UK: Suitable for retail and professional clients.

Quilter Investors

Monthly Income Portfolios

Monthly commentary – Review of May 2023

Marcus Brookes
Chief Investment Officer

Our market summary

Global equities posted a gain of just 0.5% in May. An impasse over the mounting US debt-ceiling crisis fuelled investor concerns as the deadline approached, although optimism returned towards the end of the month as an agreement was finally reached. Equity markets in the UK, Europe, and China declined while the US and Japan made gains, chiefly due to semiconductor and other technology stocks, which boomed thanks to the sudden appetite for artificial intelligence companies.

Equity markets

In May, the US news cycle was dominated by the prospect of a debt default as the deadline to raise the nation's borrowing threshold loomed large. Investor jitters were eventually allayed as President Biden reached a consensus with the Republican-controlled House of Representatives to raise the debt ceiling in time for the next round of repayments. US equities ultimately gained 2.1%, powered in the main by surging technology stocks.

After strong progress in the first four months of the year, European equities fell by 4.1% in May. Investor sentiment was soured by negative economic data, which included news that Germany had entered recession over the winter period. Even so, inflation fell in both Germany and France. Technology stocks were the one positive area as semiconductor manufacturers rallied on the sudden appetite for stocks exposed to artificial intelligence.

The UK declined more than Europe in May, with UK equities sinking 4.6%. Much like in the US and Europe, technology stocks were the only notable positives, although the UK's extensive financials sector was relatively flat for the month. While inflation fears eased elsewhere, the Bank of England continued to grapple with higher-than-expected inflation in the UK, and subsequently raised interest rates to 4.5%.

Emerging markets equities declined very modestly in May, with a fall of 0.3%. Greece was the top-performing emerging market due to a decisive vote for the New Democracy Party in the national election, easing concerns over a coalition government. South Africa was the worst-performing market, dogged by a tumbling currency and accusations of supplying weapons to Russia. China and the Czech Republic also declined notably.

Fixed income

Global bond markets were a mixed bag as investors responded to a raft of economic data from the various central banks and processed the continued rise in interest rates across developed economies. This resulted in a 1.3% loss for US Treasuries (US government bonds), a 3.8% loss for gilts (UK government bonds), and a 2.4% fall in UK corporate bonds. European bond markets generally outperformed, while the UK struggled as inflation proved more resilient than elsewhere.

Total return, percentage growth in pounds sterling except where shown, rounded to one decimal place. Global equities are represented by the MSCI World Index; US equities by the MSCI US Index; European (excluding UK) equities by the MSCI Europe ex UK Index; UK equities by the MSCI UK Index, emerging market equities by the MSCI EM (Emerging Markets) Index; Chinese equities by the MSCI China Index; UK corporate bonds by the ICE BofA Sterling Corporate Index; gilts by the ICE BofA UK Gilt Index; and US Treasuries by the ICE BofA US Treasury (GBP hedged) Index.

Helen Bradshaw
Portfolio Manager

CJ Cowan
Portfolio Manager

Performance review

May was a fairly eventful month for markets, with further strains for US regional banks, continued interest-rate hikes and mounting concerns over the US debt ceiling dominating sentiment. On the whole, financial assets suffered over the month although there was a wide dispersion of returns between different regional markets and industry sectors. Against this backdrop, the Monthly Income Portfolio and the Monthly Income and Growth Portfolio lagged their Investment Association (IA) performance comparators, declining 1.8% and 1.7% respectively.

Performance summary (%)

	Cumulative performance						*Discrete annual performance to end of May*				
	1 month	*YTD*	*1 year*	*3 year*	*5 year*	*Since launch*	*2022 - 2023*	*2021 - 2022*	*2020 - 2021*	*2019 - 2020*	*2018 - 2019*
Monthly Income	**-1.8**	**0.5**	**-3.5**	**8.6**	**-**	**3.8**	**-3.5**	**-0.9**	**13.6**	**-**	**-**
IA Mixed 20-60% Shares	-1.0	1.2	-3.1	6.4	-	4.2	-3.1	-2.7	12.9	-	-
Monthly Income and Growth	**-1.7**	**0.9**	**-1.9**	**15.7**	**-**	**11.3**	**-1.9**	**0.8**	**16.9**	**-**	**-**
IA Mixed 40-85% Shares	-0.8	2.1	-1.6	14.1	-	12.4	-1.6	-0.9	17.1	-	-

Source: Quilter Investors as at 31 May 2023. Total return, percentage growth, net of fees, rounded to one decimal place of the U1 (GBP) Accumulation shares. The Monthly Income Portfolios launched on 26 June 2019.

How our equity holdings performed

Japan market hits record high

Japanese equities continued their recent strong momentum with a return of 3.3% for the MSCI Japan Index, making it the top-performing regional market in May. Signs that Japan's decades of deflation may be ending have buoyed sentiment, as have indications that corporate governance reforms are starting to unlock greater shareholder value. Consequently, our Japanese equity holdings provided some of the top portfolio returns in May.

