verso Investment Management

Window on the world

JUNE 2023

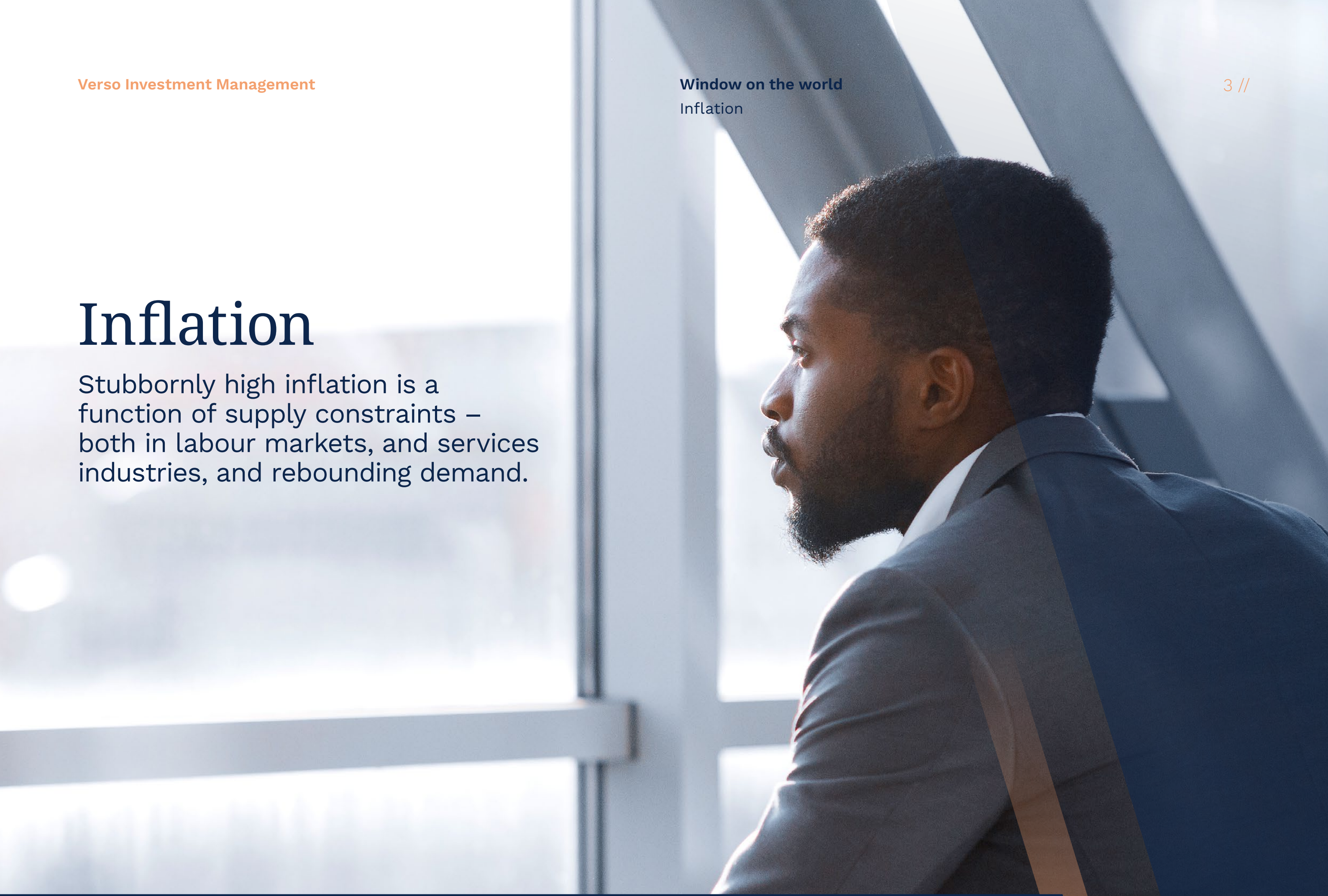
Apparent resilience of equity markets is noteworthy, but a closer look does tell us a slightly different story.

