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WEALTH PLANNING

Portfolio and Market Review

1st Quarter 2023

Economic Outlook & Market Commentary – April 2023

If 2022 taught investors anything, it was that they must be prepared for the unexpected. Last year was a tumultuous roller coaster ride for financial markets. The year began with cautious optimism, as lockdowns were lifted, and it seemed like the world was returning to normal.

However, this optimism was short-lived. Within months, Putin's *Special Military Operation* had not only shaken the peace of Europe but also the financial markets. The resulting sanctions imposed by major economies exacerbated already rising inflation, leading to price increases not seen for generations. In the latter part of the year, the mismanagement of the UK economy caused bond prices to drop by record amounts. The events of 2022 served as a stark reminder that unexpected geopolitical events, as well as economic challenges and disruptions, can have far-reaching consequences for investors.

Investors can be forgiven for thinking that, for 2023, they deserve a reprieve. And judging by the performance of the equity and bond markets over the first quarter they might just get one. Despite stubbornly high inflation and a banking crisis, both equity and bond markets posted single-digit gains over the quarter, providing some much-needed relief.

Not 2008 Again

The global banking sector has faced a crisis as Silicon Valley Bank (SVB), a medium-sized regional bank in the US, went into administration on 10th March. This event marked the largest bank failure since the 2008 Global Financial Crisis, causing widespread panic among investors. The situation escalated as other regional US banks like Signature Bank and Silvergate Capital fell into the hands of the regulator. These developments significantly impacted investor and depositor confidence, leading to a notable downturn in bank share prices.

By 15th March, Credit Suisse, the Swiss banking giant, found itself at the epicentre of the crisis when its largest shareholder, Saudi National Bank, confirmed that they could not provide any additional funding. This news, coupled with a series of previous scandals, alarmed investors and Credit Suisse's shares lost a quarter of their value in a single day. Credit Suisse secured a lifeline of £44 billion from the Swiss National Bank and was acquired by competitor UBS less than a week later.

It is crucial to differentiate between the events that transpired in the US market with Silicon Valley Bank and the challenges faced by UK and European banks, such as Credit Suisse. SVB primarily served the technology industry, and due to the booming tech sector in recent years, had accumulated substantial deposits from commercial clients such as venture capital firms and technology companies. Normally, banks create assets by issuing debt to their clients. However, Silicon Valley Bank faced an issue where it was not able to generate enough assets by lending all available funds to its current clients, given the large value of deposits amassed. As a result, the bank resorted to buying assets such as long-dated treasury securities and asset-backed securities that are highly sensitive to rising interest rates.

Over the past year, as interest rates rose, the value of these assets fell sharply. Most depositors at SVB were large corporations that were not covered by the FDIC, which is the US equivalent of the UK's FSCS deposit insurance scheme. The declining asset prices and lack of deposit insurance raised concerns among large depositors about the safety of their funds, exacerbating the situation and leading to significant withdrawals. This is in contrast to the UK

and European banks, such as Credit Suisse, which faced their own set of challenges and threats in a different context.

When looking at the shocks experienced by European and UK banks, it becomes evident that these were primarily a crisis of confidence in the banking system, rather than a risk management crisis. Credit Suisse, in particular, has been severely impacted due to its weak financial performance and a series of scandals that have unfolded over the past two years. The combination of these factors has eroded investor confidence in the bank and led to a significant loss of trust.

What does the impact of the crisis mean for your portfolio? At Timeline, we employ a strategy of global diversification when constructing portfolios, which avoids concentrated positions in any single sector or company, such as SVB .The recent bank failures in the US account for less than 0.05% of our globally diversified investment approach. However, we acknowledge that these events have had an impact on share prices across the entire financial industry.

Economic Outlook

Getting to the Core of Inflation

Over the last year, rising inflation has been a constant and unwelcome companion. Inflation can be detrimental to equity and bond investors as it erodes the purchasing power of their returns. In addition, the policies employed by central banks to reduce inflationary pressure, e.g., increasing interest rates, can negatively impact stock prices and bond yields. With inflation in the UK currently at 10.4%[1], 6.9%[2] in the Eurozone and 6%[3] in the US, it's clear the inflation picture remains challenging. However, there are signs that inflation has started to slow.

