Wealth Management

Quarterly report

Q2 2023 market review

Forward-looking
for generations

Cover image
Bauer brothers, Hortus Botanicus, detail from "Lilium," 1776/1804

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Sanjay Rijhsinghani, Chief Investment Officer LGT Wealth Management

Q2 2023 summary

Whilst in the first quarter, most asset classes, including equities and bonds, experienced a rally, the second quarter brought a more mixed performance for markets. Equities outperformed bonds as investors started to price in a soft landing. All the while, central banks continued to raise rates higher than anticipated in response to stickier inflation.

At a glance

- Stickier inflation prompts hawkish central bank rhetoric.
- Hiking cycle is no longer synchronised.
- Central banks will emphasise data dependency.
- Technology stocks lift the broader market.

Macro summary

The concentrated rally in the US during Q2 demonstrated how an emerging mega trend like AI can propel markets upward, even in an uncertain macroeconomic environment. The NASDAQ, dominated by US tech companies, stood out with a 13.1% increase in Q2, driven by the excitement surrounding Artificial Intelligence (AI) ventures. A few tech stocks were responsible for the majority of the S&P 500's growth during this period. The key question moving forward is whether AI will contribute to overall market earnings growth.

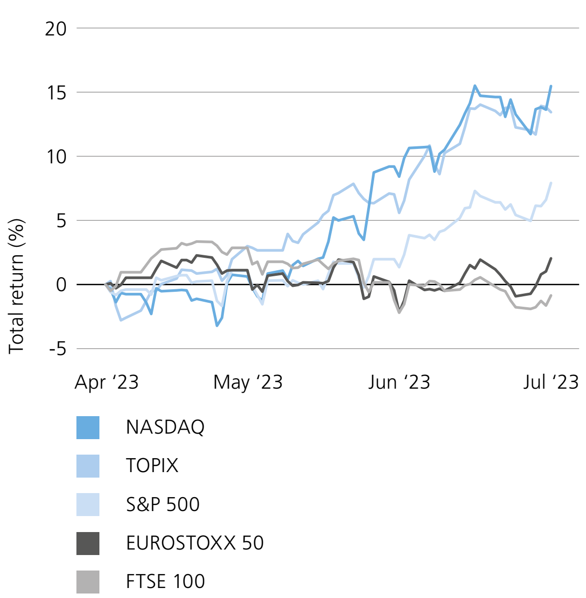
Sentiment towards equities improved during the quarter as concerns about a banking crisis subsided after the collapse of SVB and Signature. The bi-partisan resolution of the debt ceiling in May went to the wire, but saw a default averted. Despite signs of a slowing global economy, the US economy remained resilient in the face of rising interest rates, and better-than-expected corporate earnings drove positive returns for indices in the quarter. The Federal Reserve (Fed) decided to keep interest rates unchanged at its June meeting, given that headline CPI fell to 4% and that the cumulative effects of 5% of tightening are yet to be felt. However, Chair Powell hinted that continued strength in the labour market would determine whether this was a pause or a 'skip'.

In contrast to other developed markets, the UK market underperformed, delivering a negative total return over the quarter. Lower commodity prices, a strong pound and concerns about higher interest rates weighed on the FTSE 100. While headline inflation fell from double digits due to energy base effects, core inflation surprised to the upside with new multi-decade highs. Taken together with a strong labour market, this drove the Bank of England (BoE) to adopt a larger 0.5% rate increase to 5% in June. Further rate hikes are being priced in, which has seen fixed-rate mortgage rates rise to around 6%. While those re-mortgaging in the second half of 2023 are facing a significant increase, the overall impact of higher rates is less pronounced in the short term than prior cycles given the high share of fixed-rate mortgages and those owning houses outright.

The BoE was not the only central bank delivering hawkish surprises. The Canadian and Australian central banks unexpectedly re-started their hiking cycle, demonstrating how vigilant central banks have become on any inflation overshoot. The European Central Bank (ECB) raised rates as expected, but also raised the prospect of rate hikes continuing for a while longer. On the other hand, the loss of momentum in China saw its central bank enact 0.1% rate cuts. While the authorities talk about stimulus to boost growth prospects, equity markets in China and Hong Kong were down over the quarter. Given current valuations, the upside surprise of any action could be significant. The Bank of Japan has maintained its loose monetary policy. The resulting further weakening of the yen, paired with a stronger-than-expected economy and cheap underlying relative stock valuations, drove Japanese equities higher. This has been further supported by investors wanting to diversify away from China, albeit remaining invested in Asia.

