2023 Q3 INVESTMENT REVIEW

Summary

- Global equity markets generally positive over the quarter as economic resilience continues.
- Markets adopt a ‘higher for longer’ view on interest rates despite the widespread fall in core inflation.
- Increased cash deposit rates attracting investors but history suggests staying invested makes sense.
- Corporate bonds outperforming UK government gilts.

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- 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.

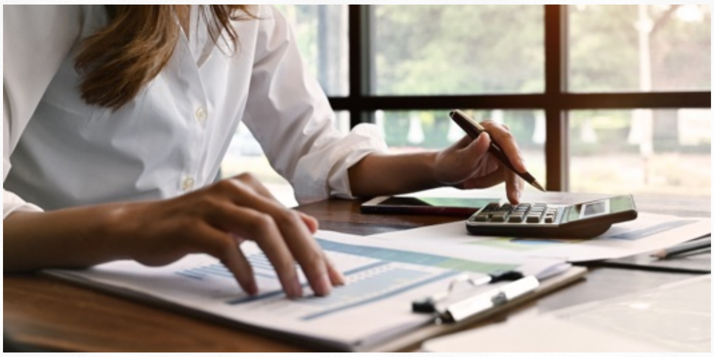
Markets continue to surprise with positive performance over the quarter, led by Japanese shares with the exchange rate being stable, though the Yen has fallen -13% year to date against sterling.

The US economy remains strong, with full employment and strong consumer spending. The US government continues to run a budget deficit adding further economic demand, which lessens the chances of interest rate cuts.

Meanwhile, the UK is likely in recession but still battling with relatively high inflation and public debt and therefore has limited levers to pull. UK gilts remain under pressure by association. The UK stock market has performed well thanks to the energy sector and influence of global companies in the index.

Commodity prices, in particular energy, rallied sharply following the Middle-East tensions, which will likely provide a tailwind to inflation.

Updated long-term investment performance data should provide investors with confidence to stay in the market, rather than move to cash even if relative returns over the past year seem attractive.



Market Data
(GBP)

Asset Class	Index	Q3 2023	Year to Date
Commodities	S&P GSCI Commodities	20.8%	5.7%
Hedge Funds	HFRX Global Hedge Fund	5.1%	0.1%
Japanese Shares	TSE Topix	3.2%	9.2%
Corporate Bonds	Bloomberg Sterling Aggregate Corporate	2.2%	1.2%
UK Shares	FTSE All Share	1.9%	4.5%
Emerging Market Shares	MSCI Emerging Markets	1.1%	0.4%
Asia Pacific Shares	MSCI AC Asia Pacific ex Japan	0.7%	-1.9%
North America Shares	S&P 500	0.6%	11.0%
World Shares	FTSE World ex UK	0.6%	9.8%
Gold	S&P GSCI Gold Spot	0.1%	-0.2%
UK Commercial Property	FE UK Property Proxy	0.0%	0.1%
UK Gilts	Bloomberg Sterling Gilts	-0.7%	-4.6%
European Shares	Euro STOXX 50	-3.9%	10.1%

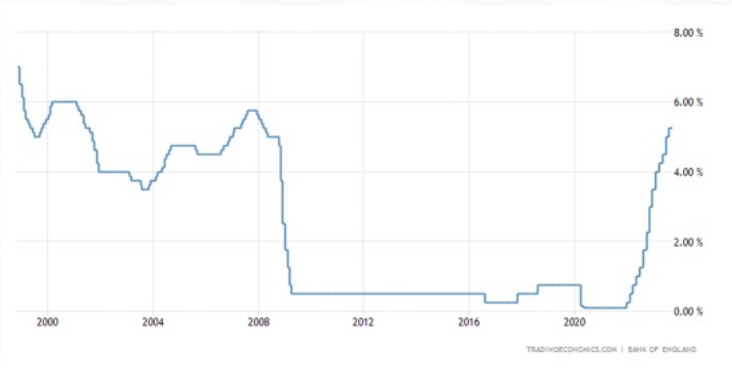
Performance Data: FE Analytics in GBP to 30/9/2023

Q3 Review

Given the economic backdrop, it is pleasing to report stability in financial markets over the 3rd quarter. To some, we appreciate that may feel a little underwhelming but given earlier forecasts of the potential impact from the inflation shock, and rise of interest rates, it comes as a bit of a relief.

