

# Investment Views



MARCH 2023

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# Into the Unknown

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# When Life Gives You Volatility, Buy Short-Dated Bonds

Equities:

# Taking a Breather

# Into the Unknown

With elevated inflation and sharply rising interest rates, it is no surprise that economic growth slowed last year. What has been more surprising is the resilience of many Development Market and Emerging Market economies. The re-opening of China, falling commodity prices - especially energy - and softer than expected US inflation readings have helped support growth in the fourth quarter of 2022 and the first two months of this year.

We are now in a period of flux. The recent good news has to be weighed against the slower moving challenges of higher interest rates and higher inflation rates making their way through the economy. Economist Milton Friedman once famously said that monetary tightening effects the economy with “long and variable lags”. This makes a lot of sense as economies are complex ecosystems with many interrelated forces and it therefore takes time for businesses and households to adjust.



## STRATEGY

A large body of research suggests that it can take 18 months to two years, or more, for tighter monetary policy to materially affect inflation. However, more recent evidence suggests that these lags have shortened over time. Central bank transparency has improved considerably and this has made it easier for policymakers to signal their intentions ahead of time which the markets are then able to price in. Furthermore, economies are much more “financialised” than they used to be, so in a credit-based system the passthrough of market movements to the real economy is shorter than it used to be.

This challenge has been compounded by unusually high economic volatility. While markets rebounded in the fourth quarter of last year, underlying economic data in the US was particularly weak. However, the past two months have been characterised by an acceleration of economic growth with strong January data across consumer spending, manufacturing, and housing. Pandemic distortions and unusual weather patterns have made seasonable adjustments difficult, but the bottom line is that economic resilience has led the Fed and markets to reassess how high interest rates will have to rise in order to curb inflation.

The resilience of the US economy is currently focussed on services. Total spending on areas hit hardest by the pandemic, like travel, tourism, live events and dining out, is running around 25% above pre-pandemic levels. Unsurprisingly, higher interest rates have taken their toll on housing market activity and have also recently exposed banking sector vulnerabilities.

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## STRATEGY

These contrasting forces make policymaking particularly tricky as inflation risk has to be assessed alongside growth risk and financial stability risk. Last year all factors pointed towards higher interest rates but the outlook is now a lot more balanced. The combination of a resilient economy and higher interest rates has meant that the US equity market has agitated both bulls and bears as it has neither rallied meaningfully nor extended its decline. With an uncertain backdrop we continue to have a defensive tilt in asset allocation, an overweight to Defensives within equities, a focus on credit quality in Fixed Income and diversification within Alternatives.

# When Life Gives You Volatility, Buy Short-Dated Bonds

Financial markets continue to operate at a higher level of sensitivity with news flow on global inflation dynamics being replaced by a renewed focus on growth. In addition, elevated US dollar central bank liquidity since October has been providing further fuel for risk assets to power higher.



For these reasons, and with valuations running ahead, we have remained defensive, preferring to generate total return via short dated US Treasuries in our US dollar bond funds. With central bank liquidity taking a turn this month and quantitative tightening resuming, risk assets lost a pillar of support and once again have turned to data and Fed Chair Jerome Powell for guidance. A recent increase in inflation pressures in Europe has provided a warning that the Federal Reserve should not declare victory on inflation too early. This raises the odds that the only way to truly put the inflation genie back in the bottle is for a hard landing later this year.

Markets experienced elevated volatility during February. More bullish economic data continued to flow out of China, Europe and the US, triggering above average moves within short dated inflation expectations, real interest rates across the curve and further upside for the US dollar. 2-year US inflation expectations rose by a large 85 basis points (bps) and the US yield curve fell to its most inverted level in decades, as the 2-10 year spread hit -90 bps. The bond market has repriced a higher-for-longer outlook for base rates and the base rate cuts that were priced in for this year have been priced out.

Rising real interest rates also took their toll on gold with a -4.8% fall during February as the 4.82% yield (1.64% real yield) available on risk free 2-year US Treasuries sapped demand. Lumber prices continued their rollercoaster ride with a -23% decline for the month as mortgage rates resumed their climb. 30-year fixed

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**-4.8%**

The figure that rising real interest rates took their toll on gold.

**-23%**

The figure that Lumber prices declined for the month.

mortgage rates reached an average of 7.03%, leaving affordability at its worst level in 15 years. Energy prices were largely flat as the market has still to determine the strength of the Chinese reopening, with global growth showing signs of life but still weak relative to previous quarters. With Europe's momentum slowing and the US toying with a policy-induced recession, China will likely determine the direction of the global economy in 2023.

