The Way We See It

April 2024
Issue 28

Goji Consulting Limited

enquiry@goji-consulting.com

What to do for an encore following a great Q1? Some thoughts for H2, and a peek into the next 5 years.

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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

On growth dynamics, recently-released data again continued to show significant growth divergences amongst key economies.

On the relatively stronger side of the ledger, final estimates of Q1 2024 GDP show that the U.S. economy remains the strongest amongst the largest industrialised nations in G7. Spending by households, corporates and government remain solid. Capital expenditures also showed signs of picking up. The only unexpected macroeconomic risk in the U.S. relates to the fragility of the office and other commercial property sectors, the weaker status of regional and smaller banks in the face of higher-for-longer interest rates.

On the relatively weaker end of the global growth spectrum, while the latest economic indicators of the Eurozone continued to underline a sluggish trend, at least it appears that its economy has bottomed.

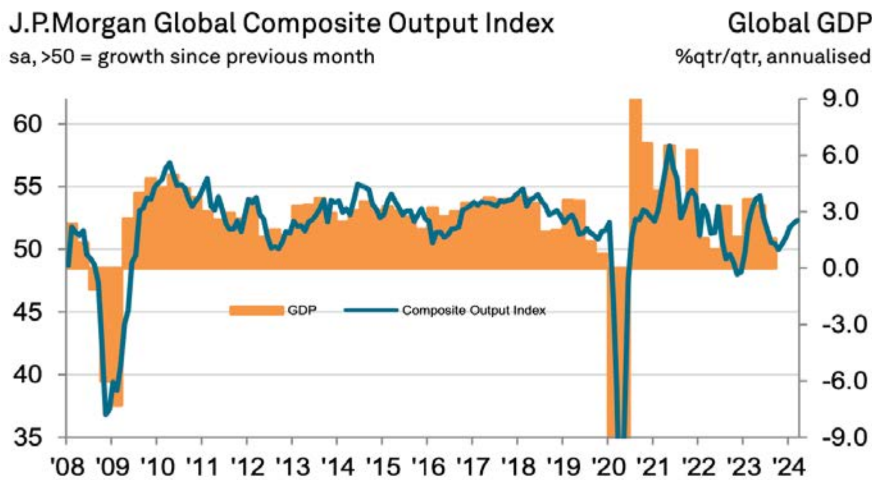
In the Asia Pacific economic zone , India continued to shine. Japan, on the other hand, disappointed. Helped by monetary and fiscal boosting incentives, the latest official release of China's annualised Q1 GDP of 5.3% showed a welcome bounce. However, anecdotal evidence continued to point to an uncertain and volatile recovery.

On the global inflation front, while headline and core inflation indicators continued to show a decelerating annual trend elsewhere in the world, the US and a few other OECD economies experienced a short-term reversal of trend. In the US, the last three monthly data showed a renewed rising trend. Wages, rentals and energy prices all contributed positively. This is not a surprise to us because we had thought that the massive fiscal spending under the Biden Administration, together with the still-ample excess liquidity in the US banking system, would be keeping the American economic machine humming. The latter has caused investors to start to worry about the hawkish sounds emanating from the Fed Chairman and a number of conservative members of the Fed Board.

US inflation data has shown a renewed rising trend.

Finally, global geopolitical risks remain high: Russia vs Ukraine, Gaza vs Israel, Iran vs Israel, plus geopolitical and trade tensions beyond semiconductor chips between the U.S. and its partners, against China.

J.P.Morgan Global Composite PMI™



Source: J.P.Morgan, S&P Global Market Intelligence

- Global Markets

The strong month and quarter of March for US and global risk assets gave investors plenty of reasons to rejoice. This good performance follows in the footsteps of good December quarter last year.

The hot areas of focus continued to include U.S. AI- and Semiconductor-related stocks. Many global equity indices in the Developed Markets bloc made all time highs, led by the S&P 500 and Nasdaq, followed by the Japanese Nikkei.

US Tech remained as the focus in Q1.

Similar to previous months, it was reported that both fundamental and quant-driven investors, who were already overweighted in equities, continued to add moderately. The former were positively motivated by the better-than-expected US corporate results, solid economic growth and a continuing fall in all inflation indicators, as well as prospects of the Fed and other G20 countries to cut rates this year. The second type of buyers of the rally was driven by the positive momentum of stock prices and falling volatility. This trend was established since early November to date.

