Quarterly Investment Bulletin

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July 2023

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Headlines

- Consensus suggests that inflation has peaked.
- Core inflation remains harder to subdue in developed markets.
- The Japanese equity market has surprised investors by its rapid rise this year.
- A narrow band of US stocks dominated US market returns.
- Apple now has a greater market capitalisation than the whole FTSE 100.
- UK interest rates hit 5% and inflation remained at 8.7% in May.
- European inflation was down to 5.5% in June from 6.1% in May.
- Emerging market inflation was lower than UK for first time in 20 years.
- The US economy remains strong, indicating further rate increases.
- Chinese growth was slower than expected after Covid rules were relaxed.
- Recession remains a possibility in the West, but the threat has receded with robust economic data still coming through.

General Economic Overview – Quarter 2 2023

The issues that dictated the pattern of market movements and confidence in the global economy during quarter two were very similar to those seen over the last few quarters. The actions of central banks continued to dominate macro thinking, with the inflation and jobs data also influencing investor sentiment depending on the levels of confidence in the decisions made. We have now moved into a different phase in central bank policy in that for the Fed at least, inflation seems to have peaked, which allows for a period of reflection whilst the effects of a tighter monetary policy work their way through the layers of the economy. In the UK and Europe the position is different as there are different influencing factors, and it is likely that there will be more rate rises in these areas. Financial markets continue to look to the US and the Fed for guidance, as would be expected as the world's largest economy, but the signposts are not that clear. The threat of recession has lessened compared to earlier in the year, as stronger than expected economic data continues to defy previous expectations. Low unemployment rates and relatively robust consumer spending across developed nations seem to be holding off any recession for the time being.

Inflation data in developed countries varies, with the UK in particular seeing very sticky inflation both at the broader and core levels. Without doubt inflation is reducing, but it will be difficult to get it down to the target of 2%. In the US and Europe core inflation is very similar, with both central banks admitting that there is more to do to bring it into line. Strong employment data and wage increases are not helping either region to slowdown as necessary. Even though inflation is falling, and certain base effects drop out later this year, it may still remain as a longer-term problem. It is unlikely that central banks will want to increase interest rates so high that a deep recession occurs, but recession still remains a threat. Service inflation is the biggest headache for central banks at the moment and will probably stay higher for longer meaning getting to the 2% target is going to be challenging and may mean interest rates stay higher for longer. It's worth remembering that the last time US service sector inflation dipped below 1% was on the back of a very deep recession, the economic cost of which makes this a politically unrealistic outcome. For governments, a little unanticipated inflation also appears an easier way out of a debt problem, having already exhausted the option of austerity.

In Asia the opening up of the Chinese economy has not been the engine for growth that was hoped for, with levels lower than expected. Investors have been disappointed with the lack of policy response including a smaller than anticipated adjustment to the main lending rate. A weaker housing market is at the centre of this, with little indication from the party that they will step in and ignite growth with large fiscal packages. India on the other hand has gone from strength to strength this year as its population overtakes China for the first time. Another shining light in Asia has been Japan, which has seen its stock market take off as a weaker yen, higher inflation and structural changes to corporate governance have attracted global investors.

Equity Markets

The narrow band of stocks that has led the rally in the US stock market has continued to dominate returns in the second quarter of the year. When we consider that Nvidia has shot up over 200% this year (FT June 2023) we can understand the concerns that parts of the market are in a bubble or over bought. Technology, and more specifically AI, has been the reason for much of the speculative investing in the last few months and this has emboldened momentum investors to join the party, as well as index investors who have no choice. Only time will tell whether this proves to be a bubble, but for the moment it is driving returns in certain sectors whilst others remain flat or even negative. The UK has been marginally positive, up around 2-3% over the quarter (Financial Express July 2023), but the stand-out market outside the US has been Japan. The returns in Japan have been more broad-based as economic growth has outstripped other developed economies without causing significant inflation.

UK

The latest Office for National Statistics (ONS) data has indicated that the UK returned to growth in April, driven by expansion in the services sector. Gross domestic product grew by 0.2% between March and April reversing some of the contraction in the previous month. It was boosted by the growth in consumer facing services which grew by 1%, although manufacturing and construction both contracted. The IMF believes that the UK can avoid a recession this year but that it faces a level of persistent inflation that may only be combatted by keeping interest rates high. The high levels of inflation have meant that gilt yields have risen this quarter as the likelihood of higher interest rates in the UK increases. The sell off has been reflecting not only the stubborn inflation figures but also the ONS data showing that wages had risen at their fastest pace since the coronavirus period.

