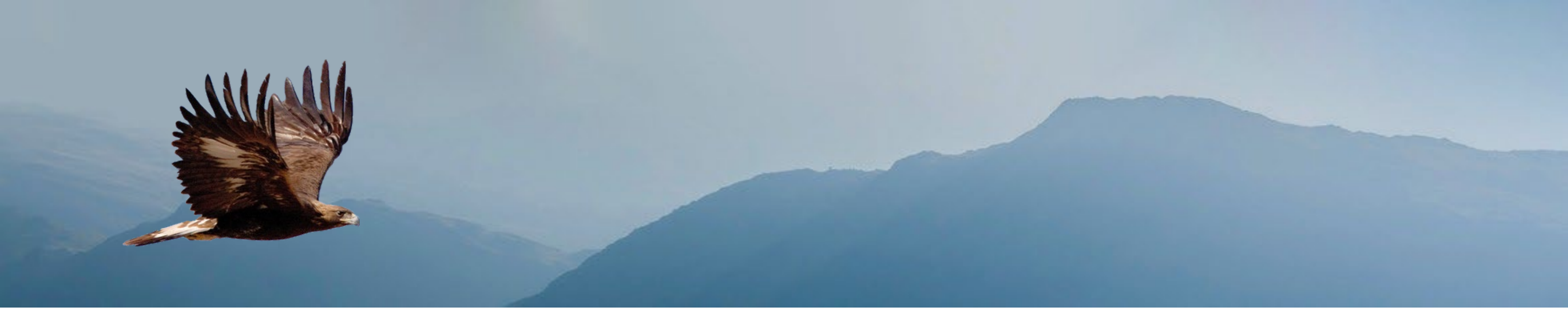

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B Capital Commentary and Outlook Update 3Q2023

Long-term investing is not about predicting the future. It is about taking advantage of opportunities that arise in the present and trusting in time and the resilience of the market to deliver the returns.

Markets This Year. Although climbing stock prices so far this year represent an impressive turnaround welcomed by beleaguered bulls, they are not the most astonishing market shift. That award goes to the collapse in volatility. In the past 12 months, the VIX, known as the "fear gauge," has declined by more than half, creating a placidity in the stock market. It's as if the bears have gone into hibernation.

This outlook is all the more astonishing given the uncertainties that could worry investors. The Federal Reserve's next move is shrouded in ambiguity, which could justify investors seeking more protection. Yet, the market remains remarkably calm, brushing off concerns that were so prevalent just a short while ago.

However, there is another species in the financial kingdom that looks rather less placid - bond investors, the more ursine creatures of the market. Unlike the bulls in the stock market, bond investors remain wary and naturally defensive. The move index, which tracks bond-market volatility, may have declined from its 13-year high, but it is still twice as high as pre-covid levels. Bond investors are far from convinced that the good times have returned.

The divergence in sentiment between the bull and the bear is a stark contrast to the early stages of the pandemic. Back then, stocks were extremely volatile, while government bonds remained relatively calm. Investors were preoccupied with the economic fallout of the pandemic, vaccine development, and economic reopening. However, the focus shifted to inflation and the actions of the Federal Reserve.

It might be tempting to judge that either the bond or stock market is wrong. However, the truth is more nuanced. The impact of artificial intelligence on major technology companies could be a tremendous boon for stock investors while having little effect on government bonds.

The problem lies in the uncertainty of such an outcome, and investors are beginning to price stocks based on earnings that may not materialise in the near future. The cyclically adjusted price-to-earnings or ratio of the S&P 500 (also known as the "Shiller PE") has climbed to levels not seen in the past two decades, indicating a bullish sentiment among stock investors. That could mean the world's biggest benchmark Index is looking peaky unless earnings are revised upwards in the near term.

