Q2-2023
QUARTERLY PERSPECTIVES

Tavistock Asset Management
Investment Outlook

Written by The Titan Asset
Management Investment Team

Performance Review

So far this year and on a rolling one-year basis, the ACUMEN Portfolios have lagged the IA sector benchmark. This is due to our defensive positioning over a period where risk assets have performed well. This underperformance follows a period of strong relative outperformance, following the strategic review in June 2020, and on a rolling 3-year basis where the majority of funds continue to outperform the benchmark.

		Year to date		2022		30 June 2020		3 year		Inception to date	
Fund	IA Sector	Fund	IA Sector	Fund	IA Sector	Fund	IA Sector	Fund	IA Sector	Fund	IA Sector
ACUMEN Portfolio 3	0-35%	-2.10%	0.60%	4.65%	-0.89%	-5.15%	-2.10%	-9.56%	-2.98%	-11.14%	1.93%
ACUMEN Portfolio 4	20-60%	-2.28%	1.22%	-4.07%	1.18%	6.29%	4.89%	1.96%	6.12%	28.32%	33.36%
ACUMEN Portfolio 5	20-60%	-2.19%	1.22%	-4.05%	1.18%	12.33%	4.89%	7.78%	6.12%	45.78%	34.18%
ACUMEN Portfolio 6	40-85%	-2.75%	2.44%	-4.74%	3.35%	18.53%	9.07%	12.91%	12.73%	49.04%	51.63%
ACUMEN Portfolio 7	40-85%	-3.50%	2.44%	-5.93%	3.35%	21.35%	9.07%	14.15%	12.73%	21.18%	21.04%
ACUMEN Portfolio 8	Flexible	-4.60%	2.18%	-7.85%	3.82%	23.81%	10.94%	14.09%	15.18%	18.66%	23.39%
ACUMEN Income Portfolio	20-60%	-1.01%	1.22%	-0.46%	1.18%	10.82%	4.89%	10.31%	6.12%	26.40%	31.46%

Performance quoted net of OCF as of 30/06/2023
Source: Lipper for Investment Management, Titan Asset Management Ltd

Inception date:
3 – 25th June 2017
4 – 1st October 2014
5 – 9th October 2014
6 & Income – 24th February 2016
7 – 25th June 2017
8 – 25th June 2017

The recent underperformance stems primarily from our underweight equity exposure and a few specific positions, namely the US Healthcare ETF, the Lyxor New Energy ETF and the dividend-based strategies, via the iShares UK dividend and SPDR Global Dividend Aristocrats ETFs. Over the prior rolling year these positions failed to deliver the returns we had hoped for with clean energy lagging the broader market, and specifically technology stocks, whilst the dividend strategies struggled in the disinflationary environment of the last few months given some indirect exposure to financials, which suffered during the recent banking turmoil. Defensive sectors also lagged the broader market as the economic data held up better than expected prompting a rotation into a handful of companies in the tech and communications sector. Our allocation to US healthcare stocks also came under pressure from proposed enforced reductions on drug prices in the US as part of the broader Inflation Reduction Act.