In summary, western central banks are closer to the end of their hiking cycle. The effect of prior increases is expected to have profound economic effects over the coming quarters. However, given recent inflation overshoots, data dependency will be key. Investors have turned their attention to AI and economic/earnings resilience, which has driven markets higher over recent months. While AI has tremendous productivity potential over the longer run, valuations for its darlings seem stretched. We continue to advocate for a selective approach of quality companies that can display long-term compounding of earnings.

Total return of major indices over Q2 (local currency terms)



Source: Bloomberg, LGT Wealth Management

> "We continue to advocate for a selective approach of quality companies that can display long-term compounding of earnings.
>
> Sanjay Rijhsinghani, Chief Investment Officer LGT Wealth Management

Fixed income

In the aftermath of the US regional banking crisis, that eventually spread and engulfed Credit Suisse, there was an expectation that this would bring us closer to the end of the hiking cycle. Even though central banks are mandated to deliver price stability, should a risk to financial stability present itself, this would then become the priority.

Over the past few decades, we have seen just that, notable periods include the Dot-com bubble and the financial crisis of 2007-08. However, given elevated price pressures, central bankers are taking no chances and continue to raise rates. There is much debate on how effective monetary policy is as a tool in fighting inflation given how debt obligations have been termed out. Arguably, this could support further increases. On the other hand, this also raises the risk of policy overkill given the lagged transmission of prior increases. A very difficult balance, further complicated by credibility challenges.

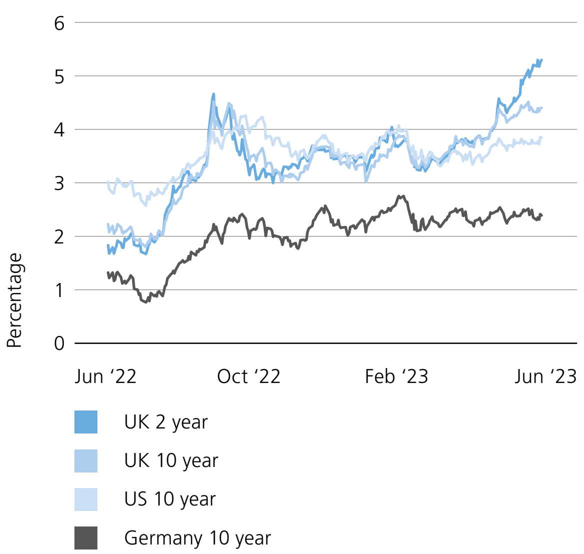
The Bank of England grapples with uncertainty

While the Bank of England (BoE) was first out of the gates in starting its hiking cycle, the rate of increases it adopted were smaller. It placed a high degree of emphasis on the decline in real incomes, a function of elevated energy costs, to deliver the slowing of the economy. However, as base effects are fading, it seems that the BoE underestimated the underlying strength of the economy. Part of it is due to fiscal intervention, which stunted the impact on real wages, but also the underlying strength of the labour market. Employers were trying to attract/retain staff and offered higher wages. The government also increased salaries given the wave of protests amongst public sector employees.

As annualised core inflation moved to new multi-decade highs over the quarter (7.1%) and wage data proved stronger (7.2%), BoE governor Bailey admitted that the UK may be facing a wage price spiral. This raised further questions about its forecasts, and thus its credibility, prompting a larger 0.5% increase in June. As rates stand at 5%, the question now for investors is whether they will need to raise it to levels above 6% as the futures market has priced in.

These developments already had a pronounced impact on mortgage rates which increases the concern about the resilience of Britain's housing market. The shock of this turn of events meant a sharp increase in gilt yields over the quarter, with two-year gilt yields rising by 1.8% to 5.27%. These are above the levels seen during the disruption of the 'mini-Budget' in autumn 2022. Although rates moved higher across the board over the quarter as the banking crisis moved in the rear-view mirror, the UK was an outlier.

