Shard Capital

Quarterly Insights - Q4 2023

"A PESSIMIST SEES THE DIFFICULTY IN EVERY OPPORTUNITY; AN OPTIMIST SEES THE OPPORTUNITY IN EVERY DIFFICULTY."

WINSTON CHURCHILL

2023 was perhaps proof that pessimism makes headlines, whilst optimism makes money.

SUMMARY

- **2023 Review……………………………………………………………………………………………Page 3**

  Developed economies in the west benefitted from disinflation, robust labour markets, and continued upside surprises to consumption. The arrival of Large Language Models (LLM) boosted AI to the top of every CEO's to-do-list, and the 'Magnificent 7' benefitted from FOMO as every investor and his dog seemed to be chasing the new narrative. Most investors however misjudged the multiplier effects from fiscal policy and the benefits this brings from a liquidity perspective. The cherry on the cake was the long-awaited and much anticipated Fed-Pivot. What a year it was!

- **Outlook……………………………………………………………………………………………Page 8**

  Despite strong labour market and consumption data, we continue to see more downside risks than upside surprise potential from a consumption perspective. That said, from an investment perspective, the opportunity set is as attractive as it has been in years. We see significant value in US treasuries, locking in real yields not seen in a long time. Emerging market equities offer attractive asymmetry, whilst our long-term thematic exposure underpinned by secular changes in society continues to offer exciting opportunities. Finally, we remain very bullish on the intersection of managed futures and ETFs, which both play a key role in our portfolios.

- **Consumption……………………………………………………………………………………Page 10**

  The US consumer has been the backbone of market strength over the last year. However, given the cost-of-debt, dwindling excess savings and the resumption of student loan payments, the outlook is deteriorating faster than investors believe.

- **Growth………………………………………………………………………………………………Page 14**

  Developed economies have defied expectations – and fears of secular stagnation, a hard landing and recession – and sentiment continues to improve. We note however the long and variable lags that monetary policy inevitably have on prices, and the importance of prices in economic growth often being misunderstood. Whilst the probability of the 'soft-landing' narrative remains achievable, sustained drivers of demand looks to be waning at the same time as geopolitics and

macroeconomic uncertainty looks set to rise. Alongside risks to consumption, we believe downside risks to economic growth remain significant.

- **Inflation……………………………………………………………………………………………………Page 17**

Cost-push inflation is a transitory factor. It is an outcome of fiscal and monetary excesses, often caused by policy decisions. To be clear, the significant rise in the cost of living during this cycle has been a direct consequence of massive fiscal stimulus via transfer payments along with central banks' dramatic balance sheet expansion. We have not created or increased structural demand drivers and secular deflation continues to be the primary risk on the horizon.

- **Liquidity……………………………………………………………………………………………………Page 19**

Many investors misjudged the benefits and liquidity boost resulting from fiscal policy decisions and the slowdown in balance sheet contraction in major economies globally. These trends are set to continue as we enter an election year for the ages. At the same time, tightening monetary policy has peaked and the marginal change will likely further support much needed market liquidity, and indeed, borrowing costs. The canary in the coalmine might be rising term-premia!

- **Secular Themes………………………………………………………………………………………Page 22**

In many ways we are entering a 'new roaring-20's'. The arrival of Artificial Intelligence and the convergence of AI, digitalization, and healthcare represent one of the most exciting advancements we've ever witnessed. Indeed, we believe innovation is accelerating and the resulting investment opportunities will continue to increase. In this section, we lay out our investment themes and a brief thesis.

2023 REVIEW

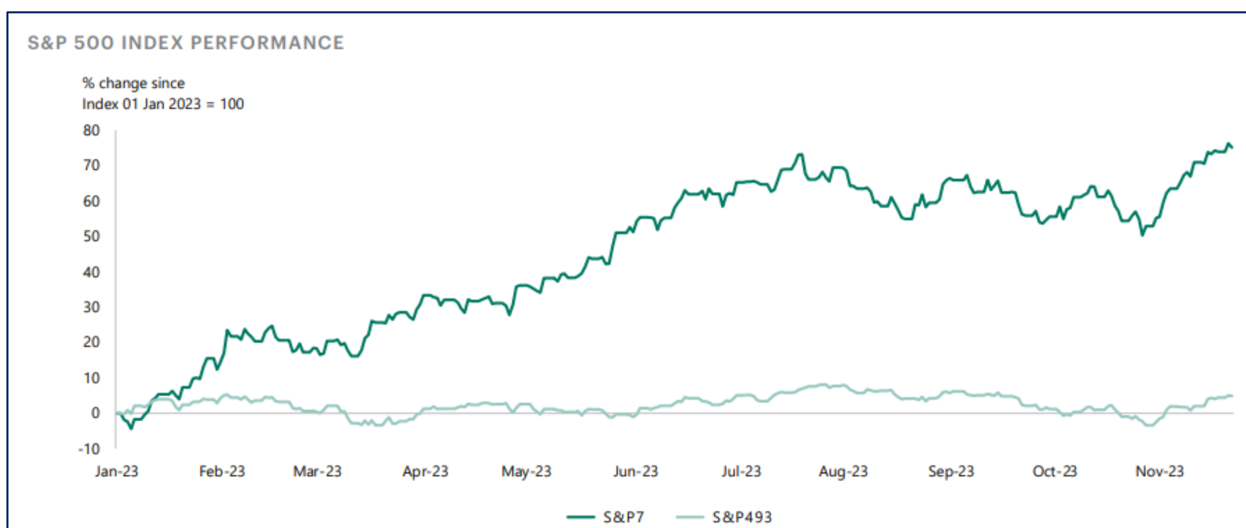
2023 seemed like the year that never was. The year where leading indicators failed everyone whilst narratives waxed and waned.

We came into 2023 with a record number of economists and market pundits predicting a recession along with sustained inflation pressures: 1970's-style stagflation. Alongside every economist alive, our primary question coming into the year was when the recession will hit western economies… Alas.

Whilst we expected inflationary pressures to dissipate over the course of the year, we misjudged the multiplier effect of fiscal stimulus that was being pumped into the system. U.S. consumers defied expectations and continued spending like the world is about to come to an end. Despite higher interest rates, record levels in the cost-of-debt, rising delinquencies and a continued contraction in bank lending, consumption seemed to only surprise the upside. I was again reminded of what a portfolio manager in New York once told me in the immediate aftermath of the Global Financial Crises: "never bet against the US consumer". How true that was in 2023.

That, and the arrival of AI boosted sentiment and equity markets alike. The FAANG acronym is now part of history books, and the new narrative is the 'Magnificent Seven'. Every man and his dog seemed to pile into these seven companies, underpinned by the AI-narrative and FOMO.

Exhibit 1: During the first 11 months of 2023 the Magnificent 7 practically made up ALL the returns equity investors experienced:

