Wealth
Management

Quarterly Report
Sustainable Portfolio Service

Q2 2024

Forward-looking
for generations

Cover image
Bauer brothers, Hortus Botanicus, detail from "Lotus corniculatus L.," around 1788
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Summary: Q2 2024

At a glance

- Rate cutting cycle underway
- Equity markets hit new highs
- Global political uncertainty continues
- Value investments in sustainable portfolios help balance risk factors
- Reallocation of positions within the core, long-term structural, part of sustainable portfolios focusing on retaining an appropriate balance of risk.

Macro overview

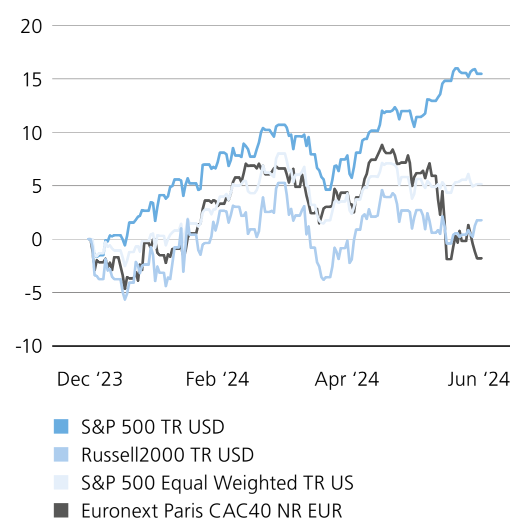
After many false starts, this quarter we saw more central banks opt for rate cuts. Most notably, the European Central Bank (ECB) cut rates by 0.25% to 3.75%. However, the number of future rate cuts remains uncertain. ECB President, Christine Lagarde, reiterated the importance of relying on data, analysing both the inflation outlook and underlying inflation before proceeding with future rate cuts. Meanwhile, the Swiss National Bank became the first central bank to issue its second rate cut in three months but delivered a rather hawkish message, indicating it is not sure when the next cut will be. Sweden and Canada also cut rates during the quarter.

Markets have oscillated between one and two Federal Reserve (Fed) rate cuts this year, although its most recent messaging indicates it will likely just be one. Stickier price pressures in the US and the resilient jobs market meant the Fed will not be able to move quickly with rate cuts as initially anticipated, and the timing remains uncertain. Meanwhile, the Bank of England indicated in June it is more comfortable cutting rates and is expected to start in August.

US equity markets hitting highs

US equity markets continued to hit all-time highs throughout the quarter, buoyed by technology companies Nvidia, Apple and Microsoft. Nvidia overtook Microsoft in June to become the world's most valuable company with a market capitalisation of USD 3.3 trillion, accounting for an astonishing 35% of the S&P 500's gains[1] so far this year. In addition to Nvidia's 12.7% increase[2] in June, Apple and Microsoft gained 9.6% and 7.7%.[3] This brought the S&P's performance to 15.3% for the first six months of the year,[4] underscoring the narrowness of the rally in US markets. If history is a guide, we believe other companies will eventually follow suit.

Equity markets performance YTD (USD terms)



Source: Bloomberg

> **After many false starts, this quarter we saw more central banks opt for rate cuts.**
>
> Sanjay Rijhsinghani, Chief Investment Officer, LGT Wealth Management

[1, 2, 3, 4] Bloomberg

The election year continues

Following UK Prime Minister Rishi Sunak's May call for a snap election in July, we had another surprise on the political front in June. The European Parliament elections in early June showed a surge of support for right-leaning parties, with President Emmanuel Macron calling a snap national election in France. The French CAC 40 fell by over 6% following Macron's announcement and spreads on French and German bonds reached levels not seen since 2017.[5] In the first round of the French parliamentary election, Marine Le Pen's National Rally party secured around 34% of the vote, with Macron trailing in third place. However, she is not projected to win an absolute majority, which brought relief to investors ahead of the second round on 7th July.

In India, Prime Minister Narendra Modi lost his outright majority for the first time in a decade and will now have to focus on forming a coalition government. This means passing important reforms will likely be more challenging. In Mexico, Claudia Sheinbaum's landslide victory sent the peso and Mexican equities falling, as markets feared these results would allow the ruling coalition to pass constitutional reforms and reduce checks and balances.

