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INVESTMENT MANAGEMENT

INVESTMENT UPDATE
October 2023

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Introduction and Market Overview

We continue to get evidence that the global economy can achieve a "Goldilocks" soft landing. This is a scenario where inflation is gradually brought under control without causing a hard recession. Inflation is broadly subsiding although it remains uncomfortably high in many parts of the world, particularly here in the UK.

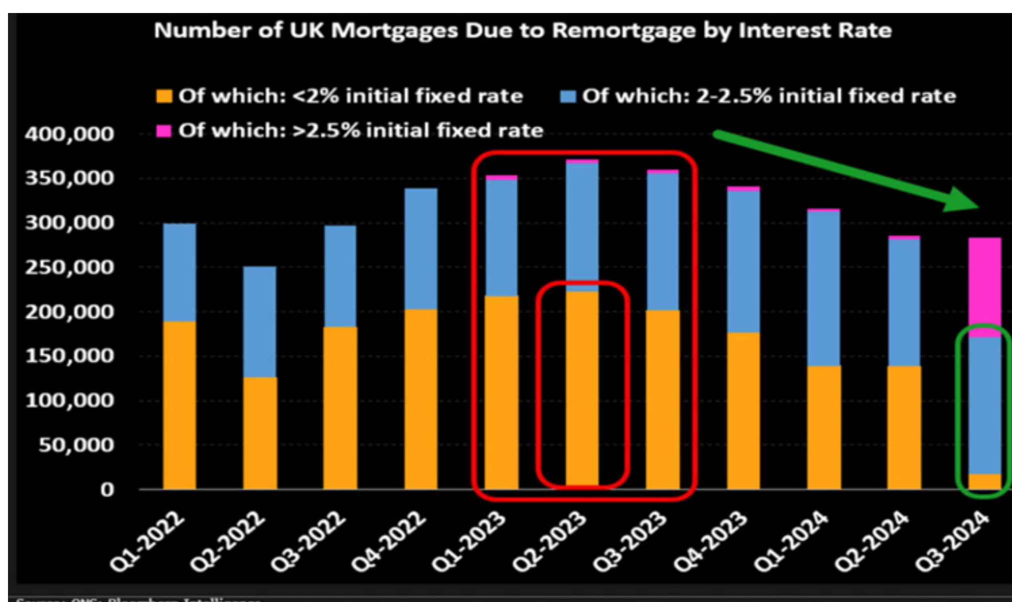
UK Consumer Price Inflation:

The price of oil jumped during the quarter as a result of supply cuts from some of the world's biggest producers. The oil price has been broadly falling since its peak in March 2022, which has been helping to bring down headline inflation. We are closely monitoring the oil price given its potential impact on monetary policy and by extension to the outlook for equity and bond markets.

Crude Oil Price:

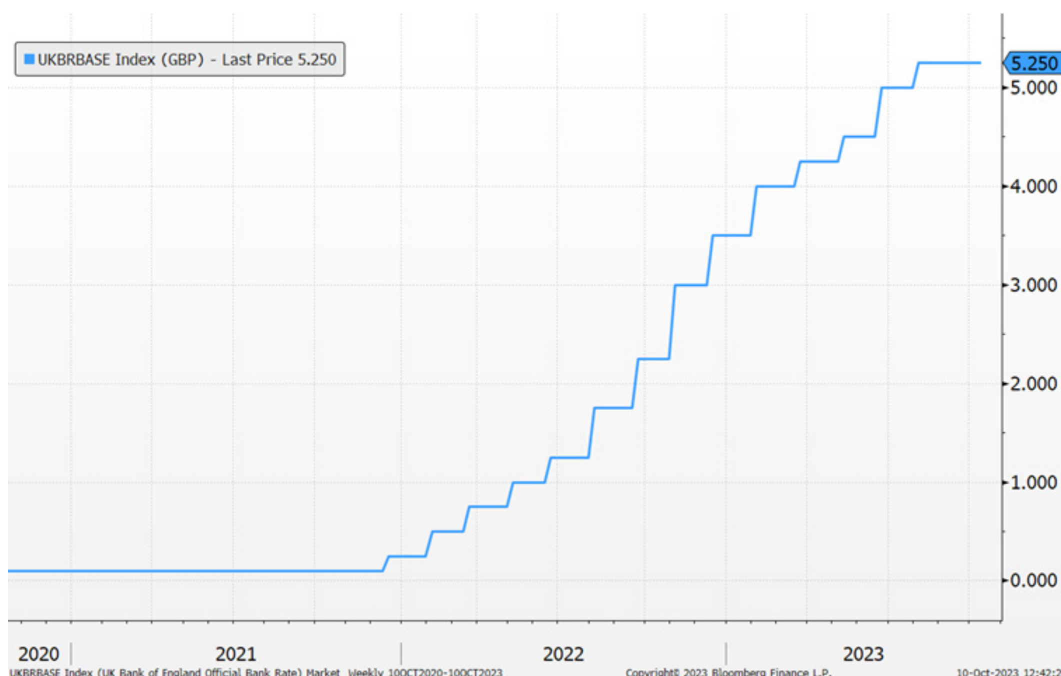
The global economy has been helped by relatively strong consumer spending, which is the largest component of Gross Domestic Product (GDP). However, much of this spending has been done with excess savings that were accumulated during the Covid pandemic. These excess savings are now close to being exhausted.

