bordier | 1844

Investment review – End Q2 2023

June 2023

Equity and bond markets have struggled to make meaningful ground in the second quarter, buffeted by the persistence of inflation and the need for tighter monetary policy. Despite oil, gas, coal and electricity prices all retreating to mid-2021 levels, underlying price pressures remain throughout the wider economy. This has forced central banks to adopt a firmer stance on raising interest rates than they had originally intended, conceding that, in some areas, there is still some unfinished work.

Rather surprisingly for this type of backdrop, 'growth' stocks – and particularly 'big tech' – have been in vogue again and 'value' stocks sidelined somewhat. This can be explained by the surge in demand for companies seen in some way as beneficiaries of the growth in adoption of Artificial Intelligence ('AI'). Demand for a relatively niche, yet dominant, group of shares has helped push stockmarket indices such as the tech-heavy NASDAQ back towards its 2021 highs, way ahead of more mainstream US shares. Some of the share price moves and heady valuations are beginning to resemble the exuberance of the dotcom boom of the late 1990s, which coincided with a period of generally available credit and liquidity. That bubble eventually burst for many companies in 2000, but it is some of those that survived that have provided the backbone to the transformative digital economy that has been built over the past 25 years or so.

Today, money is tight and liquidity poorer than it was, not ideal conditions for another boom – broadly centred around AI – to gather momentum. But that may not matter if investors place a high value on the perceived efficiency and productivity gains that AI could potentially bring over the coming years. Several of our underlying fund managers already have exposure to this theme through some carefully-selected stock ideas, but they are not getting carried away. However, we cannot ignore the fact that the adoption rate for new technologies is most definitely accelerating. We are reminded that after launch in 1999, it took Netflix three and a half years to reach one million subscribers; Twitter achieved the same milestone in two years and Instagram just two and a half months. Fast forward to 2022 and OpenAI's chatbot, ChatGPT, took just five days to reach one million users after it was made public. Whether we like it or not, AI is likely to remain in focus as its far-reaching applications and implications are better understood. Working out who the long-term beneficiaries (and losers) will be is likely to take a lot longer than ChatGPT takes to sign up its next million users, but we are keeping a close eye on this developing theme nonetheless.

In the face of tighter financial conditions, it has been pleasing to see resilience in corporate profitability, allowing market valuations generally to stay on the cheaper side of longer-term fair value. After post-pandemic reinstatements and a strong recovery in 2022, the general prognosis for dividend growth in 2023 also continues to look quite healthy.

Monetary policy influence

Early year bond market optimism has faded somewhat in recent months, sentiment being impacted by the need for further work on raising short-term interest rates: inverted yield curves, where short-term bond yields unusually exceed those of longer-term issues, are indicative of potential recessionary conditions ahead. But this anomalous relationship should normalise as the need for tighter central bank policy diminishes, as we expect it will during the second half of the year.

Real (inflation-adjusted) yields on government bonds are still negative, but the arithmetic is improving as inflation falls and interest rates move higher. Yields on investment grade corporate bonds now look particularly appealing. The prospect of further reductions in inflation – and interest rates potentially peaking later in 2023 – strengthens the argument for being more confident about this asset class going forward.

We have already prepared for this scenario, having repositioned and increased allocations to fixed interest markets over the winter and early part of this year, particularly for clients without the appetite for full stockmarket risk. Although default risks have risen, we feel investors are being more than adequately compensated and believe conditions for this asset class will steadily improve as inflation recedes and rates plateau. In the meantime, market-neutral alternative investments continue to provide a very useful defence mechanism during volatile periods for conventional equity and bond investments.

Currency movements, generally caused by interest rate policy differentials between key economies, have also impacted investor returns of late: sterling-based investors seeking the relative economic strength and opportunities in overseas markets have seen returns eroded by the rather surprising rise in the pound relative to the US dollar, for example. Markets currently seem to be overlooking the poor state of the UK economy, which is not deserving of a strong pound. We expect the US dollar to regain its ascendency once near-term monetary policy influences become more evenly balanced.

Strains within the banking sector appear to have abated since the end of the first quarter, but tighter lending conditions and the knock-on effects of more restrictive monetary policy do need close monitoring. However, global, systemically-important, banks in advanced economies are particularly well capitalised and stress tests suggest that they are generally well placed to withstand the tighter financial conditions now being seen.

Looking ahead

So, after a complicated first half of the year, what does the second half have in store for the global economy and markets, and how does this instruct our positioning? The high-level takeaway is that global economy is showing resilience and in our view still on track to grow over the course of the year, helped by the positive influences of lower energy prices, falling headline inflation, the further easing of supply chain bottlenecks and China's general post-pandemic re-opening. Some of the strongest economic growth rates are expected to emanate from Asia, with China's re-opening clearly helping drive both domestic consumption and regional demand activity.

