Lucerne Alternative Investments Fund

Quarterly Report | September 2023

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The Lucerne Alternative Investments Fund (LAIF) continues to demonstrate the benefit of investing in a well diversified alternative strategy estimated to post a strong quarterly performance of 4.62%. This performance speaks to LAIF's consistent ability to provide investors with strong risk adjusted returns. One of the key elements of LAIF and its active alternatives allocation strategy is the capacity to achieve positive returns in diverse market scenarios such as the last 12 months.

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

Australia:

- The RBA maintained a cash rate of 4.1% in September, with the RBA Governor signalling potential future rate hikes to address inflation concerns.
- The Australian dollar is trading at a near one-year low against the USD, standing at 0.64.
- Australia's Q2 GDP growth was 0.4%, slightly reducing the annual growth rate from 2.4% to 2.1%.

Global:

- Market volatility is at its lowest since the start of the COVID-19 pandemic, further supported by a 13.29% decrease in the VIX. This suggests a growing investor confidence in market stability.
- The BRICS group is expanding, with Saudi Arabia, Argentina, Egypt, Ethiopia, Iran, and the UAE set to join.
- The Federal Reserve raised its interest rates by 0.25%, bringing the Fed Funds rate to 5.33%. With US inflation at 3.2%, Chairman Jerome Powell indicates further hikes might be necessary to reach their 2% target.

Our Reflection: An In-Depth Analysis of the Current Market Landscape

Narrative Impact on Market News:

In the market, news is perceived as "good" only if it aligns with your perspective. Even though the Federal Reserve has consistently communicated that rates might remain "higher for longer", investors have become more receptive to this message due to positive economic indicators. However, we remain sceptical about the Federal Reserve's actions in 2024 to prevent disinflation from becoming deflation.

Economic Data and Market Reaction:

Each strong economic report furthered the belief in a robust economy. This caused some investors to question their expectation of imminent interest rate cuts by the Fed. As a result, long-term bond yields climbed, leading to a drop in bond prices. The stock market became cautious, with many investors selling their stocks by the quarter's end.

Market Performance Analysis:

The year 2023 started with strong momentum in the equity markets, particularly with the US markets taking the lead. However, it's important to note that despite a robust market performance this year, most of it was driven by a select few technology beneficiaries. These high market capitalisation companies, directly and indirectly tied to the AI hype, have significantly impacted market benchmarks.

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Consider a scenario where all the companies in the S&P 500 index have equal weight. In this situation, the overall performance for the year would be stagnant. This highlights that a small number of companies with significant market capitalisation mainly propels the market's remarkable year-to-date performance. When a few large companies dominate the index, it can overemphasise specific sectors or industries, potentially putting investors at risk due to concentration.

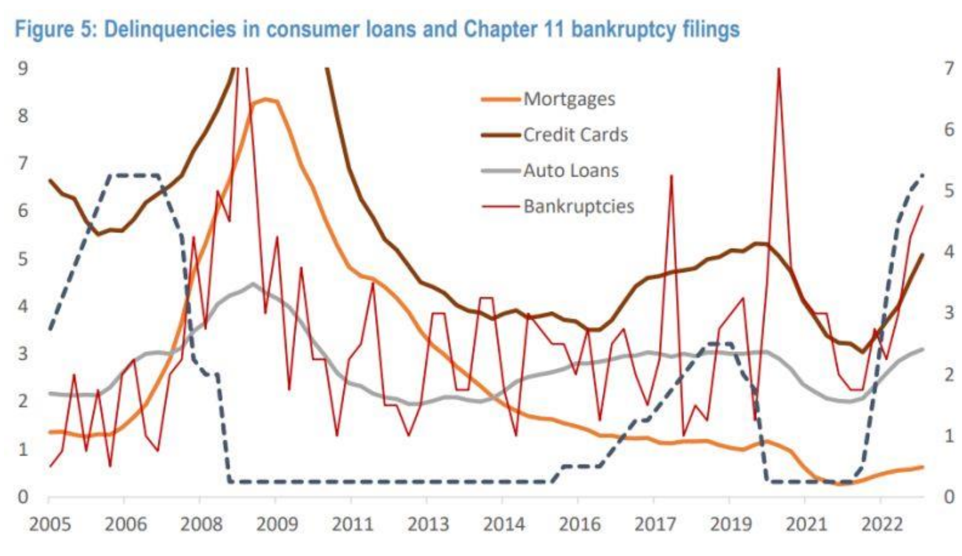
The limited diversity in the market's overall performance suggests that we are witnessing more of a bear market rally rather than the beginning of a new and enduring structural bull market**.**

We emphasise the following:

- **Narrow Breadth of Market Performance**: a small group of stocks or sectors drives the market's positive performance. In other words, many stocks need to participate in the market's recent gains, causing a lack of diversity in the performance.
- **Bear Market Rally**: we see this as a temporary upward movement in the market that occurs within an overall bear market context. It's characterised by short-term gains, often driven by investor sentiment or technical factors. However, it doesn't necessarily indicate a sustainable shift in market sentiment.
- **Structural Bull Market**: Conversely, a structural bull market signifies a more enduring and long-term positive trend typically resulting from strong economic fundamentals, widespread investor confidence, and sustained positive sentiment.