Near-term performance of various asset classes

Asset Class	US Equities	Global Equities	GEM Equities
Index	MSCI USA	MSCI World	MSCI EM
1 month	3.18%	3.27%	2.52%
3 months	10.41%	9.01%	2.44%
YTD	10.41%	9.01%	2.44%
FY 2023	27.10%	24.42%	10.27%

Asset Class	US Corporate	US Treasury	US Aggregate
Index	Bloomberg US Corporate	Bloomberg US Treasury	Bloomberg US Agg
1 month	1.29%	0.64%	0.92%
3 months	-0.40%	-0.96%	-0.78%
YTD	-0.40%	-0.96%	-0.78%
FY 2023	8.52%	4.05%	5.53%

Asset Class	Global Govt Bonds	Global Aggregate	Global Commodities
Index	Bloomberg Global TSY	Bloomberg Global Agg	CBR
1 month	0.26%	0.55%	5.53%
3 months	-2.89%	-2.08%	10.03%
YTD	-2.89%	-2.08%	10.03%
FY 2023	4.18%	5.71%	-5.01%

Asset Class	Asia ex Japan Equities	China Offshore	China A
Index	MSCI AC AxJ	MSCI China	MSCI China A Onshore
1 month	2.58%	0.95%	-0.23%
3 months	2.44%	-2.19%	-0.68%
YTD	2.44%	-2.19%	-0.68%
FY 2023	6.34%	-11.04%	-11.46%

Source: GOJI, MSCI, Bloomberg; data as of 28/3/2024

The whole global equity universe, in USD terms, performed well in the month of March. The U.S. and Developed markets led, rising by around 3.2%. For the March quarter, the US and Developed Markets equities recorded a high total return of 10.4% and 9%, respectively. China was sluggish in March; For the March quarter, China's return was negative while EM rose by 2.4%.

Global Equity universe did well in Q1, except China remained a laggard.

Delayed expectations of early rate cuts in the U.S. in this month continued to boost the value of the US Dollar.

Bond markets again went through a tough time. Re-emerging inflationary pressures in the US forced a major repricing of US Fed Fund rates, which translated into a shift of the whole yield curve from 1- to 30-year bonds.

The Commodities complex rose, helped by a strong bounce in energy and other commodity prices. Gold also rose.

Market Outlook

Despite recent adverse macroeconomic and geopolitical developments, the latest positioning of the majority of investors (both fundamental and systematics) remains bullishly positioned for a continuation of the rally in G7 equities and bonds in 2024. The attached chart illustrates the above points.

Consolidated Equity Positioning

*Weights based on explanatory power in regression of equity performance on indicators

Source: Deutsche Bank Asset Allocation

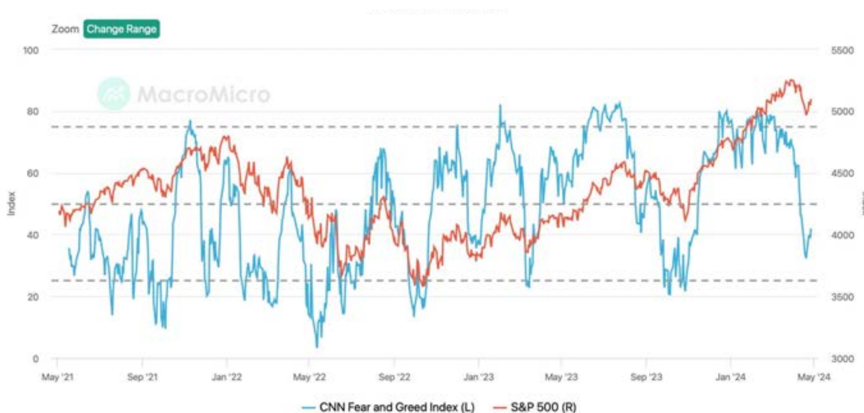
Discretionary vs Systematic Equity Positioning

Source: Deutsche Bank Asset Allocation

Investors' short-term sentiment has been declining recently. The CNN Fear and Greed index was falling from the "Greed / Extreme Greed" level towards "Neutral" in early April *(and as of 26/4 it fell further to Fear)*.

Investors' sentiment changed quickly from Greed to Neutral (and to Fear as of late).

