SARANAC
PARTNERS

Investment Committee Update

August 2021

AT A GLANCE

- Growth remains strong and above trend but the explosive expansion witnessed as the economy rebounded from the pandemic is now behind us.
- While economic growth is robust at the aggregate level, regionally it is becoming more fragmented and decoupled.
- Investors are weighing the possibility that growth may fade more quickly than initially expected.
- Above-trend growth can, in part, be extended on the back of a robust capital expenditure cycle.
- Chinese regulators have been clamping down on specific industries as it targets it's new objective of 'common prosperity'.
- These regulatory risks have soured investor sentiment, causing China's equity risk premium to rise sharply.
- Even though many equity indices are at record highs and investor optimism is elevated, most sentiment measures show few warning signals, but market breadth has been deteriorating.
- In fixed income markets real yields have collapsed whereas equity markets have been supported by record earnings growth.
- We are not making changes to the broad asset allocation as we think portfolios maintain an appropriate level of risk.

MACROECONOMIC OVERVIEW

The pace of global economic growth peaked in the second quarter of 2021. As we alluded to last month, the 'explosive' stage of the recovery now seems to be behind us at an aggregate level. Growth remains strong and above trend, but it is decelerating.

There is increasing evidence of regional disparity in current growth rates. The US is only now starting to slow whereas European growth could still accelerate further in the second half of the year. Asia is looking problematic as several economies are struggling to cope with the sharp rise in Delta variant cases.

Meanwhile, China's growth trajectory continues to slow, in part due to a regulatory clampdown but also renewed problems with the virus. While robust at the aggregate level, the global picture is becoming more fragmented and decoupled regionally.

Inflation data is little changed over the past month. We see no reason to change our view that the long-term inflation regime is intact and that the current spike will pull back to trend levels of 2% to 2.5% in the next three to six months.

Monetary policy is moving at a very slow pace. The US Federal Reserve (Fed) seems the only large central bank likely to make any changes to policy in the near term. Policymakers will probably announce that they will taper the quantitative easing (QE) programme by the end of the year. But rate hikes still seem a long way away.

If our concerns about Asian growth are confirmed then that might prompt the People's Bank of China (PBoC) to ease policy (policymakers have already cut the bank's reserve ratio). A renewed credit cycle could be positive for Asian assets.

Above-trend growth depends partly on a robust capital expenditure cycle, especially in the US. Given the level of corporate cash, interest rates, inflation and real yields, we believe there is a strong case for such a cycle to emerge. This could sustain positive earnings surprises into 2022.

The clear risk to this above-trend growth thesis is that the Delta variant creates further disruption to supply chains, particularly in Asia, interrupting the capital expenditure cycle and perpetuating high inflation for longer than expected.

Investor are shifting attention towards the economic outlook and the possibility that the pace of growth may fade more quickly than expected, as implied by the recent drop in bond yields.

CHINA'S CLAMPDOWN

Over recent months we have seen Chinese regulators step up the crackdown on some of its largest domestic companies. One side effect is that the country's stocks markets have fallen this year and underperformed global indices by over 15% (figure 1).

Initially it seemed the regulator's ire was directed primarily at tech and internet names after the high-profile Ant Group IPO debacle and the recent calamitous Didi listing in the US (China's version of Uber). But the government's goals now appear far broader.

Macro-prudential regulation is only part of China's economic policy toolkit. Monetary and fiscal policy are also important and it is possible that monetary policy may adjust to offset some of these regulatory headwinds.

This became clear after the enforcement of regulation that obliged education companies to convert to not-for-profit organisations, as well as closing off foreign investment to them. This wiped out over 90% of the sector's market value.

More recently there have been restrictions enforced on Tencent aimed at reducing the time young people spend gaming, as well as on Meituan over worker pay and monopolistic behaviour. There have also been regulatory probes launched into how data is being used by a number of internet-related companies.

