FPWM
TAILORED FINANCIAL SOLUTIONS

QUARTER 4 2023

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 policy stays too tight for too long
Investment Grade Bond	N	We prefer to stay neutral here until we see more certainty in the economic and rates outlook. Headline numbers hide the increasing stress beyond the Mega Caps. We prefer the higher quality end of this asset class and while short duration stays attractive, yields may have peaked at last
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. Increase in US bankruptcy filings suggest that we have not seen the end of the default cycle yet
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 strength of USD is turning into a headwind. We maintain the underweight preferring to take real yields in US Treasuries instead
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	+ +	“Magnificent 7” are skewing US market picture where most stocks are down over 2023 and GDP growth slowing rapidly. European earnings revisions holding in well and valuations reasonable, but economic data now starting to wane. Japan has good economic momentum but weak JPY
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 has disappointed and may be a deflationary impulse to the global economy in the coming months. USD strength a headwind
Commodities	N	Fragile Macro outlook in developed markets along with already high energy prices suggest a cautious positioning here, as we wait to see how Q4 plays out. The conflict in the middle east may lead to oil price volatility, but we would expect Saudi supply to step up to fill any gaps from Iran
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. Macro strategies may be key at this stage
Cash	+ +	We maintain our cash weighting as market uncertainties may mean further volatility before markets stabilise. Cash yields of 4% + are attractive and represent a carry hurdle for other assets. Cash also useful as dry powder. Cash funds allow for yield and quick implementation when 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.

LOOKING BACK…

Following a strong first half of 2023 for equity markets, the third quarter offered something of a reality check. Developed market equities fell over the quarter **(FTSE World -2.87%).** In bond markets Government yields rose, hitting returns. As bonds and stocks fell, commodities outperformed over the quarter with energy prices rising due to oil production cuts from Saudi Arabia and Russia.

US equities fell the most in Q3 **(S&P 500 -3.65%)** as investor sentiment and the market narrative flip-flopped again. Q2 had investors believing that the Fed was on a clear flight path to a soft landing for the economy, and an end to policy tightening. That narrative hit a severe crosswind in August and September, with the prospect of rates staying higher for longer. Some small signs of economic cooling showed with the number of unemployed increasing by 514,000 to 6.4 million (+0.3% to 3.8%) in August. The US composite PMI fell marginally to 50.1 in September, down from 50.2 in August, stopping short of falling below 50 which indicates contraction. Inflation continued its downward trend, but the Fed remained hawkish, suggesting a further rate hike may come before the end of the year, while the dot plot now illustrates a higher median rate for 2024 of 5.1% vs 4.6%previously. Some of the excess heat came out of the “Magnificent Seven” (Apple, Microsoft, Alphabet, Amazon, Tesla, Nvidia and Meta) dragging down market returns, with the IT sector one of the weakest areas, along with real estate and utilities. Energy stocks were resilient over the quarter, as energy prices strengthened - one of few bright sectors.

Eurozone shares also fell in Q3 **(FTSE World Europe ex UK -3.16%)** with investors concerned about the effects of interest rate rises on economic growth. On a more positive note, end of quarter data showed eurozone inflation at a two-year low of 4.3% in the year to September, falling from 5.2% in August, leading to thoughts that the European Central Bank may cease further interest rate rises. The consumer discretionary sector suffered on concerns over the effects of higher interest rates on consumer spending. The IT sector struggled despite this year’s enthusiasm around the long-term potential of artificial intelligence, as short term concerns over consumer spending affected demand for computer chips. As in the US, the energy sector made gains amid higher oil prices as some countries cut production. In financials, quarterly results from the banks continued to show the benefit of rising rates on their profitability, leading to some strength. Eurozone PMI data showed that the private sector was in contraction, although the reading did edge up to 47.1 in September from 46.7 in August. The European Central Bank raised interest rates twice in the quarter.

