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Investment review – End Q4 2023

December 2023

A great deal has been thrown at the world economy and financial markets during 2023 and for much of the year it has been a struggle to make headway, despite some best laid plans. However, it is pleasing to close out the year on a much more upbeat note, with positive returns having been made from a variety of asset classes and wider market confidence returning.

The challenges faced this year by businesses, consumers and investors have been both numerous and diverse: a further period of rising interest rates has stretched the finances for many, particularly those who have sought to take on – or faced the renegotiation of – debt; a more resilient US economy and sticky price and wage inflation in other areas has delayed central banks' interest rate pivots; in March, the threat of a regional banking crisis in the US and the failure of one of Switzerland's flagship financial institutions prompted fears of another banking crisis; China grappled all year with structural challenges, weaker economic growth and contributed to tensions that have restrained capital flows within the wider Asian region; central bank actions and their oscillating loose and tight-lipped rhetoric has, until very recently, induced market volatility; and a new conflict in the Middle East has added to the geopolitical risks already present from the ongoing Russia-Ukraine war. This is by no means an exhaustive list of factors impacting investor sentiment in 2023, but it does illustrate the diversity of some of the issues and influences confronting markets and investment decision-making. Several of these remain unresolved as we head into 2024, and no doubt there will be new ones to exercise our grey matter, but hopefully the picture on key matters such as the outlook for inflation and interest rates will gain increasing clarity and carry improved market optimism well into the new year.

'Higher for longer' has required patience

As noted, the year just ending has seen some testing periods of market nervousness and several false dawns, yet we have come through it in quite good shape. Savers have been rewarded with some increasingly healthy returns from cash deposits, whilst longer-term investors have ultimately benefitted from staying invested through the difficult parts of the year – this has allowed good participation in the sharp recovery in both stock and bond markets in the closing weeks of 2023. Only very recently does it feel as though the tide has really begun to turn, but the sharp rally in a variety of asset classes since early November has been both very welcome and somewhat overdue, restoring respectability to returns for the year as a whole.

It is difficult to put one's finger on a single factor that has altered the mood music, but weaker US inflation and jobs data has certainly altered the language emanating from the US Federal Reserve ('Fed'), increasing the likelihood and scale of interest rate cuts in 2024. But our action taken earlier in the year to lengthen the maturity profile of fixed interest investments in anticipation of an eventual loosening of monetary policy has required some patience. For instance, the summer's 'higher for longer' narrative – the prospect of higher inflation and higher interest rates for longer owing to a more resilient US economy – certainly put a dampener on bond market sentiment and has delayed the harvest of ideas sown earlier in the year. At last, that patience is being rewarded.

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Pandemic savings have cushioned the blow

After a difficult year for corporate earnings growth in 2023, analysts' forecasts for 2024 are more encouraging, being aided by the expectation of lower levels of inflation and the reduced cost of investment capital. But we do need to be alert to downward earnings revisions if inflationary pressures linger and cause sluggish consumer spending. One factor propping up the US economy during 2023 has been the willingness of consumers to spend savings accumulated during the pandemic. In Europe, however, consumers have been more reluctant to deplete their coffers: if this continues, and other global consumers follow suit, there is a chance that earnings forecasts will need to be pared back.

Dominators must continue to deliver the goods

The current cross-over period between tight and loose monetary conditions should increasingly become supportive for risk assets. But it will be important to keep a close eye on both the quality and durability of corporate profitability, as well as the valuation at which shares are trading relative to the growth in earnings they are realistically likely to deliver.

As we have mentioned before, global equity market returns have been hugely distorted during 2023 by the performance of just a small handful of (principally US-listed 'mega cap') shares. Their stellar returns are in stark contrast to the thousands of companies representing the manufacturing and service-based heartland of the global economy that have made much less progress. The multiple of current profits at which the share prices of the now aptly named 'Magnificent Seven' (Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, Nvidia and Tesla) trade is around 50 times, not dissimilar to the levels reached by some of the 'Nifty Fifty' stocks of the 1960s and 1970s, such as Coca Cola, McDonalds, IBM, Polaroid and Xerox. This group of yesteryear's market dominators exhibited a similar pattern of exceptionally strong earnings growth and hence traded at similarly fancy multiples of their earnings. If the pace of profits growth is maintained, then today's heady multiples of future profits can be justified and all will be well: as things currently stand, we certainly expect many of today's dominant companies still to be thriving in many years to come. But it won't be plain sailing for all of them and in some cases there is not much room for disappointment in terms of continuing their positive streak of sales growth and earnings momentum. Many must, quite literally, continue to deliver the goods. Even a mild profits undershoot versus expectations could easily be punished, prompting investors to take profits and to cast their nets wider.

