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# Courtville Partners – Investment Outlook, January 2024

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

- Following 2023's unexpectedly strong recovery, risk assets are basically flat over the last two years.
- Investors should look through the annual gyrations of capital markets and consider the longer-term developments, even as they unfold at unpredictable rates.
- We doubt inflation is quite as dead as some argue, but we see central banks reducing interest rates anyway. This could float all boats, at least for a while.
- Keep an eye on the Japanese yen and the price of gold, both of which could strengthen appreciably.
- The valuation gap between US and non-US equities is by now a chasm – and underwrites the potential rewards to be had from allocating away from the US.

The human condition is characterised by eternal struggles between opposing forces: good and evil, capital and labour, not to mention life and death. In the field of investment – itself a small, but important, part of that condition – the eternal struggle lies in reconciling the long term and the short term. Most investors know that their best chance of success comes from taking a long-term view; and they know it because the overwhelming weight of long-run data tells them as much. Yet few investors are wholly immune to the powerful cocktail of bias and emotion. Most of us think we can outsmart the aggregates, at least for a while.

The last year has illuminated this contrast between short and long term to a greater degree than usual. As 2023 got underway, the foreground was littered with all sorts of unpleasant prospects: soaring inflation, interest rate hikes galore, punishing energy costs, impending recession and squeezed corporate profits. Propitious it wasn't. Over the 12 months that followed, very little moved in a straight line; but the upshot was global equities 22% higher and global bonds almost 6% higher (both expressed in dollars). Plenty of narrower classes of risk asset clocked up eye-popping increases: +24% for the S&P 500, +28% for Japan's Nikkei, +54% for the tech-heavy NASDAQ and +153% for Bitcoin (remember that?). Fine – but what point are we making? Simply that investors with their eye on the long term would not have tried to predict any of this. Instead, they would have treated the surprising, but pleasing, returns delivered in 2023 as minor components within the machinery of long-run average investment outcomes.

After all, those same investors will have noticed that global equities are essentially unchanged from the peak reached almost two years ago in January 2022. It has been a rollercoaster ride for equity investors since then – and, indeed, over the four years since the first lockdown. For bonds, it has been even worse, notwithstanding 4Q23's notable rally (more on which later): the global bond index still stands 15% below its January 2022 level. All in all, making money has been hard over the last couple of years, at least for investors who disclaim any skill at timing markets. But we see this as confirmation of the wisdom of keeping one's investment gaze on the long term.

We try to keep our own sights trained on the distant horizon – and conversely try to avoid being distracted by all the stuff in the foreground. We do this in two ways. First, we have a broad conviction, based on a vast canon of empirical evidence, that risk assets in general – and equities in particular – offer investors the best chance of growing their wealth in real, inflation-adjusted terms over the long term. Second, we believe it is also possible to identify certain shifts in the investment landscape's tectonic plates, even if the timing almost always remains a mystery. We have explored some of these shifts in recent Investment Outlooks, including the usurpation of the

dollar as the world's uncontested reserve currency and the gradual economic coming-of-age of the Global South. Both strike us as developments with the power to influence investment portfolios profoundly, but on unknowable timescales.

If 2023 defied most expectations (and it really did) – and at the risk of putting aside our own long-termist mantra – what would count as reasonable expectations for the coming year, whether they end up being defied or not? Front and centre sits the US presidential election – not so much because of the eventual outcome, whatever that may be, but because of the gravitational pull that politics is exerting – and is likely to continue to exert – over monetary and fiscal policy for the next 12 months.

The Federal Reserve's November statement was taken as an unambiguous change of direction in interest rate policy (the so-called "Fed pivot"): no more rate hikes, victory over inflation and rate cuts of 75bp by the end of the 2024. Only a cynic would suggest that the Fed has abandoned its hawkish stance in response to political pressure, even though headline US core inflation of 3.1% remains well above the 2% target. Nevertheless, it seems hard to imagine the Fed administering any more monetary medicine this side of the election. Taken together with ultra-loose fiscal policy (viz., a budget deficit running at an astonishing 8% of GDP), financial conditions in the US seem set to be as pro-cyclical as it is possible to imagine. Perhaps the old maxim "Don't fight the Fed" should be amended for now to "Don't fight the combined forces of the Fed and the Treasury".

This raises at least two related considerations. First, what are the implications for interest rates? Our best guess is that investors hoping for a return to the ultra-low rates seen in the 2008-21 period will be disappointed. Dollar interest rates seem far more likely to settle in the 4-5% range than 0-1%, especially since many factors argue for inflation remaining well above 2%. Second, is the US government's fiscal incontinence sustainable? Debt levels in many Western countries have reached levels that bring us closer to an eventual fiscal reckoning. In the US, Federal Government debt as a percentage of GDP has almost doubled to 120% in the space of just 15 years. History tells us that bond investors will decide when the bill is to be paid.

We see many other powerful forces at work within the global economy, some or all of which are likely to affect asset prices over the next year and beyond.

- Wars are famously inflationary (though ironically the price of *waging* war has plummeted thanks to technology in general and drones in particular). Could an end to the meat-grinding conflict in Ukraine generate a disinflationary dividend? Or will the West's war-by-proxy against Iran morph into something bigger, more dangerous and much more inflationary?

