FLAGSHIP
ASSET MANAGEMENT

Quarterly Telescope Q4 2024

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01

We are a global specialist investment boutique

Flagship is a specialist global asset manager founded in 2001.

We are 100% independent and fully owned by staff and directors.

Our mission is to be the navigators and global authority of your complete investment future, wherever it may lead.

02

We manage global portfolios in three distinct strategies

Global Flexible | Global Fund of Funds | Global Equity

We believe in a focused approach to fund management

Our longest running Funds have track records spanning over two decades

03

We are long term investors who manage diversified portfolios

We use a dynamic investment strategy and active risk management to build robust, diversified equity portfolios.

Our unconstrained approach allows us to navigate diverse market conditions and identify opportunities wherever they arise.

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The Flagship Global Investment Team

Philip Short BSc (Maths), CFA

Philip is a fund manager of the global funds at Flagship and brings specialist macroeconomic expertise to the global team. Philip has gained 20 years' experience in the industry at JP Morgan, Fairtree Capital and Old Mutual as an analyst and portfolio manager. He completed his Bachelor of Science in Mathematics at the University of Pretoria and is a CFA charter holder.

James Hayward BEng (Civil), CFA

JD is a fund manager of the global funds at Flagship, having joined in 2021 as an equity analyst. At the completion of his degree, JD worked in the engineering and fintech start-up industries while pursuing further studies in investments. JD holds an Engineering degree from Stellenbosch University and is a CFA charter holder.

Paul Floquet CA (SA), CFA

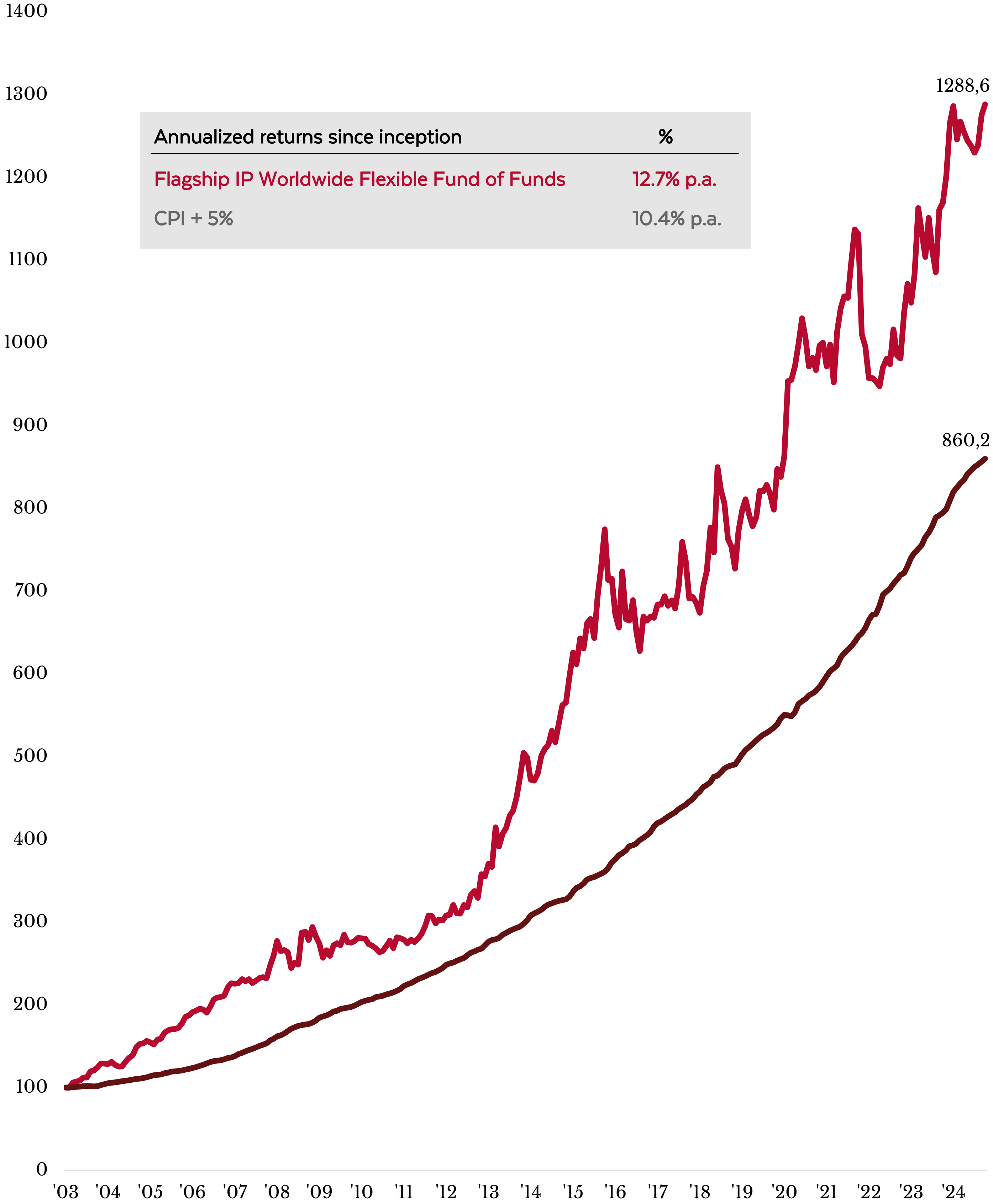
Paul is a fund manager of the global flexible strategies at Flagship, as well as portfolio manager of the Flagship IP Balanced Fund. He qualified as a chartered accountant in 1995 with Deloitte and Touche and gained international investment experience with JP Morgan and Merrill Lynch. He became a portfolio manager and director at Flagship in 2004. Paul is a CFA charter holder.

The Power of Long-term Compounding

The **Flagship IP Worldwide Flexible Fund of Funds** (net of all fees) vs. SA CPI +5%

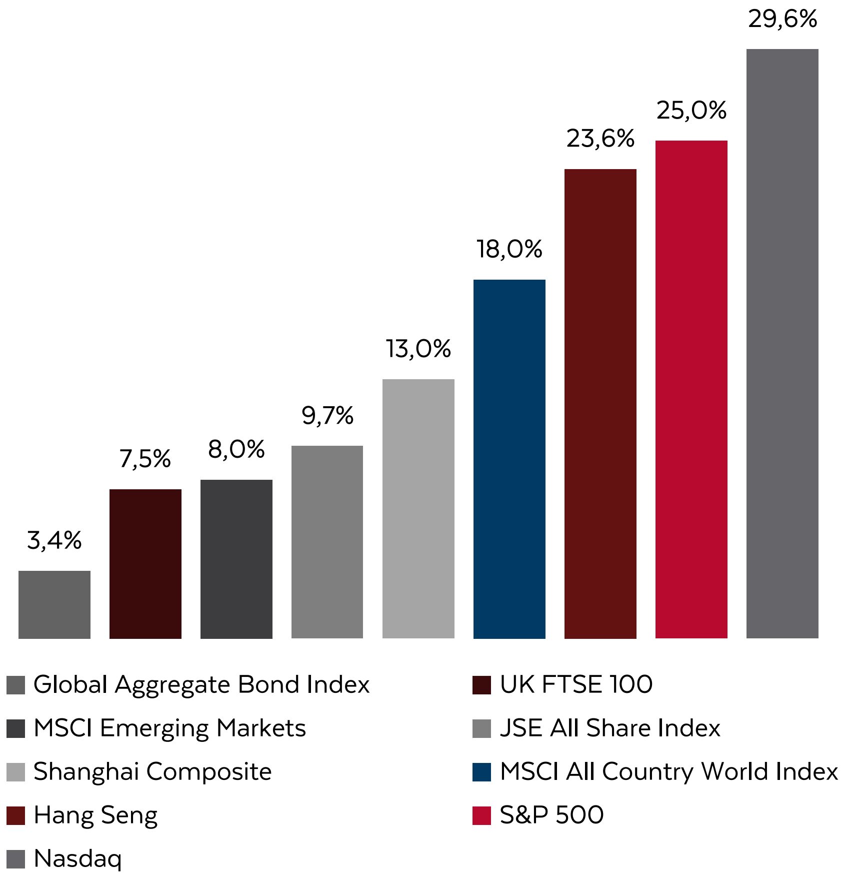
from 3 April 2003 to 31 December 2024 (21 years, 9 months)

Annualized returns since inception	%
Flagship IP Worldwide Flexible Fund of Funds	12.7% p.a.
CPI + 5%	10.4% p.a.



