

### EXECUTIVE SUMMARY

- The global economy is holding up better than it was widely expected to in the first half of 2023, led by the US. This is despite turbulence in the banking sector, US debt ceiling uncertainty, a spluttering Chinese economic reopening and ongoing geopolitical instability.
- As we argued in our January letter, “...a soft landing, characterised by growth slowing but avoiding a ‘broad-based weakening’, is fairly likely, yet under-appreciated”. Having risen 14.2% this year so far, the global equity<sup>1</sup> market appears to agree, with earnings expectations better than expected in aggregate.
- Whilst we are alert to the evolution of macro-economic conditions, and how they can shift rapidly in response to supply or demand shocks, our central expectation remains that any cyclical downturn in the US is unlikely to be deep and probably no more than a technical recession in the coming year.
- Having gradually increased the duration profile of our multi-asset portfolios over the past year, we have allocated more capital to conventional government bonds this quarter to reflect improved total return prospects and key diversification benefits.
- Equities have delivered strong returns so far this year, but a large segment of the market is yet to re-emerge from last year’s woes. This offers compelling opportunities for patient investors with allocation across global industries.
- Profit margins suffered an inevitable decline last year as cost inflation accelerated. However with inflation pressures easing and economic growth still robust, the picture for the US corporate sector as a whole is more promising. Earnings expectations have improved, supporting the returns of the broad equity market at large.
- Several of our underlying equity strategies emphasise medium and smaller companies, and in addition to improved earnings expectations, they are priced at attractive valuations. Whilst smaller companies typically trade at a discount to larger peers, the c. 40% divergence is almost as extended as ever.

There are no shortage of risks to our outlook, whether economic or geopolitical, that could shake investors’ nerves and drive volatility higher. We remain vigilant to shifts in the macro-environment that could challenge the outlook we describe.

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<sup>1</sup> Source: Bloomberg, MSCI All Country World Index, total return from 30<sup>th</sup> December 2022 to 30<sup>th</sup> June 2023.

## INTRODUCTION

Following 18 months of rising interest rates and stubborn inflation, the global recession that was anticipated by most economists remains elusive.

Since March 2022 the Fed Funds Rate has risen from 0.25% to 5.25%, yet after a 2.0% annualised GDP growth in Q1 2023, the US economy is forecast to deliver another 1.9% annualised in Q2<sup>2</sup>. The turmoil in the regional banking sector has been contained, avoiding a contagion effect that characterised the 2008 crisis, and despite the political drama, the debt ceiling has been raised without meaningful economic impact. This enduring economic strength may be because the Fed rate is only now catching up with core inflation and real rates have remained negative through this period, but usually when the Federal Reserve raises interest rates by c. 3% it has been enough to trigger a period of economic contraction.

Whilst the Eurozone experienced a six-monthly decline in real GDP of 0.2% to the end of March<sup>3</sup>, this pales into insignificance when compared to the severe economic downturn that was feared last summer. The combination of collapsing energy prices and the end to zero-covid policy in China has supported business confidence from both the cost and demand side. In turn, European consumption, particularly in the service sector, remains robust.

As we argued in our January letter, our investment outlook is built on the core view that, "...a soft landing, characterised by growth slowing but avoiding a 'broad-based weakening', is fairly likely, yet under-appreciated".

Having risen 14.2%<sup>4</sup> this year so far, the market appears to agree, with earnings expectations better than expected in aggregate. However, this has come with significant dispersion between the winners, mostly big technology firms with AI centric revenues, and the losers, particularly smaller companies, banks and energy stocks.

The resilience of major economies in recent months is encouraging, however history tells us not to dismiss the headwind associated with rapid monetary tightening. Changes to interest rates tend to impact the economy with a 'long and variable lag', and in this post-pandemic cycle the transmission mechanism is particularly uncertain. For most central banks, particularly the Bank of England where core inflation shows little sign of abating, we are not yet at a point of 'peak rates'.

This means that there is reason to remain engaged with risk assets, as equities may continue to benefit from supportive consumption trends, whilst fortifying portfolios with assets that can deliver value should the economic picture deteriorate later on.

In this letter we review why the US economy can continue to avoid recession for some time yet, how portfolios have been adjusted to reflect the risk of an adverse shock, and further granularity on the equity market backdrop.

