Quarterly report

Q3 2023 market review

Overview

- Higher for longer
- The big risk with cashing out
- Looking beyond China for investment in Asia

Higher for longer

Written by Georgie Fletcher, Associate Portfolio Manager

It appears that we have now moved into a new interest rate environment in which interest rates will remain higher than during the previous low inflation, low interest rate regime that occurred from 2010-2021. As and when interest rates do come down, we do not expect them to go back to the same levels as in the aforementioned regime. If interest rates remain higher *and* for longer than markets initially predicted, this presents a number of investment opportunities for us to take advantage of. We explore three key reasons to remain positive in the current market cycle.

1. Separates the wheat from the chaff

You tend to see a dispersion between the good and the bad companies in a higher interest rate environment; rates staying higher for longer may further extenuate the spread.

The winners in this environment will most likely be **quality** businesses, these are those that invest in technology and embrace it, those with pricing power, monopolistic control, strong balance sheets and companies which aren't exposed to cyclical or interest rate sensitive areas. Poorly run businesses are less likely to survive as the impact of higher interest rates puts pressure on businesses with high levels of debt as their debt servicing costs rise and eat into profits. This is where the value in holding active managers becomes more important as they are the ones who have the freedom to stock pick the winners. The quality equity bias of our portfolios will be a tailwind in a higher for longer environment.

2. A sign of resilience

Higher rates for longer would likely indicate that the economy is holding up better than expected which should be positive for risk assets (e.g., equities and investment grade / high yield bonds) overall. It should also indicate that unemployment levels are low and wage growth is steady; higher for longer means consumers are showing their resilience.

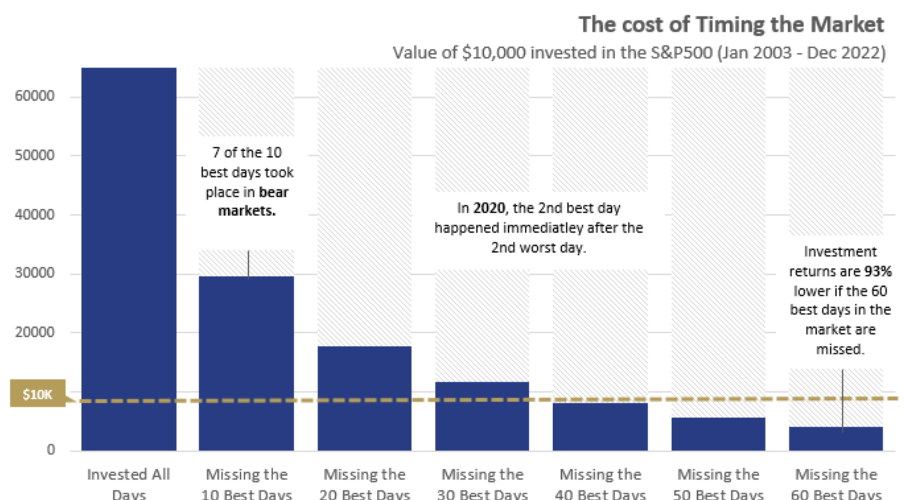
3. Headroom for future policy intervention

This environment also gives more room for future policy intervention. Markets arguably react more when rates go down. Take the pandemic for example, central banks could only cut from a very low base, whereas if we are at 5.25% or higher, there is a lot of room to move in terms of stimulating the economy when the time is right or should any unexpected crisis come along. Higher rates are a central bank's primary policy ammunition.

The big risk with cashing out

Written by Phoebe Stone, Partner and Head of Intermediary Investment Services

Interest rates, and therefore rates on cash, are the highest they have been in the UK for 15 years. For investors that have endured a tough investment landscape for the last few years, it may seem tempting to liquidate, or to invest new money into a fixed return from a cash deposit. However, making this choice is risky for a number of reasons. It is very well-documented that poor, or unlucky timing of such a move can significantly impact long-term returns. The majority of clients have their wealth invested to meet medium or long-term financial objectives. By missing the 10 best days of the market over the last 20 years, would have reduced your $10,000 invested in the S&P 500 from the potential of $64,844 to $29,708[1]. The behavioural phenomenon of buying at the top of the market and selling at the bottom is characteristic of the human psyche and negates



[1] JP Morgan, S&P total returns from 1 January 2003 to 30 December 2022 (including graph)

the fact that it is often better to leave wealth invested and compounding through the market cycle.

