THE FRY GROUP
ESTD 1898

Quarterly Investment Update

JULY 2023

A divergence of views between equity and bond markets

As we reach the halfway point of the year, one would be forgiven for thinking that the resilience seen across global stock markets reflected decreasing concerns over the state of the global economy. However, looking through the data reveals that a large portion of headline returns have been dominated by a few select stocks, predominantly focused on artificial intelligence (AI). Other factors from the first quarter, including the markets' ongoing interpretation of inflation, remain at play and will likely continue to dominate the narrative heading into the second half of 2023.

Western central banks' ongoing concerns around core inflation (ie stripping out the more volatile food and energy components), mean they continue to be committed to further rate increases. That said, equity and bond markets disagree somewhat as to how persistent restrictive monetary policy will become. Equity markets shrugged off messaging from the Fed and global equities returned +6.28% (US Dollar) for the quarter, whilst bond markets fell, with 10yr US Treasury yields nearing 4%.

Global equity market performance has varied widely with higher increases in Japan (+6.45%) and the US (+8.61%) than in Europe (+2.74%) and the UK (+2.34%) – all pricing in US Dollars. This is partially explained by the different inflation backdrops between these countries and their associated monetary policies. Moving into the second half of the year, the negative effects of interest rate rises from the past 12 months on corporate earnings and the broader health of company balance sheets are likely to present ongoing challenges. With that in mind, we remain committed to a balanced strategy with ongoing levels of broad diversification, including an emphasis on alternative asset classes to guard against any potential downside.

Charlie Buxton
Head of Investment Management
E. charlie.buxton@thefrygroup.hk

Market Focus

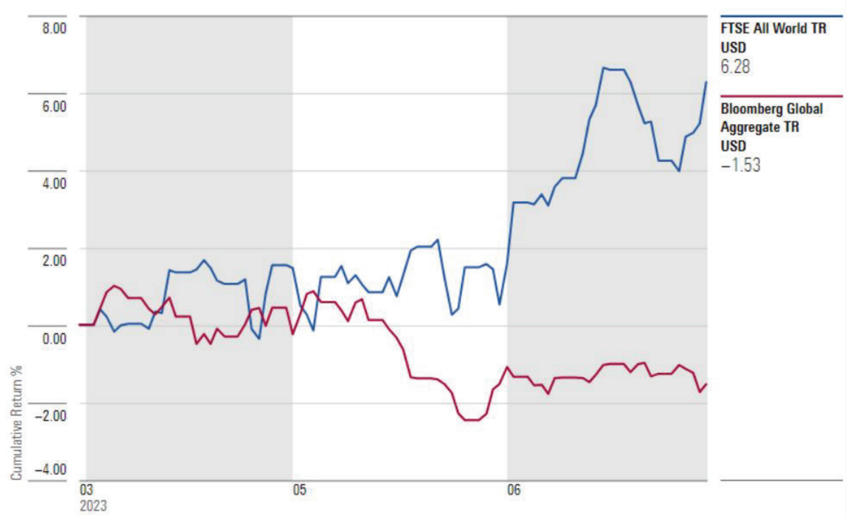
Global fixed income

Fixed interest has continued to struggle in the first half of 2023 despite initial optimism at the end of last year. The question on most economists’ minds is when are we going to get to the top of the interest rate cycle, or at least when will there be a change in central bank narrative. Central bankers cannot be completely sure of the long-term effect of the rate increases already put in place. Whilst, no doubt, rising interest rates and the increased cost of capital will slow the global economy - the questions are when, and to what extent.

A 3% gain in the global bond market during the first quarter boded well for a strong rebound as inflation was initially deemed to have peaked and reduced interest rates were priced in for the end of the year. Data from Morningstar showed that investors favoured bonds in the first five months of the year, with nearly $113bn of inflows, compared to $107bn of outflows over the same period in 2022. This short-term confidence has since waned due to more persistent core inflation in some economies.

