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Q4 Investment Perspectives

2023

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Q3 '23 Recap

Q3 2023 was a difficult quarter for most major classes, driven largely by a global surge in bond yields. In particular, global equities (ACWI) fell -3.7% in Q3 with the brunt of the decline coming from European Equities (VGK) which fell -5.7%. US Equities (VOO) fell -3.2% and EM Equities (VWO) fell the least of any major region at -2.8%. Fixed income performed poorly as well, with US Aggregate Bonds (BND) falling -3.2% which brought their total return to negative for the year. Commodities (GSG) were the only major asset class that performed well in Q3 with an advance of 15.5% (Source: Bloomberg).

Q3 was particularly painful for many investors because the correlation of stocks and bonds flipped from negative to positive, which led to both asset classes falling in tandem, echoing the moves we saw in 2022. For this reason, we continue to stress the importance of diversification when stocks and nominal bonds perform poorly, particularly through inflationary assets such as commodities and inflation linked bonds.

The Big Picture

Many of the challenges we experience today are the result of forces that were set in motion several years ago, which were exacerbated in the wake of the COVID-19 pandemic. Before COVID-19 hit, we were in an extended economic paradigm characterized by both lower-than-expected growth and lower than expected inflation. This enabled Central Banks to maintain relatively loose monetary policy for an extended period. During the COVID-19 pandemic, Central Banks and politicians alike doubled down on this loose monetary policy by injecting trillions of dollars of stimulus into the economy, forcing interest rates to fall below 1% across much of the interest rate curve.

“Ultimately… there are several structural forces that suggest that inflation will be harder to reduce going forward.”

As the world began to normalize, consumers flush with cash from government stimulus spent money at record levels while at the same time supply chains were heavily strained and commodity markets were upended following Russia’s invasion of Ukraine. These dynamics ultimately led to the highest levels of inflation we have seen in almost 40 years.

To combat inflation, central banks raised interest rates aggressively in an effort to slow demand and reduce pricing pressure. We are now 20 months into the hiking cycle which has seen inflation drop from a high of 9.1% in June of 2022 to 3.7% in August of 2023. This rapid reduction in inflation in conjunction with relatively strong macroeconomic data had caused asset prices to rise during the first half of 2023. Consequently, investors began embracing the idea of achieving a “soft landing.”

For the past year we have been skeptical of the “soft landing” theory. History has shown that in most cases where inflation has risen as high as we have seen recently, it has taken a recession to bring inflation back down to 2.5%. In Q3, it seems that markets have begun to recognize this view as well. Ultimately, as we will cover later in this quarterly update, there are several structural forces that suggest that inflation will be harder to reduce going forward. Increased geopolitical conflicts between Eastern and Western powers threatens to unwind decades of globalization which has been a profound deflationary force. Within the US, increased unionization efforts could lead to greater wage growth and therefore higher inflation. For these reasons, our positioning has grown more cautious as the year has progressed.

“With the large increase in rates in Q3, we moved our fixed income positioning to overweight in late Q3, focused on short-term inflation linked bonds.”

Positioning

We came into 2023 neutral across fixed income, equities, and real assets. As the year has progressed, equities richened, while at the same time risks to the economy grew. Last quarter we noted that equities were pricing in a “soft landing”, which we felt was much less likely. Given these concerns, we moved to underweight equities in Q2, although admittedly we were too early. We remain modestly underweight equities today. In addition, given the large increase in commodity prices and the growing possibility of a recession, we moved to underweight commodities late in Q3. With the large increase in rates in Q3, we moved our fixed income positioning to overweight in late Q3, focused on short-term inflation linked bonds. Finally, we have reduced the number of tactical tilts we are taking to keep our portfolios more nimble and focused on responding to the evolution of events. Our view is that markets are likely to become more volatile in coming months, creating interesting positioning opportunities.