Debt and Delinquency Trends (Refer to JP Morgan Chart):

There's a noticeable uptrend in credit card delinquencies, auto loans, and bankruptcy filings, similar to patterns last observed in 2007. Mortgage delinquencies however remain low, likely due to homeowners securing low interest rates and the home being the last thing that an asset owner wouldwant to relinquish. This situation differs from 2008, when a higher percentage of mortgages needed refinancing, and subprime sector leverage was substantial. Rising interest rates are particularly burdening small businesses and commercial real estate.



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Global Financial Climate:

In contrast to 2008, the current financial issues have a pronounced global dimension. Many central banks have tightened policies in response to inflation and the energy crisis. Back in 2008 and 2015, China's extensive stimuli buffered global downturns. Now, geopolitical tensions and fiscal deficits could challenge a similar solution.

2023's Market Landscape:

2023 has been a tumultuous year. We began with concerns about lasting inflation from 2022 and potential economic downturns. The first half surprised with a decline in inflation and a resilient economy, contributing to a market rebound. However, by Q3, doubts regarding inflation and economic health resurfaced. There was hope of no recession and controlled inflation in July and early August. Yet, the latter half saw these hopes dashed, and the market relinquished its gains. We delve into the Q3 market performance to understand the risk capital dynamics. Following 2022's increasing trend, 2023 has kept interest rates in the spotlight. Although treasury rates haven't skyrocketed as last year, they have continued to ascend.

Equity Performance:

Despite losing 3.65% in Q3, large-cap stocks are up by 12.13% for the year. In contrast, small-cap stocks have returned to their starting positions at the onset of 2023.

Unlike in 2008, there is also a more pronounced global aspect of this problem, as central banks across the globe tightened policy in response to inflation and the energy crisis. In 2008 and 2015, large stimulus and growth impulse from China cushioned global downturns, and current geopolitical tensions and already high fiscal deficits could complicate such an outcome.

Understanding the Factors Affecting Market Drops in Q3 2023

In Q3 2023, an uptick in interest rates partially influenced the decrease in equity and bond prices. But a pertinent question arises: To what extent did the price of risk influence this drop? In simple terms, when risk premiums rise, asset prices typically fall. Factors like political shifts and broader economic issues might have added to the market's risk perception.

To delve deeper into this, we analysed the corporate bond market, specifically focusing on default spread indicators of the risk price and the equity risk premium:

1. During the third quarter of 2023, bond default spreads, which had experienced a notable surge in 2022, exhibited a subtle decline across all rating levels. Throughout the year, higher-rated bonds showed minimal fluctuation, while the spreads for those bonds with lower ratings saw a marked decrease, indicating a change in market perception towards these riskier assets.
2. From the start of 2023 through July, the equity risk premium, a measure of the expected return of holding risky stock over a risk-free rate, dropped from 5.94% down to 5.00%. In Q3, even with rising risk-free rates, this premium remained relatively stable. By the beginning of October, with an equity risk premium of 4.84% and factoring in the ten-year Treasury Bond rate of 4.58%, the projected equity return was 9.42%, a noticeable increment from the 8.81% estimated in July. This shift reflects evolving investor expectations and market dynamics during the period.

In essence, despite the equity price and interest rate fluctuations in Q3, there is minimal indication that the pricing of risk was a primary contributor to the market's instability. The predominant factor affecting equity and bond price shifts during this quarter is the increment in interest rates rather than an escalated sense of market trepidation.

Risk Capital Dynamics

In mid-2022, we highlighted a noticeable change in risk capital (link). This pertains to the funds invested in high-risk assets across various categories, such as startups in equities, high-yield bonds within the corporate bond market, and initial funding in the venture capital realm. After enjoying an abundant presence, almost to an excessive degree, for a decade, risk capital began to recede. This withdrawal had significant implications for both private and public equity markets.

To gauge the state of risk capital, we discussed three pivotal indicators:

1. Frequency of initial public offerings (IPOs)
2. Volume of venture capital investments
3. Issuance rates of high-yield bonds

A brief review reveals that companies have optimistically started reissuing bonds, realising that waiting for a rate decline may be counterproductive. However, the portion of these issuances that fall under high-yield bonds has been limited for the past 18 months, suggesting a stagnant high-yield bond market.

