

Investment Views



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Strategy:

Upside & Downside Surprises

Fixed Income:

End of the Carry Trade

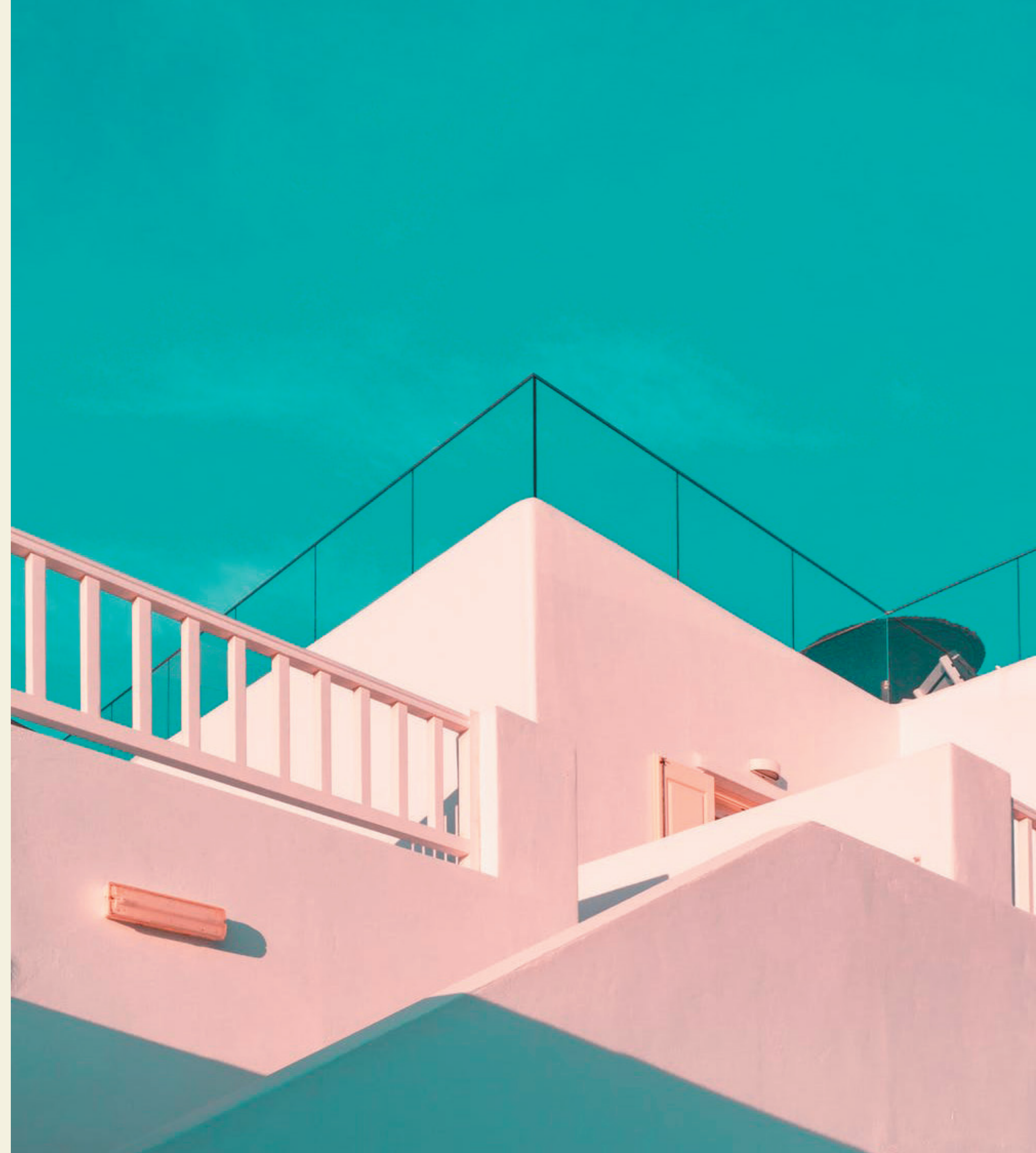
Equities:

The Magnificent Seven

Upside & Downside Surprises

In recent weeks, JP Morgan, Bank of America and the Federal Reserve have all adjusted their forecasts and no longer expect a US recession this year. Growth expectations for the US started the year at 0.3%, but the consensus has since been revised higher to 1.6%.