Last December's Politburo meeting now looks to have been a significant policy inflection point. Tying together these regulatory moves with recent PBoC and ministerial actions paints a picture of conformity in Beijing's new objectives of targeting 'common prosperity' in the next stage of development. The policy aims for a more equitable society, to promote fairness and competition, and continued support for smaller and private companies, as well as prioritising data security and sustainability.

Relations between China and the US are tense with Chinese foreign stock listings under scrutiny with regard to their auditing standards and risks of Chinese government interference.

It is important to remember that macro-prudential regulations have been, in general, on a tightening path since 2016 in order to promote financial stability. But it has become clear that Beijing's efforts to reshape the economy take priority over shareholder interests and this has soured investor sentiment, which may take some time to recover.

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Having rebounded from the pandemic first and seen economic slowing in recent months, China's credit impulse is nearing a cyclical trough. While this doesn't guarantee that rate cuts are imminent, the July reduction in reserve ratios for the banks may be a step toward easier policy.

In this context, we view the current overall policy stance as shifting from tightening to perhaps a modest easing. These may accelerate given recent Covid developments and localised lockdowns in China.

China's equity risk premium has risen sharply and the equity market now looks relatively cheap. This is likely to persist given the regulatory risks, but we think much of the correction in prices has already occurred and now reflect the political reality.

Mid-cap domestic companies are less exposed to regulatory interference and US listing angst. We are increasing our exposure to this part of the Chinese equity market as growth prospects and valuation remain attractive there.

Figure 1: MSCI China relative valuation

China's stock market has suffered a fall in valuations compared with global markets owing largely to the government's restrictions on some industries.

Source: Saranac Partners.

Business and consumer sentiment is undeniably strong as credit conditions remain very favourable and the employment outlook is improving. We don't see over-optimism as a risk to markets at this stage of the cycle.

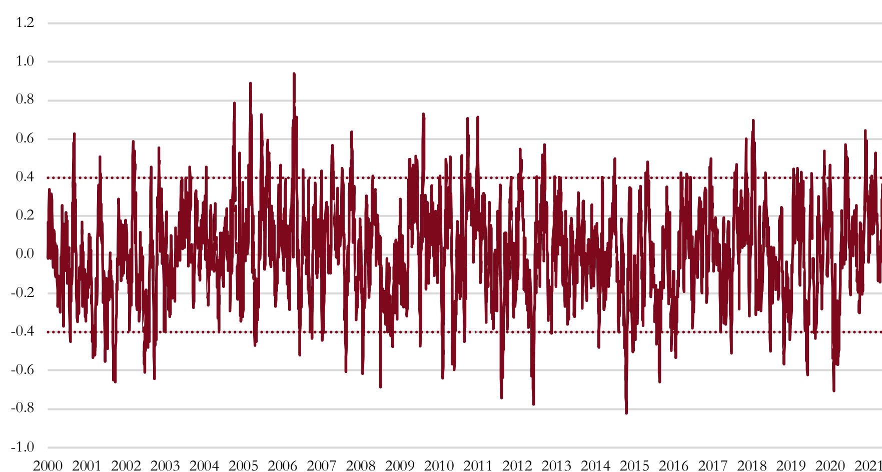
SENTIMENT IS RIDING HIGH

As some markets hit new highs, we wanted to look at investor sentiment and understand if 'animal spirits' are dangerously high. Most market sentiment studies show few warning signals – optimism is generally high but far from extreme (figure 2).

The rotation back into growth stocks has seen market concentration deteriorate somewhat. Mega-cap names are outperforming again and the breadth of the market is not as strong as it was earlier in the year. This concentration of performance means that the majority of companies are below their recent highs, despite the progress made at the index level.

Business and consumer sentiment is undeniably strong as credit conditions remain very favourable and the employment outlook is improving. We don't see over-optimism as a risk to markets at this stage of the cycle.

