

Investment Views July 2024

Strategy:

Goldilocks Still Walking the Tightrope

Fixed Income:

The Global Rate Cut Cycle is Underway

Equities:

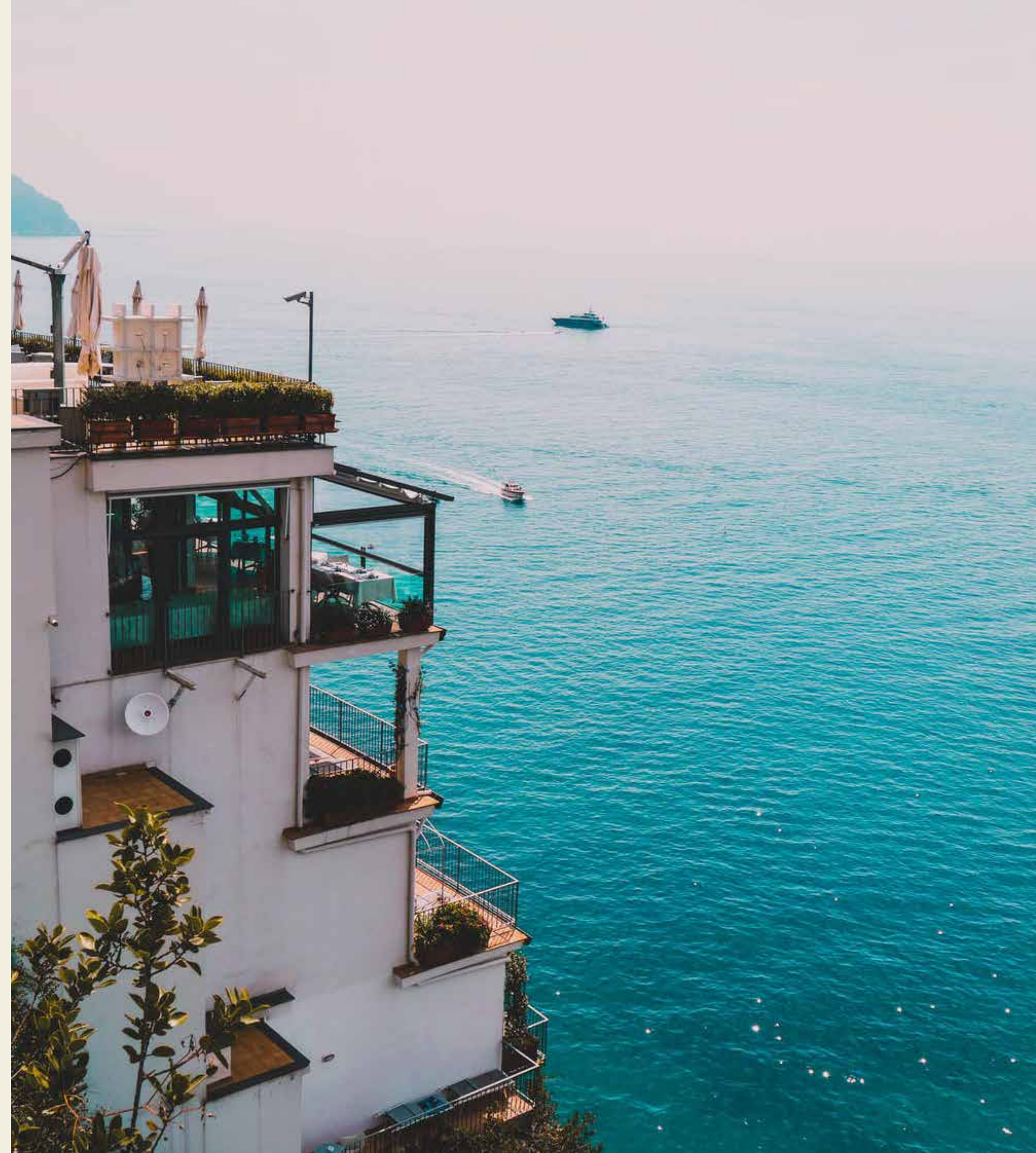
New Highs Driven by Artificial Intelligence