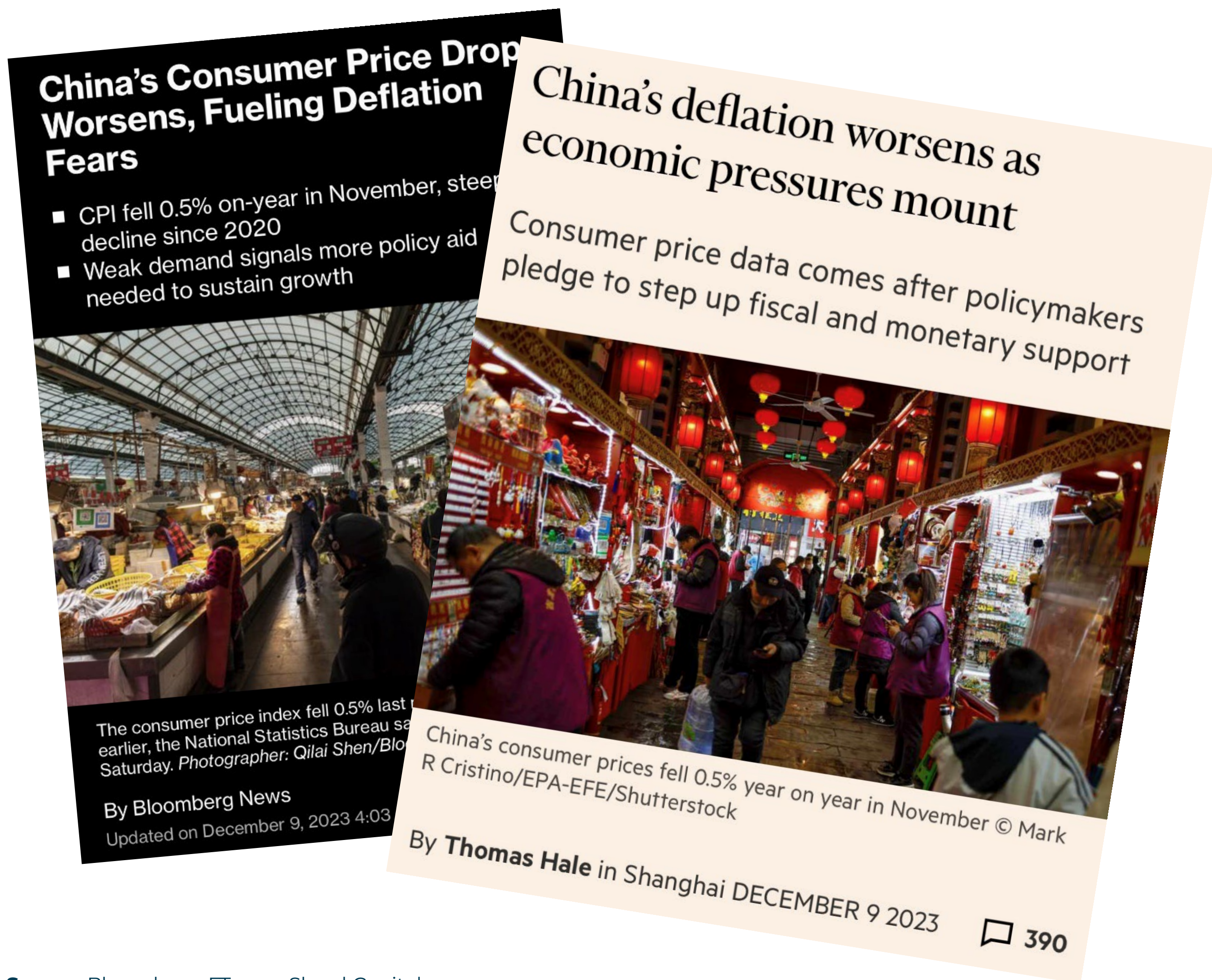


Source: Apollo Academy: The Daily Spark, Bloomberg, Apollo Chief Economist
Note: The S&P 7 are Apple, Microsoft, Alphabet, Amazon, NVIDIA, Meta and Tesla.
Date: 29/11/2023

The battle between Bulls and Bears took several turns over the course of the year, but Jay-POW delivered a final blow at the last Federal Open Market Committee (FOMC) meeting of the year and knocked-out any remaining bears when the long-awaited 'Fed-Pivot' finally arrived. Below we elaborate on the consequences of, and indeed the rationale for, the Fed-Pivot. However, suffice to say that it was the catalyst that propelled markets into Christmas.

Perhaps one of the biggest surprises of 2023 was the lack of any sort of recovery in Chinese economic activity. Rather, the property crises seemed to deepen and risks a Japan-style deflation start to make headlines. Chinese equities ended up being the worst performing major asset class globally as investors' fears continued to mount.

Exhibit 2: Chinese deflation making headlines:



China's Consumer Price Drop Worsens, Fueling Deflation Fears

- CPI fell 0.5% on-year in November, steep decline since 2020
- Weak demand signals more policy aid needed to sustain growth

The consumer price index fell 0.5% last earlier, the National Statistics Bureau sa Saturday. *Photographer: Qilai Shen/Blo*

By Bloomberg News
Updated on December 9, 2023 4:03

China's deflation worsens as economic pressures mount

Consumer price data comes after policymakers pledge to step up fiscal and monetary support

China's consumer prices fell 0.5% year on year in November © Mark R Cristino/EPA-EFE/Shutterstock

By **Thomas Hale** in Shanghai DECEMBER 9 2023 390

Source: Bloomberg, FT.com, Shard Capital
Date: 09/12/2023

We also experienced the most feeble banking crises in history. SVB was the third largest bank failure in U.S. history, and Credit Suisse was 'bought' by UBS (albeit after intervention of the Swiss Authorities) for a meagre 3bn Swiss Francs. We learned a lot about a modern-day bank-run – no more queues around the block as depositors wait to withdraw their money…rather it now happens digitally after a tweet on a social media platform.

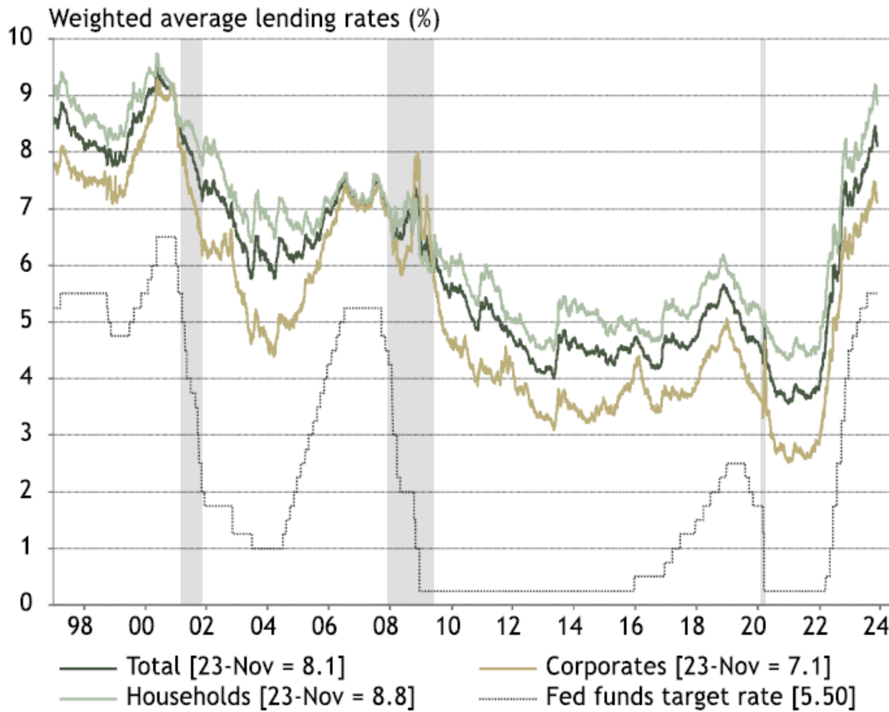
A banking-crises was really avoided thanks to three things:

- Swift intervention from policy makers (the Fed, Treasury, SNB, etc.),
- Strong household balance sheets,
- Duration of corporate debt was significantly extended amid ZIRP in 2020 and 2021.

The latter two are unintentional. The reality is a re-financing cliff still looms large, with billions of dollars of debt needed to be refinanced in the coming years. At current market rates, investors could expect an above average default cycle. Which means two things:

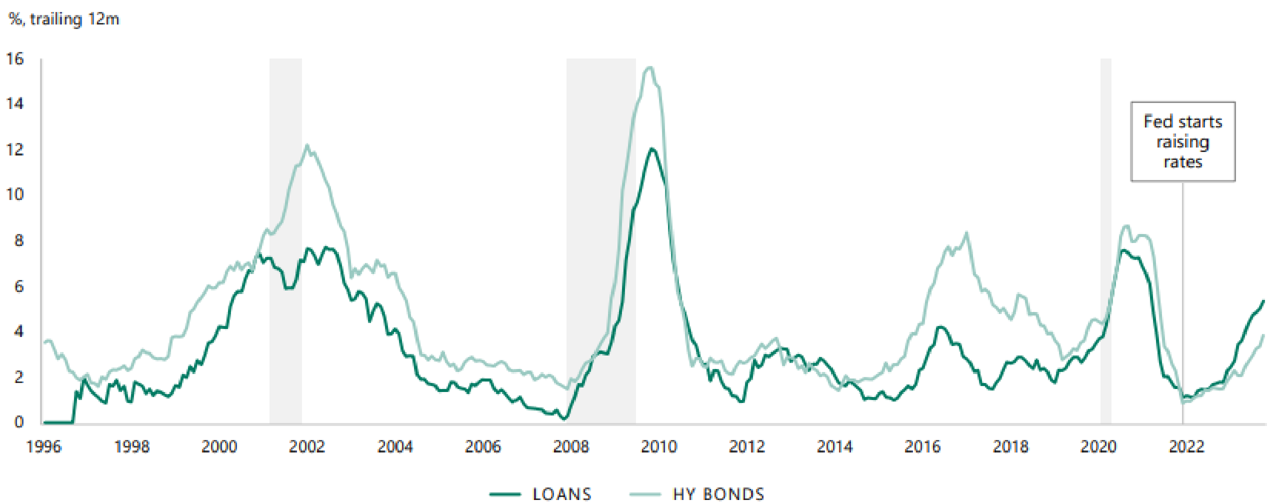
1. Corporate bond investors – especially price-incentive, passive, corporate bond investors – should expect losses. Equity investors in those corporates perhaps even more so.
2. Active distressed debt and private credit investors are licking their lips with the bonanza ahead.