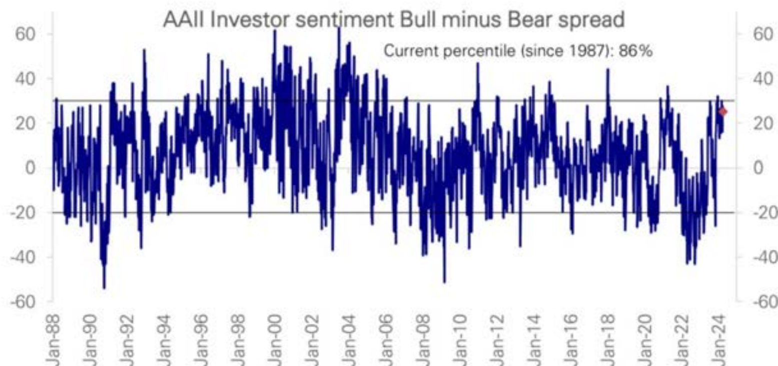
Fear & Greed Index
- vs S&P 500 in the past 3 years



Source: MacroMicro
Latest as at 26/4/2024

However, investors' longer-term sentiment remained buoyant. Investors' Bulls minus Bears readings remain a net high (*see chart overpage*).

Investor Sentiment
- Investor bull minus bear spread



Data as of 3 April 2024
Source: Barron's, Haver Analytics, Deutsche Bank Asset Allocation

As outlined back in our February report, GOJI's own fundamental research continues to point to a scenario where growth is expected to be stronger in H1, and that inflation may make a surprise return. Hence, we only expect a modest or no easing of monetary policy of the U.S. Fed towards the end of the year. The European Central Bank, the ECB, is most likely to cut rates first, since its economy is so much weaker than that of the U.S.

No change in our view: stronger growth in H1 & inflation may surprise.

As a result, our view continues to stress prudence in the next few months. In summary, we believe that there is a better entry point for long term risk asset investors.

GOJI: better entry point ahead for LT investors.

The Way We See It
- Global Markets and Investment Thematics

Thus, we, at GOJI, continue to prefer to adopt a more cautious investment strategy.

As outlined in our Global Investment Outlook for 2024 and in the two sections above, it is our belief that both fundamental and quant-driven investors have priced in, positioned for and are prepared to pay up for a best-case scenario of slowing but not recessionary growth, falling inflation and lower interest rates. A Goldilocks scenario.

As a result, based on our perspective of stronger than consensus growth, more sticky inflation and interest rates, plus an overvalued US equity market, our strategy recommends to stay modestly underweight risky assets and overweight cash and low-beta quality assets.

GOJI: modest u/w in risky assets, o/w cash & low-beta quality assets.

We would also suggest to continue to build a modest exposure to commodities. Lastly, we think that the U.S. Dollar will continue to rebound in coming months against most liquid currencies.

Short-term Technical Analysis

Soon after Q1 2024, US and global equity indices, led by AI and Semiconductor stocks, have been encountering some profit-taking and stop-loss selling by Systematics (quant-driven investors). Markets are expected to enter a consolidation phase in coming months *(and as of 26/4, SPX has fell 3% MTD)*.

S&P 500 Stock Price Index

Source: MarketWatch.com

As we argued over the past few months, despite the semblance of a sustainable strong rally, we feel that the markets will revert back to fundamentals at some stage. This would then mean a correction, the size of which depends on how high and how euphoric the equity indices are.

Hence, our recommendation to long-term investors is not to chase this short-term rally. For those who can act based on short-term trends, some profit taking of expensive names would be a sensible tactic.

Postscript

US vs Rest of Asset Classes and Rest of World - *Past vs Future*

Last 5 to 10 years

One striking feature in the comparison of total returns, in USD terms, of key liquid assets around the world, over the past 5-to-10-year period to March 2024, is the spectacular out-performance of US stocks relative to the rest of all asset classes (RoAC), and relative to the rest of the world (RoW):

Spectacular US EQ o/p in the past, vs RoAC and RoW.

	Annnualized Total Returns (%, in USD)	
	5-year	10-year
EQUITIES		
US	15.02	12.88
Global ex-US	8.04	5.34
Global Growth	15.36	12.31
Global Value	9.17	7.25
Emerging Markets	2.61	3.33
China	-6.19	1.42
FIXED INCOME		
US Treasury	-0.08	1.03
US Aggregate	0.38	1.54
Global Aggregate (unhedged)	-1.17	-0.07
US Corporate	1.52	2.61
OTHERS		
Commodity	9.58	-0.48
Gold	11.55	5.65

Source: GOJI, MSCI, Bloomberg; data as of 28/3/2024

Below is our attempt to outline some of the key reasons underlying the extraordinary out-performance of US equities:

1) US Technology:

- The explosive and sustainable growth of the near-monopolistic or duopolistic mega-cap social media platforms in the US (Amazon, Microsoft, Facebook, Google, Apple etc.);

- advanced semi-conductor chips designers (NVIDIA, TSMC, AMD, Intel, AMR, etc.) and;
- a few other incredible entrepreneurial firms (Tesla, Netflix, etc.)

have, in brief, boosted US corporates' revenues and profits globally, and labour productivity.

