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# Investment Committee Series

Q3 Outlook - August 2024

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# 01

## Introduction

Global equities continued their rally into the end of the second quarter of 2024. The first quarter's gains were primarily driven by robust economic growth expectations, while the second quarter saw the rally increasingly concentrate on the Magnificent Seven companies which benefited from the growing adoption of Artificial Intelligence (AI) technologies. Asset class dynamics also changed. During the second quarter, as economic indicators fell short of expectations, bonds and equities became more positively correlated. This contrasts with the first quarter where equities rose, despite falling bond prices.

The upside risks to growth that we noted in our Q2 outlook did not come to fruition as economic indicators surprised to the downside. The observed deceleration in strong economic data, particularly in the US where consumer spending declined, raised questions about whether this represents a temporary pause in growth or a more significant downward trend. Despite that, the global economy remained resilient, driven by a robust labour market and strong wage growth. Outside the US, global manufacturing data continues to recover, driven by Asian exports of semiconductors and semiconductor equipment, and Chinese industrial production growth. Manufacturing data disappointed in Europe, potentially driven by the political uncertainty of the French elections.

The disparity in US growth relative to the rest of the world was anticipated to narrow as other economies began to recover from weaker starting positions. Overall, the expectation is that the "US Exceptionalism" narrative will continue to fade in the second half of the year.

Inflation continues to fall, albeit more slowly than expected. Core inflation components, such as shelter, and services remain sticky. We still think the bias is downward for inflation as forward-looking estimates indicate that wages and shelter inflation should fall.

Given the progress on inflation, 42% of global central banks are now cutting interest rates. We anticipate that more central banks, including the Federal Reserve and the Bank of England, will ease rates. However, with inflation rates remaining above target, we expect central banks globally to approach rate cuts cautiously, resulting in a relatively shallow easing cycle.

**Eren Osman**  
Managing Director,  
Wealth Management



# 02

## Decisions we made

### **Increased our allocation to government bonds and reduced corporate debt, maintained our overweight in equities**

Given our confidence that inflation will continue to fall, and central banks are in a rate-cutting cycle, we have increased our global government bond allocation. Typically, when central banks cut interest rates, bond prices rise. Furthermore, government bonds provide protection to portfolios in case of a sharp economic growth slowdown.

Regarding corporate debt, we have reduced our overall weighting by exiting our Brazilian bond allocation. This decision was predicated on the fiscal outlook in Brazil, which has negatively impacted both the currency and short-term interest rates, factors that are linked to the position. Furthermore, we have opted to reduce our allocation to ultra-short bonds. While they offer liquidity to the portfolio, they may underperform the longer dated corporate bonds in an environment of declining interest rates.

“Equities rallied in the second quarter and inflation continued to fall, with central banks firmly in a rate-cutting cycle. Against this backdrop we have increased our global government bond allocation. We have also increased our exposure to “Magnificent Seven” stocks – Amazon, Apple, Microsoft, Tesla, Meta, Nvidia, and Alphabet – to take advantage of the burgeoning potential of AI.”

**Peter Doherty**

Director, Head of Investment Research



### Central banks rate cutting cycle should be beneficial for bonds



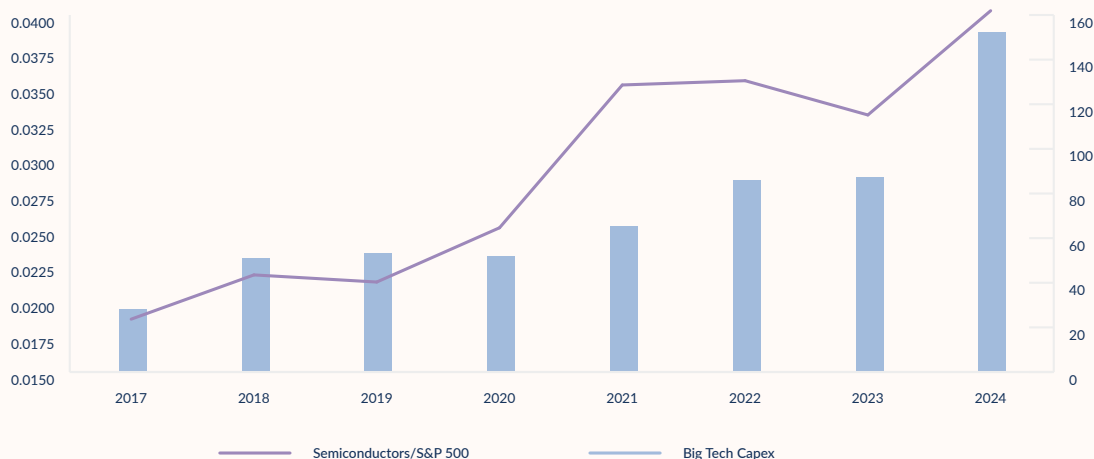
Source: Bloomberg - July 2024

On the equity front, our focus has been particularly directed towards the expanding dynamics of AI. Based on our research, we think the potential upside risk from this transformative technology warrants further exposure in client portfolios. Accordingly, we have strategically reduced our underweight in the so-called “Magnificent Seven” stocks – Amazon, Apple, Microsoft, Tesla, Meta, Nvidia, and Alphabet. These companies are at the forefront of AI development and implementation. To achieve this, we have increased our exposure through passive investment vehicles that maintain significant allocations to these specific companies, allowing us to gain targeted exposure.

