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Quarterly Investment Update

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A much-awaited turnaround in inflation

Equity and bond markets both returned positively in the fourth quarter of 2023 - a welcome relief after the sharp sell-off of the previous quarter - as several data points across the US and euro area pointed to lower year-on-year inflation levels.

Across the US, the year-on-year consumer price index, which includes food and energy costs, fell to 3.1% in November. Equally, both Euro Area and UK year-on-year inflation also fell markedly, at 2.4% and 3.9% respectively.

The data, supported by more dovish rhetoric from members of the Federal Reserve, suggested to markets that interest rates might now be at peak level, with some participants now even expecting cuts to come as soon as March 2024.

Whilst it is of course encouraging to see inflation returning to closer to central banks' 2% target, there are potentially still a number of risks at play - not least conflict in the Middle East – which could challenge the recent downtrend in inflation. It is also worth noting that over half the world's population goes to the polls this year, making it the biggest election year in history, and keeping the potential for geo-political risk firmly at play.

If the last two years have taught us anything, it is to expect the unexpected and to keep diversification at the forefront of portfolio construction.

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Market Focus

Global fixed income

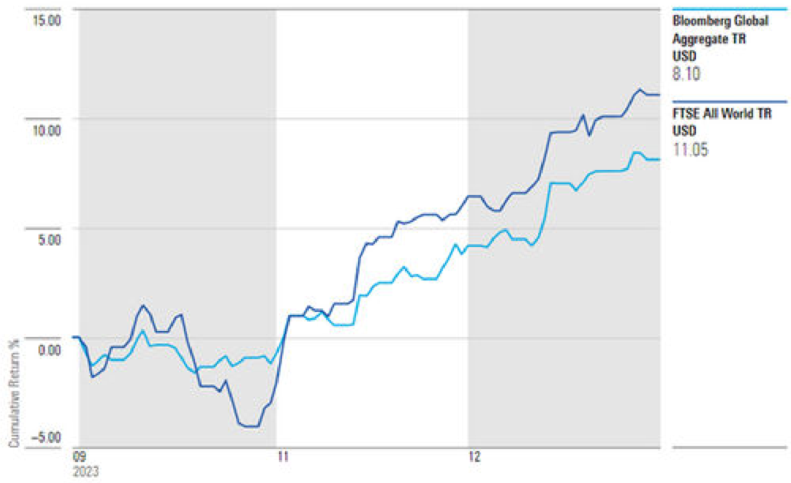
For much of 2023, bonds were challenged by the persistence in inflation – particularly within the services sector – and the strength of the US economy, which showed no signs of slowing aggregate demand.

However, towards the end of the year data showed a clear downtrend in year-on-year inflation, coming alongside a 'dot-plot' of members' expectations as to where rates will be at the end of 2024, indicating that they expect three quarter-point cuts by this point.

This helped to lift the broader bond index of government and corporate debt by 8.1% (USD) for the quarter, particularly helping portfolios which had greater duration (interest rate) sensitivity. Having peaked at 5% in November, the US 10Yr Yield finished at 3.88%, clearly benefitting from investors' revised outlook on the direction for interest rates.

UK Gilts also benefitted from an uplift in prices, as a majority of investors predict at least five quarter point reductions next year. Gilts are also benefitting from some fears of a recession in the UK, with consumers feeling the brunt of higher interest rates more than their US counterparts.

Equities and Bonds rebound from October lows



Data Source: Morningstar Direct

EQUITIES MARKET

United States

A strong final quarter of the year for US equities, with its leading index returning +11.6% (USD) reflecting the revised outlook for US rate policy, which lifted most company names. At sector level, technology was the clear outperformer (+17.5%), as it was throughout the year (+53.3% for 2023), with the focus on artificial intelligence – and those companies at the forefront of it – helping to propel returns. Fourth-quarter earnings season starts in January, and analysts expect modest growth, with consensus estimates for 2.4% earnings growth across S&P500 companies. As was clear throughout 2023, misses on these forecasts can significantly hurt share price performance and after the stellar rally of 2023, valuations could be vulnerable.

