January 16th, 2023

Cutting Through the Tactical Noise

- **Bit of a mugs game trying to work out who is right, the Fed or the market**
- **Better to focus on strategic shifts**
- **Chinese and European equities look fundamentally better placed for a full strategic asset allocation**
- **Preferred bonds an asset worthy of an allocation**

The market's fixation last week with one US inflation number was intriguing. Even as we wondered if one month's data could prove anything, market commentators continued to appear distracted by the debate about the gap between what the market discounts and what the Fed will do next.

Even as that debate intensifies, we believe it will be prudent to stop fretting about the next inflation number and worrying more about who is right: the market or the Fed? It's quite apparent that we are not in the same economic conditions that resulted in disinflationary conditions for decades. De-globalisation, re-shoring of capacities away from China, the greening of the plants that results in a multi-year growth in commodity demand, and staff and skill shortages all mean inflation is back. It's not that inflation is going to the moon; we just have to accept that inflation is a (bitter) reality now and could be a bit more of a problem in the future than many of us have assumed. The new economic conditions necessitate consistently higher central bank policy rates than we have witnessed for many years.

Meanwhile, on a strategic basis, some trends are helping to provide a better definition of investing for the longer term.

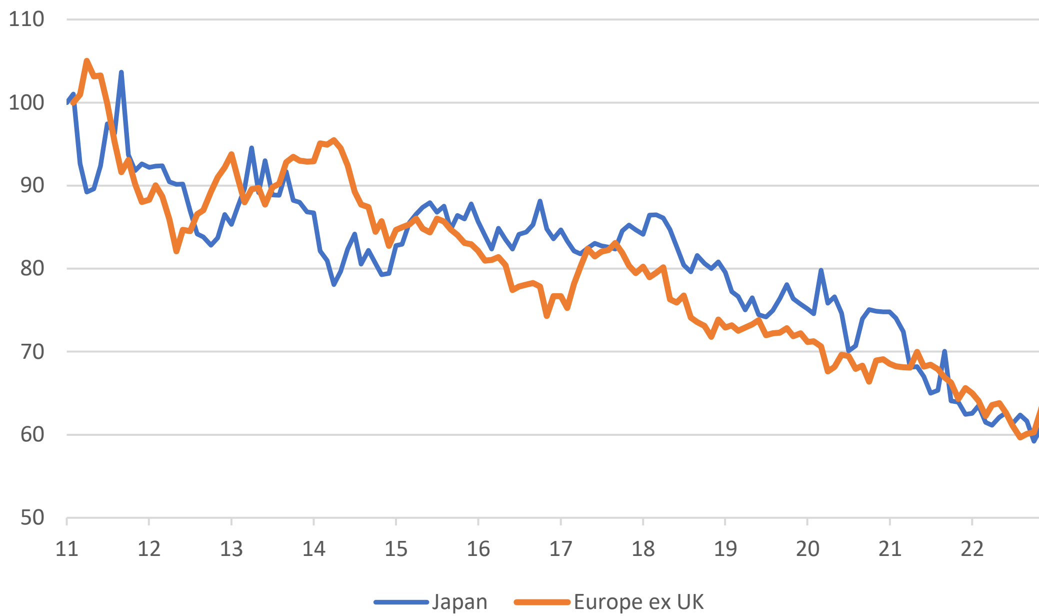
In the past, an investment in developed markets often meant focussing on US equities alone. European and Japanese equities lacked the lustre – or so the investors felt – and were often considered as old, ageing economies.

Times change. European and Chinese equities have made a comeback, making them serious contenders for investors' strategic allocations. The European rebirth that we see currently probably had its roots in the cohesiveness that was necessitated by the pan-European response to the challenges of COVID. That cohesiveness helped ensure that the resulting difficulties from the Ukraine War were met with a robust and constructive response.

In Japan, there has been a material improvement in corporate focus on return on investment and better governance, which should continue to help equity market returns. The market should also find support from a record volume of share buybacks. The global trend to onshoring should also help the longer-term secular trends of factory automation, which has generally been supportive of many Japanese industries. However, the recovery in the Japanese market has yet to convince that it will be able to sustain.

Chart 1: Structural turning point for Europe ex-UK, and Japanese equities?

The relative performance of Europe ex-UK, and Japanese equities relative to MSCI World Index rebased to Jan 2011=100



Source: Bloomberg

China

The recent extraordinary performance of the Chinese equity market has presented a massive challenge to asset allocators. We, like many, had almost written off the market as un-investable. It's, therefore, intriguing how the dialogue on the Chinese market has shifted 180 degrees in a week. Within a few days, what appeared to be autocratic circumstances made way to conditions where the administration appeared aligned to the masses' demand for a release from the stringent lockdowns, subsequently giving in to those demands. China, with some cost, has finally short-circuited its spread of COVID, with infection rates as high as 60-70% in some major cities. China is open for business, and the market is looking forward to positive growth surprises for the first time in some years.

