Quarterly insights – Q3 2023

At the start of our Q2 review we highlighted the fact that, when assessing both current valuations and probable future direction of global asset markets, humans tend to have an almost unavoidable inclination to look at the recent past and extrapolate from that what they (we) think is likely to happen in the immediate future. Whilst the effect of recency bias on the decision-making process has been known for some time (the theory was first postulated by Hemann Ebbinghaus in the late 19th century), its influence on financial markets has undergone much study and debate in recent years and was probably most famously reviewed by Daniel Kahneman in his book “Thinking Fast and Slow” (2011).

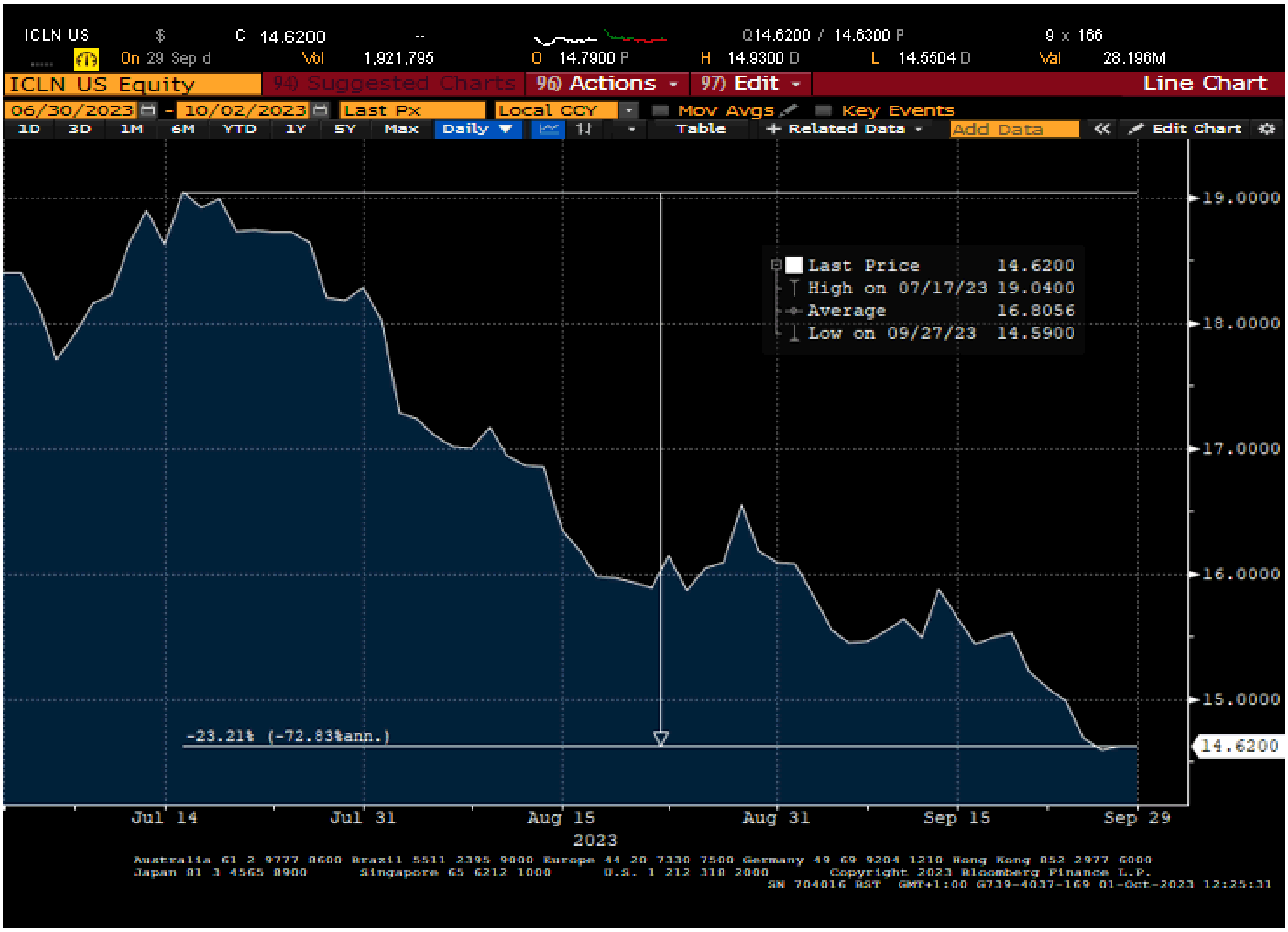
Given the foregoing we wrote that the impact of recency bias was almost certainly causing investors to ignore “all evidence of the dark storm clouds gathering on the horizon”. Events over the last quarter have shown that our concerns were well justified as Q3 proved to be a particularly challenging period for global asset prices in general. Indeed, given the headwinds markets have faced and the causes behind those headwinds it is arguably surprising that the sell-off in financial assets has not been more pronounced.