Whilst rates on cash may seem attractive today, we could be close to 'peak' interest rates, as inflation looks to be brought under control and the continuous increasing of interest rates may no longer be required. The Bank of England is cognisant of causing the economy too much pain, and if the Bank starts to see evidence of a coming recession, interest rate cuts could be needed. As and when interest rates do start to fall, the rates on cash investments will also fall, meaning that investors may not just be missing out on equity market moves which would be likely to rise on the back of falling borrowing costs. Investors will also miss out on the yields on bonds that may fall in line with interest rates falling, leading to the price of bonds to appreciate as yields fall. Investing in bonds, and benefiting from the attractiveness of current yields, which unlike cash can today produce a positive return after inflation is an opportunity to consider carefully.

The behavioural phenomenon of buying at the top of the market and selling at the bottom is characteristic of the human psyche and negates the fact that it is often better to leave wealth invested and compounding through the market cycle.

Phoebe Stone, Head of Intermediary Investment Services, LGT Wealth Management

Looking beyond China for investment in Asia

Written by Rhys Cann, Trainee Portfolio Manager

In the ever-evolving landscape of the global economy, Asia has long been a focal point for investors. The region is a vast and diverse continent with a multitude of opportunities beyond the most dominant economy, China, and there are compelling reasons to remain positive about the prospects of Asia as a whole.

Long-term prospects of China

China, often at the centre of discussions about Asia's economic outlook, has indeed faced a number of hurdles over the past few years. Gross Domestic Product (GDP) growth targets have proven elusive and the slowdown in consumer spending has raised concerns. The construction sector's struggles have sent ripples throughout the economy, leading to cautious investment strategies. That being said, China has attractive long-term trends including a growing middle class, a high rate of technological adoption, a growing sustainability sector, soaring healthcare demand along with wealth growth. As China contends with their current challenges, other countries within the Asian region provide attractive investment opportunities.

Factors driving investment in Asia

Alternative manufacturing hubs

Reasonably priced stocks

Companies demonstrate resilience and adaptability

Diversifying supply chains beyond China

Alternative manufacturing hubs

One of the key reasons for shorter-term optimism is the potential for other Asian countries to benefit from the challenges faced by China. As global supply chains undergo a transformation, countries such as Vietnam, India, and Indonesia are emerging as alternative manufacturing hubs, attracting investment and diversifying the regional economic landscape.

