Markets balance a trio of risks

Brooks Macdonald Quarterly Market Overview Q2 2023

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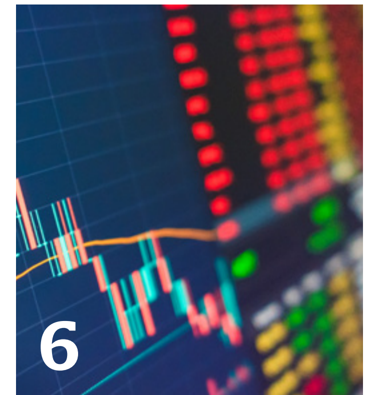

A rocky recovery

When inflation is high, the impact is felt widely.

Inflation affects all aspects of the economy, from consumer spending, business investment and employment to public service budgets, tax policies, and interest rates.

In this edition of our Quarterly Market Overview, we cover in detail the so-called knife-edge of 'economic growth and inflation'. Not that this is a problem everywhere. While the world's biggest economy - the US p6 - continued to see rates of inflation still some way above target, the world's second biggest economy - China see p9 - was instead grappling the near absence of any inflation at all.

Closer to home, here in the UK, we are experiencing stubbornly high inflation which in April stood at 8.7%, according to figures released in June by the Office for National Statistics. This is the first time it has been in single figures since August last year.

For savers, allocating monies has been a difficult decision. Investing is one option to keep money in line with - or beat - inflation. And, as clients are often investing for the long term, it is imperative that we identify trends in the global economy that could impact your investments, such as higher interest rates and above-target inflation.

This quarter, we've outlined how during periods of rising inflation, investing in equities offers the potential for capital growth and should provide real returns over the longer term. You can read more about our positive outlook for UK equities on p5.

As we look ahead, we continue to see a challenging economic outlook. Our goal is to position our asset allocation framework so that it might be able to deliver under more than just one macro-economic outcome.

I hope you enjoy reading this quarter's report and would like to thank you once again for investing with us. None of our successes would be possible without your support and trust.

Kind regards,

Robin Eggar
Managing Director
Head of UK Investment Management

29 June 2023

Introduction

Financial markets balance a trio of risks between inflation, economic growth and financial stability.

Explaining market resilience in Q2, a relatively constructive economic picture challenges cautious investor positioning.

In April, the International Monetary Fund (IMF) published its latest world economic outlook. Alongside the usual update of its forecasts, the IMF also wrote about what it saw as a 'knife-edge path' toward beating inflation without causing recession. While the comments were written about Europe, frankly, they could have been about almost any major developed market economy globally. This so-called knife-edge, which at the start of the year was a two-sided interest rate dilemma between economic growth and inflation, was difficult enough for central banks to navigate. Through Q2, it became something of a balancing act of risks, cementing a third risk of financial stability.

After the hiatus in March of the downfall of three US regional banks and Credit Suisse in Europe, by early May, a fourth US regional bank, First Republic, had run into difficulty and failed. While regulators moved at pace to facilitate solutions, this is not necessarily the end of the story. Although the consensus is that we are not facing a global financial crisis, there are still real risks to navigate. In May, the US Federal Reserve (Fed) published its latest Senior Loan Officer Opinion Survey in which it noted that banks' lending standards had tightened for both businesses and households, though the broad message around the scale was that conditions had 'tightened somewhat', rather than 'tightened considerably'. Nevertheless, with credit creation and loan growth seen as the oxygen for economic growth, should caution amongst the banks grow, it would make the continued post-pandemic recovery harder to sustain.

Inflation continued to be a problem in Q2, but that is not to say it was a problem everywhere. While the world's biggest economy, the US, continued to see rates of inflation still some way above target, the world's second biggest economy, China, was instead grappling with the near absence of any inflation at all. Not just between countries, there was also little uniformity between 'headline' (all-items) inflation which saw annual rates ease sharply due to weaker energy prices, while 'core' rates proved to be relatively more stubborn. During the quarter, the UK made unenviable headlines as annual core (excluding energy and food) consumer price inflation accelerated, rising to the highest rate in over 31 years. As a result, central banks have been forced to re-think their plans.

During June, the Bank of Canada was something of a poster child - having previously paused for two meetings in a row, it took rates up again to 22 year highs, citing concerns that above-target inflation could 'get stuck'. With interest rates across developed markets, in aggregate moving higher through Q2, this has lifted yields on government bonds, in particular for shorter-dated maturities. With 'income' very much back in fixed income products, and considered largely risk-free returns for government bonds (in nominal terms), this has quite-rightly raised the bar by which all other asset allocation choices are being made.

