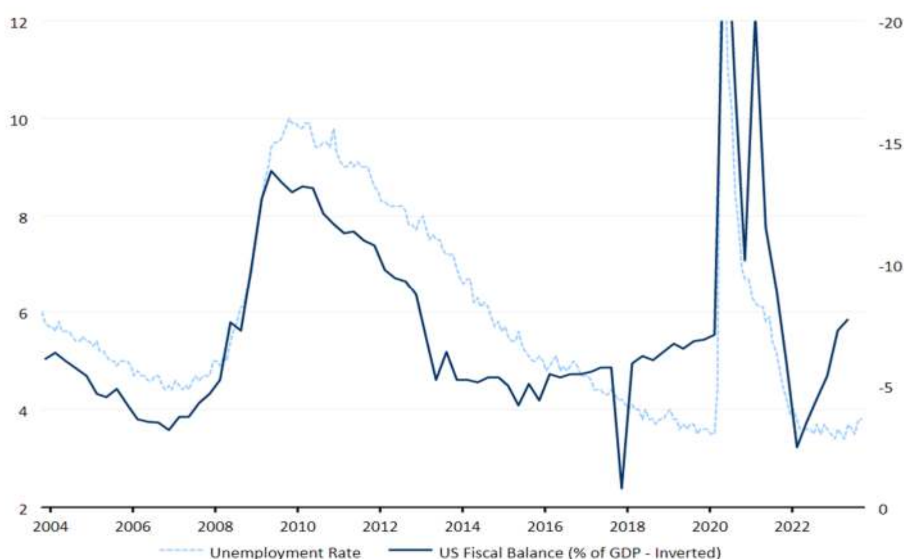
October 2023
Issue No. 29

GLOBAL INSIGHT

Overview

- In our Macro View, we consider the recent performance of equity markets in the context of our forward-looking views.
- We look at the narrow performance of US equity markets leading to a stark contrast with the equal weight index.
- In our Investment Outlook, we look at the resilience of consumers fueling the market moves and earnings expansion amidst a complicated backdrop.
- Equities have moved to price a significant recovery, although the implied level of recovery seems inconsistent with incoming data.
- A US fiscal deficit of c.8% does not look consistent with an unemployment rate of 3.8% and perhaps illustrates the reason for higher long-term bond yields.
- We consider the impact of recent macroeconomic data on markets and sectors in context of our prevailing house view.
- We discuss our preference for UK and European equities where a material economic slowdown is largely being discounted by current market pricing.
- In our feature piece Philip Meier, Managing Director, Head of Emerging Markets Debt and Multi-Asset Portfolio Manager at Gramercy covers the backdrop and outlook for EM debt in 2023 and beyond.

The US is running a substantial fiscal deficit despite low unemployment



Source: *Hottinger Investment Management / Refinitiv Datastream*

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Macro Highlights

- Equity markets are pricing a material recovery.
- Real bond yields have continued to climb as policy rates have risen and inflation has cooled.
- In the context of persistently loose monetary policy from the BoJ the Yen has continued to weaken.
- The cost of fixed rate mortgages in the UK will likely continue to dampen enthusiasm for new house purchases.
- Certain areas of emerging markets look particularly attractive given their earlier victory over inflation.

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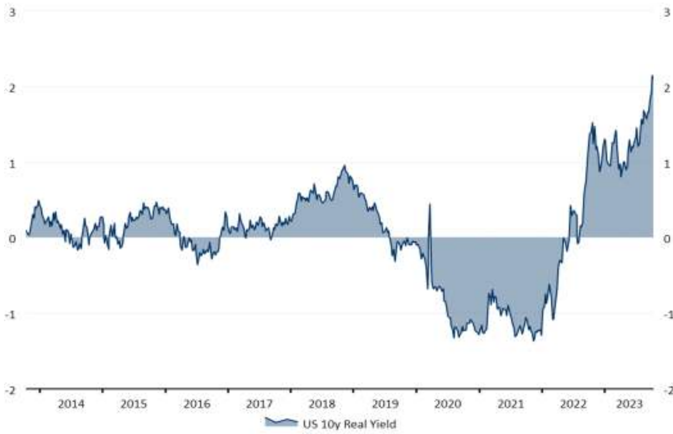
Based upon information available up to and including:

