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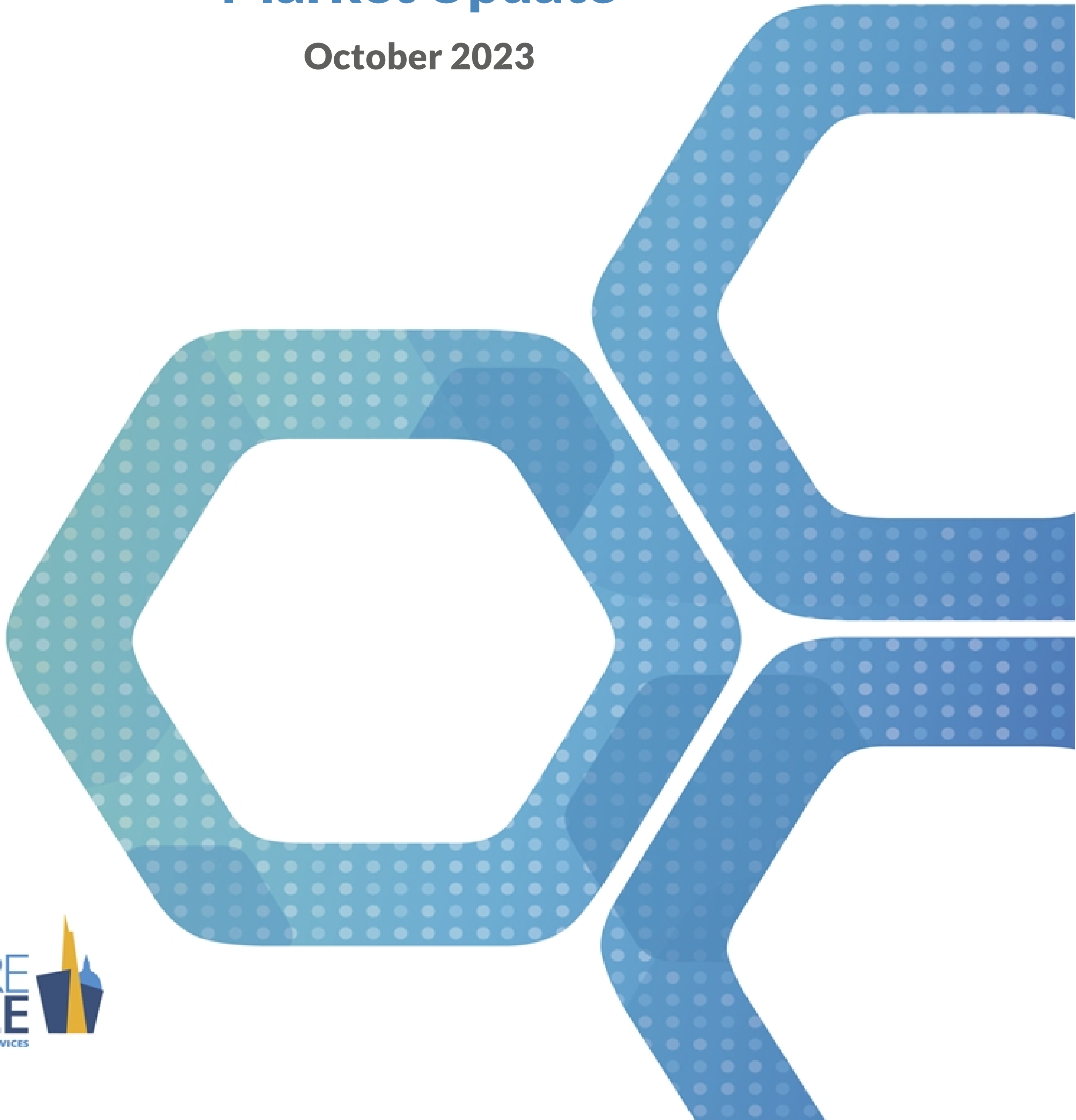
FINANCIAL PLANNING

Market Update

October 2023



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Market Update

Macro Backdrop

As it stands today one of the most anticipated recessions ever has yet to materialise. In fact, economic growth, with the exceptions of Germany and Italy, has broadly been positive across the board, although outside the US recent gains have been much more modest in nature. As we are all painfully aware the Western world has undergone one of the fastest monetary tightening phases in history, as Central Banks continue to do battle with the elusive opponent that is inflation. On that front there has generally been more positive news. Inflation in the UK unexpectedly fell to 6.7% in August, below a 7% forecast and core inflation (ex energy and food) dropped to 6.2%. This therefore allowed the Bank of England to hold interest rates in September, although further rate rises were not ruled out. Whilst inflation in the US picked up to 3.7% in the same month, largely driven by a higher oil price and the impact of year-on-year base effects, core inflation fell to 4.3%, its lowest level since September 2021. This led to the US Fed also holding interest rates in September, though with the suggestion that there could be another hike later this year. The Eurozones ECB pushed ahead with its interest rate rise but indicated that this rise was likely the last, given the fragile economic outlook. China, on the other hand, has been flirting with deflation and a debt laden property market headache. The great reopening that was expected as the country emerged from its brutal series of covid lockdowns has failed to appear. This poor economic backdrop has led to interest rate cuts and stimulus measures being implemented. Yet, as we have noted before, one positive here is that China's deflation could help the West's inflation, as they offload excess inventory and export goods at knockdown prices.