Against such a difficult inflation, interest rate and financial backdrop, it might seem hard to rationalise the resilience of stock markets during Q2. There are two factors to explain this. First, if inflation is proving stickier, in many cases it is just the flipside of marginally better than expected economic growth (albeit from a low base), whether from lower energy prices or continued consumer spending and evidenced by better than expected company results. That is not to say that growth is strong in absolute terms, just that it is better than what was feared previously. Second, market expectations are key – after all, investors invest indirectly in economies, but directly in financial markets. After the derating of valuations during 2022, even a modicum of better economic growth has proven to be a rerating force for developed market equities so far in 2023, and especially so if it comes against hitherto cautious investor positioning. Not for nothing are this year's stock market rallies being described as a 'hated' rally.

Finally, one of the biggest investing themes to take flight in recent years emerged in Q2: Generative Artificial Intelligence (AI), a technology capable of generating text, images, or other media in response to input data and user driven prompts. We have seen that technology company share prices have been a powerful leading driver during Q2. The potential for Generative AI to lift productivity and profitability for many companies across all parts of the global economy has clearly caught the imagination of investors so far this year. Surely the biggest question of all currently is this: is the current narrow market leadership centred around technology a vulnerability, only to herald a collapse to come? Or will these technological gains instead lead to a broadening-out of performance across the rest of the market as tangible benefits are delivered? While only time will tell, balance, more than anything else, continues to underwrite our investment strategy.

> **"Inflation continued to be a problem in Q2, but that is not to say it was a problem everywhere.**

The UK's economic growth outlook gets a modest lift from the IMF, as hopes rise that a recession this year might be avoided.

The flipside of relatively better economic growth, higher inflation and rising interest rates pose unwelcome headwinds for investor confidence.

Stubbornly high inflation and rising interest rates preoccupied investors during the period.

Economic growth was, on the whole, uninspiring. Month-on-month Gross Domestic Product (GDP) in March unexpectedly fell by -0.3%. The services sector accounted for much of the sluggish performance as the teachers' strike, in particular, had a negative impact on the economy. A rebound in the services sector in April supported monthly GDP growth of 0.2%. In the first three months of 2023, GDP rose 0.1% – the same rate as the final quarter of 2022 and in line with forecasts.

On the inflation front, the news was not good. Annual inflation of 10.1% in March was higher than forecast and only slightly below February's 10.4% level. Rising food prices drove the higher rate, despite a fall in petrol and diesel prices. A lower-than-expected fall to 8.7% in April disappointed investors and increased prospects that the Bank of England (BoE) would need to keep raising interest rates. An unchanged inflation reading of 8.7% in May confirmed the inevitable and the BoE continued its policy of using interest rates to tame inflation. A significant challenge to policy makers, annual core consumer price inflation (excluding energy and food prices) rose in May to 7.1%, above market expectations, and marking the highest level since March 1992.

After raising interest rates in May by 0.25% to 4.5%, the BoE surprised markets with a 0.5% hike in June to 5.0%. This was the thirteenth consecutive rise and took interest rates to their highest point since 2008. The BoE said the decision was needed to deal with persistent inflation. Despite the pressure it put on borrowers, BoE Governor Andrew Bailey was blunt in his assessment of the situation: "if we don't raise rates now, it could be worse later".

> **"The UK economic growth outlook received a small vote of confidence from the IMF.**

Wage-driven inflation remained another concern for the BoE. Average weekly earnings (including bonuses) increased by 6.1% year on year in the three months to March and by 6.5% in the three months to April. With inflation fuelling the cost-of-living crisis, pressure to raise wages intensified. The unemployment rate in the first three months of 2023 rose 0.1% to 3.9%, although the reading of 3.8% in the three months to April was lower than forecast.

Despite these economic headwinds, the UK economic growth outlook received a small vote of confidence from the International Monetary Fund (IMF). in May. The IMF upgraded its forecast for UK real (constant prices) GDP growth for calendar 2023 to positive 0.4% year on year, and up sharply from its previous negative growth estimate of -0.3%. Explaining the relative improvement in economic fortunes, the IMF noted that "buoyed by resilient demand in the context of declining energy prices, the UK economy is expected to avoid a recession and maintain positive growth in 2023".

