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Courtville Partners – Investment Outlook, October 2023

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

- Is the end of US dollar hegemony in sight? If so, what should we do about it?
- Are we entering a new age of bounty for the Global South (aka Emerging Markets)?
- We consider possible reasons for the mysterious, but relentless, rise in US T-bond yields
- Net Zero threatens Europe's car industry with destruction at the hands of Chinese rivals
- The UK's public finances are drowning under an index-linked tide of debt service costs

In our previous Investment Outlook, we suggested that investors should try to divine the nature of the age in which they are living (and investing). Easier said than done, as we freely admitted, and only ever straightforward in retrospect. Imagination is perhaps the most useful quality that an investor can apply to this exercise – that is, the ability to imagine a world quite different from the one they see around them, if only to dismiss the possibilities.

To compound the difficulty, an investor's perception tends to be influenced by their vantage point. At the risk of sounding trite, if you want to know where you (or markets) are going, it helps to know where you are. This thought ("Where are we?") quickly comes to mind when surveying the current state of the global economy and its future direction. Investors in Europe or North America tend to see the world – and the investment universe – through the lens of the post-WW2 international order. This is the world of the IMF, the WTO, NATO, the WHO, the UN, the EU and so on. Here the dollar was, is and will be the world's reserve currency; most commodities are priced in dollars; and the US commands the most powerful armed forces on the planet. But this is not how most of the world sees things. Exhibit A: roughly two-thirds of governments have not imposed sanctions on Russia. And now, in a sign of the times if ever there was one, Chinese diplomacy has engineered the addition of six countries to the BRICS, including Saudi Arabia and Iran. As a group, the BRICS may have little in common bar their dislike of the US; but, in aggregate PPP terms, they now represent materially more of global output than the G7 (37% versus 30%).

It makes perfect sense for China to cosy up to Saudi Arabia in particular, which is its largest supplier of oil, but also now represents a major outlet for reinvesting China's huge trade surpluses, especially in infrastructure. Meanwhile, the Saudi/Iran rapprochement, in which Beijing also played a role, may serve to reduce the odds of a runaway oil price. For the US and its Western allies, however, these are unpalatable developments. The US and Saudi Arabia have been bound by mutual interest since the Second World War: oil, priced exclusively in dollars, in exchange for military protection and materiel. But now the Chinese cuckoo-in-the-nest has the ear of MBS (and probably never mentions human rights). No doubt China is also suggesting that it might pay for its oil in renminbi (as it already does for Russian oil). Our point is that a world in which countries can pay for oil in their own currencies is by definition one in which they are no longer forced to earn and retain dollars if they want to ensure an uninterrupted supply of energy. And if a country no longer has to stash away dollars, neither does it have to recycle those dollars into riskless US treasury bonds. Is this one reason (though only one) why US treasury bond yields continue to drift upwards (by almost 50bp over the last quarter at the 10-year term)? Although a 10-year treasury yield of 4.7% is unremarkable by historical standards, we should remind ourselves that it was below 1% in late 2020 and was still a mere 1.5% at the end of 2021. The present level is the highest since 2007.

How do higher long bond yields tally with the narrative of falling inflation, peak policy interest rates and slower economic growth, all of which would classically depress bond yields? For sure,

Fed Chairman Powell continues to read from his "higher for longer" script, in response to which investors do still expect one more rate hike in the US, though only one. But this hardly counts as a surprise. We should look elsewhere for possible and/or plausible suspects behind the continuing rise in US T-bond yields. And, like Ko-Ko in *The Mikado*, we have no trouble drawing up a little list: rising energy prices (i.e. more inflation in the pipeline, so to speak); bond sales by either the Fed itself ("quantitative tightening") or by foreign powers spooked by the US government's *de facto* confiscation of Russia's FX reserves; investors' unease at the shocking US budget deficit (running at 7-8% of GDP, even before recession comes); portfolio sales by pension funds now paying out to the Boomers; or a loss of confidence in US treasuries as a reliable diversifying tool for balanced portfolios. The very length of the list supports the impression that no one seems to know what is going on. On the other hand, higher yields do at least help to explain the dollar's recent strength (up an eye-catching 7% over the last 10 weeks on a trade-weighted basis).

Whatever the real reason (or reasons) for the phenomenon, it prompts the question of whether investors should brace for a new era of structurally higher *real* interest rates in the West. If China, for example, prefers to invest its trade surpluses in a revivified Belt & Road programme rather than US treasuries, should the US (and probably the rest of the heavily indebted West) expect to pay more in real terms to attract the capital to fund their colossal current account deficits? And is the flipside of this a new age of bounty for the Global South (or Emerging Markets as we used to call them)? Freed of the multiple requirements to hold dollars, invest them in low-yielding US treasuries and impose tight monetary policy when dollars run short, will these countries now have increased scope to invest in higher-return projects in local currencies? Our model portfolio, which takes a long-term view, reflects just such a secular shift.

Whatever long-term doubts may loom over the US dollar and treasuries, US equities have held on to most of their year-to-date gains (+14%), notwithstanding a sluggish third quarter (-2%). Among major markets, only Japan has done better (+25%). The exceptionally strong performance of a handful of Big Tech stocks has once again been a major factor in the S&P's index-level performance. With no such boost from the so-called "Magnificent Seven", the equal-weighted S&P 500 is no better than flat so far this year. From here on, however, valuations offer few reasons to be cheerful. Calculated using cyclically adjusted earnings, the Schiller price/earnings ratio stands at a rarefied 30x – a level exceeded for less than 10% of the last 120 years. When starting from such high valuations, investors have seldom enjoyed positive investment returns over the ensuing decade. With this in mind, we have reduced our US equities weightings by 3%. Nevertheless, as the end of 2023 approaches, investors seem happy to discount a return before long to the low-inflation and low-volatility world that existed before February 2020 ("the immaculate disinflation", as wags have termed it). Wishful thinking? With one eye on a $90+ oil price, we fear it may be.

