BROOKS MACDONALD

THE Quarterly Edit

INSIDE

Q3 2024

Welcome

We are delighted to introduce *The Quarterly Edit*, our newly named and redesigned publication. This issue features insights and contributions from our team, reflecting on a quarter of significant market activity and change.

Despite recent fluctuations, our commitment to your financial wellbeing remains unwavering. We aim to guide you through these times with expertise and care.

In this issue, we explore the resilience of equity markets and our asset allocation choices which inform positioning across our portfolios. Our goal is to offer you a comprehensive overview that supports informed decision-making and helps you navigate the evolving financial landscape.

Our focus is on maintaining a balanced and diversified approach, supporting our aim to be well-positioned to weather economic uncertainties. We believe in the strength of a long-term investment strategy, adaptable yet grounded in sound principles.

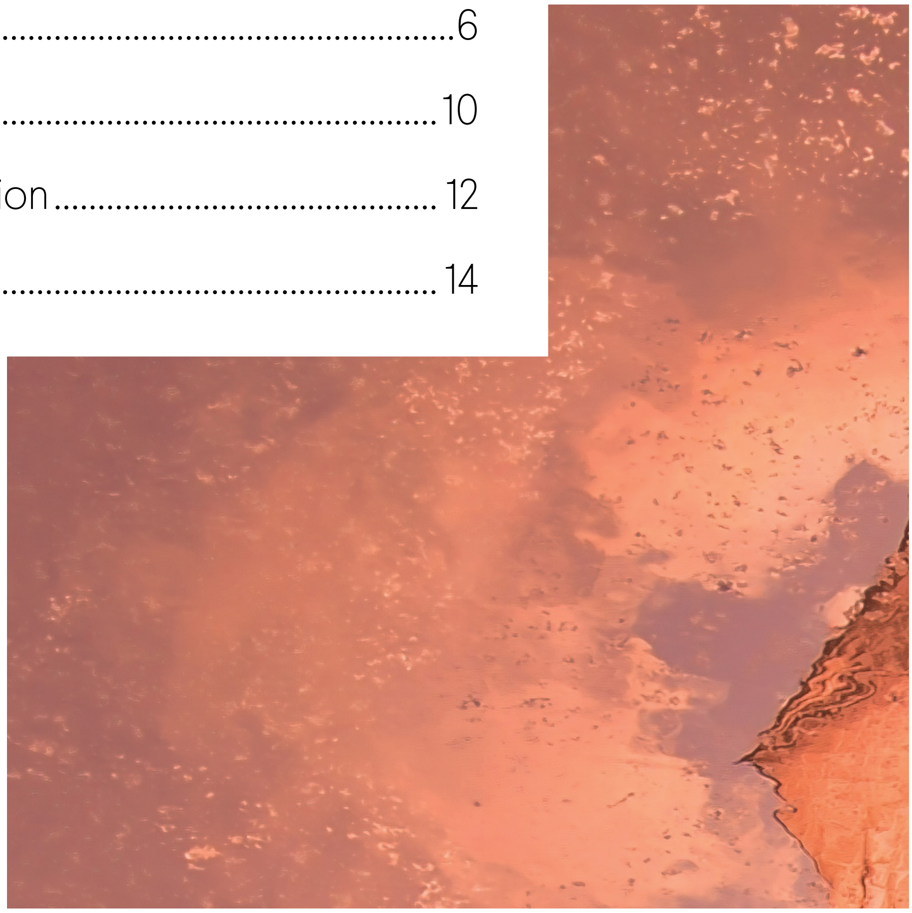
We are grateful for the trust you place in us and are committed to delivering the highest level of service and performance. Together, we look to navigate the complexities of the market and work towards achieving your financial goals.

Thank you for your continued support.

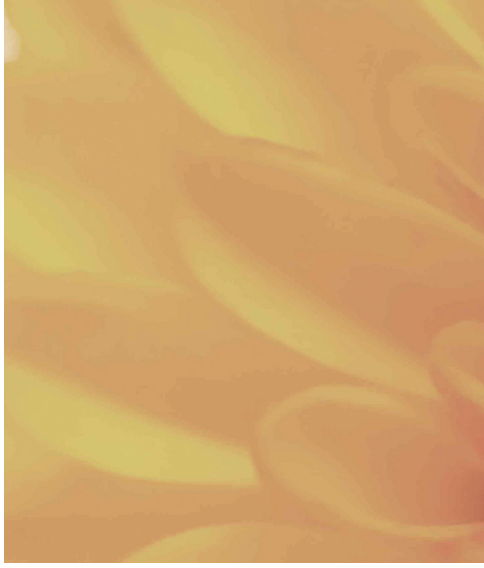
Warm regards,

Michael Toolan & Richard Larner
Co-Chief Investment Officers, Brooks Macdonald

In this issue



Quarter IN REVIEW



This summer was a rollercoaster for investors. Market activity spiked unexpectedly, and central banks made surprising moves. In early August, confidence wobbled briefly, but the markets bounced back and ended the quarter on a high note.

