

Investment Views



MAY 2023

PRODUCED BY BUTTERFIELD

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One Crisis to the Next

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The UK Looks a Bit Brighter

Back in November, the Bank of England (BoE) warned that the UK economy was facing a “very challenging” outlook and forecast a recession lasting until the middle of 2024. This would have represented the longest (but not deepest) recession since records began. Against a backdrop of falling growth, they also expected unemployment to rise materially from 3.5% to 6.5%. The BoE was in a quandary. Even though they forecast a long recession, inflationary pressures meant they increased their base rate by an historic 0.75%, the largest hike in 33 years.

The BoE increased the base rate for a 12th consecutive time in May to 4.50%. This was 0.25% higher than the previous meeting and a substantial 3.75% higher than 12 months ago. While two members of the Monetary Policy Committee (MPC) dissented to the move and were in favour of keeping interest rates on hold, the rate move was in line with financial market expectations.



The big surprise was the strong upward revision to the growth forecasts, such that the MPC is no longer predicting a recession in the UK over the forecast horizon. Real GDP forecasts were revised upward by 0.75% for 2023 and 1.00% for 2024, with GDP growth of 0.75% for both years. While this may not sound like much, the level of GDP expected in three years' time is now 2.25% higher than anticipated in February. This is a significant upgrade to their growth forecasts.

2.25%

The level of GDP expected in three years' time higher than anticipated in February.

The BoE highlights four reasons for the upward revision: stronger global growth, lower energy prices, fiscal support from the Spring Budget and less precautionary savings from households. Economic resilience has not been confined to the UK; growth in the US and the Eurozone has surprised to the upside, while China's reopening has also provided a boost. Lower energy prices have been an important reason why growth has been resilient. Natural gas prices in Europe are down around 90% from the peak last August and Brent Oil has fallen from around \$120 a barrel to \$75.

Fiscal policy in the UK has been in the spotlight since last year's "mini-budget", which was swiftly reversed after triggering stress in the gilt market. The fall in energy prices has reduced the cost of government support packages, which gave the new Chancellor a bit of leeway in the Spring Budget to provide more economic support than previously expected.

The tight labour market in the UK and strong private sector wage gains have meant consumers have been more resilient than expected. Precautionary savings have likely risen in some instances due to the way higher mortgage costs are going to continue filtering through the mortgage market. However, with the labour market remaining resilient, consumers have surprised on the upside relative to downbeat expectations.

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10.1%

The rate that UK inflation is at and the highest in the G7.

STRATEGY

Turning to inflation, the picture is still challenging. UK inflation is at 10.1% and the highest in the G7. Food inflation is running particularly high, rising 19.6% year-over-year, which attracted a lot of discussion at the latest BoE press conference. Energy inflation will fall substantially from here, but core inflation remains sticky at around 6.2%.

While higher growth and inflation forecasts increase the probability of more rate rises, Governor Bailey provided no guidance, stating that the MPC has “no bias in our setting of rates going forward... (and they will not be) giving a directional steer on rates”. Incoming data will be key as the BoE will be “guided by the evidence”.

The improved growth outlook has to be weighed against continued challenges. In global terms, the UK economy is relatively small, but it is an interesting and important case study. The UK has been a mixing pot for many global issues; a tight labour market (like the US), an energy price shock (like Europe) and a variable rate mortgage market (like Canada and Australia). Sterling has rebounded versus the dollar from a low of \$1.03 last year to around \$1.25. While the rebound versus the euro has been more muted, an improved UK outlook has been reflected in financial markets.

The current optimism is partly a reflection of just how dire the outlook appeared last year. It is fashionable to criticise the central banks for getting their forecasts wrong, but a lot of smart economists and copious data inputs are no substitute for a crystal ball. The outlook is still challenging but is brighter than what it was, and for markets that matters.

One Crisis to the Next

After the tremors in the US banking sector in March, April seemed relatively tranquil. Bond and equity market volatility fell back to levels experienced just before the initial Silicon Valley news broke. However, another risk looms, as the US debt ceiling takes centre stage. The US Treasury ended April with US\$316bn in cash, up from a low of US\$86bn in mid-April, as tax receipts boosted liquidity. The US is running a fiscal deficit and the government looks set to run out of funds by early June (US corporate tax receipts are not due until mid-June).

We continue to expect agreement and assign a very low probability of an actual default; the prospect of which would be so damaging to the economy a recession would follow in short order. However, we also need to acknowledge that politicians have no incentive to come to agreement without signs of market stress, and this remains our base case with an additional tightening in financial conditions needed to ‘focus minds’ in the weeks ahead.



