QUARTERLY INSIGHTS – Q3 2024

"BE FEARFUL WHEN OTHERS ARE GREEDY, AND GREEDY WHEN OTHERS ARE FEARFUL"
~ Warren Buffett, Investor and Chairman and CEO of Berkshire Hathaway

There is something captivating about the concept of cycles. They provide a sense of continuity, a natural rhythm in an otherwise chaotic world. The idea of cyclicality is deeply embedded in economic theory, from the invisible hand restoring equilibrium after supply-demand imbalances, to the cost of capital shaping our propensity to innovate. Cycles have a natural tendency to revert to the mean, creating a predictable pattern that allows us to make sense of complex systems. Without these cycles, finance and economics would likely be chaos.

Economic cycles have long been studied by economists and investors as a way to understand the fluctuations in market conditions, credit availability, and technological progress. Two key cycles shaping the current global economy are the debt cycle and the innovation cycle. While distinct in their nature, these cycles are deeply intertwined, and their interaction is crucial to understanding the future direction of global growth and market behaviour.

The debt cycle is currently in a critical phase. Years of low interest rates and loose monetary policies have fuelled a surge in global debt, with governments, corporations, and households accumulating record-high levels of borrowing. As central banks shift to tighten monetary policy and combat inflation, the cost of servicing this debt has risen dramatically. According to Hyman Minsky's Financial Instability Hypothesis, periods of stability encourage risk-taking and overleveraging, eventually culminating in financial crises. Minsky argued that stability breeds instability, a view echoed by Ray Dalio, who has described both short-term and long-term debt cycles. In Dalio's framework, the long-term debt cycle leads to crisis when economies are overburdened with unsustainable debt, forcing painful deleveraging processes.

Simultaneously, the innovation cycle is gaining momentum, driven by advancements in artificial intelligence, biotechnology, and clean energy. This cycle aligns with Nikolai Kondratiev's theory of long-wave innovation cycles, also known as Kondratiev Waves, which suggest that major technological breakthroughs occur in waves and drive sustained periods of economic growth. Currently, AI and automation are at the forefront of this cycle, with new technologies transforming industries and creating new markets.

Joseph Schumpeter expanded on this concept with his theory of creative destruction, where innovation disrupts industries, making outdated business models obsolete and driving economic renewal. As technology reshapes sectors like manufacturing and energy, it promises increased productivity and new growth opportunities. However, the tension between these two cycles creates a complex landscape for investors and policymakers.

Innovation, while crucial for long-term growth, requires significant capital. The tightening of credit due to the debt cycle could hinder investment in research and development, slowing the pace of technological progress. As debt-servicing costs rise, businesses may find it harder to fund new projects, creating a potential drag on the innovation cycle.

On the other hand, innovation may provide the solution to a debt crisis. Nobel prize winner, Paul Romer's Endogenous Growth Theory highlights how technological change and innovation, spurred by investments in knowledge and human capital, can drive sustained economic growth. Unlike traditional growth theories that treat technological progress as external to the economy, Romer's work emphasizes that innovation is an internal process driven by intentional investment. In this context, AI-driven productivity gains have the potential to offset the negative effects of high debt levels by increasing efficiency and reducing costs, making it easier for businesses and governments to manage their financial obligations.

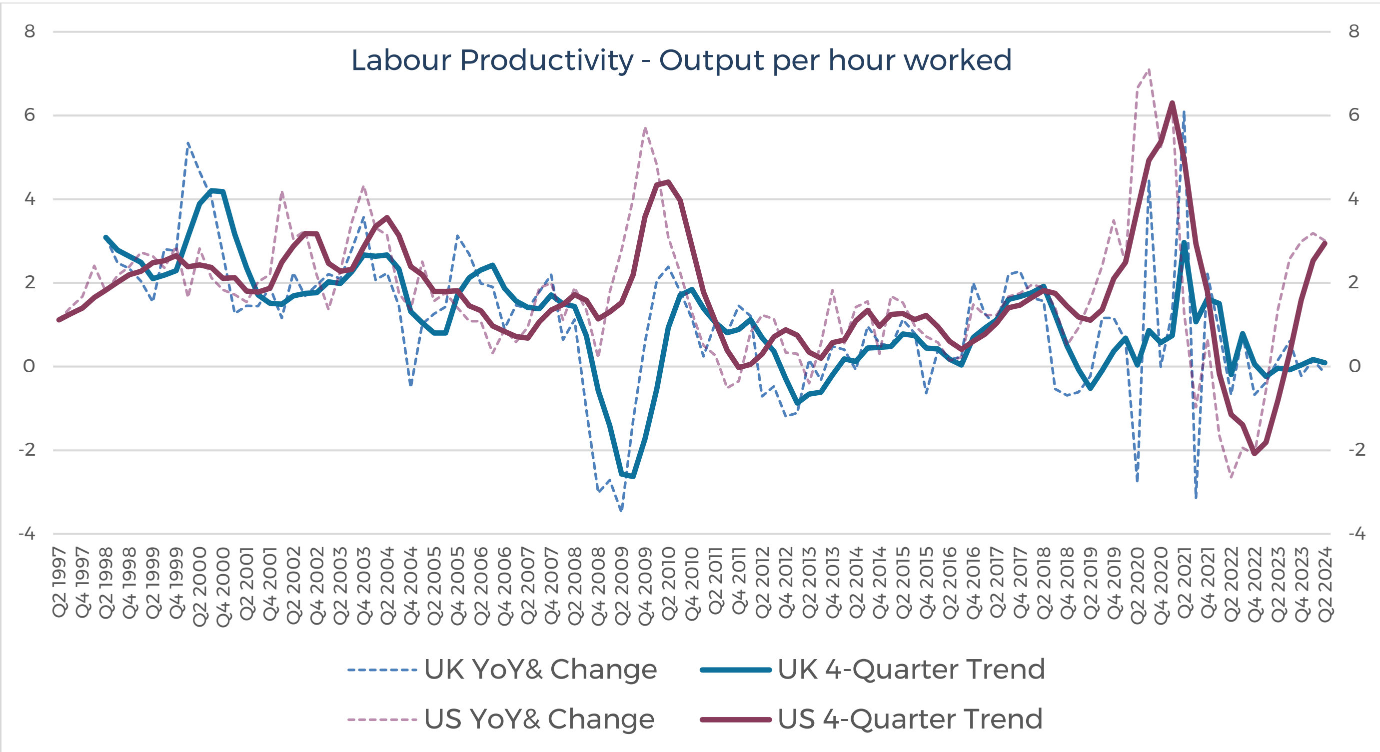
As interest rates cycle down once again, easing monetary conditions could support the next wave of R&D and capital expenditures, potentially unlocking new growth opportunities. But Schumpeter's question remains: how much creative destruction can economies withstand? The transition from old industries to new ones will take time, potentially leading to disruptions in labour markets and evermore wealth inequality. While innovation promises growth, the social and economic adjustments that follow could be painful.

Alas, as the global economy grapples with rising debt and rapid technological change, the interplay between the debt cycle and the innovation cycle will define the future of economic growth. Whether we see a financial crisis or a technological renaissance depends on how these opposing cycles evolve.

Despite the uncertainty, we believe a few things are certain:

- *Investment opportunities have never been this attractive,*
- *The 60/40 narrative will face headwinds, and*
- *Active investors, driven by robust asset allocation and security selection insights, should flourish!*

Exhibit 1: Labour market productivity also tends to be cyclical. In the US, this has soared to levels associated with past recoveries, unlike the United Kingdom, where labour market productivity growth is as exciting as a British barbeque!



Source: U.K. ONS, U.S. BLS, 30/09/2024

Performance Review

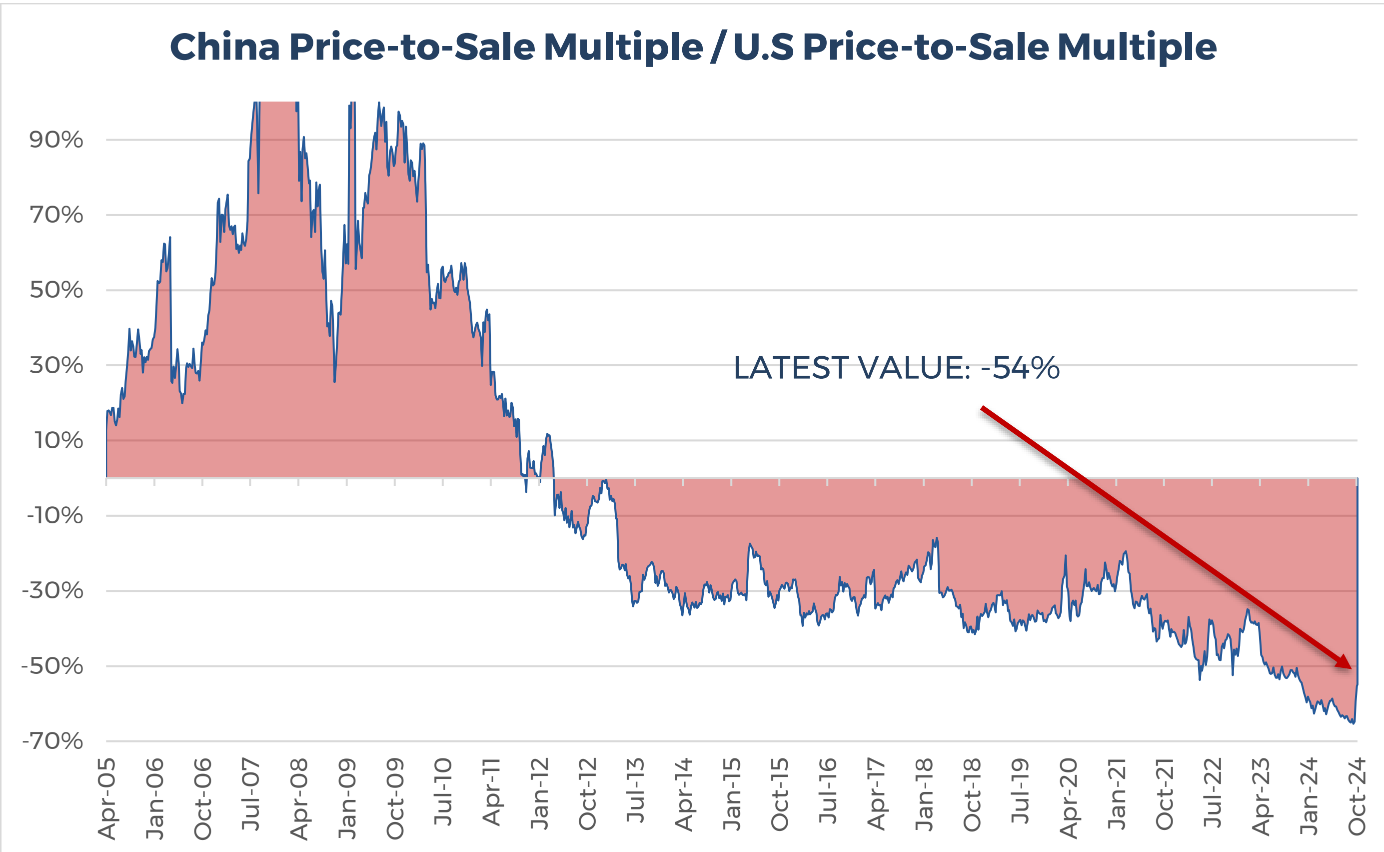
"IN THE SHORT RUN, THE MARKET IS A VOTING MACHINE BUT IN THE LONG RUN, IT IS A WEIGHING MACHINE." - Benjamin Graham

Q3 was another good quarter for our models and client portfolios.

