



# Quarterly Commentary & Market Outlook

Q3 2023

# Umbra

# Outlook – Executive Summary

## Q4 2023 OUTLOOK

Risk assets struggled to make ground as a number of macro variables came to the fore in Q3. Rising bond yields, slowing economic growth, still elevated but moderating inflation and a resurgent oil price all posed their own risks to sentiment. However, we still believe the lagged effects of the recent increases in interest rates are yet to be felt within the real economy. As Western central banks maintain their “higher for longer” discipline against stubborn inflation, it's likely that the ratcheting higher of debt servicing costs for both businesses and consumers cuts further into growth as time progresses. Money supply is contracting and the demand for credit is falling sharply. There is an increasing risk that central banks over tighten in the face of a deteriorating growth and liquidity backdrop.

Both the manufacturing and services sides of the global economy continues to weaken. Pent up savings, the other primary support which has bolstered economic growth within the West since COVID appears to have been almost fully depleted. There is evidence that only the wealthiest cohort of society in the US has any excess savings cushion left.

For now, some Western governments continue to run significant budget deficits as election cycles loom and the transition to a net zero economy continues. The increase in new issuance against a reduction in central banks' balance sheets and waning foreign investor demand has weighed heavily on pricing this year. Longer term estimates of inflation have remained relatively well anchored, so for now the weakness in bonds is being increasingly driven by term premium.

For risk assets, equities have been remarkably resilient in 2023, however beneath the surface significant bifurcation and concentration anomalies have reigned. For instance, approximately 90% of the S&P500 Index's' year-to-date gains has come from only eight stocks. The influence of this cohort on broader world indices has also been significant given that the US accounts for +65% of major world equity benchmarks. More broadly, earnings estimates have been quite firm as declining inflation and cost-cutting has benefited some companies, however there is a question mark over the sustainability of this against a deteriorating growth and higher cost of capital backdrop.

For fixed income, attractive carry has been eclipsed by the progressive rise in rates, particularly at longer maturities. We may have seen the peak in most central banks' interest rate cycle, however the rise in longer term yields has been driven by various factors of late, some of which remain out of the control of policy makers. If we are close to a peak in the interest rate cycle for most major economies, then the prospects for fixed income going forward are highly attractive despite this year's lacklustre performance.

Overall, we see very compelling areas of opportunity within both equities and fixed income. Within equities, our overall skew remains somewhat defensive due to the relative valuations between defensives and cyclicals and the slowing growth backdrop.

Where we do find pockets of opportunities within cyclicals, our preference for companies with strong balance sheets which look to withstand this more testing phase of the cycle remains key.

### ASSET ALLOCATION VIEW - +

Equities					
Fixed Income					
Cash					

Equities					
Asia ex-Japan					
Japan					
Eurozone					
UK					
US					
EM ex-China					
China					

Fixed Income					
Government: DM					
Government: EM\$					
Government: EM Local					
Investment Grade					
High Yield					
Duration					
Inflation Linked					
Loans					
Convertible Bonds					

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### HEADLINE INFLATION BY COUNTRY (CPI YOY)

	Mar-23	Apr-23	May-23	Jun-23	Jul-23	Aug-23
<b>Eurozone</b>	6.9	7.0	6.1	5.5	5.3	5.2
<b>France</b>	5.7	5.9	5.1	4.5	4.3	4.9
<b>Germany</b>	7.4	7.2	6.1	6.4	6.2	6.1
<b>Italy</b>	7.6	8.2	7.6	6.4	5.9	5.4
<b>Spain</b>	3.3	4.1	3.2	1.9	2.3	2.6
<b>Ireland</b>	7.7	7.2	6.6	6.1	5.8	6.3
<b>Swiss</b>	2.9	2.6	2.2	1.7	1.6	1.6
<b>UK</b>	10.1	8.7	8.7	7.9	6.8	6.7
<b>US</b>	5.0	4.9	4.0	3.0	3.2	3.7
<b>Japan</b>	3.2	3.5	3.2	3.3	3.3	3.2
<b>China</b>	0.7	0.1	0.2	0.0	-0.3	0.1
<b>Indon'a</b>	5.0	4.3	4.0	3.5	3.1	3.3
<b>S. Korea</b>	4.2	3.7	3.3	2.7	2.3	3.4
<b>Taiwan</b>	2.4	2.4	2.0	1.8	1.9	2.5
<b>India</b>	5.7	4.7	4.3	4.9	7.4	6.8
<b>Brazil</b>	4.7	4.2	3.9	3.2	4.0	4.6
<b>Mexico</b>	6.9	6.3	5.8	5.1	4.8	4.6
<b>S. Africa</b>	7.1	6.8	6.3	5.4	4.7	4.8

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# Q3 2023 Market Review

## EVIDENCE OF A BROAD-BASED SLOWDOWN IS EMERGING

An ongoing slowdown in the pace of global economic activity was really the story of the third quarter. From what was a story of weak activity within manufacturing has since filtered through into the services side of the global economy, particularly within the West. There are several reasons as to why this is unfolding. A higher cost of capital is increasingly weighing on the appetite for credit from both businesses and consumers, whilst consumers' excess savings which were built immediately post COVID, are now almost depleted.

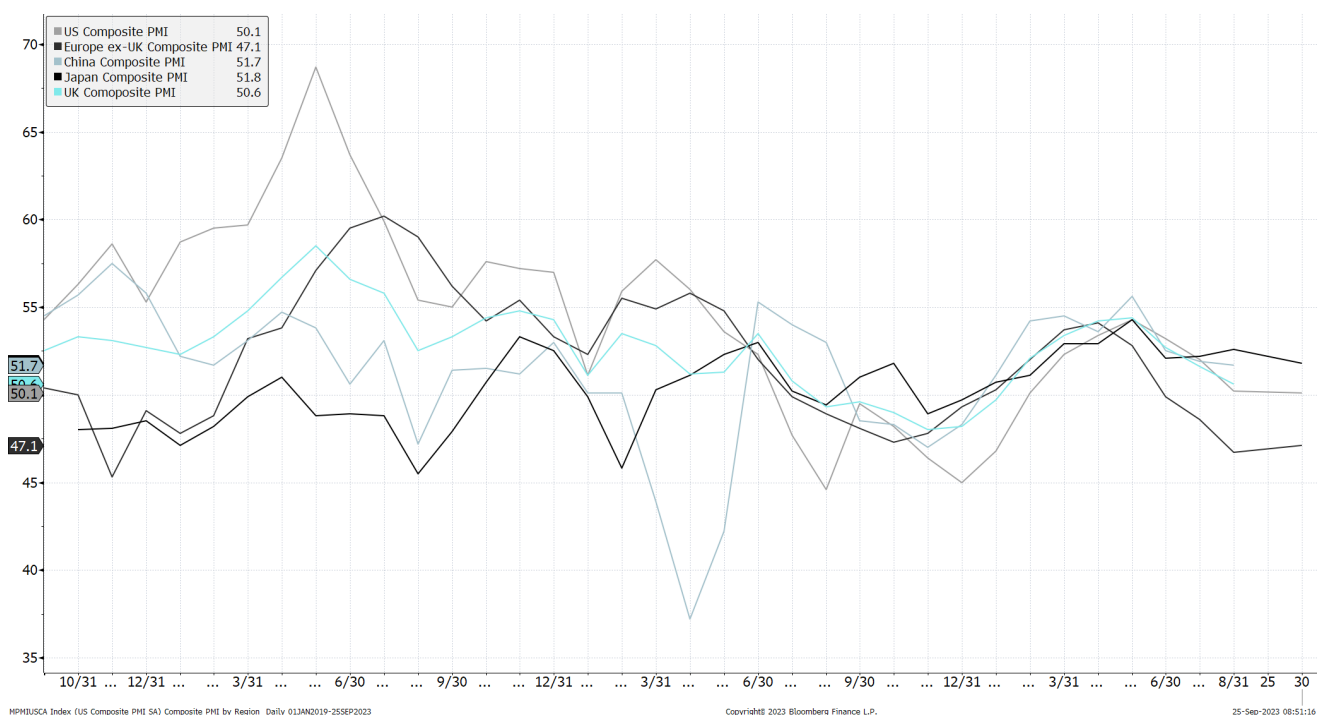
This is now starting to impact the jobs market at the margin. Here in the UK, private sector companies have recently cut jobs at the fastest pace since the pandemic of early 2020. Unemployment has recently picked up from 3.5% to 4% of the work force whilst hiring plans continue to be put on hold. The surge in borrowing costs is particularly impacting the housing and broader construction sectors. These are sectors which have significant multiplier effects within the economy.

The S&P Global UK Composite PMI declined to 46.8 at quarter end, down from 48.6 on the previous month. (Reading's <50 signal contraction). This came in below market expectations and coincides with weak indicators across other areas of the UK economy. Retail sales have also been challenged lately, with the surge in mortgage financing rates eating into consumers' disposable income. An estimated 750,000 UK homeowners are expected to refinance their mortgages before the end of 2023. Two-year fixed mortgage rates have gone from ~1% to 5.5% in just over two years as the Bank of England's attempts to rein in inflation has seen UK base rates rise by over 500bps in just under two years. The lagged effect of one of the sharpest increases in interest rates has yet to be felt, however we are already seeing ripple effects. The lagged nature of the time it takes for changes in monetary policy to be felt within economies is probably one reason why the Bank of England decided to refrain from pushing rates higher at its meeting in September. The day prior to the meeting, a raft of inflation data came in below market expectations which takes some pressure off the BoE for now.

On the continent, private sector activity also shrank in September with the S&P Global Europe Composite PMI showing a fourth consecutive month of falling output, reaching 47.1. The region's PMI Manufacturing gauge has now been in contraction for fifteen consecutive months. The ongoing slowdown in manufacturing continued at the end of the quarter and there is little to suggest a rebound as a higher cost of capital continues to weigh heavily on the appetite for credit from both companies and consumers. The Covid-related supply chain issues have all but disappeared, and supplier delivery times continued to decline in September.

