A Month in the Markets

Private Banking

From the Multi Asset Solutions Team

August 2023

In this latest edition our Multi Asset Solutions Team look at the challenges investment markets faced in July. Stock markets rose in July amid expectations that US and European interest rate hikes are nearing an end[1] and that the global economy will grow more than previous International Monetary Fund (IMF) forecasts suggested.[2]

Market Overview

Measures by China to accelerate economic growth[3] and better-than-expected UK inflation data added to investor optimism.[4]

Towards the end of the month, the Bank of Japan (BoJ) surprised investors by signalling that it might raise interest rates in the future. This would mark a significant shift away from its current policy of ultra-low interest rates, which are designed to stimulate economic growth by encouraging consumers to spend rather than save.[5]

In the latest moves in their battle against inflation, the US Federal Reserve (Fed) raised interest rates to a 22-year high in July[6] and the European Central Bank (ECB) followed suit by lifting rates to their joint highest level on record.[7]

Bonds issued by the governments of developed countries saw a slight decline in value in July[8], including US[9] and Eurozone bonds.[10] Japanese government bonds fell sharply after the BoJ signalled a willingness to increase interest rates[11] – as bond prices and yields move in opposite directions, the rise in yields that followed this decision was met by a corresponding fall in bond prices. UK government bonds bucked the trend, delivering a positive performance to bring three months of losses to an end.[12]

Baffled by bonds?

It may be worth taking some time to learn the basics to help you better understand how they work. Visit our <u>**Basics on Bonds page**</u> for more information.

PLEASE REMEMBER THAT ALL INVESTMENTS CARRY VARYING DEGREES OF RISK TO YOUR MONEY. THE VALUE OF INVESTMENTS AND ANY INCOME FROM THEM CAN GO DOWN AS WELL AS UP AND YOU MAY GET BACK LESS THAN THE FULL AMOUNT YOU INVESTED. PAST PERFORMANCE IS NOT A RELIABLE INDICATOR OF FUTURE RESULTS.

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UK and Europe

A survey of UK business leaders found that economic activity grew at its slowest pace in six months in July, as 13 consecutive interest rate hikes and increased living expenses cut into consumer spending.[13] Data released this month also showed that the economy shrank by an estimated 0.1% in May, likely because of productivity falling due to multiple bank holidays, including King Charles' coronation.

Defying gloomy predictions that it would have entered a recession by now – defined as two consecutive quarters of negative growth – a strong job market and lower energy prices kept the UK economy out of recessionary territory.[14] However, declining manufacturing sector activity and the fact that interest rate hikes have yet to take full effect mean that a 2023 recession remains a possibility.[15]

Data released in July showed that retail sales rose more than expected in June, after lower energy prices increased people's disposable income.[16] On the other hand, a separate survey revealed that consumer confidence fell in July for the first time since January. Persistent inflation and the interest rate rises implemented to combat it are eating into consumer confidence in the UK economy, despite figures released this month showing inflation fell more than expected in June.[17]

The Eurozone is facing similar issues. Business activity shrank sharply in July as demand in the European services industry – which spans sectors including finance, retail, healthcare and leisure – declined. In another worrying development, factory output fell at its fastest rate since the COVID-19 pandemic began.[18]

Data released on the last day of July revealed that Eurozone economic growth reached 0.3% in the second quarter, after zero growth in the first quarter.[19] However, like the UK, a recession remains a possibility. Headline inflation for the region fell in July, but core inflation, which excludes volatile energy and food prices and is closely monitored by the ECB, remained unchanged.[20] This may mean interest rates have to remain higher for longer, which risks slowing the economy to the point of recession.

In July, ECB policymakers predicted that core inflation would take longer to come down than they had previously expected when polled in May. This is mainly because a strong labour market is leading to high wage growth, which is stopping consumer demand from dropping further, making the fight against inflation more difficult.[21]

US

Data released in July showed that the world's largest economy grew faster than expected in the second quarter as businesses invested in factories and equipment, the government increased spending and the job market remained strong. This has fuelled optimism that the Fed will be able to bring inflation down to within its target without triggering a recession.[22]

Additional data released in July further supported the case for a so-called 'soft landing', in which inflation will ease without causing a downturn. The Fed's preferred measure of inflation continued to fall in June, while robust consumer spending is preventing the economy from sliding towards recession.[23]

The prospect of a soft landing for the economy drove the S&P 500 Index, which tracks the largest companies listed on the New York Stock Exchange, to its sixth monthly rise in the last seven months. Investors are increasingly swapping cash for shares, reflecting their growing willingness to take on risk in the confidence that the economy will continue growing.[24]

