

Investment Views



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Strategy:

Something Turned Up

Fixed Income:

Markets Riding the Liquidity Wave

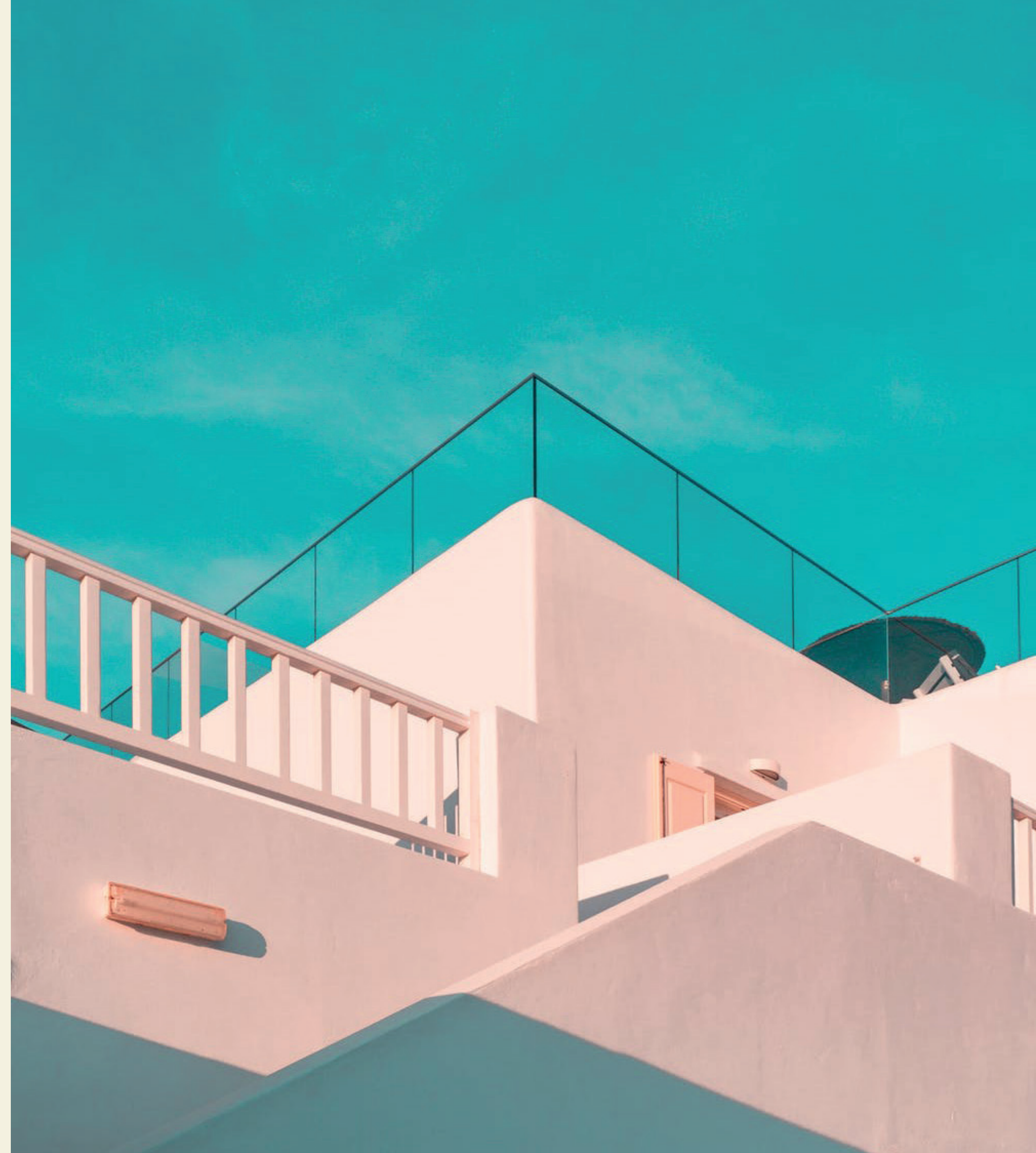
Equities:

Shifting Sands

Something Turned Up

The second quarter was another period of positive returns for global equities. US equities led the way, with Japanese equities also performing well. Emerging Markets lagged their Developed Market counterparts, but still generated a small positive return. Bond markets were mixed as central banks continued to raise interest rates in the US, UK and Eurozone. While this was a headwind for sovereign bonds, corporate credit performed well on a relative basis, with High Yield and Emerging Market bonds both seeing positive returns over the quarter.

