INVESTMENT UPDATE

SEPTEMBER 2023

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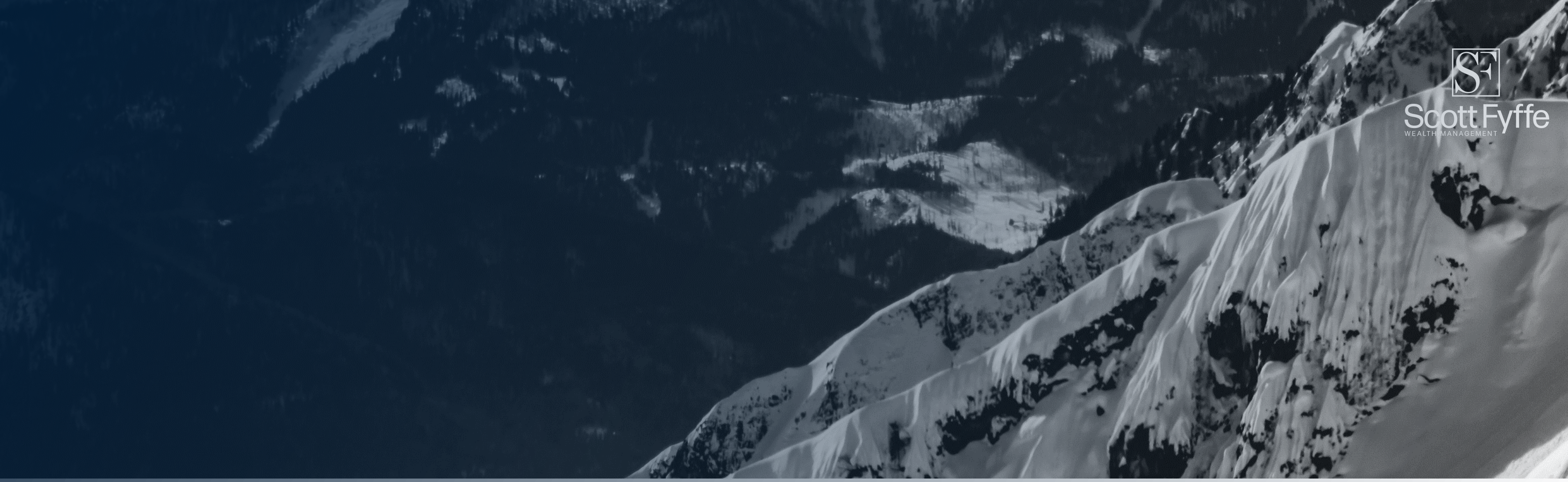

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SEPTEMBER 23

INDEX	LEVEL 31ST JULY	LEVEL 31ST AUGUST	CHANGE
S&P 500	4588	4507	-1.76%
FTSE 100	7699	7439	-3.38%
EURO STOXX 600	471	458	-2.76%
NIKKEI 225	33172	32619	-1.66%
SHANGHAI	3291	3119	-5.22%
US 10 YR TREASURY YIELD	3.95%	4.09%	+0.14
UK 10 YR GILT YIELD	4.29%	4.36%	+0.07
BUND 10 YR	2.46%	2.47%	+0.01

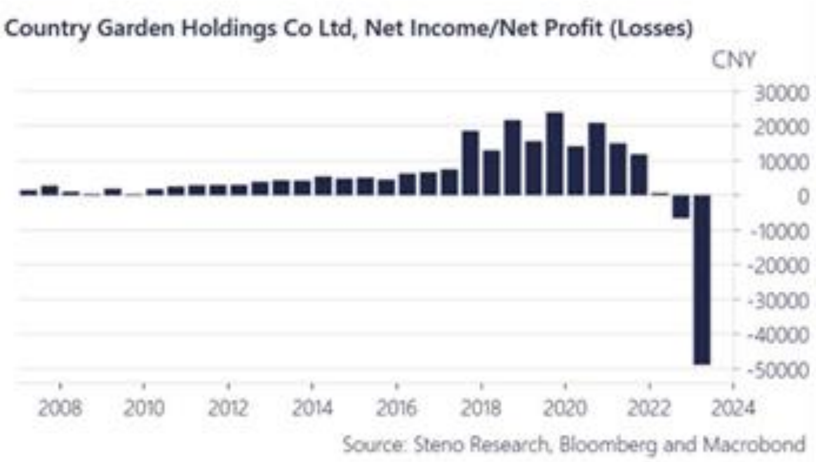
Overview

August was largely a difficult month for markets, although it should be appreciated that the holiday season means that trading activity can have a more significant impact on market movements than normal. Of particular note was China, which led Asian stocks lower, as concerns continued about the weakness of the economy. Energy stocks continued to perform well globally, Saudi Arabia's continued production cuts reflected in the increase in the price of crude oil, having risen by over $15 a barrel since its June lows. Bond yields continued to creep up, perhaps reflecting the potential impact on inflation.

