OYAT ADVISORS – QUARTERLY COMMENTARY

4Q 2023

<u>Investment landscape</u>

Market sentiment was more volatile than normal over the course of 2023, bouncing from recession worries and bank failures at the start of the year, to 'resilient growth' and the advent of artificial intelligence (AI) over the summer, to concerns about sovereign debt levels and interest rates remaining 'higher for longer' in the autumn, and eventually ending the year focused on falling inflation and growing excitement that central banks will cut interest rates sooner than previously expected.

As a result, the final stretch of the year saw strong returns across most major asset classes, including stocks, bonds, real estate investment trusts (REITs), precious metals, and cryptocurrencies. Only commodities were the outlier, with an altogether uninspiring year following a strong 2022.

This is the 'good' news in short: it was a positive year for the vast majority of financial assets. Let us now dig a little deeper into some of the more worrisome facts below the surface.

We might as well start with the banking crisis that occurred in March, which saw First Republic Bank, Silicon Valley Bank, and Signature Bank become insolvent and eventually fail; not to mention the overnight failure of Credit Suisse. As described in more detail in our 1Q23 commentary, due to rising interest rates, the value of banks' bond portfolios fell sharply, so that many small and regional banks found themselves in a vicious cycle of falling deposits and asset liquidations, which culminated with many such banks virtually on the verge of collapse. The three aforementioned U.S. institutions did eventually go bust, leading to over $500 billion in bank assets failing in a matter of days, surpassing the record from the global financial crisis of 2008.

Many more banks might have failed, if the FED hadn't intervened with a new facility, the Bank Term Funding Program (BTFP). This enables banks to borrow 100% of the face value of certain securities for up to a year. Usage of this facility rose sharply in March 2023, and then again towards the end of the year, reaching USD 136 billion as 2023 came to a close. This latest increase coincides with a widening arbitrage opportunity[1] - whereby banks can borrow from the BTFP at about 4.9% currently, and park that at the central bank to earn 5.4%, the interest on reserve balances. In other words, banks have benefitted from a risk-free arbitrage opportunity in order to help them shore up their balance sheets. This is just as well, since the BTFP is set to expire in March 2024, and unless interest rates fall substantially in 1Q24, the losses on banks' bond portfolios aren't going anywhere. Of course, as Milton Friedman once observed, *'nothing is so permanent as a temporary government program'*; still, there is some uncertainty about what banks will do come March, should this bailout program be shut down.

[1] https://www.bnnbloomberg.ca/use-of-fed-term-funding-tool-rises-to-record-in-arbitrage-play-1.2016169

Let us now turn to the state of the global economy. At the start of 2023, one of our chief concerns was the impact of tighter monetary policies by central banks on global liquidity, which is a key driver of global GDP growth (and asset prices). In our [4Q22 commentary](), we suggested that following inflation and interest rate shocks in 2021 and 2022 respectively, the next big risk facing investors was likely to be a recessionary shock.

A global recession, however, has not occurred for the time being. Why? First, because there is typically a time lag of one to two years for rising interest rates to impact economic activity, as households and businesses gradually have to refinance debts and adjust their behaviour.

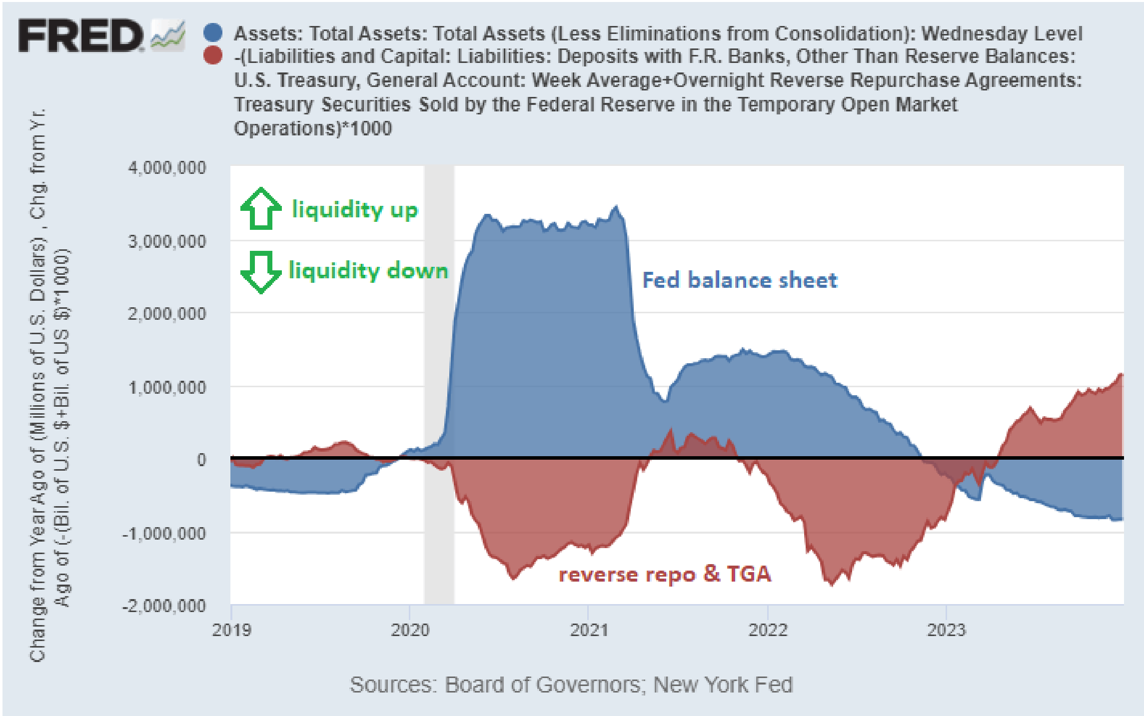
Perhaps more importantly, sovereign governments more than counterbalanced the liquidity contraction from monetary tightening by pulling their various levers to put liquidity back into the market. By and large, this has taken the form of deficit spending, which we highlighted in our [3Q23 commentary](). For fiscal 2023 (ending in September), the U.S. deficit amounted to USD 1.7 trillion, and closer to USD 2 trillion including student loan forgiveness, or over 7% of GDP.

