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2023 Q2 INVESTMENT REVIEW

Summary

- US shares continue to climb given growing interest in Artificial Intelligence.
- The Bank of England talks and acts more aggressively in trying to reduce inflation.
- Government gilts sustain a further fall in value, but offer attractions for new money.

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- This investment commentary review contains information and opinion on current economic and political positions and does not constitute advice.
- The information is provided in good faith and is believed to be accurate, but as some data is provided by third parties this cannot be guaranteed.
- Past returns should not be seen as predictors of future returns.

A surprisingly positive quarter for global stock markets, despite continued economic weakness. US and Japanese markets in local currency have performed well, but UK investors have not received much of the benefit after accounting for the strong rise in the value of sterling relative to their currencies.

Central banks continue to talk tough over the future path of interest rates, which may be enough to deter consumer demand and business investment to the extent that only modest further action is required.

Fixed interest bonds may well have hit the high in terms of yields, as inflation is finally starting to fall, even in the UK, which has structural issues compared to other economies.

For some investors with excess cash reserves government gilts are offering an interesting and tax efficient alternative to fixed term deposits. This may be suitable if held through to maturity given that the values can fluctuate in the interim period like any other asset class.

Market Data
(GBP)

Asset Class	Index	Q2 2023	Year to Date
US Shares	S&P 500	5.6%	10.3%
World Shares	FTSE World ex UK	4.1%	9.1%
Japanese Shares	TSE Topix	2.5%	5.8%
European Shares	Euro STOXX 50	1.3%	14.5%
UK Commercial Property	FE UK Property Proxy	0.9%	0.1%
UK Shares	FTSE All Share	-0.5%	2.6%
Emerging Market Shares	MSCI Emerging Markets	-1.9%	-0.8%
Hedge Funds	HFRX Global Hedge Fund	-2.1%	-4.8%
Corporate Bonds	Bloomberg Sterling Aggregate Corporate	-3.4%	-1.0%
Asia Pacific Shares	MSCI AC Asia Pacific ex Japan	-3.8%	-2.5%
Gold	S&P GSCI Gold Spot	-5.2%	-0.3%
Commodities	S&P GSCI Commodities	-5.4%	-12.5%
UK Gilts	Bloomberg Sterling Gilts	-6.0%	-3.9%

Performance Data: FE Analytics in GBP to 30/6/2023

Q2 Review

Perhaps the most surprising thing in markets so far in 2023 is the resilience shown by stock indices despite the constant supply of negative economic news and prospect of a recession.

However, again, this performance has been driven by a small cohort of technology companies in the US, as the spotlight over the quarter pointed on the potential of Artificial Intelligence (AI), with companies like Microsoft, Alphabet, Meta and lesser known Nvidia driving AI research forward.

The headline performance figures do not necessarily reflect a broad and healthy market and it is unlikely that many active fund managers will have replicated this market performance, which would have required a very narrow focus, so investors will have only received some benefit.

Japanese markets have performed very well in local terms and deserve a mention. The country has an unusual interest rate policy of maintaining negative rates at -0.1% in order to encourage inflation, as the rest of the world is trying to reduce it. The effect of this is that capital has left the country in search of higher yields elsewhere, meaning the local currency (Yen) has fallen significantly -15% v Sterling and -10% v USD Dollar.

This has made buying Japanese exports far better value and sent corporate profits and stock markets soaring. However, overseas investors again don't benefit to the same extent because of the fall in the exchange rate.

Global stock markets are behaving like the economy will find an equilibrium between inflation and interest rates, with any recession that does occur proving mild. The collective opinion of investors shown in the market often points in the right direction, though some market moves can be extreme and brought on by both excessive fear and exuberance.

The bond market however is more calculated than the stock market, with investment values closely linked to prevailing interest rates. As UK rates are still rising to counter stubborn inflation this has resulted in gilts and corporate bonds continuing to fall in value. Over the past quarter the Bank of England raised rates to 5%, including a 0.5% rise at the last meeting and is talking aggressively about doing whatever it takes to reduce inflation.