A cheap and resilient region

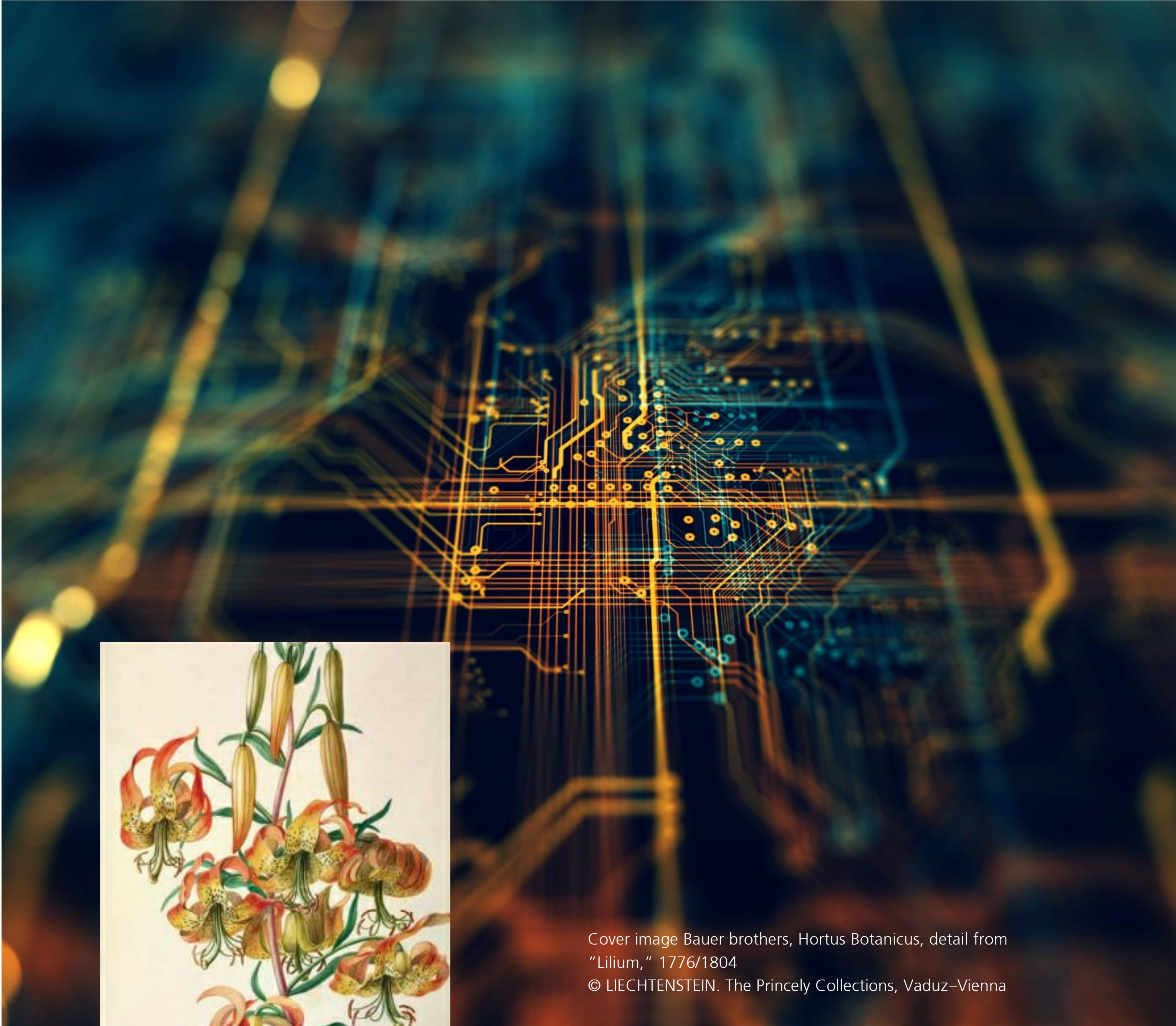
Valuations play a pivotal role in the attractiveness of Asian markets. When compared to the often-elevated valuations (expensive stocks) in the United States, many Asian markets appear more reasonably priced. This relative valuation advantage can be a compelling factor for investors seeking opportunities beyond their home markets.

Some Asian companies have continued to demonstrate resilience and adaptability when it comes to earnings expectations. As economies recover and global demand rebounds, these companies are poised to benefit.

A diversified supply chain strategy

The "China + 1" growth story is gaining traction, emphasising the importance of diversifying supply chains beyond China. This approach presents an opportunity for other Asian nations to step into the void, bolstering their economies and positioning themselves as attractive destinations for foreign investment.

Asia offers diverse opportunities and challenges for investors. While China grapples with its own economic woes, the broader Asian region offers good investment prospects. As investors, it is prudent to adopt a diversified approach, exploring not only different countries but also various sectors and investment styles across the region to harness the resilience and opportunity that this dynamic continent has to offer.