The Goldilocks scenario

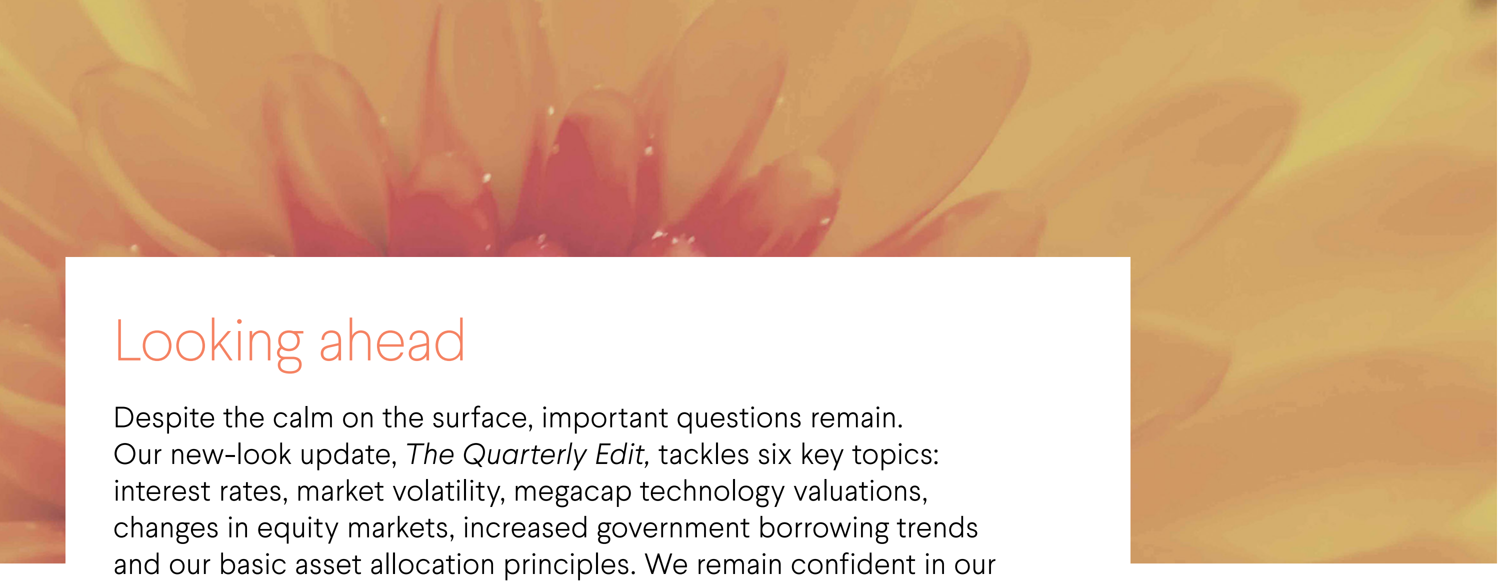
The 'Goldilocks' scenario is when economic growth is just right – not too hot (causing high inflation) and not too cold (leading to a recession). This balance kept hopes for stable growth alive. From July to September, the markets believed in this balance. The rapid rise in interest rates over the past few years seems to have tamed inflation without hurting economic growth. With inflation rates nearing targets, central banks are now cutting interest rates. Both the Bank of England and the US Federal Reserve (Fed) cut interest rates for the first time since March 2020. The old mantra of 'higher for longer' is out, replaced by Fed Chair Powell's declaration that "the time has come for policy to adjust."

A bumpy ride in August

August tested this confidence. Investors faced a triple whammy: mixed results from US tech giants, an unexpected interest rate hike from the Bank of Japan, and disappointing US jobs data. These events, manageable on their own, together sent the markets into a frenzy. At one point, market volatility saw its biggest jump in history. Panic set in, with urgent calls for central banks to step in with emergency interest rate cuts. Yet, by the end of August, equity markets had bounced back close to all-time highs, with US equities hitting new records by mid-September.

The return of confidence

What brought back investor confidence so quickly? Simply put, the good news kept coming. Central bankers reassured the markets by downplaying recession fears. Inflation news was also positive: in the UK, inflation rates continued to move to the 2% target, and in the US, they were steadily approaching the same goal. Additionally, corporate earnings were strong, with the top 500 US companies on track to show their best annual growth in earnings per share since Q4 2021.



