ForresterHyde
CHARTERED FINANCIAL PLANNERS

Investment Outlook

Winter 2023

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""I make no attempt to forecast the market, my efforts are devoted to finding undervalued securities." - Warren Buffett

Introduction

November has seen positive market movements, despite prevailing geopolitical tensions in regions like Ukraine and the Middle East. Signs that inflation has weakened across the US and Europe have significantly bolstered investor sentiment. This newfound confidence stems from a growing conviction that Central Banks have likely completed their series of interest rate hikes. However, while there is an air of optimism surrounding the potential conclusion of the rate hike phase, we still feel there are a number of concerns within the financial landscape, such as impending economic slowdowns, that warrant staying cautious.

While the US economy has demonstrated remarkable resilience, projections for early 2024 suggest an impending deceleration in GDP growth, with the ominous possibility of a recession looming on the horizon. Nevertheless, the market seems to be finding a semblance of support in the anticipation of potential rate cuts to mitigate a slow down. Investors have priced in preliminary quarter-point rate reductions by both the US Federal Reserve and the European Central Bank, by June 2024, with expectations for two or three additional cuts throughout the remainder of that year.

For us, it remains paramount to highlight the consistent failure of the market to accurately predict Central Bank movements. Our perspective holds that policymakers in developed markets are unlikely to implement interest rate cuts before the latter half of 2024, unless economic growth significantly underperforms. Presently, the consensus among economists, as surveyed by Bloomberg, forecasts a modest worldwide GDP expansion of 2.1% for the upcoming year.

The significant achievements of major US technology firms, often referred to as 'FAANGs,' 'Tech Giants,' or recently termed the 'Magnificent 7' (Apple, Microsoft, Amazon, Alphabet, Meta, Nvidia, and Tesla), continue to wield influence in driving returns in 2023. This success can be partially attributed to the integration of generative AI, notably seen since the introduction of ChatGPT.

Despite the upward trajectory of these leading companies, there is a trend suggesting a moderation in their previously consistent double-digit growth rates. Historical precedents advise caution for long-term investors, particularly during periods of heightened market enthusiasm. While we maintain exposure, our portfolio weightings are more restrained.

Given factors such as the US market's concentration to the magnificant 7, ongoing geopolitical tensions, and the impending US Presidential election, alongside the potential for a UK election, our strategic approach emphasizes a diversified investment portfolio and a steadfast, vigilant stance. Amidst the array of economic indicators influencing our decisions, we maintain a cautious stance in equities, prioritising fixed-income instruments and alternatives.

UK Equity

The British economy faced a sluggish period in Q3 of 2023, marking its weakest performance in four quarters. Despite initial predictions of a 0.1% contraction, it performed marginally better. In October, the UK experienced a significant decrease in its inflation rate, dropping to 4.6%, below market expectations of 4.8%. This decline was mainly due to reduced energy costs following Ofgem's decision to cap household bills, resulting in a 3.5% decrease in housing and utility expenses.

In the latest budget, Chancellor Jeremy Hunt implemented changes to National Insurance Contributions (NIC). These changes included eliminating Class 2 NIC for the self-employed and a 1% reduction in Class 4 NIC rates effective from April 2024. Employees were also given a 2% reduction in Class 1 NIC rates starting January 2024.

The UK has faced considerable challenges, including leadership changes, a prolonged seven-month period of double-digit CPI inflation, and a series of eight base rate increases. Consequently, UK equities are currently reflecting significant pessimism, trading at a considerable discount compared to global markets. Despite these difficulties, this situation may potentially create opportunities within the UK market.

Amid the uncertainties post-pandemic, there is additional promise within small and mid-cap sectors, where specific companies demonstrate restructured earnings and favourable valuations which could see significant growth if investor sentiment turned positive. UK small caps have corrected notably relative to larger counterparts and currently trade at an appealing 8x forward price-to-earnings ratio, below the 1998-2023 average of 14x, indicating compelling value.

