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Market Overview Q1 2024

Projections and outlook

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April 2024

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Executive Summary

In the first half of the year, the global economy continued to demonstrate the trends of recent years, namely the growth of geopolitical risks amid moderate de-globalization and the isolation of central banks in developed economies. At the same time, regional economic clusters are strengthening, and the preconditions for trade wars over resources and areas of influence are becoming more pronounced.

From a macroeconomic perspective, the US is showing signs of resilience, relying on the factors of a strong consumer, labor market and declining inflation, while leading economic indicators demonstrate a potential deterioration in each of these factors. At the same time, the stock market is absorbing the negativity, gradually increasing its concentration. However, this year, the Mag 7 group of companies has been reduced, as Tesla shares have shown a decline amid deteriorating sales figures. The same list includes Apple and Google shares.

This extreme concentration of stock market returns has a negative impact on diversification and risk characteristics, raising more questions about future prospects and, most importantly, the drivers of equity growth. The Fed is continuing its interest rate policy, but the number of interest rate cuts by the end of the year remains the main issue that directly affects the pricing of bonds, currencies, and commodity markets.

We believe that interest rate policy and information related to its prospects will be a determining factor in the coming quarter, not only in the US, but also in other emerging economies where post-covid inflationary effects have only just begun to fade. Recessionary fears may intensify in the upcoming quarters, and equity and bond markets are likely to add to volatility.

In this context, we recommend strategically:

Stocks
- companies from non-cyclical sectors of the economy
- companies with Low Beta, high FCF Yield, high FCF generation, high EPS revisions for the last 3 months and high Cash/Total Assets

Fixed Income
- rotation from short-term securities to medium-term US government bonds (7-10 years)
- corporate bonds with high credit ratings

Global Markets
- Europe: non-cyclical sectors of the economy, companies with low Beta, low Net Debt/Total Capital, high Cash/Total Assets, high ROE and high FCF Yield
- China: consumer discretionary and staples, industrial and technology sectors

Commodities
- gold, silver, industrial metals

Key events of Q1 2024:

- An inflationary spike: there was (and still is) a risk of a new wave of inflation. This is exactly what happened in January-February, which led to negative market reactions, a revaluation of macroeconomic forecasts, and the future Fed Funds rate;
- Magnificent 7 was reduced to Magnificent 4: Apple, Google, and Tesla shares dropped out of the group;
- The S&P 500 has renewed its all-time highs, but this growth is more driven by the growth of BigTech companies than by all sectors of the economy in general;
- The crisis of regional banks: negative news from NYCB has contributed to pessimism about the stability of regional banks.

Alternative scenarios by the end of the year:

- S&P 500 growth by 20% (median consensus 5,150, i.e. -2% of current prices);
- Decline in China's nominal GDP to 3% (consensus growth of about 5%);
- Rise in the US bond yield curve to 2% (baseline scenario: about 0.5%);
- The European pharmaceutical sector will resume growth (it has begun to adjust);
- Restrictive measures prevent Trump from being elected (exit polls indicate a Republican victory);
- Apple's capitalization will drop below $2 trillion (currently $2.65 trillion);
- High-yield bonds will be the fastest growing sector among fixed income instruments (corporate risks are growing).

In Q2 2024, it is expected to:

- The global economy will continue to slow, with central banks continuing to synchronize;
- A temporary increase in inflation will not stop the Fed from cutting interest rates;
- In Europe, the growth of peripheral economies will strengthen, especially in relation to Germany;
- China will continue its stimulus policy, particularly aimed at the stock market;
- The overheating of prices of certain commodity assets will continue to correlate with the dynamics of stock indices and investors' risk appetite;
- Central bank liquidity factors will gradually begin to regain influence on the market.

Market positioning:

- Given that the Fed is likely to be close to the peak point of monetary policy reversal, it makes sense to position in US government bonds;
- In the US and European equity markets, choose stocks with Defensive-Quality characteristics (with a greater focus on free cash flow generation factor);
- Hedging may be increased based on the high valuations of the US and European stock markets.

