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COMMENTARY

1st July to 30th September 2023

For professionals and intermediaries

Are we there yet?

The words and actions of western central bankers against a backdrop of moderating inflation data may have signalled that policy rates are at, or just one hike away, from their cyclical peak, but a hardening in the accompanying narrative suggesting that they will stay higher for longer dented any prospect of a celebratory market rally. Meanwhile, further evidence of shifting alliances on the geopolitical stage sent energy prices higher and served to unsettle investor confidence. Broad bond and equity benchmarks posted modest losses, as the Dollar advanced.

EQUITIES

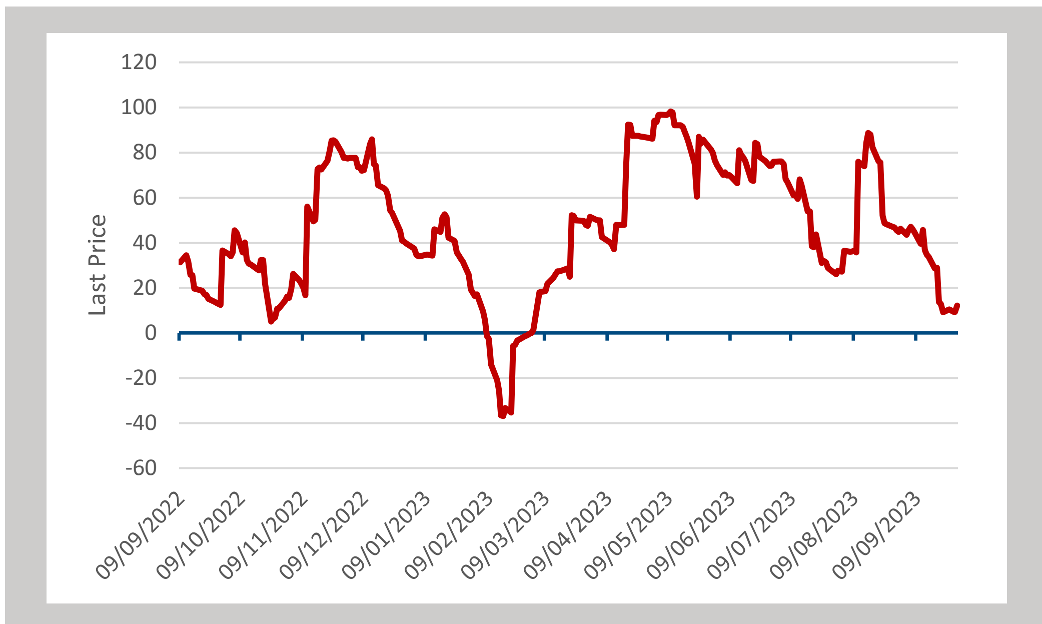
Equity Market Indices

Index	Q3-2023	YTD
MSCI World ($)	- 3.83%	+ 9.63%
MSCI World (€)	- 0.73%	+11.00%
MSCI World (£)	+ 0.19%	+ 8.66%
MSCI World (local ccy)	- 2.99%	+ 10.60%
S&P 500 ($)	- 3.65%	+ 11.68%
FTSE UK All Share (£)	+ 0.76%	+ 12.79%
MSCI Europe Ex-UK (€)	- 3.28%	+ 6.91%
Japan Topix (¥)	+ 1.52%	+ 22.82%
MSCI Asia Ex-Japan ($)	- 4.14%	- 2.38%
MSCI Emerging Markets ($)	- 3.71%	- 0.38%
MSCI Emerging Markets (€)	- 0.61%	+ 0.88%
MSCI Emerging Markets (£)	+ 0.32%	- 1.26%

Movements in equity markets over the quarter corresponded closely with the changing perceptions on the likelihood of a soft landing for the US economy. A positive response to the June inflation print that saw headline and core Consumer Price Indices (CPIs) fall, respectively, from 4.0% to 3.0% and 5.3% to 4.8%, lifted the MSCI World Index by more than 3% in local currency terms during July. Thereafter weaker data, in the form of below-forecast new job creations, a downgrade of the preliminary GDP figure (to +2.1%) and a successively softer Composite Purchasing Manager Index (PMI), in combination with higher than expected CPI prints for July and August, reversed all of the global benchmark's early gains.

Notwithstanding markets' recent weaker showing and the deterioration in some indicators, opinions over the prospects for the US remain split between three possible scenarios: a low growth "no landing", the mildest of recessions or a deeper downturn. By contrast, there can be little doubt that that the Eurozone is headed for tougher times: while second quarter GDP scraped into positive territory with a 0.1% increase, a sharp decline in the Composite PMI to 46.7 in August - its lowest reading outside of the pandemic for more than a decade – suggests that the region's economy is in all probability already contracting. Somewhere between the two, and despite headline (6.7%) and core (6.2%) inflation rates that are both meaningfully higher and stickier than those in the US (per above) and Europe (5.3% / 5.2%), the UK continues to defy the gloomy prognosis that seems to be the default setting for all commentators on a consistent basis (Fig 1).