FIXED INCOME

Global bond yields ended the month almost flat, with the exception of Swiss government bonds where nominal yields fell by -19bps, benefitting from a ‘flight to quality’ ahead of the debt ceiling negotiations. Two-year US Treasury yields fell to a low of 3.78%, rising to 4.25% before settling at 4.01%, while 10-year US Treasuries ended April at 3.43%; both almost unchanged for the month.

So, while long dated bond market volatility has fallen, volatility at the short end of the curve remains high. With monetary policy now focusing on data (primarily employment and inflation) the probability of another, and likely last, 25bps increase in the US base rate has been volatile. The probability started the month at 57%, before rising to 84%, indicating that a further increase in the US base rate to 5-5.25% is very likely at the May meeting. There were also significant moves in real bond yields, with a decline in inflation breakevens across the USD curve, as inflation data continued to soften and US growth data weakened.

During April, in aggregate, US economic data failed to meet expectations, with consumer confidence, ISM manufacturing and Q1 GDP reporting weaker numbers. This was offset to some degree by a further decline in the unemployment rate to 3.5%, together with signs of strength in US residential real estate (both a problem for the Federal Reserve). Outside of the US, Chinese and UK economic data remained buoyant, with the UK unencumbered by a large manufacturing sector sensitive to global growth dynamics and China continuing to enjoy the fruits of reopening their economy. This led to a rally in sterling which ended April at 1.257 versus the US dollar, its highest level in a year.

3.78%

The figure that two-year US Treasury yields fell to.

3.5%

The US unemployment rate figure.

