



HFMC
WEALTH

Investment Strategy
Third Quarter 2023





Summary

- Central banks remain on their relentless march - pushing up interest rates in the battle against the persistence of consumer price inflation. This has already exposed cracks in the banking sector, and recent survey data goes from weak (service sector) to very weak (manufacturing sector) suggesting a slowing economic backdrop. In China, its economic reopening from COVID lockdowns is looking temperate at best, as consumers prefer to continue saving, not spending and the property market still looks fragile.
- Inflation and interest rates remain high, but UK consumer confidence is steadily improving from the lows found in the wake of the short-lived Truss Prime Ministership. UK household savings ratios remain higher than immediately before the pandemic, but in the same way as rising energy bills sucked those accumulated pandemic savings away from any consumer spending boom, rising mortgage costs will impact the spending power in a rising number of households. US consumers have tended to spend down savings and rising interest rates tend not to be as impactful in terms of rising costs but will still pose problems for people looking to move home, as their long-term mortgage rates are not transferable to new properties.
- Unemployment remains low for now and a job-filled recession is likely to be a less fearful beast than recent recessions, during the financial crisis and the pandemic. There is a 'but', which is we're less capable of absorbing the impact of further negative shocks and geopolitical risks remain, most obviously with the potential for the war in Ukraine.
- Inflation remains enemy number 1. That central banks were too loose in keeping interest rates at their COVID ultra-low levels is now a given, and the reason why they continue to talk in hawkish tones about rate rises to come. In the US and Europe at least, they will be breathing a sigh of relief that the inflation genie is heading back to the lamp. The Bank of England has more work to do. Weaknesses remain in the banking system, for now this is a secondary concern, but has prompted commercial banks to tighten lending standards.
- In fixed income markets, 2023 is proving harder work than anticipated. UK Government bond yields have risen (which means prices fall) but have typically fallen elsewhere. Credit spreads have been relatively stable. We continue to use several strategic bond funds, some of which have been slowly increasing interest rate sensitivity in portfolios, in anticipation of falling interest rates. The yield available from fixed income, whether it be government or corporate bonds should serve as a positive, long-term backdrop for the asset class.
- The mood in equity markets remains wary of recession, but one in which investors have been happy to accept the positive returns year to date. The weakness of the UK market and the strength of sterling are negating much of these positive returns. Areas such as US equities have seen valuations move from 'expensive' to 'average' in recent years. Others, particularly the UK and Japan are looking cheap versus history, but require a catalyst to unlock that value. Pressure on corporate earnings and profits will grow as consumer spending pressures build.
- Sterling strengthened against the major currencies since January, particularly so against the Japanese yen as new Governor Ueda stuck, for now, to yield curve control. Despite the Saudis promising production cuts, Brent Crude, which started the year just below \$86/barrel, moved lower by the end of June to \$70/barrel. The US Department of Energy has announced the purchase of 3m barrels following drawdowns from the Strategic Oil Reserve last year. Gold rose sharply towards \$2000/oz as concerns rose about the banking sector, but drifted lower to close at c\$1968/oz.

Market Outlook

Arctic Monkeys, then Guns N' Roses, then Sir Elton

Having been a supporter of the team from the red side of Manchester since my early teen's and having lived in the south-east of England for the majority of my life, I find nothing ironic in saying I'm a big fan of Glastonbury, despite never actually going (so as not to completely offend my fellow Reds, I did eventually visit Old Trafford about 35 years later!).

On that basis, I'll look forward to my trip to the Eavis' farm, sometime halfway through my retirement. Until then, I'll remain a keen watcher in control of the volume button. Like the economic outlook, this year's headlines were somewhat of a mixed bag. Economically, we're in the 'Arctic Monkeys' phase; an underwhelming phase that most people aren't enjoying, inflation is problematic but probably past its peak (Guns N' Roses), and a long-way short of a triumphant, joyous celebration (Sir Elton). There will be better times ahead, but for now it remains 'tough sledging'.