Fixed interest investors now seem to be on hold for the time being as expectations of falling yields have yet to be fulfilled. The persistent messaging from major western central banks is hitting home, as investors have become more cautious in the short term, based around an expectation for rates to remain elevated. This is particularly the case in the UK, which now offers some of the highest yields across the developed world, with a 10-year gilt yielding 4.4%, compared with 3.8% in the US and 2.5% in Germany.

EQUITIES & BONDS DIVERGE FOR THE QUARTER



Data Source: Morningstar Direct

EQUITIES MARKET

United States

The continued strong performance of the US stock market this year is causing another divergence, in the form of ‘growth’ and ‘value’ styles, with the former significantly outperforming. The core seven or so growth stocks that have lifted the returns of the broader US market by 16.9% (US Dollars), have been focused on the tech sector. Apple, at a valuation of $3tn, is larger than the entire UK FTSE 100 and yet delivers around

20% of the profit. The driver for much of the latest growth in the US has been the focus on AI and how these mega cap companies will benefit.

More broadly, unemployment continues to remain at historically low levels, with US non-farm payrolls beating market expectations and showing ongoing evidence of a tight labour market. US inflation (as measured by CPI) declined to 0.1% (month-on-month) in May, easing from a 0.4% increase in April, amid a continued decline in the cost of energy. This brought down the annual rate to 4.0%, below expectations of 4.1%.

However, with inflation remaining above the Federal Reserve's 2% target, it raised interest rates by 25 basis points (bps) in May and - whilst it did not hike rates in June - it adopted what economists have termed a 'hawkish pause'. The 'dot plot' of rate predictions indicates two further rate rises in 2023, contrary to market pricing at the start of the year.

UK

UK equities fell over the quarter with the large UK-quoted diversified energy and basic materials groups the most significant detractors. This was largely due to broad-based weakness in commodity prices and concerns over the outlook for the Chinese economy. Sterling strength weighed on significant US Dollar earners such as resources and consumer staples.

A number of domestically focused areas of the market also underperformed as the Bank of England (BoE) raised rates twice – in May and then again in June to 5%, the highest level since 2008. The UK is experiencing more signs of embedded inflation and of a wage-price spiral than other economies.

Europe (excluding UK)

Despite the ongoing war in Ukraine, a sharp increase in interest rates and the threat of a global recession, the eurozone managed to avoid a contraction in the second quarter, achieving modest GDP growth of 0.7%. It is also benefiting thanks to lower energy prices, low unemployment levels and fiscal stimulus across much of the region. The IT sector was boosted by semiconductor stocks, which came in the wake of higher-than-expected sales projections from some US chipmakers. Among financials, banks outperformed as their near-term earnings are expected to be strong and sufficient to return large amounts of cash to shareholders.

Japan

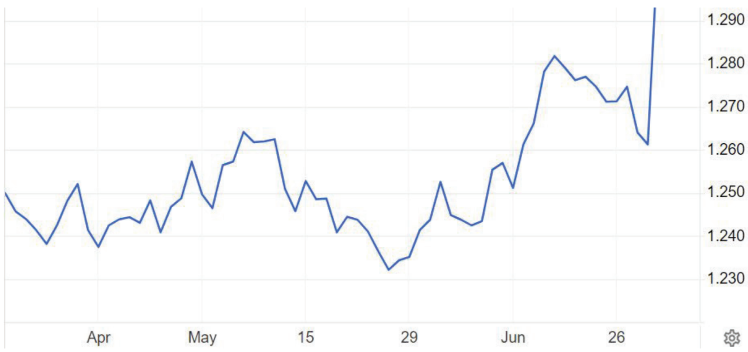
The Japanese stock market has performed well so far this year, returning +28.3% at the end of June, in local currency terms. These gains have come amidst ongoing expectations of corporate governance reforms and structural shifts in the Japanese economy. A corporate governance code was introduced in 2014 and companies are now responding to shareholders, beginning to look at ways to improve shareholder returns by restructuring, buying back shares, and selling unprofitable assets. Whilst these structural reforms have contributed to improved profitability, there have also been other catalysts driving the current rally, including a weaker Yen and the reopening of China's economy. Japan's inflation rate has also risen – something the Bank of Japan has been trying to achieve for decades – which has stimulated consumer spending.

