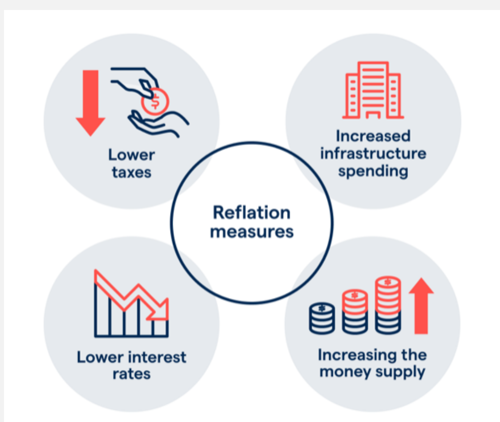
# RATIONAL MARKETS, STABLE WORLD? OCTOBER 24

We start the last quarter of the year and, to be frank, my portfolio is looking extraordinarily healthy with many good gains and of course a few losers. However, the 'sunshine' in my portfolio seems to be not reflected in the world I live in. This is more than a little troubling in terms of what to do next. The existing world order is being battered by waves of toxic global geo-politics. Markets are not exactly rational at the moment and seem to follow politicians more than the animal spirits. And to top this, there is a bunch of behind the scenes sponsors funding changes to the world that look to be self-serving and far removed from the clear benefit of humankind.

Most portfolios have done quite well this year and some astute advisors are in the process of taking actions to protect profits, contain some of the perceived risks and still seek opportunities for their clients. In this newsletter, we will try to cover some of the above and explain a few ideas to diversify away from the sky-high PEs of the Mag7. Let's begin with one big-picture story…

## REFLATION TRADE

The two biggest economies in the world are heavily supporting their economies – for different reasons – but this state support in China and the US is massive and will continue for a while. They are both easing monetary conditions that is going to support risk assets (equities and commodities). This is worth getting into.




## REFLATION TRADE cont…

The China story is fairly well known: the huge property bust of a few years ago is still unresolved and the numbers are huge – this issue is far from over. After reducing buying restrictions, supporting lending, buying distressed property, the China government has recently come out with yet another supporting package – the latest initiative offers stronger fiscal support than the previous announcements. In mid-September, even the President has come out to demonstrate his support for these latest measures. The equity market has gone stratospheric! With the belief that the party has its own credibility on the line, we bought some China equity on 23rd Sept. Our belief is that this stimulus is likely to continue for some time and not fade away as quickly as the earlier stimulus measures.

The US economy is also being heavily supported by the establishment. The economy is strong with strong retail sales, jobless claims are falling, air travel is strong, bank credit growth is accelerating, the Fed estimates strong 3Q GDP growth, S&P forward profit margins near record high. From a different angle, the US government is borrowing more money than ever to fund itself, with the national deficit at a level not seen outside a war and the deficit is growing faster than ever before. With this setting, last month the Fed announced the first rate cut (that was also the largest rate cut for years) to make financial conditions easier. In the first few days of October, Powell stated in September there are also likely to be a further 2 rate cuts this year!

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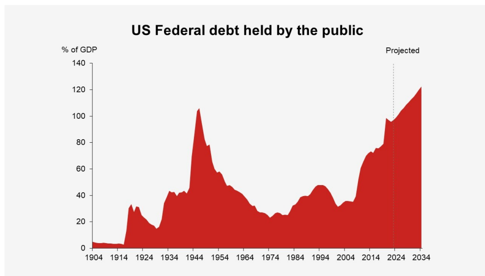
## REFLATION TRADE cont




The Fed cutting rates with a resilient economy does seem an unusual situation and this has raised questions about the Fed's independence. One thing for sure, the direction of travel of US policy has been set and is unlikely to change before a new US government is in place early next year.

Meanwhile in China, the authorities are well aware they have an issue to deal with and they now need to demonstrate to markets that these measures will do the job!

