Quarterly Report | June 2023

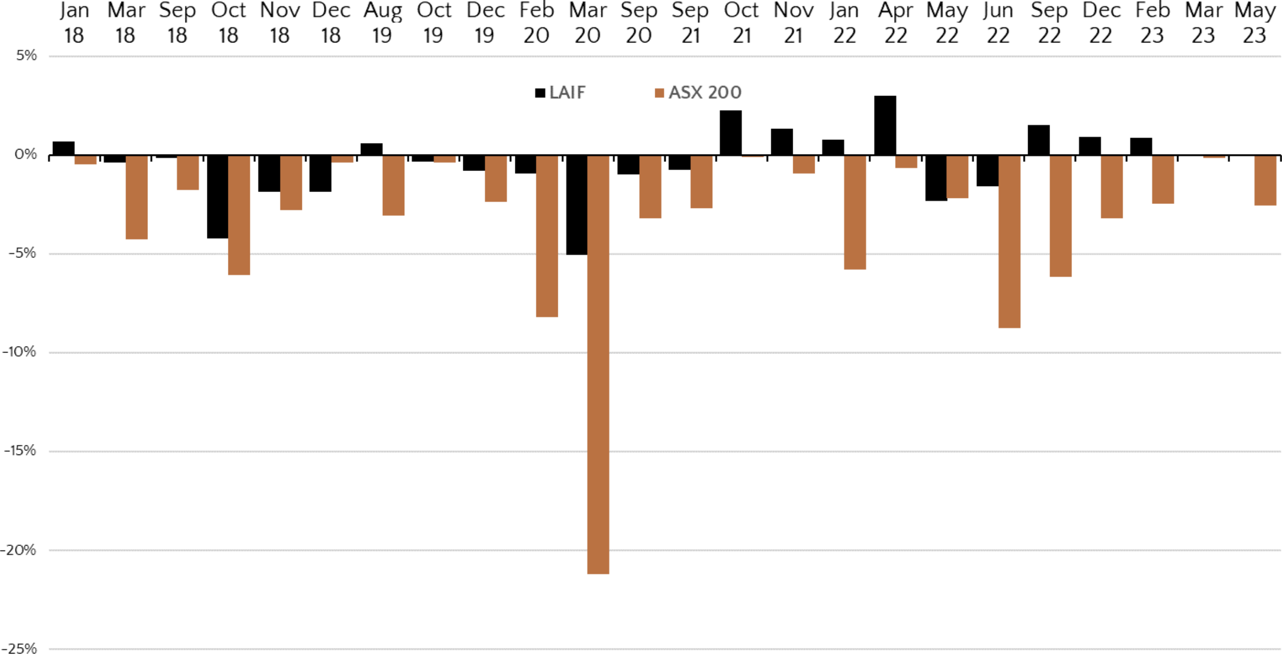
Lucerne
Alternative
Investments
Fund

June 2023 Quarterly Report

The Lucerne Alternative Investments Fund (LAIF) continues to deliver robust risk-adjusted results, with an anticipated return of 1.05% for June, leading to a strong quarterly performance of 1.97%. Over the financial year 2023, LAIF has achieved a notable increase of 4.27% and demonstrated low volatility, measuring only 3.95% over the same time.

These metrics highlight the significance of investing in a well-managed and diversified alternative Fund of funds such as LAIF. The Fund's ability to generate positive returns while maintaining lower volatility showcases its effectiveness in navigating varying market conditions.

LAIF Performance in ASX 200 down months (Source: LAIF, ASX)



A retrospective look at the second quarter reveals several key developments:

- The US Federal Reserve (Fed) implemented a 25 basis point increase in the cash rate in May, followed by a pause in June. The Fed maintained a hawkish stance, emphasising the importance of the 2% inflation target.

- The US banking system remains robust, but there are concerns about the potential impact of tighter credit conditions on economic activity, hiring, and inflation. The extent of these effects remains uncertain, and the LAIF Investment Committee closely monitors inflation risks.

