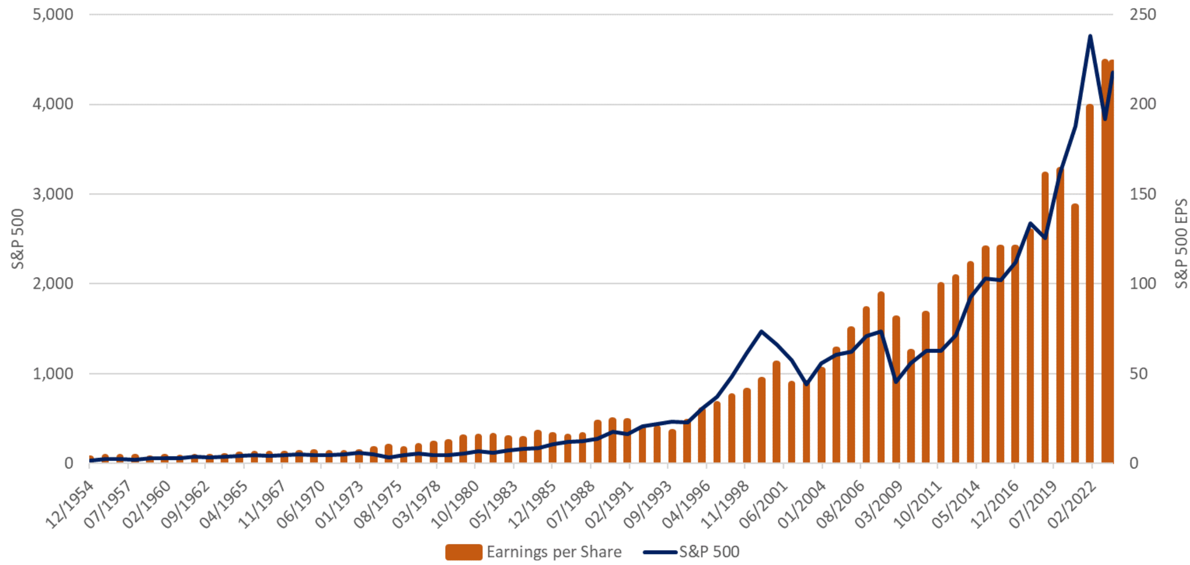
"We can only see a short distance ahead, but we can see plenty that needs to be done". – Alan Turing.

Consumer and investor confidence has been lacking over the last couple of months as uncertainty looms large despite corporates talking about a better second half to the year. This lack of confidence has manifested itself in the form of investors herding into large cap tech and jumping on the AI bandwagon, regardless of how tenuous the uplift that the company can get from the onset of this new digital revolution. We discuss later in this newsletter our rationale behind our holding in Nvidia, which has become the darling of the AI market, and why we continue to hold it despite the run over the past 9 months.

We will receive a new round of updates from our holdings in the coming month, and the focus will be on both the outlook statements and the earnings numbers. There is a strong correlation between overall market performance and earnings progression, so protection of margins in the coming reporting period will be paramount if we are to see the rally continue of the second half of the year.

Equity markets follow earnings.