Introduction

We find ourselves at the mid-point of 2023, and it's fair to say that whilst equity market volatility has been declining, it has been far from uneventful.

In the course of six months, we have observed a handful of US regional banks fail, a bailout of Swiss investment bank Credit Suisse, and parts of the US government debt market sell off sharply amid concerns that the government could breach its debt ceiling. Given such developments, which did draw some incorrect parallels with the banking crisis of 2008, the apparent resilience of equity markets is noteworthy, but a closer look does tell us a slightly different story.

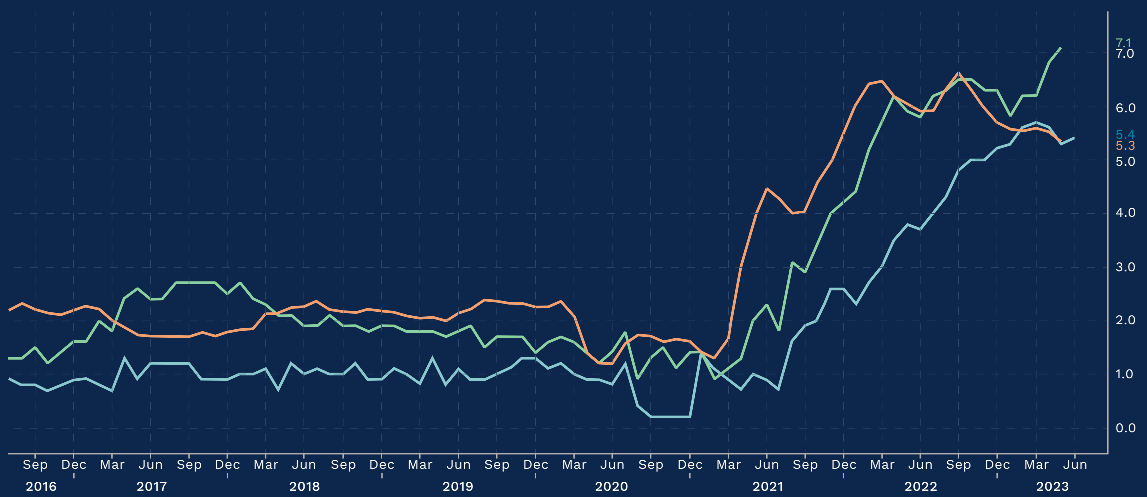
One overwhelming narrative which has dominated markets this year is the likelihood of a recession following aggressive interest rate hikes from central banks. To date, those fears have been unfounded. That said, we think the root cause of these concerns – tighter monetary policy – remains an ongoing theme. Central Banks have continued to raise interest rates in response to high inflation, which is proving to be more persistent than expected. Indeed, high rates was the key reason behind the demise of several US regional banks, as depositors left these banks to seek higher returns on their cash elsewhere in the market.



Inflation

Stubbornly high inflation is a function of supply constraints – both in labour markets, and services industries, and rebounding demand.

CORE INFLATION IN THE UK, US AND EUROPE



CPEXEMUY Index (Eurostat Eurozone Core MUICP YoY NSA) CORE CPI Daily 31JUL2016-06JUL2023 Copyright© 2023 Boomberg Finance L.P. 06-Jul-2023 13:11:27