We also highlighted in our Q2 report that there was clear evidence that whilst at the aggregate level equity markets (particularly in the US) have performed well, even a cursory examination of the reality underlying the “strength” in markets showed how narrowly based the returns were, principally focused on the new “miracle” stocks involved in the AI sector. A “market” rally predicated on a very narrow group of shares is usually, in our experience, a dangerous indicator.

With all investor focus seemingly lasered on to any stock vaguely associated with the AI sector, many commentators seem to have missed the fact that a previous “darling” of the market, the Clean Energy sector, saw share prices fall dramatically over Q3. In a sector “famous” for pursuing projects which tend to involve very high capex and very low cash generation and where, as a result, companies in the sector relied on either large government subsidies and/or cheap funding, it should come as no surprise that shares prices were be badly impacted by the sharp rise in both nominal and real rates of interest over the quarter.

The graph below shows the quarterly performance of the iShares Global Clean Energy ETF over Q3, which is down 23% from its high over the period.

Chart 1: iShares Global Clean Energy ETF



Source: Bloomberg L.P.

As mentioned above, given the nature of the headwinds affecting financial markets it is arguable that losses could have been much greater over the period.

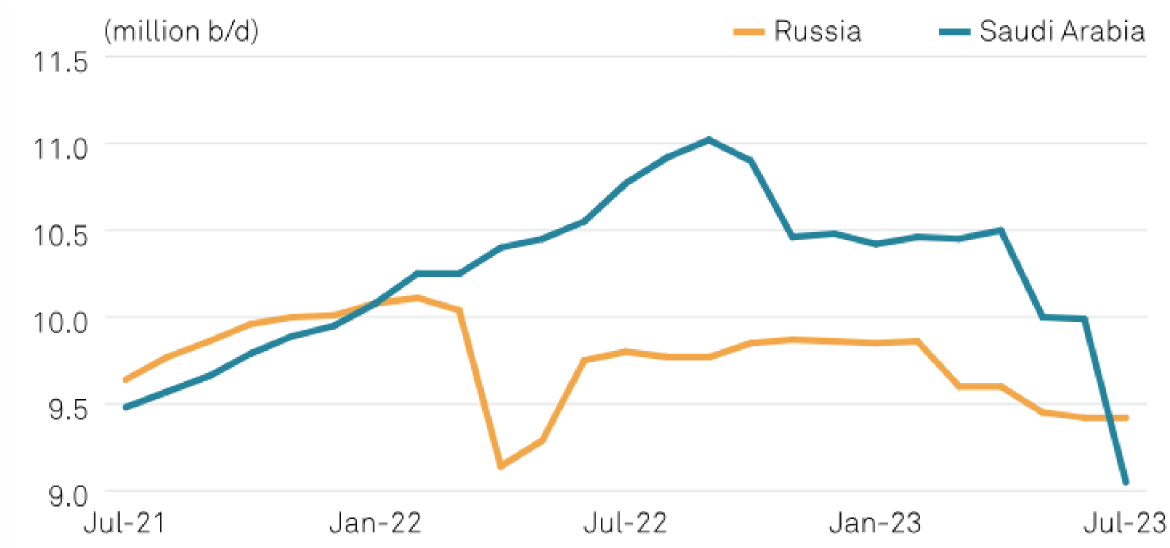
There were two principal causes for the market sell-off, both of which on their own would be considered a reason for concern, but when taken in tandem do constitute very serious reasons for investors to take notice and act accordingly.

The first "shock" to markets was the decision by Saudi Arabia in early July (which had been flagged earlier in the year), to announce a reduction in production of one million barrels of oil per day. This cut added to the cut of 1.66 million barrels oil per day which other OPEC members had announced. Add to this Russia's decision, as non-OPEC member, to join in with cuts of 500,000 bpd till the end of the year and it is not surprising that the price of oil has risen from $75 on the 1st of July to $95 by quarter-end, a 27% rise over the period.

A move of that magnitude, over such a brief period of time, acts as a very real and clear cost to production/consumption across the world, albeit the costs will be felt with a lag given many producers will have hedged against rising costs. Notwithstanding, investors do seem remarkably sanguine in the face of this price shock which is clearly inflationary over the longer term.

The graph below shows the cuts introduced by both Saudi Arabia and Russia, the second and third largest producers in the world after the USA.

Chart 2: Saudi Arabia and Russia cut back oil production.



Source: Platts OPEC+ survey by S&P Global Commodity Insights

Whilst the economic impact of these cuts is obviously very serious, we must also consider the political statement behind these cuts as well.