While navigating this economic landscape, our strategic outlook anticipates the potential onset of an extended surge in value-style investing, particularly within the UK market. This presents opportunities for higher returns, supported by the consistent outperformance of Henry Dixon from Man GLG who provides our UK value exposure (see below). Henry has the flexibility to invest across different market caps, exploring these attractive opportunities while avoiding heavily indebted entities. This diversified approach positions our portfolios to potentially benefit from the resurgence of undervalued sectors when investor sentiment improves towards the UK.

We are underweight to our benchmark.

Key Points

- The inflation rate in the United Kingdom dropped to 4.6% in October 2023.
- The Bank of England maintained its benchmark interest rate at a 15-year high of 5.25%.

Fig 1. Man GLG - Undervalued Assets Professional Fund Performance
Source - FE Analytics

US Equity

The US economy showcased impressive expansion, registering an annualised growth of 4.9% in Q3 of 2023. This surpassed market expectations of 4.3% and marked the highest growth since Q4 of 2021. Notably, consumer spending surged by 4%, a significant leap from the 0.8% recorded in Q2 of 2023.

Meanwhile, the Federal Reserve, in November, chose to uphold the target range for the federal funds rate at its 22-year high of 5.25%-5.5% for the second consecutive time. This decision underscores policymakers' efforts to balance curbing inflation towards the 2% target while exercising caution against excessive monetary tightening.

Despite the robust performance of the US economy, we foresee a notable slowdown in growth in the upcoming quarters. Factors such as the recent uptick in long-term Treasury yields, coupled with the impact of Fed tightening, are expected to contribute to this deceleration. Central banks are balancing the economy against premature easing, which could inadvertently reignite inflation. Market expectations point to rate cuts in early 2024, these actions might be delayed, warranting our cautious stance.

In political developments, recent high-level bilateral talks between Presidents Biden and Xi aimed at addressing US-China relations showed the delicate relationship dynamics. While efforts to address climate change were welcomed, underlying competition persists, particularly in areas like AI, trade, and access to advanced chip-making technology.

Despite discussions surrounding the US equity market, encompassing topics like the 2024 election, debt sustainability, and elevated equity valuations, the foundational elements for sustained US long-term performance look robust. However, for us, this entails more than simply holding onto the 'magnificent 7' which now make up more of the MSCI ACWI than France, China, UK and Japan combined (See below). Our focus remains on businesses demonstrating structural growth potential, possessing wide economic moats, robust cash flow generation, and most importantly, trading at attractive valuation levels.

We remain overweight to the benchmark.

Key Points

- The US economy expanded an annualised 4.9% in the third quarter of 2023.
- The annual inflation rate in the US slowed to 3.2% in October 2023 from 3.7% in September.

Fig 2. Weight in MSCI ACWI
Source - Schroders, 31 August 2023

European Equity

The European Central Bank (ECB) likely concluded its tightening cycle in October, maintaining the deposit rate at a historic high of 4.00%. This decision marked a significant shift from the unprecedented cycle that began with negative rates in July of the previous year.

The Euro Area's GDP reflected a 0.1% shrinkage in the three months leading to September 2023, aligning with initial estimations. Notably, this contraction marked the first decline since the pandemic's initial impact in 2020. Analysing the major economies, Germany witnessed a 0.1% GDP shrinkage, while Italy stalled, and France and Spain experienced modest growth of 0.1% and 0.3%, respectively.

The Central Bank emphasised its commitment to achieving a 2% inflation target, maintaining these heightened interest rates until that objective is realised. The Euro Area's inflation rate stood at 2.9% in October 2023. This inflation was primarily influenced by decreased energy prices (-11.2%) and a slowdown in food inflation.

Germany also encountered increased hurdles due to the disruption of Berlin's spending approach by the country's constitutional court. In its mid-November decision, the court determined that Scholz's government breached the law by shifting €60 billion of credit lines, initially intended for Covid-19 pandemic relief, to a climate and transformation fund known as the KTF. Consequently, a new budget will be necessary.

Market focus has centred on the prospect and potential intensity of a recession, as well as forecasts concerning the path of interest rates. These concerns carry consequences that span beyond European equities, affecting all markets. In response to the global nature of stock markets and the opportunity presented by comparatively reasonable valuations outside the US (as indicated below), we have spent the past 18 months shifting our approach.

