Quarterly Report

Second Quarter **2023**

moneyfarm

A letter to our investors

by Richard Flax
Chief Investment Officer at Moneyfarm

Dear investors,

It has been another positive quarter for financial markets performance, in line with the previous two. The headline numbers show good returns for equities – with developed markets rising around 4% in sterling terms – and a more muted performance in government bonds - which were flat to slightly down over the quarter. It's probably fair to say that that's not what most commentators had expected. The prevailing narrative in the first part of the year has been that bonds "were back", given the higher bond yields, while equities looked a bit risky, given the prospect of slower profit growth.

If we have to look at the story behind the numbers, which are still relevant for portfolio performance, we find that the path was more volatile than those figures might suggest.
In the US, we saw severe stress in parts of the regional banking system – most notably at Silicon Valley Bank. Policymakers and regulators both in the US and the UK spent a weekend engineering a solution that seems to have succeeded in protecting the financial system. In Europe, we saw the final demise of Credit Suisse, gradually and then very suddenly (with apologies to Ernest Hemingway).

In Asia, China's reopening had sparked hopes of a boost to global growth, and helped to drive luxury goods demand, but the recovery has been less pronounced than hoped.
Finally, the last three months have seen an intense focus on Artificial Intelligence, and a small cohort of, mostly US, stocks that are regarded as being the biggest beneficiaries.
On the macro side, it's been a tale of "stickiness" and "resilience" - two sides of the same coin. On the "sticky" side, inflation has been proven more stubborn than many had hoped. Yes, the year on year numbers have begun to fall, helped by lower energy prices, but the trajectory, particularly of core inflation, hasn't been as steep as central bankers would have liked. Domestic demand, however, has proven quite resilient, with employment and spending data, particularly in the US, holding up pretty well over the quarter. That's left central bankers at least in the developed world in a more hawkish frame of mind. Expectations for peak policy rates have generally drifted higher during the quarter. So, how does this all balance out? The overall view of financial markets remains positive, at least for now, as corporate profitability has held up fairly well, and that's been supportive for equities.

As we come into the second half of the year, our key questions are somehow familiar ones. Will developed economies avoid a significant slowdown or is it only a question of time? Are the expectations for corporate earnings too high? Will inflation continue its fall towards central banks' 2% target? And, if inflation stays stubborn, how will central banks respond?

At this point, we continue to believe that developed economies will see some slowdown in activity, but that there won't be a significant contraction. We think that corporate earnings have generally held up well, and that as economies slow there's scope for some downgrades. Inflation will continue to slow, but it may prove difficult to get back towards the 2% target in the short-term. In that environment, we'd expect policy rates to stay "higher for longer" as Central Banks try to rebuild their inflation-fighting credibility. Translating those views into our positioning, we remain on the conservative side in terms of our exposure both to equities and longer-dated bonds. But we're wary of being too conservative. Inflation is slowing and corporate profits have held up fairly well, despite significantly higher rates. That should give some confidence to investors.

Richard Flax
Chief Investment Officer at Moneyfarm

Market comment

Another very positive quarter for risky assets, driven by the strong rally of Artificial Intelligence-related stocks, especially Nvidia, which certainly surprised the majority of investors.

Since the beginning of the year, the S&P 500 and the Nasdaq 100 equity indexes have had an incredibly strong start, exceeding many investors' expectations, quieting fears of inflation, recession and a new banking crisis. Risks remain, and many signals continue to point to an economic slowdown, but it is undeniable that both consumption and, crucially, labour markets remain extraordinarily strong.

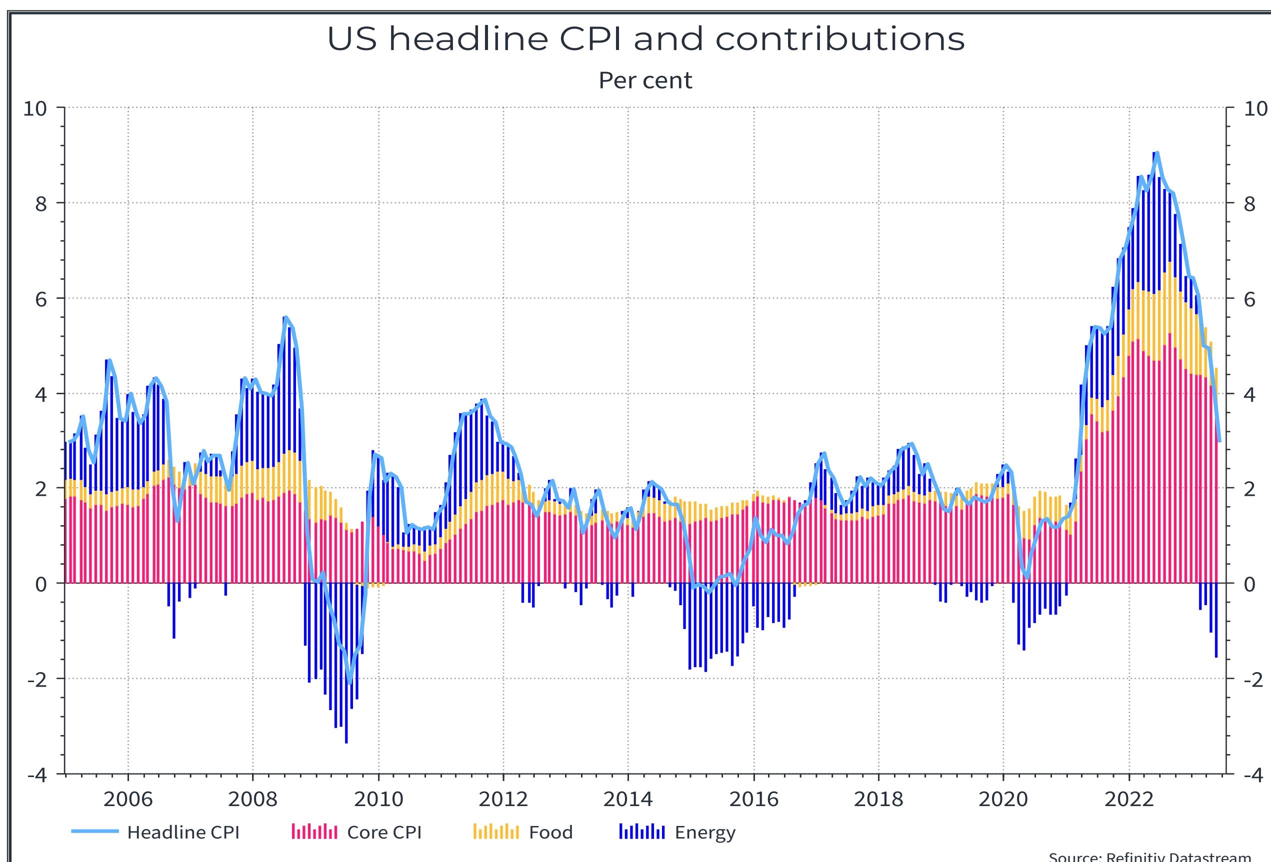
Meanwhile, inflation, which was the biggest concern at the beginning of the year, continues its slowdown in all major economies. Although central bankers continue to talk about higher and longer-lasting interest rates, the repricing of more optimistic money markets this time has not undermined equity performance, driven by idiosyncratic considerations that are stronger than macroeconomic ones.

