Investment Brief

April 2023

House View

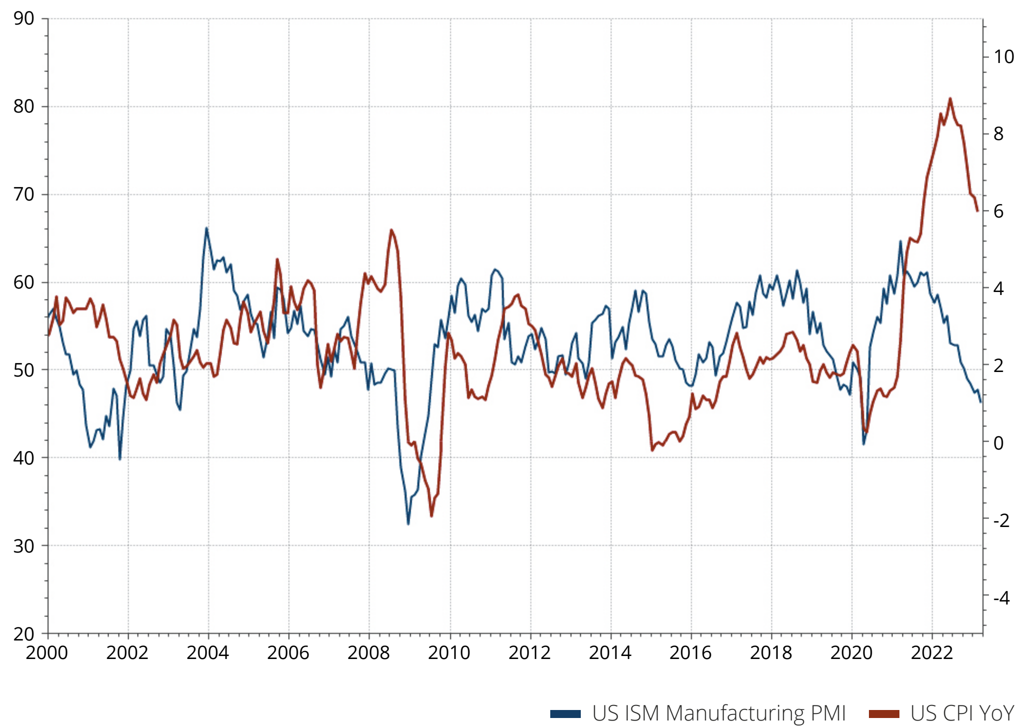
Alexander George, CFA
Associate Director of Research

With continued Central Bank interest rate hikes weighing on the global economy, we take comfort from the balance sheet strength of our underlying equity exposures, and our emphasis on higher quality issuers within the bond market. Looking to the longer-term, we believe equities, allied with selective fixed income and commodity exposure, look well placed to outperform inflation, given reasonable starting valuations, particularly outside of the dominant US market.

Macro outlook

As the year progresses, we expect inflation to continue to decline, as the spike in commodity prices which followed the start of the Russian invasion of Ukraine falls out of the data and other leading indicators, such as the manufacturing sector, weaken. However, with core inflation (which excludes food and energy), and tends to be driven largely by wage growth, likely to decline at a slower pace than Central Banks would like, we expect policymakers to make final few interest rate hikes over the coming months, before pausing and then potentially reducing rates next year should inflation continue its downward trend.

The weakening US manufacturing sector indicates declining inflationary pressure



Source: Refinitiv Datastream

The failures of Silicon Valley Bank and Signature Bank in the US, and Credit Suisse in Switzerland, further highlight some of the challenges created in a sustained period of sharply rising interest rates and fragile sentiment, with the news flow unsurprisingly shaking equity markets, and likely to lead to banks slowing lending growth and conserving more capital. However, the swift policy response from governments should help limit contagion across the broader sector, as should the fact that the banking system is far better capitalised now than it was in the run-up to the Financial Crisis.

Fixed Income

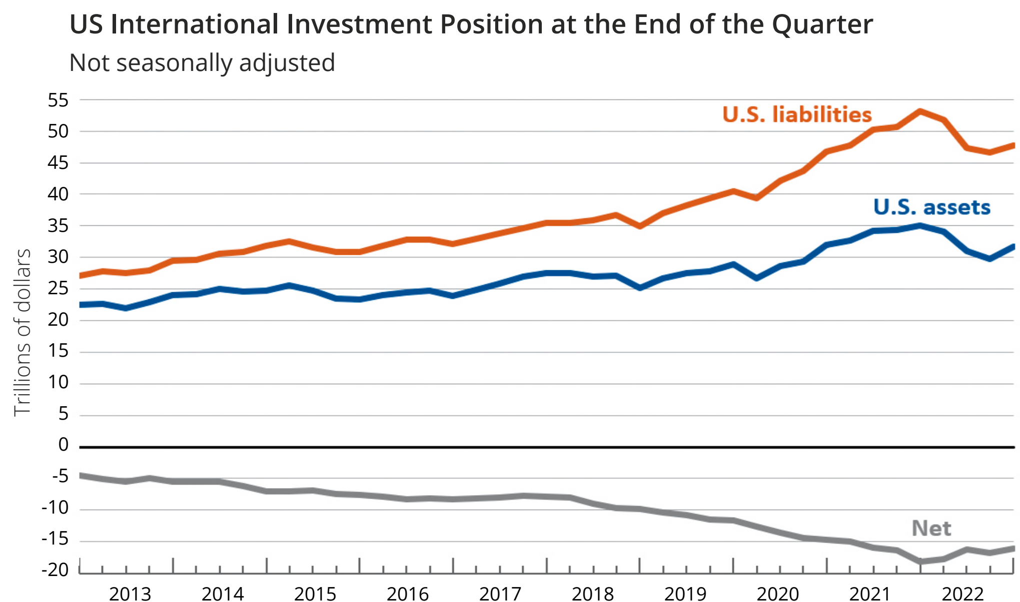
Faced with an environment where Central Banks are withdrawing liquidity from the global financial system, last year we increased our exposure to liquid government bonds which act as a liquidity buffer for portfolios, with a combination of a very short-dated Gilt, and inflation-linked US Treasuries providing this exposure. Alongside this, we continue to retain sizeable exposure to investment grade corporate bonds, where yields – which are just over 5% currently – provide an opportunity to lock in attractive yields which may not be available in the coming years should inflation return to more normalised levels over the next 12 months.

