

Investment Views



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Recession Rescheduled

At the start of the year, private sector economists forecast that in 2023 the US economy would grow by 0.30% in real terms (after inflation). This was as close as could be expected to a US recession being the base case scenario given Wall Street's inherent bias towards optimism. The Federal Reserve's forecasts for the unemployment rate also implicitly forecast a US recession but, in both cases, the central expectation was that any recession would be relatively mild.

After weak economic data in the fourth quarter, data for January came in much stronger than expected and full year expectations have since been revised higher to 1.1%. This is still a low rate, but is a long way from a recession. While 2023 growth revisions have been revised higher, expectations for 2024 have been trimmed from 1.3% to 0.8%. A mild recession remains the base case for many forecasters, but this has been pushed out from this year to next year.



STRATEGY

The US economy has been more resilient than expected due to a number of factors. Firstly, the housing market has stabilised as mortgage rates have come off their peak levels seen last November. Easing inflation pressures have also helped to support activity. Real personal disposable incomes turned positive in the second half of last year and falling commodity prices, especially oil, have been very helpful. Private sector balance sheets have remained resilient as homeowners and corporates used the period of very low interest rates to refinance and reduce sensitivity to rising interest rates. Lastly, the labour market has held up well with job openings continuing to run at very high levels. While there have been high profile job cuts at large technology orientated companies, many other sectors have been hiring.

It is also important to define what is meant by a recession. Last year, the US economy contracted by an annualised 1.6% in the first quarter and by 0.6% in the second. By some definitions, two consecutive quarters of negative GDP growth constitutes a recession, but this definition is not robust or useful. It has recently been a topic of discussion once again as Germany has seen two consecutive negative quarters. Defining a recession accurately is important particularly when thinking about financial market implications.

The two negative quarters of GDP growth in the US last year were largely due to inventories and exports, both volatile components that do not reflect true underlying activity. Consumption, which provides a much better reflection of growth, remained resilient. The National Bureau of Economic Research in the US oversees the official Business Cycle Dating process, which is the more robust definition of a recession. Their definition of a recession is “a significant decline in economic activity that is spread across the economy and that lasts more than a few months”.

1.6%

The figure the US economy contracted by in the first quarter.

After weak economic data in the fourth quarter, data for January came in much stronger than expected and full year expectations have since been revised higher to 1.1%.



STRATEGY

In prosperous times, economies are powered by a virtuous circle of positive economic growth which creates more employment, more income and therefore more demand. However, in recessions this sequence reverses into a vicious circle. Negative growth leads to falling employment, falling incomes, falling demand and financial dislocations. This dynamic then puts pressure on corporate profits, pricing power, future growth expectations and credit fundamentals.

With the recession debate continuing to rage, it is useful to focus on what the business community is saying. Recent commentary suggests that business leaders are more than aware of the risks and are already putting measures in place to tackle a potential recession. Among S&P 500 companies, the first quarter was generally described as “solid” even though macro conditions were challenging. There is more pain being felt by smaller businesses, which are important to the economy. Overall, we continue to focus on a wide range of indicators to gauge what is really happening in the real economy, rather than focussing on definitions and semantics, and the US economy remains impressively resilient.

Preparing for the Liquidity Drain

As widely expected, the Federal Reserve raised the US base rate to 5.25% in May. The US government raised the debt ceiling, in what was largely an uneventful climax, with the agreed terms more generous to the current administration than the market expected (an extension until 2025 and after the next election). This led to a relief rally across credit and equity markets.

With the US Treasury general account ending May at just US\$49bn, the US government was close to exhausting their cash reserves. Now comes the hard part for markets. Janet Yellen has vowed to rebuild this balance to US\$475bn by the end of June, taking the required issuance to US\$1tn by the end of the third quarter. With US\$2.1trn currently sitting in the reverse repo facility at the Federal Reserve, there appears to be ample funds available to meet the US Treasury's needs without seriously distorting markets. However, there will be a price to pay. The current repo rate is 5.05% and the US Treasury will need to



provide a positive spread on new Treasury bill issuance in order to tempt money market funds, the unintended consequence of this is a potential further squeeze on US banking system reserves as the massive financing needs of the US government crowd out more productive capital needs.

Economic data in China, Europe and, to a lesser extent, the UK have started to weaken. In contrast, the US economy continues to surprise and perform better than expected. This has led the market to front run the addition of further Chinese stimulus and price out the probability of a reduction in the US base rate during 2023. Futures markets are effectively expecting a pause for the remainder of the year although there is an 83% probability of one more 25bps increase by July.

