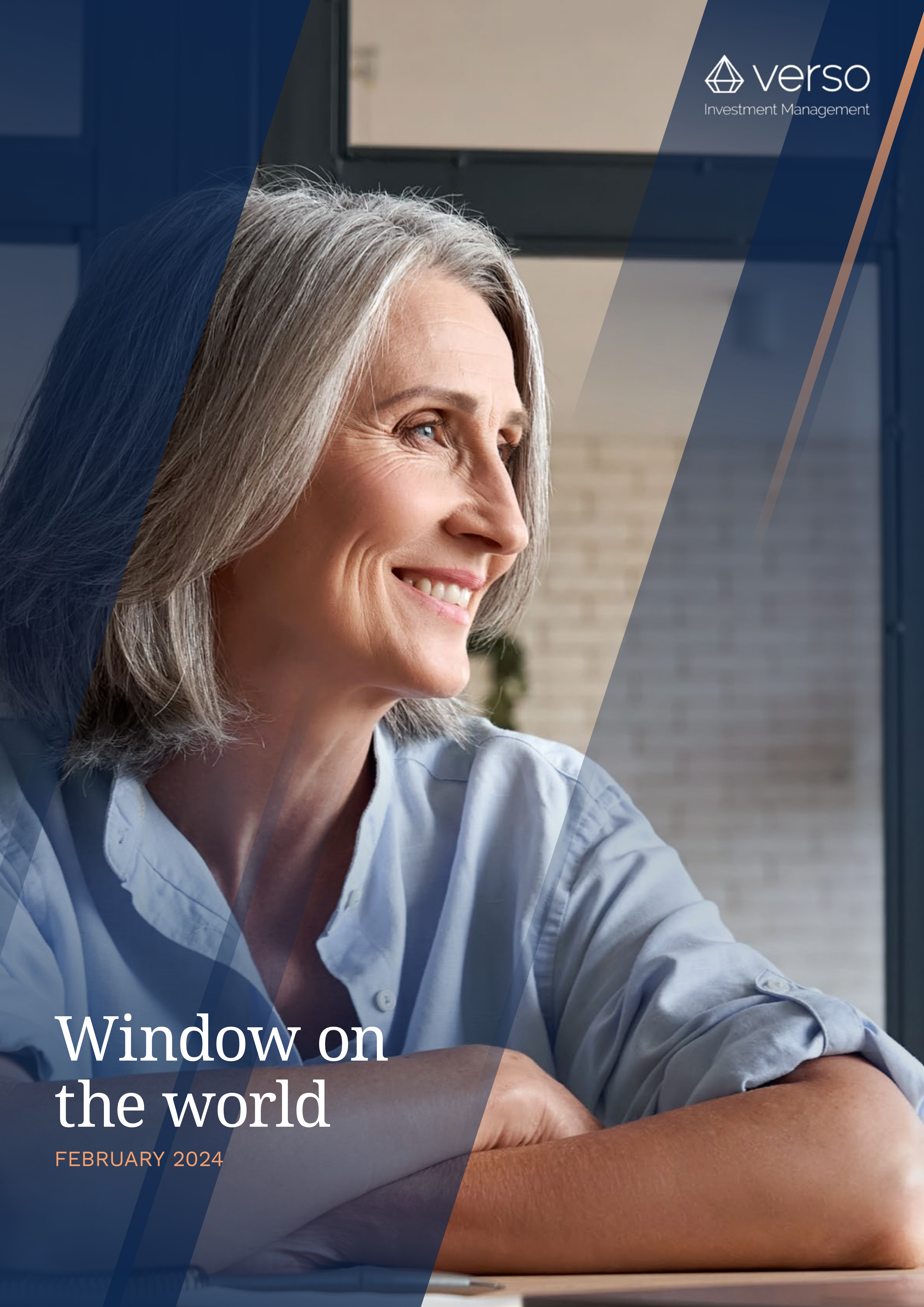
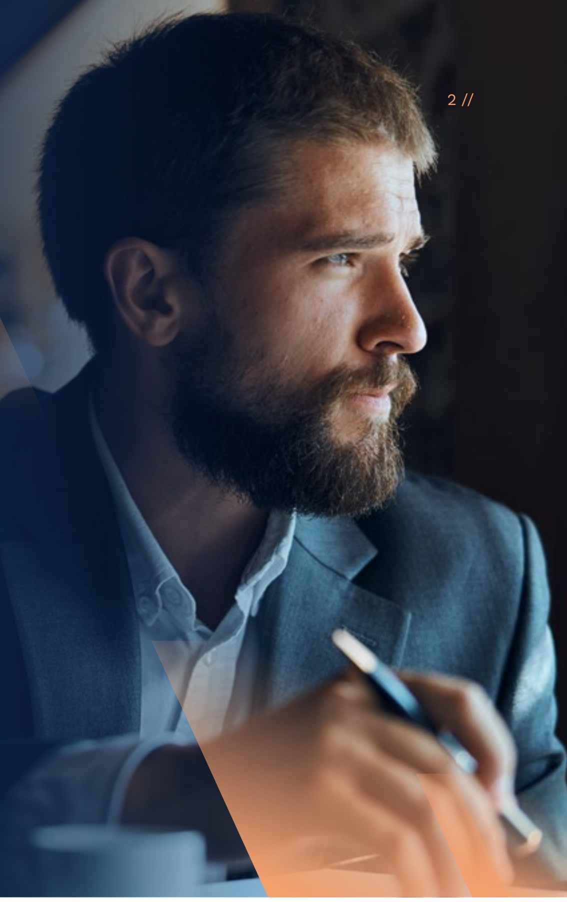


Verso Investment Management

Window on the world

FEBRUARY 2024



Introduction

January proved to be more of a mixed month for asset markets following the robust momentum witnessed in bonds and equities during the last two months of 2023.

