

Investment Views May 2024

Strategy:

Durability of US Exceptionalism

Fixed Income:

Higher Yields Amidst Sticky Inflation

Equities:

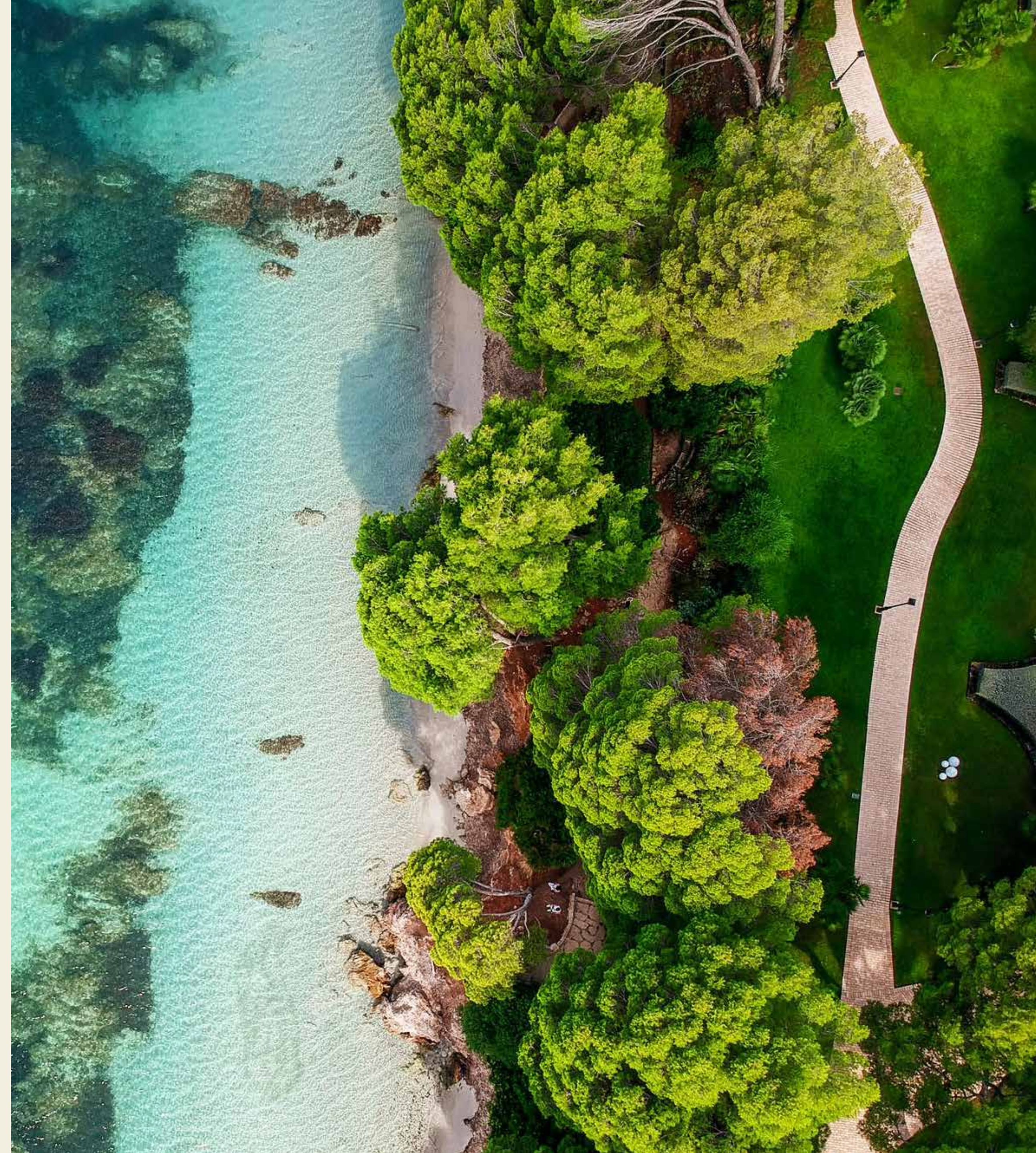
A Strong Earnings Season

Durability of US Exceptionalism

- The US economy outperformed, but the rest of the world is recovering
- Expectations for US rate cuts have been delayed
- US strength is a double-edged sword for other countries

The resilience of the US economy over the past two years against a backdrop of inflation and higher interest rates has been very impressive. Growth in the US has been strong, but that is not the case for the rest of the world. Germany and the UK slipped into mild recessions last year, while China's recovery from the pandemic has been much weaker than expected. The US outpaced other major developed countries by a significant margin, with year-over-year growth of 3.1% compared to just 0.5% for the eurozone.