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Asia Pacific

China's economy lost momentum in July as the manufacturing sector shrank and the services and construction industries weakened, while property prices slumped due to falling consumer demand. Extreme weather conditions, including heat waves and floods, further hampered manufacturing activity by damaging the energy grid and transport infrastructure.[25]

However, China's government has taken action to stimulate growth. It has outlined plans to make it easier for households to borrow money, encouraging consumers to refurbish their homes and buy goods. Steps are also being taken to increase the manufacturing of small consumer goods, which make up a quarter of China's exports. Additionally, the government softened its regulatory crackdown on technology firms, promising to make it easier for private companies to do business. These pro-growth measures helped drive gains in the Hang Seng China Enterprises Index, which tracks Chinese shares listed in Hong Kong.[26]

In Japan, the nation's benchmark Nikkei 225 Index fell in July, ending a six-months of positive returns.[27] However, earlier in the month, it had risen to a 33-year high as business sentiment improved.[28]

Data released at the end of July showed that factory production rebounded in June following a downturn in May, with increased production of cars and electronic devices leading the charge. This indicates that Japan's modest economic recovery continued into the second quarter. A weakened yen is also aiding the recovery by making trips to Japan cheaper for tourists, but rising inflation is eating into the disposable income of locals.[29]

Outlook

We continue to treat shares with caution and bonds with greater optimism.

Stock markets have seen rapid gains over the past few months, but our view is that this rally is likely to be unsustainable as companies are becoming overvalued and we are in an environment of low economic growth. As a result, we expect to see a fall in the value of shares.

We have a more positive view of bonds because we believe interest rates are approaching their peak. This should reduce the risk of bonds falling in value, as bond yields are higher and less likely to increase further.

We are therefore using excess cash to buy bonds so we can capitalise on higher yields. We favour most bonds, including UK and US government bonds, company and high-yield bonds.

We anticipate that inflation will continue to gradually fall, enabling central banks to hold interest rates steady for a sustained period without raising them further.

Portfolio positioning

As at 31 July 2023

Private Banking

The fundamental approach

An update on positioning for the following fund ranges:

- Santander Atlas Portfolios
- Santander Multi Index
- Santander Portfolio Investments (Santander Max 100% Shares, Santander Max 30% Income Shares and Santander Max 60% Income Shares Portfolios)
- Santander Vista Model Portfolios

These portfolios follow a fundamental approach investment strategy, which is based on market and economic outlook and geopolitical considerations to determine which asset or sub-asset classes, geographies and sectors to invest in, both on a longer-term (strategic) and shorter-term (tactical) basis. They are positioned with a single set of tactical asset allocation views for all regions and countries. One TAA (Tactical Asset Allocation) is driven by internal research, which is reviewed and agreed by Santander Asset Management's Global Asset Allocation Committee.

They provide a template asset allocation, which is subsequently translated to each individual portfolio by the portfolio management team in the UK, selecting the most appropriate funds and instruments in which to invest in dependent on their objectives, benchmark and investment policy whilst monitoring risk.

Discretion is exercised by the portfolio manager and there will be times where our income funds do not reflect the One TAA view as it may impact the fund's ability to deliver its income objective.

Underpinning One TAA is a modelling of market outcomes under very different economic and market scenarios. One TAA provides the benefit of a more streamlined decision-making process and a collective view.

How did the fundamental investment process change the funds' positioning during July?

Shares were added this month, reducing the underweight position relative to benchmark - meaning they continue to hold less shares than the benchmark. Most of the funds added US shares, while some UK shares were added and some Japanese shares sold.

At the beginning of the month, the decision was made to sell some UK and US government bonds and buy some UK and US company bonds instead, which pay higher yields and thus compensate investors for the extra risk.

Throughout the month, high-yield bonds were added to the funds, shifting them to a slightly overweight position in this category. Most of these purchases were funded through cash, as we currently favour holding bonds over cash.

The funds' underweight position in shares relative to the benchmark is likely to have hindered their relative performance, as shares have performed strongly. However, the timing of some of the funds' bond purchases and sales, as well as the decision to hold some UK government bonds that take longer to reach maturity, have benefitted the funds.

Portfolio positioning

Private Banking

As at 31 July 2023

The systematic approach

An update on positioning for the following funds within the Portfolio Investments range:

- Santander Max 30% Shares Portfolio
- Santander Max 50% Shares Portfolio
- Santander Max 70% Shares Portfolio

Our portfolios are positioned by combining risk parity and momentum strategies, the allocation to each depending on the portfolio's risk profile. In risk parity, we seek to balance the level of volatility among and correlation towards, each of the asset classes in a portfolio. In momentum, we seek to choose assets that have the strongest growth potential over the medium to long-term, while seeking opportunistic entry and exit points for investment in the short-term. This means the investment process may appear to act in an opposite way to how markets are behaving as it aims to capture opportunities.