In short, economies are slowing down, but less than expected, inflation continues to give very positive signals, and monetary policy seems to have lost the ability to move markets as before. There are still very real risks, especially in credit and liquidity, but the wonders of ChatGPT and similar technologies seem sufficient to reassure even the most cautious investors with the promise of new, abundant areas to explore.

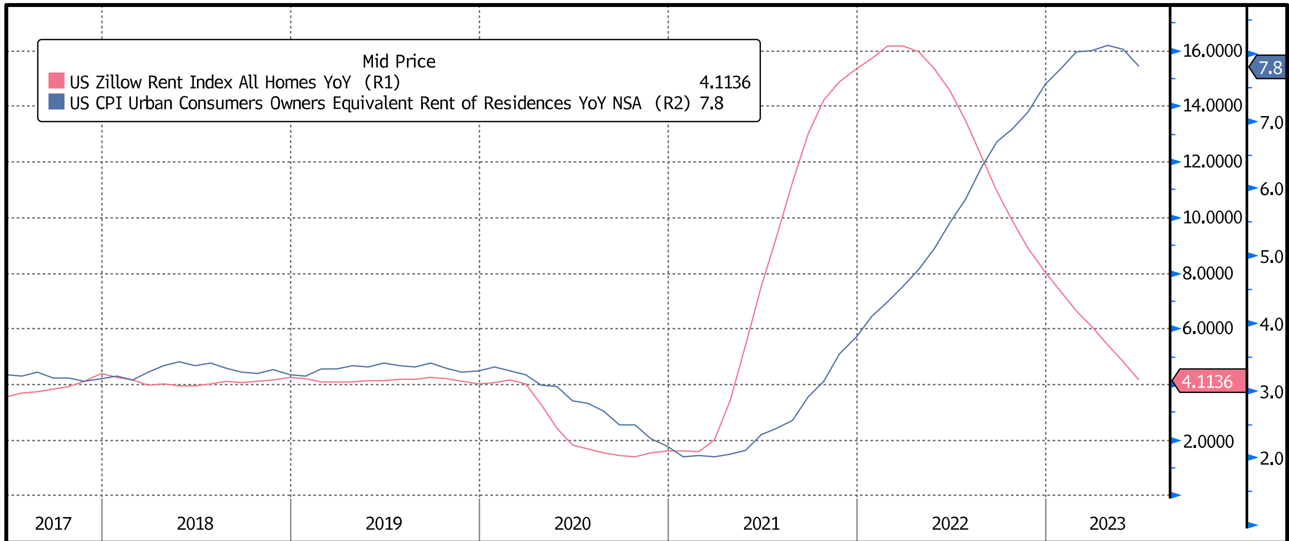
It's been another positive quarter for our portfolios, although caution and quality remain key considerations in a market that is not yet completely stable.

Has the battle or war been won?

In the US, inflation has shown very strong signs of normalisation. Overall inflation fell from 4.9% to 4% in the month of May, with core CPI also slowing down to 5.3% compared to the previous month's 5.5%. The Consumer Price Index measures the overall change in consumer prices based on a representative basket of goods and services over time. The Core CPI measures the same basket, net of food and energy components



Although absolute levels remain high, especially for the core component, there are two key reasons to look at the coming months with more optimism. First, even the 'housing' component (all costs related to housing including rent, utilities and services), a major driver of overall inflation, has shown the first signs of normalisation. Although the reduction has been minimal, it is important to remember that one of the main sub-components of this benchmark is a somewhat artificial measure that estimates how much homeowners would pay if they were renting. Consequently, this component tends to lag behind more reactive market measures, such as rent increase indicators constructed using market data, which have already declined to a greater extent. In other words, there are good reasons to expect further significant downward adjustments in this component. You can see how this dynamic plays in the below graph, where the market-based rent index(shown in pink) leads the CPI component related to rent (shown in blue).



Source: Bloomberg

Furthermore, even more severe inflation measures, which exclude, for example, unusual movements or consider only the stickiest components, have signalled downward, dispelling fears that there may be a deeper trend of price increases that are more difficult to manage. In particular, the so-called supercore inflation (core services excluding housing services) has returned to growth in line with historical data (around 0.3% month on month), increasing market optimism about the proximity to peak interest rates. In fact, this measure had been mentioned several times by Powell as the preferred indicator to monitor for considering a pause in rate hikes, precisely because it captures more stubborn inflationary pressures.

In short, inflation in the US is less daunting, although it remains high, and even the Central Bank has eased its focus by deciding not to raise rates in June, the first time in 15 months. However, both in tone and expectations of the participants in the US central bank's decisions, the Federal Reserve remains in restrictive territory, pricing in another hike and higher rates for longer.

