



To our clients, prospective clients, and fellow investors:

This is the first investment letter from our new asset management business, AMWH Asset Management. But it is also the 101st in the uninterrupted series that began in 1998 when I started managing global equity portfolios at Scudder in New York with my dear friend William Holzer. Now Mark and I continue the work. The letters try to set out our interpretation of the ever evolving and complex global economy. This study of long term structural and secular change allows us to identify the favorable investment asymmetries to exploit and the unfavorable investment asymmetries to avoid as we deploy capital.

It's a long letter as we launch AMWH Asset Management. We hope it's not too long, and that you find it interesting.

## **Market Overview**

The S&P 500 rose over 23% in 2024<sup>1</sup>, following a slightly larger gain the year before. It has risen more than 20% in four of the last 6 years<sup>2</sup>. Commonly attributed factors behind this are strong US economic growth, falling short term interest rates, and the powerful contribution of the index dominating big seven technology companies that have risen on the back of enthusiasm for AI. Trump's election victory supported market gains on the prospect of tax cuts and easier regulation. Equity market setbacks in August and to a lesser extent in December didn't change the overall outcome. US exceptionalism is such that US stock market capitalization now represents 73%<sup>3</sup> of the MSCI World index, while the US share of world GDP is 26%. Perhaps this is right for the homeland of capitalism, but long-term data suggests an extreme.

US equity markets ignored the less positive financial background elsewhere. US long term interest rates rose as inflation appeared to linger and the prospect of more interest rate cuts receded. International equities produced only modest returns, around 6% in Europe and 7.5%<sup>4</sup> in Asia. Slowing or weak economic activity in Europe and China, and the risk of deflation in both these areas were notable. Commodity prices (except for cocoa) were broadly subdued. The oil price hovered in the \$70s as global demand was projected to be weak. The US \$ was very strong as high interest rates and the prospect of good investment returns attracted capital flows. At the same time the price of gold rose steadily as foreign central banks sought to diversify reserves away from the US \$. This interplay between the US \$ and gold is a long-term anomaly. Whether Bitcoin's extraordinary gains, now at around \$100,000, are related to this, or to general equity market enthusiasm, or to having a friend in the White House remains to be seen. Private markets, however, labored against the headwinds of higher interest rates. In the absence of liquid exits, NAV lending and continuation financings are a sign of stress, masked by

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<sup>1</sup> Price return of 23.3%

<sup>2</sup> 2019, 2021, 2023, 2024

<sup>3</sup> MSCI World Index and Ycharts Data

<sup>4</sup> MSCI Europe and Asia Indices



the ability to avoid marking assets to market. For now investors tolerate the lack of liquidity. Lower interest rates are hoped for.

Political polarization is evident everywhere in the developed world. Voters in the big democracies are not content. Economic success hasn't spread to the broad population. Inflation was a big factor. High-minded liberal policies and the undeniable broad economic benefits of globalization were increasingly seen as irrelevant or costly to the national voter. Incumbent administrations have been voted out. Global geopolitical tensions are also on the rise, possibly to be increased by the new Trump administration.

For the time being the US equity market has rewarded all-time high company profits and all-time high company margins as a proportion of GDP. For the time being the promise of productivity gains from AI is supporting bullish sentiment, along with to be delivered tax cuts and deregulation. For the time being bond markets tolerate large public sector deficits. But investors in US equities in particular, who have done very well in the recent past, should examine carefully both the foundations of their returns and the starting point for their portfolios as we enter 2025. If the last few years can be characterized as a triumph for the owners of capital, it must be right at least to question the assumptions behind this. There is no doubt that the increasingly frictionless global order managed by the wealthy western countries and led by the USA since the end of WW2 has now ended, in response to both internal contradictions and external forces.