At its peak in 2020, China accounted for 40% of the MSCI Emerging Market Index. International investors couldn't ignore it. From that level, if dropped at one point in Q4 2022, 55% relative to the global index. Since the reopening of the economy, offshore investors have started to return to the market. Bloomberg reported that "Offshore investors added about $2 billion in mainland shares Friday alone via trading links with Hong Kong, the largest daily tally in two months, according to data compiled by Bloomberg. Foreigners have boosted holdings by $23.7 billion since the end of October, the month they offloaded $8.5 billion in the largest outflow since March 2020."

International investors have now bought twice the value of Chinese equities they sold in October at the market low.

Chart 2: Chinese equity market's relative collapse

Chinese equities relative to global equities rebased to January 2020=100

Source: Bloomberg

Bonds have had a strong start to the year, keeping pace with US equities but not quite matching the extraordinary returns from European equities. The Global Aggregate Bond index has generated a return of 3.3%, compared with 3.5% for the Dow Jones Index. At this juncture, we see more merit in bonds than equities. If indeed the global slowdown comes to pass soon, as the Fed must be hoping, it is better to be caught holding bonds that would be well supported by a recession risk as opposed to equities that would, in all probability, be hit by a wave of profit taking.

Preferred Bonds

For those looking for higher yields than those offered by government bonds and prepared to take a modicum of equity risk, we continue to be attracted to preferred securities. Currently, funds in this asset class can offer a yield to worst of around 7%.

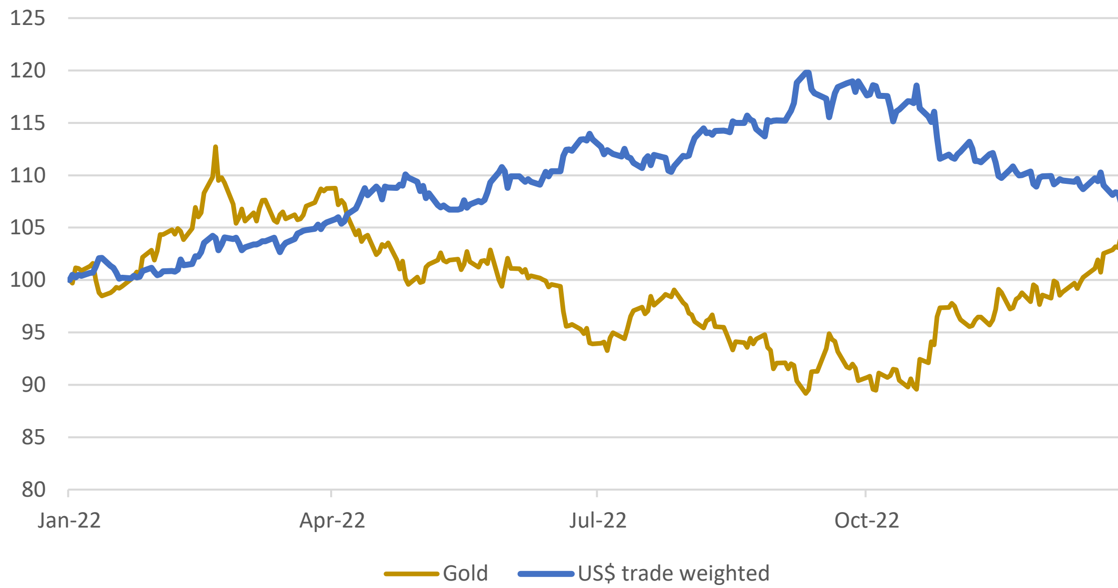
Preferred securities are structurally subordinated to senior debt, but senior to equity and are typically longer dated. Banks represent about 50% of the market and typically a larger share of institutional funds. The US accounts for over 60% of the market. US banks continue to show their resilience in the face of the wobbles in the economy. The regulatory framework developed in the wake of the global financial crisis has kept the banks in check, and buffers of capital should keep bondholders safe. About 62% of the preferred market is currently investment grade.

Gold

We receive much flack for persisting with our positive view on gold, but the market has spoken, and gold has continued to perform well in recent months. For those holding dollar cash, gold is a useful diversifier. The risk of exposure to gold helps offset against any downside risk to the dollar considering its strong performance last year.

Chart 3: Gold price strength compensates for the drop in the US$ trade weighted index

US$ trade weighted index and USD Gold price $/oz rebased to January 2022=100



Source: Bloomberg

Gary Dugan

Bill O'Neill (Consultant)