Portfolio and Market Review

2nd Quarter 2023

Contents

Economic Outlook and Market Commentary - June 2023

As we approach the midpoint of 2023, it is hard to believe how quickly time has passed this year. With the fantastic weather and mention of the dreaded 'partygate' creeping into our vocabulary again, you'd be forgiven for having a slight sense of déjà vu.

Boris Johnson and Donald Trump have once again been splashed across national and international headlines for their own respective 'antics'. Johnson resigned as an MP on the 9th of June after a report by MPs condemning him for lying to parliament over the Covid-19 partygate scandal. Despite this, Johnson has already been recruited as a columnist for the Daily Mail newspaper, so won't be out of the public eye for long.

Across the Atlantic, the GOP primaries are in full swing with newcomer Ron DeSantis facing former President Trump for Presidential nomination. DeSantis' campaign started on a 'glitchy' footing when he declared he was running at the Twitter Spaces event, which was hit by technical difficulties. Whilst Trump is currently facing 37 federal charges relating to official documents found at his Miami estate. They are both clear favourites for the election and it is looking likely one will face Biden in 2024.

Despite the political headwinds and turmoil, the equity markets have remained relatively flat across the UK in the second quarter. Inflation in the UK has remained high, however, with further rate increases on the cards for the Bank of England as we continue through the year. With the increase in food prices and continued high energy costs across the country, there is continued pressure on UK household budgets. Inflation does seem to be showing some positive signs of deceleration for the latter half of the year.

The bull market present in quarter one of this year, for US equities, continues on shaky ground. The positive returns are largely being driven by the seven largest companies and the narrow US market is causing some investors apprehension over the longer term. These seven stocks have significantly outperformed the rest of the market and currently make up approximately 26% of the S&P 500's weightings.

US Debt Ceiling: The Never-ending Issue

The world breathed a collective sigh of relief as the US narrowly avoided a historic debt default at the beginning of June. Both sides of the bipartisan government managed to garner a last-minute deal to suspend the government's borrowing limit until 2025.

This is not the first time in recent history that the debt ceiling has had to be raised. In December 2021, President Biden signed into law the increased ceiling of $31.4trn, representing a $2.5trn increase. Naturally, a question often raised when we continue to face this issue is, what would happen if the US were to default on its debt obligation?

Simply put, the global economic fallout would be catastrophic. If the ceiling had not been raised, America would face either a sovereign default or drastic cuts to state spending. Both outcomes would create economic turmoil in the global markets. The rating agency, Fitch Ratings, warned that in the "very low probability event"[1] that should the US fail to make "full and timely payments on debt securities" it would qualify as a debt default. This would result in their 'AAA' rating being downgraded to a 'D'. By the US defaulting on its loans, it would then create irreparable damage to public faith and the spending cuts could trigger a recession.

Whilst the original premise of the US debt ceiling was the good intention of preventing government spending from running rampant, the current use is to provide leverage and act as a threat to whichever party does not control the Senate in each election cycle. This is perfectly illustrated by the new deal brokered, which cuts 'non-defence discretionary' spending and includes domestic law enforcement. The deal limits all discretionary spending to 1%, effectively creating a budget cut with current levels of inflation.

The issue is resolved for now, but inevitably government debt and spending will continue to increase over time. It begs the question, are there any solutions? Our research shows what could be done:

1) The 14th Amendment of the Constitution states that the president has the authority to order the nation's debts to be paid regardless of the debt limit. This route would brand the debt ceiling as 'unconstitutional' and allow the government free reign to repay its debts. This response would initiate a wave of legal responses along with a vitriolic backlash which would prevent this from ever being written into law.

2) The most straightforward solution would be that Congress simply agrees that the ceiling is damaging and suspends it in perpetuity. As mentioned above, neither side would agree to this due to the powerful bargaining chip the debt ceiling has become.

3) Perhaps the most absurd of the options is minting a platinum coin worth $1trn and depositing this in the Federal Reserve. This would then be used to pay for government expenses and operations. The government would no longer need to borrow from public markets. Whilst an interesting premise, this idea has been dismissed by the treasury a number of times, with the U.S. Deputy Treasury Secretary, Wally Adeyemo, rejecting this idea as recently as May of this year.

Regardless of the options above, Fitch warned that platinum coins and other "non-conventional means" such as invoking the 14th amendment are "unlikely to be consistent with a 'AAA' rating". Until a more tenable solution is formed, this will continue to be an ongoing issue.

[1] Fitch Ratings (2023)

Mortgages and the Shaky Property Ladder

Other than savings accounts, the most noticeable vehicle to see the impact of the recent interest rate increases is the mortgage market. The outstanding value of all residential mortgage loans was £1,675.4bn at the end of Q1 2023.[2] This figure, however, has decreased since Q4 2022 for the first time since 2017. New mortgages in the first quarter of 2023 were down 16.1% compared to the previous quarter, and 40.7% less than a year earlier. The downward trend indicates that purchasing a property may be less obtainable in these current conditions, compared to recent history.

