SARANAC
PARTNERS

Investment roadmap

MAY 2024

AT A GLANCE

— This month's main feature reviews **the recent rally in the gold price**, in the context of the breakdown in the precious metal's relationship with dollar interest rates. Up to mid-2022, bond yields and gold were strongly inversely correlated, but in the past couple of years both have risen together. What explains the resilience of the gold price in this period? Gold supply has increased, and industrial and retail demand has not changed materially, and so are unlikely candidates to explain its strength. At the same time, private sector sales of gold ETFs have been material for an extended period. We believe the circle can rather be squared by the significant gold purchases by many central banks, in particular China. This appears in part to reflect higher perceived risk for some central banks to hold dollar liquidity, if access to these holdings may be constrained in periods of significant political tension. The spike in the gold price on Israel/Iran tensions nevertheless demonstrates that its role in a portfolio in stressed market circumstances remains valuable.

— Political concerns (Iran/Israel tensions) were a key driver of the recent correction in **equity markets**, as was the rise in bond yields as the Fed has appeared increasingly restricted in its ability to deliver rate cuts by a somewhat more challenging inflation background. We do not regard the sell-off as driven primarily by high valuation levels, as these were and remain a considerable distance from a speculative rating.

— Neither do we detect a significant growth slowdown – and this is certainly not the message to emerge from the latest US corporate earnings round. While the growth in the **global economy** remains subdued, there was evidence of a mild acceleration in economic activity in many areas in the first few months of the year. Nevertheless, we still regard 'stagnation' as the best way to characterise global economic prospects. Recessions are likely to be avoided, but subdued rather than strong growth remains the most likely outturn.

— **Fixed income** markets are now pricing much less aggressive US monetary easing than at the start of the year, although we are sceptical that this will develop into a perceived need for policy rates to be raised. If so, much of the adjustment to the changed US rate outlook has already occurred. The rise in inflation expectations means that this component of the market is better priced. We assess long-term government yields around or slightly higher than 'fair value' after their recent increase. Credit spreads remain below 'normal', in particular in high yield, and we prefer to wait for better entry levels to reinvest cash. Given inverted yield curves, we continue to prefer 4- to 5-year maturities to longer duration exposures, particularly outside the US.

— As a general theme, we note that **risk premia** in many classes are on the low side, and this underlies a somewhat more cautious investment stance than usual in Saranac multi-asset portfolios – more in diversified fixed income and alternatives, and somewhat less in equities.

Chart 1: Gold price (US$) and Saranac model

Source: Saranac, Bloomberg.

What has changed the relationship between gold and other asset prices?

1. Gold in Saranac multi-asset portfolios

Gold is an important component of Saranac multi-asset portfolios, and a major element in some more concentrated bespoke client accounts. The main rationale for this holding is that it provides diversification – a return that is to some extent independent of other portfolio exposures, such as equity beta, bond duration and credit risk. In particular, gold is expected to perform well during periods of heightened economic and political stress.

The value of such an exposure has been evident in recent weeks: the gold price in dollars has risen by some 15% in the past couple of months, even after a recent correction, as Middle East tensions have become more apparent This would suggest that at least one driver of the gold price, heightened political risk, remains reliable. However, this recent increase, which occurred at a time of rising interest rates, masks a fundamental change over the past couple of years in the relationship between the gold price and other financial assets, particularly a de-linking from long-term interest rates. We set out what has happened, and what the implications are for gold allocations going forward.

2. Structural change in the determinants of the gold price

For some years, Saranac has used a simple model of the main drivers of the gold price. The objective has not been to identify a precise fair value level for the metal, but to identify a set of fundamental influences that could indicate how the gold price may change in different economic and financial environments, and its potential attractiveness given the pricing of other relevant asset classes. This model comprises four variables:

— the 20-year dollar real interest rate;

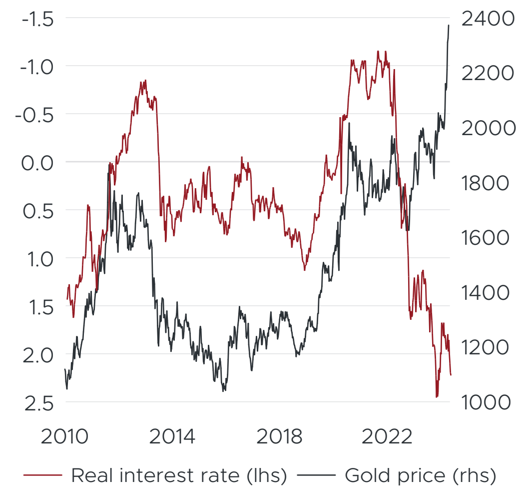
— a measure of market-based inflation expectations;

— the dollar; and

— the Vix, a measure of equity market volatility.

