whether it's an oil price inflation or just a general inflationary environment. So that is something which I think, you know, hopefully we'll have some legs to run on.

SW: And you bring us back to our regular scheduled programming, which is inflation. We have spent what feels like years waiting for inflation to just behave itself and interest rates to come down. And yet here we are, Bank of England holding rates 3.75%. Have we just reached the point where investors need to stop waiting for rates to fall and just accept that we are in this higher for longer period and we really do just mean it? And then if that is the case, what does that mean for investors' portfolios?

DM: Well, the first thing I think you have to observe is post-financial crisis to the end of COVID, that sort of 14-year period where interest rates were virtually zero or half a percent. That actually is the unusual period when you look through the longer term. Now, we all get trapped in behavioural bubbles, if you like, and you think, "Oh, three years ago, five years ago, inflation was zero." That is not the norm and is unlikely to be the norm anytime within, I think, a reasonable predictive timeframe, i.e. six, 12, 18 months.

Rates only go down when inflation goes down. And for various different reasons, inflation isn't going down at the moment. So I think, you know, although the Bank of England did hold rates at the last meeting, the expectation within the bond markets is for two increases in the next year. That may or may not happen, but that's what's priced into the bond market, I think, today.

JSL: Yes. I mean, the war has definitely had quite an impact because they were, you know, it was expected obviously that inflation and interest rates would come down, but they're now saying it's going to reach about 3.7% in the fourth quarter this year. And 4.2% next year. So it's quite a bit higher than, you know, the projected... I think in July that even they projected it to be sort of 3.2%. So it has had quite an impact.

And also obviously in the US, where they have actually raised interest rates, and the first hike since July 23. So I think sadly we just need to get used to higher inflation and higher interest rates. I mean, here in the UK, the difficulty is that, you know, inflation often increases as a result of demand, but the demand isn't really there. It's just due to the oil price. So the kind of already restrained consumer's going to be hit even further. And that may mean that sort of retail and hospitality stocks come under a bit of pressure.

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SW: And we've talked a lot about AI. Jules, you mentioned it a little bit at the beginning with commodities and their performance. And I will be the first to admit that none of us are experts on the subject. But now that the numbers being spent on AI are just so enormous, are we reaching a stage where the question changes from how big could AI become to who is actually going to make money from this spending? And are there parts of the AI trade that are just starting to make you a little bit nervous because of that?

JSL: Well, I think AI in general makes me nervous rather than excited. But yes, the CapEx being spent is eye-watering. Hyperscaler CapEx has gone from about 235 billion in 2024 to projected 700 billion plus this year. And investors have just started sort of punishing companies that can't show that that spending will increase profits sufficiently.

So, you know, early on, this was self-funded by the highly profitable hyperscalers, but more recently, obviously, it's being funded through debt, and that's the bit that worries me. I mean, if the market starts to get concerned about these levels of debt and the ability of these companies to service it, you know, that will evidently cause a market wobble.

DM: Yeah. And at some stage, the bond market may refuse to lend to the hyperscalers. I mean, you know, all those big US tech companies were hugely cash generative. As Juliet said, they spent all their free, their spare cash in the last 12, 18, 24 months, and some of them will now need to borrow. But because they're such cash earners for businesses, they're high-quality investment grade issuers.

And I know people will have heard us talk about what makes a bond. Well, it's the gilt or the US Treasury, the risk-free rate, plus the spread that you have to pay. And if a company is a very high-quality company, you don't have to pay much more to lend to them. But as that debt mountain on the balance sheets, even with good companies, they will become in themselves less high quality, and hence the spread that they will have to pay will go up.

Now, as I think you've already rightly said, none of us are experts on AI, but this is another thing that if the cost of borrowing for companies or the spread bit goes up dramatically, that in itself can be inflationary as well. So, you know, we watch the equity markets, but we also have to watch the bond market. And, you know, a number of US tech companies have had bonds and they've gone below the par rate because even when they've been oversubscribed, that future spending is such a tremendous amount of money and whatever, you know, word you want to use, that you have to be able to show you're going to make a return and be able to pay your interest.

