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Investment Management

Window on the world

NOVEMBER 2023

Introduction

November proved to be the polar opposite to how markets performed during the end of Summer and through October.

Issues which had weighed on both fixed income and equities over that late Summer period unwound to an extent, driving a powerful rally across parts of the fixed income curve and also equity markets. Factors behind this reversal are explored further in this note.

December is now upon us, potentially bringing into play "Window Dressing", which has been used to explain why the final month of the year can often deliver some of the strongest monthly returns. This concept is premised on the idea that fund managers rebalance their portfolio's during the month to give the appearance that they hold strongly performing assets, sectors or regions, at year end, helping to support equities in the final run in to the year.

Inflation and Central Banks

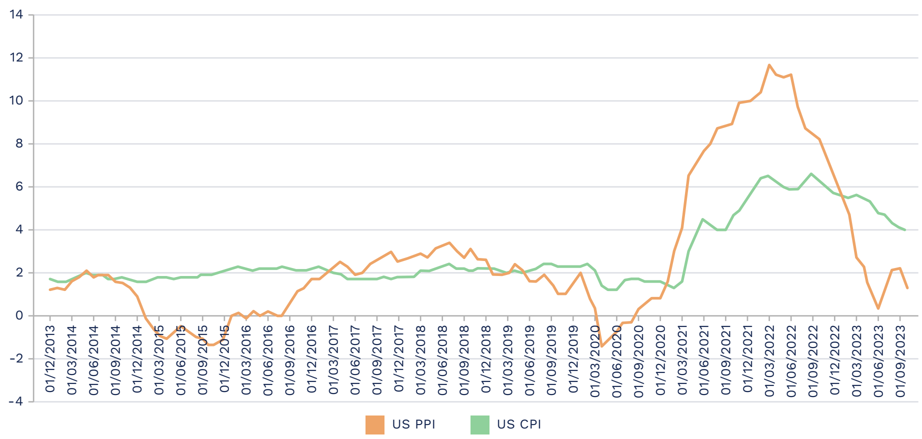
Key drivers behind the rebound in capital markets can be contributed to a range of interconnected factors – softer inflation and economic data, raising optimism that rates will start to fall early in the next year. This helped drive a rally in fixed income, and equities, as investors embraced the prospect of a possible soft landing and a faster than expected normalisation in interest rate policy.

On the inflation front, recent readings across the US, UK and Eurozone have come in below expectations, with Core Consumer Price Index continuing to decline from elevated levels. In the US, inflation has returned to levels last seen in 2021, and 18 months lows in the case of UK and Europe. This has added to expectations that inflation will ultimately return back to around 2%, in line with most central bank mandated targets.

Producer price inflation, which tends to lead consumer price inflation, has returned to pre COVID-19 levels in most regions (see the chart below for US producer price and consumer price inflation). Combining this with lower energy prices, and anecdotal evidence from supermarket operators that price pressures are easing (US supermarket giant Walmart has even talked about the prospect of deflation in general merchandise in their recent results) would indicate that this downward trend in inflation remains intact, further adding to our belief that the peak in interest rates has been reached.

Both the Bank of England and Federal Reserve (Fed) kept rates unchanged for the second consecutive month in November. Whilst keeping the door open for future hikes if needed, and retaining a reasonably hawkish stance, it looks clear that the peak is now in, and the market itself has begun to focus on the prospect for rates to start to be cut in 2024.

