CARTLIDGE MORLAND
INDIVIDUAL WEALTH MANAGEMENT

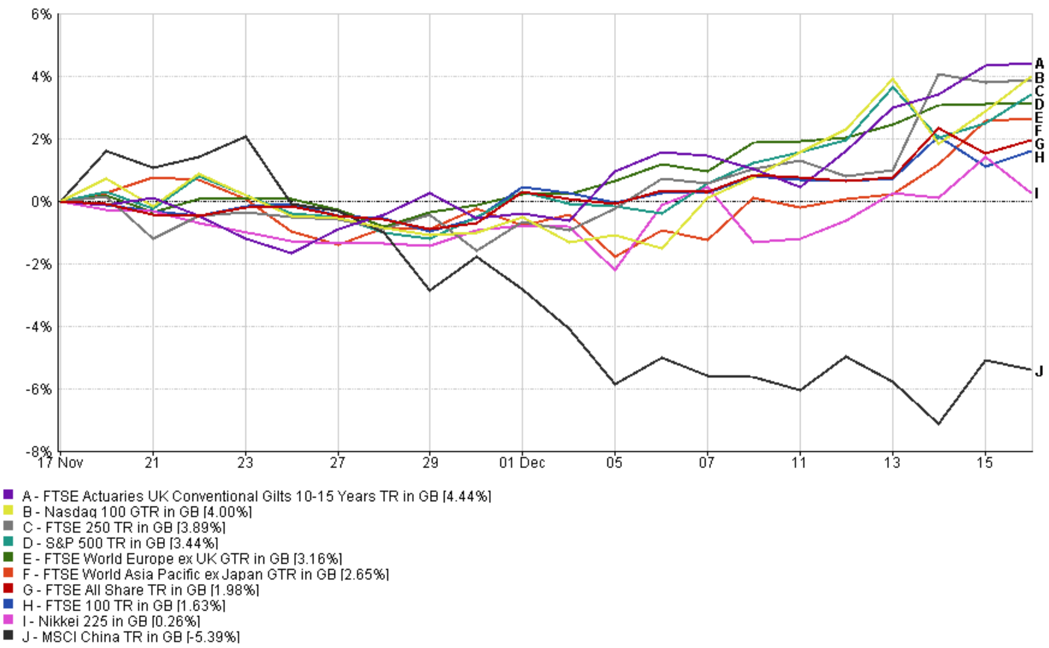
INVESTMENT COMMENTARY

18 DECEMBER 2023

OVERVIEW

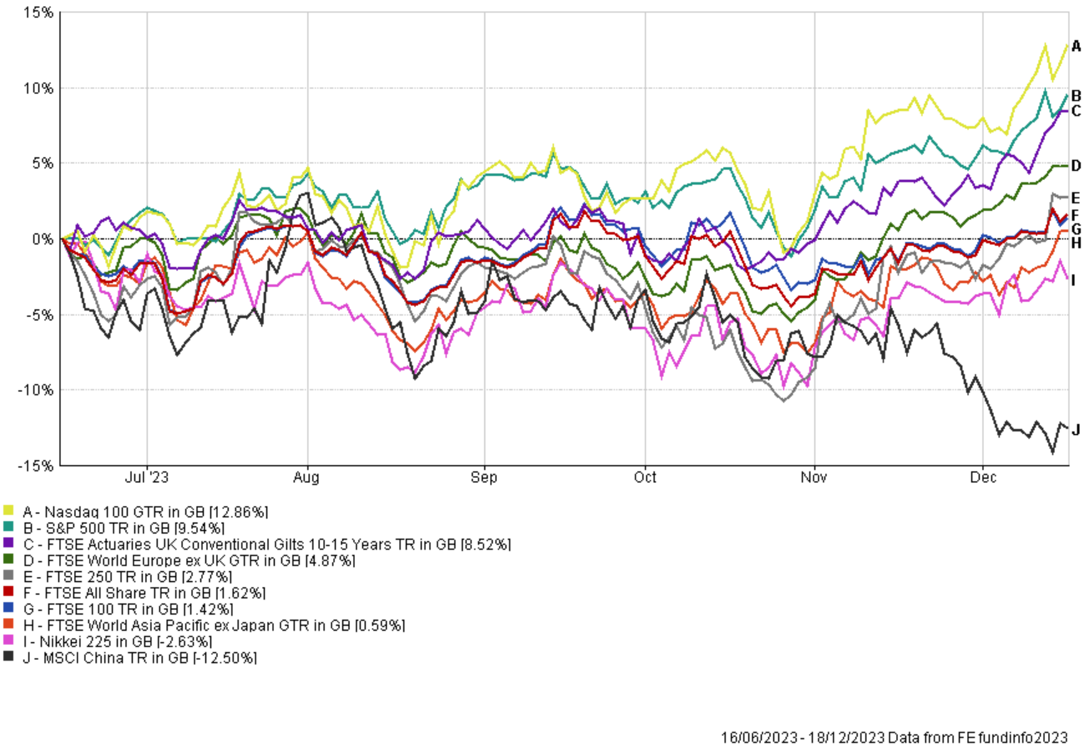
Most major investment markets have put on a growth spurt over the past month, with the exception of the Chinese equity market which continues to struggle. Our portfolios have marginal exposure to Chinese equities although negative sentiment has impacted on broader based Asia Pacific and emerging markets funds. The key drivers of increasing optimism are falling inflation and the increasing likelihood that the current interest rate hiking cycle is at its peak. The US, European and UK central banks did not alter interest rate levels at their last meetings of the year. The question now is …… when will central banks start to cut interest rates and may it be too late to prevent worse than mild recessions?