Fig 1. Citi UK Economic Surprise Data



Source: Bloomberg

In China, meanwhile, efforts to lift activity levels within the world's second-largest economy above stalling speed remain hampered by a worsening real estate crisis, depreciating currency and shrinking external investment flows. While at least in expansionary territory, PMIs have retreated steadily from Q1's insipid post-lockdown rebound peak, with the latest official composite reading for 52.0 falling short of expectations (n.b. the unofficial Caixin "shadow" survey result was 50.9). On a more encouraging note, however, the recent uptick in retail sales and travel spending suggests that the Chinese consumer may at last be waking from an extended slumber.

After factoring in index movements and a marginal downgrade in earnings estimates, broad market valuations ended the quarter modestly lower when compared with the previous period, with the MSCI AC World Index priced at a multiple of 16.6 times forecast earnings for calendar 2023 and 15.2x the figure for 2024. As we highlighted in our last commentary, that is below the average rating for the past 20 years and by no means excessive, even when allowing for the prospect of the mild global recession that is the consensus view. Moreover, when stripping out the disproportionate effect of the mega-cap technology companies ("the magnificent seven") that account for almost a sixth of the Index by value and the majority (60+%) of its year-to-date gains, but are valued at almost twice the aggregate multiple, it could be argued that the remainder of the market, at just 13.2x earnings, is cheap by historic standards.

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BONDS

Bond Market Indices

Index	Q3-2023	YTD
Bloomberg US Gov't >1yr ($)	- 3.06%	- 1.52%
Bloomberg German Gov't >1yr (€)	- 2.40%	- 0.81%
Bloomberg UK Gov't >1yr (£)	- 0.73%	- 4.61%
Bloomberg Global Aggregate ($)	- 3.59%	- 2.21%
Bloomberg US Aggregate ($)	- 3.23%	- 1.21%
Bloomberg Euro Aggregate (€)	- 1.63%	+ 0.59%
Bloomberg Sterling Aggregate (£)	+ 0.11%	- 3.03%
ICE BofA US Corporate ($)	- 2.71%	+ 0.44%
ICE Bof A Euro Corporate (€)	+ 0.30%	+ 2.34%
ICE Bof A Sterling Corporate (£)	+ 2.23%	+ 1.26%
ICE BofA US High Yield ($)	+ 0.51%	+ 5.96%
ICE BofA Euro High Yield (€)	+ 1.66%	+ 6.11%
JPM EM Gov't Bond ($)	- 2.63%	+ 1.08%

There may have been plentiful evidence that central bank policy rates have for all intents and purposes peaked, but a growing belief that the downward phase of the cycle may begin later and be slower than previously expected left sentiment in fixed income markets deflated and investors with little to cheer.

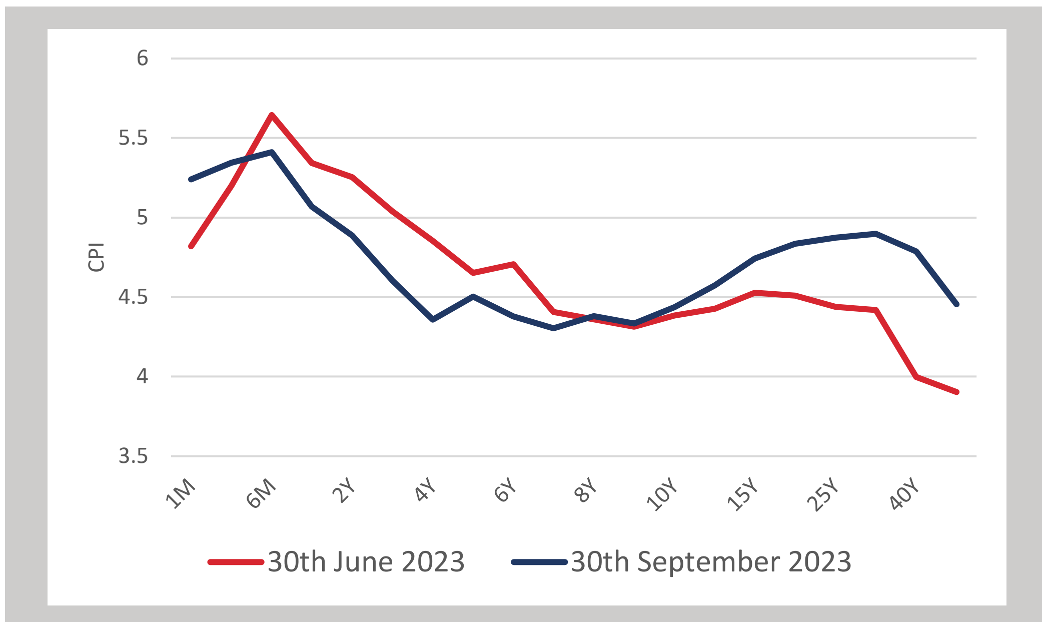
After raising the upper band by 25 basis points (bps) to 5.50% in July, the Federal Reserve's Open Market Committee left its target rate unchanged in September - only the second time that a scheduled meeting had not concluded with a hike since the beginning of the tightening cycle in March of last year. Any positive impact on sentiment from that decision was offset, however, by the accompanying publication of a "dot plot" forecast that removed two of the four rate cuts previously expected next year.