On this side of the Atlantic, Continental European equities have been struggling (still up 11% year-to-date, but down 6% in 3Q23). Our bearishness on this region going into the 2022/23 winter proved to be completely misplaced. Abnormally mild temperatures and hastily brokered LNG imports combined to save Europe's bacon. But we are still sceptical about the region's investment prospects. At the macro level, we worry about several developments: M1 money supply is contracting fast; credit growth remains anaemic; and core inflation is stuck above 5%, leaving the ECB with minimal leeway to cut interest rates. Many European companies face the double whammy of weaker demand, now that post-lockdown backlogs have evaporated, and higher costs for both capital and labour.

No European industry is under greater pressure than car manufacturing, which in addition to the prevailing macroeconomic headwinds finds itself staring at a genuinely existential threat courtesy of the Net Zero-driven shift to electric vehicles. Chinese car companies enjoy vastly lower costs

of EV production than their European rivals. For example, BYD's new Seagull five-door hatchback sells in China for less than $11,000 – roughly one-third of the sticker price for FIAT's 500e EV in the UK. China's cost advantage in EVs is neither a secret not a surprise – and reflects a combination of sheer scale (China made as many cars in 2022 at the US, EU, UK and Japan put together), cheap energy (battery-making requires lots of energy and coal-fired power stations produce the cheapest electricity) and dominance of supply chains (especially in nickel and rare earth metals). Europe's decision to prioritise EVs over petrol/diesel/hybrid cars therefore plays straight into China's hands.

Can the EU defend its indigenous car industry from the impending onslaught? Quite possibly not. Ursula von der Leyen rails against China's "huge state subsidies" and has already announced a formal investigation, provoking China into irony-free criticism of the EU's "naked protectionism". Not for the first time, the European Commission's position is made trickier by a Franco-German split. French carmakers fear being wiped out by ultra-competitive Chinese EV imports, but have almost no sales in China to worry about in the event of a tit-for-tat trade war. Germany's car giants, by contrast, have substantial operations in China and are therefore wary of provoking Chinese retaliation. BMW, Mercedes and Audi may also believe that their high-end marques are less vulnerable to competition than then mass-market brands of Stellantis and Renault. Predictably, then, Macron is calling for protection for Europe's car industry, while Scholz argues (at least in public) that "competition should not scare us".

The EU is already in the early stages of negotiating with China on the issue of EVs; but its track record is not encouraging. Separate investigations a decade ago into telecom equipment and solar panels did not stop the EU more or less giving in to China. Even the volume and price conditions of the solar panel deal didn't prevent Chinese companies from quickly taking the lion's share of the European market. Whatever else it may be, Net Zero is not a recipe for the continued health of European industry.

Across the Channel, the UK has plenty of its own worries. How about this one...? On a trailing 12-month basis, the UK Treasury must now find £117bn p.a. to meet interest payments due on the national debt – equivalent to almost 5% of GDP or 140% of the education budget. This figure has roughly doubled since the year to September 2021 – and much of the explanation lies in the UK's heavy reliance on index-linked bonds ("linkers" in financial slang). Index-linked bonds' coupons are linked to prevailing inflation, which has very obviously been a major drawback in the last two years. Almost all Western countries issue index-linked bonds, but none with as much enthusiasm as the UK. Roughly a quarter of the UK's stock of debt is index-linked. Italy is its nearest rival at 12%. The result is that the UK government will spend more than 10% of its revenues this year on debt service (the highest of any major economy); and a whopping two-thirds of that will go towards paying the coupons on linkers. Proponents of index-linked gilts argue that they help to underpin a government's anti-inflation credentials by making it much harder simply to inflate away nominal debt obligations. Whether such a strategy best serves the interests of an historically inflation-prone economy such as the UK is moot, even before taking account of external shocks such as soaring energy prices.

We are not making many changes to our model portfolio this quarter – and the changes we have made are consistent with the commentary above. We have increased exposure to both Asia and Emerging Markets (aka the Global South) in both equities and bonds. We have reduced the overweight in US equities while maintaining our underweight positions in European and the UK equities. We stick with our overweight cash position for now. Short-term cash returns in excess of over 5% represent a high bar at a time of great uncertainty over the global economic outlook.

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Asset Classes	Courtville Partners Asset Allocation (%)	FTSE PI Balanced Index (%)
UK Equities	8	14.5
International Equities	51	44.0
Fixed Income	18	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		**51**	**-1**	
Global	IWQU LN	5	0	0.30
US	VUSA LN	16	0	0.07
	XDPG LN	9	-3	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	5	2	0.22
China	IASH LN	0	-2	0.40
Emerging Markets	VFEM LN	6	2	0.25
Fixed Income		**18**	**1**	
Government Bonds				
UK Inflation Linked	INXG LN	2	0	0.25
UK	IGLT LN	2	-2	0.07
US	IDTM LN	7	0	0.17
EM	SEML LN	3	3	0.45
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	WEL5 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**		**0.21%**

Courtville Partners	Model Portfolio	FTSE PI Balanced Index	Relative performance
2023	3.5%	4.3%	-0.8%
Since inception(1/1/2015)	78.6%	70.9%	7.7%
CAGR	6.8%	6.3%	0.5%

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