Market review: December 2023

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- **Liontrust Multi-Asset funds and portfolios deliver positive performances over December, Q4 and 2023**
- **Market rallies spurred by expectations that interest rates have peaked and will be cut early this year**
- **Japanese exposure moved to overweight; profits taken in gilts duration trade**

The Liontrust Multi-Asset funds and portfolios delivered strong performance in December as equities, bonds and real estate rallied globally. All our Explorer funds outperformed their benchmarks as the risk-on stance in financial markets continued. Over Q4 and 2023, all the Liontrust Multi-Asset funds and portfolios performed positively.

Global equities rose around 17% over 2023 in sterling terms, which benefited all our investment solutions given they have unhedged exposure to international equities. Around 60% of these gains were made in November and December[1], illustrating how quickly market sentiment can change and underlining why the Liontrust Multi-Asset team prefers patient tactical exposure to markets rather than trying to time them too finely – the bounce in the final two months could easily have been missed. The total return from equities over the course of 2023 also demonstrates the benefits of a disciplined and repeatable process that emphasises staying invested for the long term and the result was market returns that dwarf those seen on cash deposits.

UK equities, for which we have a positive outlook, have also performed comparatively well over three years in sterling terms, delivering 34.5% versus 32.9% by their global counterparts, although the S&P 500 returned 41.7%.[1] Many global investors may deem the UK political environment to be too challenging to merit adding to their UK positions but this behaviour has led the UK to be, in our opinion, an undervalued market.

Overweight in Japan

The main factor driving the gains has been a pivotal change in investors' expectations that developed market central banks have ceased raising interest rates and will begin to cut them in 2024. Central bankers have been accused of being too slow to cut rates in response to growing evidence that the inflation crisis is abating, but fears of underestimating the threat of inflation is restraining the consensus among leading central bankers for rate cuts.[2]

Japan was the only equity region to deliver negative returns in December, but the Nikkei still made the strongest gain of any major country index over the year. We raised our outlook for Japanese equities, including smaller companies, from a neutral three to a positive four in our Q4 Tactical Asset Allocation (TAA) review.

Japanese equities rallied significantly in 2023, benefiting from relatively cheap valuations, a weakening currency, robust economic growth and loose monetary policy. Japan's stock market has waited more than three decades for its moment in the sun and it continues to offer a combination of fair valuations with a positive outlook for economic growth.

In December we moved our score for the region from a neutral three to an overweight four and we added to our Japanese equity targets in December. Japanese funds we have been buying include M&G Japan and Baillie Gifford Japan. We believe this blend presents a balanced approach to risks, market cap and sector exposure within the region. M&G Japan's core / value exposure will provide a valuable counterbalance to the quality growth approach of Baillie Gifford Japan, ensuring the portfolios benefit from a diversified stylistic mix. The changes to our Japan sleeve reflect a deliberate emphasis on increasing stock-specific risk in the region, positioning the blend to harness the opportunities of a changing macroeconomic and corporate governance backdrop.

As the team elected to keep its overall allocation to the equity market unchanged, the increase in exposure to Japan was funded by trimming our exposure in the US and Europe ex UK. The US was the strongest equity region in December, closely followed by Asia ex-Japan, but we remain neutral on its stock market. Our manager selection provided some exposure to the artificial intelligence (AI) theme that has dominated the US this year through US growth fund managers and index funds, but we remain careful because the AI-driven rally has been particularly narrow in nature, bringing a small cohort of stocks to valuation levels that are, we believe, unsustainable. A more diversified allocation to the US will benefit less from the AI theme when the going is good, but we also expect it to be less sensitive to the inevitable challenges that this theme will face from time to time. We are also neutral on European equities. We believe that Europe is still relatively less attractive than the UK and the European Central Bank's fight against inflation looks challenging, especially in a region with a significant divergence in growth and inflation rates operating within a single monetary regime.

Profits taken in gilts duration trade

We maintained our neutral stance on fixed income in our Q4 TAA review, although we are positive on corporate bonds. Our overall allocation to the asset class remains unchanged, but we have been actively managing our duration exposure in the MA funds and portfolios this year amid a volatile rate environment. We were underweight duration throughout 2022 but in the summer we decided there was an opportunity to add to our position in longer duration gilts to the MA funds. We believed that gilts with longer duration (or greater interest-rate sensitivity) would provide more capital returns than those with less duration as disinflation and slower growth led to lower rates and yields over time. We reduced our position in short-duration gilts and increased it in medium-duration gilts in our MA Dynamic Passive, Blended and Explorer funds. The new Strategic Asset Allocations (SAAs) we introduced in the spring allowed for us to underweight short fixed income as it is a specific line item in them.