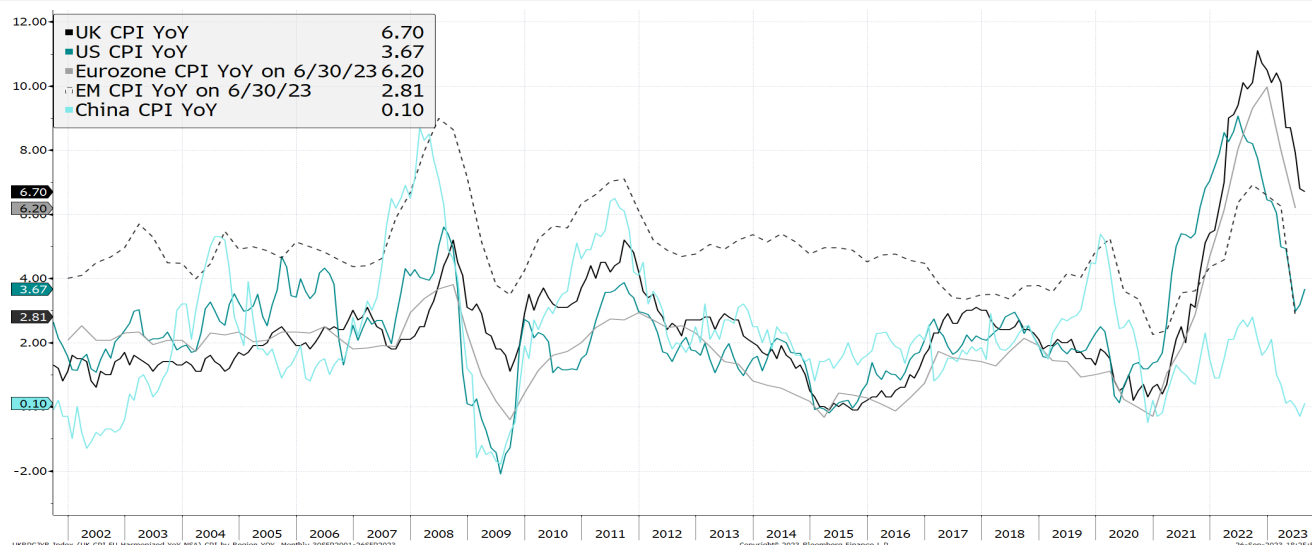
Output however is still declining, as demand continues to wane. The manufacturing output index fell to 43.1 from 43.4 in August. The new orders index rose slightly but remains well below the 50 level and consistent with a still-sharp slide in demand for manufactured goods. Backlogs of works continued to decline, for the 16th straight month.

## COMPOSITE (SERVICES + MANUFACTURING) PMI'S BY REGION



# Q3 2023 Market Review

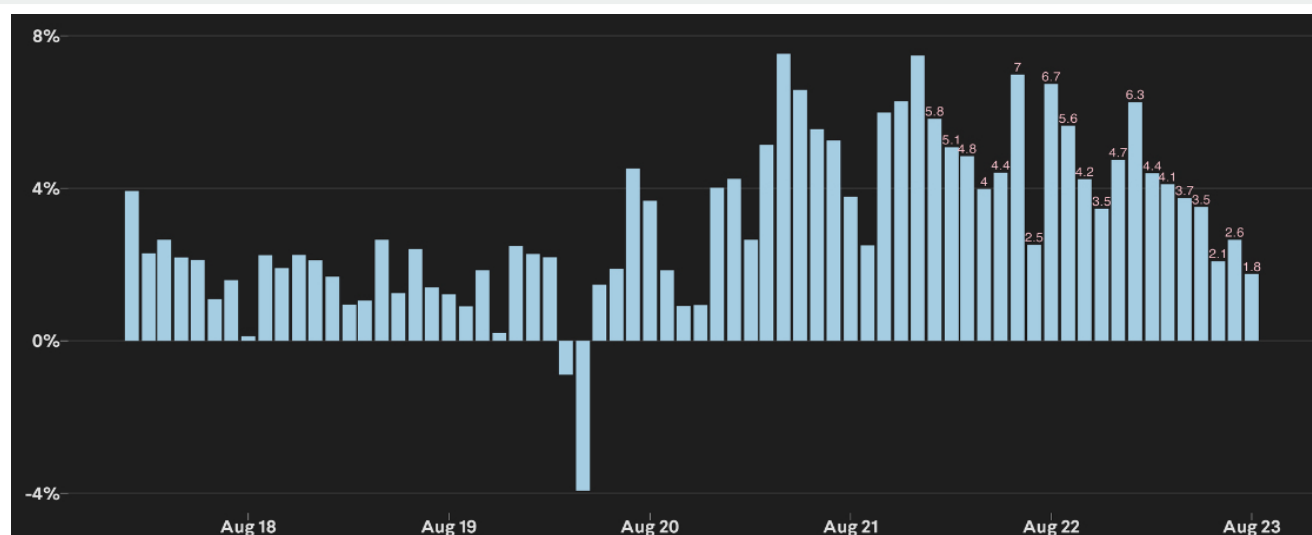
## INFLATION (CPI) BY REGION



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Inflation overall continued to moderate within the major regional blocks as the third quarter transpired. This rosier outlook however has recently been tested by the sudden increase in crude oil prices which rallied +28.5% on the quarter to leave WTI at \$90p/b. Here in the UK, CPI fell slightly in August to 6.7%, from 6.8% in July, as weaker food and services inflation offset the increase in petrol prices. Weaker services inflation was partly due to the smaller volatile categories but there was encouraging evidence of a broader decline in core pressures. Both core and services inflation missed market expectations, dropping to 6.2% and 6.8%, from 6.9% and 7.4% respectively in July. This in turn prompted the BoE to pause at the current level of interest rates during its September MPC meeting. Going forward it's likely that the inflation outlook for the UK should continue to get better as strong base effects in the energy component are still yet to feature in October, whilst retailers may continue to pass on lower input costs to consumers as operators vie for market share.

## MONTHLY % INCREASE IN US CORE PCE GOODS & SERVICES, ANNUALISED



Bloomberg

Strong pay growth in both the private and public sectors may cause alarm here but we would suggest that labour markets are lagging indicators. It's likely that as demand continues to wane against persistent growth pressures, companies may be able to exert a degree of bargaining power in wage negotiations. The softness in the labour market and rise in unemployment recently would suggest the cycle may be turning.

Moderating inflation was also a feature in the US during the third quarter. The chart above illustrates the month-on-month change (annualised) for the Core PCE indicator, the US Federal Reserve's preferred inflation gauge. Much progress continues to be achieved in taming inflation in the US and these efforts meant the Fed also decided to leave interest rates on hold at its September meeting. Markets for now continue to price in one last +25bps increase by the end of the year, whilst they continue to price in a 31% probability the Fed will be cutting interest rates by May 2024.

# Q3 2023 Market Review

## US TERMINAL RATES – NOMINAL AND REAL



The recent ascent in short term US interest rates has put the Federal Reserve on a much stronger footing than it was on at the start of the year. The chart above highlights where nominal and real terminal rates were just prior to previous easing cycles. Basically speaking, real terminal rates have always been positive prior to interest rate cuts commencing. The +500bps of increases seen in this hiking cycle, against declining inflation has completely shifted real terminal rates over the last nine months. Real rates were deeply negative at the start of the year; however, they finished the third quarter just under 2%. There is clear evidence today that the full effects of interest rate increases are yet to be felt in the real economy. Companies took advantage during the aftermath of the pandemic to refinance their debt at very low rates and locking in over long maturities. Similar can be said for consumers, whose mortgages tend to be up to 30 years in duration. Although it will take time for these shifts to take effect, the demand for finance within the Western world continues to wane.

## EUROPEAN LOANS TO ENTERPRISES



The chart above for instance highlights the current demand for loans from companies over the last three months in Europe. Demand is worse today than it was during the depths of the Euro zone crisis in 2011. This is similar to the demand for credit that we're seeing in the US today, where tighter lending criteria from the banks is crushing the appetite for loans. There is a distinct probability that Western Central banks are maintaining their hawkish posture despite clear evidence that liquidity is drying up due to its cost and its availability.