Global Market Commentary

Chart 1: YTD Global Index returns in USD (December 31, 2023 to December 31, 2024)



After most global equity markets had an exceptionally strong year in 2023, they went and did it again in 2024. For the US benchmark S&P 500 this was, in fact, the best two-year stretch in a quarter century, setting 57 new all-time highs during 2024 alone. The last time the S&P delivered two consecutive years of 20%+ returns, was all the way back in 1997 and 1998 – in the lead up to the dot.com crash.

There were several reasons that led to the strong performance, primarily, inflation in the US easing to around 3%. This led to the Fed having enough confidence to embark on their rate cutting cycle. Completing the Goldilocks scenario was the resilience of the job market, which didn't budge under the sustained period of higher rates, as some feared it would. It seemed that the fed truly pulled a rabbit out of the hat. This led to the S&P gaining 25% for the year, while the Nasdaq, whose technology stocks benefit from lower borrowing costs, rallied a mighty 29.6% for the year.

It seemed that the fed truly pulled a rabbit out of the hat.

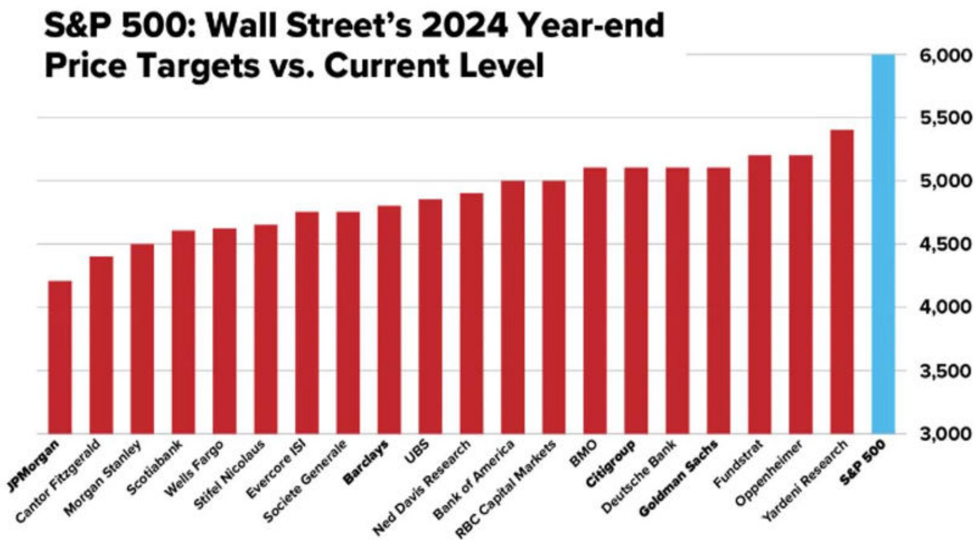
Across the pond, performance of the UK's FTSE 100 was much more subdued at 7.5%. Performance in the East was fairly strong, with the Hang Seng returning 23.6%. It is worth mentioning Japan's Nikkei 225 which also had a strong year when measured in the local Yen, gaining 21.2%. However, the weakness of the Yen vs the dollar eroded much of these gains, resulting in a more muted 8.7% return in USD. Looking at the local market, the JSE All Share Index retuned 9.7% for the year in USD, with a more respectable 13.5% in Rands.

Looking at the US specifically, there are a few noteworthy aspects to consider regarding performance over the past year. Front and centre would be the quantum of how wrong leading global banks and research institutions were in their predictions. Yardeni Research, which had the most aggressive year-end target for the S&P 500 at just below 5500, was out by more than 10% - which is already a lot, given that this is the world's best known and most widely followed index – while JP Morgan, with a year-end estimate of 4250, undershot by a mammoth 40%.

We believe there are some clear lessons here:

- Markets are unpredictable,
- Animal-spirits and behavioural finance are powerful market drivers
- Trends can go on for much longer than market participants expect them to.

In fact, after the rally in 2023, the average forecast of 40 strategists polled by Reuters was for the market to close out 2024 at around 5100 – which represented a gain of just over 2% for the entire year. This level was surpassed by late January 2024.



So, what are these analysts predicting for 2025? More of the same, it seems.

So, what are these analysts predicting for 2025? More of the same, it seems. While most expected some doom and gloom in 2024, they are now expecting markets to continue running in 2025, mostly on the back of strong US earnings, and a pro-business environment enabled by the incoming Trump administration. Yardeni Research is again the most bullish, calling for a year end level of 7000, a roughly 20% increase from current levels. If they are correct, it will truly be an amazing three year stretch of performance for equity markets. Most forecasts, however, including Morgan Stanley, Goldman Sachs and Bank of America, are slightly more subdued, calling for a year end level of about 6500. This would be a rise of about 10% from current levels, still nothing to be scoffed at, and in line with the historical average return of the market.

Another aspect to consider is that, as in 2023, the market was once again propelled forward by a handful of stocks, with the lack of market breadth concerning. These stocks, all with a market cap of more than $1 trillion, are now referred to as the BATMMAAN stocks. (Broadcom, Apple, Tesla, Meta, Microsoft, Alphabet, Amazon, Nvidia).

What is truly astonishing is that between these 8 stocks, they added $6.2 trillion in market cap during the year. The collective rest of the S&P 500, let's call it the S&P 492, added only $3.6 trillion in market cap. These 8 stocks now account for 12% of the S&P's revenue, 26% of its earnings, and a massive 34% of its market cap.

What We're All Discussing at Dinner

"In politics, stupidity is not a handicap."

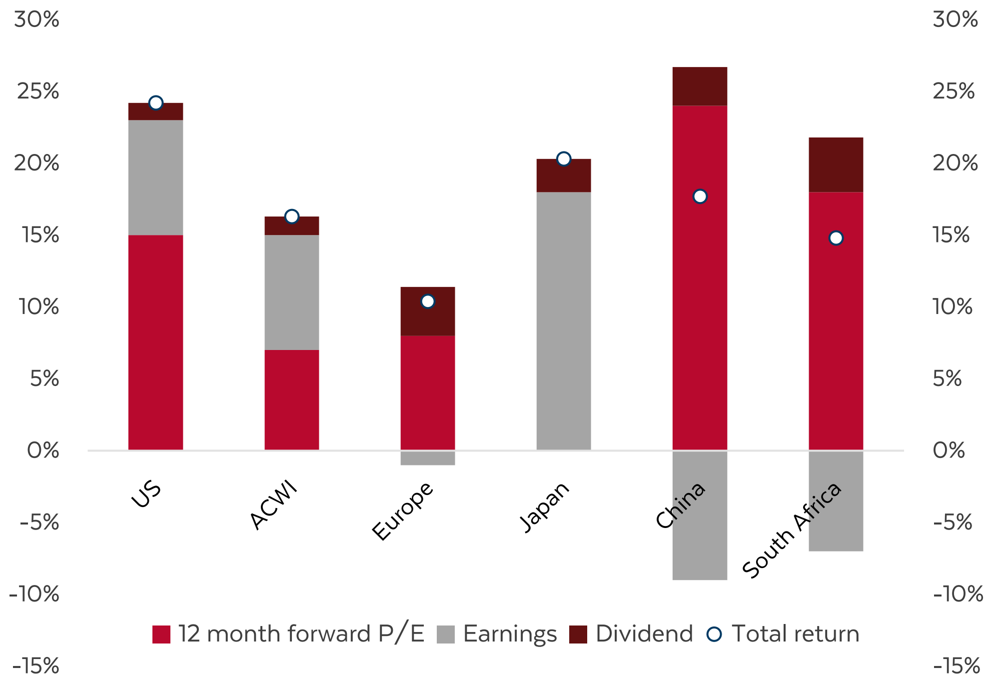
- Napoleon Bonaparte

The final quarter of 2024 was marked by heightened volatility, significant developments in global financial markets and geopolitics.

