MONTHLY UPDATE

Latest views from the investment team

Is cash king?

Multi-asset portfolios closed out the first half of 2023 with a modest gain. Equity returns were led by US (largely the technology sector), Japanese and European markets, whilst UK equities were flat and emerging markets fell. A stronger pound, against most currencies this year, held back overseas equity returns. Interest rate rises continued at pace this year, capping bond returns. In the UK, base rates hit 5% in June, leading us to ask the question – is cash now king?

The effect of interest rate rises can vary depending on the asset class, but typically those that benefitted from the ultra-low interest rate environment of the 2009-2021 era are now under pressure following the rate rises (especially at the pace they have done). Broadly speaking, it is the most conventional asset classes, such as equities and bonds, that have suffered the most. This was the driving factor for multi-asset portfolios having such a difficult year in 2022 – a repricing of assets, relative to interest rates.

With interest rates in the UK and US around 5%, cash is now a credible option in portfolios, as well as an asset class for investors to consider in isolation. Many more offerings are becoming available for investors to access a return near to that of interest rates, whether that is bank savings rates or money market funds. An example of one such option is our Cash+ portfolio, providing investors with near base rate exposure, through a mix of money market funds and ultra-short duration bond funds. Equally, some banks are offering savings accounts close to that of current base rates.

Whilst cash is clearly attractive, investors need to consider what holding cash means, relative to their longer-term goals. Whilst stocks and bonds have struggled in the last 18 months, they have (historically) been a sensible blend of assets to hold over the long-term to provide inflation beating returns, well ahead of cash. The repricing of cash rates has also made bond and equity investments considerably more attractive, where investors can reasonably assume long-term expected returns are now more favourable than they were two years ago. Bonds, for example, offer yields between 5% (for short-dated government bonds) and 10% (for high yield bonds), compared to 0% and 4%, respectively, at the beginning of last year. Our preference is in short-dated investment grade corporate bonds, where investors can get attractive yields of around 6.5%, without taking much credit or duration risk. Longer dated government bonds, whilst yielding closer to 4%, offer an attractive recession hedge. In addition, index-linked bonds provide investors with protection against inflation moving back above trend. Equity investments are more fairly valued as well after the post-pandemic exuberance, with valuation metrics such as price/earnings and price/book value ratios closer to long-run averages, meaning investors are no longer over-paying for stocks.

Bottom Line

The re-pricing of cash rates has provided a credible alternative asset for investors to consider, but also materially improved the attractiveness of investing in equities and (more so) bonds. For investors with longer-term goals, the valuation backdrop of a multi-asset portfolio, and thus the expected longer-term returns, has improved with the rise in cash rates. Therefore, any allocation to cash, through a portfolio strategy or bank deposit, should be considered part of a longer-term strategy.

Month by numbers

Change in various markets over the month:

Asset	Direction	Change	Value
Equities			
UK	↑	1.25%	
Europe	↑	2.67%	
US	↑	6.63%	
Emerging Markets	↑	3.45%	
Japan	↑	7.69%	
Bonds / Rates (* Absolute change (%))			
UK Base Rates	↑	0.50%	5%
Fed Funds Rate	–	0.00%	5.25%
UK 10-Year Yield	↑	0.21%	4.39%
US 10-Year Yield	↑	0.18%	3.81%
Currencies			
GBP / USD	↑	2.58%	$1.27
GBP / EUR	↑	0.26%	$1.17
DXY (USD Index)	↓	-1.36%	102.91
Commodities			
Gold	↓	-2.18%	$1,919.90
Oil (Brent)	↑	3.08%	$74.90
Note worthy			
Carnival PLC	↑	64.03%	

Q&A

What's on your mind?

Why are interest rates so important to investors?

As interest rates rise, the attractiveness of holding savings, over conventional asset classes like equities and bonds, also increases. Both bonds and equities are effectively priced off interest rates. For bonds, generally speaking, when interest rates rise, so do yields, and as a result prices fall. For equities, a component part of the valuation is the discount rate applied – as this increases (when rates rise), so does the discount rate applied to future growth and thus valuations come down. Investors need to also consider the second order effects that increased interest rates have, such as the tightening of financial conditions and the constraints this has on growth. In some cases this can be recession inducing, which is another reason why equities have struggled to make much progress in recent years, as fears of a recession have kept investors cautious.

How do sovereign bonds provide resilience in periods of economic stress?

Sovereign bonds are debt issued by governments to support public spending. They are an integral part of any multi asset portfolio providing a stable cash flow in normal times while offering some needed resilience in periods of economic stress. An example of this resilience came in the calendar year of 2008, when, amid the financial crisis, UK Government bonds returned 12% while the global equity market fell over 20%. What is it that gives sovereign bonds such defensive characteristics? Firstly, there is very little risk of default, or in other words it is very unlikely, especially in developed economies, that the government will not repay their debts. Secondly, during recessions, central banks tend to cut their base rate to help stimulate the economy, which has the effect of reducing yields on sovereign bonds. As stated above, when bond yields fall, their price rises, allowing sovereign bonds to benefit from an economic downturn.

What is the summer seasonal effect on markets?

The renowned stock market adage "sell in May and go away" suggests that equity markets tend to face challenges in the summer months. Data supports this claim, dividing the year into May-October and November-April periods and comparing performance over the past 50 years. In this 50-year stretch the UK market experienced average monthly returns of -0.04% during May-October, while November-April showed higher returns of 1.09%. This trend is observed in other countries' equity markets too, with the leading indexes in the US and Europe also performing notably better in the November-April period. It is believed that reduced trading volume and increased volatility during summer months, as fund managers and traders take time off, contribute to this pattern. Some also argue that this cycle has become self-fulfilling. We are more sceptical of this phenomenon and place little value on it in our decision making!

For more information, please contact your adviser.

Disclaimer

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