Looking further ahead, the IMF continues to expect annual GDP growth of 1.0% in 2024.

The period ended with signs that consumer confidence might be returning. Warmer weather helped retail sales increase unexpectedly in May, rising 0.3% month-on-month, and the second monthly rise in a row.

In currency markets, sterling appreciated mildly versus the US dollar. After strengthening in April, sterling weakened in May. However, expectations of further UK interest rate rises and the Fed taking a less aggressive approach saw sterling strengthen further in June.

Brooks Macdonald's view

We have a positive outlook for UK equities. This might appear to run counter to the present challenge of muted economic growth versus stubborn inflation, but the domestic picture is not the only driver for the UK equity market investment case. The UK economy and equity market are not the same. UK equities in aggregate have a large international skew, with around three quarters of their revenues at an equity index level derived from outside the UK. As such, the UK stock market is particularly sensitive to global trends, be they exposure to a still-resilient US consumer-led economy, an improved European energy-cost outlook, or a continuing China-economic re-opening. The continued relative valuation attraction of UK equities makes up an important component of our barbell strategy (describing balance between different equity investment styles). The UK value exposures that we seek provide a valuable foil to our growth exposures in other asset classes and regions globally.

United States

Inflation slowdown and Generative Artificial Intelligence combine to improve investor sentiment.

US Federal Reserve pauses interest rate rises but wary of sounding the all-clear, predicts further increases later this year.

Concerns over US regional bank failures that had dented investor confidence in March appeared to abate during the quarter, despite the failure of US regional bank First Republic in early May. Some positive corporate results boosted market sentiment, particularly in the technology sector which also benefited from growing interest in Generative Artificial Intelligence (AI).

A bipartisan deal to increase US government borrowing was made just before the deadline that would have triggered a government debt default. Democrats and Republics agreed to increase government borrowing limits and set caps on spending through to 2025.

Annual inflation fell to 4.9% in April, with energy prices down and food prices rising at a slower rate. A greater-than-expected fall to 4.0% in May was supported by continuing lower energy prices. This heightened expectations that the Fed would pause its path of interest rate rises.

Higher interest rates contributed to the slowdown in economic growth. Annualised GDP growth shrank to 2.0% in the first three months of 2023 compared with 2.6% in the last quarter of 2022, albeit the latest economic growth rate was above market expectations. A reminder of the resilience of the US consumer despite the past 15 months of interest rate hikes, consumer spending picked up during the quarter, with a rise in monthly retail sales in April. A slight, but better-than-forecast, rise in retail sales in May signalled still-constructive consumer confidence.

Labour markets appeared to soften a little during Q2 as the number of initial claims for unemployment benefits largely rose versus Q1 2023. More people out of work, with a modestly higher unemployment rate of 3.7% in May, the highest since October last year, is likely to ease pressure on employers to raise wages and reduce the risk of wage-driven inflation. That said, while US aggregate job vacancy numbers have fallen back from last year's highs, they are still some way above pre-pandemic levels, indicating that the US labour market is continuing to prove resilient.

> **“Positive corporate results boosted market sentiment, particularly in the technology sector.**

In May, the Fed indicated it might be nearer to halting its policy tightening after increasing interest rates by 0.25% to 5.25%. This was the highest level since September 2007 and the tenth successive hike, but Fed Chairman Jerome Powell didn't rule out further interest rate rises.

However, a change of monetary strategy came in June, when the Fed left the target for its funds rate unchanged at 5.25%. But Powell maintained the central bank's stance that interest rates may need to go higher to bring inflation back to its target of 2.0%. At the end of June, he told Congress that "nearly all Federal Open Market Committee participants expect that it will be appropriate to raise interest rates somewhat further by the end of the year".

In international developments, Treasury Secretary Janet Yellen warned of the dangers of decoupling the US economy from China. Secretary of State Antony Blinken visited Beijing in an attempt to strengthen relations between the two countries. The diplomatic effort followed growing political tensions over China's longer-term unification plans for Taiwan and a Chinese spy balloon shot down over the US earlier this year.

In company news, significant in Q2 was the very strong results and Guidance from US semi-conductor company Nvidia. With its blow-out results propelled by soaring demand for the company's designed semi-conductors used in Generative AI applications, Nvidia's news in May also catalysed widespread market enthusiasm for technology shares in general.