One of the biggest drivers of our performance in Q3 was our overweight to China. In the previous quarter we mentioned why believe the market was overly pessimistic on the coexistence of both the Unites States and China. Stimulus announcements out of China towards the end of the quarter resulted in what we believe was primarily a short squeeze of what was a heavily shorted and structurally under owned market. Even after a 30% rally, valuations remain depressed.

However, what China requires is fiscal support and reform. Chinese interest rates are the lowest of any major economy with the exception of Japan. However, with deflationary risks looming large, more can be done from a monetary perspective. Whilst the cost-of-capital is sufficiently low to kick the can down the road, it requires investment. This in turn, requires a negative real rate of interest, that is, a nominal rate below that of inflation. More importantly, it needs to boost consumer and business confidence. The most likely and efficient way of achieving this outcome, is through fiscal measures. The country has been slow to adopt loser policy positions. We expect this will change…the question is when. We do not believe however, this is a case of waiting for Godot?

Exhibit 2: Despite the recent rally in Chinese equities, the market remains severely depressed. The below chart highlights the P/S-multiple discount between the US and China. Whilst we believe a discount is justified, 54% remains too extreme.

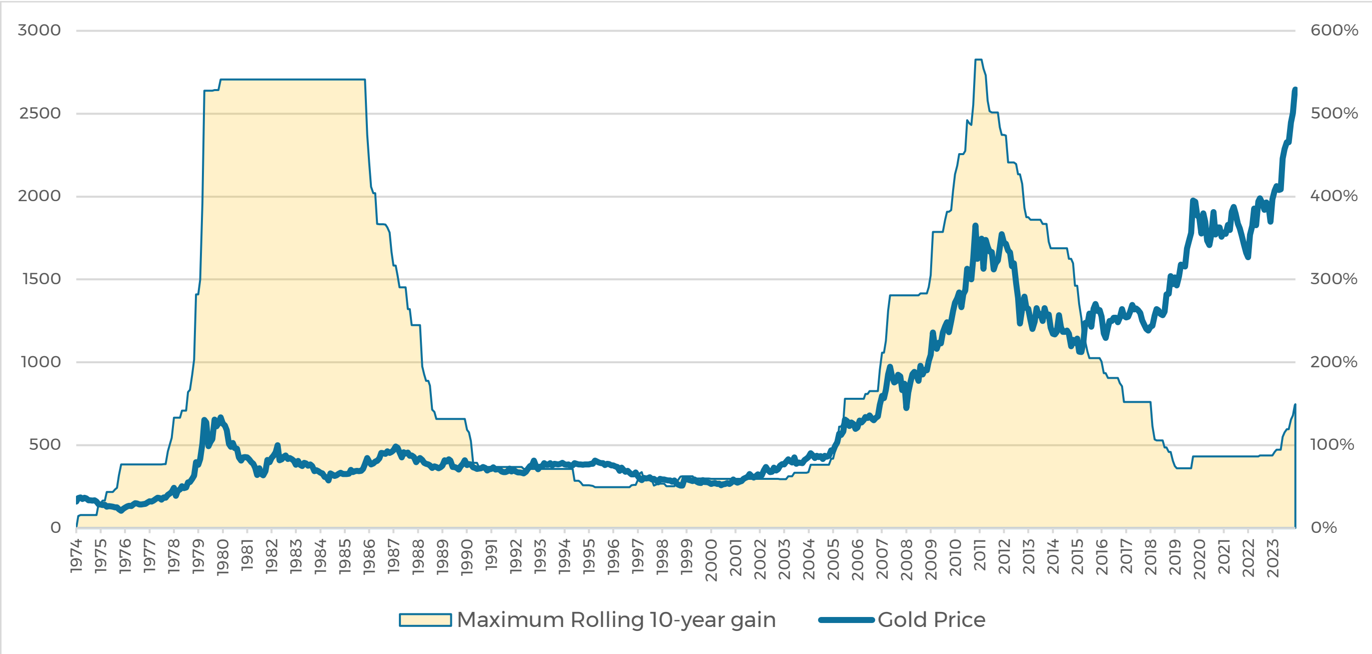


Source: Shard Capital, 04/10/2024

Gold was another major contributor, up almost 10% over the course of Q3. Gold is now up 33% over the past 12 months. We've discussed why we believe $2000 is the new floor. But it is worth considering the upside potential as well. During the bull market of the late 1970's / early 1980's, gold went up 540%. During the bull market between 2001 and 2011, gold rose 560% from peak to trough. This cycle, it is up 150% from its rolling

10-year return lows of about $1000. 550% from that point would take it well beyond $6000. You say impossible? I say the money printers will be switched on again soon!

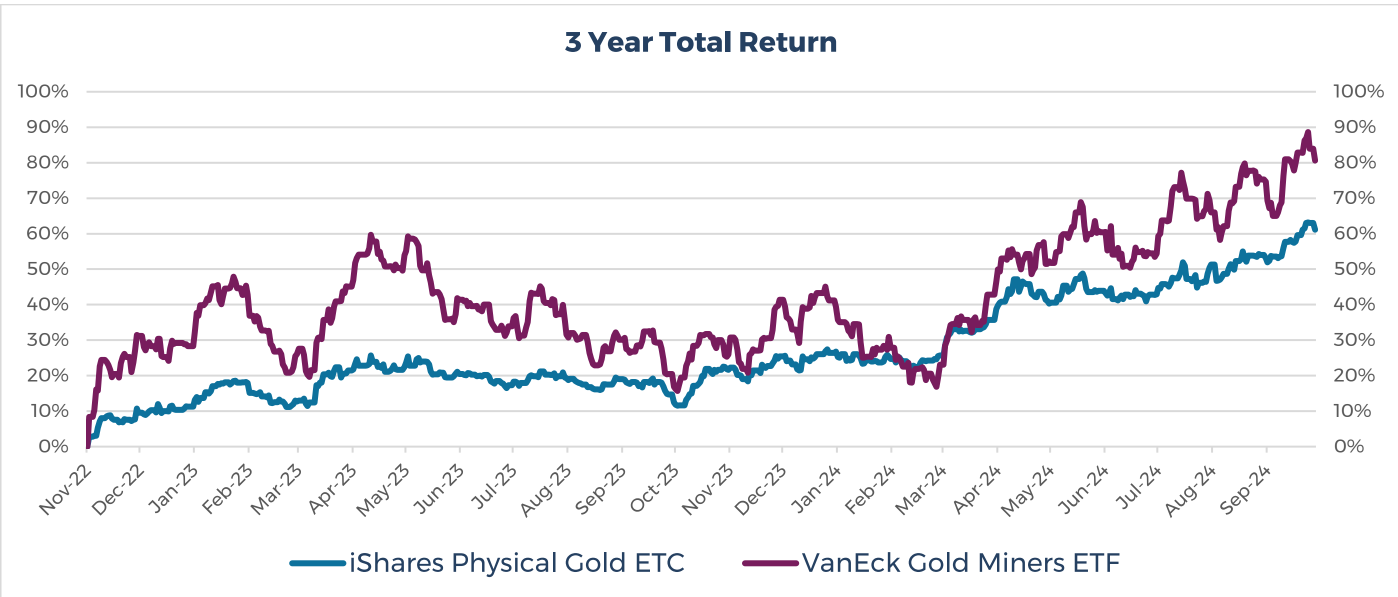
Exhibit 3: Gold prices tend to rise significantly during gold bull market cycles. History suggest 6x over a rolling 10-year period is not impossible – we're at 2.5x currently.



Source: Shard Capital, 30/09/2024

A related opportunity to consider and that has been much spoken about, is the producers. Gold Miners had another strong quarter and is up significantly since March this year. Gold miners are not without risk, including rising exploration and production costs, rising labour costs, and regional factors depending on the location of the mining activity. We retain exposure in some of our higher risk models given the gold price trends and outlook remain intact, and valuations relatively attractive given our expectations.

Exhibit 4: Gold prices are up c. 60% since the start of the latest bull market in November 2022. Historically Gold Miners have had an upside beta of 1.4 against gold. This implies some upside remains. With the bull market in tact, Gold Miners continue to be a key allocation to some of our higher risk models.