We are conscious that client portfolio returns have been modest over the past couple of years, which leads to questions about how returns might be improved. Unfortunately, when faced with such a rapid change in rates that started in 2021, there are headwinds that are difficult to avoid.

Time goes by quickly, with it now being 15 years since the great financial crisis, which brought about the tailwind of rock bottom interest rates enjoyed by investors, as shown below:



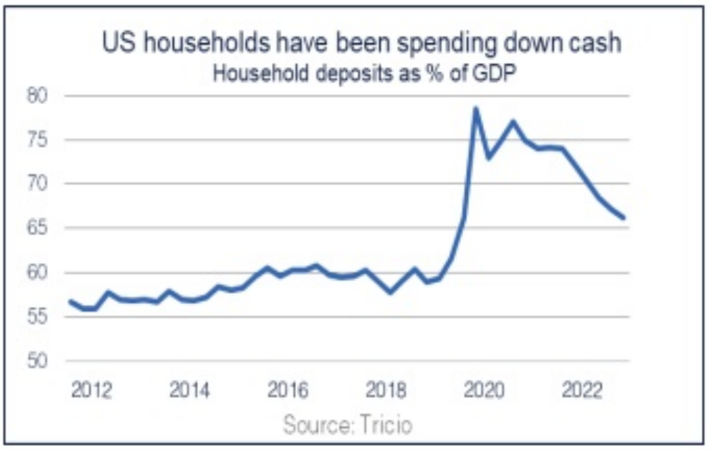
Arguably we are now at what might be called 'normal' rates. At this point in the economic cycle, notwithstanding the present resilience, we think it would be unwise to believe that returns experienced over the past decade will be matched. There are always things for markets and investors to worry about of course, but there can be little argument that investors are contending with a new economic environment.

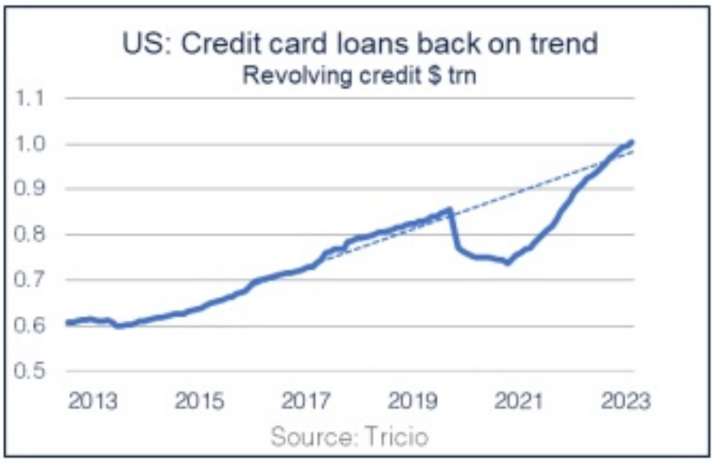
There has been some economic progress this year, as core inflation has continued to fall, and at the start of the year this was seen as a sign that central banks would be able to stop tightening monetary conditions.

However, the US economy in particular continues to show strength, which along with concerns over energy prices from the onset of war in the Middle East, suggests rates are not falling anytime soon. The narrative that has developed in markets is that rates are now 'higher for longer'.

Strong jobs data and retail sales have accelerated US GDP growth from an annualised rate of 2.1% to 4.9%, as consumer spending has fared better than expected thanks to surplus savings built up during the pandemic era.

However, these reserves are falling steadily and of course, inflation has impacted the real value of these savings. Further, as highlighted by our consultants Tricio, household debt has also been rising suggesting the consumer may not be as robust as retail spending figures show.





Also, despite the US central bank being the first mover in tightening monetary policy and unwinding the stimulus of quantitative easing, the US government continues to run a large budget deficit of over 5% of GDP, adding significant support to economic demand and offsetting the objective of slowing the economy to tame inflation.

An article by fixed income house Pimco (‘Post Peak’ 11 October 2023) highlighted that almost all such developed market tightening cycles when central banks raised rates by over 400 basis points, ended in recession.

