MARKET COMMENTARY

Executive Summary

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With further evidence to support the notion that US inflation may have already peaked earlier in the year, the broad recovery across major asset classes continued through November.

The hope among investors is that, should this be true, then the current interest rate hiking cycle from central banks will surely soon slow and thus create a more normal environment for economic growth. There have been several other factors at play too – last month, I reported on the relatively robust corporate earnings season in the US, the much-needed stability in the UK political landscape and the switch in investor mindset away from the inflationary view that has dominated much of the year, to a more traditional recessionary one. This has also supported the recovery of the bond market, with the traditional return profile seemingly re-emerging after a difficult year-to-date. One additional driver of markets during November was the change of tack in China, with policymakers succumbing to public unrest following two years of strict Covid restrictions. Whilst a complete shift away from the existing zero-Covid policy seems unlikely in the near term, investors viewed the easing of some of the strictest rules as a step closer to a full reopening of the Chinese economy at some point next year.

Markets

Starting with global equities, developed markets returned aggregate growth of 7% for the second month running, following a strong October. As per last month, both 'growth' (that is those that are not necessarily profitable today but aim to be in the future and are thus generally more sensitive to factors affecting long-term cash flows and sales growth prospects, such as higher interest rate environments) stocks and their 'value' (those in the more cyclical and lowly valued areas of the market perceived to be underappreciated) counterparts achieved healthy single-digit returns. This brought their aggregate year-to-date returns to –

24.4% and –3.5% respectively. Another continuing theme from October was the relative recovery in both global small-cap stocks and global Real Estate Investment Trusts, with both participating in the broader equity rally. The standout performers among the major regions were Asian and emerging markets, buoyed by China's significant positive contribution to the index – a seismic reversal from October. Broadly speaking, there were gains across all major equity regions.

In the US, inflation figures came in at 7.7% (year-on-year increase), which although still high, represented a fourth consecutive month of marginal contraction. The US Federal Reserve (Fed) increased interest rates by a further 0.75%, which was in line with expectations and are expected to do so again by a further 0.50% in December. As I reported last month, their ongoing stance to focus predominantly on tackling inflation levels (rather than on any form of economic growth) is often poorly received by markets, however, given the inflation pattern and the fact that both US corporate balance sheets and jobs market have both seemingly been healthier than initially predicted, US equity markets have generally been receptive to the most recent rate increases. The upshot was strong, mid-single-digit gains in all three major US equity markets during the month, despite wider economic data remaining mixed. Whilst an increase in retail sales was recorded, there was further pressure on the US property market, with transaction rates in both the new and second-hand markets slowing again. Unemployment edged higher and productivity figures in both manufacturing and services industries also declined further, with the former again registering its lowest output since early in the pandemic.

In contrast to the US, Eurozone inflation continued to increase, with the announcement that prices rose to 10.6% during the previous month. Despite best efforts, the ongoing reliance on outsourced energy continues to weigh on the cost of living across the region. That said, there were signs of economic encouragement, such as a notable decrease in German producer prices as well as an improvement in manufacturing productivity across Europe as a whole. On aggregate, European equities returned 6.15% (for sterling investors) during the month. UK equities also registered another strong month, returning 5.71% across major markets. As investors tried desperately to gauge how deep the apparent recession will be, they welcomed the generally ahead-of-consensus economic data during November, such as growing retail sales and a marginal improvement in consumer confidence. That said, there was a sharp increase in UK inflation, to 11.1%, which surprised on the upside despite a 0.75% rate hike from the Bank of England (BoE) and the ongoing rhetoric from Chancellor, Jeremy Hunt, who vows to bring that number under control as soon as possible. You can read my reaction to his recent Autumn Statement on our website if you have not already.

Corporate earnings in Japan generally came in stronger than expected which along with the wider global equity rally, paved the way for another month of low-single-digit returns for Japanese equities. I reported last time on the Japanese government's efforts to keep national inflation below the 3% level, which despite no obvious change in policy, failed to contain the latest figures below 3.7% - the highest since the 1980s. In stark contrast to October, Chinese equities were the best performing of any major economy last month. Mounting pressure on Premier Xi Jinping to relax existing Covid policy appeared to at last be showing some signs of progress, with some of the strictest rules being eased and a renewed focus to vaccinate the elderly being introduced towards the end of the month. There was also an apparent easing of tension between Chinese and US governments, with a shared sentiment to improve relations between the two nations' leaders voiced ahead of the mid-month G20 summit in Bali. The subsequent market rally saw nearly all of September and October's cumulative losses in both Asia-Pacific and emerging markets recouped.

Fixed Income

Turning attention to the fixed income market, global bonds returned an average of 4.7% during November, with the relative recovery playing out widely across regions and the credit quality spectrum. In the US, both Treasuries and corporate bonds registered low single-digit gains, following the seemingly already priced-in interest rate rise from the Fed. The yield of the 10-year US Treasury (often seen as a yardstick for medium to long-term investor sentiment and growth prospects) declined from 4.05% to 3.61% (meaning prices rose), with the shorter-dated 2-year counterpart remaining uncharacteristically higher but declining to 4.34%. After a torrid year-to-date, UK Gilts were among the standout performers, particularly the Index-Linked market, which is still in recovery mode after September's volatility. There were also positive returns for sterling investors from other major regions, such as Europe, Japan and emerging markets. Broadly speaking, it was those longer-dated bonds with higher duration (that is, a higher sensitivity to changes in interest rates) that outperformed, as, among other factors, investors viewed the US inflation pattern as a sign that the Fed will no longer need to hike aggressively for too much longer.

And Finally…

In summary, November's gains across asset classes have been welcomed by global investors, despite being somewhat marred by the recessionary undertones surrounding the outlook for 2023. I wrote last month that markets appear to have been yearning for more stability and that perhaps some form of 'reset' is required before things can improve long term. One month on and it certainly appears that some semblance of normality could be on the horizon. However, we are mindful that there remains a large dislocation between consumer confidence and current consumer activity, with the former suggesting that we are far from being out of the woods just yet. Closer to home, the Office for Budget Responsibility recently predicted that real household income in the UK will be 7% lower in April 2024 than it was in April this year, compounded by a 1.5% contraction in GBP during 2023. The tone was all too familiar with the sobering predictions from both the BoE and International Monetary Fund I reported on last time. There are clearly many headwinds to overcome.

As for our own portfolios, last month I explained that we had taken the decision to take advantage of relative dollar strength and sterling weakness by introducing a position in a hedged US equity fund, which has benefited from the continued movement in FX rate, which finished the month at the £1: $ 1.21 level. After a successful move to shorten overall duration in Q1, we are also continuously monitoring our bond exposure, specifically with a view to lengthening this back out in favour of longer-dated assets. However, I note that there have been movements within our respective underlying fixed income positions, thus creating more of a top-down duration-neutral position for us. Despite November's broad rally, market conditions remain generally tough for many asset classes, with sectors of the commercial property and infrastructure space no exception despite the obvious diversification and income benefits from both asset classes. We remain hyper-selective about what we own and our exposure here is significantly lower than it was five years ago.

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