13th October 2023

Key Issues in Charts

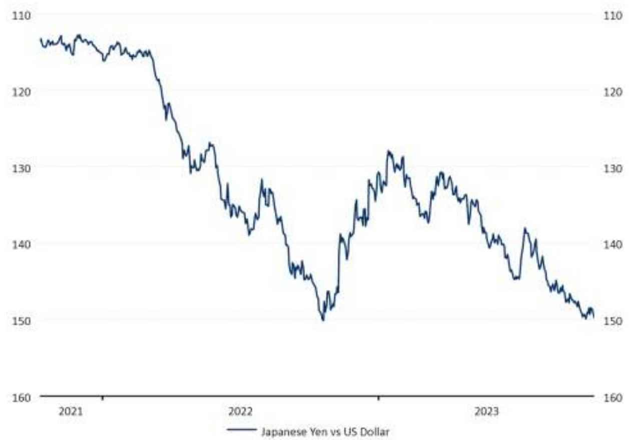
Climbing real yields



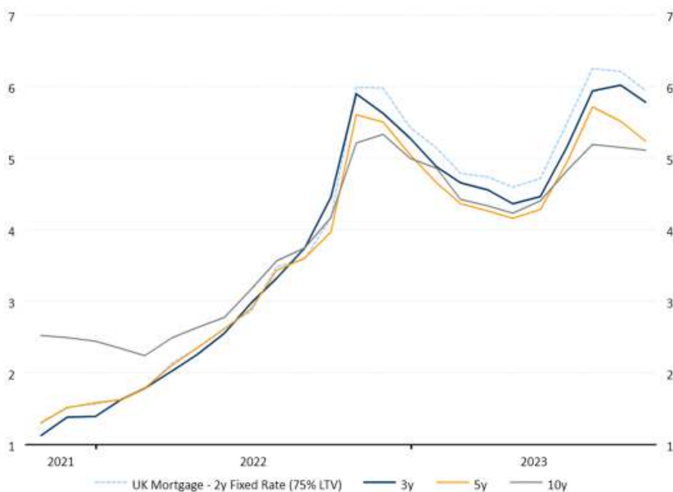
- Real bond yields have continued to climb as policy rates have risen and inflation has cooled.
- This materially increases the cost of capital for companies and could begin to affect consumption.
- The presence of attractive real yields also increases the relative attraction of bonds versus other asset classes (including equities).

Yen weakness

- In the context of persistently loose monetary policy from the BoJ the currency has continued to weaken.
- The level of 150 in USDJPY has historically proven to be a point at which the central bank intervenes in the currency market to limit further weakness.
- Japanese government bonds represent c.16% of the global sovereign bond market and yields will arguably need to rise from here. Any move higher would, in our view, drive significant strength in the Yen as a currency.



Rising mortgage costs



- The cost of fixed rate mortgages in the UK will likely continue to dampen enthusiasm for new house purchases.
- The 2y fixed rate breached 6% early in the quarter and appears to be settling just below that level.
- UK house price data from Nationwide suggested a 5% decline in value over the prior 12 months to August 2023.

Heads I Win, Tails You Lose

*By **Adam Jones**, Senior Investment Manager*

Having finally thrown in the towel and taken a more cautious approach toward asset allocation back in Q1 of this year we have since, like so many others, been surprised by the strength of equity markets (particularly in the US) and the resilience of the consumer. This has undoubtedly weighed on relative performance. The fact that equity market leadership has been so narrow also sits squarely at odds with the previously close correlation observed between large-cap growth stocks (think Technology) and the prevailing level of real interest rates.

Having taken a more cautious approach towards asset allocation we have since, like so many others, been surprised by the strength of markets (especially in the U.S) and the resilience of consumers.

> *"In the short run the market is a voting machine. Yet, in the long run, it is a weighing machine…"*
>
> *Warren Buffet, 1973 (Distilling the earlier works of Benjamin Graham in 'Security Analysis')*

Indeed, if one excludes the 7 largest stocks in the US Equity index performance for the remaining 493 companies has essentially been flat on a YTD basis. As prices have diverged so too have valuations. The top 7 companies today constitute almost 30% of the broader index by market cap and trade at an average P/E multiple of more than 50x earnings. To be clear these are valuation levels at which we are simply not prepared to participate, however plausible the growth trajectories of these companies might be. We have been here before on several occasions and recognise that the market can (and in fact often does) disagree with our own view in the near term.

If you exclude the 7 largest stocks in the US 500 Equity Index, performance for the remaining 493 companies (98.6% of the index) has essentially been flat on a YTD basis.

In our experience, however, valuations ***always*** matter over the longer term. We have good company in holding that view.

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Real interest rates and performance of Technology Stocks

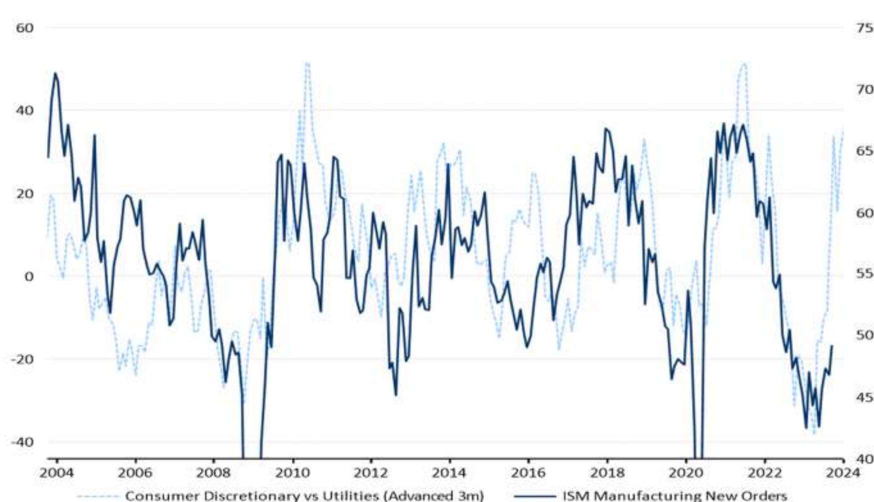
Source: *Hottinger Investment Management / Refinitiv Datastream*

