Index House View

Uncertainty remains the name of the game.

From one side, the solidity of the Western banking system was tested with significant defaults, but there is no sign it will escalate into a catastrophe. The US economy remains surprisingly strong both in macro-indicators and in household health. China is grappling with the inevitable limits to growth and challenged with its social pact. As a sweetener, geopolitical instability in the form of old-fashioned imperialism makes everything more unstable.

After the leverage-induced market correction of 2022, investors seem convinced a second market correction is in the making. It appears fears of a deterioration in fundamentals, i.e. a recession, have not been dissipated just yet.

Western banking crisis

Takeaway: *we look at the financial industry only to gauge its systemic stability, not as an investment target. The historical upside displayed by any of the players, even in a non-zero rates environment, has been consistently lower than the potential permanent loss of capital in case of default (see recent bank defaults in Switzerland and the US). Today, we think the global banking system is solid, with enough loan loss provisions stacked against very low global default rates, so far.*

The recent default of Credit Suisse and a handful of US banks has sparked a debate that will probably never cease.

What we discuss here below is more philosophical in nature than financial, and the end of it is that there is no fix to the currently dysfunctional banking system of all modern economies. Because of that, we do not consider the financial industry as a potential investment target, but as an industry to watch for period disasters and their contagion effect on the wider global economy.

The crux of the matter is that at no point in time has any bank employee of any rank been charged criminally for any type of bank default. In a default shareholders lose their investment and customers lose their cash deposits, the textbook definition of a “permanent loss of capital”.

In his latest shareholder meeting Warren Buffett called for harsher punishment on those responsible for bank defaults. And he also said that nothing will ever change until such laws exist. In other words, all bank employees can gingerly continue operating with a short-term view of quarterly results and an aim to achieve their bonus targets, without any responsibility should these practices drive the value of the bank down. This is a modern-time oxymoron: why would governments consider banks “systemically relevant” if the people running them do not consider the social stability function these institutions perform? How can the bonus of the senior management be more important than the cash deposits of customers? Western governments have no answer to these questions.

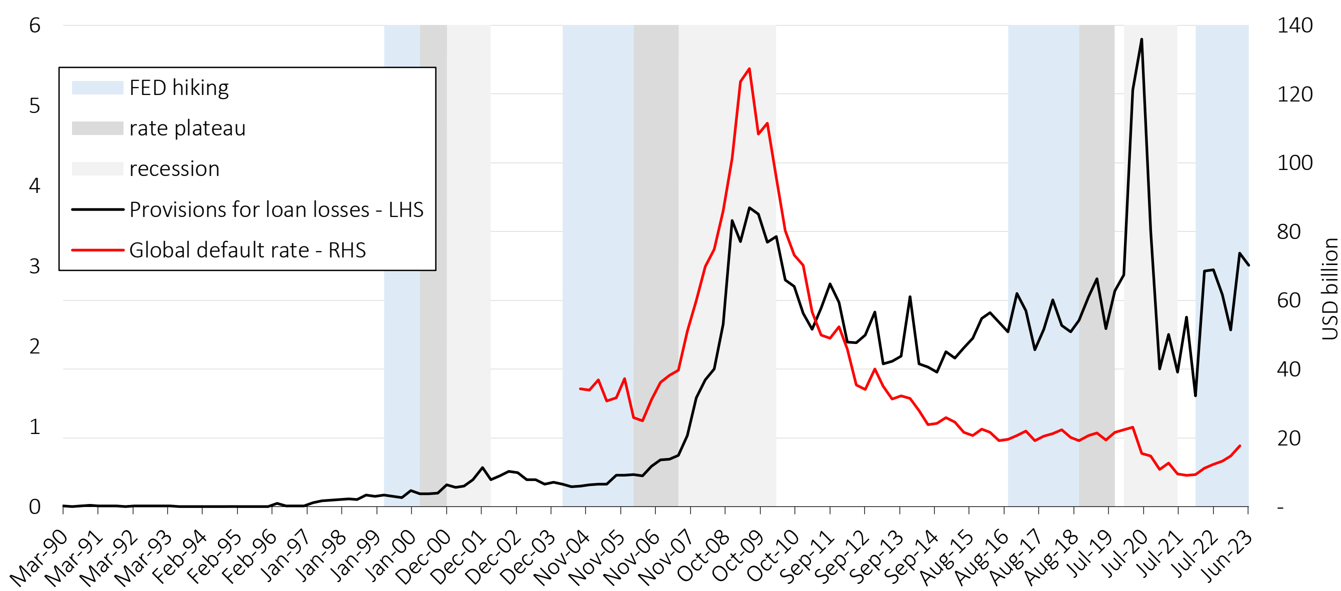
The technical side of this pathetic state of things is that all Western banks found themselves in a tough spot when interest rates hiked fast in 2022. The root problem was the regulatory obligation to invest 100% of bank reserves in investment grade bonds or government treasury bills. These reserves are designed to cushion the gradual calls of deposits by customers – no bank has all its deposits in cash, ready for withdrawal, at any moment in its corporate life. Unfortunately, bond prices go down in a rate rising environment. So the value of bank reserves also when down fast in 2022. You only need one influential customer to challenge the solvency of a bank to produce a general crash in market confidence in that bank. This situation can turn quickly lethal for some banks, as Silicon Valley Bank learnt. The point to keep in mind is that all banks are in such a situation, so the choice between default and business as usual rests uniquely on reputation.

These troubles are intrinsic to the banking business. The laws around it in the US and Europe are also way too easy to impose more conservative managerial styles, nor is the political environment conducive to adopt punishments for delinquent mismanagement. Such political support would need to challenge too many entrenched traditions, relations, interpretations. It may sound pessimistic, but the banking system will continue being the Achilles heel of Western economies, and there is nothing anybody can do to fix it during our lifetime.

In our investment view, the current way the financial sector is designed represents more a liability than an asset. At Index & Cie we do not touch legacy financials of any kind, including insurance. However, this exclusion provides no protection when the periodic banking catastrophe hits, as contagion usually spreads to every other industry.

Despite the current design, recent events do not make us fear a banking crisis is afoot. In fact, higher rates give a long-awaited breath of fresh air to banks, once the transition to a world of higher rates is completed. Concurrently, banks seem to be well defended against a possible rise in defaults due to higher rates – see graph below.

