Monthly Asset Allocation
May 2023

The past month summed up

Another US bank collapse provides further evidence of an economy starting to fray at the edges after a relentless rate hiking programme – the fastest in 40 years.

Current positioning

We have been preparing portfolios for turbulence that may arise as a result of monetary tightening. Our bond allocation has been raised to near neutral to protect against an economic downturn and heightened volatility. We remain below benchmark allocation in equities where our bias is towards quality stocks with resilient balance sheets, and we retain holdings in diversifying assets of gold, cash and real assets.

The rationale

Our central thesis remains that continued rate hikes will dampen economic activity to such an extent that some downturn is near to inevitable. We therefore maintain our defensive position with patience being our watchword. Other market participants seem to want to rush the normal cycle along: surveys show fund managers reckoning central banks will start lowering rates in the early part of 2024; other indicators place expectations for this even earlier. Attendant is the view that a hard downturn, yet to fully manifest, may never materialise.

We disagree – there is already a build-up of negative events that often proceed a more concerted downturn. The recent Federal Reserve's Senior Loan Officer Opinion Survey (SLOOS) showed both lower demand and supply of credit for companies. Falling demand would indicate a reticence on behalf of businesses, reticence that comes from trepidation about the future – you don't borrow money when you are uncertain about the economic landscape.

On the supply side it's not difficult to see the direct line from the rate increases. Banks tend to invest strongly in bonds – relatively safe securities – as the best collateral against the deposits their customers make. As interest rates rise, bond values fall, so the sharp recent rise in rates has driven a precipitous fall in the value of bank assets.

That's the story behind recent bank collapses such as US lender First Republic and there may be more to come. A survey undertaken by Stanford University estimated that bank unrealised losses stand at $2.2 trillion and that nearly 50% of the US's roughly 4,800 banks (yes, there are that many!) are in negative equity. With that kind of background which banking executive in their right mind would up their lending?

Ceiling falling in?

An upcoming own goal to the world economy may well be the issue of the "debt ceiling" – the current wrangle between US President Biden and Congress over whether to raise the legal amount the country can borrow. Any inability to reach agreement would cause the US to be unable to pay its bill, potentially to default on its debt and probably send the global economy into a tailspin. As US Treasury Secretary Janet Yellen said in early May, any default arising from the standoff would be a "catastrophe."

Yes, this brinksmanship has happened many a time in the past, and the world is acting as if it expects both sides to agree on an increase in the end. But even if that is the outcome, any prolonged spat will tarnish further the US's reputation for solidity and almost certainly unnerve investors.

Adding this into the mix: continuing bank problems in the US, falling loan demand, historical evidence that slowdowns lag rate hikes, along with an almost existential threat to the US's centrality in financial markets. The balance of probabilities still points to some sort of downturn in coming months.

Quality street

We like to invest in high-quality companies with the ability to be the architects of their own destiny and we have a distinct weighting towards these businesses within our portfolio. The attributes of these companies are easily measured along parameters such as strong margins, high returns on investment, low gearing and strong balance sheets.

This type of company comes into its own when times are tough. They're the businesses that ultimately benefit from cyclical downturns because they use the opportunity to get stronger, gain more market share when competitors are struggling, setting themselves to advance even faster when growth returns. A recent example has been the deft manoeuvring of JPMorgan amid the US banking crisis. With all of the attributes mentioned above, it's perfectly placed to come and take over the business of First Republic thereby adding $173 billion of loans to its already impressive business. Ordinarily, US anti-trust guidance wouldn't allow a company to take its share of deposits over a 10% threshold but, given present circumstances, US authorities have no option but to turn to a high-quality business such as JPMorgan to help in a crisis.

AI = KO

Who doesn't both love and fear the onward march of artificial intelligence? Students marvel at platforms that can write essays for them. But what happens when those computers replace us? Companies must be having the same mixed feelings.

While we might not yet be at the race for survival depicted in much science fiction, this advance could be the most significant disruption to the technology sector since the internet and smartphones upended the news media and bricks and mortar retailing. In the current rush of excitement, it is likely that the negative effects on companies will engender a more visceral share price response than for those where the positive benefits will emerge over time. A case in point was a recent report from US online learning company Chegg, whose shares tumbled after it noted in its earnings report that it was losing new business to AI platforms such as ChatGPT.

Investors will have to sift out those industries where human judgement cannot yet be replaced by machine or stick to businesses that rely on using or making physical things – resource companies for example – AI is going to struggle to replace hard assets.

Conclusion

As the drip feed of negative news increases and central banks double down on rate hikes, so the probability of a strong reaction increases. Thus, we remain cautious but watchful for new information that either underlines or challenges our thesis.

We are also mindful of the structural changes in the economy that might be coming and our equity holdings remain tilted towards those companies we believe are best placed to take advantage of new opportunities and challenges.