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OUT OF THE ORDINARY

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Market commentary

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Overview

The half-way point of the year is a natural moment to reflect on what has taken place so far and to consider what we can look forward to in the next six months. With the benefit of hindsight, it is abundantly clear that, bearing the scars of 2022, strategists and investors as a group were too cautious at the beginning of 2023. For example, the year began with the consensus of Wall Street's strategists calling for a down year for the S&P 500 Index for the first time since Bloomberg started to collate the data in 1998. At the end of June, it had posted a capital gain of 16%.

Neither can economists escape scrutiny. At the turn of the year, there was widespread expectation that recessions would develop in the US, the UK and Europe. Activity has surprised to the upside in the two former cases, although parts of Europe have been hampered more by a global slowdown in the manufacturing industry. Conversely, hopes were being pinned on a strong post-lockdown recovery in China, but this has not materialised.

That is not to say that there have not been alarming moments along the way. The bankruptcies of three US regional banks, which started with the failure of Silicon Valley Bank in early March, quickly followed by Credit Suisse having to be rescued by its Swiss rival UBS, sent ripples of concern through the financial system. However, the swift response of central banks to provide liquidity where needed did a lot to allay fears of the situation evolving into a more pervasive financial crisis. Indeed, it has been our long-held opinion that central banks learned some lessons the hard way during the Great Financial Crisis of 2008/09, and one of them was to backstop the banking system with liquidity when required even if allowing individual banks to fail and their equity holders to be wiped out.

Events such as these bank failures are, to some degree at least, symptomatic of a past world in which decisions were made based upon the expectation of a longer period of cheap and easily available funding: cash deposits in the case of some banks, and generous investments from venture capital firms in the case of many of the depositors of Silicon Valley Bank. However, the big rise in interest rates over the last year or so has turned those expectations on their head, and some businesses that appeared to be sustainable in a zero-interest rate world are now looking a lot more fragile.

Even so, the financial stress narrative is taking a lot longer to play out than many expected. Corporate treasurers have termed out a lot of their debt, meaning that they will continue to benefit from lower interest payments until those loans mature. A lot will then depend upon the new rate. There are similar dynamics at play in many housing markets around the world. Fixed-rate mortgages are cushioning the immediate blow of higher rates, as we detailed in last month's commentary. However, there are differences from country to country. US mortgagees are exceptionally well positioned, with around 90% of mortgages fixed for 15 years or longer. In the UK, the majority of fixes are in the two-to-five-year range, meaning that there is a much shorter fuse on the "mortgage timebomb". At the time of writing, the going rate for both two and five-year fixes had risen above 6%. That compares with 1.4% two years ago for the former and 2% five years ago for the latter, according to Bank of England data.

For some, memories of the house price crash of the early 1990s are being rekindled. Although we believe that UK house prices will remain under pressure, the probability of a similar downturn (-25%), at least in nominal prices, is lower. Back then, the UK was locked into the European Exchange Rate Mechanism, in which sterling was tied to the German Deutschmark (in the pre-euro world), even while Germany was raising interest rates to deal with its own post-unification inflation problem. The rate at which it was fixed turned out to be too high to be competitive. In a floating currency environment, the pound would have adjusted accordingly to a lower level. In the pegged world, the Bank of England had to defend the currency by maintaining double-digit interest rates, which inflicted serious damage on the economy, and by buying sterling. Before the ignominious departure of the pound from the ERM on Black Wednesday (16 September 1992), the unemployment rate was almost 10%. The Bank has no need to defend any explicit currency level today, and the unemployment rate remains exceptionally low at 3.8%. We would certainly be more concerned should unemployment start to rise quickly.

Central bankers will remain key players over the months ahead. It is clear that, as a group, they have struggled to interpret the economic signals generated during the last couple of years, and much scrutiny is being placed on their methodologies. Even so, it is possible to have a modicum of sympathy for their plight given the disruption caused by the pandemic. It is clear that different parts of the global economy are moving at very different speeds. The manufacturing economy appears to be in a recession as it battles the bullwhip effect of inventory management. The services economy is much stronger and

even booming in parts. Ryanair has just announced that it carried a record number of passengers in June. The US Transport Security Association is processing record numbers of passengers through its security controls at US airports. There again, downtown offices in many large US cities are massively underutilised and seeing big cuts to their valuations. "Big data" sets, such as for the use of mass transit and cell phone tower signals, suggest a huge drop in activity as the Work From Home culture digs in.