## RECESSION IN THE US – FURTHER DELAY?

Conventional wisdom supports the argument that, following a period of sharp interest rates hikes by the Federal Reserve, the US economy should shortly succumb to a recession. This is consistent with history, since we know that higher rates usually dampens consumer and business sentiment, suppresses profit growth, and ultimately lifts the unemployment rate.

However we also know that every period of monetary tightening is different, and with the economic consequences of the pandemic still relevant, the current cycle may diverge further from historical norms.

It's worth remembering that the past three recessions have been caused by exogenous shocks (i.e. 2020 pandemic) or financial sector excess (i.e. 2008, 2001), not monetary tightening. In each case, interest rates rose in the preceding few years, but were not the primary cause of the economic downturn that followed.

<sup>2</sup> Source: Atlanta Fed GDP Now, 20 June 2023.

<sup>3</sup> Source: Bloomberg, Euro Area Gross Domestic Product Chained 2010 Prices.

<sup>4</sup> Source: Bloomberg, USD, MSCI AC World index, total return 31 Dec 2022 to 30 June 2023.



It's also worth noting that interest rates rose meaningfully in 1983-84 and 1994, and the economy continued to expand. Whilst we did see a recession in 1990-91 following almost 4% of rate hikes, the economy shrank by just 1.4% over a six month period, and was fully recovered six months later. Equity market volatility was similarly short lived.

The key issue for investors today is whether the economy can experience a 'soft landing' against a backdrop of substantial monetary tightening, much like in these examples in the 1980's and 1990's, or is a deep 1970's style recession inevitable?

For such a 'soft landing' to play out, we need to see inflation fall meaningfully whilst employment holds up. Is this likely? Certainly, it would be unorthodox, and any economics student can tell you how there is an inverse relationship between unemployment and inflation, known as the '**Phillips Curve**'. However, we are in unusual times, and the important feature of the US labour market today is the historically high number of unfilled job vacancies compared with the available workforce.

Chart 1<sup>5</sup>: Job Vacancies Galore



It is this tight labour market that has kept inflation stubbornly high, and keeps the Federal Reserve alert to the risk of a 1970's wage-price spiral. However, as the above chart shows, this dynamic is normalising, with excess job vacancies in retreat. As higher rates take their toll and the demand for labour eases, job openings will continue to fall.

Over time, the labour market will loosen sufficiently that workers' bargaining power will be weakened, containing wage growth, and in turn core inflation. Meanwhile, the unemployment rate can remain very low. During this period, the conventional 'Phillips Curve' relationship between unemployment and inflation breaks down.

How long this period will last is not clear, but we believe it can underpin economic growth for longer than is widely expected. We have subscribed consistently to the outlook of a 'soft landing' since recession fears surged in late 2021.

As we wrote in April 2022; "Current evidence suggests that the US economy is unlikely to tip into a recession over the next year in spite of additional inflation pressures and consequential higher interest rates." Whilst we are alert to the evolution of macro-economic conditions, and how they can shift rapidly in response to supply or demand shocks, this remains our central expectation.

#### WHAT ABOUT THE UK?

Having suffered by far the deepest fall in economic activity out of the G8 economies during the pandemic in 2020 and now experiencing the highest rate of inflation of the major economies, the UK is being shunned by investors. There remain serious challenges to be addressed, including the need for the UK to recalibrate to the loss of easy access to EU labour and its markets and to re-establish confidence in its fiscal stability after the 2022 political hiatus. Investors may first need to see the UK navigate the path through the current extreme inflation pressures but, even if this involves a period of recession, valuations in the UK equity market which are at historic lows compared to other regions already discount these challenges and much more.

When markets correct for extremes they often move fast, leaving investors who had aimed to finesse their timing behind. We see sufficient value to patiently hold some of our equity allocation in UK businesses today.

<sup>5</sup> Source: BCA Research, March 2023. Jobs-Worker gap is the difference between labour demand and labour supply, as a percentage of labour supply.