Inflation – The Relentless March

Talking of nightmares, we continue to need to talk about inflation. As a reminder, the first inflationary wave, that in goods prices, was driven by COVID lockdowns restricting supply change, whilst consumers were still clamouring for "stuff". In the UK, this peaked last October to be replaced by a secondary wave, as war in Ukraine caused both energy and food costs to spike. This will begin to roll out of the annual numbers in the coming months (oil and natural gas prices are now well below the level they were at the onset on the invasion). The third, shallower, wave has been the rising level of services inflation, think pubs, restaurants, and hotels and running alongside that the rising costs of labour.

There is no question that inflation remains central bank enemy number 1. That central banks were too loose in keeping interest rates at their COVID ultra-low levels is now a given and the reason why they continue to talk in hawkish tones about rate rises to come. In the US and Europe at least, they will be breathing a sigh of relief that the inflation genie is heading back to the lamp. Weaknesses remain in the banking system but for now this is a secondary concern and commercial banks tightening their lending standards, in order to strengthen themselves, works alongside the central bank objective of sucking demand through increased cost of loans.

So, central banks remain on their relentless march - pushing up interest rates in the battle against the persistence of consumer price inflation. Recent survey data goes from weak (service sector) to very weak (manufacturing sector) suggesting a slowing economic backdrop.

Among the big economies, the UK is becoming an inflation outlier. Consumer price inflation (year over year) has been falling in the US for the past 11 months and now stands at 4% and is set to fall further. Chair Powell continues to talk about rate hikes despite a weakened banking sector and the full weight of rate rises to date still needing to feed through (their full impact is yet to feed through to economies). In Europe, the ECB is very clear that there are further rate rises to come, even whilst its own staff forecast headline inflation to fall to 3% next year and 2% the next.

The Bank of England has more work to do and will be looking for the idiosyncrasies of how energy costs are calculated in the UK to begin to bring inflation down quicker. The energy price guarantee has just ended and the large number of households on standard energy tariffs will see declines in conjunction with how Ofgem calculates the energy price cap. From 1st July, the energy price cap falls by 17% to £2074 and is predicted to fall slightly further in its October calculation (announced this August). This will help drag down UK inflation, but in chunky quarterly lags, just like it did in April where energy price falls accounted for a drop of -1.4%. More patience required.



A job-filled recession

Our recent experience of recessions has been particularly nasty. The financial crisis precipitated the near collapse of our financial system and quarter after quarter of real economic decline, with unemployment spiking amidst a protracted recovery. By contrast, the COVID-19 recession was relatively short-lived, but was incredibly deep as



workers were told to stay at home and unemployment was forestalled through stimulus packages and furlough schemes. Both were deeply scarring.

The existing threat of recession is clearly unwelcome, but all recessions are not created equally. Unemployment remains low and a job-filled recession is likely to be a less fearful beast than those recent recessions that stemmed from the financial crisis and the pandemic. Household savings remain healthy but are unequally spread, governments have large-scale stimulus packages in place as part of their industrial policy and to support the transition to a clean energy future. When central banks become comfortable that inflation has eased enough, and ultimately interest rates begin to fall, then the most significant headwind to markets over the last 18 months will turn.

The Relented March

The march by Wagner Group forces, from the battlefields of Ukraine towards Moscow sparked governments and newsrooms into life and then disappeared as quickly as Wagner did to Belarus.

The impact of the war in Ukraine was felt most significantly by markets at the outset of the invasion but has become an accepted 'negative' since. The war impacted gas markets significantly, most clearly in the restrictions in supply for Russian gas, but also because European demand for new sources of gas supplies meant countries became relatively price insensitive buyers. The warm winter has left Europe in a good position with gas storage levels over 75%, well above the 5-year average of 60% for the time of year and so energy supply is less likely to be a cause of further market instability.

Markets have absorbed and moved (or are moving) through a series of potential crises already this year – inflation and interest rates obviously, but US bank failures, debt ceilings (see next paragraph) and the continued war all hang over sentiment.

