

Investment roadmap

JULY 2024

AT A GLANCE

- The main article sets out **our market views for the second half of the year and into 2025**. The very strong equity market returns in the first half owe much to a small number of US megacap companies. We expect more subdued returns in the second half given higher valuations and slower economic growth, although market expectations of moderate rate cuts are likely to be supportive. Political risk is likely to be unusually high in the coming months, and we have increased gold holdings and implemented equity options hedges to provide some protection against higher downside tail risk probabilities.
- As a general theme, we note that **risk premia** in many asset 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.
- Following a strong start to the year, our conviction that the **global economy** is slowing has strengthened, not least as a result of the weakness in many cyclical commodities. We do not, however, view this as the precursor to recession. The growth downshift helps explain the recent flatter performance in global equities. Inflation remains slightly higher than many central bank targets, but we expect concerns in this context to become less prominent.
- **Global equity market** multiples remain 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, as the fundamentals for many highly-rated US megacap companies – notably their strong cash flow generation – remain supportive.
- **In fixed income** markets, 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 four- to five-year maturities to longer-duration exposures, particularly outside the US.
- In the **private markets** section, we highlight the continuing concerns over leveraged portfolio companies backed by private equity.

Chart 1: Global economic surprises



Source: Citi economic surprise index, Bloomberg, Saranac.

Chart 2: Two-year government bond yields



Source: Bloomberg, Saranac.

At the start of the year, the Fed and other central banks were seen as having considerable latitude to cut interest rates.

The global economy and financial markets: into 2025

We set out below our mid-year market assessment. We review the most influential market drivers in the first half of the year, and what the most important themes likely to be into 2025.

1. Three main themes in the first half of the year

Three themes dominated financial markets in the first half of the year.

First, global growth was maintained, albeit at a moderate rather than particularly robust pace. This outturn contrasted with the more subdued growth expectations entrenched at the end of last year, so that even this moderate growth rate allowed for positive surprises (chart 1). These surprises helped allay concerns that a poor outlook for corporate profits was set to emerge. Profits have in fact edged higher globally, providing support for equity markets. While these themes have played out to different degrees across countries and regions, including China, there have been sufficient similarities for a global theme to be relevant.

The second theme has been the repricing of interest rate expectations. At the start of the year, the Fed and other central banks were seen as having considerable latitude to cut interest rates, in what was expected to be an environment of weak economic growth and declining inflation. In the event, only the ECB of the major central banks eased monetary policy, and even in this case a rate cut of only 0.25% was delivered. Policy rates are therefore somewhat higher than generally envisaged at the start of the year (chart 2).

The constraints preventing more aggressive moves were the absence of a growth slowdown and low unemployment rates, but most importantly the ‘stickiness’ of inflation in many countries. Goods prices have in general stabilised after the shocks of recent years, but services sector inflation has remained elevated. While in many instances inflation has moved closer to central bank targets, it has done so in general at a slower pace than envisaged. As expectations for interest-rates cuts faded, bond yields moved higher. The ‘higher-for-longer’ environment for interest rates also contributed to

Chart 3: Japanese yen per dollar



Source: Bloomberg, Saranac.

Chart 4: Global bond and equity returns (Dec 31 = 100)



Source: Bloomberg, Saranac.

Our assessment of prevailing cross-asset market valuations is that there is a consensus for a soft landing.

further yen weakness, as the interest differential between Japanese rates and those elsewhere widened still further (chart 3).

The third important theme in the first half has been the strong outperformance of equities over government bonds and credit (chart 4). While the positive macro surprises outlined above contributed to this ‘risk-on’ environment, they do not tell the full story. US equities outperformed other markets (chart 5), largely as a result of the exceptional performance from a small group of megacap stocks. The top five of this group were responsible for 60% of the gains made in the US market in the first half, with a single stock (Nvidia) alone responsible for around a half of that gain. Chart 6 shows the significant dispersion in returns between the conventional S&P index and the same index with the constituent companies equally weighted, highlighting that the share price performance of the median US company has been much inferior to that of the market leaders. Indeed, the equally-weighted index peaked in the spring and has since edged lower even while the market-cap weighted index has reached new highs.

