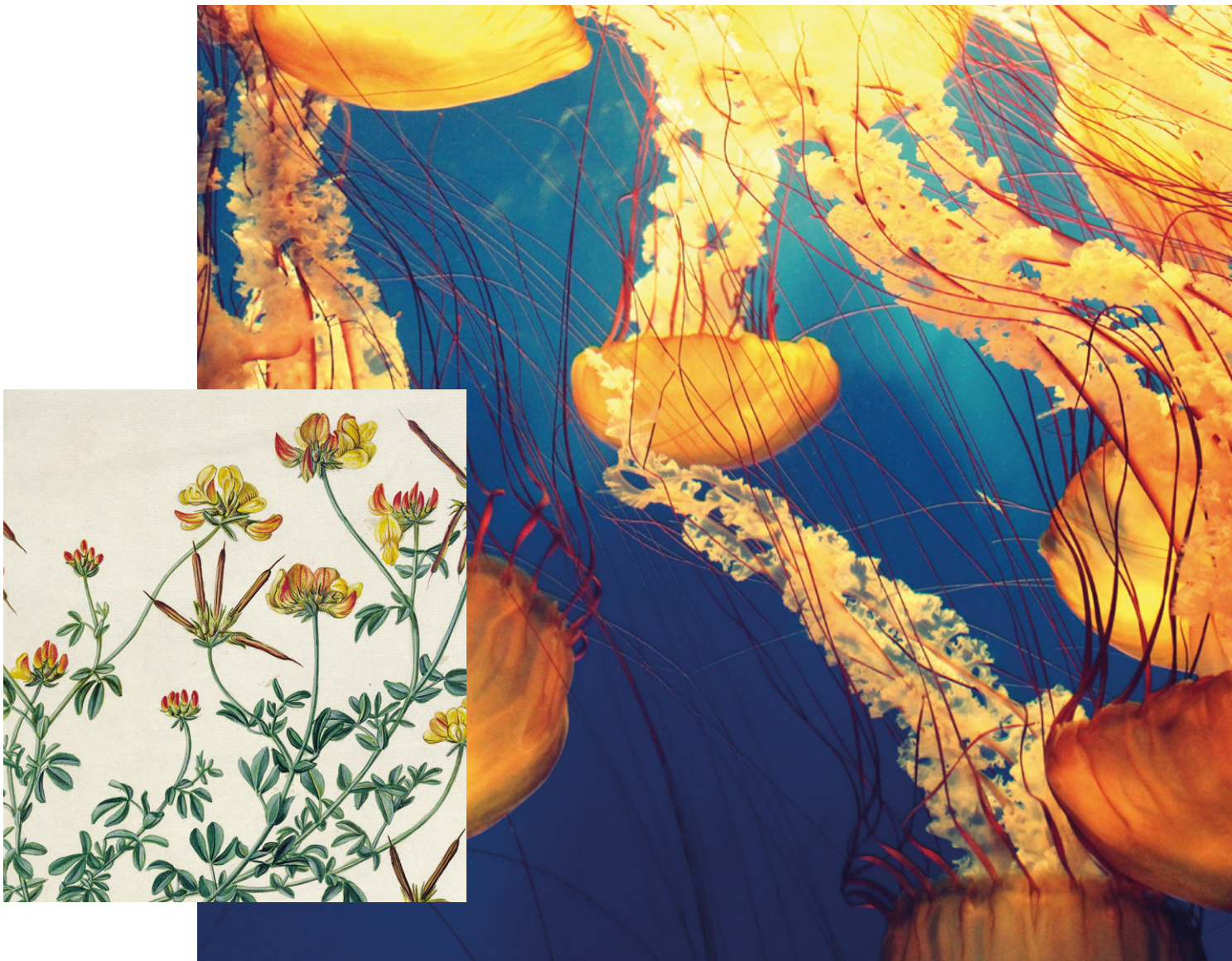




Wealth  
Management

# Quarterly Report Sustainable Portfolio Service

Q2 2023



| Forward-looking  
| for generations



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**Cover image**  
Bauer brothers, Hortus Botanicus, detail from  
"Lotus corniculatus L.," around 1788  
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We have seen some broader based gains within sustainable portfolios, with higher quality exposure now starting to behave more as we would expect in periods of economic uncertainty.

