RATHBONES | Incorporating Investec Wealth & Investment (UK)

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Market commentary

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Overview

The end of the third quarter of 2023 provides an opportunity to reflect on the performance of markets during the last three months and it makes for painful reading once again. The MSCI All-Countries World Index delivered a total return of -3.3% and the Bloomberg Global Aggregate Index of Investment Grade bonds gave up 3.6%*. Those figures are in US dollars, but UK-based investors fared better in sterling terms thanks to a very strong dollar and some underlying weakness in the pound. For example, the FTSE Private Investor Balanced Total Return Index, which we use as an independent illustration of the experience of a "typical" UK investor lost 3.2% in dollars but gained 0.8% in pounds.

The figures make even worse reading if one measures returns from the end of July 2023. Markets went through a remarkably positive phase in July itself, leaning into the potential for an "immaculate disinflation", a world in which inflation might gently subside towards the 2% level targeted by central banks, while economic growth would continue at a steady pace. Euphoria about the prospects for the benefits of Artificial Intelligence was high and even the more cyclical elements of the market, which had been left behind, started to catch up with the mega-cap technology leaders. But that moment was not to last.

This year we have divided our potential outcome scenarios for financial markets into four quadrants, each of which projects our expectation for the performance of both equities and government bonds. "Immaculate Disinflation" is in the top right-hand quadrant, which projects positive returns for both asset classes. Our Global Investment Strategy Group has always felt that this outcome was more wishful thinking than anything else, but not impossible. As such it was assigned a low probability.

Equally improbable to us was the outcome dubbed "resilient growth". This would see bonds perform poorly owing to the fact that economic growth didn't slow down, but we also felt that the higher yield on bonds would weigh on equity valuations and, eventually, growth, although not aggressively.

Is there a change in our central view?

Our central view this year has been for a "mild recession". In this scenario, weaker economic performance would undercut corporate earnings, leading to stock market weakness and a preference for more defensive companies, while bonds would prosper on the prospect of eventual interest rate cuts. There have been moments when this view has prevailed, but not for long. Indeed, this outcome would take us back to the pre-pandemic world of negative correlation between equities and bonds which provided a reasonably smooth path for balanced portfolios. But we are not in that quadrant today.

We are currently in the bottom left quadrant which we named "Tightening 2.0/Higher for Longer". This one delivers the worst outcome for investors and replays much of the stress of 2022, when rising inflation, interest rates and bond yields met growth concerns and worries about corporate earnings. Having said that, we would add that with the 10-year Gilt yield having risen from close to zero to more than 4.5%, and the 10-year Treasury yield from 0.5% to 4.6%, most of the damage has already been done, and so a replay of 2022 is improbable unless inflation takes a greatly unexpected turn higher. This would force central banks to start raising interest rates again, the so-called Tightening 2.0.

All of which suggests to us that markets are currently recalibrating towards "Higher for Longer", an outcome which has caught many by surprise. Although it was not our favoured view, neither did we bet aggressively against it. Some will have done, and it is those investors and traders unwinding their positions who seem to be causing most damage at the moment. Higher for Longer was the message issued by several central banks at their September meetings, with, as ever, the greatest attention being paid to the US Federal Reserve. Investors are now looking for a new equilibrium in terms of pricing the duration of the plateau in interest rates and the speed at which they will then come down. Fed chair Powell emphasised the intent, which was itself expressed in the Dot Plot of interest rate expectations. The focus here was on the December 2024 median projection of 5.125%, up from 4.625% in June.

Although market pricing for that date has tightened, the future still indicates a number around 0.5% lower. What one can infer from this is that there are still plenty of people prepared to bet on the view that higher rates will eventually push the economy into recession and that the Fed will, in fact, be forced into cutting rates a lot faster than it is currently willing to admit to. Some people will be taking this on as a directional bet, others as a tail risk hedge, but the effect is much the same. In any event, the market seems pretty sure that we have reached the top of the interest cycle in the US, Europe, and UK, bar a possible final 0.25% tweak.

The repricing of rate expectations has been reflected primarily in the bond market, and most visibly and influentially through the US 10-year Treasury yield. The pricing-in of a policy rate peak has helped to steepen the yield curve (as short rate expectations fall), but most of the work has been done at the long end, delivering a "bear steepening", which is not particularly friendly to investors. The US 10-year yield was 3.83% at the half-year stage, began September at 4.1% and ended the quarter at 4.61%. There was a similar story in Europe, with the 10-year Bund yield rising from 2.38% to 2.85% during the quarter.

