Lucerne Alternative Investments Fund

Quarterly Report | December 2023

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December 2023 Quarterly Report

The Lucerne Alternative Investments Fund (LAIF) is expected to report a return of -1.7% for December, resulting in a quarterly performance of -3.04%. Despite this, the Fund is anticipated to close the calendar year with a positive annual return of 3.51%.

We note that the strengthening of the AUD during the fourth quarter of 2023 and a strong run-up in global equity markets to end the year were key contributors to the weaker quarter.

Encouragingly, the Fund's underlying investments continue to offer opportunities to capitalise on our themes as they unfold in 2024.

A look back at Q4 and 2023:

Australia

- The Reserve Bank of Australia (RBA) raised the cash rate by 25 basis points in November, making it the only major central bank to continue its tightening policy.
- Since May 2022, the RBA has implemented 13 rate hikes, totalling an increase of 425 basis points.

US Federal Reserve's Position

- The Federal Reserve (Fed) maintained the fed funds rate at 5.25%-5.5% during its December 2023 meeting, marking the third consecutive session of steady rates.
- The meeting minutes signalled, for the first time since 2022, a potential easing in monetary policy with anticipated rate cuts totalling 75 basis points in 2024, a move aligning with market expectations and economic forecasts.
- On the back of dovish Fed commentary, equity markets experienced a significant upswing in Q4. The S&P 500 was up 11.7% for the quarter, while the ASX 200 Accumulation index was up 8.4%.
- The notable shift from the previously concentrated market movements to a more broad-based rally indicates the general enthusiasm for the continued strength in the jobs market, and robust consumer spending also fuelled strong economic growth and corporate profits that helped push equity prices higher.

Bonds

- Bonds saw their best performance over two decades, starting from a lower base but rallying impressively. A sharp decline in 10-year yields and anticipated rate cuts were key drivers for the rally.
- Global central bank rates appear to be nearing the peak of this tightening cycle and investors are pricing in rate cuts in 2024. We are not so confident in this scenario. Future monetary policies are expected to be heavily influenced by the evolving global economic landscape and ongoing geopolitical challenges.
- Significant disruptions in the Red Sea, impacting approximately 15% of global trade, have led to increased shipping costs, as evidenced by a 150% rise in the Drewny container index.

- Despite initial success in overcoming inflation related to Covid-induced supply chain issues, there now appears to be a looming risk of an inflation resurgence.

Consumer

- **US:** American consumers have shown remarkable resilience, with personal checking account deposits reaching a 30-year high, suggesting a strong financial buffer despite economic uncertainties.
- **Australia:** In contrast, the Australian consumer landscape appears more strained. The RBA's data indicates a near depletion of the savings ratio, and net disposable income has turned negative, implying that consumption is increasingly reliant on credit.

Market Volatility

- **Equity:** The VIX index showed significant volatility during the quarter, oscillating between 13 and 21, reflecting the market's sensitivity to narratives around rate cuts and inflation trends.
- **Bonds:** In contrast, bond market volatility tracked by the MOVE index has been more pronounced, painting a different and perhaps more cautious picture of market sentiment and expectations.

Allocator's Dilemma!

