bordier | 1844

Investment review – End Q1 2023

March 2023

It has been an eventful first quarter and one in which markets have seen periods of both strength and weakness. After last year's challenging market conditions, the broad net effect has been a general consolidation in investment values rather than any breakout into new ground. The period has, however, been characterised by high levels of volatility in both equity and bond markets as economic and market confidence has ebbed and flowed.

At the very start of the year all the talk was of a looming recession in many parts of the developed world, including the possibility of a brief, technical recession in the mighty US economy. That backdrop suggested the US Federal Reserve ('Fed') would potentially need to moderate its interest rate hikes a little sooner than initially expected. It thus painted a better picture for fixed interest markets, which could breathe again after a disastrous showing in 2022. It also provided a better backdrop for 'growth' orientated investments, where tighter policy had previously been a headwind. So, whilst the outlook still looked quite uncertain from an economic perspective, there seemed a good chance of inflationary pressures softening more quickly and tighter monetary conditions, which had been so damaging to a range of asset classes in 2022, starting to ease a little sooner. Both stock and bond markets, therefore, began the year on a stronger footing.

That early year optimism was short-lived, however, when new data suggested the US economy was actually holding up much better than anticipated. This included numbers that indicated inflation was not retreating as fast as all had expected. So, the Fed continued with its rate hikes and issued soundings that it was not yet done with policy tightening. Good news for the global economy effectively became a headwind again for markets, particularly for those assets that enjoyed a bounce in January. Hence markets rotated away from 'growth' again and in the blink of an eye the early-year shine had come off. Fast forward another few weeks and the scene changed yet again: concerns over the strength of the global banking system knocked stockmarket confidence, but the prospect of central banks needing to throttle back on rate rises gave government bonds and 'growth' assets a boost once more.

Overall, these fast-moving, rather conflicting, pushmi-pullyu-like conditions have not prompted us to make further changes to our general positioning. A far better strategy in fickle situations like this is generally to keep calm and stick it out, and that is exactly what we have done.

An improved outlook

So, after a confused first quarter, where does that leave things now? Generally, the prospects for the global economy have improved since the start of the year, helped by lower commodity prices and the re-opening of China. COVID influences have also diminished: the shortage of goods has reduced and delivery times have improved. The fears of a global recession have therefore abated somewhat. Some countries may still flirt with a technical recession this year or show very anaemic levels of economic activity – we see this as being most likely in Europe, where strikes and civil unrest are not helping the economic situation.

Leading economic indicators, as derived from global Purchasing Managers Indices, signal improved demand conditions and a return of growth in new orders; the recovery in global manufacturing sectors still seems to be lagging that of service sectors, but nonetheless heading in a more positive direction. The medium-term outlook for the global economy does, therefore, look more encouraging. The Chinese economy, in particular, appears to be rebounding strongly post the relaxation of restrictions. Generally speaking, Asian economies and that of the US seem better placed to fight any lingering headwinds and return to full strength, whilst we think the footprint of high inflation on European economies, including the UK, could take some time to fade.

bordier | 1844

UK outlook remains unconvincing

As noted, we remain unconvinced about the medium-term fortunes for the UK economy. The Chancellor's recent pro-growth budget and the initiatives to encourage enterprise might give a near-term boost, but the revised economic forecasts are hardly anything to write home about and the government does not have long before the next election to prove itself. We believe that the UK economy is still likely to remain weak by international standards, not helped by low levels of productivity and issues within its labour markets.

One of the UK Prime Minister's five key pledges for 2023, announced in early January, is to halve inflation by the end of the year to ease the cost of living and give people more financial security. This is a noble objective, but will be a tough ask, particularly when the latest monthly print of 10.4% shows inflation going up, not down. Unfortunately, it is not within the government's gift to control the prices of many things, and that includes the price of weather-impacted salad products, the latest 'excuse' for the unexpected rise in inflation. Neither does the government have any direct influence over the supply/demand price dynamics in war-affected energy markets, although without the Energy Price Guarantee, now extended to mid-year, consumer price inflation would certainly be running even higher than it is.

Inflation easing elsewhere

It is currently quite difficult to tell whether the UK Prime Minister's inflation pledge will be met, but the good news is that energy and broader commodity prices are coming down quite rapidly. The gradual return of normal demand for goods post-pandemic and the easing of global supply chain bottlenecks has been a big influence, as has a relatively mild winter in Europe, which has helped preserve gas storage and reduce energy consumption, allowing energy prices to retreat. The price of oil has fallen around 25% since last summer's peak and natural gas prices have declined by almost 80% over the same period, well below levels seen before the Russia-Ukraine crisis began and lower than pre-pandemic levels too. So, we can be fairly confident that inflation numbers will begin to ease over the coming months as base effects drop out and a greater proportion of current inflation is brought into the statistics.

