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Investment Committee Series

Q1 Outlook - February 2024

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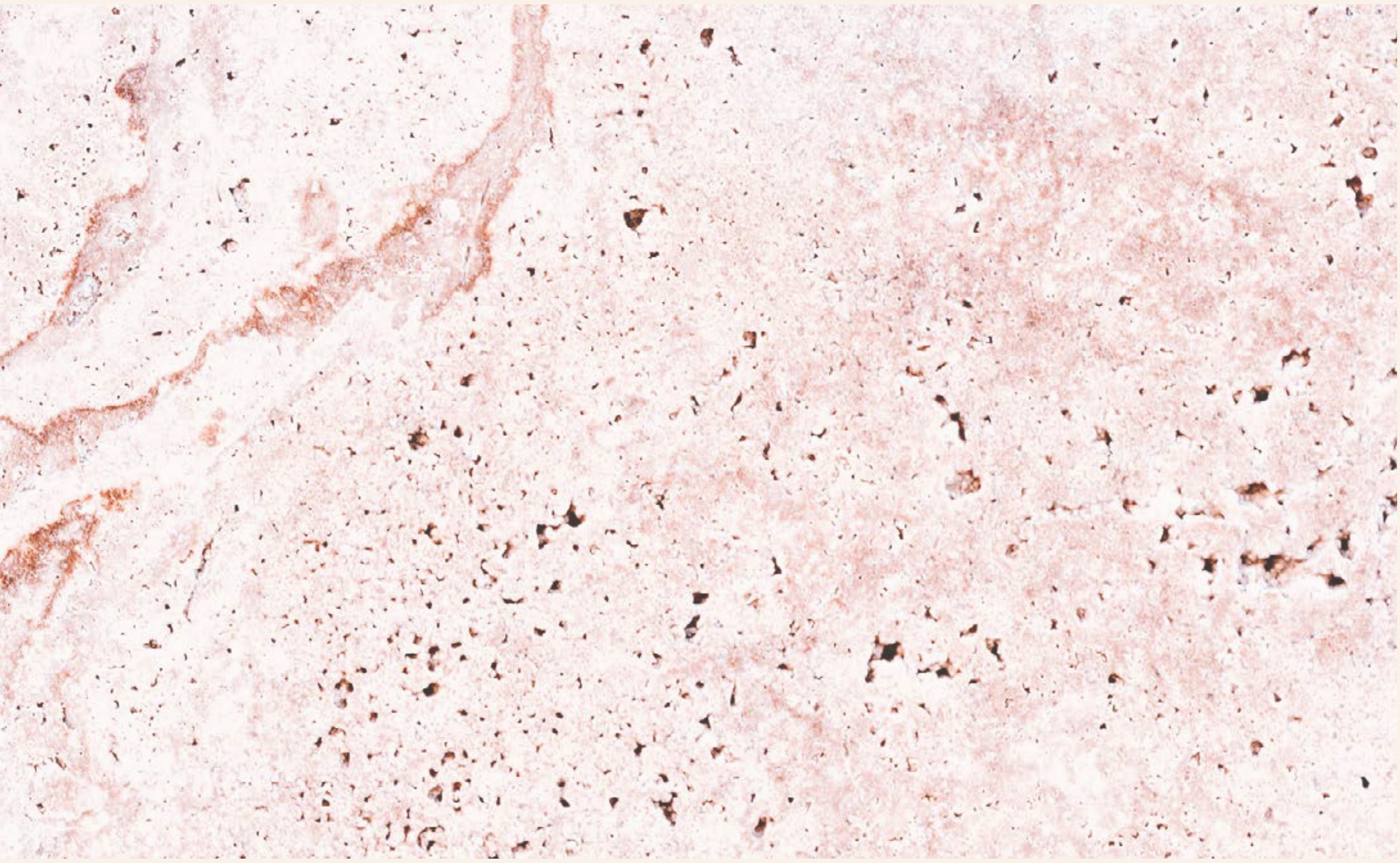


