SARANAC PARTNERS

Investment roadmap

JANUARY 2024

AT A GLANCE

— This month's main feature is on **market themes for 2024**. Last year proved to be good for many asset classes, albeit with the returns concentrated disproportionately in the final weeks of the year. The main catalyst was a perceived pivot by the Fed towards more rate cuts in the coming months. We think that this risk-on phase may have become somewhat over-extended. We are tactically cautious, taking profits on some equity and credit exposures in multi-asset portfolios, where we continue to hold more credit and alternatives than usual. Our longer-term views are unchanged. We continue to regard equities as the most attractive public markets asset, although the expected additional return over fixed income assets is likely to be modest, and less than in the past.

— The **global economy** slowed into 2024, as the US economy lost momentum, and the levels of economic activity in Europe and China remained low. While we think recessions can be avoided, the global economy still seems trapped in a low-growth cycle, for which we still regard the term 'stagnation' as appropriate.

— In **fixed income**, credit spreads are below 'normal', and we think the market has become slightly too aggressive in pricing a low inflation environment and scope for very material rate cuts. We prefer to wait for better entry levels to reinvest cash. Given inverted yield curves, we continue to prefer 4–5 year maturities to longer duration exposures.

— Global **equity valuations** are somewhat higher than normal following the recent rally: all the gains reflect a rerating largely driven by lower interest rates, as corporate earnings growth has been flat. The dispersion in valuations remains significant. US megacap valuations remain extended, but some global sectors are still priced for economic distress, if to a lesser extent than a few months ago. The potential for weakness in corporate earnings is the main threat to global equities.

— In the private markets section, we take a closer look at **continuation funds** as a tool to manage liquidity. While this area of the market has grown significantly, this was from a very low base, and we believe there is scope for it to become a more central market feature.

Financial markets: What happened? What next?

1. 2023: the owl of Minerva flew at dusk

The German philosopher Hegel claimed that 'The owl of Minerva only flies at dusk', which translates roughly as 'you only find out the things that matter very late in the day'. This is a very apposite description of 2023. For much of the year, financial markets were dominated by troubling themes, with the main debate concerning just how troubling in aggregate these negative aspects were likely to be. The challenges were partly economic. Economic growth appeared sclerotic, with recession risk seen as material – so a difficult background for corporate earnings. Inflation was above central bank targets, and while declining, appeared likely to remain so for an extended period. As a result, for much of last year the risk to central bank policy rates was in most instances correctly regarded as to the upside, increasing further the already-elevated recession risk. At the same time, geopolitical stresses gathered pace, extending beyond the war in Ukraine to tensions over Taiwan and, more prominently, in the Middle East.

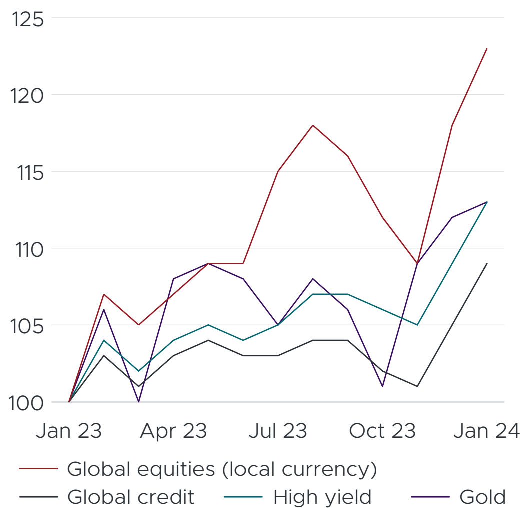
As of the end of October, these concerns were clearly driving markets. Global equities at that time were below their level in late January. Moreover, such gains as had been made were concentrated to a considerable extent in a handful of US megacap firms, up by an extraordinary 75% at one stage, liberated from the unprepossessing macro environment by the possibility of widespread gains from the deployment of artificial intelligence. By contrast, the equity return for the median global company was close to zero. Conditions were still harder in fixed income: the US 10-year rate of 5% reached in the autumn was ~1.5% higher than earlier in the year, generating a double-digit percentage loss. Investors in shorter-dated credit were less affected, but had made no meaningful gains. For much of the year, cash was an attractive asset class, in terms of returns as well as the lack of volatility.

