

Investment Views



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Realisation of Higher for Longer

The third quarter was an eventful one for financial markets, particularly within fixed income. The dominant theme over the summer was a realisation that interest rates are likely to stay higher for longer than previously expected. This reassessment was due to a combination of factors.

Firstly, economic growth in the US has been more resilient than expected. Secondly, the Federal Reserve's latest Summary of Economic Projections showed fewer interest rate cuts next year than previously forecast. Elevated US budget deficits adjusted for student loan accounting were also in focus, while weakness in global bonds, notably upside risks to yields in Japan, were another headwind for US treasuries.



STRATEGY

Over the past two years, we have arguably seen the deepest and fastest moving bond bear market in history. This has been painful for bond markets as yields have risen to highs last seen in 2007, but the flipside is that prospective bond returns looking forwards are higher than they have been for many years. The upward move in bond yields have partly been driven by a strong recovery from the lows of the pandemic, but moves of these magnitudes in such a fundamentally important asset class are causing pain in financial markets.

The period between 2009 and 2020 was characterised by low inflation, subdued economic growth and central banks holding interest rates at very low, or even negative, levels to try to help the economy. The transition from this period to interest rates repricing closer to long run averages has contributed to a bumpy path for equity markets. The US Treasury market is important as it represents the so called “risk-free rate”, which all other assets are priced off in some shape or form.

The fundamental difference between the decade prior to 2020 and the last couple of years has been the role of government spending as the source of stimulus rather than central banks. Central banks around the world engaged in various Quantitative Easing (QE) programmes (predominately buying government bonds), which by their own admission they didn't fully understand. In some instances, QE put upward pressure on bond yields (more stimulus) and in some it put downward pressure (more demand for bonds). However, the pandemic crisis heralded a new era.

A confluence of factors has created this new environment. Direct payments to households and businesses were hugely supportive of demand during the pandemic. Central banks helped facilitate this by holding interest rates low, but central banks can't inject money into the real economy in the same way as governments can.

The upward move in bond yields have partly been driven by a strong recovery from the lows of the pandemic...



STRATEGY

Supply chain stress, disruptions in labour markets, an energy shock, a costly energy transition and deglobalisation have also contributed. The result being that the supply side of the economy has struggled to adjust to demand. This is why inflation came back with a vengeance.

While inflation pressures are easing (from elevated levels) in many countries, there is a dawning realisation that we are in a new regime when it comes to investing. Bonds have gone from being a stabilising asset within portfolios to a source of volatility. This is a fundamental shift given how many portfolios have been optimised for a pre-Covid world. There are cracks appearing in credit markets, but the main stress in the system has so far been a duration (interest rate) shock.

The mix of resilient economic growth but higher bond yields is one of contrasting forces for the equity market. Resilient growth in the US has meant earnings have held up well, but valuation multiples have come under pressure as bond yields have risen. There has also been notable dispersion between sectors. Some have benefitted from favourable trends in technology (such as Artificial Intelligence), high oil prices (Energy) and the energy transition (select Industrials and Materials companies), while others such as Utilities and Real Estate have struggled.

Alternative investments continue to play an important part in portfolio construction. Hedge Funds have the ability to make money when bond or equities markets fall, while also benefitting from equity dispersion and trends in macro. In a more inflationary world, commodities have a low or negative correlation to risk assets which is also helpful for portfolios. Diversification remains very important when constructing portfolios resilient to a range of different risks, and this is something that we have focussed on.

The Limits of Fiscal Extravagance

The 10-year US Treasury yield rose by 73bps in the third quarter reaching 4.57%, the highest level since the eve of the Global Financial Crisis in June 2007. Negative momentum started building when the US Treasury released new funding requirements indicating the need for additional issuance on top of the guidance provided in May. This suggests that the 2023 fiscal deficit will be a huge \$2trn, which is now crowding out the private sector and tightening financial conditions.

In addition, the Bank of Japan expanded the trading range of 10-year Japanese bond yields to 1% and oil prices have risen sharply. This is all happening at the same time as the headline rate of inflation across the world looks set to rebound over the coming months. This led to a perfect storm for bond yields, highlighting that even if you are the US government there are limits to excessive fiscal spending outside of recessions.



FIXED INCOME

Economic growth continues to weaken in Europe and the UK. As a result it is very likely that the Bank of England and the European Central Bank are close to the end of their tightening cycles. UK Gilt yields bucked the trend in the third quarter, outperforming other G7 bond markets.

