Public

This Month in the Markets

August 2023

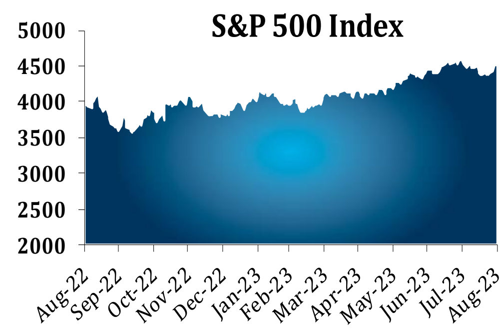
Equity Commentary

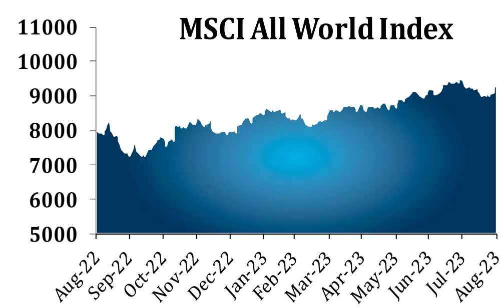
China Weakness Feeds Market Weakness

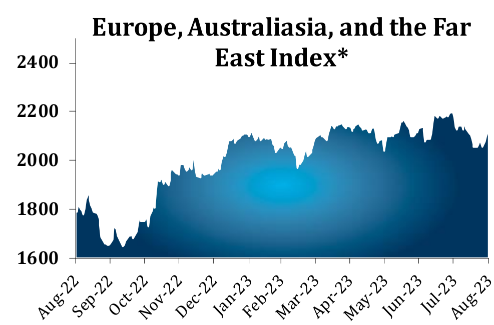
The equity market fell in August as concerns over the Chinese property market and weaker macroeconomic data led to some volatility. The MSCI ACWI Index fell 2.8%. The MSCI ACWI World Value Index declined 3.1% compared to the drop of 2.5% in the MSCI All Country World Growth Index. International markets underperformed the U.S. as the S&P 500 fell 1.6%, and the MSCI EAFE and Emerging Market Indices slid 3.8% and 6.1%, respectively. China led the decline with a loss in the MSCI China Index of about 8%. The MSCI ACWI Energy Sector index was the top performer, posting a gain of 1.4%, driven by a jump in crude prices. The MSCI ACWI Utilities Sector was the under-performer, with a loss of 5.6% as the jump in global yields pressured high dividend shares.

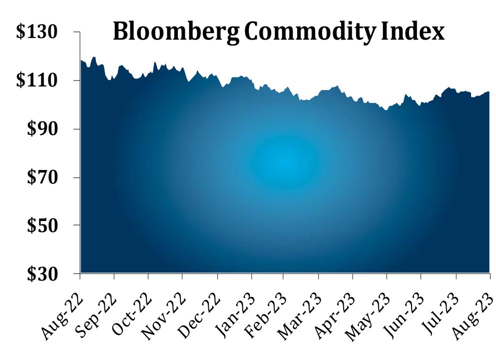
The major news for August revolved around the distress in the Chinese property market and the overall weak macro environment. On August 18th, Chinese property giant Evergrande filed for U.S. bankruptcy protection. The connected Chinese $2.9 trillion investment trust market was also questioned regarding its property exposure. Likely in direct relation to this large weakening sector, macro data in China has begun to turn more negative. Youth employment was reported at an all-time high of 21.3% (until the government stopped reporting it). Inflation in China turned negative in July, with CPI at -0.3% year-over-year. Retail sales also missed expectations and grew only 2.5% versus the expected 4.5%. Household confidence in China is also weak and is probably due to the morbidity we see in the property market. Home sales in China fell for a third straight month in August and slid 1.3% month over month. The People's Bank of China ("PBoC") cut rates twice in August, but this has failed, at least for now, to turn the direction in real estate. China contributes about one-third to global growth, so we expect to see softer growth numbers filter through to broad data measures over the next few quarters. The issue of China's poor demographics and soaring leverage seem to have finally caught up to the second-largest economy. We continue to monitor the situation and its potential effect on individual names in the portfolio. Our caution continues to have us avoid the material sector overall as 50% or more of many commodities demand is pulled from China. Given this rather glum outlook, it's worth noting that this is not unknown. Valuations in China and headline news reflect many of these worries, and Chinese authorities could make dramatic and abrupt changes to rectify some of these impediments to growth. Ultimately, China will need to transform into a domestic consumption model away from exports and investment growth to balance out the economy and move to the next stage of development. The country must also become more private-sector friendly and adopt a less "overseer mentality" to rekindle free-market animal spirits.

