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Investment Committee Series

Q4 Outlook - November 2023

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Introduction

Key takeaways from the third quarter of 2023:

- Global growth was resilient in the third quarter and exceeded expectations, however, there is evidence of some weakness ahead.
- The US continues to be a major driver of global growth, driving equity returns for investors over the year.
- The risk of recession appears to have been pushed back, although remains a consideration within our asset allocation.
- Inflation has likely reached its peak but has not reduced as rapidly as expected.
- Oil prices moved higher in the quarter, adding to inflation fears and a potential headwind for global growth.

The third quarter saw a continuation of many of the central themes we highlighted in Q2. Global economic growth has remained resilient and exceeded expectations, despite interest rates continuing to rise. The threat of a recession has lessened, although as global events move quickly, we remain cautious in our outlook.

Inflation appears to have peaked, but it is not receding as quickly as predicted by central banks and economists. This aligns with the prevailing "higher for longer" narrative from central banks, and although most central banks held rates steady in Q3, it was clear that there is to be no swift reduction in interest rates as markets had hoped for.

Key market performance trends for the year so far include a rebound in commodity prices and strong returns in the US equity market. Fixed income markets were turbulent in the face of continued central bank rate hikes, although they fared better compared to 2022. During Q3, oil prices increased as supply deficits mount into the end of this year. Oil is the lifeblood of the global economy; the aggressive rise in oil prices seen in Q3 could act as a headwind to global growth in the coming quarters.

In line with the previous quarter, the US economy remains resilient, playing a pivotal role in driving returns for investors this year. The strength of the US economy can be attributed to robust job market data, sound consumer and corporate balance sheets and a comparatively strong services sector. The US economy's lower reliance on manufacturing as a driver of growth also added protection. The flip side of this success story is the subdued growth in China, where the recovery remains weak. Europe and the UK also continue to lag the US. This is connected to global manufacturing which despite recently showing signs of improvement, remains weak while the global services sector is also weakening.

Eren Osman
Managing Director,
Wealth Management

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02

Decisions we made

Over the past quarter we have made 5 key changes to our portfolios. We have:

- Increased our overweight position in global government bonds
- Reduced overall credit exposure while increasing short duration corporate bonds
- Further reduced exposure to equities
- Increased our US equity exposure, funded by trimming holdings in Asia and Emerging Markets.
- Initiated a small position in copper

Peter Doherty
Director, Head of
Investment Research

Increased overweight to government bonds and reduced equities

The significant drawdown in global bonds - marking the largest bond bear market on record - has caught our attention, warranting a closer look at this asset class. Government bonds offer attractive income potential, especially in regions like the UK, and the US where yields are close to mid-single digits.

Given the substantial increase in yields since 2022, government bonds now have an attractive return profile. If we see a sharp economic slowdown, yields could fall significantly. Should this happen, investors stand to gain substantial capital appreciation on top of the attractive income they provide.

As we are observing a weakening trend in global growth, increasing our allocation to government bonds is a prudent decision in our view. While we do not see an imminent recession, it remains a consideration in how we position our portfolio.

The increase in our overweight in government bonds was funded by a reduction in equities, given our view that the current environment is less favourable for this asset class, especially as we are in a late phase of the business cycle, (a stage in the economic cycle where growth is present but showing signs of slowing down) and valuations for global equities - as represented by MSCI World Index - remain relatively high.

Stocks have outperformed bonds significantly in the current landscape, which may be out of sync with the current global growth conditions. This suggests that stocks may be pricing in a more robust global growth environment than we anticipated and further justifies our shift towards government bonds.

Increased short duration corporate bonds

In our credit allocation, we made adjustments by moving away from riskier bank hybrid debt (an investment tool offered by banks, blending elements of borrowing and equity risk), which experienced a significant sell-off during the US banking turmoil in late Q1 before recovering. We believed the risk of this debt was lower than market perceptions during the sell-off, and we added to our bank hybrid debt exposure which subsequently performed well, alongside the recovery in the shares of European banks.

Given this improved performance and our assessment of the current market conditions, we decided to reduce our exposure to hybrid bank debt and investment grade corporate debt. Subsequently, we recycled the capital into shorter-term corporate debt which is less sensitive to changes in interest rates and which enjoys yields close to 6%, making it an attractive asset class. This is reinforced by the fact that this short-term corporate debt yields more than standard investment-grade debt, 10-year US treasuries, and the S&P 500, making it a compelling choice for exposure.

Within equities, increased US exposure was funded from Asia and EM

Given the current outperformance of the US economy and our expectation of a deteriorating global economic cycle, we believe there is a higher likelihood of a stronger US dollar in the short term. With this in mind, we have adjusted our US equity underweight position with an aim to increase our exposure to the US dollar within our equity holdings. This tactical move is based on the US dollar's propensity to strengthen in specific circumstances, such as during a risk-off environment or when US economic growth outpaces that of other global regions, both of which are possible in the coming quarters.

