

### Fahrenheit 451

30 September 2025

If you pop something that is sitting on parchment paper into a hot oven, it's useful to know that 451 degrees Fahrenheit is the rough temperature at which the paper would burst into flames. If you ignore this point, you might need a fire extinguisher to hand.

In fact, the exact temperature at which book-paper auto-ignites is determined by factors such as the length of time exposed to heat, the composition of the paper and the coating (more flammable or heat resistant). But at least the laws of physics provide us with a range of temperature within which vigilance pays.

Unfortunately, and despite the best efforts of academics and market traders to find them, there are no such physical laws governing the valuations of financial assets.

#### Art and science

I wouldn't go so far as to call it a guessing game, but I do subscribe to the idea that successful investing is as much about the 'art' as the 'science'.

Clients ask us a lot about current market valuations – notably for US equities. The S&P 500 and more tech-centric Nasdaq

#### Quick take:

- US tech companies' AI investment is high but future returns from this are uncertain
- US government attacks on science and higher education could be bad for long-term economic growth
- We're looking out for geopolitical risks, with old elites under pressure

have been very strong performers, to the point where certain aspects of their valuations are undoubtedly looking topy – in other words, the kind of levels we tend to see at market peaks. This concern is all the more important because US equities account for around two-thirds of global indices, making them the key asset class for most investors.

The bluntest instrument for looking at equity valuations is the price-earnings (PE) ratio: share price divided by the earnings per share. This ratio breaks down into a few components. The first is what you could otherwise earn while taking no risk with your capital: generally a government bond with a ten-year maturity or, perhaps, cash. To that you can add an 'equity risk

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premium': the extra return investors demand for the risk of owning an asset that will probably be more volatile and can, in theory, go to zero (if the company goes bust). Then you might look at the growth prospects of the company you're investing in, assigning it a higher valuation today because of the prospect of strong future growth.

Every variable within this process is uncertain. What is the 'right' bond yield? Is there a 'fair' equity risk premium? For years, this seemed to be around 3%, but this has been compressed recently. There are various possible reasons for this; one might be that investors regard the risks to the downside for developed market equities as limited. And how reliable is your growth forecast? Will your chosen investment, for example, benefit from new technologies such as artificial intelligence (AI) or will it be disrupted by these technologies? Is it subject to (geo)political risk? We then have to overlay a combination of hard-and-fast numbers (such as balance sheet strength) and more subjective considerations (such as the strength of management).

You might think that the armies of economists and strategists employed in the financial industry could come up with some decent answers, but history shows how hard this is. For example, let's go back a decade and look at what a major and highly respected global asset manager

was forecasting for US equity returns in the following decade (to the end of 2024). I'm not going to name the manager because I don't want to criticise them – I just want to illustrate the difficult nature of this sort of exercise. But the information is publicly available.

Their ten-year forecast for US equity returns was a compound annual growth rate of 6.5%. The actual outcome was an extraordinary 13.1%, almost exactly twice the expected return.

The compounding effect was spectacular. A sum of \$100,000 invested on 1 January 2015 might have been expected to grow to \$187,000 but actually turned into \$351,000.

### Network effect

The key miss (and one that I believe was made by pretty much the whole financial industry) was to underestimate the success of the leading technology companies in turning themselves into oligopolies with incredibly strong platforms that benefitted from a powerful network effect. This is where the more people use a product or service, the more valuable it becomes. As a result, these companies have been able to generate strong and incredibly profitable growth with relatively low capital intensity (cents of investment for every dollar made). Plug that into a valuation process that arrives at higher or lower numbers by looking at cash flow returns relative to the capital

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required to generate them, and a higher PE ratio makes sense.

This seems almost obvious in retrospect, but was not. When US tech company Apple became the first company worth a trillion dollars, in 2018, many asked if that was sustainable. Now it's approaching \$4tn – and US chipmaker Nvidia has already passed that milestone.

This is not a cop-out: a recommendation to stick all of one's savings into passive index funds that own everything. It's more a reminder that equity valuation is more sophisticated than might appear. And we're by no means ignorant of the risks surrounding current valuations. We're always on the lookout for threats to companies we invest in, whether from a competitor or from within.

For an example of the latter, the current race to develop the winning AI models and tools is starting to incur considerable capital expenditure. It's not clear that all of this will make a decent return (or at least what's expected of it). While spending was funded largely from cash flow there was less to worry about, but more of this is being financed by debt. There are echoes of the late 1990s, in deals struck that involve making investments in client companies that will enable them to continue buying your products.

From a portfolio perspective we can limit the risks through sensible diversification, in

both individual stock selection and asset allocation. But it's also key to keep enough skin in the game to share in the upside, should stock markets go on a tear. The global asset manager I mentioned earlier has forecast US equity returns of 6.7% over the decade beginning this year. I'll be interested to see how *that* one turns out. One thing is certain, though: the returns won't be linear. There will be plenty of ups and downs along the way. That's about the only thing that we can predict with any degree of certainty.

### Burning books (and bridges)

*Fahrenheit 451* is also the title of Ray Bradbury's dystopian 1953 novel. The author himself cited various sources of inspiration, but they are all remarkably relevant to the times in which we live. A recent *Financial Times* feature-length article asked if the US was "entering a new era of McCarthyism". This recalled the country's paranoia about Communism in the 1950s, marked by a heavy-handed approach to weeding out "reds under the bed". Bradbury would have been writing around the time that firebrand Senator Joe McCarthy made his first speech on the subject. The suppression of free speech was another influence cited by Bradbury. The banning and burning of books presages today's defunding by US President Donald Trump's administration of educational and scientific

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establishments and its attempted 'curating' of educational curriculums.

