Wealth
Management

Quarterly Report
Sustainable Portfolio Service

Q3 2023

Forward-looking
for generations

Cover image
Bauer brothers, Hortus Botanicus, detail from "Lotus corniculatus L.," around 1788
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Phoebe Stone, Head of Sustainable Investing, LGT Wealth Management

Q3 2023 summary

Overview

Throughout the second quarter of 2023, the overriding hope was that rates were close to their peak. Fast forward to the third quarter and markets are getting to grips with an interest plateau, resulting in both equities and bonds posting declines.

At a glance

- Interest rates close to peaking.
- Bond yields rose and equities weakened on ‘higher for longer’ rhetoric.
- China attempts to stimulate flagging economy, but investors remain cautious.
- Commodity prices rise on supply restrictions.

The fight against inflation

Macroeconomic events once again played a dominant role in financial markets during the third quarter of the year. The Federal Reserve (Fed) raised interest rates, taking the target interest rate range to a 22 year high. Inflation has been trending lower as a result of higher rates, but it remains at levels too high for central banks to claim victory in their fight against inflation. Although inflation has continued to trend in the right direction there was a slight uptick in August, driven by a sharp rise in oil prices following production cuts from Russia and Saudi Arabia.

Going back to central bank world, the Fed doubled their previous 2023 growth expectations for the economy, reinforcing the rhetoric that interest rates would stay higher for longer. The fight against inflation partly requires some level of demand destruction but the economy has remained more resilient and has caused markets to pull back, perhaps slightly counterintuitively to some readers. A key part of reducing demand in past economic downturns has been driven by rising unemployment as there is less people with the capacity to spend but the historically tight labour market has shown few signs of cracking, and this further cemented the markets narrative of ‘higher for longer’.

In the UK, inflation is falling but also remains at levels too high for central bank comfort. Speaking in front of MPs at the start of September, Bank of England Governor, Andrew Bailey, suggested that UK interest rates are now much nearer their peak, and we are now in ‘wait and see’ mode. Unlike the US economy, we are starting to see the early signs of weakness, both in the labour market and slowing economic activity and we are keeping a watchful eye on developments here. It is not too dissimilar in Europe where the European Central Bank rose interest rates to the highest level since the union formed, a feat many thought incomprehensible when rates started their march north.

China’s re-opening

Despite high levels of consumer savings, China’s re-opening has been disappointing. Economic data has been weak and policies to stimulate the economy have been incremental and specific, rather than large and broad based. The property sector continues to weigh on sentiment, with two of the country’s largest developers making headlines over the quarter with repayment of large debt burdens taking centre stage. It very much seems that the Chinese property sector issues are a function of past, broad based, policy stimulus and it is perhaps not much of a surprise the Chinese Communist Party are treading more conservatively this time round.

Portfolios in review

Fixed Income

Fixed income markets once again became the prime focus in the third quarter. Having had a reasonable sense of where interest rates would peak for some time, markets have become more concerned around when we would be back to 'normal' – namely, that interest rates would be higher for longer. Investors, who have enjoyed a modest rally in the absence of a deep recession, gave back some of those gains as it became apparent that central banks still have some work to do on the inflation front. The impact of this change to the narrative was felt on bonds with a longer duration, i.e., you get your money back further down the line. These moves negatively impacted portfolio exposures in these longer duration government bonds.

Credit markets, bonds issued by companies, have been reasonably sanguine about this new interest rate picture – balancing higher financing costs with the reduced probability of the hard landing scenario that it represents. Perhaps surprisingly in the light of equity market declines, the additional interest rate investors demand for lending to corporations fell in the third quarter, reflecting the ongoing normalisation of markets from the chronic stress of last year. This aided exposure to shorter-dated, higher quality corporate bonds where we can take advantage of high yields without taking much risk in the way of solvency or interest rates. We retain a preference for higher quality corporate bonds and are happy to keep a shorter duration bias here.

Equities

The third quarter saw declines in equity markets, after a rally in the first half of the year that was dominated by only a handful of stocks. Energy prices, interest rates and technology drove sentiment, feeding through to regional performance that saw the UK running counter to the global market. As a result of the production cuts pushing traditional energy prices up, a number of fossil fuel companies have benefitted, which has naturally not fed through to sustainable portfolios. This comes at a time when there have been some negative headlines around renewable energy construction, but we see this as an inevitable bump in the road and highlights the need to be selective and focus on only the highest quality areas of what is a large growth area. The risk for the wider economy however, is that whilst producers can often absorb short-term volatility in energy costs, there is a likelihood that when prices remain persistently high, they will be passed on to the consumer.

Year-to-date the resurgence of technology stocks has been impressive, however, we saw a pull back in the past quarter. Much of the performance can be attributed to stock specific reasons as well as the wider economy. For Taiwan Semiconductor Manufacturing Company (TSMC), news that the company asked a major supplier to delay shipment raised fears that inventory stockpiles were building from a lack of sales. Apple also faced its own issues as reports emerged that their new iPhone is too fragile and overheating.

