Courtville Partners – Investment Outlook, July 2023

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

- "Nobody knows anything," as William Goldman put it in another context – but he may as well have been talking about markets in the first half of 2023.
- US interest rates have risen more sharply than in 40 years – but mega-capitalisation technology stocks have proved astonishingly oblivious. AI euphoria well and truly trumped the maths of discounted cashflow.
- Central banks are fighting inflation with the bluntest of tools, interest rates. Expect nothing much to happen – until suddenly it does. (Older readers may remember Wile E. Coyote from the cartoons of their childhoods.)
- Various mega-trends are emerging, including the slow death of the dollar's reserve currency status, calamitous demographics, energy scarcity and ballooning government debts.
- Cash management is important again now that zero interest rates are just a memory. We are keeping our model portfolio's cash allocation at 10%.
- Remain invested in real assets if you can. Timing markets is a matter of luck, not judgment.

William Goldman carved out a long and success-studded career as novelist, playwright and screenwriter, but remains best known for a single aphorism: "Nobody knows anything" – by which he meant that no one in the film industry knows what will be a hit with the cinema-going public. Goldman's wry wisdom comes to mind after surveying the performance of stock markets so far this year. NASDAQ and Japan have risen 32% and 29%, respectively. Heavily touted Chinese equities, by contrast, are down more than 6% year-to-date (and tumbled more than 10% in 2Q23 alone).

Who saw any of this coming? How could the growth-dependent mega-caps of NASDAQ defy the steepest rise in US interest rates in 40 years? Most turn-of-the-year strategists would have ruled it out as a serious scenario. The ruthless maths of discounted cash flows would have demanded as much. But then ChatGPT arrived on the scene, bringing with it predictions of an AI-dominated world and putting a rocket under the share prices of Nvidia and other technology companies. Ten stocks on their own accounted for a third of NASDAQ's 32% rise since the start of the year; and on average each of those ten rose an astonishing 77%. Seen from a wider angle, the MSCI All-World stock market index is up 13% year-to-date; but the same index in its equal-weighted form is up just 4%. That is the power of a handful of mega-capitalisation stocks.

Japan's soaraway performance looks less left-field in retrospect, but only because plenty of pundits had been tipping it for years without ever being right. Even allowing for a lengthy list of causes for optimism on Japanese equities, why was it going to be different this time? (We were more recent converts to Japan. We turned positive in October 2022, since when the market is up 28%.) China's stock market, on the other hand, looked like a decent bet for a bounce as the country's economy re-opened after years of futile and destructive lockdown. It has not come to pass.

Never mind the film industry. Does anyone in the world of portfolio investment know anything? Do the partners of Courtville know anything? Well, yes, we believe that we *do* know certain things – such as the superiority of equities over bonds as long-run preservers of wealth, to take a basic example. Just as valuably – and at the risk of sounding obtuse – we have firm ideas about what we *don't* know. Prominent on the "Sorry, we haven't a clue" list is what particular markets will do from quarter to quarter or even year to year; and the first half of 2023 has reminded us of this essential truth. Putting the two together – what we know, what we don't know – argues in favour of Blaise Pascal's implicit ideal: we should try to sit quietly in a room alone. For portfolio investors, this should mean staying invested in real assets for the long term without trying to time entry or exit. For us, it means not making any material changes to our model portfolio this quarter.

The year has already been full of surprises; but, as so often, advance knowledge might not have been an advantage to the investor. If, say, we had known six months ago that the Federal Reserve would go far beyond consensus with its interest rate hikes, would we have predicted this year's bull run in long-duration, rate-sensitive technology stocks? No, we wouldn't. In the geopolitical arena, who would have forecast the Wagner Group's coup-that-wasn't-a-coup? What might have been the consequences of Mr Prigozhin getting his hands on Russia's nuclear codes? Let's not go there. We therefore approach with humility the question of how to allocate assets in a world facing a nasty mix of (i) stubborn inflation, (ii) tight monetary policy and (iii) loose fiscal policy.

We have been inflation hawks for a long time, but are not tempted to change tack just yet. Price inflation only risks becoming embedded once it leeches into wage inflation – because this creates the proverbial vicious cycle (higher prices because higher wages because higher prices...). Despite central banks' interest rate increases, wage inflation has very much taken off in most major economies. (Japan and Switzerland are noteworthy exceptions – two countries that did not resort to enthusiastic money-printing during lockdown.) Wage inflation is likely to persist for several reasons, which include: the lingering effects of lockdowns (the wave of voluntary retirement above all); powerful demographic trends (ageing populations and plunging birth rates); persistently weak productivity growth in the OECD; and the relentlessly inflationary effects of Net Zero via the replacement of efficient generating capacity with "renewables" that are far less efficient, are not dispatchable and can't store their output.

