SEASPRAY PRIVATE
Creating Investment Solutions

Half-Year Investment Review & Outlook H1 2023

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"The market narrative around where future growth will come from, and the potential pace of growth, has begun to focus on what artificial intelligence might mean for the global economy. We have heard comparisons being made this year between potential future AI productivity gains and the paradigm shifts that occurred at the time of the agricultural and industrial revolutions...."

Introduction

Financial markets have had a much stronger first half of the year, after what was without a doubt a difficult 2022. US and European equities each saw a H1 rally of circa 16%, meaning 2023 so far has largely been a mirror image of last year with regard to the asset class. This positivity comes despite ongoing challenges from inflation, interest rate hikes, slowing global growth, a banking mini-crisis, an ongoing war in Ukraine, and debt-ceiling issues in the US. Headline inflation continued to decline over the first half of the year, which is encouraging. However, core inflation is looking stickier than feared and has led bond markets to weaken recently.

Despite investors recently pricing in higher rates for longer, US stocks have officially joined their European counterparts and have entered bull market territory as the S&P 500 index rebounded by 20% from its October lows, with sentiment broadly higher as a result. The increase has mostly been driven by optimism surrounding Artificial Intelligence (AI) and stronger-than-expected economic strength in the United States.

As we look ahead at macro markets over the next 12 months, we believe central banks will be front and centre once again. We see most of them finding peak rates over the course of the third quarter and holding steady at these levels for the rest of the year, while growth likely slows, and inflation remains sticky. We acknowledge the increased risk of a global recession, and we will explore what this means for investors further on in this piece. However, and as things stand, we think the US can move towards a soft landing, while the Eurozone economy continues to face more restrictive policy, and the UK continues to struggle with persistent and aggressive inflation. The risk of a so-called ‘hard landing’ scenario in H2 may keep markets on the defensive over the coming months, but it is also important to remember that this would likely mean faster disinflation and less pressure on policymakers to remain hawkish.

In other words, if the global economy does suffer a deeper than expected recession, investors should have less to fear as central bankers stand ready to take their foot off the pedal in terms of monetary tightening. Most if not all of the decline for risk assets already happened last year, and more modest valuations outside of the US should mean higher return prospects from here. At greater yields now, high grade government and corporate bonds can once again provide some cushion within a portfolio, and alternatives showed last year that they can smooth the return experience too. So, while we can’t dismiss the possibility of a bumpy landing, let alone try to time it, we take comfort from knowing that well diversified portfolios are better able to see us through one now than they have been for some time.

	1-Month	YTD	1-Year
Equity Indices			
S&P 500	1.9%	17.5%	16.7%
Nasdaq	2.6%	35.1%	23.5%
DAX	-1.1%	15.7%	25.2%
EuroStoxx 50	0.9%	16.1%	26.6%
ISEQ	3.4%	25.1%	42.0%
FTSE 100	-2.2%	0.1%	4.2%
Multi-Asset Funds			
Aviva Multi-Asset ESG 3	-0.6%	1.7%	-1.1%
Irish Life MAPS 3	-0.1%	4.4%	3.0%
New Ireland iFunds 3	-0.3%	2.4%	0.5%
New Ireland PRIME 3	-0.3%	3.0%	0.7%
Zurich Prisma 3	-0.3%	3.9%	1.8%
Aviva Multi-Asset ESG 4	-0.7%	4.0%	1.7%
Irish Life MAPS 4	-0.1%	5.7%	4.4%
New Ireland iFunds 4	-0.4%	4.2%	2.2%
New Ireland PRIME 4	-0.7%	5.4%	2.4%
Zurich Prisma 4	-0.4%	6.7%	3.6%
Aviva Multi-Asset ESG 5	-0.6%	6.4%	4.5%
Irish Life MAPS 5	-0.4%	6.7%	4.1%
New Ireland iFunds 5	-0.5%	6.2%	4.0%
New Ireland PRIME 5	-0.7%	6.9%	3.8%
Zurich Prisma 5	-0.2%	10.1%	6.7%
Bonds			
US Government Bonds	0.6%	1.3%	-5.8%
US Corporate Bonds	1.6%	2.7%	-3.0%
European Government Bonds	-0.3%	2.9%	-7.3%
European Corporate Bonds	-1.1%	-0.3%	-4.4%
Currencies			
EUR/USD	2.5%	4.9%	11.3%
EUR/GBP	0.0%	-3.2%	0.6%
GBP/USD	2.6%	8.4%	10.6%
USD/JPY	-1.2%	5.7%	0.0%
Commodities			
Gold	-0.1%	7.4%	15.1%
Brent Crude Oil	7.4%	-5.4%	-19.6%

Source: Seaspray Financial, July 2023

Global Economy & Inflation

It is worth casting our mind back to this time last year – a time when analysts and economists alike were calling for recessions to take hold around the end of 2022 or early in 2023. Then, by the beginning of this year, those forecasts had been pushed out to later in the year. Now, at the half-way point of 2023, it is becoming clear to us that the US economy has proven to be resilient so far, and some investors now think a recession is completely avoidable. However, on this side of the Atlantic, recent data has shown that the Eurozone economy actually contracted in Q4 of last year and indeed Q1 of 2023 – which does mean a technical recession has taken place.

We must point out that technical recessions do not necessarily equate to actual recessions. The United States witnessed a technical recession with two consecutive quarters of negative GDP in H1 2022, but crucially it managed to avoid falling into an actual recession. This was as a result of a strong labour market, good wage growth and accelerating industrial production keeping its economy alive. Similarly, if we continue to see recessionary pressures linger for the remainder of 2023, it could be helpful to refer back to unemployment and wage data to ascertain how the economy is really tracking.

We would like to take this opportunity to reiterate a view from our recent May Investment Update – we believe that any potential recession seen in developed regions this year would be mild in nature. US growth was still strong in the first quarter, services sectors in developed markets are still well in expansionary territory and have been for some time, employment across the board remains close to full, and even halfway through 2023 households still have excess cash savings left over from the pandemic.

Global Economy & Inflation contd.

Many countries will likely come close to recession over the next few quarters, and post sluggish growth, even in an optimistic scenario. But we must remember that weaker growth is important right now – maybe even necessary. It would help to significantly ease inflationary pressures and it is essentially what central bankers have been attempting to achieve with their sharp interest rate hikes of the last 12+ months. Consumers have been, slowly but surely, using up their Covid-related excess savings, but jobs remain plentiful at present in all the key regions. Even if unemployment rates were to rise, they would probably remain low by historical standards, in our view. As a result, consumption may slow down, but should not collapse.

