Equity Trustees

EIGHT BAYS Global ETFs

EIGHT BAYS GLOBAL FUND SPECIAL REPORT

November 2022

THE US ECONOMY & LONG-TERM THEMES

Introduction

2022 has been a year in which both economic and geopolitical uncertainty has escalated to levels not seen since the collapse of the Soviet Union and the ending of the cold war in the early 1990s. Inflationary pressures have been exacerbated by the ending of a global pandemic and the Russian-Ukraine War. Bond and equity markets have declined in response to these developments. In this report we consider some pressing issues.

Firstly, are US equities pricing in a hard landing for this economy? Our conclusion is possibly not based on a range of economic indicators and industry fundamentals. Overlaying this we consider cyclic factors such as the strong US dollar which is impacting economies both positively and negatively. We believe the US dollar is close to peaking and potentially presenting opportunities in industries and countries outside the US as we move into 2023.

Secondly, we consider some key secular trends including deglobalization, energy transition, digitization and ageing populations. Given the dislocations in the world caused by a heightening in geopolitical risk are there underlying structural changes in industries that potentially offer opportunities in certain sectors? For example, nations and industries are actively pursuing strategies aimed at de-risking supply chains, by onshoring strategic industries such as energy, technology, semiconductors, and healthcare.

Our industry centric portfolio of ETFs is structured to take advantage of the growth opportunities that these secular trends offer. The Fund owns a selection of ETFs that hold leading global companies providing investors exposure to themes such as digitization (semiconductors, cybersecurity, software), energy transition (industrial metals, semis, oil & gas) and aging populations (healthcare service, med tech, drugs).

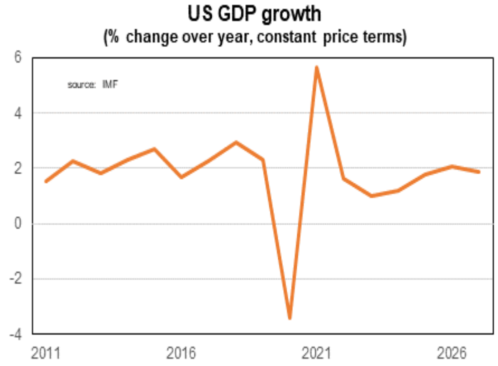
The US equity market – is it pricing in a hard landing?

There has been a lot of talk about the possibility of a recession in the global economy next year. The Russia-Ukraine War is hitting Europe hard (both directly via a drop in trade with Russia and indirectly through the higher cost of energy and food). The Chinese economy is experiencing a difficult period because of its zero-COVID policy and problems with an over leveraged housing sector.

The US is performing better although concerns have been growing that that it too may enter recession next year. When 'gasoline' prices were sky-high a couple of months ago sentiment about the US economy (as measured by the number of Google searches for 'recession') was weak. Lower gasoline prices have seen sentiment improve. Forecaster sentiment is not unduly pessimistic. For example, the IMF is forecasting a slowdown in the US economy next year but not a recession.

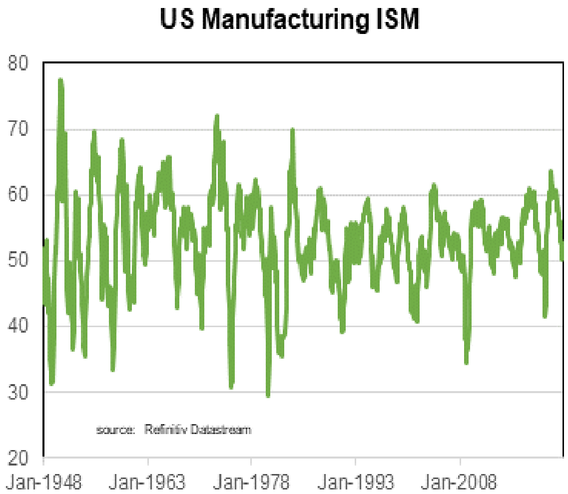
Sentiment about the US economy has been very weak.

The IMF is looking for a modest slowing of the economy next year.

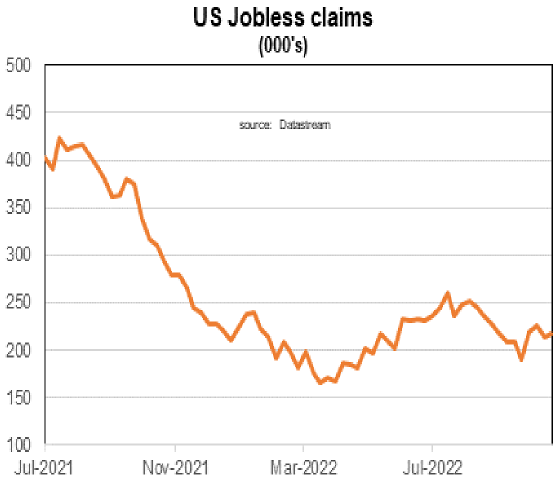


The recent economic data has been more consistent with a slowdown than a recession. The ISM survey (a long-running survey of manufacturing in the US) was still above 50 in October. This is consistent with a growing economy albeit nowhere as strong as the one that entered 2022. And it is above 40, the level that has historically been consistent with a recession. The rise in jobless claims (unemployment benefits) has so far been modest and the absolute number is still low by historical standards.

