Quarterly Investment Bulletin

October 2023

Headlines

- Inflation and higher interest rates may be with us for longer than expected.
- Core inflation remains harder to subdue in developed markets.
- UK inflation fell to 6.7% in August, surprising many observers.
- Equity market returns were flat to negative this quarter.
- The markets now accept that central banks will hold rates until inflation moves to targets.
- UK interest rates remain at 5.25%.
- European inflation was down from 5.2% in August to 4.3% in September.
- The German economy is struggling, which is negative for growth expectations in Europe.
- US interest rates are on pause, but the economy remains strong.
- China is finding it difficult to move away from a property focused economy.
- Strong employment data means a deep US recession is looking less likely.

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General Economic Overview – Quarter 3 2023

Sentiment has become more negative this quarter, and this is reflected in markets, notably in August and September. The wider global economic picture is resilient with central banks still fighting inflation and, in some cases, continuing to raise rates to levels last seen at the beginning of the century. This does not mean that the threat of inflation has increased just that policymakers are cautious as to the effects that higher rates are having. In the US for example, rates are over 5% yet the economy remains relatively robust with low levels of unemployment and strong consumer spending.

Inflation remains the most important metric for all economic and market observers as it is dictating central bank policy. Last quarter we noted that data indicated that inflation had peaked in several western economies and whilst this continues to be true, the level of inflation is much higher than central banks' longer term targets. A recent survey by the IMF studied over 100 inflation shocks in 56 countries since the 1970s and highlighted that most inflation fights took at least three years to resolve and that the successful ones came when central banks raised rates higher and kept them there for longer. Another observation was that aggressive monetary and fiscal policy did not result in a heavy economic toll over the longer term (five year data). Although not widely commented on in the press, this kind of survey will no doubt influence policymakers' actions in the coming months, suggesting interest rates will be held higher for longer. Unlike the ECB, the Bank of England and the Federal Reserve all held rates in September as both felt a pause was appropriate after falling inflation rates, although the Bank of England's (BoE) decision was split suggesting the decision was close.

We noted last quarter that the threat of recession had lessened compared to earlier in the year, as stronger economic data continued to defy previous expectations. Low unemployment rates and relatively robust consumer spending across developed nations seemed to be holding off any recession for the time being. This view has not altered with the potential for a soft landing increasing as consumer data continues to show a robust response to tightening. It is still the view of the Fed that the battle with inflation is not over, and that a 'higher for longer' environment is now anticipated with the potential for one further interest rate rise this year. Every message on interest rate movements from central banks is quoted as being 'data dependent' and the recent pause in rate increases by the BoE is an example of this, it was not anticipated by markets but better than expected inflation data in September swayed the vote. Recent OECD data forecasts show a slowing global economy and central banks in emerging economies have also begun cutting rates, indicating the direction of policy in the coming quarters. Cutting rates in the West seems unlikely in the short term as yields continue to fluctuate.

How stock markets progress over the next 12 months will depend on how markets perceive firstly the possibilities and then the eventual economic outcome delivered. In the early part of the rate tightening cycle, markets were focused and split between the possibilities of a soft or hard landing, but now a third scenario has evolved which can be described as no landing or 'growthflation' which is particularly applicable to the US. Over the last quarter it has become apparent that different regions of the world may well behave in very different ways, with growth in the US proving far more resilient than is the case in Europe or the UK, whilst the Chinese economy has delivered a tepid post-Covid recovery due to weakness in the property market.

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Equity Markets

Equity markets have been somewhat deceptive in the last quarter, with what was looking like a good year, especially in the US, turning into a flat to negative quarter. The message about higher for longer rates has certainly started to resonate in August and September. The S&P 500 is up 11% this year but is down 7% since the beginning over Q3 (source FT Sept 2023) and has only been supported by a narrow band of heavily weighted tech stocks. The equally weighted version of the US index fell back into negative territory for the year by the end of the quarter. Most equity markets are still showing gains for the year, but it looks like these levels will be tested in the final quarter.

UK

UK economic growth was negative in July with a fall of 0.5%, although the overall picture for the three months to July was better, showing a GDP growth of 0.2% compared with the three months to April 2023 (source ONS August 2023). July was a poor month as several strikes and poor weather hit the figures.

