Quarterly Notes on Investing

Q1 2024

Cautious but opportunistic: finding hidden gems amongst the macroeconomic noise

> **“A wise man will make more opportunities than he finds.”**
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> Francis Bacon, The Essays

> **“We often miss opportunity because it's dressed in overalls and looks like work”**
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> Thomas A. Edison

If 2023 was the first year you’d been introduced to investment markets, you could be forgiven for thinking that making money was pretty straightforward. We can have weak economic conditions, intense geopolitical uncertainty and war, and yet bonds and equities will rise simultaneously – some even precipitously. Then again, if you’d cut your teeth in 2022, you might well feel the opposite; that markets are erratic, unpredictable, and pessimistic. The truth of course lies somewhere in between, which leaves us with a big question: what does 2024 hold? Is this the goldilocks year between the two, or – with further economic uncertainty, major conflict and leadership elections covering nearly 80% of the world’s population – are we headed for something different once again? Here, we explore our thoughts on the fine line that investors need to tread as we move into the new year.

Are we bullish or cautious?

We'll start with the sentiment right now, which is rather subdued. A lot of the market enthusiasm we saw at the height of the festive season has been snuffed out, and equities and bonds (which are still moving largely in tandem) have started the year with something of a hangover. Does that mean we're in for a more muted year overall than 2023? Not necessarily, but we start the year with central bankers walking a tightrope between managing inflation and leaving enough room for growth, and that's the key dynamic that investors will be watching in the short term.

There are three main scenarios to account for; growth staying strong and inflation coming down without central banks having to cut rates sharply (which is effectively, the "gangbusters" scenario for equities), central banks throwing in the towel and cutting rates even though inflation hasn't come down all that much (still positive for equities), and the bust scenario, in which either inflation seriously spikes, or we see a recession.

If we read the market runes, they're largely expecting something in between scenarios one and two, but tilted towards the former. That's why, even with a shaky start to the year, large parts of the equity market still look precariously expensive.

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Be cautious, but be invested

What's our view? Our job is to protect capital as well as to make money, so we need to be positioned to thrive in as many different scenarios as possible. In this case, we think that the question of whether or not there's a recession is less important than how markets could react to one if there was. For example, while we think that a severe recession is probably one of the least likely scenarios now, it would only take a mild recession, or even just a moderate slowdown in growth to knock some of the more expensive areas of the equity market from their lofty heights. In other words, a mild recession wouldn't necessarily mean a mild reaction in markets, particularly given that markets have now largely discounted a recession as a possibility at all. We think a mild recession is a moderate risk this year, so we want to avoid the most expensive areas of the equity market.

Of course, scenario one, where growth continues and the Fed decides to abandon its focus on tackling inflation, is also a possibility, and we need to make sure that we position client portfolios to thrive in that environment as well. Interestingly enough, that doesn't present too much of a conundrum, because a rally driven by stronger economic growth (rather than simply by central banks pumping the economy with liquidity) is the kind of rally in which value equities tend to do well. Value sectors are more deeply wired into the plumbing of the global economy than their growth counterparts, so an uptick in economic activity is particularly supportive to those kinds of sectors.

What kind of scenario do we think would be most beneficial for long term investors? Funnily enough, not the first one, and that's because it kicks the inflation can further down the street, creating a bigger long-term problem for owners of capital. Indeed, over the longer term a recession might actually be the more beneficial outcome, taking some of the excess out of the equity market, resetting the economy to start a new cycle on more level footing, and creating buying opportunities. But whichever path we end up on, there will always ways to make money for those with a long-term view.

Three areas we're excited about: Japan, emerging markets and biotech

We've said that large parts of equity markets look expensive, but the good news is that there are pockets of opportunity that look interesting regardless of whether or not the economic environment is supportive in the short term. To start with, emerging markets surprised investors over the past couple of years by adopting tougher and more traditional monetary policy measures than their developed market peers, leaving them in a relatively fitter state going into 2024. Not only that but, in our view, they're on the cheap side of fair value and they're home to a wealth of high quality and fast-growing companies.

