QuotedData
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INVESTOR

Economic and political roundup

Investment companies | Monthly | August 2023

The one thing finance seems to love is a good buzzword, with the most recent one being the 'magnificent seven' – the seven mega cap tech stocks which have dominated global equity markets over 2023 - specifically, Apple, Microsoft, Amazon, Alphabet, Meta, Nvidia and Tesla. While these companies have been front-and-centre over recent months, they finally began to show signs of weakness in July, with Tesla and Apple down significantly over the month, though Amazon and Meta continued to post strong growth.

The once dominant AI growth story seems to have given way to monetary policy concerns, US inflation rose again in July, but analysts seem to think this might be a one-off. US employment also surprised, having been more resilient over July than expected, that might have fuelled concerns about a more hawkish US Federal Reserve, but 10-year bond yields fell again in July.

" The watch word for our financial markets is, "reversion to the mean" i.e. what goes up must come down, and it's true more often than you can imagine." – John C. Bogle

Despite the magnificent seven's past dominance, there is more to global equites than US technology. While the MSCI Technology index was flat on the month, the MSCI World was up 2%, with Europe, the UK, and the US components of the index all up by a similar amount. July was therefore a reflection of a more balanced equity market, driven by a broader range of companies than it has been previously, and hopefully a reflection of a possible 'soft landing' for global GDP.

Emerging markets shone once again, as they did in the previous month. The MSCI EM was leader of the pack, having risen 5% in July. However, the rebound in Chinese equites was the true standout, up 9% on the month, a huge reversal on its lacklustre performance in June and, as it turns out, not sustainable since, but that is a story for next time. In addition, the oil price was noticeably higher, which should be good news for the Gulf economies.

Tension continues to create volatile market conditions and few discernible trends, with the notable exceptions of artificial intelligence

Global equity markets were roughly flat over the six months to the end of May. This headline conceals some modest upward moves in key overseas markets such as the US and Japan that were largely lost once translated back into pounds.

[Recent] events have damaged consumer, corporate and investor confidence. Confusingly, despite this, employment trends have remained robust and corporate profitability has been better than expected.

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At a glance

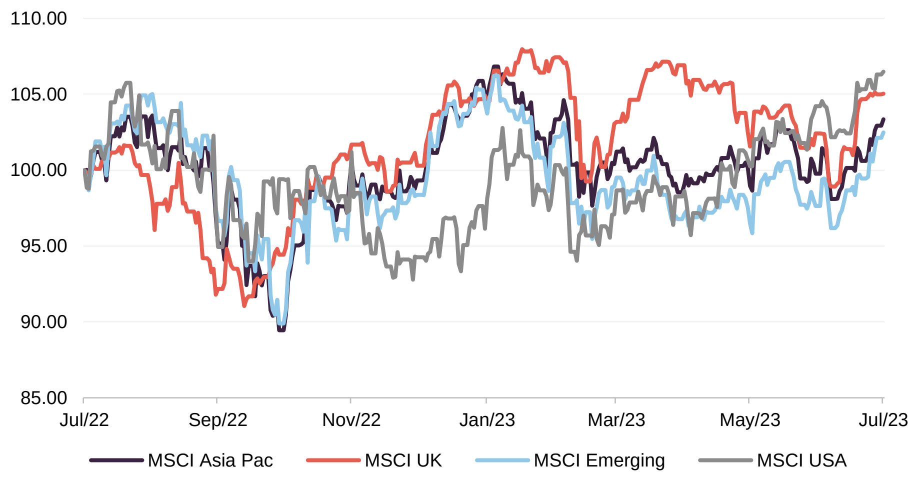
Exchange rate		31/07/23	Change on month %
Pound to US dollars	GBP / USD	1.2834	1.0
US dollars to Euros	USD / EUR	0.9093	(0.8)
US dollars to Japanese yen	USD / JPY	142.32	(1.4)
US dollars to Swiss francs	USD / CHF	0.8717	(2.7)
US dollars to Chinese renminbi	USD / CNY	7.1053	(2.0)

Source: Bloomberg, QuotedData

MSCI Indices (rebased to 100)

Despite the recent pull back in certain tech stocks, the US's performance continues to remain ahead of many of its peers, so great was the initial AI rally. The UK also remains robust, thanks to its inflationary pressures finally starting to alleviate. Asia Pacific and emerging markets have also seen a rebound, thanks in part to the recent recovery in Chinese stocks, but also an increased confidence in the global economic outlook, which is supportive of these export heavy regions.

Time period 31 July 2022 to 31 July 2023



Source: Morningstar, QuotedData. Converted to pounds to give returns for a UK-based investor.

Indicator	31/07/23	Change on month %
Oil (Brent – US$ per barrel)	85.26	17.3
Gold (US$ per Troy ounce)	1965.09	0.1
US Treasuries 10-year yield	3.96	(8.1)
UK Gilts 10-year yield	4.31	(3.0)
German government bonds (Bunds) 10-year yield	2.49	(8.4)

Source: Morningstar, QuotedData

Global

(compare global and flexible investment funds **here, here, here** and **here**)

Diana Dyer Bartlett, chair, Smithson Investment Trust - 31 July 2023

Clearly, a lot happened, with persistent core inflation (which excludes more volatile elements such as food and energy prices) prompting the Fed to increase US interest rates from 25bps at the start of 2022 to 5.25% at the time of writing, the fastest rate of increases for over 40 years. The Bank of England has raised rates at a similar pace, from 25bps at the end of 2021 to 5% currently, while the European Central Bank is only lagging a little behind, with a 4% interest rate presently. However, what is much more important to us as investors is where rates are going next, and it is very likely that we are much nearer the end of the rate hiking cycle than the beginning. The resulting increase in energy prices caused inflation to surge to the highest level for 40 years and central banks responded by rapidly increasing key interest rates.

This matters, because the downward pressure being applied to the valuation multiples of our faster growing, high quality companies due to the market's expectation of rising interest rates, has started to ease over the last few months. This is helped by the possibility that we can even, dare we say, look ahead to interest rate cuts next year.

The subject of recession is a slightly different story. As labour market, services and consumer data has remained robust in several regions, particularly the US, market expectations regarding recession have waxed and waned. People have tended to become more fearful as inflation appeared more stubborn than expected, causing central banks to further increase interest rates and leading many to the conclusion that this will continue until the economy falls into recession. This was also in combination with the short-lived regional banking crisis in the US which simply served to cause greater market anxiety.

But then, as data on consumer spending and employment showed the ongoing ability and willingness for people to keep spending, potentially thanks to pandemic era savings (which will eventually run out), the market periodically became less concerned about an imminent, or at least a deep, recession. I would characterise the market sell-offs during last October and March as the result of growing recessionary fears, while rallies in November, January and June indicated the market was becoming more sanguine on the issue. While a recession does appear likely in our view because most interest rate increases already enacted have yet to impact the economy (they tend to operate with an 18 month lag), we don't know for sure, and it could well be of the short and shallow variety.

To summarise, I would be very surprised if I had suggested to you a year ago that over the next 12 months inflation would prove so stubborn that central bank interest rate rises would be the fastest in decades, that recession would be continually on the horizon and that we'd live through another banking crisis.

Gregor Stewart, chair, Alliance Trust, 28 July 2023

Moving into the second half of the year, we are excited by the long-term potential of our holdings, with many performing much better operationally than is currently recognised in their share prices. However, the US has once again become very concentrated in a small number of very large-cap US tech-related stocks, and we are cautious about how such a concentrated market at large will evolve in the near term.

The economic backdrop is deteriorating. Despite rapid increases in interest rates, it is still possible that inflation will fall without a recession, particularly in the US where the rate of price rises has peaked, and growth remains robust. Moreover, the use of AI has the potential to boost productivity and increase corporate earnings, with a knock-on effect on share prices. Goldman Sachs estimate that AI could increase US productivity by 1.5 percentage points per year over a 10-year period, which would imply that the S&P 500's fair value would be about 9% higher than it is today. In that scenario, the rest of the US market could catch up with big tech.

Equally, the sector could be enjoying a bout of euphoria which is divorced from economic reality. The long-predicted recession may not have materialised, but high interest rates may be needed for longer than expected to squeeze inflation out of the system, especially in Europe and the UK. And many forward-looking indicators are already flashing red. These include an inverted US Treasury yield curve – with shorter-term bond yields higher than longer-term bond yields – which has historically preceded a downturn.

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Julian Bishop and Christian Schneider, managers, Brunner Investment Trust, 18 July 2023

Measured in sterling, global equity markets were roughly flat over the six months to the end of May 2023. This headline conceals some modest upward moves in key overseas markets such as the US and Japan that were largely lost once translated back into pounds. Sterling has continued to strengthen after the lows associated with the Truss/Kwarteng mini-budget of last autumn, creating a slight headwind for the valuation of overseas assets.