Looking ahead

Despite the calm on the surface, important questions remain. Our new-look update, *The Quarterly Edit,* tackles six key topics: interest rates, market volatility, megacap technology valuations, changes in equity markets, increased government borrowing trends and our basic asset allocation principles. We remain confident in our investment strategies across various regions and asset classes but recognise the complex web of financial factors that can impact global markets in an instant.

By sharing our insights, we aim to clarify where we think the markets are heading. By staying invested and maintaining a balanced, diversified portfolio, we hope to help you target your investment goals.

Market BACKDROP

Central banks have started cutting interest rates – but where will they stop?

The final level of interest rates will significantly affect markets. Many central banks in major Western economies have cut interest rates this year. The cuts began with Switzerland in March, followed by Sweden, Canada, the eurozone, the UK, and the US. This marks a shift from the 'higher for longer' approach to controlling inflation.

Despite previous interest rate rises, economies have shown resilience. Households have maintained spending through savings and borrowing, supporting economic activity and, in turn, a resilient jobs market. However, interest rates are still high enough to eventually impact consumer spending.

Central banks need to balance cutting interest rates to avoid slowing the economy while keeping inflation in check. The US Federal Reserve expects interest rates to be around 2.9% in just over two years, with inflation at 2% by then. However, if inflation stays high, it could impact the direction of interest rates and economic growth. There are worries that factors like the costs related to climate-change initiatives might also keep inflation above targets. That matters, as higher interest rates could make stocks less attractive compared to bonds.

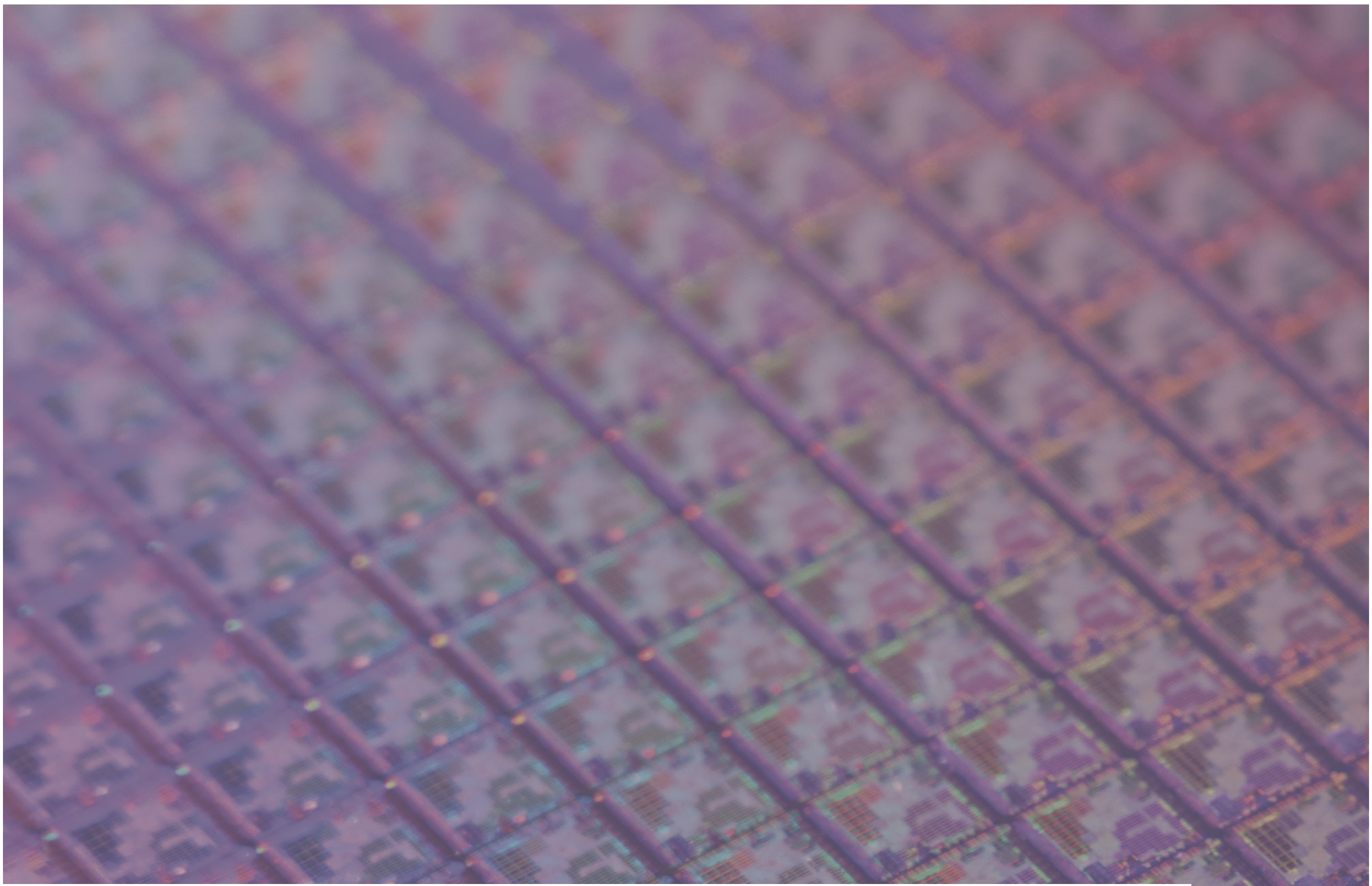
While we expect inflation and interest rates to stabilise, we remain flexible and ready to adjust our strategies as needed.

