July 2024

# CERUTTY
MACRO FUND

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## Cerutty Macro

Cerutty Macro Fund is an independent active manager of global, but predominantly Australian equities. The Manager applies a detailed investment process, using identified macroeconomic trends as the foundation of its allocation. Coupled with analysis of the liquidity cycle and bottom-up research, we aim to deliver attractive returns to investors over a 3-year time horizon.

The Fund's portfolio is a high conviction portfolio ranging from 15-40 positions in equities, to scale between high/low concentration allocations depending on liquidity conditions. It is the Fund's perspective that financial market liquidity has a large impact on asset prices, thus it being a vital component to the investment process. Cerutty's investment process is:

- Macro Themes
- Liquidity Cycle
- Bottom-up

## Fund Performance

| Fund Performance | Fund % | Index % | Excess % |
|---|---|---|---|
| 1 Month | 3.17 | 3.49 | -0.32 |
| 3 Month | 6.80 | 2.00 | 4.80 |
| 1 Year | 24.85 | 9.29 | 15.56 |
| Since Inception - 1 June 2023 | 27.18 | 13.19 | 13.99 |

## Fund Overview

| | |
|---|---|
| Portfolio Management | Chris Judd |
| No. Investments | 15-40 |
| Type of Investments | Long only<br>Australian listed equities<br>Global listed equities |
| Time Horizon | 3+ years |

*Past performance is no indication of future performance & returns are post fees with reinvestment of distributions and capital gains.*

## Monthly Update

July for U.S. markets has been dubbed "The Great Rotation" by several financial commentators, as large-cap technology stocks finally took a breather and small-cap stocks gained traction. This shift was highlighted by the Nasdaq returning -0.7%, while the Russell 2000 surged 10.2% for the month. In Australia, the ASX Small Ordinaries Accumulation Index returned 3.49%, and the Cerutty Macro Fund gained 3.17%.

The improved performance of U.S. small-cap stocks and the increase in market breadth were broadly seen as positives for the markets. However, this significant outperformance in U.S. small caps wasn't mirrored in Australia during the month of July. We continue to believe that the smaller end of the Australian market, particularly stocks reliant on retail flows, won't see improved valuations until the RBA signals near-term rate cuts and retail investors experience some cost-of-living relief. This is true even if many small caps look undervalued compared to their historical multiples. Interest rate rises don't impact the average American homeowner as much, given their mortgages have 30-year fixed rates. This, combined with the popularity of index investing strategies in the U.S., creates different market dynamics compared to Australia. Nevertheless, we believe the valuation gap between ASX small caps and large caps will eventually close, benefiting Australian small-cap stocks on a relative basis.

Whilst July wasn't fraught with many economic surprises, early August brought fireworks as a confluence of factors led to a sharp sell-off on August 5th. The main contributing factors were a weak Non-Farm Payrolls report, higher than anticipated unemployment, a surging Yen against the USD, and seasonality.

Nasdaq 100 / Russell 2000 Relative performance


Source: Trading View


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U.S. unemployment hit 4.3% after the August Non-Farm Payrolls report triggered the Sahm Rule, an indicator named after economist Claudia Sahm.[1] The Sahm Rule is triggered when the three-month moving average of the national unemployment rate rises by 0.5% or more compared to its low during the previous 12 months. Historically, the Sahm Rule has been triggered 11 times, with 10 of those instances occurring when the economy was already in recession. The one exception was in 1959, when the rule was triggered a few months before a recession began. However, it's important to note that the Sahm Rule should only be applied when labour participation rate is fairly stable. For example, if it's triggered by a major influx of population and labor participation, it's very different from being triggered by job losses.

