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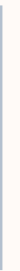
Investment Committee Series

Q2 Outlook - May 2024

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01

Introduction

Global growth remained resilient in the first quarter while inflation data proved much more challenging. Equities rose as investors shifted their focus from the current inflation challenges to improved growth prospects on the horizon. The stronger growth was driven by the US economy which continued to demonstrate its ongoing economic resilience with GDP growth remaining solid, labour market remaining tight and encouragingly, manufacturing data picking up.

Outside of the US, over the last 12–18 months we have seen economic weakness in different regions and sectors. Europe and the UK have been particularly weak, however over this quarter there were signs of improving business activity with the Purchasing Managers' Index (PMI) data and sentiment indicators edging higher. Likewise, the global manufacturing sector has been sluggish, but we are seeing signs of improvement. Rising Asian exports and this year's broad-based commodity rally suggests the manufacturing cycle could continue to recover and aid global growth.

While the improving growth environment benefited equities, it was challenging for fixed income investors. Persistent inflationary pressures in the US, driven by resilient economic activity, prompted a more hawkish stance from the US Federal Reserve (Fed). Market participants now expect fewer rate cuts from the Fed as inflation concerns gather, consequently fixed income yields were pushed higher. In contrast, the European Central Bank (ECB) has adopted a more dovish stance, as Eurozone inflation continued to make progress towards the ECB's target of 2%.

This divergent monetary policy stance from developed market central banks as different economies navigate varying inflation trajectories has been a key factor in currency fluctuations as evidenced in the dollar's strength due to rising US bond yields compared to peers.

Eren Osman
Managing Director,
Wealth Management



02

Decisions we made

Over the past quarter we have made six key changes to our portfolios. We have:

- Decreased our investment grade corporate debt
- Increased our equity allocation, focusing on attractively valued cyclical opportunities
- Increased our allocation to EU equities
- Within equities, we reduced our allocation to Japan in favour of European smaller companies
- Increased our allocation to commodities
- Increased our allocation to hedge funds.

“

During the previous quarter, we observed a differentiation between the drivers of the equity and bond markets. Equities have become more comfortable in a higher rate environment due to resilient global economic growth, prompting us to increase our equity allocation while reducing our investment grade fixed income exposure.”

Peter Doherty

Director, Head of Investment Research



Investment grade (IG) spread is extremely tight



*As at 31 March 2024.

Source: Bloomberg

Reduced our allocation to corporate debt and increased global equities through a sectoral allocation.

During the previous quarter, we observed a differentiation between the drivers of the equity market and the bond market. While sharp increases in yields have recently led to stock market weakness, equities have broadly become more comfortable operating in a higher rate environment, largely due to the resilience in global economic growth.

The increase in our equity allocation was funded by a reduction in the corporate debt allocation, particularly a reduction to investment grade (IG) fixed income. The additional compensation offered by IG bonds is at historic lows relative to government bonds, which reduces the scope for IG credit to outperform government bonds on a forward-looking basis. Figure 1 shows the additional yield compensation an investor receives for investing in investment grade corporate debt as opposed to government bonds, which is close to record lows since 2007 (see chart above).

Within our government bond exposure, we have rotated towards European bonds and gilts to benefit from the more attractive disinflationary trend in these regions. US inflation has exceeded expectations for three consecutive periods since the year began. Higher growth in the US is expected to sustain higher inflation levels compared to Europe and the UK, which both have experienced relatively stagnant economies. We anticipate the ECB to be among the first major developed central banks to proceed with rate cuts, and therefore, we expect European bonds to benefit.

The improvement and broadening growth dynamics has led us to explore the various sectors and markets which are set to benefit from a more sustained manufacturing rebound, while also seeking those that offer an attractive valuation entry point. Global smaller companies offer a compelling blend of attributes, showing a strong correlation to cyclical rebounds while also having underperformed in the past few years due to rising interest rates. Furthermore, as industrial activity is displaying signs of recovery, we have allocated exposure to materials and industrial sectors, as these too are expected to perform well during a manufacturing rebound taking hold.

Attractive valuations on the small companies space



*As at 31 March 2024.

Source: Bloomberg

Within equities, we have reduced our Japanese allocation and increased our European exposure.