So if the US Treasury is, let's just make some numbers up for simplicity, five, and company hyperscaler A wants to borrow, they might be able to borrow at five and a half, six. Maybe in two years' time, as that race hopefully nears the end, they might have to borrow at nine or 10.

So yeah, there's a lot going on in the AI space. I'm hopeful that the productivity gains that it can deliver will actually be good for both companies, humanity and stock markets. But as Jules says, there are a number of deeper, darker questions around the future of AI, which we won't cover on this podcast, that's for others to do.

SW: We'll leave that to the actual AI experts. And I'm gonna come back to bonds in a minute, but first, I want to come back to something that you said on our last episode, Darius, that really stuck out when I was editing it back, which is basically you could own a US fund, an Asian fund, and a global fund, and you think that your portfolio has this great element of diversification, but underneath, you've just made three different

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slightly bets on the AI story. Yeah. So how worried are you today with concentration? And because of that, where do you actually think there is genuine diversification for people who don't wanna do a big bet on AI?

DM: So the first thing to say, it wasn't that I was particularly worried, but more highlighting, you know, if you've got a global fund, as we said, an Asian fund and a US fund, you would naturally expect three different geographies, got lots of different currencies, different drivers, different consumer habits, different inflation, different interest rates, just a lot of diversification. And I think the comments we made last time were just saying, hmm, that diversification isn't what it was. And it may again be in future, but it certainly isn't today.

So if you have to look for markets that have little or no AI, it sort of brings us back a little bit nearer to home. UK and European markets have very little AI-related hyperscaler stocks. ASML in Holland being probably the biggest in Europe that is in the chip business, chip designing.

So yeah, if you're looking for areas that don't, then there are other areas like Latin America, frontier markets, they're sort of niche specialist investment areas, so they're not mainstream.

SW: You wouldn't say they're a core holding.

DM: No, I wouldn't. I wouldn't. But those are areas where you can make reasonably cohesive arguments that there are other drivers than just the AI trade powering their growth, particularly say in Frontier or Latin America, is around commodities, is around very low earning consumers just moving from very low earnings to low earnings and from low earnings to middle to low earnings. And that can have huge effects on financial services.

You know, in frontier markets and some Asian countries, they don't have landlines. Like, we only really have landlines to support Wi-Fi these days. They've sort of missed the landline revolution and gone straight to the digital revolution. And with that does come the ability for more banking and financial services as you start to earn that little bit more money. So, you know, an emerging market, Indonesian, Asian bank looks very different than JP Morgan or Lloyd's in London or, you know, UniCredit in Italy.

So yeah, Europe, UK, and then some sort of specialist non-core markets are sorts of places. And India, I've seen two Indian fund managers in the last week, so you always have that sort of recency knowledge. But, you know, India's going to use AI to benefit, improve what it does, but it isn't in the AI food chain, which is why India has done very little, if not negative numbers over two years, as people are taking money out of India to go and buy Korea where obviously those Asian tech stocks, Hynix and Samsung are based, and TSMC, obviously Taiwan, they've been hugely profitable areas and capital tends to follow performance.

JSL: Yeah. And I mean, just to put some numbers on it, just prior to doing this podcast, I was looking at something that was showing me that in the first half of this year, over 65% of returns globally came from the top 20 AI stocks. That gives you some indication of the amount of concentration there is out there. And as Darius rightly says, whilst a lot of the indices are, you know, sort of 40% plus in AI, Europe's only about 9%.

So just adding to, building on what Darius said about areas you could invest in. I mean, if you go into small and mid-cap funds where there's a low tech weighting, you're often more tied to domestic economic conditions than perhaps the AI trade. And there are some sectors that are less AI exposed, you know, such as healthcare and consumer staples, things like that, government bonds, I suppose. But obviously that has the whole inflation question mark around it, really.