ONE MONTH INVESTMENT MARKETS STERLING TOTAL RETURNS



17/11/2023 - 18/12/2023 Data from FE fundinfo2023

SIX MONTH INVESTMENT MARKETS STERLING TOTAL RETURNS



The US Federal Reserve (Fed) kept the Fed Funds Rate of interest on hold at its December meeting for the third time in succession - it was last raised in July by 0.25%, to a range of 5.25-5.5%. Investors have been seeking signs from the Fed that it has finished raising rates over this cycle. Jay Powell, the Fed Chair, seemed to indicate this may well be the case. His comment that the Fed's open market committee members "think it is not likely that it will be necessary to raise rates further" was interpreted as such. The committee members expect that the Fed Funds Rate will end 2024 at an average level of 4.6% - which is 0.5% lower than they expected at their September meeting. The implication is that there could be three rate cuts next year. Jay Powell also pointed out that the Fed would perhaps cut rates before inflation hit its 2% target, as it could otherwise mean that the cuts would come too late and a recession could ensue. Inflation slowed to 3.1% in November 2023 helped by lower energy and food prices, the lowest reading in five months, from 3.2% in October. Core inflation remained at 4% and the monthly rate rose to 0.3% from 0.2%, in line with forecasts. The Fed is also tasked with maintaining full employment. It would seem from recent figures that there is some degree of softening in the jobs market with 199000 being added in November, the number of job openings falling and rises in average hourly earnings running at around 4.0% pa.

Investment markets made gains in the wake of the Fed's decision and Jay Powell's comments, because lower inflation and interest rates are beneficial for companies. Profits are unpinned by lower interest payments on loans and rising demand. The bond market was also buoyed by the news and yields fell (prices increased) as a result.

Following the Fed's positive outlook on inflation, the European Central Bank (ECB) and Bank of England (BoE) were less sanguine about inflation prospects, dampening the market rally from the previous day. Christine Lagarde (ECB President) and Andrew Bailey, (BoE Governor), warned that there was still some way to go on inflation and more work would be required to get to their respective 2% pa inflation targets. The ECB maintained its deposit rate at 4.0% and the BoE also held Bank Rate at 5.25%. These more hawkish central bank views weighed on investor sentiment and cooled the rally as uncertainty about when interest rates would peak continued. Indeed three of the members of the Monetary Policy Committee of the BoE voted for an interest rate increase. The MPC decision came in the wake of weak economic data with UK Gross Domestic Product (GDP) contracting by 0.3% from September to October. However, other economic indicators point to UK business activity growing at its fastest rate in six months in December, driven by expansion in the services sector, so exceeding expectations. Consumer confidence also ticked higher in December. It now seems that contraction may be avoided in the final quarter of the year. The eurozone economy contracted by 0.1% in the third quarter of 2023, with other economic indicators pointing to ongoing weakness. It seems monetary tightening is dampening demand and growth, leading to lower inflation rates. The eurozone inflation rate was at 2.4% pa in November - its lowest level since July 2021. The UK Consumer Price Index (CPI) fell to 4.6% pa in October 2023.

The Chinese economy continues to be negatively affected by its struggling property market. New home prices are still falling. The Chinese authorities have signalled that some measures to support the Chinese economy are to be considered, but perhaps only modest interest rate cuts and some easing of the bank reserve requirements. China has committed to a growth target of 5.0% pa which might appear overly ambitious given the weakness of its economy. It should be remembered that it is only a year since China emerged from its lockdowns, so 5.0% growth should be achievable from a low starting point. The Chinese economy is experiencing deflation, with the CPI falling by 0.5% pa in November. The threat of a sustained period of deflation could lead to weakening growth and has weighed on investor sentiment.