Geopolitical stresses gathered pace in 2023, extending beyond the war in Ukraine to tensions over Taiwan and, more prominently, in the Middle East.

2. The turning point: what happened?

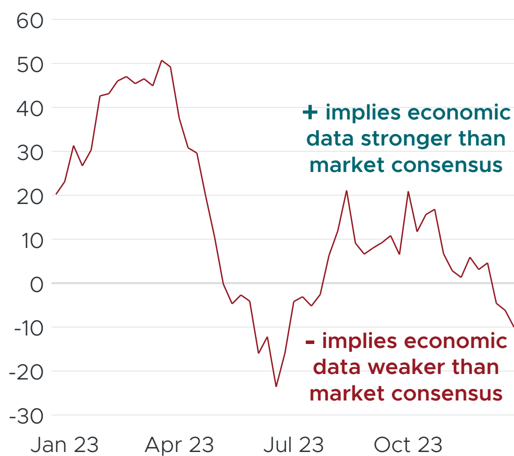
However, this challenging investment environment – and it was indeed challenging - is not how 2023 looks with the considerable advantage of hindsight and perfect knowledge of what happened next.

Chart 1: Asset class returns in 2023



Source: Saranac, Bloomberg.

Chart 2: Economic surprises largely positive in 2023



Source: Saranac, Bloomberg.

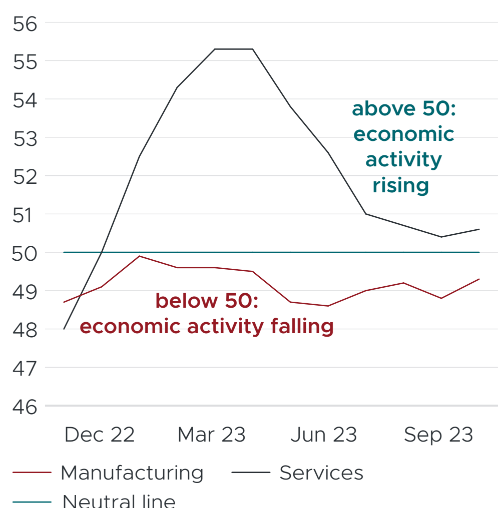
The divergence from what was generally expected was more important than whether the fundamental background was itself either 'good' or 'bad'.

The final few weeks of the year saw a material rally across a wide range of financial assets which ultimately lead to 2023 being one of significant returns in many asset classes (chart 1). For all the concerns, the year was in the event one of significant investment opportunity.

Will this carry over into the current year? Does the late flight of Hegel's owl represent a journey to a different environment, or will it find itself on landing in the more familiar territory associated with last year's economic and financial stresses. To answer this question, it's important to understand the forces underlying the recent asset-price surge. We attribute this not so much to the emergence of a very positive fundamental background for investors, although there were some positive surprises, particularly as regards the direction of monetary policy in the main economies. A better interpretation is that a still-mediocre fundamental position facilitated the market rally, because this background was more favourable than what had been widely expected. As always in financial markets, the divergence from what was generally expected was more important than whether the fundamental background was itself either 'good' or 'bad'.

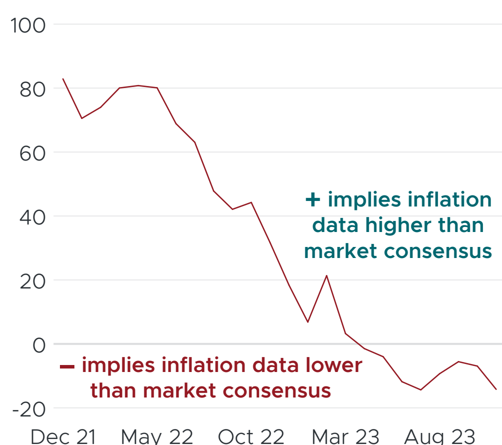
Consider, for example, the global macro background. Many of the main regional blocks struggled in terms of economic growth last year, notably Europe and China, but even in these cases 'stagnation' was a better description than outright recession, which had been a central market concern. Elsewhere, the distance from recession was still greater, with US growth of some 3% well above the long-term trend, and India and Japan also growing firmly. In aggregate, this led to firm growth in the global economy as a whole, and to positive economic surprises, particularly in the second half of the year e.g. data releases on economic activity exceeded market expectations (chart 2). We would, nevertheless, emphasise significant sectoral dispersion. Many manufacturing sectors have been in recession for much of the past year, but services sectors have proved more robust (chart 3).

