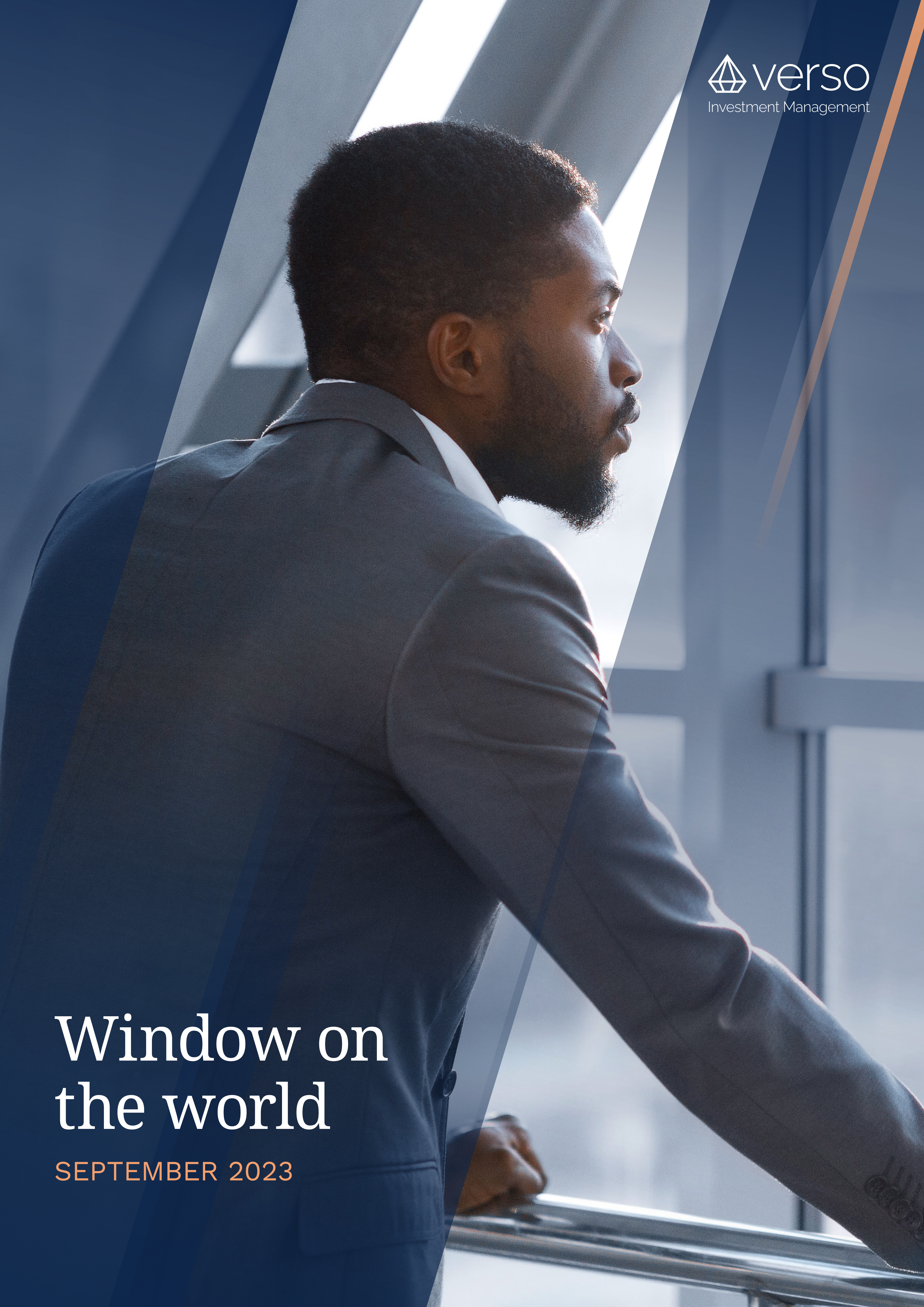
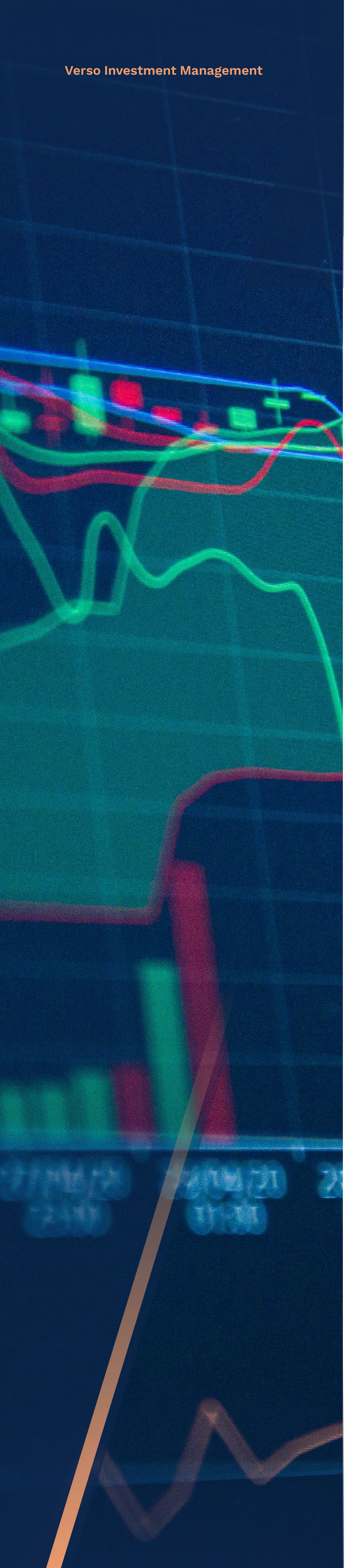


