Investment Strategy Committee Tactical Asset Allocation Views & Commentary

Tactical positions relate to the strategic allocations for our five risk rated portfolio benchmarks which power our investment process. They are expressed as in the key below.

- - Strong Underweight	- Underweight	N Neutral	+ Overweight	+ + Strong Overweight

Please contact us if you require further information.

ASSET CLASS	TACTICAL POSITION	COMMENTARY
Global Government Bond	+ +	We keep strong overweight as we approach the peak in rates. Falling inflation and signs of weakening labour market conditions should allow the Federal reserve to cease tightening in the coming months. Fed risks a deeper than necessary recession if high rates and QT continues too long
Investment Grade Bond	N	We prefer to stay neutral here until the dust settles, and we are more confident in the economic and rates outlook. Headline numbers hide the increasing stress beyond the Mega Caps. European bonds are more attractive and seem to have recovered from recent stresses in banking system
High Yield Bond	-	We remain underweight for similar reasons as for investment grade. Spreads are tighter and default rates have increased, but still sit at half of the long-term average, with yields attractive. We prefer to stay patient for the moment as we have not seen recession or the end of the default cycle.
Emerging Market Bonds	- -	Some support for hard currency bonds in the face of slowing growth, but little scope for tighter spreads. Local currency issues are attractive on real yield basis; but need to see a weaker trajectory for USD over the long run to provide some currency support. We maintain the underweight for now
UK Equity	N	We maintain exposure as UK has serious headwinds and uncertain leadership. Recession in the UK seems inevitable, and responsible fiscal policy is essential if UK plc is to emerge stronger from the slowdown. Market is cheap, well below long run average, but needs a change in sentiment.
Developed Market Equity	+ +	Narrow AI rally remains a concern in US mega cap, but elsewhere tech valuations are more in line with long run averages. European earnings revisions holding in well and valuations reasonable, but economic data now starting to wane. Japan has good economic momentum after good Q2
Emerging Market Equity	-	We remain underweight due to mixed outlook: Valuations are in line with long run average but returns at stock level continue to disappoint. China reopening momentum is fading and may be a deflationary impulse to the global economy in the coming months. A strong USD hurts EM equity
Commodities	N	Prices will moderate across the Commodity complex if recession plays out and demand slows, but OPEC+ cut should support oil prices. Base metals outlook will depend on DM economies avoiding a sharp downturn. Cereal crops have a challenging supply outlook which may be price supportive
UK Commercial Property	- -	Industrial, warehousing and logistics favoured, with portfolio balance key as capital values fall across the market. Retail and offices remain under pressure which may continue until the economy recovers. Any Sterling weakness may prompt international investors return, which may be positive
Absolute Return	+ +	We continue to rely on this allocation to provide diversification, reduce portfolio volatility and provide downside protection. The combination of market neutral and macro strategies diversifies risk exposure, despite challenging market behaviour. We expect macro strategies to rebound
Cash	+ +	We maintain our cash weighting as market uncertainties hints at further volatility before markets stabilise. Cash yields of 4% or more are attractive and represent a carry hurdle for other assets. Cash also useful as dry powder. Cash funds allow for yield and quick implementation if needed

Please Note: The views expressed are those of the Investment Strategy Committee. They should not be taken as a personal recommendation to invest or refrain from investing.
Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and can fall as well as rise due to stock market and currency movements.

FPWM
TAILORED FINANCIAL SOLUTIONS

LOOKING BACK…

Investors went into the second quarter on recession alert and expecting that the Fed could soon be cutting rates. At the end Q2 there was still no recession, inflation remained sticky, and the Fed was suggesting rates would be higher for longer. Global shares gained in the quarter **(FTSE World +6.52%)** driven largely by the US, where enthusiasm over Artificial Intelligence (AI) boosted technology stocks. Major central banks raised interest rates, although the US Federal Reserve stayed on hold in June. Government bond yields rose over the quarter.

US equities rose **(S&P 500 +8.30%)** with the bulk of the gains made in June amid moderating inflation and signs of resilience in the US economy, despite higher interest rates. Q1 annualised GDP growth was revised up to 2% from the previous estimate of 1.3%. The Fed raised interest rates by 25 bps in May and adopted a "hawkish pause" in June despite rate predictions indicating two further rate rises in 2023. US inflation declined in May, bringing down the annual rate to 4.0%. The US unemployment rate increased in May to 3.7% from 3.4%, a larger than expected move but still representing a tight labour market by historical standards. Despite investor concerns, Congress suspended the debt ceiling in the first days of June, in a deal that included concessions on spending expected to have little effect on economic growth. The IT sector led the stock market advance in the quarter, amid feverish expectation around the effects of AI and related technology which meant an exceptionally narrow leadership in the index. The consumer discretionary and communication services sectors also performed strongly, while energy and utilities underperformed.