We have moved away from regional funds toward a specialised core of top global fund managers. Teamed with discounted charges for Forrester-Hyde, this strategic alignment positions us to deliver strong returns that are anticipated to outperform the market over the long term.

Through our global managers we have adopted a neutral position.

Key Points

- The inflation rate in the Euro Area was confirmed at 2.9% year-on-year in October 2023.

Fig 3. MSCI US and MSCI ex US P/E based on forward 12 month earnings
Source: Waverton, November 2023

Japan Equity

In Q3 of 2023, the Japanese economy faced a steeper decline than anticipated, it registered a 0.5% contraction, contrasting with market expectations of a 0.1% fall. At the October meeting, the Bank of Japan (BoJ) opted to maintain its key short-term interest rate at -0.1% and 10-year bond yields around 0%, aligning with widely held predictions. However, potential negative outcomes might arise if Governor Ueda and the BoJ deviate from anticipated policy normalisation in the coming year.

Despite this setback, Japan's consumption and service demand are receiving support from the delayed reopening and the return of inbound tourists. The economy is gradually transitioning toward moderate inflation, evidenced by companies finding it more viable to increase prices and wages.

Immediate economic concerns revolve around the trajectory of inflation, the fragility of China's recovery, and the looming risk of a US recession, all of which pose potential challenges that could prompt adjustments in Japanese trade.

Our exposure to Japan is through the M&G Japan Fund, which emphasises stock selection based on perceived under-pricing rather than leaning toward a growth or value bias. Since the transition earlier this year, the fund has outperformed the sector by 1.95% (19/05/2023 to 29/11/2023).

We make no changes and remain underweight to our benchmark.

Key Points

- The annual inflation rate in Japan rose to 3.3% in October 2023 from 3.0% in the prior month.
- The Bank of Japan (BoJ) kept its key short-term interest rate unchanged at -0.1% and that of 10-year bond yields at around 0% in its October meeting.

Asia and Emerging Markets

China, the largest constituent in the emerging market landscape, differs from developed markets in terms of inflation issues, as China's consumer prices declined by 0.2% year-on-year in October 2023, contrasting with the previous month's flat reading.

Investors have experienced disappointment with the expected revival of the Chinese economy and stock market following the lifting of COVID restrictions. Despite a rebound in consumer spending, longer-term structural concerns have overshadowed these improvements.

The real estate sector, after reaching a peak in 2021 following a decade-long surge, continues to undergo a cooling phase. This downturn has left many developers grappling with financial distress, prompting increased risk aversion amongst individual investors. Furthermore, ongoing government involvement in the private sector and escalating international tensions further exacerbate investor concerns. This fuelled negative investor sentiment towards emerging market exposure.

However, two key points stand out. Firstly, with the market down by 50% from its 2021 highs and valuations nearing historical lows, amid this prevailing pessimism, it is crucial to retain some exposure as there are potential future positive outcomes. Secondly, the Chinese market, despite significant volatility, presents attractive opportunities for savvy stock pickers, boasting a wide array of liquid companies at very compelling valuations.

As we peer into the prospects of 2024, there is a growing expectation for a resurgence in enthusiasm for emerging markets. This anticipation is rooted in the possibility that US interest rates may have hit a cyclical apex, which could pave the way for an upswing in performance as rates could be reduced in 2024.

Examining specific economies, like India, which despite experiencing a minor deceleration, is forecasted to achieve a GDP growth rate of 6.5% in 2023. India's economic outlook continues to show promise, primarily propelled by robust domestic demand. This factor remains a cornerstone of strength and stability in India's economic landscape, contributing significantly to its growth trajectory.

Our primary exposure to emerging markets lies in the Vanguard Global Emerging Markets Fund. The fund exhibited robust performance throughout 2023 and is poised to outperform the sector average, making that six out of seven calendar years since its launch in 2016.

We are neutral to our benchmark.

Key Points

- Investors have experienced disappointment with the expected revival of the Chinese economy.
- Emerging Markets trade at largest discount to Developed Markets in two decades.

