FUNDS ON FRIDAY
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Fundamental versus sentimental

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Risk is the new risk!

What does that mean?

We have become increasingly conscious of the fact that risk isn't what it used to be. The dictionary defines risk as 'a situation involving exposure to danger' (noun) or 'to expose (someone or something valued) to danger, harm, or loss' (verb). Investment risk seems to have established its own version of this definition.

What does that mean?

Perhaps one of the most impactful consequences of quantitative easing is that it has resulted in risk taking on Disney characteristics. It's softened around the edges and lost its bite. And even Bambi's mother wouldn't die in the current scenario.

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A recent post by John Authers positions this very succinctly:

'For a quarter of a century now, investors have worked on the assumption that the Fed (and other central banks) lack the nerve to press ahead with tight policy if it hurts asset prices. It's not an unreasonable belief, as the central bank has caved to market pressures at every time of asking since its epochal decision to rescue Long-Term Capital Management in 1998, and then cut rates to help the market regain its feet. It was the one time when Paul Volcker ever publicly criticized his successor, Alan Greenspan.

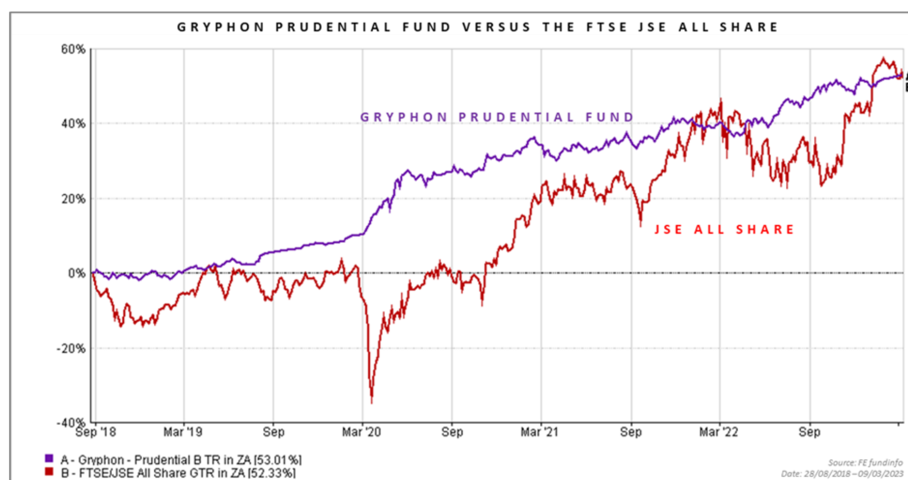
There's a widespread belief that this moral hazard can be relied on. If the stock market falls enough, or if an outright crisis breaks out in the banking system or the credit markets, then the Fed will be there to bail everyone out again.'

It appears that investors have come to expect that high risk simply implies high return; the risk element will not have any dire consequences. In line with society's penchant for helicopter parenting, we expect that my mom will talk to their mom, and everything will be resolved.

Practicing a rules-based philosophy can be challenging at the best of times, but when there is a glitch in the matrix such as the impact of quantitative easing, more effort must be made to constantly check the integrity of such a process.

Our data-based indicators got us out of equities in August 2018, and we remain ex-equity to date. This is in line with our approach of selecting the most appropriate risk-adjusted asset class for the prevailing market conditions. This philosophy does not necessarily ensure constant outperformance of peers or indices, but it does offer a 'shock absorber' for clients in any type of retirement product and those averse to capital drawdowns.

