Alpha Beta
PARTNERS

INVESTMENT UPDATE

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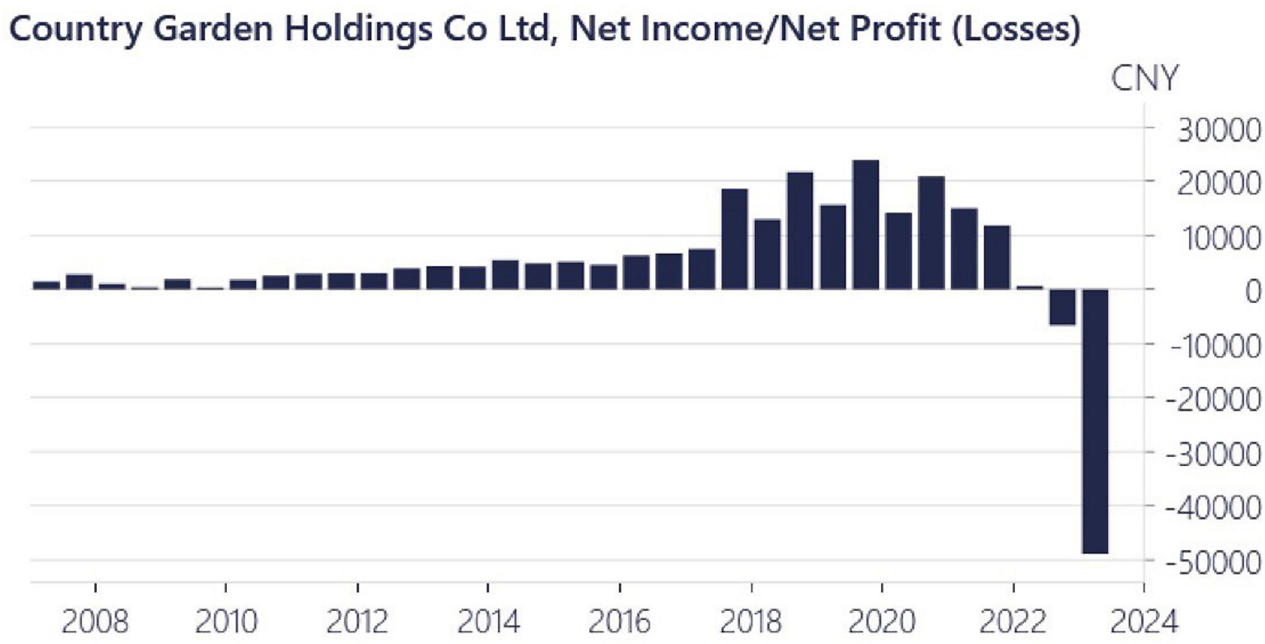
After a more challenging phase in August risk assets clawed back most of their losses by month end, based on signs of a moderating US economy.

In the past, markets calmed for a summer recess as traders and managers went to the beach. Not so these days. August once as quiet as Christmas, proved to be "business as usual". Autumn is a period when the word "seasonality" tends to be used more frequently. During the autumn, months and sometimes years of progress can happen in weeks. In the update that follows we aim to set the scene for the season ahead.

We have highlighted China's difficulties here in previous updates. The post Covid reopening has stalled with economic growth higher, but a long way shy of what was forecast and anticipated by many. The debt bubble present in the Chinese property sector is gargantuan and will cause issues for the economy overall. The Politburo and People's Bank of China will need to affect a bail out, probably delivered quietly over time. For now, the overcapacity created by a centrally run economy planning for an escalation of the industrial base with its supporting architecture is truly eye popping. Bridges to nowhere and ghost cities are the reality as many western economies, led by the US repatriate their manufacturing or forge supplier relationships closer to home. Interest rates have been cut and the Yuan is being subtly devalued. An ageing and shrinking population point to longer term issues President Xi will need to contemplate. Our position in Chinese equities has been liquidated.

The chart shows financial difficulties manifesting in one of China's massive property businesses.