This flat overall outcome masks a great deal of divergence beneath the surface. In aggregate, growth stocks roared ahead whilst value stocks retreated; a perfect inversion of what we saw in 2022, which was itself a perfect inversion of what was seen in 2021. This inversion was mirrored at the sector level. After a torrid 2022, technology stocks were very strong, whereas the lowly rated financials and energy names that fared well in 2022 resumed their longstanding underperformance.

Digging further, the first six months have been a very narrow market with a handful of tech giants - Apple, Microsoft, Amazon, Alphabet (Google) Nvidia and Meta - accounting for virtually all the gains in the S&P 500, for example. It only takes one Microsoft to perform well, with its near $2.5 trillion market cap, approximately the same as the entire FTSE 100, to mask declines in dozens of other, smaller companies. Probabilistically, this has made it a hard market to outperform.

In late November 2022, an organisation called OpenAI launched an early demo of ChatGPT, a natural language processing tool that provides linguistically fluent and logically sophisticated answers to prompts and questions. This was followed in May by an exceptional set of financial results from Nvidia, the semiconductor company. Investor, consumer and corporate interest in artificial intelligence applications is very high indeed and we have no doubt that its impact will be enormous. Nevertheless, judging the winners and losers at this early stage is likely to prove difficult. We expect speculation to abound. If history is any guide, fortunes will be made, and lost.

Events in the financial sector were equally dramatic. It was inevitable that, at some point, a rapid increase in interest rates from unusually low levels would create problems somewhere in the financial system. These emerged in March at Silicon Valley Bank (SVB), an American regional bank based in California, serving corporate clients in the technology industry. This was a reminder, if ever needed, of the inherent fragility of the fractional banking system. Put simply, not all depositors can have their deposits back at once, as they are mostly lent to others. Banks rely on trust, and when that trust is lost the results can be fatal.

Most other sectors were thankfully less dramatic in the first half of our financial year. Energy stocks came under pressure as oil and gas prices fell from the peaks seen after the invasion of Ukraine. Falling commodity prices generally gave rise to hope that inflation may be peaking. Whilst this is almost certainly true, 'core' inflation (which excludes volatile food and energy prices) remains stubbornly high due to wage inflation. Unemployment in most major markets remains very low, giving workers strong bargaining power. Central banks remain fearful of a classic wage-price spiral and so continue to tighten rates. Their thankless task is, effectively, to induce near recessionary conditions, which they have now achieved on both sides of the Atlantic.

After some of the most Draconian COVID lockdowns seen, China finally re-opened. Compared to other markets, the subsequent economic rebound has been lacklustre, to the disappointment of both domestic Chinese investors and global commodity markets which rely on Chinese demand. Perhaps the explanation lies in the lower level of government handouts to workers in Asia during the lockdowns. Consumers in the West, unable to spend and awash with stimulus payments in lieu of wages, saved a great deal during the lockdowns, unleashing a spending boom once they were lifted. Whilst generous and sensible, paying people for not working is as close to a definition of 'helicopter money' as you are likely to find.

UK

(compare UK funds **here, here, here** and **here**)

Managers, Aberforth Split Level Income Trust, 28 July 2023

The positive returns from equity markets around the world in the twelve months to 30 June 2023 contrast with the falling share prices that characterised ASLIT’s previous financial year. Several factors contributed to the improved mood. The initial shock of Russia’s war in Ukraine has subsided, while some of the worst fears about energy supplies and prices have so far proved misplaced. The reopening of China’s economy, following strict pandemic lockdowns, should contribute to global economic activity and promises to ease pressure on supply chains. Related to these points, inflationary forces appear to be abating: in most major economies, the rate of change in consumer prices is declining, though it remains elevated in comparison with the period before the pandemic.

The response to inflation has been the large and rapid increases in interest rates over the past 18 months. These have complicated economic activity and asset valuations. They have also precipitated financial accidents, such as the UK's brief LDI crisis in the autumn followed by the spring's regional bank failures in the US. The markets' calculation is that subsiding inflation will soon allow the Federal Reserve to signal that the all-important US Fed Funds rate has peaked. In stockmarket terms, the main beneficiaries so far of this expectation of falling interest rates have been the large technology companies in the US: their valuations thrived in the low inflation and low interest rate environment preceding the pandemic and they are perceived as being best placed to exploit the emerging fascination with artificial intelligence

The likelihood of the UK's monetary policy following suit seems more distant. Consumer price inflation is proving more persistent, forcing the Bank of England to raise interest rates to 5% and bringing recession closer as higher mortgage rates bite. Reawakened memories of a British problem with inflation have contributed to a pervasive and thorough pessimism about the UK's prospects. Domestic politics of recent years have not helped. A succession of prime ministers has struggled with the additional challenges that the country's departure from the EU has presented to economic activity. Ideology has too often won out over pragmatism, culminating only nine months ago in Liz Truss's extraordinary and short-lived premiership.

These concerns have affected investment in the UK. Open-ended equity funds have experienced persistent outflows for several years and institutional asset allocation decisions appear influenced more by what has been rather than what will be. Valuations attributed to UK assets languish. Against the dollar and euro, sterling remains 15% or so below its levels before the EU referendum. Gilt yields are on a wide premium to government bond yields in the US and Europe. And UK stockmarket valuations are towards their lowest in over 30 years when compared with global equity market averages.

James Henderson and Laura Foll, managers, Law Debenture, 28 July 2023

The period began positively with the return of some investor confidence in equity markets. However, this proved short-lived when the Silicon Valley Bank collapsed. There was concern at the time that this collapse might lead to contagion globally. Thankfully, this did not prove to be the case as the banking system does not carry the same degree of leverage as in the past. The narrative in the market moved on, but risk aversion in the market remains. The global inflation level has not fallen as quickly as some had hoped. This is particularly the case with the UK, resulting in continued upward movement in its interest rates. The outcome has been that the gilt market has adjusted downwards, leaving yields at a level that is even higher than last autumn. This background of rising rates has undermined investor confidence in equities, particularly in UK-orientated small companies. AIM-listed companies in particular, have experienced share price weakness, falling, in some cases, to what appear to be extraordinarily low valuations.

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Dan Whitestone, manager, Blackrock Throgmorton Trust, 27 July 2023

The first six months of the financial year bore witness to a continuation of the macro volatility to which we have become accustomed. This has resulted in a somewhat challenging market environment to navigate, with stock markets grappling with macro-economic news, the latest inflation reports, and second guessing the monetary response from central bankers and its implications for economic growth. Despite the general bearish rhetoric about an inevitable recession and an implosion in corporate earnings, the results and outlook statements from corporates in developed markets has proved far more resilient. In the US, 81% of companies beat earnings expectations for quarter one and in Europe the figure is 74%. In many ways this is a continuation of the theme of the last nine months, i.e. many reasons to be concerned about the macro, offset by broadly positive corporate news flow and profitability. This tension continues to create volatile market conditions and few discernible trends, with the notable exceptions of artificial intelligence ("AI") related shares and the diverging performance of US and UK stock markets this year, particularly pronounced in the absolute and relative underperformance of UK small and medium sized companies.

Within the UK market, concerns over the outlook for Chinese demand and global growth, the lack of any notable tech exposure, coupled with a large bias towards resources and financials has resulted in the UK underperforming most global developed markets. The underperformance of UK small and mid-caps versus the FTSE 100 has continued; since the initial underperformance which began in 2021, the mid-cap FTSE 250 has underperformed the FTSE 100 by around 30 percentage points, which is the largest underperformance on record.

Critics of the UK will highlight the myriad challenges facing the UK to explain this underperformance, ranging from stubbornly high inflation (versus our European and US counterparts), and weak productivity and growth. Brexit has not, in our view, helped many of these issues, particularly workforce related problems such as staff shortages/availability and wage inflation. However, for all these woes, the financial performance from UK listed companies, both domestic and internationally focused, is far more robust. There is a growing disconnect between strong company fundamentals and falling share prices, driven in part by persistent outflows as investors move on to other areas. Indeed, UK mid-cap funds saw a -21% reduction in AUM from outflows over the last 12 months, compared to -4% from UK large cap funds. Currently, the only buyers of note for UK listed companies are the companies themselves and private equity firms.

Whilst the backdrop is still tough overall, we believe there are reasons for optimism. The recent round of trading updates from our investments have generally been in-line with or better than expectations. However, with oil and gas prices lower year-on-year, China re-opening, USD weakening, and shipping/logistics/factory gate prices dropping, much of the inflation pressure of last year could become deflationary during the course of this year. The picture we see is one of a gradual recovery and in our view, this is not reflected in valuations so remains the biggest risk/reward opportunity for us. The underperformance of UK small and mid-cap companies is not something that we think can persist.

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Colin McLean, manager, SVM UK Emerging Fund – 26 July 2023

The year under review was an extremely difficult period for UK growth investing, particularly for funds emphasising smaller and medium sized companies. The index averages conceal just how much of the returns for the period came from a narrow group of global sectors; energy, basic materials and healthcare.