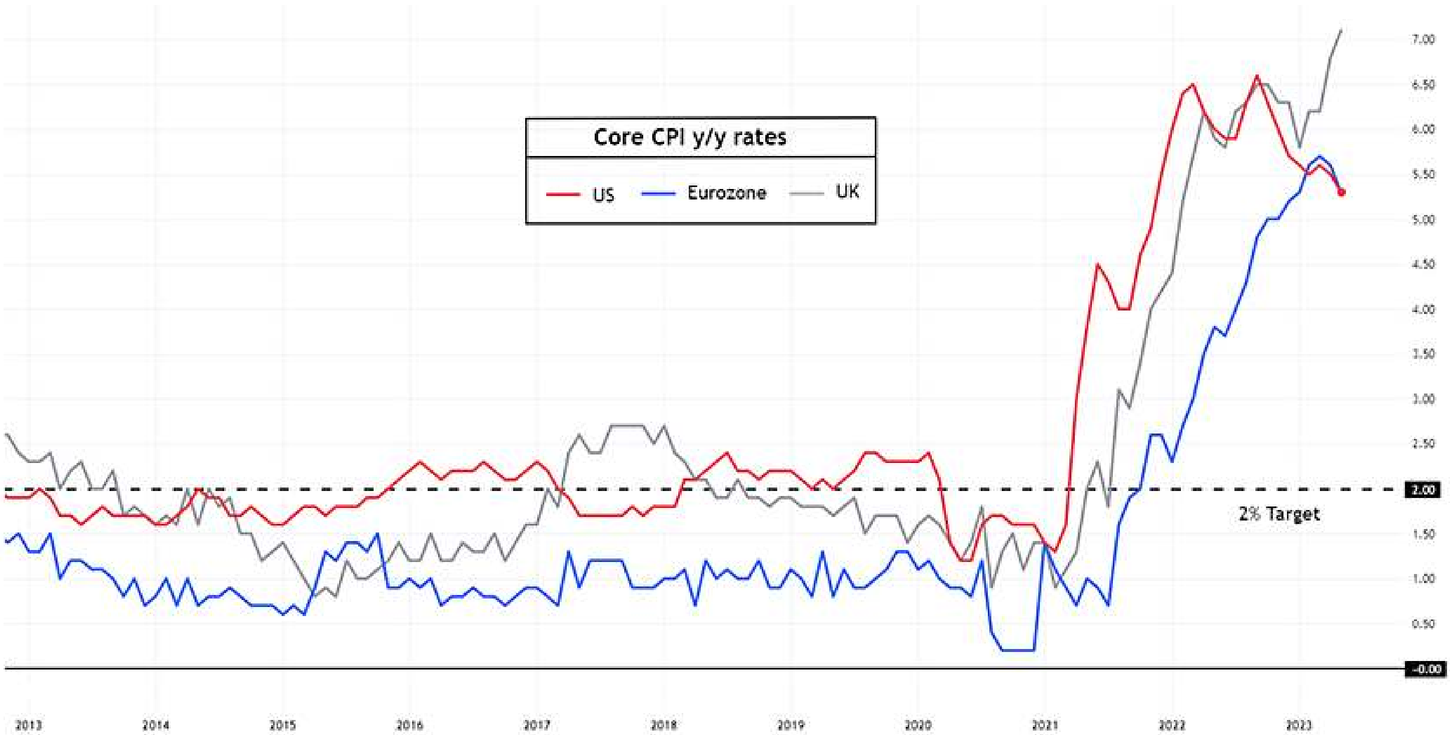
The market narrative around where future growth will come from, and the potential pace of growth, has begun to focus on what artificial intelligence might mean for the global economy. We have heard comparisons being made this year between potential future AI productivity gains and the paradigm shifts that occurred at the time of the agricultural and industrial revolutions, both of which delivered 30 to 100-fold increases in economic growth relative to the previous era. This could be a colossal disruption which might impact at least 300 million mostly white-collar jobs according to US investment bank Goldman Sachs. They have projected for widespread AI adoption to occur over the next ten years, and in light of this are expecting real GDP in the States to be boosted by an average of 1.1 percentage points every year for ten years. This would result in a cumulative effect over the decade period, likely leading to a significant surge in economic expansion. Also, it was interesting to see a few months ago that Google's chief executive Sundar Pichai wasn't short of metaphors when likening AI to humanity's harnessing of fire. So, while we accept that growth in the near-term needs to come down, in order to tame inflation this year and next, we are firm believers in the longer-term boost that AI will give to global growth.

At the start of the year, the inflation trajectory looked like being a key driver for economic activity, sentiment, and interest rates. Whilst headline price pressures have moderated, core inflation has eased at a disappointingly slow rate in many instances. Energy costs have come down over the past year, but the impact of higher food prices, elevated services inflation, and stronger wage growth have so far kept inflation above what had been anticipated at the start of 2023. Nevertheless, peak price pressures seem to be well behind us in major economies, at least with regard to headline rates, and we do expect them to ease towards the central bank target levels over the next year or so. Base effects from last year are starting to have an impact on year-over-year CPI readings and government fiscal support is helping to partly offset the impact of higher energy bills in many regions.

Additionally, higher levels of inventory, a relaxation of economic restrictions and an increase in capacity have already led to a material weakening of goods inflation. Higher interest rates should steadily slow demand, and labour market supply and demand dynamics are also beginning to very slowly improve. Participation rates are slowly normalising, which is helping to take some of the heat out of wage rises, although European negotiated salaries still pose some upside risk.

Global Economy & Inflation contd.

Most of the market believes that headline inflation will likely continue to decline over the coming quarters. What investors are less convinced of, however, is that core inflation is on a speedy path back to the all-important 2% mark. Much of this is down to the fact that demand for services has remained upbeat, as households continue to draw from their still-positive savings. History would also suggest that the tightness of the labour market and ongoing pressure on wages may also keep upward pressure on cost and prices until a potential recession hits.



Source: Seaspray Financial, July 2023.

It is also worth noting that for governments around the world, inflation in the broad area of 2 - 4% over the next few years also appears an easier way out of a debt problem, having already exhausted the option of austerity. Latest surveys of inflation expectations from investors are suggesting that higher medium to long-term inflation is on the cards. We would certainly agree that inflation over the next decade looks almost certain to be higher than in the decade or so following the financial crisis of 2008. If central banks pivot towards the end of this year amid the onset of a recession, it would strengthen our conviction further that investors should prepare their portfolios for both higher core inflation on average over the medium term and more frequent bouts of inflation-related volatility down the line.

United States

The US economy grew at an annualised rate of 2% during the first quarter of this year (seen below), well above the 1.3% that had been previously estimated for Q1, but down from Q4's 2.6% result. Many of the underlying numbers also back up this strong GDP result – consumer spending growth accelerated by more than was expected to 4.2% (strongest in nearly two years) despite stubbornly high inflation, exports were up 7.8% and imports rose at a slower 2% which helped push the contribution from net trade higher.

Source: Tradingeconomics.com, US Bureau of Economic Analysis

Up-to-date growth data for the United States in the form of PMI (Purchasing Managers' Index) figures have been more mixed in the second quarter. As has been the case for most of this year, the services sector continues to outperform manufacturing, with the region's services PMI rising to 54.4 in June, down slightly from May's 54.9 and still well above the 50.0 expansion-contraction line. In contrast, the manufacturing index slipped to a fairly weak 46.3 last month, and has been in contractionary territory now for seven of the last eight months. Consumer confidence also remains at subdued levels, albeit up from the 2022 lows.

United States

When we look at the labour market, it is clear that conditions remain extremely tight. Payroll growth has remained robust during the first half of the year, rising by an average of 278k per month. Meanwhile, the US unemployment rate has crept higher to 3.6% in June, up from January's 54-year low of 3.4%. Average earnings growth in year-over-year terms has stood at 4.4% for three consecutive months now, down from the 2022 peak of 5.9%. Regarding the all-important topic of inflation - the country's headline rate is in marked decline. It came in at 3.0% in June, and has fallen for twelve consecutive months now since its peak of 9.1% last June. Core inflation is proving stickier, with the Core CPI reading still at 4.8%. Overall, the Fed expects this figure to move down slowly towards its 2% target level over the next couple of years, falling to 2.2% by Q4 2025.