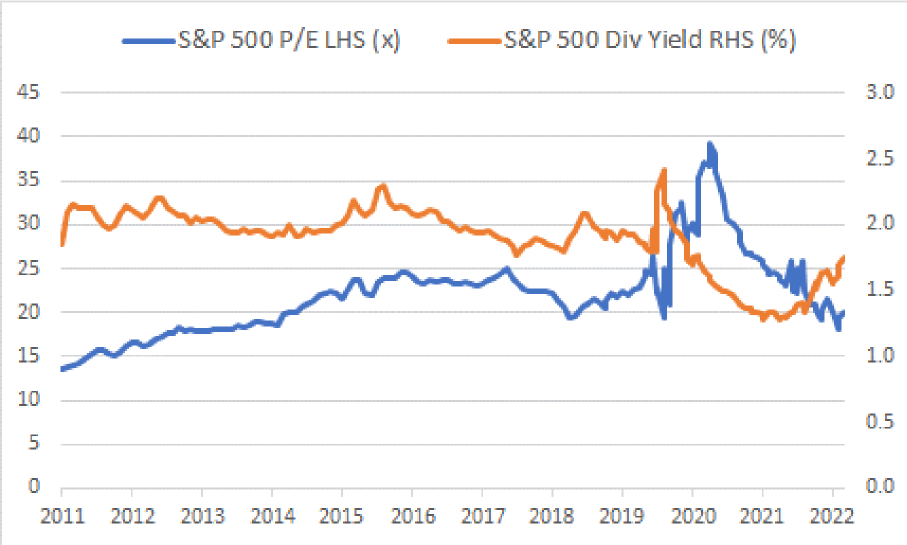
Business surveys are currently pointing towards slowing but still positive economic growth



This is consistent with what is happening in the US labour market.



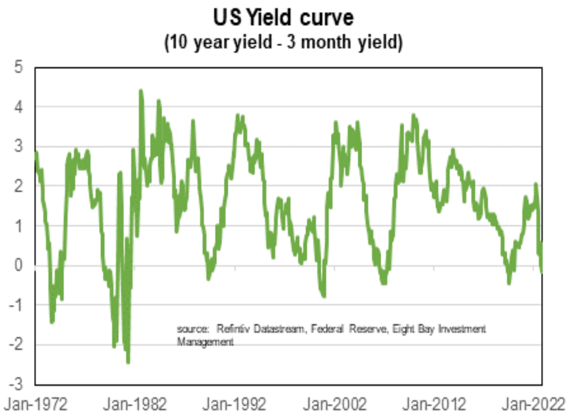
Financial market pricing is consistent with a weaker economy and not a recessionary one. The current P/E for the S&P500 20.1x compared to the 20-year average of 21.6x whilst the market dividend yield is 1.69% (20-year average 1.89%).



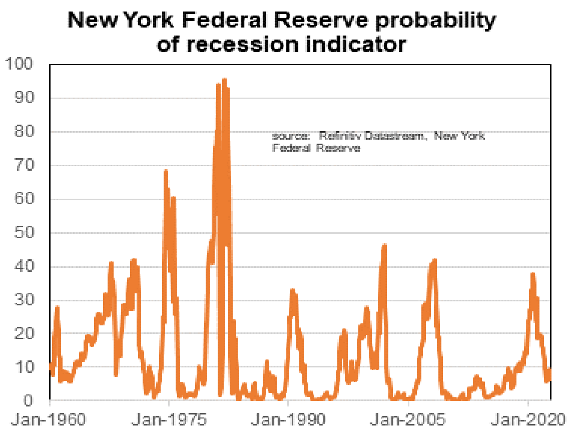
Source: NASDAQ

Certain indicators are starting to move towards a direr outlook. One measure of the yield curve (10 year minus 3month interest rates) had (at the time of writing) just turned negative (the level where analysts start to get worried about a recession). The New York Federal Reserve uses the yield curve to calculate the probably of a recession within a year and that probability is currently below 10%. Surveys of professional economists show the median expectation of a recession within the next year was a bit over 20% in the December quarter 2022, near the highest level outside of actual recessions.

The US yield curve has turned negative, often an indicator of a sharp slowing of economic growth.



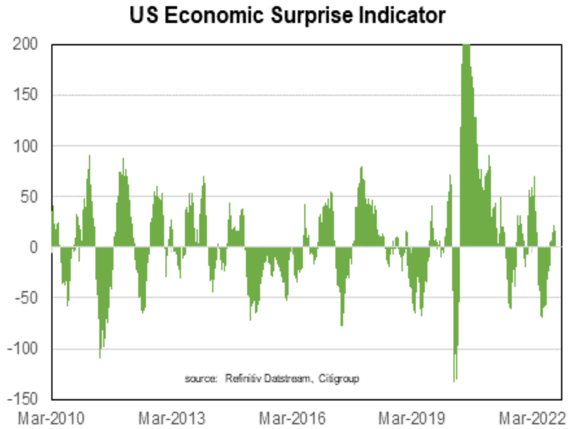
Models using financial market data are not yet blinking red for a recession.



US equity analysts have been downgrading their earnings expectations for next year although they still expect positive growth. One reason is that the recent reporting season has been reasonable. The economic data is also still (modestly) surprising analysts with strength.

