22nd Oct 2023 // Quarterly Client BRIEFING

Dear Valued Client,

[Still] 'Cycling' into Recession…

> *"History repeats itself, but in such cunning disguise that we never detect the resemblance until the damage is done."*
> **...Sydney J. Harris**

When the world becomes turbulent, opportunities start to multiply.

Volatility is likely the theme of the coming quarters; in stocks, in bonds, in commodities and in currencies (also greater volatility in global trade, financial relationships and war unfortunately!).

From a human suffering point of view, this is not good. From a portfolio management perspective, this upcoming period is likely to give us opportunities to drive returns for the years to come.

What are some of these opportunities?

From a multi-year perspective, among other things, we see attractive propositions setting up in;

- **precious metals;** particularly royalty/streaming companies that are somewhat more immune to physical mining operations that will suffer from volatility in operational costs. Eventually capital flows will shift decisively away from the USA, when this happens upside potential in precious-metals like exposures are likely to be substantially turbo-charged. (Note that our capital flow models are still showing capital concentrating relentlessly into the US system, when these flows start to moderate and reverse we hope to be one of the first to pick up on this new development – the analysis of capital flows even in the largest of institutional settings is surprisingly problematic)
- **natural resources;** starting with energy (which is suffering a cyclical & structural deficit of CAPEX & new exploration of significant magnitude) and then progressing quickly to many forms of strategic and then core industrial commodities
- **technology and manufacturing/productivity renewal themes;** within which any incoming volatility is likely to present the ability to purchase some great companies well positioned for growth in these areas
- **growing dividend income;** companies that offer a compelling pathway forward to be able to grow dividends in a world where fixed income markets are likely to continue to become more problematic (or negatively impacted by more 'activist' policy environments) are also likely to become conspicuously well supported in the years to come also

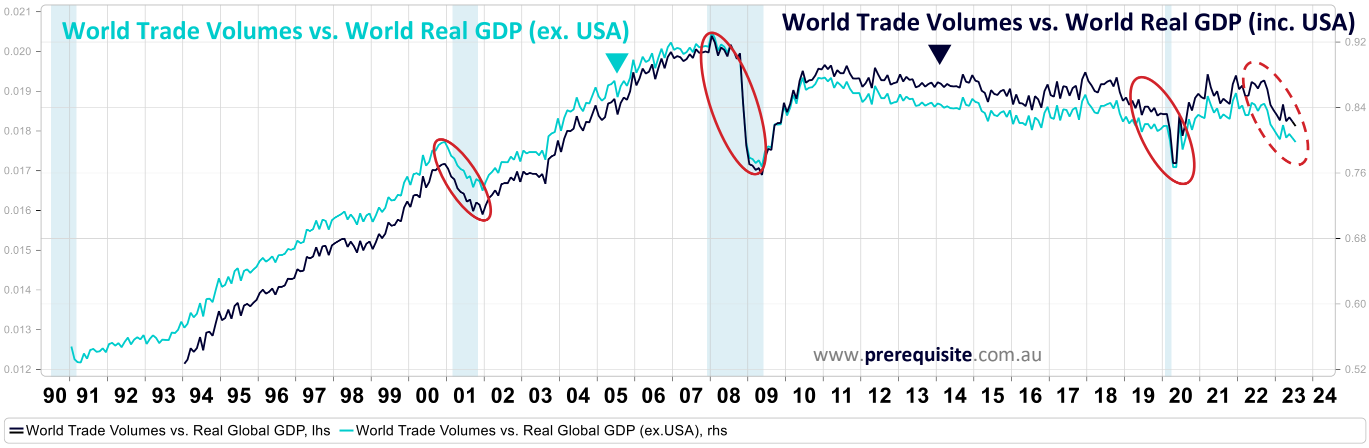
In the meantime, we suspect the uranium story will likely continue to unfold favourably and the warnings of the current economic cycle (set within a tightening banking & liquidity backdrop) will cause US dollar cash and *soon* collateral assets to potentially perform well in the interim.

Within the above backdrop, this Letter seeks to update conditions, and to identify the likely behaviour of key asset classes over the coming quarters.

CYCLES: ***Recessionary conditions***

Updating some of the charts from our last Quarterly Letter, we can see that the current downswing in both economic activity & potentially asset markets are unfolding largely according to schedule…

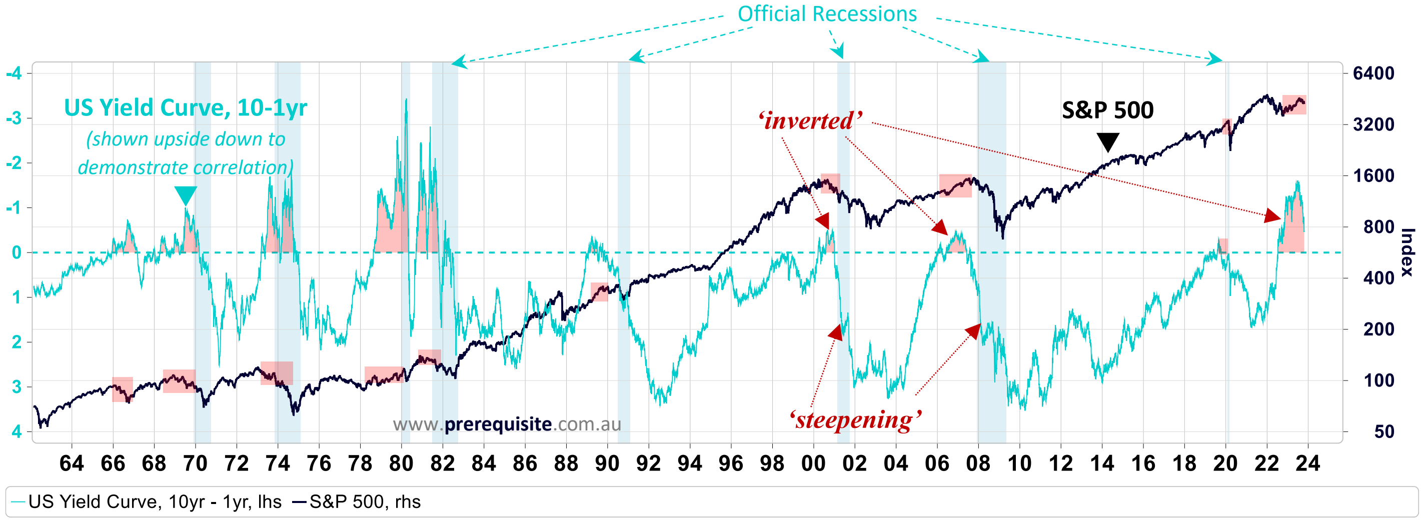
Currently the world is continuing into recession…