2. The starting point looking forward: market valuations

How does this leave markets positioned for the second half of the year and beyond? Our assessment of prevailing cross-asset market valuations is that there is a consensus for a soft landing. Despite the repricing of interest-rate prospects in the first half, the widespread expectation is that lower interest rates are still likely to emerge, albeit slowly and by a modest amount. Our views do not differ materially with prevailing market pricing, and we regard the 10-year US Treasury yield of ~4.5% as around fair value given the macro environment. In addition, credit spreads over government bonds are relatively low, particularly in high yield, so there is little sign of markets pricing in material stresses on corporate balance sheets (chart 7).

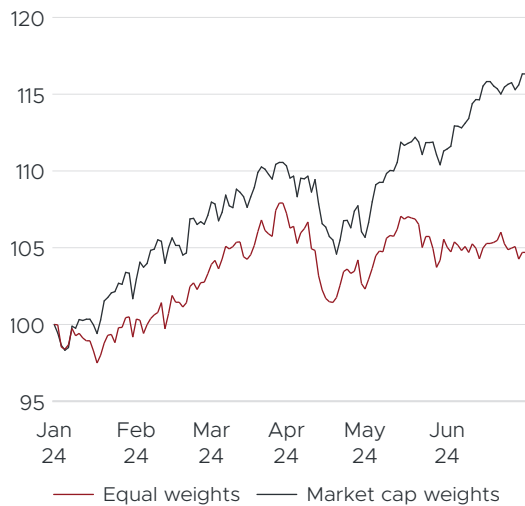
Equity valuations are somewhat extended: the PE multiple on the global equity index is 19.5x, above the ten-year average of 17.5x (chart 8). This is not a bubble-rating, but as in credit markets suggests limited expectations of corporate stress.

Chart 5: Global equity returns (Dec 23 = 100)



Source: MSCI, Bloomberg, Saranac.

Chart 6: S&P total return: market cap and equally weighted (Dec 29 = 100)



Source: Bloomberg, Saranac.

There have been 11 years in the past 70 when five companies accounted for more than 40% of the market's gain (typically in the energy and tech sectors).

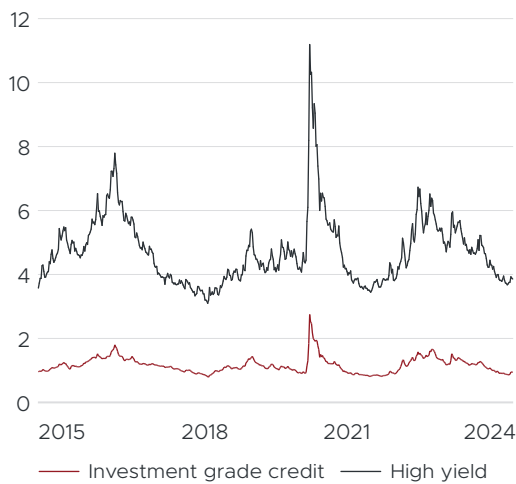
However, this aggregate valuation conceals some interesting themes. Equity markets outside the US appear close to a 'normal' valuation, and in the UK's case the valuation appears depressed on this criterion. The higher than usual rating on global equities is therefore wholly attributable to the US market. Moreover, this high US valuation is in turn attributable to the small group of megacap companies responsible for much of the equity market's gain in recent months. The equally weighted S&P index is on a slightly lower multiple than usual (17.5x), while the top 5 companies have an average PE ratio in the mid-30s. Against this background, we regard three themes as likely to dominate market prospects in the coming months.

Theme i: Equity market concentration

The first theme is the implication of the significant concentration in equity market returns noted above. Much market commentary is based around the view that such concentration is unsustainable, and will lead to a significant correction in share prices as it unwinds. However, a historic perspective suggests a more complicated picture. There have been 11 years in the past 70 when five companies accounted for more than 40% of the market's gain (typically in the energy and tech sectors). The most usual outcome in the subsequent periods was not a significant correction, but in fact further equity market gains, albeit with significant rotation between winners and losers within the market.

