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asset management

Gleneagle Asset Management Limited
Gleneagle Investment Trust (Equity Fund)

September 2022 Review

Market Summary

September was a brutal month for equities, with the US SP500 down –9.6%, the tech heavy Nasdaq down -8.5%, and our local ASX200 down -6.34%. Fortunately for us we had been anticipating the sell down and were able to profit from the weakness with the portfolio gaining +7%.

I believe last month's newsletter summarized what happened quite well so let me repeat a snippet: "In a nutshell, the US markets are facing tightening monetary conditions while China, Europe and most emerging markets are struggling, and other western nations face slowdowns due to housing market corrections. It doesn't look great for equity markets in general right now. Long only portfolios are likely to suffer. Cash is being eaten away by inflation. Bond holders are getting hurt by higher rates. Precious metals have not been working as an inflation hedge. Real estate is coming off the boil."

The reason we are in this mess right now is that Central Banks had made policy errors by over stimulating economies in response to Covid and then being slow to react to the ever-rising inflation threat. Now that inflation has finally reared its ugly head, they are now having to take active steps to combat it. As a trader and avid market watcher, it appears to me that the Fed has been making another policy mistake by over-tightening as the US economy careens off the cliff into a recession. If you believe I'm being too harsh, perhaps we should re-visit what was said just last year:

- Inflation is transitory, and will be back to 2% in 2022
- A recession is very unlikely
- Interest rates won't rise until 2024

Not a great call from an organization that reportedly employs over 400 Ph. D economists. But as they say, prediction is hard… especially about the future.

Speaking of prediction, our job as portfolio managers is to try and determine what the world might look like 6-18 months into the future. Markets are very efficient discounting mechanisms, so we must try and peer into the future to try to anticipate the anticipations of other investors. A clear picture is virtually impossible, so what we try to do is identify possible outcomes and then assign probabilities to them. Where our probability weighted outcomes are different to what the market is pricing, we can find asymmetric trading opportunities. We try to find trades where if we are wrong, we lose small, and if we are right, we win big.

Are we setting up for a rally?

October started the 4th quarter with a 5.7% jump in the S&P 500, which is the best start in history to a 4th quarter for the S&P 500. The previous best start was a 3.1% jump in Q4 1990. So, this begs the question, are we setting up for a rally in the coming months?

I should first remind readers that the sharpest rallies generally occur in bear markets, which is caused by sentiment and positioning getting to extreme pessimism, and then on the first rebound, short positions are forced to buy back their positions along with new buying, which can cause 5-10% moves in just a few days. It doesn't necessarily mean that the bear market is over, although that is how most bear markets end.

There are a few signs that we might have seen short term low, and it all hinges on whether we have seen a top in US interest rates. Interest rates have been rising quickly over the last 18 months, and we have seen the average US 30-year fixed rate hit 6.8% this week, up from a low of just ~2.7% just 2 years ago. The US has been leading the world in interest rate hikes, which has caused the US Dollar to appreciate faster than the other widely traded currencies.

We have been in a cycle of higher US rates causing higher US Dollar, and weaker equity markets. It thus follows that if we see a topping of rates (even if just for a few months), we might see this cycle pause or reverse, and thus equity markets could catch a bid. There are many economic indicators starting to suggest that higher interest rates are really starting to hurt the economy, and thus the market is beginning to believe the Fed might back off for a while, in a 'wait and see' approach.

We should not forget that it is the mid-terms elections in the US next month. Historically markets tend to rally into the final months before the mid-terms, and then we are into the Christmas period where often you get the Santa rally.

Silver had its best day this week since 2008, rising 9% in 24 hours. Gold was also very strong. The reason we pay attention to silver and precious metals is that this is signal from the market that they believe the Fed has likely started to capitulate on their rate hike path and are going to pause. The most bullish case for precious metals would be if the Fed was ever forced to put a cap on rates if bond yields continued to rally – which is also known as yield curve control. It is certainly in the range of possibilities, as we saw the Bank of England step in last week to control the yield on their bonds as their yields started spiking. The last time silver went up as much as this week was November 2008, and silver went up 400% in the next two and a half years. Another move like this in the silver price could only happen if the Fed was forced to abandon its tightening cycle.

The outlook for energy remains strong. Unfortunately, the Russian/Ukraine situation is not improving, OPEC has just agreed to cut 2 million barrels a day of production, and the US will cease drawing from the strategic reserve at the end of this month, which is another 1 million barrels a day cut from supply. At some point China will have to come out of lockdown. The transition away from fossil fuels is going to take decades.

Summary

If we shorten our timeframe down to several months, a market rally is certainly possible and looking like the most likely outcome. It is not often that sentiment gets this negative without some form of rebound. Longer term I believe we are still likely to be in the clutches of a multi-year bear market, but just like predicting the weather, the further out the forecast, the less accurate it becomes . It really does come down to what the Fed does and how much pain it is willing to cause. Many of the inflation drivers have been easing, and the interest rate hikes have been having a material impact, so there is a good case for a pause.

If you have any questions or comments, please drop me a line at tim.muirhead@gleneagle.com.au

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