Exhibit 3: Private sector lending rates have hit levels not seen since the dotcom era:



Source: Absolute Strategy Research Ltd., LSEG-Datastream
Date: 23/11/2023

Exhibit 4: A default cycle has started amongst speculative grade and the most leveraged corporate borrowers:



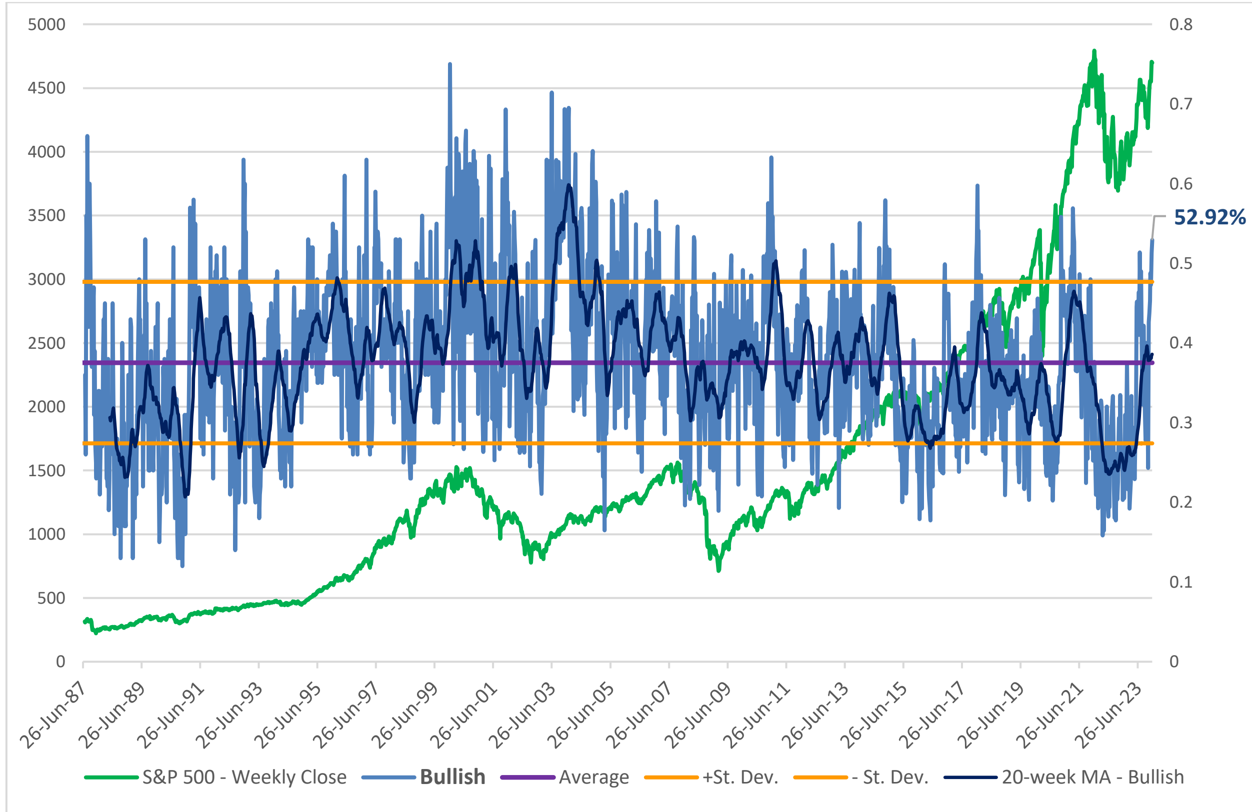
Source: Apollo Academy: The Daily Spark, Moody's Analytics, Apollo Chief Economist
Date: 29/11/2023

As for performance, growth outperformed value, significantly so, very much driven by the Magnificent 7. They are not the only reason however, as the long-duration characteristic of growth equities benefited from the continued decline in inflation and the extreme negative sentiment as markets bottomed in October 2022.

We ended the year on a rather high note. Unless you had a portfolio filled with commodity producers, utility companies and Chinese equities, hedged back into Japanese Yen, you should've done relatively

well during 2023. Despite a difficult first ten months, especially for those companies that do not carry a 'Magnificent' label, a late surge pushed most market indices into the green. Indeed, retail sentiment hasn't been this positive since April 2021 – that's when 'growth' stocks peaked.

Exhibit 5: AAII Investor Sentiment Survey - Percentage of participants with Bullish outlook:



Source: American Association of Individual Investors (www.aaii.com), Shard Capital
Date: 21/12/2023

Exhibit 6: Performance

	Index Series	FX	Last Price	2023	2022	2021	Annualised TR 2013 - 2023	Annualised TR 2003 - 2013	Annualised TR 1993 - 2003
EQUITIES	MSCI AC World Index TR	USD		23.11%	-17.95%	19.05%	8.42%	7.77%	7.0%
	MSCI World Growth Index TR	USD		37.83%	-29.04%	21.41%	11.25%	7.61%	6.18%
	MSCI World Value Index TR	USD		12.65%	-5.77%	22.84%	6.67%	7.52%	8.32%
	S&P 500 Index TR	USD		26.61%	-18.13%	28.68%	11.98%	7.40%	11.06%
	FTSE All-Share Index TR	GBP		7.75%	0.23%	18.29%	5.25%	8.80%	4.80%
	Euro STOXX TR	EUR		19.70%	-11.45%	23.47%	7.45%	6.41%	6.38%
	TOPIX Index TR	JPY		28.25%	-2.48%	12.77%	8.43%	4.02%	-2.33%
	MSCI China TR	HKD		-11.28%	-21.72%	-21.23%	0.68%	12.51%	-13.38%
	MSCI AC Asia Pacific ex-Japan TR	USD		7.88%	-17.01%	-2.52%	4.17%	11.86%	-0.25%
	MSCI Emerging Markets TR	USD		10.02%	-19.80%	-2.32%	2.69%	11.50%	-0.24%
FIXED INCOME	Bloomberg Global Aggregate Index	USD		6.02%	-16.25%	-4.71%	0.33%	4.46%	6.8%
	Bloomberg US Treasury Index	USD		4.08%	-12.46%	-2.32%	1.22%	4.23%	6.69%
	Bloomberg US Corporate Bond Index	USD		8.60%	-15.76%	-1.04%	2.89%	5.33%	7.40%
	Bloomberg UK Government Bond Index	GBP		3.97%	-25.11%	-5.24%	1.19%	5.32%	
	Bloomberg Sterling Corporate Bond Index	GBP		10.04%	-19.28%	-3.26%	3.08%	5.11%	
	Bloomberg EM Hard Currency Aggregate Index	USD		9.07%	-15.26%	-1.65%	2.99%	8.54%	10.68%
COMMODITIES	Gold Spot $/Oz	USD	$ 2,063.73	13.14%	-0.28%	-3.64%	5.50%	11.21%	0.6%
	LME Copper Spot ($)	USD	$ 8,530.25	1.98%	-14.13%	25.70%	1.41%	12.27%	2.75%
	Oil - Brent ($)	USD	$ 77.28	-10.05%	10.45%	50.15%	-3.32%	13.89%	8.62%
	Bitcoin ($)	USD	$ 42,777.44	158.64%	-64.22%	59.79%	50.23%		
CURRENCIES	GBP-USD FX-Rate	USD	$ 1.27	0.24%	-10.71%	-1.01%	-2.62%	-0.75%	1.9%
	EUR-GBP FX-Rate	GBP	£ 0.87	-0.61%	5.23%	-5.86%	0.43%	1.64%	-0.75%
	USD-JPY FX-Rate	JPY	¥ 141.68	3.92%	13.94%	11.46%	3.06%	-0.18%	-0.42%
	EUR-USD FX-Rate	USD	$ 1.11	0.87%	-5.85%	-6.93%	-2.19%	0.88%	1.14%

Source: Bloomberg L.P.
Note: Data for Equities and Fixed Income are based on Total Return, with dividends and interest income reinvested. Data for Commodities and Currencies are based on price change, with no interest or dividend income.
Date: 28/12/2023

"THE IDEA THAT THE FUTURE IS UNPREDICTABLE IS UNDERMINED EVERY DAY BY THE EASE WITH WHICH THE PAST IS EXPLAINED."

DANIEL KAHNEMAN, THINKING FAST & SLOW

2024 OUTLOOK

We always remind our clients, colleagues, and indeed ourselves: predicting the future is futile. Positioning your portfolio with this fundamental truth in mind, goes a long way to mitigating many unknown-unknowns. However, understanding pay-off profiles, probabilities and correlations, and crucially, the value of your assets, is essential in creating a portfolio with an asymmetric return profile.

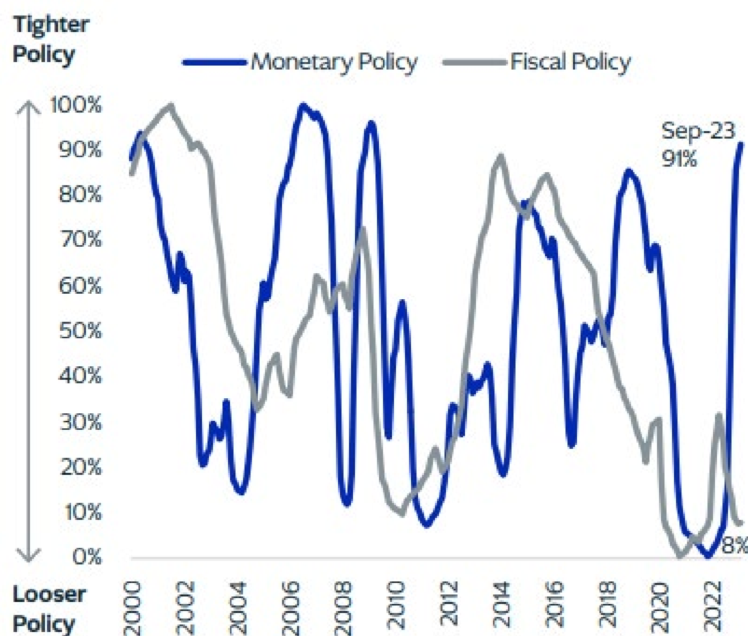
The Fed-pivot on 13 December was a key signal that global macroeconomic risks are shifting. Effectively the members of the FOMC are signalling that inflation is less of a risk going into 2024 whilst growth and consumption risks are rising. We agree with this notion.

At the same time, we expect central banks globally to stop tightening monetary policy – i.e., policy rates have peaked – and the marginal change in liquidity will lower borrowing costs, and support sentiment and much needed investment.

