

# Investment Views



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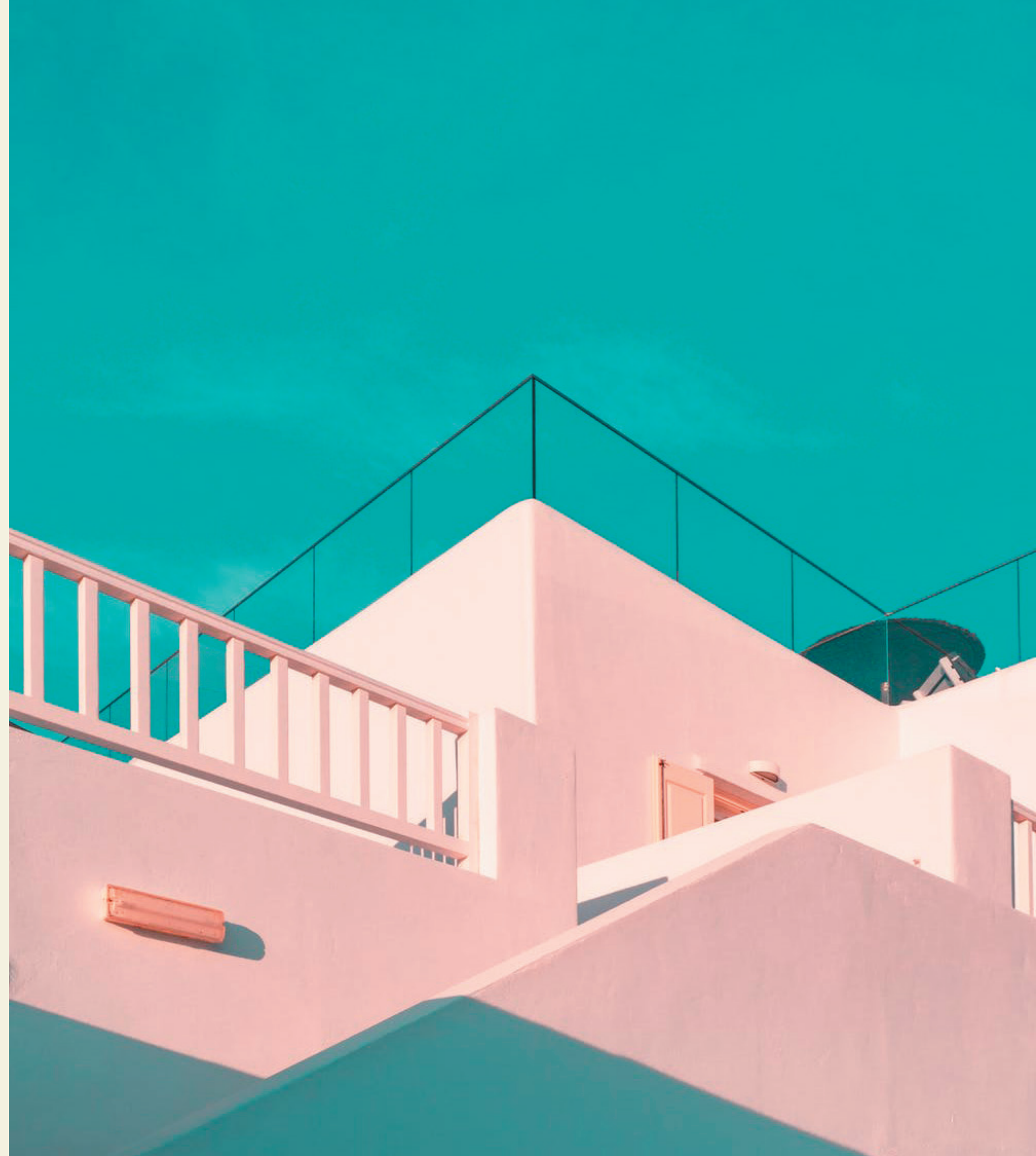
# The Magnificent Seven Part II



# The Enigma that is China

A key focus for investors this year has been China. During the pandemic, China took a different approach to all other countries and as a result its economy has been unsynchronised with the rest of the world.

