Quarterly report

2023 MARKET REVIEW

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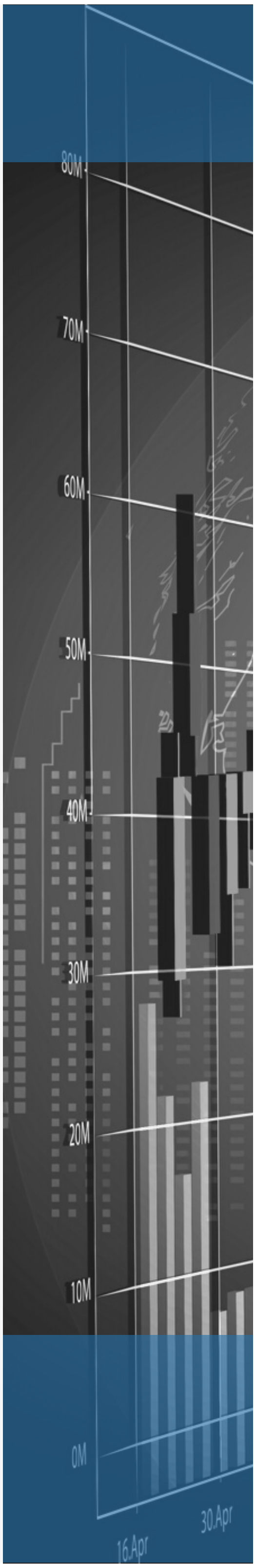
Overview

- Portfolio positioning becomes more important than ever
- Is the era of US dominance over?
- Unstoppable trends
- Putting cash to work in anticipation of a changing macroeconomic environment

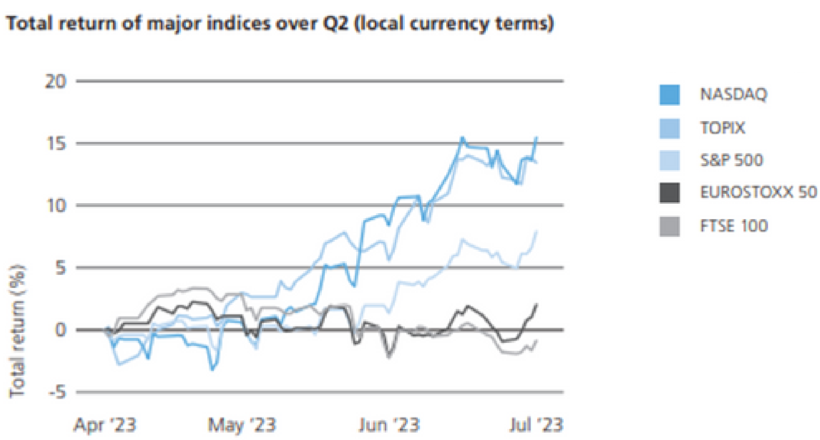
Portfolio positioning becomes more important than ever



The first six months of 2023 were more positive for markets and for economies than most expected. We saw a strong rally for global markets in the second quarter as illustrated in the graph below, and whilst for investors this welcome rebound helped make up lost ground from a punishing 2022, it could also demonstrate that markets are far too willing to look past risks that still exist. The existence of these risks leads us now, more than ever, to focus on asset allocation as a key lever in mitigating portfolio risk management during times of investor stress. From an asset allocation perspective, the extraordinary shift in interest rates over the past 12 – 18 months has provided us with investors' only free lunch, diversification. Now we can use fixed income assets to provide the diversification benefits we haven't enjoyed for many years meaning now more than ever, that asset allocation plays a crucial role in generating strong and stable returns. We have been actively managing our bond holdings in portfolios to take advantage of this 'better than expected' environment and positioning portfolios for the scenarios we believe investors could be facing over the next six months and beyond. We also reduced equity exposure with the belief that elevated valuations, driven in most parts of the world by multiple expansion, are not appropriately pricing in the potential risks at play.

2023 has so far provided a more sanguine macroeconomic environment than many were predicting. However, stubbornly high inflation, due to factors such as a tight labour market, deglobalisation and the move to a greener and cleaner economy, may well remain higher than central banks would ideally like. For investors, in this environment it is very important to know what you own. To invest in quality and strong dividend paying companies in sectors such as healthcare, and maintaining a well-diversified regional allocation, investors can weather turbulent times more effectively.

