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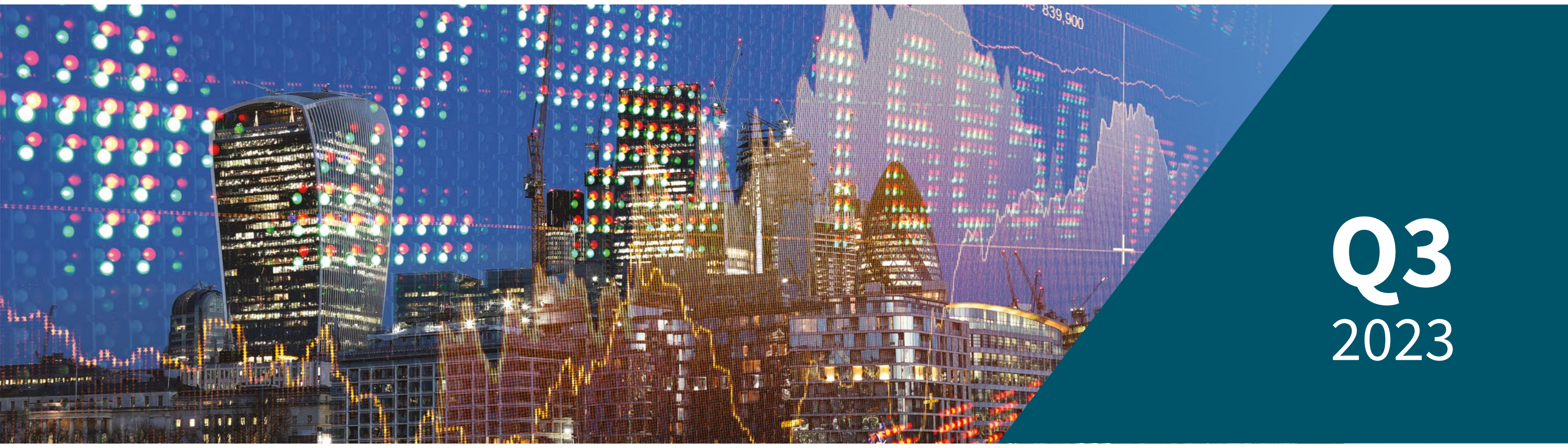
Investment Commentary



Overview

It is difficult to say that much has changed since our previous quarterly report. Inflation rates have continued to ease around the world – but by not as much as the authorities might have liked and certainly nowhere near target levels of 2.0%. In the US the inflation rate actually rose to 3.7% compared to the June level, while in Europe (4.3%), the UK (6.7%) and even Japan (3.2%) there is still work to be done. In the background, there is a chance of further spikes in inflation as the oil price is squeezed higher by OPEC restrictions and some soft commodity price rises due to Russian attacks on Ukrainian cereal exports.

In the face of these inflationary pressures, central banks have generally been pushing interest rates higher. However, in September most decided to hold fast while continuing with rhetoric to suggest they could go higher. As we mentioned last time, there is a time lag between interest rates going up and the impact on the economy – and that lag is only just expiring. While the market's current worry is "higher for longer", which has seen bond yields rise to levels last seen in 2007, any economic numbers that surprise on the downside will no doubt change the worry to "they've done too much" and recession is around the corner.

A mildly encouraging sign in the battle against inflation has been some easing of the employment numbers. Recent monthly non-farm payroll numbers in the US have come in below 200,000 (jobs created), which is the generally accepted level needed to maintain economic expansion[1]. In the UK, while unemployment has risen to 4.3%, wage growth (8.5% in July) remains too high.

The relatively modest change in most market indices over the quarter, as shown below, conceals a higher level of actual volatility just within a narrow range. Incidents such as credit rating agency Fitch downgrading US sovereign debt to AA+ seemed to have a disproportionate impact on the bond market – given that its two major competitors were already at this level. But the main swings, perhaps exaggerated by the summer months, are due to the rising and falling expectations for inflation and interest rates.

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

Index	30/06/2023	30/09/2023	Change
CBOE UK 100	752	761	1.2%
CBOE UK All Companies	13,132	13,266	1.0%
CBOE UK 250	16,905	16,026	-0.4%
MSCI Private Balanced	1,692	1,703	0.7%
MSCI Private Growth	1,891	1,903	0.6%

1. Since this note was prepared, the jobs number for September has shown 336,000 jobs created. The two previous months have been revised above 200,000, supporting the "higher for longer" interest rate argument.

Market picture

In what has been a dull period as far as market indices are concerned, the UK market has outperformed its international peers. A 22% rise in the price of Brent crude over the quarter has been a major factor as OPEC+ introduced production cuts to support the price. The oil sector was up 13%, with the two big index constituents, BP (+16%) and Shell (+11%), sustaining the market. Of the other major sectors, banks (+4%) did best, while pharmaceuticals (+1%) and telecoms (u/c) were unexciting. Utilities (-5%) suffered in the rising interest rate environment, while house builders (+11%) – already heavily beaten down – staged a rally. Mid-cap and small-cap stocks modestly underperformed, while the AIM market (-4%) continued a lengthy pullback.

In recent years, especially in the left-leaning press, a popular theme has been to portray the UK as the poor man of the developed world. Reportedly, most of the economy had underperformed. Yet at the beginning of September the Office for National Statistics (ONS) revealed it had miscalculated the performance by a full 2% since the Covid pandemic. As well as moving the UK up the G7 performance league, this meant the economy had expanded by 0.6% from its pre-pandemic level rather than having shrunk by the ONS's original call of -1.2%. Of course, this good news appeared only in the depths of the newspapers rather than on the front pages.

Among international markets, the US gave back some of its gains of earlier in the year while the technology-heavy NASDAQ (-4%) was the worst performer. So-called long-duration assets – those expected to deliver profits well into the future – are being squeezed by the higher interest rate environment as bond yields rise. The two-year US Treasury bond yield reached 5.0% at the end of the quarter, while the 10-year touched 4.6%. The Japanese market (-4%) pulled back over the quarter but remains well up for the year, while the European index was down 2.6%.

Outlook

Looking ahead, after more than a decade of negligible returns, bond markets are becoming investable once more. The recent rise in bond yields could well be regarded as a long-overdue normalisation. Interest rates are unlikely to fall back to anywhere near the artificially low levels brought about by loose monetary policies in the aftermath of both the global financial crisis and the pandemic. With inflation still of concern, within fixed interest markets we prefer short-dated maturities. Equity markets remain attractive for long-term investors. Valuations, particularly in the UK, are not excessive. Many mid-cap and smaller companies appear very undervalued. We would, however, avoid investment in over-leveraged companies or those whose business models are built upon cheap debt, as refinancing risks are growing.

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