Coming into the year, the Conference Board's popular Leading Economic Index suggested that a recession was approaching and models run by Bloomberg Economics and research consultancy Capital Economics put the chances of a US recession at 100% and 90% respectively. A mild recession was the consensus expectation but the US economy has been resilient, the simplest explanation for the strength of the equity market this year.



In a research note titled “The end is not near”, JP Morgan provided a number of reasons as to why they have revised their recession call for this year. Firstly, economic models have had a tough time for the past three years during an unprecedented pandemic and enormous policy response. This is a factor in the recession forecasts not playing out: “recessions are nonlinear events, and most economic models are linear.”

In addition, adjusting for the unusual accounting treatment of student loans, fiscal expansion has amounted to over 3% of GDP this year and, as the research states, “recessions take hold when optimistic expectations meet less upbeat realisations”. Counterintuitively, businesses preparing for recession in advance might have actually helped the economy avoid one.

Falling energy prices, savings accumulated during the pandemic, the reopening of the services side of the economy and fixed rate mortgages muting the impact of rate hikes have also been important factors helping growth in the US.

In a recent interview, explaining the Bank of America’s reversal of a recession call, CEO Brian Moynihan said that “people are employed, they have money, they are spending money... it looks like we are reaching a pretty good equilibrium”. Similarly, at the Federal Reserve’s July press conference, Chair Jerome Powell stated “so the staff now has a noticeable slowdown in growth starting later this year in the forecast, but given the resilience of the economy recently, they are no longer forecasting a recession”.

While economic surprises have been to the upside in the US, the opposite has been the case in China. The year started with a sense of optimism that the lifting of pandemic restrictions would lead to a bounce back in growth but since May the news flow has been relentlessly negative. The major problem in China is the property

1.6%

The new figure that growth expectations for the US has been revised to – up from 0.3%.

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STRATEGY

market. Unlike previous property sector downturns, the current downturn has not seen policymakers use significant policy easing to help the sector recover. Authorities appear to be attempting to manage a multi-year slowdown rather than to engineer an upcycle.

The housing market makes up a significant proportion of the wealth of Chinese households, so a weak property market has had a negative impact on sentiment. Moreover, estimates suggest that the property market, including auxiliary products and services, accounts for up to one quarter of GDP growth in China. The private sector has also been under pressure through regulatory crackdowns linked to the “Common Prosperity” drive and the export boom from overseas demand is waning.

Worryingly, an array of support measures has failed to support sentiment and, if anything, has only highlighted the pressure that the economy is under. A 31-point guideline to “boost the development of the private economy” was met with widespread scepticism and small cuts to interest rates have not moved the needle.

While recognising the structural challenges, we were optimistic that the reopening after the pandemic would support growth and financial markets in China. However, this has not played out and in July we reduced our exposure to China and allocated the proceeds to Japanese equities. In contrast to China, Japan is benefitting from improved sentiment and does not have a private debt overhang like China. Furthermore, a weak yen is helping exports, particularly autos, while initiatives to improve corporate governance and boost returns for shareholders are finally starting to bear fruit.

End of the Carry Trade

Risk assets continued their relentless rise during July, credit spreads have tightened across most sectors in a classic “fear of missing out” momentum trade. With US high yield bonds now providing a spread of just 367 basis points (bps) above duration matched US Treasuries, the probability of further capital gains is much lower than in the immediate aftermath of the collapse of Silicon Valley Bank in March. Simply put, there is little margin for a growth or inflation shock in the months ahead.

In addition, the explosion of US dollar liquidity since March helped to remove tail risks from the US banking system. This has also indirectly fuelled risk sentiment as investors, not content with 5% risk free returns, added to equities and credit markets. With



FIXED INCOME

US core inflation still north of 4%, easing financial conditions will not be welcomed by the Federal Reserve. As a result, it's increasingly likely (barring a credit event) that US base rates will remain elevated for a much longer period.

