RATHBONES | Incorporating Investec Wealth & Investment (UK)

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Market commentary

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Overview

It remains difficult to be the bringer of glad tidings in these monthly updates. Global equities and bonds have just suffered their third consecutive month of losses. Their performance remains correlated, but in a bad way, meaning that hiding places for investors remain elusive. However, we can detect a couple of possible silver linings. The first is that safe fixed income products now offer returns that can compete with riskier assets, at least in the immediate future. Index-linked issues are also providing positive prospective real returns if held to maturity. The second is that we are firmly of the belief that we are much closer to the end than to the beginning of what has been a frustratingly long-drawn-out period of lacklustre balanced portfolio returns*.

There has been no real change to the driving forces behind markets since the summer. The main weight hanging over equities has been the rising cost of capital, which in turn is a function of higher bond yields. The primary force behind higher bond yields has been the strength of the US economy (which we cover in more detail below), combined with increased bond issuance by the US government to cover a ballooning fiscal deficit. The consistent message from the Federal Reserve (Fed) is that interest rates will remain "higher for longer", and this has resulted in a steepening of the yield curve, meaning that longer term interest rates are no longer much lower than short-term rates.

Often in the past, the yield curve has steepened because short-term rates are falling relative to long-term rates. This is known in the trade as a "bull steepener" and can be supportive of risk assets as it portends lower policy rates. It can also be a signal that interest rates are being cut in response to negative economic data and deteriorating earnings, and so still requires some careful navigation. What we are currently experiencing is a "bear steepener" which is being driven by a rise in longer term rates. Even this can be split into two varieties. If rates are rising because of higher inflation, that can often be an opportune time to buy cyclical companies benefitting from strong economic activity. If it is a rise in "real rates", a result of the extra return demanded by investors to compensate for a variety of potential risks, then the environment for all financial assets tends to become tougher. It is a rise in real rates that has propelled bond yields higher in the last few months; hence the weakness in equities, including, finally, some of the high-flying US technology giants.

The ultimate cure for higher rates will be economic weakness. We are experiencing more of that in the UK and Europe (again, see below), but it is the US that holds sway over global asset prices. There remains a huge range of forecast expectations for the US economy. In the course of one afternoon during October, we hosted two external economist/strategists, both of whom work for independent research houses and whom nobody could accuse of having a vested interest in the direction of markets. They just call it as they see it. One predicted an imminent US recession; the other that growth would continue for at least another year. Their arguments were equally plausible. We have been in the "imminent" camp for a while and remain there, acutely aware that the cycle has taken longer to play out than we expected. We are far from alone. The recession "waiting room" has standing room only. Even so, given the lingering effects of pandemic-related distortions, ranging from supply chains to working patterns and from government handouts to spending sprees funded by "excess saving", we have not had sufficient conviction to adopt an extremely defensive stance. To revive a phrase we were using a year ago to describe our attitude, we remain "cautious, not fearful".

The major development during October was the attack on Israel by Hamas operatives, resulting in a tragic loss of life. Almost a month on from that incursion, markets remain almost surprisingly calm. An initial upward spike in the oil price has been fully reversed as the situation has not expanded further into the Middle East. The greatest concern was that Iran would be drawn into the hostilities, given its support for both Hamas and Hezbollah and its longstanding animosity towards Israel. Iran produces around 3% of global oil output, but, more importantly, has effective control over the passage of oil tankers through the Strait of Hormuz. These account for closer to 20% of global supply, meaning that any closure of the Strait would be catastrophic for the global economy. There is little doubt that the superpowers recognise the risks and appear to be intent on imposing some sort of restraint upon the various adversaries, but the risk of escalation is definitely not zero.

Bearing that in mind, another traditional hedge against rising geopolitical risk, gold, performed well during October, even reaching an all-time high when priced in sterling. Gold has distinguished itself by breaking its historical correlation pattern. When inflation is falling (as it has been from its peak), the dollar is strong and real yields as rising (as they are now), gold has tended to be a poor performer in the past. Why the relative strength now? In terms of visible supply and demand, we have seen strong buying from central banks, especially those in some emerging markets including Russia, China, and Turkey. The sanctions placed on Russia's dollar-based assets, notably

their holdings of US Treasury bonds, following the invasion of Ukraine, have highlighted the risk of owning such assets as reserves in a world of rising geopolitical tension. Gold is an apolitical alternative. Gold, as a real asset, also has the potential to hold its value should governments extend their fiscal profligacy with the support of central bank purchases. Such policies would be potentially inflationary and would devalue fiat currencies.