In contrast, we have pulled back exposure to less creditworthy bond issuers, where companies will eventually have to refinance at interest rates which are more than double the current interest rate on their outstanding debt, with this likely to place greater pressure on more highly indebted businesses. Having said that, we remain alert to the buying opportunity in this space should yields increase significantly from their current level.

Developed Market Equities

Within equities, we retain a tilt towards non-US markets reflective of the far lower valuations available outside of the world's largest equity market and crowded investor positioning in American assets, whilst – when investing in the US – we have increasingly focused our exposure to take advantage of the valuation anomalies which opened up during last year's sell-off. Further to this, we continue to see significant opportunities for long-term investors in smaller companies, where valuations are well-below historic averages.

Non-US investors are heavily exposed to US assets, which could reverse over coming years



Source: US Bureau of Economic Analysis

* The U.S. net international investment position, the difference between U.S. residents' foreign financial assets and liabilities, was -$16.12 trillion at the end of the fourth quarter of 2022

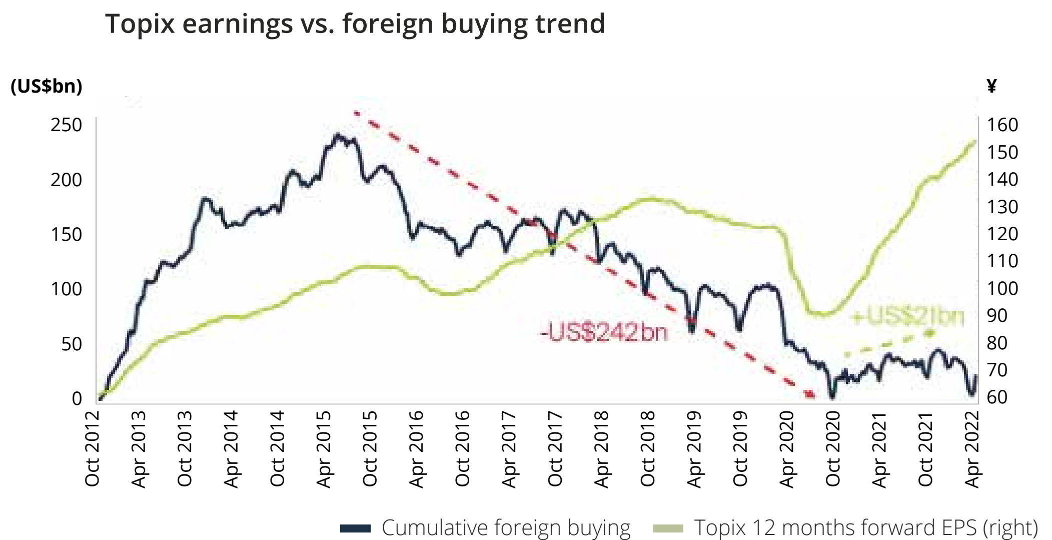
Within the US, we have increased our exposure to a large-cap investment trust – Polar Capital Technology Trust - which focuses on the largest and most profitable companies – such as Microsoft and Apple - within this area of the market, whilst trading at a significant discount to its net asset value. Dan and Joe will provide a more in-depth overview of this strategy later in their Fund Spotlight piece. Lower down the market cap spectrum, we are finding particularly attractive opportunities in smaller cap stocks, where the low valuations available reflect investor concerns over a potential US recession and the fact that many institutional investors have left the space in favour of more exciting (& expensive) venture capital and private equity strategies.

The UK remains a rich hunting ground for active managers, following the exodus of capital from the UK market over the last decade. Our favoured managers are often able to find profitable companies with clean balance sheets, trading on reasonable valuations, with this combination of positive forces providing a solid base for future returns. Set against this remains the ongoing political risk, and the risk-on nature of the Pound, which tends to fall during risk-off periods for global markets.

Asia & Emerging Markets

The focus on corporate governance in Japan continues to accelerate, with the Tokyo Stock Exchange announcing in January that they will be requiring those companies which are trading at below book value to explain the reasons for this undervaluation, and the policies they are putting in place to improve their share price performance. This provides a particularly powerful catalyst for our favoured Japanese equity fund, which has significant exposure to cash rich companies, some of which have been slow to bolster shareholder returns through increasing dividends and share buybacks. Notably, despite these improvements in corporate behaviour and solid profit growth over the last decade, Japanese stocks remain out of favour with global investors, which should help provide some cushion in the event of a renewed sell-off in western markets.

