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Q1

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Investment Committee Series

Q3 Outlook - August 2023

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"A major opportunity is developing for investors in government bonds. These are looking increasingly attractive as interest rate rises start to moderate and central bankers take comfort from falling inflation."

Eren Osman
Managing Director,
Wealth Management

1 min read

01

Introduction

Key takeaways from the second quarter of 2023:

- The global economy remains in a late cycle expansion driven by the services sector.
- Falling leading indicators and weak manufacturing data points to potential economic headwinds ahead.
- US growth continues to deliver positive results while wider global economic momentum stalls.
- While it remains high, global inflation peaked in late 2022. We expect inflation to reduce further during H2.

Many of the key themes we highlighted in Q1 continued into Q2, most notably falling inflation. We expect slowing inflation to continue during the second half of the year, especially in the UK. This should act as a tailwind for government bonds, where yields have been rising because of higher-than-expected inflation. Lower inflation should also mean that central banks slow their rate-hiking cycles; something we have anticipated for a while.

Overall, the global economic picture remains mixed, with weak manufacturing contrasting with a strong global services sector. The US economy has continued to display surprising resilience, which was a positive development in the second quarter, and acted as a key driver of the outperformance of equity markets. A strong consumer balance sheet and a tight labour market has supported US consumer spending which continues to drive the wider US economy.

Central banks turned more hawkish in the second quarter. This resulted in a more aggressive interest rate stance to tackle higher inflation, which pushed interest-rate expectations higher, to the detriment of government and corporate bonds. From a global perspective, GDP growth estimates have improved in the year so far, driven by the strong services sector and China's recovery, even though the latter was weaker than we hoped for.

3 min read

02

Decisions we made

5 key changes we made to our portfolios

- Increased government bond exposure.
- Reduced equities.
- Within equities, we increased US exposure.
- Closed our US dollar hedge.
- Reduced hedge fund exposure in favour of high yielding short-term corporate debt.

Peter Doherty
Director, Head of
Investment Research

We increased government bond exposure

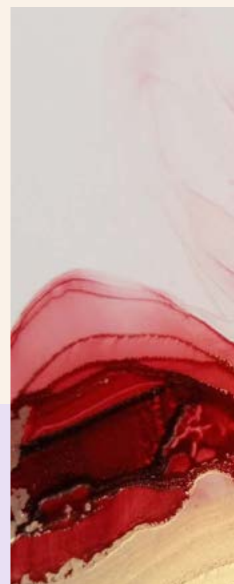
Bond valuations are now significantly more attractive compared to 2022, allowing bonds to regain their diversifying role in portfolios and offer a buffer in case of recession. We increased our exposure to government bonds to move portfolios into a slightly more defensive position based on our expectation that bond yields will fall, benefitting bond prices which move inversely to yields.

The cornerstone to this change is that global inflation, particularly for the UK and the EU, will continue to fall into H2, which should support the asset class. The potential protection to client portfolios in the event of a recession provides an 'insurance factor' while we collect higher yields. In previous economic shocks, government securities performed strongly, offsetting losses from equities and other riskier assets. We are prepared to continue increasing exposure to bonds over the coming months.

Reduced equities

Through the quarter we opportunistically reduced our allocation to European equities which had performed exceptionally well. We reduced Chinese equity exposure, as their post-COVID economic rebound has not met our expectations, and increased US exposure. This was in recognition of the economic momentum we are seeing in the US, although in selecting our exposure, we opted to avoid some of the more expensive parts of the US market.

Overall, we believe a plethora of opportunities exist in debt markets, partly driven by the higher interest rate environment though also due to their defensive characteristics. These tend to offer tangible diversification benefits during late stages of the economic cycle, which typically follow increases to interest rates. Thus, in ag-



gregate we have a mild preference for corporate and government bonds as opposed to equities, which we have moved tactically underweight in the recent quarter.

