Q2 2026 Investment Commentary

A Tale of Two Markets

It was the best of times, it was the worst of times. The division in global equity markets has been building for eighteen months. The second quarter of 2026 has made it even more jarring. For investors in major indices, the headline returns have been strong. For investors in quality companies the returns have been considerably more challenging. The divergence between the two has rarely been sharper.

Our World Stars Global Equity strategy was up +6.8% for the quarter, reversing much of the pullback in Q1 and leaving it down -2.3% for the year net of fees of 1%. This compares to the MSCI World NTR up +13.8% during the quarter and +9.7% for the year to date. Our underperformance was most marked in April and May for the reasons we discuss below. This outcome is clearly below our expectations for positive absolute and relative returns over a market and investment cycle (all data in USD unless noted).

The underlying global economy remains resilient despite the geopolitical and economic challenges. In the United States, Europe and across much of Asia, corporate investment is strong, labour markets are stable and demand is holding up. Only two weeks ago the IMF updated its forecasts for global GDP, with a small reduction in 2026 to 3.0% (3.1%) and 3.4% for 2027.

The positive forces driving this growth are real: investment in technology and computing infrastructure driven by AI; expansion of power generation and transmission capacity; a step-up in European defence spending; investment in energy independence and resilience; and reshoring of critical industries like semiconductors. Positive income effects from tax refunds and the strong US equity market are also supporting US high-end consumer spending. These structural tailwinds are substantial.

During the second quarter there was a significant de-escalation in the Middle East, starting in early May. This pushed the oil price down from US$114 to US$72, which eased fears over inflationary pressures for companies and consumers, and also led to a shift in expectations of forward interest rates. Reduced fears over a spike in inflation shifted the consensus view to one of 'unchanged rates' in the short-term whilst policymakers assessed the duration of the price pressures. This position was epitomised by the US Fed's FOMC minutes under the new leadership of Kevin Warsh. The FOMC minutes noted that inflation was elevated, but kept rates unchanged at 3.5-3.75%.

At the time of writing, there has been a further upsurge in hostile activities in the Middle East, which has taken the oil price back to US$90, and will impact on the assessment above. But events continue to change week by week.

Across many industries, the world has been buoyant in managing through the episodes of closure and partial reopening of the Strait of Hormuz. On the trade front, the partial reversal of last year's tariff impact has provided some relief, following the US Supreme Court ruling and associated refunds.

A significant barometer of business conditions and momentum is the direction of forward earnings estimates for leading companies across the world. In many areas, and for the majority of companies, this has been positive during the last few months. It has been led by energy and technology companies, and by US stocks, but the overall trend has been for higher estimates. This has also been the case in our portfolio, with a 4% increase in full year 2026 earnings estimates after the release of Q1 results.

The Thematic Market

Index returns this quarter were driven overwhelmingly by a narrow set of themes: semiconductors, power infrastructure, and a handful of large-cap listings with expectations that will be highly challenging to fulfil. The concentration data tells the story vividly. Semiconductor companies have now reached almost 20% of market capitalisation, as the semiconductor sector has more than doubled this year. This is now at its highest level in history and it is more than double the share semiconductors commanded at the peak of the dotcom bubble. This is not diversification. It is concentration risk dressed up as an index.

It is even more revealing which companies drove this. The biggest winners year-to-date were not the most sophisticated or structurally advantaged names. Micron, a memory chip company with an inherently cyclical business model, was up over 300% year-to-date at the end of the second quarter. SanDisk was up over 800%. These are businesses benefiting from a short-term memory shortage driven by the demand for AI infrastructure. This demand is real but it is cyclical, and the market is pricing it as if the cycle will never turn. Nvidia, our own holding since 2022 and one of the highest-quality businesses in the semiconductor sector, has risen just 7% this year. In other words, the market has paid the highest premium for the most commoditised parts of the stack and left the best businesses behind.

However, we should not forget that the surge in memory demand is a direct consequence of Nvidia's success. Nvidia is the catalyst behind this move: without Nvidia's unprecedented demand for AI, this memory shortage would not exist. Cyclical commodity industries always tend to end the same way: they experience strong demand, expand capacity and then price and margins crash. The Financial Times recently quoted an analyst at Morningstar who rated the competitive moat of several memory companies as "none". Several of the leading memory companies have recently announced very large capacity expansions, with their shares consequently falling more than -25% from their late June peaks.

Power companies have surged on similar logic, driven by near-term expectations of actual shortages as data centre buildout outstrips grid capacity. The question is the price you pay. When cyclical tailwinds are priced as permanent structural advantages, the margin of safety disappears.

Quality Stocks: The Other Market

Alongside this thematic surge, the tale of two markets has seen a large number of high-quality companies become available at highly attractive valuations. This is what Christopher Rossbach, portfolio manager of the World Stars Global Equity strategy and member of the Barron's Roundtable, said at the latest mid-year Roundtable update. You can read the update on the Barron's website here.

Our World Stars Global Equity strategy has had strong performance this year from many holdings across technology, consumer and industrials. These include ASML (+87%), the global leader in lithography technology, which is a critical element in the manufacture of the smallest and most complex chips. Two of ASML's largest customers, Samsung and SK Hynix, have announced a US$500bn investment in new semiconductor fabs in South Korea.