Notably, expectations for the number of interest rate cuts this year underwent a recalibration away from what initially looked like excessive levels (outside of a recession) at the end of December. Geopolitical considerations took centre stage, with heightened focus on developments in the Middle East and the Red Sea.

On the economic front, the United States continued to showcase resilience, with labour and Gross Domestic Product (GDP) data remaining robust. There were also glimpses of potential stabilisation in European manufacturing data, although a watchful eye needs to be taken to any supply chain challenges stemming from the disruptions in the Red Sea.

Geopolitics

Developments over the month would signal that geopolitical risks are rising. The conflict between Russia and the Ukraine is now close to entering its third year, with the Ukraine counter offensive failing to achieve a breakthrough. Financial and military support for Ukraine continues to come from western allies, with the European Union in the process of finalising a multi-year €50billion support package, whilst $60billion of aid from the US remains blocked in Congress. Meanwhile drone attacks on Russian energy infrastructure has added to concerns around energy prices.

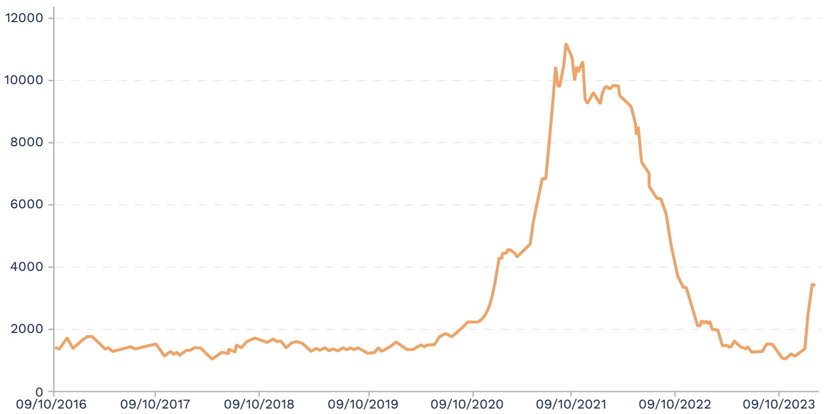
Tensions in the Middle East remain high, and disruption to trade remains a problem in the Red Sea. A drone attack which killed three US troops in Jordan has further inflamed the situation, and potentially draws Iran into the conflict. The US has subsequently responded with strikes in Syria and Iraq against Iranian backed militant groups.

This follows co-ordinated strikes against Houthi rebels in Yemen, in response to their attacks on commercial vessels in the Red Sea. Unsurprisingly this has put upward pressure on oil prices, with the cost of a barrel of Brent Crude rising by nearly 8% over the month.

Persistent and ongoing issues in the Red Sea can impact supply chains and push up costs, raising inflationary concerns. Container traffic using this route has fallen 65% over the past three months, whilst shipping costs have risen dramatically. Longer delivery times for core components have led a number of European car makers to temporarily close certain vehicle production lines. That said, whilst shipping costs have risen, they remain well below levels reached during the COVID-19 pandemic (see chart). Clearly, these geopolitical developments remain a source of risk for growth and inflation and warrant ongoing attention.

Freight rates have reached their highest levels in three years, but remain well below their COVID-19 induced peaks.

/ FREIGHTOS BALTIC INDEX: GLOBAL CONTAINER FREIGHT INDEX



Source: Bloomberg. Freightos Baltic Index provides 40 ft container indices for ocean freight. Index shows the average Dollar cost of freight rates.

Financial and military support for Ukraine continues.

