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Advisors

thenavigator
Summer 2024

"I will tell you how to become rich. Be fearful when others are greedy. Be greedy when others are fearful" [Warren Buffet]

The recent fireworks in late July, starting in Japan and then spreading across global equity markets, have only reinforced our concerns about the fragile state of many popular equity indices and sectors.

As we highlighted in the last *Navigator*, this is what happens when momentum reverses, although it didn't unfold exactly as we anticipated.

Nikkei 225 index

Source: Nikkei 225 Index, Aug 2023 – Aug 2024, chart by Bloomberg. All graphs in this newsletter are provided for illustrative purposes only and any past performance data is not indicative of future results.

As investors, we need to prepare for heightened volatility as large sums of capital continue to crowd into the same areas. What happened in Japan – the unwinding of the carry trade (borrowing cheaply in Japanese Yen to buy other assets, assuming that the currency will continue to depreciate) is for us a classic example of the risks when momentum turns against you.

We believe this is just a tremor before the earthquake!

After the Bank of Japan blinked and backed off rate hikes until the situation stabilized, some investors reinitiated their carry trades. To us, this highlights the gamification of markets and sets a dangerous precedent, one that may encourage investors to take even greater risks.

Japan seems to have an inflation problem that we believe can only be addressed through higher interest rates and a stronger currency. For an economy that has relied on a weak currency to boost exports, this could spell trouble. In our view, this is just a tremor before the earthquake based on recent market conditions and central bank actions, but, as always, conditions may evolve and our outlook may change accordingly.

We are not buying it

Source: VIX Index, Aug 2023 – Aug 2024, chart by Bloomberg

The spike in the VIX index (a measure of volatility), which moved from complacency to fear and then back to complacency again in the blink of an eye, also puts us on edge.

At one point in early August, markets were pricing in over seven interest rate cuts by the Federal Reserve ("FED"), including an immediate 0.5% cut. The persistent market participants' expectation that central banks will always bail out failed trades may be badly misplaced.

Looking back at history, the FED has, at times, stepped in to address market disruptions after significant events – such as in 2000. However, past actions do not guarantee that similar measures will be taken in the future, and outcomes may differ based on evolving market conditions.

Temporary insanity

In 1996, then-FED Chair Alan Greenspan talked about irrational exuberance. He was 4 years too early. We believe markets are currently experiencing a similar bout of temporary insanity, but we don't think we'll have to wait as long for reality to set in this time.

In general, movie sequels tend to be worse than the original, and, in this case, we deem it highly unlikely that the "Magnificent 7" will perform as strongly again.

While only time will tell and market outcomes are inherently unpredictable, one could argue that what we are witnessing is merely a vicious bear market rally.

Source: BM7T Index, Aug 2023 – Aug 2024, chart by Bloomberg.

Whilst we remain unexcited about U.S. stocks at the index level (we think you'll be lucky to achieve positive returns over the next 10 years), the possibility of two U.S. rate cuts (0.25% each) before year-end could help other overlooked parts of the market flourish.

Yes, we have revised our view since the last *Navigator,* given the moderation in inflation and the slight weakening of the U.S. labor market.

Perhaps, one of the biggest mistakes investors make is failing to assess forward returns in a rational way. To put it simply, if you buy a house for USD 1 million from someone who originally bought it for USD 200,000, would you expect to sell it for USD 5 million? Of course not. The biggest price appreciation was realized by the first buyer, reducing your potential for gains.

The same principle applies to financial markets, although very few seem to pay attention. The annualized gain of 16.07% from U.S. stocks since March 2009 versus their long-term average of 10.26% since 1957 is, in our opinion, highly unlikely to be repeated, especially given the current valuation of U.S. equity indices.

