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PARTNERS

INVESTMENT UPDATE

JANUARY 2024

FOR PROFESSIONAL INVESTORS ONLY

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We wish readers a happy new year. The much longed-for year-end rally pleased retail and professional investors alike and set the scene for a good start to 2024. The question on investor minds is an obvious one; can the rally be consolidated and act as a launch pad for a successful 2024? We will seek to offer an insight and unpack essential detail in the update that follows.

Can the rally be consolidated and act as a launch pad for a successful 2024?

2023, a year dominated by tight monetary policy in developed markets and a hawkish Federal Reserve Chairman, who seemed intent on channelling his inner Volcker with a combative stance on interest rates and "keeping at it" on the war on inflation.

At the December FOMC meeting, Jerome Powell (Fed' Chairman) delivered what can only be described as a Damascene conversion to dovishness and fuelled a robust rally across asset classes into the year end. Mr Powell signalled positive news on the war against inflation flagging lower rates during 2024.

We note 10-year US treasury yields had previously hit 5% (the same level as US GDP) which would offer a significant debt funding hurdle. The impact of Powell's speech was to meaningfully cut the cost of government borrowing almost instantly as bond yields tumbled, ending the year at 3.84%. A canny move.

The chart below courtesy of CME FedWatch plots the year ahead for US interest rates, according to market calculated probabilities.

CME FEDWATCH TOOL - MEETING PROBABILITIES									
MEETING DATE	325-350	350-375	375-400	400-425	425-450	450-475	475-500	500-525	525-550
1/31/2024				0.0%	0.0%	0.0%	0.0%	4.7%	95.3%
3/20/2024	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	2.9%	60.9%	36.2%
5/1/2024	0.0%	0.0%	0.0%	0.0%	0.0%	2.2%	47.2%	42.0%	8.5%
6/12/2024	0.0%	0.0%	0.0%	0.0%	2.0%	43.1%	42.5%	11.6%	0.8%
7/31/2024	0.0%	0.0%	0.0%	1.7%	36.0%	42.6%	16.9%	2.7%	0.1%
9/18/2024	0.0%	0.0%	1.4%	31.5%	41.8%	20.3%	4.5%	0.5%	0.0%
11/7/2024	0.0%	0.9%	19.4%	37.6%	29.0%	10.9%	2.1%	0.2%	0.0%
12/18/2024	0.7%	15.4%	33.7%	30.8%	14.8%	4.0%	0.6%	0.0%	0.0%

Source: CME Fedwatch 05 January 2024

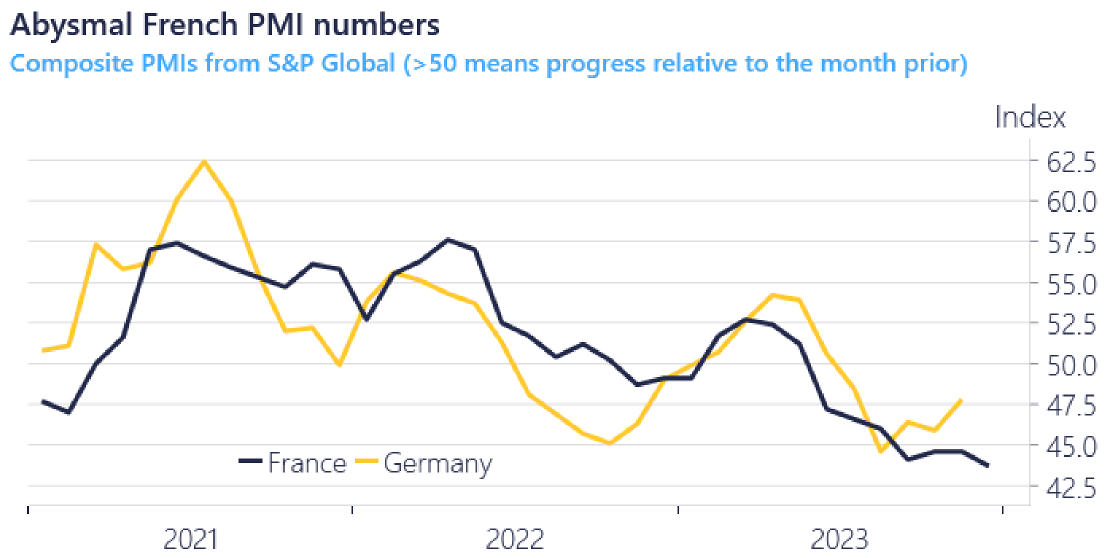
With liquidity levels rising, risk assets can be propelled higher. Conditions supporting a "macro spring" can offer upside for risk assets across the board, although cyclicals and lower valuations are perhaps best placed.