The UK's experience with the 10-year Gilt was less punitive, with the yield rising from 4.38% to 4.43%, although it did go via a peak of 4.74%. Inflation fear peaked early with a dreadful print for July, but was damped by a much better reading for August. This was followed up by a "dovish pause" at the Bank of England's September policy meeting.

Another measure to note is the US 10-year real yield. Thanks to the Fed's so-far successful campaign to convince markets that it is hell-bent on returning inflation to target, breakeven rates (the expected level of future inflation inferred from bond prices) have remained close to 2%. The two-year rate has been stuck in a range between 1.9% and 2.2% for the past three months, currently 2.03%. The 10-year rate has skipped up from 2.23% to 2.34%, but that has been far outweighed by the shift in the Treasury yield. Thus, the real rate moved from 1.59% to 2.24% over the quarter.

Rising real yields are Kryptonite to financial assets in aggregate as they raise the discount rate which then depresses the net present value of future profits. There is one way to outrun them, and that is to grow fast enough so that the growth outweighs the derating. Artificial Intelligence optimism helped a few big companies to pull off that trick for a while, but even they have latterly succumbed to valuation gravity. Let's look at the "Magnificent Seven" tech leaders and how far they are from recent peaks: Tesla -14%, Apple -13%, Microsoft -12%, Amazon -12%, Nvidia -12%, Meta -7%, Alphabet -5%.

A combination of risk-off sentiment and rising US real yields, with the prospect of them remaining elevated for a longer period, has provided strong support to the dollar. It's trade-weighted index has risen from 99.77 in mid-July to 106.17, recouping about half of the losses from its last peak in September 2022. If we combine that with the dramatic lowering of peak interest rate expectations in the UK, which were a function of a better-than-expected August inflation print alongside a "dovish pause" from the Bank of England at its last rate-setting meeting, the effect has been to pull the rug out from under the pound. It has fallen from $1.31 in mid-July to $1.22. If that sounds alarming, the fact that it has "only" fallen from €1.17 to €1.15 over the same period emphasises that this is much more a strong dollar story than that of a weak pound.

The silver lining for UK investors is that UK-listed large capitalisation companies generate the lion's share of revenues and profits overseas. Exports are more competitive and foreign sales are translated back into sterling at an advantageous rate, boosting the returns in pounds. Over that same period, UK mid and small caps, with their greater share of domestic revenues, have underperformed.

The strong dollar tends to tighten financial conditions globally because so much borrowing is denominated in dollars. We note that global M2 money supply measured in US dollars has fallen from $103.6 trillion in July to $99.95tn now. The rise from $95.5tn in November 2022 to $104tn in February 2023 was associated with a big rally for risk assets, during which time the dollar index fell from 113 to 101.

Indeed, the malaise in markets that started in late 2021, well before the Russian invasion of Ukraine, can be correlated with the rise in the dollar index from 89.8 in May 2021 to its peak of 114 in September 2022. And to put global money supply into context, that has grown from $79tn in March 2020, fuelling the extraordinary surge in asset prices and, eventually, inflation.

In the US specifically, financial conditions are the tightest they have been this year and at the same level as in November 2022 when the big equity market rally got under way. A widely quoted index calculated by Goldman Sachs is calculated with reference to bond yields, credit spreads, interest rates, equity markets and the dollar index. Acknowledging that some of the effects feed on each other, they are all moving the wrong way for investors at the moment.

At the highest level, then, it is clear that the direction of the dollar and global money supply, along with real yields, are amongst the most important keys to unlocking financial asset performance. On the basis that we believe that dollar rates are around their peak, that the US will probably enter a recession within a few months, that inflation will continue to decline, and that the Fed will end up cutting rates somewhat sooner than it currently anticipates, then we are in the end game as far as the current correlated weakness of bond and equity markets is concerned, although timing the turn remains difficult.

*All current market-related data in this commentary is to the close of business on 29 September 2023.