Goldilocks Still Walking the Tightrope

- US economy has slowed a little
- Stability in bonds has been supportive for equities
- Politics is in focus around the world

The second quarter was another eventful one in financial markets. Short-dated bonds generated small positive returns, helped by slightly weaker economic growth in the US and interest rate cuts in the Eurozone and Canada. The combination of resilient economic growth and above-target inflation had cast doubt on whether the US would be able to cut interest rates. However, the stabilisation in bond markets was welcome and supportive for equity markets. The MSCI World returned 2.6% in US dollar terms but only one third of the stocks in the index outperformed the market return.

The US economy continues to operate in a sweet spot where growth is holding up sufficiently to avoid recession, but not so strong that it is re-igniting inflationary pressure. This “goldilocks” environment



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is one that central banks were hoping for even though history suggested it would be very difficult to achieve. The balancing act of getting inflation closer to 2% without a recession has been akin to walking a tightrope. Raising interest rates so significantly in such a short period of time elevated recession risks, but conversely, there was a risk that inflation expectations become embedded in the system. Currently, the situation is finely balanced.

While the economic and inflation outlook was in focus during the quarter, politics was also a notable theme. Around 64 countries have already, or will be, holding elections this year, accounting for almost 50% of the world's population. Historically, domestic politics is very important for investors in Emerging Markets (EMs), but much less so in Developed Markets (DMs). EMs tend to have fewer checks and balances on political power and therefore have a more volatile policy environment. Politics therefore tends to have greater scope to shape economic outcomes. In contrast, more stable policy in DMs has meant that other economic factors have dominated domestic policies. For example, in the US, the stock market has historically performed a little better under Republican administrations, but there has been no meaningful difference in economic growth under either Republican or Democrat administrations.

Recent years have seen the lines between DMs and EMs become blurred. This trend started in 2016 when the UK voted to leave the European Union, followed shortly thereafter by the US election of President Trump. In this environment of heightened political volatility and increasing polarisation, the run up to major elections has the potential to drive market narratives to a greater degree than has been witnessed for much of the last 30 years.

India and Mexico are two countries which performed well in the two years through the end of the first quarter; rising 16.0% and 33.6% respectively, well ahead of the MSCI Emerging Market Index. India has benefitted from a large infrastructure buildout, growth in

50%

The percentage of the world's population holding elections this year.





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services, inward investment and favourable demographics. Mexico has benefitted from their proximity to the US and near-shoring of manufacturing away from China. Both countries had elections in the second quarter. Indian equities fell 6% as Prime Minister Modi stayed in power but failed to achieve an outright parliamentary majority. The losses were soon reversed and equities then went on to new highs. In contrast, a political shock in Mexico, with a decisive victory for the left-wing Sheinbaum, saw equities fall around 15% in US Dollar terms. Unlike India, losses were not quickly reversed.

Turning back to the West, elections in the US and UK have been well reported, but a hastily called election in France came as a surprise. With inflation still above target, levels of government spending are a key focus for investors when it comes to politics. However, there is a lot of uncertainty around this due to the lack of specifics in many of the policy proposals. Stability is also important for investors and the economy more broadly. In the UK, Alex Baldock, chief executive of electronics retailer Currys Plc, recently remarked that “wild swings in policy, interest rates, currencies, regulation aren’t helpful”.

