

Investment Views

April 2024

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From Pessimism to Optimism

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The Underwhelming Case for Cuts

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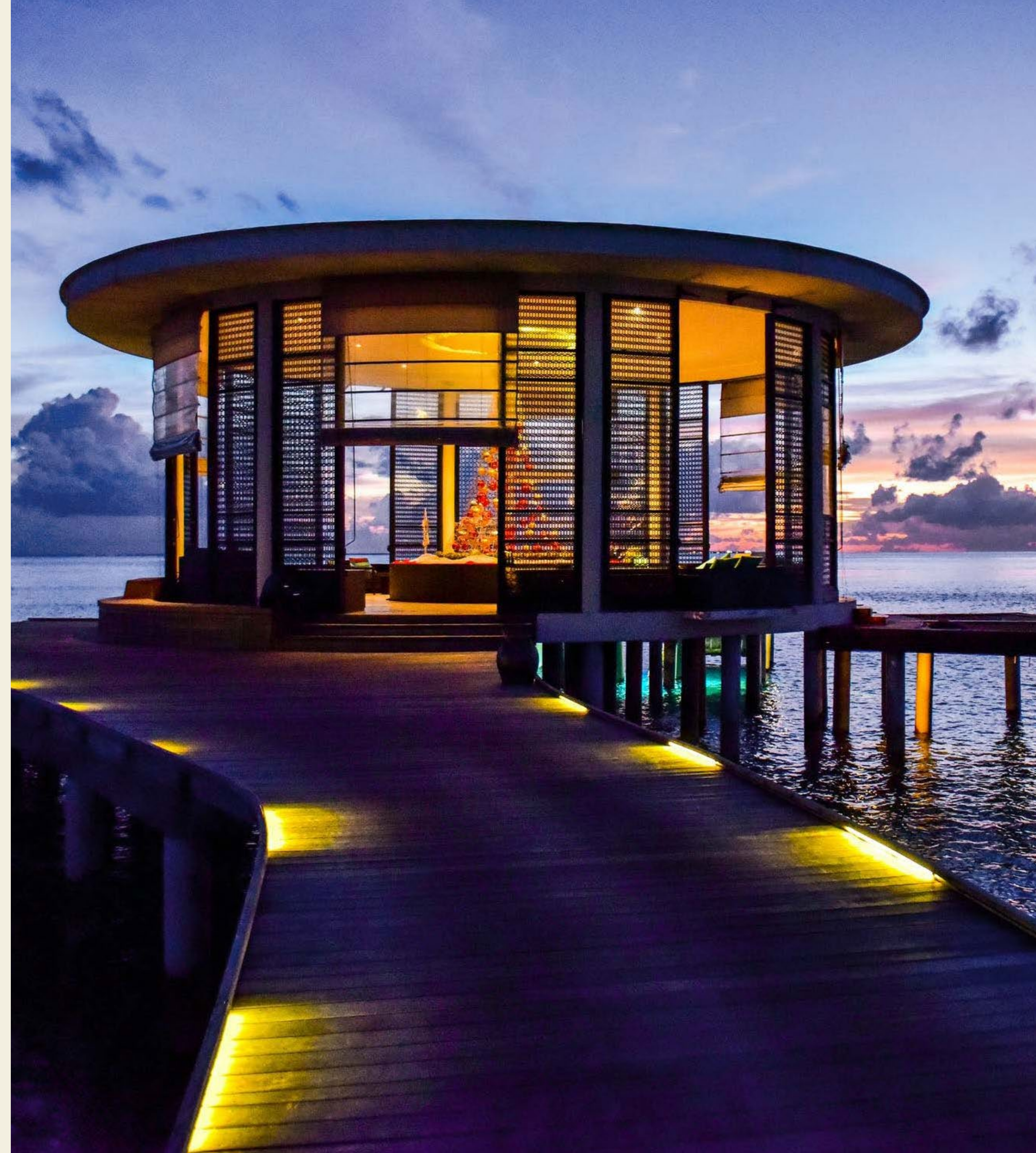
A strong quarter with low volatility

From Pessimism to Optimism

- US growth resilience continues
- Recent inflation news has been mixed
- A good quarter for Alternative investments

The first quarter was another strong one for global equities. The MSCI World returned 8.9% in US dollar terms, which was the strongest start to the year since 2019. Over the past year, a combination of better-than-expected economic data in the US and the rate of inflation falling faster than expected has been very supportive for financial markets. The inflation numbers for January and February came in slightly higher than expected, which saw sovereign bond yields rise. However, solid economic growth meant that equities and credit markets shrugged off the data, seeing it as more of a bump in the road on the path towards 2% inflation.

