SARANAC
PARTNERS

Investment roadmap

AUGUST 2023

AT A GLANCE

- The main article suggests caution over the inflation outlook. Headline rates have declined in recent months, as covid-related shocks have faded and commodity prices have declined. However, unemployment rates are very low, and there has been an insufficient growth slowdown to limit high rates of wage growth.
- While inflation is unlikely to surge again, it is still above central bank targets, and may well remain so in the next year or so. This is likely to be a material constraint on the extent to which policy rates may be cut in this period.
- In the private markets section, we highlight the material amounts of capital available to be deployed in private markets. While the macro environment contains challenges, if risks are perceived to decline, capital may be deployed quickly.
- If the window for execution becomes tight, investors should commit to funds that are close to finishing capital raising but have deployed limited funds to date.

Inflation: too early for the all-clear

Equity markets have risen on average by some 15% since the start of the year, an unexpectedly positive outturn. Several factors have been in play. For example, the widely expected global recession and associated collapse in earnings did not materialise. A further influence has been a change in the global inflation background, which in recent months has begun to appear more benign compared with the more stressed environment of a year or so ago.

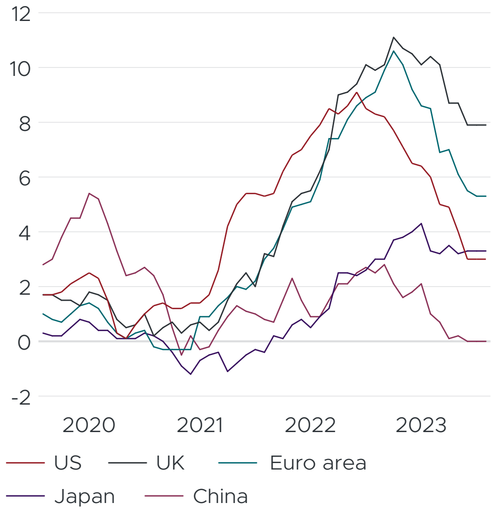
It is now evident that the upward trends in inflation apparent in many countries since the post-covid environment emerged in 2021, and which gathered pace last year, have stabilised and in some cases partially reversed more recently (chart 1). Inflation 'surprises' – the extent to which monthly inflation releases have differed from market expectations – were strongly positive last year, but have surprised on the downside more recently. Moreover, inflation expectations in bond markets show little or no sign of stress, with inflation expected to drop back to, and remain at, approximately the centre of gravity for inflation rates pre-covid (chart 2).

The inflation 'blip' may have been more pronounced and lasted longer than was the general expectation a couple of years ago, but the consensus in markets seems to be that it was nevertheless a blip. We argue in this paper that this view is too complacent, and that there are longer-term inflation risks that the market is not currently pricing.

2. Why did inflation rise?

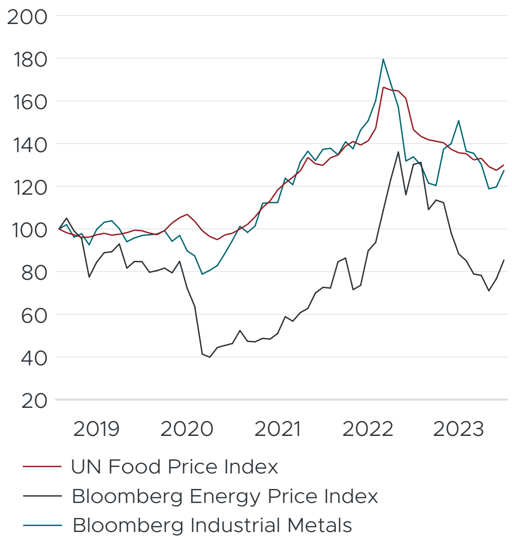
It is helpful to see the inflation surge prior to this year as reflecting four factors – the supply constraints associated with covid lockdowns; the surge in demand that emerged as these lockdowns were phased out; the tight labour markets that this surge generated; and the acceleration in food and energy prices, particularly after the Russian

Chart 1: Lower inflation – a global theme



Source: Bloomberg

Chart 2: Global commodity prices have fallen



Source: Bloomberg

In the absence of further declines, commodity prices cannot be relied on to continue to deliver lower inflation into next year.

invasion of Ukraine. Two of these adverse shocks – commodity prices and covid-related shortages are reversing, but the growth background and tight labour markets remain sources of tension.