To surmise, the US economy continued to perform well in Q2 . More recently, data have been mixed, with some signs emerging that growth may be softening. Moreover, the impact of heightened inflation and sizeable monetary policy tightening over the past year are still working their way through the economy. Looking ahead, recent stresses in the US banking system are leading to tighter credit conditions, which will be an added drag on economic activity. The Commercial real estate market is also on a clear weakening path. Overall, the US economy is set to grow more slowly this year and next, having expanded by 2.1% in 2022. The OECD sees GDP growing by around 1.5% in 2023, and circa 1% in 2024. Many are making the argument that the risks to the US economy are to the downside, with fears in particular of a possible marked tightening in credit conditions that would weigh on US activity over the remainder of the year and into 2024.

Eurozone

In recent quarters, the Eurozone has experienced a significant deceleration in economic growth, primarily due to multiple factors including heightened uncertainty resulting from the Russian invasion of Ukraine, elevated inflation, an increasingly hawkish ECB, as well as generally weaker global growth. As can be seen on the graph below, GDP fell by 0.1% in the final quarter of 2022 and again in the opening quarter of 2023, with the economy therefore entering a technical recession. Elevated inflation and increased interest rates have placed pressure on real household incomes, leading to a reduction in consumer spending. Additionally, we have also noticed a decrease in government spending over the first quarter of this year.

Source: Tradingeconomics.com, Eurostat

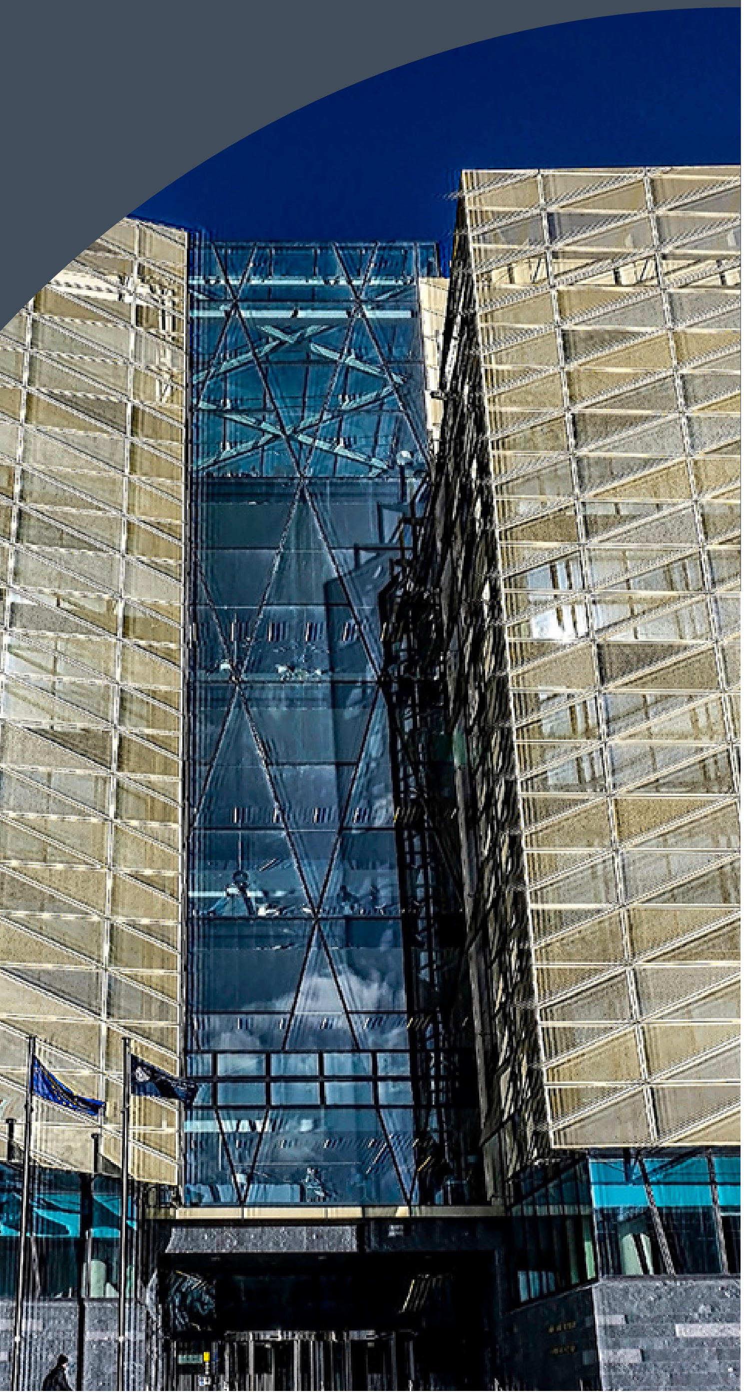
Eurozone

Similar to what we have seen in the US, services PMIs for the Euro area have continued to display an outperformance versus manufacturing. It is also important to note that the services sector makes up close to three quarters of the Eurozone economy, whereas manufacturing in comparison contributes to a relatively smaller portion. The services PMI rose to 56.2 in April, its highest level in a year before easing back in May and June. This part of the economy has been in expansion since December, and has seen a robust Q2 average of 54.4. In contrast, the manufacturing PMI remained in contractionary territory for the twelfth month running in June, falling to 43.6, its lowest level since May 2020. Industrial sentiment in the Eurozone deteriorated in Q2 also, while, consumer confidence has continued to trend higher, although, it is still well below its level seen ahead of the Russian invasion of Ukraine last February.

Taking a look at jobs data so far this year - the region's unemployment rate fell to a record low of 6.5% in April and remained at this level in May. The data point has been at or below 6.7% since April of 2022, indicating the strength of the European jobs market at present. Official Eurozone wage data shows that salaries increased by 4.6% y/y in Q1, the seventh consecutive quarter of growth. Regarding inflation, the headline rate has fallen sharply from its peak of 10.6% last October. It dropped to 5.5% last month, largely reflecting a sharp decline in fuel prices, and the big increases in energy costs in spring 2022 finally dropping out of the annual rate. Inflation in core terms, however, picked up to 5.4% in June and remains close to its recent peak of 5.7%. Clearly, this core CPI result supports the view that policymakers are likely to continue raising rates over the coming months. The ECB staff projections are for headline inflation to average 5.4% this year, down from 8.4% in 2022. Core inflation though is expected to be higher, averaging 5.1% in 2023, compared to 3.9% last year. Both rates are forecast to fall to 3% in 2024, and back towards 2% in 2025.

To conclude, growth in the 20-country Eurozone has slowed sharply over the past number of quarters in the face of increased uncertainty stemming from the war in Ukraine, high inflation and rising rates, as well as weaker global growth. However, the labour market remains very strong and there has been a noticeable fall in headline inflation since last autumn, although it still remains elevated. Overall, the IMF and OECD are forecasting Eurozone growth of 0.8-0.9% in 2023, and around 1.5% in 2024. Similarly, the ECB is projecting the economy will expand by 0.9% this year and by 1.5% in 2024, with growth of 1.6% expected in 2025.