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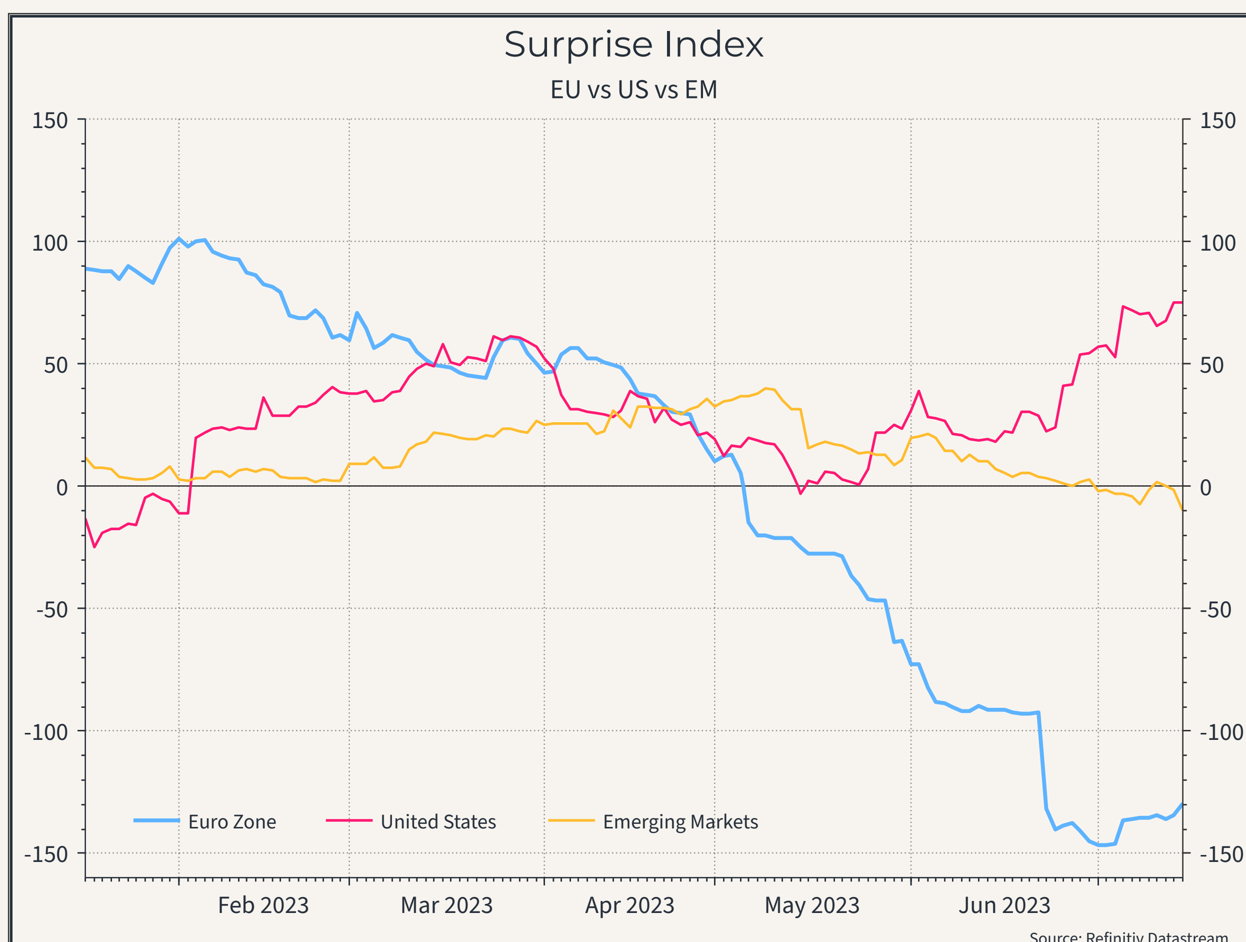
The UK is unfortunately lagging behind in the challenge to curb inflation, with the Bank of England widely expected to raise interest rates by a further percentage point potentially should price dynamics not settle in the coming months. In Europe, meanwhile, inflation continues to decline, but we are certainly lagging behind the inflationary phase as seen in the United States. At the moment, the markets expect at least two more rate hikes, but it is unclear if more will be needed. The economy in the region has slowed down more decisively compared to the US, but the European Central Bank's mandate is focused on price increases, and as long as the core is not at lower levels, it seems difficult to imagine Lagarde without her foot on the accelerator.

Overall, inflation remains a key mover on the financial markets chessboard, but it is officially no longer the most important one.

China and Europe falter, United States buoyant

Since the resolution of the banking crisis, the macro situation is captured perfectly by the graph below, which shows surprise Indexes for Europe, the US, and China. The Chinese Dragon has disappointed, dragging down Europe, while the United States has recovered after a sluggish start to the year. Surprise Indexes is a measure that adds up the gap between actual economic results and forecasts. If the sum is positive, it means the economy is performing better than expected by the market. If the sum is negative, it indicates that the economy is performing worse than expected.