Opportunities in mid and small caps

We have consistently been rather vocal in pointing out that beneath the main index heavyweights lies a vast swathe of quality growth franchises trading at undemanding multiples of future profitability, and in many cases at levels well below long-term historic averages. Many have been overlooked whilst owning today's 'nifty' stocks has been all the rage. The prospect of less restrictive monetary conditions and some reality check on what constitutes a fair price to pay for growth is likely to see the appetite for stocks further down the market capitalisation spectrum increase. It should broaden the opportunities for active managers too, particularly if they can focus more on the quality of earnings and fundamental value than on following the herd, as they invariably do. Recently, we have seen just how quickly the tide can turn, with medium- and smaller-sized company shares bouncing sharply off their lows now that peak interest rates are coming more firmly into view. We are not forecasting a complete sea-change of market dominance and influence, but it is perhaps time for some of the relative minnows to rise to the surface and be an easier catch for investors.

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We feel particularly well placed to participate in this rather overdue transition, having allocations to a range of regional and global funds that allow managers to trawl, mainly without restriction, in what is still a vast ocean of opportunity.

Asia still in the driving seat

Looking ahead, we expect economic growth to slow from current levels (some areas more than others) as the lag effect of today's current tight monetary policy conditions continues to impact business and consumer sentiment in more corners of the globe. But we do not expect global growth to grind to a halt. More likely is a mild slowdown in 2024 followed by slightly improved conditions in 2025, with overall levels of global gross domestic product increases expected to lie in an acceptable 2.5-3% range over the next couple of years, settling at a similar level to that experienced prior to the coronavirus pandemic. The lion's share of global activity is likely to originate from both developed and emerging Asian economies, as has been the case this year, with the key economies of China and India expected to benefit from more policy and political support respectively. This should allow superior growth rates in the region to be maintained.

US remains attractive, but value also found elsewhere

The pace of growth in the US economy is expected to decelerate but the US should still maintain its position in the upper part of the developed markets leaderboard. We are therefore happy to maintain the biases in our stockmarket allocations toward those regions that continue to exhibit relative strength in the context of both long term global economic growth and the access they give to many of today's leading global business franchises as well as those likely to become dominant in the future too.

Some economies in the eurozone, along with the UK, are expected to deliver some of the weakest growth amongst developed world nations, and whilst this is reflected in our relatively modest commitments to these areas, we are mindful that European stockmarkets contain many well-managed, revenue-generating and financially-sound businesses operating in a variety of global and niche sectors that are trading at attractive discounts to their historic averages. Even if the broad underlying economic conditions in these countries remain weak, there are still opportunities and longer-term value for active managers to exploit.

Japan on the up

Japan is one economy that appears to be out of sync with the rest of the developed world in terms of being on an entirely different inflation and monetary policy trajectory. We have noted previously that the 'three arrows' of Abenomics – namely monetary easing, fiscal stimulus through government spending and corporate reforms – introduced around ten years ago by the late Prime Minister, Shinzo Abe, were finally showing up in higher wage growth and a change of mindset in corporate Japan. This prompted us to add some exposure to the region during the summer. Since then, we have seen further evidence of inflationary forces beginning to build. More than 80% of the prices in a typical basket of Japanese consumer goods are increasing and headline inflation, now at 3.3%, has been above the Bank of Japan's ('BoJ') 2% target inflation rate since April 2022. The next annual round of *shuntō* pay negotiations should add weight to the argument that times are changing, confirming that Japan is emerging from the deflationary spiral that has plagued it for so long.

All this is adding pressure on the BoJ to take some action. A change in direction may still take some persuasion, the central bank having held interest rates at, or slightly below, zero for over 13 years. However, recently the BoJ has hinted that it may soon be amenable to a change in its stance.

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This subtle shift in language alone has begun to breed some renewed investor confidence. Together with significant corporate reforms and more focus on shareholder value, positive times should lie ahead for both Japan's stockmarket and its currency.

Who will be first out of the blocks?

As we move into a new year, economic forecasters and investors are likely to continue their fixation on which central bank will be first out of the blocks on interest rate cuts, and when this will be. The assumption is that it will be the US. Although the Fed was not the first to raise rates when post-pandemic supply bottlenecks and energy shortages from the Russia/Ukraine conflict ignited inflation, the US central bank did act more aggressively than other rate-setters. That stance has helped US consumer price inflation fall by two-thirds from its peak, to around 3% currently. But with eurozone inflation falling more than expected in recent months and forecasts suggesting the economy is stagnating, it is quite possible that the European Central Bank could lead the developed world into the rate-cutting cycle.