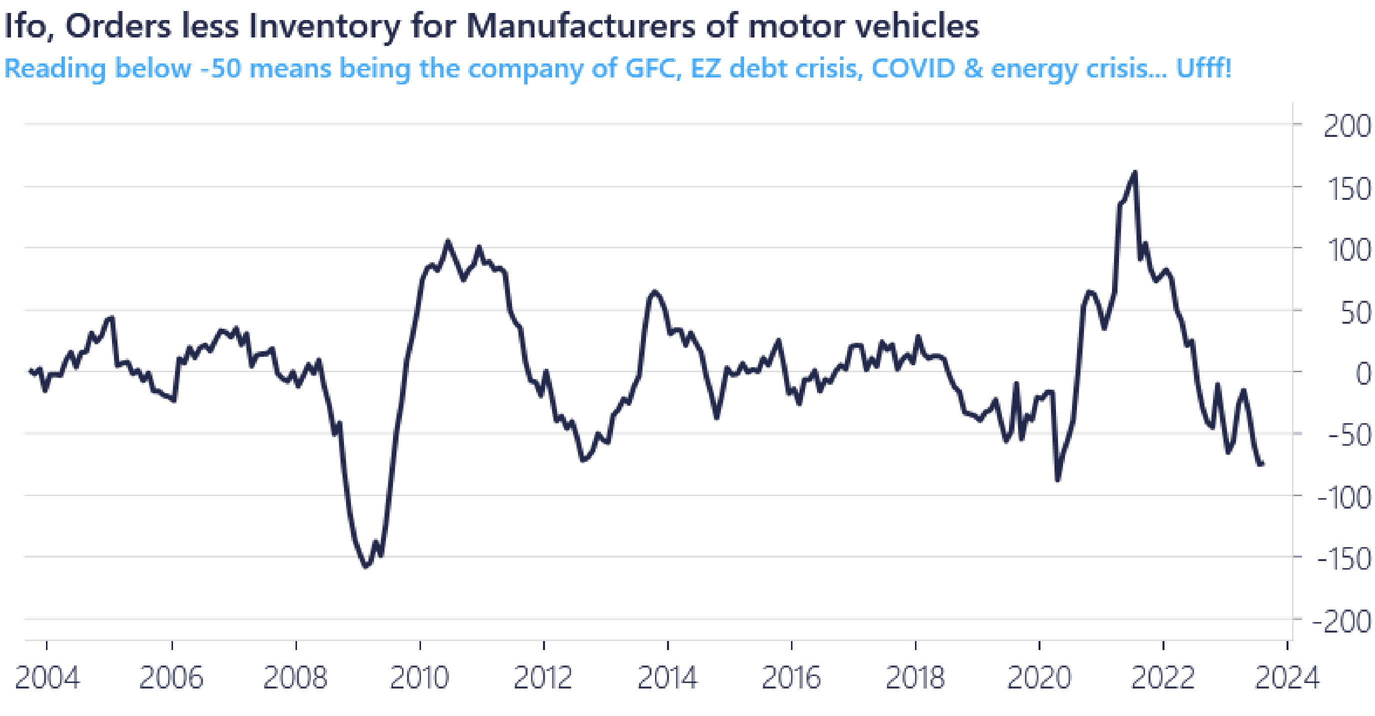
Source: Steno Research, Bloomberg and Macrobond - 31 August 2023

China's pain has proven to be Japan's gain. Mr Kazuo Ueda, the new Governor at the Bank of Japan has subtly tweaked policy such that the economy is stimulated, and exports are once again flowing from quality companies to the West.

A weaker Yen effectively greases the wheel. Japan's large pension schemes and institutional investors are systematically preferring to invest in domestic infrastructure and technology opportunities, rather than sending their monies abroad, as they have done for decades. The upswing is captured in portfolios with Japan remaining an active position.

The major economies in Europe, led by Germany and France are now in recession or skirting perilously close to it. Germany's vital industrial and manufacturing base has been impacted first by soaring energy prices and now acutely by the slowdown in China, who had been embraced by successive European leaders as a dominant trading partner.

We feel it is an exaggeration to suggest Germany's world leading automotive industries will become museum artefacts but the cut in China's demand will surely be a major blow. The chart demonstrates the decline in the German automotive industry. A further distortion shows the American Tesla, in real terms a johnny come lately, lower volume manufacturer, is worth significantly more than the once mighty BMW, Mercedes and Volkswagen Audi Group.



