

TAM INTERNATIONAL INVESTMENT NOTE



SOFT LANDING OR HARD LANDING? TAKE YOUR PICK, BUT YOU WANT TO BE IN A PLANE WHICH CAN HANDLE BOTH

Ask any seasoned investor and they will tell you this year has been particularly tricky to call. Our investment team were recently in a meeting with a 20-year economics veteran at one of the largest investment houses in the city. They presented a powerful set of charts, correlations and predictions for the next 6-12 months. This economist went on to say at the end of the meeting that, candidly, they didn't actually believe any of the economic data they had just presented on and it could go "either way". That's not to say they didn't know or didn't care but simply because the market over the coming quarters will pivot off two main outcomes: A soft, or a hard landing. Right now, it's so hard to call that some pros have given up trying.

Getting inflation back to 2% without causing a recession is notoriously tricky to pull off

The obvious starting point is the difference between a 'soft' and 'hard' landing. In short, a soft landing is an economy which gets inflation back to developed central banks' 2% target, brings interest rates back down to the 2-3% range and avoids a recession. Enabling everyone to keep their jobs and keep spending, with the stock market moving higher. The aviation (landing) terminology is used because getting inflation back to 2% without causing a recession is notoriously tricky to pull off. Central bankers need to raise interest rates just enough to slow the economy but not too much to choke it.

To make it harder, it usually takes 6-18 months for the lagged effects of raising interest rates to feed into the economy. Meaning central bankers don't know how hard they are choking the economy for about three quarters of a year. I would liken it to trying to drive a car around a racetrack only using a video monitor, which has a delayed feed of 5 seconds. A difficult task. But, if they do manage to pull off this soft landing, you will see small caps, growth stocks in the US, UK and Europe, high yield bonds and emerging markets move higher to name a few.

Essentially, a hard landing is the antithesis of this rosy outcome. Be it a plane passenger, pilot or economist, it is always something to avoid. Inflation doesn't get back to 2% quickly, interest rates stay high for longer, being raised to the point where they choke the economy entirely. Job losses start to happen, companies, governments and consumers can't go on and simply opt to stop spending. Ergo, hard landing = recession.

You would be forgiven for thinking this hard vs soft landing talk is new to the market. But, we have seen this before, we just haven't been in an interest rate hiking cycle for over a decade so most can't remember. In 1989, the financial press released an article titled "How soft a Landing?", in 2000 investor articles titled "Making a soft landing even softer" were released and in 2007 we saw "The US economy on track for a soft landing". The keen-eyed reader will know that the dates above, all preceded a recession in which the anticipated soft landing turned into a hard one.

One doesn't need to be a high-flying economist to realise you can't have soft and hard at the same time

Obviously, this isn't evidence we are about to enter a recession and I sincerely hope we do not. History does, however, show us that soft landings usually emerge as hard landings. Regardless, one doesn't need to be a high-flying economist to realise you can't have soft and hard at the same time. And this is what's cooking investors' brains right now. Which will it be?

On one side, the US economy is currently unstoppable, growth is stable and job creation in the US looks to be in fine fettle. These would be indicators pushing investors to start buying equities as the economy looks in good check and thus company earnings are resilient. However, lots of jobs means pay rises which means increased spending. Spending means elevated consumption. When you are trying to kill inflation a rampant, fully employed economy is not your friend. This is the prime reason why the bond market is getting bashed about this year because a strong economy would indicate inflation is going to stay higher and this need higher interest rates for longer which is not good for bonds. It's also not good for equities because the longer inflation persists the higher rates will need to stay and the greater the chance of the world economy succumbing to a recessionary hard landing.

Investors wrong footed in 2023

2023 has seen many investors wrong footed this year who invested into bonds firstly, to capture the value after the huge sell off in 2022 but also, to get high quality bonds into their portfolios at rock bottom prices. Which, if the economy eventually hits a recession (hard landing) will rally back strongly as the best safe haven asset. TAM was one of these who went into the bond market buying up generational value only to see it become cheaper as the economy got stronger.

