Aura Solution Company Limited

AN UPDATE FROM OUR CIO

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Aura’s Perspective on the Economic Expansion and Investment Opportunities

As the global economy continues to evolve, our Chief Investment Officers (CIOs) delve into why the current expansion is likely to remain durable, even as its pace slows. They also explore why a prolonged expansion, accompanied by central bank easing, may not necessarily be as beneficial for financial assets as one might expect. Additionally, they highlight the opportunities they see in this complex environment.

The Durability of Growth

With growth moderating, a key question emerges: how durable is the current economic expansion? When we analyze the dynamics of this expansion—examining who is spending, what is driving their spending, and how it is being financed—it becomes clear that this expansion is poised to be unusually resilient. Unlike in previous cycles, there is less spending at risk of rapid reversal, such as borrowing that can be quickly curtailed by rising rates. Instead, much of the spending is driven by longer-term considerations, which bodes well for the expansion’s longevity.

Growth is expected to continue at a pace that supply can sustain, with pockets of weakness less likely to spiral into broader downturns. This resilience is further supported by central banks' relatively cautious approach to easing, which is being initiated based on forward projections, even as inflation continues to decline but remains above target.

The Implications for Investors

For investors, however, this environment of moderate growth, inflation, and easy monetary policy may not be as favorable as it initially seems. Typically, such conditions would be ideal for financial assets, but returns are ultimately driven by how the future unfolds relative to what is already priced in. Equity valuations have already accounted for both a durable expansion and a profitable AI revolution. Meanwhile, the yield curve has inverted to levels typically seen only during recessions, indicating that markets expect significant central bank easing. If easing happens more slowly than anticipated, it could effectively tighten financial conditions, creating a bearish ripple effect on future cash flows.

Although the labor market and industrial base are less constrained than they were at the height of post-COVID supply chain disruptions, the durability of the expansion could limit how quickly inflation drifts down to target levels.

Over time, we believe central banks may find it difficult to deliver the level of stimulus already priced into rate markets, which could require an adjustment in the cost of capital. Moreover, a moderate expansion may not be enough to satisfy voters who are expressing dissatisfaction with incumbents across much of the developed world.

Strategic Investment Shifts

In this environment, equities appear marginally more attractive than bonds, but the world is already heavily invested in equities, meaning investors are earning a smaller risk premium while remaining vulnerable to risks such as a surprise recession or stickier-than-expected inflation. Given these dynamics, concentrated portfolios mean that small strategic shifts can have outsized impacts. For instance, adding investments that perform well in unfavorable economic cycles, diversifying into regions where the economic cycle is less synchronized with the US and Europe, and finding ways to earn the equity risk premium more resiliently can all provide valuable opportunities.

At Aura, we continue to explore these nuanced dynamics to guide our clients in navigating this evolving landscape, helping them position their portfolios to capitalize on both the challenges and opportunities ahead.

Aura’s Insights on Opportunities and Economic Durability

At Aura, we continue to uncover opportunities and mispricings across countries’ assets and currencies, as well as within the equity market. In equities, cross-company correlations have been unusually low, leading us to shift our risk-taking from broad equity markets to more focused, individual company strategies. We are carefully considering how the current environment will impact specific companies based on factors like demand exposure, competitive positioning, and balance sheet health.

Below, we share our perspectives on (1) how we are assessing the durability of the economic expansion, (2) the current investment landscape, and (3) where we see alpha opportunities.

The Economic Backdrop: Assessing the Durability of the Expansion

To evaluate the durability of the economic expansion, we analyze the mechanics behind spending. Economic spending can originate from income growth, new borrowing, or drawing down savings. Each of the three major spenders—households, businesses, and governments—utilizes a different mix of these sources, and their spending decisions are influenced by varying factors.

Households primarily spend from income, which currently drives most of the economic activity. Income growth is typically self-reinforcing, as spending generates more income, fueling further economic growth. This cycle is well underway, creating momentum that supports moderate expansion. While borrowing can amplify spending beyond income levels, it also increases vulnerability to interest rate hikes. Fortunately, today's households are not overly reliant on debt, and overall balance sheets are healthier than they have been in decades. Spending is being financed by incomes and available cash, minimizing the risk of a sharp reversal.