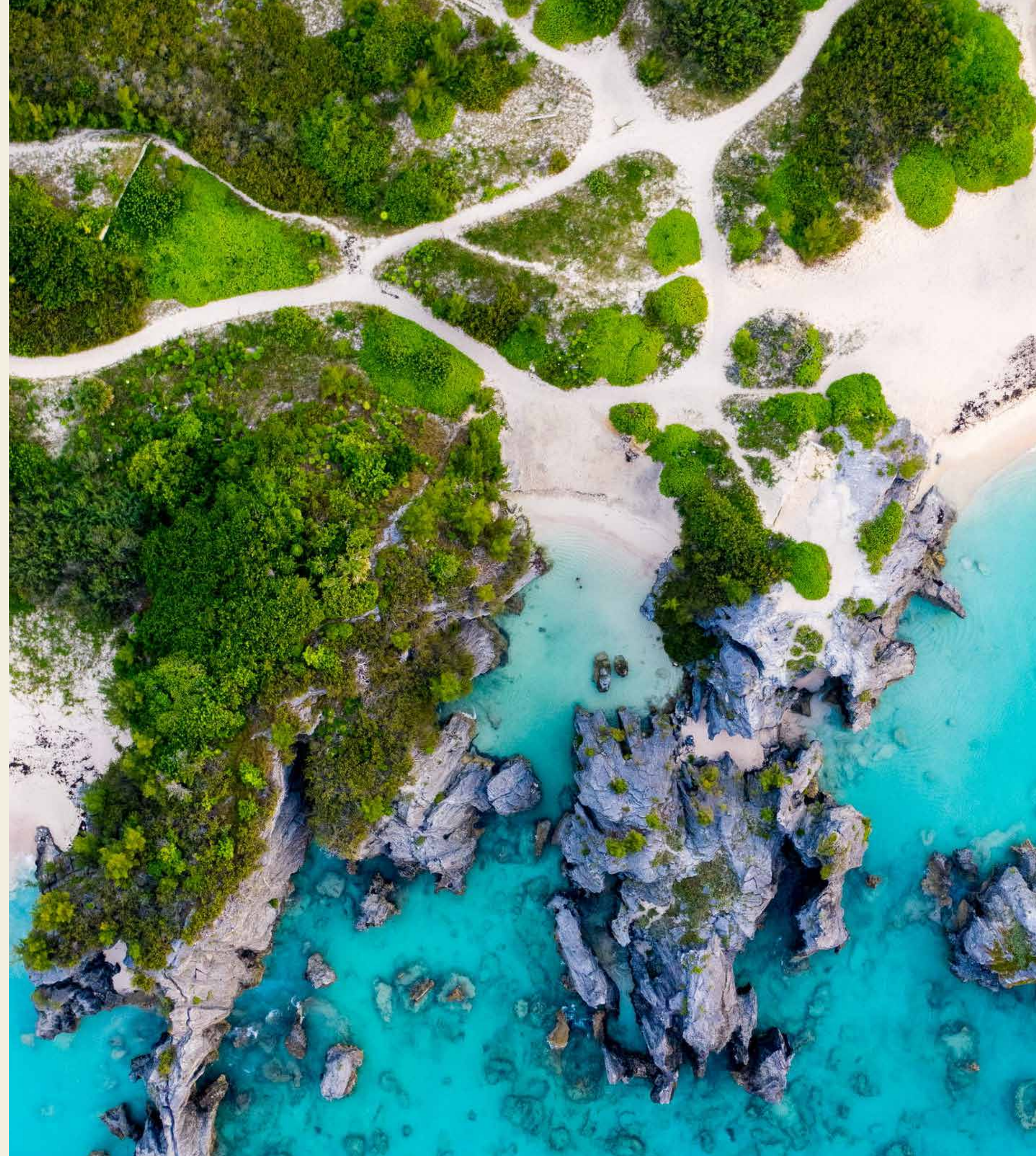
Against this backdrop, the correlation between bonds and equities has remained positive, meaning that bonds are not offering the same diversification benefits as they have done in the past. Alternative investments have therefore been helpful allocations in those investment portfolios, where they can be held. Hedge Funds are well placed to benefit in this market environment. Gold is benefitting from geopolitical risks and commodities have also been good diversifiers.