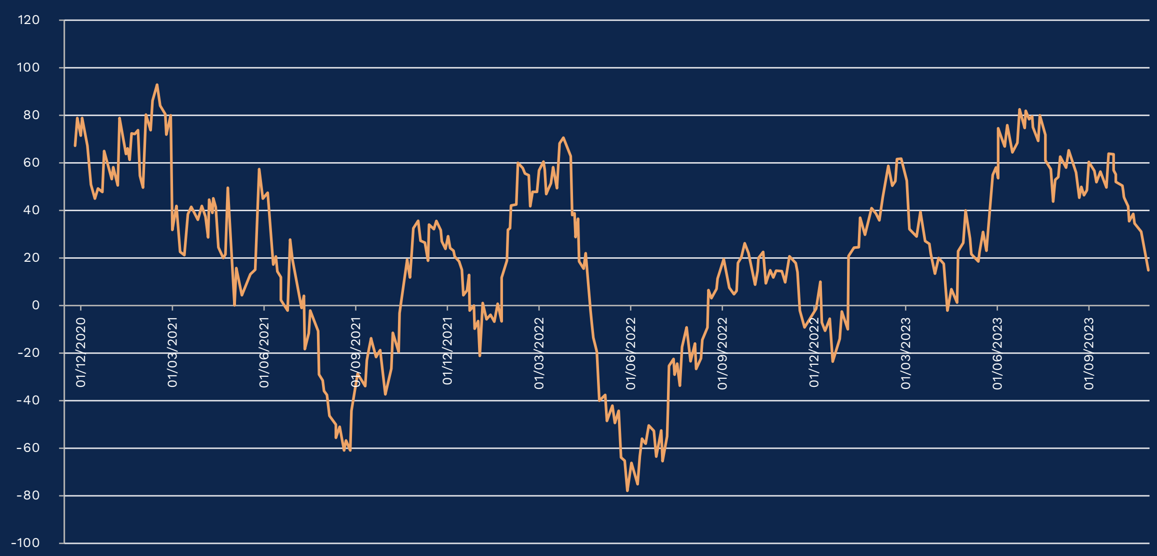
US CPI & PPI (% YOY)



Economic Data

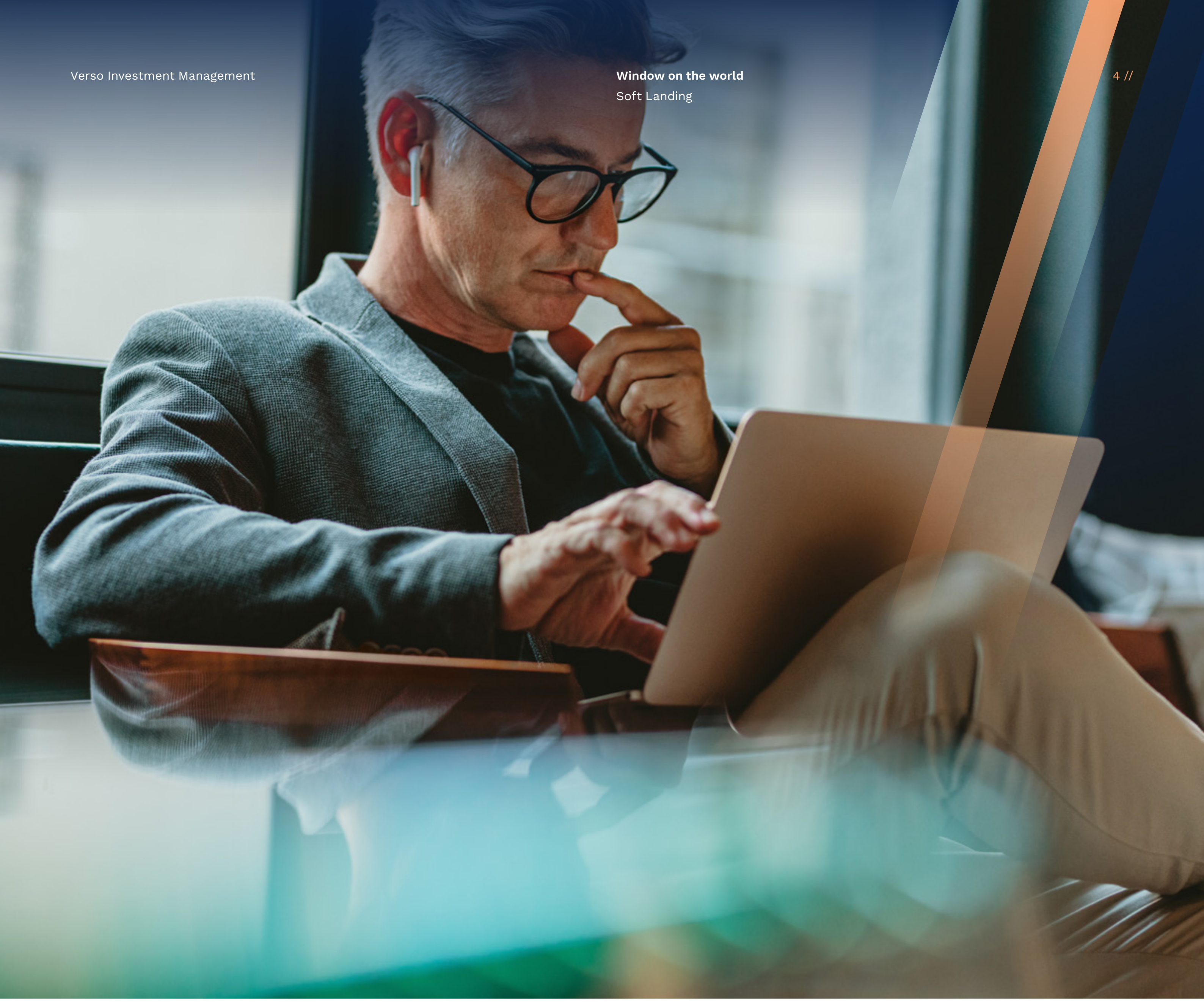
Economic data in the US has showed signs of softening over the past month, with economic surprises to the upside starting to wane (as evidenced by the Citigroup Economic Surprise Index in the chart below). At this juncture, this is a likely welcome deceleration from what proved to be very strong growth in the third quarter for the US economy.