On the face of things, this strong support in China and US is positive for equities and commodities in the short term… but bond investors should remain very aware of market expectations (see RATIONAL MARKETS? below).

## WHERE TO INVEST? RATES/DEPOSITS?

With negative real rates in 2020/21 and the increase in interest rates over the last few years, bond investors have had a torrid few years. Interest rates have probably peaked and we believe USD term deposits now offer reasonable returns for a low risk profile investor. If you believe interest rates will decline (as the bond market currently predicts) investing in 2- to 7-year investment grade bonds would be quite attractive.

We are skeptical over interest rate declines. We do not believe rates will fall to the levels we saw in 2021, so we would recommend term deposits, or the shorter-end investment-grade bonds will provide reasonable returns for the next year.

## WHERE TO INVEST? ….. cont

Emerging market government bonds also present a reasonable investment outlook. Several countries have needed to defend their currency by increasing domestic rates – particularly against the dollar strength over the last years. With the Fed clearly signaling rate reductions in the immediate future, these emerging countries would now be able to ease rates. These are good circumstances since investors gain coupon and some capital appreciation as market rates decline.

There are a few schemes that offer attractive yields – savings plans, HK silver bonds that currently offer 4.00 – 5.50%

## GOLD & CURRENCY DEBASEMENT

After sleeping for several years, gold has suddenly come back to centre stage in 2024, increasing in value by an impressive 30%. There is a lot of commentary trying to explain this move, but we attribute two key reasons:

- To move away from dependence on the USD, China and Russia are both buying a lot of gold, possibly to establish a new gold backed currency
- Most western governments are spending money like drunken sailors and printing money. Investors buy gold to avoid the implicit currency debasement. This is a world where western governments are significantly, and imprudently, increasing borrowing near the top of the economic cycle.

Below is a very simple example of how currency debasement erodes the value of your wealth in terms of spending power. We look at the cost of buying an ounce of gold 20 years ago and the current cost. All governments borrow money and use measured inflation to reduce the cost of the future repayments. Bit it comes as no surprise that some governments are far better at retaining the purchasing power of their currencies.

**The price of 1oz Gold**

| | July 04 | Sept 2024 | Debasement |
|---|---|---|---|
| In CHF | 494.1 | 2,228.0 | 4.51 |
| In USD | 407.2 | 2,663.5 | 6.54 |
| In EUR | 326.7 | 2,366.0 | 7.24 |
| In GBP | 218.6 | 1,952.5 | 8.93 |

Recent portfolio theory normally assigns a relatively modest 5% weighting to alternatives and precious metals. In these times, with western governments borrowing more than ever before, investors should look at assets that retain their spending power. Precious metals are certainly an option – property would be another. See PROPERTY FOCUS – JAPAN below

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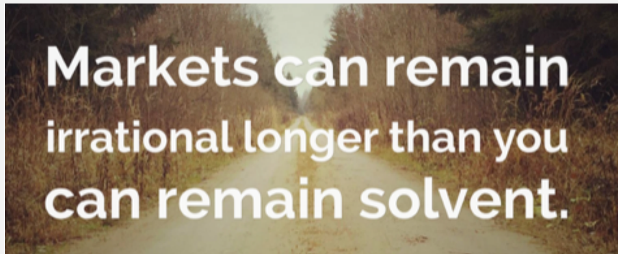
## RATIONAL MARKETS?

There is currently a huge dichotomy in the broader US market that will be addressed at some point. It really reminds me of the saying from Keynes below...




Let's explain - the US equity and interest rate markets are providing two very different outlooks on the US economy - and as the world's biggest economy, this has implications elsewhere.

### Equity View:

US corporate earnings are expected to improve in this 3Q earnings season (the next 8 weeks) and no recession is in sight. With a trailing PE of almost 30 for the S&P, the equity markets expect rising profits (profits are already taking one of the highest ever shares of gross domestic income), rising margins (corporate profit margins have risen over 60bp over the past year despite paying more in interest). Given this situation, the equity market strongly believes the fears of a hard landing are over-done, particularly since profit margins typically fall a few years before a recession arrives.

