Amplia Monthly Investor Letter

Increasing Entropy

In the Early Middle Ages, the Anglo-Saxons called the full moon of October the "Winterfylleth," marking the beginning of winter. Observing the cooling tone of the markets since mid-October's full moon, we hope financial markets have not turned to winter.

The comfortable autumn lull of rising stocks and decreasing interest rates came to a halt, reminiscent of the butterfly effect in chaos theory, when strong U.S. retail sales data for August forced rates to bottom, creating a "three black crows" pattern in the 10-year Treasury bond with three consecutive days of lower highs and lower lows.

The month ended negatively for equities in Europe and emerging markets, and bonds across Europe and the U.S. also saw declines.

31.10.2024				
Equities	Currency	Return mtd (eur)	Return ytd (eur)	Return 12m (eur)
World	USD	0,3 %	18,2 %	35,6 %
Emerging Markets	USD	-2,2 %	13,3 %	27,1 %
US	USD	1,4 %	22,3 %	39,4 %
EU	EUR	-3,3 %	8,1 %	19,7 %
UK	GBP	-2,8 %	11,2 %	18,2 %
Japan	JPY	-0,4 %	11,3 %	20,9 %
South-Korea	KRW	-3,5 %	-8,3 %	8,1 %
China	USD	-2,3 %	17,5 %	16,6 %

Bonds	Currency	Return mtd (eur)	Return ytd (eur)	Return 12m (eur)
Euro Government	EUR	-0,9 %	1,1 %	7,8 %
US government	USD	-0,1 %	2,8 %	10,0 %
Europe IG	EUR	-0,4 %	3,0 %	8,7 %
US IG	EUR	-3,2 %	0,5 %	12,9 %
EU HY	EUR	0,6 %	6,9 %	13,1 %
US HY	EUR	-0,7 %	5,9 %	14,4 %

Equity and bond returns. Source: Bloomberg, Amplia.

Stirring the pot were renewed concerns about the adequacy of China's stimulus package to contain its looming real estate sector crisis, as well as potential inflationary pressures from a possible Republican sweep in the U.S. election.

Market uncertainty was further heightened by upcoming earnings reports from six of the "Magnificent 7" companies in the S&P 500, which comprise around 30% of total market capitalization. These reports would significantly influence price behavior due to their size in the index, on top of which they also present a litmus test for the hypothesis of a productivity leap fueled by technology.

Inflationary Risks

Inflation expectations in Europe have risen over recent weeks, though markets seem to have paid little attention, focusing instead on the U.S. economy.

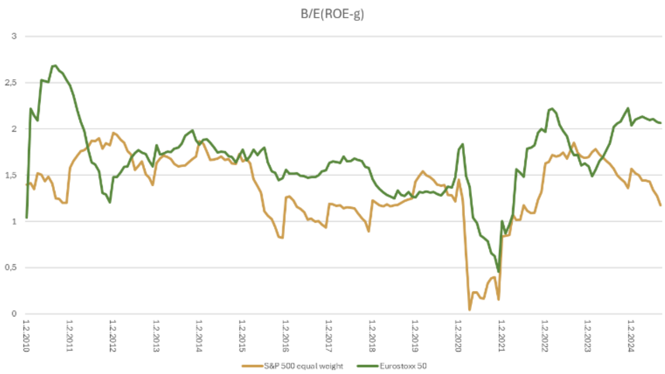
The Federal Reserve appears to have managed to soft land the economy without killing the cycle, something which central banks seldom succeed in.

The U.S. labor market has cooled compared to recent highs, but historically speaking, it remains stretched. Job openings have come down from their post-pandemic peak but are still high in a historical perspective. Continuing jobless claims are at levels consistent with peak cycle.

In a scenario where Republicans win both Congress and the presidency, a reduction in immigration could tighten the labor market further, creating conditions for wage inflation. Wage inflation, akin to the economic "LDL cholesterol," is difficult for the central bank to combat. Adding anticipated tariffs and trade barriers, the inflation picture appears even bleaker, with a Republican sweep increasing the likelihood of nominal interest rates moving upward.

Valuations Reflect a Soft Landing

Stock market valuations require a distinction between the "Magnificent 7" and the broader market. We therefore choose to illustrate U.S. valuations through the equally weighted index, which slightly distorts sector breakdown but sheds more light on general valuation levels.



European vs. U.S. equity valuations. Source: Amplia, Bloomberg.

The Eurostoxx 50 index appears expensive compared to historical norms, reflecting expectations for continued (albeit sluggish) growth alongside lower rates.
In the U.S., the Magnificent 7-neutral index looks more affordable. The main risk to current market pricing is a *low-growth, high-inflation* outcome, which would increase capital costs while reducing corporate pricing power and margins.

Sentiment is Exposed to Surprises

Sentiment, as an abstraction of market vigor, is like a moody spouse. The same price pattern can be perceived as *over-bought* or *good momentum* — a half-full or half-empty glass.

Equity markets have frequently hit all-time highs this autumn, maintaining an "all news is good news" environment. This leaves markets exposed to sudden sentiment shifts, where a small shock can spike volatility and change the climate abruptly. At the time of writing, implied volatilities are up 2–3 points, and markets are correcting accordingly. While unsettling, this could clear the air, like a thunderstorm's cathartic release.

Our Current Asset Allocation

Risky assets tend to outperform over time, despite underperforming during stress. Timing micro-crises is futile, increasing transaction costs and tax consequences. By identifying "known unknowns" that could rebase market levels and preparing an action plan for these, we can mitigate the most adverse outcomes in the return distribution.

We move to a semi-strategic overweight in equities while staying vigilant regarding catalysts we've identified that could trigger further risk. In the current macro environment, with risks to growth and the anticipated extended cycle, we favour defensive sectors likely to outperform in a negative market environment, still rising during up-markets. We also favour interestrate-sensitive sectors that might benefit from a poor growth-induced environment with lower real rates.

Equities and real estate are considered real assets in terms of inflation sensitivity, although equities tend to underperform during the initial phase of an inflationary shock. We therefore increase our exposure to the real estate sector in the U.S. and to global utilities (with a 60% weighting to the U.S.). These sectors should be somewhat protected from U.S. government isolationist measures.

As we expect Europe's growth to remain weak, and export-sensitive companies to be vulnerable to potential protectionism, we slightly reduce our exposure to Nordic companies.

In fixed income, we still favour investment-grade over high-yield bonds and prefer long maturities over short ones for diversification, conditional on global growth cooling.

On 1st November 2024

Yours sincerely

Mikael Simonsen