RATHBONES | Incorporating Investec Wealth & Investment (UK)

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Market commentary

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Overview

As recently as October, it felt as though any review of 2023 was going to make grim reading. Sovereign markets were in turmoil, equity markets were at their lowest point of the year, and geopolitical concerns were once again in the ascendant as hostilities escalated in the Middle East. However, and as is often the case in financial markets, the mood was darkest before the dawn, and portfolios delivered strong gains over the final weeks of the year. While seasonality played its part in the rally, the primary fuel was a shift in the outlook for interest rates in 2024, with traders bringing forward the expected date of the first reductions as well as pricing in deeper cuts.

The key events of 2023

We shall examine the interest rate and economic outlook in more detail later, but first we should cast our minds back to some of the key events of 2023. It's hard to believe now that a year ago the broad consensus was that the United States' economy would fall into a recession and that China's was on the threshold of a rapid recovery. The fortunes of the world's two biggest economies turned out quite the opposite of what was expected, with the US proving incredibly resilient and China remaining sluggish. A poll of economists by Bloomberg still puts the probability of a US recession in 2024 at around 50/50, with the lagged effects of past interest rate increases being balanced by the expected cuts. In China, the unwinding of an epic real estate bubble still casts a long shadow over the wider economy. Hopes for meaningful stimulus measures abound, although the government remains reluctant to oblige. Rarely does the fate of such a huge driver of the global economy rest so squarely on the whim of one individual, China's President Xi.

March 2023 provided the first real test for investors. Rising interest rates and bond yields were widely expected to break something eventually, but which was the weakest link? It turned out to be a regional US bank called Silicon Valley Bank (SVB), closely followed by two others, Signature and First Republic. The main reason for SVB's demise was, in technical terms, a duration mismatch between its assets and its liabilities. In essence, it had taken short-term deposits from its customers and invested them in higher-yielding instruments with a longer life. As interest rates rose, the value of its investments went down, which presented no real problem until depositors cottoned on to the fact and started asking for their money back. A classic "run on the bank" developed, but with a modern twist. Mobile and internet banking enabled depositors to request their funds at the touch of a screen, and the weight of potential outflows mounted rapidly, sending SVB into bankruptcy within days.

While it quickly became clear that such problems were relatively confined, there was another key reason why this episode did not escalate into a major banking crisis, namely the swift and constructive reaction of the US central bank and other regulatory bodies. They speedily created a new liquidity backstop (the Bank Term Funding Programme) and also effectively guaranteed customer deposits. It has long been our opinion that central banks have learned from their biggest mistake during the Great Financial Crisis, which was to allow Lehman Brothers to fail in a disorderly manner and that they will, in future, do their best to guarantee liquidity to the financial system. This test, alongside Switzerland's decision to allow UBS to take over its troubled domestic rival Credit Suisse, confirmed our belief.

The next major turning point for markets was a more positive one. It was the first quarter report from US semiconductor chipmaker Nvidia. Not only were its profits well ahead of forecasts, but its outlook was even more ebullient thanks to the expected demand for chips to power Generative Artificial Intelligence (AI). AI is expected to be the catalyst for the next big technology revolution thanks to its ability to deliver efficiency in the workplace as well its more creative capabilities. This was reflected in the exceptional performance of a handful of US technology leaders (dubbed the Magnificent 7) including cloud/internet stalwarts such as Microsoft, Amazon and Alphabet (parent of Google), as well as Nvidia itself. While the promise has been recognised, we might now be approaching a period where investors start to ask the market to "show me the money" more clearly. We are certainly keen to see where and how AI can be applied to improve productivity and increase profits in the wider economy.

The big move in markets during the third quarter was downward, with a relentless rise in government bond yields driving most risk assets lower. The peak-to-trough move from the end of July to late October was a fall of 11% for the MSCI All-Countries World Equity Index. Government bond yields hit highs not seen in almost two decades. The main cause of this was a growing belief that central banks would maintain a "higher for longer" interest rate policy in the face of resilient growth and sticky inflation. The stress in bond markets was exacerbated by large fiscal deficits, especially in the US, with higher rates only adding further pain in terms of rising interest bills. The return of the "Bond Vigilantes" was widely reported. But there is a price for everything, and with US and UK 10-year bond yields hitting highs of 5% and 4.75% respectively, buyers returned.

