Shard Capital

QUARTERLY INSIGHTS – Q2 2023

We mentioned in our Q1 report that one of the "side effects" of long-term monetary and fiscal support provided by central banks over the last 20 years, has been to create a dependency amongst investors on perpetual stimulus. This, in and of itself, has led to an almost Panglossian belief that somehow, despite any evidence to the contrary, "all will be for the best in this best of all possible worlds". An abundance of optimism, amongst a generation of investors that has never had to live with positive real rates of interest, together with higher disposable real incomes (see below), is a potent combination of force for markets to contend with.

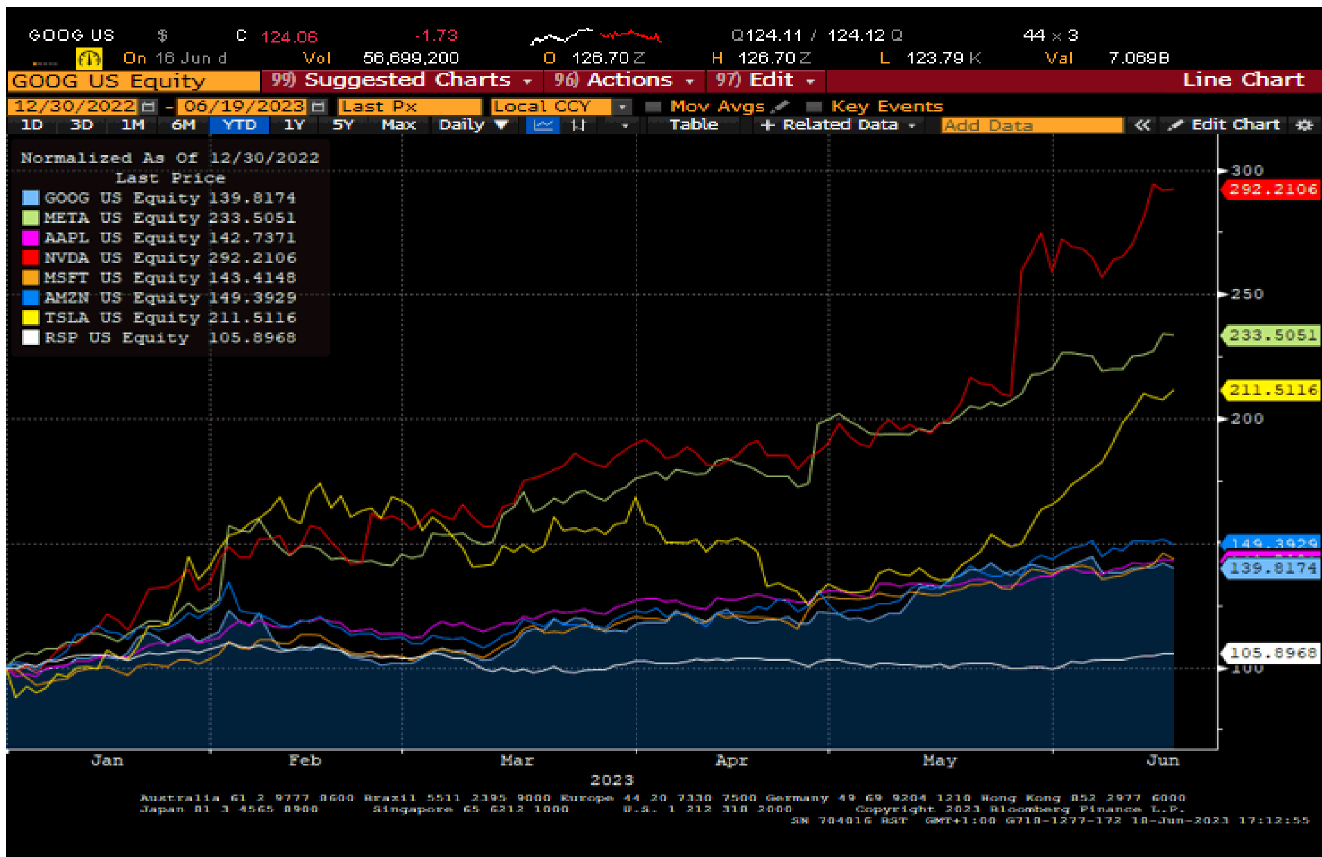
Q2 has provided yet another example of this type of confirmation bias at work. Despite central banks in the US, EU, Canada, Australia and UK continuing to ratchet up hawkish rhetoric and with short-term interest rates heading inexorably higher, investors seem determined to focus all hope on one particular ray of light shining (in the shape of AI). They are seemingly willing to ignore all evidence of the dark storm clouds gathering on the horizon.

No one knows exactly who decided that the definition of a Bull Market should be taken to be a move higher of 20% or more in a particular Index or that, correspondingly, a Bear Market should be defined as a move of 20% or more lower by a particular Index. However, it seems reasonable to expect that bull or bear markets should be judged on a number of metrics including the breadth of their respective advances or declines as much as by the extent of the moves in either direction.

In that regard, the strong moves higher in both the Nasdaq and the S&P 500 so far this year have to be seen and judged in the context of the breadth of those moves as much as by the extent of the moves. A superficial examination showing the Nasdaq +30% YTD and the SPX +14% YTD would lead the casual observer to deduce that "all was well with Corporate America". However, upon slightly more detailed analysis it quickly becomes clear that the moves higher in both Indices are based on the performance of only a very small number of stocks.

As the chart below shows, if we use the S&P500 Equal Weight Index (to reduce skewing effect of the mega-cap constituents) we see that whilst the Index itself is only marginally positive YTD, the majority of the broader index's return comes from only seven stocks, which the media (and others) have been swift to name "The Magnificent Seven". However impressive those individual returns may be, when viewed as part of the aggregate return generated by the Index itself is not something that could ever be called "broadly based".