- The Reserve Bank of Australia (RBA) paused in April but resumed raising the cash rate with two 25-basis point increases in May and June. There have been 12 rate increases since May 2022, resulting in a total increase of 400 basis points.

- Equity markets experienced a rally, reaching new highs, with particular support from concentrated artificial intelligence (AI) companies.

- As indicated by the VIX, market volatility has dropped to its lowest point before the onset of the COVID-19 pandemic, suggesting investors perceive the market to be relatively stable and less prone to significant price swings.

- Consumer spending has remained relatively stable, although signs of strain are emerging due to tighter bank lending standards and the depletion of cash buffers.

- Risk asset performance so far has been shaped by relief in the face of an end to rising interest rates. In response, the technology and long-duration investment sectors have rebounded strongly.

- Long-term interest rates, represented by the 10-year rate, have remained relatively flat this year, reflecting a decline in inflation and a tempered outlook for economic growth.

- Short-term rates have been slightly more buoyant recently, driven by better than expected economic data and Fed commentary on potential rate hikes coming to an end.

Mid-Year Market Check

Following a phase of shrinkage in the preceding year, we observe a significant resurgence in global liquidity primarily driven by the deliberate actions taken by central banks worldwide to bolster economies and ensure stability in financial markets.

Central bank liquidity's pivotal role in preserving fiscal and financial stability has become increasingly apparent. As we move forward, we expect more unconventional policy measures likely to become increasingly prominent.

Simultaneously, advanced economies grapple with escalating pressures on their public finances. These pressures are driven by increasing military expenditure and mandatory spending necessitated by demographic shifts. Moreover, the aging population in the West is eroding the tax base as high-income earners enter retirement, posing an additional challenge.

The market indices' remarkable trajectory reflects primarily the technology sector's strong performance, especially within the domain of Artificial Intelligence (AI), where a select group of mega-cap companies have assumed prominent leadership positions. The combined gains of Apple, Microsoft, Tesla, Amazon, Alphabet (Google), NVIDIA, and Meta have averaged around 65% in the first half of this year, propelling Apple's market capitalisation to an astounding $3 trillion.

However, it is crucial to recognise that this concentration of strength within the tech sector has resulted in a relatively narrow breadth of market gains. Historically, when a limited number of sectors or stocks drive market returns, it raises cautionary signals and suggests the possibility of a bear market rally rather than initiating a new bull market.

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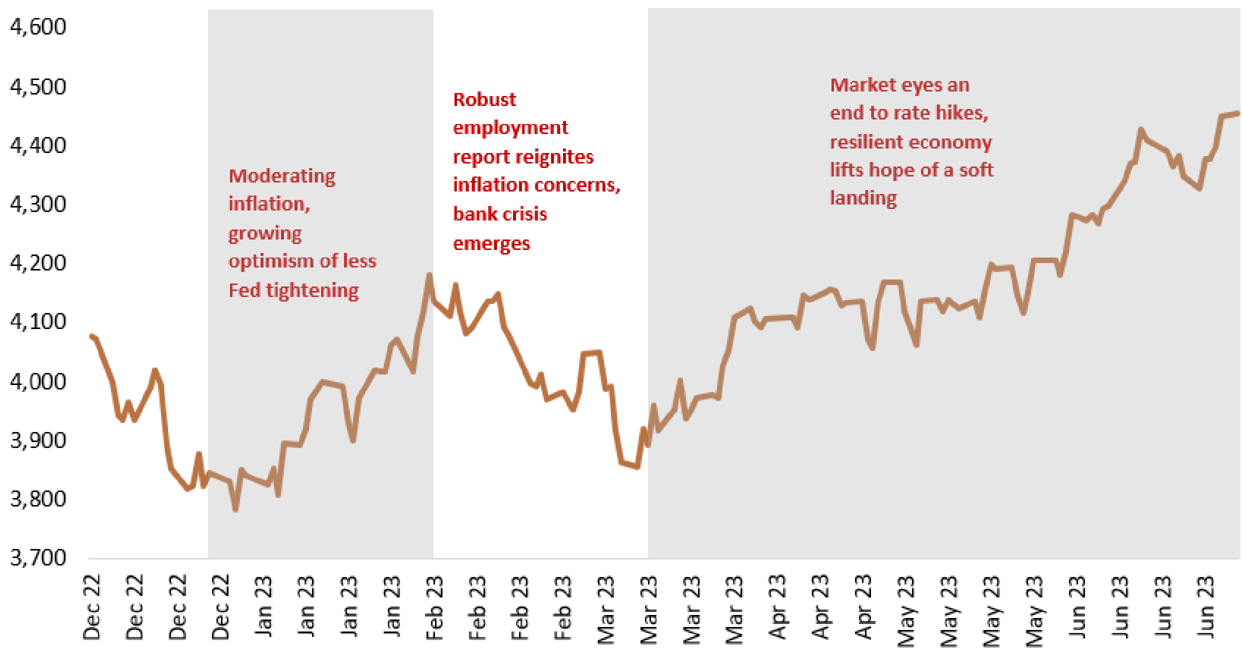
S&P 500 Index Performance (Source: Investing.com, LAIF)