Given the robust performance of the Japanese equity market during the beginning of the year, we decided to trim our exposure and reallocate the proceeds to the European region. The tactical move is predicated on the same thesis of a cyclical rebound, where European equities have shown a strong sensitivity to improving economic activity and, similarly, identified smaller companies in Europe to be key beneficiaries of not only a cyclical rebound, but also falling interest rates, and improving consumer sentiment. In our view, the decrease in European inflation will continue to boost real wages for European consumers supporting European growth. A combination of stronger European consumer growth and better industrial production will likely produce a tailwind for smaller domestic companies.

Within our US allocation, without altering the regional weight, we rebalanced towards the Russell 2000, a US smaller company index, and increased our exposure to a 'value' equity manager focusing on quality companies expected to benefit from a rebound in areas of the market that are still trading at attractive valuations. We hold the conviction that the opportune time has come for areas of the market outside the major technology companies to capture the resilient growth of the economy.

Increased our allocation to commodities, particularly to copper.

Industrial commodities are closely linked to the manufacturing activity cycle. With that in mind, we decided to increase our allocation to copper, which we entered into in October 2023. The restricted supply of copper should also benefit the return profile of the asset. In addition to this, we also topped up our broad commodities exposure due to their role in increasing inflation expectations when they rise. We consider commodities to be crucial in portfolios as a defense against cyclical inflation.

Increased our allocation to hedge funds.

The decision to increase our allocation to hedge funds aligns with the Investment Committee's focus on diversification beyond government securities, corporate bonds, and equities, whilst still seeking attractive returns above cash. We allocated to a merger-arbitrage hedge fund which should capture the upside from a growing number of mergers and acquisitions in public markets since central banks paused rate increases.

“We hold the conviction that the opportune time has come for areas of the market outside the major technology companies to capture the resilient growth of the economy.”

03

What does the future hold for investors?

Globally, we anticipate continued economic momentum in the coming quarters, supported by tight labour markets, improving real wages, and a recovering manufacturing sector that has been a key development this year. Economies that are more sensitive to global manufacturing could potentially outperform compared to last year, leading to some convergence between US growth and its developed market peers.

While leading job data points to a cooling labour market, we believe there is sufficient labour demand to keep employment relatively tight for now. Evidence of a more aggressive cooling in the jobs markets could change our view on the continuation of the solid growth currently witnessed.

We expect inflation to continue declining, especially in Europe but also the UK, where it is projected to approach target over the next few quarters. Consequently, the ECB and Bank of England are anticipated to implement rate cuts during the summer months. The US situation is more complex, with stronger economic growth posing some upside risks, though slowing rental and wage growth could mitigate this impact. The Fed's job is more challenging as the last mile to 2% inflation is proving difficult and so the prospect of no rate cuts has increased since the year's start.

Monetary policy is expected to diverge across major economies as central banks navigate different inflation paths, likely leading to dispersion in regional fixed income markets and currency returns.

On the back of resilient growth, commodity prices have rallied. We expect the cyclical industrial recovery to remain a driver for commodities. Middle East tensions are key to monitor, given the potential impact on energy supply.

Looking forward, monitoring manufacturing PMIs, Asian exports, US jobless claims, and hiring rates is paramount, especially given our more cyclical view currently. Overall, growth is anticipated to continue despite being in a late cycle, emphasising the importance of these key indicators in navigating future economic trends.

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Around the world

Switzerland

The Swiss National Bank caused a stir in the market with a 0.25% interest rate cut, marking the first major central bank to dial back tighter monetary policy in the current cycle. The decision to cut interest rates came after a drop in Swiss inflation to 1.2% in February.

Taiwan

Taiwan experienced its biggest earthquake in 25 years, causing casualties, building collapses, and power outages across the island. The earthquake led TSMC, a leading semiconductor manufacturer which supplies most of the world with advanced chips, to evacuate production lines but shortly after confirmed systems were operating normally without affecting supply lines.

Japan

The Bank of Japan (BoJ) raised interest rates for the first time in 17 years to 0-0.1% from negative 0.1%. The decision came after the Japanese economy indicated stronger inflation in recent months.

Israel

Iran unleashed a massive aerial attack on Israeli territory escalating tensions in the Middle East and changing the dynamic between the two countries. Despite the increased uncertainty, energy markets remained contained after the attack as the supply remains unthreatened for now.

Commodity prices do well in manufacturing rebound



*As at 31 March 2024.

Source: Bloomberg

The companies featured in this article are to exemplify several thematic transitions occurring in this sector presently. It is important to note that they are not intended as investment recommendations. While Arbuthnot Latham does not directly include these stocks in our main portfolios, there may be indirect ownership through funds acquired on behalf of our clients.

