The Way We See It

November 2022
Issue 10

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INSIDE THIS ISSUE

1. Review of Developments
2. Market Outlook
3. The Way We See It

The Fed Dilemma continued to cause a Dilemma for Asset Allocators

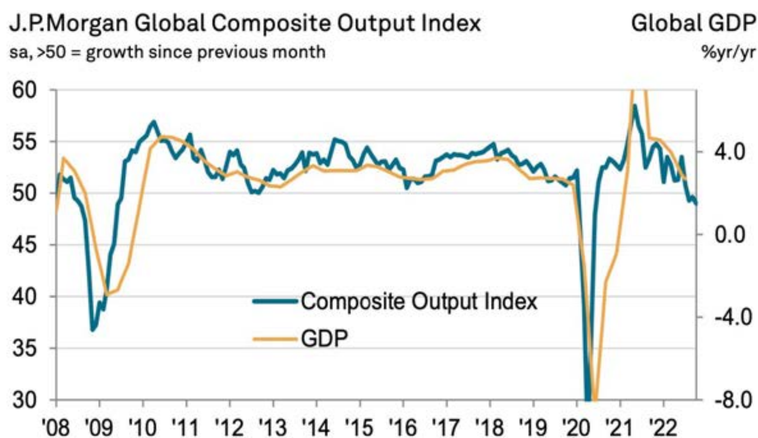
A brief update report which serves to review the recent market development and to offer our outlook for the rest of the year and beyond.

Review of Developments
- Global Economies

Over the month October, the US economy recorded a positive quarterly annualised growth rate of 2.6%. This denotes a welcome recovery from the negative first half (caused by inventories drawdown). Key European, Japanese and Chinese data economic releases continued to show that all major economies continued to grow, albeit at a decelerating pace. The key positive driver of growth in the US and elsewhere in the OECD world continued to be consumption, boosted by the re-opening of their economies, positive employment and wage gains trends. For this very reason, both headline and core inflation rates in the OECD world continued to surprise on the upside. This explained the US Fed's Chairman's continuing hawkish warnings, following the recent November FOMC meeting. To combat inflation remains the key priority, even at the cost of a possible recession. Hence, the so-called Fed's Dilemma. The latter was publicly voiced by a small but rising number of FOMC members, who fear the potential onset of a recession and loss of jobs in their

region. In spite of this, the Fed's strategy is to continue to raise interest rates, but probably with less aggression, going forward. The Fed is also targeting an ever-changing peak cash rate, as they have no visibility on the path, duration or intensity of inflationary pressures in the US. Thus, the Fed will also continue to implement their quantitative tightening program, which threatens to significantly reduce the absorption and liquidity in the privately-traded US Treasury bond market, as a significant amount of $US 90 billion worth of bonds are redeemed or sold by the Fed to the private sector each month. This is in addition to the required amount of new Treasury bonds issued by the government to fund their spending programs each month.

In the U.K., Ms Liz Truss was replaced by the more conservative Mr Rishi Sunak, caused by her ill-planned and rushed policy growth ambitions. In the Asia Pacific region, China saw President Xi re-eleted for his third term. He continued to adopt a zero-Covid policy, despite some unconfirmed rumour of a possible relaxation of the strict anti-Covid rules. China's latest GDP growth data showed a 3.9% rise in the year ending September 2022, which is reasonable, but well below the government's annual growth target of 5%. Within the Emerging Markets universe, economic growth is slowing significantly, and the risk of debt default continues to rise as a result of a very strong US Dollar, high US interest rates, and the reduced appetite of global investors to lend to weak and indebted nations. We attach charts of the latest Global PMI trends. They reflect a continuation of the softening trend of real GDP growth.



