SARANAC
PARTNERS

Investment roadmap

APRIL 2024

AT A GLANCE

— This month's main feature evaluates **whether the equity market rally that emerged last October has been more speculative than fundamentally based, and hence less likely to be sustained**. One argument in this context has been that up to the end of last year, equity markets were supported by lower bond yields, as the inflation outlook improved and the potential for interest rate cuts emerged. The inflation and interest rate outlook has since reversed, but equities have continued to rally, until the recent upturn in global political risk. This disconnect between bond and equity markets, so the argument goes, leaves equities vulnerable. Additional concerns have been the supposedly narrow breadth of market gains, and the high level of equity valuations.

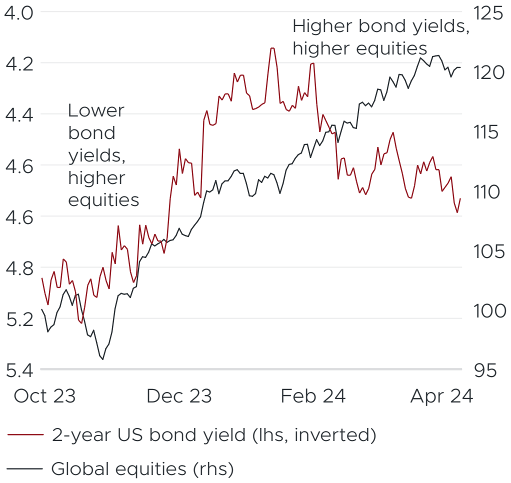
— However, we view the rally as more fundamentally based. There has been a discernible rebound in global growth this year, supporting the profits outlook and market breadth has widened (the 'Magnificent 7' has ceased to be a meaningful concept). While equity valuations reflect greater potential for a soft landing, they are not high enough to be speculative. The rally in **global equities** has indeed been the result of higher PE ratios rather than a discernible rise in corporate earnings. However, we view equity valuations on average as extended, but not in bubble territory. In addition, much of the extended global valuation reflects the high ratings on some US companies, and these ratings may be sustained while these companies are so cash-generative and maintain strong balance sheets. Outside the US, equity valuations are more muted, but so too are relative earnings prospects.

— The modest upturn in the **global economy** since the start of the year has persisted, with growth coming in somewhat ahead of expectations in many regions, business confidence rising, and the momentum in corporate earnings positive – particularly in the US. The recent strong rise in many commodity prices is also consistent with firmer growth momentum. While our central case is that widespread and deep recessions will still be avoided, we also believe that much of the global economy – in particular Europe and China – is trapped in low-growth cycles. The dominant macro theme is likely to remain 'stagnation'.

— In **fixed income**, markets are now pricing much less aggressive monetary easing than at the start of the year, and we believe that long-term government yields are around 'fair value' after their recent increase. Credit spreads remain below 'normal', in particular in high yield, although the rise in inflation expectations means that this component of the market is better priced. In general, we prefer to wait for better entry levels to reinvest cash. Given inverted yield curves, we continue to prefer 4- to 5-year maturities to longer-duration exposures, particularly outside the US.

— As a general theme, we note that **risk premia** in many classes are relatively low, and this underlies a more cautious investment stance than usual in Saranac multi-asset portfolios: more in diversified fixed income, cash and alternatives, and somewhat less in equities.

Chart 1: Changing bond–equity relationship



Source: Saranac, Bloomberg.

In our conversations with clients, it has been common for concerns to be raised that the rally has been more speculative than fundamentally driven.

1. Have equity and credit markets become disconnected from fundamentals?

Since the beginning of October, global equities have rallied by some 25% in dollar terms. Inevitably, after a rally of this magnitude, the question arises as to its sustainability. In our conversations with clients, it has been common for concerns to be raised that the rally has been more speculative than fundamentally driven. A typical line of argument is as follows:

"The rally began in October, with markets pricing in aggressive interest rate cuts as central bank concerns over inflation abated, and recession risks seemed elevated. Since the turn of the year, however, inflation has surprised on the upside. The scale of discounted rate cuts has been materially pared back, with some speculation that the cuts may not materialise this year at all, and bond yields have risen. However, equities have continued to rally.