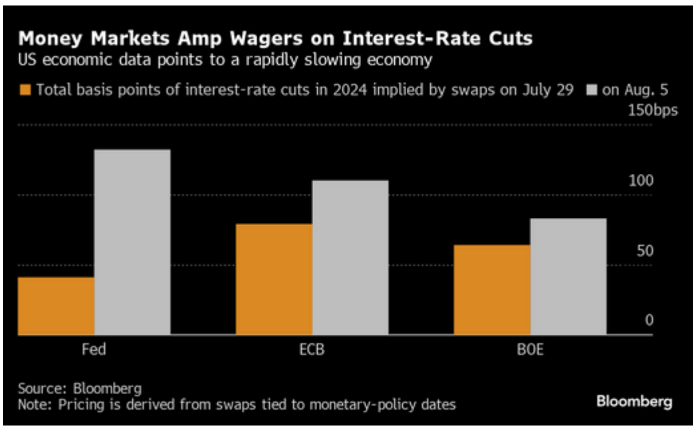
Claudia Sahm addressed this in her Bloomberg column on August 7th, 2024:

> *"Last fall, when the unemployment rate began to rise, and again this spring, as it rose notably in several states, I explained that things might be different this time — that is, why the Sahm Rule might not be an indicator the U.S. was in a recession. The increase in the labor force, particularly the surge in immigration, would contribute substantially to the rise in unemployment.*
>
> *A rise in the unemployment rate due to weakening demand for workers gains momentum in recessions, which is why the Sahm Rule has worked well historically. But a rise in the unemployment rate due to an increase in the supply of workers is different. The rate will decrease once the jobs 'catch up' with the new job seekers, and more workers allow the economy to grow more. The Sahm Rule does not distinguish between these two dynamics and can look more ominous when the labor force is expanding rapidly.*
>
> *There are signs that stronger labor supply, not just weaker labor demand, helped push the Sahm Rule past its 0.50 percentage point threshold. Unemployed entrants to the labor force (new or returning) accounted for about half of the increase. That's a notably higher share than in recent recessions when most of the contribution came from unemployed workers who had been laid off temporarily or permanently. The current Sahm Rule reading is likely overstating the weakening in demand and not at recessionary levels."*

There's also the impact of Hurricane Beryl, which the San Francisco Fed estimates negatively affected payrolls by about 13,000 to 34,000 due to weather-related work disruptions.[1]

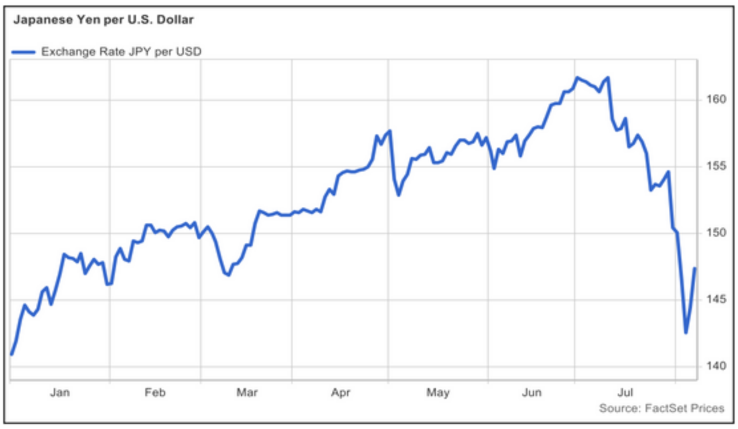
Despite population growth and weather events, Sahm has still argued that the Fed should have cut rates already, as the jobs market is clearly softening at a rapid pace. While the market fully expects the Fed to cut rates at its next meeting in September, this could have consequences for another catalyst that caused the market drop on August 5th—the unwinding of the carry trade.

### Market prices in rate cuts




Source: Bloomberg

### Japanese Yen strengthens




Source: FactSet

1. https://www.reuters.com/breakingviews/labor-market-flags-growth-slowdown-not-recession-2024-08-05/


