Managed Portfolio Service

Quarterly report – Q2 2023

Introduction

Welcome to the RBC Brewin Dolphin Managed Portfolio Service (MPS) investment review. In this report, we cover information and events that influenced performance during the second quarter of 2023.

Global equities rose over the second quarter as signs of slowing inflation and economic resilience in the world's largest economy helped to outweigh concerns about further interest rate hikes.

The US Federal Reserve raised interest rates by a quarter of a percentage point in May, before electing to skip a rate hike in June. US inflation eased by more than expected in May, but continued tightness in the labour market means two further rate hikes are expected this year.

The European Central Bank and Bank of England (BoE) increased interest rates twice in the quarter, taking their main rates to 4.0% and 5.0%, respectively. The BoE chose to reaccelerate the pace of rate hikes in June after data showed inflation remained worryingly high. With a slew of UK mortgage deals due to end over the coming months, the second half of the year is expected to be a difficult one for the housing market and UK mortgage holders.

Among equities, the buzz around artificial intelligence boosted US technology stocks. It was an unprecedentedly narrow market – seven of the largest US companies, comprising 15% of the global equity market, rose by an average of 50% in the first half of the year. This far outstrips the broader market which, without those seven shares, would have experienced single-digit returns.

In China, investors became increasingly concerned about the country's post-pandemic economic recovery. Weak consumer spending and weak demand for exports resulted in factory output starting to cool. In Japan, where equities hit 33 year highs during the quarter, the central bank chose to maintain its dovish monetary policy stance.

The big picture in Q2 2023

- The second quarter of 2023 was a strong one for investments, despite central banks continuing to raise interest rates. Higher interest rates typically hinder investments, but there are signs that the interest rate cycle may be nearing its end. Several sources of inflation have eased, including supply chain issues and commodity prices. However, food prices in the UK have remained high, partly because of Russia's invasion of Ukraine. The war in Ukraine has also impacted gas and oil prices, and any disruption in Russian or Ukrainian production could raise global commodity prices again.

- Inflation persisted in the UK and Europe, leading to interest rate hikes by the European Central Bank and the Bank of England. The UK's price cap system has delayed the increase and subsequent decline in energy prices, contributing to the slower fall in inflation. The challenge of finding people to fill jobs has also driven policymakers to consider higher interest rates to dampen consumer demand. The Bank of England's interest rate setting committee must assess whether its actions will be sufficient to bring down inflationary pressures.

- Despite rising interest rates, there are opportunities for investors. Bond prices have fallen, but they now offer attractive returns for some investors. Shares, particularly technology shares, had a strong second quarter. However, the market has been narrow, with a few large US companies experiencing significant gains. Investors might question whether these companies can justify their inflated valuations and consider other opportunities that may have been left behind.

- While risks and challenges remain, the stock market has historically overcome adversity and provided growth for investors. It is important to strike a balance between caution and taking advantage of the market's resilience. Ultimately, excessive caution may lead to regret.

Market overview Q2 2023

- The second quarter of 2023 was a robust period for investments, even with central banks raising interest rates. The interest rate cycle may be nearing its end, which is a positive sign for investors.
- Bond prices fell over the quarter, with UK gilts faring particularly poorly and dropping over 5%. The consolation is that gilts now offer more attractive returns for some investors.
- Absolute return rose 0.5%. Despite some challenges, such as the -5.8% return in precious metals and -2.2% return in property, other parts of financial markets performed well.
- Equities had a strong second quarter. North America led the way with a return of +5.4%. The buzz around artificial intelligence meant US technology shares performed particularly strongly.
- Emerging markets and Japan equities also made solid gains, with returns of +4.0% and +3.0%, respectively. In contrast, UK equities fell -0.5% amid weakness in commodity prices and concerns about the outlook for the Chinese economy.

MPS performance

MPS PERFORMANCE												
	Q2	2023 YTD	1yr	2yr	3yr	4yr	5yr	2022	2021	2020	2019	2018
Cautious Portfolio	-0.7	1.0	0.1	-7.7	-0.1	2.7	7.7	-10.1	3.7	6.7	11.2	-2.7
Cautious Higher Equity Portfolio	-0.4	1.4	1.1	-6.7	2.8	5.3	10.3	-9.9	5.5	6.6	11.2	-2.7
Income Portfolio	-0.1	1.7	2.1	-5.9	6.4	8.1	13.4	-9.5	6.8	6.8	14.5	-4.2
Income Higher Equity Portfolio	0.3	2.2	3.5	-4.3	10.4	11.8	17.2	-8.8	8.4	6.9	14.5	-4.2
Balanced Portfolio	0.8	2.8	5.0	-3.8	14.5	15.7	21.3	-9.0	10.8	7.6	16.4	-3.9
Growth Portfolio	1.2	3.4	6.6	-3.0	20.8	22.1	27.7	-9.2	13.8	9.9	18.4	-4.2
Global Equity Portfolio	1.9	4.2	8.9	-1.3	27.3	27.0	31.9	-8.9	16.3	9.7	22.1	-5.2

All figures shown above are calculated to 30 June 2023.