Figure 2: Risk sentiment
Our proprietary risk sentiment indicator shows that despite indices hitting all-time highs, market sentiment doesn't appear exuberant.



Source: Saranac Partners.

FINANCIAL MARKETS

Fixed income

Real yields have collapsed as nominal yields in the US have dropped by 0.5%, yet inflation expectations are unchanged. The -1.2% real yield of the US 10-year Treasury is the lowest level yet (figure 3). We will be looking at the possible reasons as to why real yields are so low at our next meeting.

There is no single obvious reason why yields have fallen so much in recent weeks, but fears over the Delta variant hurting growth, increasing conviction that inflation will fall back and unusually low supply are likely to be contributing. In addition, the expectation as to when the Fed will begin to taper its QE purchases has moved to later, rather than sooner. We think the beginning of 2022 is the most likely start of tapering.

The drop in yields has meant positive returns for investment grade bonds this month. But there has been some spread widening in the riskier end of the credit market, such that high yield bond returns have been lagging recently. This spread widening has been fairly broad based, but not significant and overall spreads remain quite tight.

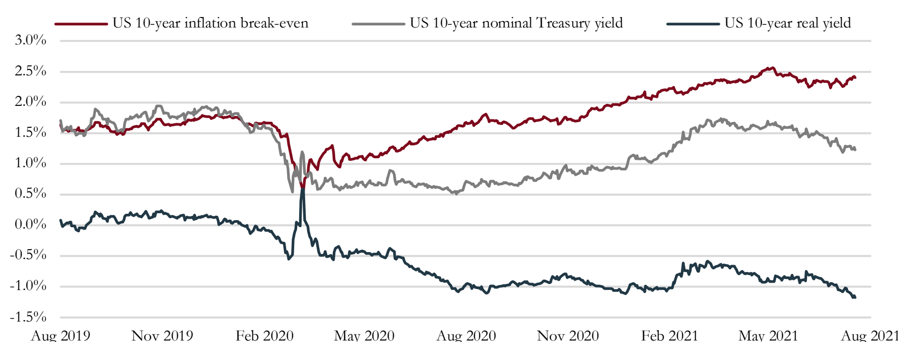
The prospect of above-trend growth and QE tapering through next year leads us to think that the most likely direction of US bond yields is upwards from here.

It is becoming apparent that the increasingly damaging impact of the coronavirus on Asian economies is acting as a drag on the earnings picture there. Developed market earnings growth is forecast to be well above that of emerging markets over the next 12 months.

With yields so low and credit spreads also tight, we are not looking to either extend our duration in our fixed income portfolios nor increase the credit risk. Having reduced both our duration and our high yield and emerging market debt allocations last month, we are making no further changes now.

Figure 3: US 10-year real yield

Real yields fallen as nominal yields in the US have dropped 0.5%, while inflation expectations are relatively unchanged.



Source: Saranac Partners.

Equities

Earnings are coming through at a record pace. US second-quarter earnings are likely to be up over 70% year-on-year, which would be 20% faster than expected. Such strong positive surprises to the earnings outlook is a crucial support for equity markets.

The earnings of cyclical stocks are benefiting the most from this rebound in profits. However, the market has shifted to favour more growth-oriented stocks rather than value or cyclical names. This move partly reflects concerns about the future rate of growth once the rebound plays out.

We would differentiate between cyclical and pure value stocks. We continue to believe that cyclical stocks exposed to the (increasingly gradual) reopening of the global economy have attractive upside and deserve their place in portfolios. The combination of favourable valuations and further positive revisions to their profit outlook means that we are maintaining our balanced approach between growth and cyclical stocks.

It is becoming apparent that the increasingly damaging impact of the coronavirus on Asian economies is acting as a drag on the earnings picture there. Developed market earnings growth is forecast to be well above that of emerging markets over the next 12 months. We are looking to be more specific in our allocation to emerging markets and reduce our broad exposure.