They were further encouraged by some benign inflation data, which, in turn, allowed the US Federal Reserve finally to acknowledge the possibility of cutting interest rates. Indeed, its December "Dot Plot" of interest rate projections suggested three quarter-point cuts in 2024 (from none in September). As good news as this might appear, there is one fly in the ointment, and that is the fact that interest rate futures markets are already anticipating as many as six quarter-point reductions in 2024. The only way we can see this happening is if economic growth (and, by extension, corporate profitability) comes in well below current expectations. Thus, we might need to see a period of consolidation as markets digest the recent strong gains. Such consolidation would be consistent with the historical average performance of US equities during the Primary season of a Presidential election year. Joe Biden and Donald Trump remain the candidates most likely to be facing each other at the ballot box on 5 November (which would be the first "rematch" since 1956) and, yes, there could be fireworks, but, we hope, not a modern day equivalent of the Gunpowder Plot.

As we head into the New Year, the key points to bear in mind are these. Inflation, if not necessarily conquered, is trending lower, and the supply problems associated with the pandemic are largely behind us. This means that the peak of the interest rate cycle is very probably also behind us and that central banks have the capacity to respond to economic weakness with easier monetary policy if required. Economic growth and corporate profitability have held up better than expected but remain vulnerable to the lagging effects of past interest rate increases. More than half of the world's population is scheduled to be deciding the fate of its leaders this year, with the US election deemed to be the most important. Investors have in the past shown a tendency to be more circumspect until the results are clear.

Thus we enter 2024 with a familiar feeling of uncertainty. As we noted in the last commentary, the big question is this: will central banks cut interest rates because they can (lower inflation) or because they have to (weaker economies)? The first reason would be preferable, while the second makes for a bumpier ride. However, we would emphasise that we are still discussing potential interest rate cuts in both scenarios, and they usually end up providing the fuel for better investment outcomes. The background is certainly more encouraging than it was at the beginning of either 2022 or 2023, which should provide some relief after two years of lacklustre returns for balanced portfolios.

Markets – US

Among major stock markets, the US was the standout performer of 2023, with the S&P 500 Index delivering a total return of 26.2% (19.7% in sterling terms). As mentioned earlier, the main driver of this performance was the "Magnificent 7" (M7) group of technology-related stocks, which rose by an extraordinary 107%. This should, perhaps, be put into the context of a woeful 2022 (-46%), meaning that the two years to end 2023 yielded a more pedestrian return of 12%. That might help to dampen some of the talk of a "bubble" in valuations. The stocks in question are Apple, Microsoft, Amazon, Alphabet, Meta, Nvidia and Tesla. The fact that they comprise around 30% of the US market capitalisation is a subject of much debate. Rarely has such concentrated leadership been maintained for long in the past. But neither have we seen current levels of growth and profitability from companies with such a global reach. And with AI in its infancy, it would need very strong conviction to bet against them. Even so, we are encouraged to see a broadening out of market leadership more recently. From the market lows in October to year-end, the S&P 500 Index rose 16.2%, with the M7 "only" +17.5%. But the equal-weighted S&P 500 was +18.5%, while the small-cap Russell 2000 gained 24.2%. We note that the current spread of strategists' forecasts for the S&P 500 to December 2024 ranges from a low of 3500 (BCA Research) to a high of 5500 (Capital Economics). The average (4755) and the median (4700) are remarkably close to the end-2023 level of 4769. But a lot of those forecasts were made before the market's late run and so we expect there to be some upgrades. Goldman Sachs has already raised its target from the 4700 posted in early November to 5100. If everyone else felt compelled to join them, the average also would jump to around 5100, or roughly a 9% total return, bang in line with long-term average annual returns... which hardly ever happens.

UK

The UK's FTSE 100 was at the other end of the performance scale, returning 7.7%, with just over half of that coming from dividend payments. The UK is not blessed with a big technology sector, although its largest component, Sage Group, returned a commendable 61%. Big sectors including Consumer Staples, Materials and Healthcare were all in the red in 2023. There is no doubt that "flows" have not been in the UK market's favour. For many years, domestic pension funds have been reducing their equity exposure in favour of bonds in order to match assets and liabilities more closely. More recently there has been a shift in favour of benchmarking portfolios closer to global indices, thus gaining exposure to a wider and deeper pool of investment opportunities. We fall into the latter camp, although that by no means necessitates a headlong rush for the exit. If the best company for the job is listed in the UK, then it should be our first choice. There is no doubt that the overall UK market looks cheap on a price/earnings multiple of a little over 10x and a dividend yield of around 4%. According to one study we have seen, only three other markets are cheaper – China, Luxemburg and Colombia. It is hard to see the UK failing to provide positive returns. But, on a relative performance basis, market composition suggests that the rest of the world offers more interesting growth opportunities.