Whilst the investing and macroeconomic landscape has so far been kinder than anticipated, it is important to take stock and consider the economic environments we may well find ourselves in over the next months and quarters, all pivoting on inflation and the corresponding response from central banks in the movement of interest rates.



Source: Morningstar

We consider three scenarios, firstly our base scenario, a soft landing in which inflation falls, growth remains subdued, but recession avoided. We also consider a tail risk inflationary scenario where inflation remains high, and more interest rate rises are required.

And finally, a second tail risk recessionary scenario, in which central banks are forced to cut interest rates in reaction to a slowing economy. We don't have certainty over which scenario will occur, although we place the highest probability on our base scenario. It is, therefore, important than the portfolios we manage for clients are positioned primarily for our base case scenario to occur, however, we have holdings in portfolios that will protect the portfolios if one of the tail risk scenarios plays out.

Base case: soft landing

- Inflation falls and hiking cycle is close to completion
- Global growth remains subdued (slow or slightly negative as evidence of the long and variable lagged impact of interest rate hikes are felt)
- Earnings remain reasonably robust for high quality business

Tail risk 1: inflationary scenario

- US core inflation remains stubborn and high headline inflation resumes
- More interest rate rises are required to bring inflation down, causing risk assets to sell off as discount rates increase

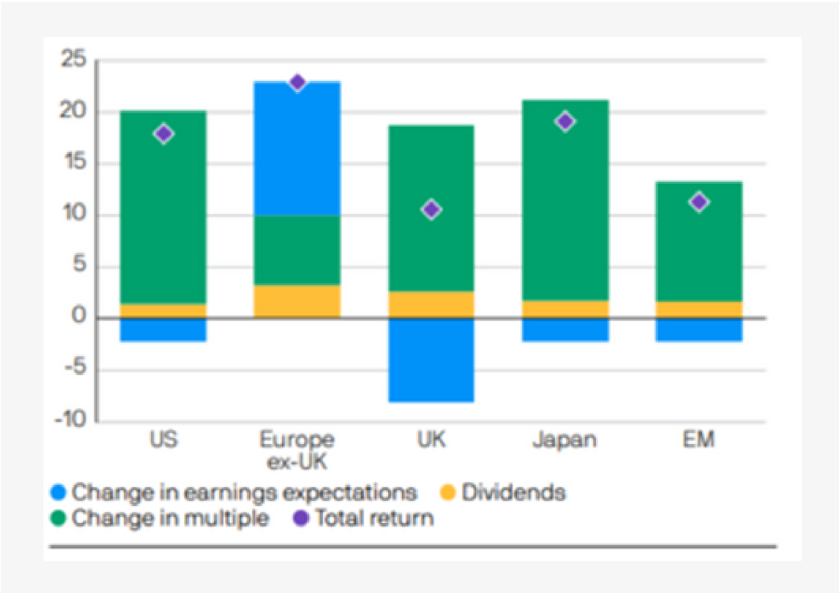
Tail risk 2: recessionary scenario

- Lagging impact of rate rises is more pronounced than anticipated, forcing central banks to cut rates
- Material earnings decline, stock market sell-off

In reality, a combination of these scenarios could be the most likely to come to pass. For example, whilst a soft landing could be the outcome for global growth prospects, central banks may be forced to keep policy tighter for longer than investors are anticipating due to supply constraints including a tight labour market in the US and more resilience shown by consumers and businesses than the bond market is currently expecting. Whilst inflation is falling in some parts of the world, the goal of core inflation of 2% still seems a lofty ambition for this year.

Is the era of US dominance over?

While the US remains home to some of the highest quality companies, investment opportunities outside of the US appear attractive. We question whether the investment cycle will differ for non-US stocks this time and lead to the potential for shorter-term gains in non-US markets. This year, the ten stocks driving the S&P 500's return have accounted for 82% of that return. 10 stocks typically account for 32% of the S&P's return[1].



Source: JP Morgan Asset Management, data

Whilst these are diversified, cash generative and in many ways defensive businesses, the narrow nature of the rally gives a misleading picture of the broader health of the US market. Focusing on the fundamentals and balance of risks, we have reduced US equity exposure during the first half of 2023. Outside of the US market, European and Japanese equities have performed well, as depicted in the graph above. The portfolios, through the global fund holdings, are well exposed to these regions and are well positioned to benefit from future returns from these areas.

