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Courtville Partners – Investment Outlook, April 2024

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

- Equities have run up a long way over the last 18 months. We are holding our nerve – and our noses – and remain overweight.
- Investors still expect interest rate cuts in the US this year. It is less clear that such cuts are needed in the face of strong economic growth, above-target inflation and scant evidence of rising unemployment.
- We are more worried about bonds (than about equities) thanks to fiscal profligacy, massive bond issuance and doubts over the Fed's commitment to its inflation target.
- The march to Net Zero continues to distort global energy policy and the associated capital investment. We have added uranium exposure to the model portfolio: aside from hydro, nuclear represents the only feasible, but carbonless, source of baseload electricity.

"Lord, make me bearish, but not yet" – as St Augustine of Hippo didn't say when reviewing his portfolio in fifth century North Africa. But that's how we at Courtville Partners feel about most equity markets at the moment. The 40%+ run-up in the MSCI All World Index since September 2022 has been unrelenting. Notwithstanding the wide array of geopolitical problems, investors' animal spirits continue to be encouraged by, *inter alia*, heavy doses of AI-inspired story-telling, expectations of cuts in official interest rates and (in some markets) abundant liquidity. In the US in particular, the Federal Reserve is tantalisingly close to pulling off the "immaculate disinflation" that few thought possible, i.e. curbing inflation while avoiding recession.

The 21st century is only two-and-a-bit decades old, but is already notable for several macroeconomic policy oddities – from zero interest rates to quantitative easing (and tightening) to lockdown fiscal fire-hosing. If the consensus is right, we're soon to be treated to another monetary policy collector's item. For now at least, investors in aggregate believe that the Fed will cut its official interest rate three times – and by 0.75% in total – by the end of the year. What would make this unusual by historical standards is that core PCE inflation is still well adrift of the Fed's target (2.8% versus 2.0%). As far as we're aware, the Fed has only cut rates twice in the last 100 years with inflation running as high as it is now. Do such rate cut expectations betray a belief that the Fed under Jerome Powell is not as committed to its 2% inflation target as it once was? That's how it looks to us – and investors should prepare themselves accordingly. Whether the Fed's lack of rigour owes to political forces in an election year is harder to judge.

To compound the prevailing strangeness, the US economy continues to grow at an impressive clip. Indeed, it's hard to argue that monetary stimulus is needed at all. GDP growth came in at an annualised 3.4% in 4Q23 and, if anything, is likely to have accelerated since then. One of the reasons for such strong growth has been the Federal Government's astonishingly profligate spending. A budget deficit in the region of 6% of GDP is eye-popping enough on its own; but, coming against the backdrop of sustained economic expansion, such largesse is – how shall we put it? – highly unconventional.

Don't take our word for this. The Congressional Budget Office, which acts as an non-partisan spending watchdog, describes the trajectory of the US Government's finances as "unsustainable". In quantitative terms, it expects the annual budget deficit to remain stuck at around 6% of GDP over the next decade. The average has been 3.7% over the last 50 years, a period that took in several wars, the Global Financial Crisis and lockdown. Outside wartime, there is no precedent for such fiscal carelessness in either scale or duration. Stern as the CBO's warning may be, the reality

will be worse – possibly much worse – since the Office is required by statute to base its projections on existing government policy, much of which is frankly fantastical.

Not for the first time, we choose to highlight America's fiscal malaise because of what it implies for the US treasury bond market – still the crucible in which the global price of money is tested every day. This remains true in spite of the many threats to the dollar's status as undisputed reserve currency of the world. US public sector debt has doubled in just 10 years and is fast approaching 125% of GDP. In fact, it is growing at a cool $6bn a day. Go figure. Over the next 12 months alone, the US Treasury must refinance $8trn of maturing debt and fund $2trn of new debt (aka unfunded government spending).

Is this "unsustainable", as the CBO alleges? Not at all, but only because investors collectively retain enough confidence in the dollar's reserve qualities. Will this always be so? No one can know; but anyone can point to the multiple factors that could one day trigger a funding (or solvency) crisis for the American Leviathan. Precedents abound: the UK in the 1970s, Latin America in the 1980s, Russia and Asia in the 1990s, Venezuela and Argentina more recently – and many others besides. Any hint that the US Treasury was unable to fund itself at acceptable rates would trigger an epic bear market in most assets – bonds, equities, property and commodities (though not precious metals, presumably).

But why worry? No one knows *whether* the US Government will one day find itself in a hole, let alone *when* or *how*. For sure, we still advise against holding many, if any, long-dated bonds issued by the US, the UK or EU governments – not at current prices or yields, anyway. But there isn't much else to be done by way of defensive measures. And even when (or if) the storm comes, it too will pass; and asset prices will re-set and eventually recover. So let's not worry.

Nor should we preoccupy ourselves with what the Fed or other central banks will or won't do to interest rates. Ignoring central bankers is a recipe for long-term portfolio success (or at least an ingredient in the recipe). Even the central bankers themselves don't know what they're going to do. So how can the rest of us? Investors like to attribute rate-setting superpowers to the monetary high priests; but the overwhelming evidence says such powers are illusory. Without wishing to sound arrogant, we would argue that the last 20 years or so have been a catalogue of policy error from the world's major central banks. So why spend time worrying about the decisions of people who routinely get the big calls wrong?