Good news, to an extent. The figures quoted above and more widely in the media reflect *headline* inflation, including both core and non-core components. Non-core inflation refers to volatile elements such as food and energy prices, which can fluctuate rapidly and unpredictably. Core inflation, on the other hand, excludes these elements and focuses on more stable and consistent price trends.

The problem is that the recent declines in inflation can predominantly be attributed to declines in energy prices, which fall into the non-core inflation category. In the UK, core inflation increased to 6.2% in February, up from 5.8% in January, compared to a forecast of 5.7%, with similarly elevated levels of core-inflation remaining in the Eurozone and US.

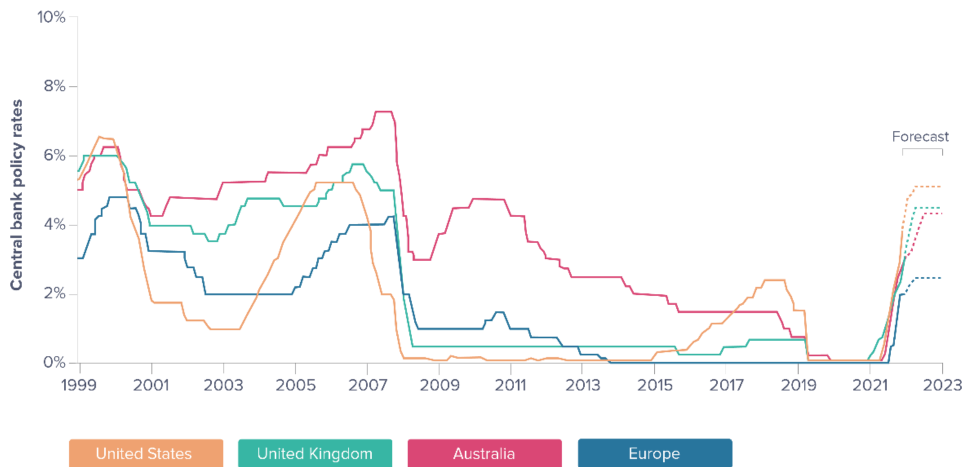
Source: Office for National Statistics (2023).

Central banks tend to focus on core inflation, when setting monetary policy, as they want to avoid overreacting to temporary fluctuations in non-core inflation, which could cause them to take inappropriate actions that harm the economy over the long term. It's widely expected that interest rates will continue to rise until mid-2023.

Indeed, in the UK in the first quarter, we saw the eleventh consecutive rise in interest rates, up from 4% to 4.25%. In a speech at the end of March, Andrew Bailey, the Governor of the Bank of England (BoE) made it clear that "*we have to be very alert to any signs of persistent inflationary pressures. If they become evident, further monetary tightening would be*

[1] Office of National Statistics (2023).
[2] Eurostat (2023).
[3] US Bureau of Labour Statistics (2023).

required"[4]. The European Central Bank (ECB) raised interest rates by 0.5%, to 3.5% despite fears that higher borrowing costs would further impact on the banking sector. It was a similar story in the US, with the Federal Reserve raising rates from 4.75% to 5% in March.



Source: Vanguard economic and market outlook for 2023: Beating back inflation Vanguard calculations, based on data from Thomson Reuters Datastream and Bloomberg.

Source: Vanguard (2023).

The central banks' approach to inflation appears to be working, as we have witnessed a steady decline in inflation since its peak in the latter part of 2022. Moreover, Vanguard, Northern Trust, and the International Monetary Fund (IMF) have issued year-end forecasts that suggest a positive outlook.

2023 Year-end Inflation Forecasts (UK)		
Vanguard 6.30%	Northern Trust 3.30%	IMF 5.90%

2023 Year-end Inflation Forecasts (US)		
Vanguard 3.00%	Northern Trust 3.10%	IMF 2.90%

Sources: Vanguard (2023); Northern Trust Asset Management (2023); International Monetary Fund (2022).

Despite the favourable forecasts above, investors should be prepared for interest rates to remain high to at least mid-2024 as core inflation tends to be more "sticky". It is typically driven by more persistent factors such as wages, productivity, and long-term supply and demand imbalances. As a result, changes in core inflation tend to occur gradually and are often more closely tied to the overall health of the economy.