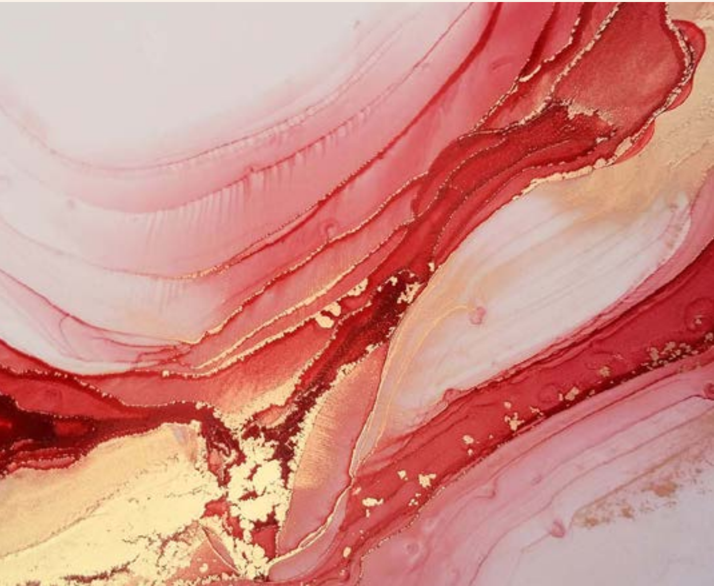
Closed our US dollar hedge

After last September's poorly received mini-budget in the UK, sterling hit a historic low against the US dollar. Following this, we hedged out a significant part of our US dollar exposure, to protect the sterling value of our international assets should we see the pound rebound. This has been beneficial given the significant rise in GBP since then. To contextualise this, to the end of June the US market (S&P 500) was up around 16% in US dollar terms, though up only 10% in GBP terms. A big takeaway from this is that currency views are crucial to portfolio construction. You would have received a third less in returns from the US equity market if you did not hedge your dollar exposure back to pounds.

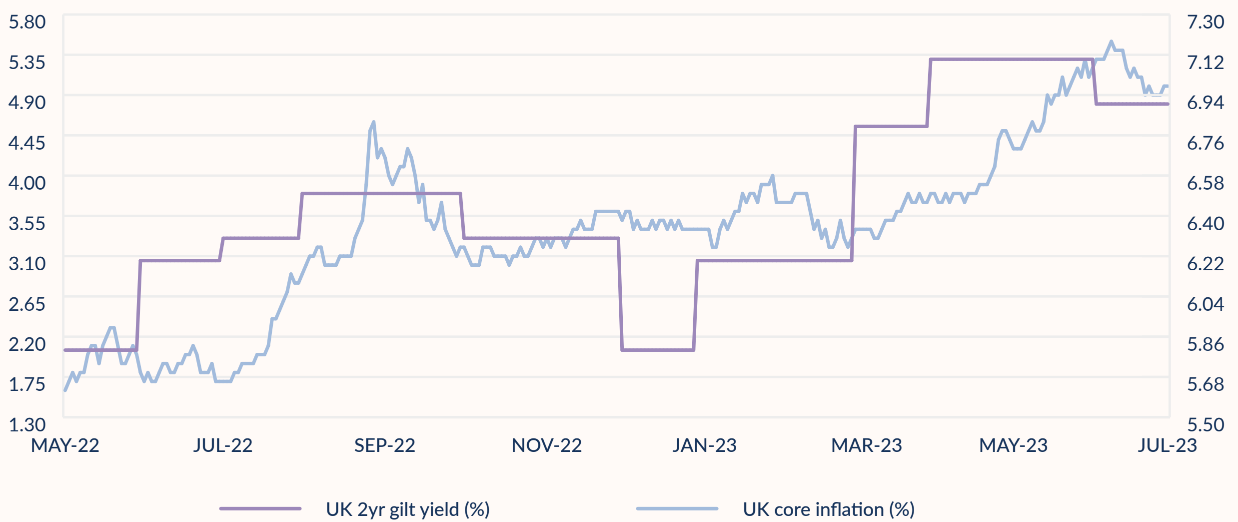
Having seen a strong move back to a more reasonable exchange rate, and with less conviction that the drivers of this strong currency performance will persist, a key decision this quarter was to remove the portfolio underweight to the US dollar, given that we now see a more challenging short-term outlook for sterling and the euro. However, over the long-term we remain positive on non–dollar currencies.

Reduced hedge fund exposure in favour of short-term corporate debt

With many central banks increasing interest rates significantly over the last 18 months, short-term fixed income has become attractive. Historically, we have had a relatively large exposure to hedge funds, and this was a key source of return during the 2022 sell off. However, given the prospect of mid-single digit yields on lower risk fixed income, the case for hedge funds is not as strong as it was in a low yield environment. We believe it is better to invest in a short-term corporate debt product yielding 5.7% in sterling terms and sell two hedge funds with less certain returns.



UK gilt yields have been driven by core inflation



Source: Bloomberg

1 min read

03

What does the future hold for investors?