The problem with today's market, at least as we see it, is that equities find themselves in the unenviable position of Homer's Odysseus who, in seeking to navigate the treacherous and narrow Strait of Messina, finds himself stuck between Scylla and Charybdis (two mythical creatures who represent equally un-

pleasant outcomes should they be met). On the one hand US equities have already moved to price a significant recovery in economic momentum, which can be seen not only in a significant revaluation (US equities have moved from an earnings multiple of 18x in Q3 to more than 22x by the end of September) but also in the behaviour of market internals. When we consider the relative performance of the consumer discretionary sector (which represents companies whose goods & services consumers would ***like*** to buy) versus Utilities (the goods and services of companies that consumers ***have no choice but to*** buy) we are struck by the implied level of recovery in economic activity. The current relative performance of these sectors is consistent with an ISM Manufacturing New Orders component of ~65, which would count among the highest levels of activity witnessed in several decades.

Current relative performance amongst consumer discretionary and utility sector constituents is consistent with an ISM Manufacturing new orders component of ~65 which would count among the highest levels of economic activity witnessed in decades.

Equity market internals pricing a material recovery in growth momentum



Source: *Hottinger Investment Management / Refinitiv Datastream*

So let's for a moment assume that this macro uplift happens to materialise, which we suggest might be challenging with unemployment already at generational lows. We shall call this the 'Scylla' outcome. What might that mean for the current level of interest rates? One would have to assume that a significant re-acceleration in growth from already high levels should drive another cyclical uplift in inflationary pressures (tentative signs of which we may already be seeing). In this scenario the only plausible perspective on monetary policy is that the current level of interest rates is simply not restrictive enough to dampen activity, and thus inflation which has to date been its sole purpose. The consequence in our view would be yet another re-pricing of short-term interest rates and, perhaps, a market environment in which bond-equity correlations once again break-down. Scylla is ***so*** 2022…

What of Charybdis? As mentioned above our belief is that equity markets are already pricing a re-acceleration in economic growth. Nowhere is this clearer than in the level of corporate earnings expectations for 2024. As at the end of September analyst consensus reflects anticipated earnings growth of 12% over the coming year. If our 'Scylla' scenario did in fact materialise this **might** be a realistic expectation. However, discount (aka policy) rates would also ***have*** to shift higher in that scenario and would likely impair or, in the very best case, satisfy already lofty valuations. Applying the 10y average US equity multiple of 18x to next year's consensus earnings yields a US Equity Index level of 4360, which is effectively where we stand today. Not so exciting.

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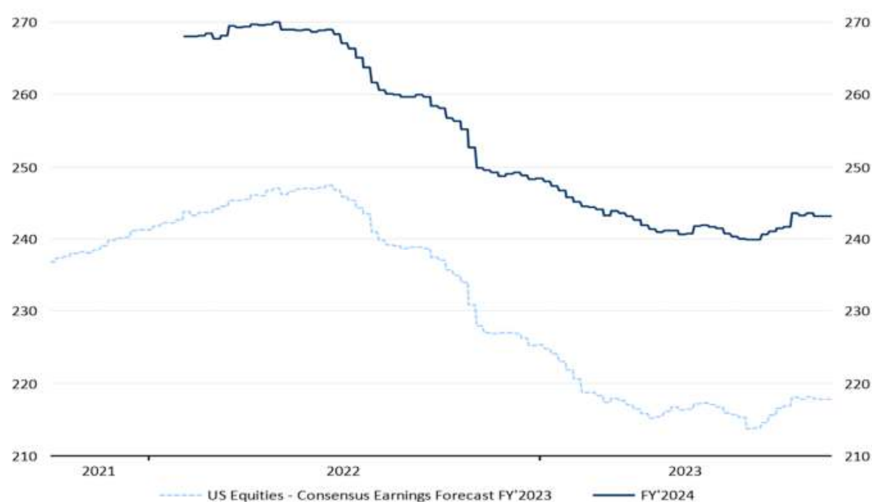
Not so exciting.

Consensus Analyst earnings expectations for FY'24 imply 12% growth



Source: *Hottinger Investment Management / Refinitiv Datastream*

The bigger concern for us is that the impact of one of the largest and fastest tightening cycles in living memory might ***finally*** start to impact the consumer and, with it, the probability of gracefully avoiding recession could so quickly dissipate. We recognise that it has become increasingly challenging to call for a US recession in the context of recent data, however our main point is that we simply don't have to. Asset markets are already discounting the avoidance of such an outcome. Our approach is centred on weighing current market prices relative to our own sense of probabilistic outcomes and their distribution. Incoming macro data has yet to evidence any sense of formal distress for consumers but when we look around, we see plenty of cause for concern. Not least of which are the four horsemen (I should stress that we **do not** anticipate an economic apocalypse, but the metaphor was one of few that fit!).

