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Keeping you informed matters

Economic review

July 2023

Outlook

Market performance over the quarter has been somewhat at odds with the underlying reality. Observed behaviours in equity markets in particular have diverged from the economic conditions that typically influence performance, with conflicting data confusing investor sentiment and outlook.

Investors have experienced a strange quarter. In the past few months, Credit Suisse and a series of US banks have failed; policy interest rates have gone up and company profits have fallen… and yet risky assets, such as shares, have risen (on average, at least). How can this be?

Investing is often confusing because it's not so much real-world events that move asset prices, but how expectations develop. At the start of the quarter, investors probably expected a global economic recession, falling company profits and an inflation problem. Instead, they got a more resilient US economy than feared, company profits that fell only a fraction, signs of diminishing inflation (less so in the UK though) and now hope that consumer prices will soon stabilise. As a result, expectations have brightened somewhat, and risky asset prices are higher.

There was also a positive surprise with the public release of ChatGPT, a generative artificial intelligence (AI) tool that has sparked the public's imagination. AI-related stocks such as Nvidia have soared to staggering size and valuations, in what might be the start of a new era in investment, or could simply be a speculative frenzy.

Companies and investors wonder whether AI can boost profitability, or instead crush whole industries. For example, who needs textbook publishers when essays can be written by AI? As an aside, here's a question for readers: "do you really think this client report was written by a human?"

Something else that was unanticipated has been the actions of central banks. Around the world, major central banks are raising policy interest rates in full public view, in an attempt to control inflation. Rising rates are usually associated with less liquidity, which is often unhelpful for risky asset prices. But companies like CrossBorder Capital, who measure global liquidity and compile 'liquidity indices' have been reporting higher liquidity in the last nine months or so. So, what is going on?

Although central banks have a mandate to control inflation, and need to be seen to be tackling their inflation problem, they have an unwritten mandate to maintain confidence in financial markets, or at least to avert crises. It seems that the UK 'gilts crisis' last October, and then the US banking crashes in March and April led central banks to provide large-scale liquidity to financial institutions, in an attempt to prevent a financial crisis.

The US Federal Reserve (the 'Fed'), for example, has increased its balance sheet by buying bonds – an action that stimulates financial markets. And speculators, now flush with liquidity and confident that there will be no financial crisis, seem to have gone back to… well, speculating. AI has provided the catalyst, or 'story', to back up much of the risk taking.

If changes in expectations drive markets, can we then predict how expectations are likely to develop in the next few months? We would like to know about consumer prices and inflation, the possibility of recession and the likely actions of central banks, amongst other things. Do we have any insights about these that other investors might be missing?

We can see that producer price inflation (the price of commodities and wholesale goods) in many countries is falling sharply, and this gives hope of lower inflation soon. Headline consumer inflation is already falling in Europe, the USA and UK, albeit from uncomfortably high levels. Is this the end of the inflation shock, or do we remain in a regime of more volatile inflation? It's still too early to disprove either view yet.

Some forces that might push up medium-term inflation include war (including trade wars), repeated largesse from governments and central banks at any

sign of social or financial stress, and the huge additional spending needed to continue with the energy transition. On the deflationary side is technology, digitisation, robots and AI, which could lead to lower prices as productivity benefits from new processes. With other factors, such as demographics and social inequality, it's less obvious how changes here will affect inflation.

On balance, we'd expect (along with most other folk) that inflation falls in the near-term, but we'd be more nervous than most about the medium-term outlook – the inflationary drivers look to have grown. The impact of AI is the wildcard.

We really don't know any more about the economic outlook than anyone else. The 'consensus' economic forecast says that a recession is probable in the next 6-12 months. Why? Well, interest rate rises tend to slow economies with a lag, and the recent sharp interest rate rises deter banks from lending quite so readily. We can already see negative economic data surprises in China and the EU, and global manufacturing (but not services) leading indicators are weak and falling.

Shares can perform well just ahead of a recession, but tend to fall once investors start expecting the lower earnings that come with recessions. Government bonds usually perform well as 'safe havens' when recessions arrive, and also benefit when expectations start focusing on lower future interest rates.

What about the actions of central banks? Although the Fed boosted its balance sheet (and with it, global liquidity) to stop the US bank collapses from cascading out of control, it's clear that central banks need to return to their knitting, so to speak, and get core inflation under control. And yet consensus has, for well over a year now, expected interest rate cuts just around the corner. Expectations here are probably still too sanguine, and might need to be adjusted to 'higher for longer'.

