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Reflections & Insights*

Many modern novels have a
beginning, a muddle and an end.

– PHILIP LARKIN

When you write a review with a quarterly cadence, the onus is on you to produce something new, even when the landscape hasn't changed that much. What has happened, of course, is that time has passed and that we are, therefore, by definition, closer to the end of the interest rate cycle, known in the current jargon as 'the pivot.' Investors have become uncannily relaxed about the prospect

of 'no landing,' another rather misleading piece of jargon which implies that the monetary tightening of the past year and a half will have no discernible effect on the economy. The centrists expect a 'soft landing', which sounds more fun than no landing but involves a smidgen of a slowdown. The pessimistic proponents of a 'hard landing' are a bit thin on the ground. As ever, the evidence is mixed.

The optimists tend to focus more on coincident data, such as the labour market. This remains strong, but despite that, inflation is falling as the post-pandemic supply/Ukraine effects begin to fade. The problem here is that labour markets are backward-looking. A deterioration in employment data is the result of a slowdown, not the cause of it. It can, of course, multiply the woe.

The pessimists, on the other hand, worship at the monetarist altar. Real money supply is falling, while fiscal deficits and real interest rates are rising. This is exacerbated by the ongoing liquidation of the Federal Reserve's (Fed) portfolio of US treasury securities and by the fact that real bank credit is shrinking – which means that banks are reluctant to lend. Debt levels are

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high throughout the system, and the academic work that suggests high levels of debt impede growth is being rehashed. In fact, the real rate of growth of the US economy since 1890 averaged 2.2% up until 2000. Since then, it has averaged 1.3%. This isn't just theoretical. The effect has been to knock \$13,000 off of what US GDP per capita would have been if the previous trend had continued (\$60,000 vs. \$73,000, in US dollar terms). That means, measured in one way, that the average person in the US is 20% worse off than they might have expected to be. It is not surprising that the issue of intergenerational inequality is rising up the political agenda across the developed world.

One of the under-sung effects of economics is the 'muddle through' hypothesis. This states that economies have natural balancing mechanisms which usually prevent the worst from happening and allow things to muddle along. Having recently undergone two experiences where muddle through did not work (the Great Financial Crisis and the Pandemic), we are preconditioned to expect that maybe it won't work this time. Muddle through is where the soft landing proponents sit – 'it may not be perfect, but it'll be OK-ish.' Needless to say, this doesn't make a good story. It doesn't contain Artificial Intelligence (AI) or the demise of liberal democracy. It just happens to be a fairly likely outcome.

The misery of inflation

Having nailed colours to this mast, it is worth quoting Jay Powell, the Fed Chairman: "It can be miserable to have inflation constantly coming back and the Fed coming in and having to tighten again and again, so the best thing is to restore price stability." This is a reference to the mistakes made during the late 1960's and early 70's, where the inflationary dragon was wounded but not slain. What it means is that interest rates may not go much higher, but they will stay at current levels for longer than markets have discounted. This is hardly a disaster but is a key part of muddling along.

One part of the capital market setup is less sanguine than this. Bond markets have taken exception to the policy mix and have sold off brutally. The robust economic data and the fiscal profligacy in the US have proven too

much for the so-called 'bond vigilantes,' and interest rates at the longer end of the yield curve have risen sharply. This, in turn, raises the cost of borrowing for government, companies and consumers and increases the risk of a recession. The interplay of these factors, while not negating the 'muddle through' scenario, tip the scales in favour of a slowdown rather than a no landing. It is also worth reminding oneself that the only real winners from higher inflation are governments themselves, which see the value of their outstanding debt falling – the best argument for independent central banks.

What about the rest of the world?

So much for the US, what about the rest of the world? In Europe, things are worse than across the Atlantic. The proximity to Ukraine and the impact of disruption in energy supply was a hard blow. Added to that, we have seen the luxury goods industry (very important to the French and Italian markets) take it on the chin as the Chinese consumer has traded down; the mighty German car industry has not risen to the challenge of electric vehicles as it might; and the EU has no response to the fiscal protectionism of the US. Witness Intel's (subsidized) investment of up to US\$100 billion in Ohio to try and wrest technological leadership away from Taiwan.

