Ravenscroft

COMMENTARY

1st April to 30th June 2023

For professionals and intermediaries

Hopes of an early peak in the global interest rate cycle suffered a setback in the second quarter, despite inflation in the US and Eurozone falling further from their highs in line with expectations, as western central banks hiked policy rates and doubled down on previous hawkish statements. Whereas bond markets gave back some of the previous period's gains, developed equity benchmarks advanced, thanks largely to strong moves in a small group of mega-cap US technology stocks that were fuelled by frenzied interest in developments within the world of artificial intelligence.

EQUITIES

Equity Market Indices

Index	Q2-2023	YTD
MSCI World ($)	+ 6.28%	+13.99%
MSCI World (€)	+ 5.80%	+11.83%
MSCI World (£)	+ 3.20%	+ 8.45%
MSCI World (local ccy)	+ 6.60%	+14.01%
S&P 500 ($)	+ 8.30%	+15.91%
FTSE UK All Share (£)	-1.48%	+ 0.52%
MSCI Europe Ex-UK (€)	+ 0.98%	+10.53%
Japan Topix (¥)	+14.23%	+20.98%
MSCI Asia Ex-Japan ($)	-2.16%	+ 1.84%
MSCI Emerging Markets ($)	-0.08%	+ 3.46%
MSCI Emerging Markets (€)	-0.53%	+ 1.50%
MSCI Emerging Markets (£)	-2.97%	- 1.57%

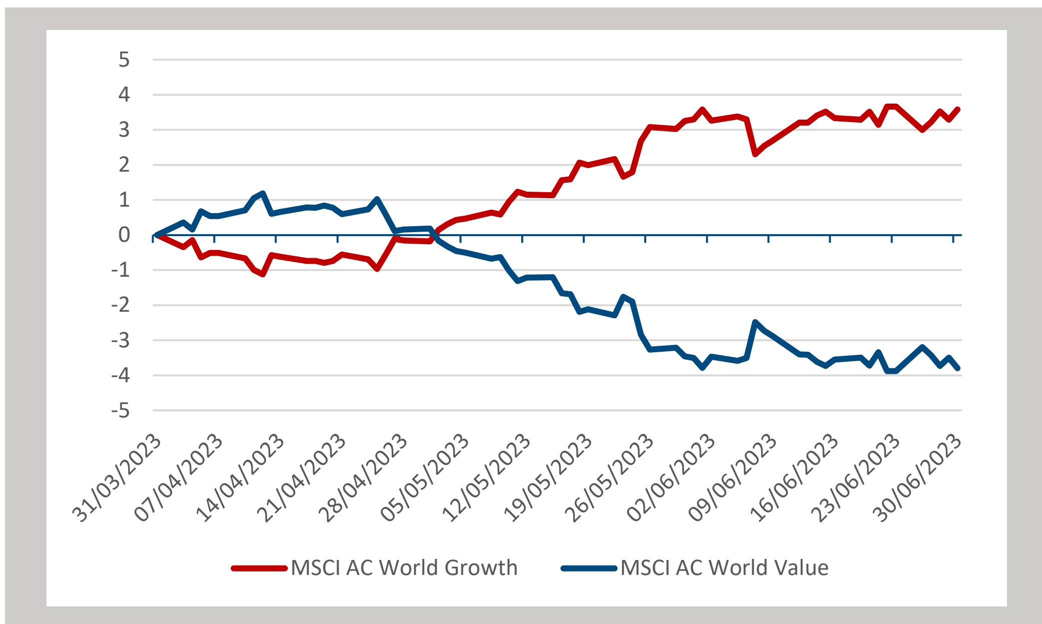
A quiet period in markets, during which global equity benchmarks were confined to a narrow (3%) trading range for the quarter's first two months, ended abruptly in early June with a positive response to the news that, after weeks of fractious and fruitless "negotiations", the threat of a US debt default had been avoided by an agreement in Congress to extend the US debt ceiling until November 2024. Measured by the MSCI (local currency) World Index, the resulting rally during the period's latter stages lifted the market to a 14-month high.

In terms of market returns, there was a marked divergence at a geographical level, in part reflecting the variations

in economic conditions and outlooks across the globe. This was manifested in the contrasting fortunes of the US and China, for example, where economic data from the former tended to surprise on the upside, while China's post-Covid reopening has proved far weaker than anticipated.