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STRATEGY

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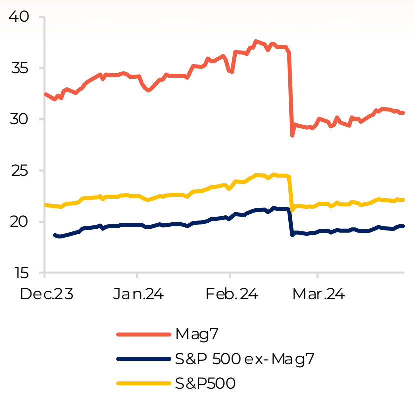
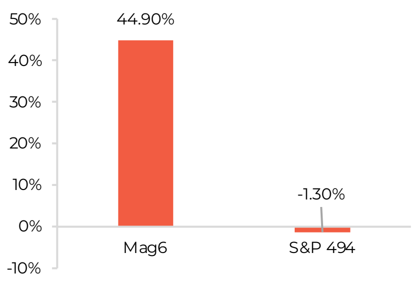
Chart 1: Dynamics of the P/E multiple



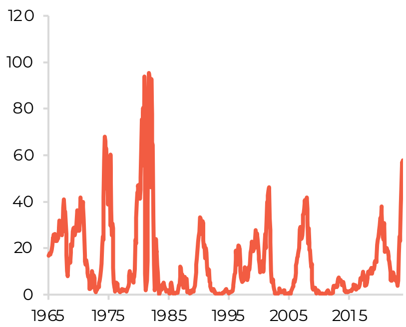
Sources: Bloomberg, Blackshield Capital

Chart 2: EPS growth for Q4 2023 S&P500 and Magnificent 6



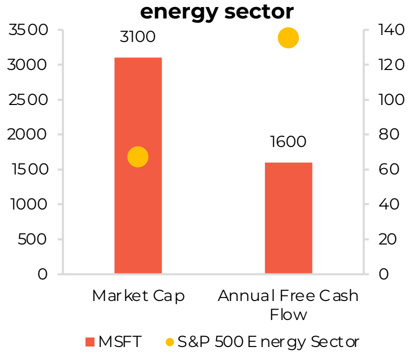
Sources: Bloomberg, Blackshield Capital

Chart 3: The Fed's probability of a recession in the US



Sources: NY FED, Bloomberg, Blackshield Capital

Chart 4: Comparison of Microsoft vs. companies from the energy sector



Sources: Bloomberg, Blackshield Capital

Strategy

One of the relevant, but not yet widely discussed, topics this year is the "new normal," or economic or market conditions that seemed abnormal in the past, but in the era of changing technology stack and investor profile have become usual and do not cause market panic. It is difficult to imagine what the profile of an investor or investment analyst will be in 20 years, who first entered the investment world in the era of covid and covid incentives, overt QE, and covert QT, where the dynamics of stock indices, which are the present and future of institutions, pension funds, and retail investors, is determined by the timing and content of Magnificent 7. And although it is unpopular to use the term "bubble" to describe what is happening in the market at the beginning of 2024, it is hard to escape the feeling of déjà vu of previous crises.

Some of the economic conditions are more extreme than the stock market peak of 2000, in particular we have previously focused on the extreme concentration of the market, where the concentration of growth stocks is even closer to the Nifty-50 era of the early 70s. Such a concentrated index poses a serious threat to hedge fund managers, as the only way to outperform a benchmark in the form of stock indices is to pursue a number of stocks with extremely high valuations. This not the most reasonable decision from the risk management point of view (FOMO) is a certain consequence of the Fed's policy and the behavior of the modern investor in the new reality with a new perception of " normality".

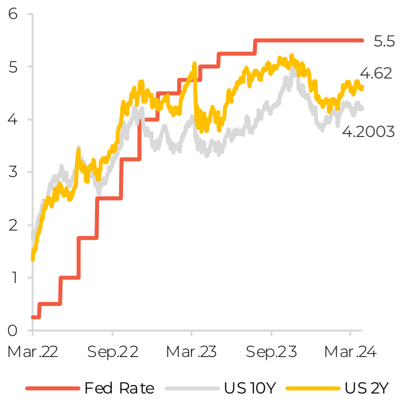
One might argue that today's high valuations are justified by the dominance of tech stocks in the S&P 500. There is certainly some truth to this claim. While it is true that the S&P 500 would have traded at only 19 times projected earnings if Alphabet, Amazon, Apple, Meta, Microsoft, and Nvidia were excluded from the index (Chart 1), it is equally true that the earnings of the remaining 494 stocks were down 1.3% year-over-year in Q4 2023 (Chart 2). In any case, it is far from clear that these so-called great stocks will remain so.

