

Investment Views



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Strong recovery for Bonds and Equities

Fixed Income:

Financial Conditions Dilemma

Equities:

Equities go for Gold

Strong recovery for Bonds and Equities

- Bond markets rallied which helped equities to rally
- Expectations of interest rate cuts next year have increased
- Markets are pricing in a lot of good news

November was a very eventful month in financial markets. After a difficult couple of years for fixed income, last month saw a reversal of fortunes as the 10-year US treasury bond yield fell from 4.93% to 4.33%.



STRATEGY

Bond prices rise when yields fall, so the aggregate US bond index generated a total return of 4.5%, marking its eighth best return since 1976. The only months when bonds generated a higher total return were all in the 1980s, when coupon income was substantially higher.

This recovery in bond prices (lower yields) also helped support the equity market. Global equities had a tricky few months, falling 2.4% in August, 4.3% in September and 2.9% in October, but staged a very impressive 9.4% rally in November. This was the 12th best month for equities since 1970 and represented the fastest recovery from a 10% correction since the 1970s.

The rally in bond and equity markets was driven by a combination of favourable growth and inflation data. The question in focus for financial markets has been whether inflation could be tamed without a recession. This would require a delicate balancing act of growth cooling enough to bring inflation down, but not so much that the economy is tipped into recession. A lower than expected inflation reading from October (released in November) assuaged any concerns that interest rates would be raised again this year. The market wasted no time in pricing in a higher probability of interest rate cuts next year.

Central bankers in the US, UK and Europe have been cautious with commentary around the possibility of interest rate cuts. After initially dismissing inflation concerns in 2021, they have had to work hard to regain their credibility on inflation and do not want to risk reigniting inflationary pressures by declaring victory on inflation too early. However, Federal Reserve governor Waller recently stated that “if you see this [lower] inflation continuing for several more months, I don’t know how long that might be – 3 months? 4 months? 5 months? – you could then start lowering the policy rate because inflation’s lower”.

4.5%

The aggregate US Bond return was the eighth best since 1976.

The question in focus for financial markets has been whether inflation could be tamed without a recession.



3.3m

The growth (in millions) in the US labour force this year.

STRATEGY

Whether interest rates are cut or not is of course conditional on incoming inflation data. Waller emphasised this by saying “inflation is still too high, and it is too early to say whether the slowing we are seeing will be sustained”. That said, markets are forward-looking and adjust based on probabilities, so the prospect of rate cuts next year is important for market pricing.

While central banks have focused on bringing down inflation by cooling demand, an important aspect to the story on inflation has come from the supply side. The US labour force has seen strong growth of 3.3 million this year, which has been helpful. US oil production has also been impressive and hit a new high in October, helping to lower oil prices which is good for growth. Lastly, supply chains have healed from the pandemic disruption such that goods price inflation is now negative.

When it comes to asset allocation, we came into the year with a modest underweight to equities of around 2.5% - that means we held 52.5% equities in balanced mandates versus a benchmark weight of 55%, an equal weighting to Fixed Income and a modest overweight to Alternatives. As the year progressed and equity markets climbed higher while fixed income struggled, we allowed portfolio weights to drift and portfolios benefitted accordingly.

Following the sharp rally in equity markets, we made a small adjustment to our asset allocation and trimmed our equity allocation by 2.5%. With cash in US dollars yielding close to 5% and the bond market having already rallied, we have moved modestly overweight cash. The US economy may continue to be resilient, but the market has priced in a lot of good news on growth and inflation. As former PIMCO chief economist Paul McCulley once said, “you don’t get to go to heaven twice for the same good deed”.

Financial Conditions Dilemma

- Global bond yields fell dramatically
- The US Treasury relieves pressure on the long end of the curve
- US financial conditions ease at their fastest rate since 2020

Fixed income markets continued their wild ride in November, as the US Treasury stabilised the long end of the yield curve via a reduction in supply and adding to treasury bill issuance instead. This was then followed by a softer than expected US inflation reading and weaker than expected US macro data, which together raised the probability of interest rate cuts and with it a soft landing for the economy.



