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Courtville Partners – Investment Outlook, October 2022

Summary of the key points in this quarter's Investment Outlook

- The value of the US dollar has continued to soar. We don't know when it will roll over, but we are alert to potential catalysts for a reversal
- Are we close to the nadir of the global bear market? Probably not – but investors should stay invested and be ready to increase exposure to risk assets at some point in the next 6-12 months
- Japanese equities offer relatively good long-term value, not least by dint of a bombed out currency
- Among its many deleterious effects, Europe's energy crunch means severe challenges for management of the electricity grid...
- ...and threatens a new wave of food price inflation next year, courtesy of fertiliser shortages

As you will have noticed, there is a lot happening in the world. In financial markets, however, there has only really been one thing going on over the summer, namely the steepling rise of the US dollar. This has been largely the product of aggressive action by the Federal Reserve to put up interest rates in an attempt to crush inflation. Many investors were sceptical that the Fed would have the stomach for the fight – viz., bond markets' persistent failure to forecast much higher rates. You won't find many sceptics now.

The statement that accompanied the Fed's 0.75% interest rate hike in mid-September was full of uncompromising language ("strongly committed to returning inflation to its 2% objective"); and it openly predicted further rate rises. Of course, this level of monetary policy aggression has only become necessary because the Central Bank stuck to its "inflationary pressures are transitory" creed for too long. That's what put the Fed "behind the curve", to use market vernacular. Our hunch is that economic historians of the future will study this period as a textbook example of how successful monetary policy is characterised by applying stitches in time. Failure to apply stitches is followed sooner or later by the sound of ripping fabric.

The sharp rise in the cost of money has naturally stoked investors' fears of recession in the US. When Jerome Powell (the Fed's Governor) says that "reducing inflation is likely to require a sustained period of below-trend growth", we must conclude that he is determined to keep interest rates high enough for long enough until it really hurts. In more quantitative terms, the Fed is committed to keeping real (i.e. inflation-adjusted) yields positive across the entire curve (i.e. at all maturities). Central bankers don't often use such plain words. No wonder expectations for US GDP growth are tumbling (to just 0.2% for 2022 from 1.7% as recently as June).

No wonder too that the dollar has continued to soar into the stratosphere. That is what yawning interest rate differentials tend to do. Measured by the broad-basket DXY index, the dollar has risen almost 20% over the last year. Such dollar strength brings with it huge problems both at home and abroad. For US companies, foreign profits translate back into fewer dollars (an effect already seen in earnings announcements from the likes of FedEx and Ford). Meanwhile, the rest of the world – and ultimately its consumers – must pay higher prices for energy and raw materials, most of which are still priced in dollars.

This leads inexorably to the biggest question now facing investors: when will the dollar begin to weaken? After all, currency valuations – at least in developed economies – usually revert to the

mean. Bear in mind also that the world's biggest commodity-importing and -exporting nations – China and Russia, respectively – are increasingly turning their back on the dollar. This bodes ill for the world's reserve currency in the long term. The snag for investors is that selling dollars and buying, say, ultra-depreciated Yen has been a fool's errand for years – and could continue to be for some time yet, however compelling the economic logic. The G20 group of world leaders is due to meet in Bali in mid-November, which has led to speculation about a "Bali Accord" (cf. the 1985 Plaza Accord to drive down the value of the dollar). Whatever the eventual timing, a weakening of the dollar will have far-reaching implications for asset prices worldwide.

As things stand, however, financial markets around the world are victims of a major dollar liquidity squeeze. And it isn't obvious to us what the trigger might be to ease the pressure. None of the usual catalysts seems terribly plausible (e.g. monetary easing by the Fed or weaker energy prices). Perhaps this is why hopes of a "Bali Accord" have risen – because no one has a better idea. Our portfolio response is to add 5% to the currency-hedged S&P 500 ETF. Half the Model Portfolio's exposure to the S&P 500 is now hedged in this way. It would be more than half if we knew when the dollar was going to roll over; but we don't.