'Crises' are overcome, but each 'crisis' saps the strength of market enthusiasm. A weak economic outlook, slowing inflation, high interest rates, a slow trudging war, and a slowing China are all accepted. There is a 'but', which is that we're less capable of absorbing the impact of further negative shocks and geopolitical risks remain, most obviously centred around Ukraine and possibly a de-stabilising Russia.

US Debt Ceiling – Why have a drama when you can have a crisis?

"Don't have nightmares, do sleep well", were the reassuring words Nick Ross would close out the long-running BBC crime-reconstruction programme, *Crimewatch*, episode after episode. Running for over 30 years, the TV cameras rolled as the public was invited to help solve some notorious crimes with a mix of

reconstruction, grainy CCTV and some dubious E-Fit's. The phrase sought to calm an otherwise terrified nation and prevent viewers being sent to their beds, wide-eyed with heartbeats racing, to face the sleepless night ahead.

"We averted an economic crisis, an economic collapse", Joe Biden asseverated to the TV cameras broadcasting from the Oval Office that yet another US debt ceiling 'will they, won't they' soap opera had passed. Less reassuring perhaps, but equally welcome as the US President signalled the passing of the Bill to agree to restrain some spending over the next decade and throwing the hot potato of the debt ceiling into another presidential cycle. The great fear of course was a re-run of the summer of 2011, when the issue of raising the debt ceiling was taken to the wire, resulting in a significant and steep fall in equity markets and the US facing the ignominy of having its credit rating downgraded.

This time, no downgrade, and perhaps a look into the future as centrist politicians held sway to ensure a relatively smooth passage through Congress...

Growth and Inflation Numbers:

Thanks, as ever, to our friends at Schrodgers for the latest consensus forecasts, which are:

	GDP (%) 2023	GDP (%) 2024	CPI (%) 2023	CPI (%) 2024
Global Economy	2.2	1.9	4.6	3.0
China	5.8	4.9	1.8	2.4
Emerging Markets	4.1	4.1	4.6	3.7
US	1.1	0.6	4.2	2.6
EU	0.7	0.9	5.5	2.4
UK	-0.1	0.8	6.7	2.8

Source: Schrodgers Talking Point, May 2023

'TINA' Turner

I must confess I was never the greatest fan, but you don't need to go much further than the 'Queen of Rock and Roll' to find a greater triumph over adversity, nor for a stronger comeback story in the annals of music history. It has been many years since cash has had its own paragraph in this revered (my word, no-one else's) publication. 'TINA', or 'there is no alternative' was the result of desultory levels of interest achievable on cash and was made for the easiest decision for asset allocators over the last five years. Zero interest in an asset that gave zero interest. Simples.

Whilst interest on a typical current account seems to be languishing (banks seem very happy to pay derisory levels of interest, whilst pushing up the interest rate on mortgages), the same can't be said for fixed rate cash accounts. With many cash savings accounts offering rates



in excess of 5%, even some pushing towards 6%, interest rates can be found at levels not seen since before the financial crisis. With inflation still ticking along at 8.7%, real returns, even from the highest paying accounts are still negative, but with inflation forecast to fall through the year, that may be temporary.

History suggests that cash held for the long-term presents a real-terms risk to maintaining its value, but at the same time maximising the rate of interest on those rainy-day savings would make a great deal of sense.

Portfolio Outlook

In fixed income markets, 2023 is proving harder work than anticipated. UK Government bond yields have risen (which means prices fall) but have typically fallen elsewhere. Credit spreads have been relatively stable. We continue to use several strategic bond funds, some of which have

been slowly increasing interest rate sensitivity in portfolios, in anticipation of falling interest rates. This is a move we concur with and across a number of portfolios we have reduced exposure to short-dated fixed income. This does not mean that we see little value in the short-dated end of the fixed income market either and we continue to hold funds in this area. Yields do remain attractive at the shorter end too but by adding to longer-dated assets you can capture the yield for a longer period, whilst accepting more sensitivity to the movement in interest rates. The yield available from fixed income, whether it be government or corporate bonds should serve as a positive, long-term backdrop for the asset class.

