# FUND MANAGER QUARTERLY REPORT

**Fund Manager Third Quarter Report - September 2023.**

**by Wayne Bishop**

A year ago, UK markets were just recovering from the disaster budget of Liz Truss that caused havoc in the Gilt market and threatened liability-driven pension schemes. Although the scare itself was soon over, and the politicians responsible were replaced, the gilt market (and the global market) staged a short recovery. However, since then, global bonds and gilts have fallen back towards the lows seen in September 2022, with U.K. ten-year yields at 4.44%, and post quarter to a high of 4.67%[1].

Much of the market commentary attributes the fall in bonds to the "higher for longer" rhetoric from central banks as they seek to tame inflation and regain lost credibility. This is certainly part of the story. Higher interest rates are something only those with over a quarter of a century of experience will remember, but we certainly feel the market is past grappling with this and other factors need to be considered.

Whereas gilts and bonds were very public victims of the Liz Truss market scare, they recovered shortly afterwards. Two other interest rate sensitive asset classes, property and infrastructure, also fell but have not recovered, and both posted losses for the last 12 months[2]. These assets continue to trade at a high discount to their net asset value (NAV), and this reflects some expectations valuations may fall as their cost of debt rises, whilst a higher discount rate negatively impacts DCF models. Whilst NAVs provide a guide to investors of asset values based on various models and assumptions, the value of an asset is confirmed upon a transaction or sale. Recent asset sales have largely supported the valuations, meaning other supply and demand dynamics are at work in fixed income, property and infrastructure assets.

Until the start of 2022, cash and conventional bonds were uninteresting asset classes, only used for risk management. Any desire for income had to be met in the other asset classes, especially property, infrastructure or higher yielding equities. With interest rates and bonds rising towards 4%, then 5% and even 6% in some shorter durations, their lower risk profile made these assets very attractive at the expense of others. This meant much less demand for property and infrastructure.

Increased investor demand for fixed income last year coincided with both increased government and corporation credit supply (financing more debt) and the end of quantitative easing (QE), as central banks stopped buying bonds in the US. Therefore, the fears of some about the end of QE and its impact on bond markets did not materialise last year.

Whilst demand from traditional asset managers (real money) has been fulfilled, government and corporate issuance remains high and the current market turmoil is as much about high supply and low demand, as it is about interest rates. In the US, the Federal Reserve continues to reduce its balance

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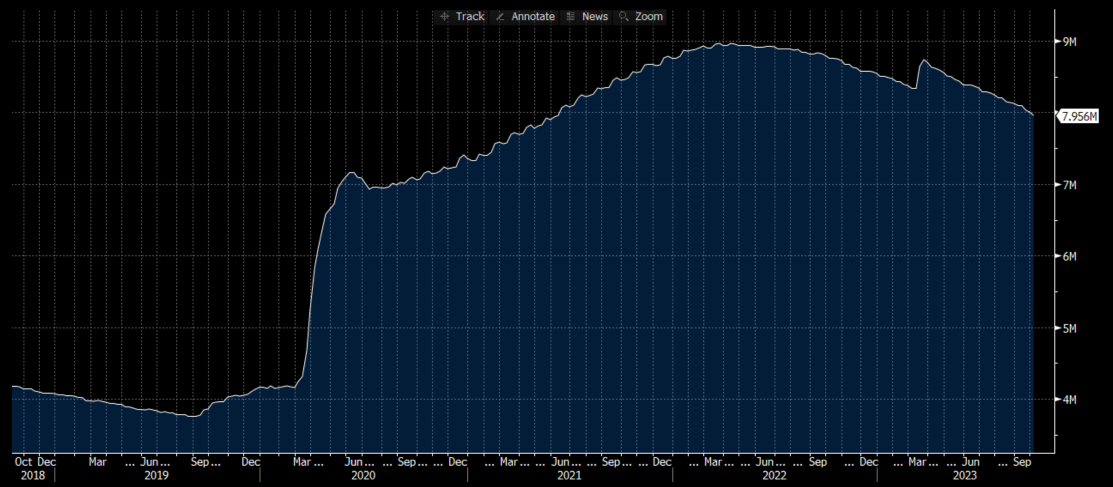
[1] Benchmark 10 Year Gilt, source Bloomberg/KSAM.

[2] iShares UK Property and Global Infrastructure ETFs 1 year sterling total return, source Bloomberg/KSAM.

sheet, down from circa $9 trillion in 2022 to $8 trillion at the time of writing. The graph below shows the extent to which this is set to continue (although there is no expectation for them to shrink it to pre-financial crisis levels of sub $1 trillion).

US Federal Reserve Banks Total Assets (September 2023)




Source: Bloomberg

The French and the Italian governments have faced criticism for their budget deficits in Europe, and the recent political brinkmanship in the US that almost led to a government shutdown are all signs that bond vigilantes are gaining the upper hand. The much higher cost of debt for governments is only adding to the deficit's that governments seem unable to reign in. Therefore, bond market direction is now less about interest rates per se, and more about lower real money demand and high supply.

With evidence that the global economy is slowing in many key areas, the interest rate narrative may become more dovish sooner, certainly for short term interest rate expectations. Whilst we do not expect a rerun of the sovereign debt crisis in 2013, there are some similarities with the current dynamics that should not be ignored.

With inflation less rampant but still untamed, the index-linked nature of infrastructure and property is more appealing, the deep discounts would imply more limited valuation risks (although we still see some risks between here and the year-end). In some cases, the business case has changed, and we have reduced exposure in battery storage focussed investments in particular.

Global growth expectations have been reduced around the world. Notable major risks are property in China, and the auto sector in Europe. The rally in equities has only been driven by a small number of technology stocks, once known as the FAANGS, but now referred to as the 'magnificent 7', as it includes the AI focussed company NVIDIA. Outside of this, markets have been more muted in 2023.

It is not just bond markets that are impacted by less money in the system. Capital discipline demands a higher risk premium for equities. This has led to far fewer companies coming to the stock market, as more realistic valuations are demanded. The re-listing of ARM in the US and two tech IPOs in the same week took place at lower than initially expected valuations. As the delayed reaction to interest rate rises now hits home (especially a risk in the UK mortgage market) has led to more defensive posturing in the markets.

AI, medical technology, and healthcare are all sectors that the market is focussing on for growth. Renewable Energy continues to suffer from some supply chain and cost issues, but the order books are growing and we expect a rotation back to this sector in the coming year. The search for genuine growth and technological change will dominate growth investing, and quality will dominate value investing for the immediate term.

Even those of us old enough to remember high interest rates (sadly I am), did not have to contend with quantitative tightening, supply chain shifts and changing technologies that are all front and centre right now. We see many impact themes, which have been battered over the last two years as unloved, but offering some growth potential as markets readjust to a new normal with much higher capital discipline.

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