Investec

OUT OF THE ORDINARY

WEEKLY DIGEST | 03 July 2023

Half-Way House

John Wyn-Evans
Head of Investment Strategy

The half-way house or hut on a golf course is a good place to stock up on re-energising snacks and beverages for the rest of the round. Half-time in sporting events is also a period of refreshment and when tactics are re-evaluated, depending upon how the match is going. This year’s midpoint for investors is likely to induce a bit of soul-searching, as many are lagging behind their benchmarks.

2023 began with the consensus of Wall Street's strategists calling for a down year for the S&P 500 (SPX) for the first time since Bloomberg started to collate the data in 1998. There is a chicken coops' worth of egg on the industry's face. The flagship equity index ended the first half of the year with a gain of 15.9% (or 16.9% on a total return basis including dividends).

US equities are hogging most of the headlines, with Japan coming second, but it's worth putting everything into a bit more context. For example, the SPX has underperformed the EuroStoxx 50 Index in constant currency terms. TOPIX's strong showing in Yen doesn't look quite as impressive when denominated in dollars, pounds, or euros. The MSCI All-Countries Index has delivered a total return of 14.3% (thanks to almost two-thirds of it comprising US shares), although only 8.7% in sterling terms, thanks to the stronger pound/weaker dollar.

The primary focus is on the Tech-laden NASDAQ Composite index, with its 32% rise, and even more narrowly on the FANG+ group, which delivered a return of 74%. And good luck to you if you bought the double-leveraged FANG+ ETF (+183%).

The FANG+ Index's equal-weighted components are Meta (+138% YTD), Apple (+50%), Amazon (+55%), Netflix (+49%), Microsoft (+43%), Alphabet (+36%), Tesla (+112%), Nvidia (+189%), Snowflake (+22%) and AMD (+36%). While a modicum of tracking error in a balanced portfolio is to be encouraged, with the best will in the world, who (in the world of professional money management) is realistically going to have the bulk of their equity exposure solely in that group? And who would not have rebalanced it down at some point along the journey? We should not necessarily beat ourselves up too much for not having been up to the eyeballs in this stuff. Maybe that's a bit defensive, but also nods towards the first principles of risk management and diversification in a broader balanced portfolio context.

It's also worth pointing out that the Dow Jones Industrial Average has only eked out a return of 3.8% so far. While the equal-weighted S&P 500 (SPW) is +6%. Much has been made of the performance gap between the SPX and SPW. Looking at the relative performance chart, it is clear that there were two distinct legs to the trade. The jaws started to open on 8 March, the day that Silicon Valley Bank collapsed. While worries about the health of the banking system pressed down on most of the market, the provision of liquidity to the financial system was interpreted as a new round of Quantitative Easing and this gave a new lease of life to mega-cap Tech. The second leg of the trade kicked off on 25 May, which was the day AI chip-designer Nvidia released its strong results and even stronger guidance. It's been pretty much been 'even Stevens' since the beginning of June, with some evidence of rotation back into cyclicals as the US economy trundles along. In fact, last month the Russell 2000 Index, which comprises mid-and small cap stocks, managed to outperform the S&P 500, the NASDAQ Composite and even the FANG+ Indices.

What themes have influenced performance?

Another feature of this year is how various theme baskets have performed against 2022 results. Goldman Sachs shows all of their US theme baskets on a grid and there is a very strong inverse relationship between last year's performance and this year's. For example, "Meme/Y(ou) O(nly) L(ive) O(nce)" stocks were the worst in 2022 and the best this year. There is only one basket that makes it into the upper right quadrant that achieves a positive return in both periods, and that is Infrastructure, thanks to hefty fiscal incentives. Unfortunately, that does not translate to the UK's quoted Infrastructure sector, which has been hit hard (too hard, in our opinion) by the rising local discount rate. It is also notable that US Regional Banks (which ran into trouble in March, initially with the bankruptcy of Silicon Valley Bank) have been equally dreadful in both periods.

At the bottom of the performance tables amongst major equity markets are China (CSI 300 +0.45% Total Return) and Hong Kong (-2.76% TR) and, for different reasons, the UK (FTSE 100 +3.11% TR, with 2% of that coming from dividend income; FTSE All-Share +2.5% TR, with 2% from dividends here too). China and Hong Kong have suffered from the lack of follow-through to the initial post-zero-Covid re-opening on the mainland. There has been consistently disappointing economic data from China, and little sense of urgency from the government, in terms of providing much hoped-for stimulus.

Here in the UK, it's our old friend index composition again, exacerbated by the recovery of sterling against the dollar. Energy and Pharma have been flat; Resources down sharply; Consumer Staples are lower. Among the heavyweights, only HSBC has made much progress, while domestic banks have struggled under the weight of interest rates, which have risen too high for comfort. Technology still has a microscopic weighting.

On the bond front, it's been a struggle for sovereign bonds, with the Bloomberg Global Aggregate Dollar Index managing a gain of 1.43% (which turns into a loss in sterling). The US 10-year yield is just five basis points below where it started the year. The UK 10-year Gilt yield has risen sharply from 3.67% to 4.38%, in the face of some nasty inflation prints. The 3.25% Gilt maturing in January 2033 (that was effectively the benchmark ten-year Gilt at the start of this year) has delivered a total return of -3.8% in the first six months. The German Bund has fared a little better, with the yield falling from 2.57% to 2.39%.

Credit and Emerging Market Debt have been happier hunting grounds, again with help from decent carry and also some spread compression as the US economy has been more resilient. Using US-listed ETFs as a proxy for Credit, Investment Grade has returned 4.3% and High Yield managed 4.5%. The dollar version of our favoured EM Debt fund (using dollars for comparability) has risen 6.5%.