2) US Fiscal and Monetary largesse:

- The massive US government fiscal and monetary injections and subsidies over the past 5 and 10 years in a relatively healthy domestic economy, which make every other economy's efforts in these aspects pale in comparison.

3) Uniqueness of the US home mortgage underwriter the Consumer:

- The US mortgage holder has been the most insulated one in the world when central banks in the Developed World raised rates over the past few years to fight inflation.
- Through their ability to lock in low fixed mortgage rates over a 20-30 period (instead of using the variable or maximum-5-year fixed rate), US households were much less affected the Fed's monetary tightening policy.
- This, together with plentiful jobs creation in America, have allowed US homeowners to leverage up and spend freely.

4) Unprecedented US fiscal spending largesse under both Parties:

- Unlike any other economy in the world, the US government, be it under the Republican or Democratic Party, has been opening the fiscal valves to the maximum (Covid, in-sourcing, massive unfunded tax cuts, large government spending and debt forgiveness, significant projects spending, etc.).

- This has undeniably added to economic growth, put pressure on inflation and interest rates, and of course, helped to raise corporates' profits.

5) The US economy and stock markets have been experiencing an unprecedented decade of growth, whereas China reversed direction

- The largest Discretionary and Systematic investors in the world appear to have nowhere to go but to invest in the US stock (and bond) markets, because not only do they offer great growth investment themes, but also good trading liquidity and transparency.

- This is in contrast to the fortunes of the Chinese equity market, which saw continuous declines in the economic growth rates, but also corporate profitability and increasing trade and geopolitical tensions with the U.S.

- Technically speaking, the US stock market has been in a long-term bull trend, whereas China has experienced the opposite.

Brief Conclusion of the past 5-10 years to March 2024:

All factors contributed positively. Strong and dominant USD has overshadowed the high debt of US Govt.

- In brief, all the above factors (not an exhaustive list by any means) contributed towards a sustainable and healthy US economy and corporate profits , which no other country can compare to.

- While the US government has been piling on debt at an accelerating pace, this long-term risk has not affected the U.S. economic growth over the past 5-10 years because the U.S. Dollar remains the strongest and largest reserve currency in the world. This may change in the future.

Next 5 to 10 years

As for the next 5-10 years, let us take a look at alternative scenarios below. Of course, the lack of accuracy or the probability of being totally wrong is extremely high. Nonetheless, this should not deter us from thinking about and forecasting the future.

I. Base Case Scenario:

An extrapolation of current key trends of the largest economies in the world based on technological innovation, labour productivity, macroeconomic targets, consumers' attitude, and government's ambitions and policy-making, would undoubtedly be the most sensible scenario to adopt in the coming 5-10 years. In other words, no real change. Let us explain:

- Why would an investor believe in a significant change in attitude in China's quality-vs-quantity growth ambitions and policy-making? What probability would a rational investor put on the scenario of China changing from a more inward and state-controlled domestic economy to a more entrepreneurial private-sector led one?

- Equally speaking, why would any sensible investor bet that the US will stop innovating and thus fall far behind the world in technological advancements, and that their consumers suddenly want to save a lot more for their future?

- And what will reverse the growth-reducing trend caused by ageing demographics, lack of immigration, paucity of global technological successes, and the more conservative attitude of consumers in Japan, Europe, and China?

In the Base Case scenario, the US equity market and currency will continue to lead the world. China's financial assets are likely to continue to languish, since a strong stock market does not seem to be a priority target of the current government. Europe and Japan are likely to tag alongside with the U.S. market but are not expected to lead.

Having said that, the double-digit annualised returns of US equities are unlikely to be repeated. High interest rates, expensive starting valuation, high premia associated with US technology stocks and the USD, and the likely need for US governments to reduce the size of their budget deficits, will translate into more modest annualised total returns for US stocks. The latter is likely to return to the historical 5-8% p.a. range.

Below is an analysis done by Fidelity, showing that S&P 500 exceeded its rising channel (in late March), together with quite an expensive P/E valuation, which seems unsustainable.

How about US bond returns? They are more likely to show a positive annual return of 3-6%, a welcome change from negative.