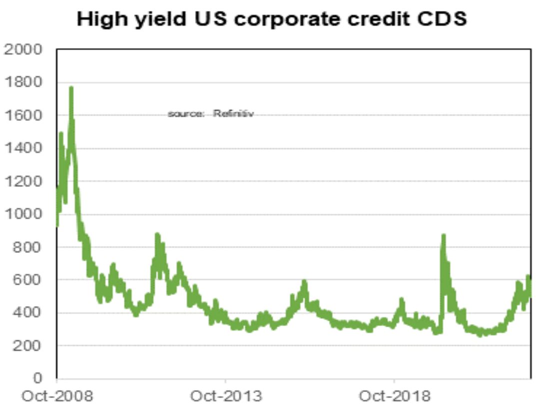
Positive earnings growth is still expected over the next year.

The US data has been modestly stronger than expected in recent weeks.

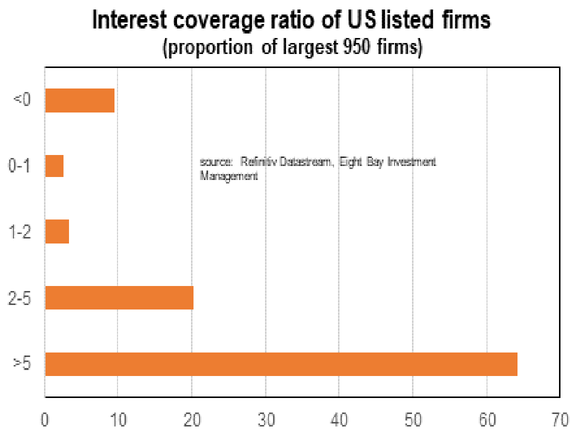


Low-rated credit spreads have not risen to a level that has historically been consistent with a recession. One reason is the decent state of the economy. Another is that the vast bulk of the largest listed US companies have balance sheets that are in pretty good financial shape.

Low-rated credit spreads have widened although below the levels typically associated with a recession.



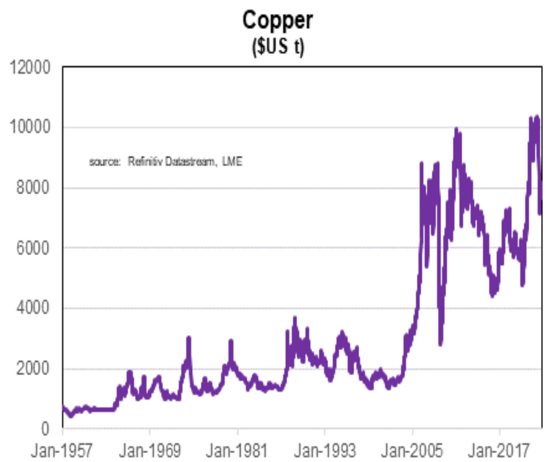
The balance sheets of most large companies are in decent shape.



If financial markets were concerned about the economic outlook that would be expected to be seen in valuations of the US banking sector. But at the time of writing, the price-to-book ratio of US banks was above one, well above the levels seen during the pandemic and GFC and the 1990s recession (and substantially above the level seen during the 1980s recession). Copper has historically been very sensitive to changes in views about the economic outlook. The copper price has declined from its peak but is well above the level that suggests that there is an imminent recession.

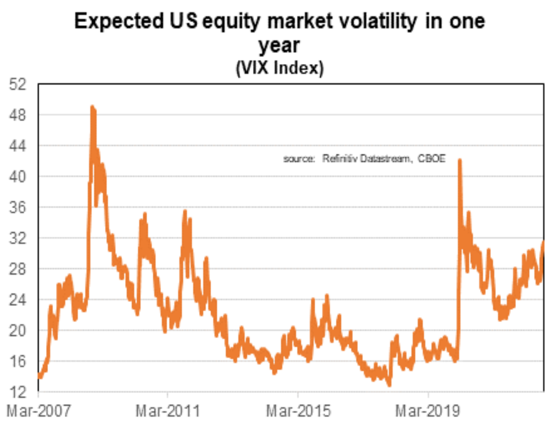
Bank valuation have declined but are not currently consistent with levels associated with a recession.

The copper price has declined sharply but remains at a historically high level.

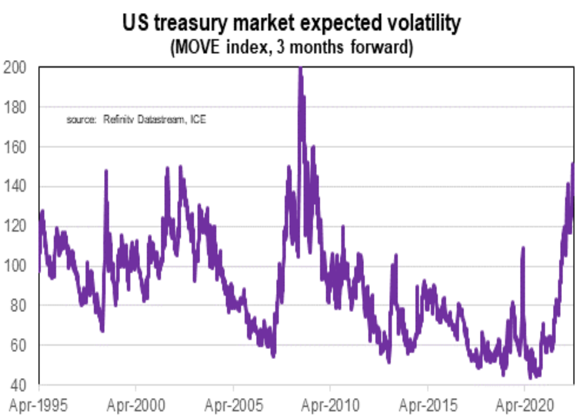


There is plenty of uncertainty about the outlook. The VIX index (a measure of what volatility investors expect for the US equity market) is well above the levels seen over recent years. Indeed, it is back to the level last seen around the European debt crisis. Uncertainty about the economic (and therefore profit) outlook is playing a role. But also important is the high level of uncertainty (as indicated by the MOVE index - a measure of expected volatility of US Government bond yields) about the outlook for US interest rates. This reflects concerns about the inflation outlook, as well as central bank rate actions.

US expected equity market volatility is elevated.



And expected US interest rate volatility is very high.