### **Investment Outlook**

The starting point for equity investors is demanding. The US economy and corporations are doing well. US equity markets reflect this. But US equities are expensive compared to history, in terms of absolute PE levels and cyclically adjusted PEs. Margins and profits are at all-time high levels both in absolute terms and as a proportion of GDP. Progress from here must depend on continued strong economic growth, strong realized productivity gains from AI (productivity improvements typically account for about 30% of economic growth), lower interest rates, and the benefits of tax cuts and looser regulation. It's interesting that under the last Trump administration profit growth in aggregate was almost entirely due to tax cuts. Equity markets are prepared to discount this at present, but for an excellent situation to improve further, faultless progress is required. We hope so, but it is worthwhile to consider whether a market priced for perfection might represent an unfavorable asymmetry. What might challenge a good outcome?



## **Growth and Inflation**

One question is whether the US economy can continue to perform strongly while the rest of the world is weak. History, if it is a guide, suggests this will be difficult. The global economy is still highly interconnected.

1. Economic growth in Europe is weak. Euroland is laboring with the fiscal constraints of its construct, and the consequences of inflation and immigration as reflected in a shift to right wing populism, especially in the big countries. China, as it has turned from export market to competitor, is also an issue. Higher energy costs due to the switch to green power are also an issue. Can the European construct survive? Debt levels, slow growth and poor demographics provide deflation threats.
2. Economic growth in China is slowing. The government is caught between its need for complete control, its ambitions for China's role in the global financial system, and the market power of the real estate debt crisis. Efforts to foster domestic economic activity are hindered by belt tightening by private actors, like Japan in the 1980s and 1990s, in the face of the debt problem. Although China has become the global leader in many industries (green power, EVs etc.) and the trade surplus continues to grow, it's facing headwinds from new global attitudes to trade and promised US tariffs. Debt deflation is also a risk in China.

Inflation is proving sticky in the US. Long term interest rates have risen, on prospects for higher inflation for longer. The new US administration's policies might also drive inflation. Tariffs have been argued to raise prices to consumers, boosting inflation, as costs are passed on to consumers through the chain. If the goal of tariffs is to bring jobs back to the US, doing so can only happen slowly. Financial market consequences will be felt first. In the meantime measures against immigration, and even deportation, could drive up labor costs. Manufacturing jobs represent only 8% of total employment in the US, so it's doubtful that tariff policy will solve this political problem.

Long term interest rates may rise for other reasons. Tax cuts while the fiscal deficit is already high could drive it higher. Bond investors may require higher rates to fund higher deficits.

Bond investors are already more cautious than equity investors. Equity investors should pay attention.

## **Demographics, Productivity and Growth**

Population growth in the developed countries is slowing, and in some is in decline. This is important because over time (going back to the Industrial Revolution) about two thirds of



economic growth is due to population growth. The balance is due to technological progress which is expressed as productivity improvements. Slow or no population growth may explain why economic growth, excluding anomalies such as Covid, has become weaker in these countries in the last 20 years. Policies to increase birth rates (child subsidies etc.) haven't worked. Immigration has been suggested to be a solution, though, aside from boosting population numbers immediately, the data on whether immigration is a net economic benefit or a cost is equivocal. Policies to remove immigrants, whatever their justification, will certainly have negative effects on economic activity.

The burden on productivity improvements to support growth, if population growth isn't doing so, is therefore much greater. The anomaly since the advent of digital technology is that productivity improvements have been weak. Productivity is hard to measure of course, but it's unlikely that significant productivity gains are completely hidden. One conclusion is that the productivity benefits of AI need to be very substantial in order to support strong economic growth. Industry participants are promising this. The rest of us will have to wait and see. Strong economic growth in the US in the last few years has been largely driven by government spending, not productivity gains.

The global economic model was founded, more than a century ago, on growth. What happens if growth is weak? Japan is an interesting example. Weak economic growth since the debt bust of the 1990s has led to deflation and taking on more and more government debt in order to maintain living standards. Another way to look at this is to argue that, for an ageing population, living off their savings (Japan is a rich country), deflation and borrowing against their assets make perfect economic sense. It doesn't make sense for Japanese equity markets, which have taken more than 30 years to return to pre-crisis levels.

