EQUILIBRIUM

# Quarterly investment report

January 2024

## Introduction

Welcome to the second edition of our new style investment report. This replaces what was previously provided in our Equinox magazine every six months but is now produced quarterly.

It has been a very strange couple of years in the investment world!

2022 was a very difficult year with most of the asset classes we invest in falling a long way, whether that be equities, fixed interest (bonds), or real estate.

2023 was a year of contrasts. It began strongly but then hit some major turbulence with the fall of Silicon Valley Bank and Credit Suisse. It seems amazing that this happened so recently, and equally amazing that the fallout has been so limited. If you'd have told us in advance that a global financial institution like Credit Suisse would need to be rescued, we would have expected some pretty severe knock-on effects!

After recovering from this potential banking crisis, markets continued to be volatile as central banks put up interest rates much more than investors had expected at the start of the year, whilst the much-anticipated recession failed to appear.

However, in the final quarter, we saw sustained evidence of falling inflation, and central banks began to signal they may be done with rate hikes and could even consider cutting again in 2024. This has allowed assets like bonds and real estate to rally, along with other interest-rate-sensitive assets like smaller company stocks. These are some of our favoured assets and this has helped portfolios to end the year strongly, with all the portfolios in positive territory for the year.

Also, in 2023 we saw big advances in artificial intelligence (AI) with the release of ChatGPT. This helped the US stock market – which has a high proportion of technology stocks – to do very well. However, the performance was very narrow and, outside of big tech, equity market returns have been sluggish.

Despite the turbulence, all the portfolios produced positive returns in 2023 and performed well relative to competitors over the long term as can be seen in **table one**. This shows our core portfolio returns and also compares them to cash and inflation. Despite the recent inflationary spike, all the portfolios have produced returns above inflation over the long term. If you had left your money in cash over 10 years, the return would have been just 0.93% p.a., which is well below the returns from investing and a loss in real terms.

**Table one:**

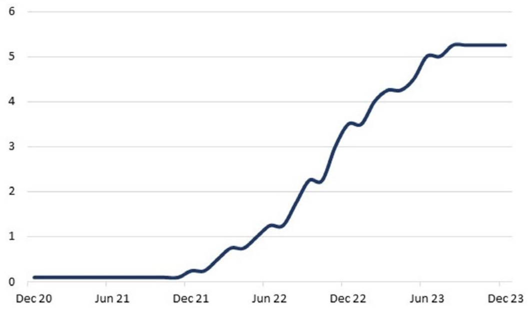
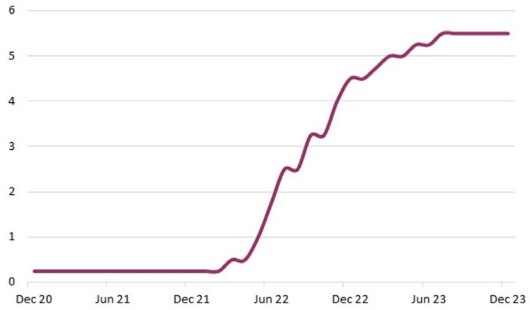
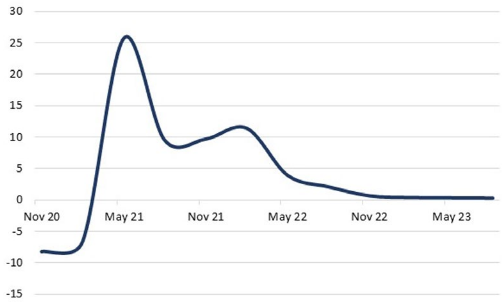
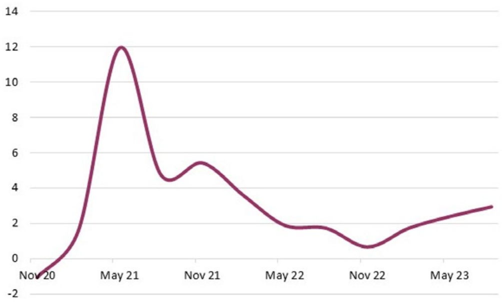
| Portfolio | 10-year total return % | 10-year % p.a. |
|---|---|---|
| Cautious | 47.05 | 3.93 |
| Balanced | 56.16 | 4.55 |
| Adventurous | 71.70 | 5.55 |
| Competitor mixed investment fund (balanced)* | 43.73 | 3.69 |
| Competitor discretionary portfolio (balanced) ** | 41.46 | 3.53 |
| UK Inflation (CPI) | 32.23 | 2.83 |
| Cash (Bank of England base rate) | 9.79 | 0.93 |

*UT Mixed Investment 20-60% Shares. ** ARC Sterling Balanced Index.

Source: FE Analytics 01/01/2014 to 01/01/2024. Green numbers denote outperformance of sector. All portfolios based on IFSL Equilibrium fund and discretionary model performance prior to fund launch. Defensive and Global Equity long-term returns based on backtested portfolio.