The first half was characterised by an expectation of falling inflation and a slow pace of interest rate hikes. While inflation remains stubborn, we expect it to moderate into the second half of the year. The declining bond volatility that follows lower inflation could create a more stable backdrop for financial assets in general.

In the UK, inflation has been particularly problematic, but we remain optimistic about the overall outlook. We believe government bonds offer an attractive risk/reward payoff and remain attractive for portfolio diversification.

Looking to the US, we expect to see a change of tone from the Federal Reserve (Fed) in the coming half of the year, heralding an end to interest rate hikes.

Manufacturing remains depressed. However, if companies begin replenishing inventories this could offer a tailwind to global economies, which poses a risk to our central case of slowing economic activity. Considering this, we have maintained our commodity exposure.

We remain cautious given high interest rates and falling leading indicators. However, while the labor market remains strong, we do not believe an aggressive underweight to equities is appropriate. We continue to find good opportunities across asset classes and are optimistic we have a strong toolkit to help clients earn long-term, consistent returns. As data driven portfolio managers, we await new information in the coming months to build on our conviction and confirm our decisions. In this market environment, patience is key.

1 min read

04

Around the world

US

Fitch Ratings has downgraded the US debt rating from AAA to AA+, as a result of the worsening fiscal conditions and governance. The rating agency explained that the downgrade reflects an "expected fiscal deterioration over the next three years" and "a high and growing general government debt burden"[1].

Brazil

Brazil, one of the most aggressive emerging markets to raise interest rates over the past two years has enacted their first interest rate cut in July – a sign that the central bank's fight against inflation is coming to an end.

Technology

Technology was one of the big stories in the second quarter. The market reacted very positively to developments in AI, pushing tech stocks higher.

Commodities

Commodity markets, in line with the better growth sentiment rallied, though remains rangebound, especially in the case of copper and oil.

Energy

Elevated energy prices in the previous year are expected to contribute to a further decline in headline inflation this quarter alongside abating food price pressure and shelter inflation, in the case of the US.

1. https://www.ft.com/content/a1ef8c31-a1fb-4bb0-bf69-272db162a296

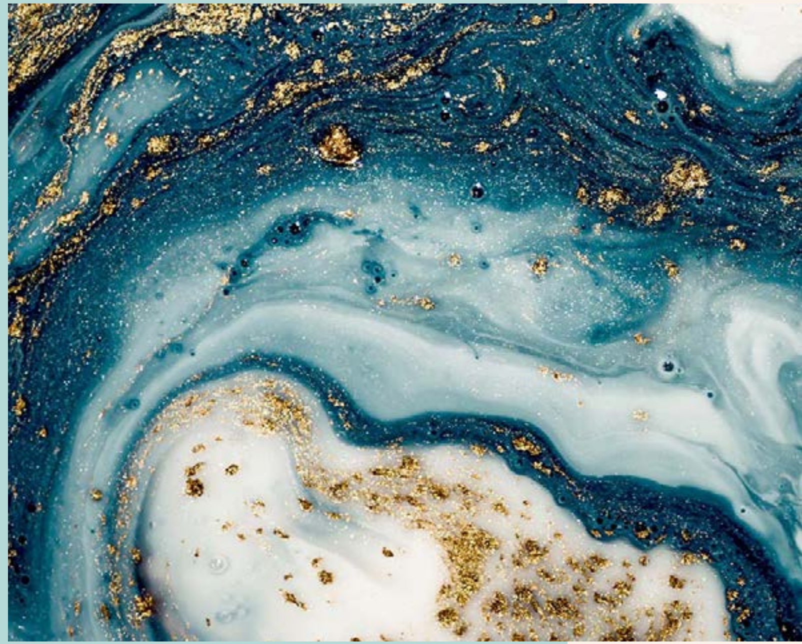
Greece

Greece's second round of elections produced a clear win for the centre right government, boosting markets.

Asia

The Biden administration moved to limit critical US technology investments in China as of mid-August. The order focuses on semiconductors, artificial intelligence and associated technologies aimed to restrict China's development and progress in these areas, as the battle for technological supremacy continues.

3 min read



05

Top of mind: Opportunity cost

One of the greatest challenges of money management

Opportunity cost can be a confusing concept, but it plays a significant role in our daily lives. Simply put, it refers to the value of the next best alternative that we give up when making a decision. This can be difficult because it forces us to think about what we give up when pursuing a particular course of action.

