Alpha Beta PARTNERS

INVESTMENT UPDATE

JULY 2023

FOR PROFESSIONAL INVESTORS ONLY

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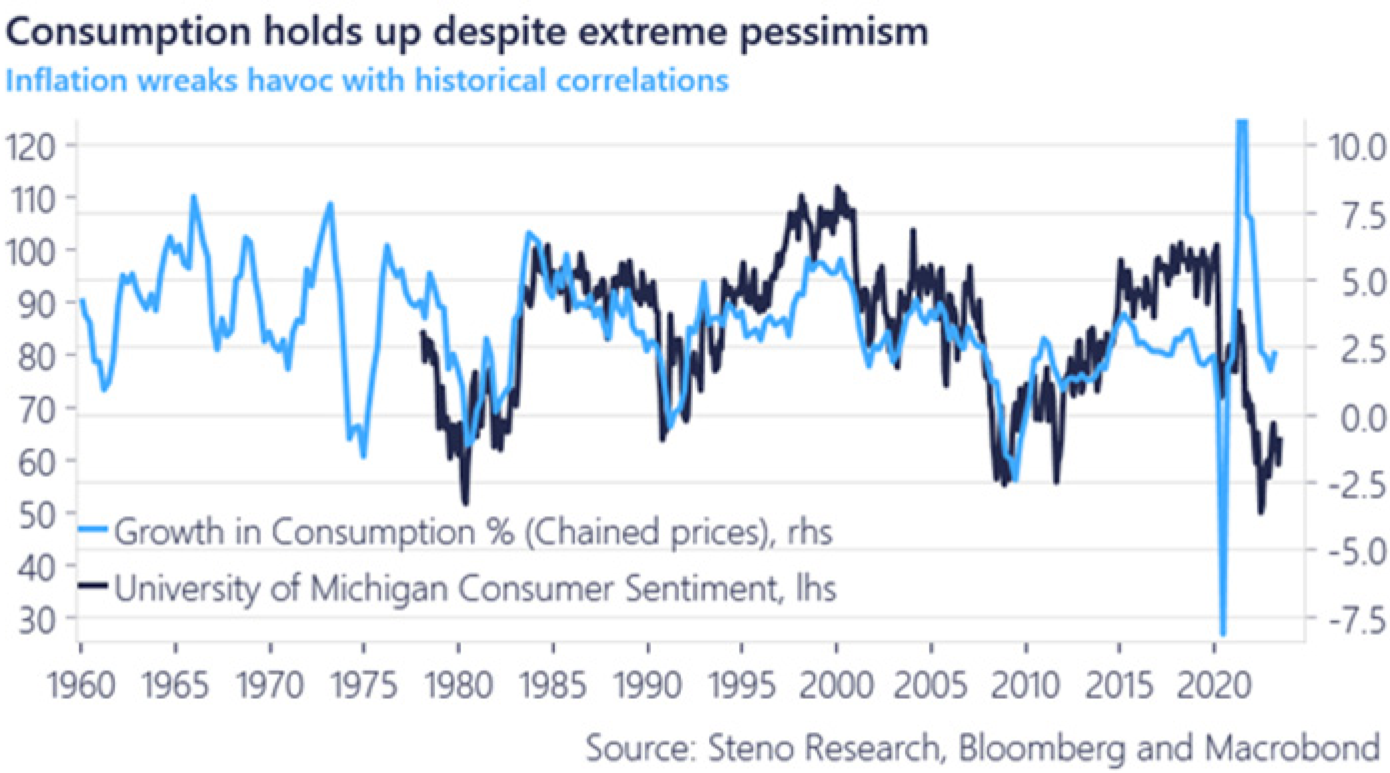
An allegorical text offers the reader a report with 2 possible meanings. In some ways, we identify an overlap with signals emitted by markets over the past month. Equity markets have pushed ahead buoyed by enthusiasm created by artificial intelligence developments, yet the far bigger fixed income market has continued to point decisively towards slowdown and recession. In the update that follows we aim to unpack the information and make sense of it for clients.