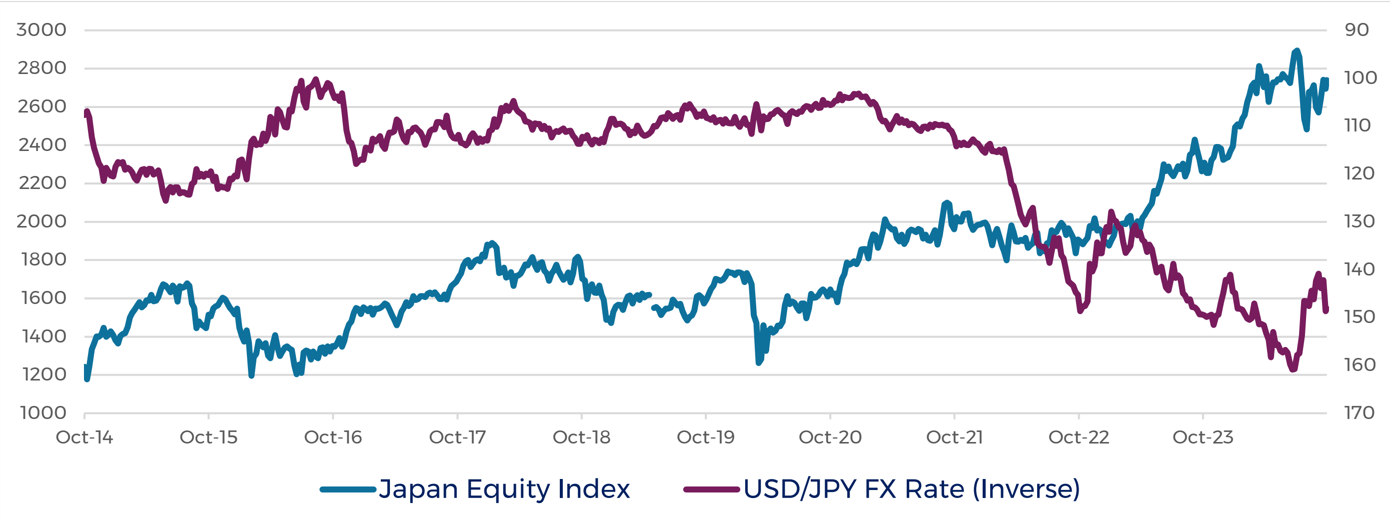


Source: iShares, VanEck, Shard Capital, 30/09/2024

Despite falling as much as -5% in local currency terms, Japan was a strong contributor to performance over the quarter. Despite equity market weakness, the Japanese Yen appreciated as much as 11% primarily on the back of interest rate differentials narrowing and fears that the JPY-carry trade has come to an end. This highlights the positive-convexity profile we've mentioned many times in the past.

We do not believe interest rates and related risks are systemic, but the Japanese Yen remains very under-valued. So does the Japanese equity market – at least in relative terms – and our overweight is very much driven by our view that our risk-return potential remains skewed to the upside. As Sterling or US Dollar investors, it's a win-win scenario!

Exhibit 5: The correlation between the USD-JPY exchange rate and the market return has been very positive in recent years. This raise questions whether gains are driven by the carry trade and JPY-depreciation? Whilst a weak yen has supported the equity market, we believe the story is much more structural than that!



Source: Shard Capital, 30/09/2024

A final mention has to go to bonds. We made 8% in our long-dated U.S treasury position as yields fell across the curve. This was primarily driven by a weak jobs report that came out at the beginning of August and subsequent fears around the Yen-carry trade. However, momentum continued well into September, and by mid-September, our long-dated Treasury position was up as much as 11%.

But, two weeks is a long time in bond markets, and much has changed since. Primarily, the Federal Reserve cut rates and China announced what markets at the time believed might be their 'whatever-it-takes' moment. This drove fears of a rebound in inflation, as we discuss below. Bonds had a relatively strong rally. We took profits.

As for the outlook for bonds, below are three scenarios. It is only three of an unknown amount of potential outcomes, but it paints a good story of where we are today, and where we are going.

Scenario 1 – The Soft-Landing:

- The US avoids a recession, disinflationary trends continue, and a soft-landing is achieved as markets continue along a normal path.

Scenario 2 – The Hard-Landing:

The US labour market continues to deteriorate, to the extent that consumption starts to wither, investment and hiring comes to a pause, and a classic slowdown occurs to the extent that the US enters a mild recession.

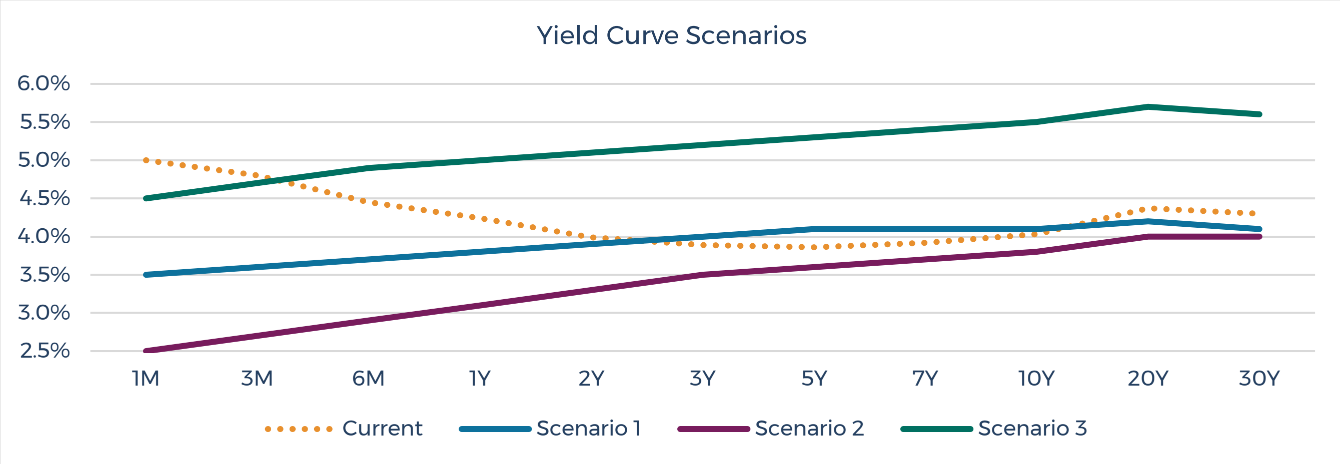
Scenario 3 – The No-Landing:

- The Tax Cuts and Jobs Act of 2017 is extended, animal spirits reinvigorated, and the new investment starts to accelerate alongside inflation expectations. Whilst economic growth accelerates, the US deficit increase beyond already extraordinary expectations, risk premia rise along with inflation and the treasury curve starts to steepen.

In these three scenarios, the following might be where the US Treasury yield curve ends up in 12 months, and the resulting total return scenarios.

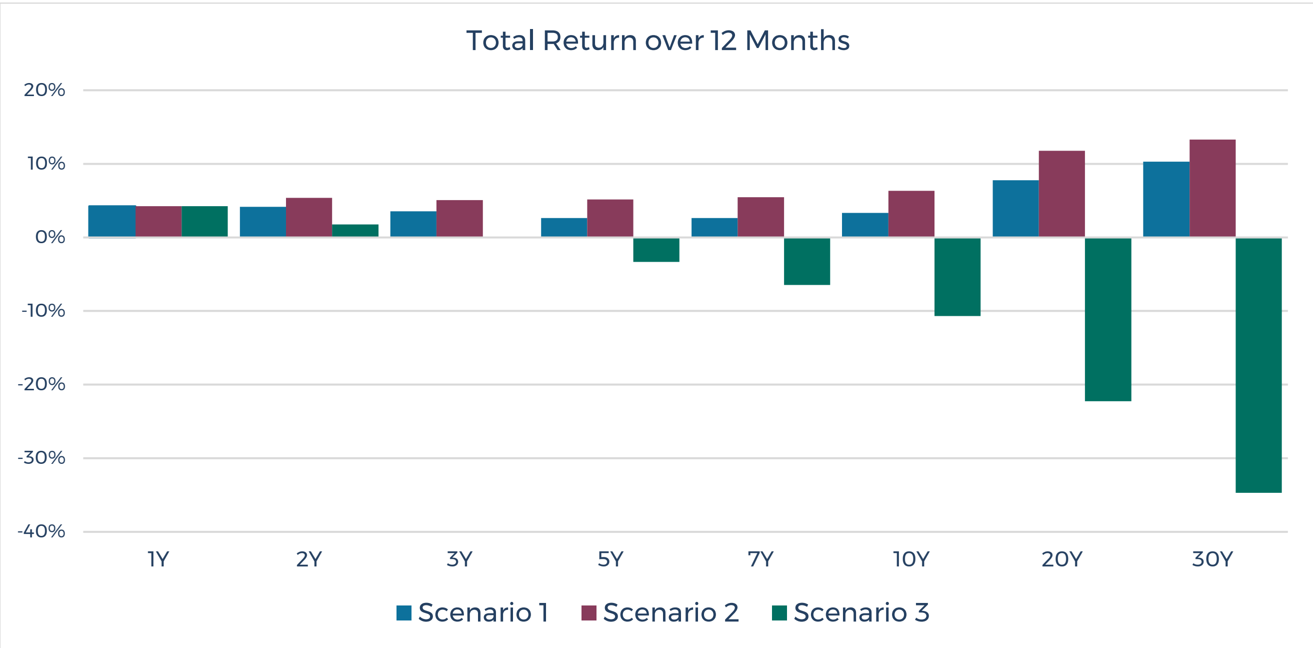
Note: these are merely three hypothetical scenarios and are highly unlikely – I would argue impossible – to play out in such an exact way.

Exhibit 6: US Treasury Yield Curve in Scenarios 1, 2 and 3, relative to the current yield curve:



Source: Shard Capital, 30/09/2024

Exhibit 7: Expected Total Return in Scenarios 1, 2 and 3 on various points on the yield curve:



Source: Shard Capital, 30/09/2024

Assign probabilities, and you can determine expected returns for your fixed income portfolio across various positions on the yield curve. Suffice to say, there's risk at the long end. Read the section on inflation! But, as is the opportunity, as discussed in the section on growth. Understanding correlations and how the rest of your portfolio behaves, is crucial. Now more than ever!

