

Investment Views



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Another Eventful Quarter

The first quarter continued the trend of the prior three years in being particularly eventful, with positive returns for bond and equity markets masking the extent of the swings in sentiment, economic data and sector performance.

The year started with a tone of optimism, but underlying caution, given the aggressive Fed hiking cycle, the sharpest since the early 1980s. Signs that inflation is in the process of peaking helped markets to recover at the end of 2022, but soft economic data then reinforced the belief that recession risks were elevated.



Recessions almost always put downward pressure on inflation. There are signs that price pressures are easing, especially in commodity markets, and price rises of goods are also cooling. It was hoped that a softer growth and inflation backdrop would allow central banks to ease up their hawkish rhetoric and the end of the hiking cycle would be visible in 2023. However, a run of strong economic data releases in the early months of the year, together with evidence that inflation is proving stubborn, led to revised expectations for higher peak interest rates.

We are now at a tricky juncture. Monetary policy works with a lag but as American economist Milton Freidman said, these lags are “long and variable”. Interest rate sensitive sectors such as housing, were impacted quickly, but other areas of the economy are just starting to feel the effects of rate hikes.

In March, the banking system came under pressure when Silicon Valley Bank (SVB) went into receivership. SVB was a unique case, growing rapidly during the boom years in Silicon Valley, which ended abruptly in 2021. Many early stage firms came under pressure as interest rates rose and the venture capital boom turned to bust. Events led to a swift resolution from policymakers and the Fed introduced a new Bank Term Funding Program to ensure the provision of liquidity to the financial system.

Stepping back, the fall in energy prices has been a key support to financial markets over the past six months. The relatively mild winter in Europe has made a lot of headlines, but there is more to the story. According to the International Energy Agency (IEA), natural gas demand in the European Union fell in 2022 by 13%, its steepest drop in history and equivalent to the amount of gas needed to supply over 40 million homes.

-13%

The demand for natural gas in the European Union fell in 2022.

Many early stage firms came under pressure as interest rates rose and the venture capital boom turned to bust.



-25%

Industrial gas use fell dramatically in 2022.

STRATEGY

The IEA estimates that buildings used 20% less natural gas than in 2021. The mild weather was helpful here, together with efficiency improvements and behaviour improvements. However, industrial gas use plunged by 25% as energy-intensive industries responded quickly to the price shock. Some factories reduced production, while others imported finished products rather than producing them domestically. While the fall in gas prices is positive, part of the fall has come from curtailing economic activity, which has been a challenge.

For all the twists and turns, the quarter ended in a similar fashion to how it started, with bonds and equities pricing different outlooks. The equity market is pricing a benign and resilient economic backdrop, while the bond market is pricing in a more troublesome picture, where interest rates will be cut quickly as we progress through this year. There is a way to square these outcomes if inflation falls quickly without a material growth slowdown, but the so called “soft landing” is looking increasingly difficult to achieve as interest rate hikes make their way through the system.

China has the potential to provide positive surprises as the economy reopens and the clampdown on the private sector eases, but in this environment, diversification, a heightened focus on risk management and correlations between assets remains important.

From Goldilocks to Volatility

The first quarter certainly had its fair share of twists, turns and surprises, with risk on in January upended by a more hawkish Federal Reserve in February. This culminated in a broad volatility event during March, as cracks appeared in the banking system.

Looking back to January, with easing financial conditions, inflation declining, as well as signs that global growth was accelerating, the ‘Goldilocks’ narrative was gaining traction. The US futures market was certainly expecting few surprises, pricing in just one more 25 basis point (bps) base rate increase in 2023. However, strong US employment data on the 3rd February and further positive economic data releases, shook dovish sentiment and reignited demand for inflation protection, with five-year US inflation expectations rising from 2.13% to 2.79%.



FIXED INCOME

As policy makers risked falling behind the curve, Fed Chair Powell moved to rein in risk appetite by reaffirming the focus on the 2% inflation target. This led to a 100 bps move upwards in two-year US Treasuries to a 15-year high of 5.07% and a complete reset of US base rate path expectations, as 5.75% became fully priced by mid-2023, resulting in the most inverted US yield curve since the early 1980s. The difference between 2-year and 10-year maturity US Treasury yields fell 109 bps, as the market priced further tightening, but also hedged for the growing risk of a recession, given US short dated real yields (up almost 2% for five years) have now reached restrictive territory.

Inversion of the yield curve, very elevated US Treasury volatility and the lagged effects of previous monetary tightening, compounded by central bank miscommunication, finally exposed weakness in the economy as Silicon Valley Bank attempted to raise additional capital. The focus then shifted to weak links in Europe and the Swiss banking giant Credit Suisse succumbed to pressure from regulators and was acquired by UBS. This episode seems to have calmed for now with the help of significant liquidity support – which was not available immediately in 2008 – being provided. The risk going forward is more generally for the broader economy, as US banks may tighten lending standards in order to optimise their balance sheets.