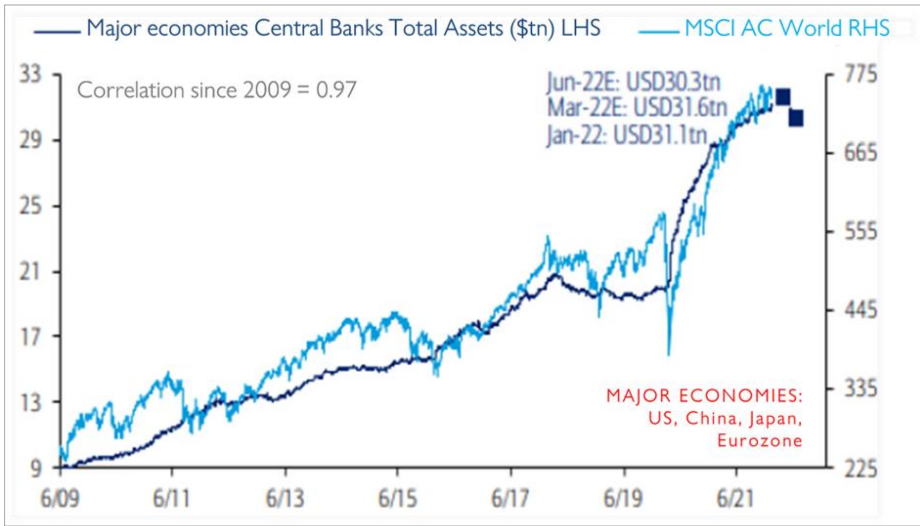
As you can see from the graph below, investors in our funds have not compromised returns yet have not had to endure the same level of volatility as an equity investor would have experienced.

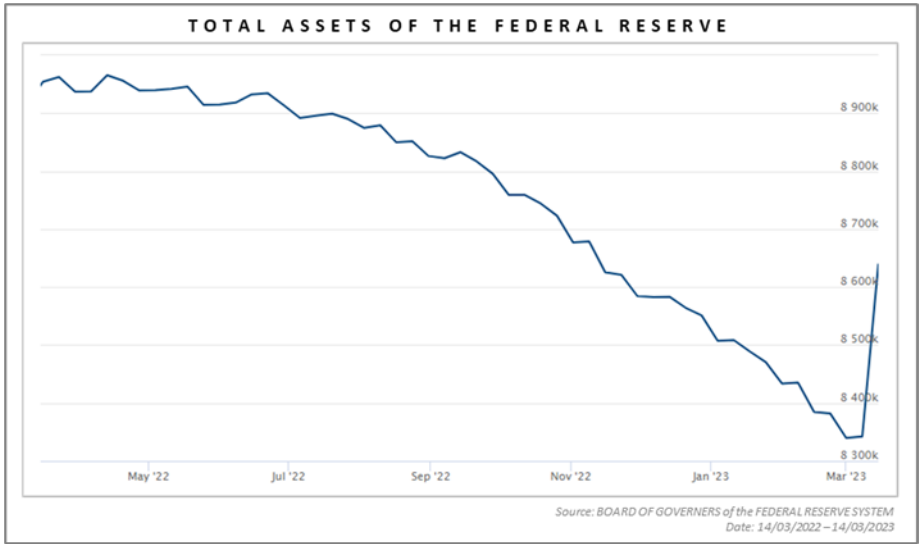


When faced with the question of when we're likely to get back into equities, the short answer is when our indicators signal that. Equity markets are volatile, and this indicator could be triggered should markets sell off; or there could be an extended period of time before value is restored. This is dependent on a number of factors which we'll touch on briefly below, namely:

- Inflation
- Company earnings
- Interest rates
- Business/economic cycle (commodity prices)

The lens through which these factors are viewed has been blurred, as mentioned previously, by quantitative easing. With the benefit of hindsight, the graphs below illustrate the growth in the balance sheet of major central banks, i.e., US, China, Japan, Eurozone, and the effect it had on asset prices (represented here by the MSCI World Equity index).