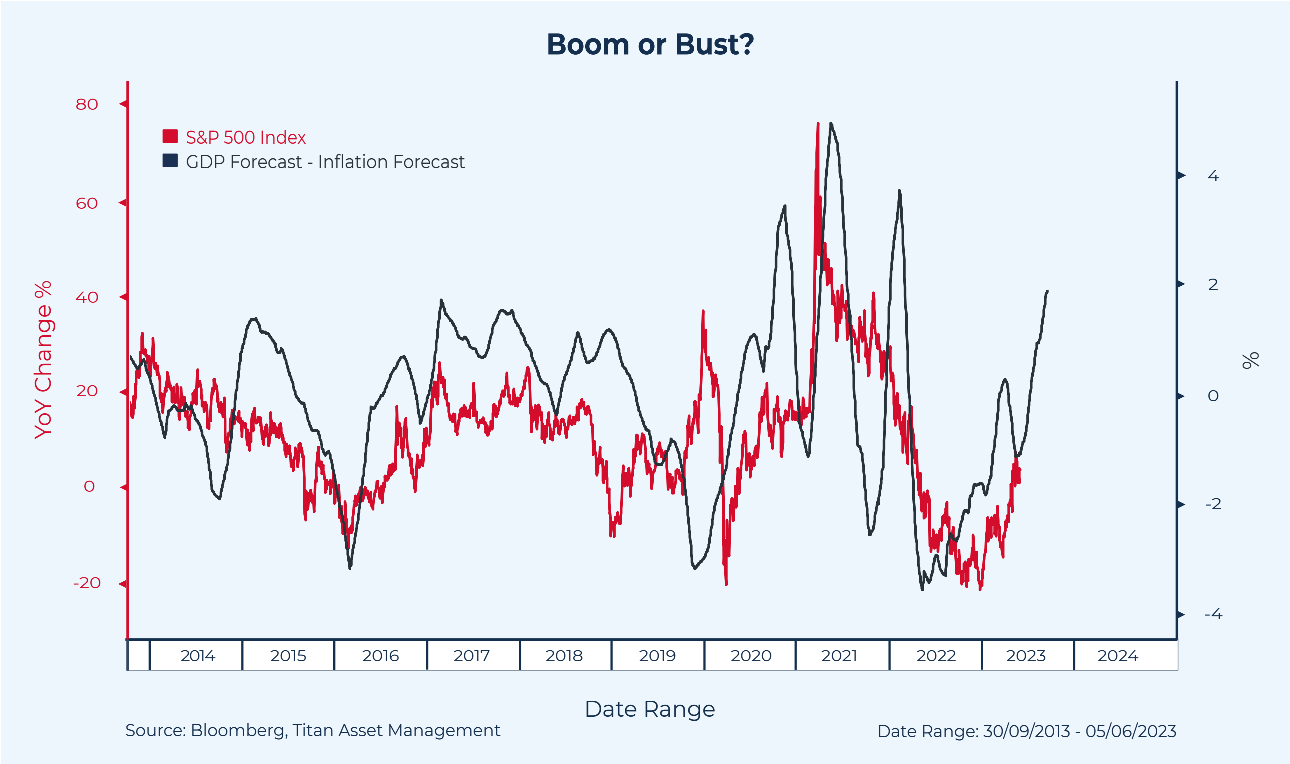
Key Themes

The rally in AI focused stocks has dominated equity market returns this year, pushing the Nasdaq almost 40% higher (see equity section) but recessionary risks remain and investors continue to underestimate the impact from monetary tightening. Whilst we think we are right on the economy, there is a question around the timeframe over which that plays out in markets. It is likely that we were too early in our execution, which is another way of saying that in the near-term we got things wrong.

Given the above, it might be worth briefly revisiting why we remain concerned over the medium-term horizon. Firstly, we think a global recession remains more likely than not. This did not materialise as feared in early 2022, which helped drive the risk rebound this year, although the UK remains close and Europe recently entered technical recession. We are not alone in thinking this. The New York Fed model puts the probability of US recession above 70%. Moreover, world trade, corporate earnings and sharply slowing US business sales growth all suggest we are already in recession. Secondly, we are yet to feel the lagged impact of prior tightening. Specifically, the pace and scale of prior rate hikes, the collapse in the money supply, shift from quantitative easing to quantitative tightening, tightening lending standards, enhanced regulatory oversight of banks, residential and commercial real-estate asset disinflation and associated impact on the collateral underpinning a generation of credit growth, all pose risks. This is a process rather than an event and we will continue to see the fallout over the coming year. Third, proxies for the output gap suggest the US economy is still running beyond its long-term potential which means inflationary risks remain skewed to the upside. If the Fed is serious about bringing inflation down, it will need to decrease the output gap and will likely engineer a recession to do so. These factors pose strong headwinds to risk assets, like equities.

As things stand today, markets are telling a different story and that's something we need to respect. So how might we have it wrong? There are a few candidates. The first is that it takes a long time for the narrative, described above, to play out. The sheer scale of prior stimulus measures, and changes to the underlying economy, may mean "this time it's different…". Candidates include post-Covid structural changes to the economy, declining home ownership levels and the shift from floating to fixed-rate mortgages. Another example is the role of banks in the credit cycle. The explosive growth of non-bank financial institutions (NBFIs) in the financial economy may have rendered banks less important as a transmission mechanism to higher rates. In short, NBFIs have stepped in where banks have retreated, hindering this process whilst supporting risk assets.

Second, inflation data has declined at a faster pace than the economic growth data, providing a tailwind for risk assets. If inflation continues to fall faster than the economy contracts, equities could continue to re-rate higher via multiple expansion.