UK equities have rallied from a low point in September 2022. But since March 2023 there has been some weakness in banks over concern about the health of the banking system. This stemmed from bank failures in the US and Credit Suisse in Europe. In contrast to 2008, the financial sector does not appear to pose a systemic risk. Large financial institutions are much better capitalised than at any point in the last 40 years. Bank share prices, however, are likely to remain volatile in the near-term and subject to changes in prevailing sentiment.

Bank problems are just one early sign of a growing liquidity squeeze. This may see investors put more value on cash generative, profitable businesses. Easy money has propped-up some poor business models for a number of years. As losses mount, many early stage growth businesses have cut back on marketing and other costs to extend their cash runway. And some older declining businesses, trapped within a high cost structure, have allowed debt to pile up.

We can expect a rise in real interest costs that accompanies widening credit spreads and falling inflation. Over the next 12 months the Bank of England interest rate is likely to fall, but real borrowing costs of many businesses could rise. This would negatively expose indebted businesses that have not focused on strong cashflow.

The global economy continues to be resilient. Supply chain risks continue, although labour scarcity may ease as unemployment picks up, but these risks are more acute in manufacturing sectors. In consumer sectors, safety probably lies with businesses that are leaders in their area or which can defend margins through innovation. Currently, consumer sectors have been significantly derated, in contrast to technology and industrials.

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Managers, Aberforth Smaller Companies Trust – 26 July 2023

The medium and long term outlook is bright. History is rather convincing: when valuations have reached today’s levels in the past, absolute and relative total returns over the next five years have been strong.

Ironically, the greater uncertainty pertains to the nearer term. Stockmarkets’ immediate obsession is US interest rates – each data release is scrutinised exhaustively for a hint of what the Federal Reserve might do next. The positive start to 2023 for equities indicates an expectation that US interest rates are close to their peak. However, there are important caveats. The speed and extent of the interest rate increases threaten further accidents – the financial world has grown used to more than a decade of almost costless money. Moreover, it is not clear that inflation will return conveniently and reliably to its pre-pandemic levels – the rate of increase will subside, but underlying inflationary pressures from labour markets and from forces such as de-globalisation linger.

While equity investors are presently enthused by the outlook for US monetary policy, they remain nervous about prospects for UK politics and economics over the next couple of years. On the political front, there will be a UK General Election within the next eighteen months. This will come at a time when the influence of the more extreme elements of both main political parties appears to be waning. However, a change of government looks likely, which brings incremental risk.

Meanwhile, the UK economy is blighted by more persistent inflation than are its peers. This threatens a more aggressive monetary response by the Bank of England and potentially a more severe downturn in economic activity. Recessions are unpleasant. They increase hardship faced by households and businesses. They reduce incomes and profits. But they are also inevitable and even necessary in order to address the effects of past policy mistakes and of unforeseeable developments such as the pandemic.

The risks are undeniable. But so is the attractiveness of the valuations attributed to the portfolio's holdings by the stockmarket, in all its worrying about the UK and about the liquidity and cyclicality of small companies. Importantly, the stress-testing of today's portfolio valuations described above suggests that much of the risk of a recession may already be embedded in share prices. While it may take time for equity investors to re-embrace the UK stockmarket and its smaller companies, private equity and overseas companies are showing no such reluctance.

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Frank Ashton, chairman, Athelney Trust – 23 July 2023

Continuing headwinds [for the UK] include sticky and high inflation, market uncertainties raised by weak global economic growth, the expectation of a protracted Ukraine-Russia war and in the US a mini banking crisis, followed by national debt default concerns.

In addition, the UK has seen considerable labour market tightening and increasing unrest, resulting in many days lost to public sector strikes. The new Sunak/Hunt partnership continues to battle with the result of COVID-related poor growth figures (compared to other advanced economies), the need to find more money for higher wage settlements (now averaging over 6%) from departmental budgets, and the snail-paced return to confidence for their government after the debacle of the Truss mini-budget.

Is inflation becoming embedded in the UK in the meantime? Interest rate rises have so far had much less effect here than in the US where inflation in June returned to a two-year low of 3%. There was downwards movement in the UK June figures for annual and core inflation which dropped to 7.9% and 6.9%. both lower than expected.

Thankfully we have transitioned to more usual business and market dynamics after the many COVID challenges of 2021 and 2022:   The need for immediate personal, governmental, or global action to combat the pandemic and its impacts is now replaced with the slow, delayed effects of interest rate rises or seeing, at long last, increased availability of product or services as capacity rises at production facilities or in supply chains.

We also seem to be transitioning from the expectation of deep recession to a mild recession or possibly no recession at all in both the US and UK. The Bank of England's forecast at the start of 2023 perhaps underestimated the likely persistence of UK inflation at a high level, currently 8.7%. After seeing that it has stuck in the high single digits, alongside negative core inflation, wage growth and employment signals, the Bank has returned to 50 basis point interest rate increases; the market is also resigned to more 'medicine' to bring inflation down to about 5% by the end of 2023 and to the Bank's target of 2% a year later.

Meanwhile companies and the public alike are still transitioning mentally to the new environment of higher costs for everything from basic supplies to financial services; it now seems this is going to be a sustained period of fiscal challenge.

More normal business conditions have allowed UK company dividends to return to more familiar patterns and amounts which is a recent positive potential trend for the future. On the other hand, wage and raw materials inflation threatens margins, and for those companies who are growing, there are struggles to recruit; it is reported there is a 1m-plus labour shortage. Similar labour problems exist in other European countries; many took a break during COVID and have not returned to full employment. Pre-tax profits were under pressure in energy-intensive businesses over the past 12 months as wholesale gas prices peaked at €340/MWh last summer and as gas prices are now decreasing, should ease one of the current constraints to business and consumer confidence.

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John Dodd and Kartik Kumar, managers, Artemis Alpha Trust – 12 July 2023

Key factors which influenced equity markets and our portfolio in the period included:

- **Energy prices** rose sharply in response to the impact of the Russia/Ukraine war on European gas supply, increasing the cost pressures affecting consumers and corporates, before falling more recently.
- **UK politics** faced a crisis of confidence in September following the Liz Truss budget. This caused extreme volatility in UK government bond yields and forced an abrupt U-turn from the new government under Rishi Sunak.
- **Inflation** remained higher than expected in the United Kingdom, Europe and the US, although economic activity proved more resilient to interest rate increases than first expected.
- **Interest rates** rose sharply as a result, and a high degree of uncertainty remains over their future path.

This series of events has damaged consumer, corporate and investor confidence. Confusingly, despite this, employment trends have remained robust and corporate profitability has been better than expected.

Idiosyncratic events in the UK hurt sentiment that was already fragile since Brexit. Markets are now pricing an idiosyncratic inflation problem in the UK, leaving the UK with higher long-term bond yields than Greece or Italy.

We continue to anticipate attractive prospective returns from our portfolio owing to a combination of macroeconomic and bottom-up factors:

- Inflation is likely to fall markedly to the benefit of consumers and businesses worldwide.
- Discounted UK asset valuations should lead to higher future returns.
- Durable equity franchises are attractively valued and provide a long-term hedge against inflation.
- Capital cycles are leading to increased profitability in capital intensive and cyclical sectors.

Gervais Williams and Martin Turner, managers, Miton UK Microcap Trust – 11 July 2023

After the global pandemic, and the giant financial stimulus, global assets valuations rose to very elevated levels in early 2021. Subsequently, over the two years to April 2023, global asset valuations have retreated somewhat, back towards prior norms, due to inflationary pressures and interest rate rises.

Interestingly, although the UK stock market underperformed most international exchanges during the globalisation decades, over the last two years it has now started outperforming all the international major indices. Specifically, the recent outperformance is all the more impressive given that UK open ended investment companies ("OEICs") have been redeemed at a near-record pace for several quarters. In our view, this underlines just how undervalued the UK stock market had become over the globalisation decades when assets paying good and growing dividends were outpaced by those with ambitious growth targets.

During the globalisation decades, UK-quoted microcaps were also overlooked. Whilst they did outperform during the year to April 2021, as few pay significant dividends, their share prices have been vulnerable to the global decline in asset valuations and the ongoing selling of UK equities over the last two years. The share prices of quoted microcaps have underperformed those of the UK majors by a very wide margin. Since many were undervalued relative to the UK majors even prior this underperformance, microcaps are in many cases now standing on low valuations in our view.

Clearly, the rise in interest rates and the economic slowdown will have reduced the longer-term prospects for some. But when their prospects are considered in absolute terms, it should be remembered that corporate sales tend to rise with inflation. In addition, those with strong balance sheets stand at an advantage compared to those which are capital constrained. Furthermore, if there is a major rise in corporate insolvencies, then those that are well financed can expand into the vacated markets, or acquire the overindebted but otherwise viable businesses, debt-free from the receiver at very low prices.

Given that [the UK MicroCap Trust] has underperformed so considerably over recent years, why do we retain such strong confidence in its prospects?