For some time now both China and Russia have been trying to create a rival economic and political coalition to challenge the US's hegemony. In February 2022 they drew up an agreement to increase economic and military cooperation and since that time they have both been assiduously courting Mohamad Bin Salman, (MBS), the Crown Prince of Saudi Arabia. Their efforts have proved highly successful, not least because President Joe Biden has not exactly hidden his dislike of MBS. In August of this year, and as part of their efforts to create a counter-alliance to the US and NATO, six new countries, including both Saudi Arabia and Iran, were invited to join the BRICS bloc of developing nations in January 2024.

Rising global geo-political tensions arising from what is increasingly perceived in the West as an attempt to destabilise their economies through a weaponization of oil prices, is hardly conducive to a positive outlook for global markets.

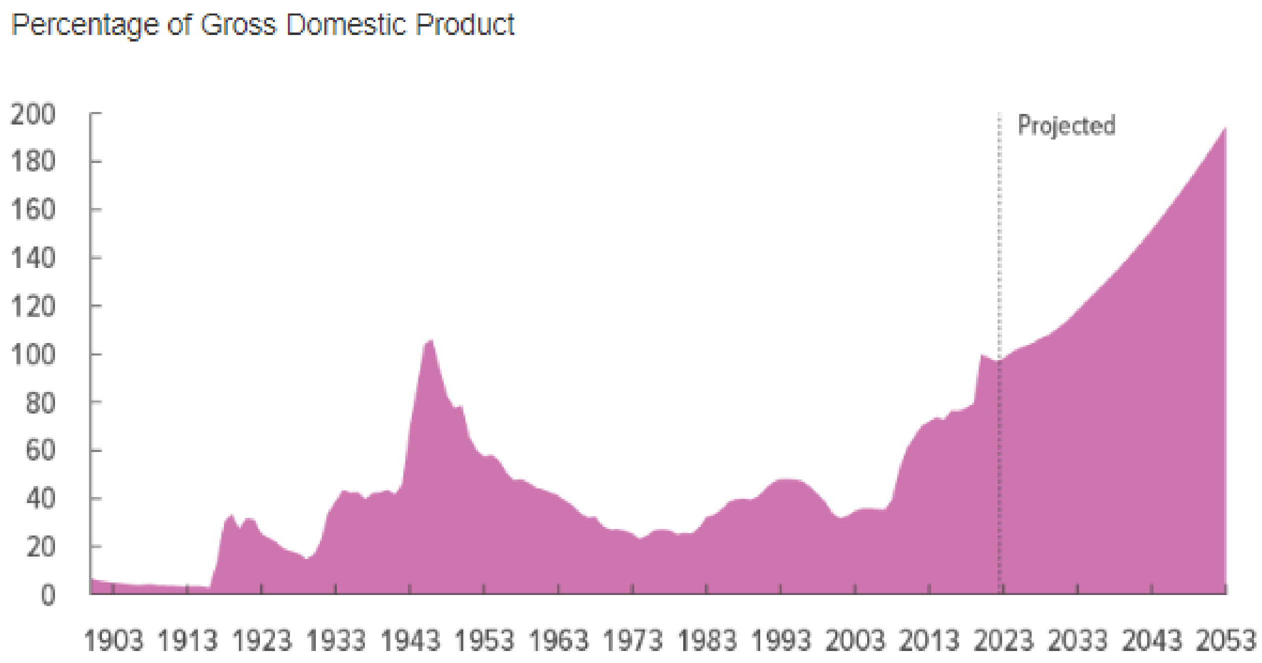
When these developments are considered in the context of the second major factor impacting global markets over Q3, namely sharply higher US interest rates, it is surprising, to us at least, that markets seem to be taking these headwinds as calmly as they are.

Over Q3 the yield on 10 Year US Treasuries rose by seventy-three basis points, from a yield of 3.84% to a yield of 4.57%. When assessed in terms of percentage increase that amounts to a rise of 19% to the cost of financing 10-year investments… and this occurred over a period of just 12 weeks. Adding 20% to 10-year funding costs obviously has serious potential consequences for both the US Government and businesses all over the world that finance in US$. At the shorter end of the curve funding costs also rose, albeit less sharply. That said, 5-year yields on UST rose from 4.15% to 4.61%, a still significant rise of forty-six basis points, or in percentage terms a rise of 11% in funding costs for 5-year financing.

There is obviously going to be a debate as to cause and effect behind the sharp rise in US yields over the Quarter, but from our perspective the more aggressive positioning from both Saudi Arabia and Russia as regards oil production played directly into the narrative coming from the Federal Reserve over the period (both at Jackson Hole in late August and subsequently at the FOMC meeting on the 20th September), namely that with labour markets still tight and core inflation still "sticky" a "higher for longer" outlook for US interest rates was merited.