On Inflation

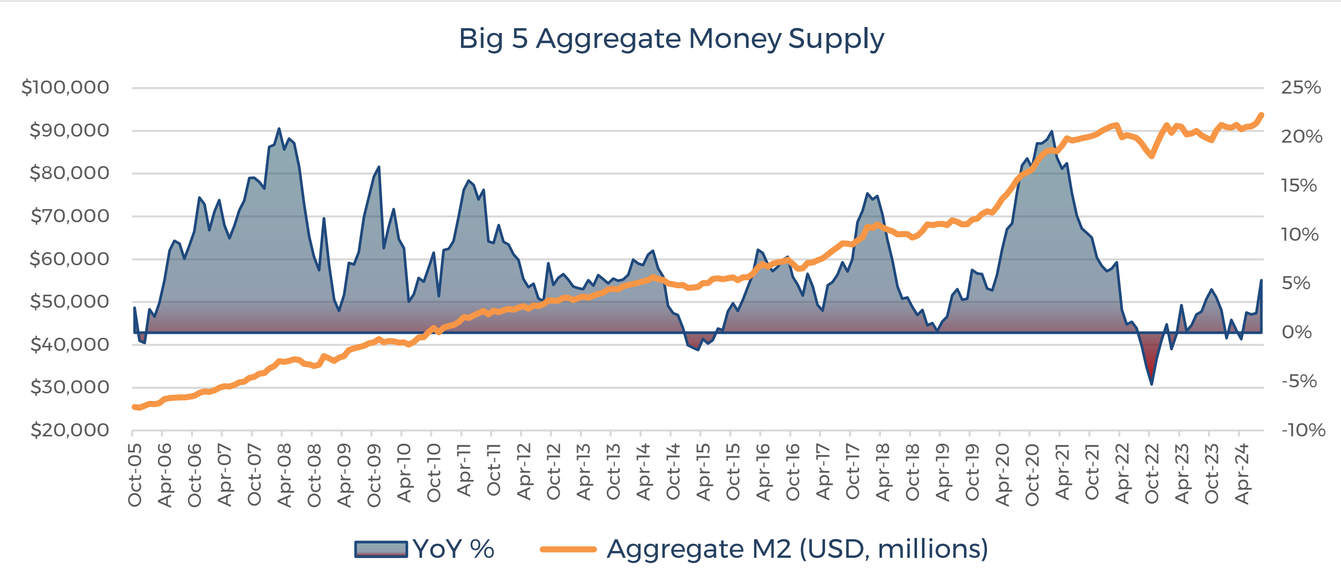
"I DO NOT THINK IT IS AN EXAGGERATION TO SAY HISTORY IS LARGELY A HISTORY OF INFLATION, USUALLY INFLATIONS ENGINEERED BY GOVERNMENTS FOR THE GAIN OF GOVERNMENTS." ~ Friedrich Von Hayek

Inflation expectations continued to fall for most of the third quarter, after turning down again in April this year. Labour market concerns and declining headline inflation were the primary driver behind this decline. But how quick does can sentiment turn. Three key factors have most likely contributed to a change in sentiment:

- The Federal Reserve started cutting interest rates,
- China has announced economic stimulus support, and
- Aggregate Money Supply is positive once again across the big 5 – China, the US, the EU, Japan and the UK.

All of these factors will likely continue to drive inflation expectations higher as we march towards Christmas.

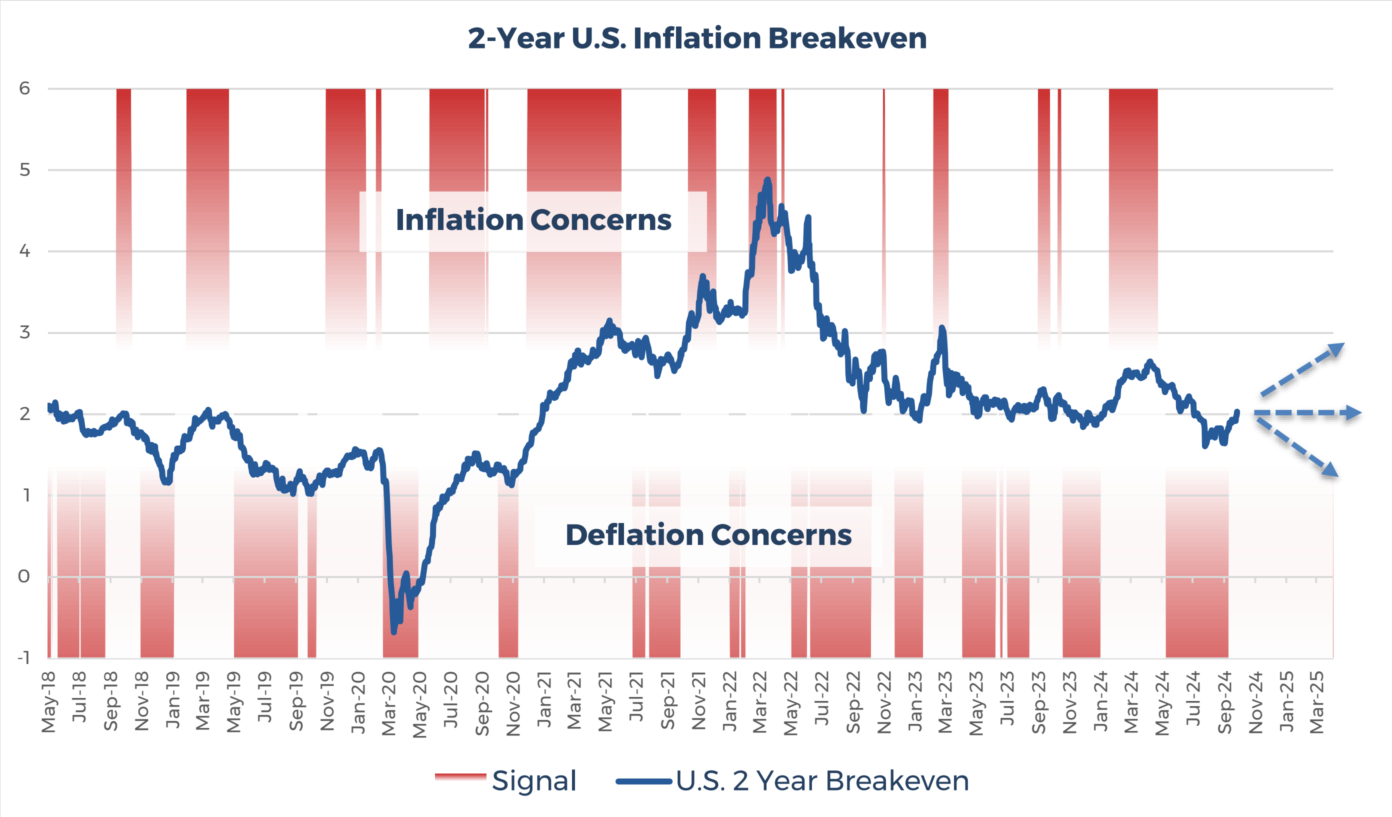
Exhibit 8: Aggregate Money Supply from the five largest central banks in the world:



Source: Federal Reserve of St Louis via Fred.org, UK ONS, BoJ, PBoC, ECB, Shard Capital, 30/09/2024

Putting pressure to the downside is a weak Chinese economy, demographic headwinds and the uncertainty surrounding the demand destruction from AI. Whilst we admit AI will drive the next big deflationary boom cycle, we do not see this as an imminent deflationary risk. If anything, AI is likely to drive a productivity boom supported by investments in R&D and knowledge capital, and a capex cycle – all but deflationary! Perhaps more of a concern is a weakening labour market in the west, inequality and the strength of consumers around the world.

Exhibit 9: A significant decline in US inflation breakeven rates – the expected inflation rate as derived from the US treasury market – coincided with a decline in yield curves as fears of inflation retreated. This drove the rally in US treasuries. However, the path of inflation expectations going forward is unknown and finely balanced.



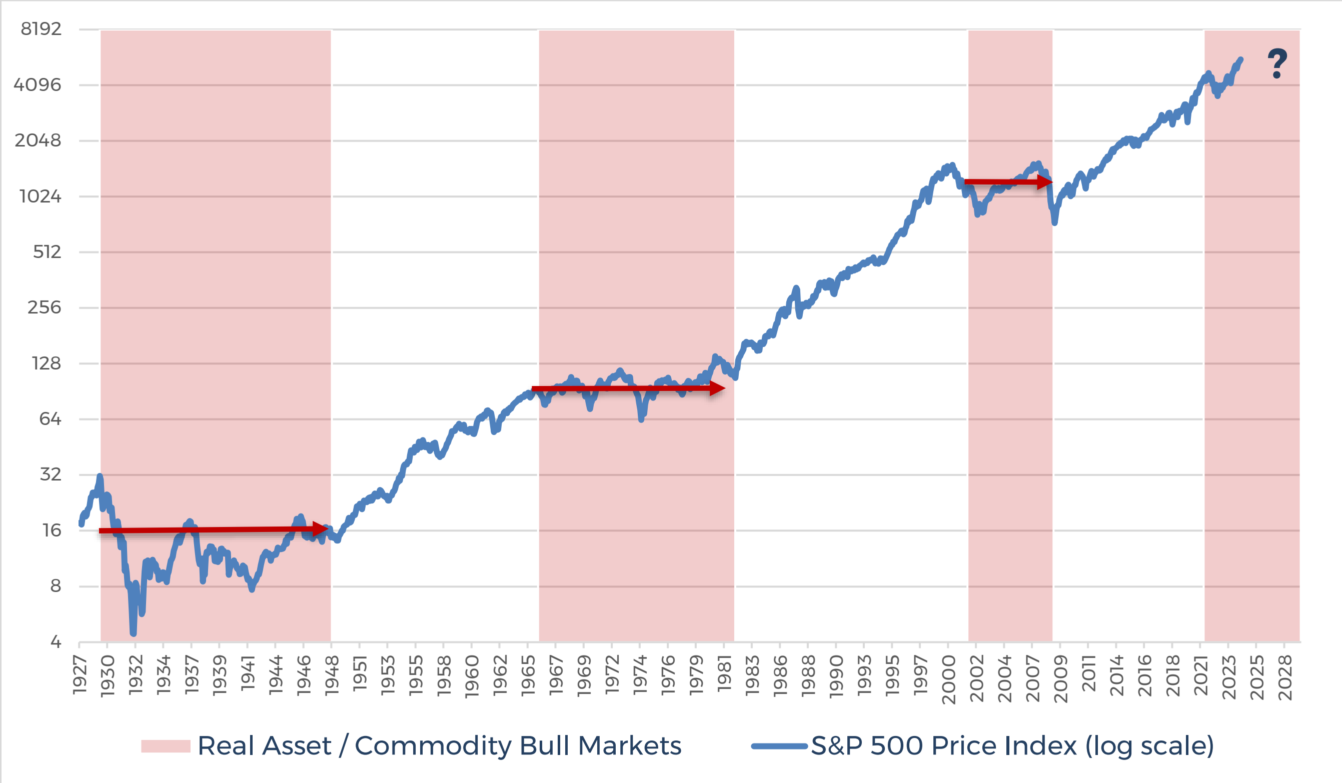
Source: US Department of the Treasury, Shard Capital, 30/09/2024

One major factor to consider is the direction of commodities. As shown below, commodity bull markets are typically not great for equity markets, on the whole. A reflationary environment is supportive of economic growth driven by the virtuous self-reinforcing cycle of rising prices and rising demand. However, the cost of capital typically rises in this environment as interest rates rise and the inflationary backdrop often puts pressure on corporate profit margins. The biggest question with regards to commodities are whether we are about to enter a new bull market era as we rebuild global energy systems and transition to a cleaner world?

