Royal London Global Equity Strategies

Quarterly Report
31 December 2022

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Executive summary

- Over the fourth quarter our pooled funds delivered net returns of 2.43% for the RL Global Equity Select Fund and 2.14% for the RL Global Equity Diversified Fund, compared to 1.86% for the benchmark (MSCI World Net Total Return in sterling). For the 12-month period, the funds have returned 1.12% and -6.93%, respectively, against -7.83% for the benchmark (fund returns net of fees, for M Acc share classes).
- The key theme of high inflation will continue to be a focus and the cost-of-living squeeze that households are facing. However, the pressures are by no means confined to energy. Others inflationary factors are also at play, such as supply chain disruption from Covid lockdowns in China, tight labour markets and sharp rises in many agricultural products feeding through into food prices. We are addressing this risk by limiting factor and sector exposure whilst focusing on stock-specific risk in the portfolios. Our preference is to own wealth creating companies with suitable balance sheets for their underlying business and a conservative approach to credit. We diversify the portfolios across regions, countries, industries and Corporate Life Cycle categories. No single model or analysis is a magic bullet for investing, but our Corporate Life Cycle model helps us to understand corporate capital allocation and identify firms that are pursuing an appropriate strategy for their position in the Life Cycle.
- There is still considerable uncertainty about the outlook for 2023 and many investors fear that higher interest rates will cause a recession. We believe the current equity bear market will be two-legged: the first leg – the interest rate-induced derating of equities, particularly growth stocks – is probably over unless inflation is genuinely out of control. The second leg is being driven by the increasing likelihood of a recession and earnings downgrades. This could still have some way to go (-10-20%) as corporate earnings for 2023 still feel overly optimistic. However, it feels like we're nearer to the end of the bear market than the beginning, not least as sentiment is really quite negative. In such an environment, markets can turn quickly. A key factor will be the outlook for inflation: if price rises start to slow and fewer interest rate increases are needed, equities will bounce sharply.

Market overview

- Central banks responded to the continued strength of inflation by further tightening monetary policy and reiterating that they will do whatever it takes to suppress rising prices. The Federal Reserve (Fed), European Central Bank (ECB) and Bank of England (BoE) each raised rates by 1.25% in aggregate over the quarter. Since March, the Fed has raised rates seven times by 4.25% in total – its 0.75% increases in June, July, September and November were the biggest single increases for nearly 30 years. Investors expect further hikes in 2023 as the services sector of the US economy has remained notably strong. The ECB was slower to react, partly due to a more fragmented backdrop with a gap between Germany and 'peripheral' economies. However, it ended its bond buying programme in July and increased rates by 0.75% (its first hike for 11 years and a bigger increase than the 0.50% expected by economists). Further increases followed in September, October and December with a clear commitment to raise rates further in 2023. The BoE increased rates to 3.5% over the quarter, taking its tally to eight increases in 2022 and nine so far in this cycle.
- Despite these increases in interest rates, the fourth quarter saw equities regaining some of the territory lost earlier in the year as investors started to anticipate falls in inflation and the peak of the interest rate cycle early in 2023. In local currency terms (i.e., without the considerable impact of US dollar weakness over the quarter), nearly all major stock markets rose. For the fourth quarter, the FTSE-All Share, MSCI World and MSCI All Countries World Index (ACWI – which also includes 26 emerging markets) returned +8.9%, +2.0% and +2.0% to sterling investors, respectively. Regional returns were dispersed: according to MSCI regional data in sterling terms, the strongest markets were Europe ex-UK and the UK, which returned +11.6% and +8.6%, respectively, while the Far East ex-Japan and Japan returned +5.3% and +5.1%, respectively. Emerging markets returned +1.9%, while the US delivered the only negative return at -0.6%.
- Within equity markets, the significant inflation-related rotation out of 'growth' and into 'value' that dominated the first half of 2022 was again evident with a swing of 9.4%. The MSCI World Growth Index returned -2.8% versus +6.7% for the MSCI World Value Index. Sector returns in sterling were widely dispersed for the MSCI World: despite weakness in oil prices, energy was again the strongest sector, returning +11.2%, while industrials and materials returned +9.5% and +8.9%, respectively. Conversely, consumer discretionary, communication services, technology and real estate all delivered negative returns of -9.3%, -6.7%, -2.4% and 1.80%, respectively.
- The UK economy continued to be impacted by the ill-fated experiment with Liz Truss and Kwasi Kwarteng as Prime Minister and Chancellor, respectively. Following the 'mini-Budget' on 23 September, after comments in support of sterling, the BoE was forced to intervene in the gilt market in the last week of the third quarter as problems with levels of collateral in the 'liquidity-driven investing' (LDI) part of the pensions industry pushed down the prices of long-dated gilts. Although this calmed financial markets temporarily, the volatility continued for several weeks until Mr Kwarteng was sacked on 14 October and replaced by Jeremy Hunt, and Rishi Sunak took over as Prime Minister on 25 October.

The policies adopted by Mr Hunt and further detailed in the Autumn Statement in mid-November served to stabilise sterling and reduce the yield premium demanded by investors in UK government bonds.