This quarter, the terms Magnificent 6 (which clearly increases concentration) appeared because Tesla shares have been the worst performers in the S&P 500 index among the top names this year, as well as Magnificent 4, which also excludes Apple and Google. History is full of companies such as RCA, Kodak, Polaroid, Atari, Commodore, Nokia, Novell, Digital, Sinclair, Wang, Iomega, Corel, Netscape, Altavista, AOL, Compaq, Sun, Lucent, 3Com, and RIM, which were once key players, and now not even all of these names are known to a wide range of investors.

At the same time, it is worth noting that the official NY FED recession probability indicator continues to grow, which directly indicates the overall risks in the economy (Chart 3). In such an environment, it is difficult to say that companies from the Magnificent 7 can avoid such a scenario like their predecessors.

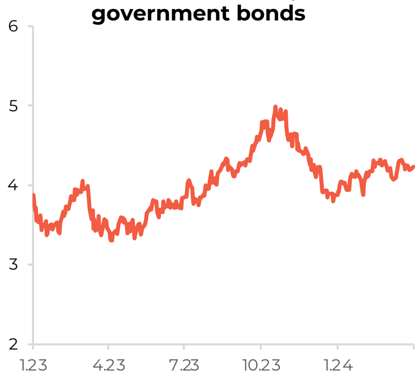
Even if Nvidia escapes the fate of these companies, it will not make it a good investment at current valuations. There is one important nuance here that is related to AI and the technology and semiconductor sector. And while there are some attempts in the direction of energy efficiency with regard to cryptocurrencies (Ethereum's transition to a new protocol, the emergence of significantly new token mixes), AI cannot exclude the energy component from the equation. The growth rates that the market expects in anticipation of the future profits of such companies cannot be achieved without a significant energy crisis and market rebalancing (Chart 4). This resonates with the scenario of the 1970s, when, among other things, stagflation developed. But at least now we see a great deal of market interest in assets outside of the stock market - debt instruments, commodities, metals, etc.

Chart 5: Dynamics of the Fed Funds rate and yields on 2 and 10 year bonds



Sources: FED, Bloomberg, Blackshield Capital

Chart 6: Yields on 10-year government bonds



Sources: Bloomberg, Blackshield Capital

Fluctuation range of 10-year bond yields and its interpretation:

- *5.0-5.5%: Challenges for most stocks;*
- *4.5-5.0%: Yields above 4.5% created problems for low-quality securities and high-risk stocks;*
- *4.0-4.5%: Normal conditions for the stock market, stocks with stable corporate profits will grow;*
- *3.0-4.0%: A decline in interest rates will have a positive impact on most stocks if it is not caused by a crisis scenario;*
- *2.5-3.0%: A decline from 3% can only be a consequence of weak macroeconomic data or corporate earnings;*
- *2.0-2.5%: Only possible in case of a very deep crisis.*