3. And why is inflation now falling?

i. Commodities

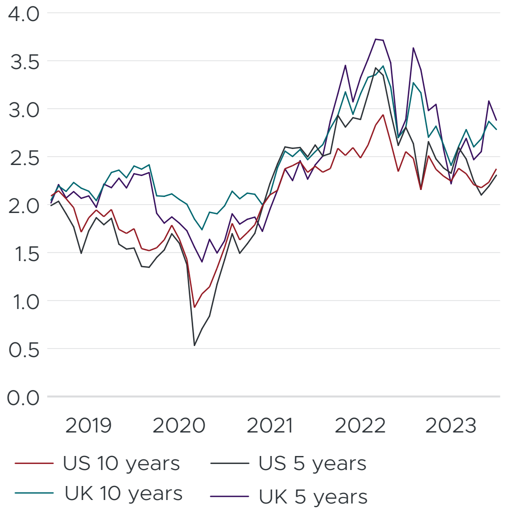
Chart 3 shows the paths of a range of commodity prices since 2021 – a rapid ascent in the initial covid recovery period, exacerbated subsequently by the Russian invasion of Ukraine, followed by a more recent partial descent. Food and energy prices have all declined materially over the past year, back approximately to their levels prior to the invasion. These declines are already showing up in headline consumer price inflation rates, notably in the US. Industrial metals prices, more relevant for producer prices, are also materially off their peaks. These commodity price trends have been of particular importance in leading the turn in consumer and producer price inflation in recent months. However, it is noteworthy that these declines have already flattened out, and in some cases there have been recent increases. In the absence of further declines, commodity prices cannot be relied on to continue to deliver lower inflation into next year.

ii. Covid aftermath

Some of the covid-related influences on inflation have also been reversed. These emerged as supply constraints, inevitable in lockdowns, lead to price rises as demand recovered when they were lifted. Two examples illustrate these pressures. For example, the Baltic freight index, which reflects shipping costs for goods, surged as economies reopened, but it has since dropped back to a more normal level. In addition, used car prices in the US jumped by 25% in the aftermath of covid, as new car production was impeded by a shortage of microchips and new cars acquired a premium value. These prices have since fallen back, albeit still not close to their original level (chart 4).

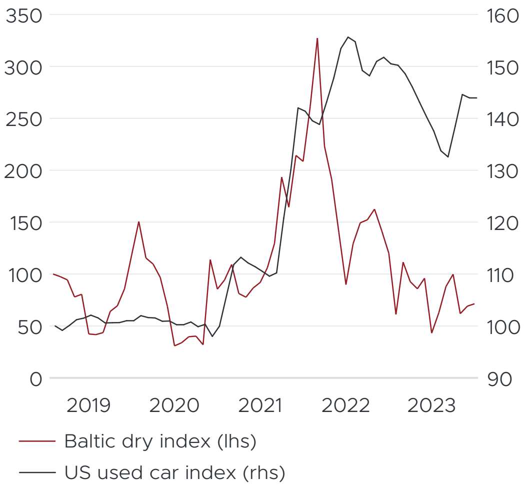
While concerns over supply-side influences on inflation persist, owing to a range of issues both global (de-globalisation) and local (Brexit for the UK), at the current moment it is relevant to the inflation background that many of the powerful

Chart 3: Inflation expectations in bond markets (%)



Source: Bloomberg

Chart 4: Two covid-related price 'spikes'



Source: Bloomberg

Table 1: Unemployment rate summaries

	US	UK	Euro area	Japan
Lowest in 10 years	3.5	3.6	6.4	2.3
Current	3.6	3.8	6.4	2.6
Average in 10 years	5.1	4.8	8.9	2.9
Difference: Current and 10-year average	**-1.5**	**-1.0**	**-2.5**	**-0.3**

covid-related inflation shocks have diminished. Optimists may argue in response that recent advances IT have dramatically altered the outlook for productivity growth and labour-saving technology, but these possible impacts are too speculative for now to integrate into a robust central case for inflation in the next year or so.

