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OUT OF THE ORDINARY

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Market commentary

John Wyn-Evans
Head of investment strategy

Overview

The beginning of 2023 has been eventful, even if we have not witnessed some of the more extreme moves of 2022. As we reported last month, January was characterised by a renewal of risk appetite as investors decided that their worst expectations for economic growth in the United States, Europe and China were not going to be met. Good news was taken as good news. This was helped by a growing view that the high for annual consumer price growth was behind us, which helped to bring down peak interest rate expectations and bond yields.

Fast forward a month, and the mood has changed. Good news is now bad news. Higher-than-expected growth has led to a perception that inflation is going to prove stickier than forecast. This has led to another rise in bond yields and to the pricing in of a "higher for longer" interest rate environment, especially in the US and Europe. This has, in turn, had a depressing effect on equity market valuations, with the US taking most of the strain after having come out of the starting gate so strongly. The good news is that company earnings reported for 2022 were resilient in aggregate, and we discuss that subject in more depth in the regional sections to follow.

What is occurring in labour markets?

One of the stickier areas of inflation is the labour market. Services companies, in particular, are struggling to hire and retain staff. In the UK, there are four potential causes. There was a big wave of retirements during the pandemic as many baby boomers decided to call it a day. The youngest boomer is now 59 years of age, and this big demographic cohort will soon have few left in employment. There is also a historically high number of long-term ill citizens of employable age. Whether that is on account of Covid-related complaints or down to the backlogs in the National Health Service is difficult to pin down, but it's a real constraint on the supply of workers. More encouragingly for the future of the economy, we can also point to a strong increase in the number of students. Finally, tighter immigration rules relating to Brexit are having an impact, although we hasten to add that this is by no means the predominant factor. The immigration situation in the US appears to be similar.

Unemployment rates remain at – or very close to – cycle lows. They are also very low in a longer-term historical context, at 3.7% in the UK and 3.4% in the US. The European rate of 6.7% might sound high by comparison but is as low as it has been since the inception of the euro. Even in Japan, a country not renowned for anything inflationary in recent decades, we have witnessed salary increases reported to be around 5% at car makers Toyota and Honda. In January, Fast Retailing, the parent company of clothing brand Uniqlo, raised salaries for graduates by 18% and for managers by up to 40%.

This is the sort of stuff that keeps central bankers awake at night. A wage/price spiral, whereby workers demand and receive higher wages, companies raise prices to compensate and that, in turn, leads to higher inflation and demands for even higher wages would be their worst-case scenario. It could potentially un-anchor long-term inflation expectations, leading to an even higher cost of capital.

What might this mean for interest rates?

In response, central bank speakers have been firmly emphasising their inflation-busting credentials and are threatening not only to raise interest rates higher, but to leave them there for an extended period. The underlying market theme of the last month has been a repricing of interest rate expectations. For example, the market-derived forecast for the peak in the US Fed Funds rate was 4.91% at the end of January. By the end of February, it had risen to 5.41%, a substantial 0.5% increase. Perhaps more tellingly, there was an even bigger shift in where traders expected rates to be after the Federal Reserve's meeting in January 2024. That figure rose from 4.27% to 5.16%, almost a full percentage point higher.

There were similar moves on this side of the Atlantic, notably in Europe, where core inflation prints for February came in higher than expected in Germany, France and Spain. Expectations for the peak deposit rate at the European Central Bank rose from 3.4% to 3.88%. Given that the current rate is 2.5%, the market is pricing in much more tightening to come from the ECB than from any other central bank. This has provided some support to the euro and been beneficial to the performance of the region's banks.

As for the Bank of England, it has been difficult for it to fight the trend towards higher rates in most developed market economies, with the peak base rate expectation moving up from 4.39% to 4.77% over the same period. However, we note that on 1 March, the Bank's Governor, Andrew Bailey, pushed back strongly on market-based projections for further increases, stating that the BofE had shifted from its previous stance that

"further increases in the bank rate would be required". Even so, he left his options wide open: "At this stage I would caution against suggesting either that we are done with increasing bank rate, or that we will inevitably need to do more". That suggests that decisions from the BofE will remain data dependent. He also invoked the risk of a 1970s-style wage/price spiral: "If we do too little with interest rates now, we will only have to do more later on. The experience of the 1970s taught us a lesson." (Source: Financial Times)

Markets – US

US corporate earnings for the fourth quarter of 2022, the great majority of which were reported in February, can be described as good, but not great. Sixty-eight per cent of companies beat the consensus forecast for earnings, which might sound impressive, but is below the five-year average rate of 77%. The game played between companies and research analysts is well-rehearsed: set expectations low and then deliver a positive surprise. But because everyone knows what the game is, the "surprise" has to be substantial to have any impact on the share price. In this period the average positive earnings surprise was only 1.2%, well below the five-year average of 8.6%, according to data from Goldman Sachs. Sales came in 1.9% above expectations, and the gap between sales and earnings points to an overall reduction in profit margins. Indeed, pressure on margins could represent a headwind to profits growth for the foreseeable future, with rising interest rates and higher wage bills being predominant factors. In aggregate, S&P 500 earnings are on track to have fallen 3.2% during 2022 (or 7.4% if we exclude the Energy sector, which was a huge beneficiary of higher commodity prices). That compares to a negative total return of -18.2% for the index last year, which illustrates the de-rating suffered in the face of rapidly rising interest rates and bond yields and also in anticipation of potentially worse to come in 2023. Having said that, the consensus bottom-up forecast for this year still sees earnings as being no worse than flat.