A wide range of returns from individual sectors contributed further to these disparities, with technology-related stocks a clear outlier and another important driver of index gains in the US when compared with other markets. Unsurprisingly given this backdrop, in terms of style groupings, growth outpaced value by a wide margin (Fig. 1).

Fig 1. MSCI World Growth v Value

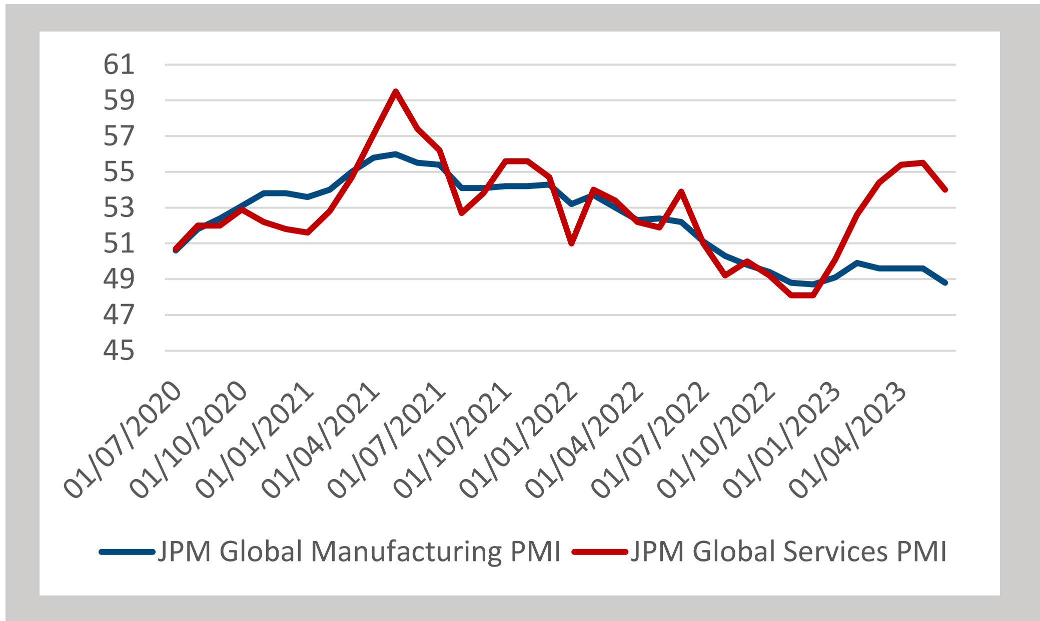


Source: Bloomberg

As alluded to above, data for the period under review highlighted the multi-speed nature of the global economy. In the US, GDP growth of 2.0% in the first quarter and a composite Purchasing Managers Index (PMI) of 53.2 for June were indicative of an economy that, although some way off peak levels, is ticking along soundly. By contrast, the corresponding figures for the Eurozone of -0.1% and 49.9 – in combination with their declining trend, point to a slowing in activity that in all likelihood will confirm that the consensus forecast for a (short and shallow) recession will prove to be correct. While healthier numbers in China - GDP +2.2% in Q1 and a composite PMI of 52.3 – at least showed the world's second largest economy to be growing, the pace of that expansion from a comparatively low base suggests that the anticipated rebound from lockdown measures that ended as recently as December of last year is worryingly sluggish, particularly when expressed in nominal terms (unlike the western world, China does not have an inflation problem – June's year-on-year Consumer Price Inflation was zero). Though perhaps less important within a global context (but according to the IMF, still the world's sixth largest), the UK's was one of the few major economies to beat expectations: Q1 GDP growth of 0.1% and the latest composite PMI of 52.8 were somewhat at odds with the overwhelmingly gloomy narrative and negative tone in the mainstream and financial media (as has been the case, it must be said, for much of the post-Brexit era).

One of the notable features of the past two quarters is the widening gap between the PMIs that indicate activity within the manufacturing and service sectors at global level (Fig. 2). Although some commentators have cited this as the harbinger of a downturn in the global economy, there is little in the way of historic evidence to back up such an assertion. Instead, we would suggest that it is more likely a function of tight labour market conditions in much of the western world.

