B Capital SA
Rue Jean-Calvin 14
1204
Geneva
Switzerland

Tel +41 22 317 7823

Thursday 19th October 2023

B Capital Commentary and Outlook Update 4Q2023

As we venture into the fourth quarter of the year, it's time to reflect on the events and trends that have shaped the investment landscape in the past few months. Our journey begins with a quote from Jerome Powell, Chairman of the Federal Reserve: "The FOMC has considerable control over short-term interest rates. We have much less influence over long-term rates, which are set in the marketplace." This sage statement reminds us of the delicate balance between monetary policy and market dynamics. Central banks around the world may have been a bit slow to catch on to inflation moves and the market has voted on this with a jump in volatility for bond markets, especially the long end.

In this letter, we'll touch on several topics, including the "Higher for longer" narrative, the strength (and potential weakness) of the consumer, the relationship between consumer spending and GDP, safe dividend stocks, and a preview of the Q4 earnings season.

Investors Now Believing The “Higher For Longer” Narrative

The world has been closely monitoring inflation and its implications for interest rates. Inflation, which had been on a sharp decline in the first half of the year, has now stabilised, though it remains well above the 2 to 3% target range set by policymakers.

Fig 1 - Global Inflation Rates
***Source - FT/Refinitiv**

Central bankers worldwide have consistently warned that interest rates are likely to stay higher for an extended period, but many investors had been betting on a pivot towards rate cuts later in the year. However, a few factors have caused a shift in this narrative. The surge in oil prices, which rose more than 30% during the quarter, along with better-than-expected economic data, including job numbers, has caught investors by surprise.

The realisation that rate cuts might not be imminent has led to an adjustment in valuations, with higher discount rates. We think that rates will likely flatline for several quarters before declining, probably sometime mid-year but quite possibly a bit later.

Are Consumers About To Crack?

Consumer spending has been a driving force in many economies, helping them steer clear of recession. The United States, for instance, has seen consistent growth in consumer spending, although August's data showed some weakening. A similar trend is observed in the UK and even in China, where retail sales have been a bright spot in an otherwise sluggish economy.

However, headwinds are looming on the horizon. High interest rates on credit card debt, mortgages, and home loans are taking a toll on consumers, and there seems to be no relief in sight. Savings accumulated during the pandemic have also been depleted, with private sector credit increasing notably in August. Furthermore, the end of the pause on student loan repayments in the U.S. will cost consumers an additional $8 billion each month.

Consumer spending is closely tied to GDP, and a slowdown in spending could significantly impact economic growth and overall sentiment. As long-term investors, it's important to monitor this closely, especially with the holiday season approaching. A dip in consumer spending could lead to two potential silver linings for investors: a faster decline in inflation and sooner rate cuts, as well as improved long-term buying opportunities.

Global Markets - Mean Reversion or Something Worse?

Equity markets had a strong start in July but experienced declines in August and September, as investors began to grasp the reality of "higher for longer" interest rates. Bond yields surged during the quarter, with U.S. 10-year yields reaching a 16-year high at the beginning of the fourth quarter.

Notably, dividend stocks and stocks tied to consumer spending were more affected by the rise in interest rates. Utilities, real estate, and consumer discretionary sectors showed weakness, suggesting that investors anticipated the challenges mentioned earlier. Meanwhile, the energy sector rebounded, driven by an oil price rally.

Globally it was India, once again, that defied the global trend in the third quarter. Utilities emerged as the top-performing sector, while energy was the worst performer. This discrepancy partly reflects mean reversion following a prior sell-off in Adani Group companies.

Dividends - Keep Them Coming

We have always harped on about the powerful effect of compounding dividend returns as we counsel remaining invested even through troubling times. It has been interesting to note however how the highest yielding stock sectors have been punished by rising interest rates and to understand why. The utilities and real estate sectors are particularly sensitive to rising interest rates primarily because these companies rely heavily on debt, so higher rates increase their cost of capital. Secondly, these stocks are typically favoured for their dividends, so when government bills yield 5.5%, even stocks with slightly lower yields may lose their appeal.

Fig 2 - US Stock Markets, 3 Month Performance By Sector
***Source: Simply Wall St**

Companies with lower yields might still pose risks, especially if they appear stable. The more debt a company carries, the higher its payout ratio, the lower its expected earnings growth, and the higher its yield, the riskier its dividend becomes.

A prudent approach to dividend investing is to choose companies with lower yields but greater compounding potential. If earnings rise and the payout ratio remains stable, the dividend amount will increase over time, even if the yield remains the same. Essentially what we are saying is keep the dividends coming but don't chase the highest yielding stocks without looking at the sustainability of those high payouts.