CITIGROUP US ECONOMIC SURPRISE INDEX



Nevertheless, attention will remain focused on the US job market, and also consumer spending. The most recent employment data did signal some cooling in the labour market, with the unemployment rate now having risen 0.5% from its low to 3.9%. A cooling job market is likely to relieve some pressure on wage growth, albeit with this now running ahead of inflation, real incomes are rising, helping the consumer. It may partly explain the strong Black Friday sales, with Adobe Analytics reporting that US consumers spent $9.8billion on the day, up 7.5% on last year.

Elsewhere, in the UK, there were some encouraging signs that economic activity may have bottomed, with Flash November UK Services Purchasing Managers Index rebounding back above 50, signalling expansion following three months of contractionary readings. Data in Europe was less encouraging, with industrial production and manufacturing activity remaining weak, particularly in Germany and France. In China, positive consumer data was partly offset by ongoing weakness in the property market, with the authorities continuing to provide liquidity to the banking system.



Soft Landing

A combination of falling inflation, a US economy growing at trend and possible evidence of a bottoming in other developed markets has led the market to embrace a soft-landing scenario for the US economy.

In the US, the yield on the 10-Year Government Bond has fallen to

4.3%

UK Government Bonds in aggregate returned nearly

3%

It has seen investors bring forward expectations for interest rate cuts next year in most major economies, driving a significant reversal in yields in medium and longer duration Government Bonds. In the US, the yield on the 10-Year Government Bond has fallen from 5% in mid-October to 4.3% by the end of November. Similar declines were observed in UK and European Government Bond markets.

This has had a powerful impact on liquidity conditions, with Goldman Sachs reporting that their internal measure of financial conditions had its largest monthly easing in November in the past four decades. Key contributors to this came from the move lower in bond yields, which drove a significant rally in fixed income markets. Over the month, UK Government Bonds in aggregate returned nearly 3%, their best month since October 2022.

Equity markets also recorded strong gains, with US equities rising on 16 out of the 21 trading days during November, rising over 9% on an aggregate basis for the month. European equities also rose, up 7%, as did Japan, which returned 5%. Returns were more muted in our own domestic market, which rose 2%. Within equity markets, growth as a style outperformed value during the month, although there were some signs that underperforming areas were starting to catch up.

Outlook

The sharp move in expectations for interest rate cuts next year – markets are pricing in five cuts from the Fed next year, and three from the Bank of England – looks quite extreme, and the sharp move lower in longer duration bond yields excessive, so a retracement in yields would not be a surprise.

Seasonally, December can prove to be a reasonable month for equity markets, albeit certain areas are looking overbought in the near-term. Looking into 2024 – and our thoughts here will follow in a separate 2024 publication – attention needs to remain on how economic data evolves in light of high interest rates, and the prospect of cooler labour market conditions. Within bonds, we retain a focus on short-dated Government Bonds, and within equities a defensive stance remains warranted.

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