## Monthly Update

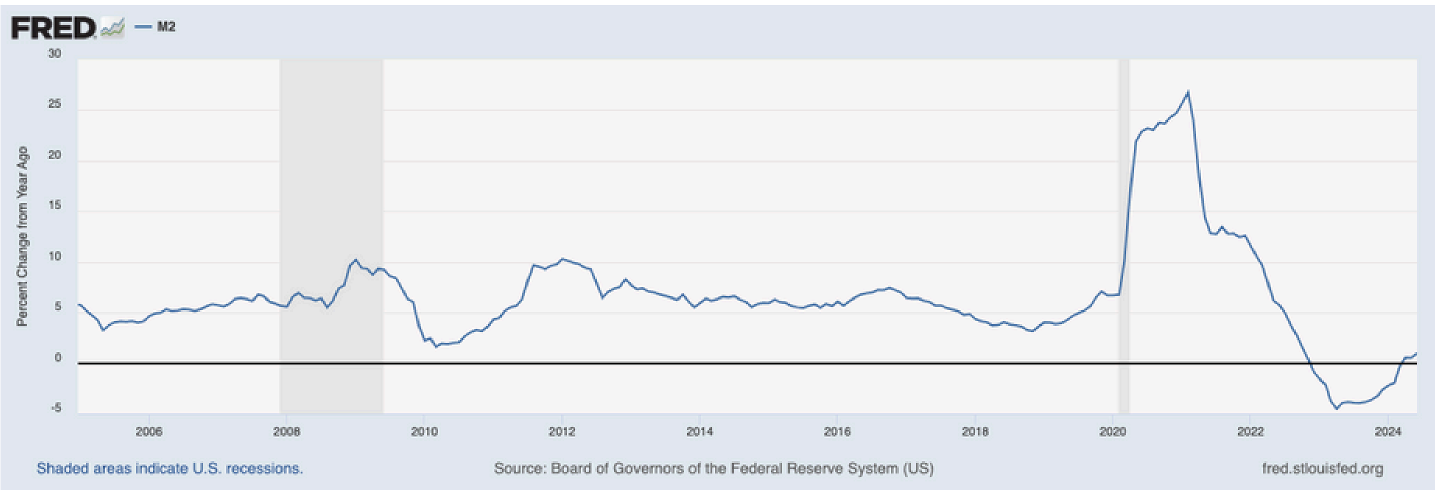
The carry trade refers to an investment strategy where investors borrow money in a low-interest-rate currency and invest it in a currency or asset with a higher interest rate or more attractive growth potential. The most popular carry trade has long been to borrow Yen (at zero interest rates) and invest in U.S. assets. This strategy works well when U.S. interest rates are significantly higher than Japanese rates, and even better if the Yen depreciates during the trade, as the money borrowed becomes cheaper to repay. However, if the Yen appreciates, the benefits from the interest rate differential diminish. If investors have more aggressive trades on the long side (such as the Magnificent 7 stocks instead of U.S. Treasuries) and the value of assets purchased reduces while the Yen rapidly gains, those with too much leverage may face margin calls and be forced to sell assets quickly.

This scenario unfolded on August 5th as the Yen gained against the USD around 13% from the July lows after the Bank of Japan raised rates by 0.25%. The Japanese stock market, the Nikkei, dropped by over 12%, while the U.S. market, the S&P 500, also saw a notable decline. Seasonal factors, such as many U.S. based fund managers being on summer holidays, likely increased volatility, as volumes in U.S. markets are down at this time of year, similar to how they decrease in Australia during January.

The Fed and BOJ now face the challenge of managing the situation if the U.S. reduces rates in September. This would typically lower the value of the USD, but if recent volatility was driven by a weaker USD against the Yen, the Fed has a complex situation to resolve. BOJ Deputy Governor Uchida attempted to calm markets on August 7th by stating that "the bank will not raise its policy interest rate when financial and capital markets are unstable," and added that "Japan's economy is not in a situation where the Bank may fall behind the curve if it does not raise the policy interest rate at a certain pace.[2]" This is a start, and we expect more commentary or policies from the BOJ and the Fed between now and the likely September rate cut to prevent a rapid appreciation of the Yen against the USD.

In times like these, we remind ourselves of one of our core beliefs: liquidity, not the economy, drives asset prices. On that front, we're seeing U.S. money supply ticking up, liquidity injections by the PBOC, a Fed that is about to start a rate-cutting cycle, a bond buyback program by the Fed, and rate cuts in Europe. There may be more days like August 5th, as such volatility reduces risk tolerance among funds and could lead to some blowups. But ultimately, the liquidity spigot is closer to being turned on, and as investors, we need to be ready and well-capitalised to seize opportunities when that time comes.

### U.S. M2 Money supply




Source: FRED

2. https://www.reuters.com/markets/asia/boj-wont-raise-rates-when-markets-unstable-deputy-governor-says-2024-08-07/

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