The bigger concern for us is that the impact of one of the largest and fastest tightening cycles in living memory might ***finally*** *start to impact the consumer.*

Incoming macro data has yet to evidence any sense of formal distress for consumers but when we look around, we see plenty of cause for concern.

We hear the arguments of recent revisions to the accumulated level of post-pandemic savings and the rise in household net worth (the very reasons we were reluctant to position ourselves so defensively in the first place) and we obviously give them credence. However, can it really be the case that consumer spending is not materially impaired by one of (if not all of) the below? Large & Medium sized banks in the US are very quickly raising the standards against which they will extend credit, oil prices have risen by almost 30% over the quarter, the USD has strengthened by more than 3% and 10y Treasury yields have risen from 3.8% to more than 4.5%. The idea that moves of this magnitude could simply be shrugged off by consumers feels, at least to us, like wishful thinking. Add to this the observation that labour markets, as we wrote last quarter, show signs of softening and the trajectory for growth over the next 12-18 months appears challenging.

US Banks are quickly raising the standards against which they will extend credit, oil prices have risen by almost 30% this quarter, the USD has strengthened by over 3% and 10y Treasury yields have risen from 3.8% to more than 4.5%.

One indicator we follow closely is the 'Sahm Rule'. Claudia Sahm is a former Federal Reserve economist, economic advisor to the Obama administration and currently leads the macro-economic research efforts at the Jain Family Institute. In a paper published during her time at the US Federal Reserve[i] Sahm observed that on each prior occasion that the 3m average unemployment rate rose by more than 0.5% from its 12m low a recession had already begun (and the unemployment rate continued to rise to much higher levels). To be clear, we are not there yet, however the recent rise sits firmly on our radar.

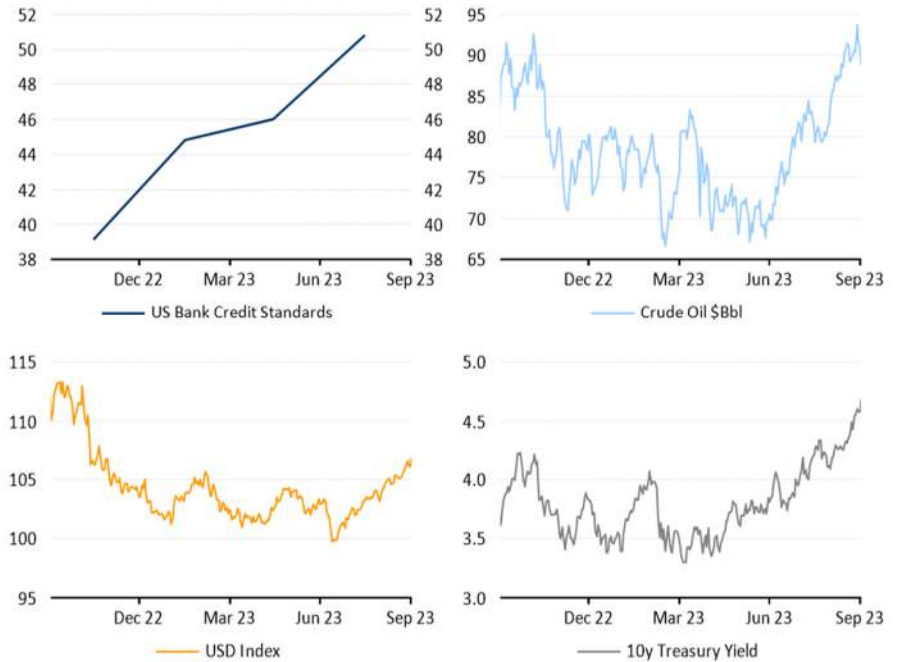
Whether we see a continuation of accelerating growth or a mild recession, US equities appear vulnerable here.

We retain our preference for U.K/European equity where we believe a material slowdown is largely being discounted by current market pricing.

*U.K equities trade at their steepest *ever* discount to US peers based on forward price/earning multiples.*

This feels like a huge opportunity for us.