Global bond markets remain volatile, with much better-than-expected US economic data at odds with a weaker Chinese and European outlook. Amid this noise, and in what could be a catalyst for an unwind of the global carry trade, the Bank of Japan surprised markets and will now offer to purchase 10-year Japanese government bonds at 1% through fixed-rate operations, effectively raising its tolerance by 50bps. Governor Ueda says this is not a precursor towards policy normalisation but merely ensures the sustainability of its yield curve control. Nevertheless, yields in Japan rose by 21bps, with further rises likely in the weeks ahead. This could potentially act as a tailwind for US yields to break through the highs of 2022, with 10-year US Treasury yields on the cusp of the 4% threshold.

Commodity markets are ignoring the slowdown in China with positive US growth dominating the narrative for now. As a result, WTI oil prices – also boosted by production cuts – rose to \$82 per barrel, an increase of 16% since June, with copper also rising by 7%, both proxies for global growth. These moves, a weaker US dollar and improving risk sentiment boosted demand for inflation hedges during July and our holdings of TIPS helped to offset some of the mark to market losses as bond yields rose.

Globally, year-on-year changes in inflation continue to weaken with very encouraging data out of the UK. However, at the core or 'sticky' level, inflation remains a problem, especially in Japan and the US. Shelter inflation looks set to rebound as the US real estate market refuses to weaken and rents in the major economic centres are now reaching record levels. In addition, the US consumer

16%

The amount that WTI oil prices increased by since June.

7%

The figure that copper rose by since June.