Investor sentiment was particularly weak at the start of 2023. It gradually improved throughout last year as the US economy avoided a widely expected recession. Sentiment indicators have continued to improve in 2024 as markets have fully embraced an economic soft



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landing (inflation falling close to 2% without a recession). Over the last 18 months, investor sentiment has swung from being stretched in the direction of pessimism to now arguably being too optimistic.

Economists and forecasters have found this a particularly challenging cycle because it has been anything but ordinary. The pandemic caused a huge amount of disruption, and also caused different sectors of the economy to become out of sync with each other. This was also the case with different regions of the world, notably the US and China, which re-opened from the pandemic at different times. On top of this, governments injected significant money into the economy, which was unprecedented in peace time. All of these factors have meant that traditional business cycle analysis have not worked for this cycle.

The large injection of money into households and businesses during the pandemic worked well to limit lasting economic damage but came with the side effect of inflation. Inflation in the US has fallen from 9% to around 3% and this falling rate of inflation over the last 18 months has been a helpful tailwind to growth. Growth outside of the US has not been as strong and the UK tipped into recession in the second half of last year. However, this was a mild contraction and growth has picked up in the early part of 2024.

For much of last year, the rally in equity markets was concentrated in a small number of Large Cap Technology companies. However, in November, favourable inflation readings and a pivot from the Federal Reserve suggesting lower interest rates may be on the horizon, helped the market broaden out. Economically sensitive sectors such as Financials and Industrials outperformed in the first quarter, while defensive sectors such as Utilities and Consumer Staples lagged. In the first quarter we reduced our exposure to Staples from Overweight back to a benchmark weight. Staples companies fared very well through the period of high inflation, as they were able to pass costs onto consumers, but this pricing power has now waned which is putting pressure on profits. On the other

9%

The percentage peak of US inflation.