# Q3 2023 Asset Class Performance Summary

## THERE WERE FEW PLACES TO HIDE WITHIN TRADITIONAL RISK ASSETS IN Q3

Regional Equity	Sept	Q3	YTD	2022	2021	2020
<b>World</b>						
MSCI AC World	-4.14	-3.40	10.06	-18.36	18.54	16.25
MSCI World	-4.31	-3.46	11.10	-18.14	21.82	15.90
<b>US</b>						
S&P 500	-4.77	-3.27	13.07	-18.11	28.71	18.40
Russel 2000	-5.89	-5.14	2.51	-20.46	14.78	19.93
S&P Small Cap	-6.00	-4.94	0.76	-16.15	26.74	11.24
NASDAQ	-5.77	-3.94	27.11	-32.51	22.21	45.05
<b>UK</b>						
MSCI UK All Cap	2.95	2.56	5.22	7.15	19.59	-13.23
FTSE 100	2.40	2.19	5.50	4.70	18.44	-11.55
MSCI UK Mid Cap	-1.94	0.39	10.58	-20.57	20.31	-3.63
MSCI UK Small Cap	-1.14	0.99	1.22	-22.40	14.54	-4.86
<b>Europe ex-UK</b>						
MSCI Europe ex-UK	-2.50	-30.8	9.19	-12.58	24.45	1.75
MSCI Europe ex-UK Large Cap	-2.40	-3.55	11.10	-11.22	25.61	0.47
MSCI Europe ex-UK Small Cap	-3.42	-3.91	2.39	-20.60	24.55	11.74
<b>Asia ex-Japan</b>						
CSI 300 Index	-1.96	-2.93	-2.50	-19.83	-3.51	29.89
MSCI Asia Pacific	-2.71	-3.37	-0.45	-17.48	-2.90	22.44
Hang Seng	-2.58	-4.19	-6.83	-12.56	-11.84	-0.24
MSCI Asia Pacific Small Cap	-2.48	1.29	8.27	-19.36	19.24	26.38
<b>Japan</b>						
TOPIX	0.51	2.45	25.70	-2.45	12.74	7.39
Nikkei	-1.74	-3.36	24.34	-7.35	6.66	18.28
JPX-Nikkei Index 400	0.06	1.61	25.59	-2.65	12.47	8.89
TOPIX Small	0.14	4.24	20.96	0.71	11.04	-0.04
<b>GEM</b>						
S&P BSE Sensex	1.54	2.05	9.43	5.80	23.23	17.16
Ibovespa Index	0.71	-1.29	6.22	4.69	-11.93	2.92
MSCI Emerging Markets	-2.62	-2.93	1.82	-20.09	-2.54	18.31
MSCI Latin America	-2.27	-4.64	13.41	9.57	-7.66	13.58
MSCI EME	-5.68	2.04	15.61	-70.97	14.69	-11.87
<b>Fixed Income</b>	<b>Sept</b>	<b>Q3</b>	<b>YTD</b>	<b>2022</b>	<b>2021</b>	<b>2020</b>
<b>World – Sovereign &amp; Blend</b>						
Citigroup World Gov Bond Index	-3.24	-4.27	-2.68	-18.26	-6.97	10.11
Bloomberg Global Aggregate TR Index	-2.92	-3.59	-2.21	-16.25	-4.71	9.20
<b>GEM – Sovereign</b>						
JP Morgan EMBI (USD)	-2.81	-2.63	1.09	-16.45	-1.51	5.88
JP Morgan EMBI Diversified (USD)	-2.60	-2.23	1.76	-17.78	-1.80	5.26
JP Morgan EMBI USD (Spread)	361.91					
Barclays EMB (Local)	-2.04	-1.71	0.04	-8.44	-1.59	5.34
Barclays EMB Yield to Worst (Local)	444.18					
<b>GEM – Corporate</b>						
Barclays EM IG USD	-2.51	-3.27	-3.00	-16.89	-0.74	7.51
Barclays EM IG USD (Spread)	125.00					
Barclays EM High Yield	-1.87	-0.61	3.08	-12.36	-3.18	4.25
Barclays EM High Yield (Spread)	651.00					
<b>US – Corporate</b>						
FTSE US Investment Grade	-2.51	-3.21	-1.14	-13.28	-1.60	7.74
US Investment Grade (Spread)	151.11					
Barclays US High Yield	-1.18	0.46	5.86	-11.19	5.28	7.11
US High Yield (Spread)	432.96					
US High Yield Energy (Spread)	331.75					
<b>Europe ex-UK</b>						
Barclays Pan European High Yield	0.33	1.78	6.30	-10.64	3.43	2.29
Barclays Pan European HY (Spread)	431.00					
<b>Asia ex-Japan</b>						
Barclays Asia High Yield (USD)	0.58	-3.87	-1.60	-16.79	-12.35	5.65
Barclays Asia High Yield USD (Spread)	944.05					
Barclays EM Asia High Yield (USD)	0.59	-3.16	-1.21	-16.45	-12.24	5.24
Barclays EM Asia HY (Spread)	891.50					
<b>Sovereign</b>	<b>Yield</b>					
France 10 Year	3.40					
Germany 10 Year	2.84					
Italy 10 Year	4.78					
Japan 10 Year	0.77					
Spain 10 Year	3.93					
Swiss 10 Year	1.06					
UK 10 Year	4.44					
US 2 Year	5.04					
US 5 Year	4.61					
US 10 Year	4.57					

MSCI World: Sector	Sept	Q3	YTD	2022	2021	2020
Communication Services	-3.01	1.54	31.65	-36.72	14.83	23.51
Consumer Discretionary	-5.49	-5.59	21.80	-33.13	18.18	37.01
Consumer Staples	-4.88	-6.27	-2.34	-5.53	13.74	8.53
Energy	2.76	11.53	7.78	47.69	41.81	-30.44
Financials	-2.12	-0.57	3.24	-9.49	28.73	-2.12
Health Care	-3.22	-2.66	-1.60	-4.49	20.35	14.11
Industrial	-5.05	-5.11	8.67	-12.77	17.08	12.22
Materials	-3.74	-3.80	2.23	-10.09	17.01	20.63
Real Estate	-6.40	-6.93	-5.55	-24.49	17.01	-4.25
Technology	-6.79	-6.04	30.67	-30.60	30.14	44.25
Utilities	-5.56	-8.92	-8.41	-3.71	10.97	5.85
<b>World Style</b>	<b>Sept</b>	<b>Q3</b>	<b>YTD</b>	<b>2022</b>	<b>2021</b>	<b>2020</b>
MSCI World Growth	-5.65	-4.85	21.10	-29.04	21.41	34.19
MSCI World Value	-2.77	-1.71	2.68	-5.77	22.84	-0.32
<b>S&amp;P 500</b>	<b>Sept</b>	<b>Q3</b>	<b>YTD</b>	<b>2022</b>	<b>2021</b>	<b>2020</b>
Communication Services	-3.26	3.07	40.43	-39.89	21.57	23.61
Consumer Discretionary	-5.98	-4.80	26.58	-37.03	24.43	33.30
Consumer Staples	-4.53	-5.97	-4.76	-0.62	18.63	10.75
Energy	2.63	12.22	5.99	65.43	54.39	-33.68
Financials	-3.14	-1.13	-1.65	-10.57	34.87	-1.76
Health Care	-2.96	-2.65	-4.09	-1.95	26.13	13.45
Industrial	-5.96	-5.16	4.50	-5.51	21.10	11.05
Materials	-4.78	-4.76	2.61	-12.28	27.28	20.73
Technology	-6.87	-4.76	34.72	-28.19	34.52	43.88
Utilities	-5.63	-9.25	-14.41	1.56	17.67	0.52
<b>US: Style</b>	<b>Sept</b>	<b>Q3</b>	<b>YTD</b>	<b>2022</b>	<b>2021</b>	<b>2020</b>
Growth (Large Cap)	-5.44	-3.13	24.97	-29.14	27.59	38.49
Value (Large Cap)	-3.86	-3.17	1.77	-7.56	25.12	2.87
Momentum	-4.82	-2.87	-3.03	-18.26	13.37	29.85
Growth (All Cap)	-5.50	-3.34	23.77	-28.97	25.84	38.26
Value (All Cap)	-3.94	-3.15	1.64	-8.01	25.33	2.86
<b>Europe: Sector</b>	<b>Sept</b>	<b>Q3</b>	<b>YTD</b>	<b>2022</b>	<b>2021</b>	<b>2020</b>
Consumer Discretionary	-5.71	-11.19	10.37	-16.21	23.21	6.81
Consumer Staples	-3.62	-4.49	1.00	-7.94	20.93	-3.07
Energy	7.33	15.09	13.05	37.87	36.38	-33.14
Financials	1.21	2.53	14.29	-2.12	29.48	-15.13
Health Care	-1.05	1.32	9.46	-3.85	26.17	-1.28
Industrial	-2.05	-4.14	12.91	-16.39	29.62	4.23
Materials	-0.75	0.10	1.56	-9.30	24.85	9.78
Technology	-5.93	-10.40	13.41	-28.47	36.83	14.72
Telecom	1.22	0.45	9.92	-11.75	15.77	-12.51
Utilities	-4.12	-7.29	4.41	-6.86	9.81	13.14
<b>Europe: Style</b>	<b>Sept</b>	<b>Q3</b>	<b>YTD</b>	<b>2022</b>	<b>2021</b>	<b>2020</b>
MSCI European Growth	-3.96	-6.21	7.66	-17.34	28.49	6.28
MSCI European Value	0.94	2.44	11.27	-0.32	22.76	-12.24
<b>Japan Style</b>	<b>Sept</b>	<b>Q3</b>	<b>YTD</b>	<b>2020</b>	<b>2021</b>	<b>2020</b>
TOPIX Japan Growth	-3.17	-3.90	15.56	-14.55	6.56	17.22
TOPIX Japan Value	2.21	6.77	29.94	5.22	14.51	-7.26
<b>UK Style</b>	<b>Sept</b>	<b>Q3</b>	<b>YTD</b>	<b>2022</b>	<b>2021</b>	<b>2020</b>
MSCI UK Growth	-0.71	-2.72	4.89	-5.21	22.32	-1.52
MSCI UK Value	4.79	5.11	4.65	14.53	17.72	-19.64



# Valuation Summary

## FUNDAMENTAL METRICS BY EQUITY REGION

Indices	Leverage		Profitability			Valuation						
	ND / EBITDA	Current Ratio	RoE	Operating Margin	FCF Yield	P/E (TTM)	P/E (NTM)	EV / Sales	EV / EBITDA	Price / Book	Div Yield	Dividend Payout Ratio
Asia												
China: A Share Index (CSI 300)	5.9	1.0	11.5	11.1	4.1	13.3	12.2	1.9	15.1	1.6	2.6	35.7
India: BSE SENSEX Index			12.2	17.3		23.0	21.7	3.4		2.9	1.4	35.8
Japan: NIKKEI Index	0.9	1.3	10.3	9.5	2.7	25.7	21.3	1.5	10.0	1.9	1.9	33.6
S. Korea: KOSPI Index	3.8	1.4	4.9	4.8	0.9	17.5	14.5	1.0	8.8	0.9	1.9	39.9
Taiwan: TAIEX Index	0.9	1.5	11.2	8.5	4.8	18.4	17.9	1.4	10.7	2.0	3.8	64.4
Europe												
France: CAC Index	1.1	1.1	12.5	12.2	7.0	12.2	12.0	1.4	8.5	1.7	3.3	49.5
Germany: Dax Index	1.9	1.2	10.5	7.7	8.0	12.0	11.1	1.1	8.1	1.4	3.8	53.2
Italy: FTSE MIB Index	3.2		14.6	14.3	8.1	6.6	7.6	1.4	7.0	1.2	4.6	37.3
Swiss: SMI Index	1.3	1.2	23.4	19.3	4.6	13.6	17.2	2.7	10.4	3.7	3.2	48.7
UK: FTSE 100 Index	0.4	1.1	15.8	15.6	7.2	10.9	10.8	1.3	5.8	1.7	4.0	42.4
US												
S&P 500 Index	1.4	1.3	17.6	13.4	3.8	20.9	19.7	2.6	14.2	4.1	1.6	38.2
S&P 500 Growth Index	0.8	1.3	29.0	18.0	4.1	23.4	22.5	3.7	16.1	7.2	1.3	32.0
S&P 500 Value Index	1.9	1.2	12.4	10.7	3.3	19.1	17.6	2.0	12.4	2.7	2.0	44.8
NASDAQ Composite Index	1.4	1.4	12.9	11.6	2.6	36.5	35.0	3.7	22.5	5.3	0.8	34.7
World												
MSCI Emerging Markets Index	1.8	1.3	10.8	11.6	6.2	13.8	13.3	1.5	8.8	1.5	2.9	45.5
MSCI World Index	1.4	1.2	14.4	12.9	4.2	18.4	17.6	2.1	12.2	2.9	2.1	42.3
MSCI World Growth Index	1.1	1.2	19.3	14.3	3.3	30.0	26.2	3.5	18.8	5.9	0.9	28.8
MSCI World Value Index	1.5	1.2	12.8	12.3	5.3	13.0	12.9	1.6	8.7	1.8	3.4	48.9