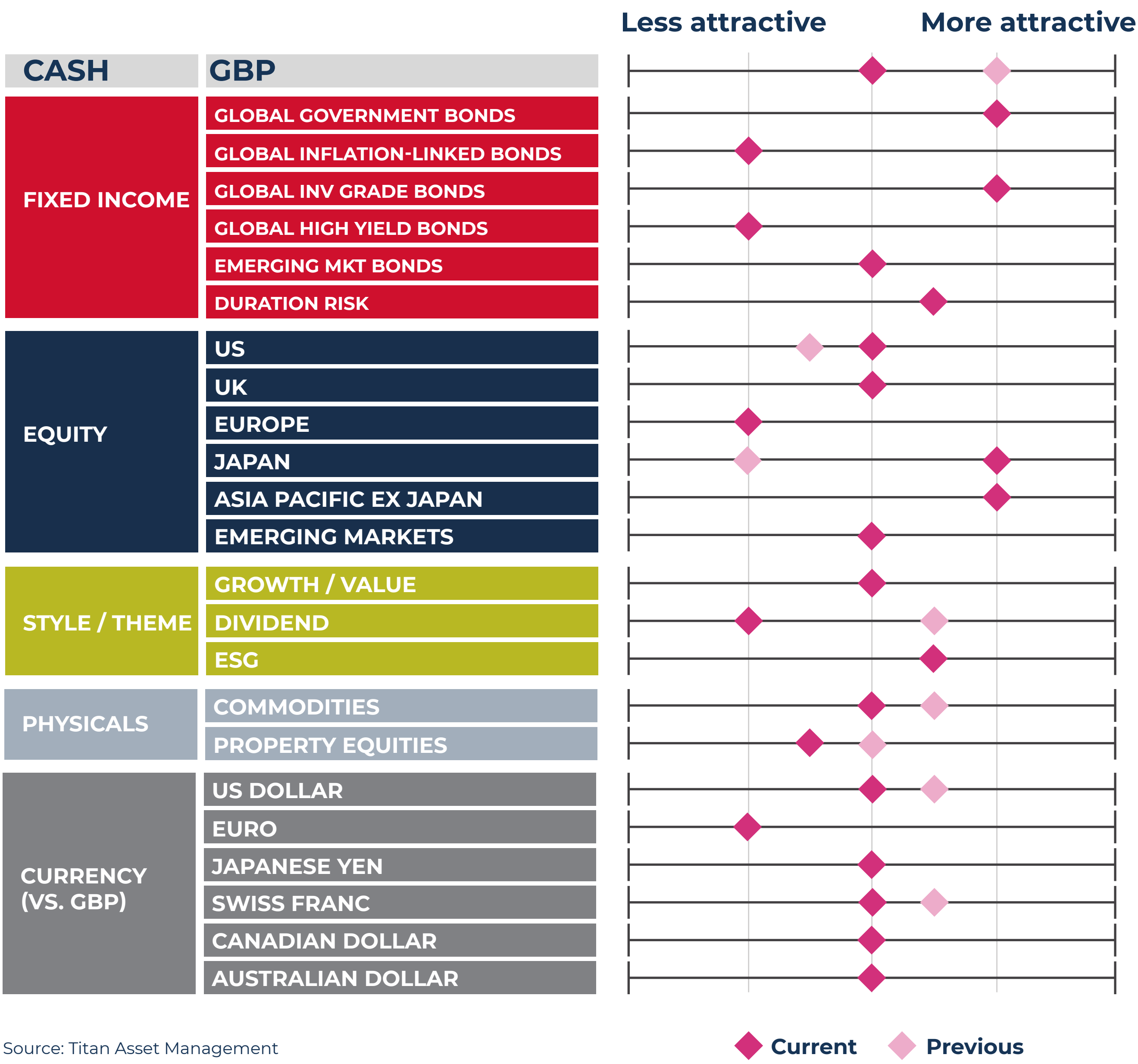
If inflation continues to fall faster than the economy, equities could continue to re-rate higher.

Third, policy stimulus remains high, be it 'technical' in nature, following the US banking sector fallout earlier this year, or from Japan or China, which recently cut interest rates. Additional policy support which boosts growth without undermining the ongoing decline in headline inflation could further boost the growth-inflation mix described above.

Finally, currency. The US dollar is caught between the negative impact of declining currency yield differentials and potential future support from recession. Recent dollar weakness has benefited risk assets and ongoing currency depreciation could continue to undermine our medium-term outlook.

In summary, whilst we remain concerned about the direction of travel for the economy and retain a cautious medium-term outlook it is likely that we were too early in our execution, which puts us in a tricky situation. We'd rather not volte-face and rotate fully into risk assets because we are mindful of the risks to doing so. That said, and as we have seen with meme stocks in the past, markets can go further in the short term and further than we deem rationale. A such, we have taken steps to reduce risk relative to the peer group by tempering our defensive stance and shifting to a more active investment style, to capitalise on specific tactical trading opportunities. If that sounds like a compromise, it's because it is. Our job is to adapt to the markets, we have a good track record for doing so, and now is the time to live up to that reputation.