In many of the major regions of the world **we have an inverted yield curve which history demonstrates is one of the most reliable forward warning indicators of recession.**

But if we're going into recession, then why are equity markets still holding up?

An inverted yield curve is a high-probability leading indicator of recession but whilst the yield curve is inverted, more often than not the equity market is *'holding in there'*… it is not until the curve is 'steepening' again that recession is really kicking in and usually assets are strongly selling off…



This would suggests the prospects for equities in the quarters to come could be 'challenging' to say the least – but this is exactly one expression of the 'turmoil' we were talking about at the beginning of this letter! This basically just sets up better buying opportunities in a variety of assets.

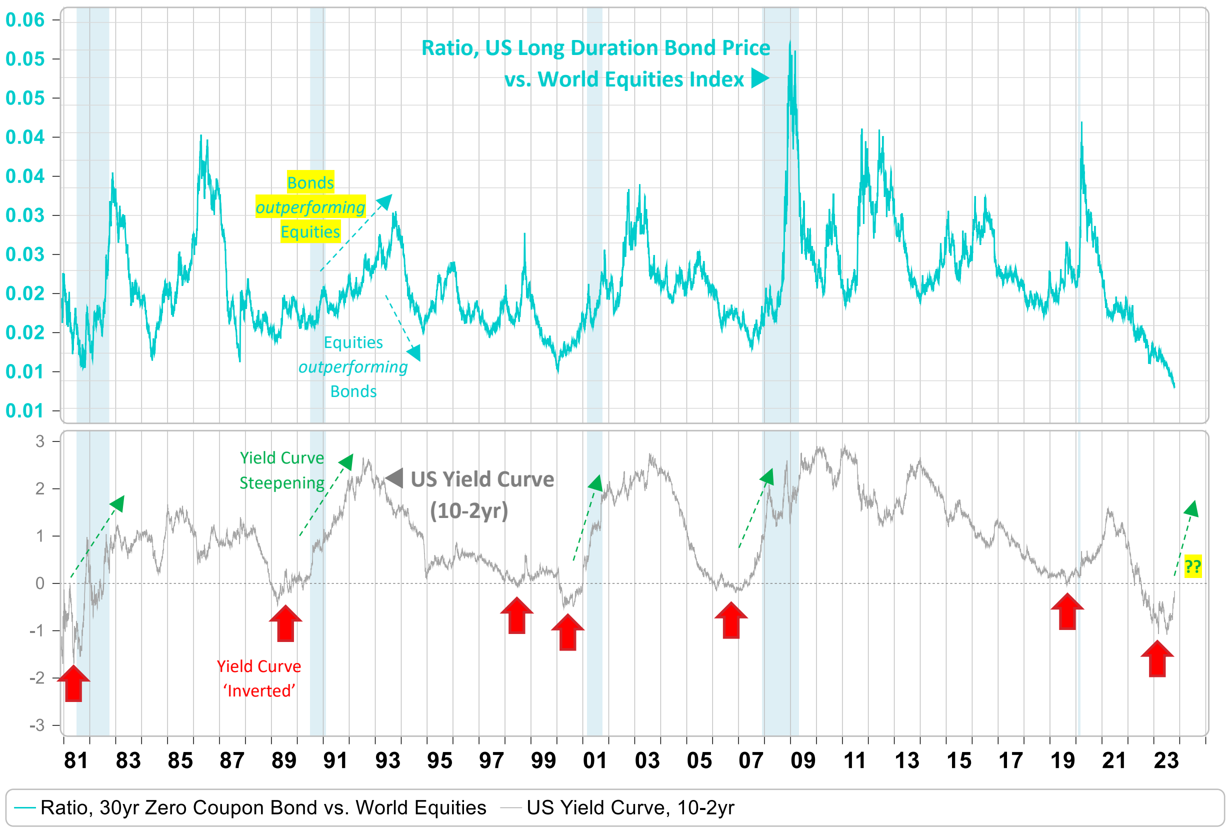
The bearishness (negative views) towards US Government Bonds are substantial at the moment, and for good reason. US Government fiscal irresponsibility is significant, the Fed are still in a rate-hiking cycle and there are ample concerns around foreign holders of Treasuries selling them indiscriminately. Basically an abundance of supply and scarce demand for US treasuries (and sovereign debt of countries all around the world).

Yet relative to historical experience, we may be at a 'peak' negative in relative performance vs. world equity markets, and if history is any guide, it would suggest we should be starting to consider that such supply considerations might be more fully in the price, and the marginal changes in the supply/demand balance of conditions might be towards demand once again waking up?