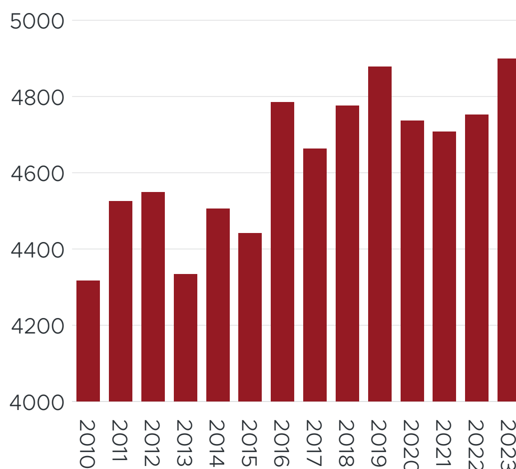
Gold is an important component of Saranac multi-asset portfolios, and a major element in some more concentrated bespoke accounts.

Chart 2: Gold price (US$) and real $ interest rate



Source: Saranac, Bloomberg.

Chart 3: Gold supply (tonnes)



Source: Saranac, Bloomberg.

This model suggested that a very favourable environment for the gold price would be falling real interest rates, rising inflation expectations, a weaker dollar, and a higher level of equity market volatility and risk. The most important driver was estimated to be the real interest rate, and from this perspective, as a starting point the gold price could be seen approximately as a 20-year US Treasury with no coupon.

This model tracked the gold price well for over a decade (chart 1), but has – to put the point politely – been much less successful in the past couple of years. The model suggested a halving of the gold price, largely in response to the repricing of real interest rates. However, this has not happened. On the contrary, in the past 18 months, the gold price has risen by 50%. Underlying this change has been a shift in the relationship between gold and real interest rates (chart 2). The gold price has surged as real interest rates have risen. Drawing attention to a model breakdown may seem uninteresting, but the interesting issue to be explored is why this breakdown happened, and how to evaluate gold's role in a portfolio going forward given this important structural change – observed also by other market participants.

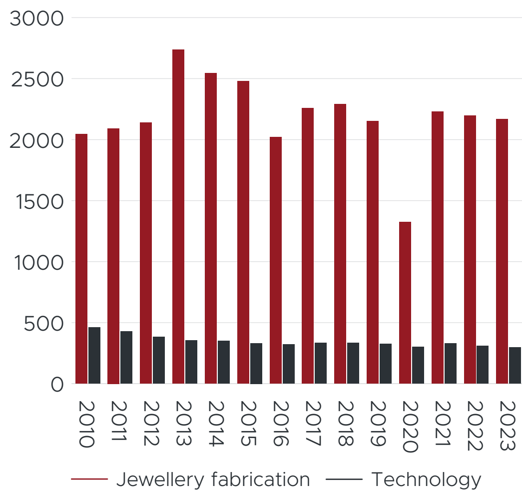
3. Gold supply has increased, and private sector financial demand has weakened…

A deeper understanding of recent market conditions can be attained by evaluating more directly the demand for and supply of gold. In principle, a significant weakening in the supply of gold could have forced prices higher. However, this has not happened (chart 3). The supply of gold (from mines, producer hedging and recycled gold) has risen in the past couple of years. In addition, new mine start-ups in North America, Asia and Australia suggests a further increase this year at least. There has therefore been no material supply shock responsible for the surge in the gold price.

What of the demand for gold? Around a half of such demand comes from end-use, notably jewellery, but there are also some important industrial uses (e.g. as an input to microchips). There has, however, been no material change in demand from these sources which could have been responsible for the price surge (chart 4).

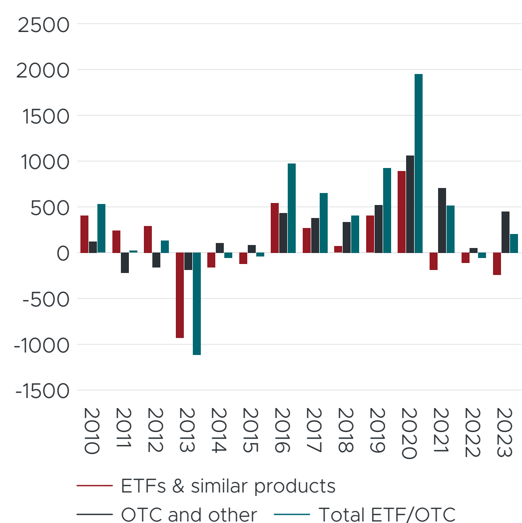
Around a half of the demand for gold comes from end-use, notably jewellery, but there are also some important industrial uses.

