For professional advisers only

VT DE LISLE AMERICA FUND

Manager's Commentary

Richard de Lisle
February 2023

Recession in the US and the effect on the VT De Lisle America Fund

Will there be a worse recession than predicted?
We think this is unlikely to be US generated because it's under the control of the Fed. The last one in 2008 was out of the Fed's control because no one understood the banks were over-lending on property until too late.
This time nobody wants a serious recession and the Fed doesn't want to cause one. Already it is back-pedalling and the 'dot plot' of future rate rises has come down even as unemployment hits a new low at 3.4%. Therefore a serious recession would have to come from elsewhere.
What could the exogenous shock be this time? There are so many fragilities and uncertainties in this de-globalising world; I think we have to conjecture externalities to the US as the most likely cause. Should we consider the Spring offensive in Ukraine or the implosion of the property market in China? Everywhere we look it seems 'Jaw, Jaw' is retreating to 'War, War'. This household was singing '99 Red Balloons' a few weeks ago. So let's presume our serious recession is precipitated by the de-globalisation theme of disrupted supply chains, increasing tariffs, on-shoring and rising commodity prices.

What would be the effect on the US market?
It would be to retreat to the pro-inflation scenario of 2022. Growth stocks would retreat again and the overall market would come down because it remains unusually overweighted to large-cap growth. Apple remains much bigger than the entire energy sector. The recession would also hurt consumer discretionary which has been strong since hopes of avoiding recession sprung up this year. Do not hold out too much hope for staples, utilities and health care, however, as these traditional havens still have relatively high ratings after performing this role last year.

And on value stocks?
Essentially, this type of recession resurrects the 1970s playbook. Low P/E and hence value is the best place to hide. While value should get hurt because of its economic sensitivity, let's not forget that all the lay-offs are coming from the big tech stocks, which

DE LISLE PARTNERS

was not foreseen at the start of 2022. Additionally, de-globalisation is helping US value stocks, through primary producers and manufacturers who benefit from onshoring. While recessions traditionally penalise value versus growth, we saw last year - and in the 1970s - that when recession is caused by things not working so well, the stagflationary consequences actually work in value's favour and indeed value outperformed last year.

And on small caps?

Small caps are vulnerable going into recession. Last year they duly underperformed but not by much. The Russell 2000 was down by 21.6%, the S&P 500 by 19.4%. So far this year, it is 8.9% versus 6.5% in favour of the Russell as recession fears have diminished. We can therefore say there is not a lot in it and, since the start of last year, the Russell is now slightly ahead. This is what we would expect because this bear market started with small stocks at a record discount to large stocks because of a decade of stretching large-cap growth to command ever higher multiples.

Unloved and ignored, small caps became relatively very cheap and even absolutely cheap when compared to their own history. Unless the severe recession will put all the small companies all out business, the Russell 2000 P/E is coming off a 10-year low made last autumn and therefore insulated on the downside as already demonstrated.

And on the De Lisle Partners portfolio?

The De Lisle portfolio is positioned for this type of recession as demonstrated by the strong outperformance last year of -10.5% versus -21.6% for the Russell. The portfolio has emphasised the characteristics required to survive this environment by having a particularly low P/E.

It is structured with an overweight in primary producers, particularly energy, and industrials which have done well and balanced it, to a lesser extent, with an overweight in consumer durables which are more vulnerable even though they too are on their lowest ratings. This has meant either one group or the other is outperforming so this year we are outperforming through consumer durables.

If we expect a slump so severe that commodity prices collapse, then so will the overall market but at least we have the ballast of low P/Es including 20% in Community Banks which are the lowest beta group and have decent liquidity, currently at 7%.

To be clear, if we expect oil at $40 and heavily negative GDP, the S&P 500 could fall 30% from here and still be above pandemic lows but so would other markets and we would expect the VT De Lisle America Fund's portfolio to fall less than the market.