INVESTMENT UPDATE
July 2023

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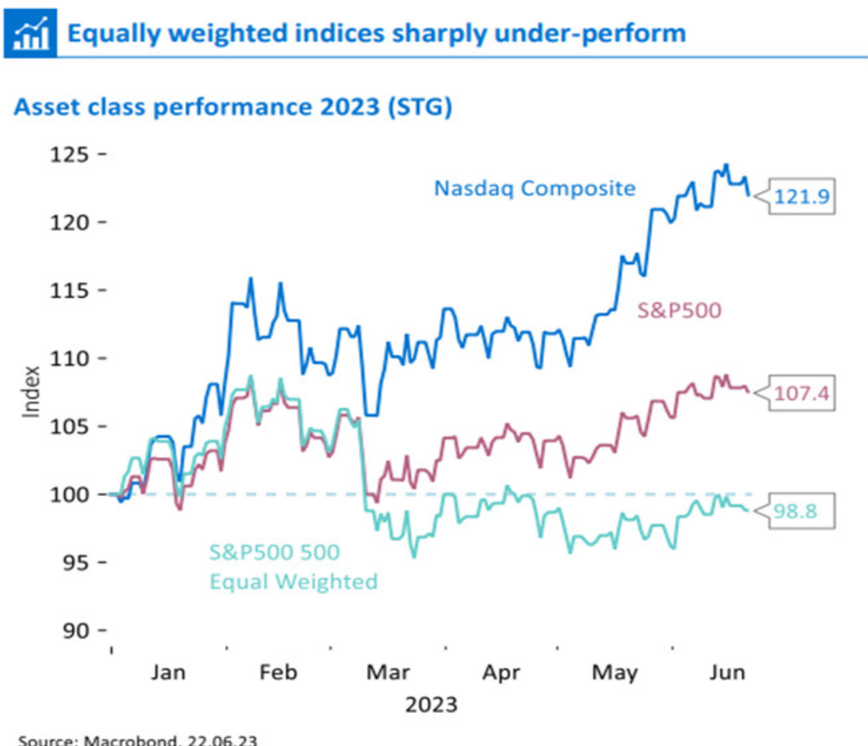
Introduction and Market Overview

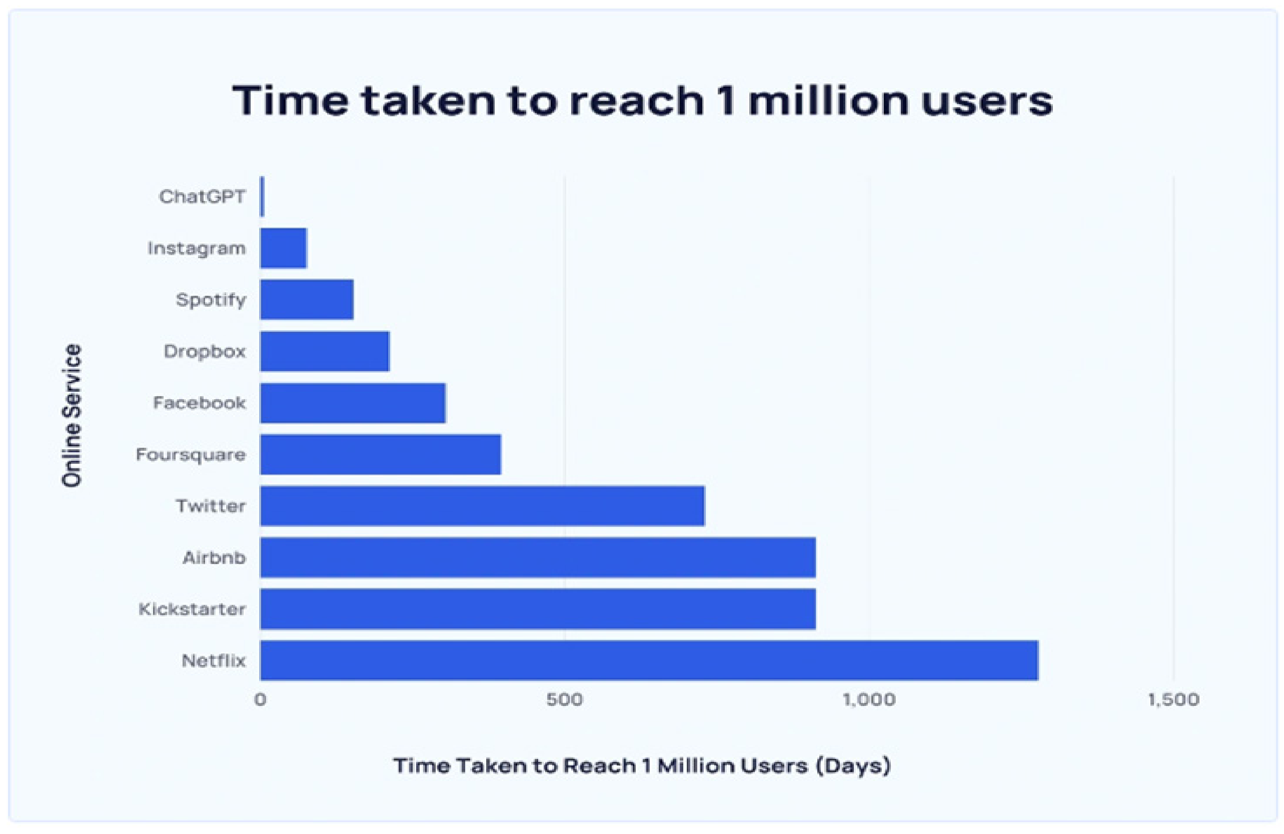
Equity and bond markets have struggled to make meaningful ground in the second quarter, buffeted by the persistence of inflation and the need for tighter monetary policy. Despite oil, gas, coal and electricity prices all retreating to mid-2021 levels, underlying price pressures remain throughout the wider economy. This has forced central banks to adopt a firmer stance on raising interest rates than they had originally intended, conceding that, in some areas, there is still some unfinished work.