Brooks Macdonald's view

We have a neutral outlook for US equities. Corporate results in aggregate continued to reflect a still-resilient US consumer, with mentions of 'recession' in US company management post-result transcripts falling sequentially for three calendar quarters in a row. Further, while analysts' earnings growth expectations for calendar year 2023 remain muted, there is a significant assumed up-tick to close to double-digit year-on-year growth in 2024. Markets have responded to the still-constructive picture by lifting valuation multiples, continuing their recovery following last year's compression. Given the size of the US economy and its markets, the US continues to have an important role in providing growth investment-style exposures within the context of our current equity barbell balanced approach to asset allocation. Our US equity weights help to support our standalone and longer-term investment themes of technology, healthcare and, to a lesser extent, sustainability which the US has exposure to at an aggregate equity index level.

Eurozone economy falls into a technical recession, as interest rates appear to weigh on activity.

The European Central Bank stays focused in its fight against inflation with higher interest rates.

Investor concerns over weak economic data and the banking sector crisis subsided somewhat at the start of the period. But fears of a global economic slowdown persisted, especially as China's economy appeared to lose some of its earlier economic reopening momentum from last year's Covid-19 lockdowns.

"Unsurprisingly, consumer confidence remained subdued during Q2.

Eurozone GDP fell -0.1% quarter on quarter in the first three months of 2023 after an initial estimate of a 0.1% rise. This meant the eurozone economy fell into a technical recession (defined as two consecutive quarters of falling GDP) as GDP also fell -0.1% in the final quarter of 2022. Despite the challenging economic picture, the IMF in April forecast Eurozone real GDP growth for calendar year 2023 of 0.8%, rising to 1.4% in 2024.

Annual eurozone inflation rose marginally to 7.0% in April from 6.9% in March. Although rises in food prices slowed, energy prices and the cost of services were higher. A larger-than-expected fall in annual inflation in May to 6.1% was the lowest level since February 2022.

However, inflationary pressures remained. A fall in seasonally adjusted unemployment to a record low of 6.5% in April meant wage-driven inflation remained a concern for markets and policymakers. At a country level, the German economy shrank -0.3% on a quarterly basis in the first quarter of 2023 as prices and borrowing costs rose. This was the second consecutive quarter of contraction and put Europe's largest economy into a technical recession.

Given still-sticky inflation, the European Central Bank (ECB) increased its deposit rate by 0.25% to 3.5% in May. This was the eighth consecutive interest rate rise and took the deposit rate to its highest level in 22 years. The ECB said it expected to announce further rises to bring inflation back to its target level of 2.0%. ECB President Christine Lagarde noted that inflation was "projected to remain too high for too long".

Unsurprisingly, consumer confidence remained subdued during Q2. The reading from the ECB's Consumer Expectations Survey for economic growth at the start of the period showed that the view for the next 12 months was negative. Meanwhile, the European Commission's Economic Sentiment Indicator produced lower-than-expected readings throughout Q2, remaining well below its long-term average.

The region continued to face heightened geopolitical risks as Russia's invasion of Ukraine showed little sign of ending. The destruction of the Kakhovka Dam in southern Ukraine and subsequent extensive flooding, along with an increase in fighting, underlined the unpredictable outcome of the war.

Brooks Macdonald's view

We have a neutral outlook for Developed Europe (excluding UK) equities. European natural gas prices, having fallen sharply earlier in the year, are providing some relative relief for both businesses and households. Additionally, the hope is that China's economic reopening can over time help to feed into European export-led economic growth. Despite challenging near-term economic data, the European Central Bank (ECB) in June continued to forecast positive annual average Real (constant prices) GDP (Gross Domestic Product) growth across the euro area for 2023, 2024 and 2025. Finally, supporting value-investment-style exposures added earlier this year, the region's banks are expected to see an improved profit outlook medium term given a backdrop of positive nominal interest rates, versus the hitherto decade of arguably lost-earnings under the ECB's prior negative interest rate regime. While structural tensions between euro area monetary union versus fiscal and political sovereignty remain, these concerns are now balanced by the relatively more constructive outlook we see.

Asia Pacific (excluding Japan)

Mixed signals on China's economic recovery prompt its central bank to cut interest rates.

While inflation pressures remain absent in the world's second biggest economy, geopolitical risks for now remain a headwind for greater investor appetite.

The strength of China's economic recovery came into question after the country's post-Covid re-opening boost appeared to be stalling during Q2.