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SW: Well, let's talk about bonds because equities valuations are looking elevated in parts of the market, and bonds could be looking more interesting again. They could be playing a more, you know, important part in the diversification of someone's portfolio. Do you think that that's true? Do you think that bonds are becoming more interesting in building a portfolio than they maybe have been the last few years?

JSL: Well, can we have an easier question, please, Staci?

SW: I'm afraid we started with the easy question.

JSL: So bonds are interesting because the yields have increased quite a lot. So you're being paid a reasonable income from them, which you're largely not getting from equities because they've gone up quite a lot. And traditionally, bonds are obviously used to diversify your portfolio because they would hold up in a market correction.

But, as we've discussed, we're in a rising inflation and interest rate environment. So as interest rates rise, the yields on bonds have to rise too, and hence the bond prices will fall. So with current yields, if we saw a resolution in Iran and a decline in inflation, then bonds would do well. But if inflation goes up quite a lot, bonds will get hurt, and you'd be better off being in a sort of short duration bond fund.

As a hedge against the AI trade coming unstuck, they work quite well, as long as you're not invested in the debt of those companies, of course.

DM: Yeah, and this also brings us back to that little bit I talked about, about what is an investment grade or a high yield bond that separates them from government bonds. And it is that sort of extra premium you pay or yield that you receive for lending to a company. And still in aggregate, the amount of extra you get paid for lending to an investment grade company is still what we would call tight. The spreads are tight, i.e. that compensation isn't as good as it can be historically.

Then we go back to what Juliet said, which was about actually the overall starting yield is quite high. And that is because government bond yields have been going up because of, amongst other things, the oil price and the threat of inflation, and because they're all spending too much. But it's that part of a corporate bond or a high yield bond. It's the sort of the risk-free bit where actually I think we probably see a little bit more value today.

And with a bond or a bond fund comes something called average maturity or average length of time to maturity or otherwise known as duration. And if rates go up, the more duration you carry, the worse your capital return will be. So gilt fund managers that we know are actually able to find a good pickup in yield, typically between investment grade and high yield, it's called crossover market, where actually you can get a nice yield, but actually low duration. So you're getting that yield that Juliet speaks of without taking minimal interest rate risk, because often these bonds are one and two and three years till maturity.

The other thing just to remember with a bond is all bonds pay at par, which is typically 100. So you can buy a bond and that could go from 100 to 85 or 90, but when it comes to mature in three years, you get your 100 back. So that shorter time to maturity is why there is less interest rate risk or inflation risk in those bonds. So that's where we have been finding probably the best returns and where we maybe expect the best returns.

And I will pick on a couple of funds, but there's a fund called the Jupiter Monthly Income Bond Fund, which is Elite Rated by FundCalibre, and that's given you a 4.08 return versus Artemis corporate bond, which is just investing in investment grade bonds of mixed durations, that given you a return of 2%, as has more

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global dynamic bonds. So they haven't been a great returner in the last year, and you need to watch that inflation and interest rates spike.

But so yeah, I think as we sit and record today, it's that sort of shorter duration, not high yield per se, but where you can get a nice yield pickup and take less interest rate risk is where we're finding the most value in the bond market today.

SW: And of course, we have to talk about UK equities. We have been saying that they look cheap for so long that it might be the longest running joke on this podcast now. So just briefly, are you seeing anything that makes you think that the story could change? Is there hope?

JSL: Well, as I mentioned, they've had a strong quarter, but in fact, last year, the UK oil companies sector was a top quartile performer, compared with North America, which was third quartile and managed less than 7%, which I think is something that people forget. But that doesn't really make up for the decade of neglect that UK equities have suffered.

Now the FTSE 100 trades roughly 13 times versus 22 times for the S&P. So that's a substantial discount, and the FTSE 250, which is sort of more UK domestic, is even cheaper at about 12 times. And actually, that is the cheapest it's looked in over 20 years relative to the FTSE 100. But when you look under the bonnet, the UK market is heavily weighted towards banks, miners, energy, defence, and light on this sort of high growth tech trade that's been driving US valuations.