What sent markets into a rollercoaster ride this summer?

Unexpected events have shaken investor confidence, but the markets have shown remarkable resilience. Summer is usually a quiet time for financial markets, but this year was different. The Bank of Japan surprised everyone by raising interest rates in late July. Then, US labour data showed fewer new jobs than expected, raising concerns about economic growth. Mixed results from big tech companies, added to the uncertainty, shaking market confidence.

On 5 August, the Japanese stock market saw a significant drop, with the main index falling by 12.4%, its worst performance since 1987. The broader Japanese market also experienced a record decline. The previous strength in Japanese stocks had been partly due to a weak yen currency, so when rising interest rates strengthened the yen, this negatively affected global investments. There was particular concern about investors borrowing in yen to invest in higher-yielding assets. This strategy becomes less profitable when the yen strengthens, causing investors to pull back. Despite the initial panic, markets quickly bounced back. By the end of August, major US stock indices were near their all-time highs, and market fluctuations had calmed down.

This episode highlights how fragile market expectations can be and the difficulty of timing short-term markets. Sticking to long-term investment goals remains crucial.



How should investors value megacap technology companies?

Valuing large technology companies, especially the ‘magnificent seven’ (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla), is vital for investors. Nvidia exemplifies this challenge. With a market cap exceeding US$3 trillion at one point in July, Nvidia’s valuation has skyrocketed since the launch of ChatGPT, a generative artificial intelligence (AI) chatbot, in November 2022. This surge impacts broader equity indices, with nearly 30% of their weight coming from these seven companies.

Nvidia’s role in generative AI, promising companies cost reductions, productivity gains, and a boost to profitability, is at the heart of this boom. However, valuing Nvidia is complex, requiring investors to both estimate the future market size for its chips as well as the share Nvidia might have of this market. With Nvidia’s CEO highlighting the need for a trillion US dollars of capital expenditure to be spent by companies and governments to upgrade global data centres, this emphasises the limitations of static valuations, like price-to-earnings ratios.

Assumptions in valuing fast-growing companies are often inaccurate, either too conservative or ambitious. This variability extends across the technology sector, leading to a wide range of potential market outcomes. Therefore, the focus should include asset allocation as a tool, rather than solely rely on precise valuation models or financial metrics.

> Diversifying investments across the tech sector and beyond can mitigate risks and balance potential returns.

Market BACKDROP

How do we position for changes in equity markets?

Large-sized companies have been leading the markets, but this could be starting to change. The post-Covid pandemic economic environment has been challenging for smaller and mid-sized companies, but larger companies have tended to perform better. Smaller firms faced significant hurdles, with arguably bigger impacts from swings in consumption patterns and higher borrowing costs due to inflation. These financial burdens were tougher for smaller companies lacking access to stable funding.

However, the tide may now be turning in favour of smaller and mid-sized companies. Recent reports, like those from the US Federal Reserve, show a tentative improvement in financial conditions. With more interest rate cuts in the US and other developed countries likely, the financial burden on smaller companies is expected to ease, potentially boosting their performance.

Anticipating this shift, we increased our exposure to US small and mid-sized companies earlier this year. Further, despite the general industry trend of reducing UK equity allocations, we maintained our UK small and mid-sized company holdings. Encouragingly, these companies have outperformed large-sized ones globally since July. Looking ahead, smaller companies could benefit from falling financial costs and increasing valuations.

While we see opportunities in small and mid-sized companies, maintaining a diversified equity allocation remains crucial as larger companies will continue to be profitable and attractive investments.

Can investors defend against the changing nature of government borrowing?

