

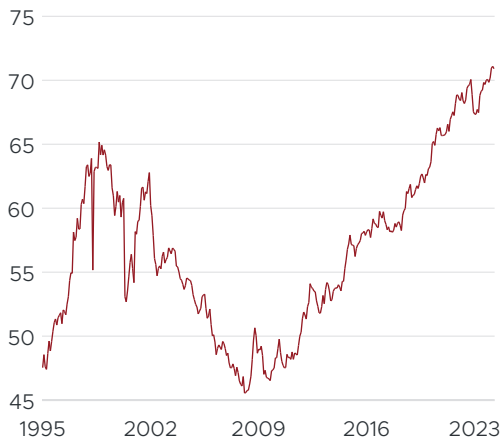
*Investment roadmap*

JUNE 2024

**AT A GLANCE**

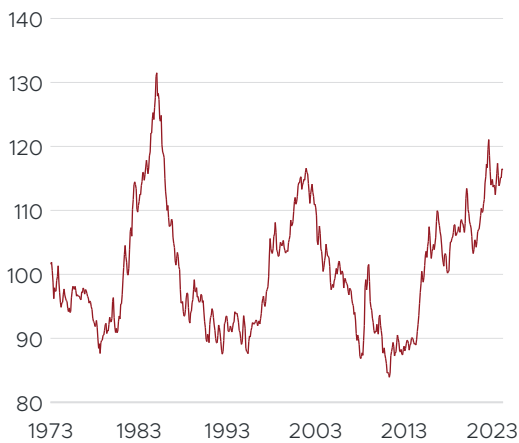
- US equities comprise around 70% of global equity benchmarks, following an extended period of outperformance of other regions. This outperformance has broadly coincided with a strong dollar. In the main article, we assess what **would be the implications for global equity investors in terms of regional allocations if the dollar were to weaken**. We note that currencies are not in general the prime drivers of relative equity market performance, because other fundamental factors are more influential. In addition, there is good evidence that in recent years weaker currencies tend to support the relative performance of the associated equity market. The impact of a lower dollar would therefore be likely to be at least partially offset by stronger relative performance of US equities in local currency terms. A more problematic scenario would, however, be a material rise in political, economic and fiscal risk which depressed both US equities and the dollar.
- Following a strong start to the year, the **global economy** now appears to be slowing somewhat, helping to explain the recent flat performance in global equities. Inflation remains slightly higher than central bank targets.
- We regard **global equity market** multiples as slightly extended, largely as a result of US megacap valuations. For now, these appear sustainable. Corporate earnings are rising slightly, and there has been no earnings recession. We do not detect an equity market bubble, but would expect only modest gains in the second half of the year.
- **Fixed income** markets now discount much less aggressive US monetary easing than at the start of the year. We do not expect the risk of policy tightening to re-emerge raised, which implies that much of the adjustment to the changed US rate outlook has already occurred. We assess long-term government yields to be around ‘fair value’ after their recent increase. The rise in inflation expectations means that this component of the market is better priced. 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.
- We are raising the **gold allocation** in our portfolios to hedge against a potential increase in political risk later in the year.
- 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: US equity market capitalisation as a proportion of global equities (%)**



Source: Bloomberg/MSCI.

**Chart 2: US dollar trades at a high level (against basket of other currencies, adjusted for inflation differentials)**



Source: Bloomberg/Federal Reserve.

*There is a range of risks associated with the US economy and politics, and the regulatory background.*

**The dollar and regional performance in global equities: would a much weaker dollar lead to US equity underperformance?**

**1. US equities dominate global equity benchmarks**

The proportion of global equity market capitalisation accounted for by US equities has continued to increase, rising from some 45% in the mid-1990s to around 70% more recently (chart 1). Indeed, large single stocks, such as Nvidia and Apple, have market values greater than the main national indices in Europe, and it is now unusual for non-US stocks to rank in the top 50 global stocks by value. Even if global equity managers were to have a material underweight position against the US’s benchmark weight it is still highly likely that the US would be the largest single country exposure by a considerable margin. Concentration risk to the US equity market is therefore typically highly material for global investors.