In sum, we (and the consensus) still expect more rate hikes from the Federal Reserve (and others). But spare a thought for the central bankers (if you can find it in your heart). More than ever, interest rates are the bluntest of instruments with which to curb demand in the economy. After so many years of rock-bottom rates, translated by banks into multi-year fixed rate mortgage deals, higher official interest rates will take months, even years, to feed through into households' finances. But then suddenly they will. (We are put in mind of Wile E. Coyote, the cartoon character that routinely runs off a cliff, keeps going and only gradually realises that there is nothing holding him up – at which point he plunges abruptly plunges to the canyon floor below.) It's not only households riding for a fall on their borrowings: Morgan Stanley calculates that $260bn of high-yield corporate debt falls due next year, double the current total. Once refinanced at (much) higher rates, the effects are likely to feed through to margins and hiring/firing. All in all, having kept interest rates too low for too long, central banks now run the obvious risk of overdoing it on the way up as well.

For the time being, then, the direction of monetary policy in many countries still points upwards. In the US, Fed Governor Powell overlaid June's rate pause (the first after 10 consecutive hikes) with some distinctly hawkish comments about the future evolution of inflation and therefore interest rates. The same mood music is to be heard from the European Central Bank and the Bank of England. At some point central banks will have to choose: keep turning the interest rate ratchet, causing recession – or slacken monetary policy in response to rising unemployment, but at the cost of structurally higher inflation? An unenviable choice – and one about which politicians everywhere will no doubt have something to say.

And what of fiscal policy? Its sheer looseness is perhaps summed up by a US budget deficit running at a scary 6% of GDP despite nearly full employment. What price that number in a recession? Put it this way: the path to fiscal rectitude is unlikely to be found via tax revenues, which in many countries are already at or near all-time highs as a share of GDP.

If there is something an investor should try to know (or at least form ideas about), it is the nature of the current age. Easier said than done, for sure – and only ever straightforward in retrospect – but always a valuable exercise for those with a genuinely long-term approach to their investments. In the present day, there are several mega-trends unfolding. The slow death of the US dollar as the world's reserve currency is one; and the shift from abundance to scarcity – above all in energy – is another. And what will be the consequences of the calamitous demographics in almost every country outside Sub-Saharan Africa? In what ways will societies and economies have to function differently as populations simultaneously shrink and age? (Our hunch: almost everything will be different, whether by design or by force of circumstance.) A related trend – also hard to ignore – is the fiscal incontinence and ballooning government debt on display in many developed economies. If debt levels cannot rise infinitely, how will this resolve itself? Whither tax rates as dependency ratios continue to climb? Should investors look predominantly to emerging markets for higher investment returns in the medium term? If the so-called Global South accounts for over half the world's GDP and much more of its growth, but only 20% of its stock market value, is this an issue that investors simply have to confront? We will return to some of these questions.

If mega-trend-gazing falls at one end of the spectrum of investment decision-making, managing cash is at the other. Frankly, how to deploy surplus cash was not something investors had to think about for many years following the GFC of 2008. Returns were essentially zero (or less) on almost all cash and quasi-cash instruments. But now money market funds yield more than 5% in dollars and a bit less than 5% in sterling, while short-dated government paper offers even more. The big question is how far to extend maturities, the answer to which necessarily flows from an investor's view of central banks' efforts to tame inflation. There are, however, quirks to exploit in the system. For example, certain ultra-low-coupon UK gilts issued in recent years now trade at chunky discounts to par (i.e. the price at which they will be redeemed at maturity). With market interest rates much higher than they were, most of the yield-to-maturity on these bonds will come in the form of tax-free capital appreciation, not income. For higher-rate UK taxpayers the effect is to boost after-tax yields to 8% or even 9% p.a., albeit with moderate duration risk.

A risk-free cash yield of 5% or more may appear an attractive short-term proposition. It certainly creates a higher bar for portfolio investment than has been the case for many years – and high enough that we have decided to keep our model portfolio's cash allocation at 10%. But our patience is wearing thin; and we expect to increase our allocation to real assets long before the impact of higher interest rates is felt in the real economy or central banks decide to loosen the monetary tourniquet. In other words, we don't intend to wait for recession to bite. Stock markets are nothing if not discounting mechanisms.

Asset Classes	Courtville Partners Asset Allocation (%)	FTSE PI Balanced Index (%)
UK Equities	8	14.5
International Equities	52	44.0
Fixed Income	17	25.9
Alternatives	12	8.5
Commercial Property	1	0.1
Cash	10	7.0
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		**52**	**1**	
Global	IWQU LN	5	1	0.30
US	VUSA LN	16	1	0.07
	XDPG LN	12	-1	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	0	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		**17**	**-1**	
Government Bonds				
UK Inflation Linked	INXG LN	2	0	0.25
UK	IGLT LN	4	0	0.07
US	IDTM LN	7	-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	WELN GY	1	0	0.18
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**	**0**	0.15
Total		**100**		**0.18%**

Courtville Partners	Model Portfolio	FTSE PI Balanced Index	Relative performance
2023	3.5%	3.5%	0.0%
Since inception(1/1/2015)	78.4%	69.5%	8.9%
CAGR	7.1%	6.4%	0.6%

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