Where to Invest in 2024?

CAPTIVATED MARKETS

Over the past 2 years, we have seen plenty of evidence that US Treasury 10yr rates are the most influential financial measure across all markets - an interest rate which is an integral part of the valuation of the majority of financial instruments, including equities. We have experienced some big swings in this period (from yielding 1.5% to 5.0% back down to 4.0%) most of this driven by the fact that longer dated US interest rates have moved in lockstep with the perceived future inflation rate on the day.

There are strong structural changes taking place in today's world – several military interventions, media bias, disruption of established patterns of trade, learning from the world's covid response, AI, to name just a few.

This note outlines a few investment ideas that can be incorporated into portfolios as we start the new year. If you would like to learn more, we would be happy to jump on a call to go over the supporting material for these views.

Markets were not straightforward in 2023, but our growth portfolios were up over 30% and even the yield/conservative portfolios have grown over 10%. We hope you enjoy the read, and of course, welcome your interaction. Wishing you the best for the year ahead.

Terry Leeworthy

STORIES YOU WILL NOT FIND ON MAIN MEDIA

In today's world, the media is frequently used to skew the world's understanding of events. Below are a few examples where the narrative is far from accurate - a reader should definitely question the motives of the media to portray such a biased view (particularly relevant when formulating views to support an investment idea).

- Ukraine is nowhere close to winning a war with Russia. The Russians have been 'dug-in' since Mar23 and the bigger risk is that Russia can make further gains. Ukraine is running out of money, weapons, troops, and goodwill. At some point the world will start discussing a longer-term settlement; although this would be very embarrassing in 2024 during a US presidential campaign

- Bureaucrats in Brussels have created endless red tape, from ESG to source of materials to carbon transition. These initiatives are driven by principles and not business logic and they impose a significant cost to European consumers and businesses. The full ramifications are becoming more apparent (Germany's cost to produce an electric car compared to China, Europe's high cost of energy)

- BRICS expands to include Saudi Arabia, UAE and Turkey. This is becoming an influential block that has vast resources and is using them wisely and bypassing western payment systems. The western world is not participating in this new order and is unlikely to be invited to participate. This is changing global trade patterns and creating new geopolitical allegiances.

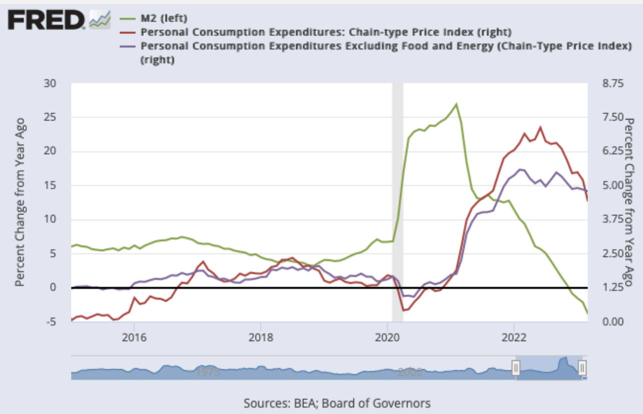
- After Russia invaded Ukraine, Europe placed heavy restrictions on the import/use of Russian energy, to deprive the Russian economy of essential revenue and not fund the Russian war machine. China is now the biggest buyer of oil from Russia and rather cynically, a significant part of Russian oil exports is recycled via India and continues to be purchased by Europe!

WORLD VIEW OF FINANCE

The covid lockdowns brought two outcomes. The first a disruption to supply chains (given factories and shippers could not operate normally during lockdowns) which caused many prices to increase given the lower availability of manufactured products/services - raw materials, shipping.

Secondly, many governments flooded their countries with money (possibly the extreme, the US M2 grew over 25% YoY in February 21) to help their populations get through the lockdowns imposed by the governments. Countries took different actions, but in broad terms, these two effects caused the spike in inflation that has rippled around the world.

All central banks were slow to respond to the initial warning signs, but the US started to raise rates in March22 and has raised rates 11 times from 0.25% to 5.50% - most central banks have taken a similar course of action to tighten monetary conditions.



The explosion of M2 (and the entire monetary base) in the US is clear (from St Louis Fed). Many G7 central banks, although less extreme, rolled out policies with similar effects.

Recently, the financial markets have been driven almost entirely by the latest perceived inflation outlook. With equity and bond markets rallying when inflation metrics move lower towards (but still some way from) the target rate of 2.0%. The opposite market moves when inflation figures appear entrenched and rates would need to remain elevated longer than expectations.

In short, investors are speculating whether the Fed can pull off a soft landing with the US economy and avoid a recession, or a severe recession.

