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Courtville Partners – Investment Outlook, January 2023

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

- We see US inflation remaining above the Fed's 2% target for longer than assumed by the market consensus – and, as a corollary, we expect US interest rates to remain higher for longer than the consensus.
- The Fed's inflation-killing determination makes recession in the US a racing certainty.
- For more than a hundred years no bear market in US equities has bottomed out before a recession has begun.
- China's re-opening will unleash three years of pent-up demand – and risks giving fresh impetus to inflation.
- We maintain our bearish view on the UK and Europe. The US market strikes us as being the "cleanest dirty shirt" among major stock markets.
- Falling real yields on government bonds may encourage buyers of gold.

The descent is more dangerous than the ascent. Astonishing as Joe Simpson's account may be, you don't have to read (or watch) *Touching The Void* to know that most mountaineers are warier of getting down from the peak than of scaling it in the first place: gravity, tired limbs and complacency underpin their caution. Does Jerome Powell, Governor of the US Federal Reserve, see himself as a mountaineer? Probably not. Even so, our guess is that he expects the descent from the inflationary summit to be trickier – and above all more gradual – than the consensus view. We doubt very much that he shares the enthusiasm for lower interest rates sooner rather than later (the so-called "Fed pivot") that greeted November's US inflation report. Instead, in his final press conference of the year Mr Powell was keen to highlight that rapid falls in goods and housing inflation are not being matched in the services sector. Although the headline inflation rate is going in the right direction (7.1% in November, down from an intra-year peak of 9.1%), it still far exceeds the Fed's 2% target. Almost no one believes the target will be hit in the next 12 months.

In sum, we expect at least another couple of increases in dollar interest rates, which admittedly is in line with the market's view; but thereafter we anticipate rates to remain higher for longer than the consensus. Barring economic miracles, the Fed's conduct of monetary policy makes recession in the US a racing certainty; and we are conscious that for more than a century no bear market in US equities has bottomed out until a recession was underway. This is partly why we judge it still too early to increase exposure to equities. That said, we would be surprised if we hadn't recommended precisely this by the second half of 2023.

Why are we such interest rate killjoys? We would point to several forces that are likely to keep the Fed hawkish: first, a US labour market still notable for its strength and concomitant wage inflation (unemployment at 3.7%, barely above its cyclical low of 3.5%, and wages growing at 6.4% p.a.); second, a steady weakening of the forces that have driven globalisation, including dollar hegemony; and, third, the better-late-than-never re-opening of the Chinese economy.

On top of all this, the Fed's self-interest represents another powerful, albeit unquantifiable, reason to press on with its aggressive monetary policy. Having badly misjudged the post-lockdown inflationary wave, the Fed must now rebuild its inflation-fighting credibility. To do this it must extinguish not only inflation itself, but also the *psychology* of inflation. ("Central banking is and always has been a confidence trick." Discuss.) No doubt Mr Powell would also like to re-stock on monetary ammunition to give himself scope for material rate cuts next time the economy tanks. *Ceteris paribus*, all of this suggests a Fed funds rate that is unambiguously positive in real terms. (For now it remains negative at 4.25-4.5% against inflation of more than 7%.)

Anyone who regards interest rates of 4-5% as "high" – and they do exist – reveals their ignorance of financial markets before 2008. It is the last 15 years that have been abnormal, not a mid-single digit Fed funds rate. To extend that thought, one can plausibly argue that it is the last *40* years that have been abnormal – in the sense that investors have had the wind of falling (or nugatory) interest rates at their back for that long. But those gentle zephyrs have been replaced by the monetary equivalent of challenging nor'easters. Good seamanship will be required from here.

Looking at the prospective path of inflation from a different angle, can we identify forces that might apply downward pressure apart from outright recession? Everything is possible, of course. All we would say is that none of the important factors in play in the early 1980s are obvious candidates this time: Powell is no Volcker; breakthrough energy sources are not in sight (certainly not nuclear fusion – sorry); union power was broken long ago; China has been and gone as an exporter of deflation; and the demographics of the West are notoriously awful (though perhaps not as bad as China's).

While he continues his climb to the interest rate peak, Mr Powell will surely have one eye on developments across the Pacific. Was it really the power of protest that persuaded China's government to abandon its Zero Covid policy and move quickly to re-open the economy? No one outside the Politburo can know. The persistent failure of people like us to predict accurately the timing of The Great Re-opening has never altered its inevitability, even three years on. For herd immunity, however achieved, is always how pandemics end. China will now simply catch up with the rest of the world, which in turn caught up with Sweden. Might there be a return to Zero Covid? It seems unlikely if only because of the resulting loss of face. Besides, the average BMI in China is far below Western levels.

So what lies ahead for China? In a word: inflation – both domestic and exported. We've seen this movie before as other countries have re-opened after lockdown. A combination of pent-up consumer demand, acute labour shortages (through illness and early retirement) and disrupted supply-chains makes for much higher prices of almost everything. The difference with China lies in the sheer scale of the demand backlog – three years of it, not three months. The impact on the prices of commodities of all kinds is likely to be material – and will be felt by companies and consumers around the world.

Against this backdrop, investors' current expectations for future inflation seem unrealistic. For example, US 5-year breakevens (as revealed by US Treasury inflation-linked bonds) stand at 2.2%. In other words, investors expect US inflation to average 2.2% p.a. over the next five years. To get there from here would require the Fed to induce a recession too deep and too long to be consistent with the political stomach for the anti-inflation fight. We are left to conclude that investors should get used to inflation running hotter than the Fed's ostensible target of 2% for longer than the market expects.

