

Investment Views



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The Godot Recession

- Economic growth has held up well
- Some cracks are emerging in economic indicators
- Bonds have become attractive again

Many economists and market analysts have spent the past 18 months warning of an imminent recession. With interest rates in the US, UK and Eurozone having increased by 5.25%, 5.15% and 4.5% respectively this cycle, the elevated risk of recession is not surprising. Furthermore, central banks explicitly told us that they were prepared to impose pain on the economy (through higher borrowing costs and a weaker labour market) to bring inflation back down towards the 2% target.



STRATEGY

A popular maxim is “don’t fight the Fed”. In this context, when the central bank is saying that they are prepared to risk recession in order to prioritise the fight against inflation, suggesting a recession could be avoided is akin to “fighting the Fed”. This has created a challenging environment for financial markets.

While there has been a lot of gloom around this year, the good news is that the incoming data has been a lot more positive than many expected. Global growth is on track for 2.7% this year, which is a full percent above the 1.7% consensus at the start of the year. Growth in the US has been particularly strong this year relative to consensus and is on track for 2.4%, well above the 0.4% consensus. The good news has also extended to inflation. Many countries have seen a marked slowdown in headline inflation and also made progress on the core (excluding food and energy) side as well.

While the incoming data has been positive, the worry is that recessions in the major economies have merely been delayed rather than averted. It is well known that higher interest rates impact the real economy with “long and variable lags”, which helps to explain why many recession forecasts for this year have been pushed out to next year. However, this has created a backdrop of uncertainty for financial markets in both bonds and equities.

The adjustment that we have seen in bond markets has been substantial, with price drawdowns in nominal terms (i.e. before factoring in inflation) worse than the painful 1970s. In real terms (i.e. having factored in inflation) the 1970s were more painful for bond investors, but it is still the case that real yields have jumped significantly in recent years. There is now more value in bond markets than there has been for many years.

2.7%

Global growth is on track to be a full percent above the 1.7% consensus at the start of the year.

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2%

The path to a soft landing (without a recession) still exists in the US.

STRATEGY

The US labour market is being watched particularly closely, as material weakness here would be indicative of a recession. So far, there are some cracks appearing, but overall things are holding up. The high level of job openings means that laid off workers are likely to find new positions, but things are getting a bit harder. On the flip side, this softening helps with inflation pressure and reduces the likelihood of interest rates going higher.

There are also some further cracks out there. Germany is already in recession and global industrials have reported mixed third quarter earnings results as global manufacturing remains weak. Equity markets struggled in October as higher bond yields put pressure on valuations (price-earnings multiples fell) and earnings have been mixed. The path to a soft landing (where inflation falls back to 2% without a recession) still exists in the US but, unlike Samuel Beckett's character Godot who never arrives, we cannot comfortably say that a recession will not happen in the next 12-months.

Term Premium Tantrum

- US bonds continue to weaken led by rises in real yields
- Weak growth in the Eurozone has stabilised European bond markets
- China and Japan have eased monetary policy but for very different reasons

The US Treasury supply shock seen in the third quarter continued to reverberate in October despite heightened geopolitical risk and falling energy prices. The extra compensation or 'term premium' required by investors in longer dated debt surged by over 100 basis points (bps).



FIXED INCOME

As a result, volatility and real bond yields rose dramatically, with the US 30-year reaching a high of 2.56% - the highest level since 2008. Furthermore, nominal yields broke through the symbolic 5% level.

Negative momentum in the US Treasury market was also compounded by better than expected US economic data. The advanced reading of third quarter GDP was up 4.9%, with core GDP (excluding volatile components) up 2.8%, led by remarkably resilient consumer spending. Whilst fixed income securities continue to be buffeted by this perfect storm, clouds are breaking across the horizon. Cheaper valuations, lagged effects of monetary policy and a peak in G7 base rates will lead to lower uncertainty and fixed income volatility stabilising term premiums and sentiment over the coming months.

In Europe, economic activity is slowing rapidly with Eurozone producer prices now in outright deflation. The region is still heavily exposed to energy price swings and, although natural gas inventories are currently ample, a winter recession would not necessarily be a bad outcome from an inflation perspective. On a positive note, as this weaker growth in Germany spreads to the rest of the Eurozone and the UK, government bond yields have stabilised and the European Central Bank looks set to be the first major central bank to reduce interest rates in 2024.