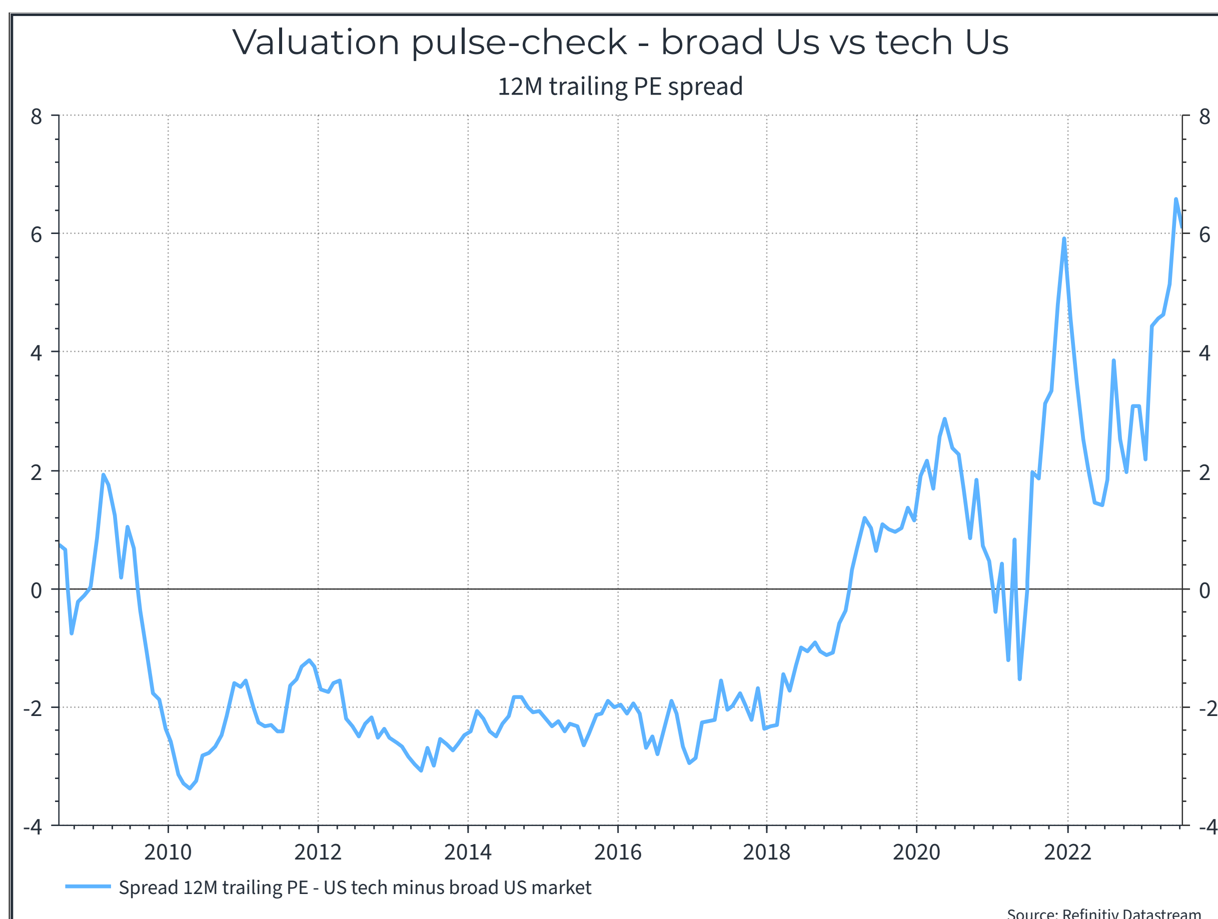
Starting with the latter, the biggest surprise lies in the fact that the great fear of a recession in 2023 has significantly diminished. The macro flow related to growth tells an unclear story, in which the manufacturing sector slows down, but the services sector drives growth, and overall, businesses and the economy as a whole are holding up very well, surpassing expectations.

Looking at key macroeconomic data, the latest aggregate Purchase Managers' Index (PMI) figures came in at 53 points (where a figure above 50 points shows an economy in expansionary territory), driven by the services sector, and GDP growth data for the first quarter was positive and above expectations (2% versus 1.1%). Bloomberg has also revised its expectations for 2023, increasing them from around 0.5% at the beginning of the year to nearly 1.5% now. And although the manufacturing sector has continued to show a clear deterioration in expectations, the levels of absolute output remain strong. Production, employment, and inflation have even grown in line with historical averages. Additionally, the labour market has shown surprising signs of recovery, with data on new construction starts beating consensus predictions. Finally, crucially, the unemployment rate remains at historically low levels (3.7% - as posted on 1st June).

In short, the American economy is surprising markets positively and remains strong, once again pushing the possibility of a recession further into the future. The story is worse for Europe and China. While the aggregated economic sentiment indicators for the Eurozone remain in expansionary territory in June, signs of a slowdown are increasing, with Germany experiencing another quarter of negative growth. The Chinese reopening, which fell short of expectations, likely didn't help, as the country struggles to encourage its citizens to spend the savings accumulated during the Covid pandemic and youth unemployment has reached 20%. In short, China is not growing as much as it should, and this has also weakened an already weak European economy. However, for now, this marginal deterioration has not significantly dented the expectations for global growth, driven by the US. Moreover, just like across the ocean, unemployment in Europe remains at historic lows, partially reassuring economists. The situation remains more fragile for China, where the government will have to find solutions to strengthen the economy, and the recent deterioration in diplomatic relations with the US certainly does not make things easier (which we'll cover later in 'Talking points'). In our view, however, there are many different options, and it seems plausible that the party will soon launch a fiscal plan to boost growth.

Keep your AIs open!

From the beginning of the year until the end of May, the most comprehensive American market index (the Wilshire 5000) has shown a return of 8.8%, of which 8.4% can be attributed to the return of the top 10 stocks in the index by market capitalisation. To provide context, between March 1999 and March 2000, at the peak of the dot-com tech bubble, only 9% of the 24.1% return could be attributed to the top 10 stocks. This number is clearly concerning because, as shown in the opening graph, it might reveal a weakness.



The most visible symptom is the increase in the 'cost' of American tech stocks, which now have a higher price-to-earnings ratio (P/E) compared to the S&P, even higher than in 2021 when interest rates were at their lowest and tech stocks dominated the market narrative post-pandemic. This is shown in the above graph, which shows the spread between the trailing Price/Earnings ratio of US technology stocks versus the general US stocks market.