Rather surprisingly for this type of backdrop, 'growth' stocks – and particularly 'big tech' – have been in vogue again and 'value' stocks sidelined somewhat. This can be explained by the surge in demand for companies seen in some way as beneficiaries of the growth in the adoption of Artificial Intelligence ('AI'). Demand for a relatively niche, yet dominant, group of shares has helped push stockmarket indices such as the tech-heavy NASDAQ back towards its 2021 highs, way ahead of more mainstream US shares.



We are reminded that after its launch in 1999, it took Netflix three and a half years to reach one million subscribers; Twitter achieved the same milestone in two years and Instagram just two and a half months. Fast forward to 2022 and OpenAI's chatbot, ChatGPT, took just five days to reach one million users after it was made public. Whether we like it or not, AI is likely to remain in focus as its far-reaching applications and implications are better understood.

Working out who the long-term beneficiaries (and losers) will be is likely to take a lot longer than ChatGPT takes to sign up its next million users, but we are keeping a close eye on this developing theme nonetheless.



Source – exploding topics blog, US.

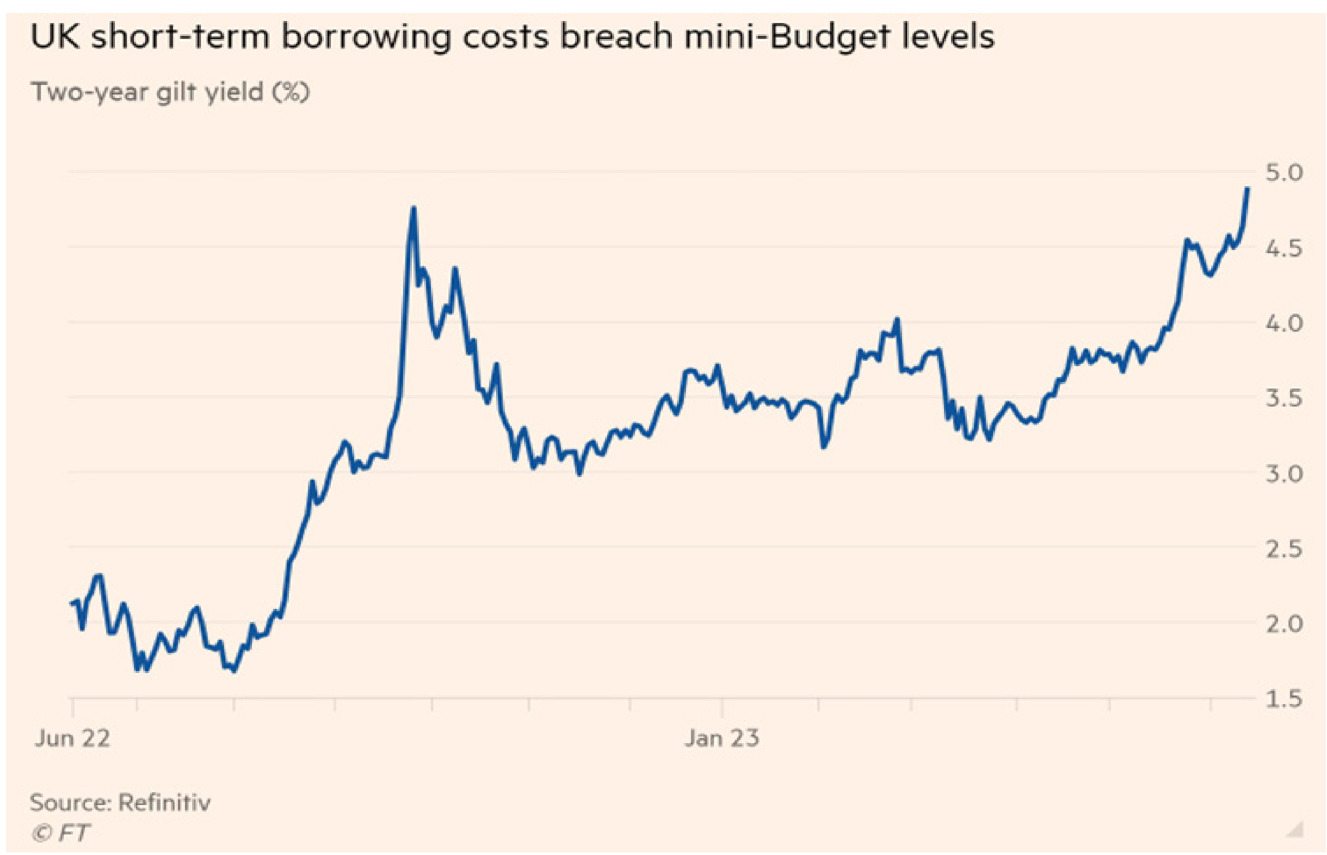
So why are interest rates failing to control inflation as quickly as was hoped? Shifts in the housing market may be key in explaining why interest rate rises are taking longer to bite. In several countries, the proportion of households that either