UK, US and Germany: two and ten-year yields



Source: Bloomberg, LGT Wealth Management

Projections at the Federal Reserve

Inflation credibility was not an issue for the Fed and the ECB. The Fed tried to carefully convey that its decision to hold rates in June should not be seen as a pause. This was reflected in the projection for rates which saw Federal Open Market Committee members support two further quarter point increases. Although the labour market has shown signs of easing, it remains historically tight. The Fed wants to maintain room to respond should wages move to levels that are not commensurate with their inflation target. While the US economy has proven to be more resilient, it has nevertheless not been exempt from the poor global trend in manufacturing and trade.

A technical recession in the Eurozone

Meanwhile, the ECB has continued hiking and strongly hinted that they would increase rates in July from 3.5% to 3.75%. Like the US, headline inflation has fallen sharply across the currency bloc, but core price pressures remain elevated. However, the growth picture has not been as rosy. The Eurozone, and Germany in particular, were in a technical recession as the economy contracted modestly between October 2022 and March 2023. This occurred despite fears of energy blackouts being avoided and fiscal intervention to help with energy bills. Furthermore, as the cheap emergency ECB lending facilities get repaid by the banks, this raises

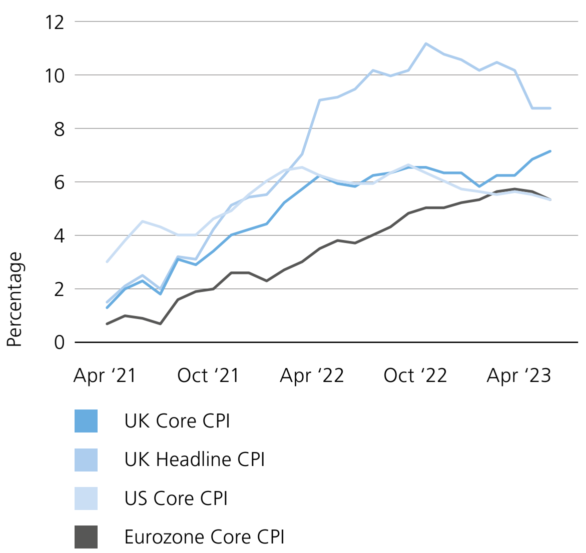
the cost of financing thereby tightening credit conditions further.

Corporate bonds

In terms of the corporate bond market, it recovered most of the widening in spread in the aftermath of the banking crisis at the end of Q1. However, looking at yield levels outside of the UK, for reasons discussed above, these remained remarkably resilient. Combined with a relatively benign environment for risk assets, this saw corporate bonds deliver solid excess returns versus government bonds, but relatively flat total returns.

Overall, as central banks reasserted their hawkish narratives over the quarter, it does appear they are determined to bring core price pressures down and perceive too little action as the greater risk to their mandates. As such, policy will continue to be volatile around key data releases.

UK, US and Eurozone inflation



Source: Bloomberg, LGT Wealth Management

> **“Given elevated price pressures, central bankers are taking no chances and continue to raise rates.**
>
> Jeremy Sterngold, Deputy CIO LGT Wealth Management

Equities

International Equities

While the first quarter of 2023 saw almost every equity market sprint out of the blocks, the second was a lot more selective.

In Europe, the CAC 40 in France and the DAX in Germany eked out a 1% and 3% gain respectively. In the context of gains elsewhere, these look miserly, but it is worth remembering that a 3% gain in a quarter is actually very respectable and (if it continues) leads to a 13% annual gain and, over seven years, more than doubles.

However, when the technology-heavy NASDAQ index in the US is up 15% in the quarter it is clear what takes the headlines. Indeed, Q2 2023 was another one of those quarters (not unlike Q4 2021) where the sheer amount of dollars added to the market capitalisations of the world's already largest companies was (and is) eye-watering.

The easy narrative has been to talk and talk about artificial intelligence (AI) as the sole reason for moves in tech company share prices. Chip company Nvidia (+52%), which indicated revenue would be 50% higher than their expectations next quarter, provided some serious rocket fuel (as did their mention of AI processing power as the reason why). However, Apple (+18%), Amazon (+26%), Tesla (+26%), and Microsoft (+18%) are not all 'AI plays', or even all technology companies, yet they added a cumulative $1.1 trillion in market cap during the quarter: yes, over a thousand billion dollars (or seven Shells).