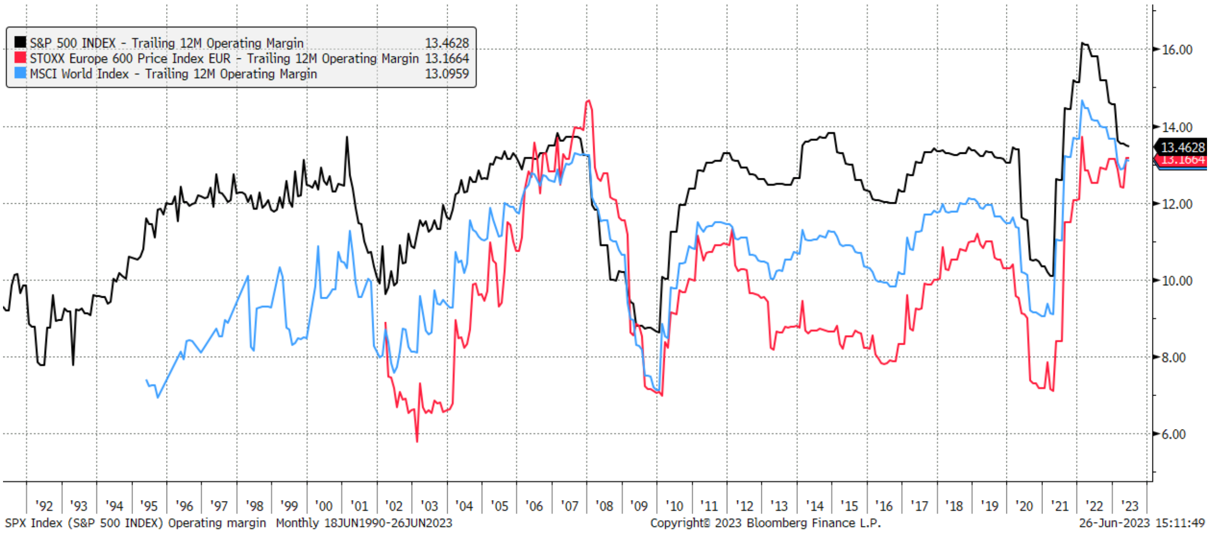


Source: TIM/Bloomberg

We came into the year with margins sitting just off their record highs, and since that time they have continued to correct, however, the most recent readings suggest that this correction has stabilised, and companies are generating a profitability level in line with the pre-pandemic cycle highs.

Although the wider global market has an operating market has a margin of 13.1%, our underlying holdings generate an aggregate margin of 21.6%, which is below the highs of 24.2% achieved last year, but greater than that achieved immediately prior to the pandemic. We believe, however that due to the characteristics of the companies that the Fund looks for when assessing whether to own a company as part of the portfolio, this level of profitability should be more sustainable when compared to the wider market.

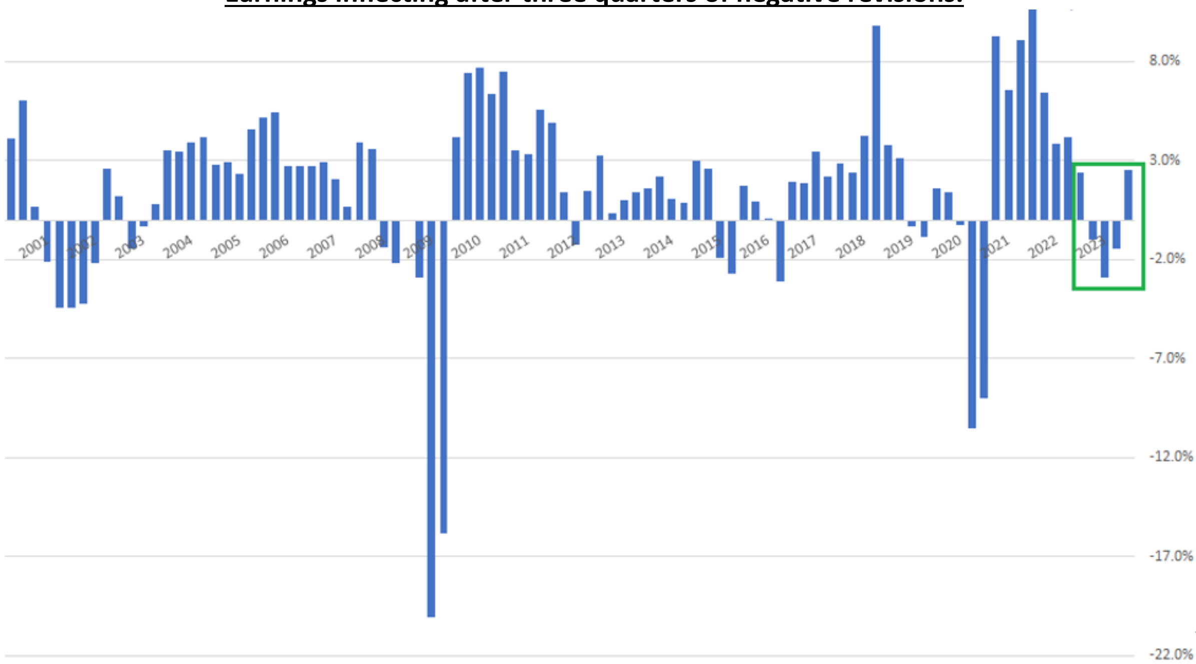
Global operating margins stabilising close to pre-pandemic highs.



Source: Bloomberg

One of the more encouraging pieces of data related to this mater of sustainability of margins comes in the form of earnings revisions, which after three quarters of downgrades have inflected positively. This data is for the S&P 500 but gives a good indication of the health of global corporates. With supply chain pressures at the lowest levels on record according to the New York Fed's supply chain pressure index, commodity prices falling and both the US Empire and Philly Fed composite price pressure indices suggesting that the gross margin pressures of 2021 and 2022 have all but vanished, all creating a supportive backdrop for margins and profits.