The economic backdrop remains particularly complex. The resilience of the US economy has defied the consensus expectation for a mild recession this year, but Germany has slipped into recession and the strength of the recovery in China has been disappointing. The inflation picture globally is also very mixed. Energy and commodity prices more broadly have eased over the past nine months, which has provided welcome relief for governments, corporates and households. This has seen headline inflation rates come off their highs last year, but the focus has turned to core inflation (the rate excluding food and energy).



STRATEGY

The US has made reasonable progress, with core inflation falling from a peak of 6.6% to 5.3%. The Eurozone has a similar rate of 5.4%, but has made less progress, with this only slightly below the peak of 5.7%. The UK is now looking like a global outlier on the inflation front, as core inflation climbed to a new cycle high of 7.1% in May, meaningfully higher than the 6.5% peak seen last year. UK inflation has both demand and supply factors contributing to it. The widely forecast recession in the UK has so far failed to materialise and demand has remained high as consumers continued to spend. Meanwhile, supply has been impaired by a tight labour market, trade frictions and an energy shock which continues to make its way through the economy.

In contrast, China faces the opposite challenge when it comes to inflation. A weaker than expected recovery and ongoing challenges in the property sector have seen deflationary pressures mount. Intuitively, lower prices are positive, but in an indebted economy with elevated youth unemployment, deflation increases the real value of debt and discourages capital investment, which constrains economic growth. The second quarter saw weak performance in assets closely linked to China's economy, such as the renminbi, industrial metals and Chinese equities. This has led to increasing calls for further policy measures to support the economy, but the government has so far been reluctant to provide stimulus and instead appears to accept a weaker level of growth in order to manage the slowdown in the property sector.

While there is a lot of pessimism around China, the investment theme of Artificial Intelligence (AI) has generated significant interest with some striking forecasts around the potential for these technological advances to boost productivity growth. Throughout history, new technologies have been pivotal in advancing the standard of living in the world and corporates have often been well placed to benefit. Use cases for AI are already evident across a broad range of industries, from the writing of software code to creative copy and image generation.

7.1%

Core inflation in the UK climbed to a new cycle high in May.

The widely forecast recession in the UK has so far failed to materialise and demand has remained high as consumers continued to spend.



STRATEGY

Chasing the latest hot theme in markets is often a high risk and high potential reward endeavour, but on the flipside, being on the wrong side of technological advancement can be costly. In a world where uncertainty runs high, advances in AI remind us of the case for being optimistic. The world today is characterised by elevated levels of debt, high inflation, climbing interest rates and geopolitical tensions; but financial markets are at the forefront of innovation and as Dickens's Micawber used to say: "something will turn up".

Markets Riding the Liquidity Wave

The second quarter was positive for risk assets, aided by the US Federal Reserve reversing 6 months' worth of quantitative tightening in the space of 14 days. This helped offset the strains in the US banking system, which threatened to produce a credit event and would have negatively impacted the US economy. With the path for US base rates also turning dovish (almost 75bps of cuts in 2023 were fully priced in), the US dollar also weakened.

The easing in financial conditions helped high yield credit spreads tighten by 65bps over the quarter. Volatility in the bond market also fell from elevated levels, with the MOVE index falling from 199 in March to 110 at the end of June, further stoking risk sentiment.



FIXED INCOME

With this easier monetary policy backdrop, there is now a high probability that inflationary pressures in the US linger for longer. This could lead to inflation expectations rising again (New York Fed 3-year inflation expectations remain at 3%) and improvements in core inflation measures have subsequently slowed. The Atlanta Fed also signalled wages are still running at 6% Year-over-year.

Given these price pressures and continued strength in employment, in our US dollar bond funds we allowed a small short duration position to naturally grow in the second quarter and this played out well with the market now not expecting an easing cycle to begin in 2023. 2-year US Treasury yields have reversed course and are approaching 5% again. Global liquidity will remain a dominant theme in the third quarter, with the Federal Reserve's balance sheet back to its pre-banking crisis size. With liquidity still ample and money market funds continuing to park their excess funds with the Federal Reserve, the bar for easing policy is very high, as it would risk unleashing further liquidity into speculative activity such as equities and real estate.

One area we are keeping a close eye on is US banking reserves, which, while still large by historical standards, are now rapidly falling again, with further US base rate increases (another 25bps in July is now priced at 81%) likely to accelerate this drain in the coming quarter. Compounding this, the European Central Bank is also stepping up quantitative tightening this summer and the Chinese have yet to stimulate in a meaningful way.