What to do given the economic backdrop

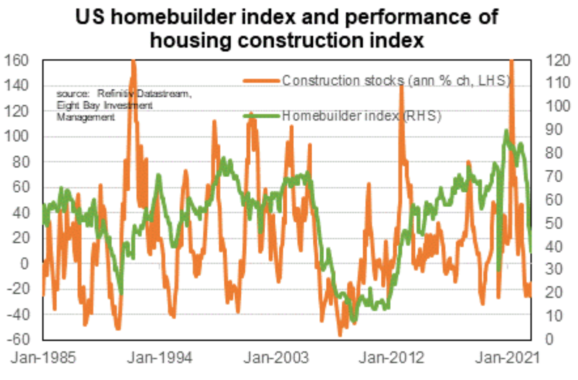
In summary, financial markets are pricing a slowing of the US economy but not (at least yet) a recession. This pricing is consistent with the current flow of economic data as well as views of most economic forecasters. There is a high level of uncertainty about the outlook.

History would say that given the extent of the rate hikes to date there will be very likely a US economic slowdown, possibly a severe one. But we can't be certain as to how much the US economy will slow, nor how long any downturn will last. One reason is that we can't be certain about the inflation outlook, not the least because a fair slab of the rise in prices has been driven by war and weather - two variables that are notoriously difficult to forecast.

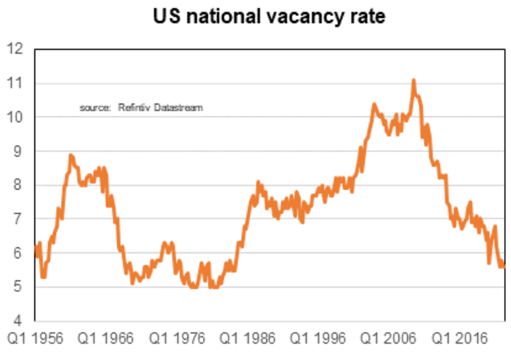
Given that uncertainty about the economic outlook, what areas are we keeping an eye on for investment opportunities? One is residential construction. Construction stocks have been hit hard in line with the rise of interest rates and declining house prices. There can be no doubt the US housing sector is heading for a weak patch. The homebuilder index (a measure of sentiment of US builders) has already dropped substantially. But construction share prices have already priced in plenty of bad news, declining as sharply as they have in previous downturns.

History would say that typically construction shares bounce back sharply. The clear exception was during the GFC. But that downturn was caused by structural problems in the housing (and banking) markets. High house price growth was driven by speculative buying at a time of weak lending standards. To cap it off there was an over-supply of housing illustrated by high vacancy rates. House prices have also risen strongly in this cycle. But the regulatory reforms of recent years have meant bank lending standards did not decline substantially in this cycle. And the vacancy rate is currently near its lowest level in forty years, a signal that there has not been any over-building in this cycle.

Construction stocks have already declined sharply.



The national vacancy rate is at its lowest level in around forty years.



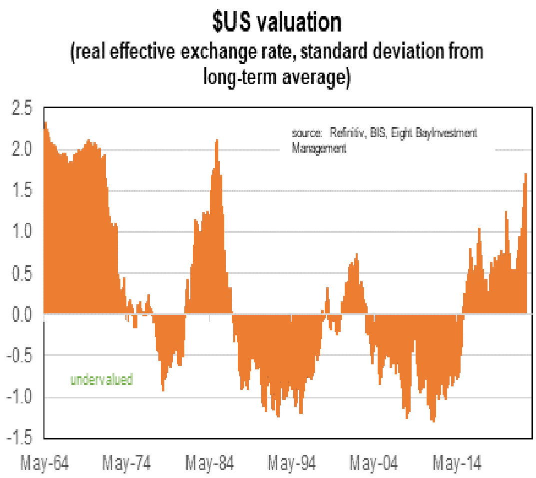
The US (and global) economy has been heavily impacted by the fortunes of the US dollar (USD). The USD has been very strong over the past couple of years reflecting the relative strength of the US economy and the more aggressive rate stance of the Federal Reserve. A very strong USD has historically been a negative for the global economy and equity markets. Partly that is because it means every other currency is lower and so increases the price of imported items (and so boosting inflation). This gets exacerbated for foreign firms that must import commodities or components (around half of all global trade is invoiced in US dollars). A strong USD is a particular negative for emerging markets (emerging markets need to increase interest rates by more than US to limit capital outflow and protect the value of their currencies).

A stronger USD is benefitting the US economy in the current environment by reducing the price of imports. But it is hurting US exporters, as well as reducing overseas earnings of US firms.

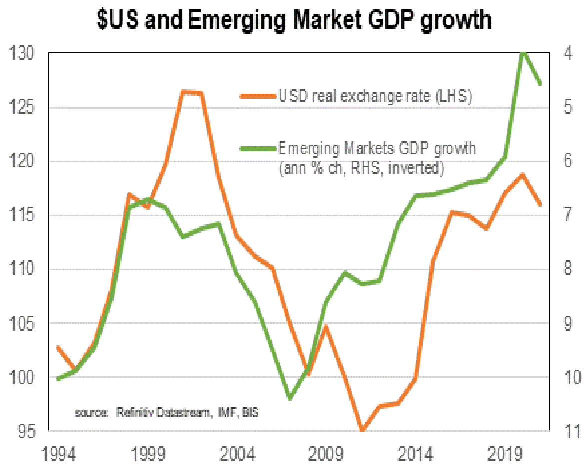
Taking into account relative inflation movements, the USD is at its highest level since the early 1980s. A strong currency and strong economy means that the US is running an increasingly large current account deficit that requires increasing inflow of capital to be funded. Currently this is not a problem with the US being the standout large global economy with expectations of having a relatively higher interest rate. But once the US economy's economic outperformance begins to dim the USD may become more vulnerable. This does not mean that a drop in the USD is imminent. That may not happen until it is clear that US interest rates have not only stopped rising but investors can see a decline in US rates somewhere on the horizon.