In a similar vein, a statement from the European Central Bank that the latest rate increase, in September, to 4.00% (the second of 0.25% during the quarter) was likely to be its last also cautioned against hopes of any immediate easing. The Bank of England seemed similarly intent on managing expectations – while its Monetary Policy Committee paused for the first time in September after 14 consecutive rate rises, the prospect of further tightening was not ruled out in the event of more persistent inflationary pressures.

Movements in core sovereign bond markets suggested that central bankers' efforts at dampening any misplaced bullish spirits were entirely successful. In addition to the resulting sell-off, there was a pronounced change in the shape of the US Treasury curve, with the yield on the benchmark 10-year issue ending the period up 73 bps at 4.57% (after hitting its highest level since September 2007), compared with a relatively modest increase of 15bps in the two-year bond. A similar pattern in the German market left the 10-year Bund up 45bps at 2.84% - down marginally from an intra-quarter 12-year high - with the two-year's yield just 1bp higher.

It was a different story for the UK, however, where a re-pricing of the peak rates implied by the futures market (from 6.20% to 5.40%) resulted in a meaningful outperformance of those other markets. Although the Gilt yield curve also saw a partial unwinding of its inverted profile, this was a function of declining yields in bonds with shorter maturities coupled with only modest increases at the longer end, with the 10-year benchmark closing at 4.44%, only 5bps higher for the period (Fig. 2).

Fig.2 – UK Gilt Yield Curve Change Quarter on Quarter



Source: Bloomberg

In a pronounced contrast to the negative response to central banks' cautionary narrative within equity markets, yield spreads on bonds within both the investment grade and high yield segments ended the period marginally tighter, resulting in positive returns across most of the credit space. Thanks to a favourable combination of low balance sheet leverage, high interest cover and extended debt profiles, corporate fundamentals are solid by historic standards. As a consequence, in spite of the sharp increase in funding costs seen over the past 18 months, defaults have risen only marginally to levels that remain well below long-term averages, with the small number of failures confined to companies at the lowest end of the ratings spectrum.

Meanwhile, thanks in no small part to those solid fundamentals described above, new issuance remains at subdued levels, resulting in a tighter supply / demand dynamic. According to the specialist managers with whom we invest and / or follow, there is little to suggest that this benign outlook will change any time soon and we therefore continue to deploy a significant portion of our fixed income allocation to this area of the market, where the prospect of attractive income yields, capital appreciation from the "pull to par" and a strongly positive, asymmetrical return profile represent a compelling opportunity on a three- to five-year view.

CURRENCIES

After a soft start to the quarter, the US Dollar extended its winning run on the foreign exchanges, with the DXY Spot Index closing up 3.17%, marginally shy of its 10-month intra-period peak (Fig. 3).

Among the 15 other major currencies listed by Bloomberg, only the Norwegian Krone, with a gain of 0.39%, appreciated in USD terms. Of the remainder, there was a reversal of fortunes for two of the biggest winners from the previous quarter, with the Brazilian Real and Pound Sterling declining by 4.94% and 3.97% respectively.