own their property outright or are renting has risen. Fixed-rate mortgages are now more popular than flexible ones. If more people hold flexible rates, then higher central bank rates feed through to households' spending power almost instantly. In the UK, the share of households owning a property with a mortgage has declined from 40 per cent in the 1990s to less than 30 per cent.

Those with a floating rate mortgage have gone from 70 per cent in 2011 to slightly more than 10 per cent this year. Andrew Bailey, governor of the Bank of England, said last week that those trends meant "the transmission of monetary policy is going to be slower as a result".

The after-effects of the pandemic on hiring trends are also still being felt. Widespread labour shortages remain — especially in the services sector, boosting wage growth and in turn inflation. Christine Lagarde, of the European Central Bank (ECB) said last week that services sector companies may be engaging in "labour hoarding", fearful of being unable to recruit should growth strengthen. The sector could be "insulated from the effects of policy tightening for longer than in the past", the ECB president said.

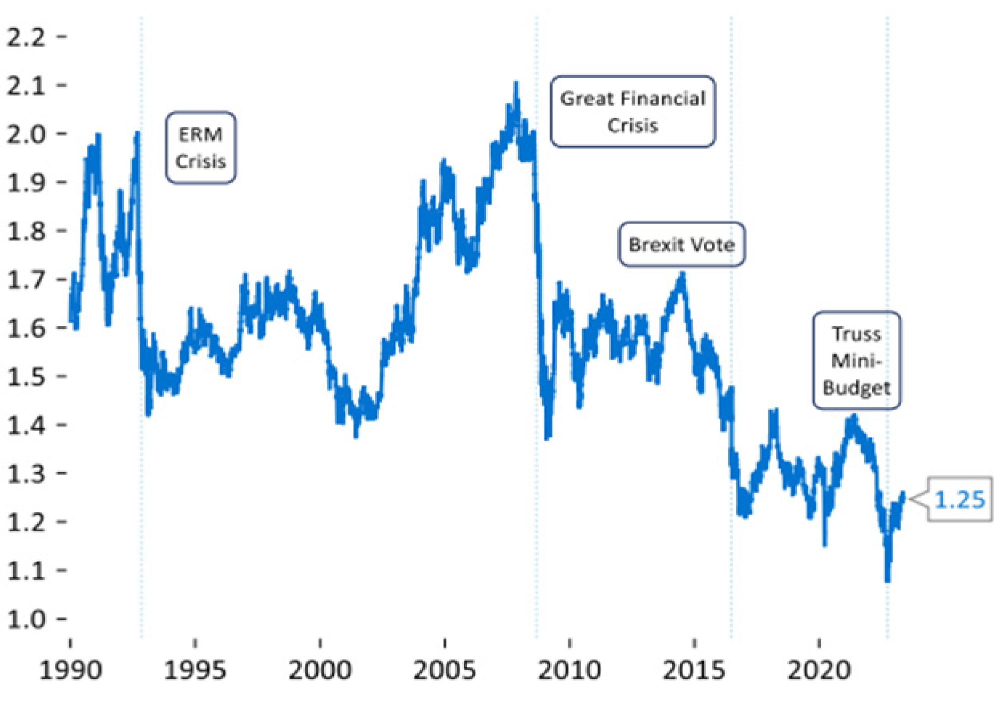
Early-year bond market optimism has faded somewhat in recent months, sentiment being impacted by the need for further work on raising short-term interest rates: inverted yield curves, where short-term bond yields unusually exceed those of longer-term issues, are indicative of potential recessionary conditions ahead.

