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Upstarts and Downpours.

Last quarter we spoke about the surprisingly resilient start to the year in markets and concluded that much remained a mystery as 2023 unfolded. Now, as we have passed the mid-point of the year, one thing is apparent. If 2022 was the flameout - 2023 is the comeback kid.

In 2022, bonds and equities buckled in widespread selling, but in 2023 stock markets – the US in particular - have bounced back with a strong tilt towards tech. Private markets, real estate, energy importers, small businesses – most have averted their much-touted demise, and it does seem at this stage that all commentators must question whether traditional relationships hold. We are in a new regime, that is for sure – but why should the new regime not have new rules, new relationships, and new nuance?

The post-Covid recovery has certainly been uneven – take, for example, the sharp divergence between the recovery of economies in Europe and North America, while China has struggled to right itself after its prolonged Covid shutdown. Did China essentially shut down for too long and in too extreme a fashion so as to render itself irrelevant?

Elsewhere (notably not in China) interest rates have continued to rise. The odd part is that this did not crimp economic activity as expected nor did it put a dent in robust employment numbers. Yet with these rising rates we did, ultimately, see inflation moderate. Is this the Goldilocks economy 2.0 – not too hot, not too cold, but just right? In this it feels awfully close to the great moderation of Goldilocks 1.0. Instead of "lower for longer" interest rates though we seem to be coming around to "higher than longer".

Higher for longer comes with a steep learning curve though. Most market participants have been weaned on lower interest rates meaning cheap borrowing and yield chasing-behaviour. Being able to earn a higher interest rate on cash changes a lot. It changes the level at which money can essentially be invested on a risk-free basis, and therefore raises the bar for other asset returns.

Higher rates also change corporate behaviour, while banking woes have changed banking behaviour. Higher energy and food prices are changing consumer behaviour and a surging interest in artificial intelligence is undermining what we thought we knew about working behaviour.

Amid all of this change has been the rain – the downpours which saw some parts of the country experience its wettest July ever. Even the seasons aren't conforming to plan this year. It certainly hasn't felt like summer. So what has this very non-conformist period held:

Key Developments since the last quarterly update:

- **Inflation at the end of the beginning –** Following on the theme of last quarter, inflation numbers in the US have come in remarkably, while the UK is the recalcitrant child of developed markets with its number staying stubbornly high at over 7%, although lower than at its peak.
- **Interest rate expectations shift as higher for longer takes hold** Surprising economic resilience kept central banks on a tightening path and rhetoric emerged around "higher for longer" – as long as two years in the case of the Bank of England. The authorities remain data dependent and resolute but as was recently seen with China – which lowered its short-term rate in response to a slackening economy – there is still the potential for surprise.
- **Downpours . . and Downgrades** As the rain fell, so did credit ratings as the US saw a spate of downgrades to the country itself (by Fitch) and a basket of regional banks (by S&P) in mid-summer. The country's downgrade came following a fraught period before the raising of the US budget ceiling when the possibility of default on sovereign debt was raised but not really deemed likely. The downgrade of a group of banks was part of a greater reaction to poor bank outlooks as they wrestle with the impact of higher rates. This failed to roil markets as banks had been sold off mostly in advance, but it did send some jitters through the system as there was a fear of more contagion and institutional fragility.
- **A bull in the China shop.** China exited some of the most stringent and prolonged Covid lockdowns anywhere somewhat suddenly but the restart to the economy has been fraught. Poor trade numbers released in July showed that both imports and exports had fallen in July and the property sector, in particular, seemed under strain. The slump in growth spurred the central bank to cut rates there – albeit by a modest amount. Overall the sluggishness that is persisting in China is a surprise to markets and evidences the impact of more reshoring and protectionist trade policies..