2 min read

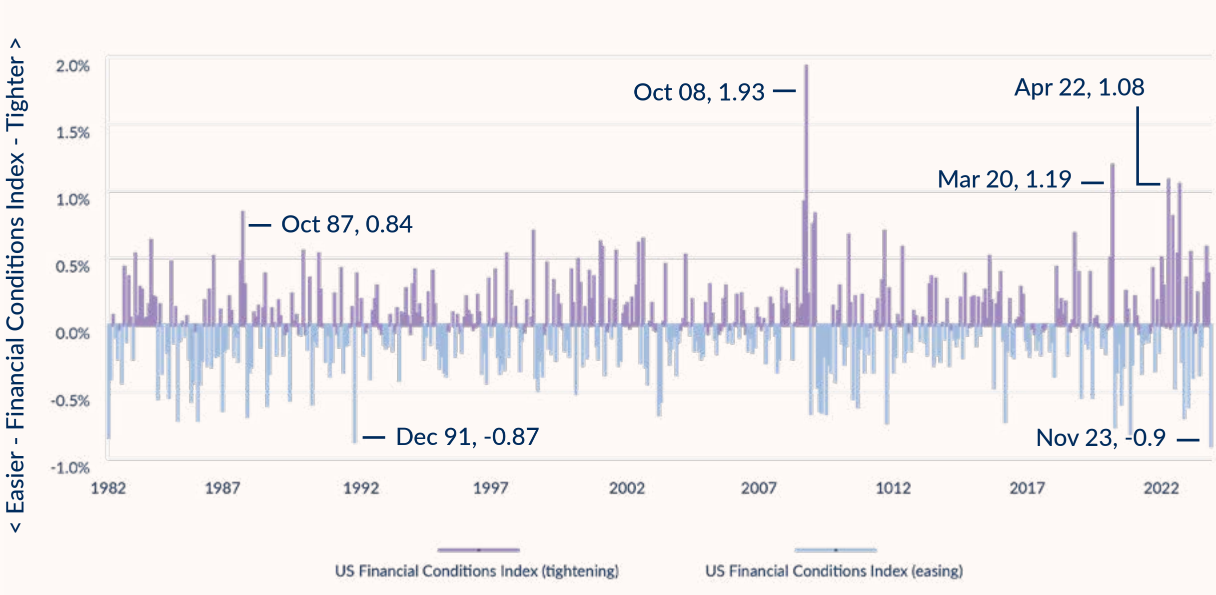
01

Introduction

Key takeaways from Q4 and full year 2023:

- A significant rally in Q4 drove robust portfolio performance.
- Despite high interest rates and a late-stage economic cycle, global conditions improved, led by the US, with stability in the UK and Europe.
- Short-term inflation trends aligned with central bank targets in the EU and US.
- Central banks shifted from a "higher for longer" stance in Q3 to considering rate cuts in 2024.
- The year concluded with strong market performance, notably the fastest easing of financial conditions in 40 years, marked by a substantial decline in bond yields and a subsequent risk-on rally driven by expectations of US Federal Reserve (Fed) rate cuts in 2024.

Fastest easing of financial conditions in history



Source: Goldman Sachs. As at 31 December 2023.

Eren Osman
Managing Director,
Wealth Management

In-depth analysis:

Inflation continued to ease throughout the year, with the three-month annualised inflation rate now below central bank targets in Europe and the US. The UK, while currently above target, is anticipated to decrease in the coming months. This decline provided the groundwork for the Fed to contemplate interest rate cuts in the current year.

Towards the end of the year, there was a tangible shift in the narrative of central banks. After cautioning markets for months about the necessity of maintaining higher interest rates for an extended period, central banks are now signalling a willingness to cut rates in 2024. The anticipated Fed policy pivot triggered a bond rally, subsequently spreading to other risk assets. Since 2021, markets have witnessed an increased correlation between world equities and bond prices, with the expectation that changes in bond yields will continue to drive global risk assets until the inflation situation stabilises.

World bonds have driven equities

Source: Bloomberg. As at 31 January 2024.

The combined impact of financial easing, falling inflation, and expected interest rate cuts is anticipated to stimulate economies in 2024, potentially prolonging an already mature phase of the economic cycle.

Continuing a trend established earlier in the year, the US emerged as one of the best-performing regions at the end of the year, while Europe and the UK lagged behind. China underperformed relative to expectations. Japan's stock market experienced one of its fastest growth years in recent history, supporting our overweight to the region.