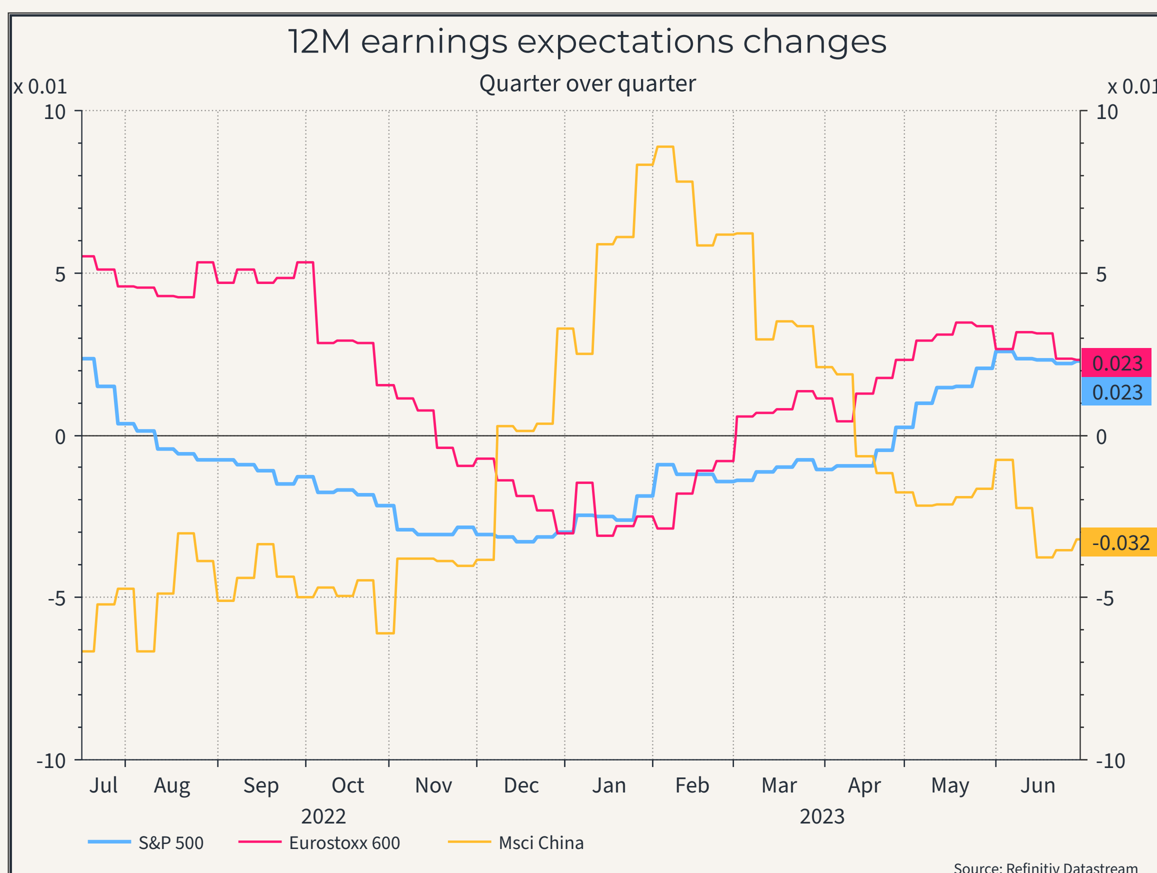
In our opinion, there is a possibility that the American market will re-normalise but with an adjustment in the multiples of these stocks.However, it is very difficult to understand what impact AI may have on the economy, and the appeal of investing in this sector is quite clear (especially after the success of chatGPT and OpenAI). The risk, however, is clear: the growth

and dominance of these stocks and the technology sector in general risks compromising the quality of ETF diversification exposed to this scenario. Therefore, we believe it is more important than ever to consider other developed countries and pay more attention than ever to valuations, which in our opinion will increasingly matter.

Where does all this take us?

Although the situation is now less negative than expected, economies continue to hold up and the risk of a recession for the US this year has certainly diminished. However, there are still fundamental questions about when and how the rise in interest rates will begin to have a greater impact on the economy, especially after the banking crisis and the credit tightening that will follow. Furthermore, the effects of the reduction in Central Banks' balance sheets, which will reach their maximum power in the coming months, are also uncertain. Finally, there is the uncertainty of China, including geopolitical risk and an economy that is not contributing as much to global growth as previously expected.

However, in all of this, developed markets continue to grow on average, and earnings growth expectations have also recovered, giving rise to increased optimism in recent weeks (except perhaps for China). The crucial question is how much of this growth is justified by the macroeconomic situation and how much is purely driven by AI fever.



In our opinion, uncertainty remains high and the keyword is, more than ever, quality, especially in the bond market. If the economy were to start slowing down more forcefully, high-yield (HY) and emerging market debt would be the first to be affected. At the same time, on the equity side, despite the significant readjustment in 2022, we believe it is important, more than ever, to increase diversification and pay close attention to valuations.

The next few months are crucial, with markets focused on the strength of consumption (especially in the services sector) and the labour market. Our base case, however, remains that of an orderly slowdown, which continues to lead us to opt for a moderate level of risk, albeit higher than in 2022, in order to secure outstanding long-term prospects.

Between the American Eagle and the Chinese Dragon

According to Blackrock's geopolitical dashboard, the risk of strategic conflict between China and the US remains high. The dialogue between the two countries has remained decidedly tense, if not worsened, by the renewed disputes that followed China's initial (albeit only in tone) support for the Russian invasion in Ukraine. The Taiwan issue remains equally sensitive, reaching a pinnacle with Speaker Nancy Pelosi's visit almost a year ago and the consequent military training exercise by the Chinese, which led to a complete encirclement of the island. A new peak was again reached at the end of June when Biden referred to Xi Jinping, the Chinese leader, as a dictator. How high, we ask, is the threat of invasion in the next six months?

Quantifying geopolitical risks and their possible impacts on markets and portfolios remains perhaps the most complicated aspect of our work as portfolio managers. Just think about the case of the surprise invasion of Ukraine, which saw the European market index not only recover in little over a month but also achieve a positive return of over 6% in the following 12 months, despite the risks associated with the ongoing war (including an energy crisis). Consequently, our recommendation remains to maintain focus on risk management and robust portfolio construction methodologies to navigate difficult geopolitical periods.

However, the reason we have not reduced our exposure to China and emerging markets

(which remains relatively low in absolute terms) is because we still believe that the risk of invasion is not excessively high over the next six months. The fundamental reason is linked to the previously mentioned weakness of the Chinese economy, which in our opinion will keep China extremely busy in the medium term. It seems unlikely, in other words, that Xi would decide to invade at a time when the economy is faltering, as it would undoubtedly result in sanctions and economic isolation as a best case scenario.