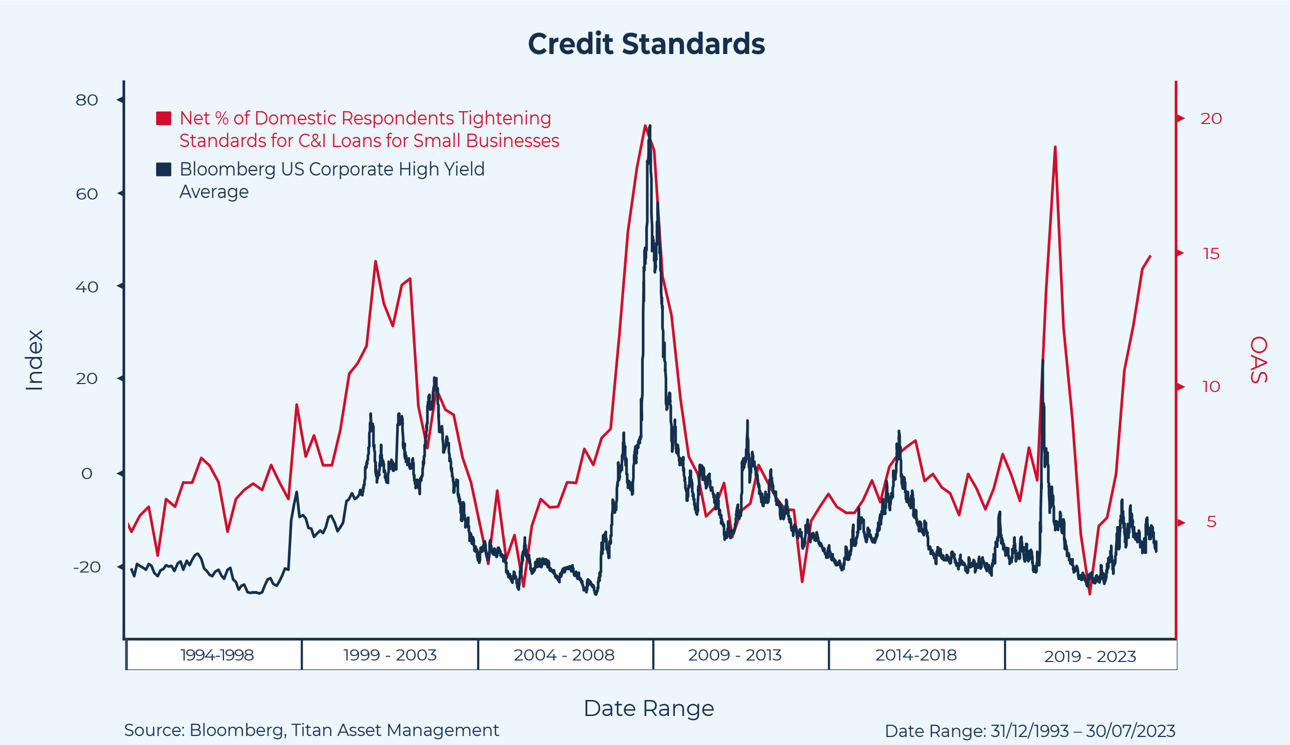
Asset Allocation Outlook



Source: Titan Asset Management

Fixed Income

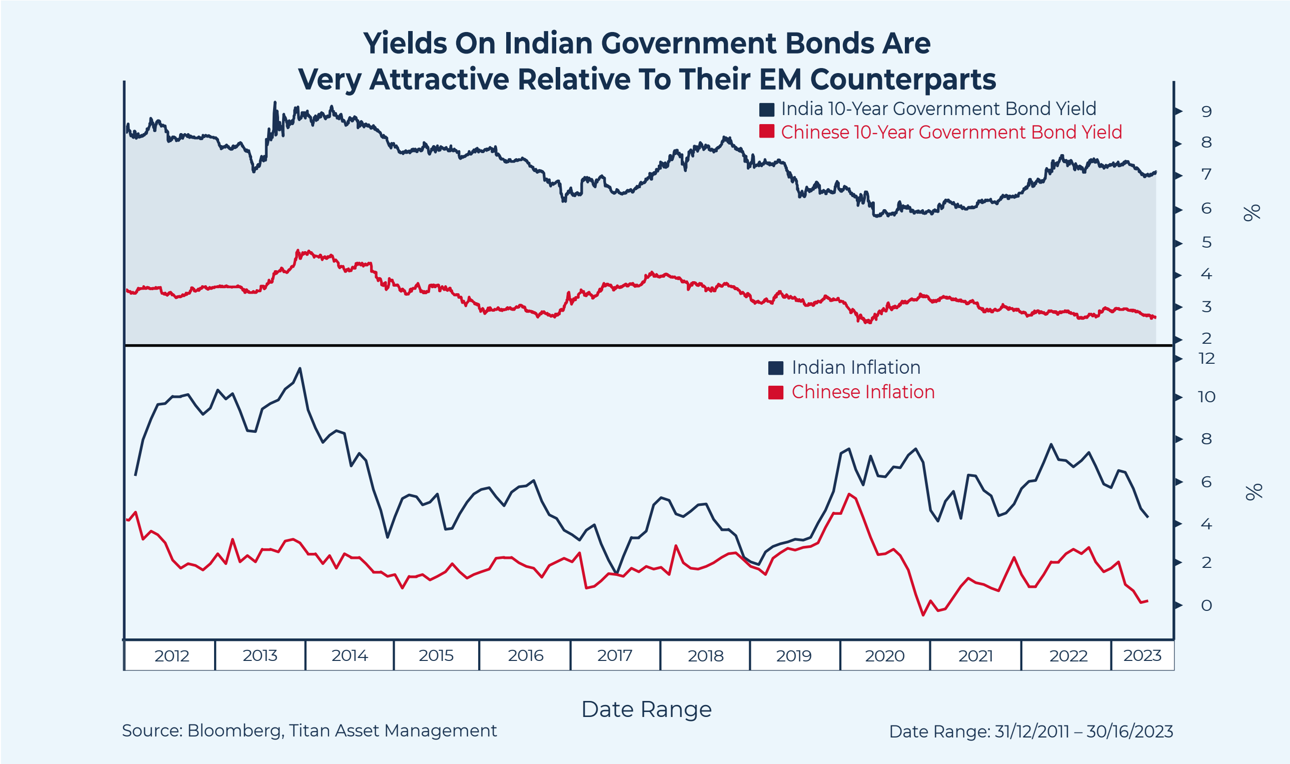
Leading indicators point to an ongoing tightening of credit standards which should cause credit spreads to widen over the next 12-months. However, spreads have yet to widen meaningfully and for now we continue to participate in the riskier portions of the market, such as fallen angels high yield debt. We retain our medium-term view that investment grade will outperform high yield debt over the next 12-months.