Chart 3: Global business confidence indexes



Source: Saranac, Bloomberg.

Chart 4: Global inflation surprises



Source: Saranac, Bloomberg.

The final weeks of the year saw additional rate rises priced out, and rate cuts for 2024 increasingly strongly discounted, starting progressively earlier in the year.

This absence of global recession also coincided with clearer evidence of lower inflation towards the end of the year, and at a faster pace than market expectations following almost two years in which inflation had surprised on the upside. Since many central banks had been suggesting that sharp growth slowdowns and significant rises in unemployment may be necessary to bring inflation under control, the decline in price pressures in the absence of pronounced economic weakness may appear surprising. One factor that may have been relevant in this context is that the 'supply-side' shocks (covid and food and energy price rises), which contributed to the surge in inflation in 2021/22, have unwound somewhat more rapidly than expected (chart 4). This in turn meant that there was less need for a growth slowdown to contain inflation. Unexpectedly strong productivity growth in the US may also have played a role in facilitating disinflation.

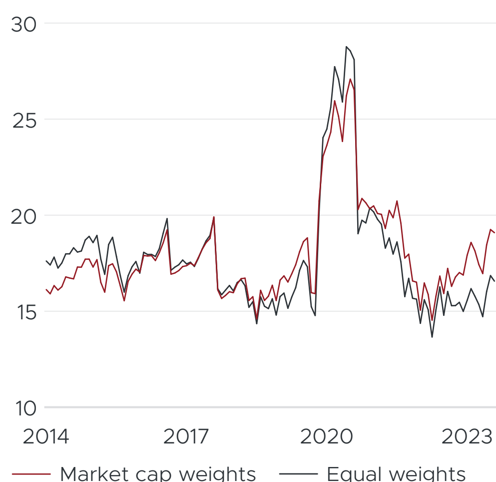
This improved inflation background was crucial in changing expectations for monetary policy in the major economies, with a change in central bank rhetoric also influential, most notably in the US. The final weeks of the year saw additional rate rises priced out, and rate cuts for 2024 increasingly strongly discounted, starting progressively earlier in the year. This prospective loosening in monetary conditions was the most important factor underlying the investment gains made at year end.

A further influence was that the rally found many investors under-risked, with conservative positioning in general evident in fixed income and credit markets. Indeed, some investors had de-risked in early October in the aftermath of the hostilities in the Middle East. The speed of the subsequent rallies forced rapid portfolio adjustments to more risk-on positions, which in turn contributed to the power of the asset-market rallies.

3. Did 2023 steal returns from 2024?

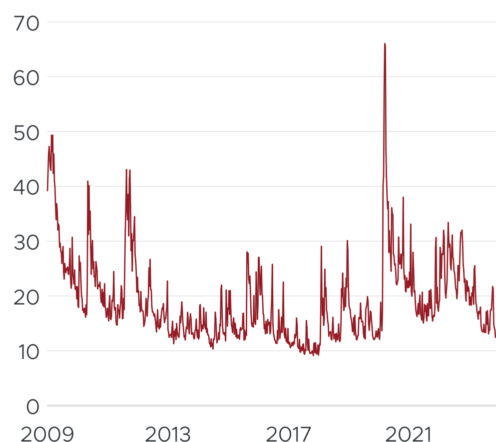
To what extent can these widespread asset-market rallies be sustained for much of this year, with additional (albeit possibly weaker) gains? We are reluctant simply to extrapolate this rally, and note that there has already been some slight retracement

Chart 5: PE ratios global equities



Source: Saranac, Bloomberg.