So far, the impact of rising rates on consumer spending has been positive, as in aggregate the extra income now being generated on cash holdings has more than offset the increased interest payments on mortgage borrowing. However, this situation will gradually reverse over the next couple of years, as the fixed deals arranged before rates started increasing roll off and need to be refinanced at significantly higher rates.



The US Federal Reserve (Fed) and Bank of England have continued to hike their key borrowing rates during the third quarter although most economists agree that the final interest rate increase has happened or is near. Both central banks paused in September although the lack of a rate rise did nothing to cool markets as the rhetoric used in delivering these verdicts suggests that they are not yet finished in their work. US Fed Chair Jerome Powell hammered home this point, when despite confirming that they are almost where they need to be with regards to interest rates, due to a better economic outlook, he stated that any relief from higher borrowing costs will be neither swift nor generous. Pressure will remain on central bankers to keep rates high whilst the labour market remains tight.

UK Base Interest Rate:



Ultimately, the gamble is that short term pain will eventually fade and economies can move forward and the next question will be whether anything will actually meaningfully change or will this boom and bust cycle continue in perpetuity?

The short term versus long term effect of higher interest rates is interesting to analyse. The Barcelona School of Economics suggested earlier this year that higher interest rates were bad news for growth over the longer term, as they choked off green shoots of innovation by increasing the cost of capital and dampening demand. The Frankfurt School of Finance and Management found, one year after a 1% rise in interest rates, that venture capital investment falls by a quarter and patenting and innovation falls by 9%.

During the quarter, the Federal Reserve Bank of Kansas City hosted the Jackson Hole meeting. This is an annual three-day event, which is formally known as the Jackson Hole Economic Symposium. Participants include prominent central bankers. At the event various experts share their forecasts and analyses of the economic and financial outlook for the United States and the meeting aims to provide key insights into the economic challenges faced and how the Fed can address them.

The Jackson Hole Fed meeting has historically been an important event for investors as it can offer clues on potential policy shifts. Last year Jerome Powell announced that price stability was to be the bedrock of the US economy and that the government would do anything necessary to achieve price stability. This harsh language and hawkish tone of further rate rises caused the S&P 500 to slide as investors and traders sold off their shares in fear of a tightening of monetary policy.

During the latest meeting, the focus was on the necessary policy adjustment from reducing inflation to keeping it under control. The rate of price increases has slowed sharply in the US and is moderating in Europe, but Powell and Christine Lagarde, the President of the European Central Bank, were clear that there is still plenty of work to do. Working out exactly when the inflation threat is diminishing is proving hard in the face of unstable supply conditions that continue to affect prices.

Post Covid, economic analysis requires adjustment to encompass extreme supply shifts ranging from coronavirus lockdowns and fractures in global supply chains to energy supply conflicts following Russia's invasion of Ukraine. Even in the labour market, the trends are very difficult to assess. When monetary policymakers set interest rates to hit their inflation targets, they must assess where they think demand is relative to supply. Put simply, if demand is estimated to be higher than supply, elevated interest rates help to cool an overheating economy — and vice versa. Economic upheaval, however, makes this calibration significantly harder. Meanwhile ageing demographics and the Artificial Intelligence revolution add more moving parts, with implications for both supply and demand. Powell described rate-setting today as "navigating by the stars under cloudy skies".

The added problem for central bankers is that interest rates, which impact demand with long and variable lags, are a blunt tool to wield in a time of rapid change. "There is no pre-existing playbook for the situation we are facing today — and so our task is to draw up a new one," said Lagarde in her speech. Central banks know they need to adapt but have been slow to do so.

There are some lessons they should heed. First, knowing when, and when not, to place weight on economic models is crucial. Since these are based on historical relationships, they become unreliable in the face of unprecedented events such as Covid, the war in Ukraine and Brexit. Lagarde acknowledged this when she quoted the Danish philosopher Søren Kierkegaard, who said that "life can only be understood backwards; but it must be lived forwards". Second, central bankers need to update their understanding of supply dynamics. For decades, globalisation has supported flexibility in supply, with free-flowing goods, workers and capital. This trend has started to reverse in post pandemic times and monetary policymakers will need more than just to look back on past trends as the future is unlikely to mirror the past.