FIXED INCOME

This will surely unsettle policy makers. Whilst the rise in long bond yields in October was painful, the Federal Reserve was happy and communicated this to the market; tighter conditions effectively allowed them to cease hiking the base rate. The problem now is that all this progress has been unwound. During November, US financial conditions eased dramatically - the equivalent of 90 basis points (bps) in US base rate cuts. As a result, there is now a risk that a pickup in economic growth leads to more inflationary pressure, which may mean central banks keep interest rates high.

The broad rally in risk assets and government bond markets led to US investment grade corporate credit spreads tightening by 25bps and high yield 67bps. 30-year US Treasuries also experienced a large volatility adjusted move, with yields falling 60bps to 4.50%, a 10% capital gain and outperformance of the MSCI World. Outside of the US, the bond market rally was just as impressive, with all major government bond yields (apart from China) falling by at least 20bps. The continued declines in energy prices also dragged down inflation expectations, with short-term US inflation breakevens now below the 2% target. In currency markets, the US dollar fell 3%, losing ground against all G7 countries, as short-term interest rate expectations converged across regions - with Australia and Japan the most hawkish central banks left within the major economies.

US economic data continues to perform well overall and looks no closer to a recession than last month. In Europe and the UK, weakness is still widespread but the most recent leading indicators show improvement. Inflationary pressures are higher in the UK than in continental Europe, so the Bank of England has a more challenging backdrop.

4.50%

US Treasuries yields fell
60bps to 4.50%.

3%

The amount the US
dollar fell, losing ground
against all G7 countries

INVESTMENT VIEWS

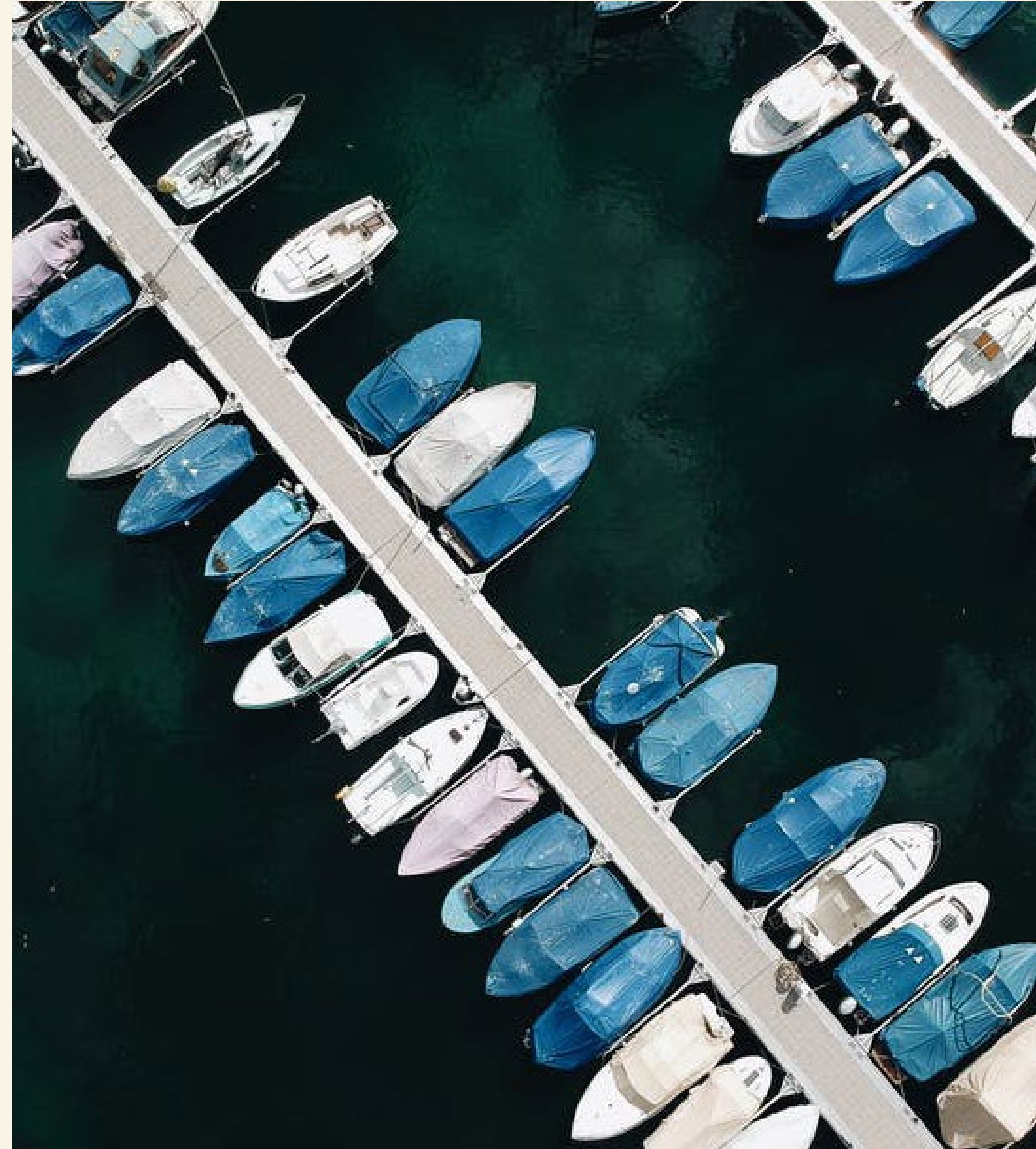
Emerging markets have rebounded and China has stabilised due to easing in monetary policy over the past few months, which helped global liquidity to turn favourable again. At a global level, growth is stable for now and inflation is easing.