At the end of June, two-year fixed-rate mortgages in the UK rose to above 6%. This rise in interest rates has caused some lenders (e.g., TSB) to temporarily withdraw their mortgage offers sold via brokers to re-price these deals. With interest rates now having increased to 5%, housing affordability seems even further from reality.

Whilst the overall cost of purchasing a property is impacted by these mortgage rate increases, it is far from the full picture. Affordability of home purchasing has been a topic of discussion in recent years, with the number of middle-aged (45-64) tenants increasing by 70%.[3] Of this 70%, 4 in 10 would like to purchase their own home, and only 2 in 10 are actively saving for a deposit. The task of saving for a deposit can be difficult alone, but it is only part of the reason for the change in the property landscape. If you do manage to save a deposit, probably between 5-10% of the property price, the next step would be to secure a mortgage. This is perhaps the more challenging part of the equation.

According to the ONS, the average weekly salary in the UK for June 2023 was £630 (£33,280 annualised).[4] In 2022, full-time employees in England could expect to spend roughly 8.3x[5] their annual earnings buying a home. This multiple has been on the rise since 1997 and with the continued strain on the cost of living brought on by inflation, it looks set to continue.

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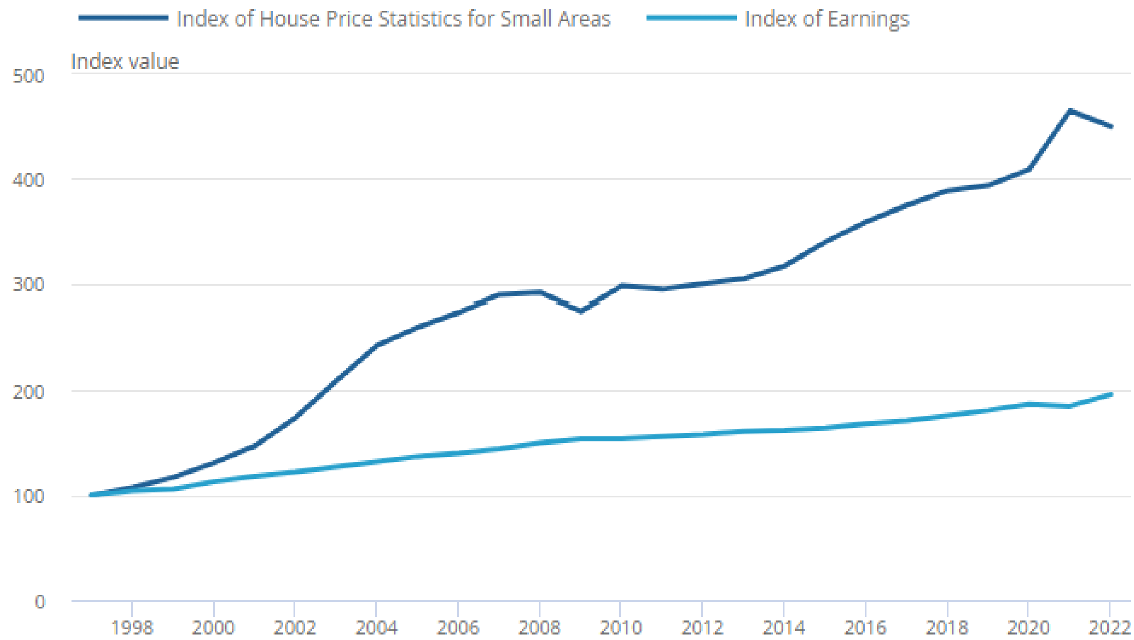
[2] FCA (2023)
[3] Paragon (2023)
[4] ONS (2023)
[5] ONS (2022)

House price and earnings indices, England and Wales, 1997 to 2022



Source: ONS (2023)

These multiples become alarming when you compare these figures to the 'rule of thumb' lending rule that a first-time buyer can borrow up to 4.5x their annual income.[6] This coupled with the gargantuan task of saving for a deposit in these current inflationary conditions leaves the prospect of home ownership unobtainable for some.

To make matters worse, if you are a woman looking to purchase a property in London, this would take even longer than a man. Thanks to the gender pay gap, the average house in London would cost 14x the average woman's salary compared to 12x the average man's salary.[7] These multiples make for a harrowing tale of what home ownership might look like for future generations.

Perhaps the singular silver lining to this woeful story is that earnings growth has been relatively strong since the trough in June 2020. The whole economy's year-on-year, 3-month average earnings growth is currently 6.5%.[8] Whilst this still falls short of current inflation levels, one would hope that a prolonged period of this growth will help to narrow the margin for housing affordability.