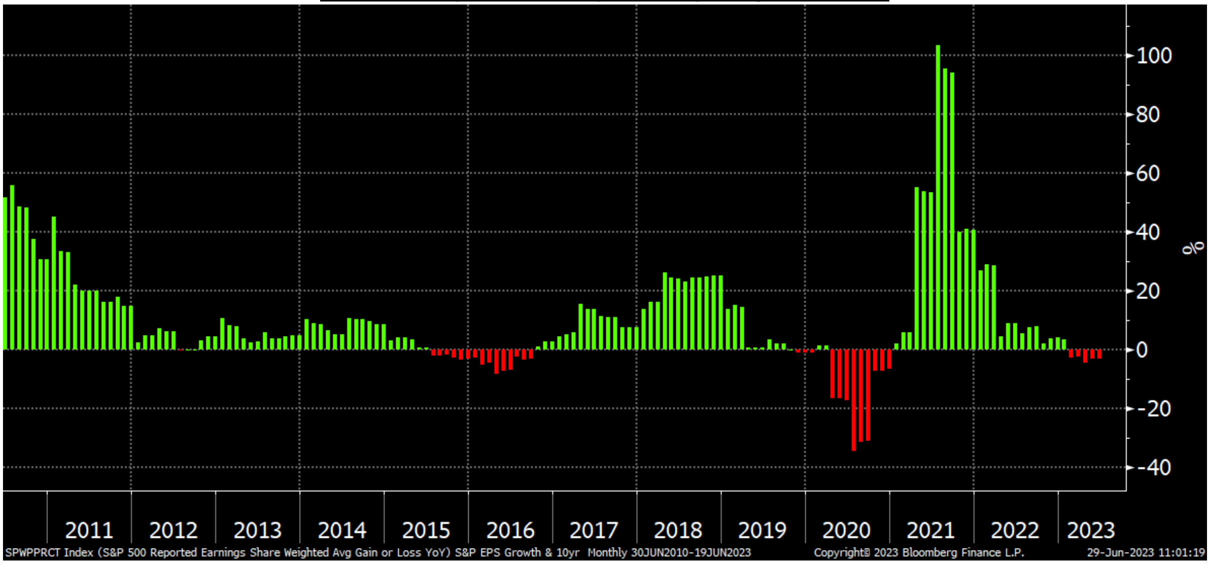
Earnings inflecting after three quarters of negative revisions.



Source: Baird

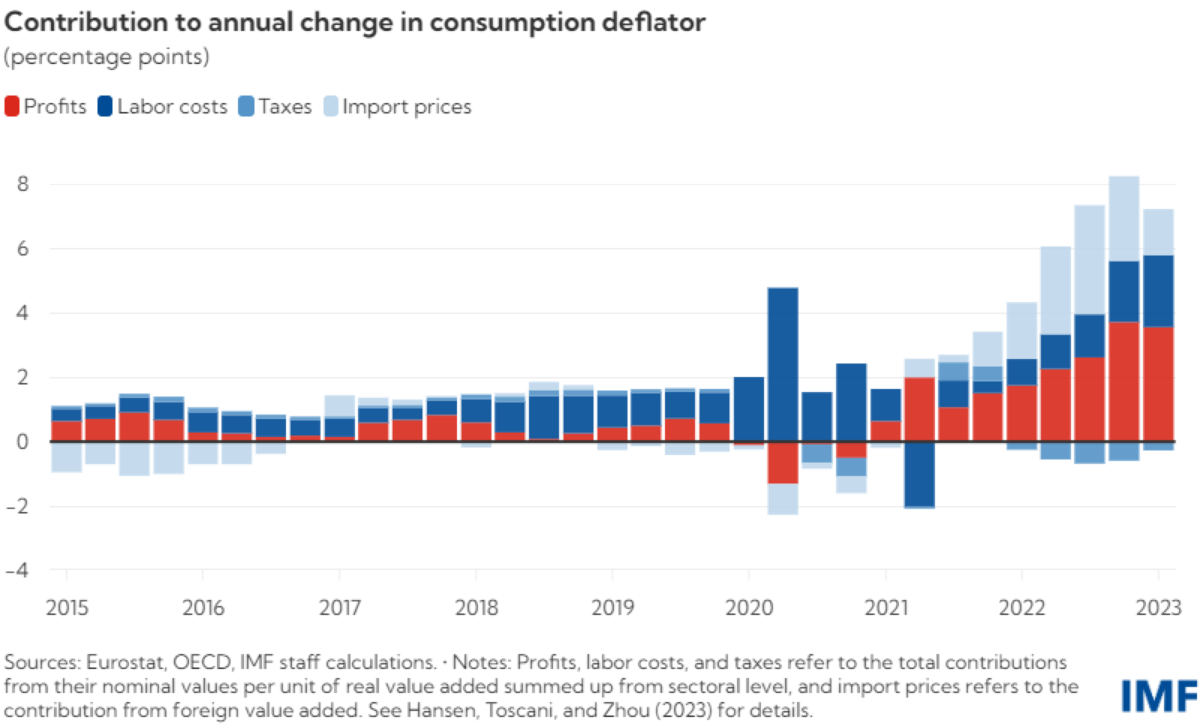
The other reason for tracking EPS revisions is that EPS bottoms normally occur 3-6 months after price bottoms. EPS revisions act as a leading indicator as to when the actual reported EPS also inflect to positive readings.

