

Investment Views



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Strategy:

Recession Watch

Fixed Income:

The Federal Reserve Reaches Neutral

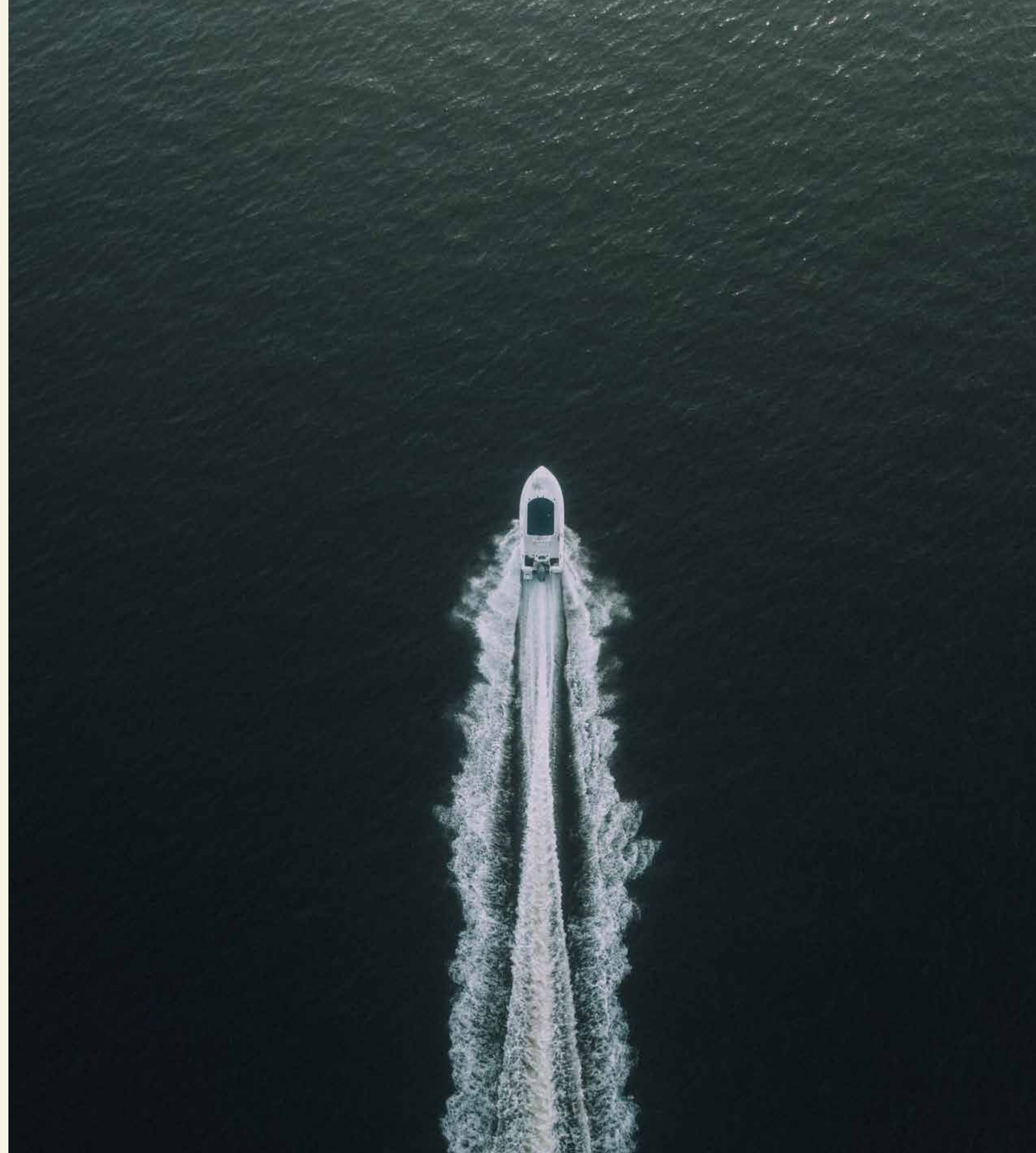
Equities:

Earnings Provide Some Relief

Recession Watch

Global bond and equity markets performed well in July, recovering some of the losses from the first half of the year. Many sentiment and positioning indicators had become stretched which, together with a corporate earnings season that was not as bad as feared, set the stage for a rally in risk assets. The stabilisation in bond markets also helped underpin equities as yields fell from the June highs.