The extent of this divergence raises the question of whether we have reached "peak divergence"? The US is the world's largest economy (based on market exchange rates), has the most important financial market in the world and the US dollar is the world's reserve currency. Therefore, what happens in the US impacts financial conditions in the rest of the world. Exceptional US strength versus the rest of the



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world can be a double-edged sword. It generates demand (imports) which helps support global growth, but higher US interest rates and a strong dollar can cause problems.

Emerging markets often have liabilities in US dollars and pay for imports in dollars so can get squeezed when the dollar rises. Developed markets are more insulated, but are not immune. The role of the dollar as a reserve currency can also put pressure on exchange rates if interest rates diverge too far from rates in the US.

Higher US interest rates and US dollar strength causing problems for other countries is by no means a new phenomenon. Back in 1971 when the US abandoned the gold standard and allowed the US dollar to float freely against other currencies, then Treasury Secretary John Connally famously said at a meeting of G-10 countries “the dollar is our currency, but it’s your problem”.

This remains an important dynamic in global markets and Japan is a notable example. Interest rate differentials have widened such that the Japanese yen has come under pressure and seen significant depreciation. This is good news for Japanese exporters and visitors to Japan, but puts pressure on Japanese consumers. Volatility in currency markets has been a cause for concern among Japanese policymakers. In Europe, weaker growth and lower inflation have heightened the focus on when the European Central Bank (ECB) will be cutting interest rates. At a recent press conference, the delay in US rate cuts loomed large. When asked about what that meant for ECB policy, President Lagarde remarked that “we are data dependent, we are not Fed dependent”.

Emerging Markets have historically been exposed to divergences between their respective interest rates and rates in the US. However, this cycle, many Emerging Markets raised rates in advance of the US and were then in a position to cut rates even as the US held interest rates steady.

9%

The percentage peak of
US inflation.





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Emerging Markets can have a tendency to move together as money flows somewhat indiscriminately from the US to Emerging Markets when investors add risk, then flows back to the US when sentiment turns cautious. However, this cycle there has been greater differentiation, with the fundamentals of individual countries being important. For example, India and Mexico have held up a lot better than Turkey and Argentina.

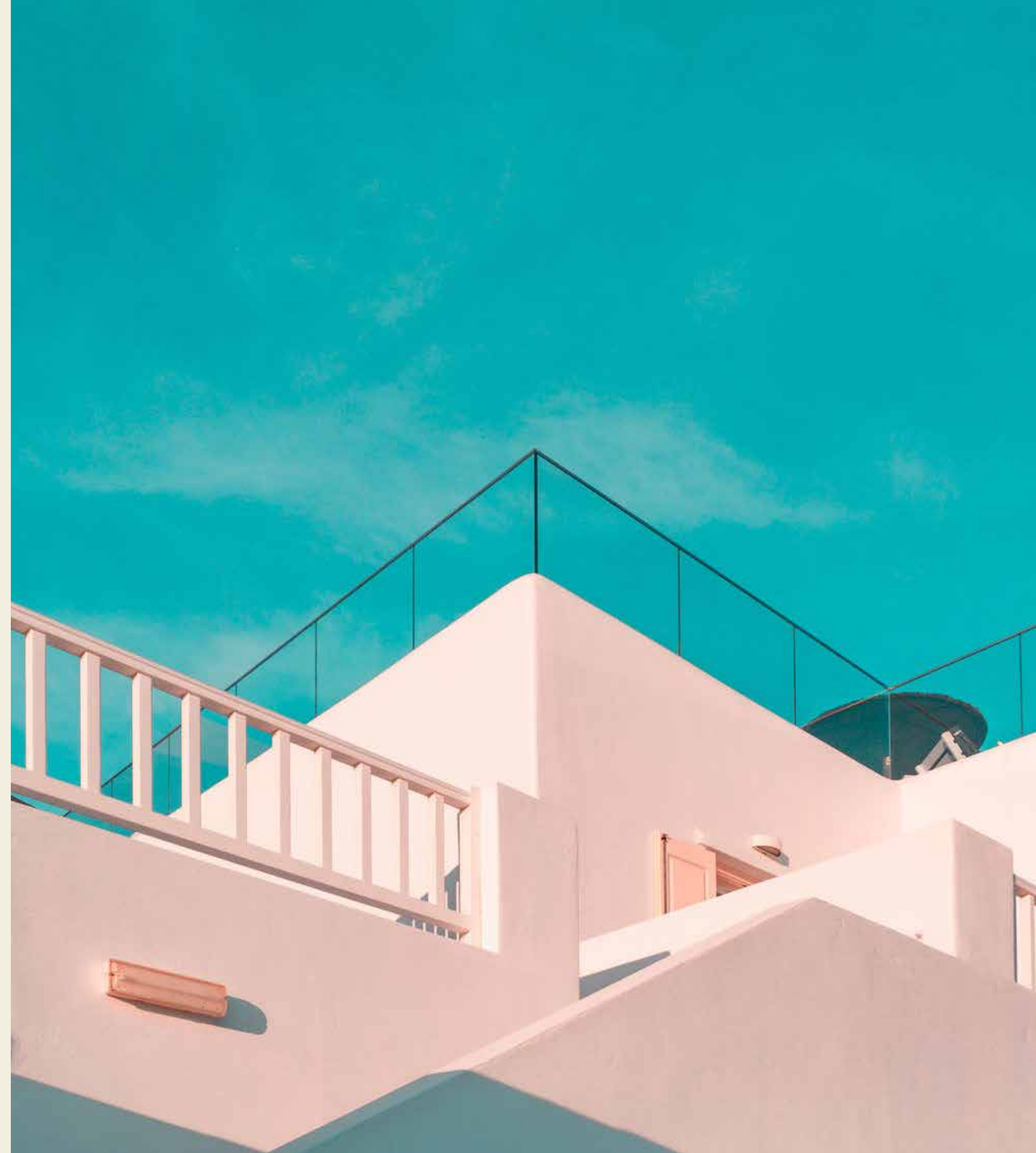
It is quite possible that we are now at peak divergence between the US and the rest of the world. Global manufacturing is recovering and countries outside the US benefit more than the US. The UK economy has picked up in early 2024, after the mild recession in the second half of last year. Growth in China is a bit of a wildcard, but it appears that growth has at least stabilised, with more policy support for the property sector forthcoming. A convergence between growth in the US and rest of the world would be a positive for financial markets, as long as it does not converge due to a US recession. We remain watchful but this is not our base case over the coming quarters.



