Goldilocks versus 3 Bears

Global equity investors have driven stocks higher this year. The main MSCI index for global stocks is up almost 20% year-to-date. As the third quarter ended a couple of stock markets in Europe and the main markets in the US reached new all-time highs. Japan set a new record early in the third quarter as did the tech-laden NASDAQ in the US. An objective observer could be forgiven for presuming that the outlook for investors is bright. The name sometimes associated with an environment such as the current one facing investors where there appear to be no discernable obstacles on the horizon is Goldilocks. It is said that markets are in a Goldilocks period, where naught but blue skies are to be expected. A sage of investing once said that prudent investors should strive to be fearful at such times, especially if other investors seem to be getting greedy. We believe this to be such a time. Caution is warranted as there may well be trouble brewing in this apparent investment paradise. In other words, Goldilocks needs to be on the lookout for the bears.

In the mythological 19th century English fairy tale Goldilocks enters the home of three bears while they are away. Relaxed and unworried, she eventually falls asleep only to encounter trouble upon the residents' return. Goldilocks and the three bears is meant to be a cautionary fable, conveying a lesson about the dangers of venturing into unknown territories. We think that might well be the appropriate tone for investors today. The three bear influences facing investors in today's markets are wars, restrictive monetary policy and uncertainty.

The world now faces two hot wars and an ever-increasing cold one. The first hot war is in Europe between Russia and Ukraine while the other hot war is an expanding fight in the Middle East which started almost exactly a year ago between Israel and Hamas but has since expanded to include Hezbollah and perhaps now even Iran. The cold war is obviously between the United States and China. The two biggest economies in the world, the world's only two remaining super-powers, seem to have no topic on which they can agree: technology and trade top the list, though. Technology is a constant source of disagreement as the US wants to keep the most advanced semiconductor chips out of China's reach. The fear is that the US might lose its military advantage over China if the Chinese get to equip their weaponry with the latest technological advantages. Following closely behind tech is trade. In the first two decades of this century after China joined the World Trade Organization Chinese exports to the rest of the world grew at an exponential rate. Now, the rest of the world seems to have grown weary of using China as its manufacturing hub. The jobs lost in other countries has become a bigger and bigger political problem and now the West is slapping Chinese exports with heavy tariffs. In fact, punishing China for "unfair" export policies may be the one thing that all the political parties and all of the Western countries can actually agree on.

On the monetary front, policy is still restrictive: the central banks of the world are lowering interest rates in response to slowing inflation and weakening economic growth. The US Fed grabbed headlines with an extra-large 50 basis points rate cut last month. The European Central Bank has cut interest rates twice since June and is expected to cut them again next month. Not to be outdone, the Bank of England is also lowering interest rates, with a base rate cut this past summer. The cuts are the obvious response to a full year-and-a-half of rate hikes in an attempt to beat back the raging inflation of two years ago.

A rational case can be made that global equity investors are always facing uncertainty. After all, no one ever knows what is going to happen. The time when uncertainty is most impactful is when there are significant imbalances in markets. For example, when economic conditions hang on a knife-edge, but investors' perceptions are not in line with that. Today, with stock markets around the world setting new all-time highs, stocks appear to be priced for perfection. Yet conditions are far from perfect. In 2023 after an inflation spike the previous year led central banks on the rate raising binge detailed above, many economists were predicting a particularly painful downturn. That did not happen. The resulting euphoric response from global equity market investors has driven stocks to their current highs.

So, the question before market participants today is whether the global economy is rebalancing, experiencing that mythical central bank engineered soft landing or drifting into a recession? Europe (and the UK) can probably continue to grow healthily as long as the US has no recession, but what of Japan…China and the Emerging Markets more generally? The strength of the Japanese yen remains a potential headache. In fact, the interrelatedness of global markets came crashing back into our collective consciousness in early August when Japan's stock market experienced a sharp decline and subsequent rebound. On Monday August 5 the Nikkei index fell 12%, its worst performance since 1987. Combined with its decrease on the Friday before, the Nikkei had its worst two-day loss ever! This was due to a number of factors, including concerns about a US recession, fears of overvalued technology stocks, and a traditional calendar cycle of selling futures in August and September (particularly those associated with yen-carry trades). On the next day, Tuesday August 6, the Nikkei rebounded with its largest daily gain since 2008. During this period, the yen moved about 13% versus the US dollar. An unprecedented burst of volatility!

While on the topic of volatility we have to mention the fact that China experienced its own surge of volatility. It is not news to followers of global markets that China has experienced a significant slowdown of late. Even after the stagnation associated with China's poor handling of the pandemic, economic prospects for the nation took another even greater turn for the worse as property market problems remain unresolved, credit growth slowed and consumer confidence (especially among the youth who cannot find jobs in record numbers) hovered near record lows. It is obvious to investors that large scale stimulus measures are needed. As if prompted, Chinese authorities came out at the very end of the quarter with a surprise package of stimulus policies designed to prime the economy. The result was the most powerful rally in the Chinese stock mark in sixteen years! Stock markets rose ~30% from low to high in less than a month. Stocks then fell 11% the next day as investors pondered whether the authorities will be willing to do all that will be necessary in order fix the myriad problems the Chinese economy faces. One thing is clear: until they do it is difficult to imagine a meaningful rebound in economic growth in China.

However, there are other EM markets poised for growth. Look to Mexico and Indonesia. But, if Chinese authorities are willing to do, "whatever it takes" then Chinese are poised to outperform. Portfolio managers always face the question of whether to follow the crowd or go their own way. It can be a lonely feeling going against the crowd, but we have never shied away from following our process, no matter whether it leads to favor or not. We believe in our process and its ability to outperform over the cycle.

The world seems headed for more volatility (after all we haven't even mentioned politics). We believe the job of a portfolio manager is to look past the uncertainty and seek out the things that are lasting. We believe that owning quality stocks which trade at a discount to their underlying fundamentals will prevail.