Ireland



A quick word on the Irish economy:

Having risen to record highs during the pandemic, Irish household savings showed the first signs of normalisation in the first quarter of this year, according to Central Statistic Office data last month. In Q1, the savings ratio stood at 13.7%, down from the 24.4% seen in the previous quarter. Most sectors, however, saw continued increases in wages over the January – March period as employment and earnings grew. Irish households are set to experience a mix of conflicting factors over the second half of 2023. Strong balance sheets, particularly in relation to the build-up of excess deposits, underpin the solid household picture. An unwind of some of the cost-of-living measures will probably act as a drag on consumers, but we believe this will be offset by declining price pressures and continued increases in earnings in what is a very tight labour market.

In June we saw the Central Bank of Ireland (CBI) painting a positive picture of ongoing growth across the nation this year when they released their latest quarterly bulletin. Some warnings were made however over our economy potentially overheating due to aggressive fiscal policy. Modified Domestic Demand, which rose by 2.7% q/q and 5.5% y/y during the first quarter, is expected by the CBI to increase by 3.7% in 2023, up from its prior forecast for 3.1%. Its projection for next year was downgraded slightly from 2.9% to 2.5%. The bank expects headline inflation to average out at 5.3% this year before slowing to 3.4% in 2024. In terms of core inflation, CBI is looking for a 2023 average of 4.9%.

Monetary Policy

Federal Reserve

The US Federal Reserve decided to leave rates unchanged at its policy meeting in mid-June, maintaining the target range for the federal funds rate at 5.00 - 5.25%. Many Fed officials in the leadup to this meeting indicated to the market that it might be appropriate to refrain from another rate increase at this juncture so that they can wait and allow more data to come in over the summer. This decision does make sense in our view, especially after the bank has already raised rates by 5% in this current tightening cycle, and also at quite a steep trajectory it must be said.

The central bank's updated economic projections were closely watched by investors last month, who were keen to gain an insight into the thinking of Fed policymakers at this critical stage of the tightening cycle. The updated forecasts reflected a view that the US economy is proving more resilient but also that core inflation has been more difficult to reduce than was previously expected. The projection for the Core PCE inflation rate in Q4 of this year was increased from 3.6% to 3.9%, even further above the 2% target. However, the Fed still sees the rate falling to 2.6% by the end of 2024 and 2.2% by Q4 2025. In terms of jobs data: the Q4 2023 unemployment rate forecast was lowered significantly from 4.5% to 4.1%, but again the projections for Q4 2024 and Q4 2025 were little changed at 4.5%.

Much stronger growth is now expected for the US, with the Fed upgrading their 2023 GDP forecast from 0.4% to 1.0%. There was very little change to the 2024 and 2025 GDP estimates, 1.1% and 1.8% are forecast respectively for these years. Policymakers' views on interest rates in the US remains that cuts will be slow to materialise in the near term, but that policy easing is still likely in 2024-25. The market has without a doubt been factoring in this view over the past month or two. Investors are no longer pricing in rate cuts for later this year, and now see rates likely remaining between 5.25 – 5.00% until the second quarter of next year.

It was interesting to see just two of the eighteen officials projecting no further rate hikes this year - the rest are expecting at least one. The median Fed projection is for rates to be raised by a further 50bp from this point before we reach a peak. The medium-term median projection from June shows that the central bank is looking for rates in the US to be lowered to circa 4.625% by Q4 of 2024 and to 3.375% by the end of 2025. This would represent 2 full percentage points of easing in 2024-25, based on the current market peak rate expectation.

European Central Bank

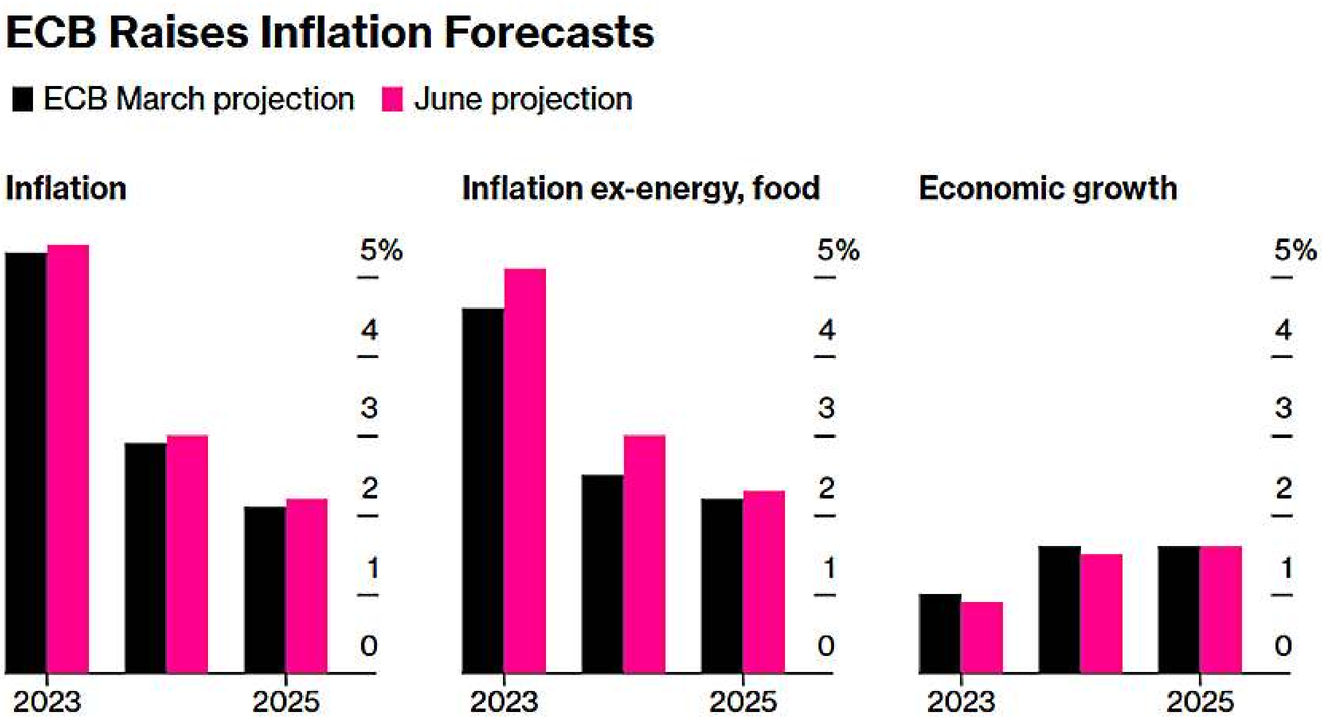
As had been well communicated to the market in advance, the ECB decided to hike rates by a further 25 basis points when they met on June 15th, pushing the Deposit Facility rate up to 3.50% and Main Refinancing rate to 4.00%. This brings the total amount of rate tightening in this cycle, which began just under one year ago, to 400bp. However, Christine Lagarde and her team did reduce the pace of rate increases to 25bp at the last two meetings, following the 50bp moves that were implemented in March, February, and December and the two 75bp hikes seen last autumn.

Last month’s hike of course came despite the region entering a technical recession and headline inflation moving convincingly lower so far this year. Stubbornly high, or ‘sticky’, core inflation is now the main concern of the ECB. This is especially true in the services sector, which remains well in expansionary territory across most of the region.

In her post-meeting press conference, President Lagarde made it clear that the ECB still has considerable progress to make in terms of policy tightening. She explicitly mentioned that their work is far from done and emphasised the likelihood of another rate hike in July. It was reiterated once again that future decisions will ensure that policy rates will be brought to levels sufficiently restrictive to bring inflation back down to the 2% target level and will be kept at those levels for as long as necessary. We were not surprised to see the ECB emphasise again that it will continue to follow a data-dependent approach with regard to its future rate decisions, with a heavy emphasis also on the assessment of the inflation outlook.