Higher Yields Amidst Sticky Inflation

- Bond yields rise reflecting concerns over inflation and robust global growth
- The ECB is expected to cut rates as Europe diverges from the US
- Increasing global liquidity should support risk assets in the months

During April, fixed income markets experienced a bout of weakness as sticky inflation dynamics coupled with rebounding global growth caused government bond yields to rise substantially. The benchmark 10-year nominal US Treasury ended the month up 48bps (basis points) at 4.68%. With long term inflation breakevens remaining almost unchanged, most of the move in yields continues to be driven by renewed hawkish (higher) interest rate sentiment across the developed world. The US Federal Reserve now expects to lower the base rate by just 25-50bps in 2024. Interestingly, global monetary policy outlooks are converging as global activity catches up to the buoyant US and the excessive dovish sentiment from earlier in the year fades.



On the macro front, while some recent US economic releases have disappointed expectations, the data were largely stable in aggregate. There are early signs the US employment market may be weakening and inflation pressures continue to stalk the Federal Reserve, but easy financial conditions and resilient growth leave a period on hold as the most likely path until after the US election in November.

In Europe and the UK, economic data is rebounding. Data in Japan has been mixed and the currency has been under pressure. Any further decline in the Japanese Yen could lead to a brief bout of imported inflation in the months ahead. The Bank of Japan looks set to buy Yen in an attempt to slow the pace of decline. However, the substantial interest rate differential and rising long-term US bond yields are likely to provide a formidable opponent.

In commodities markets, copper prices rose by almost 14%, in a further sign that global activity is re-accelerating. Although, lumber prices fell sharply, which given the importance of the US housing market and its interaction with consumer sentiment, tends to track US growth closely. Global liquidity, after contracting for the past few months, is turning positive again. This has bullish implications for risk assets. The US Treasury general account (effectively the Treasury's bank account) is well funded and the reverse repo facility remains stocked with close to half a trillion in excess liquidity. In addition, the Federal Reserve looks set to start tapering the US\$95 billion in balance sheet runoff, which has been taking place largely on auto pilot since 2022. This should help to lower fixed income volatility and depress term premiums; very useful with the US continuing to run 6% fiscal deficits.

Corporate credit spreads are now extremely tight, with the average investment grade bond yield only 87bps over US

14%

The percentage that the Copper price rose the first quarter.

