Performance commentary – October 2023

This document provides an update to our previous commentary from August. Much of the price action we spoke about 6 weeks ago has remained similar. Bond weakness has remained given the higher for longer thesis, whilst oil & gas has climbed at the same time that clean energy continues to suffer.

Yields higher for longer – the rhetoric has strengthened

In our last update (August), we spoke about the market contending with the higher for longer stance. The rhetoric from the September Federal Reserve meeting only confirmed this outlook, particularly the fact that interest rate cuts have been pushed further down the road. The oil price at circa $90 a barrel has reignited some inflation concerns, and as we have commented in our Q3 report, investors are now contending with lower central bank buying of bonds at a time when traditional asset managers have limited dry powder, whilst bond issuance, fuelled by governments deficits and corporate credit, are on the rise.

Due to the above, the rhetoric and market reaction has firmed over the last few weeks. This is reflected in the steepening of yield curves, including the UK, with the graph below showing the move from the end of August (yellow dotted line) to the end of September (thick green line). Over that one-month period, thirty-year government debt added round 30 basis points to once again trade near the Liz Truss mini-budget highs.

UK Sovereign Yield Curve (August to September moves), Source: Bloomberg

When it comes to fixed income, much of the pain for lower risk investors has been felt. Our timing was premature when we added to fixed income last year, and we have since corrected this and have been in a position in model portfolios where we have been in the duration region of 4-5 years. We feel the short end of the market has offered opportunities, particularly as the yield curve steepens. We are not yet in a comfortable position to be adding to duration again, but we are just above our neutral allocation and do have room to manoeuvre higher. The asset class is viable for the first time in a number of years, and when the volatility subsides, will provide that negative covariance against risk assets that the text book tells us they do.

Equities

This rise in yields continued to place pressure on equity markets in general, with the all-world equity index declining 4.10% in dollars terms in September, which follows on from the circa 2.8% decline in August, making the third quarter a negative period for global equities. Underneath the bonnet, large cap and value continued to outperform small cap and growth equities.

The weakness in September did feed through to the 'magnificent seven' (Facebook/Meta, Apple, Amazon, Alphabet, Microsoft, Nvidia, Tesla). However, their impact on global equities has had a significant impact on performance over the year-to-date period. The graph below highlights the total return, in US dollar terms, of the 'magnificent seven', returning circa 84% based on the equal weighted index of those seven stocks:

Magnificent Seven index - Source: Bloomberg

This has helped drive the US' main bourse to a return of +13.05% (in USD terms) or +12.05% (in GBP terms) to 30/09/2023. **If you removed these seven stocks from the index of 500 companies, the remaining 493 stocks would see the index return a negative value so far in 2023, highlighting the dominance these stocks have had on US and global equity returns.**

As mentioned in our previous update, this has been particularly tough given our avoidance of names such as Apple, Alphabet, Amazon etc. We have had very limited exposure to names such as Microsoft, and even less to AI focussed Nvidia. We have been quite clear over our rationale for avoiding the so called 'FAANGs', and it is important clients understand the impact of this screen (more of which we will touch on further below).

This has meant an increasingly concentrated top end of the US market, which has further exacerbated the weakness on smaller companies. You can see reasons for this weakness given the rising cost of capital, rising wages etc that inevitably take a bigger toll on less capitalised names. Nonetheless, we have reached a point where valuations for US smaller companies are at their most compelling levels in decades. Whilst a looming recession is a headache for timing, its likely we are going to avoid a so-called hard landing, and history would suggest an unwinding of a high concentration in large caps would benefit smaller companies, and this is something we continue to monitor closely.

There have been some welcome comments from a few Federal Reserve (Fed) officials in recent days (week of 9th October), which has been of a more dovish stance, suggesting that the higher yields mean less need for the Fed to raise rates. Pricing for the US Fed funds rate would suggest we are very close to peak rates, and this hasn't changed a great deal in the last few weeks. However, peak UK rate expectations have dropped by around 30 basis points over a similar period. We continue to believe the interest rate narrative will get more dovish sooner than expected, given the slowing economy as higher rates take their toll, and the prospects of a policy mistake continue to mount. We have previously commented on our concerns over the UK. Whilst the US remains fairly resilient for now, let's not forget some of the US's consumption has been supported by student loan moratoriums and state-level tax breaks which are being withdrawn, whilst US mortgage rates are at a two-decade high.