- The vulnerability of both the Panama and Suez Canals to disruption – courtesy of drought and Houthi piracy respectively – may persuade more companies both to shorten their supply-chains by bringing manufacturing closer to home and to build up precautionary inventories anyway. Both phenomena would be inflationary.

- Will a stronger yen give the world's economy a fillip? The yen has gone from roughly 40% overvalued against the dollar on a PPP basis to almost 30% undervalued in a little over a decade. The currencies of major trading partners cannot diverge to such a degree without provoking instability; and, if left unchecked, the yen's severe undervaluation will be bad news for other major economies. The range of unpalatable possibilities runs from another hammer-blow to the EU's industrial base to a deflationary property-and-banking bust in

China to the destabilisation of the renminbi-based Asian monetary system. Although the Bank of Japan has not yet formally abandoned its yield curve control policy, it has done so in spirit. Taken together with inflation of more than 3%, the monetary backdrop is encouraging for yen appreciation from here. Whatever the catalyst for a stronger Japanese currency, the result should provide a healthy boost to the global economy.

- Is gold having a moment? This precious metal gets a reliably bad press as a portfolio investment, though it has featured in our own model portfolio from the start and has delivered an average annual return of 6.5%. We see it as an insurance against the debasement by governments of their *fiat* currencies. Whatever role it performs, gold has been making all-time highs recently against all major currencies bar the dollar. This may owe something to the dollar's recent weakness (itself the product of rate cut fever) – in which case there is a decent chance that gold will continue to make new highs.

- Will the stark valuation (and performance) differences between US equities and non-US equities finally tempt investors to reallocate assets from one to the other? Over the last decade US equities have risen almost 150%, during which time non-US equities (as measured by the MSCI All-World ex-US Index) are up a mere 10% in dollar terms. This is the mechanical reason that the US has come to represent 63% of the All-World Index – a number that causes sleepless nights for portfolio managers everywhere. One consequence of such an extended divergence in performance is that non-US equities look cheaper than at almost any time in the last 30 years.

The Fed's sudden change of interest-rate tack towards the end of 2023 made the resulting "everything rally" easy enough to understand; and it may well be a portent of things to come this year. But – to repeat ourselves – investors serve their own interests best when they look through the annual gyrations of capital markets and consider the longer-term developments unfolding gradually in front of them.

Our Model Portfolio underperformed its global balanced portfolio benchmark by -0.4% in 2023. Asset allocation contributed a positive 1.6%, but currency (i.e. strong sterling) had a negative impact of -2%. We have a long-term aversion to sterling. The pound tends to depreciate in the long run because of structural UK economic weaknesses, not least the enduring current account deficit and relatively high inflation rate. Even though sterling has rallied strongly in 2023, we believe it makes sense for UK savers to have a disproportionate percentage of their savings in non-sterling assets. This approach does not pay off every year, of course; but it has been the right long-term strategy for the last 80 years or so. As we were saying, it pays to focus on the long term.

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| Asset Classes | Courtville Partners Asset Allocation (%) | FTSE PI Balanced Index (%) |
|---|---|---|
| UK Equities | 10 | 14.3 |
| International Equities | 52 | 46.2 |
| Fixed Income | 18 | 25.6 |
| Alternatives | 12 | 7.8 |
| Commercial Property | 1 | 0.1 |
| Cash | 7 | 6.0 |
| **Total** | **100** | **100.0** |

| Courtville Partners Model Portfolio | ETF | Weight (%) | Changes this quarter | Weighted OMC (%) |
|---|---|---|---|---|
| **UK Equities** | | **10** | **2** | |
| UK | VUKE LN | 8 | 2 | 0.09 |
| UK | VMID LN | 2 | 0 | 0.10 |
| **International Equities** | | **52** | **1** | |
| Global | IWQU LN | 5 | 0 | 0.30 |
| US | VUSA LN | 16 | 0 | 0.07 |
| | XDPG LN | 9 | 0 | 0.09 |
| | IUVD LN | 3 | 0 | 0.20 |
| Europe | 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 | 0 | 0.22 |
| Emerging Markets | VFEM LN | 6 | 0 | 0.25 |
| Emerging Markets ex-China | EXCS LN | 1 | 0 | 0.18 |
| **Fixed Income** | | **18** | **0** | |
| Government Bonds | | | | |
| UK Inflation Linked | INXG LN | 2 | 0 | 0.25 |
| UK | IGLT LN | 2 | 0 | 0.07 |
| US | IDTM LN | 7 | 0 | 0.17 |
| EM | SEML LN | 3 | 0 | 0.50 |
| 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 | **7** | **-3** | 0.15 |
| **Total** | | **100** | | **0.21%** |

| Courtville Partners | Model Portfolio | FTSE PI Balanced Index | Relative performance |
|---|---|---|---|
| 2023 | 9.0% | 9.4% | -0.4% |
| Since inception(1/1/2015) | 87.1% | 79.3% | 7.8% |
| CAGR | 7.2% | 6.7% | 0.5% |

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