However, fundamental economic data continued to deteriorate across the world. Survey measures and real data on inflation and growth showed elevated inflation and higher interest rates to be slowing economic activity. The release of second quarter GDP in the US revealed the economy contracted by 0.9% annualised, following a decline of 1.6% in the first quarter.



Two consecutive quarters of negative GDP is considered, by some definitions, a recession. This has caused some debate about the status of the US economy; however, the 'two quarter' rule is very simplistic and short-term readings can be volatile. Most of the coincident indicators tracked by the Business Cycle Dating Committee, which maintains a chronology of US business cycles, still show continued expansion over the first half of the year. An excessive focus on backward-looking data and technical definitions is somewhat counterproductive and masks the key questions around whether the US economy is heading for recession. Questions surrounding how severe it will be and how the Federal Reserve will respond are partly dependent on how quickly inflation recedes.

Looking under the hood of the second quarter numbers, there was further evidence that the surge in interest rates and rising inflation are taking a toll on activity; residential investment has been hit particularly hard and registered a 14% annualised decline. In a sense, cooling the very hot housing market has been an objective of central bank policy, and higher interest rates are having the desired effect. The risk is that the situation goes from boom to bust, but the recent stabilisation in mortgage rates is helping to manage the adjustment. The broader weakness in business investment is a concern, as there are plenty of reasons for business to invest, most notably in labour saving technology, reshoring and within the energy sector. For now, this weakness is being offset by continued consumption growth, although that also slowed to 1.0% from 1.8% in the first quarter. While consumers are being squeezed by higher inflation, the resilience of the US consumer has been one of the few bright spots in the global economy this year.

0.9%

The release of second quarter GDP in the US revealed the economy contracted by 0.9% annualised, following a decline of 1.6% in the first quarter.

1.0%

The amount continued consumption growth slowed to from 1.8% in the first quarter.

Two consecutive quarters of negative GDP is considered, by some definitions, a recession.



1.75%

Interest rates raised from 1.25% by The Bank of England.