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## FUNDAMENTAL METRICS BY EQUITY MARKET SECTOR

Leverage			Profitability						Valuation										
	ND/EBI TDA	Current Ratio	RoE CY	RoE 5 Yr Low	RoE 5 Yr High	Op Margin	Op Margin 5Yr Low	Op Margin 5 Yr High	FCF Yield	P/E (TTM)	P/E (NTM)	EV/ Sales	EV/ EBITDA	EV/ EBITDA 5Yr Low	EV/ EBITDA 5Yr High	Price/ Book	Div Yield	Dividend Payout Ratio	
US																			
Communication Services	2.0	1.2	11.3	10.7	32.8	14.8	15.5	18.8	4.9	19.9	18.1	3.5	13.6	6.5	16.9	3.5	0.8	27.0	
Consumer Discretionary	1.7	1.2	27.3	15.8	31.3	9.0	5.6	11.2	3.1	27.9	24.2	2.3	16.1	10.0	27.4	8.6	0.9	29.9	
Consumer Staples	2.5	0.9	23.6	15.2	27.0	7.3	6.9	9.7	3.9	20.0	19.6	1.6	16.9	13.1	19.6	5.8	2.7	69.2	
Energy	0.7	1.4	26.0	-20.0	11.3	17.3	-19.2	9.2	9.7	9.6	11.9	1.4	5.5	5.8	20.9	2.4	3.5	-	
Financials	-	-	12.1	7.7	15.0	19.0	15.5	30.5	-	14.9	14.1	2.1	-	5.0	10.0	1.8	1.9	27.9	
HealthCare	1.5	1.3	16.7	12.2	19.8	8.3	7.7	10.9	5.4	21.4	18.6	1.8	16.1	12.3	18.9	4.6	1.7	47.1	
Industrials	1.9	1.2	25.6	7.7	23.0	11.8	5.6	12.5	4.1	19.8	18.8	2.2	14.6	9.1	25.8	5.0	1.8	35.0	
Materials	1.9	1.6	13.8	4.0	15.5	12.5	6.9	13.7	4.2	16.5	17.7	2.2	12.2	9.9	18.3	2.7	2.1	41.6	
Technology	0.3	1.5	29.0	17.4	34.8	23.6	20.8	24.9	3.1	31.6	28.0	6.6	23.2	11.1	23.7	9.7	0.9	30.1	
Utilities	6.0	0.8	8.9	5.6	11.2	16.4	13.0	20.6	-8.6	18.3	16.5	3.9	13.2	10.9	14.6	1.9	3.5	79.9	
World																			
Communication Services	2.3	1.1	11.7	10.4	18.8	14.8	14.5	19.7	5.2	21.7	18.6	3.1	11.3	6.7	13.3	2.9	1.3	35.6	
Consumer Discretionary	1.2	1.3	16.1	7.7	18.5	8.9	5.1	9.6	3.6	22.0	20.0	1.7	12.5	8.0	19.3	3.9	1.4	32.9	
Consumer Staples	2.4	1.0	18.6	16.6	25.7	8.3	8.5	9.4	4.5	18.9	18.9	1.5	14.3	12.5	15.6	4.1	2.8	62.8	
Energy	0.8	1.3	21.3	-14.0	10.4	16.2	-12.0	9.1	10.9	8.6	10.2	1.1	4.7	5.3	30.1	1.9	4.1	37.6	
Financials	-	-	11.7	6.2	11.5	18.6	13.6	22.4	-	12.0	11.7	1.6	-	-	-	1.4	3.1	37.6	
HealthCare	1.5	1.3	15.4	11.8	16.8	9.6	8.6	12.0	4.9	22.4	19.2	2.2	15.9	13.0	19.8	4.2	1.8	50.2	
Industrials	1.8	1.3	17.0	7.5	17.5	10.1	5.8	9.7	4.8	18.4	18.3	1.8	13.0	9.0	19.8	3.1	2.1	36.9	
Materials	1.4	1.6	11.1	2.0	15.0	11.7	5.7	14.9	5.2	14.5	15.2	1.5	9.1	7.3	13.1	1.8	3.2	55.0	
Real Estate	7.8	-	3.3	2.4	10.6	16.7	18.0	31.8	0.6	26.5	24.3	6.7	22.7	14.8	25.8	1.4	4.0	182.8	
Technology	0.2	1.5	23.6	14.7	27.0	20.1	16.3	20.7	3.0	32.4	28.6	5.7	22.8	11.2	24.9	8.1	0.9	30.3	
Utilities	5.2	0.9	9.6	5.2	11.4	10.8	9.6	12.4	-4.8	15.8	14.6	2.3	11.6	9.8	13.3	1.7	4.1	71.2	

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# Q3 2023 Market Review

## EQUITIES

It was a challenging third quarter for world equities overall with wide degrees of dispersion between styles and regions. The MSCI AC World TR Index finished the quarter -3.4% to leave it up a respectable 10.0% for the year. The US (Russell 2000 Index -5.1%) weighed heavily on the MSCI World Index's performance in Q3 with weakness from the Utilities (-8.9%), Consumer Staples (-6.3%) and Technology (-6.0%) sectors more than offsetting the notable degrees of outperformance from Energy (+11.5%), Communication Services (+1.5%) and Financials (-0.6%). The Energy and Financials sectors' performance during September was the primary driver behind (MSCI World) Value's (-1.7%) relative outperformance versus Growth (-4.9%) over the quarter.

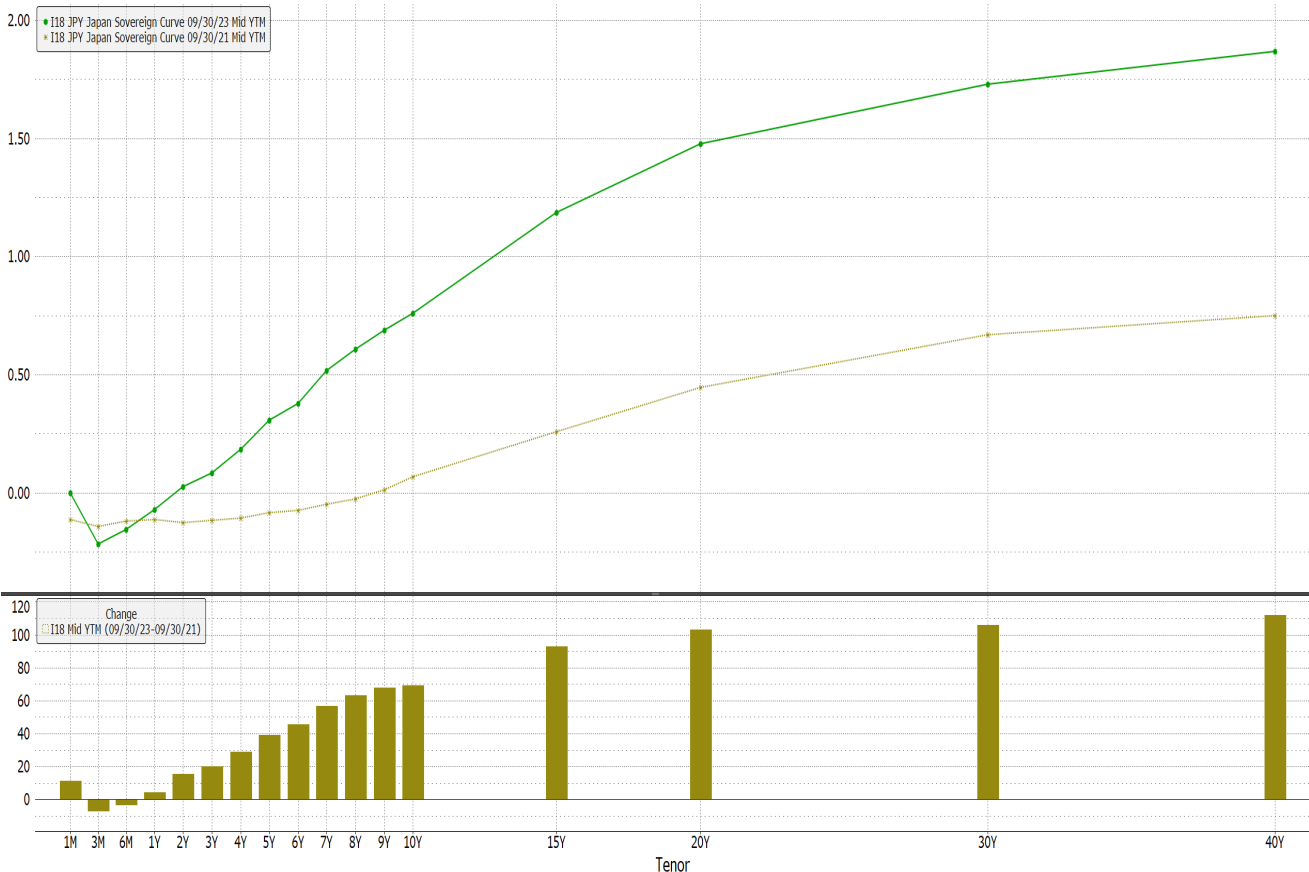
Value outperformed Growth in every major region in Q3 (UK +5.1% vs. -2.7%, Europe +2.4% vs. -6.2%), however it was in Japan (Value +6.8% vs. 3.9%) where the move was most pronounced. Value is continuing to see something of a renaissance in Japan at present with 2023's strong year-to-date gains of +29.9% adding to rises of +5.2% in 2022 and +14.5% in 2021. The normalisation in the yield curve highlighted in the chart below has seen it steepen to its highest level for over a decade. This in turn is boosting the profitability of the Financials sector, particularly for the banks.