Fig 2. JPM Global PMIs



Source: Bloomberg

With the foregoing economic picture and "glass half empty" mood of many commentators in mind, it is perhaps not surprising that, according to Bloomberg's consensus estimate for the MSCI AC World Index, aggregate corporate earnings are forecast to decline modestly, by 2.78%, over the current calendar year (around -6% in real terms). At its quarter-end closing mark, the index was valued at a multiple of 17.2 times 2023 earnings, which is pretty much bang in line (in fact marginally below) the average for the past twenty years. That, in our view, is by no means excessive, particularly when one considers that the prevailing heightened levels of inflation are actually a positive for the portion of the market that enjoys pricing power. Needless to say, such businesses represent a significant proportion of the companies in which our preferred equity managers are invested.

BONDS

Bond Market Indices

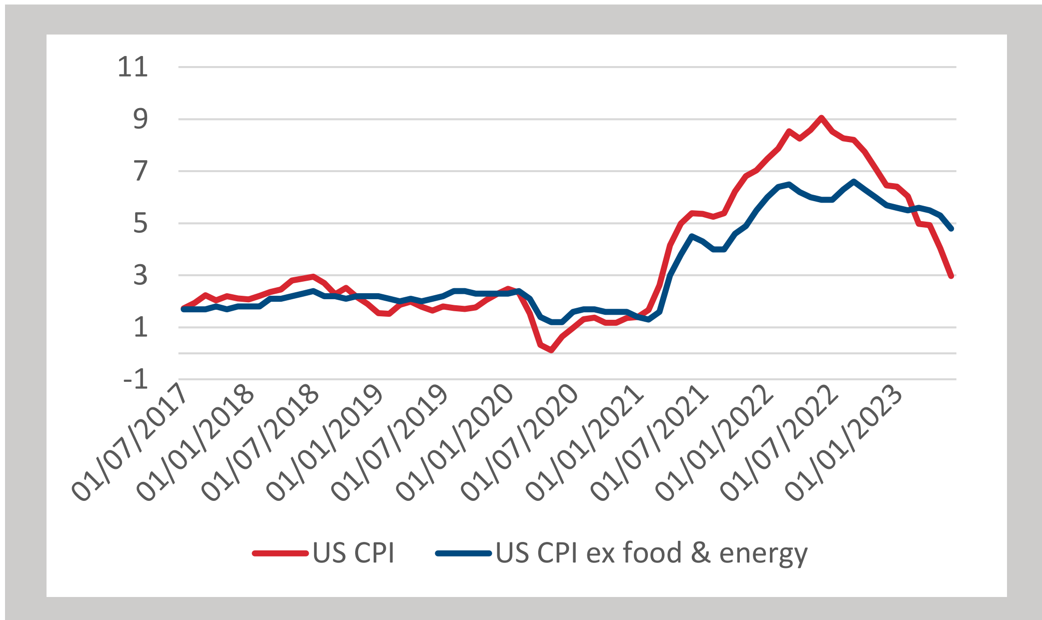
Index	Q2-2023	YTD
Bloomberg US Gov't >1yr ($)	- 1.38%	+ 1.59%
Bloomberg German Gov't >1yr (€)	- 0.36%	+ 1.62%
Bloomberg UK Gov't >1yr (£)	- 5.95%	- 3.91%
Bloomberg Global Aggregate ($)	- 1.73%	+ 1.22%
Bloomberg US Aggregate ($)	- 1.14%	+ 1.79%
Bloomberg Euro Aggregate (€)	+ 0.10%	+ 2.19%
Bloomberg Sterling Aggregate (£)	- 5.10%	- 2.99%
ICE BofA US Corporate ($)	- 0.64%	+ 2.79%
ICE Bof A Euro Corporate (€)	+ 0.40%	+ 1.98%
ICE Bof A Sterling Corporate (£)	- 3.15%	- 0.79%
ICE BofA US High Yield ($)	+ 1.32%	+ 5.09%
ICE BofA Euro High Yield (€)	+ 1.60%	+ 4.31%
JPM EM Gov't Bond ($)	+ 1.53	+ 3.81%

After positive returns in the previous quarter, core sovereign bond prices came under renewed downward pressure. Western central banks continued to raise policy rates - by 25 basis points (bps) in the US, 50bps in the Eurozone and 75bps in the UK - and the accompanying statements expressing dissatisfaction over the pace at which inflation is declining seemed to take on an increasingly hawkish tone. In response, expectations for the level and timing of terminal rates were adjusted both upwards, by between 40 bps (US and EZ) and 120bps (UK) and further out into the first quarter of next year. This bearish shift in market sentiment was seen most acutely at the short end of maturity curves, where the yields on the two-year benchmark Treasury, Bund and Gilt were up 87bps, 51bps and 183bps respectively, compared with more modest increases of 37bps, 10 bps and 90bps in the corresponding ten-year issues.

