DART CAPITAL

Market Commentary

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It was a mixed month for equity markets, as markets continued to digest the prospect of tighter monetary policy and ongoing disruption caused by the Russia-Ukraine conflict.

Market outlook & portfolio positioning

Unsurprisingly, much of our internal discussion is focused on the path of US Federal Reserve policy and the impact this will have on asset markets over coming months. Our base case is that a modest decline in inflation – the forces behind which are outlined later in this piece - from very high current levels will allow the Federal Reserve to slow their current pace of projected interest rate hikes. This dovish pivot would likely drive a relief rally in financial assets, particularly growth areas of the equity market such as technology stocks, and corporate bonds within fixed income. Less likely, although certainly possible, is that stubborn inflation will force the Federal Reserve's hand, prioritising tackling inflation through aggressively higher interest rates, over supporting the economy and financial markets. The war in Ukraine will certainly play a role in determining the trajectory of inflation. The longer the conflict goes on, the greater the upward pressure on global commodity prices.

Against this backdrop, having previously positioned for a rotation into more lowly valued areas of the equity market which has subsequently played out, we trimmed back equity allocations during May by taking some profit from some of our more value-oriented strategies which have held up particularly well this year. Whilst we have reduced overall equity levels, we have been modestly topping up exposure to the "growth" stocks that are now trading at far more reasonable valuations than they were 6 months ago, and would benefit most from a gradual decline in inflation from today's current levels. Across equities more broadly, the balance sheets of our underlying companies remain strong, and are thus reasonably well positioned for rising interest rates. This stands in stark contrast to Private Equity (to which we have no exposure), where debt levels are often excessive and company profitability already stretched.

Outside of equities, we retain significant exposure to high quality short-dated bonds, as well as the likes of gold, with this area providing a useful source of liquidity should we see attractive opportunities to re-allocate to within the equity market. Furthermore, we retain sizeable holdings in assets denominated in overseas currency, notably the US dollar which has helped bolster portfolio resiliency during the challenging market conditions of this year.

UK

The UK government finally relented and announced more stimulus measures, with sizeable cash payments to households to help pay for increased energy bills. The Bank of England remain more unpredictable than most other Central Banks, although at least one further rate increase is expected – in July - before the Bank of England re-assesses their plans. The Bank continue to balance being seen to fight inflation whilst managing concerns over the impact this will have on economic growth – particularly on the housing market – and energy bills which are already squeezing household disposable income. The inflation data for the month came in slightly above economist expectations, increasing 9% year-on-year in the 12 months to the end of April.

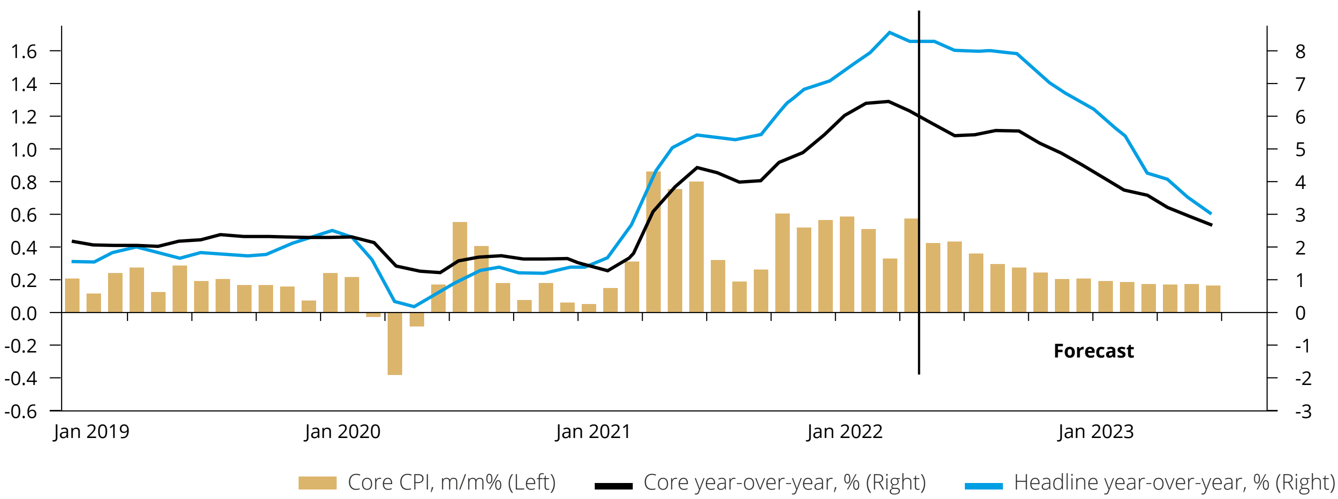
The large-cap UK equity index has remained relatively resilient despite the declines seen in the US, although this has been largely due to the greater exposure to energy and mining companies within the UK index, with many stocks outside of these sectors seeing significant declines in share prices so far this year. MSCI UK All-Cap ended the month up 0.5% in capital return terms.

