MAY 19, 2023

ROTATION

1825 words, a 5 minute read.

TV prep is always helpful, especially when it's for a Friday hit as it was today. Last week was mentally draining; we published the May Monthly, updated our two model portfolios, our Global Multi Asset (GMA) flagship and our TPW 20 thematic model, wrote the accompanying client notes and finished up with last Friday's Musings. It's often the case that some key insights from that work only make themselves apparent over time.

Such was the case yesterday when much of what is written below came to me, as often happens, when I was at the gym. Returning from the gym, I had an email from the BTV producers asking if I could come on this morning. Perfecto! I wrote up my thoughts and sent them over. Then this morning around 8, I got an email with a topic change which allowed me to write up the 2nd half of this Musings. So, thanks to the good folks at BTV for helping write this Musings on rotation. The rotation to come: from US Big Tech to cyclicals & the rotation underway, from US led global equity to non US led global equity markets.

As we see it, the Fed & rates are on hold (last 6 month's US inflation annualized = 3.3%), the debt limit is just another element of the Curtain of FUD (Fear, Uncertainty & Doubt) and the real Q is when, not if, the market rotation from Growth back to Cyclicals takes place.

Big Cap Tech is where all the $ is going because of AI and the margin expansion/moat it gives the big companies that can spend the required amounts on it. The set up is solid: big cap tech derated last yr., rate hike risk is now over and so it's a VG hedge against recession which remains the consensus base case (recession = lower rates = higher tech stock prices). We agree with all that and have shifted considerable amount of US equity exposure into tech related growth including semiconductors which we see as the pick & shovel of the AI innovation cycle.

As a result, the spread between big tech and cyclicals - commodities has gotten very wide with BBG's Commodity Index at a 16 month low & that's what sets up the rotation which we think will be confirmed once we get through the debt ceiling drama (which we will - do we really want to show the world/China how feckless we are? Don't think so) and come to the Fed meeting in less than a month.

At the June meeting, we expect the Fed to validate the on hold camp and the high nominal growth, no recession camp (the Middle Path we have been writing about for a year) by raising its 2023 and 2024 GDP estimates - note Q2 Atlanta Nowcast at 2.9%. This, in turn, will validate the rising 2H EPS estimates and positive forward corporate guidance that came out of Q1 BTE earnings seasons here and abroad. More importantly still, it will boost Cyclicals & Commodities which will allow S&P to break out & UP first to clear 4200 resistance (happening now – speed) which every technician has highlighted and thus will bring in $ and then 4300 which will mark the start of a new bull mkt (20% up off Oct low - QQQs already in its bull market and showing leadership with equal weight index up 17% ytd).

Net, net: US bonds are priced for recession, US stocks are positioned for recession in terms of sentiment and under ownership of stocks, OW of cash. Cyclical & Comm have gone quite a way to pricing in recession yet the S&P Global Composite is at a 16 month high & up 5 months in a row. In the US, housing has bottomed, auto production is booming & back above pre pandemic levels, the consumer is fine and we are about to replace the inventory destocking cycle which dragged down growth in 2022 and early 2023 with an inventory restocking cycle which will take ISM Manuf back above 50 in the next few months.

As a result, we have shifted our US equity position within the GMA model to more of a barbell - long Big Tech and Cyclicals including homebuilders, transports, financials and industrials.

One has to pull the Curtain of FUD aside to see that we are early cycle in a global economic recovery not late cycle going into recession. We continue to focus on the 4 major shifts underway policy wise; Fed - ECB validate high nominal growth world & 3% inflation target, the return of Industrial Policy to US and its expansion in Europe, end of YCC in Japan and the shift in China from FAI led growth to consumer demand led growth. All are pro growth policies.

The second rotation: from US to non US equity leadership is well underway as markets break out all over the place. LPL notes that ex US markets trade at 13x 12M forward EPS vs 18x for US equity – a significant discount to the historical spread even though 2023 EPS growth is expected at close to 4% for non US vs -1% for US equity. Europe has led and now its Mexico (THE winner from the regionalization of global supply chains) & Japan's turn as we have highlighted since late last year when we became quite bullish Asia. We have been 1/2 right so far; EWJ is breaking out with a great looking chart; China not so much - China and commodities are the Q marks as they are not validating the early cycle global economic growth story - China is economy wise but not stock wise… commodities don't act great which is the worry.