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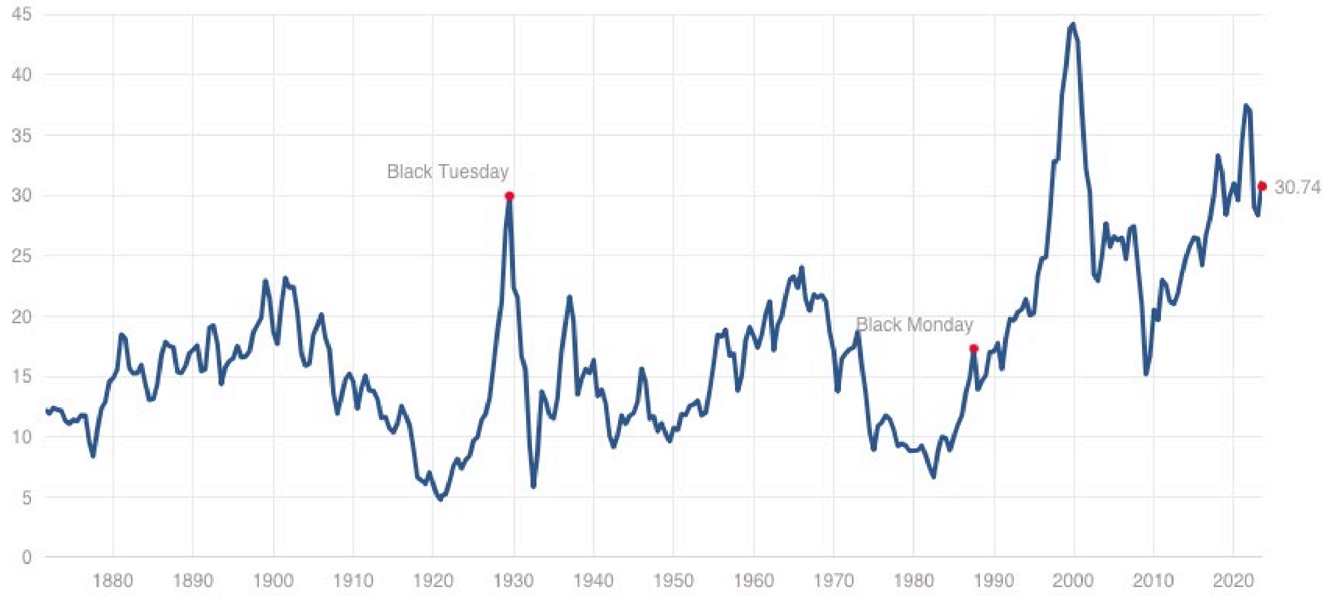

Fig 1 - Shiller PE Ratios S&P500, 1870 - 2023
Source - B Capital

What the divergence in animal spirits does say is that stock market investors have left behind their previous concerns and embraced an optimistic narrative about artificial intelligence. The lack of volatility suggests a bold bet on the revolutionary potential of new technologies and the belief that the Fed's decisions and interest rate rises will not shake the financial system or the economy.

Global Economic Indicators Show Mixed Progress in Early 2023. The global economy has shown signs of improvement in the first few months of 2023, with global GDP growth reaching just over 3% on an annualised basis in the first quarter. However, the outcomes have been varied across different countries. While Brazil, China, India, and Japan experienced growth rebounds, the United States saw a slowdown, and the euro area and the United Kingdom observed only modest output increases.

Business surveys have shown significant improvement, especially in the services sector, compared to the latter part of 2022. Consumer confidence indicators in major economies have also started to recover from the low levels seen in the previous year.

Several factors have contributed to the early-year improvement. Declines in energy prices and improved prospects for China have played a role. Energy commodity prices, particularly natural gas, have sharply fallen since last summer, primarily in Europe. However, these lower prices have yet to be fully reflected in retail prices across many countries. Oil and coal prices have also decreased significantly since the peak reached after the Ukraine invasion, relieving pressures on households and companies. Nevertheless, prices generally remain higher than pre-pandemic levels. China's decision to relax its zero-COVID policy earlier than expected in December 2022, along with fiscal and monetary policy adjustments, has also positively influenced business sentiment. The stronger growth of the Chinese economy is expected to have positive ripple effects in the Asia-Pacific region and beyond.

While recent monthly activity indicators have shown mixed results, the manufacturing sector continues to face challenges, particularly in several Asian economies, partially due to subdued activity in the tech sector. In most economies, the improvements seen in early 2023 have been more prominent in the services sectors, aided by a rebound in consumer demand in China and solid growth in the United States. However, demand for durable goods remains weak, partly due to the sensitivity of such spending to financial conditions.