Eurozone 5.4 US 5.3 UK 7.1

Source: Bloomberg

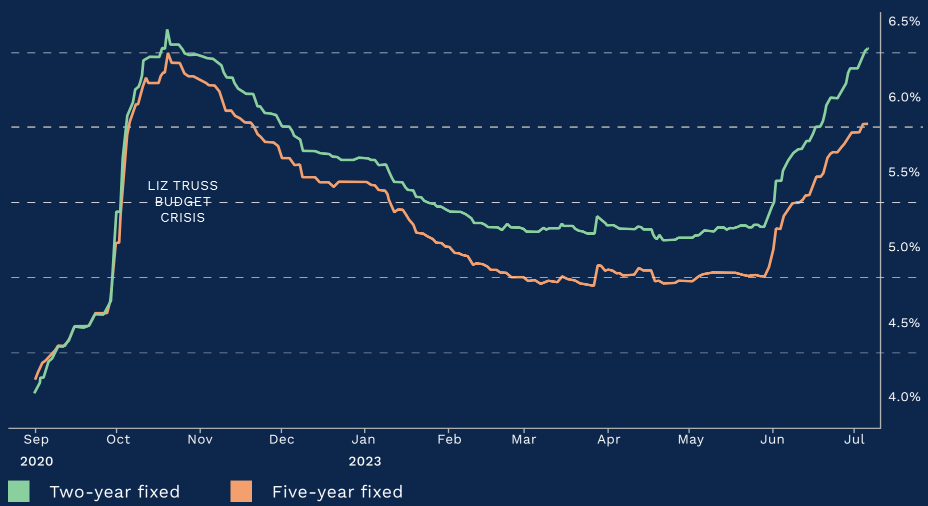
This stickiness can be seen in core inflation (core inflation excludes the impact of changes in food and energy prices), which in the UK, Europe and the US remains at elevated levels, and well above Central Bank targets. As can be seen in the chart below, we think the UK appears to be the outlier here, with core inflation continuing to move higher, whilst seemingly having peaked in the US and Europe.

6.5%
Forecasted UK interest rates (March 2024)

5.3%
Core inflation in the US (May 2023)

UK MORTGAGE RATES

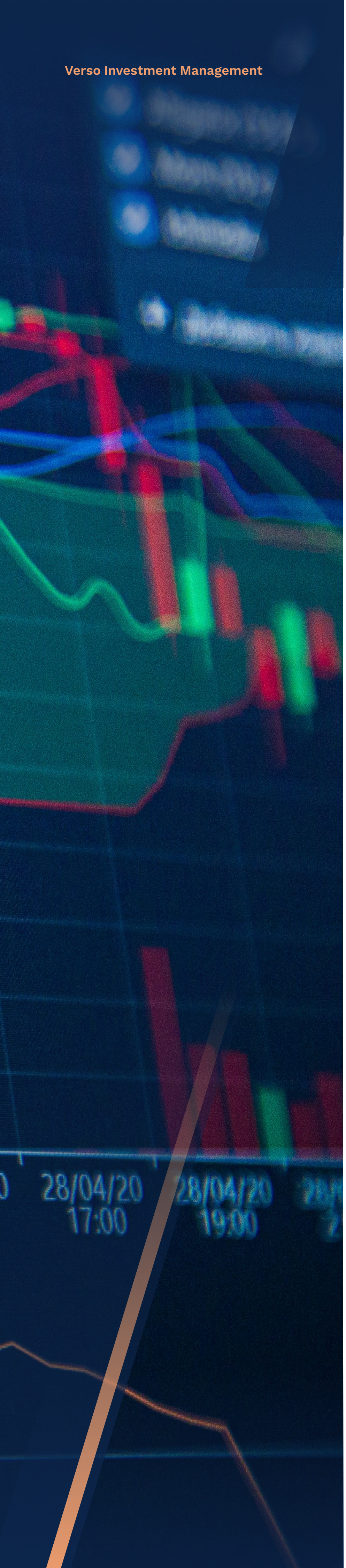
Key mortgage rates are now in painful territory



Source: Bloomberg / Moneyfacts Group

This stickiness in UK core inflation has led the Bank of England to further raise interest rates, increasing by 1.5% this year, and now standing at 5%. Expectations have continued to rise, with market pricing now forecasting that UK interest rates will peak at 6.5% in March 2024. The Bank of England therefore finds itself in an uncomfortable position, with higher interest rates putting upward pressure on both mortgage rates and availability. Recent moves have led to rates on 2 and 5 year fixed mortgage rates approaching levels last seen during the short-lived premiership of Liz Truss, which led the Bank of England to intervene in the UK gilt market. We think this has potentially negative repercussions for consumption, and a key reason why house prices, as measured by the Nationwide Building Society, started declining early this year.

