Alpha Beta
PARTNERS

INVESTMENT UPDATE

AUGUST 2023

FOR PROFESSIONAL INVESTORS ONLY

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In the movies it can sometimes be difficult to determine accurately the difference between "the dark Lord" and the "shining white knight". Until the moment of revelation comes, stress levels are heightened. And so it is with global macro investing, the similarities can be quite uncanny.

The market narrative of an immediate recession in the US has ebbed away for now. Consensus growth estimates for 2023 stood at 0.3% in January and are now at 1.5%. Our growth outlook remains sluggish and although we have pushed out the timing of our forecast, recession/ slowdown remains our economic base case.

Whilst we have said in the past that many recessions are characterised by discontinuities in data - meaning downturns happen quickly - it is also possible that a slump into recession is more gradual. There are reasons for all of this, of course - let's dig into them in the update that follows.

Recession has indeed kicked-off in Europe with France and Germany meeting the criteria or skirting perilously close to it. German manufacturing has slowed quickly as her largest trading partner, China, has stuttered back to economic life following lockdown.

France has endured similar slow economic activity whilst domestic unrest has clearly fuelled the mood. At home in UK, we have seen activity slowing and inflation beginning, perhaps, its first downward move.

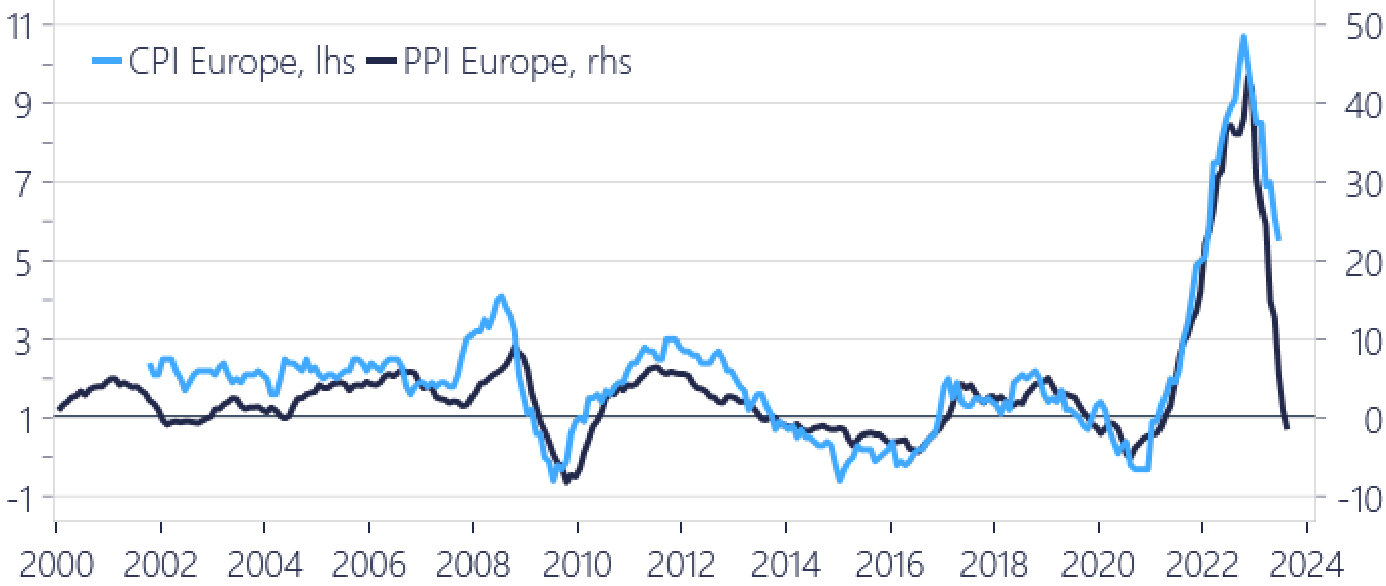
Wage demands remain at heady levels and satisfactory outcomes here must be delivered. Interest rates continue tightening across the Bank of England and the European Central Bank which will accentuate the slowdown.

Inflation across Europe, particularly in Germany, has fallen with Producer Price Inflation, the tracker for prices paid between trading entities, having plunged steeply into outright deflationary territory.

China has cut rates, continues to devalue the Yuan to assist with its export strategy and consequently we have seen an initial spike upwards in Chinese equity values. Inflation is not a real issue in China, although the ageing and shrinking population will be on President Xi's mind as he contemplates his "reign without end".

So it was transitory after all?

PPI hints of an outright land-slide in prices both in headline and core terms



Source: Steno Research, Bloomberg and Macrobond

The Asia Pacific region continues to enjoy growing prosperity without recessionary impulses and our active position for portfolios in Japan is likewise witnessing the strongest stock market since the 1990s. Mr Ueda, the new Governor at the Bank of Japan has further relaxed the yield curve control strategy allowing for bond yields to rise by a further +50 basis points, a good underpin for domestic equity and will in effect allow for interest rate to move in a wider range from herein. Japan is not known for making radical moves and this modus operandi continues, which keeps markets onside, and the positive mood here prevails.

US rates nudged higher in July to 5.25 - 5.5%, very much as we forecast and are now, according to market linked probabilities, at their zenith for this cycle. That said, The Federal Reserve Chairman, Jerome Powell is at pains to point out, he will not hesitate to hike again if inflationary pressure resumes higher. For now, inflation and its forward indicators and hitherto sticky lagging indicators are collectively on the wane. The seemingly immovable jobs market remains robust, and employers are perhaps “hoarding labour” in the expectation a slowdown will be short and shallow. Employers have discovered, post pandemic, that hiring and retaining quality staff is anything but easy - they will endeavour to hang on to the best hires for as long as possible, therefore.

