Fund Manager First Quarter Report – March 2024.

by Wayne Bishop

The anticipated bumps in the road after a resurgent end to 2023 were quickly felt at the start of the year. Caused by the moderation of expectations for interest rates cuts after overheated expectations in the last few weeks of 2023. So far, the year has seen a mixed, but essentially more resilient global economy, that has led markets to expect a much softer landing for the global economy. Inflation continues to fall, and employment remains resilient. This is the first reason we are at the shorter end of the yield curve, given our preference to not extend duration too much whilst this tussle unfolds. Nonetheless, there is a consensus that incrementally adding to duration during periods of weakness would be beneficial.

The United States economic growth remains strong and the economy continues to perform in a text book manner. Although U.S. elections are due towards the year end, its isolation from Europe's war related woes and energy independence remains a greater benefit. The energy price shockwaves that rocked Europe (and the UK) from the conflict are subsiding, but not without leaving scars, and the focus is now on the effects of the steep interest rate rises which only finished in August 2023. In a turn-around from the normal state of affairs, southern Europe is growing well (Spanish GDP grew 0.6% in 2023), whilst the industrialised North continues to show signs of stalling (German GDP declined 0.2% in 2023). In Asia, Japan continues to grow strongly (recently raising interest rates) as does India, which continues to slowly open to global markets; against this, Chinese growth remains more subdued, hampered by a burst real estate bubble, soft consumption, and lower global exports.

One universal problem around the world remains high debt levels. The woes of Thames Water owner, Kemble, are creating headlines in the UK market. In China, it is two real Estate giants Evergrande and Vanke. A number of European governments are having to rein in their budget deficits and the debt ceiling has been a political issue in the U.S. It may be a legacy issue from the Covid era but there remains a view that deficits have not been reined in fast enough; and as money supply is continually drained by central banks, bond buyers can afford to be more selective.

Fixed income retreated slightly in the quarter and although long terms rates may fall once interest rates begin to decline, we do expect the curve to steepen again. This is the second reason we favour being at the shorter end of the yield curve, as well as favouring higher quality bonds, but again, with the likelihood of adding slightly to duration during periods of weakness.

Even though expectations for lower interest rates remain in place (albeit further down the road than some had anticipated), the last policy move in the third quarter of 2023 were interest rate hikes, and this is still feeding through and impacting results and cost of capital calculations for a number of interest rate sensitive sectors. In particular, infrastructure and property both remain under pressure, with the price discount to NAV (Net Asset Value) remaining at record levels. Even where we take a more cautious view on the NAV of some investments, we still see large discounts, and the boards of these investments remain under pressure to generate returns. In the first quarter these investments, and equity investments linked to them, such as renewable energy and recycling, gave back their gains and underperformed in the quarter.

Over the last few rebalances, we have trimmed exposure to infrastructure. Some of the smaller investments remain a concern, although given the investment constraints of the underlying funds, are largely avoided within the model portfolios. The larger investments are well managed, so we see recovery potential increasing once interest rates begin to fall, especially when cash becomes less appealing.

In equities, global large caps continued to perform well. This is even after stripping out the outsized effects the Magnificent 7 (Amazon, Apple, Alphabet A and B, Meta, Microsoft, Nvidia and Tesla) continued to have on global equity indices. Once again, these 7 stocks dominated performance, but towards the end of the quarter, as Tesla and Apple continued to struggle, we have seen this gap narrow. We have seen a number of large companies perform well, notably industrial names in electrification and healthcare where M&A has picked up. Smaller listed equities lagged large-cap peers once again; however, we saw small-cap names outperform in March, evidence of the broadening of equity market returns.

Our model portfolios have a strong positive investment profile, and the equity allocation more closely aligns to impact equity benchmarks, and this returned -2.43% for the quarter, whereas mainstream equities, including M7 and those with no negative screen, were up between 3.5% and 10%. The impact of the negative screen did weigh on relative performance in the quarter, with geopolitical issues pushing oil & gas and defence sectors higher once again. Fixed income returned between -2.7% and -0.2% between government and lower quality debt. The reversal in monetary easing expectations saw property down 6%.

Real assets such as infrastructure & property, as well as more future focussed investments are more interest rate sensitive. Having weathered the post covid inflation surge, and subsequently the conflict related inflation surge, interest rate expectations remain elevated. Nonetheless, we are now more optimistic for a number of sectors, given forward earnings growth remains robust whilst share prices remain under pressure. Certain stocks in our universe have gone from trading at a premium to the general market to now trade at a discount. For example, a major global clean energy index trades on a 2025 forward P/E of 14.5x compared to the wider markets 16.3x. Whilst a basic measure of valuations, it highlights our point given the previous wide premium we had experienced in the post-covid rally.

We do expect a broadening of equity market returns outside of broad tech, which will benefit various equities in our universe, whether that’s from companies benefiting from a focus on global megatrends such as clean energy, or those likely to benefit from a rate cutting cycle, such as broader small and mid-cap companies, as well as more cyclical and industrial names.

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