In the US, President Joe Biden faced Donald Trump in the first of two debates. Following a strong State of the Union Address in March, Biden had hoped to build momentum for his re-election bid by agreeing to debate two months before he is formally nominated. However, his disjointed performance in the debate has raised fresh concerns over the President's health and has sparked speculation about a change in candidate.

Asia facing challenges

Beijing unveiled wide-ranging measures to rescue its property market, including asking local governments to buy unsold homes from property developers and ease rules on purchases. These measures include providing cheap loans to state-owned enterprises to buy unsold homes from distressed developers and they will take time to filter through. The Shanghai Composite fell by -2.9% in May, bringing its year-to-date gain to 0.9%.[6]

Meanwhile in Japan, one of the country's oldest financial institutions, Norinchukin Bank will sell around USD 63 billion in overseas bonds, primarily US and European government debt, to cover its losses. This serves as a reminder of the risks high interest rates pose to the financial system. While higher interest rates benefit companies with high cash on their balance sheets, it hurts others holding low-yield bonds. Japan's Nikkei 225 rose 2.9%[7] in June and is up 19.3% so far this year[8] while the yen continued to slump to new multi-decade lows.

[5, 6, 7, 8] Bloomberg

Portfolios in review

Equity

Global equity market returns were positive during the quarter, building upon their strength earlier in the year, as growth remained robust and monetary policy in several G10 countries began the first steps into an easing cycle. However, beneath headline returns there was a significant dispersion of performance depending upon regions, sectors, market cap, and style.

There continued to be an outperformance of growth versus value and mega/large cap versus small/mid cap companies. This trend was particularly prevalent in the US where the outperformance of a handful of mega-cap companies in the Technology and Consumer Discretionary sectors, including Nvidia, Apple and Alphabet, were the overarching driver of the overall market return.[9] These moves benefitted US focused investments such as Alliance Bernstein Sustainable US Thematic.

In line with broader market movements, the more value orientated investments in sustainable portfolios have underperformed as the gravity of the aforementioned names carried the market higher. However, on a year-to-date basis and over the longer term continue to perform positively and balance the factor risks within sustainable portfolios.

In Asia, China experienced a positive swing in sentiment during the quarter, driven by a recovery in the real estate sector[10] following the announcement of additional government policy support measures. These positive developments helped to bolster returns in the Asia Pacific and Emerging Markets element of sustainable portfolios with all positions in this region outperforming their respective benchmarks.[11]

After large gains in the first three months of the year, the Japanese market lacked direction in the second quarter. Additionally, the depreciation of the yen led to overall negative returns from the allocation to Japan.[12] Over the longer term, the outlook for the equity market will be supported by a combination of improved domestic consumption, driven by positive real wage growth and structural reforms aimed at increasing the profit margins and returns of Japanese companies.

Despite the trends witnessed during the quarter and the narrow drivers of market returns, we continue to believe that a core, diversified collection of actively managed funds with a targeted bias towards quality, complemented by satellite positions made of high-conviction global investment ideas, will provide a durable return profile for the equity component of your portfolio over the long term.

Fixed income

Fixed income markets continue to be dominated by the macroeconomic environment as investors eagerly await central banks beginning their rate cutting cycles. Over the quarter, yields on government bonds moved slightly higher and volatility was high as the outlook for rate cuts shifted.[13] In April, continued strength of the US economy evidenced by a strong job market that supported consumer spending, led investors to conclude the economy was running hot and inflation would remain elevated. Nonfarm payrolls and retail sales both came in strong and manufacturing ISM moved into positive territory. Additionally, Consumer Price Index (CPI) data came ahead of expectations at 3.5%, while the Federal Reserve's (Fed) preferred inflation gauge, the Personal Consumption Expenditures Core Price Index (PCE) remained at 2.8% in March.[14] Consequently, the yield on the 10 year US Treasury bond rose to 4.7%[15] as investors pared back their expectations on the timing of interest rate cuts. This narrative extended to Europe where we witnessed the UK 10 year gilt climb 40 basis points to 4.3%,[16] and the German 10 year bund gained 30 basis points to 2.6%.[17]