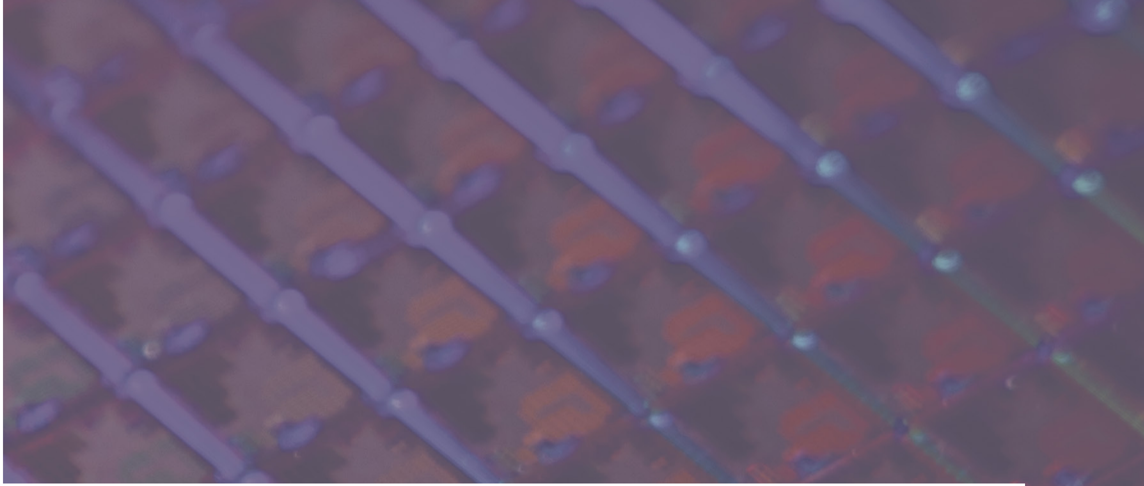
A diversified asset allocation strategy can help to manage some of the risk. Government borrowing is a hot topic, both in terms of the amount of money borrowed and how it's being raised. Recently, governments have been borrowing more money, seemingly regardless of economic conditions, especially during the pandemic's rapid economic shifts.

Traditionally, governments increased spending during economic downturns but reduced it during growth periods. Many governments are running significant annual budget deficits, even in stable or growing economies. This shift might be driven by the need to finance large projects or political pressures to fulfil election promises.

However, this approach carries risks, potentially making economic cycles more extreme and creating vulnerabilities if investor sentiment shifts. The short-lived Truss UK government in late 2022 showed just how quickly borrowing costs can rise with adverse sentiment.

Excessive borrowing can also threaten the value of a country's currency. To guard against such risk, investors should diversify geographically and across asset classes, including equities, bonds, and alternative assets.

Diversification helps mitigate single-country risks and provides a balanced approach to investing. Despite the risks, staying in cash and not investing at all arguably poses a greater long-term risk, especially when considering inflation.



Is the traditional asset allocation mix of equity and bonds still suitable?

Despite the challenges of 2022 still fresh in the memory, we should keep it in perspective. Our investment strategy focuses on diversifying risk across different regions and asset classes. For bonds, we include both government and corporate debt, considering their maturity and mix. For equities, we look at regional bias, investment style, company size, and themes. We also add a third category, which includes alternative investments, which often don't follow market trends and may include other income-generating assets.

Successful asset allocation is crucial, potentially determining over 80% of client returns over time. But there are three main challenges: tactical (short-term opportunities), dynamic (regular rebalancing), and structural (long-term suitability). The latter is arguably particularly relevant after 2022, when both equities and bonds failed to offset each other's losses for the first time since 1988.

In 2022, markets faced a toxic combination of post-pandemic inflation combined with initially low bond yields. As Western central banks rapidly raised interest rates, both asset classes were negatively affected. While a similar situation could happen again with renewed inflation, the starting point now is different, with much higher bond yields. Most interest rate hikes are thankfully likely behind us. Higher yields now offer attractive returns for future bond investors and provide a cushion, as bond yields could decrease in a mild recession, restoring their traditional role of balancing portfolios.

In summary, while 2022 challenged the traditional model, current conditions suggest our existing asset allocation mix remains relevant.

MARKET *Outlook*

Staying invested while seeking diversification in an uncertain world is crucial. Avoiding concentration risk is important, but achieving balance goes beyond choosing between value and growth investment styles.

The challenge of diversification
One of the biggest challenges for investors today is achieving true portfolio diversification. While investing in fast-growing technology sectors can be exciting, it also brings the risk of over-concentration. This is particularly relevant with the rapid growth of US megacap technology companies and their involvement in generative AI.

