MARKET COMMENTARY

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Executive Summary

October proved to be a very challenging month for equity and fixed income investors alike, as rising bond yields and heightened global geopolitical tension weighed on markets. The US economy continued to surprise on the upside, with a strong jobs report, strong retail sales data and a knockout Gross Domestic Product (GDP) print of 4.9% annualised growth for the third quarter all reflecting the resilience of the world's largest economy. Investors might be forgiven for thinking this would be positive for US equities. However, recent positive news flow has gradually reinforced the 'higher for longer' narrative, reflecting a growing consensus that strength in the US economy will allow the Federal Reserve (the Fed) to maintain rates at or near their current level into the latter half of 2024.

Inflation

The Fed's commitment to its hawkish (favouring higher rates) stance remains driven by a commitment to bring inflation back to its long-term 2% target. Data released in October showed the headline Consumer Price Index (CPI) rising slightly through September, to 3.7% year-on-year, slightly higher than expectations. This was the third consecutive increase in headline CPI, largely driven by the recent uptick in energy prices. Core inflation, which strips out volatile items like energy and food, continued to fall, however a subtle rise in housing costs will give the Fed food for thought.

Back on this side of the Atlantic it was another bruising month for UK investors. September's headline CPI (published in October) came in at 6.7% for the second month in a row, slightly ahead of expectations. October's stubborn inflation numbers were blamed on higher energy prices, particularly for motor fuels, however elevated wage growth and sticky services inflation raise the prospect of rates remaining higher for longer here, too. The question investors will ask themselves is whether the domestic economy can weather higher rates in the same manner as the US. Higher rates already appear to be biting, with a sharp drop in

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consumer confidence and a fall in retail sales through September. There is a glimmer of hope for investors (and consumers), with last year's rise in the energy price cap falling out of the 12-month data in October – this is likely to produce a material decline in headline CPI when October's data is released later this month.

Mid-October saw the onset of a new phase in the long-running Israel/Palestine dispute, with Hamas militants launching a large-scale attack. Israeli government forces responded with air strikes and a ground offensive in the Gaza Strip. Initially, the unrest led to a sharp spike in oil prices, largely driven by fears that the conflict might spill over into a regional showdown with Iran. However, concerns that the unrest would fuel further global inflation proved relatively short-lived, as waning fears of further escalation saw the oil price subside once more (note that Israel herself does not have significant oil reserves).

Markets

Moving on to markets, where the US was the best performing major region despite a 1.6% loss (in sterling terms) for the large-cap equity index. Tech-heavy indices fared slightly better, with the 'growth' segment of the market outperforming its 'value' counterparts. The Japanese large-cap index fell 3.9% through October despite ongoing weakness in the Yen (which typically favours overseas investors). Even accounting for October's weakness, Japan remains the top performing major region year to date. Unlike other developed economies, the Bank of Japan (BoJ) has remained steadfastly dovish (favouring lower rates), with inflation hovering around the 3% mark this year after decades of deflationary pressures.

UK equities broadly underperformed, and it was an all-too-familiar picture for investors in smaller, more domestically orientated companies, as the mid- and small-cap indices suffered the heavier losses. Year-to-date, UK mid-caps lag their large cap peers by over 8%. That said, UK large caps were not immune to the market sell-off, falling to a 3.7% loss despite the high relative weighting to the energy sector. European markets were similarly downbeat, with aggregate equities giving up 2.4% through October. There are growing signs that last year's upheaval in the European energy market is beginning to weigh on the Eurozone economy, with bank surveys showing a contraction in credit supply to households and businesses, and the composite purchasing managers index (PMI) deep in contractionary territory.

Asia & Emerging Markets

Turning to emerging markets, where major indices were once again dragged down by the large negative contribution from China. Despite a string of more positive economic data, including upside surprises in third quarter GDP, industrial production and retail sales, Chinese equities slumped to a 3.7% loss over the month. Continued weakness in the real estate sector, as well as new US restrictions on Artificial Intelligence (AI) chip exports to China both weighed on overall sentiment. While China was the largest absolute detractor, there was little to cheer elsewhere, with India, Brazil and Taiwan also losing ground.

Fixed Income

With the direction of central bank policy still at the forefront of investor minds, the correlation of bond and equity markets remained elevated through October. The result was another very challenging month for the traditional 60:40 portfolio. The yield on the US 10-year Treasury exceeded 5% for the first time since 2007, despite the conflict in the Middle East (historically, investors have favoured US government bonds in times of uncertainty). The move was driven by aforementioned resilience in the US economy, as well as concerns that record high borrowing is eroding the long-term sustainability of government finances. UK gilts had a better month than their US counterparts, but still slipped to a muted loss – they remain the worst performing fixed income sub-asset class year-to-date. High yield bond markets have been the standout performers in 2023, supported by better-than-expected economic data. However, they lost ground in October, as spreads (the difference in yield versus a ‘risk-free’ asset (usually a government bond of similar maturity)) widened.

Commodities

The aggregate commodity index fell 2.8% through October, with gains in natural gas and gold not enough to offset losses for other major components, including oil and industrial metals. The standout performer was natural gas – European prices rose sharply due to fears about global supply chain disruption, exacerbated by the apparent sabotage of a gas pipeline connecting Finland and Estonia. Gold also posted a strong gain as events in the Middle East prompted a flight to safety, while aggregate industrial metals were lower on fears of weaker global growth.

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