Mark Sandey

Associate Director,
Investment Manager

One example of an opportunity cost involves investing in the market versus repaying a mortgage. Both come with their advantages and disadvantages, and here we explore the options.

According to Rightmove, the current average mortgage rate for a fixed five-year 85% loan-to-value mortgage is 6.15%[1].

At the same time, banks are typically paying around 5.5% on a one-year fixed term deposit account.

When comparing this to making an investment, we encounter our first challenge: investment performance is backwards looking.

We can only see past performance and make broad estimates about the future. This unknown quantity is 'risk', for which investors expect to be paid a 'premium' – the return in excess of what you can receive 'risk free' from money in the bank (or, technically, on government debt) and your reward for taking that risk.

Since 2020, markets have been unstable because of Covid, inflation, higher interest rates, and the war in Ukraine. These same factors have increased the cost of debt and the return on cash deposits. As such, many investors are choosing safer investments to protect their money from global events, many of which are not yet resolved.

However, things are not as gloomy as they might appear.

At the start of 2023, your bank may have offered you around 4.0% to fix your deposit for one year. By the end of July 2023, you would have received around 2.3% in interest payments.

Over the same period, global stocks have increased by approximately 10.6% in GBP terms.[2] This is more than three times the return before taxes savers would have re-

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1. https://www.rightmove.co.uk/news/articles/property-news/current-uk-mortgage-rates
2. MSCI World, YTD as at 1/8/23

ceived on cash deposits.

A mixed investment portfolio with moderate risk, based on the Investment Association's benchmark, would have achieved a 3.5% return.[3] This is a modest outperformance versus fixed cash, but, unlike a fixed term deposit, you are able to withdraw your invested assets if needed.

Paying back debt, like a mortgage, is more complicated and depends on your personal situation when making a decision.

Regardless of the long-term potential in investing, serious consideration should always be given to the cost of servicing your debt.

Ultimately, it is down to you – what are your needs, your time horizon, your capacity for loss?

These can be difficult questions, but there is help available. A wealth planner can help you plan to reach your financial goals. Our wealth planners take your circumstances, needs, and aspirations into consideration before creating a financial plan to suit your requirements.

An investment manager can then create an investment portfolio that helps navigate volatile markets and achieve long-term positive performance.

Which option provides a better long-term opportunity; debt repayment, cash deposits, or investing? If you would like to discuss your options further, please get in touch.

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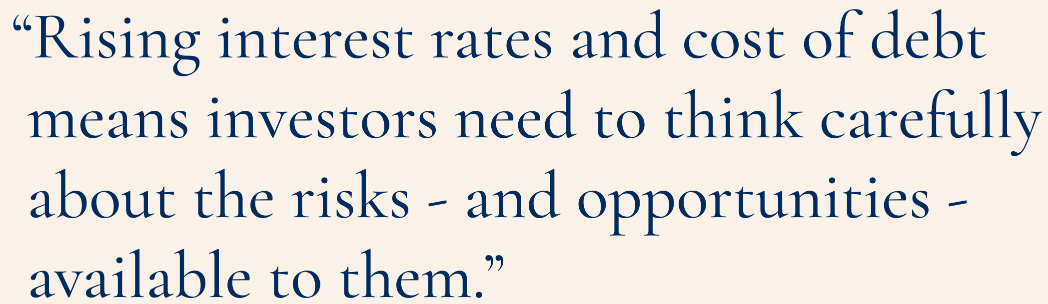
3. https://fundcentres.lgim.com/en/uk/institutional/fund-centre/Unit-Trust/Mixed-Investment-40-85-Fund/#Performance



> “Rising interest rates and cost of debt means investors need to think carefully about the risks - and opportunities - available to them.”

For business. For family. For life.

Contact information

Arbuthnot Latham & Co., Limited

Registered Office

Arbuthnot House
7 Wilson Street
London EC2M 2SN

+44 (0)20 7012 2500

banking@arbuthnot.co.uk

arbuthnotlatham.co.uk

Bristol

St Catherine's Court,
Third Floor
Berkeley Place, Clifton
Bristol BS8 1BQ

+44 (0)117 440 9333

Exeter

The Senate,
Ground Floor
Southernhay Gardens
Exeter EX1 1UG

+44 (0)1392 496 061

Manchester

82 King Street
(8th Floor)
Manchester
M2 4WQ

+44 (0)161 413 0030

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