THE FRY GROUP
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# Quarterly Investment Update

**APRIL 2023**

## A volatile start to the year

After the challenges of last year, investors hoping for a more sanguine start to 2023 were in for yet more surprises during the first quarter. Whilst equity and bond markets were largely positive, there was significant volatility, particularly over the months of February and March.

Investors initially had their focus firmly on central banks and their guidance on the path for interest rates. In January, data showed a meaningful year-on-year reduction in inflation and markets began to price in a more dovish response by the Federal Reserve. This view was quickly dismantled following February's US Consumer Price Index data, which showed an unexpected level of stickiness in the inflation data. Meanwhile, economic data continued to beat expectations and fears grew that central banks would need to keep interest rates higher for longer.

The focus on inflation and the direction for interest rates was then altered yet again in March, but for reasons that very few saw coming. A liquidity mismatch in the treasury book at US bank Silicon Valley Bank, and the UBS takeover of arch-rival, Credit Suisse, reverberated through markets. As the quarter ended, market expectations for the level of Fed funds rate by year end now stands at 4.25-4.5%, having been as high as 5.5% in early March, the view being that policymakers will not want to exacerbate problems on an already challenged banking sector.

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# Market Focus

### Global fixed income

After the pronounced sell-off across both sovereign and corporate bonds in 2022, the first quarter of 2023 saw yields narrow again, albeit not without significant bouts of volatility. In the US, the 10yr Treasury bond gained, with its yield falling to 3.42%. Inflation continued to dominate price movements, with January's optimism that the worst was behind us, giving way to renewed concerns about how persistent inflation might be. By the end of March, the personal consumption expenditures index (the Fed's preferred inflation gauge) rose less than expected to 4.6%, and yields resumed their downward trend.

The UK 10yr bond yield stabilised around 3.4% for the quarter, after a sell-off earlier in the month which had resulted in yields spiking to circa 3.8%. The Bank of England raised interest rates from 4% to 4.25%, after inflation rose unexpectedly in February. CPI inflation remains close to its highest level for 40 years at 10.4% in the year to February - more than five times the Bank of England's target.

In Europe, the month ended with the Eurozone recording its lowest levels of inflation in a year after a marked decline in energy prices, owing to a more mild winter. Consumer prices in the Euro area rose 6.9% in the year to March, reaching their lowest level since February 2022. However, core inflation, which excludes energy and food costs, hit a new Eurozone high of 5.7% in March, up from 5.6% the previous month. With this in mind, central bankers in the Eurozone have signalled that they will likely continue to raise rates in order to return inflation as close to their target 2% level as possible.

*Source: Trading Economics*

## EQUITIES MARKET

### United States

Aided by a drop in the 10yr Treasury Yield, US equities posted positive returns for the quarter, with the S&P500 returning +7% and the Nasdaq +17%. Not for the first time, a big component of the (broader sector) S&P 500's index returns also came from a select few well-known technology names, posting high double-digit returns. The central positive theme for the quarter was the drop in the long-term interest rate expectations that prompted growth sectors, such as technology and consumer discretionary, to perform strongly. However, challenges remain, including the more stubborn nature of inflation, especially given the still relatively tight labour market and elevated prices across the services sector.

### UK

The FTSE All Share returned +3.07% (Sterling terms) for the quarter, underperforming the US market, as the indices' bias to banks proved a headwind in the middle of March. Sterling strength through the three-month period also proved a challenge to the more internationally focused FTSE 100 businesses, whose revenues are typically reduced when translated back into the stronger pound. That said, a 3.07% total return is still encouraging, whilst the Spring Budget also provided an opportunity to highlight the Sunak government's fiscal prudence, which was largely achieved.

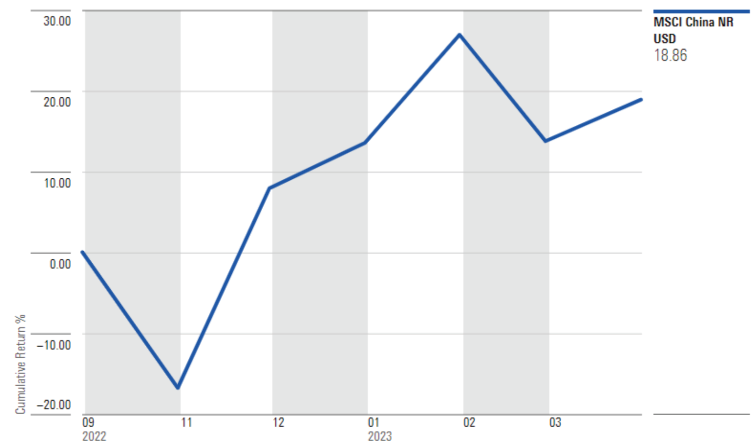
### Europe (excluding UK)

In Europe, despite ongoing rising interest rates and the severe challenges faced by the banking sector in March, economic activity also surprised on the upside, benefiting from falling energy prices and the resilience of the services sector. The flash Eurozone composite purchasing managers' index, a measure of activity in manufacturing and services, rose for the fifth consecutive month to a 10-month high of 54.1 in March, up from 52 the previous month and higher than economist expectations. The resilient performance of the Eurozone economy has boosted demand and kept price pressures elevated, contributing to the European Central Bank's decision to raise interest rates to 3.5% in March.