In contrast, US macro data remains robust and overall economic activity has surprised to the upside. The Atlanta Fed GDPNow forecast for the third quarter is an elevated 4.9% annualised. This deviation in economic prospects has led to a resurgence of the US dollar, which strengthened across all major currencies as it becomes more probable that the Federal Reserve (which raised rates by 25bps in July to 5.25-5.50%) will have to keep US base rates higher, and for longer, than their peers.

In aggregate, global economic activity has surprised to the upside, largely due to strength in the US, but remains on a weaker path as China continues to slide into stagnation. The significant rise in oil price to \$91 a barrel pushed US gas prices to \$3.82 a gallon, with diesel rising even further. US 30-year mortgage rates, which are correlated to US Treasury yields, rose to 7.74% and this is an additional headwind to residential investment. Additional risks include a US government shutdown, strikes by the United Auto Workers union and the potential for a weaker US consumer as student loan payments resume and broad fiscal stimulus fades.

With this basket of worry and the realised volatility in equity markets over the past few weeks, it is surprising that corporate credit spreads have remained unchanged. US high yield spreads are flat since the end of June at just 394bps; a level which is at odds with the rising risks that we are facing and equity volatility.

Global liquidity continues to tighten with all but the People's Bank of China reducing central bank balance sheets over the quarter.

4.9%

The Atlanta Fed GDPNow annualised forecast for the third quarter.

\$91

Oil prices rose significantly to \$91 a barrel.