This anomalous relationship should normalise as the need for tighter central bank policy diminishes, as we expect it will during the second half of the year. Real (inflation-adjusted) yields on government bonds are still negative in the UK at the shorter end, but the arithmetic is improving as inflation falls and interest rates move higher.



Yields on investment grade corporate bonds now look particularly appealing. The prospect of further reductions in inflation – and interest rates potentially peaking later in 2023 – strengthens the argument for being more confident about bonds going forward.

Currency movements, generally caused by interest rate policy differentials between key economies, have also impacted investor returns of late: sterling-based investors seeking relative economic strength and opportunities in overseas markets have seen returns eroded by the rather surprising rise in the pound relative to the US dollar, for example. Markets currently seem to be overlooking the poor state of the UK economy, which is not deserving of a strong pound.



Strains within the banking sector appear to have abated since the end of the first quarter, but tighter lending conditions and the knock-on effects of more restrictive monetary policy do need close monitoring. However, the global systemically important banks in advanced economies are particularly well capitalised and stress tests suggest that they are generally well placed to withstand the tighter financial conditions now being seen.

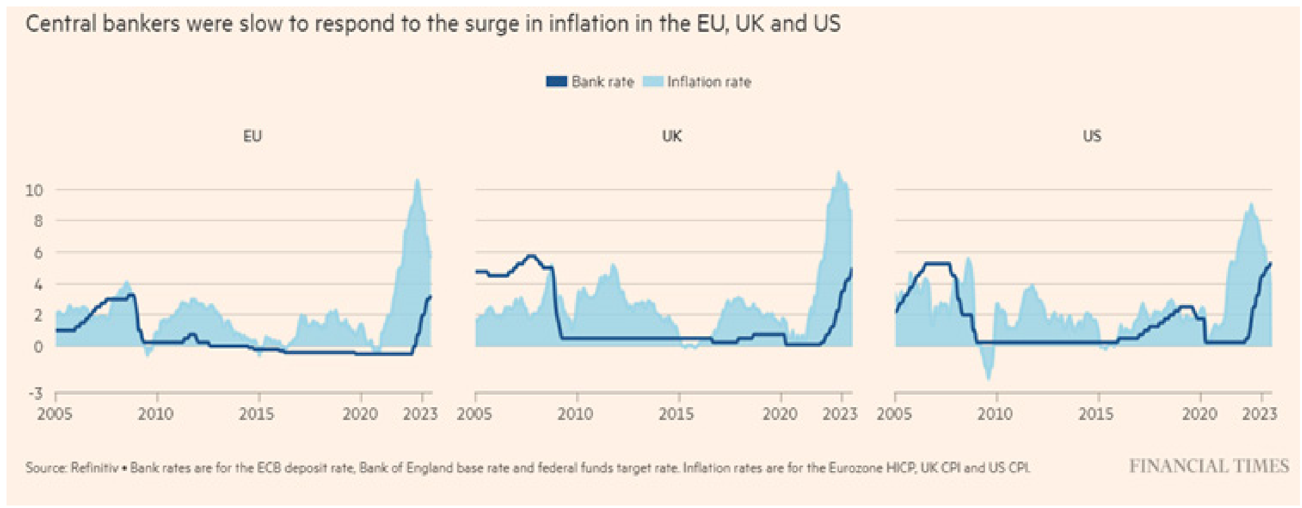
So, what comes next? The high-level takeaway is that the global economy is showing resilience and in our view still on track to grow over the course of the year, helped by the positive influences of lower energy prices, falling headline inflation, the further easing of supply chain bottlenecks and China's general post-pandemic re-opening.