Eurozone shares posted small gains in Q2 **(FTSE World Europe ex UK +1.18%)** led by the financials and IT sectors which were boosted by semiconductor stocks and the AI excitement. Underperforming sectors included energy and communication services. In financials, banks outperformed as their near-term earnings are expected to be strong. The European Central Bank (ECB) raised interest rates twice in the quarter, taking rates to 4.0%. Headline inflation declined to 5.5% in June, down from 6.1% in May, but conversely core inflation (which excludes energy, food, alcohol and tobacco prices) crept up 10 bps to 5.4% in June. The eurozone experienced a mild recession with GDP declining -0.1% in both Q4 2022 and Q1 2023 and forward-looking data pointed to slowing momentum in the eurozone economy. The flash eurozone PMI fell to 50.3 in June from 52.8 in May - a five-month low suggesting the economy may be close to stagnation, 50 being the point that separates expansion from contraction in the PMI surveys.

UK equities fell over the quarter **(FTSE All Share -1.48%)** as 2022's outperformers, the large UK-quoted diversified energy and basic materials groups, suffered on broad-based weakness in commodity prices and concerns over the outlook for the Chinese economy. Sterling strength also weighed on other US dollar earners such as consumer staples. Many domestically focused areas of the market underperformed as rates rose in May and June, and the 50bps increase in June accelerated tightening after March's decision to slow with 25 bps increments. This was due to stronger-than-expected UK jobs market numbers, wage growth and core inflation readings which suggested the BoE remained some way off getting on top of inflation. This economic uncertainty hit domestically focussed areas of the market such as housebuilders and also resulted in the sharp sell-off in UK gilts, in turn increasing mortgage rates to levels last seen after Truss and Kwarteng's mini-budget. One positive note following the June rate reacceleration was that yields on longer dated gilts did initially fall suggesting a greater belief from investors that the BoE will tame inflation, albeit at the cost of triggering a recession.

Japanese shares led the way in Q2 **(TOPIX +14.23%).**as yen weakness continued hitting 188 yen and 144 yen against sterling and the US dollar respectively in June. The market hit the highest level in 33 years, partly driven by continuous buying from foreign investors since April. The gains have been driven by expectations of corporate governance reforms and structural shifts in the Japanese macro economy, Yen weakness and strength in the US market. Despite the gains, the market price-to-earnings ratio is still only just reaching a fair level, with many investors seeing scope for upwards earnings revisions supported by yen weakness. The Bank of Japan's first policy meetings under new governor Kazuo Ueda saw no change to the dovish policy stance, and expectations of further Fed rate rises accelerated yen weakness. The central bank maintained their cautious stance on inflation and wage growth as the macroeconomic data continued to suggest solid progress.

Asia ex Japan equities fell **(FTSE Asia ex Japan -0.76%)**, with China, Malaysia and Thailand the worst-performing index markets. Chinese equities were sharply lower in the second quarter as the economic rebound cooled, following the country's reopening after zero-Covid. Factory output in China slowed on disappointing consumer spending and weak demand for exports following tightening in the US and Europe. Hong Kong share prices also fell in the quarter, as a cooling of the Chinese economy weakened sentiment towards Hong Kong stocks too. Shares in India achieved strong gains, driven by foreign inflows, steady earnings, and encouraging economic data. Equities in Taiwan and South Korea advanced, driven by gains in technology stocks as investors rushed to buy anything AI-related. The Philippines and Singapore ended the quarter in negative territory, while Indonesia achieved a modest gain.

Emerging market (EM) equities delivered a small gain in Q2 **(FTSE Emerging +0.13%)**, lagging developed markets. Tension between the US and China was a driver of EM underperformance, allied with China's anaemic economic recovery. US debt ceiling uncertainty added to the negative mood, despite being resolved in early June. Hungary, Poland and Greece were the top-performers, shrugging off rising recessionary fears in Europe. Central European markets began to anticipate rate cuts as inflation eased, with Hungary cutting rates in June. Greece's outperformance came as the ruling New Democracy party won a second term in office in May, signalling a continuation of market friendly policies. Brazil outperformed as fiscal policy concerns reduced, optimism rose for rate cuts and Q1 GDP surprised to the upside. Improved macroeconomic data and expectations of continuing easy monetary policy were supportive in India, which gained strongly in the quarter. South Africa was among the worst performers as the country's power situation continued to deteriorate, with severe consequences for economic growth. Turkey posted the largest loss in US dollar terms as President Erdogan won re-election in May, extending his two-decade rule.