Given we have just gone through one of the longest commodity bear markets in history, one has to ask whether we are on the cusp of a new bull market?

Managed Futures and Trend Following CTAs (Commodity Trading Advisors) should provide excellent returns if indeed we are about to enter a new long-term bull market. They are key components of our client portfolios, and we retain significant conviction in their role.

Exhibit 9: The shaded areas highlight commodity bull markets – historically not a great environment for equity market returns.



Source: S&P Dow Jones Indices LLC, S&P 500, Federal Reserve Bank of St. Louis, Shard Capital, 30/09/2024

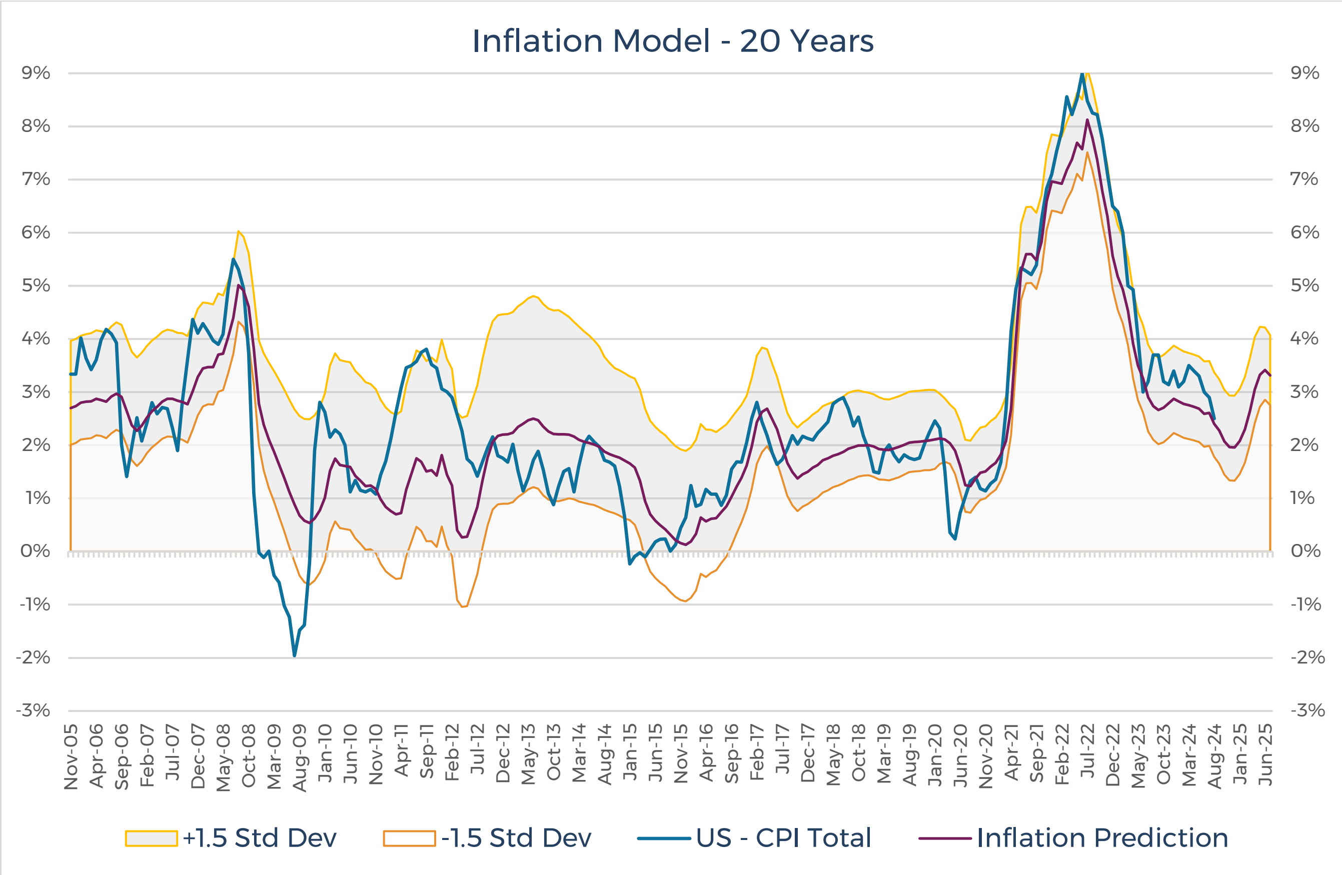
Finally, a comment on our inflation model. As a reminder, the key inputs into our model are money supply, energy prices and house prices.

Aggregate money supply growth is positive again, as shown in exhibit 8. This is a major source of inflation as increased money supply directly leads to monetary devaluation. It typically comes with a lag. Our research shows anything between 10 and 18 months. That is, H1 2025.

Energy prices has been a major driver behind the disinflationary trend, but we are likely closer to the bottom of this trend than the top. Our expectations are that the YoY contribution from energy will remain significant, but with risks to the upside.

Finally, house prices. We have spoken at length about our thesis in what we define as Rentier Capitalism. Contrary to common belief, we think that declining rates might actually drive rental prices, and inflationary pressures, lower.

Exhibit 10: Our inflation model suggest that the disinflationary trend will likely persist into year end, but the consequences of increased money supply will potentially put upward pressure on CPI data as we enter 2025.



Source: Shard Capital, 30/09/2024

On Economic Growth

"**THE ILLUSION THAT WE UNDERSTAND THE PAST FOSTERS OVERCONFIDENCE IN OUR ABILITY TO PREDICT THE FUTURE.**" ~ Daniel Kahneman.

Economic growth continues to surprise to the upside. Most economists and market pundits have given up on their calls for a recession. Those that have not are quivering in the perma-bear corner.

Indeed, we were surprised by the robustness of the global economy given the speed and magnitude of the US hiking cycle. I recall a portfolio manager in 2009 telling me: "Never underestimate the US consumer". How true that remains, especially in recent years. It is fair to say the US consumer has single handedly kept the world afloat by spending expensive dollars on holidays abroad and services locally. These trends are not changing, and if anything, broadening out.

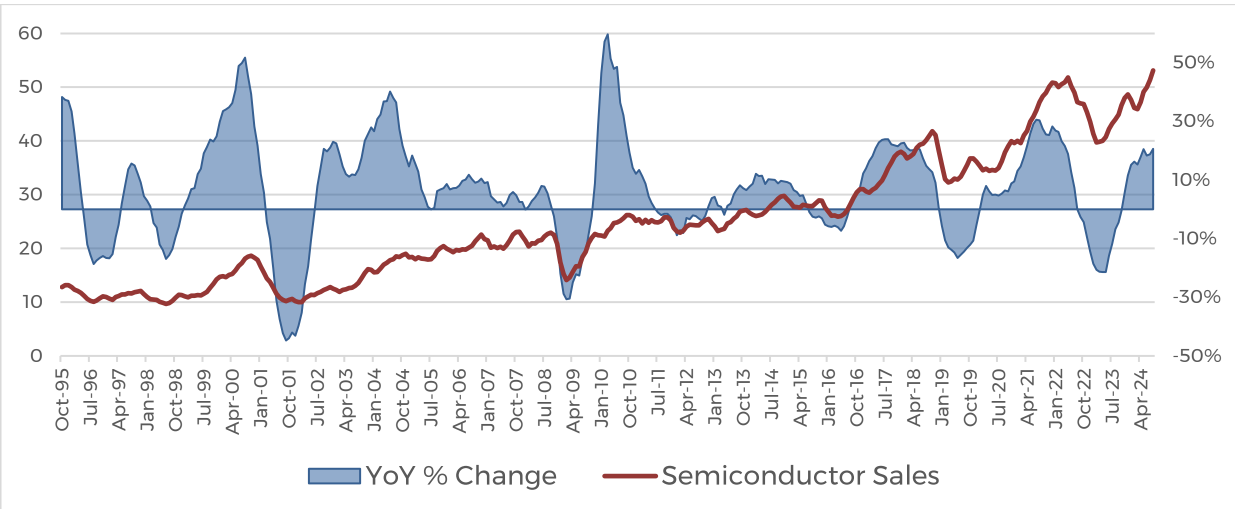
Exhibit 11: Trends at Open Table continues to be positive. The table below shows the volume of seated diners from online reservations on a monthly basis in 2024 relative to levels in 2023.

MONTH/YEAR	10/24	9/24	8/24	7/24	6/24	5/24	4/24	3/24	2/24	1/24
Global	2%	6%	4%	2%	4%	6%	1%	9%	5%	0%
Australia	34%	11%	10%	6%	1%	5%	1%	3%	0%	-7%
Canada	10%	11%	9%	7%	10%	10%	10%	14%	15%	8%
Germany	12%	1%	-3%	-3%	4%	6%	-4%	11%	7%	0%
Ireland	14%	12%	7%	6%	6%	6%	-2%	12%	8%	4%
Mexico	17%	16%	13%	14%	12%	18%	14%	17%	12%	8%
United Kingdom	7%	5%	5%	6%	10%	10%	-2%	10%	5%	5%
United States	-2%	5%	3%	0%	3%	5%	0%	7%	4%	-2%