# The economy

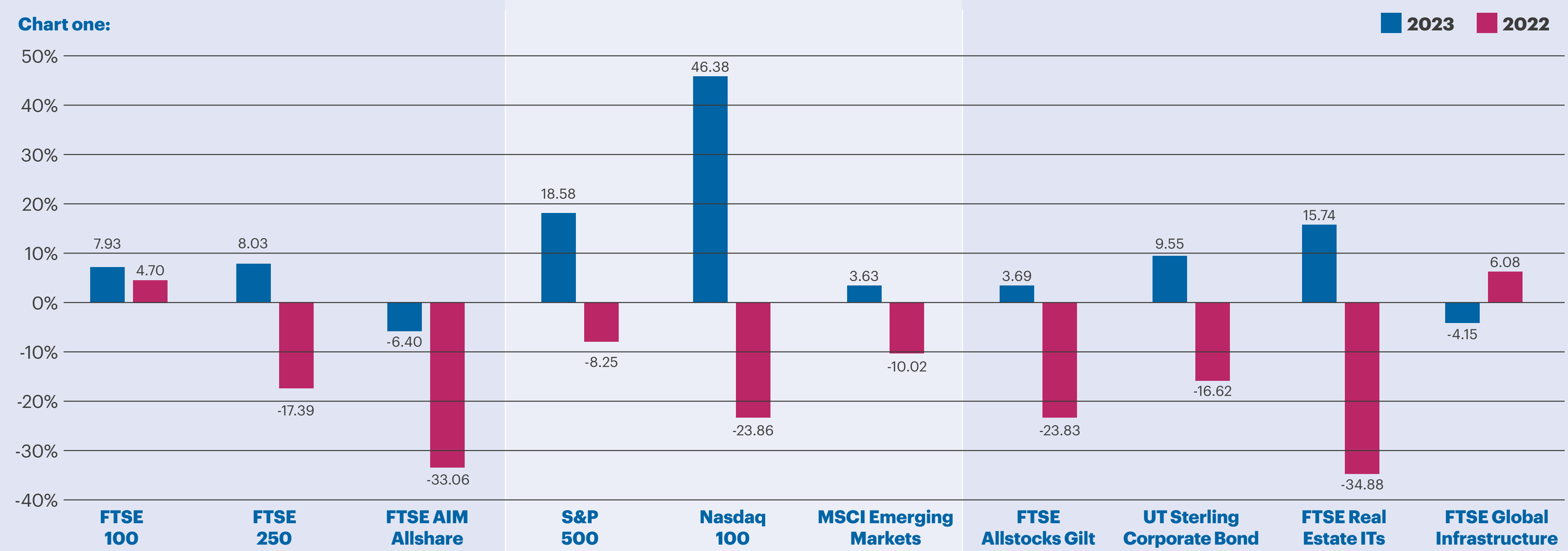
On this page, we look at some key economic indicators and how they have evolved over the past few years, focusing on the UK and the US which have the biggest effect on portfolios.

| | UK | US | Equilibrium view |
|---|---|---|---|
| **Interest rates %** |  |  | Interest rates in the UK have risen from 0.25% in 2021 to 5.25% today. Rates in the US have taken a similar trajectory as central banks try to tackle inflation.<br><br>Until recently, many expected that rates would either continue to go up or at least stay at the current levels for some time. However, with inflation falling rapidly, markets are now pricing in rate cuts starting in the first half of 2024. |
| **Inflation % p.a.** |  |  | UK inflation went from near zero in 2021 (0.4% in February 2021), to a peak of 10.4% in February 2023. This was driven by energy prices as well as accelerated growth after the covid pandemic. US inflation took a similar path, but with a lower and earlier peak.<br><br>Inflation has fallen rapidly back to 3.9% (as at December 2023) in the UK and 3.1% in the US and is expected to moderate further throughout 2024. |
| **Economic growth % p.a.** |  |  | The much-predicted recession of 2023 has failed to materialise. While growth was very weak in the UK, it remained above zero in real terms, despite the cost-of-living crisis. In the US, growth accelerated in 2023 compared to 2022.<br><br>In both countries, growth is expected to remain sluggish but positive in 2024. However, the continued rise in borrowing costs is expected to dampen growth. |

Source: LSEG Eikon, ONS, Bank of England, Equilibrium Investment Management.

## Markets

**Chart one** shows the returns of some of the major asset classes we can invest in over 2022 and 2023.




| UK equities | Overseas equities | Other assets |
|---|---|---|
| In 2022, the FTSE 100 was one of the few asset classes to make money due to its high weighting in oil and gas stocks, which benefitted from rising energy prices. It also went up in 2023, albeit relatively weakly.<br><br>Outside of the top 100, UK stocks performed poorly for much of the time, falling sharply in 2022 and struggling at times during 2023. However, the last quarter saw a strong recovery, meaning the FTSE 250 returned just as much as the top 100 in 2023, although the AIM market of smaller companies fell for the second year running. | The US market had a very good year, but it was a strange one, with seven big tech companies driving nearly all the returns. This can be seen in the performance of the Nasdaq, which did fantastically well on the back of developments in artificial intelligence. It is worth noting that this came after very steep losses in 2022.<br><br>Emerging markets performed poorly in 2023 and barely recovered from 2022's losses. Hopes for an acceleration in Chinese growth after COVID-19 were misplaced, although there are now signs of stronger growth ahead. | Fixed interest (bonds) performed as poorly as stocks in 2022, with gilts losing as much as tech stocks. In 2023, bonds struggled for most of the year but in the last few months they rallied as central banks signalled they may be done with rate hikes. This resulted in gilts ending the year in positive territory, and our favoured asset class of corporate bonds performed very well.<br><br>Real estate was the worst-performing asset in 2022, mainly due to rising borrowing costs, but it recovered strongly in the final few months of 2023. In contrast, infrastructure held up very well in 2022 but declined during 2023, particularly in renewable energy stocks. |

Source: Financial Express, total return in sterling to 29/12/2023. This is a non-exhaustive list of some of the major asset classes we can invest in. Red bars indicate the total returns in 2022 and the blue bars are the total returns in 2023.