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Current Macro Snapshot

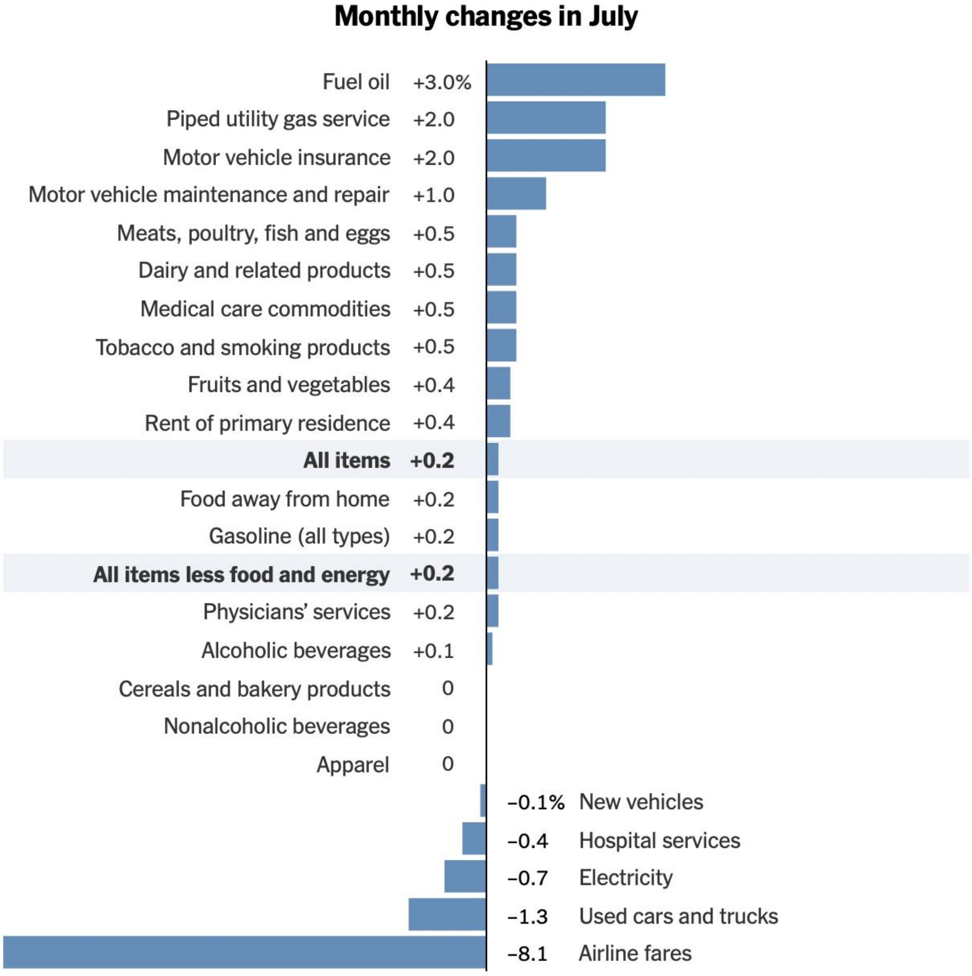
Stuck in the Mud

It is now close to one year since the "doom loop" of the Gilt crisis gripped the UK, when a wide-scale loss of confidence in the UK government led to a collapse of demand for UK gilts, which was then exacerbated by forced selling by the holders of those gilts as they sought to reduce leverage levels. Much has changed in messaging and outward perception since the Kwarteng/Truss Mini-Budget and the change in guard that followed. However, the "dye was cast" by this series of events, and in recent weeks Gilts have again sold off at times, nearing the same yields seen at the time of the crisis. There is no "one" crisis this time – rather a reckoning around the persistence of high rates as guided by the Bank of England. The current activity is more in sync with the movement in global bond yields too and so less of an outlier.

Despite this restoration of confidence though and a strengthening of Sterling, there is a still a sense that the UK economy is somewhat "stuck in the mud". Inflation has been stickier and slower to shift than in other economies like in the US and Europe and the wage spiral cited by the Bank of England in recent press releases could well choke off growth. Inflation in the UK was most recently published as 7.9%, the lowest inflation rate since February 2022, and notably down from the period between September 2022 and March 2023, when the country experienced seven months of double-digit inflation which peaked at 11.1% in October 2022.