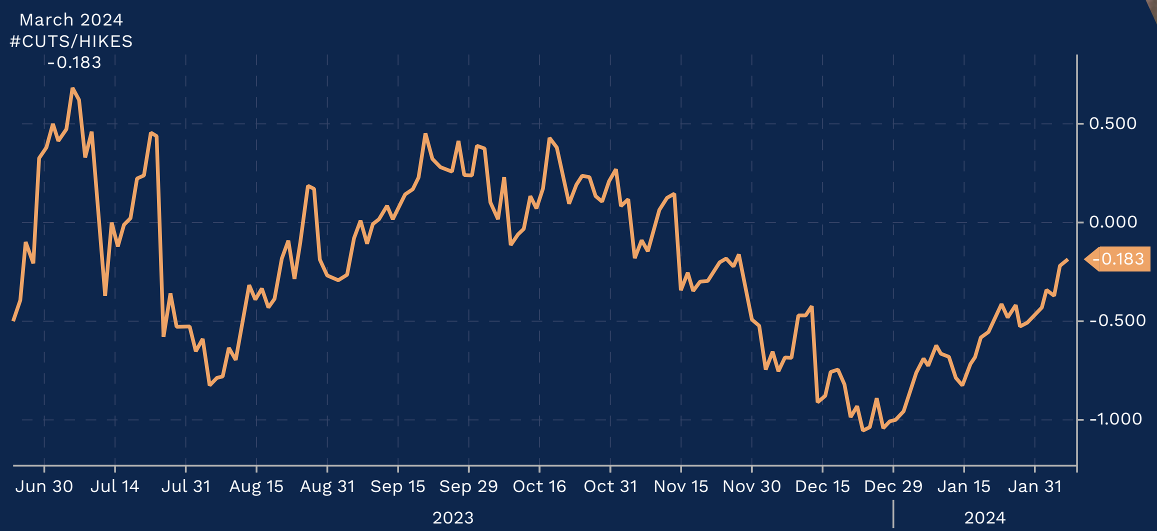
Macro Backdrop

There are limited signs that geopolitical issues are having a significant impact on economies at this juncture.

Data in the US continued to point towards an economy in good health, with the economy continuing to create new jobs in December, and the unemployment rate standing at 3.7%. One area of focus for the Central Bank will be the ongoing rise in wages, with average hourly earnings rising by 4.1% year over year in December, although this will continue to provide support for the US consumer.

US economic growth surprised to the upside in the fourth quarter of 2023, with the economy growing by 3.3% annualised, significantly above expectations of 2.0%. This has contributed to a more hawkish Federal Reserve of late, and led to a sharp reassessment of the probability of an interest rate cut as early as March. In December, the market had fully priced in a rate cut at the March meeting – now, the market assigns a 1 in 5 chance that the bank cuts then. We expect that rates will be on hold into the early summer.

Market now assigns a less than 20% probability that the Federal Reserve cuts rates in March, down from 100% a month ago.



Source: Bloomberg

Both the European Central Bank and the Bank of England kept rates unchanged at their last meeting as expected, amidst ongoing declines in headline inflation rates. In the UK, positive Purchasing Managers Index (PMI) and consumer confidence data was encouraging, although retail sales did disappoint. In Europe, manufacturing PMI data continued its recovery and indicating that activity in the sector – a key component of the European economy – is improving. In China, GDP data showed that the economy grew by 5.2% year-on-year in the fourth quarter, although weakness is still observed in the housing market.

On an aggregate basis, at present the economic backdrop continues to support the prospect of the US economy achieving a soft landing, although we remain attuned to the risk of softer activity as the impact of higher interest rates filter through economies. Growth is likely to remain subdued, but positive, in the UK and Europe.

For China, the authorities continue to implement a range of measures aimed at stabilising the property market and supporting investor confidence.

One area of concern is US commercial real estate. Evidence of the collapse in commercial real estate valuations (due to high borrowing costs and lower demand for office space) in the US is becoming more evident. In the past month US regional bank New York Community Bancorp announced it was setting aside $522million for loan losses, and Japanese bank Aozora Bank followed suit with $221million to also deal with bad loans. Both experienced sharp declines in share prices on the news, which raised fears that others may follow suit. Analysis would indicate that smaller banks are more exposed than bigger lenders, although this is likely to remain a focal point in coming months, with a large maturity of commercial real estate loans expected out to 2025.

Yields to maturity remain at their most attractive levels in 15 years.

Capital Markets and Positioning

Over the month we saw a retracement in bond yields, with UK Government bond yields moving up by approximately 25 basis points.

This left 10 Year Government bond yielding 3.8% by the end of January, compared to 3.55% at the end of 2023. UK Gilts were therefore lower over the month, declining by 2.2% on aggregate. Corporate bonds fared better, declining by 1.1% in the UK, as spreads narrowed further, and returning to levels last seen in 2021.

We retain a positive stance on this asset class, remaining focused on short-duration government and corporate bonds, and will be seeking to add duration on a further retracement in yields. Yields to maturity remain at their most attractive levels in 15 years, and we would expect them to act as a hedge in the event that economic weakness weighs on equity markets.

It was a mixed month for equity markets. Japan's, the standout performer in 2023, continued its rally, rising by over 7% in January, with markets pushing out the likely end to the Bank of Japan's negative interest rate policy on weaker wage growth. Europe was up over 3%, with gains predominantly coming from two large technology companies, ASML and SAP.

In the US, large cap technology names continued to drive returns, thanks in part to a strong performance from Nvidia, Meta and Microsoft. All three outperformed the broader US equity market, which rose by 1.7%. UK equities were lower during the month, in part a function of the weaker performance of value as an investment style, which lagged growth. Emerging market equities declined by 4.6%, dragged lower by China, with equities continuing their descent despite efforts taken by the authorities to stabilise markets.

In the near-term, we retain a broadly cautious stance on equities, but see value in both the UK and emerging market equity space, and have positioned portfolios accordingly.

10 Year Government bond yielding

3.8%

UK Gilts declined on aggregate by

2.2%

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