Chart 6: Vix Index is low (implied volatility)



Source: Saranac, Bloomberg.

Our assessment of market positioning – the extent to which there is exposure to risk assets across different investor groups - is that it has become much more 'risk-on'.

in many markets in the early part of this month. One reason why the year-end gains were so substantial was that market pricing was conservative, reflecting the stressed global environment. This is no longer the case. For example, at the start of last year the PE multiple on a broad global equity index was 15x, slightly below the longer-term average. It is now some 18.5x, towards the top end of the longer-term range, reflecting the fact that the equity rally has been driven solely by a re-rating, or a rise in the multiple, not by any rise in earnings: on the contrary, corporate earnings growth has been around zero since mid-2022. The current multiple is not a speculative rating, but it is more demanding. As noted, a disproportionate proportion of equity market gains last year came from a small group of companies, which also skewed valuations higher. Valuations of equity indices which dilute this influence have also increased (chart 5), but only to a more neutral level.

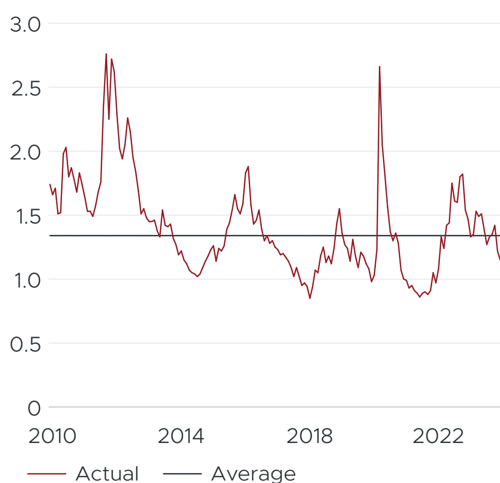
Other signs of less 'fear' in markets are the low level of implied volatility, with the Vix index at 13, around half the level of a year ago; a low level of credit spreads over government bonds; inflation being priced to meet official targets sooner rather than later; and, as noted earlier, greater confidence that material rate cuts are coming soon (charts 6 to 8). In short, market conviction in a soft landing has increased quickly in a short period of time, and the structure of market pricing suggests that it may be the most likely expected scenario for the coming year – a very different consensus from twelve months ago.

More generally, our assessment of market positioning – the extent to which there is exposure to risk assets across different investor groups - is that it has become much more 'risk-on'. Some positioning metrics are flashing red rather than amber: for example, asset managers' long positions in US equity futures are around their highest level for a decade. This implies less scope for such assets to be squeezed higher, and greater risk of short-term position unwinds should difficult news emerge. In our view, current market pricing does not fully

Chart 7: Market implied inflation: next five years

Source: Saranac, Bloomberg.

Chart 8: Bloomberg global credit spreads



Source: Saranac, Bloomberg.

We expect lethargic corporate earnings growth rather than outright declines this year, which may prove insufficient to support a further expansion in the global equity multiple.

reflect the near-term risks, and may therefore be regarded as somewhat complacent, in that there is less valuation protection in the face of problematic newsflow.

We would emphasise three main risks. The first is economic growth. As noted above, growth surprises were consistently positive last year. However, a particular challenge is that the tightening in monetary conditions up to last autumn has yet to take full effect. The global economy slowed somewhat towards the end of the year, albeit not sharply. In 2023, the macro debate was polarised around the issue of 'would there be a recession or not?', but this underestimates the range of possible outturns. In the event, recession was largely avoided, but many countries appeared to be locked into very low, if still positive, growth rates. Very strong growth in the US was the crucial factor holding up the global economy last year, but this particular escape route is likely now to be less supportive as previous rate increases 'bite'. We expect lethargic corporate earnings growth rather than outright declines this year, which may prove insufficient to support a further expansion in the global equity multiple.