In more positive news, the Office for National Statistics (ONS) indicated that in the three months to June UK GDP was 1.8% above its pre-pandemic level (end of 2019). This gives the UK similar performance to France and is ahead of the German rebound since the pandemic. The more interesting data however came in September's inflation figures which were expected to be higher as oil prices rose over the summer. The figures came in at 6.7% which was lower than the July figure of 6.8% but also below economist predictions of 7%. This was caused by a decrease in food prices and more moderate price rises in goods and services. Core inflation, a measure that the central bank uses as it excludes the more volatile energy and food prices, also fell to 6.2%, down from 6.9%, when it was expected to stay the same. This was led by the services sector which fell from 7.4% in July to 6.8% in August (source ONS). The Bank of England looked likely to raise interest rates again in September for the 14th consecutive time ahead of this inflation news, but decided to pause after a very close vote (5-4) in the committee – it is easy to forget that the current levels of interest rates have been achieved fairly rapidly and there will be a lag into the main economy of around 12 months. The one concerning factor for the Bank of England policymakers is the strength of wage increases which have reached a point where they are higher than inflation with average wages growing at 7.8% (source ONS). The hope for the rate setters is that the labour market will cool as interest rates take effect. The current trend is certainly supporting this belief with the unemployment rate rising from 4.1% in June to 4.3% in July (over a three-month period).

US

US stock market returns have been much more subdued as investors have resumed a more cautionary outlook. The problem for investors, and for the Fed, is that data has been much more variable, with stubbornly high inflation in some corners of the economy, fuelling fears that the retreat in consumer prices that many economists expect later this year will be bumpier than expected. Annual inflation as measured by the Bureau of Labour Statistics for CPI rose to 3.7% in August, up from 3.2% in July, as petrol prices rose. Looking at the details of the release, the acceleration in inflation was largely due to a far smaller year-on-year drop in energy prices as the base effect turned less favourable. This raises the question as to whether the slowing of price rises earlier this summer was just a blip. Price increases in some other areas of consumer spending, including autos and furnishings, have also contributed to this

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increase in CPI. There are more positive signs that the labour market is cooling, if slowly, and that the price rises are quite focused and less broad than seen in previous months.

The question for many observers is what this now means for future interest rates rises. This month the Fed voted to pause rate increases, despite the slight uptick in inflation, whilst signalling that they expect the funds rate to peak at 5.5 - 5.75%, allowing for one more increase this year. They also indicated that there would be fewer interest rate cuts in 2024 and 2025. This suggests that rates will be held for longer than expected to combat potential short term cyclical hikes in inflation.

Whilst growth is robust at the moment, the Fed also have to contend with fresh challenges such as the resumption of student loan repayments and an unresolved strike by car workers, alongside a rise in the oil price which could result in increased costs for a wide range of goods and services. There continue to be trade policy tensions with China and other countries closer to home such as Canada and Mexico. The chances of a soft landing do seem higher, especially with a strong economy and high levels of employment, but this can't be taken for granted hence the Fed's higher for longer stance.

Europe

The pressure of higher interest rates has caused some significant changes in the prospects for the European economy over the last twelve months but despite this, in the August review the ECB raised rates by a further 0.25%. The ECB stated that this was a majority decision, suggesting that there may now be a pause in rate hiking, although Christine Lagard did indicate that she did not rule out further increases if necessary. The strongest message from the ECB president was that the European economy was slowing and that growth over the next few years would be difficult to achieve. The forecast for growth for this year was revised down to 0.7% and the euro fell in value against other currencies after the announcement. This move raised deposit rates to their level highest since 2001 and the forecast for inflation was increased from 5.4% to 5.6% for 2023 after a rise in energy prices.

The biggest issue for the ECB at the moment, and the reason for cutting growth forecasts, is the performance of the German economy. The issues around global supply chains have affected all economies, but Germany has perhaps suffered more than most. The issues in Germany are not focused on one sector or problem but on several structural problems including labour shortages, rising barriers to trade, increased bureaucracy and a lack of investment in transport, education and digital infrastructure. Industrial production has fallen this year by 2.1% (source FT Sept 2023) with Germany's energy intensive sectors falling even further, added to which a cyclical downturn is causing further cuts in production. Investment is also being channelled out of Germany to other countries such as China and the Czech Republic where labour is cheaper and more available. There are areas of positivity in aerospace and defence but with key trading partners such as China faltering, the outlook is bleaker than it has been for some time. Not all of Europe is posting gloomy forecasts, Spain has recently seen a very strong bounce back from the pandemic with revised GDP data very encouraging. The consumer is also continuing to spend strongly across the region, with the consumer discretionary and luxury goods sectors performing well.

Asia & Emerging Markets

The story for China this year has been one of underachievement, after the anticipated growth following the post-Covid opening up of the economy failed to materialise. Historically at such points, the authorities have tended to offer a big policy response to the problem as we saw in the financial crisis in

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2008. This time around, even after months of poor data and missed payments from property developers on international bonds, Beijing has put forward limited measures in response. Interest rates have been lowered but not yet significantly enough to stimulate demand or reassure foreign investors that there is a turnaround in place. In August, readings for industrial production, retail sales, credit provision, exports and imports were all better than markets were expecting. That said, the economy continues to be held back by a slumping property sector, tepid sentiment among firms and consumers, soft external demand, deteriorating demographics, and US trade and tech restrictions. All this has had an effect on the Chinese currency with the renminbi falling to its lowest level against the dollar since 2007 in September this year.