With a US recession deferred, the debt ceiling raised and global monetary policy leaning dovish, risk assets have been well supported. However, in a warning shot for the Federal Reserve, the Bank of Canada, after pausing rate hikes for three consecutive meetings, is now seeing the resumption of speculative behaviour in the real estate market and, worryingly, inflation and wages are reaccelerating. With the Atlanta Fed wage growth tracker still registering 6% average wage growth and various measures of ‘sticky’ inflation remaining well above 4%, policy makers need to tread carefully in their actions and communication in the months ahead.

Global bond yields rose broadly in May, with the US yield curve becoming more negative as two-year US Treasury yields reached 4.41%, a 40bps upwards move in a month. With inflation expectations falling, almost all of this move was due to less dovish monetary policy expectations this year as rate cuts become increasingly unlikely. UK gilt yields also remained volatile as inflation roared back, with core prices rising to 6.8% YoY, driving the ten year yield up to 4.18%.

5.25%

The figure that the US base rate was raised to in May.

83%

The probability of one more 25bps increase by July in the Futures market.

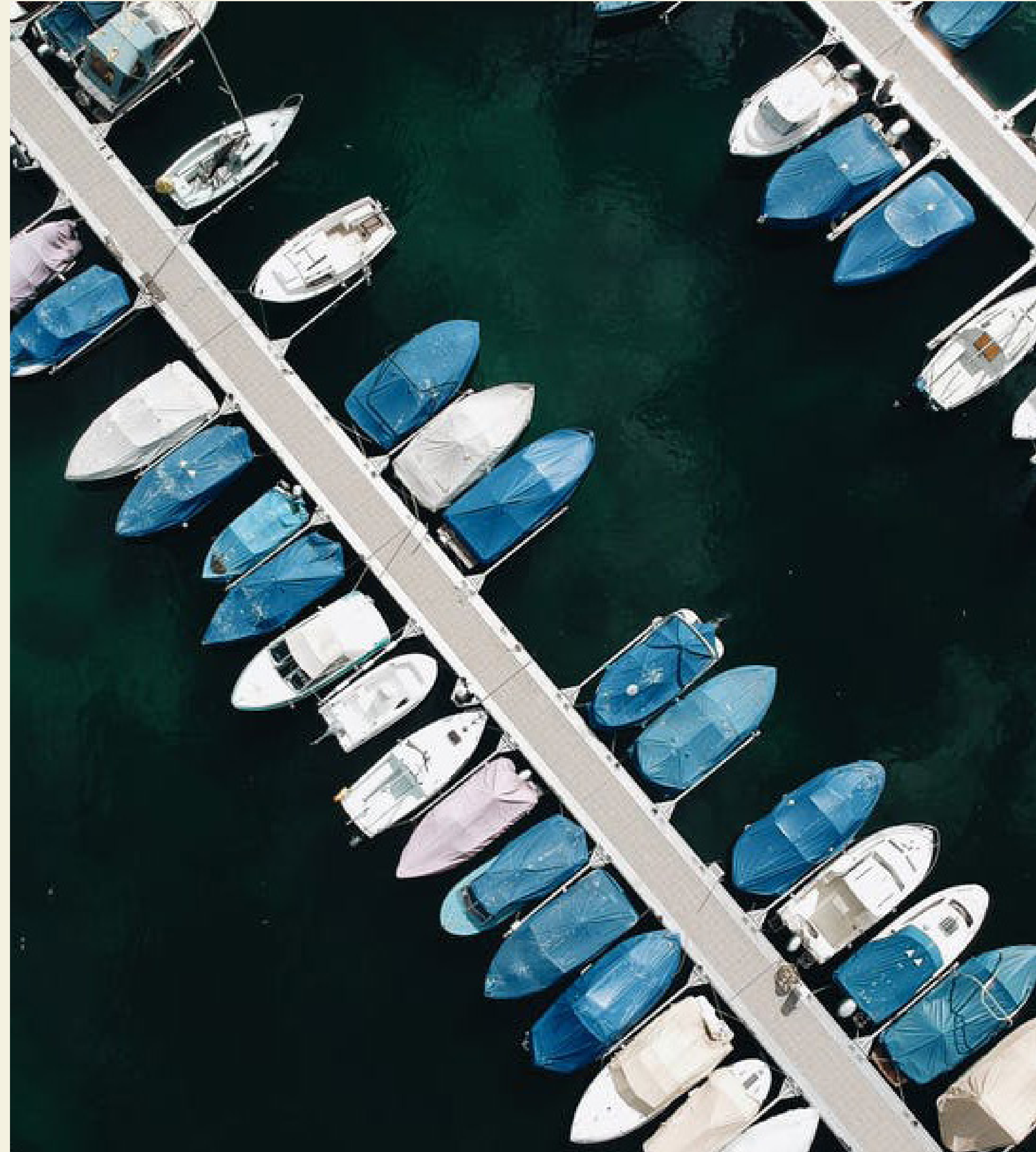
After a period of US dollar weakness, we witnessed a broad rally in May, with the Euro and Chinese yuan depreciating by 3% and 2.7%. The Canadian dollar was the only outlier appreciating vs. the US dollar due to more favourable interest rate differentials. Rising bond yields are also filtering through to the real economy as US mortgage rates resumed their upward trend. With shorter fixed ARM rates now 6.06%, borrowers can no longer avoid higher costs as they did throughout the last 12 months. If sustained this will likely force affordability levels lower. However, this is welcome as recent housing market strength threatens to break the current shelter deflation trend as house prices firm and the Federal Reserve has a very difficult balance to deliver.