The second risk is the market pricing of monetary conditions. In the US, policy rates are discounted to fall by ~1.5% points over the next year, and UK and Euro rates by over 1% point. These are plausible in the event of very weak growth outturns and the demise of inflation as a macro challenge. However, for all the recent good news on inflation, there are still problems. In particular, US wage growth remains some 2% points higher than when the core inflation rate (excluding food and energy prices) was last around the Fed's target range, at a time when the unemployment rate is still very low. The risk here is not so much of a renewed inflation spike, rather that market expectations of a continuing decline are too sanguine, and this may conflict with the market's assumed sharp decline in interest rates.

The third risk to markets is political. We are usually reluctant to give a high weight to geopolitics in taking investment decisions, because accurate prediction is difficult, and frequently adverse

geopolitical surprises do not give rise to lasting market trends. For example, the terrible recent events in Israel and Gaza have not had a significant market impact, because the oil price has to date been largely unaffected. However, we acknowledge that these geopolitical risks do seem more elevated than usual, reflecting the large number of elections in important countries this year, notably the US, and continuing flashpoints in the Ukraine, Taiwan and the Middle East.

4. Thinking strategically: what about the long term?
We have focused this analysis on near-term market issues and risks, but a longer-term view is also required. Many Saranac clients have a multi-year investment horizon. From this perspective, where are the opportunities? We continue to believe that the risk asset of choice in public markets continues to be equities. Looking through the inevitable volatility in returns, we expect gains in a diversified global equity portfolio around 4% above inflation over time, sufficient to warrant significant allocations for investors who are prepared to incur the risks of equity investment.

However, there are two caveats. First, future gains in equities are likely to be lower than in the period between 2009 and the covid crisis, when equity returns after inflation were close to double digits. These exceptional gains reflected a very low equity multiple at the start of the period, which allowed a significant re-rating of equities, and the collapse in profits during the crisis, which created scope for a large recovery in corporate earnings. Neither condition pertains today. Second, while we expect returns in fixed income to be less than in equities, the margin is not particularly large, around 2% points. The rise in yields has made fixed income an investible asset class, which is particularly relevant for investors with a lower risk appetite.

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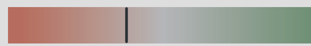
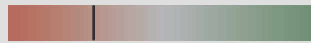
Public markets

EQUITIES

Valuation



Earnings



Positive
Healthcare; Energy; Japan

Negative
Financials; IT; Emerging Markets

Market background
In December the Federal Reserve signalled 0.75% of rate cuts for 2024. The markets concluded this was conservative and promptly priced in deeper cuts to the Fed's fund rate. Swept away by this optimism, global equity markets rallied 4.2% and finished 2023 up 16.8%. Much of this resulted in higher valuations as earnings growth will be more subdued for 2024.

Targeted exposure
Despite being well capitalised, banks should face some revenue headwinds in 2024 and commercial real estate concerns continue to hang over the sector. High valuations within IT mean we continue to focus on quality. The earnings headwind healthcare faced last year turn into a tailwind for 2024 which should be supportive. Despite oil price volatility, energy companies have exhibited a high degree of discipline which has led to strong cash flow generation. We expect this will continue. We are also sceptical about the perceived attractive valuations in emerging markets.

GOVERNMENT BONDS

Short maturity

Long maturity

Positive
US TIPS, nominal and inflation linked Gilts

Negative
>5 year European sovereign bonds, Japanese government bonds

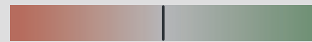
Market trends
In the final weeks of last year, financial markets moved very quickly to price in aggressive interest-rate cuts in 2024, reflecting lower inflation and a change in rhetoric from the Fed. This generated significant returns at all maturities across many markets. Markets are currently pricing between 125bp and 150bp of cuts by the end of this year in the US and in Europe, although there has been a slight retracement in these expectations in the early part of the current month.

Targeted exposure
Falling yields have made duration less attractive. Yield curves are still strongly inverted, particularly in the belly up to around five years, and these areas are relatively attractive. There are still risks at the very long maturities – particularly fiscal risks – which do not appear fully priced, particularly after the recent rally. Market-based inflation expectations are low, and we see scope for upside surprises.