The UK also struggles to capture a piece of the tech momentum in equity markets due to the overwhelming "old economy" tilt in the FTSE. Foreign investment is subdued since both Brexit and the Gilt market crisis and institutional investors like pension funds remain impaired and in retreat following the bruising that it caused.

If we look at inflation on a global scale it is coming down markedly. The last (July) print in the US was comprised of movement in the following sub-sectors:



June-to-July changes in a selection of categories of the Consumer Price Index, adjusted for seasonality. • Source: Bureau of Labor Statistics • By Karl Russell

Even after a slight increase in energy prices overall, inflation remains closer to 3% year on year, which has more than halved since its peak.

Central banks seem a little "stuck" too. They are stuck in their own loop of commitment to a low (often 2%) inflation target and an interest rate tightening cycle that, according to the textbooks, should have resulted in a recession by now. But yet . . While the US Fed has already paused once, now, after 11 rate hikes at 12 meetings and a rate of 5.25-5.5% it seems ready to pause again. The ECB and the Bank of England have sent no such message, although the pace of rate hikes has slowed. The ECB last raised rates by 25 bps in July to a high of 3.75% (last seen in 2001), while the Bank of England recently added 25bp for its 14th consecutive rate hike. UK rates now sit at 5.25%, the highest level since 2008.

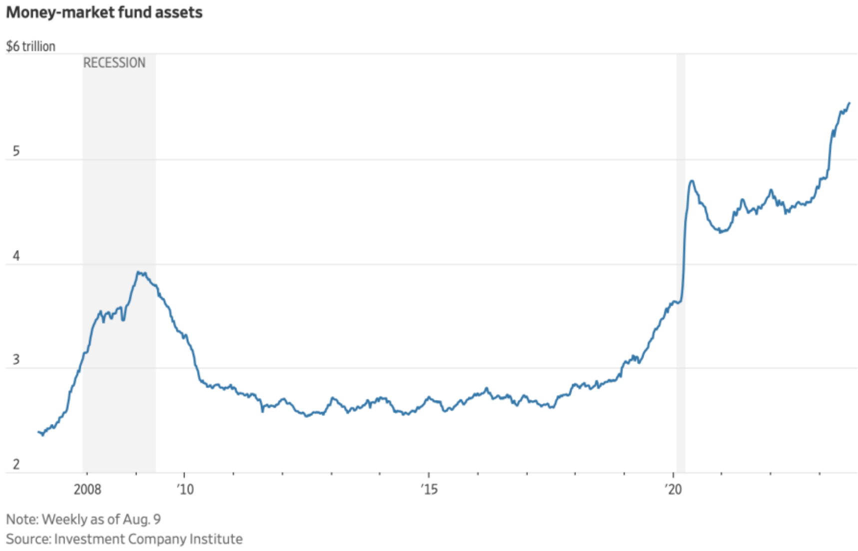
Another thing that is stuck is their credibility. It is only in the past few weeks that bond markets have started to "believe" that rates might stay higher for longer, despite little shift in central bank messaging around this plan. The yield curve in the US had been "inverted" for months – with shorter term rates higher than longer term rates, a traditional harbinger of a recession and reflecting a belief that rates would be coming down in the medium term as the economy weakened due to the expected "recession". Only when this recession seemed like it wouldn't, in fact, bite, did bonds start to sell off, which is where we are today.

Meanwhile, over in equity markets, all eyes remain on AI. This fascinating "word bubble" by HSBC and reproduced in Bloomberg shows the prevalence of this term in second quarter earnings discussions.

Where the money is – and where it is going:

Other potential reasons for the "it's different this time" thesis is that there are, arguably, different power centres at play this time than in previous cycles. Last quarter we spoke about the crisis in US regional banks and how the crisis in Silicon Valley Bank had sparked a very "new-fashioned" bank run. The modern bank-run is digitally powered and is therefore far faster and savage than prior ones which might have relied on real live tellers and paper withdrawal slips.