The US dollar staged a broad rally, as recent economic data surprised on the upside and stretched short positioning partially unwinding, especially versus the Japanese Yen (+4.7%) and the Australian dollar (+4.6%). The expected appointment of economist Kazuo Ueda as the new Bank of Japan Governor is likely to ensure no abrupt changes in future policy decisions as he takes over from Haruhiko Kuroda. The weakness in the Yen reflects further expectations of monetary easing in order to defend the yield cap on Japanese 10-year government bonds.

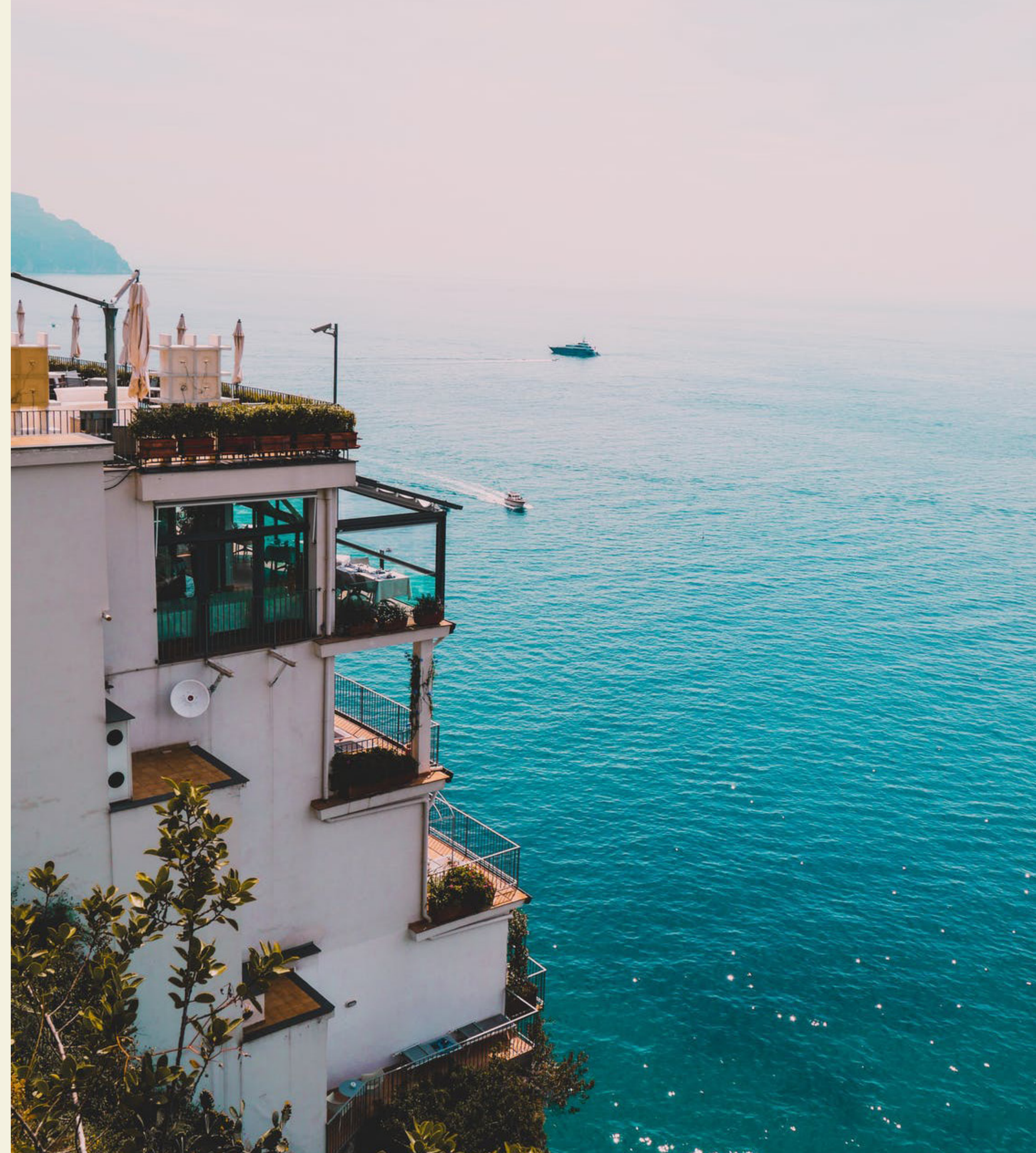
Credit spreads rose slightly in tandem with weakness in global equity markets, but low supply and renewed demand for lower volatility equity substitutes, such as US high yield credit which yields over 8%, has provided a source of stability during February. However, with bond market volatility surging once again, investors are likely to remain cautious and take longer duration investment grade credit risk.