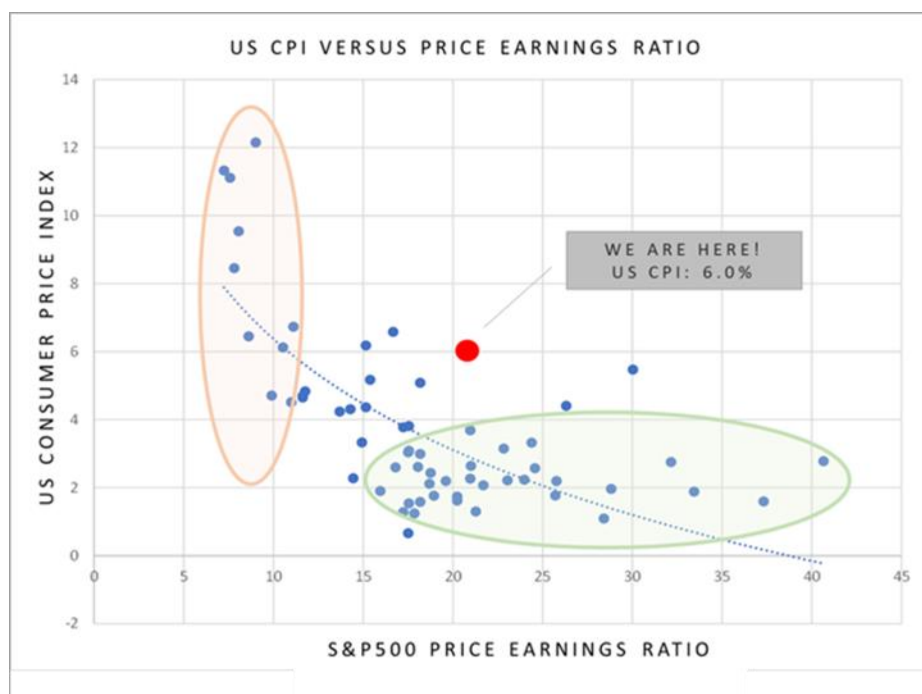


The recent bounce in the "Total Assets of the Federal Reserve" is a function of the Federal Reserve providing liquidity to the market around the implosion of Silicon Valley Bank.

Disconcertingly, the market is taking this to mean that the "Fed Put" is still in place, i.e., that the Federal Reserve is likely to come to the rescue of financial institutions and markets in the event of any trouble. We are less sure about this and are currently of the view that much of the liquidity provided is short-term in nature and will be unwound should dislocations in the banking sector ease.

The latest hike of 25bps by the Federal Reserve on 22 March also confirms that inflation remains their primary concern.

Inflation



Source: Iress/Gryphon Asset Management

This graph plots for each year, from 1961 (2009 excluded), the annual change in the consumer price index in the USA, with the price-earnings-ratio of the S&P500 at the end of the year in question.

The fitted curve reflects the relationship between inflation and price-earnings-ratios, i.e., when inflation is low, price-earnings ratios are elevated, i.e., greater than 20x. However, when inflation is high, the price-earnings ratio tends to drop quite precipitously.

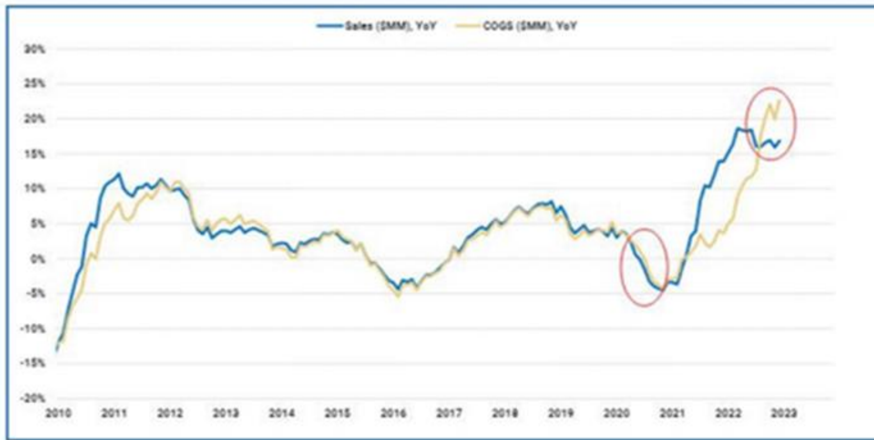
As at the end of February 2023, the S&P500 was at 3 970. This assumes earnings at approximately $188 multiplied by a price-earnings ratio of 21.1x. What can be seen from the graph is that, should inflation remain around 4% in a year's time or prove to be more difficult to get under control, that the price-earnings-ratio could decline to levels of around 15x. This would result in an index value of 3000 being more likely. That's approximately 29% down from current levels.

