HFP Independent Financial Advice and Planning

In association with

BROOKS MACDONALD

Quarterly Report
Q2 2023

- Global economic growth, consumer spending, and corporate earnings prove more resilient than expected.
- Sticky inflation pressures are the unwelcome flipside of better growth, keeping pressure up on interest rates.
- Higher interest rates challenge asset allocation, but equity 'real' yields still preferred to 'nominal' bond yields.

Income, more and more, is back in fixed income. While UK two-year government bond yields started Q2 at just under 3.5%, by late June they had risen to well over 5%, hitting their highest level since 2008. For UK 10-year yields, while these were lower in comparison, they also rose from just under 3.5% at the start of Q2, to edge close to 4.5% at one point in mid-June. Assuming no sovereign-default-risk, these levels of yields are increasingly seen by investors as an attractive risk-free rate of return, at least in nominal terms. The flipside is that it raises the risk and reward hurdle-rate for all other assets, from equities to corporate bonds to alternative investments and everything else in between.

The level of fixed income yields currently on offer present a valid challenge for asset allocators. Over the decade that followed the 2008 Global Financial Crisis (GFC), interest rates and bond yields fell towards zero and mostly stayed there. For much of this time, the investment mantra of 'TINA' ruled; this was the idea that 'There Is (was) No Alternative' to taking greater risk in the search for yield. With yields on government bonds hitherto largely absent over this period, investment flows into alternative assets grew, ranging across property, infrastructure, structured products, private equity and more.

It is important to recognise that the rise in bond yields over the past 18 months or so has not been painless. Yields look attractive now because there has been something of a value- transfer from existing holders to future holders. Despite our relative focus on shorter duration bond exposures during this time (describing bonds with shorter weighted average maturities of their cash flows), relative outperformance of fixed income benchmarks has still seen bond prices fall due to the inverse relationship between price and yield.

Looking forward from here, with government bond yields at multi-year highs this might suggest their relative attraction is assured, but it is important to balance the scales. In the case of equities versus bonds for example, an important distinction is that an equity yield is considered a real yield whereas a bond yield is typically a nominal yield. In a growing economy, a company's revenue and profits, through price increases of goods and services sold, might over the longer-term seek to keep pace with inflation. In contrast, a conventional bond's coupon and principle are fixed in nominal terms. As such, while the yield on a company's share price might initially look somewhat less attractive, the earnings yield for that company, over time, versus a given price today, might be expected to rise.

Even so, during Q2, we recognised that bond yields are higher than they have been for a long time. Also mindful of broader liquidity risks should the outlook for the general investment backdrop weaken, we increased our allocations to government bonds in June, funded by reducing our allocations to property and alternative income assets. As well as providing an important source of income, our allocations to fixed income in particular also serve another function: increasingly we see these assets providing a valuable counterweight to our equity allocations elsewhere in our asset allocation framework. With government bond yields at current levels, these provide a degree of cushion should the economic and market outlook deteriorate.

Despite the modest defensive step we took to our asset allocation settings during Q2, overall we continue to retain a net constructive outlook, with a preference for equities over bonds. In equities, while we express regional and country preferences, we have kept our global equity investment style barbell balance between value and growth, first implemented at the start of 2021, in place through the quarter. In bonds, we recognise that with higher rates, income is back in fixed income again, but here we have stayed focused on bonds with shorter weighted-average maturities which are less sensitive than longer-dated equivalents to any changes in the interest rate outlook ahead. In between equities and bonds, our remaining allocations to alternative asset help us to provide both balance and diversification to our overall expected returns.

As we look ahead, we continue to see a highly uncertain economic outlook. Our goal is to position our asset allocation framework so that it might be able to deliver under more than just one macro-economic outcome.

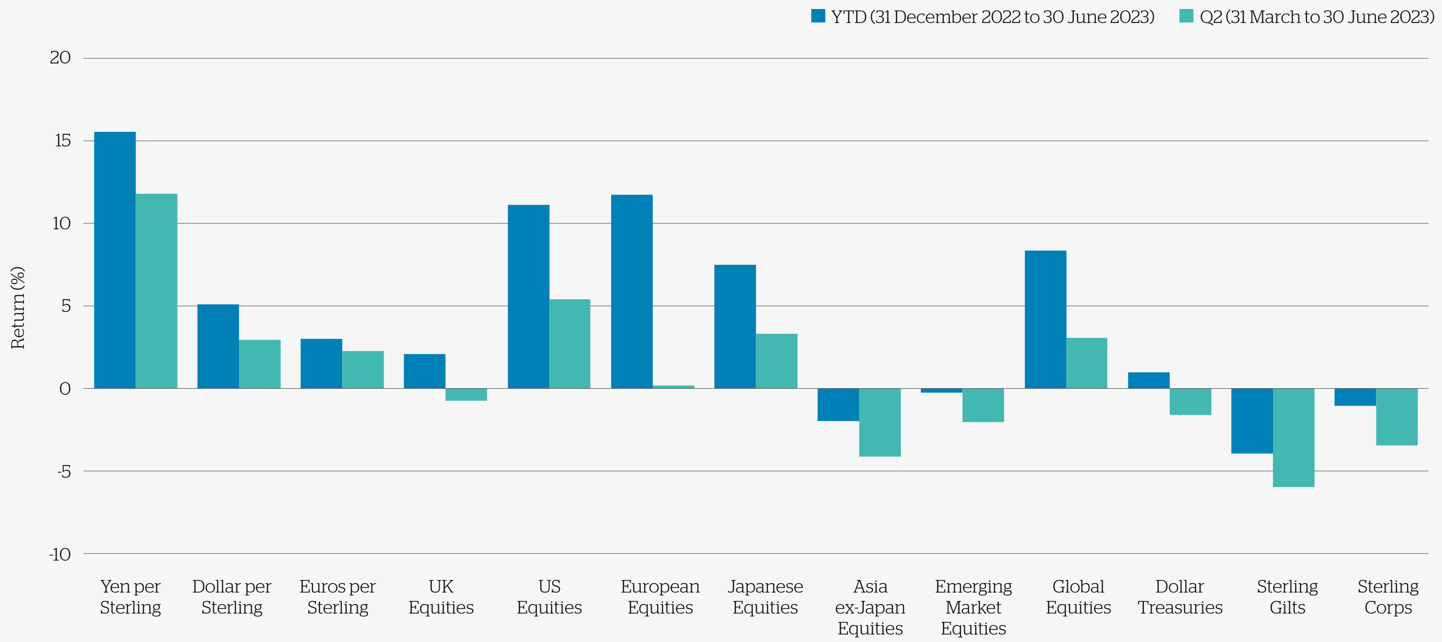
Our top three investment risks

> **Inflation:** should inflation pressures prove to be sustained and become engrained in the economy more broadly, including wages, this could curtail central banks' room for manoeuvre. This could risk a still-further tightening of monetary policy, with interest rates higher and for longer than expected.

> **Policy error:** governments and central banks face the risk of unintended policy errors as they seek to transition their economies away from unprecedented pandemic levels of fiscal and monetary support, as evidenced by the concerns over financial systemic stress contagion earlier in 2023.

> **China's re-opening:** with the pace and scale of China's post zero-COVID economic opening having disappointed versus high expectations in recent months, there is a risk that efforts by Beijing to stimulate the economy might prove insufficient, further challenging broader economic growth hopes.

Asset market return



Sterling-denominated market performance, total return performance figures. Past performance is not a reliable indicator of future results. Source: Bloomberg, MSCI: please see important information. Data from 31.12.22 to 30.06.23. YTD denotes year-to-date.

Important information

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