This environment seems to favour government and high-quality bonds over equities. However, some equity markets, for example Japan, the UK and emerging markets, seem inexpensive and already reflect much gloom. So too do some commercial property assets. This seems like a good time to be well-diversified and to consider how the portfolios might fare under a variety of scenarios. When we look at the portfolios we have built for clients, we can see that they are indeed well-diversified, holding sensibly-priced, good quality assets. This will almost certainly serve clients well over the long-term, and should provide relative resilience over the near-term, even if markets have to contend with higher interest rates and a recession.

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Key facts about the world

United Kingdom

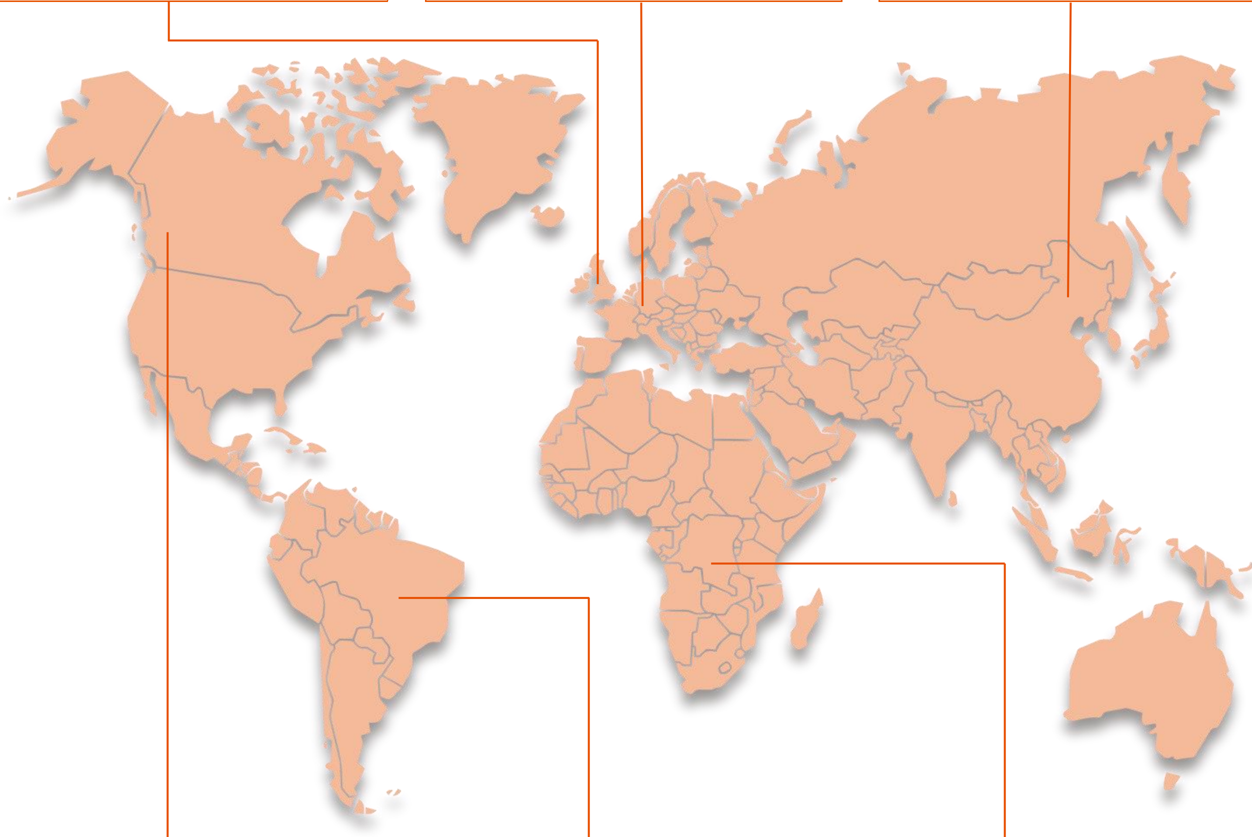
- Headline inflation at 7.9% is highest in G7 and proving more persistent, with Core inflation at 6.9%
- In June, house prices fell at fastest rate since 2011, down 2.6% to an average of £285,932
- Markets are pricing in UK interest rates of 6.5% by March 2024

Europe

- Eurozone inflation fell to 5.5% in June, the lowest since the start of 2022, but Core inflation sticky at 5.4%, up from 5.3% in May
- Prigozhin's Wagner Groups failed insurrection demonstrates the difficult and unstable situation Russia is currently facing, at home and in Ukraine