Company earnings

Earnings growth over the recent past has been stellar and operating margins in most industries are at elevated levels. While there are numerous reasons as to why margins and earnings could remain high, history (and historical performance during periods of economic weakness, in particular) is not one of them.

We are concerned that earnings forecasts remain too bullish, as supported by this statement from Morgan Stanley Research,

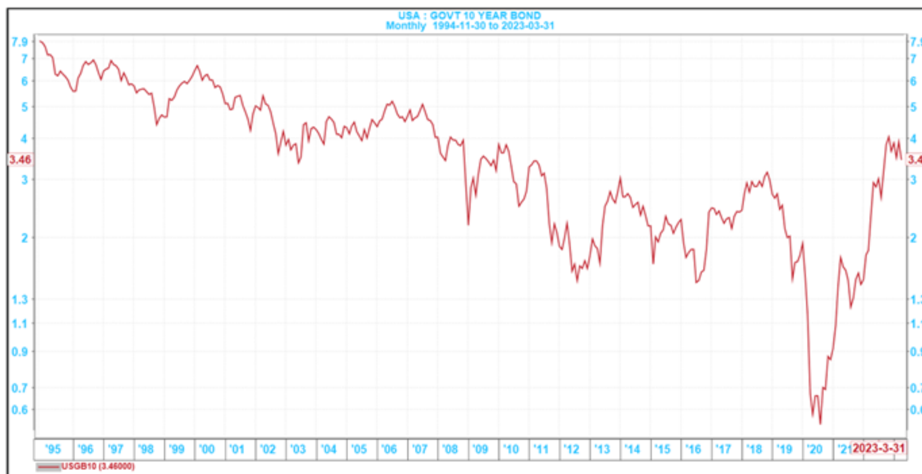
MARGINS PRESSURED AS COGS GROWTH OUTPACES SALES GROWTH



Source: Refinitiv, Morgan Stanley Research

"4Q earning season is proving to be even worse than feared, especially for margins, as cost growth is rising faster than sales growth for ~80% of S&P 500 industry groups."

Interest Rates



This is a chart of the US 10-year bond; one which we believe investors should remain aware of.

Why is the US 10-year important?

Firstly, it is the foundation upon which bonds throughout the world are valued.

We consider 10-year bonds as the "cost of money", i.e., the discount rate used by investors to discount future cashflows when making financial decisions.

Bond investors traditionally take the yield on the US 10-year and add to that the country-risk premium and inflation-risk premium in order to derive the total risk premium of the country in which they wish to invest. It therefore follows that if the yield on the US 10-year rises, then the value attributed to bonds in other countries will decline, i.e., their yields will rise accordingly (assuming country and inflation risk premiums remain unchanged).

Bonds are also considered an alternate asset class to equities and when bond yields are sufficiently attractive investors may opt to invest in bonds rather than in equities (which are generally considered to be riskier).