Markets – US

In the regional section of the last commentary, we majored on politics. This month we return to the less contentious world of economic data. The US achieved a remarkable level of expansion during the third quarter, with the annualised rate of GDP growth printing at 4.9%, which handily beat the consensus forecast of 4.5%. We often remark that the US's habit of annualising such data can exaggerate the outcome, but even dividing this number by four leaves an impressive rate of growth. The two main contributors to the growth were consumers and the government, which makes one wonder how strong things might have been if the manufacturing sector was not struggling with inventory adjustments. Even so, there is more than a suspicion of "as good as it gets" about this number. Although cash-rich households are enjoying the income being produced by higher interest rates, the "have nots" are increasingly having to dip into savings to survive. For example, more than 6% of sub-prime car loan borrowers are well past due on their current payments, which is the highest percentage since 1994. Although unemployment remains low at 3.8%, the trend in jobs growth is a bit weaker and job openings are also well off their peak. The surge in wage growth has abated and the premium for moving jobs has also fallen back. Consensus expectations for fourth quarter growth are already set a lot lower at just 0.8% on an annualised basis (although we note that economists were expecting the figure to be negative, as recently as July). There are various reasons to believe a slowdown is probable, not least the delayed effects of past monetary policy tightening. There is also the fact that graduates will have to recommence paying off their student loans. And although nobody can put an exact figure on the level of post-pandemic "excess savings", it is fairly clear that a lot of them have been spent already. We might also have to contend with the shutdown of certain elements of government if an agreement on budgeted spending is not reached in Congress, something that we discussed in detail last month. We continue to expect a further slowdown to develop, which might tip the economic scales towards an official recession, although we also continue to believe that any recession would be a mild one. The Fed's reaction to that would depend to a great degree on how fast inflation is falling. The latest Core PCE Deflator measure that it favours, last seen at 3.7%, is heading in the right direction, at least.

UK

The UK can only dream of such growth. 1% economic expansion over the course of a whole year, let alone a single quarter, would be welcomed today. In the 12 months to the end of August, which is the latest data we have, the economy expanded by 0.8%. Unlike in the US, where the great majority of mortgages are taken out at a rate fixed for 30 years, in the UK most are fixed for two or five years. This means that the refinancing "fuse" is much shorter. Around 100,000 households per month are facing a sharp increase in payments, and this will continue for some time yet as past deals expire. Transaction levels in the housing market have collapsed, with mortgage approvals at their lowest level since 2011 (ex-Covid). Inflation remains much more persistent in the UK than in other countries, a trend that has been apparent for several years. It is often blamed upon a lack of productivity growth, for which there are many potential reasons, with a lack of investment combined with (government) policy uncertainty being widely cited. At least part of the current inflation will unwind quite quickly when we see data for October owing to the latest reduction in the energy price cap. When he delivers his Autumn Statement, it is quite possible that Chancellor Jeremy Hunt will be able to claim that inflation has halved under his and Prime Minster Sunak's watch, but it will probably still start with a five. One shoe that has not dropped is employment. The unemployment rate has ticked up from 3.8% to 4%, but that is as much on account of new prospective workers joining the labour force as people losing their jobs. Even so, the GfK measure of consumer confidence fell from -21 in September to -30 in October. This

was the largest monthly fall since December 1994 excluding the pandemic. The consensus growth forecast for 2024 is a measly 0.4%, which, if nothing else, suggests that the Bank of England will be hard pressed to raise the base rate any further than its current 5.25%.