The impact of tighter monetary policies is becoming increasingly evident in property markets. Housing investment has declined in all major OECD economies during the second half of 2022. In the fourth quarter of 2022, housing investment in OECD economies dropped 7.5% compared to the previous year, with even larger declines in the United States and Canada. The trend of contracting housing investment continued into the first quarter of 2023. House prices have also started to adjust to policy tightening, with nominal price declines occurring in many economies. This is compounded by high consumer price inflation, leading to significant real price declines. Countries with high price-rent ratios, substantial household debt, and a large share of adjustable-rate mortgages have experienced more pronounced price adjustments. On the other hand, countries with strong population growth and a significant portion of fixed-rate mortgages have seen less notable price changes. However, many mortgages have floating rates or are fixed for only a few years, meaning mortgage holders will face increasing payments if mortgage rates remain at higher levels. Historical data shows that fluctuations in real house prices often coincide with business cycle fluctuations due to the negative impact on investment, household finances, balance sheets, and strains in the financial sector.

While the global economy has shown some positive signs in the early months of 2023, there are still challenges and disparities across countries and sectors.

Fig 2 - Real GDP Growth Projections 2023 and 2024
Source - OECD

Waiting For A Crash. In the world of finance, investor sentiment is currently hovering in a state of pessimism, but amidst the gloom, potential opportunities are emerging. The prevailing bearishness, as evidenced by the soaring levels of short equity interest, has reached multi-decade highs. Simultaneously, the amount of capital parked in short term money market funds and Treasury Bills (T-bills) has surged to an all-time high. In addition, short-term cash rates have climbed to their highest point since 2007. This collective data strongly indicates that investors are patiently biding their time, eagerly awaiting a decline in market indices before reallocating their assets into equities.

Remarkably, this could be shaping up to be the most highly anticipated bear market in history. However, it also poses a compelling argument against the effectiveness of market timing. If every investor is diligently waiting on the sidelines, ready to pounce at the first signs of a downturn, any potential decline in the market may be brief and present limited trading opportunities. The bad news is not coming in as predicted either. Jobs numbers are strong, consumers are spending, AI is giving hope for a new and exciting economic cycle and inflation has fallen. A shallow recession or just a slowdown? No soft landing but rather a pick-up in growth after all?

The prevailing sentiment in the investment community is one of caution and scepticism, with a keen eye on market movements. While this approach is understandable, it also introduces unique challenges for those attempting to time the market. The sheer magnitude of anticipation surrounding a bear market makes it inherently tricky to predict and capitalise on and this mass anticipation introduces a paradoxical scenario. If everyone is waiting for the perfect moment to strike, it becomes increasingly unlikely that any significant decline will persist long enough to execute trades effectively.

In essence, the current market sentiment reflects a delicate balance between anticipation and hesitation. Investors are holding back, seeking that opportune entry point into equities, but the very act of waiting may lead to missed opportunities or fleeting declines that are difficult to jump on.

Timing vs Time In. Instead, a more prudent approach involves a diversified portfolio and a long-term perspective. By focusing on fundamental analysis, identifying undervalued assets, and staying invested over time, investors can navigate the uncertainties of the market with greater resilience and potentially reap substantial rewards. That said however, it is right to look at asset prices that may have run ahead and to consider taking profit or re-balancing while still remaining broadly invested. Some good housekeeping to keep equity exposure in balance and to benefit from current high yields in bonds makes some sense even as the economic doomsters look to be more wrong than right. A crack in the employment numbers or a wider drop in real estate markets could be the catalyst for the much-heralded recession, and there is always the geopolitical risk to think about.