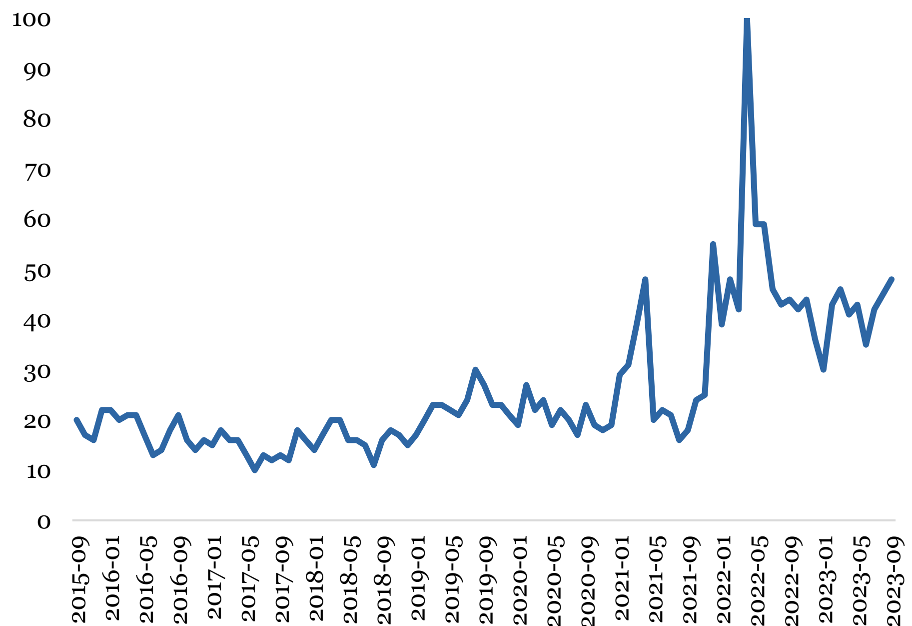
“… this strike… represents a potential acceleration in an organized labor movement…”

Power to the People

One of the biggest headlines of the 3rd quarter was the historic United Auto Works (UAW) strike which impacted the big 3 automakers in Detroit: Ford, GM, and Stellantis. While this strike stood out because it was the first of its kind, it also represents a potential acceleration in an organized labor movement which has also resulted in strikes at other places such as Hollywood writers' union, Starbucks, and Kaiser Permanente, as well as collective bargaining deals at FedEx, UPS and several airline and steel companies.

Despite union participation being in decline since 1983, demographic changes in the workforce and increased awareness on social media has increased the popularity of unionization.