The impact of restrictive monetary policy and fears surrounding economic growth has inevitably caused markets to pullback and our portfolios have not been immune to the broad declines in markets. However, over the long term we remain optimistic about the prospects for quality-growth businesses that can withstand high interest rates and generate growth through the shift to a more sustainable economy.

Sustainability update

The UK's bumpy road to net zero

UK Prime Minister, Rishi Sunak, has recently announced a watering down of some of the UK's climate policies that were originally engineered to help transition the country to net zero by 2050.

A summary of the changes

- Delaying the ban on new petrol and diesel car sales from 2030 to 2035
- Delaying requirements to phase out sales of gas boilers by 2025 with homeowners now only having to install heat pumps when they are replacing their boilers. However, boiler upgrade grants will be doubled to GBP 7 500
- Energy efficiency targets for landlords scrapped
- Previously announced in July, a commitment to issue more North Sea oil and gas licences.

These announcements may undermine the UK's position on the global stage and create further uncertainty for companies that may be looking to invest into climate friendly operations and net zero technologies. If the Government can't provide sufficient confidence and conviction around their commitment to reach net zero emissions by 2050, then companies may be more likely to delay investment or invest elsewhere. This is of course particularly relevant for those industries that need to undergo highly disruptive changes, for example the automotive industry. Interestingly, and perhaps surprisingly, there has been heavy push back on the Government's actions from some leading voices in these sectors.

US carmaker, Ford, was quick to respond saying "the UK 2030 target is a vital catalyst to accelerate Ford into a cleaner future" and "our business needs three things from the UK government: ambition, commitment and consistency. A relaxation of 2030 would undermine all three". Part of the Government's argument is that Electric Vehicles are still too expensive, but this fails to address the highly probable innovation and cost efficiencies that will occur from now up until 2030, and such a policy move could allow companies to delay investment and push these cost efficiencies down the road.

To us, it remains clear that the shift from a fossil fuel powered energy system to one reliant on renewables is both environmentally and economically attractive, which will sustain support and progress over time.

Siobhan Archer, Senior Sustainable Investing Specialist

Global developments

The UK's recent changes to key green policies marks a disappointing setback, however, we continue to watch global developments. For example, it has now been a year since the US Government set out its Inflation Reduction Act, which provided USD 369bn in support for home grown climate investments. Since its announcement, we have seen more than 270 new clean energy projects announced with investments totalling USD 132bn, supporting the creation of over 130 000 new jobs. The International Energy Agency has also estimated that more than USD 1.7trn will be invested in renewables this year, which compares to just over USD 1trn in fossil fuels. Our global approach means we are able to access compelling investment opportunities that can take advantage of both regional and global dynamics and are not dependent on the UK Government's stance and potential missteps.

So, whilst we pay close attention to these bumps in the road and assess whether they indicate any structural shift in the longer-term attractiveness of our sustainability mega trends, we place them into a broader context. To us, it remains clear that the shift from a fossil fuel powered energy system to one reliant on renewables is both environmentally and economically attractive, which will sustain support and progress over time.

Outlook and positioning

So far, market participants have focused on the downsides of interest rates being expected to remain higher for longer. Higher interest rates mechanically impact the value of assets by increasing the discount rate we apply to earnings. Expressed differently, higher interest rates over the long term mean that other assets need to fall in value in order to reflect the risk-free rates on offer. An asset with an earnings yield (earnings divided by price) of 3% say in 2019 made sense because cash and government bond yields were close to zero, but less so in an era of 5% interest rates. This has been the story of markets over the last two years, and one could argue that over the past twelve months it has created a 'two steps forward, one step back' dynamic.

There is a flipside to this for the economy and asset prices – higher than expected interest rates are a sign of economic health. In an era of fiscal activism and dominance, the rationale for interest rates remaining higher for longer aligns with the recognition that monetary policy alone is no longer the sole strategy available to stimulate economic growth. A combination of more statist economic policy and sponsoring the green transition means that governments are running the levels of deficit that are very unusual for this stage in the economic cycle. The current budget deficit of the US is at levels we have not seen outside of the Global Financial Crisis and COVID-19.

Stimulating economic growth solely by monetary policy, which is not particularly effective or precise, via historically anomalous low (or negative) interest rates is no longer required. From an economic standpoint, and setting aside discussions about fiscal sustainability, budget deficits feed directly into nominal gross domestic product (GDP) and therefore corporate profits.

Higher for longer rates suggests prolonged higher returns. We can see this in fixed income - US Treasury ten-year bonds are back at 2007 levels. Investors can now generate reasonable returns in fixed income without taking unreasonable risk. The higher yields also create an asymmetry – the yield gives you a buffer to weather potentially lower prices. And from an equity standpoint, higher corporate profits should feed into higher stock prices.