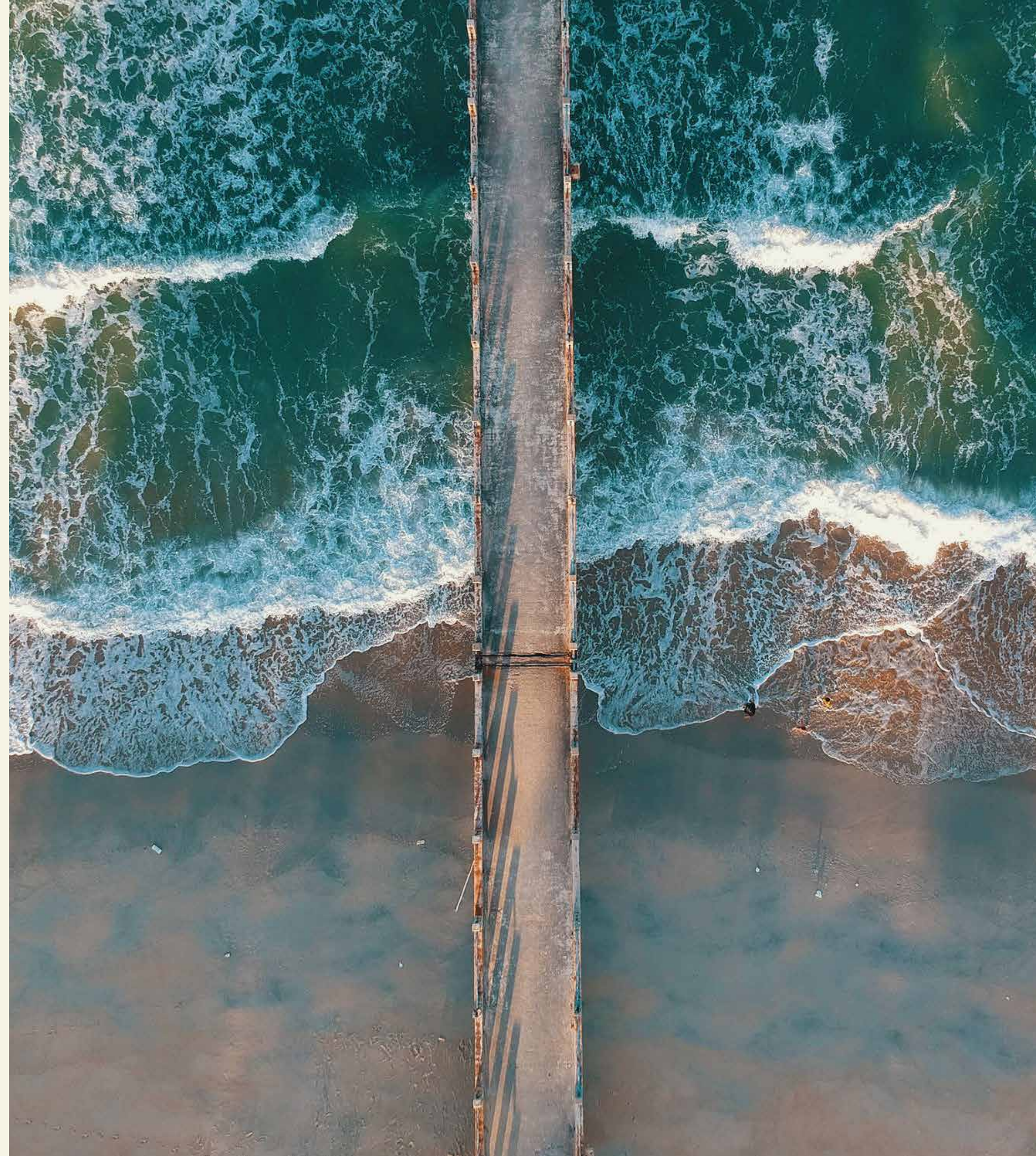
STRATEGY

Unfortunately, the situation outside of the US is bleaker. China is facing a multitude of problems, ranging from a disruptive zero-Covid policy, defaults and troubles in the property market sector, and a consumer that hasn't received the same level of pandemic support as the West. In Europe, the risks and inflationary pressures are primarily emanating from the Energy sector. The region, and Germany in particular, are predominantly reliant on natural gas from Russia and recent flows have been below normal. Furthermore, with demand set to rise significantly in the winter, there is a risk that further curtailment of supply from Russia as retaliation for the various sanctions would prove highly disruptive for both consumers and the manufacturing sector.

The UK is less directly exposed to gas flows from Russia, but faces no less of a daunting economic backdrop. The Bank of England recently raised interest rates by 50 basis points from 1.25% to 1.75% and suggested that they will "be particularly alert to indications of more persistent inflationary pressures, and will if necessary act forcefully in response". They also released a very gloomy set of projections that forecast the UK economy to contract five consecutive quarters from the fourth quarter of this year. The recent forecasting record of central banks leaves a lot to be desired, however, as the global risks have shifted from inflation to recession, we have increased our allocation to Fixed Income from underweight to equal weight in portfolios; this has been funded from either Cash or Alternatives, depending on the mandate.

The Federal Reserve Reaches Neutral

Global Fixed Income markets rallied in July with the 10-year US Treasury yield declining by 52 basis points (bps), ending the month at 2.65%. European bond markets outperformed, with yields on German 10-year Bunds halving to 0.81%, effectively recapturing most of the losses incurred in the second quarter. We also witnessed a major rally in risk assets, with investment grade corporate credit spreads tightening by approximately -20%, closely following the recovery rally in US equity markets.



The driver of these moves has been a mixture of poor summer liquidity amplifying trading activity, the continued weakening in global economic data, especially in Europe, and the perceived dovish tilt by the Federal Reserve at their July policy meeting. Given that the US base rate was raised this month by 75bps to the upper bound of 2.5% - the highest level since mid-2019 - this is counterintuitive. However, at the press conference following the decision, Chairman Powell essentially acknowledged that the current base rate of 2.50% may well be the ‘neutral rate’ for the US economy. He also noted that all future base rate moves will now be data dependent, not solely on autopilot, which effectively ends forward guidance.

Therefore, with the current negative trend in the economic data, the market has increased the probability that a ‘pivot’ from the aggressive monetary tightening policy that we have seen in 2022 may well be forthcoming. With US base rates now fully priced to move above this ‘neutral rate’ to 3.25% by the end of this year, the market expects another 50bps increase in September and 25bps in November. The bond market, and very likely risk assets too, are assuming that the worst from a monetary policy perspective is now over. We are not quite as confident, but acknowledge that we are likely closer to the end of this hiking cycle than the start, with markets likely to display volatility around every major economic data release.