[6] Forbes (2023)
[7] Schroders (2023)
[8] ONS (2023)

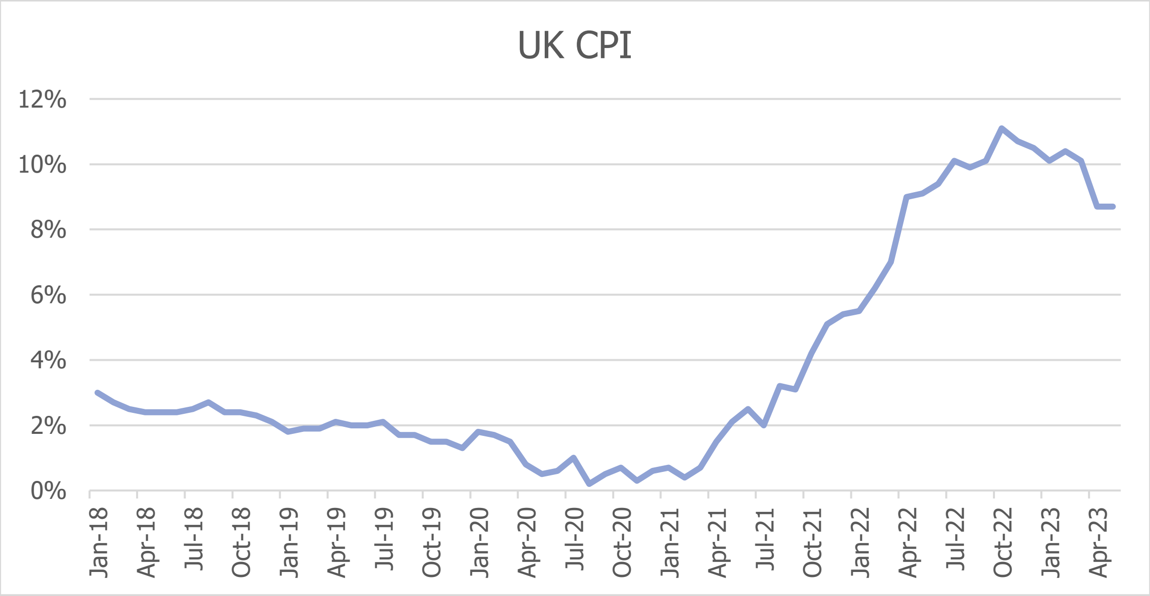
Economic Outlook

Inflation is falling (to an extent)

Inflation has remained stubbornly high so far in 2023 in part due to energy prices, but mainly continued supply chain issues which have pushed up the price of food. Food inflation had risen by 19% in April 2023[9] which was the highest sector in that month. This unrelenting rise in food costs has meant that whilst inflation has dropped slightly, these decreases are less than originally expected. Inflation in the UK currently sits at 8.7%[10] compared to 10.4% at the end of Q1, whereas in Europe inflation fell to 6.1% in May 2023.[11] The US has continued to fare better than Europe and the UK with its current inflation sitting at 4% at the end of May 2023.

Despite the doom and gloom associated with the high levels of inflation, there are some positive signs that UK inflation may decelerate for the remainder of 2023. The Bank of England has named three changes that might influence inflation over the coming year. Firstly, wholesale energy prices falling considerably - which may not have filtered through to energy bill savings yet - will have an impact on inflation. Secondly, the Bank believes that supply chains will become more efficient, leading to a sharp fall in the price of imported goods. The final disheartening factor is that individuals will have less money to spend, so there will be less demand for consumer goods and services in the UK.[12]

At the start of the quarter interest rates sat at 4.25%, and on the 22nd of June, the Bank of England made the bold choice to hike interest rates to 5%. The hope is that the increase in interest rates will lead to reductions in inflation, with the Bank of England expecting inflation to fall quite quickly to around 5% by the end of 2023. This optimism is not mirrored across the market with The National Institute of Economic and Social Research (NIESR) estimated annual CPI being 5.4% at the end of 2023. This forecast is pessimistic in comparison to forecasts from the Bank of England and the government's budget watchdog.[13]

