Market Views
April/May 2023

Markets calmed through April as fears over the solvency of the banking sector subsided. Equity markets rallied throughout most of April as investors turned their focus towards the latest earnings reports. Whilst company earnings have generally held up, attention has moved to companies exposed to the AI race which have outperformed the broader market. As we reach the end of the tightening cycle, both investors and central banks will keep their eye on the effect of the 'long and variable lags' of monetary policy.

The Federal Reserve (Fed) proceeded as expected with its 10th straight interest rate hike at its May meeting, raising interest rates by 0.25%. At the press conference, The Fed made its clearest signal yet that it is open to pausing rates at the next meeting. While inflation remains above target and the labour market remains tight, the Fed see signs of these easing over the coming quarters as the effects of policy tightening feed through. The Fed noted it is looking at the cumulative effects of its tightening to date and their potential lags. In particular, Chair Powell addressed the recent events in the banking space and the still unclear impact it will have on the economy. The Fed does believe that this serves as an additional form of policy tightening which complicates the outlook. Indeed, the recent Senior Loan Officer Survey evidenced that lending conditions have tightened further. Given this backdrop, it seems that it would take material upside surprises in inflation and the labour market for The Fed to consider further rate increases.

Outside of the realms of monetary policy, the US is contending with the ongoing issue of the debt ceiling. Treasury Secretary Janet Yellen warned that without a compromise, resulting in the limit being raised, the US could default on its debt by the 1st of June. However, with an election in sight, the Republicans are taking a hard line and seeking spending cuts. Negotiations between Joe Biden and the Republican Speaker of the House, Kevin McCarthy are ongoing. Investors are assigning a non-trivial risk of these negotiations leading to the US technically defaulting, if only for a short period. As such, investors are giving up a large amount of yield for Treasury Bills maturing at the end of the month, relative to those at the start of June. Nonetheless, all the major players in the negotiations have emphasised that they want to avoid a default, which has helped to reassure market participants.

The Bank of England (BoE) raising rates by 0.25% to 4.5% at the May meeting was widely expected. It provided new economic growth forecasts, which now show the UK avoiding a recession altogether, representing the biggest upgrade to growth projections in the MPC's 26-year history. Current market expectations are that the BoE will raise rates by another 0.25% in June. This is based on the better growth prospects potentially keeping inflation elevated for longer. Energy prices have now fallen sharply, and the BoE expects inflation to drop to 5.1% by the end of this year. This is less of a decline than the drop to 3.9% it forecast in February and the BoE predicts inflation will not return to its 2% target until early 2025. However, Governor Bailey also seemed to emphasise the long and variable lags of monetary policy. As more and more households re-mortgage at higher rates, this will undoubtedly put the brakes on other discretionary expenditure. Furthermore, while growth forecasts have been revised upwards, the BoE only expects the economy to grow by 0.25% this year and 0.75% the following year. This would be a growth path below what would be considered the normal economic trend, or 'soft landing'. This raises the possibility that the BoE pauses its hiking cycle, but this remains data dependent.

While the European Central Bank (ECB) did slow down the pace of its increases from 0.5% to 0.25%, it specifically said that this is not a pause and that they have more ground to cover. Given Eurozone banks, excluding the Swiss ones, have been largely unscathed by recent events and core inflation is near its highs, the rather hawkish tone from the ECB continued. The Eurozone continues to see core inflation remain sticky, not least due to strong labour cost pressures. As such, the consensus is that the ECB will continue to raise rates until they see signs of price pressures abating.

The latest data coming from China shows that the economy is benefitting from the re-opening, albeit activity is concentrated in the consumer sectors while property and manufacturing have seen a more disappointing start. These sectors are more cyclical in nature and may face headwinds from weaker growth in developed markets. Nonetheless, with such a strong bounce in consumption, the economy is still on track to hit mid-single digits growth. More broadly across emerging markets, political risk has come back into the fore with elections in Turkey and Thailand showing wider discontent with the incumbents.

Putting it all together, it seems that both the BoE and the Fed are putting increasing weight on the lagged effect of monetary policy. Whilst the Treasury market is pricing in rate cuts towards the end of the year, the leading macroeconomic indicators add complexity to the decision-making process. With labour markets remaining tight despite the macroeconomic headwinds, central banks are cognisant that this could add to inflationary pressures and may provide reason to keep interest rates at current levels. We expect the noise surrounding growth, rates and inflation to remain high, however, focusing on quality companies with pricing power is the best way to navigate the current environment over the medium term.

Market View Changes

- No changes

Currencies

US dollar	◀▶
Sterling	◀▶
Euro	◀▶

The US Dollar remains the reserve currency of the world and continues to benefit from its safe haven status. While the Fed policy rate is higher than most other developed markets, improving growth prospects elsewhere has taken some of its shine. Ongoing volatility in the banking system and its impact on hiking cycles are likely to cause swings in the shorter term. The growth prospects in light of declining energy costs and the subsequent impact on the hiking cycle will determine the outlook for both the Euro and the Pound. This continues to drive volatility across currencies, without any clear direction.

Fixed Income

Government Bonds	Conventional	Inflation-linked
UK Gilts	◀▶	◀▶
US Treasuries	◀▶	◀▶
German Bunds	◀▶	◀▶

Government bonds have gyrated materially as investors sought to understand the reaction function of central banks in the wake of the unfolding banking crisis. As the economy has proved resilient so far, the sharp rally in March has seen a reversal, but the likely shallower peak may see bonds regain support. Given this backdrop, the gilt market and the yields on offer are looking somewhat more attractive. However, we would continue to stress caution on the long duration nature of index linked gilts. Treasuries and Bund yields have given up some of their recent gains but yields still remain below the highs seen in February. With central banks still reducing their balance sheets and given the uncertainty surrounding the inflation outlook we still believe a neutral stance is appropriate.