Emerging markets would benefit from a lower USD as it would provide emerging market central banks with the scope to reduce their interest rates. A substantial rebound in emerging market equities may need to wait until there is an improved confidence about the global economic outlook. Sectors in the US that have companies with a high proportion of offshore earnings would also get a fillip from a lower USD, as would US exporters.

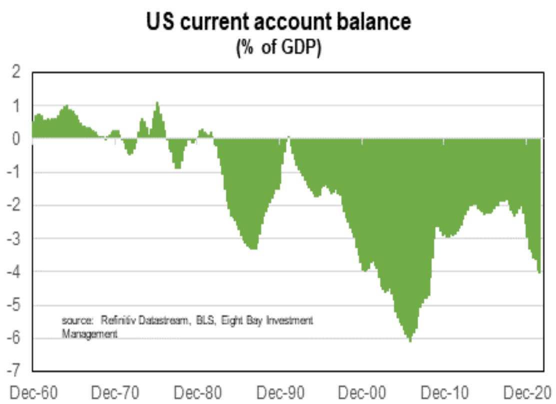
The USD appears overvalued.



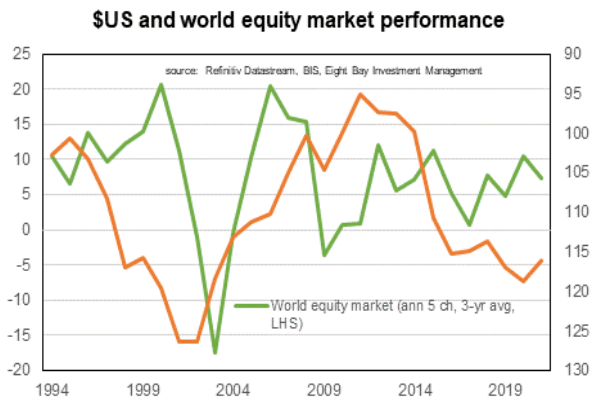
A stronger USD has typically been bad news for Emerging Markets.



The US current account deficit is widening.



Global equity markets struggle to do well while the $US is strong.



Long Term Themes

Energy Transition

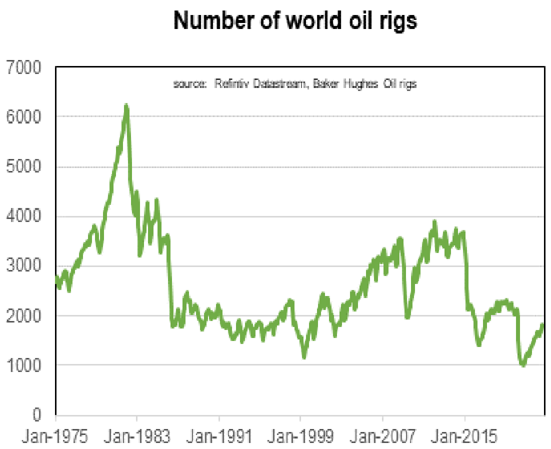
Long-term trends will remain in place regardless of the state of the economic cycle. One is developments in the energy sector. Currently that sector is being hit by three different forces. The first is concern about the cyclical economic outlook and therefore short-term demand for energy.

The second is the impact that the Russia-Ukraine War is having on global trade flows. The war has seen Europe looking to reduce their reliance on Russian energy. The Russians are looking for alternative buyers (such as China, India and Turkey). Such a sudden shift in demand and supply patterns is hard to achieve quickly in the gas industry (a significant percentage of Russian gas is delivered via pipeline towards Europe).

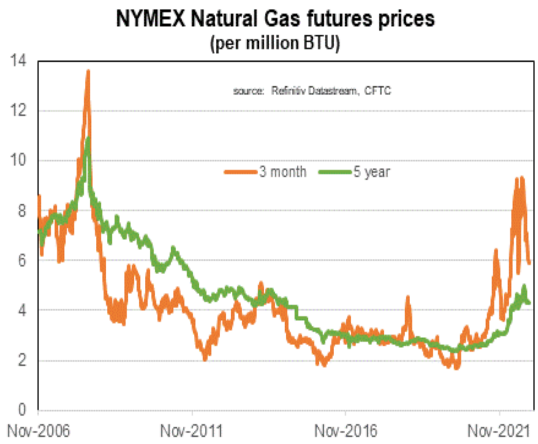
In time the shift in trade flows will occur. Europe is starting to source gas from alternative sources (such as Algeria) and has started to build terminals to enable them to source LNG from other countries. Europe will also look to source more energy from sources they currently use (such as nuclear and coal) or from new ones (hydrogen). Russia will also be able to build pipelines and terminals so that can export its gas to other countries. But this process will take years to complete. In the meantime, there will be less Russian gas supply on the global market. And this means prices for gas will be higher than otherwise.