With portfolios largely positioned defensively and duration having been permitted to drift lower in January, we managed to mitigate some of the volatility from rising bond yields during the month. We have also increased our allocation to US inflation protection. Very attractive risk-adjusted carry within short dated Fixed Income markets continue to provide us with the opportunity to keep portfolio risk low without sacrificing returns while also allowing us to be on the front foot when opportunities present themselves.

# Taking a Breather

The MSCI World peaked at the beginning of February with a year-to-date performance of 9.5%, but fell 2.4% over the full month in US dollar terms as stickier inflation and interest rates hike expectations started to take their toll. All eyes have been on the US labour market which has been stronger than expected, fuelling inflation expectations and pushing out rate cuts until next year. The Non-Farm Payroll numbers released at the beginning of February caught the markets off guard rising by 517,000, significantly higher than the 189,000 estimate. This complemented other inflation data points and suggest inflation is stubbornly persistent.

Most cyclical sectors underperformed, as one would expect, in a weaker market with Materials and Energy falling more than 4%. Some of the defensive sectors performed poorly, including Utilities, a sector where we are underweight, and Healthcare, a sector where we are overweight. Utility companies tend to have





# 9.5%

The figure that the MSCI World peaked at the beginning of February with a year-to-date performance.

## EQUITIES

higher debt loads, made possible by stable cash flows and the regulated environment they operate in, however are negatively impacted by rising rates. Healthcare on the other hand appears to be a US specific issue with politics and the debt ceiling acting as a drag. In February alone, the difference in performance between the MSCI USA Health Care Index and the MSCI Europe Health Care Index was approximately 5%. Other sectors that surprised were Technology and Industrials, which performed strongly on a relative basis, and Consumer Discretionary outperforming Consumer Staples in a falling market, having outperformed in a rising market. A potential explanation for these deviations is the fourth quarter earnings season, as many companies report their year-end numbers in February.

Growth marginally outperformed Value, which is unusual given growth usually underperforms in a weaker market. Growth has now extended its lead over Value by 6% year-to-date. Interestingly, the dispersion we had in the equity markets last year has led to some index providers reclassifying companies such as ExxonMobil, Chevron, Marathon Oil, from value indices to growth ones leading to vastly different performance amongst the different factor indices. Growth is usually defined by 3-year earnings growth rate, 3-year sales-per-share growth rate and momentum. Value is defined by price relative to sales, earnings or book value. Energy stocks have traditionally been value stocks and are cyclical which raises the question as to the benefits of the reclassification and when it will be reversed.

European equities outperformed US equities in February with MSCI Europe ex UK now outperforming its US equivalent by 4.4% YTD. The UK equities markets brushed off the regular strikes and downbeat economic forecasts returning 0.3% in February. A stark reminder that the correlation between economic growth and equity markets' performance is loose. The MSCI

## EQUITIES

Japan lost ground but the real losers were MSCI Pacific ex Japan and MSCI Emerging Markets which dropped 6.5% and gave back most of its gains this year. Traditionally Emerging Markets underperform when the US Dollar strengthens. In February the USD strengthened by 2.7% versus the EUR and 2.5% vs the GBP.

The one company that stood out this earning season was META US (Facebook). It is not often that we see a \$500bn company (once valued at \$1 trillion) jump more than 20% in a day. The company reported 2023 as the year of efficiency slashing Opex guidance by 7% (\$5bn) and Capex guidance by 12% (\$4bn) appeasing investors who are now focused more than ever on bottom line profitability. The years of cheap liquidity are over and gone with them are the companies that struggle to articulate how they will generate a profit.

# 2.7%






The figure the USD strengthened versus the EUR in February.

All eyes have been on the US labour market which has been stronger than expected, fuelling inflation expectations and pushing out rate cuts until next year.



# Global Asset Allocation

The chart below details our 6-12 month tactical investment strategy

	UNDERWEIGHT -	+ OVERWEIGHT
Asset Allocation	CASH (MODEST UNDERWEIGHT) EQUITIES (MODEST UNDERWEIGHT) \$	 FIXED INCOME (MODEST OVERWEIGHT) NON-TRADITIONAL ASSET CLASSES (MODEST OVERWEIGHT)
Fixed Income		 EMERGING MARKET DEBT HIGH YIELD DEBT
Equities Regional		 EMERGING MARKETS
Equities Sector	CONSUMER DISCRETIONARY + UTILITIES 	 CONSUMER STAPLES HEALTHCARE

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