With 2-year US real yields ending the quarter up 2.9%, the highest level since 2008, and forward dated WTI oil (OPEC supply cuts are failing to stabilise prices) and raw commodity prices grinding lower, the improvement in investor sentiment is puzzling from a pure macro perspective. Chinese economic data did improve in the second quarter, but was unable to meet bullish expectations. Recession risks are running high in Europe, including the UK, and in a forewarning to the US, inflation remains sticky. The Bank of England's hawkish turn in June has led the UK terminal base rate

3%

The New York Fed 3-year inflation expectations remained constant.

6%

The UK terminal base rate expectations rose in June from 4.5%.

INVESTMENT VIEWS

expectations to rise from 4.5% to 6.0% and short-term borrowing costs have risen to their highest level since 2008.

Throughout the rest of the world, there is a growing realisation that core inflation will remain higher for longer, with Australia and Canada also surprising markets by abandoning their policy pause and raising base rates. Services inflation continues to defy expectations globally. Fixed income investors are therefore understandably exercising caution, with Chinese and Swiss (both countries without an inflation problem) government bond yields the only major bond market with gains in the second quarter.

Positioning for the coming quarter remains defensive as we wait for the US Treasury to extract the liquidity they need. US high yield ended the quarter with a spread of 390bps over duration matched US Treasuries, the lowest level since Silicon Valley Bank collapsed in March, and is pricing in only a minor growth slowdown over the coming months. As a result, high beta assets are vulnerable with US corporate default rates likely to rise over the next 12-24 months.

We continue to prefer high quality spread products, such as US mortgage backed securities, in appropriate mandates. For example, newly issued US government guaranteed Ginnie Mae pools provide a very healthy spread of 76bps over US Treasuries and minimal credit risk. In addition, we continue to favour inflation hedges. With US inflation expectations from 2-30 years in line with the target set by the Federal Reserve, this allows us to add to our current exposure at fair value.

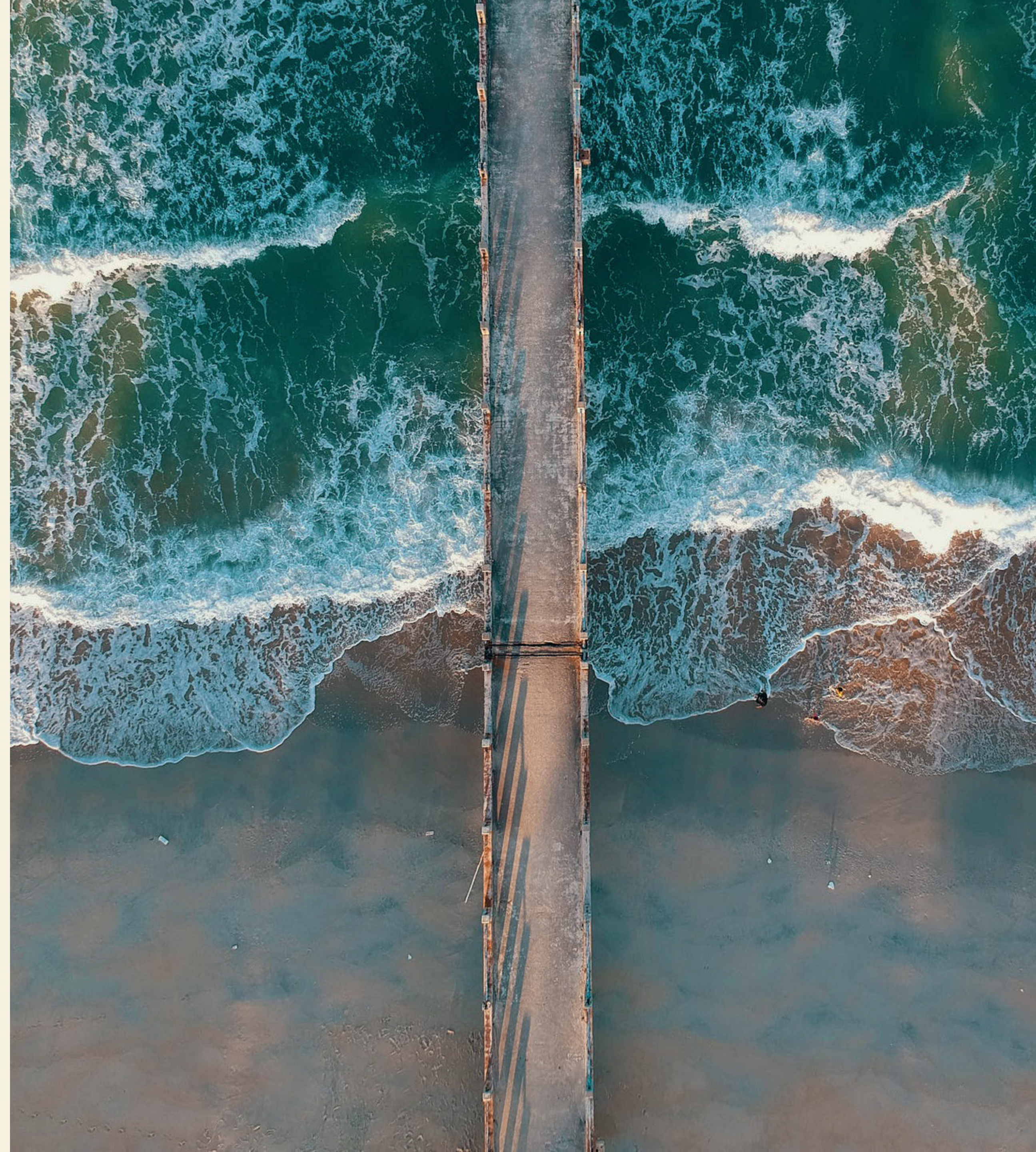
If the US economy experiences another credit event and/or inflation pressure remains above 3%, central bankers may be forced to allow a longer period for inflation to normalise. On the flip side, if we experience a recession, 'sticky' inflation pressures are likely to provide a floor to inflation expectations. Portfolio duration positioning in our US dollar bond funds is slightly underweight versus our benchmarks, but we are significantly more comfortable adding to bonds relative to the start of the quarter.