# Portfolios

The tables below show our portfolios over various time periods, compared to other funds with similar objectives and risk tolerance.

### Calendar year returns over 10 years relative to other funds (%)

| Portfolio | 2023 | 2022 | 2021 | 2020 | 2019 | 2018 | 2017 | 2016 | 2015 | 2014 | 2013 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Cautious | 4.91 | -9.62 | 6.51 | 3.60 | 12.37 | -3.60 | 8.58 | 7.76 | 4.36 | 6.27 | 12.75 |
| Balanced | 6.50 | -10.93 | 7.73 | 4.31 | 13.79 | -4.12 | 9.75 | 8.93 | 5.53 | 6.43 | 14.20 |
| Adventurous | 8.69 | -14.54 | 9.58 | 6.98 | 16.61 | -5.60 | 12.79 | 12.44 | 6.21 | 6.35 | 13.42 |
| **UT Mixed Investment 20-60% Shares** | **6.68** | **-9.47** | **7.20** | **3.51** | **11.84** | **-5.10** | **7.16** | **10.32** | **1.21** | **4.85** | **8.85** |
| | | | | | | | | | | | |
| Global Equity | 10.63 | -18.37 | 11.10 | 13.36 | 20.99 | -8.40 | 19.08 | 18.06 | 7.23 | 4.60 | 19.99 |
| **UT Flexible Investment** | **7.45** | **-8.98** | **11.30** | **6.70** | **15.66** | **-6.72** | **11.21** | **13.82** | **1.99** | **4.89** | **14.54** |
| | | | | | | | | | | | |
| Defensive | 2.93 | -9.21 | 1.93 | 7.39 | 6.29 | 0.01 | 4.95 | 4.64 | 0.90 | 4.21 | 4.09 |
| **UT Global Bond** | **4.74** | **-10.26** | **-1.05** | **6.03** | **5.57** | **-0.69** | **2.25** | **12.58** | **-1.32** | **3.81** | **-1.96** |

### Various time periods to 5 January 2024 (%)

| Portfolio | 6 months | 1 year | 3 years | 5 years | 10 years |
|---|---|---|---|---|---|
| Cautious | 3.69 | 3.21 | -0.09 | 16.04 | 46.04 |
| Balanced | 3.78 | 4.43 | 1.05 | 19.59 | 55.06 |
| Adventurous | 3.93 | 6.35 | 0.51 | 24.96 | 70.46 |
| **UT Mixed Investment 20-60% Shares** | **4.07** | **4.51** | **2.89** | **18.98** | **42.28** |
| | | | | | |
| Global Equity | 3.40 | 7.43 | -1.63 | 35.01 | 96.11 |
| **UT Flexible Investment** | **3.73** | **5.38** | **7.26** | **31.60** | **64.57** |
| | | | | | |
| Defensive | 3.61 | 1.59 | -5.49 | 7.81 | 24.60 |
| **UT Global Bond** | **3.93** | **3.08** | **-8.09** | **2.66** | **20.73** |

Source: Financial Express, total return in sterling to 5 January 2024. Green numbers denote the outperformance of the sector. All portfolios are based on IFSL Equilibrium fund and discretionary model performance prior to fund launch. Defensive and Global Equity long-term returns based on backtested portfolio.

# Portfolios

The tables below show our portfolios over various time periods, compared to wealth manager portfolios that have similar objectives and risk tolerance, as calculated by Asset Risk Consultants (ARC).

### Calendar year returns over 10 years relative to wealth manager portfolios (%)

| Portfolio | 2023 | 2022 | 2021 | 2020 | 2019 | 2018 | 2017 | 2016 | 2015 | 2014 | 2013 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Cautious | 4.91 | -9.62 | 6.51 | 3.60 | 12.37 | -3.60 | 8.58 | 7.76 | 4.36 | 6.27 | 12.75 |
| **ARC Sterling Cautious PCI** | **4.43** | **-7.60** | **4.23** | **4.20** | **8.05** | **-3.63** | **4.48** | **5.52** | **1.25** | **3.98** | **4.97** |
| | | | | | | | | | | | |
| Balanced | 6.50 | -10.93 | 7.73 | 4.31 | 13.79 | -4.12 | 9.75 | 8.93 | 5.53 | 6.43 | 14.20 |
| Adventurous | 8.69 | -14.54 | 9.58 | 6.98 | 16.61 | -5.60 | 12.79 | 12.44 | 6.21 | 6.35 | 13.42 |
| **ARC Sterling Balanced PCI** | **5.98** | **-9.14** | **7.64** | **4.31** | **11.73** | **-5.10** | **6.69** | **8.64** | **1.87** | **4.51** | **9.24** |
| | | | | | | | | | | | |
| Global Equity | 10.63 | -18.37 | 11.10 | 13.36 | 20.99 | -8.40 | 19.08 | 18.06 | 7.23 | 4.60 | 19.99 |
| **ARC Sterling Equity Risk PCI** | **8.10** | **-11.40** | **12.31** | **5.82** | **18.04** | **-6.50** | **11.39** | **13.73** | **2.06** | **4.07** | **16.13** |

