

February 2024 Investment Views

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Spotlight on Asia

- China has fallen out of favour with investors
- Japanese equities have outperformed
- Lots of dispersion exists within Emerging Markets

January saw many of the same themes continue from where they left off last year. Global equities rose 1.2% in US dollar terms, led by US equities and in particular the large cap Technology companies. Emerging Market equities lagged Developed Market equities, with Chinese equities continuing a very poor run of performance. In contrast, Japanese equities performed well and the region was the second-best performer after the US.

China and Japan are two countries with a rich history and varying fortunes over past decades. The Japanese economy grew strongly in the 1980s and early 1990s and benefited from being a pioneer in driving efficiencies in manufacturing, particularly in the auto sector. The Toyota Production System, also known as Just in Time production, was seen as a revolutionary new manufacturing process



that was studied and copied by the West. Japan's fortunes then changed in the 1990s as a property and stock bubble burst and the economy was left with a toxic combination of high debt and falling prices (deflation). While this is now distant history, it provides important context for some of the themes that we are seeing today.

As Japan struggled in the 1990s, the rejuvenation of China's economy was just getting started. China's economic fortunes changed in 2000 when they joined the World Trade Organisation. The combination of a large and productive labour force at relatively low wages made China very competitive in global manufacturing. Many companies moved to take advantage of this by moving production to China. At the same time, China spent significant amounts of money on improving infrastructure. Vastly improved links between suppliers, factories and ports made for a virtuous circle where manufacturing flourished and Chinese workers were able to improve their living standards considerably.

However, as with Japan, a period of strong growth and a manufacturing boom culminated in a speculative property bubble, which is now bursting. Chinese equities have had a torrid time in recent years, with the MSCI China Total Return Index down almost 60% from its 2021 peak. The index is back at a level it was at in 2007. The term "lost decade" was coined to describe Japan's period of stagnation in the 1990s following the bursting of their asset price bubble. China is currently experiencing similar dynamics with falling asset prices, high levels of debt and deflationary pressures. China's GDP growth per person has been very strong in recent decades, but recently, catch up with the US appears to have stalled.

While China's growth has disappointed relative to expectations, the overall size of the Chinese economy remains substantial. Based on Purchasing Power parity, which tries to adjust for differences in buying power across different countries, China's economy overtook the US back in 2014 and is now 25% larger. However, on other

60%

The percentage MSCI China Total Return Index is down from its 2021 peak.

The bursting of the Chinese real estate bubble is a major reason, but other detrimental reasons include the prioritisation of national security over economic growth.



25%

The percentage based on larger Purchasing Power parity that China's economy overtook the US. However, on other measures that use actual foreign exchange rates, the US remains the world's largest economy.

STRATEGY

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For financial markets, selling to China has been a highly profitable strategy, whereas investing in Chinese equities has not. Consumer goods, Industrials, Materials and some Technology companies have been major beneficiaries of the rise of China, and continued growth is important for many Developed Market equities. China has therefore unsurprisingly been the subject of much discussion on recent company earnings calls. The bursting of the Chinese real estate bubble is a major reason, but other detrimental reasons include the prioritisation of national security over economic growth.

As China has fallen out of favour with investors, other countries have been able to benefit. Japanese and Indian equities have performed particularly well, while Mexico has also benefitted from the re-orientating of supply chains out of China. Japan has benefitted from more activist monetary and fiscal policy since 2012 when Abe came to power, while measures to improve corporate governance are also starting to gain traction. India is benefitting from increased spending on infrastructure, cheap commodity prices and domestic investors have been buying equities.

Our Emerging Market equity exposure tends to be low and varies across portfolios. Some mandates use passive tracker funds, while others use active third-party managers. Last summer, we sold our dedicated China exposure in our passive mandates and switched the proceeds into Japanese equities, which has worked well. The dispersion within the different regions of Emerging Markets is an increasingly interesting theme and we have recently added to our non-China exposure in appropriate mandates.

Resilient Growth Pressures Yields

- The US dollar rises as rates differentials close
- European and US macro data positively surprises
- US base rate expectations have re-priced but remain too easy

Global fixed income markets started the year from an overextended position, as 150bps in US base rate cuts were fully priced in and two-year US Treasury yields had fallen to 4.25%. This included a rally of 100bps since mid-October, driven by the duel pivots from the US Treasury and Federal Reserve. As we covered last month, this significant easing of financial conditions led to a risk asset rally and a weak US dollar, causing a monetary ‘policy loop’, which in turn threatens to keep rates higher for longer.

While US inflation is falling, the rate of change is slowing and leading indicators are signalling a much stickier inflation outlook for this year. This, combined with signs of an economic recovery in China and Europe, suggests there is a growing probability that major central banks will be much slower to ease than market expectations.



FIXED INCOME

With economic growth in the US showing signs of accelerating (US Q4 real GDP was above trend by 3.3%), and the Atlanta Fed expecting this to continue in the first quarter, monetary policy appears to be looser than would be expected when unemployment is only 3.7%. We are also seeing life in the US real estate market, as mortgage rates fell to 6%, with consumers also seeing an additional boost to spending from gas prices at \$3 per gallon. China has been boosting liquidity, which has largely offset the passive quantitative tightening throughout the rest of the world. The authorities have been more cautious on the fiscal front, but there are signs that growth has stabilised.