European Central Bank

In June we saw the ECB's latest set of staff quarterly macroeconomic forecasts. The headline inflation forecast from back in March saw little alteration, with the rate expected to average at 5.4% this year, 3.0% in 2024 and 2.2% in 2025. However, the core rate forecast, which excludes food and energy, was the key focus for market participants and was moved up significantly by ECB officials. The central bank now estimates that the Eurozone Core CPI will average out at 5.1% in 2023 and 3.0% in 2024, before falling to 2.3% the following year.

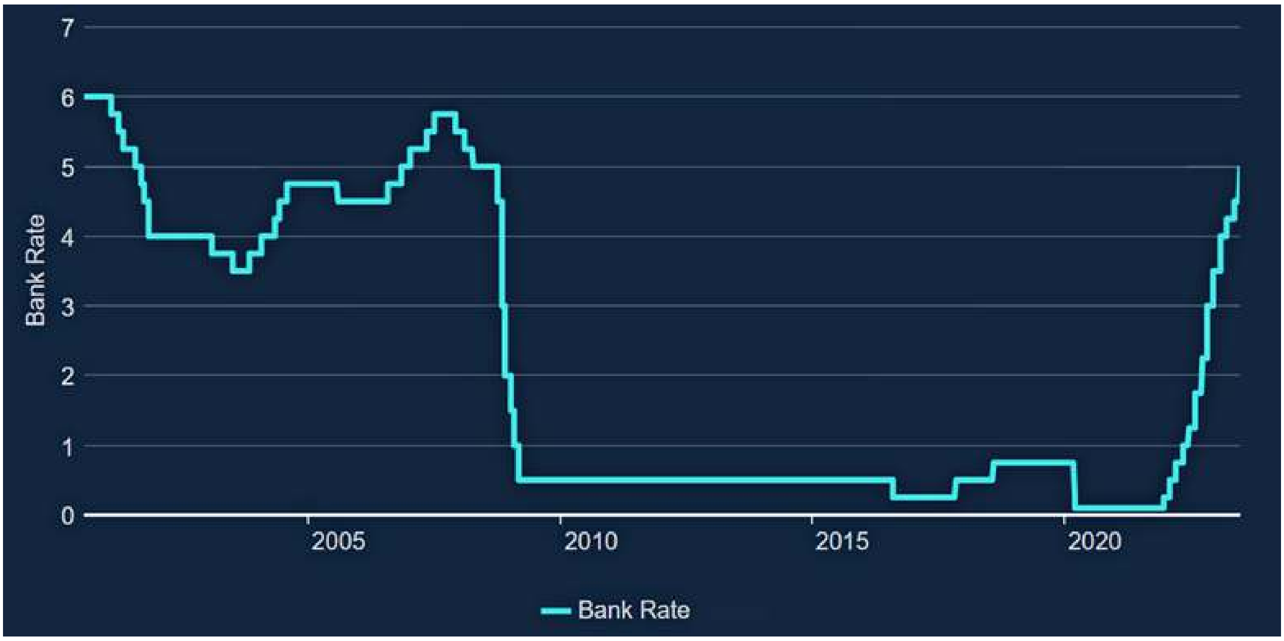


Source: ECB, Bloomberg

Taking a look at growth estimates, policymakers now expect a marginally weaker GDP result of 0.9% this year, while the previous forecast for growth of 1.6% in 2024 was also lowered to 1.5%. For 2025, the growth rate was unchanged, with the economy still seen as expanding by 1.6%. Markets are close to pricing in 50bp more worth of rate increases in the second half of this year. Several rate cuts are then expected to come from Q2 of next year onwards, which would bring rates in the Eurozone back down towards the 3% mark by the time we get to 2025. Due to the ECB's strong commitment to maintaining a restrictive policy in the face of sticky core inflation, rate cuts may be further away than markets had been hoping for over recent months.

Bank of England

The Bank of England increased interest rates by half a percent in the second half of June to bring UK rates up to 5.00%, as the central bank and Prime Minster Rishi Sunak vowed to combat high inflation. This followed two 25bps hikes at its March and May meetings. Prior to this, the BOE had implemented 50bps increases in both February and December. Sunak came out in support of the rate hike last month and warned Conservative MPs that tax cuts would need to wait. At the BOE, seven of the nine voting members opted for the rate increase. The BOE has now raised rates by a total of 490bp since it commenced hiking in December of 2021.



Source: Bank of England

“We know this is hard – many people with mortgages or loans will be understandably worried about what this means for them” admitted BOE Governor Andrew Bailey, “But if we don’t raise rates now, it could be worse later. We are committed to returning inflation to the 2% target and will make the decisions necessary to achieve that”. Policymakers at the bank made little comment on recent market expectations that rates would climb to a 6% peak by the end of this year.

The BOE did not provide us with any update to its macroeconomic projections this time around, the most recent forecasts were released at its May meeting. In May, the central bank upgraded its UK GDP growth forecast to +0.25%, from – 0.5% in February. It also raised its 2024-25 forecasts (to 0.75% for both years). Despite the upgrades though, they still represent a subdued outlook with growth running at below 1% in 2023 - 25, following a twelve-month period of economic stagnation.

The May estimates showed that inflation is expected to slow to roughly 5% by the end of this year. This is up from its prior projection for 4%. The BOE then sees inflationary pressures falling further to 2.3% by December 2024 and 1% by the end of 2025. Overall, inflation is expected to reach the famous 2% target over the ‘medium term’. We must note that these inflation forecasts were conditioned on the market view at the time that the BOE would get rates up to around 4.75% in Q4 of 2023. However, the market is now pricing the peak rate being above 6%. The meeting statement in June noted that the current headline, services and core goods inflation rates have all been “much stronger than projected”.

Markets

Equities

After a surprisingly positive start to the year for equity markets, there is now a significant disconnect between what the equity and bond markets are pricing in. Stocks have been robust throughout the first six months of the year, and have certainly been more resilient than many market participants had anticipated back at the beginning of January. With yield curves on both sides of the Atlantic now heavily inverted again, there is a significant disconnect between what equity markets are pricing in (a soft landing) versus what bond markets expect (a recession). With global growth slowing and central bankers guarding against easing policy too soon, it may be the case that equities see a pull back in the short term in order to resolve the disconnect between these two markets. If this does play out over the course of the third quarter, we would use this opportunity to allocate further to risky assets in our selected regions and sectors.

We are of the view that the longer-term outlook for equity markets remains promising, yet, we are highly selective in our allocation. In line with our long-term investment philosophy, portfolios remain geared towards high-quality, cash-generative and conservatively-capitalised businesses that focus on long-term growth and sustainability and that can maintain a high return on operating capital employed.