At the same time, economic and corporate earnings growth remains sclerotic. Virtually all the gains in equity markets have been the result of a valuation re-rating, with corporate fundamentals still weak. Equity valuations are now very extended, with little to support them, and corporate credit spreads are compressed.

A particular risk is that equity markets have become highly concentrated, with the 'Magnificent 7' in the US accounting for a disproportionate element of the gains in equities. This narrow base implies scope for a material correction once this expensive part of the market rolls over.

In short, the rally has had strong speculative underpinnings and is unsustainable".

Chart 1 illustrates the potential disconnect. At the end of last year, interest rates fell and equity markets rallied. This year, interest rates have risen, retracing much of their previous gain, but equity markets have continued to make gains.

In this article, we explore this argument in more detail, not for the sake of getting the history of the past six months right for its own sake, but to assess future prospects. If it is not possible to identify a coherent view of the environment in which equities

Chart 2: US inflation expectations (%)

Source: Saranac, Bloomberg.

have rallied so strongly, and a clear narrative around the prevailing structure of asset class pricing, this would indeed suggest a fundamentally speculative environment.

We set out below why we don't believe this is the case, although it may well prove to be the case that equity returns this year will have been concentrated primarily in the first few months of the period, particularly given heightened global political tensions.

2. Two phases to the market rally

i. Lower inflation, weak growth

The current equity market rally has seen two distinct phases. The first emerged in the aftermath of the risk-off period, which characterised last summer. Conviction at that time in the potential for a hard landing or recession, driven by aggressive central bank tightening in the face of stubborn inflation pressures, had strengthened materially: bond yields surged and equity markets sold off. These tensions were initially exacerbated by heightened Middle East tensions.

The consensus in these circumstances was sufficiently strong for many market participants with short-term horizons to be positioned in a uniform way to benefit in such a highly risk-averse environment. In these circumstances, however, it does not take much for these shorter-term players to be forced out of crowded positions once these risk-off trades begin to be questioned – as they were towards the end of last October, in particular in the context of the emergence of a more favourable background for inflation and interest rates. What had initially been a technical market rally developed into one with more fundamental support. How did this happen?

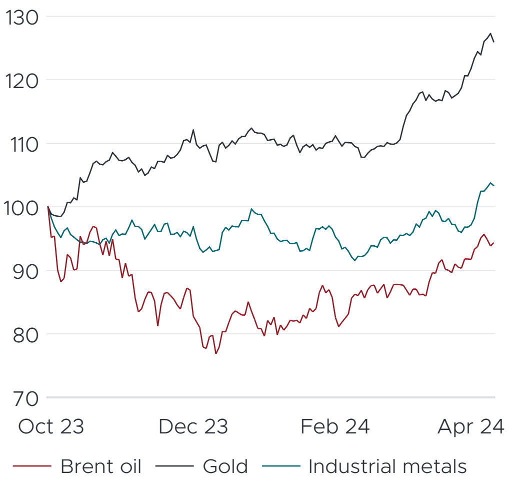
The strength of the post-Covid economic recovery in 2020/21, the legacy of Covid-related constrained supply chains and the surge in energy prices after the Russian invasion of Ukraine had led to a rise in inflation that surprised both central banks and many market participants.

The strength of the post-Covid economic recovery in 2020/21, the legacy of Covid-related constrained supply chains and the surge in energy prices after the Russian invasion of Ukraine had led to a rise in inflation that surprised both central banks and many market participants. It remained stubbornly high after the initial ascent, leading to legitimate concerns that inflation had become deeply embedded in many economies, with the deterioration viewed as potentially a multi-year rather than multi-month

Chart 3: US 10-year bond yield (%)

Source: Saranac, Bloomberg.

Chart 4: Commodity prices (Sept 2023 = 100)



Source: Saranac, Bloomberg.

phenomenon – in short, a secular change that would potentially require a deep and lasting recession to bring back under control. A competing hypothesis was that the rise in inflation was, despite its extent and longevity, more the result of temporary shocks that would fade over time.