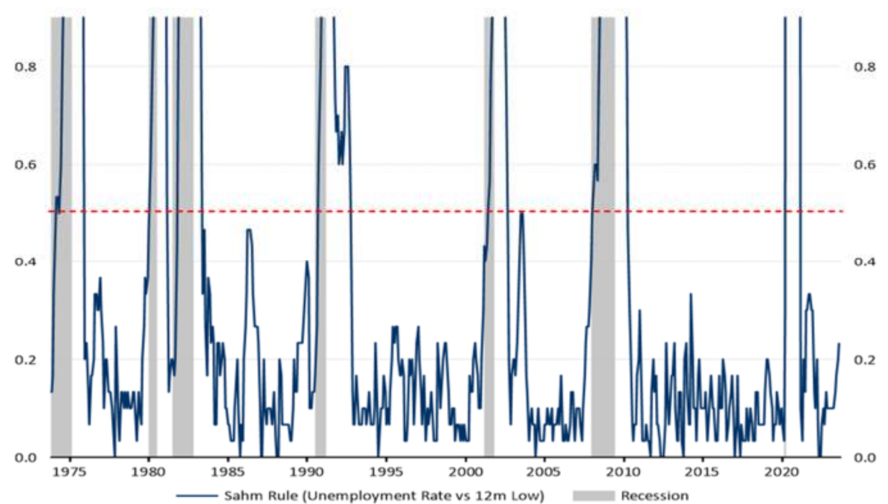
The Four Horsemen



Source: *Hottinger Investment Management / Refinitiv Datastream*

Our belief is that whether we see a continuation of accelerating growth or a mild recession US equities appear vulnerable here. We retain our preference for UK & European equity where we believe a material slowdown is largely being discounted by current market pricing. UK equities trade at their steepest *ever* discount to US peers on forward P/E multiples. That feels like a huge opportunity to us. In fixed income we continue to favour short-dated government bonds here in the UK and note that short-dated US inflation linked securities look particularly attractive offering real (after-inflation) yields exceeding 3%.

The 'Sahm Rule' is creeping higher



Source: *Hottinger Investment Management / Refinitiv Datastream*

[i] https://www.brookings.edu/articles/direct-stimulus-payments-to-individuals/

Investment Outlook

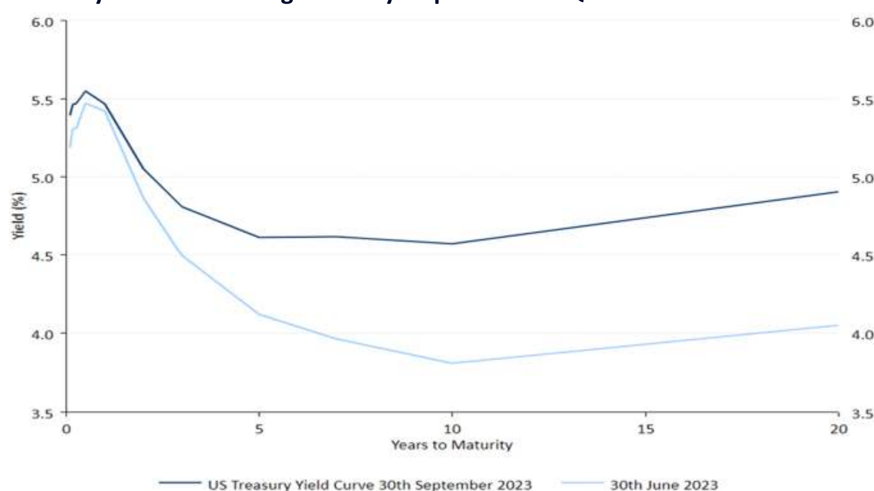
The AI-led rally in developed equity markets over the first half of the year was driven almost entirely by Price – to – Earnings (P/E) expansion rather than growth in earnings supporting our fears of an earnings recession during the second half of the year that we would expect to challenge valuations. Moreover, the mood music changed over the summer months as low quality earnings and negative year-on-year growth in many sectors started to weigh heavily on markets. The resilience of consumers has kept economies afloat and led to much optimism amongst equity investors that a soft landing by the economy will avert a recession and allow earnings growth to continue. However, attitudes changed following Fed Chairman Powell's annual speech at the Jackson Hole Symposium in August when he reinforced the message that rates would need to stay higher for longer for the Fed Open Market Committee policy to return inflation to its 2% target. Although the Committee paused its series of rate hikes in September the forecasts of its members emphasised the belief that rates would not be cut in the medium term as many markets had priced into valuations.

The resilience of consumers which has kept economies afloat has led to wider optimism amongst equity investors that a soft landing would avert recession and allow earnings to grow further, although these attitudes changed following J. Powell's speech at the Jackson Hole Symposium.

Assisted by a rating cut by Fitch, US Treasuries started to price out the possibility of rate cuts in the short term and the possibility of recession. This has led to a significant move higher in long duration bond yields known as a bear steepening, as the significant inversion in the yield curve, often the pre-cursor to a recession, is priced out. An inverted yield curve sees short term bond yields higher than long duration bonds meaning investors are not being rewarded for taking on inflation risk. The US yield curve which has been inverted for over 15 months and was inverted by over 100 basis points in July has seen the yield differential fall to nearer 32 basis points now. A bull steepener – when short end yields fall in the expectation that interest rates will need to be cut while long term yields remain relatively unchanged – is quite often the signal that a recession is about to happen, however, a bear steepener occurs when the yield of long-dated bonds rise, and prices fall while short term yields stay anchored to short term rates. A rise in long dated yields in the US has a significant effect on the housing market where mortgages are priced from the 30-yr US Treasury Bond, so we see mortgage rates for new mortgages rising to approximately 7% with inevitable consequences for the housing market.