Cover image Bauer brothers, Hortus Botanicus, detail from “Lilium,” 1776/1804
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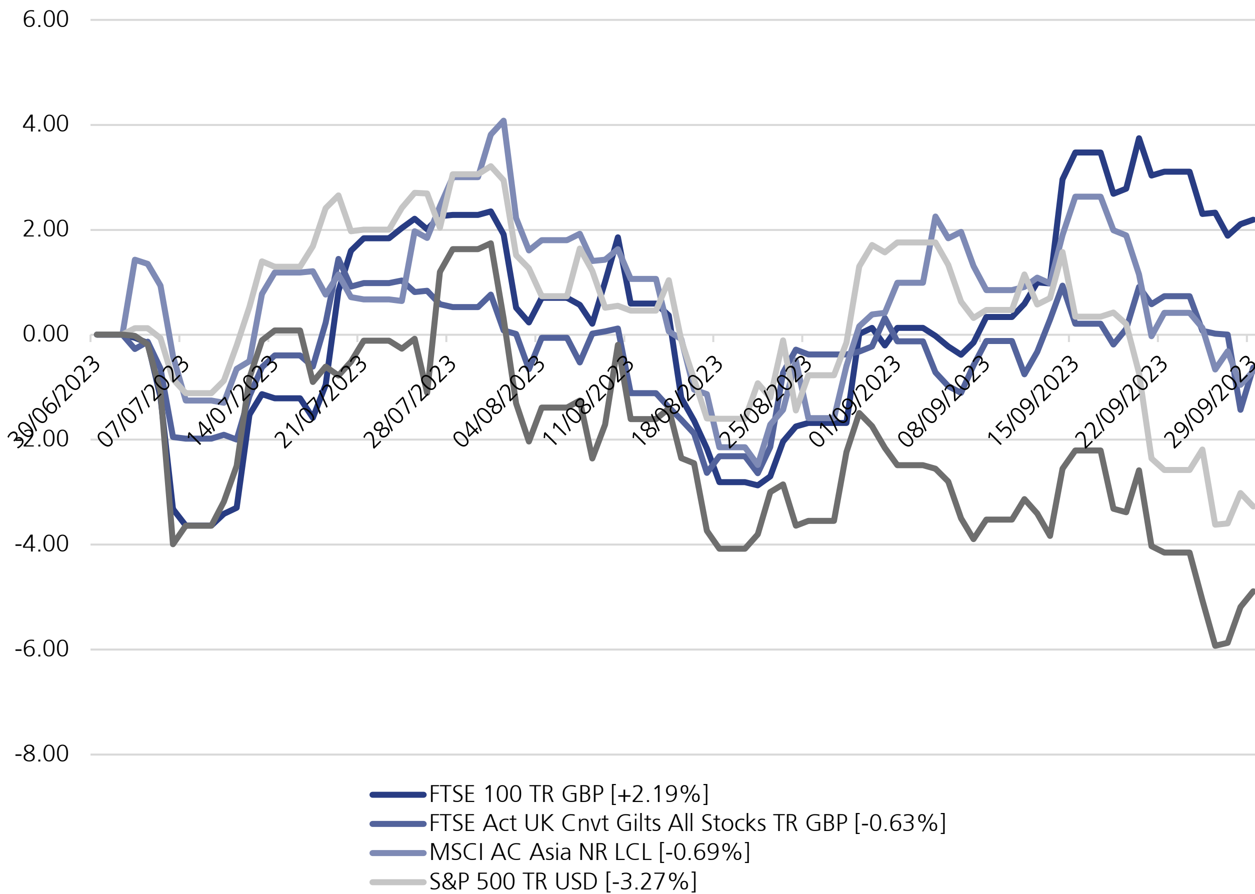
Q3 2023 index performance (%)



Model portfolio performance as at 30 September 2023

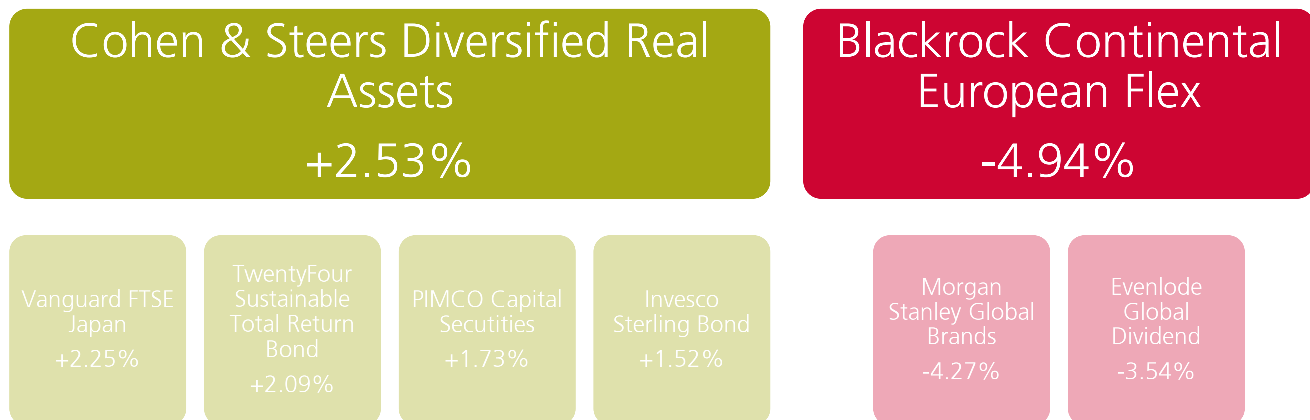
GBP Portfolio	3 months	6 months	1 Year	3 Years	5 Years
Adventurous	-1.03	-0.15	5.72	7.50	26.14
Growth	-1.12	-0.89			
Balanced	-0.96	-0.44	4.73	3.21	16.21
Cautious	-0.79	-1.03			
Defensive	-0.48	-0.88	3.94	-1.76	10.26