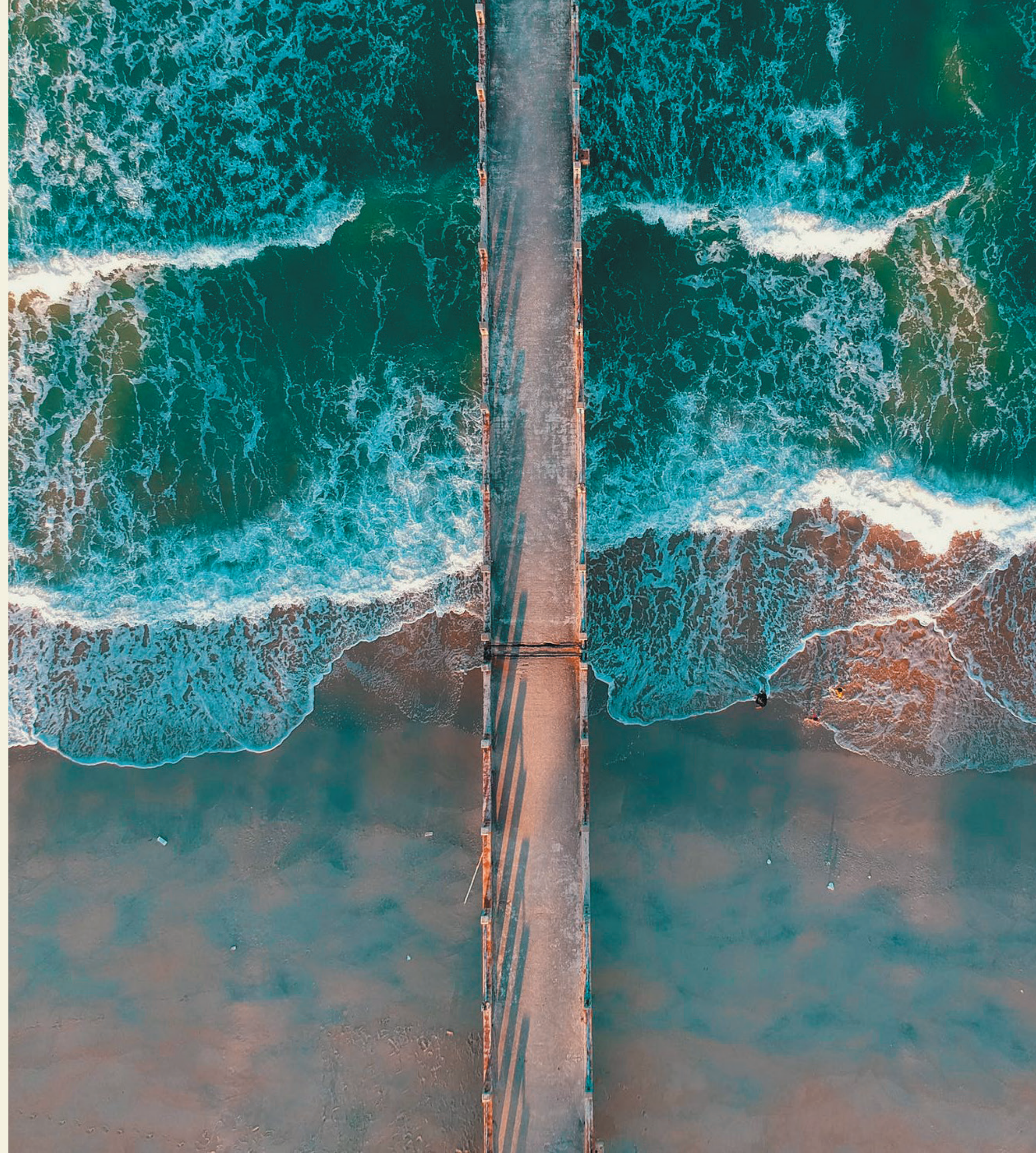
INVESTMENT VIEWS

is still spending, helping to sustain elevated services inflation. With energy inflation likely to add rather than subtract from the headline level going forward – as shelter may too – the Federal Reserve will need to see a much sharper slowdown to have any confidence that the 2% inflation target will be met.

We remain very defensive within our bond allocations. This stance has largely been unchanged for several months as the underlying backdrop for risk assets remains negative. We continue to favour government bonds, very high-quality investment grade credit and US mortgage-backed securities, but we are not currently ready to overweight duration, continuing to maintain a neutral position versus our benchmarks. However, if the global growth outlook continues to slow, real bond yields remain elevated and monetary policy tightens further, we will likely position portfolios to take advantage of any increase in market volatility.

The Magnificent Seven

The MSCI World recorded its third best month this year, increasing 3.4% in July and boosting year-to-date returns to 19%. This is impressive given the 6.1% gain in June. Research indicates that most fund managers and research houses were positioned defensively at the beginning of the year, based on expectations that higher interest rates would slow economic growth. We are now seeing some capitulate on their recession call in favour of a soft landing. We find ourselves in a goldilocks period in the US, with inflation falling and growth improving. The question is how sustainable is this.





3.4%

The MSCI World recorded its third best month this year increasing 3.4% in July.

EQUITIES

The bulls point to healthy balance sheets and high levels of excess savings, but these are being eroded as higher interest rates take hold. The issues present at the beginning of the year have not gone away and in some cases have compounded. The markets have done well, but more than 90% of performance year-to-date is due to P/E expansion and the breadth of the rally is still narrow. A risk is that we do not have a soft landing but a delayed recession. With analysts forecasting 10% earnings growth per annum for 2024 and 2025, the possibility of downgrades in our opinion is meaningful.

Fund managers' positioning suggests returns this year have been driven by momentum and short-term money. We have seen a rotation the last couple of months, which does suggest a healthier rally, but is still inconsequential compared to the moves earlier this year. The equal weight S&P500 outperformed the S&P500 for the second consecutive month. However, this was only marginal and it is still significantly underperforming year-to-date with a 10% difference. Cyclical sectors other than the three best performing sectors (IT, Communication Services and Consumer Discretionary) have had a good run over the last two months. Energy is up 13.5%, Materials 13.3%, and Financials 12.4% vs 9.7% for the MSCI World. Given the outperformance of Energy this month, value outperformed growth by the most so far this year. Interestingly, IT and Consumer Discretionary, the best performing sectors this year, underperformed in July.

Over 60% of S&P500 companies have reported second quarter results so far, with an aggregate 6% EPS beat, but a -0.5% one day price change reflecting market fatigue. We started off the earnings season strongly with global and regional banks producing better than expected results. The focus then shifted to the Magnificent Seven and other large capitalisation technology names. Tesla and Netflix kicked off the technology earnings season, both ending

up down more than 8%. Tesla missed on margins due to price cuts and Netflix was light on sales with the Q3 forecast lagging analysts' estimates. We then heard from Microsoft, Alphabet and Meta. Microsoft dropped 4% despite beating on revenue and earnings as quarterly revenue guidance fell short of analysts' expectations. Alphabet and Meta both benefitted from stronger advertising revenue, rallying 6% and 4% respectively. At the beginning of August, we heard from Apple and Amazon. Apple beat top line and bottom line however the stock closed down 5% as the beat was mainly driven by services with hardware missing estimates. Amazon rallied over 8% as AWS performed better than expected and 3Q guidance topped analysts' estimates. The last of the Magnificent Seven, Nvidia, reports at the end of August. As one of the main beneficiaries of AI and given the strong beat last quarter this is a highly anticipated earnings report.