Phoebe Stone, Head of Sustainable Investing

## Q2 2023 summary

### Overview

Global markets continued to stabilise in the second quarter, slowly recovering from the banking crisis as volatility was relatively subdued. Equity markets stayed in positive territory following strong economic data and artificial intelligence excitement. Fixed income markets, on the other hand, generally fell with sticky inflation and the backdrop of hawkish central bank decisions.

### Technology gains

The S&P 500 posted its third consecutive quarterly gain with the technology sector faring particularly well in April and May. The index's largest stocks were bolstered by strong earnings releases from companies like Microsoft and NVIDIA and momentum around artificial intelligence (AI). Meanwhile, financials continued to underperform as concerns migrated from solvency concerns to profitability.

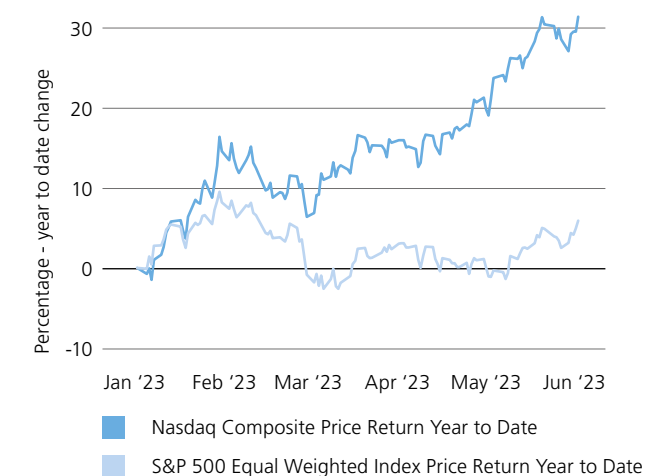
### Stickier-than-expected inflation

In addition, inflation has proven to be more persistent than expected this quarter, with the markets now pricing in a 79% chance of a Federal Reserve hike in July.

Consequently, on the fixed income side, sovereign bonds sold off – long duration bonds such as the 30-year US Treasury (-2.0%) saw losses with similar movements in longer duration German Bunds and French government bonds.

In the UK, The Bank of England surprised the market by hiking another 50 basis points, bringing interest rates up to 5%, the highest since the 2008 global financial crisis. UK headline CPI rose to 8.7% (vs. the 8.4% expected) as inflation in the UK is proving more stubborn – long duration UK gilt exposure suffered as a result.

Nasdaq Composite PR vs S&P 500 Equal Weighted Index PR



Source: Bloomberg, LGT Wealth Management

### US debt ceiling agreement

In May, the topic of conversation shifted from inflation to US debt ceiling concerns as negotiators from both the Democratic and Republican parties came to a consensus and decided to suspend the limit on the US debt pile until 2025. Although this problem has been temporarily resolved, some are concerned liquidity issues could arise in the private sector as the US government issues more debt in the future to make payments.

### Asia markets

Optimism about the Chinese economy was high at the start of the quarter as investors were hopeful after the reopening. Although the employment outlook has improved, unemployment amongst young adults is still too high and investors are now hoping for fiscal stimulus to spark wage growth and, in turn, consumer spending.

Valuations in Japan remain attractive even after the TOPIX reached a 30-year high in May. Commodities fell as global manufacturing sentiment remained weak from the consumer's post-COVID pivot from goods to services.



## Sustainability update

Whilst Q2 provided some relative performance support for our sustainability portfolios, it was a quiet period for significant sustainability news and policy developments.

One announcement that is worth highlighting was the much anticipated release of the International Sustainability Standards Board (ISSB) disclosure standards. This framework provides the first steps towards delivering consistent, compulsory corporate reporting on sustainability and climate specific information.