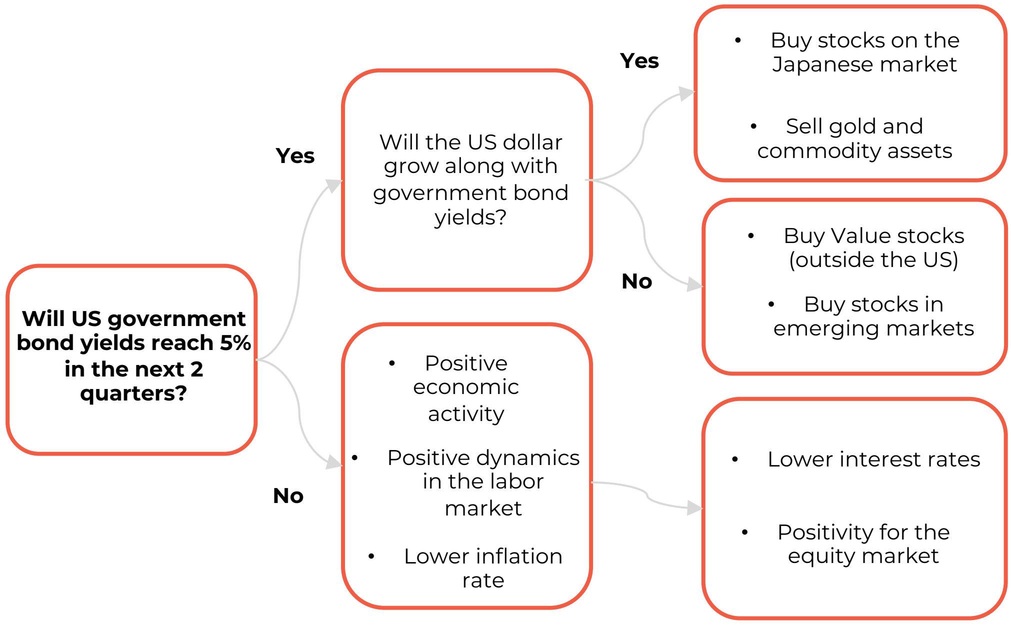
In mid-October, the yield on 10-year US government bonds reached 5% (Chart 5). Over the next 10 weeks, they declined aggressively, reaching 3.8% by the end of 2023. Since then, yields have risen again to almost 4.2%, just above the 200-day moving average. So what has happened over the past four months?

Economic growth in the US has been much stronger than expected. From US GDP figures to ISM surveys and US job openings, a number of signs point to the economy continuing to grow.

- Inflation expectations (based on five-year forecasts) have fallen from 2.5% to 2.25%, and a number of inflation data (including wage inflation) indicate that the worst of the inflationary surge is behind.

An important point is that in the current environment, many categories of market participants have consciously or indirectly started to build their investment strategies around interest rate policy. This applies not only to the debt markets (for which interest rates are one of the main factors in decision-making), but also to the stock markets (Illustration 1).

Illustration 1: A step-by-step understanding of the economic and stock market context



Source: Blackshield Capital

The interest rate divergence (target-actual) has become the main driver of the equity market's growth. In the near future, a possible market correction will depend more on interest rate expectations than on a decline in economic growth.

In fact, we have all witnessed a paradigm shift in investor psychology, as inflation and interest rates (along with employment) have become the dominant macroeconomic category.

The numbers speak for themselves: compared to 10 years ago, the number of economists forecasting inflation has increased by 56% (from 30 to 47), and the number of economists forecasting the labor market has tripled since 2022 (to 27).

Eventually, this relationship between markets and interest rates led to a negative correlation between interest rates and stock prices for the first time in decades. This effect usually reverses after a significant market correction or recession. In the meantime, the "not too bad news" = "good news" coordinate system will remain in place for some time (Chart 6).

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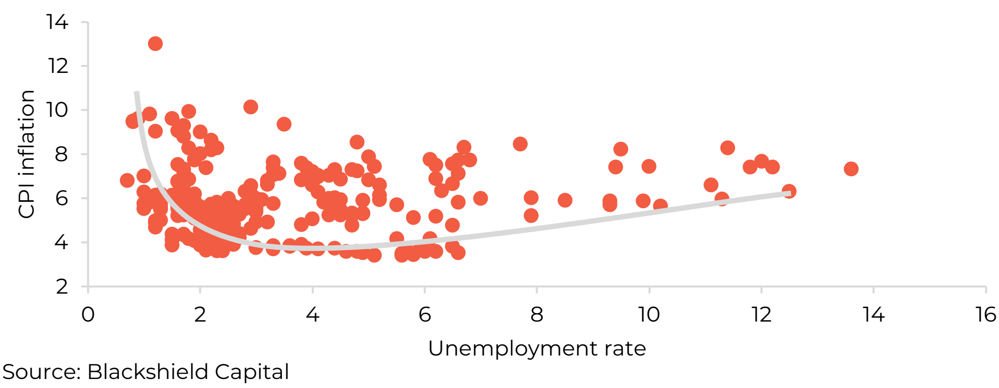
The Phillips curve is an economic concept that states that inflation and unemployment have a stable and inverse relationship in the short run, i.e. higher inflation is associated with lower unemployment and vice versa. This is because economic growth is followed by inflation, which creates more jobs and reduces unemployment.

