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Investment review – End Q3 2023

September 2023

It has been a tricky quarter for the world economy and global markets, which have remained preoccupied with the near-term outlook for inflation and interest rate policy. August was particularly volatile, but stock and bond markets have subsequently regained some composure to make modest headway over the summer months, with sterling-based investors aided by some currency gains on overseas investments after the pound's relative strength began to reverse.

Although we appear to be nearing the endgame of the current period of tight monetary conditions, with inflation now falling and two key central banks having recently paused their rate-hiking cycle, the micro-analysis of central bank actions and economic data releases continues to cause quite a twitchy market scene. Standing back from all the short-term noise, however, we are hopeful that a clearer, and more favourable, backdrop for longer-term investing should begin to appear soon.

Global growth more resilient, but short-term weakness in data expected

One key, complicating factor for markets in recent months has been economic growth. This has actually been more resilient than many forecasters, including central banks, had expected. In the USA, for example, talk in the early part of this year was all about the recessionary conditions that major economies like the US would be facing by now. It has not materialised, and if anything forecasts for economic activity for the whole of 2023 and 2024 have generally been upgraded slightly. Even the generally cautious Organisation for Economic Co-operation and Development ('OECD') has revised upwards its assessments for growth in most regions for the whole of this year.

A disproportionate share of global growth is still expected to emanate from Asian economies, despite weaker growth from China, but it is still encouraging to see forecasts of economic *growth* – albeit quite modest in some areas – rather than decline for both this year and next, and for overall levels of global economic activity to be not too distant from those seen immediately prior to the pandemic. Estimates for global gross domestic product growth in the 2.5-3% range seem attainable and would be at a level that should provide a good backdrop for investment risk-taking.

To us, this does not therefore seem to be the time to be battening down the hatches, although we accept that some patience is still required whilst the impact of high inflation and tighter monetary conditions works its way through the global economy. For the next few months we are likely to see poorer economic data, and possibly technical recessions, as the consequences of this year's higher interest rates and last year's energy crisis finally catch up with consumers and businesses that had hitherto been feeding off accumulated pandemic savings or lower rates of fixed finance. There are already signs of weakness in both housing and labour markets, for instance. All of this should help inflation ease further. In the USA, consumer price inflation has already fallen to 3.7% and in the eurozone it is now a touch over 5%. When Rishi Sunak made his pledge in January that UK inflation would halve by the end of the year, the published reading at the time was the November 2022 figure of 10.7%. The latest number for August is 6.7%, whilst core inflation (excluding food and energy) has retreated to 6.2%. With the way things are going, and a few more readings to come, there is a sporting chance that the Prime Minister's somewhat flaky promise will be met.

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Close to the tipping point for monetary policy

It seems clear that we are now entering a new phase and getting very close to the tipping point for central bank policy. At their latest meetings, both the US Federal Reserve and Bank of England's Monetary Policy Committee have paused on rate hikes. In the case of the UK, this ends a straight run of 14 rate rises since December 2021. Both central banks have left the door open in their messaging to raise interest rates again between now and the end of the year but, increasingly, it seems we will soon be entering a welcome period of pause followed by a meaningful loosening of the currently tight money belt. The latest interpretation from policymakers' voting habits and messaging is perhaps to expect a lengthier period of peak interest rates than initially forecast (i.e. rates perhaps not actually *falling* until the second half of 2024), with central banks erring on the side of caution before reducing them. But the direction of travel does, at last, now seem to be changing and, increasingly, it should breathe some new life into those investments ravaged by a high inflation and elevated interest rate environment.

High oil price could complicate things

As noted, policymakers are likely to be wary of acting too quickly before changing tack. One spanner in the inflation works could be the oil price, which has risen by around 30% since late June. It is higher not because global demand is now booming again (it is not) but largely because of the Organization of the Petroleum Exporting Countries' ('OPEC') cuts in production. Seeing the price of oil approach $100 again, to a similar level seen last summer, will make central banks nervous about their inflation projections and monetary policy stance. But more encouragingly, they will also observe the sharp fall in natural gas prices, helped in part by European gas storage levels, which already exceed 90% of capacity a few months earlier than expected in preparation for the higher demand season. Even if we see a harsher winter than last year, Europe's energy market certainly seems much better prepared to withstand further supply restrictions and increased demand, and therefore energy price movements, like we saw last year, will hopefully not be so influential on inflation and central bank policy as they have been over the past year or so.

A different playbook on the way down

As has become evident, containing inflation and setting appropriate policy has been a struggle for many of the world's central bankers, who first needed to confront the inflationary squeeze from post-pandemic reopening and supply-chain bottlenecks and then the energy-related spikes after the outbreak of war in Ukraine. It has not been what one might call a conventional inflationary period, with the monetary policy response necessarily requiring adjustment somewhat on the fly. As policymakers begin to mull over their next steps, they will at least have learnt quite a lot about the efficacy, or otherwise, of monetary policy on their respective economies.

In the UK, for instance, higher interest rates seem to have had little effect, so far, in arresting the surge in wage growth in what is a more service-orientated economy. This information may help the rate-setting authorities over the coming months as they pause and then unravel this tightening phase, but the playbook will not simply be everything in reverse. The speed with which (and extent to which) policymakers manage or need to unwind their restrictive stance will largely depend on how entrenched certain near-term inflationary influences have become, whether or not we have another energy-induced spike this winter or if there are other global events that take economies in an unexpected direction. The risk of policy error is therefore likely to remain just as high when interest rates retreat as it has been on their way up, but that does not mean the opportunities for investment will be any less.

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On the contrary, even if the path is uneven, the likely direction of travel for investment in both equity and bond markets should look more favourable once the rhetoric begins to shift, as it is starting to right now.