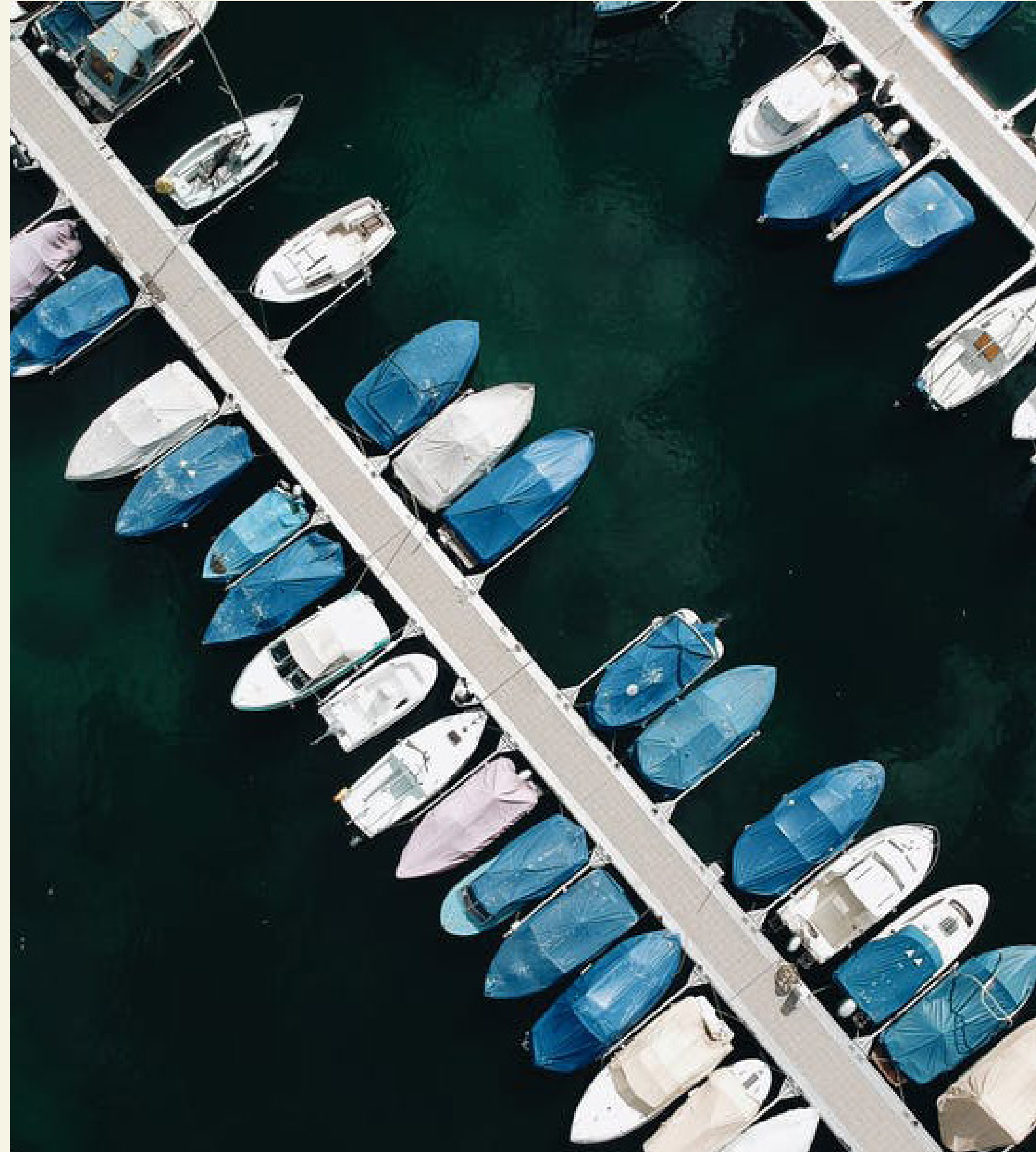
INVESTMENT VIEWS

Widening interest rate dynamics between the US and the G7 continue to hurt the US dollar, with 75bps of US base rate cuts priced in for 2023 and a further 150bps of cuts to follow in 2024. In our view, it is likely that the headwinds that are impacting the US will ‘leak’ out to the rest of the world in the coming months, reducing the need for European base rates to dramatically rise from this point onwards and providing a headwind for further strength in the Euro and Sterling.

Portfolio positioning remains defensive. We continue to exercise caution with allocating capital to corporate credit due to the impending drain of US dollar liquidity as the US Treasury rebuilds its cash reserves following any debt ceiling agreement. If talks do breakdown, then risk assets will also be impacted as volatility rises sharply. We therefore see better opportunities in short-dated government bonds (but are avoiding adding exposure to US June 2023 maturities). For the risk averse, we remain confident that 10-year US Treasuries will act as the risk off asset of choice globally in the event of a significant drawdown in equity markets. Our defensive positioning within the Fixed Income component of portfolios means that we continue to be well placed to take advantage of opportunities as they present themselves.

All Eyes on Mega-cap Tech

The MSCI World returned 1.8% in April in US dollar terms, bringing year-to-date return to a healthy 9.6%. Interestingly, the breadth of the rally has been the narrowest since 2020. A study of the S&P 500 shows that 90% of the year-to-date returns (9.1%) have been generated by five mega-cap tech stocks, namely Alphabet, Amazon, Apple, Meta and Microsoft. A market capitalisation weighted index of these stocks has returned 41% year-to-date. If we expand the Index to add Nvidia and Tesla, two other mega-cap tech companies, the total return year-to-date increases to 47%. Despite this outperformance year-to-date and mega-cap tech's current forward P/E multiple of 25x, a 50% premium to the rest of the S&P 500, the relative valuation is in line with the historical valuation.





4.3%

The return that
Consumer Staples
achieved this month.

EQUITIES

The outperformance year-to-date is partly due to the hype around Artificial Intelligence (AI), as most of the mega-caps are well positioned to lead in this new growth area. It is also partly due to a flight to safety, with mega-cap tech now being seen as a defensive play with their high margins and solid balance sheets. Risks remain, if inflation continues to be stickier than expected and interest rates keep on increasing, the long duration cash flows of mega-cap tech will be a drag. If the economy weakens and the market sells off, these popular and liquid stocks could be the first stocks to be sold and are likely to underperform.

In April, we saw some sector rotation within equity markets that suggested an underlying tone of caution. Even though we had a positive month (1.8%), the best performing sectors, for the first time this year, have been the defensive ones. Consumer Staples was the best performing sector this month, recording a 4.3% return. Healthcare, which is one of the worst performing sectors this year, was one of the best performing sectors in April, returning 3.5%. Some of the best performing sectors year-to-date, such as Technology and Consumer Discretionary, performed poorly in April returning -0.1% and +0.2% respectively. Communication Services was one of the only outliers and continued to outperform, driven by Meta and Alphabet. The sector returned 3.2% this month and is now the best performing sector year-to-date at 21.9%.

