THE FRY GROUP
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Quarterly Investment Update

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Persistence of inflation adds to challenging backdrop

Overall, the third quarter of 2023 saw global equity markets decline. Inflationary pressures across major developed economies added more impetus to central bankers' 'higher for longer' narrative.

China, Japan and Europe stock markets were also pulled lower over the quarter. However, the UK market was up circa 2% due to its defensive characteristics, commodities bias and the unexpected decision by the Bank of England to keep interest rates on hold in September.

Entering the final quarter of the year, the focus will likely remain on employment and wage data. These are both key indicators of underlying economic strength and therein the potential for inflation to remain problematic. The direction of oil, prices for which rose sharply over the quarter and which continues to face a number of supply-side challenges, is also a key contributor to inflation levels.

Whilst volatility will undoubtedly remain in these final three months as financial markets continue to digest a tighter monetary policy backdrop, from an investment perspective, dialling out the noise and remaining focused on the longer-term time horizon is crucial and has historically proved to be the best course of action.

Charlie Buxton
Head of Investment Management
E.charlie.buxton@thefrygroup.hk

Market Focus

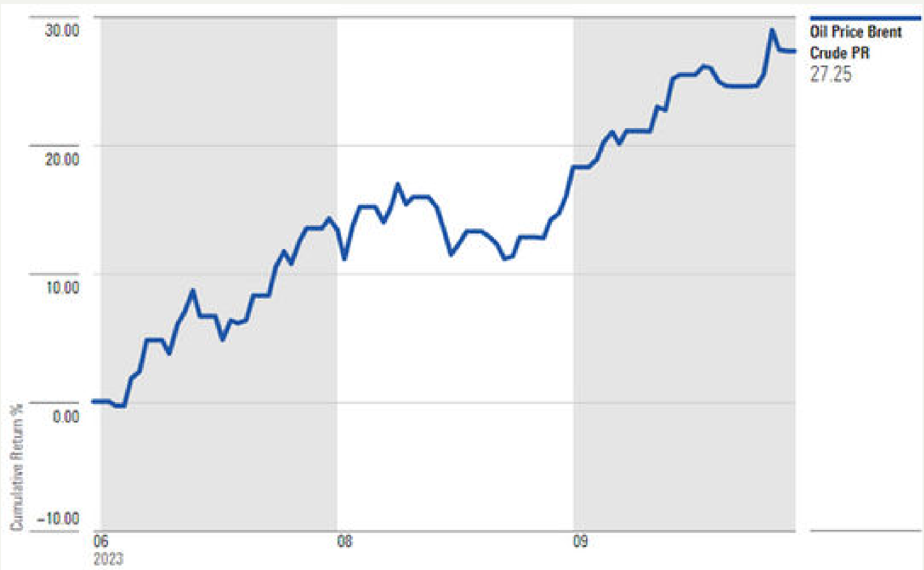
Global fixed income

Fixed income continues to be challenged, with the broad index of government and corporate holdings down c. 3% year-to-date (US Dollar). The persistence of inflation has been an ongoing feature of the year, with a buoyant US jobs market, strong wage data and resilient consumer spending.

The strongest returns have come from the high yield market where spreads have been less sensitive to interest rate changes and defaults have not yet materialised in large numbers. Corporate bond investors have generally supported bonds with better credit quality, and fixed interest managers seem more likely to favour this area of the market for the time being, especially if the global economy starts to deteriorate.

As central banks continue to talk about keeping rates higher for longer, bond yields are likely to remain elevated, although it is likely that at some point soon economies will start to feel the impact of this, potentially triggering a recession. Whilst it is unclear when or how deep that might be, in this scenario markets may begin to price in a softer outlook on rates, thereby helping to eventually lift bond prices.

OIL ADVANCES OVER THE QUARTER



Data Source: Morningstar Direct

EQUITIES MARKET

United States

A reversal of fortunes saw the leading technology names - which had spearheaded US returns for the majority of the year - fall, whilst oil majors picked up as concerns mounted over cuts to production by Saudi Arabia and Russia. The US unemployment rate was at 3.8% in September, remaining slightly above market expectations of 3.7%. This confirmed growing evidence that the labour market remains tight by historical standards, allowing the Federal Reserve to leave borrowing costs at restrictive levels for a prolonged period. This may well continue to challenge equity markets.