The risk of concentration
This latest boom in technology has led to significant concentration risk in equity markets. For example, Nvidia, a leading generative AI chip designer, briefly became the world's largest company in June, surpassing both Microsoft and Apple. More broadly, in 2023, nearly two-thirds of the performance of the main US equity indices for that year came from just seven major tech companies. Although there have been some early signs of broader equity performance since July, these tech giants still dominate. This means investors using passive equity index trackers might not be as diversified as they think.

Balancing the portfolio
Given the strong performance of megacap tech stocks, it's crucial to maintain a balanced global asset allocation. While US equities are important for growth, we like to balance this allocation with value stocks, particularly from the UK, which we believe are undervalued. We also invest in assets that blend growth and value, ensuring a well-rounded portfolio.

The importance of rebalancing
Regularly rebalancing your portfolio ensures it stays aligned with what we consider the best mix of assets at any given time. Equities offer exposure to a positive economic outlook, while our fixed-income investments, especially government bonds in the UK and internationally, help balance those risks.

Exploring alternative assets
Between equities and bonds, we also invest in alternative assets, which are great for diversification purposes because they don't always follow the ups and downs of the bond and stock markets. Examples include structured return products which are investment strategies that can be designed to achieve specific financial goals, often providing tailored risk and return profiles.

Preparing for various scenarios
While we currently have a constructive investment outlook, our blended investment strategy approach helps us prepare for a range of economic scenarios and adverse risks. What if the tech boom slows down? What if inflation rises again, leading to more rate hikes? What if geopolitical tensions disrupt global supply chains or trigger conflict or war?

Staying focused
While our asset allocation is based on a positive outlook, we recognise potential risks. As discussed in earlier quarterly updates, we aim to help you target your investment goals by staying invested and maintaining a well-diversified strategy.

Equity Regional Outlooks

UK

UNITED KINGDOM

The UK equity market index derives around three-quarters of its revenues from outside the UK, making it sensitive to global trends. These trends still point to constructive economic growth and an easing inflation picture. UK equities are a key part of our investment mix. We focus on value stocks in sectors like resources and financials, which balance our growth investments in other regions.

US

UNITED STATES

US corporate results show a robust economy in which resilient consumers still benefit from a relatively strong job market. Company earnings growth expectations for 2024 and 2025 are encouraging compared to 2023. The US Federal Reserve's recent interest rate cut could boost smaller and mid-sized companies, which we increased exposure to earlier this year.

EU

DEVELOPED EUROPE (EXCLUDING THE UK)

With European natural gas prices much lower than during the pandemic, cheaper energy is helping improve the inflation outlook. This could lead to interest rate cuts and provide relief for businesses and households. Although long-term issues exist between the euro area's monetary and fiscal policies, the medium-term outlook is more positive, thanks to relatively attractive valuations.

AP

ASIA PACIFIC (EXCLUDING JAPAN)

We downgraded the region to neutral earlier this year, mainly due to reducing our overweight position in China to neutral. Given its economic challenges, we see China more as a potential risk than an opportunity. Indeed, the longer-term investment outlook could worsen before it improves.

JP

JAPAN

Japan's main stock exchange has been working to make companies more efficient. Along with the welcome return of inflation after years of slow economic growth, this has boosted the outlook for Japanese equities, especially in the financial sector. However, Japan still faces challenges like high public debt and an ageing population, which pose risks as the Bank of Japan raises interest rates from very low levels.

EM

EMERGING MARKETS

China, previously a major buyer of global commodities from emerging markets, has been cautious about using aggressive infrastructure spending to boost its economy this year. This shift impacts resource-export-led emerging markets. Moreover, China's move to effectively export its excess manufacturing capacity, hoping to sell goods abroad that cannot be sold domestically given weak demand, could challenge the profitability of companies in these markets.

Outlooks defined: *We express positive, neutral, and negative outlooks across various asset classes. These reflect our judgement on expected returns relative to broader asset class benchmarks over the next twelve months.*

POSITIVE **NEUTRAL** **NEGATIVE**

THE *Art of* DIVERSIFICATION

Building Resilient Portfolios

Diversification is more than just a buzzword in the investment world. It's a powerful strategy that can help investors manage risk, enhance returns, and build resilient portfolios. In this article, we'll delve into the practical aspects of diversification and explore how to apply it effectively.

Understanding the power of diversification

What is diversification?

Diversification involves spreading your investments across different asset classes, industries, and geographic regions. The goal is to optimise exposure risks and reduce the impact of any single investment's poor performance on your overall portfolio. Here are a couple of examples of diversification:

DIVERSIFICATION ACROSS SECTORS

Tech Bubble (2000)

During the dot-com bubble, investors heavily concentrated in technology stocks suffered significant losses. Those who diversified into other sectors fared better. Sectors that included everyday consumer goods like tobacco and essential services like water, electricity and gas demonstrated strong performance as investors sought safer, more stable investments.

