Brewin Dolphin

Passive Plus Managed Portfolio Service

Quarterly report – Q3 2023

Introduction

Welcome to the RBC Brewin Dolphin Passive Plus MPS investment review. In this report, we cover information and events that influenced performance during the third quarter of 2023.

Global equities and government bonds declined in the third quarter, with yields peaking in September.

Commodities outperformed – particularly energy, which saw gains as Saudia Arabia and Russia cut oil production.

One of the defining trends of the year remains the outperformance of a handful of the biggest US companies, including Apple, Amazon, Microsoft, Tesla, Alphabet (owner of Google), Meta (owner of Facebook) and Nvidia (which makes graphics processors with multiple uses in artificial intelligence (AI) and other technologies).

The Federal Reserve and the Bank of England kept interest rates on hold in September, whereas the European Central Bank (ECB) hiked its deposit rate by a quarter percentage point to 4%, the highest level since the euro was introduced in 1999.

Eurozone inflation declined to 4.3% year-on-year in September, the lowest level in two years, raising hopes that interest rates may have peaked. US inflation is also on a downward trend, but the Federal Reserve has still indicated a further rate hike may be coming before the end of the year.

The Chinese stock market declined sharply in August on the back of turmoil in the country's property sector. Country Garden, China's largest private developer, was one of several major developers to struggle, warning it was at risk of defaulting if its liabilities continued to deteriorate. The Chinese stock market saw a boost in late August after the government introduced a 50% stamp duty tax cut on share dealing.

The big picture in Q3 2023

- The third quarter of 2023 has seen a shift in markets. The year began on a positive note, with stocks performing better than expected in the first half, following a challenging 2022 marked by high inflation and aggressive interest rate hikes. Concerns about inflation and recession receded in 2023, with inflation slowing down in many regions, including the US. The economy proved resilient, with consumers eager to spend their savings accumulated during lockdowns. Technology stocks, which had suffered in 2022, led the gains in 2023, further boosted by the introduction of practical generative AI tools.
- However, the third quarter saw a loss of momentum in stocks, with the global market peaking in July. This was against a backdrop of changing economic dynamics, including a sharp increase in oil prices in June. The rise in oil prices was due to a combination of factors, including supply and demand dynamics, the decision by the Organization of the Petroleum Exporting Countries (OPEC) to restrict output, and sanctions on oil supplies from Iran. The reluctance of producers to invest in fossil fuel energy due to future demand uncertainties also supported short-term oil prices.
- The global economic outlook remains uncertain. While US consumption has remained strong, other regions are seeing slowing demand. In the UK, consumer activity and job growth have started to slow, and persistent wage pressures make it difficult for the Bank of England to provide relief. The costs of home ownership in the UK have been slow to adjust to higher interest rates, and an increasing number of borrowers are having to refinance their mortgages at higher rates.
- The long-term outlook for public finances in many countries requires hard choices, and the upcoming elections in the UK and US will bring into focus the willingness of potential leaders to make these choices.

Market overview Q3 2023

- The sharp increase in oil prices over the third quarter had an impact on the market. Oil stocks performed well whereas tech stocks took more of a back seat compared to the first half of the year.

- In terms of asset class performance, absolute return and gold did well, returning +1.4% and +1.7%, respectively.

- Cash also gave a positive return thanks to higher interest rates. On the other hand, commercial property saw a negative return of -3.4%, and global bonds experienced negative returns. UK bonds were a little more resilient.

- In equity markets, Japan and emerging markets led the way with returns of +3.1% and +2.6%, respectively. North America and the UK also showed positive returns, while European equities faced a setback with a return of -1.9%.

The value of investments can fall and you may get back less than you invested.

Passive Plus MPS performance

PERFORMANCE												
	Q3	**2023 YTD**	**1yr**	**2yr**	**3yr**	**4yr**	**5yr**	**2022**	**2021**	**2020**	**2019**	**2018**
Cautious Portfolio	-0.8	0.5	2.4	-8.8	-2.4	-3.2	2.6	-10.8	4.5	4.2	10.0	-3.2
Cautious Higher Equity Portfolio	-0.6	1.4	3.6	-7.0	2.3	0.9	3.7	-10.5	7.2	3.4	10.0	-3.2
Income Portfolio	-0.4	1.8	4.2	-5.9	5.5	2.6	6.8	-9.9	8.7	2.5	12.2	-4.8
Income Higher Equity Portfolio	-0.1	3.1	5.8	-3.1	11.5	7.9	7.9	-9.0	11.2	1.9	12.2	-4.8
Balanced Portfolio	0.2	3.9	6.7	-1.3	16.0	12.0	17.4	-8.3	13.8	2.4	15.0	-4.6
Growth Portfolio	0.4	5.0	8.3	1.2	23.4	18.7	24.2	-7.4	17.1	2.4	18.4	-5.7
Global Equity Portfolio	1.0	6.8	10.8	4.2	31.8	24.1	29.7	-6.9	20.4	0.9	21.7	-7.4

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.

Passive Plus MPS performance highlights Q3 2023

Asset Allocation

What worked and why?

The underweight to property was a mild contributor to outperformance.

What didn’t work and why?

There was no significant detraction from allocation this quarter.

Fund Selection

What worked and why?

The Winton Trend and SCOR Cat Bond strategies both performed very well over the quarter.

What didn’t work and why?

The L&G UK Midcap strategy and Ninety One Global Macro Alternatives strategy detracted over the quarter.