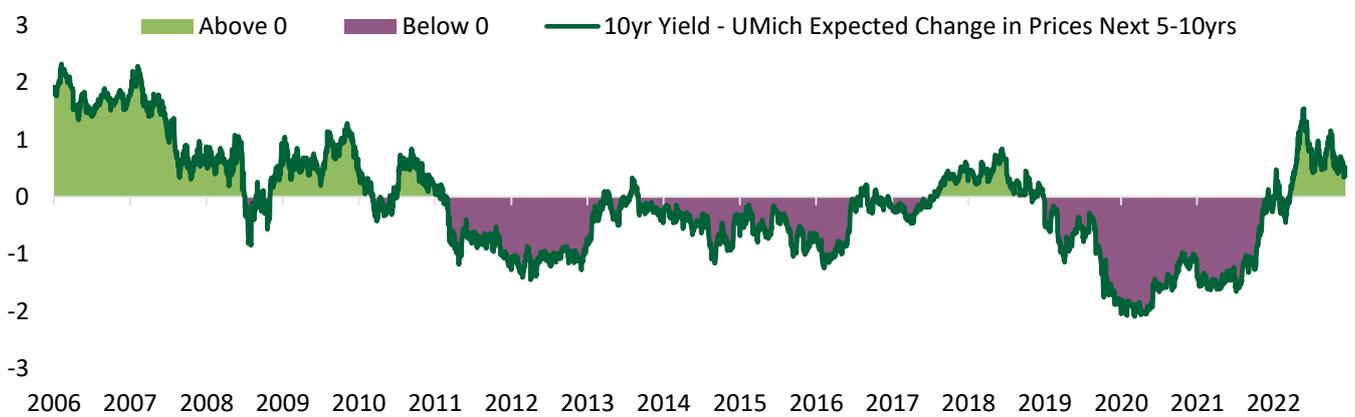
**WHAT IF WE'RE WRONG? BONDS SHOULD HELP**

Of course, the investing environment can change very quickly, and there is no shortage of threats to the favourable disinflationary growth backdrop described above. The ongoing war in Ukraine, and recent instability within Russian borders, is a clear example of the potential for a sudden adverse economic shock.

Even if such an event does not materialise, a recession could arrive sooner and with more severity than we currently expect. Rising job losses and collapsing consumer spending would be painful for equity investments, but it is likely that central banks would respond by partially reversing recent monetary tightening, pushing bond yields down.

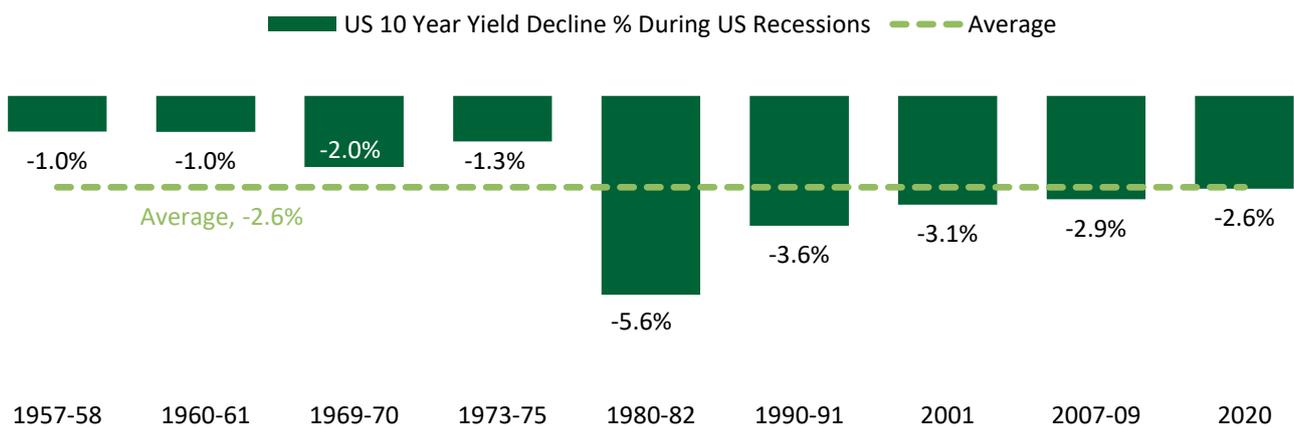
Unlike during much of the past decade, conventional government bonds now trade at yields to maturity which exceed expected inflation – a key marker for reasonable value.

*Chart 2<sup>6</sup>: Treasury Bonds are offering yields in excess of long term expected inflation*



In addition to improved total return prospects for conventional bonds at current yields, history tells us that the 10 year Treasury Bond yield falls by c. 2.5% on average during recessions, as shown in chart 3 below, resulting in double-digit price appreciate for this investment.