We're not arguing that this is happening in the US, or in Europe. But levels of government debt to GDP are rising. This may not be only a function of Covid policies. It could be a demographic inevitability. For our investment policy we think it wise to at least consider the possibility that economic growth stays subdued, and to be cautious in the assumptions we make about AI as a deus ex machina that will solve our economic problems.

### **Intergenerational Challenges**

Arguably the last great era of investment in intergenerational assets and public goods in the US peaked under Eisenhower. The Interstate Highway System is an example. Since the late 1970s intergenerational investment has taken a back seat to consumption. This century the environment has become the most important public good. Biden's IRA if not overtly was an effort to make intergenerational investments, with climate change its focus.



Intersocietal transfers – from rich to poor, from old to young or young to old, from generation to generation – are political decisions and therefore the responsibility of government. This isn't a philosophical point. In the US, for example, the existence of Social Security or Medicare and Medicaid are a so far unchallenged fact. The political issue is one of degree.

Will investments in infrastructure, education and healthcare be made? Will investments to mitigate climate change continue to be sponsored by government? How will the weight of the baby boom generation and the financial and other commitments that have been made to it weigh on subsequent smaller generations? Can dealing with these issues be postponed? And how does the US compete with China whose economic growth has been built in part on huge intergenerational investments which give it extensive modern infrastructure and a global lead in climate sensitive industries? Will the new US administration tackle these increasingly pressing issues, or kick the can down the road?

### **Complexity**

The global economy and its financial system are incredibly complex. Digital technology enables complexity. In complex systems we observe small inputs producing large unintended consequences. Weather systems are an example we all understand. This is related to the fallacy of composition, and the tendency of human actors to focus on one thing and hold everything else constant. That's either laziness or the limitations of our intellect.

The Global Financial Crisis was a crisis of complexity. One securitized mortgage was a good idea. Securitizing all of them had terrible consequences, amplified by the myriad connections in the financial system.

The question we ask is whether complexity is the enemy of productivity. Time is like real estate. Its footprint is limited, and we can only build so much on our time. (Elon Musk might be an exception). Our individual lives have become very complex. Has this made us more efficient? Or just spread more thinly over a wider area? Are we individually each doing more, but each thing we do less efficiently?

Will AI help? The large language models behind it are of unimaginable complexity. Does its simpler interface mask complexity, or help us deal with it? Does AI allow us to build more, more efficiently, on our limited time footprints?

It's a valid investment question, both with respect to productivity data, and with respect to as yet unseen unintended consequences of AI. An input here is that, in extremis, human behavior cannot be modelled under the bell curve.

Perhaps this isn't a valid discussion, but it must be worth thinking about even if eventually to dismiss it.



## **Digital Abundance and Physical Scarcities**

This much simpler observation is of most immediate relevance to portfolios today. Tech companies are becoming highly capital intensive businesses constrained by access to land, water, electricity and specialized chips for their large language models. Physical bottlenecks, of which Nvidia is the prime example, are apparent everywhere. The legacy of instantly free cash flow positive investments in software is now capital intensive investment in physical assets and power supply as the big tech companies compete in AI.

Pay offs are, by definition, further in the future, outcomes less certain, and risks greater. Bottlenecks are very attractive investments for equity investors, and have been favored in our portfolios for a while.

## **National and Global Politics**

Stepping back from the immediacy of financial markets, it's clear that the post WW2 global order has reached an end. It's a function of the failure of the political belief system of the US and Europe that began in 1945, reached its zenith in the early 2000s, and that began its decline with the GFC in 2008. It's a parallel and related function of the ascendancy of China since it joined the WTO, and Russia's regained confidence in expressing its geopolitical insecurities since the rise of Putin.

The belief system was about openness and global co-operation, to which, in retrospect, national interests were of only secondary importance, as long as western geopolitical influence was maintained for corporations and business, and financial and political elites prospered. The benefits of globalization and the post WW2 peace dividend accrued only to few. Huge improvements in GDP in poor countries were no consolation to western workers whose living standards stagnated. Populist politicians exploit this. Francis Fukuyama's 1998 book (The End of History and the Last Man) describing the triumph of liberal democracy was completely wrong.