1. Specifically, UK quoted microcaps tend to operate in industry sectors where demand is often growing on a structural basis, rather than in line with the cyclical fluctuations of the global economy. Whilst this feature was easy to ignore when

the global economy was growing rapidly, it becomes more obvious when global demand is constrained by interest rate rises. Clearly, as globalisation fades, this feature is a major advantage for the Trust's quoted microcap investment universe. Alongside it was worth noting that the historic data is reassuring, as when global growth was challenged in the past, UK quoted microcaps tended to outperform.

2. When the cost of labour is rising and corporate profit margins are under pressure, it is not uncommon for numerous businesses to run out of cash. Over-indebted businesses in particular often find they are obliged to sell parts of their company, even at disappointing valuations, to repay debt. Others end up in insolvency. At these times, quoted companies specifically have the advantage, as they can raise additional capital to acquire these operations at low valuations, with the prospect of rapid cash paybacks. Whilst such transactions enhance the returns of large mainstream quoted companies, the same deal for a quoted microcap has proportionally a much greater impact. Hence during periods when mainstream stock market indices might be unsettled, quoted microcaps sometimes have the potential to step up their returns.

Managers, Oryx International Growth Fund – 06 July 2023

Global markets faced continued turbulence, with interest rates facing additional raises to counter high inflation. Though several leading inflationary indicators have reduced in recent months, wage inflation remains steady and continues to burden businesses with higher costs. The war in Ukraine continues, with a counter offensive reportedly underway but no clarity on a near term ceasefire. The banking sector saw disruption not seen since the global financial crisis as Silicon Valley Bank collapsed as a result of a bank run on deposits. This sparked a collapse in share prices across US regional banks and most shockingly, the demise of Credit Suisse, which was subsequently acquired by UBS in a Swiss government supported rescue.

Mortgage rates have continued to climb, supressing demand in the housing sector and curtailing construction by house builders. Energy prices climbed significantly during the year but have since reduced as the energy cap comes down. International pension schemes have reduced exposure to UK equities and mutual funds faced continued outflows, putting pressure on share prices.

Overall, 2022 was a difficult year for the UK and global equity markets. While there is reason for pessimism, the outflow of capital from UK small caps has provided our Fund with ample opportunity to acquire significant stakes in companies at discounted values. Several large and small UK public companies were subject to take over bids during the course of the year, with particular interest arriving from overseas buyers looking to take advantage of suppressed valuations. Importantly, some of our significant holdings were subject to bids during the year, providing the fund with ample liquidity for 2023 and beyond.

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W. Scott, chairman, Worsley Investors – 05 July 2023

Inflation and interest rates will be key to market returns and the performance of the wider economy over the coming years. While those components of inflation related to many of the commodities directly affected by the Ukrainian war have either plateaued or have begun to decline as was to be expected, others such as retail food prices remain elevated for now as the effects of the primary commodity and energy prices are taking time to work through the supply chains. This, of course, has led to other sources of contribution to inflation, such as increasing demands for compensatory wage and salary increases, and, as homeowners will need to refinance mortgages at much higher interest rates than those of a few years ago, rises in bank rate themselves become in the short-term contributors to the very consumer price inflation which they are intended in the longer term to combat. In this latter regard, there is significant tightening already in the system, so to speak, even if Bank of England base interest rates were to remain flat for a period. We have always expected that Bank of England rates would reach a level higher than they currently are and it seems that the wider market is also now of that view. Whether its expectations or those of the Bank of England's Monetary Policy Committee overshoot, as has often been the case in past market cycles, remains to be seen but until the market can begin to anticipate that process is over, it is difficult to see wider UK market indices making strong progress. That all of this is happening in parallel with the electoral cycle is a further source of uncertainty.

I note in passing that bond yields are in general similar to the levels which destabilised the Truss administration when the Bank of England was forced to intervene in markets with liquidity on a massive scale to ensure stability. This is a powerful illustration that in markets it is often not the absolute level but the rate of change that has the greatest effect. It remains the case that the prospect of rising taxes, lower growth and squeezed living standards will inevitably restrain general market performance for the UK smaller company sector which tends to have a greater domestic exposure than, for example, the FTSE100.

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Asia

(compare Asia funds **here**)

Ian Hargreaves & Fiona Yang, managers, Invesco Asia Trust – 26 June 2023

China's economy is reopening, with a robust recovery in consumer demand, but its equity market continues to trade at a discount, even as fundamental improvement in the outlook for corporate earnings mean there is scope for positive surprises that would validate a re-rating. The rest of Asia should be a relative beneficiary of China's reopening and as such may see less earnings vulnerability from the global slowdown compared to many advanced economies, with revisions beginning to improve.

Asian markets continue to trade at a significant discount to developed markets, particularly the US. We believe there is scope for this to narrow, with US dollar strength challenged by a potential recession in the US as the Fed seeks to root out inflation. Inflationary pressures in Asia are less of a concern, suggesting greater policy flexibility, which should also be supportive for markets. Looking further ahead, US inflation might be stickier than expected, but it is declining from a high base which could lead to an easing of financial conditions at a time when Asia is enjoying a favourable growth differential. Combined, we feel this makes Asia an attractive place to be investing over the medium-term, with divergence between countries and sectors providing good opportunities for lucrative stock picking.

Biotech and healthcare

(compare biotech and healthcare funds **here**)

Paul Major and Brett Darke, managers, Bellevue Healthcare Trust – 20 July 2023

To recapitulate: calendar 2022 witnessed a combination of rising interest rates and attendant concerns over both the availability and affordability of credit. This, allied to perceptions that primary and secondary equity raises will be challenged in these market conditions, prompted investors to shy away from smaller companies with negative operating cashflows or those that might need additional funding on an 18-month+ view. Throughout this period, sectoral sagacity was of limited value; it was a sub-sector and macro-led market where 'big' was best and 'boring' was better still.

Longer duration stories were heavily discounted at much higher rates than would be imputed by base rate rises. This backdrop proved very challenging for funds like ours with a bias to small/mid-cap companies. It also led to a historical disconnect between the valuations of SMID vs. Large/Meg-Cap companies.

The past six months offered little respite on the novelty front, throwing a 'mini' US Regional banking crisis reminiscent of 2008/9 in March 2023 and an AI-driven technology mania that began in November 2022, with many echoes of 1999/2000 on top of the continuing geopolitical and macroeconomic uncertainties.

Depending on who you believe, AI will either usher in the much-needed productivity boon that will allow us to overcome the demographic burden of a rising dependency ratio or result in the destruction of the human race. As with all these things, the reality will be much less extreme and take much longer to come to fruition than anyone currently wishes to speculate, but the market loves a narrative.

The consequence of this new cocktail of market factors was the rather unexpected outcome of an equity market that rose (MSCI World Index sterling total return of +0.2% over the period in review and the US S&P500 Index total return of -0.4%) as interest rates rose and the Damoclean declivity of recession hung over the market. The S&P500 eventually tipped into 'bull market' territory by mid-June i.e. a rise of >20% from the recent low, which was in October 2022, albeit via a rally driven predominantly by a handful of AI-linked technology stocks.

On closer inspection, the remarkable thing about this period has been the robustness of corporate earnings. Companies have managed to pass on higher input costs to end customers, preserving profit margins even as consumer sentiment and discretionary spending power seemed to come under pressure. Aggregate S&P500 earnings expectations for 2024-2025 have not fallen during this period, and instead rose very modestly. Labour markets remain tight and the cost of living crisis can seem ethereal in big financial centres, surrounded as they are by packed bars and restaurants and bustling airports.

The consumer seems indefatigable. As children of the 1970s, your managers are minded to recall the Asterix comics of their youth when thinking about current market sentiment. In those books, the potion-powered and thus undefeatable Gauls have only one fear: that the sky may fall on their heads tomorrow. But "tomorrow never comes" urges their Chief, Vitalstatistix.

Investors remain worried that something is going to tip the market into a sell-off and there are plenty of candidates to choose from in today's uncertain geopolitical climate. That said, these same investors aren't really that worried because these threats don't feel tangible enough or close enough to pull further capital away. As a consequence, we are living in an era of surprisingly low volatility and little overall price direction (excluding the relentless rise of Technology shares).

Even odder in a historical context was to see healthcare materially underperform the wider market, during this period and for it to do so to a degree not seen since that same 1999/2000 period despite precisely the sort of uncertain negative economic backdrop that usually supports a positive relative performance for a sector with inherent defensive characteristics.

Healthcare Performance review

As noted previously, the MSCI World Healthcare Index generated a sterling total return of -6.9% over the period in review. The reasons for this material underperformance have been much debated by equity strategy types and the most compelling but wholly unsatisfactory answer would appear to have been positioning: healthcare was seen as less exciting than technology during this period and was a source of capital to speculate (and we chose that word deliberately and judiciously) on AI-linked stocks.