Credit Spreads Have Yet To Widen To Reflect Tightening Credit Standards.

Whilst global inflationary pressures have shown signs of easing, progress varies between countries across both developed and emerging market countries. The Reserve Bank of India (RBI) has managed inflation well, peaking at 7.8% in April of 2022, which is well below many of its peers. India is one of the only economies where the inflation rate is now back below short-term interest rates. This implies that the RBI could be nearing a shift in monetary policy. Our base case is they will likely pause, and begin to cut rates towards the end of this year. Locking in these attractive yields will give a welcome boost to yield generated within the funds and with the potential for rates to fall, this should translate into bond price appreciation, providing further tailwinds for this position.

The worsening economic outlook in developed markets is likely to result in suppressed demand for emerging market goods and services and thus a knock-on effect on corporate margins. This is largely the reason that we have simultaneously rotated out of our emerging market corporate bonds. Indian government bonds are also touted to be included in major international bond indices. When this happened to China back in 2021 Chinese bonds saw vast inflows. Although there is no set date on the decision to include it within the index, this adds an additional long-term structural driver for the position.



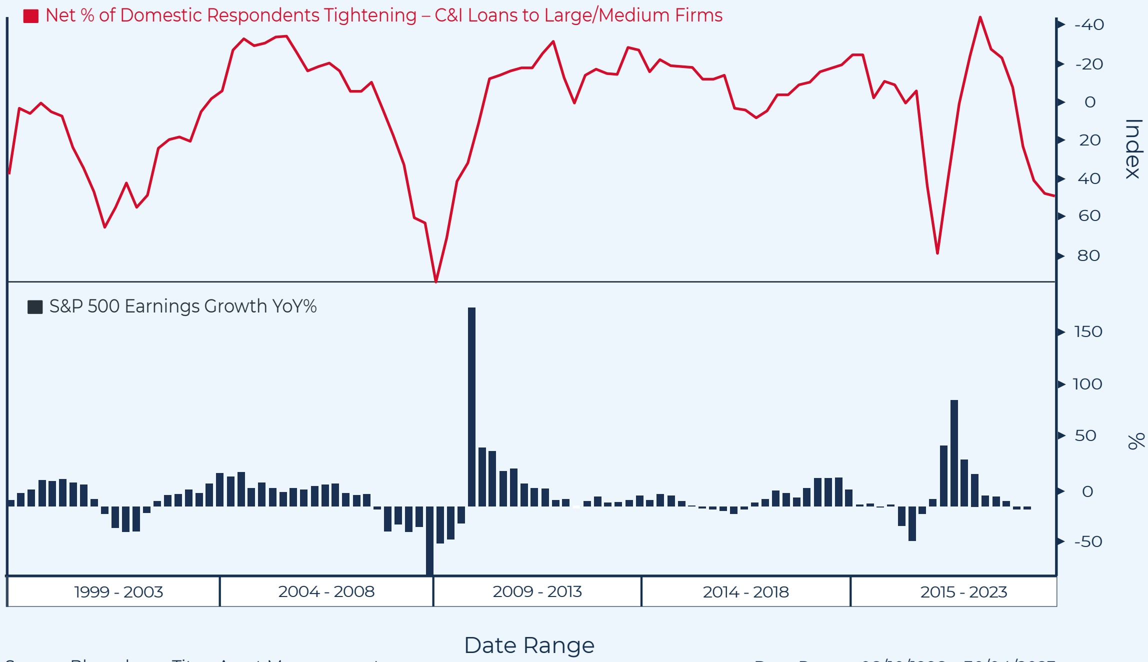
Equities

The MSCI All-Country World Index is in double-digit territory year-to-date (YTD), over 14% at the time of writing. The gains have been driven by the technology heavyweights with the Nasdaq 100 rallying close to 40% so far this year. The market rally has been extremely concentrated with the S&P 500 estimated to be close to flat YTD as opposed to up nearly 17% when eight names are removed from the index (FAANG plus Microsoft, Tesla and Nvida). The tech rally has been driven by the spotlight on artificial intelligence and expectations of a pause in the rate hike cycle.