### Various time periods to 29 December 2023 (%)

| Portfolio | 6 months | 1 year | 3 years | 5 years | 10 years |
|---|---|---|---|---|---|
| Cautious | 4.52 | 4.91 | 0.98 | 17.56 | 47.05 |
| **ARC Sterling Cautious PCI** | **4.34** | **4.43** | **0.57** | **13.23** | **26.66** |
| | | | | | |
| Balanced | 4.77 | 6.50 | 2.20 | 21.30 | 56.16 |
| Adventurous | 5.35 | 8.69 | 1.78 | 26.97 | 71.70 |
| **ARC Sterling Balanced PCI** | **4.92** | **5.98** | **3.65** | **20.8** | **41.46** |
| | | | | | |
| Global Equity | 5.76 | 10.63 | 0.33 | 37.42 | 98.51 |
| **ARC Sterling Equity Risk PCI** | **4.99** | **8.10** | **7.58** | **34.38** | **69.07** |

Our portfolios have consistently delivered strong long-term performance. Against other wealth manager portfolios, all the portfolios outperformed in 2023 and demonstrated consistent performance over the long term. For example, Balanced underperformed just one calendar year in the eleven years shown in the above table.

Generally, higher equity allocations have resulted in better performance, both in the last year and over the long term, with Adventurous and Global Equity producing the strongest returns in 2023, outperforming the fund sectors.

Balanced and Adventurous outperformed their sectors in eight out of the past 10 years, with Adventurous also demonstrating a notable lead in 2023. Balanced was in line with the sector last year, while Cautious, which holds less in equities than many funds in the sector, lagged behind despite beating ARC. However, it has outperformed seven of the 10 previous years.

The Defensive Fund is benchmarked against the global bond sector. It experienced a milder decline than bonds during one of the worst bear markets for fixed interest in history in 2022 and has shown a strong recovery, particularly in the last quarter of 2023.

Source: Financial Express, total return in sterling to 29 December 2023. Green numbers denote the outperformance of the relevant ARC index. All portfolios are based on IFSL Equilibrium fund and discretionary model performance prior to fund launch. Global Equity long-term returns based on backtested portfolio. Note there is no relevant ARC index for Defensive.

# Drivers of performance

This table shows how each of our core asset class portfolios have performed over the past 12 months, along with the current asset allocation of the Balanced portfolio and what this was a year ago. We have made similar changes in other portfolios to a greater or lesser extent.

### Calendar year returns

| Asset class | 1-year return %* | Current allocation % | Allocation 1 year ago % | Change in allocation % | Commentary |
|---|---|---|---|---|---|
| **Cash and money market** | n/a | 5 | 2 | +3 | Throughout most of the year, we kept cash to a minimum, investing instead in fixed interest where yields were higher than cash rates. However, towards the end of 2023, we sold some longer-dated government bonds as their yields fell below 4% p.a., instead topping up money market funds (which in reality are ultra short-dated government bonds) where we are getting c.5.25% p.a. interest. |
| **Fixed interest** | 5.64 | 37 | 33 | +5 | We still very much favour corporate bonds which continue to offer attractive yields above those on cash. These could also be boosted if interest rates are cut in 2024, as many investors now expect. |
| **Real assets** | -7.30 | 9 | 14 | -6 | Infrastructure and forestry suffered losses over the past year, offsetting a recovery in real estate. We reduced exposure compared to 2022, initially using these funds to top up fixed interest. We would expect recovery to continue should rates start to fall. |
| **Defined returns** | 15.30 | 12 | 12 | = | Defined returns have again produced excellent returns. We have the same allocation as this time last year, after several products kicked out and were replaced with new ones. We may well add further exposure should there be any further market dips. |
| **Alternatives** | 0.77 | 4 | 7 | -3 | We reduced alternatives this year after they held up well in 2022. This allowed us to switch into bonds after their prices fell and yields increased. We only hold minimal exposure in two funds that we believe could hold up well if stock markets dropped back. |
| **Equity** | 8.21 | 32 | 33 | -1 | Equities recovered well from 2022's losses, notably US equities. Over the year we have kept allocation roughly the same but made several changes within the asset class. Notably, we banked gains in US tech stocks and instead switched into smaller US companies which have lagged so far this year and therefore look cheap in our opinion. |

*Source: Financial Express, 12-month total return of relevant Equilibrium asset class portfolio from 5 Jan 2023 to 5 Jan 2024, gross of fees. Equity is based on Balanced Equity mix. Real Assets assumes 2/3rds infrastructure and 1/3rd real estate. Allocations may not add up to 100% due to rounding etc.

## Rate expectations drive returns

Over the past two years, we have seen some extraordinary moves in the global economy, which have led to some equally extraordinary market conditions.

In February 2021, UK inflation was just 0.4%, with prices remaining depressed due to the pandemic-induced slowdown. However, two years later in February 2023, inflation peaked at 10.4%, a full 10% higher, before falling back to 3.9% by November 2023. (Source: ONS, UK Consumer Prices Index (CPI)).

Two years ago in December 2021, interest rates in the UK were 0.25%. To combat this rapid spike in inflation, the Bank of England has now set interest rates at 5.25%, a full 5% higher. This increase amounts to 2000% compared to the starting point!

In hindsight, given the scale of such economic moves, it is not surprising that investment markets have been so volatile. Those areas most sensitive to interest rates, such as government bonds, smaller company stocks and real estate, fell very sharply in 2022 and have remained volatile throughout 2023.

More recently, central banks have given strong indications that they have finished with interest rate hikes. Inflation has been coming back down rapidly and most forward-looking indicators would suggest this should continue, although we are sure it won't be a smooth ride. For example, as discussed in December's *The Pulse* we expect it might temporarily go back up in January partly due to a short-term increase in the energy price cap.