WORLD VIEW OF FINANCE continued

We have seen many signs that the Fed rate hikes are working to cool off the economy, but this does not mean inflation will acquiesce. The non-interest rate sensitive factors of inflation remain quite robust.

In the last federal reserve meeting of 2023, Powell surprised markets with material indicating rates will be significantly lower by the end of 2024. This was a dramatic pivot in messaging with the US10 year yield falling from 5.0% in mid-October to 4.0% by mid-December and S&P500 climbing from 4,200 to 4,750 in the same period.

These moves indicate investors have the strong belief that the Fed will ride to the rescue and cut rates (and probably move back to expanding the balance sheet again) if the economy starts to falter to try and boost the economy. Such a move is even more likely in an election year with the Democrats struggling in the polls.

Whilst we see US rate cuts in 2024, we do not believe the market euphoria immediately after the Fed pivot in December.

We believe there are a number of forces that will keep interest rates higher for longer than the current market expectations of 150 bps of cuts in 2024. Those forces are the scale of US debt and required issuance, diminished foreign ownership of the treasury market.

We believe there is a delicate balancing act ahead and the Fed may be able to bring about a soft landing,

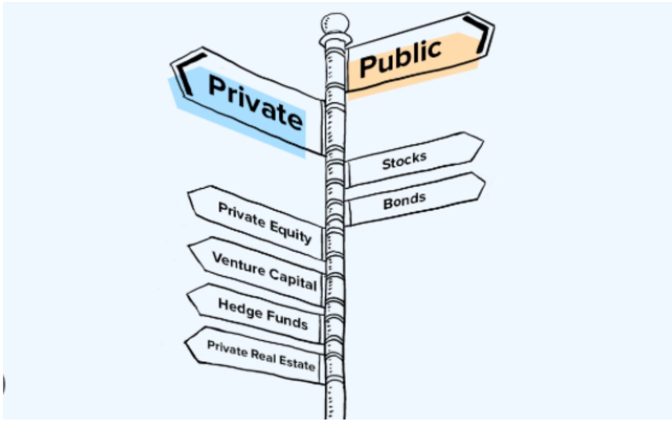
However, we enter the new year with a view that the US economy is more likely to be hit with a recession in 2024. There are certainly risks that inflation may rise this year and also that economic growth would slow.

PRIVATE MARKETS – WHERE THEY HAVE BEEN

Over the last decade, private equity investors and managers have proliferated, many influenced by the sizeable returns made by US university endowments that invested decades before. The industry had a widespread blow-out year in 2021, along with the public equity markets.

However, as public equity markets turned down in 2022 and most of 2023, the IPO market has effectively been closed. During this 'dry' period, the PE managers often needed to revise their 'to-market' strategy and restrict the cash they burn through to avoid the need to raise public money and disclose weaker valuations.

Some of the companies the PE managers have invested in will certainly not be generating free cash flow and will be under some pressure - even with the public equity markets popping 4Q23.



In contrast, in 2023, the private credit market has been booming. The private credit market is now dominated by a few large players - Apollo, Oaktree, KKR, Carlyle, etc. We are well aware that the volume of commercial and industrial loans from banks is definitely shrinking (one of the desired outcomes of the Fed rating interest rates!).

One of the impacts of the Fed increasing interest rates would be a reduction in bank lending, thus limiting credit available to the economy. This correlation is not so strong today given these private credit companies are expanding rapidly (even extending credit to companies that could not access bank lending). So private lenders are reducing the impact of higher rates to contract the economy. The loans extended by private credit companies also help the PE managers delay cleaning up their portfolios by exiting the non-performing companies.

The private debt markets have developed the business of 'net asset value' loans. This is where an alternative manager borrows money against a pool of their assets and the diversification amongst several companies reduces the borrowing cost. It could be the case that the public market would not even commit to such a loan.

These net asset value loans provide cash for the PE manager but almost certainly increases the leverage in the portfolio. These loans allow the PE managers to defer tough decisions on non-performing companies in their portfolio and defers the need for the manager to mark down valuations, thus masking the weakness of some of the companies involved.

With a little 'self-congratulatory pat on the back', Arete introduced one of the early private credit lenders in 2017 called Owl Rock and a few of our clients invested. These investors have gathered net returns averaging 9% pa when real interest rates were negative!

OPPORTUNITIES IN PRIVATE MARKETS

Furthermore, 5 of Arete's 11 direct deals have IPO'd and generating profits and or liquidity for investors. We continue to closely monitor the situation with the direct deals that we are still invested in. These 6 companies are growing, generating revenue growth and have operating cash reserves for business plans. To stress, these companies have not used the 'net asset value' loans mentioned above.