Chart 4: End-use demand for gold (tonnes)



Source: Saranac, Bloomberg.

Chart 5: Financial demand (tonnes)



Source: Saranac, Bloomberg.

The period since 2022 has been unusual in that the gold price has continued to rise in the face of net sales of ETFs.

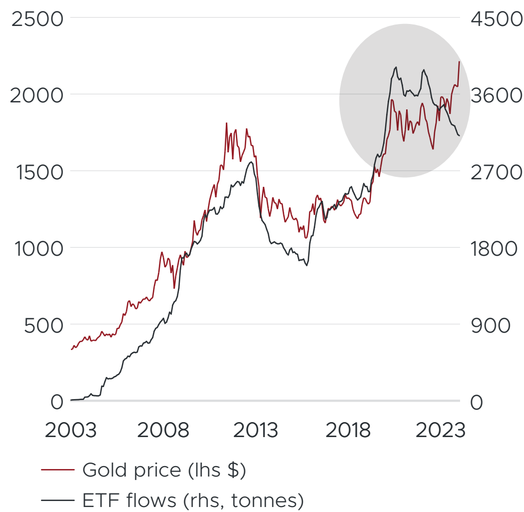
The remaining element of gold demand reflects investment activity, from private sector sources and central banks. There has been a significant change in the balance between these two groups in the past couple of years, with private sector demand falling, but offset by a surge in demand from central banks.

Private sector financial demand has been expressed largely through the ETF market, where sales in Europe in particular but also the US have been falling for much of the past three years (chart 5). Indeed, gold ETFs as a proportion of total US ETFs is close to an all-time low. In a longer-term context, ETF flows have tended to be strongly associated with gold price itself, rising or falling in tandem. The period since 2022 has been unusual in that the gold price has continued to rise in the face of net sales of ETFs (chart 6). Even though there has been some offset through higher demand for gold in over-the-counter transactions, overall private sector financial demand over recent years has weakened materially. This makes it hard to appeal to higher perceived political and economic risk among market participants in general as the main source of the rise in the gold price, and the divorce from the link with real interest rates.

One influence on this waning private sector demand is that in a world of higher interest rates, including cash rates, the opportunity cost of holding gold has increased materially. An increase in the price of some 5% is currently required for dollar investors in gold to break even, let alone earn a return above cash rates as compensation for the higher risk and volatility in the gold price. ETF outflows reflect to some extent investors responding to this changed environment of interest-rate normalisation, in which gold as a non-yielding asset has become less attractive.

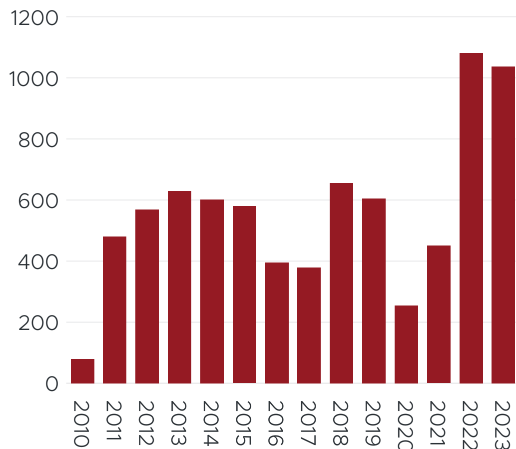
Moreover, there is little evidence that these outflows in the more recent past are related to the launch of bitcoin ETFs, a possible competitor asset. The outflows began long before it became easier to access bitcoin through the ETF route, and more recently when inflows into gold ETF did rise, bitcoin assets were also increasing. There is therefore no simple relationship at play here, and little sign that bitcoin ETFs are cannibalising their gold counterparts.

Chart 6: Gold price and ETF flows diverge



Source: Saranac, Bloomberg.

Chart 7: Central bank gold purchases (tonnes)



Source: Saranac, Bloomberg.

The surge in central bank demand for gold has come from a wide range of regions.