The significant lack of market breadth gives us caution to chase this rally in equities, particularly in the US where valuations are stretched. US earnings have fallen for three consecutive quarters and earnings revisions have been trending downwards which may test multiples that are currently well above their long-run average. While we remain defensively positioned, we do see some bright spots in the market. Japanese equities have performed extremely well with the Nikkei 225 hitting a 33-year-high but still trade at attractive valuations relative to other regions. We believe there is scope for further upside with economic data proving to be more upbeat than initially anticipated following a delayed covid restart. Increased shareholder buybacks and dividends should be another tailwind to bolster shareholder returns.

The economic reopening in China has been bumpy as we anticipated but this has not been met with the policy support we hoped for. As a result, the rebound in Chinese equities to commence the year has been short-lived. While valuations remain attractive, we have tactically closed our overweight to mainland Chinese equities as we believe negative sentiment may continue to weigh on the market until we see meaningful stimulative policy. We have opened a new position in Greek equities which offer the potential for differentiated returns and are backed by solid progress on structural economic reforms, recent electoral success for the incumbent party and the potential for a meaningful upgrade to investment grade status later this year.

S&P 500 YoY Earnings Growth vs Loan Conditions

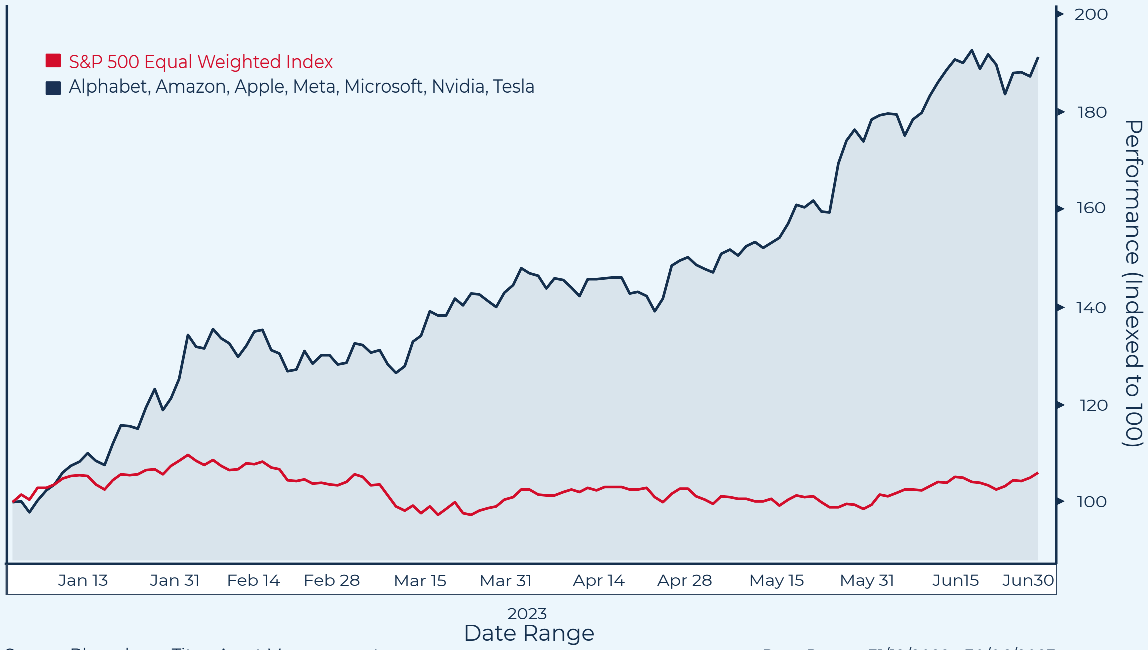


Source: Bloomberg, Titan Asset Management

Date Range: 08/10/1998 – 30/04/2023

Tighter lending conditions may become a headwind for corporate earnings.

