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FUND MANAGER QUARTERLY REPORT

20 YEARS ANNIVERSARY

Fund Managers Second Quarter Report – June 2024.

by Wayne Bishop

Politics and Economics

The quarter ended with a degree of political excitement, not for the UK election as it was a foregone conclusion, but for the elections in Iran and France. Whilst no one expects Iran to greatly change after the election of a moderate president, their hand is behind many of the troubles in the Middle East, so this may help cool some of the global issues flaring in the region, directly impacting shipping and oil, and therefore inflation.

The surprise results in the French elections, as well as the variance between votes and seats in the UK election, highlight the fractious state of Western politics. What happened about twenty years ago in countries where coalitions were the norm, is now impacting more established first past the post democracies. Germany, for example, moved from three party politics to six parties today. A number of common deep-seated social issues are coming to the fore; though blamed on immigration, in reality, the issues are clustered around access to housing, pensions, access to services (such as health), taxes and budget deficits. At the same time, environmental issues are becoming increasingly evident. Years of procrastination are now coming to a head.

For the United Kingdom, the change in government signalled the stability that markets are seeking. With more volatile politics in much of the world, the UK is finally returning from the cold after an explosive political Brexit-dominated decade. The cheap pound, a pro-growth treasury and with interest rates expected to fall, the backdrop for the UK is suddenly more attractive. A point succinctly put in the Financial Times: “Investors welcome a more boring Britain.”[1]

The result of France’s election has caused some weakness in their capital markets. Equities have sold off whilst French bonds have widened compared to their European counterparts.

Fixed income

With inflation either close to or back at target, and with global growth expectations being reined back, interest rate expectations are back in focus. The European Central Bank started the process of cutting, albeit less than expected, and the Bank of England is expected to start cutting interest rates soon. The U.S. Federal Reserve is looking at higher for longer as the U.S. presidential election looms and the U.S. economy still appears stronger.

After the level of interest rates, concern about the size of government deficits is the next major issue for government bonds. It is not just the markets that are concerned, the EU are raising issues with governments such as France where the budget deficit remains close to 5% and well above the 3% limit. The focus on government deficits has impacted government spending and plans. One reason why

[1] https://www.ft.com/content/8a1e3092-dd58-40d4-ae01-a574edd9fcc0

fiscal responsibility was high on the UK political agenda, rather than the usual promises to splash the cash.

These factors have changed the shape of the yield curve. In the UK despite interest cut expectations, long terms bond rates are higher and not lower. For example, a year ago the UK 30-year bond yielded 4.38%, now its 4.66%, a small rise, whereas two-year yields have fallen from 5.14% to 4.22%.

The quantitative tightening (taking money out of the economy) taking place in the US, EU and UK, has worked alongside the higher short term interest rates to increase competition for money. Whilst 2024 has seen record issuance of bonds, and record purchases, expectations are that demand for bonds will become more targeted.

We have favoured shorter duration and higher credit quality. We have taken the previous weakness in fixed income to add to duration and now currently sit at circa 5.5yrs in portfolios, and will unlikely be raising this anytime soon.

Property and Infrastructure

Interest rates dominate the outlook, not only for the text book cost of capital, but also as a rival asset class and this will remain the key factor until rates begin to fall. These assets continue to trade at a substantial discount to their NAV (Net Asset Value).

Our infrastructure exposure was in the green for Q2, returning around 3.8% in the UK and just over 8% from a global perspective. Meanwhile property was slightly negative over the quarter.

These investments have struggled to recover after falling sharply post the Liz Truss budget in 2022, as pipelines for growth disappeared overnight and have not yet returned. Increased political stability and lower interest rates should provide a more favourable backdrop for the pipeline of new projects and help these assets close their valuation gap. In the meantime, many of them continue to provide a level of income for portfolios. We favour infrastructure over property moving forward given the Labour governments bigger focus on a cleaner energy transition, which has already seen the ban on onshore wind rescinded.

Equities

Once again, the overall global market performance has remained driven by the Magnificent Seven stocks, and in fact this has been even narrower with three of these making the difference in relative equity performance. This difference in performance was more subdued as neither oil and gas, or aerospace and defence, outperformed the market in the last quarter, which has been a factor in underperformance in previous quarters.

Smaller capitalised companies and those with a positive focus, including in areas such as water and waste, remain under pressure given the higher for longer stance. We have been very active in our engagement with fund managers who fall into this category. Many are seeing larger-than-usual opportunities to add new names from their buy Lists, given that valuations worldwide have reached levels that are extremely attractive, both in absolute terms and relative to large-cap equities.

Renewable Energy remains a key positive investment area and in addition to the infrastructure investments that own the solar parks, wind farms, etc, we are also invested in those focussed around electrification and equipment manufacturers and developers. This theme has been mixed over the quarter.

The US based solar companies, in particular First Solar, staged a very strong recovery at the end of May after China ended their policy of price dumping in the U.S. However, the end of the quarter saw weakness amid political concerns emanating from the wave of right-wing populism in Europe and President Biden's dismal debate performance.

India's surprise election results only had a short-term effect on the market. Both the growth of India and its continued integration into both the global economy and global capital markets remains not only a key consideration for markets this decade, but also a key driver and dynamic for global climate change as they grow.

Indian equities have been strong as China continues with its struggle, whilst the market was buoyed following the results of their election. We are relatively highly exposed to India as a region so have benefited over the last few years, but we have taken select opportunities to rotate out of India into select EM countries at previous rebalances.

Although the outlook for the global economy has tempered in the last quarter and expectations abound for (more) interest rate cuts, this is largely expected. The risks are the global economy slowing either more or less than expected, and therefore an acceleration or halt in interest rate cuts. Lower rates would be good for fixed income, infrastructure and growth focussed investments, and by implication for the portfolios and at the moment expectations on interest rates are quite tempered.

While there has been talk of a slowdown in the global energy transition, we continue to see increased investment around the world even if the timescales are extended. At the moment most of positive sectors have become cheaply valued, making good profit but unloved as the market chases a small number of stocks to unrealistic valuations. The differential is narrowing and we expect the market rally to continue to broaden across sectors and stocks. It is not just the positive nature of these investments that is attractive, the valuation and market opportunity is now also compelling.

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