The US yield curve which has been inverted for over 15 months and was inverted by over 100 basis points in July has seen the yield differential fall to nearer 32 basis points now.

The US yield curve has significantly re-priced over Q3



Source: *Hottinger Investment Management / Refinitiv Datastream*

A rise in long dated yields in the US has a significant effect on the housing market where mortgages are priced from the 30-yr US Treasury Bond, so we see mortgage rates for new mortgages rising to approximately 7% with inevitable consequences for the housing market.

Therefore, rising long bond yields have the effect of tightening financial conditions even though headline rates were left unchanged creating an unfavourable environment for risk assets, in particular equity markets which have reacted negatively over the quarter. Historically, P/E multiples have reacted negatively to rising real yields - nominal yields adjusted for the effects of inflation. As yields have gone up and inflation has fallen, real yields have risen from approximately 1% to 2.34%; the S&P 500 has fallen 3.64% over the quarter, and the US equity P/E has fallen from 19.8 to 18.5[i] times. A 2-yr US Treasury yield of approximately 5% further provides investors with a significant risk-free return that challenges the long term historical return of 7.7% for the S&P 500 annualised over the last 30 years, as well as a current earnings yield of 4.6% we calculate. The influence of US Treasuries has also seen the German Bund and UK Gilt markets dis-invert as longer yields have moved higher causing similar turbulence in national equity markets with UK equities showing their defensive qualities and cheap valuations to be down only 0.6% while European equities backed up 3.4% and Japan 4.3%.

As yields have gone up and inflation has fallen, real yields have risen from approximately 1% to 2.34%.

A 2-yr US Treasury yield of approximately 5% further provides investors with a significant risk-free return that challenges the long term historical return of 7.7% for the S&P 500

The influence of US Treasuries has also seen the German Bund and UK Gilt markets dis-invert as longer yields have moved higher causing similar turbulence in national equity markets

Japanese equities have been a focus for us while we continue to follow a defensive asset allocation because the macroeconomic environment and the outlook for earnings momentum are strong in our view. The equity market has indeed been strong year-to-date; however, Absolute Strategy Research (ASR) point out that valuations remain attractive compared to other regions with an opportunity to close the valuation gap[ii].

Japanese equities have been a core focus for us while we follow our defensive stance. Absolute Strategy Research point out valuations remain attractive compared to other regions with an opportunity for the closing/narrowing of the valuation gap.

From a sector perspective the so called "Magnificent 7" of Alphabet; Amazon.com; Apple Inc.; Meta Platform; Microsoft; Nvidia Corp; and Tesla have been the focus of investor interest in Artificial Intelligence (AI) and to some extent distorted the returns of US equities at an index level. The S&P 493 (minus the 7) vs. the S&P 500 show a completely different return profile this year. The size of these companies also has an outsized effect on the index as a whole because it is market capitalization weighted so when comparing the S&P500 to the S&P500 equal weight index, the difference in performance this year is quite stark.

Cap-weighted indices materially outperformed Equal-weighted YTD (rebased)

The general market opinion is that technology stocks as well as other cyclical growth sectors are “long duration” plays because their returns will be accumulated far into the future and, therefore, negatively impacted by inflation when those expected returns are discounted to present day. However, the AI rally has coincided with a period of rising inflation and higher interest rates looking to slow economic growth, an environment that should not favour growth stocks. Our preference for quality stocks has led us to be somewhat sector agnostic preferring to focus on high cash flow, low debt companies in strong industry related positions which still tends to favour sectors such as consumer staples, certain industrials, pharmaceuticals, and healthcare. High and rising debt servicing levels is not a good back drop for small and mid-sized companies that often rely more heavily on refinancing, and this has been reflected in valuations. The software side of the Technology sector also has similar defensive qualities of strong cash generation, and low debt, characteristics that have supported the sector in the past and may help explain the resilience of the Magnificent 7 following the AI rally that has taken them to extremely high valuations.

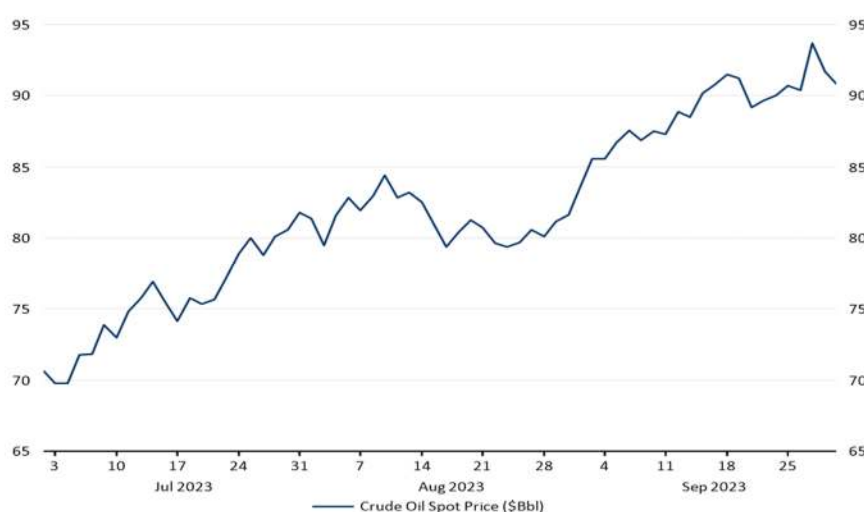
The AI rally has coincided with a period of rising inflation and higher interest rates looking to slow economic growth, an environment that should not favour growth stocks.