In April, regions continued to perform as they have done so far year-to-date. Europe (ex UK) and the UK outperformed this month, returning 5.3% and 3.8% respectively, with Europe the best performing region so far this year up 16.2%. The US added 1.2% in April. Japan, Asia Pacific (ex Japan) and Emerging Markets underperformed, with Emerging Markets falling 1.1% in April. Emerging Markets have given up much of their strength from earlier in the year and are now only up 2.8% year-to-date.

EQUITIES

First quarter earnings results were robust, with 58% of US companies beating revenue estimates and 68% beating earnings estimates. The aggregate revenue surprise was 2%, in line with the last few quarters. The aggregate earnings surprise was 7%, the highest level since the third quarter of 2021. Despite the better than expected numbers, the average one-day price change for companies that beat was only 0.3%, the smallest reward in two years. It was a similar story in Europe and stocks not rising on good news is another sign of underlying caution within equity markets.



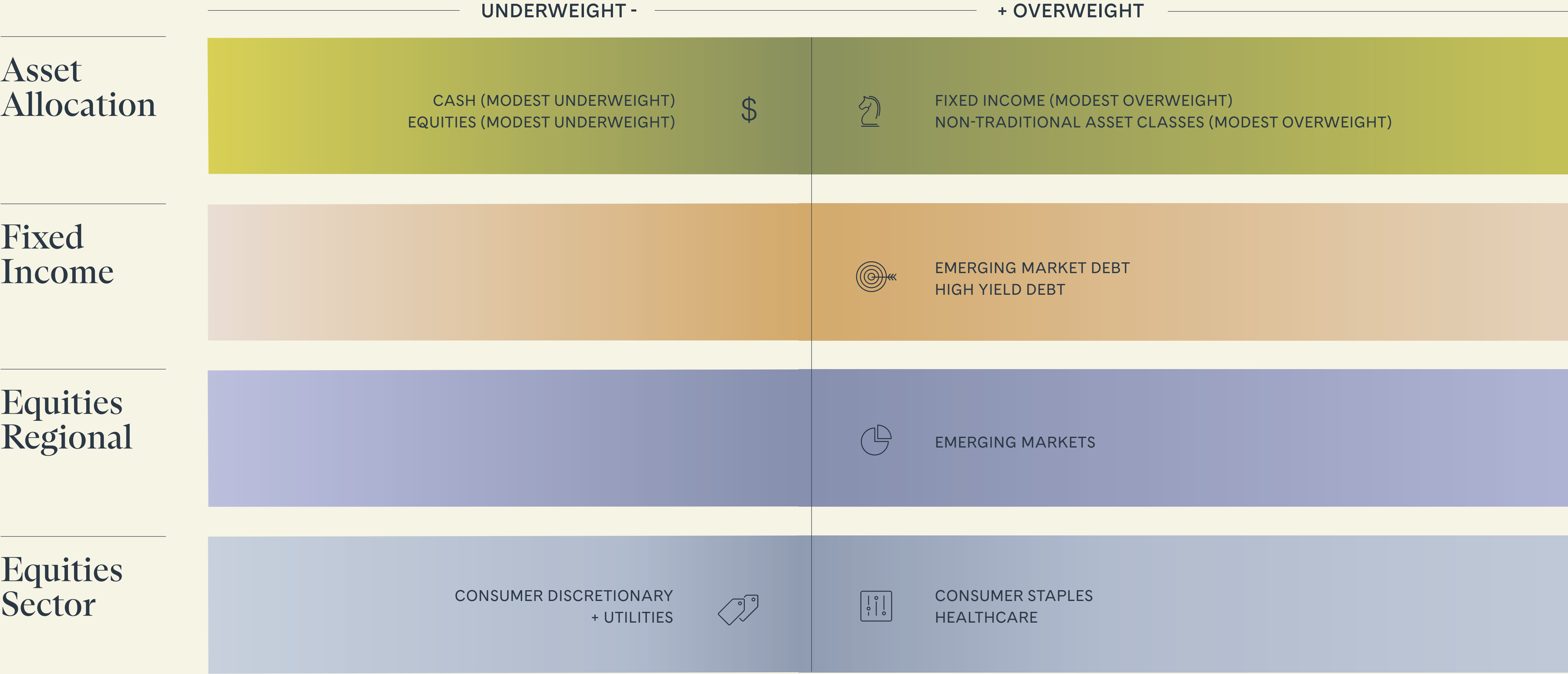
7%

The amount that aggregate earnings achieved, the highest level since the third quarter of 2021.

The MSCI World returned 1.8% in April in US dollar terms, bringing year-to-date return to a healthy 9.6%.

Global Asset Allocation

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



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