INTEGRAL Asset Management

The Outlook

August 2024

In this edition

- American hegemony ends as multi-alignment rises.
- The US still dominates markets.
- Alpine Macro bets on no US recession.
- US rotation from tech to small caps and a rate cut likely in September.
- Commercial banks create dollars, and the inverted yield curve is signalling a recession.
- US equities YTD performance and the South African GNU promises upside.

"American global hegemony ends as multi-alignment rises".

In an article published in May in The Hill, Andrew Latham a professor at Macalester College in Saint Paul, Minnesota said "*Forget the Pax Americana*. *The unipolar moment, that brief interlude where the United States reigned supreme, is over. China's rise, coupled with a growing discontent with the American-led rules-based international order, has ushered in a new era: a multipolar world with multiple power centres jostling for influence*."

As with US investors, Latham downplays the gathering BRICS+ movement against the G7 and believes that "*middle power countries are using multi-alignment tactics to play multiple sides, maximizing their strategic gains within a multipolar landscape*". Here he points to Indonesia, Vietnam, Saudi Arabia, and the UAE.

Latham admits that "*fostering peace and security hinges on a delicate balance. It doesn't preclude competition, but simply ensures it occurs within a framework that prioritizes peaceful coexistence*". If only the world was so obedient, and his views offer much for the ANC to consider.

But the US still dominates markets.

Amid sanctions, trade wars, and a growing number of non-dollar trades, the US dollar is still the dominant global reserve currency (58%), has the deepest and most flexible forex market (88%), and the largest bond ($51tr or 40%) and stock markets ($53tr or 60%).

The outsized role of the US dollar means that global markets remain focused on the robustness of the US economy, tighter monetary policy, and heightened geopolitical tension and what this means for the dollar.

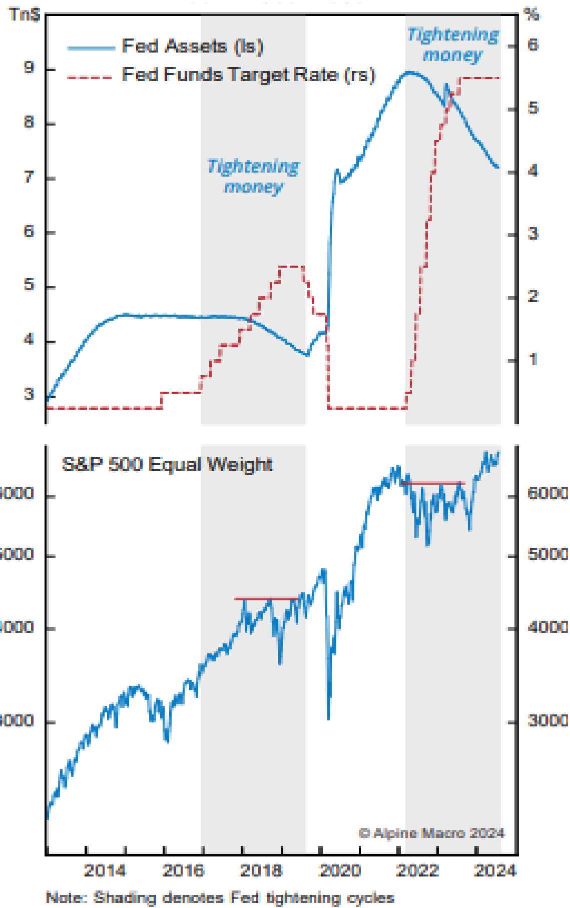
Alpine Macro bets on no US recession.

Alpine Macro research entitled **Height, Width, and Length** – 29 July 2024 says "*For the current cycle, stock market rotation seems to be happening at an interesting juncture: rates are high, but the Fed has signalled that it will ease soon. Liquidity, though plentiful, is being drained out of the system by Fed QT*" – see the chart lower down.

Alpine Macro adds that "*There is always a risk of recession, but our bet is that the U.S. economy will escape this bad outcome. The cyclical process since the 2020 recession has been primarily driven by supply-side adjustments. This has created a path for core PCE inflation to fall to the Fed's 2% target without needing the central bank to weaken aggregate demand too much*".

Alpine Macro sees a Goldilocks scenario playing out, one that is good for bonds and stocks. "*The key point*

to remember is that we are only a month away from an expected Fed rate cut. With inflation likely dropping much faster than most anticipate, the Fed may have to cut rates more than what is currently discounted.