The value of global equities fell 6% in 3Q22. Proximity bias makes it feel worse than that: a strong rally in July and early August has been outweighed by recent weakness. For the year so far, then, equities have fallen 26%. Stock market history is littered with falls of this magnitude (and worse). Arguably what marks out the 2022 bear market is the extent to which equities and bonds have moved down in near-lockstep. Such symmetry is quite unusual by historical standards – and has made a mess of the classic 60/40 portfolio (60% equities, 40% government bonds), not to mention certain liability-driven UK pension funds. Against this backdrop, our Model Portfolio has fallen a little over 8% so far this year – much better than the aggregates, although slightly worse the benchmark.

We remain wedded to our longstanding preference for equities over bonds, but have added 3% to our overall bond exposure (which at 16% remains well below the benchmark weighting of 21%). There are two main reasons. First, a statement of the totally obvious: bonds in general are much cheaper than they were. So far this year US and UK 10-year government bond prices have fallen 16% and 26%, respectively. Second, their violent downward price readjustment improves the chances that bonds will offer protection if and when economies fall into recession.

So are we near the bottom of the global bear market in equities? Our short answer: no, there is probably some way to go, both in terms of time and distance (to the bottom). Since 1926 the S&P 500 has endured 15 bear markets (i.e. peak-to-trough falls of 20% or more). Those bear markets that were accompanied by recession saw median declines of 36% over 18 months versus "only" 31% over 10 months in cases where the economy avoided recession. This time round the S&P 500 is 24% and nine months off its high. Given the challenges that face the global economy – inflation, supply-chain disruption, war, climate cultism – it would require heroic assumptions to think we have seen the worst. On the other hand, none of us knows what lies ahead. We can only repeat our mantra that investors should stay invested to the extent they can in order to profit from the compounding power that drives long-term investment returns – and should be ready to increase exposure to risk assets at some point in the next 6-12 months, however uncomfortable it may feel. Once bear markets blow themselves out, returns from equities in particular have often been strongly positive.

We mentioned the Yen earlier. We think it is worth pausing to consider Japan in general – and Japanese equities in particular. We already carry an overweight position in our Model Portfolio since we see many attractions to this market, but are adding another 1% (taking our total position

to 5%, i.e. two-thirds overweight). First, Japan is historically a low-inflation economy; and this may have value if investors believe the Anglosphere has entered a phase of structurally higher inflation. Second, the dramatic depreciation of the Yen stacks the dice in investors' favour: further Yen weakness makes Japan Inc even more competitive in world markets, while Yen strength would generate currency gains. Third, Japanese industry seems well placed to profit from the relentless digitalisation of modern life. Fourth, valuations are enticing at 11x prospective earnings (i.e. half the S&P 500's multiple) and just over 1x book value. Fifth, corporate governance, a weak suit for generations, is much improved even if standards still vary widely.

In sharp contrast to Japan, we remain just half-weighted in European equities. Three months ago we endorsed the economic aphorism that – at a fundamental level – economies are simply energy transformed. We then put the boot into the EU's Net Zero ambitions – and its "Fit for 55" legislation in particular (a 55% cut in CO2 emissions from 1990 levels by 2030). Not everyone agrees with us. Some commentators argue that the solution to the unreliability of renewable energy is yet more renewable energy – as if the challenge of generating electricity on cold, windless winter days is best addressed by erecting even more wind turbines or covering more prime arable land with solar panels. Each to their own. But Europe's shortage of *reliable* generating capacity is even more serious than it may appear – because of what it means for the grid.

The pan-European electricity grid, connecting 520 million consumers in 32 countries, matches supply and demand continuously. Supply and demand *must* balance on pain of damage to infrastructure or even shutdowns. Because the supply from renewables (wind and solar) isn't "dispatchable" (i.e. it can't be turned on and off instantly), critical incidents across the grid are becoming far more common (up 50% to 52 hours in 2021). The drive to Net Zero will make things much worse. To repeat: economies are energy transformed. But in order to be transformed, energy must first be generated and then dispatched to where it is needed. Europe has decided to ignore basic physics. Until its leaders recover their senses, European assets will verge on the uninvestible.