According to the Congressional Budget Office website (www.cbo.gov) the US deficit will amount to 5.3% of GDP in 2023. However, this is forecast to rise over time to 6.9% of GDP by 2033, significantly larger than the 3.6% of GDP that deficits have averaged over the past 50 years. At the same time Federal Debt held by the public is projected to rise from 98% of GDP in 2023 to 118% of GDP by 2033. Over that period the growth in interest costs and mandatory spending is like to outpace the growth in revenues and the economy, thereby driving up the debt burden. The CBO estimate that in only 30 years' time the percentage of debt to GDP will rise to 195%, as shown in the graph below:

Chart 3: Federal Debt Held by the Public, 1900 to 2053



Source: CBO.GOV

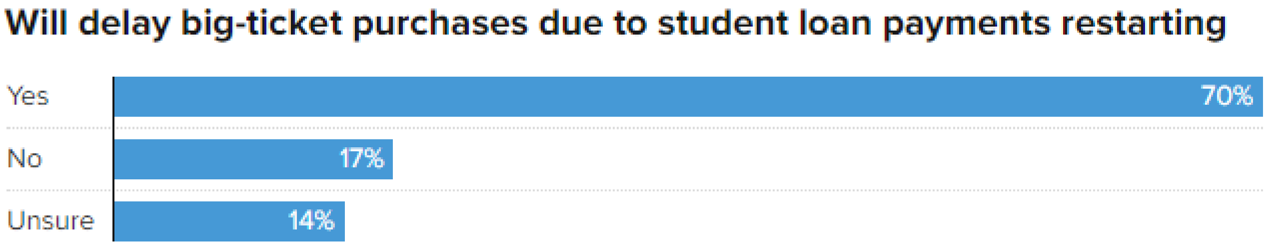
When bond investors factor in the unsustainable path for US Govt debt, then it becomes increasingly obvious that a negative feedback loop is in real danger of developing, namely: higher rates = higher interest burden for the US Government, making it harder for the US Government to continue financing projected expenditure, leading investors to demand higher rates for the greater risks associated with funding said deficit. The increase in term premia now being demanded by investors is entirely reasonable in the circumstances and there is a real danger that this shift becomes structural over time, i.e. investors don't see a realistic path towards the US Government reducing the fiscal deficit over time so continue to demand higher yields in return for financing the US deficit.

A "triple whammy" of i) rising energy costs together with ii) rising interest costs allied to iii) a growing structural deficit for the US Government, is not exactly the "stuff" that bull markets are made of… on the contrary, they are more usually associated with the "stuff" that led to bear markets.

Lastly, and as if US consumers did not have enough to worry about, the 3 Year pandemic-era pause on federal student loan payments ended on the 30th of September. This means that an estimated forty million citizens will now have to start repaying loans which, according to CNBC calculations average around $350 per month, although some are as high as $700 per month.

R5 Capital, a consumer research consulting firm, estimates that starting in October around $7 billion to $8 billion per month will be reallocated from consumer expenditure to student loan repayments.

This analysis appears to be supported by a survey conducted by Jefferies where 70% of those approached indicated that they would likely delay big-ticket purchases due to student loan repayments starting again, see chart below:

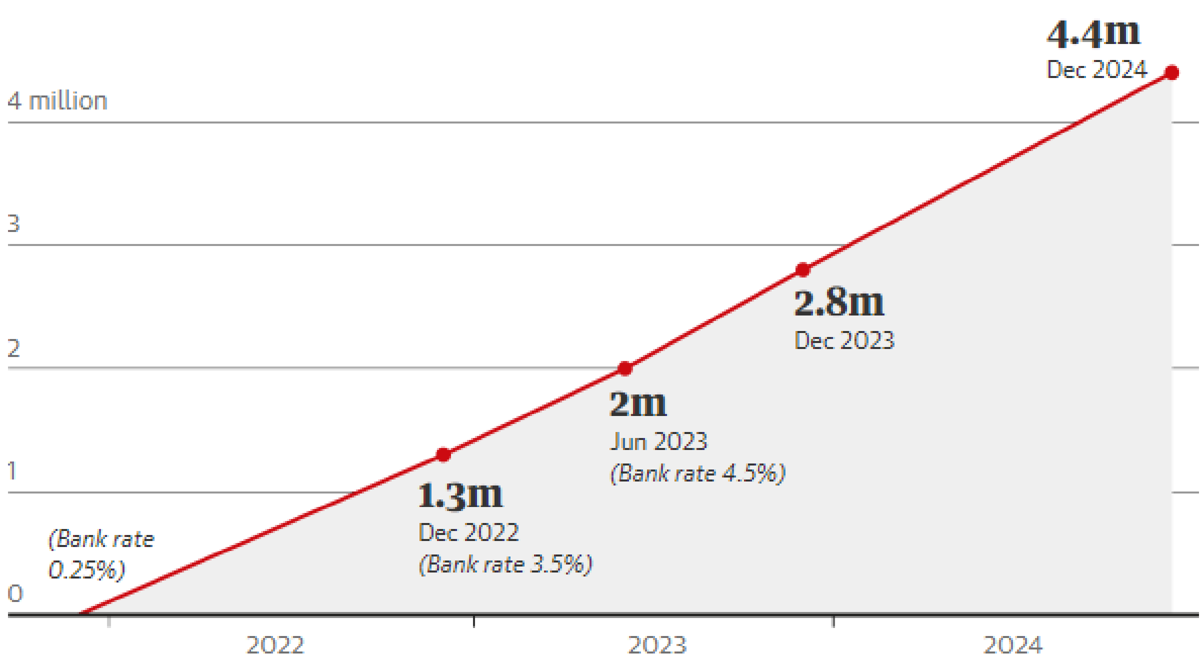


Source: Jeffries, Survey of approx. 630 U.S. Consumers, September 2023

In these circumstances it is perhaps advisable to reassess the outlook for many US equities which are still quite highly valued given the rapidly changing economic and political outlook globally.

As regards the UK it is fair to say that despite the slight uptick in the YOY GDP print in September (+0.6% vs +0.4%), the outlook for the economy remains very uncertain, particularly given the significant impact which house prices have both on investor confidence and therefore consumer confidence more generally. Unlike the US, where mortgages are fixed for longer periods (up to 30 years in some cases), fixed-rate mortgages in the UK barely get fixed for anything over 5 years. As a result, and according to figures provided by UK Finance, (the banking industry trade body), about two million fixed-rate mortgages are due to expire between now and December 2024. This is bound to have a profound impact on consumer spending just as the UK heads for a general election, see chart below:

Chart 4: Cumulative number since BoE began raising interest rates:



Source: Bank of England, UL Finance. Note: number of fixed-rate homeowner mortgages expiring by year, cumulative since January 2022

The cumulative effect on UK consumers will be substantial. According to economists at the Resolution Foundation think-tank, total annual home loan payments from homeowners are on course to rise by £15.8 billion by 2026.

Conscious of more entrenched inflationary pressures, and in an effort to soften the blow for consumers, the UK's Prime Minister Rishi Sunak has put back the date by which new petrol and diesel cars are banned from sale from 2030 to 2035 and at the same time put back the date by which the sale of gas boilers are banned from 2025 to 2035. In addition, and in an effort to enhance the UK's energy independence, he has signed off on the production of oil and gas in the Rosebank oil fields off the Shetland Isles. Will these concessions actually make any real difference to consumers in time to help the Conservatives at the next election? It is very unlikely, but it is reflective of the awareness and concern politicians have as regards the gradual erosion in disposable income for most UK households.

Taken in aggregate all of the foregoing confirms our instinct to continue with our cautious positioning towards UK focused stocks.

Outlook for Q4 2023

Given the foregoing it is not surprising that our outlook for Q4 remains cautious.

We believe that when determining optimal asset allocation for specific portfolios our decisions should be guided as much by relative as absolute valuations. This is because of the cyclical nature of markets as much as the emotional biases that inevitably influence valuations over market cycles, as we referenced above.

We therefore tend to adopt a simple risk-based approach to asset allocation which should, objectively, filter out personal biases.

In simple terms we frame our asset allocations decision not from the perspective of the returns we expect to make from a given investment, but rather from the perspective of the assessed risks we are being asked to take to generate those returns.

This begs the obvious question: "how do you best objectively measure risk"?

The truthful answer is that there is no simple way to measure risk objectively because, by definition, any perception of risk will inevitably be imbued with subjective biases.

But in an industry that is obsessed with certainty the decision has been made that risk = volatility. The simple reason for this is that, for better or worse, expressed as volatility "risk" can be mathematically modelled….and that "reassures" many people.

Whilst we obviously factor volatility into our assessment of risk, we also take into account more subjective measures based on common sense, something that quite obviously cannot be modelled and which we therefore believe means many risks go under appreciated by investors generally.

In this regard the graph below is a good example of a simple but obvious way to assess relative valuations across different asset classes.

For a very long-time cash, or near cash, investments were made singularly unappealing by very short-sighted central bank monetary policies.

Thankfully, this lunacy has now stopped and has indeed been reversed. However, and again referencing our mention of recency bias at the beginning of this piece, many investors have been slow to readjust allocations to reflect this new paradigm.