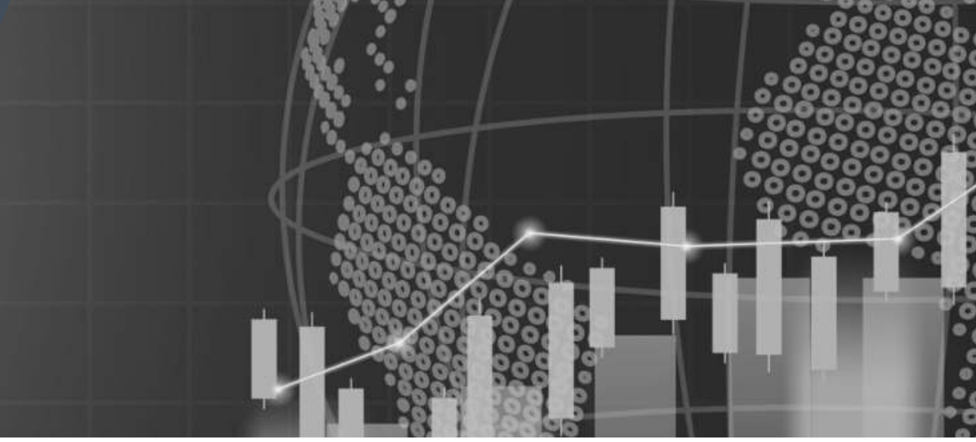
As we have explored in our recent data insights, the S&P 500 not long ago has rebounded from its 2022 lows by over 20% and is now technically back in a bull market. For now, at least, we can label the October lows as a bear market low, and delve into some bull market statistics. Forward returns after a bull market is confirmed have historically been strong for the index. The S&P has posted average gains of 18% twelve months after a bull market officially started, based on the date and level that the index breached the 20% bull market threshold. The duration of a bull market can vary significantly, but historically they have been longer-term. As can be seen on the table below, since 1929 the average S&P 500 bull market has lasted for 39.4 months and produced an average gain of 130.1%. If you exclude the Great Depression era (1929 - 1939), the average bull ran for 51 months and produced an impressive average gain of 147%.

S&P 500 | Duration & Performance of Bull Markets (1929-YTD)

Bear Market Bottom	Bull Market Peak	Months	S&P 500 Return	Annualized Return
11/13/1929	4/10/1930	4.9	46.8%	157.6%
6/1/1932	9/7/1932	3.3	111.6%	1530.5%
2/27/1933	7/18/1933	4.7	120.6%	675.4%
10/21/1933	2/6/1934	3.6	33.4%	164.9%
3/14/1935	3/6/1937	24.1	131.0%	52.6%
3/31/1938	11/9/1938	7.4	62.2%	120.8%
4/8/1939	10/25/1939	6.7	23.9%	47.9%
6/10/1940	11/9/1940	5.1	24.9%	70.6%
4/28/1942	5/29/1946	49.7	157.7%	26.1%
10/9/1946	6/15/1948	20.5	20.8%	11.9%
6/13/1949	8/2/1956	86.0	267.1%	20.0%
10/22/1957	12/12/1961	50.4	86.4%	16.2%
6/26/1962	2/9/1966	44.1	79.8%	17.6%
10/7/1966	11/29/1968	26.1	48.0%	20.0%
5/26/1970	1/11/1973	32.0	73.5%	23.3%
10/3/1974	11/28/1980	74.0	125.6%	14.1%
8/12/1982	8/25/1987	60.0	228.8%	26.7%
12/4/1987	3/24/2000	147.7	582.2%	16.9%
9/21/2001	1/4/2002	3.5	21.4%	96.2%
10/9/2002	10/9/2007	60.0	101.5%	15.0%
3/9/2009	2/19/2020	131.5	400.5%	15.8%
3/23/2020	1/3/2022	21.4	114.4%	53.4%
10/12/2022	6/8/2023*	7.9	20.0%	32.0%
	Average:	39.4	130.1%	145.2%
	Median:	25.1	93.9%	26.4%

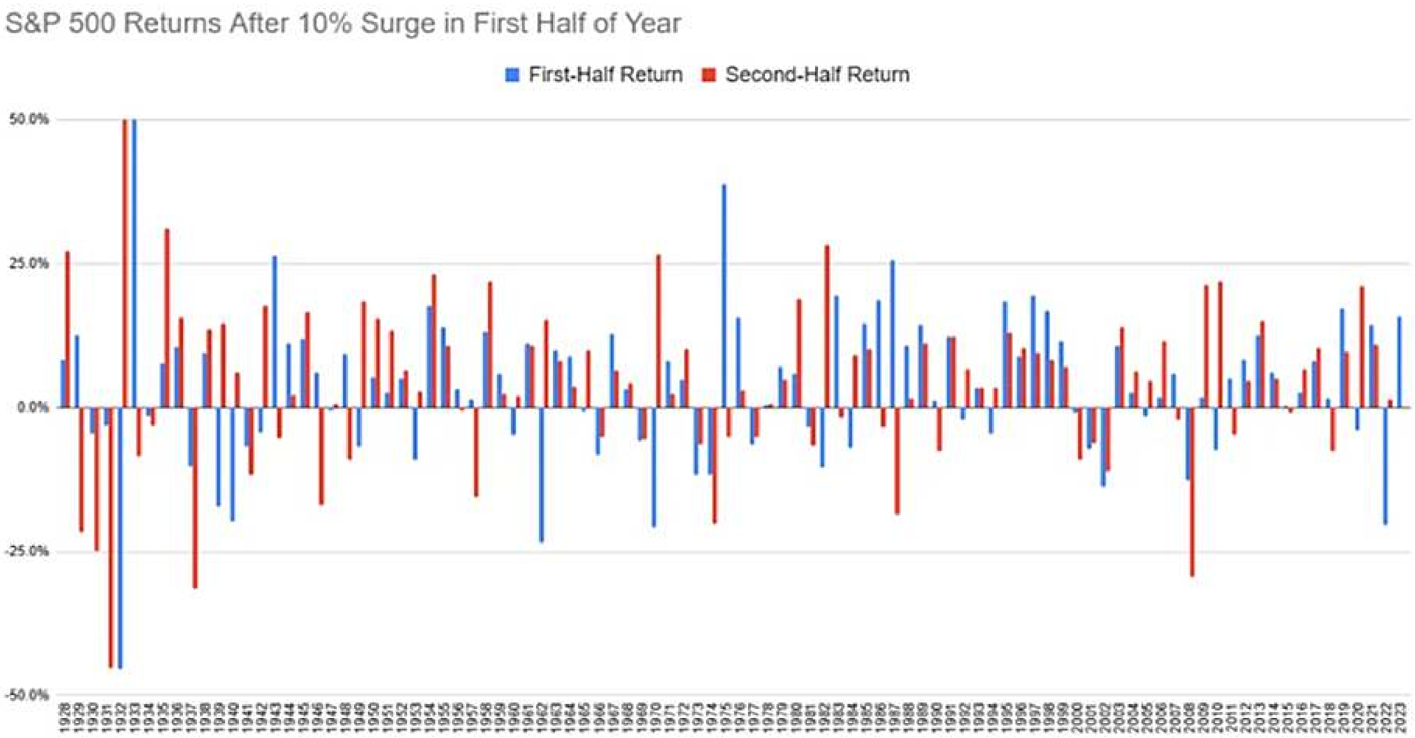
Source: LPL Research, Bloomberg

Equities



We always strive to remain objective when looking at equity markets, and find statistics to be particularly useful at times such as these. Many equity investors have been wondering if the asset class has become overheated in the short term amid the AI-related surge, after indices on both sides of the Atlantic have registered double-digit first-half gains. We would like to point out to clients that with regard to data from the past century, double-digit H1 growth for the S&P 500 has on average led to a H2 return of +6% with a win rate of 75%.