As for the labor market, there are only three critically important arguments:

1) There is a direct correlation between inflation and employment, called the Phillips Curve (Chart 7).

Chart 7: Non-linear relationship between inflation and unemployment



Source: Blackshield Capital

Why can't the unemployment rate fall and stay low? This concept is based on the idea that inflation becomes more sensitive to changes in economic stagnation when the economy is approaching full employment. When many people are unemployed, firms can hire more workers without offering them significantly higher wages. By contrast, when everyone who wants a job has a job, the only way firms can hire more workers is to lure them away from other firms. To do so, they need to offer higher wages, which puts upward pressure on inflation.

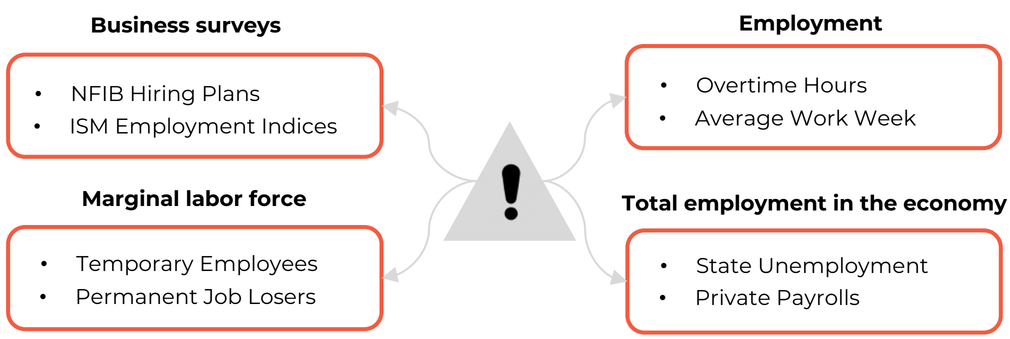
2) The employment market is cyclical, with a natural increase in unemployment after the maximum saturation.

When economy is approaching the break of the Phillips curve, many things have to go right for it to hold. On one hand, if demand accelerates again and inflation rises, this will force the central bank to raise rates. On the other hand, if demand slows down, unemployment will start to rise. Since one person's income is another person's expenditure, rising unemployment tends to be self-sustaining.

3) Rising unemployment can be both a crisis trigger and a clear sign of an economic slowdown.

The breaking point is very unstable, and the transition from one phase to another is inevitable even with full central bank involvement. However, many leading indicators point to a likely increase in unemployment, which explains the recent decline in inflation (Illustration 2).

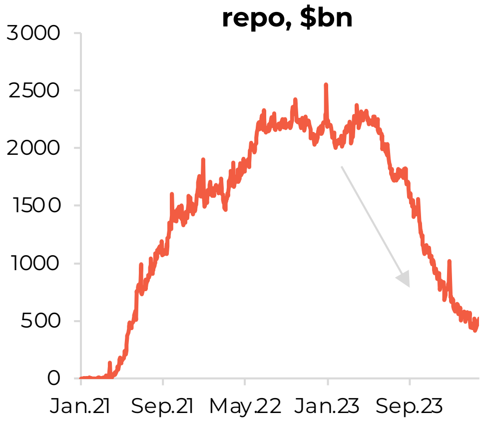
Illustration 2: Many leading indicators point to problems in the economy