UK equities rose marginally over the quarter **(FTSE All Share +0.76%)** driven by the large, diversified energy and basic materials groups. These companies rebounded as oil and commodities rose, and the strong dollar provided a tailwind for foreign earners. Some domestically focused sectors recovered amid signs of improving UK consumer confidence and hopes that interest rates have peaked. Market interest rates stabilised as the sell-off in long-dated gilts moderated (and long-term fixed mortgage rates fell) in contrast with the government bond market sell-off seen in other major developed economies over the quarter. Mid-caps fared well as a result, with housebuilders particularly strong. Some pub groups and transport operators, outperformed over the quarter, and domestically focussed banks and UK-exposed real estate companies also recorded reasonable share price performances. Despite generally low M&A activity, there were quite a few deals among the small caps, which further supported UK small and mid-cap equities over the period.

The Japanese equity market fared best among developed markets **(TOPIX +1.52%)** despite rising interest rates and bond yields in the US and Japan. Large growth stocks were hit, but smaller stocks held up well, along with value stocks. Quarterly earnings results showed solid numbers, generally meeting or marginally exceeding expectations, supported by the weakening of the yen and strong domestic demand. In late July, the Bank of Japan (BOJ) made policy adjustments that endorsed a gradual increase in Japanese government bond (JGB) yields. There were also suggestions that BOJ Governor Ueda could announce an end to negative interest rates. Inflation remained solid, and yen weakness supported market expectations. The rising interest rate concerns hit growth stocks, including semiconductor-related sectors. Financials and energy and auto sectors did well. Domestic focussed mid and small caps did well until August, when political tensions with China regarding the release of wastewater from Fukushima affected expectations for Chinese tourist demand.

Asia ex Japan declined in the third quarter **(FTSE Asia ex Japan -2.15%)** as concerns over the Chinese economy and fears over global economic growth weakened investor sentiment. Hong Kong, Taiwan, and South Korea were worst hit, while Malaysia and India achieved positive returns. Chinese stocks fell sharply, weighed down by the property sector amid investor concerns as to whether Beijing will deliver enough stimulus to put the world’s second-largest economy back on track. China’s official PMI manufacturing index rose in August, but it remained below 50 (marking contraction) for the fifth consecutive month. China has sought to boost confidence by cutting stamp duty on shares and slowing the pace of IPOs in Shanghai and Shenzhen, which can draw liquidity away from the wider market. Hong Kong struggled, as trading of shares in embattled Chinese property company Evergrande was suspended in September following sharp price falls. South Korea also fell, as weaker factory output and slowing retail sales spooked investors. Shares in Taiwan declined amid fears that the debt issues within Chinese property companies could trigger a financial crisis and send regional currencies lower against US$.

Emerging Markets gave away early gains to end the quarter in negative territory **(FTSE Emerging -1.14%)** as worries about higher for longer US interest rates along with ongoing weakness in the Chinese economy impacted risk appetite. Poland and Chile were the worst performers - Chile hurt by falling lithium prices, and Poland due to political uncertainty and an unexpected and unwelcome interest rate cut. Mexico underperformed against a backdrop of mixed macroeconomic data while South Africa continued to be plagued by its ongoing electricity crisis. Thailand and Saudi Arabia were also negative, while Colombia, Hungary India, UAE and Czech Republic all gained, outperforming the broad index. Amongst best returns was Turkey, where two rate rises in the quarter suggested the central bank may be becoming more orthodox in its policy approach, which was well received by markets.

Concerns over rising US debt issuance weighed on the US Treasury market with Fitch Ratings downgrading the US from AAA to AA+, citing the growing debt burden and an "erosion of governance" as reasons for its decision. Better news on the inflation front allowed many major central banks to indicate a pause in rate hikes later in the quarter. Despite this pause, the market anticipates a longer period of elevated rates which was the key driver of higher yields (meaning lower bond prices) over the quarter. Global government bond yields peaked in September before slightly retreating at the quarter's end **(FTSE WorldBIG Domestic Sovereign -2.71%)**. The US 10-year yield rose from 3.81% to 4.57%, and the two-year yield increased from 4.87% to 5.05%. In Europe, Germany's 10-year yield increased from 2.39% to 2.84%. In the UK, signs of slowing inflation meant rates were unchanged in September, helping gilts to outperform. The 10-year gilt remaining relatively unchanged over the quarter.