Chart 1: "The Magnificent Seven" US stocks driving the S&P 500



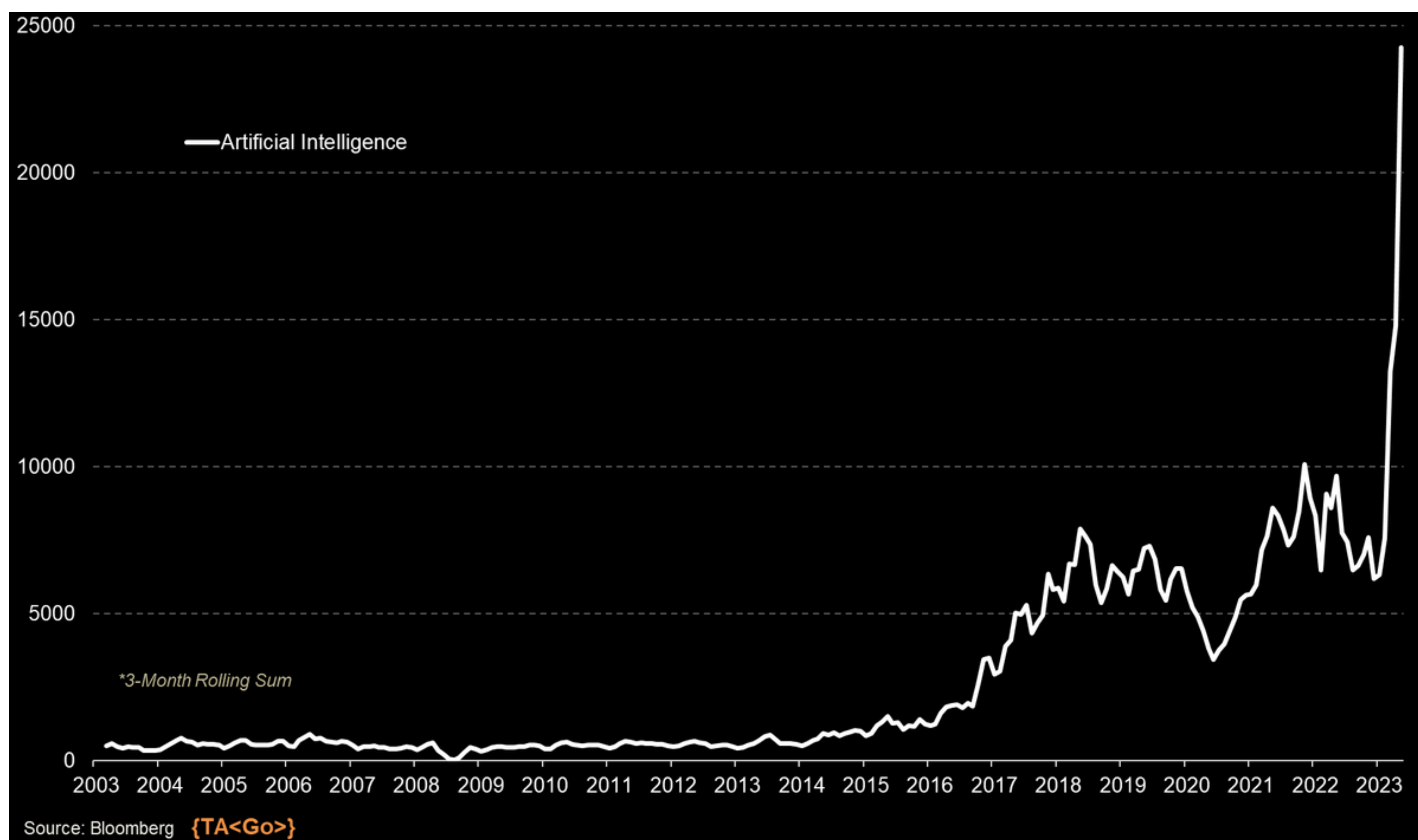
Source: Bloomberg L.P.

However, as mentioned above, it could be argued that there is actually some degree of "method in this Index Madness", given that the shares "leading the charge" all have some (however tenuous) connection to the "Next Big Investment Theme" (NBIT), namely Generative AI, or, as most of us refer to it more prosaically: AI.

Whilst it is clear that AI will prove to be transformational for societies, businesses and therefore economies more generally, much like any technology that has re-shaped the world we live in (steam, trains, radio, telephone, internet, mobile phones, etc) there is always (inevitably) a great deal of hype that goes with this, and AI will prove to be no different. Clearly a degree of caution is warranted at this juncture.

As the chart below shows, the only thing that has gone up as quickly and as sharply as AI related stocks has been reference to AI in the transcripts and earnings Calls of Publicly Traded Companies!

Chart 2: AI related mentions on Publicly Traded Companies Transcripts & Earnings Calls



Source: Bloomberg L.P.

As mentioned above, and as a result of the general level of optimism attaching to AI, markets in the US have been able to climb the proverbial "wall of worry" over the second quarter which has helped provide a firmer tone for equity markets more broadly around the world.