The mood in equity markets remains wary of recession, but one in which investors have been happy to accept the positive returns year to date. The weakness of the UK market and the strength of sterling are negating much of these positive returns, for example, the Japanese TOPIX is

up 22% in local currency terms, but the weakness of the yen means for sterling investors, the return is just over 5%. Areas such as US equities have seen valuations move from 'expensive' to 'average' since last year, but there remain pockets of very high valuations. Others, particularly the UK and Japan are looking cheap versus history, but both require a catalyst to unlock that value. We should anticipate pressure on corporate earnings and profits will grow as consumer spending pressures build, but as a broad comment, valuations are at a level that makes prospective **long-term** returns from equities look more positive than they have been for some time



Conclusion:

The year remains hard work as the pressure from rising interest rates continues to build and reverberate. Challenges, such as the US debt ceiling are being overcome, but interest rates remain the biggest hurdle and little progress is likely to be made until the tide of interest rate rises turns.

It is easy to get wrapped up in negativity and we are not blind to these economically tough times. There are, however, plenty of areas in both fixed income and equity

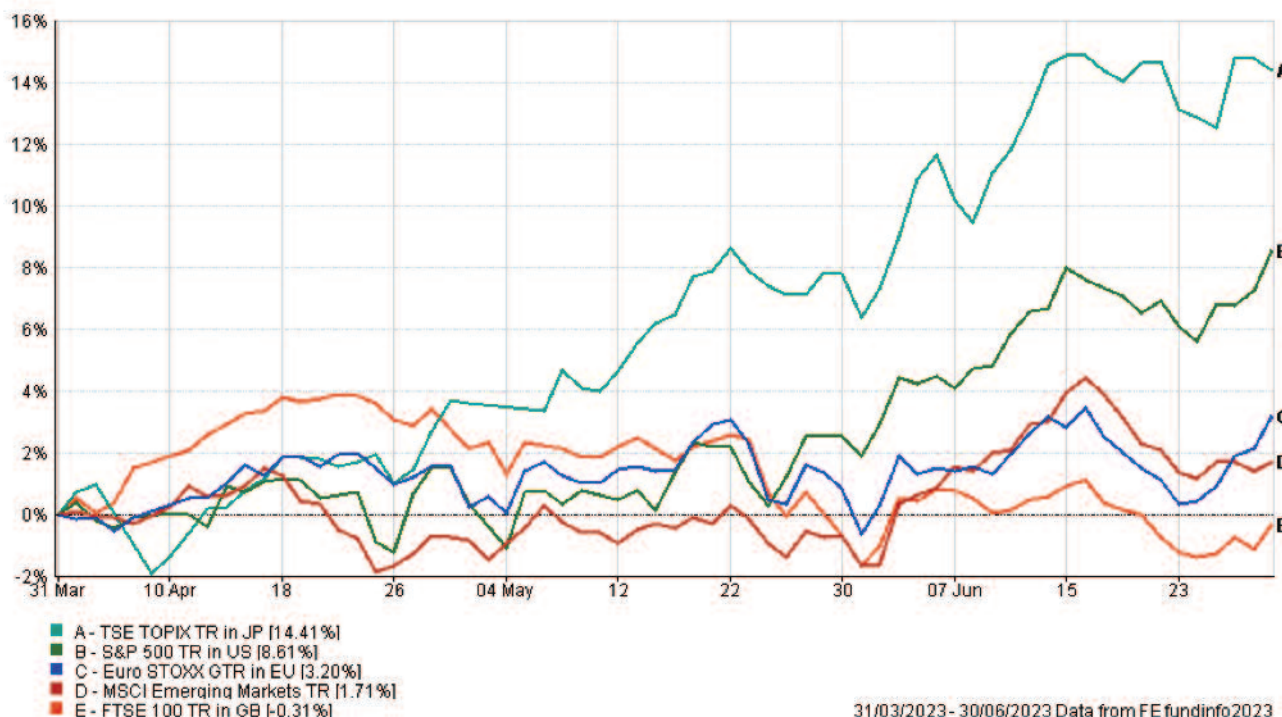
markets that should deliver long-term positive returns in future years. We ended our last quarterly arguing that time and patience are likely to be an investors best friend. Portfolios are surviving, not thriving, in these headwinds, but sometimes treading water in turbulent seas is necessary. As Sir Elton sang at Glastonbury "I'm Still Standing".

