Alpha Beta
PARTNERS

INVESTMENT UPDATE

NOVEMBER 2023

FOR PROFESSIONAL INVESTORS ONLY

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October, so often the difficult month, delivered true to form this year. In October's Investment Update we pointed to growing potential for geopolitical risk and explained it is one area of asset management that is impossible to model. The Middle East atrocities shocked the world and continue to cause deep unrest. Whilst the potential for global escalation must not be overlooked, we do note markets behaved with relative composure and the oil price has fallen back. In markets, the US dollar as a safe haven has naturally seen signs of strengthening further. Equities continued a volatile path and bond yields in the United States particularly, continued to rise.

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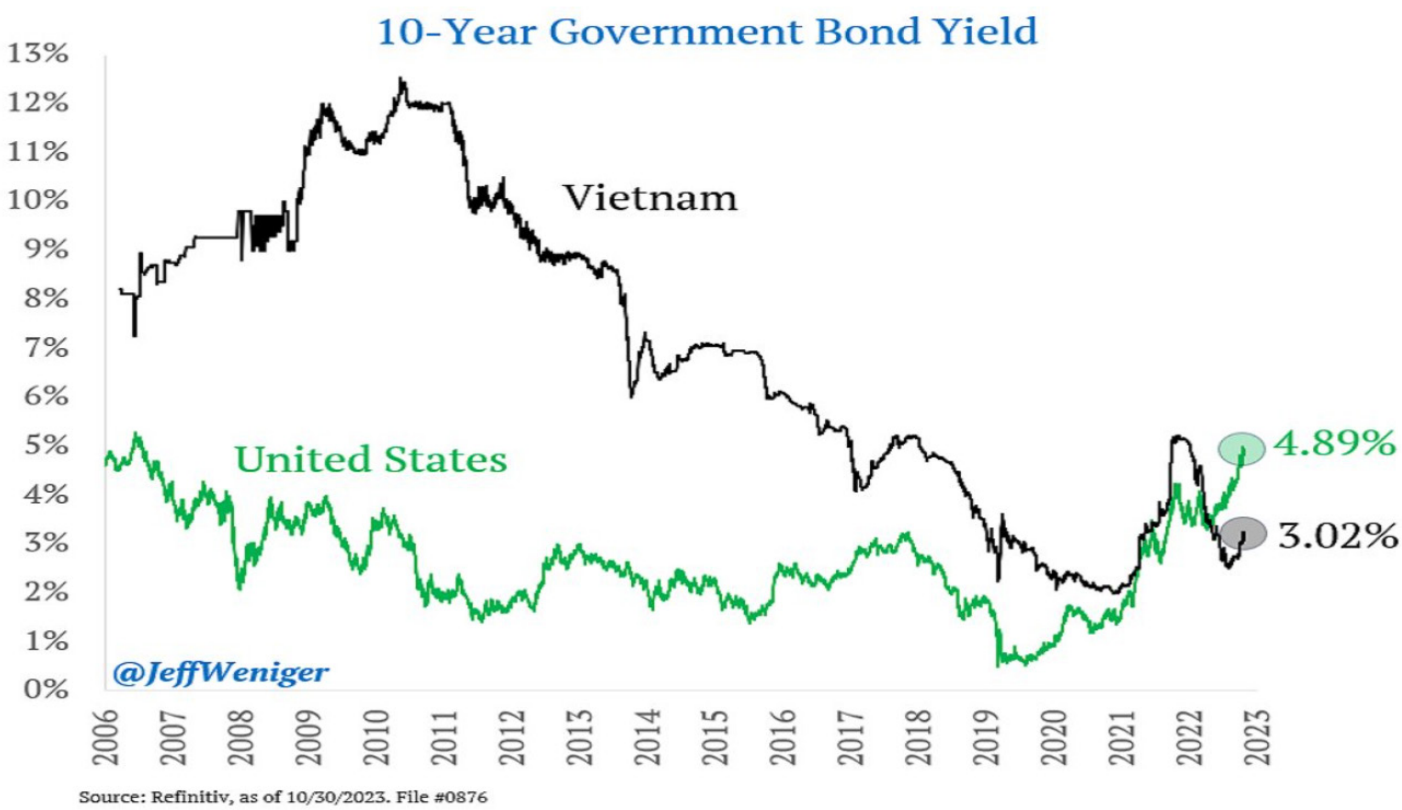
The hangover from excessive monetary stimulus during the pandemic helped recreate inflation. Central banks were somewhat slow in their reaction and consequently interest rates have risen further and faster than many thought would be seen. Inflation is slow coming to heel in the US but the long and varied lags between hiking rates and inflation reverting lower is certainly evident. When writing the economic history of the early 21st century a paragraph or two will no doubt be dedicated to the hedonistic resilience of the US consumer.