Infrastructure

Whilst persistent inflation and higher longer rates continue to lead to volatility in the sector, critical renewable energy infrastructure has faced continued negative sentiment given the concerns over higher rates impacting companies' ability to execute against development pipelines. Concerns were sparked in September following the announcement from NextEra Energy Partners (focused on clean energy projects such as wind and solar), who have reduced their distribution growth outlook, citing tighter monetary policy and higher rates impacting financing. Their share price dropped over 50% in a week and led to souring sentiment in the sector, as it raised doubts over peers' ability to deliver construction projects.

Within the model portfolios, we have favoured infrastructure investments into operational assets, and less so into the construction aspect, although there is some exposure. We continue to engage with managers in this sector (Foresight, Gravis, RM funds etc) as well as analysts from major banks who supply us with research, and the continued rhetoric is they offer excellent value. We are under no disillusion as the drag this asset class has had on portfolios. They are trading on large discounts to their NAV, and we feel much of the damage has already been done, which is why we remain convicted to this asset class given we feel we would be selling at the incorrect time.

Given growing concerns over the connection of utility scaled batteries and the construction aspect, we have reduced our exposure to this sub-sector in bespoke portfolios, and remain committed to operational assets, which provide an element of inflation linkage in their longer-term contracts.

Energy

Following the announcement that the OPEC+ cartel would maintain supply cuts, the price of oil has continued its trend towards $100 (blue line below) a barrel, and with it, the share price of many within the sector (the white line being the global oil & gas index):

Brent Oil (blue) & Global oil & Gas equity index (white) - Source: Bloomberg

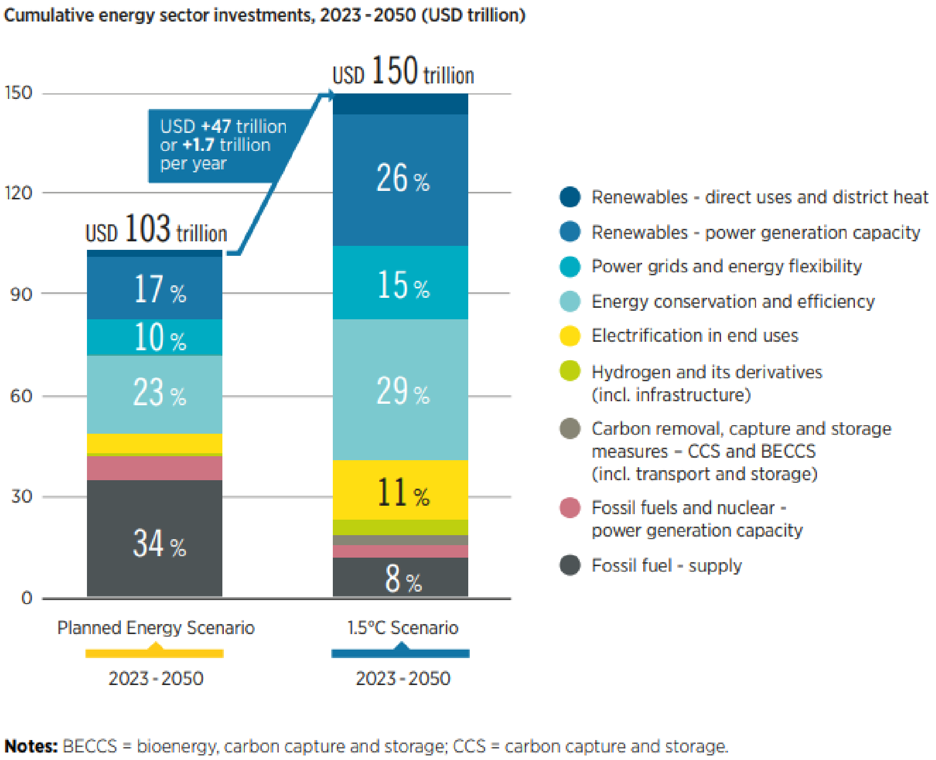
Whilst we do not want to sound like a broken record, it is an important factor to note: Our model portfolios apply a strict screen, such as fossil fuels, but also areas such as defence, tobacco and arms. Over the last few years, these sectors have been some of the strongest performing at times, particularly energy and defence given the geopolitical landscape. When this happens, it can lead to a period of underperformance versus the 'general' market. This has been exacerbated by the war in Ukraine and the inflationary pressures brought about in the post-covid recovery and ultra loose monetary and fiscal policy.