In 2023, the worldwide manufacturing industry seemed to hit its lowest point, but we expect it to improve in 2024. Meanwhile, the global services sector performed well, benefiting from lower inflation and consumers having more money to spend.

In conclusion, the investment landscape in the fourth quarter and throughout 2023 showcased noteworthy trends. Despite challenges, the market experienced a robust rally, and our portfolios benefited from this. Looking ahead, the combination of financial easing, falling inflation, and anticipated interest rate cuts is poised to stimulate economies in 2024. In the next section we offer insight into the Investment Committee's key decisions and opportunities we believe are emerging.

3 min read

02

Decisions we made

Over the past quarter we have made five changes to our portfolios. We have:

- Increased our government bond position
- Reduced our corporate debt allocation
- Reduced our underweight to US and EU equities
- Increased our allocation to Brazlian bonds
- Increased our allocation to hedge funds

Peter Doherty
Director, Head of
Investment Research

Increased our government bond position

In light of our strategic asset allocation shift, we increased our allocation to government bonds, which was funded from a reduction in corporate debt.

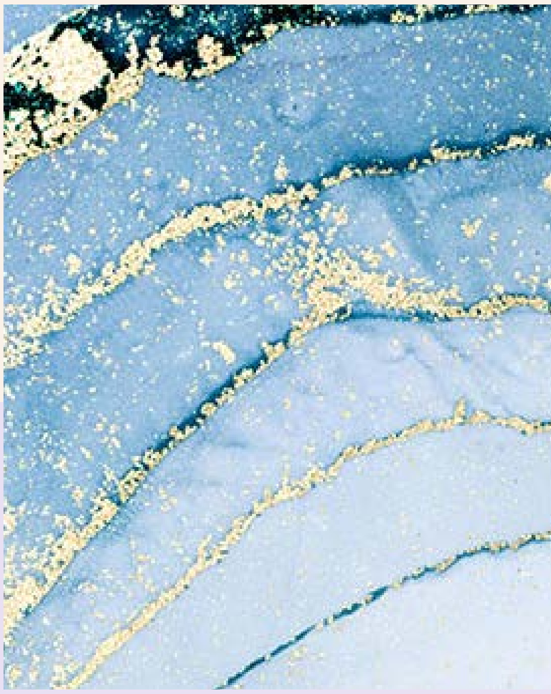
Historically, the aftermath of the last Fed rate hike has consistently seen government bonds rally, a trend that is manifesting once again. As the Fed engages in a rate-cutting cycle, bond yields are anticipated to fall, given their close correlation with the Fed funds rate. Furthermore, during recessions, government bonds tend to rally significantly which provides a ballast to client portfolios.

In the late phase of the business cycle, economic vulnerabilities arise despite ongoing growth resilience. We increased protection in this phase of the cycle, driving our overweight allocation to government bonds.

Reduced our corporate debt allocation

Our re allocation of capital from corporate debt and switching into government bonds is driven by two pivotal factors. Firstly, the yield spread of corporate debt relative to government debt is historically low. This means we are receiving little additional compensation for investing in riskier corporate debt. Our analysis suggests that when yield spreads are this low, the excess return of corporate debt relative to government debt is flat. This diminishes the risk-return profile, prompting our decision to shift capital from corporate debt in favour of government bonds.

Secondly, we have reduced corporate debt to fund attractive opportunities in hedge funds and engage in a trade that anticipates a steepening of the yield curve.