Google Trends Searches for Unionize

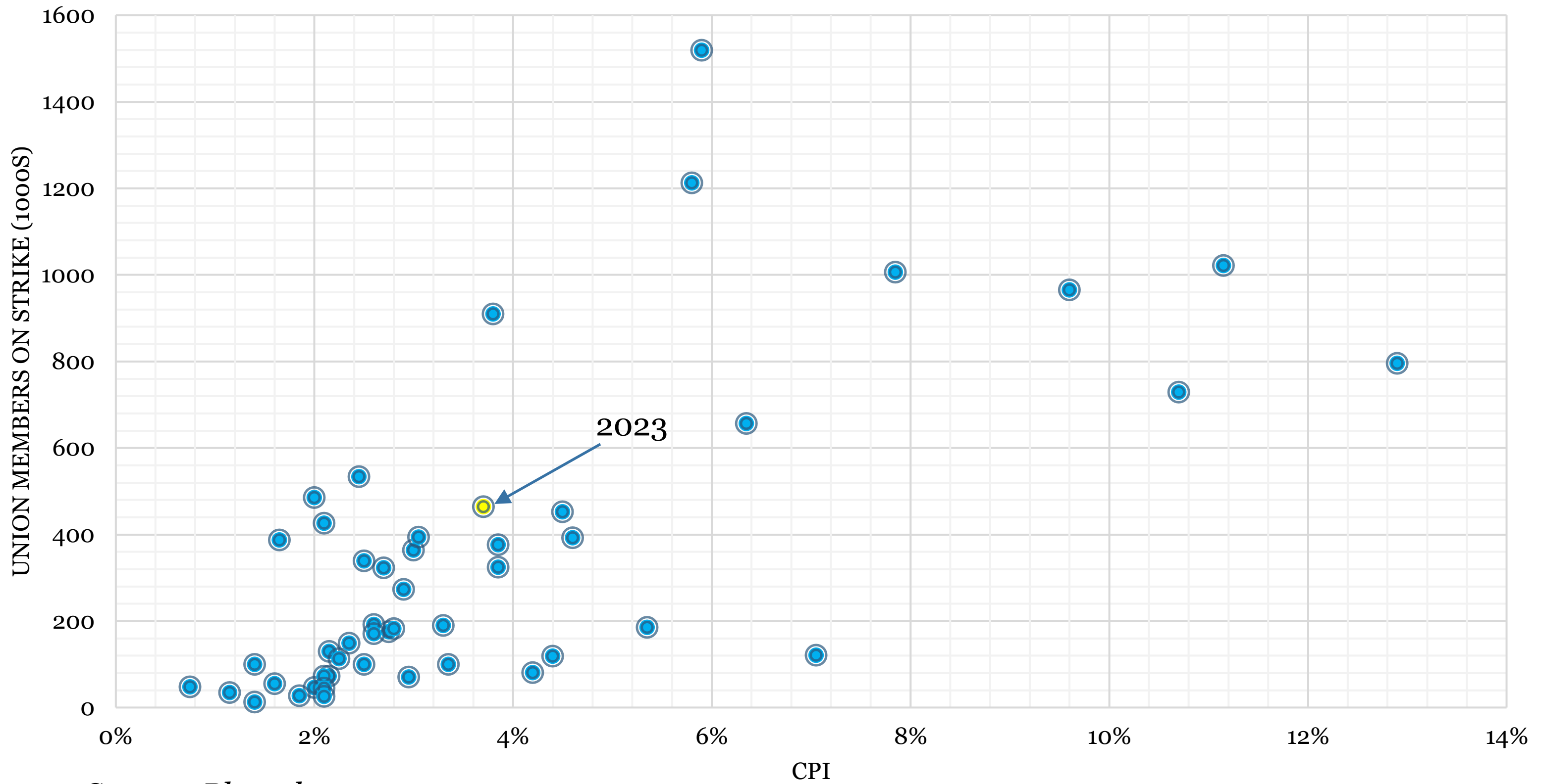


Source: Google

“If the changes in attitudes towards unionization leads to more aggressive negotiating on wages, inflation could rise further and pose a significant challenge for policy makers.”

Changes in attitudes towards unionization could pose several challenges for markets and policy makers. For the last 24 months we have been in a paradigm characterized by high inflation and, correspondingly, restrictive monetary policy. Inflation is largely dictated by people's wages, since people's wages determine how much they spend on goods and services. If the changes in attitudes towards unionization leads to more aggressive negotiating on wages, inflation could rise further and pose a significant challenge for policy markers.

As you can see from the chart on the next page, there is a positive correlation between the number of union members on strike each year, and the level of inflation as measured by the CPI.



Source: Bloomberg

> "However, with an increase in conflict comes the risk of decreased global trade, increased onshoring, and higher input costs for many goods and services."

Global Conflicts

Another headwind for the fight against inflation is the increased level of global conflicts we are observing between Eastern and Western powers. From the 1990s to the 2010s, globalization was a significant factor in maintaining low and steady inflation. However, with an increase in conflict comes the risk of decreased global trade, increased onshoring, and higher input costs for many goods and services.

United States and China

The United States is still heavily dependent on China as an input into many supply chains. However, increased conflict over Taiwan, semiconductors, and influence on the global stage has led many US based companies to begin moving their supply chains back to the US or to other countries in the Southeast Asia. Additionally, the US Dollar's status as a reserve currency is now under threat by China, who is aiming to create a replacement reserve currency with other Emerging Market nations. While this process may take many years or even decades to fully play out, it highlights an existential risk to US supremacy and the US's ability to manage their growing national debt.

> “Europe is currently facing the difficult decision of accepting even higher prices for energy as they transition away from Russia, which will likely lead to lower growth over the short to medium term”

Europe

European energy markets were upended following Russia’s invasion of Ukraine, given that many European countries were overly dependent on Russian oil. This has caused inflation to be much more entrenched in Europe compared to other developed markets. Unfortunately, this has also complicated Europe’s transition to other sources of energy. Europe is currently facing the difficult decision of accepting even higher prices for energy as they transition away from Russia, which will likely lead to lower growth over the short to medium term.