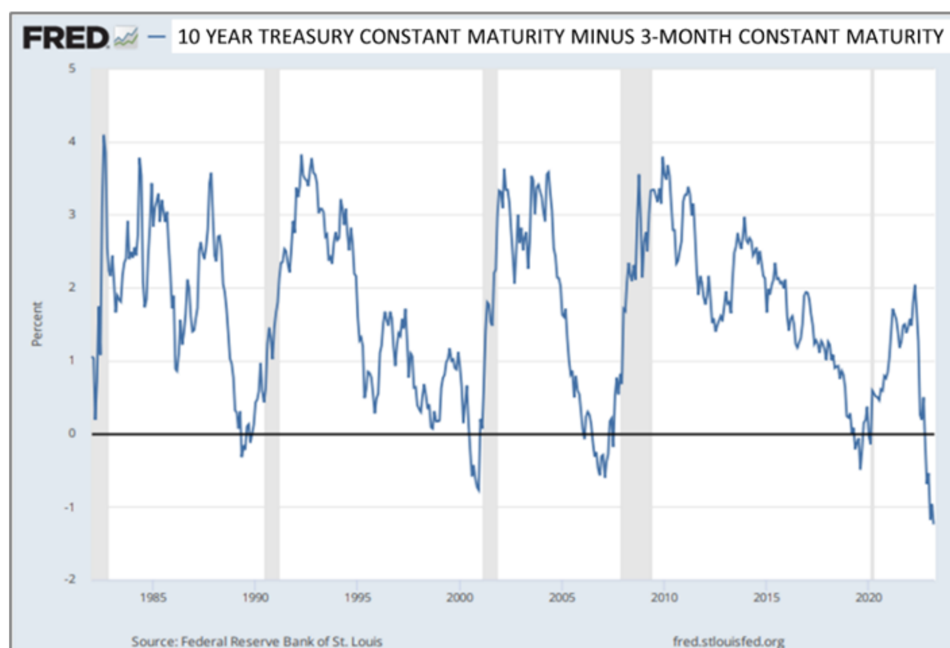
This dynamic, however, was also impacted by the quantitative easing mentioned previously, which had the effect of keeping bond yields low for an extended period of time. This rendered bonds unattractive as an option and investors were "driven" into equities in order to generate a return on their investments. With cash rates close to zero and bonds yielding less than 2%, this seemed to be a reasonable investment decision.

For some time, the market's chant was TINA - There Is No Alternative (to investing in equities).

For the non-believers in this mantra, it was merely going to be a matter of time before quantitative easing ended and bond yields reflected higher yields.

Needless to say, the impact of investments being made on the expectation that US bond yields would remain below 2% forever is now becoming a reality – recent disruptions in the US banking industry are a manifestation of this.

In addition to providing investors with a foundation for the "cost of money", bond yields also provide investors with a yield spread, which historically has indicated recessions in the US.



This graph reflects the yield of the US 10-year bond minus the three-month US Treasury Bill. The shaded areas indicate periods of recession in the US economy. Clearly, when the yield spread drops below zero, it signifies a period of recession is to follow.

It would perhaps be prescient to observe the messages being conveyed by this data.

The risk is in choosing to subscribe to the most expensive words in the financial lexicon, "this time it's different".

In conclusion

In July 2007, just before the global financial crisis struck, then Citigroup CEO Chuck Prince famously said: '*As long as the music is playing, you've got to get up and dance! We're still dancing'*… many are *still* dancing. In a great CityWire article by Duncan MacInnes, he says, "*After a brutal 2022, many investors are being lured back onto the dance floor by the siren song of FOMO*."

We've experienced the consequences of risk – the cost of recovery far exceeds the thrill of the last dance and that final tequila – we'll wait, in cash, for greater clarity and the opportunity to get back into equities. As Ayn Rand once said, *"You can ignore reality. But you can't ignore the consequences of ignoring reality".*

Glacier Research would like to thank Reuben Beelders and Megan Fraser for their contribution to this week's *Funds on Friday*

Reuben Beelders

CIO

Portfolio Manager

Reuben is co-manager of the Gryphon Dividend Income Fund, the Gryphon ALSI Tracker Fund, the Gryphon Global Tracker Fund and the multi-asset funds. Having served as the head of Strategy, he has broad experience covering most asset classes. He has been an industry professional since 1996, has commercial and accounting experience, is a chartered accountant and a Chartered Financial Analyst charter holder. Reuben is a self-confessed, unapologetic coffee snob as well as being an avid gymmer and cyclist.

Megan Fraser

Head of Business Development & Marketing

Megan has been involved in establishing business development networks in financial services for nearly 40 years. Having worked for Norwich, Investec IMS, Coronation, STANLIB, Fraters, SI, and Aylett & Co, she has a acquired a breadth of experience as well as valuable insights in this time. Her current role with Gryphon provides the opportunity to create awareness and appreciation for the unique, innovative investment approach delivered by this well-established, rules-based investment house. Beyond the office, her passions include reading, travel, holistic health, and trying to get the whole world to embrace meditation.