Financial markets

Looking at equities, the S&P 500 ended the year with a spectacular return of 25%, outperforming ACWI (All Country World Index), Europe, Japan, China, and South Africa, to name a few.

Chart 2: Select Indices return contribution in local currency (YTD 2024)

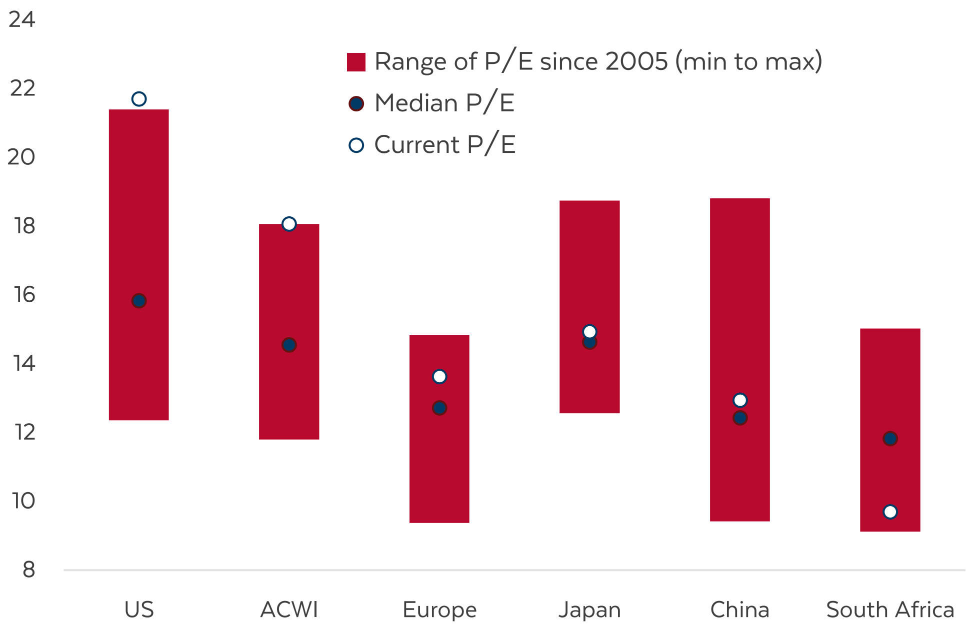


It's worth noting that 60% of the S&P 500's returns have come from a re-rating.

There are three components that contribute to an indices return, being a multiple re-rating (as measured by the 12-month forward PE level), earnings growth and dividends.

It's worth noting that 60% of the S&P 500's returns have come from a re-rating, with the remaining 38% and 2% coming from earnings growth and dividends, respectively. Japan's returns have come almost entirely from earnings. Europe, China and South Africa had negative earnings attribution at an index level and returns were almost exclusively driven by re-ratings with the rest coming in the form of dividends.

Chart 3: 12-month Forward PE for select regions (range from Dec 2005 to Dec 2024)



*Note: Range for the minimum to maximum P/E uses the 10th-90th percentile to exclude outliers.

The re-ratings in the S&P 500 (used as a proxy for the US) and ACWI have led to very punchy valuations relative to their own history, as well as to other geographies. In the chart above, one can see that the S&P 500 is currently trading on a 12-month forward PE of 21.7x. The range in which the forward PE has traded since 2005 is between 12.4x and 21.4x*. The median PE since 2005 is 15.8x. That means that the current PE is 37% higher than the median PE over the last 20 years.

The risk is that expected earnings do not materialize in 2025 and because of that, the S&P 500 has a de-rating, which will lead to a down year for the S&P 500.

Given the expensive multiple that the S&P 500 currently trades at, one should expect future returns to be driven by earnings growth, if they materialize, and not from a further re-rating. Indeed, the risk is that expected earnings do not materialize in 2025 and because of that, the S&P 500 has a de-rating, which will lead to a down year for the S&P 500. As of January 2025, consensus' bottom-up estimates expect the S&P 500 to grow earnings per share by 13% in 2025.

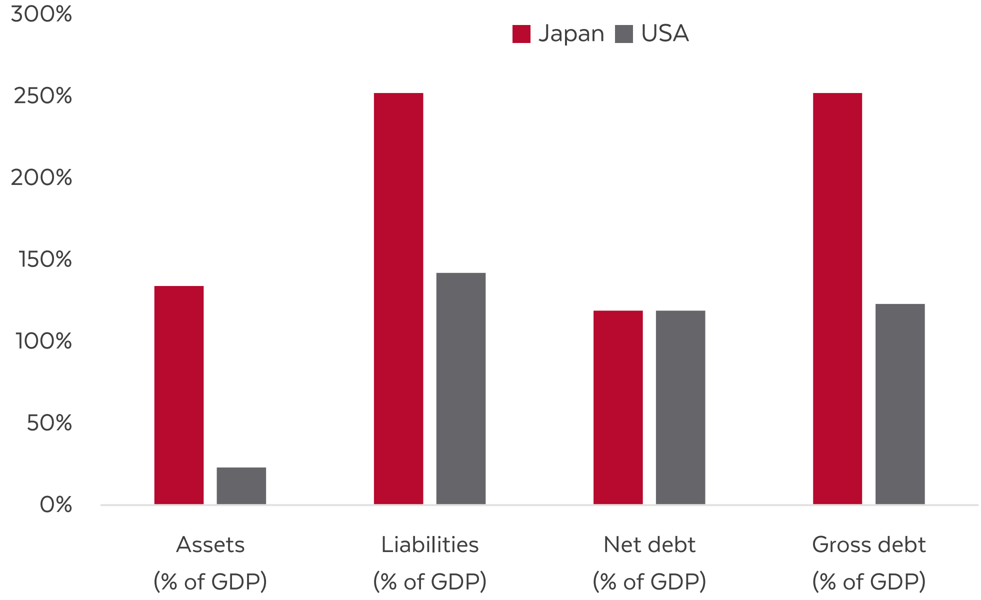
China and South Africa's forward PEs are also currently trading near to, or below, their long-term median, but in 2024, both had negative earnings growth at an index level.

In 2024, Japan's returns were driven entirely by earnings with the current forward PE trading close to its long-term median. We like this combination of strong earnings growth and a multiple that is fair relative to its own history, and relative to other geographies.

Japan is one of the few countries that is seeing its central bank increasing interest rates, albeit at a very slow pace. Contrary to most countries, Japanese households are net savers, while Japanese corporates sit on cash and have conservative balance sheets. Consequently, increasing rates should benefit both consumers and corporates, as they earn a higher interest income on their positive cash balances. Although the Japanese government has an eye-watering 252% debt to GDP, one must also consider the asset side of the government's balance sheet. If one looks at the net debt to GDP, which incorporates assets, then Japan has a net debt to GDP of 119%. While still a bit on the high side, this is comparable to the US.