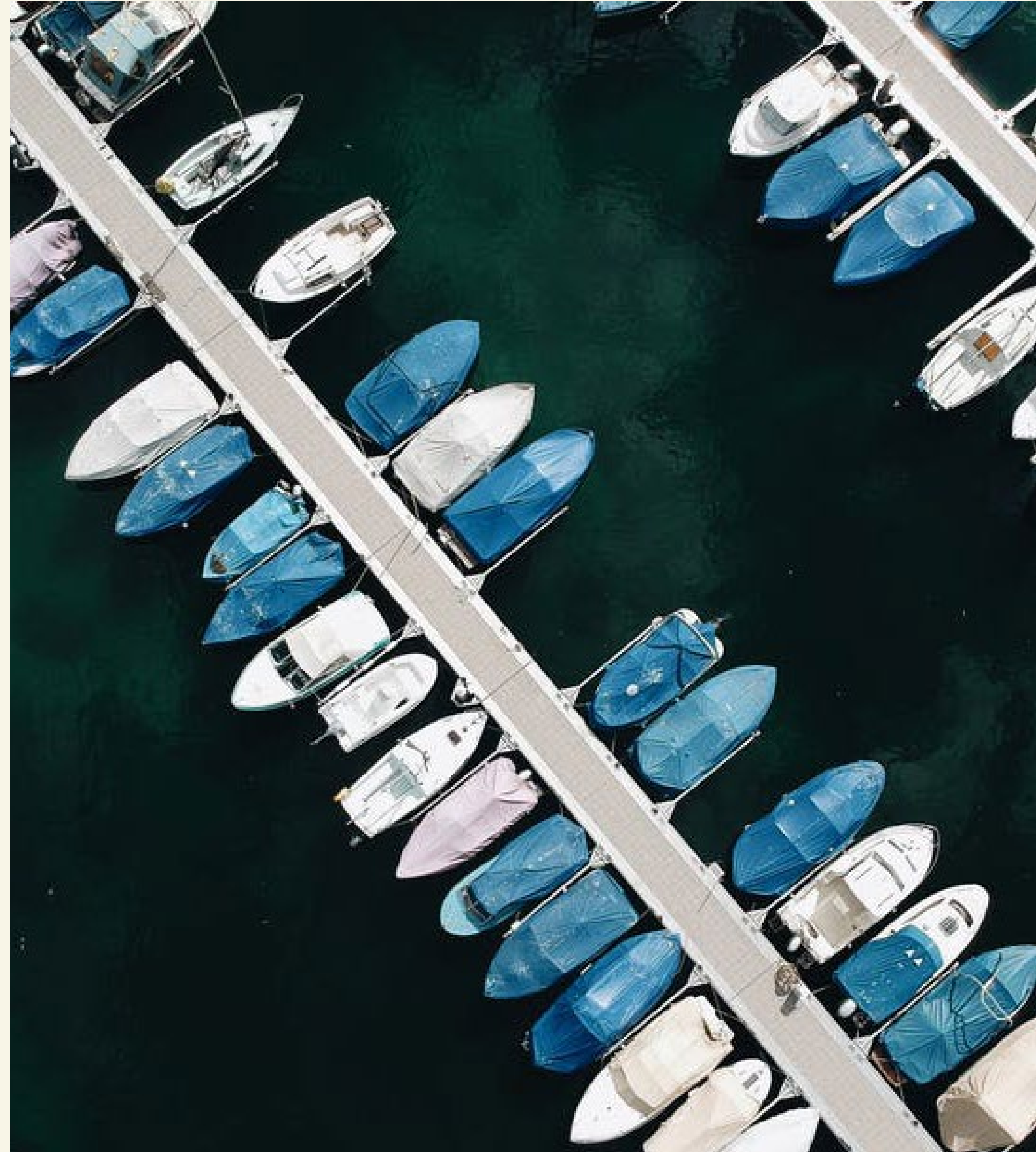
INVESTMENT VIEWS

However, reverse repo cash balances parked at the Federal Reserve by US money market funds also declined by US\$400bn, which largely offset the decline. Compounding this pressure, as the end of the economic cycle approaches, credit provided by banks continues to tighten. Lenders are reducing availability in areas such as auto loans and credit cards, with delinquencies also starting to rise.

As we move into the final quarter, quantitative tightening will take the lead as the main monetary policy transmission mechanism and this is expected to remain restrictive for some time. Portfolio positioning continues to lean defensively with a high allocation towards government debt and US mortgage-backed securities. We expect credit spreads to rise in the coming months and are actively attempting to minimise drawdowns. We also find value in short dated US Treasury floating rate notes and within multi-currency portfolios favour a continued overweight to the US dollar and underweight Euro. Interest rate risk looks attractive but we are mindful of the negative momentum now building. Short-dated 2-year yields have so far avoided the pain and make a good, low volatility and high carry, tactical home whilst we wait for stabilisation at the long end of the curve.

A Lot of Dispersion Under the Surface

The MSCI World recorded its first negative quarter this year, giving back 3.5% in US Dollar terms as the Federal Reserve signalled a higher for longer interest rate policy. A weaker China and a slowing Europe, coupled with higher oil prices, also acted as a drag. July was positive, but August was negative with September the worst performing month so far this year. Interestingly, in September we saw the Information Technology (IT) sector and the “Magnificent Seven” (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, Tesla), two areas of the market which have accounted for most of the returns so far this year, underperform the broad market.





11.5%

Energy was the best performing sector this quarter.

EQUITIES

In the third quarter, the weakest performing segments were the interest rate sensitive ones. Utilities and Real Estate were negatively impacted by the move higher in real yields, with the Utilities sector further disrupted by general weakness in renewable energy businesses. IT also lagged for the first time this year. Consumer Discretionary was weak as lower demand from China and Europe, combined with tighter wallets, led to some investors repositioning. Consumer Staples disappointed despite the favourable backdrop, highlighting how out of favour the sector is.

The best performing sector this quarter was Energy, returning 11.5% on the back of higher oil prices. The price of oil rallied from \$70 per barrel to \$91 per barrel as production cuts drove prices higher.

Europe was the worst performing region this quarter followed by Asia Pacific ex Japan. Europe started the year with a solid first quarter, but has lagged since as the economy weakened and the all-important luxury sector was impacted by less Chinese buyers. The best performing countries were the UK and Japan, with the UK benefitting from better than expected economic data and the strength in the Energy sector.

Much has been said about the Magnificent Seven and how these stocks have skewed returns, accounting for roughly 80% of S&P 500 returns so far this year. The debate going into the third quarter was around how these stocks would perform in a falling market. In February and May, when the market decreased by 2.4% and 1% respectively, the basket of stocks significantly outperformed the benchmark. In August the market contracted again and the Magnificent Seven outperformed once again. In September this changed, with the basket underperforming the benchmark by 1.5%.

EQUITIES

The difficulty with answering this question is that the Magnificent Seven are less correlated in normal times as they operate in different industry segments (think Alphabet versus Amazon versus Nvidia). What we do know is that we are more likely to see significant diversion in the fortunes of these companies and are unlikely to experience the correlation seen earlier this year again.