Asia

- Pan Gongsheng appointed as new head of People's Bank of China, as Chinese economy on the brink of deflation
- China CPI was 0% in June, amidst a weaker than expected economic recovery, with falling property prices and exports
- Japan's Nikkei 225 - the second best performing Index this year, up 27%, only behind the NASDAQ



North America

- US jobs gained 497k in private sector in June, double what was forecast, increasing expectations for 0.25% rate hike at next FED meeting in July
- Real yields (after inflation deducted) on US Treasuries rose to 1.82%, the highest level since 2009

South America

- Brazil inflation under 4%, down from 13% a year ago – interest rates since Aug 2022 remain high at 13.75%
- Argentina faces deepening financial crisis, with annual inflation at 114%, and interest rates at 97%. The country has been cut off from international markets since its 2020 debt default

Africa

- EU agrees to provide Tunisia >€1bn to aid economic crisis and stem flow of migrants
- DR Congo state mining believes country has lost the opportunity to leverage dominance of cobalt market
- DRC produced 73% of global cobalt last year, forecast to be 57% by 2030, as prices fall 65% in just over a year

Q2 Performance Review – Unconstrained strategies

Key facts

- Bond yields rise further as inflation more persistent and markets price in expectations of higher interest rates
- Artificial Intelligence theme drives markets, with the Nasdaq 100 posting 39% gains year to date, the best first half of a year in its history
- Japanese markets move to highest levels in 30 years, despite many investors remaining underweight the region
- Many assets have already priced in a recession and are well positioned for recovery

As the inflation outlook showed signs of slowing it allowed policymakers the chance to pause, or at least consider pausing, interest rate hikes. This provided temporary respite for assets such as longer dated bonds, property and commodities, but unfortunately the release of stronger economic data in the US and persistent inflation in the UK, meant markets again reflected the pessimistic outlook for growth in these sectors.

Holdings such as the L&G Index Linked Gilt fund (-8%), Balanced Commercial Property Trust (-18.5%) and the BlackRock Natural Resources (-6.9%) all had a very weak quarter and despite encouraging performance from other areas of the strategies, combined to leave them behind target.

However, these same assets now offer an attractive entry level based on our expectations going forwards and we are retaining the exposure for recovery. We believe that bond markets are pricing in significantly higher interest rates than many forecast, which should limit the yield rises from here and position them for a strong rebound when inflation finally settles. The common view, as we have held for some time, is that central banks now take rates too far, creating a mild recession in the US and a worse one here in the UK. Government bonds tend to perform well in this environment, as can real assets like property and commodities as you come out of a recession. This also extends to the smaller company exposure within strategies, that although under pressure now, historically recover ahead of their large cap peers from the depths of a recession as growth returns.

Positive performers this quarter have been anything exposed to the narrow market in the US where the five big tech companies (Apple, Microsoft, Amazon, Alphabet, and NVIDIA) which now make up c25% of the S&P 500 by market capitalisation, and including Meta and Tesla, have accounted over c88% of gains year to date. The Natixis Loomis Sayles US Equity Leaders fund (+12%), a core position in portfolios, has Nvidia, Meta, Visa, Microsoft, Amazon, Tesla and Alphabet in its top 10 holdings with a combined weight of c40% of the fund. The Regnan Global Equity Impact Solutions (+4.2%) and Fortem Capital Progressive Growth (+2.3%) funds were also resilient as European markets were stable.

SECTOR	Q2 2023	1 year to 30/06/23	1 year to 30/06/22	1 year to 30/06/21	1 year to 30/06/20	1 year to 30/06/19	5 years (annualised)
IA UK Index Linked Gilts	-8.7%	-16.8%	-20.2%	-4.3%	11.2%	9.0%	-5.1%
IA £ Corporate Bond	-2.8%	-4.8%	-13.1%	3.5%	5.7%	5.6%	-0.9%
IA Property	0.6%	-12.1%	11.1%	1.1%	-4.3%	0.8%	-1.0%
IA UK Equity Income	-1.6%	4.0%	-0.5%	25.4%	-13.7%	-2.5%	1.8%
IA UK Smaller Companies	-1.4%	-5.7%	-22.6%	50.8%	-6.4%	-6.2%	-0.7%
IA North America	5.0%	11.9%	-3.7%	27.3%	8.5%	11.4%	10.7%
IA Europe Excluding UK	-0.1%	18.6%	-12.5%	23.8%	1.0%	3.3%	6.0%
IA Japan	2.9%	12.4%	-11.8%	13.1%	7.9%	-3.4%	3.2%
IA Asia Pacific Excluding Japan	-3.9%	-3.1%	-10.8%	26.9%	2.7%	4.3%	3.3%
IA Global Emerging Markets	-1.1%	-0.3%	-17.3%	28.3%	-3.3%	6.1%	1.6%

Source: Morningstar, bid-bid pricing. Net income reinvested. Past performance is not a reliable indicator of future results.