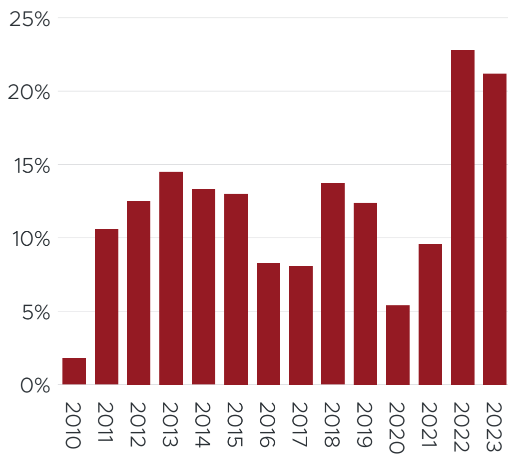
However, private sector investors are a homogeneous group, and there are clear exceptions to the generalisation of weaker demand from this source. In particular, in recent weeks there have been signs of much stronger activity in Asian gold markets, with long gold positions in futures markets and ETF volumes in Japan and China rising strongly on the rally. In the latter market, recent trading volumes have been some 50% to 100% higher than last autumn. Demand for gold as an end-product has for many years been concentrated in Asia, and the focus of financial demand also seems to be shifting in the same direction.

4. …but central bank demand has surged

There is, however, one clearly identifiable area where gold demand has increased, and this is amongst central banks (chart 7). Demand from these institutions has been over twice as high in 2022–23 compared with the previous five years. Having recently accounted for less than 10% of gold demand, central banks in the past two years have accounted for over 20% of the total (chart 8). It is likely that it is this source of additional demand which accounts for the breakdown in the relationship between real interest rates and the gold price. It is no coincidence that the period in which the gold/interest rate relationship began to break down (the spring of 2022) also coincided with the period when central bank gold purchases surged (chart 9), and no coincidence that central bank gold demand increased in the aftermath of the Russian invasion of Ukraine.

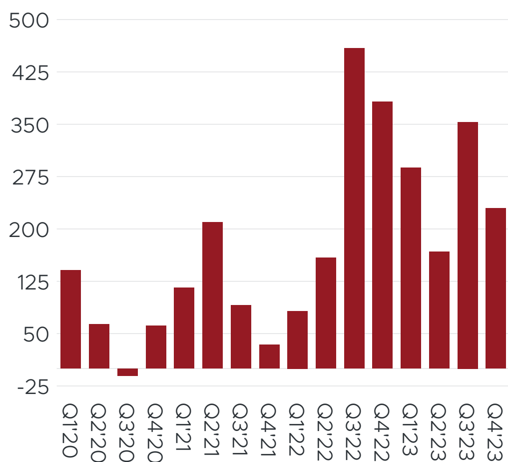
This surge in central bank demand has come from a wide range of regions. China has been most active in building up its gold reserves, which comprise only around 4% of its total reserve holding, but the increase in demand has come from diverse sources, including Poland, Singapore, the Czech Republic and Libya. There appear to be two main sources for this rise in demand. The first is ‘more of the same’ – the long-term trend for many central banks to diversify away from the dollar for financial reasons. Poland, for example, has raised its gold holdings to around 12% of the total, and has a long-term target of raising this to 20%. This process of central bank

Chart 8: Central bank purchases of gold as % of total



Source: Saranac, Bloomberg.

Chart 9: Central bank demand by quarter (tonnes)



Source: Saranac, Bloomberg.

diversification has been under way for the best part of four decades, but seems to have gathered pace more recently.

The second source of central bank demand reflects higher political risk, but of a particular form. There has been a clear tendency for some Western governments to resort to financial sanctions against individuals and governments in periods of conflict, with the potential for example for Russian reserves assets to be seized rather than merely frozen illustrating the incentive for some central banks to move away from dollar assets which may be at risk in this context. The ability of the US to constrain or eliminate access to dollar liquidity in pursuit of political objectives has increased the risk for some states of holding US dollars.

5. Gold's status as a hedge against political risk and financial turbulence remains intact

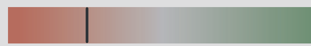
The emergence of central banks as a more significant influence on the gold price, and the increasing influence of Asian private sector investors, suggests that there has indeed been a structural shift in the main influences on the gold price. The demand for gold has always come from a wide range of sources, from retail and industrial end-use to gold demand for investment purposes, so in this context nothing has changed. However, the 'newer' influential players do appear to be less price-and yield- sensitive, and this helps to explain the resilience of the gold price to the repricing of global interest rates in the past couple of years.