Finally, consumption has been the key driver of economic growth in developed economies, accounting for over 70% of US Gross Domestic Product (GDP), 52% of the EU's GDP and c.63% of UK GDP. Consumption is the backbone of the credit-based economic structure we have created. However, downside risks to consumption are significantly greater than capital markets are pricing, and a material risk in the year ahead.

Investors underestimated the importance of fiscal policy and the effect this has on aggregate demand. Over the course of the last few months, fiscal policy has had a meaningful impact on labour markets, especially government employees, wages and liquidity more broadly. Thus, a key question for 2024 is: "which one will mean revert: fiscal or monetary policy?"

Exhibit 7: Whilst monetary policy has been the brakes to combat inflation, fiscal policy has been the accelerator to support the economy:



Source: https://www.kkr.com/insights/outlook, KKR Global Macro & Asset Allocation, Bloomberg, Shard Capital
Note: Monetary policy measures the difference between real Fed Funds and potential GDP growth. Fiscal tightness measures the difference between the budget deficit and U.S. output gap as a % of GDP.

Date: 30/09/2023

Both cannot be sustained. With prevailing policy rates, refinancing rates are too high, corporates are bust, and property is too expensive. On the other hand, governments can only fund deficits until the market lose confidence in their ability to fulfil their promise and repay debt – they can't borrow into infinity!

Given over 50% of the global population will cast a vote in 2024, including the United States, our base case is rates will come down whilst deficits are likely to be maintained. This is a major boon for economic growth, sentiment and market liquidity.

If labour markets and consumption remain robust, we see limited interest rate cuts. However, if consumption slows materially and trends in labour markets continue to worsen, central banks are likely to cut sooner and more materially than markets expect, with the Federal Reserve likely to be the leader.

This leads us to conclude that 2024 will take one of two paths:

- **Scenario 1:**
  Labour markets remain stronger than expected and employment above historic averages. The Federal Reserve and other central banks cut rates, but not meaningfully, and whilst growth slows, developed economies, and indeed emerging markets, do not enter a recession. This is the *soft-landing* narrative. This outcome will be positive for risk assets, but would benefit emerging market equities more than developed market equities, which will likely outperform credit markets. Whilst government bonds will lag, they are likely to deliver positive returns.

- **Scenario 2:**
  The long and variable lag of monetary policy – and the cost-of-capital – and a dwindling consumer, impacts consumption to the extent that it impacts aggregate demand. Economic growth deteriorates quicker than expected, market liquidity tightens, spreads blow out, bankruptcies rise, equity prices fall, and unemployment increases. This is the *hard-landing* narrative. This outcome will be negative for risk assets, but most pronounced in unprofitable and / or expensive equities, with high quality companies with stable and growing cash flows outperforming. Credit markets will struggle as credit risks rise, passive flows evaporates and liquidity fades. Significant rate cuts – not to zero however – will result in very attractive returns in hard currency government bonds.

In neither scenario is inflation a problem. As we discuss below, we do not believe inflation is a significant risk for the foreseeable future. At some point, governments and central banks will dust off the money printers to fund liabilities and the resulting monetary devaluation will push prices up again. However, we do not see this happen in 2024 unless there is a very material rise in unemployment alongside an extreme default cycle. A longer-term concern however is that the marginal benefit of further quantitative easing (QE) and debt creation to fuel growth continues to deteriorate as the incremental capital-output ration rise. This is the same risk with fiscal spending today. It is unknown how much emphasis the market will put on ballooning deficits – but we do not expect term premia to decline.

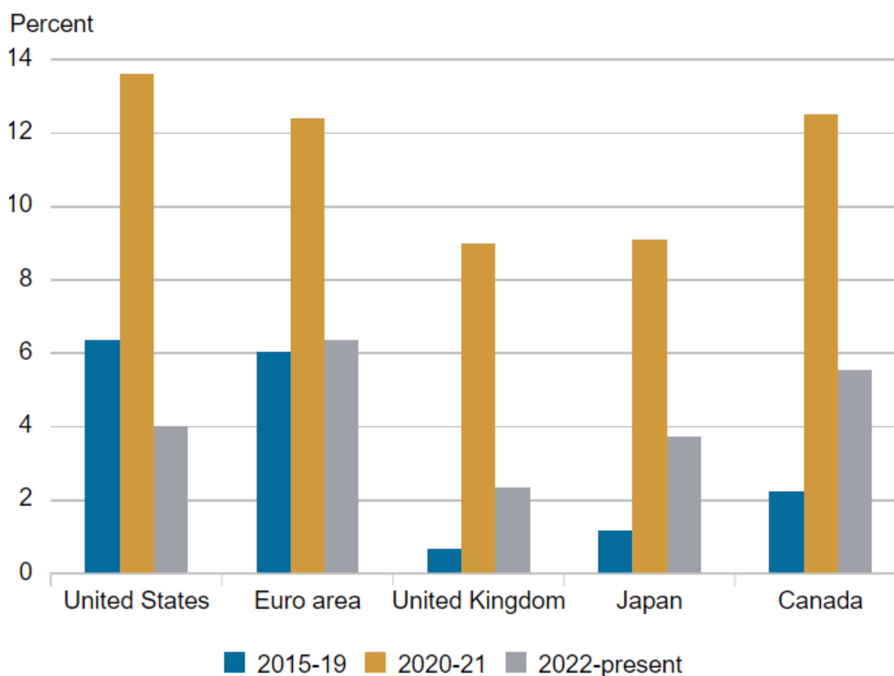
On the margin, we believe scenario 1 is less likely, and even if equally likely, positioning for scenario 2 offers a more asymmetric expected return.

CONSUMPTION

Current market expectations are overly fixated on the potential for positive surprises whilst disregarding mounting downside risks. Two key factors, unrelated to interest rates, are likely to impact consumption in 2024. These are dwindling household excess savings and the resumption of student loan payments. Not only are these independent of policy rates, but they are generally disregarded by investors. The convergence of these factors is likely to materially impact consumer spending, aggregate US demand, and global output.

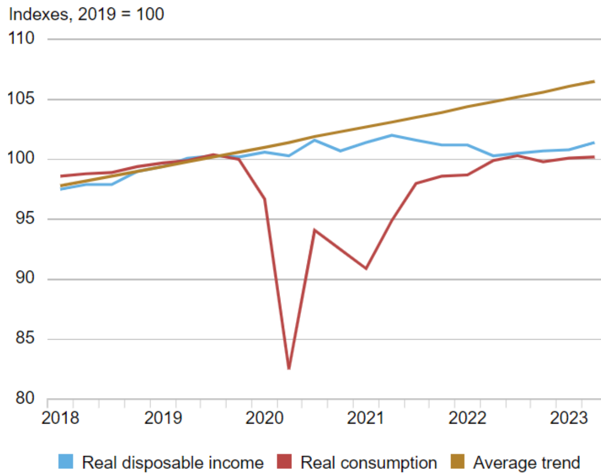
The surplus savings accumulated by U.S. households during the pandemic is very much a U.S. phenomenon and has resulted in abnormal spending behaviour. The Mental Accounting model would suggest consumers spend money they received during the pandemic far less thoughtful than they would have if it was proceeds of hard-earned labour. Despite higher rates, declining house prices and deteriorating consumer sentiment – all historically correlated with greater propensity to save – the U.S. consumer continue to deplete financial reserves to levels well below historic averages.

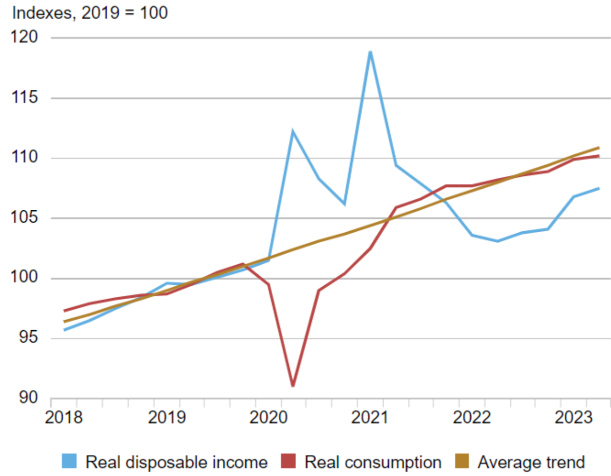
Exhibit 8: Unlike most rich countries, household savings rates in the United States are well below pre-pandemic levels:



Source: U.S. Bureau of Economic Analysis, Eurostat, UK ONS, Japanese Cabinet Office, Statistics Canada, Liberty Street Economics
https://libertystreeteconomics.newyorkfed.org/2023/10/spending-down-pandemic-savings-is-an-only-in-the-u-s-phenomenon/
Date: 11/10/2023