Asia (excluding Japan)

Asian equities recorded a negative performance in the second quarter, returning -1.26% (US Dollar). China, Malaysia, and Thailand were the worst-performing index markets, whilst share prices in India, South Korea and Taiwan gained. Chinese equities were sharply lower in the second quarter as - after initial optimism at the start of the year - various economic data points have since disappointed, pointing to a slower post-Covid recovery than many had expected. Factory output in China has also slowed due to lacklustre consumer spending and weak demand for exports.

Shares in India gained, driven by foreign inflows and steady earnings, whilst equities in Taiwan also advanced, driven by gains in technology stocks as investors rushed to buy AI-related stocks. That same enthusiasm for AI-related stocks also accounted for gains in South Korea, where a significant component of the indices has exposure.

STERLING RALLIES TO 15-MONTH HIGH AGAINST THE DOLLAR



Source: Trading Economics

Currency

Sterling strength continues to be a feature of 2023, now at a new 15-month high, after data showed the British economy shrank by less than expected in May and the Dollar dropped on the back of cooling US inflation. The UK's inflation backdrop also remains a concern, following stronger-than-expected UK jobs numbers, sticky wage growth and core inflation data remaining elevated. This contrasts to other developed nation currencies, such as the Euro and Dollar, whose economies are starting to see inflation edge down, potentially allowing for comparatively softer monetary policy. The Dollar has remained in a trading range against most currencies other than the Yen, where the Bank of Japan did not follow through with a tightening of monetary policy and weakening it further from 139 to 144. The Yen has now fallen 10% against the Dollar since late March.

Commodities

Commodities recorded a negative performance in the second quarter, with industrial metals - including zinc, nickel, and aluminium - all sharply lower. Within energy, Brent crude declined, driven by weak demand from China and concerns over the health of the global economy. Food prices also fell, although there was little evidence of it in the UK, where food price inflation over the last 12 months has been around 20%. In Europe, food prices have been inflated since the Russian invasion of Ukraine and by unfavorable regional weather conditions. Whilst gold is up +7.72% year-to-date, driven by expectations for lower interest rates and concerns in March around events across regional US banks, the quarter itself saw it in negative territory. This was driven by expectations for lower interest rates by year end being moderated – as an asset which provides no yield, it traditionally benefits when rates expectations are lower.

Conclusion

Until recently, leadership in the US equity market has been provided by a narrow group of stocks, with a bias to technology and artificial intelligence. At a macro level, the recent Federal Reserve meeting showed an upgrade to projections of economic growth and, so far, company earnings have proved broadly resilient, with investors expecting improvements to profitability in 2024.

However, concerns remain over trying to model the long and variable lag associated with tightening monetary policy in an inflationary world, which first began at the start of 2022. Bonds continue to struggle in this environment, being down -1.53% (US Dollar) for the quarter.

Outside of the US, equity markets appear to be reasonably valued, unless we experience a lasting economic downturn. When US rates eventually peak, a point on which investors continue to grapple with, the valuations within Asia and selective emerging markets, coupled with their stronger relative growth prospects, could reward investors with a medium-term horizon.

No doubt challenges remain, and the ripple effects of higher interest rates may come to the fore unexpectedly, in a way which economists have thus far struggled to predict. However, with the Bloomberg consensus for World GDP growth rising from a low of 2.1% in February to a current 2.6%, we remain cautiously optimistic that a 'hard landing' may be avoided. As ever, retaining an appropriate level of diversification across asset classes, regions and styles remains key to avoiding the potential pitfalls that could emerge at any point.

HEAD OFFICE (UK)

The Fry Group, Crescent House, Crescent Road,
Worthing, West Sussex BN11 1RN

T. +44 (0)1903 231545
E. enquiries@thefrygroup.co.uk

HONG KONG
E. info@thefrygroup.hk

SINGAPORE
E. info@thefrygroup.sg

BELGIUM
E. info@thefrygroup.be

DUBAI
E. info@thefrygroup.ae