This year has witnessed remarkable outperformance of major tech companies, despite their relatively high valuations. In the context of slowing global growth and market pressures, these tech giants' attributes - such as strong cash reserves and resilience in high-interest rate environments - offer some defensive qualities, potentially allowing them to outperform the broader global equity market. This influenced our decision to reduce our underweight stance on US equity. We implemented this change largely through a reduction in Asia and emerging market exposure.

We reduced our overweight equity position in Asia and the emerging markets, specifically trimming our Chinese equity overweight. Sentiment towards Chinese assets remains very depressed, while the growth outlook continues to be challenged, most notably due to the struggling real estate market. While we do not forecast a collapse in the Chinese economy, it has become evident that the cyclical downturn may be prolonged without serious government intervention, which has not been forthcoming.

Increased allocations to copper

Industrial commodities are closely linked to a change in manufacturing activity. While manufacturing has been slowing this year, the latest indicators point to an uptick. With this in mind, to capture a potential rebound in manufacturing, we opted to increase our allocation in copper, which has long term structural drivers to its benefit without a manufacturing rebound. Copper has priced in less global growth resilience as opposed to stocks, and we feel that by adding some exposure to commodities, we increase the risk/return profile of the portfolio should manufacturing gradually strengthen.

Stock vs. Bond prices

Source: Bloomberg

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03

What does the future hold for investors?

US economic exceptionalism has been a standout feature so far this year, with better-than-expected GDP growth, despite the US Federal Reserve's (Fed) rate-hiking cycle. However, this success story is showing some signs of slowing down.

Economic momentum still with US

Source: Bloomberg

Manufacturing remains subdued, although there are emerging signs of improvement. We are simultaneously observing a downturn in services activity. This is concerning given that previous growth trends were driven by services taking the lead. The weakening trend in services increases the risk of low economic growth in the coming quarters should the slowdown in this area overshadow stabilising trends in manufacturing. We continue to monitor the situation closely.

Inflation has been the dominant story in the markets this year, and it remains a key challenge. While the US has made progress in reducing Consumer Price Index (CPI), recent increases in CPI due to rising oil prices pose difficulties in achieving the Fed's 2% target without lower economic growth. In Europe and the UK, the inflation challenge is more acute, driven by mid-single- digit pay increases and fears of inflation being entrenched. Weak economic growth in these regions limits the ability of central banks to raise rates.

With this in mind, we continue to carefully monitor the latest data, including inflation, GDP and employment. Our propensity for data-dependency means that we are staying relatively balanced in terms of asset allocation, with a tilt towards assets where we spot better relative valuations. Therefore, any changes we make in our asset allocation are made having fully considered the current data, with constant focus on the potential for changes in how the market prices in the economic outlook. This allows us to spot valuation mismatches and align our portfolios accordingly.

1 min read

04

Around the world

US Treasuries

The FED maintained a strong stance on holding rates higher for longer, sending the yield on US treasuries to their highest level since 2007.

Energy

Oil prices continued to rally as Saudi Arabia and Russia confirmed they would extend their production cuts until year end. European gas prices also rose owing to production issues in Australia and Norway.

Currencies

The US dollar index rallied and hit a 10-month high as traders discounted higher Fed rates stretching well into 2024. The USD was strong against both sterling and the euro.

UK

The Conservative government suffered historic defeats in two by-elections, as the party looks ahead to a general election in late-2024.

Israel

The attacks launched from the Gaza Strip have prompted a deepening of the conflict between Hamas and Israel which threatens to spill over and destabilise neighbouring regions. The situation remains extremely volatile, with oil prices immediately spiking as a result of the incursion. The UN has warned of a humanitarian catastrophe in Gaza due to delays in aid reaching the region.

Sweden

The Nobel Prize in Physiology or Medicine has been awarded to Professors Katalin Kariko and Drew Weissman who developed the technology that led to the mRNA Covid vaccines. The same mRNA technology is now being researched for other diseases, including cancer.

China

The People’s Bank of China (PBoC) eased monetary policy with a reduction in reserve requirements to combat growing concerns of contagion from recent property developer defaults. The country’s real estate market remains depressed.