Performance Calculation: All income is reinvested. Performance is shown inclusive of underlying fund charges but gross of RBC Brewin Dolphin's investment management charge. Deduction of this charge will have the result of reducing the illustrated performance. Neither simulated nor actual past performance are reliable indicators of future performance.

MPS performance highlights Q2 2023

Asset Allocation

What worked and why?

The underweight position in bonds helped to support the portfolio over the quarter.

What didn't work and why?

The overweight positions in cash and absolute return detracted from performance.

Fund Selection

What worked and why?

The Winton Trend and SCOR Cat Bond funds both performed very well over the quarter. In the US, Baillie Gifford American and Artemis US Select contributed to performance.

What didn't work and why?

Gold, which is priced in US dollars, struggled over the period as sterling strengthened. In the US, JPM US Equity Income and BNY US Equity Income detracted from performance.

MPS portfolio changes Q2 2023

Asset Allocation

In May, the Asset Allocation Committee recommended increasing the allocation to UK gilts. Reductions have been made to absolute return strategies. Small adjustments were made to the regional equity allocation to account for market movements.

Fund Selection

In April, following a change in recommendation by our Fund Research team, the Man GLG Sterling Corporate Bond strategy was introduced into the MI Select Managers Bond fund. It replaces PIMCO UK Corporate Bond, which will see the fund manager retiring later this year.

Graham Macro was added as a holding within the MI Select Managers Alternatives fund in June following a recommendation by our Fund Analyst team. The team has a strong track record and should improve diversification within the alternatives exposure.

MI Select Manager fund weights

MISM FUND WEIGHTS			
Date	**MISM Fund**	**Mandate**	**Weight (%)**
30/06/2023	MI Select Managers Bond Instl Inc	Robeco Global Credits	27
		Man GLG Sterling Corporate Bond	14
		Insight UK Government Bond	19
		Colchester Global Bond	23
		DWS US TIPS	12
		Other fixed income funds	5
30/06/2023	MI Select Managers NA Equity Instl Inc	JPM US Equity Income	31
		Baillie Gifford American	11
		BNY Mellon US Equity Income	27
		Artemis US Select	31
30/06/2023	MI Select Managers UK Eq Inc Instl Inc	Ninety One UK Equity Income	41
		Man GLG UK Equity Income	41
		CT UK Equity Income	18
30/06/2023	MI Select Managers UK Equity Instl Inc	JPM UK Equity Core	31
		Redwheel UK Equity Income	28
		Lindsell Train UK Equity	28
		Jupiter UK Mid & Large Cap Crossover	6
		Teviot UK Smaller Companies	7
30/06/2023	MI Select Managers Alternatives	Commodities and other alternatives	34
		Muzinich Global Tactical Credit	17
		Ninety One Global Macro Alternatives	12
		Schroder Global Cities	14
		NN Global Convertible Bond	11
		Absolute Return funds	12

The value of investments, and any income from them, can fall and you may get back less than you invested.Neither simulated nor actual past performance are reliable indicators of future performance. Investment values may increase or decrease as a result of currency fluctuations. Information is provided only as an example and is not a recommendation to pursue a particular strategy.

Asset Allocation Committee investment outlook

These views are implemented across our portfolios but there may be deviations where asset classes or suitable investments are unavailable or excluded.

Cash

We remain overweight cash. Cash offers an increasingly attractive return and is a desirable asset class at a time when global growth momentum is slowing.

Bonds

We have a moderate overweight to government bonds. It would be surprising to see central bank interest rate expectations move substantially higher. Government bond performance generally moves in a very close inverse fashion with rate expectations. Among our three government bond categories, we favour gilts, in large part due to the UK's interest rate sensitivity. Meanwhile, we remain underweight corporate bonds. In our view, credit spreads are not sufficiently large to compensate for global economic growth risks. Meanwhile, with yield curves deeply inverted and central banks unlikely to start cutting rates any time soon, the risk-free component is unlikely to support corporate bond performance over the next couple of months.