US economic data releases during July presented a mixed picture. Continued weakness was seen in the housing market with negative trends building in some of the employment data, offset by relatively solid consumer spending and income growth, which helped push the Atlanta Fed’s Q3 GDP forecast to +2% (annualised). This effectively ends the “technical” recession that the US entered in Q2, however the trend for weak data releases over the coming months remains. In particular, we are closely monitoring the auto loan delinquency rate which has doubled over the past month (in Washington D.C. 23% of all loans are at risk). Also, the pickup in credit card debt, with the average balance growing by +13% over the past year, the largest jump since 2002.

2.5%

The amount the US base rate was raised to this month.

\$98

The amount that oil prices per barrel have weakened to in Q3.

For young people and borrowers with low credit quality, it is double this average. A massive 233m in new credit card accounts were opened in Q2 alone (one for every adult in the US), so while the US consumer looks solid, for some pockets of the country it clearly feels like a recession has already arrived.

In Europe and the UK, the probability of a recession increased further, with energy prices squeezing consumer spending and confidence. On the positive side, China and broader Emerging Market activity may have found a bottom with signs of stabilisation in some of the key growth metrics; we are watching the Australian dollar for signs that the Chinese economy has found a bottom. Commodity markets remain volatile, but contain some important signals on the likely path of inflation and the health of the global economy. Oil prices have weakened further in Q3 to \$98 a barrel, having reached a high of \$122 in June. This has helped lower US gasoline prices, with \$4 a gallon almost within reach, as global growth slows and emergency inventory building, which drove outsized gains in food prices and lumber (now down -65% and close to its 10-year average), shows signs of falling. If sustained, the favourable base effects on US consumer price inflation data in 2023 will be meaningful and potentially lead to rapid declines in annual inflation, allowing central bankers to pause.

Although risk assets rallied in July, we refrained from increasing our current exposure to credit risk and our current portfolio allocation remains invested in high-quality companies that are largely recession proof.

However, the stabilisation in global bond yields, some favourable inflation metrics, more generous valuations and slowing global growth prompted us to increase our allocation to Fixed Income to “neutral”, reducing our elevated cash balances. We are confident that global bond yields, especially short dated maturities, are likely close to their peak and any further upward pressure on yields can be absorbed effectively by the coupon income received. We also believe that the traditional negative correlation benefits that high-quality government bonds add to a balanced portfolio, are now likely to reassert themselves in the months ahead.

Earnings Provide Some Relief

Global equity markets performed well in July, returning 7.9% in US dollar terms. US equities led the way gaining 9.3%, with Developed Markets also performing well - Europe returned 5.1% and Japan 5.8%. Emerging Market equities saw small losses of around -0.2% in aggregate as many of the regions recovered but the overall index was dragged lower by weakness in China where equities fell by -9.5%. The Consumer Discretionary and Technology sectors led the way, returning 15.5% and 13.1% respectively. This was a reversal of fortunes from the first six months of the year when they were the two worst performing sectors. The Consumer Discretionary sector benefitted from the fall in gas prices and mortgage rates in the US, helping to alleviate some of the concerns around the real income squeeze on consumers.





EQUITIES

7.9%

The figure that global equity markets performed in July, in US dollar terms.

Corporate earnings have been a particular focus, as they have been incredibly strong over the past couple of years. With the majority of companies now having reported, second quarter earnings for S&P 500 companies are tracking at an impressive +9.2% compared to the same period last year. However, there is a lot of dispersion under the surface, as earnings in the Energy sector have hugely benefitted from higher oil prices and strong refining margins. Excluding the Energy sector, earnings growth would have actually fallen around -1.3%. Financials were a drag on earnings as banks added provisions for loan losses, while investment banking revenues disappointed as the market environment was less favourable for deal making.

-1.3%

Excluding the Energy sector, the figure that earnings growth have actually fallen.

Earnings in the Communication Services sector were also weak, dragged down by Meta Platforms (Facebook), which saw revenues down year-over-year for the first time in history. The appreciation of the US dollar over the past twelve months has been a headwind for US businesses with overseas earnings and this was the case for Meta, as the FX drag was responsible for 6% of the 10% fall in revenue growth. This more challenging revenue environment has led to an increased focus on controlling costs which is especially the case in Technology-orientated sectors that have focused almost exclusively on growth in recent years. The end of cheap money and the associated stress in stock price performance have been a very important factor here. In a recent hard-hitting weekly Q&A with staff, Meta CEO Mark Zuckerberg bluntly said that “realistically, there are probably a bunch of people at the company who shouldn’t be here... some of you might decide that this place isn’t for you... and that self-selection is okay with me”.