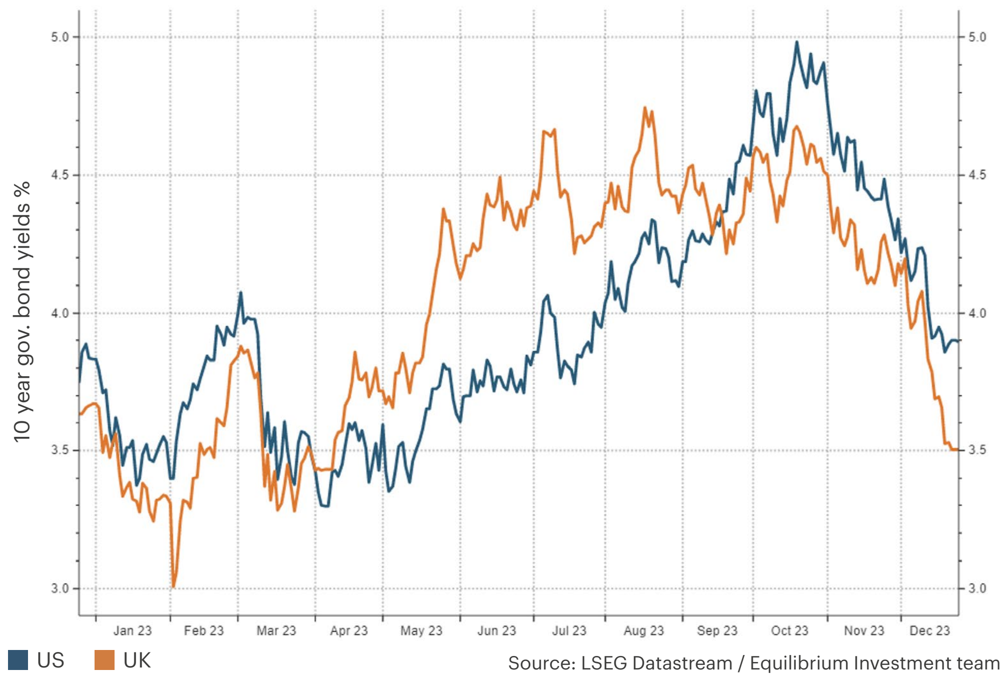
However, central bankers have hinted at rate cuts in 2024 should prices continue to come down as expected. This helped many asset classes to perform strongly in the final two months of the year. Those areas mentioned above, which have been hit hardest by higher rates, are amongst the strongest performers.

**Chart two** shows the yield on a 10-year gilt in orange, and the US 10-year government bond yield in blue. The chart shows how the yield has changed over the last 12 months.

The yields on government bonds reflect what investors think will happen to interest rates. When rates are expected to rise, the price of the bond falls and this means the yields increase.

The 10-year gilt yield went from around 3.6% at the start of 2023, to as high as 4.75% in August. This meant that gilt investors saw steep losses over this period.

**Chart two:** 10-year government bond yields %.




Source: LSEG Datastream / Equilibrium Investment team

However, from late October the yield dropped rapidly, finishing the year at 3.5%, slightly below where it was at the beginning of 2023. In a major turnaround, this means the gilt index finished the year just about in positive territory.

The US equivalent yield got as high as 5% in October, before dropping sharply to finish the year at 3.8%.

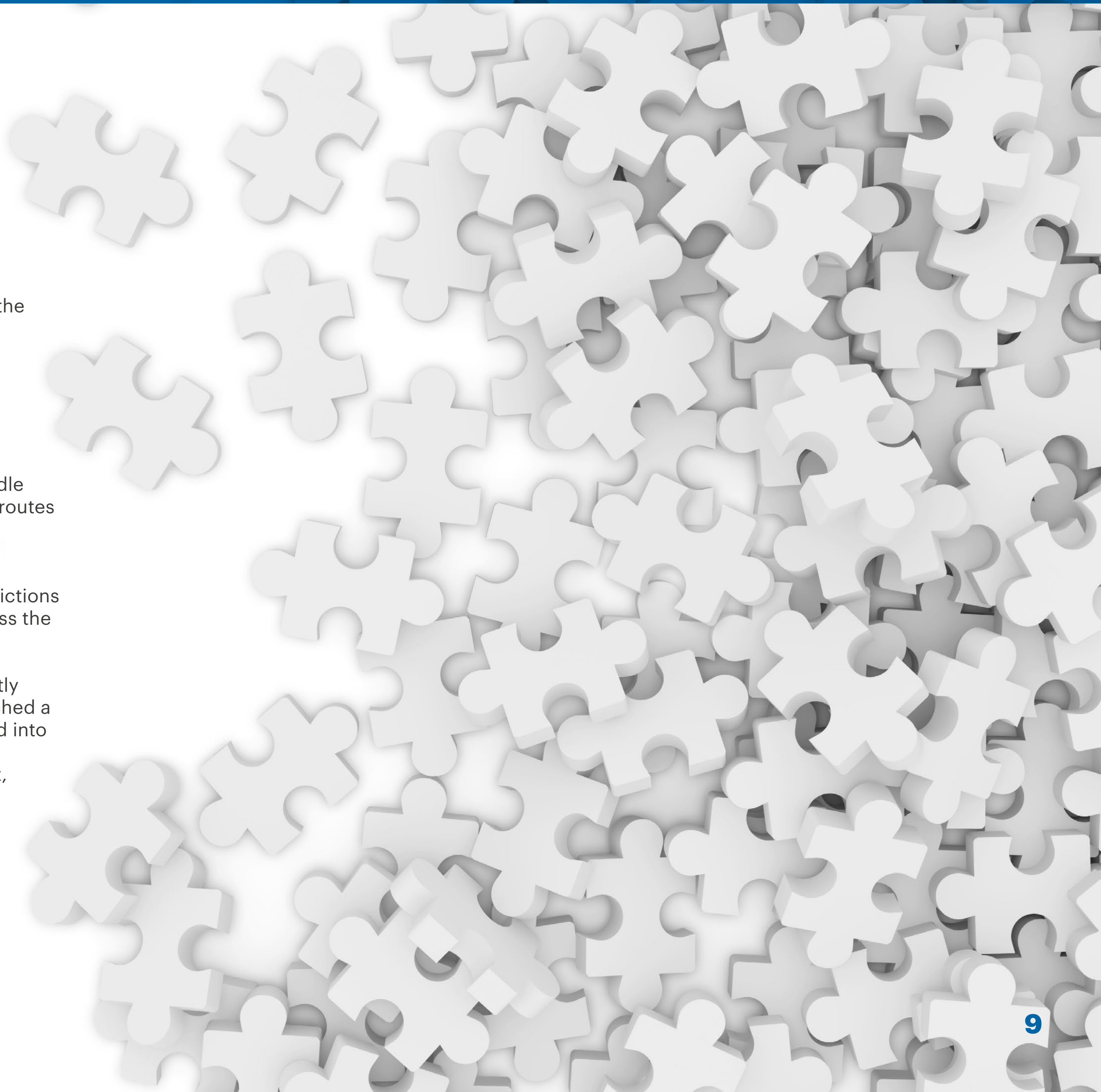
During 2023, we have topped up bonds on several occasions as the yield increased. It is therefore very pleasing to see such strong moves, as this will boost returns. However, we are starting to wonder if things have moved too far, too quickly.