Source: Blackshield Capital

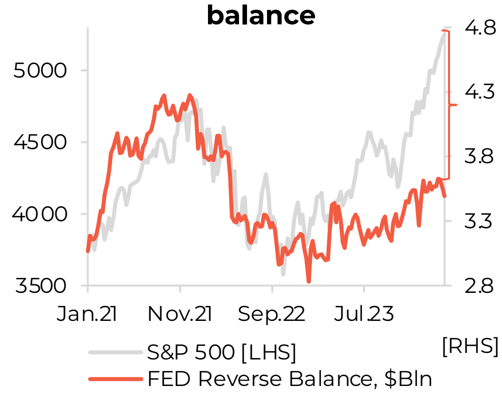
As for the Fed's liquidity, this has been a much-discussed topic recently. We believe that of the main favorable factors, liquidity flow may be the main challenge. The degree of tightening will be determined by the speed of the Quantitative Tightening (QT) program winding down, but by the end of April-mid-May, the reverse repo balance will be reduced to zero, while the Fed's balance sheet has added about 500 billion since January 2023 (Chart 8). Although the dynamics of stock indices have recently coincided quite closely with the dynamics of the Fed's liquidity, there is a significant gap, and normalization is likely to occur in the long run (Chart 9).

Chart 8: Internal reverse repo, $bn



Sources: FED, Bloomberg, Blackshield Capital

Chart 9: The gap between the S&P 500 and the Fed's reserve balance



Sources: FED, Bloomberg, Blackshield Capital

Chart 11: Treasury yield gap 10/2 years (bps)

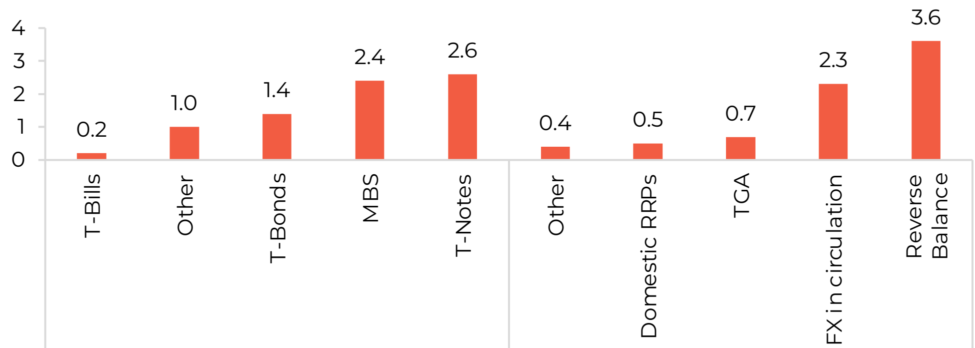
Sources: Bloomberg, Blackshield Capital

Operation "twist": 2011-2013

1) *July 2011: Speculation about the "twist" operation heats up.*
2) *21/09/2011: In a "twist" operation, the sale of short-term government bonds to buy medium-term bonds worth $400 bn is officially announced.*
3) *20/06/2012: Expansion of operation "twist".*
4) *31/12/2012: The "twist" operation is complete.*

The Fed chairman often avoids commenting on the specific timing of the QT program wind-down, as the central bank is likely to do so sooner than the baseline scenario envisaged.

Chart 10: FED balance sheet



Sources: FED, Blackshield Capital

The overall strategy involves an active reduction of mortgage-backed securities on the balance sheet to zero, as well as a shift to a much higher share of Treasuries compared to medium- and long-term bonds (Chart 10). These measures are primarily intended to increase the yield on mortgage-backed securities, but they will gradually normalize the US yield curve, which is critical for the economy.

In 2011-2012, the Fed conducted Operation Twist, in which the central bank sold T-Bills and bought medium-term bonds in order to reduce long-term bond yields (Chart 11). Although the timing is unclear, it makes sense to believe that the Fed now intends to implement the opposite strategy by actively buying T-Bills. This should normalize the US bond yield curve and subsequently stimulate the flow of assets into longer-term securities.

We believe that the main driver of stock market valuations is the fact that the priority has temporarily shifted from real returns to growth factors. This is one of the reasons why too long a pause in interest rate cuts is negative for the market - investors may be inclined to start considering negative growth scenarios and reduce their estimated projected multiples.