*Chart 3<sup>7</sup>: Declining government bonds yields during recession*



Having gradually increased the duration profile of our multi-asset portfolios over the past year, we have allocated more capital to conventional government bonds this quarter to reflect improved total return prospects and key diversification benefits.

<sup>6</sup> Source: Bloomberg, June 2023.

<sup>7</sup> Source: Bloomberg, BCA Research, June 2023.

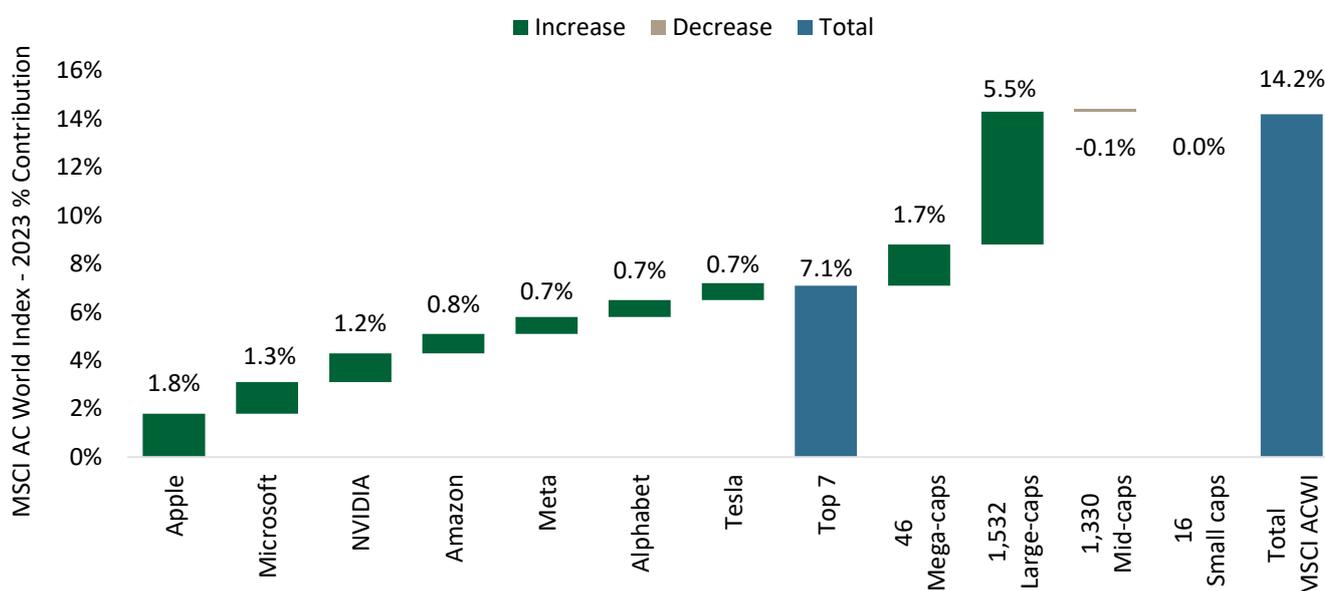


## EQUITIES – AN UNEVEN RECOVERY

After a punishing 2022, the first half of 2023 has seen a strong recovery for global equity markets, with the MSCI AC World index rising by 14.2%<sup>8</sup>. This has come with wide dispersion, with many businesses still adjusting to a higher rate environment, particularly banks and smaller companies. Their share prices have barely moved this year in aggregate, with some experiencing steep declines. Meanwhile, expected revenues from Artificial Intelligence (AI) have propelled technology firms significantly higher in some cases. Of the nearly 3000 stocks included in this global index, just 7 US technology businesses represent 50% of the market return this year so far<sup>9</sup>, with those in the mid and small cap categories making no contribution at all.

Equities have delivered strong returns so far this year, but a large segment of the market is yet to re-emerge from last year's woes. This offers compelling opportunities for patient investors with allocation across global industries.