Now making up a dominant 68% of GDP the US consumer drove economic activity higher than expected in October and helped confound those pointing to an imminent recession. However, despite stronger than forecast GDP growth the US economy still shows tell-tale signs of slowing.

Monetary aggregates and borrowing costs from debt markets are tightening rapidly and the manufacturing Purchasing Managers Index (PMI) for October closed in contractionary territory. A fall in consumer confidence, no doubt preceded by a weaker jobs market will likely tip the balance.

Meanwhile concerns around ballooning debt levels and a poor strategy to manage and reduce the debt mountain, coupled with stickier US inflation have helped push US treasury yields higher. International buyers for US treasuries have been less evident than in previous years and a wall of new issuance to fund the badly named Inflation Reduction Act, green infrastructure programme, plus the Ukraine and now Israel/Gaza wars are pushing treasury yields to higher levels.

For example, a 10-year US treasury now yields more than an equivalent Greek bond or an equivalent Vietnamese bond, as shown in the chart below.

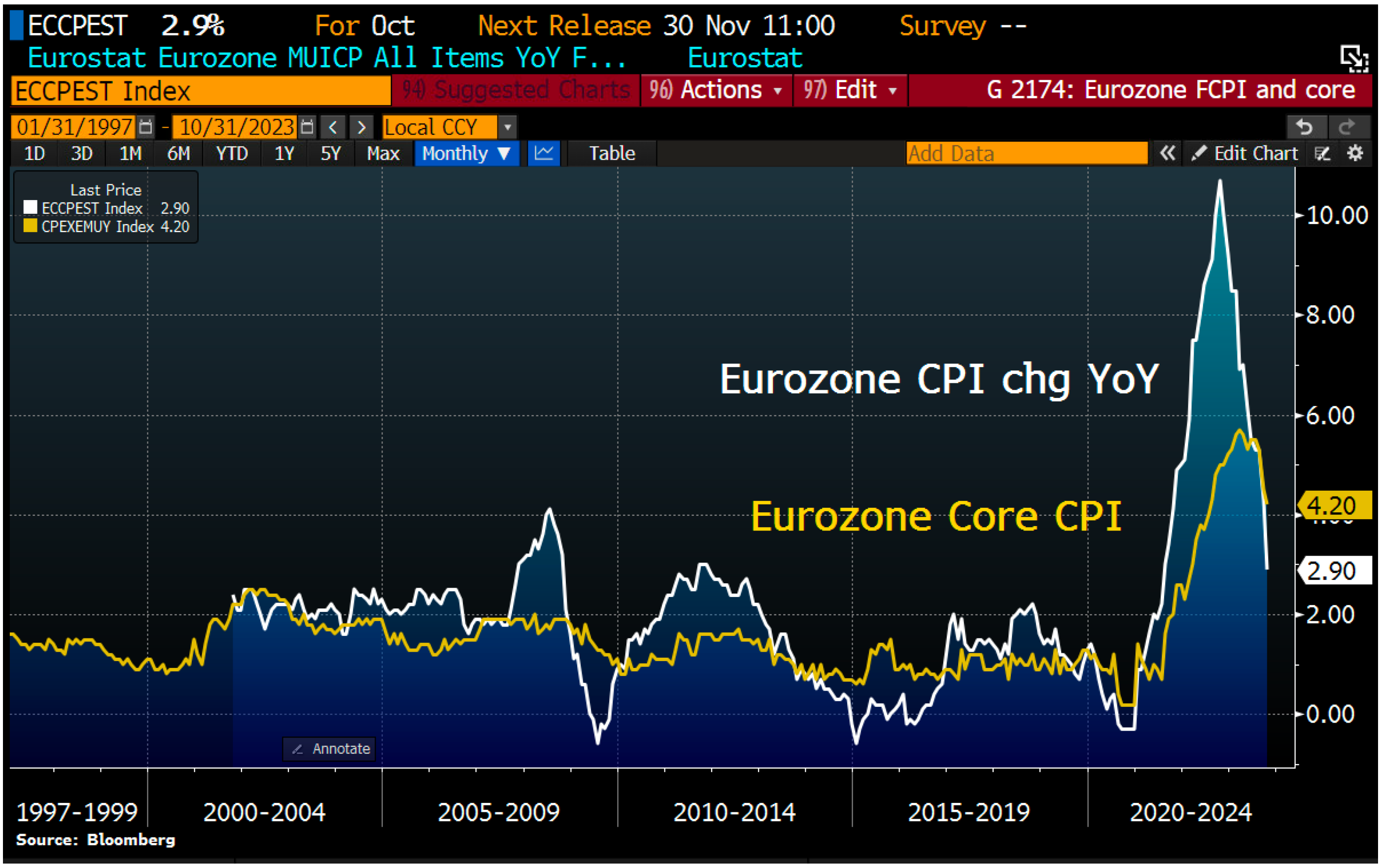


Source: Refinitiv, Data as of October 31, 2023.

Higher bond yields make equity valuations tougher to justify. This coupled with a sporadic positive correlation between bonds and equities has made equities and bond prices move in sync and obviously made life difficult for investment managers.

A positive correlation between bonds and equity prices is a by-product of higher inflation and is not necessarily an enduring market feature. The quarter 3 US earnings season has continued to deliver positive and upward earnings growth, notably from some of the behemoth technology names. However, as their valuations are already lofty, stronger still share prices have not always resulted. Current valuations assume S&P 500 companies muster +12% earnings growth in 2024. A tall ask should the economic slowdown manifest.

The economic slowdown is playing out more rapidly and visibly across Europe. Germanys over reliance on China as an economic partner has left her exposed and the well-known reliance on Russian gas has exacerbated the strategic frailty of recent political and economic alliances. Economic activity has fallen dramatically in Germany which is already in recession and now increasingly elsewhere in the Eurozone. Inflation has plunged such that Producer Prices have fallen into deflation. Netherlands and Belgium are in outright deflation as at the end of October. Headline Eurozone CPI fell to 2.9% in October, perhaps leaving the door ajar for the European Central Bank (ECB) to become the first developed market central bank to begin cutting rates in the near future.



Source: Bloomberg. Data as of October 31, 2023.

At home in UK, the Bank of England kept rates on hold in an alignment with other major central banks, although further progress on the war against inflation is required before rate cuts can commence. As we know, economic activity is generally slowing, and asset prices are now coming under pressure. Property is taking longer to sell with sale prices softening.