The stock market is reflecting this and has had a structural derating with many investors moving assets out of China indicating that it could be uninvestable at the moment. Time will tell if the economy can make the adjustment from being property led, as it was pre-Covid, to a broader more diversified one. As we noted, there were some signs of recovery in August when the data for both industrial output and retail sales was above market expectations. Together with a downtick in the urban unemployment rate, smaller contractions in exports and imports, and the end of consumer price deflation in the month, this suggests a nascent stabilisation of economic activity. Investment managers are not currently backing China or have the area on their radar, which could make it great value for the longer-term investor should a government stimulus package be introduced.

India remains the stand-out economy in the Asian region with GDP growth of 7.8% in the year to June (source Focus Economics). Consumers increased their spending more than in the previous quarter as inflation fell and confidence in the economy rose. Services activity rose the most in 13 years in July compared to the prior month, but then increased slightly less sharply the following month, likely due to an uptick in inflation and a loss of agricultural income following the driest August in 120 years. Other Asian economies such as Indonesia and the Philippines were showing strong growth but with rising inflation. Outside of China many Asian economies are doing well with generally lower inflation and interest rates than in the West.

Japan

The Japanese stock market has held up well without significantly advancing this quarter, as the main index remained fairly flat after rising some 30% this year already. The Bank of Japan (BOJ) maintained their ultra-low interest rate policy and surprised many observers as consumer price growth exceeded the BOJ target for the 17th month in a row. Japan has the world's only negative interest rates but concluded that they could not yet see that inflation was under control or stable. The short-term rate is at minus 0.1% with the ten-year rate slightly higher at 0.72%. August inflation data indicated that core inflation was at 3.1% - lower than many western economies but wide of the 2% target, hence the conundrum the BOJ finds themselves with. This stance has again weakened the yen taking it close to the Y150 mark against the dollar which has previously seen intervention from the BOJ. The yield curve control policy remains in place, but it was tweaked in July when Governor Ueda raised the cap on the ten year bond yield to 1% from 0.5% without normalising policy.

Private spending, which makes up around 60% of Japan's GDP, contracted 2.1% as the post-pandemic boost in spending slowed in Q2. With export growth normalising and private spending remaining weak, expectations are that GDP growth will cool to 0.2% in Q3.

Business activity rose less in July and August than in Q2, and while the volume of goods exports rose more in July than in Q2, momentum has likely slowed since. In other news, according to recent media

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reports, the government will introduce new economic stimulus measures in September, probably centred around boosting wages and encouraging investment in new technology.

Fixed Interest

It has felt like a long road to get to the point where interest rates may have peaked but it has only been two years. The time frame for such hikes in rates has been relatively short compared to historical cycles but this was preceded by a global pandemic and followed shortly by the first European war for 75 years. In the last review we speculated about when the rate increases would start to have the desired effect, and the recent pause in rate increases by the Fed and the BoE has indicated that the increases have begun to have an effect, even if employment and wage increase data has remained robust. Recent data seems to suggest that the global economy is beginning to slow, but it is by no means clear cut hence the wording from central banks suggesting more hikes were not 'off the table'. Rising rates and the increased cost of capital will slow the global economy, but the question remains if there is sufficient synchronisation in the credit cycle to set off a major recession. A further sign that markets are anticipating a shift in policy is that hedge fund investors have started to unwind bets against Britian's £2.5 trillion government bond market, indicating that they believe the BoE has reached the end of its rate rising campaign. Ironically a more clear-cut downturn could be more beneficial for bond investors if it allows central banks to cut rates.

Year to date returns from the bond market have been much more palatable than they were last year, with global government bonds returning around 2% so far. The strongest returns have come from the high yield market where spreads have been more sensitive to interest rate changes and defaults have not really materialised, although they have been increasing recently. Corporate bond investors have generally supported quality, and fixed interest managers seem more likely to favour this area of the market for the time being, especially if the global economy starts to deteriorate. There may be more significant opportunities in the bond market if we start to see a recessionary environment develop in the next six months. At the moment there remains an inverted yield curve with shorter rates higher than longer rates. This has meant investors have tended to favour shorter duration assets, protecting against the rising rate environment we have seen in the last two years. If rates start to fall in 2024 then bonds certainly become more attractive in terms of capital appreciation, with several managers predicting this may be a rare opportunity to capitalise on a falling rate environment. Emerging market debt may also offer up some decent opportunities as several countries have started to lower rates already.