There are two standards: IFRS 'S1' and IFRS 'S2'. The first outlines the general requirements for disclosure of sustainability related financial information and the second is focussed on climate-related disclosures. When they start coming into force next year, these two standards will create a global baseline for companies to align to with any additional regional requirements being built on top.

The inadequacies and variability of corporate reporting has often been pointed out as the largest challenge for sustainable investors. It is therefore hoped that these new disclosures will increase transparency and comparability. These are the first two standards, but it is expected that more will follow in the years to come, providing specific guidance on areas like biodiversity. This will continue to build out an increasingly diverse and rich set of disclosures.

LGT has been investing in developing our proprietary data and analysis tools for several years. We are therefore excited to see how these developments can improve our understanding. We do not believe that data and reporting provide the answers in isolation, but, when harnessed correctly, they are increasingly an extremely useful tool.

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It is hoped that these new disclosures will increase transparency and comparability.

Siobhan Archer, Senior Sustainable Investing Specialist

# Portfolios in review

## Equity

US equity investors enjoyed positive returns in the second quarter. In the midst of an inverted yield curve, a disappointing Chinese reopening and the persistent threat of a growth slowdown, the S&P 500 advanced 8.7%. The equal weighted S&P 500 was up 4% as larger companies continued to outperform. The NASDAQ Composite was up 39.4% year to the end of the second quarter with stocks like NVIDIA (+189.5%) and Microsoft (+42.7%) leading the charge. Investors are split as to whether AI is another technology related bubble or a genuine opportunity.

The implied volatility of equities has fallen considerably since the acute stress of last year. The VIX Index, which uses option pricing to calculate how volatile investors think stocks will be going forward and is sometimes referred to as a fear gauge, closed the quarter at 13.6%, having peaked at 38.9% in 2022.

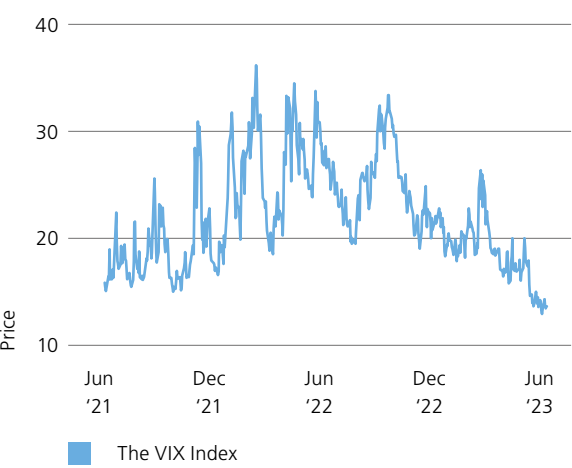
In contrast, the MOVE index, which does a similar job but applies to the fixed income market, has also peaked but has not returned to 'normal' levels. Which index converges with the other will be of great interest to investors over the coming months.

Elsewhere, China's reopening has disappointed, causing stocks to struggle to perform as the MSCI China fell 9.8% during the quarter. The path of recovery has proven to be slower than expected as manufacturing activity figures showed contractions for the third consecutive month, leading to disappointing quarters for the CSI 300 and Hang Seng Index. With MSCI China trading at 10.8 times forward earnings and markedly weak sentiment, any marginal good news would likely be very well received by the market.

Our portfolio did partake in some of the narrow rally with its holdings in Microsoft and Taiwan Semiconductor Manufacturing Company, however capturing the full upside of a rally of this nature is difficult for those holding a diversified portfolio of active managers. Being diversified has its drawbacks but, ultimately, we believe it works over the long term.

Despite the concentrated rally within global equities this year, we have seen some broader based gains within sustainable portfolios, with higher quality exposure now starting to behave more as we would expect in periods of economic uncertainty. As a result, we have seen our core quality strategies post the strongest returns so far this year. Within this, exposure to US stocks has been the primary driver of returns.

The VIX Index



Source: Bloomberg, LGT Wealth Management

## Fixed Income

After the acute banking stress of the first quarter passed, fixed income yields generally rose in the second quarter. The market's expectation of imminent rate cuts has been replaced with a sense that rates will be higher for longer, pushing yields higher. This was reinforced by Federal Reserve Chairman Jerome Powell's prediction that at least two more rate hikes may be required to quash inflation.