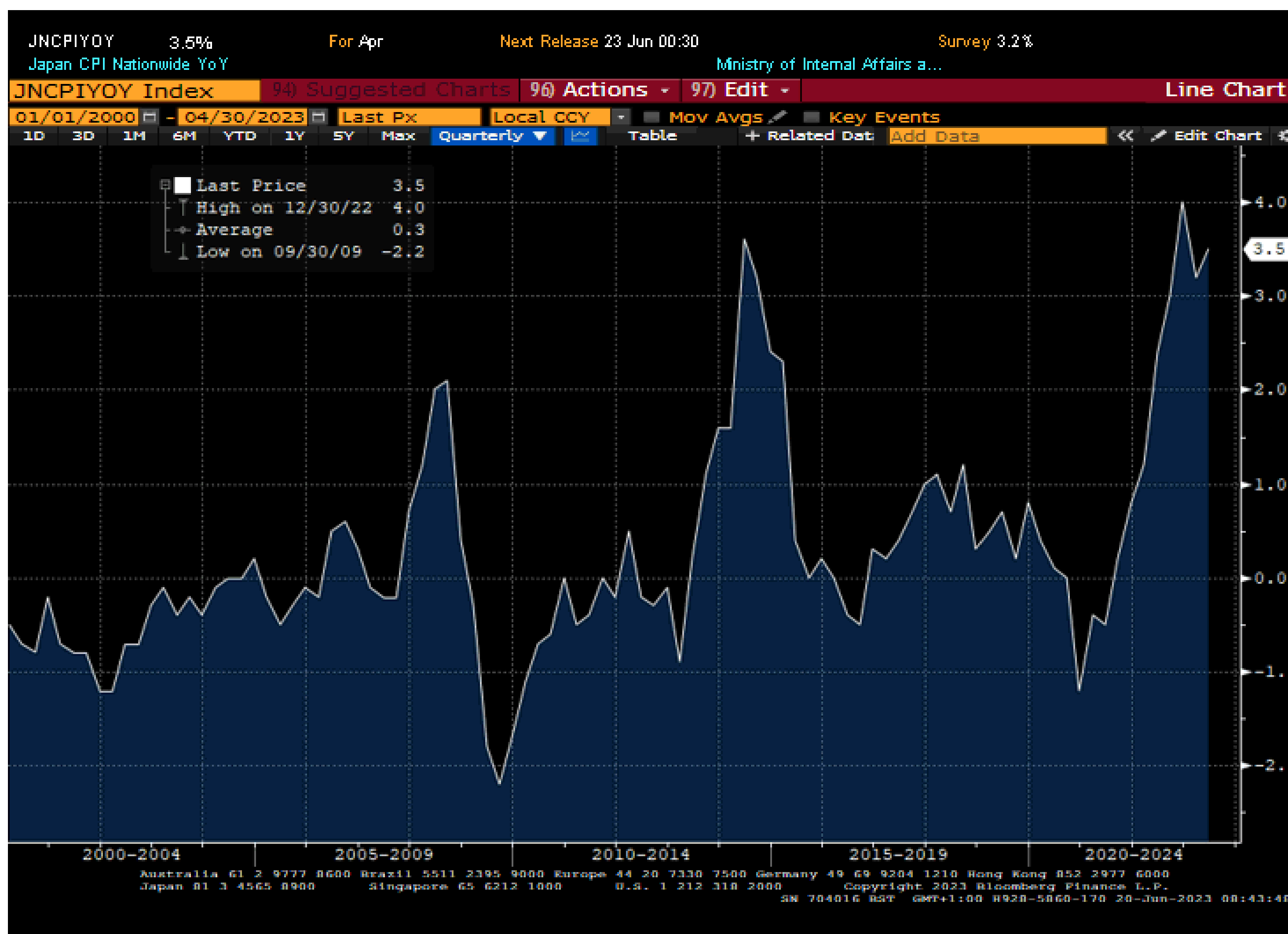
Outside of the US, the standout performer YTD has been Japan, which is deserving of special mention. As we know Japan has had to endure almost 30 years of deflationary pressures as the excesses of the late 80's bubble slowly got cleansed out of the system. Over that period, and in a desperate effort to try and stimulate inflation within the economy, the Bank of Japan (BOJ) has embarked on a series of questionable policies (including QE) which, bluntly, have had very underwhelming results to date.

However, finally, on the back of the great resurgence of global inflation post Covid "re-openings", Japan has at last managed to generate some kind of "on target" inflation, (the last print for CPI was 3.5%, comfortably above the average of the last 20 years of only 0.3%, see below). Foreign investors (Warren Buffett chief amongst those) have taken note of this and have invested heavily into Japanese shares, particularly Trading Companies, on the belief that on the back of:

i) significant corporate restructuring over the last few decades, alongside
ii) a probable change to YCC by the BOJ in due course, that an eventually stronger Yen will lead to a huge amount of repatriation by Japanese Pension funds (and others), who, to date, have found better value outside Japan for their vast savings.

The BOJ are saying it is too early to declare victory over deflation, but the "structural stars" do seem to finally be aligning in the 'Land of the Rising Sun'. Japan has been an overweight position in Shard Capital and LeifBridge portfolios for at least a year.

Chart 3: Japan's CPI Nationwide Index



Source: Bloomberg L.P.

On the other hand, one major market which has struggled over the second quarter has been China. Despite optimism following the initial "re-opening" in January, Chinese equities have struggled to make gains faced with the reality that, given a very depressed property sector (both commercial and residential) consumer confidence generally has been weak, and as a result consumers have been more prone to save / repay loans than to spend.

It seems clear that China's central bank is well aware of the problem and is focused on providing necessary stimulus. Whilst the deflationary "impulse" which China's slowdown will most likely "export" to the global economy might be seen as a positive as regards efforts to bring down global inflation rates, the potential sting in the tail could well be lower growth prospects for many export-oriented European and US companies over the next few years.

2023 – Outlook for H2

Coming in to 2023 the Fed Funds rate stood within the target range of 4.25% - 4.50%. As we noted in our previous Quarterly Insights report, many investors felt that at that level, and having risen from a target rate of 0.25% to 0.50% a mere 9 months earlier, (the sharpest Fed tightening in history), that