Gilts have struggled this year compared to other government debt such as German and US whose yields are trading lower than at the beginning of the year. Core inflation, which strips out volatile food and energy prices, is similar in the UK to Europe and the US although still higher at 7.1% compared to 5.3% in the US and 5.4% in Europe (FT July 2023). The most recent inflation data was concerning as it maintained the overall rate in May at 8.7% with core inflation on the rise at 7.1% from 6.8%. The reaction by the Bank of England was to increase rates by 0.5%, higher than official estimates were anticipating. The backlash is likely to come from mortgage holders whose new fixed rates will be significantly higher when they rebroke their maturing deals. With wages also rising at 7.2% (ONS June 2023) this combination is not on target to reach the banks goal of 2% inflation for quite some time. The Bank wants to break the wage price spiral but has to hit the consumer hard to do this. Predictions of peak interest rates have now moved closer to 6% (FT June 2023) in some cases after June’s rate rise. The threat of recession looms larger under these conditions, and with government borrowing now above 100% of GDP, the ability to cut taxes to soften the blow has reduced.

US

The continued strong performance of the US stock market this year is causing some divergence between investors given its very narrow focus. The core seven or so stocks that have lifted the returns of the S&P 500 index by 16.9 % and the Nasdaq by 32.3% have been focused on the tech sector and the names are familiar to most investors. Apple, at a valuation of $3 trillion, is larger than the entire UK FTSE 100 and this type of valuation is hard to equate if we consider that it delivers around 20% of the profit of the FTSE 100. The driver for much of the latest growth in the US has been the focus on AI and how these mega cap companies will benefit. Chat GPT is now a familiar brand to many of us and is a Microsoft product, with Bard being the Google equivalent.

More broadly, the US economy has been relatively robust this year with a slight improvement from the previous quarter's contraction, however the outlook for the rest of the year is less certain, as lower government spending, higher interest rates, and political uncertainty weigh on consumer and business confidence. The Federal Reserve Bank of Atlanta's GDPNow model estimates a growth rate of 2.2% for Q2 2023 but warns that this could change as more data becomes available. The main challenge facing the US economy is labour market tightness – the unemployment rate fell to 3.5% in April, the lowest level since 1969, but wage growth remained subdued at 2.9% year-on-year (Bloomberg June 2023). The labour force participation rate also declined to 62.4%, indicating a lack of workers available or willing to work. Fiscal policy tightening remains a threat, even after the June announcement of a pause in rate hikes. The Fed also indicated that there was the possibility of more rate increases ahead, and the current members of the committee have indicated the potential for two more increases in 2023. The recent fiscal policy uncertainty was resolved when the political parties agreed a deal for the debt ceiling to be raised but the debt burden when interest rates are still rising suggests there are more problems to come in the near future.

There are some trade policy tensions, with the US and China not yet able to reach a comprehensive trade deal after imposing tariffs on each other's goods worth hundreds of billions of dollars. The trade war has hurt US exports, especially agricultural products, and disrupted global supply chains. Other trade disputes with allies such as Canada, Mexico, and the European Union also remain unresolved.

Europe

Despite the ongoing war in Ukraine, the sharp increases in interest rates, and the threat of a global recession, the eurozone has managed to avoid a contraction and achieve a modest growth of 0.7% (ECB data June 2023). This is thanks to lower energy prices, easing supply bottlenecks, strong labour market conditions and fiscal stimulus across much of the region. However, the outlook is uncertain and fragile, as inflation remains high and core price pressures persist. The European Central Bank has continued its tightening policy through 2023 with June seeing a 0.25% interest rate increase after several 0.5% hikes. The wording from the ECB has been very clear as they are now on a different path to the US Fed – they are data dependent and do not yet see inflation falling enough to warrant any halt in interest rate rises. The EU also faces structural challenges such as an ageing population, low productivity growth and an uneven recovery among member states. Therefore it is crucial to continue supporting the economy with sound macroeconomic policies and to implement structural reforms that enhance competitiveness, innovation and social cohesion. The core German economy entered a technical recession in Q1 2023 but is expected to recover in the second half of the year. There are some positives to consider. In Europe, unemployment is low, wage growth is accelerating, and excess savings are higher than pre-pandemic levels. Many luxury companies continue to report stellar growth, some of Europe's industrial 'bellwethers' are expanding revenues and future orders at rates well above their past average, and many European banks are strong enough to return large amounts of cash to shareholders. Earnings forecasts are recovering globally and improving in Europe.