Provisions for loan losses – top 100 banks by market cap, all higher than USD 20bn



Source: S&P/Experian Consumer Credit Default Index Composite, Index & Cie calculations

A strong US economy

Takeaway: *overall very positive last earnings season with tech and discretionary posting the largest surprises, very strong labor market, inflation somewhat moderating on the back of cooling energy prices, quite solid household balance sheet with a continued expansion in leverage (mortgages). This is not the picture of an incoming recession, but could it be the unnatural calm before the storm?*

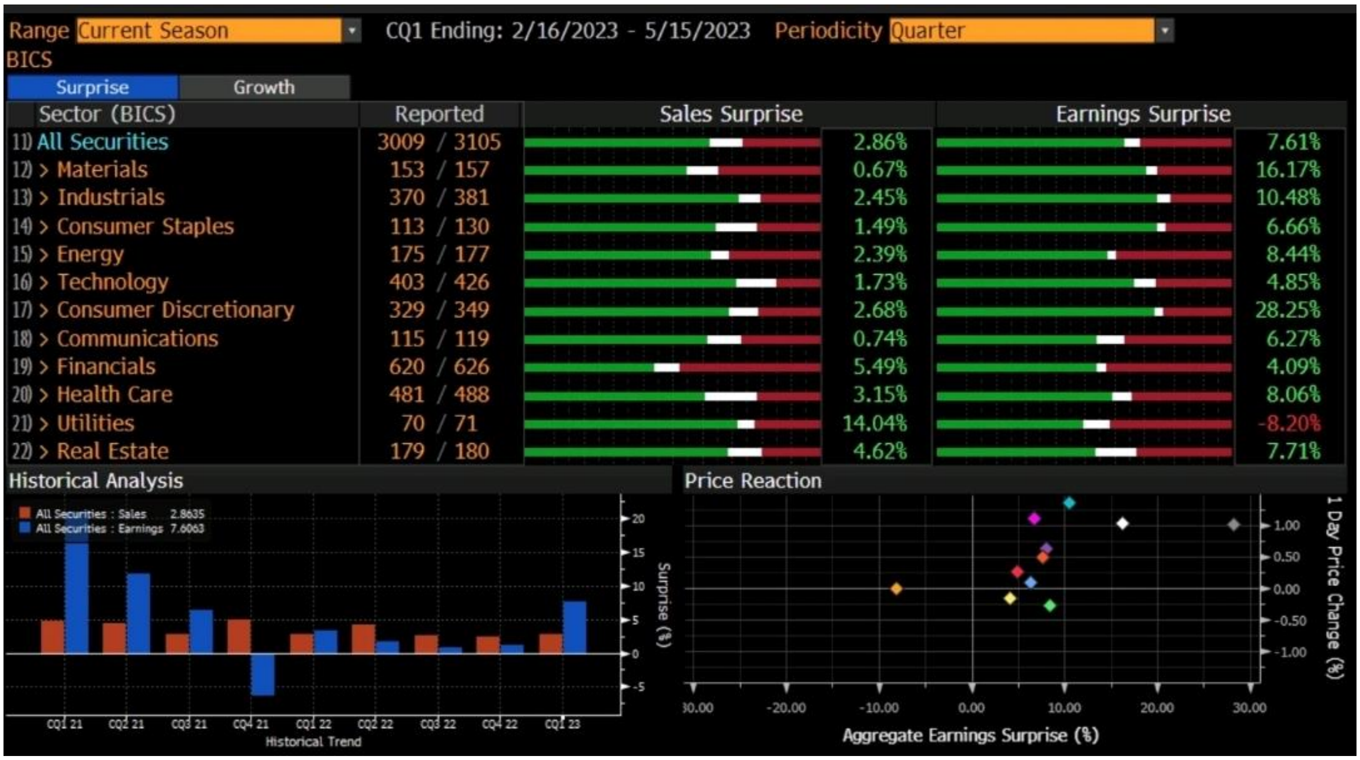
We commented in our past letter how we are right in the middle of two important US macro shifts: the beginning of an earnings contraction cycle and the beginning of a US dollar depreciating cycle.

These two waves are likely to neutralize each other over time. As earnings cool due to a slowdown in consumption, a weaker US dollar brings in more dollars for the country’s exports, sustaining the GDP by way of higher corporate earnings. It is still difficult to precisely quantify the net result, but we believe the US economy will probably experience a soft landing, without much drama.

As of the last earnings season, results were pretty good in general and better than expected – see screenshot below. In particular, consumer discretionary earnings were 28% higher than expected, which is a strong indication of consumers' health. Viewed in a historical sequence, Q1 2023 earnings rebounded strongly from a descending 2021 and a flat 2022.

A pro-recession investor would think "we are not there just yet", but it is hard to see what other damages can higher rates do in an environment where defaults have not substantially risen – the previous graph shows the global default rate close to 1%, lower than the pre-pandemic one.