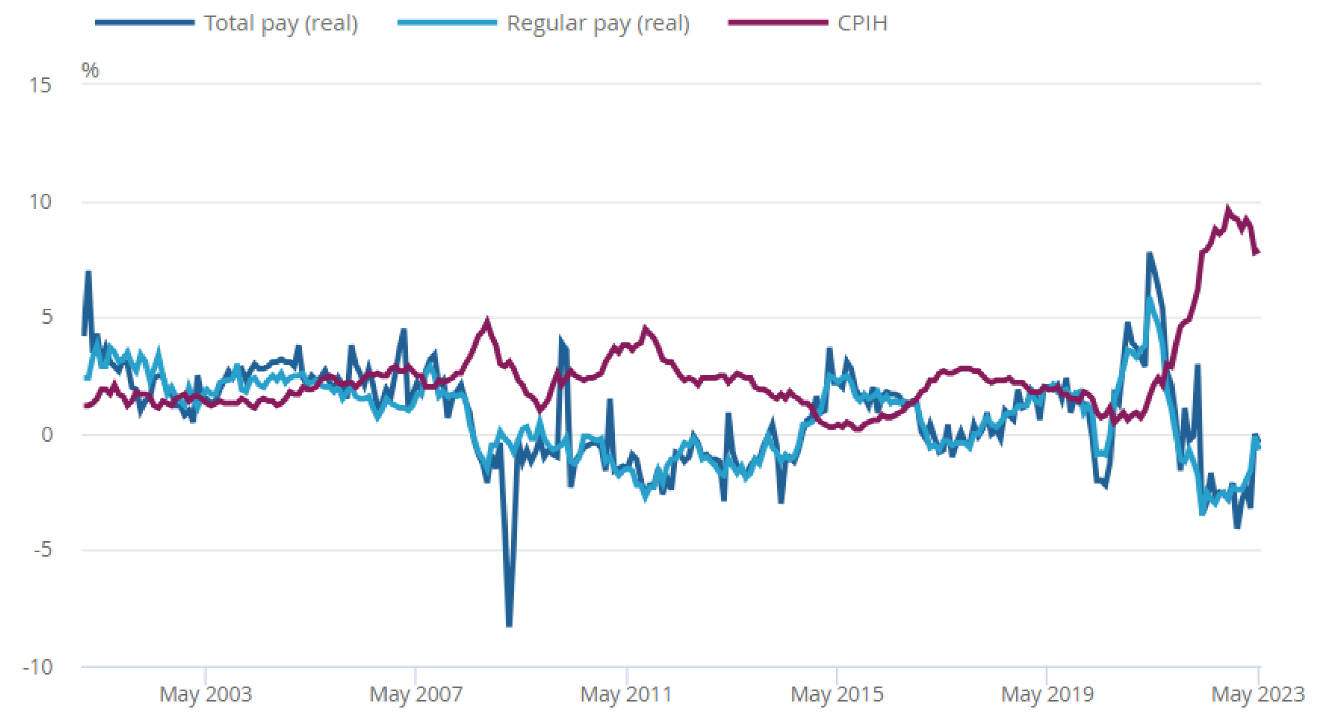
Sentiment in bonds is bleak right now as investors (and mortgage holders) fear how far higher interest rates might go. The turning point of markets i.e. when maximum optimism or pessimism appears, is difficult to spot and often has false dawns. However, according to the July Calastone fund flow index, investors are starting to move funds out of stocks and into bonds, believing the worst has now past.

Therefore investors will welcome the news just released by the ONS (at the time of writing) that UK CPI inflation in June had fallen further than expected to 7.9% from 8.7% in May, which could well see a shift in sentiment emerge. This seems the first positively received news on inflation in some time and, when sentiment changes, it changes fast.

Chancellor Jeremy Hunt has claimed success for the government here, which we suggested would happen back in January. But, if the government is independent from the Bank of England then what have they actually done?

The Economist (June 2023) highlighted that the UK government transferred more stimulus to the economy than any other country, with the exception of the US, equivalent to 23.1% of national income. This wave of demand hit a structurally impaired economy, with a reliance upon the service rather than manufacturing sector, meaning pent up spending alongside too few workers available to meet demand.

Hence, we are seeing a tight labour market and high wage growth, which is making inflation relatively stubborn. The ONS July report showed the UK employment rate at 76%, a slight increase on the previous quarter but still below the level before the pandemic. Private pay has risen +7.7% and public pay +5.8% year on year to May. Despite this households remain worse off and still have lower real spending power, which has been the story since 2008 as shown in the graph on next page.



Source: Monthly Wages and Salaries Survey, and Consumer price inflation from The Office for National Statistics.

Navigating the brave new world

We had FPC friend and former economic consultant Peter Stanyer in the office last week discussing his new book, which he co-authored for the Economist titled 'How to Invest – Navigating the Brave New World of Investment'.

Throughout the book Peter provides straight forward and clearly explained investment management principles and guidance and
we feel it valuable to highlight a few that align with our own approach:

Under-diversification – it can be cliché to talk of portfolio diversification when investing. However, the fact is that most concentrated portfolios will often underperform the market given that the probability of consistently buying and selling stocks that do most of the heavy lifting in the index, at the right time, is very low. It is safest to have a fair spread of holdings.

Portfolio Re-balancing – this is a useful counter-cyclical policy that anchors and investment strategy to a pre-determined risk structure. It is a means of taking risk when others are cautious, as defensive asset values rise and risk assets fall, with the reverse also true. Financial markets are odd in that investors are attracted to taking more risk as prices rise and assets become more expensive, and less risk as prices fall and offer better value.

Alternative Investments – the allure of investments such as private equity and hedge funds to private investors that target lower volatility whilst delivering high returns is understandable. The underlying investment portfolio may provide exposure to interesting strategies, but these can be expensive and often, in times of stress when most needed, prove disappointing for performance diversification and can be difficult to sell. To quote Peter:

"Inconveniently, an investor's own demand for liquidity can be surprisingly high when markets are least willing to supply it".

Responsible Investing – the idea that excluding certain sectors in portfolios i.e. oil/mining is a 'blunt' instrument in terms of influencing corporate change. Whilst private clients often do not have the ability to exert pressure on management directly, they can do so by selecting fund managers that do actively engage. Disinvestment may be the final outcome if companies do not listen to shareholders, but hopefully engagement works.

Peter Stanyer pictured with Moira O'Shaughnessy, Managing Partner, FPC, and Michael Lea, Investment Director and Senior Adviser, FPC LLP.

Gilt edged opportunity?

At a portfolio level Strategic Bond fund managers are well placed to take advantage of short term value in gilt markets and purchase debt below face value.

At a personal investor level, particularly for higher or additional rate tax payers with significant cash holdings, the same principle can apply but with the added attraction that any capital gains on gilts are tax free.

However, it is essential that such holdings be held to maturity and this is not a replacement for cash deposits for which access is required.

This is because the value of gilts could fall during the holding period. We will be communicating with clients separately where we feel this is an appropriate solution.

It is at uncertain times like the current period that liquidity and cash-flow planning provide additional value to investors and give confidence that even if markets experience volatility, expected (and unexpected) expenditure needs can be met.

If you have any questions regarding your investment arrangements please contact your adviser who will be happy to discuss further.

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