Eaton (+35%) and Amphenol (+31%) are key suppliers of power management equipment and connectors for industrial applications including all aspects of the data centre buildout. Alphabet (+14%) has gone from having 'lost' the race for consumer AI to ChatGPT, now to winning it with strong growth in its Gemini AI application. Finally, Givaudan (+12% in CHF) is a leader in flavour and fragrance where we now expect improved organic growth overall as an inflection in taste & wellbeing is combined with strong growth in fragrances & beauty. The market is also looking for new growth initiatives from the new CEO, who has 29 years of industry experience including the last 22 at Danone.

Software is the clearest example of mispricing. SAP (-34% in EUR), the global leader in enterprise resource planning, has fallen sharply on fears that AI will displace or disrupt large software platforms. We believe this gets the argument backwards. AI is a net tailwind for SAP, not a threat. Companies need to organise, clean and deploy their data before AI can meaningfully improve their operations, and SAP sits at the centre of that process. Only half of SAP's customers are even on the cloud. The enterprise AI transition will, in our view, reinforce SAP's indispensability rather than diminish it. Salesforce (-41%) did even worse and was our worst performer.

Consumer companies and healthcare companies with consumer exposure have been the other major area of pressure, as higher energy prices, variable expectations on interest rates and uncertainty around travel and discretionary spending have weighed on sentiment. LVMH (-24% in EUR) is being impacted by subdued demand in China, especially for higher-priced global luxury products, as some consumers favour 'quality' items produced locally. The Middle East is only c.6% of LVMH's global revenues, but the management were cautious on the overall short-term outlook after the recent results. EssilorLuxottica's concerns centre on smart glasses and how they will impact the market for vision correction. We think it will be a real and growing category but it will not displace corrective or premium eyewear at scale, and EssilorLuxottica will participate in it through its leading partnership with Meta.

We are encouraged by better progress in some consumer stocks, including Nestle (+10% in CHF) where the new Chairman and CEO have raised hopes of faster revenue growth and market share gains. Increased product innovation, targeted marketing, local empowerment and stronger incentives are well-practised ways to drive energy and growth in consumer goods.

With Nike (-35%) the turnaround is taking longer than expected, but there were encouraging signs in the recent Q4 numbers. Global revenues fell 1% with a flat gross margin of 40%, but the decline in gross margin (from 46% in 2022) is now expected to inflect in Q1. Stronger innovation, less discounting and a shift in channel focus should drive both revenue growth and margin expansion in due course.

Portfolio Activity

We have been active in repositioning the portfolio in recent weeks. In June we added to SAP, Salesforce and Honeywell before its split into Honeywell Technologies and Honeywell Aerospace; and we sold Zoetis. In early July we bought a new position in Arista Networks and added to Honeywell Technologies and Honeywell Aerospace. We sold Otis and trimmed ASML and Amphenol, which have been significant beneficiaries of the current AI-related investment cycle and performed strongly.

Arista Networks provides high-performance switching and routing solutions for data centres, AI clusters, enterprises and campus environments. It operates its proprietary EOS software platform alongside best-in-class hardware and has been the leading disruptor in networking for more than a decade, consistently taking market share from Cisco. Arista is now the primary Ethernet networking beneficiary of the AI data centre build-out. We expect networking to represent a significantly larger share of data centre capital expenditure as hyperscalers work through constraints from permitting, construction and chip supplies and increasingly shift their focus towards the network.

We sold Zoetis because of several issues that have become more persistent. These relate to higher price elasticity, increased competitive pressure in its core areas of parasiticides and dermatology (where Zoetis is the global leader), and slower development of its product pipeline. We respect the strength of Zoetis' long-term track record but believe that these issues will provide challenges both to revenue growth and to margins.

Similarly, Otis has a powerful position in the global elevator and escalator market, especially in the high-margin service business with an installed base of 2.5m units under contract. Modernisation is also a significant growth area given the average age of its installed base at over 20 years. However, the industry headwinds on new equipment sales in China appear quite entrenched. A new challenge has also emerged in global service, with disruption from labour optimisation initiatives at the service branch level.

Honeywell Aerospace offers nose-to-tail content across commercial aerospace, defence and space. It has content in over 90% of in-service aircraft globally, and its target of 6-8% top-line growth to 2030 is underpinned by US$90bn in new platform wins over the past three years, an acceleration in retrofit and upgrade activity and growth in international defence.

Honeywell Technologies serves an overall market of US$200bn. It has focused expertise in automation and technology across industrial buildings, processes and factories. It benefits from powerful megatrends including infrastructure build, energy security, digitalization, net zero, AI and reshoring.

Outlook

The resolution of the Gulf conflict, the trajectory of interest rates, the persistency of AI-related demand and the resilience of the global consumer against pressure from higher energy prices and related inflation will remain significant issues in the near-term. We cannot know when these headwinds will resolve. We do know that we own high-quality companies which should be resilient and continue to benefit from long-term growth in demand. They have strong and sustainable competitive advantages in good industries with opportunities for growth and capital allocation, strong management teams, and balance sheets that are strong enough to navigate adversity and potentially reinvest in new growth opportunities.

The most important investment discipline right now is not to chase the market. It is to be selective, patient and focused on quality. The index is highly concentrated. The most thematic parts of it are fully valued. The companies we own, and the ones we have been selectively adding to, are not. This combination of attractive valuation and fundamental strength is the proven approach for long-term investors. Quality always reasserts itself and we are confident that it will do so again.

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