October | 2023

AlphaWealth Monthly Brief

"Savers and investors have enjoyed benign tailwinds for many decades, but the question now is between headwinds and no winds."

- Antti Ilmanen

In this month's edition of the brief, we focus on how inflationary pressures and higher real interest rates impact the allocation of risk within the economy, and how prudent investors should best position themselves.

Finding Opportunity Amongst Macro Headwinds

Rather than focusing on building a model about how the economy works on average, typical macroeconomic research conducted by the asset allocation team at GMO focuses on what is different in this economic cycle, what impact those differences may have on future recessions, and the vulnerability of assets when they occur. The contrarian approach employed by GMO has helped the firm successfully call and profit from several economic bubbles including the Dot Com bubble and the U.S. housing market bubble. Today, the sharp increase in interest rates and the likely persistence of inflation makes the team at GMO believe that a recession, when it occurs, will be harder to cushion and that highly levered corporations will fare worse in a recession than investors might assume from past cycles.

The macroeconomic risks highlighted by GMO prompts a reevaluation of two crucial questions that investors, regardless of their investment style or time horizon, should always consider:

1. What are the risks associated with my investment?
2. Am I being adequately compensated for taking these risks?

A substantial increase in interest rates alters the allocation of risk within an economy, impacting the growth and default potential of various economic entities. Companies and countries heavily reliant on floating-rate debt find themselves in a much different market than they did just two years ago. On the other hand, those with ample cash reserves appear to have made prudent decisions. The opportunity cost of investment, which was virtually zero two years ago, has risen, necessitating an adjustment in the pricing of risk.

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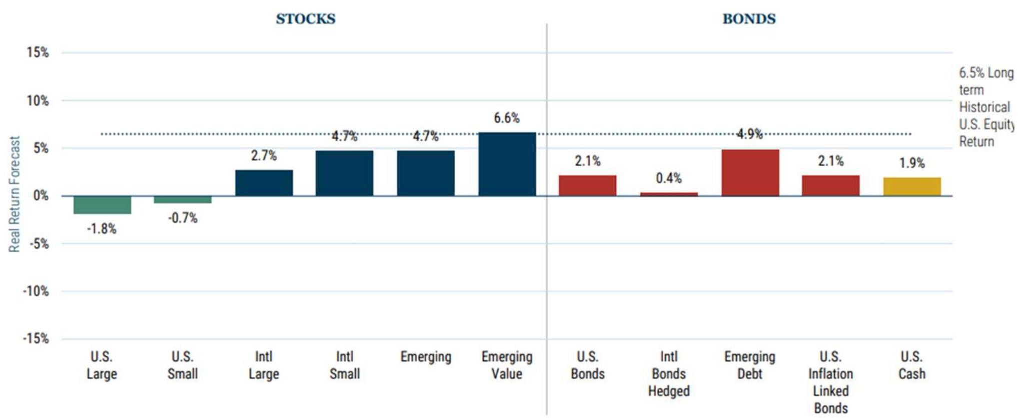
In some sectors of the market, this adjustment has already occurred. GMO notes that cyclical quality companies are now considerably cheaper than they were in 2021, while deep value companies are priced to deliver exceptional real returns globally. Certain parts of the bond markets are offering returns not seen in over a decade. However, many assets have not yet adjusted to the new economic realities. Through September, disinflation and robust economic growth dispelled concerns of a recession, leading to the recovery of risk assets, including U.S. equities and credit spreads returning to levels that seem inconsistent with the outlook for potential defaults.

7-YEAR ASSET CLASS REAL RETURN FORECASTS*

As of September 30, 2023



Source: GMO

*The chart represents local, real return forecasts for several asset classes and not for any GMO fund or strategy. These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Forward-looking statements speak only as of the date they are made, and GMO assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual results may differ materially from those anticipated in forward-looking statements. U.S. inflation is assumed to mean revert to long-term inflation of 2.3% over 15 years.

GMO

While recent disinflation has occurred rapidly, it is primarily due to temporary supply-side improvements rather than a demand-driven decline in rates. Factors like the global trend toward protectionism, greater reliance on government policy in times of geopolitical tension, and an aging population suggest that future inflation may be higher than it has been in the past three decades. Consequently, nominal interest rates are unlikely to return to zero, and leverage will come at a higher cost. Sectors of the market dependent on leverage may face vulnerabilities in this changing economic landscape and asset valuations across various classes will have to adapt to a higher risk-free benchmark.

With this as the backdrop, we continue to place emphasis on quality investments across all asset classes. Companies with strong balance sheets, low debt burden, and attractive free cash flow characteristics can be found trading below market multiples and have demonstrated the ability to grow earnings at an above average rate.

We want to avoid expensive parts of the market as any asset priced on the back of negative real interest rates is likely to be significantly repriced in a world of higher rates. With short-term yields the highest we've seen since 2000, the opportunity set in short duration and certain liquid alternative strategies remains attractive. While macroeconomic concerns remain, GMO notes that the prospective returns for a sensibly allocated multi-asset portfolio look better than anything seen in several years.

Fast Facts

Americans drink more coffee each day than any other beverage—including tap water. - U.S. Bureau of Labor Statistics

Americans 65 and up accounted for 22% of spending last year, the highest share since records began in 1972– The Wall Street Journal

In 2022, music streaming services accounted for 84% of recorded music revenues. With nearly a half-billion users and about two hundred million paid subscribers around the world, Spotify's success is heavily quantified; however, it has never posted a profit. – New York Magazine

If, instead of purchasing the newest iPhone every time Apple launched one, you'd spend the same amount of money to invest in Apple stock, you would now own 910 shares, which would today be worth roughly $146,562. – Tech Crunch

United Airlines could save $80 million a year in fuel costs if the average passenger's weight fell by 10 pounds. - Bloomberg

Contact Us

As always, feel free to reach out to us if you have any questions regarding your investments or financial plan or would like to schedule a meeting with our advisors.