UK

UK equities rose over the quarter, albeit there was a clear difference between its large-cap focused index (+2.3%) and that of the mid-cap focused index (+8.6%). The UK's relative underperformance to other indices was not helped by the prospect of lower commodity prices and earnings deterioration in key sectors such as energy and healthcare. Whilst the Office for Budget Responsibility (OBR) forecasts a sluggish 0.7% GDP rise for 2024, valuations for UK equities look attractive at 15% below their long-term average, whilst it is also worth remembering the larger UK index's more defensive allocations to sectors such as consumer staples, which served it well through 2022.

Europe (excluding UK)

Europe's leading index returned +6.4% (EUR) for the quarter, helped by eurozone inflation dropping to 2.4%, its slowest annual pace since July 2021. This supported the view for six rate cuts by the ECB for 2024, providing a clear potential fillip for investors. Within the eurozone, Spain's economy and stock market continue to outperform, boosted by strong growth in services. That said, overall economic growth in Europe remains weak with GDP estimates for 2023 expected to show just 0.6%. The growth rate is expected to rise slightly to 0.8% in 2024 according to European Central Bank, albeit lower GDP output should support the case for aforementioned rate cuts.

Japan

Another strong quarter for Japanese equities, which returned +8.2% (USD) and finished a remarkable year (+20.8%). Of particular note was Japan's decision to incentivize listed companies to boost valuations and earnings, with the possibility of delisting for firms that fail to show efficient capital allocation. With greater focus on corporate governance and shareholder-friendly policies, there is certainly room for further optimism - the one caveat being if the Bank of Japan's ultra-loose policy turns, which could result in a stronger Yen and potentially impact the country's exporters, which have benefitted from a weak currency up to this point.

Asia (excluding Japan)

China continues to struggle, particularly after the optimism following its reopening at the start of 2023. Investor concern focuses on its heavily indebted property sector, sluggish recovery post Covid and high youth unemployment levels, coupled with a lack of meaningful stimulus from the government. Three-month performance for its leading index was -4.4% (USD), albeit the broader Asia ex-Japan index returned +5.9%, with India again helping to support those returns, delivering +11.9% for the quarter. With expectations high that the business-friendly Narendra Modi will secure another term as Prime Minister at this year's elections, there could yet be further upside for the equity market.

Currency

Despite forecasts for a weaker Dollar through 2023 – in part owing to a significant rise in the indebtedness of the US alongside net selling of Treasuries by Japanese and Chinese investors - this only actually materialized in the last quarter of the year, as markets anticipated rate cuts from March 2024. Sterling, in turn, strengthened relative to the Dollar through the final quarter of 2023, as investors anticipated a divergence in central bank policy between the Federal Reserve and the Bank of England, with the latter possibly forced to keep rates higher for longer owing to more embedded inflation levels.

Commodities

Gold returned +10.2% for the quarter, helped by rising tensions in the Middle East and a more dovish outlook on US rate policy. For the year, the precious metal returned +13.7%, proving its value within a diversified portfolio. After a volatile 2022, in which Brent Crude Oil had surged to above $100, it closed out 2023 at $76.64. Ongoing concerns around the health of China's economy, alongside concerns about oversupply, led to lower price levels.

Conclusion

Despite a strong end to the quarter for risk assets, it belies what was for the most part a challenging 2023. It is of course encouraging to see data that points to a downtrend in inflation, which should help to ease the pressure on households and consumers. However, it is also worth heeding some of the lessons from earlier in the year, when investors positioned for such an outcome found themselves wrong-footed by its persistence and durability. On balance, it would appear that we are now at 'peak rate' levels and that central banks should be able to begin cutting rates this year, although we would caution that some expectations – eg for March – seem optimistic, particularly given the ongoing strength of the US labour market. With this in mind, strategies which continue to be well diversified by including non-correlated asset classes, should hold up well if the same volatility that hurt markets for much of 2022 and 2023, continues into the early part of 2024.

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