verso
Investment Management

Window on the world

SEPTEMBER 2023



Introduction

Before reviewing the past month going into publication we had tragic news of the Hamas militant group attack on Israeli citizens. Israel has responded by launching retaliatory strikes in the Gaza strip. Our thoughts are with those caught up in the war and this growing humanitarian tragedy.

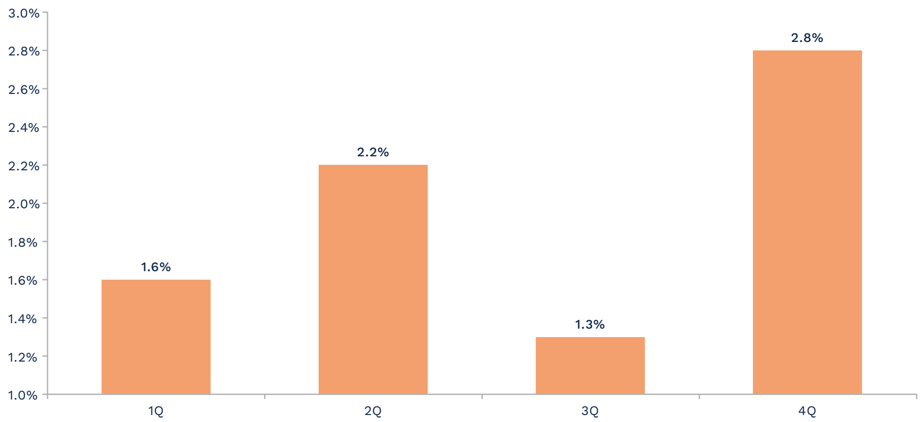
The attack, and the resulting Israeli response, appears to be much bigger in scale than what has been observed in recent years. At this juncture, the war continues, with Israel focused on dismantling Hamas' military infrastructure. Also, at this time, it remains unclear if there has been any direct involvement from Iran.

The impact on markets has been broadly limited thus far. Equity markets are flat or slightly lower immediately after the conflict. There has been some evidence of a flight to quality, or safe havens, with government bonds higher, gold up, and also a stronger US dollar. Oil prices are higher, by around 3% or so. On the latter, it should be noted that this war has not had any impact on oil supply so far – but could in the event that sanctions against Iran are tightened. This is something we will continue to monitor, given the potential inflationary impact a move up in oil prices could have. There is also a tail risk that tensions across the Middle East rise more broadly as a result, particularly if it is proven Iran had a major part to play in directing the incursion.

Our direct exposure to the region is negligible, with no significant positions held in any of the emerging market strategies we use. As unsettling as the weekend's developments are, the impact on markets more broadly should be limited, with any impact fading over time. As such, we are not making changes to our portfolios' asset allocation or composition at this time in response to this conflict. Nonetheless, we will continue to assess its potential impact on markets, the global economy and asset prices, and look to act accordingly should our assessment of the situation change in a meaningful way.

September proved to be a more challenging month for capital markets generally, with bonds and equities lower over the month for a multitude of reasons, which are discussed below. With ¾ of the year now behind us we are now into the final stretch for 2023. Attention will again return to the outlook for 2024 as we move through the autumn – and the key debate here is likely to remain on inflation, interest rates, and the impact that the latter has on economic activity. Finally, whilst the third quarter was more challenging for investors, history shows that from a seasonal basis, the fourth quarter has been a better one for market returns, according to analysis undertaken by Strategas.

S&P 500 Quarterly Performance (Since 1928)



Source: Strategas

In Europe, inflation continues to come down, whilst PMI data would signal that the private sector is currently contracting.

The Economy

Looking at the third quarter economic data provided a mixed picture. In the case of the UK, falling inflation (UK CPI stood at 6.7% in August, which compares to a peak of 11.1% in October 2022) and a loosening labour market has heightened concerns of an economic slowdown. Final GDP data for the second quarter showed the economy expanded by 0.2% quarter-on-quarter, helped by solid consumption and business investment readings.

Forward looking indicators, namely purchasing manager indexes (PMI), could indicate that activity is slowing, although this has not translated into weaker business confidence, with the Lloyds business barometer remaining above its average. Meanwhile, there is continued evidence of a slowdown in the housing market, with mortgage approvals continuing to fall, and house prices, as measured by Nationwide House Price data, falling 0.8% month-on-month.