All of this points to a more mercantilist world, where national advantage is critical. The argument about subsidies for electric vehicles looks destined to tie up the auto industry in legal wrangles for years. The unfortunate reality is that European markets have failed to make the required shift to new technologies and don't have a protectionist carapace, which has always existed in China and has been recently built in the US. The result of all this is that the Eurozone has proved more vulnerable than the US and is probably already in a mild recession. Arguments about Ukraine, political pressure from powerful interests (like car manufacturers), and added pressure from increasing immigration have all pushed politics in an ugly direction. The monetary situation is no different from that in the US. Interest rates will stay where they are for some time to come. Nevertheless, the cycle will slowly turn, and opportunities will emerge, but exposure to domestic European businesses looks premature.

A tragicomic spectacle

In the UK, we are being treated to a tragicomic spectacle as the government flip-flops on flagship policies that it introduced. The abandonment of parts of a major infrastructure project – a new zero-carbon, high-speed railway (HS2), the rollback of green commitments, and the invention of pro-car policies – all reek of electoral desperation against the backdrop of a sad post-BREXIT economy. It is still politically unacceptable to be negative about that national act of self-harm, but the electorate has moved on and now, by a large majority, recognizes the whole farrago as a disaster. You couldn't make it up.

China has not recovered from the pandemic as quickly as expected. This is in part because of the fact that the real estate market, which has been the major recipient of domestic investment, is struggling with excess supply and deficient demand. This has put pressure on developers, most of whom are hugely leveraged. The policy response so far has been muted, and growth rates have, therefore, been disappointing. The similarities between China today and Japan in the late 1980's are noticeable, particularly in the way in which excess saving leads to highly inefficient capital allocation. Whether China enters a period of subpar growth and stagnation will depend on the policy response. The short-term credit problems can be solved, but the economy needs a reorientation towards consumption and away from capital investment. In the meantime, while the attacks on tech businesses have died down, rhetoric against foreign companies and their employees has been ratcheted up. For US investors, in particular, China remains a difficult destination. For others, it contains pockets of real value but with the attendant political risk.

Taking a breather

In US dollar terms, markets took a bit of a breather in the third quarter, falling by around 3%, with most of that taking place in September as the reality of 'higher for longer' interest rates took hold. For the year to date, though, most developed markets have been strong, delivering double-digit returns despite the level of concentration reflected therein. Companies have continued to raise prices to support

revenues and margins, but the evidence shows that real revenues (actual revenues less inflation) are already under pressure. Earnings will continue to rise, although much of that will be because of the impact of inflation. Those with long memories will recall how accounting conventions developed to adjust the effects of inflation to give a truer picture of corporate health. Still, it is notable today that many commentators continue to point to rising numbers as a sign of optimism rather than price gouging.

The enthusiasm in the Information Technology sector for AI is still present, and the industry giants are all positioning themselves to benefit from how they foresee the technology developing. As is often the case with any new development, it is not the technology itself which is the barrier to entry but the ownership of vast datasets. These exist in the tech giants themselves, of course – the old adage that 'if you don't know what the product is, you're the product' holds true. They can also be found in institutions with data protection concerns, who don't know how to monetize assets or suffer from institutional inertia – for example, Britain's National Health Service (NHS), which probably has the largest comprehensive health data anywhere, but cannot agree about what to do with it. The point is that it is too early to back a single horse in this race, but the investing herd doesn't want to explain to its clients that it doesn't know what's going on, so it sprinkles fairy dust on a few supposed beneficiaries. This means that the enthusiasm probably has further to run.

A muddled slowdown

We have been in phony wars before – periods when everybody is waiting for something, anything to happen. Today feels like that, although rising oil prices and the horror unfolding in the Middle East give pause for thought. As we said, the interest rate cycle has nearly run its course, but the bond markets tell you that the interim may hold some unpleasant surprises, both for economies and for corporate profits. The markets have spent most of the year looking on the bright side, but more recently, doubts have crept in. Either way, some form of muddled slowdown should set the stage for a decent recovery

as interest rates begin to fall. They are not likely to return to zero whence they came because the perpetual crisis that engendered them has waned, and central banks are trying to reduce the scale of their balance sheets. With a following wind, we should return to calmer seas, where bonds and equities both offer returns, where interest rates are positive in real terms, where economies are growing, even if slowly, and where inflation is properly subdued.

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