The bond market continues pointing to an economic slowdown, yet the equity market is on a tear, following ignition from what they believe is the latest Kondratiev wave and artificial intelligence stimulus. Participation in positive momentum is now broadening out in healthy fashion with the equal weighted US index breaking higher. Valuations are certainly high for the most notable companies but for now the market is driving upwards - we can envisage the S&P 500 level moving higher over the next 12 months. The quarter two earnings season has delivered results for just over 50% of the major corporate names so far.

Results are broadly positive. Consumer sentiment and associated spending remains robust, and the regional banking crisis has seemingly been contained. Recession certainly did not come for the US in Q2, with GDP coming in at a better-than-expected rate of 2.4% annualised. What surprised markets most was the ramp up in capital expenditure and investment in infrastructure, with a possible reshoring narrative starting to take hold. So, all is well with the world? Not so fast!

MEETING PROBABILITIES

MEETING DATE	325-350	350-375	375-400	400-425	425-450	450-475	475-500	500-525	525-550	550-575	575-600
9/20/2023				0.0%	0.0%	0.0%	0.0%	0.0%	82.5%	17.5%	0.0%
11/1/2023	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	69.9%	27.4%	2.7%
12/13/2023	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	7.1%	65.6%	24.9%	2.4%
1/31/2024	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	2.3%	26.5%	52.1%	17.4%	1.6%
3/20/2024	0.0%	0.0%	0.0%	0.0%	0.0%	1.1%	13.9%	38.8%	35.5%	9.8%	0.8%
5/1/2024	0.0%	0.0%	0.0%	0.0%	1.0%	12.1%	35.2%	36.0%	13.6%	2.1%	0.1%
6/19/2024	0.0%	0.0%	0.0%	0.4%	5.5%	21.6%	35.5%	26.7%	8.9%	1.3%	0.1%
7/31/2024	0.0%	0.0%	0.3%	4.0%	16.8%	31.4%	29.3%	14.2%	3.5%	0.4%	0.0%
9/25/2024	0.0%	0.2%	3.2%	13.9%	28.0%	29.8%	17.7%	6.0%	1.2%	0.1%	0.0%
11/6/2024	0.1%	2.1%	10.1%	23.0%	29.2%	22.0%	10.2%	2.9%	0.5%	0.0%	0.0%
12/18/2024	1.4%	7.3%	18.5%	27.0%	24.5%	14.2%	5.4%	1.3%	0.2%	0.0%	0.0%

The chart shows market related probabilities for US interest rates, courtesy of FedWatch July 2023.

As stated, the bond market is adamant a slowdown is approaching. We agree and anticipate evidence by early 2024. This is not necessarily the end of a market upswing, although we would anticipate a slowing of progress and corporate earnings coming under pressure.

Accumulated personal savings from the “helicopter money” President Biden handouts are waning. US mortgage costs are much higher for those new borrowers and those refinancing. However, baby boomers and wealthier folk without borrowings are broadly unaffected. Those with 30-year fixed rate mortgages (a common feature in US) are typically insulated from higher borrowing costs, having fixed when rates were 5% or so lower than today.

That said, many US corporates will need to refinance their borrowings over the next year or so and will find life much tougher servicing debt. The lag time between raising rates and the knock-on economic impact can be slow and variable - it is thus, in this cycle. The VIX volatility index has been laid to rest for the past few months due largely to retail day option traders and we are not easily persuaded by this once sensible indicator. The US 10-year Treasury now yields close to 4% representing reasonable value with the expectation that longer term rates will begin to fall before too long.

The speed and sheer scale of the rate rises in US will be felt within the economy and with quantitative tightening ongoing at $95bn per month it's a matter of when rather than if the economy responds. The Dollar Index downward trajectory has arrested for now and we keep this closely under surveillance.

Geopolitically we remain vigilant to unexpected outcomes from President Putin and note the upward spike in soft commodities, notably wheat, resulting from Russia's safe passage guarantee removal. Drone attacks, albeit token sized in Moscow are bound to provoke a backlash. Sweden joining NATO will agitate Putin's position too. The great Ray Dalio made it clear that clients employ investment managers to make money over time, not to make academic forecasts. We embrace this reality and have manufactured portfolios with good levels of downside protection, catering for the possible emergence of "the dark Lord" investment scenario and indeed simultaneously with the ability to secure upside gains from a "shining white knight" outcome.

Despite the distinct mixed messages driving asset classes, we stand with positive returns from our active portfolio positions. Our dollar hedge has added value to the US weightings, whilst European, Japanese, and now Chinese equity allocations are driving portfolio valuations higher. Yet, the bar-bell approach comprising low risk money market funds, short dated fixed income and cash have delivered quantifiable yield and capital stability. We are beginning the process for extending our fixed income duration in the anticipation of lower interest rates, albeit several months hence. Overall performance versus the peer group and in absolute terms remains credible indeed.

As ever, we thank clients for their faith in us and we welcome feedback and questions should they arise.

Written by the Alpha Beta Partners Investment Team.

All sources Bloomberg July 2023, unless otherwise stated.

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defaqto EXPERT RATED DFM MPS on Platform 2023

defaqto EXPERT RATED DFM MPS (Platform) Family 2023

The Five Diamond rating awarded on Alpha Beta's Core portfolio range.