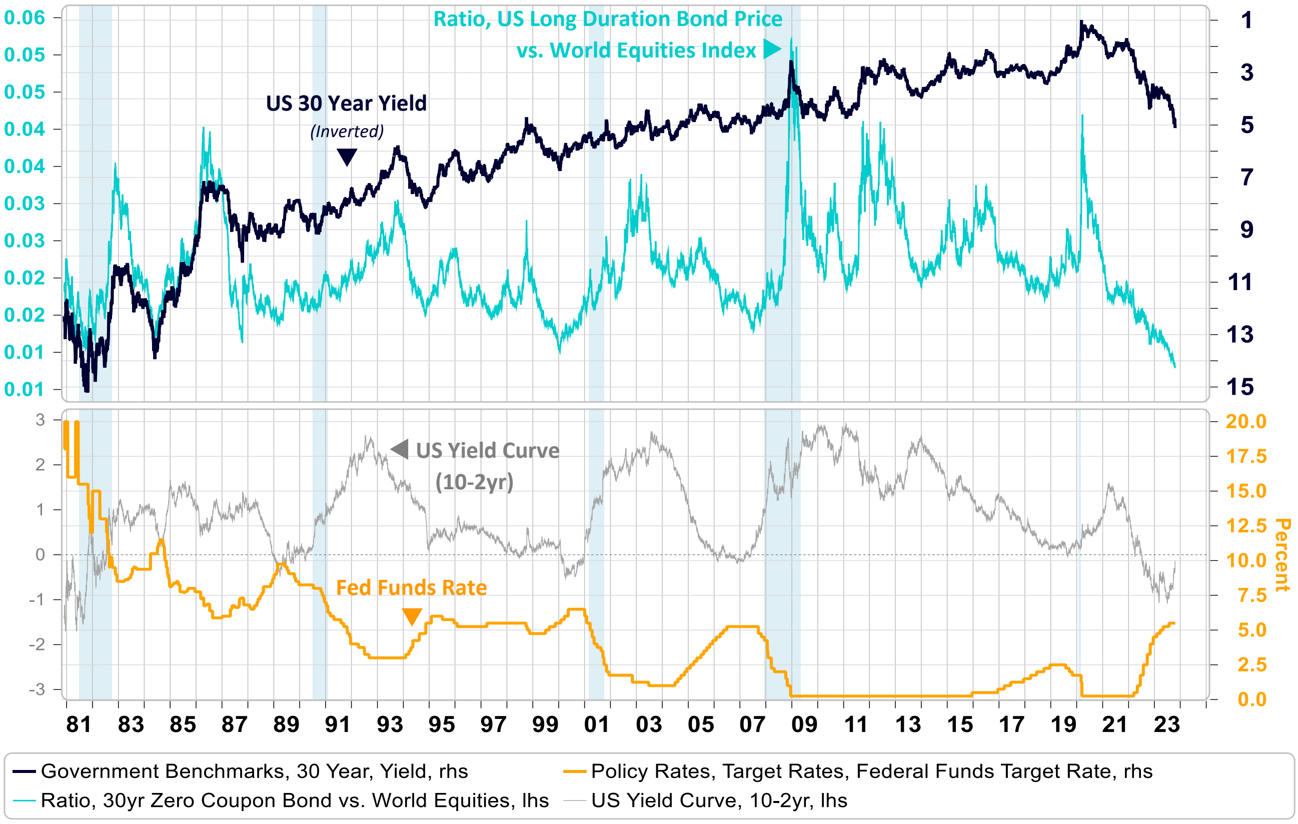
CYCLES: ***bonds vs. stocks***

In the below chart, it is interesting to see the broad cyclical correlation between the **Bonds vs. Equities Ratio** (top panel) and **the US Yield Curve** (bottom panel).

Typically, bonds are performing their worst coming into an inverted yield curve environment, however, on a forward looking basis, some of the best buying opportunities in history present themselves when the yield curve has been inverted (see red arrows) and is starting to come out of that inversion back into a 'steepening' condition (see green arrows).



Taking the same chart from the previous page, and adding both the **30 year bond yield** (inverted in the top panel) and **the Fed Funds Rate** (in the bottom panel), we can see that when the yield curve is inverting, and if the Fed are close to their peaks in their rate hiking cycles, it has typically been the best time to reallocate away from equities and towards bonds…



There are many arguing that 'this time will be different' – that Bonds won't rally during the recessionary yield curve steepening phase because of inflation, the foreign dumping of treasuries and fiscal deficits etc.

Although our analysis (in our Videos & monthly publications) is much more expansive than what is discussed here, we would suggest briefly that:

a) Inflation is not as bearish bonds as you would think. Why? Because this is a supply side disruption still, causing in particular the 'real' price of oil to rise (acting like a global tax on economic activity for most of the developed world), thereby causing downward pressures on global demand. We are also experiencing a globalised tightening cycle of credit & liquidity, which as it plays out usually causes nominal US treasury yields to fall. So a jump in inflation expectations & yields due to oil-supply fears (& rate hikes) whilst demand & monetary conditions continue to worsen, actually lays the groundwork for a treasuries bid during the coming collateral scramble phase of the credit default cycle that is brewing (which usually occurs during a bull-steepening phase in the yield curve).
b) The narrative that foreigners are dumping treasuries seems greatly over-blown, many of the datasets measuring foreign purchases of treasuries are indicating net inflows the higher the yields have gone.
c) Fiscal deficits are largely visible, known and reasonably predictable – which means it's increasingly likely to be factored into the price of bonds to a large degree.