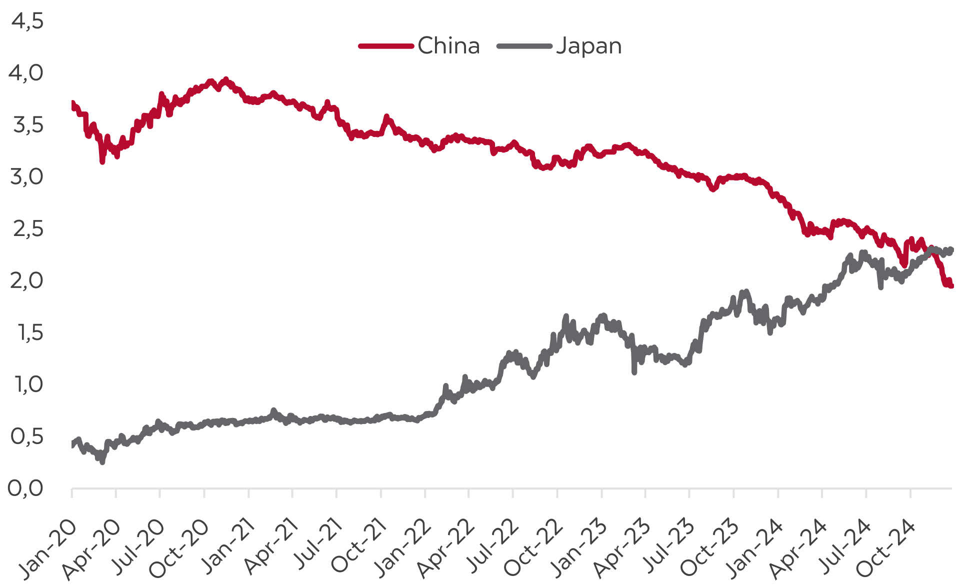
Gold was a standout performer, with a return of 28% in US Dollars for 2024, beating even the S&P 500.

Chart 4: Asset, liabilities and debt to GDP for Japan and the US (June 2024)



In the world of fixed income, US 10-year bonds had a negative return for 2024, with yields going up from 3.9% to 4.5% (bond yields move inversely to their price). Interestingly, in the east, the development of Chinese long-term bonds saw the 10-year yield finishing the year at 1.6%, having started at 2.6%. This, versus Japan 10-year yield going from 0.6% at the start of the year to 1.1% by the end of December. Indeed, their respective 30-year bonds have crossed with China's yield now below Japan's. This is a cause for concern when looking at China.

Chart 5: 30-year bond yields of China and Japan (from Jan 2020 to Dec 2024)



Since September, the Chinese government has announced a string of stimulus measures to revive the country's slowing economy. The Chinese stock market rallied sharply on stimulus news, only for it to fade back to lower levels. While the tone of Xi Jinping was encouraging, aggressive even, in trying to boost sentiment, the absence of concrete details left the financial markets undecided. Bond markets can sometimes offer insightful clues into the underlying health of an economy. China's current bond market is telling us that investors are concerned about a lack of demand in the economy (a weak consumer) and that there are concerns around deflation.

Gold was a standout performer, with a return of 28% in US Dollars for 2024, beating even the S&P 500. Our long-held view is that gold became an important asset ever since the US and its Western allies froze Russia's $300bn foreign reserves, shortly after Russia invaded Ukraine in Q1 '22. That move by the US sent a very important message to global central banks and global investors alike: your risk-free money, such as US bonds, does not necessarily come without risk, as we (the US) can choose not to repay you. If US bonds are not 100% risk-free, what is? Gold.

Geopolitics

During the quarter, the Russia-Ukraine conflict escalated, with the US now providing advanced air defence systems and precision rockets, allowing Ukraine a more advanced counter-offence strategy. US-China tensions intensified, with new trade restrictions on semiconductors and rare earth minerals, further fragmenting global supply chains. In the Middle East, geopolitical instability persisted. Interestingly, oil ended the year pretty much where it started, albeit with a lot of volatility in between. Why then has oil not shot higher with the increased tensions in the Middle East and Russia?

Some suggest that underlying global oil demand, (or specifically China, which is the largest single buyer of oil), is lower than what global GDP growth is suggesting. Or, that actual supply of the black gold is higher than what official data tells us, with some OPEC+ members not sticking to their agreed quotas. Either way, we have noted with interest that the incoming US Treasury Secretary under President-elect Trump, Scott Bessent, plans to increase US energy production to the equivalent of an additional 3 million barrels of oil per day. The world produces approximately 100 million barrels of oil per day. In this context, 3 million might not sound like much, but when you have a finely balanced demand and supply market, that additional 3 million barrels can make a difference to oil prices, and to inflation.

Elections had a cracker of a year; 2024 was the biggest election year in human history. Half of the world's population – some 3.7 billion people – had the opportunity to go to the polls in 72 countries (source: United Nations). While we go into further detail later in this Telescope, some key political headlines this past year include Javier Milei in Argentina signalling the drastic measures that can be achieved in a short space of time, right-wing parties gaining support in France and Germany, and of course, Donald Trump in the US.

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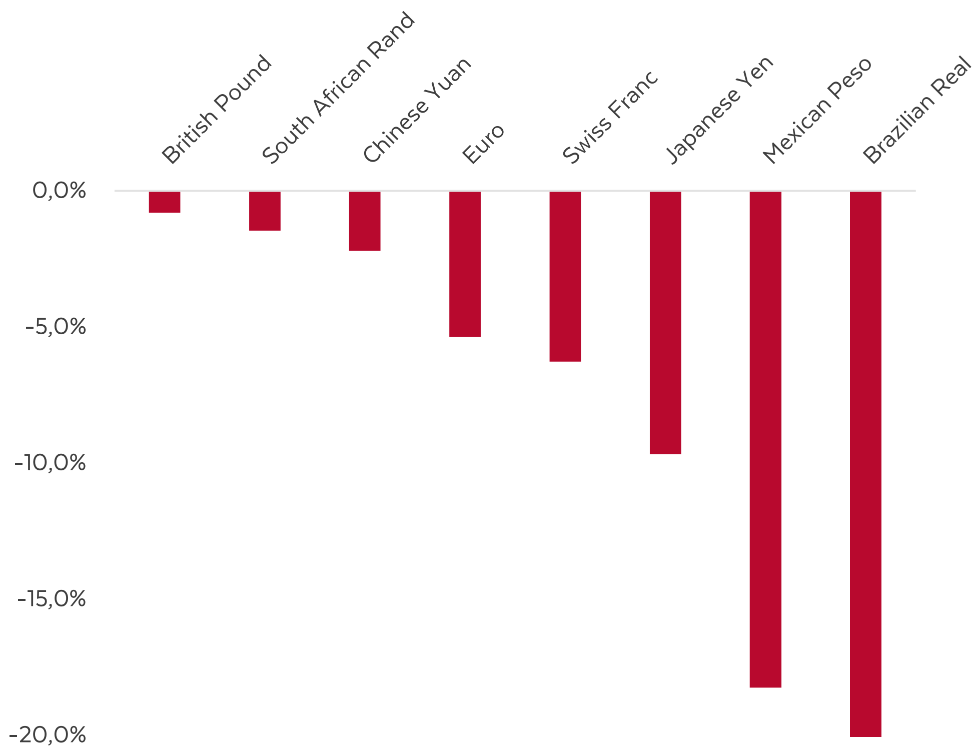
Donald Trump as a subject matter can take up at least two Telescopes worth of content on its own and we will surely have much more to write about him in 2025. He will undoubtedly influence the Russia/Ukraine war and the Middle East; rhetoric will escalate on China as well as Canada and Mexico, and it probably won't end with tariffs. In his US election campaign, Trump promised to bring government spending down, although he has already pushed for the current congress to do away with the US' debt ceiling.

We think it is dangerous to position portfolios ex ante of a president-elect assuming office, of any country, but especially the US. Firstly, what politicians say they're going to do and what they actually do, are two different things. Secondly, there are too many unknowns that are as equally unpredictable. For example, if the US applies tariffs on China, do Chinese companies cut their prices to mitigate the effective price increases that tariffs create, or does the Chinese government depreciate its Yuan to (partially) counter any increase in tariffs which are paid in US Dollars?