### Interest Rate View:

The interest rate market has already priced in rate cuts, in the next 18 months, that the only way the Fed would be able to deliver these anticipated rate cuts is if the economy turned into a recession in this period. **In mid-September, the rates market has priced in 250bp of rate cuts within the next 12months.**

It is impossible to reconcile these two views of the US economic outlook, so we should expect some market volatility in the coming months as more hard evidence is released providing an insight into the actual state of the real economy. The much stronger US employment numbers (way above consensus) on the 4th October did push yields higher and rate cut expectations have tempered since then. But the big disparity in outlook remains.

## ASIAN EQUITIES

We have watched China equities fall from grace given the rolling real estate bust that has been going on for a few years. In mid-September, the CSI is down 45% from its highs in Feb21. And we know China then announced the latest stimulus plan. This is certainly more robust than any previous announcement and this plan has support from the very top. Since then stimulus and other policy announcements have added USD2 trillion to China's market cap. It will take some time for markets, analysts and market norms (target prices, EPS, etc) to adjust to these new market levels for China. We hold our speculative positions added in September but monitor market developments.

Of course, nothing will escape price movements from wars or threats to world energy markets, but another Asian country that has been grinding out steady growth for a few years is India.

Indian equities remain the best long-term opportunity for growth orientated equity investors globally, both on a 5yr & 10yr view. Two notes of caution – the market is expensive (Nifty at PE 21x and the mid-caps on PE 33x) and there are plenty of signals of current market excesses – IPOs are over-subscribed by over 100x!

However, Indian households have bought into the long-term equity story given the market's resilience, a state-sponsored Systematic Investment Plan for individuals and favorable tax tweaks. The government's debt and leverage look virtuous when compared to G7 and India is also expected to generate the largest GDP growth of all major equity markets over the next few years.

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## PROPERTY FOCUS: JAPAN

Investing in residential property has become more popular in the last years – partly down to the low interest rate environment where residential yields were relatively attractive. A few niche projects in property have proven to be very lucrative over the last decade (student accommodation or communal living facilities). Charlie and I both consider physical property investments as a reasonable way to shield some assets from inflation and currency debasement.

As an option to offer clients the opportunity to diversify client investments beyond investing in financial assets, Arete has developed several niche real estate projects (hard assets) with above-average yield and capital appreciation potential.

Arete and participating clients have purchased selected commercial buildings in Japan on free-hold land that is favorably located very close to a shinkansen (bullet train). The properties are refurbished for purpose and let to local tenants. These projects will generate an after Japan tax yield of c. 5% to 8%. We target net IRR returns to the investor of c. 15%, in USD terms.

There is no leverage involved. We have a team in place for asset management, property management, and Japanese taxes.

The situation is very encouraging since there are a few properties in the area we have already visited that are available within our price range. We also see strong demand from established institutional tenants that is likely to remain the case for a few years. So, a good pipeline of supply and demand.

We have several clients that have already committed for the next project, and we are open for new investors.

These projects are attractive on a stand-alone basis, but the yen is still quite cheap and we believe participants will benefit from a tailwind from a stronger yen when in the future when we look to exit.

*USD JPY 10-year Chart: JPY is still cheap*

## TRUE INDEPENDENT ADVICE

We are a truly independent financial advisor. We channel our experience and resources to seek innovative solutions that can be incorporated into our client portfolios to provide good growth potential and simultaneously, have defensive qualities when downturns come.

At Arete Capital, we are sitting on our client's 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.

Take a look for yourself - www.arete-asia.com

Charlie and Terry

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### RESPONSIBLE OFFICERS

Charles Luchangco & Terry Leeworthy
For details, please visit http://arete-asia.com/

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"Sit On the Client's Side of the Table" source Best in Class Solutions and Negotiate the Best Terms for Clients.

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