Saudi Arabia

Saudi Arabia is beginning to emerge as a potential moderator in the growing conflicts between Eastern and Western powers. Their country is currently in the midst of a rapid modernization as they build out critical infrastructure in their cities and expand personal freedoms. For example, labor force participation rate amongst women in Saudi Arabia has doubled over the past 7 years. Finally, given the role Saudi Arabia plays in global energy markets, highlighted by their leadership in OPEC, they can increase their influence on the world stage.

Relics of Low Rates

As the impact of higher interest rates continues to reverberate through the economy, it’s important to examine the unique challenges faced by certain pockets of the market that became particularly distorted by the low interest rate environment.

> “Monthly payments on a 7.5% mortgage.. [are] almost 50% higher than at 4%. In the long run, lower mobility amongst the labor force could lead to lower growth.”

Housing

Currently, the prevailing mortgage rate in the US is roughly 7.5%, which is the highest it has been in over 20 years. However, most existing homeowners have a mortgage rate of roughly 4% since that is roughly where mortgage rates have been for the last decade. Since mortgages are generally not portable, meaning that you cannot apply a mortgage on an existing home to a new home, the overwhelming majority of homeowners will be inclined to stay put, or else they risk having to pay nearly double their existing mortgage rate. The median house price in the US is approximately $500k. Monthly payments on a 7.5% mortgage is $2800/month, almost 50% higher than the $1900/month at 4%. In the long run, lower mobility amongst the labor force could lead to lower growth.

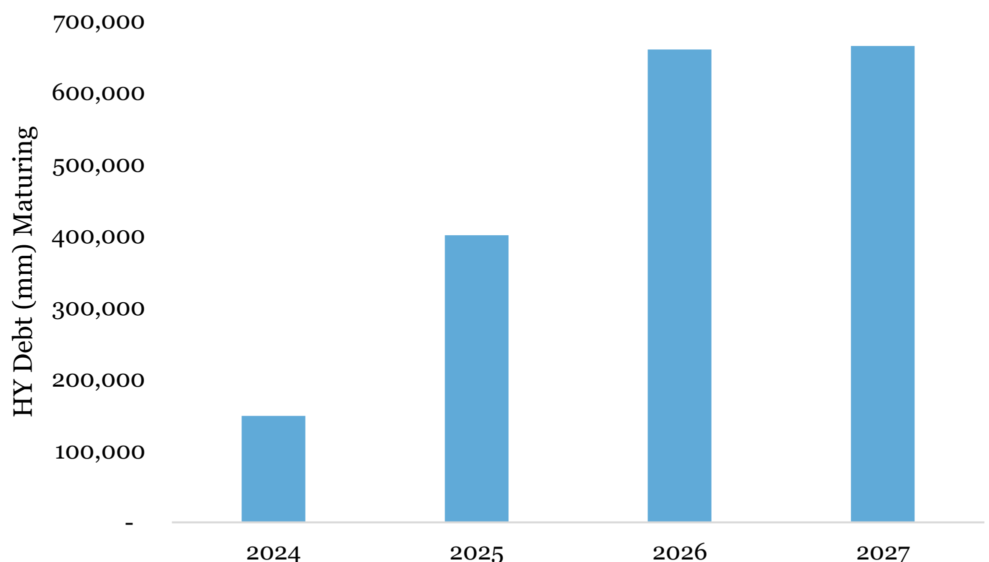
Zombie Companies

When interest rates were very low, many companies that would otherwise struggle to survive were able to receive funding at rates as low as 3-4%.

> “If rates do not go down, or these business don’t materially improve, it’s possible that we could see a wave of defaults from these businesses.”

As long as these companies could continue to refinance their debt at low levels, they were effectively being kept alive by the low interest rates, hence the nickname “zombie companies”. Now that interest rates have started to rise, the cost of funding for many of these companies has soared to over 10%. These higher interest rates resulted in high yield bond issuance plummeting in 2022 and 2023. However, a significant amount of debt is going to need to be repaid beginning in the next few years. If rates do not go down, or these business don’t materially improve, it’s possible that we could see a wave of defaults from these businesses.