Following the rally in fixed income markets, the decision to increase or decrease duration is finely balanced. While the positive changes in global liquidity and falling inflation expectations provide a tailwind for risk assets to continue rallying for a little longer, sentiment and valuations are now becoming stretched. Therefore, this rally is probably due a period of consolidation and/or a pullback in the coming weeks. We are therefore looking for a window to add to the US dollar and take gains in fixed income ahead of the next US Treasury funding announcement in January. Maintaining risk adjusted returns is paramount and the current 5% yield in risk free cash provides that tactical opportunity.

Equities go for Gold

- Equities stage a powerful rally
- Earnings growth is low but positive
- Political risks will be high in 2024

What a difference a month makes. The MSCI World Index had the best month this year, rallying 9.4%. After three negative months the markets recouped those losses in just one month, a reflection of how quickly sentiment can change and the speed at which money can be deployed. The MSCI World is up 18% year-to-date, the S&P 500 is up 20.8%, the Nasdaq is up 47%, and a market capitalisation weighted index of the Magnificent Seven (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, Tesla) is up 103%. The equity market returns this year have been truly impressive.





7.7%

The amount aggregate earnings rose in the third quarter.

EQUITIES

From a valuation perspective, the S&P 500 price earnings multiple has expanded from 17x to 19x. The valuation multiples on six of the Magnificent Seven have expanded significantly. Nvidia, which has rallied 220% year-to-date, is actually cheaper (on a forward price earnings basis) now than it was at the beginning of the year as the demand for Artificial Intelligence (AI) chips rocketed. Given the strong rebound in November, the more expensive valuations, and the narrow breadth of the rally, we have taken the opportunity to reduce our exposure to equities. On current multiples, the earnings yield is 5.3%, which we believe is expensive when compared to other asset classes, given the level of uncertainty.

The third quarter earnings season has now ended. S&P 500 sales grew by 1.9% and earnings grew by 4.5% after three consecutive quarters of negative growth. Versus expectations, aggregate sales beat by 1%, the lowest beat in recent history, but aggregate earnings surprised by 7.7%, a beat which is towards the higher end of the historical range. Despite the positive surprise, the price action was muted, with the one-day price change flat.

A running theme has been a third quarter beat but a weaker-than-expected fourth quarter guidance, indicating a more challenging environment. However, interestingly the downgrades to consensus earnings, both for the fourth quarter and 2024, match the historical pattern of earnings estimates being downgraded ahead of companies releasing their results.

Another interesting data point is the change in how companies are allocating capital. Capital expenditure (capex) and spending on research and development (R&D) grew by 5% in the third quarter, a sharp deceleration from the 14% growth seen in the first half of the year. Part of this was due to a reduction in spending from some of the Magnificent Seven companies.

EQUITIES

In the third quarter, Amazon, Apple, and Meta (previously Facebook) cut capex and R&D spending by high single to low double digits. Companies also continued to reduce share buybacks. Buybacks in the third quarter were down 9%, although in contrast to spending, this was actually an improvement on the 22% decrease in the first half. Buybacks are likely to continue to decrease as corporations re-consider the value of buying back shares versus retiring debt given the higher borrowing costs. This reduces an important source of equity demand as households are already heavily invested in equities.