Last year, we reviewed the companies in our portfolio and made a few follow-on investments. We had good visibility over numbers in all these further investments and they are all making good progress against business plans. Thus, we had the comfort to add to positions, despite the macro environment and funding drought.

From time to time, there will be good reasons to sell an asset that has performed well (reduce exposures, meet capital calls, recycle capital, end of fund life, etc). The Arete team shortlists the better opportunties and gets comfortable with potential valuations and market pricing. This provides valuable intelligence in opaque markets that can deliver good outcomes.

The team will certainly look for more secondary opportunities in 2024.

WHAT TO DO/NOT DO WITH YOUR MONEY

Many structural changes are taking place that will undoubtedly impact the established world order. Rather than trying to consider how markets would respond to these changes (a hazardous exercise at the best of times) we make a few investment views where we have some confidence, in no particular order. We can go a lot deeper if you would like more information.

- **Cash / Liquid:** We are at a time when cash deposits, US Treasury Bills, and other safe and short-term securities offer very interesting yields, for very low risk. Suffice to say that we do find these attractive, and we will be following up this paper with more advice on this topic.

- **Dollar decline:** With a view of slightly lower US rates, the dollar would lose some of the strength it has enjoyed over the last few years. The dollar index hit a 20-year high in mid-2022 and remains overvalued against JPY, AUD and SEK. A lower dollar would provide a good backdrop for Asian emerging market equity markets. We have some definite views how investors should position such an exposure.

- We favour **emerging market local government local currency bonds** over G7 government bonds. A basket of China, Brazil, Singapore, India and Indonesia are worth a good look. You can create a basket with an average yield to maturity of over 6.0%

- **Selective real estate:** Countries with predominantly floating rate mortgages will present opportunities to buy for those with some reasonable knowledge of an area. This opportunity arises because there will be distressed sellers, and a cash buyer will have the opportunity to make several low offers to try and pick up a property well below the asking price. UK and Australia for example

- **Select Japan property:** With JPY rates not turning lower this year (raising wage pressures will not allow BoJ to reduce rates), investments into selected Japan property would be interesting. Hopefully delivering an increase in the property price plus an appreciating yen. Take a look at Arete's recent report on Hokkaido real estate https://bit.ly/ACALNIsekoPaper

WHAT TO DO .... continued

- **Equities,** in general, are not so attractive: Public equities are as unappealing as they have been for 20 years. Some of this is due to stretched valuations, and some is the fact rates have increased and now offer a decent lower risk return. Generally, PEs are way above historical average - so limiting returns for a long-term investor.

- **US equities are expensive:** While the magnificent7 (AAPL, MSFT, GOOGL, AMZN, NVDA, TSLA, META) have high Price/Earnings (41) they remain powerful companies with huge revenues and good growth potential. They also have huge MOATS. There is fair weight to the comment that the S&P has been primarily driven by the mag7. Though digging a little deeper shows that the rally has been wider than most realize, with the biggest contributors to the S&P new highs since previous high being Berkshire Hathaway and Exxon Mobil. One caveat to this continued strength for the mag7 view would be if the US government bridles against the scale and influence of the tech companies (see recent case against GOOGL).

- **Buy Japan equities:** The Nikkei 225 was up 28% in 2023 and more in USD terms. After a few false starts it appears the Japan stock market is finally undergoing real corporate governance reform. Buy backs are more frequent, poison pills have been overturned, there were 23 MBO's last year and the exchange is willing to name and shame corporates with poor market credentials. We also see JPY rates not turning lower thus a likely healthy yen appreciation (after weakness 2022/3) on top of equity performance.

- **Buy selected China internet stocks:** A few China internet companies have strong balance sheets and generate a lot of free cash flow. (BABA has 40% of market cap in cash!). There are half a dozen internet names that pay dividends and are buying back their stock. These names have taken a hit after the market declines and new gaming regulations, but this could be an interesting entry point.

WHAT TO DO …. continued

- **In election years,** several countries' equity markets have, on average, performed much stronger than the average annual index return. Two countries with elections in 2024 are Indonesia and India (with an average index outperformance in an election year of 30% and 22% respectively). We suggest a small allocation to an equity index ETF in one or both of these countries.

- **Buy select commodities:** A carbon transition of sorts will happen to some degree over the next decade. This transition process is inherently inflationary. There are many raw materials required and existing production is far below potential demand - copper, lithium, cobalt, aluminium, graphite, etc. Buy a diverse mining company or a specialist miner in one of the critical raw materials (or an ETF of the same).