UK

The earnings season in the UK is about two-thirds complete in market capitalisation terms (only a third by number of constituents), compared with more than 90% in the US. Even so, some fairly clear trends have emerged, and they also highlight the very different composition of the FTSE 350 Index relative to the S&P 500. Overall annual earnings in 2022 are set to be around 32% higher than they were in 2021. There are two main reasons for this. One is the influence of the Energy sector, which at 12% of the index, is once again the largest sector. Year-on-year earnings surprised to the upside (despite no attempts, in this case, to massage down expectations) thanks to high oil and gas prices, very strong refining margins and the fact that their key commodities are priced in dollars. The pound's fall from $1.35 to $1.21 over the year provided a strong tailwind to results reported in sterling. A lighter tailwind from the euro also helped, as the pound fell from €1.19 to €1.13 against the single currency. Two more big sectors, Healthcare (11% of the index) and Industrials (10%) enjoyed a similar currency boost. Although Banks' (10%) biggest constituent is HSBC, which also benefits from a weaker pound owing to the fact that the majority of its business is located in Asia, profits for the whole sector were lifted by the increase in interest rates. This was not fully passed on to depositors, thus boosting net interest margins, which had been quite depressed for several years during the era of near-zero base rates. One surprisingly disappointing sector was Materials, which includes the big mining companies. Rising costs were the main culprit, and this might end up being a more pervasive factor.

Europe

Rounding off the reporting season, we turn to the STOXX Europe 600 (of which around a fifth by market capitalisation is comprised of UK-listed companies). This index, not surprisingly, displayed many of the characteristics seen in the UK, with Banks, Energy and Chemicals being particular bright spots. More than 35% of companies beat consensus earnings by at least 5%, but almost 20% missed by the same amount. In a world where money is no longer free and where rising costs have to be managed (either through enhanced productivity or the ability to pass them on), we expect to see a greater dispersion between winners and losers. This will provide outperformance opportunities for skilled active managers. The consensus expectation for earnings growth in 2022 has settled at

around 13% and is expected to slow to just 3% in 2023. The greatest source of upgrades during the earnings season has been certain cyclical sectors. We believe that this reflects two factors. One is the continued resilience of consumer spending allied to the ending of Covid-related restrictions. The other is the relief that an energy crisis was averted, thus negating worst-case economic and earnings scenarios. Neither of these factors can be extrapolated forward with great confidence. Even so, European equities still offer good long-term value in a global context.

Emerging Markets

All eyes remain on China, not only for its influence on Emerging Markets, but also for what its recent policy changes might mean for the broader global economy. Investors latched on to the fact that the Communist Party leadership abandoned its zero-Covid policy towards the end of 2022, anticipating an epic re-opening boom. This has not yet materialised to the extent that many might have wished, and thus there has been some impatient profit-taking. Matters have not been helped by the spy balloon incident in the United States, nor by chatter that China will supply armaments to Russia. But Chinese consumers, like their western counterparts, have accumulated “excess” savings equivalent to more than ten percent of China’s GDP, which, to put it into some context, is greater than the size of the whole UK economy. The fact that the government has also rolled back certain restrictions placed on property developers as well as eased its heavy hand on technology entrepreneurs suggests that it is sensitive to growth prospects and would not want them to deteriorate further. However, we still expect any durable recovery to be based more on consumption and efforts to increase the value-added component of its manufacturing industries, not the credit-fuelled building booms of the past. With this in mind, we await with interest the news from the forthcoming “Two Sessions” meetings of the National Party Congress, during which growth targets and how to achieve them will be delivered. Even so, we are under no illusions about the longer-term challenges to China’s growth, owing to poor demographics and a heavy debt load.

Fixed Income

The Bloomberg Global Aggregate Index (which encompasses all the world’s investment grade bonds) this year celebrated its best January performance since inception in 1990. It followed that up with the worst ever February. After years of watching paint dry as yields trended lower, bond investors are facing far greater volatility. As we have already alluded to, this is largely the result of the continued uncertainty about how quickly inflation will subside and what the reaction of central banks will be. If there is a silver lining here, it is that we are seeing bonds offer yields that have not been available for some time. Apart from the fraught period following last year’s “mini” Budget, one has to go back to early 2011 to find the ten-year Gilt yielding as much as it does now (3.82%). Given that the yield curve is inverted, shorter-dated Gilts offer even higher yields, with the one-year maturity now over 4%. Given that most of these bonds were issued during a period of very low rates, the coupons are also negligible, meaning that the prospective returns to maturity are made up almost entirely from capital gain. Given that Gilts are exempt from capital gains tax for UK holders, short-dated Gilts have become a very attractive alternative to cash deposits.

UK Gilts have delivered a total return of -4.8% over the last three months and -22.5% over the last year. Index-Linked Gilts returned -6.91% and -35.9% over the same respective periods. Emerging Market sovereign bonds produced a total return of -0.7% in sterling over the three months to end February (+2.2% over 12m). Global High Yield bonds delivered +1.2% (+4.1% over 12m) in sterling.

Conclusion and Outlook

Last month, we admitted to some surprise at the strength of markets in January, and continued to counsel a “cautious, but not fearful” approach. That approach still applies. Markets are being subjected to many short-term influences, with a lot of the daily movement being driven by a combination of short-term traders and computer-driven models. We continue to play a longer, more strategic game. Our work on long-term capital market assumptions suggests that prospective ten-year returns are looking a lot better now for balanced portfolio investors than they did at the beginning of 2022. This is

certainly not the time to be shying away from investing in financial assets. We shall return to this subject in more detail in future publications. At the same time, though, with our shorter-term tactical asset allocation hats on, we continue to see the potential for further cyclical downside in corporate earnings as the lagged effects of the huge increases in interest rates and bond yields make their impact. However, this is more a case of waiting for an optimal moment to increase equity risk weightings in portfolios than wanting to take a more defensive stance.

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