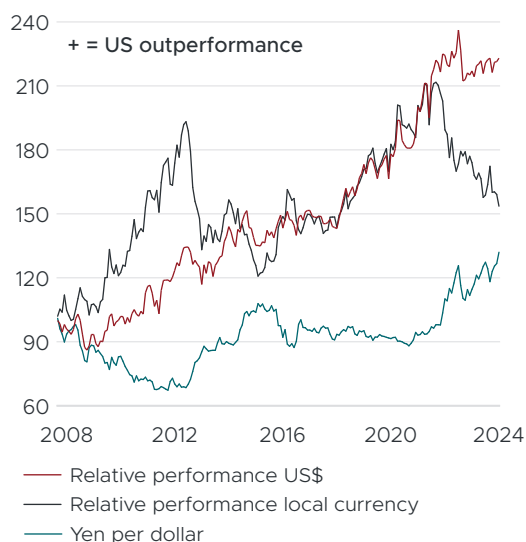
Of course, after an extended period of US equity outperformance, this risk can be seen as legitimate. However, that is to look back with perfect foresight. Looking forward, there is a range of risks associated with the US economy and politics, and the regulatory background. In this paper, however, we concentrate only on one: the dollar.

The US currency has trended higher over the past ten years and more (chart 2), and it seems intuitively plausible that this has contributed to the outperformance of US equities for non-dollar investors. However, the dollar is now trading well into the top half of its 30-year range, and indeed has only been stronger around 10% of the time. Currency forecasting is difficult, but it is sensible to acknowledge at least the possibility of dollar weakness. What would happen to a global equity investor’s portfolio if there were to be a material dollar depreciation? Would this inevitably lead to underperformance of US equities and better relative performance from non-US markets, assuming no currency hedging?

**2. Currencies do not dominate relative equity returns**

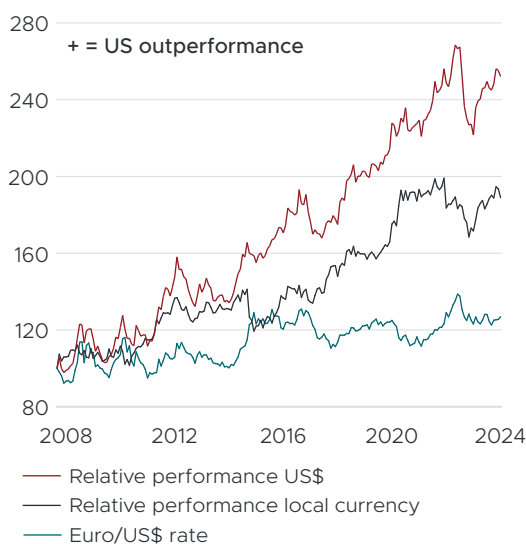
This can be regarded initially as a simple arithmetic question. If the US currency were to fall by say 20% against all other currencies, and all equity markets are assumed for now to remain unchanged in local currency terms, US equities would underperform

**Chart 3: Relative performance of US and Japanese equities**



Source: Bloomberg/MSCI.

**Chart 4: Relative performance of US and Euro equities**



Source: Bloomberg/MSCI.

*The assumption that equity markets remain unchanged in local currency terms as the dollar moves is a very strong one.*

by the magnitude of the dollar’s decline. Investors based in the euro, pound and yen – with portfolios replicating the global benchmark – would be around 14% worse off in absolute terms, reflecting the lower value of US dollar equity holdings in terms of their respective domestic currencies. This would be equivalent to almost a couple of years’ equity outperformance in ‘normal’ years. By contrast, the value of US investors’ global equity portfolios would be some 6% higher, benefiting from the appreciation of the other major currencies against the dollar.

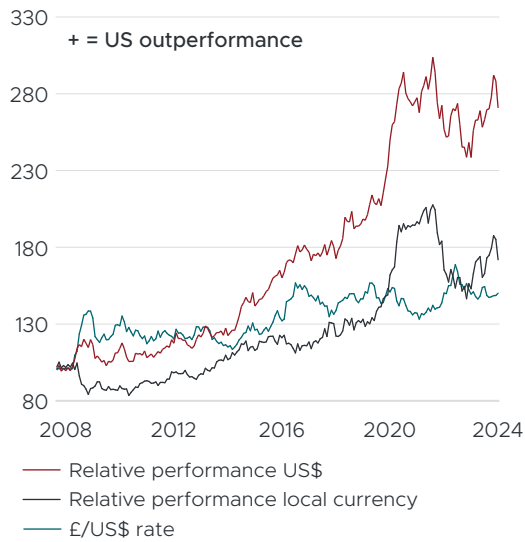
The assumption that equity markets remain unchanged in local currency terms as the dollar moves is, however, a very strong one. Two points are relevant in this context:

**i. Currencies are not in general the major driver of equity returns**

Currencies typically account for only a relatively small proportion of unhedged equity returns over time, even in the face of strong currency trends. Charts 3 to 6 show the relative performance of US equities (currency unhedged) against European, Japanese, UK and Emerging Market equities since 2007. This has been a period of US equity outperformance, even if this has become more attenuated in the past couple of years. We show the returns divided into the local currency return and the currency component. A robust generalisation is that for all these markets the US market’s strong relative local currency return has been a much more significant source of its outperformance than the currency component. The dollar’s appreciation against the yen and the euro has contributed to returns for non-US investors, but the ‘pure’ equity component has been more influential.