We are optimistic for asset price expansion at the point of writing, but risks and headwinds must be considered. The bullish case for risk assets factors in the assumption that inflation falls back to 2% in double quick time, the US election delivers the typical liquidity rush with a relatively smooth transition / resumption of power, along with the priced-in rate cuts delivering essential fuel for the positive momentum. Earnings forecasts remain aggressively optimistic – can they be delivered? Valuations, in certain sectors, are already high. The world remains locked in geopolitical disputes in key areas – Ukraine, Middle East and the China/Taiwan debate is in a state of escalation. A sudden flare up could trigger the dollar and oil prices higher which would spoil the party.

The debt ceiling argument in America remains substantially unresolved with new US treasuries being issued during the year ahead. We are presently in the debt roll-over cycle, so future lower rates are super important.

We are sticking with our forecast of a modest recession across developed markets, perhaps shallowest in the US where the latest jobs and ISM data support our case. As inflation has fallen quickly, there is room to offer rate cuts into 2024. Liquidity levels will be underpinned by a steady draining of the Reverse Repo facility. We keep a close eye on liquidity when the Treasury General Account is finally topped-up in America. Investors are paying close attention to the January quarterly refunding announcement (QRA) as a jump in long-term treasury yields has been partly attributed to concerns about the US fiscal deficit and the requirement for ongoing issuance. Analyst forecasts put US core inflation at 2.7% later this year, and so with rates at 5.5% we can finally buy into rate cuts and enhanced liquidity driving prices higher – be aware of the risks! We hold our nerve, enjoying the ride, for now at least.

The major European economies have been in recession for some time. Forward looking inflation data remains weak and, in some cases, deflationary. As previously stated here, we would expect the European Central Bank (ECB) to be a position to cut rates ahead of the US Federal Reserve's traditional lead. However, with rates at their summit, Mrs Lagarde, President of the ECB, seems intent on enjoying the view a little longer than might be good for the economic health of the Eurozone. Traditional manufacturing industries of the once dominant German economy are in trouble – poor economic and corporate management the likely cause. Volkswagen's CEO, Mr Schaefer, warned managers "all is at stake" as the automotive giant struggles with the economic situation and falling orders. Putting things into perspective, German GDP has fallen to be no more prosperous than the 38th US state, Oklahoma. The chart below shows the Purchasing Managers Indices for France and Germany, courtesy of Steno Research.



Source: Steno Research, Bloomberg and Macrobond, obtained via Twitter on 05 January 2024.

At home in the UK, we can look forward to our own General Election year. We will likely go to the polls towards the year end. In markets we have been encouraged to see Gilt yields falling back – the 10-year benchmark now yielding 3.64%. The Bank of England maintains a hawkish stance against inflation after an encouraging drop in CPI during December. Despite the current stance we would not be shocked to see an easing of policy during the second half of the year. UK equities remain attractively valued with increasing appeal to us, as, here at home we expect to see liquidity levels rising during the year ahead.

The positive investment case for Japan remains in situ. Here we would expect a very gradual easing of yield curve control policies and a rise in interest rates during the year, with a knock-on benefit to yen strength. We do not envisage this derailing the positive economic backdrop. China is struggling to recover from the pandemic slump in economic activity. We have discussed the malaise of super-high debt burdens and real estate related issues in previous updates. We anticipate the Chinese recovery lagging, for now, although the People's Bank of China is unlikely to remain a passive bystander. China is heavily invested in modern technology and with a falling population and debt issues aplenty; this is one area that could drive GDP up in the future. Away from China, the so-called emerging markets are recession free in the main and likely to enjoy the expansion in developed markets; first and foremost a weaker US dollar, making debt servicing more affordable.

At portfolio level, we increased risk asset exposures at the expense of money market funds and cash during December. This move proved profitable for portfolios. We are encouraged by the prospects of greater liquidity during the year ahead, and aim to balance this enthusiasm with the risks mentioned earlier in this update. Fixed income yields continue to fall. Our credit quality and duration positioning are providing decent returns. The combination of a continued economic slowdown and the prospects for lower rates will sustain the positive case for this strategy. We are contemplating further changes which will offer timely inclusion of some cyclical holdings and some attractively valued stock which can benefit in an enhanced way from looser monetary conditions during 2024. So, an encouraging backdrop to start the year with room for optimism amidst our perennial cautious disposition. We look forward to updating on progress in a month's time.

Written by the Alpha Beta Partners Investment Team.

All sources Bloomberg unless otherwise stated.

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defaqto EXPERT RATED DFM MPS (Platform) Family 2023

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