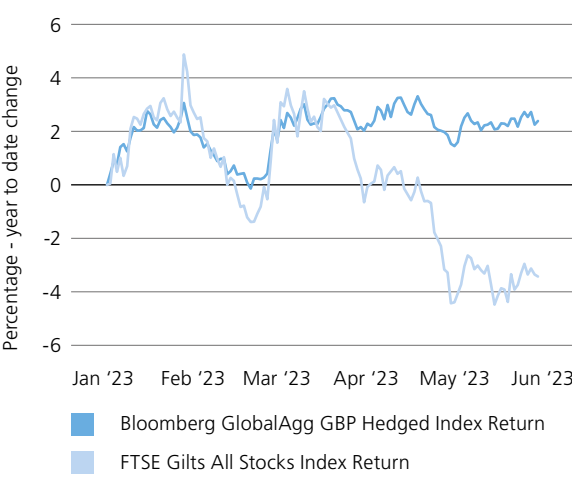
To reiterate a view we have expressed previously, such 'fine-tuning' of interest rate policy should be fairly digestible for risk assets and the economy – the bulk of the heavy lifting (the move globally from 0.0% to around 5.0%) and the resulting impact on asset prices is likely behind us.

US year-on-year headline inflation looks likely to fall considerably over the next several months as some

of the very high monthly numbers from last year fall out and are replaced by more sanguine numbers. It will likely remain above target for some time, but at a level where trade-offs and politics will likely mean the Federal Reserve is able to avoid continuing rate hikes and instead will talk tough and insist that rates will stay high for some time.

The UK emerged as a clear outlier in the fight against inflation and gilt yields moved higher to reflect this. UK inflation seems to be plateauing rather than peaking, which has caused the market to price in a more aggressive 'terminal rate' (the rate at which the market expects interest rates to peak for this cycle). The UK has a particularly difficult set of challenges for policymakers to navigate – high commodity prices, tight labour market, weak growth and a mortgage market that is particularly effective at passing on interest rate hikes.

Global Bonds vs UK Gilts



Source: Bloomberg, LGT Wealth Management

We have felt this impact in our Sterling portfolios via our long-dated UK Gilt position, which has lost approximately 10.1% since purchase. Whilst it is clear with hindsight that we were early, we continue to like this trade, firstly because we expect UK inflation to fall and concerns to turn to growth over the coming months, and secondly for portfolio construction purposes. On the latter, should an exogenous shock occur, whether that be economic or geopolitical, we would expect fixed income to react particularly well given that central banks would have significant scope to cut rates.

Global credit markets continued to be relatively strong as US recession fears continued to be pushed out. The additional yield investors receive for investing in corporate debt versus government debt narrowed and risk appetite improved after the banking crisis in March. This helped our position in the Vontobel Sustainable Short Term Bond fund.



Alternatives

Within alternatives, the Bloomberg Commodity Index returned -3.8% in Dollars as the manufacturing sector remained in contraction. Gold initially rallied at the start of April before selling off as a result of rising yields and resilient economic activity, ending the quarter -2.5%. With supply chains improving, WTI Crude returned -8.8% despite reduced production from OPEC. Given the complex macro backdrop, the HFRX Global Hedge Fund Index generated moderate gains in the second quarter, up +0.1% in Sterling terms.

Persistent inflation and changes around interest rate expectations have negatively impacted the performance of this part of the sustainable portfolios. If financial markets continue to stabilise in the coming months, we believe that both this these exposures will provide diversification benefits to our overall portfolio positioning.

Portfolio positioning

Overall, we are positioned for our base case, whilst also holding positions should a severe recession or a re-emergence of inflation occur. The base case of slow growth, fairly resilient earnings, falling inflation and recovery in China is expressed in the portfolio by a number of positions:

- Investing in quality companies whose earnings should remain steady during a period of slow growth.
- Over the long term, we expect higher growth from Asian equities with cheaper valuations as a support.
- Short-dated fixed income represents as good an opportunity, outside of a crisis, in the space than we have seen in decades as a result of higher yields.