The start of the year began with optimism around the reopening of its economy after almost three years of pandemic restrictions. Chinese businesses and consumers did not receive as much financial support as they did in the West, but the export sector was a major beneficiary of the boom in goods demand during the pandemic. As the economy reopened, retail and auto sales picked up strongly and there were signs that the troubled property market might be bottoming as property sales and construction starts both picked up from a low level.



## STRATEGY

However, as the first half of the year progressed it became increasingly apparent that the recovery was quickly losing momentum. Financial market investments closely linked to China underperformed materially in the second quarter. This short-term disappointment combined with longer-term concerns made for a powerful cocktail of negativity around China.

Recent years have seen a clampdown on private sector businesses in areas such as internet platforms and education. The state has become a more influential driver of allocating economic resources at the expense of the private sector. Furthermore, a weak property market is weighing on sentiment against a backdrop of a structural slowdown following years of overbuilding.

In a globalised world with multinational supply chains it is challenging to assess precisely how much exposure the rest of the world has to the Chinese economy. Exports make up 12% of the US economy and, of that 12%, only 8% goes to China. Exports to China therefore make up less than 1% of the total US economy.

In the last 20 years, the share of eurozone exports headed to China rose from 3% to 7.1%. Conventional wisdom is that the eurozone economy is heavily exposed to China, however, China is still a smaller market for the eurozone than the US or UK, which make up 15.6% and 9.8% of exports, respectively. Germany is the most exposed with 6.4% of its exports going to China.

Equity markets on the other hand are more heavily exposed to China. Around 9% of sales of US equities are exposed to Asia Pacific (excluding Japan), while European equities have around 15% exposure. Unsurprisingly, Asia is heavily exposed with around 82% of sales within the region.

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## STRATEGY

The Global Financial Crisis hit China through weak exports and China responded with an enormous stimulus which helped global growth recover at a challenging time. Weakness in 2015 again elicited a forceful policy response which focussed on the property market and infrastructure. While these policy measures helped lift growth, they also contributed to imbalances which help to explain the current problems.

A key question for investors here is what will China do next. Churchill once described Russia as a “riddle wrapped in a mystery inside an enigma” and the same could be said for China today. The challenge for investors is that economic outcomes have been downgraded at the expense of national security and geopolitical considerations. For this reason, a large stimulus that helps the global economy but worsens imbalances within China, is unlikely this time around. Instead, policy support is being focussed on targeted sectors and is likely to continue that way.

Certain manufacturing industries such as semiconductors, defense and autos are receiving support with varying degrees of success. The auto sector in China has become a global powerhouse. China now produces as many cars as Europe, US and Japan combined. It has almost caught up with Japan, the leader in electric vehicles, after a few years of very strong growth.

Performance within Emerging Market equities has actually held up well this year, helped by large constituent countries like India, Taiwan and Brazil. Broad based outperformance will require evidence that China’s economy is bottoming out, but the range of potential outcomes for the Chinese economy is wide. Making bold predictions about the path for China is fraught with risk so, to borrow a phrase from central banks, data dependence is key and the incoming data will be watched closely in coming months.



# Bond Yields and the Fiscal Deficit Collide

With negative seasonality in August and September, risk assets were primed for a bout of volatility with market moves amplified by poor summer liquidity.

The combination of rising Japanese bond yields, sliding growth in Europe and an even more rapid fall in activity in China left markets on edge. However, the disclosure by the US Treasury that forecasted borrowing in third quarter will now be \$1 trillion, up from the \$733 billion it pencilled in early May, finally prompted bond yields to break out of their trading range and make new highs. The 10-year US Treasury reached a high of 4.34%.





FIXED INCOME

Meanwhile, the Federal Reserve continues to shrink its balance sheet by up to \$95 billion a month by letting securities mature without replacing them. In aggregate, rising borrowing costs globally look set to constrain growth for some time and the risk premium for overleveraged consumers, corporates and countries will likely remain elevated as the US Treasury crowds out almost all borrowers.