Q2 Performance Review – Ethical strategies

Key facts

- Inflation, rising interest rates and recession fears continue to dictate market sentiment
- Net inflows to sustainable investments continue two year decline from peak
- Energy security, political concerns, mixed performance and greenwashing take shine off investing sustainably and ethically
- Regulators continue to play catch up to reassure investors, with the UK's Financial Conduct Authority due to bring Sustainability Disclosure Requirements in the next year covering anti-greenwashing rules

With markets focused on inflation, interest rates and recession, you could be forgiven for thinking ethical and sustainable investing was no longer as popular. Indeed, fund flows over the quarter would have suggested the same as investors with FOMO (fear of missing out) focused on the big US tech names, Japan and unconstrained large cap equity growth strategies.

However, our ethical strategies have been very resilient over the quarter, performing in line with expectations outside of their inflation targets, where the focused fixed interest and equity exposure in developed markets and growth factors has been beneficial. Having no exposure to assets such as government bonds, commercial property or commodities, which are not within our ethical selection criteria, has avoided some of the worst performing areas over the three months.

The Regnan Global Equity Impact Solutions (+4.2%), Liontrust Sustainable Future Global Growth (+4%) and Janus Henderson Global Sustainable Equity (+3.8%) funds have contributed positively to overall performance. Recent addition, the BlackRock Sterling Environmentally Aware liquidity fund (+1.1%), also makes the list of top performers in these volatile markets as investors continue to balance the need for holding risk assets to achieve their objectives, with very low risk and low volatility cash-like investments.

One area of note is renewable energy, where despite the acknowledged need for huge investment in this area over the coming years, we have seen weakness in the Downing Renewables & Infrastructure Trust (-6.7%). Valuations broadly in the energy, energy transition and infrastructure space have softened. After a strong period of performance over the last few years, costs are currently rising at a faster rate than prospective revenues as inflation rises. Investors are also being deterred by unhelpful intervention in energy markets by governments, but despite this, we are still confident in the longer-term dynamics and prospect for the sector.

Looking forwards, as well as clean energy, core themes in the strategies include sustainable cities and communities, responsible consumption and production, climate action and clean water and sanitation.

SECTOR*	Q2 2023	1 year to 30/06/23	1 year to 30/06/22	1 year to 30/06/21	1 year to 30/06/20	1 year to 30/06/19	5 years (annualised)
Global Sustainable	4.9%	15.7%	-17.2%	35.6%	1.8%	4.9%	6.8%
UK ESG Enhanced	3.2%	14.3%	-12.9%	34.7%	-16.5%	-2.0%	1.9%
US ESG Enhanced	8.4%	19.0%	-13.4%	42.2%	8.6%	11.6%	12.2%
DM Europe Sust	2.7%	20.2%	-21.2%	38.5%	-0.7%	6.7%	6.8%
EM ESG Enhanced	1.1%	0.0%	-25.4%	34.1%	-5.9%	0.8%	-1.0%
UK Corp Bond Sust	-1.0%	-4.0%	-25.4%	14.0%	3.9%	3.2%	-2.6%
Global Corp Bond Sust	0.0%	1.7%	-17.1%	5.1%	6.3%	7.9%	0.3%
Global Green Bond	0.3%	-0.2%	-22.3%	5.1%	2.5%	5.3%	-2.5%
Global Renewable Energy	2.0%	10.8%	-11.7%	53.2%	-3.8%	9.4%	9.6%

Source: Morningstar sustainable indices, bid-bid pricing. Net income reinvested. Past performance is not a reliable indicator of future results.