Evidence accumulated over the second half of last year that favoured this second interpretation, and the Fed in particular seemed to back it. As the legacy of the supply shocks faded, inflation began to decline in many countries, even in the absence of recession. Indeed, US inflation fell back even as the economy remained very robust. In these circumstances, the Fed perceived that it could pivot to an easier stance – initially through suggestions that rates did not need to rise further, and then indicating there was scope for eventual rate cuts.

In short, the Fed's actions in response to a more benign inflation trend decreased the risk of an inflation-related recession, and increased the potential for a more benign economic environment for many financial assets. It is no surprise that there was scope for bond yields to fall, credit spreads to narrow and equities to rally: that's what happens when significant inflation concerns subside.

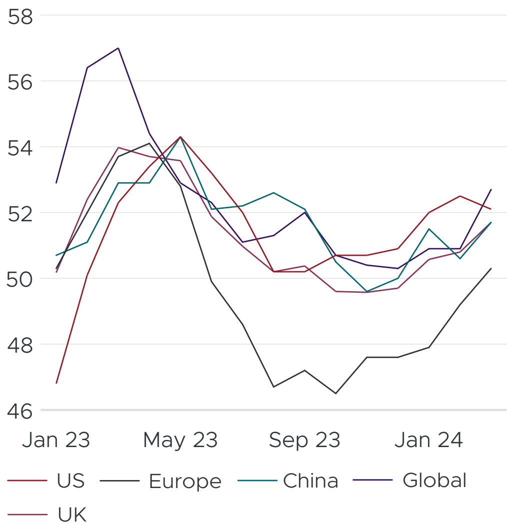
ii. Inflation concerns and growth acceleration

However, the narrative this year has changed. As evidenced in charts 2 to 4, inflation expectations have risen again, markets have priced a much slower rate of policy easing so that bond yields have increased, and commodity prices have risen significantly. In short, some of the factors that drove the widespread asset class rally at the end of last year have unwound, and this has been reflected in a much tougher environment for fixed income investors. Some investors point to the strong rallies in gold and bitcoin in particular as evidence that greater concern over the inflation outlook is warranted, and that markets and central banks have become too complacent in terms of inflation prospects.

Chart 5: Economic surprises

Source: Saranac, Bloomberg.

Chart 6: Business confidence rises



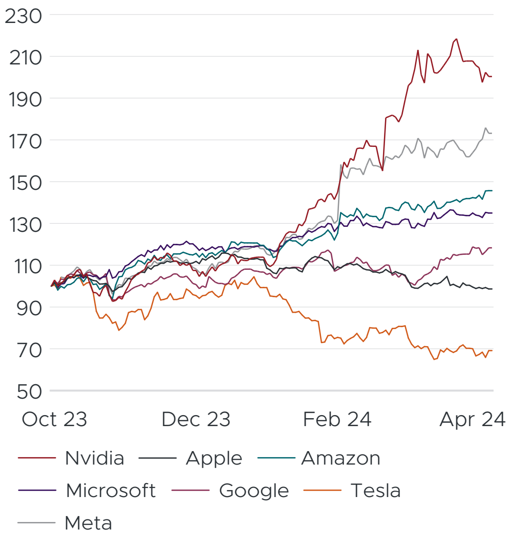
Source: Saranac, Bloomberg.

However, the equity market rally has continued unabated, the recent small correction notwithstanding. It is this disconnect that unnerves some equity market investors: if lower bond yields helped drive the equity market rally at the end of last year, why has the rise in bond yields this year seemingly had no effect in constraining equity markets? Such concerns have been exacerbated by the fact that the sectors which have outperformed the most so far this year have been those that are usually most adversely affected by higher bond yields – in particular highly valued growth companies.

The view that there has been a fundamental disconnect in market pricing between bonds and equities overlooks a further important development operative so far this year – the strengthening global economy. During the latter part of 2023, while there was an easing of concerns on the inflation front, concerns about economic growth were still prevalent. This was unsurprising, as there was little or nothing to suggest anything like the same improvement in the growth background that had been evident for the inflation background. For example, growth in Japan was slightly negative in the second half, and while China and Europe avoided conventional technical recessions, there was little or no evidence of positive growth momentum. US growth had surprised on the upside, but the strength in the second half was widely expected to give way to a weaker outturn in 2024. The global economy was stagnating, possibly for an extended period.