Reduced our underweight to US and EU equities

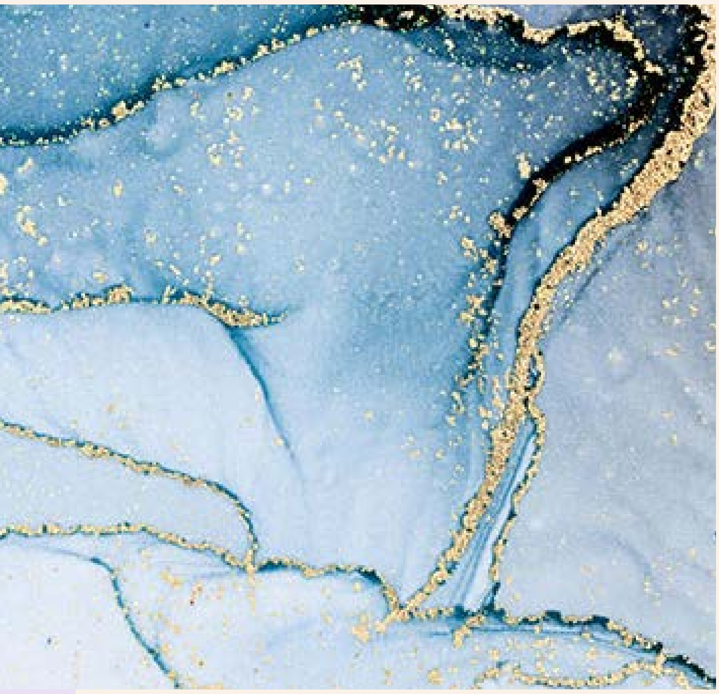
We adjusted our equity positions, reducing our underweight stance on US and EU equities. The decision to close the underweight position on European equities stems from signs of improvement in the European manufacturing cycle and growing consumer confidence in Europe.

Historical correlations between German business sentiment and European stock performance reinforce our more positive outlook.

The tailwinds for European consumers are strengthening with good pay rises and recent inflation levels below the 2% target. A healthier European consumer outlook should support the broader economy.

We also reduced the US underweight due to the resilience of US growth, particularly on the tailwinds of themes around artificial intelligence which has boosted seven large tech-name stocks, otherwise referred to as the Magnificent Seven. Given this, we prefer not to be too aggressively underweight and capture this performance.

To fund these adjustments, we reallocated from the UK and Asian emerging markets.



Increased our allocation to Brazlian bonds

Brazilian bonds in our portfolios did well last year. Given their still high yields of circa 10%, stable currency and central bank's shift to an interest rate cutting cycle, we decided to increase our allocation to Brazilian bonds. Brazil's central bank rate hikes in 2021 and 2022 successfully curtailed inflation. A shift towards an interest rate cutting cycle should see yields fall further in Brazilian bonds. While monitoring the currency risk closely, the inclusion of Brazilian bonds adds a differentiated element to the portfolio.

Increased our allocation to hedge funds

We increased the portfolio's hedge fund position, drawing from short-duration corporate bonds. The decision aligns with the Investment Committee's focus on enhancing diversification beyond government securities, corporate bonds, and equities while identifying attractive opportunities we believe could deliver higher returns than what we can experience with cash.

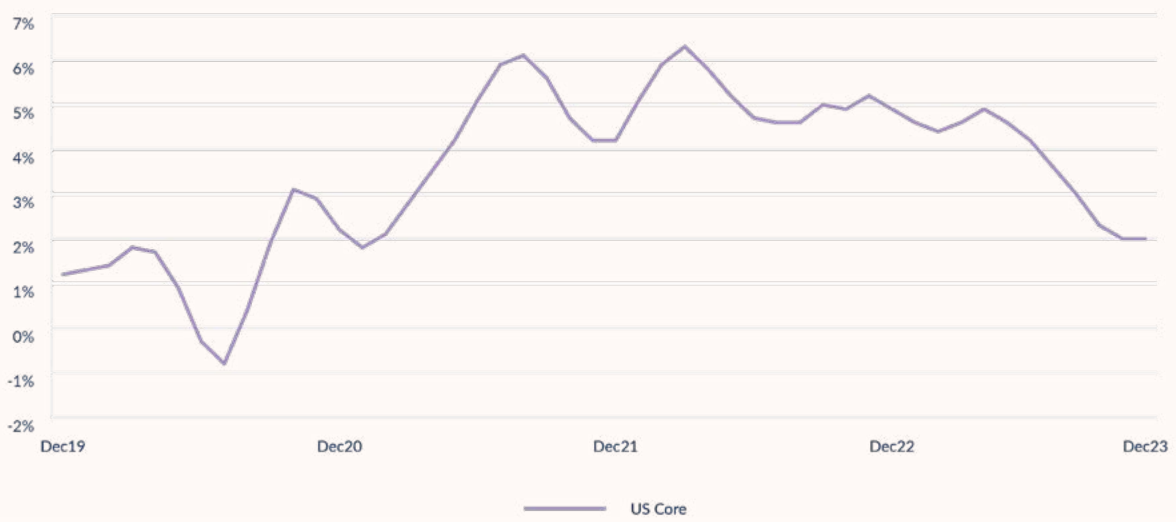
1 min read

03

What does the future hold for investors?