Despite the negative quarter, the second quarter earnings season was a success. The S&P 500 aggregate sales beat expectations by 2% which was in line with previous quarters. The S&P 500 aggregate earnings per share beat consensus by 7.7%, the highest since the third quarter of 2021. The breadth of the beats was wider than usual, with 54% of the companies versus a historical average of 48% posting better results than anticipated, suggesting a healthy improvement in underlying fundamentals. However, the immediate price reaction to positive results was muted, with one-day price change for stocks reporting down 0.2%, which signalled some market fatigue.

Looking forward, higher real yields present a headwind for equities as they put downward pressure on valuation multiples. We have a bias to companies with strong balance sheets and avoid owning companies with high leverage and low interest cover ratios. Interest expenses are on the rise and companies reliant on the debt capital markets will find it harder to operate. They are also more likely to cancel share buyback programmes in favour of reducing debt, so we prefer companies with the ability to return excess cash to shareholders.

7.7%

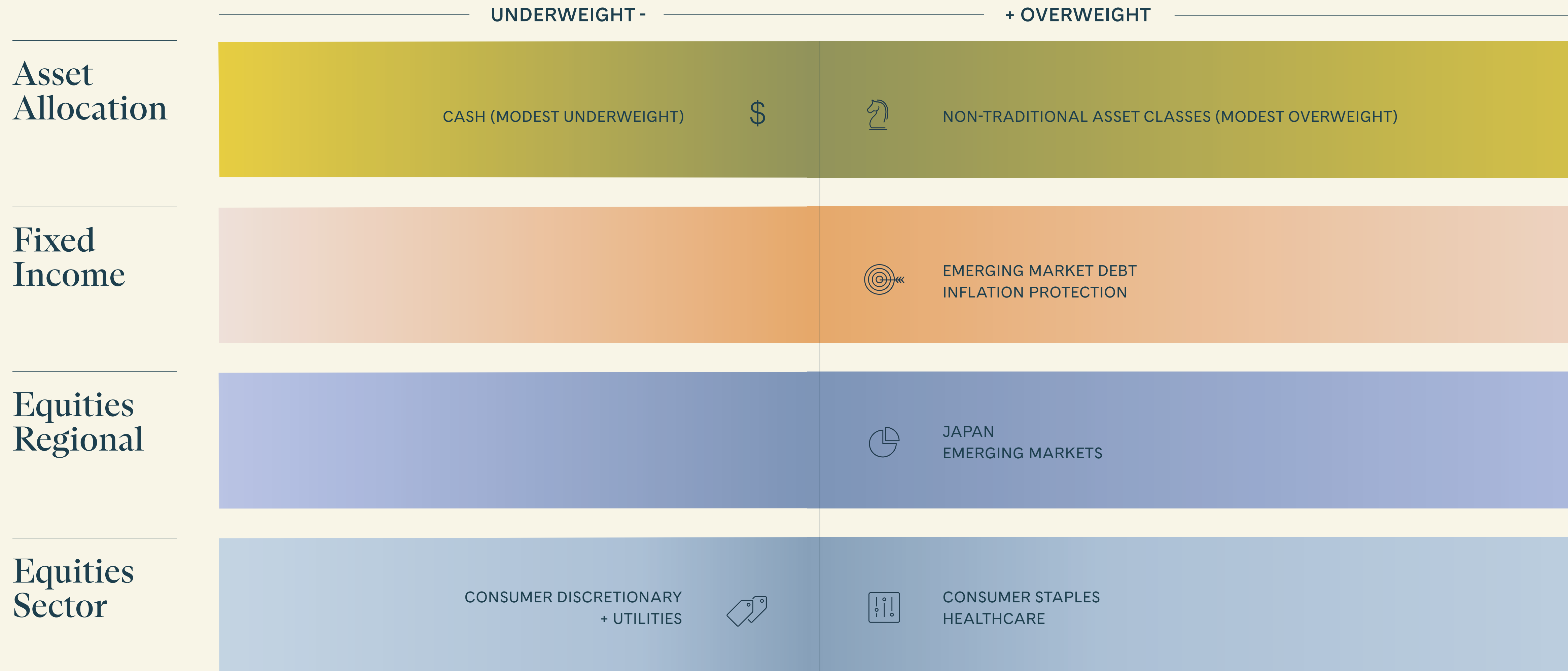
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Global Asset Allocation

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



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