DIVERSIFICATION ACROSS ASSET CLASSES

Global Financial Crisis (2008)

During the 2008 Global Financial Crisis, investments lost significant value as markets crashed due to widespread financial instability and panic. However, diversified portfolios that included government bonds and gold were more resilient. This diversification helped cushion the blow for investors, highlighting the importance of strategic asset allocation.

Striking the right balance between equities and bonds

Equities (investments in a company) and bonds (investments in the debt of a company or government) are two of the most popular asset classes. They are often combined to form a well-diversified portfolio. Equities generally provide higher returns over the longer term than bonds but also carry higher levels of risk. In contrast, bonds are considered less risky because they offer a regular income and a predetermined return on investment.

In an economic downturn, company profits tend to fall, as do their share prices. On the other hand, bonds provide a balance as central banks usually cut interest rates in a recession, meaning bond yields fall, but the capital value of those bonds rises. Therefore, while investors see the value of their equities decrease, the value of their bonds increases.

Why 'riskier' investments can lead to 'safer' portfolios

Assets within a diversified portfolio don't move in perfect sync. When one asset declines, another may rise, offsetting losses. Riskier investments (e.g., equities) contribute to higher returns, while safer assets (e.g., bonds) provide stability.

History has shown that bonds typically act as a cushion during times of market stress and can offer a pressure-release valve for equities. Traditionally, a portfolio combines equities, bonds, and cash. Depending on the portfolio, the mix of assets can be extended to include allocations to more alternative investments such as real estate, infrastructure, or commodities. A disciplined approach to asset allocation can ensure that adjustments can be made in response to changing conditions.

Dialling up or down the risk

Adjusting the risk level in a diversified portfolio involves tweaking the allocation of different asset classes. For example, within an equity allocation, investing in emerging markets can often provide high return potential but increased volatility. Size matters, too.

Equity investments in small and mid-cap companies carry greater risk and more price volatility than larger, more established companies. When markets are judged overly optimistic, equities' valuations can move up to levels that are harder to justify. At times like this, there is an opportunity to rebalance away from equities and selectively add to bonds.

We can also judge which type of bonds to buy within a bond allocation. For example, the prospects for bonds issued by different companies and governments may vary at various points, or the attraction between shorter-dated and longer-dated bonds will sometimes differ. It is prudent to steer appetite between the two to manage risk.

Building resilient portfolios for the long term

The discipline of diversification

Stay the course
Avoid chasing short-term performance.

Rebalance periodically
Maintain optimal diversification.

Diversification is not just a strategy; it's a discipline. By spreading investments across various asset classes and sectors, investors can build portfolios that are not only more resilient but also better positioned for long-term growth. Remember, the key to successful investing is not just about picking the right stocks but also about maintaining a balanced and diversified portfolio.

CIOs IN CONVERSATION

Henrietta Walker, Head of Investment Specialists, interviews co-CIOs Richard Larner and Michael Toolan, on the current market dynamics and considerations for portfolio construction.

Henrietta Walker (HW): Markets have endured a rollercoaster ride this quarter, but right at the end of the summer, the US central bank made a bold move. How has that affected markets?

Michael Toolan (MT): The recent substantial interest rate cut by the Federal Reserve, the first in four years and larger than usual, has buoyed markets and fueled investor optimism. As equity markets reach new highs, navigating them successfully is more important than ever.

HW: Is there still a vulnerability around megacap technology stocks?

Richard Larner (RL): In one word, yes! Investors are questioning the speed and productivity implications of broader generative artificial intelligence (AI) adoption in companies across the economy. Nvidia, the poster child for the AI boom, at one point earlier this year, was valued roughly equal to the UK's annual GDP in 2022. When Nvidia failed to meet the highest market estimates for its Q2 earnings, its value fell by $278.9 billion in one day, the largest absolute fall for a company in history. This move highlights Nvidia's market influence and reminds investors of the risks associated with its size.

HW: What are your thoughts on Nvidia's dominance in markets?

RL: We have long acknowledged the concentration risk of the megacap technology names. We stress the importance of active fund management, which can find opportunities in smaller, less well-researched companies to moderate this risk. Investing in passive indices can sometimes lead to unintended concentrations in a few large companies.

HW: How does the current 'big tech' dominance affect your investing style?

MT: We maintain a balanced approach to global equity investments. Our allocations to growth-focused US technology companies are balanced by value opportunities in areas such as the UK.