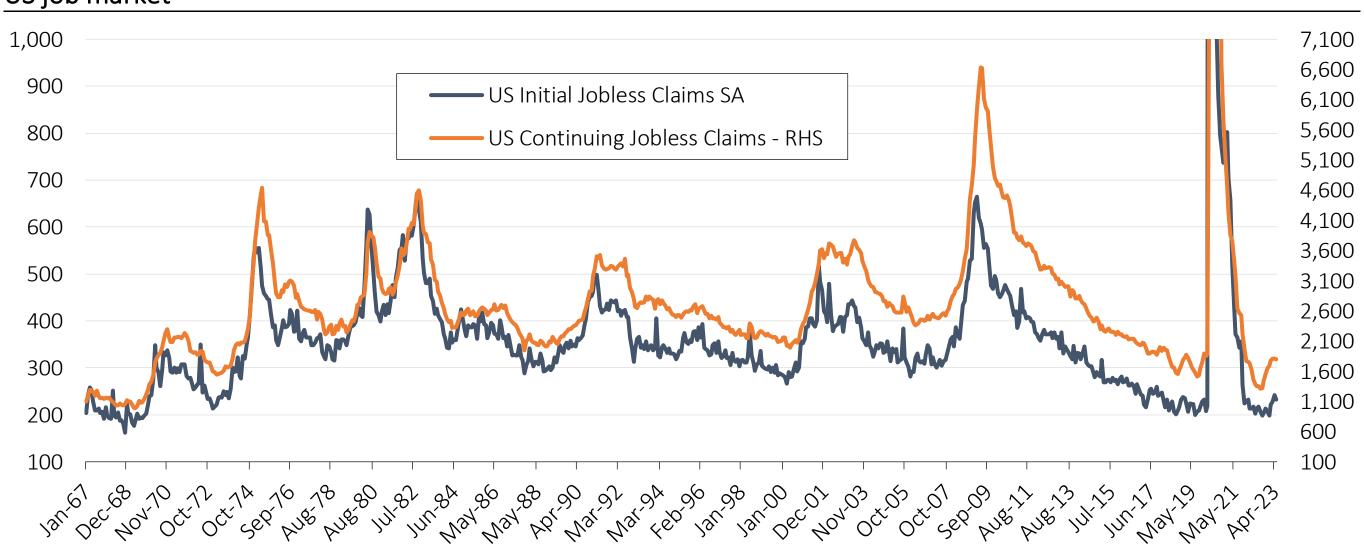
Last earnings season



Source: Bloomberg

The job market too does not give signs of budging to any rate pressure.

US job market

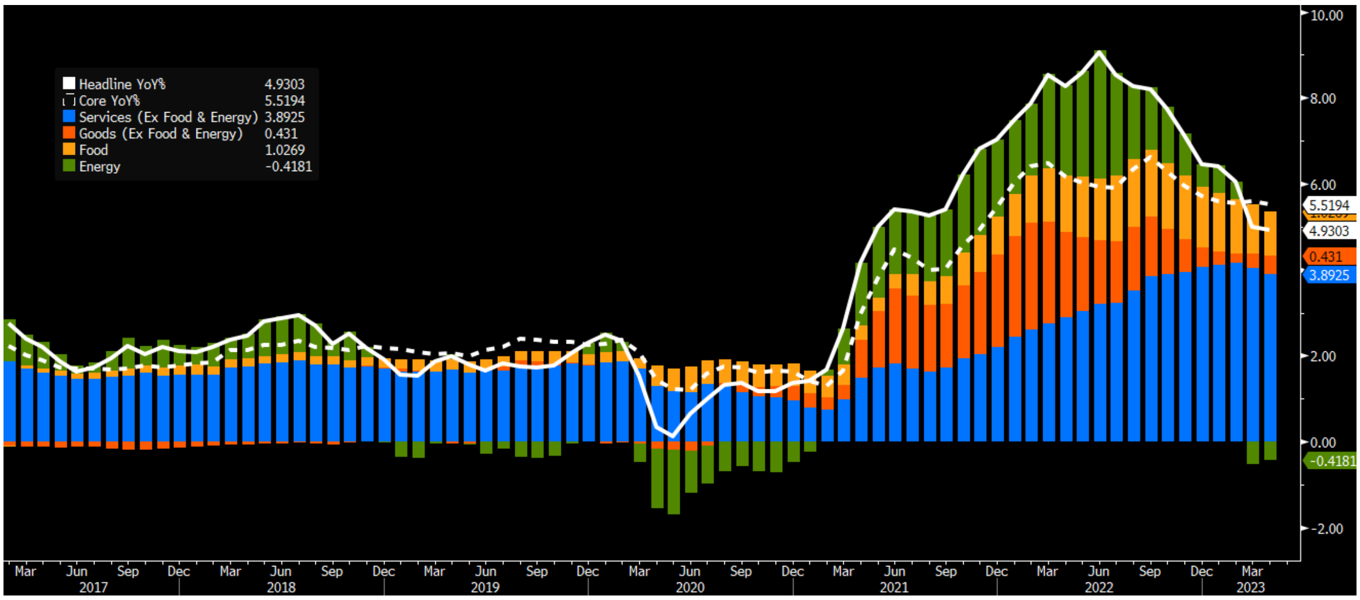


Source: US Department of Labor

On the inflation front, reduced oil prices gave some respite to the overall trend, as seen in the composite graph below.

This development does not mean energy pressure on global inflation is over. It also does not mean this temporary drop will follow a similar pattern to 2020's. It is of this week the announcement that OPEC is implementing a production cut to help sustain prices. Such measures have the obvious effect to keep inflation higher for longer, and to the detriment of event the oil exporting countries – which usually end up importing the inflation they helped keep high by way of imports.