Source: OpenTable, https://www.opentable.com/state-of-industry, 04/10/2024

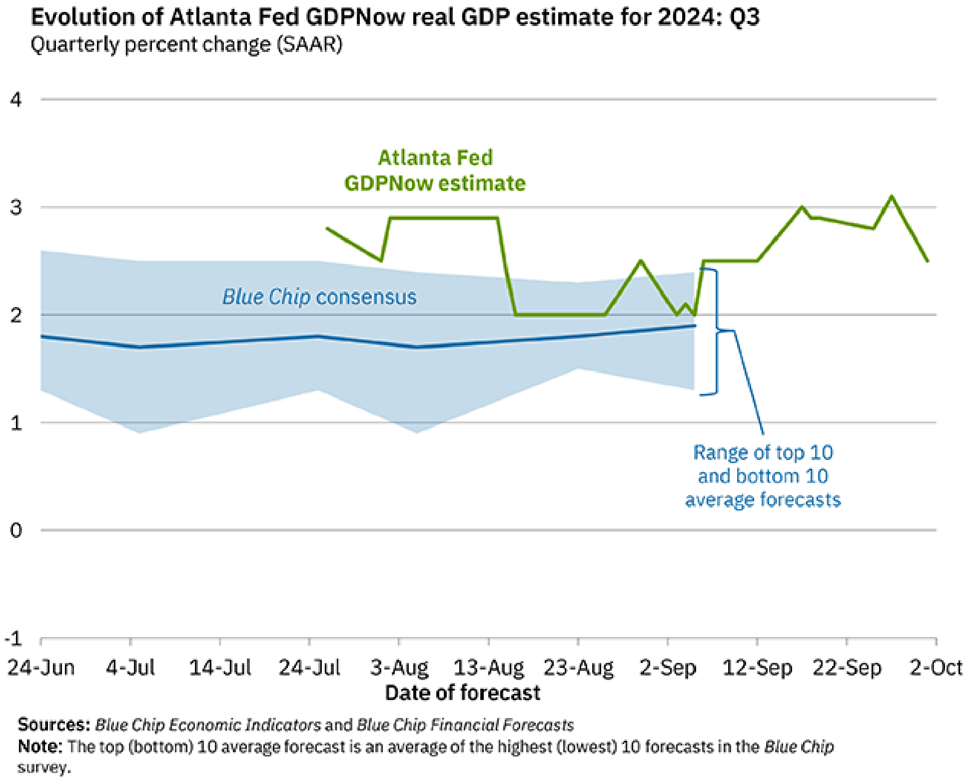
Another indicator we focus on and reference in most of our quarterlies, are global semiconductor sales. Whilst impacted by AI, the industry is significantly bigger than just Nvidia GPUs. Indeed, semiconductors are the oil of the digital economy, and an increasingly important indicator of the health of global economic activity. Suffice to say, semiconductor sales remain very strong.

Exhibit 12: Digital oil? Semiconductor sales remain robust, further evidence that demand in the real economy remains solid.



Source: Semiconductor Industry Association, Shard Capital, 30/09/2024

Exhibit 13: Atlanta Fed's GDP nowcast remains solidly in the green, supported by the US consumer and increasingly supportive liquidity dynamics.



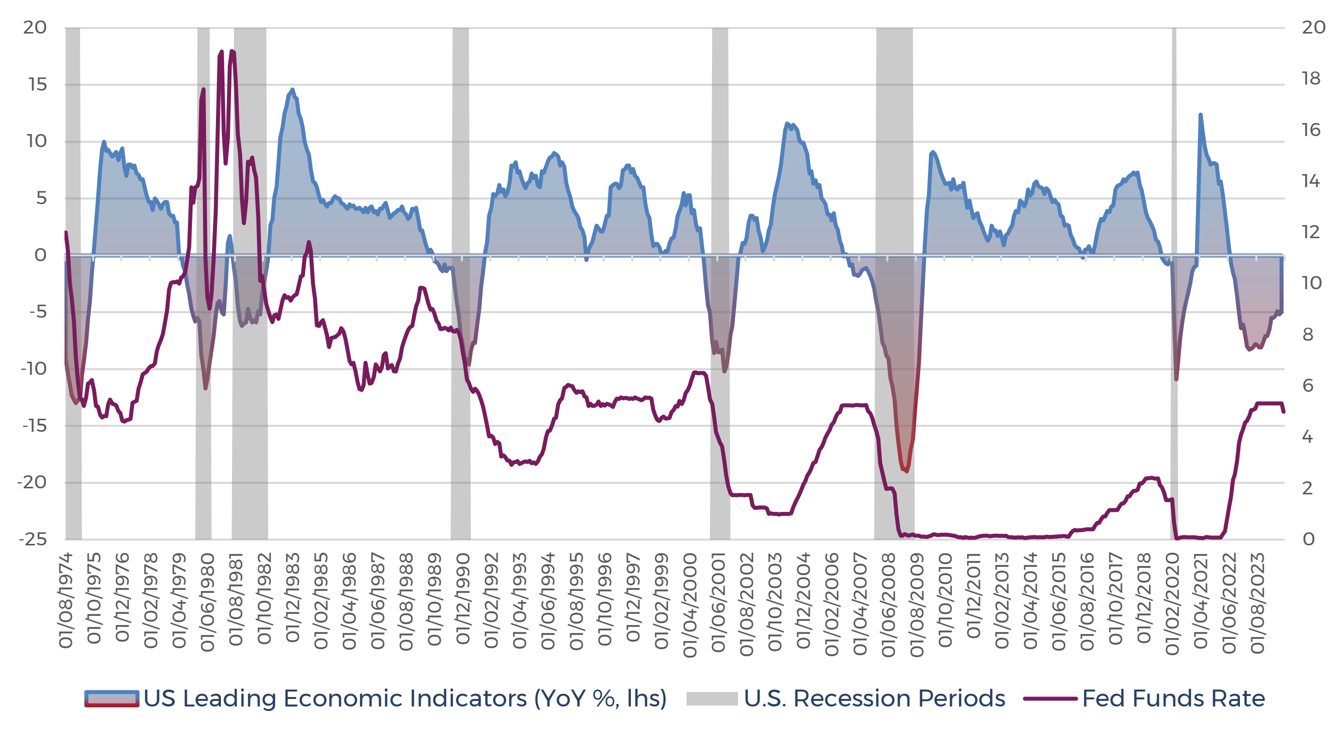
Source: Federal Reserve Bank of Atlanta, 30/09/2024

The key question however remains whether the 'long and variable lags' of monetary policy is no more? Has Jerome Powell and his Fed pulled off the impossible by ensuring a magical soft-landing despite a burst of 'bank-breaking' inflation and the biggest and quickest subsequent hiking cycle on record.

The reality is that global economic policy is overwhelmingly positive at the current time, with the west easing, China stimulating and money supply growth turning positive. Global capital markets are really large refinancing platforms, and the current economic regime is supportive of it. With this in mind, it is difficult to see a recession in the next 3 to 6 months. Beyond that, we will have to wait and see. But what is certain is that the current policy regime is also not sustainable as deficits can not grow into infinity. Somewhere the party ends.

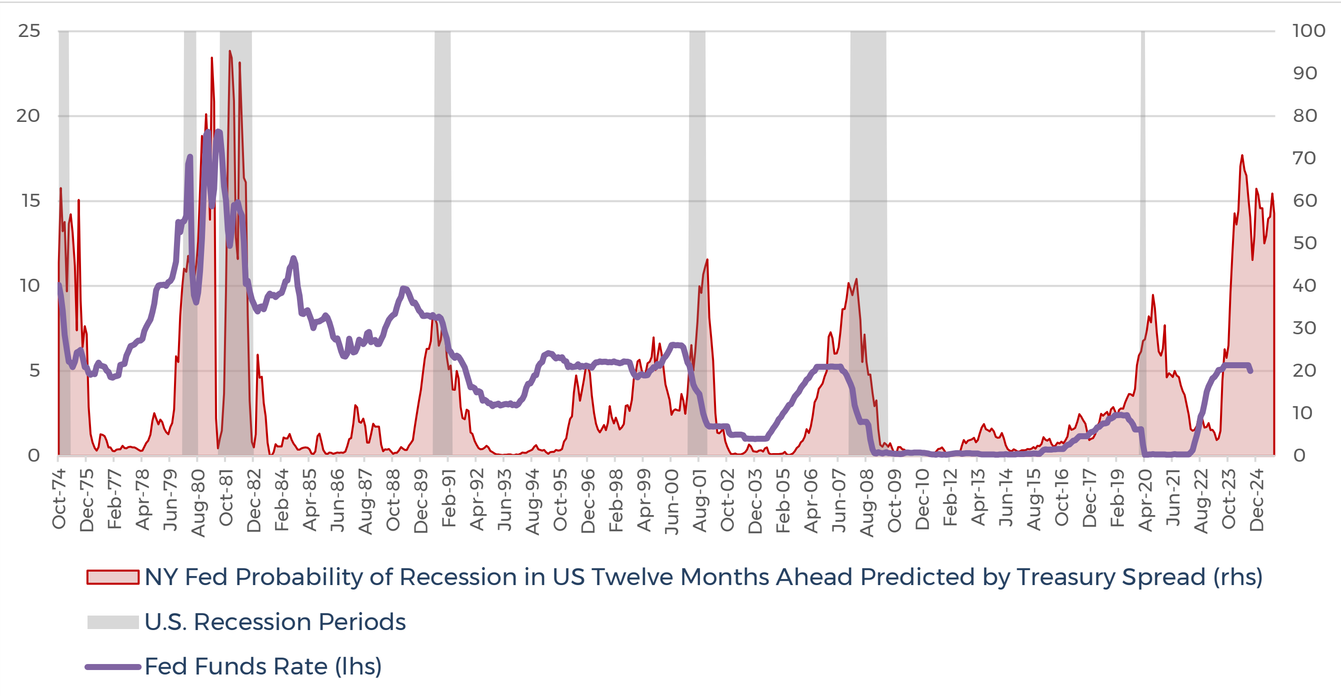
The US Conference Boards leading economic index has now been negative for an extended period of time. Auto and credit card delinquencies are rising and risks to retail and consumer spending are rising as discretionary spending capacity declines. For these reasons recession fears should perhaps not be discarded without some consideration.

Exhibit 14: The chart below shows the Conference Board's Leading Economic index, Fed Funds Rate and periods of recessions in the US. The crux is: recessions occur when LEIs are negative and after initial interest rate cuts.