In our macro analysis, we spend our time thinking about the different potential outcomes, so that when any of the scenarios ultimately materialise, we have applied our minds to how asset classes will behave and can then position the portfolios in a timely and thoughtful manner.

The last indicator worth mentioning is the US Dollar, which had a roaring year. During 2024, some questioned the USD's role as the world's leading reserve currency, with a BRICS+ currency being touted as an alternative reserve currency. Someday, there might be other currencies used as reference points in cross-border transactions, but it is difficult to picture a world without a USD. US exceptionalism was on display in 2024 in the form of AI, datacentres, semiconductor design, and quantum computing. If you are leading the world in innovation, you will have a big seat at the world's trade table.

Chart 6: Select currency performance versus the US Dollar (YTD 2024)



Since the end of Q1 '24, Flagship's flexible funds have been positioned strongly in favour of equities and, within equities, towards US equities.

Since the end of Q1 '24, Flagship's flexible funds have been positioned strongly in favour of equities and, within equities, towards US equities. We have had zero exposure to bonds since the start of the second half of the year. Our top-down view sees the US market as very expensive, although there are numerous attractive single-stock names. We are beginning to see more equity opportunities in Japan, where valuations are more reasonable, and the economy is faring well. If the Bank of Japan can manage expectations with its interest rate hike path, it should provide a large enough window for any carry-trades to unwind, without affecting markets negatively. We continue to hold gold bullion, as the asset class enjoys true risk-free status, albeit without earning an income. The traditional reasons that make gold attractive, such as lower or negative real rates, a store of value, a safe haven, and fiat currency devaluation, all still hold, and are likely acting as a secondary driver of returns.

Strategy Performance

The performance of the Flagship strategies over Q4 '24 and 1 year to 31 December 2024, net of fees, is shown below:

Fund of Funds Strategy	Q4 '24	%Δ 1YR
Flagship IP Worldwide Flexible Fund of Funds (ZAR)	4.7%	10.2%
Flexible Strategy	**Q4 '24**	**%Δ 1YR**
Flagship International Flexible Fund (USD)	-1.8%	3.6%
Flagship IP Worldwide Flexible Fund (ZAR)	12.3%	15.7%
Global Equity Strategy	**Q4 '24**	**%Δ 1YR**
Flagship Global Icon Fund (USD)	4.5%	12.9%
Flagship IP Global Icon Feeder Fund (ZAR)	14.3%	15.5%

Currency moves again had a large impact on performance as the ZAR weakened vs the USD both during the quarter and over the course of the year. However, the effect during the quarter was much more pronounced, as the ZAR gave up 9% against the USD while only weakening by 2.6% over the course of 2024.

Flagship's global strategies delivered relatively satisfactory performance during the 4th quarter. While the Fund of Funds slightly underperformed our other strategies on a relative basis, the performance of the Worldwide Flexible Fund and the Global Icon Fund were pleasing.

The Fund of Funds strategy outperformed its CPI+5% benchmark by 3.5% in the quarter, delivering 10.2% for the year vs its benchmark, which returned 8.2%. The top absolute performer during the quarter was the Artisan Global Discovery Fund, but due to a larger average position size, the top contributor to the fund's return was the Guinness Global Innovators Fund, which delivered just below 8% for the quarter. For the full year, the fund's top contributors were GQG Partners Global Equity Fund, Guinness Global Innovators Fund, and fund's gold bullion position which appreciated by 27%.

The Flagship IP Worldwide Flexible Fund delivered a strong performance during the 4th quarter, returning 12.3% (vs its benchmark of 3.3%), outperforming the MSCI ACWI and reporting a strong 15.7% for the year.

The ZAR denominated Flagship IP Worldwide Flexible Fund delivered a strong performance during the 4th quarter, returning 12.3% (vs its benchmark of 3.3%), outperforming the MSCI ACWI and reporting a strong 15.7% for the year (vs its benchmark of 12.5%). This was achieved both through stock selection and asset allocation, given that the fund was 90%+ invested in equities throughout the quarter. The standout performers and detractors for the Worldwide Flexible strategy were largely the same as for the Global Equity strategy, which follow.

The Global Equity strategy also delivered a very strong performance during the quarter, returning 4.5% in USD (14.3% in ZAR), outperforming its MSCI ACWI benchmark, which declined by 1.0% in USD (+8.2% in ZAR) during the quarter. Over the course of the year, the fund returned 12.9% in USD (15.5% in ZAR). It is worth noting that this strategy delivered stronger performance during the second half of the year. The biggest contributor to performance for both the flexible and the equity strategies during the quarter was Applovin, which appreciated by an enormous 148%. There were, additionally, several other strong performers, with Royal Caribbean Cruises, Broadcom, Netflix, GoDaddy, Rush Street Interactive and EQT Corporation all returning north of 25%.

Voters Turn Their Back on the Economic Status Quo

By Philip Short

In 2024, every governing party in major developed countries that held elections lost the vote, the first time this has ever happened.

⇒ 2024 was the biggest election year in human history. Half of the world's population, some 3.7 billion people, had the opportunity to go to the polls in 72 countries.

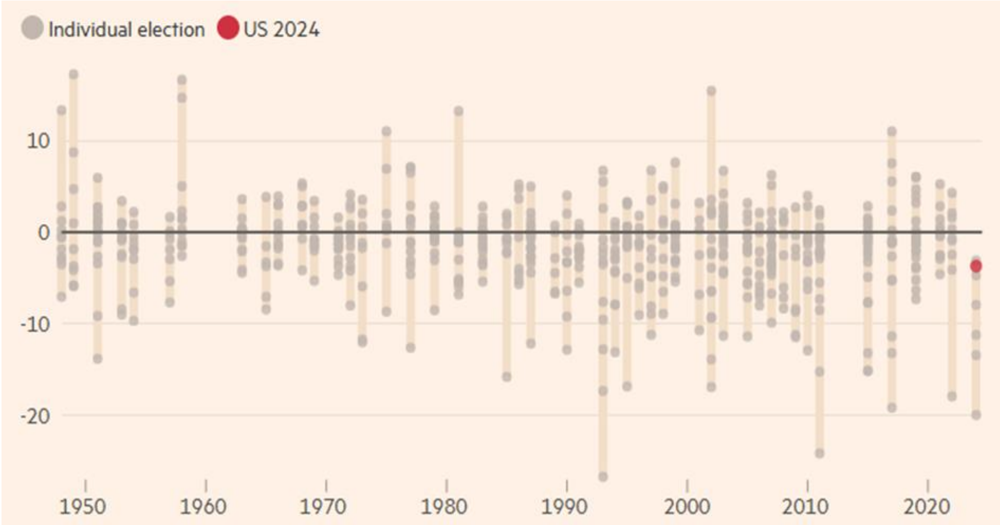
⇒ Every governing party in major developed countries that held elections lost the vote, a singular event in over a century.

⇒ The 2024 election results across the developed and much of the developing world show the impact of inflation and economic hardships on voters' perceptions of government competence.

In 2024, the world witnessed a remarkable occurrence; every governing party in major developed countries that held elections lost the vote, a singular event in over a century.

From the United States to the United Kingdom, France to Japan, voters across the developed world echoed one sentiment: dissatisfaction with the status quo. The common thread? Economic hardships, inflation, and voters tired of governments perceived as ineffective in addressing the financial pressures on citizens.