As we contemplate what is in store for 2024, one key topic is the US presidential elections. On average, equity returns tend to be weaker than average in presidential elections years. Since 1932, the S&P 500 index has returned an average of 7% during the 12 months preceding the election, versus the 9% outside of election years. Since 1984, this drops to only 4%. However, this is skewed by recessions that occurred around some of the elections. If we adjust for this, the average return is 9% vs 11% outside of election years.

The above underscores our decision to reduce our exposure to equities. Given the low equity volatility and relative volatility to other asset classes, we believe in taking a prudent approach.



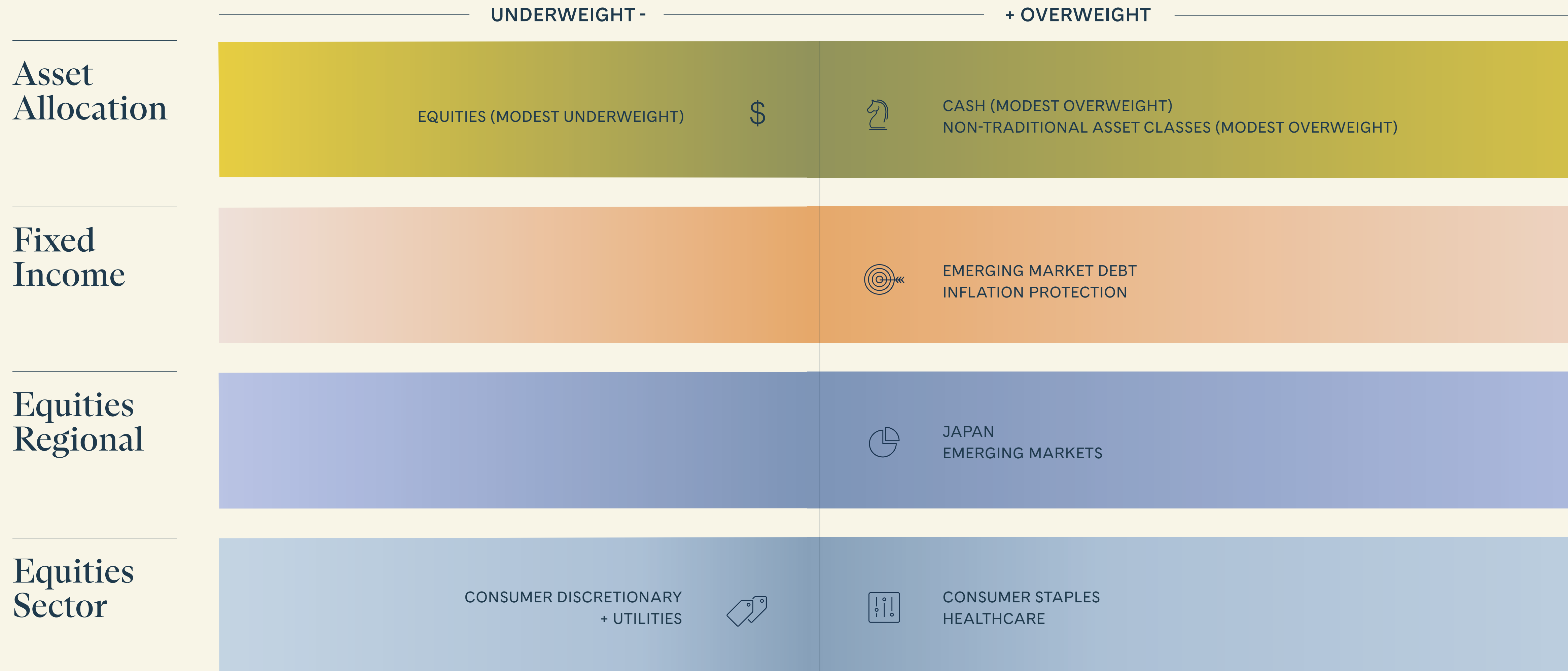
7%

The S&P 500 index average return during the 12 months preceding an election.

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Global Asset Allocation

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



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