Let us now explore an alternative scenario. We term it the *"Reversion-to-Mean"* scenario.

II. The Reversion-to-Mean Scenario:

In this scenario, any "lazy" extrapolation of current key trends outlined in the Base Case will lead to wrong results. Before going into details, we should qualify by stating that, based on current information, the probability attached to this scenario is less than 30%, but not 0%.

Let us re-examine the positive secular factors which have driven the outperformance of the US:

Factor 1: US Technology:

- The momentum behind Generative and other Advanced AI chips which are aimed to be applied in many industries and consumer on-line platforms is most likely to grow strongly.

- Furthermore, there are still lots of money invested in the technological R&D in the US to keep the US tech sector buoyant for the next few years.

- However, whether competition amongst big players will drive down profitability in future years is the more crucial question.

Factor 2: US Fiscal and Monetary largesse:

- While it's possible that the US government could continue to implement fiscal pump-priming to the tune of 6-8% of GDP each year in the coming 5 years, we think that it's highly unlikely. It's more likely that the size will revert back towards a more reasonable size 3-4% of GDP per annum.

- In addition, given the re-emergence of inflation and a strong domestic economy, it's more likely that the Fed will become a bit more restrictive in terms of liquidity injection in the banking system (i.e. a much reduced reverse repo program). The Fed Fund rate is more likely to stay higher for longer (more likely to stay at 3-4% rather than 2% pa).

Factor 3: Uniqueness of the US home mortgage underwriter the Consumer:

- While US mortgage holders will undoubtedly continue to enjoy their low fixed rates locked in some 3-4 years ago, natural family or job movements could force them to sell their existing property and take on a new more expensive mortgage.

- In brief, while this particular beneficial feature in the US household budget remains, it may not, in the coming 5-10 years, be as potent as it has been over the past few years.

Factor 4: Unprecedented US fiscal spending largesse under both Parties:

- While there is little to point to a concerted effort by the US government to significantly reduce the size of the US budget deficit and its fast-rising interest bill, it is not unrealistic to think of a choking point at which time question marks will be raised with regard to the credit worthiness of the US government.

- Consequently, it's quite plausible that this fiscal source of GDP may become a lesser contributor to growth in the coming 5-10 years.

Factor 5: The US economy and stock markets have been experiencing an unprecedented decade of growth, whereas China reversed direction

- Given what we know, it is quite challenging to imagine a scenario in which US equities lose its extraordinary outperformance relative to other markets in the global universe.

- For the above to occur, one has to envisage a great disappointment with the hyper-growth the current boom in AI and social media platforms. While not likely in the near future, this scenario could become reality in 3-5 years' time. As we previously outlined in our February report, what if the heavy investment in generative AI by corporates fail to generate adequate new revenue or cut costs?

- If this were to coincide with a surprise sustainable recovery of the New China and a continuation of growth in the Modernised India, then global investment funds may return to Emerging Markets and Europe.

- Technically speaking, despite its long-term strength, long-term momentum measures associated with the US stock market, based on weekly RSI and MACD momentum indicators, are showing weakness. In other words, these charts are flashing signs of caution in the US in coming years.

Can the US equity market sustain its extraordinary strong momentum in the coming 5-10 years? We doubt it.

- Conversely, signs of bottoming out are being observed in Emerging Markets.

- From an investor's sentiment viewpoint, the large consensus' enthusiasm for US equities and the USD stand in sharp contrast to the high pessimism and caution relating to China and Emerging Markets. Consequently, any sudden change of the fundamentals of the above could bring about a massive turn in sentiment and a substantial change in relative performances of the US vs RoW.

Conclusion:

- At present, we assign a probability of 70% to our Base Case scenario, and 30% to the Reversion-to-Mean one.

- We would again highlight that even if our Base Case (which is the Consensus' favoured scenario) were to become reality, potential returns of US equities are expected to become more normalised, rather than extraordinary, as it has been the case over the past 5-10 years to date. Both monetary and fiscal tailwinds are likely to turn to headwinds, and elevated valuations of US equities demand a delivery of spectacular revenue and profit results in the coming 5-10 years.

- In brief, the harsh reality of the future may stand is sharp contrast to any dream of a continuation of the bull market which the consensus currently nurtures.

GOJI CONSULTING LIMITED

Level 34, Tower One, Times Square
1 Matheson Street, Causeway Bay, Hong Kong

www.goji-consulting.com

enquiry@goji-consulting.com

+852 3951 0359

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