We increased the exposure to Asia and wider emerging market economies in portfolios last year due to the fact many emerging economies are helped by supportive monetary policy and long-term trends. The trends indicate superior growth potential such as a youthful demographic and a growing middle class. Whilst we were perhaps a little early on this positioning, taking stock at this half year point, the investment thesis remains intact, and if anything, at a 30% valuation discount versus developed markets, investing in emerging market economies now makes for an even more compelling case than six months ago. Developed markets are still battling significant supply constraints driven by labour shortage, geopolitical fragmentation, and an ageing population that is having a real-time impact on the US economy.

The consensus that 2023 would bring China's post-COVID recovery (and with it, boost the fortunes of the wider emerging market region) fell a bit flat as economic data underwhelmed during the second quarter. However, there is a real potential for improvement in broad market sentiment, particularly in China if we see a large stimulus package from the government. Unlike other countries, Chinese inflation currently remains muted, and in general monetary policies across emerging markets remain supportive. Countries like Vietnam, Malaysia, Thailand, Mexico, Argentina and India all have access to cheap energy, an abundant labour force and free trade with large parts of the global economy. Whereas, the negative impacts of deglobalisation on developed countries are already playing out in trade, inflation and scarcity of labour. So whilst there are near term challenges, many emerging markets have robust long-term growth prospects, making them an attractive investment option.

> ***Without question, AI has the potential to revolutionise productivity across industries.***
>
> Phoebe Stone, Head of Intermediary Investment Services, LGT Wealth Management

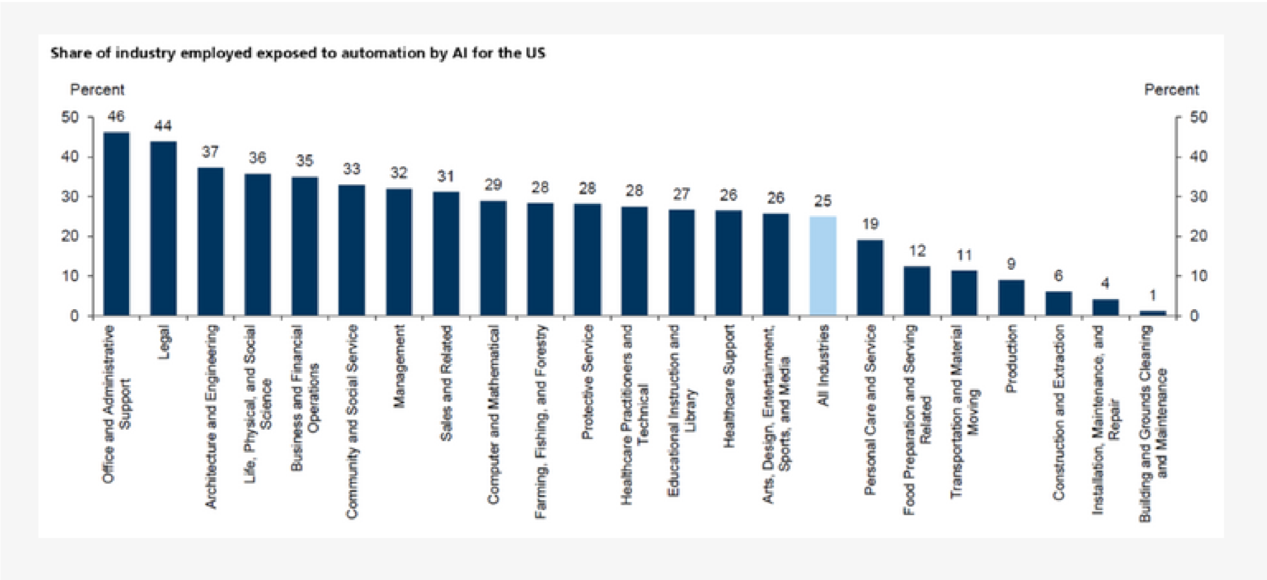
Unstoppable trends

Returns in the S&P 500 this year have so far largely been driven by the large technology businesses Apple, Alphabet, Microsoft, Amazon, Meta, Tesla and Nvidia.

One thing all these companies have in common, as well as being cash generative and diversified businesses, is significant exposure to Artificial Intelligence and more specifically, generative AI. AI should be viewed as much more than one of the many hype-investment themes we saw proliferate in 2021. Without question, AI has the potential to revolutionise productivity across industries. Following AI adoption, workers employed in occupations that are partially exposed to AI automation could have the ability to redirect newly created capacity toward other productive activities.