Europe

Europe keeps threatening to go into a technical recession (consecutive quarters of negative GDP growth), but keeps just missing, so far, at least. Quarterly growth this year has been 0%, +0.2% and -0.1%. High energy prices have hampered industry and higher interest rates are holding back the consumer. The region's exposure to weak global trade is providing a current headwind, and that is most notable in the performance of Germany's economy. It also recorded GDP growth of -0.1% in the third quarter. One big problem for the country's flagship automotive industry is that it is fighting a wave of relatively affordable electric vehicle imports from China, whose manufacturers have stolen a march over their rivals, possibly thanks to some assistance from the government. Threats of tariffs or import quotas abound, but trade wars tend never to help either side in the end. More encouraging news has come in the form of better-then-expected inflation data. The headline annual rate in the euro zone fell from 4.3% to 2.9% in October, with the core rate at 4.2%. The market is increasingly convinced that the European Central Bank has finished raising interest rates, with the deposit rate topping out at 4%. Remember that it was -0.5% in the middle of last year. Indeed, the futures market is priced for it to be the first of the major developed regions to start to cut interest rates, starting in either April or June 2024.

Emerging Markets

All emerging market roads still tend to lead to China. Every scrap of economic data from the country has the capacity to produce large swings in commodity prices, especially. This is something of a Pavlovian response, possibly thanks to the prevalence of algorithmic trading models, based upon the historical key drivers of its economy – infrastructure and real estate. China's leadership is desperately trying to leave this old model of growth behind, partly out of necessity owing to the huge amounts of debt attached to it. The unwinding of years of speculative residential construction is weighing heavily on current activity as developers attempt to deal with their liabilities. This has already led to several defaults with more to come. The government would prefer growth to be driven by more sustainable consumption, but China's citizens appear unwilling to break a strong savings habit, especially given weak housing and stock markets and the traumatic experience of Covid lockdowns. China did report surprisingly strong year-on-year GDP growth of 5.2% in the third quarter, although there is always a degree of suspicion about the trustworthiness of such figures. The latest purchasing manager surveys, hovering around or below the crucial 50 mark that separates expansion from contraction, suggest a much weaker experience. The latest move by President Xi was to announce additional fiscal support to the tune of $137bn to be raised through the issuance of sovereign debt. That represented an unusual mid-year shift in the budgeted deficit from the targeted 3% of GDP to 3.8%. This demonstrates further intent to draw a line under recent economic underperformance, but still falls short of creating a strong lift-off. Lower interest rates are an option, especially with consumer price inflation non-existent, but lower interest rates would squeeze the banks' profits, and they are key to providing credit to the economy (as well as soaking up the bad debts of real estate developers).

Fixed Income

The Bloomberg Global Aggregate Dollar Index of investment grade bonds remains in negative territory for 2023 (-3.4%), and thus on track for a third consecutive year of losses, something that has not previously occurred since its inception in 1990. During October, the US 10-year and 30-year Treasury yields rose above 5% for the first time since 2007 as markets continued to adjust to a "higher for longer" interest rate policy stance and to higher levels of issuance. Even so, the higher yields available on investment grade bonds now offer better opportunities for safe income generation as well as being a more attractive risk diversifier in balanced portfolios. Once again, we emphasise the fact that selected short-dated Gilts offer risk-free yields of close to 5% with tax benefits

even when not held within tax-exempt wrappers such as SIPPs or ISAs. Low coupons mean that the taxable income is negligible. But the “pull to par” on maturity delivers a tax-free capital gain. They remain an attractive home for surplus cash savings.
UK Gilts have delivered a total return of -1.7% over the last three months and -6.5% over the last year. Index-Linked Gilts returned -5.5% and -12.5% over the same respective periods. Emerging Market sovereign bonds produced a total return of -1.8% in sterling over the three months to end October (+6.5% over 12 months). Global High Yield bonds delivered -1.5% (+5.3% over 12 months) in sterling.

Conclusion and Outlook

Investors have become used to economic and stock market cycles coming to an abrupt end defined by a major event, such as the financial crisis or the pandemic. The cycle was then almost equally as quickly resuscitated by central banks applying monetary defibrillators. This time, the central banks are deliberately withholding the current with a view to making sure that inflation is contained, and so everything is taking a lot longer to play out.

We continue to project that our next major tactical asset allocation shift will be to increase the equity risk weighting. This could be as a result of markets declining sharply in the face of tightening financial conditions and thus offering better value; or it could be because the outlook for economic growth, inflation and interest rates align in investors’ favour. At a time when many investors are tempted to turn their backs on traditional balanced portfolios, we are keen to emphasise that such a course of action could be poorly timed.

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