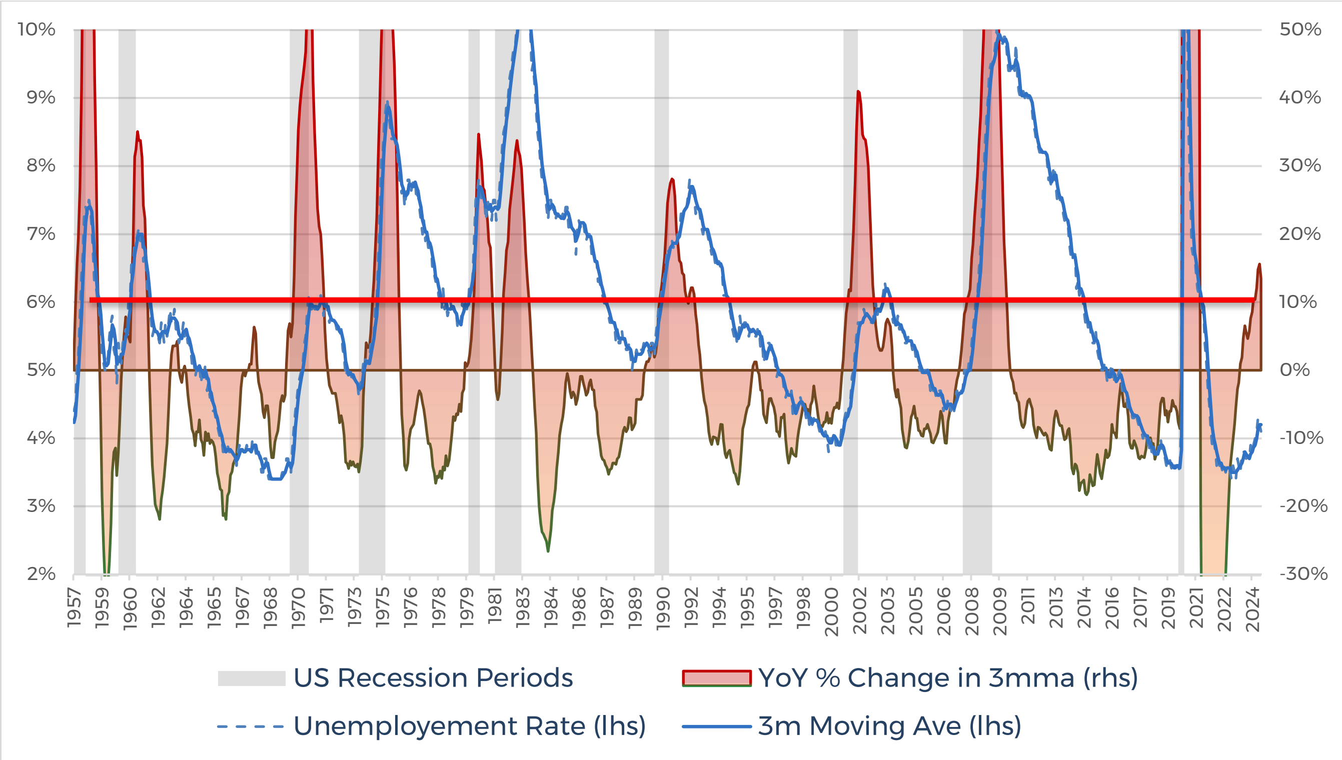
Source: Shard Capital, 30/09/2024

Exhibit 15: The Federal Reserve of New York produce a series predicting a U.S. recession in the twelve months ahead. Similar to the Conference Boards LEIs, the track record has been relatively consistent!



Source: Federal Reserve of New York, Shard Capital, 30/09/2024

Exhibit 16: Labour market trends have turned, and whilst recent announcements have been robust, the direction of travel is clear and it raises the question of when, and not if.



Source: US BLS, Shard Capital, 30/09/2024

As we mentioned in previous letters, predicting the future is difficult, even with better data and more insight. What is perhaps more important is being prepared when opportunities arise. In the near term a recession looks unlikely. However, data trends are discomforting and whilst liquidity, financial conditions and sentiment remains supportive, we know things can change on a dime. Liquidity should come at a premium and valuable when there is blood on the streets.

On Market Valuations

"IT'S FAR BETTER TO BUY A WONDERFUL COMPANY AT A FAIR PRICE THAN A FAIR COMPANY AT A WONDERFUL PRICE.", ~ Warren Buffett

The reality is that high expectations alongside high valuations means a high level of risk. Risk is not a number. Risk is the probability of a permanent loss of capital.

With that in mind, the following are crucial:

1. Understand the value of your assets
2. Ensure access to capital and liquidity should volatility rise and risk assets sell-off.

Consider exhibit 17 and 18. Government bonds look attractive relative to credit and equities, at least based on history. Rate cuts should support government bonds and history has proven, as we've shown above, this is not necessarily true for equities as rate cuts typically occur when the economy is slowing. Real rates remain stable and at c. 2% and inflation linked government bonds at this level are relatively attractive.

As for US equities, it is pushing the boundaries of what is realistic. Consensus EPS growth expectations for the S&P 500 over the next twelve months is 14%, which is extremely high given the starting point. At the same time, market multiples are back at all-time highs. The U.S. has a lot going for it, but how much of a premium does exceptionalism deserve with the knowledge that ultimately everything is cyclical.

With this in mind, we remain overweight non-US equity markets, including the UK, Japan, China and Emerging Markets more broadly. We've also started increasing inflation protection again and remain significantly overweight gold and managed futures.

Exhibit 17: Expected returns and drivers of return over the next 5 years are below.

US 10 Year Treasuries	
Yield Today	4.0%
Yield Target	3.5%
Expected Total Return	4.5%
Expected Inflation	2.0%
Expected Total Return	2.5%

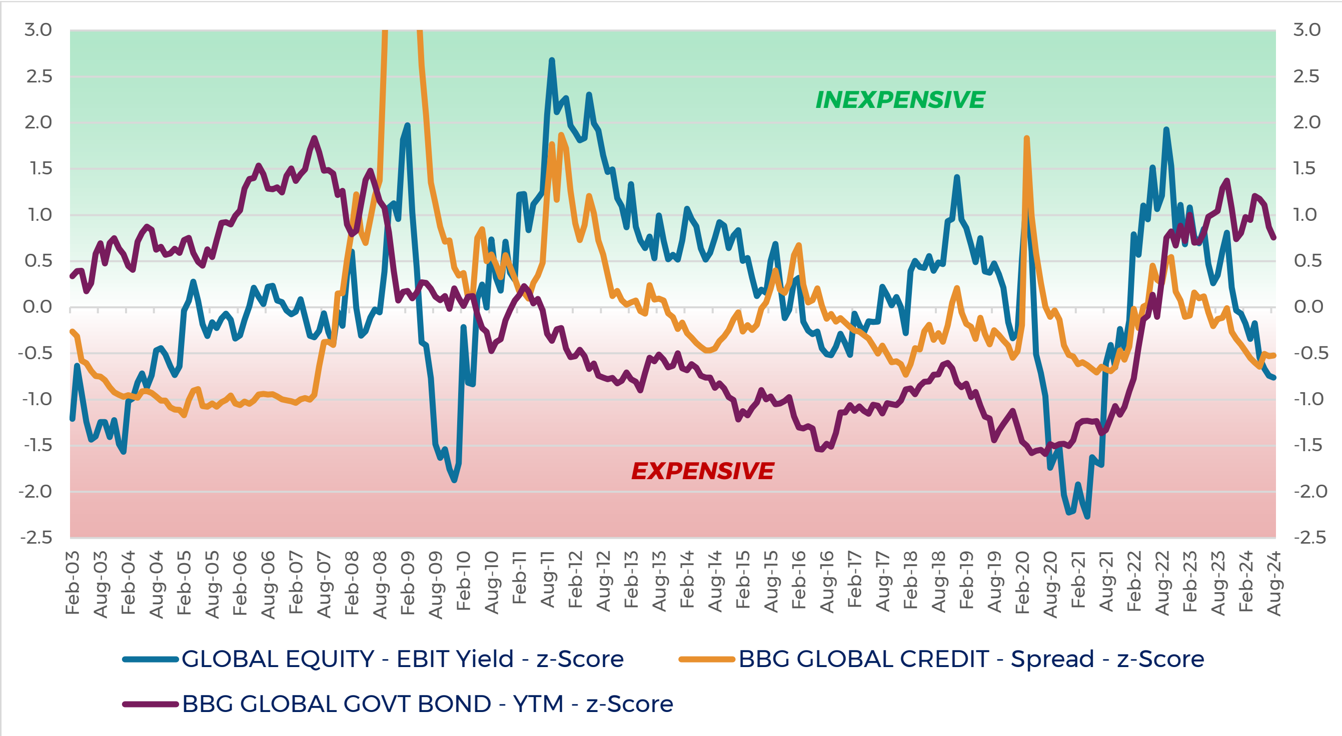
US Equity	
Multiple Expansion	-3.5%
Real EPS Growth	4.5%
Dividend Yield	1.3%
Expected Total Return	2.3%

DM ex-US Equity	
Multiple Expansion	0.6%
Real EPS Growth	2.5%
Dividend Yield	2.9%
Expected Total Return	6.0%

EM Equity	
Multiple Expansion	-0.7%
Real EPS Growth	5.0%
Dividend Yield	2.4%
Expected Total Return	6.7%

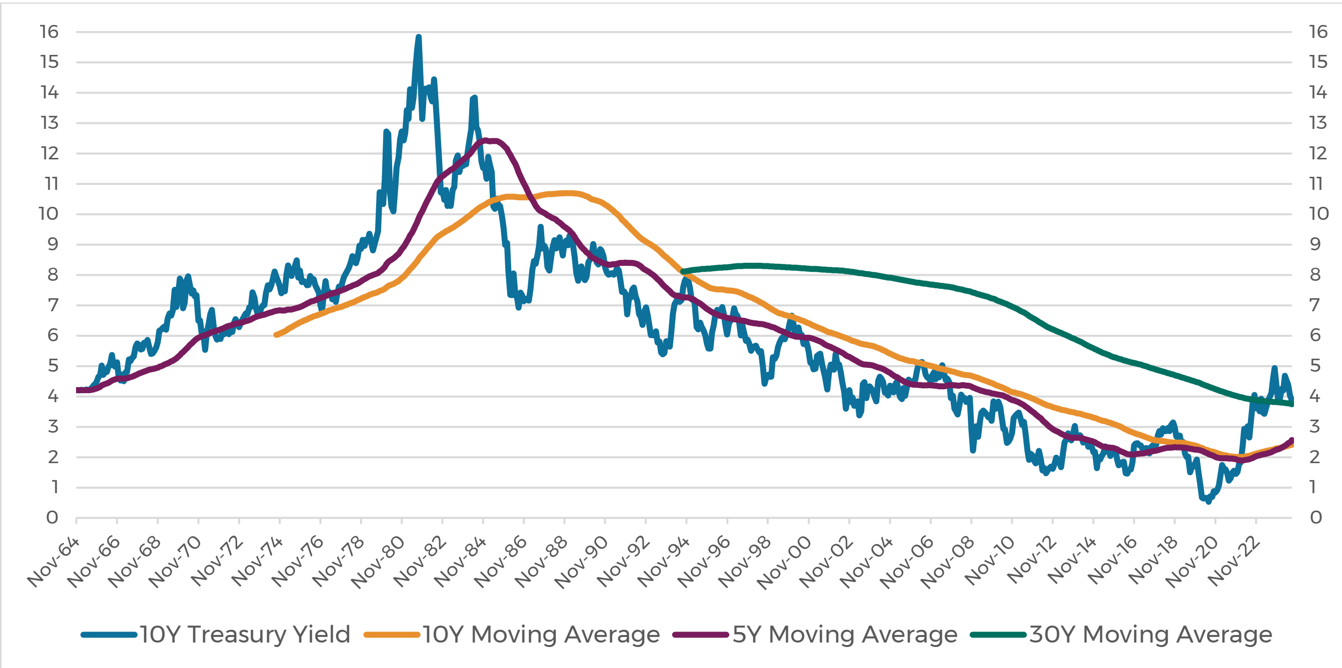
Source: Shard Capital, 30/09/2024

Exhibit 18: z-Scores for Global Govt Bonds, Corporate Bonds and Equities. Global Govt Bonds look inexpensive. Global Corporate Bonds and Global Equities, less so.