The two periods of significant correction (2000 and 2007) following the unwind of concentrated market performance required material adverse economic shocks to drive the market corrections. This could occur as a contemporary theme if, for example, the AI theme which has driven a good part of the top five's gains proves to be much less powerful than expected. This cannot be dismissed, but there is little sign of the AI fundamentals unwinding now. More generally the fundamentals of the megacap companies themselves warrant an above-market rating, given their strong balance sheets and strong cash flows. Saranac's global equity portfolio has an underweight position in these companies, but we consider it too early for this view to drive more cautious positioning on equity markets generally.

Chart 7: Global credit spreads



Source: Bloomberg, Saranac.

Chart 8: PE multiple MSCI world



Source: MSCI, Bloomberg, Saranac.

An important shift in the growth environment has emerged more recently, as there appears to have been something of a downshift in the global economy.

Theme ii: Slower growth

What of the broader macro environment? We do not expect inflation to be the source of a major shock, as the covid- and Ukraine-related shocks have faded, allowing central bank targets to become more attainable. We regard it as improbable that central banks will need to tighten policy again, and even only a modest and widely expected easing cycle into next year would provide support for equity and bond markets.

However, an important shift in the growth environment has emerged more recently, as there appears to have been something of a downshift in the global economy: the positive surprises noted above gave way later in the second quarter to negative surprises, as demonstrated in chart 1. We do not interpret this as the precursor to a recession which triggers an equity bear market, rather as a ‘mini-cycle’ in which economies continue to grow, but at somewhat slower rates. However, there is less scope in these environments of uninspiring growth for particularly strong gains to be made in equity markets, and it interesting to note that equity markets have indeed advanced more gradually since this slower growth environment first emerged. We regard credit markets as less exposed to a slower-growth, but not recessionary, environment. Investment grade fundamentals remain solid, and a modest increase in spreads would still allow for a return above cash. High-yield spreads appear too tight for the prevailing fundamentals, given the upcoming maturity wall and higher refinancing costs, but even here some spread widening could be absorbed by the high initial yield.

Theme iii: Political risk

Political risk is always relevant for financial markets, but at present its relevance and hence the scope for market dislocations is greater than usual, given ongoing war in Ukraine, tensions over Taiwan and the Middle East, and the prospective elections in France and the US. The large budget deficits run in both countries provide focal points for market concerns. Claims that challenges in France could lead to a rerun of the euro sovereign debt crisis from a decade and more ago are exaggerated given the

recent ‘Liz Truss’ lessons and the supportive role that the ECB would be likely to play in providing a backstop should this be necessary. However, avoiding this extreme environment could still allow for a difficult background for euro assets. In addition to the fiscal risks facing the next US President, a particular concern would be a Trump administration’s possible escalation of trade tensions with China, including much higher tariffs which could boost inflation; a diminution in the Fed’s independence; and more stringent immigration restrictions which could lead to a tighter labour market.

Portfolio responses to a changing environment

In Saranac multi-asset portfolios we have not chased the equity market rally, but continue to hold a somewhat lower equity weight than usual, and higher weights in credit and other alternatives. Our two preferred economic scenarios are for a soft landing, in which equities would be likely to outperform credit, and an environment of economic stagnation, in which the reverse would be true. The higher than usual weight in alternative assets is designed to provide protection to portfolio returns in the event of the market dislocations which a less stable political environment might deliver.

In recent weeks, Saranac has made some changes in multi-asset portfolios to reflect this evolving environment. We have raised the gold weight to reflect higher political risk in general, and funded higher short-term TIPS holdings with sales of longer-term Treasuries. In addition, an equity put option has been purchased to cover political risks over the coming six months.

Public markets

EQUITIES



Valuation



Earnings



Positive

Infrastructure & Resource Scarcity; MedTech; Japan/South Korea

Negative

Financials & other interest rate sensitive sectors; Emerging Markets

Market background

Investors were carefully walking the inflation / growth tightrope over the course of June. The inflation backdrop continues to move in the right direction but the macro picture appears to have lost some momentum.

Targeted exposure

We favour a number of longer-term themes spanning numerous sectors. Much of the AI theme has so far been focused on hardware companies. This is beginning to shift towards software. Incremental energy demand from data centres is complicating the shift from fossil fuels to renewable energy. We favour companies who can benefit from this. We believe medical technology is an important theme as health systems need to become more efficient to cater for an ageing population. At a country level, we're encouraged by the progress Japan and South Korea are doing to strengthen corporate governance and shareholder returns.