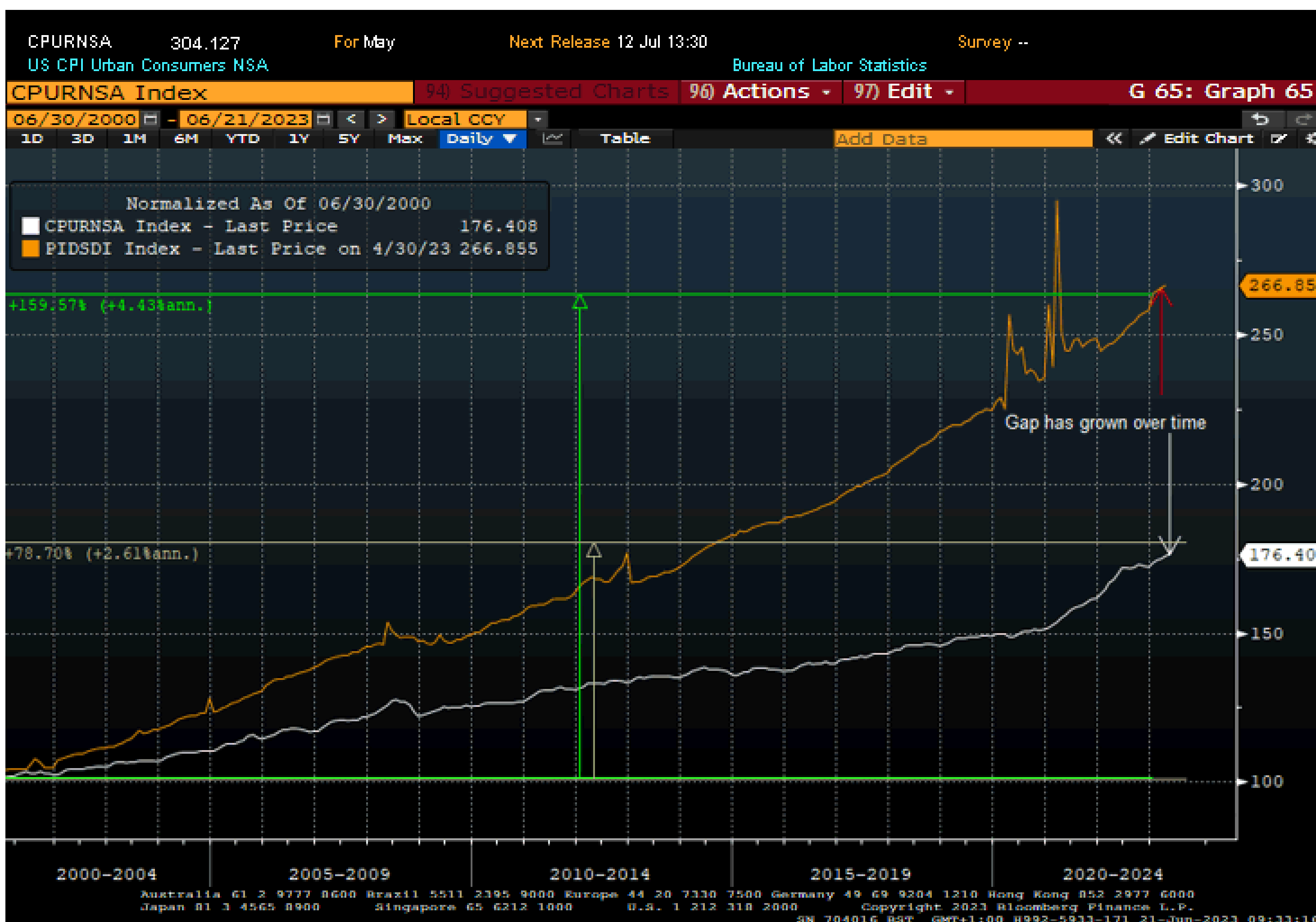
perhaps the Fed had "done enough" to contain inflationary pressures. The last 6 months have now shown that this was in fact wishful thinking, given that inflation in the US, whilst definitely showing signs of heading lower, is still struggling to get some of the "stickier" components under control. This, together with evidence of still very strong employment numbers, suggest the Fed, having paused during its June meeting, might have more work to do in the months ahead.

Many people have been surprised by the apparent resilience of the US economy in the face of sharply higher interest rates, but to us it seems clear that there have been two major factors at play which account for this resilience namely:

i) US consumers enjoying higher (real) disposable incomes, and
ii) substantial distribution to consumers of "free money" in 2020.

US Disposable Income: From our perspective it seems clear that whilst employment remains so strong inflation will prove hard to tame. The chart below shows how, over the last 23 years growth in disposable income in the US has significantly outpaced growth in inflation. Disposable income has grown by an annualised rate of around 4.4% whereas inflation has grown by only 2.6% annualised over the same period, so in real terms US consumers are significantly better off and this is helping to support consumer confidence even as interest rates head higher. We therefore believe that employment is the key variable here. Lower inflation with full employment will not cut if for the Fed, they will want to see a contraction in demand – effectively a fall in disposable income – feeding through to a sustained fall in inflation. The "pivot optimists" might be in for a shock.