We remain defensively positioned ahead of a large potential liquidity drain in the coming weeks. In our US bond funds, we added to US Treasury bill floaters which will benefit from a pause in US base rates and higher yields in order to attract funds from the reverse repo market. We also have reduced exposure to expensive corporate credit in the Energy and Technology sectors, which from a risk adjusted perspective would underperform if the US economy falls into recession.

We maintain our stagflation hedge via US TIPS, with prices at fair value and consistent with the 2% core inflation target. Sticky inflation also means that inflation expectations are unlikely to fall dramatically even if we see a broad recession. As we mentioned last month, we continue to add to US mortgage backed securities in our US dollar bond funds, which are very cheap on an absolute and risk adjusted basis, being one of the few spread products that will outperform in a recession. Interest rate risk has been allowed to drift slightly underweight as the positive stimulus from excess global liquidity and the US Treasury remain too easy for the US economy.

A Stock Picker's Market

The MSCI World gave back just 1% in May but is still up 8.5% year-to-date. This suggests May was a quiet month but that wasn't the case. May recorded the highest sector dispersion (best minus worse performing sector) this year at 18.1%. To put this into context, sector dispersion in February and April was around 5%. In January we had interest rate cut expectations fuelling a rally in Technology and Consumer Discretionary. In March we had the US regional banking crisis which drove a flight to safety resulting in Mega-cap Tech outperforming. In May we saw all things related to AI outperform. With the seven Mega-cap Tech stocks accounting for most of the positive returns year-to-date in the S&P500, it really is a stock picker's market.





6.9%

The figure that Consumer Staples fell this month.

EQUITIES

This month IT returned 8.2% as investors piled into AI winners. Nvidia, one of the largest beneficiaries of the AI theme, rallied 36% reaching a \$1 trillion valuation. IT is the best performing sector year-to-date up 31%. The worst performing sector in May was Energy, sliding 9.9% as weak economic data from China and recession fears weighed on oil prices. There were some signs of sector rotation as some of the worst performing sectors, Materials, Real Estate and Utilities, outperformed in May. In comparison, Consumer Discretionary, one of the best performing sectors, lagged. This is a classic example of investors selling the winners and buying the laggards.

A closer look at Consumer Staples and Consumer Discretionary reveals cracks in consumer spending. Consumer Staples was the second worst performing sector this month, tumbling 6.9%. This was partly driven by weakness in Household & Personal Products (down 9.5%) after an Estee Lauder profit warning, sending the stock down 20%. This was as a result of a slower than expected recovering China market. At this point you may be thinking that it could be stock specific, however, if you look at the Consumer Discretionary stocks you see a similar story. Consumer Discretionary recorded a 0% gain in May, however that number is skewed by heavy weights such as Amazon (up 14%) and Tesla (up 24%). Textiles, Apparel & Luxury Goods fell 11.2%. The luxury stocks, which generate a significant portion of their profits from Chinese buyers, sold off. Interestingly Europe, which was outperforming the US before May due to its overweight in luxury, is now performing in line with the US as luxury underperforms and tech rallies.

EQUITIES

We saw other Consumer Discretionary stocks underperform, with profit warnings from companies like Footlocker sending the stock down 27%. First quarter commentary from US retailers highlights a pattern of US consumers trading down as they manage high inflation and interest rates. Luckily for the US consumer, more than 90% of mortgage holders have long term fixed mortgages making them immune to the higher interest rate environment. Mortgage holders in countries such as the UK, Australia, and Canada are not so lucky, as more than 90% of holders have variable or short-term fixed mortgages.

Given the above, we are positioned defensively. With recent fund managers surveys suggesting most are positioned this way, one could argue that this makes a crowded trade and the risk is to the upside but, with our focus on wealth preservation, we prefer to stay defensive.








90%

The percent of
mortgages that are
fixed rate in the US.

The MSCI World gave back just 1% in May but is still up 8.5% year-to-date. This suggests May was a quiet month but that wasn't the case.

Global Asset Allocation

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

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

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