In corporate bond markets, spreads narrowed in aggregate with investment grade **(Bloomberg Global Aggregate Corporate -2.73%)** performing in line with government bonds, while high yield **(Bloomberg Global High Yield -0.17%)** outperformed strongly. Despite the weaker growth trajectory, European credit outperformed the US, showing the slowest quarter for net issuance in a decade as companies limited new funding needs due to a lower number of deals in the acquisition pipeline. In EM Bonds falls were lower than developed **markets (JPM GBI-EM Global Composite -1.68%).**

Commodities rose sharply in Q3 **(Bloomberg Commodity +4.71%)** driven by higher energy prices after Russia and Saudi Arabia cut oil production. Energy was the best-performing index component with natural gas the only segment to record a price fall in the quarter due to high storage levels. Industrial metals rose modestly, with price gains for zinc, lead and aluminium offsetting weaker prices for nickel and copper. The agriculture component fell, as weaker prices for wheat, corn, soybean and coffee offset substantial price gains for cotton and sugar. Precious metals were the worst-performing component of the commodity index, with weaker prices for both gold and silver.

In Currencies, we saw a reversal of the trend YTD as Sterling weakened vs other major currencies, with **USD +4.20%**, **JPY +0.64%** and **EUR+0.91%**. A weak Sterling enhances 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…

"Uncertainty is an uncomfortable position. But certainty is an absurd one.". ***Voltaire***

Before we look at the economic and market outlook for the coming months, we need to also reflect on the horrifying events in the Middle East. Our thoughts go out to those affected by such unimaginable violence. To date, financial markets have taken them in their stride. We have seen some flight to safety with treasury yields declining, but overall markets have had fairly mild reactions, with many regional equity markets concluding the week following the start of the violence slightly higher.

Investors appear to have taken the view that the events in Israel and Gaza are contained and there is no broader contagion. Should that change, the most likely and immediate impact could come from a declared or assumed involvement of Iran that could lead to a tightening of oil export sanctions. JP Morgan puts Iranian exports at 1.7mnb/d and any decline in supply would have to be met mostly by Saudi Arabia. The Saudis have to maintain a delicate balance as they want a higher oil price but not at the level of creating demand destruction and dragging the world into a recession. Hence, the country would be likely to reverse the most recent cuts and possibly add. That said, the current supply/demand situation is already tight, and we should expect oil prices to rise further. As of the time of writing, we have not seen any steps toward further Iranian oil sanctions but – as we know – the situation can change quickly.

Following a strong first half of 2023 for equity markets, the third quarter offered something of a reality check as investor sentiment and the market narrative flip-flopped again. In Q2 investors believed that the Fed was on a clear flight path to a soft landing for the economy, and an end to policy tightening. That narrative hit a severe crosswind in August and September, with the prospect of rates staying higher for longer. At the time of writing the Middle East is dominating our thoughts and news headlines, but the market zeitgeist is that 'higher for longer' interest rates are more of a reality than previously thought, and this is the most likely driver behind the declines that we have seen in most asset classes over August and September. While 2023 continues to challenge investors, we believe that we are closing in on the answers the market seeks that will provide clearer guidance on the direction of the global economy.

We remain firmly in the camp that the US will go into recession. At times this year it was a small camp, but as the year progresses our camp is growing and when a market luminary such as Bill Gross joins the gathering it feels like a happier place to be. We are often early in calls on markets and economics, which is preferable in our opinion, but it can be very uncomfortable as you wait for events to transpire. Early looks like wrong… until it isn't.