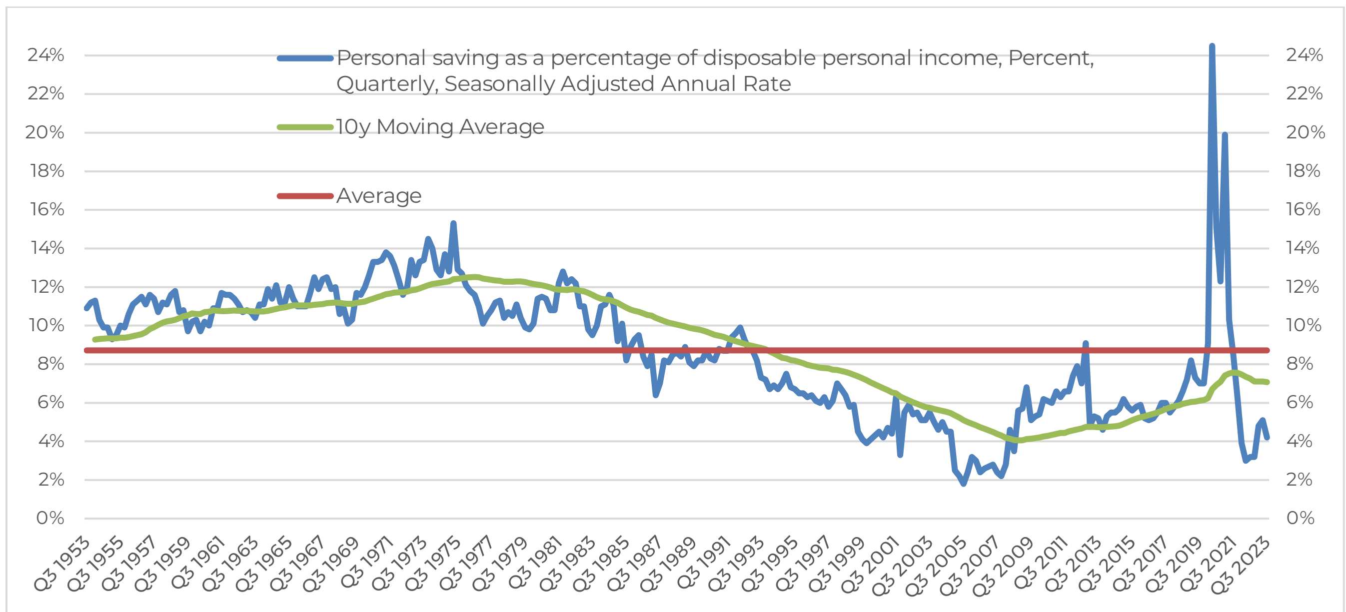
Exhibit 9: Consumption in the US has far outpaced real income levels, unlike other rich economies:





Source: Liberty Street Economics, New York Fed
https://libertystreeteconomics.newyorkfed.org/2023/10/spending-down-pandemic-savings-is-an-only-in-the-u-s-phenomenon/
Date: 11/10/2023

Exhibit 10: Personal savings as a % of disposable income is severely depleted. Increasing levels will come at the cost of lower consumption.



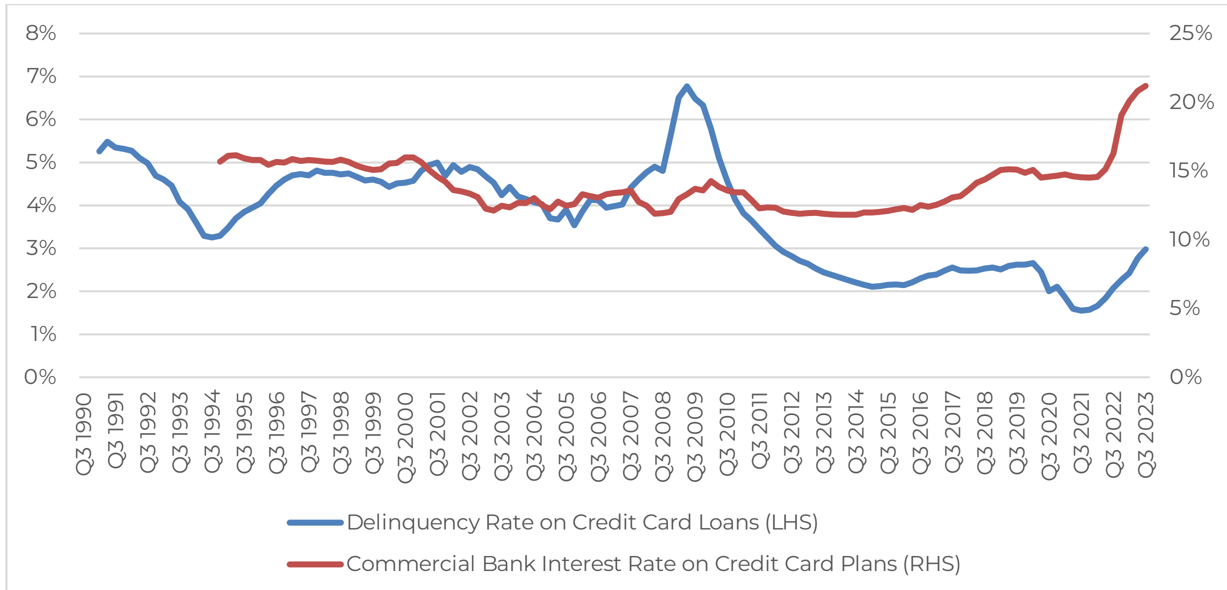
Source: fred.stlouisfed.org, Shard Capital
Date: 30/09/2023

Whilst the American consumer have not completely exhausted their resources, it is anticipated that their economic influence will diminish considerably in 2024.

Worth noting is outstanding credit card balances in the United States surpassed $1 trillion in 2023. This milestone was achieved at the same time as the interest rate charged on credit cards have hit record highs. Suffice to say that this is a major concern for household finances and consumer spending

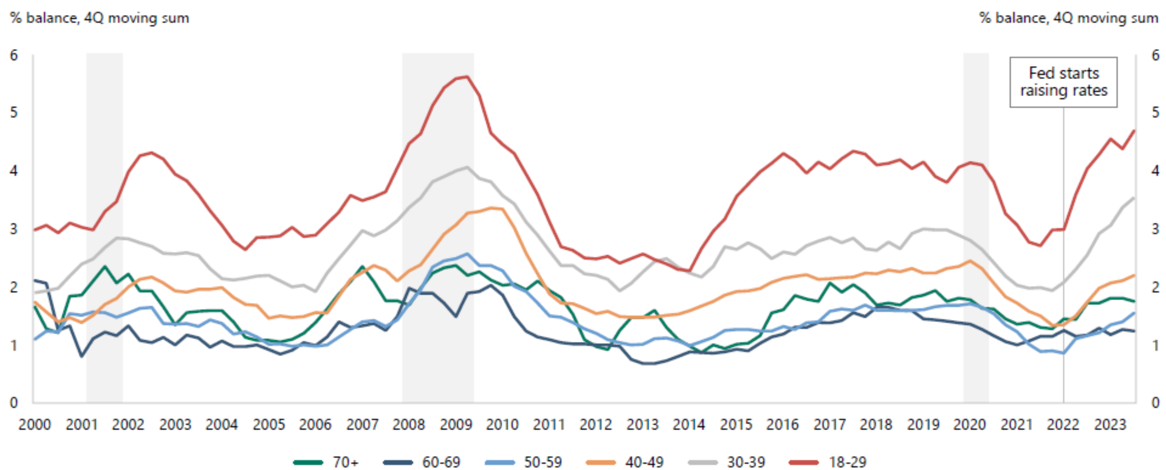
going forward. We have also seen a pick-up in delinquency rates, and whilst a long way off the highs seen during the GFC, the trend is worrisome.

Exhibit 11: Trends is credit card and auto loan delinquencies are worrisome, especially in the face of record levels in the cost of borrowing:



Source: fred.stlouisfed.org, Shard Capital
Date: 30/09/2023

Exhibit 12: Auto-loan delinquencies are especially worrisome and reaching levels last seen in 2008:



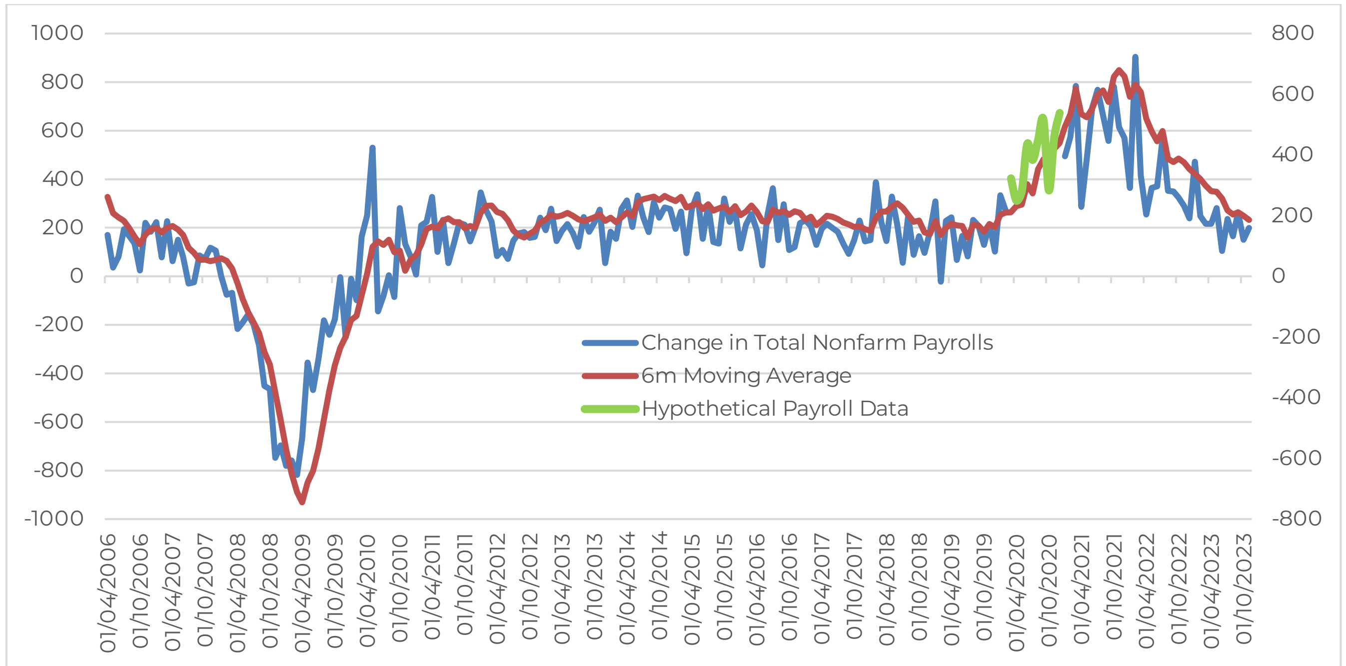
Source: Apollo Academy: The Daily Spark, New York Fed, Haver Analytics, Equifax Apollo Chief Economist
Date: 29/11/2023