4. Tight labour markets were not the initial inflation problem, but they are now

These favourable influences should, however, be put into a broader context. Other key drivers of inflation still remain problematic, if hidden for now by the probably transitory factors. A key issue for the longer-term inflation outlook affecting all the major economies is that covid-related growth rebounds pushed unemployment rates down to relatively low levels by historic standards. Current levels are not very materially below the average of the past decade or so, but significant growth slowdowns may nevertheless be required to get unemployment rates back to these averages, at which wage pressures may be expected to subside (table 1).

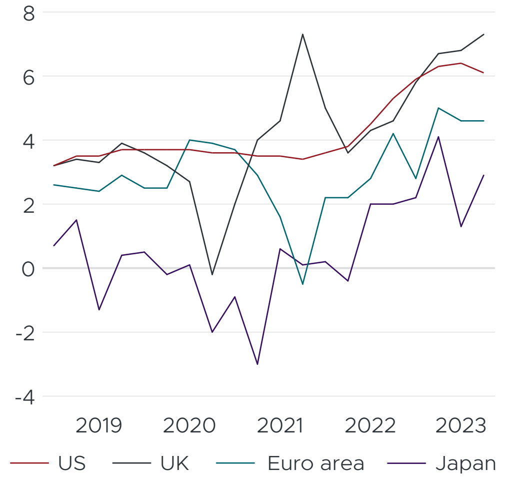
At the same time, the structures of many labour markets appear to have changed post-covid: ill-health and early retirement have restricted labour force sizes compared to the pre-pandemic period. In these circumstances, unemployment rates in isolation are less representative of labour market pressures. In the US, for example, the ratio of the number of vacancies to the number of unemployed rose sharply in 2020/21 and remains at a high level despite a slight recent decline. In this environment, the unemployed can become more 'choosy', and this is likely to be reflected in higher wage pressure as firms compete for more scarce labour resources (chart 6).

Wage growth has accelerated sharply in all countries as labour markets have tightened and wage demands have risen in response to higher inflation. To date, wage growth has been more of an effect of higher inflation rather than a prime cause. Indeed, in general wage growth has not kept pace with inflation, so that the average worker's purchasing power has declined. In some sectors, firms have been slow to pass on the benefits of lower raw material costs to final prices, to the benefit of profits rather than inflation-adjusted earnings.

Chart 6: Ratio of vacancies to US employed

Source: Bloomberg

Chart 7: Wage growth



Source: Bloomberg

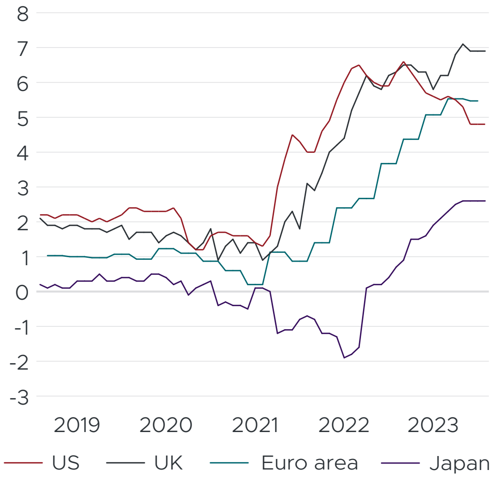
The level of wage growth in many countries seems inconsistent with inflation falling back as currently discounted by financial markets.

