OUT OF THE ORDINARY

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Market reflection

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Overview

Although they have recovered from their lows, both equity and bond markets lost ground during August. As far as we could identify a key factor, it would be that growth, notably in the United States, is proving to be too strong for comfort. Ordinarily, one might take that to be good news. However, in a financial market context, resilient growth, with the attendant risk of sticky inflation, leads to the prospect of interest rates remaining "higher for longer".

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Thus, bond yields pushed higher, with the US 10-year Treasury yield and the UK 10-year Gilt yield reaching cycle peaks of 4.33% and 4.74% respectively. Given that we continue to believe that economic growth will eventually succumb to the effects of substantially tighter monetary policy, these yields offered an attractive entry point. A higher discount rate tends to weigh on equity valuations, and that was indeed the case in this instance.

There was some evidence of profit-taking after a strong prior period of performance. It was also clear that investor sentiment and positioning had become much more positive by late July, having been exceptionally negative at the beginning of the year. Even so, the damage was relatively limited thanks to the fact that the second quarter corporate earnings season revealed profits to be somewhat better than expected. While Resource sectors' profits were hit by the retrenchment of commodity prices, the all-important (to sentiment) Technology sector maintained a good level of growth.

Later in August, central bankers convened in Jackson Hole, Wyoming for their annual symposium. The broad message was one of maintained vigilance over the threat of inflation, with the target of 2% annual growth in consumer prices confirmed. We continue to believe that we are close to the peak of the interest rate cycle and are thus anticipating the opportunity to increase equity risk in portfolios soon.

- The Bloomberg consensus for World GDP growth in 2023 has risen from a low of 2.1% in February to a current 2.7%. The outlook for 2024 continues to show limited prospects of a quick recovery, with consensus estimates at 2.65%.

- The Bank of England raised the base rate again in August by 0.25% to 5.25%. Although peak rate expectations have backed off from a high of 6.5%, futures markets are still pricing in more, with a projected peak of 5.75%. This is because inflation continues to surprise to the upside. The latest reading for July saw the price of services growing by 8.3% year-on-year. The Bank will also have been concerned to see public sector wage growth (which does include one-off payments) of 9.6%.

- The dollar-denominated Bloomberg Global Aggregate Index of investment grade bonds is still only delivering a marginally positive return year-to-date. The UK ten-year Gilt is still delivering a negative return in 2023.

- Early in August the ratings agency Fitch downgraded US government debt from AAA to AA+, citing governance concerns following Congressional wrangling over the debt ceiling (which was resolved, but will probably be resumed when the current agreement expires in January 2025). The market impact was smaller than the headlines, but it served as a timely remainder of the growing US deficit which has been boosted by extremely generous fiscal policy. The next hurdle could be a shutdown of certain US government services in October if the latest spending proposals are not ratified by Congress.

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