This echoes a sentiment increasingly seen across the industry, with Alphabet CEO Sundar Pichai recently sending a memo to staff stating that “moving forward, we need to be more entrepreneurial, working with greater urgency, sharper focus, and more hunger than we’ve shown on sunnier days”. E-commerce company Shopify has recently laid off 10% of their workforce; in a very transparent explanation the founder and CEO said that “we bet that the channel mix - the share of dollars that travel through e-commerce rather than physical retail - would permanently leap ahead by 5 or even 10 years... it’s now clear that bet didn’t pay off... we have to adjust”.

We have very low exposure to the non-profitable, high growth areas of Technology and our exposure is orientated towards more established cash flow producing businesses. This has been beneficial over the past year, but the fall in valuations in some areas of the market has been significant, so this is an environment to pick up high-quality businesses at dislocated valuations when opportunities present themselves.



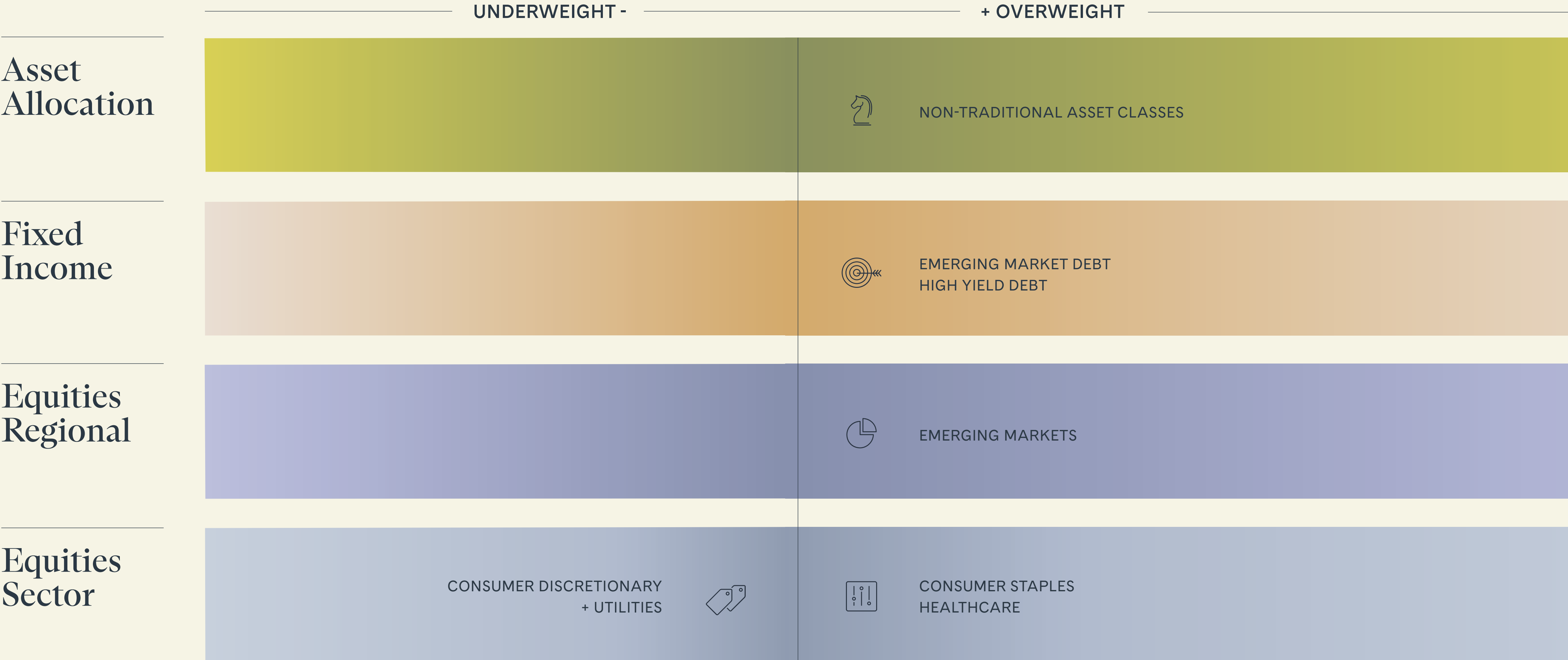
10%

The workforce that
E-commerce company
Shopify laid off.

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Global Asset Allocation

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



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