However, looking forward, tight labour markets will become more of a focal point for inflation trends. The risk remains that the loss in real wages in the past couple of years could lead to higher demands in the future to offset these losses in purchasing power. More generally, the current level of wage growth in many countries seems inconsistent with inflation falling back as currently discounted by financial markets (chart 7). A key risk is not so much an immediate sharp rise in wage growth, and more the potential that when some of the favourable but temporary factors discussed above fade into next year, as seems likely, inflation will remain 'stuck' at too high a level. One way in which such a tension is already evident is that core inflation rates, which exclude food and energy effects, have remained stubbornly high, and certainly exceed than stated central bank inflation objectives (chart 8). They are a better reflection of the underlying rates of inflation, looking through the temporary factors, and highlight that services sector inflation rather than goods prices inflation is proving to be very 'sticky'.

Of course, a key rationale for the tightening in central bank policy has been to create an environment in which these core rates do begin to decline, and an important aspect of this is slower wage growth. The 'soft' aspect of the shift to tighter monetary conditions is to signal central bank commitment to delivering a low inflation environment, but the hard aspect is the delivery of a growth slowdown which is sufficient to cause unemployment rates to rise.

There is little evidence that this process is yet underway. While it has become increasingly difficult to generalise about the global cycle across countries and sectors, some generalisations can still be made. Economic conditions in most countries are clearly less robust than in 2021 to early 2022, and many manufacturing sectors are indeed in mild recessions. However, services sector growth has held up much better. The balance of these diverse sectoral experiences varies across countries. In the first half of the year, in aggregate growth in the US and Japan was firmer than in Europe or China. However, even in these weaker regions recession was avoided, and unemployment rates remained

Chart 8: Core inflation rates remain high



Source: Bloomberg

The combination of moderate economic growth rather than recession, and a perception that declining inflation has limited the potential for the nastier versions of 'stagflation' to emerge, has lead to a new market consensus.

low. In aggregate, global economic momentum did fade in the second quarter, but overall there was still no clear signal of a widespread recessionary environment. Recessions are best avoided, but they are likely to be the most effective way for a more sustainable level of inflation to be reached in the short term.

5. Inflation to remain a challenge for central banks
This combination of moderate economic growth rather than recession, and a perception that declining inflation has limited the potential for the nastier versions of 'stagflation' to emerge, has lead to a new market consensus. Specifically, policy rates are perceived to be close to a peak, with the tightenings to date potentially sufficient to deliver a growth slowdown which can attenuate the inflation pressures associated with tight labour markets.

Saranac's concerns in this context are that there may be more pain associated with inflation retuning to pre-covid levels than the market envisages. One implication could be that this pain is more than is politically tolerable, and central banks' mandates will become more tolerant of higher inflation. If, however, they remain serious about their current objectives, this could be manifest in a number of ways:

- further rate increases if growth does not slow, and inflation remains well above central banks' inflation objectives;
- an extended period in which rates remain around current levels, even if growth rates are sluggish rather than recessionary, to facilitate a rise in unemployment;
- or if recessions do materialise, a reluctance to cut rates in response before there is clear evidence of slower wage growth.

In summary, there is unlikely to be a short-term fix for inflation in the major economies, irrespective of the better numbers evident in recent months.

Public markets

EQUITIES

Valuation

Earnings

Positive
Energy; Healthcare; Japan

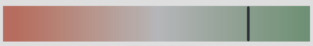
Negative
IT; Financials; Emerging Markets

Market background
July saw equity markets continue their upward trajectory. Even though the AI-related excitement continued to underpin the moves higher, all sectors progressed over the month. The energy sector sprang to life as supply cuts caused the oil price to rise sharply. As July came to a close, we were midway through the second quarter's earnings season. Having started softly, earnings improved and were on track to beat earnings estimates albeit by thin margins.

Targeted exposure
Our exposure to tech continues to be restrained largely due to valuation as multiples have expand whereas earnings growth has been relatively muted. We believe areas like industrials and healthcare offer better value and provides an element of defensive growth to the portfolio. Energy continues to be a structural theme we want exposure to.