In the UK, the labour market remains historically tight. In January, government figures showed there were over 1.16 million job vacancies and that wages had grown at their fastest rate in over 20 years in the three months to November 2022. Despite this, wage increases failed to

[4] Bank of England (2023).

keep pace with inflation. Labour shortages are also impeding the US, where there are currently 9.9 million[5] job openings, and Europe, where there are 4 million .[6]

Higher labour costs can lead to higher prices for goods and services, as businesses pass on these increases to consumers. Wage growth also contributes to inflationary pressures by boosting consumer spending, which in turn can lead to increased demand for goods and services, putting further upward pressure on prices. Economic growth can be harmed, as businesses struggle to hire enough staff. In Germany, for example, labour shortages are believed to cost the economy €86bn per year in lost output.[7] Governments are attempting to address this labour shortage by encouraging economically inactive people back into work and increasing migration, but this is not a problem that's easy to fix quickly.

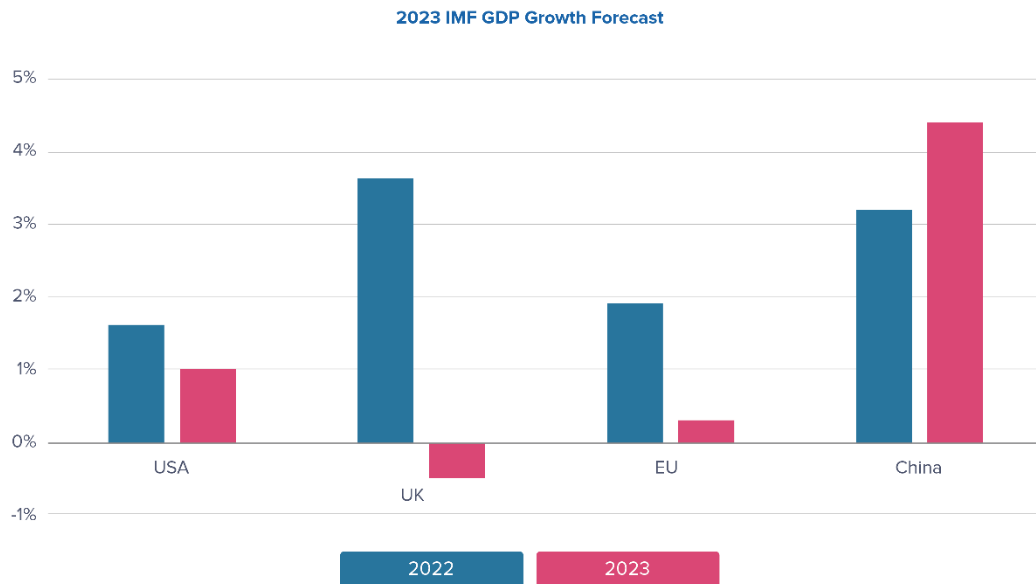
A Recession Reprieve?

The UK was widely believed to have entered recession in the last quarter of 2022. However, revised figures released at the end of March showed that growth in the last three months of 2022 was mildly positive at 0.1%, compared with an expected fall of 0.2%. The Governor of the BoE expressed optimism, commenting that he was "*much more hopeful*" for the economy, and that there would not be a recession in the UK this year.

While the UK may have avoided recession, the IMF believes it will be the worst performing economy of the developed nations, shrinking by 0.6% in 2023. To put things in perspective, Russia's economy, burdened by sanctions is forecast to shrink by 0.3%. The IMF outlined three reasons for its forecast. Firstly, the UK's dependence on natural gas, which means that higher prices will inevitably be passed onto consumers, fueling inflation. Secondly, although the labour market is tight, employment levels have not yet returned to pre-pandemic levels, which is hampering growth. Finally, interest rates continue to rise, further adding to the challenges facing the UK economy. It was not all bad news for the UK, the IMF revised its 2024 outlook for growth upwards from 0.6% to 0.9%. Plus the UK is not alone with a downgrade to growth projections, in fact the IMF believes as many as 90% of the developed economies will experience a decline in their growth rate this year.

With high inflation, rising interest rates and mounting geopolitical tensions restraining growth, the IMF predicts the weakest period of global growth since 1990. According to Kristalina Georgieva, Managing Director of the IMF, the world economy experienced a significant slowdown last year due to the aftershocks of the pandemic and the Russian invasion of Ukraine. During 2022, global economic growth had almost halved from the initial rebound from the pandemic in 2021, dropping from 6.1% to 3.4%. The IMF believes this slowdown is likely to continue throughout 2023 and could persist for the next five years.