An important question remains whether the 2 per cent inflation target central banks are aiming for remains relevant in the long-run. Even then, trying to control inflation with interest rates remains a complicated endeavour. The biggest takeaway from this year's Jackson Hole ought to be that monetary policy, in its current form, is limited in what it can be expected to achieve and without structural reforms to support supply, volatile prices risk becoming the norm.

Equity markets moved broadly sideways during the third quarter. The quarterly reporting season in the US, covering the second quarter, passed relatively uneventfully bar a release of stellar results from chip maker Nvidia. Earnings for an index of the largest US companies fell 5% year-over-year, which marked the third consecutive quarter of declining earnings, although we have some evidence that earnings have troughed.

Global Equity Performance:

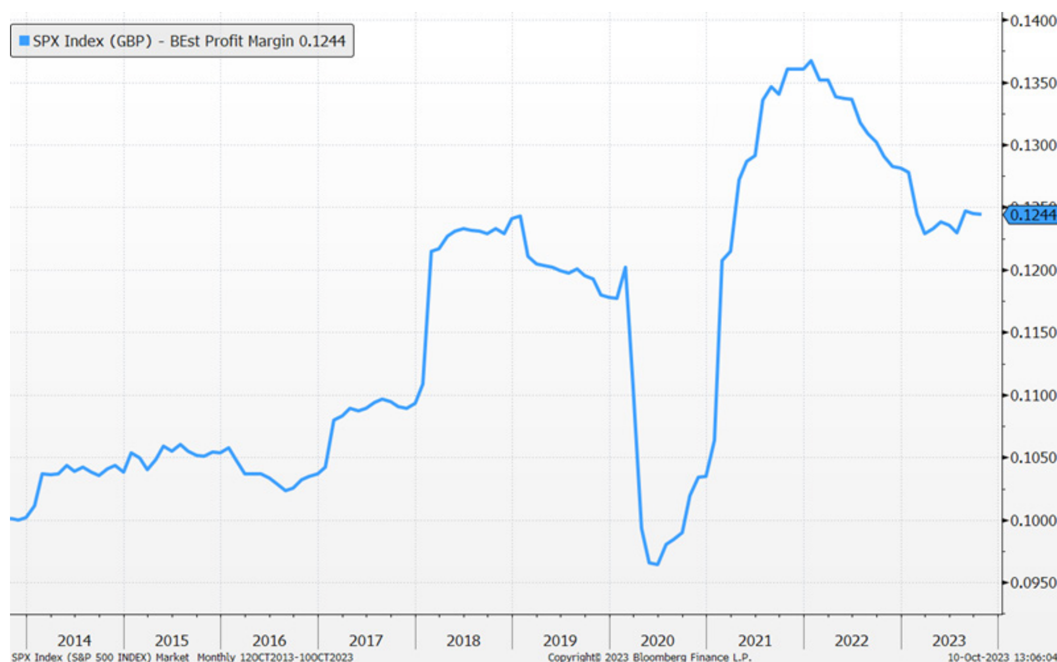
US Equity Earnings:

Although recession risks are elevated, consumers are coming from a very strong financial position. Unemployment is extremely low and those with jobs are getting raises. This should help support consumer spending.

US Unemployment Rate:

Similarly, the finances of businesses are also healthy. Many corporations locked in low interest rates on their debt in recent years. Even as the threat of higher debt servicing costs looms, high profit margins give corporations room to absorb higher costs.

US Equity Profit Margins:



We will be closely watching the earnings results of corporations. Earnings have been falling this year but analysts are projecting that earnings will rise strongly over the next 12 months, which should be supportive for equity markets. We will also be closely watching the actions of the major global central banks. Equity markets are always looking ahead, so any indication that the Fed in particular is signalling a dovish turn in monetary policy will likely be met with a positive reaction for equities. Even if the economy does deteriorate more than expected, the Quantitative Easing (QE) playbook for central banks will almost certainly be pulled out again, which should reassure markets.

The US equity market is undoubtedly looking quite richly valued, but many other parts of the world look quite attractively valued in relative terms and compared to their own history. This is where we are focussing our attention.

It has been a difficult 18 months for markets, but we see real green shoots of recovery and we may now finally have the worst of the volatility behind us and new opportunities are presenting themselves. We will continue to work hard on your behalf and thank you for the faith and fortitude you have shown. History has shown us that after enduring difficult times, one must persevere to enjoy the very good times that will undoubtedly be around the corner.

It is notoriously hard to call the direction of equity markets over short time frames, although it is interesting to note that the fourth quarter has historically been a good one for equity markets. With the expected return on bonds now as high as they have ever been since the turn of the century, the longer-term outlook for a portfolio of bonds and equities is looking very good.