GOVERNMENT BONDS

Short maturity



Long maturity

Positive
US TIPS, nominal and inflation-linked gilts

Negative
>5 year European sovereign bonds, Japanese government bonds

Market background
After hiking its reference rate to 5.375%, we think the Fed is nearing the end of its tightening cycle. We think the Fed is likely to hold rates at this level until it sees clear sign that the job market is cooling off and that inflation is sustainably back to their 2% target. We marginally extended portfolio duration over the month as the 10-year treasury crossed 4%, but in light of the deep curve inversion, we maintain a under-duration in bond portfolios. We believe the ECB will continue to hike up to 3.75%, leaving the Bund curve steeply inverted as well, limiting appetite for long-dated EUR sovereigns. Following a softer than expected June UK CPI print, with gilts now yielding 190bps above Bunds, we find value in Sterling duration. We also think the BoE may underdeliver in terms of rate hikes, creating attractive value in the 0-5Y segment of the gilt curve.

Targeted exposure
We continue to target the 0-7Y segment of the US Treasury and gilt curves. We expect the German sovereign curve to bear steepen, limiting appetite for EUR duration.

Public markets

CORPORATE AND EMERGING MARKET DEBT

Investment grade credit

High yield

EM debt

Positive
£IG credit, 0-5Y €IG & $IG credit, short-dated subordinated bonds, AAA/A securitisation, US Agency MBS

Negative
US HY, long-dated US IG, High Yield Emerging Markets

Market background
Credit spreads universally tightened over July, buoyed by a risk-on market sentiment. In IG, £ spreads (-20bp) outperformed $IG (-13bp) and €IG (-14bp), adding to Gilt outperformance over US Treasuries and Bunds. As such £IG returned +2.4% vs +0.4% for $IG and +1.0% for €IG. $HY spreads ended the month at 399bp, at their tightest level since early 2022. Adding the elevated carry, $HY returned +1.4% in July and +6.9% in 2023.

Targeted exposure
We remain constructive on corporate credit fundamentals but with IG spreads 50bp tighter and HY spreads 160bp tighter from their recent wides, they see limited room for further compression and excess returns. Our core view remains for a deceleration in macro momentum as we head into 2024, which could lead to lower sovereign yields and wider credit spreads, particularly in high yield, potentially benefiting a defensive fixed income positioning. We find best value in £IG, based on our constructive UK rates outlook and a spread pick-up over $IG. We maintain exposures to 0-5y $IG and €IG, which offer attractive yield for a limited duration risk. We maintain a defensive stance in high yield as we expect credit defaults to pick-up. Similarly, we maintain an IG bias in EM corporate and sovereign debt.

STRUCTURED PRODUCTS

Market background
There has been little change in market conditions over the course of the last month. On that basis it's fair to say that across asset classes volatility continues to fall, though now with credit and rates volatility starting to depress (whilst remaining elevated against equity volatility). As before, volatility-selling structures are generally not attractive here – but given the spike in funding in the front end and cheap volatility, capital protected notes or similar participation structures look interesting. In vanilla options space we think that combination of low volatility and elevated forwards (due to high rates) makes for one of the most attractive opportunities to add longer-dated downside equity hedges as has been the case for many years. For those who are nervous about equity momentum we think that buying puts here lines up well.