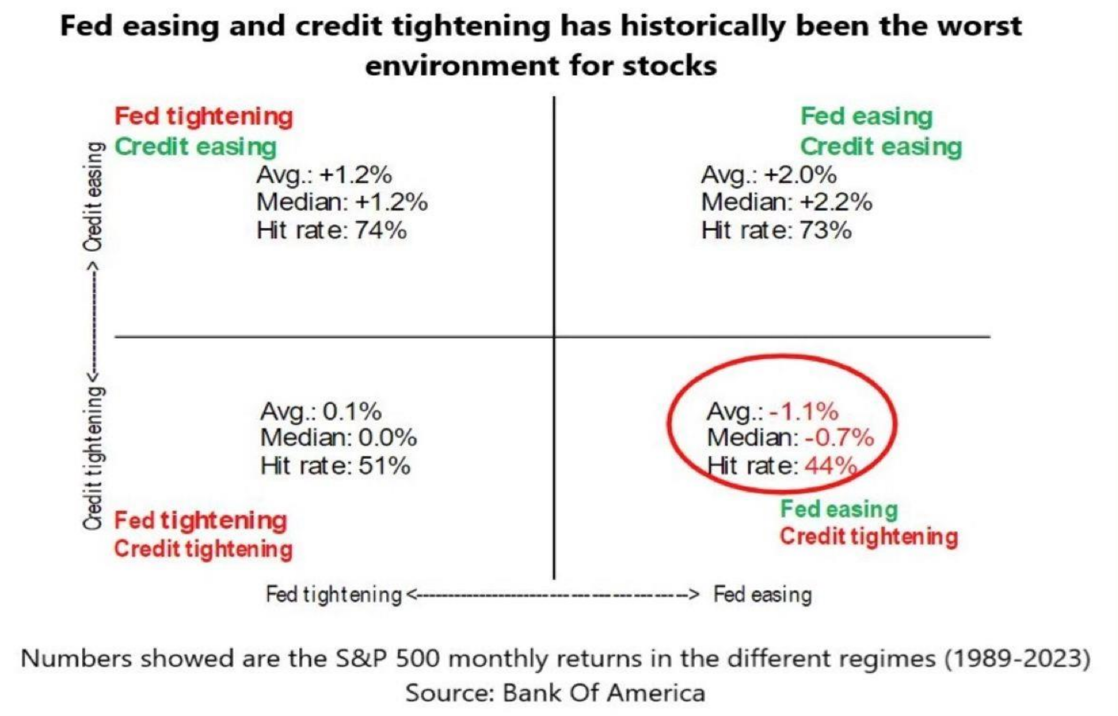
Regardless of where you stand in the ongoing debate about whether the economy is heading for a soft landing or a recession, it's important to consider the current economic and market expectations. While we have our views, the key takeaway is that as we end 2023, a noticeable sense of optimism is reflected in the markets. However, this optimism is greater than what we believe is warranted based on a detailed analysis of various signals and indicators. In other words, the market may be more hopeful about a soft landing than the data suggests.

With the potential for the Fed to ease monetary policy in 2024, it's crucial to avoid jumping to conclusions about its impact on the equity markets. While easing might seem beneficial initially, we encourage our readers to engage in deeper, second-level thinking. This involves looking beyond the surface and considering a range of possible outcomes and their implications.

Take, for example, the assumption that great companies like NVIDIA and Tesla are automatically great investments. While they may be successful in the long term, their current high valuations could lead to a period of stagnant growth, similar to what happened with Microsoft in the 2000s. Despite its strong earnings, the stock saw little change for a decade, causing many investors to miss out on its later success. This example highlights the importance of assessing valuations and not just company narratives, a key variable we look for in the managers we invest with.

December 2023 Quarterly Report

When predicting the future of interest rates and the possible rate cuts in 2024, more is needed to assume that easing will benefit. Investors should consider the broader credit environment that such a policy might create. If the economy weakens, we could see wider credit spreads and increased corporate defaults, making credit less available, which we are already witnessing. The monthly return quadrant below by Bank of America serves as a general overview of outcomes that have transpired in the last 35 years.



(Source: Bank of America)

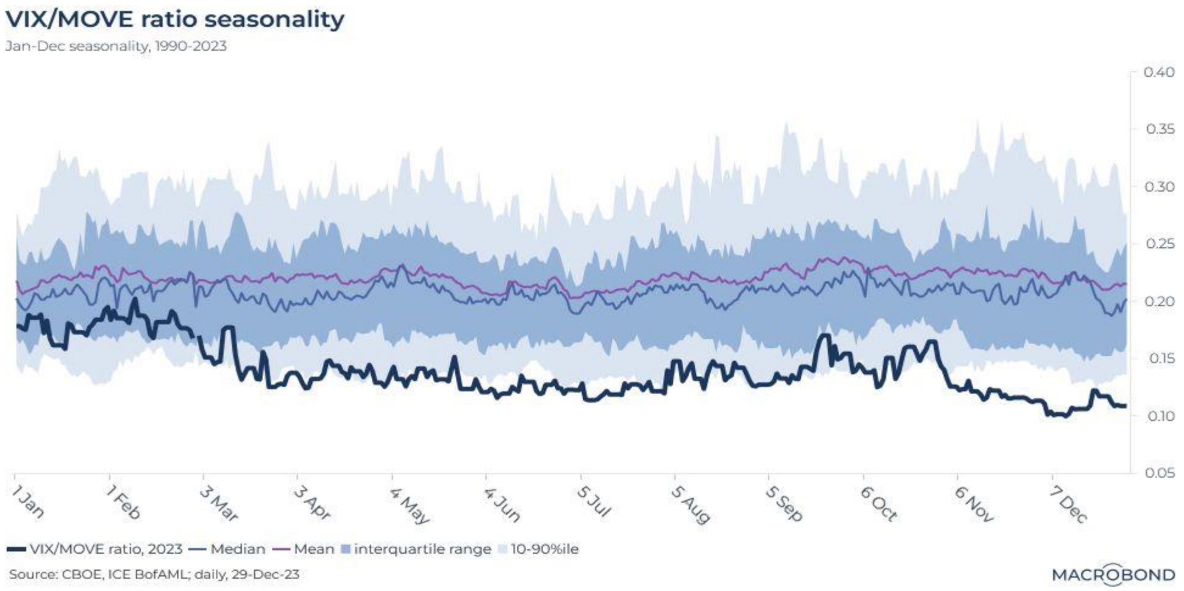
This kind of nuanced, second-level thinking is challenging but essential for long-term success in investment and generating alpha.