Expectations of falling yields have recently taken a hit as the higher for longer message from central bankers has finally taken hold and the much-anticipated cuts in rates are seen as some way off. As an example, the yield on 10-year treasuries hit its highest level since 2007 on the 27th of September 2023 (source FT Sept 2023). This somewhat delays the anticipated gains many investors were expecting as we move into 2024 should interest rates be cut.

Alternatives

In a rising interest rate environment, growth prospects for property and infrastructure investments do look challenged and this has been the case over the last 18 months. There has definitely been a period of repricing of assets in the last year as interest rates have risen. We have possibly reached a point now

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where this may be a more interesting asset class, if we think that interest rates have peaked. The global property market has seen a reset of capital values as a result of the pressures of rising rates, structural changes in working habits and trends towards logistics and data centres linked to the ongoing digitalisation of global societies. As a consequence, the focus of many investors has been on those things that they can control, which has been sectors that offer more resilient income streams. While there is uncertainty about how the repricing plays out, acquiring assets with resilient cash flow – and some growth potential – at lower capital values than in recent years looks an attractive proposition on a long-term buy-and-hold basis. Values have fallen, but could still fall further in the near term, especially if a recession takes hold and occupier stress prompts an overshooting of the correction beyond just the reset driven by higher interest rates. Essentially, the notion of values resetting reflects both the external nature of the driver of this re-rating – adjusting to a new permanently higher level of interest rates – as well as how universal it is. While there are differences across sectors and markets so far, almost no parts of the market are escaping the effects entirely, irrespective of occupier performance, with Europe seeing a faster process of adjustment in yields than most other areas.

Commodity prices have been under some stress over the year with many falling in value on the back of a potential recession and a lack of demand from China as its reopening failed to stoke demand. In August, prices for seven out of the 12 base metals posted losses (source Focus Economics Sept 2023). Waning global demand was the key driver of the downturn, which affected heavyweights copper, aluminium and nickel, as well as steel and iron ore. Contractionary manufacturing PMI readings in August for the Eurozone, the US and China pointed to subdued industrial activity. Oil is the exception as it has risen by 30% in price since June (source Focus Economics Sept 2023) as supply constraints and production controls have hit global prices raising them to close to $100 a barrel. Russia has recently barred the export of diesel and petrol which is seen as part of a retaliation for Western sanctions. This will again put pressure on inflation as we head towards the winter months and will be exacerbated if they also tighten gas supply, especially in Europe.

Real assets values can only really move forward if we can see a change in central bank language on interest rate moves and if we can avoid a global recession. There are many other factors of course – a resolution of the Ukraine war or a stimulus package from the Chinese government would be positive for sentiment and confidence.

Summary

At this stage it is impossible to be definitive about how this cycle will eventually play out, but it is clear that conventional economic models have not been able to forecast or predict the continued strength in economic activity, especially in the US during 2023. A slowdown in the US economy in Q4 would now be the market surprise when a year ago this was the consensus view. Whilst sentiment to China remains very negative, the authorities still have plenty of levers to pull to ensure the economy does not collapse and China remains a very entrepreneurial society. It should also be remembered that a year ago there were two big consensus calls, the first was for a recession in the US and the second for a strong reopening economic boom in China. China remains a world leader in many technologically driven industries, especially electric vehicles, and is well placed in fields ranging from AI to robotics.

In the short-term, markets will be focused on the outlook for interest rates and the realisation that rates will remain high by post-GFC standards for a long period of time. The oil price is a threat to economic growth and the taming of inflation, both in the developed world and in some emerging market economies such as India which are vulnerable to oil price shocks. An upward move of 30% since June in

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WTI and Brent crude is not something to be ignored and would favour US economic growth over that of Europe. If European currency weakness continues it has the potential to deliver a double whammy of more expensive oil (which is priced in US dollars), and further pressure on the ECB on the interest rate front due to the resulting higher inflation.

Whilst there has clearly been a move away from an ultra-low inflation world, the extent of regime change is still not certain. Whilst in the 1970s and 80s inflationary forces dominated markets, the 90s and 2000s saw disinflation boosting equity market valuations. Even today there are both disinflationary and inflationary forces at work over the longer-term, so it would be dangerous to be categoric about how inflation will evolve over the next decade. Markets have not sold off in Q3 due to significant declines in earnings estimates, but rather through pressure on valuation levels as real yields, particularly in the States, have risen over the quarter. It remains an environment where investors need to proceed with a certain level of caution but be prepared to act if markets do sell off sharply in the early part of the fourth quarter.

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October 2023

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