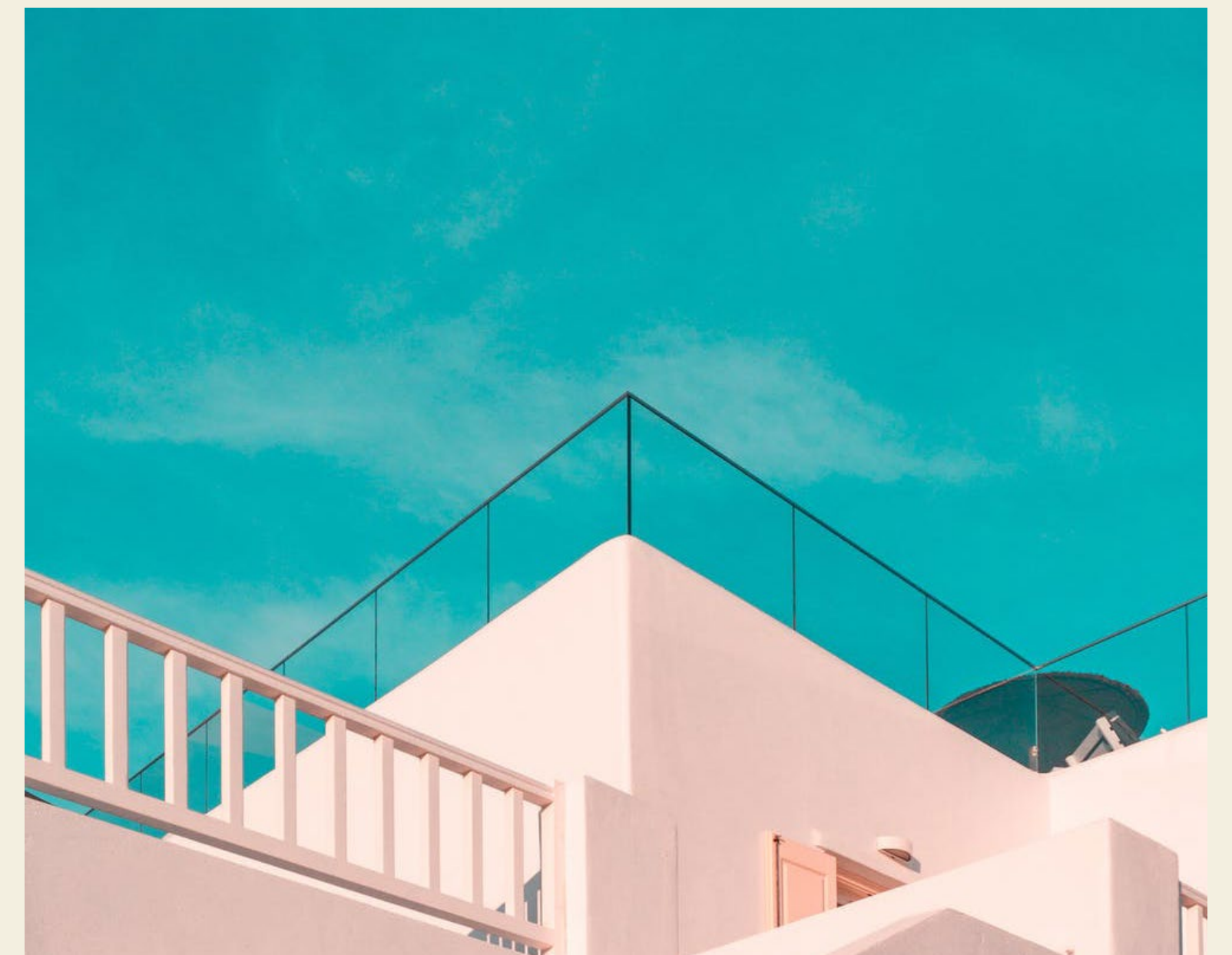




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hand, the valuation of the Energy sector is attractive and provides a good hedge against geopolitical risk and inflation so we have increased exposure here.

Alternative investments have been good diversifiers in bond and equity portfolios in this period of high inflation. The eventful economic and market backdrop has given Hedge Funds opportunities to make money in both rising and falling markets. Commodities have also had a low, or even negative, correlation to other assets; gold has benefitted from central bank buying and agricultural commodities have also provided good diversification. For example, the price of Cocoa rose 180% in the first quarter due to tree diseases and excessive rainfall in West Africa. We remain modestly underweight equities based on expensive valuations and stretched sentiment, but including our Alternatives allocation we are around neutral on an overall portfolio risk basis.



The Underwhelming Case for Cuts

- Improved global growth and sticky inflation drive down rate cut hopes
- US dollar gains on tighter policy expectations; Yen, Franc weaken
- Japan's pace of normalisation underwhelms expectations

During the first quarter, global fixed income markets grappled with a cocktail of improving economic growth, rising oil prices and sticky inflation readings. This was a challenging backdrop for bonds given that the year started with the expectation of multiple interest rate cuts. In the US, the Federal Reserve's 'pivot' in December eased financial conditions at their fastest pace since March 2020, prompting the expectation of -168 basis points (bps) in base rate cuts by the end of 2024; a far too easy monetary policy mix for the US economy at this juncture. As this became clear, markets quickly re-priced to -80bps at the end of the quarter. This led to a sell-off in most developed bond markets, with yields rising to levels not seen since early



December, although the moves were surprisingly gradual and as a result overall fixed income volatility actually declined. The MOVE index (a measure of fixed income volatility) fell to 86 from 115, which lead to an increase in risk taking appetite within credit and equities.

Global bond yields rose over the quarter, driven for the most part by rising inflation expectations, as 2-year breakeven inflation rates (the compensation for inflation risk) reached 2.72%. This is consistent with core US PCE (the Fed's favoured inflation measure) of around 2.5%. With inflation expectations at the longer part of the yield curve relatively well contained, the market appears to have accepted roughly a 3-year period of above target US inflation, followed by a return to the 2% target thereafter. With core US inflation sticky at 3-4% and an election approaching, US policy makers, emboldened by their dual mandate, clearly want to ease interest rates in order to protect employment and therefore remove themselves from the political debate. However, the overall US economy remains too buoyant for any cuts at this stage, which raises the risk of another period of volatility for bond markets, as we experienced last October.

We are currently seeing a broad recovery in economic growth, with China, Europe and the US (the major engines of growth) all rebounding. If we combine these trends with dynamics in other economies, the inflation and macro impulse is rising almost everywhere. This is a direct challenge to the broad expectation of interest rate cuts which has been priced into markets this year. Accelerating global activity and tight supply helped to push oil prices up 16% to \$83 per barrel and US gas prices to an average of \$3.54 a gallon. This will compound sticky inflation further over coming months and potentially impact consumer confidence leading up to the US election.

16%

The percentage that the oil price rose the first quarter.

Expectations of tighter US monetary policy drove the US dollar to an average 3% gain, with larger appreciation seen versus the Japanese Yen (up 7.3%) and, the Swiss Franc (up 7.2%) following a surprise rate cut. In Japan, despite ending negative interest rates and raising base rates for the first time since 2007, policy makers disappointed markets with the prospect of a slower pace of interest rate normalisation.