In Q2 government bond yields were on the rise again **(FTSE World BIG Domestic Sovereign -0.73%)**, and we saw some divergence in returns, with the UK and Australia underperforming due to higher-than-expected inflation. Central banks were hawkish and determined to combat inflation, with all but the Bank of Japan raising rates over the quarter. The Fed was the first to pause in June, leaving rates at 5% to 5.25% after more than a year of consecutive rate increases. The US 10-year yield climbed back from 3.47% to 3.81%, with the two-year going from 4.03% to 4.87%, marking a further inversion of the curve. The ECB announced the end of the Asset Purchase Programme from July 2023 and headline inflation fell. Germany's 10-year yield increased from 2.31% to 2.39%. Sticky UK inflation prompted the BoE to act more forcefully, raising interest rates by a larger than expected 50 basis points in June. The UK 10-year yield rose from 3.49% to 4.39% and two-year made even more gains by increasing from 3.44% to 5.26%.

Looking at credit markets, corporate balance sheets remained relatively strong, despite some increase in default rates. Global high yield **(Bloomberg High Yield +2.02%)** outperformed global investment grade **(Bloomberg Global Aggregate Corporates +0.07%)** as immediate recessionary concerns receded. US investment grade posted negative total returns, but outperformed Treasuries over the quarter, and US high yield posted positive returns. This pattern was reflected in Europe and the UK with high yield outperforming investment grade. In Emerging Market bonds, we saw some weakness, but the index **(JPM GBI-EM Composite -0.31%)** marginally outperformed developed market government bonds.

Commodities fell in the second quarter **(Bloomberg Commodity -2.56%)**. Industrial metals fell with, zinc, nickel, and aluminium prices were all sharply lower in the quarter. The energy sector as a whole fell, as crude oil, Brent crude, heating oil and gas oil all declined, while prices for natural gas and unleaded gasoline were modestly higher. Within the agricultural component we saw declines for coffee, sugar, and corn, and while prices for cocoa, wheat and soybeans strengthened, this failed to offset falls elsewhere. In precious metals, both gold and silver ended the quarter in negative territory.

UK Commercial Property showed a small positive return **(FE UK Property Proxy +0.85%).** For both the commercial and residential property markets the high level of economic uncertainty continues to affect real estate investor activity, there are still reports of a mismatch between buyer and seller expectations on pricing. In commercial property, the MSCI Market Rental Growth Index for offices fell marginally by -0.02% in May, down from 0.67% in April and capital values fell 1.86% over the two months. In Industrials, rental grew in April and May (MSCI industrial rental +1.24%), and capital values also rose +0.95% over the two months. The MSCI retail rental growth index was unchanged in May 2023, following a -0.17% decline in April. Retail capital values grew in May with the MSCI index rising by 0.16%, up from 0.10% in April. As in previous months, the growth was entirely driven by retail warehouses (+0.33%).

In Currencies, for the second quarter running Sterling was the standout performer vs other majors, the pound strengthening against all with **USD -2.89%**, **JPY -10.68%** and **EUR-2.44%**. A strong Sterling reduces the return for investments denominated in foreign currencies over the period.

Please Note: All quoted returns are on a price basis in local currency terms.

LOOKING FORWARD…

"The rise of powerful AI will be either the best or the worst thing ever to happen to humanity. We do not yet know which". **Stephen Hawking**

Many investors like to invest in themes or buy stories about companies or sectors that are the next big thing, but caveat emptor. The problem is what has been termed the "big market delusion" - investors pay too much for companies which they expect to grab a share of a potentially huge market, be it the internet revolution, renewable energy or perhaps now AI.

In the late 1990s, investors identified the transformative power of the internet, and that internet shopping would become huge. They paid fortunes for companies they thought would benefit from it, many of which had never shown a profit, and mostly they were wrong. I can remember the buzz around funds created specifically to capture these outsized returns, such as the Framlington NetNet fund. Where are they now, and where is the money that was invested in the story?….