Coming back to fundamentals, it is worth noting that healthcare has not seen any significant regulatory developments over the period in review that would prompt a reconsideration of the longer-term earnings power. It is also worth noting that the healthcare sub-indices of the S&P500, NASDAQ and Russell 2000 series have outperformed their parent on earnings revisions for 2024-2025 period during our fiscal H1 23 period (which is as one would expect during a period of negative economic developments adversely impacting equities as a broad asset class). In addition to being largely non-cyclical and non-discretionary, early 2023 finally saw the long-hoped for post-COVID 'return to normal' regarding elective procedures and routine physician appointments.

This is not such an easy question to answer in a generalised manner. Intuiting from the comment above regarding normalisation, one might expect procedural volume beneficiaries to have fared best (Med-Tech companies and Facilities, i.e. hospital operators) and those who pay for these procedures (i.e. Managed Care, the US insurers) to have fared worst. If you are going to hang on to some healthcare exposure, you might have wanted those defensive qualities, which applies most to Distributors, Diversified Therapeutics and Conglomerates, but there is no clear picture there. If one remains concerned about the impact of rising rates on asset duration and funding opportunities, then one might eschew the 'biotechnology' companies (Focused Therapeutics) and those companies providing services to them (Tools and Services), but again the picture looks more complex than such a reductive, simplistic top-down approach would suggest.

Dental remains the confounder. This is surely the most consumer discretionary of all the healthcare sub-sectors and yet continues to hang on to the material re-rating that it enjoyed at the turn of the year.

Technology

(compare technology funds here)

Ben Rogoff & Ali Unwin, managers, Polar Capital Technology Trust – 19 July 2023

We believe 2022 is best understood as the year 'risk was repriced' as central banks moved forcefully to rein in the economy, defend their credibility and prevent inflation expectations becoming unanchored. Proving anything but 'transitory', inflation continued to surprise to the upside taking global risk-free rates with it. In the US, consumer price inflation (CPI) averaged 8.0% during the calendar year, while the +9.1% reading in June was the largest year-on-year (y/y) monthly gain since 1981. The inflation shock was hardly unique to the US, with soaring energy and food prices, Labour markets with more jobs than available workers and the release of pent-up demand combining to create the most inflationary backdrop globally for 40 years. For the full year, global inflation averaged 8.8% compared to pre-pandemic levels of around 3.5%.

As a result of this persistent inflation, 2022 was also a year of unprecedented interest rate rises, after an oddly slow start by central banks. In the US, the Federal Reserve (Fed; the US central bank) embarked on the steepest set of rate hikes in 40 years as rates were raised by 450 basis points (bps), including four 75bps hikes, in addition to the resumption of quantitative tightening (QT) whereby the Fed reduces its monetary reserves to 'tighten' its balance sheet. Futures markets at the start of 2022 had priced in expectations for Fed Funds (the key benchmark rate targeted by the Fed) to be at c1% by June 2023; by year end, this figure had risen to c5%. In Europe, the decade-long experiment with negative interest rates ended as the European Central Bank (ECB) raised rates by 250bps despite a high likelihood of recession. Most other major markets experienced tightening in excess of 200bps.

Sharply higher risk-free rates weighed heavily on asset prices, not least bonds which experienced their worst calendar year returns since at least the 1970s, the Bloomberg US Aggregate Float-Adjusted Index losing 13.1%. This theme was painfully echoed in equity markets- the longer the duration, the worse the return. Ten-year US Treasuries suffered their worst annual performance since 1788 while record government bond losses were recorded in Japan, Europe, and the UK with drawdowns of 16.2%, 22% and c32% respectively. Having stood at $10trn in January 2022, the global stock of negative yielding bonds had fallen to essentially zero by calendar year end.

Higher sovereign yields weighed heavily on global equities, which also had to contend with elevated recession risk and negative earnings revisions. The unusual correlation between bond and equity markets, courtesy of inflation, meant that 2022 will probably be remembered for being the first year that both the S&P 500 (equities) and 10-year US Treasuries (bonds) each registered losses of more than 10% on a total return basis. It was also the worst year for combined total returns of stocks and bonds since 1982.

A bad year for US equities proved a calamity for growth stocks which suffered their worst year compared to value stocks since 2000.

Equities started strongly in 2023 as extreme pessimism and bearish positioning were challenged by disinflationary data, weaker energy prices and sharply lower real rates, as well as a better than feared Q4 company earnings season and a momentum / short squeeze. European equities and 60/40 portfolios recorded their best start to a year since at least 1987, while the tech-heavy NASDAQ Composite Index enjoyed its strongest year-to-date performance since 2001. However, sentiment turned more negative in February as a slew of strong economic data for January challenged the excitement that the interest rate tightening cycle was largely complete.

Technology Review

In addition to the pressures felt by the broader market, technology stocks also had to contend with the further unwinding of perceived 'Covid winners' which weighed on the sector's relative growth and its companies' valuations. However, marked outperformance by the sector giants during early 2023 left the technology sector (represented by the Dow Jones Global Technology Index) modestly ahead of the broader market (MSCI ACWI) for our full fiscal year to 30 April 2023, the Dow Jones Global Technology Index returning +2.7% and the MSCI ACWI +2.1% respectively, both in sterling terms.

However, overall index returns contrasted with those enjoyed by the average stock, especially during 2022, when just 30% of technology stocks outperformed. For the 2022 calendar year (two-thirds of which fell within our past fiscal year), the Dow Jones Industrial Average (DJIA) outpaced the NASDAQ Composite Index by more than 2,400bps, the greatest divergence between the two since 2000. During this period, value significantly outperformed, outpacing the most expensive quintile of technology stocks by 35% in 2022. Perceived defensive businesses such as Hewlett Packard Enterprise (+17%), IBM (+24%) and Oracle (+7%) sidestepped the massive de-rating of growth stocks that all but wiped out the EV/sales valuation premium normally enjoyed by next-generation software stocks over legacy incumbents, making it another challenging year for growth-oriented technology investors.

As in 2021, the greatest weakness was reserved for the longest duration assets with limited valuation support. Tesla fell an incredible 65% during 2022, commensurate with the decline experienced by MSCI Ukraine and Bitcoin, revealing extreme cross-correlation. Weakness in category leaders like Tesla presaged a collapse in 'second liners' such as would-be electric vehicle (EV) makers Rivian (-82%) and Lucid (-82%). The ARK Innovation fund fell a further 63% in 2022 after declining 23% in 2021. Thankfully - and something we have highlighted for the past two years - the most pain was felt beyond listed equities as bubbles in cryptocurrency, non-fungible tokens (NFTs) and Special Purpose Acquisition Companies (SPACs) were destroyed. Cryptocurrencies plunged in 2022, led by Solana (-94%), Cardano (-81%) and Ethereum (-68%) leading to many industry bankruptcies before engulfing

FTX and Sam Bankman-Fried. PCTT does not invest in either SPACs or cryptocurrencies.

Thankfully the technology sector's fortunes reversed with the arrival of the new calendar year, covering the final four months of our fiscal year, during which our benchmark advanced +16.9% as compared to the MSCI ACWI's +4.7% gain. This was driven by better-than-expected macroeconomic data which prompted optimism around e-commerce and digital advertising growth against low expectations, while Artificial Intelligence ("AI") provided a new growth outlet to many semiconductor companies given the calculation (compute)-intensive nature of large language model (LLM - see more below) training and inference. However, this period also saw extraordinary outperformance of large-cap companies, as measured by the Russell 1000 Technology Index, which delivered +22% while small-caps as measured by the Russell 2000 Technology Index, fell 1.9%, both in sterling terms. Megacap technology stock performance has been even more pronounced, benefitting from a 'flight to quality' amid the collapse of SVB, money flowing from the financials and energy sectors and excitement about and desire for AI exposure.

At the technology subsector level, AI enthusiasm proved an important driver for semiconductors, the Philadelphia Stock Exchange Semiconductor Index (SOX) returning +4.2%. This was impressive given weakness in other end markets including smartphones and PCs. Earlier widespread semiconductor shortages and price increases scared customers who then scrambled to modify procurement policies to secure supply at the expense of inventory discipline, resulting in a severe inventory correction. Auto and industrial markets were more stable and datacentre spending remained relatively resilient as the large cloud providers continue to invest in anticipation of a compute-intensive AI future.

Despite enthusiasm about AI, there was a significant slowdown in cloud revenue growth as customers optimised spend following the pandemic-induced acceleration. Aggregate cloud revenue growth slowed by 400-500bps per quarter from +36% in Q2'22 and +31% in Q3 before falling to +26% and +21% in Q4 and Q1 respectively. This was a disappointment despite the public cloud's vast scale at >$170bn annualised revenue run rate.

The slowdown in cloud revenues reflected a broader slowdown within software, especially at Software as a Service (SaaS) companies. During the year, many software companies highlighted greater deal scrutiny, longer sales cycles, deal compression and in later months found it more difficult to expand seat counts as customers retrenched. While the Bloomberg Americas Software Index returned 4%, this largely reflected strong returns from legacy players with limited growth profiles but generally strong pricing power and undemanding valuation multiples. Microsoft also delivered strong returns (+11.8%) as Azure continued to grow well and customers consolidated spend on the largest platforms. Conversely, diminished risk appetite and a higher interest rate environment presaged a material valuation reset in the higher growth parts of the sector which saw the Goldman Sachs Expensive Software basket return -27%.