Global investors have reduced exposure to Japanese stocks, despite their solid profit growth

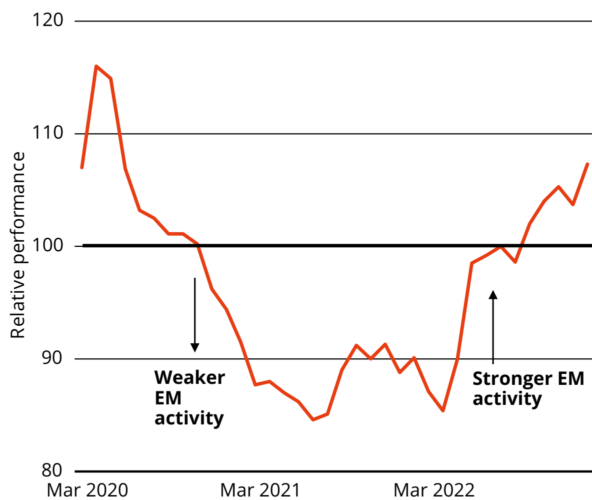


Source: MoF and Bloomberg, as at April 2022

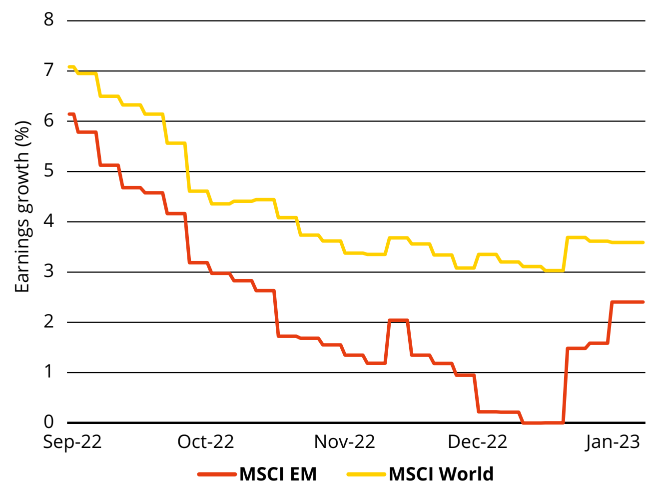
Whilst Emerging Markets remain relatively out of favour with investors which has pushed valuations close to 10-year lows, we see them as one of the biggest beneficiaries as, and when, non-US investors start to reduce their exposure to American assets.

Furthermore, with China's economic re-opening showing signs of picking up steam, this return to growth will stand in sharp contrast to the US, where economic growth is slowing.

Emerging market PMI vs. developed markets, 2020-2023



EM vs. DM earnings estimates, Sept. 2022 - March 2023



Forward looking estimates may not come to pass. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, March 2023. Notes: The chart on the left shows the composite S&P Global Purchasing Managers' Index (PMI) for emerging markets relative to developed markets. The line moving towards the 100 mark represents emerging market PMI strengthening relative to developed market PMI. The chart on the right shows 12 month forward earnings per share (EPS) growth estimates for emerging market and developed market equities. The indexes used are MSCI World and MSCI EM USD. You cannot directly invest in an index. Index performance does not account for fees.

Commodities

Many investors, following a broadly barren, and volatile, decade for returns, largely avoid commodities and commodity producing companies, with this flow of capital creating what we believe is a continued disconnect between prices and fundamental value. This is despite the huge underinvestment across the commodity complex over the last decade, which should be supportive for the future profitability of the incumbent businesses operating within this sector.

Particularly notable is that the price of some metals, typified by silver, have declined over the last decade, despite the cost of extraction increasing markedly over this period, and demand is now outstripping supply as investors seek a store of value amidst concerns over the weakening fiscal position of governments and Central Banks alike. We continue to gain exposure to this theme through the Jupiter Gold & Silver fund, which we added to portfolios on weakness in July of last year.

Property

Our commercial property exposure is heavily tilted towards the logistics sector, where vacancy rates remain low and corporate tenants increasingly regard their logistics warehouses as integral to their supply chain management. This resilient tenant demand for industrial space stands in sharp contrast to the offices sector where vacancy rates are rising amidst the rise of hybrid working. From a valuation perspective, despite our favoured REITs having seen their NAVs reduced last year to reflect a sustained base rate of around 4%, their share prices are implying an even larger decline in asset values which we don't believe is reflective of their prospective dividend growth and conservative balance sheet structures.

Market Commentary – Q1 2023

Alexander George, CFA
Associate Director of Research

The strong start to the year for equity markets tapered off over the second half of the quarter, as further tightening of monetary policy by the world's major Central Banks, and the widely publicised failure of some poorly-managed US and European banks hurt sentiment.

US

The beginning of the quarter saw a raft of strong US economic data, with jobs growth, inflation and household spending all coming in above economist expectations. Particularly notable was the January payroll data which showed a creation of over 500,000 jobs, having been boosted by an upwards seasonal adjustment of c.3 million jobs (from a loss of c.2.5m jobs in actual terms) to reflect the reduction in payrolls from December to January due to temporary hiring over the festive period. This unique adjustment likely distorted the market's perception regarding the strength of the labour market, as did the unusually warm weather during January, which allowed businesses to operate for longer than they typically would in prior years.

Inflation, as measured by the Consumer Price Index (CPI) continued to decline over the quarter, falling from 6.5% in the 12 months to December, to 6% in February. Over the course of the quarter, the Federal Reserve raised the Federal Funds rate by 50 basis points in total, with consecutive rate hikes of 25 bps each in early February and mid-March respectively. Following the March decision, Chairman Jerome Powell indicated that the Committee will remain data dependent, and won't rule out further rate hikes should core inflation remain elevated.

