Fund Manager Fourth Quarter Report - December 2023.

by Wayne Bishop

The long-awaited interest rate pivot finally materialised this quarter and as expected this led to a significant rally across all asset classes, favouring investments with a stronger ESG and positive impact focus. We recently covered this topic in more detail with a written piece at the end of December, but the significance of this pivot in market thinking cannot be overstated.

In a number of previous reports and written comments (including the one linked above), the rationale behind this significance has been explained and this remains largely intact. Towards the end of 2023 we saw interest rates cut expectations increase rapidly, and in the immediate term we anticipate a cooling of these expectations as Central Banks are expected to maintain a hawkish stance until an economic slowdown becomes more evident. That said, we expect this, and any other cooling off, to be short lived as both inflation falls and economies slow. Over the medium term (by this we feel six months) we expect interest rate cuts and, more importantly, rate cut expectations to increase.

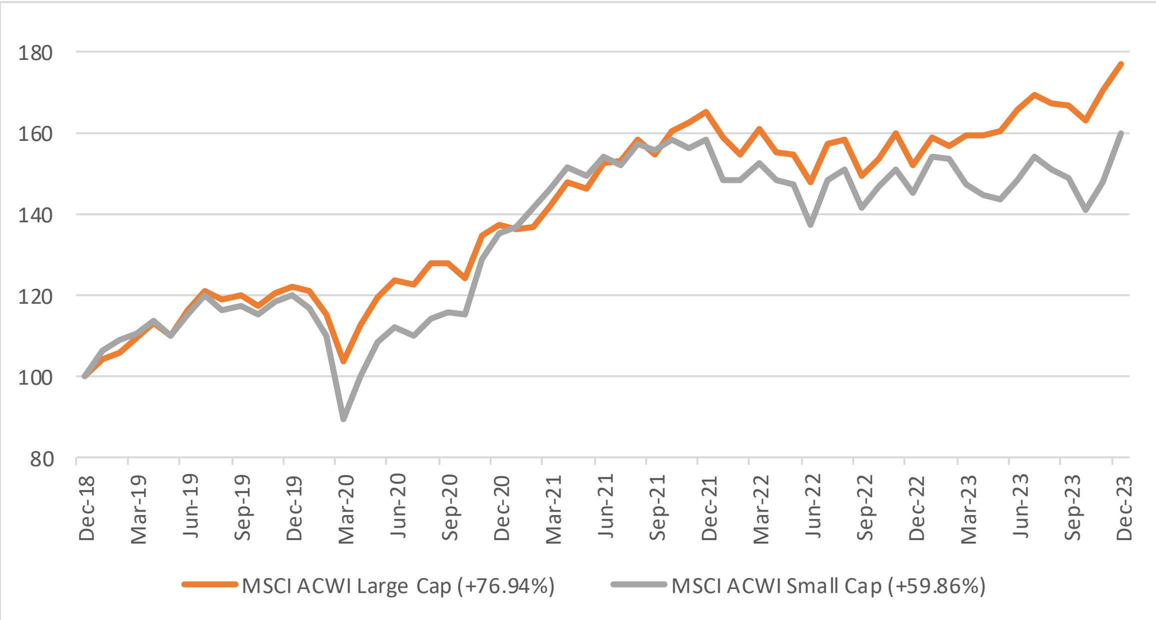
With interest rates no longer causing anxiety and uncertainty in the markets, the focus is capital discipline in a world where Central Banks are, either no longer flooding the markets with money, (Quantitative easing) or are in fact taking money out of the system (Quantitative tightening). At the moment cash levels are at a record high in money market funds. Over the year we expect to see this level reduce as markets allocate to bonds and equities. This time around we expect a far more disciplined and selective approach by the markets, as cash will remain an alternative (even at lower rates). We expect tapering to increase over the year.

The price of debt (bonds and notes) will also be subject to other influences over the coming year. The level of both government and corporate debt is already coming under the spotlight and has already caused some issues within the Eurozone (Italy and Spain in particular) and the US debt ceiling. In addition to tapering there is a concern that governments have not been reigning in their deficits fast enough in the post COVID world. Whilst short term interest rates may fall, investors may demand a higher premium for longer term debt and prefer higher quality debt. This too may have a knock-on effect for corporate debt, as both uncertainty on the economy and the impact that higher interest rates have already had will increase the markets focus on quality. Thames Water provides a very public example of some of the issues faced by highly indebted companies.

The politics of general elections, which are due in a number of major economies (U.S., U.K. and India in particular) will also impact government bond prices. Donald Trump appears to be favourite to be heading back to the White House given his double-digit lead over Biden, although his removal from certain ballots is something that rumbles on. President Modi is expected to retain power in India, whilst Labour have a firm lead over the Tories, a surprise result cannot be ruled out, particularly if the fiscal purse is loosened.

Property and Infrastructure have already benefited from the pivot in interest rate expectations. Further down the line we expect to see some mergers of smaller funds and a gradual return of pipeline opportunities for these products. In the meantime, the higher income levels and upside opportunities remain compelling.

The positive impact sector has also seen a strong recovery, reversing the negative trend that began in 2021. The solar and wind manufacturers and developers have seen a strong recovery in the last quarter, as have investments based around electrification. Whilst the pipelines have been strong for some time, it has taken the pivot in interest rate expectations to move the markets from an unhealthy focus on a very small number of global mega-cap stocks (in particular the magnificent 7) to looking at the opportunities in the wider market. The gaping performance differential between small and large companies has been narrowing since October, as seen below with the graphic of All Country Large and Smaller company indices (based at 100 Dec 2018):



Source: FE

We still see some way to go as interest rate expectations allow the equity markets to broaden. Alongside the reversal from negative sectors (oil, tobacco) towards more positive sectors, the equity market performance of more impact focussed investments has also recovered sharply in both absolute and relative terms.

Having been far more resilient than many expected, global economic growth is now showing signs of slowing as a result of higher interest rates and less money in the system. At the same time the multiple inflation shocks from Covid stimulus, supply chain issues and the conflict in Ukraine have now worked through the economy and the question that remains is whether we get a soft, hard or even any landing in 2024.

A great deal of the economic outlook depends on the extent of a general consumer slowdown and the continued transition to the new style economy. The economically important automobile sector is a pivotal example of this change as Asian electric vehicles challenge US and European combustion engine vehicles in what is a truly global market, where China is the biggest player. This disruption threatens certain western nations such as Germany, where the auto industry employs hundreds of thousands of people directly.

We see growth shifting from personal consumption-based investments as the retailer drops away, to growth in providing solutions to global issues. This puts a renewed focus on electrification, which covers a range of industries, from transport to energy consumption. Global warming is already impacting food production, and changes in how we consume are required, but solutions in organic fertilisers, AI in watering and harvesting are seeking to get more from less and reduce the impact the food industry has on our natural resources.

Other key issues we have previously touched on will continue to play out as important factors in the year ahead. Whilst 2023 was a positive year for renewable energy use, the commencement of new projects stalled in certain cases given inflationary pressures and supply chain issues. We expect revived growth in renewable energy optimism as energy security matters and the sector moves past the issues of the last two years. Positive noises came from COP28, with members attending committing to work together to triple the worlds installed renewable energy capacity by 2030, this comes alongside legislation already in place such as the Inflation Reduction Act and Repower EU.

Healthcare will take on a renewed focus, broadening out from the euphoria of 2023's weight loss drugs to other medical advances including medical technology, and we continue to monitor investments in this sector.

Even with bumps in the road, our outlook is more positive than before.

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