From all of us in the investment team, Emma, Will, Becky, Kim, Hayley and me, we thank you for continuing to place your trust with us in managing your portfolio.

Review of Q2 2023

Market Returns – a whistle-stop tour of some of the movers and shakers during the quarter.

The chart shows the returns in local currency across a cross sample of major indices.



The table opposite shows Investment Association sector average returns broken down by asset class and geography, this time in sterling. Overseas equities broadly, enjoyed a positive quarter, led by the US. The strength of sterling vs. overseas currencies has been a real headwind for UK investors.

It has been a mixed quarter for asset classes. US, global and Japanese equities and UK physical property enjoying positive returns with the remainder, in negative territory. Fixed income, except for high yield (which has a higher correlation to equities than other areas of fixed income), was particularly hard hit. UK equities also underperformed.

IA Sector Returns	Q2 2023
Sector : IA North America TR in GB	4.8
Sector : IA Japan TR in GB	3.3
Sector : IA Global TR in GB	2.3
Sector : IA Sterling High Yield TR in GB	1.4
Sector : IA Global Equity Income TR in GB	0.9
Sector : IA UK Direct Property TR in GB	0.8
Sector : IA Europe Excluding UK TR in GB	-0.3
Sector : IA UK All Companies TR in GB	-0.8
Sector : IA Global Emerging Markets TR in GB	-1.1
Sector : IA Sterling Strategic Bond TR in GB	-1.1
Sector : IA UK Equity Income TR in GB	-1.7
Sector : IA Sterling Corporate Bond TR in GB	-2.9
Sector : IA Asia Pacific Excluding Japan TR in GB	-3.9
Sector : IA UK Gilts TR in GB	-5.4
Sector : IA UK Index Linked Gilts TR in GB	-8.6

Data from FE Analytics

The following table shows the winners and losers in terms of the industrial sector for the quarter in local currency:

MSCI Sector Returns (TR)	Q2 2023
Index : MSCI ACWI/Information Technology and Communication Services TR	14.2
Index : MSCI ACWI/Consumer Discretionary TR	9.0
Index : MSCI ACWI/Industrials TR	7.4
Index : MSCI ACWI/Financials TR	5.4
Index : MSCI ACWI/Health Care TR	2.4
Index : MSCI ACWI/Consumer Staples TR	0.3
Index : MSCI ACWI/Energy TR	0.3
Index : MSCI ACWI/Utilities TR	-0.2
Index : MSCI ACWI/Materials TR	-0.6
Index : MSCI ACWI/Telecommunications Services TR	-1.9