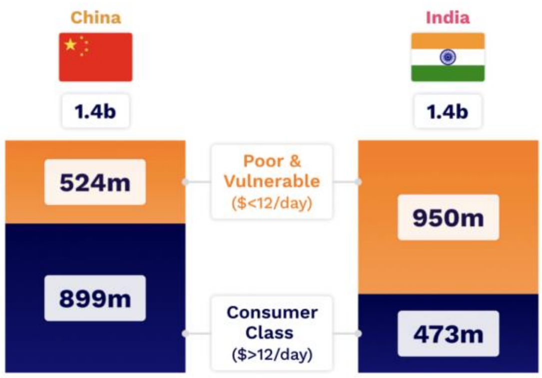
As the chart below shows, much of the assets that might otherwise be in bank deposits have ended up in Money Market Funds, were assets now top $5 trillion. This represents significant "dry powder" on the sidelines, poised to enter equity markets to pick up bargains or to enter other risk assets when they come into fashion.



We spoke in the past about the role that banks are playing in credit extension now, and how it is not what it once was. The rise of the supplier of private credit has eroded the market share and exclusive position of banks in the capital market landscape, and that is diluting the impact of some of the banking strain on companies needing credit.

Another power centre of recent decades has been China, and we have already discussed how impaired that country has looked in recent years. In many of our conversations with Emerging Markets managers India is rising in popularity for stock picking and, as the chart shows below, is already equal to China in terms of population. With a smaller consumer class as a percentage of the population and more room for social mobility there is more upside potential it seems. It will be interesting to watch how these shifts in momentum will power flows in the decade to come.

Figure 1. India and China: Same population, different consumer class (2023)



Source: World Data Pro, 2023

Sterling firms but then flatlines

Sterling continued to benefit from the stronger than expected performance of the UK economy over the quarter, although the sluggishness of economy growth paired with the stickiness of inflation led to some give back towards the end of the summer. The dollar stabilized after some earlier weakness and despite the recent country level downgrade there hasn't been much in the way of discussion of "de-dollarization" of late – perhaps due to the weaker positioning of China on the world stage. In fact, there has even been rhetoric suggesting that "dollarization" such as what occurred in Ecuador and other Latin American regions, could be the answer to some of the woes of a country such as Argentina. Due to the heavy weight in dollars in the SYPA portfolio, any dollar weakening will erode the returns from dollar-denominated assets.

Individual Asset Class Performance.

- Equities
- Fixed income
- Other asset classes

The chart below shows recent performance in main equity indices (at August 23, 2023)

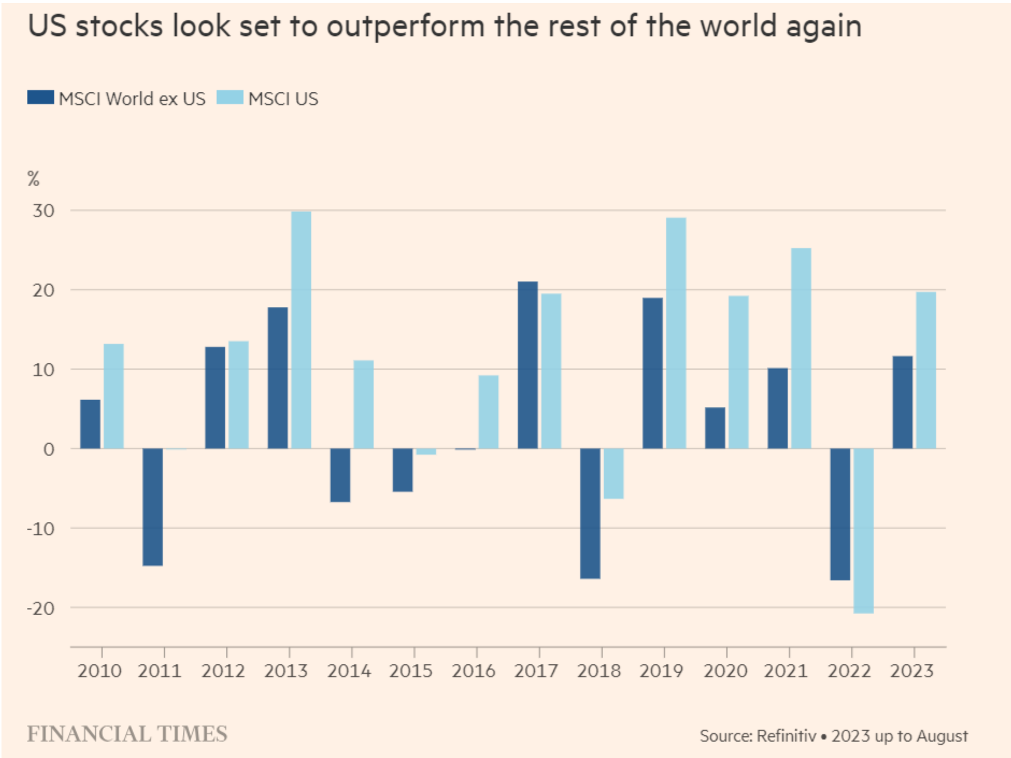
Equity Index	**Year to date (August 23, 2023)**	**1 year**
FTSE 100	-1.76%	-2.02%
S&P 500	15.54%	5.64%
Nasdaq	31.09%	8.56%