Adjusting to a new normal

Overall, the speed with which central banks take off the policy brakes is likely to be slower than the timeframe over which they have been applied. Unless the economic damage from restrictive policy gets really bad, which we do not envisage at this stage, the chance of returning to the zero or ultra-low interest rate regime we saw during the pandemic seems remote. More likely is a period of relatively low, single-digit inflation and moderate levels of interest rates – the kind of backdrop that should actually help weed out some corporate and consumer indiscipline when it comes to lending or borrowing, allow pricing power and competitiveness to return for businesses and make us all think a little more about the cost of capital. It is not a period we should fear as it should provide a reasonably conducive environment for savers, borrowers and investors alike. The adjustment to a new base level of inflation and interest rates will, however, still require some changes in mindset, as well as care.

More conventional fixed interest

With central banks likely to act with some caution when they eventually begin to pivot, any hesitancy could in itself become an unsettling factor for markets and investment decision-making. But it is also likely to create opportunity for agile investors. For example, we see the next phase of the monetary cycle, in combination with the expected path for global inflation, as providing a more favourable backdrop for investment in bond markets. We have already made changes to our positioning in the early part of this year and are now taking steps to remove some additional defensive elements, particularly for mandates lower down the risk spectrum, which typically have higher exposures to bond markets, including allocations held via 'alternative' investment funds. We see less need for some of these defensive components now that the inflation and monetary scene is changing, preferring instead to make more conventional fixed interest investments that can take advantage of current high income yields and are capable of capturing more of the potential upside as interest rates begin to retreat. This planned activity will involve an increased allocation to investment grade corporate bonds, where yields relative to equivalent government bonds still sit at the upper end of their historic ranges.

Equity market opportunities

The tool that has been used to control and contain inflation will soon become one that can prevent economies slipping into a deep decline and, ultimately, some stimulus to growth. Therefore, a more productive return period from stockmarkets should not be too far off. Following resilience in corporate profits this year and projections of a good rebound in 2024, stockmarket valuations are generally undemanding and remain below their longer-term averages, particularly in Asia and Europe. So, whilst markets could remain on edge between now and the end of the year, we believe patience will be rewarded. When the cost of capital begins to fall, as we expect it will over the coming months, the upswing, particularly in the more neglected parts of individual stockmarkets, could be quite marked and it should tempt a wider investment audience to come off the fence.

Optically, the US market seems the most overvalued global stockmarket, but even this market has plenty of scope to deliver attractive returns for investors. The plentiful supply of investment opportunities amongst a vast number of listed US securities is one of the reasons why we are comfortable retaining good exposure to the US stockmarket.

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Stripping out some of the US index heavyweights, the valuation of medium- and small-sized US companies, many of which have market capitalisations way higher than those companies listed in Europe, are barely any different from their international peers. Active managers, typically paid to take decisions that differ from the mainstream market indices, tend naturally to have a bias towards medium- and smaller-sized businesses. Such companies have been out of the limelight somewhat of late, but as the inflation and interest rate cycle turns, they are likely to come back into vogue. We feel well positioned through our range of active managers to participate as markets re-focus on where the latent value is lying, whether it be by allocating to companies further down the market capitalisation spectrum or to different style biases to capture opportunities in an altered inflation and interest rate environment.

Artificial intelligence – the next revolution?

A big influence on market returns in the year to date has been technology stocks, in particular those directly involved with, or seen in some way as being a big beneficiary of, the growth in use of alternative intelligence ('AI'). There have already been some significant share price gains for the pioneers and early innovators of AI, and these could yet see further upside as AI technology scales and adoption becomes more mainstream. Some analysts argue that the far-reaching applications and disruptive nature of AI should be likened to the way in which the railway and desktop computer changed economies in their time.

The potential uses of AI could be enormous, potentially benefiting a diverse range of sectors including (in no order of importance): manufacturing automation, efficiency and quality control; transportation and logistics; optimisation of energy consumption, grid management and renewable energy; advancements in healthcare, such as diagnosis, personalised treatment and drug discovery; crop management and pest control; education; finance, including fraud detection; cybersecurity; retail inventory management; customer service and support via chatbots or online assistants; tailored entertainment and virtual experiences; legal research, contract analysis and document reviews; data analysis to aid environmental conservation, monitoring and the protection of ecosystems; human resources, including hiring, employee engagement, training and talent management. This is by no means an exhaustive list, but it gives a flavour of how penetrative and influential AI could become in the global economy. Our conclusions are that AI is a very broad but important theme that we cannot ignore, and which is deserving of a more dedicated allocation.

Time will tell how AI ultimately impacts, both positively and negatively, economic growth, productivity and the livelihood and lives of generations to come. However, it is gaining momentum and its increasing adoption and the revolution that it has the potential to create is something we believe should be embraced. The active managers we use in different parts of the world are already talking about investments they have made either in the enablers of AI or those companies which have begun to adopt it. Some managers are only scratching the surface though, so our intention is to make a more dedicated allocation to this global theme via a specialist manager. Our aim is to gain access not just to today's, principally technology-focused pioneers, but also to a broad sub-set of companies that are likely to be at the forefront of AI enablement, adoption, reform and disruption – both young and old companies that are creating business efficiencies or adding incremental value to their top and bottom lines.

Undoubtedly, there will be both leaders and laggards as this 21st-century 'revolution' unfolds: the pace of change will not necessarily be as rapid or uniform as we have seen in these very early stages, but our hope is that through active managers, including more dedicated specialists, we can give clients access to plenty of longer-term AI beneficiaries and wider growth opportunities, whilst avoiding many of those businesses that are slow to compete as technologies continue to evolve.

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Risk warnings

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