The Fed's dilemma: how long to "keep at it" on inflation

Source: ft.com

Economics growth softening everywhere

- Global Markets

The month of October saw a welcome bounce in the majority of risk assets, led by Equities. This is somewhat similar to the rally we witnessed in July-August. While both trading and fundamental investors were net modest buyers in October, it appears that there was an increasing group of fundamental investors,who, with the hope that the Fed will soon make a policy pivot, were the principal buyers. They probably expected that the Fed, along the line of what the Australian and Canadian central banks had done recently, will likely announce a policy, starting in December, to increase rates in smaller increments of 50 then 25 bps, instead of the normal 75bps, as was the case over the past few FOMC meetings.

Risky assets bounced with investors in hope of Fed turning dovish

After a challenging month of September, of which all asset classes fell notably, many of them stabilized in October and some also rebounded strongly. The US stock market once again led all other major equity markets up; bond market still fell short during the month but stabilized MoM. The safest and best out-performing asset class over the past few months, US dollar cash, underperformed.

Near-term performance of various asset classes

as at 31/10/2022

Asset Class	US Equities	Global Equities	GEM Equities
Index	MSCI USA	MSCI World	MSCI EM
1 month	7.94%	7.21%	-3.09%
3 months	-4.55%	-6.74%	-14.01%

Asset Class	US Corporate	US Treasury	US Aggregate
Index	Bloomberg US Corporate	Bloomberg US Treasury	Bloomberg US Agg
1 month	-1.03%	-1.39%	-1.30%
3 months	-8.98%	-7.16%	-8.23%

Asset Class	Global Govt Bonds	Global Aggregate	Global Commodities
Index	Bloomberg Global TSY	Bloomberg Global Agg	CBR
1 month	-0.69%	-0.69%	2.18%
3 months	-9.88%	-9.51%	-6.14%

Asset Class	Asia ex Japan Equities	China Offshore	China A
Index	MSCI AC AxJ	MSCI China	MSCI China A Onshore
1 month	-6.09%	-16.81%	-8.16%
3 months	-18.02%	-28.75%	-20.79%

Source: GOJI, MSCI, Bloomberg

The US Dollar corrected over the period under review, providing some breathing room for all other currencies around the world.

Market Outlook
- Global Economies

While there are both positive and negative factors operating in the US and the world economy in the next few months, the potential growth positives are likely to be offset by negatives.

Positives include: solid consumption and employment growth are likely to continue to boost GDP growth in the US, together with increased spending by the government and the potential corporate spending on CAPEX. In China, the gradual re-opening of its major commercial cities and potential easing of Covid rules, combined with a modest easing of fiscal and monetary policies should help to modestly boost its GDP in H2. In addition, as the majority of countries have started to re-open and encouraged tourists and foreign workers to return, this will add to GDP growth and help to alleviate the shortage of labour in many countries.

Having said that, should the Fed tighten too aggressively in order to tame inflation within a short time frame, the US economy may not escape a recession scenario in the coming 6-12 months.

Other negative factors again focus on still-elevated inflation, still-tight global monetary policy tightening, and continuing selective supply bottleneck issues on certain specific production components, in particular labour. High inflationary pressures are likely to force central banks in major OECD countries to continue to raise rates through to year-end. In addition, while supply-side bottlenecks appear to ease a little, the complete suspension of gas and oil exports from Russia to Germany and other European countries would continue to hurt their economies. The US government has recently announced an overall review and tightening of the export of semiconductor chips to China. Lastly, the difficulty in finding workers to fill low-skilled services jobs in major economies, compounded by China's zero-Covid policy, continued to cause unfavourable imbalances in demand and supply. In brief, the world economy is expected to remain in a fragile and weak phase.

The Way We See It
- Global Markets and Investment Thematics

The above economic, monetary, and geopolitically unbalanced backdrop is expected to prevail until year-end and possibly spread through to the first half of next year.

Good chance to see Christmas rally …

In the near term, many investors are hoping that there will be a Christmas rally in risk assets, based on past tradition. We believe that there is better than 50% chance that this will happen, given our economic and Fed policy outlook, as outlined above, together with the low exposure to risk assets by both Systematic and Fundamental investors.