Top-line contributors to US consumer inflation prices

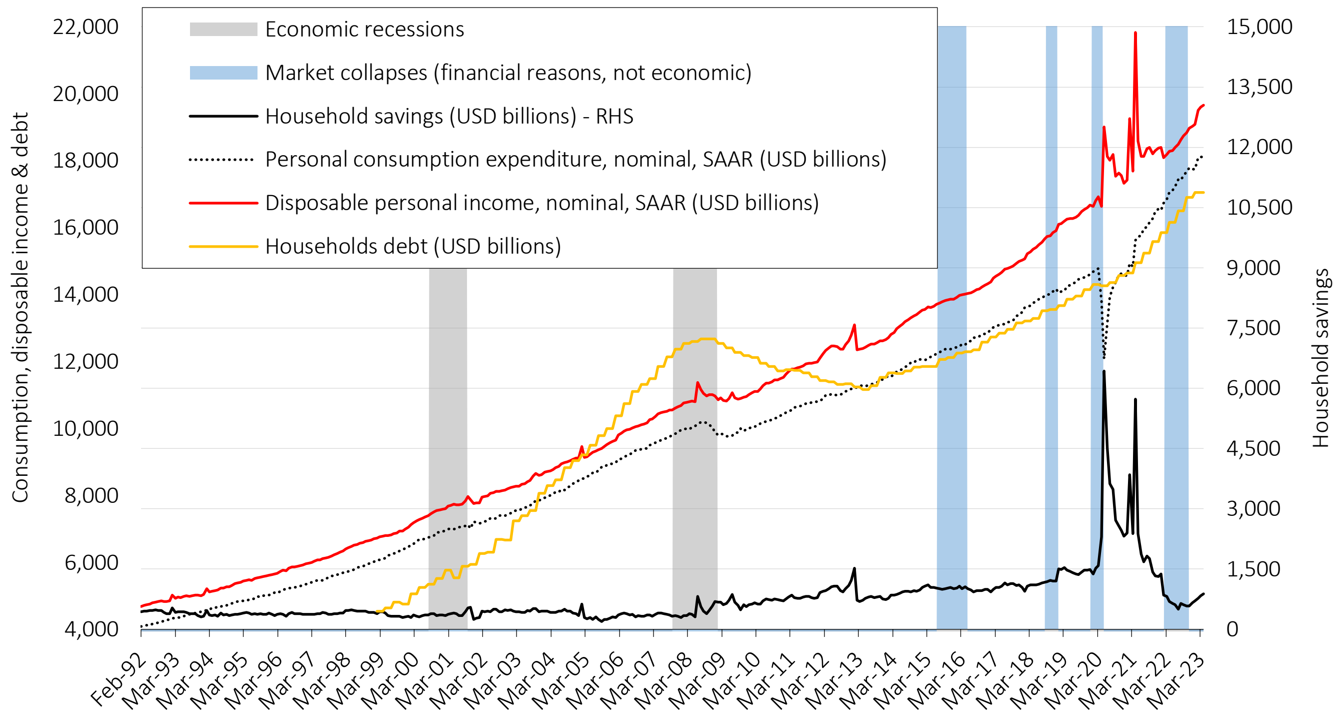


Source: Bureau of Labor Statistics, Bloomberg

In turn, such inflationary expectations are bound to be addressed by the authorities. Last week the FED gave signs of pausing rate hikes in June. Markets took this announcement as the end of the rate increases. While this might be the case, we are not entirely convinced inflation will come back to 2% any time soon, certainly not in 2023.

Among other measures, the US household balance sheet does not look unhealthy. the American population does not look dramatically different from other developed ones if one discounts that mortgages weight constantly 70% of the total household debt since 1999.

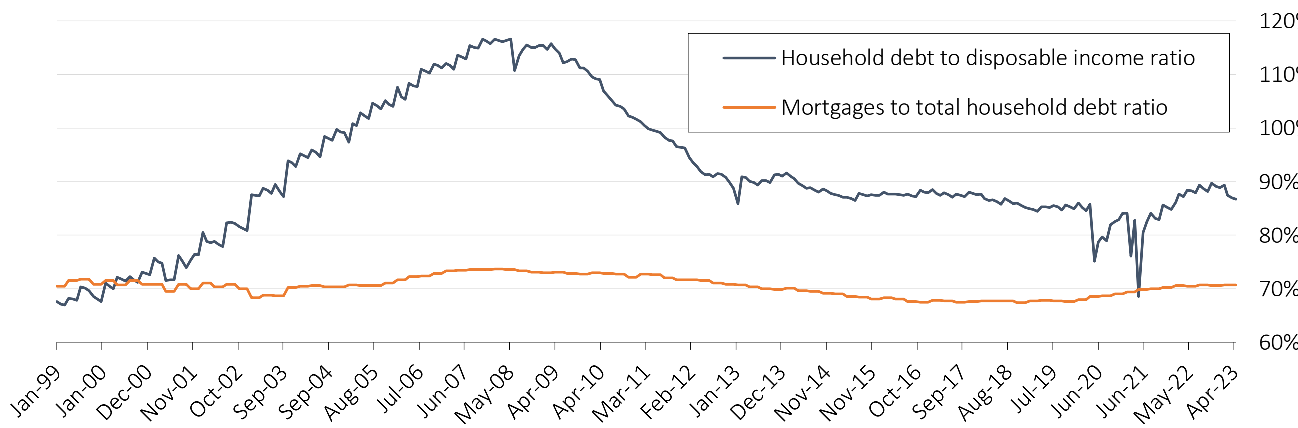
The US household balance sheet



Source: US Census Bureau, Bureau of Economic Analysis, Bloomberg, Federal Reserve Bank of New York, Index & Cie

In addition, the trend in household leverage signals expectations or the presence of a recession. The graph below shows that in 2022 and 2023 household leverage has expanded, not contracted. This is not a recessionary sign.

State of US household debt



Source: US Census Bureau, Bureau of Economic Analysis, Bloomberg, Federal Reserve Bank of New York, Index & Cie

Investors: between cautious and short, and mostly tech

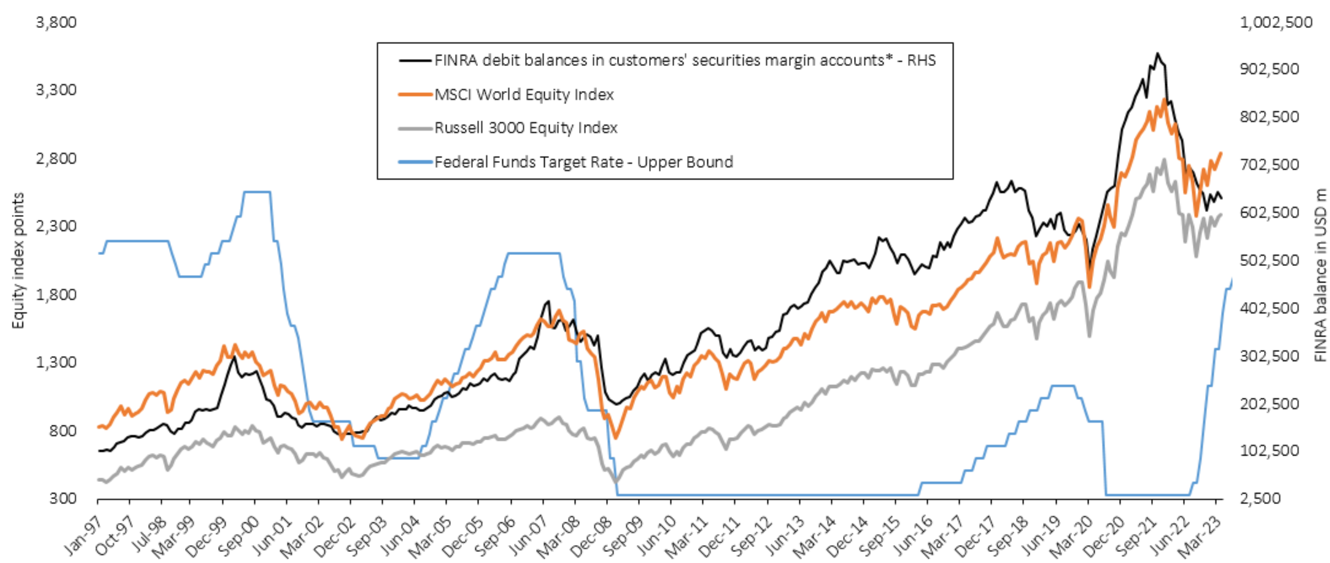
Takeaway: *the major market correction of 2022 might have been generated by anticipations of a recession. Leverage in margin accounts came down pretty fast throughout the past year, forcing widespread liquidations. The current positioning of investors is twofold: a lot of cash piled into money market funds with an inflow of $360bn in May only, and record short positions against the S&P500, only seen once during the GFC. This positioning suggests a second* *correction is expected, perhaps motivated by deteriorating fundamentals. But fundamentals have been rock solid across the entire industrial board this year, with tech and discretionary rebounding the most.*