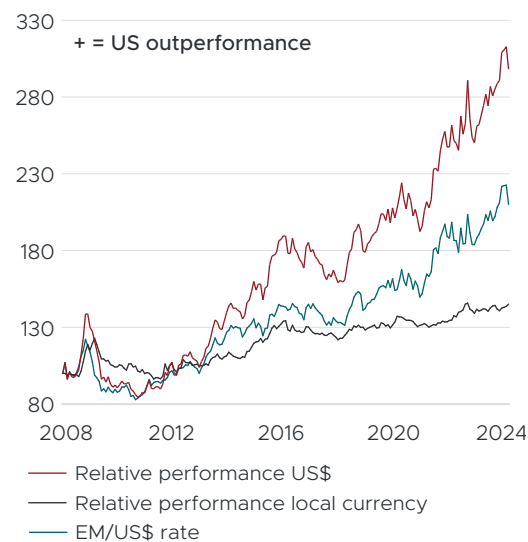
What accounts for a currency’s role as a secondary rather than prime driver of relative regional equity performance? In terms of the fundamental drivers, there is a multitude of influences on equity returns which are independent of currencies. Moreover, the volatility of currencies is significantly less than the volatility in equity markets, suggesting that these other influences are more powerful. For example, there are many reasons for the extended period of longer-term US equity outperformance,

**Chart 5: Relative performance of US and UK equities**



Source: Bloomberg/MSCI.

**Chart 6: Relative performance of US and emerging market equities**



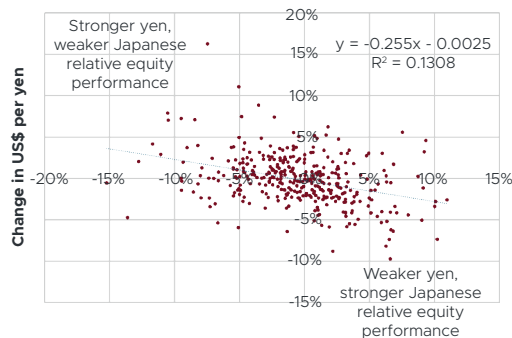
Source: Bloomberg/MSCI.

including widespread technological innovation by US companies and aggressive profit maximisation. These are not dependent on currency trends.

One further reason why currency trends tend not to dominate cross-country equity returns is that the large multinational companies which dominate the global indexes have complex currency exposures. These result from a dense network of activities in which these exposures arise, reflecting the global nature of their sales, sourcing and profits. It is certainly not the case that, for example, all US companies benefit from a weaker dollar, or are penalised by a stronger one. Indeed, for some, the reverse may be true, for example if they source primarily from abroad and sell primarily in the US. The same is true for non-US companies. If, as seems to be the case, there is a wide mix of corporate currency exposures across companies in different regions, a diversified global equity portfolio may diversify away at least some of the inherent currency risk – particularly if the companies themselves hedge their own exposures. This diversification of currency risks dampens the impact of currency moves in a diversified global equity portfolio.

Charts 3 to 6 also demonstrate that there is no simple relationship between currency trends and relative equity market performance. Consider, for example, Japanese equities (chart 3). The US equity market outperformed Japanese equities in 2008–12 in common currency terms, even though the dollar depreciated in this period by some 30% against the yen. This reflected very strong performance in local currency terms by US equities compared to Japanese equities. In the past couple of years, by contrast, the dollar has appreciated strongly against the yen, but this has not translated into outperformance of US equities over Japan in common currency terms. This demonstrates that even very pronounced currency trends in isolation do not determine whether an unhedged equity investor will be in the ‘right’ market if the associated currency rises strongly, or the ‘wrong’ market if the relevant currency weakens.