EUR Portfolio	3 months	6 months	1 Year	3 Years	5 Years
Adventurous	-2.29	0.06	7.28	10.81	27.00
Growth	-2.41	-0.91			
Balanced	-1.82	-0.21	5.72	4.18	16.73
Cautious	-1.67	-0.69			
Defensive	-1.49	-1.26	2.87	-2.00	5.96

USD Portfolio	3 months	6 months	1 Year	3 Years	5 Years
Adventurous	-4.30	-1.32	13.11	3.32	22.27
Growth	-3.69	-1.54			
Balanced	-2.90	-0.92	9.62	2.14	19.13
Cautious	-2.40	-1.00			
Defensive	-1.86	-1.45	5.94	-0.30	17.01

Past performance is not a reliable indicator of future performance; and the value of investments, as well as the income from them can go down as well as up, and investors may get back less than the original amount invested.

Performance of LGT WM funds in Q3 2023 (GBP portfolio)



Source: Morningstar

The central theme this year has been the Federal Reserve and other central banks steadily raising interest rates, adopting a "higher-for-longer" approach. This prolonged period of higher interest rates has resulted in losses for traditionally stable investments like US Treasuries and German Bunds, with declines seen in Q3, primarily occurring in September. Equity markets have also felt the impact, with world stocks, while still up by 8.5% for the year, giving back 7% since August, affecting even the technology (tech) giants.

While the tech giants, including Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla, and Meta, still hold sway, more than half of their shares have seen declines since the end of June. However, Nvidia and Meta have maintained substantial gains of around 190% and 150% for the year, respectively.

Key detractors from the portfolios this quarter have all suffered from their style and regional biases, with growth companies continuing to struggle against meaningful size and style headwinds during Q3 2023 as large-cap value companies continued to outperform, and regional allocations to Asia have struggled. Since China's lacklustre reopening, we have seen a deterioration in economic data within the region and problems within the property sector continue to weigh on sentiment.

There are, however, reasons to be optimistic when it comes to China. Equity valuations in the region trade at a significant discount to US equities, and recent data suggests the Chinese economy may have bottomed during the quarter. It is probable that the Chinese authorities' recent stimulatory actions - reducing rates, help with childcare and the elderly, a cut in stamp duty for stock trades, among others - have not yet filtered through to the economy. As such, we expect growth to pick up in the coming quarter.

On the other end of the spectrum, the Cohen & Steers Diversified Real Assets fund had a positive quarter following a difficult start

to the year. The fund has over one third allocated to commodities. Energy was the best performing sector over Q3 amid oil production cuts and industrial metals also produced a modest gain. We added this fund earlier in the year to provide protection against an environment where inflation remains elevated. Real assets provide several attractive investment characteristics such as inflation protection, and generally exhibit below average correlation to broader equity markets.

Overall, this quarter has highlighted the benefit of diversification within portfolios, be that from a regional, style, or asset perspective. Looking ahead, the remainder of the year promises to be eventful. Central bank meetings will continue to influence the outlook for higher interest rates. There is the potential for a US government shutdown, and some Emerging Markets will hold elections. Earnings season is also on the horizon. The reassuring aspect for the fourth quarter is that we may be approaching the peak of global interest rates, potentially bringing some stability to financial markets.