The macro picture is not negative. Good signs of resilience can be found in many places.

Prices of indexes such as the S&P and NASDAQ show that about 50% of 2022's losses have been recouped. This is positive, and goes to show how there isn't a widespread panic based on an imminent US recession. Surely the FED stance helps markets not assuming the worst is about to come, but something else is cooking under the lid.

One way to measure market sentiment is the FINRA balance in margin accounts. This is the leverage held at an account level for trading purposes. A massive deleverage happened in 2022, a trend usually observed when a recession hits. This time, deleveraging happened before a recession hit.

FINRA balance in margin accounts



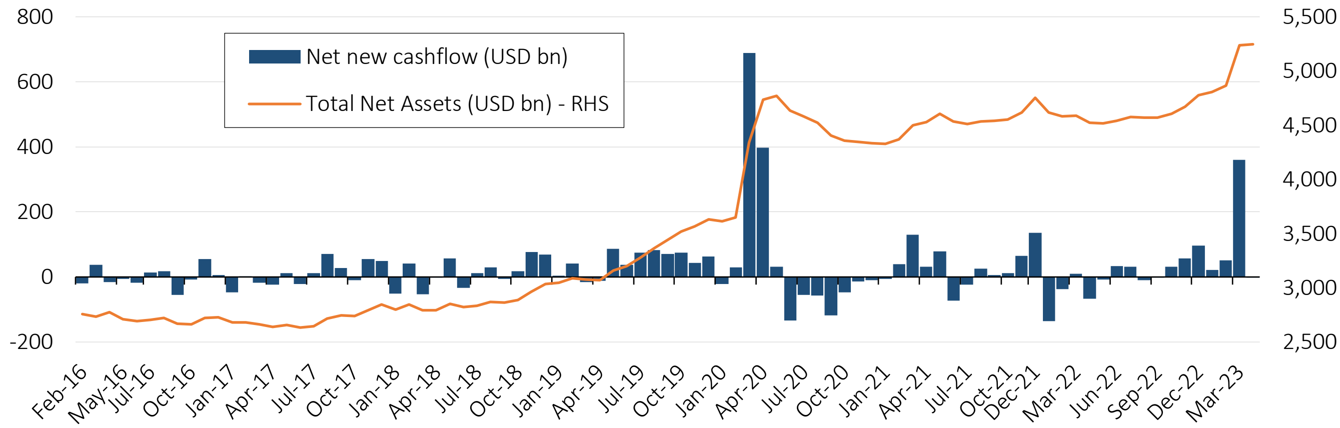
Source: Financial Industry Regulatory Authority (FINRA)

Note: 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.

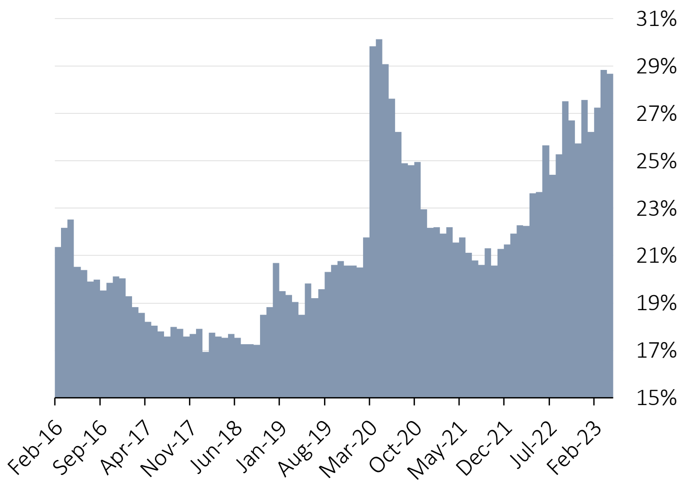
So where are we now? It seems investors ran for safety before the explosion happened. Such a reaction has not happened since January 1997. Could it be a unique reaction, and, most importantly, is there any more downside to US equities in case a recession happens? There is no precedent to answer such a question.

Furthermore, another indicator tells us of an abnormal, albeit limited in size, phenomenon. Money market funds (mm) have risen in allocation over the past three years, to about 30% of the amount invested in all other funds (conventional, meaning equity, bond and income funds). In particular, March 2023 saw $360bn inflow into mm funds, an amount third only to April and May of 2020, in full Covid panic mode. This spectacular trend shows how a non-negligible minority of investors chose to stay on the fence.