In the internet sector, echoes of the pandemic period continued to impact results, from still-slowing gross merchandise value (GMV) growth at many e-commerce companies, inventory issues at retailers and an ongoing travel and entertainment spending boom, as consumer spending continued to shift from goods to services.

The NASDAQ Internet Index returned +1.0% during the fiscal year with a material divergence between mega-cap and smaller-cap constituents.

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Financials

(compare financial funds **here**)

Nick Brind, John Yakas & George Barrow, managers, Polar Capital Global Financials Trust – 11 July 2023

Equity markets were marginally lower over the six months covered by this report. Strong performance in the technology sector was offset by the impact of stronger sterling. Having outperformed for two consecutive years, financials not surprisingly underperformed as the collapse of a number of US regional banks and the forced sale of Credit Suisse to UBS Group led to a sharp sell-off in banking shares.

Consequently, US financials were very weak over the period under review. Conversely, Japanese and European financials, (notwithstanding the turmoil around Credit Suisse), stood out for their positive performance. Asian financials were weaker than expected, following the reopening of China from its zero-Covid policy which provided less of a support to economic data than had been expected.

US government bonds were largely unchanged as a resilient labour market and stronger than expected economic data challenged the narrative that inflation and interest rates had peaked, and would quickly lead to more accommodative monetary policy. Against this, the UK, Japanese and to a lesser extent German government bonds were weaker, in the UK due to inflation coming in above expectations.

Banks

Negative sentiment around the outlook for growth weighed on bank stocks over 2022 due to concerns about the impact on their profitability from a downturn and this has continued into 2023. Nevertheless, bank shares performed well initially in the period as earnings expectations continued to rise on the increase in interest rates feeding through to higher net interest income - the income they generate from the assets they hold (ie loans and securities), relative to what they pay out to depositors and other sources of funding.

However, the offset to this is that due to higher interest rates, banks are sitting on unrealised losses on their securities portfolios from holdings they bought when interest rates were lower. This was not new news. However, the announcement by SVB on 8 March that it would be selling a portfolio of its securities at a loss while at the same time aiming to raise capital to strengthen its balance sheet unnerved both investors and depositors. Despite initial support for the capital raise, the loss of US$42bn in deposits on that day led to support being pulled and ultimately the bank's collapse.

Credit Suisse, which had seen large outflows of deposits in the last few months of 2022, saw further outflows following the collapse of SVB. Its annual report alluded to "material weakness" in its internal controls and a poorly timed or misunderstood statement from their largest shareholder that they would "absolutely not" put more capital into Credit Suisse knocked sentiment further. Despite support from the Swiss National Bank and its regulator stating the bank was solvent, it was forced into a sale to UBS Group the following weekend.

Not surprisingly, these events led to a sharp sell-off in bank shares, in particular other smaller US regional banks that were seen as vulnerable due to weaker capital. Actions by US authorities appeared to have little impact as concerns around regional banks' exposure to commercial real estate exacerbated share price falls.

However, as Federal Reserve data suggested that deposit flows stabilised within a few weeks and PacWest, a Californian bank that had been at the centre of the sell-off, stated that it had seen inflows of deposits, US bank shares saw a partial recovery. Asian, European and other bank shares initially suffered falls in share prices but stabilised quickly as the issues were seen to not be systemic.

Insurance

With the extraordinary events in the banking sector, news flow elsewhere in the sector came in a distant second. Unsurprisingly against this background, the insurance subsector outperformed, reflecting its defensive characteristics. It benefitted from the higher interest rate tailwinds and therefore higher investment income as well as improving underwriting returns, i.e. higher profitability.

There was volatility in the subsector as investors fretted over its exposure to US regional banks and Credit Suisse. Within that, some life assurance companies have higher exposure to commercial real estate, which has come under scrutiny and therefore suffered weakness in share prices, but, for the vast majority of the sector, exposure was negligible or non-existent.

Diversified financials

The diversified financials sector consists of a wider group of companies - including trust banks, investment banks, stock exchanges, asset managers, information services companies and consumer finance companies - and performance reflected that. As a generalisation, investment banks and trust banks were weak, with Charles Schwab the hardest hit as investors were concerned about its balance sheet and the impact of the outflow of deposits on its earnings.

Asset managers also saw a wide dispersion of returns. Alternative asset managers have performed extremely well in recent years but have come under pressure over the past year due to concern around fundraising and the impact on performance fees from lower returns. Consumer finance companies also held up well, reflecting the strong jobs market and household savings (outside those on the lowest income) despite concerns around an imminent downturn.

FinTech

FinTech companies performed well over the six months; valuations enjoyed a recovery following sharp falls in 2022 resulting in less downside risk for investors, while revenues remained resilient, especially for the more established businesses. Payment companies also benefited from the stronger than expected performance of technology shares.

Tim Levene, manager, Augmentum Fintech – 04 July 2023

I write to you after another 12 months of uncertainty following the economy-wide adjustment to a higher interest rate environment. Having flown the furthest under the market conditions of 2020-21, it is the listed technology sector that has faced the most significant correction to valuations in response to rising rates. Despite a bounce, in particular by the FAANG stocks, listed tech stocks continue to trade well below their 10-year average. The increased cost of capital has reordered priorities from growth to profitability, and returned focus to core business lines and expense control. The market has become more discerning of companies with strong fundamentals and those without, and the significant rotation of capital into low-risk assets means that valuation multiples for listed growth stocks, and fintechs within this, remain compressed.

The digital-asset sector suffered from a series of high-profile collapses and subsequent contagion during 2022. These events highlighted critical gaps in regulation and naivety in the nascent market structure. The response from regulators has been an acceleration in policy development and enforcement action. Europe has positioned itself as a leader through the Markets in Crypto Asset (MiCA) regulation that will apply from 2024 and brings welcome clarity to digital asset firms who are committed to building compliant, legitimate businesses. This clarity is lacking in the US market where enforcement action against high profile firms has increased and we expect to see the biggest players in the market move their domicile from the US to Europe, the Middle East or Asia unless this changes in the coming year

Recent advances in generative AI have instigated a wave of interest in the technology and its future application in financial services. We believe that generative AI will significantly increase the efficiency of generalisable content-related tasks across industries such as coding and marketing. For more complex financial services use cases, where accuracy and compliance are imperative, it is still early from both a technology and regulatory perspective. For now we remain in discovery mode but it is our job as thesis driven investors to be ahead of the curve on the investment opportunities that these innovative technologies create.

In the dislocation that follows from periods of economic turbulence, entrepreneurs are presented with new opportunities to establish ground-breaking businesses. This principle can also apply to venture capital firms that operate with a clear purpose and we have welcomed the general retreat of ‘tourist capital’ and the so-called ‘mega-rounds’ that played a distortionary role in private markets during the second half of 2020 and 2021.

Quality deal flow is visibly improving as companies funded internally through the turbulence of 2022 are now returning to market. Amongst them are high potential prospects in line with our mandate which are bolstering the investment pipeline. Increasing levels of “dry powder” in the market maintain competition for quality companies but our thesis driven approach and unique proposition – fintech specialism, patient capital and operating experience – continue to cut through.

Less compelling investment opportunities are also returning to market, and we anticipate a further shakeout and consolidation of companies to come. Several of our established portfolio companies have already found value-opportunities to add product and personnel capabilities through acquisition. As fast-growing market leaders in their respective fintech verticals they are well positioned to consider further opportunities in the period ahead. Investors should see this is another signal of maturity in the portfolio along with progression towards profitability and exit.

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Debt

(compare Debt funds **here**)

John Pattullo, Jenna Barnard and Nicholas Ware, managers, Henderson Diversified Income Trust – 25 July 2023

As discussed in our last outlook we feel the global economy is in a precarious position. The extraordinary size of the monetary and fiscal stimulus to enable a successful exit from COVID has led to a classic sine wave boom/bust business cycle response akin to fighting a war. With the benefit of hindsight policymakers have needed to put the brakes on too late and too hard to stamp down on the less than "transitory" inflationary surge. Bottlenecks were of course compounded by the surprising tightness of the labour market and the Ukraine War adding significant fuel to the fire. Investing at this time in the cycle is always challenging and is often compared to picking up pennies in front of a steam roller. We have seen a very aggressive and broadly co-ordinated tightening in global monetary conditions - it is unusual to have such a synchronised upswing and then downswing across the globe. The good news is that in America, at least, the medicine is working as core and headline inflation have peaked out and are fading. Many of the global supply bottlenecks have disappeared as witnessed by the extra-ordinary slump, albeit from high levels, in vital commodities such as oil, gas, copper and lumber amongst others.   Many corporations have found it very hard to manage stock levels given the changing demand patterns, as consumption shifted from stay-at-home goods to "revenge spending" (expenditure meant to make up for lost time after an event such as the pandemic) on services such as eating out and travel.