Markets

US

It might seem slightly odd that this month we are going to write about something that didn't happen, namely a shutdown of at least some of the services provided by the US government. However, the six-week stay of execution that was negotiated means that we might well have to deal with the problem again in early November and so we should prepare for that eventuality.

First of all, it is important to note that this is not directly related to the "debt ceiling" negotiations that took place earlier this year. Those talks centred around the total amount of debt that the US government is authorised to issue and resulted in the ceiling being suspended until January 2025. Thus, the Treasury remains authorised to pay interest on and to redeem its debts, meaning that any talk of a default is misplaced. This also means that new negotiations will almost inevitably be the first item on the agenda of whoever wins next year's Presidential election, just to add to the potential chaos.

The latest spat was about twelve appropriation bills. In a less fractious political environment (or one in which a single party had full control of Congress) , the passing of such bills would be a relatively smooth process, but that is not the case in the current climate. These bills are as close to business-as-usual as one can get, authorising expenditure on various necessary government services and procurement. These include defence spending, a number of welfare programmes, Homeland Security services including border control and airport security, and even the rangers who patrol national parks (many of which have had to close during past shutdowns). The spending also covers the generation of official economic data, the lack of which might have left policymakers driving in the dark with no headlights.

In past episodes, it has taken only a few weeks for the public to begin to notice and to complain about the lack of services, and the warring factions in Congress have been able to find a compromise. This time was expected to be no exception, with analysts suggesting that non-payment of wages to those on active military duty, which are due twice monthly, could have been the trigger for a climbdown. And it is the Republicans who will have to do most of the climbing down. Even if they are attempting to reinforce their more conservative fiscal credentials, they won't want to be seen as responsible for bringing the country to a grinding halt a year away from what promises to be another knife-edge election. (The level of conflict within the Republican Party itself were later revealed as House Speaker Kevin McCarthy became the first Speaker ever to be removed from office)

UK

The UK also faces an election. The deadline for the next General Election is January 28 2025, although it is improbable that this parliament will survive to the maximum term. One expert we listened to recently suggested that the Conservative Party's masterplan was to call the election in May 2024, hoping to benefit from an improvement in the economic data, although that feels more like wishful thinking.

Recent releases from the Office of National Statistics have confirmed that the economy is a bit larger than previously thought, running 1.8% above its pre-pandemic levels in terms of Gross Domestic Product, and tax revenues have also bolstered the fiscal position. Even so, Chancellor Jeremy Hunt is not well placed to be extremely generous when he delivers his Autumn Statement on November 22nd.

The spectre of the Truss/Kwarteng mini budget of September 2022 hangs over all fiscal policy decisions, and it's hardly as though the bond market is in the mood to be tested at the moment. Psephologists are unwilling to take hostages to fortune just yet, though, and are full of caveats about the possible result. Will the Liberal Democrats turn out to be "kingmakers", or will they split the "anti-Tory" vote and allow the Conservatives to sneak back in, for example? There are also constituency size effects to account for, which suggest that Labour will have to gain a larger share of the vote than the Tories to generate a majority, although the party should benefit from the travails of the Scottish Nationalist Party north of the border.

The polls, as ever, contain some inconsistencies. Although 65% of respondents to one poll claimed that it was "time for a change [of government]", 55% still thought that Rishi Sunak would be the next Prime Minister. A case of what they think will happen versus what they would like?

What everyone is really crying out for is more concrete policies from Labour, who are playing their cards very safely for now, no doubt still chastened by the response to the more radical Jeremy Corbyn in 2019. Some clues have been evident in the speeches of Shadow Chancellor Rachel Reeves, which have echoed some of the policies of the Biden administration in the US with a leaning towards more intervention and support for manufacturing and industry. One final observation. No British party has ever won five consecutive elections, and the Conservatives' tally is currently on four (although three of them were held in a very tight four-year window in unusual circumstances).

Europe

There are no forthcoming big political events to focus on in Europe, although there have been modest signs of stress in the periphery once again. These were evident in the spread of the yield on Italian government bonds over German Bunds. This measure has been a reliable barometer of strains within the eurozone since the Great Financial Crisis in 2008, and concerns usually centre on the ability of debt-laden Italy to meet its liabilities relative to the more austere Germans. The spread reached its zenith during the euro zone crisis in 2011/12, when there were real fears that Italy would leave the single currency. That would have led to a big devaluation of the currency, and so bondholders demanded a much higher yield to compensate for the risk. The peak spread was 5.5%.

