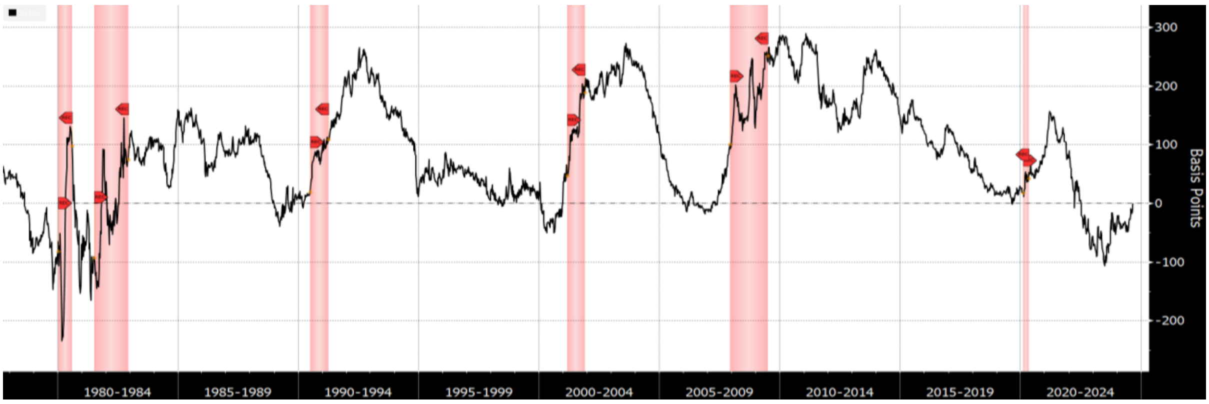
“Difficult to see. Always in motion is the future.” — Master Yoda (Star Wars)

Facts, figures, and unique insights on different asset classes

Investor performance is not a product of circumstances, but of decisions made. 2024 was a year with the prospect of over 40 country election outcomes to navigate (still awaiting the U.S.), but surprises came from France and the U.K.

US Treasuries have been enjoying the longest winning monthly streak since 2021. With markets going from 7 Fed rate cuts to 1 then 3 this year, volatility has created opportunity, and the yield curve recently briefly dis-inverted in the 2s10s spread. We have seen the longest period of inversion in U.S. history. We keenly await a Fed cutting cycle starting in September after Jackson Hole and Jerome Powell said, “the time has come”.

US 2s10s Yield curve weekly, recessionary periods denoted in red.



Source: Bloomberg

1. **Past U.S. steepening action has typically been a precursor to U.S. recessionary cycles: are we going to see another one, how to position for curve steepening?**

Fiscal stimulus was one reason for resilience in the U.S. economy during the pandemic, and as stimulus was reduced there was strong demand for labour. While inflation harmed incomes, falling inflation is undoing that damage. Labour demand is cooling, leading to higher levels of unemployment (4.3%) with a Fed year-end target at 4%. Unemployment needs to get above 5.5% for me to consider recession. Normalisation is the next possible phase if inflation stays down. Curve steepening to +60bp is viable on a series of Fed cuts. The consumer spending is holding up but be wary: credit card delinquencies are up near 11% the highest levels in 20 years. The risk to all this is if inflation starts to rise again (a risk not priced in enough in my view).

Bottom line is bonds have had a steady performance. Bias would be to keep a bond exposure as part of the 60/40 model. The key level to watch in the US 10 year is 3.67%, a long-term major support to break for lower yields.

2. **If we are going to see a soft landing, what about small caps?**

The last 3 months have seen the Russell 2000 outperform the S&P 500. Looking back to the 1970s, we might be on the verge of multi-year double digit gains. Market breadth is spreading: the "Magnificent 7" average is now -12% from their all-time highs, but stock indices near all-time highs. Small cap companies tend to have lower margins and may get squeezed by inflated input costs. However, well-managed ones may be able to pass along price increases to customers while controlling their own costs and increasing their productivity. These should enjoy stronger earnings growth, since incremental improvements in operating margins will have a more pronounced effect relative to their larger, higher-margin counterparts.