HY Debt (mm) Maturing by Year



Source: Bloomberg

Bills vs. Notes

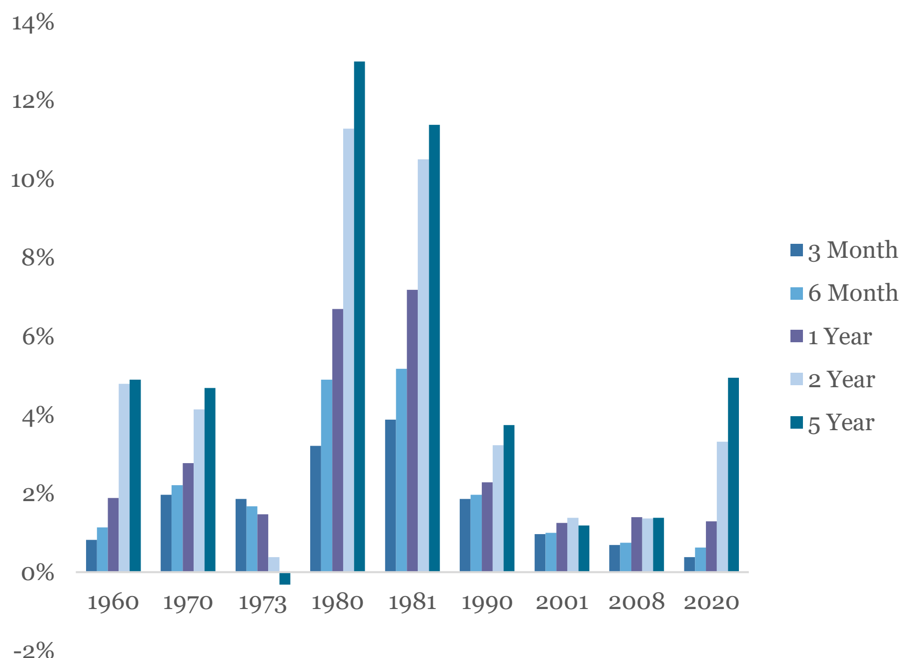
As interest rates have risen dramatically over the past couple years, short term treasuries (“T-Bills”) have become more attractive to investors. From the beginning of 2022 until today the yield on 3-month T-Bills has risen from roughly 0.1% to 5.5%. For individuals who have short-term cash flow needs, T-Bills make sense because they offer attractive yields backed by the US Government and can be exempt from various taxes depending on residency. However, we have seen a growing number of clients requesting allocations to T-bills because they are worried about a looming recession or are wary of investing in riskier asset classes such as equities. For those investors, T-bills (less than 1 year to maturity) represent a less ideal choice than longer term 2 year to 5-year treasury notes (“T-Notes”).

> "While it is tempting for investors to look at today's yield curve and choose 6-month maturity because it is the highest yield at 5.6%. . .these numbers are not directly comparable."

While it is tempting for investors to look at today's yield curve and choose 6-month maturity because it is the highest yield at 5.6%, it is important to keep in mind that these numbers are not directly comparable if an investor's time horizon is longer than the maturity of the bond because of "reinvestment risk" or the need to invest coupon payments or maturing bond proceeds at new prevailing rates which may be lower.

Below is a table comparing the returns of various maturity Treasuries (3m, 6m, 1y, 2y and 5y) over the 3 months following the onset of a recession. As you can see, in 8 of the past 9 recessions, longer duration bonds have outperformed T-Bills.

3m, 6m, 1y, 2y, 5y Treasury Returns 3 Months into Recession



Source: Bloomberg, GenTrust Calculations

Conclusions

We came into 2023 neutral across fixed income, equities, and real assets. Currently, markets are beginning to suggest that a "soft landing" might not materialize. At the same time, the risks to the economy have grown as global conflicts increase and unionization efforts gain bargaining power. For these reasons, we went overweight fixed income, with an emphasis on short duration inflation linked bonds, and underweight both commodities and equities.

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