A focus on China's difficulties

China's post Covid reopening has stalled, with economic growth higher but a long way shy of what was forecast and anticipated by many. The debt bubble present in the Chinese property sector is gargantuan and will cause issues for the economy overall. The Politburo and People's Bank of China will need to affect a bail out, probably delivered quietly over time. For now, the overcapacity created by a centrally run economy planning for an escalation of the industrial base with its supporting architecture is truly eye popping. Bridges to nowhere and ghost cities are the reality as many western economies, led by the US, repatriate their manufacturing or forge supplier relationships closer to home. Interest rates have been cut and the Yuan is being subtly devalued. An ageing and shrinking population point to longer term issues President Xi will need to contemplate. Our direct exposure to Chinese equities has previously been liquidated, but the impact has been felt across the region.

The chart shows financial difficulties manifesting in one of China's massive property businesses, Country Garden:



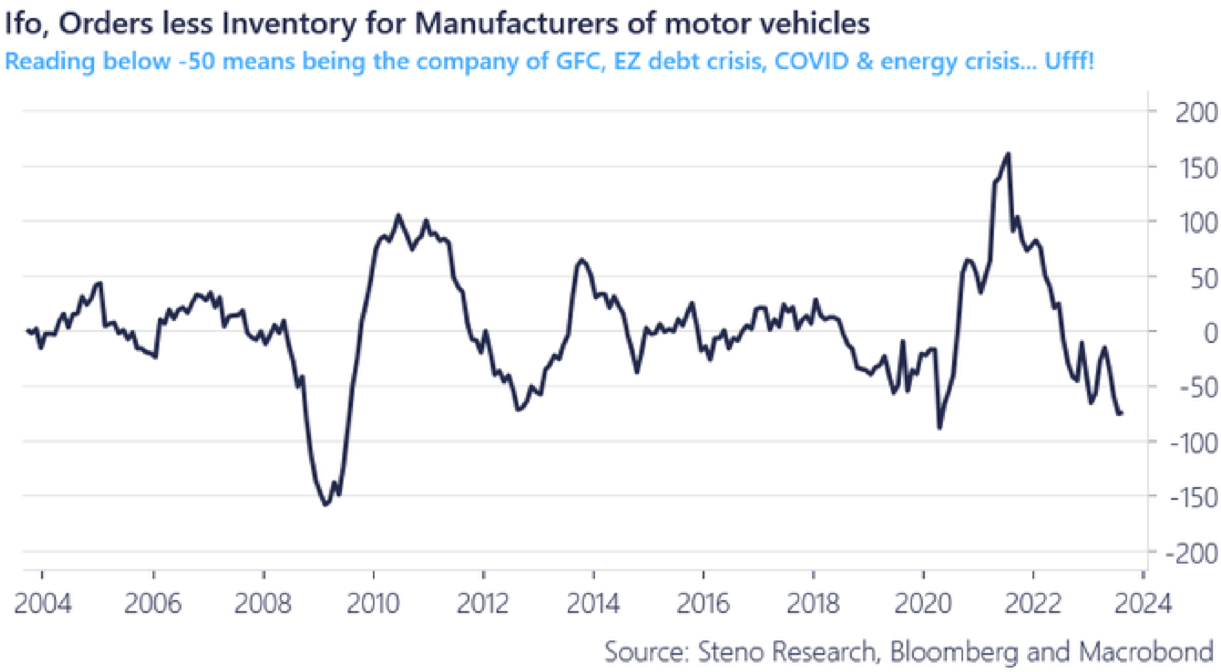
US

Much attention was drawn to US Federal Reserve Chair Jerome Powell's speech at the annual Jackson Hole summer retreat for central bankers. He used predictably tough language to signal that inflation was still too high for the Fed's liking and that they were prepared to raise interest rates further if necessary. However, markets seem to be pricing in that we are at or near to the peak in US rates. With labour markets seen to be cooling, which is a major consideration for the Fed, equity markets seem to be pricing in an economic soft landing rather than recession. This has been supported by still strong consumer demand and a generally favourable company earnings season. The highlight of the latter was Nvidia's reporting of revenues exceeding expectations and the company forecasting a surge in demand for their chips, further fuelling the hype around AI.