Conditions in some of the hitherto more economically-challenged areas such as Europe (ex. UK) and Japan appear to have improved in recent months. With the exception of the UK, Europe's economy has generally demonstrated greater-than-expected resilience in terms of dealing with last winter's energy crisis and responding to higher levels of inflation. Its core export markets have also been boosted by China's re-opening. There are also encouraging signs that Japan is, at last, beginning to shed some of the deflationary influences that have held it back for so long. Evidence of higher inflation and wage growth suggests that the negative stigma of raising prices is beginning to fade and that it will not be long before the Japanese economy can stand on its own two feet again. Meanwhile, the UK economy looks firmly entrenched as the weakest economy in the G7, not helped by inflation at a 31-year high and the ratio of its debt to GDP above 100% for the first time in over 62 years.

It is fair to say that the strength of the general global post-pandemic upturn is expected to be more subdued than originally expected, with the persistence of inflation – and the necessary actions of central banks to tackle it – becoming a stiffer headwind of late. However, reductions in headline inflation, a healthy employment backdrop and generally sound household finances should alleviate some of the near-term challenges and allow the global economy to come through this period of weaker activity relatively unscathed.

Central banks still centre stage

But it will not be an easy time for everyone or every economy: more than a year of synchronised action by key central banks to address inflation through tighter monetary policy will undoubtedly take its toll on over-indebted businesses and consumers, along with economies with more structural issues. An inevitable consequence of the necessary rise in interest rates, not helped by recent banking stress in the US and Europe, has been tighter lending conditions and borrowing criteria, which are rubbing salt into several open wounds.

Conditions in the UK look particularly precarious, where almost 1.5 million homeowners have fixed-rate mortgages expiring during 2023, around 60% of them previously fixed on rates below 2%. The latest two-year deals now exceed 6%. There is pressure on the banks to be more flexible with those struggling with repayments – this will help in the short term, but it means the debt can is merely being kicked down the road and will still need to be addressed at some point.

More persistent core inflation – which excludes food and energy prices – is likely to mean central banks keeping interest rates higher for longer: tight labour markets and higher wage settlements explain why services-related inflation is proving stickier than for goods, where falls in energy and industrial commodity prices have had a more immediate impact. It may therefore be another year before central banks' inflation targets come within touching distance. Steering the right course between tackling high inflation and avoiding recession will be no mean feat, but it is at least encouraging to see the US Federal Reserve ('Fed') now pausing its rate hiking cycle.

The big debate amongst central banks and the questions being asked by markets surround whether interest rates have now gone far enough. After its most recent meeting, the Fed's Chair subsequently commented that "we're at least close to where we think our destination is… and it only makes common sense… to move at a careful pace." There is therefore more than a glimmer of hope in the latest rhetoric that the work of the world's most influential central bank is almost done.

That said, it does now seem that terminal interest rates – and possibly inflation too – will settle at slightly higher levels than initially envisaged. This scenario may mean that certain developed market economies, including the mighty US, will enter technical recessions at some point during 2023. But these periods are expected to be both brief and mild. For the year as a whole, and for 2024, acceptable levels of global growth in the 2.5%-3.0% range still seem quite achievable. As noted, we continue to expect the strongest levels of economic activity to emanate from Asian economies, where inflationary pressures have been much more muted and the need for central bank intervention much less than in the West.

Modest adjustments

Against this backdrop, we are maintaining stockmarket exposures at the upper end of strategic ranges for different risk appetites, but are taking steps to make modest adjustments to geographic exposures, taking advantage of anomalies in relative market valuations and introducing additional equity and currency diversification into our overall exposure. As noted, we consider the relative prospects for both continental European and the Japanese economies, particularly versus the US, to have improved in recent months and their relative market valuations also look favourable.

Europe is showing better earnings resilience than other parts of the world and corporate margins have held up well in a tough inflationary environment, with companies seemingly able to pass on higher prices with greater success than elsewhere. But European stockmarket valuations do not typically reflect this improved momentum, with the valuation gap versus the US now almost as wide as it was before the Fed started to raise interest rates in the early part of last year.

Japan looks more attractive for a variety of very different reasons. As an economy, Japan has little memory of inflation – over the past 25 years it has averaged just 0.2%, in contrast to almost 2.5% in the US. But Japan is slowly learning that if policy stimulation is retained for too long, then price growth will follow and that is no bad thing for the economy. At last, Japanese inflation and wages are on the rise, helped in part by the Bank of Japan's accommodative stance through monetary policy and its control of the yield curve, but also by reforms instigated under 'Abenomics' aimed at ending Japan's deflationary era. It has been slow progress, but those reforms do appear to be having an impact: pressure has been mounting on Japanese companies to improve their corporate governance and reporting to global standards, with penalties imposed upon those businesses that do not prioritise shareholder return. This backdrop is seeing increased share buy-backs and improved dividend payouts, improving company ratings as they become less capital intensive.