GOVERNMENT BONDS



Short maturity



Long maturity



Positive

US 2-5Y TIPS, 30Y Nominal Gilts, Australian Sovereign and Agency bonds across tenors

Negative

>5 year European sovereign bonds, Japanese government bonds

In June, rate cuts were increasingly in focus, and the ECB delivered their first rate cut since the pandemic, lowering their deposit rate by 25bps to 3.75%. The Bank of Canada also delivered their first rate cut of this cycle, meaning that 4 of the central banks with a G10 currency have now cut rates this year. Meanwhile, the US CPI release for May showed the slowest monthly core CPI since August 2021. That helped to cement expectations that rate cuts were still on the horizon from the Federal Reserve, and at the June FOMC meeting, the median dot pointed to one rate cut in 2024.

Targeted exposure

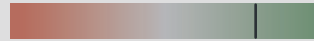
From a fundamental perspective, we now believe that US Treasury yields are in line with our fair value. However, a combination of poor technical in the treasury market, an elevated US fiscal deficit and the prospect of increased protectionism in a Trump presidency scenario, could be inflationary and lead to a steepening of the yield curve. As such, early June we took profit on long-dated nominal duration positions opened in April and invested the proceeds in 2-4Y US TIPS. Elsewhere, we are tactically playing a flattening of the long-end of the UK Gilt curve with small position in 30Y Gilts. We remain on the sidelines of the Eurozone bond market, as bund yields remain unattractive and as we may see further intra-EMU sovereign Spain volatility amidst rising French political risk.

Public markets

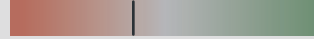
CORPORATE AND EMERGING MARKET DEBT



Investment grade credit



High yield



SUB



EM debt



Positive

AAA/A securitisation,
US Agency MBS

Negative

US High Yield

Despite a moderate spread widening in June, we maintain our view that credit spreads are trading at demanding levels, in particular in the HY space, with \$IG and \$HY spreads ending June at respectively at 98bp and 343bp, below their long term average of 120bp and 450bp. Subordinated bonds, our long-term favourite part of the High Yield market, have outperformed corporate high yield over the past 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. 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 ~5.5%. 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



Convertible bond arbitrage is a strategy group we continue to remain constructive on specifically managers who have an event/special situations style to it. Typically, a manager would be long a convertible bond position, and this will be hedged with a short stock position in the same company: key return drivers being positive carry, accretion (pull-to-par), volatility trading, and special situation events i.e. buybacks, exchange offers, mergers and acquisitions and general capital structure changes.

Much of our positive stance is down to: (1) Convertible issuance for 2024 has been robust, with traditional High Yield and Investment Grade issuers increasingly tapping the space. (2) The positive carry on offer remains attractive, bolstered by higher coupon issues that have permeated the market. (3) With equity valuations at or near all-time highs, and equity volatility in the high-teens percentile (as measured by the VIX), the opportunity for large single-stock moves remains attractive on a forward-looking basis, providing a potential tailwind for volatility trading and (5) Alpha extraction via negotiated Special Situation transactions is currently at elevated levels, which is expected to continue given the looming convertible bond maturity wall over the next 18-months.

CURRENCIES

Dollar



Sterling



Euro



Yen



Market background

After a relatively subdued period in global FX markets, we saw more life in June as markets dealt with a range of political risks at play. The French snap elections brought about renewed pressure on the EUR, meanwhile fallout from the Mexican elections has seen the unwinding of one of the market's previously-loved carry trades, the peso declining by some 8% in the month versus the dollar.

Targeted exposure

While political uncertainties remain in Europe, the US election has become increasingly in focus following the first debate on 27 June, after which implied probabilities of a Republican victory have jumped meaningfully. Current market narratives support the dollar in the case of a Republican win, but we would be minded to fade any such strength should it play out over coming months. Finally, FX markets have shown little regard for the UK election, which has been viewed as a much less controversial event by markets compared with French and US elections.

Public markets

COMMODITIES

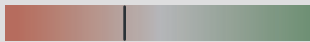
Gold



Energy



Industrial metals



Softs



Market background

Although energy and precious metals have broadly maintained the higher levels reached in the spring, the recent strength in many industrial metals has unwound, with significant corrections underway. Copper, for example, has fallen by some 15%. This weakness is associated with the downshift in global economic growth which has emerged in recent weeks.