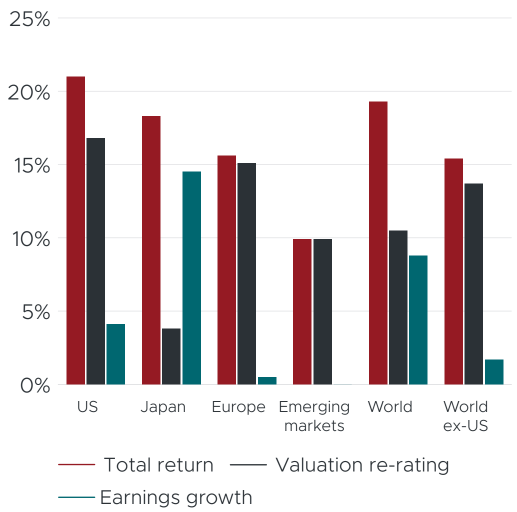
It would be wrong to suggest there has been a fundamental change in the macro environment in the early months of this year. There has been no regime change, and global growth still appears soft. However, it appears somewhat less soft than at the end of last year. A range of indicators suggest, as a global theme, that there has been a modest acceleration in economic growth. This is evident in the upturn in economic surprises (chart 5: the extent to which data releases are more or less buoyant than expected), in business confidence (chart 6), and in the broad-based rises in commodity prices and in a positive trend in revisions to corporate earnings.

Chart 7: 'Magnificent 7' go their own ways



Source: Saranac, Bloomberg.

Chart 8: Decomposing $ equity returns since September 2023



Source: Saranac, Bloomberg.

The potential for a soft landing for the global economy that incorporates not just a diminished inflation problem compared to last autumn, but also a somewhat firmer growth environment, has been an important offset protecting equities from the potentially adverse impact of higher yields. The uplift in the growth environment may appear only slight, but it is not usual for even modest changes in this context to be priced into equity and credit markets.

3. Market concentration risk

An additional concern around the market rally has been that it has been very narrow – too focused on the US, specifically the 'Magnificent 7' megacap US stocks, and on only a small number of sectors, notably IT. We regard these concerns as exaggerated. First, the 'Magnificent 7' was a useful concept up to around last autumn, since when it has lacked coherence as the component companies have largely gone their separate ways (chart 7).

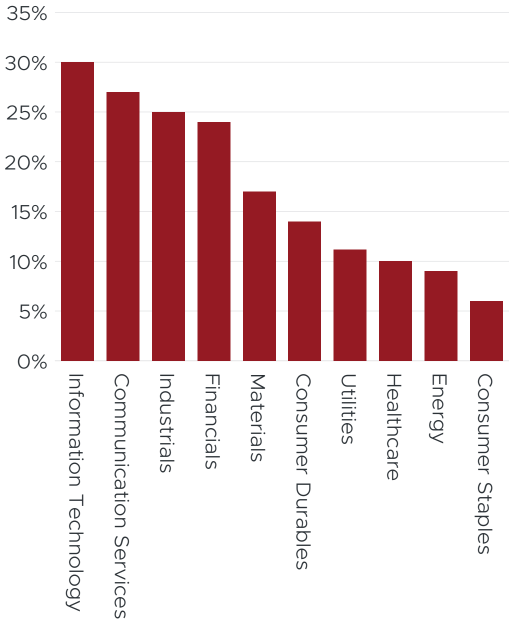
Second, markets outside the US have participated in the rally, with all the major blocs delivering returns largely in the 15% to 20% range (chart 8). While we the US has led the rally, it has not completely dominated it. Third, while IT and communication services have led the rally amongst the main sectors, 'old economy' sectors such as financial and industrials have also been strong participants (chart 9).

Finally, it is typically the case that concerns over very narrowly based market rallies are exaggerated. It is not unusual that when the small dominant group's relative performance strength ebbs away, the broader market does not decline: rather breadth increases (more companies participate) and rallies continue. Recent weeks' market performance suggests that a similar process has been underway.

