Markets
& Convictions

July 2023

RJ Management

The stock markets have displayed significant divergence since the beginning of the year, with a notable outperformance in favor of the United States driven by the theme of artificial intelligence. Central banks are expected to continue raising interest rates in response to structural inflation. At the same time, the recession is evident, as seen in Germany. We are entering a "classic" credit crisis, which will provide opportunities in short-duration bonds. On the equity side, companies benefiting from inflation and deleveraging may attract investors once again. The energy transition and ESG policies, on the other hand, are leading to exaggerations and thus creating opportunities.

Macro

- Stock markets are soaring but hiding significant dispersion: (Year-to-Date performance) S&P500 +16.05% / Nasdaq +32.01% / Europe Stoxx600 +8.74% / SMI +4.88% / CSI300 +0.71%.
- Investors are aware that this performance does not reflect a widespread improvement: the performance of the S&P500 index with equal weights for each of the 500 companies (Equal Weight) is only +6.28%.
- The magic of the AI theme largely explains the massive outperformance of these few US stocks that we do not see in Europe.
- Japan has also experienced a significant rebound in stocks, with the TOPIX index up +21.9%, but its currency JPY has lost more than -12% against the USD at the same time.
- Seeing inflation decrease, the central banks of Canada and Australia had paused their rate hikes since January.
- In June, they had to reluctantly resume their restrictive policy (rate hikes) due to persistent inflationary pressures (+0.25% for Canada @ 4.75%).
- Western central bankers currently seem determined in the face of inflation: rates will continue to rise.
- This will mechanically weigh on the real economy with a growing cost of capital, and the number of bankrupt companies continues to increase.
- Thanks to inflation, our economies still show positive nominal growth, but a recession is near, if not already present, as in Germany.
- Yet the job market remains strong both in the US and in Europe (for now).
- American diplomacy still appears hesitant and detrimental to China.
- Russia is experiencing a long implosion, and the risk of the current regime's disintegration is probably very concerning news.

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Convictions

- For over 18 months, we have been convinced that the inflation we are experiencing is structural rather than cyclical.
- Our central bankers have unleashed this "monster" with fiscal, budgetary, and monetary policies that were far too generous and lasted for too long.
- Consequently, it will be almost impossible to return to the targets below 2%.
- COVID and the crisis in Ukraine have accelerated the indebtedness of our economies, with Debt/GDP ratios often exceeding 100%.
- Therefore, the rise in interest rates also poses a problem for debt financing and repayment.
- Are our central bankers ready to continue "tapping" the consumer at the risk of triggering a VERY serious crisis?
- Or will we simply have to live with more inflation and higher interest rates as well (but with negative real rates, meaning inflation > rates)?
- One element of the answer: despite the "debt ceiling" event a few weeks ago, the US clearly has no plans to reduce its deficit, quite the opposite (debt/GDP well above 120%).
- This should provide the illusion of positive nominal growth but will undoubtedly impoverish savers in the long term.
- The beginning of 2023 saw a massive rebound in growth companies at the expense of value stocks: the market is currently paying very, VERY optimistic expectations of future growth.
- We believe that at these extreme valuation levels, these mega-caps are highly likely to disappoint.
- In this context, our equity themes focused on companies benefiting from nominal inflation while deleveraging should attract investors again, such as the commodities, energy, and value sectors.
- This environment is expected to be challenging for passive management and favor conviction-based portfolio managers, whom we prefer in our alternative allocation.
- Portfolio performance may appear limited compared to stock index returns, but we maintain our defensive approach.
- We are entering a "classic" credit crisis where we will see numerous companies go bankrupt, but also opportunities in short duration bonds such as High Yield (Carmignac Portfolio Credit/Vontobel Emerging Corp).
- American policy will focus on its electoral deadline: it is surprising to see the US National Security Advisor (a staunch Democrat) clearly adopting Republican (Trumpist) narratives opposing globalization and accusing China.
- This attitude will fuel geopolitical tensions in an already tense environment.
- The mirage of energy transition organized by our politicians and the famous ESG have also demonstrated during the Ukrainian crisis that we are not ready to sacrifice our energy comfort.
- At the first signs of urgency, Germany, a European pioneer in its nuclear choices, preferred to generate electricity from coal (the most polluting solution) rather than first consume its gas-generated electricity. Today, its politicians are beginning to pay the price.
- Our latest investment in the VOLTA long/short equity strategy will benefit from this great energy revolution and also profit from exaggerations.
- This last graph shows the relative valuations of different sectors of the S&P500 (current valuation = dark blue diamonds): sectoral disparity is extreme in this 30-year history!
- We believe that the scenario of persistent inflation will converge these sectoral valuations and correct the excesses.

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Chart of the Month: Relative sectoral valuation of the S&P500