As policy has tightened, and as we have alluded to earlier, renewable projects have been weighed down by the higher cost of capital. Certain renewable projects under construction have hit the headlines for being halted due to spiralling costs, which has been a product of the previously ultra-competitive bidding landscape, leaving little margin for error. We are now seeing this reverse or be rebuked, as developers focus on higher yielding opportunities. This was evidenced at the latest UK wind auction, which saw zero bids received given the guaranteed price for electricity was too low, in the face of higher raw material costs. We are hopeful this will be a large wake up call and prompt action at a critical time, and support developers in achieving more realistic returns.

Nonetheless, with less projects in the pipeline, and legacy backlogs to work through, equipment manufacturers such as Vestas Wind Systems have been placed under pressure. Meanwhile, a billion-dollar impairment by Orsted (one of the largest offshore wind farm operators), due to supply chain problems and higher rates, has further weakened sentiment towards the sector. This has been reflected in the clean energy index returning -27% year to date, and given portfolios exposure to this sector, they have been placed under renewed pressure just as we felt supply chain issues were being worked through and subsidies from legislation such as the Inflation Reduction Act were beginning to feed through.

Climate Action and Affordable and Clean Energy are targets of the United Nation's Sustainable Development Goals, and the model portfolios have a number of companies aligned to them. Over the last few months, we have experienced unprecedented sea and land temperatures, with the average surface temperature in September 1.75 degrees warmer than pre-industrial levels. We are off track to meet our targets and climate action is critical, however there is a lack of business certainty and support. As we mentioned in the last report, the International Renewable Energy Agency in their World Energy Transitions Outlook 2023, has shown that we are currently projected to fall short by $1.7 trillion per annum in investment to reach the 1.5-degree scenario by 2050, as highlighted below:

Global investment by technological avenue: Planner Energy Scenario and 1.5-degree Scenario, 2023-2050



World Energy Transitions Outlook 2023, Source: International Renewable Energy Agency

The Intergovernmental Panel on Climate Change (IPCC) Sixth Assessment Cycle Synthesis Report states that observed temperature increases are unequivocally the result of greenhouse gas (GHG) emissions resulting from human activities. There is a clear need to have a just transition away from fossil fuels, with climate change representing a number of risks. Mitigation, adaptation and development is required, but will need capital to flow into resources and solutions. Public support such as the US's Inflation Reduction Act or the EU's REpowerEU or Green Deal Industrial plan provide this, and here is where the investment case lies.

A large number of companies within the portfolios are developing and applying innovative solutions to issues such as clean energy, but also areas such as water, mobility and waste management. Vestas Wind Systems saw a four year high in US orders in Q3 as fiscal stimulus begins to take effect. We feel the market is over discounting these stocks for the above issues, you only have to look at the order intake to see the huge demand some of the portfolio companies are receiving for their products.

Many of these companies are longer duration plays, i.e., cash flows further down the line which are greatly impacted in analysts DCF models. However, we feel we are approaching a turning point in this story, providing a hard landing is avoided. The interest rate scenario will play a big role, and as highlighted above, we feel this will begin to turn more dovish due to a discounting of a policy mistake. Whilst not wanting to over commit, we sit around our neutral level for equity exposure, but well positioned to benefit from a pivot scenario.