Japan is another area that we think looks attractive on a fundamental basis. It's taken a long time for its economy to shuffle off its deflationary malaise, but now that inflation is picking up alongside corporate profits, its equity market has started to attract serious inflows. Indeed, Japanese equities had their best year in a decade in 2024. We think there's further for this positive story to run, particularly given that Japanese profit growth since Abenomics set in has actually been stronger than the US – yet that's still not reflected in prices.

Lastly, we've said that value equities are attractive right now, but we know that buying growth equities at the right time can be highly lucrative. One area of the growth equity world that looks interesting in terms of both valuation and tailwinds, is biotech. These stocks have had a rough patch over the last few years as higher interest rates and regulatory roadblocks dampened their prospects, but with both of these headwinds starting to lift, the outlook for biotech looks more positive. It's also an area that, in our view, doesn't look quite so vulnerable to AI-led disruption as some of the software sectors that have played such a dominant role in growth markets.

2024 view: a choppy year with opportunities under the hood

In summary, we think that this is a year in which to protect against macroeconomic surprises at the margin, while keeping our sights set firmly on capturing longer term opportunities to compound capital. In 2023, riding the growth market bull wave would have been a simple way to make money in the short term, but it came with a great deal of risk, much of which is being made clear in these first few weeks of 2024 already. We might be cautious on the shorter-term outlook for the global economy, but there's money to be made for those willing to look under the surface for more interesting sources of capital growth.

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Investment Strategy & Outlook

As we move into a new year, it is clear that investors have become more bullish about the trajectory of interest rates from key central banks. For much of 2023, many if not most equity sectors were flat or negative, with only a handful of AI-focused stocks singlehandedly driving indices into surprising heights. It has only been in the last couple of months that a deeper sense of enthusiasm has taken hold, driving a broad-based equity and bond market rally, and lifting global small caps out of a long-held rut. US Fed Chair Jerome Powell has already attempted to scale back some of this market enthusiasm by maintaining that inflation remains the key concern for the central bank, but markets now clearly think otherwise. Indeed, our view is that markets are priced for perfection, with equity and credit valuations not pricing in the risk of anything other than an immaculate soft landing for the US economy.

The good news is that distortions between economic reality and investor sentiment create opportunities for long term investors. By maintaining a carefully hedged allocation to equities with an active management tilt and long/short strategies, we believe we are still positioned to benefit from sharp upside swings without taking on the full extent of the downside risk, which we think is significant. Recessions across the globe have yet to bite. Equities, especially in the US, are still not that cheap on a historical basis, and inflation is coming down – but is still high - all of which makes a further leg down in equities a risk worth mitigating. We think that direct equity exposure is still important in portfolios, but that areas with a greater margin of safety, like value, equities outside of the US, and Japan, are the most attractive right now.

Another key question to explore is whether now is the time to buy bonds. On the one hand, yields have risen to pre 2008 Financial Crisis levels, which means that for the first time in well over a decade, investors might be adequately rewarded for taking on duration risk. On the other hand, there is still a risk of capital erosion in real terms for long-term holders of bonds, given the apparent return to an inflationary environment. Right now, given both the risk of recessions and the yields that longer duration bonds are trading at, we think that longer dated US Treasuries look attractive as portfolio protection. Macro data have been weakening in the US - with high frequency and leading indicators pointing to a reduction in activity - but equity markets have not priced in the increased risk of a deep recession. Longer duration bonds should act as portfolio ballast in the wake of a sell-off in risk assets caused by a recession. This, alongside some sustained positive momentum in yields coming down, means that we are now slightly more constructive on long-duration bonds in portfolio construction, which might not only help portfolios in an equity sell-off, but also provide another source of positive returns.

Ultimately, we think that the market and economic environment still warrants caution. We continue to favour the use of active management and hedge fund strategies, that can take advantage of heightened volatility and market dislocation. Hedging strategies, allocation to alternative strategies, and thoughtful equity positioning are all designed to provide a buffer to sharp market swings, smoothing the ride for our clients in these choppy times.

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