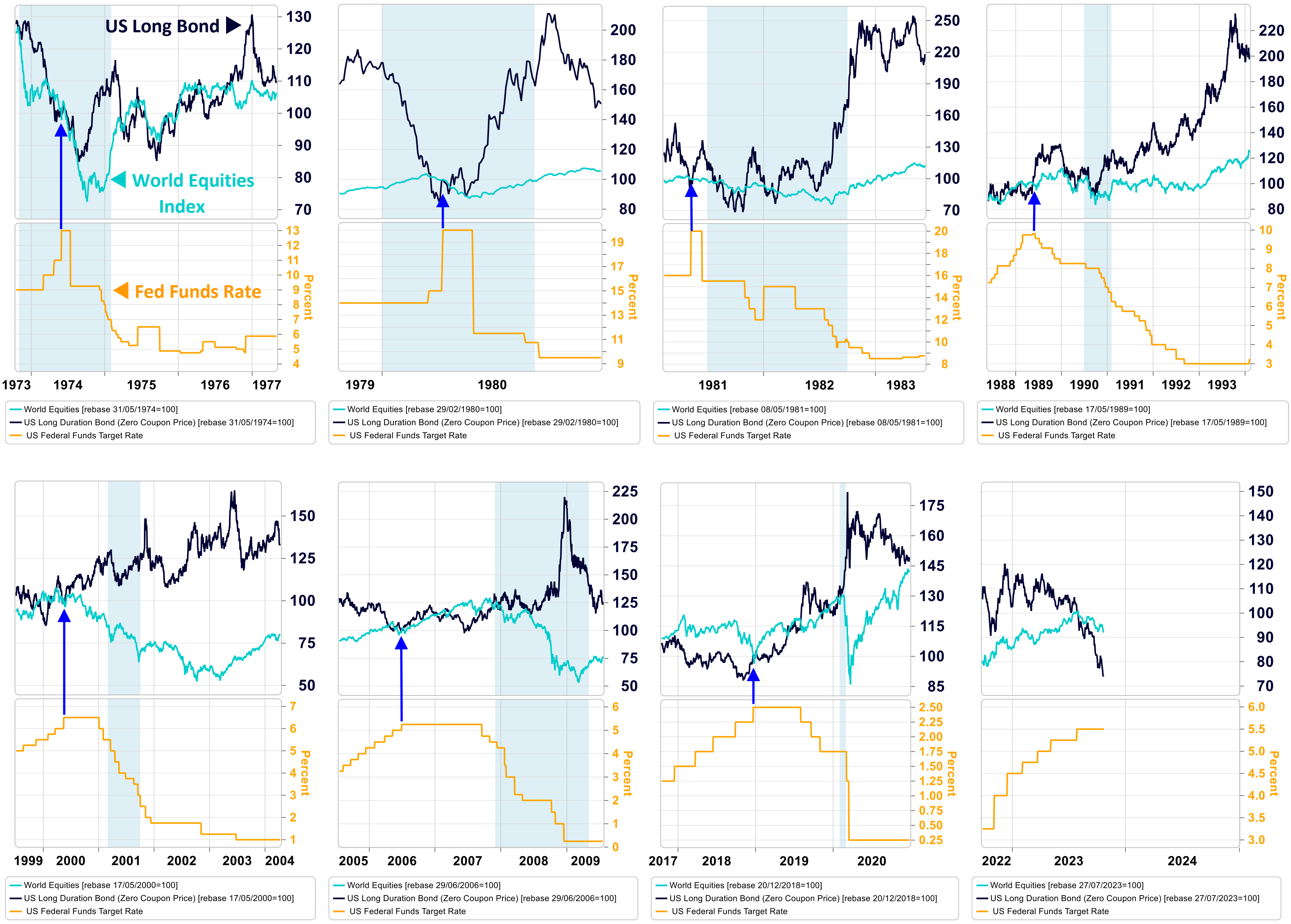
…basically what this means is that everyone who has sold or stayed away from bonds 'because of inflation & deficits' has likely already done so – which means it's not likely to take much to catalyse new demand 'at the margin'. Even the BIS have been warning lately about excessive derivative exposures to interest rate markets, and we can see significant short positions of the leveraged speculative crowd in the bond market – such may be susceptible to quite a short-squeeze. **In our recent Research Videos we detailed the demand dynamics that many are under-appreciating, that are likely to come back online in the months to come (we also demonstrate the data-driven historical dimensions to support this).**

From another way of looking at it… If everyone is selling, then why are volumes traded so huge in nearly all US Treasury Bond securities? Whilst 'everyone' is selling, we are witnessing large institutional patient money participants accumulating extremely strongly. History and the likely development of present conditions suggests that such holdings are likely to be well rewarded in the quarters to come (but on a multi-year basis however they are probably going to lose on the currency side of this investment position). So – during the collateral scramble phase of the yield curve steepening (& credit default cycle biting), treasury bonds should do really well, but once those conditions have passed, it is likely that we will need to reassess and reduce any bond exposures.

So, when the Fed finishes it's hiking cycle, is this time likely to be any different to the last 50 years of experience? No, we don't think it will. Bonds are likely to *temporarily* do well (for a few quarters perhaps).

TIGHTENING CYCLES *& bonds*

Below shows the indicative performance of US Treasury Bonds & World Equities *from the date of the last hike* in ***the US Fed Funds Rate*** (proximate to the major recessions over the last 50 years)… basically you can see **US Long Duration Treasury Bonds** generally out-performing thereafter (global equities can also be seen to struggle after the last rate hike).