[5] Trading Economics (2023).
[6] EuroStat (2023).
[7] EUobserver (2023).



Source: International Monetary Fund (2023).

One important economy, that of China, does stand out, with the IMF forecasting growth of 5.2% in 2023, up 2% from the 3.2% figure of 2022. India is also performing well, and although the forecast growth figure for 2023 is 6.1%, down from 6.8% in 2022, the IMF predicts the two countries will account for half of global economic growth in 2023.

Asset Class Returns

The first quarter of 2023 continued to build on the recovery observed in the financial markets in the final quarter of 2022. January gave investors real hope, with equity markets rallying and bond markets reacting positively to declining inflation and the likelihood of loosening monetary policy. In February, investors were reminded that many challenges remain, with downward revisions to global growth forecasts and concerns over persistent core inflation providing strong headwinds in both equity and bond markets.

Source: Timeline (2023) 1 Year: 01/04/2022 - 31/03/2023; 5 Year: 01/04/2018 - 31/03/2023; Q1: 01/01/2023 – 31/03/2023

Equities

With worries of recession in most developed markets subsiding, and US economic data suggesting the world's largest economy continued to grow, global equities returned 4.42% over the quarter. In emerging markets, there was a sense of renewed optimism as the year began, especially in relation to China. Having abandoned its zero COVID policy in December, the frequent shutdowns that had hampered the country's economy since 2020 would be finally ending.

Chinese equities went on to lag the rest of the world however, delivering a return of 1.87% over the quarter. This was due to increasing geopolitical tensions with the US. In January, China initiated a series of military exercises, which persisted throughout the quarter, near Taiwan. In February, the discovery and subsequent destruction of a Chinese spy balloon over US territory further heightened tensions. Finally, in March, Congress convened to scrutinize the Chinese CEO of TikTok, as a precursor to a potential ban of the highly popular app in the US, due to national security concerns.

The banking crisis caused some short-term volatility in the US market, but investors seemed confident that the risk of contagion was minimal. US equities returned 2.77% over the quarter. In the UK and Eurozone, equities returned 3.56% and 7.86% respectively, once more providing investors with renewed hope.

Factoring in Interest Rate Expectations

While equity returns overall have been promising over the first quarter, factor-based investors had a more challenging time, compared to 2022. Value investors observed a large reversal in fortune. Value stocks were down -1.51% over the quarter. A deeper analysis of the quarter shows that the majority of negative performance in the value factor can be attributed to the month of March. This coincides with the impact on "value" financial stocks following the collapse of the SVB, but also increased speculation that inflation has peaked and that central banks may soon switch from policies of monetary tightening to monetary loosening.

Factor Olympics (Long-Short)

2014	2015	2016	2017	2018	2019	2020	2021	2022	2023 Q1
								Value 17.5%	
	Momentum 16.8%	Value 13.9%	Low Volatility 6.4%				Low Volatility 19.8%	Momentum 13.0%	
	Low Volatility 13.4%	Size 9.4%	Momentum 1.6%	Quality 6.6%	Low Volatility 21.9%		Value 15.4%	Multi-Factor 7.5%	
Low Volatility 13.7%	Quality 7.3%	Low Volatility 8.7%	Quality 5.8%	Momentum 3.1%	Momentum 4.9%	Momentum 12.2%	Multi-Factor 6.1%	Low Volatility 6.8%	
Multi-Factor 0.0%	Multi-Factor 5.8%	Multi-Factor 3.8%	Multi-Factor 0.1%	Low Volatility 1.7%	Multi-Factor 1.9%	Quality 3.0%	Quality 3.7%	Quality 1.2%	
Value (0.4%)	Size (1.1%)	Quality (2.4%)	Value (6.6%)	Multi-Factor (1.5%)	Value (4.3%)	Size (0.4%)	Size (4.2%)	Size (2.8%)	Size (0.2%)
Quality (2.7%)	Value (7.2%)	Momentum (10.3%)	Size (6.6%)	Size (3.2%)	Size (6.1%)	Multi-Factor (10.4%)	Momentum (5.9%)		Quality (1.1%)
Momentum (3.9%)				Value (15.8%)	Quality (6.4%)	Low Volatility (27.9%)			Multi-Factor (3.7%)
Size (6.3%)						Value (36.6%)			Momentum (4.9%)
									Value (5.2%)
									Low Volatility (7.6%)

Stock Market (Long-Only)

2014	2015	2016	2017	2018	2019	2020	2021	2022	2023 Q1
14.6%	1.3%	13.6%	20.8%	(5.2%)	31.1%	17.2%	30.8%	(18.6%)	6.4%

Source: Finominal (2023)

Although value stocks faced challenges, their counterpart, growth stocks rallied, delivering a notable return of 10.70% over the quarter. Why have growth stocks performed so well? This can be attributed to the expectation of a reduction in future interest rates.