Government borrowing, on the other hand, is significantly boosting spending beyond income levels. The current fiscal deficit is the largest outside of wartime, and government borrowing is not as sensitive to interest rates as private sector borrowing. Reducing government spending typically requires political change, which makes it likely that high levels of borrowing and spending will persist regardless of the outcome of upcoming elections. There is even the potential for renewed fiscal stimulus in 2025. While other countries are more cautious, fearing market discipline on high deficits, geopolitical competition, climate change, and technological challenges will likely keep governments around the world engaged in expensive industrial policies. The US, in particular, remains in a unique position to sustain rising government debt due to strong demand for bonds, low competition from private borrowing, and the enduring strength of the US dollar.

Businesses are behaving differently in this cycle as well. Typically, businesses borrow to invest in response to rising demand. However, in this cycle, businesses are not borrowing much but are instead using their strong cash flows and accumulated cash reserves to finance spending. This is driven by a desire to address existential risks such as AI, energy security, and remilitarization, rather than by rising consumer demand. Many of these investments are supported by government subsidies and are focused on long-term preparedness, making them less vulnerable to short-term economic fluctuations.

Investment Landscape and Opportunities

Given this backdrop, we see a landscape filled with both challenges and opportunities. While broad equity markets may not offer significant upside in the aggregate, focusing on individual companies and specific opportunities within countries and asset classes presents a path to alpha. This strategy allows us to navigate the complexities of the current environment, positioning our clients for resilience and growth in the face of evolving economic conditions.

At Aura, our commitment is to continuously adapt our strategies to ensure that our clients can thrive in any environment, making the most of opportunities while managing risks effectively.

Aura's Perspective on Economic Durability and Investment Strategy

The current drivers of economic spending and how that spending is being financed indicate that we are in a late-cycle environment that appears unusually durable. The economy continues to progress at a pace that supply can maintain, and any pockets of weakness are less likely to trigger a broader downturn. The nature of spending and its sources suggest that creating sustained downward momentum would require a significant shock or a substantial tightening of monetary policy in response to persistent inflation. Central banks, however, are showing a greater willingness to ease preemptively, even with inflation still above target levels. This is a departure from past cycles, where central banks would have been less inclined to ease under similar conditions.

Navigating Central Bank Policies

The key question is: how does this cycle ultimately end? As growth stabilizes around its potential at current interest rate levels, it becomes increasingly difficult to argue that these rates are unsustainably restrictive. The ongoing easing policies could increase the likelihood of inflation staying above target for an extended period. Although the labor market and industrial base are less tight than at the peak of post-COVID constraints, they remain relatively firm. This, combined with continued spending by households, businesses, and governments, will keep gradual inflationary pressures intact.

Over time, central banks may find it challenging to provide the level of stimulus currently priced into rate markets. The cost of capital may need to rise to levels that adequately compensate for higher fiscal borrowing and durable private-sector demand. Incremental increases in the cost of capital may not significantly slow the economy, leading to further adjustments.

The Potential Impact of AI

One possible release valve could be the deflationary effects of artificial intelligence (AI). In the near term, AI-related spending is inflationary as it builds capacity without immediate productivity payoffs. However, AI's deflationary potential is substantial and could materialize quickly. The impacts may be even larger and faster than those experienced during the globalization and industrial automation shifts of the 1990s and 2000s, which displaced about 10% of the US workforce from manufacturing. These forces contributed to low inflation, rising inequality, increased corporate profits, and significant political and social changes. We believe an even bigger transformation could be ahead of us.

Investment Strategies in a Durable Environment

When we break down market returns, we consider three key factors: the return on cash, the return of assets relative to cash (i.e., risk premiums), and alpha through market timing. Currently, holding cash is relatively attractive and can contribute significantly to return goals. While an environment of easing central bank policies and economic equilibrium usually benefits risk premiums, financial assets today appear only moderately attractive. Previous asset returns have been strong, driven by central bank interventions post-financial crisis and more recently by AI enthusiasm. Much of this optimism is already priced in, so even a slight deviation from expected central bank easing could lead to repricing of future cash flows.