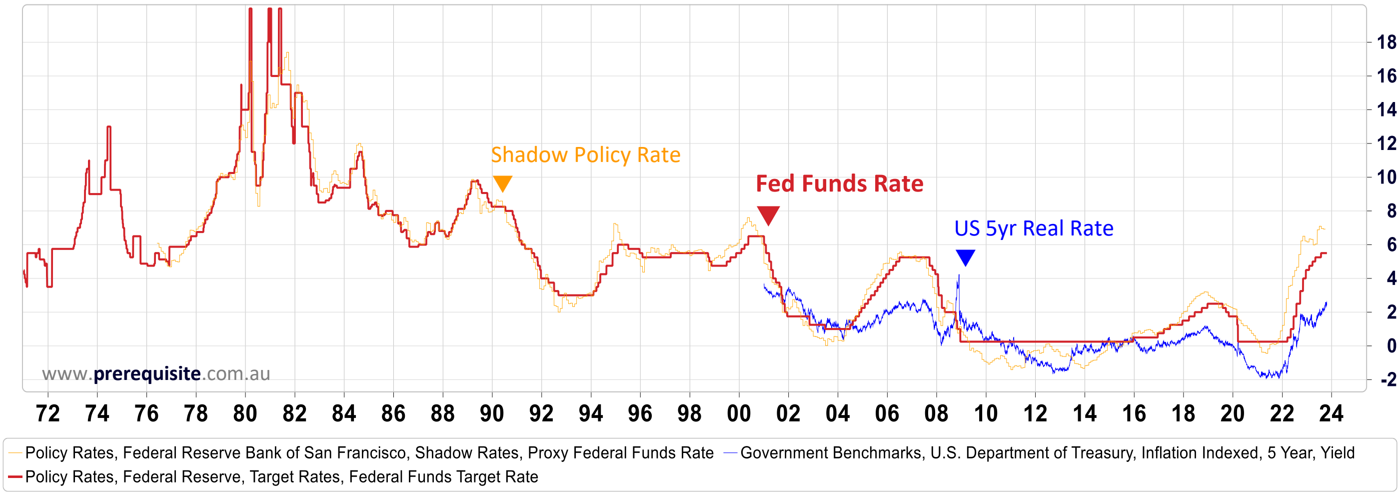


*US Long Bond = 30 Year Zero Coupon Price (20 year yield substituted prior to Feb 1977, duration adjusted to a 30 year Zero Coupon Price for comparative purposes)
**Price Return Index utilised (i.e. excludes dividend reinvestment)

Obviously knowing the date of the last Fed rate hike can only be known with the benefit of hindsight. We suspect that we are likely close to the last rate hike of this cycle, but not yet. Possibly in the weeks/months to come we may be able to probabilistically declare it likely that we've seen the last? A useful indicator is when the yield curve moves out of it's inverted state (i.e. it steepens to the point of being positive again), we are closer to this happening, but not quite there yet.

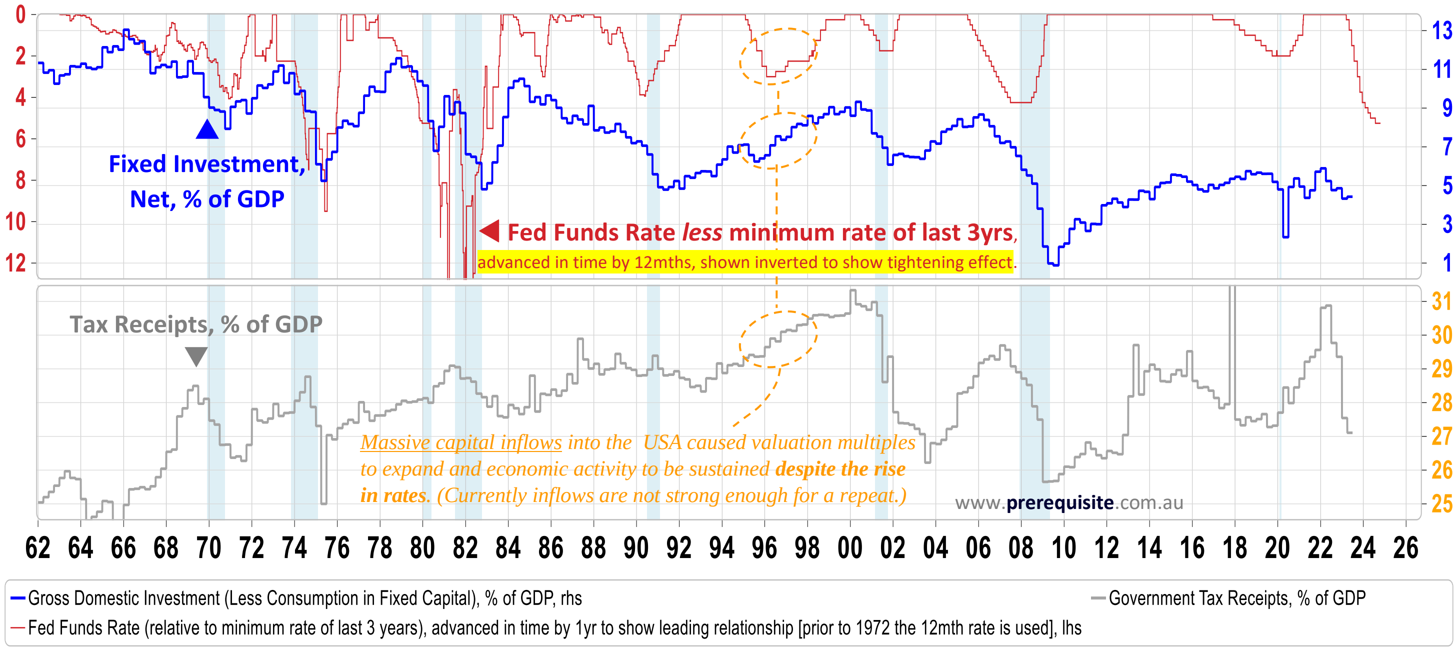
CYCLES: *force-FED Recession*

Updating some of the charts from our last Quarterly Letter… It is also worth noting that the latest tightening cycle of the Fed has been exceptionally extreme and rapid relative to historical experience…