Chart 7: Rise/fall in vote share for governing parties in national elections (%pts) by year



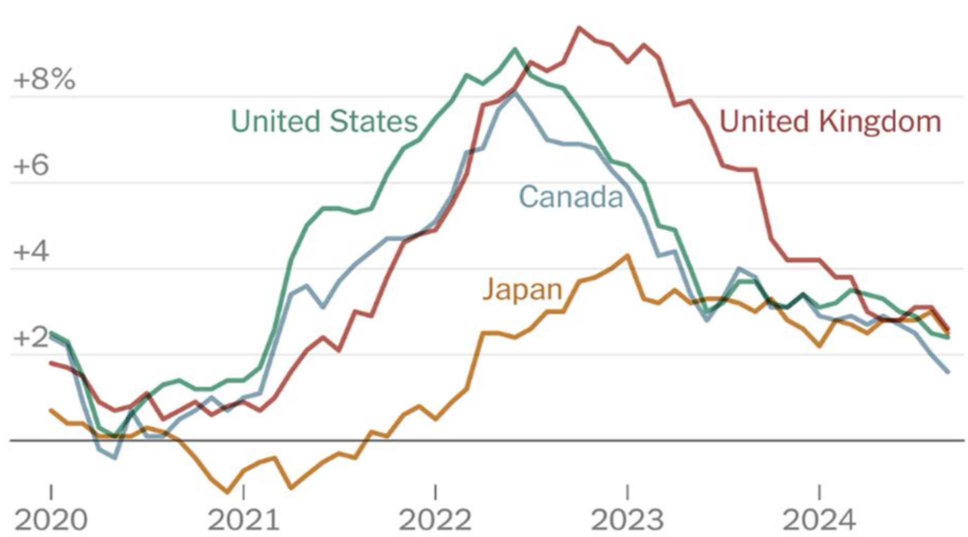
Excludes years where fewer than five countries had elections
FT graphic: John Burn-Murdoch / @jburnmurdoch
Sources: ParlGov, FT research

The same was true of many developing regions that held elections this year, such as South Africa and Argentina. Elections are shaped by a range of factors, but besides the controversial issues, almost nothing compels voters to take action as much as pressure on their wallets.

Almost nothing compels voters to take action as much as pressure on their wallets.

The most consequential election in 2024 was in the US, where the economic climate under President Joe Biden became a focal point for voter discontent. Despite a recovery from COVID-19, inflation reached its highest level in decades during 2022. The squeeze on household budgets, especially middle- and lower-income households, made it difficult for the Democratic Party to maintain its popularity. President-elect Donald Trump made sure to campaign on economic policies, focusing on local issues that affected consumers' wallets. Even as inflation in the US retreated from its peak by the time elections were held, one must keep in mind that inflation is a rate of change. Thus, the cumulative effect on prices is still increasing, even if the rate of change today is slower than in prior years.

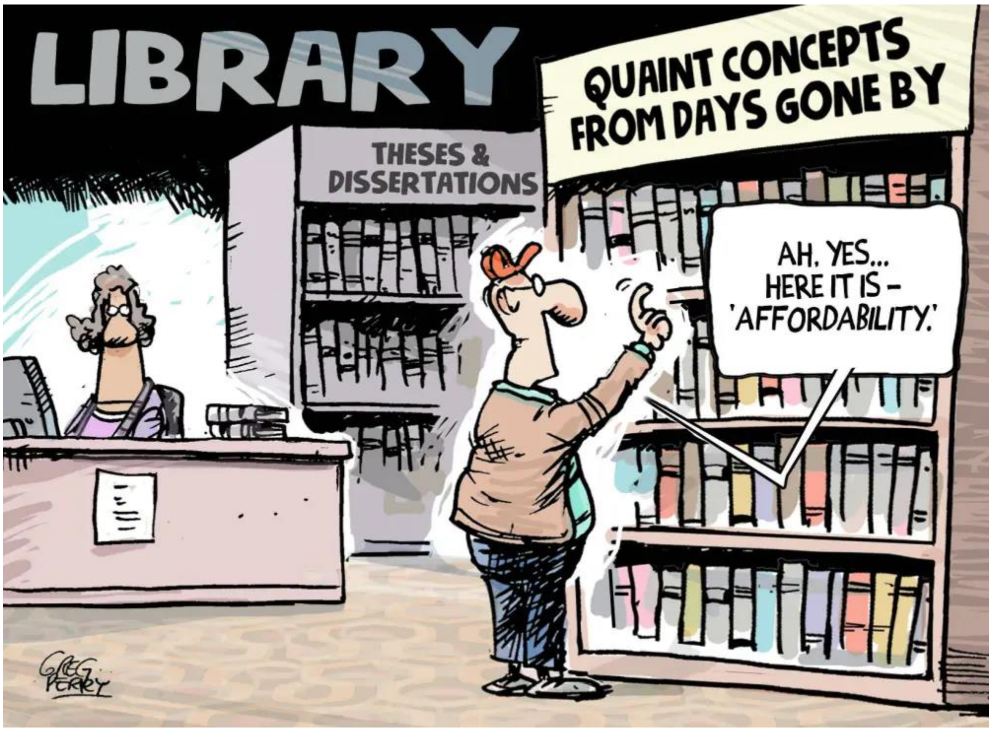
Change in Consumer Price Index



Source: National Consumer Price Index statistics for each country | By The New York Times

Many voters viewed the rising cost of living, especially the disparity between income and housing affordability, as a failure of government policies. All this while the US was spending billions of dollars supporting wars in other countries. It should come as no surprise that the economy was the top spot on voters' minds when asked about the major issues affecting their voting choice in 2024.

The US government's debt has been a key focus in the media recently, with Trump and Elon Musk positioning themselves as champions of reducing government waste, cutting regulation and simplifying bureaucratic processes while promising tax cuts. Their rhetoric resounded with voters as high inflation ate into their budgets.



Similarly, the soaring inflationary environment in the UK from 2021 to 2023, the highest this country has experienced in recent history, while perhaps not the death knell for the Conservatives, certainly did not aid their chances of winning this year's elections. A string of Tory errors, compounded by four prime ministers in five years, Partygate, using taxpayers' money to support the war in Ukraine, immigration issues and a collapsing national health system, all contributed to ending 14 years in power.

Many voters viewed the rising cost of living, especially the disparity between income and housing affordability, as a failure of government policies.

The challenges at home in South Africa were slightly different, but no less compelling. While inflation and the high unemployment rate certainly played a role in creating discontent, the country's economic struggles were compounded by an entrenched culture of corruption within the ruling party and a perceived lack of reform. Voters' frustration was not solely centred on inflation, but was also fuelled by a government that had failed to deliver on promises of economic growth and job creation.

South African voters voiced their frustration with the ruling party during the run-up to the elections. Until recently, load-shedding became a metaphor for the broader inefficiencies of the government, as citizens felt the pain of poor governance in different aspects of their lives. Opposition parties gained ground by promising to fight corruption, reduce wasteful government expenditure and implement pro-business reforms. As in the US and the UK, voters in South Africa sought candidates who pledged to change the ruling party's status quo. The message was clear: South Africans were tired of the government's inability to create jobs and meet their needs.

Similarly, in Argentina, the surprise election results clearly indicated the public's growing impatience with government mismanagement. This country, which has long battled escalating costs, saw a dramatic peak in prices in April 2024, with inflation reaching 292% at one stage. This was the culmination of decades of instability and government policies that failed to reign in rising costs, unsustainable public spending and excessive borrowing. The cost of living had become unbearable for Argentinians, and they were ready for real change.

Enter Javier Milei, a libertarian economist whose campaign was driven by ideas of radical economic reforms. He promised to slash government spending, eliminate wasteful bureaucracies, establish minimal state intervention and curb inflation. His policy ideas resonated with voters exhausted by economic struggles, particularly among young adults who had never experienced a stable economy. His outsider status and promises to dismantle the overblown public sector gave him a strong mandate.

Within months of taking office, Milei implemented policies to reduce inflation and kickstart growth. The impact was felt shortly afterwards, with inflation declining from its peak and early forecasts for 2025 predicting 5% real GDP growth. While the success of his policies and voters' stamina to see this through remains to be seen, the message to the world was clear: Argentinians voted for radical change. Inflation, once again, was a key catalyst in this demand for change.

