Chief Investment Office

January 2023

Index House View

An uncertain beginning

January is usually a very active month.

January of 2023 started with some optimism on inflation and central bank rates in US and Europe.

This is not surprising. Inflation in developed economies is coming back to Earth as oil and natural gas normalize after the Ukraine's invasion shock. As a reaction, the FED announced a slowdown in rate increases until inflation becomes manageable.

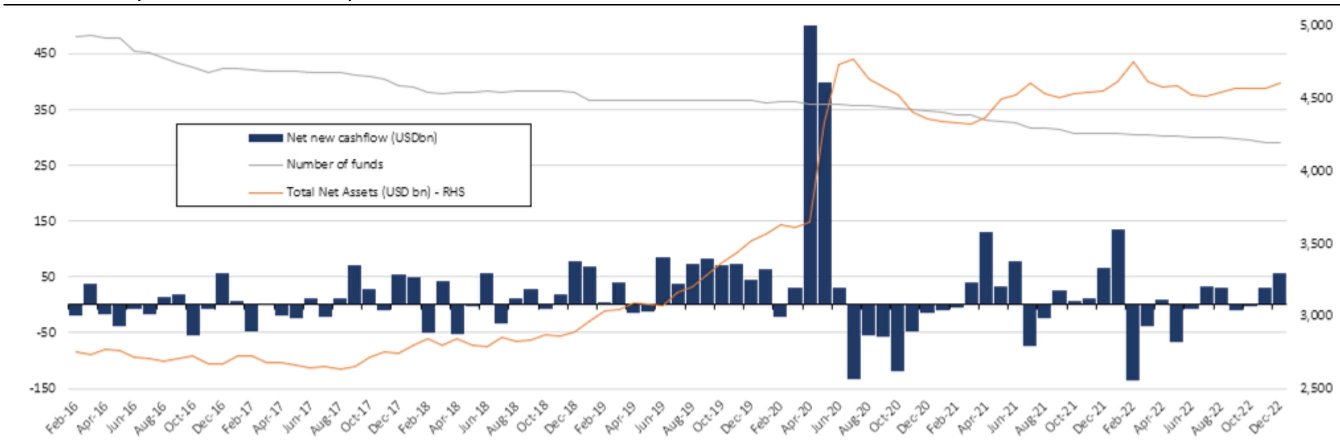
Despite some respite in the macro scenario, the US earnings season from November 2022 to January 2023 is not expected to be easy. The January numbers are not bad, but market sentiment has not materially improved from a predominantly cautious stance. Of the 506 US companies covered by analysts that reported their results in January, 28 negatively surprised by an average -39%, while 478 enjoyed an average 132% positive surprise. This is an encouraging result, but apparently not enough to trigger a bullish market rally – the mid-January weeks saw a rally, that lost steam towards the end. Eyes are still glued on inflation and rate announcements from the FED and ECB, and there is a long way for fundamentals to show resilience and size up the 2022 inflationary damage to consumption.

Focusing on January is a necessary step when trying to capture the temperature of various economies and to identify early signs of a market sentiment turnaround. However, longer analysis is what sits best with us. We worked on a couple of indicators that do not allow us to yet be optimistic. The basis is always behavioural.

Money market funds

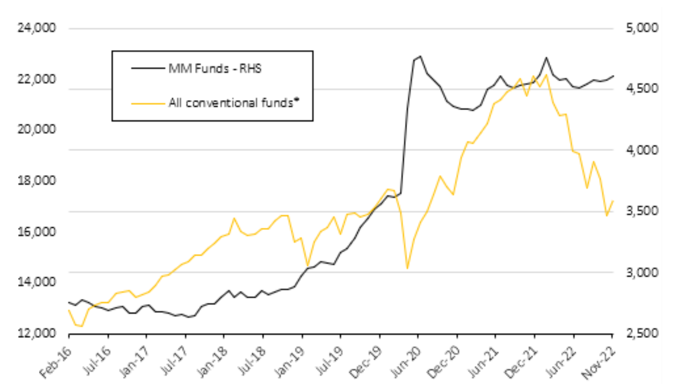
These funds are counter-cyclical in nature in that they swell in assets whenever there is uncertainty in markets – i.e. all other funds. This is clear in April and May 2020 when markets collapsed. Interestingly, since then a large quantity of cash has been sitting in money market funds, ready to be re-deployed when conditions become favourable. A comparison in total assets with all conventional funds makes this message evident: an exodus of cash out of all conventional funds into cash and money market funds since February 2020.