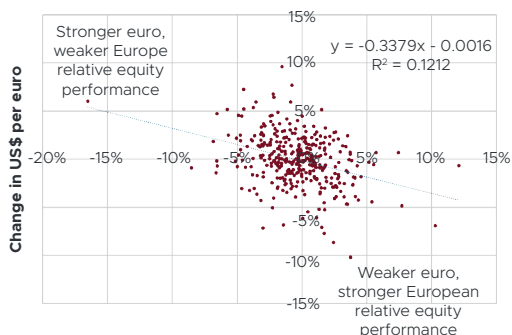
**Chart 7: Relative performance of Japanese over US equities and changes in yen/dollar exchange rate (monthly data, 1994–2024)**



Relative equity performance, Japan over US, local currencies

Source: Bloomberg/MSCI/Saranac.

**Chart 8: Relative performance of European over US equities and changes in yen/dollar exchange rate (monthly data, 1998–2024)**



Relative equity performance, Europe over US, local currencies

Source: Bloomberg/MSCI/Saranac.

*Currency changes account for a small component of the difference in local currency equity market returns.*

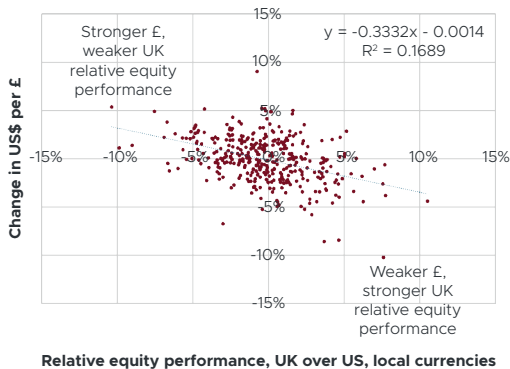
**ii. Currency trends may influence (but not dominate) local currency equity returns**

However, even though currencies are typically a lesser influence on relative equity market returns compared with other fundamental drivers, this is not to deny that there is any linkage at all. On the contrary, it's possible to drill down further to identify a systematic relationship between currencies and local currency returns in many markets: they are inversely correlated. Hence, for example, a stronger pound is likely to be associated with a lower FTSE 100 index in sterling terms than would otherwise have been the case. A simple more general heuristic is that an appreciation in the currency of a developed equity market is likely to dampen local equity market returns, and depreciation of a developed equity market currency is likely to support local equity market returns. The use of the words 'dampen' and 'support' rather than 'dominate' equity returns is important – these relationships between currencies and local currency market moves can be relevant even if other factors in aggregate are more relevant over time, as discussed above.

We illustrate this in charts 6 to 9, which show performance of the Japanese, European and UK equity markets in local currencies relative to the US, plotted against monthly changes in the respective currencies against the US\$. Two things are evident. First, consistent with the argument in the previous section, currency changes account for a small component of the difference in local currency equity market returns. Second, they are consistent with the simple heuristic outlined above: weaker currencies tend to support local equity market returns, and appreciation tends to depress them.

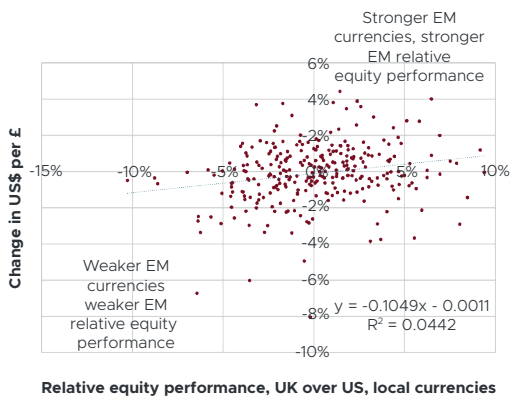
This influence is important in the context of the potential impact of a weaker US dollar on global equity investors' portfolios. It suggests that while the impact of dollar weakness would be to impair returns for non-dollar investors, it would also enhance US equity returns in local currencies and depress non-US dollar equity returns in local currencies. The estimates suggest that the offset is very approximately equivalent to around a third of the currency move. That would be sufficient to attenuate

**Chart 9: Relative performance of UK over US equities and changes in yen/dollar exchange rate (monthly data, 1994–2024)**



Source: Bloomberg/MSCI/Saranac.

**Chart 10: Relative performance of Emerging Markets over US equities and changes in yen/dollar exchange rate (monthly data, 1994–2024)**



Source: Bloomberg/MSCI/Saranac.