UK

UK equities rose over the quarter. The large UK-quoted energy and basic materials groups outperformed, as they rebounded from weakness in the previous three-month period. They benefited from Sterling weakness against a strong Dollar, whilst a sharp recovery in crude oil prices buoyed the energy groups. UK equities still trade on low valuations and if a scenario emerges where the economy avoids recession, yet inflation decelerates towards target, the prospects for UK domestic shares look more positive.

Europe (excluding UK)

European shares fell in Q3, amid worries over the negative effects of interest rate rises on economic growth. Support to growth from lower energy prices is also starting to fade. Sharp declines came from the consumer discretionary sector, given concerns over the knock-on effects of higher interest rates on consumers' disposable income. However, data released at the end of the quarter showed eurozone inflation slowed to a two-year low of 4.3% in the year to September, down from 5.2% in August, potentially paving the way for a more dovish stance from the ECB.

Japan

The Japanese stock market continues to perform well this year, with ongoing accommodative monetary policy, despite some signs that price pressures are picking up. Whilst this has continued to weaken the Yen, it has helped exporters and the equity market more broadly. Along with corporate reform, share buybacks and strong earnings, this will likely continue to keep it well supported.

Asia (excluding Japan)

China continues to concern investors, with the heavily indebted property market and the failure of some of its biggest developers within it, having a knock-on impact on broader markets. This, coupled with a slower-than-expected rebound post Covid, has impacted the demand picture both from within and also those Asian countries heavily dependent on its trade. Although China's official PMI manufacturing index rose in August, it marked the fifth straight month of contraction as the reading remained below the 50-point threshold. India continues to perform well and is benefiting from investors' rotation away from China, whilst it also has a strong and increasing internal growth dynamic.

Currency

By the end of the quarter, Sterling dropped to $1.214, its fifth consecutive weekly decline, driven by the perception of a growing interest rate gap between the US and the UK. This stems from the stronger-than-expected US economy, leading to market expectations of further interest rate hikes in the US, with the Bank of England potentially nearing the end of its tightening cycle. Supporting this view, retail sales in the UK rose 2.8% on a like-for-like basis in September 2023 from a year ago, slowing from a 4.3% gain in August.

Commodities

Brent Crude rose 27% over the quarter (see chart above), following the announcement that Saudi Arabia and Russia will extend voluntary oil output cuts through to the end of the year. Higher oil prices not only threaten to pressure consumer spending but could also prove problematic for central banks if headline inflation begins to reaccelerate. Elsewhere, gold was down 2% for the quarter, impacted by rising interest rates and a stronger Dollar, after ongoing hawkish narrative from Federal Reserve members.

Conclusion

The world economy continues to do slightly better than expected, with economists bumping up their forecasts for growth this year and next in the US, Japan and the UK. This is less so for Europe, whilst downgrades are widely expected for China.

One argument for keeping global interest rates higher for longer is the circa 20% rise in the price of Brent Crude oil over this quarter. This reflects expectations of continued limits on supply by OPEC and the relative strength of the US economy.

Whilst equity and bond markets continue to struggle in the current environment, weighed down by the higher cost of capital and unknown outcome of eighteen months' worth of rate rises, it is possible that we are nearing peak rates and a bottoming out of the equity market. At current levels, following a challenging third quarter, both equities and bonds now represent more attractive value and whilst the road ahead will likely continue to be challenging, the longer term and empirically-supported case for investing in the stock market remains.

HEAD OFFICE (UK)

The Fry Group, Crescent House, Crescent Road,
Worthing, West Sussex BN11 1RN

T.+44 (0)1903 231545
E. enquiries@thefrygroup.co.uk

HONG KONG
E. info@thefrygroup.hk

SINGAPORE
E. info@thefrygroup.sg

BELGIUM
E. info@thefrygroup.be

DUBAI
E. info@thefrygroup.ae