Markets are now pricing in at least 1% of interest rate cuts next year. Whilst certainly possible, there is also plenty of room for disappointment. What if inflation doesn't drop as quickly as we expect? There is a risk that events such as the conflict in the Middle East and recent issues around the Suez and Panama Canal trade routes could lead to a resurgence in price increases.

We also wonder what central bankers would do if the economy continued to grow as it did in 2023, despite the widespread predictions of recession. Would central banks really cut rates so steeply unless the economy takes a downturn?

Whilst we have a positive view for the longer term, we are currently feeling a little more cautious moving into the year and have switched a proportion of portfolios out of long-dated government bonds and into short-dated bonds and money market instruments. Not only do these now offer higher yields than longer-dated bonds at present, but they also provide us with some "dry powder" should there be any market setbacks in the New Year. If so, we have the ability to switch in and take advantage of any market dips.

However, we have retained a high weighting to corporate bonds where the yields remain higher than cash rates and therefore, we still expect positive total returns.



## An artificial gain?

The other big story in 2023 has been the strides made in artificial intelligence which have helped propel the large US technology stocks to new heights.

The so-called "magnificent seven" stocks went up 98% in 2023 in sterling terms (an equal weight portfolio of Alphabet, Apple, Amazon, Meta, Microsoft, Nvidia, and Tesla, rebalanced quarterly. Source: FE Analytics/Equilibrium Investment Management.) and combined they now make up almost 30% of the S&P 500 index (Source: S&P Global).

Given that nearly one-third of the market pretty much doubled, it's perhaps surprising that the S&P 500 only went up 18% in 2023. This tells you that the other 493 stocks in the market have not performed nearly as strongly. In fact, the average stock was up just 6.8% last year (as represented by the S&P 500 Equal Weight index. Source: FE Analytics in Sterling).

As we mentioned last quarter, we do think this is an area in which we believe investors have got ahead of themselves. Whilst chip maker Nvidia has seen very sharp earnings increases as their high-powered processors are much in demand, most of the other stocks mentioned have not yet seen major profit increases as a result of AI. Much of the rise in their share prices is in the hope of future increases.

Against this backdrop, we have taken profits on some of our holdings in big US tech in most portfolios by selling a Nasdaq index tracker fund earlier this year, and more recently reducing exposure to the market-cap weighted S&P 500 index (where more money is invested in the larger companies).

We have kept the allocation to the US but instead switched some to US smaller companies, which look much cheaper relative to earnings, and to an equal-weighted S&P 500 index tracker, which allocates the same amount to each of the 500 stocks in the index regardless of size. After recent moves, both of these alternative US indices have done marginally better than the S&P 500 Index from the date we switched to the end of 2023, and we think this could continue into 2024.

On this side of the Atlantic, the FTSE 100 Index again held up relatively well, but companies outside the top 100 UK stocks struggled for much of the year.

However, in the final quarter of 2023, small and mid-sized companies rallied hard, with the FTSE 250 actually ending the year higher than the 100. The AIM market remains under water but saw strong momentum towards the end of the year.

Within our UK equity fund holdings, we have a bias towards smaller companies, mainly because we hold plenty of FTSE 100 exposure via the defined returns products.

The defined returns products have done very well, with several products kicking out this year. We have then replaced them with new products and may well add to our holdings should markets drop back.

**Table two** shows the products we have set up this year, with rates of potential returns ranging from 10.25% (FTSE only product) to 13% (FTSE & S&P 500 product). We think these are attractive potential returns, often higher than we would expect from direct equity investments, but with an additional degree of certainty, as for these products to kick out and provide these pre-determined returns, the relevant market needs simply to be at or above the starting point on the relevant anniversary date.