[8, 9, 10, 11, 12, 13, 14, 15, 16, 17] Bloomberg

As investors grappled with higher-than-expected inflation in April, May and June brought some relief. In the US, softer economic data coupled with May's moderate CPI inflation reading of 3.4%[18] reassured investors that inflation is trending down. However, moderating inflation along with strong economic momentum caused markets to fluctuate between expectations of one and two rate cuts in 2024. Yields on government bonds recovered from their April highs but remained elevated compared to the beginning of the quarter. The European Central Bank (ECB) acted as expected by cutting its deposit rate by 25 basis points to 3.75% in June. As the decision was largely anticipated, the price response was limited. President Macron's decision to call a snap election did however surprise markets. Yields on French government bonds shot higher by 30 basis points with the spread between French and German bonds widening to the largest level in over a decade.

From a portfolio perspective, the fixed income component of the portfolio was flat over the quarter despite the adverse movement in yields. Our position in US inflation linked bonds performed as expected by mitigating against April's hot inflation print that sent nominal yields higher. Our two most interest rate sensitive positions in the portfolio were the only holdings to experience negative returns for the quarter, namely the long-dated UK 2053 Green Gilt.

Turning to credit markets, we witnessed slight tightening of investment grade credit spreads over the quarter as robust economic data and positive company earnings decreased the risk of default. Although a strong economy is not conducive to central banks' battle against inflation, it does increase the likelihood of corporates repaying their debt which has been supportive for the corporate debt market. Despite rising government bond yields, high-yield bonds at the riskier end of the corporate debt spectrum had a positive quarter, delivering low single-digit returns as their yields remained elevated.

Alternatives

Overall, it has been a positive second quarter of the year within alternatives, with the Bloomberg Commodity Index up 1.1% in USD terms.[19] Metals in particular were the top contributors, notably gold, which was up 3.3% in USD terms.[20] Portfolio wise, both Brevan Howard Absolute Return and Trojan Ethical delivered a positive return .

[18, 19, 20] Bloomberg

Positioning

As we remain focused on enabling the investments time to compound and the investment thesis to play out, there has been limited activity in sustainable portfolios. Early in the quarter, we reallocated some of the positions within the core, long-term structural part of sustainable portfolios by topping up the SparInvest Global Ethical Value strategy as we focused on retaining an appropriate balance of risk within portfolios. Such moves also enabled us to take some profits in areas of portfolios that have done well and top up other attractively valued investments.

In higher risk portfolios, we also introduced a position in the Cadira Sustainable Japan Equity strategy, run by a well-experienced team with over a decade of sustainable investing in the Japanese market and track record of alpha over the long term. We believe the medium- to long-term opportunity for Japanese companies is attractive and we will look to bolster exposure here as our conviction builds.

Sustainability update

Watching the flow of capital

One of the key tenets behind sustainable portfolios is to identify where attractive investment opportunities may come from in the future and where we can see attractive sustainable growth opportunities. To identify these, it is important to watch where global capital is flowing towards, as well as where it is flowing away from, and we continue to see record levels of debt being issued to pursue sustainable investment opportunities.

Sustainable debt issuance has reached a record high of USD 2.73 billion in the first quarter of the year, with a significant portion, USD 195.9 billion, coming from green bonds. The Climate Bonds Initiative (CBI) forecasts that green bonds are on track to reach a total of USD 1 trillion in issuance by the end of 2024. The United States has emerged as the largest single country source of green bonds in the first quarter of 2024,[21] with Constellation Energy becoming the first US company to issue a green bond for nuclear energy financing. The growing demand for these bonds is attributed to the erosion of the "greenium," where the lower yield on green bonds is now diminishing. As a result, investors can now invest in green bonds without sacrificing yield, making them a more attractive option.