Some of the strongest economic growth rates are expected to emanate from Asia, with China's re-opening clearly helping drive both domestic consumption and regional demand activity, although the reopening impact has become more patchy of late. Conditions in some of the hitherto more economically-challenged areas such as Europe (ex. UK) and Japan appear to have improved in recent months. With the exception of the UK, Europe's economy has generally demonstrated greater-than-expected resilience in terms of dealing with last winter's energy crisis and responding to higher levels of inflation. Its core export markets have also been boosted by China's reopening.

There are also encouraging signs that Japan is, at last, beginning to shed some of the deflationary influences that have held it back for so long. Evidence of higher inflation and wage growth suggests that the negative stigma of raising prices is beginning to fade and that it will not be long before the Japanese economy can stand on its own two feet again. Meanwhile, the UK economy looks firmly entrenched as the weakest economy in the G7, not helped by inflation at a 31-year high and the ratio of its debt to GDP above 100% for the first time in over 62 years. It is fair to say that the strength of the general global post-pandemic upturn is expected to be more subdued than originally expected, with the persistence of inflation – and the necessary actions of central banks to tackle it – becoming a stiffer headwind of late.

Before we get too downhearted, reductions in headline inflation, a healthy employment backdrop and generally sound household finances with a relatively high level of excess savings should alleviate some of the near-term challenges and allow the global economy to come through this period of weaker activity relatively unscathed.

It will not be an easy time for everyone or every economy: more than a year of synchronised (and possibly delayed) action by key central banks to address inflation through tighter monetary policy will undoubtedly take its toll on over-indebted businesses and consumers, along with economies with more structural issues.



An inevitable consequence of the necessary rise in interest rates, not helped by recent banking stress in the US and Europe, has been tighter lending conditions and borrowing criteria, which are rubbing salt into several open wounds. This is a key reason we favour quality companies with strong cash flows and resilient business models.

As already mentioned, conditions in the UK look particularly precarious, where almost 1.5 million homeowners have fixed-rate mortgages expiring during 2023, around 60% of them previously fixed on rates below 2%. The latest two year deals now exceed 6%. There is pressure on the banks to be more flexible with those struggling with repayments – this will help in the short term, but it means the debt can is merely being kicked down the road and will still need to be addressed at some point. More persistent core inflation – which excludes food and energy prices – is likely to mean central banks keeping interest rates higher for longer: tight labour markets and higher wage settlements explain why services-related inflation is proving stickier than for goods, where falls in energy and industrial commodity prices have had a more immediate impact.

It may therefore be another year before central banks' inflation targets come within touching distance. Steering the right course between tackling high inflation and avoiding recession will be no mean feat, but it is at least encouraging to see the US Federal Reserve (FED) now pausing its rate hiking cycle.

The big debate amongst central banks and the questions being asked by markets surround whether interest rates have now gone far enough. After its most recent meeting in June, the FED's Chair Jerome Powell subsequently commented that "we're at least close to where we think our destination is… and it only makes common sense… to move at a careful pace." There is therefore more than a glimmer of hope in the latest rhetoric that the work of the world's most influential central bank is almost done. That said, it does now seem that terminal interest rates – and possibly inflation too – will settle at slightly higher levels than initially envisaged.

This scenario may mean that certain developed market economies, including the mighty US, will enter technical recessions at some point during 2023 or 2024. But these periods are expected to be both brief and mild. For the year as a whole, and for 2024, acceptable levels of global growth in the 2.5%-3.0% range still seem quite achievable.

Overall, the economic scars left by the pandemic and current war in Ukraine will take time to heal, but the medium-term outlook for the global economy does still look reasonably encouraging and capable of creating a conducive backdrop for investment. Soon, less restrictive monetary conditions should stimulate the global economy once again. The current, somewhat lacklustre, market environment may continue over the summer months until the inflation and monetary policy backdrop becomes a little clearer. But increasingly, the likelihood of mild recessionary conditions, followed by a strong earnings recovery and reduced interest rate and inflation headwinds, should draw investors towards stockmarkets' undemanding valuations and the attractive yields on offer within bond markets. In the future, when we look back at the current uncertain backdrop, it is likely to have proven itself as a good period in which to have remained invested or to have made fresh longer-term investments from cash.