Alternatives

We incorporate alternative allocations that go beyond conventional assets. The LF Ruffer Diversified Return Fund, a substantial entity managing a portfolio worth £26 billion, embraces a global, multi-asset, absolute return approach, much like the JP Morgan Macro Opportunities Fund which we also use. These strategic approaches aim to generate positive returns even when equity markets face downturns.

Within diversified portfolios, we place emphasis on these alternative investments. Absolute Return strategies provide exposure to return streams that do not correlate with traditional markets, offering valuable diversification benefits. While this sector has encountered challenges recently, well-managed funds demonstrate appealing traits in mitigating volatility.

Currently, JP Morgan maintains a cautious stance, considering the cumulative effects of central banks' tightening of monetary policies on economic activity. This prudent approach is evident in their defensive portfolio positioning, featuring a negative net equity exposure. Similarly, Ruffer acknowledges persisting weaknesses in economic fundamentals, visible through reduced credit availability, vulnerabilities in the labour market, and indicators like manufacturing surveys signalling recessionary trends. Although their protection overlays impacted the portfolio's performance year-to-date, they currently present compelling opportunities and act as a hedge against potential downturns.

We are overweight to a zero benchmark.

Key Points

- Defensive alternatives are poised to provide downside protection.

Fixed Interest

We perceive long-term valuations in fixed income as attractive, reflecting restricting monetary policy nearing its peak. The market assessment of bond returns has notably improved. Recent forecasts indicate that UK bonds might yield a nominal annualised return ranging between 4.5% to 6% over the next decade. This projection marks a considerable shift from the earlier forecast of 0.5% to 2% before the onset of the rate-hiking cycle. This adjustment suggests that bonds are likely to align more closely with historical norms, and more potentially providing a buffer during market downturns.

Understanding the value of fixed income necessitates acknowledging their correlation with interest rates. As central banks globally initiated rate hikes in 2022 to counter inflation and excessive demand, the values of bonds (as well as equities) declined.

It is crucial to highlight that the decline in bond value does not materialise unless the issuer fails to meet coupon payments and the principal at maturity. This phenomenon, known as the 'pull to par effect,' implies that the total return tends to increase as a bond approaches maturity. For instance, bonds trading below par witnessed an increase in value as they neared maturity. Therefore, we believe as future bonds approach maturity there will be increased returns above simply their income yield.

One of our top-performing funds, the Man GLG Global Investment Grade Fund, has capitalised on stock selection opportunities, delivering a return of 15.69% in 2023. This performance significantly outpaces the sector average of 0.99%.

We remain highly selective, actively managed, and are maintaining exposure to fixed interest.

Key Points

- One of our top-performing funds, the Man GLG Global Investment Grade Fund, has capitalised on stock selection opportunities, delivering a return of 15.69% in 2023.

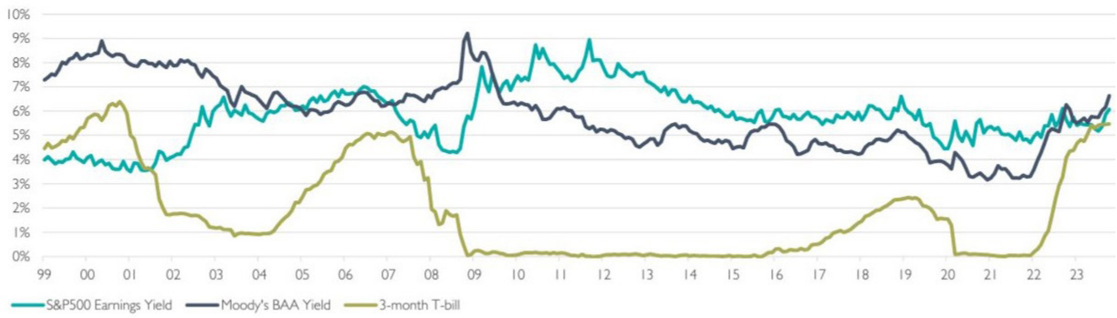
Conclusion

We are maintaining a cautious approach, especially within equity allocations. We recognise that although the cost premium on these risk assets has moderated, it does not seem notably generous given the prevailing uncertainties. Although corporate earnings plateaued earlier this year, recent releases, particularly in the United States, have surpassed market expectations. However, these positive earnings might offer limited cushioning moving forward.