The third force is the longer-term shift away from carbon-intensive energy sources to cleaner energy. This shift will require substantial investment into new sources of energy. But that shift has also meant there is less investment into existing carbon-intensive energy sources. And these are the ones that are currently supplying much of the world's energy needs. Another reason for the cautious investment into carbon-intensive energy is the big swing in prices that has taken place over the past decade (including a short period in the early stages of the pandemic when oil prices went negative!). The result is that energy prices will be higher than they would otherwise have been at least until the world has largely completed its transition towards cleaner energy sources.

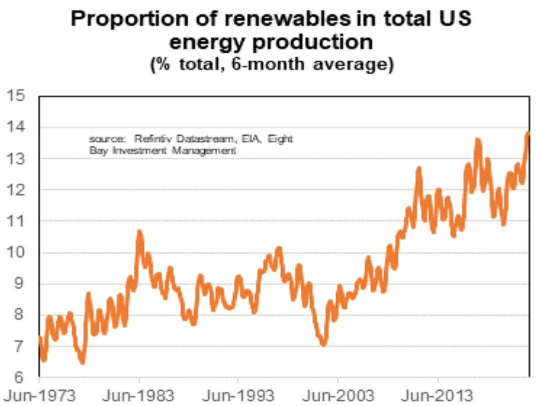
The number of oil rigs has increased but remains below the levels seen earlier in the previous decade.



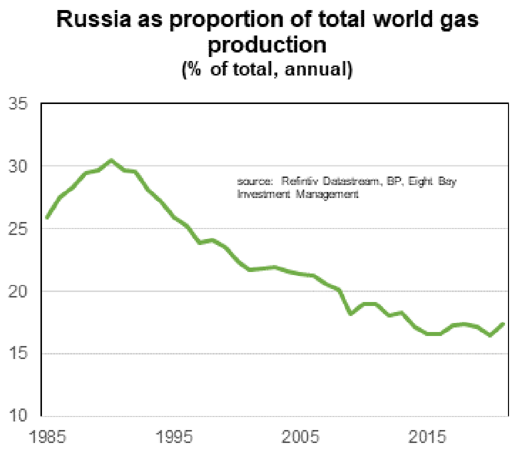
Energy consumption in the US has been relatively flat over the past couple of decades.



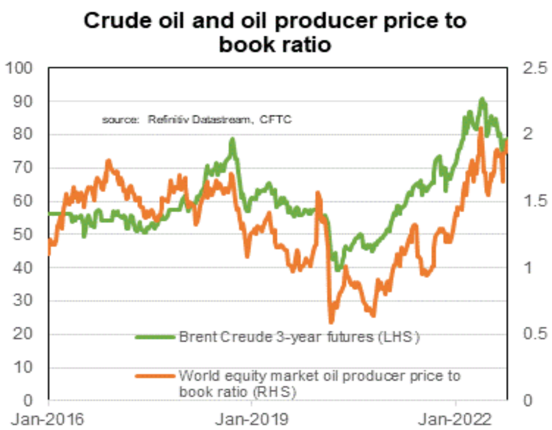
While renewables is becoming a more important part of the US energy story its contribution is still quite small.



Russia is a big player in global energy markets.



Expectations of sustained high prices are supporting energy company valuations.



Deglobalization

Another trend that has been discussed in recent times is deglobalization or onshoring of strategic industries (eg semiconductors) which will occur as countries and firms look to de-risk their supply chains following the stress they have come under over recent years through the pandemic and natural disasters. Changing geo-politics is another driver, notably the potential shift towards Chinese and US trading spheres.

In areas such as semiconductors, the US has started to shift some of that manufacturing towards home. Indeed, in August this year the US Government enacted the CHIPS and Science Act which provides around $US52 billion in tax incentives to the semiconductor industry. And only last month the US Government banned the selling and manufacture of advanced semiconductor chips to China. However, despite these headline tech wars, other measures indicate global trade has never been healthier. And for all the talk about shifting trade patterns, China's share of the global export market has continued to rise over recent years.

That big changes to global trade patterns have not yet occurred should not be a shock. Governments and companies have had their hands full over recent years is dealing with the pandemic. Global supply chains were set up for maximum efficiency, with a high degree of specialization in an often-elongated supply chain.

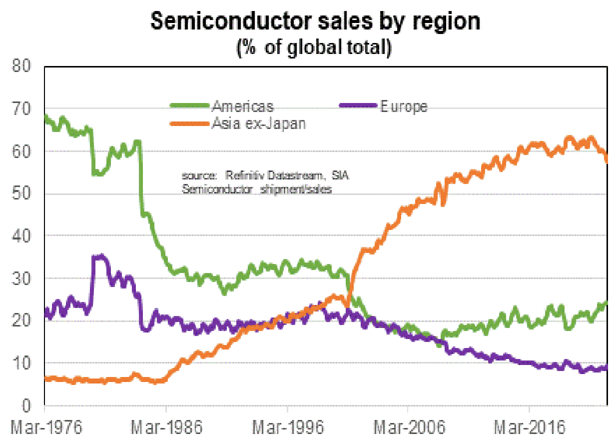
Problems with the current global supply chain structure have been widely acknowledged. There has been less agreement as to the alternative. Does it mean that instead of having one supplier for each step in the supply chain companies attempt to source from several? Do supply chains need to become shorter and therefore potentially less vulnerable even if it results in higher costs of production? Should the new suppliers all be home-based? Or with countries that have similar geo-political outlooks ('friendshoring') or countries that are near neighbours ('nearshoring')?