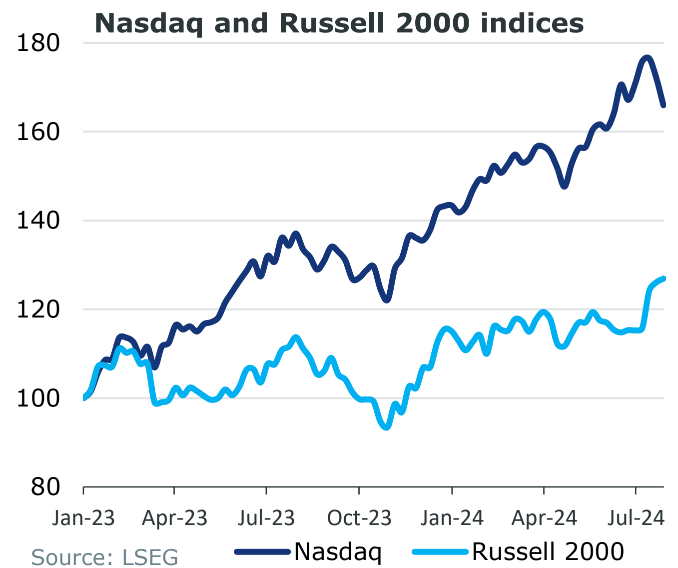


Note: Shading denotes Fed tightening cycles

The US equity rotation from tech to small caps.

The graph above shows the tightening (QT) by the Fed in recent months and the unchanged funds rate (5.38%) which Alpine Macro expects the Fed to cut more than once. But the real eye-opener has been the performance of US equities. Since January 2013 the Nasdaq has increased annually by 18.4% and the S&P 500 by 12.1% - a +50% outperformance by the tech-loaded Nasdaq.

The following chart compares the Nasdaq to the small-cap Russell 2000 index. Even over the shorter period since January 2023, the Nasdaq has outperformed. A correction in the Nasdaq has been expected and in recent days you can see the 'rotation trade' that Alpine Macro referred to above. Within days the Nasdaq has dropped about 6%, whilst the Russel 2000 has added about 7%. Clearly the small-cap stocks can't cope with the liquidity of a sizable Nasdaq sell-off. Hence the Magnificent 7 tech stocks need to maintain the expected high earnings growth rates and get a boost from a Fed rate cut.



A rate cut in September is likely.

At Wednesday's FOMC meeting, the Fed left its key rate unchanged, but according to the New York Times, hinted that "*rate cuts could come soon*". In the Q&A session, Jerome Powell seemed to edge his replies towards a rate cut in September, saying that "*we don't need to be 100% focussed on inflation*" and that "*the economy is moving closer to the point at which it will be appropriate to reduce our policy rate*".

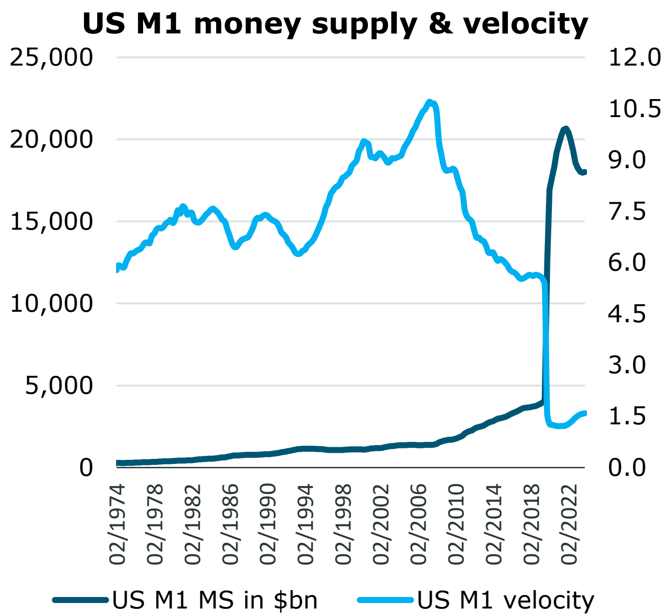
The latest US household surveys are all pointing to a cooling on the labour front which supports a rate cut. According to a recent CNN poll, "*39% of US adults say they worry that their family's income won't be enough to meet expenses.* To cope, a significant number of Americans said, "*they are adding side jobs, cutting down on driving and putting more expenses on credit cards". CNN says, "the findings underscore how, despite national statistics that show unemployment and inflation are cooling, millions of Americans are hurting from years of rising prices".*

It seems that the relatively high interest rates have taken their toll, and that the Fed has good reason to cut on 18 September.

Commercial banks create dollars.

However, many commentators differ on the Goldilocks and soft-landing scenario. This week Deutsche Bank reminded investors that "*an inverted yield curve, which occurs when short-term debt yields more than long-term paper, has been a harbinger of a recession in nine out of 10 instances over the last 70 years*. The most powerful recession indicator – a 24-month inverted yield curve – is signalling a recession. The chart below shows that since March 2022 M1 money supply (physical currency and demand deposits) has fallen by 12.1% to $18.6tr and the M1 velocity has slowed from 10.5% to 1.5%.

