INVESTMENT UPDATE

MAY 2023

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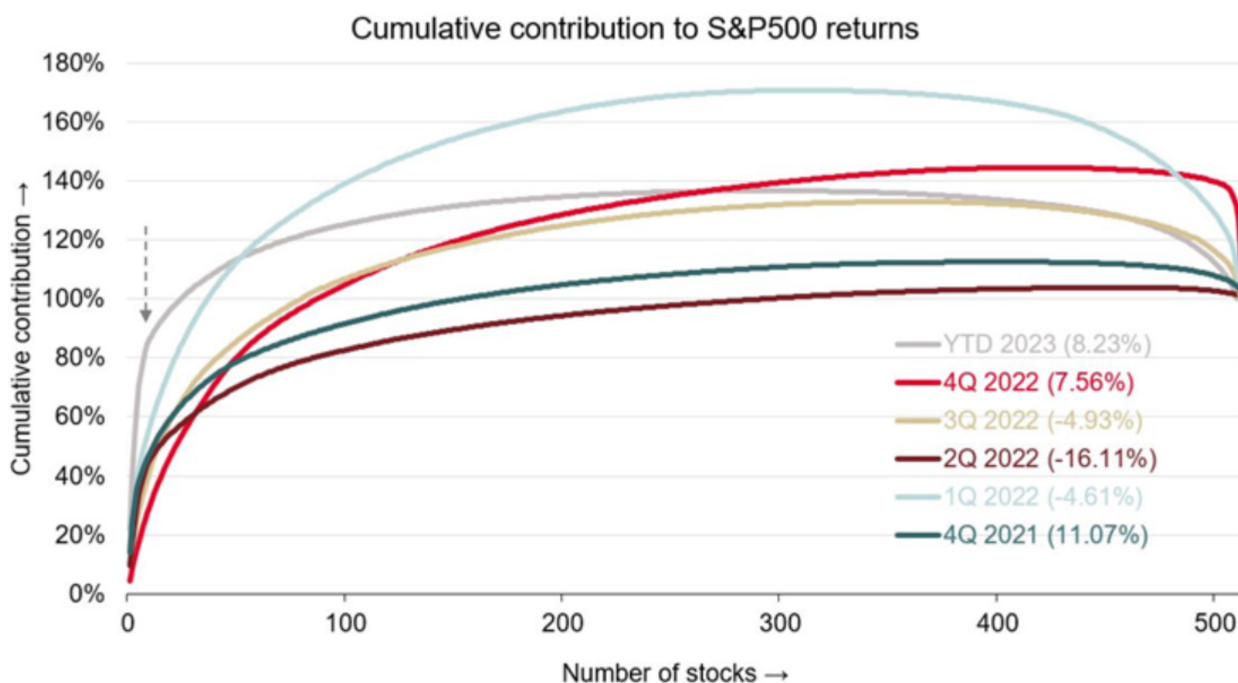
Markets continued their brighter performance during April pleasing investors with more green than red on valuation statements for the year-to-date. Volatility measured by the VIX remains surprisingly low and equity / bond correlations, which had broken down during 2022, are showing continued signs of helpful repair. So, all is well with the world and, “future's so bright we gotta wear shades”, as the song says? Life and investing are rarely so simple of course – we will seek to unpack the key areas shaping portfolio performance and positioning in the update that follows.

US equity markets, the major global driving force, have traded in a range for around 8 months. Presently towards the top end of the range after a so far better than expected quarter one earnings season. As we write, around 50% of the S&P 500 earnings results for quarter one 2023 have been announced and are ahead of where many commentators expected them to be. Of course, the major driver being technology companies, many of which chopped back their work forces by around 10% or more bolstering their financial position ahead of an economic downturn and presenting themselves as “leaner and fitter” to exploit a recovery when it comes – operational leverage in short.

This tactic appears to be working so far. Equity performance of the market capitalisation weighted S&P 500 has been buoyed by a handful of behemoth firms. Just 10 stocks are responsible for 86% of overall index return year-to-date. Good news if one is a passive investor in US but awkward and challenging otherwise. Such narrow leadership is not a sign of a resurging bull market.



Source: *Zerohedge and Bloomberg, as at 28 April 2023*

Valuation remains high at around 18.5x forward earnings for the S&P 500. Whilst earnings remain (so far) in reasonable health we are doubtful they can propel significantly higher with the headwinds of an economic slowdown buffeting progress coupled with tight liquidity.