S&P 500 reported EPS year on year gain or loss



Source: Bloomberg

Although rising profit margins are good for investors, the converse of this is that either suppliers or end consumers must bear the burden as Porter's five forces play out. In this cycle, it has been the end consumer who has had to absorb the lion's share of the pain, as companies raised prices to offset the pressures on margins from inflation in wages and import costs. As the chart below shows rising corporate profits now accounts for 45% or the inflation in the Euro-area since the start of 2022 and explains why core inflation has been much more persistent than the Central Bank would like.



We continue to believe that inflation will remain higher for longer than the current central bank projections, most of which see it returning to within their 2%-3% ranges by 2025, from the combined forces of corporates fighting to maintain their profits and workers demanding higher wages to offset the higher costs.

The VT Tyndall Global Select Fund B Acc (GBP) rose by 2.43% boosted by the continued strong returns in the IT sector and some strong performance by our industrial holdings such as United Rentals. The Fund has risen by 5.17% in the year-to-date.

Fund Activity and News

Our holding in Nvidia broke through the $1 trillion market capitalisation threshold briefly this month, raising questions whether the almost 200% appreciation in its share price since the lows of 2022 has become disconnected to the fundamentals.

Nvidia share price appreciation keeps up with the increase in earnings estimates.

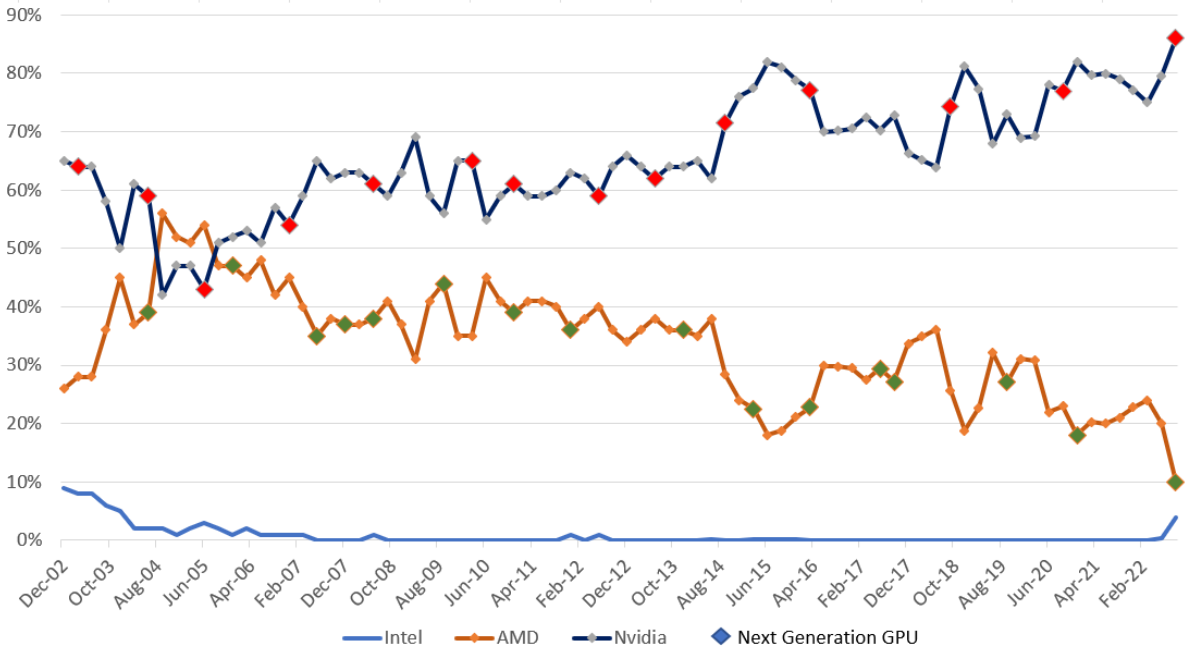
Source: Bloomberg