Chart 4: 23 years growth in disposable income in the US VS growth in inflation

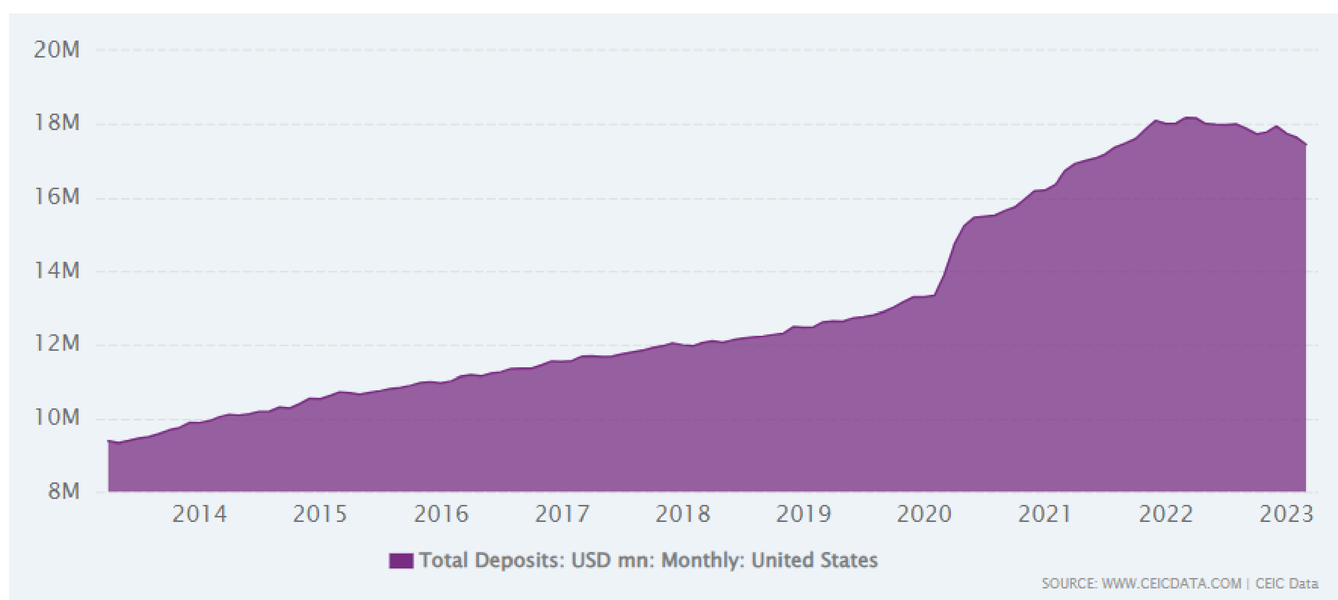


Source: Bloomberg L.P.

Covid Fiscal Stimulus: the quite extraordinary amount of money that was put into the hands of US citizens in 2020 as a result of the total shutdown of the US economy ironically ended up creating many more problems than it solved. The "problem" with this stimulus is that money was handed out to people whether or not they actually needed it. As a result, consumer net wealth, in aggregate, rose very sharply, and whilst much of that money has now been spent the residual amounts still left within the economy have indeed helped to sustain economic activity at levels higher than might otherwise have been expected. The graph below highlights the sharp spike in total deposits in 2020 occasioned by the "free money" handed out by the US government.

In addition to this, when the longer-term effects on inflation of the unfortunately named "Inflation Reduction Act" (IRA) are factored in, it is easy to see how the US Government seems apparently determined to make the Fed's job increasingly harder.

Chart 5: US deposits, including 2020 "Free Money" event issued by US government.



Source: CEIC Data, www.ceicdata.com

Major Conclusions

- The boost to consumption from Covid "stimulus" cheques, whilst beginning to fade, is still a factor in keeping inflation elevated.
- Higher interest rates work with anywhere from 9 to 12-month lags, so impact will begin to be felt in H2 and into H1 of 2024.
- Tighter lending standards will also begin to be felt more fully in H2 2023 and into H1 2024.
- A tight labour market in the US combined with high disposable income means that the Fed might keep raising rates into year end.
- Given that housing in the US, UK and China has been (and is) a large part of consumer asset base and source of wealth/funding, we expect lower house prices to eventually impact consumer sentiment…starting with China and the UK.
- Given the significant problems facing China we advise reducing direct and indirect exposure to this economy.
- We also expect Japan to continue to outperform on a relative basis as investors, finally, begin to address substantial underweight positions to local equities.

- We think the Japanese Yen is fundamentally undervalued at current levels and also provides a good "risk-off" hedge in the event of market dislocations.
- We continue to invest opportunistically to alternatives as we believe directional risk is under-priced currently in most markets.
- We recognise the long-term potential for AI but are concerned with current valuations. If possible, dispersion trades centred around AI themes would seem to offer most attractive risk/reward exposure at this juncture.

We see four main "themes" playing out over the second half of 2023.

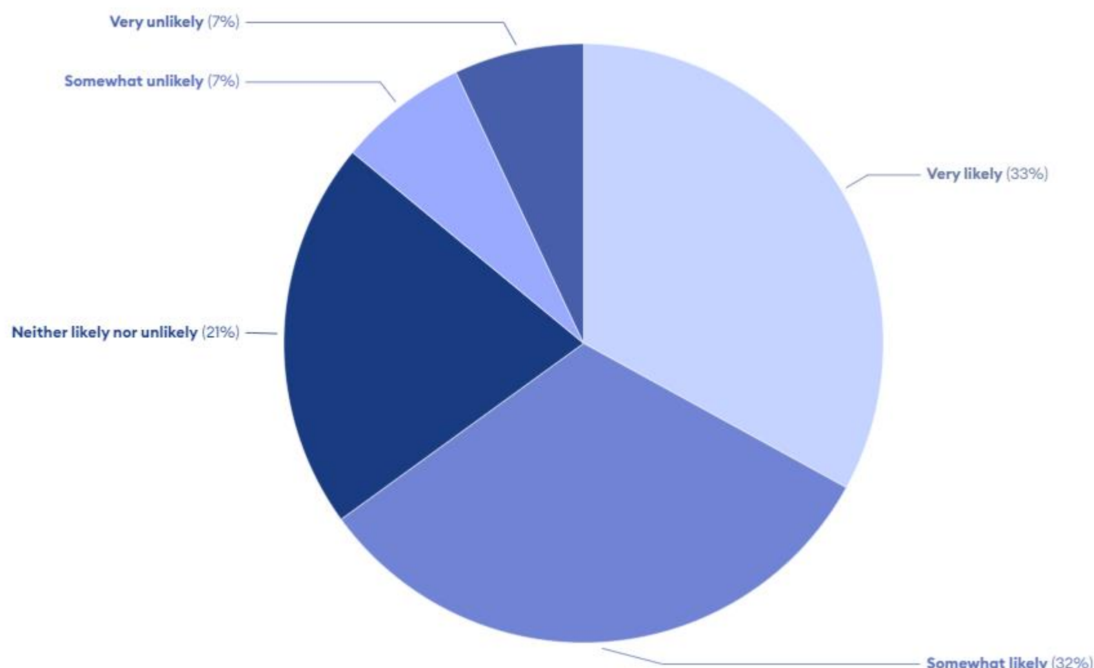
Whilst not our base case, we see a significant risk that as the Fed fights to push the unemployment rate higher, so the higher interest rates required to bring that about end up "breaking something". The risk is that somewhere deep in the bowels of the often-malignant shadow banking system, sharply higher interest rates actually end up doing what they were intended to do, namely shine an industrial size searchlight on the plethora of shoddy and ill-advised lending practises which thrived under a negative interest rate regime. A Schumpeterian cleansing of the economy should in fact be welcomed because it allows capital misallocations to be addressed and for new, more deserving businesses, to gain access to fresh capital.