In the US, the direction for inflation looks somewhat clearer, with core inflation now having fallen from 6.5% in October 2022, to 5.3% in May. This allowed the Federal Reserve to pause from raising rates further in June, albeit rates at 5.25% are the highest in sixteen years. Nevertheless with inflation still some way above the central banks target of 2%, and the economy – particularly the labour market – proving to be very resilient, our expectation is that rates in the US will stay higher for longer. As such, we think forecasts for rate cuts as early as this year look misplaced, in the absence of an exogenous shock.



Economy

Much has been made of China's abrupt re-opening at the end of 2022, and its likely positive boost to the Chinese economy.

Initial euphoria has been tempered, with recent economic data softening after a short re-opening boost in the first quarter of the year. In addition, the property market – historically a key driver of growth and wealth creation – continues to struggle. Unlike Western economies, China and the broader Asia region, does not have the same inflationary pressures, and we think finds itself at different stage of the policy cycle, and can therefore ease monetary conditions in order to stimulate growth. Despite the recent softness, the Chinese economy remains on track to expand by 5% in 2023. China, and the Asian region, is likely to be key contributor to global growth in 2023, with consensus forecasting global GDP growth of 2.6% (source: Bloomberg).

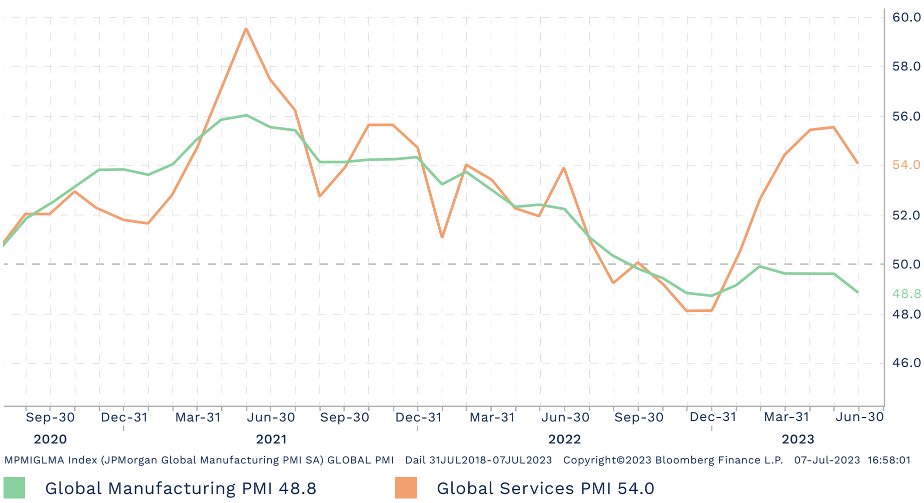
Globally, the impact of supply constraints and hangover from Covid continues to leave a footprint on economic activity. We think the dispersion in the manufacturing and services industries provide a clear example of this. As countries reopened the physical demand for goods – such as laptops and Peloton Bikes – softened, and replaced by increased demand for services – such as meals out, hotel accommodation and international travel.

This dynamic has continued to play out this year, and can be seen in global purchasing manager indices – surveys which provide a snapshot of current activity and conditions. As the chart below shows, global manufacturing has been contracting for some time, whilst services have remained resilient. We think any weakness in the latter would be an early sign that a slowdown may be forthcoming. That said, signs are limited at present, and it is not coming through in employment data currently, with unemployment rates in most economies very low, and job availability remaining high.

5.0%
Chinese economy predicted expansion (2023)