Source: Steno Research, Bloomberg and Macrobond - 31 August 2023

Across Europe inflationary headline figures are trending lower and we can envisage the European Central Bank (ECB) being the first western central bank to loosen policy. Mrs Lagarde, Head of the ECB will need to balance the necessity to defeat inflation, stimulate a rapidly decelerating economy and balance the books. We note an uptrend has begun in natural gas prices during late August.

The UK and European stock markets perform more akin to value-oriented indices which is surely a reflection of the lack of larger information technology firms being listed here than anything else. However, quality companies are resident in UK and Europe of course with commodity-rich, banking and pharmaceuticals a particular focus at home. UK equities remain one of the leading markets for strong dividend payers – the backbone for many portfolios. At home we finally saw inflation headlines turning lower, although significant wage pressures persist. Interest rates are likely to remain higher for longer in the UK and we will do well to avoid a recession. Our inverted yield curve is not an isolated phenomenon by any means, but we note the 10-year Gilt spiked to 4.7% at one stage whilst the 2-year stock yields 5.3%.

The bifurcation between equity and fixed income markets in US continues to play out. Equities, supported by a broadly positive earnings season are priced for a soft economic landing. Equities are pricing in a peak in US rates, inflation coming under control to a greater extent and corporate profits and earnings continuing to expand. A so-called goldilocks scenario. Meanwhile fixed income markets point persistently to a steeper slowdown and possible recession.

As we have pointed out here previously, the jobs market is one of the key determinants to the economic destination – recession or soft landing in America. Job creation fell below 200,000 in August for the third month in a row. The unemployment rate rose to 3.5%, its highest in 18 months, and job openings fell back notably. Putting the data into perspective this equates to 1.5 jobs available for each unemployed worker, versus the 2 jobs per unemployed worker in March. "Come hither" offers from employers on the hunt for specific skilled labour fell away too, reducing the incentive for job-hopping.

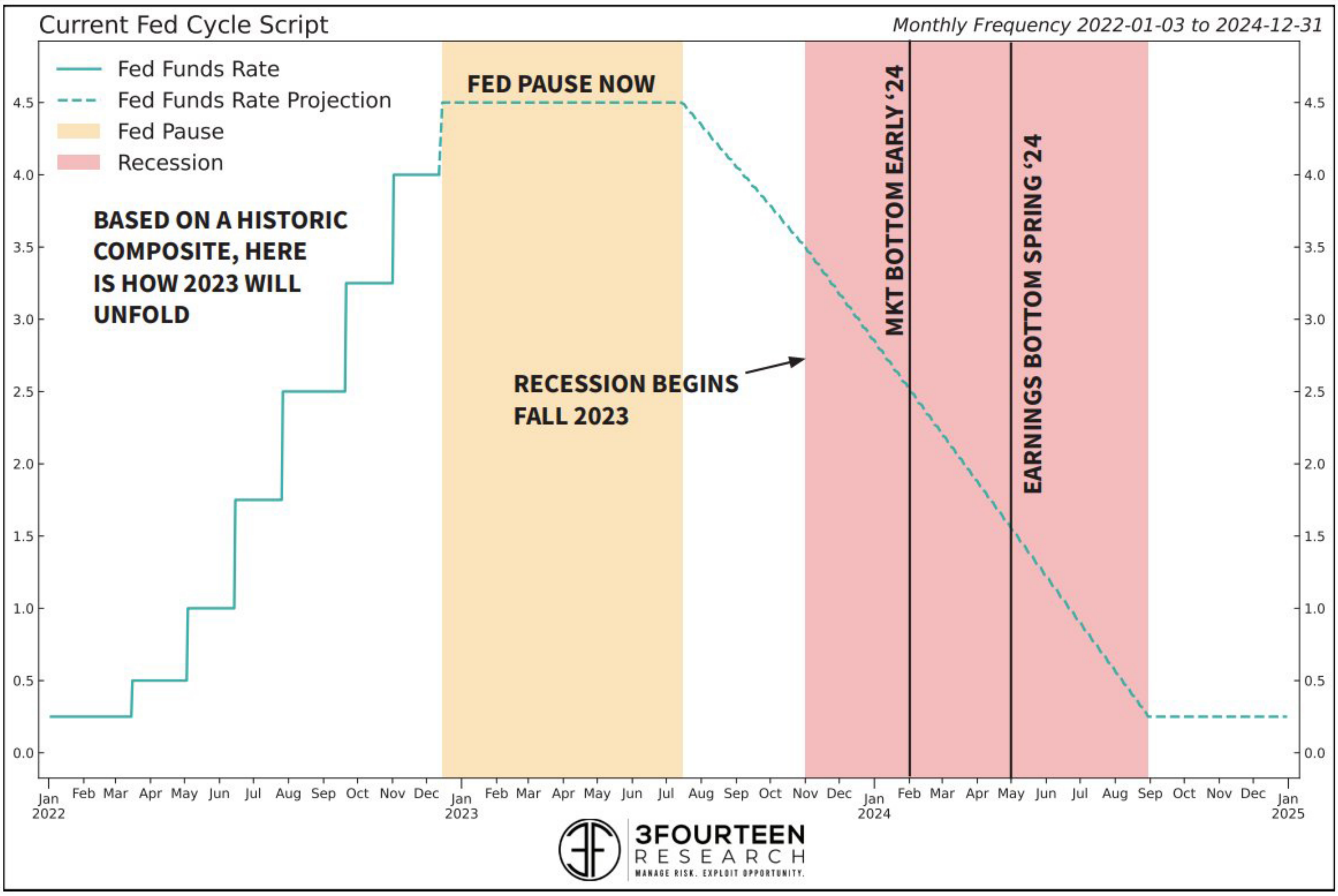
Resignations fell to their lowest level since January 2021. Simultaneously labour supply is beginning to increase with 736,000 people entering the jobs market in August alone. Whilst this data collectively may feel negative, the markets view the scenario as positive such that rates might be contained at or near to current levels and inflation linked to higher wages is likely to wane. The US consumer continues spending and remains in reasonably confident mood – one should never underestimate the robustness of the American consumer's appetite to spend. So much so that over $1 trillion of credit card debt is presently accumulated.