Furthermore, this quarterly report explores the ramifications of excessive debt and the mounting pressures on public finances faced by advanced economies, including mandatory spending and limited options for tax revenue. Additionally, we address the intricate dynamics between interest rates, fiscal deficits, and escalating debt accumulation.

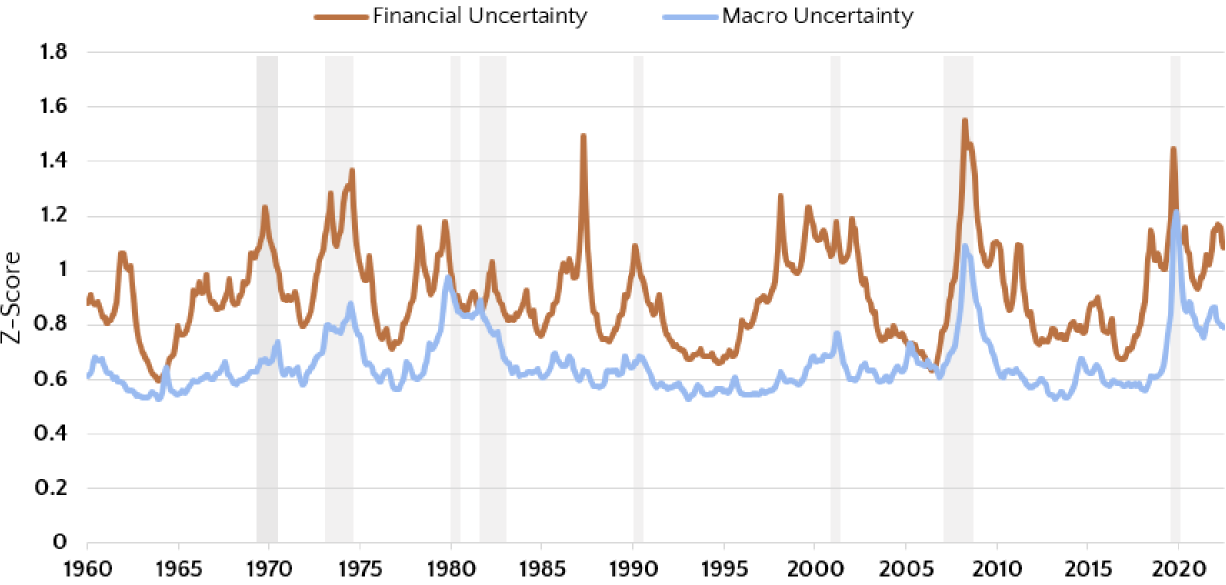
Uncertainty is the only Guarantee

Navigating the uncertain waters of today's macroeconomic conditions has proven to be a formidable task. Over the past three years, we have witnessed a whirlwind of events and unprecedented challenges that have upended the traditional economic landscape set off by the 2020 global pandemic.