Reflective of some of the stresses in the financial system being caused by monetary tightening, March saw Silicon Valley Bank – the 16th largest US bank by assets - enter bankruptcy. The catalyst was a surge in outflows from depositors (most of which were Venture Capital-backed businesses), and questionable management of their balance sheet which saw much of their cash invested in long-dated US Treasuries and mortgage-backed securities subsequently decline in value amidst last year's sharp rise in global bond yields. Policymakers did move quickly to minimise contagion across the banking system, with the US government guaranteeing deposits in both SVB and Signature Bank, and a new Bank Term Funding Programme (BTFP) which provides loans of up to one year to banks, with a broad range of bonds – crucially valued at par value - allowed as collateral. The support measures provided by the Federal Reserve led to their balance sheet expanding by c.$300bn over March, having reduced in size of over the last year as part of their Quantitative Tightening programme.

Notably, the SVB news caused many hedge funds to close out positions in their most popular trades following significant losses, most notably short positions in short-dated US Treasuries and technology stocks. The buying pressure caused by the closing of these positions helped drive a sharp outperformance for large-cap technology stocks and US Treasuries, with the S&P 500 Information Technology index gaining 21% in US Dollar terms over the quarter. In the bond market, the 10-year Treasury yield declined 34 basis points to end the quarter at 3.49%.

US large-cap stocks, represented by the S&P 500, gained 7% in US Dollar terms, although this was lowered to 4.1% in sterling terms due to the modest weakening of the Dollar over the period.

UK

UK inflation has not come down as quickly as it has in some other regions, with the Consumer Price Index actually increasing from 10.1%, in the 12 months to the end of January, to 10.4% in February. In addition to electricity, gas and other fuels, one of the biggest drivers in the most recent figures were food and non-alcoholic drinks prices, which increased 2.1% month-on-month and 18% year-on-year, driven by rising input costs. Despite this, in a recent meeting with our third-party economist firm, Pantheon, they noted that they expect UK inflation to decline to 2% year-on-year by the end of this year, and average c.6% for the year as a whole. The biggest risks to this forecast are energy prices, which are difficult to predict, and wage growth, which in certain sectors of the economy is still catching up to the high headline level of inflation in 2022.

The Bank of England's Monetary Policy Committee (MPC) raised the base rate by 50 and 25 basis points in February and March respectively, bringing it up to 4.25%, with both votes seeing the Committee vote 7-2 in favour of the move (with the two dissenting members voting for no hike). In his most recent public comments, the Governor of the Bank of England, Andrew Bailey, refused to rule out future rate hikes, particularly if inflation declines quicker than markets currently expect. The 10-year Gilt yield declined 18 basis points over the period, to end the quarter at 3.49%.

The UK equity market, represented by MSCI UK All-Cap, gained 1.8% in capital return terms.

Eurozone

European economic data also surprised to the upside over the quarter, with survey data from the services sector coming in ahead of economist expectations. The European Central Bank have responded to the combination of resilient growth and elevated inflation with continued interest rate hikes, bringing the base rate up by 100 basis points over the quarter to 3%, with further hikes expected in the second quarter.

Spain's inflation figures for March demonstrated the impact of passing the first anniversary of the start of Russia's invasion of Ukraine, with its inflation rate declining to 3.3% year-on-year, down significantly from its level of 6% in the 12 months to the end of February. However, as is the case in many European countries, the core figures (which exclude food and energy) have started to overtake the standard figures, as wage growth catches up to the elevated levels of headline inflation of the last 18 months.

European equities, represented by MSCI Europe ex-UK, gained 9.8% over the quarter in local currency terms.

Asia

Following a tepid start to the year, China's economic data improved sharply in early March, led by figures from the services sector which showed a strong rebound in output, aided by the significant loosening of COVID restrictions. Later in the quarter, Alibaba's announcement that they are splitting the business into 6 separate companies helped bolster the market as a whole, with some viewing the Chinese government's approval of the plans as an indication of their less overbearing approach to the technology sector. MSCI China H ended the quarter up 5.2% in local currency terms.

Despite the appointment of a new Governor and downward pressure on the Yen, Japan's Central Bank (BoJ) have indicated publicly that, for now at least, they are committed to suppressing bond yields through their bond buying programme, in large part because they believe any significant tightening of monetary policy would reinforce the deflationary mindset which has dominated in Japan for much of the last 30 years. Japanese stocks, represented by MSCI Japan, gained 6% in Yen terms.

Commodities

The oil price came under significant pressure over March, as traders tried to factor in the slowing of the global economy driven by the weaknesses in the global banking system. The oil price, measured by Brent Crude, declined from $86 per barrel to $80.

The gold price gained 7% in US Dollar terms over the period, aided by the decline in real (inflation-adjusted) US Treasury yields, and the weakening of the US Dollar towards the end of the quarter.