If the investing landscape in the US is dominated by loose monetary policy and even looser fiscal policy, then equities (though not bonds) probably still benefit from decent tailwinds – which explains St Augustine's name-check at the start. According to the 2024 edition of the UBS (formerly CS) yearbook, annualised returns from US equities since 1900 have averaged 9.4% during rate-cutting cycles, but only 3.6% while rates are rising. (For bonds the figures are +3.6% and -0.3%.) UK equities and bonds show similar patterns. These represent strong currents for bears to swim against.

We have picked out two other market propellants: abundant liquidity and AI's potential to transform productivity. Both are worth a closer look, starting with the liquidity picture. The prices of all sorts of assets have been shooting up, including those especially sensitive to liquidity (e.g. tech stocks, cryptocurrencies, even gold). This has occurred in defiance of a shrinking US money supply, a smaller Fed balance sheet ("quantitative tightening") and record US treasury bond issuance. So where has all the money been coming from to drive up asset prices? And will it last? The answer to the first question takes in multiple phenomena: Covid-era liquidity injections (the lingering effects of); Japan's longstanding yield curve control policy (incentivising the Japanese to

export their savings); the downwards lurch in energy costs since mid-2022; recycling of the monster US current account deficit (often into US bonds or equities); and so on. But for many of these factors, momentum may be fading. And competition for liquidity is always shape-shifting. Take the example of bitcoin ETFs, which have gathered assets at a stupefying rate since SEC approval (roughly $50bn in less than three months). Global cryptocurrency assets are now equivalent to a non-negligible 2.5% of global money supply, a fivefold increase since 2020.

Investors' enthusiasm for all things AI has driven technology stocks as a whole to 33% and 17% of US and global market capitalisation, respectively – levels not seen since 2000. As others have observed, AI may be a structural phenomenon, but customers for Nvidia's chips, say, will continue to be cyclical (which helps to explain why Nvidia's share price has fallen 50% or more 11 times since IPO). For now, though, investors are content to ignore the warning lights flashing in the Big Tech universe. Most obviously, regulators are on the attack almost everywhere. On this side of the Atlantic, the EU has imposed a mega-fine on Apple for anti-competitive practices in music streaming; and it has brought in legislation to combat the alleged "gatekeeping" superpowers of the leading digital platforms. Meanwhile, US regulators, state and federal, have launched lawsuits against Amazon, Meta and Google and are investigating whether their AI investments restrict competition. (Ponder also what a re-elected President Trump might do to the social media companies that erased him in 2021.) Even in Asia there is a plethora of antitrust cases and new legislation. For the time being, investors appear sanguine about these developments. But legally enforced break-ups have been a feature of US economic history, most notably Standard Oil and AT&T. (We flagged the risks of Big Tech break-ups as long ago as July 2021. This trail went cold through the lockdown era, but is now warming up again.)

Western governments remain wedded to Net Zero (at least in public), even as its absurdities and hyper-perverse incentives become understood more widely. The policy continues to exert huge influence over the prices of many commodities – few more so than uranium and carbon allowances, though their prices have moved in opposite directions. Uranium's price is up a steepling 300% over the last four years. It's not hard to see why: almost uniquely, nuclear power offers CO_2-free baseload electricity; and uranium is an utterly price-insensitive part of the nuclear generation process. Overall demand for electricity (not least from AI-related applications) must rise if fossil fuel energy is steadily outlawed. As for the supply side of the equation, investment in new uranium mines has been crimped for many years by low prices and political hostility. Even after the recent increase, uranium's price is still a mere 25% of its 2012 pre-Fukushima peak. We suspect there is much more upside to come.

In sharp contrast, the price of EU carbon allowances has tumbled 40% in a year. The main culprits have been lower gas prices (which elbow CO_2-heavy coal out of the picture) and weak European industrial output. This has had a painful impact on the return of our model portfolio (-50bp in 1Q24 alone), even though the carbon price has recovered 20% in the last month. We still believe the fundamentals of EU carbon pricing are intact and so are keeping the position for now.

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Asset Classes	Courtville Partners Asset Allocation (%)	FTSE PI Balanced Index (%)
UK Equities	10	14.4
International Equities	52	46.9
Fixed Income	16	26.3
Alternatives	15	7.3
Commercial Property	1	0.1
Cash	6	5.0
Total	**100**	**100.0**

Courtville Partners Model Portfolio	ETF	Weight (%)	Changes this quarter	Weighted OMC (%)
UK Equities		**10**	**0**	
UK	VUKE LN	8	0	0.09
UK	VMID LN	2	0	0.10
International Equities		**52**	**0**	
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
Euro	VERX LN	2	1	0.12
	EGRG LN	2	0	0.29
Japan	VJPN LN	4	0	0.19
Asia ex-Japan	VAPX LN	4	-1	0.22
Emerging Markets	VFEM LN	5	-1	0.25
Emerging Markets ex-China	EXCS LN	2	1	0.18
Fixed Income		**16**	**-2**	
Government Bonds				
UK Inflation Linked	INXG LN	2	0	0.25
UK	IGLT LN	2	0	0.07
US	IDTM LN	5	-2	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		**15**	**3**	
Gold	PHAU LN	5	0	0.39
Oil	WEL5 GY	2	1	0.18
Infrastructure	INFR LN	2	0	0.65
Uranium	NUCG LN	2	2	0.55
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	**6**	**-1**	0.15
Total		**100**		**0.21%**

Courtville Partners	Model Portfolio	FTSE PI Balanced Index	Relative performance
2024 YTD	4.8%	4.7%	0.1%
Since inception(1/1/2015)	95.7%	87.8%	7.9%
CAGR	7.5%	7.0%	0.5%

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