Global growth remains resilient, driven by the US, while economic data is improving, and inflation falls further in the US, EU, and UK. In the US in particular, declining inflation has prompted positive statements from the Fed, paving the way for the long hoped-for central bank interest rate cuts in 2024.

US Core PCE 3m/3m Annualised



Source: Bloomberg. As at 31 December 2023.

Expectations for positive economic data and supportive inflation trends into the upcoming quarter create a favourable environment for risk assets. Central banks' shift from maintaining higher interest rates to signalling a potential rate-cutting cycle has been a driving force behind the robust performance of risk assets.

Late cycles are prone to potential disruptions. China's uncertain property cycle further adds to the risks for the global economy. Geopolitical risks include numerous global elections this year and conflict in Europe and the Middle East.

To address potential risks, we have increased portfolio protection through allocating more to government bonds while retaining a neutral weight to equities to capture positive returns due to the short-term picture we see.

1 min read

04

Around the World

US

Former US President Donald Trump narrowly leads current President Joe Biden in the race for the White House. Both candidates are receiving poor favourability ratings from the voting public.

Interest rates

Central banks, led by the Fed, raised hopes of interest rate cuts this year and fuelled a strong bond market rally into the end of 2023.

Economic resilience

Growing consumer confidence, real wage growth, a tight labour market, and the stabilisation of global manufacturing point to an easing of financial conditions which are expected to support broader economic resilience.

Disinflation

In recent months, markets have witnessed a noticeable disinflationary trend impacting central bank sentiment on interest rate cuts. While central banks exercised caution and maintained current rates in their January meetings, the ongoing decline in inflation is encouraging.

Middle East

Tensions persist in the Middle East as the conflict between Israel and Hamas continues. Yemen rebels targeting the Suez Canal in the Red Sea have led to companies rerouting freight via South Africa, resulting in higher costs for consumers.

Taiwan

The Taiwanese elections ended with the victory of Taiwan's ruling Democratic Progressive Party (DPP). This was not well received by China, as the DPP rejects Beijing's "One China" policy.

4 min read

05

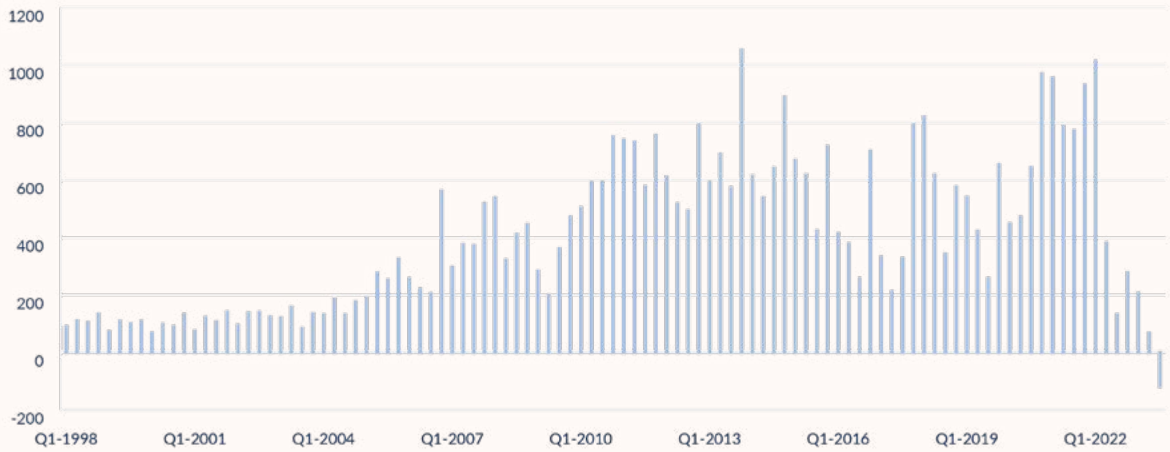
Top of mind: China Plus One

Navigating geopolitical shifts: opportunities and challenges in a 'China plus one' world

In recent years, geopolitical relations between the United States and China have undeniably been frosty, if not outright antagonistic.