The banking crisis and contagion risk

Markets seem to have already forgotten about the banking crisis, even though banking sector stocks continue to underperform compared to the broader index. On one hand, this is reassuring, given the scrutiny placed on the stability of systemic institutions since March. On the other hand, it does not reduce the two main fears associated with this sector. First, it is unclear how post-crisis credit tightening may impact the economy in the medium and long term. Additionally, quantifying similar vulnerabilities in less regulated financial sectors, which could still have an impact on the broader system in the event of a crisis, seems challenging.

While we agree on the strength of the banking system, at least regarding large institutional banks, we believe the market is underestimating the potential impact on the economy from credit tightening. In the next six to 12 months, credit tightening at levels similar to those following the outbreak of Covid after the banking crisis (and certainly not improved by monetary policy decisions taken in the last 18 months) will undoubtedly have an impact on the economy. Although this does not necessarily imply a recession, we believe that credit spreads have not priced in even a moderate impact. In particular, the high-yield credit spread has remained at very low levels, even close to those of a year ago. While it is difficult to determine when and to what extent credit tightening will materialise at the spread level, we believe that at the current level of rates, taking on too much credit risk does not make sense and the downside is certainly greater than the upside. Therefore, in the last rebalancing, we specifically reduced exposure to low-quality credit.

The risks following the American debt crisis

Despite the recent agreement to suspend the debt ceiling, which narrowly averted the threat of a US default, the months of deadlock have still had significant repercussions for the US Treasury's coffers. By mid-2022, they had approximately $1 trillion in their 'checking account', but in the last month, it has decreased to just $150 billion (normally, maintaining sufficient coverage for current expenses would require a balance of at least $500 billion). The erosion of these reserves, due to the payment of state expenses in the months prior to the debt ceiling agreement, now necessitates replenishing a liquidity stock of at least $600-700 billion (in addition to the $500 billion to be allocated for state expenses). Such a sum, to be financed within a few months through the issuance of government bonds, could create considerable stress on the market. Most importantly, it remains to be seen whether it will be banks or

money market funds that currently hold over $5 trillion in various assets and invest in short-term debt securities, including the so-called Reverse Repo Facility, a mechanism that allows them to lend money to the Fed overnight in exchange for short-term government securities. Funds invested in this facility do not enter the economic system and do not have a direct impact on the liquidity of the financial system.

The Treasury's basic idea would be to issue short-term government bonds in order to encourage, at least on paper, the purchase of US debt by funds. The uncertainty in this case is whether funds will actually want to buy the government bonds. For now, the government has managed to convince them to finance the debt by paying a rate just above 5%, but that percentage would likely increase if the Treasury wanted to encourage more massive debt purchases. If the Treasury were to issue bonds with a lower yield than what is currently guaranteed by the Reverse Repo Facility, money market funds would most likely not be willing to buy US debt, leaving the issue to the banks and resulting in critical issues in terms of reducing reserves and liquidity in the market. On the other hand, if the US Treasury could issue short-term government bonds and provide an attractive rate, it would create ideal conditions for funds to purchase US debt while simultaneously minimising the consequences in terms of liquidity and maintaining bank reserves above an alarming level. For now, the plan seems to be working, with the Reverse Repo Facility seeing disbursements of nearly $300 billion in the last month, close to the overall issuance of Treasury Bills by the government during the same period.

Your Portfolio 5

Quarterly Report

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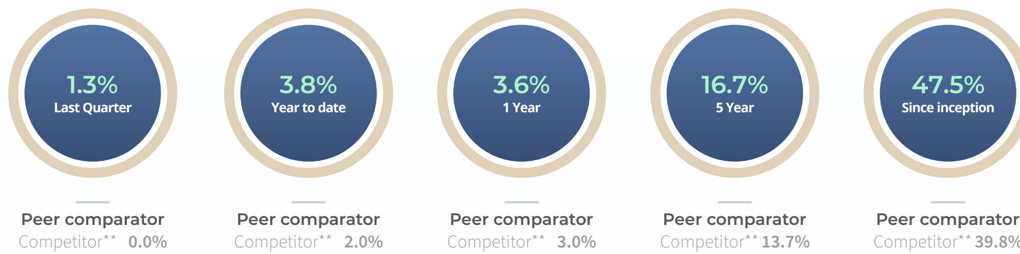
Your model portfolio

Your Moneyfarm portfolio is designed to replicate one of our seven model portfolios. A model portfolio comprises a diversified group of ETFs that target an expected return for a specified amount of risk, corresponding to your Investor Profile. Note that your portfolio and performance may differ from the model portfolio, depending on the amount invested in your portfolio and the timing of your cash flow.

These performance charts (net of all fees) were made using a monthly index from ARC (an independent consultant that compiles Private Client Indices (PCI) based on historical performance), or using a cash proxy, against which we have compared our model portfolios (after Moneyfarm's fees). This is compiled data from wealth managers and is net of fees. It includes data from large asset managers, private banks and wealth managers including close competitors of ours. It is submitted on a voluntary basis. These indexes show actual client returns for a given level of risk.

As with all investing, your capital is at risk. The value of your portfolio with Moneyfarm can go down as well as up and you may get back less than you invest. Past performance is not a reliable indicator of future performance.

Performance



**Peer Comparison Data: Asset Risk Consultants ARC collects the monthly returns of a collection of discretionary investment managers including large Asset managers, private banks and Wealth Managers to create an index of the average returns for a given level of risk. ARC benchmarks are as follows. Private Client Index Relative: Risk to World Equities: ARC Cautious PCI: 0 – 40% / ARC Balanced Asset PCI: 40 – 60% / ARC Steady Growth PCI: 60 – 80% / ARC Equity Risk PCI: 80 – 110%. Where the relative risk to World Equities means you are taking approximately that percentage of the risk global stock markets. Moneyfarm's Risk level 2 is compared to the ARC Cautious Private Client Index (PCI), our risk levels 3 and 4 use the ARC Balanced Asset Private Client Index (PCI), levels 5 and 6 are both compared to ARC Steady Growth Private Client Index (PCI) and our risk level 7 is matched to ARC Equity Risk Private Client Index PCI.