Equities are faring better this year because equity investors believe the economy is so strong that it can withstand higher rates and thus pull off a soft landing. The Nasdaq and the "magnificent 7" mega cap technology stocks have been the winners this year. When rates do finally come down, that growth rally will kick back into life, or so they hope. Alas, many investors have sat underweight in equities on the belief that a recession is imminent. A bad call given the rally!

Additionally geopolitical risk has continued to increase this year with no respite in the ongoing Ukrainian war and only this month further heart-breaking bloodshed in the Middle East. These events generate uncertainty, increase fears of contagion and increase volatility risk across the globe.

Looking into Q4, there are still rate hikes from 6 months ago to hit the economy and there are emerging signs of economic weakness in both manufacturing and consumer spending. Not to mention the eradication of consumers' COVID savings. There are also clear signs the economy is ripping higher, as seen by the September job creation in the US. This was predicted to be 170,000 but eventually came in at 336,000 new jobs which not one economist across the world saw coming.

So, yes 2023 has been tough for investors with head fakes and value traps to wrong foot even the most seasoned investors but we, as managers, have a duty to craft client portfolios which, regardless of a hard or soft landing, can withstand either scenario to protect client wealth. This is where the Consumer Duty's punishing focus on fair value comes through in pushing managers to be, well, active! So how can we do that?

In the spirit of talking about investing through aviation analogies, I will give you one more which I believe speaks to portfolio management. In WW2 the British bombing campaign was sustaining heavy losses over Europe. Those bombers that made it back to the UK were returning heavily damaged. To increase the defensive capabilities of the bombers, armour plating was increased in the areas where the damage on the surviving planes was worst. However, a statistician suggested placing armour on the areas of the plane which had no damage at all would be best. Simply, because those planes which did sustain damage to these areas never made it back to the airfield. The theory of 'survivorship bias' tells us to not overlook areas we can't see or the assumptions we tend to naturally write off.

Survivorship Bias in a 2023 portfolio would immediately note damage from the bond market, investments in volatility hedges, value stocks, bets against the dollar, commodities and some emerging market equities. Conventional wisdom would suggest cutting these from a portfolio to increase defense and decrease risk.

Last time US bond yields reached 5% was in the summer of 2007

To illustrate, the last time US bond yields reached 5%, which they did last week (bond yields go up as the price comes down and a 5% yield is seen as a very cheap bond market), was in the summer of 2007 and the subsequent rally in the bond market over the next 18 months was nearly 30%.

Likewise, volatility funds which benefit from a volatile equity market, have been underperforming this year given the equity market rallies. But that's not what they are in the portfolio to do. In the initial months of 2020, when the COVID shock took the global stock market down -20%, these volatility strategies rallied 48%.

Removing underperforming investments from a portfolio just because they are down can, in the same way as a bomber, risk adding no benefit to safety and may exacerbate the practice of buying high and selling low which will quickly bring about the portfolios demise should we enter a recession.

Trying to build a recession proof portfolio.

So, as we head into the final chapter of 2023 we have a small underweight to equities with a focus on owning less of what has done very well this year under the assumption that any economic weakness seen will hit these areas first. We continue our search for fantastic funds delivering proper, bottom-up active management for steep discounts on fees for when this market does finally get out from under these grey clouds into a blue-sky rally.

But for now, we remain invested into the bond market with a focus on high quality sovereign and corporate bonds as well as some more speculative corporate bonds displaying attractive yields as well as recession proof characteristics. We continue to top US treasuries on weakness and have retained our volatility hedges in the portfolios, which have proven one of the best investments over the last quarter and will continue to do so as this market struggles to price in either a soft or hard landing.

Its never an easy job outperforming a market which can't make its mind up about where it wants to go but one thing remains a comforting constant for TAM – defensive positioning and capital preservation for our clients rules supreme and will continue to do so regardless of what everyone else is doing.

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