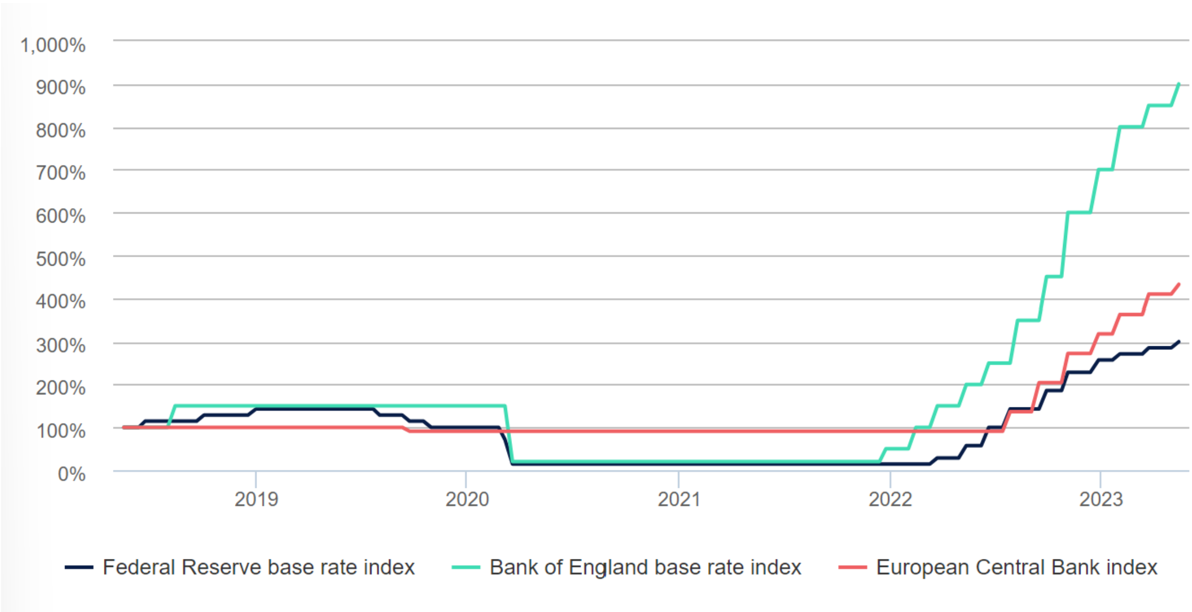


Source: Office for National Statistics (2023)

The immediate knock-on effect on the markets was a drop in response to the rate increase.

[9] Statista (2023)
[10] ONS (2023)
[11] CNBC (2023)
[12] Bank of England (2023)
[13] Reuters (2023)

Whilst rate increases were expected, the 0.5% jump has been a slight surprise to the markets. It is incredible to think that since December 2021 the Bank of England has made 12 consecutive rate increases. In comparison to other global central banks, as illustrated below, the Bank of England has shown incredible speed in its rate hikes.



Source: Hargreaves Lansdown using Bloomberg data (2023)[14]

[14] Hargreaves Lansdown (2023)

Corporate Responsibility and Consumer Sentiment

The term ESG is now commonplace for investment professionals and novices alike. ESG funds are familiar in the UK and Europe, with many being offered to investors even in their company autoenrollment schemes. These funds can help investors feel as though they are combining social good with financial returns in a way that benefits society on a wider scale. However, as more of these funds surface, the conversation has shifted towards how to accurately measure ESG amid sector wide claims of 'greenwashing'.

In the US, the debate around ESG and investment has been even more of a lightning rod debate amongst some of the largest names in the industry. In late 2022, Vanguard, one of the largest investment managers in the world, pulled out of the Net Zero Asset Managers Initiative (NZAM). A month prior to Vanguard's exit, NZAM counted 291 signatories accounting for approximately $66 trillion in assets under management.[15] Vanguard represented a considerable portion of that (approx. $7trn AUM), so its exit marked a blow to the initiative. In their comments to the Financial Times Vanguard CEO, Tim Buckley, said "We felt that our voice was being drowned out or confused". In further comments, he mentioned, "We don't believe that we should dictate company strategy."

It has been speculated that Vanguard's decision to withdraw from the NZAM could have been pressured by Republican politicians. After Vanguard's withdrawal, several Republican politicians, including the Attorney General of Utah, Sean D. Reyes, said that they were 'very encouraged' by the news. BlackRock conversely remained firm in its commitment to the NZAM which resulted in political backlash, again from the Republican party. Florida announced in December 2022 that it would withdraw $2bn from the asset manager. Asset managers continue to be accused of walking the middle line between politicians and shareholder activists in a so-called 'culture war'.

On the flip side, this year some US companies have come under fire from consumers in response to 'woke' campaigns. Target and Bud Light have angered conservative consumers resulting in 'boycotts' of the household names. Target workers began to face a deluge of threats and confrontations from customers in response to Pride merchandise being sold in their stores. Target CEO, Brian Cornwell, even wrote a letter to employees regarding the 'high volumes of angry, abusive, and threatening calls' they were experiencing. Soon a firestorm on social media sent individuals into a frenzy creating a perfect storm for consumer discontent at the brand. Target's stock has dropped since these incidents. However, there are several other reasons for this, including broader US economy shifts and overexposure to discretionary merchandise in the shadow of a possible recession.