The sharp rise in inflation expectations led to a decline in short dated US real yields, which boosted risk appetite. However, longer dated nominal yields rose by 30-40bps across most regions, leading to small mark-to-market losses, but coupon income cushioned this somewhat. Bucking this trend was Australia, China and Switzerland, where the outlook for inflation and growth remains relatively weak.

Our portfolio positioning has been defensive in terms of credit risk but, with a correction in risk assets remaining elusive, in our US dollar bond funds we are opportunistically adding to investment grade credit where we are rewarded for the risk.

Global liquidity, however, is tightening at a rapid pace and the odds of the Federal Reserve remaining on hold for the whole of 2024 continues to be under-priced, hence we are tactically ready to de-risk at the first sign of market stress. Duration positioning is very dependent on the region with large deviations between economic outlooks; we are overweight Europe, with underweights to Canadian, UK and US long dated bond markets in various degrees, as the risk from higher term premiums this year dominate and correlations with the US remain high.

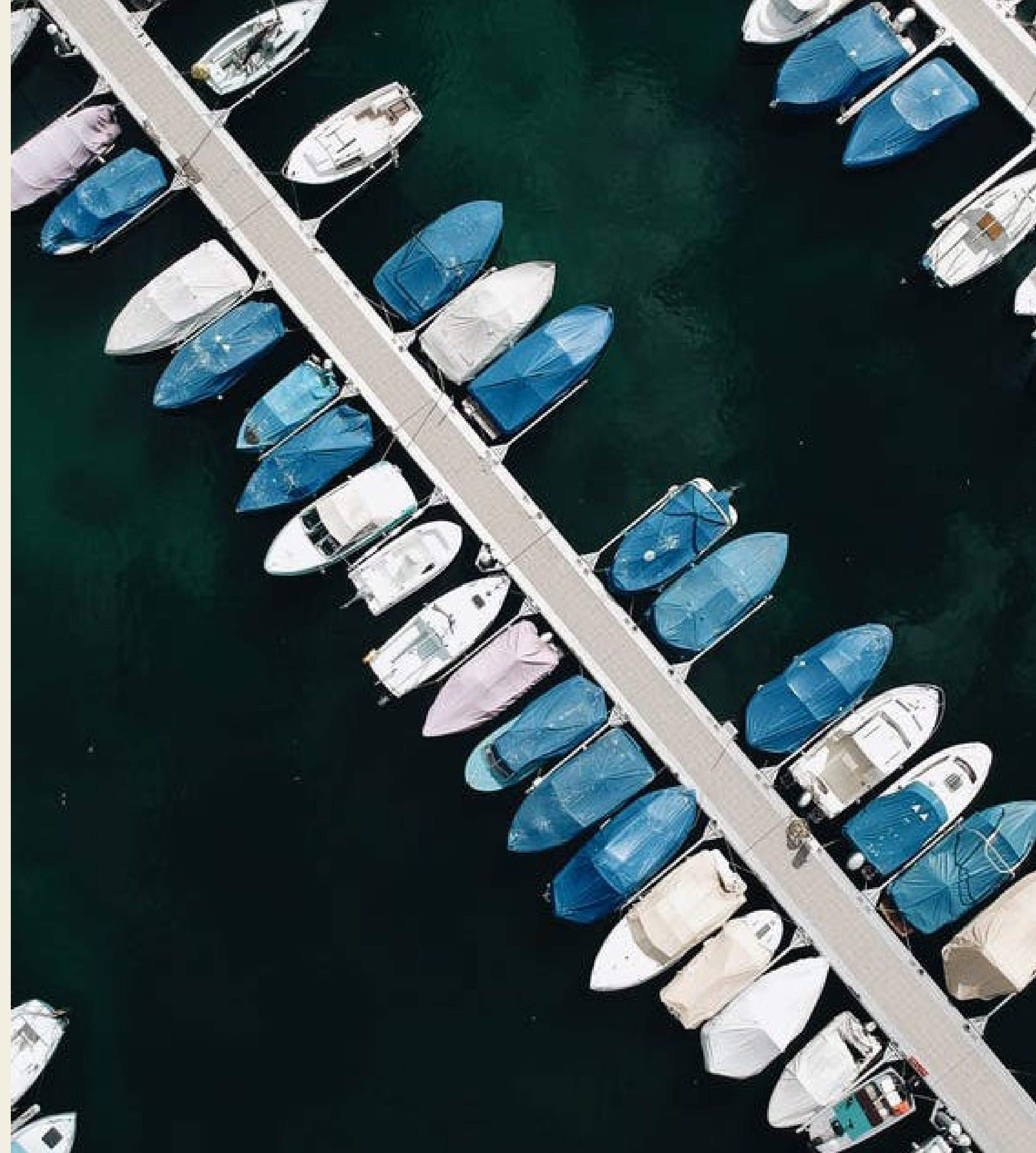
A strong quarter with low volatility

Japan and US markets lead the way

- Equities are expensive but not in bubble territory
- Cyclical outperformed defensives

