

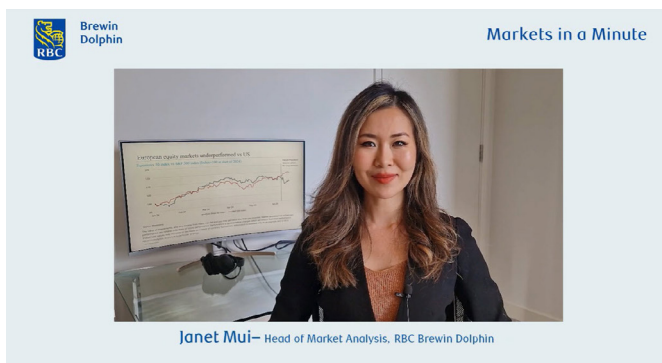
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Markets in a Minute

Janet Mui, Head of Market Analysis, discusses the mixed market response to U.S. earnings season, fresh economic data from across the globe, and the tight race between U.S. presidential candidates Donald Trump and Kamala Harris.



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A challenging week for the equity market's hottest stocks

Last week was challenging for investors, with the so-called “pain trade” hitting hard. Pain trade is a term used in financial markets to describe a scenario where the market moves in a direction that causes the maximum discomfort or losses to the largest number of market participants.

The pain trade has been building for a few weeks since the improvement in small-cap stocks. A couple of weeks ago, we described how semiconductor stocks had been hit by political pressure from both sides of the aisle – the Biden administration threatening to clamp down on companies facilitating the use of U.S. technology in the Chinese chipmaking industry, and former President Donald Trump casting doubt over the willingness of the U.S. to defend Taiwan against Chinese aggression.

Last week saw some of the biggest technology companies reporting earnings, which weren't taken well. On the face of it, with 40% of the S&P 500 having now reported, the

headlines will seem familiar: 79% of companies have exceeded analysts' estimates of their earnings. The average company has beaten earnings estimates by 4% and been rewarded by a 0.5% share price fall. The market has seen the earnings glass as half empty over the past few weeks.

As the week ended, the technical outlook for equity markets remained challenging. They fell through key support levels and have not yet fallen into oversold territory.

Beyond tech

The majority of the market's recent declines seem to relate to profit taking and sector rebalancing. Technology and associated stocks became the clear outperformers, and many sectors were left behind.

The prospect of an interest rate cut is seen as a boost to small caps, real estate, and other forgotten sectors, and investors have begun to look for less crowded ways to play the spread of artificial intelligence (AI).

Within real estate, data centres are perhaps the most obvious beneficiaries of AI, but focus has also shifted to their power needs. Utilities have staged a few rallies during 2024 as beneficiaries of the increased electricity demand from data centres. The International Energy Agency estimates electricity consumption demand for data centres could double over the next two years to 1000 TWh, the equivalent of Japan's power needs.

The current wave of technology-led returns has prompted some challenges of course, but some of these are quickly dismissed. Is this like the technology bubble of the late 90s and early noughties? No, because these companies are very profitable and seem to be on relatively sensible valuations in many cases. Challenges remain nonetheless.

Are we heading for an anticlimax?

We've all seen the incredible rise of Nvidia, with its sales doubling over the last two years - but can those sales be maintained? Inevitably, there will be a cycle of investment in demand for computing capacity. But the questions remains, how long will the current upswing last and how severe will the subsequent downswing be?

This comes down to the strength of the use case for AI. If AI is used widely and effectively in the economy, the demand will remain. Alternatively, if it proves to be more hype than reality, cloud providers may find themselves with too much computing capacity, leading to a lack of demand for new semiconductor investment.

We are quite hopeful of the potential of AI because, unlike other general-purpose technologies, there are relatively few barriers to use. The venues for many AI implementations are computing clouds, which are accessible to all. For many medium-sized companies, it's possible to develop AI applications in-house. For those without the capability, providers are deluging them with offers of service.

At the same time, the potential applications of AI seem broader than for the internet, which was essentially a communication mechanism. This seems quite different from the early days of the internet when development expertise was scarce, technology hardware was expensive, connections were slow, and not all customers were online.

Unlike previous general-purpose technologies such as rail, electricity, telecommunications, and the internet, a viable infrastructure for widespread adoption of AI already exists.

What do we know about Kamala Harris?

Another major development last week was that the Democrats were on the brink of formally confirming Vice President Kamala Harris as their U.S. presidential election candidate. Even before President Joe Biden stepped down, it was clear she would be the only viable candidate. Harris has access to existing campaign funds, which were raised for her and Biden, although funds swelled upon confirmation that Biden would no longer run.

The best guess is that she would provide a degree of continuity with the Biden administration, although the role of vice president essentially means deferring to the president's agenda, so it can serve to mask her own preferences.

Harris is considered to come from the progressive (meaning left wing) side of the party. She also hails from California, which has a poor reputation for having a high cost of living, heavy tax burden, and

burdensome regulation, while also struggling to address issues of homelessness.

Republican attacks blame her for the increase in illegal border crossings, which is perhaps unfair given this didn't fall within her area of responsibility. She also has a reputation for being prone to gaffes.

The biggest challenge Harris faces may be found in her failed attempt to run against Trump in 2020. She wasn't able to generate much enthusiasm and was fairly easily beaten in the primaries by Joe Biden. Of course, this is a competition against former President Trump rather than President Biden, who has endorsed her, so her ability to appeal to neutrals is in focus.

It will take some time for the American public to form a view on Kamala Harris. In the meantime, election forecasts, in terms of the presidency and the U.S. Congress, will be unusually uncertain.

China holds third plenum

It would be easy to overlook the Chinese Communist Party's third plenum, which took place the week before last and was reported to the public over that weekend. These party meetings are held every five years and map out the general direction of the country's long-term social and economic policies.

Understandably, the plenum ends up being a little vague. The important point is that there would be no material clarification of the role of Chinese-style modernisation, or so-called socialism with Chinese characteristics.

This essentially means continuing with the common prosperity principles that President Xi Jinping has been espousing, while recognising a greater role for markets in the economy, but confusingly, still committing to a model in which assets are state-owned or state-directed.

It's a model that must be concerning for Chinese investors because it leaves companies unclear on the extent to which profit motives should be balanced against social goals, and whether something might be socially desirable one year and less desirable the next.

If the concern is that this might lead to poor allocation of investment, then bear in mind that China's commitment to invest and build capacity in certain key industries has seen huge overcapacity in solar and is now doing the same in battery technology. It's unclear whether this strategically guided investment has resulted in the kind of technological advantage the Communist Party was aspiring towards. Many of the most efficient solar panels are built by non-Chinese companies across a range of jurisdictions. However, they have resulted in substantial declines in costs and seem to be doing the same for battery cells.

The tension here is between patient capital deployed by China and the Western model. The former works on the basis that companies can develop a strategic competitive advantage through state ownership, whereas in the Western model companies are assumed to be more nimble, motivated, and efficient if they are pursuing a profit motive.



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