Interest rates are a crucial factor in determining company valuations. When companies are valued, financial analysts look at all the future cashflow, or income, that the company will receive in perpetuity. Each one of these cashflows will be discounted by an appropriate discount rate. This discount rate will be based upon the risk-free interest rate, the "base rate", plus additional risk factors specific to that firm. Once applied to all expected cashflows, the present, or current value of the firm can be calculated.

Growth stocks are typically associated with companies that are expected to generate higher levels of future cash flows compared to their current cash flows. These companies often invest heavily in research and development, expansion, and other growth initiatives, which can result in higher expected future cash flows. When interest rates are expected to decrease, it can lead to a lower discount rate, which in turn increases the present value of these expected future cash flows, making growth stocks more attractive to investors and potentially leading to higher returns.

Property

Global property continued to struggle in the first quarter, returning -4.36%. Interest rates remain the biggest challenge for property investors, and despite signs that inflation may have peaked, central banks have made it clear that tackling inflation is a key priority. To this end, interest rates look to remain high until mid-2024.

Bonds

Defensive Returns

Certainly, last year served as a sobering reminder to investors that all investments, including bonds, come with inherent risks. Traditionally, there exists an inverse relationship between equities and bonds. When equity markets experience declines in value, bond markets tend to rise in value, and vice versa. This dynamic can help to offset the impact of market fluctuations and reduce the overall volatility of a portfolio's value. This is why bonds, which we class as a defensive asset, are held in multi-asset portfolios. However, as evident from the relative performance of bonds and equities in 2022, this relationship may not always hold true.

Indeed, last year was a shock for many investors, as it is historically uncommon for both equities and bonds to deliver negative returns simultaneously. To find the most recent occurrence in history, you would need to go back to 1969, when high inflation in the mid-1960s prompted the Fed to increase interest rates, leading to negative performance in both equities and bonds, like the situation in the past year. Prior to that, the next historical instances were in 1941, when the markets reacted negatively to the United States' entry into World War II, and in 1931, when a currency crisis forced the UK to abandon the gold standard.

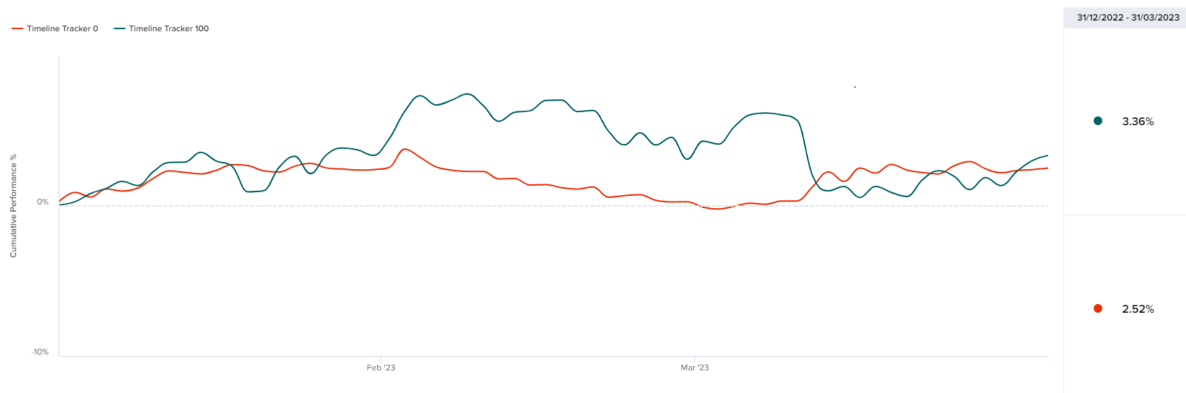
The traditional relationship between equities and bonds does indeed seem to have re-established itself, as evidenced by the market's reaction to the collapse of the SVB. Initially, as fears spread that a repeat of the 2008 financial crisis was looming, bonds rallied in response to the market turbulence. Over the quarter, Global bonds (hedged to £) returned 2.82%, while UK government bonds returned 2.22%.