Generally, we expect our tactical positions to play out over 12-18 months, but such was the rapidity of the moves in gilt yields over the course of 2023 that we needed to work on a shorter than usual timeline on these trades. We have now started to take profits from this trade following material moves in the 10-year gilt yields over recent weeks. When we initiated the trade in June, the yield on two-year gilts was 5.08% and on the 10-year it was 4.37%. These have compressed to 4.13% and 3.56% respectively. Short duration gilts have performed well but our medium / longer duration tilt has benefited us on a relative basis by around 260 basis points. We continue to express a tilt to longer duration because we believe there is scope for further outperformance in the middle of the gilt curve versus the short end on a 12- to 18-month horizon. Depending on the fund range in question, the short duration gilt allocation contains a combination of SPDR 1-5 Gilt and Lyxor UK Government bond and the 'full' duration allocation contains a combination of iShares UK Gilts All Stocks, L&G All Stocks Gilt Index and Vanguard UK Government Bond Index.

Investing for the long term

The Liontrust Multi-Asset team remain constructive on the prospects for investments from here. Markets rarely rise in a straight line and, as a result, the team recognise market risk throughout its process, making use of asset class, sub asset class, style and manager selection as a means to reduce idiosyncratic risks in the funds and portfolios. The strong returns seen in global financial markets in November and December highlight the dangers for investors of holding cash over the long-term and demonstrate that markets will often turn long before the news flow does. Having a tried and tested process and a team with experience through a variety of market cycles helps with making sensible long-term capital allocation decisions at times when it may not seem obvious.

Part of the team's role for our investors is to show fortitude and to make difficult decisions. There are times when these moves may be uncomfortable, but November and December 2023 show how quickly markets can move back into your favour. Attempting to "catch" these swings is notoriously difficult and that is why we believe in "time in the market, not timing the market". Those who believed "cash is king" and looked to time markets were most likely blindsided by the sudden move up in global equities. The recoveries seen in markets this year are a testament to the value of staying invested and keeping to a disciplined investment process. Markets may well encounter more volatility before stronger momentum builds, but thus far disinflation has been relatively pain-free without a spike in unemployment nor any other broader damage to the economy. At least for now, central bankers are on course for a soft economic landing, which bodes well for financial markets.

[1]Source: MSCI/Liontrust 3 January 2024
[2]Source: Financial Times, 3 December 2023

For a comprehensive list of common financial words and terms, see our glossary at: https://www.liontrust.co.uk/benefits-of-investing/guide-financial-words-terms

Key Risks & Disclaimer:

Past performance does not predict future returns. You may get back less than you originally invested.
The Funds and Model Portfolios managed by the Multi-Asset Team may be exposed to the following risks:
Credit Risk: There is a risk that an investment will fail to make required payments and this may reduce the income paid to the fund, or its capital value. The creditworthiness of a bond issuer may also affect that bond's value. Bonds that produce a higher level of income usually also carry greater risk as such bond issuers may have difficulty in paying their debts. The value of a bond would be significantly affected if the issuer either refused to pay or was unable to pay;
Counterparty Risk: The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the Fund to financial loss;
Liquidity Risk: If underlying funds suspend or defer the payment of redemption proceeds, the Fund's ability to meet redemption requests may also be affected;
Interest Rate Risk: Fluctuations in interest rates may affect the value of the Fund and your investment. Bonds are affected by changes in interest rates and their value and the income they generate can rise or fall as a result;
Derivatives Risk: Some of the underlying funds may invest in derivatives, which can, in some circumstances, create wider fluctuations in their prices over time;
Emerging Markets: The Fund may invest in less economically developed markets (emerging markets) which can involve greater risks than well developed economies;
Currency Risk: The Fund invests in overseas markets and the value of the Fund may fall or rise as a result of changes in exchange rates.
Index Tracking Risk: The performance of any passive funds used may not exactly track that of their Indices.
Any performance shown in respect of the Model Portfolios are periodically restructured and/or rebalanced. Actual returns may vary from the model returns.
The risks detailed above are reflective of the full range of Funds managed by the Multi-Asset Team and not all of the risks listed are applicable to each individual Fund. For the risks associated with an individual Fund, please refer to its Key Investor Information Document (KIID)/PRIIP KID.
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