We believe the emergence of AI represents a new structural megatrend. Like all megatrends, its impact on the global economy will be significant and will become increasingly evident over a long-time horizon, largely unaffected by cyclical forces. Identifying investment opportunities associated with these megatrends can be a fruitful strategy, however, it is important to be selective, particularly in the more formative stages as investor exuberance can trump investment fundamentals and it is not always clear where market leadership will emerge.

Putting cash to work



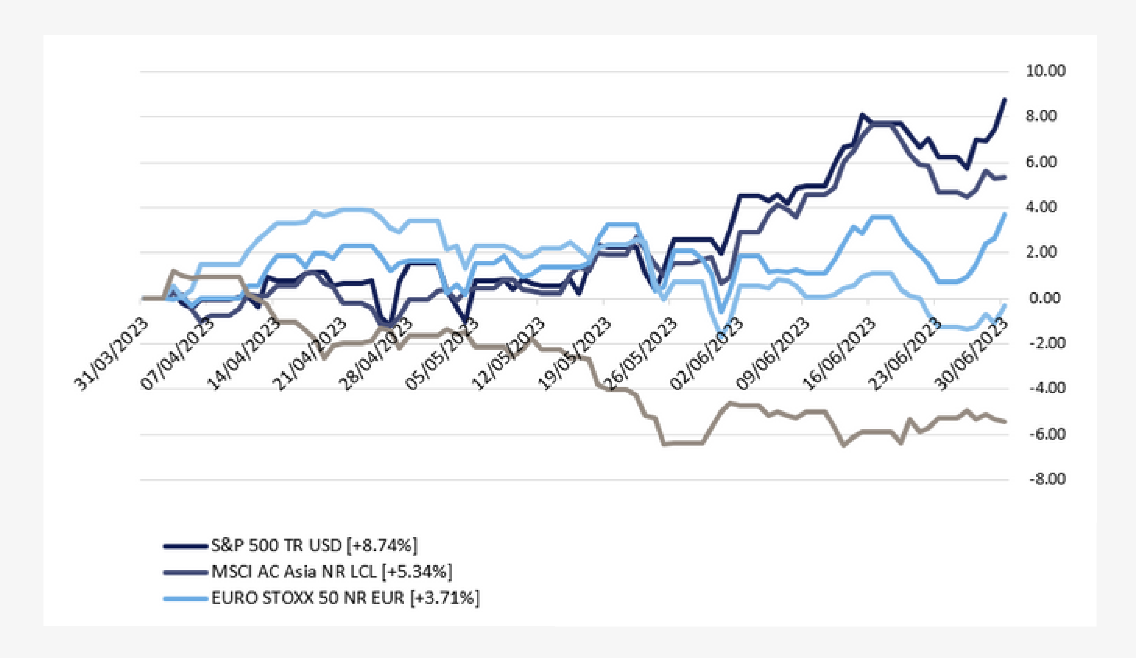
Source: Goldman Sachs

Along with drawdowns experienced across the market, 2022 also massively improved prospects for holders of cash. In the current environment, it is very tempting for investors to choose to hold bank deposits, offering in the region of 4.5% return, however, this strategy could be too short sighted. The return on cash will fall as we reach the peak of the rate cycle and the market focus moves to potential cuts. An alternative strategy that will enable investors to lock in yield would be to buy a short-dated bond that is paying out the same yield as cash, or slightly higher, but without the reinvestment risk (until the bond matures).

For this reason, we have been bringing the cash position in portfolios down and investing in the bond market to take advantage of yields.

Whilst we are currently holding a neutral equity position, reflecting the balance of risks we see on the macroeconomic landscape over the medium term, equities are the asset that enable significant capital appreciation. We believe that being selective and holding quality companies that have the ability to weather a turbulent macroeconomic environment, higher inflation or higher interest rates for longer, is a prudent way to be holding equity investments at this time.

Q2 2023 index performance (%)



Source: Morningstar

A summary of markets over Q2 2023

Headlines in June centred around decisions made by central banks as they grappled with the puzzling macroeconomic backdrop. Despite their efforts, inflation remains elevated which has left markets questioning when central banks may pause or pivot. Despite sustained concerns around inflation and interest rates, markets were much more resilient in Q2 2023, with some posting impressive gains.