Portfolio Performance

Because Timeline's investment philosophy is focused on building portfolios that take a globally diversified market-cap approach, the performance of our portfolios relative to the general market can be predicted with some degree of confidence. This is opposed to active strategies which may perform contrary to the overall market.

Timeline Tracker

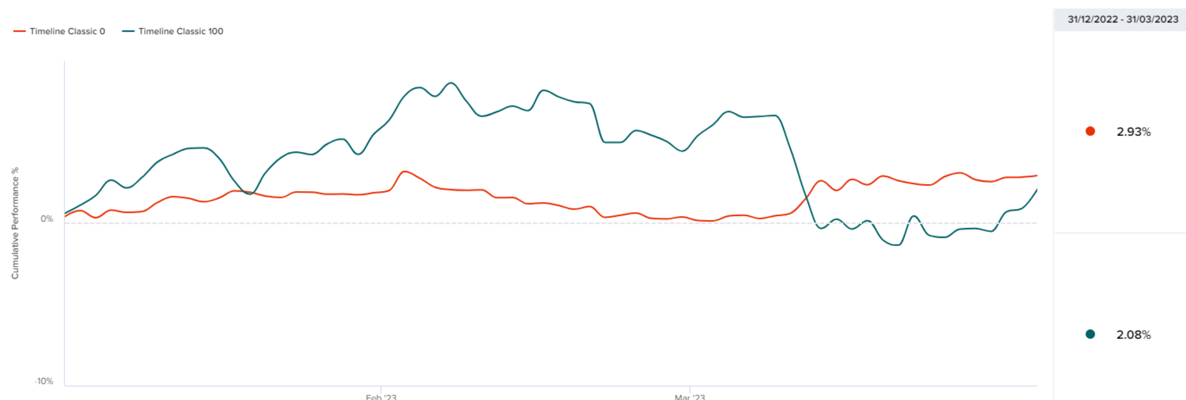
As can be seen in the chart below, our Tracker 100 model returned 3.36% over the quarter, reflecting the rebound seen in global equity markets. The Tracker 0 model, which is 100% invested in fixed income, returned 2.52%, again, in line with global bond markets.



Source: Timeline (2023)

Timeline Classic

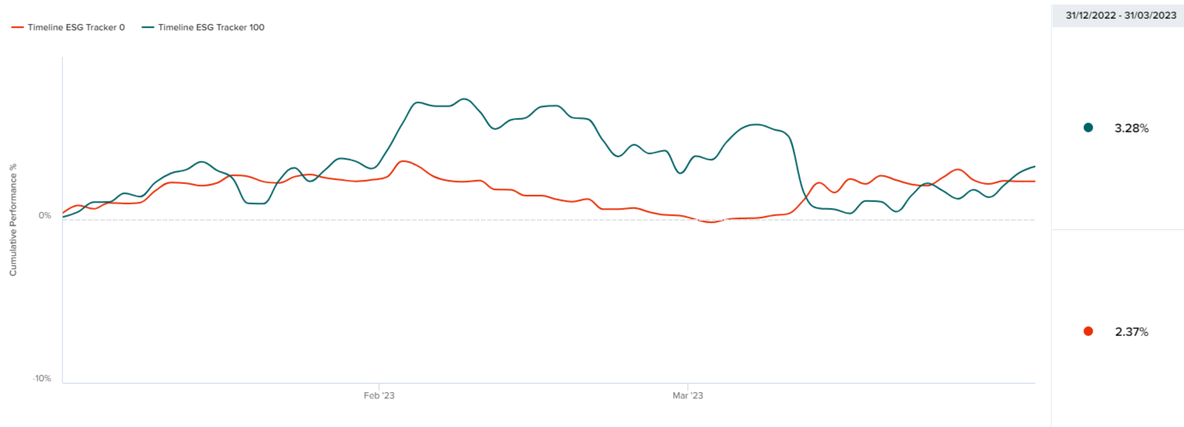
Our Timeline Classic model maintains a tilt to small and value stocks, the latter in particular faced challenges over the quarter. This helps to explain the difference in performance between the Tracker 100 (3.36%) and Classic 100 (2.08%) models. At the other end of the model range, Classic 0, we can see the impact of increased exposure to short duration bonds, to offset the higher risk of increased factor exposure in the portfolio, resulting in a return of 2.93% over the quarter.