Presently, we believe fixed income and cash present better risk-adjusted opportunities. To demonstrate the re-ratings, we turn to the illustration below. The Moody's Baa yield (blue line), indicative of fixed income, has surpassed the earnings yield of the S&P 500 Index (green line), representing equity, for ten of the last twelve months. It stands at 6.2%, in contrast to 5.9% at the end of September. This echoes scenarios witnessed during the Dotcom era in 2000 and the Global Financial Crisis of 2008.

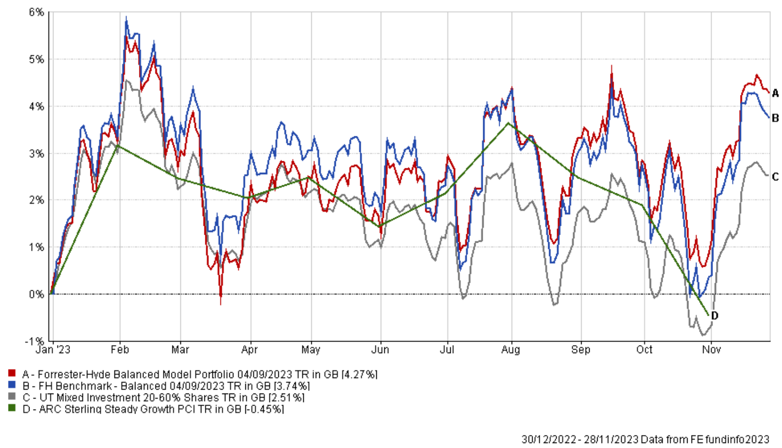
Finally, the 3-month Treasury bill rate (yellow line), indicative of cash, is currently at 5.5%, slightly trailing the S&P 500 earnings yield. This setting now presents the most competitive scenario for cash versus equities since 2001. Therefore, we believe equities should offer a higher yield considering the additional risk they entail. This view contributes to our underweight position in equities during the short term.

Fig 4 Yield on Offer
Source: Waverton, November 2023



Despite our cautious approach this year, we have successfully captured upside and aim to visually exhibit our performance in 2023. To illustrate this, we have included a comparison between our Balanced Portfolio and the following benchmarks: the ARC Index (which incorporates monthly portfolio performance data from discretionary managers), UT Mixed Investments 20-60% Shares, and our FH Benchmark (a high-level internal benchmark against which our portfolios are evaluated).

Fig 5 Forrester-Hyde Balanced Portfolio Returns v Numerous Index
Source: FE Analytics



As illustrated, it has been another challenging year, yet the FH Balanced Portfolio has outperformed both peer group averages and our own higher hurdle benchmark.

Although there is one month remaining in 2023, we aim to finish strongly and deliver a higher positive return. We maintain a close watch on market trends and stand ready to take action when necessary. However, for this quarter, we believe no adjustments in asset allocation or fund selections are justified.

Approved Fund Panel Update

Funds Introduced

No changes this quarter.

Performance (As at 30/11/2023)

Asset Class	1 Year %	3 Year %
Euro STOXX 50	14.11	28.25
FTSE 100	2.77	30.44
FTSE 250	-0.47	2.81
MSCI Asia Pacific ex Japan	-2.31	-10.20
MSCI Emerging Markets	0.07	-9.44
Nikkei 225	5.44	-7.26
S&P 500	9.94	35.85
Bloomberg Barclays Sterling Aggregate Corporate	2.60	-16.57
Bloomberg Global Aggregate Credit Index	-0.18	-9.87
FTSE Actuaries UK Conventional Gilts All Stocks	-5.76	-27.45
Bank of England Base Rate	4.49	5.83
Consumer Price Index	4.60	20.99

For detailed information on both changes and performance relating to your own portfolio please visit our client library:
https://www.forrester-hyde.co.uk/client-library_KIIDS.php

Important Notice

Past performance is no guarantee of future results. Investments can fall in value as well as rise so you could get back less than you invest. The value of an investment will depend on the future rate of return and the effect of charges; neither capital nor income is guaranteed. Our advice is based on current regulation, which is subject to change, the rates of tax payable and tax benefits we refer to are those that currently apply, they change over time and how they impact will depend on your personal circumstance.