US policy response has been more coherent and successful than Europe and the UK which seem to have some semi-persistent inflation lags. Labour markets are now more balanced, and we expect the cycle to evolve in this area as the long and variable lags of monetary policy begin to bite. Market commentators often say that the Federal Reserve raises rates until something breaks.   Well, the aggressive raising on short-term rates altered depositor and investment behaviour most pertinently in some American regional banks. This caused a digital bank run which is a new phenomenon. Further, the swift demise and wipe out of Credit Suisse junior bonds demonstrates the pressure some weaker financial institutions were under, from depositor confidence, not capital. We always keep a keen eye on the quarterly bank lending surveys - these were already tight and interestingly, the most recent surveys highlight a decline in the demand for credit as well as a decrease in the supply and cost of credit.

As noted earlier, the UK is an outlier, with headline CPI at 8.7% in April, above consensus forecasts of 8.2% and a (still rising) core CPI of 6.8%. Following the robust core inflation print and wage growth at the end of April, the UK data sparked worries about a wage price spiral which meant terminal rate expectations were lifted. This reflects concerns that interest rates have limited traction and that monetary policy is behind the curve. This argument ignores the inherent lags of monetary policy. This repricing has created attractive front-end yields of 6-7.75% for Sterling investment grade bonds.

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Managers, TwentyFour Income Fund – 18 July 2023

For the first half of the reporting period (into autumn of 2022) market sentiment as a whole remained very weak across all fixed income markets during what has been a period of elevated volatility, characterised by risk-off direction, challenging liquidity, the ongoing conundrum of interest rates policy, inflation and recessionary fears, the escalating Russia-Ukraine conflict and its associated energy supply/cost concerns. This was punctuated by the disastrous UK mini budget causing extreme moves in UK Gilt yields and the ensuing liability-driven investment ("LDI") liquidity-driven bond sell off. Amidst this we did see short periods of stability, which in turn gave rise to windows of opportunity in both primary and secondary markets. Conditions recovered towards the calendar year-end as market activity shifted in line with economic data and more benign central bank rhetoric. The start of 2023 saw markets get off to the strongest start to a year since 2019, as a number of the issues that had driven risk appetite in 2022 started to ease, although after a strong rally in most parts of financial markets in January, February and March marked a return to more negative broader market investor sentiment. Renewed inflation fears and strong labour markets in the US, UK and Europe lowered the likelihood of a dovish pivot by the central banks in the near term.

For primary Asset Back Securities ("ABS") markets, issuance was a little bifurcated; the start of the Russia/Ukraine conflict and developing challenges in tech and crypto markets saw a hiatus in issuance in March 2022 but sentiment recovered quite quickly and April provided an attractive opportunity for investors looking to add floating rate exposure following the Bank of England moving ahead with rate hikes. The month was very busy across all asset classes, even as spreads widened across the capital stack, but was followed by a virtual slowdown in May, and then a small rebound in June.

Despite the ongoing market volatility and weaker views, several issuers placed deals in July ahead of the summer. While August proved to have a relatively more constructive tone but was typically quiet with virtually no primary issuance. September saw a modicum of normality returning to the primary pipeline, allowing issuers to price deals into a receptive investor base early in the month. However, market conditions deteriorated sharply later in the month, triggered by the UK mini budget, and issuance ceased abruptly forcing one UK prime RMBS issuer to retain a deal it had planned to sell. Secondary markets also sold off heavily, more than wiping out the gains from the rally earlier in the month.

The subsequent stress in Gilts and wider rates markets was compounded by the now well-documented bond sales by pension funds running LDI strategies. The ABS market saw extremely high levels of secondary sales in the run-up to month-end; over €4bn of sales went through the typical BWIC ("bids wanted in competition", meaning a request for bids submitted by an investor to a number of dealers) in the last week of the month, more than in the previous three months combined. In the main, most of the selling activity was concentrated in senior AAA and AA RMBS/ABS/CLOs and Australian RMBS.

Secondary markets dominated ABS and CLO trading flows during October and November in the absence of much primary issuance. Rishi Sunak's appointment in late October 2022 reassured markets, and the CLO market saw the first rumblings of primary issuance after a very quiet period.

The primary market saw a solid start to 2023 with a small handful of deals; the main themes during the first two months were a very strong spread performance across all asset classes, with the understandable exception of Collateralised Mortgage Backed Security ("CMBS"), and a lot of demand for bonds across nearly all rating bands. Also during February 2023 the ABS market saw Blackstone default on a single loan within a CMBS transaction (the loan being for Finnish offices) after it failed to get bondholder approval for a maturity extension. Whilst the Company doesn't have exposure to this transaction, and we are aware the income from tenants is enough to service the debt and the LTV on the mortgage is low, we will be following the process closely. An active March 2023 in primary markets quickly unravelled as the US and European banking "hiccup" struck financial markets mid-month, which put paid to any further issuance until the last week of the month as spreads widened in quick order and borrowers waited to observe market developments.

Music royalties

(compare Music Royalty funds **here**)

Merck Mercuriadis, manager, Hipgnosis Songs Fund – 13 July 2023

Five years ago we predicted that the recovery of the music industry from the previous 16 years of technological disruption would be driven by the convenience and transformational growth of streaming. In addition, we considered that we could deliver an exceptional return by acquiring iconic Songs while they were still attractively priced.

Since then our thesis has become reality and we have transitioned from an era where almost all consumption of music was unpaid to one where almost all consumption of music is being paid for. This set of results is an early indication of what's to come in the future.

People listen to iconic Songs whatever the macroeconomic conditions; the change in the way in which we consume music means that, increasingly, when we hear a song, a payment is being generated; music streaming continues to grow with its utility-like revenues, with the number of paid subscribers globally growing by 13% year-on-year to around 600 million, according to the IFPI, including over 100 million paying subscribers in the US.

Importantly, around the world the true value of Songs and Songwriters is increasingly being recognised.

Artificial Intelligence

Recent developments in Artificial Intelligence (AI) tools offer new opportunities which we are already looking to use in support of our iconic Songs. The enduring success of our Songs is down to the strong emotional connection they have with millions of consumers all over the world and they are therefore always in demand. AI enables us and other creators to quickly and cost effectively deliver new versions of these Songs, create interpolations or otherwise introduce our music to new audiences. Global copyright laws provide a significant degree of protection for our Intellectual Property. Nonetheless we are working with legislators who are actively looking at how to fill any gaps which are created by this new technology and we will support measures which prevent AI from learning from in-copyright music and recordings to the detriment of artists and Songwriters.

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Private equity and growth capital

(compare Private equity and growth capital funds **here**)

Managers, Schroder British Opportunities - 06 July 2023

Over the 12 months to end March 2023, UK small and mid-cap stocks performed poorly as their valuations were negatively impacted by rising interest rates, as Russia's invasion of Ukraine looked set to prolong the inflation problem facing developed economies. UK mid-caps and UK small caps (represented by the FTSE 250 and FTSE Small Cap indices) saw total returns of -7.9% and -9.0% respectively, while UK large caps (represented by the FTSE 100) returned +5.4%. The UK small and mid-cap area of the market has a larger contingent of fast-growing businesses in new and emerging industries, which were shunned for most of 2022 in preference for large companies able to return cash today. At the same time, higher interest rates threatened to further squeeze consumers also struggling to cope with soaring energy and food costs, weighing heavily on quoted retailers, as well as the travel and leisure and home construction sectors. These and other domestically focused companies are well represented in UK small and mid-cap indices. Valuations reached very depressed levels in the autumn when some ill-advised policies from the Liz Truss government spooked markets. A collapse in sterling and soaring market interest rates threatened to heap further pressure on consumers and businesses, although a new government was able to restore confidence and stability to asset prices relatively quickly. More broadly, hopes built towards the back end of 2022 that central banks might 'pivot' to cutting interest rates in late 2023 also contributed to a recovery in UK small and mid-caps. Domestically focused companies recovered particularly well during this phase as the UK economy performed much more resiliently than feared as European wholesale energy prices fell back very sharply.

While private equity valuations have held up better than those of public markets, the asset class has not been immune to global economic headwinds, inflation and increased interest rates. Our focus is on the small to mid-market area of the UK private equity landscape, but we believe the following provides useful insight into recent activity to contextualise the period under review. Following a stellar year in 2021, deal volumes in the UK mid-market private equity segment fell by 19% year-on-year in 2022 (from 843 deals to 680 deals), while the total deal value fell 6%

(from £49.1bn to £46.0bn). Despite these year-on-year decreases, this was still a relatively strong year for private equity deals in the context of the last five years. Additionally, exit volumes fell by nearly 23% year-on-year in 2022 (from 189 exits to 146 exits), while the total exit value fell 55% (from £19.1bn to £8.6bn). Conspicuously there were no IPO exits over the year, which is most likely explained by uncertainty in markets.