Furthermore, we allocated to a Global Semiconductor ETF. Our analysis suggests that semiconductor manufacturers are likely to be among the primary beneficiaries of the massive investments being made in AI technology. The semiconductor industry plays a crucial role in the AI ecosystem, providing fundamental components that enhance computing and data processing capabilities. It is important to note that the process of manufacturing semiconductors, particularly those required for AI applications, is highly complex and capital-intensive, which creates significant barriers to entry and makes established companies in the sector difficult to be replaced.

These portfolio adjustments reflect the positive long-term structural growth we anticipate in AI and related technologies. However, we will continue to monitor developments and adjust our position as warranted by our ongoing analysis and changing market dynamics.

## Growing capex funnelling into semiconductor outperformance



Source: Bloomberg - July 2024

## Within equities, we have reduced our Japanese allocation and increased our US exposure

Japanese equities have demonstrated robust performance since the beginning of the year. However, recent economic indicators from the region have shown moderation in growth. Furthermore, valuations in Japanese equities are not as attractive from when we first went overweight in the region. In light of these developments, we have reduced our allocation to Japanese equities and reallocated the resulting capital to US equities.

Furthermore, we have reduced our allocation to Emerging Markets exposure and increased our allocation to the Asia Pacific region. This shift is designed to mitigate our underweight to attractive regions such as Taiwan and India, while reducing our exposure to China. The decision to decrease our China allocation is primarily driven by the ongoing challenges in the local property market, which continues to be a drag on the broader Chinese economy.

We view Taiwan favorably due to its pivotal role in the global semiconductor industry. As the primary hub for advanced semiconductor manufacturing processes, Taiwan stands to benefit significantly from the growing demand for semiconductors.

Regarding our European equity allocation, we have maintained our current position. However, we recognise that the coming months will be crucial in determining any potential adjustments to this allocation. We are closely monitoring whether the recent weakness in European economic data is primarily attributable to uncertainty surrounding the French elections or if it represents a more persistent trend.

### Increased our allocation to property

The property sector has faced challenges due to rising interest rates, which have negatively impacted the highly leveraged industry, leading to significant declines in property values. Nevertheless, despite the depressed valuations, rental growth has remained robust. As bond yields decrease, we anticipate this being a positive catalyst for the sector due to its bond-like characteristics. Lower interest rates typically enhance the relative attractiveness of property yields, reduce borrowing costs for real estate companies, and can lead to higher property valuations. We maintain a selective approach in our property exposure, emphasising quality in our property-related investments.



We have reduced our allocation to Emerging Markets and increased our allocation to Asia Pacific (ex Japan). This shift is designed to mitigate our underweight position to attractive regions such as Taiwan and India, while reducing our exposure to China. Our European equity allocation remains unchanged, but we keep a close eye on the region to understand if the current economic uncertainty is part of a longer-term trend.”

**Peter Doherty**  
Director, Head of Investment Research

# 03

## What does the future hold for investors?

Globally, we have seen growth remain resilient. We will monitor incoming economic data and if negative economic surprises continue to persist this may indicate that economic growth is cooling faster than our current expectations. For the moment, we think the global growth backdrop remains supportive of risk assets. This is underpinned by low unemployment, rising real incomes, and an improving manufacturing sector.

The overall trend in inflation continues to be downward and with global central banks cutting interest rates, we think this will be an additional support for risk assets, particularly those that are more interest rate sensitive.

Into the second half of the year, markets will become increasingly focused on the US elections. With Trump leading in the polls, there is some discussion of a repetition of the “Trump trade” we saw during his first term. The broad contours of such a trade would include a strong dollar, pro-US sentiment, and negative impact on bonds. Following the first presidential debate, some indications of these trends have begun to emerge. However, it is important to note that markets do not operate in isolation. The economic environment is different today to what we had in 2016: The business cycle is much more advanced, and inflation is higher. Ultimately, the macroeconomic backdrop remains the most critical variable, and positioning based on political outcomes must consider the broader growth environment.



## 04

## Around the world

**India**

Prime Minister of India, Narendra Modi, has secured a third consecutive term in office. However, unlike his previous victories where his party won an outright majority, this time he needed to form a coalition government. The election process, which lasted for seven weeks, saw an unprecedented turnout with over 640 million voters participating, a new “world record”.