Risk parity aims to deliver stable returns by selecting bonds and shares so that each asset class contributes an equal amount of risk to the portfolio. This strategy is designed to respond swiftly to falling markets during extreme volatility and unprecedented market movements.

Momentum seeks to deliver outperformance by identifying trends and taking advantage of these by determining their consistency and stability. This strategy may be more volatile, as the model waits for changes in the direction of markets to take hold, and, after a lag starts to pick shares with positive momentum. We also choose assets with the strongest growth potential over the medium to long-term while seeking opportunistic entry and exit points in the short-term.

The two strategies work in collaboration and are designed to operate in all market conditions when combined according to the risk profiles of the funds. Risk parity does the heavy lifting when markets are tumultuous, and momentum delivers when asset prices rise over a sustained period. The strategies make no predictions.

How did the systematic investment process change the funds' positions during July?

The three funds all increased their cash holdings relative to the benchmark during the month. The Max 30% Shares Portfolio reduced its underweight position in cash, while the Max 50% Shares Portfolio and the Max 70% Shares Portfolio both moved from underweight to overweight positions in cash, compared with the benchmark.

The Max 30% Shares Portfolio marginally reduced its underweight bond position during July through increasing its holdings of government bonds, relative to the benchmark. On the other hand, it deepened its underweight position in highly-rated bonds and marginally cut its overweight position in high-yield bonds.

It also reduced its overweight position in shares by cutting its holdings of UK shares from slightly overweight to underweight, but increased its holdings of US shares relative to the benchmark.

The Max 50% Shares Portfolio increased its underweight position in bonds, specifically reducing its holdings of highly-rated bonds relative to the benchmark.

It also reduced its overweight stance in shares relative to the benchmark in July, cutting overweight positions in US and Asian shares, including Japanese shares. Additionally, it deepened an underweight position in UK shares.

In the Max 70% Shares Portfolio, an overweight position in bonds was increased. An underweight stance on shares was also deepened, with the fund reducing its holdings of shares compared to the benchmark over the course of the month.

The fund expanded its holdings of government bonds relative to the benchmark, while only slightly decreasing its holdings of highly-rated bonds.

It shifted from a slightly underweight position on US shares to one that was slightly overweight, but cut its overweight holdings of Asian shares, including Japanese shares. The fund also deepened its underweight position in European shares, including UK shares.

For all three funds, highly rated bonds and UK shares were the main contributors to performance in July.

For more information on the systematic rules-based investment process, please refer to the Fund's Prospectus, which can be found within our **Fund Centre**.

All data as at 31 July 2023.

[1] Reuters, 28 July 2023
[2] IMF, 25 July 2023
[3] CNBC, 24 July 2023
[4] Reuters, F19 July 2023
[5] Reuters, 31 July 2023
[6] Euronews, 27 July 2023
[7] The Guardian, 27 July, 2023
[8] S&P Global Developed Sovereign Bond Index, 31 July 2023
[9] S&P US Treasury Bond Index, 31 July 2023
[10] S&P Eurozone Sovereign Bond Index, 31 July 2023
[11] S&P Japan Sovereign Bond Index, 31 July 2023
[12] S&P UK Gilt Index, 31 July 2023
[13] Reuters, 24 July 2024
[14] The Guardian, 13 July 2023
[15] Reuters, 24 July 2024
[16] Reuters, 21 July 2023
[17] Reuters, 21 July 2023
[18] Reuters, 24 July 2023
[19] Eurostat, 31 July 2023
[20] CNBC, 31 July 2023
[21] Reuters, 28 July 2023
[22] Associated Press, 27 July 2023
[23] CNN Business, 28 July 2023
[24] Bloomberg, 28 July 2023
[25] Bloomberg, 31 July 2023
[26] Bloomberg, 28 July 2023
[27] Statista, 31 July 2023
[28] Nikkei Asia, 4 July 2023
[29] Bloomberg, 31 July 2023

Note: The Portfolio Investments and Atlas Portfolios are Multi-asset, globally diversified portfolios. Although the portfolios may share similar underlying investments in terms of asset and fund selection, they will differ in terms of the way the funds are managed and the proposition in which they are held. Please refer to the Key Investor Information Document (KIID) for details on the objectives of the individual funds. If you have any questions relating to specific differences of the Portfolio Investments or Atlas Portfolios fund ranges, please contact your Private Banker.

The views expressed in this document are of the Multi Asset Solutions Team at Santander Asset Management UK Limited or where appropriate the Sub-Investment Manager, are subject to change and do not necessarily reflect the views of Santander Asset Management UK Limited or Santander UK plc (as a whole or any part thereof).