Of course, for all this to be 'unlocked', markets need to finish pricing in higher interest rates. Short term, it is very hard to say with any certainty when this occurred, but the progress is clear. Ten-year government bond yields are a measure of the market's long-term average base rate expectations. With central banks all but finished, and assuming there will be a recession or an external shock at some point over the next ten years, bond yields at 4.6% in the US and 4.5% in the UK look to be pricing in a reasonable scenario.

With cash finally paying an attractive interest rate, the question of 'why invest?' is common and indeed reasonable. We believe that where asset prices have moved over the past two years, investing will offer higher returns than cash over the medium term and that trying to time that too aggressively generally does not work. Market returns can be irregular and stepping out of the best days results in miserable returns for the long term. Cash's ability to be set 'overnight' has been a positive attribute as interest rates have gone up – the reverse will be true as and when they start to drop. When this will occur is uncertain, but this reinvestment risk could hit on both sides. Lower interest rates could mean higher asset prices, leaving investors with a lower interest rate and an asset market that is harder to step into.

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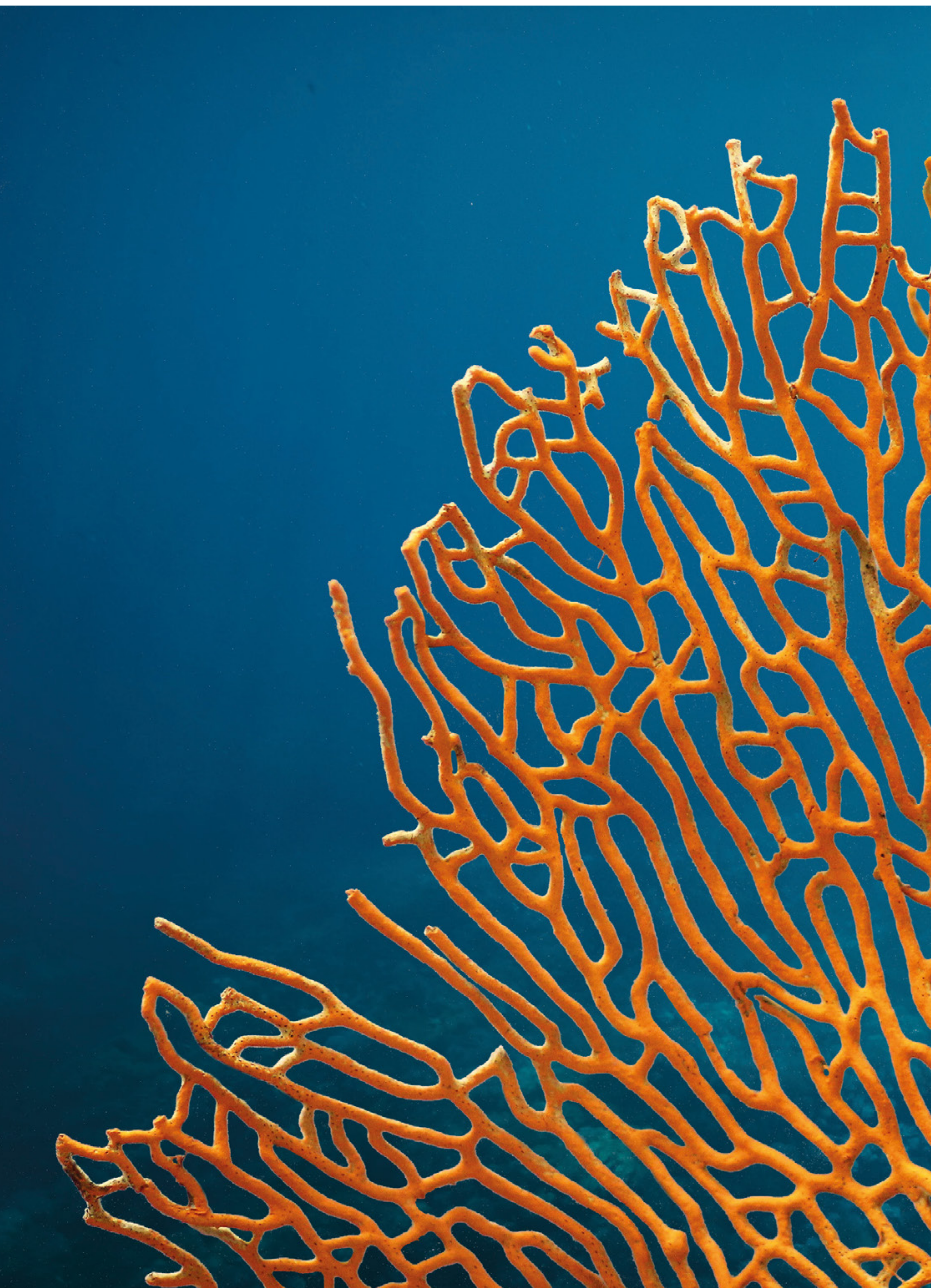
>
> Jordan Kelly, Sustainable Portfolio Manager



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