For every Amazon, there is a Pets.com, Webvan or Boo.com who didn't benefit from the internet shopping revolution and failed. In 1999 there were 457 Initial Public Offerings on the US market, many subject to severe overvaluations. Numerous companies disappeared in the early 2000s dot com bubble, with examples of companies that reached $7.5 billion valuations but are worth nothing today.

On March 10, 2000, the Nasdaq hit an all-time high of 5,048. A month later, it lost 34.2% of its value. By October 9th, 2002, it lost 78% of its value. It wouldn't reach its previous all-time high again until April 2015. The majority of companies reached high valuations despite losing money and seemed to be spending as much money on marketing as possible, with a profitable or sustainable business model taking second place. The zeitgeist was to get in on the action now before it is too late and as a result, many investors ignored classic investing fundamentals. It is important to note that some of these companies had brilliant ideas that succeeded at different companies in a later time period - first mover advantage does not guarantee success. However, not all was lost in the mess of this bubble. Amazon and eBay both IPO'd during this time period. Amazon IPO'd at $18 per share, hit $107 at its peak, and dropped to under $7 per share.

A potentially big market does not mean big profits for investors, even if that potential is realised. It is actually very difficult for companies to translate a growing market into what really matters, which is cold hard profit, and investors often underestimate these difficulties. Investment themes and big ideas can be dangerous. They distract us from what really matters in the long term, which is the ongoing profitability of companies. Does it have an economic moat to fight off competitors? Does it have good returns on capital? How much leverage does it have? Does its technology actually work? Have its managers got pricing, marketing and cost control right? Is the valuation reasonable? A potentially big market and exciting story does not mean these factors are irrelevant.

This type of scenario is perhaps an example of what Nassim Nicholas Taleb calls "the narrative fallacy". Creating attractive narratives from a jumble of facts to create compelling stories encourages us to see the world as more ordered and predictable than it really is, and to underestimate uncertainty and randomness. This can lead to overconfidence and to taking on too much risk.

We are not suggesting that we should ignore themes and investment fashions altogether, rather that we should treat them realistically. We can profit from themes as long as we ignore the hype and futurology and instead see them for what they are – waves of sentiment that can ebb and flow. Good investing is rarely about the big ideas. It's about detail, process, rules and discipline.

We are told that the take-up of AI is the fastest of any technology on record – ChatGPT has 100 million users after only two months. The ChatGPT website has more than a billion users per month. Microsoft Corp., with its tie-up with ChatGPT developer OpenAI has been a popular choice for investors chasing the AI theme, as has Alphabet, but the trend is so early that new leadership could arise at any time. Probably the greatest example of the AI theme is NVIDIA which is more of a 'picks and shovels' approach. This is a mining metaphor that suggests that during a gold rush, the best way to make money is to open a hardware store, not dig for gold. In the AI gold rush, DRAM (Dynamic Random Access Memory) plays the role of picks and shovels. AI requires servers with five to six times the amount of DRAM as regular servers - NVIDIA being the leading provider. No matter who eventually leads the AI race, investors are betting that they will need to buy billions of dollars of DRAM from someone, and that someone is going to be NVIDIA.

Anyone thinking of following the gold rush and buying a position in NVIDIA should be aware that the stock is highly volatile. At the end of November 2021, the price was US$334. It fell 66% from there until mid-October 2022, and has since rallied now sitting at over $450. For perspective, this means that the stock's Price Earnings ratio (P/E) sits at 238(!!). For comparison the P/E ratio for the S&P 500 Index is currently 26.11 (trailing 12 month earnings) and averages 16.02 historically. Does this represent a good price for this stock? Is it the Amazon of AI or is it a Pets.com, Webvan or Boo.com? Only time will tell…

Despite recent market hype, we expect that the effect of AI will be transformative, just as the internet was and still is. However, estimating the long-run impact of AI on economic growth, productivity, corporate profits and capital markets at this stage is largely guesswork. History provides us with examples of the impact of major technological breakthroughs and subsequent changes on economic growth and asset prices which are helpful for assessing AI's potential impacts over the next few decades. A recent report from MRB Partners suggested that AI could boost U.S. real GDP and labour productivity growth by 0.5-1% per year as it scales up over the course of the next decade. Goldman Sachs recently issued a note on how AI has the potential to increase global productivity by 1.5% per year over the next ten years, in turn expanding global GDP by 7% (or approximately $7 trillion) and supporting growth in company profits. However, this is contingent on the disruptive impacts of AI being effectively managed by a highly polarised political system. There will be winners and losers as a result, but it is impossible to know who they might be at this stage, or indeed how many ways this new technology will impact our lives in the future.