Economic surprise indices showed the US remains the dominant driver of global growth. That said, the global economy has in fact been stagnant since May, with weakness in China spreading through to trading partners such as Germany. With global inflation pressure still a concern, there is hope that China may export deflation to the rest of the world in the coming months, enabling the ‘soft landing’ narrative to take hold. Goods inflation is largely under control but services inflation is becoming embedded into the Western economies and a slowing China does nothing to address this dynamic.

In addition, energy prices are now rising again with WTI reaching \$84 per barrel and US gas prices \$3.88 per gallon in August. The deflationary impact of energy has come to an end and we expect headline inflation to rebound in the months ahead and core inflation to stabilise at an uncomfortable level for policy makers.

The muted effects of monetary policy so far has been surprising, but we are now seeing signs of pockets of weakness in employment, for now confined to states such as California, but with rising oil prices, a frozen real estate market - 30 year mortgage rates have reached 7.62% - and the imminent resumption of student loan repayments, loan delinquencies look set to rise even further in the months ahead. We continue to monitor auto and credit card defaults as a sign that the Federal Reserve has reached its terminal base rate.

4.34%

The 10-year US Treasury reached a high of 4.34%.

7.62%

In the US 30 year mortgage rates have reached 7.62% .

INVESTMENT VIEWS

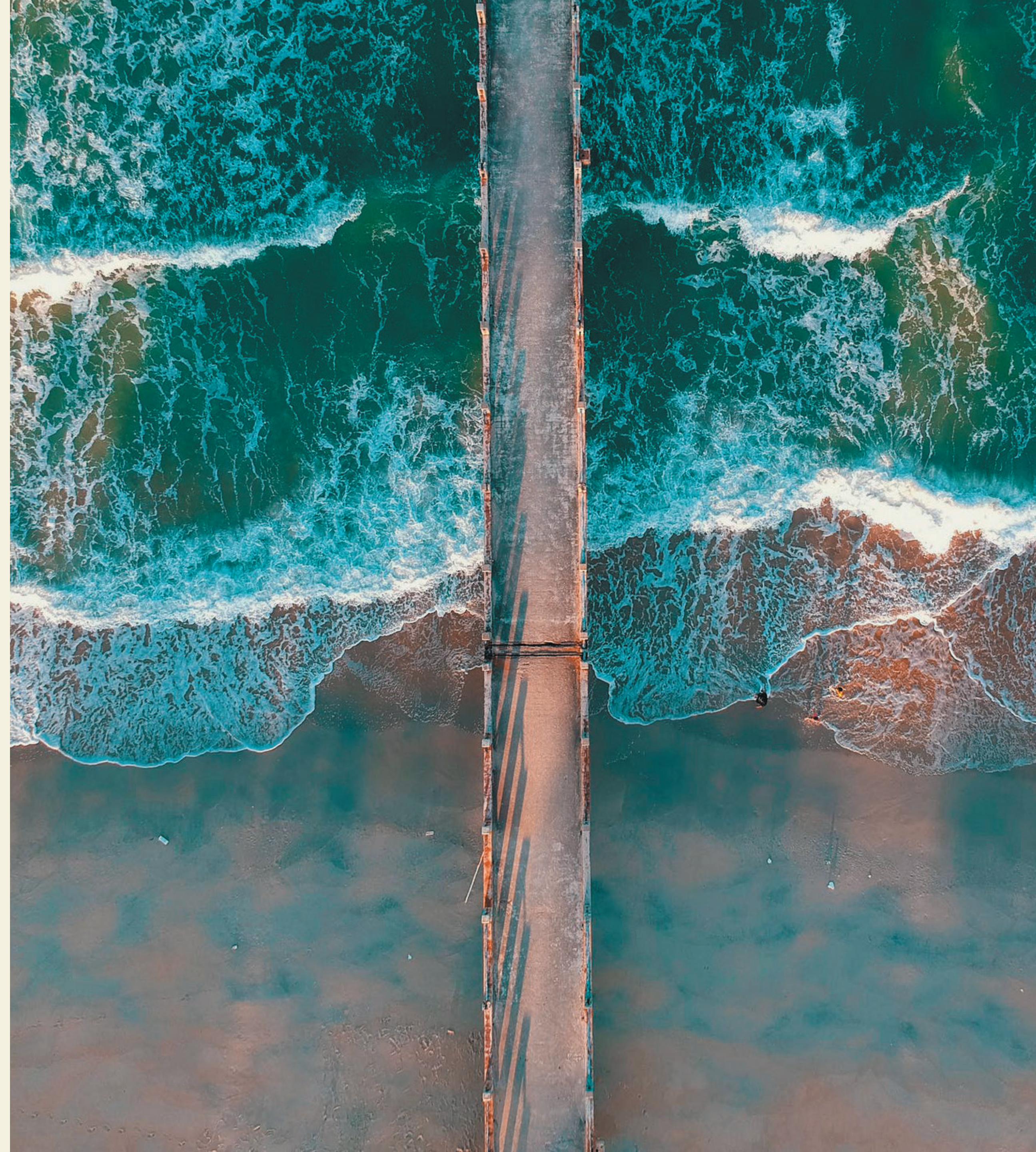
Interestingly, the market currently assigns low odds of Powell following through with the final 25bps hike that was promised in the June dot plot, but in their efforts to regain credibility we are not convinced the hawks are ready to fold just yet.