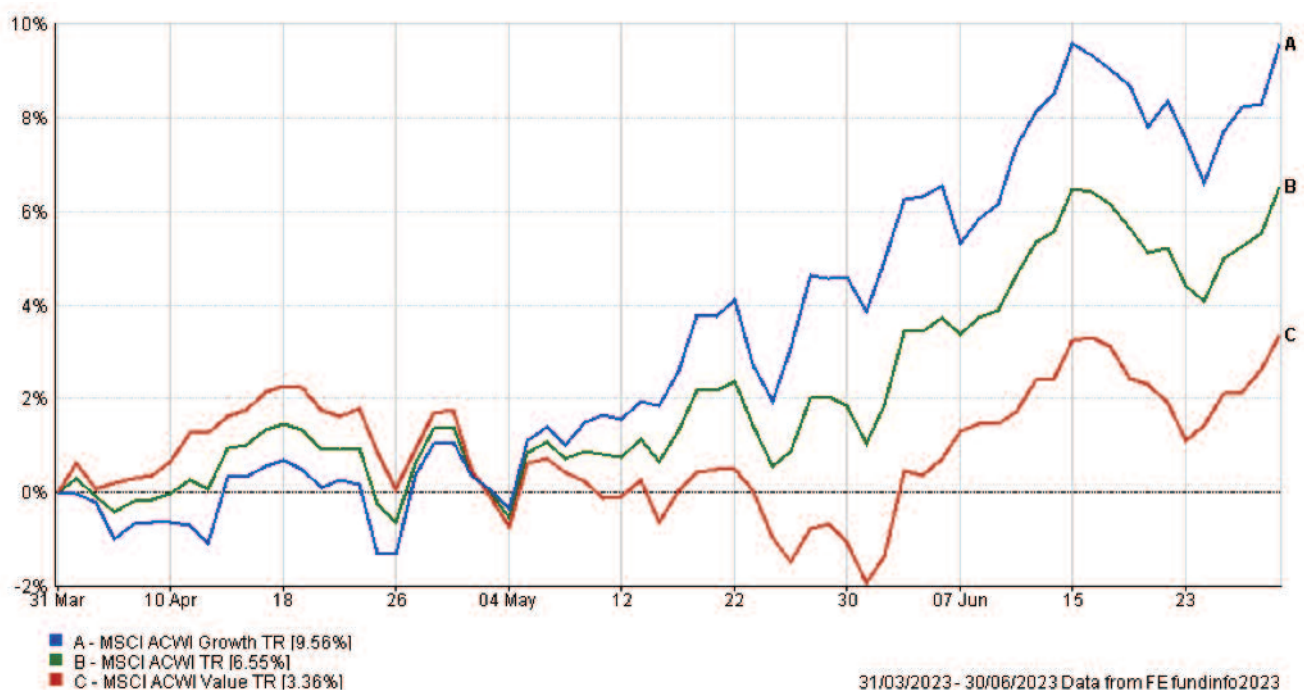
Data from FE Analytics

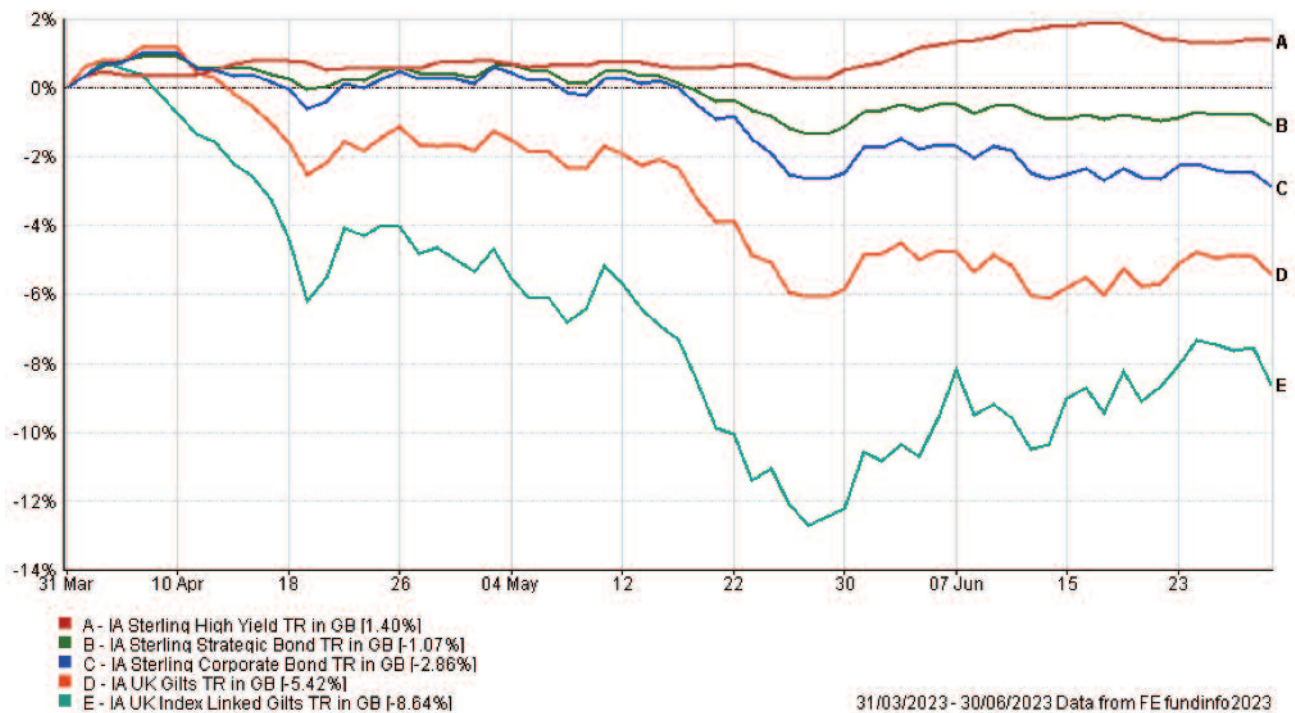
Sectors that have been the darlings over the last decade returned to the spotlight, technology produced double-digit returns over the quarter, closely followed by consumer discretionary (which hides within it names such as Tesla and Amazon). Last year's winners found themselves relegated to the bottom of the table.