AI undoubtedly has the potential to accelerate revenue growth, streamline operations, enhance profitability, and as a result shareholder returns. Its promise comes as a lifebelt to investors in a complex macro environment that has left many searching for clarity. After a period where debt has increased massively and we need something game changing to reverse the rising tide of government indebtedness, it would be nice to believe that we are in the very beginning of the next industrial revolution.

Turning to economic themes, the mix of growth and inflation data has been better than we expected at the start of the year, and the market narrative of an imminent recession in the US, and in other regions, has reduced. Consensus growth estimates for full year of 2023 stood at 0.3% in January they are now at 1.5%, but which will prove correct? A US recession remains our base case, but at the moment it is impossible to see if we are heading towards a soft landing, or a disguise for the hard landing that is still to come.

Interest rate hikes take time to affect the economy, especially after the fiscal largesse through COVID which left household savings balances very high. US households had modest real income growth during Q1 2023, inflation slowed, and wage income improved, which means that the US consumer still had savings to spend, which in part explains the strong numbers. However, our economist believes that weaker overtime trends and rising interest rates means that savings will be depleted in Q4 2023 at which point we will see the real position in the US economy. To put the excess savings contribution in context, they reached their peak at around U$1trn annualised, or around 4% of GDP, in Q4 2022. The trend remained elevated in Q1 2023, but started to soften in Q2 as the bottom quartile of income earners ran out of excess savings. US inflation was a 2022 story, and our inhouse measure suggests that improving supply has removed the output gap – in other words the US economy is no longer operating at above trend, which was inflationary. Further, inventories are rising and import price deflation is intensifying.

The combination of heavy consumer spending out of excess savings and a strong fiscal impulse has made consumers and the broader US economy insensitive to rate hikes in the last half of 2022 and the beginning of 2023, pushing the Fed to hike faster and further. The problem is that, as excess savings run out through Q3 2023, and the effect of the fiscal impulse from Yellen's US$500bn draw down the TGA by between late January and early June wanes, the US economy and the consumer in particular will become exposed to the high level of underlying real interest rates. Given consumers' focus on spending their excess savings on domestic services, it is likely that the ensuing slowdown will weigh heavily on the labour market.

Our view is that The Fed needs merely to wait but with its Financial Conditions Index improving and service sector inflation proving sticky we are concerned that The Fed risks overkill continuing with higher rates + Quantitative Tightening. Our concern is that the Fed may continue tightening too much and part of that concern is because when it comes to inflation numbers, it has made a rod for its own back; by choosing an inflation indicator that is not fit for purpose. The problem with the CPI and the PCE deflator, is that they both contain large rental components. Accommodation services account for 33% of CPI. At present, CPI services excluding accommodation is running at 0.4% annualised over three months, well below the Fed's target. But the owner-occupied rent component is running at 8% YoY, which has pulled the overall figure up to 4% YoY for May. The problem with this is that accommodation services are dangerously insensitive to Fed policy on anything under a 12-month view, so while owner occupied rent is showing at 8% annualised, the case Schiller home price index and the Redfin rentals index are now both down measured over the last year.

Underlying monetary conditions are tight and set to worsen as the Fed rebuilds the balance of the TGA. To date this has been done with shorter tern Treasury Bills, but the limit for these is close to being met, which means a significant amount of bond issuance through Q3 is expected. This has the effect of sucking liquidity out of the system, and added to high rates and QT may prove a tipping point.

Credit conditions remain tight, with the senior loan officer survey expected to show that remains the case despite US banking collapses being some months behind us. It seems that US Banks are shrinking their lending books to the extent that credit growth could be as low as -5% by year end, mostly concentrated in the smaller company and commercial real estate space. This is an important theme that isn't seen in the headline data but shows the underlying stresses emerging in the US economy. The recent Fed paper "Distressed Firms and the Large Effects of Monetary Policy Tightenings" said that an unprecedented number of distressed companies could collapse due to the high interest rates. According to the analysis, 37% of non-financial companies are in financial distress. "Reaching "a level that is higher than during most previous tightening episodes since the 1970s". "A restrictive monetary policy stance may contribute to a marked slowdown in investment and employment in the near term".

All this points to a likely reboot for the US economy, which may favour Treasuries in the short term as monetary conditions ease. It may also refresh markets as greater economic certainty could lead to the beginnings of a new bull phase, perhaps in time driven by the fuel of AI. When? Well, that is the $64,000 question, but markets are always cyclical and you have to be in it to win it…

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