Debt servicing costs should not be overlooked, along with the potential knock-on consequences to future spending patterns.

Jerome Powell's (Chair at the Federal Reserve) speech at the Jackson Hole summer retreat for central bankers was predictably tough and hawkish, but markets reacted favourably to the labour market data delivered towards the month end. The view persists that we are at or bordering the peak in US rates as inflation has fallen back allowing for positive real bond yields. Liquidity remains restrictive with quantitative tightening ongoing and no real prospect for rate cuts this calendar year unless something unforeseen occurs.

We stick to our forecast for a slowing US economy, possibly a shallow recession during early 2024 but likely a harder landing in other parts of the developed markets world. Classically, at least at textbook level, one would expect a rally in risk assets based on confirmation rates have peaked, then a tougher corporate earnings season delivering a roll-over in share prices before the next bull stage can kick-off.

The chart below aims to capture this.



Source: 3Fourteen Research - 28 December 2022

Equities performed well at index level and portfolios enjoyed the upside as longer duration bond yields fell, rendering equity valuations slightly more palatable. However, the buoyant year-to-date for large cap' stocks (particularly the 7 leaders) can be viewed in sharp contrast to the smaller companies, many of whom continue to struggle. Consequently, index investing, at least in US, remains the profitable strategy to employ.

We have seen the Dollar Index, which measures US dollar strength versus other currencies, rise during the month. This typically points to possible volatility ahead and this trend is similarly supported by the VIX volatility index, which typically rallies during the autumn. We note the bullish return of certain commodity prices, including natural gas and oil. Both will place a floor beneath inflation rates if the trend continues.

Geopolitics could well rebound into focus as summer temperatures cool and demand for affordable energy and food top the leader board of importance. We remain vigilant. Portfolios have performed well during the summer, buoyed most recently by the US equity rally and ongoing resurgence in Japan.

Money market funds continue to offer strong security and an attractive yield. We exited China for now based on concerned raised above. Once we are confident rates have peaked and ongoing data supports the likely slowdown in leading economies, we will examine longer duration opportunities in fixed income markets. For now, portfolios remain well balanced and with sensible risk adjusted returns onboard as we enter the important autumn period.

We hope you had an enjoyable summer. As ever, we thank investors for their support, and we are keen to provide further information upon request.

Written by the Alpha Beta Partners Investment Team.

All sources Bloomberg unless otherwise stated.

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