Asia & Emerging Markets

Although China has ended its Zero Covid policy, the expected surge in economic growth has not really materialised. The prosperity that was linked to the property market before Covid has not reignited as the government have focused on their common prosperity agenda rather than allowing any property boom to begin. They have recently cut their main policy rate to stimulate the economy for first time in ten months, but the drop was very small. There is also a slowdown in demand for exports and a lack of business and consumer confidence. Economists expect that there will be more support in coming months, especially for local governments which bore the brunt of Covid costs and relied on property development revenue. With the property sector still stalling and youth unemployment at over 20%, the short-term outlook for China is weak.

For the first time in twenty years, emerging market inflation is actually lower than the UK. The main driver being that the path of rate increases in EM has been ahead of developed markets with some economies, like China, now cutting rates. They have also had much less QE than the west as it has not been needed, reducing the effect of the money supply growth in their economies. They have also had fewer supply side pressures, especially in terms of energy, which has been a key element of recent European inflation. Lastly one technical factor that has helped is that China forms some 40% of the EM index weight and inflation in China is 0.2% which has brought the average down. This in effect means that EM areas should be further ahead in terms of recovery than their western counterparts, although global trade needs to be robust if the momentum is to continue.

In contrast to China, India now has a much more favourable macro environment and is attracting increasing levels of foreign direct investment (FDI) as it seeks to establish itself as a manufacturing alternative to China and benefit from multinationals moving to what's being termed 'China Plus One' when looking at improving supply chains. Infrastructure investment has always been a problem in India, but this now seems to have turned around with the construction of new roads and private investment in areas such as airports, gas and power distribution, renewable energy, and even parts of the railways. The government has embarked on often difficult but essential reforms in agriculture and labour markets. India has long been lacking an investment cycle, but funding availability has improved, and today not only state owned banks, but private sector banks, insurance companies, infrastructure, investment trusts, and the corporate bond market can participate in financing infrastructure projects. The government of India has encouraged investment in local manufacturing through attractive tax and labour reforms and there are strong productivity improvements, which a low labour cost economy such as India should be able to capitalise on. There is both a large domestic market and increasing levels of exports which stack up on the quality front as we can evidence when Apple's suppliers have invested close to a billion dollars to set up manufacturing units in India in recent years.

Japan

The Japanese stock market has performed extremely well this year and was up 28.3% at the end of June (T Rowe Price, July 2023) in local currency terms, which reflects the confidence in the reforms that were begun just over ten years ago under prime minister Abe and called Abenomics. The reforms were probably more important for the long term and appear to now be paying off. Most importantly, a corporate governance code was introduced in 2014 and companies are now responding to shareholders, and beginning to look at ways to improve shareholder returns by restructuring, buying back shares, and selling unprofitable assets. The latest development has been the restructuring of the TSE (Tokyo Stock Exchange) which took effect in April. The new structure encourages (and in some cases forces) companies to be more transparent and shareholder friendly, and to increase liquidity and shareholder value.

The structural reforms have probably contributed to improved profitability, but there have also been other catalysts driving the current rally. The weaker yen, and the reopening of China's economy has boosted exports. Japan's inflation rate has also risen – something the BOJ has been trying to achieve for decades – which has stimulated consumer spending.

Foreign investors have also begun to pay attention after seeing the gains on Berkshire Hathaway's Japanese investments. In 2020 Warren Buffett began buying shares in Japan's five largest conglomerates, some of which have risen by over 150%. Industrials, financials and consumer discretionary stocks have led the way this quarter and inflation, which has been low and has always held back the Japanese stock market, is now above 3%.

Fixed Interest

This has not been a great year for fixed interest after initial optimism when rate cuts were priced in by markets towards the end of quarter three 2022. Rate cuts now seem a somewhat remote possibility as the rate hiking cycle does not seem to be having the desired effect, over a year after it started. The question on most economists' minds at the moment is what the tipping point will be, as this will give more guidance as to when rate cuts might start to happen. Rate hikes tend to set credit cycles in motion that are contagious and bring economic subsectors and regions into a harmony of slowing sales, earnings, capex, and rising unemployment. No doubt rising rates and the increased cost of capital will slow the global economy, but the questions are when, at what level will rates bite, and is there sufficient synchronisation of a credit cycle to set off a major recession.