[15] Reuters (2023)

Conversely, Anheuser-Busch, the owners of Bud Light, seem to have seen the direct impact of boycotts. In an analysis by Bump Williams Consulting[16], Bud Light lost its position as the best-selling beer in the US. Their sales dropped after sending a personalised can of beer to Dylan Mulvaney, who is a popular transgender TikTok personality, in April. According to Forbes, in the two months since the incident Anheuser-Busch has lost $26bn in market capitalisation.[17] This market loss has been mirrored in the stock price sharply declining over the same period.

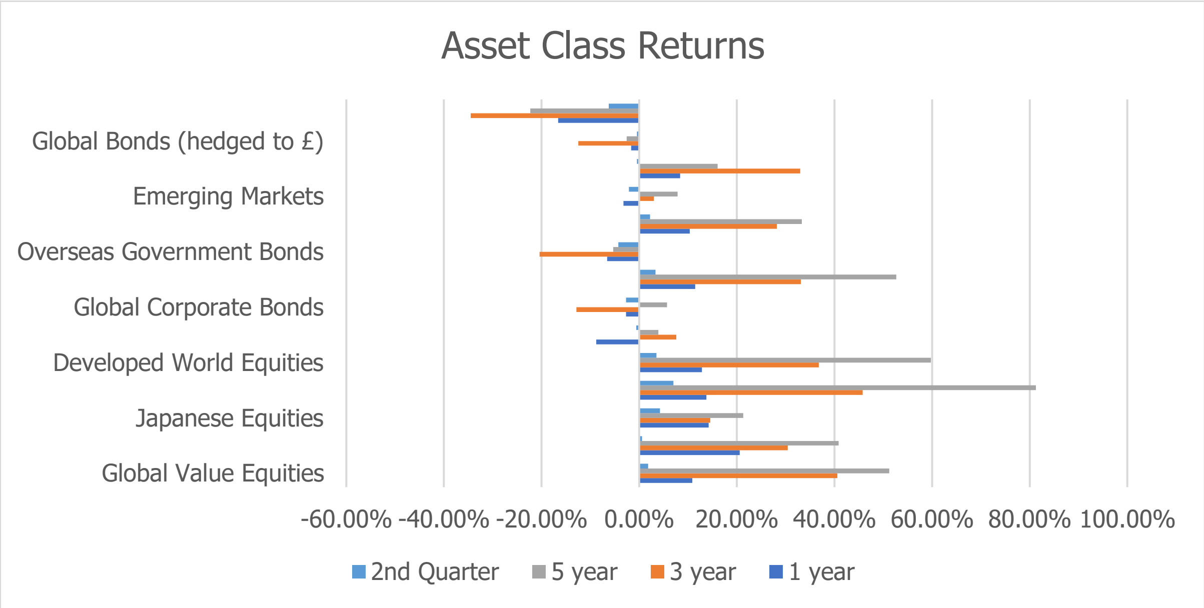
Source: Bloomberg (2023)

Brands today must deal with the instantaneous availability of news, data, and also public opinions. All these factors, teamed with the ready accessibility of social media, create a frenzy which can spiral out of control when unchecked. How do brands cope with this in the modern world? Vanitha Swaminathan, the director of the Katz Center for Branding at the University of Pittsburgh's business school, suggests the solution is as simple as remaining authentic to their values as "problems arise when brands do things inconsistently." It seems brands want to align with consumer sentiment, and the potential for this is that it can fall flat.

[16] BBC (2023)
[17] Forbes (2023)

Asset Class Returns

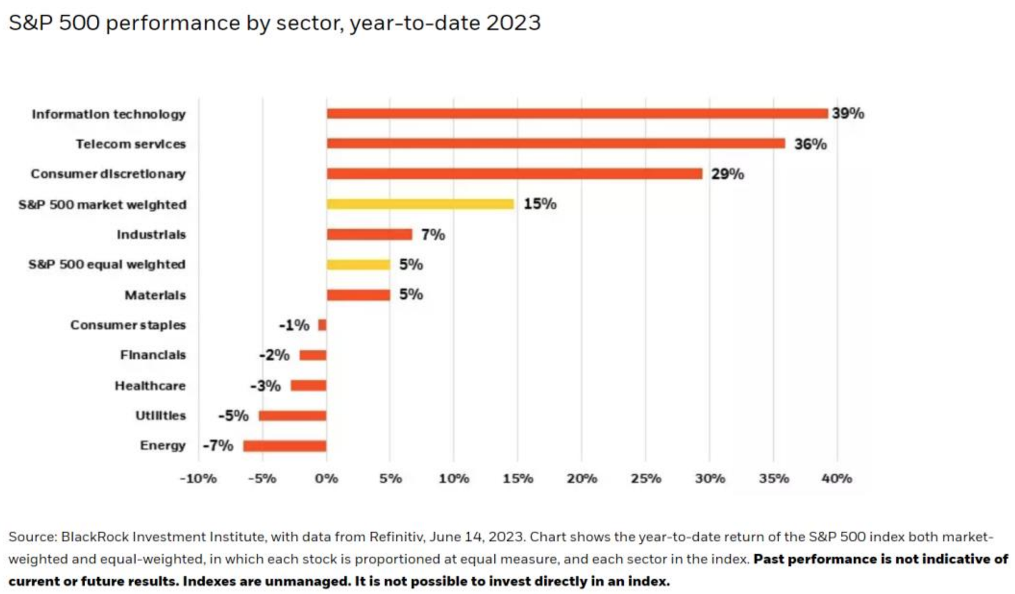
During the second quarter of the year, market movements seemed to be kept to a minimum with relative stability seen in the equity markets. Bond markets in comparison continued to struggle with the interest and inflation rates providing a drag on their relative returns.