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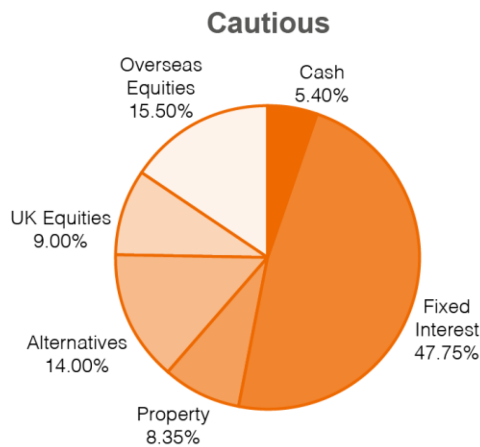
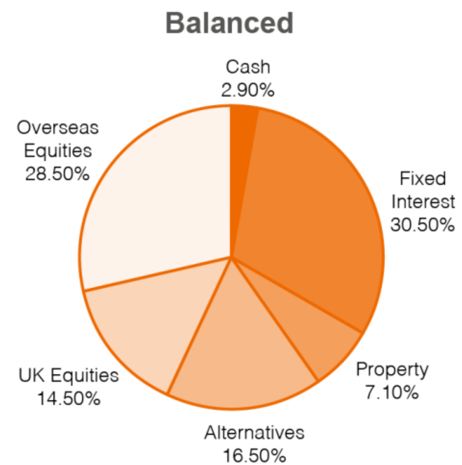
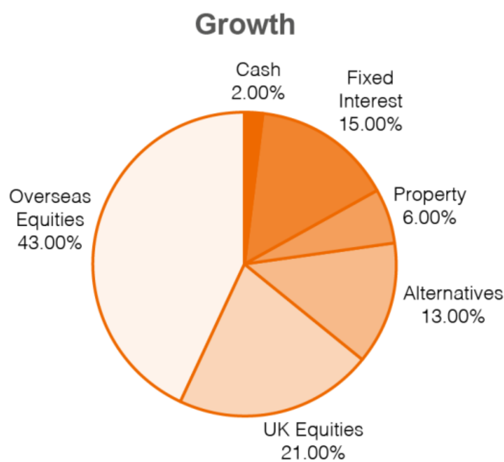
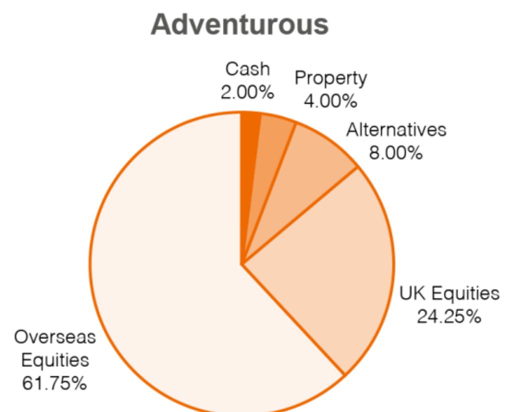
The positioning of our Unconstrained strategies

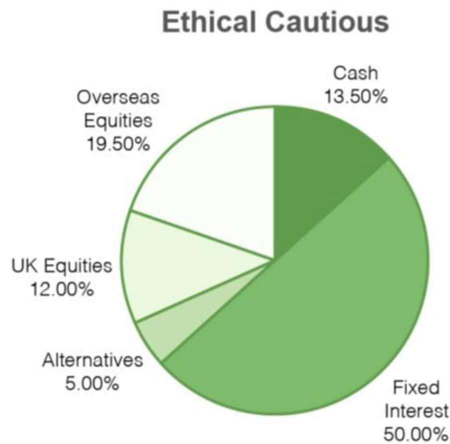


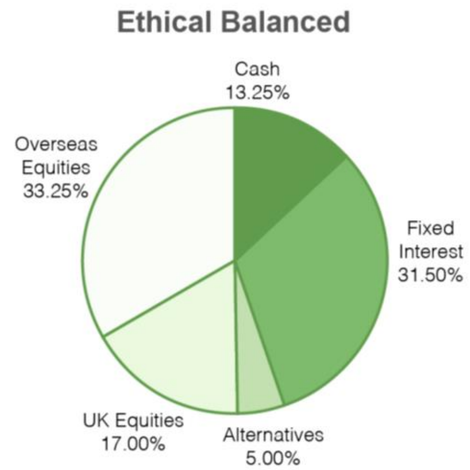


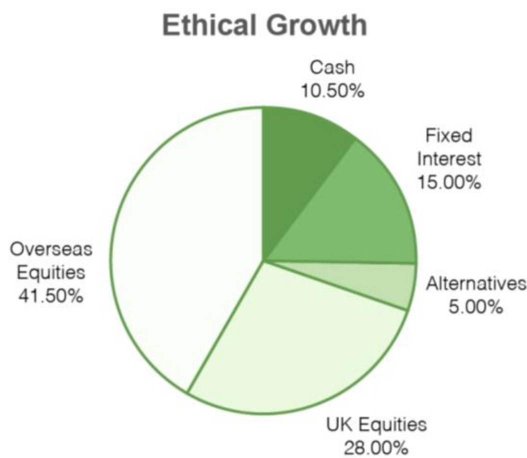




The positioning of our Ethical strategies







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