Net inflows, number of funds, total assets

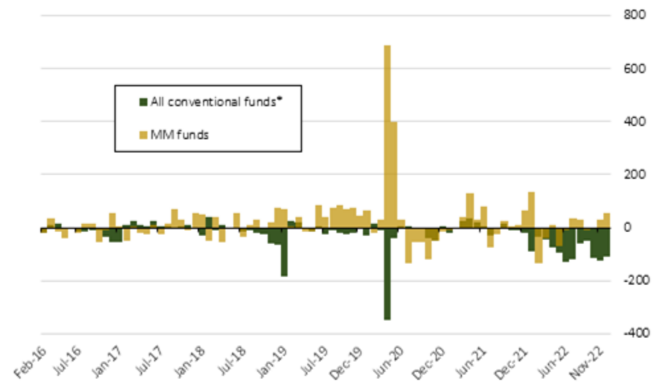


Source: Bloomberg

Total net assets comparison with all conventional funds, in USD billion



Net new cashflow comparison with all conventional funds, in USD billion



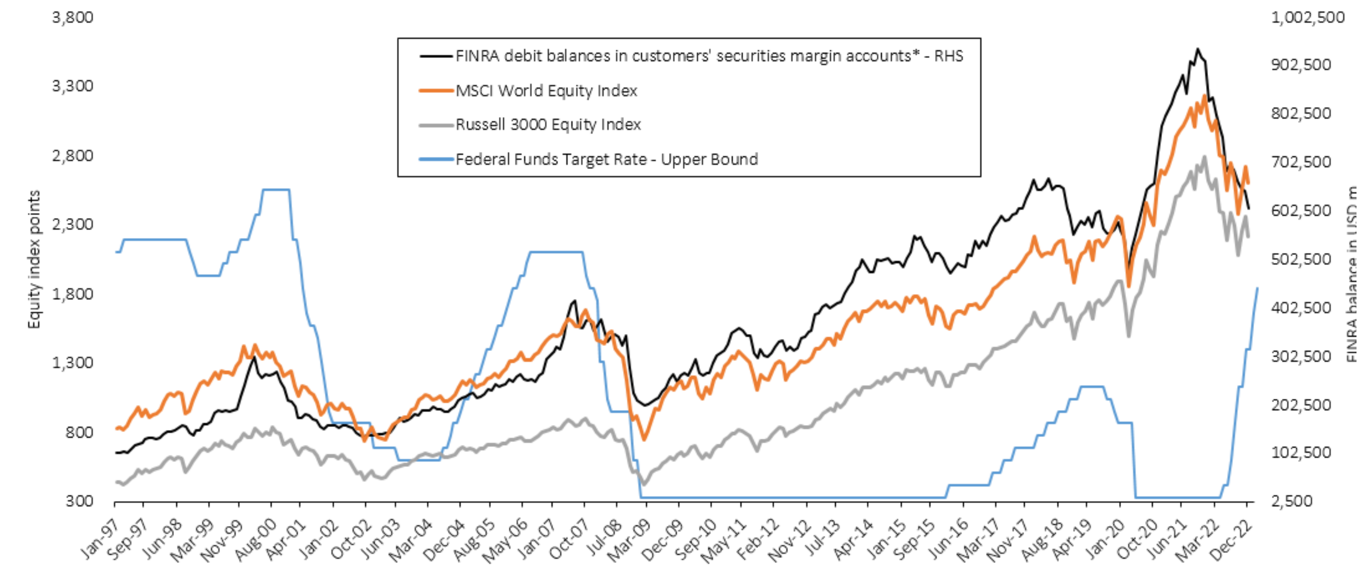
* Equity, bond and income funds. Source: Bloomberg, January 31st 2023

What does it mean? It means that whatever rallies we see in equity markets are influenced by trading volumes that are lower than the ones seen over the past 5 years, or that are external to the traditional trading challenges – perhaps higher volumes are to be expected from retail investors.

Another angle to gauge market sentiment might be coming from the Financial Industry Regulatory Authority (FINRA), a private American corporation that acts as a self-regulatory organization on member brokerage firms and exchange markets – the successor of the NASD. This institution is ultimately regulated by the SEC. FINRA requires member firms carrying margin accounts for customers to submit the total of all debit balances in securities margin accounts and the total of all free credit balances in all cash accounts and all securities margin accounts. Long story short, this info tells us how much debit by customers is used to trade (margin trading). The higher the amount, the higher the trading activity. Conversely, a diminishing level of debit balance is associated with equity markets correcting. The graph below compares the debit balance aggregate in the US with 3,000 American stocks and 1,546 among the largest world companies.

Leverage and equity values have always been deeply intertwined, especially in developed and North American markets. It is not a surprise to see how leverage and valuations retreat fast in times of uncertainty. In fact, the speed of financial markets has been deeply influenced by the ubiquitous leverage over the past 10 years, available to retail investors all the way up to UHNW wealth management clients.

FINRA debit balances vs markets and US base rate



* Credit balances are derived by adding NYSE free credit balances in cash and margin accounts to FINRA free and other credit balances in customers' securities accounts. Source: FINRA, Bloomberg, January 31st 2023

The black line does not seem to be flattening. However, this consideration has limited value, since we can see two instances in which the black line flattened gradually, and one instance during pandemic times when it quickly reversed. The question we need to ask ourselves is whether the 2022 spike in inflation and rates will produce a long or short tail of damage on fundamentals. In case of a long tail, the black line and markets will gradually invert. A short tail means there will be a decisive bounce in market sentiment in 2023.

We tend to think that at least 3 quarters are necessary to assess the inflationary damage to corporate earnings. If so, clarity on the way forward could arrive towards September-October 2023.

Current allocation

The present lack of visibility on fundamentals and equity direction bears no consequence on investors' ability to access decent returns in the bond market.

This opportunity should be taken with little to no fear of rates sky-rocketing from where they are now. Nor should this opportunity be allowed to pass untaken, as it took more than 10 years to see these yields.

The concept of bonds and money market funds is pretty similar: a parking spot for your money while waiting for clarity in equities. Are real estate, alternatives, crypto, mutual funds, hedge funds, private credit, venture capital or private equity comparable parking spots with similar remuneration, liquidity and volatility? Not at all.

Today, the only certain thing we can find in markets is a yield of ~5-7% from 5-7-year maturity investment grade, good quality, global names.

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