Once a dormant concern, inflation emerged as a pressing issue in 2021. Central banks responded by aggressively raising interest rates in 2022 to curb inflationary pressures. Despite these efforts, inflation remains well above target, and the Federal Funds rate has reached its highest level since the global financial crisis. The banking sector now grapples with compressed margins and a shrinking deposit base.

In the face of this a pivotal question arises: Will the current high levels of uncertainty persist, or should we anticipate a return to the relatively calm environment of the 2010s? Addressing this question has become crucial for us to position the LAIF portfolio.

Macro and Financial Uncertainty 1960 -2022 **(Source: JLN uncertainty index, Kyle Jurado, Sydney Ludvigson, and Serena Ng (2015)**



Quantifying macroeconomic uncertainty offers valuable insights into the economy's predictability. We note that elevated macro uncertainty is associated with high equity market volatility, leading to negative performance. Historically, when the JLN macro uncertainty index exceeds one, equities experience a significant decline in average excess returns and a sharp increase in realised volatility. These findings highlight the substantial influence of macro uncertainty on market dynamics.

Macro Uncertainty Tends to be Stubborn

Statistical forecasts are inherently uncertain, leaving room for a rapid reduction in macro uncertainty. However, the current economic backdrop indicates that this time is unlikely to deviate from the norm. Two significant factors contribute to the sustained elevated macroeconomic volatility:

1. The effects of aggressive rate hikes are only beginning to surface while central banks grapple with the delicate balance between employment and inflation—a situation not encountered in decades.

2. Secondly, market expectations of crucial economic indicators diverge significantly from forecasts by policymakers and economists, leading to disparities even within different markets.

Historical trends indicate that high or low uncertainty periods persist for extended periods, spanning quarters and years rather than short-lived intervals (as the market believes). Moreover, the present monetary policy landscape and overall market conditions support the notion that uncertainty is a prevailing characteristic of the current environment.

Policy Environment: Trade-Offs and Rate Hikes

The impact of aggressive tightening of monetary policy is just beginning to manifest in the economy (albeit in certain pockets). Changes in monetary policy influence various interest rate-sensitive aspects of economic demand, investment, housing, and consumer spending. While monetary policy affects bank lending, higher interest rates and a flatter yield curve reduce credit availability as net interest margins compress. However, these effects take time to permeate through the broader economy. (Milton Friedman)

In addition to the delayed impact of ongoing rate hikes, we see an increasing level of confrontation for the central banks as tradeoffs between their employment and inflation objectives grow, a situation not experienced since the early 1990s.

In the past few decades, the direction of monetary policy—whether accommodative or contractionary—was relatively straightforward. Economic activity tended to be robust when inflation ran high, and economic activity was generally weak when inflation remained below target.

However, with central banks raising interest rates in the face of elevated inflation, they are doing so in a weakening economic condition while inflation remains above target. Historically, this scenario of tradeoffs has contributed to heightened macro uncertainty prompting central banks to abruptly change policy, as seen when the Volcker Fed initially cut interest rates in 1980 during a rise in unemployment, only to swiftly transition to a hiking cycle that induced a prolonged recession.

Moreover, the same tradeoffs create an atmosphere of increased uncertainty about the future course of monetary policy. The notable volatility observed in the front end of the yield curve in March 2023, triggered by concerns in the banking sector, exemplifies this phenomenon, leading to significant downward revisions in expectations for monetary policy.

Market Environment: Disagreement

The disparity and disagreement between market forecasts and the expectations of policymakers and economists contribute to sustained macro uncertainty. This discrepancy is evident across crucial macroeconomic variables. The front end of the yield curve, in particular, reflects heightened economic uncertainty, with significant volatility and contrasting views on the future path of the federal funds rate. While the market anticipates rate cuts and a shift in monetary policy, policymakers and economists maintain a different perspective, projecting further tightening.

