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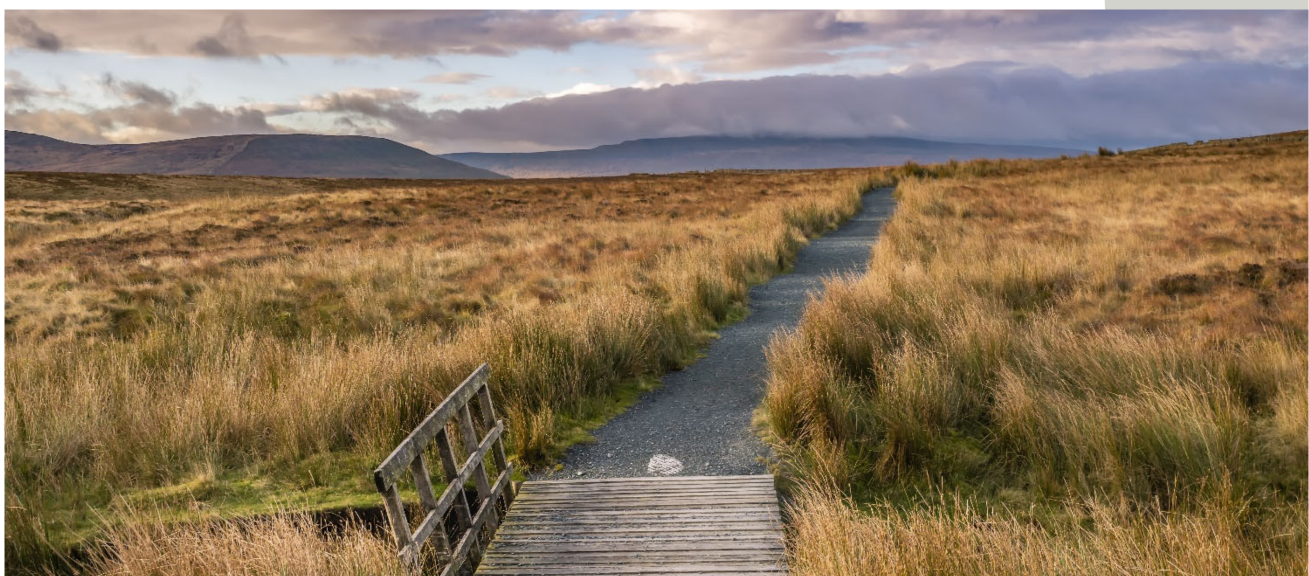
Market reflection



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Head of investment strategy

Overview

Global equities and bonds extended their losses into a third month during October. The main driver of these losses was investors pricing in an extended period of higher interest rates. That, in turn, was the result of a surprisingly strong performance from the US economy, which posted

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annualised growth of 4.9% in the third quarter of the year. Its labour market remains strong and consumers are still spending, as is the government. Inflation has fallen from its peak, but not fast enough to get close to the Federal Reserve's 2% target. As a result, the Fed has reinforced its "higher for longer" mantra in terms of the policy rate.

All of this served to drive the US 10-year Treasury bond yield above 5%, albeit briefly, for the first time since 2007. The higher cost of capital has a two-pronged negative effect. First, it raises the cost of doing business; second, it puts downward pressure on financial asset valuations. We believe that the greater part of the latter influence has now worked its way into market prices. However, the much discussed "long and variable lags" of monetary policy tightening have not yet fully exposed consumers and companies to the effects. As mortgages and corporate loans mature and have to be refinanced, economic growth will decelerate. Some businesses will fail. The transmission of monetary policy into the real economy seems to have been faster in the UK and Europe, where the whole region continues to flirt with recession. The silver lining in all of this is that economic weakness and eventual lower inflation will set up the conditions for interest rates to be cut again, setting up a new economic and investment cycle. We continue to retain a slightly defensive posture in client portfolios, while looking out for opportunities to put more money to work in equities and higher risk corporate bonds.

- The Bloomberg consensus for World GDP growth in 2023 has risen from a low of 2.1% in February to a current 2.8%. The outlook for 2024 continues to suggest slower progress next year, with consensus estimates at 2.60%.

- Markets have now come to the conclusion that we are around the peak of the interest rate cycle in the major developed market economies. The US and UK are at 5.25% and Europe at 4%. Now the market's focus turns to how long rates stay at current levels and how fast they might eventually fall. Central banks are still talking tough, but market pricing (and our inclination) is that they will cut faster once economies show increased signs of weakness. However, that is for 2024 at the earliest, barring an unexpected problem developing in the financial system.

- The dollar-denominated Bloomberg Global Aggregate Index of investment grade bonds remains in negative total return territory for this year (-3%). If maintained, this would be a third successive year of losses, unprecedented since the inception of the index in 1990.

- Hamas's attack on Israel followed by Israel's military response initially raised fears of escalation in the Middle East, seeing the oil price bounce back towards $95. However, subsequent events have not evolved in a way to suggest immediate concern, at least from a financial market perspective. Gold was also well bid, being considered as a good hedge against geopolitical risk. It briefly closed above $2,000 again. More importantly for those in the UK, that constituted an all-time high in sterling terms.

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