**Table two:**

| Product | Strike Date | Launch Price | Strike Level FTSE / S&P | Annual Return |
|---|---|---|---|---|
| BNP FTSE Autocall Sept 28 | 08/09/2023 | £1.00 | 7,478 | 10.25% |
| Morgan Stanley FTSE/S&P Autocall Sept 28 | 14/09/2023 | £1.00 | 7674 / 4505 | 11.90% |
| JPMorgan FTSE/S&P Autocall Sept 28 | 27/09/2023 | £1.00 | 7593 / 4275 | 12.40% |
| Credit Agricole FTSE/S&P Autocall Oct 28 | 09/10/2023 | £1.00 | 7492 / 4336 | 12.90% |
| JPMorgan FTSE/S&P Autocall Oct 28 | 31/10/2023 | £1.00 | 7322 / 4194 | 13.00% |

Source: Financial Express, total return in sterling to 5 January 2024.

A number of our products have six-monthly observation dates, meaning there are two points in the year when the return may be achieved (for example, a product set up in September could potentially kick out in March or September).

Large stocks have beaten small stocks again this year, however the momentum has swung recently. Despite the recent rally small capitalisation stocks remain very cheap, and trade at levels which have in the past seen very strong returns.

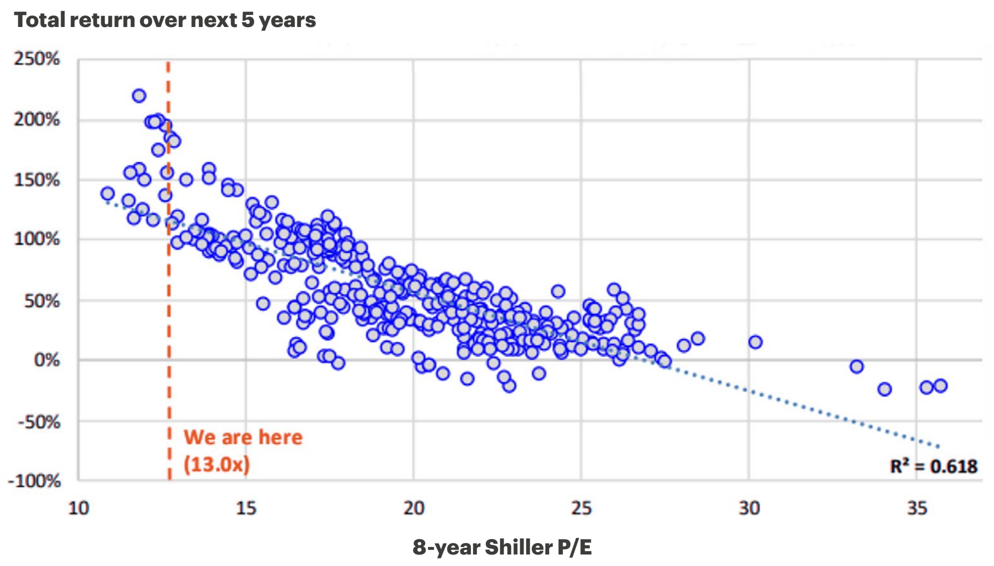
**Chart three** is from Montanaro Asset Management – a smaller company specialist. This considers the valuation of stocks using a variant of the price/earnings ratio, which looks at eight-year average earnings rather than just today's profits. In theory, this smooths out short-term fluctuations.

Each dot on the chart represents a different period for UK small caps, with the higher the dot the higher the returns. Across the horizontal axis is what the price/earnings ratio was at the start of the five-year period, with cheaper valuations on the left and more expensive on the right.

There is a clear pattern demonstrating that cheaper valuations normally mean higher returns.

Montanaro has marked on the chart the current valuations. When small caps have been at these levels in the past, returns have roughly been somewhere between 100% and 200% total return over the following five years. We therefore want to retain our exposure despite the challenges faced by the UK recently. Should the consensus be correct, the economy avoids recession and rates are cut, then in our view such stocks might be one of the best places to be.

**Chart three:** UK SmallCap return five years from the starting eight-year Shiller P/E.




Source: Montanaro Asset Management, Numis. As of 31 October 2023

## A real disappointment

The most disappointing investments in the portfolio last year were our renewable energy and forestry holdings. As "real assets" (they are forms of infrastructure and real estate respectively), these were hurt by rising borrowing costs. However, they have failed to rally as much as our other real estate holdings did in the last quarter.

The fall in the renewable energy infrastructure fund is partly due to falling energy prices in general. For forestry, after initially holding up better than other real estate there was perhaps a need to adjust along similar lines. However, the fall in both has been far bigger than the fundamentals would suggest.

We put this down partly to the "green backlash" with investors (and governments) seeming less supportive of environmental issues. However, ignoring the positive environmental effects, what both assets have in common is they produce secure long-term income streams, which we think makes them good long-term investments.

Assets within both funds are now trading well below their net asset value (NAV), with the Forestry fund priced at a 37% discount to the underlying value of the land and forests it holds. In theory, if they decided to wind up the trust and sell off all the land, we would see a huge uplift compared to the current share price. Similarly, the typical renewable energy investment trust in the UK trades at a 16% discount to NAV. We therefore believe these remain good value and should rally if interest rates start to fall. (Source: LSEG Datastream, FE Analytics).