Artificial gains

Despite widely varying returns at the sector level, US equity markets delivered modest gains. Energy and material stocks were some of the weakest performers, dragged lower by concerns over the demand outlook. This contrasted markedly with the technology sectors, where artificial intelligence 'fever' was sufficient to boost the market into positive territory. As a result, our holding in the iShares S&P 500 ETF returned 2% in May.

UK market becomes the laggard

Closer to home, equity markets were more lacklustre. The UK was the worst performing developed equity market in May with the MSCI UK Index down 5.3%. In line with the US, energy and material stocks were among the worst hit with only technology stocks making gains. Against this backdrop, all our UK holdings declined over the month.

Deflation is the opposite of inflation. It is an ongoing decline in the price of goods and services. It can arise due to gains in production but is more commonly associated with a contraction in the supply of money and credit in an economy.

How our fixed income holdings performed

UK government bonds lag

In aggregate, our fixed-income holdings weighed on the portfolios in May as government bond yields rose (meaning their prices fell). During the month, central banks in the US, UK and Europe all raised interest rates, while market volatility mounted until a US debt ceiling resolution was announced. UK government bonds suffered the worst losses due to 'stickier' than expected inflation. As a result, our holding in the Vanguard UK Gilt Fund was the worst performer. Elsewhere, some of our alternative fixed-income holdings made modest gains, with the Blackstone Loan Financing trust, rising 0.7%.

Volatility is a statistical measure that shows how much an asset's price varies compared to its mean price, over a set period of time. The higher the volatility of an asset, the more unpredictable and extreme its price movements. Hence, higher volatility means higher risk.

How our alternative holdings performed

Alternatives lose some shine

In contrast to April, our alternatives holdings lost some of their shine in May, with many feeling the impact of rising interest rates. The Hipgnosis Songs Fund was the biggest detractor; it gave back much of April's gains. Elsewhere, our infrastructure and renewables holdings also lost ground as sentiment weakened.

Meanwhile, the Janus Henderson Absolute Return Fixed Income Fund, which invests in short-dated corporate bonds while managing interest-rate risk, delivered a modest gain.

The Hipgnosis Songs Fund is a UK investment trust which pays investors an income derived from the licensing of musical intellectual property rights.

All returns in pounds sterling except where shown. Rounded to one decimal place.

Portfolio activity

During the month, we reduced our European equity exposure, banking our profits from the region's strong relative performance over recent months. We are mindful that Europe has benefitted from falls in gas prices, as well as China's reopening and our view is that the best of the momentum in both cases is likely behind us. Elsewhere, we topped up our holding in the International Public Partnerships trust following weakness in the share price. We continue to like the predictable cashflows within the portfolio, which are underpinned by regulated or contracted government-backed revenues, as well as its high level of inflation proofing.

Investment outlook

With the US debt-ceiling issue once more kicked further down the road and stability returning to the banking sector, markets should now return to assessing the outlook for corporate revenues, margins, inflation, employment, central bank interest-rate moves, the threat of quantitative tightening and the impact of likely government policy.

Quantitative tightening (QT), also known as 'balance sheet normalisation', is the process by which central banks shrink their monetary reserves, either by selling government bonds or letting them mature and removing them from their cash balances. This causes a contraction in the amount of money, or 'liquidity', in financial markets.

1. Market liquidity is drying up

We continue to be concerned as to the potential impact of the intense liquidity withdrawal we've witnessed over the last 12 months. We have noted on several occasions that the full impact of monetary tightening (namely interest-rate hikes) takes time to become apparent. Although equity markets have been broadly positive so far this year, as financial conditions continue to tighten, we expect corporate earnings to continue to soften.

Liquidity refers to the ease with which an asset or security can be converted into cash without impacting its market price. Liquid assets are relatively easy to convert to cash; illiquid assets take longer to convert and can have higher conversion costs. Cash itself is the most liquid asset of all.

2. Dividend stocks should prosper

The tightening of monetary conditions (higher interest rates) should continue to favour dividend-paying stocks, which are inherently less impacted by interest-rate changes. Additionally, in an environment of heightened volatility, higher-quality companies, and those with high free cash-flow yields (such as dividend-paying stocks), should have the greatest ability to fund their growth.

Free cash flow yield is a measure of a company's profitability. It represents the cash that is available after operating costs and other expenses to be repaid to creditors or distributed to shareholders in the form of dividends.

3. Biding our time on bonds

Value has been building in bonds over the last couple of years. Yields within the fixed-income sphere look more attractive than they have been for some time but, as noted in recent months, in the short term we've been awaiting better pricing opportunities to increase our bond exposure further. Incoming data, including solid job gains, suggest worries of an imminent recession may be overstated but it also highlights that central banks may have to do more to tame inflation.

Thank you for investing with us

Keep an eye out for your Monthly Income Portfolios quarterly commentary in July.

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