Source: Timeline (2023)

Equities

In the first quarter, there were some positive gains across the equity markets, followed by the second quarter providing some stability for investors. Global equities returned 3.32% over the quarter, with certain regions driving positive returns. The US market was the standout, returning 6.99%. Most of these positive gains were attributed to a handful of stocks, specifically in the technology sector, which could suggest that near-term improvement in economic growth could be down to a bubble.



Source: BlackRock using Bloomberg data 2023[18]

Developed markets returned 3.56% illustrating that emerging markets were a dampener to overall global returns. This quarter, emerging markets returned -2.11% with China's reopening after Covid-19 restrictions failing to translate into broad economic strength. The impact on the surrounding markets that rely heavily on Chinese demand has caused more modest returns for the region.

Finally, UK markets have also seen lacklustre returns of -0.49% for the quarter. With inflation not reducing as quickly as expected, markets were left underwhelmed. The European markets also contributed a muted performance with returns of 0.59%.

Property

With inflation proving to be a long-standing issue, global property returns continued to be stifled. Returning -0.57% this quarter has provided some reprieve from the lower returns seen in the first quarter of 2023. As central banks continue to issue interest rate increases over the remainder of the year, it may be 2024 before we see this area of the market turnaround.

Bonds

Bonds continued to have a rough run this quarter with the difficult inflation and interest rate environment. Government bonds have also struggled in developed markets, and the European Central Bank reaffirmed the need to increase interest rates further before the end of 2023. With the UK interest rate increases, alongside the US debt ceiling issues earlier this quarter, it seems most government bonds have struggled in this current environment.

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[18] BlackRock (2023)

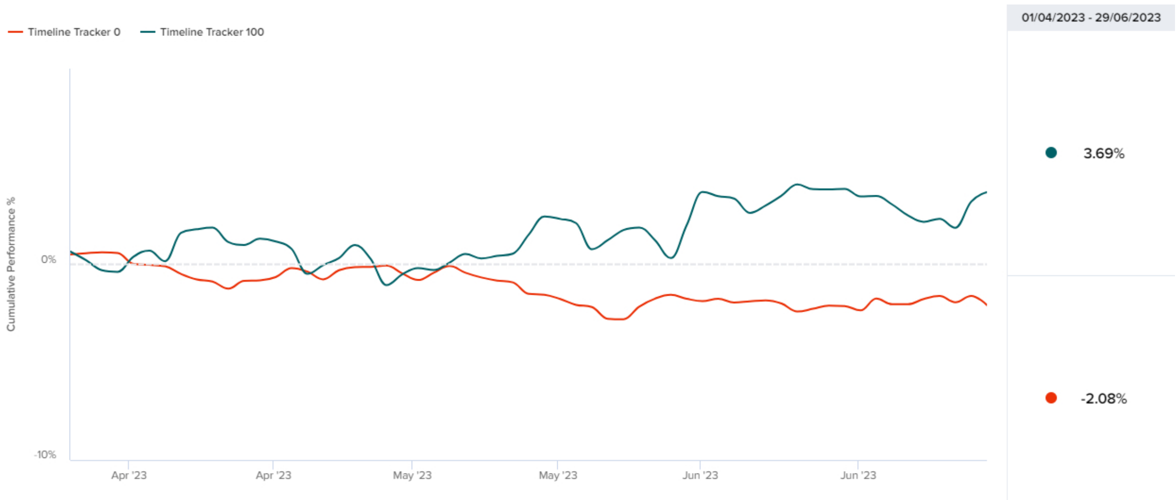
Other riskier, non-investment grade bonds are also continuing to struggle as tightening credit conditions, paired with increased costs to raise debt, have put pressure on returns. In terms of performance over the quarter, Global bonds (hedged to £) returned -0.46%, while UK government bonds returned -6.21% and overseas government bonds fared slightly better returning -4.29%.