Nvidia slumped last year after sales in their graphics processing units (GPUs) for the gaming market missed estimates and led to an inventory overload, however the company is not a one trick pony and the advancements in artificial intelligence that have come to the fore this year has opened the door to an even more lucrative opportunity. Almost every company is now referencing AI in their communications with investors and detailing how they are integrating it into their operating models.

Whether a company chooses to use ChatGPT, Bard or any other AI platform there is almost no avoiding the utilisation of Nvidia's GPUs in one way or another, as Morgan Stanley puts it "in AI, all roads lead to Nvidia". Although there are other companies that make GPUs, Nvidia is undisputedly the market leader and invests continuously in upgrading their IP to upgrade their products, keeping it at the cutting edge and fending off competition. In order to compete in the new world of AI data centres will need to replace their central processing units (CPUs) with GPUs and the latest Nvidia GPUs are 40x more efficient than traditional CPUs, handling multiples of the maximum number of computations of CPUs in a fraction of the time. This upgrade market, combined with new customers across most verticals, is leading to an explosion in demand for AI hardware and software from which Nvidia and the other GPU vendors are benefiting.

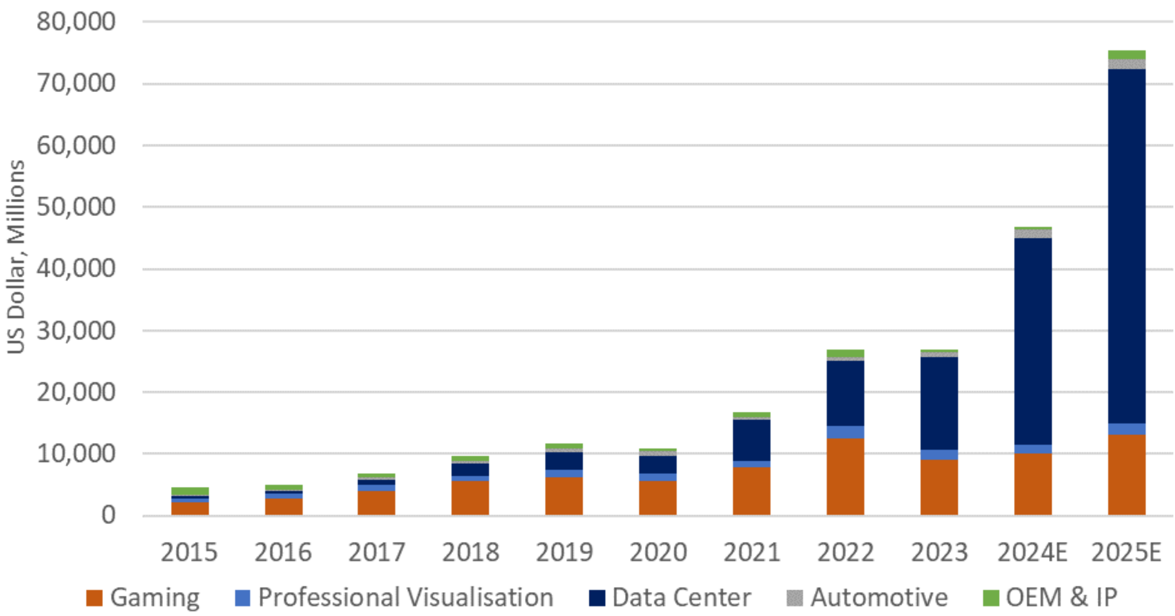
Advanced Micro Devices is the number two in the market is due to bring its next generation GPU to the market later this year which may put pressure on Nvidia's ability to charge $30,000 or more for its latest H100 GPUs. At the moment, AI developers have opted for the Nvidia option as it also allows access to its state-of-the-art CUDA software package, but we will have to wait to see if AMD's launch of a ROCm software package can compete, or in the Pamplona like rush to adopt AI, it stumbles in front of the bull's horns.