### Japan

Plenty of focus this quarter was on incoming Bank of Japan Governor, Kazuo Ueda, and his approach to the current accommodative monetary policy, including holding down yields on longer term government bonds, a feature of Japanese monetary policy for over a decade now. The challenge was made all the clearer as Japan's consumer prices rose at the fastest pace in forty-one years in February. Some larger Japanese corporations are also raising wages – in some cases by the highest level in twenty years – re-enforcing those inflationary pressures. A 3.5% return from the MSCI Japan (in US Dollars) for the quarter, but some potential challenges ahead, with markets likely to keep a close eye on Ueda's response to inflationary forces.

## Asia (excluding Japan)




*Source: Morningstar Direct*

The MSCI AC Asia ex Japan returned +4.34% (US Dollars) for the quarter, with China's re-opening, which began in December, bringing ongoing positivity to the broader Asia region. At the end of March, data showed that China's non-manufacturing sector activity expanded at the fastest pace in more than a decade, reaching 58.2 in March, up from 56.3. The Communist Party also appears to be taking a more conciliatory approach to previously out-of-favour sectors, including technology, recently approving plans to split up business units (eg Alibaba), which has been viewed positively by investors. More broadly, a weaker Dollar should be beneficial for the Asia Pacific region, whilst it is also likely more resilient to the banking crisis in the West. Further, inflation appears to be more muted in the region and interest rates have typically not risen as sharply there, putting less pressure on consumer demand.

## Currency

Dollar strength, which had been a feature of 2022 until the final quarter, continued to subside in the first quarter of 2023. Banking troubles in the US has lowered expectations for where US rates might peak, with a tightening of credit conditions expected to cool the economy in place of tighter monetary policy. Sterling, by contrast, has rallied 4.3% against the Dollar so far this year, helped by signs of resilience in the UK economy and inflation remaining elevated in February, at 10.4%. Political stability in the UK has also been a fillip for investors. In Europe, the Euro bounced back above $1.09 at the start of April, hovering around its strongest level in two months and following a 1.6% gain in March, amid expectations that the European Central Bank will keep raising interest rates in the coming months to combat still sticky levels of inflation.

## Commodities

Prices have normalised from 2022's elevated levels, particularly in the aftermath of Russia's invasion of Ukraine, but China's surprise re-opening at the end of December provided some upward momentum for certain commodities, particularly copper (+7.4%) and iron (+6.3%). We anticipate this trend to continue, albeit challenges lie ahead if we see a slowdown in Western growth.

Gold also benefited through the quarter, both as a geo-political hedge in light of the troubles across the banking sector, as well as the weaker Dollar, itself predicated off an expectation that central bankers would adopt a more dovish approach to monetary policy towards the end of the year.

For a large part of the quarter oil was lower, affected by the US government's decision to delay rebuilding its strategic reserves, whilst also a concern over increased supply coming from Iran. That said, at the start of April, OPEC announced a surprise cut in production numbers, with Saudi Arabia, Iraq and several Gulf States saying that they would cut output by a combined more than 1m barrels per day. This could complicate the outlook for inflation, particularly if it proves more persistent as a result of this move.

## Conclusion

Despite some optimism that we might be approaching the end of monetary policy tightening across Western economies, challenges remain and the outlook is far from certain. The problems that afflicted the banking sector in the middle of March only highlight some of the risks that built up through over a decade's worth of easy monetary policy, and there could yet be more surprises, areas of concern currently being around commercial real estate.

If inflation does prove more stubborn, then investors may be forced to alter their expectations on the path of interest rates, which could have a destabilising effect on what has so far been a positive start to the year. OPEC's recent decision on cutting oil production may be one such catalyst for this.

Despite this, we know that monetary policy will unlikely remain as restrictive by the end of this year, which should lend support to equity markets, and particularly those sectors that bore the brunt of last year's sell-off. Further, emerging markets continue to look attractively valued, particularly given that China is still only emerging from its zero-Covid approach. This should support global demand, particularly across the Eurozone, which has typically been a beneficiary from the Chinese consumer.

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