Political uncertainty also drives the difference, especially when elections threaten to be won by radical policymakers. Last year, there were worries around the election of right-wing Prime Minster Giorgia Meloni, although she has played a relatively conservative hand so far. However, the presentation of the latest budget has once again raised concerns around the country's finances, with the projected deficit being raised from 4.5% of GDP to 5.3%. While not an existential threat, the figure was high enough to send the spread from a relatively stable recent low of 1.6% to more than 1.9%, further increasing the cost of government borrowing when bond yields are already elevated. The spread had settled at around 1% after the pandemic and before Ms Meloni's election (which was greeted with the spread rising to as high as 2.5%). We're not expecting any sort of new euro zone crisis to develop, but indicators such as this are worth keeping an eye when markets are already jumpy.

Emerging Markets

While we're on the subject of politics, we should trail what could be the most important election globally in the next four months, and that is the one that is scheduled to take place in Taiwan on 13 January 2024. And why is it so important? For a start, Taiwan's biggest company, TSMC, manufactures around 90% of the world's high performance semiconductor chips. That makes it strategically important at the global level. The incumbent President, Tsai Ing-wen, who leads the independence (from China) leaning Democratic Progressive Party (DPP) must stand down having reached the two-term limit. Her successor as leader of the DPP, current Vice-President Lai Ching-te, has a track record of antagonism towards China, although appears to have softened his tone a little to bring more moderate voters on board. Even so, in a recent speech in the United States he still framed the election as choice between democracy and authoritarianism.

The opposition challenge is led by Huo Yu-ih of the Kuomintang Party (KMT). And the point about the opposition parties is that they are all more friendly towards China, although not necessarily in favour of unification. Concerns around the situation are rooted in the opinion that China's President Xi is intent on unification as a key part of his eventual legacy, and speculation is rife that he would be prepared to use force if necessary. This would trigger a response from the United States, which has pledged (even if in deliberately ambiguous terms) to come to the island's defence. That all smells a bit like Russia and Ukraine, hence the rising concerns.

Should the DPP prevail, one might expect the temperature to rise a bit further. Intriguingly, Terry Gou, the billionaire founder of iPhone manufacturer Foxconn, has recently thrown his hat into the ring as an independent candidate, complaining that the DPP has been too disruptive in its dealings with China. His plan might backfire if he only ends up splitting the opposition vote, although news reports suggest that the DPP will still struggle to gain an absolute majority.

Fixed Income

The Bloomberg Global Aggregate Dollar Index of investment grade bonds is now firmly in negative territory for 2023 (-2.2%), and thus on track for a third consecutive year of losses, something that has not previously occurred since its inception in 1990. The better news is that the higher yields available on investment grade bonds offer better opportunities for safe income generation as well as being a more attractive risk diversifier in balanced portfolios. We continue to emphasise the fact that selected short-dated Gilts offer risk-free yields of around 5% with tax benefits even when not held within tax-exempt wrappers such as SIPPs or ISAs. Low coupons mean that the taxable income is negligible. But the "pull to par" on maturity delivers a tax-free capital gain. They remain an attractive home for surplus cash savings.

UK Gilts have delivered a total return of -0.6% over the last three months and -2.5% over the last year. Index-Linked Gilts returned -4.9% and -13.4% over the same respective periods. Emerging Market sovereign bonds produced a total return of 0.0% in sterling over the three months to end September (+7.6% over 12m). Global High Yield bonds delivered +1.4% (+11.1% over 12m) in sterling.

Conclusion and Outlook

As we wrote a month ago, we are of the opinion that much of the valuation damage resulting from a higher discount rate has been done; but we still need to gain more conviction as to where corporate earnings might land. At the same time, we have to remind ourselves that there is a cycle at play here, and it will turn in our favour, at least unless decades of investment history turn out to be worthless. It would be very easy to give up hope of ever seeing balanced portfolios rise again sustainably. The fact that the FTSE Private Client Index that was referenced at the beginning of the commentary is back to the levels it first rose to as long ago as September 2021 speaks to the fact that gains have been hard to come by over those two years, but we continue to believe that this long period of sideways churn will ultimately be resolved to the upside.

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