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A quarterly investment update

April to June 2023

What moved markets over the quarter?

In the second quarter of 2023, investors continued to focus on inflation and interest rates.

United States

The most significant development here was the sharp fall in US inflation, helped by lower oil prices. 'Core inflation' (which excludes food and energy) has proved more persistent, but with slowing growth in house prices and rental costs, investors are optimistic that this may soon subside.

United Kingdom

In the UK, however, both core inflation and wage growth rose sharply in May. This prompted the Bank of England to raise interest rates by half a percentage point to 5% in June – a bigger increase than the previous rise, in May. Many households are currently on fixed-rate mortgages, but 2.4 million of these will expire in the next 18 months, exposing homeowners to higher interest rates.

Europe

The European Central Bank raised interest rates to 4% as core inflation remained at around 5%. Data released during the quarter showed that the eurozone suffered a mild recession over the winter.

Equity markets

In the stock markets, investors were heartened by the downturn in US inflation and excited about developments in artificial intelligence. 'Growth' stocks – shares in companies that are expected to increase their earnings rapidly – performed well, especially large technology stocks. 'Value' stocks, which appear underpriced relative to their assets, lagged behind but still produced positive returns.

But although most global equity markets rose, the UK market declined slightly. Meanwhile, UK bonds generally underperformed the wider bond markets. In both cases, this was due to higher-than-expected inflation and, therefore, expectations that the Bank of England would continue to raise interest rates.

Bond markets

In the corporate bond markets, riskier high-yield bonds generally outperformed safer investment-grade bonds. This is because fears of a looming recession have abated somewhat, increasing investors' risk appetites.

How did this affect portfolios?

A key driver of performance this quarter was global diversification as strategies with a bias towards UK assets generally struggled more.

Currency hedging

Strategies that hedged currency avoided the worst effects of a strengthening pound, which rose along with UK interest rates. For UK-based investors, performance from overseas markets was reduced as returns in foreign currencies were worth less when translated back into a rising sterling. But hedging overseas equity exposure back to pounds meant that currency moves had less impact.

Global diversification

In equities, having a similar balance of 'growth' and 'value' stocks (see above) to the market was preferable to being underweight in growth stocks. Equity holders that were underweight in the UK also benefited significantly. Similarly, bondholders that were more globally diversified outperformed those with an overweight to the UK.

Property and Infrastructure

Although listed infrastructure and property assets underperformed the wider equity market, listed-infrastructure strategies that had a lower exposure to the US outperformed. Real estate assets underperformed as higher inflation and expectations of higher interest rates meant that there was more potential for tenants to default on their payments, as well as a greater risk of falling property prices.

Summary

As equities delivered the biggest returns in the second quarter, higher-risk strategies, which have more exposure to equity markets, tended to perform best over both the second quarter and the first half of the year. However, more defensive strategies have generally seen positive returns over the quarter as well.

How do we view portfolio composition moving forward?

Asset classes are the broad investment categories that comprise portfolios. Below is a high-level outlook for each asset class. This is just an overview, and we may adapt our views as markets move.

Equities

Stock markets continue to be volatile given the uncertainties in the outlook for inflation, interest rates and growth. In the US, company valuations continue to reflect expectations of strong earnings growth over the next five years, though we think that sustained strong earnings growth is unlikely in the current economic environment. Overall, we take a neutral view, but a deteriorating economic outlook has led us to take a slightly negative view in the short term as we think that earnings estimates may prove too optimistic in the year ahead.

Government bonds

Central banks continue to indicate that they will keep interest rates high in the face of above-target inflation and relatively full employment. We believe that medium-dated government bonds (excluding the UK) look fairly priced, although prices could fall in the near term. Inflation in the US could prove more persistent than many expect, so we prefer inflation-linked US government bonds as their value and income payments rise in line with inflation protecting the bondholder from the effects of inflation. In the UK, inflation has been volatile, and lower bond prices look reasonable given the higher economic and market risks.

Corporate bonds

Investment-grade bond markets currently indicate an above-average level of defaults (failure by bond issuers to make interest payments). We expect slightly more defaults than this, particularly in the nearer term. In our view, bonds issued by the most financially secure companies are likely to provide slightly better returns than government bonds with the same maturities. In the short term, we remain cautious about riskier high-yield bonds. We think we could see more defaults than most investors currently expect.

Property and Infrastructure

Real estate investment trusts (REITs) and listed infrastructure had a volatile 2022. Listed infrastructure's innate defensive characteristics ultimately proved valuable, with strong performance relative to other equities. On the other hand, REITs struggled as the higher cost of borrowing and expectations for asset-value declines were reflected in prices. We are keeping a careful eye on US commercial real estate, as any problems there could herald dangers for the wider economy.

Currencies

Currency movements are important for our portfolios because they can affect the returns on overseas investments. In general, higher interest rates lead to stronger currencies, although other economic factors are also important. Currently, the currency markets suggest that central banks are likely to be less aggressive in raising interest rates in Japan and, to a lesser degree, the eurozone than in the US.

What did you think of this content?

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