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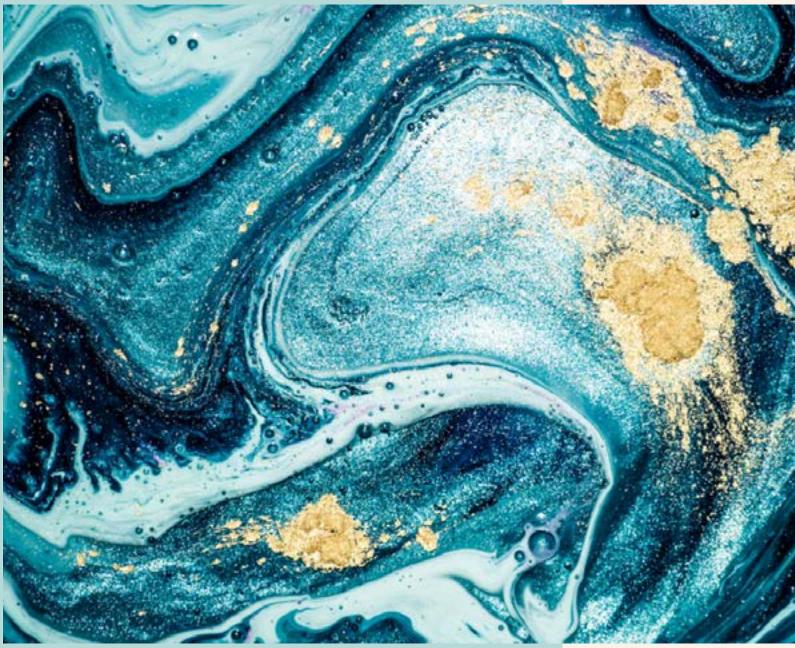

05

Uncovering prime opportunities in Europe

In a world of ever-evolving markets and global dynamics, Europe's recent economic challenges, geopolitical uncertainties, and cyclical nature have given investors reason to feel cautious. However, we see opportunities beneath the surface.

George Rudland
Senior Investment Manager

George Rudland, Senior Investment Manager, explores the European investment landscape that has captured both scepticism and intrigue. He delves into industries and companies that are reshaping the continent's investment potential, from healthcare and technology innovators to fashion and luxury giants.

Market participants have often been sceptical of investing in Europe, and rightly so. The European stock market has materially underperformed the US over the past decade. Add into the equation the war in Ukraine, slowing economic growth, and a dynamic political landscape, it is understandable that investors are nervous.

However, the backdrop for Europe is not all doom and gloom. After a year-long manufacturing downturn, we are beginning to see some early signs of stabilisation as inventories have been depleted and China imports are starting to accelerate. Moreover, the inflation story is improving, with JP Morgan predicting core inflation to fall to 4% by the end of the year, boosting income for European households and reviving the economy.

European companies are also looking attractive as they now trade below their long-term average valuations and at an almost 30% discount to the US market.

Given the cyclical nature of the European economy and with weakness in manufacturing, we have not been surprised by the recent underperformance in Europe; as a result, we are underweight in our allocation. However, while Europe might be out of favour, the top-down macro-economic picture could be improving, providing a set of circumstances where opportunities are likely to exist. Furthermore, many of the world's leading companies operate

in Europe, here are a few examples:

- **Novo Nordisk**, the Danish pharmaceutical business is a few months short of celebrating its 100th birthday and is a market leader in diabetes and obesity care. The company's exciting recent growth centres around its range of drugs for treating type 2 diabetes, Ozempic and Wegovy. These have also been proven to be successful in dealing with obesity. The diabetes market is estimated to be around $30bn while the obesity market could be worth in excess of $100bn, with very few participants operating in this field. Analysts are becoming increasingly enthusiastic about the shift in approach towards addressing weight as a means to tackle the substantial financial burdens linked to obesity-related illnesses.
- **ASML** is the sole supplier of extreme ultraviolet lithography machines that are needed to manufacture the most advanced microchips. The company has captured over 90% of the market to supply the semiconductor industry. These microchips are used in all our devices and are crucial components in advancing the operating performance of cars, phones, and medical equipment to name a few. Through world-leading research and development, ASML have enabled microchips to become smaller and more powerful. Looking to the future, the next generation of microchip design will help innovation in areas like automated transport, artificial intelligence, and faster connectivity all underpinned by ASML's market leading technology.

Stepping away from science and technology, one of the most valuable businesses in Europe dominates the world of fashion and luxury goods. Louis Vuitton Moët Hennessy (LVMH) has a portfolio of brands we have all heard of. LVMH is a well-run business with a track record of market share growth across its brands. With strong financial discipline and profit margin growth, LVMH consistently delivers robust returns to shareholders.

Notwithstanding the cyclical nature of the European market, the lion's share of our allocation has been in quality, world leading companies held by our chosen fund managers. In our opinion, these high-quality companies can ride out periods of macroeconomic uncertainty, as they have proven to do so, time and time again. To conclude, there is a lot more to the European investment landscape than just car manufacturers and airlines, and it is our obligation as investment managers to uncover these exciting investment opportunities for you.

For business. For family. For life.

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