While the Fed's control over the monetary base is complete, it's control over money supply is not. Central banks create reserves and commercial banks create the dollars.



Banks are strategically positioned to understand risk and reward. They know their competition and customers (households, corporates, and governments) intimately and are aware of the growing systemic risks.

Bankers make profits by borrowing short-term and lending at higher long-term rates. Over the last 24 months bankers have been borrowing at 5% and had to look at Collateralized Loan Obligations (CLOs) with underlying junk bonds and risky Commercial Real Estate (CRE) to make commensurate risk-adjusted returns. This is a daisy chain of risk with bankers continually looking over their shoulders. Furthermore, everyone is aware that the Bank Funding Term Program (BFTP) ended on 11 March – the emergency liquidity response to Signature and Silicon Valley Bank failures.

Of concern and never discussed at Fed Q&A sessions is that "*US banks face a day of reckoning: over the next two years, more than $1tr in CRE loans will come due*" according to The Conference Board (TCB). TCB calculates that all banking categories have CRE loan values far exceeding risk-based capital levels: small (158%), midsized (228%), large (142%), and the largest (56%). This seems like a compelling reason for lower rates. But will the Fed avoid a recession?

The inverted US yield curve is signaling a recession.

Since the 1950s an inverted yield curve has predicted nine out of ten recessions. The inverted yield curve is the most powerful predictor of a recession.

Yet how the yield curve normalizes is hardly discussed. If the economy was booming, why aren't the banks lending? It is thus not surprising that none other than JP Morgan CEO, Jamie Dimon, has regularly said on Bloomberg that "*America is headed for a repeat of the 1970's when everything 'felt great' and then quickly about turned to a period of high unemployment and inflation paired with low demand*". Hopefully the

The Outlook

August 2024

authorities have a plan.

The yield curve can only normalize by way of a bear or bull steepening. Currently we are seeing a bull steepening, the soft-landing scenario. Since 2013 we have moved from good news is good news, to bad news is good news - the Fed will cut rates. But when will bad news be bad news?

US equities and the JSE ALSI in dollars.

Year-to-date (YTD), the Nasdaq and the S&P 500 are up, respectively, 15.9% and 15.8%, whereas gold is up 18.86%, and the JSE ALSI is up 8.1% in dollars and 7.2% in rands. Information Technology (+25.1%), Banks (+21.3%), and Communication Services (+20.8%), lead the major sub-indices YTD ranking.

South Africa – the GNU promises upside.

Managed sensibly, the infant GNU has an opportunity to greatly reinvigorate our economy. Amongst many issues, crime, the Agoa discussions, health, and pension funds as a source of infrastructure capital are in sharp focus and will pressure the ANC ministers to 'grasp the nettle'. So far local shares have reacted positively to the GNU. Citizens and the business community now need to get behind the GNU and apply equal measures of support and pressure.

The SAPY (+12.4%) leads the JSE performance YTD, followed by the FINI 15 (+10.7%), the RESI 20 (+7.5%) the ALSI (+7.2%), and the INDI 25 (+5.7%). Although geo-political and economic headwinds prevail, top-end corporates are doing well and based on a soft-landing those equities are well supported. The possibility that the GNU sneaks back onto the world podium could be good for local equities. Cognisant of a potential US recession, we remain cognisant of the risks.

Bruce Williamson
Mining analyst

Keith McLachlan
Chief Investment Officer

Danilo Pagani
Chief Executive Officer

Dave Eliot
Executive Chairman

The Outlook was generated by the Integral Asset Management investment team: Dave Eliot | Bruce Williamson | Danilo Pagani
Integral Asset Management SA (Pty) Ltd issued this publication for the information of clients only. It shall not be reproduced in whole or part without our permission. The information herein has been obtained from sources and people whom we believe to be reliable but are not guaranteed accuracy, completeness, or otherwise. All opinions and recommendations expressed are subject to change without notice. No information held herein, no opinion expressed, and no recommendation made constitutes a representation by us or a solicitation for transactions in any of the securities mentioned herein and we have no responsibility whatsoever arising here from or in consequence hereof. Securities or financial instruments mentioned herein may not be suitable for all investors. Any person coming into possession of this publication is obliged to seek additional financial advice for his/her investment decisions. Past performance is not indicative of future results, and investors may get back less than they invested.

Integral Asset Management (Pty) Ltd is an authorized Financial Services Provider **FSP Number** 46545 **Registration Number** 2015/393458/07 | **Directors** Dave Eliot (Executive Chairman), Danilo Pagani (CEO), Bruce Williamson (Mining Analyst), Keith McLachlan (CIO) Block B, The Offices of Hyde Park, 1 Strouthos Road, Hyde Park, 2196 | P O Box 934, Northlands, 2116 +27 87 985 0104 | info@integralasset.co.za