The Japanese economy contracted sharply in the third quarter of 2023 by 2.9% pa which was greater than expected. The Bank of Japan (BoJ) had been expected to start to tighten its monetary policy as inflation is exceeding the BoJ's 2.0% target and wages continue to rise. The BoJ will need to proceed with caution, as the likely pivot in US interest rates could see the Yen strengthen, so rates are unlikely to rise in the short term. Against a backdrop of above target inflation, the Japanese government is taking action to coax investors away from cash deposits and into equities. Changes to the Nippon Investment Savings Account (NISA) will mean that individuals' equity investments held in NISAs will be tax exempt. Annual NISA contributions and cumulative limits have been increased substantially. If successful, these new initiatives could see stronger demand for domestic Japanese equities which together with ongoing improvement in corporate governance, should be supportive of the equity market.

The CM Investment Commentary is compiled by Angela Cooper, Managing Director of Cartlidge Morland's Investment Services team.

Angela runs the firms' investment management propositions, with over 30 years' experience in investment research working for investment companies, leading UK national IFAs and wealth managers. Angela graduated from the London School of Economics and is a Chartered Insurance Practitioner.

OUR VIEW

International investors believe interest rates have peaked and that inflation is on its way back to target. The Fed's rhetoric has supported this view, whilst the BoE and the ECB are trying to rein in expectations. Bond and equity markets have responded positively, but the timing of future interest rate cuts remain uncertain and it is very much a case of watching the economic data.

We have been increasing exposure to fixed interest assets offering attractive yields over the last few months in anticipation of the interest rate cycle peaking. As inflation rates fall and interest rates stabilise or begin to be cut, bond prices should increase. In the meantime, high yields make important contributions to portfolio returns. We have held higher cash positions than usual – again to take advantage of high interest rates. At some point, we will start to trim these cash positions as interest rates reduce and other opportunities appear elsewhere. Japanese equities have provided strong returns in sterling terms over the past year, despite the rise in Sterling against the Yen. We believe that demand will be supported as corporate governance changes improve companies and the Japanese people start to invest in domestic equities for the longer term, encouraged by government policies.

It seems that a 'normalised' financial system – with interest rates and bond yields at 'normal' levels is now beginning to deliver for private investors. Balanced portfolios are typically yielding around 3.0% pa and the yield from our model balanced income portfolio is around 4.4% pa. For those drawing income from their portfolios, these yields are of substantial benefit. The lower yield environment post credit crunch - prevailing until 2022 – made those seeking 'income' from their portfolios far more dependent upon more volatile capital returns to provide it.

It is clear central bankers and markets are now at the 'what next?' stage, believing the necessary measures are already in place to curb inflation, barring geo-political exceptions. Even before inflation returns to target, planning is beginning for delivery of the next recovery and growth phase for the global economy.

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OUR VIEW .... Continued

Presently many UK/European/Asian companies with strong earnings franchises are significantly under-priced by the markets as are many of the strongly growth-orientated companies in the mid-cap and small-cap areas. The shares of such companies offer investors strong potential returns, which will come through. The US is more nuanced as an exceptionally strongly performing economy has kept market sentiment comparatively buoyant. US companies, in general, are viewed fairly valued whilst the seven mega-tech stocks we have so often discussed have acquired a momentum of their own. We have reached the stage that younger investors often believe US equities always out-perform, or that the mega-techs will steam on relentlessly - forever. Quite when their dominance of global markets recedes, or which companies drop from the 'peloton' (or when) is impossible to predict. Index tracking investment results in their very size drawing in more buyers - but where does that end, if the price of certain shares bears increasingly little relation to the fortunes of the underlying businesses? We do not have the answers – nobody does - and views are various. Care should be taken not to be over-exposed, but as we have alluded to previously, one cannot afford to ignore those seven companies accounting for over 15%

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If you have any queries

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OUR VIEW .... Continued

of global market cap. If one weights just seven companies at 15% of one's portfolio, is that too much concentration risk? We believe that it is and will not chase returns by over-concentrating client investment risks. It was announced recently that Apple's size now exceeds the annualised GDP of all but the World's six largest economies! Corporate titans of such weight and influence in global financial markets are previously unknown. However, it is important to remember that General Electric was once for several years the world's most valuable company, yet is now ranked 52nd in the US only 'Fortune 500' corporate index. Prior to the 2008 Great Financial Crisis, Royal Bank of Scotland was the world's largest bank by asset size – need one say more? Over the longer term it pays to diversify risk - at the expense of shorter term returns.

We take this opportunity to wish all clients a very Merry Christmas and our best wishes for 2024.

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