Glossary and Abbreviations

Alpha - A measure of the return of a portfolio relative to an investment benchmark.

ARC Index – A set of risk-based indices designed to be used by private clients and advisers in assessing performance of their portfolio. The index comprises of the performance of a series of private client investment managers.

Basis point – 1/100th of 1% (0.01%).

BBB bonds – Credit rating of a bond considered to be of Investment Grade.

Bear Market – When a market shows signs of decline - prices go down.

Beta – The sensitivity of an asset's or portfolio's return to fluctuations in the return of the market or benchmark.

BoE – Bank of England.

BoJ – Bank of Japan.

Bottom-up – An approach to active investment management that gives priority to the selection of companies (with less emphasis on sector and country selection) to build up an investment portfolio.

Bull Market – When the prices rise consistently over a period of time.

CAPE Ratio – Cyclically-Adjusted Price-to-Earnings Ratio.

Correlation – The extent to which two assets' values rise and fall together.

Covenant Protection – Covenants are conditions tied to an indenture or loan agreement, usually in the form of forbidding certain actions of the issuer, put in place by lenders to protect themselves from borrowers defaulting.

Diversification – A risk management strategy that mixes a wide range of investments within a portfolio in order to reduce overall volatility.

Dividend Cover Ratio – Measures the number of times that a company could pay dividends to its shareholders.

Dividend Yield – The annual dividend on a share divided by the share price.

Duration – The duration is a measure of the average time until a bond's cash flows occur, and of the sensitivity of its price to interest rate changes.

Earnings per share – A common way of expressing company profits – dividing the profits after tax by the number of shares in issue. This is the basis for the calculation of the P/E Ratio.

ECB – European Central Bank.

ESG – Environmental, Social and Governance.

FCA - Financial Conduct Authority.

FDI - Foreign Direct Investment.

Fiscal Stimulus – Combination of tax cuts and increasing government spending in order to increase aggregate demand within an economy.

Forward P/E- Current stock price divided by the predicted next annual earnings period.

G7 Countries – The seven largest IMF-described advanced economies in the world, comprising of Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

GDP – Gross Domestic Product.

Growth stock – A stock that is expected to achieve above average earnings growth. Growth stocks normally have a high P/E ratio relative to the market as a whole, as investors are willing to pay a premium for future higher earnings.

IMF – International Monetary Fund.

ISM – Institute for Supply Management Index.

Large cap stock – A stock with a market capitalisation is among the largest within a market. Medium and Small cap definitions also used.

Liquidity – The extent to which an asset can be bought or sold quickly and cheaply.

Macroeconomics – The study of market behaviour and performance of an economy as a whole, examining general economic factors such as interest rates and national productivity.

MiFID II – A legislative framework instituted by the European Union to regulate financial markets and offer greater protection and transparency for Investors.

Monetary Tightening – When Central Banks increase interest rates and reduce the money supply within the economy to help control the rate of inflation.

Nominal – Very small or far below the real value or cost.

OBR – Office for Budget Responsibility.

ONS – Office for National Statistics.

P/E Ratio – The relationship between the company's Stock Price and Earnings per Share.

The Purchasing Managers' Index (PMI) - Is an index of the prevailing direction of economic trends in the manufacturing and service sectors.

Quantitative Easing (QE) – Is the introduction of new money into the money supply by a Central Bank, usually via a Central Bank purchasing Government and Corporate bonds.

Quantitative and Qualitative monetary Easing (QQE) – An increase in the size of the balance sheet of the central bank through an increase in its monetary liabilities that holds constant the (average) liquidity and riskiness of its asset portfolio.

Quantitative Tightening (QT) – The counterpart of QE. QT is used to decrease liquidity within the economy.

Trailing P/E - Current stock price divided by the trailing earnings per share (EPS) for the past 12 months.

Transactional Charges – Expenses incurred when buying or selling a good or service.

Value stock – A stock that appears cheap when compared with other stocks because the share price is low relative to the book value of the equity (or earnings or dividends).

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