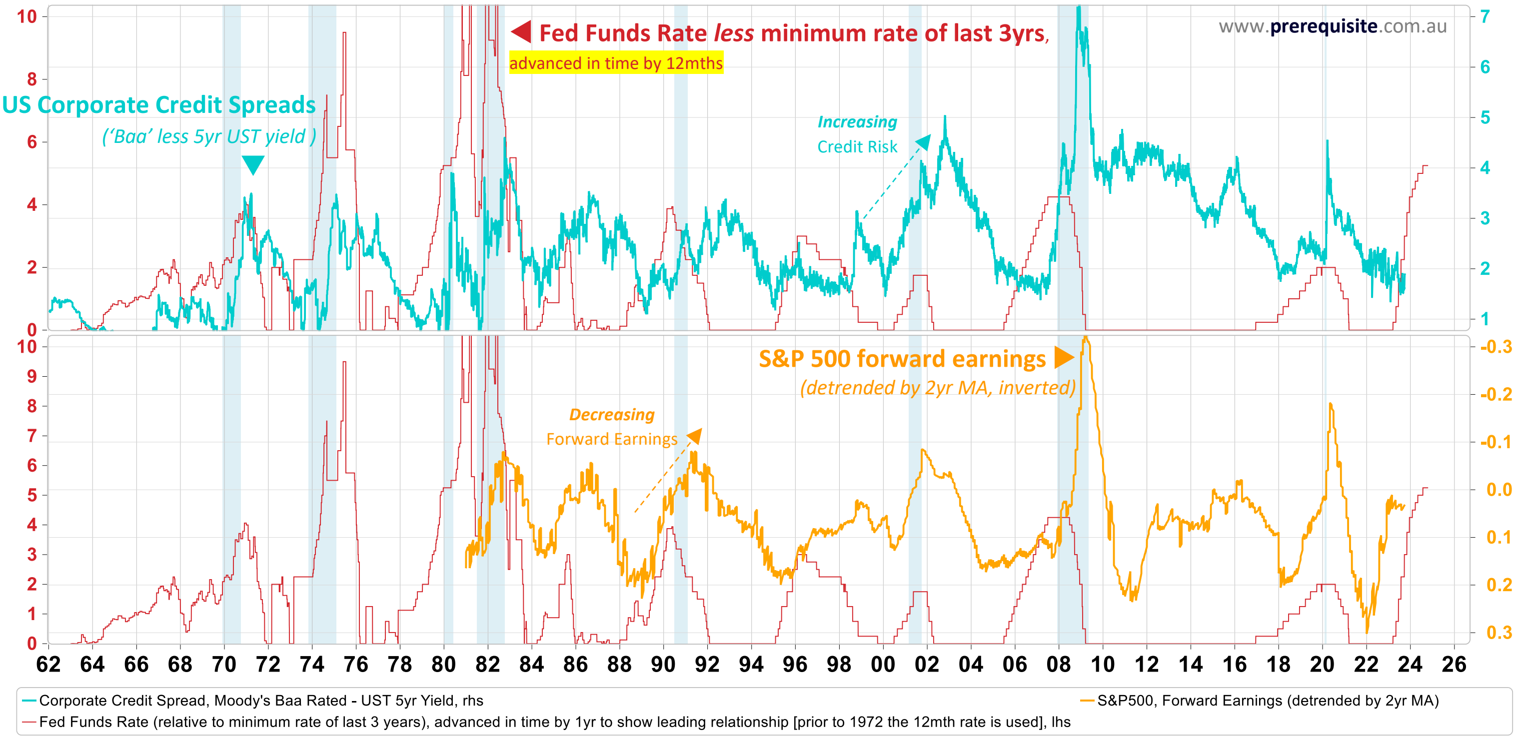
Such a 'tightening' *when we push it forward in time by a year*, shows the way it tends to 'bite' on cyclical aspects of the economy, particularly investment spending – which when in the context of a 'weak' broader economic system may cause Tax Revenues to also collapse, and we have recession…

This clearly paints a picture that **recession is not only immediately probable but it has likely already begun.**