There are so many conflicting macro variables at play today that it is not a time to be envious of central bankers. Higher debt servicing costs (for consumers, governments and corporations), inverted yield curves, falling savings levels, higher oil prices and weakness in the global manufacturing sector, all suggest a recession is on the horizon. However, tight labour markets and real wage growth has kept the consumer spending, as can be witnessed by Taylor Swift's summer tour, that had an estimated $5bn impact on the US economy.

Interest rate rises have a lagged effect, generally 12 months or more, and so the impact of more recent hikes have yet to be felt fully. Our view remains that as these feed through and if we start to see weakness in labour markets (where some cracks are appearing), as companies try to protect margins by cutting staff, this will presage an economic downturn. Whilst we cannot know when, or even if, that will come to pass, it would likely put downward pressure on interest rates, a feature markets are already anticipating for mid to late 2024. There is clearly a risk that inflation proves stubborn, not helped by high wages and recent rises in the oil price, but we do believe that we are at least near the end of the monetary tightening phase in the US and Europe.

Bond Markets

As ever the inflation and interest rate dynamic has been most keenly felt in global fixed income markets. The inflation backdrop in the UK has meant that government bond yields have continued to rise, with the yield on UK 10-year bonds touching a level not seen since 2008 in the last quarter. Yet, weak business surveys and the better than expected inflation figure saw yields falling back as investors came round to the view that we are at, or very near, peak rates. In the US, strong GDP growth lent credence to the narrative that interest rates may need to stay higher for longer, and so the yield on 10-year US government bonds climbed to its highest level since 2007. Outside of government bonds we have seen some gains, as the more encouraging economic environment has tempted investors into corporate debt markets.

Despite the rise in government bond yields, when compared to what was a brutal 2022 bond markets haven't done a huge amount this year, supporting our view that a lot of the valuation readjustment has already happened. We are not dismissing the continued inflationary threat but with, in our opinion, interest rates being near the top of their range and given the yields now on offer (UK corporate bond indices are yielding over 6%) it is right to be more optimistic on the asset class from here. We recently made portfolio changes, where appropriate, to increase the interest rate sensitivity of our fixed income holdings and continue to review our overall positioning closely.

Stock Markets

Global stock markets traded quite choppily in the third quarter, with a fairly benign July leading to a more lacklustre August and September. Markets continue to grapple with the interconnected forces of inflation, interest rates and economic growth, and remain fairly responsive to news-flow on all fronts. Nevertheless, most markets are in positive territory this year, with Japan top of the charts. Asian and emerging market equities have lagged, largely due to disappointing Chinese economic data.

One of the best performing markets so far in 2023 has been the US. Although its technology behemoths didn't gain quite as much favour in the third quarter as they did earlier in the year, the year to date divergence between the top 50 largest stocks in the US compared to the bottom 2000 is c.20%. The dominance of these, mostly AI related, companies is striking and their run up in performance does make the US market appear an expensive one. However, we draw some comfort from the fact that once the top ten largest stocks are removed from the data the US is actually trading at around its long-term average valuation.

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The underperformance of medium and smaller sized companies has also been a theme prevalent in the UK stock market. The third quarter was no exception to this, partly because a higher oil price drove up the share prices of multi-national energy companies, such as Shell, which makes up nearly 9% of the FTSE 100. Even so, whilst it has been larger companies that have generally supported the UK market this year it has still returned less than its major world peers. The UK market generally remains disliked on the international stage, and its medium and smaller sized constituents are actively unloved. The reasons for this may be myriad, and politics has likely played its part, but as such the UK market is currently cheaper (using conventional valuation measures) than the US, Europe and the emerging markets.

What can be forgotten in the time of Apple, Amazon and Microsoft, is that the UK is home to some great businesses, lots of which are household names. Our UK fund managers, where we use active strategies for portfolios, are excited about the prospects of many. This includes, for example, Dominos Pizza, which grew total sales by 20% year-on-year in August and has opened 29 new stores. As well as Trainline (the online rail ticketing platform), which is growing rapidly across Europe as deregulation opens up networks to new entrants. To quote one of the manager's that we invest in '*whilst there are risks from rail strikes and political change, Trainline offers highly attractive organic growth prospects at a significantly derated share price*'. Furthermore, the importance of having healthy and growing capital markets, which boosts growth, employment and innovation, has not been lost on politicians. The Chancellor's recent Mansion House Reforms could see pension funds voluntarily allocating up to 5% of their defined contribution funds into unlisted UK equities, from the 0.5% that is allocated today. The UK's AIM market is technically unlisted and it is estimated it could see a boost of up to £50bn of new capital, which is even more significant when one considers the current total size of the AIM market is £75bn.

Overall, we balance the risks of future economic weakness and a very expensive top end of the US market with the view that valuations elsewhere are more attractive and that those US corporate titans may retain their grip on markets for some time to come. Equities remain, in our view, one of the few asset classes that can deliver returns ahead of inflation over the medium to longer term, an argument that is becoming easier as inflation continues to fall. Therefore, we are not positioned aggressively in equity markets, but retain what we would term a neutral level of exposure in portfolios.

All data has been sourced from FE fundinfo, Refinitiv and Square Mile.

Important information

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