Markets clearly ascribe a much higher probability to the "Goldilocks" outcome than they do to the "Schumpeterian" one, but that does certainly not mean that the latter has a zero-probability outcome. Caveat emptor as they say.

Second, and in vague support of the Goldilocks outcome referenced above, the "arrival" of AI (at least in the minds of investors) does skew risks slightly more positively given the very considerable efficiencies that Generative AI is bound to bring over time. The problem, as ever, comes not from being unable to identify the opportunity, but rather it comes from assessing how to accurately value or price the future earnings associated with this new technology.

As much has been written about the existential threats that Generative AI presents to mankind as has been written about the transformational nature of the technology. It is clear this "theme" will dominate for years to come and as a result a bullish skew will be priced in by investors who don't want to miss out on the profits to be generated by this game changing technology. In a survey conducted by Forbes Advisor, 65% of respondents said that they were "very likely" or "somewhat likely" to trust a business that uses AI (see below). Only 14% of respondents said they were "very unlikely" or "somewhat unlikely" to trust businesses using AI, and this is when AI is still a relatively new "thing".

Chart 6: How likely are you to trust a business that uses artificial intelligence?



Source: Forbes Advisor

The statistics we quoted above, namely that around seven shares in the S&P 500 (who are in some way linked to AI) have generated over 90% of the Index's returns YTD, highlights just how much this "story" is helping to skew overall Index returns whilst at the same time perhaps blindsiding investors to other very real risks that are present if not immediately visible.

Third we must mention China. As the world's second largest economy and heretofore the source of much of the world's total aggregate demand for a range of goods and services, we would obviously do well to try and better understand the specific issues which currently confront China and how the authorities there are likely to address them, because ultimately, their decisions today will affect the global economy for years to come.

In simple terms China now faces two main issues.

1) The first is its property market (both commercial and residential). For years now property has been used as a source of "wealth" and income for both the Government (Central & Regional) and for consumers. According to Government statistics, property accounts for 25% of GDP and 70% of household wealth, so, to put it bluntly…it matters. Owning a house or flat was part of the government's policy designed to foster "aspirational outcomes" for the fast-growing middle class. Zoning land, granting permits, funding construction, selling developments all contributed in good measure to income derived by regional governments. For years a "virtuous circle" of increased prosperity through increased property ownership helped fuel the phenomenal growth in GDP. Certainly property was just one of the "legs" which contributed to overall growth of the Chinese economy, but importantly, psychologically, it was a central part of the "dream" that every citizen could relate and aspire to. Whilst problems were building in this "model" before Covid arrived, the pandemic has laid bare the Ponzi nature of the greater part of the property market.
2) The second issue, closely tied to the first, relates to potential social discontent. It is not surprising that the younger generation in China, who are now confronted by bleak job prospects, should take to social media to decry the fact that their dreams and aspirations

have been crushed by a government which did not plan carefully enough for the future. Symbolic of this growing sense of discontent and hopelessness is the re-emergence of "Kong Yiji", a short story published in 1919 which sought to highlight the corruption and lack of opportunity under the old Imperial system. In the story Kong Yiji is frequently ridiculed and humiliated for wanting to improve his lot in life. He aspires to wear the "Long Gown" which is a symbol of success and higher social standing, but the system weighs against him. China is now producing 10 times as many graduates as it was a decade ago, but job growth has not kept pace, hence the feeling of hopelessness as graduates are forced to take lower paid Blue-Collar jobs which pay less and offer lower future prospects. According to the National Bureau of Statistics in China, Youth Unemployment (16 to 24) now stands at 20.8%

Whilst it is important not to fixate on the significance of the "Kong Yiji" memes now circulating in China, it is also important to appreciate what they signify as regards the outlook for society in China more broadly, particularly as the country now finds itself stuck in a classic case of "Middle Income Trap". It would be a huge mistake for the West to try and turn this to some kind of political advantage, but the risk remains that they might.

Lastly, we turn to Japan. Despite languishing under a deflationary headwind for the past 30 years Japan is still the 3rd largest economy in the world, with a GDP of $4.9 Trillion. That is quite some achievement and goes a long way to explaining why the economy matters so much, particularly as regards their generous predisposition to keep financing other countries deficits.