As events over the past few weeks have dominated headlines, it has been easy to forget that during the first quarter, global economic growth expectations increased rapidly in China and Europe. The US also showed signs of reaccelerating. The reopening of the economy in China and a mild winter in Europe led to an increase in global growth, with Emerging Markets also benefitting from the rebound in Chinese economic activity.

With the global growth backdrop remaining resilient, as evidenced by the stability of forward oil and raw commodity prices, there is

5.07%

Two-year US Treasuries reached a 15-year high.

7.8%

Gold prices increased in the first quarter.

INVESTMENT VIEWS

scope for tightening lending standards in the US to be offset by strength elsewhere in 2023. 30-year US mortgage rates remain at 7%, therefore consumer demand for new mortgages has been largely anaemic over the past few months. In addition, due to the strong employment market and locked in ultra-low costs for existing borrowing, there is no guarantee that events within the US banking system slow US growth sufficiently to drive inflation back to target.

Further adding to the uncertainty has been the performance of commodity markets and currencies. Large moves in US real interest rates led to wild swings in gold prices, with the metal ending the quarter up 7.8%, WTI oil prices remained range bound at between US\$67-US\$82 per barrel and copper rebounded 7.5%. In Europe, the economy is benefiting from natural gas prices continuing their reversion trend back towards their long-term average levels and are now down 80% from their peak.

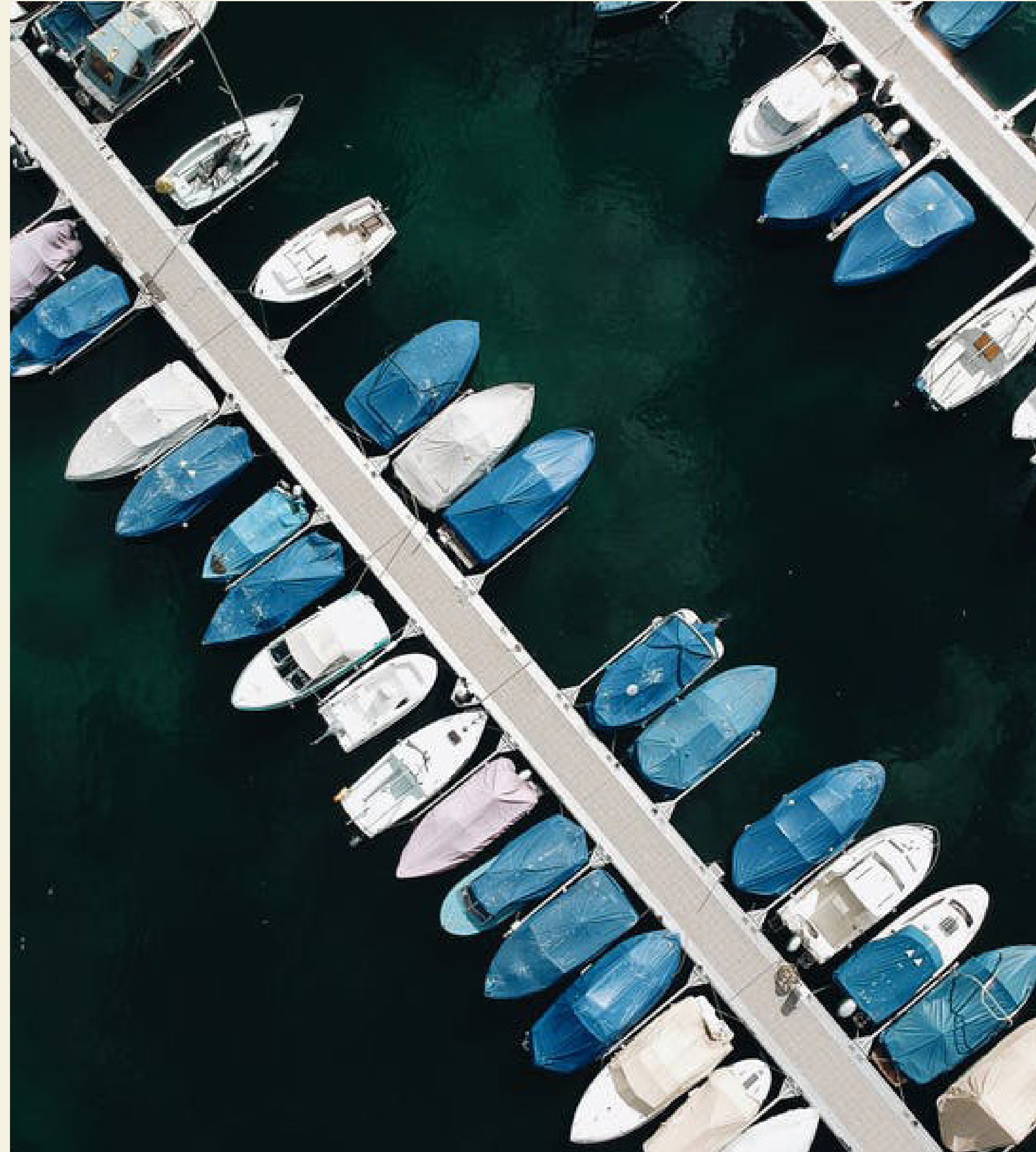
With so many changes on the macroeconomic front and the futures market pricing in 50-75bps of US base rate cuts by year end, our defensive portfolio positioning was rewarded in the first quarter. The rally in government bond yields effectively offset wider corporate credit spreads, leading to positive total returns overall, even though there was a re-pricing in credit risk. With the balance sheet of the Federal Reserve now expanding again, having grown by US\$300bn in the space of several weeks – offsetting nine-months of quantitative tightening – risk assets may well continue to rally if risks surrounding US banks remain contained.