In addition, ongoing corporate reform has seen corporate management optimise largely cash rich balance sheets for the benefit of shareholders through dividend increases and/or share buy-back programmes. This in turn has boosted return on equity for the overall market, however it's been at the value ends of the spectrum where this latency was most pronounced and depressed.

This has also attracted a number of high-profile investors such as US investor Warren Buffett and overseas private equity firms lately. Whilst at the macro level, Japanese Value stocks have also been buoyed by the rise in 10 Year US Treasury yields which have in turn supported the US Dollar versus the Japanese Yen and has aided Japanese exporters particularly.

Elsewhere in Asia, markets in China remained relatively weak with the domestically focused CSI 300 Index finishing -2.9% for the quarter to leave it -2.5% year-to-date. Economic data out of the country appeared to find a floor in Q3 and the government continued to unveil a raft of policy easing measures targeted specifically at alleviating some of the stresses within the property sector. Stimulus so far hasn't been all encompassing in its approach, which has disappointed markets to an extent. The government for now it seems remains acutely aware of the excesses past debt induced stimulus packages have placed on the economy.

### JAPANESE YIELD CURVE (COB 30/09/2023 VS. COB 30/09/2021)



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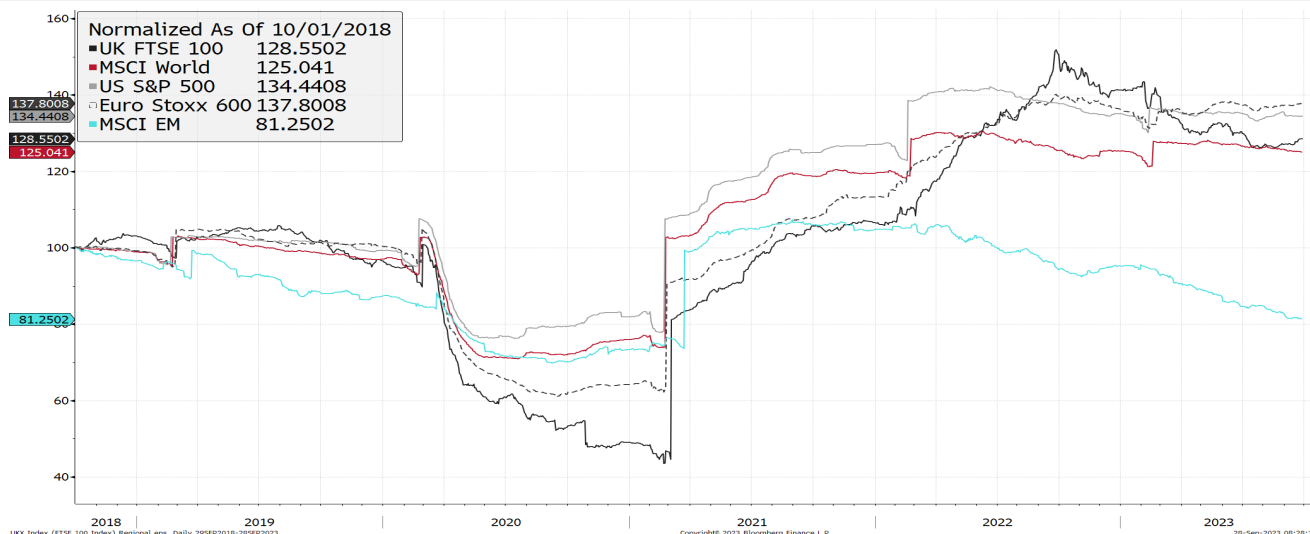
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# Outlook: Equities

## EARNINGS ESTIMATES BY REGION (REBASED TO 100)

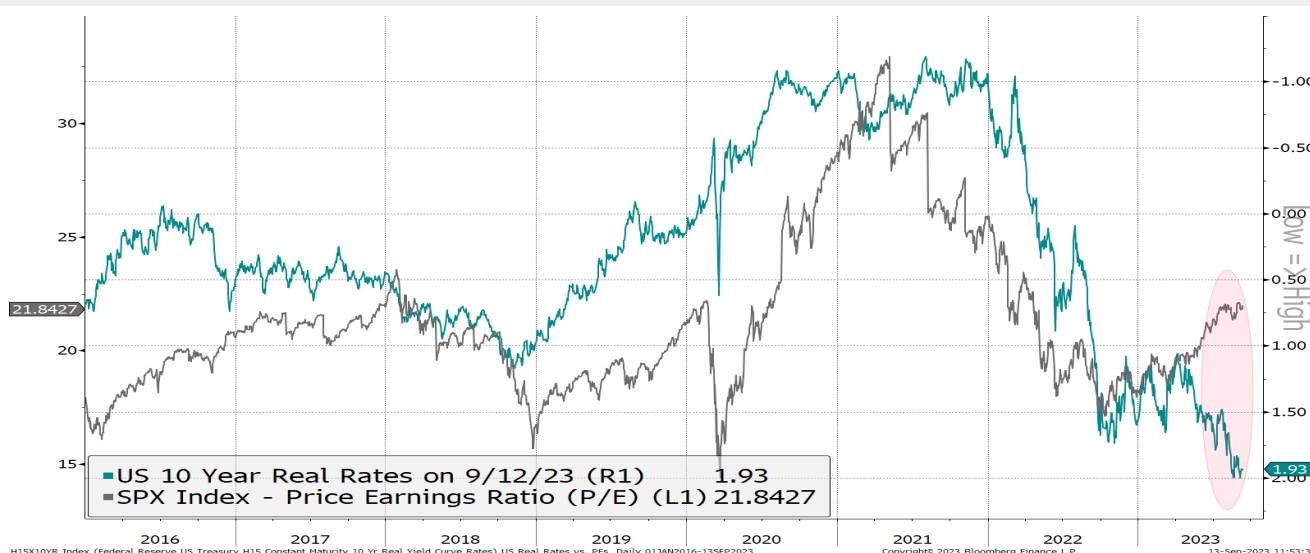


Bloomberg

Despite the weakness of equity markets over Q3, earnings forecasts have remained quite resilient globally. The chart above illustrates analysts' earnings expectations for the next twelve months by region. The US and Europe have continued to see modest earnings upgrades since the start of the year which is at odds with the broader macro fragility at present. Economic growth within the Euro zone is rather lacklustre currently with Germany being in a technical recession.

In the US, corporate margins within some sectors have been boosted by the cost cutting measures unveiled at the start of the year. High fixed costs were particularly elevated within Technology and Communication Services with a number of incumbents over hiring post COVID. Those cost cutting measures have since driven profitability and therefore earnings overall. This isn't sustainable however and the risk to equities going forward is posed by the slowdown in broader economies and the degree to which this weighs on companies' revenues overall.

## US 10-YEAR REAL YIELDS VS. THE S&P 500 INDEX P/E MULTIPLE



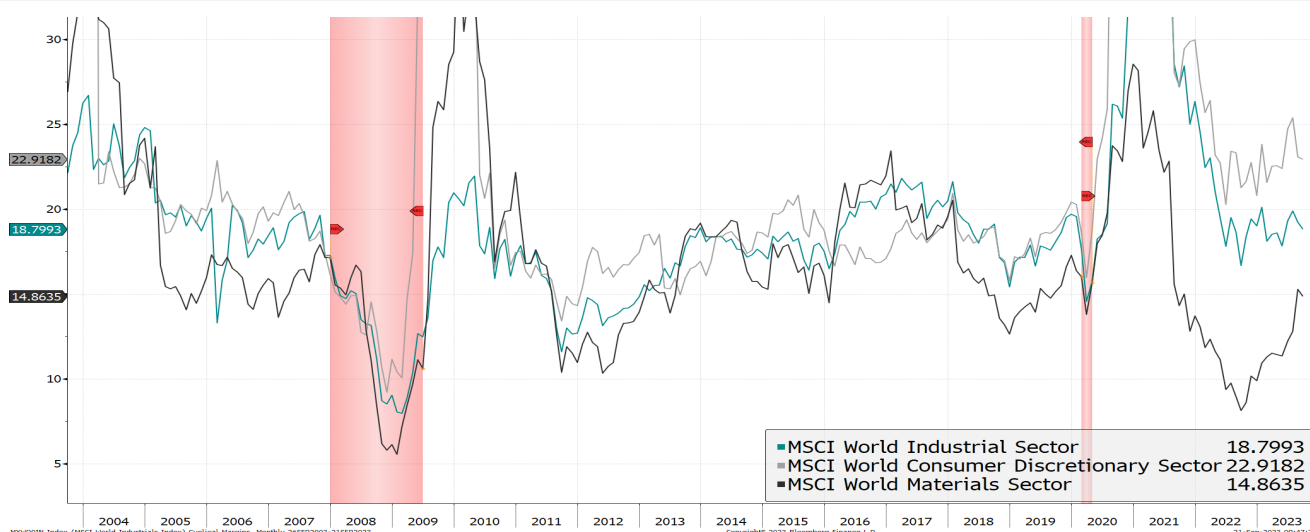
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This is the key risk for equities as we head into the final quarter of the year and the upcoming earnings season should shed some light on how companies are faring against this tougher economic backdrop. For some sectors however, they are going into this period on high valuations which in turn are predicated on cyclically high margins. For other areas of the equity market, they continue to largely decorrelate from the recent increase in real bond yields. The chart above highlights the P/E valuation multiple of the S&P 500 Index which has re-rated as this year has progressed, going from ~17.5x at the start of the year to around 22x by the end of the third quarter. Historically, there has been a close correlation between the equity market multiple and the move in real rates with declining real rates acting as a low discount rate from which long duration equities are valued off. We've seen this relationship breakdown this year as the hype around AI has pushed the valuation multiple of related companies higher. This trend is unlikely to continue, and September was notably a weak month for this area particularly.