It is encouraging to see goods price inflation starting to retreat in most countries and this is feeding through to improved manufacturing data. Core inflation, however, which excludes food and energy, is proving to be stickier than initially expected, held up by strong service sector price rises and cost pressures from very tight labour markets. This helps explain why in some economies, including the UK, it may take a recession to properly shed inflation. There may also be a need to keep monetary policy tighter for slightly longer than preferred. In all likelihood, it will take at least another year before inflation comes close to central banks' 2% targets. But that possibility is still quite real and does offer encouragement: fundamentally, the inflation picture should look very different by 2024. Central banks are being resolute in their quest to tackle inflation by raising interest rates, but the end of a period of policy tightening is certainly coming into view.

In better shape than before

We are aware that the paths for economic recovery and monetary policy have become more complicated recently by the fragilities exposed within the European and US banking sectors. But standing back from the company-specific noise, we do consider the financial sector generally to be in much better shape after the 2008 global financial crisis reforms, as evidenced by banks' significantly improved Tier 1 capital ratios and other financial strength measures. Central banks and regulatory authorities have been very much on the front foot in terms of attempting to calm concerns and providing support to minimise contagion risks. To date, we believe that their approach has been, and will continue to be, effective and they seem ready to step in again if needed to sure up the financial system.

The unfortunate consequence of recent banking failures is that tighter lending conditions are likely to ensue. Reduced access to bank funding could therefore hinder the wider economic recovery and cause deviations from central banks' intended routes, meaning that inflation is not addressed as well as policymakers, and markets, had expected.

bordier | 1844

The risk of policy error, therefore, remains elevated and so the near-term pressures on indebted consumers and businesses may not ease immediately. But as noted, there are some encouraging signs that the worst of the inflationary spike is now behind us. As a result, central banks should soon be in a position to stimulate growth once more.

Still doubts over Europe

Europe's feared energy shortages have not crystallised, aided by a mild winter, disciplined measures to reduce consumption, a build-up of storage and a more concerted effort to turn to renewables. Next winter could be a different story, but for now, as we head into spring, a real European energy crisis seems to have been averted. Until very recently it had put Europe back on the radar again as a potential area for investment, with stockmarket valuations generally looking more appealing. But we are still doubtful about the region's ability to get on top of inflation and whether it can break out from undeniably weak levels of actual and forecasted economic growth. We also need to have our concerns allayed over ongoing rumblings of eurozone fragmentation risks and more confidence that the Russia-Ukraine crisis will not escalate. Furthermore, we want to be more certain that recent issues faced by the likes of Credit Suisse will not surface elsewhere within the European banking system.

Whilst these endogenous risks are elevated, we are happier directing capital more towards those economies and markets that are showing greater resilience and exhibiting stronger medium-term growth characteristics.

Positive on equity markets

We are still quite happy to maintain stockmarket exposures at the upper end of strategic ranges. Generally, we have a positive view on equity markets given the improving macroeconomic backdrop and prospects for recovery in corporate profitability, although a sharp profits rebound is more likely to come through next year rather than in 2023. Corporate earnings have held up well over the winter months and market valuations are either cheaper or only marginally more expensive (e.g. the USA) than longer-term averages, so there is room for corporate profits to soften this year without a significant adverse market reaction.

Equities do still remain our preferred asset class for real returns, although we accept they could trade in a narrow, and potentially volatile range, especially until the inflation and monetary policy backdrop becomes a little clearer and some of the current financial sector risks dissipate, which is still our central view. We accept that recent banking issues do add another layer of potential risk for equity investment, but consider much of the current uncertainty to be priced in and do not believe it will derail our positive view on equities versus other asset classes.

We are keen to maintain our focus on relative economic and corporate strength, giving more weight to parts of the world with more entrepreneurial and economically-resilient economies and where inflationary influences are either fundamentally weaker or showing good signs of diminishing. This backdrop continues to direct us towards Asia and the USA where superior rates of medium- to longer-term growth are still expected.

A focus on quality

With various forecasts still in some state of flux, we prefer a broad, rather than narrow, range of style, sector and market cap biases within stockmarket exposures. We want to give underlying managers flexibility to pivot when appropriate and take advantage of opportunities as they arise. There is, however, a desire to place risk capital with managers who have a focus on quality companies with strong balance sheets, dominant franchises and pricing power – this should also help build resilience into our stockmarket positioning. It can also direct capital towards attractive dividend-paying opportunities for income-seeking investors.

We are also comfortable maintaining our commitments to the US dollar. We accept that in the near term different monetary policy strategies between the US and the UK, due to the latter's more persistent inflation, could mean a stronger pound (and weaker dollar), but believe this influence will be temporary and do not see a fundamental break-out into higher ground for sterling, or indeed the euro. The relative strength of the US economy should allow the US dollar to regain its ascendency and retain its status as the 'go to' currency in times of market stress.