Asset class yearly performance from 1973-1979

1973	1974	1975	1976	1977	1978	1979
Inflation 9%	Inflation 12%	**US small cap 53%**	**US small cap 57%**	**US small cap 25%**	**US small cap 45%**	**US small cap 43%**
Cash 7%	Cash 8%	Staples 36%	Banks 37%	Inflation 7%	Tech 12%	Energy 39%
Energy 2%	US Gov Bonds 4%	Discretionary 36%	Energy 29%	Cash 5%	Pharma 9%	Inflation 14%
US Gov Bonds -1%	Telecoms -15%	Utilities 33%	Telecoms 25%	Utilities 1%	Inflation 9%	Industrials 11%
Telecoms -6%	Pharma -18%	S&P500 32%	Utilities 22%	US Gov bonds -1%	Banks 7%	S&P500 12%
Pharma -11%	US small cap -20%	Industrials 32%	Tech 22%	Telecoms -5%	Cash 7%	Pharma 11%
Banks -11%	Energy -26%	Tech 28%	S&P500 19%	Tech -5%	Industrials 5%	Cash 10%
Industrials -12%	Staples -27%	Banks 26%	Industrials 18%	Energy -8%	Energy 4%	Banks 7%
S&P500 -17%	Discretionary -27%	Energy 20%	US Gov bonds 17%	Industrials -11%	S&P500 1%	Utilities 4%
Tech -21%	Utilities -29%	Telecoms 17%	Discretionary 10%	S&P500 -12%	Telecoms -1%	Discretionary 3%

Source: Bloomberg

As investors look ahead to a cycle of interest-rate cuts, do not be surprised to see value-oriented sectors gaining. Slower-growing companies with relatively low to earnings, sales or book value might benefit more from lower interest rates, because they tend to have a higher level of borrowings.

3. **The 60/40 model (60% US equities 40% Treasury bonds) is back… long may it continue.**

In 2022 the model had its worst performance (-17.5%) since 1937, in 2023 +17.2%. A decline in inflation should lead to lower correlation between stocks and bonds, increasing diversification benefits and lowering downside risk. As of Sep 4th, 60/40 has returned +10.8% YTD**:** keep faith!

4. **Gold has been a shining asset in 2024.**

I have been a perennial gold bull and still see it doing well in the next 3-4 years. Having made all-time highs in August, some have been surprised by the performance of this non yielding asset. There are some simple observations for it.

Central bank net buying reached a record H1 total of 483t. Gold's role as a hedge and portfolio diversifier remains a key consideration for central banks. Gold is also a store of wealth, a hedge against systemic risk, has historically improved portfolios' risk-adjusted returns, has produced positive returns in good and bad times since 2000 and is also well suited to a weaker USD scenario if cuts are coming.

Gold performance in USD (weekly chart) with Fibonacci projections from 2016 to 2024

Past performance is not a reliable indicator of future returns
Source: Bloomberg

5. **A Japanese game changer**

The events of July shook investor confidence initially with weaker US data, then the Bank of Japan raising rates and reducing quantitative easing Declines in Japanese stocks were the worst since Fukushima. Selling was also fuelled by the unwinding of long positions and the involvement of trend-following hedge funds exaggerating the moves. August then witnessed rebounds in many stock markets, sign of trend resilience.

There has been for years a structural short in JPY, then a big unwind came, largely due to the sharp monetary difference between the UK, Europe, and US. Japan has huge foreign asset positions and are not fully hedged. FX is important as a big sell-off in US stocks would feel worse in JPY terms and if Japanese stocks fall too, then there will be a desire to lock in profits before they fade.

End of the carry trade: Yen was borrowed to invest in higher yielding FX, this is reversing and getting out of losing trades perpetuates further Yen strength. A lot of this is done, but JPY can strengthen more vs USD due to differing rate paths but look for decent beta in pairs such as EUR/JPY and GBP/JPY to lower levels. A continued bout of JPY strength could create a change in Bank of Japan policy to loosen monetary policy in time, thus entrenching inflation in the Japanese economy.

6. **Lastly, something for the bigger picture**

AI will continue to be a big theme: $20tn will be spent in years to come on industrialisation. Part of that will be seeing global electricity generation surge with fast rises in developing countries and moderate rises in advanced economies. The electrification play and infrastructure themes are most interesting in India and the African continent. Simple reason is demographics and resources. Exposure to these countries should see investment outperformance to more traditional investments.

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