ARC compiles indexes using the average competitor returns, including Barclays Wealth, HSBC, Investec Wealth and Investment and Blackrock, as well as many others. The last 3 months of data are ARC's estimates. ARC does not produce an index that is a suitable comparison for P1, as it does not contain any equity. We use monthly GBP Libor + 0.5%, as this is a cash proxy, which Moneyfarm believes is a fair comparison".

Model portfolio performance

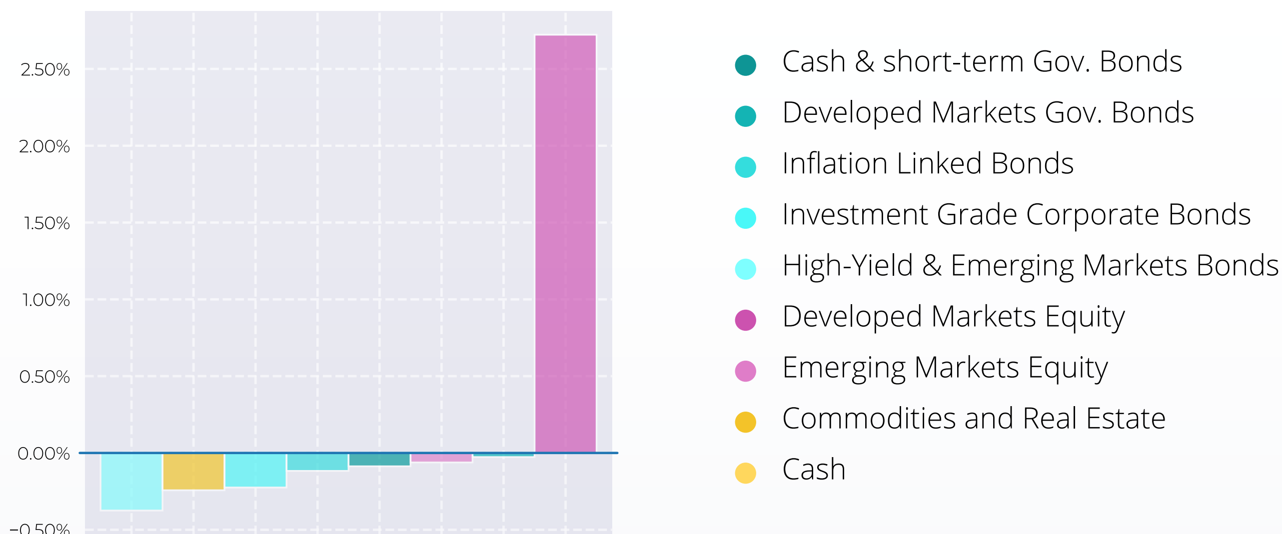
In the second quarter of 2023, the performance of the model portfolio was positive.

The bond market suffered, mainly due to the repricing of more restrictive monetary policies, with markets seemingly, at least in part, finally trusting the words of central bankers.

On the other hand, the stock markets performed very well, both due to the AI fever that started in the United States after the launch of ChatGPT, and thanks to an economic situation that remains certainly better than what many could have expected at the beginning of the year.

Commodities have slightly suffered this quarter, both because the economy continues to slow down and because the Chinese reopening has disappointed.

Performance attribution



Volatility

Here you'll find a breakdown of your portfolio's volatility over the last year, the last three years, and since its inception.The Sharpe ratio, which compares the return of an investment with its risk, helps us to understand the returns of the portfolio relative to its risk.

*Sharpe ratio is calculated using the yield of the UK Government Bonds with a maturity 0-1 year as the risk-free benchmark

Portfolio allocation

P5

Portfolio allocation

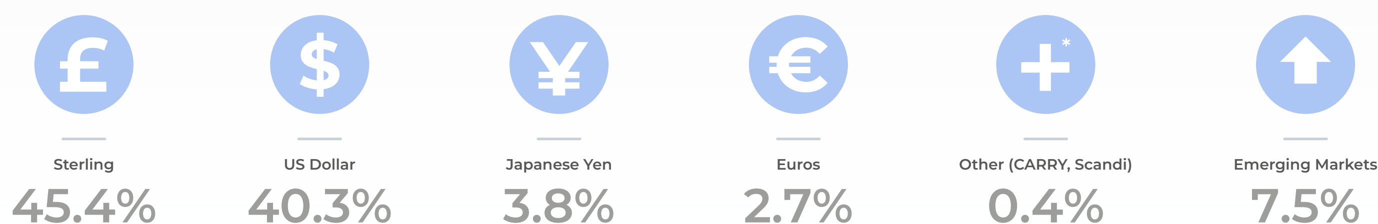
Asset class	%
Cash & short-term Gov. Bonds	4.0%
Developed Markets Gov. Bonds	2.9%
Inflation Linked Bonds	5.0%
Investment Grade Corporate Bonds	12.7%
High-Yield & Emerging Markets Bonds	12.4%
Developed Markets Equity	48.3%
Emerging Markets Equity	7.7%
Commodities and Real Estate	5.0%
Cash	2.0%

Geographic exposure

Region	%
United Kingdom	19.2%
United States	53.1%
Eurozone	7.2%
Japan	4.3%
Other developed countries	2.1%
Emerging Market (excluding China)	11.9%
China	2.2%

Currency exposure

P5



Sterling	US Dollar	Japanese Yen	Euros	Other (CARRY, Scandi)	Emerging Markets
45.4%	40.3%	3.8%	2.7%	0.4%	7.5%