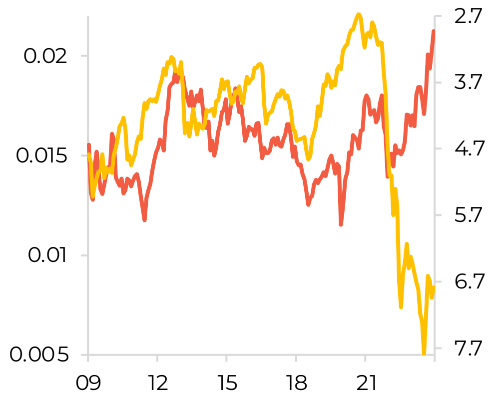
The Fed's priorities will include a set of solutions to normalize the yield curve. In turn, some sectors of the economy will be direct beneficiaries of the Fed's upcoming actions, while others will face a number of challenges. First and foremost, the normalization of the yield curve is a direct path to growth for the insurance sector (especially life insurance), which is a classic sector that grows relative to the S&P 500 during periods of yield curve flattening (Chart 12).

At the same time, a potential rise in mortgage bond yields is a significant trigger for a decline in the US new home construction sector (Chart 13):

Chart 12: Life Insurance vs. US Yield Curve

Sources: Bloomberg, Blackshield Capital

Chart 13: Homebuilders vs. Mortgage rate



Sources: Bloomberg, Blackshield Capital

No segment of the economy has given us more to think about over the past two years than the U.S. housing market. So far, home prices have typically outpaced construction by about six months, meaning that builders are using price increases to gauge likely demand when deciding how many projects to take on at a given time (Chart 14).

Chart 14: The number of new homes will decline in the next 2 quarters

Sources: Census, FED, Bloomberg, Blackshield Capital

Housing prices slowed sharply in 2023 due to higher mortgage rates. However, prices did not fall as many expected due to the historically small supply of homes on the market. This resulted in lower sales, but kept prices high as buyers who were relatively indifferent to interest rates bought the few homes they could find. The imbalance between supply and demand could lead to a decline in house prices later this year, in particular due to a deteriorating labor market and higher levels of layoffs in the corporate sector.

Hence, our strategy for the coming quarters takes into account irrationality and behavioral shifts in the market, in particular, the tendency to take more risk. At the same time, interest rate policy and macroeconomic early warning factors are among the key priorities for identifying possible recessionary signs. The future dynamics of the Fed's liquidity, along with a deteriorating labor market due to cyclical factors and lower inflation, is a likely scenario that could reduce market concentration and increase volatility.

Macroeconomic Outlook

The US economy remains at risk. A renewed acceleration in demand (an unlikely scenario due to low savings) could trigger a second wave of inflation, while a further decline could trigger a recession. In the current environment, we do not rule out a recessionary scenario and are monitoring economic triggers and early signs of macro stress.

Equities

We expect further declines in corporate earnings to lead to a revision of expectations for market leaders. This is likely to stimulate increased volatility and the flow of institutional capital to companies with more apparent and predictable cash flow. In addition, high concentration encourages investors to look for alternatives to diversify risks.

Interest Rate Policy

Despite the Fed chairman's encouraging words about a "slow" approach to monetary easing, accelerating the pace of rate cuts only when a recession has already begun, we believe this interest rate policy is more politically motivated. Ultimately, however, we expect the 10-year Treasury yield to fall to 3% during the next correction as the Fed seeks to reduce interest rates to 2%.

Corporate Bonds

The current level of corporate spreads implies a nearly 50% consensus decline in default rates over the next 12 months. Such a decline is unlikely even in a mild economic scenario, and impossible in the event of market stress. We are selective in our choice of corporate securities, and very cautious in our exposure to high-yield securities.

Currencies

The US dollar will moderately weaken over the next six months, but then strengthen closer to the US election period.

Commodities

Crude oil and industrial metals prices will remain at fairly high levels. The long-term prospects for metals are better than for oil, but this will largely be determined by the homogeneity of decisions at OPEC meetings. Although gold and precious metals are currently expensive, they will continue to be the main beneficiary of the de-globalization policies of the world's central banks.

Contrary to popular belief, the likelihood of a global recession in the next 12 months is increasing, not decreasing. We are currently generally neutral on risky assets and offer selective alternatives to stock indices. Prudent risk management and strategic thinking in the current macroeconomic environment is the best alternative to growing irrational market risk.

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