4. Equity Valuation risk

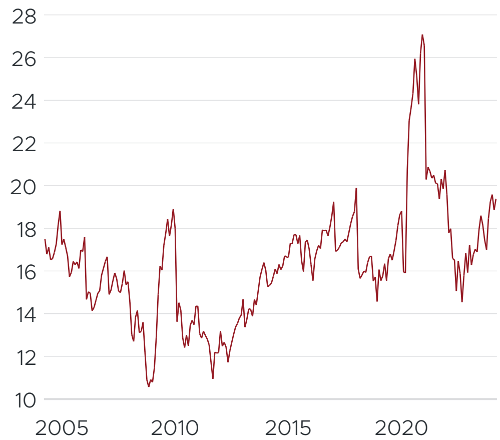
A further feature of the equity market rally has been that it has occurred despite the near absence of profits growth. Rather the driving force has been a valuation re-rating: a rise in the PE ratio. This increase has taken the PE multiple on global equities to the top end of the two-decade range (chart 10). This re-rating has occurred as confidence in a potential soft landing and the avoidance of a global recession has increased, leaving less protection for equity markets in the face of more demanding economic or political news.

Chart 9: Sector returns since September 2023



Source: Saranac, Bloomberg.

Chart 10: PE ratio MSCI world index



Source: Saranac, Bloomberg.

However, we do not regard the global equity rating as fundamentally speculative. A decomposition is helpful. We view equity valuations outside the US as normal, not extended. The global valuation 'excess' is largely concentrated in the US, but in the megacap community there rather than as a broadly based feature of the market. These high valuations have been compared with the 2000 bubble, but such claims are vastly exaggerated. The prevailing higher equity multiples in some sectors (IT, Communication Services) are several orders of magnitude less than in 2000. A further crucial difference is companies that are pushing global valuations higher are cash-rich and strongly cash-flow generative, so that their high multiples are to some extent reflective of their strong fundamentals rather than irrational pricing. Indeed, in some cases individual company valuations are less demanding than before the rally, as their earnings have outpaced the rise in prices.

5. Markets have been fundamentally driven, not speculative

Our focus in this article has been to demonstrate that there is a coherent theme around market behaviour in the past six months or so. The equity market has not become disconnected from fundamentals, and neither have bond markets. This does not imply complacency in Saranac in terms of what happens next – a key point of this article has been to show that while there has been some favourable news for equities in the past six months, markets have been quick to absorb this news and in a less favourable environment some correction would be more than feasible, as has been evident on the recent upturn in political risk. However, the starting point is not one in which speculative influences have been dominant.

Public markets

EQUITIES

Valuation

Earnings

Positive
Healthcare; Energy; Japan

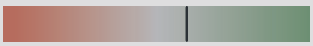
Negative
Financials; IT; Emerging Markets

Market background
Global equity markets rose a further 3.4% (MSCI World) in March finishing the quarter up 9.9%. Investors have been considering whether stubborn inflation that would cause the Fed to move more slowly with rate cuts is more important than AI in terms of the market's future direction.

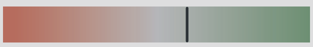
Targeted exposure
From a sector perspective we like the dynamics in health care and energy. After a challenging 2023 for health care companies, growth opportunities this year should help support the market. In terms of energy companies, management teams appear to be sticking to their cost discipline commitment, which will help drive strong cash flow generation. We are more cautious on banks, despite being well capitalised, we are concerned that lower net interest income and commercial real estate risks could weigh on share prices. Within IT, we believe valuations are elevated and have consequently focus on quality names with strong cash flows. Corporate reform in Japan finally appears to be bearing fruit which has been positive for the market.

GOVERNMENT BONDS

Short maturity



Long maturity



Targeted exposure
3-10Y sovereign bond exposures

Positive
20-30Y US TIPS, 10Y Australian government bonds

Negative
>5 year European sovereign bonds, Japanese government bonds

Market background
US Government bond yields have continued to rise, driven by adverse inflation news, an upturn in economic growth, and diminishing perceived scope for central bank interest rate cuts. An additional reasons has been growing concerns about the sustainability of government debt trajectories. The rise in yields has reflected both an increase in real yields and higher inflation expectations.

