ROYAL LONDON ASSET MANAGEMENT

Global Equity Strategies

Quarterly Report

31 March 2023

Market overview

- The year enjoyed an optimistic start, with sentiment calmer as it appeared that the major economies had avoided recession and consumer price inflation was moderating. However, expectations shifted with stronger than expected US job market data, leading to fears that interest rates would have to continue higher. The increased volatility this caused was then exacerbated towards the end of the quarter, with concerns over the health of the global banking sector.
- Central banks continued their rate hiking path. The US Federal Reserve (Fed), the European Central Bank (ECB), and the Bank of England (BoE) all pushed rates higher twice in the quarter – with the ECB increasing rates the most, by 0.75% - but with investors growing in confidence that central banks were nearing the end of their tightening cycle. Since the start of the current cycle the Fed has increased rates by 4.75% over the course of nine rises since March 2022. The BoE started the cycle at 0.1% but has moved rates higher 11 times since the end of 2022, now sitting at 4.25%, while the ECB on the other hand has only increased rates by four times to 3.0%.
- In the final few weeks of the quarter, the collapse of Silicon Valley Bank and Credit Suisse refocused attention on the strength of the banking sector and dragged returns for equity and bond markets sharply lower. By the end of the quarter, central bank action following the collapse of SVB and the rescue of Credit Suisse by larger Swiss peer UBS appeared to have calmed markets.
- In local currency terms, all major stock markets rose. For the first quarter, the FTSE-All Share, MSCI World and MSCI All Countries World Index (ACWI – which also includes 26 emerging markets) all produced positive returns for the quarter in local terms, while US dollar, euro and sterling returns were also positive. According to MSCI regional data, the strongest market was Europe, while the weakest region was emerging markets.
- Within equity markets, there was a dramatic rotation into ‘growth’ away from ‘value’. This dramatic rotation towards growth stocks came in the aftermath of the fallout of Silicon Valley Bank and expectations that central banks globally may be less aggressive in hikes, leading to longer duration assets performing well. The MSCI World Growth Index produced strong returns, while the MSCI World Value Index was broadly flat in comparison. This is important because in 2022 and at the start of 2023, rising interest rates led to a significant rotation out of growth stocks and into value stocks. Investors typically use interest rates to determine the discount rate applied to future cashflows back to compute a stock’s present value. Growth stocks typically have a larger proportion of their cash flows derived from future years (due to the growth in profits over the forecast period) and therefore their valuation is more than proportionately, and negatively, affected by higher interest rates.
- Sector returns were dispersed for the MSCI World: information technology and communication services produced strong returns, while energy and healthcare saw negative returns for the quarter.
- The price of Brent crude oil fell by another 8.7%, to below $79 a barrel – this is even below the price level at the time of the Russian invasion of Ukraine in late February. Meanwhile, copper futures recovered to rise by a further 4.5% in dollar terms buoyed by the potential demand to come from China as the country begins the process of reopening its economy after Covid.
- The US dollar appreciated by nearly 1.5% against the yen, but depreciated by 1.5% against the euro, and by 2% against sterling. On a translational basis, sterling’s 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:

- **Reliance Steel & Aluminium Co, Constellation Software** and **Steel Dynamics** contributed to performance during the first quarter. **Reliance Steel & Aluminium Co**, an American metal distributor and processor in the Slowing & Maturing category of the corporate Life Cycle, was a strong contributor to performance over the quarter. Back in February, the company announced a strong set of results alongside positive forward-looking guidance. The company has been benefitting from strong industrial demand in the US, while the management team have continued to make sensible capital allocation decisions in line with its position in the Life Cycle, with a focus on returning cash to shareholders and an open attitude to wealth-creating M&A. Canadian diversified software company, **Constellation Software** in the Compounding stage of the corporate Life Cycle performed well over the quarter. The company announced a positive set of results, presenting an uptick in revenue growth and cash generation. Activity this quarter, has reiterated the company’s commitment to continuing to compound, doing fewer but larger deals and continuing to decentralise the management functions. The company appears able to deploy large amounts of capital during periods of economic and financial stress which gives us confidence in its ability to continue to scale and compound going into future quarters. **Steel Dynamics**, the US steel manufacturing and fabrication business in the Slowing & Maturing stage of the corporate Life Cycle, was a positive contributor to performance this quarter with a solid set of results. The fabrication business continues to deliver extraordinary performance and management provided more context on the aluminium investment, giving us greater confidence in the company's ability to replicate previous successes in this new venture and thus help beat the fade.

- Detractors from performance during the period under review included **Eli Lilly, Anglo American** and **UnitedHealth (UNH).** Global pharmaceutical powerhouse, **Eli Lilly** in the Compounding stage of the corporate Life Cycle was a pull on performance during the quarter. The market reacted negatively to weaker-than-expected newsflow surrounding new drug Mounjaro. This was a demonstration for us along with the market that it will take time for new drugs, even blockbusters, to have a material effect on financial performance, and more patience is advised to counteract some short-termism in markets. We do, however, maintain a positive view on the stock; we are confident in Lilly's world-leading diabetes franchise and promising pipeline with strong ability to compound over a long-term time horizon. We remain comfortable holders of the company at this attractive valuation. Mining giant **Anglo American** in the Turnaround part of the Corporate Life Cycle has been a detractor for performance over the quarter. While the miner continues to benefit from elevated commodity prices, cost inflation has been an impediment to margins and cash generation. This came alongside some mixed results in the middle of the quarter and a write-down on their investment in the Woodside mine, which the company is developing in the UK. Despite this, the valuation pay-off remains attractive. **UnitedHealth**, "Compounding", was a detractor this quarter. UnitedHealth delivered some good results at the top of the quarter with growth across its business areas, however, missed expectations for Optum Insight's profitability was noted; there were headwinds to this business with lower inpatient volumes and delays on technology update and growth projects. We do not this this as a structural issue and still maintain a positive view on UnitedHealth's Compounding ability over the long term at this valuation.

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. However, the outlook for interest rate progression is mixed due to some of the negative impacts of rising rates. Most recently highlighted by the collapse of SVB bank due to duration mismatches causing unrealised losses in held-to-maturity assets on their balance sheet. The Fed needs to balance the need to curb inflation without causing significant economic pain for the broader economy as all the mechanisms by which interest rate hikes affect businesses aren't immediately understood.

Find out more

- Articles, videos and webinars explaining our investment thinking can be found in the Our Views section of www.rlam.com, including regular updates from Head of Fixed Income Jonathan Platt, Head of Equities Peter Rutter, and Head of Sustainable Mike Fox. It also contains our recent webinar "Credit crunch or something bigger? Understanding current market volatility".

IMPORTANT INFORMATION

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