Within Europe geographical (as opposed to Europe political), the UK has stood out as one of the best-performing stock markets so far this year, bolstered by the positive effects of weaker sterling. We are reducing our already underweight position further still (from 12% to 8%). A rebound in the pound is quite likely, which may dampen returns from large-cap stocks (many of which derive large proportions of their revenues and profits from overseas). More generally, of course, confidence in UK economic policy has been shaken. This matters a lot for a country that relies on "the kindness of strangers" to fund its gargantuan current account deficit. Another way of looking at it is simply that the UK has been living beyond its means for many years (as evidenced by that current account deficit) – and the music is either fading or stopping, depending on your degree of pessimism. And, as on the Continent, our lights are going to go out this winter as soon as windmills and solar panels fail to generate enough electricity to replace all the dispatchable capacity that has been shut down.

One final uncomfortable thought. The crop yields achieved by modern agriculture depend crucially on access to chemical fertilisers. The feedstock used to make nitrogen fertilisers is natural gas. In response to monstrous spikes in gas prices, fertiliser producers across Europe have announced swingeing cuts in output. For example, Norway's Yara International said in late August that its ammonia capacity utilisation would be cut back to just 35% across its European sites. Food inflation is already rampant almost everywhere. Other things being equal, fertiliser shortages – and eye-popping price increases for whatever fertiliser farmers can buy – all but guarantee another wave of food price hikes next year.

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Asset Classes	Courtville Partners Asset Allocation (%)	FTSE PI Balanced Index (%)
UK Equities	8	14.7
International Equities	51	46.3
Fixed Income	16	21.3
Alternatives	12	10.1
Commercial Property	1	0.2
Cash	12	7.4
Total	**100**	**100.0**

Courtville Partners Model Portfolio	ETF	Weight (%)	Changes this quarter	Weighted OMC (%)
UK Equities		**8**	**-4**	
UK	VUKE LN	6	-2	0.09
UK	VMID LN	2	-2	0.10
International Equities		**51**	**2**	
US	VUSA LN	16	0	0.07
	XDPG LN	15	4	0.09
	IUVD LN	3	0	0.20
Euro	VERX LN	1	0	0.12
	EGRG LN	2	0	0.29
Japan	VJPN LN	5	1	0.19
Asia ex-Japan	VAPX LN	3	-1	0.22
China	IASH LN	2	-2	0.40
Emerging Markets ex China	VFEM LN	4	0	0.25
Fixed Income		**16**	**3**	
Government Bonds				
UK Inflation Linked	INXG LN	2	0	0.25
US Inflation Linked	IDTP LN	0	-2	0.07
UK	IGLT LN	3	1	0.07
US	IDTM LN	7	2	0.17
China	CNYB NA	2	0	0.35
Corporate Bonds				
US	CORP LN	2	2	0.20
Alternatives		**12**	**-1**	
Gold	PHAU LN	5	0	0.39
Commodities	BCCU LN	0	-1	0.35
Commodities	NRGW LN	1	0	0.30
Infrastructure	INFR LN	2	0	0.65
Water	IH20 LN	2	0	0.65
Carbon Allowances	CARB LN	2	0	0.35
Commercial Property		**1**	**0**	
Global	IWDP LN	1	0	0.59
Cash	GBP	**12**	**0**	
Total		**100**		**0.17%**

Courtville Partners	Model Portfolio	FTSE PI Balanced Index	Relative performance
2022	-8.2%	-7.7%	-0.5%
Since inception(1/1/2015)	69.5%	60.6%	8.8%
CAGR	6.2%	5.6%	0.6%

The value of your investments can fall as well as rise, and you may not get back all the money you invested.