The tail risk scenarios we are concerned about are a nasty recession or a re-acceleration in US inflation. The former would be characterised by a meaningful fall in economic growth, concerns around debt levels and panic in markets. For this scenario, we employ longer-dated fixed income exposure and strategic bond funds. The latter scenario would see global inflation re-accelerating and would require a renewed surge in central bank activity, with terminal rates increasing. For this scenario, we use natural resource equities, alternative exposure and inflation linked bonds.



Performance

Over the quarter, the equity component contributed positively and the fixed income detracting. Yields on UK government issued bonds climbed higher as May's inflation reading exceeded expectations, causing investors to forecast further interest rate rises to combat more stubborn inflation. Longer duration exposure and UK exposure suffered, driven by the long duration UK Gilt but our overall cautious stance helped to deliver downside protection.

The equity component of the portfolio delivered a positive quarterly return with the core quality elements and US exposure generating good returns.

AllianceBernstein Sustainable US Thematic benefitted from the quality growth style bias outperforming over the second quarter and exposure to holdings such as Microsoft, TSMC, ASML, and Alphabet contributed to performance, however Asian exposure detracted.

*All performance figures mentioned are in instrument currency, gross of fees (unless mentioned otherwise) and are up to 30th June 2023. Sources are Bloomberg and LGT Wealth Management UK LLP unless otherwise stated.*

# Outlook

The narrow nature of the S&P 500 advance has been well-documented – over two thirds of the year-to-date gain has been driven by just seven stocks, however in recent weeks this has broadened out somewhat.

## AI is not just a fad

The advance in US stocks has been driven by two things. Firstly, the excitement around artificial intelligence (AI) in the light of ChatGPT's meteoric rise. Chip-maker NVIDIA, which produces the market-leading AI chip, is an obvious beneficiary and their earnings beat was really one for the ages. Other companies are less 'pure-play' – diversified

businesses like Microsoft and Alphabet – for whom AI represents a growing segment amongst more diversified product lines.

As investors, we have been conditioned to be sceptical about new technological advances. Price action in the sector in 2022, combined with a prevalence of novelties that were more hype than real (cryptocurrencies, Web3 or metaverse for example), leaves investors with the obvious conclusion AI is another fad.

Our view is perhaps more nuanced – AI is a real thing that will lead to actual productivity gains and revenue,

and therefore we would not foresee a bubble then bust in the big winners year to date. Nevertheless, by the same token, nor would we be in a rush to buy NVIDIA with a price-earnings multiple of 205 times.

## Recession looking less likely

The second aspect that has driven the rally, particularly the broadening out of the last month to other sectors, relates to the long-predicted recession which has still not yet materialised. The resilience of the US private sector has been nothing short of remarkable and indicates that the neutral rate of interest (the rate at which interest rates are neither accommodative nor restrictive) is much higher now than pre-COVID. Of course, the impact of interest rates can take some time to be felt and we are still waiting to see the full impact, but it seems increasingly likely that a truly nasty, solvency type recession will be avoided.

Both of the above, combined with an improving US inflation picture, should mean that markets remain fairly stable, albeit with perhaps some consolidation in the short term.

## Improving sentiment

One thing that has characterised the market's advance since October has been how much it has been distrusted and disliked by market participants – this has been clear from sentiment surveys. This argument for the market's advance continuing is now retired – the market's advance has many new admirers and sentiment is now improved. This does not normally mean it is time to sell – sentiment most of the time can be largely ignored and only at times of maximum bearishness (or prolonged periods of bearishness) should it be looked at.

The improved sentiment normally represents a market rally moving to its next phase, a phase where markets return to something like normal – a sustainable amount of confidence which causes investors to add to risk assets as and when they have liquidity events. Bull markets, in the end, need bulls. Markets have tested many investors' patience over the last eighteen months but one thing is clear – harvesting risk premia over the long term works, even if we all wish we could regain last year's losses over a shorter timeframe.

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Jordan Kelly, Sustainable Portfolio Manager

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