Targeted Exposure
We regard market pricing of a very shallow trajectory for US interest rate cuts as more realistic. We have a slight preference for TIPS over nominal yields, but to a lesser extent given the back-up in inflation expectations. Our duration stance is close to neutral, but we may take more risk on a rise in the 10-year yield above 4.5%. We see upside risks To UK rates in the 5- to 10-year maturity band, and view currency-hedged Australian bonds as attractive.

Public markets

CORPORATE AND EMERGING MARKET DEBT

Investment grade credit

High yield

SUB

EM debt

Positive
Subordinated bonds, AAA/A securitisation, US Agency MBS

Negative
US High Yield

Market background
Spreads over government bonds remain more compressed than usual, particularly in high yield. Higher-grade spreads are also relatively low.

Targeted exposure
We remain uncomfortable with the level of high yield spreads, reflecting rising distressed debt exchanges, the lagged impact of higher policy rates on companies, and the maturity wall in 2025–26. We maintain a preference for subordinated debt. IG fundamentals remain solid, characterised by moderate leverage, ample cash generation and long-dated and mostly fixed debt, and limited refinancing requirements. We also retain a constructive view on US Agency MBS over traditional credit, and also on and more highly rates CLOs. Our exposure to EM sovereigns remains limited. The relative attraction of UK and European credit over the US has now faded. We do not envisage material US dollar weakness, which limits the case for local currency EM debt.

Public markets

HEDGE FUNDS

– Asset class outlook +

Hedge Fund industry returns have been respectably positive so far this year and have come from a wide range of complementary uncorrelated strategies. **Equity long/short** contributed materially with strong alpha coming in from the long book – the momentum factor remaining in focus – and crowding risk remains questionable. Over a multi-year period, average net exposure levels across regions sit in the top quartile, suggesting managers are more willing to keep risk and beta on, as well as riding their winners. It was another active month in M&A benefiting **event-driven** strategies, although there was a lack of any megadeals as seen earlier in the year. **Macro** strategies continued to shine with contributions coming in from fixed income positions in the US, UK and Japan. **Trend-following** strategies continued to profit with equities a key driver as indices reached new highs. The positive trend in cocoa prices has continued while longs in crude oil have been additive.

Broader **hedged credit** strategies across the corporate and structured credit arena contributed positively – profiting, in particular, from a meaningful pick-up in convertible bond new issuance led by refinancing activity. We remain constructive on credit long-short strategies, with the credit default cycle having been fairly orderly and uneventful thus far this year, despite a now prolonged period of higher rates. The expected significant need for refinancing of corporate paper between now and 2026 may put further pressure on weak companies, leading to further defaults and a wider credit premium.

Public markets

CURRENCIES

Dollar

Sterling

Euro

Yen

Market background
The broad US dollar index has generally been range bound since the end of February, though has been pushing the upper bounds of this recent range since mid-March as Fed rate cut expectations have been repriced. Markets were predicting nearly 7 rate cuts over the course of 2024 as recently as January, however higher than expected March US jobs and inflation data have seen rates markets reprice to just 2 US rate cuts for this year. Meanwhile, macro data in Europe and the UK have been weaker and more supportive of rate cuts by the ECB and Bank of England, leaving both currencies softer versus the dollar of late. The Swiss National Bank have succeeded in weakening the CHF with their dovish surprises, the franc has so far depreciated +8% against the USD and 5.5% against the EUR this year.

Targeted exposure
Despite the Bank of Japan's March rate hike, dovish messaging has left the yen under pressure and nearing levels where many investors are expecting supportive intervention from Japan's Ministry of Finance.

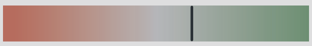
COMMODITIES

Gold

Energy

Industrial metals

Softs



Market background
Recent weeks have seen a broadly based rebound in commodity prices. Oil and industrial metals have been driven higher by somewhat firmer global demand conditions, with oil also supported by higher Middle East political risk. Gold (and silver) prices appear to have been influenced more by growing market concerns over a perceived deterioration in the longer-term inflation outlook and higher political risk, as well as firm demand from a number of central banks.

Targeted exposure
We have raised our weight in gold in recent months, and have maintained exposure to gold and silver miners. The gold rally has already been material, but the demonstration of it being a good diversifier when political, inflation and fiscal stresses appear to be on the rise suggests that there may be additional upside potential. We note that gold's previously strong relationship with real interest rates has broken down, potentially for now dominated by these other factors.