Commodities

The oil price has fallen back on the recent agreement by OPEC to gradually raise output, but most other commodities are holding up.

Gold remains around the $1,800 mark. In contrast to recent history, the fall in real yields over the past two months has not led to a noticeable increase in the gold price but we think it is a positive development for the metal. We continue to hold a 3% position in portfolios.

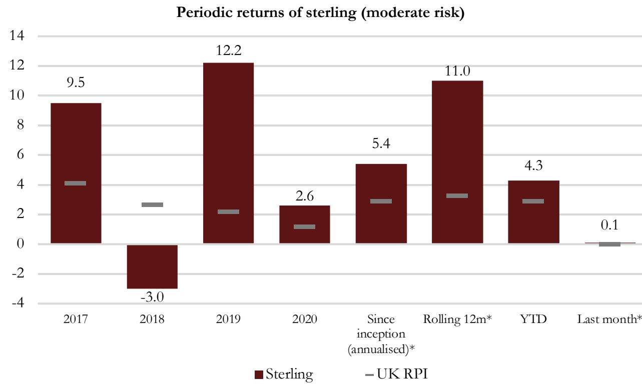
PORTFOLIO CHANGES

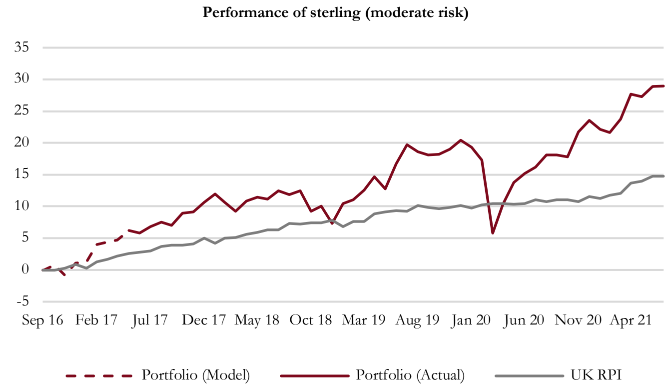
We are not making any changes to the broad allocation of portfolios. They continue to represent the amount of risk we think is appropriate at the moment. However, we are making changes to our emerging market equity allocation and reducing the broad global emerging markets exposure, while increasing the allocation to mid-cap, domestic Chinese stocks through an actively managed fund that specialises in this space.

Multi-asset strategies

Performance as of 1 August 2021

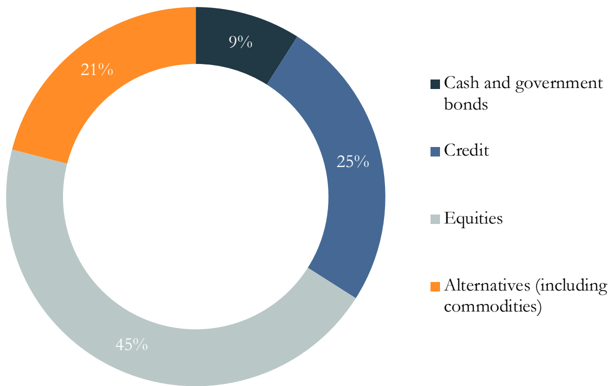
Returns (%)

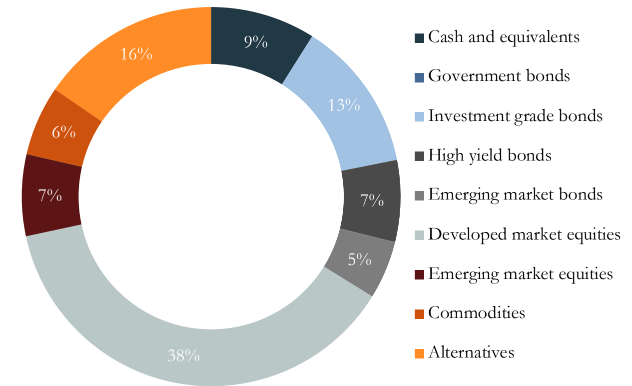




*End July 2021 for Sterling. End June 2021 for RPI (July data not available yet).

