REYL OVERSEAS

STRATEGY OUTLOOK

September 2023

Key takeaways-

- Bond pessimism vs equity market optimism – who wins?
- So much for a quiet August -China implosion, the BRICS, Milwaukee, and Bitcoin news.

August is supposed to be a sleepy month where markets calm down, news flow is quiet and if you unfortunate enough, not to be holidaying on a Spanish or Greek island, then an excellent time to sort out life's admin. Markets are finishing the month largely **in the red** albeit still with a healthy return for the year. The month saw the BRICS summit, Jackson Hole, ongoing cries of the collapse of the Chinese economy, forest fires which, at first were blamed on climate change, then laterally arson and a Republican party debate where the main contender was AWOL.

Ultimately the picture in markets is twofold. **Equity markets remain optimistic** based on EPS estimates and **bond markets pessimistic**, still pricing in interest rate cuts into the future. **Both can't be correct.**

However, the **resiliency** of global economies remains strong, and this has taken most investors by surprise, us included. Are we just downright wrong or is our timing off by 6-12 months. The underlying reason for the resiliency can probably be laid at the door of US **fiscal stimulus which has been vastly underestimated** in its impact. This will eventually fade. However, the effect of the interest rate hikes will remain a constant headwind. The flip side to this and arguably of more interest to markets is central bank liquidity.

Liquidity has gone a bit underground or less transparent as a policy tool. In a world where monetary policy is tightening, fiscal policy (at least in the US) is expansionary (and doing the opposite!) then publicly expanding one's balance sheet makes for a messed-up policy mix. However, **the need for bond market liquidity and lack of volatility is key**. Bond yields have been rising hence the value of bonds as collateral falling. Increased volatility in bonds too has seen haircuts on these assets rise all of which makes leverage more costly. These intricacies to the derivative market, we don't believe, should be underestimated. **So, best guess, for the run into Christmas?**

We've had a good first half of 2023. Bonds have sold off and stocks rallied. There remain definitive pockets of value. However, we're more cautious than a few months ago. The US markets are well priced. You could argue that that's not an abnormal situation given US outperformance over the last decade or so. **With T-bill rates at above 5% there is also a good hurdle to move into other asset classes**. We are also wary when the market consensus is so skewed as in the case for e.g., Chinese stocks or bonds. Therefore, **the short answer is we expect more volatility, we're more cautious but aren't bearish**. We continue to believe we will see headwinds ramp up perhaps in 2024 but that also meets an election cycle and authorities that may simply, publicly, press the QE button once again.

Powell in his speech at the Fed's annual offsite in Jackson Hole **got** all **poetic**.

"We are navigating by the stars under cloudy skies".

The takeaways from Jackson Hole were that the committee were likely to proceed cautiously, there would be no change to the inflation target and the focus remained on a core inflation measure that was too high.

As we mentioned at the start of the article and in previous articles, we are watching the long-term theme of **the rise of the BRICS** and what that means for the US Dollar, Gold, Oil and geopolitics. Their meeting concluded with Saudi, Iran, and the UAE joining the bloc. What we can surmise is we are seeing **the fall of the petrodollar** and that perhaps oil is the underlying asset of value rather than any claim (like the USD). Together they have 50% of the global oil export market. Control oil, you can control US inflation which means you can control US yields, the USD, and US policy. **Maybe that's a bit too sinister**. It's certainly interesting that the US is trying to bring Venezuela back in from the political freezer to the cosy fireplace with an offer of sanctions relief.

China is clearly a significant part of the BRICS story. **The current narrative is that China is struggling economically and socially**, that the belt and road initiative is just marketing, and that China needs the west more than the west needs China. This has seen steady selling of Chinese assets and Economist cover pages talking about Xi's "failing model".   We sold out of our Chinese holdings back in Q1 2022 however are starting to ask the question whether it's time to gain exposure again.

This year saw **China's exports to belt and road countries surpass exports to the US, Japan, and Europe** yet the property sector seems to be imploding with the collapse of Evergrande and Country Garden. However, look at Chinese bank shares and we see health (which is not the case in the US). Every major index too is up (albeit underperforming the US as per the graph), and commodity markets do not reflect a sinking China. In FX land the Renminbi versus its Asian peers is strong. As we reported last month with some comments on earnings, the luxury goods brands continue to report spending across the region. Chinese government bonds are too dramatically outperforming US bonds with the spread between those markets at levels not seen since 2007. However, what's not changed is the lack of transparency in the economic data, the politics and the current uncertain regulatory and cold war between the US and China. **Ultimately like all assets its "caveat emptor" and important to keep any position sizing prudent.** Could Chinese assets flatline for the next two decades? Of course, just as new regulatory hurdles could be presented but it's interesting that the narrative and underlying picture (to the extent we can see it) are diverging.

Perhaps it's a smoke screen for the underlying US fiscal situation that is in **dire straits**. Yet should we care as the debt is in the same currency and they can simply print more. Foreign buyers have been non-existent. Since beginning in this industry in 2002 buying government bonds was THE trade when growth faltered. To what extent this has changed is now almost our daily quandary. Supply however is ongoing, and the US Treasury needs to sell $1.85 trillion in USTs by Christmas.

Elsewhere the **US election cavalcade began to get a little noisier**. In Milwaukee the Republican party held a debate missing their number one candidate. Mr Trump wasn't in Milwaukee but speaking to Tucker Carson with, to date, an interview that has garnered 160 million views. This is now a record which surpasses the interview between Michael Jackson and Oprah of a mere 90 million.

Bitcoin remains a **"marmite type asset"** i.e., you either love it or hate it! Yet two positive news events occurred over the month. The EU has voted to let banks hold 2% of their capital in Bitcoin (which comes into effect in January 2025) and we saw the US court of appeal crush the SEC's interpretation preventing Grayscale converting their Bitcoin fund into an ETF.

In summary the economy remains robust driven by expansionary fiscal policy even with the opposite effect in place and tightening monetary policy. **Cracks are increasing** and current growth levels are far too far above trend. The timing, as we've experienced, is an inexact science. However, to what extent this matters to markets is debatable.

We still have a situation where equity investors remain very optimistic on earnings and bond investors still doom and gloom. Liquidity really is key but at current estimates US indices, albeit heavily influenced by a tiny number of growth stories, are expensive. **Gauging investor positioning is difficult**, but it feels like the bears outnumber the bulls.

We are more cautious than two months ago but again to labour the point that **what is most important is to figure out to what extent global liquidity i.e., the pool of cash and credit sloshing around financial markets will be positive or negative. If there is money sloshing about the system, then asset prices are going up.**

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