2.6%
Forecasting global GDP growth

GLOBAL PURCHASING MANAGER INDEXES



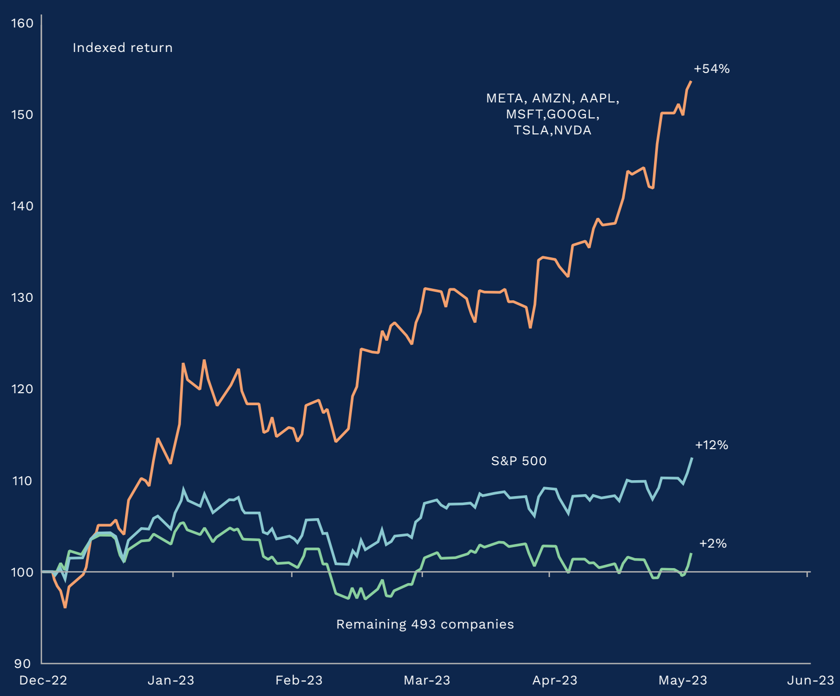
Source: Bloomberg. A reading above 50 signals expansionary territory; below 50 contractionary territory

Markets

The interplay of sticky inflation and higher interest rates has continued to leave its mark on fixed income markets.

Bond yields rose further in the second quarter, particularly in the UK Gilt market, with yields on 2 year government bonds rising to over 5%, its highest level since 2008. This depressed returns from fixed income, with UK Gilts falling by over 5% in the three months ending June.

/ GLOBAL PURCHASING MANAGER INDEXES



Source: Goldman Sachs

Equity markets remain in positive territory for the year for most markets. At face value, the US equity market looks to have led the way, followed by Japan. Closer inspection shows that the majority of the gains in the US equity market this year has come from the ‘magnificent seven’ – Nvidia, Tesla, Amazon, Apple, Google, Microsoft and Meta. As the chart below illustrates, stripping these names out, the rest of the US equity market is effectively treading water. The impressive performance of technology has been largely driven by the excitement surrounding advancements in artificial intelligence (AI), and we think valuations now look rich in these areas.

Japanese equity markets have been strong performers year-to-date, returning more than 20%, amidst optimism that the country may be finally exiting years of deflation and sluggish growth, which has driven an upward revision in earnings estimates and a valuation re-rating. European equities gave back some of their recent outperformance in the second quarter, whilst UK equity markets have lagged their peers, having outperformed in 2022. Emerging market equities have lagged their developed market peers, in part due to a subdued performance from Chinese equities.

Summary and Strategy

Investment positioning currently reflects our view that interest rates are likely to stay higher for longer, and that growth in most developed markets is likely to soften.

As such, our asset allocation is currently quite defensive in nature. Bond prices have corrected significantly over the past 18 months, and are now attractively valued, particularly in short-dated securities. Exposure to bonds in our multi-asset investment portfolios now stands at its highest levels in years. With yields now at 15 year highs in most jurisdictions we think the appeal of fixed income as an asset class has continued to grow, providing diversification, income and an attractive counterbalance to equities. We have a preference for UK government debt over US, given the higher yields on offer, and also short-dated sterling corporate bonds.

Within equities, we retain a broadly defensive stance, whilst ensuring a high level of diversification. Regionally, we have been adding to Asia ex-Japan, which appeals on valuation grounds, whilst trimming Japanese equity exposure into strength. Equity market valuations, outside of the US, don't look overly demanding relative to their historic averages. In the US the broader market, outside of technology, looks reasonably valued as well. That said, corporate earnings will remain dependent on underlying economic conditions, and therefore could come under pressure in the event economic conditions do soften, so the upcoming reporting season will be a key gauge of the current operating environment.

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