Haven Global Partners, LLC
Market Outlook: July 2024

Waiting on Rate Cuts…Still!

Interest rates have moved higher and stock market investors as well as their bond buying brethren are anxiously awaiting a wave of global policy rate cuts to put a firmer foundation under the global rally. That wait might go on for a while because current financial conditions are looser than most market participants believe. Yes, government bond yields, and the policy rates which inform them, are higher than they were a couple of years ago before central banks the world over began a campaign of rate hikes the likes of which had not been seen for decades. Their purpose was to force the inflation genie back into the bottle. While inflation no longer rages like an inferno, neither are the policymakers rushing to plaster "Mission Accomplished" signs all over the place. Inflation has fallen to levels which, while tolerable, are not yet within the parameters that central bankers have set as their targets.

There has been a great deal of debate about why many interest rate increases all over the world have not been enough to sufficiently restrain aggregate demand thus bringing inflation back down to desired levels. We mentioned last time that the rapid and consistent year and a half of rate hikes had many market sages predicting recessions. That did not happen. In fact, growth has surprised on the upside in many global economies. What could be the reason for such resilient growth in the face of so many policy rate hikes?

First of all, global stocks have rallied making consumers feel richer and supporting their spending (China is an obvious and painful exception). Also, companies with outstanding debt refinanced in the lead up to the rate hikes at lower interest rates and for longer term maturities. Households also took advantage of the refinancing option when they could (many countries have floating rate mortgages which react to rate changes in real time). Proper prior planning on the part of companies and the resiliency of consumers helped the global economy withstand the drumbeat of rate hikes far better than had been expected. Yields have been very low by historic standards since the Global Financial Crisis. From 2013 to 2023 the 10-year US Treasury yield averaged 2.4%. Today it is 4.3%, higher than the past decade, but it remains significantly lower than the average of 6% over the past 60 years. Some pundits are positing that rates might stay higher for longer. If they are correct, that decade following the GFC may come to be seen as a bygone borrower's paradise.

Next year will mark eight decades since the end of WWII. These years have been among the best in the history of the world for peace, prosperity and stock returns. But given the current state of geopolitics, with support for globalization waning and cracks appearing in the foundation of the New World Order, it would not be unreasonable to wonder whether we are heading back into another era which will be marked by protectionism and war. This matters for investors because geopolitical events can have a significant effect on the global stock markets, and with 49% of the world's population in 64 countries going to the polls to elect new leaders in 2024, the most in recorded history, the market moving events of this year will definitely have a political component to them.

Things started early in Taiwan back on the 13th of January where the already high tensions in the Taiwan Strait were worsened as Democratic Progressive Party candidate William Lai won, although he was not able to establish a majority in the Legislative Yuan, which will make it significantly more difficult for him to implement a DPP agenda as president. The People's Republic of China which considers Taiwan a rogue province was displeased with the election's outcome and stepped up its efforts at intimidation in order to threaten its tiny neighbor.

Next, India took six weeks in the spring to re-elect Narendra Modi to a new term though his party lost seats due to a stronger than expected performance by his opposition. We have also seen market moving outcomes after elections in Mexico, the United Kingdom and France this summer. Of course, an election in the United States is coming in November, as well. A famous general called war "politics by other means", so we can discuss war right alongside politics. The war which Russia forced onto Ukraine almost two-and-a-half years ago is also a market moving geopolitical event. And fighting in the Middle East between Israel & Hamas continues. One could be forgiven for thinking that such a long list of geopolitical events might introduce a higher level of uncertainty into global markets, but that has not been the case, at least not so far, but those concerned about the future performance of global equity markets must continue to monitor geopolitical events.

For the better part of three decades, international equity investors have mostly shunned Japanese stocks. The Nikkei 225 hit its all-time high in December of 1989, 35 years ago! Since then, investors have had little interest in Japanese stocks. One of the easiest ways to outperform global stock indexes has been to be underweight Japan. That narrative may have to change now. The Japanese economic system which has been slandered as socialist capitalism where little attention was paid to shareholders, companies were never exposed to external pressure to improve returns on capital and cross shareholdings among companies built a protective moat which shielded managements from the consequences of their actions, appears to be due for a star turn. Recent government initiatives and peer pressure may have brought corporations to the point where they are really embracing a true capitalist mind-set for the first time. Corporate managements in Japan are at last overcoming the trauma of the 1990s market collapse, which led to a generation of cash-hoarding and ultraconservatism.

The Tokyo Stock Exchange got hidebound managements' attention last year, launching a "name-and-shame" campaign for companies trading below their book value. Earlier this year, the Financial Services Authority made strong statements discouraging cross-shareholdings. Companies which embrace governance change can produce dramatic results. There are currently forces at work to make Japan a preferred non-U.S. destination for investors. With the U.S. dollar at 20-year highs, portfolio managers know that it is typically time to diversify and buy cheaper overseas markets, but where to go? Europe is cheap but challenging, and Emerging Markets bring with them problems that developed markets do not. Yet with Asia at 45% of global GDP, having some exposure is important.

Japan is a pre-eminent security partner for the U.S. and is quickly becoming a key partner in U.S. reshoring strategies, especially as an alternative supplier of semiconductors and technology components. This implies that Japan could regain market share that it lost over the past 20 years to China. Japan's status as a security partner to the U.S. should matter more to investors now. In Japan, 45% of the top 2000 constituents have no analyst research coverage, compared with just 3% of the Russell 3000 universe in the U.S. So, Japan is a market where companies are changing their approach in order to make themselves more attractive to investors while approximately half of those companies are not being covered. That sounds like a country to which global investors may want to pay more attention.

The world seems more dangerous than it has been. Greater volatility lies ahead. The job of a portfolio manager is to look past the uncertainty and identify the things that are lasting. We like owning quality stocks, whether doing so is in favor or not. We intend to continue to practice our process: owning quality stocks which trade at a discount to their underlying fundamentals.