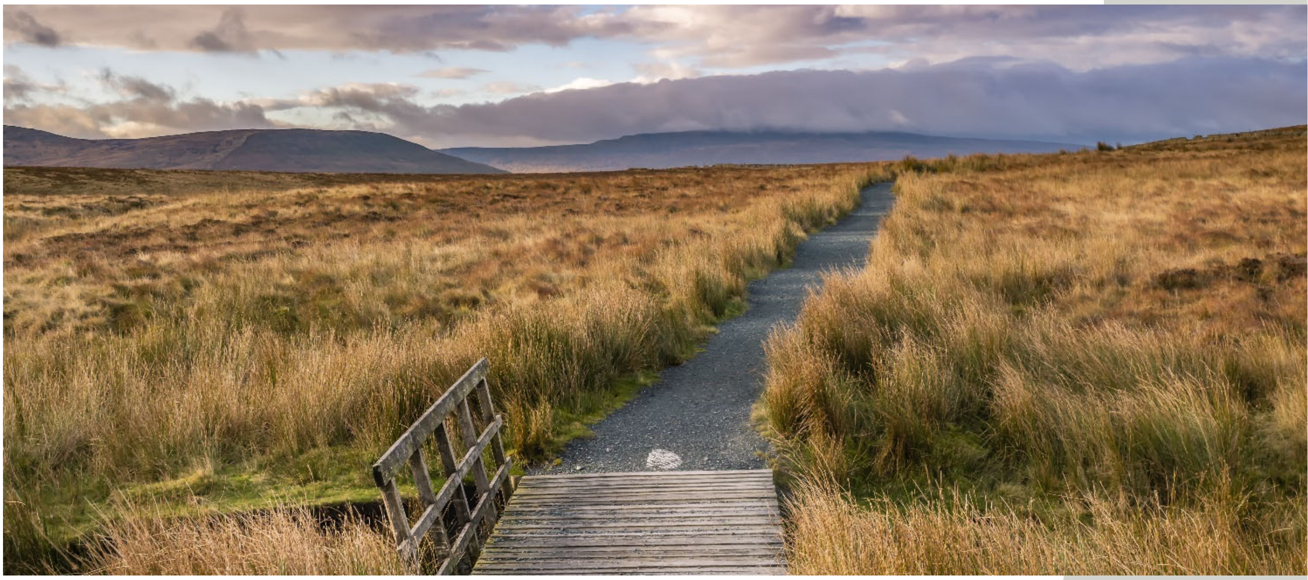
OUT OF THE ORDINARY

10 July 2023

Market reflection



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Overview

Equity markets continued to make positive progress in June, rounding off a first half of 2023 that has proved to be far more profitable for investors than was broadly expected at the start of the year. US Technology shares, as a group, stand head and shoulders above all others in terms of returns. Initially this was put down to a reversal of the negative sentiment and positioning that was prevalent at the end of 2022.

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More recently, the sector has been boosted by the prospect of a new source of growth: generative Artificial Intelligence. It is too early to say exactly how profitable it will be, but investors appear fearful of missing out on what some are describing as one of the potentially most powerful productivity-enhancing tools in human history. In June, the market's rally showed signs of broadening to embrace more cyclical sectors, especially in the United States, where economic data continues to defy expectations of a slowdown. The US housebuilding sector is in rude health amidst a persistent shortage of supply of houses for sale, and the leisure and hospitality sectors are also booming, with record numbers of passengers passing through airport security. Confidence also seems to be recovering in the UK, perhaps because wages are rising at a strong clip – more than 7% per annum. However, this is still not enough to keep up with inflation, which also surprised to the upside in May. This prompted the Bank of England to raise the Base Rate by 0.5% to 5.0%, a level last seen in 2008. The futures market is pricing in a peak rate of more than 6%. This has pushed two-year fixed mortgage rates above 6% from about 1.4% two years ago, meaning that the 100,000 fixed mortgage deals that are expiring every month are going to be repriced at much higher rates. This drag on disposable incomes is expected to slow the economy again as we move through the year.

- The Bloomberg consensus for World GDP growth in 2023 has risen from a low of 2.1% in February to a current 2.6%. The outlook for 2024 continues to show limited prospects of a quick recovery, with consensus estimates at 2.7%.

- The fact that growth in 2023 has outstripped earlier expectations means that inflation has not fallen as fast as expected. Indeed, in the UK the core rate is still rising. Central banks remain committed to keeping expectations of future inflation well anchored and remain hawkish in their policy pronouncements.

- While the Bank of England and the European Central Bank increased interest rates in June, the US Federal Reserve paused for the first time in this cycle. However, the "Dot Plot" of members' forecasts suggests that they are not done yet. Economic forecasters are struggling to model the "long and variable lags" that are associated with tightening monetary policy in an inflationary world, which is, perhaps, why the "most anticipated recession in history" keeps failing to arrive. Our opinion remains that it has been delayed rather than cancelled.

- Bonds continue to struggle in this environment, with the Bloomberg Global Aggregate Index of investment grade bonds delivering only marginally positive returns. The UK ten-year Gilt is delivering a negative return so far this year.

- The better news for savers is that short-dated Gilts offer risk-free yields of more than 5% with added tax benefits when not held within tax-exempt wrappers such as SIPPs or ISAs. They are an attractive home for surplus cash savings.

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