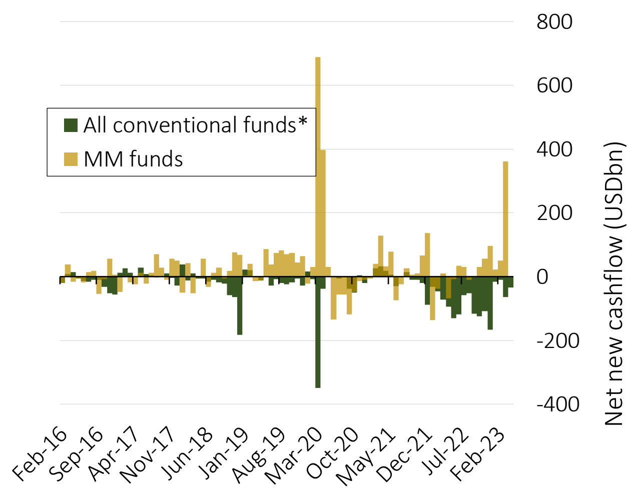
Net inflows, number of funds, total assets of money market funds



Money market funds as % to conventional funds



Net new cashflow comparison with all conventional funds

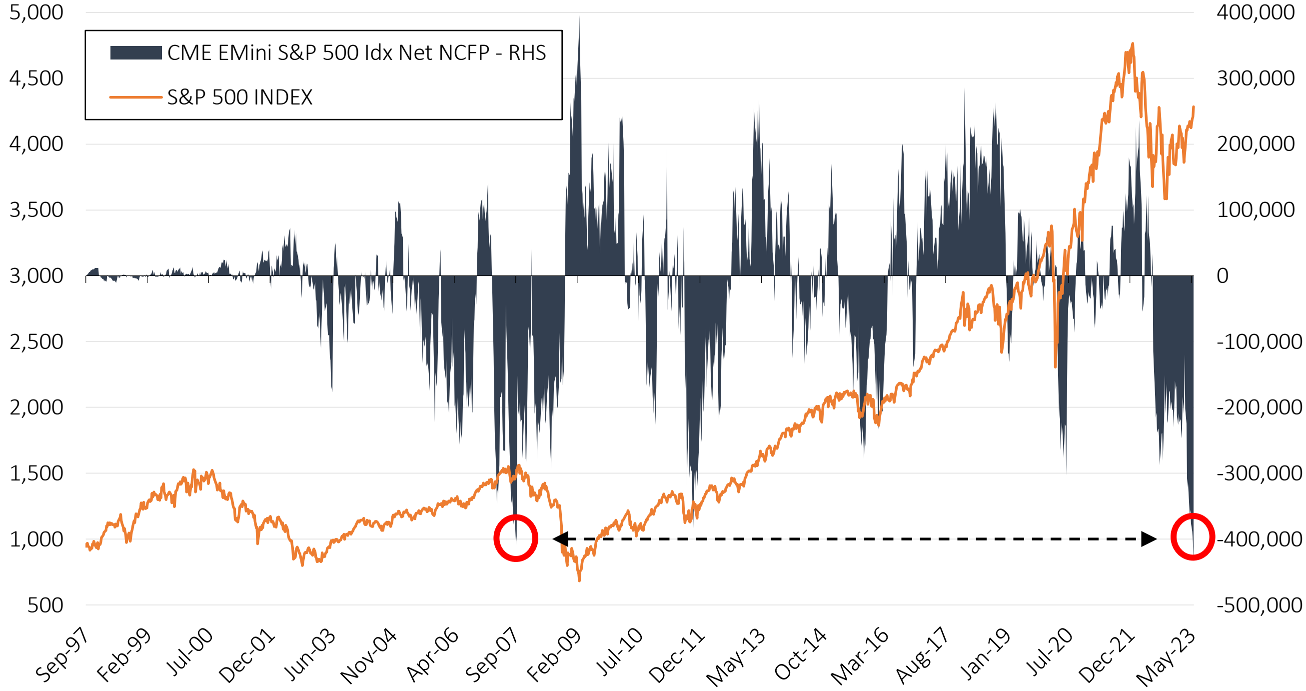


Source: Bloomberg
* Equity, bond and income funds.

More of a negative outlook on markets emerges among traders registered with the Commodity Futures Trading Commission (CFTC). This national agency reports weekly on the commitments of traders, calculated as total long and short positions that traders maintain in a particular commodity via futures and options, regardless of whether the position is for hedging or speculation. A look at the aggregate traders' net position in S&P 500 futures shows significant shorts, as large as the ones seen during the global financial crisis.

Once again, this is a non-negligible sign of traders' preference.

Commitment of S&P future traders

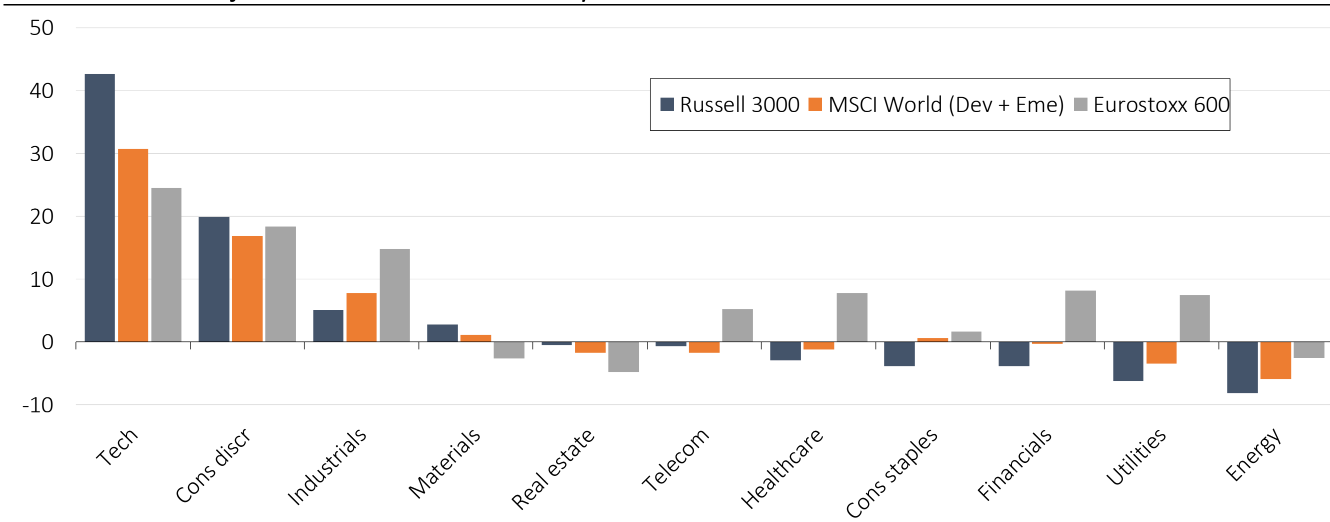


Source: Commodity Futures Trading Commission, Bloomberg

This aggregate short position is current, ongoing. Unlikely past occurrences, a deepening of the short position is now happening mid-way in a market rebound. In other words, traders registered with the CFTC think the market correction has more to go.