Extreme Divergence



Source: Bloomberg, Titan Asset Management

Date Range: 31/12/2022 - 30/06/2023

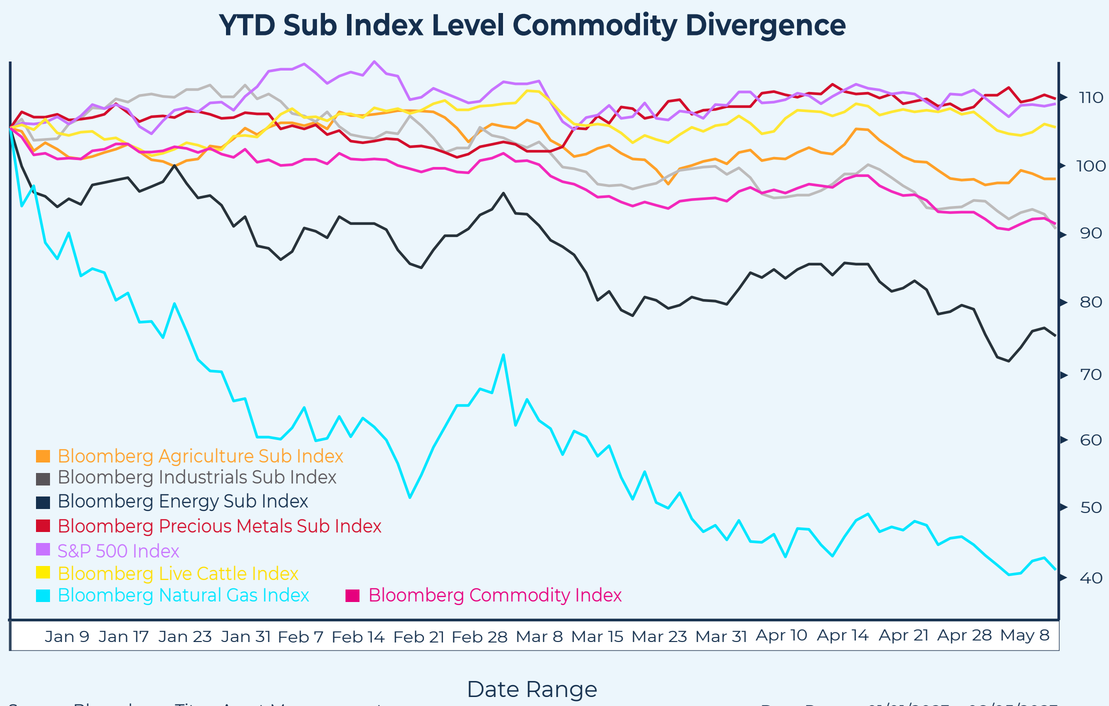
Seven mega-cap stocks equally weighted have outperformed the S&P 500 equal weight index by around 80% year-to-date.

Physicals

The commodity complex has succumbed to the same lack of breadth experienced in equity markets through 2023. A small subset of precious metals and sensitive input materials have offered diversification, but cyclically motivated physical assets have been under consistent pressure. The performance differential for the month of May is over 4.5% between a broad basket of commodities and physical gold. When extended to 2023 so far, this performance differential extends to over 16%. Natural gas, which we focused on in our last update, is now down over 70% year-to-date.

Bullish flows into energy and base metals were also predicated on the strong emergence of the Chinese economy. Data points closely followed have not materialized as expected, with smelting rates, liquid natural gas and trucking rates all tepid at best. More niche commodities such as glass markets belie this lack of demand perhaps more so than conventional commodities. With China responsible for over half of the world's glass production, a fall of around 20% in the futures price of flat glass this year may reflect demand destruction across a broad-based set of Chinese production.

Across the Titan investment proposition, where possible, we have already removed exposure to most commodity markets, specifically energy. We did so last year, citing concerns about slowing growth combined with restrictive global monetary policy. With Brent crude down 40% this year, this was a timely exit. We see continued performance opportunities in defensive precious metals, continuing to offer protection against the possibility of a reduction in real rates as well as ongoing volatility. Midstream energy infrastructure continues to offer steady cash flows, despite the volatility in the underlying energy inputs.