For most of those answers the result will be a higher cost of production. Essentially companies and nations are paying an insurance premium to mitigate risk. Firms are currently finding it easier to pass on cost rises to customers but that may not be the case as the economy slows. In some areas that define as national importance (such as semiconductors) governments might be happy to subsidize the higher costs of production. In most areas though firms will be looking to choose the method of production that is still efficient to keep costs down.

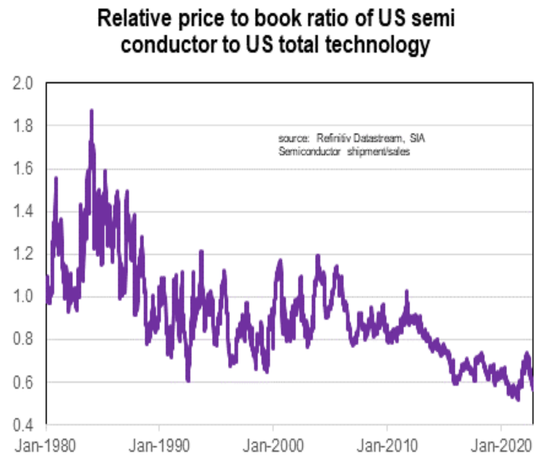
There was always going to be changes to global trade patterns. China is no longer the lowest cost producer for low value-added manufactured goods (countries such as India, Vietnam and Bangladesh are more competitive). As the Chinese economy has got bigger it has increasingly become an important global consumer as well a big producer. So more of the goods (and services) produced in China will stay in China. China for example is the world's largest supplier of solar panels.

One other potential implication of rising geo-political tensions could be rising defence spending. That has not happened to date with the US Government fiscal efforts directed towards domestic policy. China's defence spending as a share of GDP has not grown significantly and sits at 1.7% of GDP compared to 3.7% for the US. But that may well change if geo-political tensions continue to escalate.

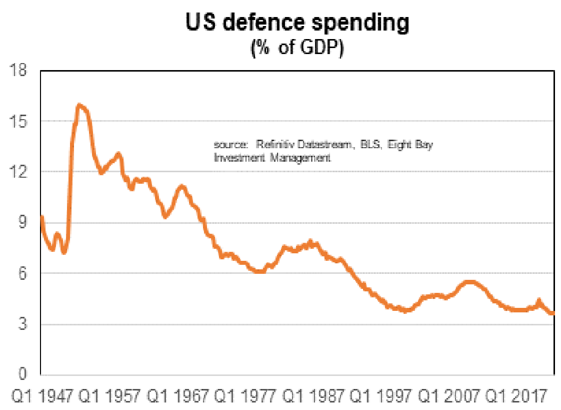
There has been a big shift in semiconductor production away from America and towards Asia.



The US semiconductor sector has underperformed over the years.



Defence spending may again be on the rise.



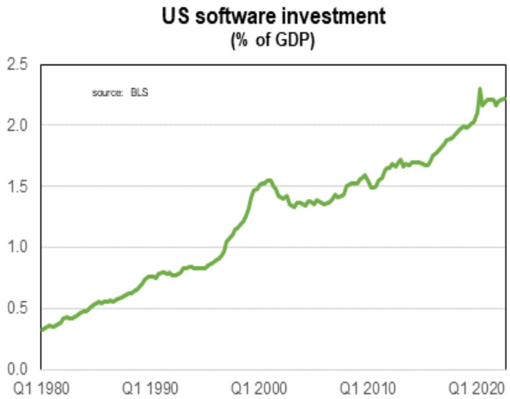
Global trade is currently doing well but it may not remain that way.

Digitization

Technology change and shifts in consumer taste has meant there has been an ongoing focus on digitization. The amount of investment into software has gone up almost six times (relative to the size of GDP) over the past four decades and has been on an upward trend for the past four decades. This trend will almost certainly continue as firms look to boost productivity and improve service to customers. Another reason to believe that this trend will continue is that the proportion of retail sales via e-commerce in the US is currently about half that in China.

E-commerce in the US has been on an upward trend.

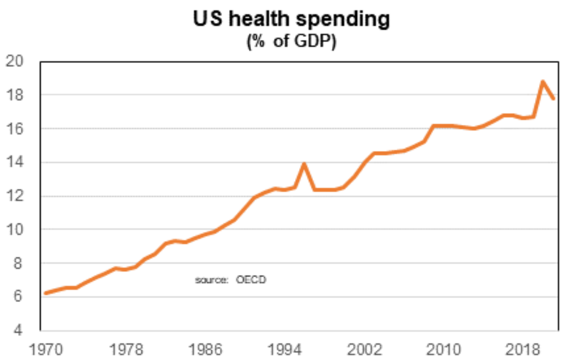
And so has IT software investment.



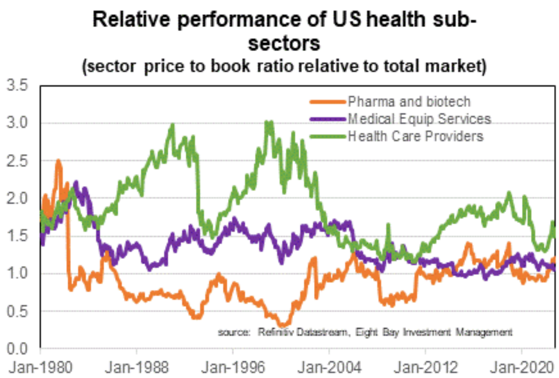
Aging Populations

Spending on health has consistently outpaced economic growth in the US. Partly, this reflects that health is something that people spend more on as they become richer. In addition, many economies (including the US) have an ageing population. Rising spending, of course doesn't necessarily mean that rising profitability (or a rising share price). Even within the US health industry there has differing performance between sectors.

