Fiske

Investment Commentary

Q2
2023

Overview

Notwithstanding the ongoing war in Ukraine, the main influence on investment markets over the past quarter continued to be levels of inflation and interest rates. Inflation rates have certainly moderated from the peak levels reached towards the end of last year. The rate has reached 4.0% in the US and 5.5% in the Eurozone, remaining more persistent – at 8.7% – in the UK. The question is what further action central banks need to take to return it to the target level of 2%. Interest rate decisions taken in June – no change from the US Federal Reserve, a rise of 0.25% from the European Central Bank and a rise of 0.5% from the Bank of England – reflect the different inflation rates prevailing in each economic zone.

Central bankers were surprised by the persistence of inflation. As a consequence, interest rates have risen at an unprecedented pace over the past year. The moves are intended to slow economies, even to the extent that they lead to recession. The time lag of the impact of higher rates tends to be 18 months or so, which means the larger part of the impact is yet to be felt. However, early signs are beginning to show in Q1 GDP figures. The US economy expanded by 2.0% (versus +2.6% in Q4 2022), the Eurozone fell by 0.1% (versus -0.1% – meaning it is technically in recession), and the UK rose by just 0.1% (versus +0.1%). Perhaps more concerning has been the very modest 2.2% rate of recovery in China following the abandonment of its harsh Covid regime at the end of last year. It was, of course, China's strong growth that helped the global economy recover after the financial crisis of 2008/09.

Other indicators for economies show a mixed picture. Manufacturing Purchasing Manager Indices have generally slipped into contraction, with the respective readings for June showing 46.3 for the US, 43.4 for Europe and 46.5 for the UK. The exception was China, which, at 50.5, just remained in expansionary mode. However, Services PMIs remain above the neutral 50 level, with the US at 54.1, the Eurozone at 52.4, the UK at 53.7 and China at 53.9. Employment numbers remain universally tight, which feeds into higher wage settlements, whilst spending remains elevated as individuals continue to benefit from savings stored up during the pandemic period.

The following table sets out the market movements for the past quarter.

Index	31/03/2023	31/03/2023	Change
CBOE UK 100	764	752	-1.6%
CBOE UK All Companies	13,358	13,132	-1.7%
CBOE UK 250	16,548	16,905	-2.7%
MSCI Private Balanced	1,701	1,692	-0.5%
MSCI Private Growth	1,880	1,891	0.6%

Market picture

Let us address the disappointing performance of UK markets first. An extremely disappointing inflation reading in May saw all the gains of the year wiped out when the main indices fell by over 5% in the month. Government bond (gilt) yields shot up, to levels last seen in September 2022 after the dreadful Truss mini-Budget, in anticipation of higher interest rates. Unsurprisingly, this unsettled equity markets. With global growth slowing, the composition of the main UK index is unhelpful. A 5% fall in the oil price over the quarter impacted large constituents BP (-10%) and Shell (+1%). Also, with several mining companies quoted in London, a near 9% fall in the sector had a significant impact. Both BT (-16%) and Vodafone (-17%) dragged the telecom sector back 16%, while housebuilders also fell as interest rates rose. The only significant beneficiary was the bank sector (+6%), although this was principally thanks to HSBC (+13%).

The strong performance of the American market indices continues to demand perspective. As mentioned last quarter, these markets have been driven by the mega-cap technology stocks. Apple's 18% rise in the period pushed its value back over $3trn – more than the value of the entire UK market. Between them, the six stocks gaining between 17% (Alphabet/Google) and 37% (Meta/Facebook) contributed over two thirds of the gain of the S&P 500 Index, perhaps suggesting a degree of exuberant overvaluation.

Elsewhere, the Japanese market, long considered good value, made an impressive gain as the authorities stuck to their guns on monetary policy. Interest rates remained unchanged at -0.1%, despite inflation rising to over 3%. The interest rate differential with Western economies has led to a sharp fall in the yen (-11.6% versus GBP, -8.6% versus USD), taking the shine off some of the market gains for non-domestic investors.

Outlook

The continuing rise in interest rates, with probably more to come, meant the UK government bond market fell over 6% during the quarter. Combined with the terrible performance last year (-25%), future returns on gilts have now reached a level where this becomes a viable asset class for investors. Particularly for higher-rate UK taxpayers, low-coupon short-dated gilts now offer redemption yields of more than 5% – with the majority of the return coming tax-free, as gains on gilts for UK investors are not subject to capital gains tax.

Meanwhile, following its underperformance and despite economic and political headwinds, the UK equity market looks very good value both in absolute terms and relative to other developed markets. As mentioned in previous reports, bull markets usually begin during or a little ahead of a recession and most often when the background news is at its worst. But timing the bottom of the market is nigh on impossible. Markets are discounting mechanisms, so for long-term investors it is important for portfolios to remain well positioned to capture the potential upturn when is comes.

July 2023

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