The MSCI World index rallied 9% this quarter, the best first-quarter performance in five years, with the S&P 500 closing at record highs 22 times during the quarter. Artificial Intelligence (AI) optimism and the reacceleration of global growth helped propel the markets forward, with the rally broader this time around but with the equal weight S&P 500 still underperforming the S&P 500. March was the fifth consecutive positive month and volatility has remained remarkably low.

With many year-end S&P 500 targets published by Investment Banks reached in the first three months of the year, expensive valuations, and surprisingly low equity volatility, it has been an unusual period of smooth sailing for equities. The S&P 500 is trading at 21x blended forward earnings, a 17% premium to its



ten-year history. The equal weight index is trading at 17x, only a 3% premium to its ten-year history. The question is will we have a catch-up or a catch-down? At 21x blended forward earnings the S&P 500 is expensive, but it is not in bubble territory. Over the last ten years the S&P500 has traded as high as 23x blended forward earnings, a 10% increase in returns from the current multiple. However, given the historical volatility of equities, these potential returns compared to the less riskier returns available in some other asset classes, makes equities a less favourable risk/return proposition. For this reason, we are positioned modestly underweight at present.

As expected, growth stocks beat value stocks in the first quarter with the Technology and the Communication Services sector (Alphabet, Meta) leading the charge. Energy, Financials, and Industrials also performed well. Energy prices rallied 22% as geopolitical tensions and strong demand drove prices higher. Large capitalisation banks outperformed regional banks, as expected interest rate cuts unwound and the cracks in Commercial Real Estate reappeared. Industrials pushed higher as global growth reaccelerated.

The weakest sectors were Real Estate and Utilities, interest rate sensitive sectors which have been negatively impacted by the shift to the higher-for-longer environment. The Russell 2000 (small-cap to mid-cap companies), which is also sensitive to interest rate expectations, underperformed the S&P 500 index. Consumer Staples and Materials also lagged, as the bond yield proxies (Consumer Staple stocks) remained unattractive in the current high yield environment and Materials continued to grapple with a stuttering Chinese economy.

The best performing countries this quarter were Japan and the US, with the former benefitting from policy tailwinds and the latter benefitting from AI and robust growth. In local currency, Japan was up 19%. Europe also did well, with the blue-chip names outperforming. The EURO STOXX 50 index consists of Europe's



largest 50 stocks and includes some of the GRANOLAS (GSK, Roche, ASML, Nestlé, Novartis, Novo Nordisk, L'Oréal, LVMH, AstraZeneca, SAP, and Sanofi). This is Europe's answer to the Magnificent Seven (Apple, Alphabet, Amazon, Meta, Microsoft, Nvidia, Tesla) according to thought-provoking research by Goldman Sachs. This large-cap focused index outperformed the EURO STOXX 600 index, which includes smaller companies, by 5%. In local currency, the EURO STOXX 50 returned 13% year-to-date.

The weakest regions were Asia Pacific ex Japan, with Australia lagging and Emerging markets with China languishing. As China's woes continue, many investors have been reviewing the long-term prospects of investing in China. Earlier this year we cut our exposure to China by investing in Emerging Markets excluding China, preferring to take a more targeted approach to Emerging Markets.

As we enter the first quarter earnings season, the market will focus on whether companies can continue to beat earnings estimates and whether valuation multiples can continue to expand given their already elevated levels.



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Global Asset Allocation

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

	UNDERWEIGHT -	+ OVERWEIGHT
Asset Allocation	<div>EQUITIES (MODEST UNDERWEIGHT)\$</div>	<div>CASH (MODEST OVERWEIGHT) NON-TRADITIONAL ASSET CLASSES (MODEST OVERWEIGHT)</div>
Fixed Income		<div>EMERGING MARKET DEBT INFLATION PROTECTION</div>
Equities Regional		<div>JAPAN EMERGING MARKETS EX CHINA</div>
Equities Sector	<div>CONSUMER DISCRETIONARY UTILITIES</div>	<div>ENERGY HEALTHCARE</div>