A bigger part of the US economy is being directed towards health.

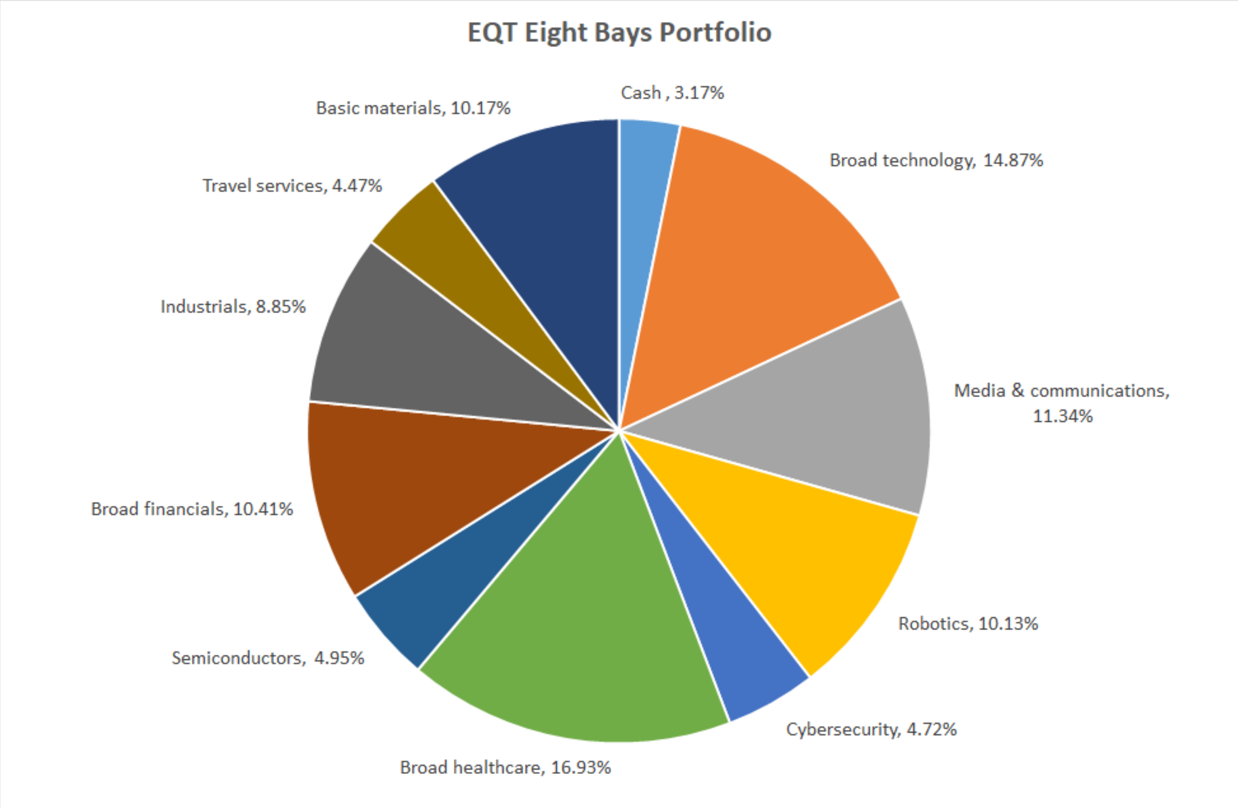


Not all segments of the health sector do well.



EIGHT BAYS GLOBAL ETF PORTFOLIO

From an investing perspective, Eight Bays believes that Exchange Traded Funds (ETFs) are ideal investment vehicles for taking advantage of developing thematic trends global markets whether they be macro or industry specific. Our current portfolio is constructed to take advantage of some of the themes discussed in this report – eg energy transition, technology leadership and the aging population.



Source: Eight Bays

THE STRATEGY

The Eight Bays Global ETF strategy is a portfolio of Exchange Traded Funds (ETFs) designed to complement domestic equity portfolios by investing in global growth industries and equities not available on the ASX. Due to the depth and liquidity of the US ETF market, we invest only in ETFs listed on US exchanges. The portfolio has a bias towards industry ETFs with sound growth prospects and attractive structural characteristics. The portfolio holds between 5 and 15 ETFs and any given time with a maximum cash weighting of 20%.

INVESTMENT PHILOSOPHY

We believe that industry factors are the primary driver of shareholder value over the longer term. Industry dynamics such as growth rates, fragmentation, concentration, disruptive forces and regulation are the major drivers of equity performance. We believe the most cost-effective way to invest in attractive industries is via an appropriate ETF.

PORTFOLIO GUIDELINES

Benchmark:	MSCI World Index (AWCI)
Universe:	US Equity ETF Market
Number of ETFs:	5 to 15
ETF weights:	Min 5% Max 20%
Portfolio Turnover:	~20%
Cash holdings:	Up to 20%
Hedged:	No. US Dollar product
Investment objective:	2-3% pa > MSCI World

The EQT Eight Bays Global Fund can be accessed by visiting
www.eightbays/invest
www.eqt.com.au/eightbays