Stresses are emerging in the US economy and a number of indicators are suggesting that consumers and businesses are starting to feel the effect of tighter monetary conditions. Bill Gross, the former chief investment officer of PIMCO, recently said that "Higher for longer is yesterday's mantra". He thinks the "regional bank carnage and recent rise in auto delinquencies to long-term historical highs indicate the US economy slowing significantly", and that he sees a "US recession in the 4th quarter".

The number of Americans behind on their car loans has reached the highest level for nearly three decades. Fitch Ratings has reported that 6.11% of subprime auto borrowers were at least 60 days behind on their loans, the highest percentage since 1995, and up from the 5.93% seen in January. More than a third of Americans are considered subprime borrowers. In further bad news for private individuals, 30-year fixed mortgages in the US hit 8% for the first time since the turn of the century. The rise, for the sixth straight week, led to demand for mortgages to drop to the lowest level since 1995, applications dropping 6% week-on-week and 21% lower than the same week last year. Applications for remortgages fell 10% for the week and were 12% lower than a year ago. Contacts in the US say that the Real Estate market is dead and with good reason. Who would want to move from a long term fixed mortgage at say 3%, to one fixed for the next 20 years at 7.5-8%? You may as well stay put and of course, this has a knock effect with consumer demand starting to dry up.

We believe the effect of higher interest rates is only now starting to be seen in the US, as many households are paying fixed long-term mortgage rates (unlike many UK households) and companies with longer refinancing schedules have yet to pay higher rates on their debt. However, data from the Federal Reserve indicates that the pre-pandemic excess savings of US households should be depleted in 2023. Student loans become repayable from October, revolving card balances have been increasing, and most datapoints lead to future erosion of disposable income. However, this data hides large differences between the lower and higher income demographics, as lower income households may have already depleted excess savings, while higher income households may still have a buffer.

Stresses within US businesses have increased significantly with bankruptcy filings reaching levels last seen in 2008 and the depths of the COVID crisis with the cost and availability of credit a big factor in this data. As nominal US GDP growth slows, the Federal funds rate is now more than 1.5% above the level of nominal GDP growth for the first time since 2009 (excluding the Covid-triggered collapse in growth in 2020). While large companies can still raise debt at relatively low rates through bond markets, this is not the case for small businesses who rely on banks for credit. The average cost of borrowing for small businesses now sits at around 9% based on the latest National Federation of Independent Business (NFIB)

small-business survey. This is 620bps above the Q2 2023 nominal GDP growth which could be seen as a fair proxy for overall corporate revenue growth. On that basis the average small company is paying 6% above its growth rate to borrow, which is not a sustainable metric. With small businesses (less than 250 employees) accounting for 74% of US private sector employment, if we are looking for labour market weakness in the US to offer the Federal Reserve an excuse to pause or even cut the Fed funds rate, this analysis provides a clue as to where we might find it.

In September companies added the fewest number of jobs since the start of 2021, and at the same time pay growth slowed. Figures from the ADP Research Institute showed that private payrolls rose 89k in September, versus a market consensus of 150k, and annual wage growth slowed to 5.9%, the 12th consecutive monthly decline. Nela Richardson, ADP's chief economist said: "We are seeing a steepening decline in jobs this month. Additionally, we are seeing a steady decline in wages in the past 12 months". ADP's performance as a predictor of the overall economy is patchy, however, it's all grist to the information mill. Overall, we feel the picture is one of a rapidly slowing economy which is finally starting to show the signs of the stresses of tighter monetary conditions.

After having witnessed declines in the US, core inflation has also started to decline in the UK and in the Eurozone. It is, however, still high compared to central banks' targets, whether you believe that they are set in stone at 2% or somewhere under 3%. The big change has been the rapid rise in yields at the long end of the yield curve across both developed and emerging markets. The higher yields may be doing some of the tightening work for the main Central Banks, and a pause to monitor the impact of previous hikes on the economy is expected and welcome. The more rapid decline in US core inflation suggests the Fed may be the closest to the end of its rate hike cycle, with little chance of another rise in November. However, they need to see inflation on a clear path to target or a very pronounced slowdown, to start to cut and make markets more comfortable.