Our preference for quality stocks has led us to be somewhat sector agnostic preferring to focus on high cash flow, low debt companies in strong industry related positions.

Our standard asset allocation has carried an exposure to general commodities for over a year as a hedge against rising inflation and although we reduced the position earlier this year, we have continued to believe that the resilience in economies may provide support for real asset prices and through supply shortages create a tailwind for prices. A threatened El Nino weather phenomenon has caused price rises in agricultural prices and OPEC+ supply restraints, most notably Russia and Saudi Arabia, has helped the oil price gain approximately 30% this quarter with Brent priced at $96.8 with some commentators suggesting $100 or even $120 per barrel. This has had a knock-on effect to stocks in the energy sector with headline oil companies such as Shell (+10%), Conoco Philips (+15%) and Total Energies (+18.5%) seeing large gains over the quarter. However, more recently the oil price has been much more volatile as it responds to changes in the macro-economic environment.

Although we have reduced commodity exposure earlier this year, we continue to believe that economic resilience may provide support for real assets through supply shortages.

Crude oil rose sharply over Q3



The El Nino weather phenomenon caused agricultural prices to rise while geopolitical tensions and conflict helped push oil prices higher by around 30% this quarter.

Another commodity that does not do well historically in a high inflation, rising rate environment is gold because it has no yield and in the case of bullion which has storage costs likely does not cover its long-term cost of carry. How-

ever, gold has been very resilient throughout this rate hiking phase maintaining its normal safe haven status despite the strength of the US dollar with which it historically has a negative correlation. However, since real yields have started to rise significantly gold has started to react losing 3.7% over the quarter with the majority of that move happening in September in line with the move in real yields.

We remain cognisant of the fact that valuations remain elevated when compared to long-term historical averages. However, there are ample reasons to maintain a cautious and skeptical stance as an investor in the current market environment.

The strength of the dollar over the quarter - +3.22% - we attribute to the "higher for longer" mantra from the Fed has provided a headwind for Emerging Markets. Furthermore, the lack of confidence of the Chinese consumer emerging from COVID lockdown and the stress in the property market has caused Chinese disinflation threatening the 3% growth forecasts for this year.

In summary, we remain cognisant of the fact that valuations remain elevated when compared to long-term historical averages. However, there are ample reasons to maintain a cautious and skeptical stance as an investor in the current market environment.

Our cautious investment strategy has resulted in our abstention from participating in the AI driven rally that swept through the markets during the first half of the year. Nonetheless, we remain optimistic about the potential vindication of our quality-driven, defensive stock selection approach in the latter half of the year. This optimism is underpinned by the fact that valuations continue to remain elevated when compared to long-term historical averages. Moreover, there are ample reasons to maintain a cautious and skeptical stance as an investor in the current market environment.

We remain optimistic about the potential vindication of our quality-driven, defensive stock selection approach in the latter half of the year. This optimism is underpinned by the fact that valuations continue to remain elevated when compared to long-term historical averages.

[i] Absolute Strategy Research - Absolute Insight, Impact of Higher Bonds Yields on Equities – October 4, 2023 Research

[ii] Absolute Strategy Research – Equity Strategy, Q4 Outlook: Equity Regions – September 14, 2023
All market statistics have been drawn from data provided by Refinitiv Workstation.

Emerging Market Debt

*By **Philip Meier,** Managing Director at Gramercy Fund Management*

As we look forward to the last quarter of 2023 and into 2024, we see a dichotomy for EM debt caught between a challenging external backdrop against underlying stories that have been improving for many credits after the consecutive macro shocks of 2020-2022. This is especially true for local debt, both from an FX and local rates perspective. In the near-term, local debt face “top-down” headwinds from “higher for longer” rates environment in developed economies, strong USD and higher global oil prices that could feed into renewed inflationary pressures going forward. On the other hand, significantly higher real interest rates versus the recent past, and largely completed, tightening cycles across the board anchor a supportive “bottom-up” backdrop for local debt, which when coupled with attractive valuations provide an attractive entry point into selective credits for investors. The critical component to alpha generation in this context is active management of the local universe.

We see a dichotomy for EM debt caught between a challenging external backdrop against underlying stories that have been improving for many credits after the consecutive macro shocks of 2020-2022.

From a valuation perspective, the GBI-EM index lost close to 12% and 9%, respectively, in annual terms in 2022 and 2021 and has only recovered a small portion of that in 2023. Furthermore, recent pressure on FX in the context of strong USD and China economic uncertainty have driven better valuations even for the most solid credits that are supported by high real rates and easing monetary policy. From this perspective, we believe that selected fundamentally strong local curves are well positioned to deliver material performance once markets get comfortable that DM rates have peaked.