Treasuries. Relative to forward equity earnings expectations and relative to historical valuations, we prefer to utilise our portfolio risk budgets in assets other than investment grade bonds at this time. US mortgages continue to provide attractive properties for portfolio allocations and we are seeing a small rise in early pre-payments, which generates a capital gain. Like lumber, this sends a macro signal that all may not be well in the US housing market. Our interest rate duration positioning reflects inflation and macro differentials. In multi-currency accounts we have overweights in countries such as New Zealand and Sweden, where growth is weak. In contrast, we are underweight Europe as the improving growth outlook threatens to clash with an ECB which is highly likely to lower interest rates in June.

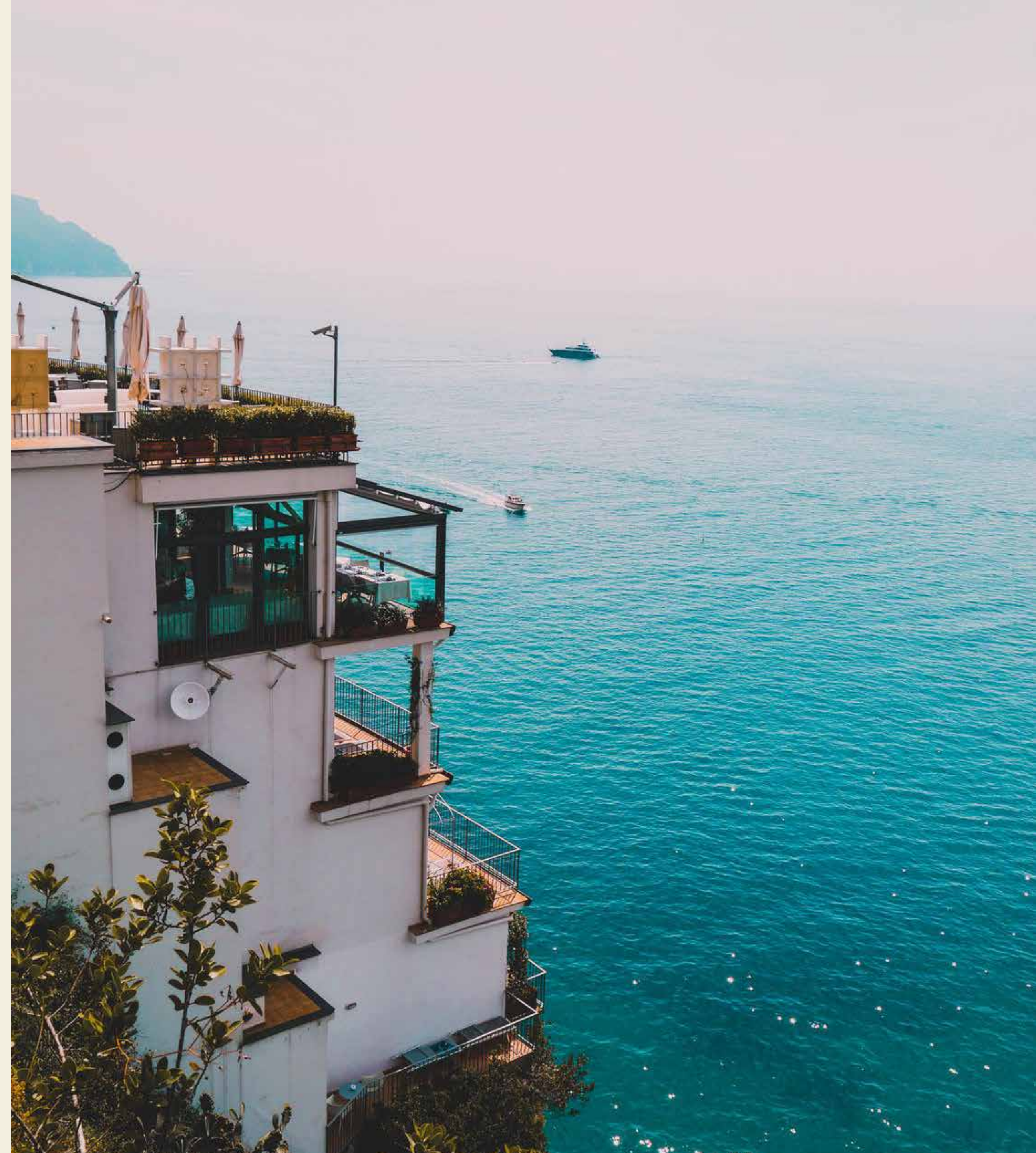


A Strong Earnings Season

- Earnings coming in ahead of expectations
- Utilities benefitting from energy demand
- Small cap stocks continue to struggle