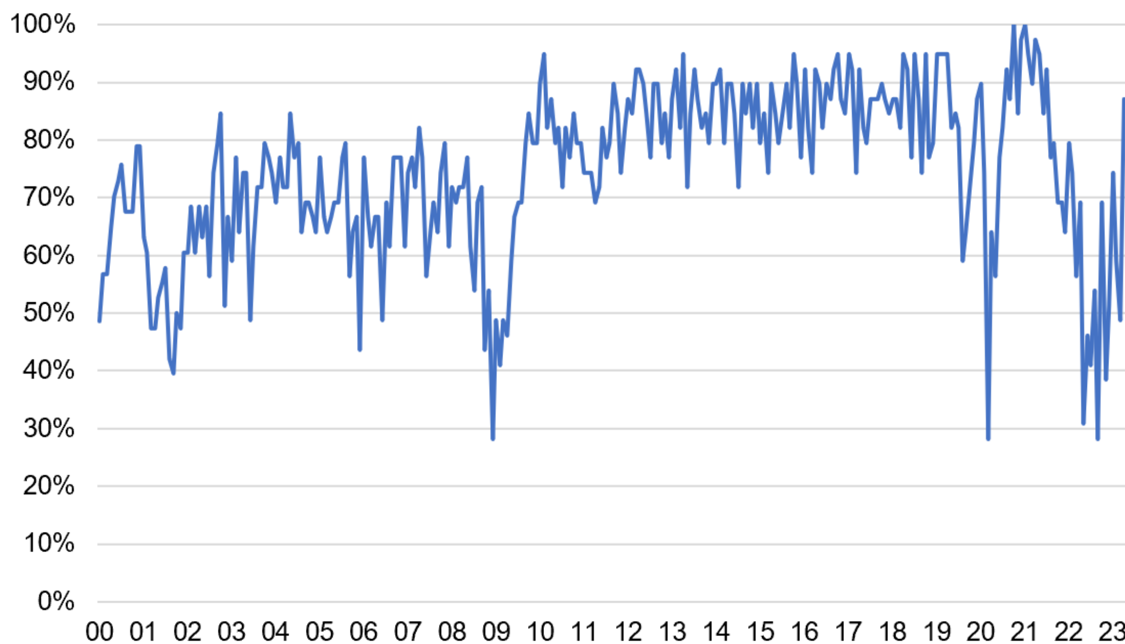
As such for equity prices to steam convincingly north we must see a change in the market's acceptance of an even higher valuation regime, to say a lofty 19x or 20x earnings. Unlikely perhaps, but even if this unfolds the pressure builds further on corporate earnings to march higher in unison.

On closer examination the economic slowdown / recession is nudging into sight and just about all credible and reliable indicators continue to point squarely to a recession in US, kicking off later in 2023. Unemployment has ticked slightly higher, but the jobs market remains tight, and the residential real estate market is stagnating and turning down, at last. A mild recession remains the central forecast.

The fight against inflation is not yet won, though nominal interest rates are now closer to prevailing core inflation, which is positive and suggests the tightening cycle is close to an end. Whilst rates will not rise to anything approaching the levels of the Paul Volcker era (late 1970s and early 1980s) we should remember that debt levels are significantly higher than previous decades and this coupled with ongoing quantitative tightening makes for extremely tight financial conditions.

It is precisely these conditions which gave rise to the latest so-called "smaller" regional bank failure. We expect US rates to peak during early May. First Republic succumbed to its fate late in April and will be taken over by the giant JP Morgan Chase. Due to the digitalisation of finance, the speed at which bank runs can happen today is incredible. As Goldman Sachs noted, in 2008 in took 9 days for Washington Mutual to lose $18 bn in deposits.

In 2023, it took 4 hours for Silicon Valley Bank to lose $42 bn of deposits! Collateral in the guise of cash and treasuries are realisable but other forms of collateral such as mortgage-backed securities and property much less so. Our property portfolio allocation has been fully liquidated to mitigate any possible issues.



The Treasury General Account which operates akin to a current account for the US Government will require "topping up" likely around mid-summer. Also known as the extension of the debt ceiling, this is usually a political pantomime played out in Congress but has always been agreed to, to avoid a US default. We anticipate drama in 2023 but raising the debt ceiling is inevitable otherwise a default scenario is the result. An ongoing theme is the likelihood for the US dollar to weaken as interest rates begin to fall and GDP weakens further – the hedging strategy implemented has worked well so far and we anticipate more to come.

China and the emerging world remain attractive at valuation levels, but stock markets have not fulfilled their promise so far. The so-called post Covid economic reopening of China continues unabated and demand for hard commodities are escalating whilst GDP is expansionary. Stock performance will follow we believe, although the yuan has softened. Meanwhile a more positive view of Japan is forming following the prima facie subtle changes in policy at the Bank of Japan(BoJ). Mr Ueda the new BoJ Governor took office seamlessly, as expected. Data dependency rather than forward guidance is likely to mean higher interest rates and a firmer yen versus the dollar as Japanese inflation crawls higher. Japanese core inflation around 3% and wage settlements around 4% marks significant multi decade change in the land of the rising sun.

Higher yields on Japanese Government Bonds and prospects for equity growth will encourage active Japanese global investors to repatriate funds for domestic opportunities, as we set out here previously. Domestically, the UK continues to struggle with inflation at higher levels (particularly food) and wage disputes for the largest publicly owned entities.

UK interest rates are set to travel higher to suppress demand and control rising prices. Dependent upon conditions, the UK stock market skew to banks, hard commodities and pharmaceuticals is a blessing or a curse and performance results accordingly. The absence of larger technology companies is notable, but valuation remains appealing. Meanwhile in Europe we also enjoy a relatively more attractive valuation, but stocks have performed well year-to-date driven-on by falling energy prices. Inflation has begun to roll over and whilst we do anticipate further monetary tightening from the European Central Bank, we can also see future rates easing sequentially somewhat later than in the US.

Geopolitically April proved relatively quiet with trends remaining on track as reported here previously. A spring offensive by Ukrainian forces may, we hope, bring Russia to the negotiation table brokered by China. Joe Biden announced his intention to stand again for US President. Potential for a lucid and physically active President in his mid-80s is hard to fathom.

Progress at portfolio level has been pleasing so far this year whilst our Risk First approach has necessitated higher cash levels to mitigate potential bear market and banking related risks. We liquidated the property weighting in all portfolios to avoid collateral risks set out above. Whilst the right decision, the underlying manager elected to close his fund, causing some disruption at retail platform level, highlighting how service at custody providers can vary markedly.

We are poised to increase short dated fixed income positions which we expect to benefit from peaking US interest rates. We keep a close eye on timing indicators for longer dated opportunities for fixed income and equity – we will increase weightings as soon as visibility is favourable. As ever, we thank our clients for the robust support and would be happy to field questions as they may arise.

Written by the Alpha Beta Partners Investment Team

All sources Bloomberg unless otherwise listed.

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