In addition, as highlighted in the chart below, the odds of success are improved further when we look at double-digit H1 returns that have followed a year of negative returns, very similar to the situation we are currently in. In these ten instances, the average second-half return has been 9.8% with a win rate of 80%



Source: Yahoo Finance

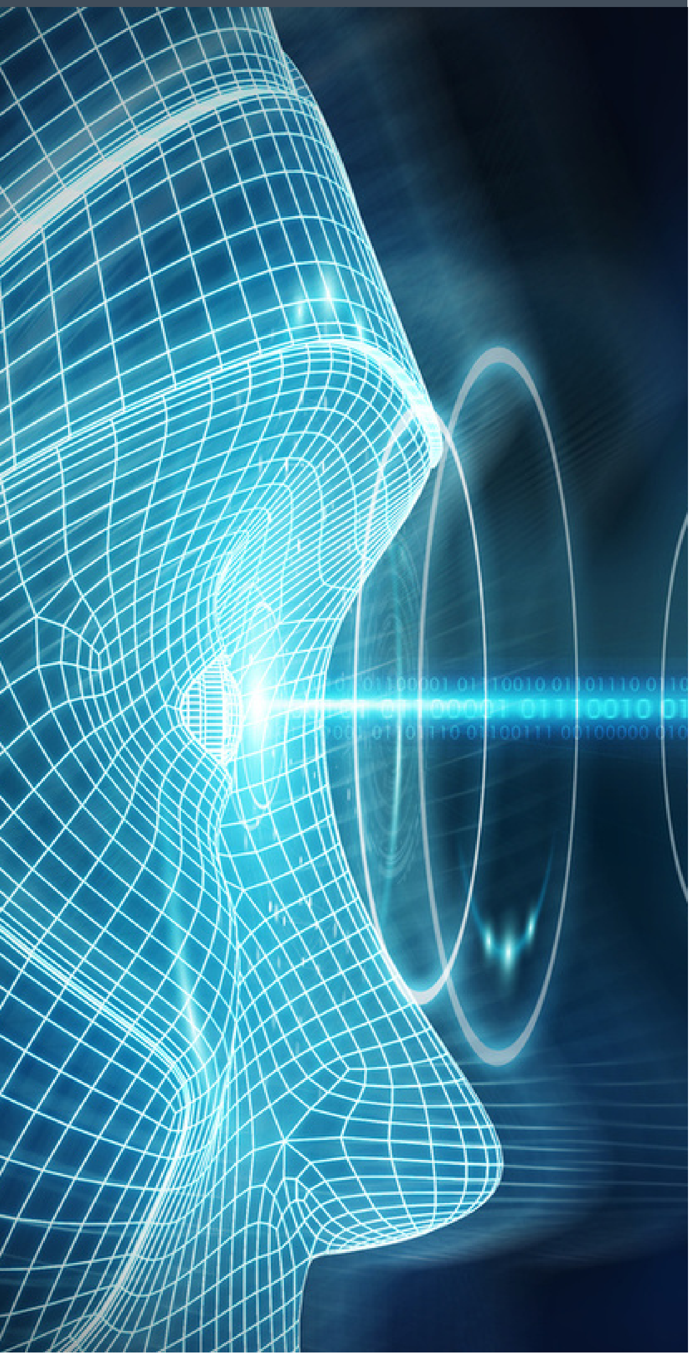
Equities

If we take a look at equity markets from a regional point of view, attractive opportunities can be found in certain areas. Global equities currently trade at 16.5x forward earnings, broadly in line with their 10-year average, but clearly there have been significant divergences by region. US markets, at 19.4x, are trading at a slight premium to historical averages. It could be argued that large-cap growth and technology stocks, which have mostly driven the H1 market strength in the region, look slightly vulnerable if rates end up staying higher for longer than is currently expected.

However, some markets such as Eurozone and UK equities look particularly cheap relative to history – the MSCI Europe, which includes both Eurozone and UK equities, currently has a forward-P/E of 12.6x (chart below) and trades at a discount to its longer-term average of 14.4x. Despite near term challenges, these regions, in particular the Eurozone, represent attractive value for long term investors who can tolerate the volatility. The market perception is that European equities are likely to underperform their US peers in a recessionary scenario, as their sector composition is more cyclical. However, there is actually no recent evidence to support this contention. The last fifty years shows that the performance of US and European equities during recessions, from their peak to trough, have been roughly the same.

Source: IBES, MSCI, Refinitiv Datastream, JP Morgan Asset Management

Equities



As we have laid out in recent investment updates, we believe a more defensive, but balanced, positioning makes sense at this stage of the cycle. Investors should focus on reasonably priced companies with established businesses, superior pricing power, stable margins, and strong balance sheets. Defensive stocks, which are sometimes referred to as 'bond proxies', would provide us with some protection in the event of a worse-than-expected global recession later this year or next year. Conversely, we see the more cyclical parts of the market as potentially vulnerable to deeper pullbacks in a scenario of sustained economic weakness. Most cyclical sectors' earnings are closely tied to the business cycle and in theory would suffer the most in a recession.

Also, long-term structural plays are definitely worth considering at this point in time, as they tend to be less correlated with short-term market moves. Certain investment themes look particularly attractive in this regard, such as AI and other areas within the technology space.

Clearly, AI-related names, especially the largest ones, have had a remarkable first half of 2023. It has been well spoken about by market commentators that the recent AI boom has been in a small number of large companies - causing the likes of the S&P 500 and Nasdaq indices to surge during H1. High concentration levels such as these may lead to stocks giving up some of their stellar early-year gains in the short term before investors are drawn back into technology once AI begins to boost the earnings of listed companies in the sector. Basically, we would not be surprised to see a short-term pullback in this space during Q3, although it is still unclear how deep this would be. It is our view that an event such as this would represent an excellent opportunity rather than a structural collapse of the trade, because multiples have not risen to historical extremes and the expanding AI economy should help its primary beneficiaries grow into their valuations in the longer run.