# Outlook: Equities

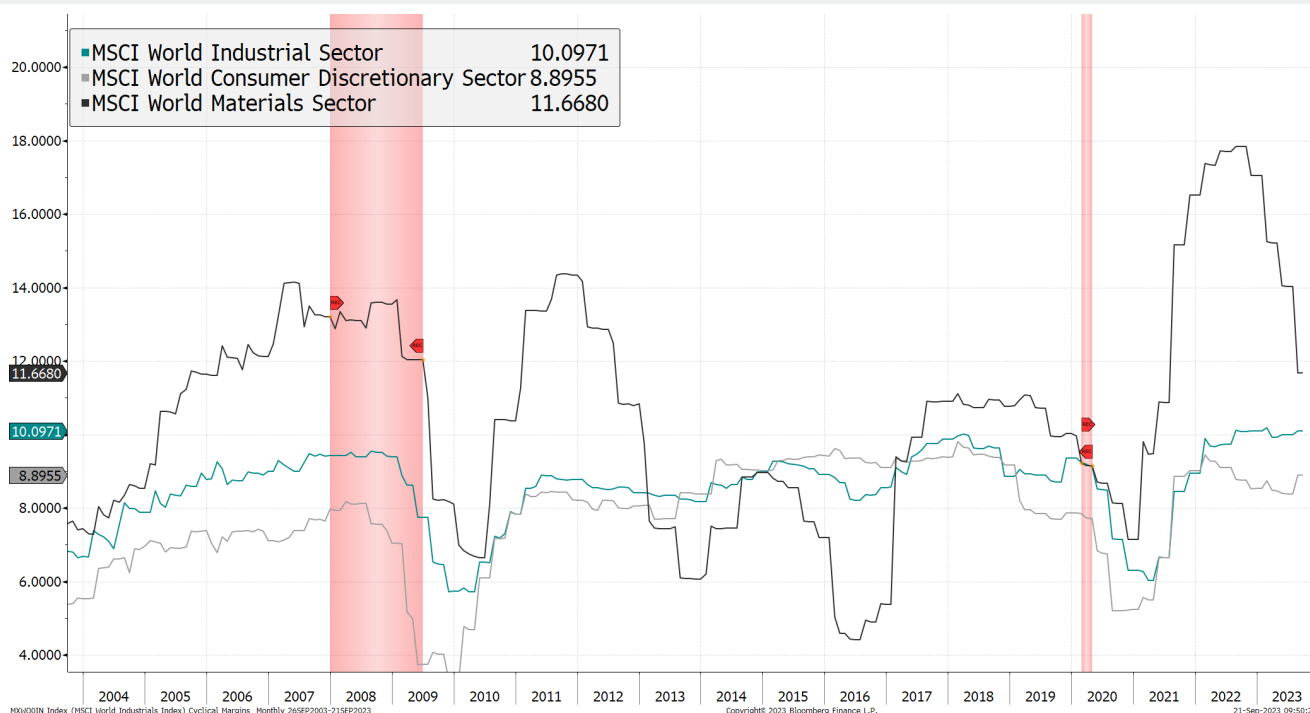
## MSCI WORLD CYCLICAL SECTORS: P/E VALUATIONS



Bloomberg

We have highlighted above the price-to-earnings multiples for three cyclical sectors, the (MSCI World), Industrials, Consumer Discretionary and the Materials sectors. The Industrials and Consumer Discretionary sectors look particularly stretched at present from a valuation standpoint, valued on 18.8x and 22.9x earnings respectively. However, when assessing the margin dynamics of these two inherently cyclical sectors in the chart below, we can see that both sectors are enjoying high operating margins at present. For the Industrials sector, operating margins are at 10% currently, well above cyclical lows of 6% and normalised margins of 8%. With the outlook for the world's economy becoming more challenging and the chances of a shallow recession unfolding in 2024, we're not sure it makes sense to be embracing cyclicity at these elevated valuation levels. If a recession does unfold then margins closer to normalised levels may become the norm, however a more sinister recession is likely to see those margins back at cycle lows. 18.7x earnings quickly becomes a 25x P/E!

## MSCI WORLD CYCLICAL SECTORS: OPERATING MARGINS



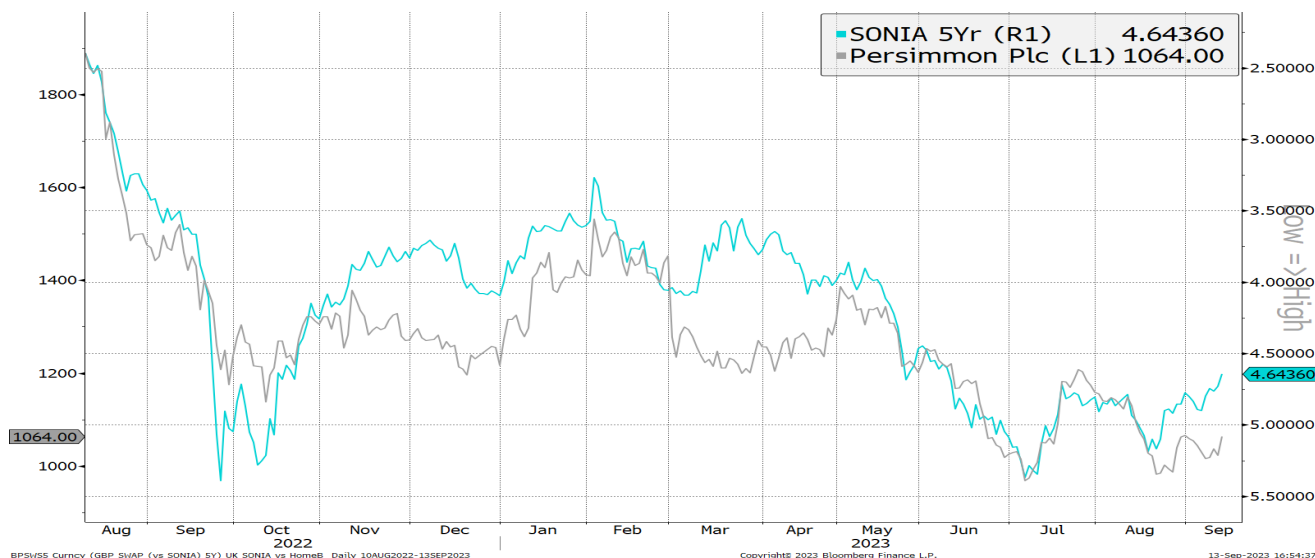
Bloomberg

With that, we'd much rather continue to embrace durability and defensiveness overall within equity positioning, however we do find pockets of opportunity within some heavily beaten down areas of the market where valuations are already at cyclical lows and already discount a very hard outcome for market operators.



# Outlook: Property (UK)

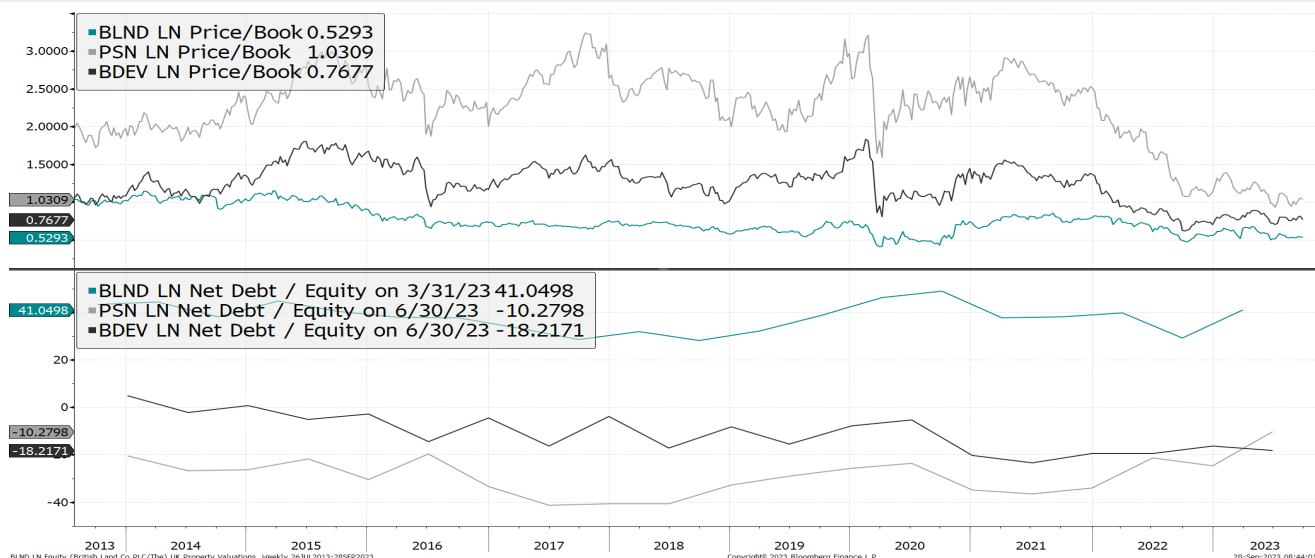
## UK HOMEBUILDER, PERSIMMON PLC SHARE PRICE PERFORMANCE VS. UK 5 YR MORTGAGE RATES



Bloomberg

One of those areas at present is the UK property sector which has really bore the brunt of the rise in interest rates lately. The chart above for instance contrasts the fortunes of Persimmon Plc, one of the UK's largest homebuilders with the 5 year SONIA rate (the right inverted axis), effectively the rate at which 5-year UK mortgages are priced. Rising bond yields and the general increase in the cost of capital during the third quarter has pushed SONIA rates up to their highest levels since 2008. This in turn has significantly impacted the affordability of mortgages here in the UK, especially from first time buyers, an area of the market which the UK homebuilders are heavily reliant upon. We are of the view that the UK may have seen a peak in the current interest rate cycle. Should this be the case, then it's likely that mortgages will get cheaper over time. Regardless of this, the share prices of many UK listed property stocks have already discounted a very bad outcome for the UK housing market.

## UK LISTED PROPERTY COMPANIES' VALUATIONS



Bloomberg

As illustrated in the chart above, the share price of Persimmon Plc was trading at book value by quarter end, whilst Barratt Developments Plc is trading at a -23% discount to book. In other words, if the company was to liquidate itself today and sell all off its assets, then shareholders would get more back from the proceeds of a sale than the value of its market listed equity currently.

