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# FUND MANAGER QUARTERLY REPORT

## Fund Manager Fourth Quarter Report MPS – December 2024.

**by Harry Thompson and Wayne Bishop**

Two major political events played out in the fourth quarter of 2024, with the UK budget and the US presidential election having a particular impact on portfolios across all asset classes. This comes on top of the continued tussle on interest rate expectations and bond yields given concerns over government deficits and fiscal expenditure.

The fourth quarter saw the bond bears prevail, with fixed income yields rising throughout the quarter, with the UK ten-year benchmark gilt rising from 4.003% to 4.568% by the end of the quarter. Whilst we reached these levels in 2023, we also reached them during the Liz Truss Mini budget disaster. Whilst we are not in a like for like position in terms of the chaos that was created in 2022, it highlights investors' concerns. The latest budget managed to raise both fears of inflation and killed all hopes of growth.

It is a pertinent point given the backlash we have seen. Investors and the electorate lost confidence back in 2022, and they have done so again following Labours dismal start in office. Stemming from two fiscal events, the UK electorate have become increasingly frustrated with the two mainstream parties, lending support to Nigel Farage's Reform party, who now poll at similar levels to Labour and the Tories. Still, plenty of time before the next election, and who knows, the UK could well be absorbed into the United States (alongside Canada and the Panama Canal) if Trump has his way.

The uncertainty is not just limited to the UK and the US, a rapid shift in the automobile industry to electric vehicles (keep in mind Europe and UK are now much less significant in this global dynamic) has impacted the European economy, along with a rapidly changing political dynamic. This has led to continued lack of budget discipline and high government debt levels. As a result, markets are demanding more for longer term debt making government borrowing more expensive and punishing certain countries such as France (who's longer term debt is more expensive than Greece's). This is known as a steepening yield curve and has implications across all asset classes.

Where portfolios are exposed to gilts, we are predominantly shorter duration, with the Amundi UK Government Bond 0-5Y returning +0.113% in the fourth quarter. Portfolios are more exposed to labelled bonds (green, sustainable and development bank bonds) and the iShares green bond index returned -0.11% in sterling terms for the fourth quarter (for reference, the iShares UK Gilts All Stocks Index Fund returned -3.509% and a leading sterling corporate bond index returned -0.16% in the fourth quarter).

The re-election of Donald Trump was not taken well by a number of positive investments. When it comes to the energy transition, there are obvious concerns over how this sector will fare, and there has been a souring in sentiment towards the climate sector which has been felt in 2024, although we think some of this is overdone. There is wide consensus that offshore wind will most certainly be negatively impacted, and we expect this to come to a halt very early on in his tenor, in a similar fashion to how Biden suspended oil & gas leasing when he came into power.

The benefits to Republican states of the Inflation Reduction Act have been well documented. The projects being made possible are creating billions in additional private investment and subsequently thousands of new jobs, and not to the detriment of older industries that some initially had political concerns with (the number of coal mining employees is actually slightly higher since the introduction of the IRA). There are huge benefits of the act to US jobs and growth, but also building new industries to protect against Chinese dominance – all high up on Trumps agenda. Given the bi-partisan support, it will be hard for Trump to reach thresholds such as the 60% majority needed in the Senate to repeal the act. Even as recently as this summer, a number of Republican senators wrote to the house speaker to put their support behind preserving the IRA energy tax credits.

The push back in longer dated yields in major markets has impacted duration sensitive alternatives and equities. Our model portfolios do not have any pureplay property fund exposure, but there will be some incidental exposure, predominantly in the infrastructure funds we hold. Property was particularly weak in December, declining around 6-7% and largely erasing all the gains from the third quarter, a similar story for portfolios infrastructure exposure, which is held around 6-7% within portfolios. We do have some concerns over infrastructure, particularly as 30-year gilt yields reach multi decade highs, but we're hesitant to pull back here given we do feel that would be capitulation. Nonetheless, this asset class has weighed on portfolios. Whilst we do see some recovery potential, it may be slower than we had initially anticipated, and other opportunities may be more appropriate moving forward.

When it comes to equities, the quarter was mixed, with weakness in October before the US election, followed by a strong rally on the result, and then a sell-off again in December as markets weighed up the implications of higher rates for longer. Despite this, US growth equities once again lead the way in the fourth quarter, whilst more generally, large caps outperformed smaller peers. The calendar year was dominated by US exceptionalism, with more modest gains in Europe and the UK.