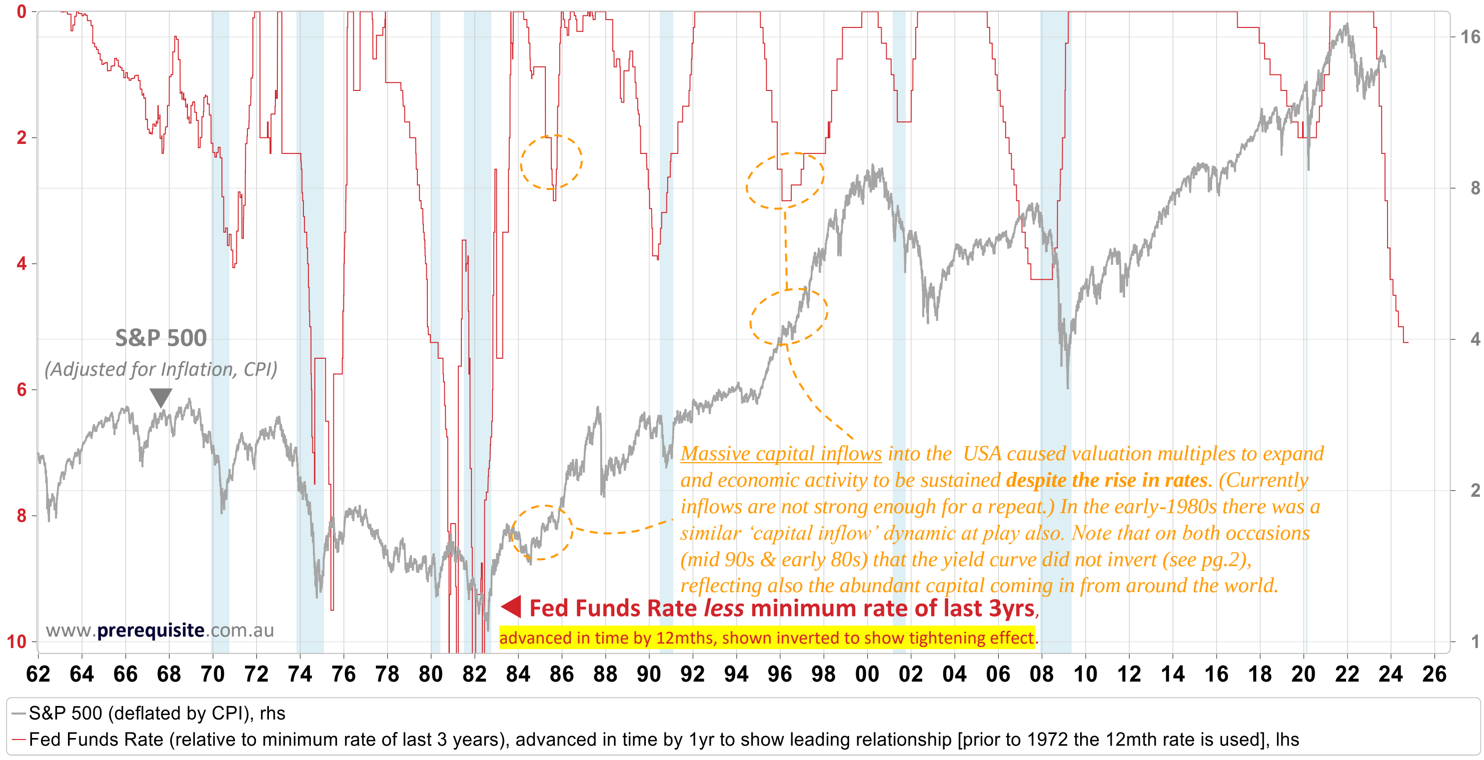


TIGHTENING CYCLES *& equities*

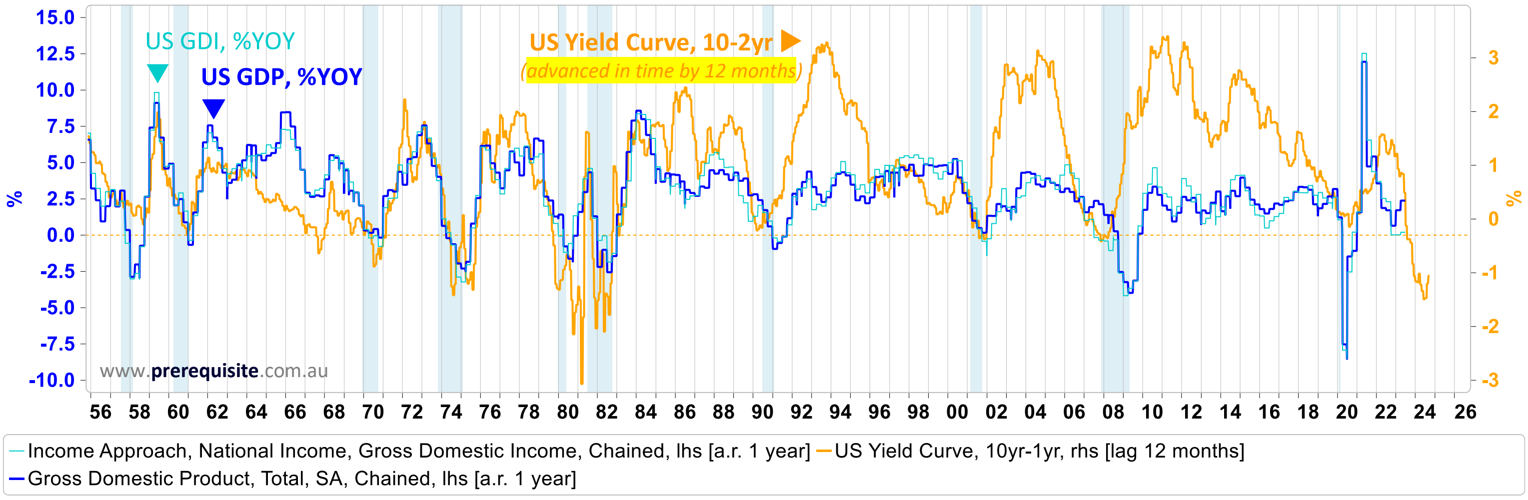
With the exception of the 1995 tightening cycle where normal cyclical economic dynamics were steamrolled by massive capital inflows into the USA (which historically also tend to buoy valuation multiples) – every spike higher in Fed Funds rates has led to a worsening credit & profits cycle circa 12 months later… **it suggests further 'sharp' contraction in profits and credit conditions <u>both imminently and into 2024</u>:**



Currently we don't have capital inflows into the USA anywhere near the magnitude required to repeat the mid-1990s bull market in US stocks *despite* lacklustre earnings expectations (this could change so we need to monitor flows) or to prevent an inverting yield curve… but **it is likely that we get a 'real' bear market in equities (consistent with every other tightening cycle since the early 1960s) into 2024…**



History seems to be repeating on schedule… and if this is roughly any guide, it is likely that the recession will bottom sometime mid 2024 which would likely be around the time many high quality assets are likely to be trading at more attractive prices.