Labour markets remain strong, but we note that employment is a lagging indicator – it has no statistical efficacy in predicting economic weakness. In fact, it's the opposite: economic weakness is a very reliable indicator of future unemployment. That said, since the fed started raising interest rates, a meaningful slowdown in labour activity has been witnessed. It is worth considering that labour market strength and activity is coming off very high levels following lockdowns during the pandemic and subsequent recovery. A slowdown can be seen as merely a normalisation of labour markets and

despite increasing interest rates, labour markets have maintained relative strength throughout the past year.

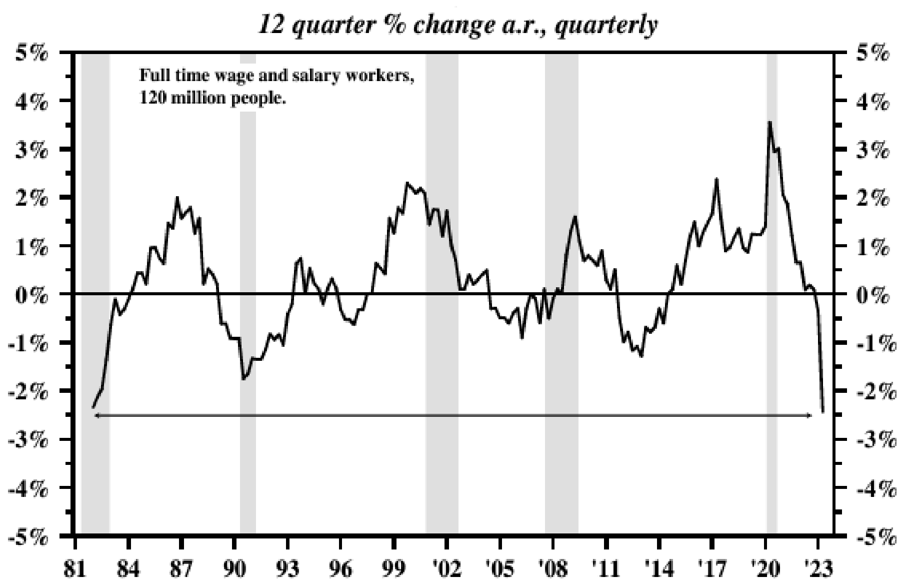
As for wage growth, commentary has been focused on the strength in nominal terms. But once considering wages in real terms, a different picture appears, one that clearly highlights consumers' struggle with the cost of living.

Exhibit 13: Since the Federal Reserve starting hiking rates in March 2022, changes in monthly nonfarm payroll data have slowed materially. Keeping rates where they are would suggest a continuation of this trend:



Source: fred.stlouisfed.org, Shard Capital
Date: 30/09/2023

Exhibit 14: Real Average Weekly Earnings – Full Time Wage and Salary Workers:



Source: Hoisington Investment Management, Federal Reserve Board, Bureau of Economic Analysis
Date: 30/06/2023

ECONOMIC GROWTH

"The long history of business cycles illustrates that rising inflation precedes recessions. Inflation accelerations don't just happen, they are caused. Accordingly, a more complete description of these aggregate fluctuations is that monetary accelerations precede rising inflation, which then requires monetary decelerations that inevitably lead to recessions. Thus, monetary policy actions are pro- rather than counter-cyclical and the financial cycle will continue to lead the GDP and price/labour cycle."

Source: Hoisington Investment Management, Quarterly Review and Outlook, Third Quarter 2023
https://hoisington.com/pdf/HIM2023Q3NP.pdf

Developed economies have defied expectations – and fears of secular stagnation, a hard landing and recession – and sentiment continues to improve. We note however the long and variable lags that monetary policy inevitably has on prices, and the importance of prices in economic growth often being misunderstood. Whilst the probability of the 'soft-landing' narrative remains achievable, sustained drivers of demand looks to be waning at the same time as geopolitics and macroeconomic uncertainty looks set to rise. Alongside risks to consumption, we believe downside risks to economic growth remain significant.

This brings us to the recent Fed-Pivot. As mentioned previously, our view is that the more dovish tone is a reaction to shifting macroeconomic risks. Specifically, The Fed has signalled that inflation risks are decreasing whilst economic growth and consumption risks are rising.

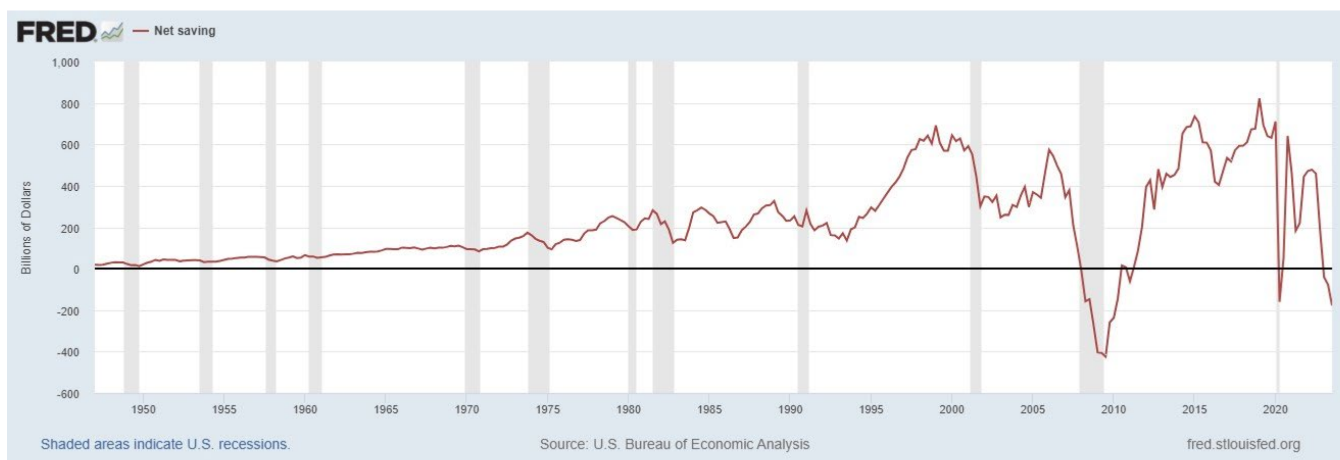
One factor we believe the bears misinterpret is the extent to which boomers can work longer – effectively remaining in the labour market beyond expected levels. This is merely a hypothesis, but it is not unimaginable and the benefits to consumption would be very significant.

Regardless, uncertainty remains and risks are increasing. Whether the Fed models are telling them something we don't know, or whether they are indeed ahead of the curve remains to be seen. However, policy actions and spending behaviour during and post-pandemic have resulted in negative net national saving.

Net saving comprises three elements: private saving (from households and businesses), foreign saving (inverse of the current account), and government saving (the inverse of government spending). Adequate saving is essential for the sustained growth of a country's capital stock, and it is crucial for budget deficits to be reduced during economic expansions so that when bad times hit, we are able to fight back. Without it, when a downturn occurs, private saving declines, and government dissaving increases due to a surge in spending and a drop in tax collections.

Net National Saving has gone negative only once before in history, during the global financial crash (GFC). Current levels will significantly impair economic growth well after the Fed start to cut policy rates. Indeed, the coming downturn may send net national saving even more deeply negative.