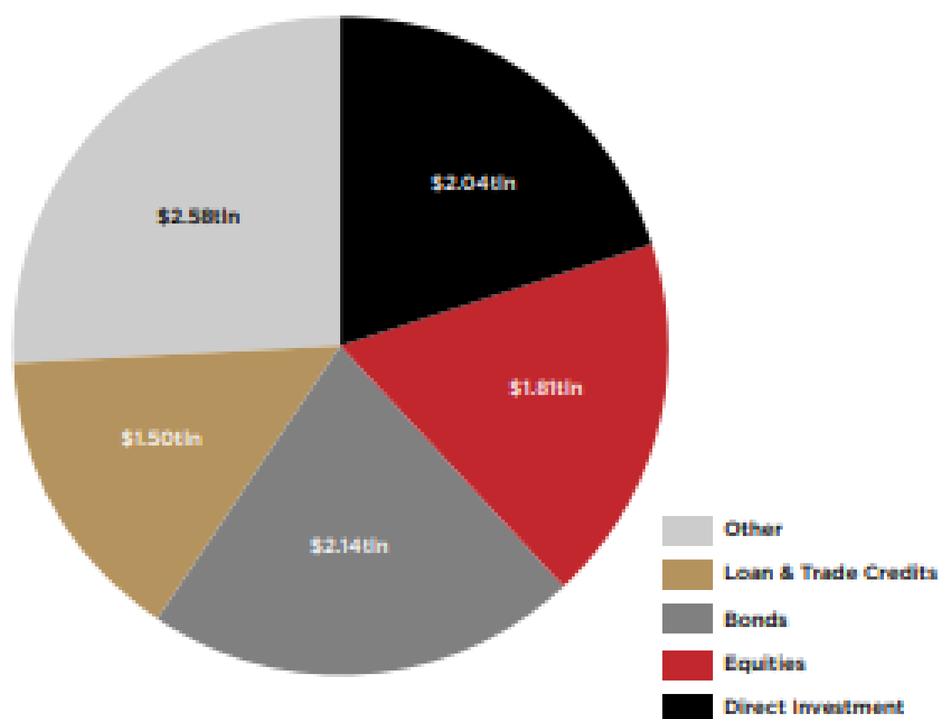
We can skirt the first 23 years of Japan's "deflationary bust" and pick up the story in 2013. This was the year that Haruhiko Kuroda took over as head of the BOJ. Kuroda worked closely with the Prime Minister, Shinzo Abe, to help develop what became known as Abenomics" or the "Three Arrows Policy", which effectively focused on

i) pumping money into the system and pushing interest rates lower by buying Govt bonds (aka QE),
ii) undertaking govt spending to "pump prime" the economy and
iii) undertaking extensive regulatory and economic reforms to improve Japan's competitive position.

Whilst the "first" arrow, QE, failed to achieve desired inflationary impulse (much like QE elsewhere), arrows ii) and iii) met with modest success. In the meantime, attempts to push Japanese bond yields lower and keep them within set bands (Yield Curve Control or YCC) simply encouraged domestic Japanese investors to seek higher returns overseas thereby i) pushing the value of the Yen lower and ii) failing to support the local equity market.

As mentioned previously, the re-opening of the global economy post-Covid caused an inflationary surge across the developed world and Japan, finally, has seen inflation push higher over the last 12 months. This move higher in inflation has got investors thinking that maybe, finally, Japan can put its deflationary past behind it and that, in due course, the BOJ will abandon its YCC "experiment" and allow JGB yields to rise higher. In this environment it is reasonable to assume that a strengthening Yen might cause Japanese investors to reconsider such a heavy exposure to overseas assets and to instead consider repatriating part of the overseas investments which, as the graph below shows, are not inconsiderable, adding up to close to US$10 Trillion!

Chart 7: Japan International Assets (US$ tln) 2022



Source: Grant Williams

Despite the fact that the Nikkei is already up +27% YTD in local currency terms we continue to believe that valuations on Japanese companies still represent excellent value, on both an absolute and relative basis. On a technical basis Japan may look short-term overbought, but for long-term investors the prospects still look attractive. On a Purchasing Power Parity basis (PPP) using either the "Big Mac" Index or the OECD Index, the Yen is close to 50% undervalued vs the US$.

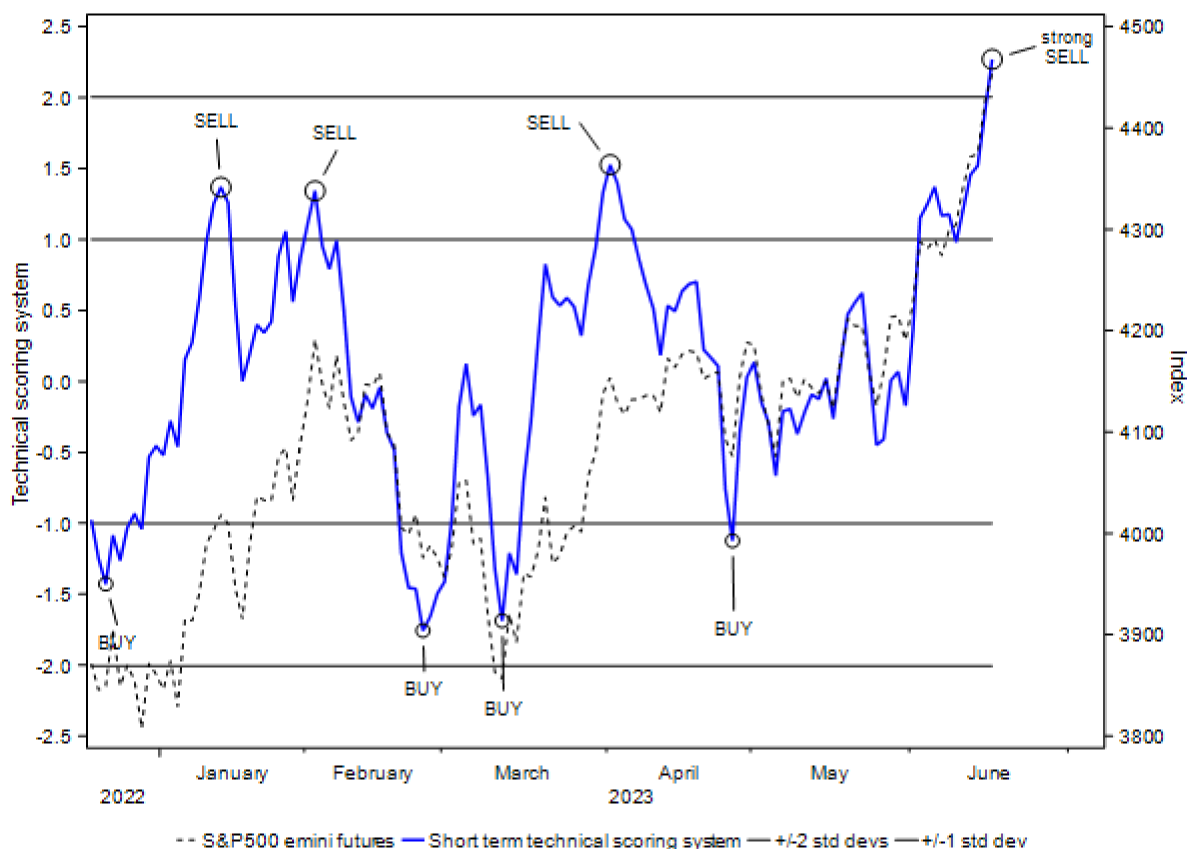
What does this mean for portfolios?