In terms of portfolio positioning, with the market volatility this month we took the opportunity to evaluate whether our defensive positioning remained appropriate. The continued weakening in the Chinese and European economies as well as the recent rally in the US dollar and energy prices reaffirm our conviction that we are entering a period of heightened volatility for risk assets. In addition, the market moves that we witnessed in August, whilst welcome were not sufficient for us to deploy capital into risk assets. Therefore, we await better opportunities in the months ahead. The increase in US bond yields has provided a valuation offset for the negative effects of rising government issuance and short-term inflation expectations, so we are comfortable adding to very high-quality bonds.



# The Magnificent Seven Part II

The MSCI World Index retreated 2.4% in August, recording the second worst performance this year. Achieving a 7.7% return in the first quarter and 6.8% in the second quarter, the 0.9% returned so far this quarter suggests the market is losing steam. Raising rates and uncertainty around China's economic growth path have created some uncertainty in the markets.







# 2.4%

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## EQUITIES

Energy was the best performing sector this month (up 1.9%) and this quarter (up 8.5%) as oil prices rallied from \$70 at the end of last quarter to \$84 at the end of August. Utilities was the worst performing sector this month (down 5.4%) and this quarter (down 3.6%) as higher interest rates took their toll and pockets of weakness emerged in the renewables sector. The defensive sectors had mixed results, with Healthcare outperforming but Consumer Staples lagging. Both sectors have lagged the market considerably year-to-date as investors have favoured the sectors with more technology exposure such as IT and Communication Services.

The US market outperformed and is now leading Europe by 5% year-to-date. The US's reputation for being a resilient market is shining through as growth forecasts are being revised upwards. Europe and the UK markets on the other hand are slowing with inflation staying stubbornly high and the possibility of stagflation increasing. Asia Pacific (excluding Japan) and Emerging Markets were the worst performing regions dropping 6% as more negative headlines on China emerge.

We have had many discussions regarding the 'magnificent seven' and how 80% of the S&P 500's returns have been generated by these seven stocks. This led to a debate about how these tech stocks would perform in a falling market. In August, with the equal weight S&P 500 underperforming the S&P 500 by 1.6%, the magnificent seven outperformed in a down market. However, given their different business models and growth trajectories we would expect performance to continue to diverge, so being selective is key.



## EQUITIES

Overall, the second quarter earnings season was a success. S&P 500 aggregate sales and earnings-per-share (EPS) beat by 2% and 7.7% respectively. The sales beat is in line with previous quarters, however the EPS beat is the highest since 3Q21. The breadth of the beats was wider than usual with 54% of companies reporting a beat versus a historical average of 48%.