The style switch from value to growth, that we noted previously, continued its winning streak in the second



quarter of 2023. Growth stocks, which have been leading markets for the last decade, fell out of favour last year, but the style continues to push higher throughout 2023.





Fixed Income

It has been another volatile quarter for fixed income, particularly for index-linkers, who finished the quarter at the bottom of the pile; only high yield was in positive territory. We continue to use strategic bonds but have reduced short-dated fixed income funds and have tentatively started to increase duration; the fall in fixed income markets provided an opportunity to add to select pockets of value within fixed income.

Currencies

Sterling continued its onward march and reigned supreme in the second quarter of 2023. Whilst the story of 2022 was a strong US dollar, particularly against sterling, year to date sterling is in vogue.





Commodities

The catalyst

The impact of the war in Ukraine has had major implications, particularly to global energy markets, but also as a catalyst for driving government packages focused on driving an energy transition. Russian oil, trading at a \$25 discount to international oil, is helping to suppress the rise in the oil price, which has steadily been falling from its early invasion peaks, despite OPEC cuts. For China and India who continue to be the primary purchasers, this is delivering a cheap energy boon. Tempering the profits from Russian oil, whilst not exacerbating energy price inflation, being the main result of 'Western' sanctions.

Longer-term, the most significant implication resulting from the war is the recognition by governments around the world that they need to achieve a higher level of energy security. As a result, major fiscal programmes are being directed towards this whilst incorporating the necessity to transition away from a carbon economy. The Inflation Reduction Act in the US as well as the European Union's Recovery fund and EU Green Deal Industrial Plan are results of governments seeking to achieve greater energy independence, but in a cleaner form that has been the case since the Industrial Revolution.

Whilst the early year enthusiasm that buoyed commodity prices, such as copper, stemmed from the high expectations surrounding a strong rebound in the Chinese economy, following its reopening from COVID lockdowns. The China 'reopening' boom now looks disappointing which, in turn, has impacted commodity prices through the course of the year, but some longer-term tailwinds remain, justifying their continued inclusion in some higher risk/reward portfolios.

Supply...Better management, better future

From the supply side, inventories have been drifting lower across multiple commodities, for example according to JPM Asset Management, copper inventories have fallen from their peaks in late 2017 of 900,000 tonnes to around 250,000. Inventory levels have been falling for the last decade at a time when we need more copper due to the energy transition. It isn't just copper, London Metal Exchange inventories across almost every base metal are at lows helping to support prices. With the supply bottlenecks created by having to source, mine, refine and transport commodities, the lead in times to generating more production present an obvious obstacle. Lead times in bringing new commodity supply is measure in years, not days, weeks or months.