Despite the recent uptick in equity markets, there's a noticeable cautiousness in the return of risk capital. This hesitancy might be because large-cap, profitable firms drive market recovery. Only when the gains in the equity market expand to include smaller, unprofitable companies significant rallies in both venture capital and the high-yield bond markets are likely.

However, we are optimistic that even if (or when) this rebound materialises, we won't see a return to the overindulgences of the past decade. We note that such a shift would be a commendable market progression.

Reflecting on 2023's Economic Landscape

As we approach the end of 2023, it's remarkable how the financial landscape remains largely unchanged from nine months ago. The dual uncertainties we flagged at the year's outset — the longevity of inflation and the potential for a recession — are still prominent. If anything, the often incorrect predictions by economists and market experts regarding these significant macroeconomic factors have only deepened our scepticism about the forecasts, leaving us more uncertain about future trends.

Initially, there was a shared belief that 2023 would witness a recession; the primary debates were about its onset and severity. Surprisingly, the market has performed well this year due to the economy's resilience. Not only did we avoid a recession, but employment figures also remained robust.

Regarding inflation, the predominant view at the beginning of the year was its inevitable decrease, mainly attributed to economic frailties. The market experienced an unexpected twist in 2023: inflation was reduced without signs of an impending recession.

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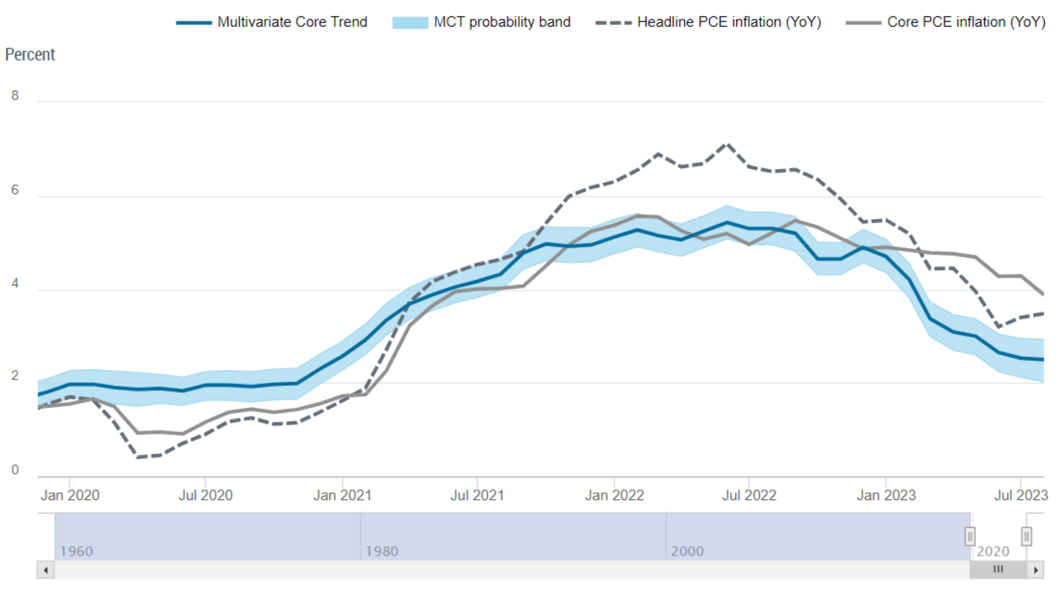
The dip in inflation during the first half of 2023 was notable, as evident from tangible metrics (like CPI and PPI) and anticipatory indicators (consumer surveys and the treasury market). Although Q3 witnessed a plateau in this decline, it's undeniable that inflation has diminished throughout the year.



Sources: Bureau of Economic Analysis; authors' calculations.

Notes: The twelve-month changes in the headline and core personal consumption expenditures (PCE) price indexes are plotted alongside Multivariate Core Trend (MCT) Inflation for comparison. The shaded area surrounding the MCT estimate is a 68 percent probability band.

However, it's still hovering above Central Bank's target levels. For those who claimed the inflation spike was short-lived, this year doesn't entirely support that perspective. Even if inflation stabilises, prices are anticipated to be roughly 20% higher than they were two years prior. While strides have been made in managing inflation, it's premature to claim complete success, especially given the challenges that still lie ahead.

Conclusion

As we near the end of 2023, the investment landscape remains as intricate as our early 2023 evaluations suggested. Despite ongoing concerns about enduring inflation and a possible recession, market reactions have often been unpredictable. Yet, a clear sense of prudence is evident, especially regarding high-risk investments such as venture capital and high-yield bonds.

The current market uncertainty has led LAIF to reduce its market beta in its strategy to manage it more effectively. The Investment Manager with its overarching thematic driven approach maintains a robust and unwavering conviction, positioning the portfolio to leverage emerging opportunities and handle any prospective challenges optimally.

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

October 2023

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