The time value of engagement

Engagement is rarely an activity that bears fruit in the early days and is often a multi-year process. Rio Tinto, the global mining company, is a great example of this. In 2021, we joined Climate Action 100+, which engages Rio Tinto regarding its environmental footprint and collectively voted against its Climate Transition Plan due to its failure to include the entirety of its climate footprint in the scope of the plan (scope 3 emissions). We subsequently engaged the company directly in 2022. In 2023, we also joined Mining 2030, another collaborative engagement focused on creating a more sustainable mining sector and escalated our vote against all three members of the committee responsible for climate risk. This marked nearly three years of collective engagement with no progress. However, in 2024, the company announced a commitment regarding their scope 3 emissions. This engagement highlights the importance such collective engagements can have on pooling resource and expertise across the industry to lead to positive outcomes. We are proud to participate in such initiatives and play a role in creating a more sustainable economy via our stewardship and engagement activities.

We continue to see record levels of debt being issued to pursue sustainable investment opportunities.

Jordan Kelly, Sustainable Portfolio Manager,, LGT Wealth Management

[21] Green bond issuance surges as investors hunt for yield

Conclusion

At the start of the year, investors were expecting at least six interest rate cuts from the BoE, the Fed and the ECB. Stronger economic growth and stickier inflation have derailed this path, with only the ECB cutting rates so far. The market is now pricing in only two interest rate cuts for 2024 for the Fed and the BoE. The disappointment of this has been mitigated somewhat by improving earnings expectations, but whilst the market appears to have mostly shrugged off these concerns, high-level global index performance disguises historic levels of dispersion and divergence under the surface.

The higher-for-longer interest rate picture has created a split in the market. On the one hand, mega cap technology stocks have marched to the beat of their own AI-inspired drum. These companies have more cash than they do debt, meaning they are much less sensitive to interest rate changes. Their earnings growth is structural and therefore not currently subject to the economic concerns that higher interest rates bring. On the other side is the rest of the market - every other sector, region and company size grouping. In aggregate, higher interest rates impact these companies in a number of ways, raising the discount rate and lowering earnings via interest costs.

This has created an historic gap in performance between US market cap weighted indices (that have larger weightings to larger companies), and equal weighted indices (which show investors how the average stock has performed) and equity indices in other regions. At 6.9%, the performance differential between the S&P 500 and S&P 500 Equal Weighted[22] index in the months of May and June was the largest two-month gap since 1990,[23] a period that includes the tech bubble. Nvidia, the chip maker and a main beneficiary of investment in AI, has contributed over 30% (4.6%) of the total return of the S&P 500 (15.3%).[24]

This dynamic is creating a clamour for passive investing, as very few institutional active managers are overweight on the so-called Magnificent Seven. In the market, nothing works forever and, whilst we may look to add to our exposure to these companies should the opportunity present itself, we would expect the rest of the market to participate more in the rally from here for several reasons.

Firstly, whilst the level of rate cuts is disappointing relative to the start of the year's expectation, we do expect the cutting cycle to begin over the next few months. US economic growth finally appears to be slowing down, as the job market cools and consumer spending slows down. The last part of the fight against inflation seems to be merely lagged components, such as shelter and insurance, and should resume its decline over the remainder of 2024.[25] US interest rate cuts will give the market certainty about the discount rate and reduce interest expenses.

> “
> **The last part of the fight against inflation seems to be merely lagged components, such as shelter and insurance, and should resume its decline over the remainder of 2024.**
>
> Sanjay Rijhsinghani, Chief Investment Officer, LGT Wealth Management

22, 23, 24 Bloomberg

Secondly, the earnings growth differential between the largest seven stocks and the remaining 493, which has been historically wide over the past twelve months, is expected to narrow considerably over the next three quarters. EBITDA margins have declined from 17.9% at the start of 2022 to 15.8% for the average US stock, resulting in weak earnings despite relatively strong revenues. This margin compression is expected to reverse over the next 18 months, providing operating leverage. On the other hand, the Magnificent Seven's earnings growth is expected to slow from 53.4% this year, to 18.4% in 2025 and 12.2% in 2026.[26]

Ultimately, the value of artificial intelligence will only be realised if its benefits are widely distributed. For investments in AI-enabling chips and software to be justified, the broadening of the gains must occur.

25, 26 Bloomberg

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