We therefore think the slowdown and possible recession in the US is delayed, rather than avoided. UK and European economies are thought to already be in recession and there is still likely to be a lagging effect of higher interest rates to come through. On balance, we sit on the side of caution at this time.

Strategic Value of Cash

We have long supported the idea that the main purpose of holding cash is to meet expenditure requirements, both known and unknown (a rainy day pot). The conundrum for investors right now we have been hearing is:

“Why not just put more money on deposit given the attractive interest rates available?”.

It is a fair question but there is no answer that doesn’t require a level of trust that you will be better off over the longer-term maintaining a diversified portfolio of investments.

Investment bank Credit Suisse produces an annual investment returns year book covering asset performance since 1900 using data from Dimson, Marsh and Staunton. The 2023 edition shows annual total real returns (after inflation) of 6.4% for equities, 1.7% for bonds and 0.4% for bills (proxy for cash).

Granted, these are averages and so there will be times, such as the last couple of years, when these returns do not play out. We are reminded to never walk across a river with an average depth of four feet.

If it were simply a case of comparing the returns delivered over the past 12 or 24 months then clearly cash wins in a risk v return battle.

However, recent data from Vanguard suggests that in the 12 months following peak interest rates, which they forecast as reached in Europe, and will be in the first half of 2024 in the US and UK, that gilts, bonds and equities usually outperform cash. This is because as interest rates fall, fixed interest investments rise in value, which is something that cash does not.

We should also not forget that whilst at times capital performance can be underwhelming, patient investors are also paid in dividends and interest. To quote former FPC economic consultant Peter Stanyer “compounding will take care of you”.

We know it is tempting to be chopping and changing when offered over 5% fixed for 12 months with little risk, but over a sensible time period, investors with diversified investment strategies have been fairly rewarded for remaining in the market and sticking to their plan.

Corporate v Government Bonds

FPC clients will have noted in their portfolio values that fixed interest values have fallen as interest rates have risen. More recent annual reviews delivered after the quarter end however show strong performance from corporate bonds as values bounced back strongly following the mini-budget disaster in September 2022. This is in stark difference to UK gilts (which we do not have direct exposure to), which did not enjoy the same recovery as can be seen on the chart below:

When we show the performance of corporate bonds we look at the Bloomberg Sterling Aggregate Corporate Bond index. This is an index of bonds issued in sterling but not necessarily by companies in the UK, meaning the index has a weaker association with the UK than the Bloomberg Sterling Gilt index also referenced.

In addition, there is an important difference in what is called index duration. This means the average length of time for maturity of bonds within the index. In theory the longer the index duration, the more sensitive to a change in interest rate expectations. In this case, the UK gilt index has a longer duration, so as the market has adopted a ‘higher for longer’ view on rates, this has caused the gilt index to have relative underperformance.

Finally, there is considerable new gilt issuance required to finance the government’s borrowing requirements, which will cause supply pressure and weigh on prices.

In our last review we commented that gilts as an asset class are starting to look interesting but felt there was no rush to buy and the 10 year yield has risen slightly from 4.3% to 4.5% since then. The real value of gilts will most likely be seen in times of economic stress and we will continue to challenge the place of gilts in client portfolios.

Open-Ended Property Funds

Investment house M&G recently announced the closure of its UK property fund due to falling interest from its retail investor base.

The open-ended fund structure allows for investors to buy and sell exposure to the underlying property on a daily basis, despite the illiquid nature of property as an asset class. The fund needs to retain sufficient cash to meet redemption requests, but when large waves of sell orders are received it can mean the need to sell properties, which can take time.

Much of the rest of the sector, including the largest commercial property fund L&G UK Property, have committed to the market noting that their client bases also contain institutions with very long-term investment horizons. They can therefore expect less redemption requests.

That said, the open-ended structure remains questionable for this illiquid asset class, with investor attention moving to Real Estate Investment Trusts (REITS), which are stock exchange listed and do not suffer the same liquidity issues. We do see commercial property as an attractive real asset class, especially for diversification of income, but the sector faces immediate challenges in the post pandemic economy.

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

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