INVESTMENT COMMENT May 2023

- **A Pause in Rate Hikes**

The recent banking turmoil in the U.S. has further added to the already tightening monetary conditions. Higher debt servicing costs have taken a toll on other areas of the economy such as real estate where foreclosures have increased for 23 straight months. Yet continuous rate hikes have had little impact on unemployment which remained stubbornly low at 3.4%.

We expect the Fed to take a pause raising rates rather than relentlessly fight to achieve an inflation rate of below 2% - still far away from the current 4.9%. The U.S. mega-cap tech stocks' (FAANG – Google, Apple, Amazon, Netflix, Meta) near 40% year-to-date rally may be a testament to this view. Typically, higher rates hurt growth stocks even more than value stocks.

- **Raising the Debt Ceiling – But at What Cost?**

U.S. Treasury Secretary Yellen has warned Congress of the potential consequences of inaction should the debt ceiling not be raised on time. The dispute has pushed one-year CDS spreads for the U.S. above those of Mexico, Brazil and Greece – a sign of heightened default risk.

As long as the USD remains the global reserve currency, the world would continue to finance high levels of US debt. Yet the current annualized debt financing cost of USD 930 billion is already higher than the defense budget. This does not bode well for the U.S. dollar.

- **Why are Chinese Equities Not Rallying?**

While New York is full of frustrated bears who expected a bear market that has not happened yet, Hong Kong is full of frustrated bulls. Asian investors had expected tailwind from the re-opening of China. After the initial boost, Chinese equities have lost steam and are flat year-to-date. As international investors remained on the sidelines, the market's underperformance is due to the lack of buying by Chinese investors. Some may have lost confidence after the country's handling of the Covid lockdowns.

Yet companies that benefit from Chinese luxury goods demand (which account for 17% to 19% of global luxury goods spending) have rallied. Equities such as LVMH are offshore alternatives to capture China's growth, albeit currently at a nice premium. Furthermore, other Asian regions, such as India and Vietnam, are attractively positioned to pick up investor demand.

- **What Warren Buffett is Doing**

During the first quarter Warren Buffett sold equities worth more than USD 13 billion. The rationale was lower earnings expectations and higher interest rates. At the same time, he added to his short-term treasury exposure and predicted that Berkshire Hathaway will receive interest payments north of USD 5 billion this year.

- **Asset Allocation**

We remain underweight equities and continue to hold predominantly short duration fixed income. We continue to like gold. Continued central bank buying, tight physical supply, a weaker U.S. dollar as well as a technical break-out on the upside should carry this safe-haven asset higher. Times remain uncertain; we will not get compensated for being heroes. We are keeping higher cash levels in money market funds – opportunities will come our way.

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