We try always to look ahead in our Investment Outlook, referring to past events only to put our views into context. But 2022 was a genuinely bizarre year for investors, summed up by the fact that since 1926 only two other years (1931 and 1969) have seen *both* US equities and US treasury bonds lose money for investors. No wonder investment coroners have been pronouncing the death of the classic 60/40 portfolio (60% equities, 40% bonds – or vice-versa for the more cautious). Beneath the surface of apparent uniformity (almost all asset classes down), investors had to navigate a landscape in which actions and consequences seemed divorced from each other. For example, war in Europe and runaway inflation almost everywhere might have been expected to give a fillip to the gold price – yet gold barely moved. Alternatively, any one out of tumbling OECD leading indicators, collapsing purchasing manager surveys and a 20%+ fall in the S&P 500 might reasonably have sparked a rush to government bonds; but the reward would have been once-in-a-generation losses.

Nonetheless – and in a spirit of seasonal introspection – we feel duty-bound briefly to survey what we got right over the last year and what we got wrong. To our credit, we were right about non-transitory inflation, the bear market in bonds, the resilience of gold (at least in relative terms), energy stocks (even before Russia invaded Ukraine) and EUAs (aka carbon credits). We also foresaw a stronger Yen and called the dollar peak in late 2022. Less propitious were our over- and underweight positions in Chinese and UK stocks, respectively, and our faith in index-linked gilts, which provided no inflation protection at all.

As it turned out, the UK was the best performing stock market in the developed world last year. Even so, we are not changing our bearish stance. The heavy representation of energy companies (and perhaps even banks) may help the indices from here. But the UK's fiscal, monetary and currency outlooks remain miserable. Marginal income tax rates for the middle classes are eye-watering (between 60% and 90% depending on personal circumstances); fiscal drag is now a deliberate feature of Treasury policy, not a bug; and capital gains allowances are being whittled away to almost nothing. Labour governments of the 1970s would have recognised all of this; and before long the prospect of a new Labour administration may be casting its shadow across the investment landscape.

Going into the new year we have made some adjustments to our Model Portfolio.

- We expect emerging market equities to continue to do well in 2023 – and remain overweight. A weaker dollar and a reviving China (with the associated boost to commodities of all kinds) should represent an even more favourable macroeconomic picture than those prevailing for most of 2022.

- We have added a 4% position in the iShares Quality Factor ETF (IWQU). In the event of recession, companies with strong cash flow and dividend profiles, high returns on capital and robust competitive positions should fare relatively well.

- As far as regions of the world go, we expect the US and emerging markets to outperform Europe and the UK. This may seem counter-intuitive given our views on inflation; but we detect greater political will in the US to tackle inflation than in Europe. And – at the risk of stating the obvious – the US benefits from both energy self-sufficiency and an essentially business-friendly culture. In other words, the US remains the "cleanest dirty shirt".

- Gold is not an inflation hedge *per se*; and the last 18 months have been a reminder of this. But we feel comfortable with our relatively chunky allocation to gold (5%) at a time when US treasury yields are likely to fall as recession bites. We would also submit that a combination of crypto chaos and American confiscation of Russia's dollar-denominated foreign reserves creates a vacancy for a more reliable store of value (than the dollar). And, finally, if central banks' inflation-fighting resolve weakens, gold ought to be a decent hedge.

Asset Classes	Courtville Partners Asset Allocation (%)	FTSE PI Balanced Index (%)
UK Equities	8	14.7
International Equities	51	46.3
Fixed Income	18	21.3
Alternatives	12	10.1
Commercial Property	1	0.2
Cash	10	7.4
Total	**100**	**100.0**

Courtville Partners Model Portfolio	ETF	Weight (%)	Changes this quarter	Weighted OMC (%)
UK Equities		**8**	**0**	
UK	VUKE LN	6	0	0.09
UK	VMID LN	2	0	0.10
International Equities		**51**	**0**	
Global	IWQU LN	4	4	0.30
US	VUSA LN	15	-1	0.07
	XDPG LN	13	-2	0.09
	IUVD LN	3	0	0.20
Euro	VERX LN	1	0	0.12
	EGRG LN	2	0	0.29
Japan	VJPN LN	4	-1	0.19
Asia ex-Japan	VAPX LN	3	0	0.22
China	IASH LN	2	0	0.40
Emerging Markets ex China	VFEM LN	4	0	0.25
Fixed Income		**18**	**2**	
Government Bonds				
UK Inflation Linked	INXG LN	2	0	0.25
UK	IGLT LN	4	1	0.07
US	IDTM LN	8	1	0.17
China	CNYB NA	2	0	0.35
Corporate Bonds				
US	CORP LN	2	0	0.20
Alternatives		**12**	**0**	
Gold	PHAU LN	5	0	0.39
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	XSTR LN	**10**	**-2**	0.15
Total		**100**		**0.18%**

Courtville Partners	Model Portfolio	FTSE PI Balanced Index	Relative performance
2022	-6.8%	-5.9%	-0.9%
Since inception(1/1/2015)	72.2%	63.8%	8.4%
CAGR	7.0%	5.6%	1.4%

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