Portfolio changes and rationale

Diversifying exposure to the wider Emerging Asia region

- Following the addition of **Stewart Asian Pacific Leaders Sustainability** into the Cautious portfolio earlier in the year, we decided to add a position in Balanced, Growth and Adventurous over Q3
- This strategy offers clients a large-cap defensive growth focused approach to sustainable equity investing in the region where capital preservation is prioritised. We believe it complements the existing Asian funds held within portfolios (Morgan Stanley Asian Opportunities and Schroder Asian Total Return)

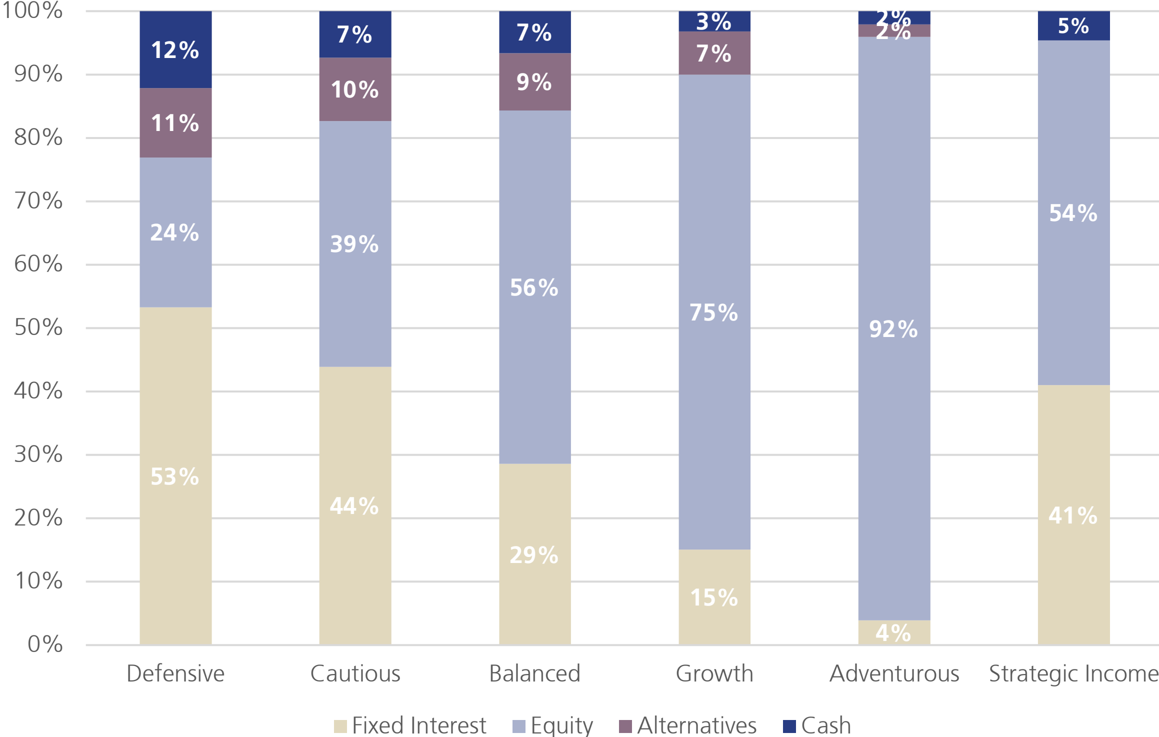
Ability to be agile and dynamic in our portfolio construction

- With GBP sinking versus USD in the days following the ex-Chancellor’s mini-budget a year ago, our IC recommended we leverage off the benefits generated for sterling investors. As a result, we hedged a portion of the dollar exposure in the GBP portfolios through the **iShares S&P 500 Hedged ETF**
- We took profits on the position in Q3 after a strong run generating positive performance, and selectively added to existing US equity holdings with the proceeds of the sale

Fixed Income: Maintaining duration while simplifying exposures

- We sold the **Allianz Strategic Bond** fund across the Adventurous portfolios and reduced the allocation across the other risk profiles
- The fund has a broad tool kit to generate returns within fixed income, however, recent trades have the fund positioned for a hard landing as they are long rates, overweight duration and have a short exposure to credit spreads
- As our view of the economy is not as extreme, we no longer wanted to hold a position that has a short position in credit markets. The proceeds of the sale were prorated across existing positions with a view to maintaining overall duration and simplifying our exposure

Portfolio positioning



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