The golden thread connecting the election results in all these countries is the impact of inflation and economic hardships on voters' perceptions of government competence.

The golden thread connecting the election results in all these countries is the impact of inflation and economic hardships on voters' perceptions of government competence. Although some of the drivers of inflation can be attributed to external factors, such as strong recoveries after COVID-19, abruptly interrupted supply chains, the war in Ukraine and an extended period of easy money (low rates), voters typically attribute a big portion of the blame to whichever political party is in power at the time.

The 2024 election results across the developed and much of the developing world reflect a deeper trend of discontent with governments that increasingly appear out of touch with the struggles of everyday citizens. In the US, high inflation contributed directly to Trump's win. While not the overriding factor, the steepest inflationary environment for decades certainly aided the Conservatives downfall in the UK. In South Africa, voters were driven to demand more accountable leadership in the face of economic stagnation and corruption. The soaring cost of living in Argentina mobilized voters to seek radical solutions, choosing Milei's extreme policies as the antidote. While the contexts may differ, one thing is clear - economies, and inflation, drive election results.

Investment case: Sprouts Farmers Market

SPROUTS™ FARMERS MARKET

By JD Hayward

⇒ Sprouts Farmers Market sits at an intersection of the consumer staples and consumer discretionary sectors. The company is a beneficiary of an ever-growing trend towards healthy living.

⇒ They have experienced strong same store sales growth and are aggressively expanding their footprint across the US. Operational efficiency is also improving, as evidenced by gross- and operating margin expansion.

⇒ Since addition to the portfolios in June 2024, Sprouts' share price has increased by 70%, outperforming the ACWI by nearly 67% and the consumer staples sector by 73%.

"The food you eat can be either the safest and most powerful form of medicine, or the slowest form of poison."

- Ann Wigmore

There's a well-worn saying that when the US economy sneezes, the rest of the world catches a cold.

The overwhelming majority of South Africans would probably question why they should care about the state of the US consumer. After all, we have plenty of our own concerns, such as sky-high unemployment, widespread corruption, and the odd patch of tar in between our potholes (if you live outside of the Western Cape). "Fair enough", I find myself thinking, we do have our own, very valid issues. Unfortunately, though, it is not quite that simple to ignore the influence of the US consumer on both the local consumer, and local investing landscape.

Why does the US consumer matter?

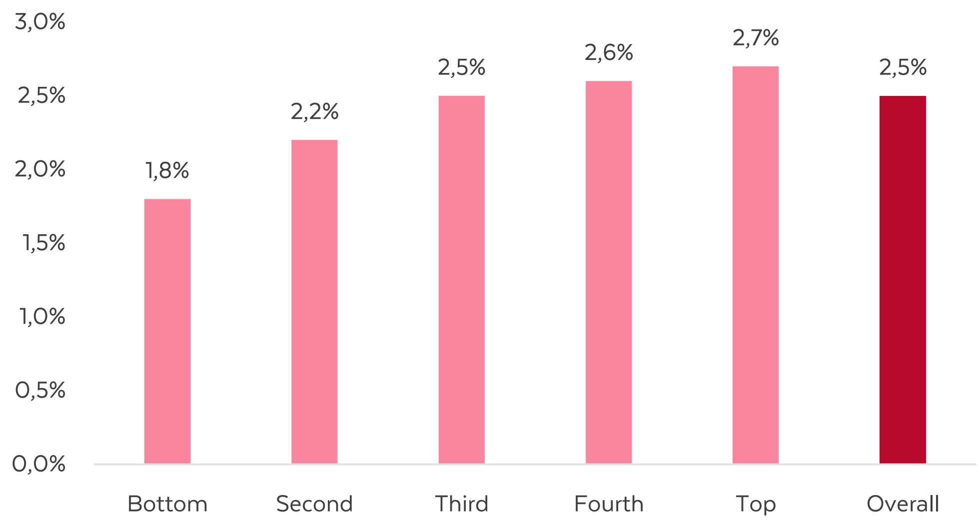
The Butterfly Effect is the idea that something very small, such as the flapping of a butterfly's wings could, theoretically at least, lead to something very big, such as a ripple in the air, leading to a storm halfway across the globe. Well, in this case, the US consumer is the butterfly, but instead of normal butterfly wings, this butterfly has big ol' American-made eagle wings. To better explain this point, it's worth spending a minute contextualising the size of the US economy, and, thus, the impact of US consumers on the rest of the world. If individual US states were classified as countries, California, with a GDP of almost $4 trillion, would have the world's 5th largest economy, just beaten out of the top 3 by Germany and Japan. Texas would be 8th, and New York State would rank 10th. South Africa, with a GDP of roughly $380 billion would struggle to make the list of top 20 US states.

There's a well-worn saying that when the US economy sneezes, the rest of the world catches a cold. What is not quite as well known is the size of the US consumers' role in the overall US economy. 40%? 50%? No, two-thirds. 67% of the US economy is driven by the spending of US consumers. The equation now becomes a bit clearer. If the US consumer stops spending, either due to higher interest rates, higher inflation, lower confidence, or any other factor for that matter – the US sneezes, and the rest of the world catches a cold. So, the short answer as to how important the US consumer is in our lives? Very.

Contradicting economic indicators

Several somewhat contradictory data points have emerged from the US over the last year. Drivers of a strong consumer generally include a strong job market, resultant low unemployment, and inflation-beating wage increases. (chart below). For the most part, these have all been strong over the past year, and one would expect this to lead to continued consumer strength and continued GDP growth.

Chart 8: Real income growth forecasts 4Q'24 / 4Q'23 by Income Group (% change)



Based on these numbers, the US consumer seems to be in a relatively strong position.

This has been the case, with US GDP growth in the third quarter coming in at 3.1%, slightly above the 3% seen in the second quarter, and double the 1.4% achieved in quarter one. Retail sales in the third quarter also grew quite strongly at 2.3% year-over-year.

Based on these numbers, the consumer seems to be in a relatively strong position. This is also echoed in the slight uptick seen in the recent consumer confidence polls – hitting their highest levels in more than a year. (There is some variation here for different income group cohorts).

Lastly, another datapoint supporting the US consumer is the strength of household balance sheets. Compared to before the pandemic, house prices in the US have increased by as much as 50%. Equities on the other hand, have rallied even more. Using the S&P 500 as a proxy for returns and measuring from before the market crash in early 2020, i.e., not fitting the data to the narrative, we see that investors have potentially boosted their nest eggs by 70% in less than 5 years. This large gain could further support bullish sentiment for some time to come.

The numbers leave little doubt that the consumer (or at least a large enough portion to drive retail sales numbers and GDP growth) is feeling buoyed by the increasing possibility of a goldilocks scenario, where the US completely avoids recession, and the labour market remains strong.