Given the foregoing we see no reason to change our more cautious positioning going in to the second half of 2023. If anything, we may look to barbell our fixed income exposure by allocating an equal weighting to short duration bonds (3 years or less) to take advantage of higher rates as a cash proxy to be used in the event markets do dislocate and at the same time extending duration to the 20 Year area in order to also benefit from capital gains if we are right and most central banks are actually at, or close to, peak rates of interest in this cycle.

As also mentioned, we are concerned about China and what the government decides to do regarding economic and social pressures beginning to build in the country. Of course, if the situation in China does deteriorate further there would inevitably be repercussions within global markets, but most specifically in the Asia/Pacific region, including Japan. For these reasons it may pay to still remain neutral on copper and commodities generally, and also to reduce exposure to multi-national companies which have large exposure to China.

The US is the hardest market to call given it is so heavily weighted to tech and specifically "The Magnificent Seven". All technical indicators, (see below), would suggest that the US market appears overbought at this juncture but as we noted above it is very hard to shift investor sentiment when there is such euphoria in the market re AI and its potential.

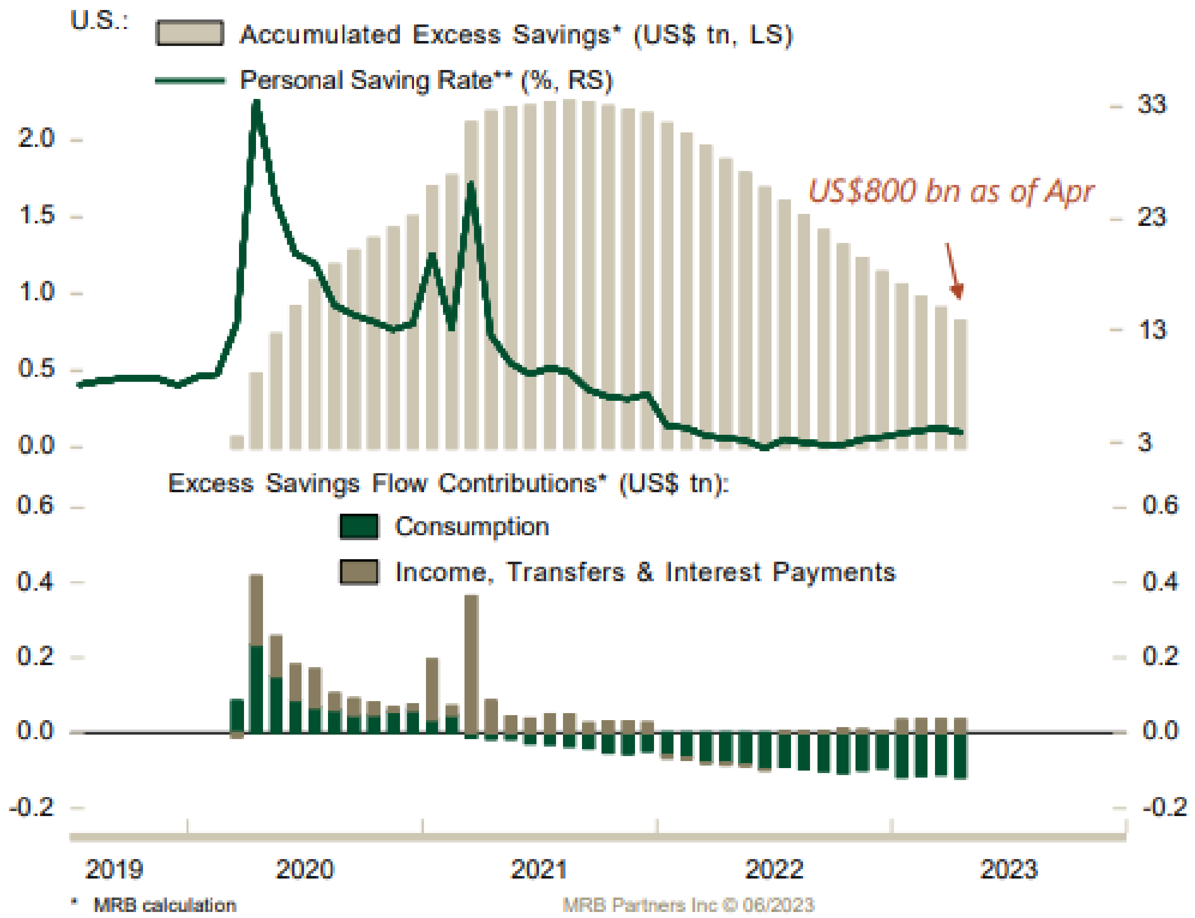
Chart 8: US equity market looks overbought in the short term:



Source: Longview Economics, Macrobond, June 2023

Furthermore, the US is, as we know, dependant on the consumer. The US consumer accumulated significant excess savings during the pandemic. Demand, and in turn inflation, has been fuelled by these excesses. However, at the current pace of drawdown, excess savings would last until late 2023 or early 2024...then what?!?

Chart 9: Accumulated US personal savings and savings rate:



Source: MRB Partners Inc., June 2023

It was Sir John Templeton who famously commented that "bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria". Perhaps the euphoria which now accompanies "all things AI" might yet prove to be the final leg of the impressive bull market in equities going back to 2009.

CONTACT US

For further information on any of our services, or if you would like to arrange a meeting with an investment manager to see how we can work with you, please get in touch.

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