Thanks to a favourable combination of yield premia and a narrowing in credit spreads, investment grade and high yield corporate bonds, along with emerging market debt, outperformed the broad market trend, which in the case of the latter categories delivered a positive outcome. Happily, in the absence of any further negative events within the banking industry, bonds in the financials sub sector enjoyed a partial recovery from their Q1 sell-off and also delivered market-beating returns. As we have highlighted previously, following the unprecedented sell-off experienced last year, the attractive levels of income and the prospect of capital upside with a pleasingly positive asymmetry mean that the opportunity set within credit markets – in particular at the short end of maturity curve – is as compelling as we have seen in many years. Accordingly, we have introduced further to the existing exposure in this part of the market within our portfolio models.

For those inclined towards a more "glass half full" view of the world, there were some positive aspects to the period's news flow and events. At 4.0% and 5.3% the US headline and core CPIs for May represent significant declines from their cycle peaks of 9.0% and 6.6% respectively. Moreover, the Federal Reserve's decision to raise its target rate by the lowest (25bps) increment in May and then leave it unchanged at its June meeting for the first time since the current hiking sequence began, suggests to us that, in spite of the hawkish rhetoric, there is scope for a favourable surprise in the near future (**STOP PRESS:** June headline and core figures of 3.0% and 4.8% undershot consensus estimates and the subsequent market moves have seen the level and time scale for peak rates both reduced Fig. 3).

Fig.3 – US CPI vs core CPI



Source: Bloomberg

This inflation surprise is entirely consistent with the view among the managers of our strategic bond fund holdings that the lag between implementation of interest rate rises and their eventual impact means that effects of central banks' aggressive tightening have only recently begun to take hold. Thus, although current forward market pricing suggests that rates have further to rise (by 25bps in the US, 50bps in Europe and 125bps in the UK), it's entirely possible that we may be only one or two positive data points away from a shift in expectations.

CURRENCIES

What was by recent comparisons a quiet period on the currency markets saw FX volatility measures decline to a 16-month low and the US Dollar record its smallest quarterly change (+0.40%, as measured by the DXY Spot Index) since December 2013.

Notable among the larger movers in the major currencies listed by Bloomberg was the Japanese Yen's fall of 7.98% in Dollar terms. After the announcement of an upward adjustment in its government bond yield control programme surprised (most) market participants back in November, the subsequent inaction and silence from the Bank of Japan has seen the strong and sharp rally that followed the de facto rate hike eroded away, as the yield differential between the JPY and other currencies has widened (Fig. 4). The South African Rand was another laggard, declining 5.58% in USD terms, as the economic consequences of the ongoing problems affecting the country's power supplies took their toll.

Fig.4 – JPY vs USD

Source: Bloomberg

At the opposite end of the scale, the Brazilian Real and Mexican Peso extended their run of strong relative performance with gains of 5.80% and 5.38% versus the Dollar respectively. In both cases, this was a reflection of improved economic performance, as the early and decisive action by their respective central banks to tackle nascent inflationary pressures has put them ahead of most other countries in the recovery phase of the cycle.

COMMODITIES

Broad commodity benchmarks ended the quarter in negative territory, dragged lower by weakness in industrial metals and energy prices: the Refinitiv CRB Commodity Index declined -2.14% in USD terms.

The small number of winners among the CRB Index's underlying components was largely confined to agriculturals, and included Lean Hogs (+27.11%), Cocoa (+13.13%), Live Cattle (+7.81%) and Soybeans (+3.44%).

Whereas softness across the metals complex (Nickel -13.94%, Aluminium -10.84% and Copper -8.63%) can be attributed to the declining trend in global manufacturing activity (as referred to earlier in this commentary), the declines in crude oil prices are harder to explain, given the further cuts in quotas announced by OPEC+ producers and forecasts of rising demand from the International Energy Authority for the year ahead. The solution to this apparent paradox lies with the increased production from Russia and Iran, the volumes from which have, until recently, been well below their allowable limits and in spite of the sanctions and / or price caps imposed on both, the oil they produce has found its way onto the international markets (mostly into Asia). Against this backdrop, the front month contracts for West Texas Intermediate and Brent ended the period down 7.07% and 5.10% at USD70.64 and USD75.41 per barrel respectively.

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