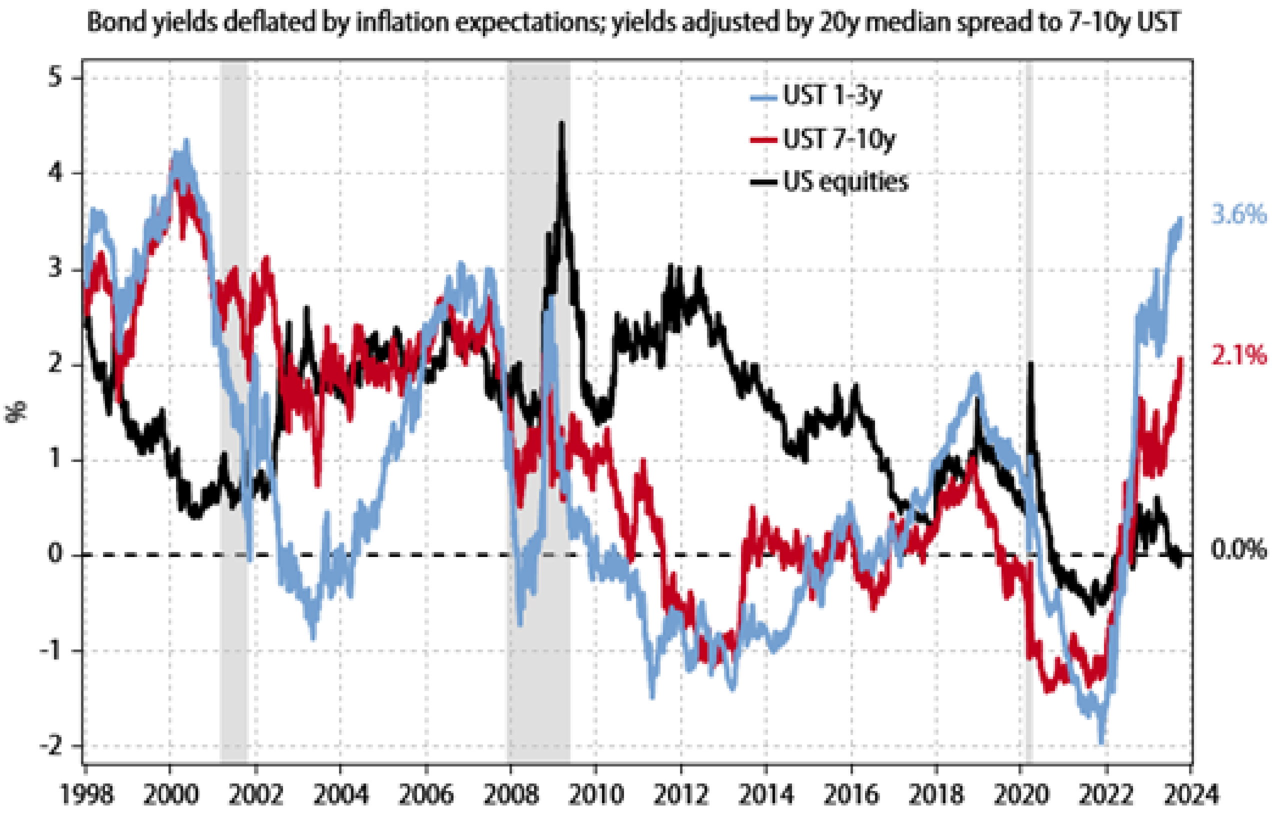
If, inflation adjusted, you can pick-up 3.6% in 1-3 Year US Treasuries (risk free at a nominal level) over equities yielding 0% (also inflation adjusted but putatively not risk-free at a nominal level), then you have to be uber bullish on stocks generally to think that, on a risk-adjusted basis, an index-based allocation to stocks offers anything resembling "compelling value".

The exception to this view will obviously apply to stock specific investments, where proper research and due diligence will rightly be rewarded but, as we said, at an Index level we find it very hard to justify a broad-based allocation to equities over bonds at current valuations.

The last time 1-3 Year UST offered a 3.6% pick up in yield over equities was in 2000, and we all know what happened to equity markets over the next 3 years. Of course, history never exactly repeats, but the broad takeaway from these figures seems fairly self-explanatory to us.

It is true that the late (and some would say great) John Maynard Keynes famously quipped that: "markets can remain irrational longer than you can remain solvent", but when Mr Market offers up this level of relative value between equities and bonds, we find it hard to resist.

Chart 5: US equities offer poor risk-adjusted yields compared with US bonds:



Source: Gavekal Research/Macrobond

Major Conclusions

- Fiscal stimulus resulting from the Covid pandemic has now faded across most economies.
- Structurally higher inflation, principally caused by higher energy prices, is beginning to more directly affect consumer sentiment.
- Added to this, after a 3-year pause, repayments of Student Loans in the US begin again on the 1st of October which is estimated to affect forty million people.
- Notwithstanding the foregoing, the Federal Reserve has indicated that, as things stand, interest rates are likely to remain higher for longer.
- At the same time investors are becoming increasingly concerned about the projected direction and size of the US Budget Deficit.
- As a result, over Q3, the entire US Government Bond market curve has steepened dramatically leading to structurally higher term premia at the long end.
- In the EU and UK, we believe interest rates have likely peaked and that both the ECB and BOE will tolerate slightly higher headline inflation rates over the short term.
- Whilst that may be good news for consumers today, the "less good news" is that this is because longer-term growth prospects in both regions have deteriorated.
- In Japan, the move higher in US rates has forced the BOJ to intervene in the JGB market to keep 10-year rates within targeted bands.
- This has caused investors to continue to speculate that the BOJ will eventually move the band higher once more, in its efforts to finally abandon YCC altogether.
- In China, whilst recent economic data might suggest the economy is finally stabilizing the path to recovery will be long and difficult, complicated by political tensions with the US.
- In this scenario China is unlikely to be able to add meaningfully to aggregate global demand in the years ahead.
- Given the foregoing we believe that asset allocation should continue to favour exposure to businesses with strong balance sheets and the ability to generate sustainable cashflows.