Exhibit 15: 'Saving for a rainy day' has been thrown away:



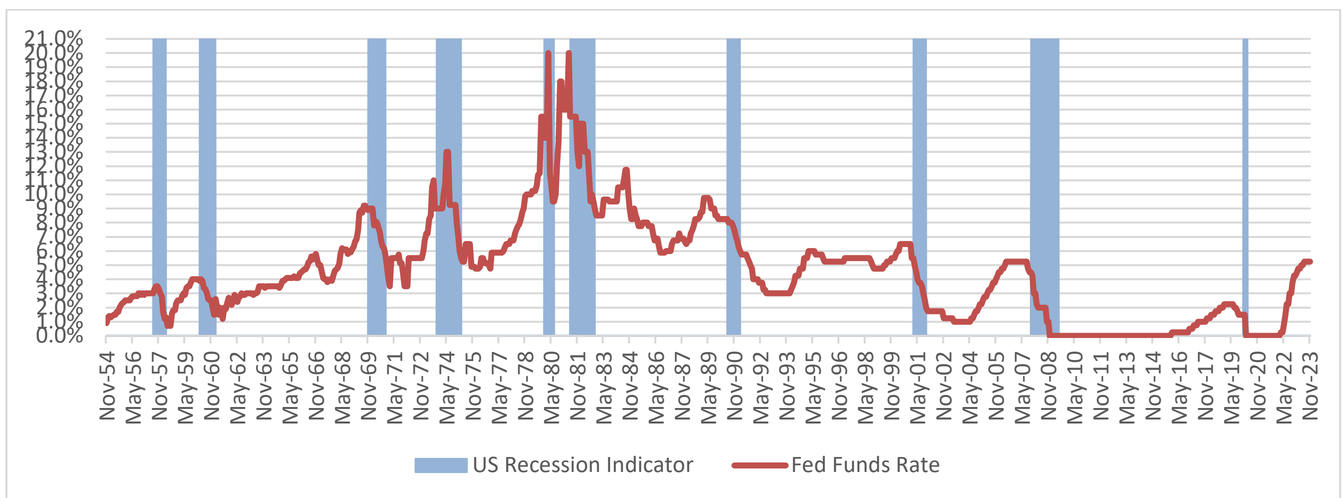
Source: fred.stlouisfed.org
Date: 30/09/2023

But predicting economic growth is hard. Modelling it is even harder. The reality is, we only have a few data points over the last 100+ years, not enough to give our statistical models any significance or put a meaningful probability behind it. Most leading indicators suffer from this problem. Whilst many of them carry sufficient fundamental and theoretical weight, what will cause the next recession, how it will play out, and how it will differ from recessions in the past, is relatively unknown. With the exception of a few factors: consumption will drop, prices will fall, inflation will turn into deflation, and fear will result in selling pressures, exacerbating liquidity risks. But these are all consequences, we need to see output slow meaningfully before these events will occur.

As for the averages, here's some data to ponder:

- On average a recession in the US occurred 9 months after the final rate hike.
- The longest duration between the final hike and a recession was 18 months, which occurred in June 2006.
- The first rate cut typically occurs 8 months after the last hike.
- The last Fed rate hike was in July – we are five months in!

Exhibit 16: 'The Fed Funds Rates vs US Recessions – hiking typically cycles precedes recessions:



Source: Bloomberg L.P., Shard Capital
Date: 30/11/2023

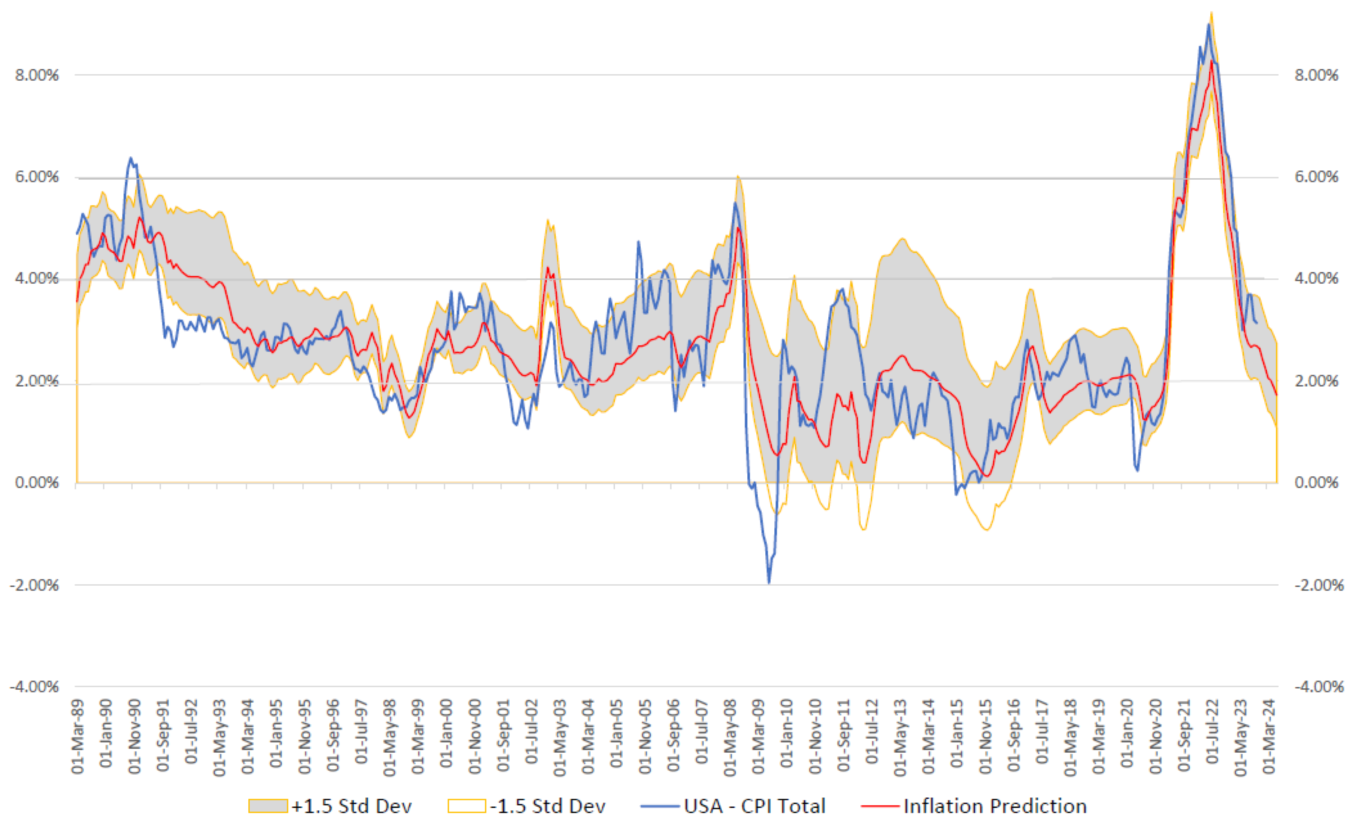
INFLATION

To confirm, the significant rise in inflation this cycle was a consequence of massive fiscal stimulus via transfer payments along with central banks' dramatic balance sheet expansion. Giving millions of people money, and then telling not to spend it until the authorities decide otherwise, is like putting inflation pressures in a pressure cooker... and then waiting to see what happens!

Even in normal circumstance, the extent of M2 growth in all major economies globally would've likely created inflationary pressures. The pandemic lockdowns intensified these pressures, and the extent to which it played out. The energy crises resulting from Russia's invasion of Ukraine further exacerbated these inflationary pressures. There were arguably some thoughts put into the timing of the invasion.

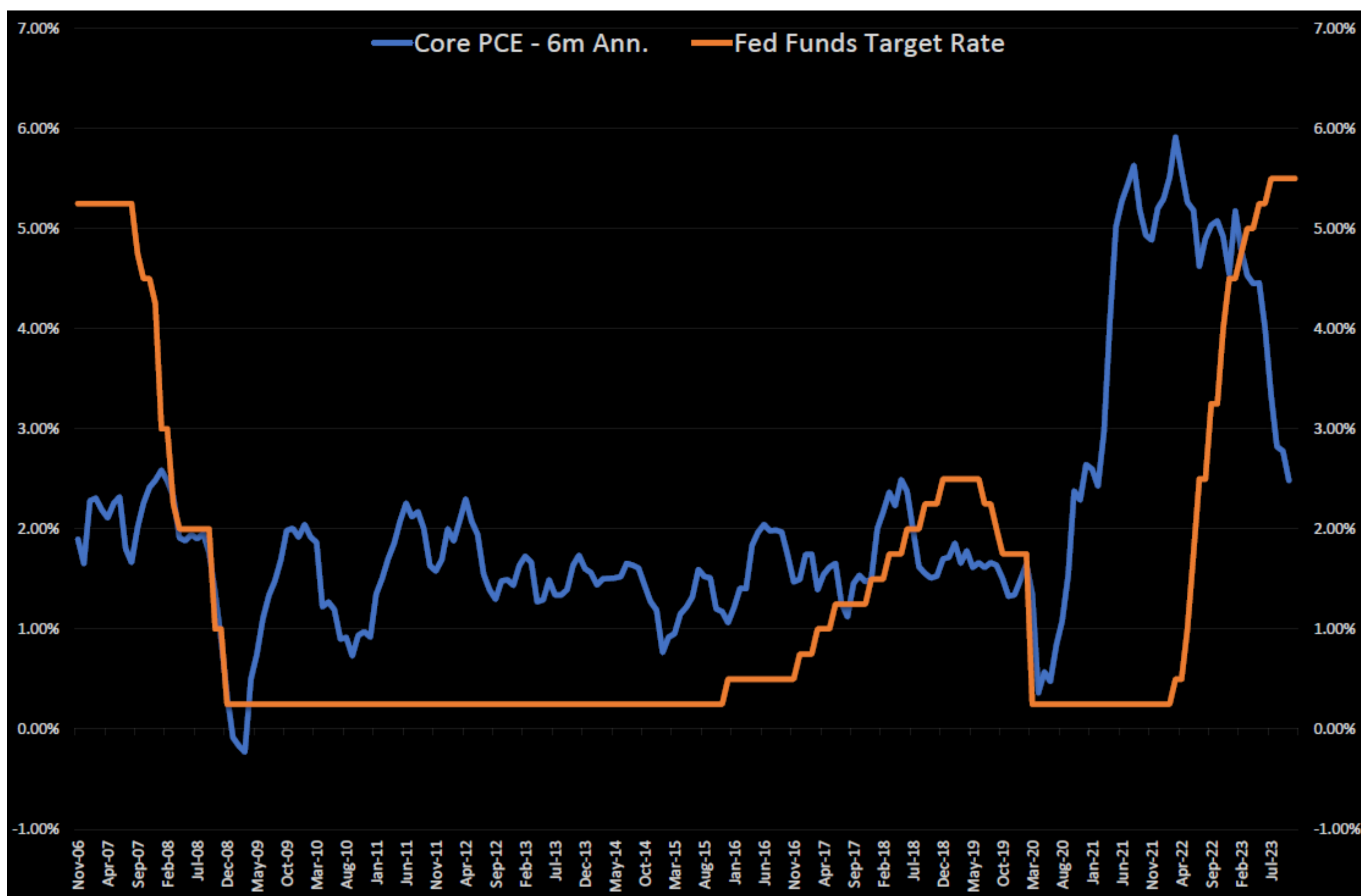
However, these factors are now behind us.