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In terms of DM rates, G10 yields repriced significantly higher over the past quarter and the move in US long-end yields in September was relentless, taking a toll across the board in EM local markets. This largely reflects the market’s coming to terms with the “higher for longer” regime emphasized by the US Federal Reserve in its most recent market communications. One can argue that although global investors have had time to adjust to the idea of higher interest rates, both the pace and magnitude of the most recent move in G10 yields have caught markets by surprise. One of the key “enablers” of the “higher for longer” US rates regime has been the remarkable resiliency of the US economy and its ability to navigate the Fed’s most concentrated rate-hiking cycle in decades.

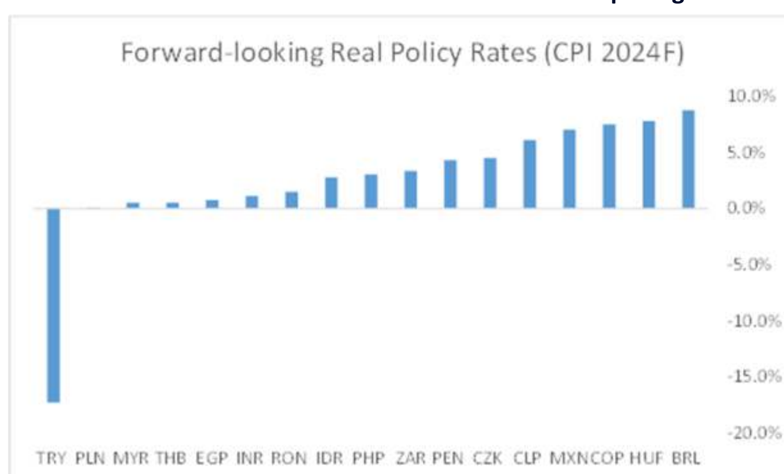
One can argue that although global investors have had time to adjust to the idea of higher interest rates, both the pace and magnitude of the most recent move in G10 yields have caught markets by surprise.

Looking ahead, the US economy appears to remain on sufficiently solid footing to avoid falling into a recession in the very near term. However, we believe that the combination of high oil prices, higher yields and strong USD will inevitably drive a slowdown, cooling domestic demand and, in turn, lowering the Fed’s appetite for further tightening of financial conditions. Short of a major policy mistake by the Fed that could derail a “soft landing” narrative for the US economy, we do not anticipate rate cuts any time soon. However, we believe we are at or very close to “peak rates” environment, especially considering CPI inflation that decelerated sharply in the Eurozone in September and lingering Chinese economic woes. All else being equal, we think the local debt is supported by better fundamental backdrops should regain market sponsorship once US yields find a ceiling and investors ease back into the carry trade.

For local markets in which we see reasons to be structurally bullish, the fundamental thesis remains valid, but is now enhanced by even more attractive entry points and materially higher real carry compared to the recent past. As Exhibit 1 shows, of all major issuer in the GBI-EM Global index, only Turkey, a special case, remains in negative territory in terms of real policy rates using forward looking inflation expectations (average 2024 forecasted CPI). This means that, although the threshold for EM rate cuts has probably increased in a "higher for longer" environment, several major central banks in emerging economies have built enough of a real interest rate cushion to be able to continue to ease policy. Latin America stands out as the region where real rates are highest, and we continue to expect the likes of Brazil, Mexico, Colombia, Chile and Peru to be able to lower rates for their economies and continue to unwind the significant tightening delivered in recent years.

Although the threshold for EM rate cuts has probably increased in a "higher for longer" environment, several major central banks in emerging economies have built enough of a real interest rate cushion to be able to continue to ease policy.

Exhibit 1. Ex-ante real interest rate buffers in EM are compelling



Source: *Bloomberg, Gramercy sovereign research*

Other central banks, mainly in Asia, where real rates remain on the lower end of the EM spectrum, might find it more difficult to cut in the current environment, and in some cases, might even need to deliver some limited further rate hikes. Nevertheless, our base case is that even in such situations, any meaningful policy tightening is now in the rear-view mirror, and we are well beyond the point of "peak hawkishness" by global EM central banks. In fact, as shown in Exhibit 2 by forward interest rate pricing, investors expect that most EM central banks will be cutting over the next 12 months. We are of the view that this is a backdrop that remains favorable for selectively investing in the most structurally sound EM local debt stories. We will continue to look for credible independent central banks that benefit from historically high real interest rate buffers and have the space to deliver further rate cuts despite a "higher for longer" DM rate environment. While the top-down macro environment has arguably grown more challenging in the near term, the underlying bottoms up resiliency of many of these credits remains intact, in our view, offering investors to opportunity to add/increase exposure at attractive valuations.

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Exhibit 2. Investors expect EM central banks will continue to cut rates

Source: *Bloomberg, Gramercy (as of Sep 28, 2023)*

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