Moreover, the U.S. Treasury decided to shift borrowing heavily into short-term bills, with an astonishing 85% of Treasury debt issues in 2023 due within one year or less. This had the knock-on effect of enticing money market funds to switch excess liquidity parked at the FED in reverse repurchase agreements (RRPs) back into T-bills, effectively pushing additional liquidity into the financial system.

Without going further into the weeds, it is important to realize that these rather uninteresting and technical details are significant, because we're talking about really large numbers. To add some perspective, the Treasury market now is 14% bigger than the entire U.S. banking system, according to Wells Fargo economists cited in a Barron's article last month[2]. In 2006, the Treasury market was only 44% the size of the banking system.

In a recent Seeking Alpha article[3], macro analyst Lyn Alden included a graph that does a great job at illustrating the overall impact of U.S. monetary and fiscal policies on total liquidity. As shown below, 2023 can be broadly characterized by some level of monetary tightening, which was more than offset by fiscal easing, for a net positive impact on liquidity. This had a significant short-term positive impact on the global economy and financial markets, though the longer-term consequences of these actions are likely to be detrimental.

[2] https://www.barrons.com/articles/u-s-treasury-massive-stock-bond-repeat-3c3580b4
[3] https://seekingalpha.com/article/4661453-fiscal-and-monetary-divergence



Source: Lyn Alden Seeking Alpha article

Finally, let's briefly discuss inflation and the growing expectation that central banks will soon start to cut interest rates. We explored the topic of inflation in some detail in our 2021 Annual report (pg. 7-10). Let us add to that by making a number of observations.

First, it is important to understand the base effect in interpreting the declining rate of inflation. Prices are still increasing, but at a slower rate, partially due to a higher baseline. Cumulatively, the consumer price index (CPI) is up nearly 20% since the start of 2020. So, while the rate of inflation is coming down, inflation is still a real concern for many people.

Second, we appear more cautious than some in assuming that the fight against inflation is over and done with. Considering the current rate of positive growth in global liquidity, we find it difficult to see inflation decline much further towards its stated target, barring a deflationary recession, which may still occur. But overall, considering the likely interest rate cuts in 2024, as well as a possible phasing out of quantitative tightening[4], we would not be overly dismissive of the chance that inflation starts accelerating once again. After all, it isn't uncommon to have periodic disinflationary episodes throughout longer periods of structural inflation, as occurred during the 1970s.

[4] https://www.reuters.com/markets/us/deflating-qt-cushion-may-have-raised-red-fed-flag-mike-dolan-2023-12-06/

Financial markets

From the global economy avoiding a recession to the massive stock market rally, 2023 defied many people's expectations. Heading into the year, many investors expected volatility in financial markets, and the potential for further price declines from an already difficult 2022. The outlook for stocks appeared challenged, as the FED was continuing to raise interest rates at a rapid pace, and many investors felt that a recession was likely just around the corner. Even those in the more optimistic camp predicted tepid gains at best for 2023.

Instead, 2023 turned into one of the best years for stock market performance in the past decade. In a dramatic reversal of fortunes, it was a particularly strong year for certain technology stocks and other 'growth' companies that suffered the biggest losses in the 2022 market collapse.

Stock market index	2023 performance (in local currency)	10y bond	Yield	Yoy change	FX	Yoy change	Precious metals	Yoy change
MSCI World (USD)	24%	US	4.05%	22 bps	USD Index	-2.0%	Gold-USD	12.8%
Dow	14%	Germany	1.11%	-145bps	CHF-USD	9.8%	Silver-USD	-1.2%
S&P	24%	Italy	3.66%	-93 bps	EUR-USD	3.2%		
NASDAQ	43%	Switzerland	0.83%	-79 bps	GBP-USD	5.3%		
Stoxx	13%	UK	3.87%	20 bps	JPY-USD	-7.0%		
SMI	4%	Japan	0.61%	20 bps	CNY-USD	-2.8%		
FTSE	4%				RUB-USD	-17.5%		
Nikkei	29%							

Source: LSEG Refinitiv. All data as of Dec. 31st 2023.