Exhibit 17: Our inflation model continues to suggest inflation pressures are abating and will continue to fall:



Source: Shard Capital
Date: 29/11/2023

Exhibit 18: The Feds 'favourite measure' of inflation is showing similar trends:



Source: Bloomberg L.P., Shard Capital
Date: 29/11/2023

But what about labour shortages and aging populations, the deglobalisation and / or the localisation of supply-chains and the energy transition?

It's worth noting that these are costs, and are typically transitory in nature. Demand is they key driver of structural inflation, and we lack drivers of demand. The energy transition for example, is well underway in Europe. However, pre-pandemic it has had no consequence on inflation. This dynamic will not suddenly change. Labour shortages will have a negative effect on productivity, and aging populations, when I last looked, was deflationary.

As for deglobalisation, our primary working assumption is that the private sector will carry these costs given governments are more inclined to cover social security expenses, healthcare, pensions, military, and of course... interest on debt. The best-case scenario is it implies private sector spending is merely diverted elsewhere, having significant deflationary consequences elsewhere in the supply chain as demand falls. A worst-case scenario is costs are passed on to the consumer that is running out of savings, ultimately weakening output.

To be sure, for inflation to be sustained we need increasing demand. Either more working people or more debt. As population growth slowed in developed economies over the last 40 years, we have relied on credit creation to sustain growth whilst the cost-of-capital were artificially suppressed by policy makers. This era is coming to an end.

LIQUIDITY

Liquidity pressures bottomed-out in October 2022, marking a slowdown in the contraction of central bank balance sheets for major economies. This trend of improving liquidity is expected to persist into 2024, particularly as we enter the election year in many large global economies.

Indeed, fiscal policy has been the accelerator supporting market liquidity over the past year. Many investors globally misinterpreted this liquidity boost and were overly fixated on monetary policy and tightening from central bank hiking cycle.

Exhibit 19: Global Liquidity is set to turn positive:

Source: Global Macro Investors (GMI), Raoul Pal, LSEG-Datastream
Date: 30/09/2023

Contrastingly, policy rates, acting as a brake on economic activity, are now poised to loosen. Our current view is that rates will remain higher for longer, at least in the absence of worsening consumption and labour markets. However, the marginal change will be positive. We are highly unlikely to see further rate hikes from the Federal Reserve (Fed), the Bank of England (BoE), or the European Central Bank (ECB). It is perhaps worth noting that the inflation objective has not been achieved. This could mean there is still a propensity amongst central bankers to continue to tighten. However, we also believe they are aware that inflation is a lagging economic indicator, and as such would be more proactive in cutting rates on economic weakness.

Term premiums in the US have been rising recently, a result not linked to longer-term inflation or growth expectations, but rather stemming from rising uncertainty in supply-demand dynamics of US Treasuries. If it continues to rise, it will increase borrowing costs not only for the US government, but US corporates as well.

Exhibit 20: The 10-year U.S. Treasury "term premium" is rising:

Source: Apollo Academy: The Daily Spark, Bloomberg, Apollo Chief Economist
Date: 29/11/2023

SECULAR THEMES

We are super excited about the future. A new roaring-20! If you read the above, it's clear it will not be a smooth ride... but the opportunity and potential is enormous.

If we can put our differences, beliefs, and opinions aside, we believe we now have the tools to make the world a better place and improve the quality of life of every person. Alas, we have to be realistic, but the opportunity is there!

The arrival of artificial intelligence in the form of Large Language Models and ChatGPT have shown the world glimpses of the potential impacts AI will have on society. Whilst the unknown will also bring with it fearmongering and uncertainty, we believe the benefits AI will bring to society far outweigh the risks. It is too early to identify a 'winner', or indeed how AI will be monetized, if at all. However, in the years ahead we should continue to see corporate and private expansion into the cloud, digitisation of societies integrated with AI-supported systems, an explosion in the adoption of AI-models in digital entertainment, massive efficiency gains in logistics, supply chains, R&D, and many more, and the start of a new and ever greater semiconductor cycle.

Healthcare and health sciences are set to be one of the biggest beneficiaries of AI. And indeed, the need for cost savings in global healthcare systems is dire. We need more healthcare, at a lower cost, so every citizen of the world can have access to treatments and services.

Other secular and thematic opportunities we are excited about include smart and renewable infrastructure and the emerging consumer.

Below, we list the various themes we are excited about and invest in for our clients. One theme to note is inflation as a theme – primarily as we believe our view on inflation is not only significantly different from consensus, but will result in ongoing opportunities for investors to benefit from changes in inflation dynamics.

As ever, if you wish to talk to us about your investment allocations, and ways Shard Capital can help position your portfolios to benefit from the themes mentioned in this article, please contact us using the information on page 22.

	Theme		Description	Thesis
1	**Health Sciences**		Exposure to innovation and deflationary forces in healthcare.	Global Healthcare Systems are too expensive. We expect new technologies with deflationary benefits to receive outsized profits from quicker adoption, both in private and public healthcare models. Scientific advances and the use of AI have allowed for an increased pace of innovation. This should result in accelerated approval times, with new therapies and technologies applied in all areas of healthcare, including diagnostics, drug discovery, patient care and services.
2	**Artificial Intelligence & Digitalisation**	**Software & Cloud Infrastructure**	Beneficiaries of monetising the efficiency gains of adopting AI and moving business models into the cloud.	Innovation has occurred and new technologies have been developed, including IaaS and SaaS. It is now a matter of the Cloud Infrastructure and Software market leaders – including the "*Magnificent 7*", continue to monetise their products and services.
3		**Digital Entertainment**	Digital entertainment is defined as taking the human experience into the digital universe.	Eventually all digital experiences should or could culminate in the Metaverse. The best way to access this trend is by investing in Gaming and eSports, a subset of the digital entertainment universe closest to transcending and monetising this experience into the metaverse. We further view digital entertainment industry as one of the first to monetise AI in one form or another. "*You don't live in the real world... You're like me. You live inside this illusion.*", Ready Player One.
4		**Robotics & Automation**	The automation of manufacturing, supply chains and service deliver.	The automation of supply chains is crucial to ensure we are able to sustain productivity and at the same time maintain an equilibrium between the supply-demand curve of goods and services. Labour shortages? Not so quick!
5		**Semiconductors**	Rising demand for semiconductors.	The need for both increasing and faster data-management will continue to drive growth behind semiconductors, in all areas of life! Whilst Nvidia, ASML and TSMC are the poster children for this industry, we also know this is not a winner-takes-all market, and with rising geopolitical tension, opportunities across the world will arise.
6	**Smart Infrastructure**		5G, renewable energy, logistics and much more as outdated infrastructure in the world we live in, are being replaced.	Attractive rates of return, often through income distributing investments, offer sustainable and growing dividend streams. Furthermore, in a world of uncertain inflation dynamics, there are gems in the infrastructure space that offers protection against high and volatile inflation. A characteristic we like and seek to take advantage of.
7	**Emerging Consumer**		Wealth creation in emerging economies, especially the east, will drive higher per capital disposable income.	Rising disposable incomes will lead to an upgrade of current consumption as well as opportunities for new products and services. We particularly favour Central and Southeast Asia and beneficiaries from ongoing US-China tensions, like Vietnam and Mexico.
8	**Inflation**		An understanding of inflation risk, the market's expectations for inflation, its direction and the shorter-term consequences.	With the arrival of AI, an increase in the pace of innovation, poor demographics and significant debt levels, the deflationary forces globally are very significant. At the same time, the changing dynamics of global supply chains - moving from just-in-time to just-in-case, alongside the transition to net zero, labour shortages and populist politics, the inflationary forces at work remains equally significant. The biggest factor however is monetary devaluation – an inflationary force few investors are prepared for!
9	**Energy Sustainability**		Energy security is a more significant focus and objective for politicians and policy makers as the world come to terms with the importance of independence and our attempts to transition to net-zero.	The opportunity set in energy and energy related investments resulting from the need for energy security alongside the global transition to a greener economy, is vast and attractive. Opportunities might involve traditional oil & gas producers, renewable energy infrastructure or the pick & shovels supporting these.

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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