Another big surprise in the US has been the resilience of the construction industry. In past monetary policy tightening cycles, this has been a regular casualty. This time, though, with those higher rates deterring existing mortgaged homeowners from moving (as they would have to take out new loans at around double their locked-in rate), the supply void is being filled with newly built houses. And there is demand. The millennial (or echo boomer) generation, aged 27 to 42, is in the sweet spot for new household formation (getting married, having children, etc.), and cannot live in its parents' basement for ever.

Additionally, there is a US boom in the construction of new manufacturing facilities (despite the global manufacturing recession). This is being driven by fiscal incentives from the Biden administration to shorten and strengthen supply chains, to reduce the dependence on China, especially, and to accelerate the green energy transition. This effectively means that the government is pressing down on the economic accelerator while the Federal Reserve is hard on the brakes and helps to explain some of the persistence of higher core inflation.

We cannot wrap up this section without some mention of the latest hot investment topic, generative Artificial Intelligence (AI). The excitement started to build in late 2022 with the release of Chat GPT, the first publicly available interactive and intuitive iteration of AI. But it was not until late May that the excitement turned into a frenzy. This resulted from comments made by semiconductor chip-designer Nvidia, in which it massively upgraded its expectations for future demand. Nvidia's chips are the market leaders by some distance in terms of their ability to handle the computational needs of AI models. Investment demand spilled over into other potential beneficiaries. Amongst the large companies that we analyse, we categorise these as the "makers" (including, for example, companies such as Microsoft, Meta, and Alphabet), the "processors" (Microsoft, Amazon, Alphabet), the "picks and shovels merchants" (Nvidia itself and Cisco for networking), the "suppliers to the merchants" (ASML), and the cybersecurity "police" (Palo Alto). (Please bear in mind that mention of these companies does not constitute an investment recommendation)

We certainly believe that the latest iteration of AI is a potential game-changer in terms of productivity. However, it is far from clear exactly how the benefits and losses will be distributed. The launch of Chat GPT has been likened to that of the iPhone, in that it provides everyday utility in an easily accessible form. It's a product breakthrough as much as an advance in technology. Famously, the iPhone was the source of great disruption to the taxi industry (think Uber), and, more recently, the ability to withdraw deposits from a bank by tapping a phone contributed to the swift demise of Silicon Valley Bank. Such outcomes were not predicted when Steve Jobs unveiled his new device. We are bound to be surprised by what happens in the next few years.

Markets – US

Technology stocks, especially those benefitting from the enthusiasm for all things AI (see above), have led the market higher this year. The Tech-laden NASDAQ Composite index has risen 32%, and the even more narrowly focused FANG+ group has delivered a return of 74%. The FANG+ Index's equal-weighted components are Meta (+138% YTD), Apple (+50%), Amazon (+55%), Netflix (+49%), Microsoft (+43%), Alphabet (+36%), Tesla (+112%), Nvidia (+189%), Snowflake (+22%) and AMD (+36%). The Dow Jones Industrial Average has only ground out a return of 3.8% so far, while the equal-weighted S&P 500 is +6%. Much has been made of the performance gap between the market-capitalisation weighted and equal-weighted versions of the S&P 500. There were two distinct legs to the divergence. The jaws started to open on 8 March, the day that Silicon Valley Bank collapsed. While

worries about the health of the banking system pressed down on most of the market, the provision of liquidity to the financial system was interpreted as a new round of Quantitative Easing and this gave a new lease of life to mega-cap Tech. The second leg of the trade kicked off on 25 May, the day of Nvidia's afore mentioned announcement. But no sooner did it become a "thing", than the divergence stopped. The two versions of the index have traded in line since the beginning of June, with some evidence of rotation back into cyclicals as the US economy continues to grow. In fact, last month the Russell 2000 Index, which comprises mid-and small cap stocks, managed to outperform the S&P 500, the NASDAQ Composite and even the FANG+ Indices.