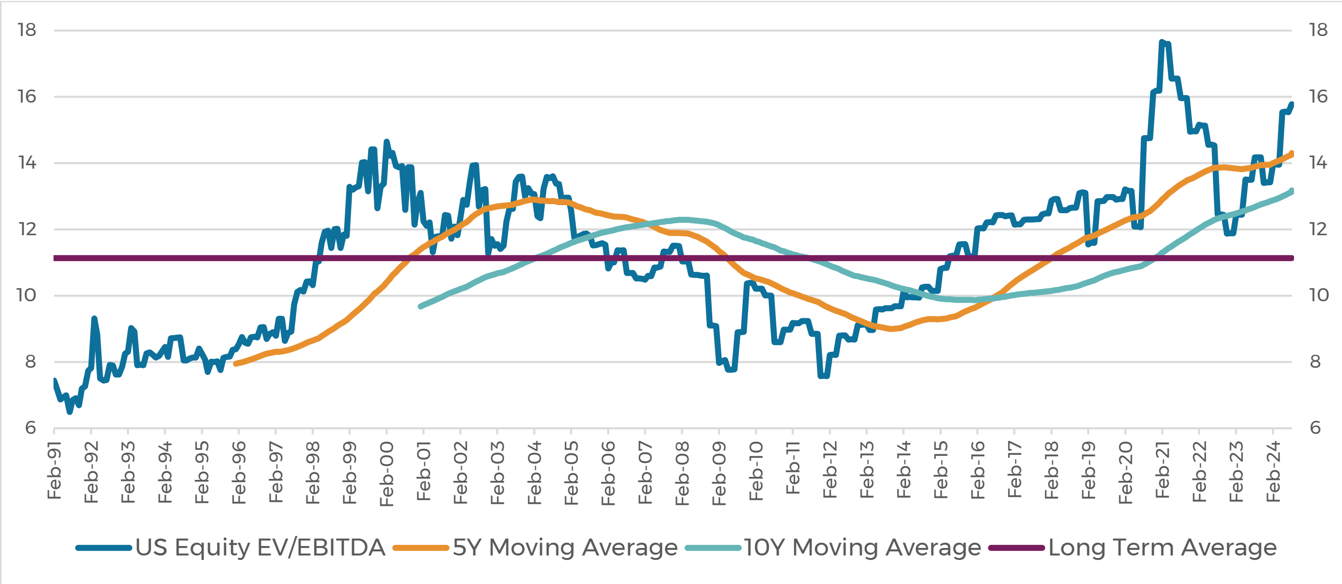
Source: Shard Capital, 30/09/2024

Exhibit 19: Long term US 10y Treasury Yield. The current yield is right on the average yield over the last 30 years.



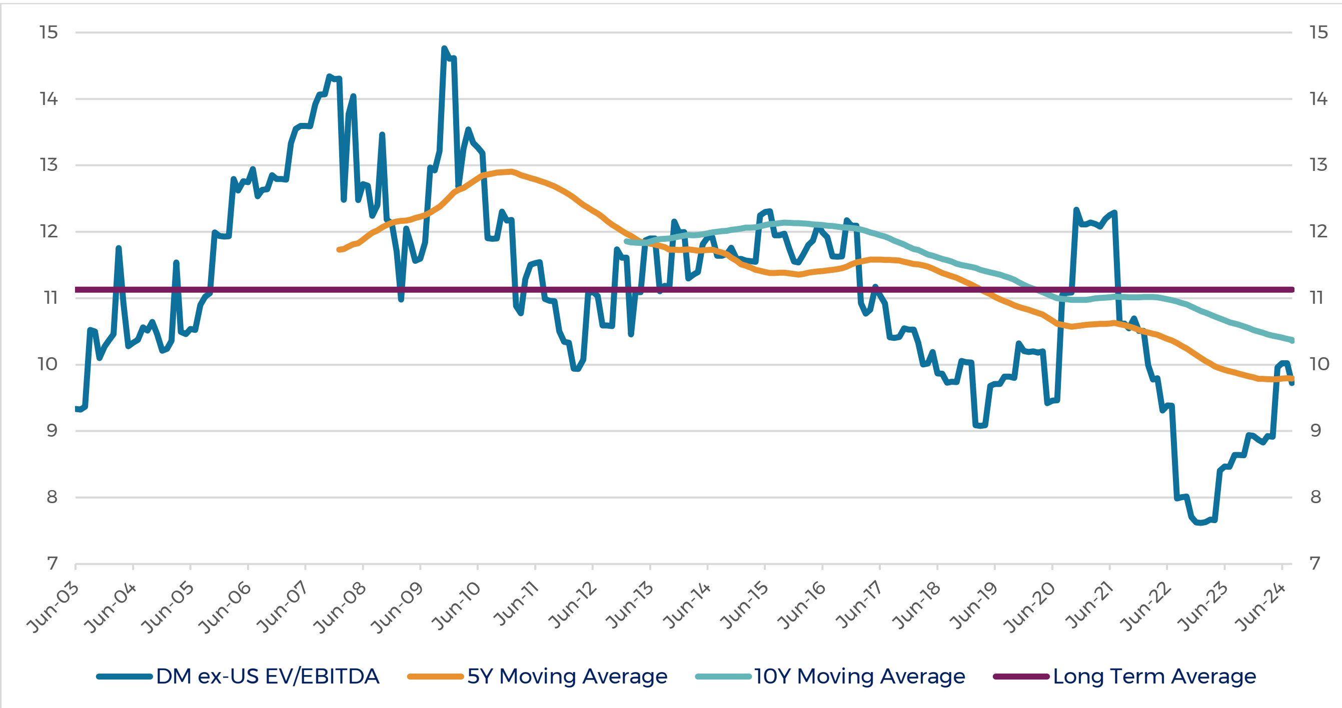
Source: Shard Capital, 30/09/2024

Exhibit 20: S&P 500 EV/EBITDA multiple:



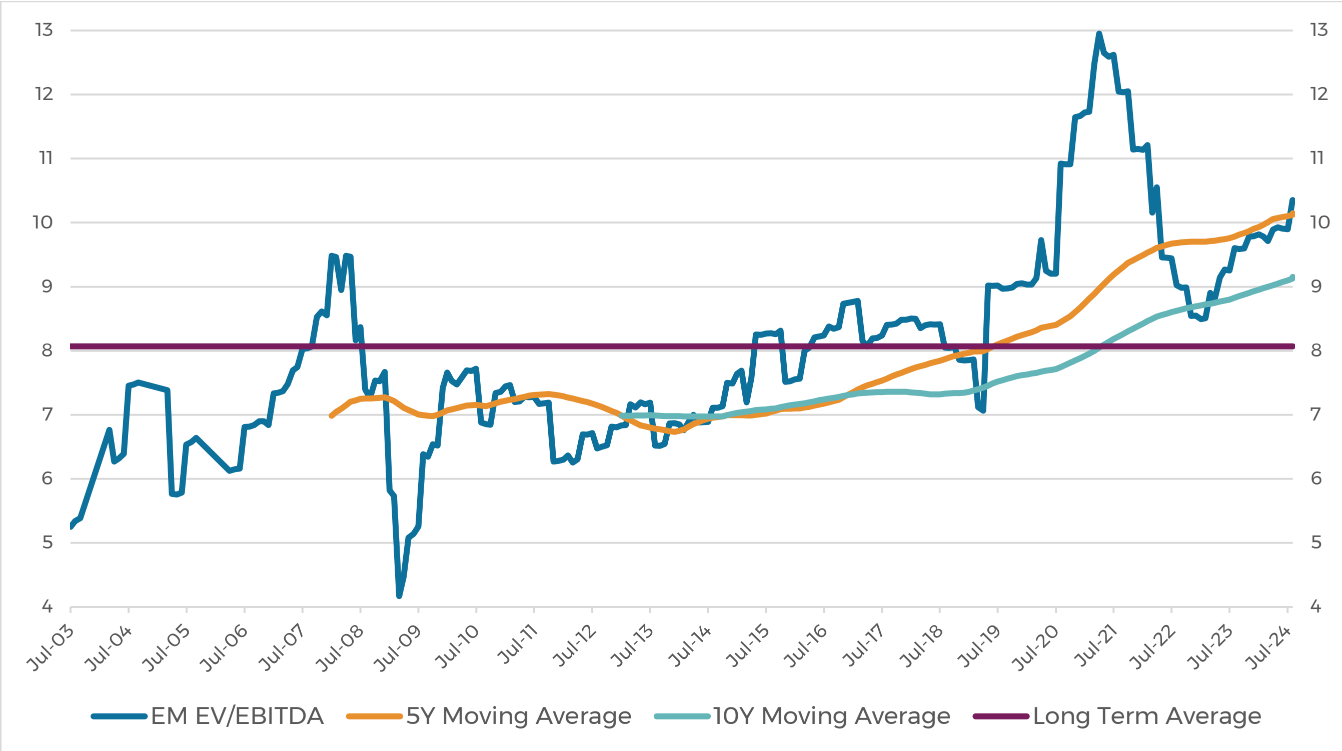
Source: Shard Capital, 30/09/2024

Exhibit 21: Developed Markets ex-US EV/EBITDA multiple:



Source: Shard Capital, 30/09/2024

Exhibit 21: Emerging Markets EV/EBITDA multiple:



Source: Shard Capital, 30/09/2024

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