ETF breakdown*

Name	ISIN	Weight	TER	Currency Hedged
Emerging Markets Equities local currencies	IE00BKM4GZ66	7.7%	0.18%	N
UK Sovereign Bonds Short Maturities	IE00B4WXJK79	4.0%	0.07%	N
UK Investment Grade Corporate Bonds 0-5 years	IE00B5L65R35	9.7%	0.20%	N
Global Developed Markets Equities (MSCI WORLD) Sterling Hedged	IE00BD45YS76	4.5%	0.30%	Y
iShares Edge MSCI Wld ValFactor UCITS ETF USD A	IE00BP3QZB59	3.0%	0.30%	N
Lyxor Core STOXX Europe 600 DR	LU0908500753	2.0%	0.07%	N
Global Commodities	IE00BZ1NCS44	5.0%	0.28%	N
Emerging Markets Sovereign Bond in US Dollar	IE00B2NPKV68	6.2%	0.45%	N
US High Yield Credit	IE00B4PY7Y77	6.2%	0.50%	N
Japan Equities (MSCI JAPAN)	IE00B4L5YX21	3.0%	0.15%	N
US Investment Grade Credit	IE00BZ163K21	3.0%	0.09%	N
UK Equities (FTSE100)	IE00B810Q511	7.0%	0.09%	N
US Equities (S&P500)	IE00B3XXRP09	18.8%	0.07%	N
US Equities (S&P500) Sterling hedged	IE00BM67HX07	10.0%	0.09%	Y
Global Inflation Linkers Sterling hedged	LU0641007264	5.0%	0.20%	Y
Global Sovereign Bonds Sterling hedged	LU0641006290	2.9%	0.25%	Y
Cash		2.0%		

* This breakdown refers to the model portfolio allocation

Asset allocation changes

The composition of our portfolios was adjusted in May to reflect the overall improvement in long-term expected returns, the strengthening of the macroeconomic situation, and the decrease in inflationary and geopolitical risks. The level of risk and duration remains conservative but higher compared to 2022, especially on the equity side.

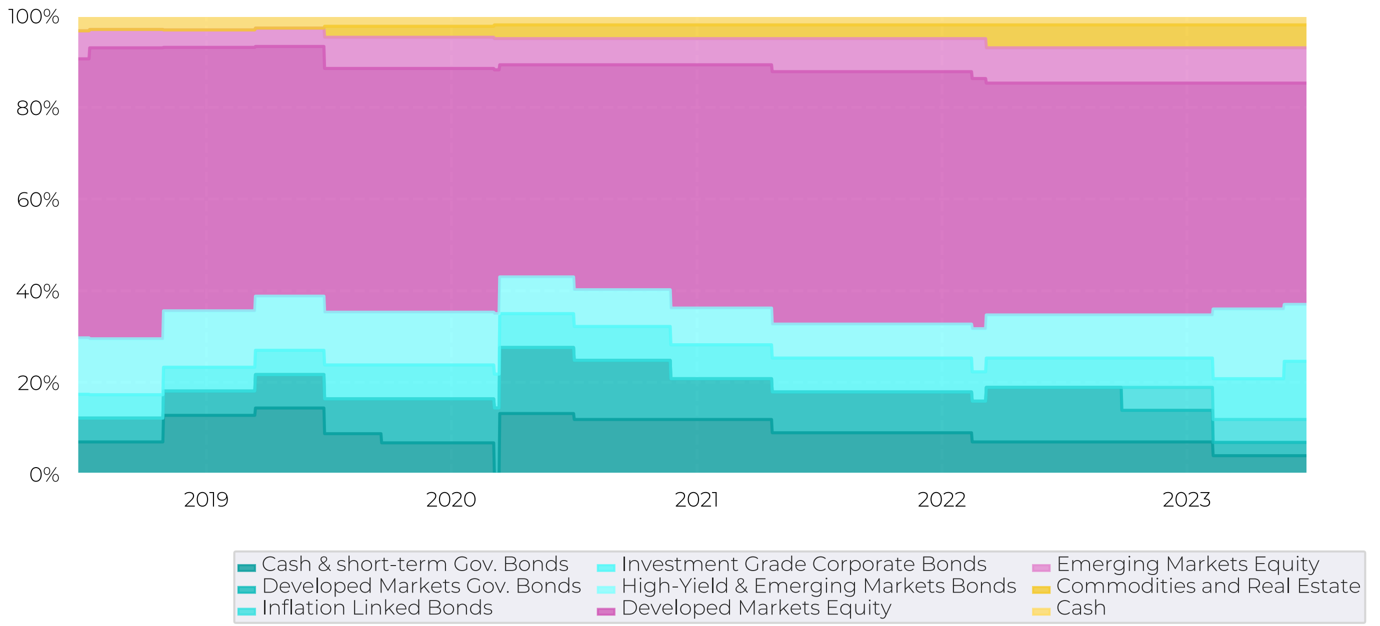
Overall, the rebalancing decision was driven by two main considerations. First, the level that short-term rates have reached makes this investment class particularly attractive and reduces our appetite for overexposure to duration and risky credit, especially after the banking crisis and the subsequent credit tightening. Second, given that uncertainties remain, although perhaps the worst-case scenarios are becoming less plausible, we have decided to focus more on diversification of the risk factors driving the portfolios, particularly in terms of equities.

We have reduced our US exposure in favour of developed equity markets in the rest of the world. This decision is based on fundamental reasons, with valuations in this investment class offering better prospects, especially in a geopolitical context where the focus is shifting from Ukraine to tensions between China and the United States, and it increases portfolio diversification. We have rebalanced towards less expensive equities that enhance portfolio diversification.

On the bond side, first of all, we have maintained exposure to high-quality corporate bonds and inflation-linked bonds. We believe that both have excellent potential to perform well in the coming months given the level of interest rates (for the former) and the relatively high possibility, in our opinion, of higher inflation for a longer period (for the latter).

However, we have reduced exposure to high-yield debt and emerging markets bonds. After the banking crisis and given the continuation of restrictive monetary policies, we believe that credit spreads have not risen enough to justify the risk. Due to the negative slope of the yield curves, and thus the high level of short-term interest rates, we prefer high-quality corporate bonds with very low duration, which show better risk and return profiles compared to government bonds.

Your portfolio's allocation over time



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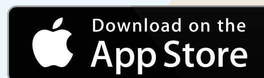

As with all investing, your capital is at risk. The value of your portfolio with Moneyfarm can go down as well as up and you may get back less than you invest. If you are unsure investing is the right choice for you, please seek financial advice.

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