Japan remains the bright spot in the Asian region with positive momentum across the economy. The Bank of Japan continues it incremental reduction in the established yield curve control policy and the positive domestic stimulus remains in place. A weaker yen assists exports although makes imported energy costs (typically is dollars) more expensive. A further expansion of Japan's nuclear industry seems inevitable.

China's economic activity has shown recent improvement, although not yet a confirmed trend. The colossal debt mountain, unhelpful demographics and property market debacle is troubling. A deflationary pulse which shows early signs of development will not assist state debt burdens. There is no economic slowdown in the rest of Asia and many emerging economies are making progress. Faster and more notable progress will result when the US dollar finally begins to weaken, relieving the pressure on borrowing servicing costs made in USD.

Commodity prices have remained constrained despite geopolitical concerns. Copper is weaker and is a leading economic indicator, oil has fallen back from recent highs, but remains volatile with potential for bottlenecks and disruption of supply from the Middle East. Other energy costs whilst seasonally higher have not yet driven higher still. Gold by contrast has perhaps unsurprisingly moved to $2,000 per ounce marking the instability stalking the globe. This reminds us of Mr. JP Morgan's quote of yesteryear – Gold is real money, everything else is paper.

So, what next? Importantly, at portfolio level we chose to reduce risk from US and European equities in timely fashion and have raised our short duration and Money Market exposures further during the month. There is certainly emerging value in the US treasury market with yields at these levels. Our approach remains one of caution – we adopt a "if this happens, then" process, rather than taking early strategic positions in deflated assets which typically fall lower still until they mean revert. We understand investors need for dependability, and short duration yields, and Money Market security coupled with a circa 5% annualised return is prudent.

Dollar denominated assets enjoy the protection of the safe haven global reserve currency. We remain overweight Japan which has delivered pleasing equity returns and our position is intact for now.

Of course, we are a prudent manager with a Risk First framework, meaning portfolios have remained in their prescribed volatility corridors without breach since our inception. We also strive to deliver consistently attractive returns, which we have delivered since launch when measured against our Investment Association peer group. When the time comes for redeployment to risk assets, we are in a strong position to react and to position portfolios to benefit. Meanwhile we remain vigilant.

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.

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