It can at times be common to find cyclical stocks trading below book value during market troughs, indebtedness is usually an overbearing factor which can weigh heavily on equity values as higher debt servicing costs eat into residual equity value. In the case of the UK property market today, indebtedness is less of an issue than it has been historically. Also illustrated in the chart above is the Net Debt to Equity ratios of Persimmon Plc and Barratt Developments Plc, both of these companies' trade with net cash balance sheets. In the case of Barratt Developments Plc. it has ~£1.2bn in cash on its balance sheet against £249mn of debt. This is a far cry from where





# Outlook: Property (UK)

the company was back in 2008-09 during the Great Financial Crisis (“GFC”). Barratt went into the GFC with a Net Debt to Equity ratio of 7x which quickly ballooned to 60x as the freefall in earnings meant the company was loss making, whilst debt servicing costs surged. Debt on the balance sheet stood at £1.6bn at the low point against a company which lost £460mn in EBITDA in 2009. Equity holders were almost wiped out and mass equity dilutions and rights issues resulted.

Today the UK homebuilding sector is a shadow of its former self. Balance sheets are in pristine condition and management have done the right thing in safeguarding shareholder value within a franchise which is so inherently cyclical in nature. UK homebuilders are very likely to survive this cycle given the strength of their aggregate balance sheets. Moreover, the difficulties facing smaller, family-owned and private UK homebuilders is stark. They don’t have similar access to capital markets like the major listed entities, nor can they benefit through greater economies of scale.

The fallout of the GFC led to material consolidation in the UK housing market. Over the past decade, approximately 80% of the new supply in homes has been generated by the ten largest homebuilders. They now benefit from oligopoly-like characteristics and should become even more entrenched over the medium term. Aside from the low valuations common across the sector at present, under normalised conditions, these businesses tend to generate mid teen returns on equity, comfortably above their cost of capital.

From a secular growth angle, the UK housing sector is attractive. There has been a chronic undersupply of new houses in the UK for the last thirty years. In order to meet natural fertility rates and net migration to the UK, the country has needed to provide around 300,000 new units per year to meet demand. In reality, and although variable year-on-year, around 200,000 new units have been built per annum over the last two decades. This undersupply has boosted home values whilst it has also increased pent-up demand. Although housing affordability is likely to remain stretched for average first-time buyers, the ability of some first-time buyers to leverage off their parents’ assets should remain a key supporting factor with an estimated ~ 40% of all UK homeowners owning their home outright. First-time buyers are also now extended mortgage maturities, borrowing now over the course of thirty years as opposed to a historical average of twenty years.

We believe better times lay ahead for this sector and many of today’s headwinds should recede over time, however we take comfort in balance sheet resilience shown across the sector today.





# Outlook: Fixed Income

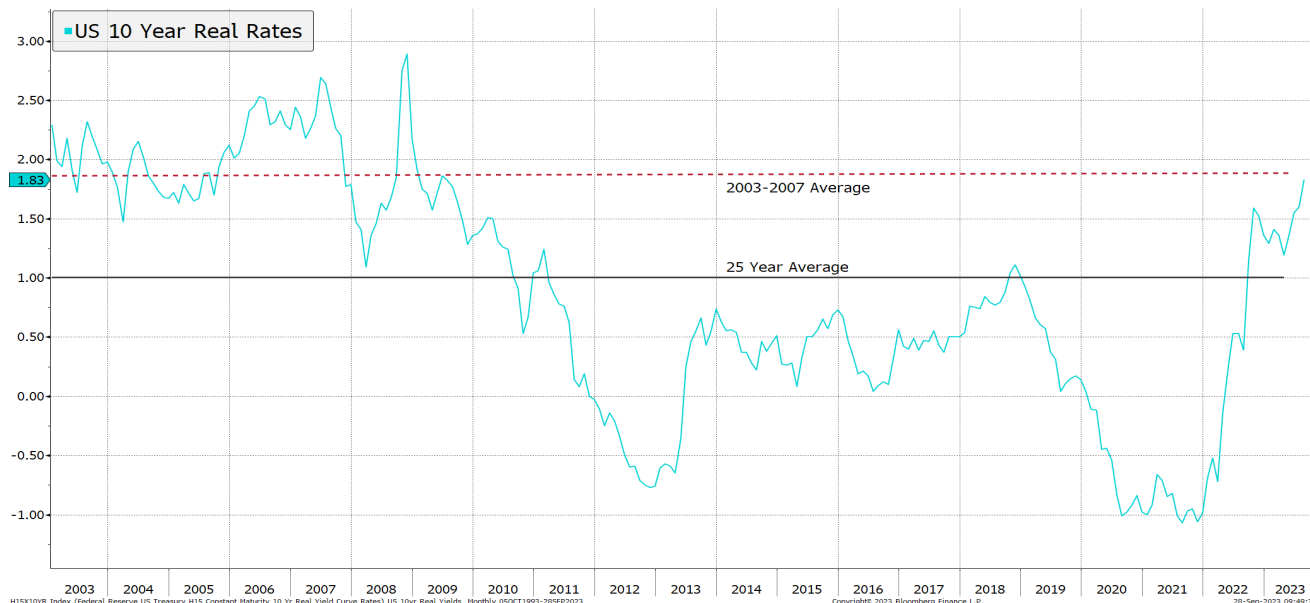
## LONG MATURITY SOVEREIGN BOND YIELDS



Bloomberg

2023 is shaping up to be another disappointing year for fixed income investors. Having recalibrated markedly from the low point in yields, reached during the depths of the COVID pandemic in early 2020, bonds now look set to record their third consecutive year of negative total returns. Unless we see a rally in bonds during the fourth quarter, this will be the first time in history that some measures have recorded such a feat. The chart above illustrates the ongoing rise in long term government bond yields in US, UK and German markets over the last decade. US 10 Year Treasuries finished the third quarter at ~4.6%, their highest level since 2007, just prior to the Great Financial Crisis ("GFC"). This year's decline in bond prices and rise in yields (the two move inversely to one another) have come despite clear evidence of short-term inflation moving lower, whilst longer term measures of inflation have also remained relatively well anchored. For value-conscious investors, the rise in bond yields against subdued longer-term measures of inflation has pushed real rates higher. From the chart below, the US 10-year real rate is now above 25-year averages and almost back to the pre GFC levels.

## US 10-YEAR REAL RATES



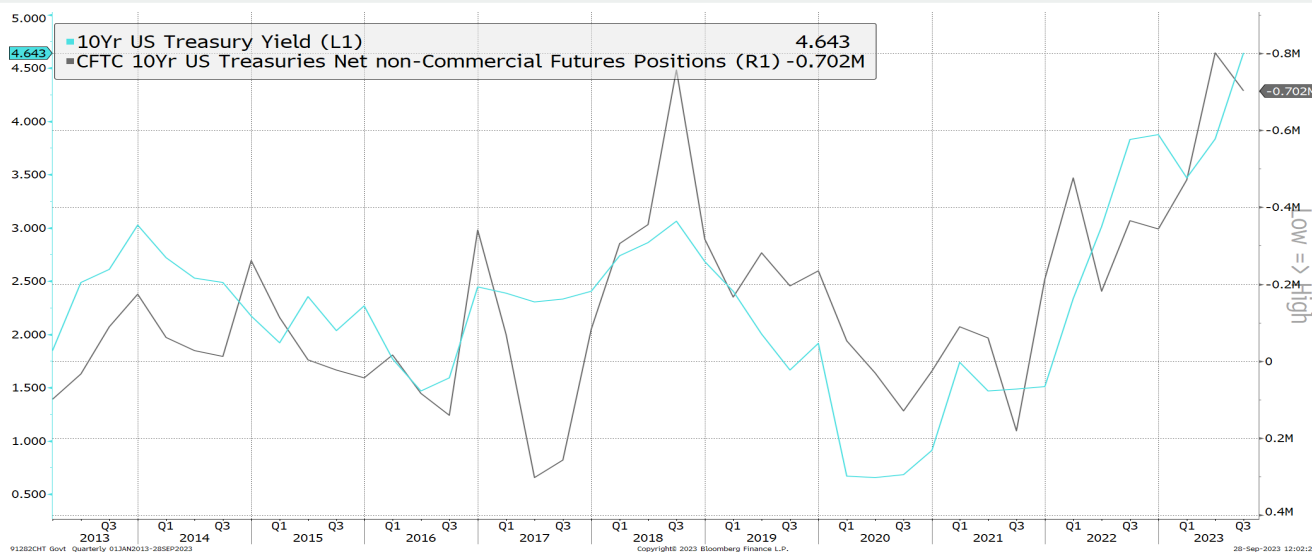
Bloomberg

The key question for bond investors is are we going back to a pre-GFC period or does the indebtedness of governments today mean that real yields will quickly decline back to the post GFC trend of around zero percent?