Siemens AG was the largest underperformer in the portfolio for the month, falling 11.9% as global growth concerns surrounding China's weakening economy led to weaker digital industry orders involving short-cycle factory automation. UBS Group AG was the top performer in the month, up 20.5%, as investors realized that the Swiss bank had rescued and taken over its primary rival at a very attractive valuation.









*MSCI EAFE Index

Fixed Income Commentary

U.S. Downgraded but Growth Resilient

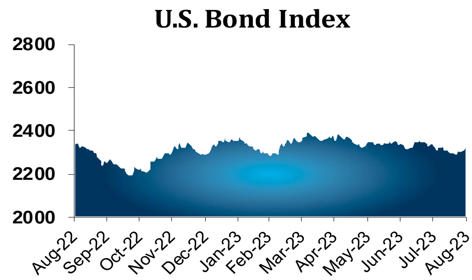
August began with Fitch downgrading the USA's credit rating from AAA to AA+. S&P downgraded the USA's credit rating to AA+ twelve years ago. As such, two of the three major rating agencies now rate USA government debt AA+. For context, there are countries (such as Norway) and companies (eg. Microsoft) that are AAA-rated by the major rating agencies (Moody's, S&P, and Fitch). U.S. treasuries are the global risk-free asset; as such, investors have historically flocked to treasuries in times of financial stress. Additionally, the U.S. treasury market is the world's largest, most liquid financial market, and the U.S. dollar is the dominant global reserve currency. To be sure, it seems the very definition of an oxymoron for the global risk-free asset not to have the highest possible credit rating (AAA). The Fitch downgrade was driven by profligate government spending and projected budget deficits. After the COVID-induced government handouts in 2020 and 2021, fiscal spending has flourished on the back of the Inflation Reduction Act, CHIPS Act, and the Infrastructure Investment and Jobs Act. Fitch expects the general government deficit to rise to 6.3% in 2023 (from 3.7% deficit in 2022). As such, the U.S. is currently running a pro-cyclical fiscal policy. Governments typically run an anti-cyclical fiscal policy: in a recession, tax receipts contract, and government spending rises to support the economy/citizens, leading to a budget deficit. We don't expect the dollar to lose its dominant reserve status or for treasuries not to be considered the global risk-free rate anytime soon, but it's hard to disagree with Fitch's rationale for the ratings downgrade.

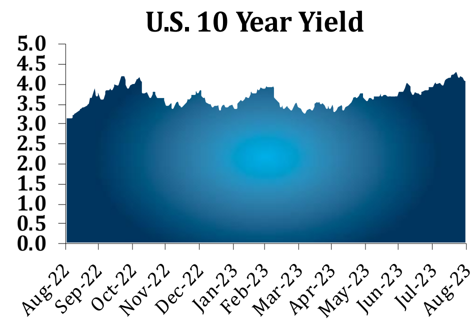
Front-end treasury rates, which are the most sensitive to fed funds rate expectations, were largely unchanged in August. At the time of writing, fed funds futures are pricing only a 7% chance of a 0.25% rate hike in the September FOMC meeting and a 40% cumulative chance of a hike in the November meeting. The Fed narrative has consistently guided for higher rates for longer to tame inflation, which remains above target (though declining). This was emphasized again in Chair Powell's Jackson Hole speech. Meanwhile, treasury rates at the long end of the curve rose notably. The 10-year treasury yield rose 0.15% to 4.11%, while the 30-year rose 0.21% to 4.21%. As a result, the treasury curve steepened (well, became less inverted!). The 2Y/10Y slope rose from -0.92% inversion to -0.75%. The move in rates in the long end was influenced by a couple of factors:

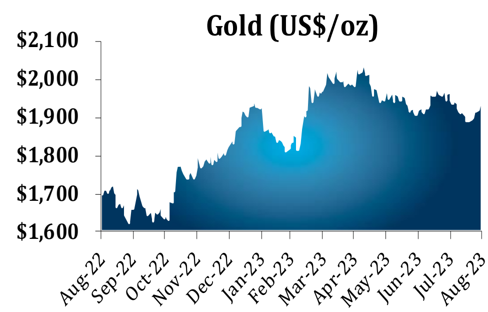
1. Economic Resilience: The Atlanta Fed GDP Nowcast currently predicts Q3 GDP will be 5.6%. Despite 5.25% of interest rate hikes since March 2022, consumers have held up well, as evidenced by recent retail sales data in August, which beat economist expectations. Data from the July Personal Consumption Expenditures report showed consumer spending picked up on a YoY and 3-month annualized basis in July. Consumption accounts for around 70% of US GDP. Another factor is that consumer balance sheets are in much better shape given the deleveraging since the global financial crisis - the fiscal handouts in 2020 and 2021 further buffeted consumer balance sheets.

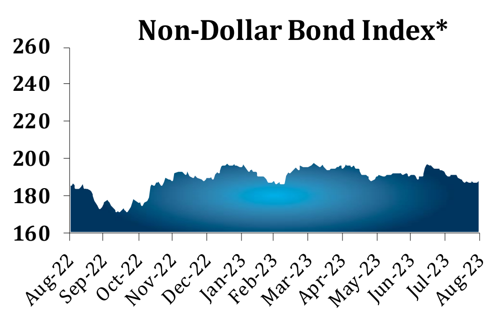
2. Treasury Supply: Treasury Secretary Yellen increased the quarterly treasury issuance to fund the fiscal deficit. Given the Fed is not buying Treasuries and certain foreign buyers stepping back from buying treasuries (China), the private sector must fill the void.

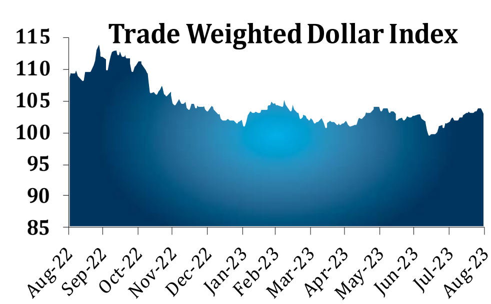
Monetary policy works with "long and variable lags," as per Milton Friedman. A good example of this can be seen in the housing market. Heavy refinancing activity in 2020 and 2021 at historically low interest rates, has meant that those mortgage rates have been unaffected (at least their mortgage payments) by the rise in interest rates since early 2022. For context, the 30-year mortgage rate is ~7.5% (per the Bankrate.com US Home Mortgage 30 Year Fixed National Average rate), while the effective rate on outstanding mortgages is just 3.6%. This same dynamic is at play in the corporate bond market. Some parts of the economy are feeling the pinch of tighter monetary policy – commercial real estate and existing home sales, for example. Additionally, banks have tightened lending standards and bankruptcies have risen, albeit from low levels. We will be on the lookout for signs of labor market and consumer weakness. From a positioning perspective we continue to view high-yield credit as mispriced and are more comfortable with interest rate risk over the medium term.











*Merrill Lynch Global Broad Market, Ex US Dollar Index

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