*Consider the Truss budget in the UK, which caused the currency to fall sharply and the UK equity market to fall at the same time.*

materially, but not eliminate, the direct impact of dollar weakness on global equities for non-dollar investors. However, in particular periods, this effect can be stronger: it is noteworthy in chart 3 that for the past couple of years, the weakness in the yen against the dollar has consistently been equivalent to the outperformance of Japanese equities over US equities in local currency terms, leaving the relative performance in common currency terms between the two markets broadly flat.

This also suggests caution in over-interpreting the impact of dollar strength on overseas' equity investors returns from unhedged US equity exposure since 2007, as shown in charts. Had the dollar not been as strong, the US equity market's return would probably have been higher in local currency terms, and non-USD markets' returns would probably have been less. This is consistent with currencies being systematically less relevant than other fundamental factors in determining relative equity market returns.

This argument also suggests that our previous assessment of a 20% dollar decline on non-US investors' portfolios, including the offset delivered by local currency, would be of a smaller order of magnitude – perhaps relative underperformance of some 10% as a central case. If this were to be spread over a multi-year period, this is a shock which could easily be absorbed, particularly if other fundamental factors remained in the dollar's favour.

**3. Some complications: what if US political and economic risks increase significantly?**

These relationships are not, however, hard-baked into all financial markets at all times. They do not hold invariably, and indeed it is easy to think of examples where they do not. Consider, for example, the Truss budget in the UK, which caused the currency to fall sharply and the UK equity market to fall at the same time. When adverse 'shocks' arise that depress all asset classes in a country, currency weakness tends to add to overseas investors' equity market losses. Indeed, this has consistently been the case for Emerging Markets, which are characterised by 'risk-on' phases when all asset classes, including the currency,

perform strongly, and ‘risk-off’ phases when there is no hiding place. The currency/equity relationship is therefore the opposite of that seen in the major developed markets, as evidenced in chart 10.

The really problematic scenario in which the concentration of global equity exposure in the US would be much more challenging for overseas investors would be if the US were to face an ‘emerging-market’ type of shock. These could include much higher political or fiscal risks concentrated in the US. In this event, investors in US equities from a non-dollar base could face significant losses from the relative underperformance of US equities arising from underperformance in local currency terms as well as from the weaker currency. There is little or no sign of markets pricing such an environment at present, but this would be a key risk for global equity investors were such risks to become more visible.

# Public markets

## EQUITIES



- Asset class outlook +

### Valuation



### Earnings



### Positive

Infrastructure & Resource Scarcity; MedTech; Japan/South Korea

### Negative

Financials & other interest rate sensitive sectors; Emerging Markets

### Market background

May proved to be a game of two halves. The probability of the Fed succeeding to thread the US economy through the eye of the soft-landing needle initially improved. This positive momentum petered out mid-month as the strong macro data challenged the number of US rates cuts the market was discounting. The MSCI World finished the month off its highs but still gained +2.7%.

### Targeted exposure

We live in a world of scarce resources yet have a seemingly insatiable demand for energy as we shift to an electric revolution and attempt to power energy sapping data centres. Furthermore, developed markets are trying to reduce their reliance on fossil fuels. We think this dynamic presents investment opportunities in spanning many sectors. We believe medical technology could be an important theme as health systems need to become more cost effective and efficient. There is an ongoing effort by countries to strengthen their corporate governance and shareholder returns to attract foreign investment. We like the initiatives in both Japan and South Korea that could benefit from these efforts.

## GOVERNMENT BONDS



- Asset class outlook +

### Short maturity



### Long maturity



### Positive

US 2-5Y TIPS, Australian Sovereign and Agency bonds across tenors

### Negative

>5 year European sovereign bonds, Japanese government bonds

May was characterised by softer data than expected in the US (NFP and CPI) and a dovish Fed meeting, which contrasted with a rebound in European PMIs and inflation. This led to an outperformance of US Treasuries over their European peers. Signs that the US consumption is softening at the same time as oil prices are retracting, fed hopes that inflation will continue to decelerate, opening the door to rate cuts. The 10-year US Treasury yield declined from a ~4.7% high late April to ~4.3% in early June.

### Targeted exposure

After increasing the portfolio duration in April, we are now considering a tactical reduction following last month's rally. This is in part to adjust the positioning ahead of the US election, as we believe that the back-end of the treasury curve could come under renewed pressure in a Trump win scenario. Following encouraging US data, Inflation break-evens have pulled back, especially at the front end of the curve. We are considering adding to short-dated TIPS as a hedge against potential expansive fiscal and monetary policies post-US election.