Fund Spotlight – Polar Capital Technology Trust

Joe Healey
Investment Analyst

Daniel Patterson
Investment Analyst

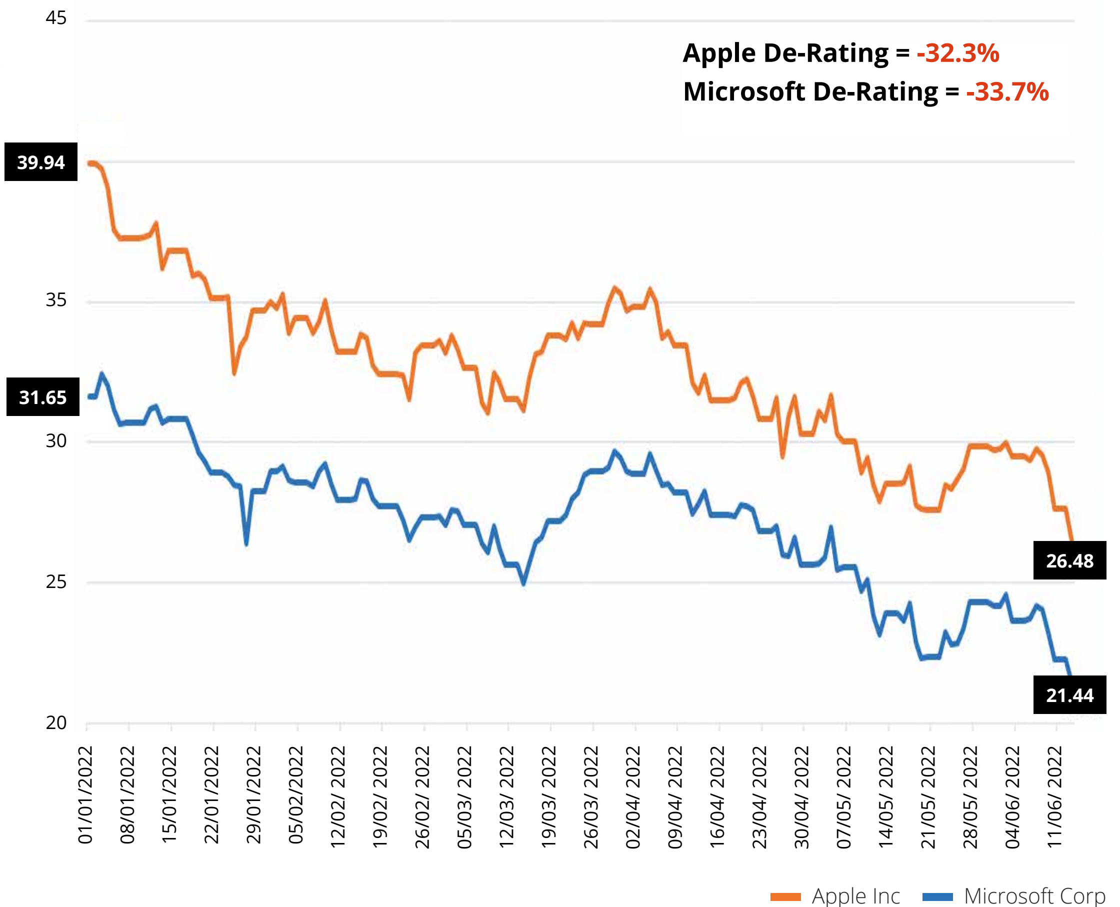
Launch Date:	16/12/1996
Strategy Assets:	£2.50bn (31/03/23)
Asset Class:	Global Equities
Managers:	Ben Rogoff, Nick Evans, Alastair Unwin, Fatima Iu, Xuesong Zhao

Ben Rogoff

The Polar Capital Technology Trust (PCT) was added across mid and higher-risk strategies during mid-June last year. The strategy provides a core, US-centric quality growth exposure focusing on companies with strong profitability and high cash-flow generation. Paired with its top-heavy exposure to resilient global businesses (the top 10 holdings representing 40% of the portfolio) the managers take a number of smaller positions in companies that are less well-proven but exhibit high potential for future growth.

Having held an underweight to US technology companies across model portfolios heading into 2022, strategies were shielded from much of the violent valuation de-rating in the first half of the year which saw the tech-heavy US Nasdaq index fall 29%. Even highly profitable index heavyweights such as Microsoft & Apple both fell over 20% (in US Dollar terms) over the same period having traded at elevated multiples heading into the year as highlighted below. This aggressive de-rating created a much more compelling opportunity to start narrowing our underweight to technology.

Apple & Microsoft PE Multiple (H1 2022)



* Morningstar 31/12/21-13/06/22 (Point of PCT Purchase)