Part of that discount is the different sector mix. But UK smaller companies, definitely still cheap. They were cheap in comparison with large caps before, and they didn't really participate in the rally last year, so that gap has widened even further. And money's been flowing out of UK small caps in the same way that the UK has been haemorrhaging billionaires, really.

You know, there's a definite question mark over the UK economy as taxes rise. And higher interest rates obviously tend to be bad for smaller companies. So if we do see inflation coming back, and hopefully a more business-friendly budget, then, you know, UK smaller companies should go.

DM: Yeah. I take Juliet's point on the relative valuation to the US looking as, you know, one of the cheapest it's ever done, but that's really, in my mind, not because the UK's done so badly, but because the US has outperformed.

That said, and this is some statistics that we get once a week from our friends at T. Rowe Price, as of Monday just gone, UK equities did 25.7% in 2025. Actually beat the S&P. Well, 10%, 10.4% year to date. 2024 was up 9.6, 7.7 in 23. And in fact, you know, UK was one of the places that did less bad in 2022.

So it's not the UK equities have done badly. They're certainly not cheap versus their own history anymore. They'd probably be on the fair value to maybe slightly expensive. But compared to more expensive markets that Juliet has highlighted, then clearly, you know, you could argue they're cheap versus the States. But the UK always trades on a big discount to the States anyway.

SW: And finally, while I would love to say that when we do our next episode, which will be our end of year recap, that everything will be calm and inflation will be under control and it will all be fine and dandy and it will be super quick and everything's going swimmingly. I'm not gonna jinx it, but I am going to finish on another positive, which is what is just one area that you are kind of most excited to watch from here where you see a lot of, a lot of potential, or maybe it's overlooked by investors?

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DM: I mean, Juliet touched on it earlier. I think commodities is a very interesting place to be invested in, in higher inflationary time. We've talked about gold and silver earlier in the year and maybe late last year when that had its spectacular run. But I think generally, the demand for commodities to power the AI revolution, whether it's data centres or robots, you know, robots aren't going to just be these creatures. They're going to need copper and battery materials like lithium and so on.

So I'm positive on commodities. And just in your summary, I think we just need to remind ourselves, we've been having a really strong bull market really for a vast number of years. 2022 was the one bad year when rates went from roughly a half to five and a half in record time. That had dislocations and made a change in environment.

But there's lots and lots of markets that are up double digits last year. And it wasn't just US for once, Europe, UK, Japan, emerging markets, another area that we've been keen on. So I'm absolutely in the positive camp and don't want to jinx it. And whilst we do have to look at winners and losers, and we tend to do that in this particular environment, markets have been very strong in recent years and long may it continue.

JSL: Oh, Darius, I was gonna say commodities too. I hate to agree with you. But, you know, they're gonna be in demand as infrastructure continues, infrastructure spend continues. So maybe infrastructure is a good play, I mean, against rising inflation, although you do have to be aware that that too is linked to the AI trade.

As Darius mentioned India earlier, I mean, that has had, you know, a rough ride for two years now because it's the wrong side of the AI trade, and it's been badly hit by the rising oil price. So if there were to be a resolution to the conflict in Iran, then, you know, I think India would certainly be the place to be. But maybe I'll be keeping a bit of healthcare in the mix as a non-AI play as well.

SW: Well, those interested in more insights on India will be pleased to know we have some India interviews coming up after this episode, so something to look forward to and a reminder to subscribe so that you get notifications when they're published. But Darius and Jules, thank you both for joining me.

JSL: Our pleasure. Thank you for having us.

DM: Thanks, Staci.

SW: And until 2027, which will be the next time we do one of these, we will recap all of the year, not just the quarter. So again, thank you for listening. And if you'd like any information on the funds or topics that we have discussed today, please do visit fundcalibre.com. And whilst you're there, don't forget to subscribe to the Investing on the Go podcast.