Europe

The EuroStoxx 50 Index of leading Continental companies returned a decent 23.2% in 2023. Technology (15%) is the biggest sector in Europe, and companies such as Dutch semiconductor equipment-maker ASML (+37%) and German enterprise software company SAP (+47%) were key contributors. European banks had a strong year thanks to rising interest rates which increased their profit margins. This helped bank-heavy indices in Italy (+35%) and Spain (+28%) to perform strongly. It is interesting to note that one of the best-performing shares in Italy last year was Ferrari (+53%). Founder Enzo Ferrari's philosophy was to "make one less car than the company can sell". A useful lesson on supply management which seems to persist. Although it was not the best single performer, Denmark's Novo Nordisk (+51%) rose through the ranks to become Europe's largest company. Historically known for producing drugs to control diabetes, its big breakthrough has been in the new category of appetite-suppressing "GLP-1" drugs. Eli Lilly (+61%) in the US was another big winner in this category. But it seems that for every winner there must be a loser, and one can see this thesis playing out in the poor performance of calorie-heavy Consumer Staples. Stocks such as Swiss food manufacturer Nestle (-7%) and French drinks company Pernod Ricard (-11%) struggled alongside UK companies including Diageo (-20%) and Unilever (-6%).

Emerging Markets

We have often commented in the past that Emerging Markets is too generic a label to pick up the divergent performance of different regions, and 2023 was a prime example of this. If we look at the markets of the two most populous nations on Earth, China and India, the former's CSI 300 Index fell 9%, while the latter's Nifty 50 Index rose 22%. China's economy remains under the shadow of its over-leveraged real estate industry whilst also coping with an ageing and stagnant population, while India is benefitting from market-friendly government policies and much more favourable demographic trends. China's policy is driven autocratically by a single man who is much less well disposed towards a more "capitalist" economy than his predecessor was; and while Narendra Modi is undeniably a "strong" leader, his leadership will be tested by democratic elections in May. Should he prevail, as the polls currently predict, then we can expect to see more of the same. More broadly, we continue to believe that a weaker US dollar provides a tailwind to EM in general because it loosens financial conditions. If the Federal Reserve does proceed with rate cuts as expected, then the background for EM should remain helpful.

Fixed Income

The Bloomberg Global Aggregate Dollar Index of investment grade bonds broke its two-year losing streak with a gain of 5.7%, with all of those gains coming in the final six weeks of the year. For all the volatility in bond markets during 2023, the US 10-year Treasury yield closed the year at 3.87% having started the year at exactly the same level. A rule of thumb which creates a fair value range for 10-year government bond yields with reference to potential nominal GDP growth currently suggests a range of 3.5% to 5% in the US and a wider 2.5% to 5.5% in the UK (where we might expect to see lower potential growth and the possibility of structurally higher inflation). Current yields of 3.87% and 3.53% are towards the lower end of those ranges and substantially lower yields from here will probably only occur in a much weaker economic environment. In that case, we would expect government bonds to resume their role as equity risk diversifiers in a balanced portfolio. The biggest risks to government bonds are sticky inflation and/or uncontrolled fiscal deficits.

UK Gilts have delivered a total return of +8.1% over the last three months and +3.6% over the last year. Index-Linked Gilts returned +8.6% and +0.2% over the same respective periods. Emerging Market sovereign bonds produced a total return of +5.4% in sterling over the three months to end December (+13% over 12m). Global High Yield bonds delivered +3.5% (+8% over 12m) in sterling.

Conclusion and Outlook

The markets' rally during November and December provided a clear example of the benefits of staying the course when investing for the longer term. Lacklustre returns until that point were tempting many to throw in the towel and to opt for the greater certainty of cash deposits. But once sentiment turns for the better, decent returns are often generated rapidly, and that was certainly the case this time. Indeed, more than a year's worth of the interest available on a cash deposit was delivered in about nine weeks, even by a reasonably conservative balanced portfolio. Unlike the steady drip of interest that one receives on cash, returns from riskier financial assets tend to be more lumpy, but it is this volatility that pays the entry fee for higher returns in the longer term.
No doubt our patience will be tested again in 2024, but we continue to have faith in the ability of the companies we invest in to compound returns for shareholders.

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