Increases in retail sales and industrial output helped China's economy to grow 4.5% year on year in the first three months of 2023 after expanding 2.9% in the final quarter of 2022. However, growth in industrial output in May was less than forecast. China's central bank, the People's Bank of China cut key lending rates in June to encourage more borrowing and boost economic recovery. Underscoring Beijing's commitment to ensuring a successful economic reopening, in June, China's Premier Li Qiang said that China GDP growth in calendar Q2 would be higher than Q1, while reiterating the annual economic growth target for 2023 of 'around 5%'.

With tensions simmering over China's longer-term unification plans for Taiwan and a Chinese spy balloon destroyed while flying over the US earlier in the year, US Treasury Secretary Janet Yellen urged against decoupling the US economy from China. The strain in political relations between China and the US appeared to ease a little in June following the visit to Beijing by US Secretary of State Antony Blinken.

In Taiwan and South Korea, key technology stocks such as Taiwan Semiconductor Manufacturing and Samsung Electronics surged. Taiwan's economy contracted in the first three months of 2023. South Korea's economy grew quarter on quarter in the first quarter of 2023 after shrinking in the previous quarter. South Korea's annual inflation rate eased to 3.3% in May from 3.7% in April. The slowdown in inflation saw the Bank of Korea leave interest rates unchanged at 3.5% in April and May.

> **“The strain in political relations between China and the US appeared to ease a little in June.**

An easing in food price rises and transport costs saw Australia's annual inflation fall to 7.0% in the first three months of 2023, down from a 30-year high of 7.8% in the final quarter of 2022. Despite the reduction in inflation, a surprise increase by the Reserve Bank of Australia took interest rates up 0.25% to 4.1% in June. The unexpected move followed a similar 0.25% hike in May and took rates to their highest level since April 2012.

Brooks Macdonald's view

We have a positive outlook for Asia Pacific (excluding Japan) equities, reflecting the opportunity to gain exposure to attractively valued markets and their faster-growing economies – for 2023 the IMF estimates that China and India will contribute around half of global GDP growth. While the region's equity markets have given back some of their performance in Q2, sentiment in June was lifted by interest rate cuts from the People's Bank of China for the first time since August 2022. With China annual consumer inflation around zero, China's central bank can afford to lower the cost of credit to businesses as well as indirectly incentivise households to spend pandemic-accrued savings. With expectations of more China government stimulus to come, we see the potential for investor tailwinds to rebuild this year. Within our broader Asia Pacific ex-Japan allocation, we seek a value-investment-style skew, recognising the positive optionality for a continued Beijing-driven economic re-opening trade in 2023.

JAPAN

Markets respond positively to an upbeat outlook alongside hopes for stock exchange reforms.

Falling inflation and improved economic growth support the central bank's decision to leave interest rates unchanged.

In currency markets, the Japanese yen retreated against the US dollar over Q2. This came as the Bank of Japan's (BoJ) new governor, Kazuo Ueda, remained supportive of the central bank's long-running ultra-easy monetary policy stance. The governor, saying in April that the BoJ would "patiently" continue with accommodative policy settings, implied it was too early to change course by announcing a policy review which is expected to take between 12-18 months. Annual inflation rose to 3.5% in April from a six-month low of 3.2% in March, with food prices continuing to increase. More encouragingly, inflation fell in May to 3.2% when it had been forecast to rise. The economy grew 0.7% quarter on quarter in the first quarter of 2023 which was more than forecast and higher than the 0.1% expansion in the previous quarter. A reduction in sales to China held back the country's exports which only rose 0.6% on an annual basis in May, albeit higher than expected, after increasing 2.6% in April.

The Japanese equity market responded positively to the BoJ's decision to leave its short-term negative interest rate of -0.1% unchanged in June. Furthermore, the central bank's policymakers predicted a slowdown in inflation and a continuation in monetary easing.

> **"BoJ's new governor remained supportive of the central bank's long-running ultra-easy monetary policy stance.**

Brooks Macdonald's view

We have a neutral outlook for Japan equities. Market performance has been supported this year by hopes that after years of false dawns around stock market reforms in particular, we might have finally reached a tipping-point. Of particular note, for Japanese listed companies with a market price below the book value of their net assets, the Tokyo Stock Exchange has earlier this year tasked them to 'disclose policies and specific initiatives for improvement'. Balancing hopes for better corporate governance and capital allocation, Japan still has well-documented structural headwinds: high public debt levels and a declining and aging population. These provide an unwelcome backdrop for the Bank of Japan as it might look to unwind decades of unconventional monetary policy, following which the central bank owns around half of the Japanese government bond market.