The Chinese economy is flatlining but monetary policy is being eased in a gradual and measured way. In contrast, Japan is buoyant as an undervalued yen continues to stoke exports and import inflation. As a result, Japanese 10-year bond yields were permitted to rise to 0.94% as the Bank of Japan effectively ended yield curve control. Expanding the balance sheet to defend the 1% yield ceiling was self-defeating, as this led to further currency weakness and inflation.

5%

Nominal yields broke through the symbolic 5% level.

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\$3.46

The average amount per gallon regular gas prices fell to.

FIXED INCOME

Further signs of a global slowdown are also being seen in commodity markets. Despite a Middle East war premium, supply cuts and a stronger US dollar, oil prices slid 11% to \$81 per barrel. This was passed on to US consumers almost immediately with regular gas prices on average falling to \$3.46 per gallon – providing stimulus to the US economy as the holiday shopping season approaches.

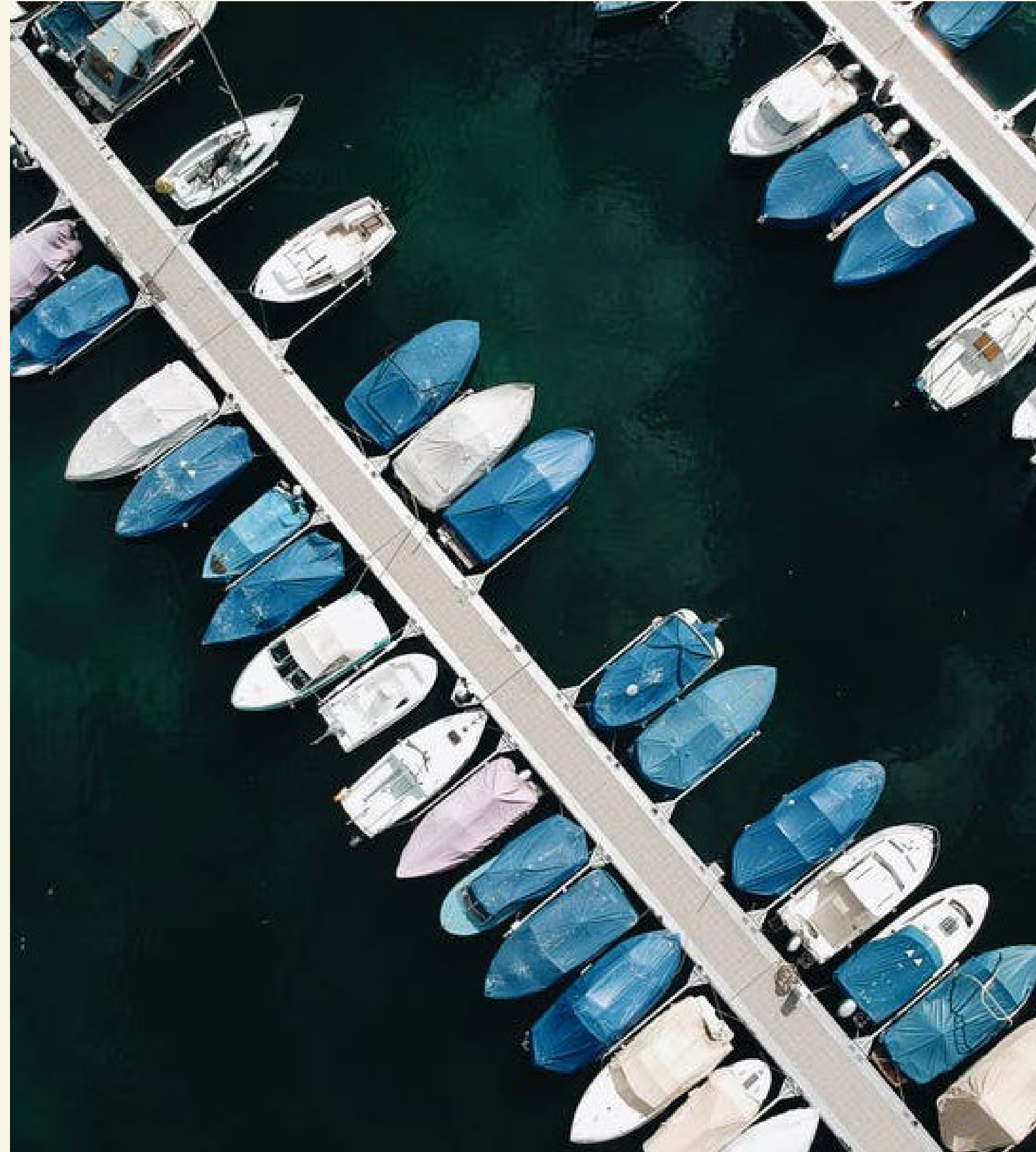
Credit spreads widened in line with the weakness seen in equity markets. However, a 40bps increase in high yield bonds remains subdued and is not a catalyst for us to deploy capital into credit markets. Currency market volatility was exceptionally low given the movement in risk assets. The US dollar marginally rallied, but failed to benefit from the move higher in US real interest rates. The Canadian dollar weakened by 2.2% versus the US dollar as a recession is starting to look more likely in the highly levered economy. We took this opportunity to add cheap Canadian bond exposure to portfolios where appropriate.