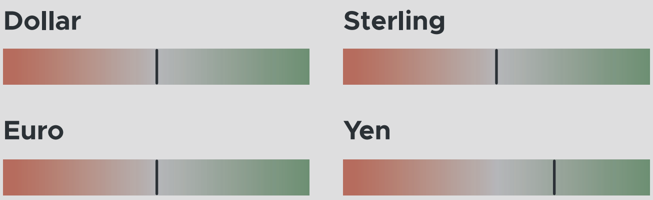
Public markets

HEDGE FUNDS

Market background

Many investors in hedge funds have return targets for these exposures expressed as a cash plus target, for example cash +3%. In the years in which cash rates were close to zero, this represented a return target of little more than 3%. However, for dollar investors that target now translates into a target of some 8%. Will hedge fund returns rise in line with cash rates? For strategies implemented via derivatives which require small margin payments (e.g. CTAs, discretionary macro and fixed income relative value), there will be high levels of unencumbered cash which can benefit from higher cash rates. In addition, long-short equity managers may benefit from cash proceeds associated with the sale of borrowed shares. However, for other managers the cash tracking effect is less apparent, and the much higher return requirements in a higher cash rate world could lead some managers materially to ramp up the amount of risk they take to meet higher required return targets. Monitoring this type of behavioural 'drift' will come a more important element of hedge fund oversight.

CURRENCIES



Market background

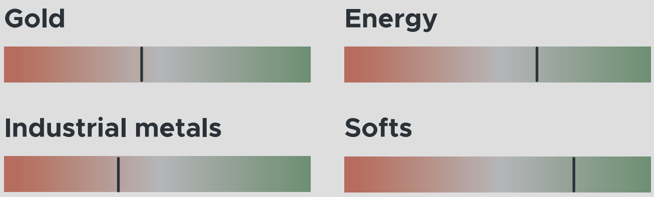
The dollar has continued to trade slightly weaker against the European currencies, despite a stronger performance in late July. This downtrend has been in evidence since last autumn. Market focus has remained on the yen, which has been the weakest of the major currencies this year, falling by some 15% against sterling for example.

Outlook

There are strong offsetting pressures on the yen. The OECD suggest that its equilibrium rate against the dollar is some 40% higher than the current spot rate. However, interest differentials have moved against the yen as overseas central banks have raised interest rates aggressively. The Bank of Japan has recently tweaked its yield control policy, allowing a rise in long-term yields. However, it has also suggested that this does not represent a prelude to an immediate exit from its low-rate strategy. The upside potential for the yen remains material, but the required monetary catalyst is for now in abeyance.

Public markets

COMMODITIES



Market background
The last month has proven volatile in the commodity space, with Russia / Ukraine developments taking wheat & grain prices higher, alongside India banning exports of non-basmati white rice and the acceleration of the El Niño weather system. Against this backdrop oil has also had a very strong month, with Brent up nearly 13%. Industrial metals have also finally shown a small uptick, with nickel, zinc, aluminium and copper all rallying to various degrees – against the backdrop of a Chinese Politburo meeting which was perceived as relatively dovish on possibly property stimulus.

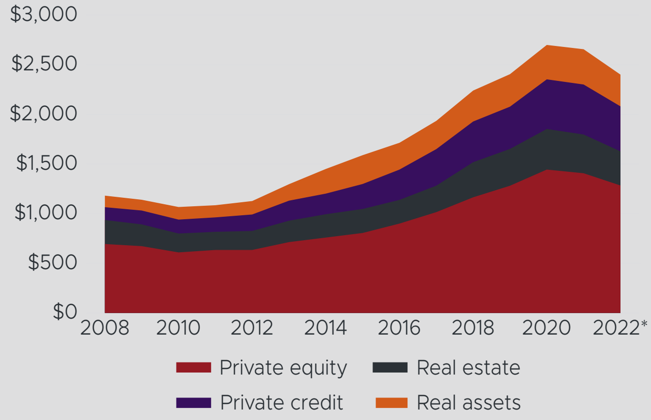
Targeted exposure
We continue to hold a structurally positive view on both energy and soft commodities through both our equity positioning and also direct commodity exposure, with the recent addition of the agriculture ETF underpinning this.