EMERGING MARKETS

China's economic recovery focus on domestic drivers risks a potential headwind for emerging markets.

Main emerging markets see some relief from lower inflation as energy and food prices fall.

Inflationary pressures appeared to be easing in the main emerging markets. However, a slowdown in global economic growth and concerns about the shape of the post-Covid recovery of China's economy arguably presents a challenge to the emerging markets outlook. Reflecting the perceived focus on domestic drivers for China's economic reopening, one index of globally traded commodities saw prices overall subdued during the quarter and well down on last year's highs.

South Africa's economy expanded by an annualised 0.4% quarter on quarter in the first three months of 2023 after a revised 1.1% fall in the final quarter of 2022. This meant the country avoided a technical recession, despite widespread problems with power cuts. In May, lower food prices helped annual inflation fall more than forecast to a 13-month low of 6.3% from 6.8% in April.

Brazil's economy grew by a higher-than-forecast 1.9% quarter on quarter in the first quarter of 2023 after shrinking by -0.1% in the final three months of 2022. The country's annual inflation fell to 3.9% in May from 4.2% in April on lower transportation and petrol prices. This was the lowest level since October 2020 and below forecasts.

Turkey's annual inflation fell to 39.6% in May from 43.7% in April, taking it to the lowest level since December 2021. Turkish shares made gains after President Recep Tayyip Erdogan won a run-off election during the quarter.

An easing of food price rises helped India record a reduction in annual inflation to 4.25% in May from 4.7% in April. The figure was below consensus estimates and took inflation to its lowest point since April 2021. In June, the Reserve Bank of India left interest rates unchanged for its second consecutive central bank meeting.

Brooks Macdonald's view

Our neutral outlook for Emerging Market equities disguises a more cautious outlook to the mix of emerging countries outside of our preferred Asia Pacific (excluding Japan) focus. Given the uncertain global economic outlook, the headwind this has presented for commodity prices might also weigh against those emerging markets which are more resource-export-led. It is notable that China, a consumer of significant shares of global commodity export markets, has appeared to prioritise a domestic, services-led, consumption recovery, rather than lean on the past-model of infrastructure spend to boost its economy. This might challenge the traditional emerging market 'playbook' where emerging market export growth might feed off a Chinese-led commodity reflation narrative. We are mindful that second-order impacts following the Covid pandemic in particular, such as so-called 'near-shoring' of global supply chains, have undoubtably complicated what might otherwise be a more-normal economic growth profile that emerging economies might hope for.

Outlook

Higher interest rates present a higher hurdle-rate for risk and reward expectations across all assets.

Debate around the expected path for inflation, interest rates and economic growth continues to advocate investment-style balance.

Income, more and more, is back in fixed income. While UK two-year government bond yields started Q2 at just under 3.5%, by late June they had risen to well over 5%, hitting their highest level since 2008. For UK 10-year yields, while these were lower in comparison, they also rose from just under 3.5% at the start of Q2, to edge close to 4.5% at one point in mid-June. Assuming no sovereign-default-risk, these levels of yields are increasingly seen by investors as an attractive risk-free rate of return, at least in nominal terms. The flipside is that it raises the risk and reward hurdle-rate for all other assets, from equities to corporate bonds to alternative investments and everything else in between.

The level of fixed income yields currently on offer present a valid challenge for asset allocators. Over the decade that followed the 2008 Global Financial Crisis (GFC), interest rates and bond yields fell towards zero and mostly stayed there. For much of this time, the investment mantra of 'TINA' ruled; this was the idea that 'There Is(was) No Alternative' to taking greater risk in the search for yield. With yields on government bonds hitherto largely absent over this period, investment flows into alternative assets grew, ranging across property, infrastructure, structured products, private equity and more.

It is important to recognise that the rise in bond yields over the past 18 months or so has not been painless. Yields look attractive now because there has been something of a value-transfer from existing holders to future holders. Despite our relative focus on shorter-duration bond exposures during this time (describing bonds with shorter weighted-average maturities of their cash flows), relative outperformance of fixed income benchmarks has still seen bond prices fall.