Passive Plus MPS portfolio changes Q3 2023

Asset Allocation

In July, the Asset Allocation Committee recommended an increased exposure to fixed income within portfolios. This allocation was offset against a decrease in absolute return by 1%. The rationale was that yields were more attractive and the downside risks of persistently high inflation were now better balanced against the risk of an economic slowdown. The committee elected to add 0.5% each to global sovereigns and inflation-linked bonds, and also rotated 0.5% from global credit into UK credit as a valuation gap has opened up, making UK bonds more attractive.

Fund Selection

In July, the allocation to sovereign bonds was increased while the MI Select Managers Alternatives fund was decreased. Within the MI Select Managers Alternatives fund, a number of absolute return strategies were reduced.

In August, the HSBC Global Corporate and Global Government bond funds were introduced in Passive Plus.

As we move towards the end of the rate tightening cycle for central banks, and Japanese rates begin to normalise, we believe it is appropriate to diversify the bond exposure beyond the US.

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 offers an increasingly attractive return and is a desirable asset class at a time when the risk/reward backdrop for equities is not great.

Bonds

We have an overweight to government bonds. Government bond performance has a tight inverse correlation with central bank rate expectations. While we don't foresee rate expectations dropping meaningfully anytime soon, it would be surprising for them to move substantially higher. Among our three government bond categories, we favour gilts, in large part due to the UK's interest rate sensitivity and challenging growth outlook. Meanwhile, we remain underweight corporate bonds. In our view, credit spreads are not sufficiently large to compensate for global economic growth risks.

Global Equities

Factors supportive of global equities at present are the resilience the economy has exhibited, the potential for AI themes to push equity prices higher, and sentiment, which has turned negative. The main headwinds are the current stage of the economic cycle (late), monetary policy (tight), valuation metrics (high), the returns available on competing assets such as cash (high) and the technical backdrop (poor). Weighing everything up, the cons seem to outweigh the pros. We maintain a mild underweight.

Alternatives

The gold price has historically been inversely correlated with real (inflation-adjusted) bond yields. Notwithstanding the decline over the past four months, gold has held up surprisingly well given the surge in real yields since early 2022, not to mention the strength in the dollar. 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 of quarters. As such, we retain a neutral position to gold. We remain overweight property, as real bond yields should remain elevated (for now), inflationary pressure is weakening, and credit conditions are tightening.

UK Equities

After strongly outperforming in 2022 (in common currency terms), UK equity relative performance has underperformed the global equity market this year. The main headwind has been the fact that globally, value style stocks have fallen out of favour relative to their growth style counterparts. This tends to weigh on UK equity relative performance given its high exposure to the former (via energy and financials mostly) and low exposure to growth-oriented tech. We would advise against looking at the underperformance this year as an opportunity to raise UK equity exposure versus the global benchmark. Although we expect the outlook for value versus growth equities to be more balanced going forward, the domestic growth backdrop remains challenging.

US Equities

There are several factors leaning against the US. Tech stocks appear to have disconnected somewhat from both their industry and macro fundamentals. The broad US market is trading on significantly higher than normal premiums compared to their global ex US counterparts. Finally, the dollar is richly valued, making it vulnerable to a decline in the longer term. Importantly, these headwinds are offset by several tailwinds. The US, with both its defensive currency and sector composition, is generally a good market to be in when global economic growth slows. Even if digital stocks are expensive, the structural demand backdrop for the goods and services they sell appears strong. Despite their strong performance, there doesn't appear to be excessive froth around tech nor the US market more broadly. Against this mixed backdrop, it doesn't appear to be a good time to make big bets on the US equity relative performance outlook in either direction.

Europe ex-UK Equities

After a strong start to the year, Europe ex UK stocks have sharply underperformed in common currency terms since the end of April. Sparking the underperformance has been the fact that 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. European currency weakness versus the dollar has since mid-July made things worse. Looking ahead, it doesn't appear to be a good time to add exposure to AI plays due to concerns about valuation. 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 AI 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 late July, the Bank of Japan (BoJ) surprised markets by tweaking its yield curve control policy in what was considered a stealth way. While it maintained guidance of allowing the ten-year Japanese government bond (JGB) yield to move +/- 0.5% around the 0% target, this would now be considered a "reference" rather than rigid range. The BoJ promised to buy ten-year JGBs in fixed-rate operations at the 1% level, instead of the previous rate of 0.5%. This effectively signals that it will now tolerate a rise in the ten-year yield to as much as 1%. Looking ahead, if the yen strengthens as we expect, Japanese GDP is likely to outperform US GDP in common currency terms. Against that backdrop, there's probably a window for Japanese equities to outperform. That said, in the long term, with both the population and birth rate in free fall and given Japan's lack of enthusiasm for immigration, Japan's demographic should act as a roadblock to any sustained economic and equity outperformance.

Asia ex-Japan Equities

Following a promising start to the year, incoming Chinese economic data has disappointed. Property remains a key area of weakness. House prices continue to contract, and residential floor space sold remains deep in negative territory on a year-on-year basis. Unlike much of the rest of the world, deflation rather than inflation is the bigger concern. Even with the 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. Despite this attractive combination of decent relative growth prospects and poor investor sentiment, we are not optimistic with regards to Asia ex Japan relative performance. It would be surprising to see much additional downside versus 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. 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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BDM4769_2310_0.3
Issue date Xxxxxxxx 2023