We have added some risk to our US dollar bond funds, mainly via currency exposure and US mortgage backed securities, where we are now almost maximum overweight. Elevated fixed income volatility, slow prepayments and lack of demand from US banks and the Federal Reserve has led to distressed pricing in agency mortgage pools. However, rising unemployment and peak base rates in the G7 should reverse those dynamics in 2024 leading to high single digit total returns. In addition, we remain neutral duration in the US as we wait for signs of a broader economic slowdown. In Canada, Europe and the UK there are already sufficient signs of a slowdown and we are therefore more comfortable with duration (interest rate risk) in these regions.

A Mixed Earnings Season

- The S&P500 Equal Weight index is now in negative territory
- A mixed earnings season sees increased volatility
- Buybacks are a key source of demand for US equities

While the S&P 500 is still up 10.7% after the recent sell-off, the equal weight S&P 500 is now in negative territory for the year. This highlights the narrow breadth of the rally and arguably points to an index return which is disconnected from the underlying fundamentals.



EQUITIES

The returns of the equal weight S&P 500 help paint a clearer picture of underlying cyclical dynamics as S&P 500 earnings per share (EPS) growth is anaemic this year. The aggregate earnings number is slightly skewed due to the energy sector, with strong returns last year and normalising returns this year. However underlying earnings growth this year is more in line with the return of the equal weight S&P 500 index return. Earnings growth is expected to be 9.6% next year and 10.6% in 2025, however given the higher-for-longer interest rate expectations and the recent spike in yields (equivalent to three interest rate hikes), we would expect these numbers to be cut as we approach the end of the year. Historically, analysts typically lower earnings estimates by 4% each year.

Heading into the third quarter earnings season, consensus was for 2% sales growth and flat EPS growth relative to last year. Excluding Energy, S&P 500 earnings are expected to grow by 5%. So far 60% of S&P 500 companies have reported and the results have been more mixed than the previous two earnings seasons. A running theme has been companies beating earnings estimate for the current quarter but providing weaker than expected guidance for the following quarter. This indicates a more challenging operating environment. Clearly, there has been a change in sentiment with companies being punished for lower guidance and investors demanding more to remain invested in equities. The one-day price change is negative and lower than previous earnings seasons, even though the aggregate EPS beat is towards the higher end of the range.

9.6%

The rate earnings
growth is expected
to rise to next year

A running theme has been companies beating earnings estimate for the current quarter but providing weaker than expected guidance for the following quarter.



6.8%

Amazon and Microsoft
closed up 6.8% and
3.1% respectively.