Asset allocation (average across all portfolios, %)

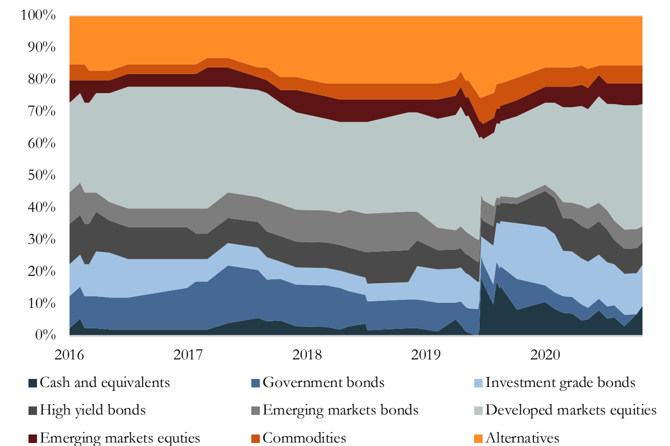




Changes over the past month (%)

	Sterling	Change
Cash and government bonds	**9.4**	**2.5**
Cash and equivalents	9.4	2.5
Government bonds	0.0	0.0
Credit	**24.9**	**-1.7**
Investment grade bonds	12.9	0.1
High yield bonds	7.0	-0.8
Emerging market bonds	5.0	-1.0
Equities	**44.8**	**-0.8**
Developed market equities	38.3	-0.5
Emerging market equities	6.5	-0.3
Alternatives	**21.0**	**0.0**
Commodities	5.5	0.0
Alternatives	15.5	0.0

Changes over time (%)

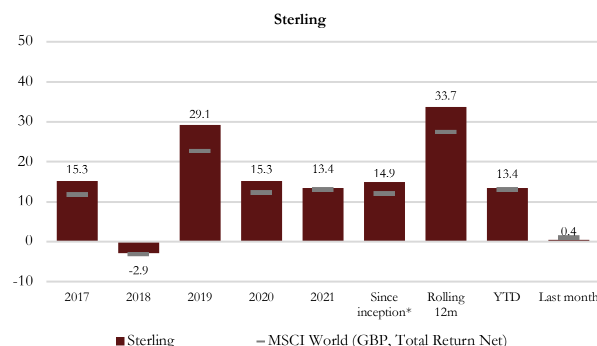


Performance figures from inception (28 September 2016) to end May 2017 are based on model portfolios, simulated from a full record of trading decisions and execution levels are readily available for review. Performance figures from June 2017 onwards are based on an aggregation of actual client portfolios whose mandate most closely follow the Moderate Risk model. Dividends have been included on an accruals basis in both cases. All performance is shown exclusive of fees as charging structures may vary. Your capital is at risk and past performance is not a reliable indicator of future performance.

Equity strategies

Performance as of 1 August 2021

Returns (%)



Euros and US dollar

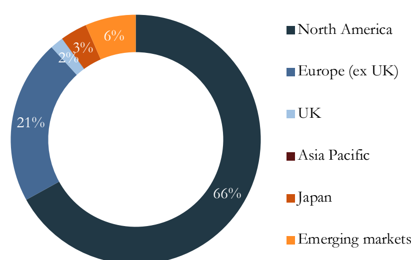
	2017	2018	2019	2020	2021	Since inception*	Rolling 12m	YTD	Last month
Euros	10.9	-4.0	36.7	9.1	19.1	14.9	41.3	19.1	1.1
MSCI World (EUR, Total Return Net)	7.5	-4.1	30.0	6.3	18.7	12.2	34.7	18.7	1.8
US dollar	26.2	-8.6	34.3	19.0	15.4	17.9	41.7	15.4	1.1
MSCI World (USD, Total Return Net)	22.4	-8.7	27.7	15.9	15.1	15.1	35.1	15.1	1.8

*Since inception figures are annualised.