Investment Grade Corporate Bonds ◀▶

As central banks have normalised policy, we have seen both government bond yields and credit spreads move higher. With the BoE and the Fed unwinding their balance sheets, this is taking liquidity out of the market. Given the elevated yields on offer, investors have moved to take advantage and have been heavily favouring corporate debt. While yields look attractive relative to history, the additional compensation for corporate bonds has become less attractive. As such, we would advocate a highly selective approach.

High Yield Credit ◀▶

As financial conditions tighten further, this typically results in an increased level of defaults. While companies have extended maturities, resulting in less acute pressures, sentiment may weigh on this market. The overall yield looks attractive, but we would stress selectivity and likely ongoing volatility.

Emerging Market Debt

Local currency denominated debt	◀▶
Hard currency denominated debt	◀▶

With developed market central banks still set to tighten policy somewhat further, this historically has weighed on emerging markets. Though, many emerging market central banks have already raised rates substantially, which is likely to result in a much smaller impact than previous hiking cycles. With China seeing a boost in economic activity following its reopening, this has seen risk assets in the region rebound. However, certain countries are facing debt sustainability issues. Furthermore, recent elections have caused larger swings. Therefore, we emphasise that selectivity remains as important as ever, and we retain our neutral stance across this diverse asset class.

Equities

UK Equity ◀▶

While cyclical exposure had buoyed the FTSE 100 Index last year, the repricing of financials and weaker commodity prices has taken some of the shine away this year. The market continues to trade at valuations that look cheap compared to markets elsewhere in the world, which may offer investors the opportunity to pick-up companies at discounted prices. As such, we have seen a pickup in takeover activity. However, the UK domestic economy faces headwinds from inflation and interest rate rises, weighing on more domestic focused stocks such as those in the FTSE 250. Considering the mix of factors, we recommend a selective approach in this market.

Europe ex UK Equity ◀▶

After a torrid time last year given the outbreak of war on its borders, the combination of a less acute energy crisis and the re-opening of China has improved the outlook for Europe with luxury stocks benefitting from this. However, the issues surrounding longer term energy security remain and may weigh on future growth potential. Furthermore, the ECB's aggressive hiking cycle may exacerbate long standing issues between nations of the Eurozone. As such, we retain our neutral view.

US Equity ◀▶

The ongoing volatility surrounding growth, inflation and its impact on the long-term discount rate has continued to cause gyrations between cyclical and less-cyclical companies. The recent woes have seen bank stocks fall out of favour and technology stocks come back into favour. Furthermore, the outlook in the face of rising interest costs and slowing demand may be more challenging for earnings going forward. Hence, we expect volatility to continue. Nonetheless, the US market remains a source of attractive companies with good long-term prospects.

Japan Equity ◀▶

The Bank of Japan's new Governor has stuck to the old script so far. As the shift that many investors had been expecting has not materialised, this has seen the Yen weaken materially versus its broader peers. However, given the export nature of the Japanese economy, this has buoyed the Nikkei Index towards its longer-term highs. The BoJ announced a monetary policy review which will take over a year to conclude, further dampening expectations of a more immediate shift. Nonetheless, given moderate valuations and increased international investor interest, Japan could have room to perform if global growth remains resilient.

Asia ex Japan Equity ▲

China's rebound continues to gain traction. It has laid the foundations to provide support to the property sector, which had faced years of weakness, and tourism has rebounded sharply. Consumers are showing signs that they are comfortable spending their excess savings. However, the risks of political business interference in China remains high, but this is cushioned by the cheap valuations relative to other markets. A growing China tends to provide support for the wider region. Domestic growth elsewhere has been strong as a result of earlier easing of restrictions. The lack of sanctions on Russia confirm that energy headwinds are less of an issue for some countries in the region. As such, we think the potential for long-term growth is higher than elsewhere.

Emerging Markets ex Asia Equity ◀▶

Emerging markets continue to be caught in the middle between softening demand from the West and a re-emerging China. Commodity prices have softened from their peaks as supply chain concerns have moderated, but declining export demand continues to weigh on the outlook. Despite a weakening Dollar, ongoing geopolitical uncertainties highlights the importance of selectivity. Furthermore, developing countries need continued foreign investment but the outlook, combined with tightening financial conditions in the West, may adversely impact sentiment. Despite this, long-term growth prospects for many emerging markets remain high. Hence, we continue to stress a highly selective approach in this diverse universe, emphasise its volatile nature and maintain our neutral stance.

Alternative Investments

Hedge Funds/Targeted Absolute Return

Given pronounced movements across interest rate expectations, this will undoubtedly weigh on financing costs which may temper some merger and acquisition (M&A) activity. Conversely, the elevated levels of interest rate volatility may present opportunities elsewhere. On the regulatory side, geopolitical fronts mean that regulatory intervention has become more commonplace. This has tempered our enthusiasm for event-driven strategies. More broadly, when allocating to this space, we look for funds that could diversify returns away from the directionality of conventional bonds and equity markets, and favour these strategies. Nevertheless, we continue to stress the importance of finding the right vehicle and investment manager, which requires extensive due diligence on the strategy and fund.

Property

Rising borrowing costs continue to weigh on property markets globally. Tightening financial conditions, exacerbated by recent events is likely to further dampen enthusiasm for long term assets with limited liquidity. Given recent notable lockups by large property funds, we continue to stress that any exposure to property should be selective and closed-ended over open-ended vehicles. Although property has historically been a good hedge against inflation, the sharp rise in borrowing costs may alter that characteristic, at least in the short to medium term.

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