The sharp rise in the gold price in recent weeks indicates that its role as a hedge against heightened political risk, and some economic risks, remains intact. This remains the dominant rationale role for the continuing holding in Saranac multi-asset portfolios.

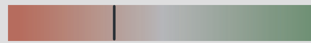
Public markets

EQUITIES

Valuation



Earnings



Positive
Infrastructure and Resource Scarcity; MedTech; Japan/South Korea

Negative
Financials and other interest-rate sensitive sectors; Emerging Markets

Market background
After five solid months of gains, global equity markets could no longer ignore sticky inflation and the escalating conflict in the Middle East. The MSCI World fell -2.9% in April as the US 10-year treasury yield surged past the 4.5% level. Investors drew some comfort from the solid 1Q earnings season.

Targeted exposure
There are a number of longer-term themes we like which span across sectors. As AI has grown in importance, investors have become more focused on the energy required to power data centres. We believe this will put additional strain on the shift from fossil fuels to renewable energy. We therefore like companies who can benefit from this. We believe medical technology could be an important theme as health systems need to become more cost effective and efficient. At a country level, Japan and South Korea could present opportunities as corporates are encouraged to strengthen their corporate governance and shareholder returns.

GOVERNMENT BONDS

Short maturity

Long maturity

Positive
Gilts, US Treasuries and Australian Sovereign and Agency bonds across tenors

Negative
>5 year European sovereign bonds, Japanese government bonds

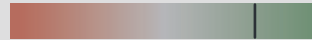
Market background
In April, US inflation data continued to surprise to the upside (PCE, CPI, Employment Cost Index) and Federal Reserve officials started to talk down the prospects for imminent interest rate cuts. As such, the market now anticipates only one Fed cut in 2024 down from three at the end of March. These dynamics pushed bond yields higher, seeing the US 10-year Treasury yield rise to around 4.7%, 90bp higher than its Dec 2023 trough. So far in 2024, the sustained rise in long-dated bond yields flattened the yield curve and led to a significant underperformance of long-dated bonds compared with cash and short-duration fixed income.

Targeted exposure
After weathering relatively well this year's duration sell-off, we now believe intermediate sovereign yields offer attractive value. As such, in April we increased portfolio duration. Following the rise in inflation break-evens, which led to a significant outperformance of inflation-linked bonds over nominal bonds, we reduced the TIPS overweight in portfolios.

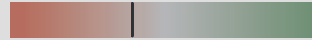
Public markets

CORPORATE AND EMERGING MARKET DEBT

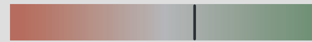
Investment grade credit



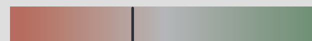
High yield



SUB



EM debt



Positive
Subordinated bonds, AAA/A securitisation, US Agency MBS

Negative
US High Yield

Market background
We now view credit spreads as too tight, in particular in the HY space, with $IG and $HY spreads ending April respectively at 92bp and 336bp, well below their long term average of 128bp and 455bp. We continue to find better value in the subordinated bond space. Complexity premium offered in the structured credit space remains attractive. For instance, $ AAA CLO tranches trade at a ~140bp spread above SOFR, compared with just 85bp for the 1-10Y $IG credit segment which has A- average rating. Finally, MBS spreads remain attractive compared with $IG credit, especially considering the improved convexity profile of the asset class and as we expect the Federal Reserve's to start tapering its quantitative tightening program some time during the summer.

Targeted exposure
Despite relatively tight spreads, IG corporate fundamentals remain excellent and headline yield levels have risen to attractive levels of around 5.7%. As such, we are increasing the duration of IG credit allocations. We continued to trim EM and DM HY exposure due to relatively demanding valuations. We continued to find new attractive short-duration carry opportunity in the short-dated subordinated bond arena. Lastly, after a timely partial profit taking decision in January, we are adding to our US MBS position within multi-asset class portfolios.

Public markets

HEDGE FUNDS

Hedge funds year-to-date remain broadly positive and ahead of cash-plus targets. Performance at the industry level year-to-date was led by CTAs, long/short equity (directional) and discretionary macro. Overall, the industry continued to produce strong alpha in the year thus far.

Equity long/short. The alpha environment remains supportive, albeit with regional nuances. Stock price and valuation correlations have collapsed in most regions year-to-date, while stock dispersion has surged – specifically in Europe vs. US and Japan.