- **Buy quality traditional energy companies**: The growth of sustainable energy production, although rapid, is not likely to be able to replace the run-off currently taking place in existing traditional energy production (Oil&Gas and Nuclear). For some time to come, the world will continue to need the energy currently produced from oil and gas and nuclear plants to satisfy the worlds growing energy needs. (buy O&G and/or uranium companies, or an ETF equivalent).

CHINA

Living in Asia, it would not be wise to formulate any view without considering what is happening in China. The headlines refer to China's economy as struggling on several fronts:

- GDP is much lower than the country was able to produce 5 years ago. China has invested big in infrastructure, however, China cannot continue since any new infrastructure makes a much lower contribution to productive growth given what has already been built.

- Global investors have reversed much of the investments that have been made in China. Some of this has been due to falling asset prices, some has been down to the west seeking to economically isolate China through sanctions, etc.

- Net foreign direct investment was negative last year for the first time after more than 25 years of inflows.

- Developers in China are effectively bust. Given real estate was at the heart of China's economy, an income source for authorities and a source of wealth for citizens, the developers' troubles have broken confidence in the property market. It will take some time for the system to digest the sheer scale of the debts.

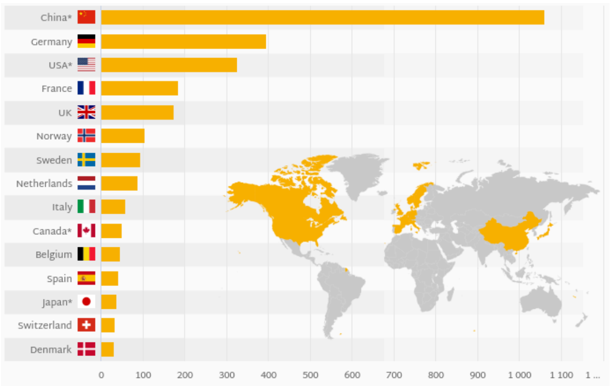
There are analysts calling to now invest in China equities given the scale of the bad news that has come to light (bottom fishing given equities have dropped 40% since the market peak in early 2021). We are not so convinced on the merits of this recommendation since the sheer scale of the debts owed by the developers are a long way from being worked through, and international money has evaporated.

CHINA …. continued

However, there are a few things to be very positive about China.

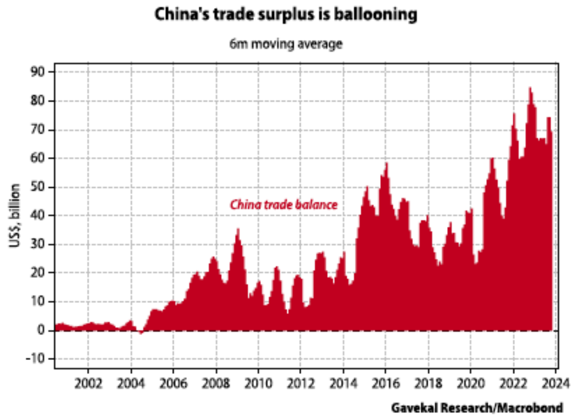
- China has a very dominant position in the mining and distribution of raw materials and rare earths required for batteries, solar panels, and electrical equipment. This is a very powerful position if the world is serious about carbon transition since these minerals are essential for manufacturing the equipment that would be required for transition. Remember, every utility in the world will continue to make investments in sustainable energy and every grid needs to build electrical storage in the near future – think batteries!

- China has a leading position in the design and manufacture of EVs. The capability to make these cars in volume, build the required infrastructure to support these vehicles on the roads leaves western governments and western car manufacturers in the dust. This is particularly embarrassing (and possibly a near death experience) for the likes of Mercedes, Toyota, BMW, etc.



- Chinas trade surplus has tripled over the last 3 years where trade has been redirected to the 'global south' (ASEAN, Africa, Latin America, India, Pakistan, Saudi Arabia, UAE and Turkey).

What is more interesting is that a growing percentage of this trade is conducted in local currencies and not the dollar. G7 are not participating in this new world order.



There are a few bright spots in the huge China economy. One of our favoured sectors is China internet companies. Buying selected China internet stocks is amongst trades we should consider at the beginning of this new year (see above).

TRUE INDEPENDENT ADVICE

We are a truly independent financial advisor. We channel our experience, network and resources to seek proven solutions that can be incorporated into our client portfolios. We regularly construct portfolios of exchange traded assets, but Arete has successfully pitched real estate and private equity as sound additions to some client portfolio's.

At Arete Capital, we are sitting on our clients' side of the table - we have the capability to offer the smarter solutions from numerous providers – we advise the solutions most suitable for our clients.
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