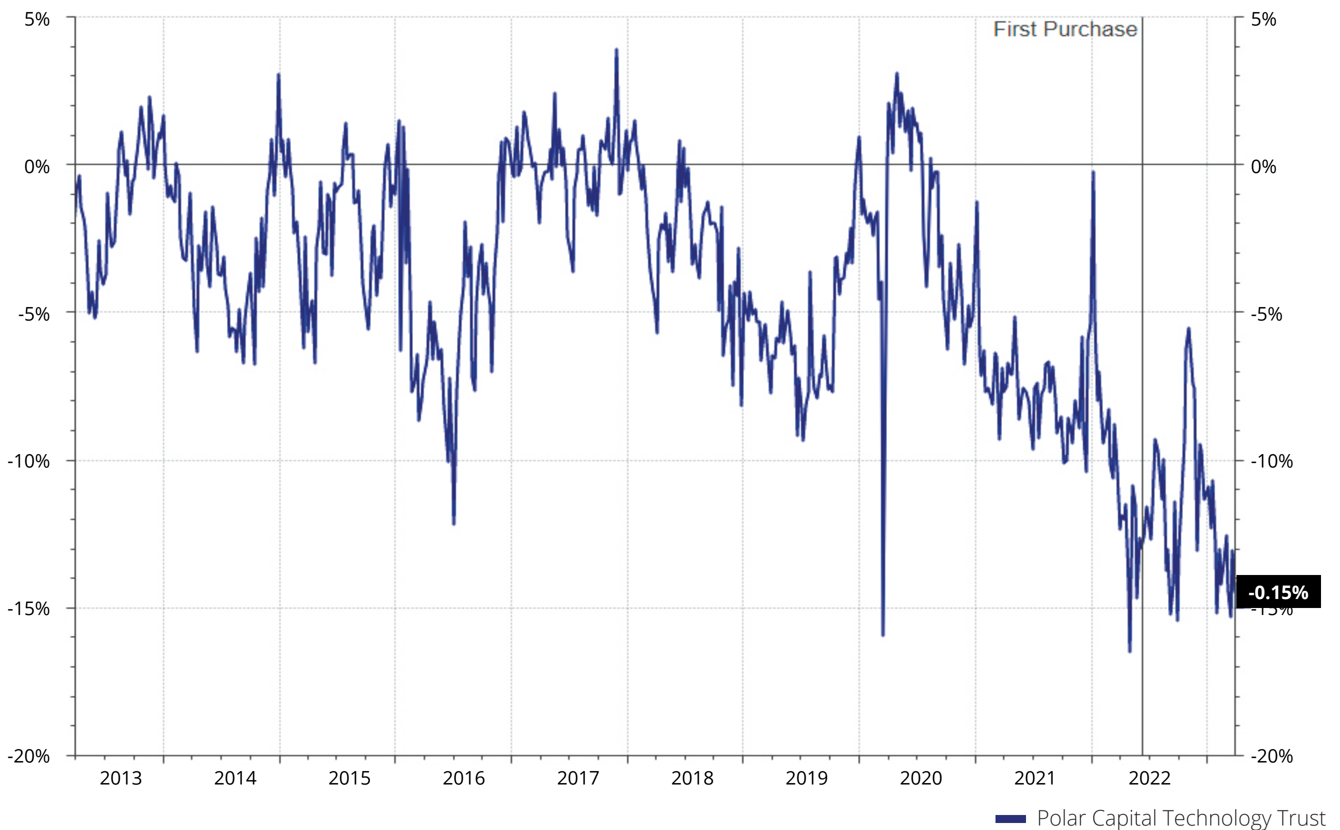
PCT retains zero-exposure to privately listed companies, which stands in sharp contrast to the likes of Scottish Mortgage Trust which has almost 30% exposure to unlisted companies, where valuations are slowly catching up to the sharp declines seen in publicly listed technology stocks last year.

Furthermore, the trust has no gearing (debt) at the portfolio level currently and a healthy cash balance of c.6%, which means that the trust will not have to refinance debt at higher interest rates, and can continue to fund share buybacks which should help lower the discount to Net Asset Value (NAV) over time.

This, in our view, is particularly important given the current higher cost of capital environment we have entered, with companies that have taken on excessive leverage likely to see higher debt servicing costs and lack of financing options weigh on future prospects. In addition to this, exposure to highly profitable companies with strong balance sheets is crucial in providing better downside protection in times of market stress.

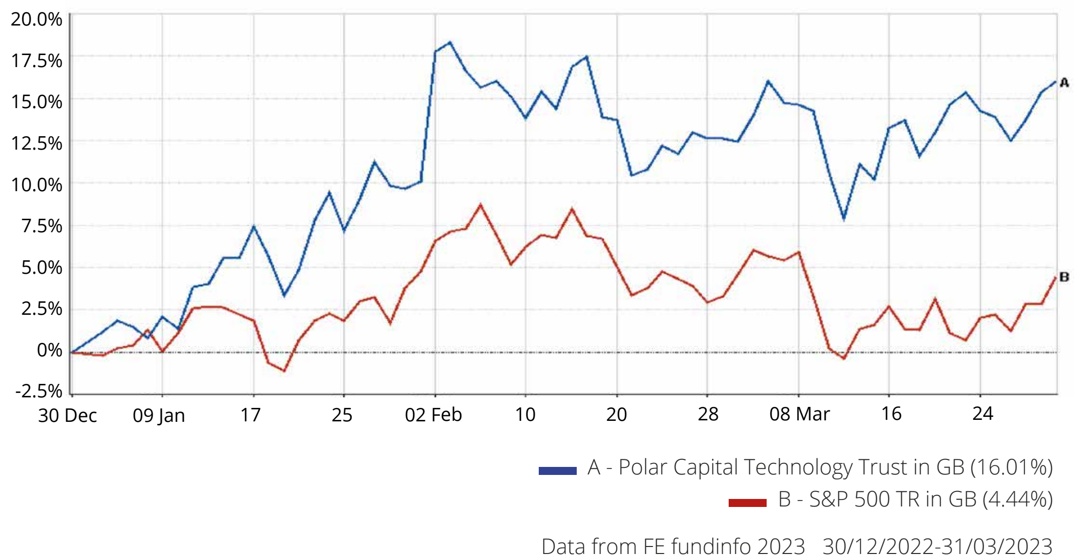
Furthermore, as PCT is an Investment Trust, the negative sentiment towards technology has pushed its discount to historically low levels. Typically, Investment Trusts such as those investing in real estate will trade on average at a slight discount to the underlying value of its assets to reflect the lower levels of liquidity of their underlying assets. However, in PCT's case the underlying assets are global large cap companies with very high liquidity and therefore in our view does not warrant the same level of discount widening. On entry into the portfolio, this discount was 12% and has not moved materially from there. Having historically traded at an average discount to NAV of between 0-5%, the trust could provide an additional 7%-10% return should the current discount narrow to more normalised levels.

