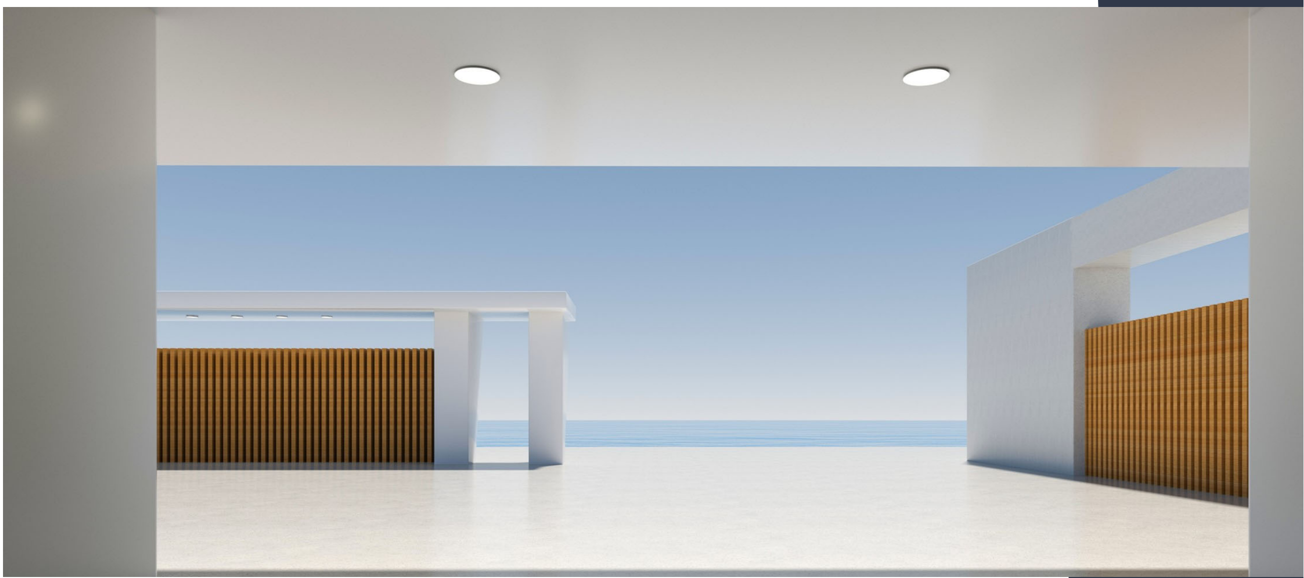
Incorporating Investec Wealth & Investment (UK)

WEEKLY DIGEST | 03 October 2023

Clearing The Slate



John Wyn-Evans
Head of Investment Strategy

The beginning of a new quarter is often a good moment to clear the slate and look ahead. That's even more the case when the old quarter has not been a kind one, and the summer months this year held few favours for investors.

We have talked and written a lot about the correlation of returns between equities and bonds in the last few years and held it up as, potentially, the greatest challenge to balanced portfolio construction in the years ahead.

That's not to say that a positive correlation between the two asset classes is necessarily a bad thing. When inflation expectations and bond yields are falling in an environment of steady growth driven by rising productivity, as was the case in the 1980s and 1990s, then investors make out like bandits because they can harvest great returns from both bonds and equities.

The following two decades were characterised by negative correlation during a period of relatively muted growth and inflation (punctuated by a financial crisis). A world of low inflation that sometimes threatened to slip into deflation meant that bonds and equities acted as a counterbalance to each other, with one tending to rise if the other fell. This reduced overall portfolio volatility, leading to exceptionally good risk-adjusted returns, even if not the bounty of the two previous decades.

A reminder of the trends we have seen recently

And so, to the present. As is now carved into history, 2022 was a dreadful year for balanced portfolio investors because both bonds and equities fell. There was no place to hide in "traditional" assets, save cash. The MSCI All-Countries World Index (ACWI) delivered a total return of -18%, while the Bloomberg Global Aggregate Bond Index (AGG) notched up a loss of 16%. A balanced 60:40 portfolio of global equities and investment grade bonds (60:40 as defined by Bloomberg) was down 17% (all returns in US dollars).

The reason for this was that inflation expectations rose sharply, dragging interest rates and bond yields up with them. Growth expectations declined at the same time, creating a nasty cocktail of negatives for equites – falling earnings expectations and a higher cost of capital.

Coming in to 2023, the most widely held opinion was that a global economic slowdown would develop, capping bond yields and putting downward pressure on equities. That's not how it has turned out, at least not yet. The worst potential economic outcomes for the UK and Europe did not materialise, and the US, bolstered by household savings and a burgeoning fiscal deficit, has outstripped pretty much everyone's expectations on the growth front. The main source of disappointment has been China, which has weighed on some commodity prices and held back mining companies' shares in particular.

Even so, a balanced portfolio didn't do so badly until around July. There were signs of the negative correlation between bonds and equities reasserting itself earlier in the year, and bonds did provide the necessary safety net in March when Silicon Valley Bank and others imploded. Even as yields rose again (and prices fell) during the second quarter, equities were boosted by the increasing growth expectations engendered by the outbreak of Artificial Intelligence fever, as well as the fact that the economic cycle refused to roll over, a factor that helped more cyclical companies' shares.