This is where alpha becomes crucial. When risk premiums are compressed, the ability to generate alpha through strategic investments becomes more important. We see an opportunity for alpha because global risk premiums are not declining uniformly, allowing for selective investments that can outperform.

Enhancing Portfolio Resilience

Relative to holding cash, equities are more attractive than bonds. However, concentrating too heavily in stocks comes with risks. While we expect a durable economic expansion, it is already priced in, along with anticipated AI-driven profits. This leaves investors with a smaller risk premium and greater exposure to potential surprises, such as a recession or stickier-than-expected inflation. Additionally, after a prolonged period of equity outperformance, many portfolios are now more concentrated in equity-like risk and less liquid than ever.

To enhance resilience, we recommend three key strategies:

1. **Diversify to Prepare for Potential Economic Shifts:** Add investments that can perform well if the economic cycle turns unfavorably.
2. **Seek Opportunities in Different Economic Cycles:** Shift investments to regions with less synchronized economic cycles, such as the large Asian markets, which have independent central banks and distinct economic conditions compared to the US and Europe.
3. **Optimize Equity Risk Premiums:** Consider how to earn equity risk premiums more efficiently, including thoughtful security selection and hedging strategies. This approach can help reduce traditional equity vulnerabilities, especially in an environment of low correlations across public stocks and illiquidity in private equity.

The Role of Bonds

Investors had reduced their bond holdings in a period of near-zero interest rates, where bonds could not fulfill their traditional role of diversifying portfolios during an economic downturn. However, bonds are now better positioned to provide that diversification again. While bonds may seem less attractive compared to cash, they offer the option of locking in moderate cash rates and can benefit from central bank easing in case of an economic surprise. Inflation-linked bonds are also a viable option, offering protection against inflation while potentially earning higher returns than nominal bonds.

Opportunities in Asian Markets

We continue to find opportunities in large Asian markets, where central banks operate independently and economic cycles differ from those in the US or Europe. For example, despite poor economic conditions in China, Chinese assets have been performing well. Even with expectations of years of deleveraging and moderate growth in China, the Chinese yield curve is not inverted, equities are relatively cheap, and the incentive to support asset prices remains strong.

By focusing on these diversifying Asian economies, investors can mitigate regulatory, reputational, and geopolitical risks while benefiting from the opportunities these markets present.

At Aura, we believe that adapting to these conditions through careful portfolio management, diversification, and a focus on alpha generation is key to navigating this durable but complex economic environment.

Aura's Perspective: Where We See Alpha Opportunities

At Aura, we are identifying tactical opportunities in areas where economic dynamics are diverging. The decline in inflation is not occurring uniformly across regions, which is allowing central banks to follow their own distinct monetary paths. This creates promising opportunities, particularly in currency and bond markets. Additionally, cross-asset opportunities are emerging as countries navigate different stages of their economic cycles—for example, Japan stands out as a market with unique potential.

In equity markets, the correlation across stocks is currently low, highlighting the significant disparities between companies that are exposed to different parts of the economic landscape. Our research points to several key areas where companies are likely to outperform. These include:

1. **AI Beneficiaries:** Companies benefiting from artificial intelligence (AI) developments, particularly those with "winner-takes-all" market dynamics.

2. **Value Laggards:** Companies with large risk premiums that have been lagging in value but are under pressure for the valuation gap to close.

3. **Past Underperformers:** Companies where recent underperformance may have been overdone, creating potential upside.

These market dynamics are closely linked to critical questions that guide our research process, such as:

- **The Impact of AI:** How advancements in AI will influence companies and the broader economy.

- **Inflation Projections:** Where inflation is likely to stabilize and how central banks around the world will adjust their policies in response.

- **Efficient Risk Premiums:** How to efficiently accrue risk premiums in an environment where these premiums are generally compressed.

- **Political Changes:** The impact of recent global elections and political shifts on the allocation of funds, and how these changes will ultimately shape economic and market outcomes.

Aura remains committed to navigating these complex landscapes through rigorous research, strategic insights, and a focus on generating alpha in a dynamic global market.

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