Elsewhere, in the US economic activity remained broadly resilient, particularly the labour market, which has remained strong. This is a likely driver behind the strength of US consumption, which has carried on through the summer. As with the UK, forward looking indicators do suggest that momentum may be weakening in some areas, although the services industry remains reasonably buoyant. Across the globe in China, which has been dealing with issues in its property and trust banking sector, there was evidence of some improvement in activity later in the summer, with industrial production and retail sales data surprising to the upside.In Europe, inflation continues to come down, whilst PMI data would signal that the private sector is currently contracting.

Central Banks

We have potentially reached the end of the hiking cycle from Central Banks, following 18 months of tightening monetary policy. Both the Federal Reserve (Fed) and the Bank of England (BoE) kept interest rates unchanged at their September meeting, along with the Swiss National Bank. That said, both the Fed and BoE have warned that further hikes in rates may be required.

US 10Y REAL YIELD 2.4832

.US10RY U Index (US 10Y REAL YIELD) US 10Y REAL YIELD Week;y 03AUG2007-06OCT2023

US 10Y REAL YIELD 2.4832

Source: Bloomberg

Crucially, the key message is that whilst interest rates may have peaked, they could stay at elevated levels for longer than anticipated, and it is markets coming around to this realisation that has unsettled investors. Real yields in the US – as measured by the difference between the nominal yield on 10 year government bonds and 10 year breakeven inflation now stand at close to 2.5% – the highest level in over a decade, and signalling that monetary policy is tight (see chart above).

Interest rate increases operate with a lag, typically around 12-18 months, and looking forward higher borrowing costs may start to impinge on activity.

Oil Prices

One significant development over the past few months has been the move back up in oil prices. This appears to be a response to a cut in supply, as opposed to excess demand.

It follows announcements of supply cuts from both Saudi Arabia and Russia in the summer, which has pushed the price of a barrel of oil up from $75 in June, to over $95 by the end of September. Clearly, if energy prices remain elevated this can add to inflationary pressures – which also supports the higher for longer outlook for interest rates. Conversely, it also puts a squeeze on income and input costs, which may also weigh on activity.

$75
in June for a barrel of oil

>$95
by the end of September for a barrel of oil

Fixed Income

A combination of economic resilience, lower inflation, and higher oil prices has put upward pressure on bond yields in certain areas. In particular, this applies to longer duration US Treasuries. The yield on the US 10 year government bond rose to 4.6% by the end of September, from 3.9% at the end of June. Meanwhile, yields on shorter-dated US government bonds were only marginally higher – supporting the thesis that rates are a) close to peak, and b) the market is adjusting to price in a higher for longer scenario.

In the UK, where our exposure is focused – and primarily in short-dated bonds – yields were broadly flat, to slightly higher. For the month of September UK gilts in aggregate were 1% lower, albeit much of this was attributable to lower prices in longer duration government bonds. For the third quarter, Gilts were around 0.5% lower, outperforming their overseas equivalents as investors re-priced where UK interest rates would peak.

Equity Markets

The sell off in bonds also put some pressure on risk assets in September, with the technology sector (outside of the Big 7) leading equities lower, with the Nasdaq composite falling by nearly 6% in September.

This weighed on broader US equities, which declined by 4.8% in local currency terms. European equities were 3% lower, whilst emerging market equities declined by 2.5%, with China concerns continuing to weigh on the latter. UK equities bucked the trend, up 2.4%, thanks in part to the high exposure to energy stocks, which performed well against a backdrop of rising oil prices.

2.4%
up – for UK equities

Outlook

With interest rates likely to remain higher for longer, the prospect that this could weigh on future economic activity remains elevated, and as such we are retaining a broadly defensive stance across our portfolios.

Equity valuations in areas such as the UK and Europe do not look stretched, potentially discounting the prospect of weaker economic conditions. In the US valuations are above average but look less demanding when stripping out the impact of the 7 large technology stocks. In fixed income, valuations have returned to levels last seen 15 years ago and remain attractive. Here our focus remains on short-dated UK government bonds and UK investment grade corporate bonds.

IMPORTANT INFORMATION

- Past performance is not a guide to future returns and the value of investments, and any income from them can go down as well as up. You may not get back as much as you put in. Please bear in mind that for funds that invest in overseas markets, changes in currency exchange rates may affect the value of your investment.
- Cash investments whilst secure may still be affected by the effect of inflation eroding your capital value.
- Unlike cash, stock market-based investments are not guaranteed and fall in value as well as rise, we therefore believe you should only invest for the long term (5+ years). Ultimately you could get back less than you invest. Any yields will vary over time, so income is variable and not guaranteed.
- The information provided is not advice, it is provided solely to enable you to make and monitor your own investment decisions. If you are unsure of the suitability of any investment, you should contact your financial adviser for advice.

Here our focus remains on short-dated UK government bonds and UK investment grade corporate bonds.

verso
Investment Management

versoim.com / info@versoim.com / 020 7380 3300

Verso Investment Management is a trading name of Verso Investment Management LLP (VIM)
Registered in England No. OC351100 at 2nd Floor, The Clove Building, 4 Maguire Street, London, SE1 2NQ
Authorised and regulated by the Financial Conduct Authority - 517235