Freddie Gabbertas
Investment Manager

Direct Foreign Investment into China



Source: safe.gov.cn/en. As at 31 December 2023.

Geopolitical landscape: A frosty relationship

Despite the efforts made during the recent meeting between Presidents Biden and Xi to improve relations, mutual distrust lingers, and the competitive tensions between the two nations remain. This predicament poses a significant dilemma for companies and investors worldwide.

The question arises: should one reinforce existing investments in China, hoping for a diplomatic resolution and a return to the fully globalised supply chains of the past, or is it wiser to diversify investments beyond China to shield against potential geopolitical fallout?

The rise of 'China Plus One' strategy

A growing number of companies are leaning towards the latter option. The traditional strategy of committing funds to manufacturing in China is being reconsidered, with a new approach known as the 'China Plus One' strategy gaining traction among major global players. This strategy involves diversifying supply chains outside of China to mitigate risks. According to Chinese data, foreign direct investment into the country has experienced a sharp decline, reaching a net negative for the first time in Q3 2023.

Emerging opportunities in a 'Multipolar World'

While the concept of decoupling may seem straightforward, the reality is more complex. Modern supply chains are deeply entrenched and intricately woven through the global trading network, a result of the cost-driven globalisation era. China still possesses substantial advantages in logistics, infrastructure, and low outbound shipping costs. Consequently, the shift away from China is not an instantaneous process. For instance, replicating a textile mill in Bangladesh is relatively straightforward, whereas reproducing a factory manufacturing advanced electronic components is a more challenging endeavour.

Nevertheless, this shift away from China presents lucrative opportunities for investors who can anticipate and leverage the dynamics of this emerging 'multipolar world.' Several countries are poised to benefit from this trend, with India, Vietnam, and Mexico emerging as key players.

India's ascendancy: A key beneficiary

India has seen a substantial uptick in its role as a global supplier. Wal-Mart, for instance, increased its US imports from India from 2% in 2018 to one quarter between January and August 2023, while simultaneously reducing Chinese imports from 80% to 60% in the same period[1].

Apple is also seeking to diversify its manufacturing operations by expanding iPhone production in India, aiming to assemble a quarter of its total production there and scale up to 50 million devices annually in the coming years[2].

Vietnam: A crucial player in Southeast Asia

In Southeast Asia, Vietnam has become a crucial supplier for several industries. Foreign Direct Investment (FDI) into Vietnam reached a record $23.2bn in 2023, while future FDI pledged rose over 32% year on year to $36.6bn[3].

Samsung, a major player in the tech industry, now considers Vietnam its "key production site," producing around half of its smartphones there[4]. Similarly, LG has invested significantly in Vietnam to produce appliances and cameras[5].

Mexico's nearshoring advantage

Mexico, in proximity to the United States, has positioned itself as a key beneficiary of 'nearshoring.' The preference for sourcing goods closer to home by the US, coupled with geopolitical trade barriers, has led to increased investment in Mexico. Industrial vacancy rates near the US border were remarkably low in 2022 as investment poured in to manufacture products such as communications and computer equipment[6].

Autos are also leading the charge, with announced investments including $870m from BMW, $764m from VW, $700m from Nissan and $200m from Stellantis in addition to a $5b Tesla investment[7].

Investing in Emerging Markets: Navigating uncertainties

In conclusion, as the tides of geopolitical relations continue to shape the global economic landscape, investors stand at a crossroads. The 'China Plus One' strategy underscores a pivotal shift in approach, with diversification becoming a strategic imperative. While decoupling from China is a nuanced challenge, the emerging opportunities in India, Vietnam, and Mexico showcase the resilience of global markets. There is an emphasised need for strategic foresight in navigating the unpredictable currents of today's investment landscape. As we embrace this 'multipolar world', the key lies in adapting to change, seizing emerging prospects, and navigating uncertainties with informed precision.

With Arbuthnot Latham's experts, skilled in identifying trends and complexities, investors can feel assured that the investment team is able to navigate these uncertainties and position client portfolios for success in the dynamic global marketplace. The journey continues, and the opportunities are as vast as the evolving global economic canvas.

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Helping you go further

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