… but stay defensive in 2023.

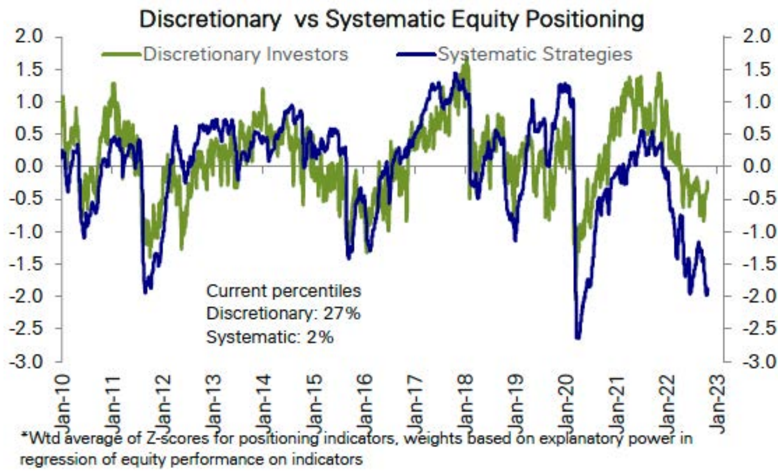
However, in 2023, we continue to advise that it would be sensible for investors to continue to adopt a defensive strategy in overall terms, consistent with our key message since November of last year. This translates into a strong focus on quality and lowly-geared assets that can deliver predictable cash flows, and, until the Fed's Chairman, Mr Jerome Powell, truly pivots, an overweighting in US-dollar-denominated short-dated Treasuries and Investment Grade corporate bonds.

In addition, as selective growth stocks with a healthy cash flow generation capacity, strong business franchises and good management have also suffered from falls in their share prices along with the overall global markets, long-term investors should take advantage of these opportunities to selectively add.

From an investor's sentiment and positioning perspective, both Quantitative- and Algorithm-focused and Fundamental investors have been, and remain, very underweighted or short risk assets.

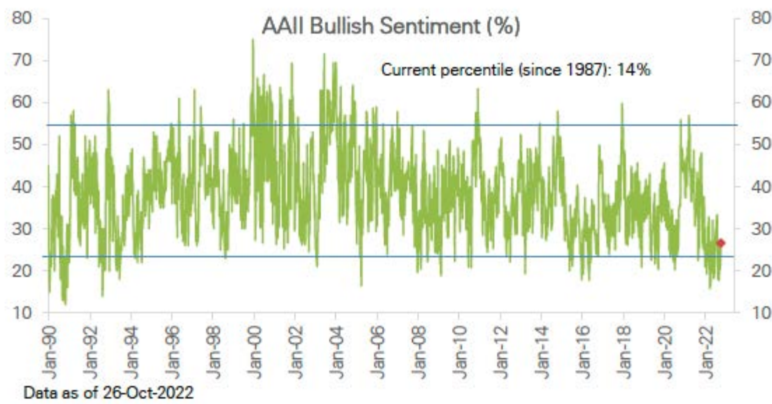
The charts below show the extent to which all investors (Quantitative-driven Systematics and Fundamental investors) have, significantly, been reducing their exposure to equities and long-dated bonds, based on their view that the current stagflation may turn into a recessionary environment in the coming 6-12 months.

Discretionary vs Systematic Equity Positioning



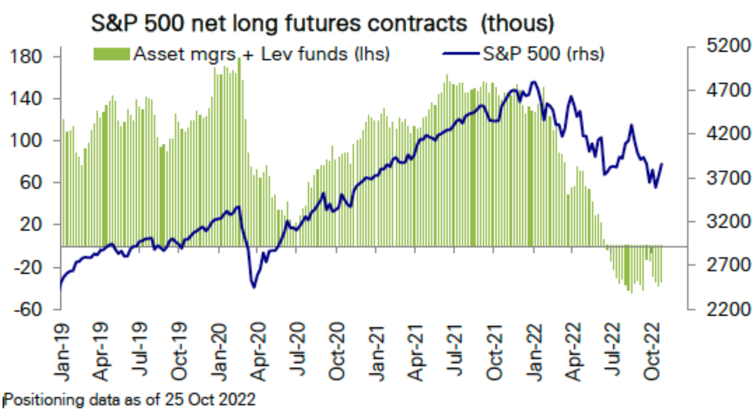
Source : CFTC, Bloomberg Finance LP, Haver, Deutsche Bank Asset Allocation