# Public markets

## CORPORATE AND EMERGING MARKET DEBT



**Investment grade credit**



**High yield**



**SUB**



**EM debt**



**Positive**

AAA/A securitisation,  
US Agency MBS

**Negative**

US High Yield

We now view credit spreads as too tight, in particular in the HY space, with \$IG and \$HY spreads ending May at respectively at 90bp and 338bp, well below their long term average of 128bp and 455bp. Subordinated bonds, our long-term favourite part of the High Yield market, have outperformed corporate high yield over the last 15 months. As such, spreads have tightened to levels that offer less relative value, and we have started to trim some of our positions. Complexity premium offered in the structured credit space remains attractive. For instance, \$ AAA CLO tranches trade at a ~120bp spread above SOFR, compared to just 81bp for the 1-10Y \$IG credit segment which has A- average rating. Finally, MBS spreads remain attractive compared to \$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 sometime during the summer.

**Targeted exposure**

Despite relatively tight spreads, IG corporate fundamentals remain excellent and headline yield levels remain attractive at ~5.6%. As such, we are maintaining significant IG credit allocations. We started trimming some of our corporate hybrid and AT1 exposures. We maintain our material exposure to securitised credit and Agency MBS, both providing attractive relative value against IG credit and US Treasuries.

# Public markets

## HEDGE FUNDS



We set out five reasons to use CTAs in a hedge fund portfolio. First, CTAs tend to provide downside protection as they are positively correlated with volatility. CTAs are usually the most profitable in elevated and sustainably high volatility phases, typically observed in late and recession phases of the economic cycle. Second, they bring diversification in portfolios. They show limited sustainable correlation with most traditional assets, and nicely diversify portfolios of hedge funds. Third, they provide access in a liquid way to smaller market segments, in particular in agricultural, metals, and assets of smaller countries that a majority of investors would not cover. Fourth, CTAs benefit from high cash rates. They structurally maintain only a slight net long overall market bias (0.3 beta today and over the long run), which represents the balance of their long and short futures positions. They ‘mechanically’ earn a cash yield on their short futures. We estimate this contribution to level above 2% per year at the current level of cash rates. Finally, CTAs optimize portfolio allocation over the long-run. We find that a core CTAs holding in a diversified allocation tends to reduce volatility while slightly improving returns. A 10% allocation to CTAs improves Sharpe ratios in most profiles.

## Public markets

### CURRENCIES

#### Dollar



#### Sterling



#### Euro



#### Yen



#### Market background

Following four consecutive months of gains, the US dollar, measured on a trade-weighted basis, declined by ~1.5% in the month of May. We believe that we are now starting to see early confirmatory signs of a slowing of the US economy across a broad set of macro measures, with bets for rate cuts this year starting to edge higher once more. The FX market environment has generally been low volatility and somewhat directionless in key dollar crosses for most of this year. However as the US election draws nearer, we expect that investors will begin focusing more on November, weighing up the implications of a richly valued dollar with US fiscal challenges becoming increasingly in focus, with the potential for more US inflationary policies (e.g. greater protectionism) looking increasingly likely.

#### Targeted exposure

The ECB's well telegraphed June rate cut was all but priced in, focus now shifts to whether the ECB will pursue their own path thereafter or await more visibility from the Federal Reserve's on their intentions. We are watching developments in Canada and Australia closely, both economies are highly sensitive to interest rates and we are seeing signs of consumer weakness which would suggest rate cuts are going to be needed. Meanwhile inflation continues to print above central bank targets in these countries, we expect both currencies to be challenged in coming months.

# Public markets

## COMMODITIES

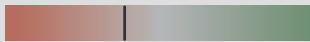
### Gold



### Energy



### Industrial metals



### Softs



### Market background

There was significant strength across the industrial metals sector in April and much of May, and leaving prices much higher than at end-March, despite a more recent correction. The strength appears to reflect a moderate increase in global economic activity since the start of the year. There has also been a significant rally in precious metals, driven largely by central bank purchases. Energy and soft commodities have not participated in the rally, displaying no material trend.

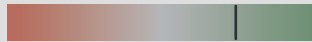
### Targeted exposure

We have increased our gold exposure slightly, to provide a further hedge against potentially higher political risk later in the year. While there are good longer-term arguments supporting some industrial commodities – such as copper in the energy transition – we are more cautious in the near term given an apparent slowdown in global economic activity, particularly in the China and other parts of Asia.

# 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



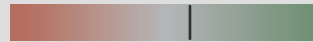
More attractive given supply chain issues and geopolitical uncertainties

### 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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