In terms of market performance this year, the tech and consumer discretionary industries played the lion's share across developed and emerging markets.

Performance of major stock indexes since January 2023



Source: Bloomberg

This is a telling story, with roots in the tech disaster of 2022. It naturally follows the magnitude of positive surprises in tech and consumer discretionary names in the past two earnings season. But it also shows that the remaining industries are not really performing financially, despite the positive surprises so far.

In other words, investors have chosen to remunerate only the best performing industries. Can a market recovery be driven by three sectors only? Hardly so. In fact, we tend to believe that remuneration was scant and only focused on fast-moving industries. The basic elements, including cyclicals, have not been considered, perhaps because much of the rotation happened in the second half of 2022.

It appears investors have been waiting for a direction so far in 2023, and are choosing carefully where to speculate.

Waiting for China, but when?

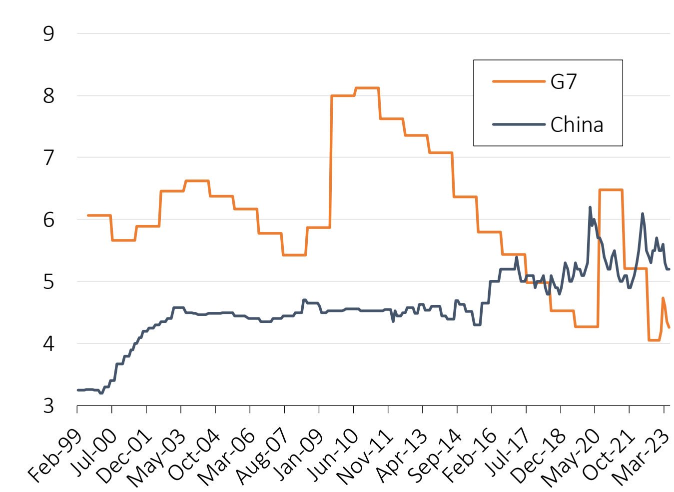
Takeaway: *China remains glued to its export business model, with an ever-present government support. The country is also experiencing the normalization typical of any large economic system that reached its limit to growth. Pivoting more significantly on domestic consumer demand remains a theory unverified by numbers. This is a potential internal headache at a time of rising geopolitical confrontation. It has resulted in the party adopting increasingly extreme measures to deal with malcontent around faults in its communistic social pact. We still like the long-term thesis, but we do not fault those who lost faith in it ever happening.*

Another notable topic this year is China not really growing since pandemic times.

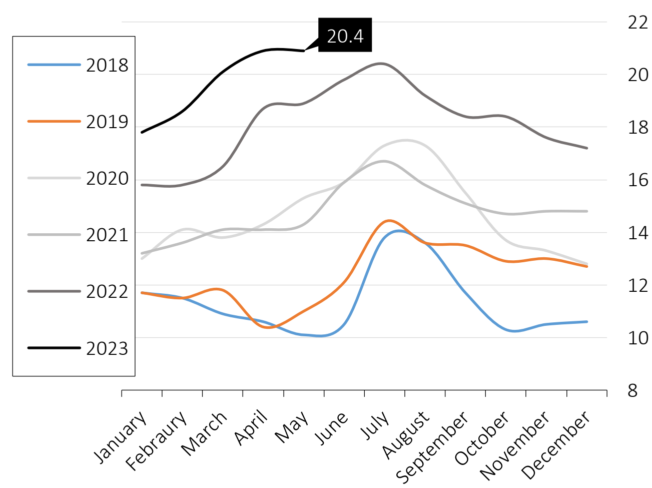
We believe this is really a story of economic cooling, natural to stable systems. After decades of commodity gobbling and frenetic infrastructural growth of the 90s and 2000s, China has not really succeeded in changing its cheap manufacturing, government-sustained model into an economy powered by its own consumer market. This market is indeed the second if not the first largest on the planet, but it is also entering a crucial phase of complexity typical of large economies.

The labor market, trade balance and industrial production give it away. The comparison with the US is telling, specifically when trying to isolate the Trump administration effect – the one administration most antagonistic to Chinese business.

Unemployment rates

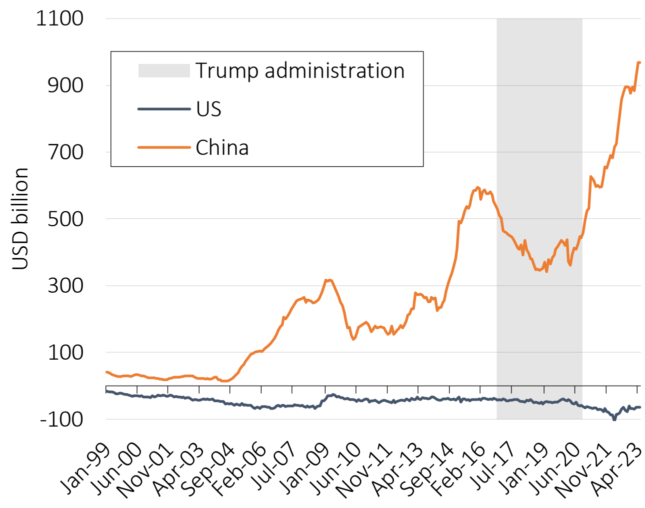


Urban unemployment rate among 16-24 year olds

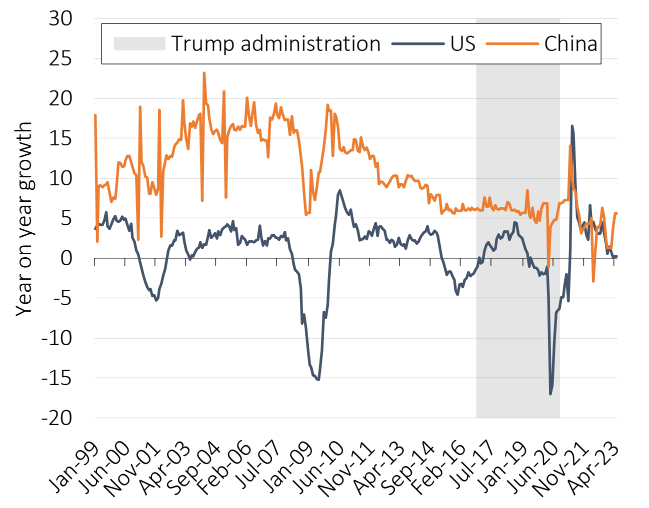


Source: IMF, National Bureau of Statistics of China

Global trade balance



Industrial production



Source: US Census Bureau, Customs General Administration PRC

The unemployment rate is rising among the general population, lately surpassing that of G7 countries. Youth unemployment is most worrying, with a peak of ~20% in May this year and in steady growth since 2018. This is a typical sign that a limit to economic growth has been reached in the internal job market. It is only inevitable.