At the end of January, the US Treasury also announced their plans for US Treasury supply. At first glance, the data was positive for bonds as there is likely to be less issuance in the second quarter (a good period for tax receipts). However, as we have seen in previous quarters, the numbers only provide guidance and, given the high fiscal deficits, there is little margin for error if tax receipts disappoint and/or spending remains elevated. Term premiums on longer dated US Treasuries remain deeply negative and inconsistent with the still high level of uncertainty in fixed income markets given elevated volatility. One further risk given market talk of a ‘taper’, is that quantitative tightening remains unchanged and on auto-pilot this year. Healthy bank reserves and solid economic growth removes the need for a pre-emptive expansion of US liquidity, which could all have implications for bond yields.

With dovish expectations of a rapid pivot by the Federal Reserve running significantly ahead of the underlying strength of the US economy, we positioned for more hawkish pricing in fixed income markets by shortening duration in our US dollar bond funds. This has largely played out as expected. With US growth re-accelerating, this leaves the Federal Reserve little choice but

3.3%

The percentage US Q4 real GDP grew.

FIXED INCOME

to dampen expectations of the easing cycle beginning in March, which was priced at 90% just two weeks ago, and May now also looking unlikely.

Looking ahead, we maintain this positioning with the yield curve vulnerable to any further positive macro developments. Risk assets, whilst buoyed by rising growth expectations and easy monetary policy, are entering the weakest seasonality period of the entire year. Despite very positive sentiment in equity markets, tight high yield credit spreads provide another reason for portfolio risk to remain defensive.



Déjà Vu

- Diverging fortunes within the Magnificent 7
- Emerging Markets continue to lag
- Valuations are elevated

January saw a continuation of many of the trends exhibited in 2023. Information Technology and Communication Services outperformed the broad market, returning 4.0% and 4.3% respectively. Materials was the worst performing sector, slipping 4.7%, with weakness seen in the Metals and Mining subsector. Interest rate sensitive sectors such as Real Estate and Utilities underperformed as markets started pricing in a higher for longer interest rate environment.

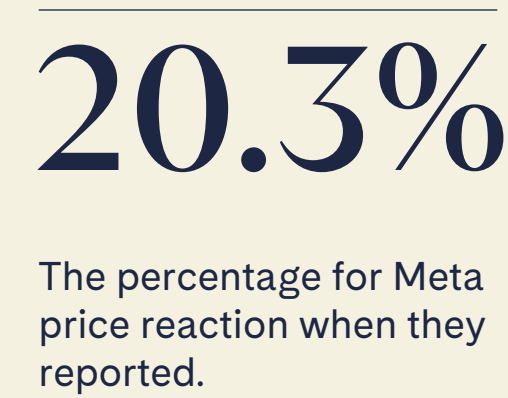
On a regional basis, there was significant dispersion as the world equity markets decoupled. Developed Markets performed well, with Japan shining, gaining 4.6%. The US outperformed Europe ex UK by 1.5%, while the latter outperformed the UK which lagged 1.3%. Emerging Markets was the worst performing region, lagging Developed Markets by 4.6% as China underperformed.



The S&P 500 outperformed the equal weight S&P 500 by 2.5%, as the “Magnificent 7” (Apple, Alphabet, Amazon, Meta, Microsoft, Nvidia, Tesla) started the year strongly. Small caps, a sector that at the end of the last year was expected to do well due to interest rate cut expectations and low valuations, lagged by 3.9% as interest rate cut expectations unwound. Historically, for the broader equity market, economic growth matters more for equity returns than movements in the yield curve, suggesting that even if all the priced in interest rate cuts are unwound, equity markets could still have a good run.

Equity valuations continued to expand and are expensive, as earnings revisions remained on average unchanged. The S&P 500 price-earnings ratio (P/E) has expanded from 17x at the beginning of 2023 to 20x, ranking in the 85th percentile since 1990. Over the same period, the equal weight S&P 500 has expanded from 14x to 16x, ranking in a similar percentile. The Magnificent 7 trade at 30x P/E is up from 22x. This is currently in line with its 10yr average valuation, having traded twice above 40x earnings and four times below 25x forward earnings over the last 10 years.

The fourth quarter earnings season started in mid-January with 43% of the S&P 500 companies having reported by month-end. On aggregate, reported sales beat by 1.3%, the lowest result since Q4 2022, while reported earnings-per-share (EPS) beat by 6.9%, an above average result for the last two years. The average one-day price change post results was relatively muted at 0.1%. Results from large-cap banks were on the whole mixed, with Citigroup and Goldman Sachs closing the day slightly higher, and JPMorgan and Bank of America closing slightly lower. Morgan Stanley and Wells Fargo disappointed, sliding 4.2% and 3.3% respectively on the day. US regional banks lagged the MSCI World by 6.4% in January, with Commercial Real Estate loan exposures resurfacing, causing some concern, but not enough to derail the equity markets.



So far, six of the Magnificent 7 stocks have reported and the price reaction has been volatile. The winners have been Meta and Amazon, up 20.3% and 7.9% respectively on the day. The losers have been Tesla, Alphabet, Microsoft, and Apple, which were down 12.3%, 7.5%, 2.7%, 0.5% respectively on the day. Meta beat expectations, provided strong guidance, introduced a dividend and boosted share buybacks, signalling a bright future to investors. Google, on the other hand, disappointed on advertising revenue, fuelling speculation that their tardiness to AI may impact revenue. Tesla continues to disappoint, as investors start wondering whether the company is a cutting-edge technology company or a traditional car manufacturer trading on an inflated valuation. Nvidia, which reports on the 21st of February after market close, is expected to once again be the best performing stock in the Magnificent 7 as Artificial Intelligence semiconductor demand shows no signs of slowing down.

So far, the year looks a lot like 2023. However, from a valuation perspective, our starting point is meaningfully higher, which suggests equity returns this year are unlikely to be as attractive.



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Global Asset Allocation

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