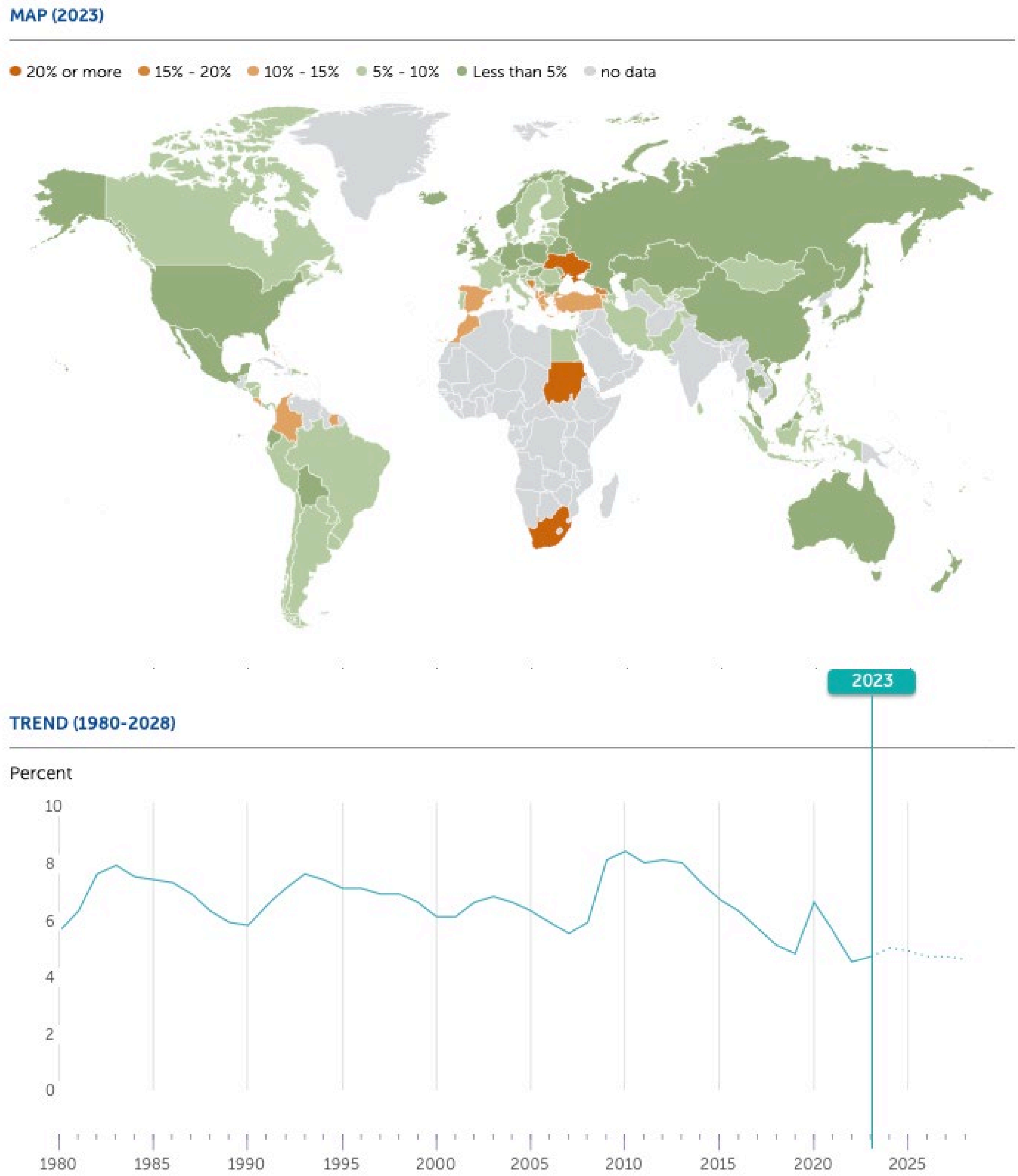

Fig 3 - Global Unemployment
Source - International Monetary Fund

Next Up. With equity markets doing so well in the first half of the year and with bond yields also offering attractive returns there is definitely a feeling of "Don't lose what we made so far" and a doubt that prices can go higher with the current earnings forecasts. We would subscribe to taking some risk off the table in favour of investment grade bonds with yields that reward us sufficiently. If the news and markets become less favourable, then this will have been prudent action and if the market does grind higher then the bond returns need to be high enough to still compete. After a decade and a half without this oft-magical balance between stocks and bonds we can finally feel good about both major components of portfolio construction, and we will be taking advantage. The second half of 2023 will likely see a mix of lower inflation but also fairly flat growth prospects in the developed markets, while developing nations present more volatile and sometimes diverging results. Looking further out, we see a moderately better growth story overall but still not strong enough to warrant outright optimism. For this reason, the diversification of portfolio assets remains key and collecting income over time is golden.

Finally, in the world of investing, taking risks is part of the game. It's about weighing the opportunities against the uncertainties and making informed decisions. As we navigate the market's twists and turns, let us remember the wisdom of long-term investing and trust in time invested and the resilience of the market.

Lorne Baring
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