# Outlook: Fixed Income

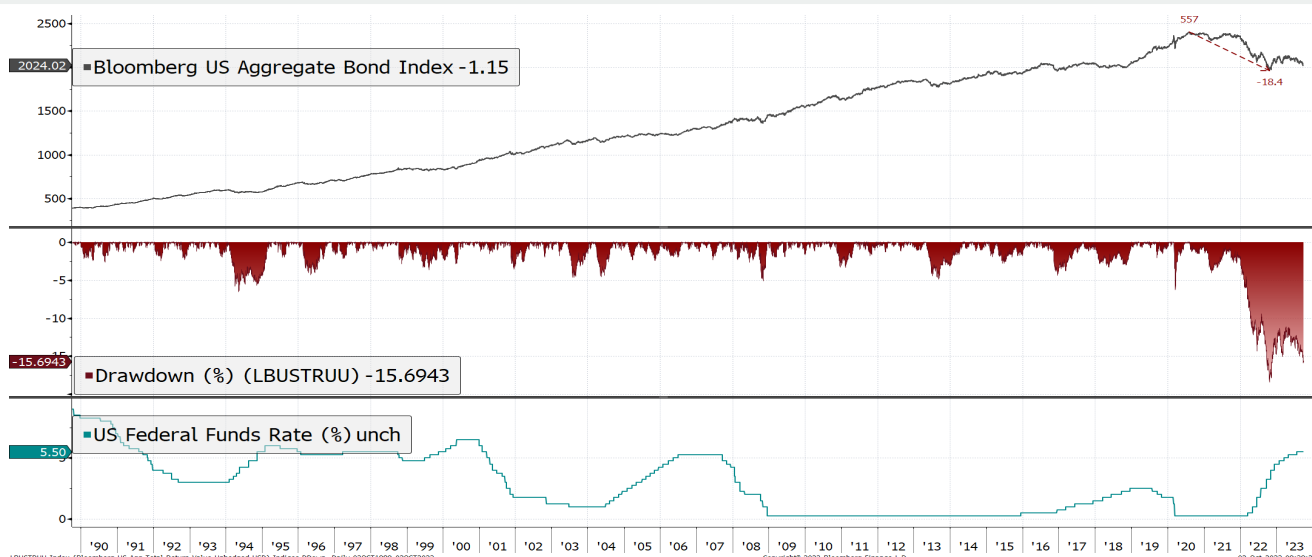
## 10 YEAR US TREASURIES VS. CFTC 10 YEAR US TREASURY NET NON-COMMERCIAL POSITIONING



Bloomberg

Markets can perhaps point to a number of reasons at present as to why long-term yields have moved higher. US sovereign debt was downgraded by Moody's during the third quarter, citing the government's fiscal spending programme which equates to around 6% of GDP as one of the primary reasons for the downgrade. This comes at a time when the US Federal Reserve is doing the opposite and is seeking to tighten monetary policy as it seeks to curb inflation. Via Quantitative Tightening ("QT") the Fed is progressively winding down the size of its balance sheet through the outright sale of US Treasuries. Together with the new issuance of sovereign debt to fund the US Government's fiscal spending programme, the supply of bonds into the market has picked up significantly. Speculators have moved swiftly to capitalise from this change in supply. The chart above on the right Y axis illustrates the total net non-commercial futures positions of US 10 Year Treasuries held with the CFTC currently. This is inversely illustrated to show the correlation it has had lately with the rise in 10yr US Treasury yields on the left Y axis. Investors are significantly net short.

## BLOOMBERG US AGGREGATE BOND INDEX DRAWDOWNS & THE US INTEREST RATE CYCLE



Bloomberg

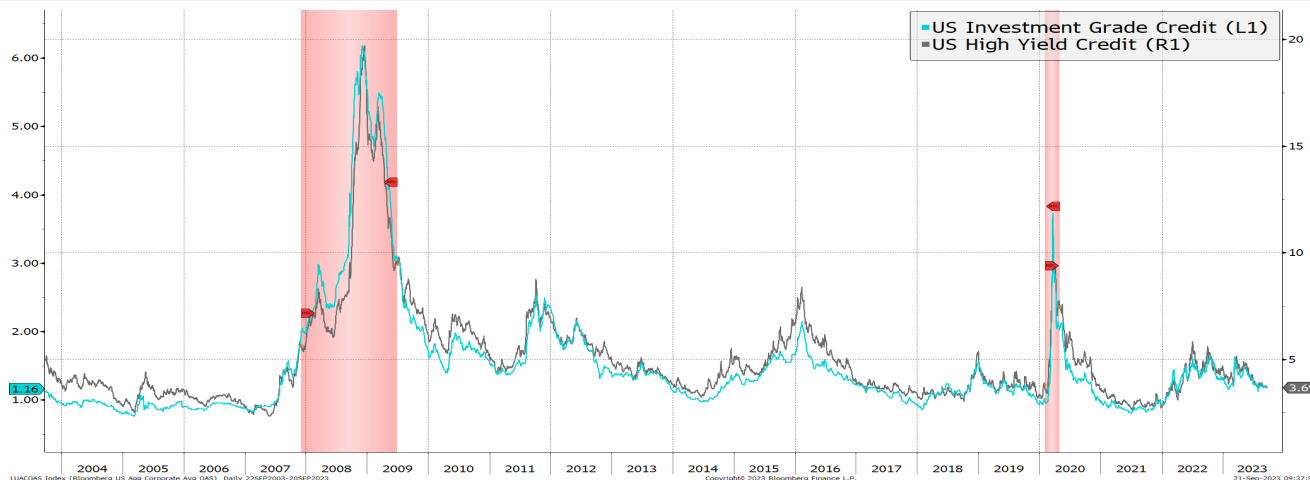
Encouragingly for bond investors, a peak in the interest rate cycle has often heralded the start of a new bull market for the asset class. The chart above puts into context the last 3 years' performance drawdown for the Bloomberg US Aggregate Bond Index going back to 1990. Historical drawdowns for the index have often troughed when the US Federal Funds rate has also peaked. Past cycles have seen strong returns over the proceeding five years with those gains always being front-end loaded. Following the peak in the last four US rate cycles, the Bloomberg US Aggregate Bond Index delivered an average +7.0% return over the next five years per annum. Returns have been the strongest over the first year after the peak, delivering 10% on average.

Of course, starting valuations matter in this regard and yields are now back above long-term trends in real terms. The biggest question mark which is causing considerable debate currently is to what extent has the world changed since COVID?



# Outlook: Fixed Income

## US IG & HY CREDIT SPREADS

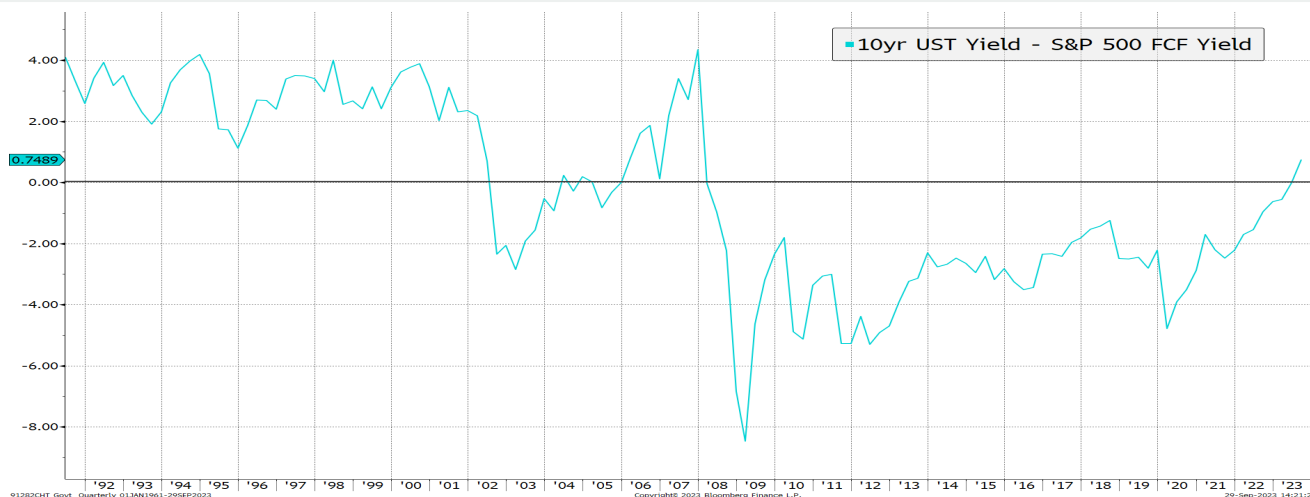


Bloomberg

Geopolitics hasn't been a dominant theme impacting bond markets in the past like it is doing today. The fracturing in relations between the West and China and its close allies is arguably causing the world to split into two. This is forcing Western companies to shift their manufacturing production and reliance away from China and back onshore within domestic markets or "nearshore" with allies close by. This "reshoring" in activity comes at a time of relatively tight labour markets and is taking time for supply chains to be built. This may be inflationary over time, however other low-cost centres of production are being utilised, especially within countries such as India, Indonesia, Vietnam and Eastern European countries particularly.

Overall, we still believe we are living in a globalised world and the three mega forces of Debt, Demographics and Digitalisation have not gone away despite the supply chain-induced problems from COVID which have since dissipated. The other major variable today is the ascent of AI (Artificial Intelligence) and how this benefits economies over time. The technology has shown early signs of it being a disinflationary force within society, boosting productivity and cutting inefficiencies overall. The potentially limitless adoption of AI should cut pricing in many industries and enable society to focus its attention on higher value areas.

## 10 YEAR US TREASURY YIELDS – S&P 500 INDEX FREE CASH FLOW YIELD



Bloomberg

Above all, the starting valuation standpoint for bonds today provides an attractive entry point. Bonds provide an attractive (real) yield whilst they increasingly offer an asymmetric return profile. Assuming the US slips into a recession over 2024 as some economists now predict, then it would be easily conceivable to see 10 year US Treasury yields falling 200bps from their current level of 4.6% to 2.6%. Such a move would lead to a +20% total return for the asset class. We increasingly find longer duration bond sensitivities more compelling than short duration sensitivities where convexity is less pronounced. For instance, assuming a duration of 7 years and assuming a -100bps decline in 10-year Treasury yields should the US economy falter into a recession then investors would still enjoy a +7% gain in the bonds repricing due to duration, in addition to receiving the bond's carry. These are attractive returns and particularly against the free cash flow yield of the S&P 500 Index (above) currently. We do however stand with a degree of caution towards corporate credit currently due to the relative tightness in credit spreads. The chart at the top of the page highlights spreads within the US Investment Grade and High Yield sectors currently. Both are close to cycle tights of +116bps and +369bps respectively. During a typical recessionary backdrop, it's been common to find spreads closer to >200bps and >600bps respectively.



# Umbra Capital Partners LLP

## MARCUS SZEMRUK, CHIEF INVESTMENT OFFICER



Marcus serves as the firm's CIO and is a Partner of Umbra Capital Partners. Marcus has over 24 years of industry experience, exclusively spent on the buy-side. Before joining the firm in September 2021, he was a Senior Portfolio Manager, Asset Allocation Strategist & Managing Director at UBP SA. Before this, he was a Partner, Asset Allocation Strategist & Fund Manager at ACPI Investments Ltd from 2008 to 2018. Prior to this, he was a Long-Only and Hedge Fund Analyst whilst at Stonehage Fleming. From 2001 to 2005 he was a Hedge Fund Analyst at HeadStart Advisers. Marcus began his career on the European Equities team at UBS Phillips & Drew in 1999.

He holds the Certificate in Investment Management (CertIM) and holds a BSc in Banking & Finance from Loughborough University.

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