10%

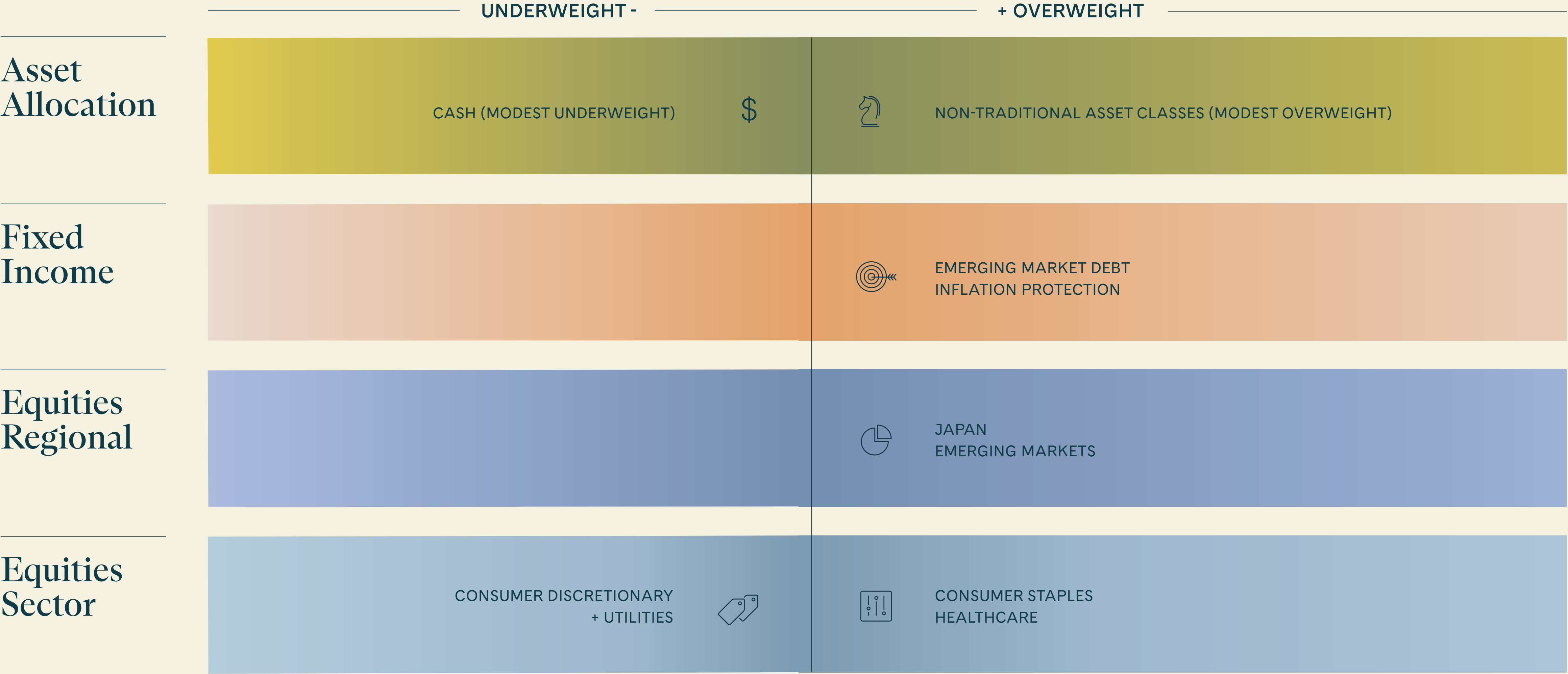
The figure that analysts are forecasting for earnings growth per annum for 2024 and 2025.



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Global Asset Allocation

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



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