The one weak spot this earnings season was the price reaction, with the one-day price change for stocks down 0.2% despite the beats. Going into the earnings season the expectations were for a 9% decline in earnings YoY. The strong earnings led to positive revisions for 2023, with 2024 and 2025 calendar years also set to benefit. Should the elevated oil price persist, it is possible that we see further upward revisions to consensus EPS this year.

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# 1.9%

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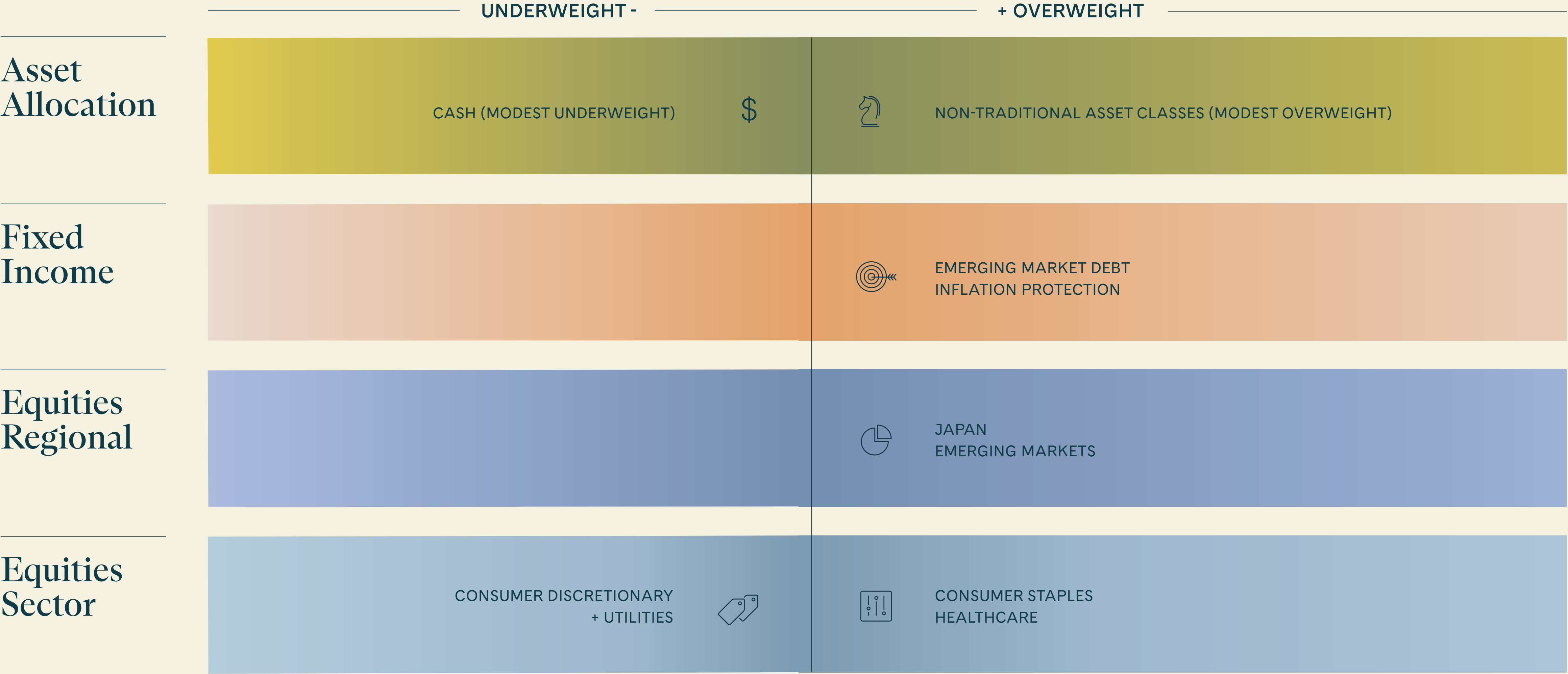
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# Global Asset Allocation

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





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