Merger arbitrage. The backdrop remains supportive for this strategy. We expect corporate activity to resume, which will provide managers with a broader menu of opportunities. Deal funding stress is receding as we enter the final phase of monetary tightening. Corporate confidence is reviving on signs that global growth is remaining resilient, and banks are willing to lend again, reflected by their easing lending standards. Lots of dry powder is still waiting to be deployed ($2tn in private equity, $5tn sitting in corporate cash), while a pipeline of delayed acquisitions since rates surged in 2022 is also ready to proceed. Uncertain US elections might delay some operations in sensitive sectors, but there is a strong M&A rationale for strategic deals in sectors exposed to AI and digitalisation, energy transition, re-onshoring and energy. Tighter corporate margins, moderating profit and revenue growth are also supporting external growth.

Public markets

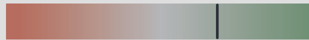
CURRENCIES

Dollar

Sterling

Euro

Yen



Market background
The US dollar delivered its fourth consecutive month of gains in April, following a solid mid-month bounce in the currency. The latest bout of dollar strength has been driven by the combination of better-than-expected US macro data, signs of ongoing stickiness in inflation data and a Federal Reserve which is now predicted to cut interest rates just once this year. Meanwhile, macro data in Europe and the UK has lagged, reinforcing the narrative of 'US exceptionalism' and in the process creating support for the dollar.

Targeted exposure
From a positioning standpoint we have seen the market becoming longer the USD on a speculative basis, and we would be cautious of chasing this narrative from current levels and particularly after the ~5% gain in the broad dollar index. Elsewhere, the Japanese yen sold off in a disorderly fashion, breaching USD/JPY 160 and causing Japanese authorities to intervene to stabilise the currency. We believe that alongside the rhetoric and emergency interventions, tighter monetary policy will be needed to bring more stability to the yen.

COMMODITIES

Gold

Energy

Industrial metals

Softs

Market background
The first part of the year has seen significant gains across a wide range of commodities. Energy, precious metals and industrial metals have all delivered double-digit returns. The main exception has been prices of agricultural goods, where the price trend has been flat. The key drivers have varied. Gold and silver have benefited from higher political risk; industrial metals from the modest global cyclical upturn, and energy from a tight supply/demand balance.

Targeted exposure
We retain our gold exposure, despite the recent attainment of an all-time high level. Gold supply is rising, and end-use demand for jewellery and industrial purposes is rising. In addition, the net gold sales through ETFs suggest that the impact of higher interest rates may be dampening demand from this source. However, central bank demand has been very strong, and this is likely to persist while the political risk to some central banks of holding dollar liquidity is perceived by them to have risen.

Private markets

Is there still opportunity in private equity?
Over the past few years, private equity research has highlighted the growth of assets under management (AUM) as a marker of the growth in the industry. Pitchbook's latest estimates are that private equity has around $5.3 trillion of AUM. Although this sounds like an excessive amount, we don't believe it is relative to the opportunity set within the universe.

To contextualise this, we would compare this with the capital deployed in public markets and the proportion of the market that is public. In the US alone, it is estimated that allocations to public equities have amounted to around $9 trillion, with most of this being allocated towards those companies that are within the S&P 500. This capital is invested in companies that only account for 18% of total US employment.

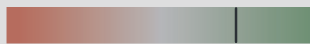
Traditionally, companies that went public was a sign of scale and quality. However, over the past decade that dynamic has shifted significantly with more quality companies staying private. In the US alone, it is estimated that the share of public companies that have revenue in excess of $100m is around 13%. In other words, of the 20,800 companies in the US that have revenues of $100m or greater, 18,000 are privately held. This heavy tilt towards private ownership and the fact that capital is deployed predominantly to the public companies is part of why we believe private equity opportunities continue to exist, particularly in the middle and lower middle market (<$1bn).

In addition, while $5.3 trillion is quoted at the headline level, it is important to remember that capital in private equity has a maturity – exits create cash, and new money is re-invested with managers. This further tips the scale of opportunity (supply) vs capital (demand) in favour of investors. Pitchbook forecast that private equity strategies will accumulate up to $8 trillion by 2028, which even at that level, still provides significant favour towards investors given the breadth and depth of the private universe.

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

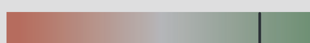
Venture capital

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

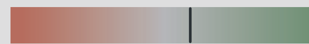
More attractive given supply chain issues and geopolitical uncertainties

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).

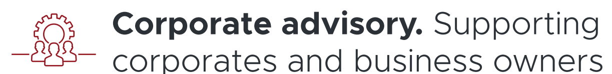
OUR SERVICES

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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