Inflation in the US

Having referenced inflation remaining elevated, we are beginning to see some positive data emerging in relation to US inflation levels. The Federal Reserve (Fed) has been raising rates since 2021 and we are starting to see the impact of these hikes bear fruit as headline CPI (Consumer Price Index) numbers have eased to 3%-4% range, with some expecting they'll be as low as 2% by the end of the year. However, the risk of overtightening remains and we are being mindful of this within portfolios.

The UK faces an uphill battle

Within the UK, inflation is proving much stickier. It is fair to say that the Bank of England (BoE) is in a bit of a bind and we face an uphill battle in taming prices. There are many factors contributing to elevated inflation, a tight labour market, Brexit, supply chain issues, to name a few, and these headwinds certainly suggest that interest rate rises may continue. Some economists are predicting hikes to 6%, possibly peaking at 6.75%.

Touching on China

China has struggled on emergence from lockdown and their reopening has fallen below expectations. This hurt Chinese stocks, specifically those aligned with the Chinese consumer who disappointed on reopening in terms of travel and spending. Despite this, there are reasons to be optimistic on the region; there's an upcoming government meeting this month where more positive policy stimulus could be expected, the government have been introducing policy to increase domestic demand to drive growth and expand consumption. The Chinese consumer is undergoing an innovation and is entering a new phase of development.

Emerging Markets

Stripping China out, emerging markets, particularly the likes of Vietnam and India, have seen good market growth across the quarter. Emerging markets, both the equity and debt of these regions, continue to be areas we view as powerful tailwinds for growth over the medium to long-term for more growth centric investors.

Q2 2023 index performance (%)

Top performing funds

	Performance	Comment
Fidelity American Special Situations	Return +5.14	The American special situations fund takes a value tilt to US investing. Cyclical sectors such as industrials and technology outperformed in July as stronger than expected growth beat market expectations. Defensive sectors such as energy, healthcare and financials have outperformed in August and September as fears of recession saw a sell of in growth assets.
iShares Physical Gold ETC	Return +4.88%	Growing recession fears have driven up the value of Gold this quarter hovering below the $2k mark. The dollar has increased in value this quarter as growth beats forecasts acting againts the increase demand. However, as growth slows a softening dollar should have a positive impact on gold prices.

Source: MSCI ACWI

Q2 2023 index performance (%)

Bottom performing fund

	Performance	Comment
BGF Sustainable Energy	Return -7.96%	An increase in interest rate forecasts has led to sell off in growth assets as higher for longer impacts future cash flows. Rishi Sunak back track on net zero targets and policy received back lash concerning investors that are heavily investing in the energy transition. Despite the recent volatility the need for renewable energy to reduce climate change as well as improving energy security will likely see continue investments as well as government subsidies and tax credits for the foreseeable.

Portfolio positioning rationale by asset class

Fixed Interest
The emergence of higher inflation caused havoc to global bond and equity markets in 2022 and has since peaked and fallen to mid-single digits in most developed countries. There is an increasing likelihood that inflation stays elevated, and specifically remains above central bank target levels for the foreseeable future. This quarter we added Global Inflation Linked Bonds in order to provide protection to an environment where inflation stays higher for longer.

Equity
In the equity space, we have made adjustments across the models to address geographic or stylistic underweights. In doing so, we have cautiously taken profits from US funds and sought to incorporate more value-focussed funds that seek to identify high quality companies but also operate a strict valuation thesis. Elsewhere, in line with our house view, we have added further to Asian equities, an area we continue to look for opportunities in.

Absolute Return / Alternatives
Our conviction in our active alternative managers remains high and the funds continue to offer diversification benefits and robust, stable returns in periods of economic uncertainty. We have increased our exposure to absolute return over the quarter to provide protection further diversification against recessionary scenarios.

Cash
The allocations to cash were modestly reduced over the quarter, moving from what were particularly high levels to more modest levels in line with the respective risk tolerances. Cash buffers are held across the portfolios to add further protection in periods of volatility and enable us to act quickly should investment opportunities arise.

Important information

Important information

Pensions are a long term commitment, you may not be able to access your pension funds until the age of 55 (currently), investments can go down as well as up and you might not get back your initial capital. Pension and tax legislation does and can change in the future which could impact your pension.

Please note: The Financial Conduct Authority does not regulate tax planning.

As a mortgage is secured against your property it may be repossessed if you do not keep up the mortgage repayments.

The value of your investment and any income from it could fall or rise, and you may not get back the full amount you invest.

Past performance is not a reliable indicator of future results. We always recommend you talk to a qualified financial adviser before making any investment decisions.

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