

THE GREAT (AMERICAN) DEBATE

Are celebrations in order? Headline US inflation in June declined to 3.1% year, after hitting a high of 8.9% one year ago. The US economy has not crumbled despite the Fed funds rate being raised rapidly to the highest level in 22 years. Recession forecasts continue to get postponed and, in many cases, watered down. So...all clear? Below we review the two dominant opposing narratives and provide an update on where we land.

First the bear case. The fight against inflation is far from over. The favourable base effects from commodity prices (particularly food and energy) are now wearing off and have upside risk. The labour market's resilience has helped propel wages higher and into positive real (inflation-adjusted) territory, which should bolster aggregate demand. Not only will it prove challenging to get annual CPI down to the 2% target, but the risk of renewed inflationary pressure cannot be ignored. This will force the Federal Reserve to tighten further (increasing the risk of a "hard landing" scenario), or at minimum, prevent monetary loosening cycle from materializing.

Ok, breathe.

The countering view is that inflation remains in a broad downtrend. Per the chart below, this is being led by a roll-over in rent prices, which have historically provided a useful indication of where overall shelter costs (which account for approximately one-third of the US CPI basket) are headed. This would enable the Federal Reserve to slash interest rates. The lagged impact of previous monetary tightening would likely not be potent enough to drag the US economy into recession, especially with a burgeoning fiscal deficit and a financial system still awash with excess liquidity deployed during COVID lockdowns.

It may be a cop out to land somewhere in the middle, but that is where our base case currently resides. We agree with the bears that inflation will remain stubbornly sticky, despite falling rent prices. But we also agree with the bull

camp that potent fiscal spending will counteract the lagged effects of monetary tightening (as well as offset the impact of potential future interest rate hikes), making a "hard landing" scenario relatively unlikely. Overtightening by the Federal Reserve remains the key risk to monitor, but the resilience exhibited by the US economy should continue to produce a self-reinforcing "positive inertia" over the near-term.

With a wide range of potential outcomes on the horizon, how best to position portfolios? Bonds remain vulnerable in this environment, as persistent inflation and a sharply improved growth outlook should exert a steepening force on the inverted US treasury yield curve (a credit quality downgrade from Fitch isn't particularly helpful either!). Cash is useful as a volatility buffer and for income generation, given high (relative to recent history) short-term yields, but would suffer an erosion in purchasing power amidst rising price levels. Equities (and particularly commodity sensitive exposures) remain the preferred vehicle, offering the best inflation hedge and pro-growth alignment. The recent rally has eroded valuations somewhat and may signal a shift too far in favour of the bullish narrative. However, with professional investor surveys showing an unwinding of defensive positioning just in the early innings, the risk/reward trade-off still looks attractive.

GLOBAL STRATEGY OVERVIEW

CASH

Inflation in emerging markets varies across countries but is broadly trending lower. Many EM central banks were more proactive than their developed market peers, aggressively raising policy rates once signs of inflationary pressure first emerged. With an unusually wide real yield advantage vs. developed markets, EM currencies offer an attractive carry opportunity. We remain overweight EM currency exposure in client portfolios.

BONDS

Despite much higher nominal yields compared against recent history, real yields in most markets remain deeply negative. With our expectation of “sticky” inflation for longer than the consensus currently expects, bonds continue to be relatively unattractive vs. equities. We remain underweight fixed income exposure this quarter.

EQUITIES

The failure of multiple regional banks in the US has shaken investor confidence in the financial sector. However, bank solvency remains strong, regulators have acted expeditiously to shore up liquidity and protect depositors and credit risk from commercial real estate exposure is manageable. We have switched from a broad market-cap weighted US financial sector overweight to a more targeted equally-weighted US bank exposure in client portfolios.

OPPORTUNITIES

We maintain a favourable view on EM debt, as we expect EM inflation to continue to roll-over, policy rates to ebb and growth to outpace developed markets. However, our preference is for local currency debt rather than hard currency (primarily US dollar-denominated) as the latter is exposed to a weakening greenback and tends to take cues from the US high yield bond market which we believe is vulnerable to widening spreads. EM hard currency bond exposure has been reduced in income-oriented strategies this quarter.

FORSTRONG STRATEGIES	INCEPTION DATE	1 MONTH	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEARS	SINCE INCEPTION
BALANCED								
Global Income	30/06/08	1.66%	4.08%	7.41%	1.86%	2.89%	6.05%	7.00%
Global Balanced	30/06/03	3.00%	6.91%	10.50%	4.80%	4.81%	7.42%	6.89%
Global Growth	30/06/03	4.17%	9.11%	11.88%	7.80%	6.27%	8.85%	8.07%
Core Income	30/06/08	0.91%	3.87%	5.11%	2.39%	3.21%	5.13%	5.96%
Core Balanced	30/06/03	2.52%	6.37%	8.99%	5.75%	5.27%	6.87%	6.96%
Core Growth	30/06/03	3.58%	7.88%	9.06%	8.53%	6.34%	8.00%	7.91%
GLOBAL EQUITY								
Emerging Markets Equity Focus	31/01/19	7.21%	7.02%	12.22%	3.51%	-	-	2.96%
Global Ex-North America Equity Focus	31/12/19	3.53%	9.70%	16.89%	6.93%	-	-	4.22%
ALTERNATIVE INCOME								
High Income Opportunities	30/06/22	2.95%	8.28%	15.18%	-	-	-	16.94%

* Performance as of July 31st, 2023

Performance statistics for ETF Managed Portfolios are calculated from documented actual investment strategies as set by Forstrong's Investment Committee and applied to its portfolios mandates, and are intended to provide an approximation of composite results for separately managed accounts. Actual performance of individual separate accounts may vary with average gross “composite” performance statistics presented here due to client-specific portfolio differences with respect to size, inflow/outflow history, and inception dates, as well as intra-day market volatilities versus daily closing prices. Performance numbers are net of total ETF expense ratios and custody fees, but before withholding taxes, transaction costs and other investment management and advisor fees. Past investment results provide no indication of future performance. Future returns are dependent on the general investment environment, the nature of the investment mandate and specific portfolio risks. A rate of return for one year or less is not annualized.