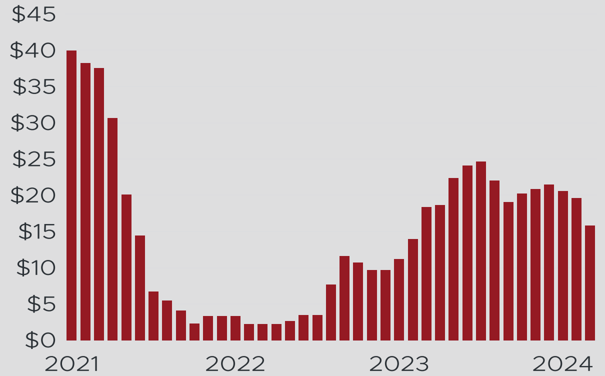
Private markets

Distressed credit update
Given the previous pieces we have written regarding the state of private credit, default cycles and the rise in distressed exchange transactions, we thought it would be useful this month to provide a quick snap snot of the market as it stands today, and why we still remain positive for distressed / special situation credit strategies.

The charts below highlight some of the key data points we monitor for tracking the health of the US loan market. The traditional default rate indicates that the overall market remains relatively stable relative to historic levels, with no real indication of stress. This is the same when assessing the "LTM US Loan Default Volume ($bn)" and "Sponsored vs non-sponsored loan defaults by issuer count" data. However, what we find interesting is when we start to dig a bit deeper, particularly focusing on the last two charts, where we can see that the underlying fundamentals do not look as strong.

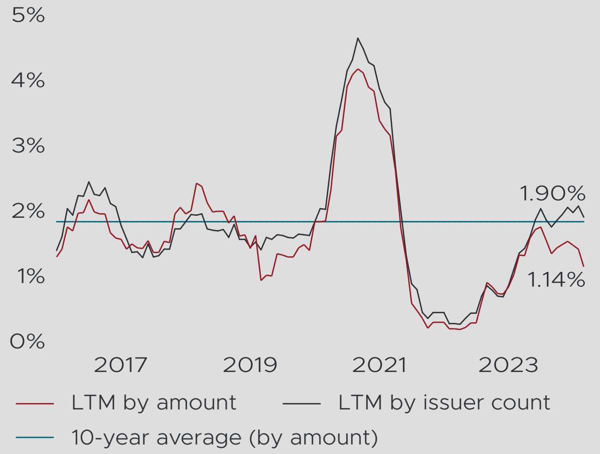
We see that loan volumes that are classified as "distressed" are higher than historical levels (excluding covid), and when combined with the data in chart 2, would indicate that much more distress is happening on the lower end of the market (i.e., more distress, but on a smaller notional of capital) relative to what we've seen before. In addition, the "Dual-track US loan default rate", which monitors the rate of default including and excluding those that being restructured via the distressed exchange also paints a much more concerning picture, one we view as much more reflective of the real defaults concerns we have for the US loan market.

LTM US loan default volume ($bn)



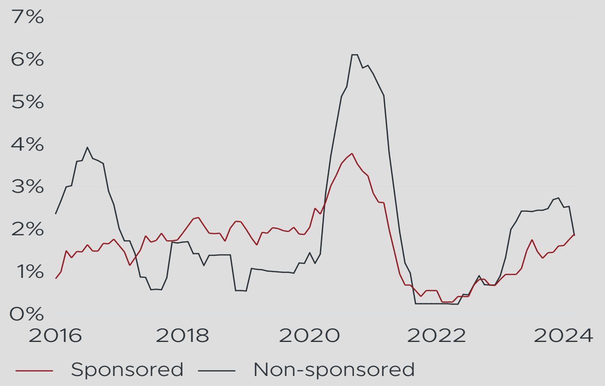
Source: Pitchbook, LCD.

US leveraged loan default rate



Source: Pitchbook, LCD.