Chart 4<sup>6</sup>: Global equities in 2023 – Leading from the top



There is little doubt that AI has the potential to be transformative across multiple industries and economic segments. Whilst these 7 companies represent the largest and most dominant across semiconductor manufacture, cloud technology and AI application, we allocate to managers who are also finding compelling structural growth opportunities further afield. For example, approximately one third of the Stonehage Fleming Global Best Ideas strategy is invested in companies that have material exposure to AI<sup>10</sup>, including critical enablers such as ASML (European manufacturer of semiconductor equipment), and those with associated revenue lines, such as Accenture and Adobe.

In addition to market allocations which access the returns of these 7 companies, we expect 'quality growth' active managers emphasising AI centric opportunities to benefit from this trend over time.

It is encouraging that earnings and share price momentum of the broader market has also improved in recent weeks, having trailed the AI / technology leaders for most of this year. Profit margins suffered an inevitable decline last year as cost inflation accelerated. However with inflation pressures easing and economic growth still robust, the picture for the US corporate sector as a whole is more promising. Earnings expectations have improved, supporting the returns of the equity market at large.

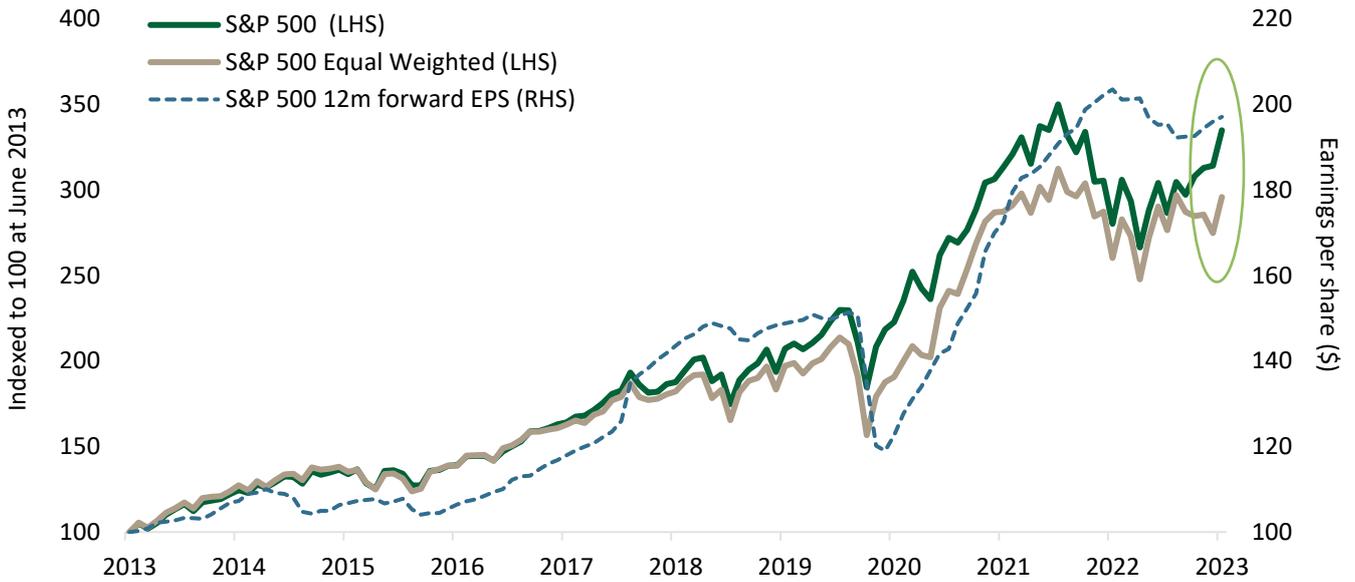
<sup>8</sup> Source: Bloomberg, USD, 30 June 2023.

<sup>9</sup> MSCI All Country World Index for the period 31 December 2022 to 30 June 2023. The seven US technology businesses are shown in Chart 4.

<sup>10</sup> Stonehage Fleming Global Best Ideas Fund holdings as at 31<sup>st</sup> May 2023.