Investor bullish sentiment



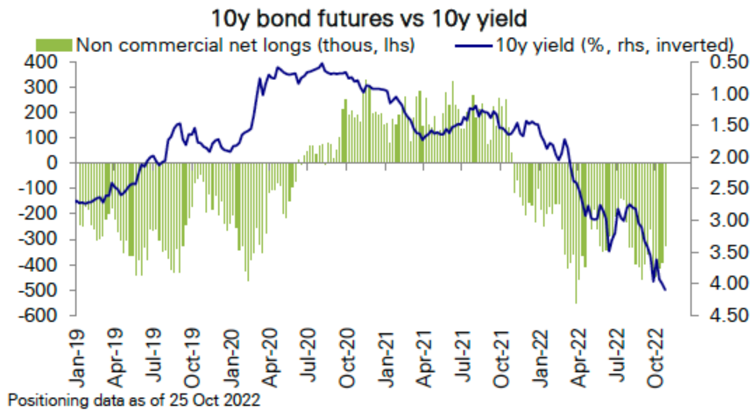
Source : Deutsche Bank Asset Allocation, Barron's, Haver

S&P 500 futures positioning



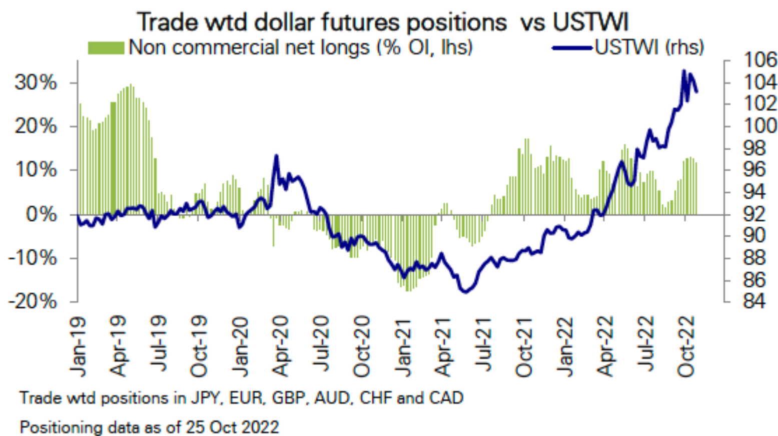
Source : Deutsche Bank Asset Allocation, CFTC, Haver

10y treasury notes futures positioning



Source : Deutsche Bank Asset Allocation, CFTC, Haver

US trade weighted dollar positioning



Source : Deutsche Bank Asset Allocation, CFTC, Haver

The continuing substantial net short position in US equity futures and long-dated bonds is the clear proof of investors' current bearishness.

Finally, we highlight that Investors' sentiment is bearish and their positioning in equities is underweight, relative to their historical averages. This suggests that a fair amount of bad news, outlined above, has already been discounted. Therefore, any unexpected good news from the Fed's pivot from their current tight policy is likely to send prices of equities and other risky asset classes up strongly, and quickly.

Any unexpected good news will lead to sharp rebound.

To summarise, it remains our strong belief that a sustainable bull market in equities and corporate bonds will return at some stage, in the coming 12-month period. But it would only occur when valuations fall further to reflect the likely US and global recession, and, more importantly, when the US Fed and other major central banks are perceived to switch from the current tightening to a pause, or an easing mode.

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