Looking forward from here, with government bond yields at multi-year highs this might suggest their relative attraction is assured, but it is important to balance the scales. In the case of equities versus bonds for example, an important distinction is that an equity yield is considered a real yield whereas a bond yield is typically a nominal yield. In a growing economy, a company's revenue and profits, through price increases of goods and services sold, might over the longer-term seek to keep pace with inflation. In contrast, a conventional bond's coupon and principle are fixed in nominal terms. As such, while the yield on a company's share price might initially look somewhat less attractive, the earnings yield for that company, over time, versus a given price today, might be expected to rise.

Even so, during Q2, we recognised that bond yields are higher than they have been for a long time. Also mindful of broader liquidity risks should the outlook for the general investment backdrop weaken, we increased our allocations to government bonds in June, funded by reducing our allocations to property and alternative income assets. As well as providing an important source of income, our allocations to fixed income in particular also serve another function: increasingly we see these assets providing a valuable counterweight to our equity allocations elsewhere in our asset allocation framework. With government bond yields at current levels, these provide a degree of cushion should the economic and market outlook deteriorate.

Despite the modest defensive step we took to our asset allocation settings during Q2, overall we continue to retain a net constructive outlook, with a preference for equities over bonds. In equities, while we express regional and country preferences, we have kept our global equity investment style barbell balance between value and growth, first implemented at the start of 2021, in place through the quarter. In bonds, we recognise that with higher rates, income is back in fixed income again, but here we have stayed focused on bonds with shorter weighted-average maturities which are less sensitive than longer-dated equivalents to any changes in the interest rate outlook ahead. In between equities and bonds, our remaining allocations to alternative asset classes help us to provide both balance and diversification to our overall expected returns.

> **"During Q2, we recognised that bond yields are higher than they have been for a long time.**

As we look ahead, we continue to see a highly uncertain economic outlook. Our goal is to position our asset allocation framework so that it might be able to deliver under more than just one macro-economic outcome.

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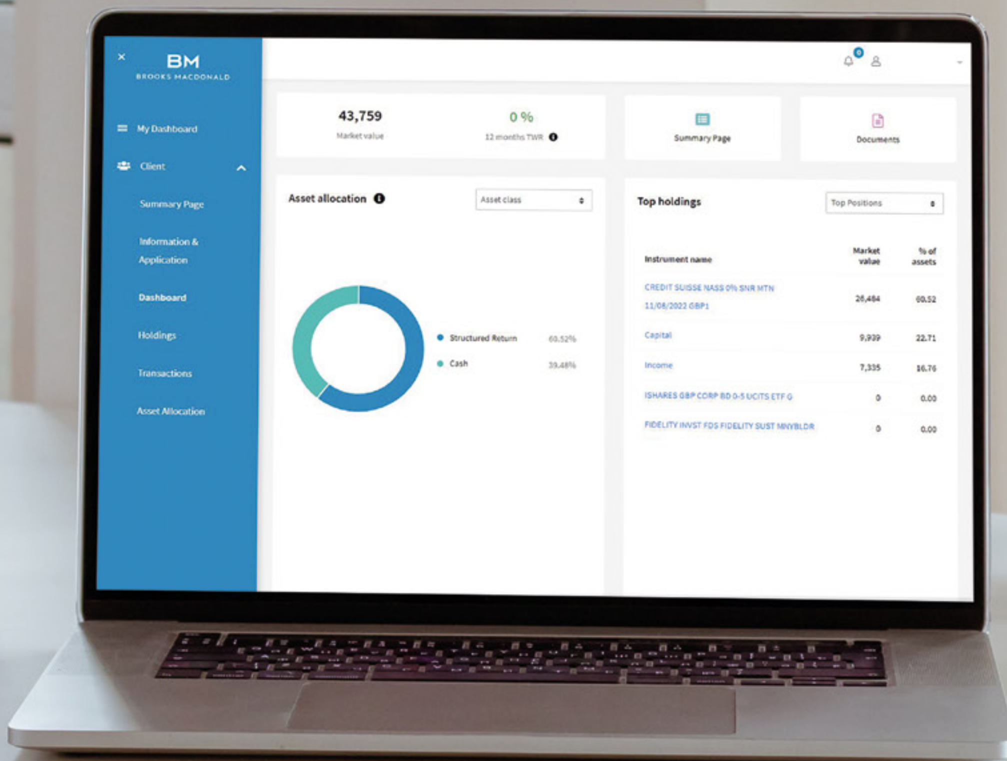

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The views in this Quarterly Market Overview report are correct as at 29 June 2023. All information is current at the time of issue and, to the best of our knowledge, accurate.

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