Bringing politics into investment commentary is fraught with danger. Political events have often only had limited long-term effects on financial markets despite generating much short-term volatility. It tends to pay to tie yourself to the mast, Odysseus-style, and focus on the ultimate destination. Even so, it's impossible to ignore the current episode in US politics, including the apparent attempt to demolish many of the existing pillars of national and international governance. The US Constitution is supposed to mitigate the risks, but Trump appears intent on bypassing it as much as he can. And if he does so, measures that could hit US science and elite higher education are not great for the long-term economic growth of a country whose GDP and stock market are increasingly built on brain rather than brawn.

### Old elites under pressure

Having said all that, it's welcome that the US is trying to bring China to heel, after years of abuse of intellectual property rights and other rules it's supposed to abide by as a member of the World Trade Organisation. It's not too hard to have sympathy with the need for other Nato countries to spend their fair share on defence. And cutting the fat from federal

budgets? Bring it on, if it saves the Treasury money! But the federal government's new *modus operandi* has been a shock to markets, not least with the initial tariff announcements in April.

It might well be that this sort of disruptive behaviour is something we have to learn to live with. In a thought-provoking essay for the *Financial Times* last weekend, Giuliano da Empoli, an Italian-Swiss political scientist, wrote about both populist leaders' and technology innovators' desire to move beyond the liberal democratic consensus and "wipe out the old elites and their rules". The rise of parties such as Reform in the UK, Alternative for Germany and National Rally in France, show that many people think that the current system is broken. I'm not at all convinced that the proposed alternatives are any better – they're probably worse. But I understand why so many people desire change.

As we can see from the writings of Bradbury, we have been here before: such moments are an inevitable part of longer socio-political cycles. It's no use ignoring them. I always say that we have to play the hand we are dealt and not the one we would like to have had. That goes in spades for investing and we shall have to accommodate these developments when managing portfolios.

*For recent economic highlights, see below.*

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**UK** – Final revisions to GDP data for the second quarter of 2025 showed that overall economic activity remained sluggish, although at a slightly higher level than previously calculated. This suggests that growth in productivity (output per worker) has been less anaemic than previously thought. It might also help explain the persistently high levels of inflation. While Q2 growth of 0.3% quarter-on-quarter (q/q) was unrevised, this is still a slowdown from 0.7% q/q in the first quarter. However, annual growth was revised up from 1.2% to 1.4%. The key revision was to business investment, from -4.0% q/q to -1.1%. This offers some encouragement for investors worried about the UK economy. Inventory reductions and weaker external trade trimmed the final figures. Consumers remain cautious, with their savings ratio rising again to 10.7%. A lower savings rate could boost future consumption. But that will require an improvement in consumer confidence, which looks improbable in the short term.

What does this mean for policy? There will be no revisions to either consumer price or employment statistics, so the Bank of England will have no reason to change its current focus on reducing inflation. Futures markets continue to see no further cuts in the base rate until possibly as late as April 2026. November's Budget is of more immediate interest. There's nothing

in the GDP numbers to change the widely held opinion that the Chancellor will once again raise taxes. That's because underlying economic growth, which is used to work out how much money the government is likely to raise from existing taxes, still looks quite low. Latest reports suggest that an increase in the basic rate of income tax is no longer off the table. Although this contradicts the promises made in Labour's election manifesto, it's one of the few avenues available to raise sufficient funds to reduce the fiscal deficit enough to appease the bond market.

**US** - In contrast, the US economy powered higher in the second quarter, with annualised growth revised up from 3.3% to 3.8%. The main driver was personal consumption growth, revised up from 1.6% to 2.5%. The near \$7trn quarterly increase in household net worth, driven by a booming stock market, will have been a powerful tailwind.

But one area of the economy not contributing to growth is housing. Although average 30-year mortgage rates have fallen from a peak of more than 8% to 6.3% today, the majority of existing mortgages were taken out at much lower rates. This means that homeowners with these low-cost mortgages are unwilling to move, since they'd be forced to take out a new mortgage at the prevailing rate. This

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has created weakness in housing construction and home moves, which stimulate the economy as people refurbish their new homes. But balancing this weaker activity is a boom in data centre construction as the race for leadership in AI runs its course.

The latest readings for core personal consumption expenditures (PCE) inflation, the Federal Reserve's preferred measure of price changes, underline why it's reluctant to cut interest rates too aggressively, despite White House pressure. August's annual rate was 2.9%, well above the Fed's 2% target.

**Europe** - Survey data suggests sluggish activity in the Eurozone. The latest purchasing managers index (PMI) survey readings showed a contraction in manufacturing but growth in services. Exports have tailed off because of tariffs and the ending of an inventory build-up in the US, to buy stock before the tariffs came in. Business sentiment has fallen to a four-month low, weighed down by France's political troubles. Although Germany is providing a fiscal boost to its economy, even there sentiment weakened, according to the latest Ifo survey. Eurozone inflation, at 2.3%, is far more controlled than in the US and the UK, but market pricing suggests a very limited probability of the European Central Bank cutting rates below the current 2% level. We retain faith in the region's desire to

reduce regulatory barriers and encourage more innovation and investment, but patience is required.

**China** - The state-compiled purchasing manager surveys for September continue to suggest a slow economy. The manufacturing reading was 49.8, with services at 50.0 - the dividing line between expansion and contraction. Investors will concentrate this month on how the government's latest Five-Year Plan might support growth. A key aspect will be how it encourages households to spend more and save less. Analysts also expect measures to support childcare and education, as well as improved social assistance programmes. Self-sufficiency in an increasingly polarised global economy could also be a theme, especially in technology. Even so, very high levels of debt relative to the size of the economy continue to present challenges.

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