In our previous Quarterly we saw four main themes playing out over H2 of 2023.

Two of those themes have developed much as we expected (China and Japan), whereas the other two (Credit Event and AI "bubble") are still in the process of developing going into Q4.

As regards the risk of a Credit Event occurring, we believe that the sharp rise (bear steepener) in US Treasury rates absolutely confirms our fears as to this possible outcome as it reflects very real investor concern as to the ability of the US to continue to credibly finance its budget deficit without resorting to either the printing press and/or engage in YCC. The higher rates being demanded by investors drive to the very heart of the problem, namely the vast amount of capital misallocation which occurred during the misguided era of ZIRP and NIRP.

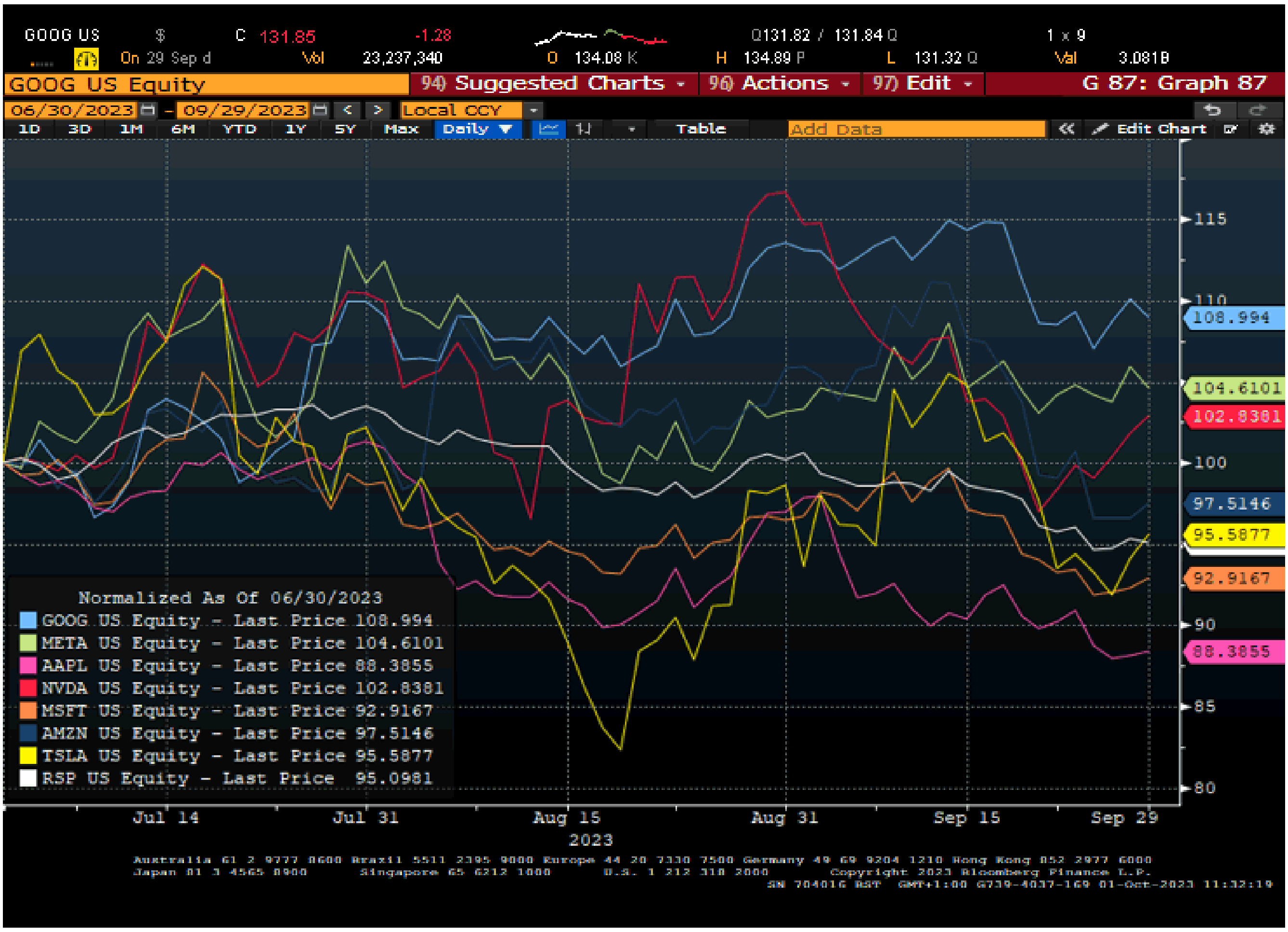
The shadow banking system, as its name implies, allows for credit misallocations to occur at an industrial pace, (apologies for the poor pun), where loan covenants are light to non-existent and where mark-to-market "valuations" are pretty much a function of management "interpretation".