Deciphering Market Signals: Exploring the Intricacies of Volatility

The current financial landscape presents an intriguing scenario with a low VIX index (indicating option-implied equity market volatility) and a high MOVE index (indicating option-implied bond market volatility) as we end 2023 and progress into 2024. This situation is highlighted by a low VIX/MOVE ratio, observed since the 1990s through various economic cycles, including recessions and periods of monetary policy uncertainty.

In financial markets, volatility tends to be higher during market downturns than in rising markets. This asymmetry, coupled with the typical strategy of being long on volatility while shorting the underlying asset (especially in equities), suggests that equities might face downward price pressure relative to bonds in the near future, primarily due to these volatility valuations.

December 2023 Quarterly Report



We note there's been increased attention on comparing the MOVE Index (reflecting bond market volatility) with the VIX Index (reflecting equity market volatility). The MOVE/VIX ratio, currently at a high level, is being interpreted as a warning sign for the equity market. However, this interpretation warrants a deeper analysis.

The MOVE Index measures the implied volatility of US Treasuries across different maturities (2y (20%), 5y (20%), 10y (40%) and 30y (20%) US treasuries). In contrast, the VIX measures the implied volatility of the S&P 500. To understand the relationship between equity and bond volatilities, one must consider the fundamental value of equities as a series of future discounted cash flows. Equity prices fluctuate based on revisions in expected future cash flows and changes in discount rates, which are influenced by bond yields.

A more accurate comparison would involve looking at the implied volatility of longer-dated Treasuries, such as the 20-year or 30-year bonds, rather than the shorter maturities that dominate the MOVE Index. When comparing the volatilities of these longer maturities with the VIX, the relationship appears more correlated, and the ratio of fixed-income volatility to equity volatility doesn't show anything unusual.

Thus, the high MOVE/VIX ratio indicates that short-term Treasury volatility is high relative to long-term Treasury volatility, especially in fluctuating monetary policy. While the bond market, as noted in the MOVE Index, is pricing in more market risk than equities (VIX), the futures market's implied Federal Funds rate suggests expectations of a soft landing.

However, our thesis is that these expectations may not hold, as deflationary pressures on growth could intensify over time due to the lag in monetary policy effects. The accuracy of the futures market's predictions, which currently imply a Federal Funds rate of 3.75% to 4.0% in the first quarter of 2025, remains uncertain given the evolving economic landscape and the intensifying geopolitical conflicts that could further complicate the situation.

December 2023 Quarterly Report

Conclusion

The investment landscape remains challenging and increasingly disconnected from underlying valuations. LAIF successfully navigated a difficult quarter with high volatility across equity, bond and currency markets. This period of instability, exacerbated by recent statements from central banks about a potential easing of rate hikes, provided unique challenges in positioning the portfolio.

The prospect of rate cuts and the profound impact of monetary policy on both economic growth and market movements emphasise the importance of a strategic and well-informed investment approach. Despite all the macro noise and challenges, the investment committee believes the Fund is strategically positioned to capitalise on the emerging opportunities anticipated in 2024.

If you, or someone you know, would like to talk with us, please do not hesitate to contact us at laif@lucernepartners.com to arrange a call. Again, thank you for your interest in LAIF, and we wish you safe investing for the quarter ahead.

The Lucerne Alternative Investments Fund

January 2024

December 2023 Quarterly Report

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