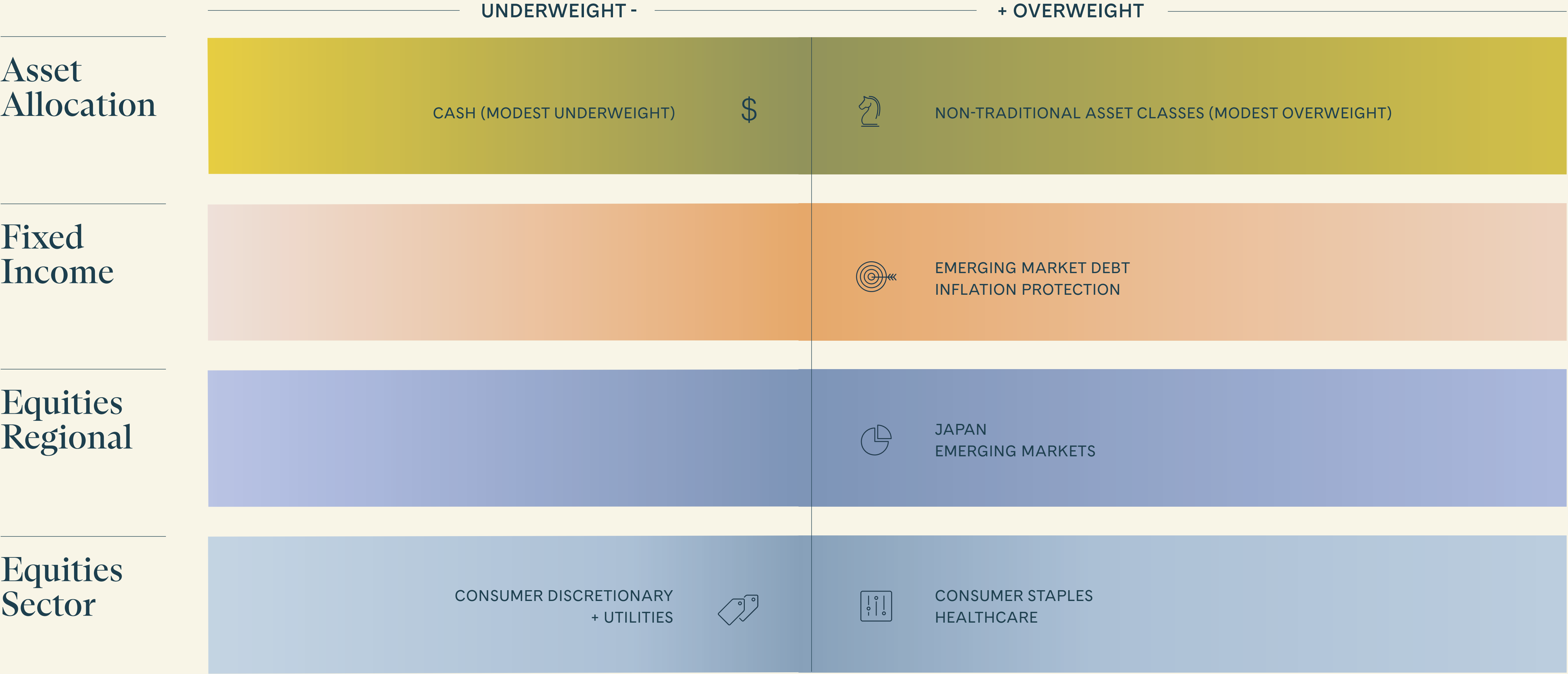
EQUITIES

We started the earnings season with the large capitalised banks reporting strong earnings and smaller regional banks reporting mixed results. Investors’ attention then shifted to the so-called Magnificent Seven (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla). While many came in ahead of estimates on sales and EPS, the one-day returns dispersion was high. Alphabet and Tesla were nearly down double digits, and Meta closed down 4%. Apple was roughly unchanged. Amazon and Microsoft closed up 6.8% and 3.1% respectively. As we said in previous publications, the correlation earlier in the year has been quite exceptional and that it is unlikely to continue given the different underlying businesses. These seven companies accounted for 12% of S&P 500 sales and 17% of EPS in 2022 and are expected to contribute to 15% of S&P 500 sales and 24% of EPS by 2025. This would further distort the returns of the S&P 500 index.

As bond yields have become more attractive, an important question is “who is buying equities?” We recently found out that Berkshire Hathaway has been a net seller of equities for the fourth quarter in a row. Demand for US equities in 2021 and 2022 has mainly been driven by households, however this changed in 2023 as households were already heavily invested in equities. This only left corporations, mainly through buybacks, as the main buyers of equities. However, higher yields are forcing corporations to reconsider the value of buying back shares versus retiring debt, meaning this source of demand could also dwindle, which would be another headwind for equities.

Global Asset Allocation

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



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