Targeted exposure

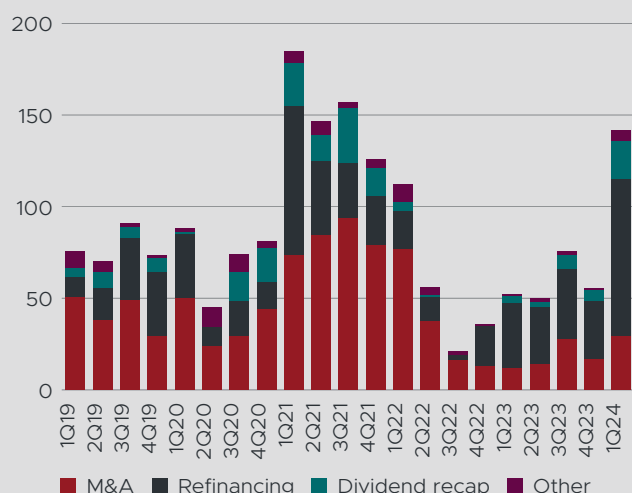
Our preference in the commodities universe remains the gold price, supported by central bank purchases and an elevated level of global political risk. We remain cautious over the near-term outlook for industrial metals until there are signs that the global growth slowdown has stabilised, although we acknowledge that the longer-term case is better-founded. We expect range trading in the oil price.

Private markets

Private equity sponsors reducing risk

As the environment in which the exit opportunity for private equity sponsors remains subdued, the persistent lack of net new supply across public and private credit markets has pushed spreads to multi-year low. This compression has led to a notable uptick of private equity sponsors opportunistically increasing leverage to reduce risk within portfolio companies via dividend recaps. This has resulted in the proportion of loans used for dividend recaps relative to the overall loan market being notably higher than it has been over the last few years. On year-to-date basis through to 11 June 2024, we have seen loan issuance used to funded dividends surge to \$35.3billion; this compares to the sub \$10 billion total volume we saw in 2023, and the \$34.8billion we saw in 2021 – a record year for dividend recaps.

US institutional loan volume



Source: Bloomberg, Saranac.

Following on, we have also seen this year the median dividend recap amount paid out to private equity sponsors increase to \$333m. This is far above the level we have seen in recent years, and whilst this could be in-part due to larger companies executing more transactions than the historical average; and recently low leverage levels and growing EBITDAs allowing for increased notional of capital to be extracted, we also view this increase in activity as a signal that private equity sponsors are opportunistically taking risk out of their investment portfolio.

Over the last few years, we have continued with the view that higher rates following a period of historically low / zero rates has created a number of structural risks in the economy. As a result, since the increase in base rates globally, we have remained cautious on private debt strategies due to the risk we saw within private equity portfolios, particularly those with stretched balance sheets; and whilst market speculation is suggesting a few rate cuts in the coming years, we still remain of the view that rates will remain above 4% for the foreseeable future, and hence the financial underwrite of many private equity investments remains at significant risk. In addition, whilst the possibility of a soft-landing continues, we believe the growth rates projected when set against the fact that rates now are still not high enough to allow over-gearred balance sheets the option of outgrowing their debt burdens.

Therefore, we remain of the view that many private equity backed portfolio companies, particularly those that have been mismanaged, carry high levels of debt, and are coming to the end of their legal hold period within their sponsor's fund structures and are at significant risk. Consequently, we have the view that this increased activity in dividend recaps is a signal that private equity sponsors are taking risk off the table in order to limit potential losses within their portfolio.

We therefore continue to remain highly negative on sponsored led private debt strategies, as we believe that investors are not being compensated for the additional risk we see in the market.

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

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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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Saranac Partners Limited

questions@saranacpartners.com
+44 (0)20 7509 5700
16 St James's Street
London SW1A 1ER

Saranac Partners Europe

questionsEU@saranacpartners.com
+34 919 545 130
Calle Hermosilla 11
2 planta. 28001 Madrid
Agencia de valores autorizada y
supervisada por la CNMV (nº313).
CIF A72440142

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