Discount to NAV



Source: Refinitiv Datastream

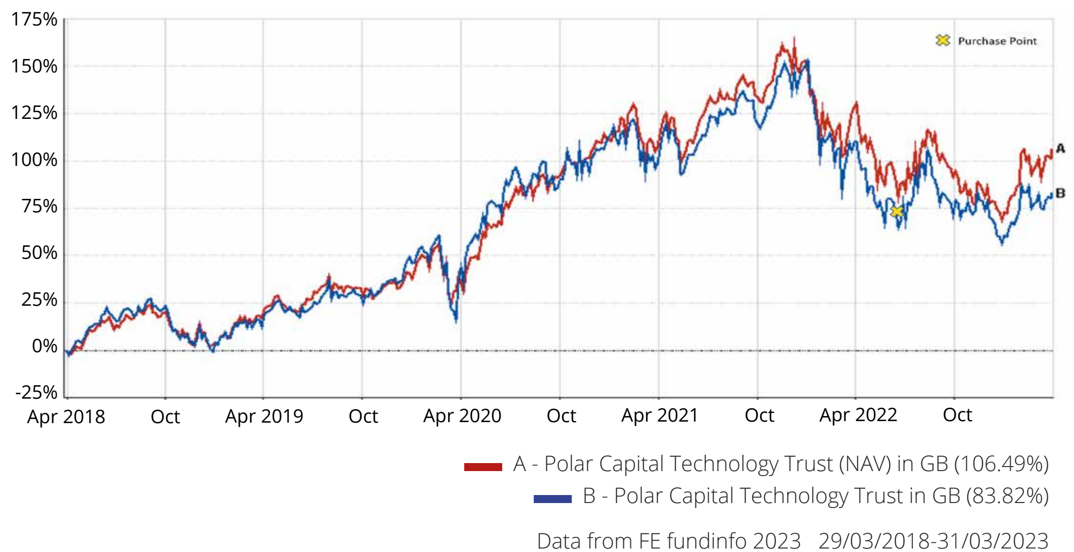
PCT has been a strong performer so far this year with it returning 16% over the first quarter. A peaking of US inflation and a slowing in the pace of interest rate rises has served to boost optimism across most of the technology sector after an extremely difficult 2022. Q1 earnings season across the sector was varied, however stock reactions were generally positive with management on the most-part signalling a clearer pathway through recent volatility. Artificial Intelligence (AI) has also been a prominent theme in markets this year, with the fund benefitting through its exposure to software and semiconductor stocks which will benefit most from the greater use of AI. For instance, Microsoft's announcement of their partnership with ChatGPT, an AI powered technology which is expected to disrupt many sectors and improve productivity also served to boost sentiment across the sector as the application of broader technologies in the advancement of economies becomes more widely appreciated.



A - Polar Capital Technology Trust in GB (16.01%)
B - S&P 500 TR in GB (4.44%)

Data from FE fundinfo 2023 30/12/2022-31/03/2023

In recent years, PCT's share price has widened meaningfully from its NAV, presenting an attractive buying opportunity.



A - Polar Capital Technology Trust (NAV) in GB (106.49%)
B - Polar Capital Technology Trust in GB (83.82%)

Data from FE fundinfo 2023 29/03/2018-31/03/2023

Although valuations still remain lofty in certain areas across the technology sector, we believe the Trust's attractive discount and focus on higher-quality, industry-leading businesses make it our preferred strategy for accessing technology stocks at this point in time.

Post Budget Pension Allowances

The Lifetime Allowance

Clare Hough
Senior Paraplanner

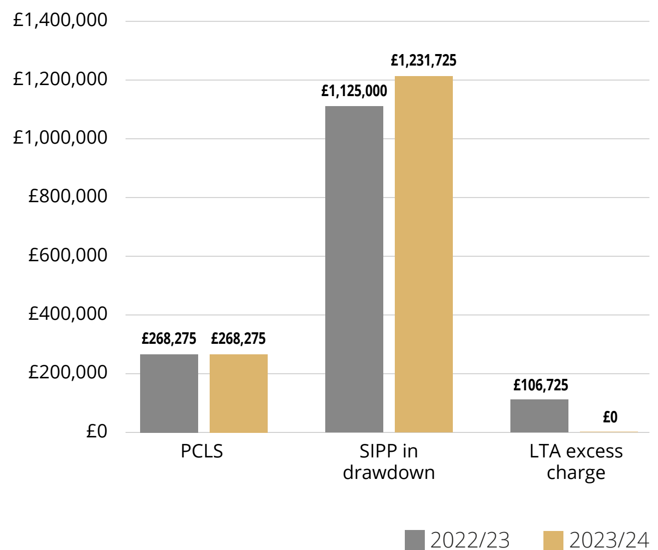
As Jeremy Hunt prepared for his first Budget speech, rumours were already circulating that pension allowances would change as part of the Government's growth plans to get people back to work and stem the flow of early retirees. Pre-Budget reports suggested that the lifetime allowance (LTA) would be increased from its current level of £1,073,100 but how far would the Chancellor go - would it increase to the original 'A-Day' limit of £1.5 million or to the heady heights of 2010/11 when it was £1.8 million?

To everyone's surprise, the Chancellor announced that from 6 April 2023, any withdrawals in excess of the LTA would no longer be subject to a tax charge and he proposed abolishing the LTA entirely from the following tax year, 6 April 2024.

For savers, this could provide the opportunity for further contributions even if the LTA has previously been used. In addition, those holding any of the pension protections can start contributing to their pensions again whilst retaining their protected tax-free cash lump sums.