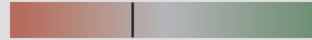
Public markets

CORPORATE AND EMERGING MARKET DEBT

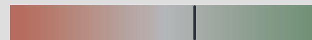
Investment grade credit



High yield



EM debt



Positive
IG credit with a preference for £IG, short-dated subordinated bonds, AAA/A securitisation

Negative
US B/CCC junk bonds

Market background
Credit spreads tightened further in December, with global spreads falling below 1% at one stage, below our assessment of fair value. High yield spreads also fell sharply, to nearly 3% at one stage as fears alleviated concerning the 2024–25 maturity wall. Subordinated bank debt and corporate hybrids continued to perform strongly, as a consequence of elevated carry and further spread compression. The main driver of spread compression was greater conviction in the possibility of a soft landing, and the fall in yields in all markets.

Targeted exposure
We remain constructive on corporate credit fundamentals but with credit spreads at their tightest levels since early 2022, there is limited room for further compression and excess returns. We have reduced our holdings in MBS. Our core view remains for a deceleration in macro momentum as we head further 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 maintain a defensive stance in High Yield as we expect (i) HY spreads to widen as we near the 2025 maturity wall and (ii) as credit defaults to pickup from current low levels. Similarly, we maintain an IG bias in EM corporate and sovereign debt.

STRUCTURED PRODUCTS

Equity volatility continues to remain around a multi-year floor, with the VIX remaining in a sub 14 range. The cost to hedge remains at multi year lows in light of elevated forwards and subdued implied volatility, so for investors seeking to add protection to the downside we view this as an attractive window. Medium dated puts on both the Nasdaq and the S&P500 are as cheap as they have been in a decade. We continue to view the autocallable environment as particularly poor at present and consider the risk premium gained from underwriting risk at these volatility levels as unattractive. Our structured product allocation sits towards the bottom of the range at the moment, reflective of our view that the opportunity set is more compelling elsewhere for the time being.

Public markets

HEDGE FUNDS

December 2023 / January 2024
With 2024 likely a year of elevated economic and political uncertainty, we believe macro and multi-strategy funds are well-placed to exploit shifting market conditions. Elevated debt levels and interest rates above pre-pandemic levels create opportunities for credit long/short funds that take advantage of mispricing between stronger and weaker borrowers. We expect the backdrop for equity long/short strategies to be attractive too, due to the considerable rise in short rebates and economic conditions within major geographic regions. As hedge funds in general are structurally long cash, high cash rates are a blessing not a curse for this diverse strategy grouping. Higher short-term interest rates have increased the short rebate to levels unseen since the GFC. In fact, a fund's short book now generates yields greater than benchmark equity dividend yields for the first time since 2008. A higher short rebate improves potential future performance, as it lowers the cost of carrying short positions and increases the opportunity set for single-name alpha shorts. Overall, we continue to believe that hedge funds are powerful tools for managing risk and diversifying sources of returns within a multi-asset class portfolio.

CURRENCIES

Dollar

Sterling

Euro

Yen

Market trends and targeted exposure
The Fed's pivot and drop in US bond yields at the end of 2023 were important for FX markets, where we see downside potential for the US dollar in 2024. US macro data is showing signs of continued cooling, albeit at a controlled pace for now. Should the US economy move towards a softer landing scenario or even shallow recession, these outcomes should, all things equal, prove negative for the currently expensive USD.

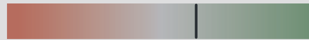
Upside risks for the US dollar come in the form of a growth rebound and/or resurgence in inflationary pressures, the latter of which we view as the greater risk due to the potential for supply-side shocks. We are not constructive on Sterling from current levels given the fact that GBP is a pro-cyclical currency and we expect the global economy to slow further this year, and we are also wary of UK election risks. We expect the Swiss Franc to weaken in 2024 as authorities push back on recent strength and after a difficult two years, we believe that the Japanese yen will appreciate as the Bank of Japan finally begins to adjust ultra-accommodative monetary policy.