Environmental

(compare environmental funds **here**)

John Wallace, manager, Jupiter Green Investment Trust – 13 July 2023

The first several months of the period under review were characterised by a continued slump in global stock and bond markets as concerns grew around persistent inflation, moderating economic growth and hawkish central bank policy. In Europe, energy prices surged as Russia cut supplies in retaliation for sanctions related to the war in Ukraine. In China, the economy was constrained by a faltering property market and lockdowns intended to control COVID-19.

Markets began to pick up in the second half of 2022 and into the first quarter of 2023, latterly due to investor optimism from China's reopening. European stocks benefited in-part from being one of their largest trading partners and the market continued to rebound in the region on falling natural gas prices and improving investor sentiment from depressed levels. In the US, gradually moderating inflation and signals of economic resilience led the market to view the Federal Reserve's slowing pace of interest rate rises as a signal that a deep recession can be averted.

In July, a largely unexpected breakthrough in Washington led to the Inflation Reduction Act (IRA), which was subsequently passed by Congress in August. The Act represents the largest government investment in addressing climate change in US history and provides $370bn over 10 years for climate solutions.

In response to the US Inflation Reduction Act (IRA) published last year, the European Commission published two important components of its Green Deal Industrial Plan in March: (1) the Net-Zero Industry Act, to scale up manufacturing and attract investment for strategic net-zero technologies in the EU; and (2) the Critical Raw Materials Act to ensure the EU's access to resilient and sustainable supply of critical raw materials.

Renewable Energy

(compare renewable energy funds **here**)

Dr Alex O'Cinneide, manager, Gore Street Energy Storage Fund – 17 July 2023

The world is experiencing unparalleled transition to a cleaner, more secure energy system through the widespread adoption of renewable energy sources. Generation from wind turbines, solar panels and other distributed renewable energy resources is rapidly decarbonising global power grids with inherently intermittent output, leading to higher volatility on energy grids. The ability to effectively capture, store and discharge energy when it is most needed has become a critical tool in successfully integrating clean power generation, improving the efficiency of energy systems and reducing the world's reliance on polluting fossil fuels.

New urgency has emerged within the low carbon energy transition following Russia's ongoing invasion of Ukraine, which has exposed several markets' overreliance on fossil fuels. Shortages of oil and gas, combined with increased episodes of extreme weather, have caused energy prices to spike as demand outstripped supply.

Energy storage owners are well placed to provide grid operators with the flexibility they need to reduce these imbalances between energy demand and supply by supporting them to reduce system volatility. This improves energy security to maintain the electricity grid system at the correct frequency and keep the lights on while ensuring the global move towards decarbonisation can continue at pace. The faster these flexible renewable energy solutions can be deployed, the faster society can move to a more sustainable world.

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Property

(compare UK property funds **here, here, here, here, here, here** and **here**)

Rita-Rose Gagné, chief executive of Hammerson:

The consumer and occupier landscape continues to evolve at pace. Occupiers are continuing to shift to using physical space for a broad mix of uses, including point of sale; last mile fulfilment; returns; servicing; experiential; education; workspace, and leisure -living spaces. At the same time, consumers demand top quality environments and experiences.

Consumer spending continues to be resilient, with sales positive vs HY 22, reflecting an inflationary environment, although we have seen some change in spend patterns with consumers trading down in certain categories (e.g. fashion accessories outperforming jewellery). In-store footfall and sales have also been supported by a more cautious consumer, focusing on value (price vs. quality) which is easier to do in-person. In addition, the increasing number of occupiers charging for online deliveries and returns continues to drive store visits.

David Sleath, chief executive of SEGRO:

Occupier demand for industrial and logistics space is proving resilient due to the long-term, structural drivers at play in our sector. At the same time, modern sustainable space is in short supply across our chosen sub-markets in Europe and a lack of available land limits the potential supply response. We expect that this supply-demand tension will drive further rental growth across our portfolio, normalising over time towards our long-held expectations of 2% to 6% per annum.

Valuations have been much more stable in the first half of 2023 and investment has activity picked up across the market, including our own disposal of a UK big box portfolio since the period end (which was sold ahead of June 2023 book value). This demonstrates that investors are seeing value at current levels of pricing, and we believe that demand will further increase as clarity emerges around future interest rates, with investors attracted by the positive fundamentals and long-term structural growth potential in logistics and industrial warehousing.

Harry Hyman, chief executive of Primary Health Properties:

The primary care market continues to face challenges in meeting the growing demand for healthcare services. The capacity of existing facilities remains a significant obstacle to implementing government policies aimed at expanding service delivery within general practice, including social prescribing, clinical pharmacists, physiotherapists, mental health, minor operations and other activities. The need for additional space is driven by a population that is growing, aging and suffering from increased chronic illnesses, which are placing a greater burden on healthcare systems in both the UK and Ireland. The extent of the NHS England backlog remains a significant concern, with hospitals struggling to meet objectives for cancer care and routine treatments. The number of patients waiting for treatment has reached record highs, exacerbating the need for improved and increased primary healthcare infrastructure.

There is a growing expectation that many services in the medium-term will progressively move from hospitals to primary care settings, necessitating substantial investment in facilities to accommodate these changes and alleviate the pressure on secondary care. in the years to come. The UK government's new vision for primary care premises, advocating the establishment of hubs or "super hubs" is a step in this direction. The UK government's vision is that these hubs is to promote collaboration among various primary care staff and provide a wider range of services in a single location. Larger GP practices with more staff and patients are shown to produce better outcomes. This is in line with larger purpose-built medical centres typical of PHP's portfolio.

Declining rents in real terms have made investing in the transformation of GP facilities less appealing. Construction costs have risen significantly over the past decade, surpassing the growth in primary care rents, driven by material and labour costs and increasing sustainability requirements, all of which has been compounded by Brexit and the COVID-19 pandemic. Future developments will now need a significant shift of between 20% to 30% in rental values to make them economically viable and we continue to actively engage with both the NHS, Integrated Care Boards and District Valuer for higher rent settlements.

The commercial property market continues to be impacted by economic turbulence but primary care asset values have continued to perform well relative to mainstream commercial property recognising the security of their government backed income, crucial role in providing sustainable healthcare infrastructure and more importantly a much stronger rental growth outlook enabling attractive reversion over the course of long leases.

The lack of recent transactions in the first half of the year has resulted in valuers, to an extent, placing reliance on sentiment to arrive at fair values. We continue to see that for both the primary care and indeed the wider commercial property markets, the high level of financial market volatility and economic uncertainty has resulted in a 'wait-and-see' attitude amongst investors until the outlook settles down.

Rising interest rates will undoubtedly continue to impact the market. However, notwithstanding the significant increases and volatility in interest rates seen in the first half of 2023 we continue to believe further significant reductions in primary care values are likely to be muted with a stronger rental growth outlook offsetting the impact of any further yield expansion.

Additionally, the market for primary care assets is relatively small with most assets tightly held by the main specialists in the sector and consequently we anticipate most investors will likely hold their existing assets in the current market primarily because of:

- Limited supplies of stock;
- Very secure, rising income streams with an improving rental growth outlook;
- The main specialists in the sector all having strong balance sheets so there are unlikely to be any "forced sales"; and
- A desire from investors to seek a "Safe Haven" with some shifting from other property sectors.

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Richard Smith, chief executive of Unite Group:

Structural factors continue to drive a growing supply / demand imbalance for student accommodation. Demographic growth will see the population of UK 18-year-olds increase by 140,000 (19%) by 2030. Application rates to university have also grown steadily over recent years, reflecting the value young adults place on a higher level of education and the life experience and opportunities it offers. Demand from international students also continues to grow, as reflected in the 2% increase in undergraduate applications for the 2023/24 academic year.

The supply of student accommodation cannot keep pace with student demand, and many university cities are already facing housing shortages. There has been a 20-40% reduction in the availability of homes to rent in most UK regions when compared to prior to the pandemic (source: Zoopla). Private landlords are choosing to leave the sector in response to rising costs from higher mortgage rates and increasing regulation, such as EPC certification and the anticipated Renters Reform Act. Annual mortgage repayment costs for buy-to-let landlords are expected to rise on average by £3,300 by the end of 2025. We expect these additional costs to either be passed on to students or result in a further reduction in the supply of HMOs (housing in multiple occupancy). The recent reduction in private housing supply has significantly increased demand for our product in many cities and we expect this trend to continue for a number of years.

New supply of purpose-built student accommodation (PBSA) is also down 60% on pre-pandemic levels, reflecting viability challenges created by higher build and funding costs. In many markets, property valuations are now below replacement costs, further constraining new supply. Once allowance is made for first generation university-owned beds leaving the market each year through obsolescence, we expect to see almost no net growth in PBSA supply in the near term.

Market conditions are the strongest we have seen for many years. There is growing unmet need for high-quality, affordable student housing at a time when HMO landlords are leaving the sector and new supply of PBSA is limited. There is growing appeal for students in our all-inclusive, fixed-price offer, which compares favourably in price to HMOs. This supports sustainable growth in rent and earnings in 2024 and beyond.

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