Shifting Sands

The markets finished the quarter on a strong note with June recording the second-best monthly performance so far this year. The MSCI World printed a 6.1% gain in US dollar terms for June, following signs that headline US inflation continues to subside and that the Fed hiking cycle may conclude during the second half of the year. The Index has returned 6.8% over the quarter, cementing a 15.1% return year to date. This is quite an exceptional performance given flat earnings growth and no major revisions in earnings estimates for the S&P 500 this year. This had led to the S&P 500 Blended Forward 12 months Price to Earnings (P/E) ratio expanding from 16.8x at the start of the year to 19.3x, higher than the ten-year average of 17.6x. In addition, the ten-year average needs to be adjusted for the historic low interest rate environment, so overall at 19.3x blended forward earnings, the US market is on the expensive side of fair value.

15.1%

MSCI World year to
date return





29.7%

Communication Services
rose 9.7% up to a YTD high.

EQUITIES

The second quarter was very much like the first, with the same sectors and stocks leading the charge. Information Technology returned 14.8% (up 39.1% YTD) with the sector benefitting from the Artificial Intelligence hype. Consumer Discretionary gained 10.7% (up 29% YTD) as Amazon and Tesla, two of the seven mega-cap tech stocks that have performed well this year, rallied. Communication Services rose 9.7% (up 29.7% YTD) driven by two other mega-cap tech stocks, Alphabet and Meta. The sectors that lagged in the second quarter were Energy contracting by 0.3% (down 3.4% YTD), Utilities by 0.2% (down 0.6% YTD), and Materials by 0.1% (down 6.3% YTD) despite performing relatively well in the first quarter.

From a geographic perspective, the mega-cap tech rally supported US markets, which were lagging European markets in the first quarter, but are now nearly two percent ahead. In terms of investment style, the equal weighted S&P 500 lagged the S&P 500, while growth outperformed value once again.

The most interesting recent data point in our opinion is the June performance numbers. For most of the year, the breadth of the market rally was narrow and has been driven by the seven mega-cap tech stocks: Apple, Amazon, Meta, Alphabet, Microsoft, Nvidia, and Tesla. Most fund managers performance relative to the benchmark year to date can be explained by how they were positioned vis-à-vis these seven stocks. The June performance data however suggests we could be at an inflection point. For the first time since January, the equal weighted S&P 500 outperformed the market cap weighted S&P 500. Value and Growth both returned 6%.

In June, IT and Communication Services were not the best performing sectors, Industrials and Materials were. These are indications that the market breadth is widening which is a good thing for the markets. This also points to a catch-up rather than a catch-down. So even though the rally this year has been on shaky foundations, the widening market breadth could suggest there is still more positive momentum in the markets.