The Global Rate Cut Cycle is Underway

- Many global central banks have now cut interest rates
- The US and the UK are more hesitant to cut rates
- Corporate bonds are expensive relative to government bonds

Fixed income markets were mixed in the second quarter, with short-dated US treasuries generating small positive returns, whereas longer-dated bonds saw small losses. Corporate credit spreads (the premium companies pay to borrow over governments) remained stable, with small gains in April and May offset by a slight widening in June. Investment grade bonds therefore performed mostly in line with treasuries, while high yield bonds fared a little better. Emerging Market bonds lagged, especially local currency bonds, with Brazilian and Mexican bonds in particular performing poorly.

Investors have continued to closely follow central bank projections and speeches from the respective governors to assess



the likely path of interest rates. In early June, Canada became the first G7 country to cut interest rates from 5.00% to 4.75%. Like almost all other countries, Canada suffered from a period of high inflation, which peaked in 2022. Since then, the inflation rate has fallen from 8% to 2.9%. While inflation is still elevated, policymakers felt they had the latitude to cut rates a little to support economic growth.

The Swiss National Bank also cut interest rates in the second quarter, lowering them from 1.50% to 1.25%. This was the second cut in the cycle after they cut from 1.75% to 1.50% in March. In Sweden, interest rates were also cut in May. With the global rate cutting cycle underway, the Eurozone followed suit, with the European Central Bank cutting interest rates from 4.5% to 4.25%. In this cycle, Emerging Market economies were the first to increase interest rates and then the first to cut interest rates. Many countries suffered from the pandemic period in a fairly synchronised way, but more recently, we have seen more dispersion between different regions. Country specific factors have been playing an increasingly important role in the outlook for interest rates, rather than global factors.

Japan has been an outlier in the global interest rate cycle for many years. They did not raise interest rates in the 2022-2023 period when almost all other major central banks hiked rates. After years of deflationary pressure, an inflation boost was a more welcome development, shifting the mindset in Japan and allowing wages to rise. However, interest rate differentials between Japan and the rest of the world reached an unsustainable level and the yen has depreciated materially. While other central banks have been cutting rates, Japan actually increased rates from -0.1% to 0.1% in March. However, this has been insufficient to stem currency weakness and the yen was the weakest currency in the G10 in the second quarter, depreciating by 5.9%.

2.9%

The percentage of the inflation rate in Canada.

The Federal Reserve continues to be key given the importance of the US dollar in the global financial system. The Fed has moved from a position of being very concerned about inflation to now being more balanced with the risk of growth slowing too much also a consideration. They have so far resisted calls to cut rates on the basis that inflation is still above target. Goods inflation has normalised, but services are a large part of the economy and inflation there is still elevated. However, their recent forecasts suggest that the Fed is preparing for an interest rate cut later this year and possibly four cuts of 0.25% next year.

A notable development in the quarter was that the Congressional Budget Office revised up their projection for the US federal deficit this year. They now forecast a \$1.9 trillion deficit, which is \$400bn (or 27%) larger than the agency estimated in February. This would represent a deficit of around 6.7% of GDP, which is particularly high for an economy not in recession. Elevated government spending has created a more challenging backdrop for fixed income due to the increase in new issuance of government debt.

In terms of corporate bonds, the spread over government bonds remains very tight so investors are not well compensated for taking credit risk instead of holding government bonds. BCA Research estimate that current level of corporate spreads is pricing in a 35% decline in the default rate over the next 12 months. Such a decline is unlikely even in a resilient economic backdrop and if the economy were to tip into recession defaults would pick up significantly. On this basis, we remain defensively positioned in credit and await better buying opportunities while earning attractive levels of income from holding government bonds.