Source: Bloomberg, Titan Asset Management

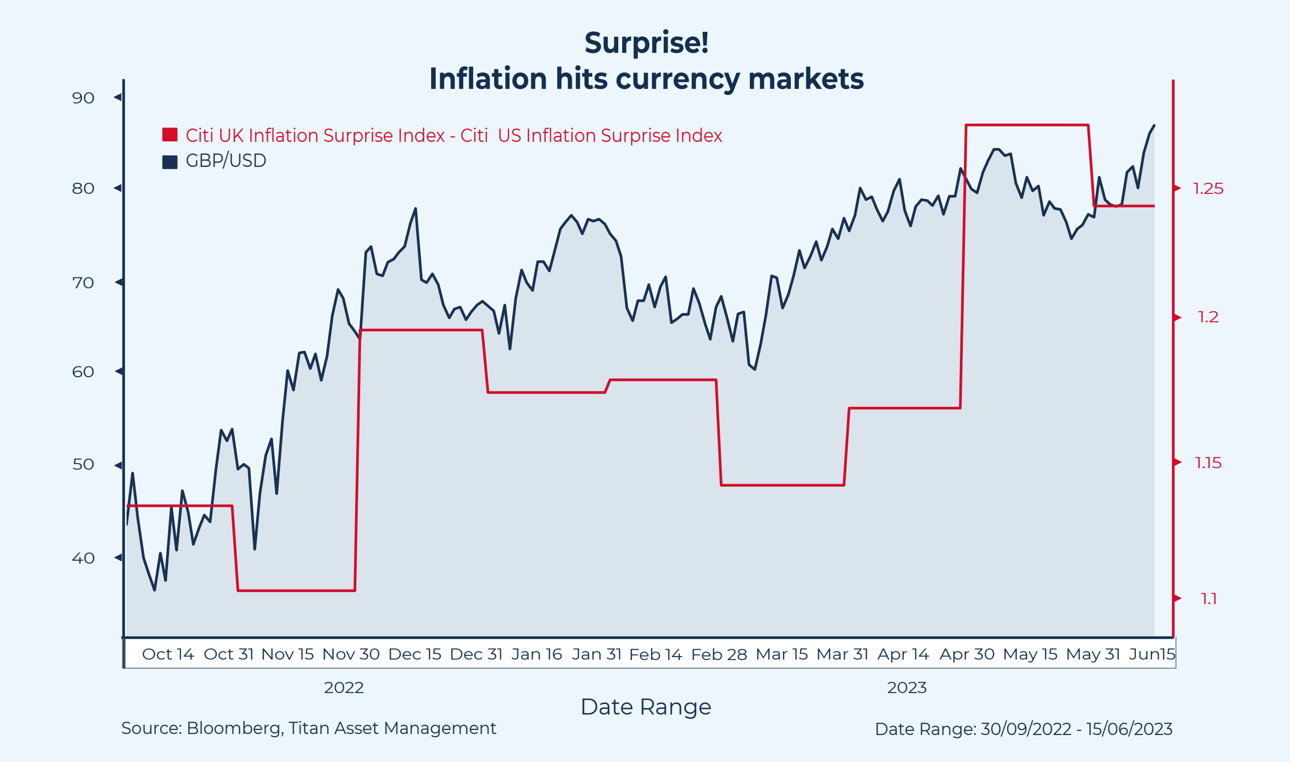
Date Range: 01/01/2023 – 08/05/2023

Like equities, performance disparity within commodities is extended in 2023. For example, the difference in performance between energy and precious metals is over 70% this year. During volatile times, the ability to invest in sub-sectors is imperative. We removed all exposure to energy and industrial metals where possible, retaining exposure to precious metals, the only subset to outperform the S&P 500 as per the chart.

Foreign Exchange

The UK pound has seen a resurgence this year as US inflation expectations peak whilst UK inflationary pressures remain resilient. This has been largely supportive of broader risk appetite, spurring the pound onto fresh 2023 highs of over $1.27 against the US dollar. This is reflected in the chart below with a higher Citi inflation surprise index reading meaning a higher-than-expected inflation reading. In turn, this has forced the Bank of England to hike rates more aggressively this year, narrowing interest rate differentials, leading to further appreciation for the pound.

As the aggregate effects of monetary tightening feed through the economy and household savings decline, we anticipate a meaningful economic slowdown later this year with the very real risk of a recession. This could enhance the US dollar's safe-haven status as investors seek secure assets amid concerns of a recession and increased volatility in risky investments. Once we navigate through, or at least make additional steps towards, the global economic slowdown and witness the Federal Reserve beginning to ease monetary policy, investors will likely look ahead to an eventual recovery, triggering a more sustainable downtrend for the US dollar. Further afield, emerging market currencies have had a difficult start to the year when priced in pounds with concentrated areas of weak growth combined with tempered commodity prices placing pressure on central banks to ease policy, in turn lowering yields and negatively impacting currency values.



Final Thoughts

On a medium-term basis we remain concerned that risk assets remain vulnerable to the downside. The real question is the timeframe over which that plays out. Whilst we think we are right on the economy, the markets are telling a different story and that's something we need to respect. We have taken steps to address recent underperformance by making a number of changes to the funds. The intention is to take a more active approach to investment management, to capitalise on specific pockets of opportunity via a number of high-conviction tactical trades. The goal is to do so without compromising on our medium-term outlook. We aim to achieve this by differentiating between strategic and tactical positions. We think this nimble approach is better suited to the current investment climate.

Recent changes to the ACUMEN Portfolios:

- Initiated a new position in fixed income via a yield curve steepener ETF
- Sold exposure to emerging market hard currency corporate bonds and initiated a new position in Indian government bonds
- Switched our Chinese government bond exposure from unhedged to hedged
- Reduced underweight to equities via adding a new allocation to the MSCI World
- Reduced exposure to global dividend stocks and US healthcare stocks and initiated a new position in Japanese equities and global mining stocks
- Sold Chinese equities and initiated a new position in Greek equities
- Reduced exposure to gold, initiating a new position in agricultural commodities