- After weakness in the third quarter, the price of Brent crude oil fell by another 4.0%, to below $86 a barrel – this is below the price level at the time of the Russian invasion of Ukraine in late February. Meanwhile, natural gas prices fell over 50% in the quarter as the weather in Europe remained relatively warm. Meanwhile, copper futures recovered to rise by 3.5% in dollar terms despite the evident slowdown in China.
- Currency movements had a notable impact in the quarter, following the volatility in the first three quarters of the year. The Fed's apparently softer approach to raising interest rates pushed the dollar sharply lower and it was the weakest major currency: it depreciated by nearly 10% against the yen and euro, and by over 7% against sterling. On a translational basis, sterling's recent strength against the dollar impacts sterling investors in overseas assets as it lowers the returns over the quarter. However, the weaker dollar will benefit any emerging markets countries and companies that have borrowed in dollars.

Performance and activity

Global Equity Select and Global Equity Diversified:

- **Steel Dynamics, Sumitomo Mitsui Financial Group** and **HCA Healthcare** were strong contributors to performance during the fourth quarter of 2022. Steel Dynamics, the US steel manufacturing and fabrication business in the Accelerating category of the corporate Lifecycle, performed strongly from an operational perspective. Facilities were running at high utilisation levels. Beyond the commodity steel business value add is generated through offering customers coatings and painting of the raw steel, and an increasingly significant fabrication business. The company has reinvested in a new steel mill in Texas and is planning an aluminium mill. The shares joined the US-based S&P 500 Index on 22 December. Japanese financial group Sumitomo Mitsui Financial Group – 'Mature' –posted earnings that exceeded expectations this year, helping to drive strong performance from the shares. There is a focus on improving returns on capital and managing costs. The company has several initiatives to execute on especially in overseas markets, though key is the consistency of the attractive returns in the domestic market. The company continues to offer an attractive valuation pay-off. US hospital operator HCA– 'Compounding' – benefited from the additional spending during the pandemic and then from the catchup of procedures that were postponed due to the pandemic. Labour availability and costs were a challenge earlier on in the year though the company is managing this and passing costs on through higher fees, demonstrating its pricing power.
- **Amazon, Lithia Motors** and **Alphabet** detracted from returns over the period. Online retail giant Amazon in the Slowing & Maturing category underperformed as a slowdown in the AWS cloud business growth was a notable concern – as was guidance for Q4. We continue to view the business as having strong competitive advantages and an attractive valuation pay-off. Lithia Motors in the Slowing and Maturing category of the Life Cycle has faced concerns about declining second hand car values and the continued shortage of new cars associated with supply chain disruption. The North American car dealership network had a challenging quarter for earnings. Having enjoyed high prices for used cars in recent years, supply chains are normalising and putting downward pressure on sales and margins. Our analysis suggests that the valuation pay-off remains attractive as while short-term trends are negative, the shares are pricing in an excessively negative scenario. Alphabet Inc., the parent company of Google 'Compounding' has been impacted by falling advertising rates as competition for space from other online companies has reduced pricing. There are concerns over the impact of AI products such as OpenGPT and what impact they might have on the search business. This is unclear now though we believe that there is increasing financial discipline at the company and the valuation pay-off remains attractive.

Outlook

- Consumers are facing a significant cost of living squeeze, as inflation is currently at its highest level for decades. Likewise, companies are battling to defend margins, as their own input costs increase significantly. We believe our approach of investing in a broad range of companies who are in control of their own fates, irrespective of market conditions is the right one. As well as looking for durable businesses, a willingness to look through short-term extremes of sentiment and buy stocks when they are out of favour, or take profits when sentiment becomes exuberant should drive longer-term performance.
- There is considerable uncertainty about the outlook for 2023. The Fed has continued to raise interest rates and many investors fear that this could tip the US into a hard-landing recession, although the hard data remain mixed at this stage. The picture is only marginally different in the UK and Europe, with energy prices remaining high in absolute terms and geopolitical events continuing to affect sentiment. Meanwhile, China is experiencing a slowdown in growth with particular problems in its over-invested property sector and an ongoing drag on growth from Covid-19.

- Nonetheless, the near-term outlook improved over the fourth quarter from an economic perspective with signs that inflation is close to its peak, yet without a collapse in economic activity. Investors have scrutinised every comment from the Fed to try to anticipate the pivot away from higher interest rates. To an extent, however, the rate of economic slowdown or recession is somewhat irrelevant as these have already been discounted by asset prices. Of more importance is whether inflation continues to fall back towards the Fed's and BoE's targets of 2.0%, or whether it sticks at around 4-5% (which might lead to further increases in interest rates). In addition, the relative valuation of equities compared to bonds looks 'wrong', and it will be interesting to see how this is resolved over the coming months.

Additional information

- Our 2023 Outlook is available here, and includes an overview from RLAM Chief Investment Officer Piers Hillier, as well as individual articles from RLAM investment managers providing a unique insight into the risks and opportunities in their asset classes for the new year. Articles, videos and webinars explaining our investment thinking can be found in the Our Views section of www.rlam.com, which also contains includes regular updates from Head of Fixed Income Jonathan Platt, Head of Equities Peter Rutter, and Head of Sustainable Mike Fox.

IMPORTANT INFORMATION

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