This divergence raises questions about how a resolution can be achieved and its potential impact on the market. Possible outcomes include repricing interest rate expectations if policymakers and economists are correct or erosion of Federal Reserve credibility if the market proves accurate. Either scenario will likely contribute to financial market volatility and sustained macro uncertainty.

The significant divergence in expectations across different asset classes and the uncertainty at the front end of the yield curve underscore the delicate state of the economy. Dissonant market pricing increases the potential for higher volatility as the economy remains on a precarious edge awaiting resolution.

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LAIF Portfolio Design and Risk Mitigation

In 2022, the traditional stock/bond portfolio experienced more significant wealth destruction than during the 2008 Global Financial Crisis. The Investment Committee had already been contemplating an equities and bonds price retraction and had taken proactive measures to protect the LAIF portfolio by reducing market beta and implementing strategies to mitigate excessive market volatility, as outlined in the preceding discussion.

In particular, we addressed the following questions:

1. Which strategies are best suited for a risk mitigating portfolio?

2. What popular diversifying or defensive strategies don't belong in a risk mitigating portfolio?

By actively considering the relevant questions and implementing effective strategies, the LAIF portfolio has consistently delivered a performance that aligns with our expectations.

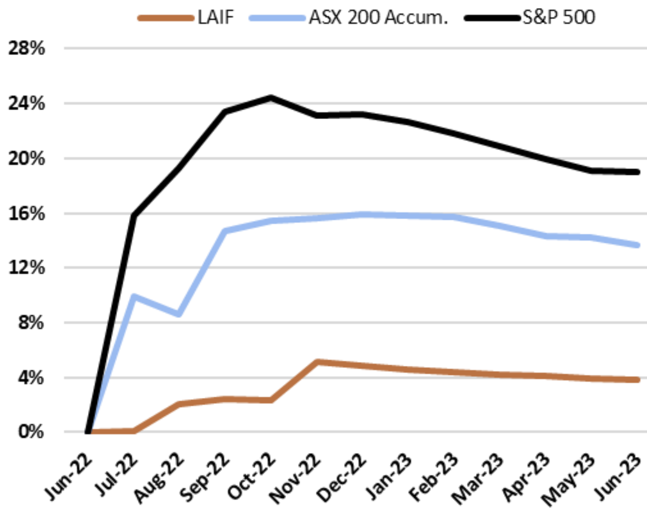
Over the past twelve months, the LAIF portfolio exhibited a volatility of 3.95% and a return of 4.01%. These figures highlight the portfolio's ability to manage fluctuations while preserving capital and generating positive returns for investors. Furthermore, the portfolio's Sharpe ratio of 1.09 outperformed both the ASX 200 Accumulation Index (with a Sharpe ratio of 0.41) and the S&P 500 (with a Sharpe ratio of 0.42) during the same period.

The Investment Committee is focused on preserving the stability of the portfolio and is committed to navigating and growing the portfolio in the face of uncertain market challenges.

LAIF Annualised Volatility Since Inception

LAIF | ASX 200 Accum. | S&P 500
20% 16% 12% 8% 4% 0%
Dec-17 Jun-18 Dec-18 Jun-19 Dec-19 Jun-20 Dec-20 Jun-21 Dec-21 Jun-22 Dec-22 Jun-23

LAIF Annualised Volatility Last 12 Months



(Source: LAIF, ASX, S&P 500)

Conclusion

The misconception that the monetary transmission mechanism operates more swiftly in the present era likely arises from the observation that monetary policy actions are swiftly reflected in the prices of liquid assets such as stocks and bonds. However, given the inherent volatility of asset prices and their ownership primarily by affluent households, the impact of changes in liquid asset wealth on consumption is relatively minor. This so-called "wealth effect" does not serve as a primary channel through which monetary policy actions affect economic outcomes.

It is worth noting that all central banks, whether explicitly stated or not, strive to achieve full employment and low inflation.

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

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