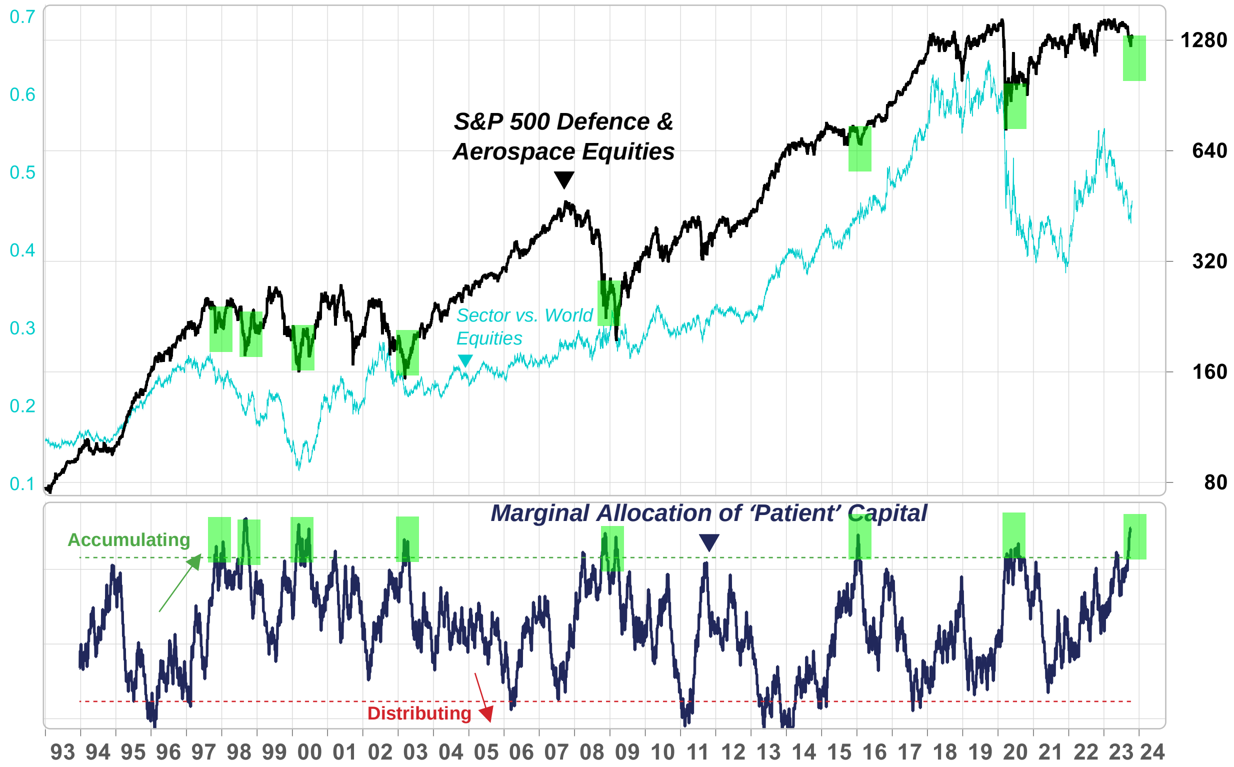
GEOPOLITICAL UPDATE: *Dangerous Preconditions*

Clients will be likely familiar with the Geopolitical Series of Research Videos that we've been producing over the last 6-9 months.

In September we were able to use some of our proprietary long term 'capital market' implied ***real yield*** models [giving us a longer history to review than TIPs yields that only go back to the late 1990s], in addition to ***capital flow*** and ***sovereign risk premium*** modelling – to go through the history of the last hundred years to explore the common characteristics that occur in the lead up to significant conflicts in the world, even World Wars I & II. We explained:

> *When we look at the way capital markets seem to be moving and pricing different things in the broader constellation of what is happening in the world… We basically see a constellation of conditions that is a little bit similar to the buildups or the early phases of World War I and World War II and also some of the other minor conflicts that the U. S. have been involved in over the years, like the Korean War, Vietnam, Iraq and Afghanistan [Wars].*
>
> *…we have a fairly common pattern when it comes to real yields… usually they're driven up with the escalating sovereign risk premium being priced into U. S. assets. More generally, we also tend to see a fairly common pattern with regards to capital flows because of the nature of the way the world has been the last 100 years, typically conflict in the world… [has] seen a bias towards capital heading more towards the U S. And obviously anytime we're seeing either major or minor conflict in the world, you tend to see commodity prices and, inflation supply related inflationary pressures shifting higher. And we basically have that same configuration today.*
>
> *…from a risk management point of view, we need to probably start to get a little bit more serious about thinking through scenarios where geopolitical outcomes or surprises could be of a negative characteristic over the next 12 to 24 months.*

It's probably also not a great sign that large institutional money is accumulating defence sector stocks quite aggressively again (see chart next page).



CYCLES: *Conclusion*

Rising uncertainty in the world tends to be counter-cyclical (i.e. when uncertainty rises, economic performance tends to weaken). This is because growth conditions are underpinned by both confidence and trust. With increasing uncertainties, we see more risk adverse behaviours and a greater propensity towards mistrust. This tends to result in increased volatility, it also tends to be accompanied by credit-default cycles as adverse trade & business conditions start to cause the fragility in the system to be exposed.

Increased volatility conditions tend to equate to increased investment opportunities.

So to summarise, at the moment conditions tend to favour USD cash type exposures, however opportunities in US Treasuries & Precious Metals are beginning to present – this could help us to do well through the collateral scramble phase where recession or crisis conditions predominate. After this, it is likely that there will be great opportunities to be buying great companies at better prices.

We hope this has been a helpful Letter. As always, please feel free to contact us should you have any questions about your portfolios or the conditions unfolding in the world.

Kind regards,

The PCM Team

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