DM's have been the main driver led by Europe and now Japan with EAFE up 11% ytd vs SPY up 9%. Europe has had a massive run up about 30% over the past year and roughly 17% ytd as the Curtain of FUD which fell over the continent following the Russian invasion has been torn asunder. Current natural gas prices in Europe are now close to and in some cases below levels that existed pre invasion. Recession averted, record low unemployment, best earnings beats since 2007 & compelling valuation are among the positives for European equity. We favor EUFN given EU banks are trading at 50% discount on P/E basis to the broad market with a total yield of 11% according to MS.

Here at TPW Advisory, Europe was really last year's call. This year we have been focused on Asia, mainly Japan but also China and SE Asia. Japan is working well with EWJ breaking out to a new 52 week high as the underlying market hits a 30 year high. Why one asks? For the simple yet powerful reason that Japan is finally exiting the structural deflation that has bedeviled the country since the 90s. With wage gains at multi decade highs and inflation running about 3-4%, Japan is now the fastest growing of the G7 economies; something PM Kishida has been happy to note at this weekend's G7 gathering in Hiroshima.

We think there is much more to come as the BOJ exits its Yield Curve Control (YCC) strategy, leading to a back up in interest rates and a significant domestic investor asset allocation away from bonds to stocks – the likes of which have not been seen for many years. In addition, there is a real governance effort going on to push companies that have been hoarding cash and trading below book value to shift the cash and get valuation above book. At the same time there is demographic change in SME leadership leading to significant opportunity for the major PE firms like KKR and others in Japan. This in turn helps unlock value and investment opportunity.

Among EMs, Mexico has been a major focus thank to our Tri Polar World framework which has us particularly attuned to the shift in global supply chains to regionalization across each of the three main regions: Asia, Europe and the Americas. We see it in Asia as production shifts to a China +1 focus benefitting Thailand, Malaysia, Indonesia, India etc. thus our SE Asia position. We see it in Europe with the expansion of industrial policy to foster the build out of EV & semiconductor supply chains, not to mention the overarching EU climate mitigation and defense efforts.

And we see it in the Americas with Mexico being the poster child as EV and semi plants start to proliferate across the Southwestern US, right across the border from Mexico. As a result, northern Mexico, long the locale for US destined production efforts under NAFTA, is now seeing EV and semi fab related production set up. Mexico is the best performing global major equity market ytd up roughly 20% while MXN, the Mexican peso, is one of the world's strongest currencies, at a six year high vs the USD thanks to high real rates, remittances & FDI inflows.

Of course, it's not all sugar and spice; China has been a major disappointment as an equity market. After last Fall's big run up following the sudden drop of it's Zero Covid policy, Chinese equity has given much of that performance back – surprising many, including ourselves. This has been most evident in the China tech space which has not only failed to keep up with the QQQs breakout but has fallen double digits ytd. A combination of attractive cash yields & lack of domestic investor confidence coupled with foreign investor worries over geopolitics has led to a lack of interest in China tech.

Given that China represents roughly 50% or so of broad EM equity indices and ETFs, EEM, up only 2% ytd, has been a drag on non US equity performance. In our GMA EM equity exposure, we have been country or regional specific and so hold no broad EM equity exposure. In the fixed income space, we have a good sized position in EMLC as we expect the Fed to go on hold as noted above which should lead to USD weakness and EM FX strength. We also expect EM to lead the world in a rate cutting cycle once the Fed clearly goes on hold. Many major EM Central Banks, such as Mexico and Brazil, are already on hold. We expect the next move to be rate cuts to help jumpstart their domestic economies & stock markets.

We continue to expect non US equity markets to lead the new cycle but accept that AI is a US centric real game changer and so the relative tech led, US equity weakness we expected is now less likely. As such we have deployed somewhat of a barbell approach in our global equity allocation as well – US and non US with a latter bias to DM over EM.

Keep it simple, keep it supple.

Next
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