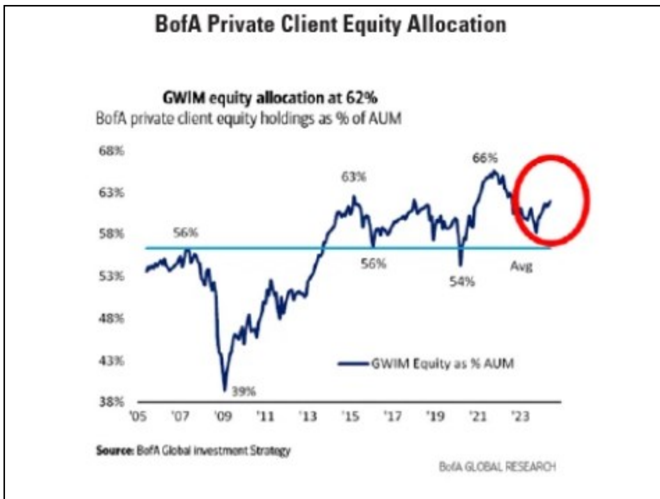
Price of U.S. Stocks (S&P500) to Average 10-Year Earnings Per Share

Source: SPX Index, 1997-2024, chart by Bloomberg.

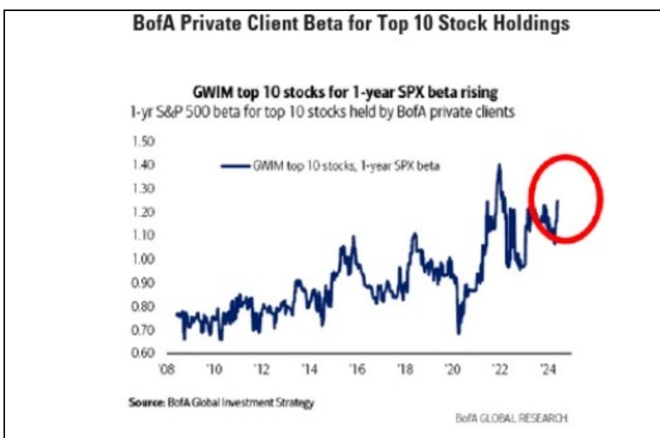
We believe widespread fears of an imminent U.S. recession may be overstated. Instead, we see the current economic environment as a healthy slowdown, bringing growth back to more normalized levels.

The recent sell-off in global cyclical stocks, in our opinion, represents a gift, as we do not foresee an imminent recession or even one on the horizon, although, as always, market conditions can change.

However, there is a caveat: investors are now taking on significantly more risk, as evidenced by the higher stock allocation – 63% versus 39% in 2009.



Source: BofA Private Client Equity Allocation, 2005-2024, chart by Richard Bernstein Advisors LLC.

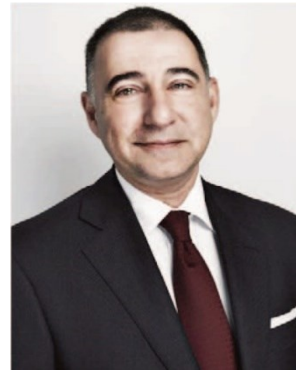


Source: BofA Private Client Beta for Top 10 Stock Holdings, 2009-2024, chart by Richard Bernstein Advisors LLC

Additionally, the Beta, a measure denoting market volatility or systematic risk of a security or portfolio compared to the market, has increased from 0.75 in 2009, suggesting that portfolios are now more sensitive to market swings. How would investors react if there were a major market accident?

Our base case for the global economy remains a soft landing. We anticipate that interest rates are likely to decrease in Europe and the U.S. in the very short term (hence our exposure to shorter-dated bonds). While we believe the easier part of the inflation battle has been won, we recognize that the final leg – bringing inflation down to the 2% target set by most central banks – may not be so easy.

The days of 0% and negative rates are firmly in the rear-view mirror as we return to a more normalized economic cycle, compared to the past 15 years. Adjusting to this regime is likely to be uncomfortable for investors, which is why we maintain a higher- than-normal cash weighting within portfolios - to ensure we have the firepower to capitalize on future opportunities.



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