Private markets

Dry Powder and the Window of Opportunity in Private Markets
As expected, the natural lag in valuations and inherently lower volatility within the private markets asset class meant the impact of higher rates was delayed when compared to the public markets. This is largely due the private markets being more in line with the real economy and hence the fallout/impact traditionally takes longer to reach the real economy than it does in the financial economy. We are now starting to see the impact occur, stressed/distressed corporate credit is on the rise, M&A activity has slowed, valuations have declined, and real estate cap rates have started to blow out. It is clear to see that those that have been deploying heavily over the last few years are potentially those at risk from subdued returns given the current environment. However, we believe this period could be interesting for investors looking to deploy into what could be a very attractive environment. The question is however, how long could this window of opportunity last?

Over the last decade private market asset managers have been able to accumulate significant amounts of capital as investors looked for alternative strategies to drive excess returns. This is well documented and well known across the industry, and whilst the last 12 to 18 months have proven more difficult for fund raising activities the picture doesn't look as bad as one would initially think. One area of interest for us as a team is the level of dry powder these managers have after a decade of building coming into, what we think, could be a favourable investing environment. The chart below highlights dry powder levels over the years by some key sub-asset classes within private markets.

Dry powder ($b)



Source: Saranac

When we look deeper into how this could play out, taking private equity as our example, we see that c.$1.3trillion of capital is currently sitting on the sidelines ready to deploy. In addition, we see an even larger cash pile on the balance sheets of corporations. In the US alone, cash holdings surpassed $4.0 trillion in Q1 2023, and whilst only a small portion of this could be used for acquisition activity, the notional is a substantial addition to the levels of dry powder available for deployment. At the same time, we've seen that M&A activity has fallen 33.7% (in nominal terms) YoY to $873m. This clear weighting in favour of capital availability over transaction activity, to us, feels like a clear signal that opportunities could come and go in a quicker than expected.

Now, whilst coming to this view it is important to note that the decline in M&A activity has been driven by a few other external factors, not just capital availability. These factors are:

1. Higher rates have resulted in more expensive financing options for traditional LBO asset managers – yield to maturity for B-rated leverage loans have risen to 11% from c.5% only 12 months ago. As a result, we are seeing deals funded with less debt and more equity – 43.3% vs 52.2% LTV YoY. This dynamic ultimately limits the level of deal activity compared to historical levels that these managers can now complete.
2. Pullback in credit markets have further exacerbated the restriction on financing options as many traditional lenders have pulled back activity and tightened credit standards.
3. A bearish macro-outlook by most industry professionals have meant that many firms have been hesitant to close new transactions given the potential for further economic deterioration.

The reason for highlighting these factors is that we now sense the market is beginning to either normalise to these new conditions or see through this period to a more friendly environment given the continued decline in inflation and hence we believe that these conditions that have subdued activity could begin abate.

Private markets (continued)

Therefore, we believe the combination of a more favourable macroeconomic outlook, the normalisation of a new rate environment, the significant amounts of dry powder, and the pullback we are seeing in valuations means that as these opportunities continue to grow, the speed of execution for asset managers is critical.

As a result, we believe the window to execute could become very tight. Investors should be seeking to commit to managers/funds that are close to finishing capital raising/have already completed, and have only done minimal/zero capital deployment to date, positioning them in a highly favourable position for capital deployment for the period ahead.

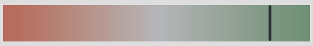
Private markets

ALTERNATIVE SOURCES OF RETURN

Secondaries

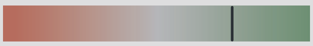
Record levels of secondary volume as investors seek to rebalance portfolios has resulted in a very attractive pricing environment

Special situations



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

Venture capital

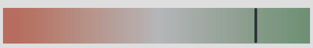


Early-stage venture has benefited from the correction in late-stage valuations, providing an opportune time to invest in long-term productivity gains, labour replacement and other venture investment qualities

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

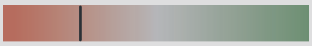
GP stakes and financing

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

Real assets

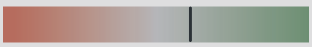
At risk from weak growth environment

Private debt



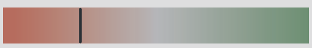
A negative economic outlook with the potential for above-trend default rates and extension risk make private direct lending unattractive on a risk-adjusted basis

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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