The technology rich NASDAQ index is up 30% so far this year. At first glance the excitement and positive impact to corporate earnings driven by artificial intelligence (AI) is the next step-change in economic growth and productivity. The top 7 technology behemoth stocks alone in the NASDAQ make up more than 50% of the market capitalisation weighted index whilst Microsoft and Apple' individually are more valuable than the entire Dax index representing German equities. As grey-haired investment professionals, we recall the dot.com phenomenon of the late 1990s. Of course, the internet has changed our world, many would argue for the better, but those changes were not delivered instantly and, in many cases, took years to permeate our way of life. We suspect this is analogous to the positive and exciting developments in AI today. An AI phenomenon and unexpected liquidity provided to avoid a deeper banking crisis, aided too by the seemingly ever-robust consumer spending have delivered oxygen for equities so far, as we reach the halfway point for the year.



The number of stocks pushing confidently higher is small and confined to a narrow category. Most shares across the largest markets in the world have performed adequately given the tight monetary backdrop but gains by no means raise one's pulse. Equity market volatility remains surprisingly low.

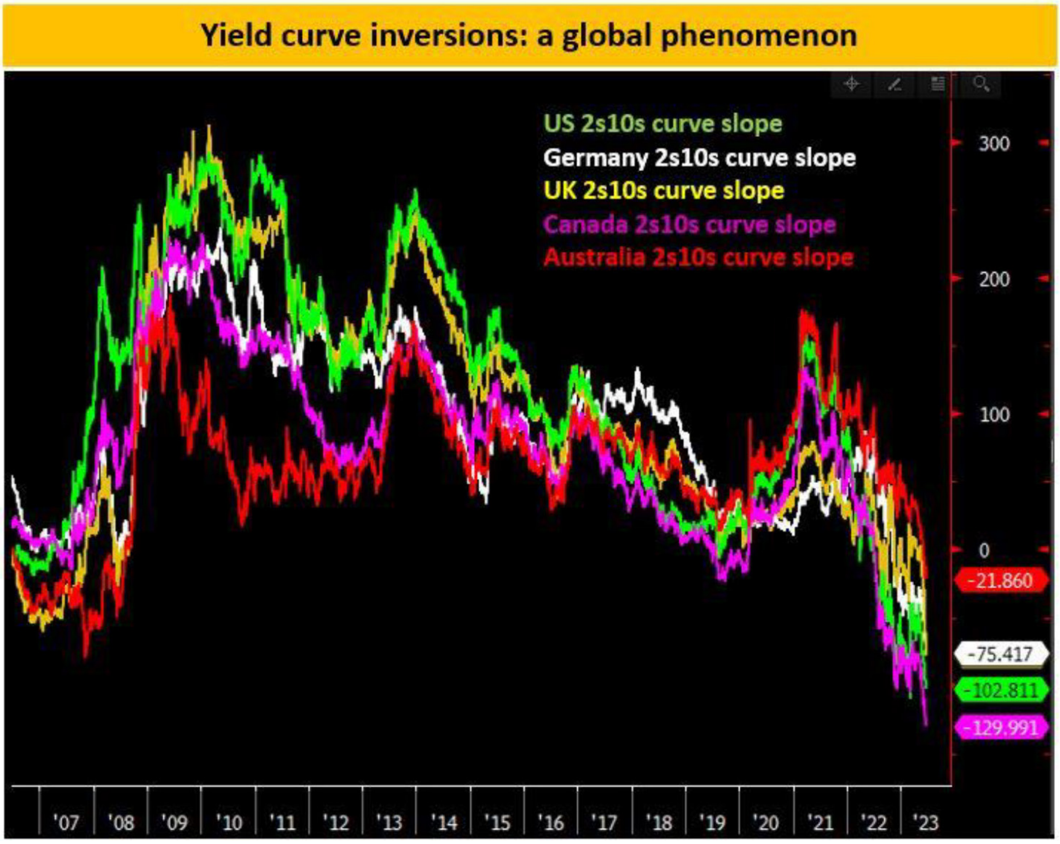
Inflation in the United States continues to fall with the Federal Reserve's preferred measure showing the lowest inflation rate since April 2021. PCE inflation dropped to 3.8% year-on-year in May from 4.3% in April. Quarter 1 GDP was revised higher, fitting a pattern for advanced economies - slowing growth, but not catastrophically slowing. A key reason for this is middle income consumers' resilience. Inflation for this group is less than what headline consumer price data suggests, meaning their spending power is not as weak as it appears. This coupled by an uptick in the housing market and an ongoing tight labour market could well lead to a further interest rate hike in July. The dollar index has nudged back higher to 103 indicating the likelihood of further rate hikes. That said, members of the Federal Reserve Open Markets Committee (FOMC) which sets interest rate policy are now split over the direction of travel for monetary policy.