Source: Timeline (2023)

Timeline ESG Tracker

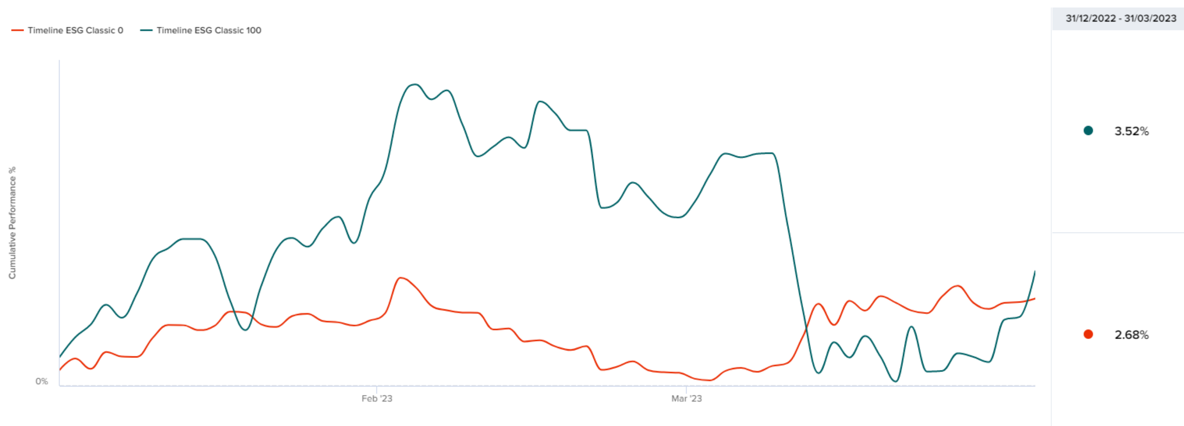
Timeline ESG Tracker 100, returned 3.28% over the quarter, which is a similar performance figure returned by the Timeline Tracker 100 model, that of 3.36%. During 2022 the strength of energy stocks resulted in the Tracker 100 model, with its higher exposure to equity consistently outperforming the ESG Tracker 100 model by a comfortable margin. During the first quarter, however, energy stocks dropped by 5.52%, reducing this advantage, resulting in a narrowing of the gap. Unfortunately, the ESG Tracker 100 model also suffered due to a greater exposure to financial stocks, which dropped by 4.14% over the quarter. On the bond side of the portfolio the Timeline ESG Tracker 0 model returned 2.37%, in line with the overall bond market.



Source: Timeline (2023)

Timeline ESG Classic

The Timeline ESG Classic 100 model returned 3.52% over the quarter, 1.44% greater than its Timeline Classic 100 counterpart. Key reasons for this differential in performance are the higher exposure to financials in the Classic 100 model which faired particularly badly over the quarter, and less exposure to the technology sector, which has some of the strongest gains over the quarter. Once more, the 100% bond portfolio, Timeline ESG Classic performed in line with expectations, returning 2.68%.



Source: Timeline (2023)

Final Thoughts

The first quarter has been remarkably positive for both equity and bond investors. While returns may have been modest, the performance came against a backdrop of various headwinds.

Geopolitically, the quarter saw the war in Ukraine reach the one-year point, with no end in sight, while tensions continued to rise in the Taiwan strait. Fears of a 2008 banking crisis were quickly shrugged off by the market, despite the collapse of Silicon Valley Bank in the US, and a hastily brokered takeover deal involving the Swiss government, which saw Credit Suisse, one of Europe's biggest banks being rescued from bankruptcy by UBS. Finally, even fears relating to rising core inflation and the potential for further increases in interest rates were not enough to hamper investor sentiment.

While the recent performance of financial markets is certainly encouraging, it is important for investors to remember that investing is a long-term game. Market volatility is a natural part of the investment landscape, and it is normal to experience ups and downs over time. Focusing solely on short-term market movements can lead to unnecessary anxiety and potentially harmful investment decisions.

The first quarter really goes to show that it's impossible to predict what will happen and how the financial markets will react in the short term. What we do know, after analysing decades of data, is that markets trend upwards over the long term, but that periods of decline are not uncommon. This is why, here at Timeline, we design our portfolios for the long term, diversifying globally to give investors the best possible chance of achieving their investment goals.

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