From a balanced portfolio perspective, the FTSE Private Investor Balanced Index was up 3.45% in the first half. That's a perfectly respectable annualised 7%, but I'm sure some people will feel chintzed when they could have made 10x as much with all their eggs in the FANG+ basket. Thanks to a full US equity weighting, the Bloomberg Global 60:40 portfolio returned +9.7%, although that only translates into 3.8% in sterling terms.

What is the outlook for the next six months?

As we head into the second half of 2023, it looks as though it's still all going to be about the after-effects of inflation and interest rate increases. The front page of Monday morning's Financial Times carried the following headline: "Bond fund giant PIMCO prepares for 'harder landing' in global economy". We're all waiting for that "most anticipated recession in history" which remains reluctant to reveal itself.

In Deutsche Bank's latest client survey, 39% of respondents expected a US recession to begin this year, with another 48% saying it will occur in 2024. But, it is anticipated to be relatively shallow.

If terms of policy mistakes, the most popular answer in the US, UK, and Europe, was to say that central banks will be too hawkish, maintaining interest rates too high for too long as they make absolutely sure that inflation – and inflation expectations – are crushed. This fits with the recession call.

There was an interesting view on bonds versus equities. There was a 51/49% split on the predicted US 10-year Treasury yield, in terms of whether it will hit 4.5% or 2.5% first (it's 3.83% currently). Meanwhile, 76% of clients made the call that the S&P 500's next 10% move will be down, with only 24% saying it will move up. Those betting on the latter are therefore calling for a new all-time high. Finally, on the subject of Artificial Intelligence, a "glass half full" attitude prevailed, with 36% of clients saying it will have a huge positive effect on productivity, and a further 46% saying it will have a noticeable or medium effect.

How investors might respond to benchmarks

There is no point trying to hide the fact that we, too, have been positioned for a weaker, but not catastrophic, economic environment, and so I am slightly disappointed by our returns so far. It's of limited consolation that we are far from being alone in this boat. I was recently informed that US Large Cap fund managers endured their worst ever month of relative performance in May, and I'm not entirely surprised. Hardly anyone had a full index weighting in those FANG+ stocks. But they still generally made positive absolute returns.

Benchmarks can be a useful blunt instrument with which to beat managers, but they can also force managers to take positions that they would fundamentally not agree with, to combat "career risk". Chief Investment Officers around the world said "never again" when they were suckered into buying Telco, Media and Technology (TMT) shares at the peak of the boom in 2000. The current boom might not be anything like as egregious, but there is more than a whiff of Fear of Missing Out (FOMO) in the air again.

Economic Commentary

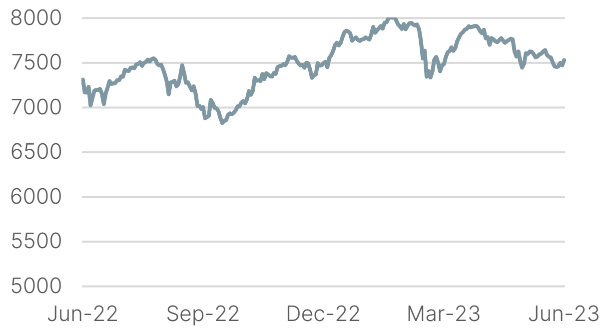
FTSE 100 weekly winners

Just Eat Takeaway.com N.V.	12.7%
Sage Group plc	5.0%
Abrdn plc	4.0%
Pershing Square Holdings Ltd Public Class USD Accum.Shs	3.7%
Rightmove plc	3.7%
Experian PLC	3.6%
Vodafone Group Plc	3.4%

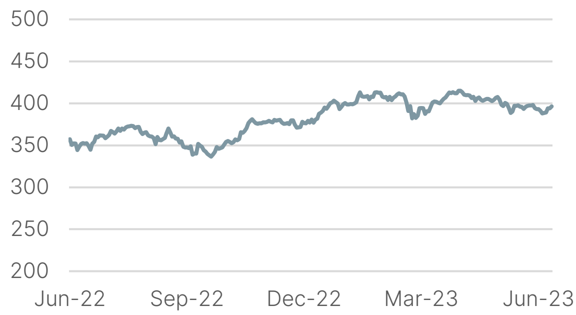
FTSE 100 weekly losers

Persimmon Plc	-7.7%
BT Group plc	-5.3%
Ocado Group PLC	-4.9%
Rolls-Royce Holdings plc	-4.7%
Anglo American plc	-4.2%
B&M European Value Retail SA	-4.1%
DS Smith Plc	-4.0%

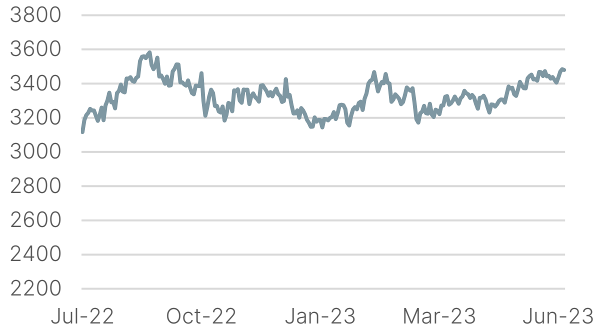
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



All data shown in GBP.

investecwin.co.uk

Member firm of the London Stock Exchange.
Authorised and regulated by the Financial Conduct Authority.
Investec Wealth & Investment Limited is registered in England.
Registered No. 2122340. Registered Office: 30 Gresham Street, London, EC2V 7QN.