The poster child for the 2023 rally is semiconductor chip designer Nvidia, whose stock rallied a gigantic 239%, as the emergence of AI disrupted the technology landscape. In the prior year, Nvidia's market value had dropped by about 50%.

Overall, technology stocks posted a huge year, surging 59%, or their best performance since 2009, according to Morningstar[5]. The so-called 'Magnificent Seven' stocks generated a 75% return for the year, versus 24% for the S&P 500; so without them, the index would have risen just 12%, according to calculations by Neuberger Berman[6]. By the end of 2023, the cumulative weight of these seven stocks represented close to 30% of the S&P 500.

While the rally in stocks did broaden towards the end of the year, 2023 ranked as the second worst year in decades for value vs. growth stocks[7]. For instance, the MSCI World Value Index posted a modest 9% gain, while its 'growth' counterpart soared by 36%.

Moving on to bonds. The broad fixed-income market looked on pace for a third consecutive year of losses, as uncertainty around a 'hard' or 'soft' landing lingered and interest rate volatility persisted. But with a significant year-end rally due to the FED's shift in policy, the bond market eventually managed to eke out some small gains for most investors.

[5] https://www.morningstar.com/markets/15-charts-surprise-everything-rally-2023
[6] https://www.nb.com/en/global/equity-market-outlook/equity-market-outlook-1q2024
[7] https://finimize.com/content/value-vs-growth-stocks-which-ones-to-favor-in-2024

Currencies were extremely volatile throughout 2023. Following two years of gains, the dollar index declined by 2% in 2023, driven by rising debt levels, a credit downgrade by Fitch in August, and growing expectations that the FED will start cutting interest rates in 2024. Relative to the U.S. dollar, Japan had the worst performing currency among G10 nations for a third consecutive year, as it held out as the only central bank maintaining a negative interest rate policy. On the other hand, the Swiss franc was the strongest performing G10 currency for the second year in a row, followed by the British pound and the Euro. The currencies of Sweden, Australia, Canada, New Zealand and Norway also performed well.

Last, looking at the precious metals market, gold rose 13% (in USD) in 2023, hitting a record high in December. This might have surprised a number of investors, who supposed that gold might decline as a result of higher real interest rates, as observed historically. But it appears that this was more than offset by rising overall global liquidity, robust buying from a number of central banks, as well as persisting geopolitical risk. On the back of these dynamics, the price of gold is expected to test new all-time highs in 2024. Silver, on the other hand, did not rally alongside gold throughout 2023. The gold to silver ratio increased to 86.5 by year end - a fairly elevated level, although still way short of the 125 reached in March 2020.

In conclusion, today's investment landscape is a fairly tricky one to navigate. On the one hand, markets - as represented by their benchmark indices - appear priced for perfection, with asset prices reflecting a substantial number of interest cuts in 2024, as well as a 'soft' landing of the global economy. On the other hand, there are valid concerns to be had about rising debt levels, geopolitical risks, the possibility of an economic recession, as well as the future trajectory of inflation. On the latter, we believe that it is far from impossible that we are currently experiencing a period of temporary disinflation, in an overall long-term inflationary era which may last for some years to come.

In times of structural inflation, the nominal price of productive and real assets typically perform quite satisfactorily, whereas the performance of fixed-income securities and cash suffers, especially in real terms. With that in mind, let us reiterate what we've stated incessantly over the past couple of years: in a world of monetary abundance, we want to mainly focus on owning scarce and productive assets, thoughtfully selected on the basis of our investment process that focuses on quality businesses trading at reasonable prices. We also want to maintain some level of optionality by holding liquid reserves, predominantly in the form of physical gold.

This continues to be the case as of today.

Disclaimer:

The content of this document is for informational purpose only. It constitutes neither a solicitation or an offer or recommendation to buy or sell any investment instruments or to engage in any other transactions.

The information provided in this document is provided “as is” and “as available” without warranty of any kind. Your use of this information is entirely at your own risk. Although the information in this document is obtained or compiled from sources we believe to be reliable, we cannot and do not guarantee or make any representation or warranty, either expressed or implied, as to the accuracy, validity, sequence, timeliness, completeness or continued availability of any information or data made available in this document. In no event shall Oyat be liable for any decision made or action or inaction taken in reliance on any information or data in this document or on any linked documents.

All trading in financial instruments entails risk. Investors should evaluate their intended investments in light of their knowledge and experience, financial positions and investment objectives - or speak to a financial adviser - before making any investment decisions. Past performance is not indicative of future results.