Discipline required

Looking beyond the recent market volatility, a potential backdrop of improved economic data (versus forecasts), lower inflation and reduced interest rate expectations should not only prove supportive for equity markets but bond markets too. After a period of underutilisation, bonds have begun to exhibit more of their traditional low-risk/reward attributes again. We have already taken advantage of better opportunities within both government bonds and credit markets over the winter months, lengthening fixed interest duration accordingly: shorter-duration positioning, with its reduced sensitivity to inflation and interest rates, had largely done its job. We see no immediate need to make further changes within fixed interest markets at this juncture and feel comfortable with our revised, more balanced, positioning which reflects the fact that bond markets are now investible again. The real yield on bonds may still be negative, but falling inflation expectations and the prospect of peak interest rates in 2023 strengthen the argument for being more confident about this asset class than we were last year.

Choosing the right bond market investment essentially boils down to two key things – the likelihood of being paid back (at some date in the future) the full amount one has lent and in the meantime the likelihood of being paid the agreed amount of interest on predetermined dates. That assessment is a slightly easier exercise in government bond markets, particularly if one sticks to the relative safety of developed world government debt. But analysing corporate debt requires an entirely different skillset. Reading through the small print of listing documents, issuer covenants and the pecking order of debt repayment in a company's capital structure often requires a cold towel over one's head, and that is just one of the reasons why we delegate the day-to-day selection of bond investments to specialist managers whose job it is to sort the wheat from the chaff. Mis-priced opportunities can often be found in the secondary markets, particularly where there is some difference in opinion over investors' calculations of fair value. But in the end everything typically circles back to quality, an often overlooked characteristic of any investment, but particularly when there has been little or no alternative.

After a lengthy period of hitherto low inflation and interest rates, it is not surprising to find some skeletons in the cupboard and investor indiscipline lurking under the surface: it is clear that some investors in search of higher yields have strayed from the mainstream or not done their homework and are now getting caught out. Although credit default risks have begun to rise in recent months, we believe investors are generally being adequately compensated, provided one keeps a sharp focus on quality. The active managers we are investing with are all human and do make 'mistakes' from time to time, but keeping that focus on quality business franchises and corporate strength, particularly in times when the monetary policy landscape is changing, is what matters to them and us. In particular, it gives us greater confidence in being able to deliver the desired outcomes we set out to achieve for our clients.

Modest reduction in alternatives

In making way for a slightly increased allocation to conventional fixed interest markets, we have reduced slightly our exposures to alternative investment funds during the past quarter. The funds, typically market-neutral in nature and with moderate return aspirations, continue to offer important risk diversification benefits in portfolio construction, particularly in those mandates without the full appetite for investment risk. They can also play a crucial role in times of market stress, as they did last year. But now that a few more traditional, lower-risk investment options have become available, the need for a full set of portfolio stabilisers has diminished a little.

Cash is also now earning a better rate of interest, but we are also able to find attractive income yields, where necessary, within equity markets and, once again, in a cross-section of fixed interest instruments. We do not, therefore, see a need for high levels of cash, where there is no potential for capital appreciation as interest rates fall and returns are still being clipped back by heightened inflation.

A period of adjustment

In conclusion, weaning businesses and consumers off zero interest rates and low levels of inflation was never going to be an easy exercise, but the transition needed to happen and it is what all asset classes are currently adjusting to. We are not afraid of the likely new order, where moderate levels of inflation and interest rates have historically been quite good for business and stockmarkets generally, so we are reasonably optimistic about being able to make headway this year and beyond. This does not mean we will return to a period of calm immediately. But as things currently stand, we do believe the financial system, and markets, can withstand the current pressures being placed upon them. Separating market noise from genuine risks is always a challenge, so heightened volatility should probably be expected in the near term. We are, however, being careful where, and in what, we invest whilst also giving underlying fund managers the freedom to uncover those opportunities that are so often inadvertently caught up in any general market uncertainty. Our conversations with these managers suggest there is no shortage of ideas and certainly some attractive longer-term value to be found for the nimble, yet disciplined, investor.

Risk warnings

This document is issued and approved by Bordier & Cie (UK) PLC ('Bordier UK'). Incorporated in England No: 1583393, registered address 23 King Street, St James's, London, SW1Y 6QY. The company is authorised and regulated by the Financial Conduct Authority ('FCA').

Bordier UK is a specialist investment manager dedicated to providing portfolio management services. We offer Restricted advice as defined by the FCA, which means that if we make a personal recommendation of an investment solution to you, it will be from Bordier UK's range of investment propositions and will reflect your needs and your approach to risk.

This document is not intended as an offer to acquire or dispose of any security or interest in any security. Potential investors should take their own independent advice to assess the suitability of investments. Whilst every effort has been made to ensure that the information contained in this document is correct, the directors of Bordier UK can take no responsibility for any action taken (or not taken) as a result of the matters discussed within it.

CL8617/20230331/1.0