Beware the Fat Man - A Global Equity Strategy

The other day, I walked into a presentation with a client who, upon seeing the title of our discussion, commented, “Yes, Trump weighs 250 pounds and is fat.” While this remark may have been an attempt at humour, it inadvertently highlighted one of today’s most polarising figures. Certainly, investors should be mindful of Donald Trump, given his propensity for volatile policy changes and their potential impact on financial markets. However, our presentation's title is inspired by Warren Buffett’s famous quote: “You don’t have to know a man’s exact weight to know if he’s fat.” Buffett’s point, which serves as a guiding principle for stock valuations, is that one doesn’t need precise calculations to discern whether the stock market is expensive or cheap.

Buffett’s insight aptly describes our current perspective on the U.S. stock market. Regardless of the valuation method, assumptions about growth, or projections for interest rates, it is clear that U.S. stocks are trading at historically high valuation levels. Therefore, on a balance of probabilities, thereturns from U.S. stocks over the medium—to long-term will likely be muted. Investors need to face the reality of this situation and assess different investment strategies they can utilise to navigate this environment.

The Good

Several factors support the case for continued optimism in the U.S. stock market. The overall U.S. inflation trajectory is gradually retreating toward target levels, which bodes well for economic stability. Economists anticipate a few interest rate cuts next year, albeit not to the extent expected a few months ago. This is creating a favourable background for consumer spending and company valuations. Moreover, the U.S. economy remains robust, with low unemployment and corporates reporting robust growth in aggregate. From a political perspective, the Republican clean sweep in the recent elections has given President Trump the latitude to implement his pro-growth agenda, almost unrestrained. He has also surrounded himself with a team whose calibre, skillset and wealth are probably unmatched. The term “Trumpaphoria” aptly captures the euphoric sentiment surrounding his re-election victory, fuelled by promises of low taxes, reduced energy costs, minimal regulatory burdens, and an America-first manufacturing strategy.

As Trump recently remarked, "Starting in January, we will give our companies the lowest taxes, the lowest energy costs, the lowest regulatory burdens, and free access to the best and biggest market anywhere on the planet…but only if they make their products right here in America." Peter Thiel once noted, "Trump should be taken seriously, but not literally." This sentiment underscores theimportance of discerning the tangible impacts of President Trump's rhetoric from the hyperbole.

Elon Musk's appointment to lead the new administration's Department of Government Efficiency may significantly reduce a bloated bureaucracy where, would you believe it, 7% of the population is employed at either a state or federal level.

The Bad

Nevertheless, there are significant risks that could derail the stock market's performance. Tariffs, a hallmark of Trump's trade policy, may have an inflationary effect and risk sparking retaliatory measures that could disrupt global supply chains. Geopolitical tensions remain heightened, posing a persistent threat to market stability.

U.S. tax cuts, while pro-growth in the short term, could exacerbate the U.S. debt burden, which has now surpassed $33 trillion. The government's interest bill is poised to reach unprecedented levels as maturing debt necessitates refinancing at higher rates. Meanwhile, the stock market's valuation already factors in over 10% p.a. earnings growth for 2025 and 2026, leaving little room for error or disappointment. Additionally, Elon Musk's aggressive cost-cutting measures, while potentially streamlining bureaucracy, could lead to increased unemployment. In the tech sector, spending on cloud and AI has reached cyclical highs, and early signs of inefficient capital allocation are emerging. Finally, the long-avoided recession looms as a potential outcome of these converging risks.

The Ugly

Our most pressing concern is the elevated valuation of U.S. equities, particularly in the technology sector and stocks with a high-quality factor. These areas are especially vulnerable to a significant correction or an extended period of subdued returns. Warren Buffett wisely noted, "You don't have to know a man's exact weight to know if he's fat." This quip underscores the U.S. stock market's current overvaluation state.

The Strategy

History provides valuable lessons in times of uncertainty. From the Asian and Russian crises in the late nineties to the dot-com bubble, the global financial crisis, and the covid 19 pandemic, stock markets have always faced periods of turbulence. There is nothing novel about the current environment. We also know that there is strong empirical evidence demonstrating that it is impossible to time the market consistently. Compounding this dilemma is the fact that the days with the highest returns also often occur during the worst times.

After considering all of the above, we believe a defensive posture is prudent for global equity investors. Raising some liquidity and reassessing other ideas in theinvestment toolbox will provide investors with mental comfort and flexibility in the event of financial market duress.

Safe-haven currencies like the Japanese yen and Swiss franc should offer stability. Debt instruments may also come into play again after sub-par returns for a significant period. Despite its stellar run, gold looks interesting, as its role as a sovereign asset class has permanently been enhanced following the Russian invasion of Ukraine and the subsequent freezing of Russian financial assets held in Western jurisdictions. There will always be opportunities in stocks with a structural earnings growth profile. The biotechnology sector could fit this bill as it is a sector that will benefit from artificial intelligence (AI) as drug discovery, trialling and approval periods are condensed in terms of time and cost. Value shares and emerging markets have underperformed for an extended period, and this cannot continue indefinitely. Mean reversion is a powerful force in financial markets. Potentially, the Trump administration’s drive to reduce regulation will herald a period of continued prosperity for U.S. banks. Tactical trading opportunities will also present themselves across the spectrum of asset classes. The search for the next generation of long-term AI software winners warrants exploration as they have not yet revealed themselves. Remember that many recent technology stock winners only started after the dot-com era.

Finally, investors must be patient, maintain a disciplined approach to weather the challenges ahead, and position themselves to capitalise on future opportunities. Beware the fat man.

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