Change is needed. History teaches us that substantial political change, for good or bad, only happens at moments of extreme crisis. Is the move to populist governments in the west the solution, or the last act before the real crisis? The test will be whether new administrations, whatever their political persuasion, understand the real issues, some of which we describe here. Do they have the skills and personnel to rebuild institutions, not only to make them more efficient, but also to reflect intergenerational and demographic challenges? Can a new era of global rivalry defined by the powerful expression of more narrowly defined national interest avoid descending into conflict?

What are financial markets discounting? Are equity markets, dominated by a small number of huge technology companies and at high aggregate valuations, discounting a continuation of the



recent past? Or are they discounting a future that is very likely to be more competitive, with more friction for corporations than during the golden years of globalization? Will the proximity of these giant corporations to government and the suggested benefits to productivity of AI allow equity markets to progress from here? We don't know the answer, but we would guess that the asymmetry, given the starting point, may be greater to the downside than to the upside in the longer run.

### Portfolio Positioning

The discussion so far in this letter is about the backdrop against which we invest. We emphasize this now because, if the case for a turning point in the global economy is correct, identifying and understanding these changes is a particularly necessary prelude to specific investment choices.

Our goal is to produce attractive risk adjusted returns over a 3-5 year cycle. We try to defend against market drawdowns as an important contribution to long term returns.

The main allocations of capital in our Global portfolios are set out below. Energy Transition portfolios are a subset with focus on those ideas.

1. We're wary of starting aggregate valuations for equities in the US. We think that global frictions in the form of retooling supply chains, tariffs and growing national and regional competition will become headwinds to company returns.
2. We don't assume liquidity in financial markets, nor do we believe that we can time when our investment ideas work. We prefer to position portfolios when we can, rather than when circumstances dictate. We avoid illiquid investments. We can envision circumstances when liquidity might be worth a significant premium.
3. We are excited, like everyone, by the prospects for AI. But at the same time we are wary of the weight and concentration of these investments in equity indices. These concentrations usually eventually unwind painfully. We prefer in our portfolios to make careful individual stock choices, and to have much lower weight aggregate exposure in our portfolios than in equity indices. This is a somewhat contrarian view, which allows us to diversify portfolios better.
4. If all economic activity is energy transformed, we are surprised by the very low weight of energy investments in equity markets. If we are in a world of digital abundance and physical scarcities, this supports the case for proportionately much greater exposure to energy in portfolios than in equity markets. The tech companies' scramble for available, reliable power supports the notion of a bottleneck. Our logic is that these investments should be at least the same weight in portfolios as exposure to technology. Under the general heading of energy, we're careful to avoid categories where capital has been



overallocated, and instead to focus on areas where capital is scarce. Our working assumption is that long-term energy supply will be a mix of hydrocarbons, nuclear and alternatives. For alternatives the prerequisite is distribution and storage infrastructure that is so far lacking.

5. We're wary of the degree of leverage supported by the economy. To us, at least, private credit is opaque, and probably provides better returns for its intermediaries than for end investors. It's definitely illiquid. We avoid credit risk and leveraged balance sheets in portfolios. If deflation is a risk, then at some point government bonds would have a place in the portfolio, but this would reinforce the case against credit.
6. We have some exposure to undervalued pharmaceutical company R&D. This is largely uncorrelated to global political and financial headwinds, and in the meantime these companies pay attractive dividends. Healthcare spending accounts for about 17% of GDP in the US, almost double European levels. We avoid the complex chain of intermediaries in the US system that are likely to come under political pressure in the search for lower healthcare costs.
7. We think it continues to be worthwhile maintaining some holdings in gold bullion while the possibility of financial or geopolitical discontinuity exists. We view this position as an opportunity cost and therefore as an insurance premium paid that would be valuable in times of distress.
8. Given equity market valuations, we hold a significant position in cash. Interest rates make this decision easier. Its value will be realized if and when we can act in times of significant market distress.

Please get in touch if you have any questions, or if you would like to join the investment conversation. All ideas are welcome!

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