Even after recent moves, the Japanese stockmarket still trades at compelling valuation levels relative to other developed markets – the price-to-book valuation of the Japanese stockmarket, for instance, looks particularly attractive versus the US and is the lowest in the G7, with a large part of the market trading well below book value. Encouraged by these improved metrics, money is now flowing back into the region again, particularly from foreign investors who also view the reduced need for Japan's super accommodative policy as finally drawing a close to the yen's weakness. As inflation begins to present itself across the economy, even domestic investors are starting to realise that it is no longer sensible to stash cash under the mattress. There have been a number of false dawns for Japan, but this time the 'land of the rising sun' does seem capable of sustaining its current momentum.

So, we will be shuffling the deck a little over the coming weeks to make way for these renewed opportunities. Our plan is to trim existing US positions, in many cases crystallising good gains, and generally reintroduce exposure to continental Europe, which was cut at the start of the Russia-Ukraine conflict. We are also adding to Japan. Exposure to the UK, which includes diversified domestic and international businesses across the market cap spectrum, is being maintained, despite the poor economic outlook: valuations remain very cheap and businesses with strong balance sheets and good cashflow, some offering generous dividend yields, can still be found.

US still a market of opportunity

Optically, the US stockmarket appears the most vulnerable to softer economic conditions – but richer headline valuation metrics are heavily skewed by just a handful of mega cap 'tech' companies that dominate mainstream US market indices. Beneath these heavyweights lies a rich seam of attractively-priced US companies to which we intend to maintain exposure. The US economy may be slowing, but it is still growing, and in this vast market there will always be investment opportunities to find amongst the thousands of quoted businesses. Our modest reduction in US exposure is not because the opportunity set has diminished; it is just that by already being at the upper end of the strategic stockmarket ranges and seeing fresh opportunities elsewhere, something needs to give. Having led global markets higher in recent years, the US market seems a logical place to skim off some of the general gains that have accumulated.

We remain comfortable with a broad, rather than narrow, range of style, sector and market cap biases. We look to our active managers to seek out valuation anomalies and growth opportunities in a rather trying environment that exhibits pockets of detachment from investment fundamentals and, in some cases, defies logic. Underlying managers' discipline on buying quality companies with dominant franchises and pricing power should continue to bring resilience into clients' stockmarket positioning if we continue to see volatile markets in the near term.

Commitments to global infrastructure assets and businesses exposed to important environmental and climate change initiatives continue to feature prominently in our stockmarket positioning. Government policy and regulation is driving significant capital towards these sectors. In the US, for example, President Biden and his Administration have just embarked upon their three-week 'Investing in America' roadshow, which will not just showcase how it plans to create jobs and opportunities across the country: it will be an opportunity to highlight how communities are benefitting from new manufacturing and investment in clean energy technologies spurred by the Inflation Reduction Act; it will also highlight the government's priority to fix broken critical infrastructure. This type of exposure should give further momentum to the stocks owned by the funds to which we are allocated.

USD remains currency of choice

As mentioned, our general conviction in the US dollar is being maintained, although some modest reduction is planned and additional currency diversification introduced via the yen and euro as part of our planned stockmarket modifications. Sterling's recent strength has been surprising, but we believe a severely challenged UK economy should limit its upside.

bordier | 1844

The US dollar continues to be viewed as the global currency of choice for international trade and we would expect it to adopt its traditional safe-haven status in times of wider economic, market or geopolitical uncertainty. The Japanese yen looks particularly oversold and our increased (unhedged) allocations to Japan will hopefully benefit from some currency uplift as Japan's economy gathers momentum and money flows back to the region.

Cash is now earning a better rate of interest, but we can also find attractive income yields, where necessary, within both equity and bond markets. We see little need to maintain high levels of cash, aware of the corrosive impact of inflation on returns.

Looking further out

Overall, the economic scars left by the pandemic and current war in Ukraine will take time to heal, but the medium-term outlook for the global economy does still look reasonably encouraging and capable of creating a conducive backdrop for investment. Soon, less restrictive monetary conditions should stimulate the global economy once again.

The current, somewhat lacklustre, market environment could continue over the summer months until the inflation and monetary policy backdrop becomes a little clearer. But increasingly, the likelihood of mild recessionary conditions, followed by a strong earnings recovery and reduced interest rate and inflation headwinds, should draw investors towards stockmarkets' undemanding valuations and the attractive yields on offer within bond markets. Our positioning is therefore looking slightly further out, beyond 2023's expected slowdown – much of which we believe is priced in – to the recovery in 2024.

In the future, when we look back at the current uncertain backdrop, it is likely to have proven itself as a good period in which to have remained invested, or to have made fresh longer-term investments from cash.

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.

CL8971/20230630/1.0