## Emerging from the gloom

Another area which struggled in 2023 was emerging markets. Many had tipped this asset class to have a good year in 2023, as China opened up following Covid restrictions.

However, the boost to economic growth was not as strong as hoped, and China struggled with deflation throughout much of the year, even while the West fought inflation.

One of the reasons we often invest in emerging markets is they tend to see higher economic growth than developed economies over the long term, but in recent years that premium has reduced, particularly since Covid. However, forward-looking indicators such as business surveys show that growth appears to be picking up (Source: S&P Global, Purchasing Manager's Index) and economists forecast that this growth premium could return back above the long-term average in 2024 (Source: Numera Analytics).

Again, like small caps, we think that emerging markets are relatively cheap, but have the potential to grow strongly.

**Chart four** is from JP Morgan Asset Management, comparing how cheap or expensive each region is relative to its own long-term average. As mentioned earlier, US stocks are expensive relative to history whilst UK stocks are relatively cheap. Emerging markets are just as cheap as the UK whilst, if you're prepared to take the risk, China is almost as cheap as it has ever been.

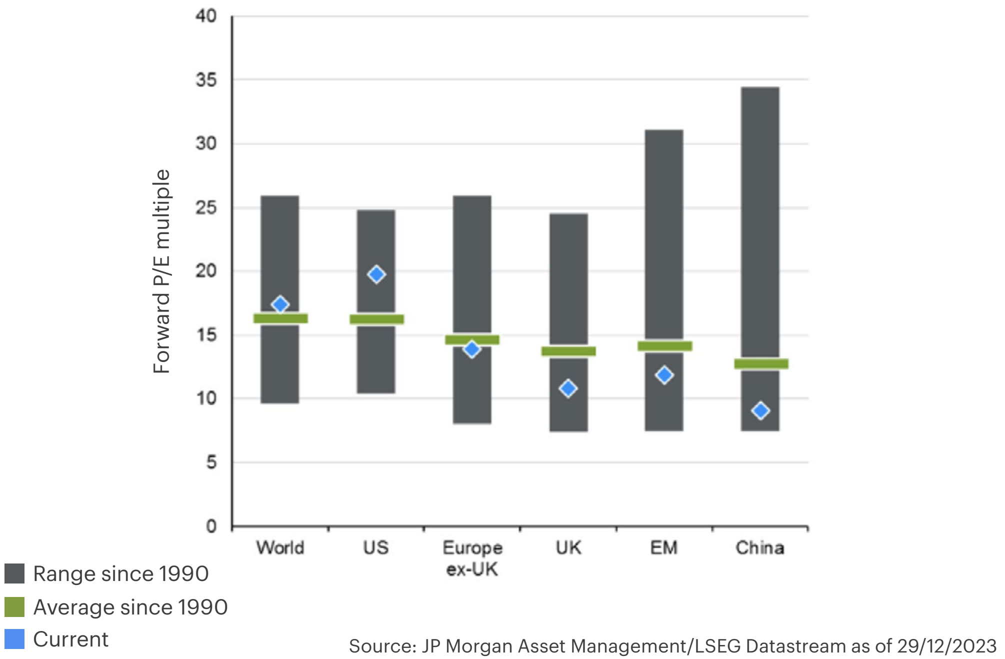
**Chart five** (also from JPM) shows the estimates for earnings growth for 2023 and 2024. Many people would say that the US justifies the higher valuations because of the higher expected growth, with around 10% growth forecast in 2024, more than other developed economies. However, emerging markets are expected to see earnings growth of at least 15% this year.

Whilst we should always take forecasts with a large pinch of salt, where assets appear cheaper AND with superior growth, we find them interesting and therefore retain a reasonable weighting in portfolios.

After a tough couple of years for investors, there are definite reasons for optimism about the future. Many asset classes remain much cheaper than they were a few years ago and cheap relative to their own long-term history.

Therefore, if the consensus is correct and inflation continues to fall, economies remain steady and interest rates are cut, then we think there is a chance of some very attractive returns going forward. However, in our view it is important not to be too exposed to the more "bubbly" areas of the market; avoiding the potential blow-ups is just as vital as trying to gain exposure to the areas with the highest growth potential.

**Chart four:** Global forward P/E ratios.




Source: JP Morgan Asset Management/LSEG Datastream as of 29/12/2023

**Chart five:** Consensus estimates for global earnings per share growth.


Source: JP Morgan Asset Management/LSEG Datastream as of 29/12/2023

## Risk warnings and notes

Past performance is never a guide to future performance. Investments will fall as well as rise.

Any performance targets shown are what we believe are realistic long-term returns. They are never guaranteed.

None of the information in this document constitutes a recommendation. Please contact your adviser before taking any action.

Unless stated otherwise:

- All performance statistics are from Financial Express Analytics on a bid-bid basis with income reinvested.
- All performance data is to 5 January 2024.
- Model portfolio performance is stated after a 0.5% investment management fee with no adjustment for financial planning or platform charges.
- Your own performance may vary from that shown due to dividend pay dates, transaction dates, contributions and withdrawals.
- Actual performance may also differ slightly due to constraints over how we can reflect fees and discounts from fund managers. These are assumed not to change over the whole investment period. In reality, discount levels change as we change the funds in which we invest.
- Individual sector portfolios are shown with no charges taken off or fund manager discounts applied.

For details of your own portfolio performance, please refer to your half-yearly statement from the wrap platform in which you are invested. We will also provide personalised performance information at your regular reviews.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