Dax (Europe)	12.96%	18.97%
Hang Seng	-7.922%	-8.79%
Shanghai Comp	0.28%	-4.57%

Equities: The Same Song – On Repeat

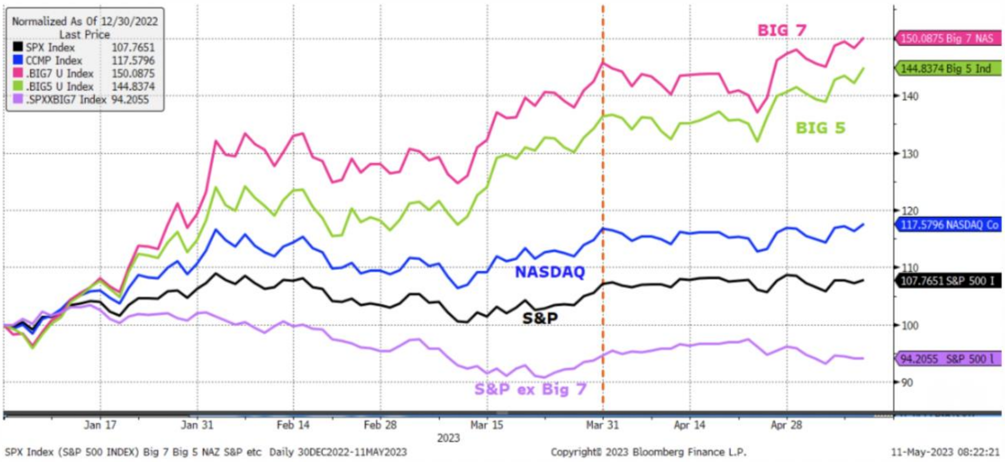
The themes of equity market strength year to date have been surprise – at the comeback – concentration – around the “big seven” stocks that have dominated headlines and buying action, and the AI hype cycle that is driving a frenzy of interest in any stocks exposed to artificial intelligence as well as its component parts such as chipmaker Nvidia. As the chart below shows, the dominance of the US is continuing and the US is outperforming the rest of the world again. Most notable have been the collapse in year to date returns in the UK as well as Asia. While much of the Asian movement will have been driven by China, the UK loss of ground is more confounding.

As the chart below shows the US is again outperforming the rest of the world and this is driving flows in to domestic equity market funds there.



For a global investor such as the pension fund, this will bode well given that a significant amount of assets are invested in US equity markets. We used the chart below last quarter to illustrate the divergence in performance across different stocks and the prevalence of the “big seven”.

Big 7, Big 5, NASDAQ, S&P, and S&P ex Big 7 year-to-date.



