MARKET UPDATE

Q2

Global equities pushed on in the second quarter, rising by 5.7% in euro terms to bring the year-to-date return to +11.8%, an impressive result given three bank failures in the US (the second and third largest bank failures ever), the failure of Credit Suisse, a protracted debate over the US debt ceiling, a disappointing reopening in China, and continued hawkishness from western central banks. While the debt ceiling issue turned out to be little more than political theatre in Washington, the ending of student loan relief and various other measures agreed to will, at the margin, create something of a headwind for consumers.

Economic data has been mixed. In the euro area, the weakness in "soft" data such as Purchasing Managers Indices has been backed up by the "hard" data, euro are GDP having seen two consecutive quarters of contraction. Inflation has started to fall, but only slightly, and ECB officials are growing concerned that higher wage settlements of late are indicative of embedded or "sticky" inflation, leading to concerns that the ECB will simply be forced to continue to tighten policy despite a weakening economy. US data, on the other hand, appears to show an economy that is continuing to fire on all cylinders. Consumer spending and policy-supported non-residential investment spending are continuing to expand, and the housing market appears to be bouncing back from a remarkably shallow downturn given the rapid hikes in interest rates and the tightening of credit conditions. Inflation is drifting lower, but at a pace that is simply not fast enough for central bank officials, Fed chair Powell pointing out that there "has been little progress on inflation in the last six months", core inflation averaging more than 0.4% each month, an annualised pace of more than 5%.

As mentioned above though, notwithstanding weak growth in Europe, stubbornly high inflation, hawkish central banks, various bank failures, and tightening credit conditions, markets look quite strong year-to-date, at least on the surface. Underneath, however, market breadth is extraordinarily narrow – more than half of the year-to-date return for global equities has been delivered by just 6 stocks, which represented (at the end of 2022) less than 10% of the global market. Excitement about AI has been a key driver of this, stocks like Nvidia almost trebled this year, Meta more than doubled, and other large AI beneficiaries rose by approximately 50%. In fact, when looking at sector returns year to date, only technology (+34%), communication services (+22%, driven by Alphabet and Meta), consumer discretionary (+20%, driven by Amazon and Tesla) and industrials (+10%) have meaningfully positive returns.

Outlook

The point being this rally is built on extraordinarily narrow breadth, a few sectors and fewer stocks driving market returns. Meanwhile, the hawkish drumbeat from central banks continues. The Bank of England surprised with a 50-basis point hike, as did Norway's central bank. Federal Reserve and ECB officials have been abundantly clear that not only are rates going higher than the market is priced for, but they also expect them to stay higher for longer – a message the market so far refuses to accept.

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Outlook

To the hawkish narrative from central banks, we would add concerns about liquidity (ongoing quantitative tightening, Treasury cash balance rebuild, TLRO repayments, large debt issuance by the US government) and credit availability (US regional bank deposit drain, increasing bank capital requirements, lending conditions tightening) meeting the buyback blackout and summer order books. Sentiment is stretched, US equity futures positioning has flipped from extremely short last September to a small long position now, so market participants are no longer short. All of the above warrants a cautious stance.

Positioning and Performance

Although we began the year with a very positive outlook for asset markets, the risks that we outlined at the beginning of the year increased dramatically towards the end of Q1, and we reduced risk accordingly towards a more neutral stance. We reduced exposure further over the course of April towards the lower end of the asset allocation range and have maintained that positioning since – given the headwinds outlined above, and after a 25-40% rally depending on the index, the threshold for adding risk has got to be very high.

The cash raised in the defensive side of the funds is invested in European Treasury bills at yields above 3%. Given the potential volatility in markets ahead and the low price of index option protection, we have a higher-than-normal level of protection in place.

WARNING: Past performance is not a reliable guide to future performance.

WARNING: The value of your investment may go down as well as up.

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