Fitch (one of the large credit rating agencies) downgraded the US government's credit rating one notch to AA+. Credit ratings provide investors guidance on the likelihood an institution or government fulfilling their financial commitments. Fitch cited the sustainability of increasing government debt levels and political agreement, following the concerns about the debt ceiling earlier this year. Overall, this move had little impact on markets and it is unlikely institutional investors will move away from US government bonds.

Europe

The major economies in Europe, led by Germany and France are now in recession or skirting perilously close to it. Germany's vital industrial and manufacturing base has been impacted first by soaring energy prices and now acutely by the slowdown in China, who had been embraced by successive European leaders as a dominant trading partner. We feel it is an exaggeration to suggest Germany's world leading automotive industries will become museum artefacts but the cut in China's demand will surely be a major blow. The chart demonstrates the decline in the German automotive industry by showing an excess of inventories over orders. A further distortion shows that the American company Tesla, in real terms a johnny come lately, lower volume manufacturer, is worth significantly more than the once mighty BMW, Mercedes and Volkswagen Audi Group combined.



Across Europe, inflationary headline figures are trending lower and it is possible that the European Central Bank (ECB) will be the first western central bank to loosen policy. Mrs Lagarde, Head of the ECB will need to balance the necessity to defeat inflation, stimulate a rapidly decelerating economy and balancing the books. Ahead of an impending gas industry workers strike in Australia, we note an uptrend has begun in natural gas prices during late August, which will impact European energy costs.

UK

The UK and European stock markets perform more akin to value-oriented indices which is surely a reflection of the lack of larger information technology firms being listed here than anything else. However, quality companies are resident in UK and Europe, with commodity-rich, banking and pharmaceuticals a particular focus at home. UK equities remain one of the leading markets for strong dividend payers – the backbone for many portfolios. At home we finally saw inflation headlines turning lower, although significant wage pressures persist. Interest rates are likely to remain higher for longer in the UK and we will do well to avoid a recession. The UK's inverted yield curve (short term gilt yields higher than longer term ones), often an indicator of recession, is not an isolated phenomenon by any means, but we note the 10-year Gilt spiked to 4.7% at one stage whilst the 2-year stock yields 5.3%.

Japan

China's pain has proven to be Japan's gain. Mr Kazuo Ueda, the new Governor at the Bank of Japan has subtly tweaked policy such that the economy is stimulated, and exports are once again flowing from quality companies to the West. A weaker Yen effectively greases the wheel. Japan's large pension schemes and institutional investors are systematically preferring to invest in domestic infrastructure and technology opportunities, rather than sending their monies abroad, as they have done for decades. The upswing is captured in portfolios with Japan remaining an active position.

Asia and Emerging Markets (EM)

Performance of Asia and EM has been challenging in August, mostly driven by weak economic data from China, where there was news of deflation for both Consumer Price Inflation (CPI) and Producer Price Inflation (PPI). Attempts by the central government to stimulate the economy, such as two reductions in the interest rate set by the People's Bank of China, have been met by a relatively muted response by markets. Despite being below expectations, GDP growth remains high - reading 6.3% as of June. There was also news of a potential expansion to BRICS*, where Argentina, Egypt, Ethiopia, Iran, Saudi Arabia and the United Arab Emirates were invited to join. The new members would increase the BRICS' share of global GDP from 32% to 37% on a purchasing power parity basis, and importantly, would strengthen their trade influence, particularly in South America and the Middle East.

*BRICS is an informal group currently comprised of Brazil, Russia, India, China, and South Africa, who aim to work together to resolve economic, financial, and regional issues.

Outlook

As investors continue to pour over every economic data release in search of clues to the future path of central bank policy actions, volatility is likely to remain heightened in global bond markets. However, with government bond valuations now reflecting some reasonable compensation for the elevated levels of uncertainty, the additional spread on offer from corporate bonds means that investors are being paid a decent all-in yield to cushion against any further short-term weakness. These, more historically normal, investment valuations mean that bonds are now able to better fulfil their traditional income generating role within a portfolio, as well as offer valuable diversification properties as recent high correlations between asset classes continue to decline. However, experience tells us that we should not try to front run the data in bond markets, so we maintain a generally shorter duration (lower sensitivity to interest rates) stance in the UK and will do so until we see evidence of peak interest rates here. Meanwhile, we receive a reasonable return from our positions.

Rockhold Asset Management, with contribution from Alpha Beta Partners and Marlborough, August 2023

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