Looking forward, on balance, we do not expect a rapid recession and decline in inflation within the US, therefore, where appropriate within our US dollar bond funds, we are adding to high quality floating rate notes and inflation protection. We will potentially look to extend duration later this year if and when global growth slows.

Keep Calm and Carry On

The MSCI World had a strong start to the year, finishing the quarter up 7.7% in US dollar terms. An impressive return given the news flow and volatility. Equities were up 7.1% by the end of January and continued to rally at the beginning of February to a 9.5% peak, as the equity market was supported by expectations of interest rate cuts as early as mid-2023.

During February, the MSCI World Index consolidated a portion of recent gains, as data suggested that inflation may be proving stickier than expected. This was in part attributed to ongoing resilience in the labour market and, as a consequence, expectations of interest rate cuts were pushed out to 2024. In March, we saw strains in the financial system, with regulators acting swiftly to address the specific issues and restore confidence more broadly, resulting in equity markets rebounding by 5% from the lows in mid-March.





21.2%

The percentage that
Information Technology
rose in the first quarter.

EQUITIES

Sector performance varied significantly during the period, with technology-orientated sectors outperforming, while more cyclically sensitive areas such as Energy and Financials sectors lagged. In the first quarter, Information Technology (IT) and Communication Services (which includes Alphabet, Meta, Netflix) outperformed the broader market, rising by 21.2% and 18.2% respectively. This outperformance was largely fuelled by equity investors rotating into IT and Communication Services as a flight to quality trade.

Energy was the worst performing sector, as oil prices weakened from their highs of 2022, finishing the quarter down 3.1%. Financials were also weaker, ending down 1.4%, as investors assessed whether Silicon Valley Bank's downfall would have a ripple effect. With IT stocks outperforming and more cyclically sensitive areas such as Energy lagging, it is no surprise that the MSCI World Growth index outperformed the MSCI World Value index by 14.1%.

The best performing region this quarter was Europe, with the MSCI Europe Ex UK up 11.9%, helped by lower valuations and sector specific tailwinds. The US and UK traded well, with the US up 7.6%, benefiting from a high weighting to IT. Emerging Markets and Asia Pacific lagged after a strong start to the year, returning 4.0% and 2.1% respectively. The reopening of China post-COVID has been a bit stop-start, but is still an important theme this year.

The fourth quarter earnings season was mixed, but despite all the headlines, earnings estimates for the next twelve months have been remarkably resilient. The S&P 500 earnings per share (EPS) has been downgraded by 1.5% and the Dow Jones EPS by 0.9%. The NASDAQ 100 EPS is up 0.4%. The FTSE 100 followed in the footsteps of the US estimates, but the real outlier is in Europe, which actually saw a 1.6% increase in EPS forecasts for the next twelve months.

EQUITIES

Changes to the Global Industry Classification Standards have seen the Data Processing & Outsourced Services group within IT dissolved and the constituents reallocated to Financials and Industrials. The reclassification adds several growth stocks to the traditional value stocks within Financials. Visa, Mastercard, and PayPal, the three largest stocks affected, comprise around 16% of the Financials sector in the S&P 500. The moves increase concentration within the IT sector, with Apple and Microsoft comprising around 46% of the sector after the moves.

We reduced our exposure to US regional banks earlier in the quarter, which helped limit our exposure to the stresses witnessed in this sector during March. With interest rates now approaching 5% and economic risks more elevated, we are now positioned overweight Insurance, due to this sub-group's defensive characteristics. We also increased our exposure to Asia and Emerging Markets during the quarter, which should benefit from the reopening of the Chinese economy.








46%

The amount Apple and Microsoft now comprise within the IT sector.

We reduced our exposure to US regional banks earlier in the quarter, which helped limit our exposure to the stresses witnessed in this sector during March.

Global Asset Allocation

The chart below details our 6-12 month tactical investment strategy

	UNDERWEIGHT -	+ OVERWEIGHT
Asset Allocation	<div>CASH (MODEST UNDERWEIGHT) EQUITIES (MODEST UNDERWEIGHT) \$</div>	<div>FIXED INCOME (MODEST OVERWEIGHT) NON-TRADITIONAL ASSET CLASSES (MODEST OVERWEIGHT)</div>
Fixed Income		<div>EMERGING MARKET DEBT HIGH YIELD DEBT</div>
Equities Regional		<div>EMERGING MARKETS</div>
Equities Sector	<div>CONSUMER DISCRETIONARY + UTILITIES </div>	<div>CONSUMER STAPLES HEALTHCARE</div>

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