Public markets

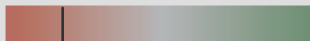
COMMODITIES

Gold

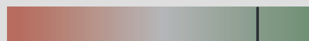
Energy



Industrial metals



Softs



December proved to be another difficult month for commodities despite the continued risk on rally elsewhere. Food and energy performed poorly, with preciously metals more resilient but still flatter after a very strong November on the back of the repricing in interest rates. Our relative preferences are unchanged into year end, although would note that we view oil related expressions as interesting here given the extent of the recent pullback. We retain direct gold exposure and also higher beta exposure via the substantial gold/silver miners weighting within the Baker Steel fund. Away from this we retain our medium-term conviction in the agricultural commodities trade and have additional exposure to the space in a lower correlated expression via the commodities carry implemented using capital protected notes.

Private markets

Are continuations funds here to stay?
In our last publication we touched upon the introduction of NAV loans as a mainstream lever for private equity managers to provide liquidity back to their limited partners. In that note however, we also flagged a number of key issues we have with the utilisation of them as a liquidity tool, and why they are unlikely to be a long-term solution for the market.

If we look back over the last decade, liquidity events have historically been driven through four main routes: (1) M&A sale to corporate/strategic; (2) sale to another private equity manager; (3) public listing via reverse merger; and (4) public listing via IPO. However, what we've seen in the last 24 months is that as rates have risen many of these methods have flatlined, either due to weak public markets, limited leverage availability, or weak investment appetite amongst private asset managers.

As a result of this, we think it is likely that we will see a number of new liquidity methods created over the next decade, and whilst those we have seen recently warrant, in our view, little merit, one area we think will continue to expand is the use of continuation vehicles. Over the last few years as we have monitored the new liquidity levers being used, we've come to the conclusion that continuation funds have proven to be the easiest to execute.

In our view, this is largely due to two main reasons: the first is that the assets involved in continuation vehicles have been owned for a number of years prior, and therefore GPs have a large pool of existing LPs that are familiar with the asset, and therefore are likely to provide / roll capital if further upside can be evidence. Another reason is that LPs like the short duration associated with continuation vehicles. When we've spoken to large LPs in the market, they've noted that the short duration of these vehicles allows them to solve for short-term portfolio allocation issues, limiting the need to allocate capital to long-term strategies/ structures, making their portfolio more flexible and nimble than traditionally associated with their private market allocations.

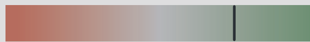
The second driver is the growth we've seen in the secondaries market, specifically, the growth we've seen in the GP-led secondaries part of the market. In 2017, GP-led transactions accounted for 24% of overall transactions, but in 2022 this number had doubled to 48%. If our outlook is right, and continuation funds become a solid fixture of the exit strategy for private market managers, we expect the trend we've seen in the GP-led secondaries market to continue.

Following on, it is important to note that the growth we've seen, whilst impressive, at the overall level still represents a very small part of the market, and hence why we think this could present a number of interesting opportunities in the short-term, as capital availability to investment opportunities remains significantly out of balance. To help contextualise just how small this part of the market remains, in 2023 71 continuation transaction took place, accounting for $6.5bn of deal value. In the primary market 15,056 transactions were completed in 2023, accounting for $1,323bn of deal value. Hence, whilst a lot of attention and capital has been brought into the secondaries market in the last 18 months, the relative position still provides a long-term tailwind for secondary opportunities.

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

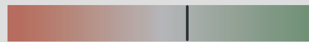
Infrastructure

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

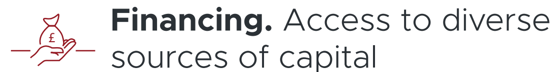
We founded Saranac Partners to do things differently. To create a community based around like-minded people, shared wisdom and collective learning. To work as partners, creating compelling opportunities and effective solutions. To offer unfailing support, honest challenge and thoughtful inspiration.

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).

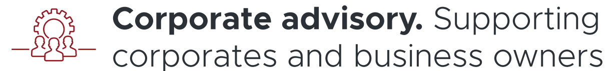
OUR SERVICES

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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