Higher interest rates always, and we mean always, eventually expose bad loans. It is just a question of time. Sub-Prime was a classic example of this. From the first red flags being raised to the final collapse took over 6 years, (Robert Prechter first highlighted the "giant house of cards" in the property market in a book he wrote in 2002). But being early is as bad as being wrong, so we need to be patient, but that does not mean the risk is real and potential catastrophic.

As regards the "AI bubble" we have seen some very slight profit taking over Q3, but on the whole the theme still garners good investor support. We did mention in our last report that given the extreme valuation in some AI related names that perhaps dispersion strategies were perhaps the best way to play this theme. As the graph below shows that would have been a profitable trade over the quarter (without taking directional risk) as the dispersion of returns between the best performing stock (Google +9%) and the worst (Apple -12%) was 23%.

Given our assessment of a changed risk outlook moving into year-end we would expect equity investors to begin to rotate into more defensive sectors over the course of the quarter.

Chart 6: The Magnificent Seven vs S&P 500 Equal Weighted Index - Q3:



Source: Bloomberg

In conclusion, we think Q3 will go down as a key inflection point as regards investors revised perception towards the outlook for the US economy going into 2024. As if economic headwinds were not enough next year is likely to see one of the most polarised and contentious Presidential elections ever witnessed in the US. With Donald Trump so very far ahead in the polls for the Republican nomination (according to a recent CNN poll he is currently supported by close to 58% of the GOP primary electorate, 43 points ahead of the next closest rival Ron DeSantis), we could have the absurd prospect of a Republican nominee who has one, if not more, criminal convictions against his name standing for President of the USA !

One of the key attractions for investment into the US over the years has been the belief that the country possesses a stable political system with a responsible attitude to managing the economy. Whilst those two essential elements still remain a positive factor, investors are increasingly beginning to question just how long this state of affairs will continue. We do not expect a dramatic reallocation from investors away from the US, but we do expect this trend to begin to gain traction in the years ahead.

Whilst we of course seek to remain impartial in any debate as to the eventual outcome of the US elections we can't help thinking that with the electorate facing a choice between Joe Biden and Donald Trump it will be a case of: "fool me once, shame on you, fool me twice, shame on me".

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.

Shard Capital Jersey,
3rd Floor, 5 Anley Street,
St Helier, JE2 3QE,
Jersey.

Telephone: +44(0) 1534 500 040
Email: Info@shardcapitaljersey.com
Web: www.shardcapitaljersey.com

Disclaimer:
We try to ensure that the information provided is correct, but we do not give any express or implied warranty as to its accuracy. We do not accept any liability for errors or omissions. The content of this brochure is for guidance purposes only and does not constitute financial or professional advice.

This document has been prepared and issued by Shard Capital (Jersey) Limited ("Shard Capital"). Shard Capital is a limited company (reference no. 130205) with its registered office at 3rd Floor, 5 Anley Street, St Helier, Jersey JE2 3QE. Shard Capital is authorised and regulated by the Jersey Financial Services Commission for Investment Business under the Financial Services (Jersey) Law 1998.

IMPORTANT INFORMATION

Shard Capital (Jersey) Limited is an associated company of Shard Capital Partners LLP, a limited liability partnership registered in England and Wales (Company No. OC360394). Shard Capital Partners LLP Registered office: 36-38 Cornhill, London, EC3V 3NG. Shard Capital Partners LLP is authorised and regulated by the Financial Conduct Authority in the United Kingdom, reference number 538762.

This document is provided for information purposes only and is intend for confidential and sole use by the recipient. It is not to be reproduced, copied or made available to others. The information set out in this document does not constitute investment advice or a personal recommendation. The views expressed in this document are not intended as an offer or a solicitation, to purchase or sell any security or other financial instrument, credit or lending product or to engage in any investment activity.

Past performance is not a guide to future performance. It is important that you understand that with investments, your capital is at risk. The value of investments, as well as the income derived from them, can go down as well as up and investors may get back less than the original amount invested. It is your responsibility to ensure that you make an informed decision about whether to invest with us, based on your particular objectives. If you are still unsure if investing is right for you, please seek independent advice.

The information and opinions expressed within this document are the views of (the company) and are based on information we believe to be reliable, but we do not represent that they are accurate or complete, and they should not be relied upon as such. Any information provided is given in good faith but is subject to change without notice.

No liability is accepted whatsoever by (the company) or its employees and associated companies for any direct or consequential loss arising from this document.