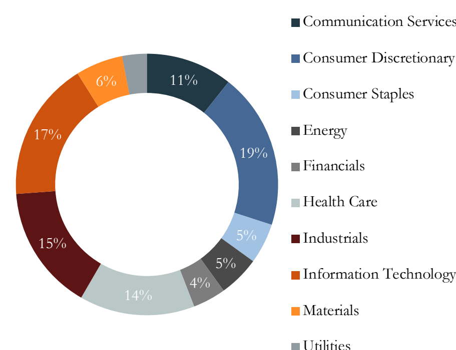
Top 10 holdings (%)

Holding	Weight (%)
ALPHABET INC-CL A	4.8
FACEBOOK INC-CLASS A	4.4
DISCOVER FINANCIAL SERVICES	4.2
MICROSOFT CORP	4.1
UNITEDHEALTH GROUP INC	4.0
LVMH MOET HENNESSY LOUIS VUI	3.9
ADOBE INC	3.7
INTUITIVE SURGICAL INC	3.6
VISA INC-CLASS A SHARES	3.5
UNITED RENTALS INC	3.4

Regional exposure



Sector exposure

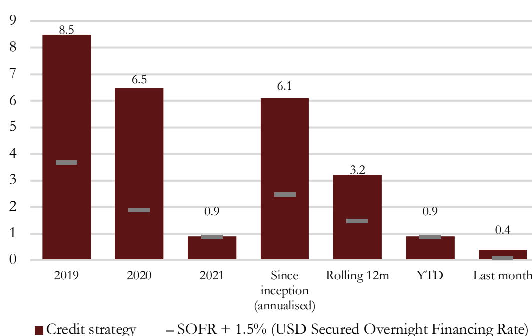


Performance figures from inception (1 January 2017) are based on a model portfolio, simulated from a full record of trading decisions and execution levels are readily available for review. Dividends have been included on an accruals basis. All performance is shown exclusive of fees as charging structures may vary. Your capital is at risk and past performance is not a reliable indicator of future performance. Actual fe.es paid by the client portfolios excluded. Fees may vary.

Credit strategy

Performance as of 1 August 2021

Returns (%)



	Credit strategy			Benchmark		
	USD	GBP (hedged)	EUR (hedged)	USD	GBP (hedged)	EUR (hedged)
Last month	0.4	0.4	0.3	0.1	0.1	0.1
Rolling 12m	3.2	3.0	2.3	1.5	1.3	0.7
2020	6.5	6.0	5.2	1.9	1.4	0.6
2019	8.5	6.6	5.3	3.7	1.9	0.6
Since inception	16.6	13.9	11.3	6.6	4.1	1.7
Since inception (annualised)	6.1	5.2	4.2	2.5	1.6	0.6

Asset allocation and performance measures

Issuer type	Weight (%)	Yield to maturity (bps)	Modified duration	Composite rating
Core IG allocation	**73.0**	**196**	**4.6**	**BBB**
Developed markets	51.0	180	4.7	BBB
Emerging markets	18.0	233	4.8	BBB+
Asset backed securities	4.0	226	2.1	A+
High yield satellite	**27.0**	**444**	**3.0**	**BB**
Developed markets high yield	12.0	437	1.7	B+
Emerging markets high yield	3.0	376	3.5	B
Corporate hybrids	4.0	413	3.2	BBB-
Financial subordinated	8.0	495	4.6	BB+
Total portfolio	**100.0**	**263**	**4.1**	**BBB-**

Performance figures from inception 31/12/18 are based on an actual client portfolio whose mandate most closely follows the Diversified Credit Strategy. All performance is shown inclusive of fees. Since inception, the portfolio has experienced zero defaults. Your capital is at risk and past performance is not a reliable indicator of future performance.

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