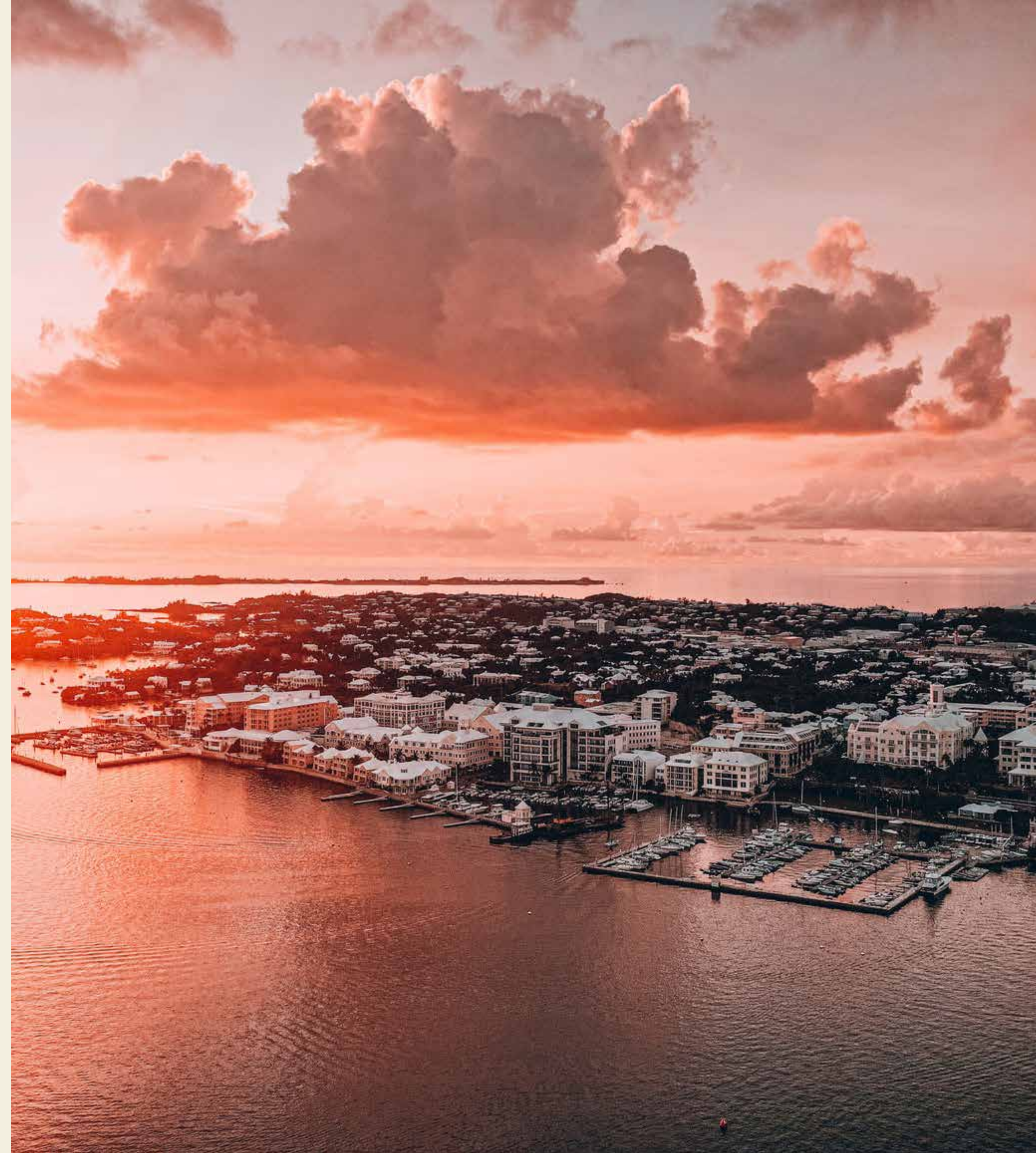
New Highs Driven by Artificial Intelligence

- Nvidia briefly becomes the world's largest company
- Market concentration has become a challenge for investors
- Earnings growth has supported equities

The second quarter was a positive one for global equities, with the MSCI World returning 2.6% in US dollar terms, although there was a lot of dispersion under the surface at both a sector and geographical level.