**South Africa**

South Africa’s political landscape is undergoing a significant transformation after the elections. The African National Congress (ANC) is facing coalition as recent elections ended the party’s dominance after decades of securing landslide victories. ANC’s grip on power has steadily weakened on the back of economic stagnation and rising unemployment.

**Europe**

The European Commission has taken a significant step to protect its domestic automotive industry by imposing provisional anti-subsidy duties on electric vehicles (EVs) imported from China. The impact of these tariffs is expected to vary across different EU member states, with Germany likely to feel a particularly strong effect because of its automakers being highly exposed to China.

**Canada**

Canada becomes the first G7 nation to cut interest rates. The central bank reduced rates to 4.75% from 5% after four years. Nevertheless, the Bank of Canada stressed the importance of data dependency before the next rate cut.

# 05

## Top of mind: Changing dynamics in the real estate market

The real estate market has faced significant turbulence in recent times. Property values have fallen as the post-COVID environment continues to shift demand dynamics, while interest rate increases played a significant part in falling property values. Despite this, many sectors of the property market have demonstrated robust rental growth. With the global interest rate hiking cycle behind us, in this article, we explore the potential opportunities in listed Real Estate.

### Pandemic fallout and interest rate hikes

The property sector has been impacted by two significant events over the last four years. First, the COVID-19 pandemic has fundamentally altered the dynamics of both retail and office real estate markets. The rise of ecommerce and remote working has negatively impacted the demand for these spaces. Second, following the pandemic, central banks worldwide embarked on an aggressive interest rate hiking campaign to combat inflation. Higher interest rates drove down property values. This created a particularly challenging environment for real estate companies, a sector heavily reliant on leverage, which resulted in the stark underperformance of listed Real Estate.

### Impact on valuations and income potential

It is important to note that despite the depressed valuations, rental growth in many sectors remained robust. This resilience in rental income has made listed property an increasingly attractive source of income for investors seeking yield in a challenging market environment.

### As yields fall, REITs tend to outperform



Source: Bloomberg - July 2024

The impact on Net Asset Values (NAV's) nevertheless, has not been uniform across global markets. A notable divergence has emerged with the US market demonstrating greater resilience compared to the UK and EU. The US real estate market has weathered recent storms better, due to its diverse sector composition and particularly to the higher allocation to data centres and warehouses. The exponential growth in digital transformation and cloud computing has propelled the continued demand for data centre space. Simultaneously, the ecommerce boom after the pandemic increased the demand for logistics, keeping vacancy rates low and allowing rental growth to remain solid.

In contrast, the UK and European real estate markets have faced more significant hurdles in their recovery as they are heavily exposed towards traditional sectors such as office and retail properties. These sectors have been challenged by working from home and ecommerce trends.

The disparity in performance underscores the critical importance of rental levels. Markets and sectors that have maintained strong rental growth, paired with low vacancy rates, have seen better returns.

### **Loan-to value ratios and market fundamentals**

Despite the impact of higher interest rates on real estate loan books, our research indicates that loan-to-value (LTV) ratios have remained relatively stable across various sectors. This stability suggests that while the rising interest rate environment has certainly posed challenges, it has not led to a widespread deterioration in the financial health of real estate companies and investment trusts. Our analysis revealed that most real estate companies and Real Estate Investment Trusts (REITs) have maintained conservative LTV ratios, providing a buffer against market volatility and potential property value declines.

### **Historical perspective: REITs and interest rates**

Examining historical data reveals a strong relationship between the US 10-year Treasury yield and the performance of REITs. During periods when yields rise, the global stock market (as represented by world indices) tends to outperform Global REITs and vice versa. The significant increase in interest rates since 2022 has been the primary catalyst affecting REIT valuations. Now that the aggressive interest rate hiking cycle is behind us and bond yields are contained, REIT performance has stabilised. Bond yields falling from hereon could be a catalyst for REIT outperformance.

### **The cyclical nature of REITs and their economic sensitivity**

While REITs share certain characteristics with fixed-income securities, particularly their sensitivity to interest rate fluctuations, REITs are also sensitive to economic growth. This cyclicity becomes especially pronounced during periods of economic turbulence and recovery, adding an important dimension to their performance relative to other asset classes. The relationship between REITs and Gross Domestic Product (GDP) is strong. During periods of economic contraction, when GDP growth slows or turns negative, REITs often experience downward pressure on their valuations. In an environment where interest rates are falling or reaching their peak, combined with signs of growing economic activity, REITs are often positioned to outperform equities.

### **Looking ahead: potential opportunities**

Despite the challenges, the current market environment may present an opportunity for REIT outperformance relative to other sectors, with yields falling and growth remaining solid. Depressed valuations in certain sectors may offer attractive entry points for long-term investors. With robust rental growth in some sectors, REITs and other real estate investments can provide competitive income streams. However, capitalising on these opportunities requires more than a passive, broad market approach. The disparities between different sectors and regions underscore the critical importance of active investment management in the current environment.

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Investment Manager



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