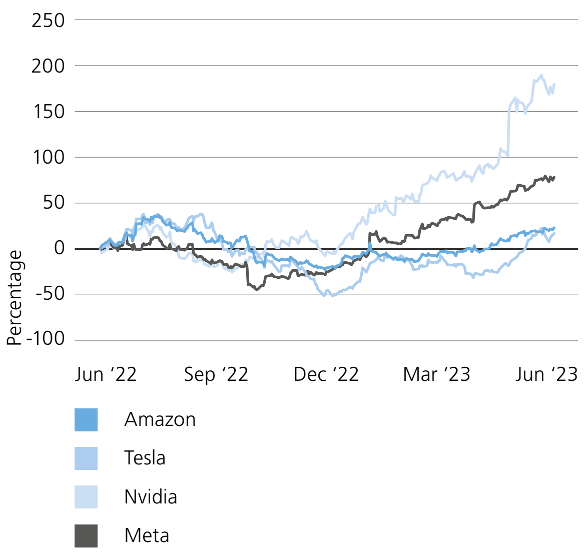
Alphabet, the owner of Google, rose 16% (+$200bn market cap) while Meta / Facebook rose 36% and has now added $420bn to its market cap this fiscal year, even as it has invested tens of billions in the so-called metaverse with not a cent of revenue in sight.

Many of these companies had a very tough 2022, though more on the share price than the operational side, so there is a degree of (extremely rapid) catch-up as wobbles in the fourth quarter of 2022 for earnings have for the most part subsided. We have all been led to believe the world would be in recession, yet (as yet) we are not. Indeed S&P 500 earnings per share in Q1 2023 rose 5% even into the teeth of persistently high inflation. If it was a relief rally, then it was a very sharp and narrowly focused one.

China disappointed once more with the Shenzhen index falling -5%, and Shanghai -2%, as the great reopening trade has turned out to be a disappointment.

Indeed, the only other market to join the Q2 party was Japan, where the Topix index rose a NASDAQ-esque 14% (though only 5% or 2% for the dollar and sterling investor respectively). Semiconductor manufacturing equipment maker Tokyo Electron rose 28%, but showing it as a 'Japan trade', rather than a tech one, Toyota also rose 23%, commodity trader Mitsubishi Corporation 46%, and bank MUFG 26%.

Amazon, Tesla, Nvidia, and Meta share price return over one year



Source: Bloomberg, LGT Wealth Management

UK Equities

Investors in the UK equity market might be disappointed as the first six months of 2023 were characterised by a lacklustre 3% gain in the FTSE 100 index, hampered by a stronger pound. This is in contrast to the stellar performances in the S&P 500 index highlighted already, led by the tech megacaps.

Large UK stocks were held back by weak commodity prices, inflation and interest rates, and the ensuing recession fears. These factors affected the more domestically focused mid-cap stocks, given the unease over the outlook for retail sales and the mortgage market.

UK shares are valued cheaply across a number of metrics, but still appear shunned by global investors. To some extent, this reflects quality differences, with a market like the US generally considered to be higher quality thanks to higher weighting of 'knowledge industries' like Tech, and a lower weighting of capital-intensive industries like oil and mining. It also reflects relative growth considerations and an appreciation that the UK market is only host to a limited number of potential world-class companies in sectors that are shaping the future.

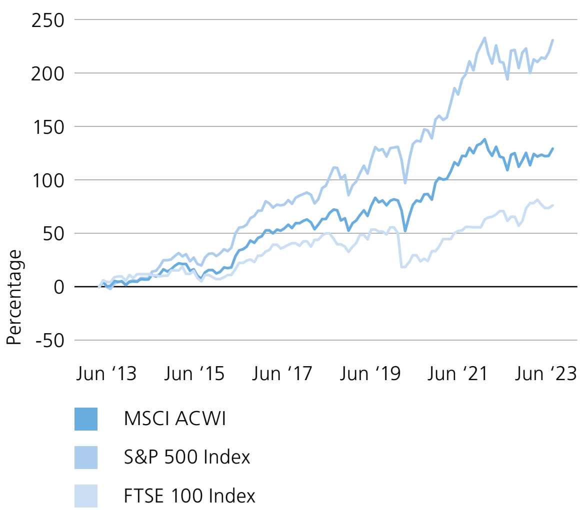
We acknowledge that the UK should perform well if global investors perceive it to be the beneficiary of accelerating global growth, thereby lifting oil and commodity prices. Stability could trigger a hunt for bargain-basement stocks that might also be bid for.