After lagging in the first quarter, Emerging Markets bounced back and led the way, returning 5.1%. US equities also performed well, returning 4.3%. Japanese equities were weak after a strong first quarter, falling 2.4% in dollar terms, but rising 3.5% in local currency yen terms. European equities were positive for the quarter through the end of May, but gave back gains in June, dragged lower by political risk in France to finish the quarter flat.

Information Technology was the best performing sector, helped



by semiconductors, particularly Nvidia, while Apple also rallied. Communication Services performed well, helped by Alphabet (Google) and Meta (Facebook), which are large sector constituents and benefitted from exposure to the Artificial Intelligence (AI) theme, which was a strong driver of performance during the quarter.

Another beneficiary of the AI theme was Utilities, which was the third best performing sector. Utilities is not typically an exciting sector, but data centres and AI tasks are very energy intensive, so the sector has been in focus after a long period of weak sentiment.

While the S&P 500 returned 4.3% in the quarter, the Equal Weight S&P 500 fell 2.6%. This represented the third largest quarterly outperformance for the market-capitalisation weighted index in data going back to 1990. The only two quarters with wider outperformance were in the fourth quarter of 1999 (the dot-com bubble) and the first quarter of 2020 (the onset of the pandemic). Not only was the spread wide, but the fact that the performance was directionally different is notable. Of the top 10 occurrences, which includes the pandemic, the Global Financial Crisis, and the Gulf War, four occurred in this late 1990s period and three have happened in the last 18 months.

Nvidia was again the standout stock in the quarter, retuning 36.7%, which took its year-to-date return to a remarkable 149.5%. It briefly became the largest company in the world, overtaking Microsoft and Apple, before weakness late on in the quarter lowered the weighting back to being the third largest company. Nvidia is at the centre of the AI revolution and providing the market leading chips with the computing power, architecture and precision for the deep learning tasks involved in AI. Such a meteoric rise has drawn comparisons with the dot-com bubble, and specifically Cisco Systems, the telecoms network which provided the infrastructure for the Internet build-out and briefly became the largest company in the world in 2000.

The comparisons have some merit, but there are also important

4.3%

The percentage that the S&P 500 returned in the quarter.

distinctions. Many of Cisco's customers were using leverage to fund their technology spending, whereas Nvidia's largest customers are the hyperscale cloud providers such as Microsoft, Meta, Alphabet and Amazon. All of which are highly profitable companies. Furthermore, Cisco's valuation peaked at a price-to-earnings ratio (P/E) of over 100x, whereas Nvidia's current P/E is closer to 45x. During the mobile internet cycle in the first half of the 2010s, semiconductors took an early lead. Then as the mobile internet became more mainstream, infrastructure and devices participated, with Software and Services being the last. It's quite possible that the AI theme will evolve in a similar way, so this is something we are focussing on.

The rise of these mega-cap technology companies has left the US equity market more concentrated than it has been for decades. The top ten stocks account for 34% of the index, which is a challenging environment for active managers. Given the concentration of returns in the mega-caps, only 33% of the stocks in the MSCI World equity index managed to outperform during the quarter. Regulatory constraints around portfolio concentration have meant that some funds have not been able to replicate this exposure, which has been a headwind. This concentration is a reflection of success but also comes with risks, which provides a conundrum for investors. Our exposure to these mega-cap technology names varies across mandates but, overall, they have been strong drivers of portfolio returns.

On a regional basis, investor sentiment became a little stretched in Japanese equities and weak economic data saw Japan underperform during the quarter. The weakness of the yen has been a mixed blessing. It has made the country very competitive and exporters have benefitted, as have visitors to Japan. On the other hand, it has been a challenge for Japanese consumers and policymakers. At a global level, corporate earnings have picked up, which has supported equities. The bar for further positive earnings surprises is high, but assuming the US continues to avoid recession, earnings should remain well supported.

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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>