The MSCI World index retreated 3.7% in April, marking the first negative month since October 2023. The worst performing sectors were Real Estate and Information Technology down 7.2% and 5.7% respectively. The best performing sectors were Utilities and Energy up 0.8% and 0.3% respectively. Real Estate and Utilities usually trade in tandem given their sensitivity to interest rates, but this correlation appears to have broken down recently. The Utilities sector is becoming more attractive as energy demand to support Artificial Intelligence (AI) and datacentres becomes a theme. The Real Estate sector instead remains structurally challenged.

The worst performing region was the US, dropping 4.2%, followed by Europe excluding the UK, which fell 3.0%. The UK stock market performed well achieving a 1.9% return. The divergence in



performance can be partly explained by the composition of the indices, with the US equity market skewed towards technology stocks and Europe less so. The UK equity market is tilted towards Energy and Materials which outperformed in April. Japan dropped 4.9% in April, but in Japanese yen terms only dropped 1%. This reflects the weakening yen, which temporarily breached 160 versus the US dollar. Asia Pacific excluding Japan and Emerging Markets outperformed returning 1.2% and 0.5% respectively, recovering some of the underperformance year-to-date.

The Russell 2000, a US small market capitalisation index, dropped 6.1% in April adding to the significant year-to-date underperformance relative to the S&P 500 index. The average company in the Russell 2000 index has a borrow cost of 5.7% which is 2% above that of an average S&P 500 company. In addition, the Russell 2000 companies have more floating rate debt. Given the unwinding of interest rate cuts and higher yields so far this year, the small market capitalisation companies have suffered. Furthermore, the annual profits of the companies in the S&P SmallCap 600 index are less than Microsoft's earnings in just the first quarter.

In April we saw a flurry of US companies reporting first quarter earnings. So far 80% of the S&P 500 companies have reported. The overall takeaway is that large cap US companies are firing on all cylinders. Aggregate sales beat by 1.5%, the largest beat since the second quarter last year. The earnings picture was even more impressive with aggregate earnings beating by nearly 9.0%, the largest beat in over two years. Despite this, the one-day price change for companies reporting was negative with companies beating estimates not being rewarded and companies missing estimates being punished. This suggests buy-side expectations were too high.

The results from the large market capitalisation banks were better than expected. Goldman Sachs and JP Morgan pointed to stronger

6.1%

The percentage that The Russell dropped in April.

6%

The percentage that Apple rallied after publishing earnings.

sales and trading revenue, in addition to a pickup in Investment Banking, finishing the day up. This was echoed by Citigroup and Bank of America however their stocks did not perform as well. JP Morgan and Wells Fargo disappointed on Net Interest Income with JP Morgan shares sliding more than 6% on the day.

Six of the seven large market capitalisation technology companies have reported so far, with Nvidia expected to report on 22 May. The one-day price action post earnings were volatile with double digit returns for three of the companies. Tesla missed on sales and earnings but closed 12.0% up as the company guided to a sooner-than-expected launch of lower-cost vehicles. Alphabet, Microsoft and Amazon pointed to stronger than expected cloud numbers propelled by AI. Google followed in Meta's footsteps by introducing a dividend and boosting share buybacks. The stock ended the day 10% higher. Both names now offer a circa 0.5% dividend yield and 3-4% share buyback yield. Meta, which had a strong start to the year, plunged 11% after reporting soft guidance and higher spending expectations.

Apple, which has been lagging year-to-date, rallied 6% after publishing better than feared Greater China revenue on the back of iPhone growth. The company also boosted its dividends and share buybacks program. Overall, the large market capitalisation technology companies are guiding to higher investments in AI which should support AI infrastructure companies such as Arista Networks as well as the technology sector in general.

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Global Asset Allocation

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

	UNDERWEIGHT -	+ OVERWEIGHT
Asset Allocation	<div>EQUITIES (MODEST UNDERWEIGHT)\$</div>	<div>CASH (MODEST OVERWEIGHT) NON-TRADITIONAL ASSET CLASSES (MODEST OVERWEIGHT)</div>
Fixed Income		<div>EMERGING MARKET DEBT INFLATION PROTECTION</div>
Equities Regional		<div>JAPAN EMERGING MARKETS EX CHINA</div>
Equities Sector	<div>CONSUMER DISCRETIONARY UTILITIES</div>	<div>ENERGY HEALTHCARE</div>