Equity valuations are high in US, coupled with modest earnings growth expectations are where dangers lie for market progress. To highlight the point, we point to the divergence between the NASDAQ index of technology type companies and long-dated US treasuries known as TLT. The equity market has moved mechanically higher with no imminent sign of a recession. The 1-year treasury yield stands higher than the earnings yield on the S&P 500. Apart from Japan, in which the data still appears to have some residual momentum, all economies we track display a degree of weakness. Were it not for the pandemic-era accumulated savings, the OECD would doubtless be in recession.

We further believe that should central banks continue their present path of aggressive tightening and stringent quantitative tightening; a recession will unfold - our views remain consistent for now, but of course will be updated as the facts unfold. The fixed income market and a long list of credible supporting data insist upon the economic slowdown unfolding. Steep yield curve inversions are present across the world whilst US treasury yields have backed-up, with 2-year issues offering just under 5%.

Longer dated yields remain under surveillance as they move back up towards 4%. When these yields begin compressing it could help us pinpoint the arrival of the slowdown. For now, the allegorical text we referred to above continues to play out.

The chart shows inverted yield curves across the world's developed markets.



Source: *TheMacroCompass.com*

In Europe the economic slowdown has arguably kicked off, with German manufacturing turning down decisively. Core inflation appears stubborn to fall here whilst in southern Europe, notably Spain, inflation has fallen steeply - quite the opposite to what might hitherto have been expected. Germany's largest trading partner China continues to struggle to find its forward momentum.

The People's Bank of China have cut rates to stimulate growth and the currency is likely to be subtly devalued to affect greater attraction for exports. Japan continues to see investment being repatriated from overseas and productivity enhancements and share price gains from quality companies - we remain positively disposed.

UK equities struggled against inflationary and interest rate upward momentum during the month. Rates are set to be higher for longer on the domestic front. UK gilt yields backed-up, with the 10-year now close to 4.5%, in recognition of the economic prospects, not far away now from levels seen under the short-term tenure of Mrs Truss. Some UK insurance firms, and pension funds are showing interest at these levels. UK wage demands remain problematic.

The UK valuation is consistently cheap, bordering on attractive and some stocks offer interesting defensive qualities in the guise of dividends. The Thames Water debacle will only serve to tarnish sentiment in the near term.

In Russia, the mercenary, Wagner Group's march on Moscow, and subsequent retreat from the march on Moscow occupied news headlines. Financial markets have bordered on indifference. The Ukrainian summer offensive is making small progress and we note the positioning of Chinese comments which we would like to interpret as a willingness to broker a settlement for the benefit of global security and prosperity – and no doubt to forward the interests of China in its policy of repatriating Taiwan. We are monitoring unrest in France for signs of escalation to other parts of the continent.

At portfolio level, our active positioning in Japan has benefitted portfolios handsomely and we remain bullish, whilst European exposures have delivered positive gains too. The US weighting has benefitted from the technology stock mean reversion and our dollar hedging strategy has proven positive to valuations. We remain patient with our China and Emerging Markets allocation. Short dated fixed income exposures have delivered stability whilst our fulsome allocation to money market funds brings low risk and a sensible return.

The moment has not yet arrived when we can allocate to long dated fixed income and despite economic indicators pointing overwhelmingly to a slowdown a so-called soft landing should not be totally discounted if consumers keep spending, driving corporate earnings and economies muddle through despite the headwinds. For the half year, portfolios are in decent shape with performance broadly ahead of Investment Association comparators, delivered with well anchored risk aligned to mandates.

As ever, we thank our clients for their generous support. We are keen to hear from you and look forward to fielding questions.

Written by the Alpha Beta Partners Investment Team.

All sources Bloomberg unless otherwise stated.

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defaqto EXPERT RATED DFM MPS on Platform 2023

defaqto EXPERT RATED DFM MPS (Platform) Family 2023

The Five Diamond rating awarded on Alpha Beta's Core portfolio range.

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