A return to positive correlation?

August and September, though, have seen a return to positive equity/bond correlation. Continued growth and inflation that fails to fall as fast as central banks might prefer (exacerbated by the oil price, which has seen Brent crude rise from a low of $72 per barrel in June to a current $93) combined to persuade central banks to reiterate more firmly their "higher for longer" mantra. This served to push interest rates and bond yields to new cycle highs. Not only did this provide a valuation headwind, but it increased the risk of tighter monetary policy and financial conditions eventually breaking something in the economy. Indeed, we note that Goldman Sachs's US Financial Conditions Index made a new high for the year last week, indicating the tightest financial conditions since November 2022.

At the same time, global liquidity is under pressure. Central banks are still reversing many years of Quantitative Easing through a combination of asset sales and not reinvesting maturing bonds. The rising dollar, whose trade-weighted index is up almost seven percent since mid-July, is also tightening global liquidity. It has not escaped savers' attention that the yield of dollar cash or money market funds is greater than the earnings yield on the S&P 500 Index. Although we continue to believe that staying invested in "real" assets such as equities for the longer term is the right course of action, there are those who would rather take the "nominal" bird in the hand than the two in the bush.

Looking back to performance since the end of July, the ACWI is -6.75% on a total return basis, AGG is -4.25% and 60:40 is -5.63%. Not as bad as 2022, but ugly, nonetheless.

We are acutely aware that these are trying times for investors. I note that the Bloomberg 60:40 has delivered just 11% in total since the beginning of 2020, or an annualised return of 2.84% – and that's before accounting for inflation. Then again, cash, the supposedly safe alternative, will have yielded even less over the same period given that interest rates were so low for most of it. To that extent, investors have harvested some risk premium.

But 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. There are still a few bumps to come, no doubt, but the worst effects of the derating of equities are largely behind us, we believe, especially if we look at non-US equities. The earnings yield on the FTSE 100 Index is close to 10%, even if the components might not have quite as exciting a growth outlook as some of their US peers.

Futures markets, while not having been infallible in their outlook, are suggesting that the interest rate cycle is peaking and that base rates will be heading lower during the second half of 2024. Yes, that might be a result of a weaker economy and lower corporate earnings, including a recession, but it should also be the harbinger of better returns on bonds. Furthermore, equity markets, if history is anything to go by, will fulfil their usual role as a discounting mechanism and begin to anticipate a recovery while the economic situation remains dark. That tends to be the part of the investment cycle that delivers that best annualised returns in pretty short order.

Economic Commentary

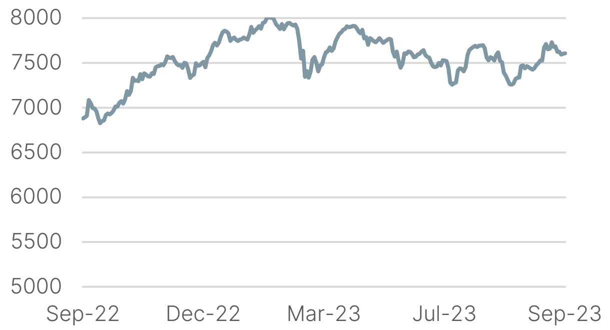
FTSE 100 weekly winners

Ferguson Plc	10.9%
CRH public limited company	4.6%
Glencore plc	3.3%
Barclays PLC	2.3%
B&M European Value Retail SA	2.3%
Intermediate Capital Group plc	2.0%
3i Group plc	1.9%

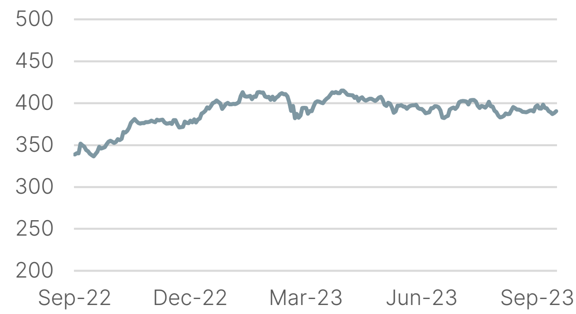
FTSE 100 weekly losers

Ocado Group PLC	-13.1%
Entain PLC	-11.7%
Phoenix Group Holdings plc	-8.6%
Just Eat Takeaway.com N.V.	-7.5%
J Sainsbury plc	-7.4%
Hargreaves Lansdown plc	-6.3%
Barratt Developments PLC	-5.7%

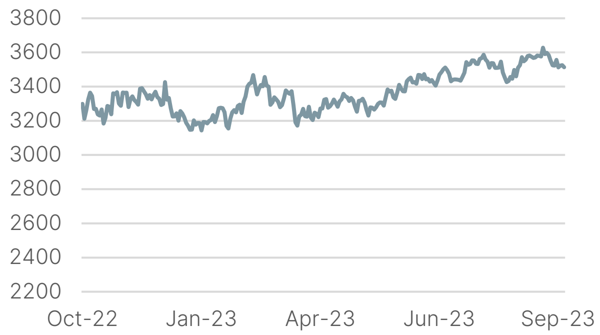
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



All data shown in GBP.

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