UK

UK equities have been a distinct laggard this year. The FTSE 100 has delivered a total return of 3.11%, with 2% of that coming from dividend income; the FTSE All-Share 2.5%, with 2% from dividends here too. While it would be easy to blame this performance on the problems in the economy, it is really index composition that has been the problem once again, exacerbated by the recovery of sterling against the dollar. Energy and Pharma have been flat; Resources are down sharply on account of the weakness of China's economy; Consumer Staples are lower too. Only HSBC amongst the heavyweights has made much progress, whilst domestic banks have struggled under the weight of interest rates which have risen too high for comfort. Technology still has a microscopic weighting. In the financial press, much is being made of the fact that ownership of UK equities by domestic pension funds has dwindled to virtually zero. It would be nice to think that several decades of selling pressure is now coming to an end. Many UK equities continue to screen cheap against peers in other regions, although it might take a pick-up in takeover activity to unlock the value.

Europe

Last month we wrote about European equities' relationship with Citigroup's Economic Surprise Index. They had tracked upwards its recovery from the lows of last summer to the peak of February, and ground to a halt as the index fell back from 101 to -62 at the end of May. It is worrying to report that in June it plummeted to -146, with timely survey data from both businesses and consumers failing to meet expectations. It has only been lower during the pandemic in 2020 (-300) and, before that, during the financial crisis in 2008 (-185). With the eurozone Core Consumer Price Index ticking up from 5.3% in May to 5.4% in June, the European Central Bank continues to talk tough when it comes to monetary policy, suggesting that that there are at least two more interest rate increases in the pipeline. The market, perhaps unsurprisingly in the face of the activity data, is less sure. The forthcoming second quarter results season might prove to be a tricky one.

Emerging Markets

China continues to dominate the Emerging Markets narrative, and for all the wrong reasons. Here, too, the Economic Surprise Index is in something of a freefall (from 162 in April to a current -59). The post-lockdown recovery has failed to gain any real traction. While global demand for goods is weak, hampering the export economy, domestic consumption is also lacklustre. This is largely being blamed on the housing market, where prices are flat. Many of China's citizens have ploughed their savings into residential property as a substitute for a pension, but with house prices not moving, they are not feeling flush. One factor in China's favour, potentially, is that it is one country in the world where inflation is not a problem. Consumer prices are rising at just 0.2% year-on-year, and Producer Prices are running at -5%. This uniquely gives the Peoples' Bank of China leeway to be more generous with monetary stimulus. But it is slow in coming. There have so far only been small cuts to banks' Reserve Requirement Ratios and minimal reductions in interest rates. It might take a more comprehensive fiscal package from the government to turn the tide.

Fixed Income

It has been another tough year for sovereign bonds, with the Bloomberg Global Aggregate Dollar Index managing a gain of just 1.43% (which turns into a loss in sterling). The US 10-year yield is five basis points below where it started the year. The UK 10-year Gilt

yield has risen sharply from 3.67% to 4.38% in the face of some nasty inflation prints. The 3.25% Gilt maturing in January 2033 (that was effectively the benchmark ten-year Gilt at the start of this year) has delivered a total return of -3.8% in the first six months. The German Bund has fared a little better, with the yield falling from 2.57% to 2.39%. Credit and Emerging Market Debt have been happier hunting grounds, again with help from decent carry and also some spread compression as the US economy has been more resilient. Using US-listed ETFs as a proxy for Credit, Investment Grade has returned 4.3% and High Yield managed 4.5%. The dollar version of our favoured EM Debt fund (using dollars for comparability) has risen 6.5%. However, the pound's continuing recovery against the dollar will have dampened returns to sterling-based investors.

UK Gilts have delivered a total return of -5.4% over the last three months and -14.5% over the last year. Index-Linked Gilts returned -6.7% and -17.5% over the same respective periods. Emerging Market sovereign bonds produced a total return of -1% in sterling over the three months to end June (+2.6% over 12m). Global High Yield bonds delivered -0.8% (+5.55% over 12m) in sterling.

Conclusion and Outlook

Our analysis of forward-looking indicators continues to suggest that tougher times are ahead for the global economy and that central banks will persist with tight monetary policy either until they are convinced that inflation is permanently contained or there is a nasty financial accident. Either way, we expect to experience a period of retrenchment for risk assets, even if it would be fair to say that we, like the majority of analysts and investors, have been surprised by the resilience displayed so far. We continue to believe that such a sharp repricing of the cost of capital as we have seen in the last year will ultimately have more widespread negative consequences, although any recession will be relatively shallow owing to the fact that neither consumers nor companies are excessively stretched, as they were, for example, in the lead up to the financial crisis. Thus, we are still proceeding with caution, although still prepared to take some targeted risk to achieve longer-term returns.

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