The year started with a reasonable amount of confidence after 2022 had been something of a disaster for the bond market, with the Bloomberg Global Aggregate Index down by 16% (Bloomberg June 2023). The 3% gain in the first quarter boded well for a strong rebound as inflation was felt to have peaked and interest rates were potentially being cut towards the end of the year. The preference at the time was to extend duration. Investors were showing confidence in bonds in the first five months of 2023 according to Morningstar data, with nearly $113 bn flowing into bonds compared to $107bn of outflows over the same period in 2022. This confidence was misplaced, as interest rates have continued to climb, especially for longer duration assets. The two-year treasury yield continues to stay above that of the ten-year, and edged up further when the Fed indicated more rate rises were to come after the recent pause. A two-year Treasury yield that is higher than the ten is often seen as a harbinger of recession, but there is lots of data that indicates this may yet be someway off and that we need to get used to higher inflation and interest rates. For many investors in bonds, the saving grace is that rates are relatively high, giving a cushion for the poor capital performance. Clipping the coupon or yield is more acceptable when rates are higher and provides a margin for error if prices fall.

The fall-out from the US regional banking crisis seems to have blown over, although the Fed have indicated they are still watching the situation closely. All US banks have just been reviewed by the Federal Deposit Insurance Corporation (FDIC) and had over $515bn in unrealised losses at the end of quarter one, $100bn of which was Bank of America. These losses only become a real issue if crystallised which is not expected. As we have noted previously the main effect of this is to restrict lending, which has longer term growth consequences for the global economy.

Fixed interest investors seem to be on hold for the time being as expectations of falling yields have yet to be fulfilled. It seems like this message is hitting home as investors have become more cautious in the short term. There have been outflows from short-dated government bonds in April and May according to Morningstar data, with investors preferring money markets or ultra short-dated government bonds. There is no definite timeline as to when the yield curve might move from being inverted, or when longer duration assets may become attractive to investors as many were caught out at the beginning of the year.

Alternatives

2022 was a challenging year for investors as stocks and bonds fell together, posting one of the worst returns on record for a traditional 60/40 portfolio. There have only been three occasions in the last 65 years when US stocks and bonds both lost money – in 1969 when US inflation breached 6%, in 1974 when inflation reached 12% on the back of the oil crisis, and in 2022 when inflation suddenly reached a 40-year high (source JP Morgan). This illustrates the importance of looking at diversifiers in a portfolio.

Alternative assets, such as infrastructure, could continue to prove relatively defensive while also providing some inflation protection with an attractive income, and as the push towards green energy continues there will be significant opportunities in commodities that support this transition such as lithium, copper and silicon.

Commodity prices have been on a downward trend this year, with gas and oil more obvious examples, but not all commodities fall into this category and positive examples include industrial metals. The threat of recession does still hang over the global economy with inflation remaining high, and the slow progress of the Chinese economic recovery has not offset any of the price falls in the commodity sector.

Commercial property also had a difficult year with any interest rate sensitive assets struggling. The change in occupational rates in offices and the habits of companies have changed the dynamic in this area, and city centre locations are being thought of differently by owners and developers. Lower levels of occupancy are clearly seen in major centres like London, with companies needing less space as we embrace hybrid working. Other factors that have negatively impacted commercial property valuations in recent years include the economic uncertainty of Brexit, and the liability-driven investments pensions issue, all of which have added to the current levels of uncertainty.

We are also seeing a lot of regional and sector variations at the moment, rather than the more uniform movement in valuations that occurs in a normal cycle. Quality is an increasing theme within commercial property with developers moving to upgrade offices to fit new requirements including leisure facilities and cafeterias. If we do move into a recessionary environment, then rental growth will reduce, and yields may then increase making some property more attractive.

Summary

Markets have progressed over the second quarter as concerns over an immediate recession dissipated. The recent Fed meeting showed an upgrade to projections of economic growth and employment, although on the negative side forecasts for the Fed Funds Rate also increased. So far, earnings have proved broadly resilient, and investors expect improvements in profitability in 2024, although how this pans out remains to be seen. Valuations in the US do remain high by historic levels, but the headline number is affected by the ratings of the technology focused mega caps which have driven this year's market gains. Outside of the US, equity markets appear reasonably valued, unless we experience a lasting economic downturn, although concerns over persistently higher interest rates in today's new investment regime will cap valuation levels, meaning a rapid return to previous market highs is unlikely.

For long-term investors there remain pockets of value which strong stock picking has the potential to exploit. When US rates eventually peak, the valuations within Asia and selective emerging markets, coupled with their stronger relative growth prospects, could reward investors with a medium-term horizon.

We are entering an uncertain period for economic growth as the effects of higher interest rates bite more strongly and central banks weigh-up whether they have done enough to curb inflation without tipping their economies into a recession if it is not necessary. For most investors there is no clear and obvious direction for markets to take so a broad diversified approach continues to be appropriate on a medium term view.

Ken Rayner, CEO, RSMR
July 2023

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