If, as we believe, a recession comes, there are different degrees of severity, and risk markets could remain resilient in a mild recession. As an example, the German Dax Index (the Dax) was up in the first half of 2023 despite the country having entered a technical recession in the fourth quarter of 2022 continuing through Q1 2023 and is still up year to date.

Our industry is fond of a moniker (BRICS, FAANGs etc) and the new term in town is the Magnificent Seven, drawing on the classic western film starring Steve McQueen and Yul Brynner. The markets version is the seven huge US tech firms. Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla that dominate the S&P 500 index. To illustrate this, the S&P 500 is up 10% so far this year, but if we take out the returns from the Magnificent Seven, the market would be down -1% year to date. In other words, the combined efforts of all of the other 493 companies in the index have delivered less than nothing. You could argue that the majority of the S&P 500 is still in the Bear market that began in January 2022. The average US S&P 500 bear market in a normal recession has fallen -25%, which was the level hit in October 2022. Does that mean that most of the pain has been felt and the narrow market in 2023 was just a bear market bounce? Has the AI excitement masked the reality of the current market? Only hindsight will answer these questions with absolute certainty, and timing the bottom of bear markets is a very difficult game to win. Ignoring the COVID crisis, the shortest bear market since 1957 lasted just 3 months and the longest 31 months. Depending on your view, the current market malaise has lasted 21 months and counting, so on the long side of average.

We are not running for the exit in equity markets, but selection remains key. We prefer investments in companies where structural drivers are stronger than cyclical exposure. We continue to have a bias towards the quality spectrum - companies with strong moats, pricing power, balance sheets and cashflow generation. This style factor has shown the greatest resilience and return through the latter stages of the market cycle. We don't think this is the time to buy broad market indices. We favour stock pickers, because as companies deal with a high interest rate (and a positive real rate) environment, weak demand, and relentless innovation, there will continue to be winners and losers. Our approach is to trust our active managers to position their funds in the right areas to benefit.

We also find the long end of the developed sovereign bond markets (including US, UK and German longer dated government debt) interesting following the recent price sell off. It is difficult to find the perfect entry point in the midst of such market volatility, but with the Fed close to, or at the end of its hiking cycle, history suggests that this is a time when we see peak yields. This should be a good time to buy longer dated government bonds, which also provide 'insurance' should a macroeconomic slowdown ahead be more significant than the market expects, or a geopolitical crisis emerges.

We have maintained our asset allocation exposure following long and detailed discussion at the Investment Strategy Committee meeting. As more people find their way into our camp, we are comfortable with our positioning. The exposures to government bonds, developed market equities, USD assets and absolute return baskets, along with our tilts in style and bond duration, should provide the balance and return profile our clients seek to achieve their goals, as the world moves inexorably towards the next stage in the economic and market cycle.

This stage of the market cycle is always a challenge for investors, as returns become hard to obtain, but history shows us that the best returns always come after a period where many have given up hope that they will see positive returns. At these times it pays to stay invested and Schroders recent analysis of 35 years of the FTSE 250 shows us the difference staying in the market can make:

- 11.4% per year if you stayed invested the whole time
- 9.5% per year if you missed the 10 best days
- 8.1% per year if you missed the 20 best days
- 7% per year if you missed the 30 best days

Smart investors reap the rewards of staying invested and following Warren Buffet's oft repeated aphorism to "be fearful when others are greedy, and greedy when others are fearful". This is the key contrarian discipline of successful investors, who go against natural bias and don't follow the crowd.

It is sometime difficult to remember that the equity market is a forward forecasting mechanism, that needs to see light at the end of the tunnel to start its recovery. It seems that at the moment the market is unsure whether the light it can see is the end of the tunnel, or just a train coming towards us… However, we feel that we are much closer to the end of what seems a very protracted fallow period for markets and feel more positive on the outlook for portfolio returns as we move towards 2024.

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