From a trade balance perspective, it is evident global trade drives China's economy. In comparison, the US have only worsened their net importer status, despite being energetically independent. The Trump administration did put a dent in China's books, but only temporarily. Industrial production is perhaps the most compelling metric here: it is slowly approaching zero, and will naturally normalize in the same 5/-15% range the US traded around since the 1990s – that is, very low positive growth on average, with occasional and deep negative shocks. As a further confirmation, Chinese consumers are developing along the same lines of the Americans, with both household expenditure and retail sales year-on-year trends resembling each other.

Our view is that the oligarchy is now dealing with natural and serious limits to growth. Beginning with Mao Tse Tung, the communist party – composed of seven people commanding 97 million party members – locked themselves in a social pact with the country's population that is increasingly harder to maintain. More extreme measures are becoming the norm, such as kidnapping CEOs of tech companies until they finally make public amends and hand over their capitalistic riches. Such interventions can only happen without setting off a revolution if the party ensures that everyone has a seat at the grand economic table.

It is clear that double-digit growth in China is not repeatable. The next best thing is a strong improvement of internal consumer demand, one that reduces the national trade balance by importing more of foreign goods. The problem is that there is as much uncertainty on "when" this will happen as there is on "whether" this will happen at all.

As the fundamental angle remains inscrutable, perhaps history can provide some perspective on the market front.

Chinese stock market crashes

No.	Event	Start	Finish	Days	MSCI China index peak to trough	return in USD 12m	18m	2y	3y
1	Global slowing & SARS	May-02	Apr-03	335	-18%	78%	70%	82%	156%
2	Hard-landing fears	Feb-04	May-04	91	-13%	17%	26%	78%	151%
3	Mid-cycle slowing	May-06	Jun-06	35	-5%	64%	154%	97%	55%
4	Pre-crisis unwinding	Aug-07	Aug-07	5	-4%	-6%	-43%	-6%	-1%
5	Global Financial Crisis	Nov-07	Oct-08	340	-59%	41%	53%	59%	11%
6	Tightening & sovereign risk	Apr-10	May-10	32	-4%	10%	-12%	-3%	-3%
7	Double dip & debt concern	Apr-11	Aug-11	122	-4%	-18%	-1%	-14%	0%
8	US growth & EU debt concern	Sep-11	Oct-11	32	-23%	20%	29%	32%	33%
9	China growth & EU sovereign concern	May-12	Jun-12	34	-14%	15%	27%	18%	55%
10	QE tapering concern	May-13	Jun-13	33	-2%	3%	8%	35%	-7%
11	China credit concerns	Dec-13	Feb-14	63	-10%	15%	11%	-15%	6%
12	China correction & growth fears	Apr-15	Sep-15	153	-22%	9%	14%	45%	43%
13	FED hike, China FX/growth	Oct-15	Feb-16	123	-9%	21%	53%	94%	53%
14	US election uncertainty	Sep-16	Dec-16	95	-3%	43%	59%	27%	33%
15	Rates risk & Trump trade war	Jan-18	Oct-18	273	-11%	-6%	-4%	23%	13%
16	Covid-19	Jan-20	Mar-20	62	-2%	42%	14%	-8%	-19%
17	Regulatory rein on tech	Feb-21	Jul-21	150	-9%	-32%	-41%		
18	Ukraine's war	Feb-22	Mar-22	27	-20%	-6%			
	Average			**111**	**-13%**	**17%**	**24%**	**34%**	**36%**
	Median			**91**	**-9%**	**15%**	**14%**	**30%**	**23%**

Source: Goldman Sachs, Cederberg Capital, Bloomberg, Index & Cie

This is the depiction of boom-bust cycles, mainly determined by foreign trust in the Chinese investment thesis.

The market recovery from 18 crashes has been quite fast, within 12 months from the trough on average. While encouraging, the current, persisting slump in valuation occurred only twice, during the 2007-2009 GFC and the global debt crisis of 2011. It is also quite possible that such prolonged slump is determined by a double whammy of reaching limits to growth and heightened geopolitical tension, which result in tariff and sanctions against Chinese exports. These two factors put the communist party in a delicate international position, the development of which we cannot map out.

Despite strong current headwinds, we remain positive on China's economic strength in the long term. Yes, we cannot translate Western consumer habits on to a very culturally far civilization. Yes, the domestic market does not buy and probably need nearly as much Chinese manufacture as foreign buyers, which presents a problem of demand substitution. However, the sheer size of the internal market is indeed a unique feature of China. As much as the US is considered by any company to be the dream market for infinite expansion, China can become that market too.

We would love to see the much-awaited business model shift toward internal consumption, but there is no trace of that so far. Any forecast is also futile. We do not fault those investors who threw in the towel, but history shows that flows will materialize fast when the economic signs improve.

Conclusion

The fundamental picture shows a prepared Western banking system, a strong US economy, moderating inflation and solid household finances with expanding leverage.

However, a record 30% of fund monies is parked in money market funds, margin leverage amounts have reduced sensibly since 2022 and we sit on record short positions on the S&P500 (as high as during the last major financial disaster). This means that last year's market drop was leverage-based, while the current positioning bets on a drop in fundamentals (i.e. a recession). In addition, investors are getting into three specific industries, while waiting for direction in other corners of the global economy. This is a touch-and-go environment, with a fragile sentiment that can change very fast.

We remain cautious in this environment. We sit on bonds that are statistically providing us with a convenient return, while minimizing sharp market movements. The thesis of decreasing interest rates with a two to three years' horizon remains intact.

Equities and commodities remain in our radar, but the gains of 2023 could be easily undone at the first manifestation of fundamentals' deterioration – if that ever happens.

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