Portfolio Performance

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

Timeline Tracker

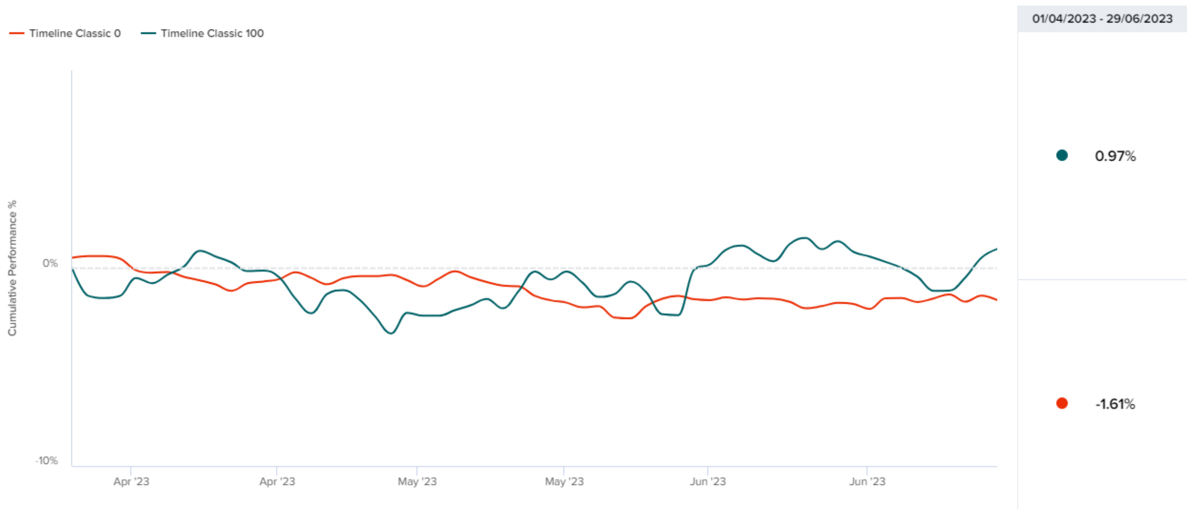
As can be seen in the chart below, our Tracker 100 model returned 3.69% over the quarter, continuing the positive growth seen in Q1. The Tracker 0 model, which is 100% invested in fixed income, returned -2.08%, which is down on the first quarter. However, this performance mirrors the returns seen in global bond markets.



Source: Timeline (2023)

Timeline Classic

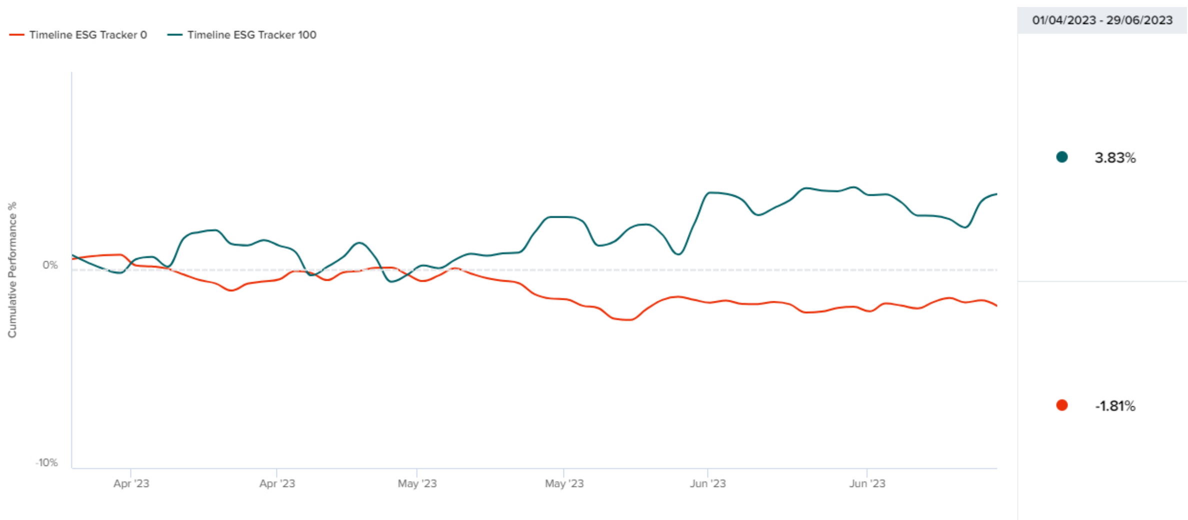
Our Timeline Classic model maintains a tilt to small and value stocks, which once again faced lower returns than their growth counterparts this quarter. With the technology companies in the US market driving the market returns. This helps to explain the difference in performance between the Tracker 100 (3.69%) and Classic 100 (0.97%) models. The shorter duration bonds in the Classic 0 model, have helped protect the portfolio from greater volatility in the fixed interest side of the portfolio. This has resulted in a return of -1.61% over the quarter.