While long-term growth prospects are challenging, we see value in certain selective areas. There are some businesses we would regard as being natural takeover targets. Furthermore, there are a number of high-yielding insurers who may well prove to be natural beneficiaries of regulatory changes that are being considered.

For the avoidance of doubt, we continue to prefer larger FTSE 100 stocks to companies in the more domestically-orientated FTSE 250 index. According to the property website Rightmove, a third of all homes for sale in the fourth week of June were listed with discounts on their asking prices. This is a post-COVID high and up from 18% a year earlier. With mortgage costs rising steeply, impacting first-time buyer confidence, we continue to be concerned about the outlook for UK housebuilders. Separate data highlights that retail insolvencies have soared to a new decade-long high and, with disposable incomes squeezed by higher rent and mortgage costs, we remain cautious on UK retail stocks.

We should also note that the relative pressure being felt by these sectors could be exacerbated if small and mid-sized companies (who account for approximately 60% of UK private sector employment) start cutting jobs in response to a downturn in the economy, and/or a hiatus in decision-making ahead of the next General Election.

MSCI ACWI, FTSE 100 and S&P 500 ten-year total return



Source: Bloomberg, LGT Wealth Management

Key market data

Key market data (as at 30 June 2023)

Asset class	Level	1m %	3m %	6m %	1y %	3y %	5y %	YTD %
Equity indices (total return) *								
FTSE All-Share (GBP)	4096	0.72	-1.48	0.52	3.94	20.09	-2.52	0.52
S&P 500 (USD)	4450	6.47	8.30	15.91	17.57	43.55	63.72	15.91
Euro Stoxx 50 (EUR)	4399	4.29	1.95	15.96	27.33	36.02	29.55	15.96
Nikkei 225 (JPY)	33189	7.45	18.36	27.19	25.75	48.91	48.80	27.19
MSCI World (USD)	2318	5.72	7.32	15.46	18.85	45.96	62.67	15.46
MSCI AC Asia Pacific ex Japan (USD)	607	2.86	0.04	4.57	3.37	13.92	17.73	4.57
MSCI Emerging Markets (USD)	59844	3.54	1.85	5.76	3.76	13.47	18.01	5.76
10 year bond yields **								
UK	4.38	0.20	0.89	0.71	2.15	4.21	3.10	-1.52
US	3.83	0.19	0.36	-0.04	0.82	3.17	0.97	-3.06
Germany	2.39	0.11	0.10	-0.18	1.05	2.84	2.09	-1.52
Japan	0.40	-0.04	0.05	-0.02	0.17	0.37	0.36	-0.25
Commodities (USD)								
Gold	1922	-2.18	-2.43	5.57	6.49	7.14	53.53	5.57
Oil	74.90	3.08%	-6.11	-12.82	-34.76	82.02	-5.72	-12.82
Currency								
GBP-USD	1.27	2.58	2.82	5.69	4.69	2.89	-3.70	5.69
GBP-EUR	1.17	0.24	2.39	3.39	0.31	5.93	3.05	3.39
EUR-USD	1.09	2.34	0.42	2.23	4.36	-2.86	-6.56	2.23
USD-JPY	144.54	3.45	8.60	9.54	6.39	33.97	30.49	9.54

Source: Bloomberg, ICE, London Stock Exchange, MSCI, Standard & Poor's, Stoxx Tokyo Stock Exchange

* Performance is given on total return indices, but the levels are for the main indices.
** Displayed as absolute changes in yields, rather than percentages.

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Western central banks are closer to the end of their hiking cycle. The effect of prior increases is expected to have profound economic effects over the coming quarters.

Sanjay Rijhsinghani, Chief Investment Officer LGT Wealth Management

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