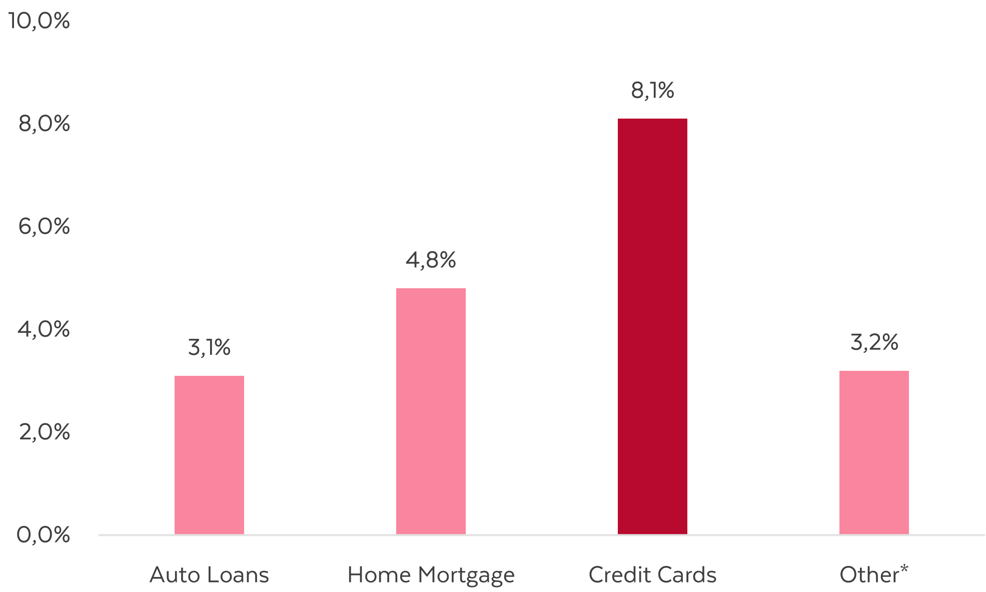
There are, however, some negative datapoints as well. When inflation runs as hard as it has, something must normally "break" to correct it – and something is quite often the labour market. This is usually achieved by the Fed raising the borrowing rate, making money more expensive, essentially acting as a brake on an economy that is running too hot. The challenge for the Fed lies in attempting to apply the brakes smoothly – and to avoid a 180-degree handbrake turn – something that history teaches us is very hard to achieve. At the moment, it seems the Fed is coming out on the right side of the line.

The number of jobs added in the US economy between March 2023 and March 2024 was revised down by more than 800 000 jobs in August 2024 – an indication that the labour market, while by no means weak, might not have been holding up quite as well as initially thought. The most recent prints, however, seem to indicate that the job market is steaming ahead, as almost 100 000 more jobs were created during December compared to what analysts were expecting. Keep in mind that unemployment is a lagging indicator, and by the time it starts to rise, the damage has often already been done. The waters are muddy, indeed.

This raises the concern that consumers are turning to bad debt (credit cards) to maintain their spending levels.

Total US household debt of $18 trillion has also steadily been increasing, rising by roughly 4.5% in 2024. The more concerning factor is that credit card debt, while only a small portion at about $1.2 trillion, is increasing much faster than all other debt segments. This raises concern as much of the pandemic-era excess savings have been spent, and consumers are turning to bad debt (credit cards) to maintain their spending levels. On top of this, default rates on credit cards have slowly started increasing, as higher borrowing rates start to bite.

Chart 9: Increases in household debt 3Q'23 – 3Q24 (%)



*Other includes retail cards and consumer loans.

All in all, household debt as a percentage of disposable income currently sits at around 10%, which, if historical precedent is anything to go by, is not particularly high. They are, in fact, as low as they have been during the past 4 decades (bar the free-money funded, post-pandemic lows) and a lot lower than the 13% seen in 2007. However, the combination of higher rates, increasing levels of credit card debt to fund expenses, and depleted savings, is certainly worth a note of caution.

Investment Implications

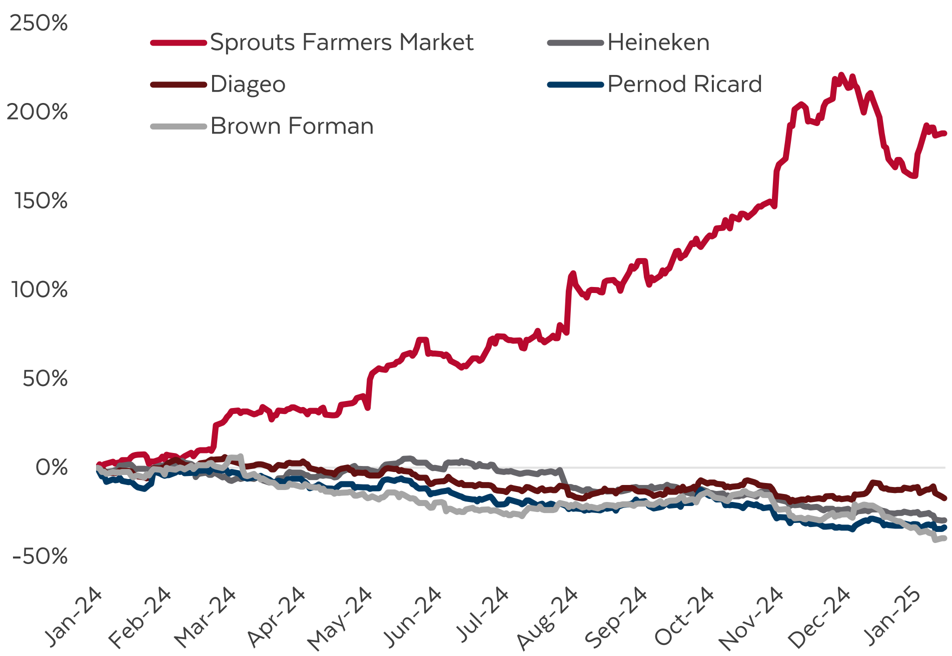
Where does this leave one from an investing standpoint? In a world where tech stocks are historically expensive, but the consumer looks like they still have some gas in the tank, do you rather buy consumer-driven staples? This would not necessarily have worked out well over the past year. Several traditional staples have been struggling. Iconic beer brewer, Heineken, as an example, has performed poorly despite beginning the year in inexpensive territory. Curiously, several of its liquor peers have suffered the same fate, with Diageo, Pernod Ricard, Remy Cointreau and Brown-Forman all suffering double digit declines over the past year. Weakness in the consumer, or weakness in the sector?

The diverging fortunes of these companies, measured by their share price at least, highlight the unpredictable impact consumer behaviour has on stocks.

It certainly doesn't seem to be the case for all staples, and the sustained levels of consumer spending being reported must go somewhere. Case in point - Sprouts Farmers Market. While technically a consumer staple according to GICS classification, the case here is a bit more nuanced. Sprouts sits in a sweet spot between staple and discretionary spending, with an added healthcare angle to boot. The company is a beneficiary of the ever-growing trend towards healthy living and healthy eating, catering to every imaginable dietary preference. (Interestingly, the polar opposite to the above-mentioned liquor companies).

Share prices are generally driven by investor expectations of future returns. Over the past year, Sprouts has outperformed some of it better-know staple peers by leaps and bounds. If this is anything to go by, one could quite easily conclude that while consumers might be more discerning on where they spend their money, they remain willing to spend, and Sprouts Farmers Market stands out as a clear favourite.

Chart 10: Share price performance over 1 year (%)



The diverging fortunes of these companies, measured by their share price at least, highlight the unpredictable impact consumer behaviour has on stocks. Though the consumer may be strong, shares you would expect to benefit have not necessarily done so, and new kids on the block, like Sprouts, have. This highlights how crucial it is to look below the hood for differentiated investment opportunities within the greater macroeconomic context, especially in the consumer-facing sectors.

In conclusion

Flagship's global investment process is centered on a comprehensive, active risk management system that has been designed to let our winners run, while cutting our losses sooner. Our funds own a highly diversified selection of businesses across industry groups that we believe are favorably positioned compared to their peers from a multifactorial perspective.

We believe this combination of a proprietary risk management system, combined with our approach of considering several factors before a stock or manager can be included in our portfolios, will lead to superior risk-adjusted returns across our range of funds.

While we recognize and appreciate that investing is a long-term endeavour, we also realize that most investors do not want to endure prolonged periods of relative underperformance. We believe our approach strikes a middle ground whereby we can deliver alpha (or excess performance relative to one's benchmark) over the long-term, while shielding investors from protracted periods of negative alpha, compared to the benchmark.

We write these Telescopes so that our investors know what it is we are doing, and why we are doing it. For many of you, we are the caretakers of your global investments, and we would like to use this opportunity to thank you for the trust you place in us and emphasize how deeply committed we are to the responsibility that we hold.

Warm Regards,

The Flagship Global Team

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