Q3 Earnings Season Will Beat Forecasts

In the past four quarters, S&P 500 companies consistently outperformed their estimated earnings by an average of 4.4%. During this period, 74% of these companies reported higher actual earnings per share (EPS) compared to the mean EPS estimate, leading to a 1.6% average increase in the earnings growth rate. If this trend continues, the estimated earnings decline of -0.3% at the end of Q3 2023 would turn into an actual earnings growth rate of 1.3%.

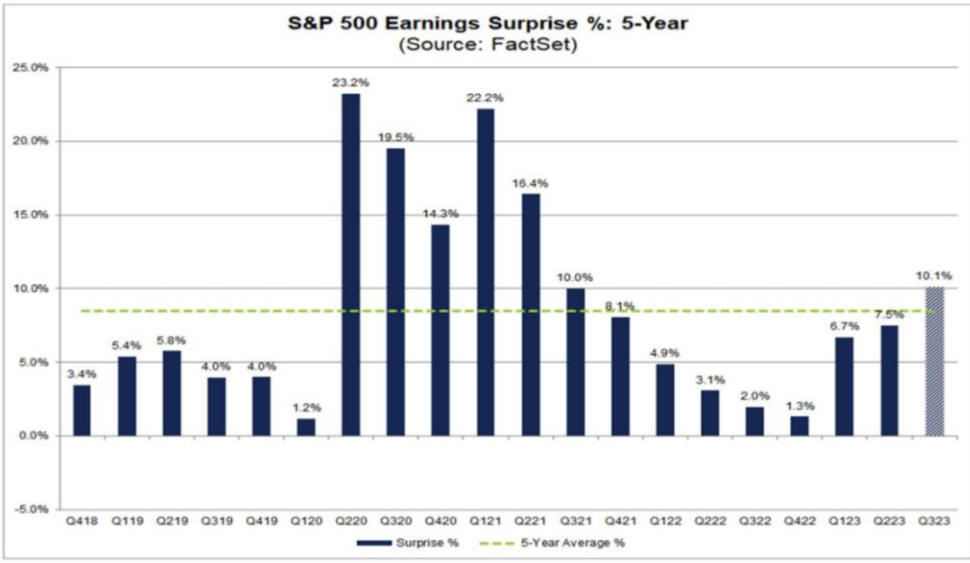

Fig 3 - S&P500 Earnings Surprises, Last 5 Years
***Source: Factset**

At the time of writing, 84% of the S&P 500 companies that have reported their Q3 2023 earnings have exceeded the mean EPS estimate, with an average earnings surplus of 10.1%. This suggests a strong start to the Q3 earnings season, with both the number of companies reporting positive EPS surprises and the magnitude of these surprises trending higher than the 5-year averages. Since the end of Q2, the earnings growth rate for the S&P 500 has improved by 0.7 percentage points, reaching 0.4% from an initial -0.3%. The strong performance seen so far indicates the potential for continued positive results in the remainder of the earnings season.

In fact, If 0.4% is the actual growth rate for the quarter, it will mark the first quarter of year-over-year earnings growth reported by the index since Q3 2022 (2.3%).

Anticipating the future, financial analysts have set their sights on the performance of companies in the upcoming quarters. In the final quarter of 2023 (Q4 2023), they forecast a robust year-over-year earnings growth rate of 7.6%. This positive outlook suggests that companies are expected to significantly increase their profits compared to the same quarter in the previous year.

Zooming out to encompass the entire calendar year of 2023 (CY 2023), analysts are predicting a year-over-year earnings growth rate of 0.9%. This relatively more modest projection indicates that companies are expected to experience some growth in profitability over the course of the year when compared to the earnings generated in 2022.

Furthermore, when considering the prospects for CY 2024, analysts covering US majors are notably more optimistic, forecasting a substantial year-over-year earnings growth of 12.2%. This enthusiastic forecast suggests a promising outlook for companies, with expectations of considerable profit expansion compared to the previous year.

Although analysts are in aggregate foreseeing a mixed yet generally positive trajectory for corporate earnings, with a stronger end to 2023, modest growth throughout the year, and a significant leap in profitability anticipated for 2024, we think that the higher interest rate environment will act as a brake on many sectors through next year. The net result will still be earnings growth but companies with higher levels of gearing will be affected if there are revenue misses.

In summary, as we enter the final quarter of the year, we expect the road out of the now nearly forgotten pandemic to be full of bumps as the inflation picture keeps central bankers hawkish after a slow reaction at the start. Bonds are offering attractive fixed returns and the balance between equities and fixed income has finally reasserted after 15 years' absence. We look for decent fixed returns in IG credits further out on the curve and remain overweight to the US economy with equity allocations. Within EM we have reduced our allocation to the Chinese markets and added to India, which has continued to show strong growth as global GDP slows. At sectoral level we maintain energy and mining exposures and hold our conviction that crude prices will reach or exceed $100 per barrel. Indeed, with the tragic events in the Middle East deepening geopolitical risk for the region there is upside potential for energy prices in the medium term.

Lorne Baring
Managing Director