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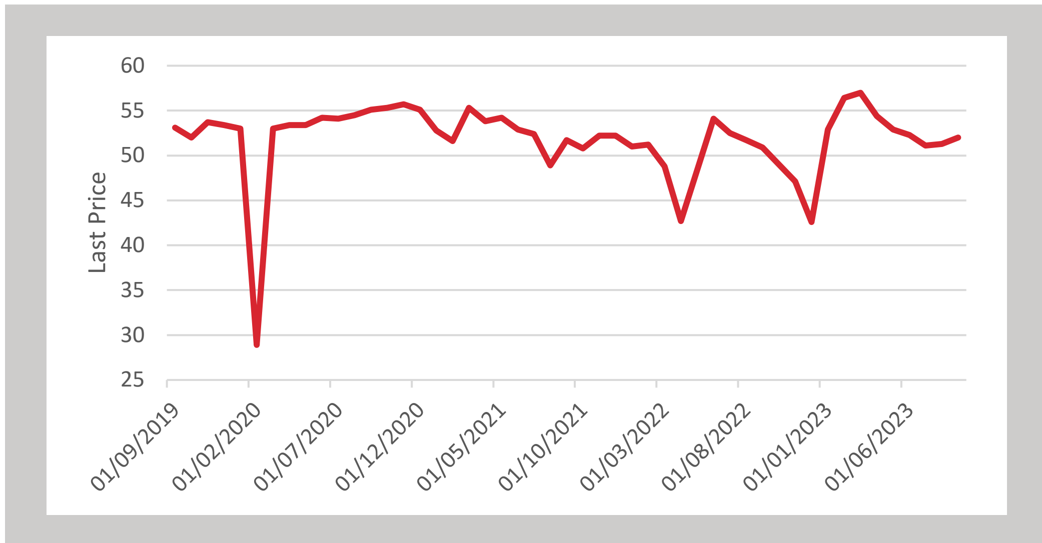
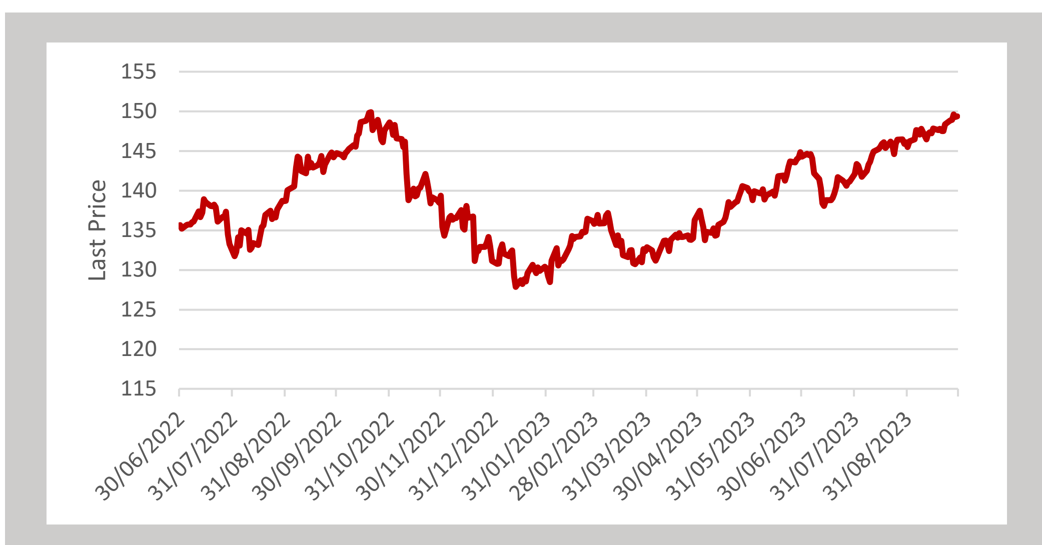
Fig.3 – China Composite PMI



Source: Bloomberg

The Japanese Yen was again among the weakest performers, slipping towards the JPY/USD150 mark that coincides with the bottom of its long-term trading range and the level that the Bank of Japan (BoJ) has defended in the past – most recently October of last year - through direct market support (Fig. 4). Though there has, unsurprisingly, been no indication that it is preparing a repeat of its previous intervention, history suggests that the BoJ will be reluctant to tolerate any further depreciation in its currency. That has prompted speculation that it may look to abandon its policy of yield curve control and allow its government bond rates to trade free of their current constraints. Should that prove to be the case, those betting on any further weakness are likely to be in for a painful experience.

Fig.4 – JPY / USD Exchange Rate



Source: Bloomberg

COMMODITIES

Broad commodity benchmarks posted strong gains in response to a surge in oil prices that followed the decision by Russia and Saudi Arabia to extend the production cuts that had been announced in the previous quarter. The Refinitiv CRB Commodity Index ended the quarter up 8.60% in US Dollar terms.

Though widely anticipated, concerns over the possibility of a further squeeze on an already tight energy market lifted the front month contract for West Texas Intermediate crude steadily throughout the period under review. It advanced from an opening level of USD70.64 per barrel (bbl), via a 10-month high of USD93.68, to a closing mark of USD92.20 bbl for a gain of 28.52%. Though much has been made of the potentially sinister implications of what appears to be a growing affinity between the world's second and third largest producers (behind the US), the consensus view among industry experts is that Saudi Arabia remains a "rational actor" and its actions are consistent with its stated objective of maintaining the oil price in a range of USD80 to USD100 bbl.

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