EQUITIES

The first quarter earnings season was better than expected with 62% of companies beating on revenue and 64% beating on earnings. The aggregate revenue surprise was 3%, in line with the last few quarters. Aggregates earnings surprise was 8%, the highest level since 3Q21. Despite the better than expected numbers, the average one-day price change for companies that beat was only 0.4%, the smallest reward in two years. The numbers beat, but the overall trend is downwards. Sales growth has slowed, but is still positive, while earnings growth is now in negative territory pointing to normalising operating margins. Earnings growth is expected to reaccelerate in the second half and then increase to 10% per annum for 2024 and 2025. This appears to be a classic example of analysts starting with a high number and downgrading over time. With interest rates creeping higher and corporate margins still under pressure, it is going to be challenging for earnings to meet these lofty expectations, so selectivity remains important.

10%

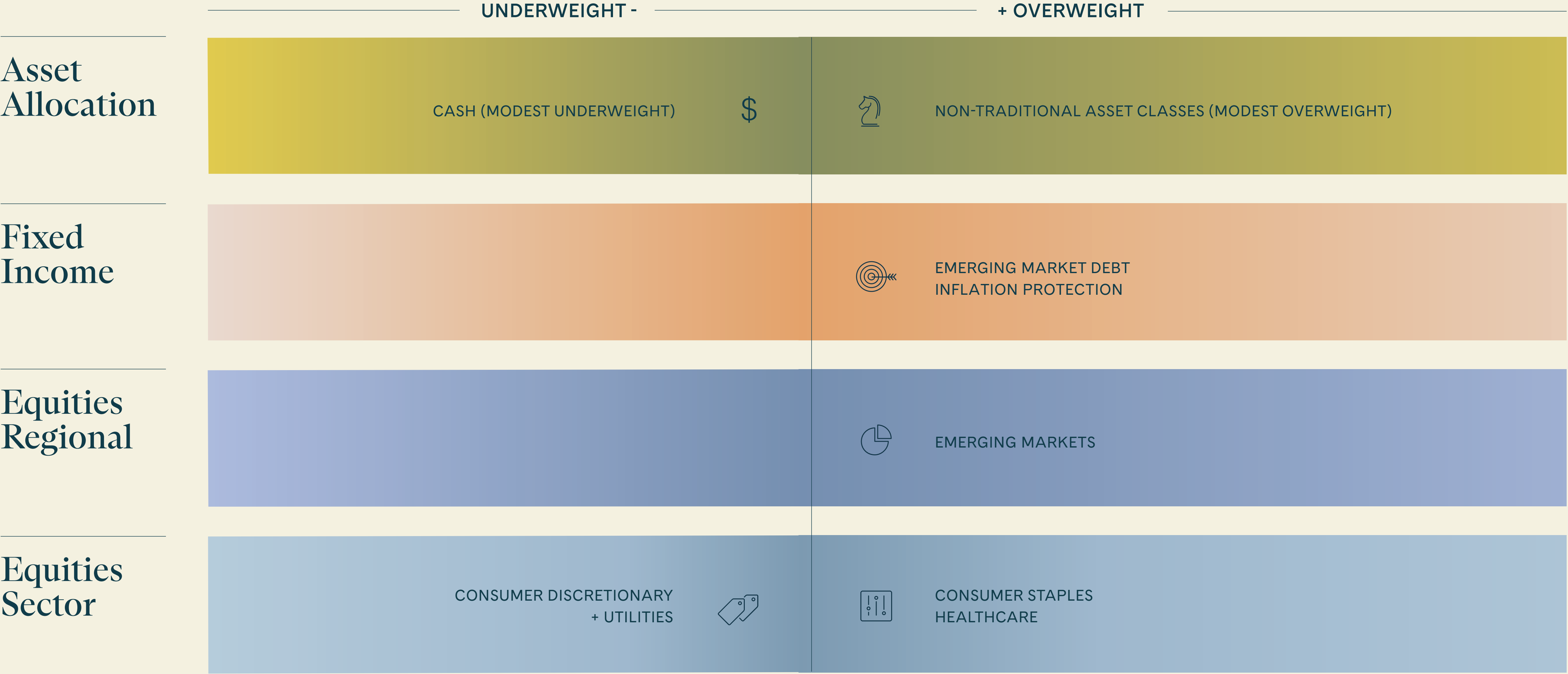
Earnings growth is expected to increase for 2024 and 2025.

Sales growth has slowed, but is still positive, while earnings growth is now in negative territory pointing to normalising operating margins.



Global Asset Allocation

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



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