Discrete desktop GPU market share



As to whether the current valuation can be justified depends on the size of the AI opportunity, as datacentre (DC) becomes the largest segment of Nvidia's revenues. In May, management surprised the market by the magnitude of its $4 billion additional revenues coming from the DC and guided that the second half of the year will be even larger as supply comes on-line, suggesting that the 88% market share captured by Nvidia last year is being maintained. Simultaneously, the gaming sector revenues are improving as the inventory problems have been resolved, and the other operating segments seem well set for return to growth in the coming years. However, should the estimates of the AI potential prove to be even close to correct, Data Centre, which up to last year was only the second largest driver of revenues, is set to dwarf all the other revenue streams combined.

The AI opportunity strikes gold for data centre revenues.



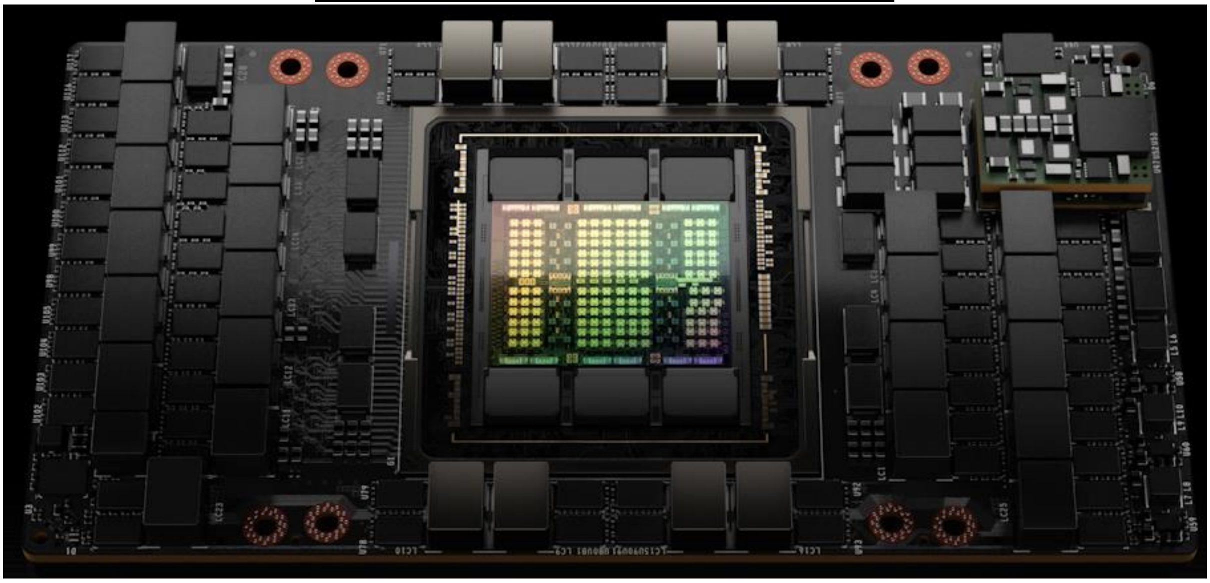
Source: TIM/ Company Reports

Growth in revenues is one thing, but growth in margins and cash flows is another. Here again Nvidia has struck gold and platinum together, as despite the increased investment that will be required to meet demand and remain the market leader, Nvidia has a capital light business model, with a net cash balance sheet, deriving returns on invested capital in excess of 30%, and these will likely increase as data centre revenues are higher margin than the other segments; while Free Cash Flow yields look unpalatable today, looking forward 18 months we estimate that a FCF yield in region of 8% is not outside the realms of possibility.

We do not contest that as of today the rally looks stretched and that the shares may tread ground for a period of time, however, if AI is to become integrated as widely as companies currently suggest in their communications with the market, then, as the market leader Nvidia should be able to grow into its lofty valuation. Even so, we are unlikely to add to our position at current levels but intend to hold onto our existing position.

For those who remember that Vodafone passed up the opportunity to have sole European distribution rights on the iPhone when approached by Steve Jobs, believing that in the age of minimalization of handset sizes, there would not be significant demand for a large phone from a computer manufacturer, the words of Jensen Huang, the founder and CEO of Nvidia are prescient when talking about ChatGPT: "This is the iPhone moment of artificial intelligence". Bill Gates, goes even further, describing it as the "most important advance in technology since the graphical user interface"; the technical term forerunner of every operating system including Windows.

<u>State of the art: Nvidia's H100 Tensor Core GPU</u>



Source: Nvidia

Richard Scrope, Fund Manager, VT Global Select Fund, 30th June 2023
Data source (unless otherwise stated): Bloomberg.

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