Source: Timeline (2023)

Timeline ESG Tracker

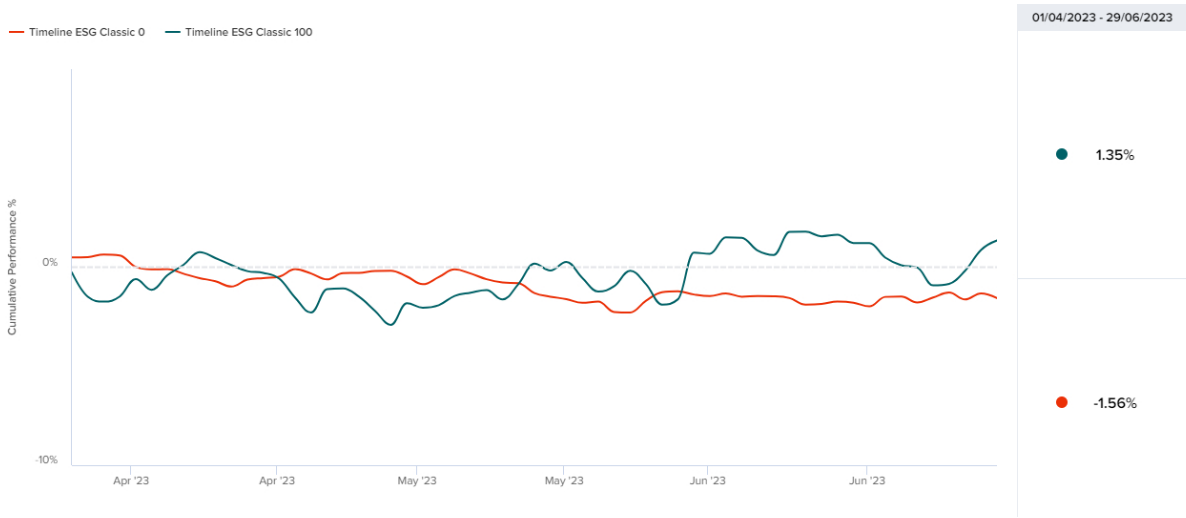
Timeline ESG Tracker 100 returned 3.83% over the quarter, which is a similar performance figure returned by the Timeline Tracker 100 model. The ESG 100 portfolio has a large exposure to technology stocks. The recent rally after a dampened performance at the end of 2022 has led to strong returns from the portfolio. On the bond side of the portfolio, the Timeline ESG Tracker 0 model returned -1.81%, roughly in line with the overall bond market.



Source: Timeline (2023)

Timeline ESG Classic

The Timeline ESG Classic 100 model returned 1.35% over the quarter, outperforming its non-ESG counterpart by 0.38%. Much like the Tracker and ESG Tracker models, this portfolio has a larger holding in the technology sector which drove returns across the board. Once more, the 100% bond portfolio, Timeline ESG Classic performed in line with expectations returning -1.56%.



Source: Timeline (2023)

Final Thoughts

As we reach the halfway point of 2023, we are encouraged by the positive returns so far this year. However, inflationary and interest rate increases continue to put pressure on both returns and household budgets. With mortgages and food prices continuing to rise, the monthly budgets for households are becoming much tighter. Unfortunately, these headwinds do not show signs of easing just yet. This being said, predictions suggest that this may change towards the end of 2023, hopefully creating positive conditions in early 2024.

The second quarter continued the trend of relatively calm waters in the equity markets. This has helped investors recover from the volatile markets seen throughout 2022. However, it does not mean that volatility should be ruled out for the year just yet. With continued disruption in the bond markets due to high interest rates and US primaries around the corner, choppy investment waters could yet emerge.

Regardless of the current market conditions, 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 harmful investment decisions. Our evidence-based approach should encourage investors to not 'watch the waves', but to 'watch the tides' when it comes to investment horizons. This is why we partner with Timeline, as they design their portfolios for the long term and diversify globally to give our clients the best possible chance of achieving their investment goals.

The Timeline Investment Team


Nicki Hinton – Jones CFA
Chief Investment Officer


Daniel Rawlinson
Senior Investment Analyst


James Gillespie
Senior Investment Analyst


Laurentius van den Worm
Investment Strategist


Emmanuel Asare
Investment Analyst


Alex Crowther
Investment Analyst


Reva Bala
Investment Analyst

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