US

US inflation data showed a modest decline in April, indicative of a potential moderation of price gains across the US. There are clearly some areas of the US inflation figures which will decline over coming months, such as used car prices, which skyrocketed during the pandemic, and manufacturer profit margins, which will likely moderate. Notably, our third party economics research provider Pantheon Macro expect that this will drive a sharp decline in core inflation (which excludes food and energy) over the second half of this year. However, some components of the standard CPI inflation figures – which currently stands at 8.3% in the 12 months to the end of April - are expected to remain stickier, such as rent increases and energy prices, which will keep the figures elevated well above the Federal Reserve's 2% target for at least the remainder of this year.

As the US is largely self-sufficient in energy production, high oil and gas prices have less overall impact on their economy than the Eurozone. Whilst this has helped drive a rally in the US Dollar over recent months, we remain wary of the fact that the high asset valuations and debt levels – particularly across private equity and residential property – make the financial side of the American economy highly sensitive to higher interest rates and the Quantitative Tightening that the Federal Reserve are using to quell inflation concerns. As a result, we are more cautious on the Dollar than most at this juncture, given its extremely elevated valuation and the potential softening of the Federal Reserve's stance on rate rises later this year. The S&P 500 ended the month flat in US Dollar terms.

US Core inflation will fall sharply from Q4 onwards



Source: Pantheon Macro

Eurozone

Having been slow to react to rising inflation, the European Central Bank (ECB) are now expected to raise the currency bloc's base rate in their July meeting, with the market currently pricing in a total increase of over 100 basis points by year end, which would bring the base rate up to c. 0.6%. The inflation figures for the currency bloc increased for the sixth consecutive month, with Eurozone CPI increasing to 7.4% year-on-year in the 12 months to April. MSCI Europe ex-UK ended the month down 1.7% in local currency terms.

Asia

China is edging closer to the end of its "zero COVID" policy, as the costs of frequent lockdowns look increasingly larger than the benefits of such a stringent policy, although most managers we speak to believe an official end to the policy won't come until President Xi is officially re-elected for his third term later this year. The government announced some modest further stimulus measures, including a tax rebate for certain industries and an extension of increased social welfare benefits whilst Shanghai's government opened the door for manufacturers to re-start operations at the start of June. MSCI China H ended the month up 2.6% in local currency terms.

In Japan, much news coverage is focused on the plans of the Bank of Japan (BoJ), which have diverged from the policy stance of the US Federal Reserve and ECB by maintaining their easing stance, and this has placed renewed pressure on the Yen against the US Dollar. Outside of the spotlight, corporate news flow has remained broadly positive, with seven companies held by our favoured Japanese equity fund, Polar Capital Japan Value, announcing share buybacks in their most recent earnings announcements, whilst a number of companies are significantly raising dividend guidance. From here, we believe the economic re-opening, which is only now starting to take place across Japan following a number of delays, should provide a revenue boost for domestically oriented companies over the remainder of the year. MSCI Japan ended the month up 0.8% in Yen terms.

Commodities

The oil price (as measured by Brent Crude) pushed higher over the month to end the period at $122 per barrel, in part due to the supply disruptions caused by the ongoing conflict in Ukraine, and strong fuel demand from households and businesses. Despite the surge in inflation, gold and silver prices have remained relatively muted this year, weighed down by the prospect of rising US interest rates. However, we believe that both precious metals are poised to perform well over coming years, as they did historically during higher inflation periods such as the 1970s, once the market appreciates that the Federal Reserve are constrained in how far, and how fast, they can raise interest rates. Gold and silver ended the month down 3.3% and 6% in US Dollar terms respectively.