Most equity-watchers have an eye on earnings, and as we write, earnings reporting is almost over: •with nearly 90% of companies across the US & Europe having reported earnings. Generally, although earnings were weak, off around 1% year-on-year in the US and 8% down in Europe, most companies were able to outperform weak consensus estimates (highlighting the importance of properly guiding those estimates!). Tech stocks are continuing to outperform other sectors and, interestingly retail is taking a particular bashing in recent days. Apparently, not only are sales down, but they are being impaired by increased "shrinkage" or shop-lifting activity (on which more below).

Fixed Income: Relentless

After 14 consecutive rate hikes the Bank of England has been somewhat relentless in its quest to beat inflation, and it is fair to say that the task in the UK has been more complex and urgent than in other countries. Now the bank seems resolute that the time period for which such high rates will have to remain is around 2 years at least. Gilt markets have responded by selling off – as discussed earlier but the upside is that cash rates are now attractive, even on a post-inflation basis, now that inflation has come down. We will continue to explore ways within the portfolio to take advantage of higher yielding short term government debt as cash substitutes.

There is a lot of confusion around the US 10-year yield "breaking out" above 4% - is it because the economy is strong and higher rates are here to stay? Or is it because of the soft landing so the Fed won't have to cut? Bonds remain a source of ballast and a refuge in a flight to safety in markets, but the volatility being experienced in the asset class recently is actually making them seem less stable. All in all the recent bond action doesn't seem to point to recession – as the inverted yield curve heads towards a "disinversion" - but could the higher rates themselves be a tipping point for lenders? Time will tell.

Other asset classes/Spotlight:

During the quarter the consultation on local government pooling received quite a bit of attention and in particular the suggestion that private assets should have a target allocation of 10%, with some of them earmarked for UK investment projects. This somewhat crude amount and definition is causing some consternation within investor circles, and it seems particularly ironic now when the outlook for private equity is far from clear.

As we discussed last quarter, private equity is not forced to mark assets to market on a daily basis and valuations have been slow to adjust to comparable public market valuations. Recent press coverage suggests that there are some pockets of distress within the sector but that it is largely playing out behind the scenes and kept quiet, particularly as the lenders of credit facilities are not banks but other private equity firms. There have still not been many valuation adjustments so returns will still appear robust but the opacity and illiquid nature of this asset class is one of the reasons for concern about the pooling consultation suggestion.

Outlook. . .Predictions – for what they are worth?

Over the summer the same narratives that persisted earlier in the year have continued. Inflation anxiety peaked and then receded quite rapidly, without much celebration. Predictions seemed to be abundant, and therefore lost their value.

In coming months we will be watching in particular:

- **It ain't all good.** While the consumer, on average, seems to be doing well, it seems that there is growing strain in certain parts of the consumer base. As noted earlier, there is a higher incidence of "shrinkage" or theft at retailers, mortgage rates in the US have crossed 7% which is close to a 20 year high, while in the UK they are also multiples of prior cut rates and childcare costs in particular are spiralling with no end in sight. This squeeze of the blue-collar worker will cause both societal stress and high-profile policy failures such as a rise in homelessness. This will increase political pressure and fractures and could well become divisive political fodder in the US presidential election of 2024.
- **A quiet retirement of ESG activity in places.** Since some of the pushback against the term "ESG" and the attendant policies there is evidence of a pull back of support from climate resolutions and other activism[1]. Blackrock, in this case, claimed that some environmental resolutions were overly prescriptive and not sufficiently flexible, and this is clearly part of an

[1] https://www.bloomberg.com/news/articles/2023-08-23/blackrock-backs-fewer-climate-social-shareholder-proposals

evolving approach to the debate. We don't expect it to be the final salvo however, as the massive shareholder led momentum behind change and a drive towards sustainability has not abated, but it does seem ripe for a course correction.

- **More exploration of the "higher for longer" reality.** We are still watching the experiment of significantly higher rates and watching expectations for their duration shifting. It is natural therefore that collateral damage to companies and banks, as examples, will only play out over time. The long-term effect of these higher rates is key to observe.

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August 23, 2023