Global Equities

Recession risks are currently elevated – we attach a slightly higher than 50% chance of a recession occurring in the first half of 2024. These odds aren't as high as some forecasters, but they are well above the odds of a recession in any given year. However, due to the uncertainties, it makes sense to perform a scenario analysis and attach weights to different outcomes. On this basis, the equity outlook does not look appealing relative to cash. After adjusting for the fact that equities are higher risk, the relative attraction of cash over equities increases. This thinking underpins our desire to remain overweight cash and slightly underweight equities.

Alternatives

The gold price has historically been inversely correlated with real (inflation-adjusted) bond yields. With this in mind, gold has held up surprisingly well given the surge in real yields over the past 16 months. The reportedly strong buying from foreign official sector purchasers (China, Russia) looking to diversify their reserve holdings probably explains some of the divergence. In our view, real yields are unlikely to go up or down by much over the next couple quarters. As such, we retain a neutral position to gold. We remain underweight property. Real bond yields should remain elevated (for now), inflationary pressures are weakening, and credit conditions are tightening. We have also reduced our exposure to absolute return to fund our government bond weighting increase.

UK Equities

After strongly outperforming in 2022 (in common currency terms), UK equity relative performance has underperformed the global equity benchmark in common currency terms so far this year. Although strength in the pound versus the dollar has been supportive, value-style stocks have fallen out of favour relative to their growth-style counterparts, a development that tends to weigh on UK equity relative performance given its high exposure to the former. Looking ahead, the outlook for value vs growth equities is balanced, in our view. Meanwhile, the boost to UK equity relative performance that could come from any further gains in the pound appear to be offset by a relatively challenging domestic growth backdrop.

US Equities

With tech looking overbought in the short term, and given the lack of catalysts to push the dollar higher, it's not clear that now is the best time to pile aggressively into the US at the expense of other regions. However, growth in artificial intelligence (AI) looks set to develop into a long-term structural tailwind that benefits the US equity market disproportionately. Against that backdrop, it appears justified to maintain a structural bias to the US, much in the same way that Japan's demographic challenges justify a structurally cautious stance. We're inclined to think that looking for more attractive entry points to add to US equity positions relative to other regions appears to be the best strategy at this stage.

Europe ex-UK Equities

Despite the renewed rally in the euro and broader European FX, Europe ex-UK stocks have not outperformed in common currency terms. That's because the region has low exposure to the names benefitting from the buzz around AI. Globally, when tech stocks outperform, that tends to coincide with Europe ex UK underperformance. Looking ahead, it doesn't appear to be a good time to add exposure to AI plays due to concerns about valuation and the disconnect from bond yields. Equally, given the potential for what currently looks like a mini-bubble to turn into a bigger bubble, one would not want to be underweight these names relative to the global equity benchmark. With this in mind, and given the mixed backdrop for European FX, in our view it makes sense to continue to hold positions in Europe ex-UK that are consistent with it performing broadly in-line with the global equity benchmark.

Japan Equities

In our view, to get the Japanese equity relative performance outlook right, the best approach is to gauge relative economic growth prospects. Looking ahead, Japanese gross domestic product (GDP) growth is likely to outperform US GDP in common currency terms over the near term. First, there appears to be scope for the yen to appreciate vs the dollar. Second, Japan's economy should expand at a reasonable pace at a time when we expect US GDP growth to be sluggish. Against that backdrop, there's probably a window for Japanese equities to continue to outperform. That said, in the long term, with both the population and birth rate in freefall and given Japan's lack of enthusiasm for immigration, Japan's demographics should act as a roadblock to any sustained economic and equity outperformance.

Asia ex-Japan Equities

Contrary to consensus expectations, it does not appear that China is set to slip into a deflation phase. Down the line, while pockets of deflation within the country and in certain sectors are likely, it seems unlikely that the authorities would tolerate sustained, broad-based deflation. Even with the recent growth stumble, it's still not a bad bet that GDP in China and the region more widely outpaces that of the rest of the world over the balance of this year and next. Meanwhile, more and more investors are throwing in the towel on China, with several large banks recently downgrading both Chinese GDP and year-end equity targets. Despite this alluring combination, we are not optimistic with regards to Asia ex-Japan relative performance. It would be surprising to see much additional downside vs the global market, but equally risk/reward doesn't appear to be attractive.

Emerging markets ex-Asia Equities

Brazil, Saudi Arabia, South Africa, Mexico, and the United Arab Emirates are the countries with the highest market capitalisation weightings in the EM ex-Asia equity index, making it very commodity exposed. There are crosscurrents confronting the region. On the one hand, we don't expect much upside to commodity prices in an environment where global growth is slowing and China refrains from large scale stimulus. That said, EM ex-Asia remains very cheaply valued.

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