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INVESTMENT POLICY NOTES

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As we approach the end of the first half of 2023 both equity and bond markets have recovered some of last year's losses. Bond markets have benefited from more benign inflation figures, and a banking crisis that started in the US regional banks. In equity markets nearly all of the index recovery has been generated by the megacap technology companies, such as Microsoft and Nvidia. Overall the environment has been much better than in 2022. However, the meeting considered the likelihood that markets are being too complacent, particularly on the outlook for inflation, and that this complacency is preparing the ground for a significant fall, which will probably start at the end of the summer.

Today markets are priced for a 'bullish recession'. In other words a recession that is mild and brief, which will allow inflation to fall in a predictable way down to the Federal Reserve's official target of 2%. In this scenario the Fed will be able to start cutting interest rates by the end of 2023, and continue to cut throughout 2024. Any rise in unemployment is likely to be small, inflation will become unthreatening again, and corporate profits soften only modestly. The goldilocks environment of the past decade can then resume.

However, this consensus view looks too optimistic, and the danger is if reality proves different then markets may adjust violently. The main danger Gavekal sees is that to get inflation down to the target of 2% will require a much stronger tightening cycle than currently envisaged, and if enacted it is likely to lead to a severe recession with much higher unemployment. The reason Gavekal doubt this will happen is that we are heading into a US Presidential election year and such a draconian policy looks unlikely, particularly given how intensely divided US politics is. Therefore, the Fed are likely to let inflation run at a higher rate than their target, rather than tackle it aggressively. As a consequence investors will have to adjust to an inflation rate running around the 4-5% level. As markets start to recognise that inflation is not under control but embedded at a much higher rate, this will weigh on bond and equity markets. Bonds are intrinsically undermined by inflation. Equities will suffer because companies' costs will be pushed higher by inflation, and PE ratios will fall as bond yields rise, particularly those of the growth stocks which have been leading the market. The reason that this is likely to happen at the end of the summer is that this is when the base effects that have held inflation in check roll off. After Russia invaded Ukraine in Spring 2022 commodity prices were pushed higher, peaking in summer last year. From August 2023 the year on year comparisons will start to show an upward impact on cost pressures. The US is the most vulnerable market if this inflationary shock transpires. Other markets have risen less and are therefore less exposed.

Another outcome is possible, but very unlikely. That is that inflation does come under control. In this scenario inflation proves to be contained despite all the forces that have been brought to bear that one would expect to have stimulated it namely: holding interest rates at zero for ten years, the gigantic Covid-related stimulus packages, the war in Ukraine, and deglobalization caused by US/China tensions leading to the relocation of supply chains. If inflation dies down despite all of this, that would be hugely bullish for asset prices. It would mean that Modern Monetary Theory is not inflationary as the purists have feared, and governments can borrow and spend without worrying about inflation. Equities would enjoy a significant rerating.

The much more likely outcome is that inflation is structurally embedded, and the investment consequence is that the market leadership will change. The current leaders are the dominant technology champions. These companies operate an asset light model that requires little capital investment. They have flourished in the last decade of stagnation, because they showed superior growth in a low growth world, and they were rerated accordingly. The new leaders should emerge from the sectors that will benefit from the massive decarbonisation policies that are being prepared in the West. These programs will be highly capital intensive and include sectors such as energy, transport and urban transformation. It will require hundreds of trillions of dollars of capital. Equally important is the infrastructure boom in Emerging Markets. China's capex boom may be over, but the need for infrastructure is evident in countries such as India and Indonesia, and the Middle East. These countries have reached a level of development where demand for proper housing and electrification has arrived. With the world dividing into US-centric and China-centric spheres of influence, there is also likely to be overinvestment in two sets of supply chains as both sides aim to secure their own needs, rather than sharing existing facilities. It will involve enormous building programs because it is not just the factories that need to be built, but also the roads, ports and logistics needed to support them.

The conclusion by Gavekal is that investors need to be prepared to make radical changes. If, as expected, inflation persists at a level in the region of 4-5% instead of 2%, and the Fed does not take strong enough action to moderate it, then bonds and the equity winners of the last cycle look overstretched. Instead investors should start to rotate to capital intensive sectors such as commodities, energy, and construction. Geographically Europe, Asia and Japan look more attractive than the US. Such a rotation is likely to take time and evolve over the next ten years, and be accompanied by a relative decline in the US dollar. However, the first step in this rotation may see a painful adjustment later this year.