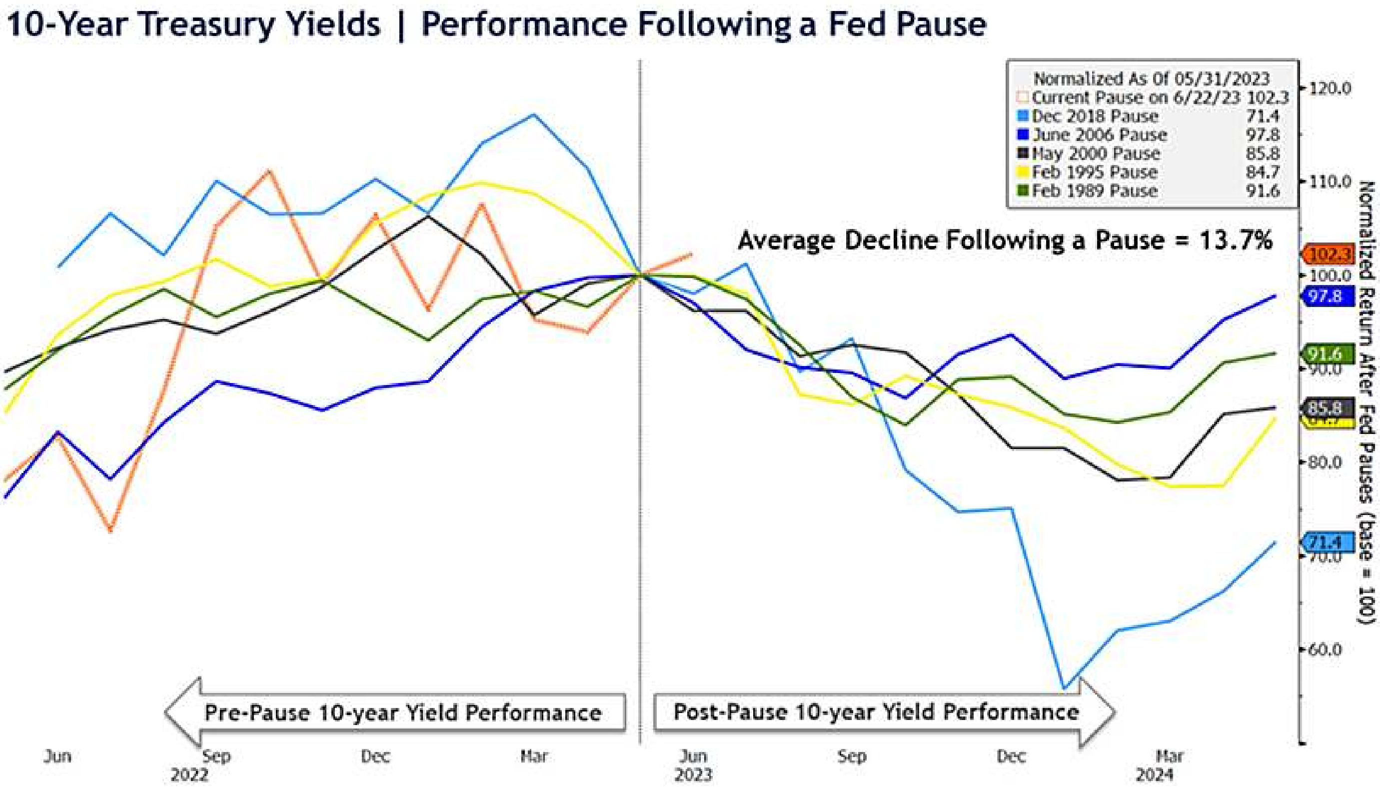
To summarize, we are neutral on developed-market equities in the short-term and will continue to use pullbacks and spikes in volatility to enter into longer-term positions within our chosen regions and sectors. While bonds reflect a safer and better risk-reward trade at present, we believe the overall return of stocks will be greater than fixed-income assets over the coming decade. Stock valuations on a long horizon do not appear stretched to us. Although we do acknowledge that in the short to medium-term there is a risk that central bank rate hikes may cause further financial cracks and economic damage to emerge, as there is usually a lag effect when it comes to monetary tightening. Also, corporate earnings expectations have yet to fully reflect even a modest recession, so there is some room for short-term disappointment there in the event of a recession.

Fixed Income

Following the surge in bond yields seen over the past year or so, as we have highlighted in past Investment Updates, fixed income markets now look more attractive on a risk-adjusted basis than equities in the near term. They provide a higher yield for a lower risk. Taking a look at relative valuations between equities and government bonds, the global equity risk premium has fallen to 3.3%, compared with 6.2% in March 2020 and 20-year average of 4.2%. This metric calculates excess return that investors can expect to earn from equities compared to a risk-free rate of return.

With many equity analysts around the globe continuing to highlight the risk of downside earnings surprises for the remainder of the year, the outlook for the bond market looks considerably better in the near-term. A so-called 'soft landing', with slow growth and slowing inflation, would mean favourable total return prospects across fixed income. In fact, even as policymakers have been raising short term rates, longer-term bond yields have been falling as investors anticipate both inflation and growth to decline.

When more and more central banks likely pause their rate hiking cycles over the course of Q3, we believe bond markets will start to benefit. The chart below, for example, demonstrates what has happened to the 10yr US Treasury yield after the last five rate pauses by the Federal Reserve. Each instance is set at the 100 mark on the chart, at the time of the pause - with the yield falling from this point by an average of 13.7% over the following 12 months.



Source: LPL Research, Bloomberg

Fixed Income

The bond market seems to be torn between sticky core inflation and the prospect of further rate hikes on the one hand, and then negative repercussions to the economy due to significantly tighter policies on the other hand. This, in turn, has kept rates in the US and Eurozone mostly within a broad range. The benchmark US 10-year rate peaked back in October at 4.34% and has since pulled back to 3.8%. In Germany, the 10-year yield saw a peak of 2.77% in early-March of this year but is now at 2.4%. Many are wondering if bonds have bottomed out or what the chances might be that these October/March yield highs could be revisited again? History suggests that this will ultimately depend on two crucial factors: the remaining number of hikes in either region, and the timing of cuts further out.

We would like to reiterate our preference for short-term government bonds at this juncture, as well as high-quality investment grade corporate debt. We are cautious on high yield credit as we see the asset class as more vulnerable to recession risks at present. We are of the view that the inflation-related jump in shorter-term bond yields last year, and indeed during Q2 of this year, has reduced the need to take risk by seeking yield further out the curve. We are also overweight inflation-protected government bonds. While there could be significant room to the downside for yields over the second half of this year, we must acknowledge that sticky core inflation in developed regions could throw a spanner in the works for the bond market, at least in the short-term. Longer-duration bonds are still quite vulnerable to medium and longer-term inflation risks, in our view.

Currencies

At the beginning of the year, we outlined our view for a weaker US dollar if inflation in the region continues to decline over the first half. Six months on, and this is precisely what we have seen – the headline CPI rate for June last week fell to a 26-month low of 3.0% y/y, helping the dollar index fall below 99.50 and EUR/USD to push above 1.12 (+4.9% YTD). We also spoke about the potential for some short-term dollar strength during H1, which we did see play out in both February and May, before the world's reserve currency ultimately moved lower.

Looking ahead, we would like to reiterate our view that over the medium and longer term, the dollar looks vulnerable to high valuation and an inevitable global recovery following a possible recession. Furthermore, the dollar could weaken still if markets become confident that a recession can be avoided, given the counter-cyclical nature of the currency. We do, however, acknowledge there could also be some short-term drivers of strength for USD. These would include 1) the Fed defying market expectations and sticking with their plan to hike by 50bp more this year, and 2) any bouts of volatility in risk assets during the second half.

Looking specifically at the euro – the ECB places great importance on reducing inflation to 2% and has expressed its plans for additional rate hikes, which should underpin the common currency. The ongoing war in Ukraine remains a potential risk, but the EU has reduced its reliance on Russian oil and gas. Overall, the euro should in theory continue to appreciate against USD as the ECB catches up with the Fed, and as the Eurozone is supported by a degree of convergence on growth.

Sterling has rebounded year-to-date after a tough 2022 when the currency had to endure significant investor concerns about the UK economy and Liz Truss' mini budget. Over the course of the last six months, GBP/USD has recovered to circa 1.31 and EUR/GBP has fallen to 0.855 amidst reduced political risk with a new Prime Minister and Chancellor promoting fiscal constraint, as well as stubbornly high inflation keeping BOE policy tight. Much will depend on monetary policy going forward, in our view. The market is priced for between 100 – 150bp more of hikes in the UK, versus just 25bp in the US and 50bp in the Eurozone. This should support the British pound, however there is also risk to the downside if the UK economy struggles and the BOE fail to deliver on these expected rate increases. We see a high likelihood that EUR/GBP remains within the 0.845 – 0.865 area in H2.

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