05

Top of mind: The investment potential of GLP-1

Our dedicated investment research team has undertaken an in-depth exploration of the potential of GLP-1 medications.

As global health concerns, particularly obesity and diabetes, continue to increase, GLP-1 medications have emerged as a promising solution, displaying efficacy not only in diabetes treatment but also in the weight loss market. Goldman Sachs is projecting the weight loss market to reach a staggering \$100 billion by 2030, with giants like Eli Lilly and Novo Nordisk dominating.

Amidst the promising results, our team aims to guide investors' portfolios through the complexities, providing insights into potential risks, market expectations, and the economic impact of GLP-1 medications. Our research emphasises the need for cautious optimism as speculation around these products has spread quickly and the extreme valuations of Novo Nordisk and Eli Lilly reflect this. We continue to monitor the GLP-1 market with a particular focus on the insurance coverage, signs of improvement in supply chains, and market penetration.

The evolution of GLP-1 medication

GLP-1 medications have a long history and were first approved two decades ago for Type 2 diabetes treatment. These medications mimic the action of the GLP-1 hormone, by regulating sugar levels, slowing digestion, and suppressing appetite. Notably, their ability to affect areas of the brain that increase satiety led to significant weight loss results. Moreover, trials

“GLP-1 medications offer a promising future for Global Healthcare, with their proven efficacy in tackling obesity and diabetes. Companies at the forefront of these GLP-1 treatments could present a great opportunity for investors to participate in this exciting healthcare innovation”

Nefeli Neophytou
Investment Research Analyst



of these medications exhibited promising outcomes in reducing the risk of diabetic complications and combating cardiovascular diseases, strokes, and related conditions. A recent trial has shown the benefits of Novo Nordisk's medication on cardiovascular risks and the FDA approved a label expansion for its medications for reducing cardiovascular diseases. Despite transient side effects, such as nausea, the overall benefits of GLP-1 medications outweigh the associated risks.

Cost effectiveness of GLP-1 medications

Diabetes and obesity are global health issues, and the World Health Organisation (WHO) has estimated that the diabetic and obese population could increase to over half of the global population by 2035. Annual obesity related medical costs globally are expected to increase to \$4.32 trillion (3% of global GDP), which is similar in economic impact to the COVID-19 pandemic.

The Johns Hopkins University estimates that a 40-year-old man who moves from obese to overweight could lead to average lifetime savings of \$18,000 in direct medical costs and regained productivity. If GLP-1 medications are successful in treating obesity and diabetes on a global scale, the economic and health benefits will be tremendous.

Market potential and dominant players

The growing weight loss market presents a lucrative investment opportunity, projected to reach \$100 billion by 2030 according to Goldman Sachs. Leading pharmaceutical companies such as Eli Lilly and Novo Nordisk dominate this space with flagship GLP-1 medications Ozempic, Wegovy, Mounjaro, and Zepbound. The spectacular success of Ozempic and Wegovy made Novo Nordisk the biggest European company by market capitalisation, with a market value of around \$480 billion in 2023.

Competitive landscape and regulatory hurdles

While competitors like Amgen, Pfizer, and AstraZeneca battle for market share, Eli Lilly and Novo Nordisk maintain a stronghold due to the long and complicated Food and Drug Association (FDA) approval process and established distribution networks. Regulatory hurdles and supply chain constraints pose challenges to new entrants, solidifying the dominance of Novo Nordisk and Eli Lilly in the GLP-1 arena.

Disruption across Industries

Beyond healthcare, GLP-1 medications could disrupt industries like food and beverages. Reports indicate a decline in consumption of calorie-dense products among GLP-1 users, prompting companies to innovate and adapt to healthier, less calorie dense consumer preferences. While these shifts pose challenges, they also present opportunities for market diversification and innovation.

Challenges and uncertainties

Despite promising prospects, challenges loom on the horizon. High production costs, shortages in supply, and limited insurance coverage hinder widespread adoption of GLP-1 medications. Additionally, the long-term implications of these medications are still to be observed, as well as the willingness for users to stay on the medications for a lifetime. We continue to closely monitor any data that can affect market penetration.

Conclusion: Thriving amid uncertainties

GLP-1 medications represent a paradigm shift in healthcare, offering effective solutions for obesity and diabetes management. While the investment potential is substantial, careful assessment of market dynamics and regulatory landscapes is essential. As developments unfold, investors must remain vigilant to navigate the dynamic landscape of GLP-1 investments, which are potentially set to reshape the healthcare industry and beyond.

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