HW: What is your outlook on global growth?

MT: Our view is that we may experience a slowdown in global growth just sufficient to reduce high inflation without causing a recession, known as a 'soft landing'. This is like gently applying the brakes to a speeding car to bring it to a safe stop. Central banks do this by raising interest rates, which helps to cool down spending and inflation. Interestingly, recent company earnings and employment figures in the US indicate that the health of the US economy, often considered a good barometer for the world economy, is holding strong. We do not currently see sufficient evidence of an imminent recession.

HW: What are your current views on bonds?

RL: You may have heard the phrase 'income is back in fixed income (or bonds)' due to higher yields meaning bonds offer better returns than previously. However, we believe that investors in lower quality, high-yield bonds are not being sufficiently rewarded for the extra risk, which is why we prefer to focus on more stable options like high quality government and corporate bonds.

HW: Have you identified any global risks on the horizon?

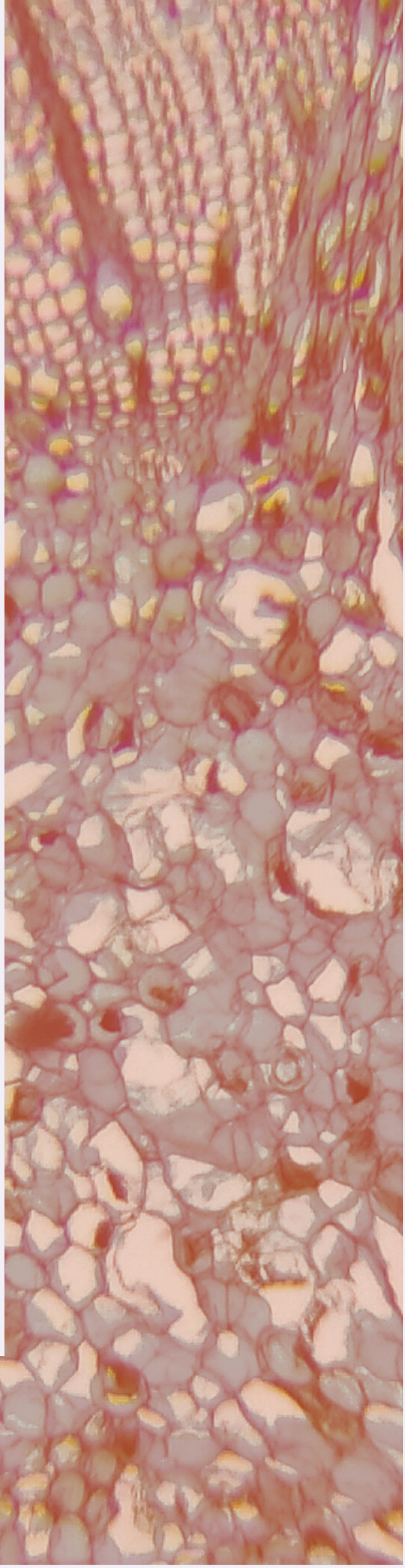
MT: We currently have concerns over increased US government spending, which could lead to higher deficits and national debt, undermining confidence in the US dollar. As the world's primary reserve currency, it plays a crucial role in global trade and finance.

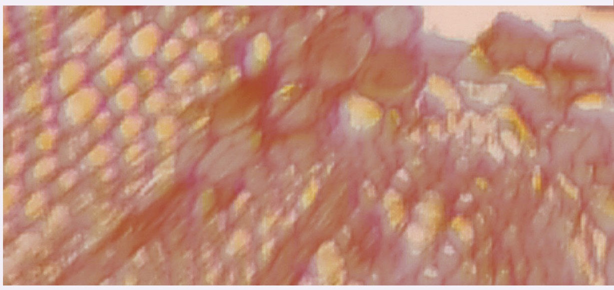
HW: What are the implications of the result of the US Election?

MT: The election race is now closer, with Kamala Harris's involvement narrowing the gap. Interestingly, regardless of the election outcome, the US government debt expansion is likely to continue. We are particularly concerned about rising debt levels and persistent inflation. These factors could significantly influence the Federal Reserve's ability to cut rates, impacting both bond and equity markets.

HW: How does Brooks Macdonald ensure its portfolios remain resilient in such uncertain times?

RL: At Brooks Macdonald, we continuously evaluate the role of each asset class to optimise overall portfolio construction. This rigorous analysis and active management allow us to adapt to changing market conditions, ensuring our clients' investments are well-positioned to weather any economic storms. Our approach reflects a deep conviction in balancing risks and opportunities to maintain resilience.





Important information

BM894-2024-09-006

BM