Capital investment levels from the major mining and energy companies have fallen from their peaks early in the previous decade when the clamour for new projects came at the expense of capital discipline, leading to weak share price performance for the rest of the decade. Corporate debt levels are now much lower in aggregate and the focus shifted to shareholder friendly dividends and buybacks. All good news from a corporate health perspective.

There is a 'but'.

Underinvestment in capital expenditure and increased capital discipline in boardrooms, has been running alongside the increasingly pressured long-term outlook for traditional energy sources, oil and gas. The net result being significant reductions of capital expenditure in traditional oil and gas projects and, whilst there has been growing investment in renewable energy sources, overall investment in global energy supply has been falling since the middle of the last decade.

...and Demand – The essentials needed for the energy transition

Society is evolving and developing the technologies to move to a lower carbon future. Both sentiment within society has shifted to recognise the need for the sustainable use of the resources our planet offers up. Importantly, this coincides with, first, the ability to scale up the shift away from fossil fuel reliance and, second, the political will to support the transition under the need to ensure more secure energy supplies. The costs of solar and wind power have fallen dramatically to already make it an economically more attractive option than traditional fossil fuels, and as the pace of the renewable energy transition continues, delivering energy from renewable energy sources will make economic sense. Earlier in the year, according to National Grid, the UK generated its trillionth kilowatt hour of renewable energy. Whilst it took 50 years to reach that landmark, their forecast is for the next trillionth kilowatt hour of renewable energy to be generated in just the next 5 years.

Transitioning away from a carbon economy, whether it is achieved through increased solar or wind generation is going to need plentiful other resources, whether that be copper or rare earth's minerals. For example, electric vehicles are 4 or 5x more copper intensive than a conventional car. A wind turbine contains approximately a tonne of rare earth metals

This energy transition will form a strong backdrop of demand for commodities in years to come.

Inflation Friendly

We've written in previous quarterlies that the decade or so since the Global Financial Crisis saw central banks keeping interest rates at lows, and then ultra-lows as the pandemic struck, in an attempt to meet their inflation targets. Looking forward, we'd argue inflation is likely to

trend down from the current highs but hover slightly higher than the policy targets of the major central banks. This will promote a shift mentality in central banks to constantly 'tap the brakes' with rate rises to keep inflation suppressed, rather than 'foot to the floor' to try and push inflation higher. In that environment, the positive relationship between commodities and inflation should be maintained. Either way, the prospect of a deflationary episode, which would be a headwind for commodities, seems some way distant. Whilst the inflation argument isn't, in our view, the primary reason for holding, it does serve as a useful 'back-pocket' reason.

Conclusion

The short-term outlook remains challenging for commodity markets. A slowing global economy tends not to serve as a warm backdrop. However, look through the near term and the outlook becomes more positive for a variety of reasons. The demand/supply dynamic as we transition our energy production and supply to a cleaner, low-carbon option will demand huge number of resources. The corporate management of resource companies has also become more shareholder friendly and less capital destructive than it was during parts of the previous decade. Finally, should inflation remain higher than it has since the Financial Crisis, commodities relationship with inflation could be helpful.

We are moving into a period where demand for commodities is likely to be turbocharged by the push from governments to transition their economies to a cleaner energy future. The need for transitioning away from a dirty carbon economy has been known for some time, but the sharp focus delivered by the war in Ukraine on governments and their need to achieve energy security has delivered the motivation and fiscal push to deliver. The European Union's Recovery Fund, The US Inflation Reduction Act and the EU's Green Deal Industrial plan will help drive the demand for this energy transition, both from the need for energy security, but also from the desire for their economies to be the winners in this new energy cycle. Investing in the companies that supply some of the critical materials to enable that global transition makes long-term sense.



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