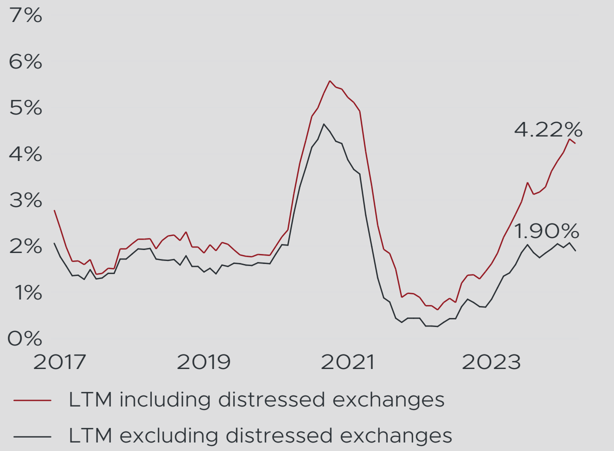
Sponsored vs non-sponsored loan default rates by issuer count



Source: Pitchbook, LCD.

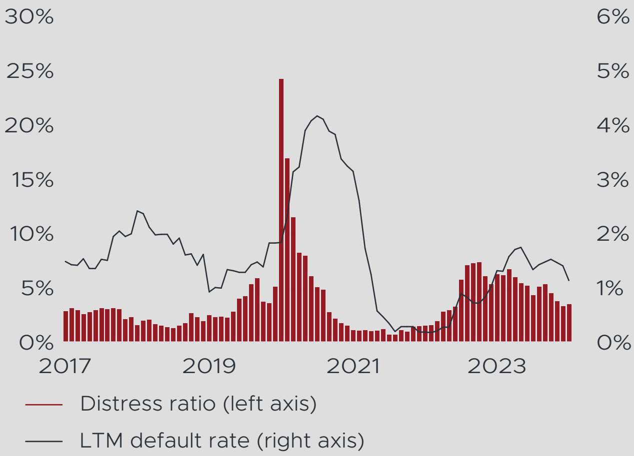
Private markets (continued)

Dual-track US loan default rate: issuer count



Source: Pitchbook, LCD.

Morningstar LSTA US leveraged loan index distress ration and LTM default rate



Source: Pitchbook, LCD.

Private markets

ALTERNATIVE SOURCES OF RETURN

Secondaries

Record levels of secondary volume as investors seek to rebalance portfolios has resulted in a very attractive pricing environment

Special situations

Favourable market environment given the likely stress corporates will face in a higher rate environment

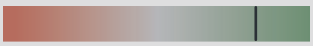
Venture capital

Early-stage venture has benefited from the correction in late-stage valuations, providing an opportune time to invest in long-term productivity gains, labour replacement and other venture investment qualities

Infrastructure

More attractive given supply chain issues and geopolitical uncertainties

Real estate



Pricing is unattractive given the narrow spread (in some cases negative) between cap rates and the risk-free

GP stakes and financing

Opportunity of higher yield and greater downside protection as a result of attractive secondary pricing dynamics

Real assets

At risk from weak growth environment

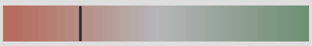
Private debt

A negative economic outlook with the potential for above-trend default rates and extension risk make private direct lending unattractive on a risk-adjusted basis

Leveraged buyouts

EBITDA multiples have begun softening and hence in time valuations could again become attractive

Mid-market growth



A prolonged period of weak/negative earnings growth as a result of a weak economic environment and increased cost of capital will see valuations struggle in the short term

ABOUT SARANAC PARTNERS

We founded Saranac Partners to do things differently. To create a community based around like-minded people, shared wisdom and collective learning. To work as partners, creating compelling opportunities and effective solutions. To offer unfailing support, honest challenge and thoughtful inspiration.

Our business combines the personal touch of a private office with the capability and breadth of a large institution. Our firm has strategic shareholders, outstanding technology, broad capabilities and the highest standards of corporate governance. Saranac Partners is a signatory to the United Nations Principles of Responsible Investing (UNPRI).

OUR SERVICES

We start with the question. We listen and seek to understand. We don't make assumptions or force solutions. Rather we co-create a path with our clients.

Strategy. Planning, governance and oversight

Financing. Access to diverse sources of capital

Investments. Allocation and deployment of capital

Corporate advisory. Supporting corporates and business owners

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