Chinese equities staged somewhat of a recovery for the year after a strong third quarter, although there was notable weakness in the fourth quarter as investors felt short changed on any potential fiscal stimulus. India mid-caps have performed strongly on the year, which has raised questions over a frothy market. We have taken the opportunity at the last couple of rebalances to reduce our exposure slightly and rotate into broader EM including selective China exposure.

Portfolios healthcare exposure has been a detractor on the quarter. Healthcare came under pressure following Trumps announcement that Robert Kennedy (RFK) was a candidate to be the next health secretary, given his controversial views on issues such as vaccines. This impacted pharmaceuticals and biotech in particular. Polar Capital, where we have pureplay exposure to healthcare, believe RFKs appointment is in doubt and they see the panic as opportunities given the growth on offer in the sector.

Renewable energy and climate-based investments, whether equity or infrastructure have continued to underperform. Energy is a key market and economic sector, forming around 10% of market weight. Ironically in 2024 both oil and gas and renewable energy were negative on the year. Global demand for renewable energy remains very strong and this will remain the case regardless of the US, the issue for investors is who will benefit. The main issue of growth in this sector has become more global and with that China now plays a larger role, which muddies the waters. Likewise Electric Vehicles is now dominated by Chinese companies, adding to complications in our ethical screens with a number of social issues.

One factor that has impacted relative performance has been a lack of exposure to a number of large US tech or growth names. A lot has been discussed with regards to the concentration of a number of major indices due to the dominance of the so-called Magnificent 7 (Mag 7). When taking the largest 500 US companies, the top 10 names total circa 39% of the total market cap, which is an all-time high. In terms of returns, the points contribution in 2024 to the index of 500 leading US names by the Mag 7 was 645.35 or 58.05% share. That rises to a whopping 149.92% share of the index's returns for the fourth quarter given many stocks were negative over the period (the Defiance Large Cap ex-Mag 7 ETF returned -1.67% in Q4).

Some of the leading US growth names that have propelled markets higher are excluded from our portfolios due to concerns over tax, labour practices, and anticompetitive policies (this includes names such as Apple and Amazon). It is important to understand the performance dynamics this has given the oversized weight they hold in major indices. Of the Mag 7, portfolios are only exposed to Microsoft and Nvidia (and whilst not currently held, potentially Tesla). This means portfolios top ten (and beyond) will look different to a conventional portfolio.

This raises two points that are important; firstly, we are positioned like that due to the desire of clients to avoid companies with poor environmental, social or governance practices. Secondly, our portfolios offer an opportunity to diversify clients’ portfolios even if there is less of a desire to be focused on sustainable outcomes, an important factor given the concentration in a small handful of names.

**Outlook**

The new year begins with uncertainty in three key areas; these are political, economic and deficits. The political uncertainty, whilst dominated by the new Trump presidency, will also include elections in Germany and parliamentary uncertainty in France.

With regards to the new US presidency, markets will be wanting to see the extent of trade friction and also the reaction of others, which is just as important. There is hope that the talk is louder than the reality, and if this plays out markets have priced this in, if not, there are some far reaching concerns.

The expectation is Germany will shift to the right with its politics, but the country also needs reform as its outsized exposure to the car sector has become a significant economic risk. European rates are expected to fall further.

The main economic worries focus around the fact that outside of the US (and India) the rest of the world appears much more economically weaker. This is known as US exceptionalism and recent US economic data has only added to this. We are more exposed to India (where ethics permit) and see opportunities for growth. The risk is increased market concentration in the US (which is now 76% of market capitalisation). There remains a significant amount of uninvested cash in the world, and should interest rates fall we see this being invested in both bonds and equities to maintain returns.

Finally high budget deficits pose a risk to bond markets that has already begun to play out. Whilst the UK has been in the limelight since the budget, it is also an issue in Europe and the US. In all the problem is the same, deficits are too high, growth is too low and the answer is not simply more taxation as it kills growth (as seen in the UK). What can be learned from the UK is that there is a higher level of scrutiny and political leaders must step up from words to meaningful actions. Higher long-term interest rates have severe implications on the investment decisions needed for growth.

All of these risks are significant and we expect short term volatility for the next quarter as markets adjust and we move from expectations to reality. Given the high cash levels markets are poised to exploit any weakness and we see this as the prevailing trend for 2025.

**Quarterly performance**

| **Portfolio** | **Performance** |
|---|---:|
| Ethical Defensive | -1.31% |
| Ethical Cautious | -1.78% |
| Ethical Balanced | -1.93% |
| Ethical Balanced-Growth | -2.06% |
| Ethical Growth | -2.24% |
| Ethical Adventurous | -2.55% |

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