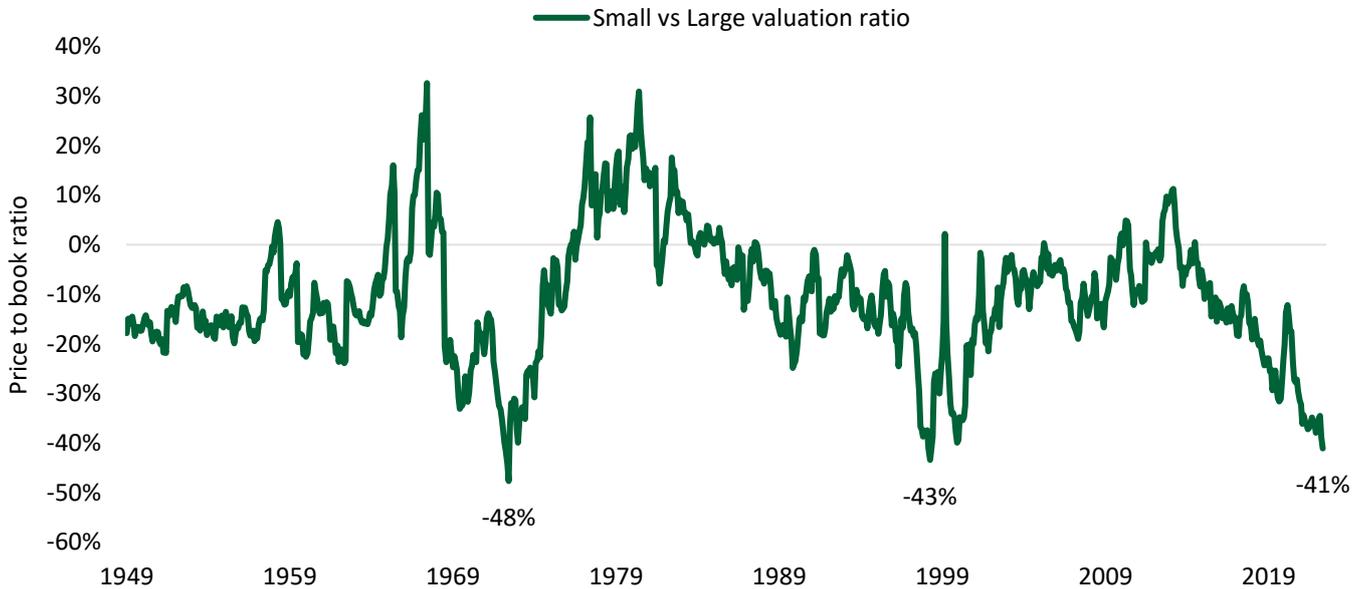


Chart 5<sup>11</sup> – Improving earnings momentum is lifting the broad US market



Accessing opportunities across a range of company sizes is a key aspect of our equity strategy. Several of our underlying equity strategies emphasise medium and smaller companies, and in addition to improved earnings expectations, they are priced at attractive valuations. As the below chart shows, whilst smaller companies typically trade at a discount to larger peers, the c. 40% divergence is almost as extended as ever.

Chart 6<sup>12</sup>: Smaller companies are extremely cheap by historical standards



<sup>11</sup> Source: Bloomberg, USD, June 2023.

<sup>12</sup> Source: Dimensional Fund Advisors, average of Fama/French small cap indices relative to large cap indices, USD, April 2023.



## CONCLUDING REMARKS

The global economy is holding up better than it was widely expected to in the first half of 2023, led by the US. This is despite turbulence in the banking sector, US debt ceiling uncertainty, a spluttering Chinese economic reopening and ongoing geopolitical instability. Head line inflation rates are already falling quickly from peak levels as base effects feed through. As the year progresses, we expect to see more evidence of last year's monetary tightening in the real economy. The final stretch to re-anchor core inflation expectations back to typical 2% targets is expected to involve some economic pain and strong political support may be required for Central Banks to hold the course, but at the current time there is little sign that a deep recession is imminent.

In April of this year we made the argument that, with economic and earnings expectations muted, *"positive surprises are within reach, should financial stress remain controlled, inflation fall and growth hold up, as we expect"*. Investors have celebrated as earnings have indeed surprised positively, however the dominance of AI centric technology stocks means that the broad market's advance is only a few weeks old.

We continue to have strong conviction in the merits of an all-cap, multi-sector equity strategy, seeking out a broad range of opportunities through select managers and differentiated strategies.

There are no shortage of risks to our outlook, whether economic or geopolitical, that could shake investors' nerves and drive volatility higher. We have added to conventional fixed income positions this quarter, capitalising on higher yields and valuable diversifying properties, and remain vigilant to shifts in the macro-environment that could challenge the outlook we describe.

**SFIM Investment Team**  
**July 2023**

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