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An analysis of the "tricky juncture" for the global economy

We are currently at a tricky juncture. We see very significant upside for many of the Fund's long positions, particularly beaten down cyclicals. At the same time, opportunities on the short side are also clearly diminishing. Markets appear to be largely pricing in a recession, particularly in Europe, where many cyclicals are down 40% to 50% in the last 12 months and are trading on single digit P/Es.

There is pervasive bearishness in markets. An example of this is that on 23 September the volume of puts traded in the US hit record levels, higher even than during the pandemic. Speculators are close to record net short S&P 500 futures. There is also a mountain of cash on the sidelines. Money market funds have $2.4 trillion of cash parked at the Fed in its overnight reverse repo facility. Expectations are now very low, and a bad situation is expected to just keep getting worse.

We think it is highly likely that US inflation is peaking and as a result Fed hawkishness is likely also cresting. Any dialing back of the Fed's current extreme hawkishness would have ramifications across financial markets, especially given current positioning. It would likely lead to declines in both the dollar and bond yields. This could trigger major rallies across equities, particularly outside the US, declines in credit spreads, rallies in commodities and a broad-based surge in currencies other than the dollar. However, as seen this month, timing this is difficult and when markets enter panic mode, as happened towards the end of September, they can sell-off sharply in a short period.

The global economy seems to be transitioning from an environment of low nominal GDP growth, which prevailed for much of the 2010s, to one of higher nominal GDP growth. This likely means higher interest rates, both in nominal and real terms, along the yield curve.

The fundamental drivers of this shift are various. Austerity has been discredited as a policy; the pandemic led to dramatic fiscal spending, and this has been followed by further bailouts in Europe as a result of the energy crisis. A recapitalised and de-risked Western banking system that wants to lend is particularly important for Europe due to its reliance on bank rather than market funding. Globalisation lowered unit costs and led to lower prices. De-globalisation will lead to higher unit costs and higher prices. The rise of e-commerce was a significant deflationary force, however retail margins have been crushed and so prices will now have to reflect unit costs, which are rising.

The Green Transition will require massive investment, which will be happening at a time of tight commodity markets due to historic underinvestment. During the 2010s, the low nominal growth environment favoured high duration assets, and growth won over value. From the peak in December 2006 to the trough in November 2020, the MSCI Value index underperformed the MSCI Growth index by 63%. The final leg down for value was mainly driven by a widening of the P/E differential. The P/E discount of MSCI Value to Growth is now back to the dotcom extremes (a 51% discount currently, it is usually closer to 20-25%). The 2020s could well favour low duration value stocks.

While the long-term outlook is for structurally higher inflation and rates, on a 12 to 24 month view it is highly likely that inflation will moderate from current extreme levels. To understand the outlook for inflation you need to know how we got in the current pickle in the first place.

The pandemic led to a helicopter drop of money, which, set against a relatively fixed supply of goods and services, led to a step up in the price level. US M2 growth hit 27% YoY in February 2021, which was twice the previous peak growth of 14% YoY in 1976. One of the 'real world' manifestations of this

was that US Bank deposits surged 38% (by $5 trillion to $18 triliion) from February 2020 to May 2022, and this increase was 20% of US GDP. In this context, it is unsurprising that between January 2020 and June 2022 US CPI jumped 15%.

The multi-trillion-dollar question is whether this is a big, but one-off, step up in the price level or whether it is the start of an inflationary spiral? The current data points to a one-off step up. US M2 growth, the main culprit of the current high inflation in the US, has now slowed sharply, and the growth rate is down to 5% YoY, below the 20-year average (6%). Also, the best way to forecast the economy is interest rates: they tend to be inversely correlated with activity 12 to 18 months forward. Higher rates now mean lower GDP growth in 12 to 18 months. There has already been a massive amount of tightening. The Fed Funds Rate is up from 0.25% to 3.25% in a year, a decade high, US 10-year bond yields have doubled to 3.9% in a year, also a decade high. US 30-year mortgage rates have doubled from 3.0% to 6.3% in a year, another decade high.

With a lag, all this tightening will definitely slow the US economy in 2023. This is consistent with the message from the yield curve. The yield curve is as inverted as it was in 2006, 1999 and 1989. There are already clear signs that the supply chain problems which also contributed to high inflation are easing. ISM Prices Paid dropped from a 40 year high of 92 in June 2021 to a below average 53 now. The US housing market is already slowing sharply; the NAHB index has slumped from a multi-decade high of 90 in 2021 to a below average 49. There are early signs that the upward pressures on rent are also easing, with declines recorded in some surveys.

The overwhelming balance of evidence is that inflation will decline, probably sharply, in 2023. This will allow central banks to step back from their recent uber-hawkish rhetoric.

The travails facing Europe with regard to gas supplies are clearly a very well-trodden topic, normally including doom-laden hyperbole. The reality is the situation is actually a lot better than many investors assume. On 27 September, Patrick Pouyanne, CEO of Total, noted that 'Europe will go through winter without gas problems'. As CEO of an oil major with a very large LNG business, Pouyanne likely knows what he is talking about. He is sanguine as Europe has made great strides diversifying its supplies, it has nearly filled up its storage, and high prices are already curtailing demand. Gas storage across Europe is over 80% full.

Pierre Andurand, a top performing commodities hedge fund manager, recently wrote an op-ed in the *Financial Times*. He estimated that a 3C drop in thermostats across the EU for heating (21C to 19C) would solve two-thirds of the deficit left by the elimination of Russian gas imports net of new LNG imports. This would take home temperatures back to those that prevailed in the mid-1990s – which is perfectly achievable. Pouyanne and Andurand's comments are consistent with the recent -40% decline in European gas prices from over €300 to €183/MWh, obviously still very elevated by historical standards but well off their panic highs. At current prices, the impact of high gas prices is about 5% to 7% of EU GDP. This is manageable, and governments across Europe have planned bailouts of consumers to largely mitigate these effects, while still keeping the price consumers pay high enough to trigger falls in demand.

The critical thing for policymakers is being able to plan. Now they know it is highly likely Russian gas flows will be cut to zero, they can plan on this basis. In addition to diversifying supply and ramping up renewables spend, they can target demand management. In the US, California has proven adept at short-term demand management when it has had grid problems. It simply uses text messages to ask homeowners and businesses to curtail demand between certain hours and this allows it to avoid mandatory blackouts. This has proven very successful and could be used in Europe to deal with any pinch points.

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