Meanwhile, despite meeting its pledge to halve inflation by the end of the year, the UK government is also staring at some rather moribund economic data – the latest UK economic growth forecasts, presented in the Chancellor's recent Autumn Statement, have been pared back to just 0.7% for 2024 and 1.4% in 2025 – only in March 2023 had the government predicted there would be a rebound to 1.8% and 2.5% respectively. Over the course of just a few months, therefore, the government's projections of growth in the UK economy in the next two years have more than halved. But the Bank of England ('BoE') may be reluctant to cut rates too early whilst its policy stance is still proving to be somewhat ineffective in bringing down the likes of wage inflation: Andrew Bailey, the BoE Governor, is currently insisting that it is still far too early to be thinking about rate cuts, but the Monetary Policy Committee will be very aware that the longer it holds off relaxing policy, the higher the risk of policy error and the sooner it may be forced on the back foot to take more aggressive action, potentially damaging the economy even more in the process. It is therefore possible that the UK may need to join the rate-cutting party sooner than markets currently predict. In contrast, on the other side of the pond, a stronger and more resilient US economy, as we have seen this year, may mean the Fed has to delay its first cut in interest rates to beyond the first half of 2024 that markets currently anticipate.

Currency implications

Increasingly, central banks know they will need to act fairly soon. Markets believe the first interest rate cuts are most likely towards the end of the first quarter of 2024 or into the second, slightly earlier than envisaged only a few weeks ago. Who will blink first is still anyone's guess, and so this uncertainty also complicates the currency outlook too in the near term. As we see things, it is by no means a certainty that the US authorities will cut rates first, and therefore the US dollar, having lost some of its lustre of late relative to the pound and euro, could see support once more. Interest rate differentials and the timetable of change may influence currency movements in the very short term, but taking a slightly longer-term view we are comfortable retaining exposure to the US dollar: we still see it as the international currency of choice both when the global economy is thriving and also in times of trouble.

Convergence, but at a slightly higher level

When we are through this period of transition, inflation and interest rates in the developed world are expected to converge and settle at slightly higher, but manageable levels.

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The finer detail of how this period of convergence plays out is still very much the debate within markets, but once we get there, and barring any new economic or market challenges, the investment conditions should be a little more conducive for risk-taking, even if the inflation and interest rate hurdles over which assets need to jump are a little higher than those investors have faced in the past few years.

Looking into the new year

Overall, we feel very comfortable with our positioning after the different phases of adjustment made during 2023. That said, there is a case for some further lengthening in the maturity profile of fixed interest exposures, where this is present in portfolios, particularly now the Fed has declared more of its hand on monetary policy. Our planned action in this area should increase clients' participation in a further recovery leg for bonds as the interest rate cycle turns and yields fall over the coming year, as we expect. Alternative investments, including those structured around bonds, continue to do a fine job in helping to preserve wealth and dampen volatility, but we intend to further unwind some of the defensive elements within this segment of clients' portfolios to make way for, and capture the expected superior upside from, more conventional fixed interest investments.

In equity markets, we already have exposures to what we consider to be the more dynamic and economically-robust regions of the world, and believe that as the interest rate cycle turns it will favour our inherent biases towards less-expensive, quality growth companies further down the market cap scale, typically fertile ground for active managers as already noted. To add to their attractiveness, a reduction in the cost of capital and an improved flow of cheaper financing could be the catalyst for a pick-up in merger and acquisition activity and a conduit through which latent value in a variety of sectors and corners of different markets could be released. Selectively, there should also be scope for further participation from some of the market behemoths, including the early enablers and adopters of artificial intelligence, but it will make for a generally healthier market scene and instil greater investor confidence if we see a much broader church of companies begin to participate.

Counterintuitively, softer economic activity could actually be quite good for markets in 2024: it might see inflation falling further and a more rapid reduction in interest rates, alleviating the pressure on businesses and consumers and increasing the appeal of both bond and equity markets. This is what markets are beginning to respond to right now as we close out the year. The path for markets will not be linear and we should expect continued volatility in 2024 as data are released and the global economy grinds along in the near term. It is also a big year for global politics, with some key elections having the potential to influence short-term market sentiment. All this said, we do think there will be opportunities to make attractive real returns in the year ahead – particularly as inflation and interest rates fall – from an actively-managed and well-diversified investment portfolio.

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