As a recap of the LTA excess charge, if you currently take the excess as a lump sum, it is taxed at 55% and if you leave it in the pension to draw an income in the future, there is an immediate tax charge of 25%. You then pay income tax on the income when you receive it.

For 2023/24, the LTA will remain at the current level of £1,073,100 however, any withdrawals during the tax year that are in excess of the LTA will not suffer a tax charge. The graph below illustrates the difference in values based on a pension fund of £1.5 million and no pension protection:



Removing the LTA excess charge can be particularly valuable for those close to (or exceeding) the LTA who hold both defined contribution and defined benefit pensions.

For example, Bob has a SIPP worth £1.3 million and deferred benefits in an employer's defined benefit pension that will pay a guaranteed income for life of £35,000 gross from retirement. Bob has Fixed Protection 2012 meaning that he has an LTA of £1.8 million.

For LTA purposes, the income payable from a defined benefit pension is multiplied by an industry factor of 20 to calculate the 'fund value' of the benefits. Therefore, an income of £30,000 gross equates to a fund of £600,000 meaning that Bob's total pension fund is worth £1.9 million.

Under current rules, Bob would be subject to an LTA excess charge when he takes benefits and he would need to decide whether he pays the charge from his SIPP, reducing his flexible fund, or his defined benefit pension, reducing the fund and subsequently the income available. From 2023/24, with no excess charge applied, Bob can benefit from both his SIPP and the full level of defined benefit income.

Current rules

Draw SIPP first	
SIPP value	£1,300,000
Tax free cash	£325,000
SIPP to provide income	£975,000
LTA used	72.22%
DB value	£600,000
LTA used	33.33%
Total LTA used	105.56%
Excess over allowance	£100,000
LTA excess charge	£25,000
Income pa - pre-charge	£30,000
Income pa - post charge	£25,000

Draw DB first	
DB fund	£600,000
LTA used	33.33%
Income pa	£30,000
SIPP value	£1,300,000
Tax free cash	£324,990
LTA used	72.22%
Excess over allowance	£100,000
LTA excess charge	£25,000
SIPP to provide income	£950,010

New rules

Draw SIPP first	
SIPP value	£1,300,000
Tax free cash	£325,000
SIPP to provide income	£975,000
LTA used	72.22%
DB value	£600,000
LTA used	33.33%
Total LTA used	105.56%
Excess over allowance	£100,000
LTA excess charge	£0
Income pa	£30,000

Draw DB first	
DB fund	£600,000
LTA used	33.33%
Income pa	£30,000
SIPP value	£1,300,000
Tax free cash	£324,990
LTA used	72.22%
Excess over allowance	£100,000
LTA excess charge	£0
SIPP to provide income	£975,010

As the LTA is due to be abolished, the question now arises as to how much tax-free cash can be drawn and how it will be calculated.

For 2023/24, for those with no pension protection, the LTA will remain at £1,073,100, therefore the amount of tax-free cash, known as the Pension Commencement Lump Sum (PCLS), will remain as the lower of 25% of your pension fund or 25% of the lifetime allowance, £268,275. For those with pension protection, the level of PCLS will depend on the protection held as shown below:

Pension Protection	Maximum PCLS
None	£268,275
Enhanced Protection (no lump sum rights)*	£375,000
Enhanced Protection (with lump sum rights)*	Capped at 25% of the pension fund value on 5 April 2023
Fixed Protection 2012	£450,000
Fixed Protection 2014	£375,000
Fixed Protection 2016	£312,500

**If you have protected lump sum rights, this is shown as a percentage on your Enhanced Protection Certificate. Under current rules, this percentage is the amount of PCLS that can be drawn each time you take benefits from your untouched pension fund.*

From 2024/25, when there is no LTA, PCLS will be capped at £268,275. For those with pension protection, it is expected that PCLS limits will remain as shown although this has not yet been confirmed. It is also unclear at this stage how PCLS will be calculated – as a total monetary amount or as a percentage of LTA used as it is today. If defined as a monetary amount rather than 25% of the LTA, will it mean that those who have previously used 100% of their lifetime allowance but received less than £268,275 will be able to draw further PCLS?

The Annual Allowance

Not quite so much of a surprise, as it had already been 'leaked', was the increase in the pension contribution annual allowance. From 6 April 2023, the maximum contribution you can make each year is increasing from £40,000 to £60,000 gross per annum (subject to earnings). You will also be able to continue using carried forward allowances from the previous three tax years using their prevailing annual allowances.

For higher earners who have been impacted by the tapered annual allowance, the lowest allowance available will increase from £4,000 to £10,000 gross from April 2023. The adjusted income figure, from which the tapered allowance is calculated, is also moving up from £240,000 to £260,000. This means that anyone with threshold income of £200,000 and adjusted income of £360,000 or more will have a tapered annual allowance of £10,000 gross for 2023/24.

The money purchase annual allowance, which is the maximum contribution available to those who have taken taxable income from their pension, is also increasing from £4,000 to £10,000 gross per annum.

Summary

Whilst these changes are the most significant pension changes since 2015's pension freedoms, Labour have already stated that they will reintroduce the LTA should they win the next election. Therefore, whilst the removal of the LTA excess charge and the increased annual allowances are welcomed, it is important to remember that tax rules are subject to change in the future and we are consequently mindful when pension planning that there could well be further tax and pension changes in a relatively short period of time.

If you have any questions regarding these changes, please contact your Investment Manager.

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